

European Capital Markets

AUGUST 2008

Overview: Yield Shift Spreads Across Europe

One of the clearest trends in Q2 2008 was that the effect of the credit crunch on prime yields spread more widely across Europe, in terms of both location and sector. There are now very few cities where commercial property prices have not been affected and, while initially it appeared that the retail sector was in some way insulated from the effect, yield shift is now being seen in all property sectors.

It remains true that the biggest yield shift has been recorded in the UK. Despite the fact that yields appear to have stabilised in the Central London markets, there has been further outward movement in provincial cities. In Birmingham, for example, the prime office yield has increased by 175 bps in the year since the credit crunch began.

The biggest yield movements in the second quarter were in Spain, Ireland, Sweden and France. Although clearly the credit crunch is the trigger, the weakening of their underlying economies is also a factor. Ireland and Spain in particular are experiencing significant economic slowdowns.

It is the extent of the economic slowdown that will ultimately determine the longer term effect on the property sector. Occupier demand is already slowing and in its wake so is the rate of rental growth. Rental growth in the retail and industrial sectors was negative in Q2 and would have been flat in the office sector if not for the increases in Milan and Rome. However, even where rents are falling, the rate of decline is not rapid, and as the supply pipeline in most cities is constrained the downside for rents is generally limited.

Uncertainty is not just affecting the property sector. Both equity and bond markets experienced significant falls in Q2, with the 'benchmark' 10-year government bond yield in most countries increasing sharply. The German bond yield jumped by more than 70 bps during the quarter, its biggest three month rise since 1999, but coincidentally bringing it back to the same level as at the start of the credit crunch.

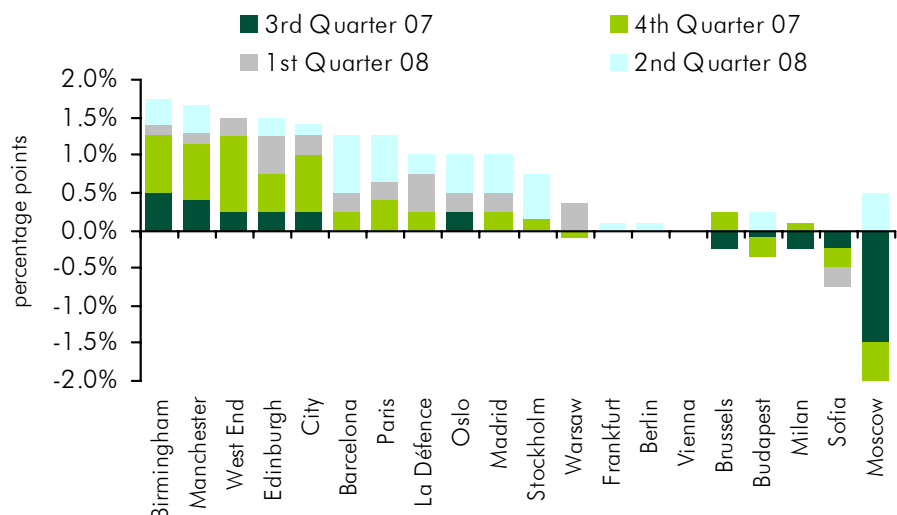
KEY TRENDS

In Q2 2008 yield shift has become more widespread across Europe, in terms of both location and sector

The biggest pricing corrections took place in those markets where credit crunch has been accompanied by further economic weakening

Current market uncertainty has affected the pricing of all asset classes. This makes it even more difficult to judge 'fair value' for real estate

Quarterly Prime Office Yield Movements



YIELDS

The rate of increase in the prime yield index for the EU-27 accelerated in the second quarter, with average increases of more than 20 bps in all three main sectors. The rises are increasingly widespread, with very few locations now immune to the effects of the credit crunch.

A number of the major property markets saw prime yields move significantly over the quarter, in particular Paris, Stockholm, Madrid and Barcelona. In all of these cities the prime office and retail yields rose by more than 50 bps, with industrial yields also increasing. There is still downward movement in a small number of emerging markets in Eastern Europe, but these are few and far between.

With the credit crunch now a year old, the office sector has so far been the hardest hit – not surprising as it is in this sector where occupier demand is most directly affected. It is interesting to note, however, that yields in Central London seem to be stabilising at around the levels at the end of 2007.

After seeming to be insulated from the impact of the credit crunch, yields in the retail sector now seem to be following the general market trend. However, this has not stopped some major deals being agreed in the sector, the latest being the acquisition of Steen & Strom by a JV of ABP and Klépierre.

RENTS

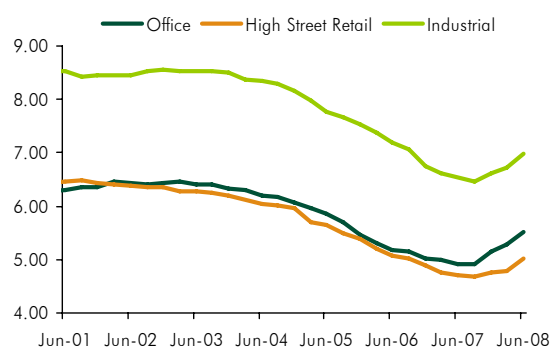
The weakening economic outlook in Europe is being reflected in rents across the region. The rate of rental growth is slowing in all sectors and, although the year-on-year rate is still positive, on average rents fell over the quarter in the retail and industrial sectors.

Until recently it appeared that the retail sector was seeing less impact on rental growth than either offices or industrial property. However, the last quarter has seen that position reversed. A significant influence on that has been the rapid fall in consumer confidence, which has had a direct impact on consumer spending. Several European countries (including UK and Germany) are already seeing negative growth in spending and this is obviously affecting retailers attitude to taking on new space.

The impact on office rents has varied from city to city. There are few cities where prime office rents are still increasing. The clearest exception was Italy, where a distinct shortage of top quality office space in the centre of both Rome and Milan is causing prime rents to increase, although there is no upward pressure on rents outside their CBDs.

Rental values in the industrial sectors are generally stable, with the negative growth in the index in Q2 being driven entirely by falls in Madrid and Rome.

EU-27 AVERAGE PRIME YIELDS, %

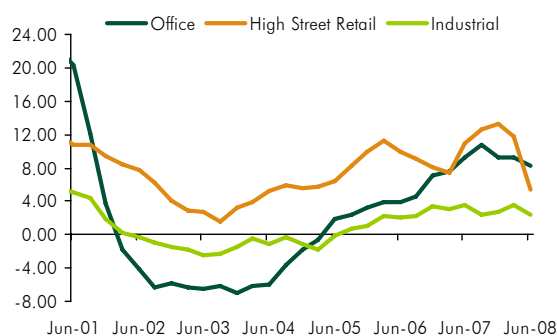


Source: CB Richard Ellis

	All Property	Office	High Street Retail	Industrial
EU-27 Prime Average Yields (%)	5.49	5.51	5.02	6.99
Quarter-on-Quarter shift (bps)	23	24	22	25
Year-on-Year shift (bps)	49	60	32	46

Source: CB Richard Ellis

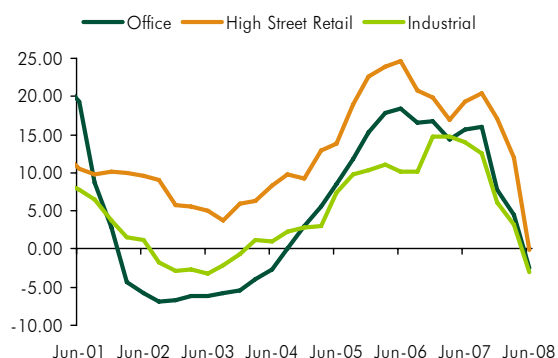
ANNUAL CHANGES IN EU-27 AVERAGE PRIME RENTS, %



Source: CB Richard Ellis

	All Property	Office	High Street Retail	Industrial
EU-27 Prime Rent Index	146	130	181	110
Quarter-on-Quarter change (%)	0.3	1.8	-1.1	-0.5
Year-on-Year change (%)	6.5	8.2	5.3	2.3

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	183	153	241	142
Quarter-on-Quarter change (%)	-3.8	-2.3	-5.1	-3.9
Six-monthly change (%)	-3.9	-2.9	-4.8	-4.4
Year-on-Year change (%)	-1.5	-2.5	-0.2	-3.1

Source: CB Richard Ellis

CAPITAL VALUES

The most notable feature of the Capital Value index is that the rate of rental growth is no longer sufficient to offset the rise in yields and that even on a year-on-year basis all sectors are now seeing negative capital value growth.

The CBRE index is based on prime rents and yields and so effects of yield and rental value changes are immediately reflected in the index (whereas they will be more lagged in actual properties).

Only Milan, Warsaw and Bucharest – in all cases as a result of strong rental growth – made significant positive contributions to the index.

There are a number of the less volatile European markets where the credit crunch has had little impact on the value of prime property to date. As can be seen from the chart on the front page, these include cities such as Frankfurt, Vienna and Brussels.

The biggest negative contribution to the capital value indices came from Paris. In the retail and office sectors there were falls in rental value and significant yield increases.

Rising yields have so far only brought the capital value index back to the level last seen in Q2 2007. To put the impact of the credit crunch into perspective it is worth looking further back into the index. A further 13% fall in capital values would be required to take the index back to its level two years ago – in June 2006. Most property investors, therefore, will still have registered capital gains since they first invested even if there is a further substantial fall in values.

FINANCIAL INDICATORS

	Official/ Policy Rate	10-Year Government Bond	Index-linked Bonds	5-year Swaps	CPI (% change to June)	\$ exchange Rate
Euro-zone		n/a	n/a		n/a	
France	4.25	4.51	2.13	4.86	3.57	1.5562
Germany		4.36	2.04		3.28	
Italy		4.92	2.52		3.82	
Spain		4.64	n/a		5.01	
Norway	6.75	4.89	n/a	5.99	3.38	5.1415
Sweden	4.50	4.19	1.72	5.17	4.31	6.0841
Switzerland	2.25-3.25	3.06	n/a	3.29	2.85	1.0486
UK	5.00	4.83	1.74	5.55	4.58	1.9739
JAPAN	0.50	1.52	1.20	1.36	2.00	107.525
USA	2.00	3.93		4.15	5.02	n/a

 Source: Financial Times (Monday 4th August), Reuters EcoWin

Outlook: Volatile Benchmark makes it hard to judge 'Fair Value' in Real Estate

There are two factors that are making it increasingly difficult to form a reliable view of whether real estate is fairly priced in the market at the moment and therefore where prices are likely to go in the short and medium term.

The first of these is the economy – and therefore the prospects for vacancy rates and rental growth. There was a short period of optimism following the release of stronger than expected GDP data for France and Germany for the first quarter, but since then most of the news has been more negative. Eurozone economies are seeing the double effect of weak domestic demand (due to falling house prices and poor consumer confidence) and weak exports (due to slowing world growth and the strong Euro). Consensus forecasts for this year have continued to weaken for most countries, but more importantly forecasts for 2009 have also been revised down significantly and the outlook remains uncertain.

The second factor making forecasting real estate performance more difficult is the extreme volatility of the bond markets. Traditionally the risk free rate against which the price of other assets is compared is the yield on the 'benchmark' 10-year

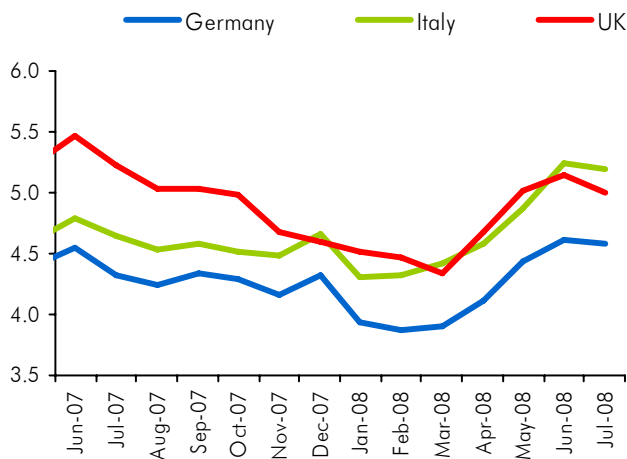
government bond. However, this has been increasingly erratic over the last year making it very difficult to assess fair value.

Between the end of March and the end of June this year, the 10-year German government bond rate increased by 71 bps and there were even bigger increases for some other countries (Greece 84 bps, Italy 82 bps, UK 80 bps).

This means that despite the yield increases for real estate, the yield gap between property and the risk free rate actually increased – in theory implying that the market's rental growth expectations had increased. In practice today's active investors are likely to be using a more stable, absolute returns target rather than trying to price against such a volatile benchmark.

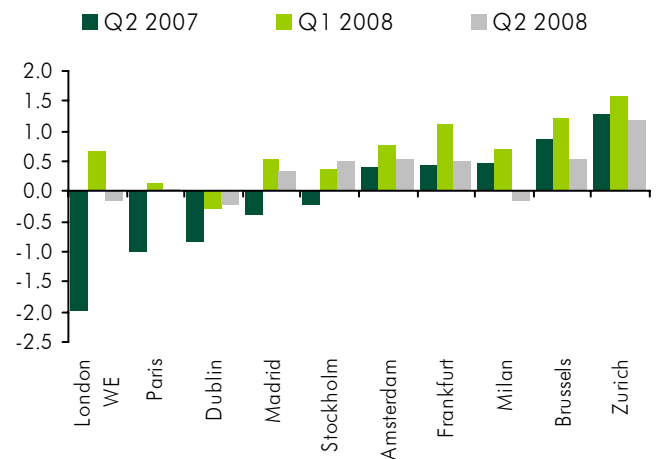
This volatility in the fixed interest market makes planning even harder for investors that are using significant levels of borrowing. Swap rates have been almost as volatile adding further complexity to decisions over pricing. The uncertainty means that buyers are generally holding back, although there is an increasing amount of equity waiting for the right time to enter the market.

Yield on 10-year Government Bonds



Source: Ecwin

Yield Gap (prime office yield minus 10-year bonds)



Source: CB Richard Ellis, Ecwin

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