Emerging Trends in Real Estate® Europe

2004

Urban Land Institute

PricewaterhouseCoopers

Emerging Trends in Real Estate® Europe

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Emerging Trends in Real Estate® Europe 2004

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ULI Editorial and Production Staff
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David James Rose, Manuscript Editor
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Interview/Survey Participants
Emerging Trends in Real Estate® Europe 2004 presents a consensus outlook for the future and reflects the views of more than 210 individuals who completed surveys or were interviewed as a part of the research process for this report. Interviewees and survey participants represent a wide range of industry experts—investors, developers, property companies, lenders, brokers, and advisers. A list of the participants in this year's study appears at the end of this report. The individuals and companies listed therein include all of those who were interviewed and most of those who returned surveys. To all who helped, ULI and PricewaterhouseCoopers extend their sincere thanks.

Emerging Trends Highlights

■ Capital flows will be the dominant force in European real estate markets. Huge sums awaiting investment from German open-ended funds, opportunity funds, institutional investors, and other collective vehicles will underpin investment demand for prime well-let properties with long leases.

■ Occupier demand will remain weak due to subdued economic recovery in most major European markets. Growth will pick up, but not enough to see a substantial increase in demand before the end of 2004.

■ Markets will be 'two tiered.' Reversionary properties and buildings in nonprime locations not fully let or in need of redevelopment will struggle to find buyers, and then only at a price that reflects the harsh realities of occupier demand.

■ Equity capital will take precedence over debt capital. Market-determined interest rates will rise and with them the cost of financing real estate.

■ Underwriting standards will become more stringent under the influence of forthcoming Basel II regulations. Developers will be hardest hit.

■ Peripheral markets will deliver higher returns than the Eurozone 'core,' with the lone exception of the central business district of Brussels. The best total returns will be seen in Moscow, Brussels's CBD, and the capitals of the largest central European countries scheduled to join the European Union in May 2004.

■ Retail shopping centres will experience the strongest sector returns. The weakest returns are projected for out-of-town business parks. Generally, offices are predicted to have a tough year, with substantial excess or underutilised supply in many markets.

■ Developers should be planning for the upturn several years hence because lead times are long. New development coming on stream in 2004 that is not prelet will suffer from a challenging demand environment.

■ Indirect real estate investment will increase. Demand for funds of all types managed by those with specialist expertise will expand.

■ Listed real estate markets will continue to shrink where there is no REIT-type structure available. Public companies will be merged or acquired and taken private where discounts to NAV are substantial.

■ Cross-border capital flows and rising numbers of pan-European and global investors will continue to increase market transparency as part of a transformation similar to what occurred in the European bond and equity markets over a decade ago.

Capital Conquers *the* Fund

There appear to be underlying supports in European *real estate markets that are less ephemeral than refugee capital from volatile equity markets.*

amentals

A third year of falling rents and rising vacancies is expected in almost every office market in the E.U. in 2004. Can profitability really continue in a real estate industry with such negative fundamentals in its most important investment sector? The majority of participants in this *Emerging Trends* survey think the answer is yes. Over three-quarters of respondents believe that profitability will be at least 'modestly good' if not better in 2004. That's a fairly startling consensus.

But it's also a consensus suffused with an uncomfortable awareness that this anticipated profitability owes a good deal of its vigor to the 'weight of money' still sitting in the coffers of German open-ended funds, private syndicates, and opportunity funds awaiting deployment in the markets. If some signs of bottoming out in the uncomfortable fundamentals don't start to come through over the next year there could be trouble ahead. "Investing today must be done very cautiously, with a focus on mitigating near-term occupancy exposure." "In most places there is a very long, hard road of falling rents and rising vacancies. Put on your seat belts!"

Strong Investor Appetite for Real Estate

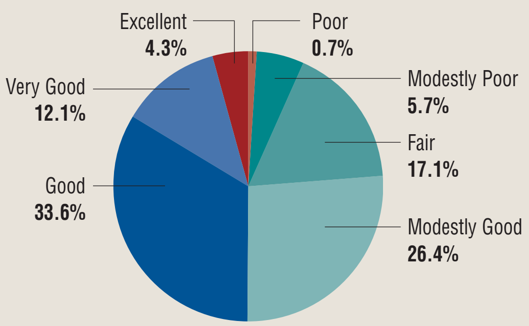
Nevertheless, there appear to be underlying supports in European real estate markets that are less ephemeral than refugee capital from volatile equity markets. Many institutional investors are looking to increase their exposure on a long-term strategic basis. These institutions are waiting for signs of market weakness and distressed selling to create opportunities more consistent with their estimates of fair value. This same sentiment is echoed by a number of prominent property companies that have been selling into what they perceive as an overheated market over the past year. They will increase their exposure when they see deals consistent with their financial models.

Although these long-term investors are sceptical of current prime office cap rates, none of them—and indeed few interviewees regardless of firm type—characterises current market levels as a 'bubble.' Expectations centre on a correction rather than a crash. Estimates of overvaluation tend to be in the 5 to 15 percent range and some think liquidity will buy the market sufficient time to adjust partially through a resumption of rental growth.

Further fundamental support for the markets comes from the fact that the structure of European real estate investment is changing, albeit slowly. Markets that have been essentially 'local' are becoming less opaque and more diverse in their investment base. Whilst there is still a strong perceived need for local partners, particularly local developers, foreign investors have "bashed down doors with their cheque books that were previously closed." "Large markets are becoming more transparent."

As a result, the industry is seeing the tentative beginnings of a move towards a more pan-European and even global investment market akin to what occurred in the bond and equity markets in the 1980s. "Three years ago, clients didn't even ask about opportunities for pan-European investment. Now the inquiries are frequent." There is an "internationalisation of investment activities and financing" and an "increasing focus on real estate as a trading asset."

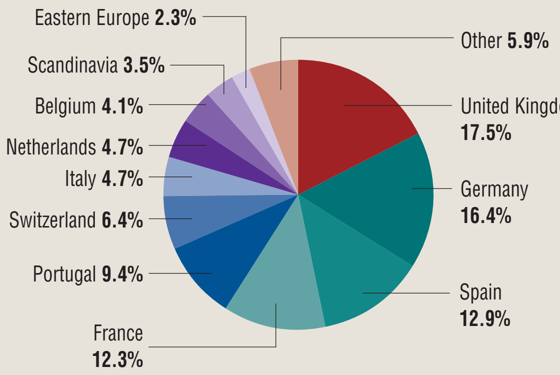
Exhibit 1-1 **Real Estate Firm Profitability Prospects**



Source: Emerging Trends in Real Estate Europe 2004 *survey.*

A more open, professional industry is evolving as real estate achieves "greater recognition as a 'mainstream' rather than an 'alternative' asset class." Though this will not prevent capital values from falling in the event of further declines in occupier demand, it argues towards different equilibrium levels than history might dictate. Some think that more transparency, greater depth, and enhanced liquidity suggest that real estate risk premiums should decline.

Exhibit 1-2 **Survey Responses by Country/Region**



Source: Emerging Trends in Real Estate Europe 2004 *survey.*

Waiting for Growth

Make no mistake—the economic fundamentals are a problem. Interview participants in this survey cited economic growth, more frequently than any other factor, as the most troublesome issue for European real estate markets. This stands to reason given that underlying demand for real estate is more highly correlated with gross domestic product (GDP) growth than anything else. "We need a sustained pickup in the economy to see job creation and occupier demand. Most of the recent rises in corporate profits have come from cost cutting."

For the past two years, participants in Europe's real estate markets have been watching their economies with growing unease. In each year since 2001, the consensus has been that the next year would see growth in GDP And each year hopes have been summarily dashed. The Euroland's largest economy, Germany, was in outright recession throughout 2003. The French economy shrank in three of the past four quarters of 2003. In most other core Euroland countries, growth has been similarly anaemic. Since Euroland does most of its trade within its own borders, weakness in the largest two economies is depressing activity in the entire area. In fact, the only large E.U. economies that are likely to have achieved growth of 2 percent or more in 2003 are Spain and the U.K.—and the U.K. is notably not a member of the Euro zone.

Yet returns on real estate not only have held up but also have exceeded expectations in most markets and so have industry profits. Half of the survey's participants said that their 2003 profitability was 'good' to 'excellent' and the vast majority reported that their businesses were either stable or growing. A similar proportion of participants expect their businesses to grow in 2004 and the majority of them expect decent profitability (see Exhibits 1-1 and 1-2).

Yet there is little complacency when one digs a bit deeper. The returns expected in most markets are modest, and when participants refer to their profitability few are expecting this to come from a further compression of cap rates. What they are expecting is further support for transaction levels from the players that have been a dominant force in the markets over the past three years, namely the opportunity funds and the German open-ended funds.

The impact of these funds is explored in some detail in Chapter 2 of this report, but it is impossible to get away from the fact that prime yields in most markets would not be where they are today were it not for these conduits of massive capital flows into real estate. They are not the only source of capital, but they are the most frequently cited source of the disconnection between occupier demand for real estate and the prices at which it is changing hands.

GDP Prospects Improving Modestly

The majority of participants are, yet again, expecting a pickup in GDP growth in 2004—which sounds familiar, but this time they could finally be right. Many of those surveyed look to growth in the U.S. economy to pull Europe out of the doldrums. With U.S. growth for third-quarter 2003 having come in at a 20-year high of 8.2 percent, they may well get their wish. Equally promising are the Ifo Business Climate Index results for Germany, which have been rising since May 2003. This index has been a good leading indicator for German economic activity in the past and though the former east German region remains weak, it appears confidence elsewhere is definitely rising.

At the time of the survey, consensus expectations for 2004 GDP growth in the Euro zone were at 1.8 percent. This is not a startling reversal of current weakness but a definitive improvement on the 0.4 to 0.5 percent growth that is the likely outcome for Euroland in 2003 (see Exhibit 1-3). The strongest 2004 growth within the region is expected from those countries that proved most resilient in 2003, namely Spain, Ireland, and Greece.

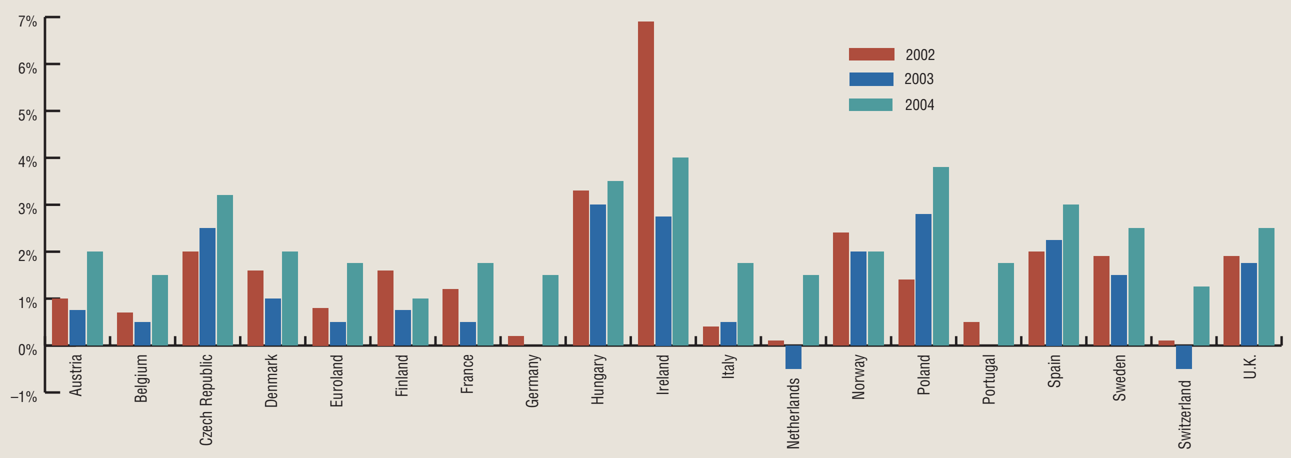
Growth outside Euroland will be stronger. U.K. GDP growth is forecast to accelerate to 2.7 percent in 2004, whilst Denmark and Sweden should achieve 2 percent and 2.3 percent, respectively. Meanwhile, the accession countries of central Europe should continue to surpass their western counterparts by a significant margin, with the Czech Republic, Hungary, and Poland expanding at rates in excess of 3 percent.

Outlook Stable for Inflation and Interest Rates

Emerging Trends survey participants largely concur with consensus expectations for GDP growth, although the majority also think that risks remain on the downside. In keeping with these low expectations for recovery, most do not anticipate any significant rise in inflation. Likewise, expectations for interest rate rises are modest. Few can envisage a scenario in which interest rates would have to be raised substantially by the European Central Bank within the next year or even three years.

The structural impediments to growth in Euroland's heavyweight economies are frequently cited as a persistent problem and interest rates will have to remain low to counteract it. If there is no change in the regulations that are putting a break on economic innovation and the efficiency of labour markets, many think long-term growth will be stunted. The mounting tax burden on employers to pay for huge government social

Exhibit 1-3 Annual Growth in Gross Domestic Product



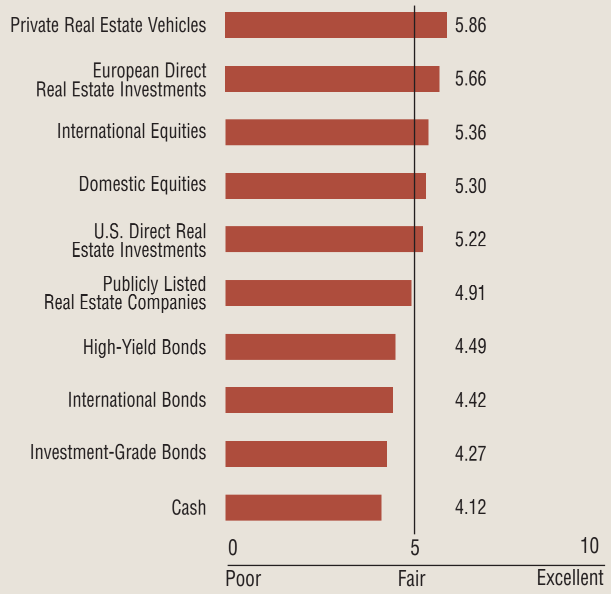
Sources: PwC, Destatis, INSEE, INE, Statistics Netherlands, Swiss Statistics, ONB, OECD, CSO, Central Bank of Ireland, National Statistics, IMF, Consensus Economics.

programmes and pension obligations is blocking the potential drivers of a strong economic recovery in Euroland.

In keeping with the more sanguine outlook for U.K. growth, the outlook for U.K. interest rates is for steeper rises than for those in Euroland. Since the economy has demonstrated that growth is gaining momentum, the Bank of England has already started to increase base rates and bond yields are well off their lows. Despite the more lacklustre growth prospects in Euroland, euro-denominated bond yields have also risen well off the lows seen during the first half of 2003. Most expect this trend to continue, but believe the magnitude of the increases will ultimately prove to be modest.

The general feeling is that the professionals will take dearer money in stride and even welcome it. "Higher borrowing rates will take the froth off the market." "A rise of two to three percentage points over several years is manageable." However, if rates increase a lot further or faster than the market is anticipating, it will create problems. "Large interest rate rises could do real damage. A big increase would rearrange everything." "Debt-backed deals are highly sensitive to interest rates—the deals not properly hedged will fall out of bed." "Office investments will appear very aggressively priced if bond yields go up again. Capital values will fall."

Exhibit 1-4 **Investment Prospects by Asset Class for 2004**



Source: Emerging Trends in Real Estate Europe 2004 *survey.*

Real Estate Should Remain a Favoured Asset Class

In spite of general scepticism about the near-term growth prospects for occupier demand in much of Europe, most of those surveyed expect direct real estate and private real estate vehicles to outperform bonds in 2004. More surprising, respondents think that real estate will also marginally exceed equity returns (see Exhibit 1-4). Scope for a recovery in occupier markets by 2005 is seen, with office markets (the largest and most troubled sector in terms of occupier demand) bottoming by year-end 2004.

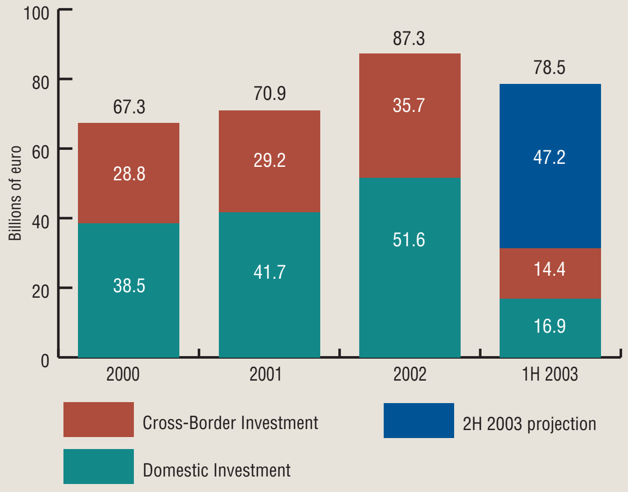
Meanwhile, investment flows are expected to reduce what might otherwise be a significant upward adjustment in yields. Retail sectors across Europe are expected to remain resilient thanks to continued consumption growth and planning laws that limit supply of out-of-town retail developments in most countries to protect central city retail areas. Warehousing will be bolstered by its relatively high yields in an investment climate where many are hungry for income. Meanwhile, modern logistics and distribution are seen as crucial to the structural change that is taking place in the way goods are moved around Europe. These vast generalisations are explored in more detail in Chapter 4.

Pan-European Investment: Global Money, New Property Vehicles

Ask anyone involved in European real estate fund management about the barriers to pan-European investment and the most typical response is something like, "Have you got a week?" The members of the Euro zone share a currency, but that's about as far as the official facilitation of cross-border real estate investment has gone. And, of course, some of Europe's most important real estate investment markets—including its largest, the U.K.—are not even part of the Euro zone.

As a result, pan-European investors are presented with a host of obstacles and problems. "Taxes, legal structures, business infrastructure, leasing conventions, operating standards, business culture, and language are different in every country." "Property is taxed locally. A deal that's tax efficient in one country is a tax disaster in another." "Execution on a European basis is costly in time and money. One can't move as quickly as local competitors because you need to adapt the process each time." "You need a local presence or a local alliance with people on the ground." "Transaction costs can be high and access to stock poor." "The complexity of setting up a vehicle to make a purchase tax efficient means the cost is often prohibitive. You need high returns to justify investing." Interviewees from property law practices corroborated investors' complaints.

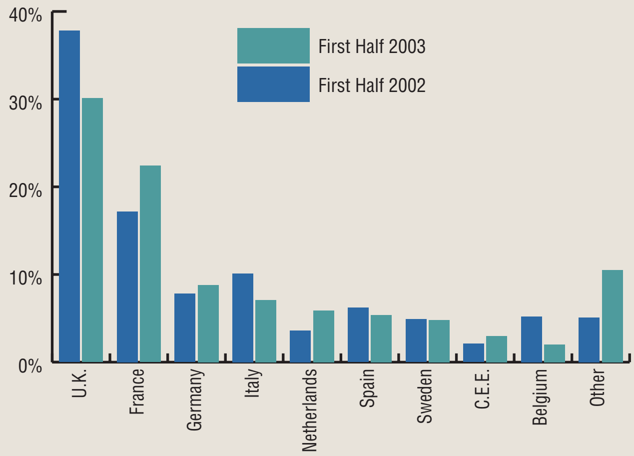
Exhibit 1-5 **European Direct Real Estate Investment**



Source: Jones Lang LaSalle European Research.

Note: Cross-border investment activity is defined as any direct transaction that involves a foreign buyer or seller.

Exhibit 1-6 **Cross-Border Investment Activity by Country**



Source: Jones Lang LaSalle European Research.

Note: Cross-border investment activity is defined as any direct transaction that involves a foreign buyer or seller.

However, they pointed out that "the more deals that are done, the easier it gets."

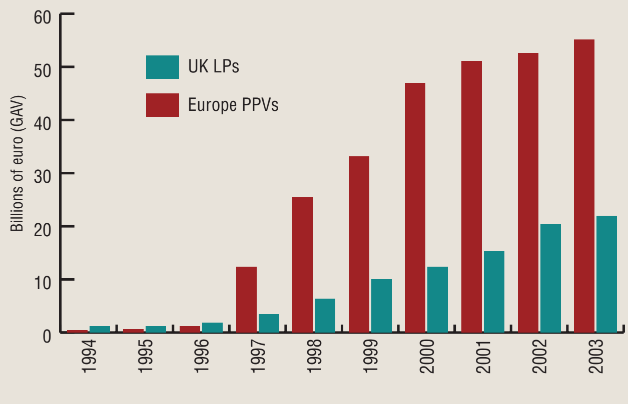
On the whole, pan-European investment in real estate is not as widespread at the institutional level as it might be and the majority of investors are still domestically oriented (see Exhibit 1-5). The leading countries for investment activity are the United Kingdom and France, which account for more than 50 percent of activity, according to Jones Lang LaSalle (see Exhibit 1-6).

Ironically, many innovations in pan-European investment have been pioneered by U.S. opportunity funds and other big international players. Clearly, considerable critical mass is required to realise the economies of scale that make pan-European investment viable. Many institutions would like access to the diversification offered through cross-border investment. "Although yields appear to move somewhat uniformly throughout the E.U., the diversity in occupancy and rent levels indicates diversification potential." However, most institutional investors are too small or lack the expertise and local connections to do direct investing for themselves. Thus there is increasing demand for indirect investment offerings. "More indirect investments—shares, funds, etc.—are needed." Expect to see a "megatrend from direct real estate investment to indirect investments."

At present, most European indirect property vehicles are specialist country or regional funds that have the attractive benefit of being able to draw on local expertise. There are also some pan-European offerings, but they are thinner on the ground. As a concept, these indirect vehicles have been welcomed by both investors and developers, and their growth has been impressive in recent years (see Exhibit 1-7). Many of them are offshore private partnerships for tax reasons—particularly where REIT structures are not legal in domestic markets such as the U.K. They provide an exit for developers and a means of gaining otherwise difficult to obtain exposure for investors.

A number of survey respondents pointed out that they would like to have access to indirect investment in central European markets as well as those in core Europe. Both are

Exhibit 1-7 **Growth in European Cross-Border Private Property Vehicles (PPVs) and U.K. Limited Partnerships**



Source: Property Vehicles Databank.

Note: European figures relate to cross-border PPVs; U.K. figures are for U.K. LPs only.

likely to be growth areas for the future. Regardless of the investment market, the key for investors is the ability to obtain exposure in a tax-efficient manner and the icing on the cake would be to have liquidity as well. However, tax transparency and liquidity are not always achievable given current tax laws in some countries.

In contrast to the current state of the pan-European real estate investment market, pan-European lending is in full swing. Major banks are financing real estate deals across the E.U. with no problem and it is wholly unnecessary these days to find a local lender.

Underpinning from Corporate and Government Sales

Underpinning both domestic and global investor interest in European real estate is the fact that corporate sale and leaseback deals continue to grow, although not at the rate of increase many have hoped for. Heralded for several years as the likely source of huge amounts of investment product, companies have been slow to jump on the bandwagon. Estimates for corporate owner-occupation are still around the 69 percent mark in western Europe.

One reason why companies might be fighting shy of getting property off their balance sheets is the pending introduction of new international accounting standards. It is difficult to tell a priori how these changes will affect individual companies.

However, the sale and leaseback of government-owned buildings is gaining even more momentum as deficit-plagued public authorities seek to raise cash. This is a trend that will run and run.

Development Prospects

One respondent said simply, "Very few projects can be justified in today's markets." Many respondents, but certainly not all, echoed this sentiment. There is a consensus that speculative office development is currently to be avoided in the E.U. markets where there is clearly considerable excess supply. In such markets only bespoke or prelet projects can be undertaken with confidence if the development is projected to come on stream in the next year or two.

However, it's hard to generalise about a group of markets as diverse as those falling under the rubric 'Europe.' In many cities, lead times are long and the supply overhang in prime space is not that large. Overbuilding was not as prevalent this cycle as in the previous one and a resumption of trend growth in take-up over the next two years could easily bring vacancies way down in CBDs like Paris, Milan, and Barcelona. Many office developers learned their lesson from the debacle of the early 1990s. "Most of them have battened down the hatches for the past two years." "If developers are going to ride the cycle, they should be thinking about the next upturn now."

Though offices may be investors' main focus, they clearly do not constitute the universe. In fact, there is increasing sector diversification occurring. In supply-constrained sectors such as shopping centres where "lead times can be as long as six or seven years" due to the political difficulty of obtaining permissions, property cycles are almost irrelevant. In some other sectors like warehousing and logistics, tough economic conditions imply a general downturn but can lead to added demand in certain areas of distribution as companies strive for greater efficiency in their efforts to cut costs. More generally, a pickup in economic activity will perk up demand for modern product in many parts of Europe and there are private investment vehicles being specially designed to channel institutional money into new development purchases.

Meanwhile, new development will also be affected by the movement of service jobs from western to eastern countries; this is a growing issue for European economies and a trend that is beginning to perturb some European real estate professionals. Though the issue is not yet generating the level of controversy in Europe that it has in the United States, its profile rises with every announcement of another call centre or back office being moved abroad. "Will we need all of the offices we've built if the jobs all move to India?"

So far, the number of European jobs lost is tiny but undeniably growing. Technology is enabling companies to source services—including those of professionals—as well as goods where they can be had most cheaply. One U.K. developer reported hiring a major firm of U.S. architects and finding that much of the team working on his building were situated in an eastern outsourcing hotspot. At present, the subject of outsourcing is generating far more heat than anything else, but some of those surveyed said the subject was already making an impact on their long-term strategic thinking. If this trend ultimately affects millions rather than thousands of jobs, it could have an important influence on office properties and development in the future.

Central and Eastern Europe: The Land of Opportunity?

The expansion of the E.U. and the drive towards integration of the central European economies suggest there will be future growth in all real estate sectors in these countries. Past precedent would indicate that E.U. money should flow in, particularly for road and transport infrastructure. This could create important logistics development opportunities in the future. At present, the accession countries scheduled to join the E.U. in May 2004 crop up as a source of opportunity mentioned by many in both our survey and interviews despite the small relative size of these real estate markets. "Central Europe offers the best overall prospects. It has rental growth opportunities and yield convergence prospects."

Though not all investors agree that there are great prospects for a quick killing on convergence since yields have been converging for years, many like the diversification and the existing yield differential. "Investors are increasingly seeking alternative markets." Although some "overenthusiastic office development" occurred in the mid-1990s, particularly in Budapest, markets are moving into better occupier balance.

For existing developers, it has been a good time to sell as there has been "a lot of money chasing quality product." Equally, for investors it's seen as a good time to buy. "Institutions can pick up a good bondlike return with the risk now mitigated." Though "it's probably still too early to develop new [office] product unless preleased," rising real wage growth is creating good conditions for retail development and warehouses. At the same time, the rising aspirations of the middle class have opened up "huge opportunities" for development in residential property, particularly as central European banks are now offering mortgages.

Further east looms Moscow, the market deemed to have the greatest potential returns in our survey, albeit accompanied by the highest risk. Development opportunities are there "for the brave" in all categories. Moscow needs high-quality offices, warehouses, retail space, logistics, housing—there's even a glaring shortage of two- and three-star hotels. "Demand is strong, but lending markets are undeveloped, which is hindering [real estate] development. Institutional lenders and investors are investigating the market but are concerned about the immature legal environment."

Changing Markets, Mixed Use, and Urban Regeneration

A number of interviewees questioned whether the industry is actually providing the environment and the buildings that will meet demand in future decades. "We are building as we have done for the past 30 years without questioning if this meets the requirements of a changing society." Traffic congestion problems are on the increase and many cite London as a particular black spot in this regard, although the problem is widespread in urban areas across the E.U. The rise in the number of single-person households and problems commuting into and out of city centres are motivating a trend towards urban living. There are indications that 'empty nesters,' i.e., couples whose children have left home, are also starting to move back into urban areas to take advantage of city amenities and the proximity of services. These changes argue for more mixed-use development and urban regeneration to recycle hollowed-out urban areas.

However, mixed use often struggles to gain acceptance from investors and is still not as sought after as pure office. This may be partly due to the greater difficulties in analysing and valuing mixed use with its shorter history as a sector. Whatever the reason, there would appear to be factors militating against the alignment between occupier demand and developer supply. "The real estate industry… must focus on what demand really exists and how to meet that demand. At the moment, markets are driven too much by money—especially German open-ended funds—looking for investment, regardless of how sustainable this investment might be." Working in tandem with government is seen as the way forward by many and there have been notable successes in a number of cities. "City centre regeneration schemes in smaller cities have tremendous potential if supported by local planning and government."

Urban regeneration, mixed-use development, and retirement housing often cropped up in discussions of planning for demographic change. On this front, remarkably little is being done despite widespread knowledge that populations are aging in most of the larger European countries. Multiple participants in this survey remarked that there was a clear future need for retirement housing and retirement communities. In addition, the majority of participants think it is the real estate industry, not governments, that must be proactive in planning for the changing requirements of an aging population. Partnerships with government in the planning and provision of all types of social housing, hospitals, and other needed infrastructure are almost certainly going to be a feature of the industry's future, but this trend is in its nascency. Most are monitoring, rather than actively pursuing, opportunities of this type.

Real Estate Capital

There has been intense competition for prime, well-located properties that are fully let to high-quality *tenants on long leases.*

Flows

A decade ago, anyone predicting that investors would be queuing up to buy London offices on a sub–6 percent yield in a market with double-digit vacancy rates would have been laughed out the door. It's amazing what cheap money can do. An abysmal three years of equity market performance and a nosedive in interest rates have sent investors running for the safety of good old-fashioned property. The main motivator is clear. Direct property returns measured on a ten-year comparison basis have beaten those on all major European equity markets.

In 2002—the latest period for which reasonably comprehensive data are available—European direct real estate returns (ungeared) were somewhere in the region of 7 to 8 percent. Property's relative performance over the past decade has restored confidence in markets that were marginalised after the bruising investors took at the end of the last cycle. But for others, the key to property's attraction has been that banks were happy to lend on it, and geared returns that took advantage of healthy yield differentials have been very beguiling indeed.

Not all types of property have participated in the investment party. In fact, markets have been distinctly two-tiered. There has been intense competition for prime, well-located properties that are fully let to high-quality tenants on long leases. It is these types of properties that have seen cap rates driven down to historically demanding levels. German open-ended funds and other core investors are targeting these properties. Syndicators and private high-net-worth individual investors also want them, and the institutions seeking bond-like property investments need them.

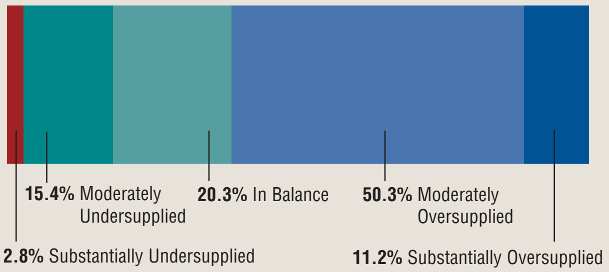
These investors have largely confined their purchases to such properties and there have not been enough of them to keep pace with investor demand. "The core segment seems very crowded at the moment." "Large core investors are competing for high-quality properties and paying good prices notwithstanding the relatively poor fundamentals of supply/demand underlying many of the major markets." The competition amongst core investors for suitable product has been such that those who previously confined themselves to the office sector have branched out into prime retail, logistics, and warehouses.

On the other hand, properties in second-tier locations with short leases or vacancies or needing refurbishment are, relatively speaking, orphaned in current market conditions and are trading at large discounts. There are purchasers prepared to do deals, but only at prices that reflect the real demand conditions and rental prospects for such properties. For some players there are attractions to going up the risk curve that this second tier represents. "This dichotomy presents the opportunity for value-added investors who are willing to take a view on the market and able to execute redevelopment, repositioning or re-leasing strategies to make good risk-adjusted returns in exchange for taking these risks." A

Ask anyone which core equity investors have had the biggest impact on the European real

Exhibit 2-1

Real Estate Capital Market Balance Prospects



Source: Emerging Trends in Real Estate Europe 2004 *survey.*

number of interviewees from institutions that would previously have focused on prime properties with long leases are actively considering the merits of taking on additional risk if discounts are hefty enough and the potential returns look good enough to justify the additional management burden.

Weight of capital has clearly dominated markets over the past two years. Will it continue to do so? Our respondents say it will. Over 60 percent believe the real estate capital markets will be moderately to substantially oversupplied in 2004. Availability from equity and debt sources in 2004 is projected to be as strong as that seen in 2003 (see Exhibits 2-2 and 2-3).

German open-ended funds, opportunity funds, private vehicles, insurance companies, and pension funds are all expected to be active in the market. Whilst some banks may be retrenching, others are expected to continue to add to their exposure. No one is expecting spectacular market returns, but investors' objectives have shifted and many are looking for defensive ballast in their portfolios. Many individuals are more concerned with wealth preservation than accumulation. "The emphasis of real estate investors has changed over the last three to four years from return maximisation to capital protection."

Capital Trends: Equity

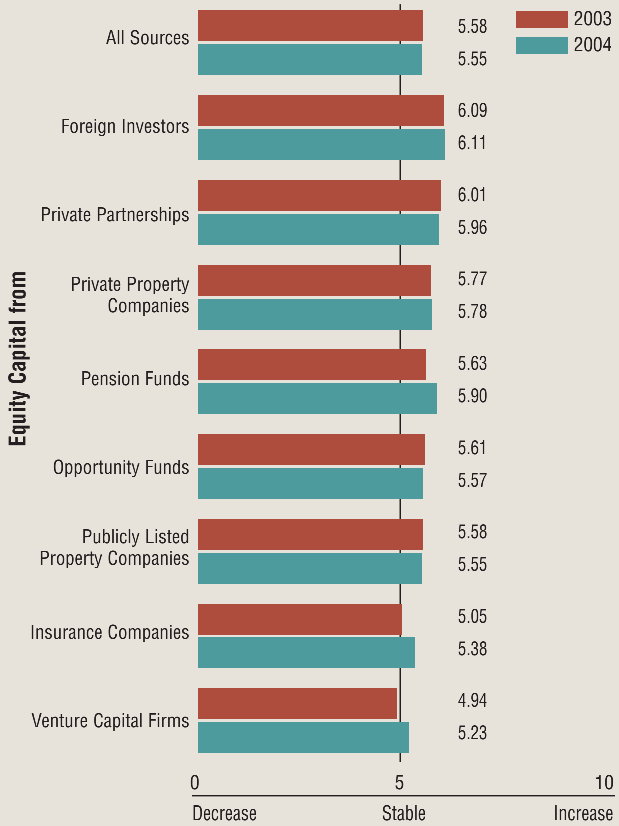
Equity is going to become more important in 2004. It shared the limelight with debt in 2003, but the emphasis is likely to shift following rises in swap rates that dictate the cost of real estate finance. In the sterling market, these have risen around 140 basis points above their H1 2003 lows as of 1 December 2003, whilst in the euro market they have risen around 120 basis points (see Exhibit 2-4). This has inevitably tightened the property yield spread over financing rates.

In previous decades, this would have been a signal to head for the trenches, but this time around the sources of equity are so numerous and their resources have been expanding so rapidly that there's plenty of fire power to keep the deals

Exhibit 2-2

Availability of Equity Capital for Real Estate

Change in the Availability of Equity Capital for Real Estate

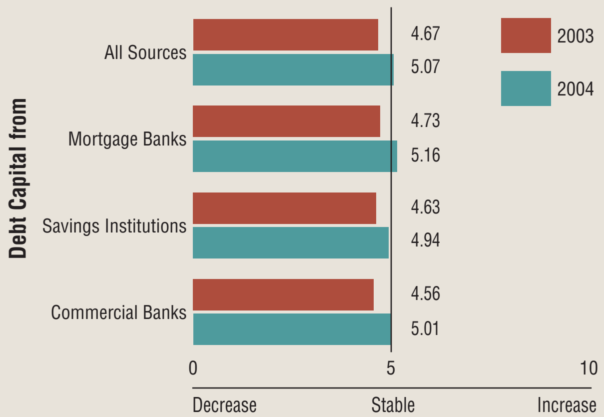


Source: Emerging Trends in Real Estate Europe 2004 *survey.*

Exhibit 2-3

Availability of Debt Capital for Real Estate

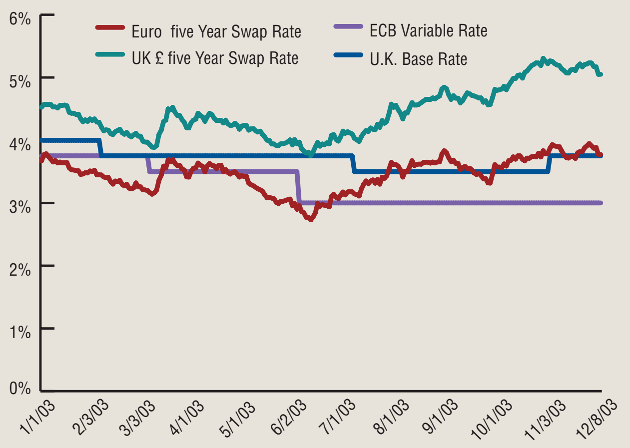
Change in the Availability of Debt Capital for Real Estate



Source: Emerging Trends in Real Estate Europe 2004 *survey.*

estate markets and his or her answer will be the same: **German** *open-ended funds.*

Exhibit 2-4 **U.K. Sterling and Euro Five Year Swap Rates**



Sources: Datastream and ECB.

Note: UK: £ Interest Rate Swap Five Year–Middle Rate.
Europe: € Interest Rate Swap Five Year–Middle Rate.

coming. Indeed, it is quite clear that far more transactions would have been done in 2003 if equity investors had been able to find suitable product to purchase. The bottom line is: there is plenty of equity around. Huge sums of money already raised are waiting to go into the market.

German Open-Ended Funds

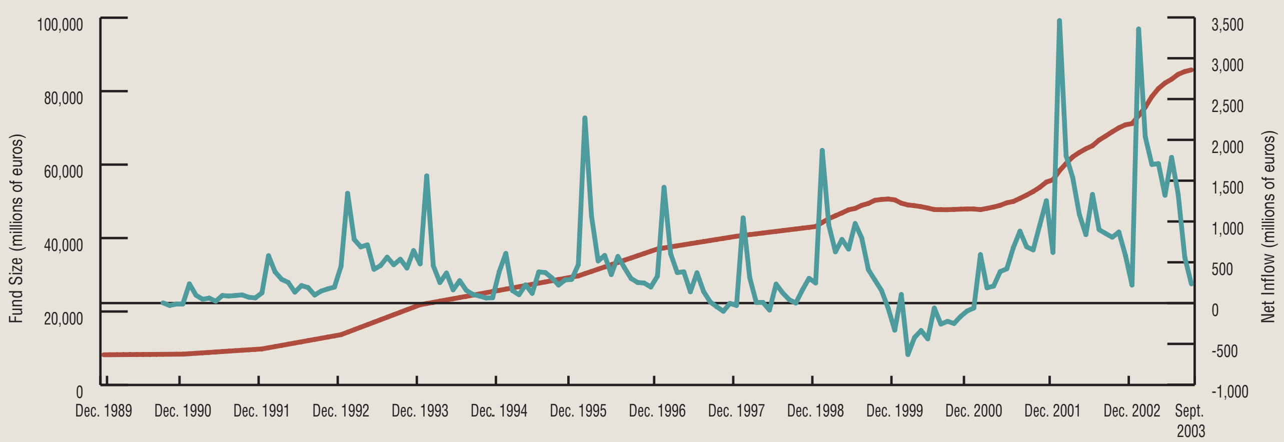
Ask anyone which core equity investors have had the biggest impact on the European real estate markets and his or her answer will be the same: German open-ended funds. These retail investment trusts have been amongst the main beneficiaries of private savings fleeing the German equity markets following their post-2000 implosion. In 2002, the open-ended funds experienced inflows of €14.3 billion, nearly twice as much as that seen in the previous year. In the first eight months of 2003 alone they took in almost the same again—inflows exceeded €14 billion (see Exhibit 2-5).

These funds have been hard pressed to invest these sums in the properties that they traditionally purchase. Over the past few years, they have diversified across Europe, competing for prime well-let offices in all major markets. CB Richard Ellis estimates indicate that German investors were responsible for 38 percent of all transactions in France during the first three quarters of 2003 and a high proportion of these would have been attributable to open-ended funds. However, even casting so widely for suitable product has not enabled them to invest the funds that keep flooding in. At the time of writing it has been estimated that they still have between €20 billion and €30 billion to invest. That's a lot of cash.

Heavy investment inflows combined with recent regulatory changes have motivated open-ended funds to diversify their asset allocation strategy more than seen in prior years. They have been diversifying into sectors they were formerly shy of, such as shopping centres. Moreover, changes were made to the legal framework governing these funds—in July 2002 and January 2004—that now entitle them to invest up to 100 percent of their funds outside the E.U. (previously the limit was 20 percent). The limit on the amount they are allowed to invest in indirect real estate vehicles has also been increased from 20 percent to 49 percent. These factors will enable open-ended funds to put more money into structured deals and large-volume transactions as well as invest a greater proportion of their portfolios outside the E.U. However, they will remain reluctant to invest in development projects given current market weakness, and this type of exposure is legally limited to 20 percent of a portfolio anyway.

The sheer volume of funds to be deployed indicates that German open-ended funds will continue to be active long-term

Exhibit 2-5 **Growth of German Open-Ended Funds**



Source: BVI.

investors in European direct property and indirect property vehicles in 2004. What will happen beyond 2004, however, is less clear. Inflows weakened substantially in the second half of 2003 and some open-ended fund managers are themselves expecting weaker inflows in 2004. This expectation is attributable to a recent decline in returns as a result of weaker rental markets and the low returns on the funds' considerable cash.

A number of interviewees concurred that German investors are likely to seek a more remunerative home for their savings if returns on alternative assets improve. Others think that there is an opportunity for asset managers to offer more exciting real estate products to German savers. Retail savings should flow back into other assets in time, but many German savers were so burnt in the equity markets that they will never return to them and the outlook for bonds (the other traditional asset for risk-averse German savers) is unenticing at present. There are also a few who think the massive flows into open-ended funds are storing trouble for the future. "The open-ended funds are paying too much money for properties. I believe that in three or four years they could be forced to sell and will find no buyers."

Opportunity Funds

Opportunity funds operate in a very different part of the risk curve than German open-ended funds, but they, too, are finding it hard to deploy funds, albeit for different reasons. These funds are looking for returns in excess of 20 percent on projects that meet particular financial criteria on relatively short time horizons—and in the current climate there aren't as many such 'opportunities' to be had as there were a few years ago. "Securitised vehicles have replaced opportunity funds in the investment hierarchy."

Although German open-ended funds try to avoid leasing and rent level-risk, opportunity funds are most concerned with liquidity risk. There must be a strong likelihood of a good 'exit' within a specified time period because they are highly leveraged. Estimates from Property Vehicles Databank (PVD) indicate that average target leverage is over 70 percent. PVD also estimates that opportunity funds have approximately €23 billion in as-yet-undeployed capital.

Most opportunity fund interviewees expressed a desire to avoid bidding battles with both core and smaller debt-backed investors. Typical transactions that big funds target are the large, complex sale and leaseback deals in which financial engineering skills are essential. They also target opportunities to take publicly listed real estate companies private. On the latter front, the recent narrowing of discounts to net asset value (NAV) will not have expanded the number of potential deals. Some of those surveyed are hoping to see some distressed selling from highly leveraged investors caught out by rising interest rates over the course of 2004.

Expect to see opportunity funds become more proactive in proposing deals to government entities and companies whose core business is not real estate. Some of those surveyed in other parts of the real estate industry said that they suspect that opportunity funds are lowering their return criteria in preference to having to return capital to investors.

Institutional Funds and Private Property Vehicles

Pension funds and insurance companies have long been investors in property. However, their exposure has varied considerably over time and the norms for exposure vary considerably across countries. The average across Europe is estimated to be around 9 percent, but continental European exposure tends to be higher than in the U.K. Despite the fact that net investment has not been unusually strong in the U.K. over the last four quarters for which there are data, our interview and survey evidence indicates that investment is likely to rise in 2004. This is important because the U.K. has the largest institutional pension fund sector in Europe. Many funds have no current exposure at all and allocations could continue to rise for the next two to five years. Typical target allocations are likely to move towards 5 to 15 percent depending on the fund. "The attractiveness of real estate assets to pension funds will trigger a further influx of capital from such institutions."

Pension funds are receiving encouragement to increase property exposure from the specialist actuarial consulting firms that advise them. This is a profound reversal from previously held attitudes on the part of consultants. Property's 'rehabilitation' comes partly from the post-crash recognition that equities are not an ideal match for pension fund liabilities. In addition, the diversification that property provides for a multiasset portfolio is seen as helpful in risk reduction.

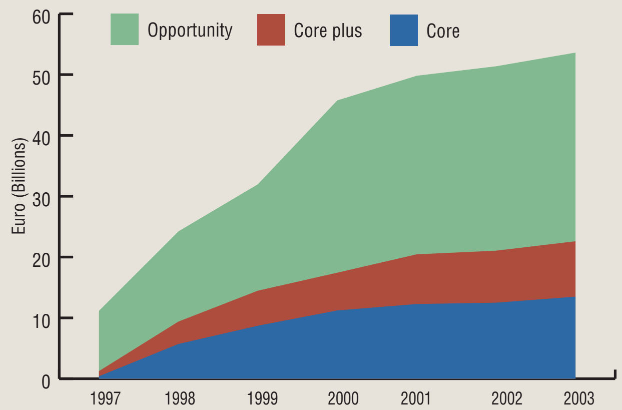
There is also a new analytical approach being proffered that argues that some properties can be viewed as higher-yielding substitutes for long-term corporate bonds. The argument is based on the thinking that there is little difference between holding a bond issued by a FTSE 100 company and the income stream from the rent on its headquarters. This argument is particularly pertinent in the U.K. market, where leases of 15 years' length with upward-only rent reviews are common (although the current U.K. government has criticised this norm and wants to see more flexibility in leasing, which could threaten the 'property as a bond' paradigm).

Many funds aiming to increase their exposure via direct property purchases have been stymied by the intense competition for well-let prime properties. Most pension funds are true core investors and are prohibited from using leverage. Moreover, many can't move quickly because of the long process from evaluation to investment, so they lose out to other more nimble investors. Furthermore, many do not wish to invest on yields that they deem indicative of a frothy market.

region, or sector and this trend is likely to continue.

In nondomestic markets they are generally even more disadvantaged, as only the largest have the expertise to invest cross-border. As a result, there is a very important trend towards using private vehicles and pooled funds to gain exposure. There has been a veritable explosion of private vehicles that focus on a single country, region, or sector and this trend is likely to continue. Growth has been particularly strong for private property vehicles (PPVs) that use an opportunistic style (see Exhibit 2-6). Small pension funds can use these vehicles to obtain diversification that they couldn't possibly achieve on their own and larger funds gain access to expertise they don't have 'in house.'

Exhibit 2-6 **Growth in European Private Property Vehicles by Type of Fund**



Source: Property Vehicles Databank.

As the projected increase in institutional allocations is only nascent—and these investors are long term—they will provide a very important backstop when the refugee equity money leaves for the greener pastures of recovering stock markets and the retail financial engineers get squeezed out by rising interest rates.

Syndicates and Other Fringe Players

In the United States, they say you can call the top of any market when doctors start buying. In Europe, doctors aren't such a useful contraindicator because they work for national health systems where salaries are more modest. But European real estate markets are full of the equivalent of those U.S. doctors, i.e., punters who aren't part of the usual landscape. The professional investors despair of these fringe players and the phrase "dumb money" is heard over and over again. They claim these outsiders are buying buildings on absurdly low yields using heavy leverage, and if the markets correct even modestly some of these punters "are going to get hosed."

Wealthy individuals have featured prominently as buyers. They are particularly prone to buying—and, according to professionals, overpaying—for trophy buildings (hotels are a favourite). However, it would be unfair to paint all of these investors with the same brush. Some are canny investors taking profits in one property market and reinvesting in another; witness recent Irish investment in the U.K. Capital flight money is a feature, too. Interviewees frequently mentioned funds coming in from the Middle East in response to the deteriorating political situation or being moved from the U.S. markets to Europe due to political sensitivities. These flows are not necessarily ephemeral.

It is, however, the syndicates that attract the most ire and derision amongst professional real estate investors. Complaints are rife that these retail investors are bidding up the prices of well-let buildings to absurd levels. Comments like, "If there is a bubble, it's in the syndication market," are heard time and time again. These funds are set up by firms that provide investment products for 'high-net-worth individuals.' Most of the syndicate formation reported is in London, although syndicates are also on the scene in Paris and lurking around in other markets such as Copenhagen.

Some of the firms doing the syndicating have only recently become involved with commercial real estate, bar a few tax-advantaged products. These syndicators are taking in retail money and buying well-let property (primarily offices). There is nothing wrong with that. The criticism is that many are doing heavily leveraged deals (85 percent is common) on yields as low as 5 percent. The existing income pays the interest and investors get the benefit of future rent increases and capital gains—if there are any.

It's clear that many syndicators are leaving little or no margin for error. From the professionals' point of view, they are paying 'silly money.' Many claim that the standards of due diligence are variable and there is a lack of discipline. The syndicators' repost is that their financial models are robust, their interest rate exposure is hedged for several years, and their product is attractive to their investors.

These funds have certainly taken in a lot of money and one London syndicator alone is reputed to have done £1 billion (€1.42 billion) in deals in the past year. The deals they are doing are significant and their influence has been felt, particularly across the London office and U.K. shopping centre investment markets. Institutional investors (amongst others) have been selling product to them—even institutions that are looking to increase property weightings—on the basis that the prices achievable now are unlikely to persist. In other words, the London office market is being distorted by the syndicate activity and "the smart money is selling."

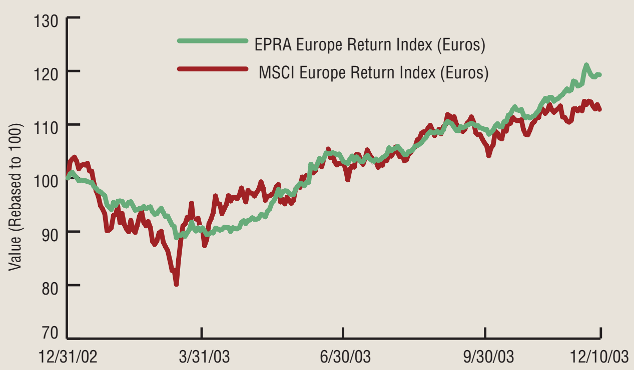
"Debt-funded buyers are paying prices that equity-funded institutions find hard to justify given current growth prospects. A good market in which to sell property let on long leases."

What's the future for syndicates? With interest rates and equity markets going up, the best guess is that retail investors will start to commit more of their new savings elsewhere in 2004. Deals that were done when five-year swap rates were 140 basis points lower cannot be done now, and big equity investors like German open-ended funds will gain the upper hand in bidding for well-let prime assets. In the medium term, there is a widespread belief that many of the more aggressive investments made by the syndicates in the past year will "end in tears." Time will tell.

Publicly Listed Real Estate Companies

The listed European real estate sector was a relative beacon of stability during the three years of equity bear markets thanks to its defensive qualities. However, a bigger surprise is that the sector has performed so well in the 2003 equity market rally. Indeed, at the time of writing the real estate sector has outperformed the broader European equity market. This may be partially because Euroland's growth prospects have been so uninspiring that equity investors have held onto some defensive sectors when they would normally be piling into growth stocks. The European Public Real Estate Association (EPRA) Europe Index delivered total returns of 19.3 percent in euros as against the MSCI Europe Index total return of 12.83 percent for the period 31 December 2002 to 10 December 2003 (see Exhibit 2-7).

Exhibit 2-7 **EPRA Europe Index vs. MSCI Europe Index YTD 2003**



Sources: European Public Real Estate Association (EPRA) and Morgan Stanley Capital International (MSCI).

But more has been afoot than an attachment to real estate's defensive qualities. The discounts to NAV that always plague the market have narrowed outside the office-heavy companies in the sector. Several forces are at work here. In the U.K. market (which constitutes 50 percent of the EPRA index) there were a number of significant share buybacks when NAVs widened in early 2003. More important, it was clear that more companies were being targeted to take private. There is a realisation that either the sector's fortunes will be revived by U.K. government approval of a REIT-type vehicle (in which case most listed companies will turn themselves into REITs—provided that legislation allows them to do so) or corporate action is going to continue to shrink the sector. Either way, investors will be able to obtain values closer to NAV. In the absence of REIT legislation, the trend for U.K. property companies to turn themselves into real estate fund managers is also likely to continue. However, this business model has yet to prove itself a platform for consistent outperformance and will not necessarily provide the answer to the sector's ills.

In France, corporate activity combined with government approval of a REIT structure for the sector buoyed the market. There is every likelihood that consolidation will continue and this is also the case in Spain, where M&A activity has been increasing as companies seek greater economies of scale.

It is clear to all that tax transparency is needed for the listed real estate sector to really thrive. Where REITs are not available, the listed sectors will continue to contract. Indeed, given current trends the U.K. listed sector will disappear in less than a decade. The real estate equity sector's historic performance has not enabled investors to access direct property returns or diversification since the sector tends to be more highly correlated to equity markets than direct real estate. At the same time, the sector's performance is usually dull compared with broader equity indices, leaving the publicly listed real estate companies without the attractions of either direct property or equity markets. In contrast, the outlook appears to be positive for REIT-like structures and it is likely that an increasing number of countries will legislate for them. Even three of the major accession countries (the Czech Republic, Hungary, and Poland) are in the process of doing so.

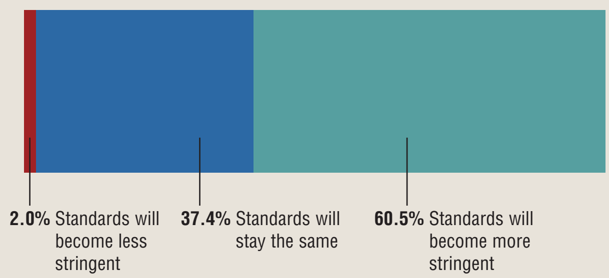
Capital Trends: Debt

It is clear that debt has played a huge part in oiling the wheels of European real estate at a time when occupier fundamentals could have derailed the markets. Banks have competed in earnest across Europe to lend on real estate, seeking its security at a time when Europe's corporate sector has been in recession and lending opportunities relatively limited. In some cases, "bank money has been used to structure a way through poor cash flow" in real estate deals.

at a time when occupier fundamentals could have derailed the markets.

But for the most part, those surveyed believe that lenders have been disciplined during this cycle and expect them to remain that way. In aggregate, the availability of debt for real estate finance is expected to remain the same in 2004 as it was in 2003. But what comes to light is that lending tightened considerably over the course of 2003 for some types of borrowers and the market anticipates more of the same. Over 60 percent of those surveyed expect underwriting standards to become more stringent in 2004 (see Exhibit 2-8).

Exhibit 2-8 Underwriting Standards Prospects



Source: Emerging Trends in Real Estate Europe 2004 *survey.*

Basel II: Already Making Its Mark

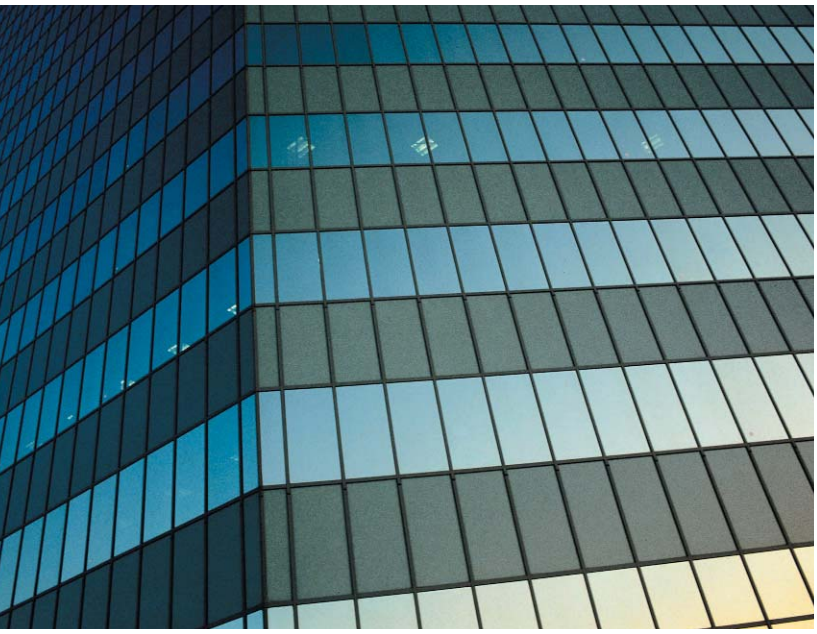
The new global standards for calculating required bank capital, Basel II, won't be introduced until 31 December 2006. Yet they are already having a profound influence on lending policy in some quarters. This is because lending on commercial real estate has been identified as one of the primary historic sources of banking instability across the globe. In the new, more sophisticated risk assessment regime of Basel II, 'high volatility commercial real estate' (HVCRE) loans have been singled out for the highest capital requirement—150 percent of the average 8 percent target capital requirement. Banks are already adapting their policies to the new regime.

So what exactly is 'high volatility commercial real estate'? The regulators' definition is "commercial real estate that displays high asset correlation when default occurs." The largest category to which this applies is real estate development, particularly any development undertaken that is not prelet or is in any way speculative. As a result, developers have felt the impact of Basel II before virtually anyone else. Those surveyed revealed that many developers are already facing much higher lending spreads than in previous years in conjunction with lower loan-to-value (LTV) ratios.

The impact of Basel II is being most widely felt in Germany, where previous opaque lending practices are facing a crackdown. This is happening concurrent with legislation that removes state government guarantees for the Landesbanks progressively from 2005. As a result, many Landesbanks are facing big reductions in their credit ratings that will affect their own ability to raise capital as well as that of their real estate customers. Small developers are already being squeezed or going bankrupt. As one major German developer stated, "Even though Basel II will not be effective until 2007, it is practically established today. . . . This will probably result in higher costs and shorter [time] perspectives. . . . The willingness on all sides—investor, developer, lender—to take risks will decline." On the basis of this analysis, Basel II is doing what it is supposed to do. The objective of the new regulatory regime is to make lenders more risk sensitive.

The present increase in stringency may be greatest in Germany, but it is having an impact on real estate developers seeking to undertake highly leveraged projects across Europe. Equity requirements are rising, spreads are increasing, and weaker companies are experiencing greater difficulty in obtaining finance.

So, development finance will be harder to obtain and more expensive than it used to be on average. Some believe there will be considerable reductions in real estate lending as



all this plays out. "Commercial banks will withdraw slowly from development finance." "Commercial banks, mortgage banks, and savings institutions will decrease the credit lines for real estate." That doesn't mean strong companies with robust project plans will have problems. They don't have any problem obtaining finance now and they are unlikely to have a problem in the future. It is the weaker proposals that will struggle. Many don't think this is a bad thing. "Standards of professionalism will increase," "instruments will become more sophisticated," and "loan portfolios will incorporate more international diversification."

When one looks at the big picture, it is probably fair to say that Basel II has already assisted the real estate industry by reducing the amount of excess supply that might otherwise have been in the pipeline. It may even be that the industry can expect a less volatile real estate cycle in the future thanks to Basel II. That would be an important change and a big payoff, but it's not a certain one. The law of unintended consequences often takes charge once new legislation is introduced.

Wider Lending Margins Ahead

Developers aside, there is no shortage of debt finance at present. There is fierce competition to lend on acquisitions, refinancing of standing investments, prelet development, and other lower-risk propositions. Despite the retrenchment of German lenders, a number of banks have been keen to expand their real estate exposure or diversify across borders and "some have been more disciplined than others." The same names crop up again and again on a pan-European basis. Local and national lenders are still in the frame trying to compete, but pan-European real estate lenders have become a real feature of the market along with pan-European competition. This has driven margins on senior lending down to the bone and borrowers have reaped the benefits.

This keen pricing is already under pressure and may not persist through 2004. The price of debt is rising in tandem with the market-driven uptick in swap rates and banks are looking for ways to increase their margins. The emphasis in some corners is shifting from senior lending to other more profitable products such as structured finance, advisory services, M&A assistance, and mezzanine.

At the same time, LTVs are ticking downward. Most lenders have already become "more selective" and some that have been competing fiercely to gain market share are going to become more exacting in their underwriting standards. Despite the fine margins accepted in 2003, expect margins to move out on senior lending over the next year as banks seek to differentiate more carefully between the risk of different borrowers and different tenants. Lenders' ardour towards real estate may also be dampened by an improvement in opportunities for corporate lending in a firmer European growth environment.

CMBS and Mezzanine Will Grow

There is a strong consensus that the commercial mortgage–backed securities (CMBS) market will continue to grow and become an increasingly important source of capital for real estate in Europe. The market is still small by U.S. standards, but it is deemed an important potential debt capital growth source for the future. "The CMBS sector will increase in Europe—particularly in the U.K. if the long lease holds up." "Generally, banks will need to be more conservative in their underwriting standards, which should open the door to more competitive products—CMBS, etc.—similar to the phenomenon that took place in the U.S. a decade ago."

Though 2003 was not a year for strong issuance growth on the basis of H1 figures, the market consolidated its position with a number of existing issuers coming back to tap the market and some first-time issuers appearing as well. Securitisation of existing loans almost certainly has a strong pipeline as banks restructure their exposure and make way on their balance sheets for new lending activities. Moreover, the brighter growth outlook for Europe should have a positive impact on the market. Any improvement in corporate tenant ratings as a result of increased economic activity will improve related CMBS ratings and further assist growth in the market. In addition, firmer growth will reduce fiscal deficits, and with them the rate of issuance of government bonds. These currently absorb substantial investment flows from fixed-income investors that might in the future take a greater interest in CMBS.

Mezzanine finance has also been growing and that growth should be sustained. New sources of debt capital will be required for development and mezzanine is a natural source. The entities providing the finance are looking to move up the risk curve to enhance their returns, and with Basel II there is now a bigger financing gap to fill. Whether this market will meet developers' needs at a price they like is another matter. The greater risk sensitivity coming to the banking world is likely to affect all types of lending. Expect mezzanine to evolve and increase in importance.

Markets to

No major capital with a highly developed investment market gets enthusiastic endorsement *from those surveyed.*

Watch

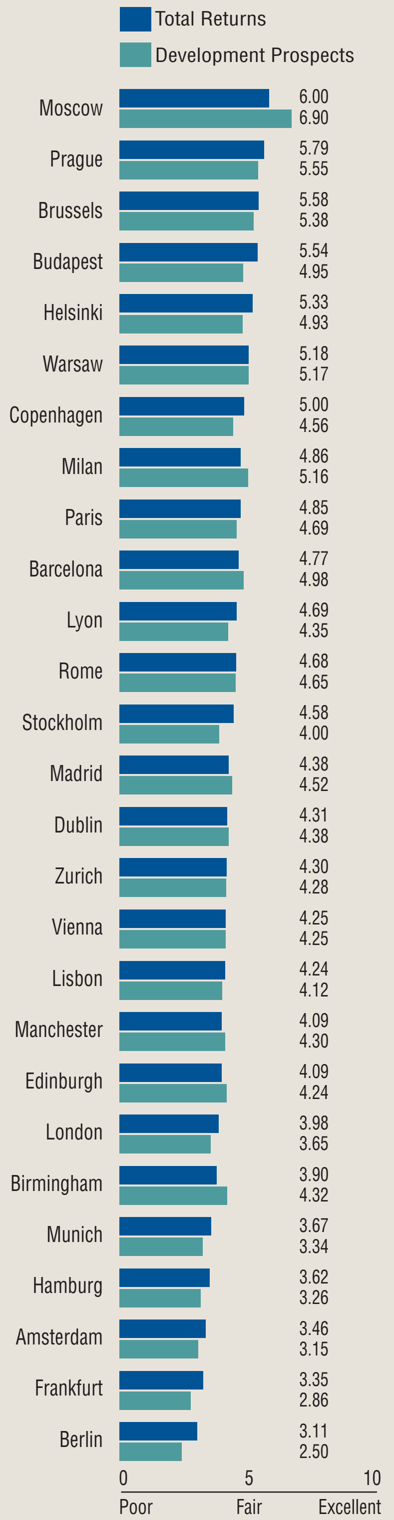
Weak growth across Europe's major economies has adversely affected private sector occupier demand almost everywhere and there are no capital cities in the E.U. that haven't felt the chill. Some could be mired in permafrost for some time to come—Berlin, Frankfurt, and Amsterdam are principal amongst these. No one is able to see what would get the kind of growth going that could take slack out of these cities in the next couple of years. No major capital with a highly developed investment market gets enthusiastic endorsement from those surveyed. Vacancies are rising, rents are falling, and no one is expecting a reversal in the gloom much before the end of 2004.

The markets that buck the trend are definitely in the periphery. Most of them are not even in the E.U. yet. What's more, the top position in the survey goes to Moscow, the least developed and least integrated real estate investment market in Europe (see Exhibit 3-1). These markets attract attention because their growth outlook is stronger and they are playing 'catch-up' with the rest of Europe. But can they absorb huge inflows of real estate investment cash? Of course not. These investment markets are tiny in comparison with those of the major E.U. capitals.

There also may be some misplaced optimism about the C.E.E. markets. The accession countries have a lot of growing to do, but they are not immune to what happens in Germany or France. The recession in Europe's core has already put a brake on the growth these economies could have achieved. Their office sectors are struggling with double-digit vacancy rates and rents continue to fall just like everywhere else. Their accession to the E.U. in May 2004 may open up E.U. export markets and bring in E.U. cash, but accession is also bringing what Brussels churns out the most of—red tape and regulations. Hopes may be pinned on new jobs coming east to take advantage of lower central European wages, but those wages are rising fast. They're already far higher than those in the corporate outsourcing hotspots of India and southeast Asia. With wages trending towards western levels and a huge serving of costly E.U. red tape on top, forward-thinking businesses that have benefited for years from low-cost central European manufacturing and assembly plants are already relocating further east.

There is only one E.U. capital city where total returns are expected to be even 'modestly good' in 2004: Brussels. The city's CBD has long had the stabilising influence of E.U. government demand, but at present it is also getting a kicker from growth due to E.U. enlargement. This has ratcheted up demand for offices in a very concentrated area of the city. However, the greater balance of the market—the part that serves the corporate sector—languishes under heavy double-digit vacancies and no one is expecting these to disappear soon.

Exhibit 3-1 **Markets to Watch**

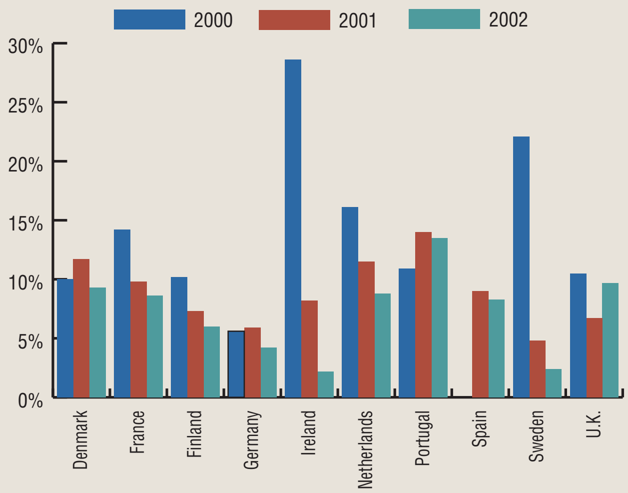


Source: Emerging Trends in Real Estate Europe 2004 *survey.*

The rest of the best are the Scandinavian capitals of Helsinki and Copenhagen—although 'least worst' may be a more appropriate description, since there was little unbridled enthusiasm about them. What can be said is that Scandinavian economic activity has been more resilient than the E.U. average and vacancy rates in these two capitals remain relatively low. One might add that they are both still relatively domestically focused investment markets where cross-border trends have only recently made a noticeable impact. Stockholm, the largest and most open market, does not get the same vote of confidence.

The bottom line for investment in 2004 is that it's not really about favourite markets and fundamental attractions. It's about individual deals. If the property is prime, the lease is the right length, and the tenants are good, it doesn't matter—at least for the present—whether the property is located in Brussels or Barcelona.

Exhibit 3-2 **Real Estate Total Returns for Selected Countries 2000–2002**



Sources: Investment Property Databank and KTI (Finland).

The Best

Russia: Moscow

Moscow takes the top slot in our survey for both total returns and development returns. These rankings are not risk adjusted, so this outcome is not as surprising as it might seem. It stands to reason that the highest-risk market with the strongest GDP growth has the highest prospective returns. However, there is virtually no investment market for property in Russia, and what little there is tends to be dominated by domestic investors. Moreover, "Moscow is a hard place to do deals."

Most sale and purchase transactions are owner-occupier deals for office and retail space. Distribution facilities and warehouses are usually build-to-suit propositions. Anecdotally, it seems that "oligarchs are using the office market to park money. In some cases they are way overbidding, driving cap rates as low as 12 percent, which leaves little margin for risk."

In practical terms, Moscow's opportunities lie for the most part in the development sphere. However, lending markets are underdeveloped, which hinders financing. Although prime office space has steadily increased and considerable new supply is in the pipeline, demand is keeping pace as international and domestic firms upgrade and expand their space. In third-quarter 2003, vacancy rates were estimated to be in the region of 5.3 percent by Jones Lang LaSalle and prime yields average around 15 percent.

The retail sector also holds many opportunities for developers, but there is virtually no product available for investors. Existing shopping centres (aside from modern bespoke developments for the likes of IKEA and Auchan) tend to have legal title or construction problems. Since Moscow has less retail space per capita than any other major European city, even recent strong growth in shopping centre construction has not come close to saturating demand. Rising real personal incomes and consumption imply that retail will remain a growth sector.

The warehousing and distribution sector has seen an increase in construction, but again there is little on offer for investors. However, there is strong growth, particularly in the region of the airport, and much of this has been build-to-suit for both Russian and international companies, retail and industrial. Again, it is development that offers the greatest scope to benefit from the sector's positive outlook.

Exhibit 3-3 **Prospects for Moscow's Real Estate Market in 2004**

	Prospects	Rating	Ranking
Total Returns	Modestly Good	6.0	1st
Rent Increases	Modestly Good	5.6	1st
Capital Growth	Modestly Good	6.3	1st
Supply/Demand Balance	Modestly Good	6.3	1st
Development	Good	6.9	1st

Investment Recommendation of Survey Respondents

Buy	Hold	Sell
58.3%	16.7%	25.0%

Source: Emerging Trends in Real Estate Europe 2004 *survey.*

For the future, it is clear that investors would benefit from an indirect route into the market and such vehicles would be popular. However, the government must upgrade the legal environment. The new Land Code of 2001 has yet to be adopted in the city, although implementation is reputedly scheduled for 2004. At present, land can only be leased from the city for a maximum of 49 years, albeit with the potential to renew. Though this is not an insurmountable difficulty, the absence of a stabilised legal environment remains a risk that cannot be overlooked.

Central Europe: Prague, Budapest, and Warsaw

The capitals of the largest accession countries occupy three of the top six places in the survey for expected total returns and three of top five slots for development returns. The inward investment and income growth that accession is already bringing and their planned future entry into the Eurozone make them attractive to those surveyed. Yields have been converging with those in the E.U. for some years, but there are still attractive premiums and the prospect of further convergence in the medium term. Eventual entry into the Eurozone will reduce interest rates, which in turn should put downward pressure on yields.

Office rents are stabilising after falling for five years in response to the explosion in commercial space developed during the 1990s. Retail is on a strong growth path as real incomes rise and consumer demand outpaces the expansion in modern retail centres. Expansion in modern warehousing and logistics stock will be required as new infrastructure is funded by the E.U., although this is only in short supply in a few areas at present.

On the downside, there are double-digit office vacancy rates in all three markets. Prospective rental growth is unlikely to be significant for some years given the high level of rents relative to the cost of other inputs in these economies. For investors, perhaps the most important thing to keep in perspective is the tiny size of these markets compared with the markets of leading western European cities. There is little high-quality stock on offer at present and these markets will not have the capacity to absorb huge inflows of real estate

Exhibit 3-4 **Prospects for Prague's Real Estate Market in 2004**

	Prospects	Rating	Ranking
Total Returns	Modestly Good	5.8	2nd
Rent Increases	Fair	5.0	3rd
Capital Growth	Modestly Good	5.7	2nd
Supply/Demand Balance	Fair	5.2	3rd
Development	Modestly Good	5.6	2nd

Investment Recommendation of Survey Respondents

Buy	Hold	Sell
64.3%	26.2%	9.5%

Source: Emerging Trends in Real Estate Europe 2004 *survey.*

Exhibit 3-5

Prospects for Budapest's Real Estate Market in 2004

	Prospects	Rating	Ranking
Total Returns	Modestly Good	5.5	4th
Rent Increases	Fair	4.6	7th
Capital Growth	Modestly Good	5.6	3rd
Supply/Demand Balance	Fair	4.7	12th
Development	Fair	5.0	7th

Investment Recommendation of Survey Respondents

Buy	Hold	Sell
61.5%	28.2%	10.3%

Source: Emerging Trends in Real Estate Europe 2004 *survey.*

Exhibit 3-6

Prospects for Warsaw's Real Estate Market in 2004

	Prospects	Rating	Ranking
Total Returns	Fair	5.2	6th
Rent Increases	Modestly Poor	4.4	13th
Capital Growth	Fair	5.4	5th
Supply/Demand Balance	Fair	5.0	7th
Development	Fair	5.2	4th

Investment Recommendation of Survey Respondents

Buy	Hold	Sell
55.6%	27.8%	16.7%

Source: Emerging Trends in Real Estate Europe 2004 *survey.*

capital. Best bets for 2004 are probably in the development of retail centres, residential space (there is a shortage of high-quality affordable housing in all of the former communist countries), and hotels.

Belgium: Brussels

Brussels is the exception to a lacklustre outlook for returns in the major E.U. cities for one reason only: it is the seat of E.U. government. With the E.U. expanding from 15 to 25 members in May 2004, the accession governments need office space in the central area of the city dominated by the E.U. institutions. Demand is strong for high-quality offices in the CBD and competition is keen for new or redeveloped space. At present, occupier demand exceeds supply.

However, the area in question is small and the rest of the Brussels office market is suffering from the same malaise as other capitals. Corporate demand is weak, there is downward pressure on rents, and the private sector is cutting costs. Many companies have moved to periphery locations as the E.U. takes over central properties, but even in such cases a number of private occupiers—including some global names—have been trying to sublet space. The office market in Brussels's 'periphery' is likely to remain comparatively weak until there is sustained corporate profits growth, and even then it is doubtful there will be sustained upward pressure on rents any time soon. Current vacancy rates in some areas are verging on 20 percent. Development land is plentiful in the airport area, which is only 20 minutes from the centre of Brussels.

Retail space has fared better because of its scarcity, but second-tier locations will continue to suffer relative to prime locations. The logistics market should remain stable in 2004, but demand is specific to individual businesses and companies tend to do their own developing. However, there are sale and leaseback opportunities.

The influx into Brussels of space users from the new accession countries is spurring demand for housing, and residential prices in prime locations have adjusted in advance. Private investor demand for residential investment properties has been strong as retail flees the stock market. Although prices have risen, rent increases are not in prospect. Planning restrictions are not onerous and the new supply tap can be turned on fairly easily.

The hotel sector in Brussels should continue to hold up better than most due to the concentration of government and international organisations and the more stable demand they bring. Hotels with meeting rooms in the vicinity of the airport will continue to do well on E.U., NATO, and recovering corporate traffic.

Exhibit 3-7

Prospects for Brussels's Real Estate Market in 2004

	Prospects	Rating	Ranking
Total Returns	Modestly Good	5.6	3rd
Rent Increases	Fair	5.3	2nd
Capital Growth	Fair	5.4	4th
Supply/Demand Balance	Fair	5.3	2nd
Development	Fair	5.4	3rd

Investment Recommendation of Survey Respondents

Buy	Hold	Sell
54.5%	36.4%	9.1%

Source: Emerging Trends in Real Estate Europe 2004 *survey.*

Finland: Helsinki

Helsinki gets a vote of confidence from those surveyed. Its economy was surprisingly resilient in 2003 relative to the Eurozone's core capitals, but little Helsinki's big attraction is the strong growth projected for 2004–2005. Finland's GDP growth looks like it could exceed 2.5 percent in 2004 and its capital's economic activity is likely to grow even faster—by 3.5 percent, according to Cambridge Economics. The nadir of Finland's fortunes came in 2001 with the steep downturn in global technology markets. But the home of Nokia is one of the leading ICT clusters in Europe, and as the outlook for technology companies improves so does Helsinki's real estate market.

Such fundamental improvement will come against an existing market with little slack. Overall office vacancies have risen sharply from 3.7 percent in January 2002 to stand at around 6.8 percent in third-quarter 2003, but vacancies in the Helsinki CBD are still under 5 percent and prime rents have eased only by about 2 to 4 percent (although rent-free periods and other incentives have become more prevalent). Prime yields fell around 25 basis points over the same period, but at 6.5 to 7 percent they still stand at a higher level than most other Eurozone capitals. Much of Helsinki's empty space is in older buildings as companies continue to move to modern developments. Any pickup in demand will come against a market with little new supply in the pipeline and the majority of that is prelet.

Helsinki's retail sector has little slack and vacancies are running at only 1.4 percent. Despite a great deal of recent development, retail space remains in short supply and should continue to offer attractive opportunities to developers. The warehousing and distribution sectors are similarly short of supply, with vacancies running at only 1.8 percent. The yields are highest in this sector, but developers have shied away because occupiers are primarily interested in short lease lengths. According to Catella European Research, there is virtually no available space measuring 5,000 square metres or greater.

It is fairly obvious from all of the above why those surveyed prefer the Helsinki market to most others. But the investment market is small and dominated by domestic institutional investors, many of which are trying to increase their allocations to real estate. The city's population is only 1.2 million and the market's capacity to absorb large inflows is minimal at present. A few sizable portfolios have changed hands, but the amount of available product is not large. However, the market will continue to grow and further impetus from new transport links to Russia and close ties with the Baltic accession countries make this a market to monitor for investment opportunities.

Exhibit 3-8 Prospects for Helsinki's Real Estate Market in 2004

	Prospects	Rating	Ranking
Total Returns	Fair	5.3	5th
Rent Increases	Fair	4.8	5th
Capital Growth	Fair	5.2	6th
Supply/Demand Balance	Fair	5.2	4th
Development	Fair	4.9	8th

Investment Recommendation of Survey Respondents

Buy	Hold	Sell
50.0%	34.6%	15.4%

Source: Emerging Trends in Real Estate Europe 2004 *survey.*

Denmark: Copenhagen

All is not well in Denmark—at least as far as current economic growth is concerned. GDP forecasts were scaled down as each successive month passed in 2003 and growth of 0.8 percent is the consensus expectation for the final outturn—better than the E.U. core, but not by much. Expectations for 2004 are more optimistic, but Copenhagen's ranking in our survey probably has more to do with trends in the investment market than hopes for a near-term resurgence in occupier demand.

The real estate market, particularly the office market, is dominated by Danish pension funds, which are experiencing strong capital inflows. The funds are looking to increase their overall allocation to real estate, so their increased demand for product is greater than the rise in capital inflows would normally dictate. International interest in the market has also been on the increase, giving further 'weight of money' support to the office sector. In addition, private real estate investment companies are being formed by syndicates of individuals. On the back of these trends, prime office yields should continue to hold steady in 2004 but rents could weaken further before bottoming out at the end of the year.

An important trend in Copenhagen has been the migration of what is seen to be 'prime' to new areas. In fact, the whole map of real estate value has been changing as the harbour areas become the most desirable office locations and the old CBD is deemed less important. Relative rents will continue to adjust accordingly. New transport links are also turning Copenhagen into a hub between Germany and the rest of Scandinavia, which will have a very positive medium-term impact on the city.

The retail sector in Copenhagen has had more fundamental near-term support because retail sales have held up well. This is due in part to the reduction in interest rates, which has lowered mortgage costs for many homeowners. The retail sector was also given a shot in the arm when legislation was introduced in April 2003 enabling landlords to increase rents to market levels on existing lease agreements. Tax cuts scheduled for 2004 should keep consumers spending.

The other sector with fundamental support is residential. Copenhagen's household formation and population have been growing due to the resurgence in urban living and an increase in single-person households. Even though the residential market is highly regulated, returns have been strong in recent years and the continued shortage of properties indicates that this trend will continue.

Exhibit 3-9 **Prospects for Copenhagen's Real Estate Market in 2004**

	Prospects	Rating	Ranking
Total Returns	Fair	5.0	7th
Rent Increases	Fair	4.8	6th
Capital Growth	Fair	4.8	7th
Supply/Demand Balance	Fair	5.1	5th
Development	Fair	4.6	11th

Investment Recommendation of Survey Respondents

Buy	Hold	Sell
31.0%	58.6%	10.3%

Source: Emerging Trends in Real Estate Europe 2004 *survey.*

The Worst

Germany: Berlin, Frankfurt, Hamburg, and Munich

Berlin ranks at the bottom of the survey for expected returns in 2004. Germany's capital has been the site of a building boom since the early 1990s and construction has only recently begun to slow. New supply, including massive mixed-use developments, overhangs the market and yet more is on the way. Government has been a ready source of demand for space and there are still government agencies to relocate to the capital from elsewhere in Germany. However, the volume of new office space, both already built and in the pipeline, is such that it will take more than government relocations to fill it. "There is an entire tower sitting empty on Potsdamer Platz and a huge new mixed-use development under construction at Leipziger Platz." The developers are counting on major domestic and global companies to relocate their German headquarters to Berlin to be near the seat of government, but companies have been slow to respond.

This is due in no small part to the fact that Berlin has no international airport. Whilst wrangles over financing this vital piece of infrastructure continue to block progress, global companies understandably fight shy of moving to a city that has few direct flights from other major capitals. At the same time, hard-pressed German companies battling with recession have no motivation to relocate and would probably meet with resistance from regional governments and workers if they did. The lack of a major airport has also left Berlin off the logistics map. One can't have a logistics operation without transport.

As of third-quarter 2003, Berlin's office vacancy rate including sublets was at 9 percent and climbing, average rents had fallen 7 percent in the third quarter alone, and average prime yields were rising towards 6 percent. Expect none of this to change in 2004. The retail market is stronger, but space has increased 70 percent since 1991 and more is in the pipeline. There is still firm demand for prime locations from international retailers and prime yields are around 5.25 percent. However, older secondary locations are suffering as spending shifts to the newer major shopping centres.

Frankfurt's property market also has an unenticing outlook for 2004. The demand problems started with difficulties in the financial sector, but the real problem is oversupply. Huge additions of high-quality office space are still coming on stream and the vacancy rate including sublets had already risen to just under 14 percent at the end of third-quarter 2003. This is the highest vacancy rate in any of the major German cities. Prime rents are under pressure as a result and fell 6 percent in the third quarter alone. Yields are edging up, and for 2004 expect more of the same. Retail is on a more robust footing in Frankfurt as the city has a catchment area of nearly 2 million people that use both the prime central shopping district and the shopping centres that have been built on the outskirts of the city. Prime yields in central locations have remained firm at 5 percent and major new supply is not expected until 2006.

Hamburg's IT-, media-, and telecom-intensive economy was hit by the post-2000 downturn in those industries. Office demand naturally suffered in consequence and the market is still heading south. Vacancies including sublets rose from 2.4 percent in 2000 to 7.7 percent at the end of third-quarter 2003 and have undoubtedly risen further as significant new speculative development hit the market in the fourth quarter. Rents have been declining for over two years. However, there are some glimmers of hope on the horizon, though 2004 is too early to see much change. The number of IT companies in the city is growing again, and the rate of take-up during the first three quarters of 2003 was only 8 percent down on the year before, according to Jones Lang LaSalle. Yields have remained in a stable range of 5 to 5.75 percent throughout 2003 and there have been isolated instances of higher rents. Hamburg's retail sector, one of the city's most famous attributes, has held up well through the downturn, with prime yields holding at 5 percent.

Munich's diversified industrial base hasn't insulated the city from the wider problems in the German economy. However, employment continues to grow in Germany's favourite city. This would be grounds for encouragement were it not for the massive amount of new space coming to a market that already has "new high-quality high-rise office buildings standing vacant." The vacancy rate at the end of third-quarter 2003 stood at 7.5 percent including sublets, up from virtually nil in 2000, and huge new speculative office developments will be coming onto the market for the next two years. Prime rents are slipping, yields are rising, and more of the same is expected over the coming year. The retail sector, however, is a different story. Stringent planning regulations mean it is highly supply-constrained, although a new out-of-town shopping centre is opening in first-quarter 2004. Expect yields to hold at their current level of 5 percent.

Exhibit 3-10
Prospects for Berlin's Real Estate Market in 2004

	Prospects	Rating	Ranking
Total Returns	Poor	3.1	27th
Rent Increases	Poor	2.7	27th
Capital Growth	Poor	3.0	27th
Supply/Demand Balance	Poor	3.0	27th
Development	Poor	2.5	27th

Investment Recommendation of Survey Respondents

Buy	Hold	Sell
22.6%	43.4%	34.0%

Source: Emerging Trends in Real Estate Europe 2004 *survey.*

Exhibit 3-11
Prospects for Frankfurt's Real Estate Market in 2004

	Prospects	Rating	Ranking
Total Returns	Poor	3.4	26th
Rent Increases	Poor	2.8	26th
Capital Growth	Poor	3.2	26th
Supply/Demand Balance	Poor	3.2	25th
Development	Poor	2.9	26th

Investment Recommendation of Survey Respondents

Buy	Hold	Sell
18.2%	60.0%	21.8%

Source: Emerging Trends in Real Estate Europe 2004 *survey.*

Exhibit 3-12
Prospects for Hamburg's Real Estate Market in 2004

	Prospects	Rating	Ranking
Total Returns	Modestly Poor	3.6	24th
Rent Increases	Poor	3.4	23rd
Capital Growth	Poor	3.4	24th
Supply/Demand Balance	Modestly Poor	3.9	23rd
Development	Poor	3.3	24th

Investment Recommendation of Survey Respondents

Buy	Hold	Sell
31.0%	50.0%	19.0%

Source: Emerging Trends in Real Estate Europe 2004 *survey.*

Exhibit 3-13
Prospects for Munich's Real Estate Market in 2004

	Prospects	Rating	Ranking
Total Returns	Modestly Poor	3.7	23rd
Rent Increases	Poor	3.4	24th
Capital Growth	Modestly Poor	3.5	23rd
Supply/Demand Balance	Modestly Poor	3.5	24th
Development	Poor	3.3	23rd

Investment Recommendation of Survey Respondents

Buy	Hold	Sell
31.0%	50.0%	19.0%

Source: Emerging Trends in Real Estate Europe 2004 *survey.*

The Netherlands: Amsterdam

The Netherlands has the dubious distinction of having had Europe's weakest economy in 2003, with GDP contracting by an estimated 0.6 percent. Recovery in 2004 is projected to be anaemic at best, with GDP growth of only 1.1 percent—again the weakest in Europe. Against this background, it is hardly surprising that the real estate market of its largest city, Amsterdam, triggers little enthusiasm. Take-up in the office market probably fell 20 percent in 2003, whilst new completions led to a 25 percent increase in new supply. Vacancy probably ended the year close to 15 percent—and with a lot more supply in the pipeline through 2005, things can only get worse. It may seem surprising given these statistics that rents have been relatively stable, but the figures don't really reflect what's happening on the ground. Long rent-free periods and other incentives are widely in evidence, so the figures must be treated with great scepticism. It's hard to believe that rents won't ultimately reflect the manifest downward pressure they are under in 2004.

Prime yields, however, are a different matter. Amsterdam's investment market saw transaction volumes rise around 20 percent during the first three quarters of the year, and there's every possibility this will continue into 2004. However, "prospects for all but the newest and best-located properties will stall." And if capital deserts the market the fallout could be harrowing.

In the retail sector, prime rents have been unchanged for two years despite a steep decline in retail trade confidence. Expanding international retailers are still keen to take prime space. However, it's a different story outside the best locations. Rising unemployment and falling disposable income are both depressing consumer spending. Over 42 percent of the respondents rated Amsterdam a 'sell,' a higher percentage than all other markets in the survey.

Exhibit 3-14 **Prospects for Amsterdam's Real Estate Market in 2004**

	Prospects	Rating	Ranking
Total Returns	Poor	3.4	25th
Rent Increases	Poor	2.8	25th
Capital Growth	Poor	3.4	25th
Supply/Demand Balance	Poor	3.1	26th
Development	Poor	3.2	25th

Investment Recommendation of Survey Respondents

Buy	Hold	Sell
17.5%	40.0%	42.5%

Source: Emerging Trends in Real Estate Europe 2004 *survey.*

U.K.: London, Birmingham, Manchester, and Edinburgh

Opinions of those surveyed on the U.K. markets are very divided. No one is expecting great returns, but only a fifth say the markets are a 'sell.' The U.K. has surprised market observers with its growth. Although this was largely because of rising government expenditure in 2003, it's hard to argue with a 2 percent rise in the U.K.'s GDP against the Eurozone average of 0.4 percent. The U.K. looks set to surpass the major Eurozone countries bar Spain yet again in 2004, with a projected GDP increase of 2.7 percent. Perhaps that's enough reason to keep sufficient faith to 'hold,' which is what the majority surveyed are doing.

According to Investment Property Databank (IPD), 'all property' returns in third-quarter 2003 were 11.7 percent on an annualised basis. Rent declines are bottoming out and the cumulative decline since year-end 2001 has only been –6 percent. Annualised third-quarter 2003 returns ran at 16 percent for retail, 11.8 percent for industrials, and 4.5 percent for offices. Firm consumer spending and the resultant demand for space have been driving retail rents up and yields down. Though consumption growth is expected to weaken in 2004 at the same time as new space comes onto the market, the market is unlikely to alter drastically. The U.K. industrial sector benefited from favourable yield shifts in 2003 as geared investors moved into the sector (ignoring the increasing amount of vacant secondhand space). A repeat performance is unlikely to be in store for 2004 as interest rates should continue to rise following the November 0.25 percent rise in the base rate, but the sector has potential support as manufacturing activity picks up to bolster rent levels. The office sector is beginning to see a revival in occupier demand. Rental levels, whilst still falling, are doing so at a declining rate.

According to IPD, central London vacancy rates stabilised in September. However, any recovery has a long way to go. London West End vacancies are around 7 percent and London City vacancies are a hefty 13 percent. The good news is the flow of new office supply into the market has slowed and the level of enquiries for space has risen. Nevertheless, fundamental support in 2004 is unlikely to rise sufficiently to justify current office yields on its own. As of the end of third-quarter 2003, these prime yields were 6.5 percent for the City and 5.75 percent for the West End. Yet again, investment activity has had a greater influence on yields than anything else. London has been a primary destination for cross-border flows, and although the yields look very demanding on a historic basis, they look more appealing when compared with, say, the 5.5 percent yield on offer in Frankfurt. Much depends on whether the tide of money keeps flowing in.

Prime yields in regional office markets have been very resilient, perhaps because they, too, have become destinations for cross-border capital flows. However, to give them their due, their fundamental performance has been better than that of London. Prime rents have been stable to slightly up in Birmingham and Manchester and yields have firmed. Edinburgh has not been quite so resistant to the downturn because of its concentration of financial services companies, but rents fell only 10 percent over two years as against the City's 18 percent decline in the year to September 2003 alone. All three markets, particularly Edinburgh, have seen new development supply, but rents are projected to remain stable in 2004. The retail sectors in Birmingham and Manchester experienced slightly positive yield shifts in 2003 whilst Edinburgh was stable. Little change is expected in 2004.

slowed and the level of enquiries for space has risen.

Exhibit 3-15

Prospects for London's Real Estate Market in 2004

	Prospects	Rating	Ranking
Total Returns	Modestly Poor	3.9	21st
Rent Increases	Poor	3.4	22nd
Capital Growth	Modestly Poor	3.9	22nd
Supply/Demand Balance	Modestly Poor	4.1	20th
Development	Modestly Poor	3.6	22nd

Investment Recommendation of Survey Respondents

Buy	Hold	Sell
31.0%	46.6%	22.4%

Source: Emerging Trends in Real Estate Europe 2004 *survey.*

Exhibit 3-16

Prospects for Birmingham's Real Estate Market in 2004

	Prospects	Rating	Ranking
Total Returns	Modestly Poor	3.9	22nd
Rent Increases	Modestly Poor	3.9	19th
Capital Growth	Modestly Poor	4.2	18th
Supply/Demand Balance	Modestly Poor	4.4	17th
Development	Modestly Poor	4.3	15th

Investment Recommendation of Survey Respondents

Buy	Hold	Sell
33.3%	48.5%	18.2%

Source: Emerging Trends in Real Estate Europe 2004 *survey.*

Exhibit 3-17

Prospects for Edinburgh's Real Estate Market in 2004

	Prospects	Rating	Ranking
Total Returns	Modestly Poor	4.1	19th (tie)
Rent Increases	Modestly Poor	3.8	21st
Capital Growth	Modestly Poor	4.2	19th
Supply/Demand Balance	Modestly Poor	4.1	21st
Development	Modestly Poor	4.2	19th

Investment Recommendation of Survey Respondents

Buy	Hold	Sell
25.0%	53.1%	21.9%

Source: Emerging Trends in Real Estate Europe 2004 *survey.*

Exhibit 3-18

Prospects for Manchester's Real Estate Market in 2004

	Prospects	Rating	Ranking
Total Returns	Modestly Poor	4.1	19th (tie)
Rent Increases	Modestly Poor	4.2	17th
Capital Growth	Modestly Poor	4.1	20th
Supply/Demand Balance	Modestly Poor	4.3	19th
Development	Modestly Poor	4.3	16th

Investment Recommendation of Survey Respondents

Buy	Hold	Sell
42.4%	42.4%	15.2%

Source: Emerging Trends in Real Estate Europe 2004 *survey.*

The Middle

Italy: Milan and Rome

Italy's economy has suffered along with the rest of the Eurozone. However, its real estate markets have been so supply-constrained due to drawn-out and restrictive planning processes that there is little overhang of space. Once growth kicks in, the situation will become tight fairly quickly.

Milan's office market is characterised by a shortage of prime space in the CBD, where vacancies are in the region of 4 percent. Vacancies in the periphery are higher where transport links are lacking (in the region of 10 percent) but considerably less for high-quality space near the ring roads. Rents in 2003 were stable after rising 80 percent over the five years to 2002. Economic activity should pick up over the course of 2004 and with it occupier demand. As some new supply is coming on stream, this won't exert immediate upward pressure on rents, but it is clear that medium-term prospects are fairly good.

Milan will continue to attract international investors, although there is a shortage of product relative to the degree of interest in the market. Prime office yields of 5.5 percent in the CBD look reasonably safe for 2004, with German funds again maintaining investment pressure. Milan's retail sector is relatively small as an investment market, again due to planning constraints. Retail sales have been weak, but this has had little impact due to the shortage of product. Retail trade confidence has been rising in recent months and an upturn is expected over the coming year. The advent of mixed-use urban regeneration schemes is seen as providing good opportunities in the medium term.

Exhibit 3-19

Prospects for Milan's Real Estate Market in 2004

	Prospects	Rating	Ranking
Total Returns	Fair	4.9	8th
Rent Increases	Fair	4.9	4th
Capital Growth	Fair	4.8	8th
Supply/Demand Balance	Fair	5.0	8th
Development	Fair	5.2	5th

Investment Recommendation of Survey Respondents

Buy	Hold	Sell
55.3%	29.8%	14.9%

Source: Emerging Trends in Real Estate Europe 2004 *survey.*

Exhibit 3-20

Prospects for Rome's Real Estate Market in 2004

	Prospects	Rating	Ranking
Total Returns	Fair	4.7	12th
Rent Increases	Fair	4.6	9th
Capital Growth	Fair	4.6	12th
Supply/Demand Balance	Fair	4.9	9th
Development	Fair	4.7	10th

Investment Recommendation of Survey Respondents

Buy	Hold	Sell
47.6%	40.5%	11.9%

Source: Emerging Trends in Real Estate Europe 2004 *survey.*

The office sector in Rome has been weaker than that in Milan. Weakness in the service sector put downward pressure on rents in 2003. However, those surveyed are positive about the outlook in 2004. The main opportunities are seen in redevelopment of government spin-offs of public real estate portfolios. The shortage of high-quality space is far more severe than in Milan and development is hampered by lengthy planning procedures. However, this lack of supply also underpins what market there is.

Those surveyed had a reasonably positive view of the Italian markets in that over 55 percent thought Milan was a 'buy' and nearly 48 percent thought the same of Rome. However, there are dissenters who think Milan looks expensive. Generally, "deals are hard to close."

France: Paris and Lyon

France made advances on the U.K. in 2003 and remains the second most popular destination for cross-border investment. German open-ended funds were the largest investors, and clearly the fact that they could invest without exchange risk in a market with fewer oversupply problems than London was a big attraction. The big inflows have set off some alarms as to the sustainability of current yields, but generally those surveyed were comfortable. Nearly 51 percent rated Paris a 'buy.'

Like other capitals in the Eurozone, Paris has had to contend with weak occupier demand. However, its highly diversified occupier base has left it in better shape than those markets that are highly dependent on only a few industries. The vacancy rate for prime offices was only 6 percent as of third-quarter 2003, and in the CBD it was even lower at 4.6 percent. Prime rents have held fairly firm, with a decline of around 5.7 percent in the year to September 2003. Speculative completions in the pipeline are low, so oversupply is not a big worry. Indeed, things could get tight fairly quickly if economic growth were to return to trend. The uncomfortable thing about the Paris office market is the yield. Investment activity has brought prime yields down to 6 percent, leaving little room for much to go wrong. Consumption has held up well, giving support to retail yields that nudge just above 6.1 percent. Paris also holds a key position in European logistics and the sector has been firm.

Lyon also gets a relative vote of confidence, and over 46 percent of those surveyed rate it a 'buy.' It is the second-largest industrial city in France and an important regional logistics hub serving southern France and the Mediterranean area. Vacancy was low in the office sector at just over 5 percent at the end of third-quarter 2003, and there is demand for light-industrial premises with a high office content.

Exhibit 3-21

Prospects for Paris's Real Estate Market in 2004

	Prospects	Rating	Ranking
Total Returns	Fair	4.9	9th
Rent Increases	Modestly Poor	4.4	12th
Capital Growth	Fair	4.6	10th
Supply/Demand Balance	Fair	4.9	10th
Development	Fair	4.7	9th

Investment Recommendation of Survey Respondents

Buy	Hold	Sell
50.9%	32.7%	16.4%

Source: Emerging Trends in Real Estate Europe 2004 *survey.*

Exhibit 3-22 Prospects for Lyon's Real Estate Market in 2004

	Prospects	Rating	Ranking
Total Returns	Fair	4.7	11th
Rent Increases	Fair	4.6	8th
Capital Growth	Modestly Poor	4.4	13th
Supply/Demand Balance	Fair	5.0	6th
Development	Modestly Poor	4.4	14th

Investment Recommendation of Survey Respondents

Buy	Hold	Sell
46.2%	38.5%	15.4%

Source: Emerging Trends in Real Estate Europe 2004 *survey.*

Spain: Barcelona and Madrid

Spain has had the sprightliest growth of all the large economies in the Eurozone. GDP is estimated to have expanded by around 2.2 percent in 2003 and the outlook for 2004 is for further acceleration to 2.8 percent growth. Nevertheless, Spain has followed the same pattern seen elsewhere. Occupational demand has been on the weak side whilst investment demand has been strong. Spain's two main investment markets have been the beneficiaries of interest on the part of national and international investors, both institutional and private. However, there is a shortage of well-let high-quality stock with good tenants on long leases. The tough corporate environment has led to a tendency towards shorter leases and incentives to get tenants in. In addition, would-be sellers are waiting until their buildings are fully let to put them on the market in the hope of achieving better prices.

The survey shows a preference for Barcelona over Madrid, which probably stems from the oversupply of peripheral office space in Madrid. New supply in Madrid probably peaked in 2003 but could remain around for a while as much of it is in new out-of-town locations. Rents have declined by over 15 percent and vacancy was up to 8.7 percent in third-quarter 2003. Industrial property was more sought after, but there is a shortage of modern supply and rents on old, outdated stock fell. Retail had the best occupier demand against

Exhibit 3-23 Prospects for Barcelona's Real Estate Market in 2004

	Prospects	Rating	Ranking
Total Returns	Fair	4.8	10th
Rent Increases	Fair	4.5	10th
Capital Growth	Fair	4.6	11th
Supply/Demand Balance	Fair	4.8	11th
Development	Fair	5.0	6th

Investment Recommendation of Survey Respondents

Buy	Hold	Sell
52.6%	29.8%	17.5%

Source: Emerging Trends in Real Estate Europe 2004 *survey.*

Exhibit 3-24 Prospects for Madrid's Real Estate Market in 2004

	Prospects	Rating	Ranking
Total Returns	Modestly Poor	4.4	14th
Rent Increases	Modestly Poor	4.1	15th
Capital Growth	Modestly Poor	4.3	16th
Supply/Demand Balance	Modestly Poor	4.3	18th
Development	Fair	4.5	12th

Investment Recommendation of Survey Respondents

Buy	Hold	Sell
44.1%	37.3%	18.6%

Source: Emerging Trends in Real Estate Europe 2004 *survey.*

a background of strong consumer spending supported by low availability in prime locations.

Barcelona has less office supply overhang, with a vacancy level of only 6.9 percent at the end of third-quarter 2003. However, rents have been under pressure here, too. The resilient sector was again retail.

Investment flows have caused downward pressure on yields such that Barcelona and Madrid prime offices yields fell below 6 percent in 2003. Retail prime yields also fell to a meagre 5.75 percent in Barcelona. A lot of caution prevails in both markets because value seems to have departed the scene. Many think that prospects are best in development, particularly shopping centres—if planning can be obtained—and large modern warehouses. Redevelopment of existing retail is also favoured.

Sweden: Stockholm

Despite being the largest city in Scandinavia, Stockholm's prospects for 2004 are seen as less interesting than those in the other capitals in the region. In the office sector, this can be attributed directly to high and rising vacancy rates that are well into the double digits. Rents are still falling and recovery looks a long way off as companies are still cutting back on space. The retail market softened in 2003 and a rebound in 2004 is unlikely. Consolidation in the logistics market has also left spare capacity in this sector. On the positive side, medium-term growth prospects are probably better than in the core Eurozone, but this is a market where 2004 performance will be driven by capital flows.

Exhibit 3-25 Prospects for Stockholm's Real Estate Market in 2004

	Prospects	Rating	Ranking
Total Returns	Fair	4.6	13th
Rent Increases	Modestly Poor	4.4	11th
Capital Growth	Fair	4.6	9th
Supply/Demand Balance	Fair	4.7	13th
Development	Modestly Poor	4.0	21st

Investment Recommendation of Survey Respondents

Buy	Hold	Sell
51.4%	37.8%	10.8%

Source: Emerging Trends in Real Estate Europe 2004 *survey.*

The Rest

Dublin, Zurich, Vienna, and Lisbon

The remaining markets generate little enthusiasm, perhaps because of their small size and domestic orientation. They share low-growth outlooks with the exception of Dublin and there is little availability of investment product. Potential for residential development in Zurich, where vacancy is extremely low, was cited. Tax cuts in Vienna could eventually breathe some life into that market, but not in 2004. Ireland has posted some of the most attractive total returns in Europe in recent years—28.6 percent in 2000—but the bloom was off the rose in 2002, with total returns falling to 2.2 percent; total returns

Exhibit 3-26 Prospects for Dublin's Real Estate Market in 2004

	Prospects	Rating	Ranking
Total Returns	Modestly Poor	4.3	15th
Rent Increases	Modestly Poor	4.0	18th
Capital Growth	Modestly Poor	4.3	15th
Supply/Demand Balance	Fair	4.7	14th
Development	Modestly Poor	4.4	13th

Investment Recommendation of Survey Respondents

Buy	Hold	Sell
34.5%	37.9%	27.6%

Source: Emerging Trends in Real Estate Europe 2004 *survey.*

Exhibit 3-27

Prospects for Zurich's Real Estate Market in 2004

	Prospects	Rating	Ranking
Total Returns	Modestly Poor	4.3	16th
Rent Increases	Modestly Poor	3.9	20th
Capital Growth	Modestly Poor	4.2	17th
Supply/Demand Balance	Fair	4.6	15th
Development	Modestly Poor	4.3	17th

Investment Recommendation of Survey Respondents

Buy	Hold	Sell
31.4%	42.9%	25.7%

Source: Emerging Trends in Real Estate Europe 2004 *survey.*

Exhibit 3-28

Prospects for Vienna's Real Estate Market in 2004

	Prospects	Rating	Ranking
Total Returns	Modestly Poor	4.3	17th
Rent Increases	Modestly Poor	4.3	14th
Capital Growth	Modestly Poor	4.4	14th
Supply/Demand Balance	Fair	4.6	16th
Development	Modestly Poor	4.3	18th

Investment Recommendation of Survey Respondents

Buy	Hold	Sell
26.7%	40.0%	33.3%

Source: Emerging Trends in Real Estate Europe 2004 *survey.*

Exhibit 3-29

Prospects for Lisbon's Real Estate Market in 2004

	Prospects	Rating	Ranking
Total Returns	Modestly Poor	4.2	18th
Rent Increases	Modestly Poor	4.0	16th
Capital Growth	Modestly Poor	4.1	21st
Supply/Demand Balance	Modestly Poor	4.0	22nd
Development	Modestly Poor	4.1	20th

Investment Recommendation of Survey Respondents

Buy	Hold	Sell
37.8%	44.4%	17.8%

Source: Emerging Trends in Real Estate Europe 2004 *survey.*

have recovered to a reasonable 8.8 percent for the 12 months ending third-quarter 2003, according to IPD. The Irish property market is still adjusting to tax hikes, and performance will continue to be modest in 2004.

Perhaps the most interesting market in this group is Lisbon. IPD data show that Portugal posted very attractive total returns in recent years—14 percent in 2001 and 13.5 percent in 2002. However, survey respondents rank it only 18th in its prospects for total returns in 2004, and its prospects for supply/demand balance are rated even lower. The attraction of Lisbon will continue to be limited by unfavourable leasing legislation.

Property

Shopping centres

top the list, but expectations

for 2004 are subdued.

Types in Perspective

No single sector is expected to produce outstanding investment total returns in 2004. Shopping centres and residential are the two favoured sectors for investment and development, with city centre offices, manufacturing, and business parks projected to be the weakest sectors in 2004. A slow recovery in occupier demand throughout many European cities will combine with degrees of oversupply to limit short-term development potential in the office and out-of-town business park markets. "The retail sector is still the strongest sector, followed by the residential sector. The office sector is still falling behind the rest of the market."

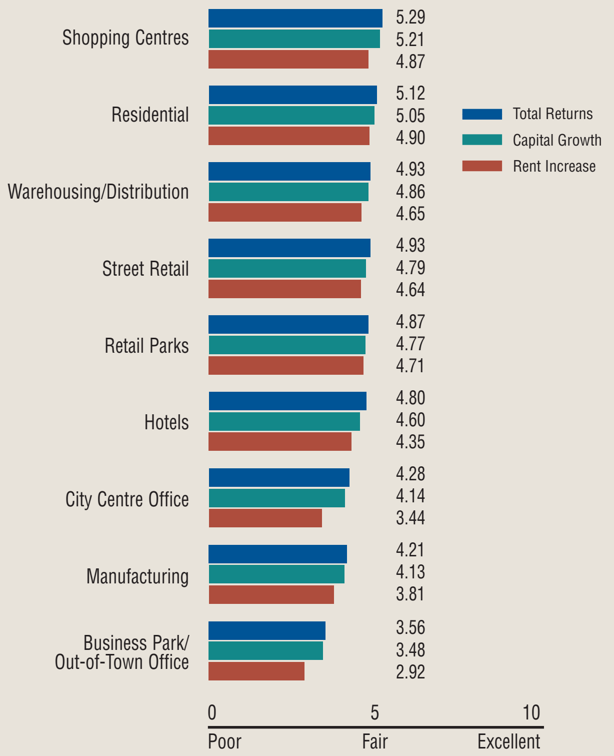
Although there are some concerns over consumer confidence and weak or slowing consumer spending, the retail sector scores well amongst survey respondents, with shopping centres favoured for investment (see Exhibit 4-1). The stability of income from a diversified tenant base, the opportunity for active management, and undersupply in southern Europe and in central and eastern Europe (C.E.E.) are all factors supporting investment and development in the sector.

The retail park sector has been an outstanding performer in the U.K. market in recent years because of a combination of restrictive planning and strong retailer demand for out-of-town facilities. It is an evolving market in other parts of Europe and is seen to have modest growth potential. Likewise, for the street retail segment, where demand from international brand retailers has remained strong, respondents anticipate fair performance.

The residential market will continue to be affected by the changing demographic structure in Europe, in particular the growing number of households, the aging of the population, and a trend towards higher homeownership levels. These structural changes will require specific responses from the market to satisfy demand. The sector remains management intensive and attractive, in the main, to specialist investors.

Exhibit 4-1

Real Estate Sector Performance Prospects



Source: Emerging Trends in Real Estate Europe 2004 *survey.*

Exhibit 4-2

Development and Market Balance Prospects for 2004

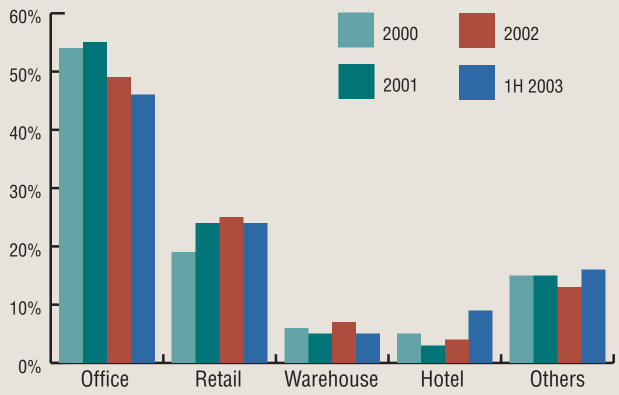
Source: Emerging Trends in Real Estate Europe 2004 *survey.*

The warehousing/distribution sector is seen to offer fair prospects for both investment and development opportunities, but is less attractive to investors than shopping centres and residential. The geographic areas that merit attention are the established western European hubs, C.E.E., and southern Europe. The C.E.E. markets will benefit from the relatively strong economic growth anticipated in the ten E.U. accession countries and from E.U. funding of road and rail infrastructure improvements. C.E.E. and the south both suffer from obsolete stock and immature supply chain management. Development of new, investment-grade stock will be required to satisfy retailers, suppliers, and logistics operators. The demand for strategically located warehousing will bolster some existing locations and lead to the development of new distribution hubs and intermodal facilities built to western European standards.

Hotel prospects are seen by survey respondents as fair to modestly poor, whilst prospects for manufacturing and office properties are modestly poor to poor. An oversupply of space

Exhibit 4-3

Investment Activity by Property Type



Source: Jones Lang LaSalle European Research.

(see Exhibit 4-2) and sluggish job growth will continue to affect these latter sectors in 2004. The business park/out-of-town office sector is the weakest property sector in the survey, with poor prospects for 2004.

Investment activity has been shifting away from offices and towards retail properties in recent years, a trend that is expected to continue in 2004 (see Exhibit 4-3).

Office

Strengths

Despite weak occupier demand across Europe, prime, well-let long-lease premises are still attracting significant investment flows, and the office sector remains the primary sector for investors in Europe, capturing roughly 50 percent of investment activity over the past three years, according to Jones Lang LaSalle. A healthy guaranteed income stream is the key attraction. The U.K. office market is proving particularly attractive because of the U.K. lease structure. The availability of long leases and five-year upward-only rent reviews is considered by many investors to be advantageous. "The U.K. is still underpriced compared with other European office markets."

As mentioned earlier in the report, investment demand is being largely driven by German open-ended funds and debt-backed buyers seeking security of income. For U.S. buyers, vacancy rates (see Exhibit 4-4) appear modest when compared with the home market, and the risk of tenants not renewing at lease expiration is considered low. The demand for prime, well-let offices is evident in most other major European cities including Paris, Brussels, Madrid, and Milan. The sheer weight of money will contribute to minimising any softening of yields in the sector.

With the European economies expected to show improved growth in 2004, some office markets are perceived to be at or close to the bottom of the rental cycle. This is particularly the case where new supply is limited and excess supply can be absorbed more easily. "At some point absorption will turn positive." Local market knowledge is critical to superior investment decisions.

Exhibit 4-4 **Office Vacancy Rates for Selected Cities, Third-Quarter 2003**

Sources: CB Richard Ellis, DTZ, FPD Savills, Catella, Jones Lang LaSalle, KTI, King Sturge.

Weaknesses

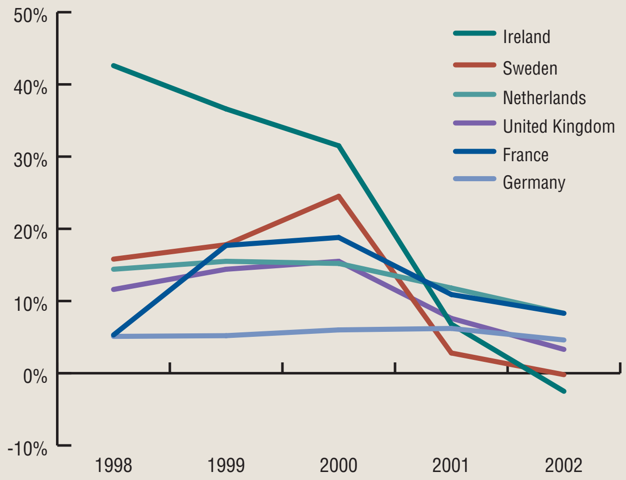
In 2004, rental growth will be zero or negative in a number of markets, and survey respondents view rent growth prospects as generally poor. Current reported vacancy rates are, by European benchmarks, high and these figures do not account for the "hidden supply" or phantom space that needs to be absorbed before real underlying demand begins to reduce the levels of empty stock.

It's a tenant's market. Occupiers are taking advantage of excess supply to trade up to better-quality premises at affordable rents and are driving a hard deal on rents, lease terms, and incentive packages. However, welcome though these transactions are, in many locations they are not removing spare capacity from the market, but are simply replacing vacant new and Grade A space with difficult to let, tired secondhand space.

Economic growth is the key to providing the employment growth (especially in the service sector) that will trigger market recovery. This should begin to filter through in 2004, although growth in some European economies will continue to be very weak.

The business park sector has fallen out of favour as investors concentrate their activities on CBD purchases. This sector ranks at the very bottom of the survey, with generally poor prospects on all measures.

Exhibit 4-5 IPD Office Property Total Returns for Selected Countries



Source: Investment Property Databank.

Total returns in the office sector have fallen considerably since 2000 in most markets, with several countries—including Ireland and Sweden—recording negative returns in 2002 (see Exhibit 4-5).

Best Bets

The consensus view would appear to support investment in CBD offices in the major cities that benefit from a diversified, growing service sector and, where possible, a limited supply of high-quality office space. Cities with low office vacancy rates—such as Milan, Paris, and Barcelona—are good bets if the price is reasonable.

Alternatives, though by no means with comprehensive support, include major cities where the office market is perhaps more reliant upon one sector; for example, the City of London and Brussels. The argument is that the strength of the City, as the financial services hub of Europe, will continue to generate demand and drive real estate investment performance in the medium to long term. For Brussels, the growth of the European Union is generating a burgeoning demand for high-quality office space from the increasing number of 'Eurocrats.' However, demand is localised within Brussels and not all parts of the city's office market will benefit.

For those prepared to take on a higher-risk profile, major centres within the larger E.U. accession countries will benefit from growth. High-quality stock is limited, but medium-term yield convergence will drive strong capital gains in these markets.

Other opportunities lie in identifying well-located buildings for refurbishment to take advantage of the upturn in the cycle from late 2004 onwards.

Avoid

There are contrary views expressed with regard to the market for shorter-lease and off-prime/secondary properties. Put simply, rents in secondary office markets will take two to three years to show any growth—so steer clear unless this risk is reflected in the pricing. However, some investors are showing a keen interest in nonprime short-lease stock, considering it mispriced and representing good value. Clearly this depends on the city, the 'micro location,' the tenant, and an assessment of the rollover risk or re-letting/void risk at the end of the lease. With the market already at or close to the cyclical trough in several cities, local knowledge will again prove invaluable in identifying any such opportunities.

Development

"Very few projects can be justified in today's markets—developers should play golf or go to the beach." Admittedly, the last 12 months or so have not been the best time to be involved in office development. However, it takes time to acquire sites and clear the planning hurdles. Developers should observe those markets where demand is showing early signs of recovery. In a number of cities where new supply is limited, act now to take advantage of the cycle upturn.

Outlook

For 2004, office market returns will again be modest, but the weight of money will limit capital value falls. Our survey shows prime yields in 2004 are expected to be around 6.5 percent for city centre offices and 7.4 percent for business park/out-of-town offices. Rents in some of the major European centres have reached their nadir—and year-on-year rental growth should return to positive figures in late 2004 and into 2005. From 2005 onwards, the sector should return a clean bill of health once more in all but a couple of major cities.

Exhibit 4-6 Prospects for City Centre Offices in 2004

	Prospects	Rating	Ranking
Total Returns	Modestly Poor	4.3	7th
Rent Increases	Poor	3.4	8th
Capital Growth	Modestly Poor	4.1	7th
Supply/Demand Balance	Modestly Poor	4.1	8th
Development	Modestly Poor	3.8	8th
Expected Prime Yield	6.54%		

Buy	Hold	Sell
38.2%	42.6%	19.1%

Source: Emerging Trends in Real Estate Europe 2004 *survey.*

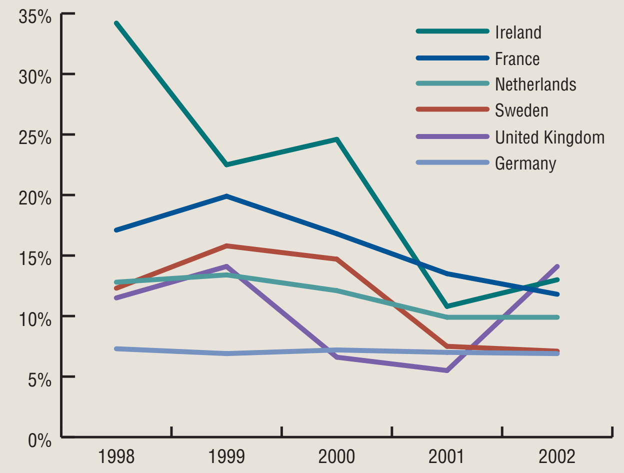
Exhibit 4-7 **Prospects for Business Park/Out-of-Town Offices in 2004**

	Prospects	Rating	Ranking
Total Returns	Modestly Poor	3.6	9th
Rent Increases	Poor	2.9	9th
Capital Growth	Poor	3.5	9th
Supply/Demand Balance	Poor	3.5	9th
Development	Poor	3.3	9th
Expected Prime Yield	7.35%		

Buy	Hold	Sell
17.5%	50.8%	31.8%

Source: Emerging Trends in Real Estate Europe 2004 *survey.*

Exhibit 4-8 **IPD Retail Property Total Returns for Selected Countries**



Source: Investment Property Databank.

Retail

Strengths

In many, though not all, parts of Europe, consumer spending is what has kept the respective economies afloat over the last two years. "Retail remains buoyant due to continued consumer spending power." This has been particularly noticeable in the U.K., where the strong housing market has led to significant equity withdrawal. Much of this cash has been spent on retail and leisure goods. Strong consumer spending has driven the retailer demand, contributing to the relatively strong returns of the last two years.

In the eyes of many investors, the attraction is the opportunity to acquire a product—in shopping centres and retail parks—that can be actively managed to drive medium- to long-term performance. In addition, the tight planning legislation governing out-of-town development in most parts of Europe provides an element of protection against future competition. The survey indicates that shopping centres are expected to show the best short-term returns, and they also show the highest 'buy' recommendation. "Retail investments will outperform office investments until 2005."

Retailers and new retail concepts will evolve, which will continue to deliver healthy demand for prime units in city centre 'high streets' and shopping centres. Unlike the office sector, total returns have held up well in recent years in many countries (see Exhibit 4-8). The consensus view for the sector is for increased exposure.

Weaknesses

There are concerns over rising interest rates (more so in the U.K. than in Europe) and the impact they will have on consumer spending. The sector has been strong for some time, and many expressed concern over how long it can continue. "The retail market is still fairly consistent, although cooling off is near." "The retail market is weakening—we see a weaker investment market, but okay for development."

It is not a "transparent" sector—there are many external factors that affect it. An adverse impact on spending could result in a rapid change in performance prospects and sentiment.

If there is an obvious weakness in the sector it is in poor secondary and tertiary shop units. Competition from shopping centres, out-of-town retail parks, and hypermarkets selling ever-increasing nonfood ranges is making life very difficult for fringe traders.

Though Internet and TV shopping sales have yet to have the devastating impact on the sector considered likely only a few years ago, these segments are continuing to grow. But does it matter if 'e-tailers' are also the same retailers represented in the 'high street' shops, shopping centres, and retail parks? There are very few pure e-tailers. In its simplest form, an e-tailer is just another route to market—some products sell well over the Internet, others don't. It's all part of retail evolution and most retailers are adapting to take advantage.

The push away from out-of-town towards town/city centre developments and redevelopments, and often mixed-use rather than pure retail, means ever more complex proposals. Site assembly and planning negotiation can take several years and mixed-use development is not for the faint of heart.

The ownership structure of shopping centres in Europe (often hypermarket anchored) is often unattractive to overseas buyers.

Best Bets

Retail sectors across Europe vary in maturity, with the U.K. probably being the most mature market. Some retail concepts, like retail parks and factory outlet centres, are immature in parts of Europe, particularly the Iberian Peninsula, Italy, and C.E.E. These areas tend also to be undersupplied with shopping centre facilities and development opportunities remain. The E.U. accession countries have to be a good bet, as joining the E.U. will promote above-average economic growth. With this will come consumer wealth and a demand for improved retail facilities ranging from convenience stores to luxury goods.

Facing increasing levels of competition, it is the dominant shopping centres in major and second-tier cities that will continue to do well. Look for the dominant contenders or those with the potential to dominate. Investors must be prepared to actively manage centres, and those prepared to work with retailers to accommodate their changing needs will benefit the most.

Restrictive planning in most countries will continue to favour well-located, out-of-town developments attractive to shoppers who arrive by car. In the U.K. there are still some opportunities to refurbish and reconfigure first-generation retail parks.

Prime and well-located secondary units should continue to deliver strong performance. The demand from an increasing range of international brands, and the demand from national and international names for large space in prime positions, will shunt weaker players to off-pitch prime and good secondary pitches. Look for new trends—the U.K. has seen dramatic shifts in prime pitch as major food retailers (Tesco, Sainsbury, and Marks & Spencer) have focussed their attention on town and suburban centres for growth of their convenience store operations. Will this trend be matched in other parts of Europe?

Avoid

The weak will get weaker. Avoid poor secondary units. Competition from better locations is crippling. Avoid shopping centres that are weak in terms of both scale and attractiveness. Once trade has been attracted elsewhere, it is difficult and expensive to win back.

Development

Development prospects will be fair for all three retail sectors, and the supply/demand balance should remain in relative equilibrium. In the U.K., planning policy dictates that most major shopping centre development opportunities will be in or on the edge of city centres. Major shopping centre development and retail-based mixed-use schemes are being used as the catalyst for regeneration of existing town or city centres—for example, the Bull Ring in Birmingham and Paradise Street in Liverpool. But these are major long-term projects.

Shopping centre and retail park opportunities remain in those countries undersupplied with high-quality retail environments and those expected to benefit from E.U. accession. Head south and east, but look at the development pipeline closely—beware of oversupply. There is already evidence of this in some countries, such as the Czech Republic. "The market for shopping centre development in and around Prague is over except for several already in planning."

Outlook

Even though economies across Europe are expected to recover in 2004, there is an air of caution. Levels of personal debt are at very high or record levels in several European countries, with the U.K. being most vulnerable on this score. Although immediate interest rate rises are unlikely in the Eurozone, the Bank of England edged up U.K. interest rates in November 2003. This is expected to affect consumer spending in 2004. Commentators will be eagerly awaiting the Christmas trading figures.

In general, the outlook for retail is better than that for most other sectors, and thus the sector will continue to attract investor interest. "Retail continues to be a very safe investment generally throughout Europe, as entitlements for new construction are very difficult to obtain. This is especially true for France, Italy, and Spain." "The retail sector is expected to show increased capital growth and strong rental

Exhibit 4-9 **Prospects for Shopping Centres in 2004**

	Prospects	Rating	Ranking
Total Returns	Fair	5.3	1st
Rent Increases	Fair	4.9	2nd
Capital Growth	Fair	5.2	1st
Supply/Demand Balance	Fair	5.2	2nd
Development	Fair	5.1	2nd
Expected Prime Yield	7.30%		

Buy	Hold	Sell
50.8%	34.9%	14.3%

Source: Emerging Trends in Real Estate Europe 2004 *survey.*

Exhibit 4-10 Prospects for Street Retail in 2004

	Prospects	Rating	Ranking
Total Returns	Fair	4.9	3rd (tie)
Rent Increases	Fair	4.6	5th
Capital Growth	Fair	4.8	4th
Supply/Demand Balance	Fair	5.3	1st
Development	Fair	4.8	5th
Expected Prime Yield	6.84%		

Buy	Hold	Sell
33.9%	49.6%	16.5%

Source: Emerging Trends in Real Estate Europe 2004 *survey.*

Exhibit 4-11 Prospects for Retail Parks in 2004

	Prospects	Rating	Ranking
Total Returns	Fair	4.9	5th
Rent Increases	Fair	4.7	3rd
Capital Growth	Fair	4.8	5th
Supply/Demand Balance	Fair	4.9	5th
Development	Fair	4.9	4th
Expected Prime Yield	7.38%		

Buy	Hold	Sell
38.8%	35.0%	26.2%

Source: Emerging Trends in Real Estate Europe 2004 *survey.*

value growth." Stronger returns will be available in the less mature markets where the risk is greater.

Overall, our survey shows that prime yields in 2004 are expected to be around 7.3 percent for shopping centres, 6.8 percent for street retail, and 7.4 percent for retail parks.

Industrial

Strengths

The defensive characteristics of the sector, together with the relatively high yields available for industrial and warehousing properties, have attracted investor interest, with private debt-backed buyers competing aggressively against institutional investors for limited stock. The lack of modern-quality warehousing across Europe has contributed to downward pressure on yields and has encouraged some owner-occupiers to cash in on higher values through sale and leaseback transactions.

In many parts of Europe, particularly southern, central, and eastern Europe, the logistics sector is immature and there is huge scope for improvements to the supply chain. "Stronger economic growth in the E.U. accession countries will benefit the sector and there is likely to be yield compression." In addition, E.U.-funded infrastructure improvements are likely to benefit strategic locations.

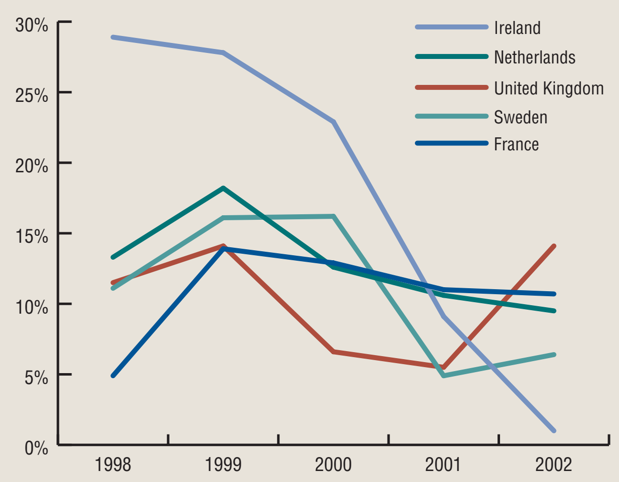
The survey indicated favourable views for returns on warehousing and distribution, with this submarket coming in second only to shopping centres as a 'buy' recommendation.

Weaknesses

Occupier demand has been generally weak across most markets, with the exception of a few large strategic distribution requirements. Although economic growth is forecast to improve, in most European countries growth will be fairly pedestrian for the next 12 months. Manufacturing sectors have been extremely weak, although there are recent signs of improvement. Low-cost manufacturing locations in Asia will continue to provide fierce competition for western Europe. Total returns in the manufacturing property sector are expected to be modestly poor, and only 12 percent of respondents rate it a 'buy' sector—fewer than any other sector.

Identifying high-quality stock is an issue for industrial properties. In some European markets, "existing stock is virtually obsolete" and is not suited for today's logistics operators.

Exhibit 4-12 IPD Industrial Property Total Returns for Selected Countries



Source: Investment Property Databank.

Best Bets

"Stay close to existing strategic locations." It seems clear that the logistics markets in central, eastern, and southern Europe will be subject to the same structural changes in supply chain management as witnessed in the more mature western European markets over the last five years or so. Demand is likely to come from retailers and third-party distributors for large, strategically located distribution centres. Markets favoured in the survey included northern France, Belgium, Netherlands, Germany (Rhine/Ruhr), Spain, the Czech Republic, and Poland.

Cost pressures are leading some operators to consider less traditional locations for logistics bases. With a sensible length lease, good covenants, and pricing to reflect the additional risk, these locations may be attractive alternatives to the mainstream.

Avoid

With investor demand exceeding supply, beware of overpriced locations given the limited rental growth prospects for the sector. Avoid older and outdated products.

Development

Development may be the best route to gain exposure to the sector, to satisfy demand from both national owner-occupiers and international logistics companies. However, the specialist requirements of some occupiers make speculative development risky. Developers are able to react quickly to new demand requirements, and prelet build-to-suit schemes can be ready in months rather than years, reducing the need for speculative development.

Outlook

The industrial market comprises manufacturing and distribution/warehousing. Demand from the manufacturing sector is likely to remain subdued as Europe faces stiff competition from China and other Asian countries for production facilities.

The distribution sector offers greater opportunities, and although only modest rental growth is anticipated, replacement of obsolete stock and growth in demand as structural changes in the industry take place will result in falling yields and capital growth in many parts of Europe, particularly central and eastern Europe and the south. "We consider warehouse and logistics space a 'buy' in prominent locations with newer, up-to-date space." However, a shortage of good product for investors will remain. "The market needs more stock. Existing product is limited and now owned by investors who make long-term investments. The opportunists have already sold their goods."

Our survey shows that prime yields in 2004 are expected to be around 8.2 percent for warehousing/distribution properties and 8.6 percent for manufacturing properties.

Exhibit 4-13 **Prospects for Manufacturing Real Estate in 2004**

	Prospects	Rating	Ranking
Total Returns	Modestly Poor	4.1	8th
Rent Increases	Modestly Poor	3.8	7th
Capital Growth	Modestly Poor	4.1	8th
Supply/Demand Balance	Modestly Poor	4.4	7th
Development	Modestly Poor	4.1	7th
Expected Prime Yield	8.59%		

Buy	Hold	Sell
12.4%	43.8%	43.8%

Source: Emerging Trends in Real Estate Europe 2004 *survey.*

Exhibit 4-14 **Prospects for Warehousing/Distribution Real Estate in 2004**

	Prospects	Rating	Ranking
Total Returns	Fair	4.9	3rd (tie)
Rent Increases	Fair	4.7	4th
Capital Growth	Fair	4.9	3rd
Supply/Demand Balance	Fair	5.0	4th
Development	Fair	5.0	3rd
Expected Prime Yield	8.24%		

Buy	Hold	Sell
46.4%	42.0%	11.6%

Source: Emerging Trends in Real Estate Europe 2004 *survey.*

Hotels

Strengths

"Hotels will present an opportunity in 2004—partly because the sector has been so badly beaten up since 9/11; partly due to a rebound in business and leisure travel; and partly because of cyclical rotation in the sector." The improving external environment should benefit the hotel sector outlook, although trading continues to remain mixed throughout Europe. The U.K. sector appears to have reached a turning point in the cycle and things can only get better.

A key factor driving hotel sector performance is the economic cycle, and the forecast global economic pickup will boost hotel demand growth. The international air travel outlook continues to improve (slowly) and there was a steady rise in traffic in the three or four months to December 2003.

An upturn in business travel is expected in 2004. Low-cost air travel will continue to buoy up the European and domestic short-break sector.

A more optimistic second half of trading has been reported in 2003 from key U.K. operators.

London is expected to lead the recovery in the European hotel sector, but we anticipate a 'long haul' back with further revenue per available room (RevPAR) declines this year and RevPAR growth of just 0.9 percent in 2004 and 4.8 percent by 2005.

Trophy hotels, often prime real estate investments, retain their appeal for a certain type of investor.

Weaknesses

Hotel trading remains mixed, geographically and by segment, with luxury hotels in European gateways faring worse. Operating margins remain under pressure from a shifting business mix (from business to leisure breaks and small conferences in the U.K.) and higher fixed costs, such as insurance.

So far there have been few consistent indicators of a revival in corporate travel volumes—indeed the corporate business model may have changed for good.

It is likely to be a long and arduous recovery for many markets, especially international gateways. Many operators remain cautious about the pace of recovery. German economic recovery is vital for hotel sector resurgence.

Best Bets

Bright spots on the landscape include the largely (but not entirely) resilient branded budget sector, some niche products, and, looking ahead, 'refreshed' value for three- and four-star products, which, through refurbishment and updating, may offer opportunities. Hotels remain a specialist investment market in Europe and the opportunity to create value lies in introducing innovative products. "We will see more cooperative investments from specialists, with contingent leasing." Investors will be prepared to take on more of the risk.

Despite rumours of looming oversupply in the U.K., growth is expected to continue for the next five years driven partly by new products and the involvement of the venture capital market. The sector is considered to offer many opportunities in Europe, and some U.K. operators are looking to Germany, Spain, and Italy for growth. "Spain is still a good location for hotel investment." "We expect strong demand and many new developments due to lack of supply in the Italian market." "Good prospects for hotels in Spain and Italy." "Barcelona has good potential in the hotel sector for tourism and business." A more competitive environment is likely in the future.

Lifestyle hotels also offer some promise. PricewaterhouseCoopers (PwC) conducted a survey of the lifestyle hotel sector in July 2003, including interviews with 19 European lifestyle hotel operators representing 109 hotels. Despite few signs of a sustained recovery in corporate travel demand at the time, lifestyle hotel supply continues to expand. Over the past year, six operators increased supply by more than 20 percent each and the sector continues to plan for future growth. PwC research shows that the sector managed marginal RevPAR growth in 2002. Stronger leisure travel demand helped some operators and performance varied by location. However, several issues—such as expansion without becoming ubiquitous, and the emergence of low-service stylised concepts—have become a greater concern to operators in the 2003 survey, and these threats, combined with high staff costs and an increasingly price-driven market, may restrain the sector's rebound in the next five years.

Avoid

Avoid missing cyclical opportunities. Don't compromise on location or quality. Avoid panic sales. A short-term attitude towards investing in the sector is not recommended unless you are sure 'turn and burn' works.

Development

The difficult trading environment over the past three years has resulted in severe reductions in capital expenditure for most groups—for both maintenance and expansion—and there are few major oversupply concerns, although some cities have supply imbalances and are finding it hard to fill beds, e.g., Berlin.

Development has also been restrained by the large number of public companies in the business that have had trouble raising capital to grow. A recent trend, likely to continue, has seen several hotel chains returning to private ownership. For example, BIL's acquisition of Thistle, Macdonald Hotels's management buyout, Trefick's acquisition of Hanover International, and, in Spain, Hesperia, seeing an opportunity, tried (and failed) to acquire a share of NH Hoteles. Watch this space.

Consolidation and restructuring are likely to lead to a growing number of asset disposals.

As the economy improves, however, some believe there will be strong development opportunities. "We see an increasing number of good development opportunities in light of growth forecasts and an improving market cycle."

Outlook

Survey respondents expect fair prospects for hotel total returns, capital growth, supply/demand balance, and development, and modestly poor prospects for room rate increases. Hotels finished roughly in the middle of the nine property sectors in our survey, and there is some optimism about this sector in 2004. "I believe that some niche products like hotels will see good demand." "Hotel investments still seem attractive due to high occupancy levels and comparatively high cap rates."

In the U.K., expect improving market conditions based on a pickup in global and U.K. economic growth, strengthening international and corporate travel demand (including the release of some pent-up demand), and a further pickup in the conference sector. RevPAR growth should be good in the U.K., around 2.7 percent for 2004 according to PwC forecasts. Should legislation be passed, U.K. REITs could potentially alter the landscape for U.K.-based hotel companies and offer an alternative route to direct investment in the sector.

In Germany, PwC forecasts for the hotel sector to 2005 reflect the expected pickup in global economic growth in 2004, as well as marginally improved economic prospects for Germany in 2004 and 2005, and slowly recovering travel markets. In 2004, PwC forecasts expect occupancy growth of 1.5 percent and a moderating room rate decline of 0.5 percent that will lead to RevPAR growth of 1.1 percent.

The *Emerging Trends* survey shows that for Europe generally, prime yields for hotels in 2004 are expected to be around 7.4 percent.

Changes in household structure, leading to an increasing number of smaller households, are driving the demand for more housing. Further, the ageing profile of the population in Europe points to an increasing demand for specialist types of housing, retirement communities, and sheltered housing in the coming years.

The rental market should also receive a boost from potential buyers deterred by rising interest rates and, to a lesser extent, from mobile workers' preference to rent rather than buy given punitive transfer duties. Key worker housing provision is becoming an issue in several metropolitan areas across Europe, and innovative rental solutions will provide further support to the market. The survey indicates strong anticipated short-term performance in the sector (second only to shopping centres) and it is considered the best development opportunity. Total returns have been relatively attractive in recent years and have held up well in several leading countries, including the U.K., Sweden, the Netherlands, France, and Germany (see Exhibit 4-16).

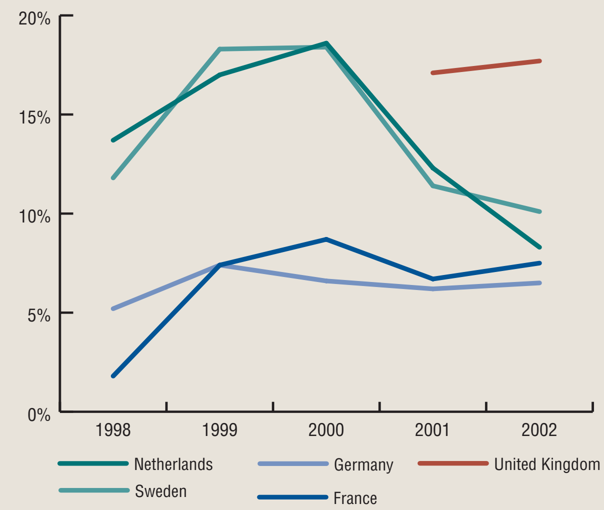
Exhibit 4-15 **Prospects for Hotels in 2004**

	Prospects	Rating	Ranking
Total Returns	Fair	4.8	6th
Rent Increases	Modestly Poor	4.4	6th
Capital Growth	Fair	4.6	6th
Supply/Demand Balance	Fair	4.6	6th
Development	Fair	4.6	6th
Expected Prime Yield	7.44%		

Buy	Hold	Sell
38.8%	32.7%	28.6%

Source: Emerging Trends in Real Estate Europe 2004 *survey.*

Exhibit 4-16 **IPD Residential Property Total Returns for Selected Countries**



Source: Investment Property Databank.

Residential

Strengths

The residential sector has been the best-performing market in a number of European countries in recent years, including the U.K., Sweden, Denmark, the Netherlands, Spain, and Portugal. "Investment in residential properties is getting more attractive." However, investors must keep in mind that the structure of the residential market differs considerably across Europe, including differing regulatory environments and varying levels of homeownership (e.g., around 80 percent in Spain and 45 percent in Germany).

Weaknesses

Generally, the residential sector involves low-yielding and management-intensive assets that require specialist skills to deliver good performance. The sector is not a recognised major asset class in all European countries. Low interest rates and historically low affordability ratios have are encouraged increased homeownership and hence a reduced rental market.

Know your market. Some European countries are still subject to rent controls that maintain rents at below-market levels. Dominant social housing sectors with subsidised rents will require any institutional or private landlord to compete on price to attract tenants. Suitable large lot size stock (apartment blocks) can be difficult to acquire and are virtually non-existent in some markets (e.g., the United Kingdom). Some markets can be volatile, such as Spain and the U.K.

There is a bewildering variety of housing systems, supply chains, institutions, property laws, housing policies, tax breaks, and subsidies across Europe. Most are the outcome of country-specific housing policy histories. Structures of housing provision and policy towards them are subject to continual revision.

Low interest rates and poor performance of the equity markets have drawn a raft of private 'buy-to-let' investors into the market. Although this does not apply across the board, a combination of increasing personal debt, rising interest rates, imprudent lending, rental falls (in some markets), and unbudgeted maintenance costs could be potentially explosive.

Best Bets

Favoured areas in western Europe are France (Paris apartments), Denmark, Switzerland, and Portugal (medium/high end in Lisbon). "Rents of Parisian residential will increase." Central Europe also offers opportunity. "Because of the shortage of housing and infrastructure, investors have started to investigate numerous attractively located parts of Warsaw."

Demographic changes and an aspiration to "retire to the sun" will favour southern European established and emerging retirement concentrations in the medium term, especially the French Riviera and the Spanish Costas.

Government policy on urban regeneration will result in an increasing number of mixed-use schemes. This will provide opportunities for large-scale investment in the residential sector.

Avoid

Avoid areas of oversupply and forecast population decline. Caution is advised in Spain, where the market has performed consistently well in recent years and may be due for a correction. Likewise, beware of high-end properties in central London, where the rental market is under pressure.

Development

The demand for urban living has been on the rise. Watch for the emerging 24-hour cities (e.g., Birmingham, Prague, Budapest) and satisfy demand for high-quality apartments through conversions and mixed-use developments. At the other end of the spectrum, affordable and key worker housing supply is of growing concern in many major urban areas. Demand will continue to grow and innovative solutions are required.

Some of the more active and controversial markets can be found in France and Spain. Notes one French observer: "There is a huge increase still going on. The most important indication of the future trend is the evolution of the market for older properties. This market will also depend on the evolution of interest rates." Notes another French observer, "Residential is very strong; it probably won't crash but it can't get better." Notes a Spanish observer, "Madrid is still growing in the residential sector." But another is concerned about Spain: "We have big concerns about a possible crash in the Spanish residential market because it will affect the international investors' view of the Iberian market." Notes another, "Residential in Spain and Paris is very dangerous."

Demand will continue to come from retirees and second-home owners for apartment and villa complexes in sunny climes. Watch for new budget airline routes in Europe that have the potential to unlock new destinations in Spain, Portugal, France, Italy, and beyond.

For the risk taker, look to C.E.E. and Russia. The former communist states suffer from very poor quality, if not obsolete, housing stock. As personal wealth in these countries grows, so too will the demand for decent family accommodation. The future market for reasonable quality, affordable family units must be huge.

Outlook

The consensus view is one of caution and modest growth. Markets that have experienced strong performance in the last couple of years are seeing that growth reined in, and in some markets both capital value and rental decline. In the medium to long term, demographic pressures would suggest a continued supply/demand imbalance in many parts of Europe. Once again, local market knowledge will be the key to identifying opportunities at the right moment in the local/regional/national cycle. Our survey shows that prime yields for residential real estate in 2004 are expected to be around 6.3 percent. Prospects on most measures—including total returns, rent growth, and development—are expected to be fair, and better than most other sectors.

Exhibit 4-17 **Prospects for Residential Real Estate in 2004**

	Prospects	Rating	Ranking
Total Returns	Fair	5.1	2nd
Rent Increases	Fair	4.9	1st
Capital Growth	Fair	5.1	2nd
Supply/Demand Balance	Fair	5.2	3rd
Development	Fair	5.4	1st
Expected Prime Yield	6.24%		

Buy	Hold	Sell
35.7%	32.1%	32.1%

Source: Emerging Trends in Real Estate Europe 2004 *survey.*

Interview/Survey Participants

AEW Italia SPA
Andrea Amadesi

AGIV Real Estate
Jörg Scheele

Aguirre Newman
Howard John Pierce

AIG Global Real Estate Investment (Europe) Ltd.
Elizabeth McLoughlin

AIG Lincoln España
Howard Barnes

Akeler Developments
James R.B. Cole

Alban Cooper
Nuno Costa Prata

Aldabra Investments
Mark Curtis-Bennett

Alkas Shopping Center Consulting Ltd.
Avraam Alkas

Allgemeine HypothekenBank Rheinboden AG
Thomas Lammerhirt

Allreal Holding AG
Bruno Bettoni

Andersson REIM AB
Leif Andersson

Andrew Boggis & Associés
Andrew Boggis

Archiplan S.L.
Jaime Hernandez Masses

Ashurst Morris Crisp
Hugh Lumby

Association des Études Foncières
Chantal Dekeyser

ATIS Real Auguste-Thouard
Nicolas Mestrallet

ATIS Real Wetheralls
Keith Steventon

Atlantic Partnerships International, Ltd.
Andrew Krawchuk

ATLANTICUS
Harald G. Engbrocks

ATP Ejendomme A/S
Mads Rude

AXA Real Estate Investment Managers, Ltd.
Kiran Patel

Baltic Property Trust
Martin Holm

Barcelona Regional, S.A.
Maria Buhigas Sanjosé

Bech-Bruun Dragsted
Torben Schon

Bouwfonds Property Developments B.V.
Han P.T.M. Joosten

Bovis Lend Lease Portugal
Luis Fernando Rodrigues Silveira

Bulwien AG
Andreas Schulten

C & T Development GmbH & Co. KG
Robert Roethermund

Capital and Regional plc
Linda Coral

Catella Property Group
Alessandro Bronda

CB Richard Ellis
Jan Findeisen
Veit Fischer
Michael Haddock
Carsten F. Remmert
Pedro M. Seabra

Chesterton
Tony Burdett

Citigroup
John Herbert

Citycon Oyj
Petri Olkinuora

CMS Cameron McKenna
Steven D. Shone

Cofinimmo
Jean Franken

Colizeo Eurazeo
Philippe Brion

Colliers International
John Banka
Ewen Hill

Colliers P & I
Joaquim Chambel
Goncalo Nascimento Rodrigues

Constructa
Etienne Marcot

Corio N.V.
Jan De Kreij

Credit Suisse Financial Services
Dr. D. Keller

Currie & Brown
Kevin Owen Ellis

Cushman & Wakefield Healey & Baker
Eric Van Leuven

Deka Immobilien Investment GmbH
Willi Alda
Andreas Wellstein

Desarrollo Urbanistico Chamartin
Luis Irastorza

Deutsche Bank
Ismael Clemente
Gerardo Solaro del Borgo
Nick Tyrrell
Christopher Voutsinas

Deutsche Baumanagement GmbH
Rolf Reh

DID S.A.R.L.
Chris Curtis

DIFA Deutsche Immobilien Fonds AG
Dr. Reinhard Kutscher

DOKAR Construction Ltd.
Semih Karabay

Dundas & Wilson CS
Donald Shaw

ECE Projektmanagement GmbH & Co. AG
Alexander Otto

Equinox Partners Ltd.
William P. Kistler

Estudio Lamela
Carlos Lamela

Eurohypo AG
Yves Aubret
Carlos Leiria Pinto
Karsten von Koeller

FPD Savills
Eri Mitsostergiou

FUNDBOX
Rui Alpalhao

Gabetti SpA
Alessandro Ghisolfi

Garanti REIT
Erdogan Dagli

GE Capital Golub Europe
Kenneth A. Munkacy

GE Real Estate
Mike Bryant
Olivier Piani
Lennart Sten

Gemini Commercial Investments Ltd.
Peter D. Marano

GLL Partners
Barry McGowan

Global Switch
Andrew Vander Meersch

GM Sociedad de Inversiones Immobiliarias S.A.
Isaac Nunez

Goldman Sachs International
Edward Siskind

Grosvenor
Jeremy Newsum
Marc Reijnen

Groupe France Terre
Timothy Cyr
Guy Portmann

Groupe Saggel
Patrick Mougne

Grupo Financiero Riva y Garcia
Pedro Vinolas

GVA Grimley
Stuart Morley

Henderson Global Investors
Guy Morrell

Heintz & Co.
Florian Busse

Heitman
Gordon Black

Hines
John Gomez Hall
Carlo Matta
Lee Mays
Robert Rackind

HPE Property Holding GmbH
Udo Stocker

HRO International
Howard P. Ronson

HSBC Investment Bank
Alan Patterson

Hugo Ceusters
Thomas Willekens

Hypo Real Estate Investment Banking Ltd.
Seth Lieberman

ING BHF Bank
Thomas Etzel

ING Real Estate Investment Management
Maarten Van der Spek

INVESCO Real Estate Limited
Gerald Parkes

Invescon, Lda.
Augusto Silva

IPI SpA
Ivano Ilardo

IS Real Estate Investment Company
Markus Lehto

Istanbul Technical University
Fulin Bolen

IVG Immobilien AG
Michael Lipnik
Rolf-Moritz Webeler

Jelmoli Holding AG
Peter Leumann

JER Real Estate Advisors, Ltd.
Malcolm LeMay

John Neild & Associados
Francisco Rocha Antunes

Jones Lang LaSalle
Tony Edgeley
Anne T. Kavanagh
Chris Staveley

JP Morgan
Bernard Penaud
Peter M. Reilly

Karl Steiner AG
Nigel Woolfson

KASPAR Associates
Karen Sieracki

King Sturge
Angus McIntosh
Henry Woodruff

Klépierre Services
Jan Verschueren

KMD-Architects
Jorge Campos de la Borbolla

Kuzeybati Worldwide Real Estate Service
Murat Ergin

Lamda Development
Panagiotis M. Nikolaou

Landertshammer Real Estate
Andreas Landertshammer

Landesbank Hessen-Thuringen
Dieter Kasten

LaSalle Investment Management
Gerald Blundell
Phillip Schaper

Layetana
Maribel Melendez

Legal and General Investment Management
Michael Patrick

L'Habitation Moderne
Philippe R. Dereppe

Linklaters
Simon H.T. Clark

Llanera
Francisco Aviles

Lusotur
Gilberto Jordan

Maaf Assurances
Brigitte Sagnes

Major Valor Consulting
Vasco Lanca de Morais

Matrix-Securities Limited
Robert Randall

McKinivan Moos, Inc.
Pius Sidler

MEAG Munich ERGO Asset Management
Brigitte Schmale

Mercer Investment Consulting
Greg Wright

MetLife
Giles Parker

MIDI Plc
Benjamin Muscat

Miller Developments S.L.
Peter J. Boyle

Morgan Stanley Real Estate Funds
Stephane Theuriau

Multi Development Corporation International, S.A.
Paulo Sarmento

Munchener Hypothekenbank EG
Leonhard Goebel

Nabarro Nathanson
Colm Quinn

Nuñez y Navarro
Josep Lluis Nuñez Navarro

O'Connor Capital Partners
John McCarthy

Oficiencia S.L.
Nicholas Fraser

Paref
Hubert Lévy-Lambert

Patron Capital Limited
Matt Utting

Pelicano – Investimentos Imobiliarios S.A.
Joaquim Da Cunha Mendes Duarte

Pensimo Anlagestiftung
Richard Hunziker

Portland Trust
Robert Neale

Praxis PN Management/3W Finance
Paul Van de Perre

PRICOA
Philip Barrett

Progetto CMR
Massimo Roj

Prokom Investment S.A.
Zbigniew Okonski

Property and Portfolio Research, Ltd.
Peter Hobbs

Prudential Property Investment Managers Ltd.
Paul McNamara

PSP Swiss Property AG
Fritz Jörg

Quintain Estates and Development plc
James Hamilton Stubber

R & L Properties
Arman Ozver

R.E.S. Real Estate Strategies LLC
Patrice Chole

Real Development
Nelson Manuel Rego

Real Estate Group REG
Rahman Rahmanzadeh

Realia Business, S.A.
Jaime Llorens Coello

Rechtsanwalt
Juergen Baumann

Redevco Europe
J.W. Dalmeijer

RETRI Group
R. Thompson

Revas Hotel Investments
Rene Van Eijsden

Rock Building
Luis Roquette

Sagestamo S.A.
Joao Placido Pires

Sampension Administrationsselskab A/S
Ole Simonsen

Sampo plc
Kim Westberg

Semihabitout S.A.
Pla Miro Yoan

SG Odiprom
J.F. Drouets

Skanska AB
Johan Bergman

Sopedi Real Estate Financial Products
Gerard Philippson

Sponda Plc
Sari Aitokallio

Squire, Sanders & Dempsey
Daniel E. Larkin

STAM Europe
Vincent Behaghel
Antoine de Broglie

Standard Life
Neil Cable

Stevebis
Antoon Van Coillie

Storebrand Eiendom AS
Frode Asenden

Strategic Real Estate Advisors
Jeremy Gates

Strauss & Partner Immobilien GmbH
Karl-Heinz Strauss

Studio Legale Albertazzi and Associati
Roberto Albertazzi

Stuetzer Real Estate Consulting GmbH
Harald Stuetzer

Sunbelt Developments
Marcus Donaldson

Sviluppo Sistema Fiera SpA
Claudio Artusi

Swiss Prime Site
Markus Graf

Tasinsa
David Marquina

Tishman Speyer Properties
Michael Spies

TMW Immobilien AG
Georg Frhr. von Hammerstein
Thomas Hoeller
Klaus Trescher

Twynstra Gudde
J. Winters

UBS Fund Management AG
Riccardo Boscardin

Urbis
Julian Solis

Vivico Real Estate
Christian Balletshofer

Vuotekno Oy
Pekka Viukari

WBMS
Juan Luis Soucheiron

Zublin Immobilien
Dr. Franz Hidber

3W Finance
Paul Van de Perre

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Senior Executives

Richard M. Rosan
President

Cheryl Cummins
Chief Operating Officer

Rachelle L. Levitt
Executive Vice President, Policy and Practice

William P. Kistler
President, ULI Europe

ULI–the Urban Land Institute
1025 Thomas Jefferson Street, N.W.
Suite 500 West
Washington, D.C. 20007
202-624-7000
www.uli.org

ULI Europe
Brussels, Belgium
+32-2-743-4441
www.uli.europe.org

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Real Estate Leadership Team

Patrick R. Leardo
Global Real Estate Business Advisory Services
New York, New York
646-471-2666

Peter F. Korpacz
Global Strategic Real Estate Research Group
Baltimore, Maryland
301-829-3770

Mark Charlton
Global Strategic Real Estate Research Group
London, U.K.
44-(0)-20-7212-6263

www.pwc.com

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