

Amidst the Global Uncertainty, Focus on Local Property Performance

Key Highlights

- Continental European property returns held up well in 2007, in contrast to the sharp declines recorded in the UK.
- However, performance is expected to diverge in 2008 as the market digests the impact of the global credit crunch.
- In uncertain capital markets, investors need to identify property markets with potential for future income growth by focusing on local economic growth prospects, supply dynamics and leasing market fundamentals.

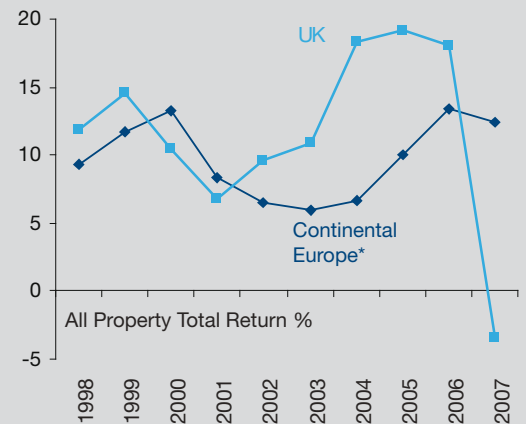
2007 PERFORMANCE REVIEW

Continental European property performance held up well in 2007, as average ungeared total returns of 12.4% were only marginally below the 13.4% recorded in 2006, according to data from IPD (Investment Property Databank)¹. This compared favourably with the UK in 2007, where performance worsened significantly in the second half of the year, culminating in a full-year total return of -3.4% (see Figure 1).

The onset of the global credit crunch caused uncertainty to prevail in economic and capital markets and was a major factor behind the weak UK property performance. However, the effect on Continental European property performance was much less marked and only Ireland, Denmark and Spain recorded significant declines in total returns during 2007 (see Figure 2). In fact, a number of European countries recorded an improvement in total returns over the course of the year.

- **Norway, France and Sweden** were the leading markets in Europe, with strong levels of capital growth underpinned by healthy leasing market dynamics.
- In **Southern Europe**, total returns improved slightly in Italy and Portugal as office leasing markets, and to an extent economic cycles, turned more positive.
- Total returns in **Spain** were lower as weaker economic sentiment affected performance in the office market.
- The lower yielding and less volatile markets in **Germany, Austria and Switzerland** continued to feature at the lower end of the spectrum, but both recorded higher returns and benefited from more stable economic conditions through the year.

FIGURE 1: Continental European property returns held up well in 2007



Source: IPD

* Please refer to footnote 1

FIGURE 2: Returns were notably lower in only a few European countries



Source: IPD

¹ IPD has reported full-year Property Performance data for 2007 in Continental Europe for Austria, Belgium, Denmark, Finland, France, Germany, Ireland, Italy, Netherlands, Norway, Portugal, Spain, Sweden and Switzerland.

THE VIEW FORWARD

We expect Continental European property performance to moderate in 2008 as the market digests the impact of the global credit crunch. However, capital value declines are unlikely to mirror those recorded in the UK last year, largely because the capital growth experienced in Continental Europe since 2002 was substantially lower than in the UK (see Figure 3).

We believe that capital growth prospects vary significantly across the Continent, due to differences in local economic growth prospects, supply dynamics and leasing market fundamentals over the medium term. Using Figures 4 and 5, we draw out some conclusions regarding the relative strength of key demand and supply drivers:

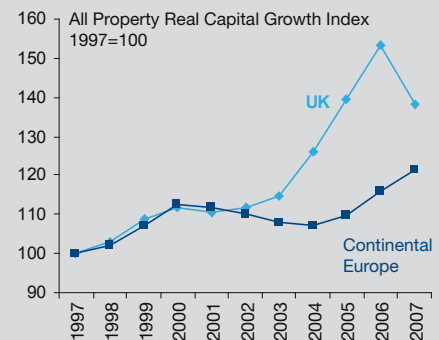
- **Economic growth is the main driver of property leasing demand.** While the global credit crunch has caused widespread economic uncertainty, a clear divergence has emerged between Continental European countries (see Figure 4). Economic growth over the next five years in Spain, Ireland and parts of Scandinavia is expected to be notably lower than in the previous five years, while the opposite is generally true of core western Europe (Portugal, Germany, Italy, the Netherlands and France). Tenant demand is more likely to hold up in markets with improving growth prospects and exposure to tenants across a broad range of business sectors.
- **Local supply pipelines also vary significantly across Continental Europe** (see Figure 5). Most office markets have moved into a cyclical phase of rising supply as developers have sought to benefit from strong tenant demand and rental growth. Ireland, Spain and parts of Scandinavia appear to be more exposed to the risk of over-supply, particularly when the slower leasing demand picture is factored in. On the other hand, supply pipelines in core western Europe (mainly France, Germany and Italy) are more limited in size and are expected to increase only moderately.

In summary, we believe that Continental European property performance will diverge in 2008. Investors need to identify those markets with the greatest potential for future income growth, by focusing on local economic growth prospects, supply dynamics and leasing market fundamentals.

Countries facing much slower economic growth and higher risks of over-supply, such as Ireland, Spain and parts of Scandinavia, are expected to under-perform.

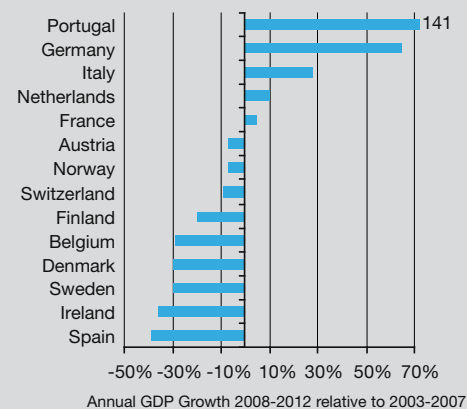
Property performance in core western Europe, particularly France, Germany, the Netherlands and to an extent Italy, is expected to benefit from a more stable economic growth outlook and constrained supply pipelines.

FIGURE 3: Capital growth since 2002 has been more moderate in Continental Europe



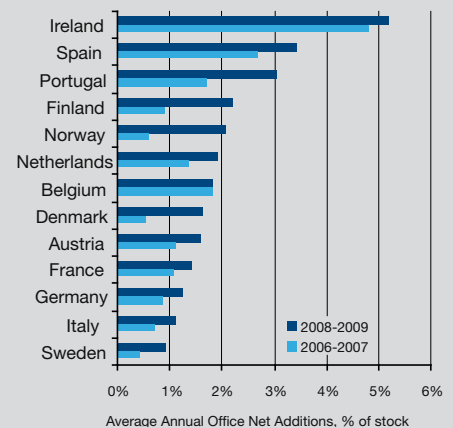
Source: IPD, Datastream, Invista REIM. Ungeared performance. Continental Europe represents the weighted average of countries within the IPD universe at each year-end data point – see footnote on page 1 for full list of countries included in 2007.

FIGURE 4: Economic growth prospects are more divergent now



Source: OECD, EIU

FIGURE 5: Supply pipelines also vary across Europe



Source: PMA.

Note: Data for Switzerland is not available.

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