2006

Emerging Trends in Real Estate® Europe

Urban Land Institute

PricewaterhouseCoopers

Emerging Trends in Real Estate® Europe 2006

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Emerging Trends *in* Real Estate® Europe 2006

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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 third 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 represents a consensus outlook for the future and reflects the views of more than 300 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 150 individuals, and survey responses were received from 157 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.

Executive Summary

■ Market opinion is both divided and undecided as to whether we are in a period of structural change in the equilibrium value of real estate or in the thrall of "irrational exuberance." The major challenge in 2006 is to negotiate the imbalance between investable funds and available assets without moving pricing to a dangerously unsustainable level.

■ Sentiment is hugely weighted to the "buy" side. Even the lowest-ranked city markets have much higher "hold" recommendations than "sell." A vocal minority of those surveyed believe this is indicative of a market nearing its peak. However, there are a few who firmly believe that we are in a market bubble that will burst in the next 12 months.

■ There is an increasing consensus that real estate has been repositioned as an asset class. This contention is supported by the continuing increase in strategic institutional target weightings in real estate. Private equity, venture capital, and hedge funds that invest in real estate–related assets are all now the recipients of increasing percentages of institutional allocations in addition to core investments.

■ The German open-ended funds are in deep trouble and will be the only source of equity not expanding in 2006. According to official figures, they experienced €3.43 billion outflows in 2005, €3.05 billion of these in December alone as fear left investors running for the exit doors following the freezing of one of the largest funds. A general loss of confidence has taken hold and the funds currently face potential regulatory changes from both within the industry and from the German federal government. The only ray of light is the timely explosion of international interest in German real estate that could bolster the value of the funds' holdings. The increase in cross-border traffic hunting for German assets is one of the most significant changes highlighted by our survey and interviews since a year ago.

■ The nonlisted vehicles sector is experiencing growing pains. The number of investors now wishing to get into funds has created waiting lists for some funds. In addition, many large institutions are questioning the utility of investing in closed-end funds when the biggest problem they face is reinvestment risk. The new "flavour du jour" is the institutional open-ended fund, which has no expiration date. Despite the current problems, indirect investment is still deemed the most efficient route to cross-border investment for the majority of investors.

■ Listed real estate in Europe will receive continued firm support in 2006. There is growth in global investor interest and European institutions have huge sums to put into the listed real estate sector if more tax-transparent REIT vehicles become available. French SIICs will expand markedly in 2006 as more corporates sell their property assets into the sector. REIT legislation has been proposed in the U.K. that would come into effect in January 2007, but crucial details have yet to be disclosed. The German government has also committed itself to introducing a G-REIT, but the vehicle may not be tax transparent.

■ The past year saw the emergence of a real estate derivatives market in the U.K. The range of potential transaction types is already on the rise because established derivatives professionals who are familiar with how quickly these markets can grow are keen to develop the market. The world's largest interdealer broker has expressed intent and another major international interdealer broker has partnered with an international real estate advisory group to create over-the-counter (OTC) property derivatives for both U.K. and continental commercial property. In addition, at least three major international banks have committed themselves to the market.

■ Growing numbers of investors are now prepared to take development risk. Even speculative development is making a comeback. A significant number of investors are looking to team up with developers to get product for their portfolios.

■ The shortage of conventional real estate is forcing investors to look at a much broader range of assets than ever before. A huge array of investors are interested in gaining exposure to new areas such as nursing homes, retirement communities, student housing, self-storage, car parking facilities, pubs, recreational facilities, spas, resorts, entertainment complexes, condo-hotels, schools, hospitals, airports, and other infrastructure assets.

■ There will be a substantial increase in the availability of debt finance from all sources. Rising competition has sent margins on a downward trajectory and no one expects any relief this year. The investment banks engaged in securitisation are frequently cited as the major force behind increasingly aggressive pricing.

■ Substantial further growth in CMBS issuance is expected for 2006. This will be driven by rising numbers of conduit programmes, expanding appetite for CMBS on the part of a widening pool of investors from all over the world, and the fact that this is the cheapest form of real estate finance for many borrowers. B-note issuance will also grow because it enables CMBS arrangers to achieve better pricing on the senior or A-note of a securitisation. There is also a considerably expanded pool of dedicated mezzanine investors looking for B-notes.

■ The top markets for solid risk-adjusted returns will be Paris, London, Helsinki, Madrid, and Barcelona, in that order. Paris and London were in the top five last year, but Helsinki has risen from fifth place while last year's number two, Milan, has fallen well down the rankings. All the favoured markets have good prospects for rental growth.

■ The sustained downward shift in yields has sent many investors seeking higher returns out to new markets—most of them to the east. A surprisingly diverse set of investors is now looking at Romania and other nascent central and eastern European markets. However, the big movers are heading to the Far East and India because they offer investment opportunities in larger scale.

■ Istanbul and Moscow retain the top rankings for development prospects for the same reasons cited in last year's report. These are fast-growing economies with a shortage of modern high-quality assets, but the risks have to be carefully mitigated in any project.

■ The best sectors in which to invest will again be retail parks and shopping centres, but there are increasing concerns about a number of markets, so investors must be discerning. Hotels rise to third place from sixth in last year's survey, pointing to their increasing acceptance as a mainstream sector. In addition, they are beneficiaries of improving cyclical factors as well as the secular increase in intra-European leisure travel.

A Liquidity

Deals that might have attracted *two or three bids in the past are now attracting 30 or 50 or even more.*

Hurricane

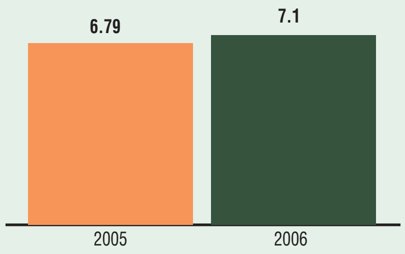
Europe's real estate markets enter 2006 at levels where investors are going to have to make some tough judgement calls. Are we in a period of fundamental change in the equilibrium value of real estate due to a "structural change in demand for the entire asset class"—or are we in the thrall of "irrational exuberance" that will "ultimately lead to overshooting" and "end in a train wreck"? The 2006 survey and interviews for *Emerging Trends* show that market opinion is both divided and undecided. But, if actions speak louder than words, then the escalating appetite for European real estate assets appears to show that the path of least resistance for now is to keep buying.

More Buyers Than Sellers by a Very Fat Margin

"The market has gone white-hot." "We're having to take on more and more risk for less and less return." "People are prepared to pay what would have been considered crazy yields only a year ago." These comments are heard across almost all of the major markets. Deals that might have attracted two or three bids in the past are now attracting 30 or 50 or even more. One investor said, "We lost an asset in Warsaw. If you added up the bids for that asset, it was more than the total invested in Poland in 2004." This type of bidding war accelerated yield compression in the final quarter of 2005, according to those interviewed, and the acceleration came on top of heady yield compression already documented in most of the major markets during the first three quarters of the year. "Has pricing gone too far?" "How do you price risk and what is an acceptable rate of return?" These are the questions in many investors' minds.

The presence of debt-driven buyers particularly challenges seasoned European real estate professionals. Bidding wars over prime assets—and even secondary assets—are so competitive that many investors who were formerly able to take out an asset when they really wanted it have been beaten by a wide margin in the past year, often to a debt-backed player with leverage in excess of 90 percent or even 95 percent. It is not uncommon to hear: "We bid on something and it went for a price that was our year-three exit value." The sceptics

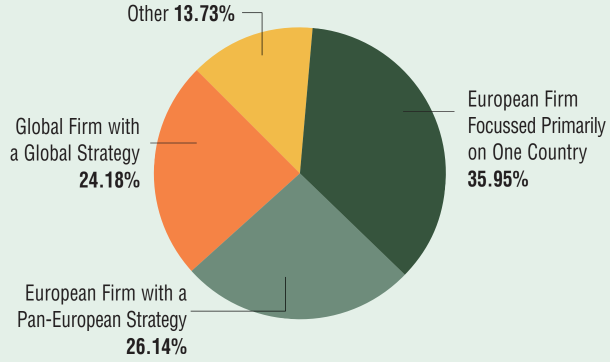
Exhibit 1-1 **Real Estate Firm Profitability Prospects**



Source: Emerging Trends in Real Estate Europe 2006 *survey.*

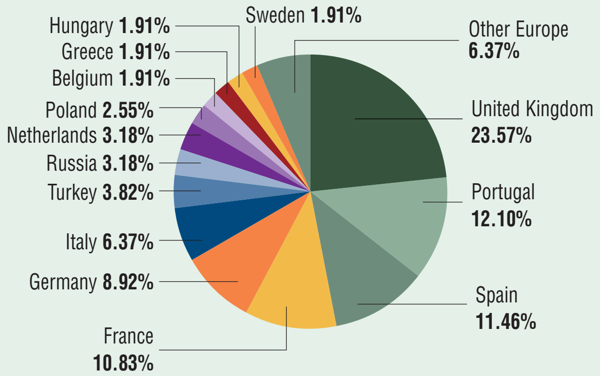
Note: 6 = modestly good, 7 = good, 8 = very good.

Exhibit 1-2 **Survey Responses by Geographic Scope of Firm**



Source: Emerging Trends in Real Estate Europe 2006 *survey.*

Exhibit 1-3 **Survey Responses by Country**



Source: Emerging Trends in Real Estate Europe 2006 *survey.*

are faced with a dilemma. Do they adjust their target returns downward or do they sit and wait for a correction that may not come? There are some—but not many—who are selling. "These things run in cycles. There's going to be disappointment in a few years because things like replacement cost eventually do matter." "We've lost sight of residual values at these levels." "People understand risk and return—but not at the same time. We won't have lower returns forever."

The decline in yields has to stop at some point, but few of those we interviewed believe that it is going to stop in 2006. The majority believe that there is simply too much money pouring into European real estate relative to the near-term supply of assets. "This is a liquidity hurricane." "Capital is coming out of every orifice." "New investors are popping up every day—U.S. investment banks, Middle Eastern petro dollars, Australian REITs, hedge funds, and deep pockets of private money from the Far East." At the same time, "It's a totally product-starved market and people who are potential sellers only do so because they think they can get an unbelievably good price." And of course, many of those who do sell then have the dilemma of getting the money back in the market.

The shortage of product has meant that turnover has not increased as much as it might have done in the past year and there are lots of disappointed buyers with cash awaiting deployment. Nevertheless, profits in 2005 were good and our current survey anticipates even better profit growth in 2006 (see Exhibit 1-1). Much of this optimism is based on the sheer weight of money coming into real estate, but there is some fundamental comfort, too. Occupier markets have stabilised in many major markets, vacancy has ceased its vertiginous increases, and in a few markets headline prime rents have even started to rise. However, for now the recovery is patchy. It is confined to particular pockets of the markets with the strongest economies rather than across the board. Moreover, most of the mainstream data do not reflect incentives such as rent-free periods and thus overstate yields. Nevertheless, there is some optimism that the worst may be over.

A look at our survey statistics on city markets reveals that in each city and major sector, sentiment is hugely weighted to the "buy" side. Even the lowest-ranked city markets have much higher "hold" recommendations than "sell," while the vast majority of recommendations on even middle-ranked markets are unequivocally "buy." This is not a market that is going to correct anytime soon in the judgement of most of our interviewees and those surveyed. However, a minority believe this is indicative of a market nearing its peak. Those who are most sceptical of current market conditions say that this is "just another cycle" and cap rates could correct as soon as the second half of 2006. They point in particular to the debt-driven buyers who "will disappear as soon as the arbitrage between borrowing rates and yields disappears." The funding rates for these players are determined by market-driven bond yields and swap rates that have been highly cyclical in the past. "Bond yields look dangerously low and a reversal in the fixed-income markets would send real estate pricing into a tailspin."

Inflation: Shifting to Lower Volatility

There are plenty of players in the real estate markets who would like nothing better than a nasty surprise increase in interest rates and bond yields just big enough to "get rid of the debt-driven buyers who are mucking up pricing." However, our interviews indicate that the majority of participants expect only marginal increases in Eurozone interest rates in 2006. Moreover, for the U.K., most expect another modest reduction in interest rates.

The fixed-income markets clearly back the real estate market's judgement. The swap and bond yield curves are indicating that the fixed-income markets expect both low inflation and a low volatility of inflation. As a result, they also expect low volatility in interest rates. They are certainly not discounting a big cyclical swing at present. The bottom line for real estate is that the current financial conditions driving real estate pricing are not expected to disappear anytime soon.

There is also an important trend in the "big picture" for bond markets that is influencing fixed-income pricing and, in turn, the pricing of real estate finance. The growing percentage of populations nearing retirement in most developed countries has increased the need for assets that will generate low-risk, long-term cash flows to fund pensions. As a result, the demand for long-maturity investment-grade bonds has increased dramatically. This has caused the yield differentials between medium-term bonds and riskier long-term bonds to diminish or, in some cases, to disappear entirely. At the extreme, there are markets such as the U.K. where the riskiest government bonds, the 30- and 50-year gilts, yield less than two-year gilts. If this sounds strangely familiar to real estate players, it is because their markets are being influenced by the same "big picture" trends. It also explains why long-term finance for real estate is so cheap.

A Repositioned Asset Class

While it is hard to find anyone who is not wary of pricing going forward, there are few—even among the sceptics—who firmly believe that we are in a market bubble that will burst in the next 12 months. "A pending disappointment" or "a slow deflation back to realistic levels after 2006" are more common expectations. For others, "current market levels potentially represent a new mean for values." What tempers pessimistic opinions and underpins the beliefs of the optimists is the increasing consensus that real estate has been repositioned as an asset class. This contention is supported by the continuing increase in strategic (i.e., long-term) institutional weightings in real estate.

"The pension funds are back because they 'lost the ranch' in equities" is the sceptical view of the current institutional enthusiasm for real estate. While there is a kernel of truth here, it ignores demographic trends and the changes in the way pension fund liabilities are accounted for in corporate balance sheets, which are the major drivers of renewed appetite for cash-generating assets. The principal force behind the twin shift to higher fixed-income and real estate weightings in institutional portfolios is the ageing populations in the majority of European countries and the need to fund their pensions with long-duration, low-volatility assets that generate reliable cash flows. Real estate now "fits the bill" in a way it could not even a mere five years ago.

Until recently, the absence of reliable statistical information on most real estate markets handicapped the entire asset class as far as institutional investors were concerned. The lack of robust long-term statistics on performance and the resulting inability to analyse the risk-return characteristics of real estate with confidence meant one could not do meaningful comparisons with equities and bonds. This is all changing with the increase in the number of reliable indices and the rising turnover in real estate assets. "The tool kit is now getting there for real estate in the way it has been there for other asset classes." The institutions and their consultants are getting more of the information they need to justify higher exposure, and the improvement is set to continue in 2006. Moreover, this information gap is declining in tandem with a rise in liquidity. Since portfolio theory—which underpins institutional investment models—dictates that increasing information and liquidity will drive down risk premiums, at least some of the reduction in yields we are witnessing makes perfect sense. "The new equilibrium value for the market—whatever it turns out to be—will be higher than it was when liquidity was low and markets were opaque."

Growth Is Picking Up—But Not by Much

Economic growth forecasts for the Eurozone in 2006 are actually being revised upward at the time of writing, which is a welcome contrast to what was happening a year ago. While no one is expecting to see strong gross domestic product (GDP) growth in the Eurozone, the anticipated increase to around 1.7 percent or perhaps even a bit higher for the area as a whole provides some much-needed underpinning for occupier markets.

Germany in particular has seen some surprisingly positive surveys on business confidence and business conditions. As the largest economy in the Eurozone, a somewhat healthier growth rate in Germany bodes well for the rest of the region. However, almost all of Germany's growth is export led, thanks to a weaker euro exchange rate and strong GDP growth outside of Europe. This is feeding healthier corporate profits—but so are negotiated wage cuts, outsourcing, and mass redundancies. As a result, consumer spending remains weak and employment growth is not evident, so the picture is hardly one of unalloyed cheer. Although consumer confidence and retail sales started to rise in the autumn of 2005, they were still below their year-earlier levels. Also, the retail sales pick-up may have been due to fears that the new coalition government in Germany would raise the value-added tax (VAT) rate this year. In the end, the government postponed the VAT rise until 2007 and this will push forward some welcome consumer spending into 2006. But, it also holds the danger that 2007 will see recovery go into reverse before it really gathers momentum.

Nevertheless, there is currently an explosion of international interest in German real estate based on the assumption that the bottom of the cycle has been reached. This is one of the biggest changes highlighted by our survey and interviews since a year ago. Investors from all over the world are combing Germany for assets. At the same time, German investors are focussed on diversifying out of their home market and happy to sell if a fat price can be achieved. This sudden stampede into what is, ironically, one of the most opaque and fragmented markets in Europe has prevented the distressed selling that many had anticipated. On the contrary, competition for assets has been fierce and information is so patchy that "pricing is all over the place." One thwarted investor observed, "We have occasionally been beaten by 10 or 15 percent in other countries, but in Germany we were beaten by a 100 percent in several situations!" In fact, "The only common denominator on Germany is total confusion."

Elsewhere in the Eurozone, France and Italy are also seeing stronger data for both the business and consumer sectors and guarded optimism is mounting for 2006. The pick-up in France is expected to be modest and will take growth to the Eurozone average, while Italy has glimmerings of hope that it will overcome the stagnation of the past year and return to growth, albeit subpar in comparison with the rest of the E.U. Little more can be expected because political leadership is lacking and Italy's structural problems will not be confronted until after the elections that take place this year. Likewise, the policy initiatives needed in France are unlikely to be seen until after the next elections there, which don't take place until 2007.

Exhibit 1-4 **European Economic Growth: Consensus Forecasts**

	Percentage Real GDP Growth			
	2003	2004	*2005	*2006
Russia	7.3	7.2	5.9	5.7
Turkey	5.8	8.9	5.1	5.0
Ireland	4.4	4.5	4.7	4.6
Czech Republic	3.2	4.4	4.8	4.3
Poland	3.8	5.4	3.2	4.3
Hungary	3.4	4.6	3.9	4.0
Spain	3.0	3.1	3.3	3.1
Greece	4.6	4.7	3.2	2.9
Sweden	1.6	3.1	2.5	2.9
Finland	2.4	3.5	2.1	2.9
Denmark	0.6	2.1	2.4	2.2
United Kingdom	2.5	3.2	1.8	2.2
Austria	1.4	2.4	1.9	2.1
France	0.9	2.1	1.6	1.8
Belgium	1.3	2.7	1.4	1.8
Netherlands	-0.1	1.7	0.6	1.8
Switzerland	-0.3	2.1	1.2	1.7
Portugal	-1.2	1.2	0.9	1.4
Germany	-0.2	1.6	0.8	1.2
Italy	0.4	1.0	0.1	1.2
Eurozone	**0.7**	**1.8**	**1.3**	**1.7**

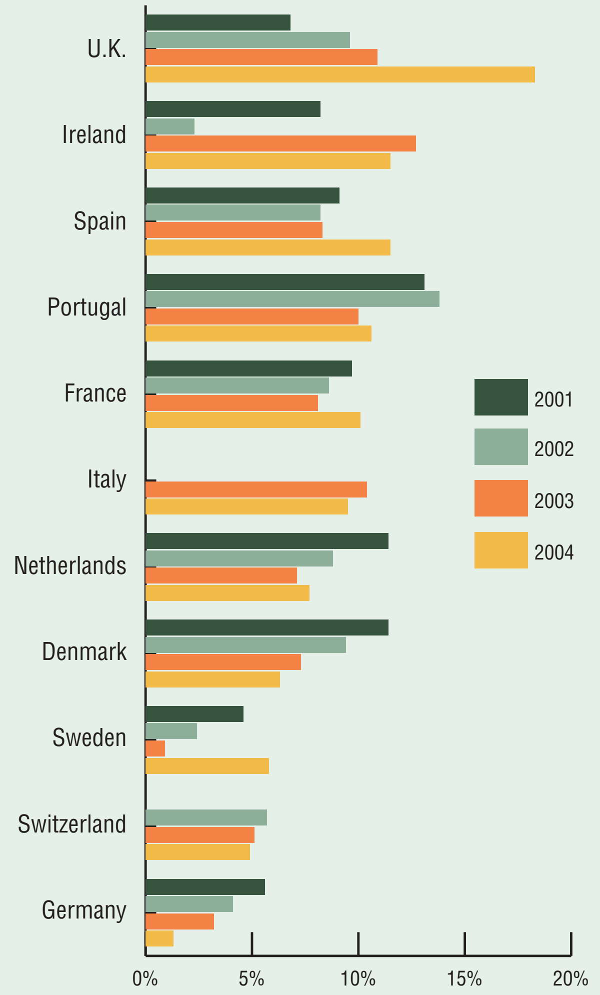
Source: Consensus Economics Inc. (www.consensuseconomics.com) November 2005.

** Projections.*

The Benelux countries are all forecast to achieve higher growth on the back of the uptick in German activity, but whether this will be sufficient to generate stronger occupier markets this year is open to question. Once again, the strongest growth is expected in the periphery of the Eurozone, i.e., Spain, Finland, and Ireland, and this is reflected in the enthusiasm for these markets in our survey, despite market pricing that a number of those interviewed regarded with discomfort.

Growth rates are expected to be relatively stronger outside the Eurozone, as was the case in 2005. The Nordic region is likely to maintain firm if unspectacular growth, with Sweden experiencing a pick-up to 2.9 percent thanks to the low interest rates that were maintained throughout 2005. However, this will not bump up occupier demand sufficiently to eradicate an office vacancy rate in Stockholm that exceeds 17 percent. The U.K. is expected to recover modestly from its disappointing performance in 2005 thanks to easier monetary policy, although the forecast 2.2 percent GDP growth rate is well below the 3.2 percent achieved in 2004. Consumers' reluctance to take on more debt is one cause of the slower growth and this is hitting U.K. retailers. However, occupier *it did at the start of 2005.*

Exhibit 1-5 **Real Estate Total Returns for Selected Countries**



Sources: Investment Property Databank (IPD), KTI Finland.

Note: In local currencies. Figures for 2005 are available for Ireland and the U.K. only. Ireland provided 19.6 percent total returns for the 12 months ending in September 2005, and the U.K. provided 17.5 percent total returns for the 12 months ending in October 2005.

demand for the important London West End and City office markets has already turned the corner.

Once again, top E.U. growth honours go to the new accession countries. Poland, Hungary, and the Czech Republic are all expected to grow at rates in excess of 4 percent, with inflation remaining well contained despite higher energy prices. These economies have very close trading ties with Germany, so they will benefit from the increased activity in Europe's core economy as well as from firm domestic demand driven by consumption and investment growth. Foreign direct investment continues to pour into all three countries and that bodes well for the long-term future of today's real estate investments.

However, the highest growth rates for the markets covered in this report are again to be found well outside of the E.U. Russia's oil- and commodity-fuelled economy will continue to benefit from the consumer boom that is being fed by rising incomes, falling unemployment rates, and the increasing availability of credit. Investment appears to be picking up now, too, so GDP growth is likely to be more balanced in 2006 than last year, although inflation will remain a problem. The outlook for the Turkish economy is equally impressive. Turkey is expected to achieve another year of firm growth combined with falling inflation. This should allow the monetary authorities to cut interest rates further, which will provide a boost to the new retail and commercial mortgage markets. Turkey's E.U. accession talks have started, and while the process is expected to take at least a decade, it is providing a genuine spur to economic stabilisation efforts.

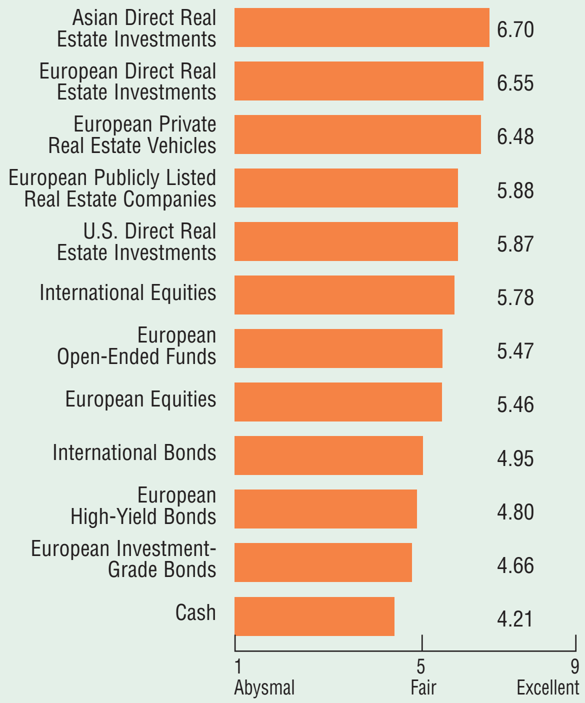
All in all, the economic picture looks a good bit rosier for Europe's occupier markets this year than it did at the start of 2005. What worries real estate investors is that an external event that no one has foreseen will suddenly materialise to "upset the applecart." "It's often a bolt from the blue that turns things upside down." "The thing to worry about is the disruptive event that you can't predict." Some of those interviewed expressed concerns about bird flu crippling the business environment. One interviewee noted, "I was in Toronto during the SARS outbreak and you could have shot a cannon down the main thoroughfares." "If bird flu turns into a human pandemic, all bets are off." Still, as another player put it, "The markets have already had everything you can imagine thrown at them—wars, terrorist attacks, tsunamis, earthquakes, hurricanes . . . and we still have more investors coming in."

Returns Still Attractive Relative to Other Asset Classes

Our survey indicates that investment prospects for 2006 have improved for both real estate and equities relative to a year ago. Surprisingly, those surveyed still believe that real estate has the best outlook relative to other asset classes despite the phenomenal performance of the past year. Asian real estate tops the charts for the second year running, but European direct real estate investment and European private vehicles are not far behind. The laggard is U.S. real estate, which may explain why so many U.S. investors are now hunting around Europe and Asia. Our sister publication on the U.S. real estate market shows that sentiment on the other side of the Atlantic has moved hugely to the "sell" side, while our European survey is overwhelmingly weighted to the "buy" side.

"There is no way you can get **large amounts** *of money into this* **market**

Exhibit 1-6 **Investment Prospects by Asset Class for 2006**



Source: Emerging Trends in Real Estate Europe 2006 *survey.*

The outlook for Europe's publicly listed real estate companies is even perkier than the outlook for the wider European equity market, according to those surveyed. This optimism might be due to enthusiasm about the introduction of REIT legislation in the U.K. (although there will be no U.K. REITs before 2007) and the expansion of the SIIC (French REIT) sector in France.

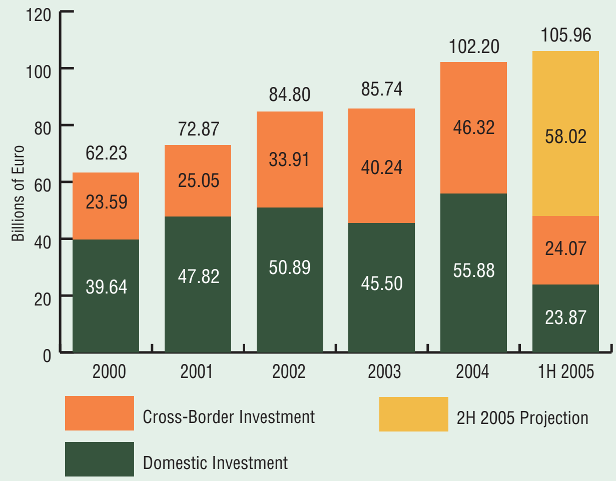
Once again, prospects for bonds are deemed to be unexciting, which is not surprising given the low level that yields have been chased to. Meanwhile, cash comes in at the bottom of our survey, which is consistent with the view that big interest rate rises are not in the cards for 2006.

Pan-European Investment: the Flexible Friend

Pan-European investment will continue to expand in 2006. The usual motivations of diversification and the potential to make higher returns than those available in one's home market remain. But, on top of this, the flood of money coming in and the increase in competition that accompanies it mean the big players need more options in order to merely acquire sufficient assets. "There is no way you can get large amounts of money into this market without being pan-European." "You can't focus too narrowly; you have to be flexible."

Cross-border investment grew 27 percent during the first half of 2005 in comparison with the same period a year earlier, according to Jones Lang LaSalle, and there is no reason to expect growth will slow in 2006. "Cross-border is an unstoppable trend." This growth is not due to government initiatives at the European level to foster cross-border investment since there have not been any. In fact, quite the opposite is occurring. "There's no hope of E.U. harmonisation." "Property law and tax law will be the last bastions of sovereignty since it's more or less impossible to harmonise legislation." What has continued to evolve is transparency and the efficiency of service providers such as lawyers, accountants, and agents. "The more you do things, the more efficient everybody gets." "The tax side remains a challenge, but not a barrier."

Exhibit 1-7 **European Direct Real Estate Investment**

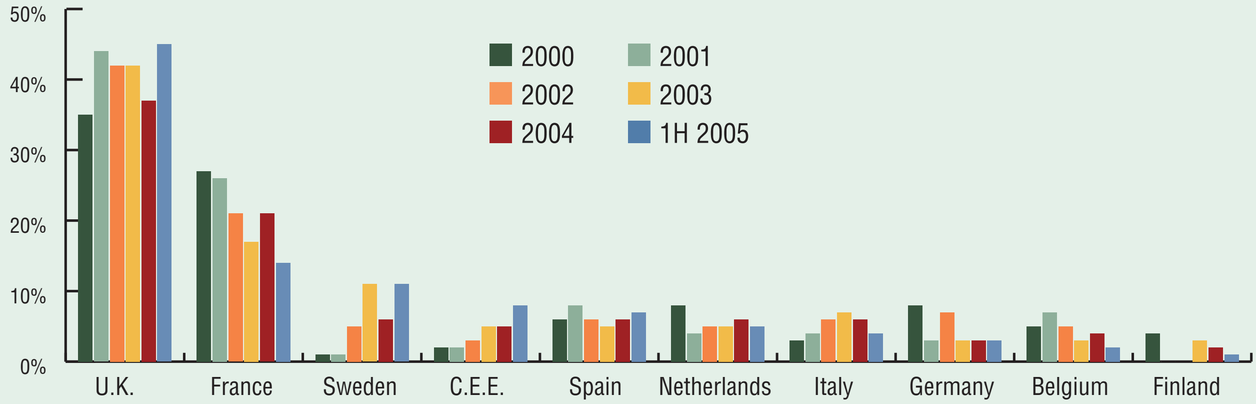


Source: Jones Lang LaSalle European Research.

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

Legal experts are working hard to try to find holding structures that could enable investors from anywhere to invest at the top level of a fund of funds, but this legal Valhalla has not been discovered yet. So, for the present, building a pan-European portfolio remains the cumbersome bespoke task of stringing together properties in a myriad of special-purpose vehicles under the umbrella of an appropriately domiciled holding company (usually in Luxembourg). On the plus side,

Exhibit 1-8 **Cross-Border Real Estate Investment Activity by Country**



Source: Jones Lang LaSalle.

a degree of standardisation has crept in among the big law firms that has somewhat reduced the time and expense involved. Documentation is now often done in English with an Anglo-Saxon model for leases. However, a pan-European portfolio remains a much more expensive beast to assemble than its single-country equivalent. For many, the level of expense and complexity is daunting—and this is assuming that you have somehow managed to obtain the assets.

For the majority of investors, a local office or a local partner is still needed if one is to have any hope of success in accessing product, even in core markets. As to markets outside the core, "they remain fragmented and lack transparency, which is a huge barrier to doing business unless you partner with someone local." "Real estate is, and always will be, a local business." "You have to team up with a long-term local partner who knows the hidden rules." Ironically, as cross-border investment grows, so does demand for trustworthy expert locals, and the difficulty in finding or retaining them is frequently mentioned. Some local experts who used to work as operating partners with international investors are becoming fund managers themselves as they see more lucrative opportunities to capitalise on their expertise through going it alone with their own fund.

Indirect Investment Gets Growing Pains

The financial and human resources, critical mass, and local expertise required for pan-European investment continue to push a significant number of those who wish to diversify across borders into indirect investment. Both listed funds and private vehicles continue to multiply and attract new adherents. They are available in every style, sector, and geographical region. Some are diversified and others are specialised. Investing indirectly neatly circumvents many of the obstacles faced by those who wish to go cross-border, making them the preferred route for all but the largest institutions. However, they are not without their problems at present.

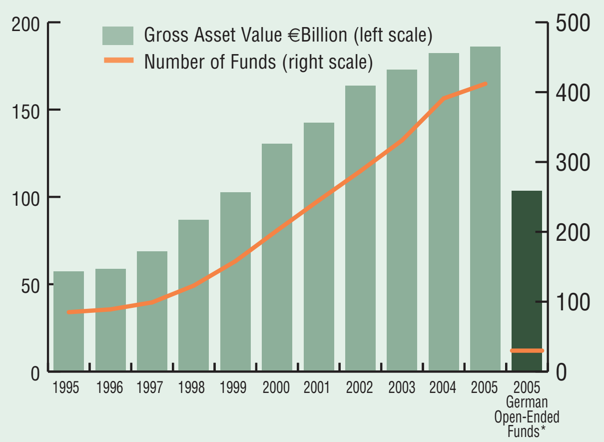
The number of investors now wishing to get into funds has created a veritable logjam that is likely to persist well beyond 2006. Many of the vehicle managers we interviewed said that they had long waiting lists to get into their funds even after accepting double the amounts they had initially hoped to attract. "People are now deliberately oversubscribing for funds because they know they're going to be cut back." "Raising money isn't the problem—investing it is the problem." "Not everyone who has raised money will be able to get it all in the market." More than one client institution admitted, "We assume a certain percentage of the funds in these vehicles will never get invested."

The difficulty of getting money into the market has possibly been responsible for fewer (albeit larger) funds being launched during the first three quarters of 2005, according to INREV. This is a considerable change from the past eight years in which relentless growth in the number of new funds was witnessed in the INREV universe. Another change in trend is occurring in fees. These had previously been declining for several years due to competitive pressures, but fees are now on the rise as experienced fund managers capitalise on increasing demand for their services. Of course, "track record is what you pay for and it is by far the most important factor in fund selection." Also, under current market conditions greater effort is required by fund managers to achieve the desired returns. However, it remains to be seen whether managers can deliver returns in more difficult markets. These funds did not exist at the time of the last market cycle.

Along with rising fees, investors are observing a weakening in covenants in favour of the fund managers. Technical points such as default clauses, exclusivity, and termination rights are critical to some institutions, and several long-term participants in the indirect market are now turning back toward doing more direct investment with local joint venture partners due to the deterioration in covenants. In addition, many large institutions are questioning the utility of investing in closed-end funds when the biggest problem they face is reinvestment risk. "What good is a fund that matures and returns my money after seven years when I can't even get to my target weighting?" In response to the latter problem, the new "flavour du jour" is the institutional open-ended fund that has no expiration date. Several of these have already been launched and more are expected in 2006.

Despite the current problems, indirect investment is still the most efficient route to cross-border investment for the majority of investors. There are more systematic data on funds, and this will continue to improve during 2006 with initiatives from organisations such as INREV and IPD. There

Exhibit 1-9 **Growth of Private Property Vehicles in Europe**



Sources: Investors in Non-listed Real Estate Vehicles (INREV), Investment Property Databank (IPD), November 2005.

** Note: Total number of vehicles including German open-ended funds equals 442 funds.*

is also growth in the number of "fund of funds" on offer and these are attractive to those seeking to have diversification of their holdings done by specialists in this area, albeit at a price. And for those who want "hands-on" exposure, the closed-end unlisted vehicles are a good compromise because "the investors are closer to the properties and the managers than they could possibly be with a listed investment."

You Can Get It if You Really Want—but at What Price?

The past two years have seen investors forced relentlessly up the risk curve in order to meet promised internal rates of return (IRRs). Vacant assets, short-lease properties, and buildings in need of major refurbishment are now sought after. The logic is: "You want assets where you can add to the income stream to mitigate your risk." As a result, many of those we spoke to observed that secondary yields have compressed even further than prime in the past year. "There's a hint of madness at this point. Buyers are getting less rational." "One day, these people are going to wake up and say, 'What do I own all this junk for?' The risk-adjusted returns are now considerably higher for prime assets than for secondary."

Reputedly, some deals are being done just to get money into the market. In some cases, this is a cynical move to trigger the fund manager's fee structure, but for others there is genuine pressure to get real estate exposure rather than sit on low-yielding cash. More investors are moving out to cities they never considered before where liquidity is lower and the risk of being stuck with an empty building if the existing tenant leaves is much higher. Some claim this might be more rational than it appears at first glance if there is a permanent increase in liquidity, "but who knows if the interest in these markets will stick." Some make the argument that smaller cities have higher risk-adjusted returns than major markets because both prices and volatility are lower. Marseilles, Valencia, Zaragoza, Cologne, and Dusseldorf are most frequently cited as new investment targets, but there are many others.

"Nothing is easy out there right now," so people are trying to get creative about sourcing product. In a retrograde step, more investors are attempting to do off-market transactions in order to escape the auction process. However, it is usually in the seller's interest to enjoy the fruits of a transparent market, so off-market deals can be full of angles. "Off-market you might pay less, but these deals are usually smaller—and of course you can get shafted." As one investor observed, "The challenge right now is to resist the temptation to rationalise others' irrational behaviour."

Development Is Back on the Menu

One of the most notable changes from last year is the growing number of investors now prepared to take development risk. The thirst for high-quality assets has pushed even core investors in this direction. In some markets such as the central European cities and the less developed markets, it is virtually the only way to obtain high-quality product. Elsewhere, development is seen as the best way to avoid overpaying for standing assets.

Speculative development is making a comeback and this has some investors running scared. "The new pipeline could come in too early and choke off the rent recovery before it gets going." Others insist that the average quality of existing stock is too low and new development is badly needed. "We should be tearing down the rubbish and replacing it with working environments that people really want." The proponents of sustainability tend to support this contention.

The Universe Is Expanding—Even Core Investors Are Going Niche

The shortage of conventional real estate is forcing investors to look at a much broader range of assets than ever before. As a result, the investment universe is well and truly expanding. Even venerable institutions that were once synonymous with core investment are focussing on assets that would not have been considered real estate a few years ago. Hotels—once a niche sector—are now considered mainstream. And a huge array of investors are interested in gaining exposure to new areas such as nursing homes, retirement communities, student housing, self-storage, car parking facilities, pubs, recreational facilities, spas, resorts, entertainment complexes, condo-hotels, schools, hospitals, airports . . . you name it. As one investor put it, "If it's nailed to the ground, we'll look at it."

Many of these niches fall within the ambit of what is called "opco-propco" (short for operating company–property company), which used to be territory dominated by venture capital, private equity players, and hedge funds. Given their presence, these niches are not short of competition when the bidding starts. However, the real estate investors tend to split the deals into two separate businesses, the operating company and the property company, and the latter can usually be financed more cheaply than the finance on offer for the company as a whole. This often gives real estate bidders an edge.

Mixed Use Moves Up the Agenda

The hunt for investment possibilities has also begun to increase acceptance of mixed-use schemes, although the majority remain wary. "Mixed use is riskier because there are more pieces to go wrong." "In the U.S., they say that for every successful piece of retail in a mixed-use scheme there is a bust hotel." While more investors accept that this is the kind of development many governments want—which means it is the kind of product that will be increasingly on offer—they require higher returns for the additional complexity. Many do not want the residential exposure that is typically part of such schemes. Even the proponents are alert to the problems posed. "I love the concept because people want the convenience that mixed use offers. The problem is the tenants hate each other."

Since most urban regeneration schemes are mixed-use ones, the problems noted above need to be dealt with carefully in order to achieve support. At present, there is a lot of scepticism about planning authorities' ability to get it right. Nevertheless, there is increasing openness to well-designed developments with strong input and backing from the private sector.

Wanted: Corporate and Government Assets

Once again, there are hopes that the relentless rise in capital values will finally trigger corporate entities and owner-occupiers to release a substantial slug of property into the investment market. So far, this long-predicted trend has not materialised in anything approximating the size anticipated. "At some point, more corporations are going to want to capitalise on the generous prices they can obtain for their real estate assets. It's only a matter of time." In fairness, there has been "an upward creep" in the number of sale and leaseback deals done voluntarily (in addition to the usual distress selling), but, on the whole, owner-occupiers are not queuing up to sell.

Perhaps more interesting is the rising number of sale and leaseback deals that are being proactively initiated by investors. Disillusioned with wasting millions of euros on due diligence for unsuccessful bids, many investors are trying to source deals themselves. In some cases, they or their agents are actively approaching owner-occupiers or corporate owners in order to initiate sale and leaseback deals. Occasionally,

Infrastructure *is gaining increasing profile among asset-starved real estate investors in*

investors are even sourcing new premises for the former owner-occupiers to move to so that they can reposition the assets they acquire. Some buyers even offer a piece of the leveraged upside to the seller to induce them to sell.

Governments are also starting to help free up corporate assets through legislation that lowers the capital gains tax payable when assets are sold. The French SIIC III legislation announced at the end of 2005 might lead the way, enabling corporate sales for cash to these REIT-type vehicles at reduced tax rates (previously, sellers were only allowed payment in shares). German G-REIT legislation is expected to contain similar tax concessions and Italy is considering giving substantial capital gains tax concessions for corporate real estate sales without any tie to a REIT. Given that well over 70 percent of commercial property in Europe is still in the hands of owner-occupiers, there is a lot of potential to increase the institutional stock if tax systems foster such transactions.

Where central governments show fewer signs of helpfulness is in privatising state-owned properties. Many previously mooted programs have simply been put on hold. There is little prospect that 2006 will see any major initiatives in this sphere, although a trickle of sales will probably continue in the majority of European countries. The most high-profile privatisations have been in Germany at the *Länder* and city level with the sell-off of huge residential portfolios. These will no doubt continue as long as the financial arbitrage driving them remains to be exploited and the prices paid purportedly exceed the wildest expectations of the vendors.

Infrastructure Gets a New Fan Club

One area where governments are planning an important release of assets is infrastructure. Many fixed-income investors have already discovered the attractive attributes of bonds issued in connection with public/private partnership (PPP) financed projects. They have long duration, relatively high cash flow (often linked to inflation), and low correlation with equities and other types of bonds. In short, the risk-return profile is very much akin to that of real estate.

Infrastructure is gaining increasing profile among asset-starved real estate investors in Europe and is already an accepted extension of the real estate universe for those in the vanguard. "In a world with a wider definition of what is considered real estate, infrastructure makes sense." "Reservoirs, tunnels, toll roads, [and] bridges can all deliver strong long-term cash flows with good residual values." Germany, France, Spain, Poland, Sweden, Greece, and the U.K. all have PPP initiatives or ongoing programmes. Expect to see more real estate investors gain exposure.

Sustainability Issues Barely Surface

Awareness of E.U. sustainability legislation has a long way to go if our survey and interviews are anything to judge by. A significant proportion knew little and cared less about the issue. "Sustainability is just a slogan." "A sustainable building is just a good building in a good location." "Sustainability is just an additional layer of cost for developers." Agents do not believe that tenants care enough about energy efficiency to pay more for a sustainable building (although some corporate premises managers might disagree). Likewise, investors tend to believe that overall good design is more important.

Like it or not, the issue of a building's compliance with sustainability requirements will rise up the agenda in the future. It could shorten the life cycle of many existing assets and alter the relative merits of refurbishment versus building new. In theory, it should also hit the relative pricing of assets, with sustainable products attracting higher prices. However, for the present, E.U. governments need to raise awareness of sustainability legislation because it appears to be woefully lacking.

Going East for Opportunity

The sustained downward shift in yields across most of the markets covered by this report has sent many investors seeking higher returns out to new markets—most of them to the east. A year or more ago, some opportunistic investors headed for the countries that will make up the next wave of E.U. entrants. They are now being followed by a surprisingly diverse set of investors, including a few that were once on the conservative end of the investment spectrum. In this regard, Romania is the most-often mentioned because it is relatively

Europe and is already an accepted extension of the real estate universe for those in the vanguard.

large and Bucharest is thought to have the potential to achieve a transformation similar to that seen in Warsaw, Budapest, and Prague. At present, the assets are few, the legal and title risks are myriad, and there is a distinct gap in market professionalism, but none of this has deterred investors or stifled hefty yield compression.

Other central and eastern European markets attracting interest are the main cities in Slovenia, Bulgaria, Croatia, the Ukraine, and a great many secondary cities in Poland, the Czech Republic, and Russia. These markets will no doubt become more interesting to a broader spectrum of investors as new development and refurbishment enhance their built environment. However, the amount of investment they can absorb at present is limited. The big movers are heading to the Far East and India, where rapid growth and big, expanding urban populations offer opportunities in larger scale. This may take a brick or two out of the "wall of money" trying to get into European markets, but it's unlikely to bring that wall down. The major challenge for European real estate markets in 2006 is to negotiate the imbalance between investable funds and available assets without moving pricing to a dangerously unsustainable level.

Real Estate

There is thwarted *capital hunting everywhere.*

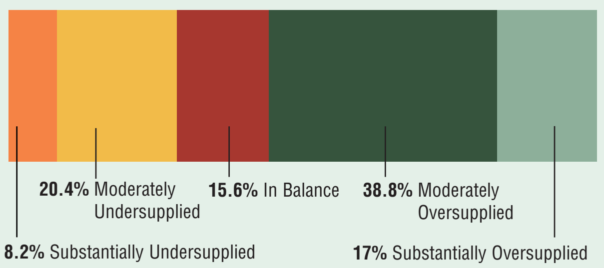
Capital Markets

The one thing Europe's real estate investment markets are not short of is capital. "If you have an asset with an income stream to sell, there are 50 people queuing up to take it off you." In most markets, the ample funding of a few years ago has given way to surfeit. Indeed, the excess of capital given the shortage of investment stock is seen as one of the most serious problems facing investors over the coming year. Nearly 56 percent of those surveyed think that capital will be either moderately or substantially oversupplied in 2006 and the availability of both debt and equity capital will continue to increase relative to last year.

However, a significant minority—nearly 29 percent—think that capital will be moderately or substantially undersupplied during the same period. This result appears to be contradictory, but it is not. Capital shortage is the stark reality for small- to medium-sized developers who depend on debt finance. There is now little appetite for lending to developers unless they have a prelet or presold project because the capital requirement to back lending for speculative development is so onerous under the rules for Basel II.

The European Parliament approved the Capital Requirements Directive—the law that makes the Basel II bank capital adequacy rules obligatory throughout the E.U.—in September 2005. Thus, those banks that are planning to use the "Foundation Internal Ratings Based" (IRB) approach under

Exhibit 2-1 **Real Estate Capital Market Balance Prospects for 2006**



Source: Emerging Trends in Real Estate Europe 2006 *survey.*

the new rules are now doing a final year of "parallel running" of systems before the full move to Basel II at the end of 2006. Those banks that have elected to use the more sophisticated "Advanced IRB" approach will do parallel running until the end of 2007. Regardless of which system banks have chosen, speculative development lending is now very costly in terms of the capital that needs to be committed, and the Basel II

The German **open-ended** *fund industry is in grave trouble.*

regime is designed to make sure that there will be less of it. There are good reasons for this stern approach, since imprudent lending for development has caused the majority of banking crises over the past 40 years. However, that is cold comfort for the developers struggling to obtain debt finance. Speculative development now requires plenty of equity and a very good business plan to get backing from one's bankers.

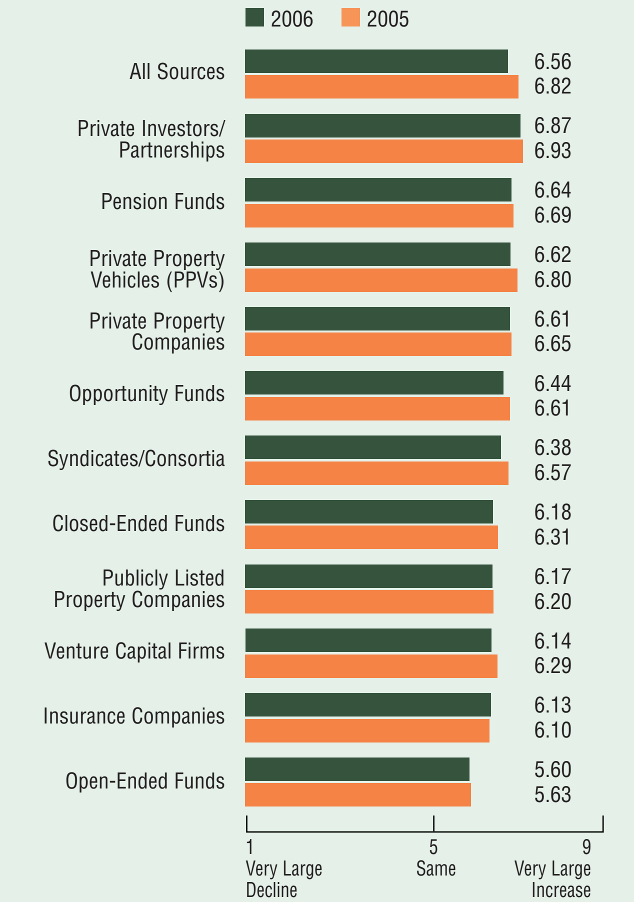
A mere 15.6 percent of those we surveyed believe that the capital markets will be in balance this year. Small wonder, then, that investors with significant funds to deploy are looking to team up with developers to get product for their portfolios. We'll see a lot more of this in the next few years.

Capital Trends: Equity

"There is thwarted capital hunting everywhere" and it is coming from every conceivable corner of the world. More capital came into the markets last year than anyone anticipated and there is no letup in sight. Increasing investment flows are expected from all over Europe, but they will be met with stiff competition from Middle Eastern, North American, Asian, and Australian money. "An Australian pension fund would not have thought of investing in the E.U. ten years ago. Now they're everywhere." "Oil money from the Middle East will make an even bigger impact this year—and we'll see Russian petro dollars, too." "The full force of Asian money has not been seen yet and the impact will be big." "There are rivers of capital pouring in from the U.S.—investment banks and all kinds of funds with massive institutional backers."

Our survey predicts that we will see more capital from every type of investor. To the dismay of the professionals, private investors and private partnerships top the table for projected increases in activity. Some players are nervously wondering whether real estate is going through something reminiscent of the dot.com boom. "Even taxi drivers are now talking about real estate." Almost all of the usual sources of equity will be expanding—most importantly, the pension funds. But in addition, there may be more capital committed by the new entrants first seen in 2005, the hedge funds. The only source of equity where a question mark looms is the German open-ended funds, where "event risk" has once again sent shock waves across the industry. This time, the problem arose so late in the year (mid-December 2005) that our survey does not reflect the unwelcome developments.

Exhibit 2-2 **Change in Availability of Equity Capital for Real Estate by Source Type**

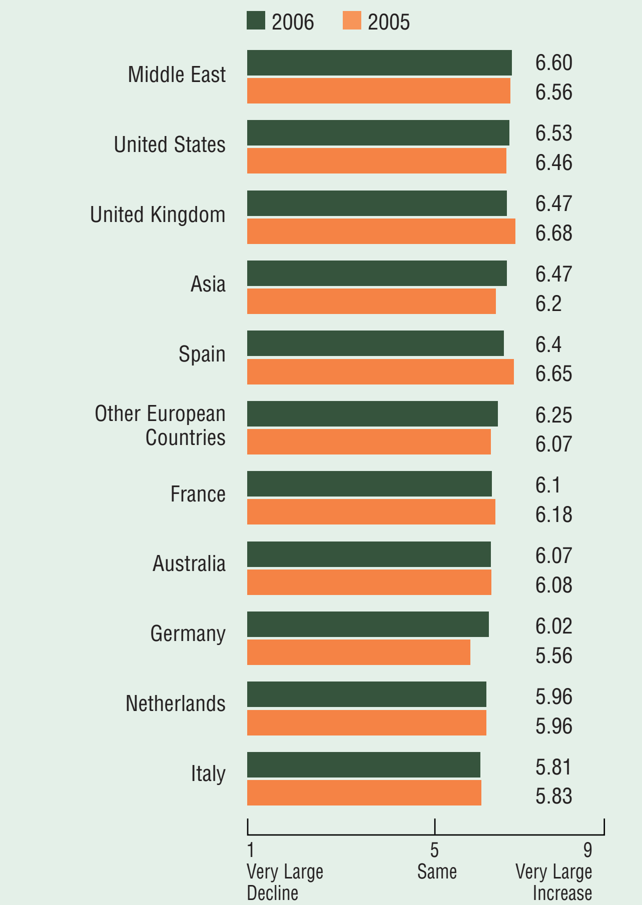


Source: Emerging Trends in Real Estate Europe 2006 *survey.*

German Open-Ended Funds: The Prisoners' Dilemma

The German open-ended fund industry is in grave trouble. Assets under management shrank by €3.43 billion in 2005 (€3.05 billion in December alone) but we may never know the precise extent of the outflow because official statistics are distorted by emergency support operations from the funds' parent institutions. Three funds have taken the unprecedented step of freezing redemptions, thus locking their luckless investors into unwanted holdings for an indeterminate period of time (funds are legally allowed to freeze for up to two years). Accusations of misselling are being voiced with increasing vehemence and the finance ministry is so alarmed that it is calling for legislative change to restore diminishing

Exhibit 2-3 **Change in Availability of Equity Capital for Real Estate by Source Location**



Source: Emerging Trends in Real Estate Europe 2006 *survey.*

public confidence in the sector. Changes are also being proposed by the fund management industry body, the BVI, in hopes this will stem the outflows that are threatening to spiral out of control. The outlook is so uncertain at the time of writing that no one knows whether this will be a short-lived scare or the onset of a contagion that will force many more funds to freeze.

Massive redemptions from those funds with significant exposure to the German real estate market started in December 2003 and escalated well into 2005. However, during the course of last year it appeared that the funds had restored public confidence sufficiently to contain the worst of the damage. Parent institutions of troubled funds had been purchasing fund units and buying assets from the fund portfolios at book value in order to reliquefy their offspring. Like the participants in the best-known example of game theory, "the prisoners' dilemma," these parent firms realised that if they all supported their funds until the German market picked up, they could potentially find an orderly way out of difficulty. Then, one parent bank broke ranks and refused to support their fund—indeed, they took the unprecedented step of freezing it—and the fragile, hard-won confidence of the public was sent into a tailspin. A month later, two more funds were frozen. The problems that underlie the mass redemptions from the latter were corporate governance– rather than performance-related. Nevertheless, there is an escalating feeling of panic seizing the entire open-ended fund market.

German assets dominate the portfolios of the largest and oldest open-ended funds. These "historic big battleships from the 1960s" own some "old and not very structurally sound stuff" as well as the impressive new assets that take pride of place in their annual reports. Their allocations are heavily weighted towards offices, and book values are well in excess of market values in some cases. This is partly because of the characteristics of the officially mandated method for valuing fund assets (described in our 2005 edition of *Emerging Trends*) but also partially due to the ill-judged use of that valuation methodology. The book values rely on assumptions about future rents and occupancy, and the optimistic estimates for these factors used by some funds' valuers have led to systematic overvaluation of German offices for the past several years. "The problem is epidemic. You can't take a few assets out of a fund and solve it."

The difference between market and book valuations of German office assets in some open-ended funds is purported to range between 10 and 30 percent. The bank that first decided to freeze its fund did so in front of a revaluation that could take up to one-sixth off of its total value, according to news reports. And the current reductions may not be the end of the story. A lot of older secondary office space is over-rented and now being abandoned in favour of new prime office space at cheaper rents with long rent-free periods. "Who is going to lease this tired old space in a stagnant economy with a shrinking workforce?" "A lot of the secondary office will never be relet."

Revelations about the valuation of fund assets are destined to change the way they are overseen and possibly the frequency with which they are done. It is also likely to lead to more external regulation of the open-ended fund industry. However, some are questioning whether the industry has a future, particularly if a successful G-REIT structure is introduced. "Open-ended funds are flawed in their present form. It's illogical to have a liquid fund based on illiquid assets." "The REIT is a far more joined-up financial concept and it will replace open-ended funds." Some open-ended fund managers are already planning to float G-REITs when they are introduced. Although open-ended funds cannot be directly converted to REITs under current laws, many of their assets could find their next home in a REIT. The parent institutions of funds can buy the assets out of the funds at book value—which many have already been forced to do—mark their prices down to market level, and put them into a REIT portfolio to await an initial public offering (IPO).

Not all open-ended funds are invested in Germany and experiencing outflows, but those that focus on foreign markets are having their own problems. They have continued to attract investors and they are now sitting on billions of euros in cash that they cannot get invested into their target markets. A number of managers have stopped selling units in their international funds because the cash piles are reducing returns and ruining performance figures. Many funds complain that they are consistently outbid by the debt-driven buyers because they are allowed only modest overall gearing. "We've been forced to sit on the sidelines in some markets."

The open-ended funds clearly face a tough year and some big changes are potentially afoot in their regulatory and statutory environment. It is unlikely that they will be adding much to the European equity pool in 2006, given the recent fund freezes and the contagion that could be triggered. However, they are not suddenly going to disappear and they could live to fight another day. The revival of international interest in German real estate markets may have come just in time to bail out the old battleships.

Private Equity, Venture Capital, and Hedge Funds: Crowding into the Same Space

"The lines are blurred between private equity, venture capital, and hedge funds." They are all absolute-return investors (i.e., they target specific return levels and do not invest relative to an established index or bench mark), they can all do opco-propco—but hedge funds are very diverse, so this comment refers only to a subset of these funds—and when they are not competing against one another, they occasionally do deals together. It is also not unknown for hedge funds to put money into private equity funds. The other thing they have in common is they are the recipients of increasing percentages of institutional allocations. They share the moniker of "alternative investments" along with direct real estate, and all have been beneficiaries of the decline in returns on conventional bond and equity portfolios. It is now not uncommon to see institutional allocations on the order of 20 percent in "alternatives" (which generally include the real estate allocation).

Private equity used to be synonymous with opportunity funds, but this is no longer the case. "The opportunistic returns don't pencil out as often anymore in Europe, so private equity has moved into value-added investing." Opportunity funds are still being launched, but the target returns have been lowered. "You used to see a typical target of 20 percent net. That's now moved to 20 percent gross—which is around 16 to 17 percent net—but no one believes them." Of course, in a world with euro cash returns of sub –2.5 percent, that sort of return looks great, but "20 percent was always an arbitrary number. Anyone who started a fund in the mid-1990s should have done better than that, and anyone launching a fund now will have to turn over a lot of stones to get anywhere near there." As a result, some opportunity funds have moved to more realistic target returns on the order of 18 percent gross.

No one knows how much private equity money earmarked for real estate is out there. Ernst & Young conducted a survey of real estate private equity fund managers in the United States and the responses for their sample alone added up to US$118 billion in leveraged buying power awaiting deployment. Some of that money is definitely earmarked for European investment. "Forty percent of participating fund sponsors, and 76 percent of fund sponsors with aggregate capital raised in excess of $1 billion, indicated that at least a portion of their capital is earmarked for markets outside of the United States."

However, this is by no means the full picture. Interviews conducted for this survey indicated that around 30 percent of the real estate private equity funds have been raised from European investors by European-domiciled sponsors. On top of this, private equity money is being raised in the Far East for European real estate investments, but no one has a feel for the amounts. Add to this the competition for opco-propco deals from global non–real estate focussed private equity funds, which are estimated to have £275 billion (US$485 billion) according to *The Times* newspaper in London, and the wall of money looks intimidating. Bear in mind that in 2004 the total turnover in European real estate markets was only €100 billion (US$120 billion).

Of course, private equity investment is not just focussed on the conventional real estate assets covered in brokers' market statistics. The majority of opportunity funds may still be diligently seeking distressed and difficult assets to reposition so that they can be sold on to core investors. However, many of the big headline deals of the past two years have been seen in areas like German residential portfolios, where assets are purchased from government or corporate owners, and nonperforming loans (NPLs) that are purchased from banks trying to clean up their balance sheets.

German Residential Portfolios: Shock and Awe. The German residential deals have inspired a mixture of awe, scepticism, and distaste among onlookers. They were a topic in the German elections last autumn when the funds were referred to as "locusts" flying in to asset-strip the economy, then take the money and run. These deals are "financial arbitrage driven" and thus highly leveraged—generally in the region of 90 percent. The downside is limited if underwritten correctly because the rental incomes are very stable on large

German residential portfolios. And these portfolios are big—deals have been done in sizes as large as 150,000 units. The kicker is the potential equity uplift if units bought wholesale can be sold to the residents retail—or, failing that, sold on at a higher price to another investor. Those funds that got in early are already feeling smug since cap rates have fallen by over 200 basis points in the last 18 months. However, there are plenty of people in the market who do not believe that the funds doing the recent deals—let alone those going forward—will achieve their targeted internal rates of return (IRRs). German observers are particularly scathing. "Where is the exit at that level of leverage on these prices?" "There's no real estate exit, just 'the greater fool.' " "The opportunity funds don't know what they're buying; €1,000 per square metre in Berlin is one thing, but €1,000 per square metre on the outskirts of Dresden is not a good investment—though you won't lose money."

The fact remains that only 44 percent of Germans own their own homes and the tenant protection laws are very favourable to renters. Nevertheless, there are homebuyers out there and some private residential developers in Germany have found that they can sell over 50 percent of the units without much effort when they refurbish a nicely designed bloc. Whether this points to potential for similarly successful sales of the former state- and corporate-owned portfolios (many of which are rather aged) that the opportunity funds are buying remains to be seen. "The first 30 percent is easy, but it's the last 30 percent where you make the money." If the 'wholesale-to-retail' exit strategy doesn't fly, there is one more potential exit—the G-REIT. At least one big buyer of German residential portfolios appears to be positioning for an IPO as a REIT if the legislation is enacted, and there may be several others.

Nonperforming Loans: Profits from Others' Mistakes. The sales of big German NPL portfolios hit the front pages of the business papers in 2004, but last year saw fewer of these headline-grabbing deals. However, the lack of press coverage does not mean that the market has stopped growing. "There are more smaller deals being done on an exclusive basis, so the market doesn't know what's going on." "Players are trying to avoid competitive bidding wars when possible. These make it too expensive for the smaller deals to be worthwhile." The sellers of NPL portfolios also have good reason to keep a low profile because they do not want to upset their client relationships. As a result, it is hard to gauge just how much is changing hands. However, some big deals were done in the final months of 2005 and it is likely that more NPLs changed hands last year than in 2004.

Depending on which estimate one wishes to believe, there is somewhere between €160 billion and €300 billion of NPLs in Germany. The market is extremely competitive and dominated by U.S. investment banks along with private equity experts in distressed debt and experienced Far Eastern players. "The bigger the transaction, the more competitive the deal—if you have a lot of money to get into the market, you want size." Not all NPLs involve real estate, but the proportion is high. Prices have risen in tandem with the increasing liquidity the investment banks have brought to the market, but, generally, the impression is that "the sellers are valuing their assets more realistically." Most important of all, the selling banks have put on more loan loss provisions so they are in a better position to sell, indicating that the market will continue to expand. Also, the exit strategies are tried and tested. Billions in distressed loans have already been rebundled, packaged, and sold on by the investment banks, often for a quick turn of around 3 percent of face value.

Of course, like every other market, it has its detractors. "Paris NPLs in 1995 were done at 20 to 40 percent of face value. You could approach the borrower and ask for 50 percent of the original loan back and they could borrow that from another bank. We got our return and they kept their building. These deals in Germany are being done at 70 percent of face. They're going to have to repossess a lot more real estate, with all the legal costs that entails." On the other hand, a player in the current German market noted, "There's a lot of money stuffed in mattresses in Germany. The old lenders didn't approach the borrowers, and we've found that they often come up with the money when pressed." Just the same, planned exit strategies do include repossessions and securitisations.

Hedge Funds Hit the Market. The last thing anyone wanted to see was a major new source of equity capital entering the European real estate markets. But, in a world of fast-flowing information, it was perhaps inevitable that hedge funds would notice the returns being made in real estate and attempt to get a piece of the action. According to the *Financial Times*, hedge funds have global assets of €1,000 billion (US$1.2 trillion) under management. They are so diverse in terms of their investment mandates that there is no uniformity in their activities.

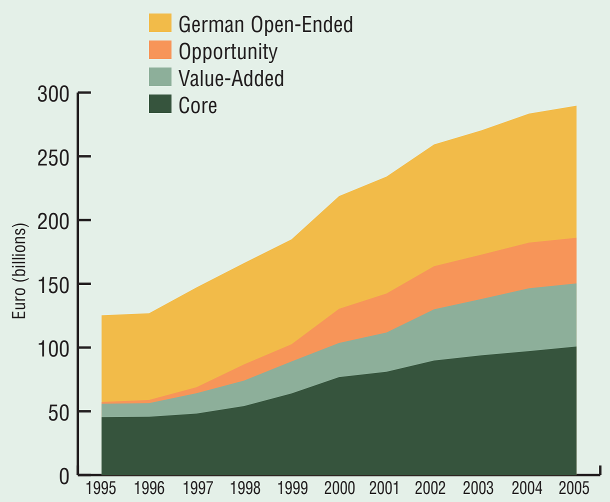
Hedge funds have been seen in many different areas of the real estate markets in the past year. According to our interviews, they have been encountered bidding for health care deals, bidding for core offices, backing local players to buy assets, taking illiquid positions in residential developers, and taking out the equity pieces in securitisations and other types of mezzanine loans. "They have loads of money and they will take any piece of the structure."

Some do not take them very seriously. "The guys I've seen don't know what they're doing." "They're not a danger—more of a pest. They get into companies when there are rumours, but they don't do hands-on real estate." "They're irritating because they drive prices up." Others are respectful. "Hedge funds are hiring some experienced real estate professionals and they are moving into our space." Whatever the opinion of their skills, if they stick around, they will add to the pressure on real estate prices by sheer virtue of their financial clout. They will also add depth to the mezzanine market, where their skill sets in fixed-income investment meet real estate.

Institutions and Private Vehicles: Asset Starved

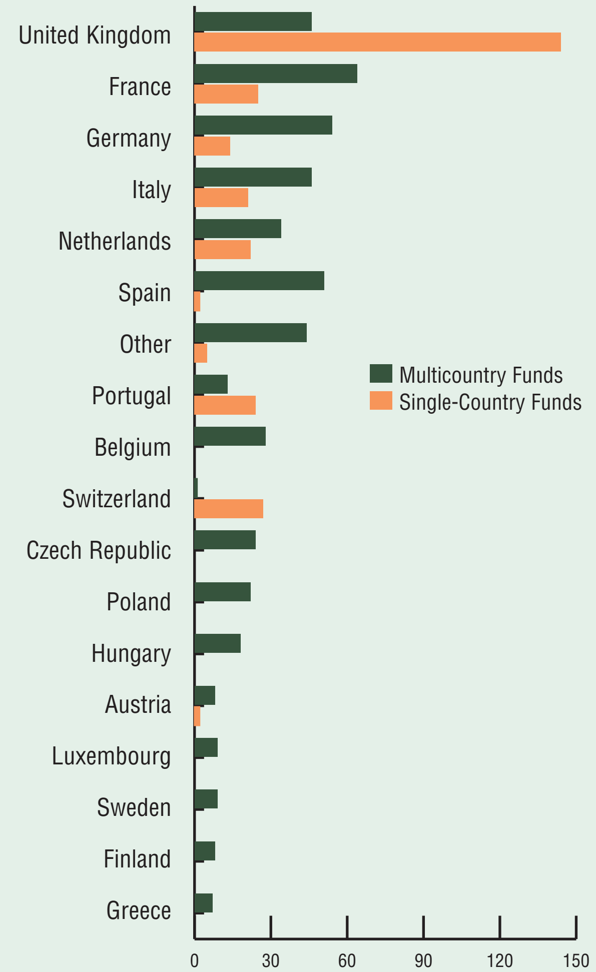
According to a number of studies done in recent years, European pension funds are woefully underweight in real estate. Asset/liability modelling exercises tend to indicate that they should be holding between 10 and 15 percent of their portfolios in real estate, depending on the maturity of the fund. Yet, the most recent figures available indicate the average weighting of real estate in European pension funds is still only around 6.5 percent. They are now trying to close this gap, but the sums involved are formidable. Several of those we interviewed admitted, "Just trying to reinvest our cash flows and dividends is difficult—we're behind." Real estate allocations may be higher, but the money has not made it into the market yet.

Exhibit 2-4 **Private Property Vehicles by Type of Fund: 1995–2005**



Sources: Investors in Non-listed Real Estate Vehicles (INREV), Investment Property Databank (IPD), November 2005.

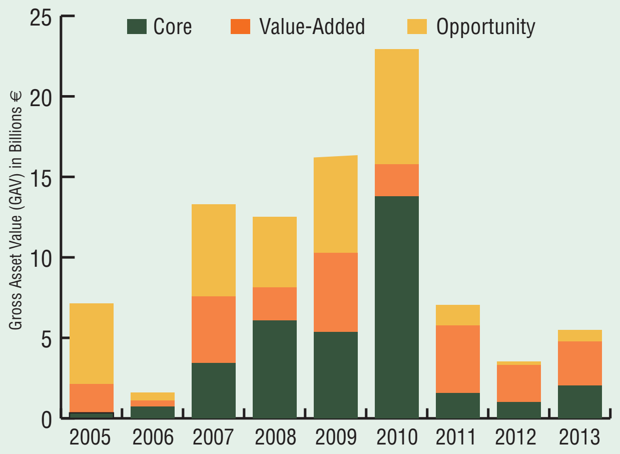
Exhibit 2-5 **Private Property Vehicles by Target Country and Type of Fund: 1995–2005**



Sources: Investors in Non-listed Real Estate Vehicles (INREV), Investment Property Databank (IPD), November 2005.

According to studies done by a number of different sources (which are nicely summarised in the CB Richard Ellis report *The Pensions Crisis and the European Property Market*), a reweighting of current European pension fund allocations to the recommended 10 to 15 percent level in real estate would require between €150 billion and €350 billion in real estate acquisitions. In a European market with an estimated total annual turnover of only €105 billion in 2005, this is an impossible task to do in short order. There would be formidable problems even achieving this reallocation in global real estate markets. The problem will be exacerbated if governments move to funded pension schemes, as this would require additional real estate investment of between €15 billion and €45 billion per annum.

Exhibit 2-6
Private Property Vehicles in Europe by Termination Year and Fund Type



Sources: Investors in Non-listed Real Estate Vehicles (INREV), Investment Property Databank (IPD), November 2005.

Note: From 2007 to 2012, 167 funds with GAV €76 billion are planned to end.

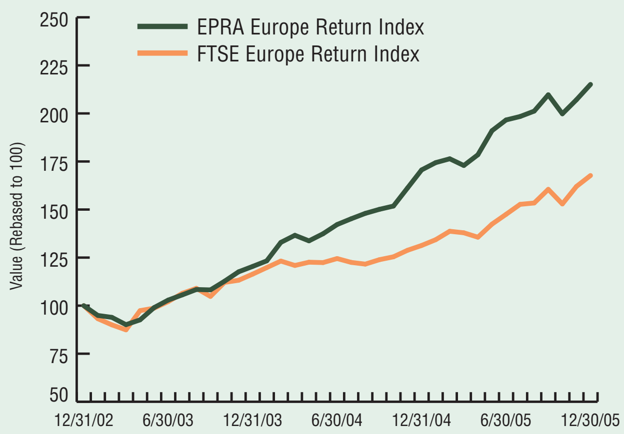
Pension funds and their advisory consultants are trying to negotiate this minefield, but there is obviously a limit to what they can acquire, even in the medium term. There is also a fear that the objective of providing pensions for an ageing population will be negated by everyone trying to pile into real estate at the same time, with a resultant distortion in pricing. To some extent, this cannot be avoided because there are investment deadlines to be met and the returns on cash are miserable. Clearly, more assets are needed because there is a structural shortage of institutional-quality real estate.

Some of those we interviewed from outside the pension industry optimistically stated that "more product will come on the market soon, because the scheduled liquidation of closed-end private vehicles between 2007 and 2011 will release huge amounts of assets." But the majority of investors in these closed-end vehicles are none other than the institutions themselves. This means that these institutions will have the additional headache of getting the money released by the funds back into the market. For this reason, open-ended funds with no end date are becoming more popular as noted earlier in this report.

Publicly Listed Real Estate: High Hopes for the Future

The listed real estate sector slightly underperformed the broader European equity market but still turned in a robust performance in 2005. The EPRA Europe index served up an ample total return of 26.1 percent, while the FTSE Europe total return index notched up a 27.7 percent increase. The continued support was quite an achievement for a sector that is normally abandoned when the broader market is strong. The returns were driven by hefty increases in the French market's premium to net asset value (NAV) as investors hopped onto the SIIC (French REIT) bandwagon. The Spanish market benefited too as another major Spanish listed company acquired semi–tax transparent status by acquiring nearly 70 percent of the largest French SIIC. The U.K. market lagged its continental counterparts, but it benefited from anticipation of future REIT status. The U.K.'s discount to NAV narrowed to the point where it no longer exists if adjustments are made for tax treatment. All markets (except Germany) benefited from yield shift in the underlying assets.

Exhibit 2-7
EPRA Europe Return Index vs. FTSE Europe Return Index



Sources: European Public Real Estate Association (EPRA) Europe Index, a European publicly traded real estate return index and FTSE.

Note: Returns rebased to 100 (beginning December 31, 2001).

A Mercers survey of 157 investment management firms worldwide with US$20 trillion under management shows that expectations for equity performance this year are modest in comparison with last year. However, our own survey indicates that listed real estate in Europe will receive continued firm support in 2006. There is significant growth expected in dedicated global listed real estate funds and this sector was already around US$14 billion in size at the end of last year, according to UBS. There is also growth in retail investor interest everywhere and, of course, European institutions have huge sums to put into listed real estate, particularly if more tax-transparent vehicles become available. REITs behave somewhat like direct real estate and have a fairly low correlation with the broader equity market, so they are used somewhat interchangeably with direct investments by some institutions. The problem for European listed real estate is that the sector is tiny—only around €100 billion in total—and only 27 percent of it is in REITs. But that is going to change soon. "The previous trend was public to private. The new trend will be private to public."

The French Listed Market: SIICs Forge Ahead. In France, the listed sector has increased by over 50 percent since the introduction of SIICs. The SIIC II legislation (along with its recent amendments that allow companies to sell their assets to a SIIC for cash instead of shares) will motivate more companies and assets to come to the market. Corporates have until the end of 2007 to take advantage of the time-limited 50 percent reduction in capital gains tax on the sale of real estate assets to SIICs. "It's taken companies awhile to become aware of the legislation, but 2006 and 2007 should be big." "Shell companies are changing into REITs and the sector will be well into double digits in size. It can now cope with more money." "We could conservatively see €3 billion in new assets hit the market over the course of the three years."

Of course, there are detractors. "New issuance is going to hold back the sector, so it will be a quiet year for returns." There are also worries about the big premiums to NAV. "The market is overcooked and will have to come back." The more philosophical say, "The premium to NAV will not always be there, but at least we no longer have a structural discount."

Players outside the listed sector are more concerned that SIICs have added to the competition for assets. And many are annoyed that the listed sector in France is being favoured over other types of investors who would also like to get their hands on some French corporate assets.

The Dutch FBI: Time to Remodel? The Dutch government has eyed the success of the French SIIC and decided that its own REIT-type vehicle, the FBI, could do with some updating to make it more flexible and competitive. Proposals are now being considered to relax restrictions on development activities, capital taxes, foreign shareholders, withholding taxes, and the minimum required payout. While the changes are not a done deal, there is considerable pressure to relax the restrictions on foreign ownership at very minimum, since these appear to violate E.U. law. As to the other measures, it is likely that at least some will be adopted since the Netherlands is currently losing business to more favourable regimes.

U.K. REIT Proposal: Unfinished Business. The U.K. government "finally got its act together" and draft legislation was put before parliament in December 2005 that will enable the U.K. REIT to be born on January 1, 2007. Under current proposals, the vehicle will be closed ended and tax transparent, although it will have a withholding tax of 22 percent. U.K. REITs will have to distribute 95 percent of their profits to investors and they will have to obtain 75 percent of their income from rents, although the other 25 percent can come from development and services. There will be no limits on gearing, but they will have to meet an interest cover test that is fairly stringent. Also, no shareholder will be allowed to own more than 10 percent of a U.K. REIT. What is unknown—and will not be announced until the spring budget—is the conversion charge that companies will have to pay to become REITs. If the conversion charge is set at a realistic level, it can be assumed that the majority of the listed sector will convert to REIT status. If not, the legislation will be irrelevant. There are already viable tax-transparent vehicles offshore and the sector will continue to migrate in that direction.

As one would expect, concerns about the draft U.K. REIT legislation are already being voiced. The 95 percent distribution level is seen to be too high, given the need to retain cash flow to maintain properties. The interest cover restriction could also pose problems if the government suddenly raised interest rates. There is also a chorus of criticism regarding the rule that no one can own more than 10 percent of a REIT because many of the companies have existing shareholders with larger holdings. While the government clearly wanted to avoid the kind of foreign takeovers that have been such a feature in the French SIIC market, they may have gone a bit overboard on the ownership restrictions. Given that changes can be made to the draft legislation, the current proposals may not be the final word. But, it has been made abundantly clear that the Labour government will not consider any change that would lower its current tax take from the property industry. Any hopes for "REIT II" legislation to encourage corporate real estate release will take a lot of pleading and may possibly have to await another government.

The G-REIT: Obsession with Tax. The U.K. REIT proposal "has put the cat among the pigeons in Berlin." "The German government wanted to beat the U.K. to the market with a REIT. Now the pressure is on—not just to come up with a G-REIT, but to come up with a competitive structure." The front-running proposal for a G-REIT is not what most investors would consider a REIT because it is not tax transparent. It is a complex hybrid involving both an AG company and a "trust vehicle." The trust vehicle would hold the real estate and income would be distributed as "rents" rather than dividends. This would enable the government to tax the income at source at a proposed rate of around 20 percent and—since income is not dividends and thus not subject to international dividend withholding tax treaties—Germany would keep the tax revenues. The proposal is understandable given the parlous state of government finances, but the resulting vehicle may not be attractive to international investors. On top of this, it may not even be legal under E.U. law.

Many of those interviewed thought that the German government had become too obsessed with worries about tax take. "They're worried about withholding tax leakage abroad and foregone capital gains tax at home, but if they don't come up with a competitive structure, no one will partici-

blamed for driving yields into **"crazy"** *territory.*

pate." "They won't get the capital gains taxes from corporates unless they give them the incentives and a successful vehicle to sell into." "They should be trying harder to get a competitive structure." As the listed real estate sector in Germany is currently a paltry 0.45 percent of the equity market while the country's stock of real estate is Europe's largest, it can only be hoped that the government will come up with something workable. If it does, our survey indicates that there will be tremendous enthusiasm. "It will be new and sexy—the investors will love it." "The G-REIT could easily reach €30 billion to €60 billion in size within a few years if the government gets it right." However, many of those surveyed and interviewed doubted that we will see a G-REIT in 2006.

Perhaps, for inspiration, Germany should take a look at what the introduction of a French-style REIT has done for Bulgaria's fledgling real estate market. At a stroke, it has raised the professionalism and transparency of the sector and brought in long-term foreign investors. There are already ten funds, another six are preparing to list, and market capitalisation is up to lev 100 million (€50 million), which is 1 percent of the Bulgarian equity market. Not bad for starters.

Derivatives and Exchange Traded Funds: Off the Starters' Block

The past year saw the emergence of a real estate derivatives market in the U.K. Somewhere between £600 million and £800 million (but possibly more) transactions were done, and this total could grow steeply in 2006 as investors gain familiarity with the market and the types of transactions on offer expand. Most of the transactions to date have been done in property index certificates (PICs), which are bonds with an embedded return based on the Investment Property Databank (IPD) index. However, the range of potential transactions types is already on the rise because established derivatives players from the capital markets are coming in. A Property Derivatives Interest Group (PDIG) was set up by the Investment Property Forum to promote understanding and this should help the market gain further traction. According to a survey conducted by the PDIG, investment groups with collective assets of £43 billion now have a mandate to use property derivatives and 63 percent of them are actively preparing to use them.

Commercial property is the largest physical asset class currently not taking advantage of derivative products, and the derivatives professionals who are familiar with how quickly these markets can grow are getting in to develop the market. The world's largest interdealer broker has expressed intent and another major international interdealer broker has partnered with an international real estate advisory group to create over-the-counter (OTC) property derivatives for both U.K. and continental commercial property. In addition, at least three major international banks have committed themselves to the market and one has set up a dedicated property derivatives trading desk. The latter did the first-ever sector-specific deal in which an investor group took a position based on the view that the U.K. retail sector would underperform against a LIBOR-based return over 15 months. The bank warehoused part of the risk, so a full counterparty did not need to be found immediately. If more are willing to do this, many such transactions will follow.

On the listed side, there are now two exchange-traded funds (ETFs) that track the continental European listed real estate markets. These can be used to take indexed exposure to the entire Eurozone market in one transaction. They can also be sold short if one wishes to make a tactical allocation change without selling one's own portfolio of stocks. Alas, the market is still waiting for an ETF based on the U.K. listed real estate sector. The advent of U.K. REITs may mean that this will have to wait until 2007, as there could be enormous changes in the market.

Private Investors, Syndicates, and Consortia

Private investors have seized on European real estate to such a degree that they are now the biggest growth group in the market, according to our survey. And they are not just European investors. Private wealth is flooding in from all over the world and in many cases those with this wealth are bringing their bankers with them. The private investors most frequently cited in the markets by those we interviewed were Irish, Middle Eastern, Israeli, Italian, and Spanish. However, just about every nationality got a mention. Their presence is a source of perpetual consternation to the seasoned professionals because many appear to have "never met the real estate rule book." "Discipline in markets has gone down and it's the nonprofessionals who are doing damage." "These people have no thought for residual values." "We lost an Italian asset because the seller gave bidders only one day to do due diligence and a private investor accepted their terms."

Clearly, not all private investors are inexperienced and unprofessional. Many have made fortunes in their home markets and are seeking exposure in new regions. They see markets that are potentially at the bottom of the rental cycle and they are willing to take the bet that cap-rate compression will be replaced by rental growth in a couple of years. Fortunately for them, they do not have institutional clients to answer to or targeted IRRs to meet and their banks are willing to back them as long as the properties they go for have an income stream. In addition, some are investing cash for the next generation and want a trophy asset that will be in the family in 50 years' time. Crucially, private investors are able to make quick decisions that are simply impossible for the institutions and the funds that invest on their behalf.

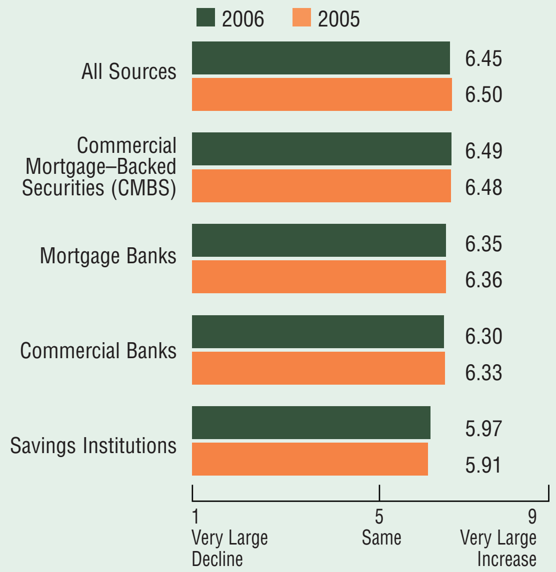
While not all private investors are doing irrational deals, the new players are frequently blamed for driving yields into "crazy" territory. This may not be entirely fair. "It's the people who do the 200 million deals, not the 10 million deals, that drive the market." In any case, if private investors are using

"The banks are **tripping** *over themselves to lend money."*

substantial equity to fund their deals, it is not a huge problem if they overpay. However, since many are leveraged there is concern. "Do new players really understand the fundamentals of real estate? There's too much emphasis on initial yield and the differential with finance costs." "Many have lost sight of residual values"—if indeed they ever had sight.

Most worrisome are the highly leveraged private buyers. "These guys aren't using equity—they're borrowing at the banks to do the deal, then borrowing against the deal with another bank." "When you see this stuff, you realise we have maybe two more years. Then someone's got to lose some money." Equally disturbing are the proliferation of syndicates, some of which are run by inexperienced (and occasionally unscrupulous) advisers luring in high-net-worth individuals. The advisers get their money upfront and the deals are often done on a highly leveraged basis, leaving little or no margin for error. "If there's an accident waiting to happen, it's in the high-net-worth market."

Exhibit 2-8 **Change in Availability of Debt Capital for Real Estate**



Source: Emerging Trends in Real Estate Europe 2006 *survey.*

Capital Trends: Debt

There will be no shortage of debt capital for real estate acquisitions in 2006. Our survey highlights a substantial increase in the availability of debt finance from all sources. Commercial banks, mortgage banks, investment banks, and savings banks are all competing aggressively for business. Banks that pulled back from the markets in the early 1990s are reentering the fray. Those that have been continuously active are expanding their coverage and their expansion is not just confined to the E.U., but is spreading to markets like Turkey and Russia. "The banks are tripping over themselves to lend money."

The increase in competition has sent margins on a downward trajectory and no one expects any relief this year. The investment banks engaged in securitisation are frequently cited as the major force behind the increasingly aggressive pricing. This is "a new pool of capital" and "it needs to feed its conduit programs with a continuous supply of loans." "Margins have drifted down from 2 percent to a few basis points to keep the conduit programmes going." Since finance determines what the buyers can bid for a deal, competition has pushed the more aggressive banks to underwrite according to the buyer's exit strategy. As a result, there are more bullet deals being done. The loans are then either syndicated or securitised, so that the risk is taken off the balance sheet. "Lenders don't take as much risk on their books as in the past, but there may be more risk out in the market."

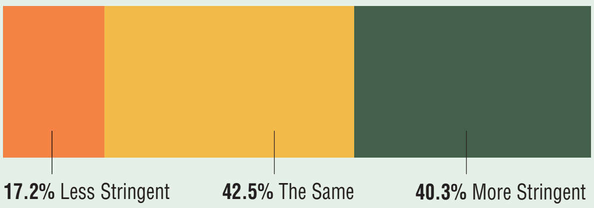
Not all banks are trying to shift everything off the balance sheet. Some are trying to grow their loan books, and these banks are less inclined to syndicate unless the loan size exceeds their "hold level." Some have increased the size of their maximum exposure to single assets in order to beef up the size of their books. However, others need to get their return on equity (ROE) up, which implies that they need to become issuers rather than holders. In a world of consolidation in banking, self-preservation is a keen motivator. "The German banks need to get their ROEs up before they get eaten." On the other hand, "Bankers are rewarded for doing deals, not the bank's ROE." For those attempting to do more conventional relationship banking in order to write more business, the demands of the client inevitably lead to more flexible pricing than many would wish. In general, LTVs are up (typical levels mentioned for a private investor or private property company are 90 percent versus 85 percent a year ago) and margins are well down.

Underwriting Standards Will Be More Stringent in 2006

Once again, the level of underwriting discipline was generally thought to be high by borrowers. "A lot more effort is going into pricing risk." "Lenders are being disciplined." However, the banks themselves were less certain. "Lenders have been less disciplined in the past year. If you don't take on more risk, you can't remain competitive." "We're seeing less amortisation and more interest-only loans." "The banks are the ones taking the risk when they underwrite a 95 percent LTV. If something goes wrong, the borrower can just hand them the keys."

Over 40 percent of those surveyed thought that underwriting standards would become more stringent this year. This is curious, given that most believed that lending would be subject to increasingly aggressive competition. However, one can reconcile the contradictory appearance of higher leverage and greater discipline on two levels. The banks may be less demanding than a couple of years ago on their underwriting for standing investments, but they are no longer taking big risks in speculative development. This constitutes a substantial increase in discipline and a step change in risk exposure in comparison with the last real estate cycle. In addition, if you believe that we are in an era of lower and less volatile bond yields "it's rational to have higher leverage when the rate environment has lower volatility." However, a long-term move to higher leverage and cheaper debt finance implies that you have to accept higher real estate pricing, because it is the price and availability of debt finance that are dictating what investors can pay.

Exhibit 2-9 **Underwriting Standards Prospects for 2006**



Source: Emerging Trends in Real Estate Europe 2006 *survey.*

There is no doubt that lending for commercial property has taken a disproportionate share of the recent growth in lending. According to the Bank of England, lending to U.K. resident commercial property companies has grown more than twice as fast as other corporate lending and is now the commercial lenders' single largest industrial exposure. Rising levels of debt and asset price inflation have been the focus of increasing concern among all central bankers. They, too, are wondering whether we are in an asset price bubble—not just for real estate, but for all asset classes—or a period of structural change due to the growth in savings. However, the central banks are not in control of the situation. Increases in official rates have had little impact on market-determined yields and, in some cases, perverse effects. To illustrate, euro swap rates and bond yields have actually fallen in comparison with a year ago for periods longer than six years, and this has occurred despite a 25–basis point December rate increase from the European Central Bank and threats of more to come. It may be the case that the more proactive the central banks are on interest rate policy, the lower long-term yields will go. "If the ECB raises rates too much now, it will only depress GDP growth and put further downward pressure on long yields." And, of course, lower growth means fewer corporate lending opportunities and continued emphasis on real estate lending. But, "lower GDP growth will also postpone occupier recovery, piling up the pressure on residual values."

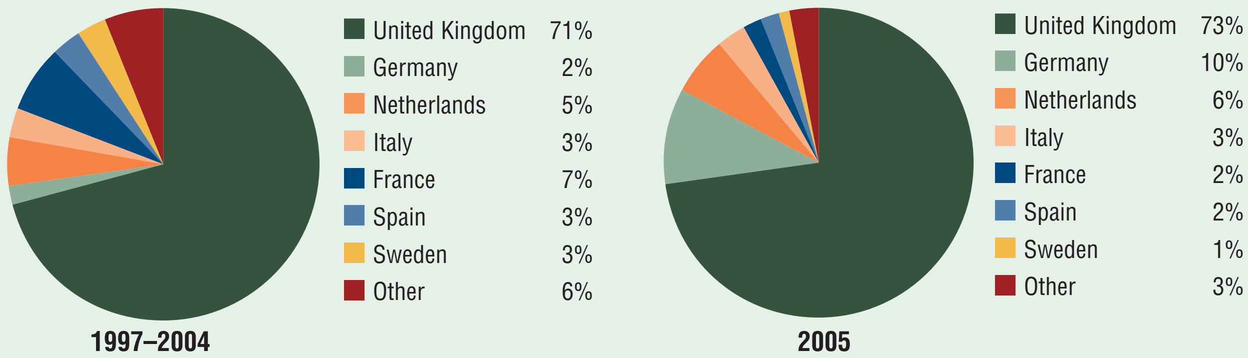
Exhibit 2-10 **U.K. Sterling and Euro Base Rates and Five-Year Swap Rates**

Sources: Datastream, European Central Bank, Bank of England.

CMBS and Mezzanine: The Capital Markets Come to Town

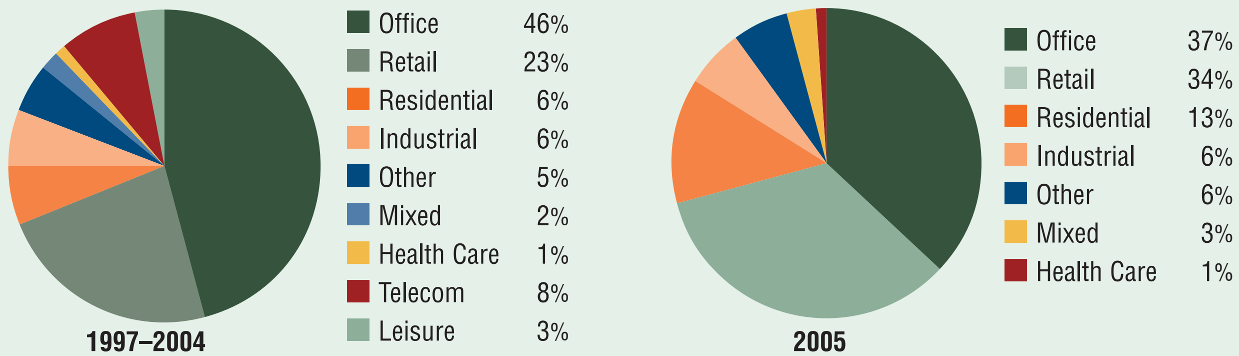
After years of just ticking along, the European commercial mortgage–backed securities (CMBS) market burst into growth mode in 2005. Our survey last year predicted that CMBS would deliver the highest growth rate in the debt markets for real estate and that is exactly what happened. Issuance reached a new record high of €40.7 billion in 2005 according to the London CMBS team at Barclays Capital, which was more than double the 2004 level of €19.4 billion. The U.K. dominated CMBS issuance with 73 percent of the total, but Germany's contribution grew to 10 percent and there were also deals from the Netherlands, France, Italy, Spain, Sweden, and others. The dominant source of growth was CMBS conduit programs and they accounted for 59 percent of the total issued. These are programmes set up by commercial and investment banks with the specific intent to originate loans for securitisation. There were 17 European CMBS conduits in 2005, according to Barclays Capital, but their number is still growing.

Exhibit 2-11 **European CMBS Issuance by Collateral Location**



Source: Barclays Capital.

Exhibit 2-12 **European CMBS Issuance by Property Type**



Source: Barclays Capital.

Our survey this year predicts that we can expect very substantial further growth in CMBS issuance for 2006. This will be driven by rising numbers of conduit programs, expanding appetite for CMBS on the part of a widening pool of investors from all over the world, and the plain fact that this is the cheapest form of real estate finance for many borrowers. Spreads averaged a mere 21 basis points for AAA issues in 2005 and 93 basis points for BBB over the same period.

The CMBS market is likely to see further growth in deals based on pools of loans because many investors prefer these for their diversification characteristics. However, there should still be a hefty percentage of single-borrower issues. We may also see more non-U.K. issuance—almost certainly from the Eurozone, according to our interviews and possibly from outside. Even Russia has put legal structures in place to promote securitisation, and while only consumer loans have been done to date, there are plans for mortgage-backed securities in the future.

It is hoped that the growth in CMBS will engender some much-needed clarity in the mezzanine market. The European mezzanine market is often ill defined and still lags its U.S. counterpart in terms of efficient pricing. "We're frequently offered something that turns out to be totally mispriced senior or undisguised equity." Nevertheless, the market continues to grow and attract more investors. "Five years ago, there were four or five names to sell B pieces to. Now there are 30 buyers looking for every piece." "There's been a proliferation of buyers—even the hedge funds are in there."

One of the problems for holders of CMBS (A-notes) is they often don't know who holds the B-note/mezzanine positions. According to our survey, the banks and opportunity or value-added funds are major buyers, which should give the A-note holders some comfort that they are likely to be dealing with professionals if a default trigger occurs. However, the market needs increased transparency on the identity of B-note holders and more clearly defined intercreditor agreements if CMBS is to broaden its appeal. This is because there is a potential conflict of interest between A-note and B-note holders when defaults are triggered. The B-note holders are often more inclined to hold on when a deal gets into difficulty, while the senior CMBS holders usually want to cut their losses.

B-note issuance will inevitably grow because it enables CMBS arrangers to achieve better pricing on the senior or A-note of a securitisation. An issue that might only achieve a sub–investment grade rating can be repositioned to investment grade by means of tranching subordinated positions. In 2005, around 23 percent of CMBS issuance was supported by loans that also had B-notes, according to Barclays Capital.

The big benefit for mezzanine to be derived from the growth of the securitisation market will be better transparency and more efficient pricing. This should also enable improved pricing of mezzanine loans that are not connected to securitisations—if they ever take off again. Many investors complain that there is little call at present for conventional mezzanine loans because the senior lending has become so generous. Too many borrowers can now get all they want from a friendly banker with an onerous underwriting target to hit by the financial year-end.

Markets to

Respondents continue to express optimism *for most European property markets in 2006 as they did in 2005.*

Watch

Survey respondents consistently expressed optimism for most European property markets in 2006 as they also did in 2005. Based on overall benchmarks and ratings at the property market or city level, and including specific office, retail, and industrial property types within each city, respondents believe that European property markets offer diverse opportunities for investment and development in 2006.

However, the growth in optimism for European property markets does not appear to be as great as that expressed by respondents in the *Emerging Trends in Real Estate Europe 2005* report. There are caution signals for investors and developers as 2006 unfolds based on survey results, direct comments from many pan-European interviews, and year-end 2005 property market reports. The spirited search for property investments and development in mainstream European cities is now spreading to many new targeted secondary property markets. Respondents frequently mentioned cities in Cyprus, Croatia, Ukraine, the Baltics, Slovenia, and Romania in surveys—an early indication for future capital flows and an expanding investment horizon?

Paris continues as the number-one city based on the average of total return and city risk ratings, followed by London, Helsinki, Madrid, and Barcelona; Stockholm, Dublin, Lyon, Copenhagen, and Lyon round out the top ten. New entrants into the top-ten rankings for 2006 include Madrid, Dublin, and Copenhagen, as Milan, Brussels, and Zurich slipped out of the top ten (see Exhibit 3-1). Frankfurt is the lowest-ranked city in the survey by a wide margin, with modestly poor prospects for total returns and a below-average risk rating. But on the bright side, its prospects have improved markedly from last year.

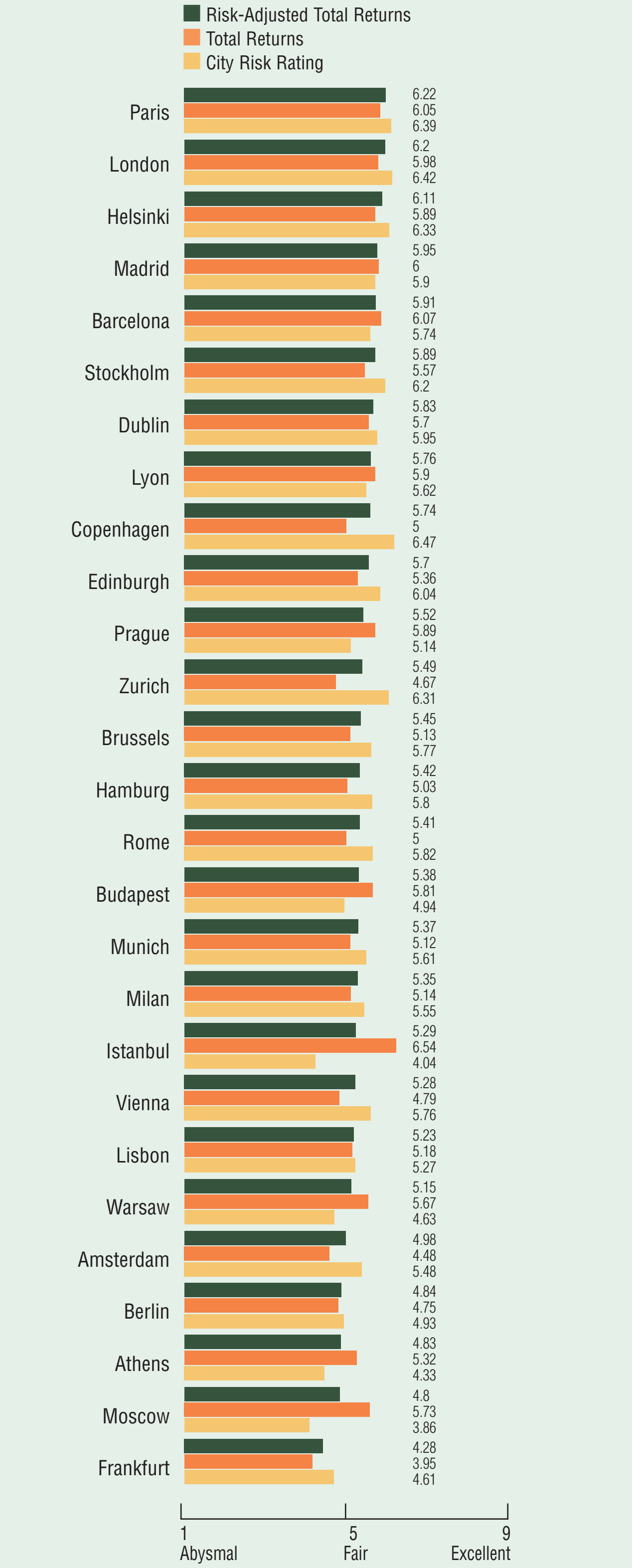
A comparison between 2005 and 2006 survey responses clearly indicates that investors believe overall total return and city risk ratings will improve in 2006—a continuing trend from the initial survey in 2004 and 2005. Yet, there are selected cities where year-over-year ratings changes suggest prudence due to slight deterioration of city risk ratings in Paris, Lyon, Milan, and Istanbul, and total return rating decreases in cities such as Edinburgh, Prague, Brussels, Rome, Milan, Vienna, and Moscow.

If we shift gears and look at cities with the best development prospects, the picture changes a bit. From this perspective, the fast-growing but riskier markets of Istanbul and Moscow rise to the top of the chart. Paris, Barcelona, and London round out the top five for development prospects.

There are several themes for European property markets in 2006 that emerge through the interviews and analysis of the survey results:

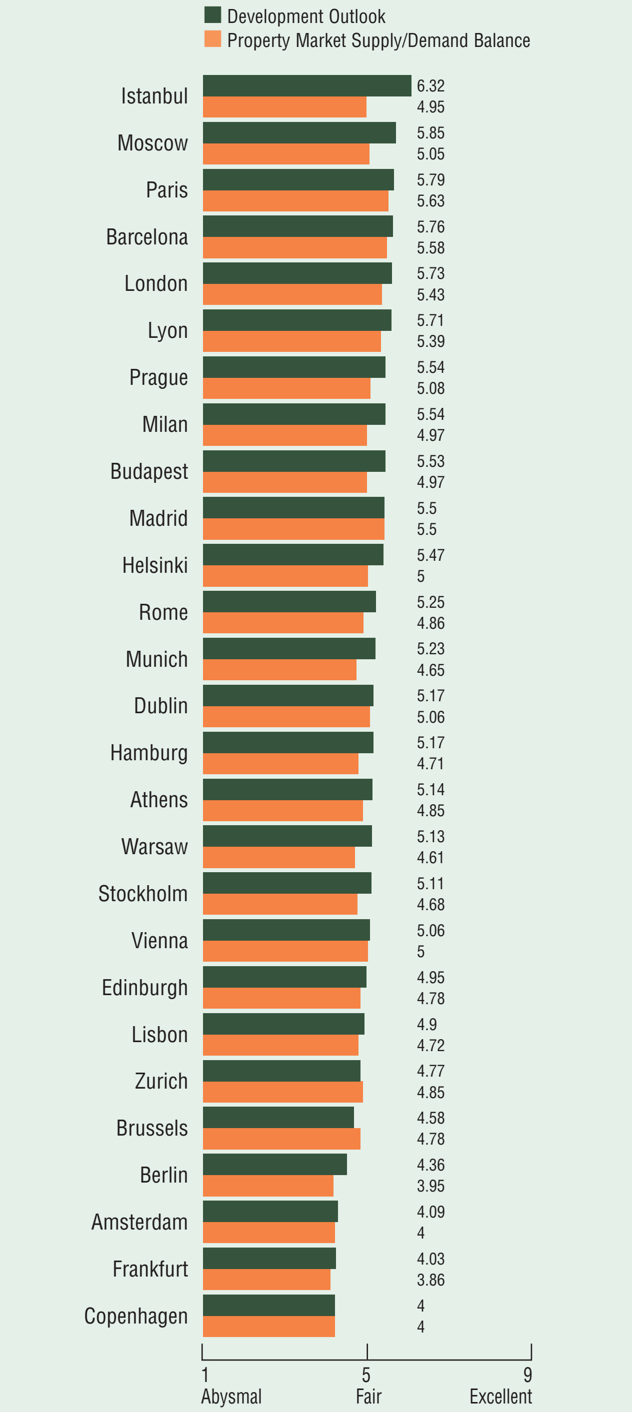
■ The majority of the European property markets previously ranked in the top ten and bottom ten in 2005 remain in their respective clusters in 2006, indicating that respondents don't envision significant movements in favourite and challenging property markets over the next year.

Exhibit 3-1 City Return/Risk Prospects



Source: Emerging Trends in Real Estate Europe 2006 *survey.*

Exhibit 3-2 City Development and Market Balance Prospects



Source: Emerging Trends in Real Estate Europe 2006 *survey.*

opportunities in 2005 and prospects for 2006.

■ Although cities in the bottom ten have not significantly changed from 2005 results, average ratings for city risk and total returns increased for Frankfurt, Moscow, Athens, Berlin, Amsterdam, and Warsaw.

■ Buyers are on the hunt with little to hunt. Although yields are historically low and property values potentially peaking, it appears that only a minor segment of respondents believe that 2006 is a good time to sell regardless of property market or property type across Europe.

■ The lack of acquisition opportunities in primary European property markets and CBD submarkets will force domestic and foreign investors and developers to widen the scope of their strategies to include secondary European property markets and non-CBD submarkets in major European markets.

■ Urban regeneration, mixed-use development, and movement into noncore property types such as student and seniors' housing will also increase in 2006 (and 2007) in most European property markets.

The next section briefly provides an overview of the 27 European property markets covered in this year's survey. The ranking methodology used remains consistent with last year's *Emerging Trends in Real Estate Europe*. At the end of this chapter, we present a new cluster analysis of the European markets that provides an alternative view of the 27 cities. Rather than being ranked, cities are clustered based on several key buy-hold-sell ratings in order to help readers create new, or challenge existing, investment and asset management strategies.

The Top Ten Markets

Paris

Paris reigns supreme again, taking the top spot in our risk-adjusted total return rankings for the second year running. Does it really have everything? Many survey respondents think so and are quick to praise its ability to offer "long-term investments in a consolidated city." In this capital-rich, product-poor property environment, the city also gets top marks for its size and liquidity. "You can buy and sell at the same time depending on the opportunity," says one respondent.

Total return prospects for Paris are among the best in Europe (third in our survey), and this, together with its attractive risk rating (also third), pushes it into first place overall. Notes one respondent, "Assuming the economic growth in France will not stagnate, Paris is one of the structurally healthiest real estate markets in Europe." At 1.8 percent GDP growth predicted for France in 2006 by Consensus Economics, it is just about in line with European averages.

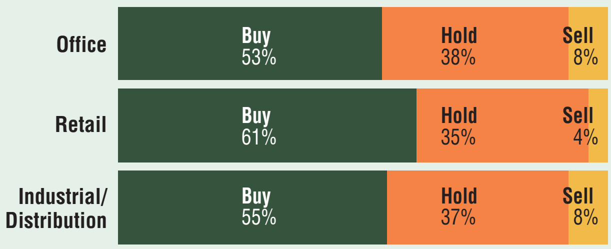
Respondents often mentioned Paris and London in the same breath as tops for opportunities in 2005 and prospects for 2006, but few speak with as much enthusiasm and romance about London. The relative yields of the two cities explain why Paris edges ahead on the office side: Paris is pretty steamy at 5.1 percent, according to CB Richard Ellis, but it is 60 basis points above London at 4.5 percent. Paris offices were in soft recovery last year, according to our respondents, and the city is now looking at certain submarkets experiencing strong recovery for 2006, with prices supported by actual and expected rental growth. Also, some development is expected to commence again (but not in La Défense submarket, where vacancy still exceeds 10 percent), and with supply having started to fall in 2005, this is looking to be a main trend for 2006.

However, Paris's popularity is resulting in some dissatisfaction among investors. With the capital a little too hot for some, there is a marked move towards second-tier French cities as investors chase apparent mispriced opportunities. "In provincial markets, rental growth is not yet reflected in prices," commented one respondent. There is also sustained interest in industrial and retail property types, and Paris has retained its top-ten ranking in both these sectors as it relates to buying opportunities. Yet, competition is heating up with a short supply of shopping centres, with the 60 percent "buy" rating being a wish more than a reality. For industrial, the transport links and the density of the city make it a good bet for 2006, say respondents.

Exhibit 3-3 **Prospects for the Paris Real Estate Market in 2006**

	Prospects	Rating	Ranking
Risk-Adjusted Total Returns	Modestly Good	6.2	1st
Total Returns	Modestly Good	6.1	3rd
Risk	Modestly Low	6.4	3rd
Rent Increases	Modestly Good	5.6	5th
Capital Growth	Modestly Good	5.9	5th
Supply/Demand Balance	Fair	5.4	3rd
Development	Modestly Good	5.6	1st

Investment Recommendation of Survey Respondents



Source: Emerging Trends in Real Estate Europe 2006 *survey.*

London

Survey respondents continue to be positive about the London market, hence its second-place ranking. As one respondent observed, the depth and size of the market, just like Paris, continue to give it merit for both buy and sell opportunities. The survey results indicate investors in all property sectors wanting to continue to buy or hold in 2006, with little emphasis on selling.

The property product crunch is likely to continue in 2006. For many, it is a recovery market gathering pace in 2006—"the cyclical upturn is underway," says one interviewee. The West End still outranks the City, where recovery is slower. At a vacancy rate of 5 percent, the West End has its lowest vacancy rate in four years and CBRE's rental index for the area is up 3.6 percent year over year. In addition, new supply is 40 percent lower than its peak in 2003 and many interviewees see the West End as a healthy development option.

Exhibit 3-4 **Prospects for the London Real Estate Market in 2006**

	Prospects	Rating	Ranking
Risk-Adjusted Total Returns	Modestly Good	6.2	2nd
Total Returns	Modestly Good	6.0	5th
Risk	Modestly Low	6.4	2nd
Rent Increases	Modestly Good	5.9	1st
Capital Growth	Modestly Good	5.8	8th
Supply/Demand Balance	Fair	5.4	4th
Development	Modestly Good	5.7	5th

Investment Recommendation of Survey Respondents

	Buy	Hold	Sell
Office	53%	33%	14%
Retail	24%	44%	32%
Industrial/ Distribution	38%	47%	16%

Source: Emerging Trends in Real Estate Europe 2006 *survey.*

Respondents generally believe the office sector has two to three good years of performance ahead of it. The City lags in its recovery, but it is starting to see positive demand figures that have reduced ready-to-occupy space to 10 percent. Tenant incentives need to be worked out of the market before anything more than marginal rental growth is seen.

For retail property, high-street retail yields in London are among the lowest in Europe at 4.25 percent, and London is one of the lowest-rated cities in our survey for retail property buying prospects. However, interest could pick up for Oxford Street if plans by the local business improvement districts proceed with a major refurbishment to provide more flagship stores, hotels, and restaurants.

One word litters the survey responses from the U.K.: REITs. Finally, the market's ambitions for a tax-transparent vehicle look set to be realised, though several issues are yet to be resolved. Notably, the government made no early indications on the level of an exit tax other than to reiterate that it would take no chances in losing tax revenue from the REITs' introduction. There are also concerns that the government will introduce a development land tax. Worries about the implications of the tax have come from all sectors. The retail industry is worried that schemes in regeneration areas could be at risk, while the housing industry says fewer sites could come forward for residential if they become subject to this tax.

Helsinki

Helsinki jumped from sixth place last year to third in the rankings for 2006. The city ranks in the top ten in risk-adjusted total returns (third), total returns (seventh), and city risk (fourth). Rent increases and capital growth should be modestly good in 2006, and a high percentage of survey respondents recommend buying office (65 percent) and retail (62 percent) in Helsinki, while less than 5 percent believe

Exhibit 3-5 **Prospects for the Helsinki Real Estate Market in 2006**

	Prospects	Rating	Ranking
Risk-Adjusted Total Returns	Modestly Good	6.1	3rd
Total Returns	Fair	5.9	7th
Risk	Modestly Low	6.3	4th
Rent Increases	Modestly Good	5.5	8th
Capital Growth	Modestly Good	5.8	7th
Supply/Demand Balance	Fair	5.0	9th
Development	Fair	5.5	11th

Investment Recommendation of Survey Respondents

	Buy	Hold	Sell
Office	65%	30%	5%
Retail	65%	30%	5%
Industrial/ Distribution	35%	47%	18%

Source: Emerging Trends in Real Estate Europe 2006 *survey.*

Madrid *and* **Barcelona** *in ageing industrial locations.*

that 2006 is a good time to sell in either property sector. Industrial properties are seeing far less interest. Yields are relatively high for Europe at 6.5 percent for both office and high-street retail properties, and very high for industrial at 10.3 percent.

Office vacancy rates increased in 2005 and there are structural differences between older and newer office stock, with oversupply a potential risk in 2006. Helsinki has "passed the worst," states one experienced investor in the market. There is strong demand from foreign investors for Helsinki office properties; according to a year-end market report, 20-plus foreign property investment firms have been active in the market over the last several years.

Madrid

There's a national victory for Madrid this year as it beats Barcelona in the rankings for the first time. This reflects investors' sentiment that the Spanish capital is reaching a turning point. Last year, there was caution over the huge supply of offices on the outskirts—which was still mentioned in several 2006 interviews. While it remains a heavily supplied market, there has been little change in the vacancy in 2005, and speculative supply in 2006 and 2007 will be no more than 550,000 square metres. Demand has been steady in 2005, giving respondents more confidence for including

Exhibit 3-6 **Prospects for the Madrid Real Estate Market in 2006**

	Prospects	Rating	Ranking
Risk-Adjusted Total Returns	Modestly Good	6.0	4th
Total Returns	Modestly Good	6.0	4th
Risk	Modestly Low	5.9	9th
Rent Increases	Modestly Good	5.9	2nd
Capital Growth	Modestly Good	5.8	6th
Supply/Demand Balance	Modestly Good	5.5	3rd
Development	Modestly Good	5.5	10th

Investment Recommendation of Survey Respondents

	Buy	Hold	Sell
Office	61%	28%	12%
Retail	55%	28%	18%
Industrial/ Distribution	63%	23%	14%

Source: Emerging Trends in Real Estate Europe 2006 *survey.*

Madrid on their prospects list. A solid majority (61 percent) rate Madrid a "buy" market for office properties. Enthusiasm among some is tempered by the perception that Madrid is a "medium-term" prospect, while others note the possibility of undersupply in key areas and think central Madrid provides opportunities for Grade A office development.

Solid prospects for industrial are expected in 2006 as its location creates opportunities in the main corridors from Madrid to Barcelona, Valencia, and Toledo. Respondents expect to see a rise in demand from tenants and investors in these areas. The best possibilities of development in this sector are between Madrid and Zaragoza. Madrid is also a highly rated "buy" market for industrial properties, with 63 percent giving a buy recommendation.

Madrid ranks in the mid range for retail (55 percent recommend buying) and there is a 50/50 view among interviewees as well. Madrid has some of the worst prospects for some, whereas others say there is still value in the eastern side of the city. An infill approach appears to be favoured, with developers looking at smaller centres for more innovative schemes such as development at train stations.

Survey respondents frequently mentioned Madrid when questioned about urban regeneration opportunities across Europe. Domestic and foreign investors alike see a variety of redevelopment opportunities in Madrid and Barcelona in ageing industrial locations. Infrastructure improvements supporting urban regeneration include the extension of the Paseo de la Castellana thoroughfare, which will have associated development of 1 million square metres of offices and retail space.

Barcelona

On many levels, Barcelona should reign supreme over Paris. Without the adjustment for city risk, Barcelona actually takes the top spot as it beats Paris this year in outlook for both rent increases and capital growth, and it places second behind Istanbul for total return prospects. Barcelona is also on par with Paris for its supply/demand balance and development outlook. The city just doesn't have the size and the liquidity, which holds back this continually attractive city at fifth place overall, though it rose from its eighth-place position last year.

The majority of respondents are attracted by what they think will be a continuation of strong rental growth in 2006. Those surveyed describe it as a "gradual" improvement in fundamentals. Yet, it is scaring off some investors for 2006; they refer to Barcelona as a "difficult" market in which to find

The Dublin market is its own internal engine. **Growth** *continues to be impressive; it*

Exhibit 3-7

Prospects for the Barcelona Real Estate Market in 2006

	Prospects	Rating	Ranking
Risk-Adjusted Total Returns	Modestly Good	5.9	5th
Total Returns	Modestly Good	6.1	2nd
Risk	Modestly Low	5.7	14th
Rent Increases	Modestly Good	5.8	3rd
Capital Growth	Modestly Good	5.9	3rd
Supply/Demand Balance	Modestly Good	5.6	2nd
Development	Modestly Good	5.8	4th

Investment Recommendation of Survey Respondents

	Buy	Hold	Sell
Office	48%	41%	11%
Retail	55%	34%	11%
Industrial/ Distribution	68%	19%	14%

Source: Emerging Trends in Real Estate Europe 2006 *survey.*

value and with prime office yields at 5 percent, which is ten basis points lower than Paris, it is definitely too hot for some. Others continue to find Barcelona appealing and point to opportunities for refurbishment, whether offices or residential.

Respondents believe the fringe and out-of-town market will continue to do well in 2006. Demand has picked up, supply is in check, and rents are favourable to prospective tenants. Second-tier-city syndrome is also hitting Spain. Respondents mention Valencia and Malaga as high-growth areas that are attracting interest from international investors that in the past considered only Barcelona and Madrid. In these second-tier cities, they say, pricing has not adapted to reflect the growth prospects.

Barcelona industrial jumps to third place in 2006 in terms of buy recommendations, compared with mid-range mediocrity last year. Respondents talk of good prospects in areas where main communication centres link Madrid to Barcelona. Interestingly, retail sparks little interest anecdotally and it is a stable-to-down market, unlike office or industrial. However, more than 50 percent say it warrants a buy rating, if the opportunity arose.

Stockholm

Stockholm's prime yields continued to fall in 2005, driven by a competitive investment environment and an increase in the number of investors from Norwegian and Danish property firms. Declining office vacancy rates are positive, although still higher than levels seen during the late 1990s. A "jobless" recovery in 2006 coupled with increased construction risks may dampen future investment capital flows. Respondents overwhelmingly choose "buy" or "hold" for each property type in Stockholm for 2006. City risk ratings are favourable, while capital growth and development ratings are fair. Speculative office developments in 2006 may signal future supply/demand imbalance in the office market.

Interviewees from the Nordic region mention hotels, mixed-use, and industrial property types as alternative investment and development opportunities in Stockholm in lieu of the aggressive office sector.

Exhibit 3-8

Prospects for the Stockholm Real Estate Market in 2006

	Prospects	Rating	Ranking
Risk-Adjusted Total Returns	Modestly Good	5.9	6th
Total Returns	Modestly Good	5.6	13th
Risk	Modestly Low	6.2	6th
Rent Increases	Modestly Good	5.5	7th
Capital Growth	Fair	5.3	13th
Supply/Demand Balance	Fair	4.7	21st
Development	Fair	5.1	18th

Investment Recommendation of Survey Respondents

	Buy	Hold	Sell
Office	48%	43%	9%
Retail	45%	45%	10%
Industrial/ Distribution	40%	44%	16%

Source: Emerging Trends in Real Estate Europe 2006 *survey.*

Dublin

The Dublin market is its own internal engine. Growth continues to be impressive; it is down from the high levels of the late 1990s but continues to outpace Europe, with a higher growth rate expected in 2006. More important, the strength is domestic, with less reliance on foreign direct investment and more economic generation of indigenous companies.

is down from the high levels of the late 1990s but continues to outpace Europe.

Exhibit 3-9

Prospects for the Dublin Real Estate Market in 2006*

	Prospects	Rating	Ranking
Risk-Adjusted Total Returns	Modestly Good	5.8	7th
Total Returns	Modestly Good	5.7	11th
Risk	Modestly Low	6.0	8th
Rent Increases	Modestly Good	5.6	6th
Capital Growth	Fair	5.3	17th
Supply/Demand Balance	Fair	5.1	7th
Development	Fair	5.2	14th

Investment Recommendation of Survey Respondents

	Buy	Hold	Sell
Office	22%	44%	35%
Retail	20%	55%	25%
Industrial/ Distribution	18%	59%	23%

Source: Emerging Trends in Real Estate Europe 2006 *survey.*

** Fewer than 20 (but no fewer than 14) survey respondents rated this city on some measures.*

Domestic demand and capital sources are also the engine of Dublin's investment and lettings markets. Three years of sluggish conditions in the office sector turned round in 2004, and early indications are that respondents expect sustained demand through 2006, once again primarily from domestic firms. Office vacancy declined from 13.8 to 11.3 percent during the year ending in the third quarter of 2005. Drawbacks for 2006 are that deals are starting to take longer to transact as negotiations are prolonged by fighting over incentives. In some sectors, particularly manufacturing, Irish companies are facing competitive pressures from overseas firms. In the office market, strong lettings continue to drive rental and capital growth, fuelling investor demand. Once again, the majority of the investors are locals. Other Europeans are interested but continue to find themselves outbid by strong local buyers. Office property yields as of third-quarter 2005 were—together with London—the lowest in Europe at 4.5 percent.

Retail properties have been in demand, but prices are now quite high, with high-street retail yields now at the near-ridiculous level of 3 percent. These yield levels are undoubtedly among the prime reasons that survey respondents do not give a high buy recommendation for Dublin retail, suggesting that holding is the best strategy for 2006. Supply is curtailed, with restrictions on large-scale schemes, but European retailers continue to want to get into the high street in an effort to capture the spending power of the young age profile in Dublin. Any worries in this sector are out of Dublin, with concerns that the amount of retail warehousing in provincial cities will be realised.

Investor interest in the hotel market may well tail off from 2005 levels as tax incentives designed to stimulate development end, with qualifying projects needing to be finished by July. Irish buyers' reputation is just as strong overseas, but for some it may be time to realise the gains, despite its seventh-placed ranking for total returns among European cities. As one respondent says: "Dublin is very strong and may be a sell to buy elsewhere."

One interesting note on Dublin: the sell recommendations for office, retail, and industrial are above average when compared with other markets. Are the high sell recommendations a market signal that the property cycle has peaked, or an opportunity for foreign investors to buy from willing domestic owners? As yields for office, retail, and industrial properties in Dublin are the lowest in Europe, according to CB Richard Ellis, investors will need to bank on growth in rents, rather than further yield compression, to achieve attractive returns in 2006.

Lyon

Lyon punched above its weight in last year's return-adjusted prospect rankings and it is just about holding its own again this year. It has dropped four spots to eighth place and, while it is still named by many as a top ten favourite prospect, this is countered by talk of competition and increasing prices. In 2006, Lyon continues to head the pack of second-tier French

Exhibit 3-10

Prospects for the Lyon Real Estate Market in 2006

	Prospects	Rating	Ranking
Risk-Adjusted Total Returns	Modestly Good	5.8	8th
Total Returns	Modestly Good	5.9	6th
Risk	Modestly Low	5.6	15th
Rent Increases	Fair	5.3	9th
Capital Growth	Modestly Good	5.9	4th
Supply/Demand Balance	Fair	5.4	5th
Development	Modestly Good	5.7	6th

Investment Recommendation of Survey Respondents

	Buy	Hold	Sell
Office	64%	28%	8%
Retail	68%	24%	8%
Industrial/ Distribution	64%	24%	12%

Source: Emerging Trends in Real Estate Europe 2006 *survey.*

Investors rate **Copenhagen** *as the city with the lowest risk of any in the survey.*

cities, which are benefiting from the overspill of competition in Paris. Office property yields in Lyon at 7.5 percent are still 160 basis points above Paris at 5.1 percent. It is a smaller, less liquid market, but respondents have the confidence to believe that development with some preletting will be possible in 2006. While Lyon is perceived as being somewhat risky, over 60 percent of survey respondents recommend buying office, retail, and/or industrial properties in Lyon in 2006, making it one of the favourite “buy” markets in Europe.

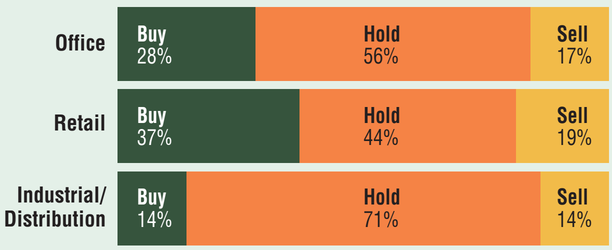
Copenhagen

Copenhagen has moved into the elite top ten market rankings in 2006 from the middle of the pack last year. Falling yields, fundamental improvements, and optimism regarding employment growth in 2006 fuel positive expectations that flat prime rents in 2005 will improve in 2006. Investors also rate Copenhagen as the city with the lowest risk of any in the survey, which significantly bolstered its rating. Positive economic growth is sustaining property market demand and foreign investment is visible in the market. Retail properties attracted foreign investors in 2005 with continued interest in 2006. The hold recommendation for industrial at 71.4 percent is the highest among all property markets, and the hold recommendation for office is high as well, with office vacancy at a fairly low 7.2 percent.

Exhibit 3-11 **Prospects for the Copenhagen Real Estate Market in 2006***

	Prospects	Rating	Ranking
Risk-Adjusted Total Returns	Modestly Good	5.7	9th
Total Returns	Fair	5.0	21st
Risk	Low	6.5	1st
Rent Increases	Fair	4.9	13th
Capital Growth	Fair	5.2	20th
Supply/Demand Balance	Modestly Poor	4.0	25th
Development	Modestly Poor	4.0	27th

Investment Recommendation of Survey Respondents



Source: Emerging Trends in Real Estate Europe 2006 *survey.*

** Fewer than 20 (but no fewer than 14) survey respondents rated this city on some measures.*

Edinburgh

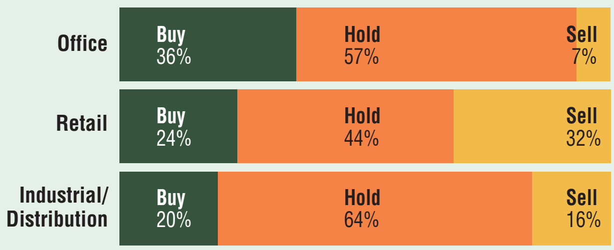
Edinburgh rounds out the top ten favourite markets—the same ranking it held in 2005. In 2006, Edinburgh’s office market will experience the full impact of its reaction to an oversupply problem dating back to 2000. No new buildings will be completed in the city in 2006, giving Edinburgh a driver for short- and medium-term rental growth. However, next year also depends on how demand fares. The market had an expectation of improved take-up in 2005, but this is proving premature as demand was down 40 percent compared with the same levels in 2004. Office yields stood around 5.5 percent in late 2005.

German investors have been active in the city for more than a decade and they continue to head a cosmopolitan mix of players. There is little the city can do to satisfy the weight of money it experiences. It is a tighter market than more traditional U.K. locations and, as such, has a stronger disposition towards owner occupation.

Exhibit 3-12 **Prospects for the Edinburgh Real Estate Market in 2006**

	Prospects	Rating	Ranking
Risk-Adjusted Total Returns	Modestly Good	5.7	10th
Total Returns	Fair	5.4	14th
Risk	Modestly Low	6.0	7th
Rent Increases	Fair	5.2	11th
Capital Growth	Fair	5.4	12th
Supply/Demand Balance	Fair	4.8	17th
Development	Fair	5.0	20th

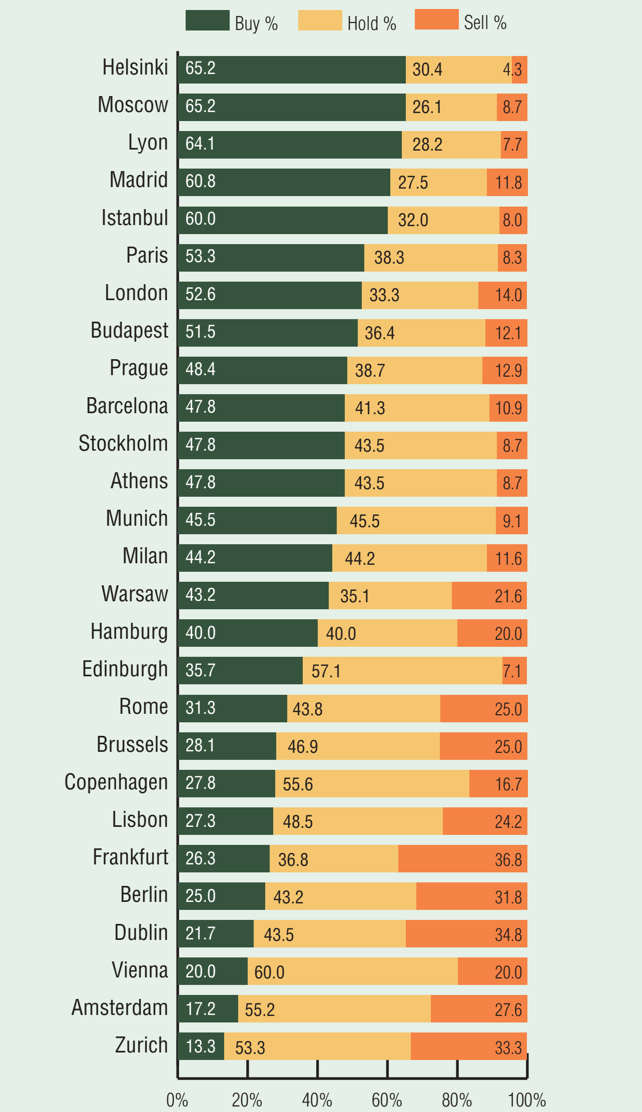
Investment Recommendation of Survey Respondents



Source: Emerging Trends in Real Estate Europe 2006 *survey.*

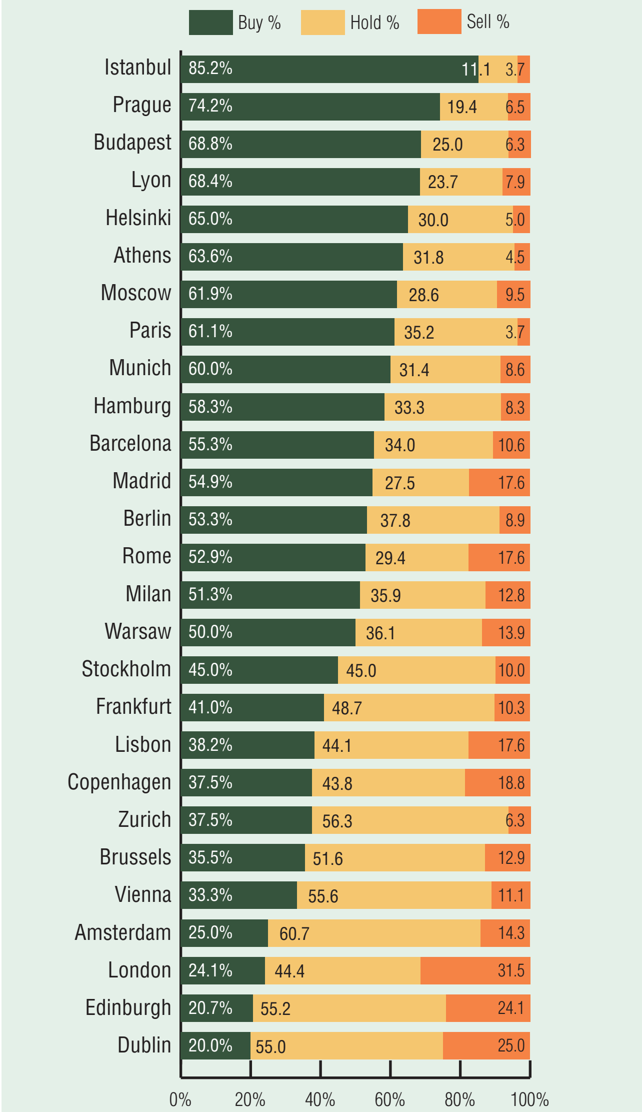
On the retail side, a dearth of opportunities for large floor plate retailers is holding the city back compared with competitors such as Glasgow. The city is considering for a second time a big-bang solution at Waverly Station, but this is in its early days yet. The market is well liked overall in our survey, coming in tenth, but on an individual-sector level there is more scepticism over its place as a buy city, with most recommending holding.

Exhibit 3-13 **Office Property Buy/Hold/Sell Recommendations by City**



Source: Emerging Trends in Real Estate Europe 2006 *survey.*

Exhibit 3-14 **Retail Property Buy/Hold/Sell Recommendations by City**



Source: Emerging Trends in Real Estate Europe 2006 *survey.*

The Middle-Ranked Markets

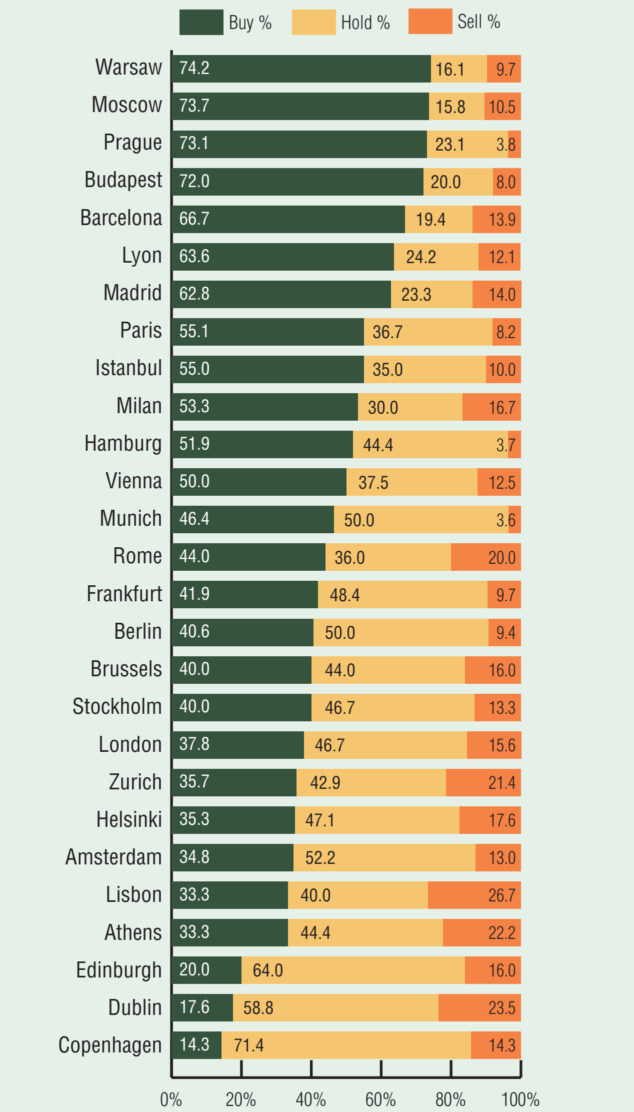
Prague

Prague comes in at the 11th ranking in this year's survey, with fairly strong total return prospects but some investor concern about risk. Prague also offers one of the better development outlooks in Europe, ranking seventh on this measure.

Office vacancy rates decreased in 2005 to the lower teens from the mid teens in 2004 due to information technology and business service positive take-up. Respondents' office buy recommendation decreased from 73 percent in 2005 to 48 percent in 2006, indicating that a larger percentage of

Hamburg *moves up from the fourth-lowest spot in 2005 to the middle-ranked cities*

Exhibit 3-15 **Industrial/Distribution Property Buy/Hold/Sell Recommendations by City**

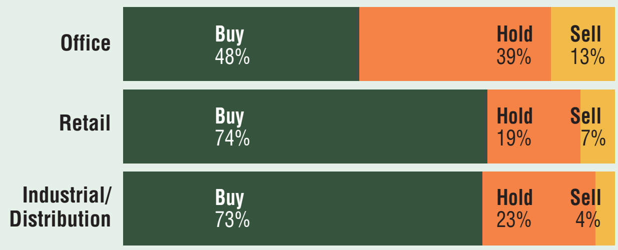


Source: Emerging Trends in Real Estate Europe 2006 *survey.*

Exhibit 3-16 **Prospects for the Prague Real Estate Market in 2006**

	Prospects	Rating	Ranking
Risk-Adjusted Total Returns	Modestly Good	5.5	11th
Total Returns	Modestly Good	5.9	8th
Risk	Moderate	5.1	20th
Rent Increases	Fair	4.9	14th
Capital Growth	Modestly Good	5.6	11th
Supply/Demand Balance	Fair	5.1	6th
Development	Modestly Good	5.5	7th

Investment Recommendation of Survey Respondents



Source: Emerging Trends in Real Estate Europe 2006 *survey.*

investors see office as a hold in Prague for the next year. The buy recommendation for retail has increased to 74 percent, up from 65 percent in 2005, whereas Prague's top ranking as an industrial buy city in 2005 has decreased slightly to 73 percent in 2006—still one of the top industrial buy recommendations in 2006.

Prime yields for office, retail, and industrial properties remain on the high side for European cities, ranging from 7 percent for office up to 8.75 percent for industrial, according to CBRE.

Zurich

Foreign investors are starting to make an impact in what remains one of Europe's weakest office markets. It is a big change for the market to see international interest in a historically domestic market. Private investors—often Middle Eastern in origin if not location—are taking the long view on investments in Zurich, pricing locals out of the market with yields of 4.5 to 4.8 percent, compared with previous levels of 5.5 percent. Respondents expect the international presence to grow in 2006. Zurich continues to rank as one of the lowest-risk markets in Europe.

However, the consensus is that 2006 will be a more difficult year and survey respondents agree; only 13 percent recommended buying offices in 2006, placing Zurich at the bottom of the "buy" recommendations list. The backdrop is a predicted weak economic growth rate, which has translated into little demand for office space. Leasing activity in 2006 is likely to remain the same as occupiers take advantage of consolidating businesses and upgrading offices rather than activity that affects net absorption. Capital has remained available *in 2006.*

Exhibit 3-17

Prospects for the Zurich Real Estate Market in 2006*

	Prospects	Rating	Ranking
Risk-Adjusted Total Returns	Modestly Good	5.5	12th
Total Returns	Fair	4.7	25th
Risk	Modestly Low	6.3	5th
Rent Increases	Fair	4.5	24th
Capital Growth	Fair	4.7	24th
Supply/Demand Balance	Fair	4.9	16th
Development	Fair	4.8	22nd

Investment Recommendation of Survey Respondents

	Buy	Hold	Sell
Office	13%	53%	33%
Retail	38%	56%	6%
Industrial/ Distribution	36%	43%	21%

Source: Emerging Trends in Real Estate Europe 2006 *survey.*

** Fewer than 20 (but no fewer than 14) survey respondents rated this city on some measures.*

Exhibit 3-18

Prospects for the Brussels Real Estate Market in 2006

	Prospects	Rating	Ranking
Risk-Adjusted Total Returns	Modestly Good	5.5	13th
Total Returns	Fair	5.1	18th
Risk	Modestly Low	5.8	12th
Rent Increases	Fair	4.7	19th
Capital Growth	Fair	4.8	23rd
Supply/Demand Balance	Fair	4.8	18th
Development	Fair	4.9	19th

Investment Recommendation of Survey Respondents

	Buy	Hold	Sell
Office	28%	47%	25%
Retail	36%	52%	13%
Industrial/ Distribution	40%	44%	16%

Source: Emerging Trends in Real Estate Europe 2006 *survey.*

and disciplined, although respondents report that this discipline is starting to slip away with the desire to invest. There are discussions on the horizon to widen to residential the Lex Friedrich legislation, which opened up the country to foreign ownership of commercial properties. Housing is an emotive issue in Switzerland and one that is likely to be resolved through a referendum.

Brussels

The home of the European Union slipped in overall rankings from 2005 to 2006, primarily due to less favourable city risk ratings. Investors appear mixed on office investment and development, although residential appears acceptable. Several investors ranked residential development in Brussels on par with London and Paris. Office supply in 2006 is a potential risk affecting rent growth expectations, and Brussels is one of a few markets where office vacancies have been on the increase, rising 100 basis points over the past year to 11.7 percent as of the third quarter of 2005. The private sector is showing modest gains in office occupancy share and respondents indicate a major fight for tenants over the next year with significant relocation opportunities. One investor stated, "…E.U. institutions are prepared to look outside the traditional Leopold area" in Brussels, with non-CBD locations growing increasingly attractive.

Brussels, a very pan-European investment market, shows improved prospects as a distribution market, as respondents increased the "buy" recommendation for industrial in 2006 versus 2005. On the other hand, investors' enthusiasm for buying retail and office properties has waned considerably from last year.

Hamburg

Hamburg moves up from the fourth-lowest spot in 2005 to the middle-ranked cities in 2006. "The city may come back in 2006 . . ." asserted one interviewee. The final stages of the FIFA World Cup in July 2006 provide a "world stage" opportunity for Hamburg to showcase itself to a global audience. Survey respondents describe rent increases, capital growth, supply/demand balance, and development issues as fair—very similar to Munich's ratings and higher than Berlin and Frankfurt.

Budapest gains ground from the lower tier in 2005 to the **middle-ranked** *tier*

Exhibit 3-19

Prospects for the Hamburg Real Estate Market in 2006

	Prospects	Rating	Ranking
Risk-Adjusted Total Returns	Fair	5.4	14th
Total Returns	Fair	5.0	20th
Risk	Modestly Low	5.8	11th
Rent Increases	Fair	4.6	21st
Capital Growth	Fair	5.0	21st
Supply/Demand Balance	Fair	4.7	20th
Development	Fair	5.2	15th

Investment Recommendation of Survey Respondents

	Buy	Hold	Sell
Office	40%	40%	20%
Retail	58%	33%	8%
Industrial/ Distribution	52%	44%	4%

Source: Emerging Trends in Real Estate Europe 2006 *survey.*

Exhibit 3-20

Prospects for the Rome Real Estate Market in 2006

	Prospects	Rating	Ranking
Risk-Adjusted Total Returns	Fair	5.4	15th
Total Returns	Fair	5.0	22nd
Risk	Modestly Low	5.8	10th
Rent Increases	Fair	4.6	23rd
Capital Growth	Fair	5.3	14th
Supply/Demand Balance	Fair	4.9	14th
Development	Fair	5.3	12th

Investment Recommendation of Survey Respondents

	Buy	Hold	Sell
Office	31%	44%	25%
Retail	53%	29%	18%
Industrial/ Distribution	44%	36%	20%

Source: Emerging Trends in Real Estate Europe 2006 *survey.*

Hamburg's buy signals improved for all property sectors compared with last year. Office vacancy rates were stable in 2005 at 8.5 percent, with continued positive take-up trends throughout the year. If office rents eventually improve, coupled with continued positive take-up trends throughout 2006, the fairly strong buy rating for office may turn out to be understated for the year. "Buy" recommendations for office have risen to 40 percent in 2006—a significant increase from 27 percent in 2005. Buy signals for retail and industrial also increased from 2005's ratings of 32 percent and 31 percent up to 58 percent and 52 percent, respectively. Office yields stood at 5.3 percent as of third-quarter 2005, up 30 basis points from a year earlier.

Rome

Rome remains a government town, but some respondents predict that this stability will soon be the backdrop for something more. "Rome is slowly but surely moving into the limelight," says one respondent. "Good, but not amazing," is a more moderate view expressed by other interviewees. Rome is one of a minority of cities that did not experience yield declines in 2005 in the office sector, with yields holding steady at 5.75 percent.

Some international investors continue to get exposure to the city through major portfolio deals such as the Carlyle Group and private investor Operae's joint venture to buy 26 assets for €255 million in Rome, Milan, and Turin. Refurbishment opportunities are welcomed in a market with limited prime space, but interviewees add that the high level of middle-quality space offers the market an inherent stability. Tenants may start to look at out-of-town submarkets such as the EUR business district, where a majority of new space is proposed.

The attraction of the retail sector has declined for buyers, falling from a 61 percent buy rating for 2005 to a 53 percent buy rating for 2006. However, there are signs of momentum in this sector as the industry continues to react to Italy's generally undershopped status. Cushman & Wakefield Healey & Baker (CWHB) estimates that Italy's retail space per 1,000 inhabitants is 130 square metres, well below the E.U. average of 159 square metres. New retail supply will bring 273,000 square metres into the market by the end of 2006 in three major schemes in Rome, with expectations of increasing international investment interest.

Budapest

Budapest gains ground from the lower tier in 2005 to the middle-ranked tier in 2006, largely due to its improved risk rating. The city ranks in the top ten markets in several benchmarks such as prospects for total returns, capital *in 2006, largely due to its improved risk rating.*

Exhibit 3-21

Prospects for the Budapest Real Estate Market in 2006

	Prospects	Rating	Ranking
Risk-Adjusted Total Returns	Fair	5.4	16th
Total Returns	Modestly Good	5.8	9th
Risk	Moderate	4.9	21st
Rent Increases	Fair	5.1	12th
Capital Growth	Modestly Good	5.6	9th
Supply/Demand Balance	Fair	5.0	12th
Development	Modestly Good	5.5	9th

Investment Recommendation of Survey Respondents

	Buy	Hold	Sell
Office	52%	36%	12%
Retail	69%	25%	6%
Industrial/ Distribution	72%	20%	8%

Source: Emerging Trends in Real Estate Europe 2006 *survey.*

Exhibit 3-22

Prospects for the Munich Real Estate Market in 2006

	Prospects	Rating	Ranking
Risk-Adjusted Total Returns	Fair	5.4	17th
Total Returns	Fair	5.1	19th
Risk	Modestly Low	5.6	16th
Rent Increases	Fair	4.8	18th
Capital Growth	Fair	5.3	16th
Supply/Demand Balance	Fair	4.7	22nd
Development	Fair	5.2	13th

Investment Recommendation of Survey Respondents

	Buy	Hold	Sell
Office	46%	46%	9%
Retail	60%	31%	9%
Industrial/ Distribution	46%	50%	4%

Source: Emerging Trends in Real Estate Europe 2006 *survey.*

growth, and development. The industrial buy rating at 72 percent remains strong, albeit 11 basis points lower than 2005, and compares favourably with the other top-ranked industrial markets of Warsaw, Prague, and Moscow. Office vacancy rates declined 400 basis points in 2005 to 13 percent as of the third quarter, due to solid demand and limited new supply. The above-average office buy rating of 51.5 percent reflects survey respondents' optimism for this property sector in 2006. Retail receives favourable buy ratings as well, with 68.8 percent rating it a buy; retail is diversifying in locations around the city and also into various retail formats.

Munich

Munich is the second German city to jump from the lower ranks in 2005 into the middle ranks of European property markets in 2006. Just like Hamburg's, Munich's rise is due to improved property fundamentals during 2005. Office vacancy rates remained within the 9 percent range with continued take-up through most of 2005, and respondents' office buy rating has increased from 27 percent for 2005 to 45.5 percent in 2006. Office yields increased 20 basis points to 5.2 percent as of the third quarter of 2005, according to CBRE. "Munich may start to pick up while Frankfurt may continue to underperform . . . " in 2006, suggests one interviewee, a sentiment that was echoed by other respondents. Retail buy recommendations increased from 41 percent for 2005 to 60 percent for 2006 and industrial buy recommendations also increased from 36 percent for 2005 to 46 percent in 2006. Interviewees mention Munich as a growing market for retail warehouse development opportunities.

Milan

Milan tumbled down the markets-to-watch rankings this year from second place in 2005 to 18th in 2006. Interviewees view the market as nonvolatile with modestly low risk, but its risk rating declined for 2006. The city also lost its footing in the retail buy recommendations, falling from first place to 15th. Rental and capital growth prospects fared no worse than last year, and the city appears to have suffered in part from the fact that other cities around it are just getting more attractive. Milan ranks in the middle for industrial prospects, but options are limited with few sites—and small ones at best—to invest or develop.

Interviewees now see declining interest from international investors in Milan. Foreign investors' presence is still very relevant, but with fewer corporate spin-off transactions, potential portfolios are becoming too small for foreign investors. Instead, the real estate funds are taking a good share as are the property companies, which have gained critical mass over the last five years.

Istanbul remains a **favourite** *with buyers despite its higher risks.*

Exhibit 3-23

Prospects for the Milan Real Estate Market in 2006

	Prospects	Rating	Ranking
Risk-Adjusted Total Returns	Fair	5.4	18th
Total Returns	Fair	5.1	17th
Risk	Modestly Low	5.6	17th
Rent Increases	Fair	4.8	17th
Capital Growth	Fair	5.3	15th
Supply/Demand Balance	Fair	5.0	5th
Development	Modestly Good	5.5	11th

Investment Recommendation of Survey Respondents

	Buy	Hold	Sell
Office	44%	44%	12%
Retail	51%	36%	13%
Industrial/ Distribution	53%	30%	17%

Source: Emerging Trends in Real Estate Europe 2006 *survey.*

A worry for Milan's prospects in 2006 is the view that Italy's real estate liquidity spreads to many of the smaller towns in the country, thus increasing the number of competitive markets. Investors are starting to see good opportunities all over Italy, mainly in the northeastern part of the country (although some see this as a "one-way" investment), but also in the less wealthy south. This has been proved, say respondents, with the breakup of Enel and Ferrovie Italiane's office and residential portfolios, which were spread all over the country.

There is scope for development, but investors, particularly international ones, are still cautious over the risks from a protracted process. A prelet might make the proposition more palatable. On a large scale, a few are taking the risk. Italian developer Risanamento is due to start work on its Montecity scheme in the southeast of Milan, which will provide 170,000 square metres of offices as well as housing and retail. Prospects for property supply/demand balance are better than for most European cites, as Milan ranks fifth on this measure.

Hotels pique an interest with some respondents as the city (and country) have few hotel chains and the sector is still very fragmented, despite demand from both tourist and business travel markets. There are a few transactions, but they tend to be small; others note that while there are plenty of projects on paper, few are interesting enough to warrant an investment in the sector.

Istanbul

Although Istanbul dropped in the rankings for risk-adjusted total returns for 2006, its rating remained the same and the city still captures top ranking for development, capital growth, and total returns and fourth place for rent growth. It suffers in the overall rankings again because of its poor risk rating, the second worst in our survey behind Moscow. Survey respondents appear optimistic for sustained economic growth as evidenced by the very high retail "buy" rating at 85 percent, up from 47 percent in 2005. Foreign investors are acquiring significant shares of existing retail properties and looking for development opportunities in an expanding market. Well-located office buildings in the CBD of Levent command premium rents in a high-occupancy market, and office yields, while still high at 10 percent, have fallen 300 basis points over the past year. Survey respondents also give Istanbul a high buy rating for office. Others believe the Mediterranean coast offers residential and resort opportunities targeting European and Middle Eastern homebuyers and tourists.

Exhibit 3-24

Prospects for the Istanbul Real Estate Market in 2006

	Prospects	Rating	Ranking
Risk-Adjusted Total Returns	Fair	5.3	19th
Total Returns	Good	6.5	1st
Risk	Modestly High	4.0	26th
Rent Increases	Modestly Good	5.7	4th
Capital Growth	Good	6.5	1st
Supply/Demand Balance	Fair	5.0	13th
Development	Modestly Good	6.3	1st

Investment Recommendation of Survey Respondents

	Buy	Hold	Sell
Office	60%	32%	8%
Retail	85%	11%	4%
Industrial/ Distribution	55%	35%	10%

Source: Emerging Trends in Real Estate Europe 2006 *survey.*

Vienna

Vienna drops from 14th to 20th place in the risk-adjusted total return rankings for 2006. Buy recommendations are below average for retail and office, and average for industrial properties. Austria's influence in the European theatre tends to be through its investors, who are increasingly active in central Europe and Russia, often taking the lead for international

Exhibit 3-25 **Prospects for the Vienna Real Estate Market in 2006***

	Prospects	Rating	Ranking
Risk-Adjusted Total Returns	Fair	5.3	20th
Total Returns	Fair	4.8	23rd
Risk	Modestly Low	5.8	13th
Rent Increases	Fair	4.9	15th
Capital Growth	Fair	5.0	22nd
Supply/Demand Balance	Fair	5.0	10th
Development	Fair	5.1	19th

Investment Recommendation of Survey Respondents

	Buy	Hold	Sell
Office	20%	60%	20%
Retail	33%	56%	11%
Industrial/ Distribution	50%	37%	13%

Source: Emerging Trends in Real Estate Europe 2006 *survey.*

** Fewer than 20 (but no fewer than 14) survey respondents rated this city on some measures.*

investment along with the Germans. Back home, domestic property firms are regaining territory by squeezing out international investors. According to CBRE, international investors previously accounted for 50 percent of the investment market, adding that the market is judging acquisitions on lease length and covenant rather than location and condition. This may explain the 20–basis point yield compression for office properties in the past year to a heady 4.8 percent. Demand may be up, but everything else—supply and rents—is stable, with nothing set to change for 2006. Investor interest in neighbouring eastern European countries such as Slovakia is growing.

Lisbon

Portugal's outlying European location has led international investors to label Lisbon as undiscovered territory in their pursuit of product. To a certain extent, investors have been disappointed: the supply of product is no different there and competition is as high, with local private investors getting in on the act. Yields are somewhat higher than other prime markets at 6.75 percent for prime office properties and 7 percent for high-street retail. However, Lisbon's ranking at seventh from bottom in our risk-adjusted ratings illustrates that the premium is not enough for most, and respondents are not enthusiastic about buying prospects in office, retail, or industrial property sectors.

If the government finally settles lease law reforms satisfactorily, international interest may increase. A strong majority government should ease reforms into place for the beginning of 2006. The laws will mean less flexibility for tenants to vacate on short notice, giving more confidence for landlords to invest. Even in light of reforms, the office sector is still risky, with low demand and excess supply. Office vacancy rates have increased dramatically in the CBD, rising from 5 percent in the third quarter of 2004 to 9.12 percent in the third quarter of 2005, according to CBRE. According to Jones Lang LaSalle, the city saw a 54,630-square-metre take-up in the first half of 2005 compared with 95,365 square metres in the same period in 2004. Excess supply in the out-of-town western Corridor market will continue to be a problem into 2006.

Exhibit 3-26 **Prospects for the Lisbon Real Estate Market in 2006**

	Prospects	Rating	Ranking
Risk-Adjusted Total Returns	Fair	5.2	21st
Total Returns	Fair	5.2	16th
Risk	Moderate	5.3	19th
Rent Increases	Fair	4.7	20th
Capital Growth	Fair	5.2	19th
Supply/Demand Balance	Fair	4.7	19th
Development	Fair	4.9	21st

Investment Recommendation of Survey Respondents

	Buy	Hold	Sell
Office	27%	49%	24%
Retail	38%	44%	18%
Industrial/ Distribution	33%	40%	27%

Source: Emerging Trends in Real Estate Europe 2006 *survey.*

Any stability for rents is to be found in the CBD, which respondents say could also still sustain new development, if chances arose. Otherwise, the development message for next year is to "pick your opportunities carefully." Retail continues to be the darling investment class in Portugal, but most of the fierce fighting is for properties located outside the capital. One important trend for this sector for 2006 and beyond, which will affect Lisbon, is the move towards intown regeneration projects and the importance of high-street retail. The Portuguese economy generally reflects an extreme version of the European average—at present, it is the extreme of underperformance; thus, there is cause for concern in 2006.

Respondents see few buying opportunities in Amsterdam, but they are not enthusiastic

Warsaw

Warsaw remains at the lower end of the rankings for 2006, similar to its place in 2005. While total return prospects are not bad, the city's risk rating is among the worst in the survey, and its prospects for rent increases and supply/demand balance also receive low ratings. Survey respondents (70 percent) still recommend industrial as a strong "buy," but office and retail buy recommendations have declined from last year. Yet, several interviewees identify Warsaw as a best bet for office in 2006, but ". . . not a market for speculative office development." Office vacancy rates have declined and now fluctuate in the lower teens to single digits, depending on whether you're talking about city centre or noncentral submarkets; most new office supply targets noncentral areas. Some respondents mention Warsaw as a growing "offshoring" market for Europe, further increasing interest in the office sector. One interviewee noted that Warsaw has "many old brownfields in great locations in need of development, especially on east side of the river Wisla."

Exhibit 3-27 **Prospects for the Warsaw Real Estate Market in 2006**

	Prospects	Rating	Ranking
Risk-Adjusted Total Returns	Fair	5.2	22nd
Total Returns	Modestly Good	5.7	12th
Risk	Moderate	4.6	23rd
Rent Increases	Fair	4.6	22nd
Capital Growth	Modestly Good	5.6	10th
Supply/Demand Balance	Fair	4.6	23rd
Development	Fair	5.1	17th

Investment Recommendation of Survey Respondents

	Buy	Hold	Sell
Office	43%	35%	22%
Retail	50%	36%	14%
Industrial/ Distribution	74%	16%	10%

Source: Emerging Trends in Real Estate Europe 2006 *survey.*

Several interviewees mentioned the return of foreign investment and development, particularly in the industrial sector from firms like ProLogis, due to Warsaw's strategic location as a major distribution hub, and in general from firms such as GE Capital and Heitman, which are back in the market. According to several respondents, urban regeneration is described as ". . . promising but slow," while new residential offers potential development opportunities.

Challenging Markets

Amsterdam

There is little change in Amsterdam in our survey rankings, even though its rating improved over last year's. Rising a few positions up the risk-adjusted return league to 23rd for 2006 is little compensation for its continued grouping with other "challenging" markets near the bottom of our survey rankings. Respondents see few buying opportunities in Amsterdam, but they are not enthusiastic about selling either; it remains a solid "hold" market for most investors.

Exhibit 3-28 **Prospects for the Amsterdam Real Estate Market in 2006**

	Prospects	Rating	Ranking
Risk-Adjusted Total Returns	Fair	5.0	23rd
Total Returns	Fair	4.5	26th
Risk	Modestly Low	5.5	18th
Rent Increases	Modestly Poor	3.8	26th
Capital Growth	Modestly Poor	4.4	26th
Supply/Demand Balance	Modestly Poor	4.0	24th
Development	Modestly Poor	4.1	25th

Investment Recommendation of Survey Respondents

	Buy	Hold	Sell
Office	17%	55%	28%
Retail	25%	61%	14%
Industrial/ Distribution	35%	52%	13%

Source: Emerging Trends in Real Estate Europe 2006 *survey.*

The office market is seeing a good level of take-up but little net absorption as tenants take advantage of lower costs to relocate. Amsterdam has the highest office vacancy rate (16.8 percent in third-quarter 2005) of the 23 cities covered by CBRE, and this rate showed no improvement over the past year. Investors with a strong stomach can risk investing in this oversupplied office market for yields of around 6 percent. With the right lease length and tenant, investors can underwrite on zero or even negative rental growth, say respondents.

Investors also give some credit to the residential market, but even then a tough local policy on new housing developments causes obstacles. For 2006, all eyes could be on retail. A new retail policy from the government will allow more large-scale retailers to locate on the periphery of cities rather than just "do it yourself" or garden centres. The policy will offer more oppor-

about selling either; it remains a solid **"hold"** *market.*

tunities for retailers to trade from bigger stores—a certain attraction to international retailers that have been frustrated in their attempts to find large-scale stores in inner cities. Rents for warehouse retail are still low in comparison with those in other European countries, but with a more flexible approach to supply, they are not expected to see dramatic growth from their yearly range of €60 to €125 per square metre.

Berlin

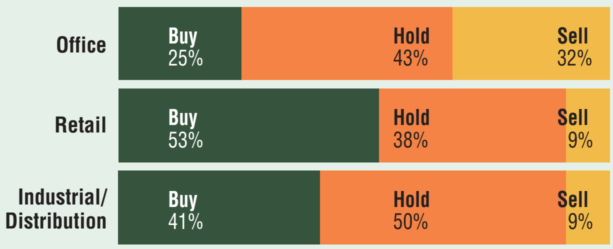
Though it moved up two spots in the rankings, Berlin is still entrenched near the bottom of rankings for 2006. There are some positive trends as the office sector has experienced the highest take-up since 2001 due to public sector demand, outpacing flat private sector demand. Vacancies remain high at around 10.3 percent, according to CBRE; office yields rose from 5.1 to 5.6 over the year ending in the third quarter of 2005. Speculative office development is a major risk in 2006, while new office stock in 2007 appears very moderate. The market still has much to prove to investors before rents start to grow appreciably, supporting our respondents' stable office buy recommendation at 25 percent in 2006 compared with 22 percent in 2005. Industrial buy recommendations are also flat from 2005 levels, remaining at 41 percent. However, the retail buy recommendation has jumped from 38 percent in 2005 to 53 percent in 2006, reflecting some aspirations for positive growth in the economy and disposable incomes.

Exhibit 3-29

Prospects for the Berlin Real Estate Market in 2006

	Prospects	Rating	Ranking
Risk-Adjusted Total Returns	Fair	4.8	24th
Total Returns	Fair	4.8	24th
Risk	Moderate	4.9	2nd
Rent Increases	Modestly Poor	4.1	25th
Capital Growth	Fair	4.6	25th
Supply/Demand Balance	Modestly Poor	4.0	26th
Development	Modestly Poor	4.4	24th

Investment Recommendation of Survey Respondents



Source: Emerging Trends in Real Estate Europe 2006 *survey.*

Athens

It will be a testing 2006 for Athens as it adapts to having value-added tax (VAT) applied to new buildings from the beginning of the year, as opposed to a transfer tax of 9 to 11 percent. The impact had already started to be seen with a rush to get building permits before the end of 2005. There also will be a gradual increase through to 2008 in the "objective values" of buildings, on which tax is based, which has seen those with disposal plans step them up a gear. While residential is likely to see more impact from these VAT plans, the commercial sector is on guard. A framework is also being put in place to launch private/public partnerships in Greece, which could provide more opportunities for developers 2006 onwards.

Athens drops slightly in the risk-adjusted rankings this year to 25th place, third from the bottom. The risk applied to the city anchors it here. Its ratings on prospects for rent increases, capital growth, and development are a bit better and are considered to be fair.

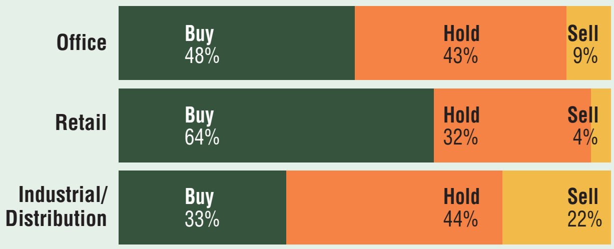
High-net-worth individuals continue to have the run of the market, although the influence of foreign investors is increasing. Their impact is expected to be felt at the €15 million–plus end

Exhibit 3-30

Prospects for the Athens Real Estate Market in 2006*

	Prospects	Rating	Ranking
Risk-Adjusted Total Returns	Fair	4.8	25th
Total Returns	Fair	5.3	15th
Risk	Modestly High	4.3	25th
Rent Increases	Fair	4.9	16th
Capital Growth	Fair	5.2	18th
Supply/Demand Balance	Fair	4.9	15th
Development	Fair	5.1	16th

Investment Recommendation of Survey Respondents



Source: Emerging Trends in Real Estate Europe 2006 *survey.*

** Fewer than 20 (but no fewer than 14) survey respondents rated this city on some measures.*

of the market, with acquisitions below that level remaining the preserve of private investors. Capital values will be affected positively, say respondents, but not exponentially. Many flag up a worry about land prices continuing to rise in 2006, though.

Debt and equity are available in Greece, with debt looking to increase in share in the coming years. Syndicates are expected to be an important source of financing. Most respondents agree that the capital is generally disciplined, but mainly because "there is not an abundance of investment-grade products." Also, with a less transparent market, more care is needed before investing.

Retail is a preferred sector, which shows with its sixth-place ranking on retail buying prospects—64 percent recommend buying retail in Athens—but there is a shortage of product. This is likely to be exacerbated in 2006 as respondents see development interest in retail tailing off but investment interest increasing. Industrial remains an owner-occupier market, so little action is forecasted for 2006. In the hotel sector, development of top-end, five-star hotels is a significant trend for 2006.

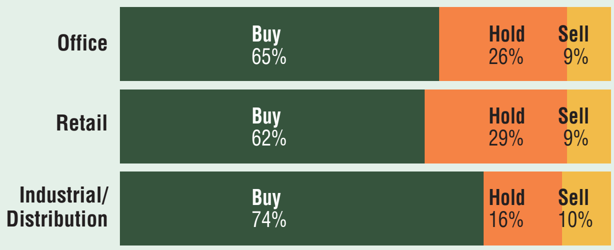
Moscow

Even though Moscow ranks at the lower end of the pack, survey respondents are conflicted about the market and overwhelmingly indicate strong "buy" signals for all property types, especially industrial. Moscow suffers in the rankings largely because of its poor risk ratings; respondents rate it the highest-risk city of all 27 cities in our survey. This is reflected in office prime yields, which stood at 12.5 percent in the third quarter of 2005, according to CBRE. There is still the ". . . need for the market to become more transparent and open; people should be comfortable that there would be fair, open, clear rules," according to an interviewee active in Russia and other CIS countries. Moscow's risk-adjusted total return rating puts it in 26th place. On the other hand, Moscow ranks highly (second place) on prospects for both capital growth and development.

Exhibit 3-31 **Prospects for the Moscow Real Estate Market in 2006***

	Prospects	Rating	Ranking
Risk-Adjusted Total Returns	Fair	4.8	26th
Total Returns	Modestly Good	5.7	10th
Risk	Modestly High	3.8	27th
Rent Increases	Fair	5.3	10th
Capital Growth	Modestly Good	6.1	2nd
Supply/Demand Balance	Fair	5.1	8th
Development	Modestly Good	5.9	2nd

Investment Recommendation of Survey Respondents



Source: Emerging Trends in Real Estate Europe 2006 *survey.*

** Fewer than 20 (but no fewer than 14) survey respondents rated this city on some measures.*

A limited amount of high-quality space is available in the office sector, with economic demand increasing. Class A office vacancy rates have steadily declined over the last two years, with rental rates increasing in the mid-$800s per square metre per annum, while vacancy rates remain in the 6 percent range and rents are relatively flat. Foreign investors are increasing, with some interest growing from German mortgage lenders. Retail and warehouse vacancy rates have been declining since 2002. The warehouse sector is underdeveloped with "incredible demand," stated one respondent on Moscow's future industrial demand trends. The industrial buy recommendation jumped from 45 percent in 2005 to 74 percent in 2006. Open Investments, Russia's only traded real estate company, recently received a buy recommendation from an investment bank.

about the market and overwhelmingly indicate strong **"buy"** *signals.*

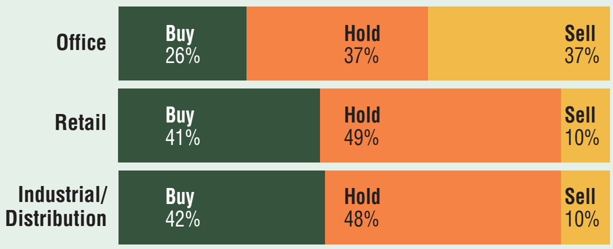
Frankfurt

Frankfurt remains at the bottom in this year's markets-to-watch ranking, with the lowest rankings in risk-adjusted total returns, rent increases, capital growth, and supply/demand balance. Yet, there is some encouraging news; Frankfurt's risk-adjusted total returns and city risk ratings improved over last year's (3.6 and 4.2 in 2005 to 4.8 and 4.9 in 2006, respectively), thus indicating some improvements in prospects as with many other European markets. Buy recommendations in 2006 increased over last year's recommendations for retail and office, while industrial remains flat. Retail's buy recommendation jumped from 27 percent in 2005 to 41 percent in 2006, and office increased from an abysmal 11 percent in 2005 to 26 percent in 2006. Office vacancy rates fell 50 basis points over the past year but remain high at 14.5 percent as of the third quarter of 2005, according to CBRE.

Exhibit 3-32 Prospects for the Frankfurt Real Estate Market in 2006

	Prospects	Rating	Ranking
Risk-Adjusted Total Returns	Modestly Poor	4.3	27th
Total Returns	Modestly Poor	4.0	27th
Risk	Moderate	4.6	24th
Rent Increases	Modestly Poor	3.6	27th
Capital Growth	Modestly Poor	4.0	27th
Supply/Demand Balance	Modestly Poor	3.9	27th
Development	Modestly Poor	4.0	26th

Investment Recommendation of Survey Respondents



Source: Emerging Trends in Real Estate Europe 2006 *survey.*

Property Types in

Retail continues to be the jewel *in the* crown.

Perspective

An industry struggling for product has shifted the sector rankings slightly for 2006, illustrating a broadening appetite for real estate in a variety of sectors.

The last two years saw a consolidation of investor interest and appetite towards retail, warehouse, and residential, but this year only retail holds its place at the top as warehouse and residential move down the rankings—behind alternative sectors such as hotel and mixed use. City centre office, though still low in the rankings, has shown significant increases in its rating, and now shows modestly good prospects.

Of the ten property types in our survey, eight have modestly good prospects for total returns while two have fair prospects. This is a significant improvement over last year, when only three sectors had modestly good prospects and six had fair prospects.

Overall, there is a general upward trend in how sectors are rated; the top spot is rated at a 5.9 rather than 5.8 and the bottom spot—this time manufacturing—takes the place with a ranking of 4.8 compared to business parks and out-of-town offices with 4.5 last year. This would indicate that the larger, and still growing, appetite for property has seen investors' optimism for all sectors elevate as they desperately seek those rare sparks of opportunity.

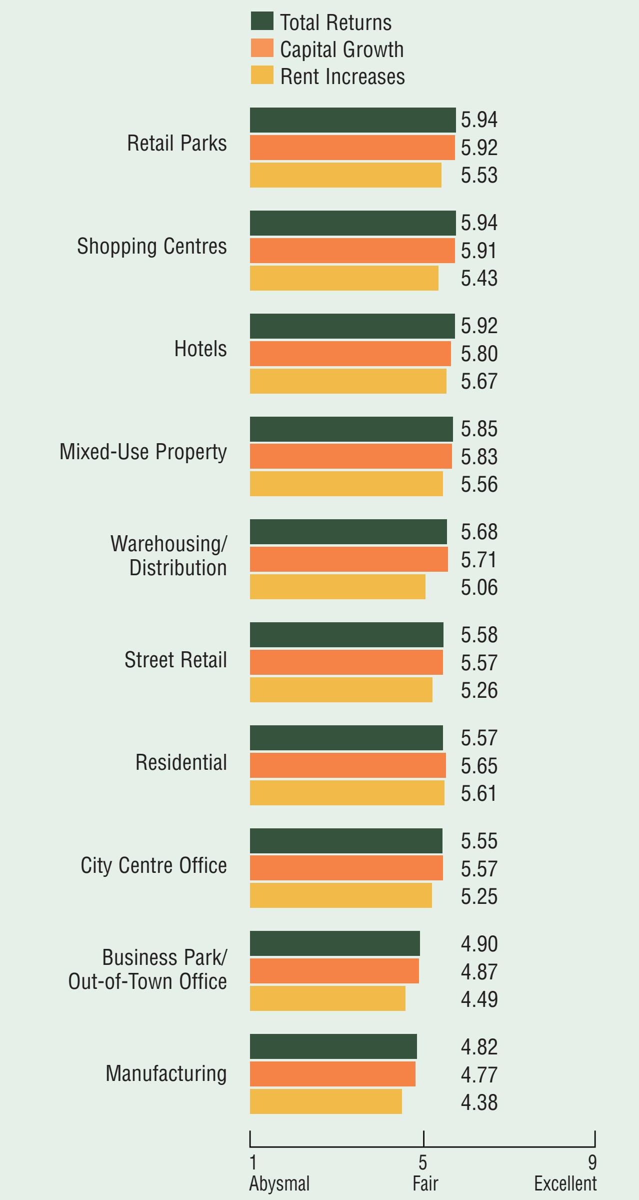
Retail continues to be the jewel in the crown as retail parks and shopping centres tie for first position for total return prospects. Clustered with these two retail categories near the top are hotels, which moved up with strengthening fundamentals, and mixed-use properties, a new category for this year. Mixed use, coming in at a respectable fourth place, illustrates that all those trends around sustainability, regeneration, and city centre development are very real and potentially profitable for investors.

The middle of the total return rankings are anchored by the warehouse sector, which dropped a bit in the rankings but held steady with last year's rating of 5.7 (modestly good) for total return prospects. The middle is rounded out by street retail, residential, and city centre office. Street retail is not expected to fair as well as the more suburban retail products. Residential prospects have fallen, in part due to fears of overheating in two strong residential markets—the U.K. and Spain. City centre offices, while still low in the rankings, have shown significant improvement, and the sector is now viewed as a good "buy" sector for 2006.

Clearly, the least-favoured sectors for 2006 are business parks/out-of-town office and manufacturing. The business park sector actually moved up from its bottom-place spot last year; with more optimism for a demand-led recovery across Europe, investors are clearly thinking that there could be just a glimmer of opportunity for good, standard, cheaper Class A space on the accessible edge of cities, particularly when put-

Exhibit 4-1

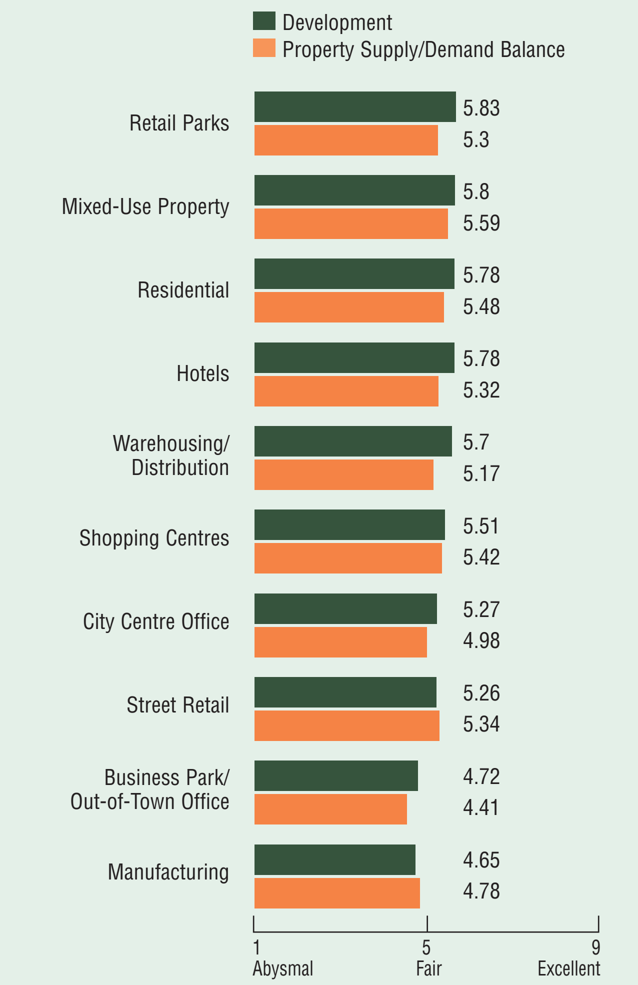
Real Estate Sector Performance Prospects for 2006



Source: Emerging Trends in Real Estate Europe 2006 *survey.*

Exhibit 4-2

Development and Market Balance Prospects for 2006



Source: Emerging Trends in Real Estate Europe 2006 *survey.*

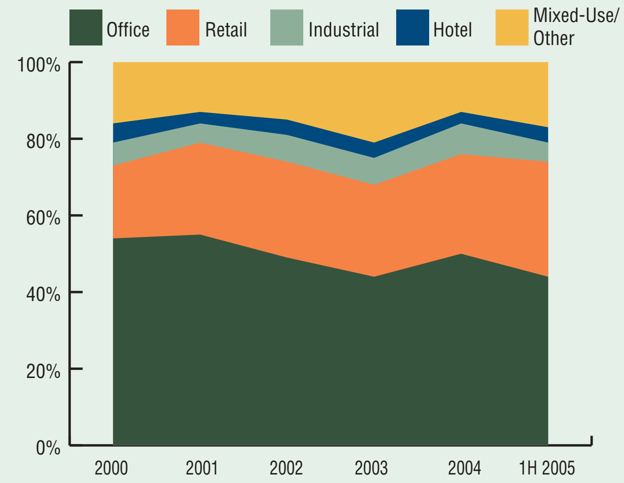
ting relocation arguments to corporates still operating in lean times. Manufacturing is largely in decline in much of Europe and out of favour with most investors.

While yields are now quite low, further yield compression will likely occur in most property sectors in 2006, most notably hotels, city centre offices, shopping centres, retail parks, and warehousing. The only sector where yields are not expected to compress further is residential.

From a buy/sell/hold perspective, which tends to be driven by a longer-term outlook, the picture changes a bit. From this perspective, the prospects for warehousing/distribution and city centre offices stand out. Most notably, city centre offices rise up the rankings from sixth place last year to second place this year; 47 percent recommend buying in this sector while only 16 percent recommend selling. This is supported by our interviewees who believe that office performance is at a low point and is likely to improve in many cities across Europe over the next several years.

On the development front, the favourites are retail parks, mixed use, residential, and hotels, all with modestly good development prospects. Warehouses and shopping centres

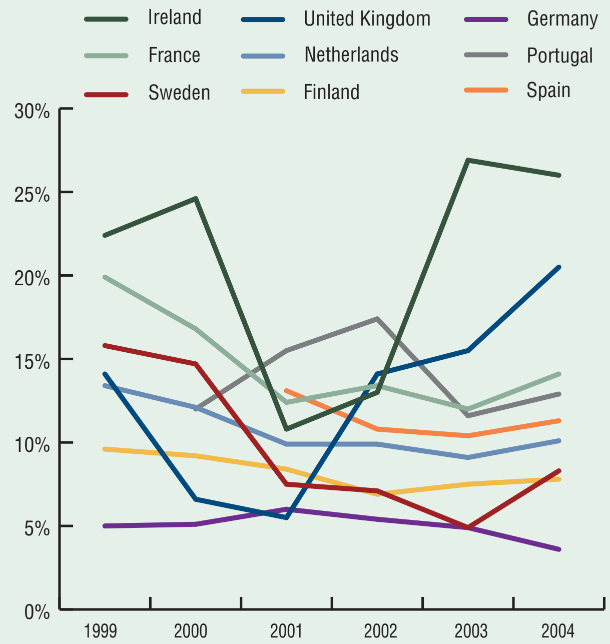
Exhibit 4-3 European Direct Real Estate Investment, by Property Type



Source: Jones Lang LaSalle European Research.

Note: Figures exclude Portugal and Denmark.

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



Source: Investment Property Databank (IPD).

Note: For Ireland, 2004 figure was not available; figure shown is for the 12 months ending in third-quarter 2005.

also show some promise, but office, street retail, and manufacturing offer only fair prospects. It is no surprise that, while the prospects for the office market may improve, the sector certainly does not need any new development, especially in the business park/out-of-town segment.

Retail

There is much less consistency of views about the retail sector this year from our survey. Retail parks and shopping centres have remained the top-rated sectors for total returns, with slightly higher ratings than last year, but beneath this headline the survey ratings show creeping concerns over rental growth and development prospects.

Continuing weak consumer spending across Europe is now causing concern among investors as well as economists. Spain and the U.K. face a somewhat weaker 2006. Germany continues to be somewhat weaker but is set to get a temporary boost with the staging of the World Cup in summer 2006. Meanwhile, bucking the trend, at least temporarily, is France, which is outpacing economic forecasts for its consumer spending.

Despite this, retail remains the sector of choice for many. "Retail has been very attractive, and because of the more stable performance, many investors are looking at it. The outlook for Germany, France, southern Europe, and the Nordic region is very attractive, while the prices in the U.K. and central Europe are not." Yields are quite low, but survey results suggest that some further downward pressure can be expected on retail property yields in 2006.

Out-of-town is still a preference for most investors—shopping centres and retail parks—although a general acknowledgement that city centre regeneration will become key could shift some interest back into town.

Best Prospects

Germany provides a restructuring opportunity, and with domestic investors failing to see even long-term value in their own market, international investors will continue to take the lead in 2006. Entrepreneurial U.K. investors have been very active, but now this has been followed by North American capital such as Canadian investor Ivanhoe and LaSalle Investment Management linking up with Merrill Lynch. Respondents say that growing interest has already meant that supply is a problem. These investors are looking for high-yielding retail investments, which means the sector is not an option for all. "Opportunities exist in Germany, but risks are higher than markets such as France," says one.

Exhibit 4-5 High-Street Retail Prime Property Yields

(Percent)

City	2004 Q3	2005 Q3	Year-over-Year Change
Dublin	3.50	3.00	-0.50
London Oxford Street	5.00	4.25	-0.75
Amsterdam	5.20	4.80	-0.40
Brussels	5.50	5.00	-0.50
Madrid	5.75	5.00	-0.75
Paris Centre West	6.50	5.00	-1.50
Vienna	5.00	5.00	-
Frankfurt	5.25	5.25	-
Zurich	5.00	5.25	0.25
Copenhagen	5.50	5.50	-
Milan	6.00	5.75	-0.25
Barcelona	6.00	6.00	-
Stockholm	6.25	6.00	-0.25
Helsinki	6.60	6.50	-0.10
Athens	7.50	7.00	-0.50
Lisbon	7.50	7.00	-0.50
Prague	7.50	7.50	-
Warsaw	10.00	10.00	-
Istanbul	17.00	13.00	-4.00

Source: CB Richard Ellis.

Exhibit 4-6 Prospects for Shopping Centres in 2006

	Prospects	Rating	Ranking
Total Returns	Modestly Good	5.9	2nd
Rent Increases	Fair	5.4	5th
Capital Growth	Modestly Good	5.9	2nd
Supply/Demand Balance	Fair	5.4	3rd
Development	Modestly Good	5.5	6th

Direction in Which Prime Yields Will Move by Late 2006: Stable/Down

Investment Recommendation of Survey Respondents

Buy	Hold	Sell
43.6%	37.6%	18.8%

Source: Emerging Trends in Real Estate Europe 2006 *survey.*

The top-rated "buy" cities for retail in our survey include Istanbul, Prague, Budapest, Lyon, and Helsinki. The top three here are strong growth markets in developing regions, factors that are bolstering consumer demand for retail property. Other C.E.E. cities, such as Bucharest and Sofia, are also in need of more prime centres.

Exhibit 4-7 Prospects for Street Retail in 2006

	Prospects	Rating	Ranking
Total Returns	Modestly Good	5.6	6th
Rent Increases	Fair	5.3	6th
Capital Growth	Modestly Good	5.6	7th
Supply/Demand Balance	Fair	5.3	4th
Development	Fair	5.3	8th

Direction in Which Prime Yields Will Move by Late 2006: Stable/Down

Investment Recommendation of Survey Respondents

Buy	Hold	Sell
36.2%	44.1%	19.7%

Source: Emerging Trends in Real Estate Europe 2006 *survey.*

Retail parks offer the best development prospects out of all property types in the survey. These big box–oriented projects are still new in some parts of Europe, and demand for the product is fairly strong. Planning constraints will keep development in check.

Proceed with Caution

Potential for shopping centres in central Europe remains strong, especially outside the capitals, as the major cities are now experiencing oversupply and there are also question marks over the quality of that supply. "Central European cities are overshopped and some of the retail spaces will fail, particularly the 'first generation' shopping centres. We haven't seen a good shopping centre come to the market this year in the Czech Republic, Poland, Hungary, or Slovakia."

The better prospects are cities of more than 300,000 inhabitants and with a trend to developing smaller retail shopping centres. "We can see large growth in the number of international tenants, which are now willing to move outside the city centres."

Retail in central Europe is still high yielding, says an interviewee, but good-quality shopping centres are still difficult to buy. The market is not yet saturated, so the advice remains to invest only in dominant centres, but "it is difficult to buy into retail. There are too many investors and too little product."

Compared with retail parks, development prospects for shopping centres and street retail are less compelling.

Avoid

The U.K., despite its maturity, is pegged as a no-go area for retail investors for 2006. Weak consumer demand and at least two high-street retail chains going into administration during the Christmas period set the scene. "Retail in the U.K. has

Exhibit 4-8 **Prospects for Retail Parks in 2006**

	Prospects	Rating	Ranking
Total Returns	Modestly Good	5.9	1st
Rent Increases	Modestly Good	5.5	4th
Capital Growth	Modestly Good	5.9	1st
Supply/Demand Balance	Fair	5.3	6th
Development	Modestly Good	5.8	1st

Direction in Which Prime Yields Will Move by Late 2006: Stable/Down

Investment Recommendation of Survey Respondents

Buy	Hold	Sell
44.0%	39.2%	16.8%

Source: Emerging Trends in Real Estate Europe 2006 *survey.*

peaked, but there are still opportunities on the continent," says one respondent, with weaker rental growth feeding into lower returns. Ireland is similarly out of favour. Survey results show the cities with the lowest "buy" recommendations in Europe are Dublin, Edinburgh, and London; only 24 percent of respondents rated London a "buy" market for retail, whereas 32 percent rated it a "sell." Only 20 percent rated Dublin and Edinburgh as "buy" markets. Retail property total returns in the U.K. and Ireland were very strong in 2004 due in large part to yield compression, and the very low retail yields (e.g., 3.0 for high-street retail in Ireland as of the third quarter, according to CBRE) will likely give pause to investors in 2006.

However, investors' caution will have to be seen to be believed. It is a continuation of 2005's story and that has not stopped predictions of retail at least matching or even topping its €20 billion of property trades for 2004.

The main battle in the U.K. has been out on the high street, which has offered the weakest rental growth prospects and has low income return, according to CBRE. Yields in this subsector have fallen to a staggering 4.25 percent in the third quarter, a 75–basis point drop on the same quarter in 2004.

A lack of stock is likely to prevent the 2005 shopping centre investment figures from beating the £9.8 billion traded in the U.K. in 2004, but low yields are encouraging some stock to come to the market.

New shopping centre developments will not ease the lack of stock burden too much, either—2005 will see just 230,000 square metres of space come on the market, according to CBRE, and the majority of this—78 percent—is within town centre shopping schemes.

Hotels

The hotel sector looks to be a top prospect both by total return and development outlook, according to our survey. It takes third place behind retail parks and shopping centres by just a slight margin for total return with a 5.92 (modestly good) rating. It also has modestly good development prospects, ranking alongside retail parks, residential, and mixed-use property at the top of our rankings.

For 2006, our survey has upgraded it to a strong buy (44 percent) or hold (41 percent) investment recommendation, with fewer respondents wanting to sell: 15 percent this year compared with almost 29 percent for 2005.

Terrorism and natural disasters have overshadowed the industry worldwide, but this has tended to redirect travel flows rather than halt them. The World Tourism Organisation (WTO) estimates that 460 million tourist arrivals were recorded worldwide in the first seven months of 2005, a 25 million or 5.9 percent growth on the same period last year. However, this does incorporate a slowdown in the second quarter of 2005, which was 4 percent compared with 9 percent in the first.

Leisure tourism continues to outpace business due to more low fares for short-haul travel, but there is anecdotal evidence, according to the WTO, that business travel will improve. This includes recovery in the conference and meetings sector.

Exhibit 4-9 **Prospects for Hotels in 2006**

	Prospects	Rating	Ranking
Total Returns	Modestly Good	5.9	3rd
Rent Increases	Modestly Good	5.7	1st
Capital Growth	Modestly Good	5.8	4th
Supply/Demand Balance	Fair	5.3	5th
Development	Modestly Good	5.8	4th

Direction in Which Prime Yields Will Move by Late 2006: Down/Stable

Investment Recommendation of Survey Respondents

Buy	Hold	Sell
43.8%	41.1%	15.2%

Source: Emerging Trends in Real Estate Europe 2006 *survey.*

There is promising growth in the sector. French consulting group MKG reported that revenue per available room (RevPAR) across Europe in the first six months of 2005 was up 2.6 percent on a year-on-year basis to €61.10. There was growth in both of the sector's main drivers: a 1.2 percent rise in average daily room rate to €93.20 and a 0.9 percentage point rise in occupancy to 65.5 percent.

Respondents generally reflect this confidence through their support of the hotel sector. Hotels, for example, are the highest-rated sector in our survey for rent/rate increases in 2006. Hotels are also expected to see more downward pressure on yields than any other sector, reflecting increasing investor confidence in the sector. Some offer it up as a necessity as other sectors get way too crowded and competitive. "There will be a large interest in hotels, mixed use, and warehousing due to overheated markets in retail and residential," explains one. There is reluctance among some interviewees to enter the sector, preferring to admire its prospects from a distance.

Others think it is a good bet with more inclination among people to travel, particularly those in the 50-plus age group as this growing demographic looks to spend the inheritance.

Best Bets

The U.K. and France continue to find favour with investors and this is matched by the growth their hotel sectors are seeing. The U.K., in particular, saw strong growth, with RevPAR up 5.9 percent, which is well above the European average of 2.6 percent. In addition, room rate growth was strong for the second year running at 4.5 percent, prompting concern that this cannot be sustained. Investors in the U.K. have been a main beneficiary of the trend for hotel companies to sell their assets. For example, Lehman Brothers with GIC Real Estate and Realstar Group recently bought a £1 billion U.K. portfolio of Intercontinental hotels.

The high levels of capital in the market are likely to tempt more owner-operators. Business Travel International (BTI) says the terrorist attacks in London have been having a small impact on provincial markets with bookings up, but from a property point of view these tend to be balanced markets in the short, with early worries over new supply in Manchester and Birmingham, according to Jones Lang LaSalle Hotels.

France's growth is less attractive with RevPAR up 2.9 percent, but it is still on most hotel investors' buy list.

Italy offers opportunities for consolidation. Italy has hotels, but in a fragmented ownership structure; Italian chains exist, but they are small compared with European and international chains. Respondents see potential here as the chains will consolidate and major brands will be seeking opportunities in well-located hotels, which still have little or no presence in major cities. Rome is high on the list. In the south, there is also room for development opportunities in resorts. High-profile banks have already provided some financing for resorts, which is expected to lead to investment by funds or property companies in the short term. However, the drawback so far has been that the available investments tend to be small in size.

Poland also presents selected investment opportunities. "Warsaw is now seeing an increase in room rates and occupancy rates after the crisis resulting from oversupply in the last five years," is one interviewee's take on Warsaw, adding there may still be a few distressed owners wanting to sell. Major cities outside the capital are also looking more interesting, with Krakow mentioned in particular followed by Wroclaw and Gdansk. Budget hotels have performed better in these modest conditions, with four- and five-star values in many cases below development costs.

Development

Two countries come out as particularly strong for new development: Russia and Turkey. In Moscow, respondents report that demand for hotel space exceeds capacity by four times. The city also holds the record for the largest room rate increase—a 29 percent increase according to BTI, which puts the daily rate at £165.21. The market has benefited from growing business development prospects, its growth in importance to business travellers, and a lack of supply.

Opportunities also extend outside Moscow, with investors looking at regions with a million-plus people as all have few high-quality hotels. "St. Petersburg needs more hotels," pleads one business traveller. Investors and developers, say respondents, are still primarily local.

Turkey is now ready to further tap its potential as a tourist market, respondents say, and needs hotels to do this. Golf tourism is big in areas such as Istanbul, Izmir, and the Aegean, while high-standard hotels are also needed at ski destinations such as Kartalkaya, Erzurum, Sarikamis, and Kastamonu.

Here, the interest has also been picked up by foreign hotel developers looking in Antalya, Bodrum, and Marmaris. Istanbul is on everyone's list, but it is more difficult to get development realised there. The major demand in large cities is for three- and four-star hotels.

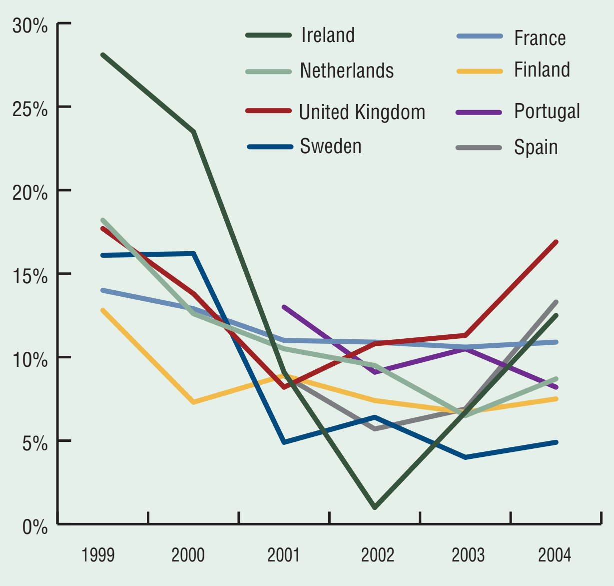
Industrial

Prospects for the industrial sector in 2006 again see a split in our survey between manufacturing real estate and warehousing/distribution (logistics). Manufacturing property comes in at the bottom of our rankings for total returns and development prospects and second from the bottom for supply/demand balance. Only 17 percent of respondents rate the sector as a "buy" while 46 percent see it as a "sell" sector.

While logistics prospects are higher in the rankings, competition from other sectors has pushed them down a few places compared with 2005. The sector's third- and fourth-place rankings have been replaced by fifth-, seventh-, and eighth-place spots. Prospects for total returns were modestly good, giving it a fifth-place ranking, with those surveyed expecting this to be fed by a fairly good prospect for capital growth. Letting it down with an eighth-place ranking are its prospects for rental growth. The buy/hold/sell graph is almost a mirror image of its manufacturing property subsector, with almost 49 percent hoping to buy and just 13 percent wanting to sell.

Industrial has been a beneficiary of a flood of capital in the market and this is starting to be reflected in its yield compression and causing some to believe that "standing investment logistics are too competitive on pricing." Madrid has seen a 125–basis point fall in yields from third-quarter 2004 to third-quarter 2005, and three other markets—Prague, Paris, and Oslo—have each seen a 100–basis point fall, according to CBRE; most other cities have seen drops of 25 to 75 basis points. The markets with steady yields were Vienna, Frankfurt, Amsterdam, and Zurich. Just Stockholm saw its yield move out. Our survey results suggest that yields will likely remain stable, with some further yield compression possible in 2006.

Exhibit 4-10 **IPD Industrial Property Total Returns for Selected Countries**



Source: Investment Property Databank (IPD).

Note: For Ireland, 2004 figure was not available; figure shown is for the 12 months ending in third-quarter 2005.

It is a mixed bag of responses reflecting the lack of harmonisation in the sector across the continent, with each country offering some merit for investors. Many countries still have substandard stock that needs replacing.

There continues to be a massive restructuring play in central Europe, "where the infrastructure is being improved," which explains the yield fall in Prague and interest in Budapest and Warsaw. However, many prefer the more mature "usual hot spots": the Netherlands, particularly Rotterdam; Paris and northern France; and western Germany.

Best Bets

The best bets are still central and eastern Europe as they continue to benefit from E.U. funding for improved infrastructure, enabling them to fulfil the appetite of growing consumer spending. The preferred industrial "buy" markets in our survey are Warsaw, Moscow, Prague, and Budapest, with over 70 percent of respondents rating these cities as good buy opportunities. "The best prospects are southern Poland, where you can already be connected with the Czech Republic and Germany. The worst will be northern parts of Poland." There is the view that in this region "all capital cities are underprovided with logistic space," making it a strong sector for acquisition and development, but many feel the sector is taking a more regional approach, with logistics spreading out from the capital cities as long as it is "close to harbours, airports, and highways."

Respondents do consider what the rise of the east will do to more traditional western locations. "There is a threat to northern France as there is a general shift to the east—it's not imminent, but it is in the short term." However, Jones Lang LaSalle says the effect on existing centres in Belgium and the Netherlands has been slight, as the change eastwards has been incremental. Third-party logistics providers have tended to split service provision among three regions—western Europe, central Europe, and the Nordic countries.

There were favourable words for Spain as well, which still has good prospects in many of its major arterial routes. "Not only do we expect growth in the sales market, but also that of rents." The corridors between the capital and cities such as Barcelona, Valencia, Toledo, and Zaragoza were highlighted. Barcelona and Madrid both received strong "buy" recommendations in our survey for warehouse/distribution.

Weaknesses

The U.K. market is causing some concern for investors. "I don't expect the U.K. to perform strongly," says one, and another felt underweight in the market, but "pricing is too high." More broadly, there were also worries of the knock-on

Residential is the only **sector** *in our survey where* **respondents** *believe yields*

Exhibit 4-11 Industrial Prime Property Yields

(Percent)

City	2004 Q3	2005 Q3	Year-over-Year Change
Dublin	6.50	5.75	(0.75)
U.K. Wide	6.35	5.75	(0.60)
Barcelona	7.50	6.75	(0.75)
Madrid	8.00	6.75	(1.25)
Copenhagen	7.50	7.25	(0.25)
Brussels	8.25	7.50	(0.75)
Vienna	7.50	7.50	0.00
Frankfurt	7.70	7.70	0.00
Amsterdam	7.75	7.75	0.00
Milan	8.25	8.00	(0.25)
Oslo	9.00	8.00	(1.00)
Paris Île-de-France	9.00	8.00	(1.00)
Stockholm	8.30	8.50	0.20
Zurich	8.50	8.50	0.00
Prague	9.75	8.75	(1.00)
Helsinki	10.50	10.30	(0.20)

Source: CB Richard Ellis.

Exhibit 4-12 Prospects for Manufacturing Real Estate in 2006

	Prospects	Rating	Ranking
Total Returns	Fair	4.8	10th
Rent Increases	Modestly Poor	4.4	10th
Capital Growth	Fair	4.8	10th
Supply/Demand Balance	Fair	4.8	9th
Development	Fair	4.7	10th

Direction in Which Prime Yields Will Move by Late 2006: Stable/Down

Investment Recommendation of Survey Respondents

Buy	Hold	Sell
16.8%	36.8%	46.3%

Source: Emerging Trends in Real Estate Europe 2006 *survey.*

effect on distribution of weakening retail demand. The lowest industrial yields in Europe—5.75 percent—can be found in the U.K. and in Dublin, each 100 basis points below the other low-yield markets.

Investor focus is on the south in the U.K., which benefits from the stronger regional economy. To counter some of the pricing worries, the U.K. has stable rents, and strong demand in the southeast is seeing a reduction in incentives for tenants, according to JLL.

Exhibit 4-13 Prospects for Warehousing/ Distribution Real Estate in 2006

	Prospects	Rating	Ranking
Total Returns	Modestly Good	5.7	5th
Rent Increases	Fair	5.1	8th
Capital Growth	Modestly Good	5.7	5th
Supply/Demand Balance	Fair	5.2	7th
Development	Modestly Good	5.7	5th

Direction in Which Prime Yields Will Move by Late 2006: Stable/Down

Investment Recommendation of Survey Respondents

Buy	Hold	Sell
48.7%	37.8%	13.4%

Source: Emerging Trends in Real Estate Europe 2006 *survey.*

On the continent, there was little short-term interest in the Italian market, which offers only a "few projects in the investment and development market, and those are of small size and [low] quality." However, there is a broadening general interest in logistics in the medium to long term with the "delocalisation" of production. Most felt that this would have to be coupled with improvements to infrastructure; good prospects, for example, were close to the highways linking Turin with Trieste and Milan-Rome-Naples.

Manufacturing in general remains a weak part of the European property market, with modestly poor prospects for rent increases in 2006 and only 17 percent of survey respondents looking to buy in this sector while 46 recommend selling. Rent increases for warehouse/distribution are not expected to be much better—only fair—and investors will need to look to capital growth to prosper in the warehouse sector in 2006.

Residential

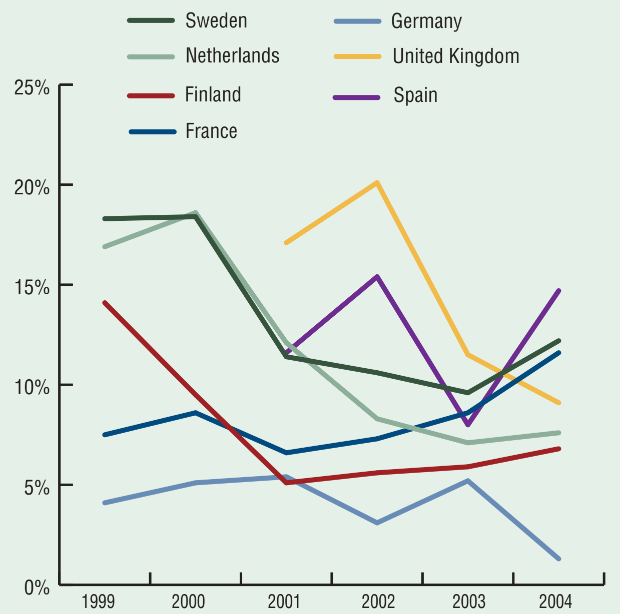
The acquisitions of German residential by U.S. funds have stolen the sector's headlines this year. The majority of those acquisitions have been in a rarefied part of the market reserved for players with €500 million and upwards (€7 billion in the case of the Terra Firma's acquisition of Viterra).

However, down on the ground in Germany, there is expected to be some kind of knock-on impact on the regular residential market. Some say the portfolio deals are "getting pricey," but for others the pricing of these transactions is "suggesting high retail" prices. Whether this is buyers' anticipation or residential growth in Germany gaining momentum is yet to be seen, but interviewees suggest that there are definitely opportunities for the market to mature.

In our survey, prospects for residential were "modestly good." It came just seventh in the sector rankings on total returns, sixth by capital growth, but second for rent increases and second for supply/demand balance prospects. Fewer respondents rate residential as a "sell" this year at 23 percent compared with 37 percent last year, with the difference now preferring to "hold" the sector. Notably, residential is the only sector in our survey where respondents believe yields are more likely to move up than down.

Residential is also where some longer-term trends are starting to affect respondents, or at least be at the forefront of their minds. They were very conscious of the impact of increased migration into their cities and that volumes and types of housing would be needed to respond to that. "Immigration is driving demand for rent or acquisitions of lower segments of residential property," says one. "There will be an overall increase in consumption, but we need to develop an appropriate housing offer." The development outlook is thus relatively bright, and residential ties for third in our survey on this measure, with modestly good prospects across Europe.

Exhibit 4-14 **IPD Residential Property Total Returns for Selected Countries**



Source: Investment Property Databank (IPD).

Also, this sector expects to see the impact of demographic changes, with families living in smaller family units. "There is a changing pattern of residential. The average size of unit is decreasing, with more one- and two-bedroom units and [fewer] three-bedroom" units, says one. "The structure of families is changing, implying a trend of smaller housing and a transformation of the housing stock." Many already express interest in the retirement communities sector as well.

Best Bets

The more opportunity-led money is heading east for 2006. "The residential market continues to be strong in Poland in 2006, with good prospects for Warsaw and key secondary cities." These include Krakow and Wroclaw, but it is "less positive in cities below 100,000 inhabitants." A "solid" year for Poland is predicted, with further growth expected on the current 7 percent annual growth of transactions. The Czech Republic has annual sales growth of 5 percent.

Many are already taking up the opportunities in Poland, prompting some to observe that "the market is overstocked with large, low-end products. We see potential for development in smaller and higher-quality projects." It is very much a sales-driven market, with few wanting a large portion of their salary to go towards rent.

However, with all opportunities comes risk. "Future growth of capital values is uncertain. This is because the rent increase has to a big extent been fuelled by speculative investment demand and not the real demand for apartments." There are also barriers to entry, including the "high level of bureaucracy in securing building permits for new developments."

Rapid population growth and migration into larger cities are making the Turkish residential market look attractive for some, although local expertise could be a crucial factor as the market's growth will "bring a tougher competitive environment where investors without sufficient local knowledge will be at risk." Bigger cities will support the trend, including Istanbul, Ankara, Izmir, Bursa, and Adana.

The government is also helping promote ownership with changes in the mortgage law. Buyers will be able to take up fixed- or variable-rate mortgages up to 30 years rather than the five- to ten-year time frame, which has been making ownership less accessible. But mortgage rates are at around 1.2 percent per month; there needs to be a decline in these rates before take-up improves.

Avoid

Did someone say bubble? It is a problem that most respondents deny exists for the rest of the market, but when it comes to either U.K. or Spanish residential, they are happy to adopt the term.

"Yes, there is a bubble in Spain. Residential is overvalued by 20 to 25 percent," says one interviewee. Another interviewee estimates that housing starts will fall from current levels of more than 700,000 to around 400,000.

Pessimists call Spanish housing a "low growth" opportunity and that the market's "oversupply will come into focus" in 2006. Any adjustment in pricing, say interviewees, will depend on possible interest rate rises and the pace of those rises.

High land prices have tempted some to look beyond the major cities for better prospects in Valencia, Murcia, and Castellón, where land is available at a more reasonable price. While a couple of interviewees put Madrid at the top of the list for the worst prospects, some said the capital afforded conversion opportunities.

Others are looking to the second-home market as having the most growth potential as Spain becomes an option for more Europeans. For example, many U.K. residents were taking the chance in 2005 to buy a second home to place in their Self-Invested Personal Pension. However, the U.K. government recently ended this option.

Exhibit 4-15 Prospects for Residential Real Estate in 2006

	Prospects	Rating	Ranking
Total Returns	Modestly Good	5.6	7th
Rent Increases	Modestly Good	5.6	2nd
Capital Growth	Modestly Good	5.7	6th
Supply/Demand Balance	Modestly Good	5.5	2nd
Development	Modestly Good	5.8	3rd

Direction in Which Prime Yields Will Move by Late 2006: Stable/Up

Investment Recommendation of Survey Respondents

Buy	Hold	Sell
36.6%	40.2%	23.2%

Source: Emerging Trends in Real Estate Europe 2006 *survey.*

In the U.K., there is a view that the "ownership market is facing a four- to five-year correction" and that this weaker market could deter institutional investors, which were starting to feel more comfortable with the sector. A destabilising effect has come from private purchases of buy-to-let properties, which will suffer as growth fails to come through in 2006.

Greece also could have a tough 2006. Its residential market will feel the brunt of the introduction of VAT onto new development, which will cause a slowdown in the market. "The Greek residential market shows a similar slowdown every time tax changes are introduced—it usually takes between six months and a year for the market to adjust," explains one interviewee. Regardless of this, the message from Greece is that there is real demand in Athens and other major cities.

Office

"Pure cut-throat competition" is how one interviewee summed up the office investment market. In addition to the amount of capital chasing dwindling stock, there are also concerns about the expertise of that capital. Some expressed the view that a 90-day economic shock might be good for the European office property industry, as it might chase away some of the hot money in the sector, leaving a clearer investment run in the office sector for more experienced players.

In 2006, the sector will also have to continue to contend with the advent of a new tranche of longer-term capital, which values the income component of property, allowing it to pay higher prices for assets as they were considering investments on a much longer term. These investors are unlikely to be deterred from the market in 2006, even by a 150– to 200–basis point shift in interest rates.

For the office market to thrive longer term, the sector needs to see rental growth in 2006. "If there is no rental recovery, then this could result in problems—maybe not in 2006, but in 2007." The sector is seen as having the greatest potential for growth by many interviewed, but can this move quickly enough in 2006? "For rental growth versus price, it is becoming more difficult to see the value," comments one respondent.

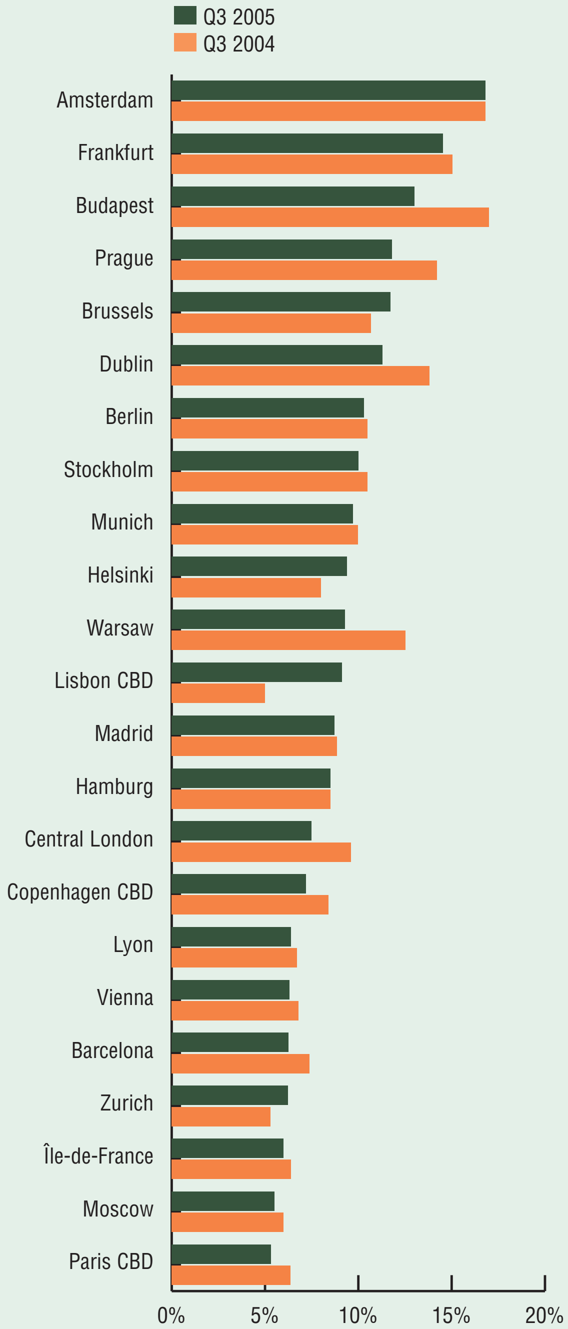
Exhibit 4-16 Office Prime Property Yields

(Percent)

City	2004 Q3	2005 Q3	Year-over-Year Change
London West End	5.50	4.50	-1.00
Dublin	5.25	4.50	-0.75
Madrid	5.75	4.75	-1.00
Vienna	5.00	4.80	-0.20
Barcelona	5.75	5.00	-0.75
Paris Centre West	5.75	5.10	-0.65
Munich	5.00	5.20	0.20
London City	6.00	5.25	-0.75
Hamburg	5.00	5.30	0.30
Frankfurt	4.90	5.30	0.40
Stockholm	6.60	5.50	-1.10
Edinburgh	6.00	5.50	-0.50
Milan	5.75	5.50	-0.25
Zurich	4.75	5.50	0.75
Berlin	5.10	5.60	0.50
Copenhagen	6.25	5.75	-0.50
Rome	5.75	5.75	0.00
Amsterdam	6.75	6.00	-0.75
Brussels	6.25	6.25	0.00
Helsinki	6.80	6.50	-0.30
Lisbon	7.25	6.75	-0.50
Warsaw	9.10	7.00	-2.10
Budapest	8.00	7.00	-1.00
Prague	7.75	7.00	-0.75
Lyon	7.75	7.50	-0.25
Athens	7.00	7.50	0.50
Istanbul	13.00	10.00	-3.00
Moscow	13.00	12.50	-0.50

Source: CB Richard Ellis.

Exhibit 4-17 **Office Vacancy/Availability Rates**



Source: CB Richard Ellis.

This can be seen in the yield shifts experienced in the sector in a year that has seen only moderate occupier demand. Paris fell 65 basis points to 5.1 percent in the year to the end of the third quarter, but may even look cheap in comparison with London at 4.5 percent (a 100–basis point drop) and Madrid at 4.75 percent. The yield shifts also show how far-reaching investors have been on the search for office product: Istanbul has seen a 300–basis point drop in yield to 10 percent, Warsaw has fallen 210 basis points to 7 percent, and Lyon has fallen 25 basis points to 7.5 percent. Our survey results suggest that downward pressure on office property yields will continue in 2006 across Europe, and that this downward pressure will be especially noticeable in city centre offices.

A clear division remains between city centre offices and business park/out-of-town business space. City centre offices, at 47.4 percent, are the second most favoured sector in our survey in terms of the percentage wanting to buy in 2006. This stands in stark contrast to business park or out-of-town space, where just 24.8 percent want to buy, with the majority at 39.2 percent wanting to sell the sector in 2006. Business park/out-of-town offices also rank at or near the bottom on prospects for total returns, rent increases, capital growth, development, and property supply/demand balance.

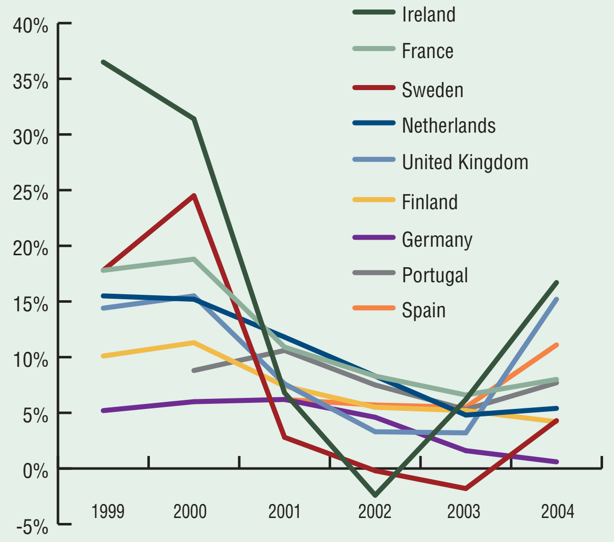
Best Bets

For risk-adjusted return prospects, core markets with expectation of rental growth remain favourites in our survey. Paris and London lead the way with solid total return and rent growth prospects and favourable risk ratings. In London, the West End can rely on "good core tenant demand," but the City office market is lagging and is "not recovering as quickly as anticipated," although London as a location generally has "two to three years' good performance ahead of it." "Paris remains robust" and with supply in check, it should see growth continue in 2006.

Top "buy" markets for the office sector are Helsinki, Moscow, Lyon, Madrid, and Istanbul, with over 60 percent of respondents suggesting that these were good markets for buying offices in 2006. Helsinki, Lyon, and Madrid are each considered low-risk markets with reasonable rent growth prospects, and Moscow and Istanbul both rate highly for growth prospects. With the exception of Madrid, office yields are relatively high in these markets, ranging from 6.5 percent in Helsinki to 12.5 percent in Moscow.

Other investors looking for value will continue to search cities outside the capitals in 2006. A typical response has been to focus on locations where rental prospects are strong and pricing has not yet adapted to reflect this. "France [except Paris], Spain [except Madrid and Barcelona]." For France, this means Marseilles and Lyons, and Alicante, Valencia, and Seville in Spain. The trend is also spreading to Italy, where "there will be a reduction in the demand for offices in the main cities and growth in the middle-size cities, both for development and investment." In most cases, this investor strategy is occurring where the capital city market is favoured but has become too hot for investors, who nevertheless want to benefit from the country's economic prospects.

Exhibit 4-18 **IPD Office Property Total Returns for Selected Countries**



Source: Investment Property Databank (IPD).

Note: For Ireland, 2004 figure was not available; figure shown is for the 12 months ending in third-quarter 2005.

The U.K. is one exception to this, where there is more caution with regard to the regional markets, which tend to be more mature relative to continental second-tier cities. "It is very important to look at local supply in U.K. regional office markets," says one, with others seeing office rental growth in London but "less evidence in the U.K. regions."

Avoid

Germany and the Netherlands get the consistent thumbs down for 2006. For Germany, the caution is patchy; few will touch Frankfurt and Berlin, but the other cities may have some merit in 2006. "The German market is still a question mark and Munich may start to pick up while Frankfurt will continue to underperform." Concerns over economic performance continue to underpin the lack of confidence in the German market, but where there is less of a supply/demand imbalance, markets could recover more quickly, say respondents.

Exhibit 4-19 **Prospects for City Centre Offices in 2006**

	Prospects	Rating	Ranking
Total Returns	Modestly Good	5.6	8th
Rent Increases	Fair	5.3	7th
Capital Growth	Modestly Good	5.6	8th
Supply/Demand Balance	Fair	5.0	8th
Development	Fair	5.3	7th

Direction in Which Prime Yields Will Move by Late 2006: Down/Stable

Investment Recommendation of Survey Respondents

Buy	Hold	Sell
47.4%	36.5%	16.1%

Source: Emerging Trends in Real Estate Europe 2006 *survey.*

Exhibit 4-20 **Prospects for Business Park/ Out-of-Town Offices in 2006**

	Prospects	Rating	Ranking
Total Returns	Fair	4.9	9th
Rent Increases	Fair	4.5	9th
Capital Growth	Fair	4.9	9th
Supply/Demand Balance	Modestly Poor	4.4	10th
Development	Fair	4.7	9th

Direction in Which Prime Yields Will Move by Late 2006: Stable/Down

Investment Recommendation of Survey Respondents

Buy	Hold	Sell
24.8%	36.0%	39.2%

Source: Emerging Trends in Real Estate Europe 2006 *survey.*

Berlin and Frankfurt are near the bottom of our office "buy" list, while Hamburg and Munich fall more towards the middle. Office yields in the German markets as of the third quarter were generally in the range of 5.2 to 5.6 percent, but yields actually rose 20 to 50 basis points from third-quarter 2004 to third-quarter 2005, according to CBRE.

The Netherlands' poor rating is more a concern over supply. "We expect a natural balance back in the market in three to five years. There will be a shortage of high-quality office within two years." Amsterdam, Rotterdam, and the Hague are highlighted by many as particularly poor prospects. At a stretch, good markets in the Netherlands are named as Zwolle, Breda, and Maastricht.

Zurich, Amsterdam, and Vienna received the lowest "buy" recommendations for office in our survey, with Dublin, Berlin, and Frankfurt also near the bottom of the shopping list. However, such extremes do encourage contrarian investors. "Our targets are where rental growth prospects are poor but pricing is attractive, such as Germany." Or: "With Amsterdam, Frankfurt, and Brussels there are relatively high yields, so depending on lease length/tenant you can underwrite on zero or even negative rental growth."

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