

Emerging Trends in Real Estate® Europe 2005

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Emerging Trends in Real Estate Europe 2015 Contents

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Recommended bibliographic listing: ULI-the Urban Land Institute and PricewaterhouseCoopers LLP. Emerging Trends in Real Estate® Europe 2005. Washington, D.C.: ULI-the Urban Land Institute.

ULI Catalog Number: E22 ISBN: 0-87420-936-6

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Executive Summary

- More money is being raised than can currently be placed in European real estate markets. The sources of capital are expanding, but there is a shortage of suitable assets for acquisition.
- Except for German open-ended funds, all sources of equity and debt will have more money to deploy in 2005. There will be no dominant source of equity this year, given the huge sums that private equity funds, institutions, syndicates, private companies, publicly listed companies, and a myriad of other players have to invest.
- European real estate markets will outperform bonds and equities again in 2005. The high level of inflows to real estate will continue because it is deemed "the least-worst asset class."
- The disconnection between occupier markets and the investment market will not disappear, but more markets are turning the corner or will do so by the end of the year.
- Investors are taking on increasing risk in order to obtain real estate assets. They will continue to seek out niches where there is room for adding value through refurbishment or repositioning of assets in order to obtain additional return.
- Prices are historically high and could face a setback if interest rates finally rise in earnest, but significantly higher rates are not expected this year. There has been a structural expansion in the investor base for real estate.
- The shift to indirect investment will continue as more institutions seek to diversify their real estate holdings across sectors and access foreign markets. There will be more listed and unlisted vehicles offering core and value-added strategies to meet this increasing appetite for diversification.

- The framing of plans for REIT legislation will progress in more European countries, including Germany, although actual passage and launch will probably not occur until 2006. Derivative offerings will make their first serious appearance this year for both listed and direct property.
- Both CMBS and mezzanine finance will become more important to the markets as preparation for Basel II progresses. Underwriting standards will be more stringent, particularly in senior lending to developers.
- The best investment markets for solid risk-adjusted returns will be Paris, Milan, and London. All three are seeing an improvement in occupier markets and have reasonably good fundamentals. The markets that garnered the most "buy" recommendations are Prague, Warsaw, and Budapest. Their economic growth is projected to be double that of the E.U. average, and they offer higher yields with prospects for further convergence.
- The best development markets—but with considerable risk—will be outside the E.U. Istanbul tops the rankings as it offers scope in most sectors and a vibrant, entrepreneurial high-growth economy that is aspiring to join the E.U. Moscow follows with its huge potential market and rising incomes, although political considerations complicate the picture.
- The best sectors to invest in will be shopping centres and retail parks, although they are unlikely to deliver the returns seen last year. Warehousing and residential properties are also attracting attention, and hotel fundamentals are expected to strengthen.
- Office fundamentals will remain problematic, but city centre offices will start to attract more investment interest as the year progresses, as investors seek to catch the cyclical upturn that is expected in coming years. Manufacturing and business parks/out-of-town offices are still mired at the bottom of the ranking.

Preface

A joint undertaking of the Urban Land Institute (ULI) and PricewaterhouseCoopers, *Emerging Trends in Real Estate® Europe* is a trends and forecast publication now in its second edition. The report provides an outlook on European real estate investment and development trends, real estate finance and capital markets, property sectors, metropolitan areas, and other real estate issues.

Emerging Trends in Real Estate® Europe 2005 represents a consensus outlook for the future and reflects the views of more than 250 individuals who completed surveys and/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 consultants. ULI and PricewaterhouseCoopers researchers personally interviewed over 100 individuals, and survey responses were received from 175 individuals whose company affiliations are broken down as follows:

Real Estate Service Firm	29%
Private Property Company	19%
Developer	15%
Publicly Listed Property Company	12%
Institutional Investor	11%
Investment Bank	6%
Commercial Bank	5%
Other	2%

A list of the interview participants in this year's study appears at the end of this report. To all who helped, the Urban Land Institute and PricewaterhouseCoopers extend sincere thanks for sharing valuable time and expertise. Without the involvement of these many individuals, this report would not have been possible.



Since weight of money
will drive markets yet again, most
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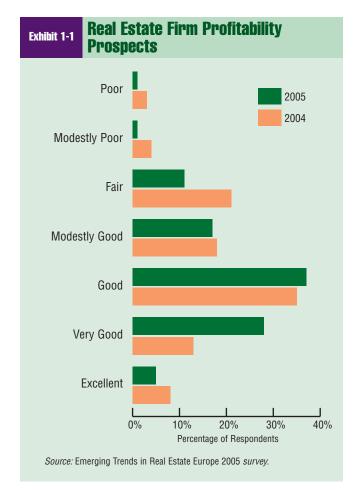
Money, Little Product

here's too much money and too little product." "The big problem in these markets is pricing." "There's an overabundance of capital." You hear these same plaintive observations from investors the length and breadth of Europe. Such is the state of European real estate investment markets at the end of 2004. Will it change in 2005? The majority we interviewed and surveyed said: "No." And most of the rest say: "Sadly, probably not."

There are a few harbingers of change in investment flows, principally the steep fall-off in net inflows to German openended funds. These have been the most influential participants in pan-European core investment for the past few years—and they still featured fairly heavily in 2004 cross-border transactions—but their dominance is "on the wane." This doesn't worry most players. "A big reduction in their activity two years ago would have shaken the markets severely, but not now." In

2005 there will be numerous investors eager to take their place. Indeed, some are counting on a reduction in competition from German open-ended funds in the hope that this will enable them to get more of their own money into the market.

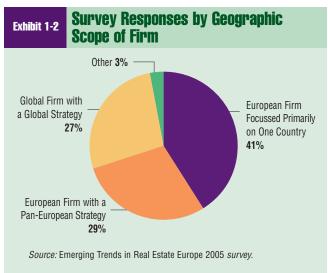
Since weight of money will drive markets yet again, most firms are looking forward to another year of profitable growth. In 2004, profits turned out even better than last year's optimistic survey anticipated. That was in no small measure thanks to the rise in transactions seen relative to 2003. Our respondents expect more of the same in 2005. A formidable 87 percent of firms believe profit growth will be "modestly good" to "excellent" (see Exhibit 1-1). That's a big vote of confidence in the outlook for real estate investment inflows and transactions next year. However, it's got little to do with expectations of a near-term improvement in most occupier markets. "The fundamentals are still mixed at best."

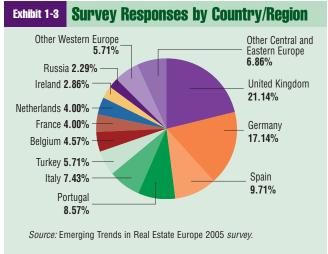


The Least-Worst Asset Class

Too often one hears that real estate's principal support comes from the belief that "it's the least-worst option" when compared with equities, bonds, and cash. Our survey predicts that most (but not all) forms of European real estate investment will beat equities and bonds yet again in 2005 (see Exhibit 1-4). Private real estate vehicles and direct real estate investment get a firm, though not ecstatic, vote of confidence. However, there is scepticism that listed real estate companies can continue their stunning bull run and even less optimism regarding the German open-ended funds.

Asian real estate is projected to be the best-performing asset category and many global investors, both European and U.S., are turning their attention to this market. "The opportunity play has ended in most European markets. To make outsized returns you have to go east." (This is not everyone's view as the growing number of private equity players hover-





ing around Germany waiting for some cut-price selling attests to.) Of course, neither of the above is a viable option for investors seeking stabilised returns and low-risk cash flow. However, the message is clear: Exciting returns are not expected from European core investments—just modest, stable income streams and perhaps a touch of capital growth in the faster-growing economies.

There are plenty of people in the market who are sceptical of current cap rates, but most don't see the markets returning to their previous long-term averages, even in the medium term. The observations often heard are: "We're in a low interest rate environment for the foreseeable future, which justifies lower nominal yields" and "There's been a structural change in cap rates because there's been a structural change in the investor base."



Increased demand for real estate as an asset class is certainly apparent among institutions across Europe. In their efforts to more effectively match liabilities and diversify to reduce risk, the majority have increased target weightings on a long-term strategic view. According to a UBS survey, European pension funds currently hold 6.5 percent of their portfolios in real estate, yet 52 percent have target weightings in the 11 to 15 percent range and 19 percent have even higher target weightings. Mercer Investment Consulting and the European Public Real Estate Association (EPRA) calculate that a move to a 15 percent average weighting for pension funds would require inflows into real estate on the order of €359 billion. That's big money in markets that saw only €81 billion turnover in 2003. And consider this: the pension funds are only a subset of the institutions trying to get more money into property.

Of course, institutions are not the only investors with bulging coffers of cash intended for deployment in real estate. Private equity funds, public companies, limited partnerships, venture capitalists, hedge funds, private syndicates, high-networth individuals, Middle Eastern funds...the list goes on. No wonder it feels like everyone's trying to squeeze through a narrow door to join the party.

Moving Up the Risk Curve, to What?

The difficulty in obtaining prime assets and the heady prices they command has led to an interesting change in the past year or so. Nowadays, even core investors who were previously known for their conservative investment policies are moving up the risk curve in order to obtain product. The intense competition for prime assets and the "sometimes nonsensical" prices they command has forced almost everyone to search for overlooked corners of markets to get that extra bit of return and avoid competitive bidding wars.

As a result, assets that were once shunned, such as offices with short leases and tired retail centres in secondary cities, are now in considerable demand. "Look for asset management potential" and "refurbish and reposition" are the new mantras. There is also a lot more forward funding going on, particularly in retail. But going up the risk curve means just what it says—more risk. Many on the sidelines look in askance and wonder: "Will the returns be there when it's time to sell?" A few think it might be evidence of a market about to launch into overshoot territory.

Could this be a case of "irrational exuberance"? We asked participants for the second year running if we are seeing a market "bubble" and the majority again said "No"—but there was a bit less conviction than a year ago. Moreover, a significant minority said perhaps it is a bubble, "but not one that will burst suddenly or any time soon." Some said there is a bubble "in certain places." The residential markets in the United Kingdom (U.K.) and Spain were frequently mentioned in this regard. More concern was voiced about the compression in spreads between prime and nonprime yields. "People are paying prime for secondary. Someone's going to get caught."

In the main, justifications for today's cap rates are based on continued low interest rates. Those interviewed believe that rate rises in the Eurozone will be marginal in 2005, if indeed they happen at all. "For a monetary tightening you need stronger growth in Germany." But no one knows when or how that growth is going to kick in. "Germany has problems that could still be there in five years' time."

Europe's Handicapped Economy

"Where will the growth come from?" is a frequently heard rhetorical question. "We need to see Germany back on its feet." "The 'small steps' taken towards structural reform are too slow and policy prevarication continues where big changes are needed." "Germany needs to empty its dustbins." These despairing comments on German economic policy reflect deep frustration with an economy that was meant to be Europe's dynamo and has turned into its handicap. Optimism briefly took hold when a modest economic recovery actually started to materialise in core Euroland during the first half of 2004. Growth even surpassed expectations in France. However, hopes for increased economic momentum in 2005 are now fading.

The main economies appear to be heading south, with growth in the third quarter of 2004 down to a disappointing annualised 1.2 percent for the Euro area as a whole. Germany's gross domestic product (GDP) growth shrank to a flaccid 0.1 percent in the third quarter of 2004. Worse, Germany's IFO business expectations index (a key leading indicator for Euroland as a whole) peaked at the beginning of 2004 and has been trending downward ever since. French GDP growth has also slowed and both consumer confidence and business expectations are weakening, presaging a poor start to 2005. Meanwhile, Italy's recovery hardly even got off the ground.

With all of Euroland's heavyweights moving towards the doldrums, some even think they could be "flirting with recession" in the first half of 2005. Why? Domestic demand never really got going and consumer spending in particular barely moved. The modest recovery in the first half of 2004 was export led, and now, thanks to a depreciating dollar and higher oil prices, the outlook is deteriorating. Recent consensus forecasts show virtually no pick-up in growth for Euroland in 2005 from the 1.8 percent expected outturn for 2004. Moreover, everyone thinks the risks are on the downside. This is not the stuff that will drive a quick recovery in Euroland's weakest occupancy markets.

While the heart of Euroland struggles, the periphery continues to outperform. Spain's domestic demand-driven economy has internal momentum and employment growth. The outlook for 2005 may have weakened a touch due to the problems elsewhere in Europe, but it should continue to deliver above-average growth. The same goes for Ireland, Finland, and Greece (although Greece will slow down after its Olympic expenditure binge).

European Economic Growth: Consensus Forecasts

	Percentage Real GDP Growth		
	2003	2004	2005
Germany*	-0.1	1.2	1.5
France*	0.5	2.2	1.8
Italy	0.4	1.2	1.7
Spain	2.5	2.6	2.6
Netherlands	-0.9	1.2	1.7
Austria	0.7	1.7	2.4
Belgium	1.3	2.5	2.4
Finland	2.1	2.8	3
Greece	4.5	3.9	2.7
Ireland	3.7	4.3	4.6
Portugal	-1.2	1.2	2
Euroland*	0.5	1.8	1.8
United Kingdom	2.2	3.2	2.6
Sweden	1.7	3.4	2.9
Denmark	0.5	2.2	2.4
Switzerland	-0.3	1.8	1.8
Czech Republic	3.1	3.8	3.9
Hungary	2.9	3.8	3.8
Poland	3.8	5.7	4.9
Russia	7.3	7.0	6.0
Turkey	5.8	9.3	6.0

Source: Consensus economics surveys (November 2004).

*German, French, and Euroland estimates adjusted for latest Q3 2004 data

Outside Euroland, the U.K. and Sweden surprised on the upside in 2004 and it's anticipated they'll continue to outpace Euroland as a whole in 2005. However, both economies are expected to slow a bit in response to monetary policy tightening. A possible correction in the U.K.'s overheated housing market also adds uncertainty to the outlook for consumer spending.

The major central Europe (C.E.) countries shared economic growth stardom in H1 2004 along with Ireland. Poland surged to 6.1 percent while Hungary and the Czech Republic delivered 4.0 percent and 4.1 percent, respectively. These countries are all expected to retain top growth accolades in 2005, although the C.E. accession countries will not be immune to a slowdown in Euroland. Preliminary Q3 figures for Hungary have already demonstrated this with a slowdown in year-on-year GDP growth to 3.7 percent. It pays not to forget that Germany is the most important trading partner for the big three accession countries. When Germany slows down, it holds back its trading partners in core Eurozone and central Europe alike.

If you really want to escape the influence of sclerotic German growth, you have to leave the E.U. altogether. Go to Russia, where GDP grew 7.4 percent in the year to Q2 2004 thanks to its oil-driven economy. Or, better still, go to Turkey, where growth was 13.4 percent (and inflation fell) over the same period.

Our interviewees had varied opinions on the economic outlook for 2005 depending on the country under discussion. Most expect a modest slowdown in the U.K., perkier growth in Spain and Finland, and sideways or modestly higher growth in the rest of Euroland. However, the interviews were done before third-quarter 2004 figures were available and, in any case, most thought the economic risks were clearly on the downside.

As to interest rate expectations, few thought there would be much more than moderate increases from the European Central Bank (ECB) given the fragility of the core Euroland economies. However, there were divided opinions on whether the U.K. would see further increases in interest rates. The five base rate hikes to date (totalling 1.25 percent) appear to have taken the steam out of the U.K.'s overheated housing market (and, for that matter, the debt-driven retail syndications market), but further increases can't be ruled out. However, no one is expecting interest rate rises in the U.K.—or anywhere else—to be large enough to seriously damage real estate investment markets in 2005.

You Can't Always Get What You Want

The divergent growth paths across Europe are reflected in the investment preferences revealed in our survey. However, "product is king" this year and you have to go where you can find some. It's clear that not everyone can get what they want, where they want it. "You'll have to work even harder in '05 to do as well as you did in '04." A few occupier markets show indications of turning the corner, but weakness in tenant demand is still a major feature in most office markets. The "disconnect" between investment and occupier demand has been around for some time, but no one is any more comfortable with it now than they were a year ago.

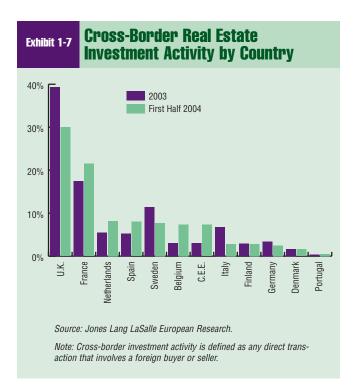
Those surveyed generally want to go where the growth is and where the occupier markets are closest to turning the corner. This has moved interest in London and Stockholm well up the rankings since last year. There are also plenty of buyers looking in the big three C.E. accession countries but, as one insider noted, "there's approximately €6 billion in equity capital chasing €2 billion sustainable investments." Another old hand in these markets said he'd "never seen such rapid yield compression." "It's hard to win against the private consortiums—they can move faster."

Investing Pan-Europe Is Still a Pain

For those based in lagging economies, finding the 'green shoots of recovery' means going cross border. Alas, the obstacles to pan-European investment haven't been eased. For all the talk about increasing transparency and professionalism, it's still hard to go cross border. Differences in tax codes "make it painful." Add to that "the different styles of lease in every country, different ways of measuring buildings, places where you find breaches of planning law but it doesn't matter, places where you find the same breaches and it DOES matter..." and then there's the language barriers that can so easily lead to misunderstandings...and the cultural barriers that so often trigger the outburst "That's not how we do it here!"

However, the continuing growth in knowledge from cumulative experience of pan-European deals has actually started to make things easier. The professional advisers now have a bank of knowledge about how to get around the barriers and the investors have a better idea of what it will cost so they can price it into their deals. There are also improving data on many markets and a continued improvement in transparency. As a result, interest and participation in direct cross-border investment continues to grow. However, "you still need a good relationship with a local partner in almost every market." Otherwise, "you don't see the deals."

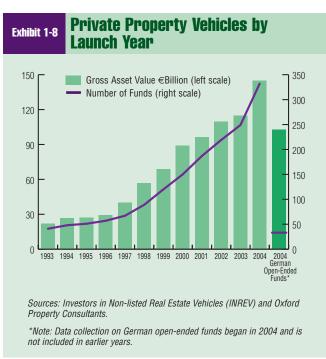




In this sense, most European markets are still frustratingly local. In the first half of 2004 there were probably more people and firms trying to do cross-border deals than ever before, but domestic investors were more active and the statistics show that they used "home advantage." Cross-border investment for the first half of 2004 was on course to fall short of 2003, but domestic investment appears to be up substantially (see Exhibit 1-6).

The Trend to Indirect Investment Continues

For those who want to bypass the knowledge barriers required to do direct investment across borders (including the need to find a local partner in each market), the logical answer is to go indirect. This trend continues writ large. The expense and critical mass required to do cross-border investment are such that it's not realistic for most investors to go it alone in every market. More funds are being created to meet the demand (see Exhibit 1-8) and the offerings are increasingly diverse: listed funds and unlisted, opportunistic, core, and value-added funds; regional funds (including central European); sector funds; single-country funds. As long as the required expertise is there (and that isn't always the case), it is sought after.



INREV (Investors in Non-listed Real Estate Vehicles) notes that there has been a trend towards more value-added funds and pan-European offerings in contrast to previous years, when the tendency was to launch more in the opportunistic and geographically focussed end of the spectrum. This may be somewhat driven by the nature of the assets available and their pricing ("It's the wrong time in the property cycle for opportunity funds"), but it's also indicative of where the demand is. As European real estate investment professionalises and markets become more global, investors do not require opportunistic returns to come in. U.S. investors who formerly considered Europe only if returns exceeding 20 percent were on offer are now coming in for diversification purposes and do not necessarily demand a premium over their domestic market returns.

The creation of reliable indices for the main markets has made an essential contribution to transparency, which in turn is fostering globalisation. Performance can be measured and compared in a way that was impossible even a year or two ago in some markets. There will be more information in 2005 than ever before and it will be easier to tell if the fund you bought is a star or a goat.

The other notable development in indirect investment is the movement to REIT-type vehicles in more countries. Belgium and the Netherlands have long had tax-transparent vehicles, but France just got its SIIC in late 2003, enabling listed companies to convert to tax-transparent status in return for a 16 percent exit tax paid in four annual instalments. The SIIC regime is currently being extended to enable listed companies of all types to separate their property holdings and

package them into a SIIC subsidiary. This should foster growth in the market in 2005 that would have not been possible otherwise.

It also looks like Germany will now get laws in place for a REIT-type vehicle in 2005 or 2006 as the legislators work to come up with an alternative to open-ended funds. Alas, the largest listed real estate market, the U.K., has been left hanging for another year on the question of REITs. A U.K. general election is coming up and real estate does not figure high on the chancellor's agenda. Instead, the government has decided to do another "consultation process," meaning the earliest a U.K. REIT—or property investment fund (PIF) as it is known—could be put in place is late 2006. Meanwhile, more and more specially packaged assets from the U.K. publicly traded real estate industry and a host of fund vehicles are moving offshore to the tax-free host that is the Channel Islands.

Corporates and Governments Are Selling at Last

There are not many potential sources of instant additional real estate investment stock. However, one rich vein that is finally being mined is corporate real estate sales. As times get tougher, more and more companies are selling their property assets to reduce gearing and focus on their core business. We'll see more of this in 2005, particularly where companies are operating in slow-growth markets. There has already been a spate of corporate sales in countries where traditionally few were enamoured of this sort of thing, e.g., Germany and France. It still goes against the grain for most, but more companies are seeing the logic and others have few alternatives. While French listed companies will now have the option of putting their holdings into a SIIC, others will have to sell to outside buyers and take the full domestic tax hit.

More governments are also getting keener on selling. The deficits are not going down by themselves and there's not enough growth to bump up tax revenues, so more are preparing to sell real estate assets. France has decided to start a programme, although no one knows what form this will take yet. Many suspect that sales will be restricted to quasi-state financial institutions to "keep the patrimonie." One non-French investor active in the market said, "I doubt we'll get a look in." Cash-strapped German states are also doing some selling, particularly their residential portfolios. This has provided some high-profile deals for a few U.S. opportunity funds and there is likely to be a lot more to come. At the same time, the Italian government has been working its own property assets for several years. It is packaging them into funds, gearing them, and selling securities backed by the assets. No doubt they will be doing more of this.

Development Prospects Improve

A shortage of grade A space is quite apparent in many of the markets covered by this report. These markets may seem like an occupier's paradise for those who wish to upgrade premises, but often that's not the case because the top-quality space just isn't there. As one investor put it, "We've been looking to lease a good-quality office for ourselves in Paris for over a year." Another said, "Finding the grade A space with a big floor plate in the centre of Paris is like hunting for unicorns." The vast majority of those who contributed to this survey are most enthusiastic about markets where the supply and demand balance is reasonably tight and the rental cycle could turn quickly over the next 18 months. These are also the markets where developers need to start being proactive. In contrast to last year, our survey indicates that the outlook for developers has improved, albeit on a very selective basis.

Of course, assembling sites for projects in favoured markets like Paris, central London, and Milan is not trivial and takes years. In many cases, the venerable prime office and retail areas cannot be adapted to accommodate modern requirements in sufficient scale. In recognition of this, the trend towards working with government on urban regeneration schemes with mixed-use development is gathering momentum. At their best, these schemes align the interests of developers, occupiers, cities, and investors. Admittedly, they can also be "very frustrating." However, they may ultimately be the only way to build modern high-quality office, retail, and residential space in a size that will satisfy growing investor appetite and comply with the newfound requirements on "sustainability."

Minds Have Broadened on Sectors

A year ago, a surprising number of investors told us they were primarily focussed on office investments because retail was a tricky specialist sector, industrial had high occupier turnover, residential was too time intensive, and hotels were not real estate. What a difference a year makes! More investors are shifting into multiple sectors, and even evincing interest in residential, hotels, and niches like car parks and self-storage facilities. "Everyone is looking for income" and if they can't get it in the accustomed sectors, they are willing to look elsewhere. This may go a long way towards explaining the continued strong performance seen in the retail and warehouse/logistics sectors. Also, all that money has to find a home somewhere. We're back where we started: "There's too much money and too little product."

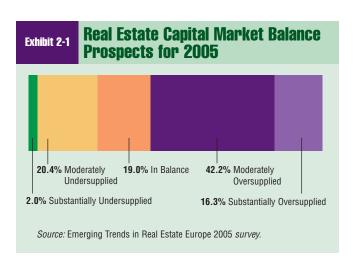


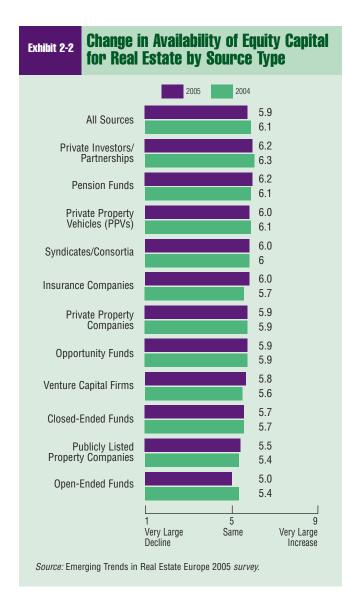
For the past three years, the oversupply of capital for real estate has been escalating.

Capital Flows

year ago, there was already intense investor competition for prime properties in prime locations, but big discounts were available for properties in second-tier locations with short leases, as well as for properties with significant vacancies or requiring refurbishment. Well, those days are over. Nowadays, weight of money is being felt in every niche of the real estate markets. For the past three years, the oversupply of capital has been escalating.

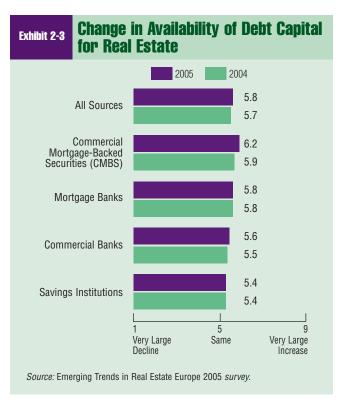
Will this continue for a fourth year? Last year, 11.2 percent of those surveyed thought that capital would be "substantially oversupplied" in 2004. Our survey this year shows that 16.3 percent of respondents now expect capital to be "substantially oversupplied" in 2005. A further 42.2 percent think it will be moderately oversupplied and, overall, those surveyed think the availability of both debt and equity will increase again in 2005.





Cash keeps flowing into real estate for the same reasons as before. Equity returns in the largest European markets disappointed in 2004, euro-denominated government bond yields are so low they have nowhere to rally to (unless there is another outright recession), investment-grade corporate bonds are trading at risible spreads to governments, high-yield bond spreads have also compressed hugely, and euro-denominated cash has a real yield of zero.

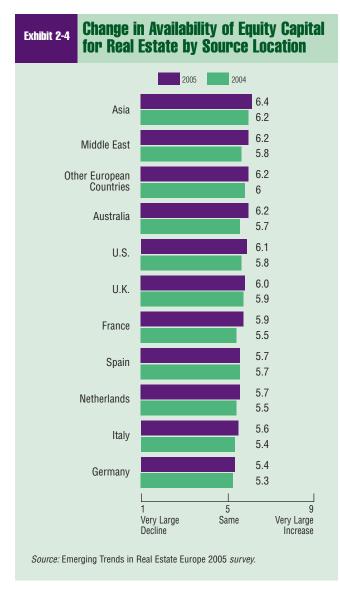
That leaves real estate, which at least has the virtue of steady current income at a decent pick-up on bond yields with potential for future growth. Moreover, lenders are still eager to lend on real estate, in part because they have limited alternatives for growing their loan books. The banks' corporate customer base has not experienced sufficient economic growth to contemplate expansion, so opportunities in corporate lending have been meagre.



Capital Trends: Equity

More equity capital is expected from every part of the world, attesting to the growing globalisation of European real estate investment. Asian, Middle Eastern, Australian, and U.S. investors are all expected to commit increased amounts of capital this year. This comes on top of expanding capital allocations everywhere in Europe. The sources are myriad: private partnerships, private property vehicles, pension funds, private equity groups, syndicates and consortia, insurance companies, private companies, venture capital firms, publicly listed companies, high-net-worth individuals—in short, almost everyone. The impact this has had on yields is starting to sound alarm bells for some. "The lenders have been good. It's the equity that's been irrational." The only source of equity that will not be expanding in 2005 is German open-ended funds. Their inflows have gone into reverse, marking the biggest change between the outlook today and that which we saw a year ago.

German open-ended funds were by far the largest single source of expansion in European real estate equity capital for the past three years. Now, in a startling reversal, their capital base is shrinking. Yet many in the market have greeted this news with more relief than concern. "Perhaps we'll be able to buy more stock this year" is a response that's not atypical. "Maybe we'll see less pressure on prices now." Of course, open-ended funds will not entirely disappear from the market. But, they will now be just "one of the many" competing in the core segment this year. There is so much money being allocated to real estate at present that "there will be no dominant source of equity in 2005."



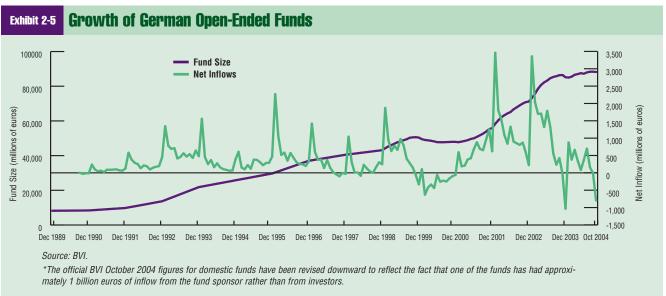
German Open-Ended Funds: The Curse of Interesting Times

"May you live in interesting times" is said to be an old Chinese curse. Well, for German open-ended funds these are "interesting times." A year ago, they were the overwhelming investor presence in European real estate markets. The funds had taken in €28 billion in a mere two years. In fact, they were scrambling to get all those inflows invested and some were coming dangerously close to their 49 percent maximum cash limit. A few even considered asking their distribution channels to stop selling units.

Now, in breathtaking reversal, the money is fleeing some open-ended funds as fast as it came in, but this flight is not uniformly distributed across the funds. The money is leaving those funds that invest primarily in German real estate. A couple of domestically focussed funds were pushed close to the edge some months ago, which reputedly led their parent institutions to quietly administer some first aid behind the scenes (such as removing problem assets and exchanging them for performing assets). However, one major fund's outflows have been so serious that they necessitated a very public rescue by its parent bank. The problems that led to this fall from grace are now fuelling a huge debate within Germany about the future of the entire open-ended fund industry. The biggest question for those involved is: "Do open-ended funds have a future?"

The Funds' Dilemma. The problems that triggered the current dilemma can be summarised as: 1) poor performance; 2) illegal sums changing hands in exchange for transacting deals; 3) controversy over asset valuations; and 4) the fundamental viability of a non–publicly traded product that guarantees liquidity but invests in illiquid assets.

"The performance of open-ended funds has been lamentable," said one interviewee. Average returns were never spectacular, having been in the 5 to 6 percent range for some



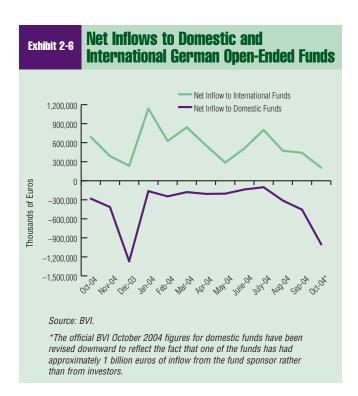
years, but they have now shrunk to a paltry 3 percent. The picture gets worse when one looks at the funds that are invested primarily in German real estate. They have returned well less than 2 percent in the past year. In other words, they have delivered negative returns if adjusted for inflation and even more negative returns if the typical 5 percent front-end fees are taken into account. Poor performance was almost inevitable given that domestic funds were pouring money into a market with negative rental growth and high vacancies. However, returns were further depressed because the huge money inflows had to be held in low-yielding cash while awaiting investment.

The international and pan-European open-ended funds suffered from the same low cash yield handicap, but they have not been hit with the same outflow problems. Inflows to these funds were much reduced in 2004, but investors still want to buy international real estate assets (see Exhibit 2-6). "German investors don't believe in their own market right now," said one insider. "They want to invest where there is growth."

Bad performance is hard to contend with, but scandal is worse. And scandal is the next ingredient in this saga. Between 40 and 60 people involved in the real estate industry are being investigated in connection with allegations of illegal payments in exchange for transactions. At least one of those being investigated had a senior position in an open-ended fund. The German public had previously assumed that those who handle its highly regulated retail investment products carried out their fiduciary responsibilities in a manner beyond reproach. Now "their illusions have been shattered." "The scandals have created fear in the investing public."

Following the journalistic scrutiny of the fraud case, the trickle of redemptions became a stampede. The most troubled funds' liquidity rapidly evaporated and it became clear that assets would have to be sold. Investors are guaranteed reimbursement on demand at the stated net asset value (NAV) of the open-ended fund. But—and herein lies the rub—this NAV is not based on the current market value of the assets.

German law requires that assets in open-ended funds are valued using a method based on income that is not dissimilar to methods used in many other countries. This is more a notional income than an actual one, since it is the estimated income over the life of a property, discounted by an "all-risks yield." The approach smoothes returns and reduces volatility. But how do you estimate the income-based value of an empty office building or a massive speculative development project in a market with 20 percent vacancy and a moribund local economy? Obviously, lots of assumptions have to be made regarding future income streams. But the key point here is: there is little likelihood that the income-based value will be the same as the price that can be achieved in a forced sale. In any case,



the official valuations are done once a year, so official NAV could be higher than current market value in a falling market.

The fund in greatest trouble in 2004 had to look at what the current market values might be for its assets because it was haemorrhaging cash and potentially needed to sell. It was no surprise to industry insiders that current market values were lower than official valuations. However, the differences were a shock to everyone else, including the retail investors and the press who don't normally concern themselves with mundane topics like valuation methodologies. It suddenly occurred to a lot of people who had been buying units in open-ended funds that they didn't really know much about what they had invested in. This has created "a crisis of confidence" in the market.

So now the great debate is on. Does the open-ended funds' operational model that guarantees instant redemptions but invests in illiquid assets make sense in this era of "hot money" flows? Those we spoke to in the funds themselves think a way must be found to ensure that the investors they get are "long term." The funds don't usually handle their own distribution channels, so they have little current control over their investor base.

There is also debate as to how much liquidity the funds should hold. Clearly, the more cash they hold, the less real estate they can buy, which lowers returns and negates the funds' investment objectives. The current minimum cash level of 5 percent may be too low going forward and many funds hold more liquidity than the minimum anyway. However, no reasonable cushion of liquidity would have avoided the problems that outflows created for the funds with the biggest problems.

The bottom line for European capital flows is that openended funds will be far less active in cross-border investment during 2005 than they were in 2004, but they are unlikely to disappear. The pan-European and international open-ended funds are still getting net inflows at the time of this writing and they are happy with the more modest rate at which they are coming in. We will still see them investing in prime real estate across Europe, although many will also be putting money into Asia, North America, and even South America.

As to the funds that invest part domestically and part cross-border, these are not necessarily in long-term trouble. "They've been buying good-quality assets all over Europe that will perform. These are first-class assets they can sell if they need to." Perhaps the more interesting question is: "What are they going to do with their less prime assets?" But no one has seen any overtly forced sales to date. "We haven't had any calls from Germany saying someone has to offload a big portfolio in a hurry—and I doubt we'll get that call."

The German Banks' Dilemma. Another big unstated question is: "What will happen to German cap rates?" Outside of Germany, a typical view is: "Market pricing is far below stated values and the whole thing is a house of cards." "The market is a time bomb." But others think: "They will sort things out." "You'll see structured sales, loans to funds, and behind-the-scenes supports to maintain asset prices." There's already a precedent for a parent bank stepping in to rescue a fund and it is safe to assume that any other fund in trouble will get similar backing. Seen in perspective, the loans required are small when compared to most banks' balance sheets. But even some German insiders admit that their real estate market is overpriced and that many of the parent financial institutions are weak. The latter have been trying to get rid of problem loans, not take on more.

Nevertheless, the best guess is that banks will support the funds because the knock-on effects of large-scale sales would have an even more adverse impact on their loan portfolios. "Many loan-to-value ratios would look more like 80 percent than 50 percent if the assets were marked-to-market." For this reason alone, "No one wants to see fire sales." "When the banks support the funds, they are supporting their own debt portfolios." In any case, open-ended funds are not allowed to sell assets at a price more than 5 percent below the official valuation by law. There would have to be major legislative changes to enable funds to sell at a greater loss or write down assets.

Opportunity Funds: One Man's Meat Is Another's Poison

Opportunistic investors are hoping that the problems in Germany will give rise to some interesting investment propositions, although some have also voiced concerns. "The openended funds were a major part of our previous exit strategies." Nevertheless, forced sales, nonperforming real estate loans

(NPLs), distressed companies with large property portfolios on the balance sheet, and deficit-ridden governments with real estate to sell are the meat and potatoes of their business.

Some high-profile deals of all these types were done in 2004. Several large German city- and state-owned residential portfolios were sold to opportunity funds in 2004, and the first sizeable pure NPL portfolio deals were done. More such deals are awaited in 2005, although they have been very slow to materialise considering that the book value of German banks' NPLs is approaching €300 billion. From one frustrated investor's point of view, "The NPL market hasn't really taken off in Germany." "German banks are resistant to selling NPLs at big discounts to book value. They don't want to take the hit on capital."

Opportunity funds have plenty of firepower, although it's hard to find out exactly how much. Estimates on the order of US\$30 billion in equity are bandied about for U.S. private equity funds, which would represent around US\$150 billion on average gearing—but this might be a conservative estimate. More than half of these funds will be channelled to investments outside the U.S., but not all of that is destined for Europe. Asian markets may provide richer fodder for these funds since there is increasing acceptance of more realistic prices for distressed debt and real estate assets in that part of the world.

In much of Europe, including the major C.E. accession countries, opportunity funds are often doing as much selling as buying as they close funds and take profits on deals done in the 1990s. However, they are a major presence in emerging European countries and very much on the ground to do deals across Europe. They aim to harness their expertise on large, complicated cross-border corporate transactions, and their resources are significant enough to swallow big government and corporate sell-offs whole. With governments across Europe selling assets, opportunity funds should stay in the news. If sales of distressed debt really take off, they will be among the principal players. Their beginnings were in the U.S. savings and loan crisis, so they know a thing or two about NPLs.

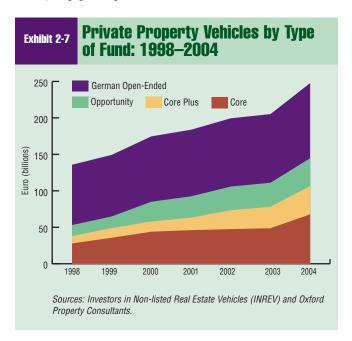
Of course, opportunity funds are just one style of investment done by private equity real estate groups nowadays. One of the most important trends to emerge is that these private equity groups are doing more "core plus" and "value-added" funds in Europe. The potential for the big double-digit returns that these groups achieved in the 1990s has severely diminished in the major European markets, so they have turned to investment styles that can be executed more easily in today's markets. The appetite for diversification on the part of their mainly institutional clients is such that they are now able to market these funds successfully despite the lower returns on offer.

Institutions and Private Property Vehicles: The Tankers Are Turning

Institutions do not change their strategic asset allocation often or quickly. But when change occurs, it tends to have big implications. The move towards increased real estate allocations in Europe is just starting to be implemented, following a change in the stance of pension and actuarial consultants that took place over a year ago.

A UBS survey of European pension funds found that in 2004 they held approximately 6.5 percent of their portfolios in real estate. Yet the majority have target weightings that are more than double this level. Mercer Investment Consulting and EPRA calculated that a move to a 15 percent average weighting for pension funds would require inflows into real estate on the order of €359 billion—four and a half times total market turnover in 2003.

Even if the average target is actually lower than 15 percent, there are myriad indications that pension funds are intending to increase their real estate weightings substantially. However, they tend to move very slowly and have long evaluation processes—a big disadvantage in current competitive markets. One thing is for certain: if an average double-digit industry target is to be achieved, it will take years. In addition, it can be presumed that some of the investment will go to real estate markets outside of Europe. While at this point most pension funds are only just considering their first forays into European cross-border investment, the largest and most sophisticated are already engaged in global real estate investment.





Insurance companies also turn at a speed more akin to oil tankers than polo ponies when changing strategic asset allocation. However, our survey indicates that the growth in their presence will be marked, in contrast to last year when most expected little change. This again portends a huge long-term increase in funds committed to real estate. In many cases, the intention will be to increase exposure globally, but European markets will get their share.

The rise in institutional real estate investment is only barely discernable in the U.K. statistics at present and this is probably the case in Europe as well. One gauge of institutional caution is the German Spezialfonds. Their growth rate in the first three quarters of 2004 was more than a third lower than in the previous year. Part of the problem for all institutions is current pricing: It just doesn't fit in with their

valuation models. As one institution asked, "Is an illiquid asset yielding less than 2 percent over a long-term government bond giving you adequate return for the additional risk?" But part of the drive towards real estate is based on its diversification benefits, so despite the valuation problems, institutions will be attempting to gradually increase their exposure. However, "They haven't moved big time yet." "No one is saying we must get in there now."

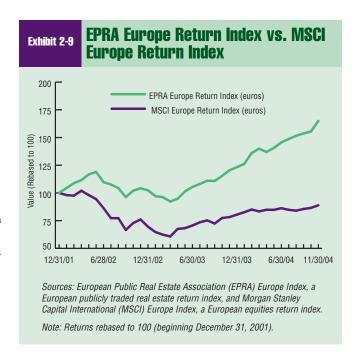
Institutions are increasingly using funds and unlisted private vehicles to increase their exposure (see Exhibit 2-7). The big Dutch pension funds led the way here by going fully indirect in the mid-1990s and more are following in their footsteps. Even those institutions that have their own research and management capabilities are turning to indirect investment for their cross-border and sector-specialist requirements. Pension funds in some regions such as Scandinavia are selling direct domestic holdings in favour of indirect European funds. In turn, the growth area in fund offerings is in the core and value-added segments, which are styles that are more in keeping with the institutions' risk profile.

If INREV has its way, 2005 will see an important development in the unlisted funds market—the first index for the extensive INREV unlisted funds universe. This enhancement in transparency will make it possible to report on unlisted fund performance against an accepted benchmark. It is this type of innovation that is likely to accelerate the acceptance of indirect investment using unlisted funds and further the development of indirect investment generally.

Publicly Listed Real Estate Companies: REIT Fever

Publicly listed real estate companies had another superb year in 2004, delivering returns well in excess of expectations. Over the 11 months to the end of November, the EPRA Europe total return index rose nearly 34 percent, more than three times the 10.5 percent return on the MSCI Europe Index (the most widely used benchmark for the broader equity market). The EPRA return was driven by strong performances from the U.K., French, and Spanish markets, while the rest of the major constituents put in steady, solid returns. Only Germany (which has a tiny listed sector) registered negative returns.

The real estate sector's outperformance of the broader market was unusually flamboyant. The sector historically does best when the wider markets are weak, which they have been, but returns on this scale are not the norm. The U.K. market—which constitutes half of the EPRA index—powered ahead in the hope that there would be government legislation to allow a U.K. REIT-type vehicle. The U.K. sector's discount to NAV has at the time of writing narrowed to 12 percent, well below its long-run average of 18 percent. At the same time, the market action following the conversion of the main constituents in the French sector to SIIC status (the French equivalent of a



REIT) sent prices upward there, sending them to a 14 percent premium to NAV. Meanwhile, Italy and Spain racked up big gains on the back of corporate activity.

Despite the disappointing announcement in December that U.K. legislation on a new tax-transparent vehicle will have to wait until 2006, the market looks set to remain resilient. Equity prices did not correct much following the announcement. The lack of reaction may stem from the good company results seen recently and the big deals being done by Australian firms in U.K. real estate. It may also reflect the belief that the property sector will get its tax-transparent vehicle or it will continue to get taken private at attractive prices.

Our survey does not indicate that investors really expected a U.K. REIT to materialise in 2005 and most of those interviewed expressed scepticism. "The government won't timetable it in an election year." Looking further ahead, there is ample room for disappointment even if the industry does finally get its REIT in 2006. As always, the devil will be in the detail—and the detail may be to no one's liking. On a historic basis, many think the market is very overbought and due for correction.

In contrast to the U.K., France has won huge plaudits for the creation of its SIIC and the proposed extension of legislation to allow listed nonproperty companies to create SIIC subsidiaries. However, all is not perfect. The U.K. property sector is still far more liquid than its French counterpart. According to Morgan Stanley, the annualised monthly turnover in French quoted property only just exceeds 50 percent of market capitalisation, whereas the U.K. proportion is around 120 percent. This reflects the much lower free float

(i.e. percentage of a company's stock that is available to trade) in the French market—at present, only six companies have any real liquidity to speak of. It is all very well to have a tax-transparent vehicle, but if the free float is miniscule this is hardly accessible to investors.

It does not help that SIICs are getting taken over and effectively being taken private. For example, a Spanish company purchased 98 percent of one major SIIC, leaving a free float of only 2 percent. This enables the new parent to access tax transparent returns since the SIIC it bought can maintain its tax favoured status with only 2 percent of its shares available to the investing public. As one insider commented, "The SIIC is just a corporate tax evasion vehicle on present rules." One can only hope that the new legislation will add more companies with liquidity to the sector.

The German government is no doubt mulling over the strengths and weaknesses of the SIIC as it deliberates on what form its own REIT should take. The G-REIT could be introduced as early as mid-2005 if it is brought out under the existing act that governs open-ended funds. However, there is currently strong lobbying on the part of the real estate industry to create separate legislation in order to give G-REITs more flexibility.

One important goal of those advocating flexible G-REITs is to mobilise the real estate assets of German companies. At present, high capital gains taxes prevent companies from selling their nonoperational property holdings. If a G-REIT could be introduced that gives companies a lower tax exit for taking the real estate off their balance sheets, the government could potentially increase its tax take and companies could free up valuable capital. The downside here is the legislative route would take more time. If separate legislation is opted for and there is rapid finalisation in 2005, the law would still not become effective until 2006.

There is inevitably some speculation as to whether open-ended funds will convert to G-REIT status if the option becomes available. This is doubtful, at least in the near term. As one interviewee said, "The quoted sector is more volatile than open-ended investors are accustomed to, so it's doubtful they would want such a product." One might add that most of the domestically invested open-ended funds could easily sink to a rather nasty discount to NAV if they converted to quoted status in the near future. However, there may be some potential for conversion in the future if G-REITs take off and occupier markets improve.

Real Estate Derivatives: Potential for Instant Gratification?

This may turn out to be the year that real estate derivatives finally take off. With so many investors trying to gain exposure, change their exposure, or enhance returns on the quoted shares they own, derivatives have a lot of potential adherents in real estate if they can prove themselves. The big indirect investors are very keen to have them in their tactical allocation arsenal, and at least one pension fund consulting group has said derivatives have an important role to play in property portfolio management.

Real estate derivatives first arrived on the U.K. scene in 1994 and were greeted with enthusiasm. It turned out to be something of a false dawn, but this was mainly down to tax treatment. Recent changes in tax law have eliminated the previous problems and real estate derivatives are a big talking point nowadays.

December 2004 saw the first £100 million issue of property index certificates (PICs) since the 1990s issued on the London Stock Exchange, and if the appetite is good there will no doubt be more. PICs come in the form of a four-year Eurobond and they will give investors a capital and income return based on the IPD All Property Index for the U.K., with no stamp duty or any of the other associated costs of doing direct property deals. You simply buy the PIC. There are plans that in the future PICs will be issued for individual sectors and other European markets covered by IPD indices.

The next derivative set to launch based on U.K. direct property returns is a property total return swap. The first issue will be £100 million in size and the buyer will get the IPD Annual All Property Index return in exchange for paying away three-month LIBOR (London Interbank Offered Rate) plus a spread of 50 to 100 basis points. The contract is for three years and again there's none of the usual costs associated with direct investment.

And for those who want instant exposure to the European quoted sector without assembling a portfolio, there is now an Exchange Traded Fund (ETF) that launched on the Euronext exchange in December 2004. It tracks the EPRA Eurozone index, so one gains exposure to the entire index with one low-cost transaction. The ETF also enables investors to take short positions and portfolio managers can lend stock they already own to the fund to enhance returns. Another ETF is planned for launch on LIFFE in 2005 to track the EPRA U.K. index, so between them one will be able to obtain exposure (or go short) the entire EPRA Europe index.

Syndicates, Private Investors, and Consortia: The Shopping Spree Continues

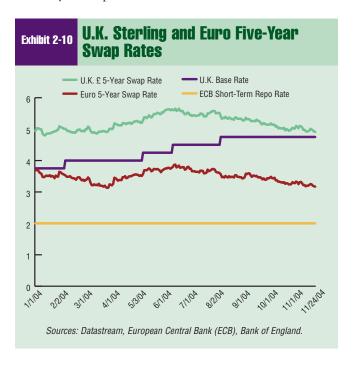
The institutions, companies, and funds that have been investing in European real estate for decades are feeling very crowded these days. They hoped last year that a rise in interest rates would chase some of the debt-backed buyers away and leave them in peace. Trouble is, the only country that saw any interest rate rises in 2004 was the U.K., and even that didn't help much. Sterling five-year swap rates are no higher at the time of writing than they were a year ago and the yield curve is so flat that ten-year money costs much the same as five-year money (see Exhibit 2-10). Over in Euroland, five-year money is even cheaper than it was at the end of 2003. Little wonder that the debt-backed buyers are still in evidence everywhere, though they have moved the focus of their activities from the U.K. to the euro area, where the product is generally cheaper and so is the credit.

The syndications market has mushroomed and it is spreading across Europe as high-net-worth individuals seek secure assets. Their activity has recently fallen a bit below the radar screen in the U.K., where they grabbed the headlines last year, but some very big names that used to focus on company activity are now doing syndications for U.K. private investors. "It's a very profitable business," one admitted. "It's the syndicators that make all the money." The continued rise in London prices has led most U.K. syndicators to source new deals in regional cities or areas where the government has given special tax relief to encourage urban regeneration. Many are also now hunting for assets on the continent. They claim to be using less gearing than they did in earlier years.

Syndicated deals are not just a U.K. affair. They are being done from Paris to Prague. They have been popular in Denmark for years because of a tax-advantaged limited partnership vehicle that management companies structure and sell (for a nice upfront fee, of course). Each of these typically has ten private investors, but collectively the sums are big and they do not confine their investments to Denmark. They have made their mark in the U.K. and other European and Scandinavian markets, too. They use 100 percent gearing and one shudders to think what might happen if markets go into reverse. As one interviewee observed, "Lots of syndicators have not been disciplined. People could get hurt and ultimately that's bad for the whole industry."

Wealthy individuals and consortia are everywhere. The Irish have been particularly prominent, as have Israeli and other Middle Eastern investors looking for a safe home for their capital away from geopolitical disturbances. "They are hard to beat when they want to buy." They have considerable equity and "current euro interest rates are so low that they are comfortable gearing way up with long-term money." Trophy assets and prime, well-let buildings in Paris, Amsterdam, London, and the central European capitals have received the most mention in connection with their activities, and no one expects their activity to decline this year. "If anything, they may get more aggressive."

However, it would be misleading to say that any one nationality or subset of investors is dominating the debt-driven deals. There are debt-backed investors from every country in the world in Europe and the deals they are doing range from small scale to "breathtaking," according to the institutions and companies they are bidding against. Venture capital firms are also in on the act, having discovered the virtue of real estate—anchored deals. Since no one anticipates significant ECB interest rate rises any time soon, they will be present in every E.U. market until the outlook for economic recovery is well rooted enough to move market-determined interest rates. "The debt-backed buyers will be there as long as money is cheap."

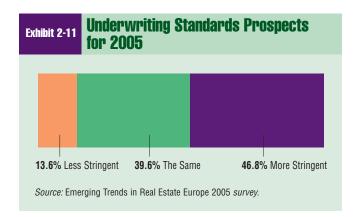


Capital Trends: Debt

There will be no credit crunch for real estate investors in 2005. One thing our survey highlights is that debt finance from all sources is expected to increase in 2005 (see Exhibit 2-3). The wide availability of debt finance for the acquisition of standing investments has played a major role in increasing market activity and making European real estate "more dynamic." The presence of so many debt-backed buyers is testimony to the fact that banks have a big appetite for lending on property as long as the income stream is there. But, have the banks got it right or are they making similar mistakes to those they made in previous cycles?

The benign view is: "Highly geared deals cannot be wholly irrational—they need the cash flow to service the debt." When done by savvy investors—with long-term finance on assets with high-quality tenants and long-term leases—this would appear to be true.

However, the big picture makes many uncomfortable. The Bank of England (BOE) voiced its disquiet in December when it published a report saying that banks may have "underestimated the risks" of lending to the commercial property sector. The BOE's deputy governor pointed out, "In the present benign environment, there is a possibility that lenders, borrowers, and investors may be inclined to underestimate long-run vulnerabilities and take on too much risk." The warning was motivated by the fact that commercial property loans have risen from only 20 percent of U.K. banks' commercial loan portfolios to 35 percent in a scant four years. Further, over half of all new corporate lending by U.K. banks in the year to September 2004 was to commercial property. No wonder the alarm bells are ringing.



The vast majority of our interviewees and those surveyed think the banks have been quite disciplined to date and just under half think underwriting standards will continue to get more stringent in 2005 (see Exhibit 2-11). However, there are some dissenting views. "There's too much debt priced too cheaply" and "There's no differentiation in pricing between a 50 percent LTV and an 80 percent LTV" were some of the views expressed.

Disconcertingly, those closest to the business of lending seem to think that "discipline varies quite a lot." One banker said, "Competitive pressures and limited alternative lending opportunities are pushing margins down, LTVs are going up, and banks are being forced to take more risk." Another said lending had been "much more active," but there is now "less focus on rating agencies, income cover, and amortisation, as well as greater acceptance of refinancing risk." And yet another admitted, "Banks are under pressure to keep LTVs high [up to 85 percent], so interest cover and amortisation are suffering." All these bankers realise this could all come back to haunt them in the long run.

So how is it that borrowers perceive banks to be disciplined while the lenders themselves (and their regulators) are not so sure? Much depends on what country you are in, which banking system you are borrowing from, and what you are trying to do. If you are a well-capitalised investor buying a prime standing asset or a developer with a good prelet or forward-purchased project in the E.U., the money is there and chances are there will be competition for your business. If you are in a higher-risk area of the market like speculative development, or you are a medium-sized property company in Germany trying to borrow from a local Landesbank with a fat portfolio of NPLs—let alone in Turkey or Russia—it is a wholly different matter.

Basel II: Some Feel the Cold, Others Don't

The real estate community's awareness of the implications of Basel II has grown significantly in the past year. The new regulatory regime is still two years off, but the banks are (in theory) preparing for it now. The new regime singles out loans to "high-volatility commercial real estate" (HVCRE) for the highest capital requirement of any category of lending. As a result, speculative developers and others with projects that fit into the HVCRE slot have been getting the cold shoulder from their bankers. The regulators' intention is to make lenders more risk sensitive, and perhaps it has done the trick, although the comments in the preceding paragraphs cast a bit of doubt on how finely calibrated the new awareness of risk is.

Those surveyed anticipate that Basel II will make an increasing impact in 2005. "Basel II will lead to a more restrictive financing environment," "Basel II will restrict investment from financial institutions," and "Basel II has been creating an environment where only those who have access to private equity at moderate rates will have a chance to compete in cities with high property prices" are just a selection of the comments obtained in our survey. But some of those surveyed saw the positive side of Basel II. "Basel II will improve the quality of mortgage lending. The capital flow to real estate could increase." "Senior lending—traditional and CMBS—should become cheaper. It is development and mezzanine finance that will become more expensive."

It is quite clear that compliance with Basel II is already at the forefront of banks' planning, but it may also be having some unintended interim effects. More than one institution has whispered that they thought some in the market were trying to do as many deals as possible before the new regulatory regime kicks in. That may account for some of the gap between the perception and the reality of current lending practices. Others are doing far too little of anything. The Landesbanks lose their public subsidies this year and should be actively managing or disposing of their huge NPLs if they are to have any hope of competing under Basel II. Instead, they are wrangling with the European Commission for the right to have one last round of subsidies from central government.

CMBS and Mezzanine Finance: New Pools of Capital

European commercial mortgage-backed securities (CMBS) used to be perceived as a somewhat exotic security by fixed-income fund managers. It is a lot more complicated to analyse than other asset-backed securities (ABS), so it has taken more time to catch on. Thankfully, this is changing fast. CMBS yield more than other ABS, so fixed-income investors hungry for yield have been snapping it up. The market has become more demand than supply driven and this is good news for real estate borrowers in 2005. Spreads over LIBOR/Euribor for floating-rate issues have shrunk as demand has grown and spreads of fixed issues have tightened in equivalent fashion. This means it is a much cheaper form of finance than it was a year ago, which is quite remarkable given that issuance appears to have increased substantially in 2004 relative to 2003.

Our survey indicates that the strongest growth in real estate debt finance will come from CMBS this year (see Exhibit 2-3). The market is evenly split between sterling and euro issuers—a distinct change from a few years ago, when it was dominated by sterling issuance. Issuers from France,

Sweden, Spain, and the Netherlands as well as the U.K. were seen in the first half of 2004. From the borrower's point of view, the market provides a relatively inexpensive way to tap huge additional pools of capital.

Large borrowers can access the market directly and are expected to do so in ever-greater numbers. The banks will also continue to increase their use of CMBS. Basel II is motivating them to get both "lumpy" assets and pools of commercial loans off their balance sheets to make room for further transactions. Those we interviewed expect to see more geographic diversity in issuance this year and more companies and funds tapping the market to take advantage of the fact that it is cheaper than bank finance.

Mezzanine finance is also growing by leaps and bounds. Unlike those who invest in CMBS, mezzanine investors tend to be real estate players. Real estate banks, U.K. institutions, other asset managers, private equity funds... "everybody's talking mezz." The attraction is the same as for CMBS investors: the big pick-up in yield. Likewise, the increased demand over the past year has caused spreads to narrow forcefully. "Up and down the capital spectrum returns have compressed."

The growth outlook for mezzanine finance is excellent from both the supply and the demand side. Investors continue to look for ways to enhance return and want an increasing spread of exposures to diversify risk. There are also dedicated mezzanine funds being assembled by several groups. On the supply side, mezzanine enables borrowers to enhance LTVs. "It's the slice that makes the deal work." It can cost as little as 300 to 400 basis points over senior lending at the time of writing, although for development projects it tends to be a great deal more. However, this type of debt is adaptable to the project, and "mezzanine with equity participation" is more than occasionally used to reduce the spread over senior debt.

Both CMBS and mezzanine spreads have come down so much that few can envisage much more compression in 2005. But real estate investors have been hearing that sort of statement for some time now. However, in this case, the outlook is at least as dependant on what happens in the fixed-income markets as what happens to the underlying real estate. If the bond market backs up, it has an impact on all debt securities.



Almost every city in our survey
has a slightly better total return
Outlook for 2005 than was
the case in 2004.

to Watch

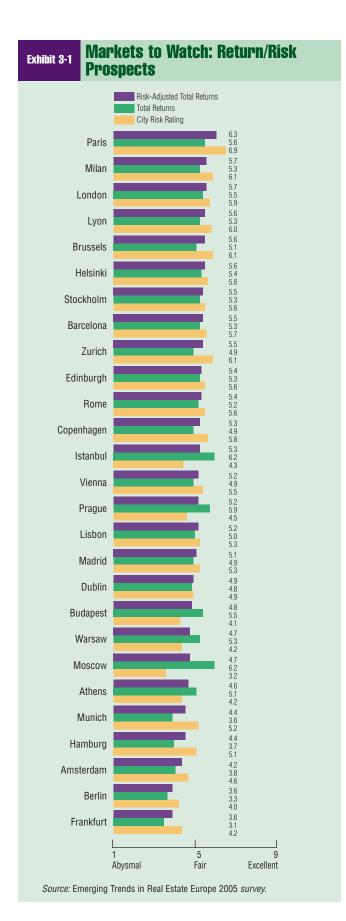
he respondents to our survey are feeling noticeably more cheerful about most individual investment markets this year. They have decided that almost every city market has a slightly better total return outlook for 2005 than was the case in 2004. The top three picks (rated on risk-adjusted total returns) for 2005 are Paris, Milan, and London, but London gets the prize for the most dramatic improvement in outlook. Last year, our survey gave it a "modestly poor" rating. This year, it has moved all the way up to "modestly good"—which is as good as it gets for 2005 in this survey. Yet again, no one sees prospects for stunning returns in any market, but they are seeing the green shoots of recovery or hints of a turning point to come in enough places to feel a bit more optimistic.

There are, of course, a few markets where no one sees the slightest crack in the cloud cover. No prizes for guessing these are in Germany and the Netherlands. Munich and Frankfurt share the dubious distinction of having even lower scores this

year than last, but the same five cities (the four German cities we survey plus Amsterdam) inhabit the bottom of the returns table for 2005 in basically the same order as 2004. Berlin and Frankfurt tie this year for the accolade of "worst market outlook in Europe."

The method for ranking markets this year changed from last year in that the rankings now use risk-adjusted returns instead of absolute returns (see Exhibit 3-1). We asked those surveyed to give a market risk score for each of the markets as well as scores for outlook on returns. The risk-adjusted rankings reflect the average of these scores and, it is hoped, give a more useful picture of what the participants really think and act on.

Inevitably, the risk-adjustment process has changed the rankings quite dramatically from those seen last year. The C.E. capitals and Moscow are now well down the table, despite having optimistic outlooks for projected total returns in absolute terms. The C.E. capitals are still very high on our survey's "buy" lists, so there has been no change in our partic-





ipants' thinking on them. The general enthusiasm has not diminished and the presence of core investors in these markets has risen dramatically since they formally joined the E.U. last year. It will be interesting to see the evolution of their risk ratings over the coming years as their integration into the mainstream of European real estate markets progresses.

In contrast, our participants' greater familiarity with Moscow one year on is reflected in controversy. Moscow's office and retail sectors have high numbers of both "buy" and "sell" recommendations. This may seem inconsistent, but it is probably indicative of the fact that you have to take a view on numerous political and legal issues in addition to the usual risk/return concerns embedded in real estate investment.

Finally, we have added two new cities to our survey: Athens and Istanbul.

The Best Investment Markets

Paris

Paris takes top honours in our survey for risk-adjusted return prospects, even though it does not come on top of any of our survey's "buy" lists. Everybody loves Paris—and it looks like spring is nigh in the Paris real estate cycle. "Paris is in soft recovery." The fundamentals are very comforting: an extremely diverse economic base, relatively low vacancy (only 6.4 percent in office), a reasonable—if unspectacular—growth outlook, a modest future supply pipeline, and now rising take-up in office space. "Paris is a safe market. There's no risk of oversupply." One cannot go overboard on the

Prospects for the Paris Real Estate Exhibit 3-3 Market in 2005 **Prospects** Rating Ranking Risk-Adjusted Total Returns Modestly Good 6.3 1st **Total Returns** Modestly Good 5.6 4th Risk 6.9 1st Low Rent Increases 4th Fair 5.3 Capital Growth Modestly Good 5.5 5th Supply/Demand Balance Fair 5.4 3rd Development Modestly Good **Investment Recommendation of Survey Respondents Hold** 29% Office **Hold** 27% Retail Industrial/ Hold Distribution Source: Emerging Trends in Real Estate Europe 2005 survey.

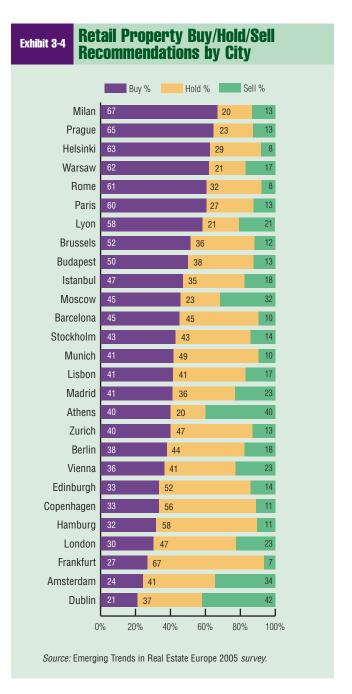
recovery yet, since the rise in take-up represents tenants trading old space for new at cheaper rents with fat incentives. And those rents bother some investors. They have fallen 30 percent from their peak in 2001 and 12 percent in the year to October 2004. While some districts saw rents stabilise and even start to inch up in the third quarter of last year, others are still seeing declines, so one has to be discriminating.

Paris retail looks even more secure—if you can find any to buy. Prime rents and yields have held quite stable. Downtown retail was a fast-moving sector in 2004 and this could continue in 2005, but shopping centres are in tight supply. There are potential opportunities in reversionary retail and refurbishing both retail and tired office space, but these are not for the impatient. "Refurb is highly technical in Paris because of planning. It takes at least 18 months and nothing goes through the first time." The logistics market is in good balance and take-up was 50 percent up in the year to October on the previous 12 months. Our respondents liked this market, too, even though rents fell a bit in 2004, because they think the market will turn around over the course of 2005.

The main complaint about Paris is the yields. "Paris is scary. Prime office yields have fallen to 5.75 percent [from 6 percent a year ago], but the rents are still heading south." This decline in yields has been driven by incessant growth in investment demand. Turnover was €9.5 billion in the first three quarters of 2004 and probably topped the 2001 record of €12.0 billion transactions for the year as a whole. Given the appetite for Paris seen in this survey, expect a very competitive investment market in 2005.

Milan

Milan came second overall in our survey and topped our retail sector "buy" list (see Exhibit 3-4). This may seem extraordinary given Italy's weak official economic growth rate and shrinking official retail sales volumes, but as one participant noted, "The Italian economy is not as weak as it looks: 42 percent of it is 'black economy' and you don't see it in the statistics." One is inclined to believe this, given that Milan's prime retail rents rose last year and many think this will continue in 2005. Supply constraints are an important support to the sector. Milan is very protective of its historic central shopping area



Prospects for the Milan Real Estate Exhibit 3-5 Market in 2005

	Prospects	Rating	Ranking
Risk-Adjusted Total Returns	Modestly Good	5.7	2nd
Total Returns	Fair	5.3	9th
Risk	Modestly Low	6.1	2nd
Rent Increases	Fair	4.6	18th
Capital Growth	Fair	5.2	12th
Supply/Demand Balance	Fair	5.3	5th
Development	Modestly Good	5.8	3rd

Investment Recommendation of Survey Respondents



Source: Emerging Trends in Real Estate Europe 2005 survey.

and any insider will tell you that the path to planning permission is labyrinthine. As a result, almost all foreign investment is in prime standing assets, while the domestic investors and developers are left to battle it out with the local authorities. There is also domestic opining that the banks are inexperienced and unenthusiastic about loans for development and there are not enough top-notch construction firms with expertise in refurbishment.

The prime CBD office sector is little different. Total vacancy in the Milan area including periphery is down to 6.3 percent, but the CBD is more like 4 percent. Vacancy fell during 2004 and rents rose, but yields moved sideways thanks to capital growth. This year promises an even tighter market, which has whetted investors' appetites—not that they weren't out in force already in 2004. Some complain, "All prices have gone up indiscriminately" and believe that "this year, only the quality will rise." Others are not so sure. "Most of the grade-A buildings have already been acquired. The trend needs to move toward refurbishing existing buildings, but international investors only want financial transactions.'

There is one cautionary factor for office and retail, but it has little bearing on the short to medium term. There are several massive mixed-use regeneration schemes currently planned, and if they come to fruition they will change the

structure of Milan real estate. However, the largest two will not be delivered until 2010 and 2014. Near term, the development pipeline is largely prelet.

Our survey also shows enthusiasm for industrial and logistics. This sector has had very stable rents and prime yields of around 8.25 percent. However, some contrarians are sceptical due to "the chaotic structure" of the logistics sector in Italy.

London

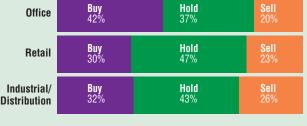
London ranks third in our survey overall, despite the fact that it is nowhere near the top of our survey's "buy" lists. The attraction is that economic growth is clearly well entrenched, even if it is set to slow somewhat this year. Those surveyed consider it a "fairly safe" market.

The retail sector literally "shot out the lights" in terms of performance in 2004. Most downgrade its prospects for this year because it is now considered very expensive with the "all shops" yield down to 5.3 percent. The general thinking is that consumer spending will be slowing down as house price growth eases and the credit-fuelled retail boom is over. This, along with the trend decline in retail margins, leaves the sector very exposed to a correction in rents.

London's prime office sectors, the West End and City, both show signs of recovery in occupier demand. The West End market was the first to come off the bottom, showing modest rental growth from the second quarter of 2004, and by the end of the third quarter the City appeared to be stabilising. There are some in our survey who question the recov-

Prospects for the London Real Estate Exhibit 3-6 Market in 2005

	Prospects	Rating	Ranking
Risk-Adjusted Total Returns	Modestly Good	5.7	3rd
Total Returns	Modestly Good	5.5	6th
Risk	Modestly Low	5.9	6th
Rent Increases	Fair	5.2	5th
Capital Growth	Fair	5.4	6th
Supply/Demand Balance	Fair	4.8	14th
Development	Fair	5.0	12th



Source: Emerging Trends in Real Estate Europe 2005 survey.

ery, but most think it is gathering momentum, particularly in the West End. The problem is price (prime yields in the West End are down to 5.5 percent) and lack of stock to meet investor appetite. Many of our U.K. interviewees are contemplating development or refurbishment projects in the West End in view of the heady yields, low vacancy, and shortage of prime stock. In contrast, the City has double-digit vacancy and it is almost entirely grade-A space. Many investors, particularly foreign, are interested in the recovery play in this market. It will lag the West End, but it has a higher yield (6 percent). It is hard to buy in both markets. "Landlords don't want to sell because they see rents going up in a year or 18 months' time."

Industrial is viewed as the "safest" market by many of those surveyed. Some worry that the logistics sector is heavily linked into the retail sector and that a downturn in U.K. consumer spending would adversely affect them both. However, the majority think it offers low volatility and attractive rising rental income, although the big reduction in yields in 2004 limits the 2005 upside.

Lyon

Lyon comes in fourth place overall in our survey. It is unusual for a secondary city to place so highly, and this shows the increased willingness of investors to look outside the main capital cities for opportunities. Lyon offers a fat 2 percent pick-up in yield on Paris in the prime office sector and few seem to be put off by the vacancy level, which has

risen to 7.1 percent from 5.7 percent a year ago. In fact, a higher percentage of those surveyed rated the Lyon office sector a "buy" than Paris. The city offers a robust retail sector with stable rents and one of the most important logistics hubs in Europe. Those familiar with Lyon logistics all seem to expect rent increases and yield compression in 2005, which is why the city is in the top three on our survey's industrial sector "buy" list. All three of Lyon's main sectors are expected to benefit from increased investor interest.

Brussels

Brussels ranks fifth in our survey this year. It attracts because it is Europe's government city. The home of the E.U. with 25 members (and more to come) has seen strong rent increases for offices in the areas favoured by all the various public institutions. However, supply is increasing in the centre this year, so the best increases may be behind us. In the Brussels periphery, where the majority of the private sector firms locate, vacancy is still verging on 20 percent. "It's a catastrophe," said one interviewee. Retail, the sector liked best by those surveyed, should continue to do well on the continued influx of people working for the new entrant states and all the lobbying organisations. They provide a stimulus to all of the shops as well as restaurants and leisure facilities. The outlook for the industrial market is not quite so sanguine since it is hooked into the fortunes of the private sector. Occupiers are consolidating into more efficient space so there is some activity, but falling rents could continue.

Prospects for the Lyon Real Estate Market in 2005					
		Prospects	Rating	Ranking	
Risk-Adjuste	d Total Returns	Modestly Good	5.6	4th	
Total Returns	3	Fair	5.3	11th	
Risk		Modestly Low	6.0	5th	
Rent Increase	es	Fair	4.9	11th	
Capital Grow	th	Fair	5.2	11th	
Supply/Dema	and Balance	Modestly Good	5.7	1st	
Development		Modestly Good	5.5	4th	
Investment Recommendation of Survey Respondents					
Office	Buy 60%			old Sell 2% 8%	
Retail	Buy 58%		Hold 21%	Sell 21%	
Industrial/ Distribution	Buy 72%			Hold Sell 12% 16%	
Source: Emerging Trends in Real Estate Europe 2005 survey.					

		Prospects	Rating	Ranking
Risk-Adjusted	Total Returns	Modestly Good	5.6	5th
Total Returns		Fair	5.1	15th
Risk		Modestly Low	6.1	3rd
Rent Increase	s	Fair	4.8	12th
Capital Growt	h	Fair	4.9	17th
Supply/Dema	nd Balance	Fair	4.7	16th
Development		Fair	4.9	19th
Investment Recommendation of Survey Respondents				
Office	Buy 37%		Hold 37%	Sell 27%
Retail	Buy 52%		Hold 36%	Sell 12%
Industrial/	Buy 29%		Hold 42%	Sell 29%

Helsinki

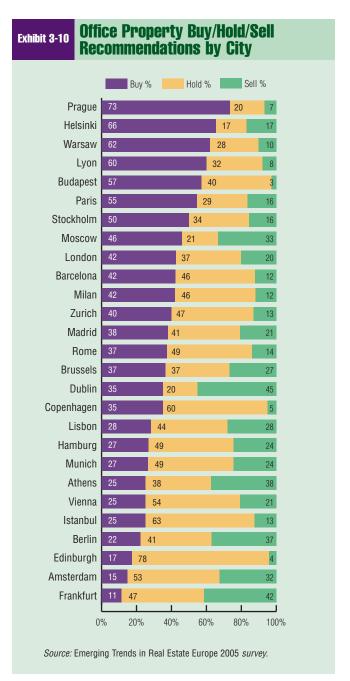
Helsinki came up second on our survey's "buy" ranking for the office sector, third in the "buy" ranking for retail, and also scraped into the top ten for industrial. The volume of investment has been growing rapidly over the past two years, and foreign interest has increased to the point where external investors are involved in around half of all transactions. The market used to be closely held by a small group of domestic institutions, but these are now diversifying their portfolios through indirect investment, which has freed product up to liquefy the market. The market also has the virtue of good transparency, thanks to reasonably timely data and the increasing volume of research available.



The office sector saw vacancy rise to 8 percent in October 2004 from 6.8 percent a year earlier, but CBD vacancy is much lower than in secondary locations and the high vacancy is in older buildings. Prime rents have been very stable and prime yields (6.8 percent) are very attractive compared with most other capital cities in the euro zone. There is not much office development going on and, as Finland's growth continues to be well above the Euroland average, the office sector is reasonably well supported. The retail sector remains very tight, with vacancy only around 1.5 percent. However, lots of new space is in the pipeline for this year and 2006, so the shortage

should become less acute. The industrial sector saw some decline in average rents in Q3 2004, but low availability in prime industrial space has held prime rents stable. All of this no doubt will continue to fuel investor interest in the market.

The potential problem for Helsinki is its high dependence on the IT sector. IT startups are still weak and there are only a few major companies, some of which are threatening to leave the country for tax reasons. This may just be posturing, but one would hate to contemplate the consequences. On the plus side, an increasing number of foreign investors are active in Helsinki, and the government is actively considering REIT legislation.



Strong "Buy" Markets

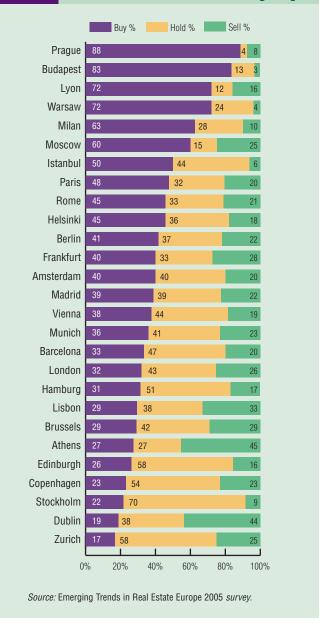
Prague

Prague was voted top of our "buy" tables for both the office and industrial sectors (see Exhibits 3-10 and 3-12). Moreover, it was just barely beaten into second place for the retail sector's best buy by Milan. The high average risk rating our respondents assigned to the city moved it down to the middle of the risk-adjusted rankings, but Prague is clearly in demand. The risk for Prague is that yield convergence towards the levels of the main E.U. cities has come too far too fast. "Prague has had the most accelerated yield compression I've ever seen," said one interviewee. But, you still get a pick-up of 2.85 percent over Frankfurt, and as one fund manager said, "The opportunists have taken their gains, now we get our cash flow." Most are expecting to see rental growth down the line and some further capital gains in all sectors in 2005. "More capital is being raised than can be placed in central Europe," so weight of money is likely to have a further impact on yields.

Lest we forget, the legal and tax environment is still less stable in the Czech Republic than in the "old" E.U. countries, and while economic growth is double that of the E.U. average there are still low double-digit vacancy rates in newbuild offices. However, there is virtually no vacancy in Prague retail or modern industrial space. No wonder our survey was enthusiastic.

Prospects for the Prague Real Estate Exhibit 3-11 Market in 2005 **Prospects** Rating Ranking Risk-Adjusted Total Returns 5.2 15th **Total Returns** Modestly Good 5.9 3rd Risk Moderate 4.5 20th Rent Increases Fair 5.1 7th Capital Growth Modestly Good 5.9 3rd Supply/Demand Balance 10th Fair 4.9 Development Fair 5.4 7th **Investment Recommendation of Survey Respondents Hold** 20% Office **Buy** 65% Retail Industrial/ **Buy** 88% Distribution Source: Emerging Trends in Real Estate Europe 2005 survey.

Exhibit 3-12 Industrial/Distribution Property Buy/Hold/Sell Recommendations by City



Warsaw

Like Prague's, Warsaw's overall ranking in this survey has far more to do with its risk rating than its projected returns. Warsaw ranked third on the "buy" list for office and fourth on the "buy" lists for both retail and industrial. Investors' interest in Warsaw has rocketed since Poland's accession to the E.U. in May 2004. "More money has been raised than can be placed." Striking yield compression has been seen in all sectors, and although Poland still had higher prime office yields than those in Prague and Budapest at the end of Q3 2004, there is a strong possibility that the differential has disappeared. Foreign investors account for around 90 percent of investment, and they are increasingly interested in retail, industrial, and residential assets as well as office.

Warsaw's office sector is slightly unusual in that the big take-up has been in noncentral locations. Overall vacancy fell to 12.5 percent in October 2004 from 15.6 percent a year before, but in the outer areas vacancy was only 8.3 percent while CBD vacancy is 18.6 percent. Ironically, it is the upmarket space that is begging for tenants while the more modestly priced space in the outskirts is in high demand. The

	cts for the V Warket in 20		Real		
	Prospects	Rating	Ra	nking	
Risk-Adjusted Total Return	s Fair	4.7	20	th	
Total Returns	Fair	5.3	12	th	
Risk	Modestly High	4.2	24	th	
Rent Increases	Modestly Poor	4.1	22	nd	
Capital Growth	Fair	5.3	7t	h	
Supply/Demand Balance	Modestly Poor	4.3	22	nd	
Development	Fair	4.9	16	th	
Investment Recommendation of Survey Respondents					
Office	Buy 62%		Hold 28%	Sell 10%	
Retail	Buy 62%		Hold 21%	Sell 17%	
Industrial/ Distribution	Buy 72%		Hold 24%	Sell 4%	
Source: Emerging Trends in Real Estate Europe 2005 survey.					

Polish capital has a traffic problem and limited parking, so the ever-practical locals prefer their offices in locations where gridlock is less likely and they can park. These offices also tend to be located in proximity to shopping centres and other amenities that enhance their desirability. The owners of prime CBD space are trying to lure in more tenants by offering incentives, but they do not want to lower rents so there is something of a stalemate at the present. However, the prime properties are still changing hands for ever-higher sums, and some have been purchased while not fully let.

Warsaw is well supplied with retail for the present, but a good investment market has developed. The vacancy rate is low and the new space that will be delivered in 2005 is preleased for the most part. Rampant retail development is a thing of the past now that the planning regime is tighter. Proposals for new shopping centre development now have to include traffic and environmental impact studies, and no new retail development is being allowed in the centre of the city—all of which is advantageous for existing retail centres.

Industrial is deemed the big growth area for development in 2005 and investor interest is strong. Vacancy is low and rents have probably bottomed out. The residential sector is also a notable growth area now that mortgages are freely available. One of the more peculiar aspects of the market is the presence of foreign consortiums that are buying entire blocks of flats and sometimes leaving them to stand empty.

Budapest

Budapest's moderately low position in this year's return/risk ranking is not indicative of investors' interest in the market, but it does show that they are sensitive to the risks posed by C.E. investment. If the ranking had been done on the basis of expected total returns (instead of risk-adjusted returns), Budapest would have been in fifth position. It came in second in the "buy" ranking for industrial, fifth in the "buy" ranking for retail.

The enthusiasm for buying Budapest industrial/distribution is understandable. Vacancy was down to 5 percent in the third quarter of 2004 despite an increase in supply. Some 70 percent of Hungary's manufactured exports are from the operations of international companies that have moved in to take advantage of the lower cost base and central position of the country. These have modern warehousing and logistics requirements that increase with the growth of their activities, and the assumption is their activity will continue to grow. There was certainly a big boost in demand in the run-up to accession and the momentum appears to have continued. There is also plenty of momentum on the investment side, resulting in a decline in prime yields to 10 percent despite a slight reduction in rents.

Prospects for the Budapest Real Exhibit 3-14 **Estate Market in 2005 Prospects** Rating Ranking Risk-Adjusted Total Returns 4.8 19th **Total Returns** Modestly Good 5.5 5th Risk Modestly High 25th 4.1 Rent Increases 13th Fair 4.8 Capital Growth Modestly Good 5.6 4th Supply/Demand Balance Fair 4.9 12th Development **Investment Recommendation of Survey Respondents** Office 40% **Hold** 38% Retail **Sel** 3% Industrial/ **Buy** 83% Distribution Source: Emerging Trends in Real Estate Europe 2005 survey.

Budapest's office sector is still characterised by high vacancy (17 percent), but this fell substantially last year and those surveyed tend to think that the oversupply will further abate in 2005. What was more striking was the 50 basis point move in prime office yields from 8.5 percent to 8 percent in the first three quarters of 2004. Accession has been the green light for Budapest to move into the ambit of the core investors' universe and the yield convergence has been striking. There is less enthusiasm from our respondents regarding retail, because many think it has been oversupplied relative to the current buying power of consumers. However, some are enthusiastic about the outlook for outlet centres, because these may be more in keeping with consumers' budgets.

Leading Development Markets

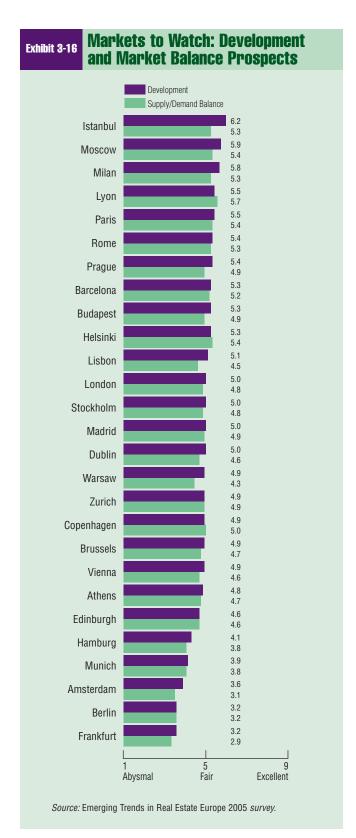
Istanbul

Istanbul topped our survey for best development prospects in 2005 (see Exhibit 3-16). The real green light is on now that the E.U. has agreed to start accession talks with Turkey in October 2005. This was the news the Turkish real estate industry has been waiting for. The accession process will be a long one, probably at least ten years, since much has to be

Prospects for the Istanbul Real Exhibit 3-15 Estate Market in 2005* **Prospects** Rating Ranking Risk-Adjusted Total Returns 5.3 13th Fair Total Returns Modestly Good 6.2 1st Risk Modestly High 21st 4.3 Rent Increases Modestly Good 5.9 1st Capital Growth Modestly Good 6.3 1st Supply/Demand Balance 5.3 6th Fair Development Modestly Good 1st **Investment Recommendation of Survey Respondents Hold** 63% Office **Hold** 35% Retail Industrial/ Distribution Source: Emerging Trends in Real Estate Europe 2005 survey. *Fewer than 25 (but no fewer than 15) survey respondents rated this city on

done to align Turkish laws and policies with the E.U. criteria. However, the go-ahead has been given, and this will enhance the policy makers' ability to continue economic reforms that have already delivered excellent results. A few scant years after the 2001 crisis that rocked the economy, Turkey has enjoyed faster growth and a steeper decline in inflation than even the optimists could have predicted. Inflation is now in the single digits, and GDP growth was in the double digits in H1 2004.

The real estate market is not developed enough in terms of grade-A standing assets to absorb much investment. However, as noted above, our survey highlights that many think there are good opportunities in development. Previously, development finance was difficult to obtain, but now E.U.- and U.S.-based banks are moving in and the situation is changing rapidly. The office sector had a 10.5 percent vacancy rate at the end of Q3 2004, but this was down from 16 percent a year before and rents for prime offices actually increased because there are few buildings with big floor plates to accommodate the major international companies that are moving in. Those surveyed think there will be opportunities to develop prime assets in the European-side CBD, which is the major commercial centre.



They are also enthusiastic about residential development as the growing economy is fuelling pent-up demand for improved housing. On top of this, there is a shortage of modern industrial space. The retail sector is the one area where there has been a good deal of development, both foreign and domestic, in recent years. This market is currently perceived to be in balance by some respondents, but others think there is a need for more modern shopping centres and upscale street retail because an increasing number of international retailers want to move in. To top it all off, one of the fastest-growing sectors in the Turkish economy is tourism, so there is also a need for more high-quality hotels.

The potential for good development returns to be made in all sectors is there, but as always, a good local partner is essential. The planning process is arduous, site acquisition is very difficult, permits are hard to obtain, and the bureaucratic headaches are particularly acute when executing a shopping centre, since they are not included in the zoning laws. However, others have managed to date and there are indications that changes in the law will make Istanbul more real estate friendly in the not-too-distant future.

Moscow

"The more I look at Moscow, the more impressed I am."
"Lots of people want to crack the nut. No question that the people who figure it out will make a lot of money." "We've bid on deals, but Russian buyers won them." "We need to get our heads around it—but we might do something small with a partner just to get our feet in the water." "More people are running around Russia. The equity providers are showing up and certain debt players are considering it." "We are actively looking at Moscow." "We've been doing deep research on Moscow. The legal issues are a problem, but there's huge potential for the next ten years." "How many cities have 10 million people? The issue is how to make Moscow work for us."

These are just a selection of the comments heard in our interviews. They are from every type of participant in the European real estate markets—opportunistic to core, lenders and developers. Alas, as far as investment is concerned there is very little scope because the suitable standing assets are few, and Russia, unlike the C.E. countries, has huge domestic equity capital that does not require the same risk premium as western capital, nor does it engage in the same level of due diligence. Moscow is undersupplied in terms of grade-A assets in every real estate sector, and what little there is to buy is subject to intense competitive bidding. In most cases, the foreign bidders lose. At this point, existing prime assets are so expensive in risk-adjusted terms that many ranked Moscow a "sell" in each sector.

However, those surveyed voted Moscow the second-best development market. The ranking was done on development prospects alone, so no explicit account of risk is taken, but

Prospects for the Moscow Real Exhibit 3-17 Estate Market in 2005* **Prospects** Rating Ranking Risk-Adjusted Total Returns 4.7 21st Fair **Total Returns** Modestly Good 6.2 2nd 27th Risk 3.2 High Rent Increases Modestly Good 5.5 2nd Capital Growth Modestly Good 6.0 2nd Supply/Demand Balance 5.4 4th Fair Development Modestly Good 2nd **Investment Recommendation of Survey Respondents** Office **Sell** 32% **Hold** 23% **Buy** 45% Retail Industrial/ Distribution Source: Emerging Trends in Real Estate Europe 2005 survey. *Fewer than 25 (but no fewer than 15) survey respondents rated this city on

the comments received showed that risk is at least implicit in the thinking of our respondents. "This is not a conventional market—it is closer to China than central Europe." There is tremendous concern regarding legal entitlement, corruption, terrorism, arbitrary government interference, and general political risk. Yet Moscow is a tantalising proposition "if the politics go the right way."

As several of those interviewed pointed out, Moscow needs debt providers before large-scale private sector development can take place to create the assets investors want to buy. At present there is no long-term finance available and the only major lenders are Russian banks. It also needs more experienced developers.

In the office sector, the lack of prime space has driven rents up to a level on par with some major western capitals. These would clearly not be sustained with greater supply, in much the same way that the high rents in the C.E. capitals dissipated once adequate supply was developed. Nevertheless, the potential development returns are high if one can negotiate the obstacles. These are myriad: It is increasingly difficult to find central plots; the municipal government wants a stake in projects and requires contributions to infrastructure; it is difficult to negotiate all the permissions required for development and construction; and there is a huge City of Moscow Project to develop offices that could undermine private sector endeavours.

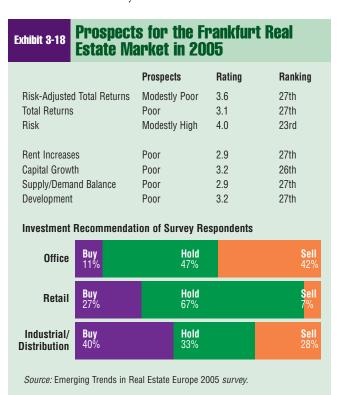
Retail is the path most trodden to date, but there is still an overwhelming need for more. The Russian economy is growing and incomes are growing with it, so there is pent-up consumer demand. With retail comes the need for modern logistics and warehouses. Most businesses have been making do with old, outdated buildings and there is huge demand for more modern premises, but acquiring land with adequate utilities is difficult and zoning is a problem.

These are just a few of the issues. The problems are not insurmountable and it is purported that before the Yukos affair a number of firms were preparing to do projects. As one interviewee said, "Developers are optimists." If the politics permit, 2005 may see foreign participation in the Moscow market move to a new level.

The Worst Investment Markets

Frankfurt

"Frankfurt is scary!" said one investment manager. He is not alone in his thinking; Frankfurt tied with Berlin for bottom honours in this survey, but Frankfurt has the edge on the misery stakes because the outlook is deemed even worse than it was a year ago. Faith in the city's financial industry has been severely shaken and many think that the problems are structural rather than cyclical.



Vacancy in the office sector rose to 15 percent at the end of October 2004 from 12 percent a year before, and if you include sublettings that figure rises to somewhere around 17 percent. Worse, more speculative supply is in the pipeline for 2005. Rents have been tumbling for four years, and while recent figures indicate the decline has slowed down, this may say more about the dramatic collapse in take-up than anything else. Incentives have been escalating hugely, but tenants are not moving. A lot of leases are ending in 2005 and landlords are focussing on trying to keep their tenants, which probably means rent reductions are taking place that have not appeared in the statistics yet. The investment market for offices has also ground to a halt, with a big dive in transactions.

There are some chinks of light amid the gloom for Frankfurt. Our survey shows that many like industrial warehouse. They are keen on it because they see a general change in requirements and a shift to Internet purchasing on the part of consumers ("Shoppers are tired of hunting for car parking spaces, getting wet feet, little service, poor variety, and short hours. They are turning to ralphlauren.com.") There is also interest in residential in the form of modestly priced housing.

Berlin

"What is Berlin for? What is the point of it?" said one interviewee. Many Germans perceive Berlin as a white elephant in a country of decentralised regional capitals, each with its own distinct identity and the loyalty of its citizens. Berlin's shiny new towers still sit empty, waiting for relocations to bring the

corporate occupants from other parts of Germany. To date, they are not coming. The only relocations have been a few media companies lured away from Hamburg with subsidies and incentives. The supply keeps mounting as speculative buildings come on stream and vacancy keeps rising. Rents are still falling, too, registering a decline of 13 percent year-on-year in October. There is now a way to get a direct flight from New York to Berlin, but the international airport that would enable global corporations to locate in Berlin still has no date for commencement of construction. In fact, local residents are fighting to block the new international airport altogether.

The big activity in Berlin is government asset sales. The municipal government is crippled with financial problems. The city sold a huge portfolio of residential properties to a U.S. opportunity fund in 2004 and is expected to do more sales in 2005. With rising unemployment, which is already much higher than the national average, our survey showed little enthusiasm for Berlin's retail sector despite the fact that the sector has been relatively stable. However, there are contrarian investors who say Berlin may start to look interesting in all sectors if some price correction is seen.

Amsterdam

Sandwiched in between the four German cities in our survey, Amsterdam comes in as the third-worst investment market for 2005. The office vacancy rate rose to 18 percent in October 2004 from 12 percent a year earlier, and rents are falling. The problem is the huge new supply that has been

	D	a fan Alas D	auliu Daal	Fatata
	Prospect Market ii	s for the B n 2005	eriin keai	Estate
	inai not ii	Prospects	Rating	Ranking
•	Total Returns	Modestly Poor	3.6	26th
Total Returns Risk		Poor Modestly High	3.3 4.0	26th 26th
Rent Increase	c	Poor	3.0	26th
Capital Growt	_	Poor	3.1	20th
Supply/Demail		Poor	3.2	25th
Development		Poor	3.2	26th
Investment I	Recommendat	tion of Survey Re	spondents	
Office	Buy 22%	Hold 41%		Sell 37%
Retail	Buy 38%	Hold 44%		Sell 18%
Industrial/ Distribution	Buy 41%	Hold 37%		Sell 22%
Source: Emerg	ging Trends in R	eal Estate Europe 20	005 survey.	

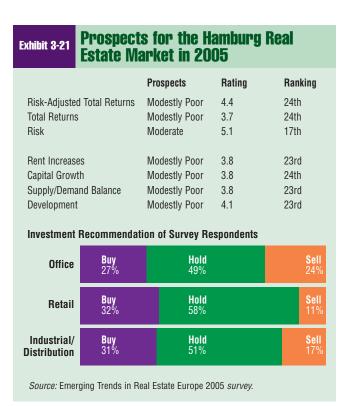
		s for the A arket in 20		m Real
		Prospects	Rating	Ranking
Risk-Adjusted	Total Returns	Modestly Poor	4.2	25th
Total Returns		Modestly Poor	3.8	23rd
Risk		Moderate	4.6	19th
Rent Increase	S	Modestly Poor	3.6	25th
Capital Growtl	1	Modestly Poor	3.8	23rd
Supply/Demai	nd Balance	Poor	3.1	26th
Development		Modestly Poor	3.6	25th
Investment I	Recommendat	tion of Survey Re	spondents	
Office	Buy 15%	Hold 53%		Sell 32%
Retail	Buy 24%	Hold 41%		Sell 34%
Industrial/ Distribution	Buy 40%	Hold 40%		Sell 20%
Source: Emerç	jing Trends in R	eal Estate Europe 20	005 survey.	

coming on stream for the past three years, and there is more in the pipeline this year, although it will be a lesser amount than seen in 2004. Many expect no recovery before the end of 2006 or beyond. Amsterdam retail looks as bad as offices to our respondents, but there is a bit more comfort with the industrial sector.

Unlike the problem German cities, Amsterdam's investment market has actually been quite lively. Well-let assets are still changing hands at good prices and volumes in the first half of 2004 were actually up 50 percent on the previous year.

Hamburg

Hamburg is the only major German city in our survey with a single-digit vacancy rate. This rose to 8.5 percent in October 2004 from 7.2 percent a year earlier, but the situation is not extreme. The city's media and IT sectors are showing more confidence and are using the favourable conditions to upgrade their space at reduced cost. The city's unemployment



rate is rising, but it is still below the national average, so retailers have not done badly. They, too, have been actively taking new space. The industrial market is at a standstill, but prime rents have been unchanged since 2002, so there is no overt downward pressure.

It is quite possible that Hamburg could start to see an occupier recovery in 2005, but those we surveyed are not taking this on trust. Everything will look different if Hamburg-based Airbus is allowed to build and deliver the large freight

version of the new Airbus 380 as it hopes. This will create thousands of new jobs and provide stimulus to all sectors of the real estate market. However, local residents are opposing the 589-metre extension of Airbus's runway, which is needed to do the deliveries of the larger craft. The project is on hold while the antagonists fight it out in court.

Munich

Many of the people we interviewed believe that Munich will be the first of the German cities to recover. The city has a diverse economy, employment is stable, and the unemployment rate is half the national average. The industrial sector



has been seeing increased activity and prime rents have risen year-on-year while prime yields are among the lowest in continental Europe at 7.5 percent. Prime retail rents have been stable and are expected to remain that way this year. The problem in Munich is oversupply in the office sector. Demand is stable, albeit at a lower level than the ten-year average, but new supply keeps mounting—and the pipeline for the next two years is so large that it is hard to envisage how it is going to be absorbed. This looks like a recipe for further declines in rents. As with Berlin, there are some contrarian investors who would be willing buyers of offices if some price correction is seen.

Cities with High "Sell" Recommendations

Athens

Exhibit 3-23

Athens was given the thumbs down in all three sectors in our survey, and investment and development prospects are both near the bottom of the rankings. The economic fundamentals are quite reasonable, so the negative sentiment may stem from frustration with current planning regime and tax laws. The Athens market is disconnected from the rest of Europe and almost wholly dominated by domestic players. Much of the market is owner occupied or leased to occupiers by banks. Those foreign institutional investors that have gone in search of assets have found that the current tax regime is difficult to contend with. And in any case, there are not sufficient assets of the right quality.

The foreign developers who have gone in hoping to ameliorate the situation have found that there are loads of barriers to prevent them from doing large projects. There has been pent-up demand for modern premises on the part of international retailers for some time, but foreign developers are only just cracking the planning system after years of effort. To the extent that there has been modern retail development, the capital growth has been breathtaking. There is not enough modern warehouse or logistics. The supply of offices is more

Prospects for the Athens Real Estate

	Prospects	Rating	Ranking
Risk-Adjusted Total Returns	Fair	4.6	22nd
Total Returns	Fair	5.1	16th
Risk	Modestly High	4.2	22nd
Rent Increases	Fair	4.5	20th
Capital Growth	Fair	4.9	18th
Supply/Demand Balance	Fair	4.7	17th
Development	Fair	4.8	21st

Investment Recommendation of Survey Respondents

Market in 2005*



Source: Emerging Trends in Real Estate Europe 2005 survey.

*Fewer than 25 (but no fewer than 15) survey respondents rated this city on most measures.

than is required for now, but there is insufficient supply of grade-A space in the CBD. In short, there is a lot that needs to be done in Athens.

The current government has been in power only since the beginning of March 2004 and it is considering changes in both taxation and planning law. This may ultimately open up the market, but "the policy makers are moving at a snail's pace," so little will change for investors in 2005. The main positive note is that real estate investment companies (REICs)—a listed almost-REIT-type vehicle—are getting off the ground. They are not wholly tax-transparent, but they are very tax-advantaged because they are exempt from transfer tax (normally 11 percent), and other taxes are much reduced. REICs will probably be the vehicle of choice for most investors in the future, provided legal changes are made that enable appropriate assets to be developed.

Dublin

While overall investment prospects for Dublin are expected to be fair, the survey responses indicate high sell recommendations across all sectors. This may seem surprising, given the continued strength of the Irish investment market in 2004, with around 75 transactions totalling €800 million, and clear signs of a recovery in occupier demand. Low interest rates continue to drive intense demand from Irish private investors and syndicates. This demand is complemented by a return to the market by Irish institutions, which have been net disinvestors and primary providers of stock in recent years.

Prospects for the Dublin Real Estate Market in 2005*

	Prospects	Rating	Ranking
Risk-Adjusted Total Returns	Fair	4.9	18th
Total Returns	Fair	4.8	22nd
Risk	Moderate	4.9	18th
Rent Increases	Fair	4.6	15th
Capital Growth	Fair	4.9	16th
Supply/Demand Balance	Fair	4.6	20th
Development	Fair	5.0	15th

Investment Recommendation of Survey Respondents

Office	Buy 35%	Hold 20%	Sell 45%	
Retail	Buy 21%	Hold 37%	Sell 42%	
Industrial/ Distribution	Buy 19%	Hold 38%	Sell 44%	

Source: Emerging Trends in Real Estate Europe 2005 survey.

^{*}Fewer than 25 (but no fewer than 15) survey respondents rated this city on most measures.

A number of factors may be at play in determining the negative survey response. With the availability of investment stock at record lows and prime yields already at very keen levels (e.g., prime retail yield 3 percent, prime offices 5 percent), some owners consider there to be little room for further yield compression. Clearly some investors view now as an opportune time to sell. The Dublin suburban office markets remain oversupplied, which has led to some applications for change of planning consent to retail and residential development, while further new development continues at South Docks and the CBD, some of it on a speculative basis. There is some concern over whether the new supply will outpace the increased occupier activity. The industrial market has suffered from high vacancy rates and poor-quality/obsolete stock.

The Middle of the Pack

Stockholm

There is a lot more enthusiasm about Stockholm now than a year ago. Sweden's economic recovery has been impressive and domestic institutions have started adding to their real estate holdings. Rents are still falling in the office sector and vacancy rose to 10.5 percent in Q3 2004 from 9.5 percent a year earlier, but there is positive take-up and many think the market is bottoming out. Yields look attractive on the surface, but there are a number of caveats. "Swedish office leases are short, so the market is a very volatile one." In addition, there is already new speculative development coming onto the market with rents at the same price as old space, so

Exhibit 3-25		ts for the S arket in 20		n Real
		Prospects	Rating	Ranking
Risk-Adjuste	d Total Returns	Modestly Good	5.5	7th
Total Returns	3	Fair	5.3	8th
Risk		Modestly Low	5.6	10th
Rent Increase	es	Fair	5.2	6th
Capital Grow	th	Fair	5.2	9th
Supply/Dema	and Balance	Fair	4.8	15th
Development	İ	Fair	5.0	14th
Investment	Recommenda	tion of Survey Re	espondents	
Office	Buy 50%		Hold 34%	Sell 16%
Retail	Buy 43%		Hold 43%	Sell 14%
Industrial/ Distribution	Buy 22%		Hold 70%	Sell 9%

Source: Emerging Trends in Real Estate Europe 2005 survey.

"much of the occupier activity is just firms trading up in a buyer's market, leaving older space empty."

The retail sector is more stable, but investors complain that "no one is selling anymore." Many investors are now seeking out retail assets in Sweden's secondary cities. Prime industrial rents appear to have stabilised after falling 22 percent from their peak, but our survey respondents are still cautious about this sector.

Barcelona

Our survey again prefers Barcelona, the capital of Catalonia, to the seat of national government, Madrid. This may be because office vacancy is a good deal lower in Barcelona at 7.4 percent overall. Take-up has been robust and vacancy fell in the CBD to 3.6 percent as of October 2004. Development

		s for the Barket in 200		Real
		Prospects	Rating	Ranking
Risk-Adjusted	Total Returns	Modestly Good	5.5	8th
Total Returns		Fair	5.3	13th
Risk		Modestly Low	5.7	9th
Rent Increases	S	Fair	4.9	10th
Capital Growth	1	Fair	4.9	14th
Supply/Deman	nd Balance	Fair	5.2	8th
Development		Fair	5.3	8th
Investment F	Recommendat	ion of Survey Re	spondents	
Office	Buy 42%	Ho 46'		Sell 12%
Retail	Buy 45%	Ho 45°		Sell 10%
Industrial/ Distribution	Buy 33%	Ho 47		Sell 20%
Source: Emerg	jing Trends in R	eal Estate Europe 20	005 survey.	

activity is fairly tightly constrained in the city, so supply and demand is in reasonable balance. Some point out that "the amount of Class A office space is still low in relation to the size of the population and economic growth." Turning to retail, there are some concerns that consumption growth may slow this year and have an adverse impact on retail rents, but others think there will be further rent increases on the order of those seen in 2004. The notable decline in retail prime yields last year "still leaves room for convergence to Madrid's level." The low level of prime yields in both sectors gives rise to discomfort for some.

While survey respondents overall view Barcelona as a fairly low-risk market, a number of our survey respondents expressed concern about the political situation in Barcelona. "In the medium-to-long run, Barcelona is riskier than Madrid. It has a weaker competitive position in terms of location and a higher degree of political risk."

Zurich

The Zurich market is 95 percent domestic and there are almost no transactions because no one will sell. The Swiss have more money than they can possibly deploy domestically, so they are starting to invest abroad, but assets are not being freed up in Switzerland.

In theory, foreign investors can now buy commercial real estate, but in practice there are so many hurdles that most do not deem it worth the effort. In any case, "the yields are so low it's not worth bothering."

Prospects for the Zurich Real Estate Exhibit 3-27 Market in 2005* Rating Ranking **Prospects** Risk-Adjusted Total Returns Modestly Good 9th 5.5 Total Returns 19th Fair 4.9 Risk Modestly Low 6.1 4th Rent Increases Fair 4.6 16th Capital Growth Fair 4.9 15th Supply/Demand Balance Fair 4.9 13th Development Fair 4.9 17th **Investment Recommendation of Survey Respondents** Office



Source: Emerging Trends in Real Estate Europe 2005 survey.

Edinburgh

The survey suggests investment prospects for Edinburgh will be fair—and better than most other cities in the survey—and Edinburgh is rated a firm "hold" across all sectors. Retail demand remains firm on the back of strong retail sales figures. There continues to be a shortage of large, high-quality accommodation in the prime areas and investor demand has continued to drive yield compression. The physical nature of the prime shopping area of Princes Street determines that it will always provide solid performance.

		Prospects	Rating	Ranking
Risk-Adjusted Tota	l Returns	Fair	5.4	10th
Total Returns		Fair	5.3	10th
Risk		Modestly Low	5.6	11th
Rent Increases		Fair	4.7	14th
Capital Growth		Fair	5.2	8th
Supply/Demand Ba	alance	Fair	4.6	19th
Development		Fair	4.6	22nd
Investment Reco	mmendat	ion of Survey Re	espondents	
	8 uy 7%	Hold 78%		Sel 4%
	uy 3%	Hold 52%		Sel 149
Industrial/ Distribution	6%	Hold 58%		Sel 16%
		eal Estate Europe 2		

The office market has been a little slow, but steady takeup has successfully reduced supply by 20 percent over the last 12 months. Rents are stable, with incentives still widely available. Letting activity has reduced the number of empty new build schemes in the city centre and this has prompted two further projects to commence.

Land prices around Edinburgh are too expensive to justify industrial development. Increasing residential development land values have allowed industrial occupiers to benefit from sales and to relocate to purpose-built premises outside the city.

^{*}Fewer than 25 (but no fewer than 15) survey respondents rated this city on most measures.

"hot" sector in Copenhagen.

Rome

Rome is not a transparent market. "You can get more research on Warsaw than you can on Rome," complained one fund manager. While Milan has opened up to foreign investment, Rome remains something of an enigma. The overwhelming presence of government means it is a stable market, but there is little turnover and low availability of space that would be considered prime. Vacant space is of poor quality and negotiating the bureaucracy required for refurbishment requires more patience than many outsiders feel is

Fubilitie 0.00 Pf	ospect	s for the R	ome Real	Estate
	arket ii			
		Prospects	Rating	Ranking
Risk-Adjusted Tot	al Returns	Fair	5.4	11th
Total Returns		Fair	5.2	14th
Risk		Modestly Low	5.6	12th
Rent Increases		Fair	4.5	21st
Capital Growth		Fair	5.1	13th
Supply/Demand E	Balance	Fair	5.3	7th
Development		Fair	5.4	6th
Investment Rec	ommendat	tion of Survey Re	espondents	
Office	Buy 37%		Hold 49%	Sell 14%
Retail	Buy 61%		Hold 32%	Sell 8%
Industrial/ Distribution	Buy 45%		Hold 33%	Sell 21%
Source: Emerging	Trends in R	eal Estate Europe 2	005 survey.	

justifiable. The retail sector benefits from the stability of government employment in Rome and the statistics (such as they are) indicate that prime yields have fallen noticeably. Industrial is reputed to be stable. There are some big projects afoot in the office sector that could change things and they should come on stream in the next three to four years.

Copenhagen

Copenhagen's major commercial real estate assets have been closely held by Danish pension funds for many years. Once these institutions buy an asset, it effectively leaves the market since they are not allowed to trade and have to hold for ten to 15 years. This has led to a very stable market, albeit an

illiquid one where even local investors complain that there is not enough product. The situation is changing somewhat in that the pension funds are now diversifying their real estate exposure. They are not necessarily selling assets, but they are not buying everything that comes onto the market at present and that leaves a little room for other investors. Foremost among these are the Danish limited partnerships that club together high-net-worth individuals and invest using large amounts of debt. However, foreign investors have also made some inroads.

The economic growth outlook for Denmark is quite positive and the retail sector would appear to be well supported. The office sector is in the midst of change, with a lot of new supply in peripheral areas and a shift in preference for the harbour area as opposed to the old CBD. A number of old city centre offices are now being converted into residential, which is the "hot" sector in Copenhagen. The industrial sector has a lot of obsolete stock, so the increase in vacancy over the past year has been misleading. Prime industrial has been stable and should remain so this year.

Prospects for the Copenhagen Real Estate Market in 2005* Prospects Rating Ranking Ranking

	riospecis	natiliy	nalikiliy
Risk-Adjusted Total Returns	Fair	5.3	12th
Total Returns	Fair	4.9	21st
Risk	Modestly Low	5.8	7th
Rent Increases	Fair	5.0	8th
Capital Growth	Fair	4.8	20th
Supply/Demand Balance	Fair	5.0	9th
Development	Fair	4.9	18th

Investment Recommendation of Survey Respondents



Source: Emerging Trends in Real Estate Europe 2005 survey.

*Fewer than 25 (but no fewer than 15) survey respondents rated this city on most measures.

Vienna

"The Vienna market is boring and stable." But that has not stopped Vienna from participating in last year's yield compression party. Prime office yields are down to 5 percent while vacancy is up to 6.8 percent (which is high in historic terms). The German open-ended funds bought Vienna heavily for three years while the Austrian investors moved east. Austrian investors have been heavily involved in the accession countries for some time and have moved on to Romania and Bulgaria, where they are forward purchasing new development or buying standing assets. There is some concern as to what will happen to the Vienna market if German openended funds need to sell offices, but the German closed-end funds are still buying, which mitigates some of the worry. There is more confidence that prime retail and logistics will do well in 2005, but secondary retail will continue to suffer.



Lisbon

"Offices are to be avoided." "There is clear oversupply in the office market that will probably take years to accommodate." No one who cared to comment about it had a good word to say about Lisbon's office market. Prime yields have been stuck at around 7.25 percent for a year while the Spanish neighbours have yields 150 basis points lower. Ostensibly, Lisbon's CBD should be doing better with vacancy at only 5 percent, but that narrow statistic does not tell the whole tale. Average vacancy is much higher and the legal regime is not supportive to investors. "The government traded one bad set of leasing laws for another and they are only just waking up to that fact because they want to sell some assets." Portuguese leasing law gives tenants the right to quit their lease at 90 days notice, regardless of the length of the lease. "In effect, there's no such thing as a lease in Portugal." Foreign owners with foreign tenants can get around the law by drawing up an additional contract under another country's jurisdiction, but for everyone else a lease is only a 90-day contract.

Lisbon's retail and hotel sectors have more support, but the outlook for industrial remains uninspiring except for a few bright spots in logistics.

		Lisbon Re	al Estate
	Prospects	Rating	Ranking
d Total Returns	Fair	5.2	16th
;	Fair	5.0	17th
	Moderate	5.3	15th
es	Fair	4.5	19th
th	Fair	4.8	19th
and Balance	Fair	4.5	21st
	Fair	5.1	11th
Recommendat Buy 28%	Hole	d	Sell 28%
Buy 41%			Sell 17%
Buy 29%	Holo 38%		Sell 33%
	Market in d Total Returns es th and Balance d Buy 28% Buy 41%	Market in 2005 Prospects d Total Returns Fair Fair Moderate es Fair th Fair and Balance Fair t Fair Recommendation of Survey F Buy 28% Hol 41% Buy Hol 41% Hol	Prospects Rating d Total Returns Fair 5.2 Fair 5.0 Moderate 5.3 es Fair 4.5 th Fair 4.8 and Balance Fair 4.5 Fair 5.1 Recommendation of Survey Respondents Buy Hold 41% Buy Hold 41% Buy Hold

Madrid

Investors are feeling cautious about Madrid, at least in the near term. Although the majority of those interviewed were positive on a long-term view, the near-record development completions in 2004 left the market with a huge oversupply of new offices in the periphery. The vacancy in the CBD was only around 6 percent as of October 2004 (and most of that was old stock), but the equivalent figure in the periphery was 21 percent despite rents that had fallen 34 percent in one year; "you can't lease it and you can't sell it." However, many developers are more confident about the outlook. Furthermore, a considerable number believe that if they cannot lease their new buildings as offices they can always convert them into residential.

The new supply pipeline is much lower for 2005, but it remains to be seen whether the developer's confidence in an upturn this year is justified. Most of those we surveyed think there will be stabilisation, and some are even expecting an upturn in rents. Others disagree, particularly in view of the huge development planned for the former Real Madrid practice fields that will complete in 2007. However, there seems to be a consensus that the heady prime yields in the CBD will not be under threat due to the weight of investment inflows.

Madrid's retail sector delivered increases in prime rents on the order of 15 percent in the first three quarters of 2004, but few expect a repeat performance this year. Stability appears to be the consensus. Some see potential in logistics and large-scale warehousing. Residential provokes the most concern after years of breathtaking increases in capital values. Many private investors have highly geared holdings in residential investment properties, and if interest rate rises materialise the consequences could be nasty. On the other hand, there is frequent mention of Spain's growing influx of immigrants from both wealthy northern Europe and poorer countries who are adding dynamism to the economy and putting constant pressure on the housing stock.

Prospects for the Madrid Real Estate Exhibit 3-33 Market in 2005 **Prospects** Rating Ranking Risk-Adjusted Total Returns Fair 5.1 17th Total Returns Fair 20th 4.9 Risk Moderate 5.3 14th Rent Increases Fair 4.6 17th Capital Growth Fair 4.7 21st Supply/Demand Balance Fair 4.9 11th Development 13th **Investment Recommendation of Survey Respondents Buy** 38% Office **Hold** 36% **Sell** 23% Retail Industrial/ Hold Distribution Source: Emerging Trends in Real Estate Europe 2005 survey.



While no single sector is
expected to have outstanding

Prospects for investment
or development, the relative
prospects across the board are more
optimistic than last year.

Types in Perspective

hile offices remain the dominant sector for real estate investors in Europe, the year 2004 saw a continuing shift of investor interest towards retail, warehouse, and residential properties. In a repeat of the *Emerging Trends 2004* findings, shopping centres are once again expected to produce the highest total returns for investors, and this sector has emerged as a favoured property type for those looking for alternatives to office. Beneath this leading category, there has been some shuffling of the pack, with retail parks moving up the list from last year and replacing residential as a very close second choice for investors. The bottom positions in the ranking for investment remain the same property types as last year, with business parks/out-oftown offices and manufacturing propping up the table in 2005 (see Exhibit 4-1).

On the development and supply/demand balance side, there is very little change in the sector rankings from last year. The residential sector is respondents' favourite, once again closely supported by shopping centres and warehousing/distribution. In line with the investment prospects rankings, business parks/out-of-town offices and manufacturing are firmly out of favour (see Exhibit 4-2).

What is particularly noticeable this year is the improvement in the relative ranking score expectations for all property sectors. While no single sector is expected to have outstanding prospects for investment or development, the relative prospects across the board are more optimistic than last year. Total return prospects are expected to be modestly good for shopping centres, retail parks, and warehousing, and fair for all other property types including the office and manufacturing sectors. Last year, total return expectations fell into a range between fair and modestly poor.

The office market across Europe is emerging from a torrid period. Although vacancy levels have continued to escalate in many cities, signs of a recovery in occupier demand are emerging and the consensus is for rental growth to be evident across most of Europe's key cities by the end of 2005.

The retail sector has had another strong year of investment performance, and investors have shown a strong appetite for shopping centres and retail parks. In the U.K. alone, shopping centre transactions totalled £3.5 billion in the first half of the year. The ability to actively manage cen-



tres to drive performance and to dominate catchment areas is an attractive proposition for investors. In addition, retailer demand remains healthy throughout most of Europe, which, coupled with tight planning controls, particularly for out-oftown development, creates the upward rental pressure.

The industrial market retains its defensive attractions. Investors and developers are now looking to track the structural shift in logistics to the C.E. accession states and beyond, with further opportunities in emerging markets like Greece and Turkey.



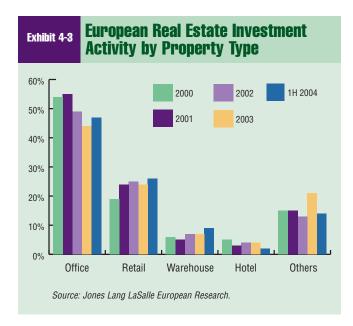
For the European hotel sector, a successful, growing tourism industry and an expanding economy are the key drivers to investment and expansion. A more confident sector is looking cautiously to 2005 for further improvement, including some room rate improvements.

The residential market scores highly in the survey, but is a sector that can be very difficult to penetrate as an investor. The forecast demographic shifts in Europe are there to seegreater numbers of households and an ageing population, which together with supply constraints should maintain an upward trend in values.

Office

Strengths

"The office market is more cyclical and there are opportunities to benefit from this." Prime office investment demand has continued unabated across Europe despite the weak

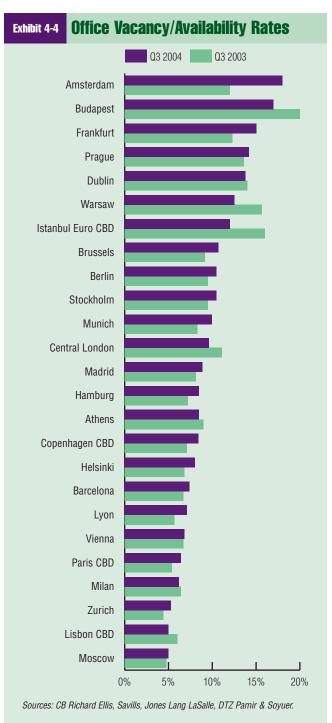


underlying fundamentals. While some players are prepared to consider secondary pitch or short lease properties, the investment focus has tended to be on prime CBD, long-lease, strong covenant buildings. This is the type of product that many investors seek, whether private or institutional buyers. The return may not be exciting, but it is pretty much secure, and the CBD location provides the liquidity for a safe exit route at a chosen time. Jones Lang LaSalle data for H1 2004 indicate that almost 50 percent of the value of cross-border investment was in the office sector (see Exhibit 4-3).

Again the U.K. market, with its attractive lease structure, has attracted both overseas and domestic monies by the bundle. The security of long leases and five-year upward-only rent reviews has driven prices higher through yield compression while occupier demand in most locations has remained weak. In a similar pattern to 2003, U.K. offices in 2004, particularly in central London, have proved particularly attractive to German open-ended funds and syndicators, many of them Irish backed.

A key difference from the 2004 survey is that many respondents now view the office sector across Europe as being at, or very close to, the bottom of the rental cycle. "There is excitement at the smallest hint of an increase in demand." There appear to be clear signs of a recovery in some leasing markets, although not everyone is convinced. For example, the London West End office market has seen prime rents rise by over 30 percent this year. One interviewee described this recovery as "illusory." The West End does benefit from a wide occupier base, but much of the stock below prime is let on shorter leases and is vulnerable to any economic shocks. "Average" West End office rents have only risen by about 5 percent in 2004.

Many European city markets are expected to see a recovery in occupier demand in 2005, with rents showing increases at the end of the year and into 2006.



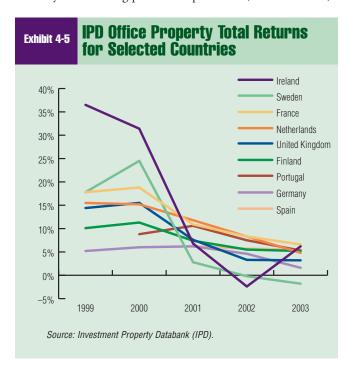
Weaknesses

The office market cycles across Europe are out of sync. Yes, as stated above there are some signs of recovery in some markets, but generally vacancy rates have increased across Europe between Q3 2003 and Q3 2004 (see Exhibit 4-4). Some cities, such as Amsterdam and Frankfurt in the west and

Warsaw, Budapest, and Istanbul, are suffering embarrassingly high vacancy rates that will take some time to work out of the system. In the U.K. "the Thames Valley is still shot." Of course, on top of the published vacancy levels there is a less transparent amount of "hidden supply" or phantom space—where occupiers themselves are sitting on thousands of square metres of additional empty space.

So, there are "significant variations at a local level" to take into account. Service sector employment growth will recover at different rates in different cities depending on national and regional economic growth. In addition, the development pipeline will vary widely. As one adviser stated, "The occupier recovery is not consistent across countries."

Business parks remain firmly out of favour except in some central eastern European locations where prospects are considered to be better than for CBD. Sector returns overall have generally drifted down from a peak in 2000, although recovery is now being priced into purchases (see Exhibit 4-5).



Best Bets

CBD offices are certainly favoured over business parks/out-of-town investments. It is crucial to understand the local supply/ demand balance. Cities that gained strong support and were top of the office sector buy list for 2005 include the C.E. cities of Prague, Warsaw, and Budapest, with the French cities of Paris and Lyon and the Nordic centres of Helsinki and Stockholm also favoured. The C.E. cities still offer comparatively favourable yields, but the strength of support does seem

to fly in the face of the high vacancy rates in these centres (see Exhibit 4-4). High-quality investment product is still in short supply and some survey respondents in these specific markets suggest business parks as an alternative target for investors. Investors are clearly anticipating the stronger C.E. economic growth to drive expansion of multinationals and expansion and relocation of local service sector businesses to better-quality premises. This, in turn, will reduce vacancies and provide a return to rental growth.

Although Paris vacancy levels have increased in 2004, in comparative terms they remain low. It remains a popular choice among investors because of the diverse occupier base and liquidity. Lyon is an example of investors' beginning to seek value in "second-tier" cities where yields are more attractive. Helsinki and Stockholm are both considered transparent and liquid markets. Both cities provide buyers with a relatively high yield in the western European context. Helsinki has a limited development pipeline, with the highest vacancy rates outside of the CBD. Stockholm is experiencing a recovery in the hard-hit IT sector, driven by new business inward investment from overseas. More people are employed in IT now in Stockholm than in the boom of 2000. New speculative development that commenced in 2002 is creating high-quality space to allow expanding businesses to relocate.

Avoid

The cities that score highly in the "sell" recommendations are a mixed bag (see Exhibit 3-10). As one would expect, Germany figures prominently with both Frankfurt and Berlin. Both have high vacancy levels and the economic growth forecasts do not suggest an early recovery in demand. Amsterdam suffers a similar fate, with vacancy levels rising to 18 percent in Q3 2004. In Dublin, despite seeing slight falls

cts for City	y Centre C	offices
Prospects	Rating	Ranking
Fair	5.0	7th
Fair	4.6	8th
Fair	5.0	7th
Fair	4.5	8th
Fair	4.8	7th
lian)	6.3%	
lation of Survey	Respondents	
		Sell 13.7%
	Prospects Fair Fair Fair Fair Fair fair fair fair Hair Hair Hair Hation of Survey	Prospects Rating Fair 5.0 Fair 4.6 Fair 5.0 Fair 4.5 Fair 4.8

Prospects for Business Park/Out-of-Exhibit 4-7 **Town Offices in 2005** Rating Ranking **Prospects** Total Returns Fair 4.5 9th Rent Increases Modestly Poor 4.0 9th Capital Growth Modestly Poor 4.4 9th Supply/Demand Balance Modestly Poor 4.0 9th Development Modestly Poor 4.4 9th Expected Prime Yield (median) 7.3% **Investment Recommendation of Survey Respondents** Buy Hold Sell 48.3% 20.4% Source: Emerging Trends in Real Estate Europe 2005 survey.

in vacancy levels during the year and continued strong economic growth, investors are wary of excess supply in the suburbs and the potential for further new development. Athens also experienced a slight fall in vacancy rates, with public sector occupiers taking Olympics-related space, but the market remains relatively nontransparent to foreign investors.

Development

The office development market will remain tough in many locations. It is difficult to generalise, but the market in 2005 does look better for office development on a selective basis. "Europe is better than the U.K. because of interest rates and costs." Developers "should be active now to benefit from the upturn." There has been little speculative development. The banks have understandably been prudent in their lending. While vacancy rates are admittedly high in a number of major cities, there has been no development boom in this cycle and grade-A space could be absorbed quite quickly in the event of sustained economic recovery. If London is viewed as a leading barometer, speculative development is underway in both the West End and City office markets in anticipation of recovery.

Outlook

CBD office prospects for 2005 rank as "fair" and business parks/out-of-town rank as "modestly poor" (see Exhibits 4-6 and 4-7), with both property types near the foot of the table. However, the consensus is that many cities are at the bottom of the rental trough and rents will show growth towards the end of 2005. Indeed, the IPD U.K. Monthly Index data for October 2004 indicate month-on-month rental growth for the sector—yes, even in the City of London. The U.K. is leading the office rebound.

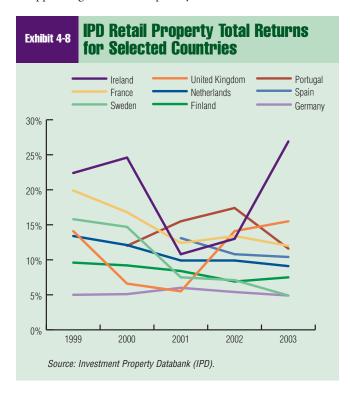
Retail

Strengths

Respondents consider the retail sector, through shopping centres and retail parks, to have the best performance prospects for 2005—"modestly good." Both submarkets also rank highly (though not the highest) in the development prospects and market balance ranking. Street retail sits in mid-table. The retail sector provides large-lot-size investment product with the potential for active management to drive medium-and long-term performance. In a low-interest-rate environment, consumer spending in many (but not all) European markets has been robust, with shoppers accessing cheap debt to fuel their habits. Ireland, U.K., and Spain are examples, but surely the party must end?

The retail market is at different stages of the maturity curve across Europe. Respondents still see opportunities for further shopping centre and big-box retail development in southern France, southern Italy, Spain, Greece, and Russia. All are considered to be undersupplied in terms of floor space per capita. "Retail parks are still missing in Italy: there is a big opportunity for first movers." In C.E. countries, responses are a little more cautious regarding the major cities where markets are approaching saturation.

In performance terms, the retail sector for most European countries has shown consistent and relatively strong performance. Germany has been the exception, with Finland and Sweden also disappointing in the last couple of years (see Exhibit 4-8).



Weaknesses

"Pricing is unquestionably high." And in reference to the U.K. market, one lender states, "Yields are too low—all the juice has been squeezed out." "Investment yields are now at unsustainable levels, particularly in the U.K., but this is also true of some other European locations, for example, Spain." There is a perception from many respondents that the retail market has seen its best. "The fundamentals are still strong, but weakening." One fund strategist said, "The foot is off the accelerator across Europe." There are certainly clear signs of a slowdown in consumer spending and consumer confidence in the U.K. as the interest rate rises seen in 2004 finally hit the mark. Of course, several European economies have not been fortunate enough to benefit from high-spending consumers. "A rate rise in the Eurozone could have serious implications for the retail sector."

Some of the major C.E. markets have seen overbuilding of shopping centres that will clearly affect future performance. And further east, comments on Moscow, while declaring that the retail sector will continue to boom, do indicate concern over volatility, the "lack of structure," and the fact that the market is essentially a "free for all." Political uncertainty is perhaps higher on the agenda now than last year following recent events in Ukraine. Reports in the media question whether the economic boom is over and whether Russia is on the cusp of a return to a state-run economy.

Secondary and tertiary retail pitches continue to be affected by the growth in out-of-town retail facilities that are increasingly providing comparison goods shopping despite the efforts of planners to control development. In addition, the large superstore and hypermarket operators continue to use their large store formats and immense buying power to develop their nonfood ranges. This trend will continue.

Of more concern is a quote from one international adviser: "The high street is dying." Particularly in the more mature western European retail markets, shopping centres will continue their march towards being more leisure focussed and the larger shopping malls will continue to build market share. This not only affects the neighbouring high street, but neighbouring second-tier town and city centres. How will they compete in the future?

The structure of ownership in certain parts of Europe, where often there are high levels of owner occupation, does make it difficult for investors to access product.

Best Bets

Milan and Rome feature high on the buy list, but it is very difficult to acquire stock in these cities. The historic nature of these locations and planning issues delay delivery of new

	Prospects	Rating	Ranking	
Total Returns	Modestly Good	5.8	1st	
Rent Increases	Modestly Good	5.7	1st	
Capital Growth	Modestly Good	5.6	2nd	
Supply/Demand Balance	Modestly Good	5.6	1st	
Development	Modestly Good	5.8	2nd	
Expected Prime Yield (median)	6.5%			
Investment Recommendation of Survey Respondents				
Buy 45.5%	Hol 32.		Sell 22.1%	

developments. Significant new retail space is planned as part of large mixed-use schemes, but neither city will benefit from completions until 2006. The Italian market is opaque. While market transparency is improving, investors still feel that, with the right "connections," there is an element of mispricing to be exploited.

Paralleling the office sector, Prague, Warsaw, Helsinki, and Paris again feature in the top six "buys." Each has a tightly defined central retail area where new supply is limited, although one portfolio manger commented that "Warsaw retail is on the edge." Helsinki city centre has a major mixed-use scheme presently under construction providing a sizeable new shopping mall. It will undoubtedly strengthen the city centre, but may dampen short-term rental growth when completed.

For C.E. and Russia, a strong theme mentioned by several respondents was to seek investments and development opportunities in regional centres beyond the major cities. Significant potential exists for shopping centres and food store—anchored district centres and retail parks. "Investors seek quality." Depending on your view on political stability, Moscow appears to be significantly undershopped, particularly for high-quality shopping centres.

Avoid

The build quality of some recently completed retail schemes in C.E. is questionable—beware. Also, avoid those C.E. centres that are suffering from an oversupply of new shopping centre facilities, where equilibrium may take some time to be restored.

In the more mature western markets, be wary of towns/cities that are open to new competition from both expanding competing centres and out-of-town retail park and hypermarket formats.

manufacturing is one of the least favoured property types.

Prospects for Retail Parks Exhibit 4-10 in 2005 Rating **Prospects** Ranking Total Returns Modestly Good 5.8 2nd Rent Increases 2nd Fair 5.4 Capital Growth Modestly Good 5.6 1st Supply/Demand Balance 5.4 Fair 3rd Development Modestly Good 5.6 4th Expected Prime Yield (median) 7.5% **Investment Recommendation of Survey Respondents** Buy Hold Sell 42.4% Source: Emerging Trends in Real Estate Europe 2005 survey.

Prospects for Street Retail in 2005				
	Prospects	Rating	Ranking	
Total Returns	Fair	5.4	5th	
Rent Increases	Fair	5.2	3rd	
Capital Growth	Fair	5.3	6th	
Supply/Demand Balance	Fair	5.4	4th	
Development	Fair	5.2	6th	
Expected Prime Yield (median)	6.5%			
Investment Recommendation of Survey Respondents				
Buy 34.3%	Hold 41.8%		Sell 23.9%	
Source: Emerging Trends in Real Estate Europe 2005 survey.				

Development

The trend towards replicating tried-and-tested western-style retail formats is likely to continue in the less mature markets, providing the increasingly affluent consumer base with their desired retail environments—both in town and out of town. Exercising some degree of caution, there is still scope in C.E., especially in the second-tier cities. Russia and, to an extent, Greece and Turkey, offer bold developers yet greater opportunities. In mature markets, the emphasis will be on replacing, refurbishing, and extending existing centres to reposition them as a more dominant force in the retail hierarchy. Further, retail will play a key role in large mixed-use developments across

Europe, often being used as a catalyst for urban regeneration. The scale and length of the planning and development process really places large-scale retail development beyond any cyclical factors.

Outlook

With concern over slowing growth rates in many European economies in 2005, there is also concern over consumer confidence and consumer spending. For the U.K. and Spain in particular, house prices that have been flying high in recent years are now in real danger of a firm landing, or in a worst-case scenario a crash landing. House price falls will feed through directly to the consumer and the retail market. It is widely accepted that after a bull run, retail sector performance will slow in 2005.

Industrial

Strengths

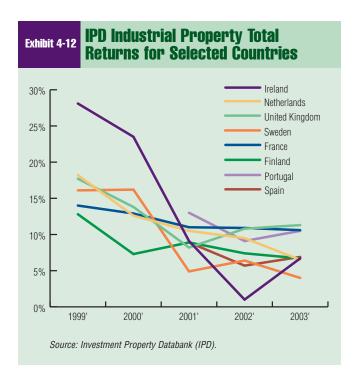
The industrial sector is always considered to be a solid defensive investment because of its higher yield characteristics. The sector divides into warehousing/distribution (logistics) and manufacturing. From investment and development perspectives, the two submarkets are at opposite ends of the rankings. Logistics features in the top three for investment and development prospects—"modestly good"—whereas manufacturing is one of the least favoured property types, with "modestly poor" investment and development prospects. Prime yields in western Europe average around the 8 percent mark, but in C.E. they can be 9 percent plus. In places where the market for modern industrial/warehousing space is "just opening up"—for example, in Greece, Turkey, and Russia—prime yields are into double digits.

"The sector offers low volatility and good returns and is benefiting from structural changes in European logistics." IPD performance figures bear this out (see Exhibit 4-12). "A demand recovery could result in rents rising quite quickly." With construction and commodity costs rising, those markets where rents are linked to a price index will see rental growth. "There is still much investor and occupier demand."

For the active management specialists, the more traditional industrial estates are still attractive buys. A combination of repositioning, refurbishment, and redevelopment can produce exceptional returns.

Weaknesses

"The U.K. market is too mature." Across Europe, "Sourcing of stock is very tight, particularly for the right scale and quality." Some consider the market "fragile." There is a general



shift to low-cost areas that may leave some geographies exposed. In addition to land costs, employment, in terms of both availability and cost, is becoming an issue for some of the very large 24/7 logistics operators. "Remote but accessible sites are being developed." "The logistics sector is corporate occupier driven rather than investor driven." It is increasingly important to understand the client and understand the product. Significant infrastructure improvements are still required in many parts of C.E. to facilitate the further evolution of efficient supply chains.

Best Bets

C.E. was mentioned time and time again in our interviews. In addition to indigenous demand from within the new accession countries, we are seeing growing cross-border logistics movements from proximate non-E.U. countries such as Serbia, Croatia, and Bulgaria. It is no surprise therefore to see Prague, Warsaw, and Budapest in three of the top four "buy" positions. Third-party logistics providers have been a significant source of demand, together with value-added component assembly.

In Russia, the sector "is waiting to explode." There is strong demand and the market "is severely undersupplied." "The opportunities are high, but acquiring land with utilities is difficult and zoning is a problem." "First-in investors and

developers will benefit." In addition to the Moscow area there are "excellent opportunities in the regions." Istanbul also stands high on the list. As an immature market in a country with a relatively strong and (now) stable economy, development opportunities must emerge. However, this would have to be "user driven, as there is very little local development expertise [if any] in developing industrial real estate."

Lyon, the second-largest industrial city in France, benefits from a good strategic location in southern France and still offers investors competitive yields. Although not featuring as highly on the "buy" list, interviewees also gave fair support to Benelux, northern Italy, Spain, and Germany for the industrial sector. One other potential target market for investors is that of urban area industrial sites. Not only is there generally a good level of demand for units, but increasingly, by working with planners a change of use to residential planning consent can dramatically increase the site value.

Prospects for Manufacturing Real Estate in 2005				
		Prospects	Rating	Ranking
Total Returns		Modestly Poor	4.6	8th
Rent Increases		Modestly Poor	4.7	7th
Capital Growth		Modestly Poor	4.7	8th
Supply/Demand	d Balance	Modestly Poor	4.7	7th
Development		Modestly Poor	4.6	8th
Expected Prime	Yield (median)	8.8%		
Investment Recommendation of Survey Respondents				
Buy	Hold		Sell	
14.7%	34.3%		51.0%	
Source: Emerging Trends in Real Estate Europe 2005 survey.				

Avoid

In general, research for this report turned up few negative comments about the sector. Those cities listed as "sells" tend to have a very limited industrial market. The Swiss market barely exists, logistics being sourced from neighbouring countries. Similarly, the small populations of Ireland, Sweden, and Denmark require limited distribution support.

Development

"Retailers will continue to demand state-of-the-art product." The established logistics hubs close to Paris, Milan, the Ruhr, and Benelux will remain popular with developers. But the macro shift is east, to the accession C.E. states and beyond,

	Prospects	Rating	Ranking	
Total Returns	Modestly Good	5.7	3rd	
Rent Increases	Fair	5.2	4th	
Capital Growth	Fair	5.4	4th	
Supply/Demand Balance	Fair	5.2	5th	
Development	Modestly Good	5.7	3rd	
Expected Prime Yield (median)	8.0%			
Investment Recommendation of Survey Respondents				
Buy 41.8%	Hol o 37.3		Sell 20.9%	

with further opportunities in the emerging markets like Greece and Turkey. Infrastructure is key to efficient supply chain management and developers should monitor E.U. funding and investment.

Outlook

The industrial market is a "substantial area for growth in 2005." Intense competition from the Far East is resulting in a structural shift in Europe's manufacturing industries. The result is reduced demand for heavy manufacturing space and assembly plants, and increased demand for warehousing space used for distribution and freight forwarding. All the Chinese imported goods require storage and distribution centres somewhere! "The long-term potential is very good." "Trade flows are increasing across Europe." The long-term trend is shifting from retail to industrial, a move towards supplying the consumer direct from warehouses. "E-business has yet to reach its full potential."

Hotels

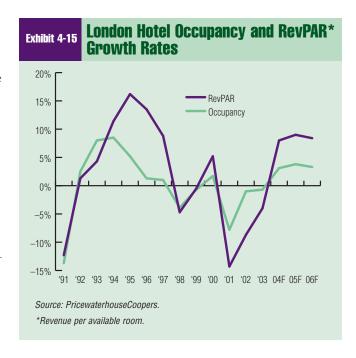
Strengths

There is cautious optimism in the hotel sector after several years of highly challenging market conditions. Currently, hopes of recovery rather than gloom characterise the sector. In the investment and development prospects survey ranking, the hotel sector is mid-table, with development and market balance prospects a slight improvement over 2004. For some countries, mainly the U.K., recovery is already well under-

way; for others, anticipation of a long-awaited recovery is underpinning investor interest. "The hotel cycle roars back." It is a countercyclical play. Investors are looking because of low returns from equity markets and slowing returns from commercial real estate. High-net-worth investors and syndicates are investing simply because they can. Recovery should help enhance values.

The release of three years' pent-up demand for international travel helped drive tourism volumes up this year. Worldwide tourism statistics show that more people travelled internationally in 2004 than at any time previously recorded, with 526 million international trips in the first eight months of 2004. Airline traffic also maintained an upward trend. A steady improvement in business travel volumes is good news for the hotel sector. An online poll of 450 business travellers in Europe found that prospects for the future are improving. American Express predicts business travel demand will outpace supply and push long-haul air and hotel rates up over the next 12 months.

In the U.K., following three years of gloom, the economic and travel backdrop should support three years of growth in the hotel sector. London is busy again. PricewaterhouseCoopers expects occupancy and room rate gains to drive RevPAR growth to 8 percent overall in the U.K. and London in 2004. 2005 should see a continuation of this upward trend, with RevPAR reaching 9 percent in London (see Exhibit 4-15).



Occupancies are improving in France as well, with Paris reporting encouraging performance in September and October. In Germany, some products in some urban locations report slight performance improvements—some international chains (Hilton, Millennium & Copthorne) report stronger RevPAR growth. Hosting the football World Cup in 2006 should stimulate Germany's tourism sector and help lift room rates.

Weaknesses

It's not all plain selling just yet and the pace of recovery will vary greatly by region and country, with the U.K. well placed. For many it will be a long haul to get back to past peaks. Little movement in room rates has been seen across much of Europe. Concerns include fears that the recovery may stall and the strengthening euro—the Eurozone's prospects are tied to its future.

There are also concerns for Germany as weak domestic demand threatens overall growth prospects and clouds the outlook for hotel sector performance. For Spain, oversupply issues currently overshadow future performance in some locations and it's likely to take some time to absorb the room increases.

For many operators, margins remain under pressure from discounting and the corporate travel slump, with its resultant changing leisure and business mix. Some experts express concerns that the cost base may be set to increase above inflation—staffing levels may become an issue and the drive for greater efficiencies and productivity a differentiator.

Best Bets

Use good judgement—to identify genuine countercyclical plays. Look for areas with supply shortages, high-quality product, and assets flexible enough to allow exploitation of a diversity of income streams. As the guests come back, they remain value focussed. A key issue is what products or services do guests want and how much are they prepared to pay for them?

For consumers, style and affordability are important, and new brands have emerged including Yotel—"luxury in a small space"—for around €109 per night. MWB, owner of the Malmaison chain, recently acquired the Hotel du Vin lifestyle chain—a great food offering plus a stylish hotel product, with local market appeal.

Budget hotels remain popular with consumers and drive value for money expectations. More budget rooms were built in the U.K. in 2003 and 2004 than ever before, so the going is getting tougher with revenues growing more slowly and gearing levels increasing.

Locations that received favourable mentions in the survey included Italy. "The Italian market is at its lowest cycle; a huge increase is expected in the next two to four years." Milan looks "very good." In Lisbon, "Hotels look like a good investment opportunity," Moscow has demand for three-star and five-star hotels in particular, and Vienna "has a high need for hotels in all categories." The emerging markets of Croatia and Romania also received plaudits.

Avoid

Poor locations: the economics of hotel operation dictate that location is the most important competitive dynamic. Location can't be changed and the inventory rolls every night—if you don't sell a room one night, it's a lost opportunity. Good times and bad times—if there is a cutback in demand or an increase in supply, no matter how good an operator you are you get hurt.

Areas of oversupply: increases in demand stimulate supply developments. However, the adjustment of supply to demand is not necessarily instantaneous or smooth. In the past, we have seen periods when demand runs ahead of supply, creating shortages, high occupancy rates, and high prices. Higher occupancy and room rates make existing hotels increasingly profitable and as a consequence encourage developers to enter the market. Supply shortages can in part contribute to profitability and high occupancies. The survey flagged up concerns of oversupply in some Spanish cities and coastal resorts and Warsaw.

Development

The difficult trading environment has curtailed new development programmes. While recovery is signalled, the hotel markets in many cities are finely balanced. There are opportunities for consolidation in many countries. This may take the form of family-run businesses being acquired by international brands for major refurbishment or redevelopment. Russia and the new emerging markets of Croatia and Romania perhaps offer some of the better longer-term opportunities.

Outlook

Widespread asset restructuring and disposals have characterised the U.K. scene recently, as groups move to a less asset-intensive business model and dispose of underperforming assets to improve performance and value for shareholders. InterContinental Hotels Group and Whitbread have announced strategic intent here. Buoyant demand for hotel assets should boost the sales and help forecasts of record highs for European hotel transactions in 2005 become a reality.

	Prospects	Rating	Ranking	
Total Returns	Fair	5.4	6th	
Rent Increases	Fair	5.1	5th	
Capital Growth	Fair	5.4	5th	
Supply/Demand Balance	Fair	5.1	6th	
Development	Fair	5.3	5th	
Expected Prime Yield (median) 7.7%				
Investment Recommendation of Survey Respondents				
Buy 38.8%	Hold 32.7%	6	Sell 28.6%	

More capital is expected to flow from the U.S., Asia, and the Middle East as investors seek countercyclical opportunities. More private equity house interest is also likely. German domestic open-ended funds have been active (DIFA now has 20 hotels in its portfolio), but will probably step back in 2005 in response to current net income flows. For high-networth individuals, trophy hotel assets still have great appeal—and reflect an overriding penchant for prime stock.

A successful, growing tourism industry and an expanding economy are the key drivers to investment in and expansion of Europe's hotel sector. A more confident sector is looking cautiously to 2005 for further improvement including some room rate improvements. Certainly the travel backdrop is encouraging; 4 percent growth is expected in global travel volumes. Corporate travel outlook is also expected to strengthen further in 2005.

Residential

Strengths

As in the 2004 survey, respondents rank the residential sector highly. "Residential is good everywhere—even Germany!" The sector retains its premier standing for development prospects, ranked as "modestly good," and the supply/demand balance also ranks in the top two as "modestly good." From an investment perspective, the sector has drifted down the table a little, to fourth spot for total return. Prospects for return, capital growth, and rental growth are considered "fair." "The sector may offer interesting opportunities across Europe—it has a low correlation with commercial returns."

The problems with house price indices are numerous, but for those countries that IPD covers (see Exhibit 4-17) there is evidence of reduced 2003 performance in the previously high-performance markets of Spain and the U.K. Returns in other countries are quite stable.

The residential sector is one that is difficult to generalise about. The structure of the market differs considerably across Europe, with different regulatory environments making an impact on the relative split between the owner-occupied and rental markets. The sector is broadly supported in many countries by the fundamental mismatch between supply and demand. Demographic trends point to a continued growth in household formation through ongoing changes in household structure. This will continue to drive the demand side. Counter to this, the planning system tends to restrict new supply. The combination of the two will result in long-term price increases. In a market economy, one would expect additional new supply to be the market reaction to increasing prices, but in fact, when one looks at the E.U. housing statistics for 1995-2001, countries like the U.K., Netherlands, and Italy all experienced reduced new supply as a reaction to house price growth!

The stronger-growing E.U. economies of C.E. and Greece, with growing personal wealth, will create a new generation of aspirational homebuyers, and this bodes well for housing investment and development in these areas.

The changing age profile across Europe towards a more elderly profile will also have an impact. "Baby boomers," many of whom have accumulated wealth through house price increases, are seeking second homes, often for holidays, sometimes for income, but often with one eye on retirement. The warmer climates of Spain, Portugal, and southern France have already benefited and the second home market is evolving in Turkey, Greece, and Croatia. The Black Sea coasts of Bulgaria and Romania and the Adriatic coast of Serbia could be the next markets to open up.

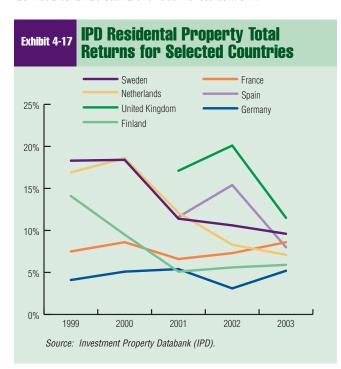
While the European residential market is nowhere near as clearly segmented as that in the U.S., demographic drivers are beginning to more comprehensively support "seniors' housing" initiatives—sheltered housing, care homes, retirement villages, and "extra care" facilities.

Weaknesses

Successful investment in the residential market requires specialist skills sets. Ownership is extremely fragmented and for large-scale investors, acquiring stock in scale is a real issue. It will always be a management-intensive asset and appeals to a limited investor base. As one U.K. institution said, "I wouldn't touch it with a barge pole." Contrary to this, a recent DTZ survey indicates there is in excess of €58 billion of retail and institutional money to be invested in residential over the next five years.

Low interest rates encourage buying rather than letting. For example, in the U.K. this has encouraged a boom in the "buy-to-let" market to the point where some localities are suffering a glut of rental properties and falling rents. But many buyers are still prepared to consider a "buy-to-let" purchase in anticipation of steady medium- to long-term capital growth compared with the current nonperformance of equities. The low interest rates in the Eurozone do not help support the rental market.

Social and private rented sectors in each country operate in relation to different national legislation and investors really do need to understand the local forces at work.



Best Bets

There are chronic shortages of supply in the former communist states in C.E. "Develop to sell." An expected VAT increase in the Czech Republic is accelerating demand for development land and is increasing land and construction costs. In Moscow there is strong demand for prime downtown accommodation, townhouses in good locations, and dachas out of the city. Growing foreign direct investment into Turkey (Istanbul in particular) will drive demand there. "Demand is very strong, and will get stronger as mortgages become more affordable. Local developers have a great deal of expertise and appetite for residential real estate."

In Spain, despite some expressed concerns of a price bubble, the consensus is that "demand will outpace supply." "Average-price homes still have growth potential." In Switzerland, one of the few European markets with major institutional investment, the market remains good and stable, with opportunities in the stronger economic regions and some grade-B and grade-C locations. Northern and central Italy is also mentioned, particularly the area around Turin. In Greece there will be opportunities for retirement and second home developments and major construction projects are now reported to be better organised. An improvement in the Portuguese economy is expected to benefit the residential market around Lisbon. Denmark seems to have embraced city living and Copenhagen is proving very popular for office to residential conversions, but watch the supply pipeline.

U.S. opportunity funds have purchased a number of government residential portfolios in Germany recently, with Fortress (€3.5 billion), Goldman Sachs' Whitehall Fund (€1.97 billion), and Blackstone (€1.4 billion) all buying apartment portfolios. In addition, a Eurohypo/Citigroup/GMAC joint venture has taken on a Eurohypo residential nonperforming loans portfolio valued at €2.4 billion.

Avoid

The two countries where the survey indicates a mixed response over the residential sector are the U.K. and Spain. In terms of house price growth, the U.K. market would appear to have turned a corner following successive interest rate rises and a reaction to the relentless media coverage warning of the next house price crash. Growth forecasts for 2005 were cut drastically in late 2004, with many commentators forecasting price falls. It is a time of uncertainty, which may benefit the rental

market as potential buyers take a "wait and see" approach. The warning signs for Spain point mainly to the danger of overbuilding in the coastal markets. Many respondents consider demand to exceed supply in other parts of Spain.

Development

The trend towards urbanisation and consolidation continues. Look for infill locations and high-quality apartments in 24-hour cities offering entertainment, culture, and convenience; this market will likely grow and grow in the coming years. The growth in popularity of mixed-use schemes links into this demographic shift, but this type of development requires specialist skills and is at risk from planning delays and political interference.

Developers can take their lead from the "Best Bets" section above—C.E. for high-quality affordable homes; Moscow for high-end apartments, townhouses, and dachas; and the growing second home and retirement destinations of Greece, Turkey, Portugal, and Croatia.

Affordable and key worker housing is an issue yet to be fully addressed in many major cities and it is rising up the political agenda. As a developer, solve this problem and potentially you've got it made.

Outlook

It remains to be seen how far Europe follows the U.S. into a highly segmented residential market, but the looming demographic shifts are there to see—greater numbers of households and an ageing population. First-movers into the evolving "seniors' housing" type markets should benefit from strong returns as the market matures and establishes itself as a niche. Masters of city infill, urban redevelopment/regeneration, and mixed-use developments will prove popular with the planners and satisfy the trend towards urban living.

While it is difficult to generalise, planning systems across Europe seem unable to cope with the latent demand for housing in places where people want to live and work. This simple supply/demand imbalance would suggest that values will continue to rise.

Prospects for Residential Real Estate in 2005				
	Prospects	Rating	Ranking	
Total Returns	Fair	5.4	4th	
Rent Increases	Fair	5.1	5th	
Capital Growth	Fair	5.4	3rd	
Supply/Demand Balance	Modestly Good	5.5	2nd	
Development	Modestly Good	5.9	1st	
Expected Prime Yield (median)	6.0%			
Investment Recommendation of Survey Respondents				
Buy 37.3%	Hold 25.4%	Sell 37.3%		
Source: Emerging Trends in Real Estate Europe 2005 survey.				

Aareal Financial Service

Karl Wilson

ABP Investments

Accura Advokataktieselskab

Henrik Groos

Allied Irish Bank

Michael Cooke

AP Fastigheter AB

Anders Ahlberg

Arlington Property Investors

Andrew Smith

ATIS Real Weatheralls

Keith Steventon

AXA IM

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Kiran Patel

Babis Vovos International

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Hypo International

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Invesco Real Estate

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Emerging Trends in Real Estate® Europe 2005

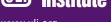
What are the best bets for real estate investment and development in 2005? Based on personal interviews with and surveys from more than 250 of the most influential leaders in the real estate industry, this forecast will give you the heads-up on where to invest, what to develop, which markets are hot, and how the economy and trends in capital flows will affect real estate. A joint undertaking of PricewaterhouseCoopers and the Urban Land Institute, this second edition of *Emerging Trends in Real Estate® Europe* is the forecast you can count on for no-nonsense, expert advice.

Highlights

- Reports how the economy and concerns about job growth are affecting real estate.
- Describes trends in the capital markets, including sources and flows of equity and debt capital.
- Tells you what to expect and where the best opportunities are for both investment and development.
- Assesses real estate prospects and opportunities in 27 European cities.
- Discusses which metropolitan areas offer the most and least potential.
- Features detailed analysis and prospects for office, retail, industrial, hotel, and residential property sectors.
- Explains which property sectors offer opportunities and which to avoid.



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