Emerging Trends in Real Estate Europe 2010

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Emerging Trends in Real Estate® Europe 2010

Emerging Trends Europe participants are cautiously optimistic about the prospects for their industry in 2010. Europe’s economies are recovering and transactional markets are thawing, but there are major uncertainties overshadowing these positive trends.

Concerns centre on two specific issues: whether the withdrawal of government stimulus packages will choke off a fragile economic recovery in Europe, and how the financial system will deal with both the large amount of real estate debt on banks’ balance sheets and the commercial mortgage-backed securities that are maturing.

By 2010, economic growth will be subdued throughout Europe and unemployment will remain high. Capital values of real estate are bottoming out and in some cases, like the United Kingdom, rising sharply in anticipation of recovery. However, the fundamentals of the real estate market are still deteriorating and will remain under pressure.

There is substantial equity available for European real estate in 2010, primarily from conservative institutions like insurance companies, sovereign wealth funds, and private property vehicles. However, they are very selective about what they will buy, focusing on prime income-producing property.

Private property vehicles are sitting on a large amount of equity earmarked for European real estate: around US$35 billion. But there is widespread disillusionment with the fund format amongst investors, and those seeking to raise fresh equity in 2010 will find it difficult. The publicly traded real estate companies’ fortunes are taking a turn for the better. Their shares have rebounded sharply and they are well positioned to take advantage of buying opportunities in 2010.

The squeeze on debt available for European real estate is easing, but credit remains tight in 2010. Banks are still deleveraging and deciding what to do with their damaged loan books. Larger deals will require banks to club together or syndicate the loan, and relationship banking is back. Underwriting continues to be strict, with loan-to-values and copious covenants.

It is not yet clear how Europe’s financial system will cope with refinancing the large amount of real estate debt that is due to mature over the next five years. However, it is unlikely that European banks will opt for large discounted disposals of distressed loans and assets; they are more likely to work them out over time. Alternative debt providers like insurance companies, pension funds, and opportunistic new lending platforms may help in the process.

Investors seek safety, concentrating on core and core-plus assets in mainstream commercial property sectors. Higher-yielding niche sectors are temporarily relegated to the watch list for most.

Executive Summary

Green issues are now very much to the fore in most of Europe. New energy-efficiency regulations and concerns over oil prices and global warming are shaping business decisions. Nongreen stock is in danger of accelerated obsolescence and retrofitting will be a major concern for the industry.

In terms of individual cities, much of the sentiment of the 2009 survey has continued to hold true. Munich and Hamburg held the top two spots for investment prospects in the 2009 survey. This year, they remain the top prospects for existing portfolio performance, with many respondents seeing Germany as being more stable than other countries, both in terms of property markets and the broader economy. The view that German markets were less frothy when times were good and therefore do not have as far to fall remains as prevalent as it did in 2009. For new property acquisitions, two broad views on the market appear regularly in the interviews for this year’s report: “We will be concentrating on the markets we know” and “the deeper, liquid markets—the U.K., France, and Germany.” This is a sentiment shared by both investors and lenders. The key issue across Europe is the availability of assets to acquire.

The majority of interviewees comment that they will be shying away from development in the short term. The top-ranked cities are a mix of those that feature at the top of the rankings for investment, together with two longer-term prospects, Istanbul and Warsaw. Istanbul, which is first, and Warsaw, which is fourth, are favoured for their economic growth prospects.

Most major property types are regarded as offering “fair” or “modestly poor” prospects for existing property performance. Apartments for rent take the lead, followed by retail, mixed use, residential for sale, office, industrial/distribution, and hotels in that order. Looking at the subsectors, city offices are taking the lead. By and large, investors are more confident about the prospects for new acquisitions than for existing property performance. All categories were rated “fair,” except for industrial/distribution, which is considered “modestly poor.”

Fears about the occupier markets caused respondents to put development opportunities on the back burner. Apartments for rent managed to just cross the line into the “fair” category; all other property sectors are deemed to provide “modestly poor” opportunities. Cap rates have undergone an adjustment and shifted outwards, but the market seems to have hit bottom. For 2010, yields for most sectors are expected to firm up.

Preface

A joint undertaking of the Urban Land Institute (ULI) and PricewaterhouseCoopers, Emerging Trends in Real Estate® Europe is a trends and forecast publication now in its seventh edition. The report provides an outlook on European real estate investment and development trends, real estate finance and capital markets, property sectors, metropolitan areas, and other real estate issues.

Emerging Trends in Real Estate® Europe 2010 represents a consensus outlook for the future and reflects the views of more than 645 individuals who completed surveys and/or were interviewed as part of the research process for this report. Interviewees and survey participants represent a wide range of industry experts—investors, developers, property companies, lenders, brokers, and consultants. ULI and PricewaterhouseCoopers researchers personally interviewed 269 individuals, and survey responses were received from 360 individuals whose company affiliations are broken down as follows:

Private Property Company or Developer 29.2%
Real Estate Service Firm 27.1%
Institutional/Equity Investor or Investment Manager 19.8%
Other 8.6%
Bank, Lender, or Securitised Lender 7.4%
Publicly Listed Property Company or REIT (including SIIC, SICAFI . . .) 5.6%
Homebuilder or Residential Land Developer 2.4%

A list of the interview participants in this year’s study appears at the end of this report. To all who helped, the Urban Land Institute and PricewaterhouseCoopers extend sincere thanks for sharing valuable time and expertise. Without the involvement of these many individuals, this report would not have been possible.
Waiting for the Fire Sale

“Expect a long, slow haul.”

Europe’s real estate industry is cautiously picking itself up and surveying the road ahead. “It’s looking positive, but we are taking small steps.” Credit is easing, values are steadying, and deals are being done. “Not being in free fall is an improvement.” Many Emerging Trends respondents are optimistic, expecting better profitability in 2010. There’s talk of prudent buying, launching new funds, and even teeing up some development. However, their mood is cautious. “Another year when we need to remain absolutely diligent about everything to do with our business.”

Europe’s economic recovery is weak and fragile. Unemployment remains high, consumer spending restrained. Tenants ask for rent reductions, and negotiations with bankers are “mentally gruelling.” “2010 will be choppy.”

Real estate players fear “temporary improvement followed by what may be Armageddon”—that Europe’s economy will go into meltdown when governments stop their stimulus programmes. And they know that eventually—though not necessarily this year—interest rate rises, tax increases, and spending cuts are on the cards. “The key question is: Will the other shoe drop—will there be tenant defaults?”

When’s the Fire Sale?

“There’s a huge problem coming over the hill.” Everyone in European real estate—investors, bankers, developers, and brokers—is apprehensive and understandably so. The scale of real estate debt that needs refinancing is colossal. There is €781 billion of commercial real estate loans sitting on Eurozone banks’ balance sheets, plus some £250 billion (€278 billion) in the U.K. banking system. And that is not

EXHIBIT 1-1
Survey Responses by Geographic Scope of Firm

<table>
<thead>
<tr>
<th>Type of Firm</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>European Firm with a Pan-European Strategy</td>
<td>26.1%</td>
</tr>
<tr>
<td>European Firm Focused Primarily on One Country*</td>
<td>40.8%</td>
</tr>
<tr>
<td>Global Firm with a Global Strategy</td>
<td>26.4%</td>
</tr>
<tr>
<td>Other</td>
<td>8.7%</td>
</tr>
</tbody>
</table>

* See breakdown of countries below:

Russia 12.0%  Italy 7.2%
Spain 11.2%  Portugal 6.4%
United Kingdom 10.4%  Belgium 4.8%
Germany 9.6%  Greece 4.0%
Turkey 8.8%  France 3.2%
The Netherlands 8.0%  Nine other countries 14.4%

Source: Emerging Trends in Real Estate Europe 2010 survey.
The European Central Bank estimates that Eurozone banks will write off €37.7 billion worth. Most worrying are the loans where high leverage was piled onto poor-quality property in 2006–2007, when property values were at their highest. CBRE reckons that there is £79 billion of this debt in the U.K. “The definition of real estate got inflated—a lot of land disguised as real estate got back into the system and as the value burned off it, there is nothing left. Ashes to ashes, land to land.”

“How banks unravel the debt will have a big impact on the market.” Will they get tough, hold a fire sale in 2010, and get on with life? Dumping property risks pushing prices down yet further, maximising losses and battering already bruised balance sheets. Or will banks hang on, dribbling out distressed assets and extending loans in the hope that they can work out the problems over time? In this case, they will have much less capital for new lending, not only to real estate but also to other sectors of the economy.

Some of the Emerging Trends interviewees think that Europe’s banks will start to offload real estate in 2010. “Banks are feistier as they seem to have gone past the most difficult phase and are now playing hardball. The most difficult time for property players to manage cash flow/gearing issues is ahead of us, not behind us.”

But most believe that a fire sale is not on. “The banking system is too fragile for the banks to mark-to-market on real estate.” Sales would crystallise losses, triggering pressure for them to beef up their capital bases. “The instinctively right thing is to take your time, to do it in a thoughtful way,” says a fund manager, noting that during the 1990s, Sweden’s strategy of hiving bad real estate loans into a state-run bank “worked very well.” Indeed, Ireland is copying the Swedish solution and has set up the National Asset Management Agency, a “bad bank,” to buy €77 billion of toxic real estate loans.

### Survey Responses by Country

<table>
<thead>
<tr>
<th>Country</th>
<th>Response</th>
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<tr>
<td>Sweden</td>
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<td>Portugal</td>
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<td>Greece</td>
<td>5.9%</td>
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<td>France</td>
<td>5.6%</td>
</tr>
<tr>
<td>Russia</td>
<td>5.6%</td>
</tr>
<tr>
<td>The Netherlands</td>
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</tr>
<tr>
<td>Italy</td>
<td>6.5%</td>
</tr>
<tr>
<td>Turkey</td>
<td>6.5%</td>
</tr>
<tr>
<td>Spain</td>
<td>9.4%</td>
</tr>
<tr>
<td>Germany</td>
<td>12.4%</td>
</tr>
<tr>
<td>Belgium</td>
<td>3.2%</td>
</tr>
<tr>
<td>Other</td>
<td>13.9%</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>18.3%</td>
</tr>
<tr>
<td>Other</td>
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Source: Emerging Trends in Real Estate Europe 2010 survey.

### European CMBS Loan Maturities 2009–2018

<table>
<thead>
<tr>
<th>Year</th>
<th>United Kingdom</th>
<th>Germany</th>
<th>France</th>
<th>Netherlands</th>
<th>Italy</th>
<th>Other</th>
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<tbody>
<tr>
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<td>1.56</td>
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<td>0.42</td>
<td>0.00</td>
<td>0.00</td>
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</tr>
<tr>
<td>2010</td>
<td>1.81</td>
<td>1.03</td>
<td>0.25</td>
<td>1.44</td>
<td>0.00</td>
<td>0.44</td>
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<tr>
<td>2011</td>
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<td>6.91</td>
<td>1.10</td>
<td>0.35</td>
<td>0.00</td>
<td>0.67</td>
</tr>
<tr>
<td>2012</td>
<td>6.56</td>
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<td>1.64</td>
<td>0.07</td>
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<tr>
<td>2013</td>
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<td>0.46</td>
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<tr>
<td>2014</td>
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<td>0.78</td>
<td>1.00</td>
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<td>2016</td>
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<td>2017</td>
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<td>2018</td>
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<td>0.00</td>
<td>0.00</td>
<td>0.00</td>
<td>0.07</td>
<td>0.00</td>
</tr>
</tbody>
</table>

Source: Fitch Ratings, November 2009.
Note: Billions of Euros.
Emerging Trends in Real Estate® Europe 2010

Chapter 1: Waiting for the Fire Sale

will count again as heavy asset management, repositioning, and cyclical plays are the major investment themes.

**Cash calls:** There will be large institutional and retail inflows into property as investors go for income. Plus, real estate offers potential upsides: income protection should inflation take off and the prospect of longer-term capital gains if and when property values recover.

**Debt drought:** Credit stays tight as banks decide what to do with their property-laden loan books. Loan-to-values are low, underwriting is strict, and lenders are focused on income.

**CMBS:** Securitisation might reemerge in 2010, but as simple, easy-to-understand structures backed by strong covenants. Existing issuance is on the critical list. German Pfandbrief and other covered bonds gain traction as a funding mechanism.

**Interest rates:** Most of Europe’s real estate players think that interest rates will stay low in 2010. But they worry about what will happen when central banks start to ratchet them up. Higher borrowing costs would hit consumers and businesses, threatening to choke off economic recovery.

**REITs’ revival:** Investors like the liquidity, transparency, and corporate governance of REITs. Plus, REITs have the basic bread-and-butter skills needed to create value from real estate in a leverage-light world.

**Ground control:** “Plain, old-fashioned” direct investing makes a comeback as big equity players—insurance companies, pension funds, and sovereign wealth funds—decide they want more control over their assets. Separate accounts and small clubs flourish; big pooled funds lose popularity.

**Funds consolidate:** “Investors have issues with fund managers.” The private equity business is restructured as external managers are culled and new money is doled out sparingly. Some will not survive; others will be sold or will merge. “Rather than loads of half-baked businesses, there will be half as many better-baked businesses.” Funds will be smaller, their missions more tightly specified.

**Asian adventures:** Those who aspire to global diversification are heading east. “Europe needs to figure out how to participate in global growth and come to terms with the reality that it’s not going to revolve around Europe and the U.S. anymore.”

**The Road Ahead**

“It will be a long, slow crawl back up the hill, and how much values recover will depend on where Europe ends up economically against global competition.” The following is what interviewees expect in 2010:

**No more quick wins:** Good old-fashioned property skills are back in demand. Real competence and experience

The “hold on” contingent argues that European banks traditionally avoid fire sales and are not under pressure to get rid of distressed assets. “They have taken write-offs, set up internal bad banks, and will work through their portfolios.” “Banks don’t want to become real estate companies. They will get into bed with people for workouts if they don’t have the management to do it themselves.”

At least with bank debt, the rights of different parties and procedures for foreclosing are pretty clear cut. Not so with CMBS. When these complex and often ill-documented structures go sour, it can turn into a free-for-all between bondholders and special servicers and amongst different tranches of bondholders. “No one knows how to deal with CMBS yet.” That issue will pop up in 2011, when the bulk of CMBS begins to mature.

Meanwhile, there is a daunting mountain of real estate to refinance just as European banks are being asked to shrink their balance sheets. “It is a deeply, deeply worrying mismatch. Are there enough players to provide additional equity?” Cash-laden institutions, sovereign wealth funds, and “opportunistic lending platforms” may help fill some of the gap.

“If the debt market remains stable, if structural adjustments happen in the course of time, the consequences are manageable,” says a German interviewee. That’s a big “if.”

**Economic Backstory**

Europe’s economic recovery is underway, but it will be sluggish and uneven. In 2010, unemployment remains high, credit stays tight, consumer demand continues to be subdued, and investment is low.

According to Emerging Trends interviewees, the recovery will be variously “U-shaped,” “W-shaped,” “wok-shaped,” “Nike swoosh-shaped,” or even “square root-shaped.”

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**EXHIBIT 1-4**

**U.K. Commercial Real Estate Loan Maturities**

<table>
<thead>
<tr>
<th>Year</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>2009</td>
<td>19%</td>
</tr>
<tr>
<td>2010</td>
<td>14%</td>
</tr>
<tr>
<td>2011</td>
<td>14%</td>
</tr>
<tr>
<td>2012</td>
<td>12%</td>
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<tr>
<td>2013</td>
<td>10%</td>
</tr>
<tr>
<td>2014-18</td>
<td>14%</td>
</tr>
<tr>
<td>after 2018</td>
<td>17%</td>
</tr>
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</table>

Germany and France are leading Europe’s recovery. The “motor of the euro economy,” export-oriented Germany had a “rough ride,” but now benefits from the pick-up in global trade. However, with the strong euro dampening exports, gross domestic product (GDP) growth will be modest in 2010. Meanwhile, rising unemployment worries Emerging Trends’ German interviewees. “When the Kurzarbeit [the government’s short-time work scheme] is terminated and the first jobs are lost, only then will we be heading for the trough.” The German government is also concerned and has introduced a €6.1 billion package of tax cuts to support the economy. Over the longer term, our interviewees are convinced that “Germany will recover into a stronger position than ever before.”

France’s downturn has been shallower than most, partly because Europe’s second-largest economy is less export-driven and has a large public sector: nearly one-quarter of French workers are employed by the state. Consumer spending is holding up well and exports are rising; manufacturing is ticking up. But French unemployment is 10 percent and our respondents wonder: “What will create jobs and drive recovery?” If France’s massive state spending is cut down, its economy could go off-piste again. President Nicolas Sarkozy has said that he will not raise taxes in 2010, but France’s public finances are in a dire state. “Everything they are doing appears to be a temporary fix.”

“Italy will go on doing what Italy does.” Growth will be anemic in 2010 as the strong euro hits the competitiveness of Italian exports. At over 100 percent of GDP, Italy’s public sector debt is amongst the highest in the Eurozone and the government is planning new revenue-raising measures to tackle it. These include the scudo fiscale, a tax amnesty allowing Italians who hold undeclared capital abroad to repatriate it and avoid prosecution if they pay a 5 percent levy. “Much of the returning capital will flow into the real estate market.” International investors are less enthusiastic. “Italy is in poor shape and the government is not capable of addressing the issues.” “There are too many obstacles—a country that takes a minimum of five years to give you your VAT [value-added tax] back!”

“The Netherlands will be at the back of the queue.” Also heavily dependent on exports, the Dutch economy will see muted growth in 2010. The country went into recession with a tight labour market, so at 3.9 percent, Dutch unemployment is the lowest in the Eurozone, but consumers remain cautious. With local elections due in March, the ruling coalition proposes modest spending cuts in 2010.

For their part, households and businesses—including those in real estate—are beginning to believe that the worst is over. Surveys indicate that confidence is rising across the Eurozone, but not yet enough to boost spending in the high streets.

### Exhibit 1-5
**European Economic Growth**

<table>
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<tbody>
<tr>
<td>Poland</td>
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<td>1.0</td>
<td>4.9</td>
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</tr>
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<td>8.1</td>
</tr>
<tr>
<td>Czech Republic</td>
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<td>2.7</td>
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<tr>
<td>Sweden</td>
<td>1.2</td>
<td>-4.8</td>
<td>-0.2</td>
<td>2.6</td>
</tr>
<tr>
<td>Denmark</td>
<td>0.9</td>
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<td>-1.2</td>
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<td>Finland</td>
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<td>-5.1</td>
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<td>Greece</td>
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Sources: International Monetary Fund, Moody’s (www.economy.com).
* Projections.
Chapter 1: Waiting for the Fire Sale

Emerging Trends in Real Estate® respondents expect higher taxes, higher inflation, higher unemployment, and a higher burden of public debt. “We are going to find 2010 an extremely uncomfortable year.”

Norway and Sweden are leading the Nordic region out of recession. Norway was relatively untouched by the financial meltdown and its economy has been underpinned by a large stimulus package. Investment in its oil industry also supports demand. Sweden, the region’s largest economy, suffered a worse downturn than its neighbours, partly because of the banking sector’s exposure to the Baltic countries. It is out of recession, but there is considerable slack to take up. The outlook for Denmark and Finland is also improving, but it will be “a quiet year in the Nordics.”

In contrast, emerging Europe faces another tough year. It has been knocked back by the flight of foreign capital, and inward investment is likely to remain low for some time. The bright spot in this region is Poland, which has avoided drag on growth. An election looms this spring, but whichever party wins, Emerging Trends’ respondents expect higher taxes, higher inflation, higher unemployment, and a higher burden of public debt. “We are going to find 2010 an extremely uncomfortable year.”

Norway and Sweden are leading the Nordic region out of recession. Norway was relatively untouched by the financial meltdown and its economy has been underpinned by a large stimulus package. Investment in its oil industry also supports demand. Sweden, the region’s largest economy, suffered a worse downturn than its neighbours, partly because of the banking sector’s exposure to the Baltic countries. It is out of recession, but there is considerable slack to take up. The outlook for Denmark and Finland is also improving, but it will be “a quiet year in the Nordics.”

In contrast, emerging Europe faces another tough year. It has been knocked back by the flight of foreign capital, and inward investment is likely to remain low for some time. The bright spot in this region is Poland, which has avoided...
Russia has been a bit more volatile than other economies. Having seen GDP growth yo-yo between 8.5 percent and –7.5 percent in three years, Russia is now pencilled in to deliver 1.5 percent growth in 2010. While this will be one of the better performances in Europe, it is low for Russia. Weak oil prices are not helping its energy-exporting economy and the government will be pumping €6.1 billion in to stimulate it in 2010. “For those who understand and are willing to take the risk, Russia is the best play.”

Turkey has weathered the storm better than most. Its banking system is solid and the economy is rebounding, helped by single-digit interest rates and tax breaks that boosted domestic spending. “Turkey will emerge as a new logistics hub between Europe and the East.” However, its bid to join the European Union seems to be fading.

Where’s Value?

Global diversification may have hit a small road bump, but Emerging Trends respondents are still en route to rebalance portfolios. In particular, they want to increase their exposure to the Asia Pacific region. This region has weathered the financial crisis in much better shape than either Europe or the United States and is regarded as the engine of global growth. “Our first choice short term is Australia. It has the best macro picture. Longer term, it’s Asia—Beijing and Shanghai,” says an international investor.

But last year, buyers stayed home. Direct investment in European real estate halved to €68 billion, just a quarter of its 2006 peak. Leveraged buyers were vapourised by the credit crunch, while cross-border deals tanked as investors everywhere focused on their domestic problems—and opportunities. Overseas buyers, who have been a significant force in European markets over the last four years, accounted for about half the cross-border capital.

Those who venture out play safe, concentrating on the big, liquid, “priced-to-buy” markets. “The U.K. is top of everybody’s list. France and Germany will surprise on the upside.” Last year, the United Kingdom scooped up 43 percent of all cross-border investment in Europe as euro- and dollar-denominated buyers swooped in to take advantage of low prices and cheap sterling. “It’s buy one, get three free.”

The spotlight is on the U.K., where the sheer amount of money chasing an extremely limited supply of prime assets has tightened yields in central London, to near-boomtime lows in some deals. The pressure is also pushing up prices of retail and industrial property and spilling over into secondary stock. This rapid snap back stuns some. They think pricing isn’t taking into account the still-deteriorating occupational markets, where rents are falling. “You’ve got a lot of hotheads out there, bidding stuff up.”

Poland has emerged entirely. Its economy is less reliant on exports and employment has held up better than expected, supporting domestic demand. Forecasts indicate that Poland will outperform the rest of Europe in 2010, but at 2.5 percent, GDP growth will be subdued. The Polish government has postponed its plan to join the Eurozone in 2012, as it deals with a large deficit.

The Czech Republic is also on a good track, emerging from a relatively short and shallow recession. But Hungary is a “basket case.” Relying on a loan from the International Monetary Fund to keep afloat, the country is on an austerity programme to trim its budget deficit and is unlikely to pull out of recession until 2011.

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Similarly, Turkey’s young demographics and growth prospects mean that Istanbul has its fans. It is number one for development prospects in 2010, with one caveat: the high ranking may be reflecting the preferences of the relatively large group of domestic Turkish players in this year’s survey.

**Safety First**

2010 is all about safety and stock selection. Virtually everyone is fixated on prime and core-plus property. “There’s no need to climb up the risk curve because you get a damn good return on core.” “Investments done now will look good in ten years’ time.”

Moreover, there is precious little debt for anything that is remotely risky. “We finance only core investments at the moment,” says a European banker whose loan book used to be 50 percent development and “would like to come back to that market.”

Quality of location, building, and tenant is the overriding consideration. Centre city offices, high street retail, and shopping centres are the top commercial investment picks for 2010. However, residential investments also are highly rated, and expected to turn in a better performance than commercial property in 2010.

As one investor puts it: “Buy good income with decent assets, lock in decent financing, and you have got a very good income stream, which, medium term, may benefit from an inflationary bubble. It’s not the market bottom, but it’s a reasonable play.”

But for many, 2010 is a year of stabilisation and asset management: “Work like the devil to stay at the same level as last year.” They have loans to renegotiate and properties to let; they expect some tenants to default and others to push for rent reductions. On the plus side, property prices have hit bottom in most European markets: “No further impairment in the portfolio is expected.”

Opinion is divided as to whether this is a bubble or not. “It’s hard to beat central London, especially the City, because rents have adjusted hugely. We could see growth in prime rents in 2010, and yields are still relatively high,” says a fund manager. Others think London is for “lemmings.” “There is now a glut of overseas investors trying to jump into this market thinking they will get distressed prices when they have already missed the boat.”

Germany also gets mixed reviews. Opinions range from “strong fundamentals” to “mildly negative” and “cautious—there’s less price transparency.” Views differ on different cities and on whether the German economy offers reassuring stability or low growth prospects. This year, Munich comes out on top of the Emerging Trends league of city prospects, scoring first for standing investments and second for new acquisitions and development. Frankfurt, in contrast, is lower down, reflecting worries about its finance-heavy tenant base.

There is more unanimity about France or, more specifically, Parisian offices. “Fundamentals look solid. Values have bottomed out at the prime end, rents are stabilising, and there is little new supply.” “Paris is stronger than London as it is less heavily reliant on financial services and has a wider industry base.”

Central and eastern Europe (CEE) has dropped off most investors’ list altogether: “too many people nursing too many wounds.” The exception is Warsaw, which is judged to be in relatively good shape. “Poland is the strongest and most stable market in CEE.” Meanwhile, Moscow’s fall from grace has been particularly steep, tumbling to 24th place from sixth in the rankings of European cities’ prospects this year. But “Moscow will have opportunities if you take a longer-term view.”
Niche Plays

Although mainstream real estate sectors are favoured, Emerging Trends respondents are not entirely abandoning the more offbeat types of real estate. Student housing, self-storage, retirement homes, social housing, health care facilities, infrastructure, car parking, agricultural land, and garden centres all have their fans. “Our alternatives fund is doing very well,” confides an investment manager.

But many believe that prospects for alternatives are poor. They don’t want to go “off-piste” when they can find value in more conventional real estate. It is “back to the basics and core competences.” Moreover, bankers do not always view niches kindly. “It’s a hugely problematic area. Leverage is even lower than in secondary property.”

Most see potential in the kind of property that caters to Europe’s aging population. “Hospitals, sheltered accommodation, private clinics will have an upside in the future.” A few of Emerging Trends’ respondents are already active in this market; others are about to enter. “We are considering launching a fund specialised in health care.” The rest are keeping a watching brief: “The market is not sufficiently large or organised.”

Similarly, seniors’ housing and residential care homes are judged to be interesting, but not necessarily today. For some, these segments are too small and “not something everybody can afford.” Government policy will influence how this niche develops. “Who is going to pay? Clearly there’s a lack of supply, but you need to be reasoned about risks,” an interviewee asks.

Social housing appears to have a small following, notably in Italy. The sceptics think that “its success will depend on the future relative tax advantages granted by the Italian government, if any.” In contrast, the student housing market is more established. Some already invest in it—7 percent yield—and others view it with mild interest.

“Nonsexy” public sector property is gaining popularity. “The deep core buyers may be tempted to come back into leases with local councils or governments where they have 33 years of fixed-income streams from schools or hospitals.” Infrastructure, which also provides low-risk, long-dated income, appears to be splitting off. “It is a different alternative asset class, more private equity than real estate.”

Mixed-use real estate that helps restructure cities is reckoned “to make a lot of sense” and perform well. “But it is a very difficult product for investors to understand.”

None of the Emerging Trends interviewees is enthusiastic about leisure this year. Highly dependent on discretionary spending, it is not performing particularly well in these belt-tightening times. “It is a difficult sector,” says an investor.

Going Green

Given the bad times that Europe’s real estate industry is going through, it is slightly surprising to find that green issues are “absolutely” moving up its agenda, “from 20 to 80 on a scale of 100. Nobody wants to be with the last 20 percent.”

This year, a big majority of Emerging Trends survey participants are green converts. Typical comments include: “immense concern,” “impossible to neglect if you want to stay in the race,” “no longer a freakish trend,” and “it should become part of the DNA of our businesses.”

An international developer puts it thus: “You can save your tenants money by having an energy-efficient building. That allows you to lower the risk of default and makes the service charges more attractive. We don’t build anything without considering the green applications. Not least, this is because I’d like my children to be able to enjoy these buildings and the world as I have enjoyed it.”

Undoubtedly, the industry’s focus was sharpened by the European Union introducing compulsory energy efficiency ratings for buildings last year. This, and Europe’s dependence on oil, has concentrated minds. For the first time since Emerging Trends started canvassing views on the subject, there is evidence that green issues are influencing investment decisions.

“We walked away from a deal in France that possibly did not meet efficiency standards,” reports an investor. “We would not buy anything new that is not top-of-the-line in terms of green ranking,” says another. “Green is no longer hype, but a selection criterion for investments.”

Global warming is also entering explicitly into the investment equation. “We passed on a hotel in the Maldives,” reports an investor. Another has set a deadline to reduce CO₂ emissions by 20 percent. “Every new building in our portfolio has gas, solar, or terrestrial heat. There is not a single new building with an oil heating system,” says a Swedish interviewee.

The push for more energy-efficient, sustainable buildings is coming from occupiers and investors. “It is absolutely at the top of their agenda. They ask first about our green credentials—we have to jump that hurdle just to advise them,” says a European CEO of a global property consultancy. “We have tenants that want carbon credits for offsets and a company that wants to use Seine River water for cooling its building.”

True, big-brand corporates are more concerned about environmental issues than smaller occupiers. Also, to date there is little hard evidence that tenants in Europe are willing to pay more rent for green buildings. But there are some interesting portents. In the Netherlands, for example, there is talk of incorporating green building and sustainability factors into the nationwide points system that determines rents for social housing.
Emerging Trends in Real Estate® Europe 2010

Chapter 1: Waiting for the Fire Sale

Top Tips

**Keep it simple:** Go for “plain-vanilla real estate investments that everybody understands.”

**Best buys:** Core is king. Stick to core and core-plus investments in large, liquid markets. Buy city centre offices, high street retail, shopping centres, and residential for rental. Avoid industrial and distribution facilities, hotels, and out-of-town offices.


**Development:** For those with the stomach for risk, buy land and start building up a pipeline of projects. Residential for rental or sale and mixed use are the best sectors.

**Go for debt:** Buy a bank or set up a lending platform. Now is a great time to lend on real estate, if you have the right skill set and no legacy issues. Values are low and “the gap between cost of funds and loan margins is as good as it gets.” Or, buy distressed debt at a discount.

**Green is good:** Real estate is on the front line in the battle against climate change. “There is now a clear realisation that environmental and social responsibility is connected to economics. It has become an action issue.”

**People power:** In tough times, human capital counts as much as financial. “There is a saying that you should come out of a recession with better assets than when you went in. We are investing heavily on not only good-quality assets but also recruiting quality human capital,” says an interviewee. Or, as another puts it: “The real sustainability of business is people.”

There are also plans for investment funds that focus specifically on eco-sustainable assets, although the financial crisis caused at least one of these launches to be aborted. But they are still in the pipeline, and there is even talk of “dark green funds” featuring green buildings with green tenants.

More and more, Europe’s real estate industry is convinced that “nongreen is a form of obsolescence.” For investors, prime now encompasses environmental qualities. They believe that eco-friendly buildings will command a premium over environmentally unfriendly ones. “Sustainability is increasingly expected by the occupiers, important for the long-term occupancy, and, therefore, important for sustainable value.”

Developers and landlords ignore this message at their peril. “If you don’t deliver green buildings, you won’t find takers.” “We are not buying any properties now which we believe are not sellable in ten years’ time,” says a core investor.

This divide will create a two-tier market, polarising buildings that meet the new corporate standards and those that don’t. Owners of “semiobsolete” properties face difficulty leasing them unless they spend on greening them. Some are getting ahead of the game: one investor is analysing the entire international portfolio, identifying what fails to meet environmental standards in every country and starting methodically to fix it, “from left to right.”

Indeed, the biggest headache for the industry is the existing stock. “There’s far too much focus on solar panels, windmills, and new buildings and not enough on retrofit. It’s just not sexy,” complains a fund manager. “Real estate provides for 40 percent of the CO₂ production worldwide, so policy makers will impose penalties for those who have not or will not adjust,” predicts another. A consistent standard is needed: “At the moment there are too many labels promoting green and meaning different aspects.”

Not everyone is happy about the new regime. “These environmental regulations are adding £20,000 to the cost of building a basic house. They are a real millstone for residential developers.”

And, there are still very noticeable differences in how seriously environmental issues are taken in different European markets. The larger western ones, with more mature investment markets, are heavily green. Germany, the Netherlands, and the Nordic countries are in the vanguard, with the U.K. and France catching up. In southern Europe and eastern Europe, environmental issues are not as big. In Russia, developers say they have trouble getting green features approved by the authorities, “who have never seen them before.”

EXHIBIT 1-13
Strategic Investment Allocation Preferences for 2010

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Source: Emerging Trends in Real Estate Europe 2010 survey.
Emerging Trends in Real Estate® Europe 2010

Chapter 2

Real Estate Capital Flows

“There’s a great deal of money out there that’s feeling much more confident and looking for a home.” That may be true of equity, but for debt it’s a different story. “Debt will be rationed for a long time and the price will be high.”

The European real estate industry expects capital to “dribble” back into the market in 2010. It is more optimistic about equity, however, with a large majority of those surveyed by Emerging Trends saying there is enough, or almost enough, to meet the market’s needs. The problem is the substantial undersupply of debt.

Banks hold the key to 2010. They control both sides of the real estate equation: “Their ‘extend and pretend’ strategy is removing the pressure on existing borrowers to sell, and on the other side they are very reluctant to finance new deals unless for absolutely prime assets.”

Equity Makes a Comeback

“Equity vastly exceeds opportunities. There are large pools of committed and uninvested capital.” Only 21.5% of those surveyed think that equity will be substantially undersupplied in 2010. But equity is very, very choosy about what it wants.

After a grim 2009 when investors sat on the sidelines and waited for markets to stabilise, they are prepared to buy real estate. Heading the queue are the classic sources of equity: insurance companies, pension funds, and open-ended funds: institutions that shun leverage and still have cash coming into their coffers. “German open-end funds will be winners in 2010. The money is just dropping in.”

Private property vehicles also are on the prowl. Though many were beaten up by the credit crunch and survive thanks to bankers’ forbearance, the newer ones are sitting on an estimated US$35 billion of dry powder. The difficulty for them is

EXHIBIT 2-1
Real Estate Equity Capital Market Balance
Prospects for 2010

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<th>Moderately Undersupplied</th>
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Source: Emerging Trends in Real Estate Europe 2010 survey.

EXHIBIT 2-2
Real Estate Debt Capital Market Balance
Prospects for 2010

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Source: Emerging Trends in Real Estate Europe 2010 survey.
Emerging Trends in Real Estate® Europe 2010

Institutions Go for Gold

Traditional institutional investors—“plain-vanilla insurance and pension funds”—are in for a real estate bonanza. In a capital-constricted world, they have equity and the will to spend it.

Although real estate provided “significantly less diversification than one [had] hoped for” when the financial system went into meltdown, institutions are still positive about the asset class. They scent recovery, seek income, and fear inflation. “Buying core assets today is a winning proposition over the next ten years.” European pension funds are bumping up their allocations; foreign ones are going global.

With the denominator effect now working in favour of real estate, institutional investors find themselves lightweight as equities and bonds have reflated more rapidly. “They are rushing to reverse this.” Plus, the inflows of pension contributions and premiums need to find a home. “They are piling on cash, but that can’t last forever,” especially when cash yields next to nothing.

Individual investors also stage a comeback in 2010, but with a difference. These are not the debt-fuelled cowboys of the go-go years, but the super-cautious superwealthy, the middling wealthy, and family offices. “Real estate looks an attractive asset class for high-net-worth individuals when interest rates are so low.” “We see a lot of high-net-worth individuals investing in tickets of between €5 million and €20 million.”

They hope that 2010 will flush out more game, as banks get tougher with their borrowers and force sales.

Real estate investment trusts (REITs) and listed property companies also will have a good 2010. They have mended their balance sheets with sales and rights issues, reorganised their finances, and are cautiously looking for opportunities. Their real estate skills are now back in fashion.

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They hope that 2010 will flush out more game, as banks get tougher with their borrowers and force sales.
But these organisations are not nimble. It will be a slow flow, not a flood, of money into real estate. “Expect more capital to be available, but not hugely.” The financial crisis has shaken investors out of their comfortable assumptions about risk, diversification, liquidity, and structures. “Institutions are in a recovery phase: they haven’t quite got their mind around asset allocations or how they want to invest in real estate.”

“We are ready to invest again, but can be patient. We are not under any pressure to move too soon,” says a major U.K. insurer. The pace also depends on whether the right kind of stock—safe, core, and core-plus real estate—is available at the right price. Institutional investors will have to work hard to spend their money in 2010.

Overwhelmingly, they focus on core and core-plus in more mature and liquid markets: “secure cash flows that earn 100 to 150 basis points above bonds.” “Anything that vaguely smells of risk or takes a bet on the future is difficult.” This “wall of money” chases limited stock. Yields rebound, making core and core-plus assets too expensive for some. “There’s a danger that investors are losing sight of occupier market fundamentals in the U.K.” Some braver institutions leapfrog into assets higher up the risk curve: “We see devel-
Emerging Trends in Real Estate® Europe 2010

Small institutions, which don’t have the luxury of investing directly, will stick with pooled vehicles for real estate. But they too will go through the fine print of fund prospectuses with a magnifying glass. Control and alignment of interests are major issues. “Investors want to get closer to deals and due diligence.”

And large or small, institutional investors will be very, very fussy about who gets their equity. “We will be more selective about managers, gearing levels, what the story is.”

State Capitalists

“Sovereign wealth funds [SWFs] are still interested in real estate, but it is not clear what they are going to do.” These big beasts are rethinking their strategies, and adapting them to the new financial terrain.

They are rebalancing their portfolios, changing allocations, and restructing their organisations. Commercial real estate is quite low on their list of targets in 2010, according to the Sovereign Wealth Fund Institute’s consensus demand meter, which measures investment intentions on a scale of 1 to 10. (See chart.)
Chapter 2: Real Estate Capital Flows

Taken as a group, SWFs have some €3 trillion of assets under management. But not all SWFs are large and not all invest in real estate internationally. There are only about ten with serious global portfolios, mostly the larger Middle Eastern and Asian funds that are old hands at real estate.

Others are joining in; new entrants include China Investment Corporation, Qatar Investment Authority, Oman Investment Fund, Australia’s Future Fund, Libya Investment Authority, and Norway’s Government Pension Fund. The first five put their markers down last year, splashing out on some big-ticket purchases, most in London.

SWFs have the reputation of being big-game trophy hunters in real estate, but this is simplistic. They use private property vehicles for opportunistic and value-added investments, they buy listed real estate securities, they develop, and now they are getting into niche strategies like real estate debt and distressed assets.

The big players are upping their game: expanding in-house teams, recruiting seasoned professionals from investment banks and private equity houses to head up their real estate activities. For them, control of assets is a big issue. “SWFs got burnt badly and now want to put it out themselves.” Expect to see them investing more directly, partnering up with other SWFs and in joint ventures with like-minded investors and developers.

Open-Ended Funds

Equity-rich, open-ended real estate funds are in a good position to snap up some of their favoured assets in 2010. They top the list of equity providers for 2010 in the Emerging Trends survey. “German open-ended funds have much lower IRR targets than the closed funds and are collecting cash.”

Spending, rather than collecting, money is the headache for open-ended funds in 2010. Unless owners can be persuaded to part with more core or core-plus property at the right price, funds will be hard-pressed to put their equity to work.

Indeed, heavy inflows from both retail and institutional investors have prompted some German and U.K. fund managers to restrict new entrants, for fear that they would not be able to spend the money on suitable stock.

A caveat: these funds are at the mercy of investors, whose mood is volatile. Having stabilised and seen investors return in 2009, most of the 45-strong German open-ended sector lifted redemption bans and started to spend, both at home and selectively elsewhere: buying office buildings in London and Paris, Italian shopping centres, and Dutch logistics facilities.

Their focus is on natural resources, equities, and distress. And while SWFs are not abandoning developed economies like Europe’s, they are allocating more to emerging markets. They are also under political pressure to do more at home. The Middle Eastern funds in particular are rethinking how they invest their sovereign wealth.

Like others, these “state capitalists” have soured investments to sort out. But with oil prices stabilised, exports recovering, and stock markets rebounding, SWFs will be spending more freely. “The Asians are already looking strong and we can expect others to be back in 2010.” And there are a lot of them: 55 and counting.
France’s OPCIs (organismes de placement collectif immobiliers) are also proving popular with institutional investors. Given the green light in 2007, they are now a 30-strong sector holding some €6 billion of real estate.

**Funds Under Fire**

“It’s a slow grind.” Private real estate funds face a tough year. “Darwinian principles are coming into play: survival of the fittest. The very big and the very small and niche players are likely to survive better.”

The evolutionary cull is already underway. Global investment banks are selling off their real estate fund management businesses, while other groups divest themselves of European platforms, and some managers and funds migrate to new homes. Capital will move from poor performers to those with better track records; some will have to close down.

Survivors are gingerly picking their way through the rubble of the market meltdown. Some €17 billion of assets are held by funds that are due to end in 2010, but a large proportion is choosing to extend or roll over the fund. “Unwinding problem assets will be a two- to three-year plan.” Investors are reluctant to commit fresh equity; INREV found that a third of them and half of fund-of-funds managers had turned down requests.

“There’s a lot of pain to still go through, deleveraging.” Banks tolerate loan covenant breaches, but negotiating with them is “mentally gruelling.” “Banks are incredibly slow. They only deal if you’re falling off a cliff and they are not uniformly sensible,” says a fund manager. “We have given keys back in some cases,” admits an opportunity fund manager who is “very tough” about putting more equity into existing investments.
Chapter 2: Real Estate Capital Flows

Last year, fundraising for private real estate vehicles focusing on Europe hit a US$4.9 billion nadir as investors sat on the sidelines, nursing their losses and waiting for markets to bottom. But, anticipating the green shoots of recovery, managers are trying to drum up a whopping US$42.6 billion for new vehicles—nearly double the amount they snagged at the 2008 peak.

They face an uphill struggle. Traumatised by their losses, investors are more demanding, while the competition for their equity remains intense. Funds take longer to close and raise less than targeted; some will have to throw in the towel. “Capital has gone from being cheap to dear. The market for blind pools is difficult or nonexistent; business will take three to five years to come back, and be 50 percent of what it was.”

“The big boys are looking more at club deals because they want to be sitting across the table from equally big players.” Sovereign wealth funds and institutional high-rollers want to know who their fellow players are; they don’t want to join games with people who will fold when more equity is needed. “We are in funds with investors who don’t honour their commitments. In the future, we will do due diligence on co-investors in the funds we underwrite.”

The opportunity fund model is under particular stress. In an environment where debt is scarce, they will struggle to achieve the 20 percent returns they target. Says an opportunity fund manager: “Any new opportunistic product has to say, ‘Let’s use less leverage, let’s be honest with ourselves about the returns we can achieve, and let’s take less risk.’”

Predicts an investor: “We’re in for a massive change. Real estate funds will be smaller, more targeted, less leveraged, and more independent.” Alignment, track record, and a storyline are of paramount importance. “Managers have to rethink what is a good structure.”

Some prominent investors go further and say that the closed-ended private fund model is “broken and has to be repaired.” They are angry—angry about misuse of leverage, about “mission creep,” about fee structures.

“He is not alone. “There is an enormous amount of private equity out there. The number and volume of funds are much higher than during the last crisis.” Private real estate funds have a US$35 billion mountain of dry powder for Europe, from equity raised in 2008–2009 and unspent. Most of it is aimed at the opportunistic end of the spectrum, waiting for banks and distressed owners to clear out their stock. This is taking longer than expected. “In 2010, everything will be quiet. There will be the occasional deal, but not on a large scale.”

“Few deals will get done. We are focusing on raising money and positioning ourselves for the 2011–2012 period when sellers will start to capitulate,” predicts a global opportunity fund manager.

<table>
<thead>
<tr>
<th>Strategy</th>
<th>Targeted Commitments</th>
</tr>
</thead>
<tbody>
<tr>
<td>Distressed</td>
<td>2% US$0.9 Billion</td>
</tr>
<tr>
<td>Value-Added</td>
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<tr>
<td>Core-Plus</td>
<td>5% US$2.2 Billion</td>
</tr>
<tr>
<td>Debt</td>
<td>8% US$3.0 Billion</td>
</tr>
<tr>
<td>Opportunistic</td>
<td>66% US$26.8 Billion</td>
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</tbody>
</table>

“That won’t last. Do they think they could have made a better job of it than the fund manager? They’re not even trained to do it,” scoffs a fund manager.

Fees also are in the firing line. “There will be a structural change, with investors requiring the ability to block fees. Fees will be cost or cost-plus with a promote.” “We stopped taking fees, input new money in the form of sweat equity into our own funds, and spend much time showing investors what we do,” admits the manager of a global opportunity fund.

Although investors talk tough, their current markdown of private real estate funds is likely to herald a hiatus rather than a longer-term shift away from these vehicles. “The third-party-managed fund structure will survive,” predicts one manager who admits he has a vested interest in the matter. “There will be a point when investment management skills will be necessary again and people still subscribe to blind pool funds.”

REITs Bounce Back

“Publicly listed vehicles are the flavour of the month.” REITs are making a comeback. They’ve shored up their balance sheets, their share prices are up, and they expect to see action in 2010. “The listed vehicle format has shown its strength during the credit crunch. Transparency, corporate governance, and liquidity have value for investors.”

With portfolio values stabilising, U.K. REITs—Europe’s largest public real estate sector—are anticipating the property market’s recovery. “We have high expectations that we will start development. We want to be early in this area so we can be best placed when rents improve.” REITs and other listed property companies raised £5.3 billion last year via deeply discounted rights issues and placings. “We will invest the equity raised in 2009 and complete developments started in 2006 and 2007 or mothballed in 2008,” says one.

REITs are also on standby to help banks work out their problem properties. “The sheer scale of bank portfolios will require additional resources.” Big public property companies have the know-how, the teams, and an important edge: transparency and respectability. For banks, especially ones in which the government has a stake, selling assets to private opportunity funds may not be a politically acceptable option. This is especially true if the fund is perceived as a foreign “vulture” profiting from domestic distress.

“REITs have better operating skills than private equity houses and they have shown that they have access to equity capital,” notes a banker. “There are opportunities to be had by working with banks.” agrees a U.K. REIT, adding, “We won’t be looking to manage things for others. We want our capital to work for us.”
However, the stock market has already factored in the public property sector’s improved prospects. Last year, quoted companies’ share prices staged a remarkable recovery; EPRA/NAREIT’s European index rose by 22 percent. In 2010, their shares may drift, having already priced in any growth. “Capital is being diverted into REITs in lieu of direct market opportunities. I see a slight correction in 2010.”

And 2010 may turn difficult. Across Europe, occupational demand remains fragile. CEOs worry that “the weak economic environment due to high government debt will impact the property fundamentals.” “An increase in vacancy could be an issue. Lease renegotiation could become more difficult to manage.” “Consumer trust is starting to decline, meaning that retailers are beginning to feel the pain.”

In Spain, the quoted real estate sector is still working through its problems. Overleveraged and overcommitted to development, larger players stay afloat thanks to debt-for-equity or debt-for-asset deals with their banks, whilst smaller ones file for creditor protection.

The government has given the go-ahead for a Spanish version of REITs—sociedades anónimas cotizadas de inversión en el mercado inmobiliario, or SOCIMIs—to launch in 2010. It hopes these vehicles will help revive Spain’s traumatised housing market. Critics claim that SOCIMIs are a “decaffeinated” version of REITs.

This is because they pay corporate tax at a lower-than-standard 18 percent, whereas most other European REITs are not taxed. “SOCIMIs will be a good revivifying instruments, but not in the short term.”

Elsewhere in Europe REITs are stalled. Germany still only has two, and Italy one.

Debt: Back to Business

“The banking environment is difficult, but not hopeless.” Emerging Trends’ interviewees report that they can borrow once more, albeit on lower loan-to-values (LTVs) and higher margins. “Banks are doing club deals again; syndications are possible up to €400 million to €500 million in Europe.”

“The next step is when healthy competition starts and margins start coming down.”

But 2010 will see “a trickle rather than a torrent” of debt going into European real estate. The lending universe remains small and conservative. “The problem is that banks are so gun shy, they are getting out when they should be getting in. They are not providing liquidity when the market is crying out for it and prepared to pay for it.”

Will it be enough? “We need more liquidity, more confidence. I can’t see debt spreading out to support a broadly based recovery of the investment market.”

Global investment banks are out of action; the few surviving cross-border European lenders are constrained. “German banks that can raise money as Pfandbrief are back for a bit of the market.” Others are “still preoccupied doing their homework”: zombie banks. Of those that remain in business, most concentrate on their home market. “Commercial banks are lending, but for small amounts.”
Emerging Trends in Real Estate®  Europe 2010

is not much more expensive than the precrunch one. “For high-quality, well-secured income streams one can get to an all-in cost of debt of 5 percent, which gives you a good basis to make money.” “Pricing is not the issue. LTV and other covenants and getting less recourse are more critical.”

Lenders are stringent: “more controls, checklists, compliance.” “More lawyers are involved in the interpretation of financing documents.” Lenders are also extremely picky about the properties they back. “A lot depends on the stability of the income stream, length of leases, and the quality of tenants.” Development finance remains scarce to nonexistent. And, it pays to know your bankers. “Those who shopped for the cheapest loan are being given the cold shoulder.” “I lost 90 percent of my financing contacts, and those who are left do not take in new requests. They only want me to pay down debt,” wails a borrower.

Debt Facilitators

“The capital gap will create new players.” In a world where fewer banks lend smaller amounts on stricter terms, “insurance companies, mezzanine lenders, and other players will be active.” “German insurance companies are entering the markets for funding.” This reprises a traditional role for European insurers, who in the past were a major source of long-term mortgage finance for commercial real estate. Others also see opportunities in Europe: a U.S. insurance company has bought into a European platform it hopes to develop for senior and mezzanine lending.

Private equity is another burgeoning source of debt. The credit crunch has spawned a mini-industry of funds offering

EXHIBIT 2-19
European Property Yields vs. Five-Year Interest Rate Swaps

“We are able to generate a return on equity of 10 percent before tax and loan provisions from our lending,” says a German bank. “This is the bottom line for lending business; hence, we believe that today margins and fees are at an acceptable level.”

That said, the credit crunch has changed the geography of spreads. “There are substantive differences between countries as a result of country ratings,” says a banker. In Russia, the crisis has made new credit “practically unaffordable” as margins zoomed up by 300 to 600 basis points; in Turkey, they have hit 600 to 1,000 basis points “if you are lucky enough to find debt available.”

However, in western Europe, borrowers say they can live with higher margins because, with LIBOR and Euribor bobbing around the sub–1 percent mark, their overall interest cost is not much more expensive than the precrunch one. “For high-quality, well-secured income streams one can get to an all-in cost of debt of 5 percent, which gives you a good basis to make money.” “Pricing is not the issue. LTV and other covenants and getting less recourse are more critical.”

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Private equity is another burgeoning source of debt. The credit crunch has spawned a mini-industry of funds offering
Different players target different slices of the capital stack. Some see opportunities in safe, low loan-to-value senior debt. Others aim higher up the stack. “We are considering opportunities to act as nonbank or mezzanine lenders.” Another group targets distressed debt. All are frustrated by the lack of deals: “We don’t know where to invest the debt we do have.” In 2010, the logjam will start to break up, as the investment market revives and banks start to bump borrowers off their balance sheets. But some players may have to rethink their pricing. “There is space for mezzanine, but not at 15 to 20 percent IRR in Europe—more like 10 to 12 percent.”

Sceptics doubt whether these surrogates will be able to plug the debt hole. “Insurance companies or other nonbank financial institutions may act as substitute lenders, but they will do this selectively and will not be able to replace the banking function in a sufficient magnitude.”

**CMBS Resuscitated**

Commercial mortgage–backed securities (CMBS) are registering some vital signs, but they “will not make a meaningful comeback until the current mess is sorted out.” Unlike those in the United States, Europe’s real estate markets never became securitisation junkies, but there is €5 billion of CMBS due to mature in 2010. Another €61 billion falls due between 2011 and 2014. “CMBS workouts will take at least five years.” That’s the rose-tinted view. “It is scary to see how much is coming due, and the question is, how much will be recycled?” The bearish view is that Europe’s real estate debt mountain of CMBS and bank lending combined is so large that it will need government aid.
So far, less than 5 percent of European CMBS loans have missed payments, but a growing number are breaching their loan-to-value covenants. Borrowers will find it difficult to repay the mainly bullet debt. This is particularly true in the U.K., where property values have fallen most sharply, but most of the CMBS due over the next five years is in mainland Europe, where markets are still adjusting.

“It’s the classic example of a product that no longer has a lender. Leveraged buyers will be required, and they will only do that at a price that gives them exceptional opportunities and exceptional returns.”

As part of their moves to pump liquidity into the financial system, the European Central Bank (ECB) and the Bank of England include CMBS in their repo facility: banks can package up loans to provide collateral that is eligible for short-term financing from the central banks. Last year, around 15 to 20 CMBS issues used these facilities. However, the ECB is winding down its programme in 2010, towards an end date of March 2011. The criteria are being tightened, making deals more difficult and expensive.

Optimists think securitisation will return shortly, though in a plain-vanilla form. “CMBS will come back, maybe in 2011, in smaller lots and more recourse-based, small portfolios with assets that you can identify and cash flows that are identifiable.” “Longer term, CMBS is needed for larger deals. It will be initially expensive and simple structures.”

There were three new public CMBS deals in 2009, the first issuance in 18 months. But these are simple structures that rely entirely on the tenant credits underlying them—a major retailer and the U.K. government. Investors see these as a substitute for corporate bonds, but with higher yields and more security. “CMBS will not return in 2010 apart from single-borrower, strong-covenant, single-tranche issuances.”

The return of “easy-to-understand” CMBS may help refinance some existing bank debt, but today’s underwriting is much more stringent. “There will still be a component that will not be refinanced.”

Derivatives Subside

Europe’s fledging derivatives market is back to Earth with a bump. It survives the fall, but it will take time to get airborne again.

Trading volumes are sharply down, dropping by 75 percent in 2009 in the case of the U.K., while the German market shut down. Important players—50 percent of trades were interbank—are out of action, others have downsized, and some who were going to take the plunge have stepped back. Investors are spooked by the banking meltdown and counterparty risk: Lehman Brothers was heavily involved in property derivatives.

There are some encouraging signs: a handful of property hedge funds and institutions continue to trade and several Emerging Trends interviewees are planning to get into the market in 2010. “We are looking at using derivatives more because there are fewer transaction costs and more speed and flexibility.” If more fund managers and other “hard-core property folk” get involved, it will help the market to recover traction.
Moreover, there is now a U.K. property index futures contract that can be traded on the Eurex derivatives exchange. Since this is a standardised instrument that doesn’t involve counterparty risk and comes in bite-sized chunks of £50,000, fans are hoping that it will help boost interest and activity in derivatives.

The synthetic market in real estate should benefit from the increased focus on risk management. “Institutions can use derivatives to manage their exposure when they’re getting all these cash inflows. It’s the perfect moment to use them, when the market should be lifting off.” It would also make sense for banks to use derivatives to hedge losses on their large real estate portfolios.
After a very gloomy prognosis last year, this year interviewees are showing signs of cautious optimism. In the 2009 report, investment and development prospects were expected to decline across the board—no city showed improvement in either category. This year, sentiment regarding investment prospects has stabilised and although sentiment regarding development continues to decline, it is a less dramatic fall than that witnessed last year.

Cautious optimism is not universal, however. Some interviewees remain resolutely gloomy, with one commenting on the market, “If it were a horse we should shoot it.” Many respondents expect some of the key themes from 2009 to continue into 2010. Bearish views regarding the economy are still widespread and interviewees are concerned about the continuing impact that this will have on the occupier side of the equation. Many interviewees are worried that unemployment will continue to rise in 2010 and that this will result in increasing vacancy. As one interviewee commented, “The highest risk for 2010: a second downswing of the economy, which would have a big impact on the leasing market.” The concern that rents will continue to decline is very widely held and there is general agreement that a strong focus on asset management will be required. As one respondent put it, “Tenants are kings: the market will be driven by tenants.”

The view that performance will be highly dependent on managing fundamentals and very specific to the individual asset has made many respondents this year nervous about ranking cities—there is a widespread belief that the quality of the tenant is more important than the city or asset type.

During the interviews for the 2009 report, conducted as the crisis unfolded, it became apparent that the views of respondents varied depending upon whether they were considering the prospects for existing portfolios of assets or looking at opportunities to invest. In the case of the former, the more stable markets that had fallen the least were the more attractive. In the case of the latter, those markets that had corrected the most sharply present the best opportunities. For this reason, this year we asked respondents to rate the investment prospects for individual cities separately for each of these situations. However, as capital values have begun to stabilise, the differences in sentiment between the prospects for existing properties and acquisition opportunities have become less marked, and there is now stronger correlation between the cities under both measures.

EXHIBIT 3-1
Average City Prospect Ratings

<table>
<thead>
<tr>
<th>Year</th>
<th>Investment Prospects</th>
<th>Development Prospects</th>
</tr>
</thead>
<tbody>
<tr>
<td>2006</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2007</td>
<td></td>
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</tr>
<tr>
<td>2008</td>
<td></td>
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<td></td>
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<tr>
<td>2010</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: Emerging Trends in Real Estate Europe surveys.
Note: 4 = modestly poor, 5 = fair, 6 = modestly good, 7 = good.
* Investment prospects are the average of scores for existing property performance and new property acquisitions in exhibits 3-2 and 3-3.
Emerging Trends in Real Estate Europe 2010

Emerging Trends in Real Estate® Europe 2010

Emerging Trends in Real Estate Europe 2010

Emerging Trends in Real Estate Europe 2010

Emerging Trends in Real Estate Europe 2010

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Emerging Trends in Real Estate Europe 2010

Existing Property Performance

Although some respondents remain very pessimistic, the general view across Europe is that the worst is over in terms of falling capital values. As one interviewee commented, “Most of the pain for existing investments has already been felt. Opportunities are now starting to emerge.” A recurring theme from the interviews is a sense of relief from having come through 2009 in reasonable shape. As one interviewee put it, “2009 was a ‘survival year’—we had to step back from growth plans, manage internal efficiencies to keep capabilities intact. 2010 will be a stabilisation year.” Another commented, “2009 was a year we batten the hatches and focused on keeping our costs low while trying to maintain our occupancy rates.”

In terms of individual cities, much of the sentiment of the 2009 survey has continued to hold true. Munich and Hamburg held the top two spots for investment prospects in the 2009 survey. This year, they remain the top for prospects for existing portfolios, with many respondents seeing Germany as being more stable than other countries, both in terms of property markets and the broader economy. The view that German markets were less frothy when times were good and therefore do not have as far to fall remains as prevalent as it did in 2009. As one local interviewee commented, “German markets seem to be amongst the most stable ones for commercial properties; there has been little volatility.”

There are, however, concerns about the broader German economy. Although Germany was already in recession at the time of the interviews for last year’s survey, there was a general view that it would be less affected by recession than other countries. Many continue to express this view in the interviews for this year’s survey. However, others also expressed concern about the robustness of Germany’s economy. A number of German respondents were worried that the Kurzarbeit program...
gramme (state-subsidised part-time work) was concealing the true level of unemployment and that there will be significant economic pain when the programme comes to an end. Not all respondents think that all German cities are equally lacking in volatility. As one observer remarked, “The big six markets in Germany are still stable, maybe except Frankfurt.”

As markets stabilise, London and Paris also scored well in this category—holding third and fourth spot, respectively—although concerns regarding the economic prospects were again an issue for many respondents. This was particularly the case for London. At the other end of the table, the bottom three for investment prospects in 2009 (Barcelona, Madrid, and Dublin) remain the bottom prospects for existing portfolios for 2010.

**New Property Acquisitions**

Two broad views on the market appear regularly in the interviews for this year’s report: “We will be concentrating on the markets we know” and “the deeper, liquid markets—the U.K., France, and Germany.” This is a sentiment shared by both investors and lenders. Both groups are also very focused on cash flow. As one fund manager commented, “We look for an income-producing asset that we are able to buy well and not necessarily take the value-add activities or risk that we would have taken two or three years ago.” Whether the strategy is to buy prime or secondary, investors comment that they are “buying income.”

The key issue across Europe is the availability of assets to acquire. Sellers are felt not yet to be under compelling pressure to sell, so there is an expectation gap between buyers and sellers. The banks are felt by many to be the source of the answer to the availability of assets. As one investor comments, “The one big question mark is what the banks are doing with their properties—I think this is one of the keys for the next few months, if not years.” Views differ as to whether or not the banks will be the trigger of extensive disposals. Some interviewees believe that weakening cash flows from occupiers will put pressure on banks to take actions, whilst others believe that lenders will continue to sit tight and “extend and pretend.”

As has been noted already, as capital values have begun to stabilise, the differences in sentiment between the prospects for existing properties and acquisition opportunities have become less marked. The same four cities held the top four positions for new property acquisitions as for existing property performance, but in a slightly different order. For this category, London ranked top, with investors citing the dramatic falls in capital values and the weakness of the pound making prices look attractive. However, there was a widespread concern—particularly from U.K.-based respondents—that a bubble was developing and that “capital markets are far ahead of fundamentals.”

**Development**

As previously noted, although sentiment regarding development continues to decline, it is a less dramatic fall than last year. The majority of interviewees comment that they will be shying away from development in the short term. A minority of respondents are considering reentering a less cluttered market, with one interview observing that the competition is “lying by the wayside.” The top-ranked cities are a mix of those that feature at the top of the rankings for investment, together with two longer-term prospects, Istanbul and Warsaw. Istanbul, which is first, and Warsaw, which is fourth, are favoured for their economic growth prospects. In terms of the league tables, both cities also benefitted from the general lack of enthusiasm for development. Any city garnering positive responses was propelled up the table and there were some positive fans of both Istanbul and Warsaw.

**EXHIBIT 3-4**

City Development Prospects

<table>
<thead>
<tr>
<th>Rank</th>
<th>City</th>
<th>Prospects</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Istanbul</td>
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<tr>
<td>2</td>
<td>Munich</td>
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<tr>
<td>3</td>
<td>Hamburg</td>
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<td>4</td>
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<td>27</td>
<td>Madrid</td>
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Source: Emerging Trends in Real Estate Europe 2010 survey.
EXHIBIT 3-5
Leading European City Investment Prospects

<table>
<thead>
<tr>
<th>Existing Property Performance</th>
<th>New Property Acquisitions</th>
<th>Development</th>
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</thead>
<tbody>
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<td>Modestly Good</td>
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<td>Fair</td>
<td>Fair</td>
<td>Fair</td>
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<tr>
<td>Modestly Poor</td>
<td>Modestly Poor</td>
<td>Modestly Poor</td>
</tr>
<tr>
<td>Poor</td>
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### Exhibit 3-6
**Best Sectors for Acquisitions by City**

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<thead>
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<th>City</th>
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<th>Retail</th>
<th>Industrial</th>
<th>Apartment</th>
<th>Hotel</th>
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</thead>
<tbody>
<tr>
<td>Amsterdam</td>
<td>25.8%</td>
<td>30.6%</td>
<td>9.7%</td>
<td>24.2%</td>
<td>9.7%</td>
</tr>
<tr>
<td>Athens</td>
<td>9.6%</td>
<td>33.5%</td>
<td>5.8%</td>
<td>21.2%</td>
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Source: Emerging Trends in Real Estate Europe 2010 survey.
The Cities

Munich
As previously indicated, German cities are regarded favourably by respondents for existing investments as they are seen as being more stable. This is true for both international and local investors. German investors rated Munich and Hamburg ahead of other German cities, citing in both cases the broadly based local economy giving a diverse tenant mix: “For offices, Munich and Hamburg are top of the list,” and Munich has the “strongest office market and diversified economic base.” For Munich, sentiment regarding investment properties shows a slight improvement on the previous year, with no material distinction between existing assets and new acquisitions. Sentiment regarding development is unchanged. The city is ranked first for existing investments and second for new acquisitions and for developments.

Hamburg
The general observations regarding Germany hold equally true for Hamburg and it is regarded as having many similarities to Munich. One interviewee comments that like Munich, it has a “diversified economic base and is not overbuilt,” whilst another observes that “Hamburg has narrowed the gap to Munich in terms of attractiveness as a place of living.” Sentiment regarding investment properties shows no change on the previous year. Returns on new acquisitions are expected to outperform existing assets. Hamburg is ranked second for existing assets and third for new purchases. Prospects for development are believed to have declined slightly in comparison with 2009. However, sentiment regarding development has fallen less than for other cities, causing Hamburg to rise from sixth last year to third this year for this category.

Paris
The city is seen as having a broader economic base than London and is less dependent on the financial services sector. As one investor commented, “It is seen as being less volatile than the U.K. and there are still good opportunities there despite there being limited stock on the market. This is likely to continue into 2010. This market is displaying similar characteristics to London at the present time.” Another observes that “Paris is the next choice after London—France has a more robust economy than others,” and yet another: “Paris [is] more stable than London; not priced as efficiently as London.” A number of interviewees comment on the strength of the occupier market. One notes that “Paris has demonstrated with a low level of vacancy that it remains one of the most interesting markets

EXHIBIT 3-7
Munich Real Estate Market

<table>
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<tr>
<th>Prospects</th>
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2010 Acquisitions Recommendation of Survey Respondents

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Office 33.8%  Industrial/Distribution 4.9%  Hotels 9.9%

Investment Prospects

Source: Emerging Trends in Real Estate Europe 2010 survey.
Note: Investment prospects for 2010 are the average of scores for existing property performance and new property acquisitions from above.

EXHIBIT 3-8
Hamburg Real Estate Market

<table>
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2010 Acquisitions Recommendation of Survey Respondents

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<tbody>
<tr>
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<td>22.2%</td>
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Office 22.2%  Industrial/Distribution 16.2%  Hotels 9.4%

Investment Prospects

Source: Emerging Trends in Real Estate Europe 2010 survey.
Note: Investment prospects for 2010 are the average of scores for existing property performance and new property acquisitions from above.
Chapter 3: Markets to Watch

The main focus is offices, with nearly half of respondents citing this as the preferred asset type. There is a widespread concern that for prime properties “the best of the opportunity has already passed in London.” Indeed, a number of investors express concern at the exuberance of the rebound, commenting that “a capital markets–led recovery is leading to a bubble in pricing in the face of continuing weak fundamentals,” and “London is overheating due to a lack of supply of commercial and residential property, relative to available equity to invest.”

Others note that this recovery is taking place “only in a very small segment of the market, only the top-quality segment, perhaps 5 percent of the market,” and that there are in practice “only very few transactions taking place.”

The return of confidence in London has been sufficient for investors to again be considering development, with one respondent commenting, “London and Paris are the two markets that have the strongest interest from non-European investors.”

Sentiment regarding London has improved significantly. “The U.K. market has corrected very quickly—especially London, where Middle Eastern and Asian money has come in.” In 2009 it was ranked fifth for investment prospects, having risen from 15th in 2008. For 2010 sentiment has improved further still, with the city ranked fourth for existing properties and first for new opportunities. For acquisitions, the main focus is offices, with nearly half of respondents citing this as the preferred asset type. There is a widespread concern that for prime properties “the best of the opportunity has already passed in London.” Indeed, a number of investors express concern at the exuberance of the rebound, commenting that “a capital markets–led recovery is leading to a bubble in pricing in the face of continuing weak fundamentals,” and “London is overheating due to a lack of supply of commercial and residential property, relative to available equity to invest.”

Others note that this recovery is taking place “only in a very small segment of the market, only the top-quality segment, perhaps 5 percent of the market,” and that there are in practice “only very few transactions taking place.”

The return of confidence in London has been sufficient for investors to again be considering development, with one saying, “Somebody is going to shoot me, but now is the time to do some development in the City—not much good stock available once existing is absorbed,” and another: “We have high expectations that we will start development next year.” The rating for this increases from 3.9 last year to 4.5 this year. With confidence in development elsewhere falling, this propels London from 23rd place for development in 2009 to fifth place in 2010.
Emerging Trends in Real Estate® Europe 2010

Vienna

Vienna is perceived as having many of the same characteristics as the German cities and attracts positive ratings from German investors who have ranked the city more highly than other respondents. This has resulted in a slight improvement in sentiment regarding investment property performance and sentiment remaining stable in respect to development. As sentiment regarding other cities has declined, Vienna has risen from mid-table mediocrity to fifth for existing property performance and seventh each for new acquisitions and development.

Milan

Milan, and Italy more generally, polarise opinion. Sentiment regarding Milan has improved regarding investment prospects and the city has risen from 18th in 2009 to sixth for existing properties and ninth for new opportunities. However, a number of interviewees questioned the relative stability of the Italian market, speculating that it may be that bad news is being deferred. Many overseas investors express concern regarding transparency, some in fairly blunt terms. Others, however, see opportunities arising from the distress, with a reduction in the level of competition. One local investor commented, “The sector is also facing a reduction in the number of the players across the real estate value chain; in terms of investors, as of today, the Italian listed companies are out of the market.”

Several respondents commented on the lack of truly prime assets in Italy. Much of the office stock in Milan and Rome is located in the historic centre of the cities and is described by a number of respondents as “obsolete.” Bureaucratic and practical difficulties in development are regarded as having prevented oversupply. In the short term, this lack of prime, income-producing properties is seen as a brake on investment as “there are few assets that appeal to the sovereign wealth funds and pension funds.” On the other hand, the best properties in Milan and Rome can maintain good rents: “In the centre of these cities, there is a limited choice of high-quality buildings. This reduces the possibility of rent fall. ‘You have to take what you find’ and there is little margin for negotiation for rental prices with the building owner.” In the longer term, this shortage of top-quality property may also represent a development opportunity as the property stock needs to be upgraded.

For acquisitions in Milan, the main focus is retail, with nearly half of respondents citing this as the preferred asset type. There were few transactions in 2009, and views differ as to whether or not this will change materially in 2010. For development, its rating and ranking remain pretty much unchanged in comparison with 2009.
Chapter 3: Markets to Watch

Istanbul
In 2009, sentiment regarding Istanbul remained strong and it was ranked third for investment prospects and first for development. There was a view last year that Istanbul would be less affected by the economic problems besetting the rest of Europe: “Economic troubles haven’t had the same impact on Istanbul’s commercial real estate as they have with other European locations.” This year, sentiment has weakened, particularly for existing properties, and Istanbul has fallen to seventh for existing properties and fifth for new acquisitions. An interviewee comments that the “investment community is very reluctant about Turkey.” Investors recognise that 2009 was a tough year, but the view is that the situation is stabilising. As one investor commented, “Nothing will be worse than 2009, but we do not expect a quick recovery in the market.” The long-term economic prognosis for Turkey generally and Istanbul specifically is extremely positive. As one international investor observes, it is a “large city with young population.” It is for this reason that investors rank Istanbul first for development, as was the case in 2009. The enthusiasm of local investors was generally greater than that of cross-border investors.

Berlin
The city continues to benefit from the generally positive sentiment regarding Germany. In 2009, it was ranked ninth, equal with Frankfurt. Sentiment has improved slightly for 2010, lifting it above Frankfurt to eighth for existing property performance and sixth for new opportunities. The prospects for development have declined fractionally, but as other cities have declined further, Berlin has risen up the rankings slightly, moving from 15th to 12th. Residential property is favoured. As one interviewee comments, “Berlin is an interesting market for residential, ‘It is hip to live in Berlin.’ ” This is reflected in the investment recommendations, with 31 percent of respondents citing residential as the preferred asset type, the highest proportion for any of the cities covered by the survey.

Rome
The general perception of the Italian market outlined in respect to Milan holds equally true for Rome, the key difference for the latter being the importance of the state to the local property market. In Rome, many of the buildings are rented to government and government-related entities. Views differ as to whether this is a positive or a negative. One respondent comments, “Rome has always been more stable, due to the enormous percentage of offices related to its capital city status,” whilst another takes a slightly different view: “Rome can be considered more risky because the

EXHIBIT 3-13
Istanbul Real Estate Market

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2010 Acquisitions Recommendation of Survey Respondents

Retail: 28.3%  Apartment Residential (Rental): 19.8%
Office: 19.8%  Industrial/Distribution: 13.2%  Hotels: 18.9%

Investment Prospects

Source: Emerging Trends in Real Estate® Europe 2010 survey.
Note: Investment prospects for 2010 are the average of scores for existing property performance and new property acquisitions from above.

EXHIBIT 3-14
Berlin Real Estate Market

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2010 Acquisitions Recommendation of Survey Respondents

Retail: 37.2%  Apartment Residential (Rental): 30.6%
Office: 15.7%  Industrial/Distribution: 5.8%  Hotels: 10.7%

Investment Prospects

Source: Emerging Trends in Real Estate® Europe 2010 survey.
Note: Investment prospects for 2010 are the average of scores for existing property performance and new property acquisitions from above.
cost-cutting governmental policy will lead to an increase in the vacant space in a situation of modest demand from the business sector.” As with Milan, the prospects for existing properties are rated pretty much the same as for new opportunities. In other cities, new acquisitions generally receive a higher rating than existing property, so that in the league tables Rome ranks higher for existing properties than it does for new acquisitions, ninth for the former and 14th for the latter. It ranks 15th for development, down slightly on 2009.

Frankfurt
As already mentioned, Frankfurt does not share fully in the generally positive sentiment regarding Germany. As one interviewee commented, “Frankfurt is still suffering.” Respondents’ key concern is the exposure to the financial services sector. It is regarded as having “dynamics similar to London” and interviewees express concern about falling rents and vacancy for offices. Some see selective opportunities arising from the distress. One respondent comments, “I would put both a question mark and an exclamation mark at the same time for Frankfurt.” One investor comments on an opportunity not widely highlighted: “Frankfurt is dramatically undersupplied with residential.” In 2009, Frankfurt was ranked ninth, equal with Berlin for investment prospects. Sentiment for Berlin has improved slightly for 2010, lifting it above Frankfurt to eighth for existing property performance and sixth for new opportunities, whilst Frankfurt has slipped to tenth for existing property performance and 11th for new opportunities. It rises slightly from 17th to 14th for development.

Zurich
Having risen most rapidly up the rankings in 2009, Zurich slips back in 2010, ranking 15th for new acquisitions, and sixth for development. It is regarded as “still strong and stable,” but has fallen back as sentiment regarding other cities has recovered.

Stockholm
One interviewee predicts “decreasing rents and increasing vacancies,” whilst others believe that the occupier market has bottomed out. Generally, the situation is “not as bad as predicted.” One interviewee is concerned that the population of investors may be limited: “The international demand for investing in Sweden/Stockholm will not increase and the national players will not get any financing.” In terms of overall rankings, Stockholm remains largely unchanged from last year—12th for existing properties, tenth for acquisitions, and ninth for development.
Warsaw

The shift in sentiment to more transparent and more liquid markets has left central and eastern Europe generally out of favour. Warsaw is cited by many respondents as a possible exception: “Central Europe—nervous except for Poland, which has a big domestic market and seems to be holding up well.” And another: “Warsaw is a possible exception to general CEE gloom—a larger, more secure transparent market.” For existing properties, one investor notes that “Warsaw has not really given us a headache.” The positive view is driven by Poland’s economic performance, coupled with a good stock of assets to acquire. As one investor observes, “The quality of buildings is rather good in Poland; growth forecasts are more positive than elsewhere,” and another: “Poland is the only market in the EU with positive growth.” Despite the positive news, there are concerns on the occupier side requiring a focus on asset management, with interviewees noting that “rents are falling,” “demand for office space is down sharply,” and “retailers are trying to link rents closer to the złoty.”

Warsaw ranked 13th for investment prospects last year and retains this position for existing property performance for 2010. Sentiment is stronger for new acquisitions, for which it is ranked eighth, with a particularly emphasis on retail, with 43 percent of respondents citing this as the preferred asset type.
Amsterdam

Amsterdam is another smaller market that has fallen in the rankings this year, as investor sentiment has turned to larger, more liquid markets and to core asset types. Even in 2009, there was a view that the city was difficult for offices, and the investment recommendations were for other asset types. This sentiment continues this year, with interviewees observing an oversupply of offices in the city.

Lyon

After being the greatest faller in the rankings in 2009, Lyon has recovered slightly this year, with positive sentiment regarding France overcoming concerns regarding secondary cities. Investors favour the broadly diversified economic base of the city. For new acquisitions, there is a recommendation of 26 percent for industrial and distribution, the highest proportion for this asset subclass of any of the cities covered by the survey.

Lisbon

Another of the smaller markets that suffer from the current interest in larger, more liquid markets, Lisbon is neither large nor does it have the scent of blood in the water to attract opportunistic investors. There is little positive or negative comment from respondents, and it remains in the lower reaches of the rankings as in 2009.
Chapter 3: Markets to Watch

Prague

As indicated already, the shift in sentiment to more transparent and more liquid markets has left central and eastern Europe generally out of favour. Prague is not felt to have the positive economic story of Warsaw: “Prague is having a tough time.” It remains more or less where it was in the rankings last year for investment, but slides down the table from tenth to 16th for development. Despite the general pessimism, some international investors are positive. “In the first half of 2010, investments will be made in Prague, which is expected to remain an interesting market.”

EXHIBIT 3-22
Lyon Real Estate Market

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2010 Acquisitions Recommendation of Survey Respondents
Retail: 29.0%  Apartment Residential (Rental): 19.4%
Office: 22.6%  Industrial/Distribution: 25.8%  Hotels: 3.2%

EXHIBIT 3-23
Lisbon Real Estate Market

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2010 Acquisitions Recommendation of Survey Respondents
Retail: 37.5%  Apartment Residential (Rental): 20.8%
Office: 22.9%  Industrial/Distribution: 6.3%  Hotels: 12.5%

EXHIBIT 3-24
Prague Real Estate Market

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2010 Acquisitions Recommendation of Survey Respondents
Retail: 39.0%  Apartment Residential (Rental): 10.2%
Office: 22.0%  Industrial/Distribution: 15.3%  Hotels: 13.6%
Brussels

Brussels is consistently average. For the last five years, it has hovered around the middle of the rankings—sometimes towards the upper end of average, sometimes towards the lower end. This year, with larger markets in favour and smaller ones not, it is at the lower end of average.

Athens

Relatively few international investors expressed a view regarding Athens, and where they did, they were generally less supportive than local respondents. Both local and international players expressed reservations about the short-term economic prospects for Greece. Two areas of opportunity were identified by respondents: In the short term, opportunities from distress, with overleveraged developers expected to find survival through 2010 a challenge; and in the longer term, opportunities from tourism. The investment recommendations were for retail, residential, and hotels, although respondents added the caveat that this would be highly selective.

Edinburgh

There was some positive sentiment regarding the city. One interviewee commented, “We are also positive about secondary cities that are main towns, such as Edinburgh and Cardiff, because they are considered primary locations by sovereign wealth funds and pension funds.” The more com-
Chapter 3: Markets to Watch

The market I’m most worried about: high vacancy rates in the office market and a difficult economic situation.” Others were even more forthright in their views. As it did in 2009, Budapest remains close to the bottom of the rankings for all of the categories. However, amongst the general gloom there are some signs of light: there are a few international investors who are starting to see opportunities. As one interviewee commented, “Budapest, with a strong tenant mix and leases signed not too long ago at a yield of 7 to 8 percent, could be an interesting investment.”

Moscow
Moscow has continued its fall from favour that started last year. In 2008, it was the highest-ranked city for investment, with one investor commenting at that time, “Prices also have gone crazy, but will stay high as long as oil stays high.” By last year, oil prices were falling and some respon-
Concern regarding the Spanish economy was widespread. One investor commented, “There has been a sharp fall in GDP, above the European average, despite the greater stability of the Spanish financial markets,” and another: “The outlook is difficult, even if growth resumes, with unemployment so high, it’s like going into a race with a big backpack full of stones.” Both local players and foreign investors are predicting higher vacancy rates and lower rents, although one observed that “Madrid is economically under pressure, but does not have a structural supply issue.” There was slightly more optimism regarding acquisition opportunities, with some investors commenting that the distress would create opportunities: “Increased activity because sellers will have to sell.” Others expressed the view that whilst opportunities would be forthcoming, it was too early to go back into the market. “Spanish cities are knocked out for some time, but Madrid and Barcelona will come back.”

Looking to the longer term, there is greater optimism, particularly from local investors, who see a long-term recovery in commodity prices driving economic and occupier recovery. Sentiment regarding development has remained relatively stronger, thus ensuring a fall only to eighth from fourth last year. The overall sentiment can be summed up by one international investor: “Russia is a big marketplace and a place to be in the future, but has enormous political and social issues.”

Madrid

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The consensus view is that development will be off the agenda for some time, with the most pessimistic saying for three or four years. Sentiment for the performance of existing properties remains the same as the rating for investment property in 2009. The sentiment for acquisition opportunities is better, lifting Madrid one place to 24th for this category. The outlook for development has declined, dropping Madrid to 27th out of the 27 cities that are ranked in the survey.
Chapter 3: Markets to Watch

Emerging Trends in Real Estate® Europe 2010

Barcelona
As with Madrid, respondents’ concerns are driven by fears over the deteriorating economic situation and rising unemployment in particular. The ratings for investment property—both existing and new acquisition opportunities—are almost identical to those for Madrid. Although the rating for development is marginally better than for Madrid, the outlook is still regarded as poor.

Dublin
In 2009, Dublin was rated lowest of the 27 cities evaluated, for both investment and development, with one investor last year commenting, "Ireland’s a real struggle, a bubble that’s popped." Despite a slight improvement in sentiment for investment, it remains in 27th spot for the performance of existing assets. Prospects for new acquisitions are slightly better, and some overseas investors are positive about the opportunities. As one investor commented, “Ireland has strengths that people are not seeing and end up focusing on its major downsides.” Unfortunately, there are insufficient respondents sharing this view to lift it from bottom place. Although sentiment regarding development prospects has declined a little since 2009, sentiment elsewhere has fallen further, lifting Dublin above Madrid and out of bottom place.
Sectors are not the key question right now,” says one participant. What matters is quality in terms of both assets and markets. “We see a push towards quality.” Though there are “very few investment transactions,” “investor appetite for well-leased, prime real estate [is] still alive.” While “at the peak you were not able to pay for prime properties,” such investments are now available at affordable prices. This indicates that location and tenants are a prerequisite for any investment activity. “We are fleeing to the larger, more liquid, more mature, more transparent markets, [favouring them over] the smaller, less liquid markets,” says one interviewee, and another: “We only go into markets which we know well and those with sufficient liquidity.” The second driver of the investment market is the occupier. “The most important thing is to keep the tenant. There should never be empty spaces, as this speeds up the fall in prices and makes it more difficult to win new tenants.”

In terms of property types, “offices and retail are the main things we would like to concentrate on.” This is echoed by these comments: “Focus on office and retail” and “strategic sector: office and retail.” It has to be noted, however, that the current market is still suffering from inertia and “commercial property investment activity remains weak,” not least due to a lack of debt finance available.

Looking at the performance prospects of the main property types, the ratings for offices, industrial/distribution, and hotels weakened, while retail and mixed use are roughly in line with last year’s marks (Exhibit 4-1). Overall, apartmants for rent are taking the lead (4.9 points) in the performance outlook on existing properties. Together with apartments for sale (4.4 points), these sectors were the only ones that were awarded higher performance ratings than last year.
Emerging Trends in Real Estate® Europe 2010

(Exhibit 4-2). All categories bar one are deemed to deliver “fair” prospects. Apartments for rent and retail take the top spots (5.2 points) followed by offices (5.1 points), while residential for sale, mixed use, and hotels were assigned 4.8 points. The outlook for industrial/distribution is considered “modestly poor.”

The deteriorating ratings in the commercial property sectors are a reflection of the apprehension felt about a downturn in the letting markets. “We have seen a clear adjustment of yields; what we don’t see at all yet is an adjustment in the occupier markets. I am absolutely certain, that apart from the yield correction which has happened this year, we shall see a correction of rents.” The “end-user market is something everybody needs to be wary of—if there is less demand for space, logic says that rental values will fall. I am not sure that the investment community has got to grips with that.” “Tenant demand will fall more in the coming months.” “As properties need to be occupied, the greatest challenge is in the occupational market,” says one respondent, and another: “The lettings markets will be difficult in 2010.” “Tenants are kings. The market will be driven by tenants.” Property owners are responding to these concerns by saying, “Letting will be our key activity in 2010 and it will hold the highest priority,” and “our focus will be on asset management activities and securing a stable cash flow for our portfolios.”

Given the fears about occupier markets, new development has been put on the back burner. Except for residential for rent (4.5 points), which manages to just cross the line into the “fair” category, prospects for development are regarded as “modestly poor” for all property types. In
the subsectors, manufacturing and suburban/out-of-town offices are not considered valid development propositions; with ratings of 3.2 and 2.9 points, they hold no more than “poor” prospects. Not only do these sectors not warrant new development, there is also a huge question mark hanging over existing stock as this interviewee notes: “We have seen some very large transactions in secondary and tertiary locations or in primary locations in secondary and tertiary cities in the past, the equity in them is gone, the exit into the capital market has been abandoned, it is as yet unclear what happens to them.”

By and large, cap rates have undergone an adjustment and shifted outwards (Exhibit 4-5). In 2009, the adjustment was much greater than participants had anticipated in their forecast for 2009. Compared to the yield increases, expected yields are now 100 to 150 basis points higher for the different segments. Now the market seems to have hit the trough. For 2010, cap rates for most sectors are expected to stabilise or to decrease slightly.

With a cap rate of 6.52 percent, rented apartments remain the most expensive property type. Price rises are expected over the coming 12 months with a cap rate reduction of 21 basis points. The category remains the most expensive one. Apartments for sale are considered less of a buy, with cap rates moving up by 38 basis points to 7.33 percent. Together with hotels, they are the only categories that are expected to see further falls in values. Yields for street retail (7.16 percent) are almost on par with central city offices (7.21 percent). This demonstrates continued demand for core assets. Over the next 12 months, these properties are expected to become more expensive, with yield reductions of 15 and 20 basis points, respectively.
Despite these caveats, both institutional and private investors are keen to get invested in the sector. "Institutions are looking for reasonably sized transactions." "We buy residential to rejuvenate our residential portfolio—not because the yield expectation is spectacular, but at the moment a residential investment at 4.5 percent is more attractive than a government bond." Large and medium-sized transactions were notable by their absence, but "the market for small-ticket trading in the order of €3 million to €10 million is alive and kicking. Regional investors are buying to consolidate their positions in local markets and they are prepared to pay reasonable prices," observes one interviewee. Yields for rented apartments are expected to firm up by about 40 basis points to 6.3 percent.

Inflation fears are also generating interest in the residential sector. "Due to inflation fears, there is a big demand for [for-sale] apartments in some markets that were not affected by a housing bubble [e.g., Germany]." There will be "increasing demand in good- and medium-quality locations, because private investors like family offices and high-

### EXHIBIT 4-7
**Best Acquisition Opportunities by Sector and City in 2010**

<table>
<thead>
<tr>
<th>Sector</th>
<th>Office</th>
<th>Retail</th>
<th>Industrial</th>
<th>Apartment</th>
<th>Hotel</th>
<th>Any Sector in City</th>
<th>Best Sector for Acquisitions in City</th>
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</thead>
<tbody>
<tr>
<td>London</td>
<td>12.7%</td>
<td>4.8%</td>
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<td>7.9%</td>
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<td>Paris</td>
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<td>8.7%</td>
<td>10.1%</td>
<td>Office</td>
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<td>3.3%</td>
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<td>8.7%</td>
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<td>Office</td>
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<td>Barcelona</td>
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<td>7.0%</td>
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<td>5.2%</td>
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<td>4.7%</td>
<td>4.1%</td>
<td>6.9%</td>
<td>Office</td>
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<td>Madrid</td>
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<td>6.6%</td>
<td>Hotel</td>
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<tr>
<td>Moscow</td>
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<td>2.6%</td>
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<td>6.2%</td>
<td>Hotel</td>
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<tr>
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<td>Industrial</td>
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<tr>
<td>Rome</td>
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<td>3.7%</td>
<td>1.1%</td>
<td>3.1%</td>
<td>5.6%</td>
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<td>Hotel</td>
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<tr>
<td>Prague</td>
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<td>4.9%</td>
<td>2.7%</td>
<td>1.6%</td>
<td>2.5%</td>
<td>4.9%</td>
<td>Retail</td>
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<td>Helsinki</td>
<td>2.6%</td>
<td>2.5%</td>
<td>4.9%</td>
<td>2.9%</td>
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<td>Industrial</td>
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<tr>
<td>Amsterdam</td>
<td>2.8%</td>
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<td>2.5%</td>
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<td>3.1%</td>
<td>3.8%</td>
<td>3.9%</td>
<td>1.7%</td>
<td>3.8%</td>
<td>Apartment</td>
</tr>
<tr>
<td>Budapest</td>
<td>0.5%</td>
<td>2.0%</td>
<td>3.8%</td>
<td>2.3%</td>
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<td>Industrial</td>
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<tr>
<td>Vienna</td>
<td>2.6%</td>
<td>3.1%</td>
<td>0.5%</td>
<td>2.6%</td>
<td>3.3%</td>
<td>3.3%</td>
<td>Hotel</td>
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<tr>
<td>Lisbon</td>
<td>1.9%</td>
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<td>2.6%</td>
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<td>Retail</td>
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<td>Zurich</td>
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<td>Edinburgh</td>
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<td>Office</td>
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<td>Brussels</td>
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<td>Industrial</td>
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<tr>
<td>Copenhagen</td>
<td>1.7%</td>
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<td>1.6%</td>
<td>0.4%</td>
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<td>Retail</td>
</tr>
<tr>
<td>Dublin</td>
<td>1.4%</td>
<td>0.8%</td>
<td>1.6%</td>
<td>1.0%</td>
<td>0.4%</td>
<td>1.6%</td>
<td>Industrial</td>
</tr>
</tbody>
</table>

Source: Emerging Trends in Real Estate Europe 2010 survey.

Note: Survey respondents were asked to choose—for any city where they were active—one property sector that offers the best acquisition opportunities in 2010. Any result of 5 percent or more appears in bold for easy reference.
According to the survey, rented apartments are deemed to offer the best chances for development among the property types, but the outlook remains “modestly poor.” Development of the for-sale apartment sector is hampered by the lack of mortgage financing available to homebuyers. “There should be certain growth due to the returning accessibility of mortgages.”

Best Bets

Cities that offer the best apartment acquisition opportunities, according to the survey, are Berlin, Munich, London, Hamburg, Paris, and Istanbul, in that order. “It is hip to live in Berlin,” says one interviewee, a view shared by other participants. Matching sector to city prospects, almost one in ten respondents regards Berlin as a top location for residential investment (Exhibit 4-7). The other large German cities are also considered to offer good prospects as there has been “practically no new developments in the sector.” “Hamburg, Munich, Stuttgart are all undersupplied with attractive residential units of high quality.” Demand for affordable housing in Germany is also “likely to rise as the redistribution of income at the macro level will lead to [growth in] the number of low-income households.”

While prospects in the U.K. housing market are bleak, London is considered to play in a different league. “Rents may pick up slightly in London/South East and values are expected to rise.” “The 2010 outlook is positive for London residential. Values will pick up.”

Development

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Markets to Watch

In Poland, market conditions in the residential sector are expected to improve, since "no investment [was] started in 2009. Therefore, we expect an upturn in the market in the next two years." "Price rises are expected from 2011 onwards, however, not to the extent as in 2006–2007."

The housing market in Frankfurt is one of mixed fortune. "I would put both an exclamation [point] and a question [mark] to Frankfurt." There is clearly a "lack of quality space in the inner city," says one respondent, and another: "Frankfurt is dramatically undersupplied with residential." But slim opportunities to increase rents coupled with high construction costs limit the chances of economic success when it comes to residential development. "If there is money to be made, it is in site development."

Avoid

In Spain, oversupply needs to be absorbed. "Some of the stock will never be sold given its location. The coastal residential unit sales will take longer than urban units." For the time being, there is "no new construction until existing stock is absorbed." "Rents have not dropped dramatically. However, [as] some vacant residential buildings [for sale] will be rented in the future, rents will decrease." "Banks are selling some of their schemes with 20 to 30 percent discount with very good financing conditions." First-time buyers are active "since the sellers started to drop prices." Some forward-thinking players are embarking on land development to ensure a steady development pipeline once the situation improves.

Retail

"The retail sector’s prospects are relatively good, probably the best of [the] commercial property types." "Very good prospects for quality retail products—i.e., well positioned and with sound tenants." "Quite positive expectations" and the "retail market manages quite well in the current market conditions. Rents are relatively stable."

These comments reflect a degree of faith in the sector; however, considerable worries in terms of unemployment and loss of consumer confidence are in the offing. "Due to rising unemployment, consumption will remain low in all the established economies; therefore, prospects for the retail sector are rather negative." Even though in general terms consumption holds up, "we have to be worried about this and how long it is going to last." "In general, vacancy rates are relatively low and the prospects of retail markets are generally good. Nevertheless, rents will remain under pressure for another two to three years as retail sales are affected by higher unemployment. "Retail will see a longer, but less intense, downturn than the office market." "If there are more people out of work, more people having less money, turnover in shops is going down, rents [are] going down, and shopping centre values [are] going down. I don’t think we have seen that yet." "Tenants are suffering. Sales are only slightly decreasing, but at the detriment of margins."

Not all retail formats will be hit to the same extent. "Stores more focused on the primary necessities of life will feel less of the recession." "People always need food—it is just a question of where they buy it," and if "you have discounters in your portfolio, it will hold up pretty well." "People will continue to consume, discounters will work." The factory outlet business will achieve a good operating performance as "people still spend money, just in different places."

Concern about the luxury segment is voiced. "I think we are seeing trouble at the higher end of the retail market at the luxury end." "High-end goods and shops suffer." "High-end [goods are] possibly more difficult, luxury segment may suffer."

Looking at the subsectors, street retail receives higher marks than shopping centres and retail parks. "High-street assets represent still a good opportunity of investment since the prices are sensibly decreasing. It’s a really good period to go for it," says one interviewee. "High-street retail will work," a view shared by this participant: "Potential in high streets in bigger cities." For the existing stock performance, street retail collects 4.8 points, while prospects
Emerging Trends in Real Estate® Europe 2010

Chapter 4: Property Types in Perspective

Concept will be affected more severely,” so we are witnessing the “survival of the fittest.”

Retail parks are considered the weakest retail segment. “Retail parks have no future since consumers lack spending power.” “Retail parks are a no-go.” “Large-scale retail is not performing well.” “Large-scale retail parks will suffer.” For both new property acquisitions and existing properties, the performance outlook is “fair” at best.

“Today for prime shopping centres, [yields] would be 6 percent–plus, and then you go up depending on what country or what city you are talking about.” According to survey participants, street retail is the most expensive retail format with a yield of 7.16 percent, followed by shopping centres with 7.53 percent and retail parks with 7.8 percent. In 2010, yields for street retail and shopping centres are expected to firm up by 20 basis points and a lesser improvement for retail parks.

Development

Given the uncertainties about economic development in general and consumer confidence in particular, development opportunities are not very high up on the agenda of our survey participants. In some markets—Moscow, for instance—land prices have come down. That makes new development more viable in theory, but the lack of debt finance puts a serious stop to any kind of new development.
Emerging Trends in Real Estate® Europe 2010

Best Bets
Cities that offer the best retail acquisition opportunities, according to the survey, are Berlin, Paris, Munich, Barcelona, Hamburg, Frankfurt, Milan, and London, in that order. The outlook is “reasonably good for German retail.” Berlin attracted the highest number of votes, but Munich, Frankfurt, and Hamburg are also viewed positively. Some observers regard the German market as having “too much retail space per capita, there will be no growth in retail space. Leasing will remain stable at ten-year averages and better quality will win the competition.” But “the market accepts good products, always bearing in mind that it is difficult to close big-ticket transactions.” Initial yields for shopping centres are 6 to 6.5 percent. “This is the level we had before the bubble, compared to the bond market you have got a premium.”

Markets to Watch
Among the new economies in eastern Europe, Poland stands out as a country that is likely to experience an earlier recovery than its neighbours. “It is our impression in Poland they are not hit in the same way as are other [markets].” “Activity levels are really quite good; retail offers possibilities.”

Avoid
Southern Europe has also been crossed off the wish list. “Spain [is] a write-off for ten years.” “Spain and Portugal are overheated, some shopping centres will die.” Central and eastern Europe (CEE) stirs up similar sentiments: “CEE? Forget it—sell stock or have a long horizon.” “The investment community is very reluctant about Turkey and Bulgaria, not to mention markets like Ukraine and Russia, which are completely dead.”

In terms of per-capita retail turnover, the U.K. leads continental Europe by a wide margin. “More unemployment and more taxation are going to reduce retail spending.” This will create difficult trading conditions for retailers. “There won’t be many winners and there will be quite a few losers.” London is seen as a comparatively safe haven, but the “rest of the U.K. [is] worrying.”

Anything that does not stand the location test will be difficult, hence a “poor outlook for secondary locations, C-locations, and properties on the periphery.” “Secondary shopping centres and retail parks will have high vacancy rates,” and “secondary will suffer very much or even close [its] activity.”

Office
The office sector is “one of the sectors that still work even during a crisis period.” While this statement points to enthusiasm in office properties, a caveat applies: “provided they are in prime locations.” Investors “will focus only on the high-quality assets, already rented to very good tenants and based in the best central locations.” “Prime targets and areas will perform relatively well.” “Flight to prime assets.” “Flight to well-located, good-quality buildings.” “Central city offices will be good.” On the flip side of the quality coin, “everything that is not prime, in terms of both location and quality, will take much longer to recover,” and “very low appetite for second-class assets.”

Values have taken a hit, and “significant yield correction has happened in most markets.” “Adjustments in value in most markets are around 30 percent down.” Talking about London and Paris, one respondent says: “I think we would not look today at those cities less than 6 percent–plus, which is a 50 percent difference in yields.” Some regard the correction on London offices as an exaggeration; future expectations suggest that “yields should stabilise in December 2009 and decrease in 2010 for prime assets.”

Major worries over the occupier markets are voiced. “The office sector is possibly the most fragile or vulnerable to further downturn, based on the hypothesis that unemployment will increase and therefore office demand...
Chapter 4: Property Types in Perspective

must fall." The “economic downturn reaches office markets with a time lag: if you regard 2009 as the year of an economic downturn, it has not yet affected the office market.” “Companies are looking for flexible workplaces for their employees and the average square metres per employee will decrease, so the office space needed will decrease.” Due to the “return of M&A activity, you are seeing high vacancy in a lot of markets.” Other participants take a more sanguine stance: “Office markets in Europe are generally in reasonable shape. Occupier markets are weaker than two years ago, [there are] higher vacancy rates, but not to the extent that letting markets are completely dead.” “There will be lettings against the backdrop of consolidation processes; some occupiers will take advantage of their strong position to extend their leases, but on different terms. Alternatively, they may look for new, more efficient space and lower gross rents in energy-efficient buildings.” Overall, letting will become a more tedious affair. “Lease renegotiation could become more difficult to manage.” “Now you try to keep your tenants in your property, even if this means that you have to make concessions in terms of

EXHIBIT 4-17
IPD Office Property Total Returns for Selected Countries

EXHIBIT 4-18
Office Prime Property Yields

EXHIBIT 4-19
Office Vacancy/Availability Rates

Source: Investment Property Databank (IPD).
All returns in euros.

Source: CB Richard Ellis.
is supply for the next one or two years coming on stream in quite significant amounts. But beyond that, it starts to become more sensible.” “Over six months, the market will tighten and there will be a big spike in rentals as a result of shortage of space.”

Solid fundamentals are the driving force for bargain hunters in Paris. “Paris seems in a good position compared to other major cities in Europe.” “Prime locations in Paris will hold values; however, [there are] greater opportunities and higher yields just outside of Paris where you have good transport links.” “France has reduced the supply of new development/buildings very quickly, which is good. Volume will remain low.”

Development
“There’s not a lot of new stuff coming onto the market, though. Pre-leases are very valuable right now, and a requirement for financing.” At the same time, “the development pipeline is drying up completely.” Hence, “anticyclical project developments make sense, but you have to fund it entirely with equity. That is difficult.” For developers, new office buildings hold a competitive edge in terms of space and energy efficiency over older stock. “This should trigger corporate users to exchange old buildings for newer buildings.”

Development prospects for the sector deteriorated compared with last year. For central city offices, they are now rated “modestly poor”; out-of-town/suburban offices are considered to hold only “poor” prospects.

Best Bets
Cities that offer the best office acquisition opportunities, according to the survey, are London, Paris, Munich, Frankfurt, and Madrid, in that order. As investors are flocking towards large, liquid markets, it doesn’t come as a surprise that the survey participants consider London and Paris the most-favoured markets. In London, values have adjusted. “The warning lights are still flashing, but new development activity has ground to a halt, so there still is supply for the next one or two years coming on stream in quite significant amounts. But beyond that, it starts to become more sensible.” “Over six months, the market will tighten and there will be a big spike in rentals as a result of shortage of space.”

Proceed with Caution
While interest in central and eastern Europe has generally waned, the Warsaw office market may be an exception to the rule. “Poland remains an attractive country for BPO [business process outsourcing] companies.” “In case of an economic recovery next year, we can expect rent
increases in [Warsaw’s] CBD in 2011–2012 as there is no supply there.” “Rents decreased significantly in 2009,” but the decreases are expected to stop in 2010 as there are fewer projects in the pipeline and “demand from prospective tenants is expected to increase” in line with improvement in the overall economic situation.

Avoid

“Avoid business parks and fringe locations.” “More vacancy and a decrease in the value of portfolios in B and C locations.” “Office centres outside cities will be difficult.” “The value of old properties will be under more and more pressure in 2010 since there will be no tenants for these buildings.” Only the bravest and most adventurous players are pondering the question: “Is quality the only thing that matters or are you willing to buy secondary quality on the view that, on a five-year position, inflation is coming? Therefore, I gotta have some of this.”

Mixed Use

With mixed use having been in the spotlight in recent years, particularly in the context of urban renewal schemes, this year’s survey participants were much less inclined to comment on it. This may be attributed to the fact that mixed use mainly relates to new development and to a lesser extent to existing schemes. The sector may offer value as these comments suggest: “In terms of cities being renovated, being restructured from the inside, these mixed-use projects make a lot of sense.” “In most cases, well-designed, mixed-use projects raise the quality of the area and are therefore valued by investors.”

As noted earlier, liquidity is looking for core-type investments, with office and retail being most attractive. In general, mixed-use products are a “very difficult product for investors to understand.” Selling a mixed-use scheme as a whole may thus be difficult; breaking it up into core components may prove more effective, as the following remark suggests: “I do believe that mixed-use projects make sense, but they probably make sense as a development project that gets split in ownership. I am not sure that the same person should own all of it at the same time.” “Appetite for mixed use depends on the way the product is sold. If it’s possible to decouple units and sell mono-functional blocks, there won’t be a problem. Quality of the surroundings will be important.” Some respondents sound a note of caution. “Mixed use, mixed picture,” so the verdict of one interviewee. “We think only a small part of the total investment on them will have success in the future. Nevertheless, to hope getting a good return on this kind of asset, we think the developers should choose locations near to retail parks or commercial centres.” For others, “regeneration schemes will remain unviable.” In the relative ranking of the sectors, mixed use fell from third position last year to sixth place for existing properties and for new acquisitions to ninth place, with “fair” performance expectations for both.

Yields are expected to soften slightly. For 2010, the forecast for mixed-use yield is 8.16 percent, compared to 8.06 percent in 2009.

Given the deteriorating conditions in the occupier markets in general, getting new schemes off the ground in the near future may not be an easy endeavour. “For our developments, we need prelets of 60 percent; this allows us to service the debt.” Despite taking up the position as runner-up for new developments (4.4 points), it holds only “modestly poor” prospects.

Some urban renewal schemes are currently underway. For example, in Germany the redevelopment of former railway sites in Frankfurt and Munich is taking shape. Development of sites in the neighbourhood surrounding the new Central Station in Berlin is scheduled to commence in 2010. While these schemes are office-led, in the Netherlands some construction on some retail-led developments has started.

Industrial/Distribution

“Logistics firms are the early-warning system,” says one observer, “because the lease agreement, construction time, and adjustments of supply happen much faster than in the office sector,” explains another. “This sector suffers most at present,” but “core investments will work.”

Two aspects are of key importance. First, “the location is a main factor and the property should be located in a strong industrial cluster.” “The focus is more on the prime end of the range, e.g., major ports and airports are still attractive; more peripheral areas are likely to struggle.” “Anything that is not in a port or on the edge of a big city centre or is slightly older is going to suffer a lot.”

<table>
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<td>New Property Acquisitions</td>
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<td>Development</td>
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Source: Emerging Trends in Real Estate Europe 2010 survey.
The gap between office yields and logistics has widened. Some regard this as a temporary phenomenon: “Yield spreads between office and logistic will narrow again; I don’t think that a gap of more than 3 percent is justified.” Yields for warehouse distribution are expected to improve by 23 basis points to 8.4 percent by the end of 2010.

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**Development**

Some observers expect “a big increase in vacancy in industrial/distribution.” As “occupier demand is muted,” new developments require a prelet. In some markets over-supply needs to be absorbed, so “you only build if you have got a tenant—developments on spec are rare.”

In terms of location, “there is a chance for new distribution centres in dependence of even stronger just-in-time production processes.” “There will be a few new logistic hubs—you need to own the operator rather than being chased by the few international operators.” This view is echoed by this comment: “The industrial sector will raise investments only from specialised operators. Nonspecialised operators will quit this sector.” “[The] prospects in 2010 and 2011 are very poor indeed; [the market] will come back, but at a much lower rent level.” It is difficult to make out the winners, rather “it is a moving feast and there are no particular consistencies across the European map. Every country’s logistics system is a little different. We always have one eye on the unexpected and we remain truly opportunistic.”
Chapter 4: Property Types in Perspective

**Best Bets**

Ranking the cities in terms of sector prospects shows Hamburg as the leading light for industrial distribution. While struggling as “the production sector stepped on the brake, with positive signs from China, India, and Asia, exports can become a driver for the German economy, [so the] sector will benefit.”

Survey participants are also attributing positive perspectives to Lyon, Istanbul, Barcelona, Frankfurt, Warsaw, Helsinki, and Prague. In Spain, the favourable outlook is not so much driven by positive economic development, “but Spanish companies have started outsourcing distribution, so as they downsize and restructure, [it] creates demand.”

**Avoid**

In Poland, “demand decreased significantly, tenants are offered huge incentives.” The industrial market is experiencing “still-significant vacancy, so the owners will focus on renting the available space rather than building new [space]. The only activity expected is on the build-to-suit market; very limited other development.”

“[The] industrial sector and logistics, especially [in Russia], are facing severe challenges due to the dramatically decreased volume of industrial exports.” Therefore, any signs of improvement in the logistics market depend on an economic recovery, which is not expected to start before 2011. As in other markets, “there will be more build-to-suit rather than speculative investments.”

“Logistics represents one of the worst real estate sectors” in Italy. Facing oversupply, “the market is suffering, because of the decline of manufacturing. Most of the production has been transferred abroad.” “There is an oversupply of new logistic premises. It is a sector with tight margins.”

**Hotels**

“The hotel market has been [affected] by the global recession and is bouncing along the bottom as transaction volumes remain very thin. In the first six months of 2009, the volume of transactions was similar to that of the same period in 2002, one of the worst periods.” “Very, very quiet on the transaction front.” “It has always been the slightly more adventurous investors who got into hotel ownership and whilst there has been a huge element of education

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**EXHIBIT 4-26
Industrial/Distribution**

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Source: Emerging Trends in Real Estate Europe 2010 survey.

**EXHIBIT 4-27
Warehouse Distribution**

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Source: Emerging Trends in Real Estate Europe 2010 survey.

**EXHIBIT 4-28
Manufacturing**

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Source: Emerging Trends in Real Estate Europe 2010 survey.

The category includes two subsectors: warehouse distribution and manufacturing. The former is held in higher esteem (4.4 points) than the latter (3.7 points), but both are considered “modestly poor” performers. New property acquisitions of warehouse distribution are expected to offer better value and are rated as holding “fair” prospects (4.6 points.)

**Manufacturing**

“This market is suffering.” Due to the decline in manufacturing as a result of outsourcing processes, the subsector has long been seen as one of the least-attractive ones. New property acquisitions are viewed as “modestly poor” and the outlook for new developments is no more than “poor.” Yields are expected to move up marginally to 9 percent in 2010.
Emerging Trends in Real Estate® Europe 2010

**EXHIBIT 4-29**

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Source: Emerging Trends in Real Estate Europe 2010 survey.

Over the last five years to widen interest in the sector, if we want some real stability we need to attract people like the pension funds and the longer-term investors.” It may be a while off for these investors to arrive, particularly as hotel assets are now viewed as a risky asset class. “We think that this kind of asset is really becoming more risky. On one side, the new rent contracts are variable and based on the return of the hotel itself; and on the other, a strong knowledge on the hotel manager’s quality is required.” “Contracts are such that the hotel manager transfers the entrepreneurial risk to the investor.” “Hotels are doing quite badly, so that there are several renegotiations of the contracts where the rents are calculated as a percentage of sales, with an increase in the risk for the owner.” “We don’t terribly like the risk, as a whole it is not our sector.” “Values have fallen 30 to 40 percent,” and the hotel sector “is seen [as being] in big crisis,” hence “our objective is getting out of the hotel sector.” Trading conditions for hotel operators will remain difficult. “2010 will be a hard year.” “[The] hotel industry is late in the real estate cycle. Therefore, recovery will not take place before 2011,” and “negative forecast for 2010. Recovery as from 2011 expected.”

This seems to suggest that the hotel sector offers an opportunistic play: “bottom of the cycle, interesting time to look at them and buy them.” “There are opportunities. Returns are now sensible and there are distressed situations.” For the time being, these seem to be more of a theoretical nature. “Partly due to the low interest rates, banks didn’t have to pull the plug on many loans. Because of that, the bid/ask spread is very high—people aren’t prepared to sell at discounts when they see what the purchase price was even two years ago.”

In the ranking for the main sectors, hotels dropped from second place last year right down to the bottom spot. Rated 4.2 points, performance expectations are “modestly poor.” New hotel acquisitions receive a higher rating of 4.8 points and prospects are considered “fair.” Yields are expected to increase by 15 basis points, evidencing the poor outlook for the category.

Opinions on the relative performance of the different hotel categories span a wide range. For some, “the top end of the market—i.e., four- and five-star hotels—suffers a lot.” “The best return [forecasts] for hotels are for the medium-level categories, while luxury and low-budget ones are generating profits.” “Best values will be among three- to four-star portfolios.” “Volume business will fare best. However, there will be interest in opportunities all through the spectrum.” Others expect a polarisation. “The two-star segment will grow, four-star will do well, three-star will become extinct.” “Middle market is getting killed.” “Budget hotels are performing well, so they will also in 2010.” Weaker chains will face a tough time, “due to a lack of access to booking systems.”

**Best Bets**

Cities that offer the best hotel acquisition opportunities, according to the survey, are Paris, Istanbul, London, Barcelona, Madrid, Moscow, Munich, Berlin, Athens, and Rome. “London and Paris are the two markets that have the strongest interest from non-European investors. Whilst there is interest in other significant cities, these two are head and shoulders above the others in terms of interest.” “Top-end hotels in London are doing fine. Super top end will be held.”

**Proceed with Caution**

Tourist hotels in Spain are expected to benefit from economic recovery in other parts of Europe. While occupancy rates showed a “decrease of 10 percent, the high dependence on U.K. and German [visitors means that] they will recover in line with their economies.” Barcelona is facing “oversupply in the luxury sector. Tourism will be reduced in the next years, with direct impact in the sector. Cost-cutting policies in companies will have direct negative impact on the urban sector. Lower rates and lower occupancies. 2010 will not be better than 2009.”

“The Moscow hotel market looks a bit shaky. Not really much happening. Hotels are clearly one of the most problematic areas anywhere in Russia, primarily in Moscow. A lot of activity was directed at the more glamorous stuff of which there was oversupply.” At the same time, there is a shortage of hotels in the lower segments. “The recession is adjusting behaviour to do something far more sensible in terms of hotels, but again that is the most positive spin you could put on it.”

This budget segment may also be an interesting invest-
ment proposition in Poland. “People are travelling in Poland and they want to stay in cheap roadside hotels. In the medium term, that is quite a sustainable model. In all of central Europe, any strategy that looks at trying to focus on growing spendable income at the lower level comparative to the West in our view is quite an interesting one.”

**Avoid**

“Berlin [is] massively oversupplied in the last five years; the crazy thing is people still want to buy hotels.” “Berlin is a difficult market—family-owned hotels will die.” Some of the smaller capitals and secondary cities have been dropped from investors’ radar screen. Cases in point are Lyon, Edinburgh, Copenhagen, and Dublin.
Interviewees

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Aberdeen Property Investors
Alessandro Bronda
Bob Reidtsma
Andrew Smith
Acciona Inmobiliaria
Isabel Antúnez
AFIAA Investment AG
Brauwers Hans
AFI Europe Romania
Rox van der Hovar
AG Capital
Georgi Pavlov
Aguirre Newman
Jaime Pascual-Sanchiz de la Serna
Allianz Real Estate
Olivier Piani
Altera Vastgoed NV
Cyril van den Hogen
AMB Generali Immobilien GmbH
Bernhard Berg
Annexum
Huib Boissevain
Apellas Asset Management GmbH
Ulrich Weber
ASR Vastgoed Vermogensbeheer
Dick Gort
Assoimmobiliare
Guilherme Tamburini
Atrium Ljungberg
Anders Nylander
Aviva Investors
John Buckley
John Gellatly
AXA Investment Managers Schweiz AG
Rainer Suter
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Dennis Lopez
Kiran Patel
Hermann Montenegro
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Pietro Macri
Roberto Ponte
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Cirrus Andrus Cabot
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Sergey Egorov
CIT
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Peter Roscrow
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Steven Shone
Vladislav Sourskov
Coalco Development
Will McFarren
Colonial
Juan Celli
Colonial Capital
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Carl-Christian Siegel
Compagnie La Lucette
Thomas Guyot
Cordea Savills
Justin O’Connor
Piergiulio Dentice di Accadia
Cristiano Ronchi
Corio
Gerard Groener
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Carla Gianini
Ian Marcus
Rainer Schenew
Cushman & Wakefield
Harry Farthing
Braxus Kell
Mark Stiles
Jet Van Doorslaar
Eric van Leuven
De Alliantie
Arnold Purevend
Deka Bank
Matthias Etienne
Mark Titcomb
DELA Vastgoed
Pieter Leeflenn
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- Product structuring and advice (the establishment of real estate funds, REITs, and property derivatives);
- Transactions;
- Assurance and compliance; and
- Operational efficiency and sustainability.

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The mission of the Urban Land Institute is to provide leadership in the responsible use of land and in creating and sustaining thriving communities worldwide. ULI is committed to:

- Bringing together leaders from across the fields of real estate and land use policy to exchange best practices and serve community needs;
- Fostering collaboration within and beyond ULI’s membership through mentoring, dialogue, and problem solving;
- Exploring issues of urbanisation, conservation, regeneration, land use, capital formation, and sustainable development;
- Advancing land use policies and design practices that respect the uniqueness of both built and natural environments;
- Sharing knowledge through education, applied research, publishing, and electronic media; and
- Sustaining a diverse global network of local practice and advisory efforts that address current and future challenges.

Established in 1936, the Institute today has more than 31,000 members worldwide, representing the entire spectrum of the land use and development disciplines. ULI relies heavily on the experience of its members. It is through member involvement and information resources that ULI has been able to set standards of excellence in development practice. The Institute has long been recognised as one of the world’s most respected and widely quoted sources of objective information on urban planning, growth, and development.

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