

# Diverging markets present opportunity

### Key Highlights

- In 2010 European property performance is expected to benefit from:
  - more stable economic conditions;
  - subdued development activity; and
  - attractive relative pricing.
- Divergence is becoming more evident as economic, capital and rent cycles advance at different speeds across Europe.
- Property investor demand is expected to be dominated by:
  - the appeal of high and stable income returns in the short-term; and
  - cyclical growth opportunities in the medium-term.

## Optimistic outlook for European property

2009 was a weak year for the Eurozone economy and its commercial property market. Gross Domestic Product (GDP) fell by a record 4.0% (Source: Eurostat, 4 March 2010), led by Germany and Italy where demand for exports contracted sharply. We estimate that Eurozone commercial property total returns were also negative in 2009 at 3.1%<sup>1</sup>.

In recent quarters GDP growth has resumed in the Eurozone, although growth rates have diverged between 'Core Eurozone' countries, such as France and Germany which have benefited from significant government spending on initiatives such as 'car scrappage', and 'Eurozone Periphery' countries including Italy and Spain, which both experienced declining GDP in Q4 2009.

Figure 1 shows the relationship between Eurozone economic growth, property returns and office supply rates. Eurozone GDP is forecast to grow by around 1% in 2010, representing only modest growth but a marked improvement on 2009. Historically when GDP growth has been at this level Eurozone property returns ranged between 1.0% in 2008, to 5.8% in 2003 and 6.3% in 2002 (Source: IPD). We believe Eurozone property returns in 2010 could however surpass these levels, for the following reasons:

- The return to economic growth from a sharp decline and the subdued development pipeline are expected to provide a degree of stability in the leasing market which was less evident in 2002-03. Rental declines have so far been caused by a sudden reduction in leasing activity, as cautious tenants reduced their

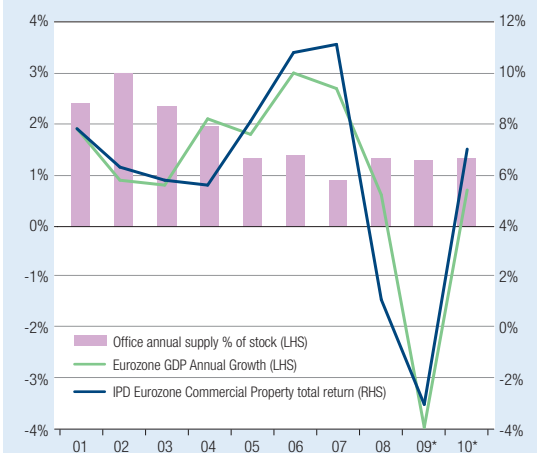
expectations of future profits in an environment of rapidly declining economic activity. However, we expect rental declines to slow in 2010 as confidence in the economic outlook improves and tenants take advantage of better rental affordability.

- The attractive relative pricing of commercial property. In the past two years property yields have risen while government and corporate bond yields have generally fallen. As a result, the spread between Eurozone property yields and bond yields has increased significantly (Figure 2), and we believe this should continue to attract new capital into the property sector during 2010. Importantly, the outlook for inflation in the Eurozone is subdued over the next year, increasing the likelihood that the attractive yield premium of property over bonds will be maintained.

<sup>1</sup> Invista forecasts the performance of commercial property in the IPD Eurozone Databank, which represents over 14,000 individually valued properties across nine countries. IPD (Investment Property Databank) is an independent provider of valuation-based property performance indices and benchmarks. Data for 2009 is an Invista estimate.

Figure 1

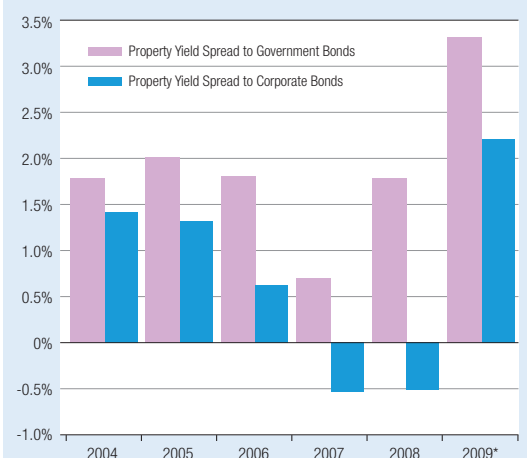
Following a weak year in 2009, Eurozone property returns are forecast to improve in 2010



Source: Economist Intelligence Unit, IPD, PMA, Invista  
\* Data for 2009 and 2010 are forecast estimates sourced to EIU (GDP), PMA (supply) and Invista (total returns).

Figure 2

Property yields have increased and are now at a significant premium to bonds



Source: Datastream, IPD, Invista  
Property represented by IPD Eurozone Commercial Property.  
Government Bonds represented by synthetic Eurozone 10-year bond series.  
Corporate bonds represented by IBXX Euro Corporate A-Rated bonds.  
2009 property estimated by Invista.

## Investment and rent cycles expected to diverge in 2010

Even though we expect European leasing activity to improve from low levels in 2010, we believe that further rent declines are possible in the short term. In contrast, capital values are expected to be influenced by the positive impact of yield compression. We have seen evidence of this trend in prime property, where according to CB Richard Ellis (*Figure 3*), capital values increased in Q4 2009 as the positive impact of yield compression offset rental declines. We expect this trend to gather momentum in the next six months, mainly in the largest, most transparent property markets such as France and Germany.

This is consistent with our view that economic growth in the Eurozone should continue to diverge between 'Core' and 'Periphery' countries. In France and Germany, there is evidence that capital values are stabilising, whereas in the less liquid property markets on Europe's periphery such as Spain, Italy, parts of Scandinavia and Eastern Europe the capital cycle is likely to lag due to cautious investor sentiment and lower investment volumes.

Within the preferred 'Core Eurozone' countries of Belgium, France, Germany and the Netherlands, we believe investment turnover should initially rise in established sub-markets of the largest cities, as investors seek assets with stable or high income return characteristics.

## Cyclical markets favoured in the medium-term

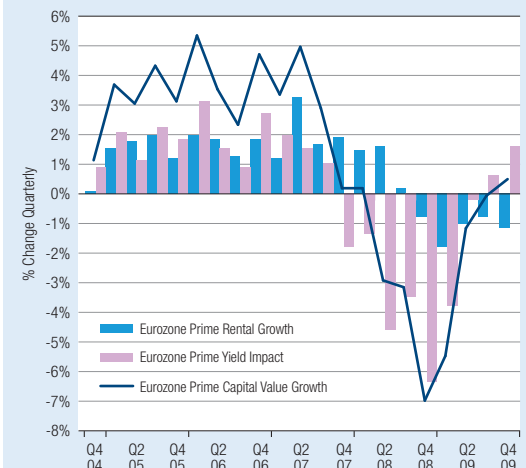
Looking beyond the next two years we expect economic, capital and rent cycles to advance at different speeds across Europe. To an extent this would lead to a return of 'normal' diversified property total returns, where relative performance is determined more by income return levels and the rate of rental growth, than by the degree of movement in yields.

Invista's forecasts (*Figure 4*) indicate that in the medium-term, market total returns will be more clearly differentiated between the outperformers and the underperformers:

- **France** is forecast to perform strongly in comparison to most other countries. Prospects for rental growth are considered to be good in Paris' CBD Office market, where low vacancy rates and negligible future supply are expected to lead to strong competition amongst tenants for good quality space. By comparison industrial total returns are forecast to be primarily driven by attractive income returns, with the major distribution hubs around Paris, Lyon and Marseille preferred due to established transport infrastructure.
- In the markets underpinned by more cyclical economies, such as **Ireland**, **Portugal** and **Spain** we expect returns to improve following the 2010-2011 period, as capital re-pricing abates and rental growth resumes.
- **Belgium** and the **Netherlands** are expected to see ungeared returns in the 7% to 8% per annum range, driven primarily by high and stable income returns.
- Returns in **Austria**, **Germany** and **Italy** are forecast to remain in a 4% to 5% per annum range over the medium-term, reflecting stable but lower income returns and limited prospects for rent-driven capital growth.

Figure 3

Property investor sentiment turned positive in H2 2009, ahead of the leasing market

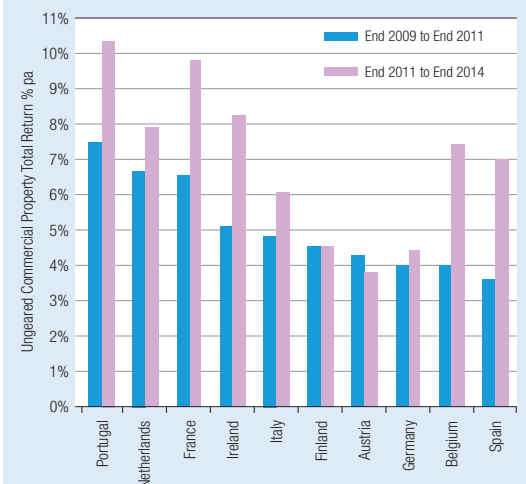


Source: CB Richard Ellis

Note: Yield impact refers to the effect of yield movements on capital growth, where a rise in yields is shown as a negative impact and vice versa.

Figure 4

Medium-term performance to diverge in favour of high income returns and cyclical markets



Source: Invista

Note: The sector, geographical and building quality characteristics of IPD Databanks can vary significantly between European countries.

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