



WINTER 2011/2012
EUROPEAN
INVESTMENT

Commentary

Knight Frank

HIGHLIGHTS

- The economic outlook has deteriorated significantly in recent months, influenced by continuing developments in the Eurozone debt crisis, the impact of austerity measures and a slowdown in global trade. It appears increasingly likely that the Eurozone will re-enter recession in the early part of 2012.
- The strength of occupier activity over the course of 2011 has varied between European markets, with improved office take-up recorded in cities such as Paris and Munich, but reduced activity observed in London and Madrid. The momentum of prime rental growth has slowed as the year has progressed.
- Overall, European investment volumes during 2011 were up on 2010, boosted by a strong increase in activity in Germany. However, investors and lenders remain cautious and demand continues to be highly focused on low-risk prime property in core locations.

The economy

GDP growth

The Eurozone economy grew by a sluggish 0.2% in Q3 2011, the same level as in Q2, confirming the weakening of economic activity since the relatively strong performance of Q1, when quarterly growth was 0.8%. GDP growth in Q3 was above the European average in Germany (+0.5%) and France (+0.4%), but contractions were recorded in Portugal and the Netherlands.

Leading indicators suggest that economic activity has softened further in Q4, with Purchasing Managers Index surveys signalling that there has been a slowdown in global manufacturing activity which has been most sharply felt in the Eurozone. The escalation of the sovereign debt crisis and increased austerity measures have weighed heavily on sentiment, and business and consumer confidence indicators for the Eurozone reached two-year lows in late 2011.

The likelihood of the Eurozone slipping back into recession now appears high. It seems increasingly certain that negative growth will be recorded in Q4 2011 and many forecasters anticipate that this contraction will continue at least into Q1 2012, before growth picks up modestly later in the year.

Sovereign debt

The Eurozone debt crisis continues to play out, overshadowing all other aspects of

the economy. European leaders agreed a package of measures aimed at reassuring the markets in October, with banks accepting a 50% write-down on their holdings of Greek government bonds, and plans announced for an increase in the size of the European Financial Stability Facility to about €1 trillion and a bank recapitalisation package worth €108 billion.

At an EU summit in early December, the Eurozone countries, supported by all other EU nations except the UK, agreed a pact committing them to the establishment of stricter rules on budget deficits, with penalties for countries that overspend. However, the markets appear unconvinced that this will be enough to prevent further countries from requiring bailouts and Italian 10-year government bond yields rose back into the “danger zone” above 7% in mid-December. Contrary to hopes that the December summit would deliver a lasting solution to the crisis, the future of the Eurozone remains in the balance.

Inflation

Eurozone inflation remained at a three-year high in November, standing at 3.0%. However, price pressures are expected to ease in 2012, with domestic demand remaining weak and energy price inflation likely to fall as a result of favourable base effects. The European Commission forecasts that the annual rate of Eurozone inflation will decrease to 1.7% in 2012.

Interest rates

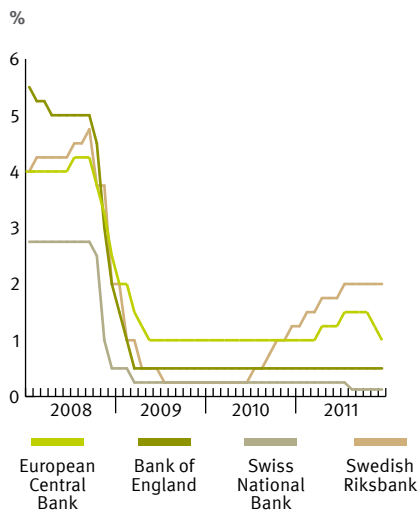
The European Central Bank reduced its refinancing rate by 0.25% in both November and December 2011, taking it to 1.00%, reversing rate rises made earlier in the year. These cuts have been made despite inflation remaining well above the ECB’s 2.0% target and reflect its concerns about the strength of the Eurozone economy.

Elsewhere, the Bank of England base rate has remained at 0.5% since March 2009, and seems unlikely to be changed in the immediate future. The Swiss National Bank reduced its interest rate target range to 0-0.25% in August, and is reportedly considering introducing negative interest rates, in an attempt to halt the appreciation of the Swiss Franc against the Euro.

Labour market

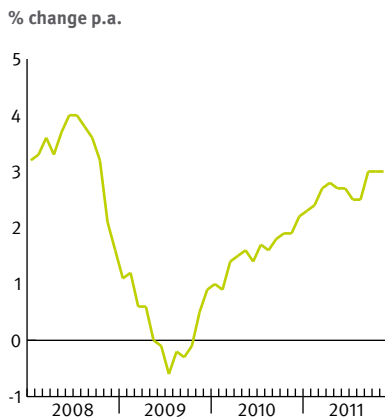
European unemployment has edged upwards in the second half of 2011, reaching 10.3% for the Eurozone in November; up from 10.0% at the start of the year. Germany has bucked the general trend, with unemployment falling from 6.5% in January to 5.5% in November. In contrast, joblessness continues to grow in Spain and, with youth unemployment reaching nearly 50%, there are concerns that a diminished skills base will have an adverse impact on future economic growth.

Figure 1
Key interest rates



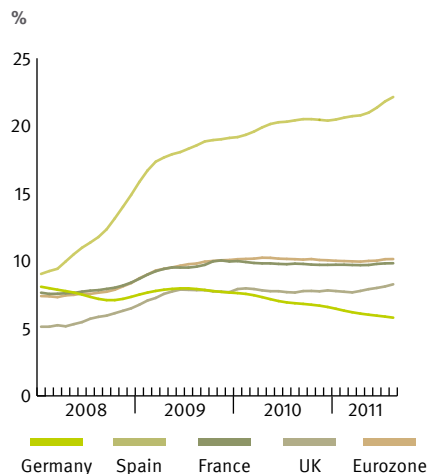
Source: National Banks

Figure 2
Eurozone inflation (HICP)



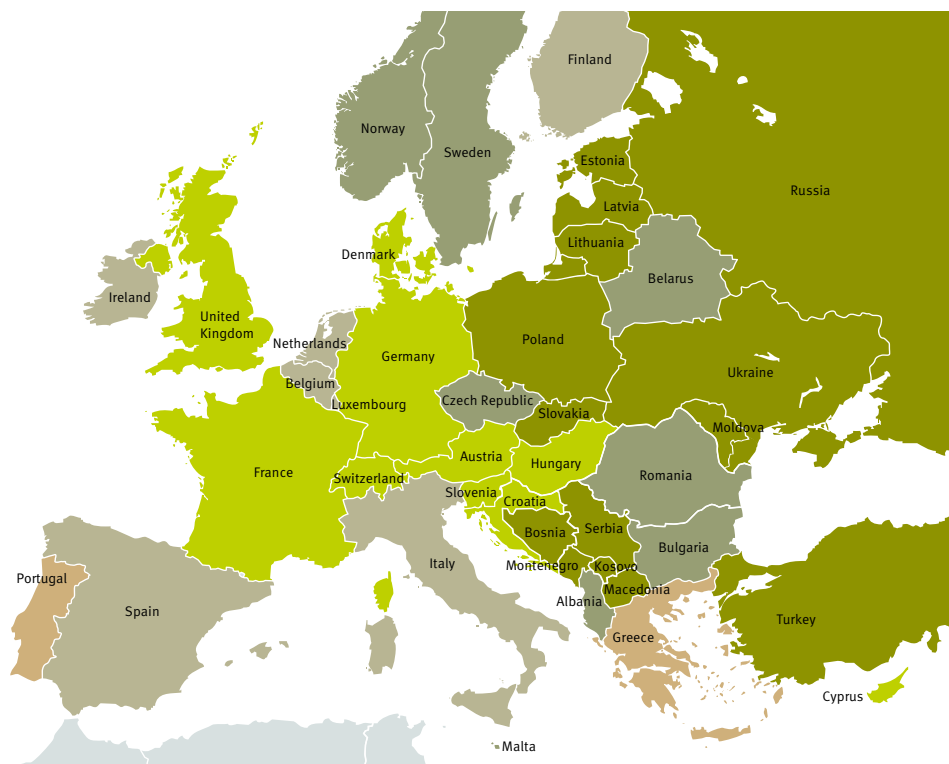
Source: Eurostat

Figure 3
Unemployment



Source: Eurostat

LOW OR NEGATIVE GDP GROWTH IS FORECAST FOR THE MAJORITY OF EUROZONE COUNTRIES IN 2012.



GDP growth forecasts, 2012

- 2.0% or higher
- 1.0% to 1.9%
- 0.0% to 0.9%
- -1.0% to -0.1%
- -1.1% or lower

Table 1
European overview

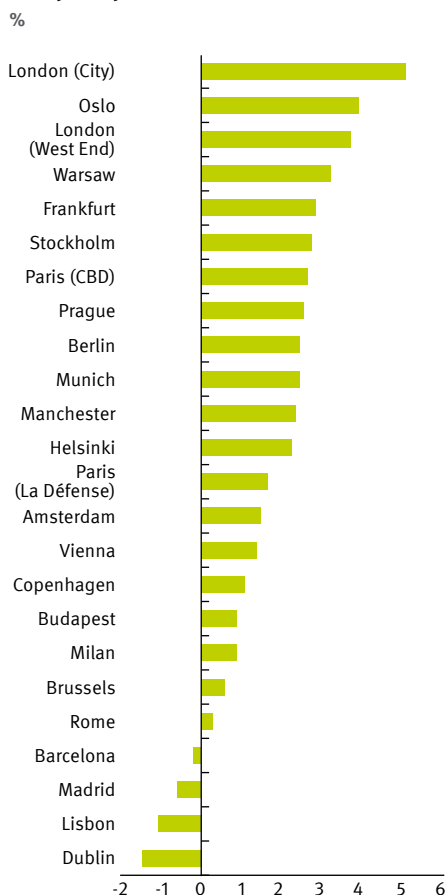
Country	EU member status	Currency	Interest rate, December 2011 (%)	GDP growth rate 2011 ¹ (%)	GDP growth rate 2012 ¹ (%)	Unemployment (%) ²	Inflation (%) ²	Population
Eurozone		Euro	1.00 ▼	1.5	-0.3	10.3 ▲	3.0 ▲	331,996,617
European Union				1.5	-0.1	9.8 ▲	3.4 ▲	502,519,978
Belgium	Full	Euro	1.00 ▼	2.1	-0.1	6.6 ►	3.4 ▼	10,951,665
France	Full	Euro	1.00 ▼	1.6	0.0	9.8 ►	2.5 ▲	65,075,373
Germany	Full	Euro	1.00 ▼	3.0	0.2	5.5 ▼	2.9 ▲	81,751,602
Ireland	Full	Euro	1.00 ▼	1.1	-0.2	14.3 ►	1.5 ▲	4,480,858
Italy	Full	Euro	1.00 ▼	0.6	-1.0	8.5 ▲	3.8 ▲	60,626,442
Netherlands	Full	Euro	1.00 ▼	1.5	-0.3	4.8 ▲	2.8 ▼	16,655,799
Spain	Full	Euro	1.00 ▼	0.6	-0.7	22.8 ▲	3.0 ►	46,152,926
Czech Republic	Full	Czech koruna	0.75 ►	2.1	1.5	6.7 ►	2.6 ▲	10,532,770
Poland	Full	Złoty	4.50 ►	3.8	2.5	9.9 ▲	3.8 ▲	38,200,037
Sweden	Full	Swedish krona	2.00 ►	4.1	1.2	7.5 ►	1.1 ▼	9,415,570
United Kingdom	Full	Pound sterling	0.50 ►	0.9	0.6	8.3 ▲	5.0 ▲	62,435,709
Turkey	Candidate	Turkish lira	5.75 ►	7.5	3.5	9.2 ►	7.6 ▲	73,722,988
Russia	Non-member	Ruble	8.25 ►	4.0	3.7	6.4 ▼	7.2 ▼	142,411,000
Switzerland	Non-member	Swiss franc	0.0-0.25 ▼	1.8	0.6	3.6 ▼	-0.5 ▼	7,866,500
Ukraine	Non-member	Hryvnia	7.75 ►	4.2	3.4	8.9 ▲	5.4 ▼	45,665,281

Forecasts ² Latest available data as at mid December 2011

Source: European Commission/International Monetary Fund/The Economist/Economist Intelligence Unit/National Banks/National Statistics Services/Knight Frank



Figure 4
European prime office rent forecasts, 2012



Source: IPF European Consensus Forecasts, November 2011

Occupier markets

Occupier activity across Europe's major office markets proved to be relatively robust during 2011, in spite of mounting concerns in the wider economy. However, the strength of activity has varied greatly, as demonstrated by the contrasting trends experienced by Europe's two largest office markets. Over the first three quarters of the year, take-up in the Paris (Île de France) market totalled 1.96 million sq m, about 20% up on the previous year. Conversely, Central London office take-up in Q1-Q3 amounted to 724,000 sq m, nearly 25% down on the same period of 2010.

Improved leasing activity has been observed during 2011 in the major German cities and many CEE markets. In both Warsaw and Prague, office take-up during the first nine months of the year has surpassed the full-year total for 2010. Reduced take-up has been recorded in the major Benelux markets, Brussels and Amsterdam, as well as a number of cities in poorly performing economies affected by sovereign debt concerns such as Lisbon and Madrid.

A small number of European office markets recorded prime rental growth during Q3 2011, although the momentum of growth has generally slowed over the course of the year. In Q3, Paris prime office rents edged

upwards to €800 per sq m per annum, 6% up on the level recorded at the start of 2011. After rising by 9% over the previous two quarters, prime office rents in London's West End were unchanged in Q3 at £92.50 per sq ft (c. €1,144 per sq m). Prime rents were unchanged in most German markets in Q3, following modest increases in the first half of the year.

With the level of construction completions remaining low, office vacancy rates have edged downwards over the course of 2011 in the majority of European markets. Despite this tightening of supply, nervousness surrounding the economic outlook appears to be reining in rental increases and expectations for rental growth in 2012 have receded. The latest IPF European Consensus Forecasts, published in November, show prime rental growth forecasts for the majority of European markets being revised downwards, with no European office markets expected to see rental growth of more than 6% in 2012. The IPF forecasts anticipate that prime rents will continue to fall in the main Iberian markets and Dublin.

Despite weakening consumer confidence, the prime segment of the high street retail market has been resilient, with rental increases recorded during 2011 in a number of the continent's best shopping locations. International retailers continue to target expansion into European markets, as demonstrated by the US clothing retailer Abercrombie & Fitch opening new flagship stores in Paris and Madrid, among others.

Little movement has been recorded in prime logistics rents over the course of 2011. With development completions remaining limited, availability levels in the sector continue to diminish, most notably in Moscow, where the vacancy rate for Class A warehouse space has decreased sharply to less than 1%.

Figure 5
European weighted average prime rent index

Index, Q1 2004 = 100



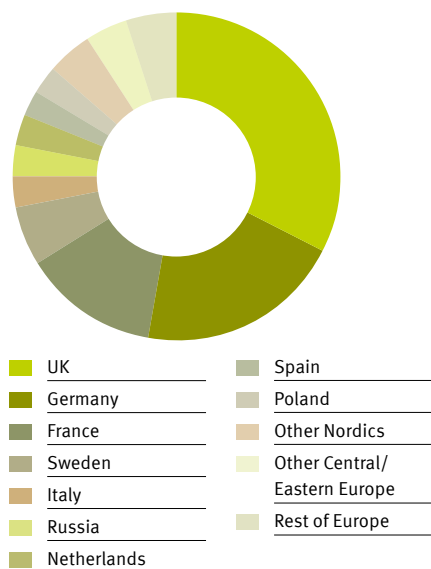
Based on averages of prime rents in major European markets, weighted by market size and maturity
 Source: Knight Frank

PRIME RENTAL GROWTH HAS SLOWED, DESPITE FALLING VACANCY RATES.

Investment markets

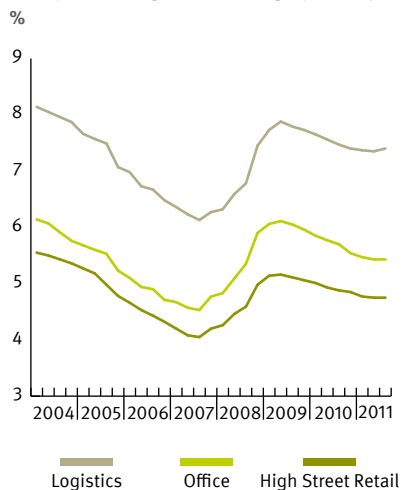
Despite recent economic uncertainties, overall European investment volumes have held up well throughout 2011. Over the first three quarters of the year, around €83.0 billion was invested in European commercial property, according to Real Capital Analytics data, approximately 28% up on the same period

Figure 6
Destination of capital, Q1-Q3 2011
 %



Source: Knight Frank/Real Capital Analytics

Figure 7
European weighted average prime yields
 %



Based on averages of prime rents in major European markets, weighted by market size and maturity
 Source: Knight Frank

of last year. Activity has been remarkably consistent throughout 2011, with each quarter recording transaction totals of between €25-30 billion.

The increase in investment volumes during Q1-Q3 2011 was led by Germany (+65% up on Q1-Q3 2010), France (+40%), the Nordics (+50%) and Central/Eastern Europe (+45%). However, reduced investment totals were recorded in Spain (-33%) and Portugal (-63%), underlining the continuing polarisation between activity levels in the weaker peripheral economies of Europe and those countries which have maintained relatively good economic growth and remained immune from the worst effects of the sovereign debt crisis.

German investment volumes were boosted by a significant uplift in retail investment, with €8.9 billion being invested in the sector during the first nine months of the year, more than half the country's total activity. With the flight towards prime low-risk assets continuing, German retail property has attracted investors perceiving the sector as offering relatively secure, stable returns, in addition to asset management opportunities.

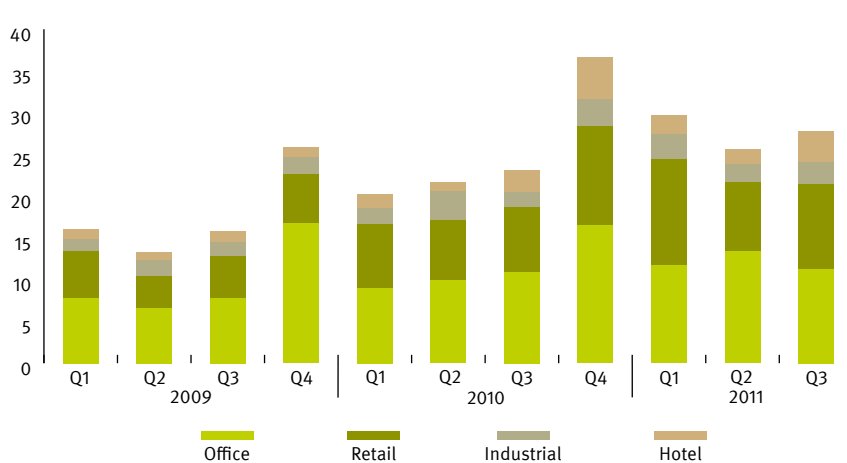
Investor interest in core prime properties remains strong, although sentiment is clouded by the current uncertainty in the Eurozone.

Demand is focused very strongly on assets in the best locations let to good tenants on long leases, but the time taken to conclude deals has increased, with cautious investors and debt providers keen to ensure that careful due diligence is undertaken. Bank lending is highly restricted, putting cash-rich investors in an advantageous position in the current market.

After two years of steady yield compression, more limited movements in prime office yields have been recorded in most European markets during H2 2011. Over the year as a whole, very modest inward yield movements have been seen in markets including Paris, the major German cities and strong CEE locations such as Warsaw and Prague. Prime office yields have remained broadly flat in the Benelux region, and have remained steady at 4.00% in London's West End. In contrast, prime yields are currently coming under outward pressure in markets in some of Europe's weaker economies, notably Lisbon and Dublin.

Minimal yield compression is anticipated in 2012 and, as a result, any increases in capital values will need to be driven by rental growth. For secondary stock and properties in peripheral markets, yields and capital values could weaken over the next year.

Figure 8
European commercial investment volumes
 € billion



Source: Knight Frank/Real Capital Analytics

RESEARCH



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Chile

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New Zealand

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Austria
Belgium
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Hungary
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Italy
Monaco
Poland
Portugal
Romania
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