

European Capital Markets

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Q2 2011

Quick Stats

	Change from	
	Q1 11	Q2 10
Total Turnover	↓	↓
Capital Values	↑	↑
Yields	↓	↓

Hot Topics

- Market weakens to €25.7 billion in Q2 from €29bn in Q1
- Economic outlook for Germany and Nordics attracting increasing investor interest
- Economic concerns affecting Southern Europe and UK, with fears of further upheaval driving a flight to quality approach

OVERVIEW

• European investment market weakens in Q2 2011

Total turnover in Q2 fell by 11% compared to Q1, at €25.7 billion. This is broadly in line with turnover in both Q2 and Q3 2010, but does suggest that the growth in real estate investment activity over the last two years may now be slowing.

• Germany, Nordics and selective CEE markets attracting interest

Activity remains strongest in Germany and the Nordic region, which are both seen as markets with strong occupier fundamentals. The German market totalled investment turnover of €5.6 billion in Q2, accounting for an above-average 20% of the European total. The Nordic markets attracted €4.5 billion of investment during the same period, an increase of over €1 billion compared with Q1, although the source of capital remained biased towards intra-regional investors. Both Poland and Russia attracted just under €2 billion each in the first half of the year – almost equal to their turnover in the whole of 2010 – with Russia in particular seeing a significant increase in activity over the past few quarters.

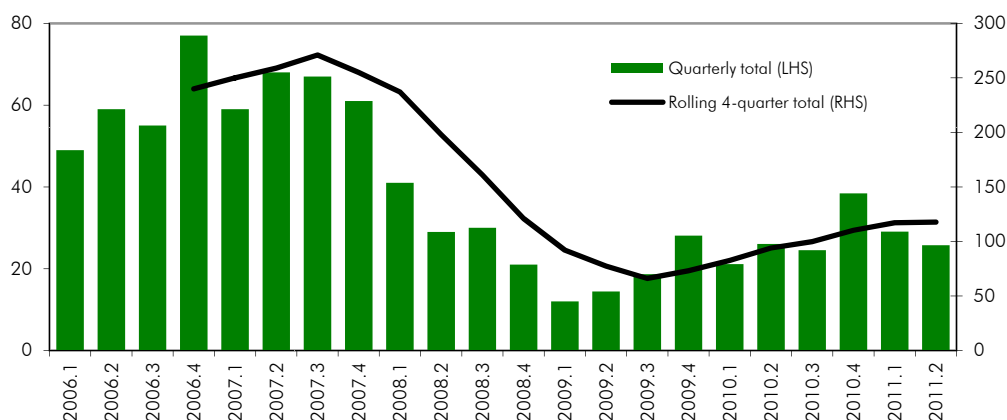
• Corresponding weakness in UK and Southern Europe

Investor sentiment was, however, patchy elsewhere in Europe. The UK market was quieter than previously expected, at €7 billion in Q2 compared with €11.5 billion in Q1. This clearly reflects the economic picture which surprised on the downside during Q1 and Q2. Similarly, the decrease in activity in Southern Europe reflects growing uncertainty around the sovereign debt crisis and prospects for the Euro. Total activity in Italy, Spain and Portugal dropped to €3 billion for H1, which is about the same as Q4 2010 alone.

• Flight to quality tactic exacerbated by economic upheaval

The recent revival of the sovereign debt crisis and fears that this may spread to other markets across Europe, reinforces the flight to quality and economic growth. In this context Germany and the Nordics stand apart, with sound fundamentals and, most importantly, low levels of sovereign debt. There is, however, some evidence of investors taking advantage of current pricing to pick up prime assets in core locations in Spain – viewing this as a rare opportunity to enter a normally competitive market – but this type of long-term strategy is the exception not the rule.

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



CROSS-BORDER INVESTMENT

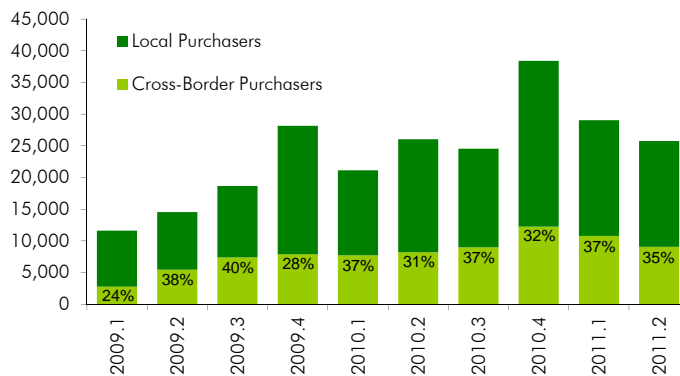
The 11% reduction in investment activity in Europe over the quarter was mirrored by an even greater fall in cross-border activity (down by 19%). However, as a percentage of the market cross-border investment activity remains broadly in line with the 2010 average, accounting for 35% of the market in Q2 (and 36% in H1 as a whole) compared with the 2010 average of 34%.

There was an increasing focus on investment in CEE and Germany by foreign buyers in the first half of 2011. For example, the CEE region attracted €3.7bn of cross-border investment in H1 compared with less than €1bn in H1 2010. Poland accounted for almost half of this and the market continues to attract investors with its sound occupier fundamentals and positive economic indicators. This combines with the perception that it currently offers better value than most Western European markets. Investment activity remains focused on retail properties in Poland and the CEE as a whole. This contrasts with Western Europe, where the emphasis of cross border investors has been on the office sector.

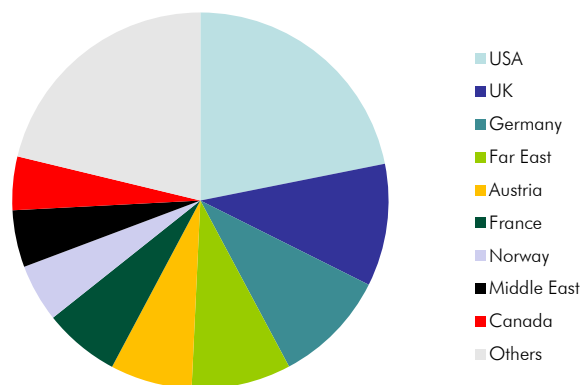
The buyer nationality break-down of cross-border investment in the first half of the year reveals a similar trend to 2010, with a considerable contribution from non-European investors (41%). Investors from the USA alone accounted for 22% of all cross-border investment, up from just 16% in 2010. The other significant change in the composition of cross-border activity during the first half of the year was the decline in German investment activity. This was particularly true of the German Open-ended Funds who bought just €647m worth of cross-border real estate in H1 compared with €1,249m in H1 2010 (€2,477m in 2010 as a whole). It was also notable that the German open-ended funds were engaged in some significant cross-border sales, particularly among the funds that are closed to redemptions or in liquidation, such as Degi International.

More generally German, US and Middle East investors were net sellers of cross-border real estate in the first half of the year. This primarily relates to sales in the UK and France, as well as Germany (by US and Middle Eastern investors) where investors are locking in the capital appreciation that has been achieved over the past 18 months. In contrast Far Eastern and Canadian investors, were net purchasers of cross-border assets in Europe.

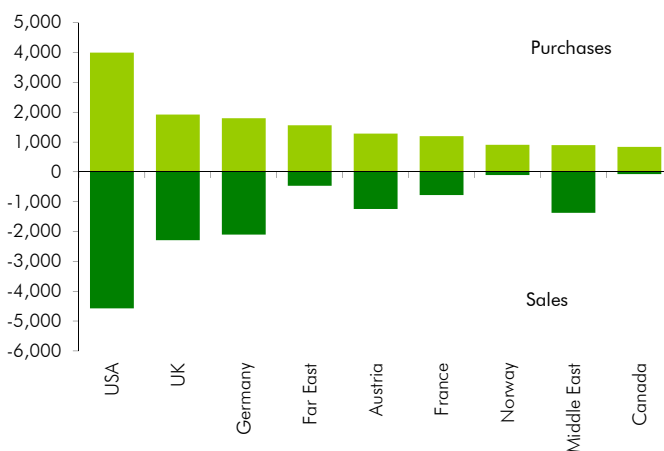
Cross-Border Investment Activity in Europe (€million)



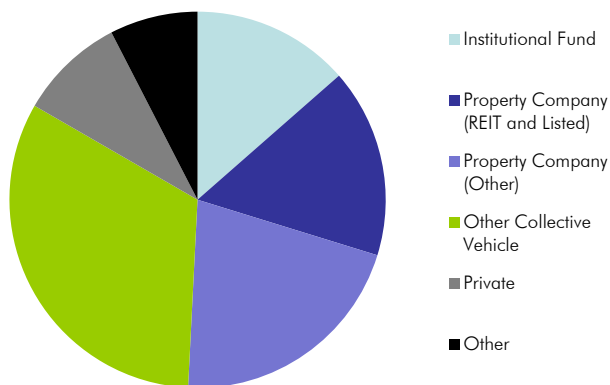
Cross-Border Investment by Buyer Nationality, H1 2011



Cross-Border Purchases and Sales by Buyer Nationality (€ million), H1 2011



Buyer Mix by Value, H1 2011



BUYER TYPE

The increase in equity investment during 2010 resulted in institutional funds accounting for a larger share of European investment activity. This trend has stalled in H1 2011, with institutional funds accounting for 14% of total activity in H1, down from 24% in the second half of last year. The fall in institutional investment activity is not viewed as permanent.

The reduced share of activity by institutions over the first six months of the year was counteracted by a boost in property company activity, in particular by REITS who were very active in the UK market. In general their interest remains focused on offices in Central London and the South East, but H1 activity also included Capital Shopping Centre's purchase of the Trafford Centre in Manchester for €1.9bn in Q1 from Peel Holdings.

Ten Largest Investment Markets, H1 2011

	Turnover (€ million)	Change on 2009	% of European Market*
Central London	7,921	68%	17.1
Paris	3,721	54%	8.0
Manchester	2,013	172%	4.4
Moscow	1,759	118%	3.8
Stockholm	1,494	43%	3.2
Frankfurt	1,388	48%	3.0
Hamburg	1,176	202%	2.5
Milan	1,096	138%	2.4
Warsaw	1,003	19%	2.2
Berlin	885	317%	1.9

TOP TEN INVESTMENT MARKETS

The first half of 2011 has seen something of a shake-up in the list of most active commercial real estate investment markets, with both Moscow and Warsaw featuring.

London and Paris continue to occupy the top two places, but their share of the market (25.1% of identified locations) was much lower than is normally the case. By contrast the two cities represented 32.1% of the market in H2 2010.

The presence of Moscow and Warsaw testifies to the growing level of activity in the main CEE markets. With competition for prime assets in Western Europe intense, both markets offer large, relatively liquid alternatives, with the added advantage of a yield premium.

Manchester's presence is as a result of the transfer of the Trafford Centre from Peel Holdings to Capital Shopping Centres and otherwise the market in UK provincial cities was in line with recent trends.

The other places are taken up by Stockholm, Milan and several of the major German cities, all of which are regulars in the top ten.

*Excluding indivisible multi-city portfolios

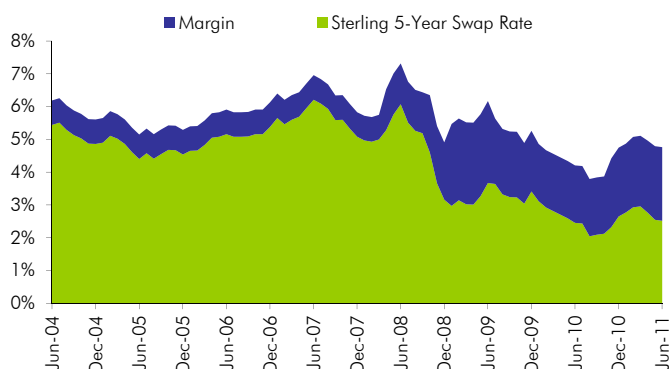
**Key Lending Terms*:
Top Quality Real Estate and Tenant, June 2011**

Market	Max Loan	Max LTV	Margin**
France	€75 mil	65%	165 bps
Germany	€200 mil	70%	145 bps
Netherlands	€70 mil	70%	150 bps
Spain	€35 mil	65%	300-325 bps
UK	£60 mil	70%	225 bps
Market Trend	➔	➔	⬆

* New 5-year loan based on the maximum underwriting ability of a single lender

** Margin over euribor/libor swap

**Evolution of Property Financing Cost in the UK:
Top Quality Real Estate and Tenant:**



DEBT MARKET

The tightening in lending terms seen in Q1 2011 has accelerated in the second quarter due to the deteriorating economic situation and new concerns over sovereign debt. This trend, which was first evident in Southern European markets from the middle of last year, has now spread across Europe.

Germany is the only market where it could be argued that this is not the case. There is competition between lenders to finance prime transactions, with the maximum loan size having increased over the year. The capacity of lenders to finance large, prime transactions is materially different in Germany compared to other European markets. However, there is little appetite for financing more secondary property transactions and borrowers are still finding it difficult to refinance loans on such properties.

At the other end of the scale financing conditions in Spain are very tight. The downgrading of Spain's sovereign debt has had a knock-on effect on the cost of capital to Spanish banks. As a result margins are high and single lenders are prepared to finance only relatively small transactions.

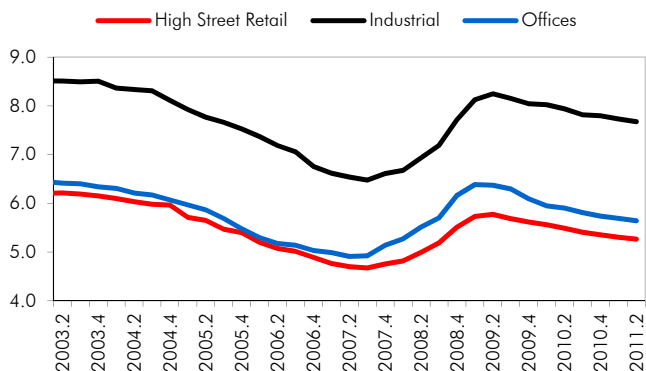
German banks remain active across much of Europe and, in the Netherlands, this is keeping margins relatively low. It has also created a gap in the market for loans that are too small to interest the Landesbank, but too big for local niche players. Outside prime, lending is very relationship driven, with lenders only prepared to provide capital to borrowers with whom they have a track record.

In France lending remains generally available for prime assets and good secondary properties. Unlike many other European markets where the German banks are major players, local lenders are dominant in France. Once loan size exceeds €50 million there are more club deals, but there have been recent examples of financing over €100 million for best in class investors. However, a substantial proportion of lenders capacity is being absorbed by refinancing existing debt rather than new lending.

In the UK, availability of finance is also reasonably good for prime and good secondary property. However, there has been a steady increase in margins over the last nine months, which has continued in 2011.

In terms of development finance, there is almost no desire in Europe to finance speculative construction, except perhaps from some mezzanine lenders at very high margins. Lenders will fund some pre-let developments.

EU-27 Average Prime Yields (%)



EU-27 Average Prime Yield Index, June 2011

	All Property	High Street Retail	Industrial	Offices
EU-27 Average Prime Yield (%)	5.71	5.27	7.68	5.64
Quarter-on-quarter Shift (bps)	-5	-4	-5	-5
Year-on-year Shift (bps)	-25	-22	-26	-26

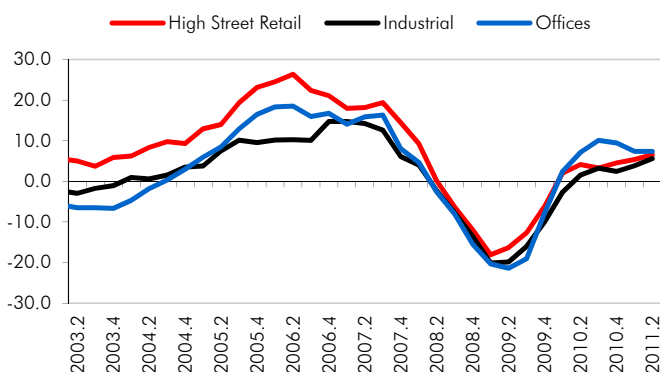
YIELDS

The most recent CBRE data shows that although prime yields continue to fall across Europe, the rate of decline has slowed, with the 'All Property' yield index falling by just 5 basis points in the second quarter. This slowdown has affected all three main property sectors, with office, retail and industrial property all seeing less yield shift in the last six months than in the previous six.

This yield stabilisation is a trend that we have been expecting, as in many major cities the current prime yield is already approaching the level that was achieved at the peak of the market in 2007. Although the risk free rate has fallen since then, it is hard to see how prime yields could fall much further in today's weaker economic environment. Notably cities in Germany, Sweden and the CEE where the economic picture is generally stronger continued to see downward yield shift.

Instead of continuing to drive down prime yields, investors' attention appears to be refocusing on opportunities for yield enhancement. Investors are still very risk averse, but they are increasingly prepared to look at slightly more risky markets or at property with some value-add potential.

EU27 Capital Value Index (% per annum)



CAPITAL VALUES

With yields starting to stabilise, rental growth is taking over as the main driver of capital value change. Having said that, rental value growth is not increasing as fast as might be expected given the low level of new development coming to the market. Weak economic growth looks as though it is to blame, with occupier demand – particularly in office and industrial sectors – not as strong as expected.

As a result the rate of capital value growth for prime space appears to be stabilising at around 6 to 7% per annum.

Outside the prime segment of the market the trend is rather mixed. Although the market for poor quality property is still very weak, there is some evidence that capital value growth is accelerating for property just outside the most prime segment. This suggests that at least some investors are prepared to relax their investment criteria in order to obtain a slightly higher yield.

DEAL SIZE

While investment turnover in the H1 2011 is 13% down on H2 2010, in terms of deal size, its composition remains similar. The market continues to be made up of more deals over €100 million than in 2009 and the first half of 2010, while the number of deals under €50 million remains lower. In total there were 10 deals worth €500 million or more compared with 15 in the whole of 2010. However only one of these deals took place in Q2. This suggests that the general weakness in investment and increasing economic uncertainty across Europe is also affecting investment appetite for larger lot sizes.

It was also notable that seven of the ten largest deals in H1 took place in the UK and Germany, and that more than half of these were retail purchases. In fact, for all deals over €100 million investors were heavily focused on office and retail assets in Germany and the UK, indicating that the trend for core assets in core markets remains prominent.

The average deal size fell slightly to €26.8 million from €27.5 million, remaining considerably above the low of 2009 when the lack of debt finance and unprecedented level of economic uncertainty restricted activity among both debt and equity investors. The risk of further economic shocks over the next six months is likely to stilt the recovery of investment appetite for large lot-sizes although there is clearly underlying interest for this sector of the market subject to the macro-economic climate.

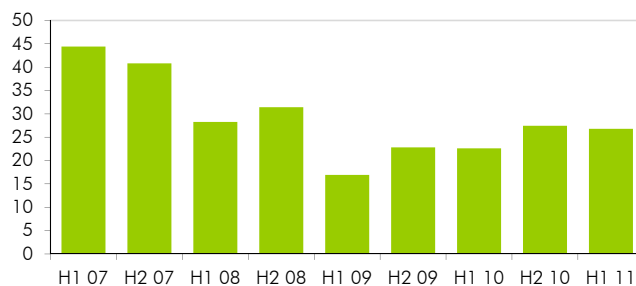
MARKET ANALYSIS



The investment market in **Austria** was continued to be weak in the second quarter, with around €300 million of transactions completed. However, activity is expected to pick up in the second half of the year, with a number of new opportunities coming to the market.

The **Belgian** market saw a substantial increase in activity in the second quarter. The majority of transactions (by value) was in Brussels, but there were deals across a variety of locations. In terms of property type, the office sector dominated activity. In particular there were few transactions in the retail sector and those that did complete were typically quite small. German investors were particularly active, completing three significant office acquisitions in Brussels.

Average Deal Size (€ million)



Largest Investment Deals in Europe, H1 2011

Market/Sector	Buyer	Price, € million
UK/Shopping Centre	Capital Shopping Centres	1,853
CEE/Portfolio	CA Immo	890
UK/Supermarket	Tesco Pension Fund	794
Germany/Retail Warehouse	Cerberus	c 700
Germany/Shopping Centre	Canadian Pension Plan IB	c 650
Germany/Office	DWS Access Deutsche Bank Türme	584
Sweden/Student Housing	Uppsala hem	565
UK/Business Park	Blackstone Real Estate	556
UK/Mixed Use	Pension Fund of Norway	524

Paris dominated investment activity in **France**, accounting for over €2 billion €2.5 billion of investment transactions in Q2 2011. It is also notable that the vast majority of investment was in offices, with the retail sector particularly quiet. The active investors remained largely unchanged, with equity capital dominating the market and funds providing much of the property for sale. The sovereign debt crisis is keeping investors cautious, although some investors are becoming less stringent in their buying criteria.

Germany has been one of the strongest of the European investment markets over the last year and a half, and Q2 2011 was no exception. With €5.6 billion of transactions completing Germany was the second largest investment market in Europe, only just behind the UK. Strong consumer spending growth is encouraging high levels of investment in the retail sector, which made up 45% of the total.

With €143 million transacted in H1 2011, the investment market in **Ireland** is very quiet. The bulk of the half year total was made up by Google's acquisition of Gasworks House and Gordon House for their own occupation. Uncertainty over changes to the law, including the outlawing of upwards only rent reviews is keeping potential investors out of the market.

Turnover in the **Italian** investment market was at its lowest since 2005 at €1.9 billion in H1 2011. The biggest transaction by far was Fondo Ippocrate's acquisition of La Rinascente Duomo in the centre of Milan. The fact that Italy appears to be being drawn in to the sovereign debt crisis is clearly having an impact on investor confidence.

The **Dutch** market is being affected by the lack of buying activity from the German Open-ended Funds. It is traditionally one of the key investment markets for the GOEFs, but they have been substantial net sellers outside Germany so far this year. We expect that the market will remain quiet for the rest of the year, dominated by small transactions and domestic investors.

The picture is similar in **Portugal** where the market is also made up of a few domestic investors. The sovereign debt crisis is having a significant impact in Portugal and the public sector cut-backs that are required as a result will subdue both economic growth and the real estate market over the next few years.

The **Spanish** market has also been weak so far this year, with just over €1 billion in transactions in the first half of 2011. However, unlike other markets in Southern Europe, which foreign investors are avoiding, there are some overseas investors targeting Spain. Over three quarters of all transactions in H1 2011 involved foreign buyers who are mainly interested in what they see as a one-time opportunity to buy prime Spanish property at yields that are far higher than the long-term average. Buyers are from all over the world, including USA, Canada, China and Japan.

In the **UK** investment was particularly weak in Q2 after what is by recent standards quite a high level of transactions in the first quarter of the year. Oddly, although the European market is dominated by institutional capital at the moment, an absence of transactions involving direct institutional buyers seems to be behind the lack of transactions in the UK in Q2. Having been behind 25% of UK deals in 2010 (and 30% in 2009), they represented just 14% of buyers in Q2 2011.



The **Nordic** region has been one of the strongest parts of the European investment market over the first half of the year, with total activity of just over €8 billion, well ahead of the €7 billion transacted in H1 2010.

In particular, the level of foreign investment in the region was much higher than the recent past, with nearly €1 billion of transactions just in Q2, including Grosvenor's acquisition of a retail portfolio in Sweden for around €270 million.

Sweden accounted for the bulk of transactions in H1 2011 and was also the destination for the majority of foreign investment into the region. After a quiet period over the last couple of years, there was an uptick in the level of retail activity, with nearly €1 billion of transactions in the first half. **Finland** also had an active H1, with just over €1 billion of investment transactions. Foreign investors accounted for quite a high proportion (38%) of the total, with German Open-ended funds continuing their run of acquisitions. In contrast, the **Danish** and **Norwegian** markets have been relatively quiet so far this year, with turnover down relative to the same period last year.



The **CEE** is another region that has been experiencing a high level of investment activity, with over €2.5 billion of transactions in each of Q1 and Q2. As usual foreign investors accounted for the majority of transactions, but a trend that has been evident in the last eighteen months has been the growth in the

proportion of deals, particularly in **Russia**, involving local investors.

The Russian market saw a particularly high level of transactions in Q2 2011, at €1.7 billion. There were transactions in all three main sectors, although the largest single deal was the sale of the Ritz-Carlton Hotel.

Although it was quieter in Q2, the other very active market in the CEE region is **Poland**, with around €1.8 billion of transactions in the first half as a whole. Poland is attracting attention as a result of the country's robust economy (no recession in 2009 and growth of around 4% expected in 2011) and the fact that it still offers a yield premium over the major Western European markets. Activity is also starting to pick up in more peripheral CEE countries, such as **Bulgaria** and **Slovakia**.

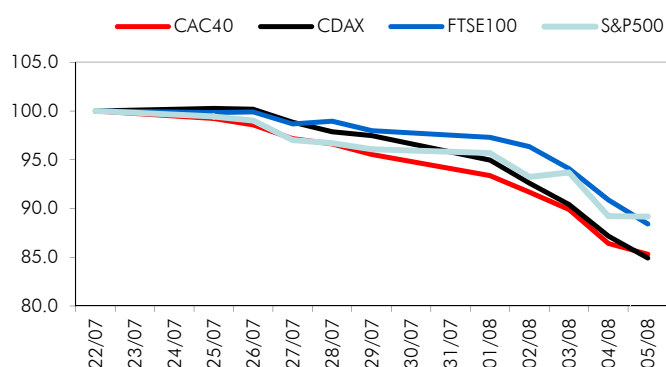
Market Outlook

As we have moved into the third quarter, the situation in the world's financial markets has changed radically. A number of factors have combined to strip the markets of confidence:

- The resurgence of the sovereign debt crisis in the Eurozone;
- Confusion over raising the US debt ceiling and the subsequent downgrading of US debt by S&P;
- The release of weaker than expected economic data in most developed countries.

The result has been a couple of weeks of extreme movements in financial indicators, illustrated by the falls of 10-15% in major stock market indices between 22nd July and 5th August.

Major Stock Market Indices (rebased)



It is early to be drawing conclusions from this on the likely impact on real estate markets. However, the tendency under such circumstances is for capital to head for the assets that offer the greatest liquidity, which do not include property. The turmoil of the last two weeks will almost certainly persuade some investors to sit on their hands until the situation becomes clearer. A lower than expected total investment turnover for 2011 could therefore be one outcome.

The inclusion of sovereign debt in the mix of influences also suggests that investors across currencies will be particularly tempted by inaction. However, investors who are less sensitive to short-term exchange rate and liquidity may benefit. Competition for prime assets in core markets has been intense, with many investors complaining that they have been struggling to identify suitable investment product. For such investors the withdrawal from the market of some competing investors for the late summer is an opportunity to become more active, not less.

The data in the charts shown in this report is principally that of CB Richard Ellis. However, additional information has been sourced from: PropertyData, KTI, Realia Management and Macrobond.

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