



WINTER 2010/11 EUROPEAN INVESTMENT

Commentary

Knight Frank

HIGHLIGHTS

- The European economic recovery has continued, though the rate of GDP growth slowed during Q3 2010. Forecasts for 2011 suggest that growth will remain fairly muted, with concerns over sovereign debt and the impact of government austerity measures clouding the economic outlook.
- Most European markets are continuing to see gradual improvements in occupier activity, with office take-up levels in 2010 increasing on the previous year. Prime rents have begun to show the first signs of recovery in a growing number of European office markets, including Paris, Stockholm and Moscow.
- European investment volumes are well up on 2009, but remain considerably below the levels reached prior to the downturn. Investor interest remains focused on prime assets in the core Western European markets of the UK, Germany and France.

The economy

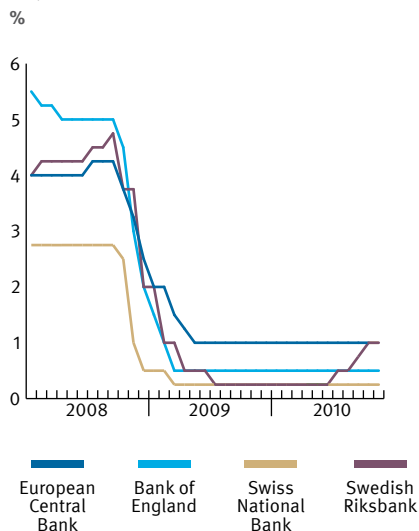
GDP growth

The economy of the European Union grew by 0.4% in Q3 2010, down from Q2's figure of 1.0%. While a slowdown in Q3 was widely expected, as the previous quarter had been boosted by short term factors such as a rebound in the construction sector, the moderation in growth also reflects the fact that Europe's economy is running into significant headwinds which will hinder a smooth recovery.

Despite easing in Q3, growth levels in Germany and the UK continue to exceed the EU average. However, many of the weaker and most indebted economies on the periphery of Europe remain in serious difficulties. Greece is mired in a deep recession, while Ireland was forced to accept a €85 billion EU/IMF bailout in November. Concerns remain over the possibility of contagion to other Eurozone economies, notably Portugal and Spain.

For 2010 as a whole, EU GDP growth is expected to come to around 1.8%. However, a slight slowing to about 1.7% is forecast for 2011. The various austerity measures announced by governments across Europe will take a greater hold over the coming months, while weak labour markets and consumer spending are also likely to drag on growth.

Figure 1
Key interest rates



Source: National Banks

Inflation

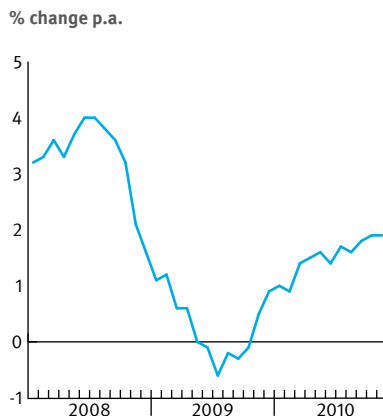
Inflation in the Eurozone reached 1.9% in November, the highest level for two years and in line with the European Central Bank's target level of just below 2.0%. Despite recent rises, most forecasts suggest a relatively benign outlook for inflation into 2011, as price pressures should remain weak while there is significant spare capacity in the economy and wage inflation is subdued.

Interest rates and monetary policy

The European Central Bank's refi rate, at 1.00%, and the Bank of England's base rate, at 0.50%, remain held at historically low levels. Market expectations suggest that these rates will not be moved until well into 2011.

Neither the ECB nor the BoE has yet followed the US Federal Reserve's lead by embarking on a second round of quantitative easing ("QE2"), though both may come under pressure to implement further QE should the economic recovery falter. The strength of the UK's Q3 GDP figures has encouraged the BoE to hold off on this for the time being. The ECB has publicly appeared committed to an exit from non-conventional measures, but has stepped up its purchases of bonds issued by the countries most affected by the sovereign debt crisis.

Figure 2
Eurozone inflation (HICP)



Source: Eurostat

Labour market

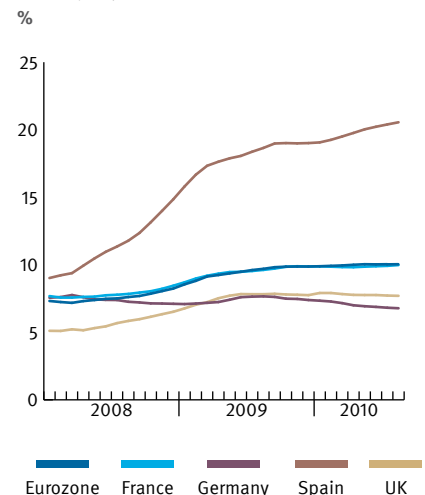
The overall unemployment rate for the European Union stood at 9.6% in October, having seen minimal movement over the previous six months. However, this masks a divergence in trends, with unemployment falling in Germany and some CEE countries including the Czech Republic and Hungary, but rising in weaker economies, particularly Spain and Ireland.

Unemployment is likely to remain at relatively high levels over the coming months. Government austerity measures may lead to public sector job cuts, while the modest levels of growth anticipated in the economy are unlikely to lead to significant job creation.

Retail sales

The volume of retail trade in the European Union was up by 1.8% in October 2010 compared with the same month of the previous year. Retail sales growth has remained relatively muted across much of Europe in light of high unemployment and limited wage inflation, though improvements in German retail sales have indicated that the economic recovery in this country has become increasingly broad based, and not just driven by exports and manufacturing industry.

Figure 3
Unemployment



Source: Eurostat

GROWTH FORECASTS FOR GERMANY AND POLAND HAVE IMPROVED, BUT THE OUTLOOK REMAINS WEAK IN SPAIN, PORTUGAL, IRELAND AND GREECE.



GDP growth forecasts, 2011

- 4.0% or higher
- 3.0% to 3.9%
- 2.0% to 2.9%
- 1.0% to 1.9%
- 0.9% or lower

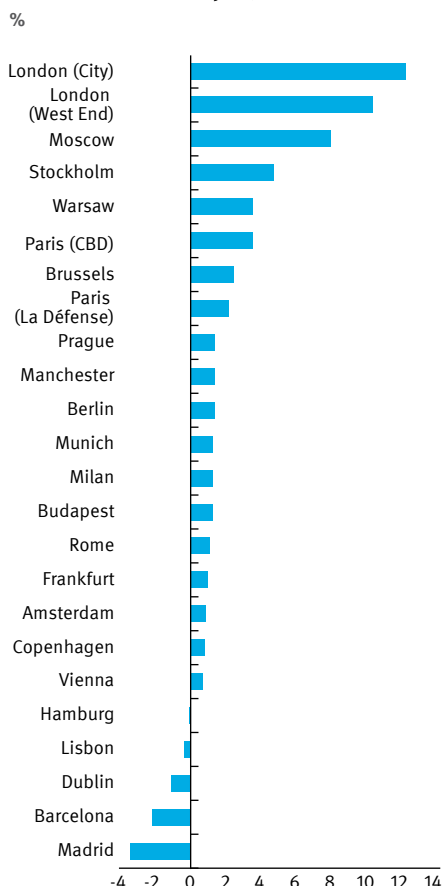
Table 1
European overview

Country	EU member status	Currency	Interest rate, Dec 2010 (%)	GDP growth rate 2010 (%) ¹	GDP growth rate 2011 (%) ¹	Unemployment (%) ²	Inflation (%) ²	Population
Eurozone	-	Euro	1.00 ▶	1.7	1.5	10.1 ▲	1.9 ▲	329,575,150
European Union	-			1.8	1.7	9.6 ▶	2.3 ▲	501,090,520
Belgium	Full	Euro	1.00 ▶	2.0	1.8	8.5 ▶	3.1 ▲	10,827,000
France	Full	Euro	1.00 ▶	1.6	1.6	9.8 ▶	1.8 ▶	64,714,074
Germany	Full	Euro	1.00 ▶	3.7	2.2	6.7 ▼	1.3 ▶	81,802,257
Ireland	Full	Euro	1.00 ▶	-0.2	0.9	14.1 ▲	-0.8 ▲	4,467,854
Italy	Full	Euro	1.00 ▶	1.1	1.1	8.6 ▲	2.0 ▲	60,340,328
Netherlands	Full	Euro	1.00 ▶	1.7	1.5	4.4 ▼	1.4 ▶	16,574,989
Spain	Full	Euro	1.00 ▶	-0.2	0.7	20.7 ▲	2.3 ▲	45,989,016
Czech Republic	Full	Czech koruna	0.75 ▶	2.4	2.3	6.9 ▼	1.8 ▲	10,506,813
Poland	Full	Złoty	3.50 ▶	3.5	3.9	9.7 ▲	2.6 ▲	38,167,329
Sweden	Full	Swedish krona	1.00 ▲	4.8	3.3	8.2 ▼	1.6 ▶	9,340,682
United Kingdom	Full	Pound sterling	0.50 ▶	1.8	2.2	7.7 ▼	3.1 ▼	62,008,048
Turkey	Candidate	Turkish lira	7.00 ▶	7.5	5.5	11.4 ▼	9.2 ▲	72,561,312
Russia	Non-member	Ruble	7.75 ▼	3.5	3.8	6.8 ▼	7.5 ▲	141,945,966
Switzerland	Non-member	Swiss franc	0.25 ▶	2.6	1.8	3.6 ▼	0.2 ▼	7,785,800
Ukraine	Non-member	Hryvnia	7.75 ▶	3.7	4.5	9.2 ▼	10.1 ▲	45,822,214

¹ GDP forecasts: source: European Commission, except Ukraine – source: IMF ² Latest available data as at early December 2010
Source: European Commission/IMF/National Banks/National Statistics Services/Knight Frank



Figure 4
Three-year prime rental growth forecasts, 2010-12 (p.a.)
 %



Source: IPF European Consensus Forecasts, November 2010

OFFICE MARKETS INCLUDING PARIS AND STOCKHOLM HAVE FOLLOWED LONDON IN RECORDING PRIME RENTAL GROWTH.

Occupier markets

Europe's office markets have mostly continued to see a gradual recovery from the low levels of occupier activity observed last year, though the strength of improvement has varied between markets.

In Paris, take-up for the whole Ile de France market in Q3 came to approximately 510,000 sq m which, while down on Q2, brought the total for the first three quarters of 2010 to c.1.62 million sq m, 28% up compared with the same period of last year. Leasing activity has been boosted by a particularly strongly increase in take-up within the CBD and an improved number of large-scale transactions.

The Central London leasing market has also revived. For the period between Q1-Q3 2010, take-up amounted to just over 960,000 sq m, 80% up on the first three quarters of 2009. This recovery in activity, combined with limited development completions, has pushed vacancy rates down since late 2009.

Significant improvements in take-up have also been seen in other markets including the large German cities and Madrid. However, in the case of the Spanish capital, the market is coming from a particularly dire performance in 2009, and take-up is still some way short of long-term average levels.

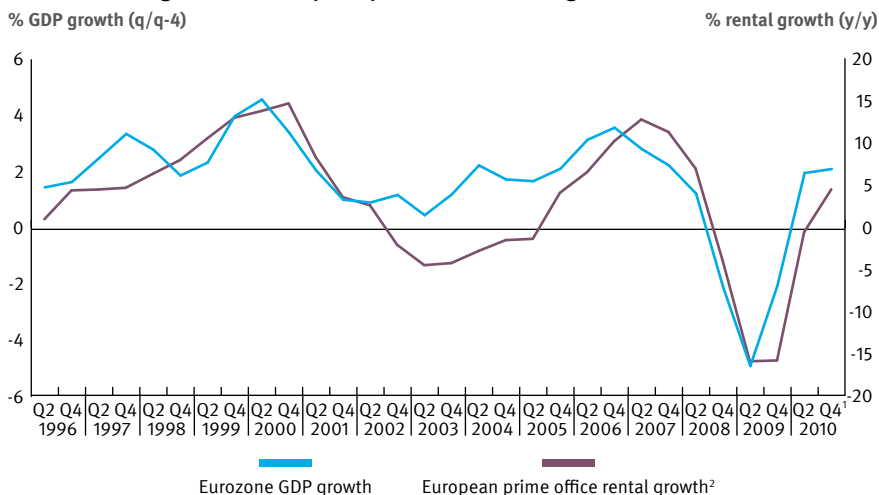
Across most of Europe's major markets, prime office rents have either stabilised or begun to show the first signs of growth following the widespread falls seen during 2008-09. Rental growth has been led by the Central London market. In Q3 2010, prime office rents in the West End were £82.50 per sq ft per annum, 25% higher than at the start of the year.

Nowhere else in Europe has seen rents rise by anything like the degree that they have in London, but markets including Paris, Moscow and Stockholm have seen the beginnings of rental growth in recent months. Prime office rents are generally stable in Germany and the Benelux but are still coming under some downward pressure in a small number of weaker markets, notably in Spain.

In Europe's retail sector, a polarisation between the fortunes of prime and secondary markets has become increasingly evident. Rents have generally held up well for prime pitches in major retail locations such as London, Paris, Milan and Munich. However, demand for retail space remains weak in many secondary towns, putting pressure on rents and vacancy rates.

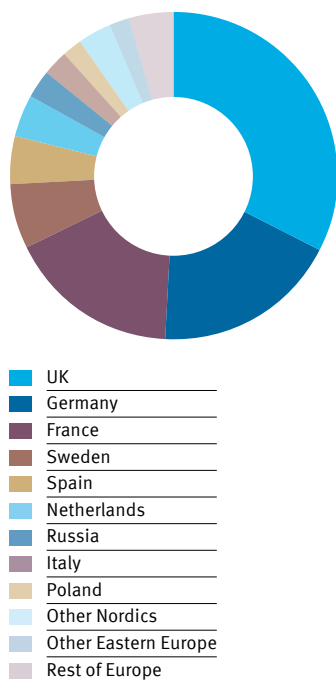
Prime rents within the logistics sector are showing signs of stabilising. There are very few speculative development projects underway in most European logistics markets, causing an increase in built-to-suit activity.

Figure 5
Eurozone GDP growth vs European prime office rental growth



¹ Forecasts ² Based on a weighted average of rents in 15 key European office markets
 Source: Knight Frank/Eurostat

Figure 6
**Destination of capital,
Q1-Q3 2010**
%



Source: Knight Frank/Real Capital Analytics

Investment markets

The European investment volume for Q3 2010 came to €24.2 billion, according to Real Capital Analytics data. This was down from Q2's figure of €26.4 billion, but brought the total for the first nine months of the year to €73.5 billion, more than 45% up on the same period of 2009.

Investors remain risk averse and the core Western European markets of the UK, Germany and France are still the main focus of investment activity, accounting for more than two-thirds of all activity in Q3. The year so far has also seen notable improvements in investment volumes in other relatively low risk Western markets such as Sweden and the Netherlands.

The investment volume for the CEE region during the first three quarters of the year was up by more than a third compared with 2009. Poland has proved to be the most robust of the CEE markets, benefitting from strong economic growth, which has helped to attract a much improved flow of capital from non-domestic investors, notably the German funds.

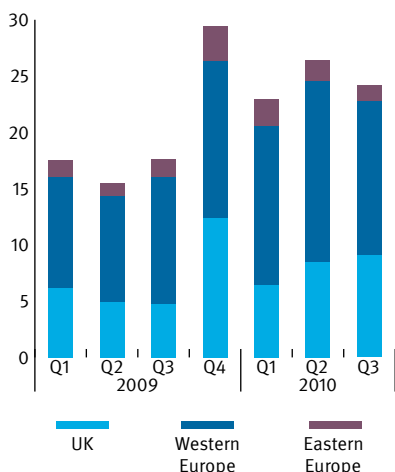
The recent downward movement in prime yields has showed signs of abating in some markets. Prime yields in Central London were flat during Q3, bringing a pause to the yield compression which had been observed over

the previous twelve months. In contrast, the weight of money chasing prime product in Paris has continued to push yields down, with prime offices trading at around 4.75% in late 2010, 75 basis points down on the start of the year. Prime yields currently appear to be either broadly stable or subject to modest downward pressure in the key Benelux, German and Nordic markets.

In all sectors and locations, investor interest continues to be largely focused on prime properties let to secure covenants on long leases. Investors remain cautious towards non-prime assets and there is little debt financing available for secondary product. A large gap has emerged between prime and secondary yields but, even so, it may take further improvements in economic and occupier market conditions before many investors see attractive risk premiums in the yields on secondary properties.

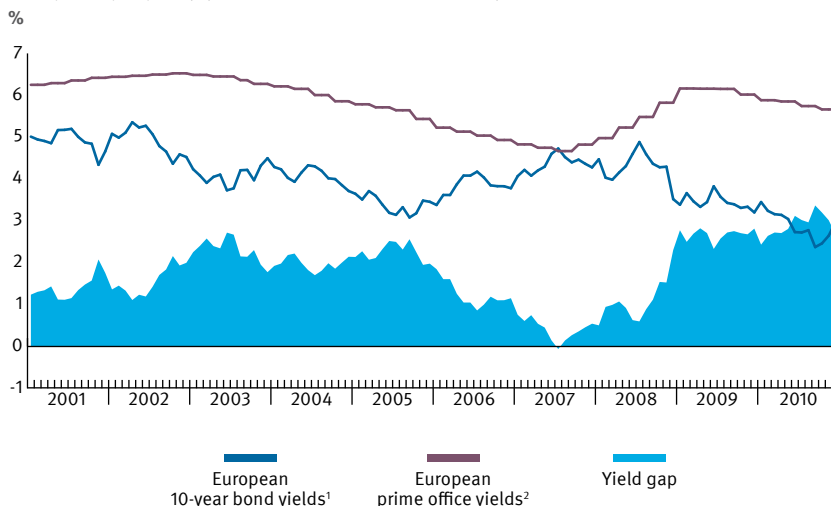
The relative appeal of property as an asset class has been boosted by persistently low government bond yields, which have created unusually wide gaps between the yields for prime European property and government bonds. For example, German 10-year government bond yields reached levels as low as 2.10% during the second half of 2010; more than 300 basis points below prime yields in most of the big German office markets.

Figure 7
European investment volumes
€ billion



Source: Knight Frank/Real Capital Analytics

Figure 8
European property yields vs Government bond yields



¹ Barclays Capital Euro Government Bond 10yr Term Index

² Weighted average of prime office yields in 19 key European markets

Source: Knight Frank/Barclays Capital

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