



EUROPE

SPRING 2010

Key highlights European office markets

- After a synchronized downturn, European office markets enter a phase of increasing disparities, which offers opportunities in selected parts of the market.
- The European labour market is expected to level off during mid-2010, but a strong rebound remains unlikely in the foreseeable future.
- Uncertainty with respect to the economic growth outlook has recently increased substantially due to public debt financing issues in several Southern European markets.
- Despite early signs of rent recovery in London and Paris, we expect further rent decreases for most other major markets during 2010. Recovery will become more widespread in 2011.
- After a relatively strong rebound in 2010, yield compression in Western Europe is expected to slow down in 2011 and to remain limited in 2012. CEE office markets are forecast to benefit from an inflow of foreign capital in search of attractive yields when Western European yield declines slow down.
- The three office markets in Continental Europe that we are most positive about in the upcoming three years are Prague, Paris La Défense and Brussels (see page 5).

Ranking	Office market (prime properties)
1	Prague
2	Paris La Défense
3	Brussels

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Current conditions & outlook 2010 for European office markets

office employment 	prime capital values
occupancy rates 	yield spread over gvt bonds
prime rents 	investment volumes

Thumbs indicate current conditions, arrows reflect our outlook to end of 2010.

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A BIRD'S EYE VIEW ON OFFICE INVESTMENTS

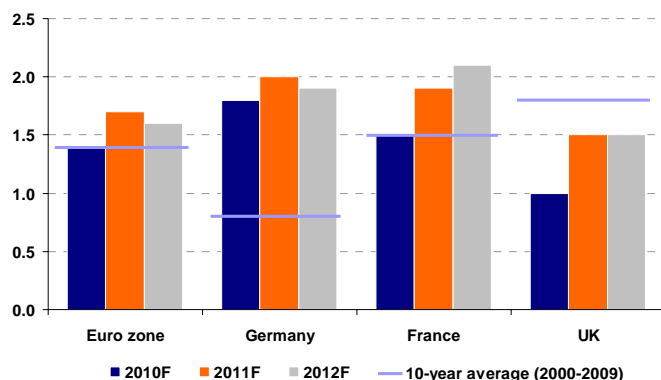
Office markets show a strong relationship with changes in the general economy. As European economies slowly start to recover from the recession that hit the global economy in 2008 and 2009, office markets are expected to follow in their path. However, the severity of the economic crisis and the measures taken by governments to prevent total collapse of the financial system still leave substantial uncertainty about the path of recovery of office markets. Current consensus is that European office markets are facing muted growth as governments, consumers and companies work their way out of unbalanced accounts. During the transition period between the synchronised downturn in 2008/2009 and sustained growth, European office markets are showing increasing disparities in many facets of the office market.

Office demand drivers

Short-term economic activity is on the rise...

Of all real estate sectors, office markets are among the most sensitive to economic activity. For 2010, rising GDP is expected to create jobs, causing improvement on the demand side of the office occupier market. However, uncertainty with respect to the economic outlook remains elevated. Recent events in Greece are a clear representation of existing disturbances in the European economy. The crisis revealed weak economic fundamentals that were masked by subsidised or leveraged growth, particularly in Southern Europe. The coming quarters will show whether a €750 billion rescue package initiated by Eurozone member states and the IMF is sufficient to maintain a positive momentum.

Figure 1: Economic growth outlook 2010-2012 (%)



Source: EIU, ING Economics (8 April 2010)

... but a self-sustaining recovery soon is less likely.

To achieve a self-sustaining recovery, investment and private consumption need to replace the boost from inventories and the effects of fiscal easing. Government saving will put public sector jobs at risk, thereby harming

the prospects for consumer spending. Consumers are still very cautious, despite employment indicators that suggest the labour market should level off during mid-2010. Therefore, even with the near-term outlook remaining fairly bright, further recovery will stay fragile.

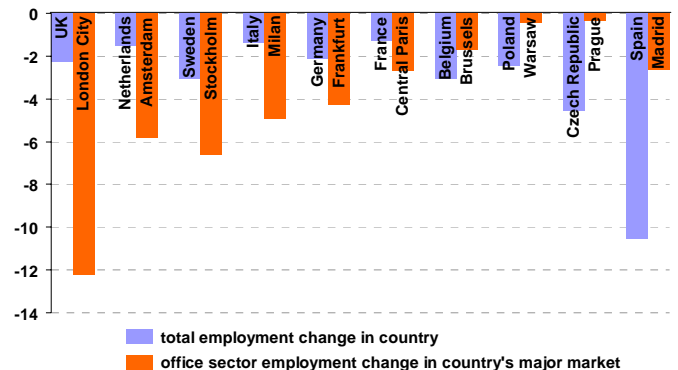
Germany and France recover stronger ...

European countries do, however, differ in their growth outlook. Germany's economy was hit hard by the fall in world trade, but is expected to show relatively attractive growth rates in the years to come, as shown in Figure 1. France, which was less affected by the crisis than neighbouring countries, is expected to show a continued rising trend over the next years. Economic growth in the UK is expected to stay below European averages as a result of continued weakness in local demand.

... but labour demand will not rebound strongly yet...

The European labour market is continuing to deteriorate at a moderate pace, though more consistent signs of stabilisation are becoming apparent in several countries, including Germany and the UK. Because the economic recovery is still facing headwinds and European productivity falls well short of the US, a sharp rebound in European labour demand remains unlikely in the foreseeable future.

Figure 2: Expected peak-to-trough employment change (%)



Source: EIU (April 2010), PMA (Spring 2010)

Note: Peak values were generally reached in 2008 while the trough is expected in most markets in 2010.

... while office sector employment is hit even harder.

While decreasing total employment levels are a reflection of the recession that hit European countries, it is specifically the fall in office employment that hurts occupier markets. Figure 2 reflects this difference. Notable are the loss of office sector employment in London City and the relatively strong loss of total jobs in Spain. In general, loss of office employment at the local level is outpacing loss of total jobs at the national level. Exceptions are Brussels, Warsaw, Prague and Madrid, where office employment seems to be less affected by the crisis than the national aggregate for total employment.

Outlook office occupier market

High and rising vacancy...

Vacancy rates across European office markets increased as a result of falling office employment levels and the completion of projects initiated before the crisis. Vacancy in Amsterdam was elevated going into the crisis and increased even further as a result of the downturn. Low pre-crisis vacancy rates in the booming Spanish office market led to relatively strong construction activity. These products arrived on the market when the negative effects of the global economic crisis started. At present, vacancy rates are at double-digit levels in many European cities and continue to rise; exceeding their long-term averages (Figure 3).

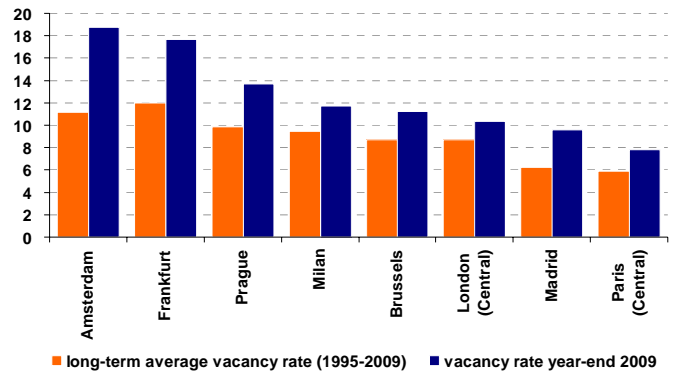
... will prevent rental growth until 2011...

CBRE has nevertheless already recorded modest prime rental growth for London and Paris. Nonetheless, we expect further rent decreases for most other major office markets. Prime rents in the government institution dominated Brussels office market are forecast to outperform during 2010. For 2011, we expect a more widespread recovery of office occupier markets to be initiated by a combination of two effects. First, employment levels are forecast to slowly start growing again in 2011. The second effect is embedded in the headwinds real estate developers are facing. The level of completions will fall to historically low levels across European cities as from 2011, thereby helping occupier markets in their recovery. However, with much office space still available and hidden vacancies at downsized companies, markets are expected to remain loose, causing a drag on rent recovery. Prime rent levels are expected to increase marginally in 2011 with further growth expected during the following years.

... though Prague, La Défense and Brussels prime rents look promising.

The three office markets in Continental Europe that we are most positive about for the upcoming three years are Prague, Paris La Défense and Brussels. Although inward yield shifts will boost returns for these markets, relatively strong rental growth is also part of the story, as we explain on page 5.

Figure 3: Current versus long-term average vacancy rate (%)



Source: PMA (Spring 2010)

Outlook office investment market

Investors are moving back into property markets...

With an improving outlook for the European economy, investors are moving back into property markets. This is causing yield compression after roughly two years of rising yields. The first signs of declining yields were visible in the second quarter of 2009 in UK office markets, triggered by steep value declines of both office properties and the British Pound. Paris, another liquid office investment market, joined the next quarter. During the first quarter of this year, most commercial real estate transactions occurred in the UK, Germany, France and Sweden. The number of large deals is rising steadily. According to CBRE, in the first quarter, prime initial yields declined further and in an increasing number of markets. This occurred primarily in office markets, where yields declined in about half of the covered prime markets during the first quarter.

... but still predominantly for prime products ...

Thus far, investor attention has been mainly focused on the prime segment of the market, as investors have become increasingly risk-conscious. This caused the first positive shifts in prices to be concentrated in a narrow segment. Markets for secondary properties are expected to improve with a lag. There are early signs that some investors are open to slightly higher risks such as shorter leases or lower occupancy.

HOW GREEN IS YOUR BUILDING?

An emerging change in the real estate investment industry that has proven to be recession proof is the increased focus on energy efficiency and sustainability. While still far from being a fully integrated factor in the market, given, for example, that the impact of sustainability on property valuations is still unclear, investors are increasingly aware that it will play a more important role in the future and are acting accordingly. The growth in awareness concerning sustainability still has to be accompanied by more clarity concerning its measurement on the European mainland. While sustainability is a hotly debated topic, there is no widely incorporated rating methodology for measuring the level of sustainability at the property level. Energy efficiency labels are being introduced in an increasing number of countries, but the introduction of a widely accepted and broader sustainability measure is still being awaited.

Thus far, a lot of attention is being focused on the development industry, but in a world where the flow of new product represents only two percent of existing stock on average, it is apparent that existing stock must be addressed to make a difference.

... influenced by contradicting factors.

Investment market recovery will be supported by gradually increasing debt availability and the rising awareness that market values have reached their turning point. Yield declines could be mitigated by rising bond yields, especially in those countries with large fiscal and budget deficits. Another constraint is that about half of the European commercial real estate loans are due to mature during the next three years which could trigger forced sales if new debt capital is unavailable.

Yields recover at two different speeds.

For 2010 we expect yields in France to continue the compression trend that started in 2009. Major office markets in Spain, despite the dire state of the local economy, are also expected to show yield compression as investors are drawn in by the strong negative revaluations which put office prices in Spain at significant discount to long term average values. The capitals of Central and Eastern Europe (CEE) belong to a 'second-tier' group of markets where investor interest belatedly follows changes in Western Europe. After a relatively strong rebound in 2010, yield compression in Western Europe is expected to slow down in 2011. Investor attention to CEE markets is likely to commence by then, causing wide spread yield compression in these markets. Continued, albeit limited, yield compression in Western Europe is expected in 2012, while CEE markets are forecast to benefit from an inflow of foreign capital in search of attractive yields.

European office markets are set for attractive returns...

In general, as the existing divergence in European office markets is expected to decrease next year, both the occupier and investment markets are forecast to improve, causing expected returns to rise. Figure 4 shows the graphical representation of an office total return cycle. While uncertainty remains, there are reasons to expect

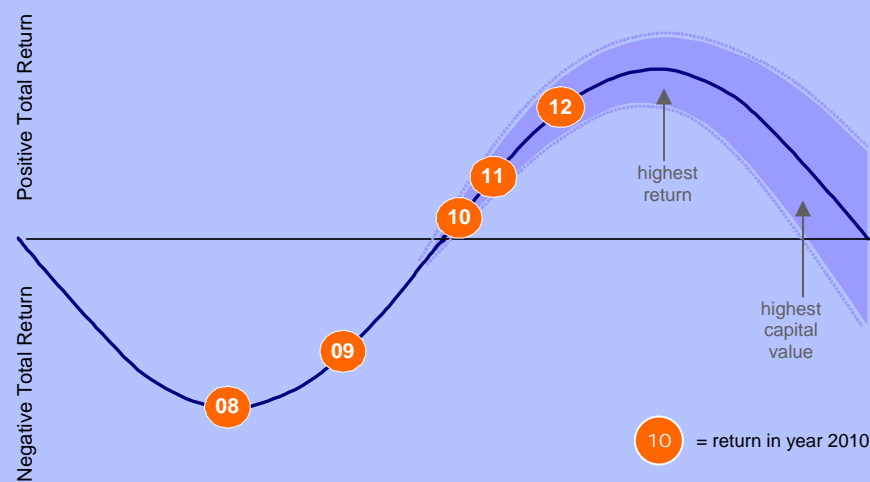
that European office markets are set to achieve attractive returns for the following years as both occupier and investment markets find the way upward again.

... initially for Northern and Western Europe.

Figures 5 and 6 show our 3-year outlook for European office markets. French office markets are forecast to exhibit the strongest yield compression in 2010 and, despite some continued rent decline, total returns are expected to outperform the European average. German office markets are expected to underperform other European markets during the period 2010-12, as their yield compression potential is limited due to the limited outward movement in yields during the crisis. To a lesser extent, this also holds for office markets in the Netherlands, where outward yield movement was limited. The relatively strong performance of office markets in Northern and Western Europe expected in 2010 is explained by above-average expected yield compression this year. The quick recovery of UK office markets is expected to subdue expected returns during following years as occupier markets still have to work their way out of the crisis. Central and Eastern European markets lag behind changes in investment activity seen in other markets, resulting in below-average expected returns in 2010. In 2011, divergence in the occupier and investment market is likely to be reduced leading to less variation in total return forecasts. Investor interest in markets on the upper side of the risk spectrum is expected to return in 2012, resulting in above-average expected returns in Central and Eastern European markets.

ING PROPERTY RETURN CYCLE

Figure 4: Prime Continental European office markets, 2008-2012



Source: ING REIM Europe Research (Spring 2010)

Real estate returns are cyclical. Figure 4 shows a simplified version of the cyclicity of office markets. Total returns based on changes in transaction yields for a weighted average of European office markets hit bottom in 2008. While rents are expected to show negative growth in 2010, total return forecasts are slightly positive for the year due to expected yield compression. In 2011-2012, total returns are on an upward slope as a result of combined yield compression and positive, yet muted, rental growth across Europe. Overall, European office investments are expected to show increasingly attractive returns during the following years.

A time to invest in offices?

Labour markets reach the bottom...

Forecasting uncertainty recently increased with public debt financing issues in several Southern European markets. Nevertheless, the European labour market is expected to level off during mid-2010. A strong rebound remains unlikely in the foreseeable future as private and public sector employment growth is muted by the lasting effects of the crisis.

...fuelling attractive returns...

Despite early signs of rent recovery in London and Paris, we expect further rent decreases for most other major markets during 2010. Recovery will become more widespread in 2011. After a relatively strong rebound in 2010, yield compression in Western Europe is expected to slow down in 2011 and to remain limited in 2012. CEE office markets are forecast to benefit from an inflow of foreign capital in search of attractive yields when Western European yield declines slow down.

...for investors with the right timing and selection skills.

Overall, 2010 appears to be an attractive year for investors to start entering the office market. With financing costs and opportunities improving, the expected recovery in both investment and occupier markets can be grasped by those investors with the right timing and property selection skills.

ING'S TOP 3 OFFICE MARKETS IN CONTINENTAL EUROPE

Figure 5 presents our 3-year return outlook for European office markets. Figure 6 ranks the European regions relative to each other. The three markets that we are most optimistic about (2010-12) are prime offices in Prague, Paris La Défense and Brussels.

Ranking	Office market (prime properties)
1	Prague
2	Paris La Défense
3	Brussels

Source: ING REIM Europe Research

Note: forecasts shown in Figure 5 are only indicative and based on prime rents and prime transaction yields, without leverage, and do not reflect actual property or portfolio returns.

1) Prague

High returns in Prague will be driven by a combination of positive rental growth and solid yield compression. The yield levels moved out significantly during the last two years and office space in Prague is now attractively priced. A continuous structural shift of Central Europe to Western Europe is expected to continue, which should help to bring yields down further. Demand for offices as an investment product is strong at present, which puts Prague (together with Warsaw) in a different

position compared to the rest of the CEE region.

Prague is currently the most advanced in regard to rental growth cycle in the region. Despite demand still being low, vacancy is stable because there are very few projects in the pipeline. With an expected recovery in demand, a decrease in the vacancy rate and an increase in rents are imminent.

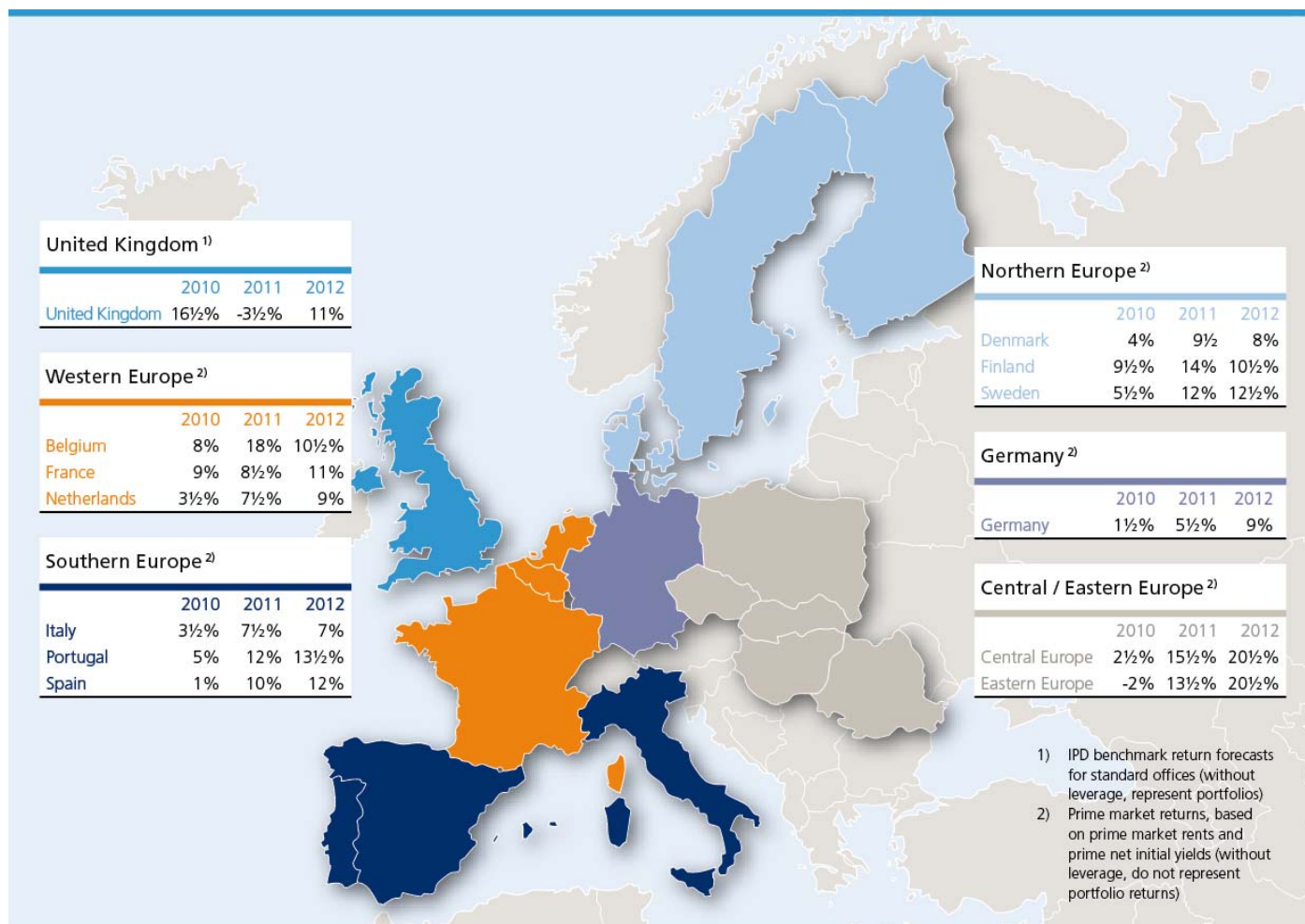
2) Paris La Défense

Attractive returns in Paris La Défense will be driven by positive rental growth combined with yield compression. Despite the crisis, demand remains high while supply is falling due to the low level of completions during 2009. Consequently, rents in La Défense are not expected to continue to fall. In the upcoming three years, this situation is expected to last because the attractiveness of La Défense is expected to stay given that it is one of the traditional and most sought-after business districts in Paris. At the same time, new supply coming on the market will be limited to the release of space in existing buildings because construction activity has fallen dramatically. This will cause a shortage situation that will support rental growth, while the yield compression, which is already underway, is forecast to continue due to the strong interest of investors for the Parisian market.

3) Brussels

The attractive return for the Brussels office market for the next three years is mainly driven by an early expected rent recovery. Brussels benefits from the high take-up from the public sector thanks to the presence of the European institutions and the various Belgian administrations. Prime office rent in Brussels is forecasted to show a slight increase in 2010, leading other European office markets in the timing of rent recovery. Stable demand combined with very low completion levels of new space during 2011-2012 result in a continuing favourable outlook for rents. Like all other office markets Brussels endured an upward yield shift during late 2008 and 2009. As the financial market is slowly recovering so is the Brussels office market. This trend is expected to continue for the next coming years, resulting in an interesting yield prospective and fuelling the total return expectation for prime office space in Brussels.

Figure 5: Prime office market total return outlook 2010-2012 (unlevered)



Source: ING REIM Europe Research (Spring 2010).

Figure 6: Prime office markets with their relative return outlook for 2010-2012

	Office market returns				Office market capitalisation (sums to 100%)
	2010	2011	2012	2010-2012	
Northern Europe	above	at	at	at	11%
Western Europe	above	at	at	at	33%
Germany	below	below	below	below	28%
Southern Europe	at	at	below	below	26%
Central and Eastern Europe	below	above	above	above	2%

Source: ING REIM Europe Research (Spring 2010)

The table indicates whether our market return outlook is above, close to or below the weighted average return for prime office markets that we cover in Continental Europe, for respectively 2010, 2011 and 2012. Returns are not corrected for risk. The forecasts are shown in Figure 5, which are only indicative and based on prime rents and prime yields, without leverage, and do not reflect actual property or portfolio returns. The UK is not included in this analysis as ING REIM forecasts IPD benchmark returns in this country, which are not comparable to return forecasts in Continental Europe.

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