



European Quarterly Property Snapshot

Overview

The recovery in European commercial property markets has continued into the first half of 2010, with falls in prime yields across Europe becoming more widespread, while prime rental levels are also beginning to stabilise. Nevertheless, there has been a slowdown in the pace of prime capital uplift in the more mature, responsive markets such as the UK and France, and since Easter, increased risk aversion towards more secondary property in particular. Concerns over security of income have increased again due to doubts over the strength and durability of the economic recovery. Although total returns will slow over the next year, as capital values stabilise, or even fall again for more secondary property, a sharp fall in capital values is not projected. The pronounced fall in bond yields that has occurred for Europe's major economies over the last quarter has made property's income yield look more attractive. A renewed recovery is projected for 2012 when employment growth is expected to gain more momentum. This will be aided by the resumption of rental growth, which in turn will be supported by very modest levels of new completions.

Over the next five years, we expect the UK, the Nordic region and the core western European countries to outperform. Southern Europe is 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 economy

Overview

GDP for the EU and eurozone rose in the second quarter at the fastest quarterly pace since 2006, beating the U.S. by a wide margin. The surge in growth mostly reflects a huge spike in activity in Germany, and a blistering level of expansion in the export dependent manufacturing sector, underpinned by a very buoyant Asian economy. European domestic demand, unlike that in the U.S., stayed modest in the year to Q2 as the recovery has yet to lead to an improvement in the incomes of the majority of households.

Along with Germany, the rest of northern Europe, the UK and the Nordics reported robust growth in Q2, whereas southern European states struggled amid the financial upheaval caused by the government debt crisis. Central Europe has been helped by strength in western European demand and performed well into Q2. EU labour markets have stabilised, with the unemployment rate unchanged at 9.6% for six months to July. However, consumer confidence is subdued due to the impending fiscal squeeze across much of Europe. Underlying inflation is weak at around 1% on an annual basis, although strength in energy prices has pushed headline inflation to around 2% recently.

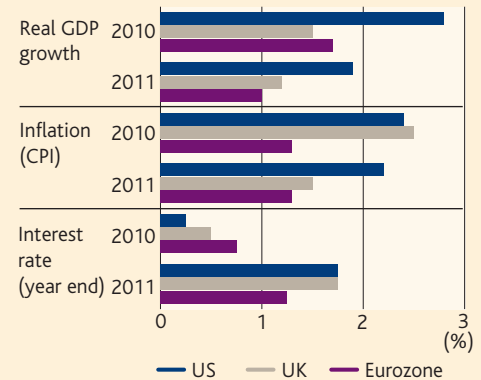
Prospects

Global growth is set to slow to below trend in the second half of 2010, although there are few indications that a double dip recession is on the horizon. We expect eurozone growth to slow, back below trend by the end of the year on weaker export growth and the end to the global inventory cycle. The de-leveraging of the U.S. and some European household and bank balance sheets is still ongoing, and remains a force for a moderate growth environment. European domestic demand is not in a position to take over the reins of growth, as confidence is likely to be hurt by high unemployment rates and significant fiscal tightening.

The economies of northern Europe should continue to outperform, helped by relatively low fiscal deficits and restrained private debt positions. Southern European countries will implement sharp fiscal tightening into 2011, while banks in the region will continue to find it difficult to access funding in capital markets because of perceived counter-party risks. Banks, more generally in Europe, need to bolster their capital positions, which will keep the availability and pricing of loans tight, and limit the recovery in business capital expenditures. In central Europe, greater risk aversion will pull back capital inflows and take its toll on economic activity next year.

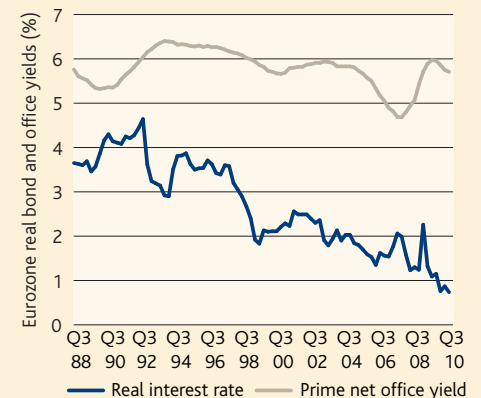
As inflation pressures remain low, the European Central Bank (ECB) is not expected to raise interest rates until late 2011, which will provide some relief to southern European states and their banks, although investor distrust is unlikely to fade quickly. The growth outlook therefore, remains very uncertain, and we expect EU growth to slow from a near trend of 1.7% in 2010 to just 1.1% in 2011. Given the continuing European sovereign debt issues and a renewed slowdown in the U.S. housing market, the risks to growth are on the downside for next year, and may force European central banks, such as the ECB and the Bank of England, to support growth through additional liquidity injections.

Economic outlook



Source: Aberdeen Asset Management

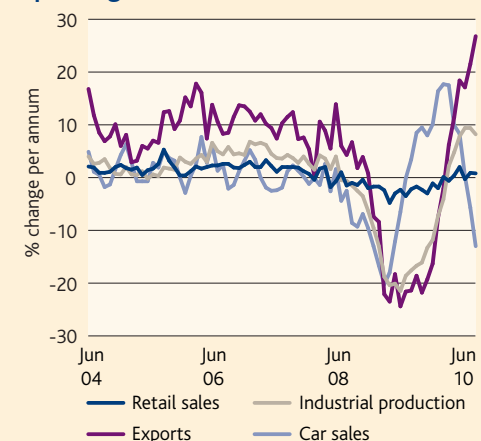
Real bond yield collapse makes property cheap



Source: Aberdeen Asset Management

The prime net office yield has been calculated as the average weighted yield of 44 eurozone office markets

Exports booming, although consumer spending still weak



Source: Aberdeen Asset Management, Reuters Ecowin

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Recent property market trends

Offices

Investment transaction volumes have increased again in the first six months of this year, especially at the prime end of the market, although only off a very low base. Transaction levels are running at less than half the average over the past decade however, these levels are still higher than those experienced during the first half of 2009. Prime yields have fallen in most markets across Europe over the past six months, even in countries which have been hit particularly badly in the economic downturn, such as Spain. In Q2 2010, yield compression has slowed in most locations, due to an increased level of investor risk aversion. In some cities, where yields have fallen substantially over the past year, such as London and Paris, yields are now starting to stabilise.

Across all sectors, prime units, let on long leases to financially robust tenants, are the main targets for investors. Investors remain cautious about property in non-prime locations, let to weaker tenants and with shorter leases. Indeed, with heightened investor risk aversion and concerns about a 'double dip', yields for more secondary property have started to increase again in the UK. As a consequence, the pricing gap between prime and non-prime assets has continued to widen.

The occupational market continues to gradually improve. Prime rents have stabilised across Europe, and are rising in some markets, such as London, Stockholm, Oslo and Istanbul. Vacancy rates are stabilising, and in London's West End, the vacancy rate has fallen for four quarters in a row, to 7.1%. Take up has picked up off a low base, although generally remains weak. A notable exception is London, where the financial and business services sector has recovered rapidly and take up levels have been strong.

Prime rental levels across Europe have stabilised much quicker than in earlier property market downturns. This can partly be explained by the much more muted levels of development in the current property cycle. Demand remains weak across Europe and vacancies are generally still trending higher, although very little new supply is coming onto the market. This lack of new supply, hindered by the continued lack of development finance, will aid the eventual return of rental growth, as Europe's economies pull out of recession and take-up eventually recovers. Nevertheless, an improvement in labour markets will be needed to support new demand as a condition for any sustainable growth in rental values, and this has yet to materialise.

Retail

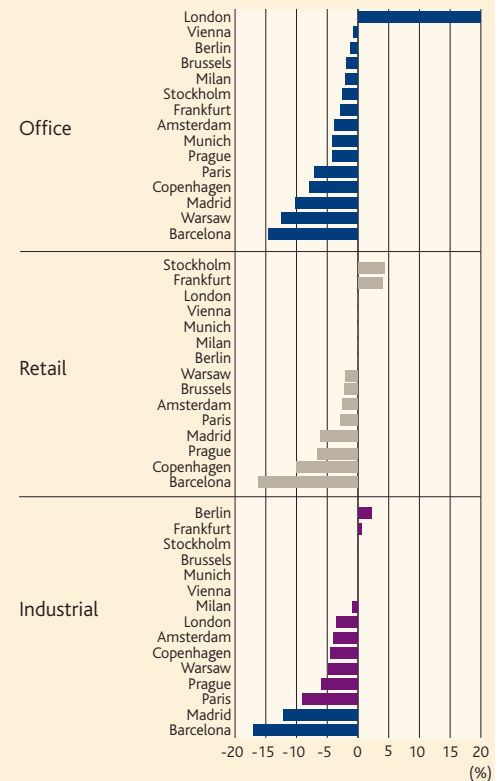
In the short term, a muted economic recovery, large scale fiscal tightening and market distress related to maturing property loans, will result in low, but positive, returns for the retail sector.

The various austerity plans currently being rolled out in Europe will probably hit the retail property sector hardest. Cutting government spending will prompt declines in the disposable incomes of welfare recipients (Ireland), government employees (Greece, Spain and Ireland) and private-sector contractors working with governments. VAT and income tax rises (Portugal and UK) are likely to put further strain on consumers' budgets. Over the medium term, falling savings rates from historically very high levels should aid private consumption growth and lift property returns to materially above the long term average, from 2012 to 2015, to just under 9% per annum. We expect that retail sales will recover first in the Nordic markets and Poland, followed by France and the UK, while retail sales are likely to remain flat in Germany this year and to continue to stagnate in the southern European markets.

The pace of rental decline has slowed appreciably since mid 2009. 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 centres under construction falling to 6% of the existing stock in 2010. We expect limited construction activity to eventually contribute to falling vacancy rates. Rental growth prospects for the period 2011-2015 are strongest in Paris, Stockholm, Brussels, Istanbul and Warsaw, while Lisbon, Athens, Bucharest and Budapest are anticipated to be the weakest.

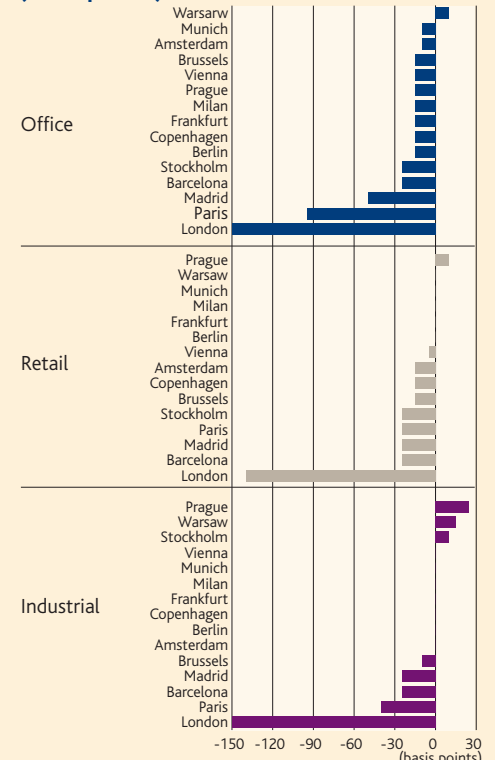
According to CBRE, retail property investment accounted for 35% of the €45.1 billion transacted in Europe in H1 2010. Core markets dominated activity, with Germany and the UK attracting 60% of total investment. The revival in retail property sales was driven by strong interest in dominant regional malls that typically generate a secure, predictable rental income that supports values. With debt remaining restricted, retail property specialists and cash-rich institutions have teamed up to make acquisitions. Strong competition among investors for shopping centres with a track record has helped reverse the slide in values, and in some cases, yields have fallen back to the pre-crisis levels. On the high street, some marginal yield compression has occurred in the first half of 2010 (5

Prime rental growth year to Q2 2010 (%)



Source: Aberdeen Asset Management

Prime yield shift year to Q2 2010 (basis points)



Source: Aberdeen Asset Management

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basis points in the eurozone and 20 basis points in CEE) and we expect values will stabilise through the rest of this year.

Industrial

The European manufacturing sector continues to grow, albeit at a slowing pace. Manufacturing production output has increased for each of the first six months of 2010, growing by 8% over the year to June. Average quarterly PMI survey results, in June 2010, for manufacturing employment, output, input prices, export orders and new orders all remained above 50, representing continued growth. However, manufacturing employment is lagging and all of the other manufacturing PMI results are now starting to experience a decline in the rate of growth. This reflects a slowdown in inventory restocking and concerns about the economic outlook. The weakening economic climate, overcapacity in the industrial sector as a whole, and the withdrawal of the car scrappage schemes are anticipated to contribute to a further decline in output growth rates.

Occupier demand for warehouses was weak in 2009, having reached just 50% of the level seen in 2007. Demand for distribution space is primarily focused around large conurbations, close to multimodal terminals or port facilities. This has meant the core northern and western European hubs have dominated take-up, while more peripheral markets, in central and eastern Europe and southern Europe, have experienced weaker demand. Overcapacity in the manufacturing subsector is still restricting large scale requirements across Europe, while weak consumer demand has eroded the appetite for space from the retail segment.

New development still remains subdued at less than 50% of peak levels. Schemes going underway are generally pre-let units or are focused in locations where modern supply is very low. Persistently tight financing conditions, mediocre demand and a fragile outlook, as well as falling rents and high yields, are making new developments difficult to justify. The pronounced lack of new supply is resulting in the stabilisation of prime rents despite continued weak demand. Prime rents have stabilised in the UK, Germany, France, Sweden and Belgium, while prime rental decline has slowed in most other European markets.

In the UK, industrial yields have fallen substantially over the past year, although have now stabilised and are starting to rise, especially at the secondary end. Continental Europe has followed the UK trend with yields now stabilising in most locations, with some facing upward yield shifts, most notably southern European markets, where the debt crisis has deflated any buoyancy in investor sentiment, and where government bond yields have risen sharply in recent months.

Investment market

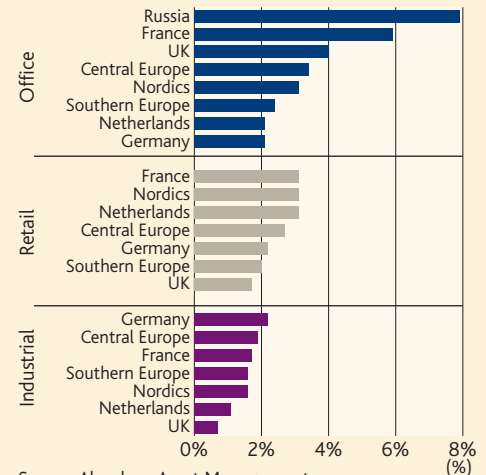
Investment in European commercial property amounted to €23.5 billion in the second quarter of 2010, a 15% increase on the €20.3 billion transacted in the first three months of 2010, according to the latest data from CBRE. Investment turnover rose despite the stress factors emerging in the broader capital markets, such as the sovereign debt crisis and the introduction of austerity measures by many European governments.

Sentiment in the past weeks has turned and become somewhat more pessimistic about growth prospects as a result of concerns regarding sovereign debt in southern Europe. Investors and lenders remain risk averse and investment and lending activity remains focused on prime property. Non-prime property is likely to see further falls in values in the months to come.

There has not been a 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. This situation has been aided by the very low funding costs and high margins now being charged, which has meant that banks are under little immediate pressure to dispose of assets, in contrast to the situation in the early 1990s when interest rates were much higher.

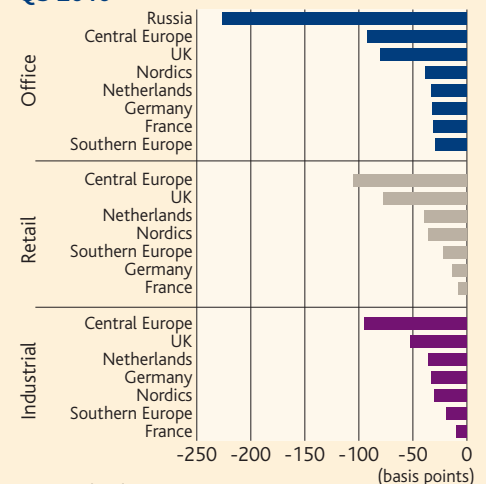
Nevertheless, lenders have tightened terms substantially and are demanding much higher margins and lower loan-to-value (LTV) ratios on new lending than they were two to three years ago. Most banks are seeking to reduce their exposure to commercial property as they repair their balance sheets. On the whole, lending terms have not changed significantly over the last quarter, with our estimates putting margins over swap rates at between 90-140 basis points for prime property assets. Margins for secondary property are much higher, with lending conditions still difficult for non-prime assets. According to PMA, lending terms have become slightly more competitive over the last quarter across Europe with LTVs rising, even for southern Europe. Lending terms are projected to gradually improve in the UK, Germany and France over the remainder of the year.

Prime rental growth: Five years from start Q3 2010



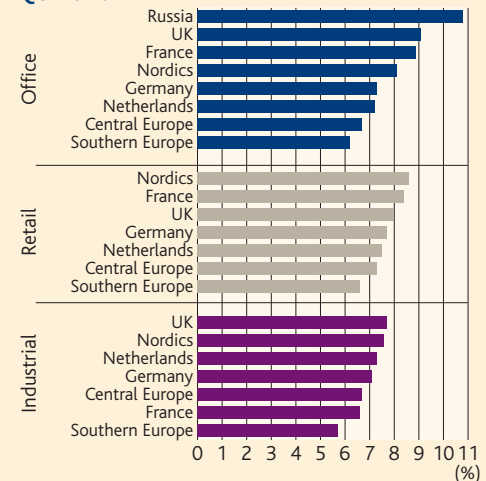
Source: Aberdeen Asset Management

Prime yield shift: Five years from start Q3 2010



Source: Aberdeen Asset Management

Prime total returns: Five years from start Q3 2010



Source: Aberdeen Asset Management

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Outlook

We continue to project a two stage recovery in the European commercial property market. The first stage of the recovery, which involves an investment market driven bounce in capital values has already occurred in most of the more mature markets, such as the UK, France and Germany. The second stage of the recovery will be aided by the resumption of rental growth, which is projected to occur in earnest from 2012 onwards. Yields are likely to start to stabilise again across Europe during the remainder of 2010. Increased levels of risk aversion will be driven by concerns of a renewed economic slowdown, compounded by the effects of the sovereign debt crisis in southern Europe and further public spending cuts and tax increases across Europe. Secondary property is likely to see some upward yield pressure. This is already occurring in the UK, which tends to lead other European property markets. Nevertheless, given the very low level of government bond yields and the exceptionally low return available on cash, property's income return looks very attractive and any capital falls are expected to be modest.

Investment demand is likely to remain subdued. The banks' need to recapitalise means little will be available to finance debt-backed purchasing. There is an estimated €482 billion of re-financing requirements outstanding, according to DTZ, which is likely to lead to an increase in investment property coming to the market from the banks, especially at the prime end where investor demand is strongest. This process is already underway in the UK. This increase in investment supply will limit the potential for further capital uplift.

Our forecasts indicate that, from 2012 and onwards, total returns will pick up again. A resumed uplift in capital values will be aided by moderately improving occupier market conditions as rental growth accelerates. The exceptionally low levels of development currently occurring 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 will only resume in earnest across the office and retail sectors as a whole in 2012. However, we do expect yields to compress post 2011, as the economic recovery gathers strength, with rising interest rates and bond yields only having a negative market impact late in the market cycle as monetary policy becomes restrictive.

There is a modest differential between sector returns at an 'All Property' basis. Projected returns are strongest in the European office sector, at 7.8% over the next five years on an annualised basis, the retail sector delivering 7.7% and the industrial sector lagging at 7.2%. Logistics and industrial rents are usually quite stable throughout the entire property cycle, which means this sector will benefit less from the improvement in rental growth as economic growth resumes, which will be concentrated in the retail and office sectors.

Differing levels of fiscal strength across Europe lead to a wide divergence in total return prospects across Europe. The strongest total returns are projected to be in the Nordics, the UK and France, as well as Russia and Turkey. Low levels of public and private sector debt in the Nordics in particular, ensure that returns are above the eurozone average. The UK, despite its fiscal problems and exposure to the financial services sector, will be able to use its independent monetary policy regime to support an economic recovery, unlike Ireland and the southern European members of the eurozone. We expect the UK to be among the strongest performing markets in the region for the next five years. Both prime and average (IPD) property in the UK is likely to outperform, providing (non-UK) investors with compensation for more volatility and currency risks. Russia is also expected to perform well, although it carries an exceptionally high level of risk. Total returns will be boosted by high income returns and a substantial inward yield shift off a very high base. The weakest performers are Romania, Croatia, Greece, Portugal, Italy and Hungary, hindered by weak economic growth, high and rising government debt and modest investment demand. Southern and eastern European markets generally underperform, with the exception of Poland.

Important Information

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

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