

European Investment Commentary

Summer • 2008

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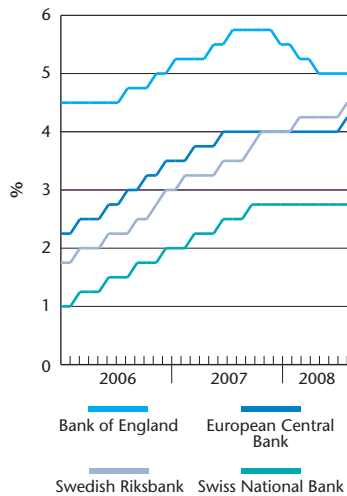
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Executive summary

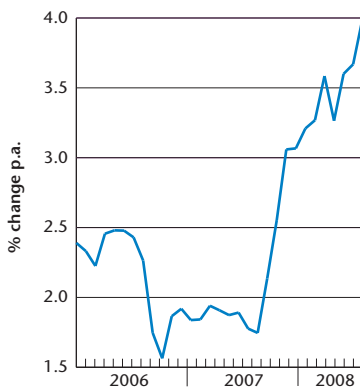
- Despite unexpectedly strong GDP growth during Q1 2008, European economic activity is anticipated to slow markedly over the rest of the year.
- Eurozone inflation has been rising steeply, driven by escalating food and oil prices. In an effort to control inflation, the European Central Bank raised interest rates in July.
- A mood of increased caution among office occupiers is expected to result in a general weakening of take-up levels this year.
- The slowdown in commercial property investment markets has continued, with investment volumes down significantly compared with 2007.
- Following the trend which was first observed in the UK market in the second half of 2007, prime yields have softened in most European markets across all property sectors.

Figure 1
Key interest rates



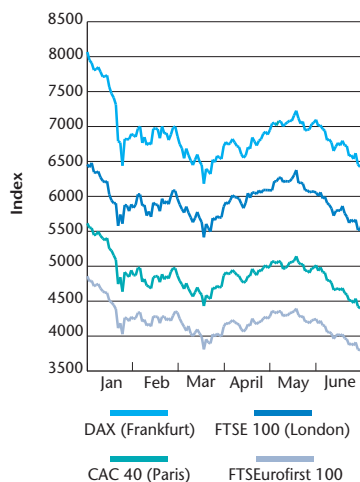
Source: Various

Figure 2
Eurozone inflation (HICP)



Source: Eurostat

Figure 3
Stock market performance



Source: Various

The economy

GDP growth

European GDP growth in Q1 2008 was unexpectedly strong, with quarterly growth of 0.8% recorded in the Eurozone, up from 0.3% in Q4 2007. Growth was primarily driven by a surge in the German economy, which recorded its strongest quarterly growth for 12 years at 1.5%, due largely to unusually high construction activity.

The strong growth in Q1 may, however, prove to be a high-water mark, with the outlook for the rest of the year appearing weaker in most key European economies as the influence of the global credit crunch and the slowdown in the US is felt. Those countries which have benefited from easy credit conditions in recent years, such as Spain, the UK and Ireland, are vulnerable to the effects of the crisis in the financial markets. The German economic upswing is already showing signs of slowing, while Italy's growth prospects appear poor.

Inflation

Rising inflation has become an increasing cause for concern to Europe's policymakers. By June, inflation reached 4% in the Eurozone, driven by rising food and fuel prices. A steep rise in oil prices created particularly strong inflationary pressure, with the price of crude oil jumping by over 45% in the first six months of 2008.

Interest rates

The European Central Bank raised its key interest rate by 25 basis points to 4.25% in July, in an effort to control mounting inflationary pressures. A number of other central banks, including those of Sweden, Poland and the Czech Republic, have also raised interest rates this year.

Though the Bank of England has cut its base rate three times since last December in an attempt to stimulate the slowing UK economy, inflationary concerns may limit the Bank's room for manoeuvre to make further cuts.

Retail sales

Retail sales have been fairly weak in the early part of the year, partly because rising fuel costs have left consumers with less money to spend in shops. In May, compared to the same month last year, the volume of retail trade in the Eurozone was up by just 0.2%. Eurostat's consumer confidence indicator has shown steadily deteriorating consumer sentiment in the Eurozone, by June reaching its lowest level since October 2003.

Labour market

Employment growth in the Eurozone was 1.6% in 2007, but the European Commission forecast a marked slowing this year, with growth of around 0.8-0.9% expected.

Having fallen steadily for the last three years, the rate of unemployment in the Eurozone has showed little movement since the start of the year, standing at 7.2% in May. The overall level of unemployment is expected to remain around this level until the end of the year, although the European Commission forecast rising unemployment in Spain, Ireland, Belgium and Austria.

Stock markets

Europe's stock markets recorded sharp falls in January amid renewed pessimism over the threat of a US recession and global slowdown. At the end of June, the London FTSE and the Frankfurt DAX indices were down from the start of the year by 13% and 20%, respectively.

“Slovakia is due to join the Eurozone on 1st January 2009, taking membership to 16 countries.”



Table 1 **European overview**

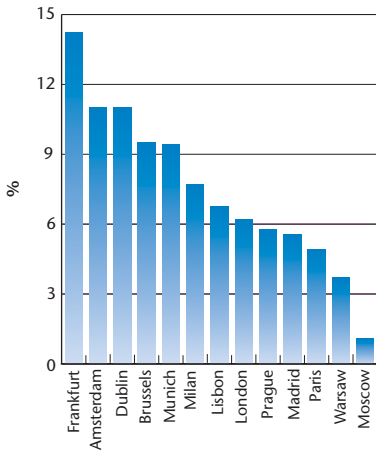
Country	EU member status	EU accession date	Interest rate (%)	GDP growth rate 2007 (%)	GDP growth rate 2008 (%) ¹	Population	Euro currency adoption target
Eurozone*	–	–	4.25	2.6	1.7	321,547,138	Slovakia 2009
European Union**	–	–	–	2.9	2.0	497,565,959	Lithuania 2010 Estonia 2011
France	Full	1958	4.25	2.2	1.6	63,753,140	Bulgaria 2012+
Germany	Full	1958	4.25	2.5	1.8	82,221,808	Latvia 2012+
Spain	Full	1986	4.25	3.8	2.2	45,283,259	Poland 2012+
Italy	Full	1958	4.25	1.5	0.5	59,618,114	Czech Republic 2012+
Sweden	Full	1995	4.50	2.7	2.2	9,182,927	Hungary 2012+
United Kingdom	Full	1973	5.00	3.0	1.7	61,270,283	Romania 2014
Poland	Full	2004	6.00	6.5	5.3	38,115,641	
Czech Republic	Full	2004	3.75	6.5	4.7	10,381,130	
Turkey	Candidate		16.25	4.5	4.3	70,586,256	EU candidate countries' accession target
Switzerland	Non-member		2.75	3.1	2.2	7,591,414	Croatia 2010
Russia	Non-member		10.75	8.1	6.8	142,753,551	Macedonia 2012
Ukraine	Non-member		12.00	7.3	5.6	46,329,901	Turkey 2013+

* Comprising Austria, Belgium, Cyprus, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Malta, Netherlands, Portugal, Slovenia and Spain

** Comprising the Eurozone countries + Bulgaria, Czech Republic, Denmark, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia, Sweden and the UK

¹ European Commission/IMF forecasts for 2008

Figure 4
Office vacancy rates



Source: Knight Frank

Occupier markets

Weaker economic growth prospects and credit market uncertainty have created a climate of increased caution among office occupiers across Europe. Many companies, particularly those in the financial sector, are taking a “wait and see” approach to their property strategies as they assess the impact of recent market developments on their businesses. This has translated to a general softening of demand for office space in most key European markets.

In Q1 2008, take-up in the Central London office market was 10% down compared with the first quarter of the previous year, while in Paris take-up was 20% below the Q1 2007 level. Demand in the key German markets appears to have held more strongly, with take-up higher in Munich and Frankfurt in Q1 2008 than in the same period last year. However, the overall outlook across Europe is for somewhat reduced take-up levels throughout the rest of this year.

Rental growth has continued in a number of markets, albeit at a slower pace than has been observed in recent years. Prime rents rose in many of the larger CEE markets, including Prague and Warsaw, during Q1 2008, while there was also modest rental growth in German markets including Munich. Prime rents remained stable in Paris, Madrid and the West End of London during the first quarter. Very few markets have seen rents fall, with the notable exception being the City of London, where prime rents fell by 5% in Q1, with this market suffering from its reliance on demand from financial occupiers and a surfeit of new space coming onto the market.

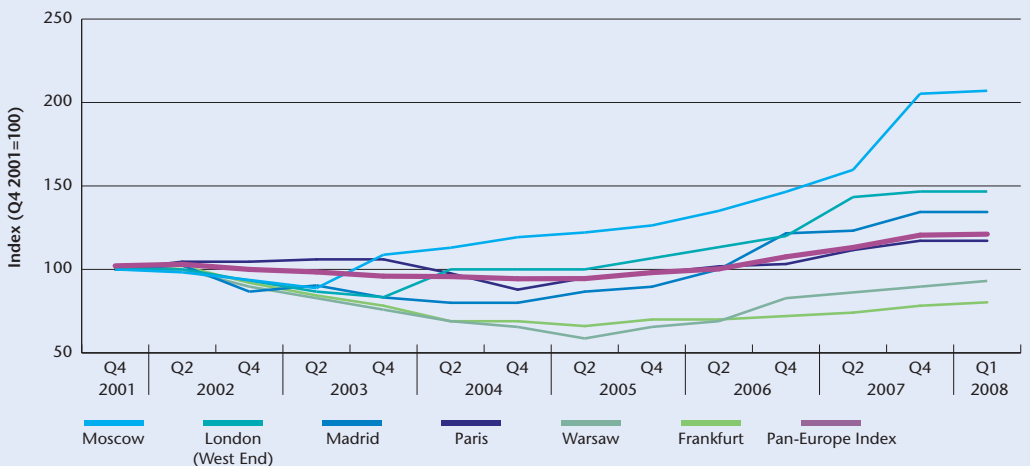
Retail markets currently face uncertainty with consumer confidence waning amid higher inflation. Retail property has continued to show rental growth, most notably in prime high street locations, though, given the economic backdrop, the expectation is for weaker growth this year. Southern European and CEE markets may offer the best rental prospects as international retailers continue to expand into these markets.

Industrial markets are also set for a challenging period, with manufacturing output growth expected to slow this year across Europe. Weakness in the retail sector may also impact on demand for logistics properties. There are large amounts of new space in the development pipeline in CEE markets, and as this space comes on line, rental growth prospects are likely to weaken.

“Weaker economic growth prospects are likely to result in a general softening of demand for office space this year.”

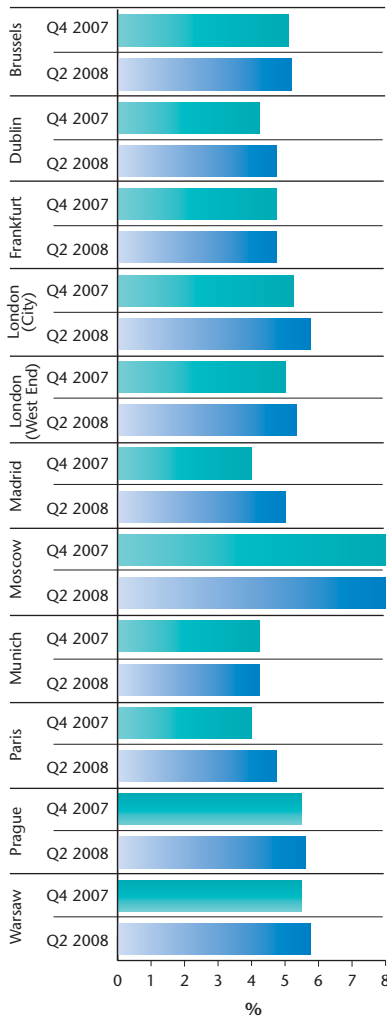
The Knight Frank **European Prime Office Rents Index** tracks rental movements since Q4 2001. The Pan-Europe index shows a weighted average of prime rents across 15 key markets, illustrating that office rents have grown strongly over the last three years, but that there are signs of rental growth slowing into 2008. There has been exceptionally strong rental growth in Moscow in recent years. Prime rents in London’s West End and Madrid have tended to exhibit greater volatility than rents in Paris.

Figure 5
European prime office rents index



Source: Knight Frank

Figure 6
Prime office yields



Source: Knight Frank

Investment markets

While the credit crunch has so far had a relatively moderate influence on occupier markets, investment markets have felt its full effects. Investment volumes are down significantly across Europe as investors show increased caution towards the property sector or find it difficult to finance deals. According to Real Capital Analytics, commercial property sales in Europe were down by 40% in Q1 2008 compared with Q1 2007.

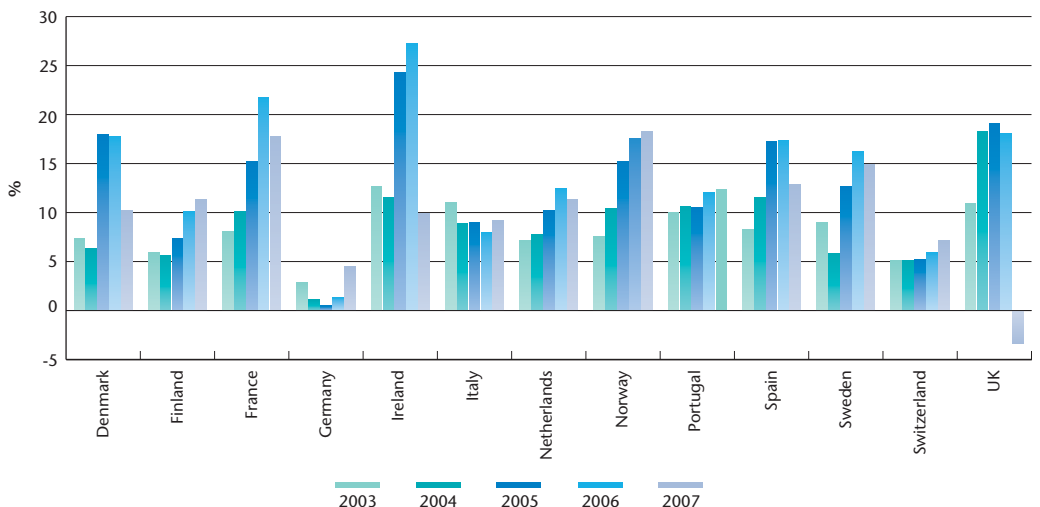
During the first four months of the year, Real Capital Analytics estimate that investment in offices was down from last year in Germany, the UK and France by 78%, 61% and 42%, respectively. Although the overall investment volume in Spain increased, this was boosted by one very large deal which saw a consortium led by Propinvest purchase Banco Santander's Financial City headquarters in Madrid for €1.9 billion.

The outward movement in yields which was initially observed in the UK market in the second half of 2007 has now been followed in continental Europe. Prime office yields in Paris softened by 75 basis points over the first half of the year to reach 4.75%, while in Madrid, prime yields have moved out sharply to 5%, having been sub 4% in the middle of last year. There has been less pronounced movement in yields reported so far in the CEE region, though with the margin between yields in these countries and more established Western markets narrowing, some risk repricing seems inevitable and yields can be expected to soften.

In the current environment, cash-rich investors have been able to take advantage of reduced competition from investors who have to rely on debt to fund deals. For example, sovereign wealth funds, large pools of government-controlled capital mostly originating in the Middle East and Asia, have been taking an increasingly high profile in European investment markets, finding it more easy to act than leveraged investors.

IPD's Pan-European Property Index recorded that all property total returns across Europe fell to 5.9% in 2007 from 12.4% in the previous year. The overall performance was dragged down by a dramatic fall in UK returns, from 18.1% in 2006 to -3.4% in 2007. Most continental markets proved more resilient with, for example, France and Spain recording total returns of 17.8% and 12.9%, respectively. However, much-reduced returns can be expected to be delivered throughout Europe this year. In all three of the European markets where IPD reports results on a quarterly basis, Norway, the UK and Ireland, negative total returns were recorded in Q1 2008.

Figure 7
Total returns, all property



Source: IPD

“Prime office yields moved out significantly in Madrid and Paris over the first half of 2008.”

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