



EUROMARKET

July 2011

WHERE NEXT IN THE EUROPEAN OFFICE SECTOR?

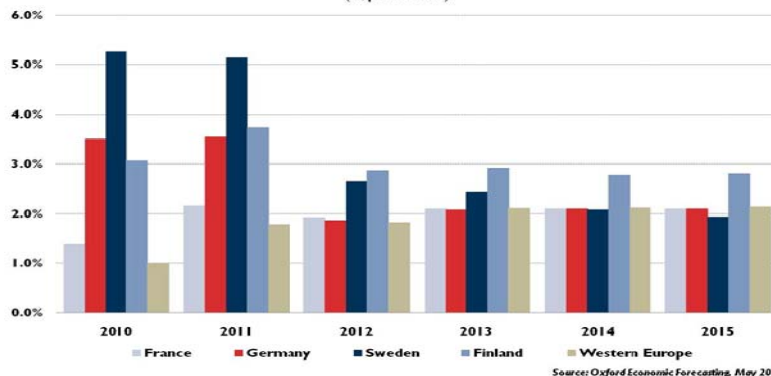
The strong property performance recorded in 2010 has been driven almost entirely by capital growth. Total returns in the prime office sector for Europe (ex.UK) reached 13.0% with rental growth of 0.6% only¹. This has now run its course, particularly in core countries (UK, France and Germany). Yield compression, at least at the prime end, is nearing an end in most mature markets with a few already keenly priced: Paris CBD office yields fell to 4.25% at the end of the first quarter of 2011, only 45 bps higher than the yields recorded at the peak of the market in 2007; similarly, London West End offices compressed to 4.00% vs. 3.50% at their peak in 2006². Furthermore, with interest rates expected to slowly increase as central banks act towards progressively normalising the monetary environment, pressure on yields is likely to turn upwards over the 2012-2015 period. Looking forward we therefore expect to see prime yields stabilise in late 2012. Renewed downward pressure on yields is unlikely until rental growth is seen to be established and sustained. In that context, future performance is again heavily dependent on market fundamentals. Rental growth will be the main driver of performance going forward as well as more labour-intensive value-add or opportunistic investment strategies.

CHASING RENTAL GROWTH

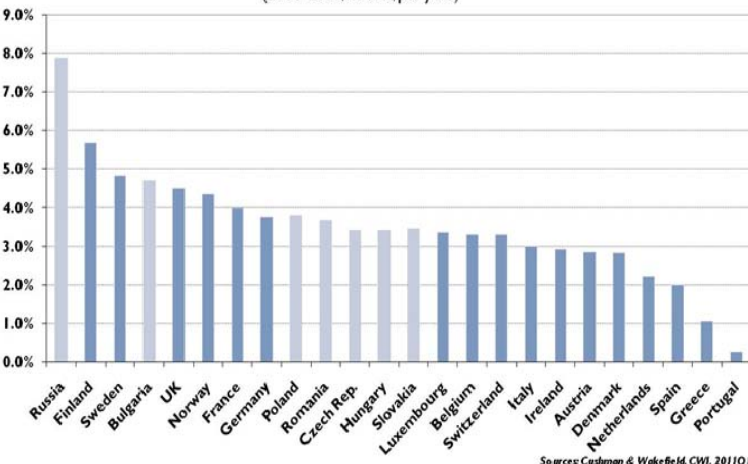
Western Europe is expected to see GDP growth of 2% per annum on average over the 2011-2015 forecast period³. A few European countries are expected to record above average growth over the next 5 years: Germany is forecast to grow by 2.3% on average, Sweden by 2.8% and Finland by 3.0% for example. That should feed into higher employment growth and consequently higher demand for office space.

A few local markets are also seeing increased activity independently of the overall national economic performance as they benefit from the dominance of a faster growing sector (such as the Financial and Banking Services in Central London or Frankfurt) or from their dominant status (capital cities such as Paris).

GDP growth (% per annum)



Rental growth forecasts (2011-2015, CAGR, per year)



Most markets have been starved of new supply during the crisis as a lack of financing led to pipelines drying up. With demand steadily improving, the immediate supply of office space has reached a plateau and vacancy rates have started to decline. At the same time, few completions were brought to the market last year and few are expected in Europe this year, leading to a rapid decline of the share of new office space in the overall supply. Local pockets of scarcity are likely to appear over the rest of 2011 and into 2012.

As a result of the combination of an improving demand and a tight supply of adequate space, we expect a few markets to outperform over the forecast period. We forecast prime office rental growth in Frankfurt, Paris and Stockholm to reach 4.3%, 5.2%, and 4.8% respectively (CAGR⁴), compared to 3.2% for the Western European average (ex.UK). Contrarily to the recent yield movements which have led to a convergence of performance, rental growth prospects will vary from one market to another and will lead to a further differentiation of market performance going forward.

¹ Source: Cushman & Wakefield, Long-term performance summary 2011Q1.

² Source: Cushman & Wakefield, 2011Q1 prime data.

³ Source: Oxford Economics Forecasting May 2011.

⁴ CAGR: compounded annual growth rate over the 2011-2015 period. Source: CWI.

DECLINING RISK PREMIUM EXPECTED

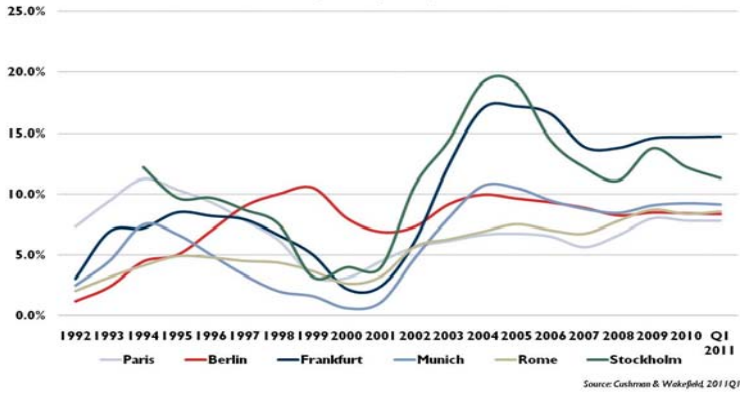
With vast investment funds available, intense competition for the best products and falling yields in European core property, investors have had to review their definition of core/core plus. A high level of risk aversion has meant that this definition has become much more conservative and restrictive than justified. As a result the market which used to be segmented into prime and secondary assets has been redefined into a three tier market made of prime, secondary and tertiary assets.

The shortage of grade-A assets on the market has now forced investors to look into those B-locations regarded as safe, and take on more quantifiable risks (void, shorter leases). As market occupier activity improve, we expect to see investors (and banks) more "at ease" to deal with asset management issues and return progressively to less secure assets and locations newly (and probably wrongly) qualified as secondary. As a result, we expect to see a reduction in the risk premium for these "good" secondary assets. The more challenged parts of the secondary market, now qualified as tertiary, are likely to continue to see a dearth of transactions until investors consider values have corrected enough.

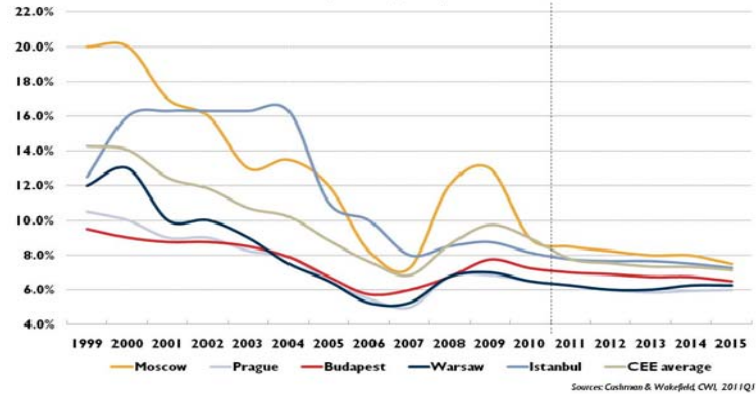


In parallel, investors who were primarily targeting the more liquid and core markets of Europe, but who have more of an appetite for risk than most institutional players, have started to return to less mature markets (Poland, Czech Rep, Russia) and emerging markets (Turkey) which we believe are underpinned by good market fundamentals. The Warsaw and Prague markets have seen their yields decline by 50bps only since the 7.00% peak reached in 2009, after having recorded a 200bps increase during the crisis. As liquidity improves, we expect yields to harden by a further 50bps to 100bps in these markets. Similarly, while yields haven't started compressing yet in the more emerging markets, we expect them to decline within the next 2 to 3 years.

Office vacancy rates
(%, end of period)



Prime office yields
(%, end of period)



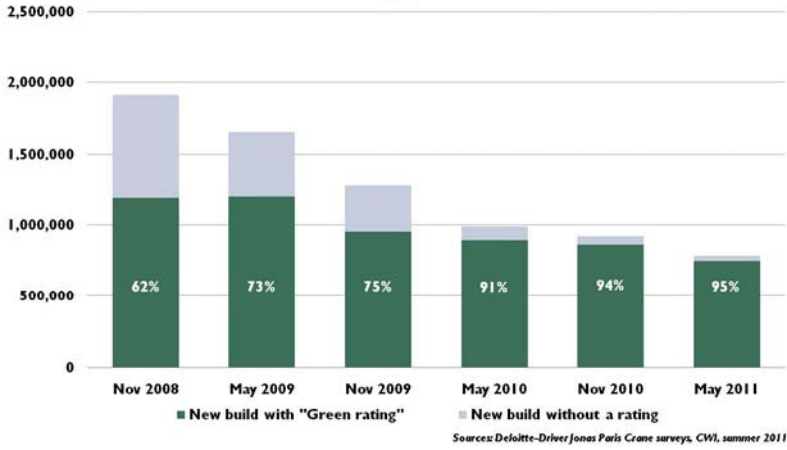
GOING HIGHER UP THE RISK CURVE

A shortage of good quality supply at the investment level means that the best way to access such product is by financing development opportunities. Forward-funding deals have made a reappearance on the market as they provide both the access to the market and a higher yield. In the Paris market for example, the first quarter of 2011 saw as many forward-funding deals as for the whole of 2010. Taking on the leasing risk is rewarded by an additional 100bps to 150bps on prime. The rationale behind such transactions is particularly attractive at the current point in the cycle. Indeed, as the market is also seeing a shortage of suitable supply at the occupier level, the leasing risk taken on by investors is rather limited. Furthermore, with most of the markets relatively tight (vacancy rates haven't risen dramatically compared to previous cycles), it should not take much of an increase in demand to put pressure on rents.

As an aftermath of the crisis and the need for a lot of investors to concentrate on refinancing their portfolios and reducing their loan to value ratios, a number of secondary properties have been neglected from an asset management point of view, notably those held by banks. We expect the banks to start releasing more of these properties on the market now that values have recovered somewhat. These are likely to create interesting opportunities for "hands on" investors to work these more labour-intensive value-add assets.

Sustainability is more and more of an issue, notably in the more mature markets where the existing stock is made mostly of older buildings. With a large majority of new construction being built to a "green" standard, the risk of seeing older "non green" space being priced at a significant discount is increasing. While redeveloping all the out-dated space into environmentally efficient buildings does not seem feasible, retro-fitting a number of these existing buildings to fit at least an "in use" green benchmark

Share of "green" construction in the Ile-de-France pipeline
(sqm)



Buyers and sellers will need to maintain a realistic view on pricing. The recent yield compression has shown that the market tends to over-tighten and tighten too quickly. Future performance is again heavily dependent on market fundamentals. A discerning investor with the right knowledge and the right connections in the market should be able to yield a comfortable profit from well chosen opportunities. Though there will always be a market for prime, the limited number of assets on the market is forcing investors to widen their investment requirements in order to perform. More assets of lower quality than prime are also expected to be released on the market as the pressure on banks to write down bad loans is increasing notably under Basel II and Basel III regulations. Already, some situations are starting to unravel with more news of banks forcing sales or selling off entire portfolios.

For further information on any of the areas mentioned please contact:

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⁵ Green regulations, standards and ratings differ from one country to another with more and more markets adopting an international reference as well as their national standard (the LEED for example is being used more often in French constructions).