ING Real Estate
European View Quarterly Update

AUGUST 2008

KEY HIGHLIGHTS

- **'It's going to get worse before it gets better.' Economic growth expectations for the near term have been adjusted downwards, with the midterm economic outlook being more positive than the near term, as sustained inflation and a reduction in the growth rate of world trade pose a threat to growth.**
- **The severity of the situation varies across the continent, with growth rates in most Eastern European countries still exceeding 5%, while Western Europe is slowing down rapidly.**
- **Due to the slowing economy, office take-up levels are expected to decrease further, but limited pipelines are preventing rents in most Continental European office markets from falling in the short run, except for Spain.**
- **Despite a continued deterioration of consumer confidence, consumers are still not reducing their spending in most countries. However, sales will decline and will not be able to preserve current rent levels, especially in markets with considerable pipelines. Outlooks vary across markets and retail types, though.**
- **In the logistics market, letting activity remains brisk in European Distribution Centre locations, but is on hold in more regionally oriented markets. Rents are currently stable and are not expected to change much, except for infrastructure-driven primary hubs, which will see further rental growth.**
- **Due to the credit squeeze, the strongest upward yield shifts have occurred in office markets, but retail and industrial markets are now following as well. The strongest price corrections are occurring in markets with the lowest yields and for properties reflecting more risk. Yields are anticipated to stop rising only after 2009.**
- **Returns on core properties will be relatively low in the near future. Due to lower property returns and higher debt costs, leverage could contribute negatively to return on equity. More investors are looking for new opportunities in distressed or re-priced assets.**


Triangle-Part-Dieu, Lyon, France


Romaest, Lunghezza, Italy

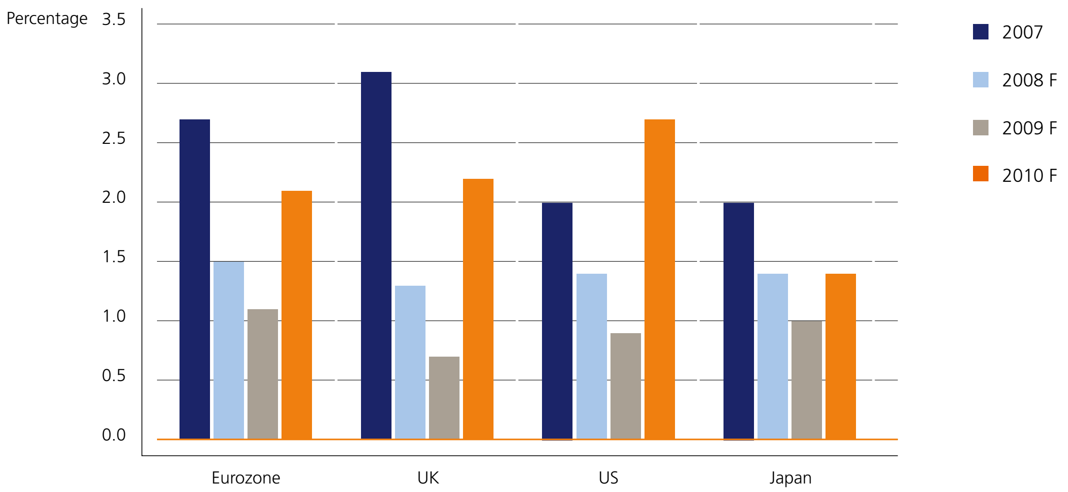
ECONOMIC CONDITIONS

It becomes clear that we are at the end of the current global economic cycle when all the major economies of the world experience a period of below-trend economic growth. Confidence indicators in Western economies have fallen as purchasing power has been affected by high inflation and ongoing volatility in stock exchanges worldwide. The shorter-term global economic outlook is becoming less favourable given the current deteriorating macroeconomic situation worldwide.

With expectations of disappointing corporate earnings, higher debt default rates and lower asset prices, the global economy could be facing more adverse news in the coming quarters. The volatility in forward-looking financial markets indicates that confidence has not yet been restored. A return to more normal conditions is not expected in the short term, so the next two years are likely to see a continued reduction in the availability of credit. Furthermore, the midterm economic outlook may be more positive than the near term with its major inflationary concerns (Figure 1). Central banks are expecting the credit crunch and weakening labour markets to act as a disinflationary force.

The European economy will not escape from the unfolding global economic slowdown. The severity of the situation varies across the continent, with growth rates in most Eastern European countries still exceeding 5%, while Western Europe is slowing down rapidly. The Nordic countries are performing relatively well. Southern Europe seems to be affected most by the current market turmoil, with GDP growth in Spain forecast at 0.6% for 2008. The appreciation of the euro during the first half of the year is having a continuing negative impact on exports. In addition, debt financing has become more expensive as banks require higher spreads on loans in order to compensate for increased risk. While the economic outlook is becoming more unfavourable, unemployment is still declining or stabilising, indicating that labour markets are not putting a drag on the economy. In the current economic climate, workers may seek compensation for rising inflation through higher wage demands, which could further fuel an inflationary spiral. However, if wage increases outpace current inflation, this could also result in real income growth and provide a cushion for consumers.

Figure 1 **Economic growth rates likely to recover in 2010**



Source: EIU (history) and ING Economic Forecasts (forecasts)

The forecast growth in European economies in 2008 is below the long-term trend and indicates a continuing slowdown in economic activity. Although growth expectations for the near term have been adjusted downwards, the ECB raised its main interest rate to 4.25% after keeping rates stable since June 2007. This emphasizes the ECB's commitment to fight the current level of inflation, in accordance with its primary mandate. Sustained inflation is posing a threat to growth, but the risk is that higher interest rates will deepen Europe's current economic downturn, particularly in light of the depressed housing markets in Ireland and Spain. Inflation will probably have to fall back to below 3% on a sustainable basis before the ECB will consider any cut in rates.

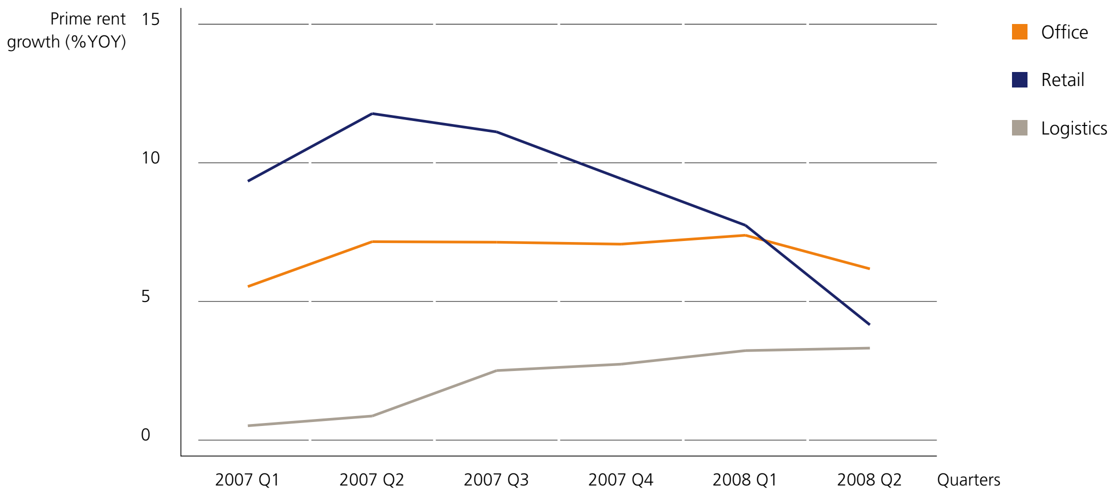
OCCUPIER MARKETS

Despite still positive job growth, the slowing economy increasingly translates to lower office demand, with European take-up falling 6% in the first half of the year, compared to demand during the same period the year before. Demand is expected to decrease further in the course of this year and fall below the record take-up recorded in 2007. After a strong first quarter in which virtually all markets in Continental Europe saw prime rents growing, the second quarter yielded lower average growth rates, as only half of the markets saw increasing rents (Figure 2). In the UK, rents continued to decline. However, as pipelines are modest in most markets due to increasing construction costs and low debt availability, vacancy rates are anticipated to remain relatively low. For most markets, we therefore do not expect that rents will start falling yet, with the exception of the major Spanish markets, which are leading the Continental European office cycle and will face more difficulties to let vacant space.

Retail is proving to be less dependent on the general business cycle than the office and industrial sectors. Despite the fact that uncertainty in the economy and financial markets is pushing down consumer confidence in Europe, retail sales are still not falling in most countries. Thus far, demand from national and international retailers is healthy, which, combined with limited modern supply, is pushing rents up modestly. However, retail sales growth is decelerating and is already declining in several European countries. Eventually, due to the worsening economy, it is expected that sales will even decline in half the countries in Europe in 2008. Combined in some cases with considerable retail pipelines, this eventually will prevent rents from growing much further. Nevertheless, there will be differences across retail formats and markets. For example, specific prime schemes in Central Europe still have strong growth potential.

Although overall economic growth has a major impact on the development of the logistics and industrial property sector, sector-specific drivers still remain significant for logistics property market development and there are substantial regional differences. European Distribution Centre locations like the Netherlands, Belgium and Germany benefit the most from the sustained worldwide growth in trade. On the other hand, Italy, Spain and, to a lesser extent, France are more regionally oriented and therefore more dependent on local and national economic conditions. In these markets, activity is on hold and take-up levels are subdued. However, speculative development remains limited except for specific locations. Despite the mixed picture, rents are generally relatively stable across Europe. Upward movement of warehouse rents is only being observed and expected to continue in the infrastructure-driven primary hubs in the Netherlands, Belgium and the German cities of Hamburg and Frankfurt, where high demand meets limited supply. On the other hand, no or very limited change in rent levels is expected in the secondary logistics hubs, where land is generally available and thus offers more new supply potential.

Figure 2 **Prime rents still grow but at a lower pace**



Source: ING REIM, based on Jones Lang LaSalle

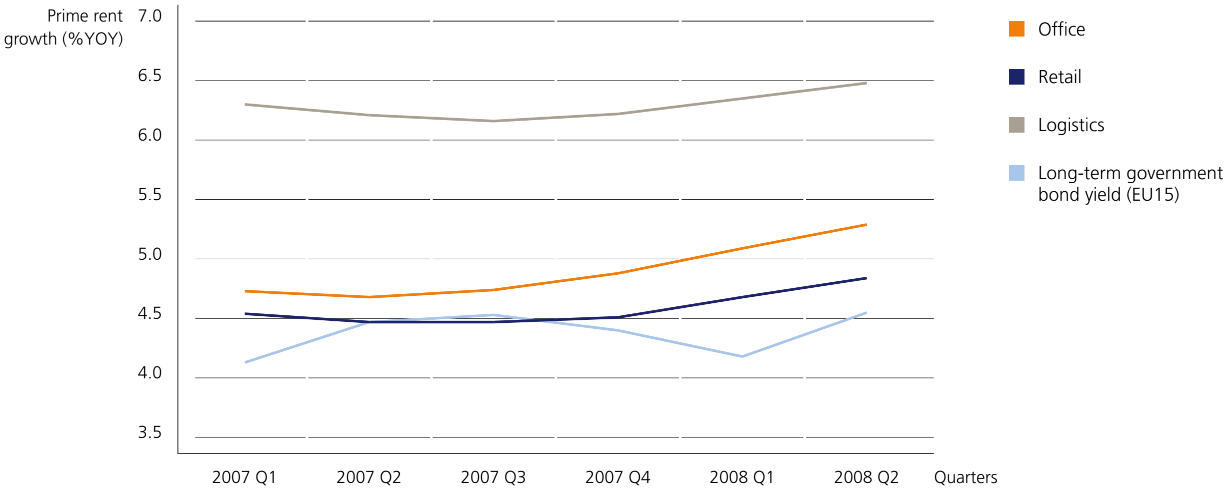
INVESTMENT MARKETS

The impact of the credit squeeze was first observed and was most pronounced in the office investment market, where prime market yields moved outward by 60 basis points over the past four quarters (Figure 3). Retail and logistics markets faced increasing yields too, but to a lesser extent, by 35 basis points on average. European yields are converging, as the strongest corrections are occurring in markets that initially had the lowest yields. In addition, properties reflecting more risk, as shorter cash flows and weaker covenants, are more vulnerable to yield increases too. Thus far, markets with a strong growth outlook or a higher yield, such as those in Central and Eastern Europe, have remained relatively less affected.

A gap in price expectations between vendors and potential buyers and more stringent debt market conditions cause a clear fall in investment activity. The decline in the number of portfolio deals is significant. The poorer economic outlook and stringent conditions in the debt market will keep investment volumes low until yields and yield spreads are sufficiently high to compensate for the risk. In the meantime, properties reflecting more risk in their location, leases, quality or size, are likely to experience larger price corrections. Changing economic conditions and refinancing problems are also likely to result in some forced sales by developers or investors, thereby speeding up the price correction process to some degree. We anticipate that yields will stop increasing only after 2009. Banks will continue to be cautious for some time and recent declarations by the European Central Bank concerning inflation as well as the increase in base interest rates will continue to make the financial markets nervous and volatile.

Despite the current market uncertainty, a significant amount of capital is still available to be deployed across Europe by a range of equity investors and an increasing number of opportunistic funds targeting distressed or re-priced assets. While many investors are sitting on the sidelines, a number of lower leveraged and equity players remain active in the market, especially German open and closed funds, which are actively negotiating in Continental European markets.

Figure 3 **Prime net initial yields are on the rise, spreads becoming positive again**



Source: ING REIM, based on Jones Lang LaSalle and EIU

CONCLUSIONS

The economic fundamentals that supported real estate markets in the recent past continue to soften. The pace of growth in retail sales is slowing and many markets are likely to experience rising unemployment. Nevertheless, in some prime locations, vacancy rates are sufficiently low to create some further rental growth. However, this income growth will not outweigh the negative impact of financial markets on property values. With a delayed response, valuations are now picking up previous broker signals of rising property market yields, and will start confronting investors with negative revaluations. The double-digit property returns of the recent past will most likely not reoccur for core properties during the few next years, as core returns will be mainly driven by rental income, inflation-related rent indexation and, in some markets, real rental growth. Due to lower property returns and rising financing costs, leverage is likely to have a negative effect on portfolio returns and should therefore be reduced in order to reduce risk and safeguard returns.

However, the changing investment climate also provides new opportunities. There is some initial evidence of tightened debt market conditions causing distressed sales by developers and investors. Distressed and re-priced properties are increasingly the target of newly launched opportunistic funds. Moreover, in a risk-averse climate, the security and inflation-indexation from real estate is expected to maintain institutional investor interest.

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