

European Quarterly

Market Perspective

Executive Summary

- Sentiment about the economy has improved and growth may return before the end of the year, but there is a danger that the market is getting ahead of itself. Current policy measures are unsustainable and the recovery is likely to be anemic at best.
- The banking sector remains problematic. Distressed real estate loans are being restructured in a benign way, but that cannot continue forever. With values nearing a floor, banks are considering ways they might participate in the upside.
- Listed property shares have been swept up by a broad wave of optimism, rising 36% since their trough and raising new capital in the process. For the rally to sustain itself, operating fundamentals must stabilize.
- Transaction volumes recovered slightly in the second quarter, but remain chronically low. Activity may pick up. Valuations look more attractive and there is some fresh equity around, notably from listed companies and German open-ended funds.
- The outlook for the occupier market is poor. Retail and trade volumes are falling and unemployment is rising across Europe. Rents have at least another 10% to fall across the sectors, which will put more downward pressure on property values.

Overview

How banks deal with the wider financial crisis and the implications of their actions remains the biggest story in the commercial real estate markets in Europe. Banks remain short of capital and have been actively retreating from real estate lending, resulting in a slowdown in real estate transactions. The speed of the recovery will depend in large part on how the distressed-loan problem is solved and whether new debt sources become available.

Some new equity is appearing. German open-ended funds have recorded more than €2 billion of net inflows this year, while €7.7 billion has been raised by listed companies. But the occupier downturn has yet to reach its nadir as rents are still falling across Europe. This means that asset values are still dropping, even in markets where yields have “hardened.” Add in the ongoing debt shortfall faced by many property owners, and it is hard to envisage transactions picking up significantly, aside from a few prime assets in core markets.

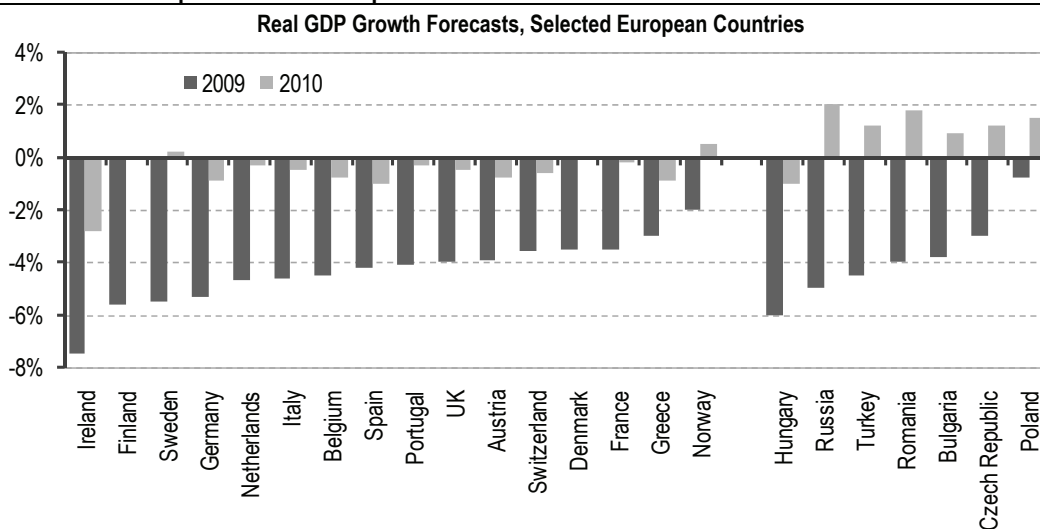
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Economic Environment

Sentiment about the European economy has improved, but output is being propped up by a combination of monetary and fiscal expansion that will have to be withdrawn at some point. This suggests an anemic recovery, with only sporadic pockets of growth across Europe over the next year or so. Forward-looking indicators such as the Purchasing Managers Index (PMI) have nudged up only slightly from historically low levels.

Poor Growth Prospects Across Europe for 2009 and 2010



Economist Intelligence Unit, Prudential Real Estate Investors

It also remains unclear as to whether credit conditions have improved. Interest rates are down: 3-month Euribor is down to 1.3% and the Euro Area “Ted Spread” – the gap between Euribor and treasury bills – is 50 bps, down from a peak of 225 bps recorded in the eye of the financial storm in 3Q08. Despite this, the European Central Bank’s (ECB) lending survey shows that most institutions continue to tighten lending standards, while swap spreads have risen sharply despite a drop in swap rates to about 3%.

The banking sector continues to face difficulties. Europe’s banks may have already written down a staggering €280 billion, according to the ECB, with the prospect of another €200 billion to come. To date, the lion’s share of write-downs has been on liquid assets and off-balance sheet vehicles, while book values of property loans have remained largely intact, despite the major correction in values of the underlying assets. RBS, one of Europe’s biggest lenders, has said that it has not yet made any significant write-downs on its €105 billion property-loan book.

Although the worst of the crisis may have passed, banks are not entirely out of the woods. Credit Suisse has estimated that Spain’s savings banks face a black hole of up to €40 billion that is likely to require targeted action from the Spanish government, while the ECB has assisted the Swedish Riksbank to the tune of €3 billion due to domestic exposure to the struggling Baltics. Europe’s banks also require an injection of up to €425 billion of capital in order to return to reasonable leverage levels, according to the International Monetary Fund (IMF). With this in mind, many banks are exploring the possibility of raising capital by selling and leasing back the offices they occupy. Spanish banks have started the ball rolling.

Santander sold its headquarters building to a British investor, followed by BBVA, which sold off part of its branch network. HSBC and Credit Suisse are among those looking to follow suit.

Debt Markets

In the recession of the early 1990s, banks were quick to foreclose on non-performing loans, which served to lock in losses as the wave of defaults helped push values down. Today, European governments are reducing incentives to sell loans at distressed prices by giving implicit future price guarantees to banks. As a result, banks have been sitting on their hands. This is true even in the UK, where Savills estimates that 75% of the €350 billion property loan book is currently in breach of covenants.

Survey evidence from BNP Paribas shows that banks are now evaluating problem loans on a case-by-case basis, with size, interest coverage and the financial strength of the borrower the most important factors. A more measured approach has replaced the panic of last year, when there was a lot of short term “rolling” of debts. Lenders are now considering two- or three-year restructurings, ideally with some amortization, to reduce overall leverage. Still, there is no free lunch. Borrowers must post new equity, even if it is a token amount, while margins on loan pricing have risen significantly to 200-300 bps over Libor.

However, a benign restructuring of problem loans can't go on forever. Rising vacancies and falling rents will stretch income coverage, possibly leading to defaults. Despite this, some banks are confident that the market is nearing a bottom and have started to consider strategies for participating in the upside. Since lenders are effectively putting themselves in an equity position, many believe they should be targeting equity-like returns. There may be a political element to this, as banks look to generate profits to free themselves from public ownership.

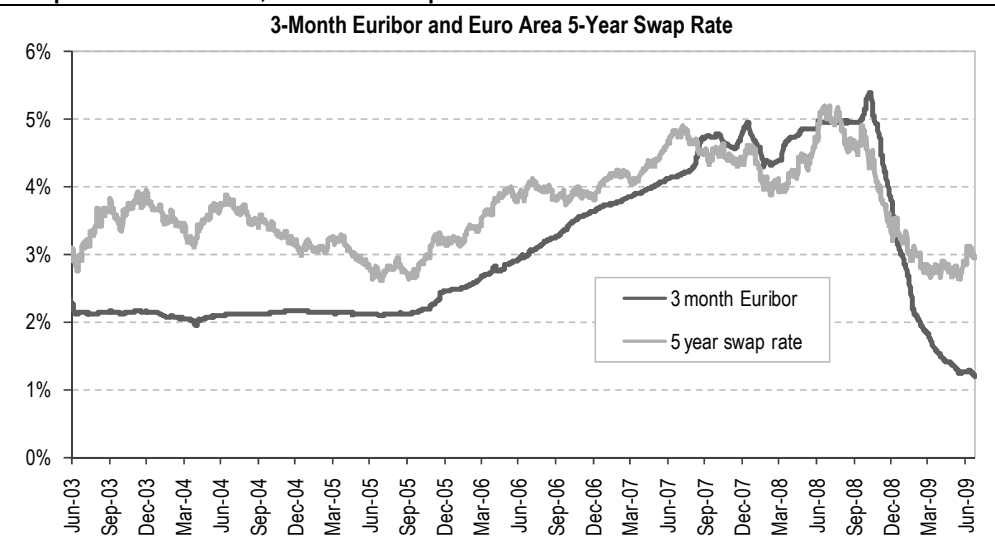
Banks looking to take a stricter approach to defaulting loans have several options. One is simply to take back the keys and use a third-party asset manager until the market recovers and the property can be sold at a profit. Another is a debt-for-equity swap, which is more likely if the bank retains faith in the management team. Both options are highly dilutive for existing equity holders. If enough banks choose these options, there could be a round of foreclosures and restructurings across Europe. Lenders in the UK, Ireland, the Netherlands and the Nordics would be in position to act more quickly than other parts of continental Europe, where borrowers typically enjoy greater legal protection, according to S&P's insolvency regime classifications.

Rising CMBS loan defaults also threaten to become a significant flash point, despite being just a small part of Europe's real estate debt markets. Foreclosing or restructuring CMBS is not necessarily an easy task. In the event of a default, special servicers are charged with maximizing proceeds to all bondholders, but conflicts of interest are numerous and documentation in European loans is poor. In some cases, senior bondholders are best served by liquidating loans and recovering the remaining value, while junior bondholders, who typically control the special servicing, may be best-served by extending the workout process. With CMBS prices depressed, some borrowers are buying discounted CMBS backed by loans on their own properties, which enables them to retire the bonds and thus reduce the size of their debt positions.

Looking ahead, the health of the real estate market depends on whether lenders are able or willing to originate new loans. There are some signs of life. UK retailer Tesco recently floated the first new European CMBS in two years, raising €500 million via an oversubscribed A-rated note secured by 12 properties. Despite strong covenants, Tesco still had to pay a margin of 330 bps over gilts, far higher than in the pre-financial crisis world. Unfortunately, it is unlikely that many more deals are in the works. Demand for the bonds remains uncertain, and other would-be borrowers are unlikely to match the strong covenants.

The mounting list of banks “boasting” full or part-public ownership means that there could be an element of political support for new lending to real estate even if banks would otherwise be looking to reduce their exposure to the sector. There are tentative signs that the pfandbrief market may be making a return. Deutsche Bank recently completed a €1 billion issue, which was heavily oversubscribed, while private placement volumes have also risen. Some competition is now emerging as lenders look to finance the few high-quality deals in the market, while a few continental lenders are considering large loans. For those who are able to borrow, interest rates have fallen significantly since last year. Yet this may not have a big impact on overall borrowing costs. Swap rates haven’t fallen as sharply as Euribor, while borrowers are now looking at interest rate margins upwards of 200 bps.

Swap Rates Have Fallen, But Haven’t Kept Pace With Euribor



Bloomberg, Prudential Real Estate Investors

The lack of debt is putting a brake on transactions. A Cushman & Wakefield survey found that only 22 out of the 83 largest European banks were open to new clients, with even fewer willing to lend more than €20 million in one chunk. It is not realistic to expect banks to increase volume while they anticipate further loan write-downs. What’s more, a gap of more than €100 billion is developing between the volume of debt maturing in Europe over the next two years and the amount of debt that banks will be willing to originate to replace those loans. Alternative debt sources will be needed to fill the gap between senior lenders and scarce equity. Concerned that asset values will continue fall, investors remain reluctant to step into the void. Yet the emergence of gap financing is a critical step if transaction activity is to return to anything approaching ‘normal’ levels.

Listed Sector

A rally in wider equity markets took place in the second quarter, reflecting increased confidence that a financial meltdown had been avoided. Financial stocks rose sharply, sweeping in a broad wave of optimism in the listed property sector. The European Public Real Estate Association/ National Association of Real Estate Investment Trust (EPRA/NAREIT) Total Return Index climbed 19% in the quarter and has now gained 36% since March's trough, reversing some of the 78% peak-to-trough decline which began in 1Q07. Defensive stocks with conservative leverage ratios, high-quality assets and proven management teams have clearly outperformed their riskier counterparts since the financial crisis began. However, riskier names rode the wave of the rally, benefiting from depressed pricing and some improvement in investor risk appetite. Nevertheless, the long-term viability of some of these companies remains questionable.

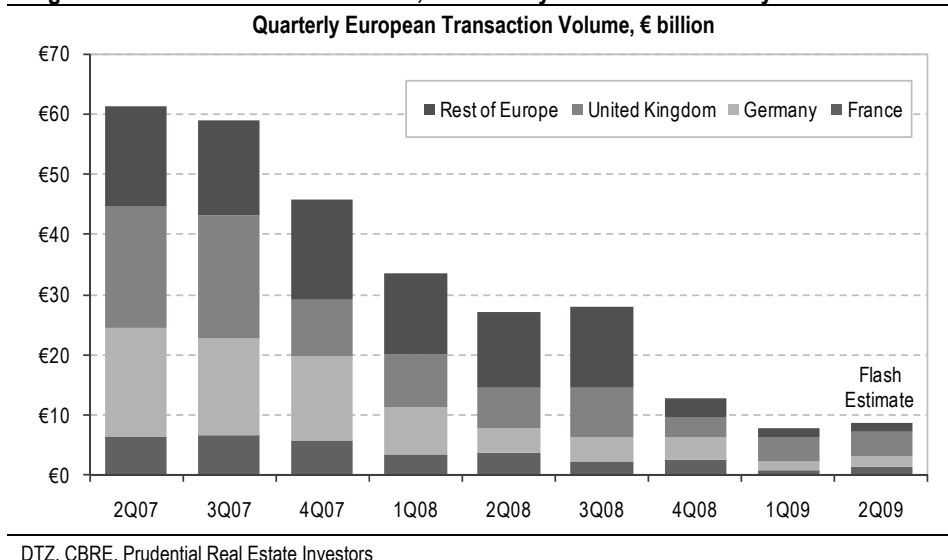
Public real estate companies have been reducing leverage, taking advantage of the recent appreciation in equity markets to raise additional capital at a relatively low cost. This capital infusion has been highly successful, raising about €7.7 billion in Europe so far this year – a significant amount given EPRA's March trough market capitalization of €40.5 billion. But real estate fundamentals are expected to deteriorate further and a number of companies will undoubtedly need to raise more equity to strengthen their balance sheets. New capital will be used to deleverage companies that need to adjust to the more conservative environment. While much of this new capital is defensive, as cash is still required to shore up impaired balance sheets, some companies have signaled intentions to pursue offensive strategies if the opportunity arises. Some further earnings dilution is anticipated as companies come back to the equity markets.

Listed property companies are widely expected to recover ahead of the direct property market due to the speed at which new information is incorporated into pricing. Listed investors are now starting to look beyond trough net asset values (NAVs). But even taking this into account, recent performance looks more like a "relief rally" in light of a large number of companies trading above expectations for next year's NAVs. For the rally to sustain itself beyond a reversal of negative sentiment, rising equity prices need to be backed up by stabilization in operating fundamentals. For this reason, listed property investors should be careful not to get ahead of themselves. As the occupier downturn worsens, earnings will likely be revised downward across the sector. Investors should focus on companies that offer attractive cash yields, long leases and a diversified tenant mix.

Investor Appetite

Investment activity across Europe remains chronically low, although the volume of transactions rose slightly in 2Q09, according to CB Richard Ellis (CBRE). There was another modest increase in UK activity. Investment in France more than doubled, although the quarterly volume was just one-third of its average since 2004. Across Europe, the broad trends remain the same: investors and lenders have retreated to home markets and financing for big-ticket deals simply is not available.

Slight Increase in Transaction Volume, But Activity Remains Chronically Low



Given that any deal in today's market is the exception rather than the norm, valuations must take into account the sort of deals that would normally be considered outliers. This reduces the reliability of pricing and explains to some degree why yields rose only slightly in 2Q09, despite the dearth of transactions. Prime office yields stayed flat in most core European markets, and actually fell in Paris and a number of UK cities (though not London) as transaction activity improved slightly. Even in Eastern European markets, for which investors have developed decidedly cold feet recently, only Moscow and Budapest recorded higher yields than in 1Q09.

There are three main factors which could justify a degree of optimism that transaction activity will pick up. The first is simply that real estate values have now fallen dramatically enough to be close to bottom. In itself, this could trigger a renewed interest from institutional buyers that are looking for stable income streams. Secondly, as outlined above, there are some signs that the debt markets may be sputtering to life. That said, senior lenders are requiring more equity and charging higher interest rates, while alternative debt sources may be required to fill the mezzanine portion of the capital stack. And with a significant funding gap still to be filled, it appears likely that lenders will continue to cherry-pick the best deals and strongest sponsors, with supply of debt falling short of demand.

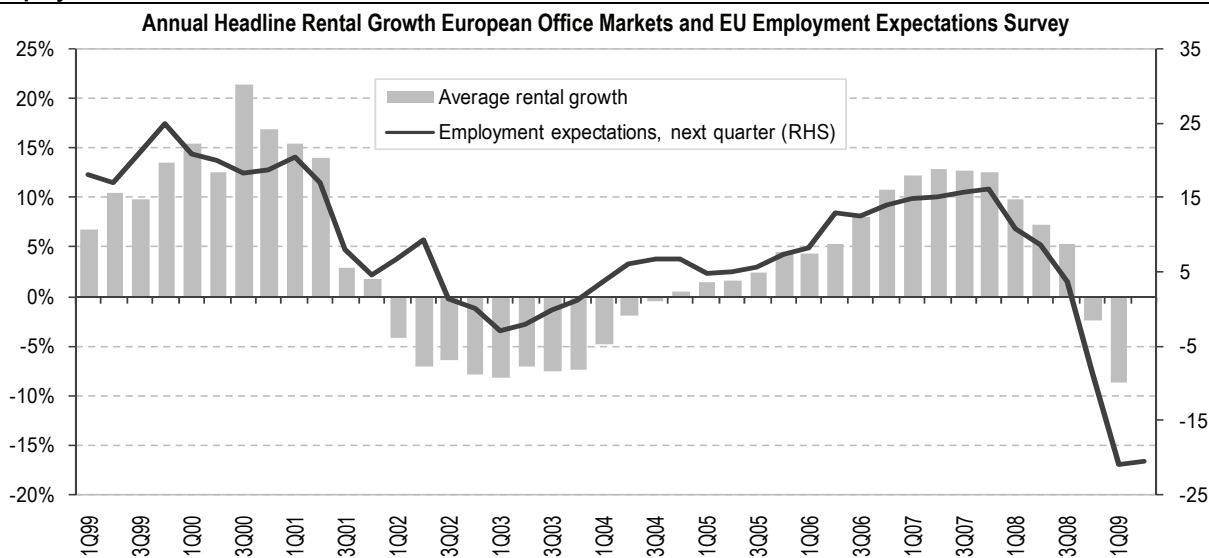
On the face of it, the third factor – that new equity may be ready to come into the market – is perhaps the most promising of all. Listed property companies have been raising equity and private capital flows may also be picking up again. The €85 billion German open-ended fund (GOEF) sector is open again, following a moratorium on redemptions as the financial crisis intensified last year. Despite investors again having the option to withdraw their cash, net inflows to GOEFs have been positive so far this year, to the tune of €2.3 billion. While many investors are retreating to domestic markets, these funds have global aspirations. According to Real Capital Analytics, Germans have been responsible for nearly a third of global cross-border transactions so far this year. Sovereign Wealth Funds are also renewing their interest in property, with substantial sums reportedly targeting the UK and other core markets.

Time will tell whether these new funds will be sufficient to generate a significant rebound in activity. Investors are becoming more particular about the assets they want to own. Rather than turning to secondary assets and locations – a strategy which characterized the exuberance of the boom years – real estate managers are instead exhibiting patience and waiting for the right product to become available. Sale-leasebacks by banks and governments could be one catalyst. Investors typically benefit from good locations, strong covenants and long leases providing bond-like returns that would characterize such transactions. But even the best deals will need debt sources and with banks struggling to meet demand, alternative debt vehicles will be needed to prime the engine of transaction activity.

Space Markets

Transaction activity will likely remain tepid as long as space market fundamentals are poor. The worst of the recession may be over, but because of the inevitable lag between the economy and space markets, vacancies are up and rents are down throughout Europe. The European Commission's survey of employment intentions is consistent with office rents falling by another 10% across Europe. Meanwhile, declining retail and trade volumes illustrate the difficulties facing retail and industrial occupiers.

Employment Intentions Point to Further Rental Declines



Cushman & Wakefield, Eurostat, Prudential Real Estate Investors

Offices: Tough business conditions and changes to the financial landscape mean there are fewer corporate occupiers taking space across Europe. Those remaining are consolidating space requirements and cutting back on staffing levels. An increasing amount of so-called “grey space” is coming to market as tenants look to sublet unwanted portions of their existing space. Companies looking for new space or negotiating lease renewals are fighting to secure lower headline rents as well as other incentives. Landlords of prime central business district (CBD) space may have to compromise to keep tenants from moving to cheaper out-of-town space.

The downward pressures on rental values are unrelenting. CBRE's flash estimates show a sustained decline in rents in 2Q09 across Europe, although this masks some divergence in performance of individual

markets. Prime office rents continued to fall steeply in the UK, Spain, Ireland, and across Central and Eastern European markets. In contrast, rents were broadly flat in CBDs with tighter supply in Germany, Italy and the Netherlands. The path rents take from here will be driven by the balance between changes to supply and demand from corporate occupiers. Coming into the downturn, development may have been relatively contained, but there is 6 million square meters of new office space coming to market in Europe this year. Assuming an average of 20 square meters per worker, filling this would require an additional 300,000 employees. In contrast, Experian Business Strategies forecasts a decline of around 1 million office jobs, which would clearly add to vacancy rates and put downward pressure on rents.

Retail: Remarkably low levels of consumer confidence are weighing down on the retail sector. Concerned by rising unemployment and falling real wages, and unable to access credit, consumers simply are not spending much money, preferring instead to rebuild savings. Most retailers are looking to control costs and are putting expansion plans on hold. Those that are looking to open new stores are finding attractive terms, including shorter lease lengths, rent-free periods and reduced service charges. Ironically, confidence among retailers has ticked up slightly, possibly reflecting reduced competition following a host of bankruptcies. Some major fashion retailers are still looking to expand eastwards, looking to exploit the almost forgotten long-term growth potential of countries that include Poland, Russia and Turkey.

The retail pipeline remains substantial, particularly around Southern and Eastern Europe. Despite falling values, some construction projects are continuing, particularly those that are well underway and located in larger markets. Projects that have yet to break ground are being postponed across Europe, while virtually all development is being halted in Eastern Europe.

Logistics: The logistics sector has been hit hard by the drop in consumer spending and the collapse in world trade, which could drop by as much as 12% this year. There are a few pockets of growing demand. Many food retailers and discounters are expanding operations, and there may be a temporary boost from “reverse logistics,” the process of returning goods from their point of consumption back to the distributor or manufacturer.

There is a potential supply overhang stemming from a glut of new completions from last year, although the full impact has still to register. Headline rents, defying gravity, are only down by about 5% across Europe since peaking in 2Q08. As with other sectors, the UK, Spain, Portugal and Eastern Europe are leading the way with double-digit rent declines. In contrast, rents have remained more resilient across Central Europe and in key trade hubs such as Hamburg, Rotterdam, Antwerp and Marseille. These markets should benefit once global trade gets going again, while the UK and France will be relying more heavily on consumers recovering their appetite to spend.

Closing Thoughts

After the dark clouds from the financial crisis, there is a growing sense that the storm is clearing. But there is a risk that investors may become too enthusiastic and start identifying signs of recovery that simply don't exist. To an extent this is happening in the UK and France, where a modest pick-up in transaction volume has been enough to drive yields down slightly. The optimism is at odds with the bleak outlook for occupier markets and the ongoing retreat of the banking sector from real estate. Capital values on prime property across Europe have already fallen substantially from their peak, but remain likely to drop another 15%.

Equity is coming back into the market in a trickle rather than a flood. Consequently, it will largely be up to the banks to define the recovery's shape. How lenders deal with problem loans and the speed with which new debt is made available will be crucial to timing and strength of the recovery. In the absence of forced sales, distress may simply not emerge as anticipated. A dichotomy remains between prime assets – which appeal to overseas buyers and could generate bidding wars if debt is available – and secondary assets, for which there is almost no appetite. For investors, two clear strategies are emerging. One is to purchase core assets based on long-term fundamentals, and the second is to originate debt to take advantage of the financing gap which will become pronounced as banks retreat from the commercial real estate market.

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