



Emerging  
Trends  
*in*  
Real Estate®  
Europe

2007

## Emerging Trends in Real Estate® Europe 2007

A joint venture of:



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# Executive Summary

■ The European real estate market is near the top of the investment cycle. Real estate prime yields will largely stabilise in 2007, although some slight further compression is possible. Investors are anticipating single-digit core returns and a calmer investment environment in 2007.

■ European real estate executives are optimistic about the economy in 2007 following the strongest gross domestic product growth in the last six years. In 2007, European real estate firm profitability is expected to remain good, with prospects up slightly over those for 2006. However, higher oil prices, an elevation in interest rates, value-added tax increases in Germany, and tax rises in Italy will provide some dampening effect.

■ Global real estate investing in Europe continues to grow as investors with deep pockets of capital continue to emerge from different parts of the world. Cross-border investment in Europe has become simpler since the euro eliminated currency risk across 13 markets. Cross-border capital investors remain largely focussed on opportunities in the United Kingdom, France, and Germany, but are also increasingly looking favourably on more far-flung markets in central and eastern Europe.

■ Three newer topics of discussion that investors will be keeping an eye on are infrastructure, sustainability, and human capital shortages. Each of these areas will affect real estate investment and development opportunities as the year progresses.

■ Equity capital continues to pour into European real estate from many different sources, and equity capital markets will remain largely oversupplied. Investment capital continues to flow across continents, with strong growth in flows from the Middle East, Asia, and Australia. Opportunity funds, private investors, pension funds, and private property vehicles will lead the growth in real estate investing in 2007.

■ Increases in debt capital are expected as well, with new growth from international and cross-border lenders. However, more stringent underwriting standards and increases in interest rates should keep the market in relative balance.

■ The market for publicly traded real estate will continue to grow as the introduction of tax-efficient REITs fuels interest in real estate securities. Currently, seven REIT-type structures are running throughout Europe, including the 2007 launch of the U.K. REIT. Launches are also being planned for REITs in Germany and Italy.

■ Compared with 2006, European real estate markets now provide less risk, higher return prospects, better supply/demand balance, and improved development prospects.

■ Based on a risk-adjusted total return measure, the top five markets are Paris, London, Stockholm, Munich, and Lyon. As with last year, Paris and London remain in the one and two positions, but the other three cities have moved up the rankings considerably. Istanbul and Moscow offer the best prospects for development and are also high on the list for property buyers.

■ Many European investors and developers will be placing more focus on urban regeneration and redevelopment opportunities than in previous years. Investors believe these creative opportunities are being generated by the very competitive real estate investment environment.

■ Eight out of ten property sectors in the survey offer at least modestly good prospects for total returns in 2007, and these prospects have improved over 2006. Rental growth and development prospects have improved for all of these property types as well.

■ For the third year running, shopping centres will offer the best total return prospects, followed by hotels, mixed-use properties, and city centre offices. The latter has strengthened considerably from last year. Other retail categories, together with warehousing/distribution and residential, fill in the middle ranks. Business park/out-of-town office and manufacturing sectors continue to lag other sectors, similar to last year.

## Preface

A joint undertaking of the Urban Land Institute (ULI) and PricewaterhouseCoopers, *Emerging Trends in Real Estate® Europe* is a trends and forecast publication now in its fourth edition. The report provides an outlook on European real estate investment and development trends, real estate finance and capital markets, property sectors, metropolitan areas, and other real estate issues.

*Emerging Trends in Real Estate® Europe 2007* represents a consensus outlook for the future and reflects the views of more than 390 individuals who completed surveys and/or were interviewed as a part of the research process for this report. Interviewees and survey participants represent a wide range of industry experts—investors, developers, property companies, lenders, brokers, and consultants. ULI and PricewaterhouseCoopers researchers personally interviewed over 165 individuals, and survey responses were received from 228 individuals whose company affiliations are broken down as follows:

Real Estate Service Firm	20%
Developer	20%
Private Property Company	19%
Investment Bank	7%
Publicly Listed Property Company	6%
Institutional Investor	6%
Commercial Bank	2%
Other Entity	20%

A list of the interview participants in this year's study appears at the end of this report. To all who helped, the Urban Land Institute and PricewaterhouseCoopers extend sincere thanks for sharing valuable time and expertise. Without the involvement of these many individuals, this report would not have been possible.



# Top of the

*“At some point real estate will take a pause from delivering double-digit growth, and performance will be pretty average.”*

# Cycle?

“If 12 o’clock is the top of the cycle, we are at five or ten minutes to 12.” This is the message coming from our survey and interviews: European markets are peaking and yields will stabilise in 2007.

On average, half of those surveyed believe that yields will stick at their current levels in 2007. The rest are split between 27 percent who think that yields can still be squeezed down a bit further and nearly as many who expect them to move out. “Yield compression can’t go on forever.”

Sector to sector, the verdict varies a bit. Business parks and out-of-town offices are thought to be most at risk of an upward yield shift: 30 percent of those surveyed are expecting one by late 2007. In contrast, logistics facilities and distribution warehouses is the sector where the highest proportion of respondents—34 percent—expects yields to fall.

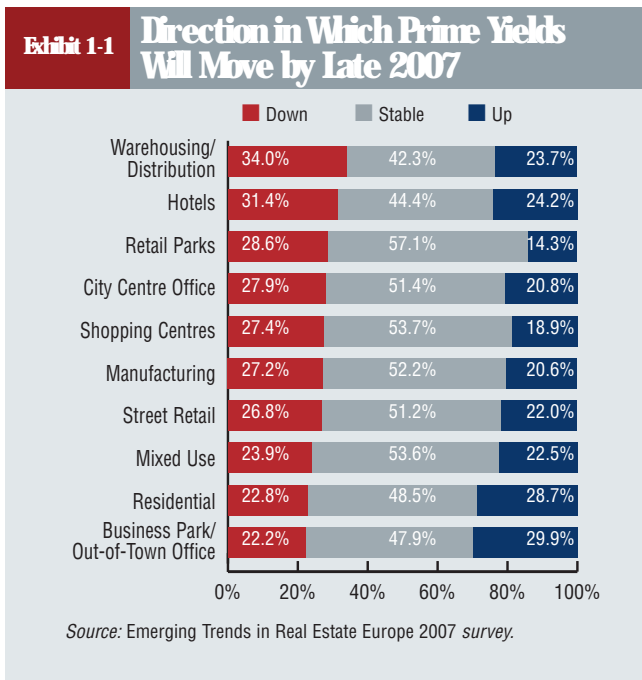
Investors seem to be adjusting to “overliquid and overexcited” markets. At the start of 2006, many were bemused by the cutthroat competition for assets and rapid drop in yields. “Has pricing gone too far?” they wondered. Entering 2007, they are poised to pick their way through this minefield, finding value where they can. “Central Europe is the place to go—we’ve opened an office in Warsaw.” “We like supermar-

kets, even in small locations. The yields are high and they can be traded internationally.” Or even: “We are core investors and have to pay high prices anyway.”

No one thinks the capital pressing down on Europe’s real estate markets is going to lighten up anytime soon. “Institutional investors around the world are actively placing equity in real estate.” “Prices are high, but the money stays.”

However, investors are expecting a calmer, steadier time in 2007. “No glaring pitfalls or huge opportunities.” “The ferocity and velocity [are] slowing down.” “At some point real estate will take a pause from delivering double-digit growth, and performance will be pretty average.”

Over the last couple of years, falling yields have been driving returns in Europe. With yields now reckoned to be at or near their low in many European markets, returns are forecast to drop into single digits in 2007. “In some markets, it’s just going to be an income return.” Attention is now switching back to property market fundamentals. “You have to be prepared to get your hands dirty, find angles, and exploit values.” “It is harder to make money on the quick hit and run.”



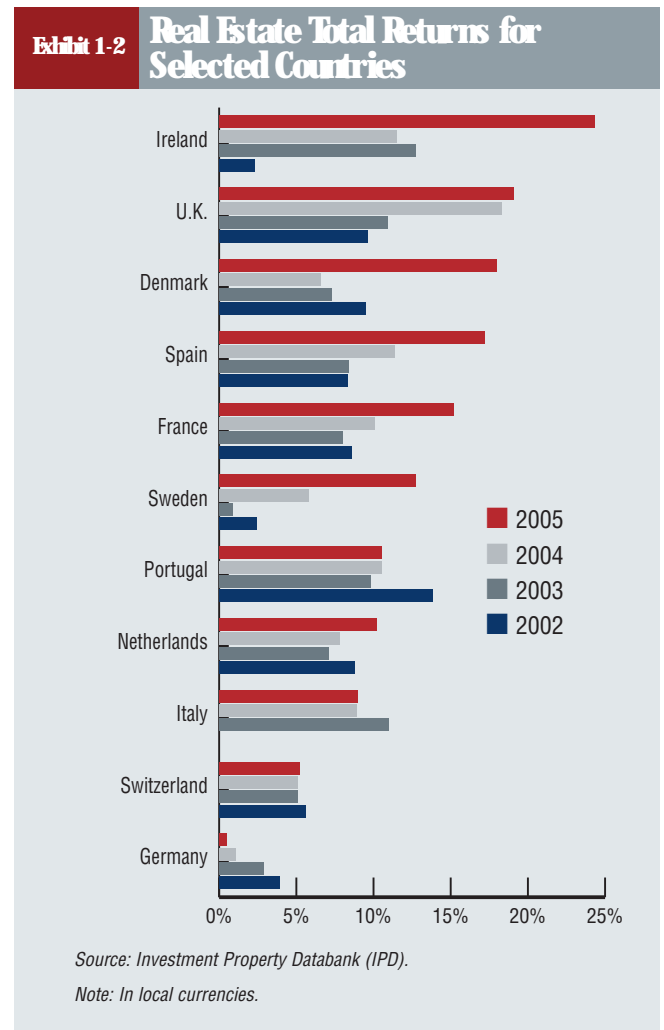
Our survey shows that buyers now outnumber sellers by two to one. For three sectors—industrial/distribution, hotels, and mixed use—the “buy” vote is over 50 percent. This suggests that investors have adjusted their mind-set to cope with current pricing, perhaps because they are more confident that yields will bottom out in 2007.

A few markets are deemed to be too hot. “Spain is clearly untouchable at this point.” “The yields in central and eastern Europe have gone down quite dramatically, and don’t justify the country risk and everything that goes with it.”

Indeed, yields have been converging across Europe. Prime offices in the three capitals of central Europe—Budapest, Warsaw, and Prague—are now almost on a par with western European capitals. Two years ago, there was a considerable gap.

Though many we interviewed are still complaining about the difficulty of finding suitable investments, this may be easing. Tightening interest rates in 2006 have shaken some of the highly leveraged private buyers out of the market, while high prices are tempting more owners to put their stock onto the market. “We are selling anything old at new prices to foreign investors” “It’s a very good time to be a value-added investor—there’s a lot of product coming onto market now.”

Moreover, there is still a large volume of private and publicly owned property to be hived off into the investment market. DTZ estimates that there is potential for 51.7 billion of real estate to be outsourced in Europe between 2006 and 2010. “As corporate users and others outsource their real estate, capital will be matched by availability.”



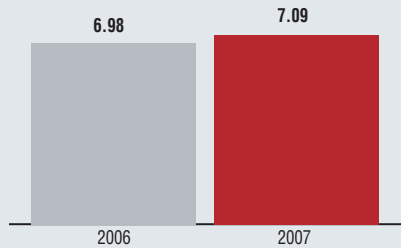
Not everyone we interviewed is comfortable with current pricing, however. “Some bidders are really reaching for the stars.” “Prices have been driven to unacceptable levels by foreign investors.” Conversely: “If you want stock at yesterday’s prices, then it is difficult to invest. At the current price, it’s quite a reasonable market.” “The pricing of prime property looks [like] fairly good value relative to stock at [the] moment.”

Nonetheless, few of those interviewed think that European real estate is in the grip of completely irrational exuberance. “There are no indications of madness . . . yet.” “The assumptions people are making may be optimistic, but not fundamentally ridiculous or irrational.” “There’s no comparison with the dot.com bubble. People are investing in assets that have cash flow and can be managed.”

In general, the *Emerging Trends* survey finds that prospects for profitability are good for real estate firms of all types in 2007, and these prospects have improved slightly over those for 2006 (see Exhibit 1-3).

**Exhibit 1-3**

**Real Estate Firm Profitability Prospects**

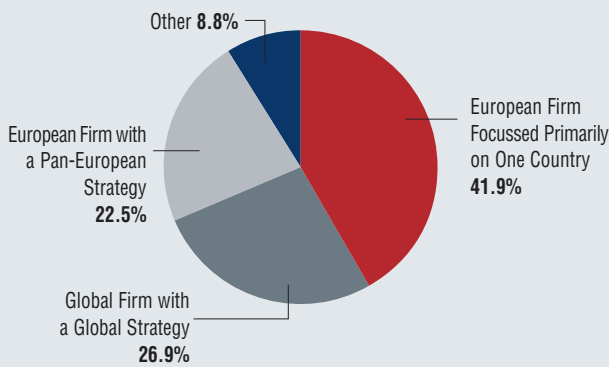


Source: Emerging Trends in Real Estate Europe 2007 survey.

Note: 6 = modestly good, 7 = good, 8 = very good.

**Exhibit 1-4**

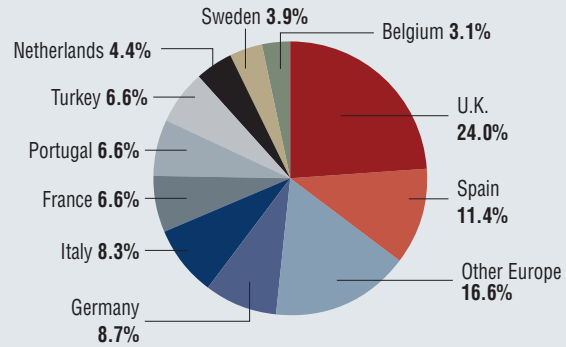
**Survey Responses by Geographic Scope of Firm**



Source: Emerging Trends in Real Estate Europe 2007 survey.

**Exhibit 1-5**

**Survey Responses by Country**



Source: Emerging Trends in Real Estate Europe 2007 survey.

## The Economic Backstory

Most of Europe’s economies are entering 2007 in a relatively upbeat mood. Eurozone gross domestic product (GDP) growth for 2006 is being revised to a better-than-expected 2.6 percent, its best performance in six years.

The consensus is that 2007 will deliver a lower figure. Higher oil prices, higher interest rates, value-added tax (VAT) increases in Germany, and tax rises in Italy are all expected to take their toll. But even so, the European Central Bank and others are feeling cheery and pencilling in GDP growth of around 1.9 to 2.2 percent.

Euro-pessimists are looking nervously over at the U.S. economy, wondering if its slowdown will stall Europe’s growth. Euro-optimists expect a soft landing in the United States. They point out that in any case, domestic demand, not exports, has been fuelling the Eurozone’s admittedly modest GDP growth.

One big reason for cheer is that Germany may be moving out of the sick bay. It represents close to 30 percent of the Eurozone’s economy and German GDP growth in 2006 is coming in above forecast, at around 2.5 percent. A 3 percent increase in VAT, due to kick in at the start of 2007, is likely to dampen German households’ spending, but the hit might not be as strong as feared since employment continues to rise. Although retail sales are still depressed and wage growth is weak, business and consumer surveys say confidence is at a five-year high.

Real estate investors worldwide have anticipated this recovery, pouring capital into Germany: at least 41 billion over the last two years, according to Jones Lang LaSalle. Yields have plummeted under this weight, but there is no let-up in investors’ interest. There is still a 135- to 150-basis point margin over borrowing costs and large volumes of property to be shaken out of government and private hands, either as big portfolios or single assets. With the prospect of office rents picking up in selected cities, opportunistic investors’ attention is switching to that sector. “Offices are very cheap, well below replacement cost.” There also are still large chunks of residential property to come out in Germany, though opportunistic returns are more difficult to achieve since prices have shot up. Residential portfolios are now being bought less as plays on quick yield shift and breakup and more as operating businesses.

Elsewhere in the Eurozone, Spain and Ireland are economic hotspots. Ireland is forecast to remain so in 2007, with the strongest GDP growth in western Europe. Irish private real estate investors are still swarming out of their domestic market. Mainly geared buyers, they are being driven out of the U.K. by recent interest rate rises and are now to be found on the continent as far afield as Romania and Russia, where yields still show a healthy positive margin over borrowing costs.

**Exhibit 1-6 European Economic Growth**

	Percentage Real GDP Growth			
	*2007	*2006	2005	2004
Turkey	6.48	7.10	7.38	8.90
Russia	5.99	6.41	6.40	7.20
Poland	4.55	4.95	3.24	5.40
Czech Republic	4.49	5.70	5.95	4.40
Ireland	4.16	4.86	4.70	4.50
Greece	3.31	4.00	3.70	4.70
Sweden	3.30	4.59	2.70	3.10
Finland	3.21	4.13	2.10	3.50
Hungary	2.90	4.01	4.14	4.60
Spain	2.82	3.65	3.40	3.10
Belgium	2.51	2.98	1.20	2.70
Denmark	2.39	3.00	3.10	2.10
Netherlands	2.20	2.85	1.10	1.70
France	2.20	2.05	1.50	2.10
Switzerland	2.12	2.89	1.90	2.10
Austria	2.04	3.57	1.90	2.40
U.K.	1.95	2.43	1.80	3.20
Italy	1.49	1.64	0.00	1.00
Germany	1.33	2.46	0.90	1.60
Portugal	1.32	0.90	0.30	1.20

Sources: World Bank, Moody's ([www.economy.com](http://www.economy.com)).

\* Projections.

Spain, too, has been experiencing a sustained economic boom, thanks to cheap money and a spending spree by Spanish consumers. Commercial and residential property prices have rocketed as both domestic and cross-border buyers have piled into bricks and mortar. “People are in a buying frenzy. Though the word is taboo, I would describe it as a bubble.” The fear is that rising Eurozone interest rates and high levels of household debt could bring Spain’s fiesta to an abrupt end.

France has been growing well and looks like registering its best growth for several years in 2006, 2 percent. However, Europe’s second-largest economy stagnated unexpectedly towards the end of 2006. Although unemployment has fallen, job creation is disappointing. French consumers are feeling downbeat about the future, a mood that may reflect uncertainty at election time. Even so, the economy is expected to do a bit better in 2007.

In contrast, Italy’s economy appears to be losing steam. The government has decided to jettison spending cuts and tackle Italy’s budget deficit by raising taxes instead. There are worries that this might stall the fragile recovery that started

last year. The tax changes included introducing a 4 percent stamp duty on property deals, which brings Italy in line with other European countries. But the proposal to levy a 10 percent sales tax as well has dismayed foreign and domestic investors alike. “Real estate is under attack from the government. It is becoming quite difficult to operate.”

The Benelux economies are on a solid growth path. However, occupational demand in their main office markets remains weak and vacancy rates are still high. The U.K.’s GDP growth has also been good, but is expected to decelerate in 2007. Harder times may lie ahead, and consumer confidence deteriorated towards the end of the year. Successive interest rate increases in 2006 are starting to take some of the heat out of its commercial property market as debt-driven buyers look for yield arbitrage elsewhere. “Everyone is going into continental Europe—Terminal 1 at Heathrow is the place to be.” However, occupational demand for offices in central London is picking up; rental growth has resumed and is expected to accelerate in 2007.

GDP growth in the Nordic region is expected to outpace the Eurozone average, as it did in 2006. Last year saw several pan-Nordic property funds launched and a 1.3 billion Nordic portfolio listed in London, signalling that the region is registering on the cross-border real estate radar. Sweden in particular has seen international investors flock in, pushing yields to record lows. Its economy turned in a much better than expected performance in 2006, and the upturn has helped pull its property market out of a three-year slump.

A smallish cloud on the horizon is the euro, whose value has surged thanks to higher interest rates and worries over how much growth will slacken in America. A strong euro could hit exports and weaken growth at home in Europe. However, economists reckon that the Eurozone economy is strong enough not to buckle under the pressure.

In central and eastern Europe, three out of four of the economies are also expanding robustly, underpinned by both foreign and domestic investment and strong consumer spending. The forecasts for 2007 indicate a slight easing of GDP growth, as the world economy slows down. The odd one out is Hungary, where the government is trying to balance the books with an austerity programme of increased taxes and spending cuts. Political uproar over a tape that revealed the newly elected prime minister lied about government finances is further clouding the future.

Topping the growth league is Turkey, with GDP growth of around 7 percent last year. The outlook for 2007 is mixed. Its economy is still expected to outperform the rest of Europe, but the Turkish lira has weakened, pushing inflation to 10 percent. This has scuppered any cut in interest rates, which have soared to 17 percent as of early 2007. The government is also keeping a tight rein on finances, but faces an election in 2007. Talks on Turkey’s accession to the E.U. are continuing, but proceeding slowly and with difficulty, unsettling foreign investors.

# rental growth.”

However, international real estate investors think Turkey is a good longer-term bet and are sniffing around. Several have already moved in, attracted by its young, dynamic population and enormous growth rate. Most are focussing on retail. “E.U. accession is relatively unimportant; if Turkey joins in ten years’ time, it would be a super bonus, but it does not matter.”

## The Interest Rate Question

The Eurozone has Germany’s prolonged economic slump to thank for a lengthy period of low interest rates. But with inflation on the rise, the European Central Bank has ratcheted up its rates, raising them 125 basis points to 3.5 percent over 2006. Similarly, in the U.K. the Bank of England has tightened its rate.

The consensus among economists is that euro and sterling interest rates have peaked and are likely only to tighten by another 25 to 50 basis points or so in 2007. The reason: central bankers are feeling more relaxed now that inflationary pressures appear to be easing.

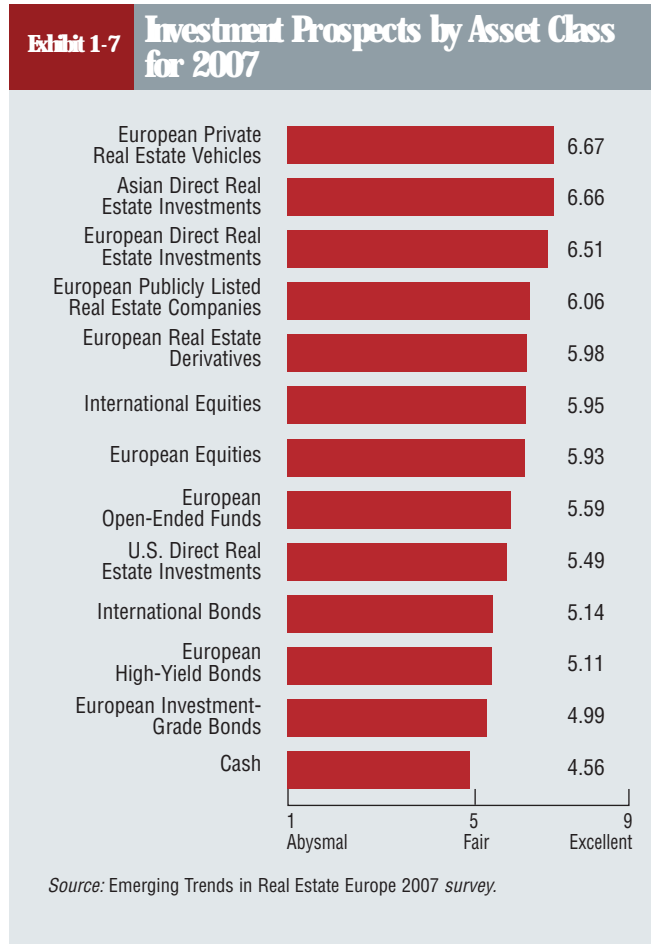
However, markets around the world are awash with excess cash looking for a home. The danger is that overinvestment will create asset bubbles that then burst, like the 1990s’ dot.com boom in U.S. technology companies. So central banks are keeping a close eye on rising asset prices, particularly for real estate. In the U.K., the Bank of England has singled out commercial property and the bank debt riding on it as “key vulnerabilities” in the U.K. financial system.

Lending to U.K. property companies has been climbing rapidly. An additional £20 billion of new loans were pumped into commercial real estate in 2006, taking the total outstanding to a record £156 billion. This set alarm bells ringing at the Bank of England, which has warned that commercial property prices could fall as much as 35 percent over three years if some shock jolts the U.K.’s economy into reverse.

In the U.K., the all-property yield and the cost of five-year money crossed paths in 2006, eliminating the arbitrage. This is taking some of the heat out of the real estate market. On the continent, there is still a positive 100– to 150–basis point gap between property yields and euro interest rates in the main western European cities.

## Investment Prospects Strong

Real estate is still topping the chart of investment prospects. Our survey shows that it is again expected to outperform all other asset classes worldwide in 2007. European private vehicles and Asian real estate are in top place, with the European vehicles ahead by a whisker.



In fact, except for open-ended funds, European property in all its forms is ranked highly, above international equities, European equities, U.S. property, and bonds. “Property still offers a nice spread of 50 to 75 basis points compared to the bond market.”

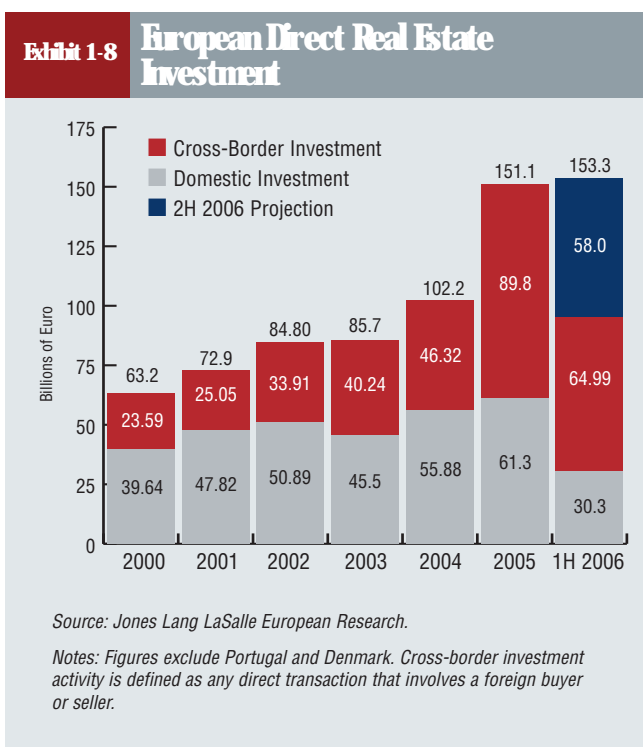
However, this does not mean that investors are expecting European property markets to deliver the double-digit returns of the last couple of years. “Yield compression is coming to an end. If you want to make returns, you’d better focus on markets that have good prospects for rental growth.”

Across the pond, U.S. real estate is deemed to have worse prospects than in 2006. It has tumbled to ninth from fifth place, at the bottom of the real estate pile. Bonds and cash remain the low men on the investment totem pole.

## Real Estate Going Global

Real estate is becoming a global asset class. Not only are investors worldwide pouring capital into property—an estimated US\$600 billion was purchased directly in 2006—but they also are crossing frontiers to do so. In the first half of 2006 alone, 65 billion/US\$80 billion crossed borders to be invested directly in European real estate, according to Jones Lang LaSalle.

This is nearly three times the volume that went in during the same period the previous year. It is also three times as much as European investors spent in their individual domestic markets. “Five years ago, hardly anyone was ‘pan-European’; now, it is the only way to operate.”



Cross-border investment in Europe has become simpler since the euro eliminated currency risk across 13 markets, but that is not the whole story. The 65 billion U.S., Middle Eastern, Asia Pacific, and “global” capital spent on real estate in the first half of 2006 shows that foreign investors are much more comfortable negotiating the obstacle course of different tax and legal regimes that still exist in Europe. Over half of all transactions in most European markets are cross-border, according to Jones Lang LaSalle.

Moreover, there is now a one-stop solution to foreign investment: using funds to channel money into Europe via global, pan-European, multicountry, country-specific, or fund of funds. Run by investment banks, private equity houses, and specialist property fund managers, these vehicles amass capital from around the world. In Germany, globally sourced capital bought 40 percent of all the commercial property traded in the first half of 2006—US\$10 billion worth—as well as large residential portfolios.

Germany is currently one of three top European destinations for cross-border capital, along with the U.K. and France. Together, they sucked in 70 percent of the H1 2006 inflows. Sweden and central and eastern Europe (C.E.E.) are the next two most popular markets, with around 6 percent each.

## Investor Base Broadening

Five years ago, U.S. pension funds were debating whether it was relevant to invest overseas, given the size of their home market. Last year, they were planning to spend US\$6 billion (4.8 billion) abroad, 10 percent of their allocation to real estate.

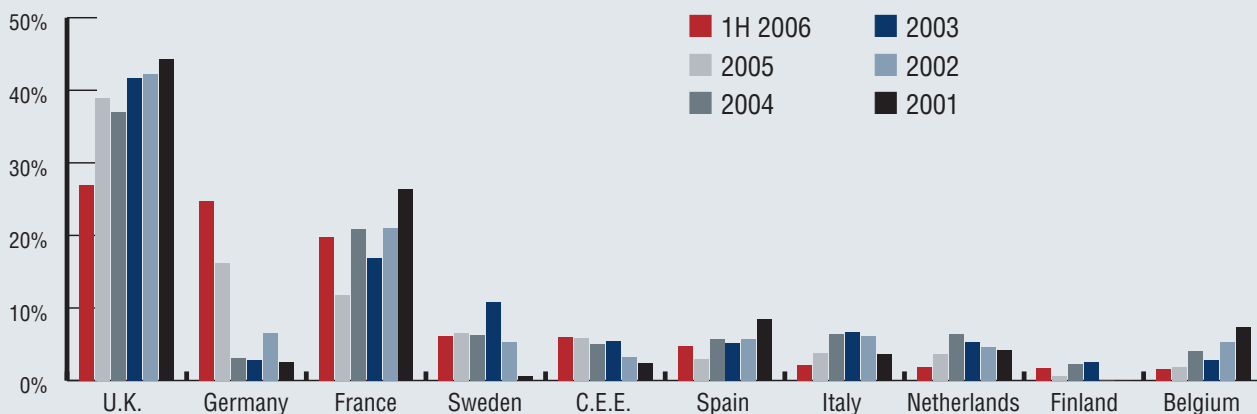
This shift is one of the reasons why there is a growing consensus that real estate is now viewed as a serious asset class. Another is the increasing weight it is being given in institutional portfolios. Having studied real estate this way and that, actuaries and portfolio theorists have concluded that it is a good diversifier, because its returns are not highly correlated with bonds and equities. And pension funds (and insurance companies) need low-volatility assets that can produce long-term, reliable cash flows to match their long-term liabilities.

Property’s repositioning is due in large part to the robust, reliable indices that are now available to measure and compare returns. “Just knowing what performance has been in major markets across Europe is helpful.” With increased transparency has come more liquidity: it is estimated that in 2006, US\$600 billion of European real estate has changed hands.

Liquidity is also increasing because the real estate world is increasingly sophisticated and varied in the products it offers. Writing out big cheques for buildings is no longer the only option for investors. They can now spread their capital—and risk—by taking small slices of funds, or buying into a fund of funds. Large Dutch pension schemes discovered this a decade ago, and now most of their real estate is held indirectly. For newer, smaller entrants, indirect is the logical route into an asset class they would otherwise not be able to access. “We have been investing in real estate for two years, during which we have committed 265 million into mainly European nonlisted funds.”

Institutional investors are not the only ones keen on real estate. There is also another pool of capital waiting in the wings: the man or woman on the street. However, most of the investment products available to the general public are struc-

### Exhibit 1-9 Cross-Border Real Estate Investment Activity by Country



Source: Jones Lang LaSalle.

tured around equities or bonds. Listed real estate securities are still a miniscule (but growing) part of the equities market in most European countries, and—German open-ended funds aside—there are not many unlisted vehicles open to small retail investors in Europe. Yet they too want a bit of commercial property to diversify their private portfolios. “Real estate is being democratized. Individuals are taking control of their pension funds and investments, and making decisions.”

REITs are one obvious vehicle for individual investors, and this sector is set to boom in Europe. Tracker funds are also beginning to emerge. Expect a rush of open-ended and closed-ended funds in 2007. “In the future, capital will be more broadly based. We have to be flexible and intelligent about products we develop. Liquidity and transparency will be very important.”

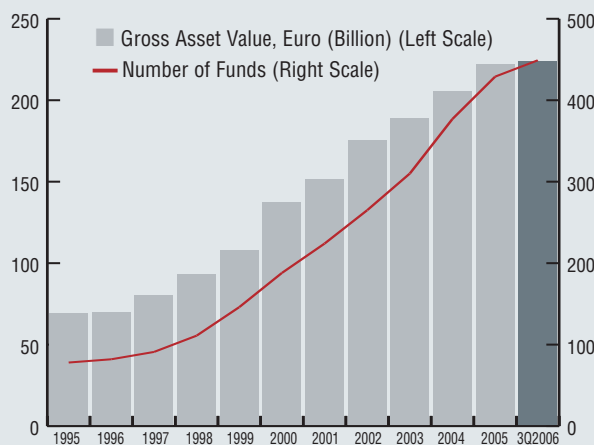
## More Indirect Investment

Investors have a widening choice of both listed and private property funds that they can use to access European real estate. “It’s the logical choice of entry to the asset class for investors, especially outside their domestic market.” “We go indirect to get access to skills, or particular assets, or difficult parts of the market.”

“The amount of money going into property vehicles is now an important part of the real estate universe.” At latest count, there are some 400-plus private property funds available. They come in all shapes and sizes, from small ones investing in U.K. convenience stores or car parks in central Europe to giant, diversified pan-European ones.

Getting money into vehicles is no problem these days. “There is strong demand for indirect property from a huge range of investors, institutional down to retail.” A survey by

### Exhibit 1-10 Growth of Private Property Vehicles in Europe



Sources: Investors in Non-listed Real Estate Vehicles (INREV), Investment Property Databank (IPD), September 2006.

Notes: Does not include German open-ended funds, comprising 32 funds with a gross asset value of €104.87 billion.

INREV (Investors in Non-listed Real Estate Vehicles) estimated that the European unlisted real estate industry raised somewhere between 26 billion and 52 billion in 2005, most of it from within Europe itself. Gross asset values now stand at 224 billion. Such is funds’ popularity that some managers have introduced “a degree of discipline” on inflows.

About two-thirds of funds target single countries. The selection is widest for the U.K., which has about 140 funds focussing on it exclusively. Elsewhere, the sector is growing in

Italy and Germany. There is also a significant group concentrating on the central and eastern European markets.

Pan-European or Eurozone funds are fewer in number, but bigger, accounting for 60 percent of gross assets currently. This is logical, since they require a large critical mass to achieve diversification and economies of scale.

However, getting money into the market is a problem. Competition is fierce, particularly at the core end where, upon INREV's last count, there are some 243 vehicles currently active. With product hard to find and prices very toppy, some of these investors are tweaking their strategies. “First-choice markets may not be available at a sensible price and therefore secondary cities and secondary locations within primary cities will need to be considered.” “Core funds are moving up the risk spectrum, with or without a mandate to do so.”

There are also question marks over whether the opportunistic funds will be able to earn the 20 percent-plus returns they target in Europe. “Performance thresholds need to come down in the fund structures, because double-digit IRRs are becoming increasingly difficult to hit. There is some dishonesty going on in the market about what is really achievable.” “Investors will start to question getting value-added returns for opportunistic fees.”

Fees and how investors' interests can be aligned with managers' are a continuing subject of debate. Performance-related fees are now a more common formula, but vary with funds' investment style. More generally, the increased competition among funds seems to be putting some downward pressure on fees. However, it is not that simple. For example, multicountry fund managers can command higher fees, since investors figure this is a tougher job than running a single-country fund. Those who run very specialised funds may have near-monopoly pricing power. Managers who can source product and make it perform are also highly prized.

According to INREV's annual survey of its members, investors say the management's track record is critical to their choice of fund. Indeed, they ranked access to expert management as the number-one reason for going into nonlisted funds, followed by diversification and enhanced returns.

Given the trend to indirect and the plethora of private property vehicles around, fund-of-fund products and mandates are on the rise. These are particularly suitable for investors who want diversity, but who lack the capital to take direct stakes in several property funds. Most are looking to earn an internal rate of return (IRR) of around 8 percent. Though these involve paying two sets of managers, fund-of-fund managers argue that their fees are relatively low, and point to the parallel with unit trusts/mutual funds.

## Risk vs. Return: Value for Money?

Prices for European property are “challenging.” “If people had been out of the market for three years and came back, they'd think we were all crazy.” “The spread between core, value-added, and opportunistic has become too small.”

To get the level of returns they have been promising, investment managers have to work harder or move up the risk curve. “Prime core property is relatively well priced, opportunistic is down to the stock underwriting capability of the manager. Value-added probably hides a whole heap of nasties,” is how one investor we interviewed sums it up.

It is difficult to detect any consensus on what style of real estate will offer the best risk-adjusted returns, now that yield shift will not be turbo-charging them. For example: “Core funds are arguably more risky. They're buying at 4 percent and if cap rates move out 25 basis points, returns are stuffed.” “Anything core or new is overpriced.” Others we interviewed take the opposite view. Core should perform well for good assets—new, modern standard buildings will benefit from rental growth. “If there's less scope for yield compression, you need rental growth and you won't see that in over-supplied or secondary markets.”

At the overcrowded core end of the market, investors are branching out into new territory seeking better returns: into secondary and even tertiary cities, riskier markets like central and eastern Europe, development, and even niche sectors. Some think this unwise. “Because the risk premium has disappeared, I would rather own in Paris than Warsaw. For core, it is best to go for the top quality and location because there is less risk.”

Opinions are also divided about whether opportunistic investors will be able to hit their targets. “To get the returns that they are targeting, opportunity funds must move up the risk scale.” Big portfolios are now commanding premiums rather than discounts, and being priced aggressively. “I would question some of the portfolio acquisitions in tertiary locations in Germany, which change hands at less than 6 percent.”

However, at least on the private equity side of opportunistic, those we interviewed are feeling pretty confident. “We are continuing to find interesting deals. Maybe it's because buying and selling companies is more complicated than buying and selling buildings.” “Returns are not quite so dependent on cap rates, providing you have it right at the operating level.”

Value-added investors think their strategy of buying problematic stock and fixing it will yield better results. “It's more defensive to be in the value-added space. You're more protected if yields start moving the other way.” “Best risk-

adjusted investment opportunities are value-added because opportunistic investors have to take on rather large risks, and for core and core-plus you pay through the nose.”

## Development on the Rise

“The development cycle has started.” Across Europe, demand for investment-quality property is sparking a new bout of building. In central and eastern Europe, there are decades of underinvestment to make good. “There’s not enough stock in countries like Russia.” In more mature western European markets, the competition for high-quality assets is so intense that even core investors are increasingly prepared to undertake or fund development. “Many funds are changing their strategy to include direct development as a way of getting money invested faster.”

Investors are also buying into developments, even without prelets, for that bit of extra yield. “There’s increased risk, but we think we can manage it.” And others are even developing or redeveloping speculatively. It used to be mainly opportunity funds that did this to source high-yielding stock, but now core and core-plus investors are joining them. “Institutions now regard speculative developments as a class of investment.” Indeed, the market is moving towards the “developers’ sweet spot”—when investors are willing to pay “full-blown” yields for purely speculative projects. “A golden era for developers is coming.”

Banks, too, are getting more flexible about funding development, even speculative development. However, they are being cautious: it has to be the right project, in the right location, and by the right developer.

Some of those interviewed were reassured by the fact that development is being undertaken by equity players rather than highly leveraged ones. “They are better suited to do it, more disciplined, and more diversified.” Others are worried. “There’s creeping euphoria. Will too many take the plunge and build?” “Investor-led development is a big warning sign.”

For the developers we interviewed, the outstanding issue—aside from the perennial one of red tape and planning bureaucracy—is construction costs. “They have picked up enormously since start of year.” “In Europe, the construction industry and some of its trades are now oligopolistic or near-monopolistic. Their pricing power is a real issue.”

## Alternative Investments in Demand

The chase for higher yields is taking investors into new areas. “You have to look beyond traditional sectors, to others that have real estate and create value from that.” Formerly fringe real estate—once the preserve of opportunity or private equity capital—is making its way into the institutional mindset. This includes property as varied as petrol stations, student accommodation, marinas, motorway services, trade parks, prisons, car parks, and windmills. “Anything producing income.”

Investors have checked out the demographics and decided there will be good money to be made out of “silver industries.” Europe’s population is ageing and older people need seniors’ housing, nursing homes, clinics, and hospitals. These sectors require operating know-how, but increasingly mainstream real estate investors are teaming up with “opco” partners to run the businesses while they work the “propco” angle.

In both our survey and interviews, a significant minority said they are seriously considering the silver sector. “We’re looking at the health sector. It uses a lot of real estate and there’s an opportunity to unlock value.” A handful has already taken the plunge and is building up their portfolios. “We saw it as an opportunity to diversify.” However, nursing homes and seniors’ housing are not for everyone. “They require specialist skills.” “There’s reputational risk.”

Leisure is another sector that is getting second, and third, looks. Hotels are already virtually mainstream investments. Resorts and second-home developments in Europe’s Mediterranean sunbelt are considered to have good prospects. Today’s generation of tourists and Euro-pensioners are cross-border sunbirds. “Demographics will push people in Europe to use Spain long term for a second home or short break.” Golf courses, fitness centres, and spas are other leisure assets that investors are starting to collect.

However, not everyone is convinced that “quirky” property is worth the effort: “I haven’t seen a niche sector that produces such exceptional returns that it stands out.”



## Infrastructure Hot

Infrastructure is the flavour of the month. A catchall term, it encompasses businesses that own and/or operate the buildings and networks that are used to provide essential services: schools, hospitals, prisons, airports, rail systems, electricity companies, toll bridges—the list is long.

For investors, particularly those with long-term liabilities like pension funds and insurance companies, infrastructure has some very attractive attributes: long-term, stable, and relatively predictable income-oriented returns. In this, it is similar to real estate.

Europe's market for infrastructure assets is huge, as governments are selling off state assets and looking for private sector finance to build new ones. In the new E.U. accession countries, there is a lot of outmoded infrastructure to replace. Indeed,

RREEF estimates that the European economic infrastructure market—that is, services that can be charged for, like transport, utilities, and communications—is now worth between 4 trillion and 5 trillion. Public/private partnerships and private finance initiatives are widespread across the continent.

Real estate investors in Europe have already picked up on the possibilities. The U.K. has a clutch of Private Finance Initiative (PFI) funds and, last year, three new European infrastructure funds were launched. Property companies are also getting in the act, buying airports and port facilities.

## Sustainability Issues Growing

Sustainability is emerging as a significant concern of both investors and developers in Europe. This is a change from last year's survey, when many dismissed the issue as "just a slogan."

The responses this year, to both our survey and interviews, indicate that environmental issues have moved sharply up the agenda. E.U. sustainability legislation is starting to register with those we surveyed, though it has yet to make any meaningful impact. “This will add to costs, and will result in an army of consultants.”

Environmental issues and sustainability cropped up frequently in our interviews. “It’s all become rather in-your-face.” “We won’t be able to escape it and it will change the way we do things very rapidly.” Although tenants and occupiers are not yet demanding—or willing to pay for—“green” buildings, developers and investors are having to take sustainability on board. “The biggest issue for a developer is when the occupiers are going to take it seriously.” “It is easier to address in development, less with standing investments.” “The planning process is getting more complicated because of sustainability issues.”

The more long-sighted are trying to puzzle out what a green agenda might mean for the marketplace. “Sustainable development has massive implications for land use planning because a lot of the energy load of buildings depends on where they are located.”

## Human Capital and Skill Shortages

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Europe’s real estate markets might be awash with debt and equity, but another kind of capital is in short supply—“finding human capital is very, very tough.”

Across Europe, firms of all kinds are having trouble finding suitable staff, from investment bankers to construction workers. “We need quality staff; salaries are rising. It limits our ability to grow and invest.” “Human capital is far more important than buildings or money. If I cannot secure good staff, I have nothing left.”



While **capital** is plentiful for investment, one noticeable feature of this property cycle is that **debt finance** for development is much tighter.

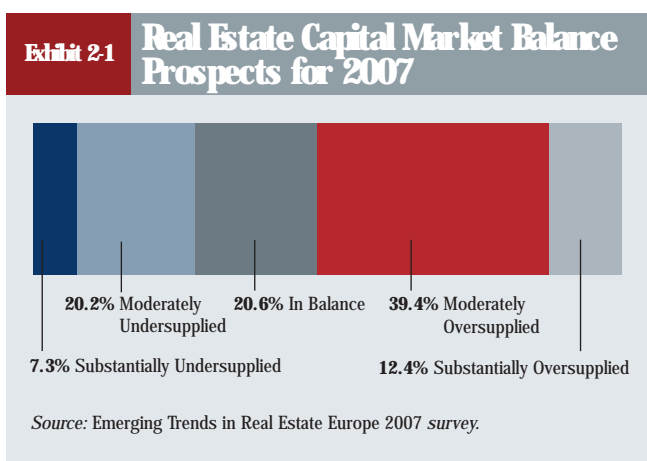
# Real Estate Capital Flows

Europe's real estate markets are awash with capital. "It is coming out of every orifice." In most places, too much money is chasing too few assets, making investors' lives difficult. "When you're getting outbid by 20 percent to 25 percent, you wonder, 'What am I missing?'" "New cross-border investors have pushed prices up to levels I feel uncomfortable with."

Few expect things to get much easier. Just over half of those surveyed think that there will be an oversupply of both debt and equity again in 2007. Moreover, they are expecting even more capital relative to what was available last year.

There is a significant minority—28 percent—who takes the opposite line and thinks that capital will be tight in 2007. This is puzzling, but perhaps reflects the markets where they operate. They include central and eastern Europe and Turkey, where both the lending and investment markets are not yet as deep and fully developed as elsewhere in Europe.

Moreover, those who say that capital will be undersupplied also include a substantial proportion of developers and private property companies. While capital is plentiful for investment, one noticeable feature of this property cycle is that debt finance for development is much tighter. "There is a realistic possibility that interest rates will rise, which will make it more difficult for developers." Having been burned



in the 1990s, banks are definitely tougher about funding developments, particularly speculative ones.

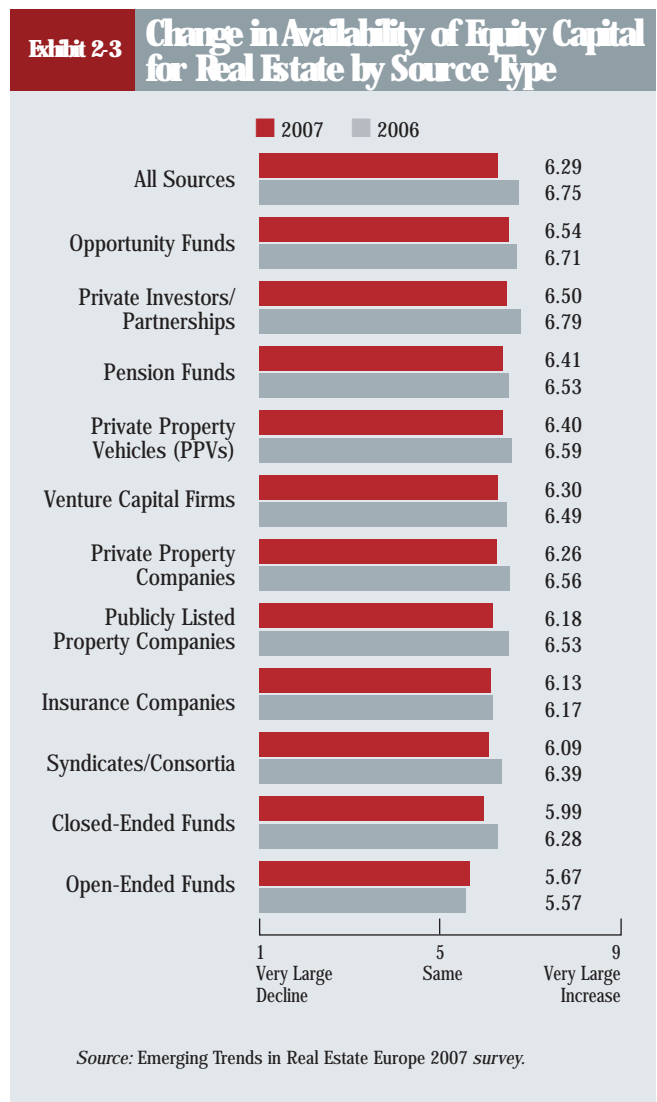
Those private investors who have been borrowing at high loan-to-value ratios are also finding it tougher to make deals stack up now that interest rates have ticked up. In the U.K., commercial property yields have dipped to 4.6 percent, 80 basis points below the five-year swap rate. "Debt buyers are out, and you have a market of equity-driven buyers."

However, there is a sizeable group that thinks capital markets will be in equilibrium in 2007, and at 21 percent, this group is bigger than it was last year.

## Diverse Private Equity Sources

New real estate investors are popping up daily in Europe. “Aussies are coming over with bucketloads of money.” “A major deal was won by a Finnish group I’d never heard of.” A surge of Asian, Middle Eastern, and Australian money is expected in 2007, competing with European and U.S. capital. “Middle Eastern investors are flush with petro dollars.”

Our survey predicts that every type of investor will be pumping more capital into Europe next year. “It’s coming from a wider range, including institutional equity investors, wealth managers, and retail investors.” Opportunity funds top the table: not surprising, given the massive amounts of money that they raised in 2006. Although many of the global ones are now switching their focus to Asia, Europe still figures large in their investment targets. Private investors, partnerships, and pension funds are also high up the league table of equity investors for 2007. “Private investors have discovered a new El Dorado.” The only group that is not expected to be putting more money into the market is the German open-ended funds, which are picking themselves up after weathering a serious liquidity crisis last year.



## Private Equity, Opportunity, and Hedge Funds

Private equity, opportunity, and hedge funds are converging on real estate. These days, the distinctions between these groups are blurring. They all target absolute returns, usually at the higher end of the spectrum. They are opportunistic, and not necessarily wedded to particular countries, sectors, or assets types. They are prepared to take on operating and property companies as well as pure real estate plays. And they have a great deal of money to spend.

No one knows how much money is sloshing around in these funds, much less how much is earmarked for real estate. They are attracting a growing percentage of both institutional and personal capital. It is not unusual to see pension funds allocate 20 percent to these “alternative assets”—a tag that also includes direct real estate. Over the last two years, U.K. pension funds have increased their investment in hedge funds sixfold, to nearly 8 billion, while their private equity assets have doubled to almost 9 billion, according to a survey conducted by Greenwich Associates.

Hedge funds are the new boys in town. At latest count, this is now a US\$1.3 trillion industry, according to Hedge Fund Research. These largely unregulated pools of private equity have discovered real estate and are muscling in on turf usually occupied by private equity and opportunity funds. In Europe, they have popped up as bidders on big portfolios, buying commercial mortgage-backed securities (CMBS) B-notes and other subordinated debt and taking stakes in property companies. Some of their activities are complementary to private equity—providing debt capital, partnering deals, and buying portfolios of company assets.

There's no doubt that it is getting harder to squeeze opportunistic returns out of European real estate. High-return capital is still keen on Germany, but it is now a crowded marketplace and high-yielding deals are harder to find. Intense competition has driven prices up, particularly for larger portfolios. “There's romance with scale—the bigger the deal, the bigger the price, on a relative scale.”

Many of those interviewed, particularly pan-European and global players, are looking further east. In Europe, capital is moving into central and eastern European markets; Turkey and Greece are also on the radar screen. “Moscow and Istanbul are inevitably going to become major investment destinations for pan-European investors.”

## Private Investors, Syndicates, and Consortia

Private wealth is still being pumped into European real estate. “A lot of capital is coming from private banks and individuals.” “It's difficult to know the source.” Real estate is now an accepted element in personal portfolios, prized for its rela-

tively high income yield. The megarich can buy trophy buildings; those with more modest fortunes club together or entrust their money to advisers. “The Spanish market is now supported mainly by domestic family equity.”

This gush of money is expected to increase in 2007. But the rate of flow is slowing slightly, according to our survey. Last year, private investors and partnerships ranked as the biggest growth group, but for 2007 they have slipped to second place.

Inflows from syndicates and consortia are also expected to decelerate, with our survey showing them falling from sixth to ninth place in the growth league. This is not surprising, since many rely heavily on gearing, playing the arbitrage between low interest rates and higher yields.

Their returns are now being squeezed at both ends. Interest rates are ticking upwards, while yields across Europe fell further over 2006. In the U.K., the gap has virtually disappeared. In continental markets, there is still yield arbitrage to be exploited, but it is narrower.

Private investors are often blamed for the current frothiness in the market. “They aren't calculating risks properly.” “There are Irish buyers saying, ‘We couldn't care less about prices.’ ” “There is anecdotal evidence that Middle Eastern investors are happy with yields that show a three in front of the decimal point.”

However, branding all private buyers as naïve or irrational is unfair. Some are property professionals with enviable track records at home who are expanding into new markets. They can apply their skills in emerging markets or to take advantage of cyclical opportunities in other countries. Germany, for example, has been attracting serious professional private capital from the U.K. Others may be taking a (very) long-term view, investing family money for future generations.

## Institutions

European pension funds have taken real estate to heart: it is the most popular alternative to equities and bonds. However, most are still seriously underweight. On average, 8 percent of their assets are real estate, but the allocation currently being recommended is in the 10 to 15 percent range, depending on a fund's maturity.

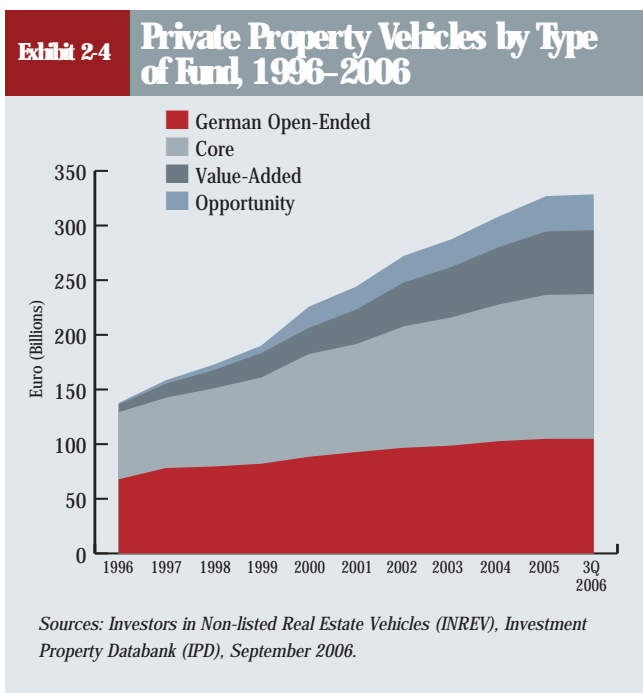
Real estate is benefiting from the move to liability-driven investment, where pension funds seek to invest in tax-efficient assets that reflect the nature of the schemes' obligations over time. “Attitudes towards portfolios have changed dramatically—people are looking at liabilities, not assets. They want to de-risk and spread in a meaningful structural way.” Real estate's high and stable income yield makes it a good match.

However, pension funds and other institutional investors have been finding it difficult to get their money into the European market. Primarily equity purchasers, they are being outbid by leveraged players. "There is a myriad of competitors for core assets."

With higher interest rates, core and core-plus investors will have an easier time in 2007. "The ferocity and velocity [are] slowing down. There are fewer bidders." Some are anticipating an increased supply of property coming onto the market. "As we see it, there are a lot of opportunity funds on the verge of exit. Our plan is to position ourselves nicely to purchase assets from them."

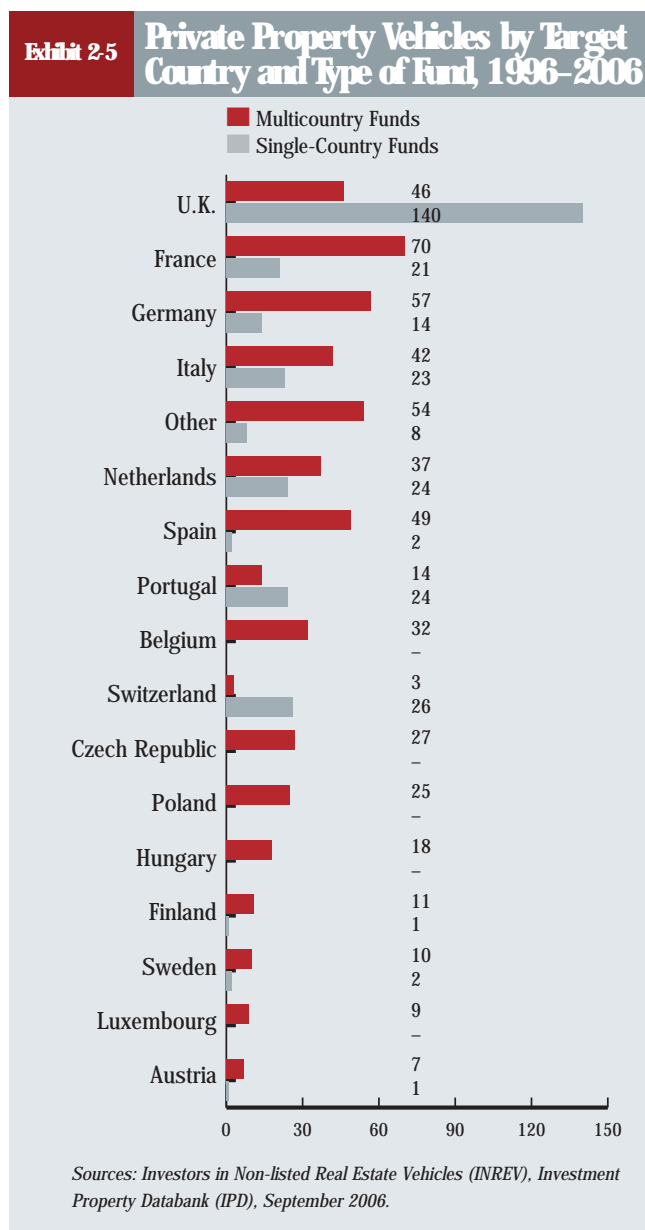
## Private Property Vehicles

The trend to indirect investment means more and more institutional money is going into dedicated real estate funds—some opportunistic, some not. Increasingly, the equity comes from all regions of the globe: Europe, Asia, Australia, and the United States. Property Funds Intelligence found 62 global real estate funds with a combined gross asset value of 104



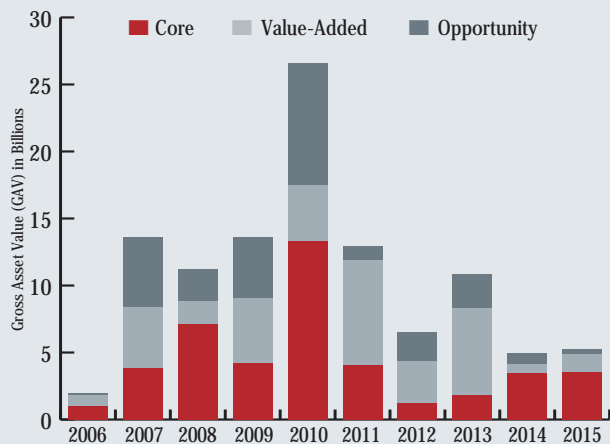
billion. A portion of that—no one knows how much—is focussed on Europe. Throw in another 400 to 800 funds with purely European investment mandates (headcounts vary depending on whose database) and there is around 300 billion to 400 billion in the frame.

Excluding German open-ended funds, INREV logs around 449 vehicles in Europe, with 224 billion of assets.



Over the next three years, funds with 39 billion worth of European assets are due to terminate— 14 billion of which come up in 2007. However, not all this property may come to the market. Given the current difficulties of getting capital into the market, some of the investors in these funds might plump for extending their lives rather than liquidating them. Indications from a survey carried out by INREV suggest that extensions, or rolling funds over into a new format, are the preferred exits. With the listed market riding high and REITs arriving in the U.K. and Germany, a rollover into the public arena may be appealing. Last year, a U.S. opportunity fund floated 20 percent of its German residential operation, raising 853 million. However, a successful flotation is not guaranteed; one fund manager pulled a 425 million listing when the equity market wobbled last summer.

## Private Property Vehicles in Europe by Termination Year and Fund Type



Sources: Investors in Non-listed Real Estate Vehicles (INREV), Investment Property Databank (IPD), September 2006.

### German Open-Ended Funds

Germany's open-ended funds are breathing a bit easier. They have weathered a tough year, buffeted by poor returns at home, a liquidity crisis, a bribery investigation, and worries over the robustness of their valuations. Three funds took the unprecedented step of freezing investors' redemptions. For a while, the industry teetered on the brink of meltdown.

Times are calmer now. The frozen funds have reopened and investors seem to be recovering their faith in the sector. Outflows finally reversed in the third quarter of 2006. But the question is whether the open-ended funds, once the German banks' premier real estate product, can regain the preeminent position they had before the crisis. Moreover, they are facing new challenges at home in the form of G-REITs, due to arrive on the German market in 2007.

While the open-ended funds have been struggling to regain their balance, the German property market has heated up. Sensing recovery, international capital has been flooding in: "Everyone wants to play in Germany." Fierce competition for assets has driven prices up, easing the open-ended funds' dilemma. Under German law, they cannot sell at prices that are "substantially" below book value. Most of the funds' portfolios were overvalued, a consequence of Germany's official methodology, combined with some ill-judged assumptions about rental growth and occupancy rates.

Discrete writedowns have helped bridge the gap between market and book values, as has shifting portfolios to parent banks. But the real saviour has been the international capital

pouring into Germany and the yield shift it has precipitated. Massive sales of both domestic and foreign holdings in 2006 have restored the funds' liquidity. Revaluations have reassured investors. To the bemusement of foreign valuers, some of their German colleagues are now claiming that the high valuations had been correct all along.

The crisis has highlighted serious weaknesses in the funds' open-ended structure: lack of liquidity, scant information about holdings, and the valuation methodology. BVI, the German fund management association, has proposed measures to deal with these. These include voluntarily raising minimum liquidity levels from the required 5 percent to 10 percent (with a cap of 40 percent) and allowing funds to invest up to 20 percent in REITs and other securities. Large shareholders' ability to withdraw capital at short notice would also be restricted and shares in frozen funds would be allowed to trade. Valuations remain an issue. The BVI is sticking by Germany's unique methodology, but is proposing that funds publish market values and rents for each asset, plus more frequent and independently reviewed valuations.

Today the funds are facing new challenges. Their home market is intensely competitive and yields have dropped a further 20 to 50 basis points in 2006. "It is hard for us to find value here." "We will not compete for portfolio acquisitions—we are more likely to be on the sell side." Most are concentrating on ferreting out individual assets in Germany and looking further afield for higher returns: to London, Warsaw, Moscow, Turkey, and Asia. They are also being pushed up the risk curve. "Most of our investment activities in Europe are in development projects."

At home, competition will intensify when G-REITs arrive this year. Though these are stock market investments, G-REITs are likely to suck in some of the retail and institutional money that has traditionally gone to the open-ended funds. As the law currently stands, open-ended funds cannot be converted into G-REITs, but their properties could be migrated into their parent institutions and floated as an initial public offering (IPO). There are new opportunities ahead. "G-REITs will be good for the property and the capital market. As an asset manager, we will try to find a role in that market."

As a sweetener, the German government is giving open-ended funds parity with G-REITs in one important respect: companies selling assets to funds will also be taxed at a reduced rate. Germany's closed-ended property funds are complaining that this is unfair. In the past, closed-ended funds were mainly popular for their tax benefits, but many of these advantages have been abolished, making the product harder to sell.

## OPCIs: French Open-Ended Funds

The French government has tabled legislation for new open-ended real estate funds, *Organismes de Placement Collectif Immobilier*, or OPCIs. Modeled on the German open-ended funds, OPCIs are aimed at small investors. They will replace the 30-year-old *Société Civile de Placement Immobilier* (SCPI). Critics point to the problems experienced by the German open-ended funds; supporters claim OPCIs are structured to avoid a rerun.

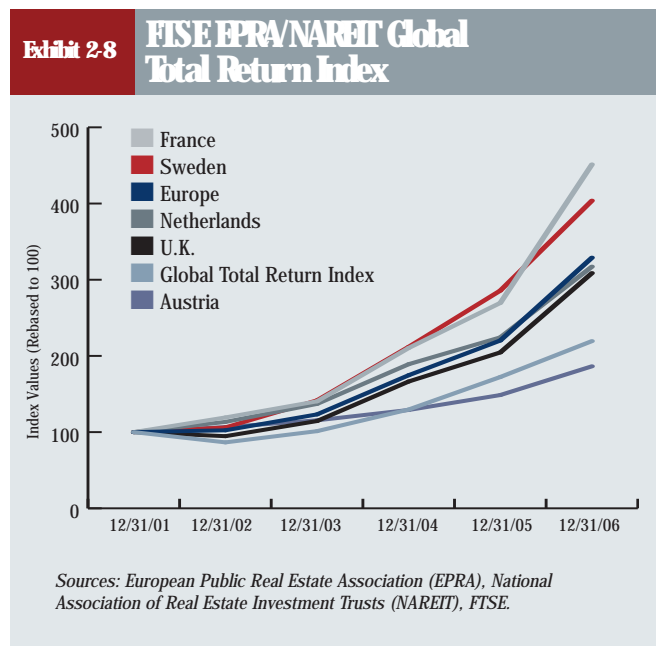
At least 60 percent of OPCIs' assets must be property, though up to 30 percent can be indirect investments in real estate. Unlike SIICs, they will not be allowed to invest in developments. OPCIs will, however, be allowed to invest outside France.

For liquidity, 10 percent must be in cash. And, to safeguard small investors and prevent panic selling, managers can freeze redemptions by institutional investors holding more than 20 percent of a fund. Assets must be valued several times annually by independent experts.

Critics say OPCIs are "unbelievably complicated and technical" and "two years too late." Supporters claim OPCIs "meet an existing demand for mutual funds that are invested directly in assets but with a relatively high level of cash and equivalents." They are gearing up to launch some, and predict the sector will attract 3 billion to 5 billion annually in its initial two years.

## Listed Market Expanding

The public real estate markets are booming globally. "There's an almost 'Internet-like' fever for listed property companies and REITs." The global market in real estate securities is cap-



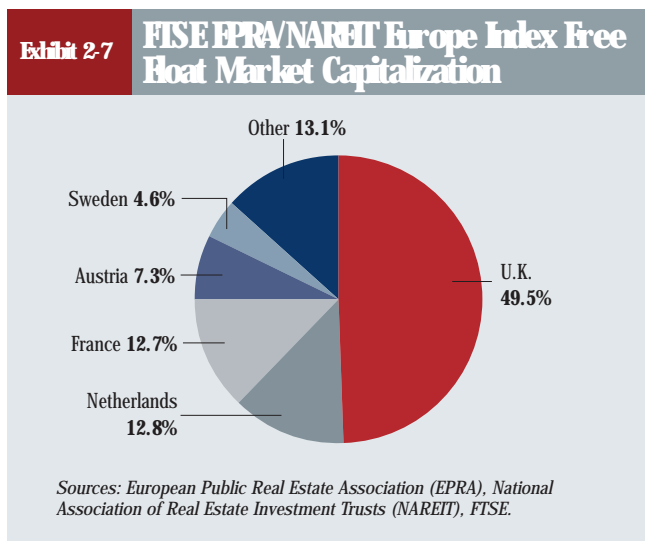
italised at US\$1.8 trillion and Europe is the world's second-largest after the United States, accounting for 23 percent. The U.K. market is by far the largest listed market in Europe.

Last year, Europe's listed real estate sector outperformed the wider equity market by a wide margin, rising 30 percent. The FTSE EPRA/NAREIT index registered a massive 49.4 percent total return for 2006.

Some of this outperformance is down to yield shift, which has boosted the value of the companies' holdings in all markets. But the turbo-charging comes from investors' continuing enthusiasm for all forms of real estate. Institutions and individuals alike are swarming into real estate securities. They like the liquidity, the stability of the income flow, and the fact that the shares do not move in lockstep with equities generally. A headcount by AME Capital reckons that there are now over 100 global securities funds specialising in real estate and some 50 that focus exclusively on Europe—35 were launched last year alone. Altogether, these funds manage US\$39 billion of real estate securities.

The introduction of tax-efficient REITs in Europe—actual or anticipated—is also fuelling demand for real estate securities. With the sector on a roll, new companies have been rushing into the public markets, while existing ones are taking advantage of their high share prices to raise more capital. More mergers and acquisitions are in the cards, as players seek to bulk up. "2007 is all about what happens in public markets—if REITs take off in Europe, there will be lots of activity as people reposition themselves."

There are now seven REIT regimes up and running in Europe: in Belgium, Bulgaria, France, Greece, the Netherlands, Turkey, and the U.K. Germany and Italy have pencilled in launches later in 2007.



Exchange-traded funds (ETFs) are also popping up. On the listed side, there are now three ETFs that offer exposure to European real estate securities—one for the Eurozone and two for the wider European market. Two track the FTSE EPRA/NAREIT index, while the latter is based on the Dow Jones STOXXSM 600 Real Estate index. Two ETFs tracking the U.K. commercial property market were launched in 2006, linking returns to the Investment Property Databank's monthly and annual U.K. index, respectively.

## U.K. REITs: Off the Starting Block

On 1 January 2007, the starting gun for U.K. REITs was fired. To the relief of the real estate industry, they are flexible and workable. "It's exactly what we were after."

U.K. REITs will be tax-transparent listed companies, though subject to withholding tax on dividends at 22 percent. To qualify for REIT status, a company must earn at least 75 percent of its income as rent from investment properties and distribute at least 90 percent of its income profits to shareholders. The remaining 25 percent can come from other activities, including development. However, the profit on these noninvestment activities will be taxed at the usual corporate rate of 30 percent.

There are no restrictions on the types of assets that U.K. REITs can own and investing directly in foreign real estate is allowed. However, if non-U.K. properties are held by non-U.K. subsidiaries, the cash flow from these companies will be taxed. Owner-occupied property does not qualify.

While there is no maximum limit on gearing, U.K. REITs will suffer tax penalties if interest is more than 125 percent of gross income. Tax penalties will also apply if a U.K. REIT pays dividends to corporate shareholders with a direct or indirect shareholding of more than 10 percent. This is aimed at preventing tax leakage.

The entry charge for converting to a REIT has been set at 2 percent of the market value of investment properties. This is much lower than was feared, and compares very favourably with the 16.5 percent that is levied on French SIICs. At the last minute, the government included a measure to encourage new listings. U.K. REIT IPOs will be allowed to float holding cash, and invest up to the 75 percent minimum in real estate over a year. The 2 percent conversion charge would be paid after the first financial year of operation.

A rush of new REITs is now expected later in 2007, from fund managers and private property companies. Of the 40-odd property companies currently listed on the London stock exchange, about half are planning to convert to REITs.

## G-REITs Emerging

After much delay and deliberation, the German government unveiled its draft legislation for G-REITs just as 2006 was ending; G-REITs were planned to launch on 1 January 2007,

transforming Europe's largest real estate market. "There is a gold-rush mood." This euphoria subsided quickly as a political wrangle over residential G-REITs broke out. It now seems unlikely that the German cabinet will approve the legislation until later in 2007.

The issue of whether residential property will be included in G-REITs is a political hot potato. Tenanted housing is a big sector in Germany and could make up to a quarter of the potential 120 billion G-REIT market, according to Deutsche Bank Research.

In recent years, the sector has undergone a radical shift, as large portfolios of tenanted state and social housing have been sold to foreign opportunity funds, private equity groups, and German investors. The prospect of this housing being resold into the public markets has aroused fierce opposition from tenants' groups and various political factions, who fear that G-REIT landlords might undermine tenants' rights and increase their rents. The government first said residential would be excluded, but it is now vacillating.

In other respects, the G-REITs proposals are unexpectedly bold, following the French and U.K. versions. G-REITs will be *Aktiengesellschaft*, public limited companies, not the unwieldy company/trust hybrid that had been first mooted. They must be listed and at least 75 percent of gross income must come from property letting, with 75 percent of capital invested in property. They must also distribute 90 percent of profits to shareholders. Sales of assets are limited to 50 percent of the portfolio over a five-year period to prevent G-REITs from becoming property traders, while gearing is restricted to a maximum of 60 percent.

As listed companies, G-REITs must have an initial free float of 25 percent and a long-term free float of 15 percent. No investor may own more than 10 percent.

The exit tax for companies converting to G-REITs has been set at 20 percent of gross assets—that is, half the normal rate for capital gains on properties. This concession will run for three years. However, the tax rate is higher than France's 16.5 percent and the U.K.'s 2 percent and may discourage some conversions. The same concession applies to companies that sell real estate to G-REITs (and open-ended funds)—a measure that will surely shake yet more of Germany's investment stock into the public arena. "Many of the closed-ended funds that are ending will switch over to either REITs or open-ended fund as most of the investors in those funds want to keep the assets."

## The French Listed Market: SIICs and the "Spanish Problem"

Four years on from their introduction, SIICs are flying high in France. A previously small and sleepy quoted sector has ballooned to 45 billion. "It has been fantastically successful." But it has not been all plain sailing.

Critics are now complaining that SIICs have not made property investment accessible to the general public. And there is "the Spanish problem." So far, four of France's largest SIICs have been taken over by Spanish property companies. The buyers have benefited from fiscal treaties that allow them to avoid being taxed on their French dividends.

Moreover, although these SIICs are virtually 100 percent owned by their Spanish parents, they and a couple of other foreign-owned SIICs are still quoted on the French stock exchange. The listing regulations for SIICs are "liberal, or some might say lax": there is no minimum free float required.

Consequently, the French government is now considering so-called SIIC 4 legislation. This would require a minimum 25 percent free float and put a 60 percent cap on shareholdings.

That said, French SIICs are poster children for the benefits of a REIT regime. The sector is on a roll, trading at a premium to net asset value and there were 11 new SIICs launched last year. "There will be more players and consolidation is bound to occur."

Plenty more action is expected in 2007. This year, a time-limited tax concession runs out: vendors have been paying reduced capital gains tax on properties sold to SIICs. Non-SIIC competitors grumble: "It's not a level playing field."

## Dutch FBIs

FBIs, the Dutch REIT-type vehicle, have been around since 1969. But they are looking outdated and restrictive, particularly in comparison to SIICs and the new REITs coming out in the U.K. and Germany. While REITs have boomed globally, Dutch FBIs have languished; the sector currently contains only eight companies.

The Netherlands is also in danger of losing yet more business to the new U.K. and German REITs, whose regimes are more flexible and allow investment in foreign real estate.

Hence, the Dutch government is proposing revamping FBIs.

The new "luxury version" would drop the current 25 percent limit on shareholdings by nonresidents. Restrictions on development would be relaxed, allowing FBIs to do this via subsidiaries. However, these would be taxed normally. The FBI itself can refurbish or redevelop property in its portfolio, as long as this activity stays within 30 percent of the market value of its holdings.

In addition, from 1 January 2007, E.U. pension funds and other similar tax-exempt organisations will be entitled to a refund of Dutch withholding tax on their dividends. Moreover, the tax rate is also being reduced from 25 percent to 15 percent. These moves should boost FBIs' international appeal, but Amsterdam will face stiff competition from London to become the stock exchange of choice for European REITs.

## The Italian SIIQs

Not to be left behind, Italy is rushing out its own REIT. The government is proposing to amend its finance bill to introduce *Società per Investimento Immobiliare Quotate* (SIIQs) and launch them by mid-2007. The potential market is huge: the Italian government and other public authorities still own around 160 billion of commercial and residential property that is ripe for hiving off. Some observers think that Italy's SIIQ sector could be worth 50 billion.

Modeled on the French SIIC, the new vehicles would also attract international capital, which is having a hard time accessing the rather closed and opaque Italian market directly. SIIQs would also bring some much-needed transparency into the market.

The move has been broadly welcomed, though most of Italy's major real estate players are taking a "wait-and-see" attitude towards conversion. Italy's closed-ended real estate investment funds (FIIs) are less pleased. "Closed-ended funds will lose a lot because of their lack of liquidity." Catering to both institutional and retail investors, FIIs benefit from a sheltered tax regime. Over the last couple of years, the sector has boomed as new funds have been launched; it is now a 20 billion sector.

## Debt Capital Markets

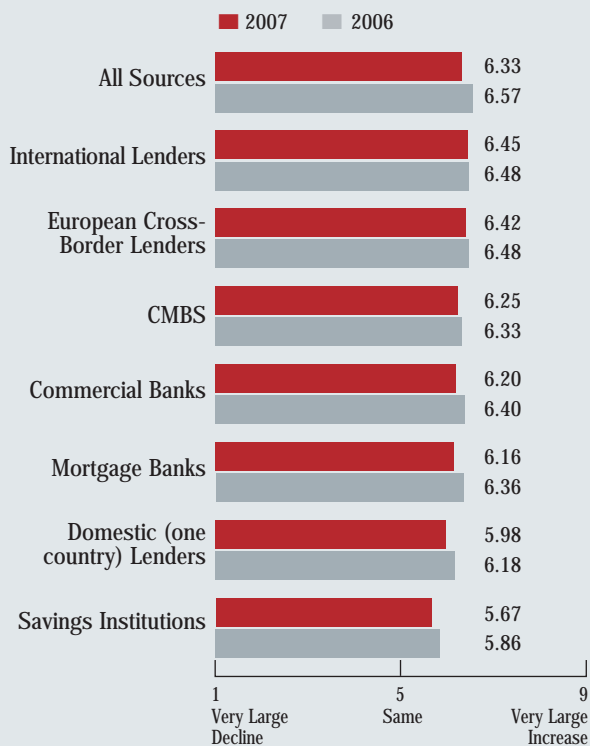
Barring some exogenous shock, 2007 will see even more debt available for real estate. Our survey highlights that all types of lenders are expected to grow their loan books. International and cross-border lenders will be leading the charge. "There's an insatiable appetite, led by U.K. and German banks." "We've even seen Japanese banks back in the market for the first time since 1990." But it is not just the big boys who are active. "Some savings or smaller banks now feel comfortable enough to enter the real estate market." "There are more and more new lenders."

Interestingly, the *Emerging Trends* survey also indicates that the market is not expecting debt to expand quite as vigorously as in the last couple of years. This is not surprising, given that European interest rates and property yields are moving in opposite directions. In the U.K., the five-year swap rate is over 5 percent, while the all-property yield has fallen to 4.62 percent (November 2006). Highly leveraged private buyers have melted away from the U.K. market. "They've moved into continental Europe and gone east." Lenders are following their customers. "We've gone into Russia and have been very successful backing known players with local partners."

Overall, underwriting standards are thought to be high. "Lenders are much better able to assess risk than during prior periods." "All forms of debt are performing well with low defaults." Around 40 percent of those surveyed expect that

**Exhibit 2-9**

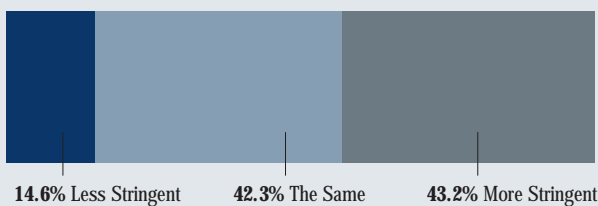
**Change in Availability of Debt Capital for Real Estate**



Source: Emerging Trends in Real Estate Europe 2007 survey.

**Exhibit 2-10**

**Underwriting Standards Prospects for 2007**



Source: Emerging Trends in Real Estate Europe 2007 survey.

underwriting standards will become tighter in 2007, despite the intense competition among banks. However, not many of the lenders we interviewed agree: “Banks are on an inexorable climb up the risk curve because it is so competitive.” “Banks are being more flexible with interest cover.” “There’s a greater willingness to fund things that were previously excluded, like speculative development.”

Loan-to-value (LTV) ratios look aggressive, but this masks the way banks are now slicing loans up. They will keep the senior portion—the 60 or even up to 80 percent LTV—but sell riskier, higher-priced 80 to 90 percent LTV tranches.

“They’re bought by insurance companies, hedge funds, and even banks that failed to win the deal initially.”

Two issues, however, are causing disquiet: amortisation and margins. Lenders are focussed on interest cover, which has been creeping down to 1.15 to 1.25. “Banks are voluntarily taking less capital repayment.” “Margins are going through the floor.” “We’re close to [the] point where margins cannot shrink further.” Most are pointing to CMBS conduits as the culprits, or benefactors, depending on which side of the loan they are on. “Conduit lenders can be much more aggressive on pricing because their cost of capital is lower.” “In the past, we had to pay a margin of 60 to 70 basis points. Today, we can get a rating from S&P for this AAA portfolio and we pay 20 basis points.”

In response, many balance sheet lenders who previously insisted on holding onto their loans have “cracked.” “They will underwrite transactions, but flog the top piece.” Others are planning to set up their own CMBS conduits, adding to the pressure.

The sheer amount of debt riding on Europe’s property markets might be giving central bankers restless nights, but few lenders we interviewed think a 1990s-style liquidity crisis looms. As they point out, real estate debt is much more widely spread today, either syndicated out to other banks or sold to investors as CMBS. The downside of this is that if there is a crash, “unwinding positions will be horrendous—but a potentially lucrative opportunity for a different class of investor.”

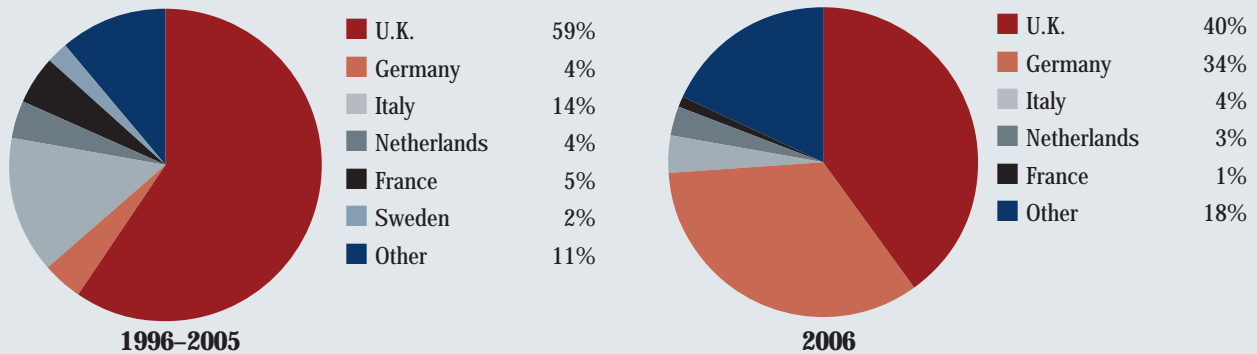
**CMBS: B-Notes and Beyond**

After a slow start, Europe’s CMBS market took off in the second half of 2006. Issuance hit 52 billion and the securitised debt markets also registered several firsts: the first CMBS deal in a portfolio of nonperforming German loans, the first securitisations of German residential property, and the first issuance of collateralised debt obligations backed by commercial real estate.

Last year was also marked by a surge in CMBS from continental Europe. Although the U.K. still provided the largest chunk of backing, both German- and pan-European-backed issuance rose sharply. Both represented over 50 percent of all CMBS deals totaling 25.8 billion, indicating that arrangers have found a way through some of the difficulties in structuring across countries’ various different (or nonexistent) securitisation laws. Next year is likely to see even more cross-border transactions, but players still hope for a common legal framework to reduce the complexity and costs of these deals.

Germany’s CMBS market has taken off, rocketing to 17 billion—34 percent of European issuance last year. This included 1.3 billion of nonperforming loans and hefty portfolios of tenanted housing. Among the latter was a whopping 5.5 billion deal, the largest to ever hit the market outside of

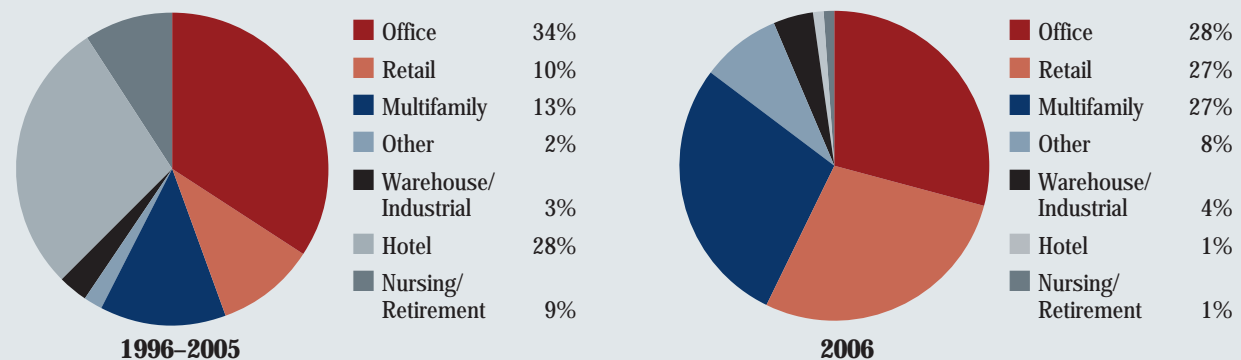
**Exhibit 2-11 European CMBS Issuance by Collateral Location**



Source: Commercial Mortgage Alert.

\*All data as of September 30, 2006.

**Exhibit 2-12 European CMBS Issuance by Property Type**



Source: Commercial Mortgage Alert.

\*All data as of September 30, 2006.

Italian government-backed issues. These first securitisations of residential property in Germany were well received, and more are likely to follow as the buyers of these portfolios use this route to exit or refinance their investments.

Multifamily housing accounted for 27 percent of all European issuance in 2006, rivalling retail and offices. Indeed, last year's issuance was marked by a more mixed bag of property finding its way into the CMBS pool. These included more eclectic sectors like student accommodation, car parks, and petrol stations. Retail property backing for CMBS also rose sharply last year; deals included a 1.3 billion securitisation of Dutch stores and £2 billion of U.K. supermarkets.

Our survey predicts that 2007 will see even more CMBS issued, as yet more banks set up conduit programmes. The

market is also being boosted by the growing demand for B-notes. These sub-investment-grade portions of loans, subordinate to the A- or investment-grade loans, pay a higher rate.

Until recently, B-notes were in limited supply in Europe, partly because there was not enough of the right sort of collateral—a diverse pool of mezzanine and the riskier bits of loans. However, banks have started to slice their lending into tranches, keeping the investment-grade part and selling the B-notes, which carry a higher rate, on to specialised buyers. "Even banks that failed to fund a deal are buying subordinate pieces." CMBS deals, too, are including larger tranches of B-notes. Yield-hungry, asset-starved insurance companies, hedge funds, and others are keen to get their hands on these.

The margins payable on CMBS are still under pressure: for the less risky AAA-rated, they are 16 to 30 basis points. For B-notes, they have dropped to around 200 to 350 basis points.

Some worry that the flood of CMBS may bring problems later down the line. "I think there's a lot of mispriced paper floating about." "B-notes can range from 'toxic' to 'slightly below investment grade.'" "I think some of the rating agencies have gotten way ahead of themselves. They are using models extrapolating from the last ten years—but we've been living in Nirvana the last ten years."

## Collateralised Debt Obligations

Another milestone in 2006 was the first issue of collateralised debt obligations (CDOs), backed by European real estate. These securities are underpinned by a basket of riskier assets, including CMBS bonds, property company loans, B-notes, and mezzanine debt.

In the United States, commercial real estate (CRE) CDOs are a well-established market, with US\$37 billion issued last year. Europe has lagged behind, because of the scarcity of high-yielding backing material. But with real estate B-note issuance increasing, opportunity funds and others have been collecting up these and other suitable assets with a view to packaging them up as CDOs.

Europe's first CRE CDO was a 263.5 million (US\$341.8 million) issue of notes, backed by CMBS, B/C loan notes, and other real estate debt secured on a portfolio of German and U.K. properties. Strong demand from investors meant the AAA-rated notes priced at 27 basis points over Euribor, while the spread on the lowest-rated B-note was 275 basis points.

The success of this deal will encourage others to follow suit. Other deals are already rumoured to be in the pipeline and a major U.S. player in the CRE CDO market has set up shop in Europe. As the market develops, it will open up a new source of debt capital, providing a source of more flexible, short-term financing for riskier properties. "The beauty of a CRE CDO is that it's a bucket in which a variety of things can be placed."

## Nonperforming Loans

Germany's first nonperforming loan (NPL) securitisation highlights the way its capital markets are being transformed. Over the last couple of years, there has been a feeding frenzy as German banks and lending institutions sold off large chunks of nonperforming loans to U.S. investment banks, opportunity funds, and specialists in distressed debt.

Though there were fewer headline-grabbing sales of big portfolios in 2006, Germany is still the largest and most active NPL market in the world. According to Ernst & Young, there is an estimated 300 billion in various stages of resolution. Banks are still cleaning up their balance sheets: a 1.4 billion (US\$1.8 billion) portfolio was sold to a Japanese bank at the end of 2006.

Last year, one of the big buyers of German NPLs launched the first securitisation. This milestone 3.1 billion bond issue is backed by a 2.2 billion portfolio of commer-

cial and residential property. It was enthusiastically received and opens a new exit route for this debt.

## Derivatives

Real estate derivatives are taking off in Europe. There was a dramatic upsurge in trading during 2006, with a record (£2.6 billion/US\$5 billion) transacted in the first three quarters of the year.

These are bespoke and over-the-counter swaps based on the Investment Property Databank's (IPD) U.K. commercial property index. Although the majority of trades have been at the all-property level, the volume of sector-level deals is rising. In August, the first U.K. subsector swap took place, a £10 million contract on U.K. shopping centre returns versus the all-property index.

The plus point of derivatives is that investors can buy or sell real estate exposure easily, cheaply, and quickly. They can be used to hedge portfolios, to make tactical allocations to real estate, or as a proxy for direct investment. Stamp duty is not payable on the transactions, provided the instruments are structured so as to give no rights or interest in the land, other than the security interest. However, liquidity is an issue. Though the volume of trades is rising, an active secondary market has not yet developed.

Getting derivatives off the ground has involved educating traditional property investors like property companies and pension funds. They are now actively trading: one U.K. institution, for example, used Property Income Certificates, which are swaps in a Eurobond wrapper, to reduce its exposure to real estate as part of an asset allocation switch into equities. Hedge funds, too, have started using derivatives to access property-based returns.

The path is now opening up for this market in virtual real estate. "We will see a wider range of users and applications of derivatives." Estimates of how fast it might develop over the next five years vary wildly, from £5 billion to £50 billion. Until now, all the derivatives action has focussed on the U.K. commercial property market. This is not surprising, since it is the most mature and liquid in Europe. But IPD also compiles indices for ten continental European countries. Not all of these are yet robust enough to support derivatives, but there has been interest in trades on the Swedish, French, and German indices. The Netherlands is also considering introducing real estate derivatives.

Meanwhile, the International Swaps & Derivatives Association is drawing up a standardised contract for real estate that will be internationally recognised. By cutting across different legal systems and languages, this will make cross-border investment in derivatives much simpler.



## Emerging Trends in Real Estate® Europe 2007

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