



# European Quarterly Property Snapshot

## Overview

Prime rents have stopped falling in most European markets, aided by a rebound in demand in Q3 2010 as well as a pronounced lack of new development. Availability levels are stabilising as a consequence.

The sharp fall in government bond yields over the past year in the core European economies has highlighted the attraction of property's income return relative to the yields on real government bonds. Prime property yields have fallen over the past six months, although at a relatively modest pace (Figure 1).

Total returns are projected to weaken in 2011, as the inward yield shift in the core European markets slows. However, a renewed fall in capital values is unlikely beyond the peripheral economies of the eurozone. Weakness is likely to be limited to secondary property, if concerns over security of income increase further, due to doubts over the strength and durability of the economic recovery. A renewed recovery in total returns is projected for 2012. This is forecast to be aided by the resumption of rental growth, as employment growth is expected to gain more momentum and new development remains modest.

Over the next five years, we expect the UK, the Nordic region and the core western European countries to outperform. Southern Europe and Ireland are projected to underperform, held back by weak economic performance, substantial government debt burdens and a lack of competitiveness on a European and global scale. The relative underperformance of southern Europe, according to our forecasts, has increased over the past quarter.

## The economy

### Overview

The European real economy has been weathering the sovereign debt crisis reasonably well. Some momentum has been lost, according to Q3 GDP statistics, as governments in southern Europe have cut spending and as the global inventory cycle has waned. However, business surveys indicate renewed positive developments into Q4, helped by robust growth in Asia, with confidence rising to a three year high in November (Figure 2).

Northern economies (especially Finland, Germany and Sweden) are growing at an above average pace, driven by a jump in exports and strengthening domestic demand. Most economies in the south have stagnated amid ongoing turmoil in the government debt market. EU/IMF funding for countries in distress, and purchases of sovereign bonds by the ECB, have at best provided partial relief from market fears of medium term government insolvency.

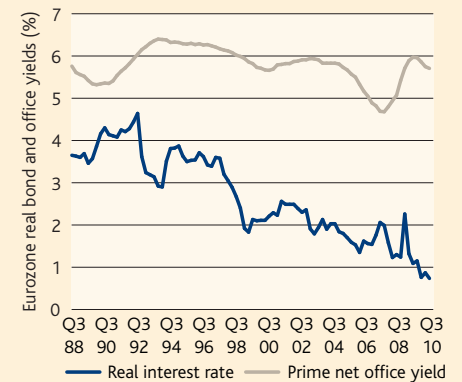
### Prospects

The overall economic environment in Europe looks promising for 2011; however, marked divergences in performance are expected. Highly competitive export orientated countries with a healthy fiscal position, led by Germany and most of the Nordics, should perform well. The remaining core European economies with high credibility in financial markets and who address any perceived debt problems (which includes the UK, France and Benelux) are expected to achieve moderate, close to trend growth.

Economic development is forecast to stay weak for much of southern Europe. Southern Europe is characterized by increasingly unsustainable debt problems, partly in combination with uncompetitive export industries, and faces years of painful debt deflation. Central European exports are projected to benefit from the resilience of core Europe, although the region is at risk of contagion from southern Europe.

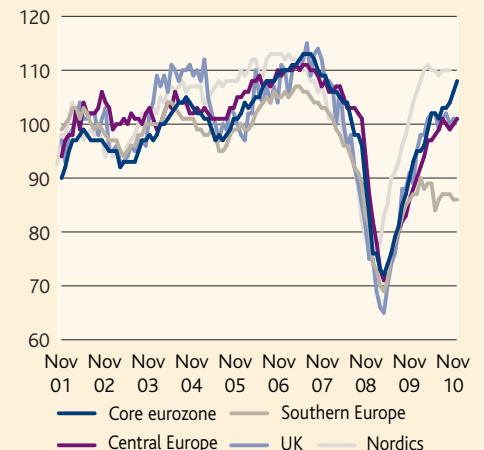
Fragile sentiment towards highly indebted European economies is likely to prevent the European Central Bank from tightening monetary policy in 2011. The risks to southern Europe are on the downside. However, robust growth in emerging Asia, a strong domestic profits rebound and low European interest rates, point to balanced risks for the rest of Europe, despite decreases in consumer spending over the next 12 to 24 months in Europe, and the potential for a financial shock from southern Europe.

**Figure 1: Real bond yield collapse makes property cheap**



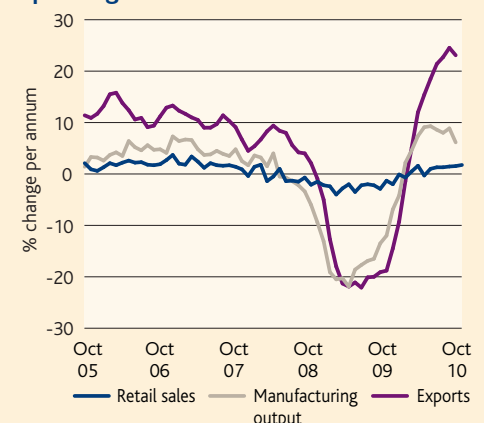
Source: Aberdeen Asset Management  
The prime net office yield has been calculated as the average weighted yield of 44 eurozone office markets.

**Figure 2: European business confidence indicators**



Source: European Commission

**Figure 3: Exports booming, consumer spending recovers**



Source: Aberdeen Asset Management, Reuters Ecowin

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## Recent property market trends

### Offices

The occupational market continues to gradually improve across Europe. Prime rents have stabilised in almost all markets over the past quarter, although rents are still at a lower level than a year ago (Figure 4). In a few locations, prime rents are rising, such as London, Paris, Stockholm and Oslo. There is a pronounced difference between prime and secondary rental trends, with secondary and average rents at best stable or continuing to fall in some markets. Vacancy rates have also stabilised in the majority of cities, aided by rising occupier demand and development levels remaining very low. Take-up has increased across Europe in Q3 2010. A few cities have seen vacancy rates fall quite sharply, such as London, Moscow and St Petersburg.

Business sentiment surveys have improved sharply over the past year, a good leading indicator of rental growth trends, and suggest that a widespread improvement in rental markets is likely. The shortage of new supply is likely to continue, hindered by the lack of development finance. This is projected to further aid the eventual return of rental growth, as the economic recovery becomes more established over the next year. Nevertheless, an improvement in labour markets is expected to be needed to support new demand as a condition for any sustainable growth in rental values, and this has yet to materialise.

Prime yields have continued to fall in the majority of markets across Europe over the past quarter (Figure 5). The UK has been an exception as prime yields have now stabilised following an increase in capital values of 16% over the past year. Investors remain keen on prime assets, let to strong covenants with long income streams; although demand has waned again for more secondary assets. As a consequence, the pricing gap between prime and non-prime assets has continued to widen.

### Retail

Retail sales in Germany rose by 2.3% in October, the largest increase in almost 3 years, as falling unemployment prompted households to step up spending. Positive news, however, on European retail spending is likely to remain patchy and we expect to see continued month-on-month volatility through 2011. With governments cutting back on spending, consumers are likely to remain cautious in 2011.

While fundamentals have improved somewhat for the larger operators, smaller tenants continue to struggle with returning to profitability. Value retail continues to outperform and some of the luxury brands are also staging a comeback. We expect retailers to continue to optimise their store networks and new openings are likely to target only the best located properties. Recent commodity price rises are likely to exert further pressure on retailer margins and retailers may in turn pass these on to consumers, stifling demand further.

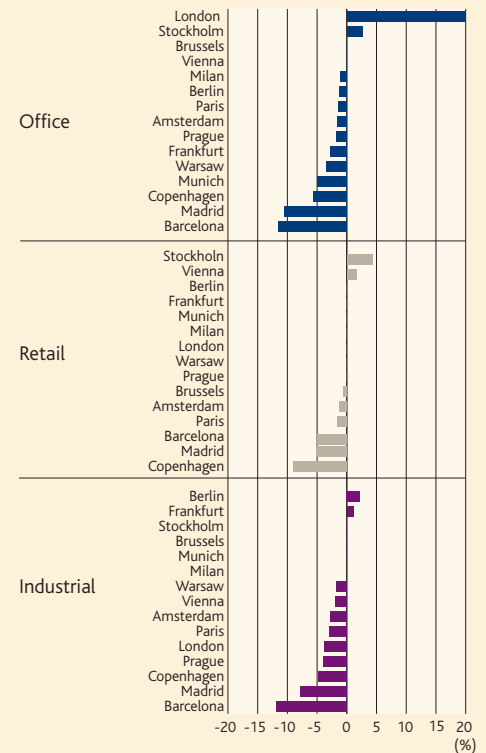
Prime rents in the main European markets are recovering at different speeds, with London, Stockholm, Munich and Frankfurt leading a modest recovery, with the rest of the main European locations bottoming out. We expect a gradual rental market recovery, with sustained increases only envisaged by early 2012, helped by lower vacancy levels. Development funding remains very restricted, with new shopping centre completions falling to 4% of the existing stock in 2010. Vacancy rates are low in the prime locations and have reached new highs in secondary locations. Rental growth prospects for the period 2011 to 2015 are strongest for prime assets in Paris, Brussels, Istanbul, Barcelona and Warsaw; while Lisbon, Athens, Bucharest and Budapest are anticipated to be the weakest.

Cash rich investors have bid yields for income producing retail assets in core Europe down to levels close to the lows seen before the crisis. Falling yields in the last quarter were most pronounced for shopping centres. We estimate that to end Q3 2010, prime retail capital values have recovered by 10% in Western Europe and by 5% in CEE. The scope for further inward yield movement is, in our view, limited in the short term and we expect prime retail yields to remain broadly stable in 2011.

### Industrial

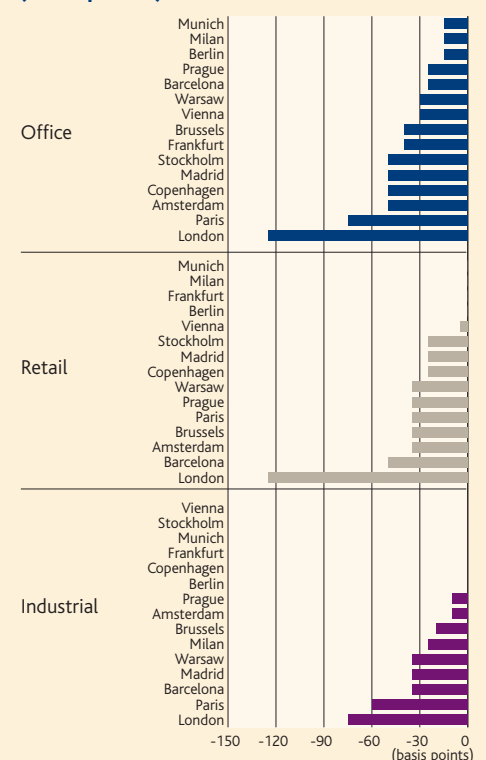
Global trade volumes and industrial output levels have recovered sharply in 2010, although this is in part due to a boost from inventory restocking after the slump of 2008-09, the effect of which is expected to wane in 2011 and 2012. Take up levels in the first half of 2010 have picked up and risen above those experienced in 2009, although they are still below those in either half of 2007 and 2008. Take-up has rebounded most strongly

Figure 4: Prime rental growth year to Q3 2010 (%)



Source: Aberdeen Asset Management

Figure 5: Prime yield shift year to Q3 2010 (basis points)



Source: Aberdeen Asset Management

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in the UK and Germany in particular. Most demand is due to relocations, where occupiers are upgrading their accommodation and taking advantage of some attractive incentive packages. Occupier demand has remained weak in southern Europe, with take-up levels falling even relative to subdued 2009 levels.

Development levels have fallen dramatically across Europe, with financing for speculative development extremely difficult to obtain. Completion levels are running at less than half of 2007 levels and are continuing to fall. Schemes currently under construction are generally pre-let or purpose built units. Prime availability rates are stabilising and starting to fall in some instances, as a consequence of low levels of new supply, while secondary availability continues to increase. In turn, falling availability of prime space is helping prime rents to stabilise in most markets across Europe. Nevertheless, prime rents have continued to fall in Spain, Greece and Ireland. Whilst there is little evidence of a resumption of prime rental growth in most markets, incentives are starting to fall.

Yields have fallen in an increasing number of markets over the past quarter. The most substantial falls in yields to date have occurred in the UK, France and the Nordic markets, but even Spain and CEE markets have also now experienced falling yields. UK yields fell first and fastest in the recovery, although they have now stabilised and there are signs of a slight upward movement in yields for secondary property.

### Investment market

Investment in European commercial property amounted to €68.2 billion in the first 3 quarters of 2010, a 53% increase on the volumes transacted in the same period of 2009, according to the latest data from CBRE. On a quarterly basis investment transaction levels were broadly similar in Q3 to Q2, at €23 billion as opposed to €25 billion. This is despite the continued sovereign debt crisis and cuts in governments' spending.

Investors' intentions surveys indicate a sustained interest in well let and well located assets across all retail formats. The aggressive pricing now prevalent in core Europe is likely to restrict the amount of investment activity in 2011.

Nevertheless, investors and lenders remain risk averse and investment and lending activity remains focused on prime property. Non-prime property may see further falls in values over the next year. Banks remain reluctant to provide finance for new investment, even with low funding costs and the high margins now being charged. Banks will continue to gradually reduce their overexposure to the sector. Many state sponsored banks, such as RBS and Lloyds in the UK, German Landesbanks, other German nationalised banks such as Eurohypo, and the Irish banks via NAMA, will be particularly keen to offload property assets.

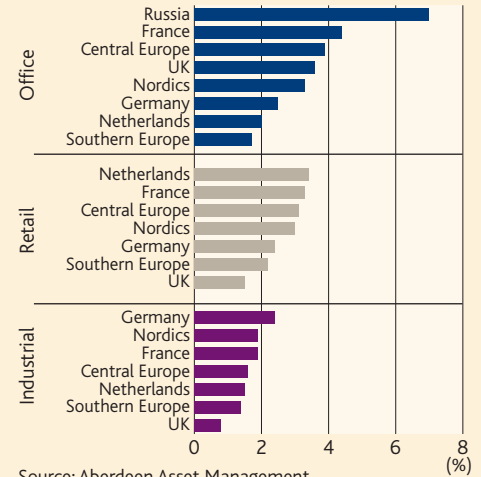
Nevertheless, we anticipate a gradual increase rather than a sudden glut of investment property coming onto the market from the banks, despite capital covenant breaches. Banks have generally tolerated such capital breaches, as long as interest payments are being made. Low funding costs, and the high cost of breaking swap contracts tied to property loans, often means that banks are under little immediate pressure to dispose of assets.

### Outlook

Despite the recent uptick, the fall in both government and corporate bond yields over the past year in the core European markets has made property's income return look more attractive relative to the yields on other asset classes. The risk of a 'double dip' in capital values appears to have receded. However, we continue to project a slowdown in the rate of uplift of prime capital values following the bounce over the past year in the core European markets, such as France, the UK and Germany. There has also been a sharp pick up in the listed property market in the last six months, which has tended to be a reasonable leading indicator of direct capital values in the following six months.

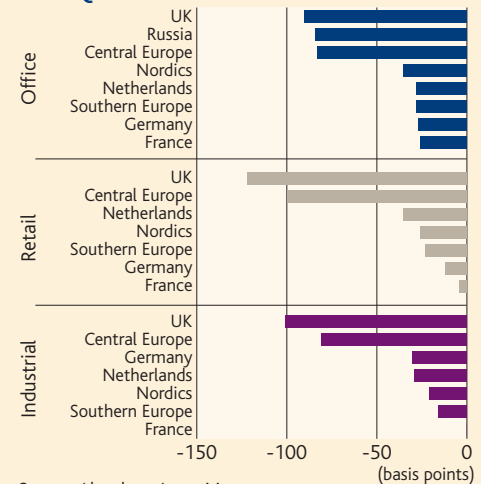
Total returns in 2011 are projected to fall back at a pan-European level, with prime total returns projected to be 6% as opposed to 9% in 2010. Many of the major European property markets (Germany, France, the Nordics, and UK) have experienced a sharp rise in capital values in 2010, as prime yields have dropped. However, in 2011, yields in most of these markets are projected to stabilise, a process which has already occurred in the UK, a market which has led the European property market recovery. The stabilisation is anticipated to be driven by concerns of a slowdown in the pace of economic recovery, compounded by the effects of the sovereign debt crisis in southern Europe and Ireland, and further public spending cuts and tax increases across Europe. Any upward yield pressure is likely to be limited to secondary property, defined by weaker covenants, poorer locations or shorter lease terms.

**Figure 6: Prime rental growth: five years from start Q4 2010, per annum basis**



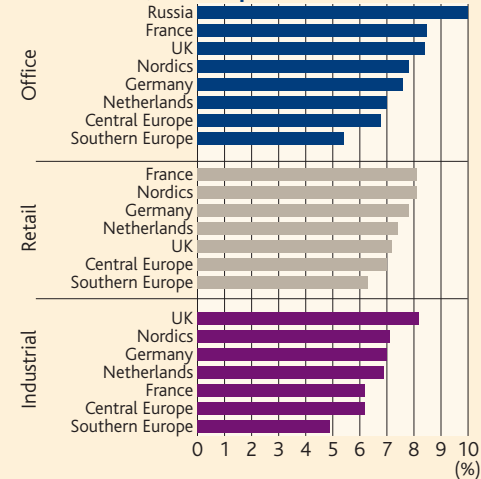
Source: Aberdeen Asset Management

**Figure 7: Prime yield shift: five years from start Q4 2010**



Source: Aberdeen Asset Management

**Figure 8: Prime total returns: five years from start Q4 2010, per annum basis**



Source: Aberdeen Asset Management

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With prime yields stabilising in 2011, total returns are projected to drop back. Nevertheless, this will not be a uniform picture across Europe. In some markets, which have seen little recovery during 2010, total returns are expected to improve in 2011. These include Spain, Ireland and Greece, although total returns in these markets are anticipated to remain weak relative to the rest of the eurozone. Total returns across Europe are forecast to improve again in 2012 and 2013, aided by the resumption of rental growth. The exceptionally low levels of development currently occurring are projected to contribute to the recovery in rental values. Weak levels of new construction are projected to continue, with finance for new development remaining in exceptionally short supply. Although rental growth across Europe is expected to occur in a few more prime office locations during 2011, it is only forecast to resume across the office and retail sectors as a whole in 2012 (Figure 6). We project a further modest fall in yields in 2012 and 2013 (Figure 7), as the economic recovery and rental growth gathers strength. Typically, rising interest rates and bond yields only have a negative market impact late in the market cycle as monetary policy becomes restrictive.

Investment demand is likely to remain subdued. The banks' need to recapitalise means little capital is likely to be available to finance debt-backed purchasing, and more investment stock looks set to be released onto the market from the banks. This process is already underway in the UK. This increase in investment supply should help limit the potential for further capital uplift.

There is a modest differential between sector returns at an 'All Property' basis. Projected returns are 7.5% for both the office and retail sectors in the eurozone over the next 5 years on a per annum basis, while the industrial sector lags at just 6.3%. Logistics and industrial rents are projected to benefit less from the improvement in rental growth, as economic growth resumes, which is forecast to be concentrated in the retail and office sectors. For retail investors, opportunities are likely to be found in refurbishment and asset management of properties in strong catchment areas.

We are projecting a sharp divergence in performance across Europe. The core European markets such as France, the UK and Germany are forecast to perform well (Figure 8). The Nordic markets are also expected to deliver strong performance, aided by generally low levels of public and private sector debt, and the flexible nature of their economies. The UK, aided by an independent monetary policy, has benefited from the depreciation of sterling. The UK is forecast to be an above average performer in a European context, however, it has dropped down our ranking as property values have recovered much more rapidly than in most other European markets, by 16% over the last year. Russia and Turkey are also projected to perform well, although at a higher level of risk. Total returns there are projected to be boosted by high income returns and a substantial inward yield shift off a very high base.

Some of the weaker Eurozone members, particularly Ireland and some of the southern European economies, do not have the ability to let their currencies devalue, and are struggling with large and rapidly increasing government debt levels. Economic growth in these markets is projected to be held back by the public spending cuts being implemented. Government bond yields have increased sharply in the southern European markets and Ireland over the past six months. The weakest performers in terms of total returns are Slovakia, Greece, Portugal, Spain and Hungary, hindered by weak economic growth, high and rising government debt and modest investment demand.

### Investment Policy

The table below show Aberdeen's recommended positions for "All Property", relative to the eurozone benchmark. The weightings reflect return forecasts and an analysis of pricing for each country over a five year forecast time horizon.

Market	Strategy
Benelux	Neutral
Central Europe	Underweight
France	Overweight
Germany	Overweight
Iberia	Underweight
Italy	Underweight
Nordics	Neutral
Switzerland	Neutral
United Kingdom	Neutral

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