King Sturge

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European Office Property Markets

The outlook for the European economy remains mixed and overall occupiers are focusing on consolidation and renegotiation strategies.

Top performing European office markets include London, Paris, Berlin, Warsaw and Moscow which all recorded double digit rental growth in 2010. Weaker markets where rents have fallen include Dublin, Athens and Prague.

The narrow investor focus on core assets in the most liquid markets is likely to continue in 2011, although given the weight of capital chasing core product and as certain markets begin to look close to being fully priced, investors are starting to look at other locations.

Market fundamentals

The European economic outlook remains mixed. The uncertainty that surrounded its most fragile economies in 2010 has refused to go away, with Portugal the latest to seek a bail-out. Ireland, Spain and Portugal are all now expected, with Greece, to endure falling output in 2011.

By contrast, the core of Europe appears to be in good health. The German economy recorded its strongest growth in a decade during 2010 on the back of buoyant manufacturing exports. Neighbouring France, Italy and Benelux grew less strongly, but all felt the benefit of this impetus. The UK and the Nordics also returned to growth in 2010, albeit that the former experienced a setback at the end of the year with a reversal in output.

2011 is likely to be a tougher year for Germany and only marginally better for the rest of western Europe. Domestic demand will be curbed by fiscal retrenchment and rising inflation, while export demand is unlikely to match last year's peaks. The unspectacular recovery will be further threatened if there is another bout of market turbulence involving the vulnerable economies of Portugal, Italy, Greece and Spain.

Longer term, some thorny policy dilemmas are set to re-emerge. Inflationary concerns have returned in the core and policy-makers will have to consider how to balance the demands of different economies at different stages of recovery. In April, for the first time in nearly three years, the ECB raised interest rates by 25 bps to 1.25%, and this may well increase again in 2011. This increase could heighten economic disparities because the ecomomies of the 'periphery', including Portugal, Spain and Ireland, are much more dependent on variable rate debt than Germany.

The stronger than expected recovery in world trade has boosted CEE economies, with a further boost from commodity prices in emerging economies like Russia and Turkey. In 2010, economies in the east returned to growth, with Poland and Turkey recording the most notable expansions, and even laggards like Hungary faring better.

As with the western economies, this year will be only slightly better than 2010. Higher inflation is already bringing a monetary tightening in the Eurozone and CEE and this will dampen activity. While healthy growth is expected to be maintained across the region, the risks are also more pronounced in these less mature economies. Most notable of these would be any setbacks to world trade or contagion effects from the sovereign debt crisis in the west.

For European office centres, service sector job prospects will be the key to future prospects. This year, the employment outlook is generally better than 2010, though there will remain patches of weakness, including Portugal, Italy, Greece, Spain and parts of CEE, where the revival in output is not matched in jobs. With ongoing public sector consolidation, it may be 2012 before the recovery in output is mirrored in job creation in many countries.

There are exceptions to this sluggish picture in the major office markets and it is here where the prospects for rental performance are likely to be strongest. Oxford Economics' NUTS3 forecasts for European office hotspots (shown in the table below) indicate that German cities, Bucharest, Budapest and Central London will lead the office market upturn over the medium term.

Office hotspots 2010-15 based on NUTS3 regions

	Office job growth 2010-15 (national rates in brackets) /%pa
Bucharest	4.8 (3.9)
Frankfurt	3.2 (1.3)
Budapest	3.0 (1.4)
Munich	2.7 (1.3)
London	2.5 (1.8)
Prague	2.4 (1.0)
Berlin	2.3 (1.3)
Vienna	2.2. (1.4)
Helsinki	2.1 (1.7)
Amsterdam	2.0 (1.1)
Warsaw	1.9 (1.4)
Sofia	1.9 (0.0)
Stockholm	1.8 (1.7)
EU27	1.7

Oxford Economics, end-2010

In a few cases, strong national performance explains a centre's performance, notably in Bucharest and Stockholm. But generally it is a market's concentration of faster-growing services and manufacturing industries that are the key factors. In the current cycle, cities with a limited public sector exposure are also expected to fare better.

Occupier markets

The overall outlook is one of cautious optimism for Europe's office markets in 2011, following a year of modest economic growth for many countries, which, fed into a revival of many property markets. Notable upturns in office demand over the last year were recorded in London, Paris, Berlin, Frankfurt, Milan, Warsaw and Moscow. Office demand was bolstered by the return of financial and professional service companies seeking premium accommodation. It was also characterised by cautious occupiers pursuing consolidation and optimisation strategies. Renegotiations on existing space accounted for a larger share of take-up than in 2009.

But the recovery was not uniform across Europe. Markets such as Athens, Prague and Budapest did not revive. Moreover, while rental growth was recorded in a few select markets such as London, Paris and Moscow, others continued to see falling rents (Dublin and Athens).

In 2011, we expect to see increased occupier confidence from more established companies, though demand from renegotiations will remain high in the medium term, as austerity measures take effect. Demand for premium quality space will increase and low levels of speculative development will limit supply and help to keep vacancy rates in check, leading to prime rental growth by next year in many markets.

In the UK, a total of 969,000m² was taken-up in 2010 (in units over 929m²), 45% more than 2009 and the highest level for four years. **Central London** led the vigorous upturn, with the **South East, Bristol** and **Glasgow** also showing strong recovery from 2009 lows. The **City of London** experienced its best annual take-up in a decade in 2010, accompanied by sharply declining vacancy and a rebound in prime rents as financial demand returned. The **West End** also exceeded expectations in 2010, with a sharp drop in availability, a near doubling in take-up and the return of prime rental growth.

This buoyancy comes with a note of caution. Looking ahead, in 2011, we expect demand to remain under pressure. In contrast to London, regional markets are less outward-looking, with global operations scarcer and the public sector more important. The highest concentrations of public sector activity lie in the second-tier cities, such as **Liverpool, Newcastle, Nottingham** and **Cardiff**. Their reliance on government occupiers increased during the recent downturn and it is in these cities where take-up will be hit hardest.

Take-up in 2010 in the **Paris / Ile-de-France** office market was 2,160,000m², reflecting a 15% rise on 2009. As in 2009, the quality of accommodation seemed less important than location and rents. Paris attracted its highest ever share of total occupational transactions (43% of floorspace), showing that occupiers have been prompt coming back to the most established office market following a significant rental readjustment and the completion of several refurbishments allowing large transactions. The vacancy rate at the end of 2010 stabilised at 7%.

Although there was a clear rebound in the occupational market in 2010, the market recovery remains limited to the most established office locations. As long as economic prospects remain subdued, a new cycle of growth is likely to be a long time coming, especially in a context of financial austerity, both in the public and private sectors. The outlook for 2011 is therefore quite cautious, with a best case demand scenario being to reach a similar level of activity as in 2010.

German office markets began to recover in 2010. **Berlin** and **Frankfurt** experienced a strong rebound in office demand compared with previous years. A total of 541,000m² of office space was leased in Berlin, up 22% from the previous year, whilst 447,000m² was transacted in Frankfurt which represented an increase of 33%. In the context of further economic recovery, the occupier market should increase again in 2011.

Vacancy rates are expected to remain stable or to fall slightly, whilst new construction levels should moderately exceed 2010 levels. Prime rents contracted slightly over 2010, but should now hold steady as a result of stabilised supply and increased demand.

The **Brussels** office market is still recovering from the financial crisis. Take-up in Brussels and its periphery during 2010 was 495,000m². That is lower than the 10-year average of approximately 550,000m², but better than the 413,000m² of 2009.

Take-up was bolstered by one large transaction over 50,000m² in December. However, one large transaction per year in the public sector is not unusual. Vacancy rates decreased from over 12% last year to approximately 11%, and to under 10% in the central business district. Prime rents came under pressure but nominal values in the Leopold district remain at €260/m²/annum. On the periphery prime rents are at €165-180/m²/annum.

We expect the main trend for 2011 to be the continued concentration of larger companies around the train stations and generally where there is modern and green buildings available near large public transport facilities. As new speculative development is limited, vacancy rates in-town should remain under 10%. Rental levels will remain under pressure, certainly for second-hand buildings, and we expect the real rental levels to remain about 10% lower than headline rents.

The adverse economic conditions in Greece in 2010 led to weak occupier activity in the **Athens** office market, with around 50,000m² transacted during the year. Prime rents for CBD office accommodation have fallen to €288/m²/annum, but this level of rent only applies to a handful of modern buildings. Generally, rental values in most locations have fallen by around 20% since their peak in 2007 but some buildings continue to achieve higher than average rents because there is still a shortage of class A space in favoured locations. There has been very limited speculative development. Tight planning controls, high land prices and a conservative approach from the Greek banks have resulted in there being only a handful of projects under construction in northern Athens.

Given that Greece is in an economic depression which is likely to last well into 2012, we expect the occupier market in 2011 to remain slow, with the majority of activity driven by cost cuttings and lease re-gearings. There will be a growing supply of distressed properties leading to higher vacancy and increased pressure on landlords to reduce rents and increase incentives.

Occupier confidence in the **Milan** office market improved in 2010. Consolidation and rationalisation were key drivers of the market. Letting activity increased significantly, with some 303,000m² of office space leased compared with 190,000m² in 2009. Demand in the second half of the year was predominantly focused on units in peripheral locations outside the CBD, generally sized between 1,000-2,500m², with most occupiers preferring to lease rather than purchase. The majority of demand came from industrial / manufacturing groups (31%) and the banking and financial sectors (29%).

There was little in the way of new office construction and the delivery of several developments has been delayed. The overall office vacancy rate was 9.7% at the end of 2010 with the highest levels of empty offices concentrated in the peripheral areas of the city. In 2011, we expect a further slowdown in new office construction and growing take-up. Prime city centre rents should remain stable at around €450/m²/annum.

Demand in the **Dublin** office market improved in 2010 with a total of 121,000m² office space transacted compared to 70,000m² in 2009. Although this was an improvement on 2009, it was still around a third

European office prime rents & yields

Source: King Sturge, data as at end of December 2010

below the 10 year average. Over 65% of floorspace was transacted in the city centre, where tenants are continuing to secure very flexible terms with early and multiple break options becoming the norm.

The recent sale of Montevetro, Barrow Street to Google as well as lettings to Tullow Oil, Bord Gais, Yahoo, Bank of Ireland and the Central Bank have been positive for the market generally. We anticipate an increase in the amount of corporate space being offered to the

market during 2011 which will be well presented and fully fitted out. This type of accommodation is being offered on increasingly competitive terms, as companies seek to stem the flow of outgoings. It is possible that rents could fall further before stabilising and recovering in the later end of 2011 and 2012.

The **Warsaw** office market underwent a revival in 2010. Leasing activity was twice as high as in 2009 (at 563,200m²). However, renegotiations and lease extensions were still an important part of the market (accounting for 35% of demand). The development pipeline reduced by roughly a third from 2009, with 13 new projects completed over the year (totalling 188,400m²). Demand versus supply levels started to rebalance and the vacancy rate, which had increased sharply between 2008 and 2009, stabilised and was edging down by year-end (to 7.0%).

In 2011 we expect to see continued growth in demand for office space in Warsaw. At the same time we expect fewer pipeline projects to be delivered to the market, which should result in a small decrease in the vacancy rate. This may also influence rental levels in 2011 though these will not get close to the peak levels of 2008.

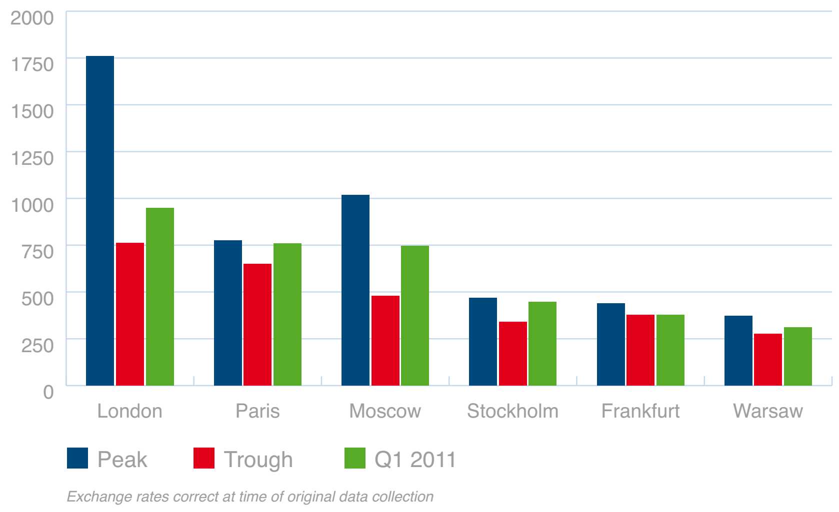
Take-up in the **Prague** office market marginally contracted in 2010. Around 215,000m² of office floorspace was transacted, a 12% decrease compared with 2009. Many companies focused on consolidation rather than expansion and preferred to renegotiate rather than relocate. Lease renegotiations and sublease transactions accounted for a high proportion of total demand (around 45%). The total volume of completed offices reached 41,800m², a 75% reduction from 2009. During the year, the vacancy rate increased from 11.8% to 13.2%. Prime headline rents in comparison to the previous year remained around the same level, though some rental growth was recorded in outer city locations.

For 2011, we estimate the volume of leasing transactions will improve slightly to around 220,000m² to 240,000m². We are not expecting any major fluctuations in prime headline rents and from March onwards we expect the vacancy rate to gradually decrease, reaching 12% to 12.5% by the end of the year.

2010 was a lacklustre year for the **Budapest** office market. Vacancy peaked at 21.6% and only ebbed down in Q4 to finish the year at 20.5%. These conditions encouraged occupiers to renegotiate their leases to optimise their terms. Take-up reached 307,000m², a 4% increase compared to 2009. Lack of finance, combined with falling rents and demand dominated by lease renewal or relocation have led to a rapid reduction in new construction which has practically dried up. Only 81,600m² will be delivered in 2011.

In 2011 the office sector is expected to undergo a slow recovery, though tenants will remain cautious. Limited new supply and an improvement in GDP growth will help to slowly reduce the vacancy rate and firm rental levels.

Prime office rents: peak - through €/m²/year (June 2007 - March 2011)



Source: King Sturge Research

2010 was a year of great change in the **Moscow** office market. The major trends were a significant rebound in the demand for office space, increased rental levels, a greater number of owner-occupier acquisitions or long-term leases of large premises, with the highest demand for class A offices and a decline in class A and B office vacancy rates.

Occupier demand for quality office space will increase again in 2011 and this should promote further rental growth. The turnaround time on newly constructed office premises is likely to get shorter and as a result office vacancy rates will move downward. Renegotiations will make up a smaller share of total transactions and the average area of leased office space is expected to rise.

Like many other European markets, demand for offices in **Istanbul** saw a gradual recovery in 2010. Take-up increased as economic conditions and business sentiment improved. A shortage of Grade A space resulted in rental increases in the main office CBD strip from Esentepe, through Levent to Maslak on the European side. Prime rents in Levent for Grade A fitted space have reached $40/m²/month.

The outlook for 2011 is positive. Requirements are increasing in size and there is a trend for larger space users to consider relocating some of their operations to the Asian side of Istanbul to bring down overall rental levels across their occupational holdings. Office stock in the CBD is set to increase over the next 24-36 months, as a number of new office projects have now started or are about to start. Such activity has had the effect of encouraging a number of larger occupiers to consider office moves to accommodation that better meets their business needs, something they had previously not been able to do, as choice was restricted.

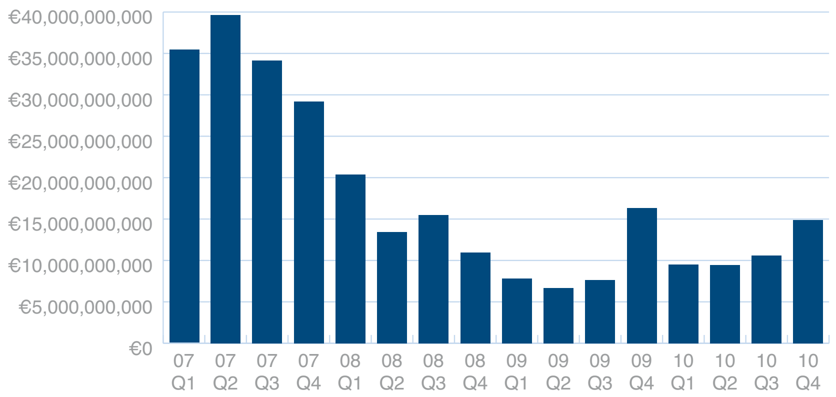
Investment market

In 2011 the volume of European property investment transactions looks set to strengthen, following a buoyant 2010. Total transaction volumes rose by 41%. The office sector increased by 15% from 2009 and attracted 39% of the total investment volumes, followed by retail with a share of 29% and industrial at 9%. Out of the €44bn of office sector deals, over 60% occurred in the two lead markets of Paris and London, with Frankfurt, Berlin, Moscow and Stockholm also faring well. Overall investors were still cautious with interest concentrated on prime buildings in core markets. As a result of this and the continued dearth of bank finance, overall volumes have remained far below the exceptional investment years of 2006-07. Nevertheless the improved transaction level of 2010 is encouraging. It now appears that 2009 was the bottom of the market and we anticipate a further increase in 2011.

Both France and Germany saw better year-end performances compared to the UK. The UK market may have peaked last year, with investors increasingly looking at opportunities in Paris and Frankfurt.

There was steady yield compression after mid-2009 across core European office markets. But the trend slowed during 2010 and the downward movement had stabilised by late last year, and even reversed in selected markets (for example Athens and Budapest). This was in part a correction to the haste of previous movements, which had taken yields below long-term averages in many centres.

European quarterly transaction volumes



Source: Real Capital Analytics

Largest European office investment transactions 2010

Market	Property	m² (000's)/ Units	Price €(m)	Purchaser
London	1 Bishops Square	77	667	JP Morgan Asset Mgmt
London	25 Bank Street (fmr Lehman HQ)	95	593	JP Morgan Inc
Berlin	Sony Center	132	571	Nat'l Pension Service
Frankfurt	OpernTurm	66	550	GIC RE (Gov't of Singapore)
Paris	HSBC France HQ	33	400	Cilоger

Source: Real Capital Analytics

There is only limited scope for further yield compression in European office markets. Rising returns on other assets are set to erode the premium on property. Gilt rates have edged higher in recent months, as the sovereign debt crisis ended the post-QE bond market rally. In addition, short-term interest rates are rising as a result of inflationary pressure and the gradual recovery in most European economies.

Pre-crunch levels of debt finance will not return for many years. Banks are only now beginning to work through their more problematic property assets, a process that is likely to be protracted. Although this may bring more stock to the market, much of this is likely to be secondary and may undermine values. Investor interest in secondary stock is very limited. These trends will put a floor on further office yield compression. The implication is that rental growth will be required to drive capital growth and total returns ahead. In lead markets such as London and Paris, this is already a realistic expectation. But elsewhere this upturn may be another 12 months away (or further). For this reason, we would expect further progress in the investment recovery to be relatively slow.

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