

European Capital Markets

MAY 2008

Overview: Correction in Pricing Has Been Slow

The first quarter of 2008 confirmed that the widely expected slowdown in capital markets is progressively spreading across the continent. No longer a 'UK-only' phenomenon, the fall in investment activity is now evident across most European markets, as is the rise in yields. At just under €37 billion in Q1 2008, European investment activity has fallen 36%, compared to Q4 2007 when around €58 billion was transacted.

The deteriorating financing conditions meant that activity slowed, most notably impacting on large assets and portfolio deals, which dominated the market in 2006 and 2007. However, it is pricing, or rather the correction in pricing, that has limited activity. Potential buyers and vendors, faced with an uncertain market, are generally adopting a 'wait and see' approach where they can. Pricing expectations have also been slow to adjust and, where there is no pressure to sell, the gap between buyers' valuations and vendors' expectations is substantial.

In the first quarter of 2008 the CB Richard Ellis EU-27 Average Prime All Property Yield Index increased for the third consecutive quarter to 5.33%. A quarterly shift of ten basis points was recorded, with the office sector seeing most change and the retail sector proving more resilient.

So far the price corrections across the real estate market have been driven by the changes in the financial and debt markets, rather than reflecting the underlying market fundamentals of supply and occupier demand. As such, the biggest yield shifts have been in the markets where yields were lowest – relative to 'risk-free' government bonds. This is because the market is now driven by yield-focused equity investors, such as the German Open-ended Funds. On the other hand, the less volatile markets, such as Vienna or Brussels, are proving more resilient to price corrections. Looking forward, yield shifts will start to be more reflective of the individual market fundamentals.

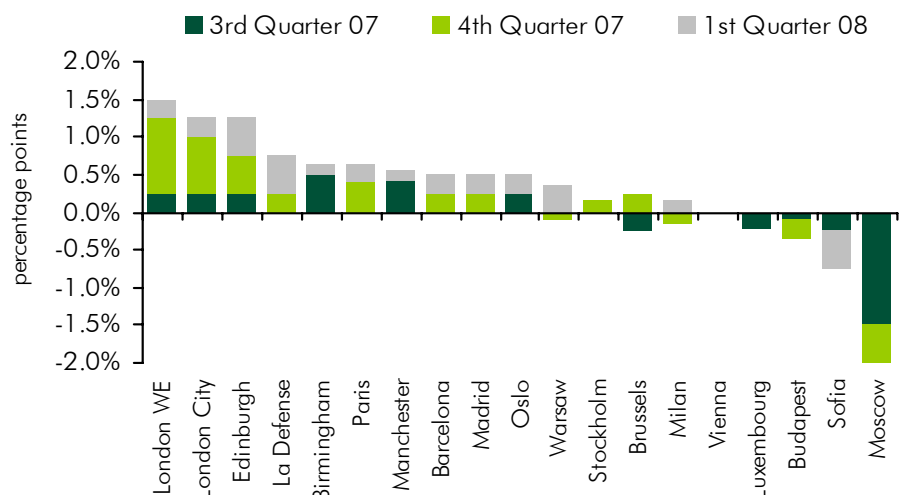
KEY TRENDS

In Q1 2008 European investment activity fell 36% quarter-on-quarter

Pricing corrections reflect the changes in debt markets, rather than real estate market fundamentals

Economic outlook and local market conditions will be key in determining the next stage of yield movements

Quarterly Prime Office Yield Movements



YIELDS

The first quarter of 2008 saw softening in yields across all property types. However, the magnitude of yield increases varied substantially between the sectors.

The CB Richard Ellis EU-27 Average Prime Office Yield Index increased by 14 bps in Q1 2008 to 5.28%, with 23 out of 53 markets monitored registering an increase. Although still predominantly led by the UK, with yields rising in London and many regional centres, the overall correction is starting to spread across the continent. Retail and industrial sectors are not exceptions to the trend, with the yield indices rising by 5 bps for retail and 12 bps for industrial.

By the end of Q1 2008 the majority of European markets had seen at least some correction in pricing. So far, however, the yield shift has been driven by financial factors – turbulence in the financial markets and limited availability of debt – rather than the underlying real estate fundamentals of supply and demand in the individual markets.

It is notable, therefore, that the biggest yield movements were reported in the markets where yield levels were lowest, relative to ‘risk-free’ government bonds. This is especially true of the UK market, where the gap between the prime real estate yields and government gilts had been negative for quite a while.

RENTS

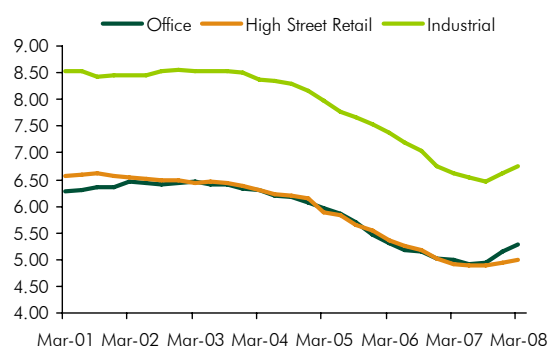
Weakening economic conditions are starting to affect European letting market prospects. Although occupier markets held up relatively well in the last two quarters of 2007, take-up slowed in Q1 2008 as many occupiers are postponing decision-making on relocation/expansion plans. The weakening economic outlook and slower letting market have started to impact on rental levels and future rental growth expectations.

The EU-27 Average Prime Rent Indices registered quarterly increases across all sectors, but it is notable that the rate of growth has slowed substantially across all three. Although this slowdown is mainly driven by weakening economic fundamentals, it was widely expected as most European markets are now close to the top of the rental cycle.

For both the office and industrial sectors the majority of Western European markets saw no change, or a very slight increase, in rents this quarter. At the extremes of the office rental picture were London City with a -8% fall and Moscow offices with a 21% increase in prime rents quarter-on-quarter.

Rental growth has stalled across most high street retail locations, but some quarterly increases in prime rents were registered in Athens, Rotterdam, London West End, Sofia and three of the Spanish markets (Barcelona, Madrid and Palma de Majorca).

EU-27 AVERAGE PRIME YIELDS, %

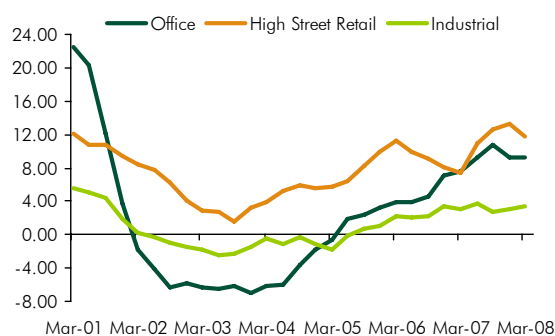


Source: CB Richard Ellis

	All Property	Office	High Street Retail	Industrial
EU-27 Prime Average Yields (%)	5.33	5.28	4.99	6.74
Quarter-on-Quarter shift (bps)	10	14	5	12
Year-on-Year shift (bps)	19	29	6	12

Source: CB Richard Ellis

ANNUAL CHANGES IN EU-27 AVERAGE PRIME RENTS, %

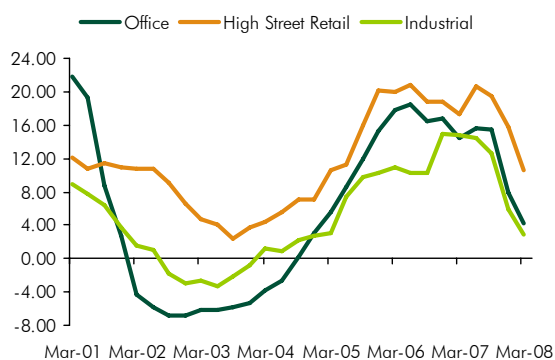


Source: CB Richard Ellis

	All Property	Office	High Street Retail	Industrial
EU-27 Prime Rent Index	146	128	183	111
Quarter-on-Quarter change (%)	1.3	1.9	0.9	0.6
Year-on-Year change (%)	9.9	9.3	11.7	3.4

Source: CB Richard Ellis

ANNUAL CHANGES IN EU-27 AVERAGE PRIME CAPITAL VALUES, %



Source: CB Richard Ellis

	All Property	Office	High Street Retail	Industrial
EU-27 Average Prime Capital Values Index	182	156	235	147
Quarter-on-Quarter change (%)	-0.5	-0.8	-0.3	-0.3
Six-monthly change (%)	-0.4	-2.6	1.9	-0.3
Year-on-Year change (%)	6.9	4.2	10.6	3.5

Source: CB Richard Ellis

CAPITAL VALUES

Rising yields, coupled with muted rental growth, have had a negative impact on capital value growth. The EU-27 Prime Capital Values Indices fell across all sectors in Q1 2008. The falls this quarter have been relatively small, varying from -0.3% to -0.8%, but the expectations for the next few quarters are again downwards.

It is notable that retail capital values have held up relatively well so far. Since the end of Q3 2007 the aggregate change in the Retail index has been positive at 1.9%, compared to a -2.6% fall for the office sector. Out of the 52 high street retail locations covered only eight (three of which were in the UK) reported outward yield movement in Q1. In the eyes of some investors the retail sector is seen as defensive, especially the prime high street and shopping centre segments. Constrained supply, fixed location and diversity of occupiers have helped investment prices to hold up relatively well so far. However, a consumer spending downturn remains a downside risk for the sector.

The decline in the EU-27 Capital Values Office Index was much sharper. It was strongly led by the UK, where both components of capital value have had a negative impact – as yields moved upwards and rents fell in some locations. Some other major European markets have seen falling capital values in the prime segment of the market, most notably in both major Spanish markets and Paris.

There is a second group of Western European markets where only a small change or no change in capital values has been registered so far. This is true of many traditionally more stable markets, such as Zurich, Vienna and Brussels.

FINANCIAL INDICATORS

	Official/ Policy Rate	10-Year Government Bond	Index-linked Bonds	5-year Swaps	CPI (% change to April)	\$ exchange Rate
Euro-zone		n/a	n/a		n/a	
France	4.00	4.54	2.31	4.67	3.03	1.5628
Germany		4.35	1.95		2.41	
Italy		4.80	2.35		3.30	
Spain		4.57	n/a		4.19	
Norway	6.50	4.77	n/a	5.82	3.13	5.0422
Sweden	4.25	4.36	1.76	5.08	3.41	5.9794
Switzerland	2.25-3.25	3.17	n/a	3.41	2.27	1.0388
UK	5.00	4.97	1.72	5.74	4.19	1.9808
JAPAN	0.50	1.77	1.40	1.58	1.20*	104.765
USA	2.00	4.01	2.19	4.16	3.94	n/a

Source: Financial Times (Thursday 29th May), Reuters EcoWin

* Annual % change to March

Outlook: Market Fundamentals Will Drive Next Stage of Re-pricing

The pricing corrections that have been seen in the European market so far have been a response to the turbulence in the credit market. This means they have generally been indiscriminate, reflecting only the level of yield, rather than underlying supply and demand.

On the supply side – one of the areas where the European banks are being most restrictive is on funding development. Loan-to-Value ratios have fallen rapidly across the board, and it has become increasingly difficult to obtain development finance. The two-year development pipeline completions for London City offices in the 2009-2011 period are likely to fall to half the level expected a year ago. Many existing projects have been shelved all together, with very few new schemes being given the go ahead.

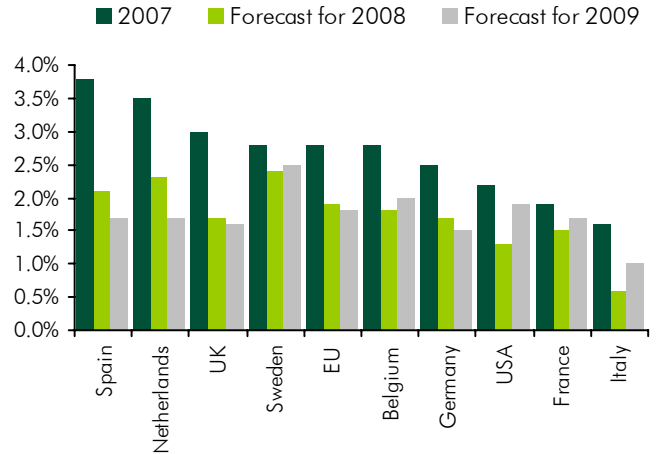
Of course some markets are affected to a greater extent than others, in particular the UK, Spain and Ireland. However, development finance is more difficult to secure across the whole of Europe and a high level of pre-leasing is now key to a developer's ability to go ahead with a scheme.

In the context of falling supply, the outlook for the occupier market has weakened too, as the US economic slowdown is filtering through into Europe. What started as a phenomenon in the financial markets has spread to the 'real' economy. The restrictions on borrowing and loss of consumer confidence are affecting economic growth, and thus occupier demand.

2008 is forecast to see slower economic expansion compared to 2007 across all European countries. For some, such as the UK, Netherlands, Spain and Italy, the slowdown is particularly marked, with GDP growth levels falling dramatically. In the Eurozone economic growth is subdued further by rising euro exchange rates that will reduce overall economic competitiveness and is also likely to impact negatively on export levels.

For some markets this slowdown is expected to be more prolonged, whilst others are forecast to begin their recovery as early as 2009.

Annual GDP Growth



Source: Consensus Economics Inc, May 2008

Central and eastern European economies should be more insulated from the downturn. However, it is true that most of the growth is coming from the rapidly expanding service and financial sectors, so the downside risks remain.

Although weaker demand expectations are to an extent offset by a slowing development pipeline, the bottom line for both letting and investment activity in 2008 is that it will be weaker than that registered in 2007. The degree to which individual European markets will be affected will vary substantially, depending on local demand and supply characteristics.

Once the first (indiscriminate) phase of re-pricing has unwound, which may yet take some months, the next stage will be driven by the markets' fundamentals of supply and demand. By the time this first phase is over, it is likely that some markets will have been oversold. However, for others this will mean further outward movement for yields. Pricing needs to reflect more accurately the very different rental prospects between markets.

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