

## Turning Points and Fair Value in European Property

### Key Highlights

- Some economic indicators are stabilising in Europe, but property leasing volumes are expected to remain subdued until 2010.
- Property values are expected to fall at a slower rate as the emphasis shifts from a capital to a leasing correction.
- Property investment pricing is closest to fair value in Europe's largest, most mature property markets, particularly the UK.
- Attractive investment opportunities are expected to emerge as balance sheets are repaired and portfolios are restructured.

## Is the European economy turning the corner?

The first six months of 2009 saw confirmation of the weakest economic conditions across the Eurozone since its inception. Figure 1 shows the severity of the downturn in economic activity, as Eurozone Gross Domestic Product ('GDP') fell by 4.4% year-on-year in Q1 2009. Inflation, which was running well above long-run trend levels in early 2008, has followed GDP growth downwards and recently turned negative. Unemployment in the Eurozone has risen from 7.2% in early 2008 to 9.5% as at end May 2009, although the disparity between countries is wide eg. Netherlands at 3.2% and Spain at 18.7% (Source: Eurostat, as at 31 May 2009).

To an extent however this data is backward-looking as it reflects changes in economic activity recorded over the past few months and quarters. What is potentially more interesting is that some forward-looking indicators have begun to stabilise or improve, albeit from very low levels. For instance, the OECD's Composite Leading Indicator<sup>1</sup> for the Eurozone improved in three consecutive months since January 2009 (see Figure 2).

At the same time, conditions in Europe's credit markets are showing signs of stabilisation. According to the ECB, European banks became less negative in their future lending intentions during Q1 2009<sup>2</sup>. Perhaps more significantly, the cost of finance in the Eurozone has fallen sharply from the peak levels of Q4 2008. Figure 3 shows that the spread between

the Euribor 3-month rate and typical AAA-rated Euro 3-month government bond yields has decreased to 40-50 basis points for the first time since the onset of the credit crunch. The divergence between falling bond yields and rising property yields has increased the long-term attractiveness of property.

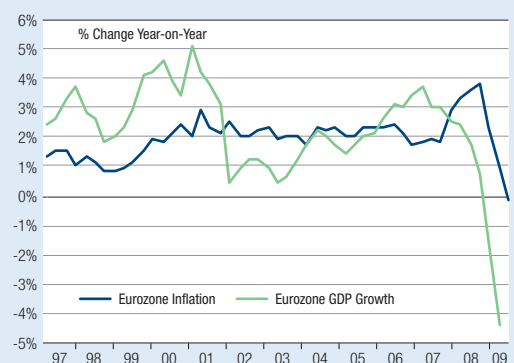
The supply and cost of credit is likely to be a major determinant of the shape, strength and sustainability of Europe's economic recovery. We believe the above signs are positive and can be interpreted with cautious optimism. However, we recognise that due to the scale of the downturn in Europe's economy, activity in the property market is likely to remain subdued until expected economic growth becomes more firmly established in 2010-2011.

<sup>1</sup> OECD is the Organisation for Economic Co-operation and Development. Its Composite Leading Indicator has accurately predicted turning points in industrial production growth and other key economic output indicators.

<sup>2</sup> ECB is the European Central Bank. Its quarterly Euro Area Bank Lending Survey measures the lending intentions of banks to consumers, households and businesses.

Figure 1

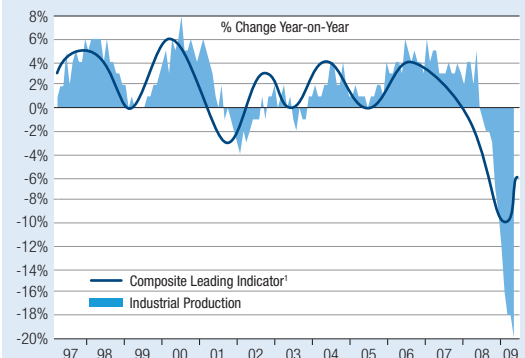
### Record downturn in Eurozone economic growth Q2 1996 - Q2 2009



Source: Eurostat Note: GDP data to Q1 2009 only

Figure 2

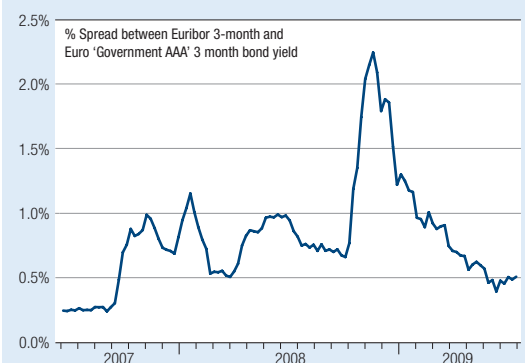
### The worst of the recession may be behind us



Source: Eurostat, OECD

Figure 3

### Euro cost of finance sharply lower since Q4 08



Source: Datastream

## Prospects for property – short term outlook

There has been clear evidence of a sustained slowdown in leasing activity across the Eurozone property markets since the end of 2007. In Q1 2009, quarterly office take-up across key Eurozone markets fell to its lowest level since the trough of the previous cyclical downturn in 2002. However, given the expected depth of the current economic downturn, we expect property leasing activity to fall further, potentially bottoming out in H1 2010 (see Figure 4).

Although leasing data for the retail and industrial sectors is less widely reported, we believe that similar trends are being observed in these markets as tenants seek to reduce costs by consolidating space and where possible negotiating lower rents.

As a general rule, price movements in listed property company shares have foreshadowed the investment performance of direct properties, albeit with greater volatility. This in part reflects the higher liquidity of listed shares, which enables prices to be 'marked-to-market' far more rapidly. Figure 5 shows that since the onset of the global credit crunch in July 2007, European listed property shares fell by 66%<sup>3</sup> (to March 2009) in anticipation of falls in direct property capital values. By contrast, direct prime property values in the Eurozone peaked in March 2008 and have since fallen by 23%<sup>4</sup>.

Property price falls to date have been more influenced by the credit market than by the leasing market. We expect this balance to switch in the short-term, with the rate of value decline slowing as the effect of lower rents filters through to property values more gradually.

<sup>3</sup> FTSE EPRA/NAREIT Europe ex.UK Index. <sup>4</sup> CBRE Prime Eurozone Commercial Property Index

## Identifying longer-term value opportunities

Invista uses a proprietary model to estimate the equilibrium yield, or 'fair value', for various European property markets at any point in time. The calculation is based on a number of inputs such as government bond yields, property-specific risk factors including liquidity, transparency, volatility and future rental growth expectations. Comparing current prices available in the market against this fair value measure enables investors to judge whether they believe they are being fairly compensated for acquiring property in the current market. The model is a very useful guide of market direction and pricing which, when linked to the experience of our local teams, can help shape our investment decisions.

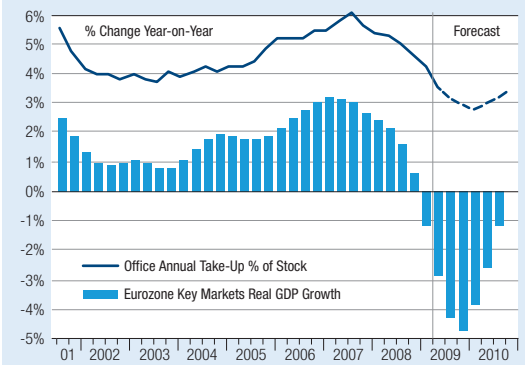
Based on our analysis, the UK is currently the only European country where market prices are considered to represent fair value, as shown in Figure 6. This is mainly due to the earlier and more substantial upward movement of property yields in the UK compared to Continental Europe, where the least developed and riskiest markets remain substantially below fair value. The larger, more liquid and transparent property markets such as France, Germany and the Netherlands, however, are considered to be closer to fair value.

### Summary

The European property market is moving from a capital to a leasing market correction and the rate of value falls are therefore expected to slow. With improved visibility on bottom-of-the-cycle valuations, we are in a better position to judge market pricing against fair value. This will assist in identifying attractive investment opportunities across these markets, some of which are experiencing distressed selling. The UK is currently the only market we consider to be 'above fair value' however this is still entirely dependant on the quality of the stock being traded. It is interesting to note that the largest and most mature Continental European markets are not far behind – we estimate some 6-9 months – and deal flow is likely to improve during the second half of 2009.

Figure 4

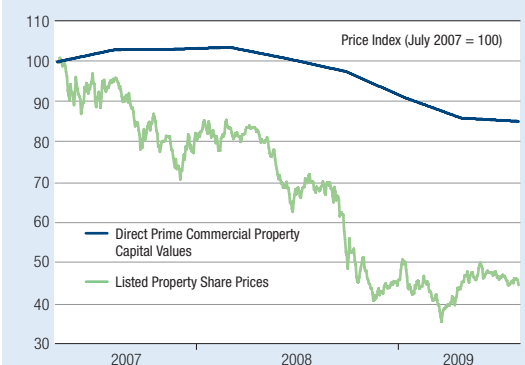
### Leasing activity subdued until mid-2010



Source: Eurostat, PMA, OECD (forecast GDP), Invista REIM (forecast take-up)  
Note: Key Eurozone markets are represented by Austria, Belgium, France, Germany, Ireland, Italy, Netherlands, Spain.

Figure 5

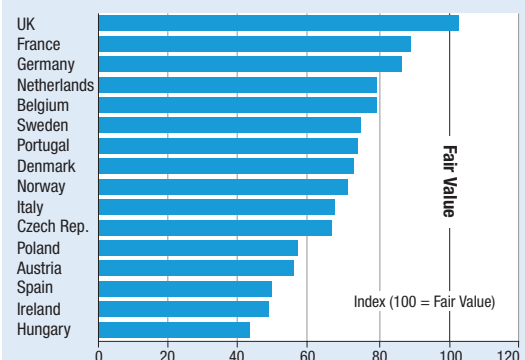
### Property shares leading the direct market



Source: CBRE, Datastream, Invista REIM. Note: Listed performance represented by FTSE EPRA/NAREIT Europe ex.UK price index. Direct performance represented by capital growth in CBREs Eurozone Prime Index.

Figure 6

### UK and mature Euro markets near fair value



Source: Invista REIM, Datastream, PMA. Note: Fair Value Index based on difference between current investment market pricing and equilibrium yield.

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