European Market Perspective

July 2010

FOR INVESTMENT PROFESSIONALS ONLY

INVISTA REAL ESTATE INVESTMENT MANAGEMENT

Property performance driven by income

Key Highlights

- Despite the recent recession, Continental European property income returns held up between 2007 and 2009 and are expected to be the main component of total returns over the next five years
- The risk to property income from tenant default is higher, but varies widely across business sectors
- Despite a cautious outlook for rents, growth hotspots could emerge due to competition for the best locations and limited new supply

Robust income returns despite recession

The European property market's ability to deliver attractive income returns has not been damaged during the past two years, despite the worst economic conditions of modern times. According to IPD[1] the income return on its Eurozone Index increased from 5.1% in 2007 to 5.6% at the end of 2009, its highest level since 2003.

This cushioned the impact of falling capital values, and with government bond yields falling from 4.4% to 3.7%[2] over the same period, the attraction of property income returns is clear.

Over the longer term, income returns make a larger contribution to overall property performance than capital growth in Europe *(Figure 1)*. Interestingly, this is not only true in lower growth markets such as Germany and Finland, but is also evident in the more cyclical property markets such as France, Netherlands and Sweden.

With interest rates set to remain low in the short term, we expect to see an increasing allocation of investor capital towards relatively high income-producing property investments.

From a country perspective, our forecasts suggest income returns will range from 5% in Austria, Belgium and Germany to more than 7% in Finland, Ireland, Portugal and Spain *(see Figure 2)*, in part reflecting the different investment risks inherent in these countries.

Investors should demand a higher income return from 'riskier' markets, so we adjust the diverse income returns to take account of country and market risks by looking at the premium of sovereign debt over the 'risk-free' German 10-year bond yield. On this measure, Austria, Finland, France and the Netherlands appear to be less risky than Ireland, Italy, Portugal and Spain.

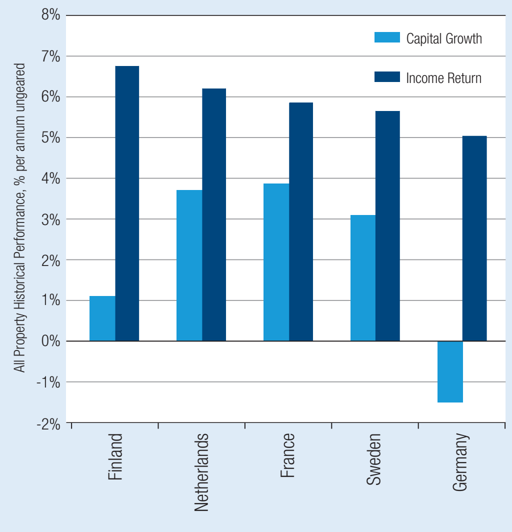
Since property investment turnover bottomed-out across Europe in Q1 2009[3], investor demand has focused on high quality properties and prime submarkets in Europe's larger, more liquid property markets. As pricing in some prime segments hardens, we expect this relatively defensive strategy to shift as investors look for higher yielding properties in 'good secondary' locations.

However, taking into account the subdued outlook for rent-driven capital growth (explained overleaf), we expect investors to remain focused on preserving and enhancing income returns at their currently attractive levels – and thus are unlikely to be attracted to higher risk, capital growth investments.

1 Investment Property Databank (IPD) is an independent provider of property performance indices and benchmarks.
2 Source: Datastream.
3 Source: CB Richard Ellis 'MarketView European Investment Quarterly Q1 2010'.

Figure 1

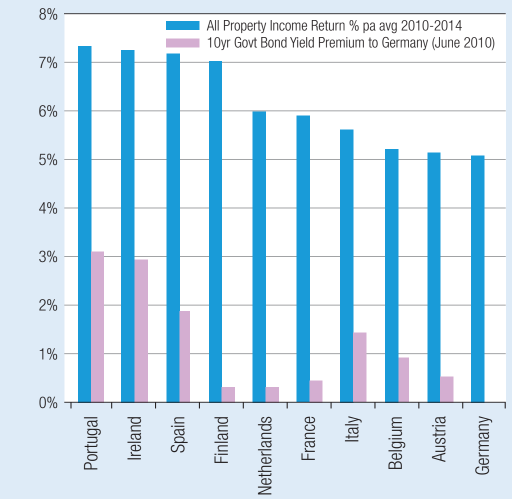
Income returns have historically contributed more to total returns than capital growth



Source: Investment Property Databank (IPD)
Note: Compound average growth rates vary in length according to the availability of data from IPD: Netherlands 1995-2009, Germany 1996-2009, Sweden 1997-2009, Finland and France 1998-2009.

Figure 2

Investors should assess income returns alongside sovereign risk premia



Source: Invista REIM, Datastream

For more information on Invista Real Estate Investment Management ('Invista'), please visit **www.invistarealestate.com**

Default risks are above 'normal' levels

In all points of the property cycle the main risk to the sustainability of property income stems from tenant default. Pricing trends in the credit default swap (CDS) market reflect the changing perceptions of default risk relating to corporate loans, whereby higher prices are broadly indicative of a greater potential for default. The CDS market therefore provides a useful indication of risks relating to tenant default.

Against the background of the worst global economic conditions of modern times, pricing in the Eurozone CDS market has indeed risen, although as *Figure 3* shows the rate of increase varies widely between key business sectors.

The latest data for the Eurozone suggests default risks are higher in the telecommunications, utilities, banking and insurance sectors than in the retail, technology, food & beverage and industrial sectors.

The other key risks to property income returns are weak property leasing activity and declining market rents, both of which have transpired across Europe over the past year, but have impacted individual properties and submarkets in a variable manner.

But there are rental growth hotspots

The return of rental growth across Europe is intrinsically linked to the level and sustainability of economic and employment growth. In our view, both of these factors have become more uncertain in the short-term due to government commitments to introduce austerity measures in most countries.

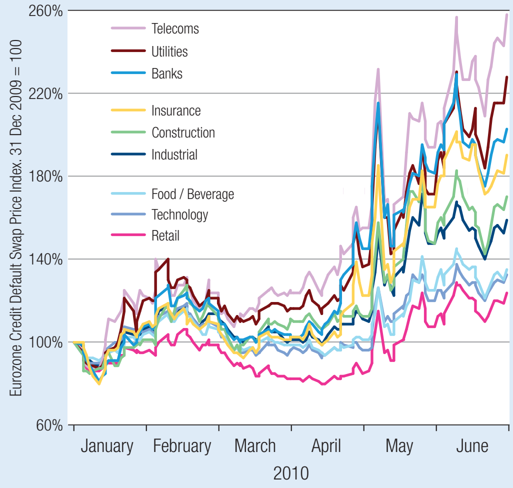
In addition, there are indications that Europe's nascent economic recovery, which was stimulated by a huge wave of government spending in 2008-2009, is starting to lose some momentum.

Against the background of weak economic growth and falling employment, we expect that 2010 will be the worst year for rent declines in the current cycle *(see Figure 4)*. Although the subsequent recovery of rents is forecast to be gradual, we believe a number of 'hotspots' for rental growth could emerge over the medium-term in Europe:

- The potential rental growth winners in Europe are modern **office** properties in the most supply-constrained city centres, where vacancy rates have remained low and the development pipeline is limited due to the lack of financing for speculative development and tight planning restrictions. Such examples include Paris, Munich and Vienna, where the Central Business Districts (CBD) are contained within the heart of the historical and densely built up city centre.
- In the **retail** sector, we expect rents in general to remain under pressure due to weak consumer spending growth. Following a long period of above-average out-of-town retail supply, and faced with limited financing for new schemes, we expect retailers to consolidate within the best units and centres in a 'flight to quality' to protect their profits. This could generate some competition and a degree of rental growth in prime city-centre locations and dominant regional shopping centres, in contrast to weaker locations where vacancies are expected to rise further.
- In the **logistics-distribution** market rents are forecast to remain under pressure as retailers and manufacturers adapt to lower trade volumes and profit margins. A similar 'flight-to-quality' trend is expected to emerge amongst distribution warehouse occupiers, which could support prime rents in hub locations, in contrast to secondary properties and less established locations where higher vacancy rates may persist, leading to flat or negative rental performance.

Figure 3

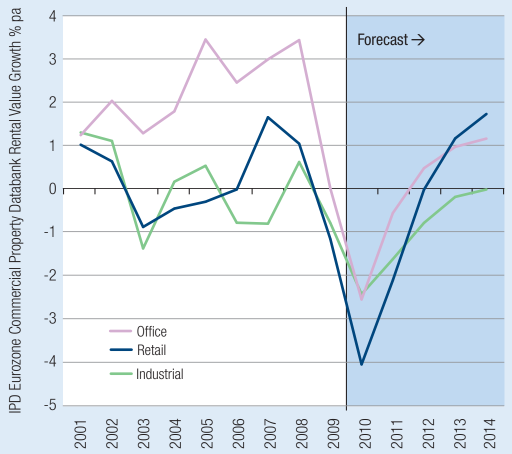
Cost of insuring against credit default has risen since 2009, but varies widely between sectors



Source: Datastream
Note: Credit Default Swap price indices track the cost to a buyer of protection against corporate bond or loan default.

Figure 4

Rental growth outlook is subdued overall, but potential hotspots could emerge



Source: IPD (2001-2009), Invista REIM (2010-2014)
Note: Data represents the weighted average performance of commercial properties within the Euro denominated countries covered by IPD.

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