CB RICHARD ELLIS
MarketView

European Capital Markets

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Q2 2009

Quick Stats

	Change from H2 08	Change from H1 08
Total Turnover	↓	↓
Cross Border (%)	→	↓
Yields	↑	↑
Capital Values	↓	↓

Hot Topics

- Investment activity was low in H1 2009, at just €25 billion, but showed some signs of recovery towards the end of that period, with higher levels of investor interest and activity.
- The UK and Spain appear to be at the forefront of the recovery in market activity, with investors spotting value in the substantial repricing that these markets have seen.
- Cross-border activity is at a relatively low level and is primarily intra-region. With US investors largely absent from the market German, Irish and British investors accounted for nearly half the cross-border investment in H1 2009.

OVERVIEW

The first half of 2009 has been an exceptionally quiet period in terms of the total value of commercial property investments traded in Europe. However, it is possible to take some positives from the trends seen.

It was clear that investor interest – at least in Western Europe – was turning up towards the end of that period, and was beginning to be reflected in higher transaction levels in the last few weeks of the second quarter.

The trend in prices also seems to be stabilising, with prime yields showing little change quarter-on-quarter at the end of Q2. However, as the effects of the recession are further reflected in the occupier market, falling rental values mean that capital values are still declining.

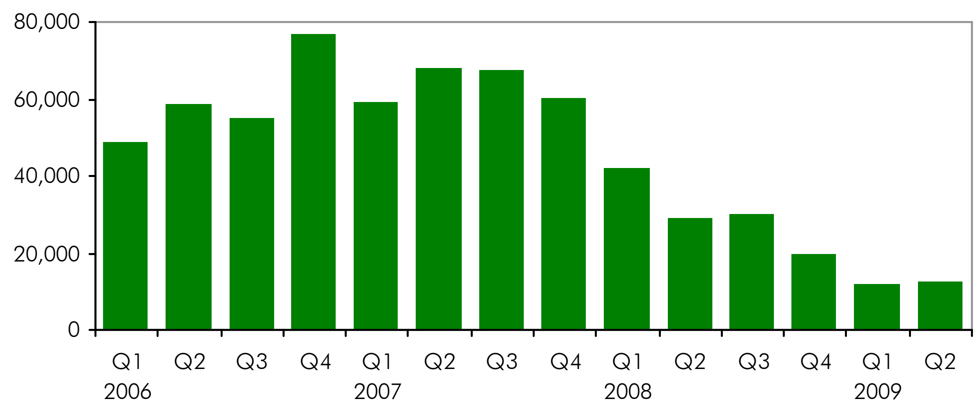
One of the more perplexing aspects of the current market is the very small number of genuinely distressed sellers. The evidence of the amount raised by opportunity funds (and the rates of return that they are targeting) suggests that fund managers have been expecting to be able to cash in on a substantial amount of forced selling. However, it is hard to find many actual examples.

As a result it is frequently said of the market that it is lack of appropriate product – or at least product at the right price – that is keeping down the level of investment turnover.

One reason for this lack of distressed sellers may be that the recession has not yet been fully felt in the occupier markets. Although rental values have been falling for a while, the impact on vacancy rates has so far been limited. Coupled with the low level of interest rates, this means that the vast majority of loan defaults have been of loan-to-value covenants rather than actual payment failures. While payments continue to be made the banks see little point in calling in the loans.

Looking to the future, there are two important facets to the evolution of the market. Firstly, when and to what extent, will the banks start to generate significant amounts of turnover by calling in loans? Secondly, will the effect of the recession on rental values be more or less than the market is currently pricing in? At the moment both of these suggest a long slow recovery rather than any sort of immediate bounce back in capital values.

Total Commercial Real Estate Investment Turnover in Europe (€ million)



Source: CB Richard Ellis

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CROSS-BORDER INVESTMENT

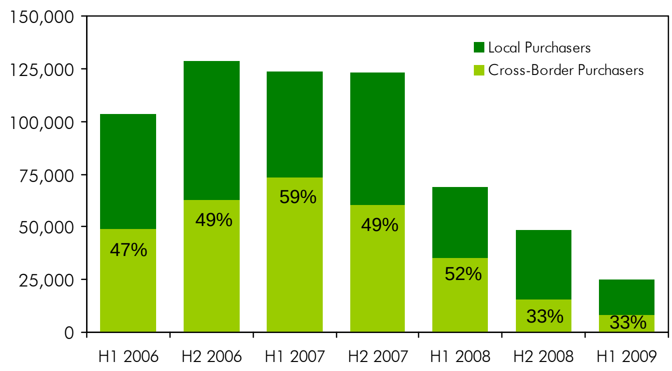
The lower volume of transactions due to the credit crunch and the downturn in the market continues to result in a lower proportion of cross-border investment. In the first half of 2009, only a third of deals involved a foreign buyer – matching the position in H2 2008. This finding contrasts with anecdotal evidence from CB Richard Ellis investment teams, who have described investor interest in the market at the moment as "... as international as they have ever seen it." However, so far that interest does not appear to have translated into many transactions.

A possible explanation for the lower level of activity by international investors is the substantial changes that have occurred in the average lot size being transacted. Traditionally cross-border investors are over-represented in the largest deals and it has been this part of the market that has seen the greatest contraction during the credit crunch. However, further analysis shows that the lower proportion of cross-border activity has been repeated across the entire market, including the few large lot-size deals that have taken place.

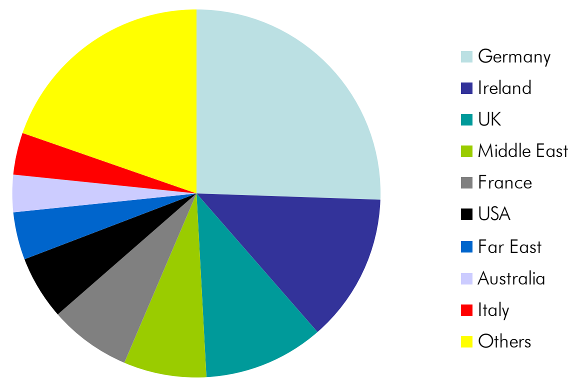
The most active cross-border buyers in H1 2009 were the Germans, with both the Open-ended Funds and the Spezial Fonds active across a broad range of countries. This is something of a change for the Spezial Fonds, which until recently have been primarily investing in their domestic market. However the last year or so has seen them very much more active outside Germany. The Open-ended Funds have mostly recovered from the turmoil of last October and, although they are less active than in 2008, there have been a number of major acquisitions so far this year. Notable has been the range of cities where Open-ended funds have made acquisitions, with deals struck in Liverpool, Helsinki, Monza and Zurich, rather than the more traditional destinations for the funds such as London, Paris and Amsterdam.

Probably the most remarkable turnaround has been the level of activity by US investors. Two years ago, the Americans were by far the most active cross-border buyers, recording €35 billion of transactions in 2007. In the first half of 2009, just over €400 million in deals have been attributable to investors from the USA. As US investors were also responsible for sales totalling over €700 million, this made them net sellers for the first time in many years. UK cross-border investment has followed the same trend, with sharply reduced buying activity over the last two years.

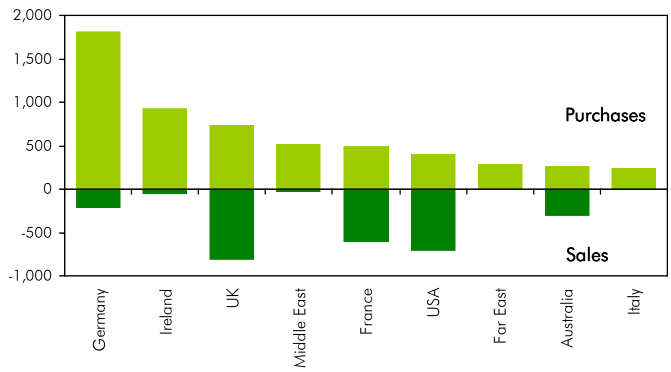
Cross-Border Investment Activity in Europe (€million)



Cross-Border Investment by Buyer Nationality, H1 2009



Cross-Border Purchases and Sales (€ million), H1 2009



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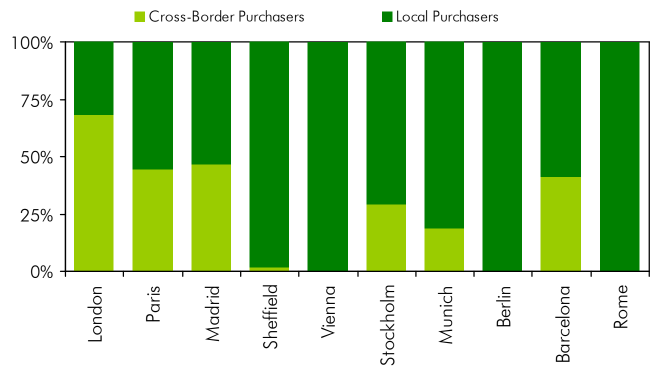
Ten Largest Investment Markets, H1 2009

	Turnover (€ million)	Change on H1 2008	% of European Market*
London	2,853	-61%	14.8
Paris	1,246	-73%	6.4
Madrid	954	-67%	4.9
Sheffield	671	+646%	3.5
Vienna	571	+326%	3.0
Stockholm	560	-72%	2.9
Munich	503	-57%	2.6
Berlin	498	-68%	2.6
Barcelona	403	-35%	2.1
Rome	373	+11%	1.9

*Excluding indivisible multi-city portfolios

Proportion of Cross-Border Investment in 2008



TOP TEN INVESTMENT MARKETS

The sharp downturn in the level of investment activity has had a noticeable effect on the identity of the largest investment markets in Europe, although not on the top two positions, which continue to be London and Paris.

The consistent liquidity of these two markets is in some ways self-sustaining. It has been notable during the current downturn that owners that have needed to raise capital quickly have looked to these two cities as the most straight forward places to achieve sales. Investors have been attracted by the same liquidity, with a range of realistically priced opportunities always available.

Madrid and Stockholm are also close to joining these two, being almost ever-present at the top of the league table. Both continued to see fairly high levels of activity in the first half of 2009, despite the otherwise quiet market.

One of the effects of the much lower levels of total turnover is that it is possible for a city to enter the top ten markets purely on the basis of one major (typically shopping centre) transaction. This was the case for Sheffield, where the sale of a 50% interest in the Meadowhall Shopping Centre by British Land for nearly €600 million was sufficient to launch it into the top ten for the first time.

Vienna is also only infrequently in the top ten most liquid markets, but in this case the completion of five separate transactions, each of over €50 million, and in a variety of sectors showed greater depth to the market.

An interesting feature of the activity in the top ten cities in H1 2009 was the very high proportion of local investment. Only in London was there a majority of foreign buyers and in several of the markets there was almost no foreign investor activity. This is a distinct contrast to the position in previous years, when the most liquid markets have also had a tendency to see a higher than average share of cross-border investors.

In fact London sticks out as unusual in the context of the current European market. The total proportion of cross-border investment in Europe as a whole has fallen markedly over the last couple of years. However, London is experiencing higher levels of foreign investment than has been seen for many years, with investors from all over the world. Middle Eastern investors have been most active, principally due to the purchase of Bishop's Square by the Oman Investment Fund. However, French, German Irish and Spanish investors also made substantial purchases.

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FALL IN AMERICAN INVESTMENT IN EUROPE

The credit crunch has had a substantial effect on the property market, but one of the most significant has been that on investors from the USA. Their activity, both in terms of buying and selling, has fallen off enormously over the last two years. From being one of the most active groups of investors in Europe, with acquisitions totalling over €20 billion in H1 2007, they have bought less than €500 million in H1 2009 and have become net sellers.

The market on which this has had the biggest effect is Germany, which has been the destination of nearly half the US investment in Europe since the start of 2006. In fact American investors have bought 27% of all the German property traded since 2006 (and 30% of that in 2006/07), more even than local German investors.

Looking forward, there are some signs that US investors will return to the European market in the relatively near future. Data on capital raisings by American fund managers show that they have raised substantial amounts in the last 6-12 months for opportunity funds to be invested in the European market. Although there is no strict period during which this capital must be invested, it seems fair to assume that it will be in the fairly near future.

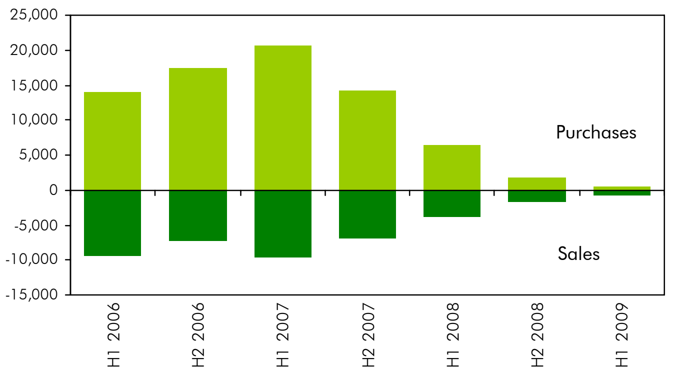
SPAIN – A LEADING INDICATOR?

Recently attention has been focussed on the UK market – and more specifically London – as a potential leading indicator of how the European market will evolve in the near future. However, this is to ignore the fact that the Spanish market too seems to be ahead in the cycle.

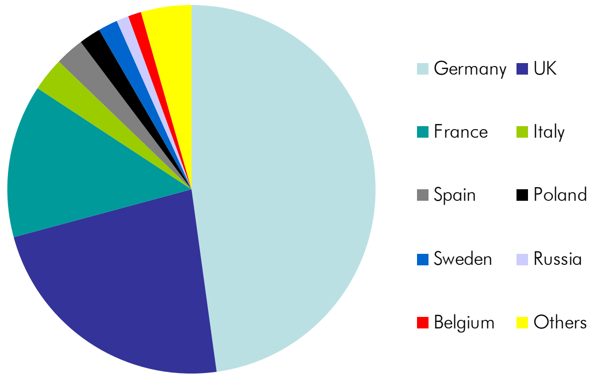
Although, like all investment markets, turnover in Spain has been down on the peaks reached in 2007, the decline in activity in Spain has been much less than the European average. In fact the last two years have seen Spain's share of the European market more than double, to around 7.5%. Spain also saw several of Europe's largest transactions in H1 2009, including two of the nine transactions for more than €200 million.

An important driver behind this level of activity is the extent of repricing that has already been seen there. Prime yields have increased by over 200 bps since mid-2007 and the evidence is that the majority of transactions are being concluded at yields of between 6.75% and 7.5%. By comparison, the movement in the CB Richard Ellis EU-27 Prime Yield Index has been only 136 bps from its peak. This degree of repricing has clearly been sufficient to convince some investors that Spain now represents good value.

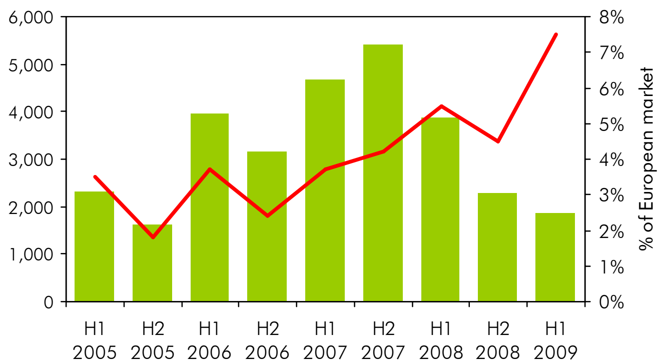
Activity of USA Investors in Europe



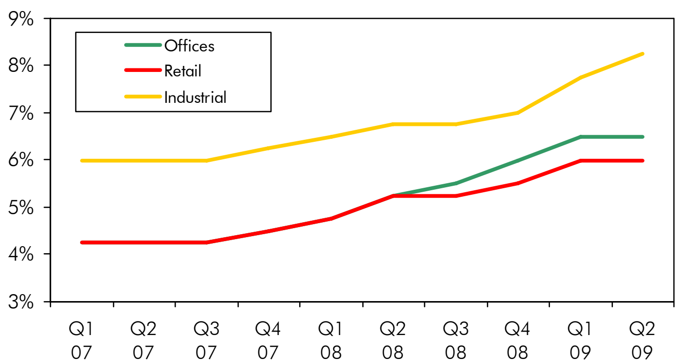
Locations of USA Investment in Europe (2006-2009)



Turnover of the Spanish Investment Market (€ million)



Evolution of Prime Yields in Spain



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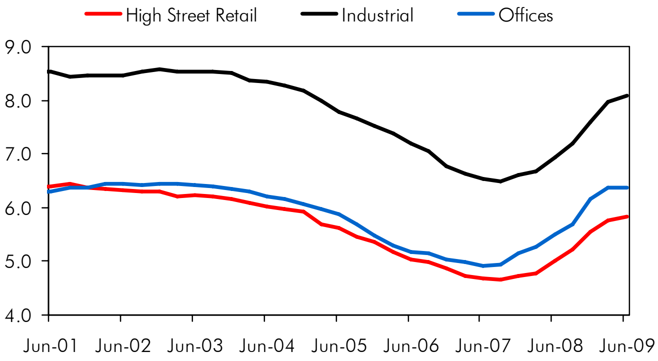
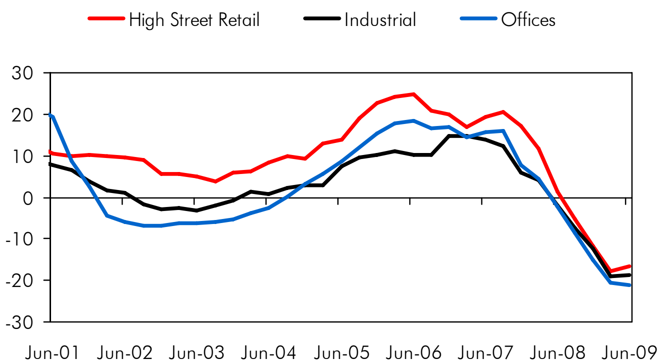
EU-27 Average Prime Yields (%)



EU-27 Average Prime Yield Index, Jun 2009

	All Property	High Street Retail	Industrial	Offices
EU-27 Average Prime Yield (%)	6.36	5.84	8.09	6.37
Quarter-on-quarter Shift (bps)	+3	+8	+12	-1
Year-on-year Shift (bps)	+88	+84	+116	+86

Annual Change in EU-27 Average Prime Capital Value (% pa)



EU-27 Average Prime Capital Value Index, Jun 2009

	All Property	High Street Retail	Industrial	Offices
EU-27 Average Prime Capital Values Index	150	203	117	122
Quarter-on-quarter Change (%)	-2.4	-1.9	-3.3	-2.7
Year-on-year Change (%)	-18.8	-16.6	-18.6	-21.1

YIELDS

The second quarter of 2009 saw an interruption to the rapid rise that has been seen in prime property yields over the previous year and a half. Although overall the average prime yield still increased quarter-on-quarter, the rise was a nominal three basis points – compared to an average quarterly rise of 26 bps in each of the previous four quarters.

The turn around in the office sector was particularly noteworthy. As a result of stabilisation in most markets, and declining prime office yields in Paris and provincial UK cities, the index actually declined quarter-on-quarter, albeit only by one basis point.

There does appear to be some correlation between yield shift and investment activity. Those markets where prices have corrected most quickly have been the first to see returning liquidity. It is not a coincidence that London, Paris and Madrid all saw relatively high levels of investment activity and top the list of Europe's most liquid markets. Each of these has had owners that are looking to sell and have priced product accordingly. This has both generated activity and resulted in prices in these markets reaching equilibrium more quickly than others.

CAPITAL VALUES

With yields starting to stabilise, rental value change is taking over as the driver of capital value change. As a result there were quarterly capital value falls in all the major sectors, but the rate does appear to have slowed sharply. Consequently the year-on-year capital value decline has stabilised at between 17% and 21% depending on sector.

This next phase of capital value movement will be an interesting one, depending crucially on the extent to which the recession drives down rental values and results in increased vacancy. So far the impact on the occupier market has been relatively limited in most cities, but the recession has hit so quickly that levels of employment – an important driver of demand for office space and indirectly for retail space too – have yet to react to anything like the extent that is ultimately expected.

The other unknown is the extent to which the expected decline in rental values is already priced in. As the scale of the downturn becomes clearer there could be a further reaction from yields depending on whether the impact on rents is smaller or larger than expected.

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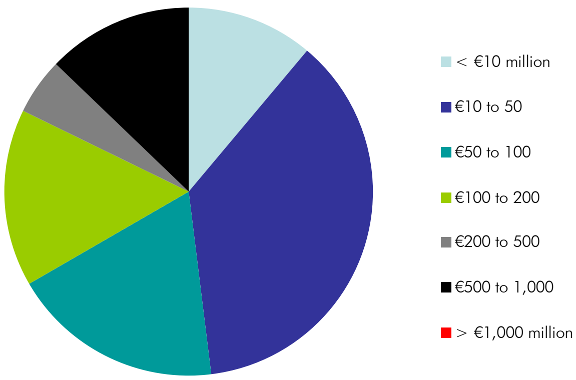
Turnover By Deal Size, H1 2009



Largest Investment Deals in Europe H1 2009

Market/Sector	Buyer	Price, € million
UK / Retail	F&C Reit Asset Man/ Apollo European REF III	669
UK / Retail	London & Stamford/ Green Park Investments	655
Italy / Retail	Firmit Fund Immobiliare	530
UK / Retail	Tesco Pension Fund	525
UK / Office	Oman Investment Fund	383
France / Retail	Mercialys	334
Spain / Retail	Orion Capital Management	235
Spain / Retail	GIC	215
UK / Office	Green Property	Confidential

DEAL SIZE

The affect of the credit crunch on the ability (and willingness) of the market to complete large transactions was further evident in the first half of 2009. There were no transactions larger than the sale of the former Dawnay Day portfolio in the UK for over £600 million (€669 million).

Deals for under €50 million now make up nearly half the market. Back in H1 2007 when the credit crunch was just starting, only 25% of transactions (by value) were in this segment. In H1 2009 this has jumped to 48% by value (and an astonishing 92% by number of transactions completed).

Some of the change in average lot size is down to changes in value, of course. With capital values for European property down by 25-40% from those at the peak of the market, the average deal size will inevitably decline. However, the average has fallen from a peak of €44.4 million in H1 2007 to €18.4 million in H1 2009 a decline of 59%, indicating that it is not just falls in capital value that are to blame.

At the top end of the scale, clearly the difficulty in financing large transactions is playing a part. The inability of banks to refinance large transactions through securitisation means that they are wary of making major commitments. Funding conditions have eased slightly, but banks are generally unwilling to look at transactions for much over €100 million.

MARKET ANALYSIS

At nearly €700 million Austria experienced a fairly healthy level of activity in H1 2009, at least relative to the rest of Europe. Vienna in particular saw a range of transactions of all types and sizes. One thing that was evident was the lack of foreign investment, with buyers almost exclusively Austrian.

The Belgian market has slowed significantly over the last year. Turnover held up well until mid-2008, but since then has been very low. Total activity totalled just €400 million in H1 2009, and it was notable that retail made up a larger than normal proportion of total activity, with very few office deals completed.

With just €2.3 billion completed in H1 2009, the French investment market has been quiet so far this year. However, it was interesting to note that the market picked up markedly in the second quarter.

An interesting feature was the relatively small proportion of transactions that were in Paris. The city still made up over 50% of total activity, but this is much lower than has been the case in previous years.

With US buyers no longer in the market and the German Open-ended Funds no longer actively selling their domestic property, the German market has contracted very sharply and just €3.3 billion was transacted in the first half of the year. Local buyers are now dominating the market, accounting for around 85% of acquisitions in H1 2009. Local institutions (pension funds and insurance companies) are now the bedrock of the market, with the Open-ended Funds and Spezial Fonds also active buyers.

The very substantial yield shift that has been seen in Ireland has gone some way to reviving interest in real estate investment, but the market is still very quiet, with almost no transactions being completed in the first half of the year.

The retail sector has been particularly active in Italy in 2009, with a number of major transactions. The most notable of these was the sale of 180 Unicredit bank branches to FIMIT Fund Immobiliare for just over €500 million. Also notable was the resurgence of activity late in the half year, with the value of deals transacted in Q2 twice as high as that in the first quarter.

The Netherlands also saw nearly twice as much property traded in Q2 than Q1 at €861 million out of a total of €1.3 billion in H1 2009. The outlook for the Netherlands is also strong, with a number of investors taking the view that the major Dutch markets have repriced sufficiently to be of interest. Private investors accounted for the majority of activity in the first half of 2009, but the German Open-ended Funds are expected to be more active in the second half of the year.

The market in Portugal has been particularly quiet so far in 2009. It is notable that there were no office transactions in the first half of the year, with retail and logistics accounting for all the activity. In addition buyers were exclusively local funds.

In Switzerland it is the domestic institutions that are dominating the market as they still have sufficient capital to be active as equity buyers. This is evident in the profile of value adjustments. The biggest yield shifts have been seen in secondary and tertiary locations, with prime yields – where the institutions are active – relatively stable.

An interesting feature of the UK market at the moment is the high level of foreign investment, particularly in Central London. Traditionally the UK has been a market where local investors account for the majority of acquisitions. This remained true in H1 2009, but at 40% foreign investment was substantial. The strong foreign interest in the UK market is one of the reasons that transaction levels are starting to increase again.

With just €2.6 billion of investment turnover in H1 2009 the Nordic region had a particularly quiet time, a reversal of the position in 2008, when activity had actually held up much better than elsewhere.

Denmark saw almost no major transactions in H1 2009 and only one in excess of €50 million. With the market therefore limited to relatively small deals, one of the effects was an absence of foreign investors. Private investors and local property companies were the only active buyers.

Finland too, experienced a very quiet market in the first half of this year. However, the €650 million transacted did include one major deal, the Swing Life Science Centre in Espoo, bought by HausInvest Europa for €120 million. As that deal shows, there was also some foreign interest, principally from German Open-ended Funds.

Lack of available product is one of the factors holding back the Norwegian market. There are few forced sellers, and potential vendors who are not in financial difficulties are choosing to hold on to their property. As a result there was just €550 million of transactions in H1 2009, compared to €1.7 billion in H2 2008.

Sweden was one of the markets to see the biggest fall in activity from H2 2008 to H1 2009. The €1 billion transacted represented an 86% decline in the total value of property traded. Most notable was the virtual absence of large deals (only two of more than €50 million), but also evident was the lack of activity in the retail sector, which accounted for just 3% of the total.

The CEE market has been one of those most obviously affected by the credit crunch. The absence of available debt is particularly evident. The Austrian banks which are the most established lenders in the region are having to cut back their activity, while more recent arrivals have in many cases withdrawn all together. All sectors have been affected, but investment in retail property has been particularly weak. The lack of buyers has resulted in substantial yield shift, but so far this has not resulted in a recovery in investor interest.

Russia was the most active of the CEE markets, continuing to see transactions across all sectors, but totalling only €261 million in H1 2009. However, unlike previous years there were very few large transactions. It was also notable that hotels made up a significant proportion of total activity.

The core CEE markets also continue to see some activity. However, total turnover in Hungary, Poland and the Czech Republic was just €213 million in H1 2009, compared to €1.8 billion in H1 2008, and €3.7 billion in H1 2007. Interestingly, German Open-ended Fund manager DEKA has accounted for the two largest transactions, representing more than half the total value traded.

OUTLOOK FOR THE MARKET

For the majority of H1 2009, there was little to be optimistic about. Investor interest was low, transaction levels were very low and capital values continued to fall steadily. However, towards the end of the second quarter things seemed to turn around somewhat. Turnover in the investment market started to improve, and yields began to stabilise.

This was true not just of the real estate market. The wider economy also started to show signs of improvement during the second quarter. Sentiment indicators have improved considerably, stock markets have bounced back and even some of the economic data has been better than expected. This has been reflected in the consensus forecast for GDP growth in 2010, which has increased slightly in the last couple of months.

Certainly it seems that we are at or close to the end of the first phase of the capital value correction. In the markets that are most advanced in the cycle yields have definitely stabilised and most others are close behind. However, there is a built-in lag between the effect of a recession on yields and its effect on rental values.

Although some places have already seen rental values decline substantially, they are the exception. As unemployment rises and companies further rationalise their property holdings, vacancy will increase and rental values will fall further. The question is, to what extent is this already priced into current yields.

Our impression is that the buyers who have been active recently have priced into their purchases a substantial fall in rental values – although in most cases they are buying properties with long leases that will insulate them from short term downturns in rental value. As this decline in rental values is realised, yields should start to fall to limit further falls in capital value. If the decline in rental values proves smaller than expected (and thus what has been priced in) yields could actually start to recover quite quickly.

At the moment nearly all the investor interest is in the prime end of the market, where buyers are able to operate with 100% equity or low levels of borrowing. So far no significant recovery in interest in the secondary market has been seen, nor is one expected without an improvement in the availability and cost of debt.

There is a danger of over-optimism, with the point at which things have stopped getting any worse being mistaken for the start of the recovery. There is an extent to which anything short of a complete collapse of the economy comes as a relief after the extreme pessimism that followed the Lehmans' bankruptcy late last year. For Western Europe the recovery from this recession will almost certainly be long and slow. However, it is good news that we can at least start talking about a recovery rather than a slump.

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