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INVISTA REAL ESTATE INVESTMENT MANAGEMENT

European property and the global recession: mitigating the rental downturn

Key Highlights

- The global financial crisis has evolved into an economic recession, with falling demand initially hitting major exporters hardest.
- In Europe, economic growth prospects vary widely with Scandinavia and 'core' Eurozone countries forecast to fare better.
- Property occupational markets began to weaken in 2008 and a rental downturn now seems likely.
- However, the scale of the rental downturn is mitigated by a modest supply pipeline, and highly expansionary economic policies are expected to drive strong medium-term recovery in demand for property.

Comparing economic and property cycles

The fourth quarter of 2008 provided evidence that the global financial crisis had evolved into a global economic recession. A series of bank collapses across the world in October sent shockwaves through financial markets, damaging investor sentiment and eroding confidence in the economic outlook. GDP growth was markedly weaker in Q4 2008 (Figure 1), particularly in export-dependent countries such as Japan (-3.3%), Germany (-2.1%) and Italy (-1.8%), as global trade volumes and industrial production fell sharply.

Across the Eurozone, GDP growth of -1.5% in Q4 2008 was by far the worst recorded quarterly performance since the inception of the Euro, while in the "high debt / high consumption" economies of Spain, UK and USA, the pace of decline was less severe.

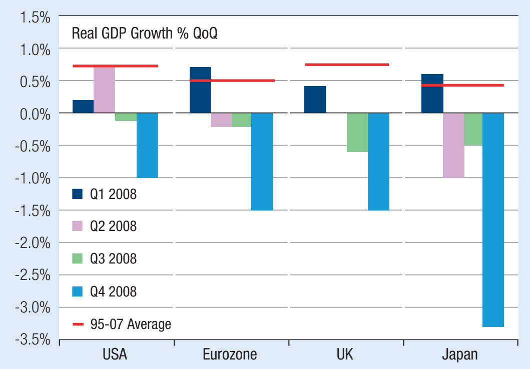
Against this background, the European Commission recently forecast that economic output in the Eurozone would fall throughout H1 2009, before gradually turning positive, but well below-trend, until the end of 2010. As Figure 2 shows, growth prospects at a country level are forecast to vary widely, broadly favouring those countries with substantial public spending programmes, high household savings ratios and lower dependency on credit for private consumption and investment spending (such as Scandinavia, Germany and France).

Commercial property markets are highly dependent on economic growth to drive leasing activity and rental growth. As Figure 3 shows, the historical correlation between real economic growth and real rental growth (measured by CBRE's Eurozone Prime Rent Index) is very strong. According to CBRE, prime commercial property rents started to fall across the Eurozone during Q2 2008, indicating that the economic downturn is already being reflected in the property market.

From an economic growth perspective, therefore, the short term outlook for property rents in the Eurozone appears to be negative. However, as the analysis overleaf shows the level of property supply has historically been a very important factor determining the depth and duration of previous rental downturns. We believe that modest levels of supply in 2009-2010 could be an important factor mitigating the scale of rental declines in this property cycle.

Figure 1

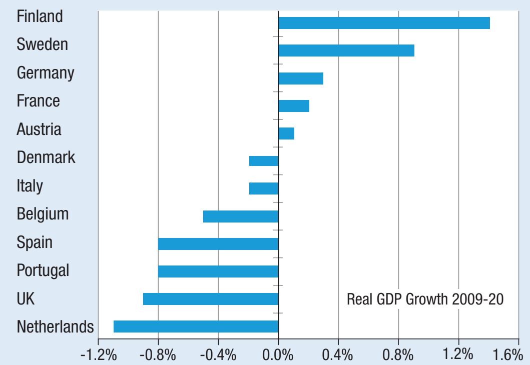
Global economic growth turned negative during 2008



Source: Eurostat

Figure 2

Growth prospects vary widely across the largest European economies



Source: European Commission

Figure 3

Eurozone prime rental growth is highly correlated with GDP growth

Source: CBRE, Eurostat, European Commission, Invista REIM
Note: Weighted average growth of prime rents in office, unit shop and distribution warehouse markets across the Eurozone.

Rental growth outlook – lessons from the past

Since 1990, the Eurozone commercial property market has experienced two distinct prime rental cycles, between 1991-2001 and 2001-2008*. As Figure 4 shows, the cycles differed in several key aspects:

Duration	Whereas the 1990s cycle lasted 10 years, the 2000s cycle was three years shorter.
Depth	Rents fell in real terms by 37% in the 1990s cycle, compared to only -12% in the 2000s cycle. The recovery was also much more significant in the 1990s (+49%) than in the 2000s (+17%).
Volatility	The standard deviation of quarterly rent changes in the 1990s cycle was more than twice the level recorded in the 2000s.

At both an economic and property market level, the 1990s downturn was more painful because GDP growth fell more sharply and turned negative, while a much larger wave of supply hit the property market between 1990 and 1995 (see Figure 5). By comparison, in the early 2000s GDP growth remained positive and property supply was much more constrained.

Recent forecasts suggest European GDP growth in 2009-2010 will follow a similar pattern to the early 1990s recession, and it would seem reasonable to expect larger rental declines than we saw in the early 2000s. However, with property supply remaining close to or below long term trend levels, we believe the rental downturn will be less severe than in the 1990s.

*According to CBRE Eurozone Prime Rental Indices

Reasons for optimism

Looking beyond the next two years, we are cautiously optimistic about the medium term outlook for property demand in Europe. The economic policy response to this recession has been extremely expansionary, with interest rates having been reduced substantially (see Figure 6), and a huge wave of public spending approved to stimulate domestic economic growth.

We expect this to have a strongly positive impact on household confidence, business spending and investment activity over the medium term, particularly once the availability of credit improves.

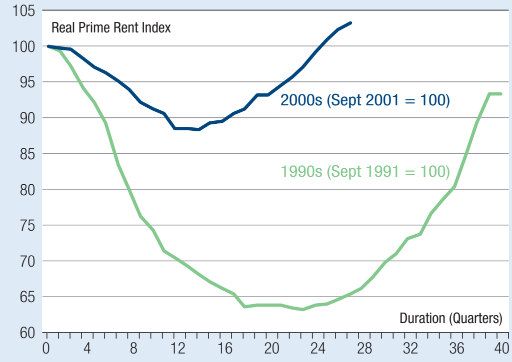
The property supply pipeline appears to be far less threatening than it was in previous rental downturns, particularly in office markets. Shopping centre completions could slow further over the next two years, with development more likely in structurally undersupplied markets. In the logistics market supply tends to respond more quickly to changes in demand, and hence we do not believe that the supply-side poses a significant risk to logistics rents.

Summary

Negative economic growth should lead to rental declines across Europe over the next two years, but the downturn is expected to be mitigated by modest levels of future supply. In the medium term, highly expansionary economic policies should give added impetus to the recovery in occupational demand, potentially driving above-average property performance.

Figure 4

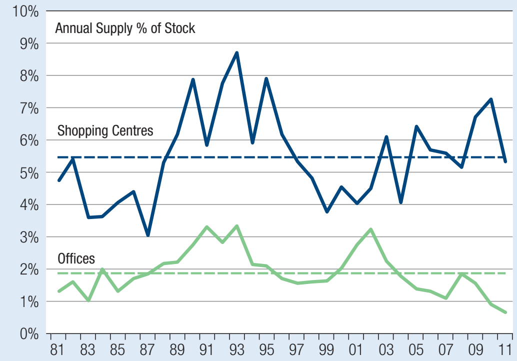
Eurozone prime rent cycles differed substantially in the 1990s and 2000s



Source: CBRE, Eurostat, Invista REIM

Figure 5

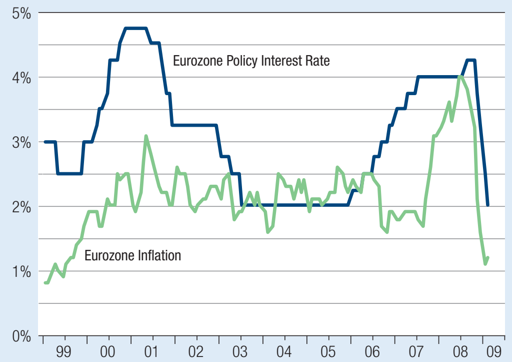
Supply has played an important role in shaping previous rent cycles



Source: PMA Note: Dashed lines indicate long term historical averages

Figure 6

Inflation and interest rates have fallen rapidly in recent months



Source: Datastream, Eurostat

Contacts

Jayne Phelan
Marketing
Telephone
+44 20 7153 9424

Tim Francis
Research
Telephone
+44 20 7153 9423

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