

Amundi Real Estate

European Property Market Review – Q4 2009

Quarterly
February 2010
n°5

Summary

- > The worst year since WWII ends with contrasting economic indicators across Europe
- > Despite an increase in 4Q09 lettings, no improvement in sight for 2010 occupier demand
- > Rising activity in investments with a focus on the prime segment
- > Decline in yields for the best products to continue in 1H10, with secondary products seeing a slight fall

Economic context

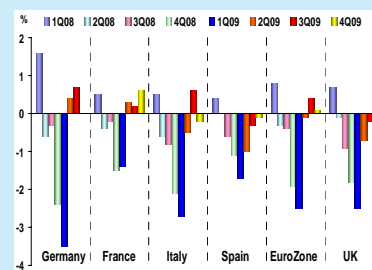
> Economic recovery underway but at a very slow pace

Following the positive trend that began in 3Q09, the Euro Zone economy grew again in 4Q09 but at a much slower pace than expected. As GDP rose by 0.1% following an increase of 0.3% over the previous quarter, economies were buoyed by an increase in exports arising from renewed vigour in global demand rather than from household consumption or investments. Having considerably sustained GDP growth in 3Q09 as demand from emerging countries returned, industrial output remained moderate in 4Q09 increasing slightly by 0.2% QOQ. Ongoing recovery in European economies was however confirmed by further improvement in the 4Q09 Economic Sentiment Indicator published by the European Commission.

This overall figure hides a wide variation of national results, as governments across Europe fail to synchronise the phasing out of their respective economic support measures. Of the main Western economies, only France recorded a significantly positive performance with GDP expanding by an unexpected 0.6% QOQ. Despite further deterioration in the labour market, household consumption benefited from the car scrappage scheme and boosted growth during the last three months of 2009, up by 3% QOQ. In the UK, as output recovered GDP improved slightly at 0.3%, the first positive result after six consecutive quarters of recession. In Germany the economy was dampened by weak domestic consumption and stagnated in 4Q09; this was despite a recovery in exports which contributed positively to GDP. The Italian and Spanish economies contracted by a further -0.2% and -0.1% QOQ respectively. In Italy, a slowdown was expected after the seasonal increase in 3Q09. Whereas in Spain the government's austerity plan, implemented in early 2010, has started to weigh on consumer confidence and spending. Both should however return to growth in 1Q10.

With annual GDP evolution at -2.3% YOY, the French economy, actively supported by the effective use of 'social shock absorbers', demonstrated better resistance to the crisis last year than other European countries. Elsewhere GDP fell much more strongly - by 3.1% in Spain, 4.8% in the UK and 4.9% in Germany. The labour market suffered significantly across all countries in 2009, especially during the first half of the year. However in 2H09 the unemployment rose further, albeit more slowly, and should continue to increase into at least the first half of 2010.

GDP Growth



Source: Eurostat

Property markets

Letting markets

Office

> Prime rents on the way to stabilisation

2009 was a two-speed year with 1H09 seeing European economies reach the bottom of the deepest crisis seen since World War II and the progressive, although still weak, recovery seen during 2H09. Both leasing and investment markets reflected this, with limited activity in the first half year of 2009 but a significant improvement in the second half of the year.

With the exception of Germany and Italy, most European markets saw a significant increase in take-up in 4Q09 thanks to the improving economic climate. In all, recorded take-up for the last three months of the year grew by 13% QOQ and remained stable compared with 4Q08 with London and Madrid seeing the most dynamic leasing markets. In London take-up bounced back by 32% and grew for three consecutive quarters. With occupiers now keen to benefit from the significant falls in prime rental values recorded over the last two years, the City and the West End remained the most sought after submarkets. In Madrid around 150,000 sqm were taken-up during 4Q09, just before the Lehman Brothers bankruptcy, this was the highest level since 2Q08, tripling QOQ and rising by 78% YOY. This substantial level of take-up was driven by the completion of several large lettings that had been initiated earlier in the year. During the last three months of 2009 four transactions over 10,000 sqm were completed, the largest of which was for a public authority. The five biggest lettings of the quarter accounted for nearly half of the total quarterly take-up.

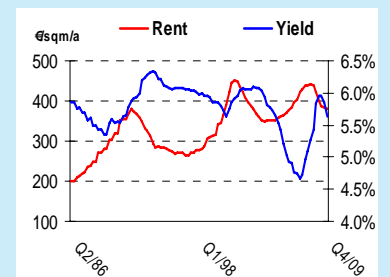
Buoyed by several large transactions signed at the end of the year, Paris recorded a take-up of more than half a million sqm in 4Q09, historically a good performance. Take-up rose by 38% on a quarterly basis and even by 13% on 4Q08. Supply continued to increase, albeit less rapidly than in previous quarters, leading to the vacancy rate reaching 6.8% at the end of 2009, its highest level since end 1997. With net absorption reaching -100,000 sqm and a dwindling level of completions, 72% of immediate supply is now second hand. Quality buildings offering large and efficient space units are likely to remain scarce in the Greater Paris Region in the medium term.

Occupier markets did not recover in Germany and in Italy in 4Q09. Take-up remained down both on a quarterly and a yearly basis as medium-sized transactions were the main drivers of leasing activity. In Milan only five lettings exceeded 3,000 sqm during 4Q09, even though demand was more concentrated in the periphery where large, modern buildings are available. After four years of positive net absorption in Frankfurt, the proportion of occupied stock saw a sharp decline between 4Q08 and 4Q09, down -130,000 sqm.

Unlike varied changes seen during 4Q09 in European leasing markets, all markets registered a fall in take-up on an annual comparison. In all, lettings declined by 30% between 2008 and 2009, mainly due to very low occupier demand in 1H09. In 2009 take-up evolved unevenly compared with the 2008, and fell by 38% in Spanish markets, 29% in Milan, 26% across all major German markets, 25% in Paris and 23% in London. The general decline in occupier demand was mainly as a result of the economic crisis and the general slowdown in activity. Increasingly, transactions were driven by SMEs as they are more reactive and flexible in adapting to the deteriorating economic climate. Company relocations were also reduced as landlords have become increasingly willing to accept lease renegotiations in a bid to avoid vacancies in their portfolios.

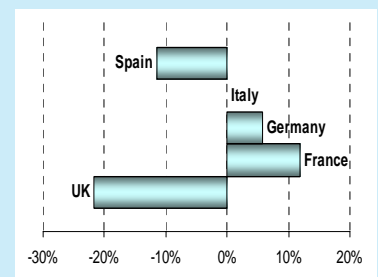
Despite the general decline of completions and the halt of future projects, availability increased across most markets, although at a lower pace than during previous quarters. In London and Italian markets, substantial vacancy rates started to be reabsorbed in 4Q09, for the third consecutive quarter in London but only for the first quarter in Rome and Milan.

European Office – Weighted average Rent and Yield



Source: Brokers*, Amundi Real Estate

Prime Retail High Street Rental Growth (4Q08/4Q09)



Source: Brokers*, Amundi Real Estate

Average rental values continued to fall from the beginning of 2009 whereas prime rents became progressively stable. In London, the prime rent started to even out during 4Q09 in the City and Midtown while it remained stable in other market districts. In Milan, the prime rent has remained stable for the last six months but only a few lettings transactions were completed in the CBD. This leaves us with no real indication of rental evolution, as occupiers continue to focus on the peripheral market districts. In other markets the sharpest fall was seen in Paris where the prime rent saw significant correction, down by -11% over the last three months, -17% since the end of 2008 and -22% from the peak in 3Q07. For average market rents, the change was less marked with a decline of only 6% over the last 12 months. In Germany, as prime rental values fell in Munich and in Hamburg, the average prime rent across all major markets fell slightly by 1.5%. The overall decline in occupied stock, although slight, is putting pressure on both prime and average rental levels. Spanish markets saw a further decrease in 4Q09, of nearly 2%, representing a fall of 27% from the peak recorded in 1Q08. Downward pressure on rental values also comes from landlords offering incentives to attract or even retain tenants and thus reducing net effective rents.

Retail

> Prime rents plateau while average rents decline further

Prime rents for high street premises were again generally stable in 4Q09. Only Spanish markets saw a further slight decline in prime rental values after three quarters of stability. Economic uncertainty and low consumer spending continued to weaken the retail sector. As a result, the main motivation behind retailer moves was mainly cost reductions and retailers carried out harsh negotiations in their search for better rents and lease terms. However, vacant units in prime locations, especially in Madrid, were immediately reabsorbed.

In Germany, prime rents remained stable across all major markets although slight decreases were recorded in smaller cities. Paris remained one of the most sought-after destinations in the world. Demand from international retailers seeking locations on the French capital's best high streets was again strong in 4Q09. In this context, stabilisation of the prime rent was confirmed and further reinforced by the lack of medium and large premises in the most attractive areas. However, as more local retailers became significantly affected by the effects of the economic crisis, demand for secondary locations was reduced. This in turn affected average rental values that have seen a further slight decrease.

The London market showed significant signs of recovery. General improvement in household consumption was particularly strong at the end of the year and retail sales increased by 2.4% in December on November volumes. Non-food stores and the clothing and footwear sector performed well, and drove rental values up in 4Q09. In anticipation of a general improvement in the economic climate, retailers jostled to reposition themselves in the best locations. As a result, the prime rent increased by 20% in the last three months of the year in London's West End. However, average prime rental values in the regional UK markets fell slightly but are expected to have reached their lowest level. As such prime rents for high street shops across most markets should stabilise over the coming quarters and, following the trend already observed in London, improvements should be seen for the most attractive markets.

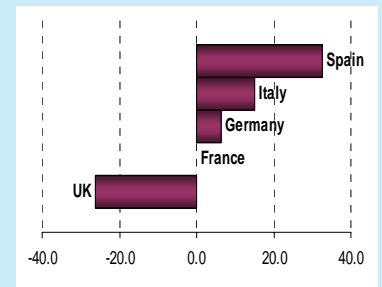
Industrial

> Progressive stabilisation of prime rents

Demand for industrial space is still limited by fragile consumption levels that are difficult to forecast. As a result, industrial did not see the same increase in demand as office markets. Market activity was dampened as occupiers sought more flexible lease terms.

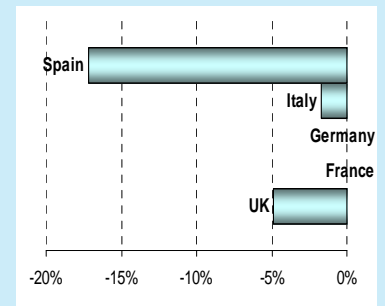
Despite high vacancy rates, owner-occupier transactions significantly fuelled take-up figures, reflecting the low availability of new and efficient premises as a result of the very low level of completions over the last few quarters. In France, more than half of lettings were owner-occupation transactions, a comparable level to that seen in Germany. Supply remained high but is of lower quality and less well-adapted to tenant needs. As a result developments were increasingly supplied on a build-to-suit basis.

Prime Retail High Street Yield Growth (4Q08/4Q09, basic pts)



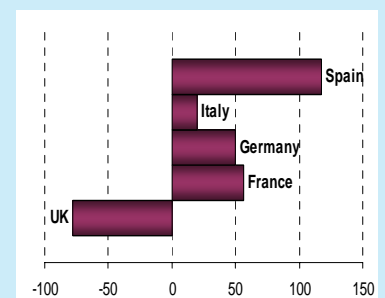
Source: Brokers*, Amundi Real Estate

Prime Industrial Rental Growth



Source: Brokers*, Amundi Real Estate

Prime Industrial Yield Growth (4Q08/4Q09, basic points)



Source: Brokers*, Amundi Real Estate

In nearly all monitored markets, prime rental values started to stabilise. In Milan, rents stabilised for the second quarter in a row due to the lack of available Grade A buildings. Only in Spain did prime rents see a further slight fall of 2% QOQ. However, as occupiers begin to relocate closer to the city centres of Madrid and Barcelona, at more attractive rents and at the expense of the outer suburbs, they are expected to stabilise over the coming months.

Investment markets

> Prime yields driven down by significant increase in investments

After showing sporadic signs of recovery in 3Q09 investment markets bounced back in all monitored countries in 4Q09. This rapid and surprisingly high growth in investment volumes over the last few months of the year is reflected in improving investor sentiment as European economies begin to come out of recession.

Most of the quarterly statistics were above 4Q08 levels, sustained by higher average transaction sizes. The total volume of acquisitions narrowed to €28 billion in 4Q09, 42% higher than 3Q09 and 40% more than 4Q08. In France, the last three months accounted for nearly half of the total investment volume. In the UK, investment volumes were up 64% in 2H09 compared with the first half of the year and reached an annual level of €25 billion. Overseas investors, especially from the Far and Middle East, were the main source of investment in 2009 and cross border activity accounted for 42% of the total investment volume in the UK and 72% in Central London. With a quarterly volume slightly down on 3Q09, Germany was the only market not to register an increase during the traditionally very active last quarter.

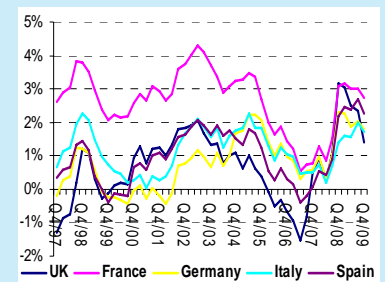
On an annual basis, the investment volume recorded in Europe reached €70 billion, a fall of 42% compared with 2008 figures. In anticipation of a stabilisation in yields for industrial premises, investors focused their attention on retail assets for their resilience and on office products for their volatility which makes them more prone to a faster recovery. This focus on resistant and more mature products, historically high for investors, was particularly impressive in Germany where office and retail premises represented 70% of investment volumes and in France at 92%. Retail investments also increased significantly compared with 2008. Increasing 73% on a yearly basis, their share in total volume rocketed from 9% in 2008 to 25% in 2009. In London also, retail properties saw heightened demand in 4Q09, with a 50% increase on the average amount invested in the first nine months of the year.

As a result, retail premises remained a focus for investors in 2009 with volumes concentrating on the best assets. According to figures from Jones Lang LaSalle, investments in Europe rose by nearly 60% to reach €4.5 billion in 4Q09. However, retail investments were down by 32% in 2009 compared with 2008. Investors continued to show a preference for prime locations. Retail buildings in secondary locations face increasing vacancy rates combined with difficulty in attracting credit-worthy tenants.

The last three months of the year saw an increase in liquidity for investment in prime properties. The resulting competition among investors for the best-located, income-secured buildings drove prime yields down across all monitored markets. The slight increase in long-term rates combined with a general fall in prime yields across all monitored markets has seen the spread between property prime yields and long-term rates narrow for all property types. This has driven risk premium rapidly and significantly down, especially for office assets. After four quarters of historically high levels, the risk premium for office investments moved down by 43 bps QOQ.

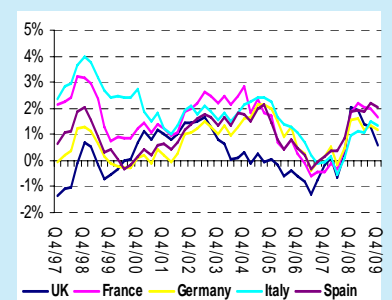
The fall was particularly marked in the UK, by -93 bps over the last three months for offices. This confirms that the property market has finally bottomed out - ahead of the cycle observed in continental markets.

Office: Spread LT Rates / Average Country Yield



Source: Brokers*, Amundi Real Estate

Retail HS: Spread LT Rates / Average Country Yield



Source: Brokers*, Amundi Real Estate

Outlook

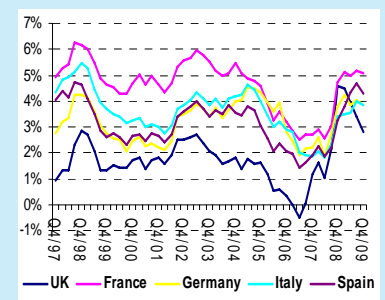
> Another difficult year to come ... with clear signs of optimism

The fear was that the progressive withdrawal of Government support measures would dampen economic recovery through falling consumption and resulting production levels. This came true in January as retail sales fell sharply in the UK (-1.8%) and in France (-2.7%) compared with December 2009. The main challenge in establishing how robust the recovery is will be in determining whether private institutions will be able to take over from the public sector in creating growth. European economies are currently expected to remain weak with a level of growth significantly below historical levels. This will mean further rises in unemployment and a dampening of consumer spending. Given that inflation is expected to remain constrained in 2010 (albeit higher than in 2009), repos are not expected to be lifted by either the European Central Bank or the Bank of England before the end of the year.

In the leasing market, demand for offices should remain cautious as it continues to be affected by the rising unemployment rate. Moves will continue to be driven by cost-cutting exercises as companies seek to relocate to better buildings that allow for a better use of space at lower rents. Rental values should decline further, with secondary assets seeing a bigger fall. As occupiers prefer relocations to new and modern buildings, the declining quality of available space, will put increasing pressure on rental values for secondary buildings. Landlords will find it difficult to secure tenants and maintain rental income for such premises.

The gap between prime and second hand products will also continue to widen in 2010 in the investment market. Liquidity is expected to improve progressively as it should be sustained by a low but steady flow of debt allocated by banks. On the supply side, prime products offering secured rental income might be scarce, which should lead to heightened competition between investors, as was the case at the end of 2009. We do not expect refinancing issues to have strong impact on the market in 2010 but this is a possibility in the future. The resulting pressure on prime yields will remain strong and they could move down by further 25-50 bps. This should progressively force investors to increase risks by redirecting their interest to non-prime offices (in terms of occupancy), with a preference for modern or renovated product. In the retail sector prime premises will continue to attract investors. Prices for secondary products are expected to decline further as increasingly restrictive environmental sustainability measures are put in to place and increase the capital expenditure required to upgrade such buildings. Depreciation of secondary assets will be driven by further significant rental falls while yields are expected to keep on increasing, albeit to a lesser extent than previously observed. At the end of 2008 and beginning of 2009, prices fell but it was difficult to determine how far they fell. As prices rise in 1H10 it will be equally difficult to determine fair value in a context of low economic recovery and with an uncertain level of occupier level of demand.

Industrial: Spread LT Rates / Average Country Yield



Source: Brokers*, Amundi Real Estate

* Brokers: CB Richard Ellis, C&W, DTZ, JLL

Special Focus

RESEARCH AT AMUNDI REAL ESTATE

In 2007, Amundi Real Estate established an in-house Research team to better understand real estate market dynamics in France, Western Europe, Morocco and Japan.

Research in the asset management process

Amundi Real Estate's Research team works to understand the market drivers and to support decision making through the provision of detailed and reliable information.

Beyond drafting Amundi Real Estate's market data publications, the Research team's role is one that crosses all departments and provides an essential link in the development of both real estate management and Amundi Real Estate's investment strategy. For each investment and every sale, the real estate asset and its environment are subject to an in-depth study based on a market approach. In asset management, each asset has its own set of characteristics; these are defined in agreement with the asset manager and monitored to ensure continued rental income, enhanced performance and well-timed disposals.



In a top-down approach, the Amundi Real Estate Research team's aim is to establish market forecasts, anticipate future trends and to give a precise medium and long-term view of market evolution for the various classes of real estate assets. In a collaborative approach that brings together our various departments from Milan and Paris, we hold a Research Committee twice a year to define our investment strategy.

Amundi Real Estate Views are the outcome of this Research Committee. These views are drawn up based on results from our econometric models established in 2007. In econometrics a model is a mathematic representation of the various phenomena that influence market development. The objective is to represent the significant features of events with a view to explaining and understanding them. These models provide both support and a framework for market forecasts. The various members of the committee then enhance these forecasts with their unique market knowledge and understanding.

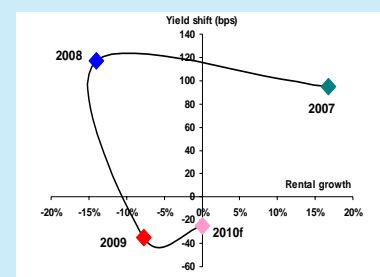
Econometric models

The Amundi Real Estate Research team currently uses two models, each of which has its own set of specific characteristics. One is based on multiple regression and the other on chronological series the key indicators for which have been determined as prime rents and yields.

The Multiple regression method uses several indicators to model the variable in question. We use this method to model take-up forecasts because variables can be modelled as a function of several indicators that genuinely affect take-up.

The limitation of this method lies in the accurate assessment of the set of indicators that influence the variable and in establishing their relative importance. This is important as the data required for analysis may be lacking or consist of insufficiently long data series.

Office UK forecast



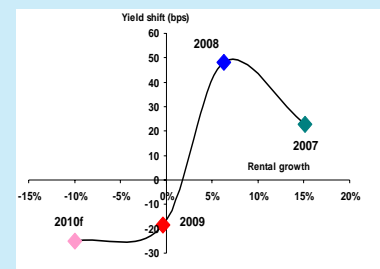
Source: Amundi Real Estate

As take-up forecasts are modelled, they are brought together with future supply. Future supply is determined by the number of sqm in the development pipeline and a proportion (depending on the market) of projects for which building permits have been applied. Changes in rents are dependant on the balance or imbalance of these figures. Using the same approach we are currently in the process of developing a model to forecast prime yields and are currently defining the various indicators that influence them.

The second method used, chronological series, represents the development of a single variable over the course of time. The model is applied to determine the characteristics of changes in the series by drawing out both long-term trends as well as the stability of values. The value in this method lies in the ability to base findings solely on the available statistical properties of the series and then, from the average and its variations, to be able to model changes without having to determine the various indicators that influence them. On the other hand, this model may only be used for stable, broadly linear chronological series without high levels of volatility.

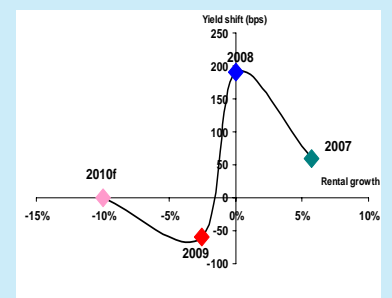
Amundi Real Estate therefore has two models based on distinct methods. We compare these to establish the most relevant medium and long-term trends in market evolution and real estate products. These models are continuously improved to give us results as close as possible to that of the market reality. The main challenges in improving the multiple regression model lay in determining as many explicit variables as possible and obtaining the required data. This must be done alongside refining statistical tests that allow us to highlight the significance of the variables compared to the modelled indicator. It is this significance that allows us to adjust the weighting of each variable in the model. For the chronological model we have developed a series of tests that are continually applied to increase accuracy. These tests make it easier to analyse results and to apply statistical operations that allow us to improve the quality of any model adjustment for a considered series.

Retail UK forecast



Source: Amundi Real Estate

Industrial UK forecast



Source: Amundi Real Estate

Amundi Real Estate market views

The outcomes of the Research Committee combine both the results of our statistical models and the knowledge of the committee members. These views are then used to drive the investment strategy and fund allocations in terms of geography and products within a defined timescale. Office, retail and industrial markets in the UK, France, Germany, Italy and Spain (among others) are subject to in-depth analysis and relative scorings are awarded to each.

UK markets, especially London, achieved the best score of all monitored markets and appear to be the most appropriate for capturing high performance over the coming quarters. In the UK, the current climate is considered to be the best entry point for seizing opportunities. As capital values are expected to have reached their low point, the main focus is on London offices. Occupier demand started to improve at the end of 2009, reflecting the slow but steady economic recovery, while the volume of supply slightly declined over the last three quarters. Back in 3Q09, following the fall of 21% from the 4Q07 peak, we anticipated that there would be an increase in prime rental values within the next twelve months. A further negative yield shift is expected for the prime office segment with prime yield expected to decline by 20 bps on 2009 levels. The key criteria for investment are well-located office premises with no potential for over-renting (recently leased to creditworthy tenants on a long-term lease).

The outlook for the industrial sector seems to be somewhat less positive. Contrary to the other property products, a stabilisation in yields is expected but no downward shift in sight over the coming quarters. The rental fall we had forecast has been observed but should carry on into the next two quarters before stabilising. In this context, the most appropriate market timing to invest in the industrial sector is expected to be during 2H10 with leasing contracts signed at headline rents, effective at that period in time.

Across all the other markets only the Paris prime office market is deemed to be of interest at present. As we expected, rental falls to have come to an end while the prime yield is still under further pressure. As far as other markets are concerned, caution is still to be exercised as, in our opinion, they have not yet plateaued, especially in terms of rental values.

