King Sturge

Market recovery exhibits north-south divide

- Recovery continues but sentiment remains fragile.
- Office rents in London and Paris rising, while elsewhere in Europe rents are stabilising.
- Prime yields expected to remain stable in the short term until occupier market picks up.

Economic Outlook

Economic growth expected to flatten out.
Over recent months, global demand has continued to recover, but uncertainty about the future has also risen. Eurozone GDP climbed by a healthy 1% during Q2 2010, though this concealed a wide range of national outcomes, with a clear north-south divide. German output jumped by 2.2%, driven by buoyant export demand. France was well behind (at +0.6%), however, while activity was even more marginal in Spain and Italy, albeit still positive.

Europe is central to ongoing concerns about the short-term global outlook, with the sovereign debt crisis dragging on into the autumn. Large support packages have not allayed fears about prospects in the most vulnerable economies. Greece has evaded default, but without convincing markets that it is clear of danger. Bond spreads are back to all-time highs in Ireland and Portugal as well. Spain alone has been favourably re-evaluated, after taking the necessary fiscal steps to reassure investors.

With the US recovery faltering, prospects for the rest of this year and into next are for growth to flatten out. As a result, Eurozone GDP is forecast to dip slightly next year to 1.4% compared to 1.5% this year, with no acceleration predicted until into 2012. There are also downside risks with any sovereign default likely to hit Europe's fragile banks and choke off the supply of credit for the recovery.

Fortunes remain mixed across the EU. Germany is expected to lead GDP growth in 2010, but fails to sustain this next year. France has a more consistent, but slower, upturn, with Italy lagging further behind. Spain, Ireland, Portugal and Greece are forecast to experience falling output this year and, at best, muted revival in 2011. Prospects are stronger outside the Eurozone, with the UK the top performer of the larger western economies after 2010. Central and eastern European economies are likely to return to their post-crisis growth rates by 2012. Currently, Poland outperforms its central European neighbours.

Office Markets

London and Paris lead recovery
Most office markets across Europe experienced stable levels of occupier activity in Q3 2010. While London and Paris registered strong rental growth on the back of improving occupier sentiment, the rest of Europe shows a more mixed picture.

London continues to perform well with Q3 office take up in the West End roughly on a par with Q2 and a significant boost in activity registered in the City. While rents remained stable in the West End, the City recorded growth for the fourth consecutive quarter. Prime City rents now stand at £52.50/ft² (€656/m²), up around 23.5% on the year. Further rental growth is expected in the next six months as the pause in development starts during 2008 and 2009 has tightened new office supply considerably.

The Paris office market experienced sustained levels of demand, pushing up rents for the second consecutive quarter to €750/m². The 7% rental growth seen in Paris was the highest in Europe during Q3 2010. Elsewhere, rents also increased in Luxembourg and Stockholm.

Frankfurt and Athens fared less well with prime rents coming under further pressure. Athens registered the sharpest rental decline, with a 6.7% fall to €336/m². Further rental decline in Q4 is likely as competition between landlords remains fierce.

Subdued demand for office space across CEE continues to put downward pressure on rents in a number of locations. Sofia saw a sharp correction in Q3 2010, with rents down by around 5.3% to stand at €216/m². Rents in Prague and Bucharest eased to €240/m² and €246/m² respectively. For most of the cities surveyed, rents should remain stable until the end of 2010. The two exceptions

Economic forecasts: Oxford Economics (July 2010)

Rent and yield data as at end September 2010 are Moscow and Istanbul, where a gradual increase in occupier demand, combined with a tightening of Grade A supply, should support further rental uplifts.

Office investment activity continued apace across Europe in Q3. According to preliminary figures from Real Capital Analytics (RCA), total investment volumes came to €8.3bn in Q3. Whilst this is 7.5% down on the previous quarter it still represents a 12.6% increase on the same period last year.

The office investment upturn is strongest in Western Europe and more specifically London and Paris. Both centres saw some marginal yield compression in Q3. Elsewhere in the West, markets generally remained stable with no yield change on Q2. With yields now close to their historic averages, the outlook for most Western European markets is stable over the next quarter.

In Central Europe most surveyed cities recorded a further inward yield shift. In Warsaw yields seem to have stabilised somewhat after three consecutive quarters of hardening. The prime office yield now stands at 6.35%, 65bp less then a year ago. In Eastern Europe, most centres saw no change in Q3 2010. Prime yields are likely to remain stable in the short term unless investor interest picks up considerably.

Industrial Markets

Investment activity slows in Q3.
European occupier markets in the industrial and logistics sectors paint a mixed picture. Some of the underlying demand drivers are improving, with overall economic activity generally expanding, world trade sharply up on last year (when it contracted by around 12%) and container volumes through Europe's largest 10 container ports up 12% in the first half of the year compared with H1 2009. That said, the economic recovery remains fragile in many parts of Europe and manufacturing activity remains volatile.

In the UK, demand for logistics property has picked up during 2010 with take-up on an upward trend since Q1 2009. Recently, enquiries have picked up around Heathrow Airport but rents in this market remained stable at £13/ft² (€162/m²) in Q3, and are expected to do so in the short term. In general, rent free periods and other incentives, which have risen significantly over the last two years, will need to come down further before any upward movement in headline rents can be expected.

Dublin and Milan registered a sharp fall in rents as demand for logistics space continues to slow. Elsewhere in Europe, rental levels remained broadly stable with the exception of Moscow, where rents moved up over the quarter. Given the decline in the availability of new speculative product and the tentative improvement in demand, headline logistics rents should remain largely stable across Europe during the rest of 2010.

Following a strong first half of the year, investment transaction volumes in the industrial sector fell in Q3. According to preliminary figures from RCA, around €1.3bn was transacted in the quarter, just over 20% down on the same period last year. Pricing has now stabilised across most parts of Europe, with yields coming down from their highs of early 2009, and with limited rental growth expected in the short term the industrial sector has lost some of its attraction. In addition, there are still concerns about the fragile state of the occupier market.

The recovery of industrial investment activity over the last 12 months was largely led by strong activity in the UK. This picture was somewhat different during Q3 with core markets such as Germany, France and the Netherlands, but also some of the Nordics, accounting for an increasing share of transactions.

Prime yields saw some further, marginal, downward movement in a number of markets, while in Dublin and Athens prime yields softened in Q3. In general, prime yields are likely to remain fairly stable at their current level towards the end of the year in most markets, although certain CEE markets could still see some yield compression.

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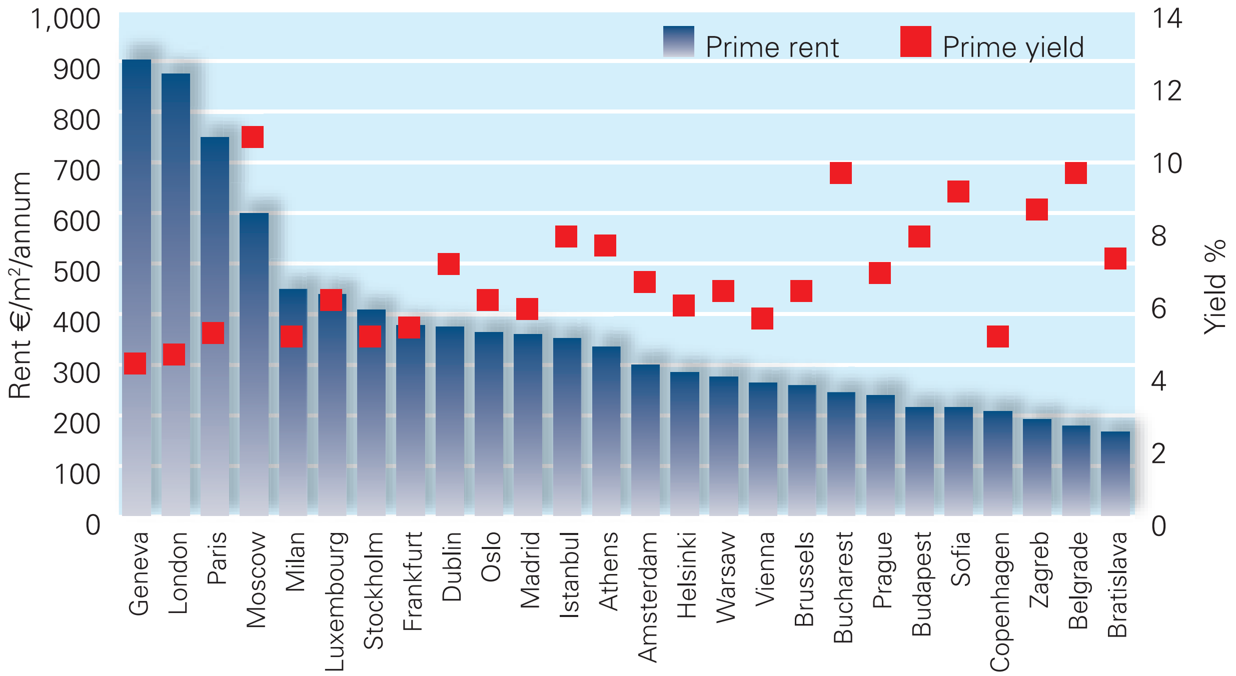
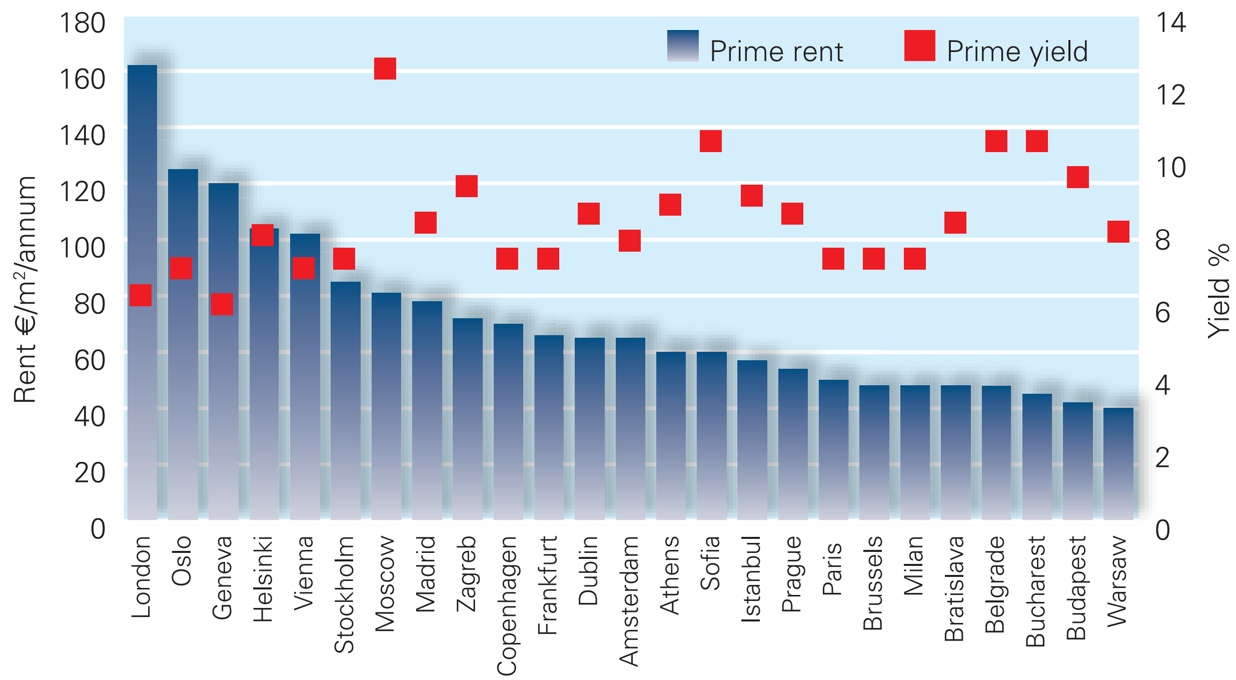
Office: rents (€/m²/annum) quoted refer to headline rents in high quality buildings situated in prime locations and are assumed to be over 500m². Investment yield (%) quoted refer to a valuation of office property let at full market value and which is of the best physical quality, in the prime location, and with the best tenant's covenant and contemporary lease terms. Generally, a benchmark with which to compare other properties. Warehouse: rents (€/m²/annum) quoted refer to headline rents in high quality buildings situated in prime locations and are assumed to be over 5,000m². Investment yield (%) quoted refer to a valuation of logistics property let at full market value and which is of the best physical quality, in the prime location, and with the best tenant's covenant and contemporary lease terms. Generally, a benchmark with which to compare other properties.

Chart 1: European prime office rents and yields



Source: King Sturge (September 2010)

Chart 2: European prime industrial rents and yields (units >5,000m²)



Source: King Sturge (September 2010)