

Laurence Tauzin
+ 33 (0)1 78 40 92 63
laurence.tauzin@aeweurope.com

Ken Baccam
+ 33 (0)1 78 40 92 66
ken.baccam@aeweurope.com

Publication Editor
Mahdi Mokrane
+ 33 (0)1 78 40 92 60
mahdi.mokrane@aeweurope.com

European office markets outlook

Economic crisis and office rents: Which markets will prove most resilient?

Summary

- The global economic situation has further deteriorated and growth forecasts for the next few years have been revised downwards. Thus the latest forecasts for February 2009 predict an annual growth rate in GDP in the Euro Zone of -2.0% in 2009 and 0.7% in 2010, compared to 1.4% in 2009 in June 2008.
- The office job market has been greatly affected, with disparities according to economic areas, sometimes in the same country. This is for example the case with Milan and Rome (Rome should suffer more from a slowdown in the employment market), and also with the German cities (the situation in Munich is more favourable than elsewhere in Germany).
- The slowdown in the office job market has repercussions already visible on office take-up in Europe. The first decreases in take-up have been recorded in London, Paris, Madrid, Brussels and Stockholm.
- On the supply side, vacancy rates have risen since the 2nd quarter 2007 on certain markets. This is the case for London, Rome, Barcelona, Madrid and Budapest. Vacancy rates in Amsterdam and Frankfurt still remain at a high level (over 15%).
- A certain inertia still keeps the prime face rental values at a stable level. In London, the market has adjusted (-19% between the 4th quarter 2007 and the 4th quarter 2008 in the City).
- Investment activity is marking time. Prime yield rates are already up in European markets, and we expect further rises in the coming years (until 2010) then a new decrease during the subsequent years. They varied between 5.75% and 6.25% in Paris central business district in January 2009, and are still at 5.4% in the 4th quarter 2008 in Frankfurt.

Our forecasts

Based on the aforementioned macroeconomic and financial scenario:

- With demand adjusting, the change in rental values will also depend on the future supply and the ability of the markets to control the production of new offices.
- In this sense, construction starts have tended to progressively decrease, even if Madrid and Barcelona are still characterised by construction starts levels among the highest in Western Europe (over 3.5% of the stock per year in each of the two cities). In Madrid, 80% of the construction supply is situated in the suburbs. However, there were far fewer construction starts in 2008 than in 2000/2002.
- In our opinion, rental values should reach the through of the cycle towards 2010 in the majority of the markets (with a delay for certain cities such as Madrid, where the through is forecast for 2011).

On the basis of key elements (macro-economy, future supply, creation of office jobs), it appears that during the 2009-2010 period, London City, West End, Madrid, Barcelona, Dublin and Manchester should experience more significant rental value corrections than the other markets (falls of over 15% per year on average). The Rome, Paris and Budapest markets should undergo less significant albeit important corrections (between -10% and -15% per year). The Vienna, Helsinki, Stockholm, Milan, Brussels, Frankfurt and Lisbon markets should undergo a moderate fall (between -10% and -5% per year). The prime rental values in markets such as Munich, Hamburg, Berlin, Dusseldorf, Copenhagen, Athens, Prague, Warsaw and Amsterdam should remain stable (between -5% et 0% per year).

Our analysis shows that the change in the parameters of the office space investment market (the wait-and-see policy of investors, fear of a deep recession, credit restrictions) will result in a rise in yield rates in 2009, and in our opinion, probably an over-reaction to the rise in these same rates. An over-reaction, because we show that the expectations, even if very low, of economic growth rates, service sector jobs, combined with control of the new supply of office space, with a progressive return to normal of the credit markets, and with downward inflation in 2009-2010, in the majority of European metropolises, will not lead to sharp falls in nominal rents (with the exception of certain markets, as we saw in the previous paragraph).

An illustration of our analysis is the recent return of positive investment intentions targeting London office markets for 2009 (after a very negative year in 2008), whereas these intentions have become negative for the rest of Europe (for 2009). In fact, we note in the analysis of the last survey carried out on a sample of investors by PMA, that their investment intentions have fallen in Italy, Spain, Portugal and Germany. This illustrates a wait-and-see policy exacerbated by the restriction on credit markets. Only investment intentions in the United Kingdom and in Ireland are rising, proof that investors are ready to reposition themselves when they consider that the "repricing" is sufficient.

Despite the impact of the economic crisis, the French and particularly the German (except Frankfurt) office space markets seem to us the most buoyant in the current context. A threat in France could be the indexing of the current commercial rents, the ICC, which has sharply increased recently (+10.46% per year to 3Q08): Article L.145-39 of the French Commercial Code could be applied for certain tenants, granting them a new negotiation of the rental values at market values, if the accrued growth from the indexing of their rent exceeds 25%.

Economic situation in Europe

As we said in the last Quarterly (4th quarter 2008), GDP growths in 2008 were worse than forecast, despite the progressive revisions downwards by the forecasters. The global economic situation has further deteriorated. Thus the latest forecasts dated February 2009 consider the annual growth rate in GDP in the Euro Zone at -2.0% in 2009 and 0.7% in 2010, compared to 1.4% in 2008 in June 2008. In Europe, the countries affected by a sharp decrease in GDP in 2009 will be Ireland, Great Britain and Germany. Germany is to suffer a fall in global external demand (with the German growth model being based on exports) and also a fall in domestic demand (the confidence of German households has fallen over the past few months).

Annual changes in GDP per country 2005-2010

Annual changes in GDP	2005	2006	2007	2008	2009	2010
Greece	3.80%	4.20%	4.00%	2.90%	0.10%	1.30%
Norway	4.60%	4.80%	6.20%	2.10%	-0.60%	1.30%
Netherlands	1.50%	3.00%	3.50%	1.80%	-1.50%	0.60%
Belgium	2.20%	3.00%	2.60%	1.30%	-1.40%	0.60%
Germany	0.80%	2.90%	2.50%	1.30%	-2.50%	0.80%
Spain	3.60%	3.90%	3.70%	1.10%	-1.90%	0.20%
USA	3.10%	2.90%	2.00%	1.30%	-2.10%	2.00%
Euro Zone	1.80%	3.00%	2.60%	0.80%	-2.00%	0.70%
Sweden	2.70%	2.50%	2.70%	0.70%	-1.20%	1.10%
France	1.70%	2.20%	2.10%	0.70%	-1.40%	0.80%
UK	1.80%	2.90%	3.00%	0.70%	-2.60%	0.60%
Portugal	0.70%	1.20%	1.90%	0.20%	-1.40%	0.20%
Italy	0.20%	1.90%	1.40%	-0.70%	-2.30%	0.30%
Ireland	5.90%	5.70%	6.00%	-1.70%	-4.00%	-0.30%

Sources: Consensus Forecasts February 2009, AEW Europe, sorted by decreasing GDP 2008

The office job market has been affected, with disparities according to economic areas, sometimes in the same country. This is for example the case with Milan and Rome (Rome should suffer more from a slowdown in the employment market), and also with the German cities (the situation in Munich is more favourable than elsewhere in Germany, with growth of nearly 2% per year in office jobs).

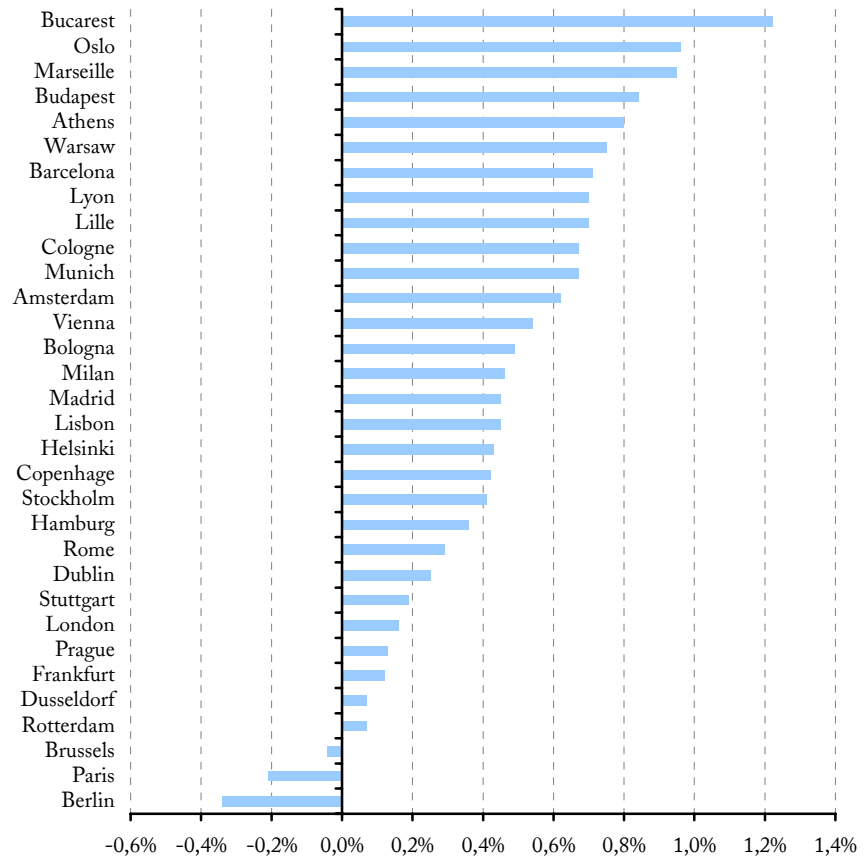
Forecasts for unemployment rates per principal countries 2005-2010

End of the year unemployment rate	2005	2006	2007	2008	2009	2010
Royaume-Uni	2.7	2.9	2.7	2.8	5.0	6.2
Euro Zone	8.8	8.3	7.5	7.5	8.8	9.5
Germany	11.7	10.8	9.0	7.8	8.4	9.4
France	8.9	8.8	8.0	7.4	8.5	8.9
Italy	7.7	6.8	6.1	6.8	7.9	8.4

Sources: Consensus Forecasts February 2009, AEW Europe

The global economic situation has further deteriorated in the last quarter

Forecasts for annual average growth in service sector employment (% pa) 2009-2015



Sources: Experian, AEW Europe

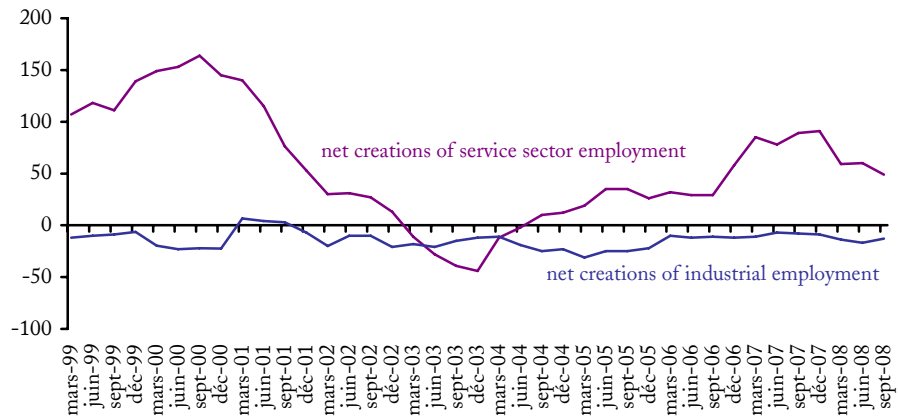
In times of recession, Paris central weight in terms of service jobs should decline in favour of French secondary cities

In Berlin, after a period when employment growth had been stagnant between 2002-07, a reasonable amount of jobs had been created in the last three years. Thus, the job cuts forecasted in the upcoming years will appear sharp in contrast

In the Ile-de-France, together with the industrial sector and the construction sector, the service sector should suffer a fall in the creation of jobs over the coming months. From the start of 2008, we note that annualised creations total 50,000 service sector jobs in the Ile-de-France, falling below their average rate from 1999-2007 (57,000 jobs). At this pace, and given the pessimistic employment market prospects, we anticipate negative net job creations in 2010.

In times of recession, Paris central weight in terms of service jobs should decline in favour of French secondary cities. Foreign investment, a key constituent of local growth, could also become more sparse. As of Berlin, the German capital, located in the east of Germany, is suffering from negative population growth. After a period when employment growth had been stagnant between 2002-07, a reasonable amount of jobs had been created in the last three years. Thus, the job cuts forecasted in the upcoming years will appear sharp in contrast.

**Annual job creations
in industry and in the services sector
in the Ile-de-France (x 1,000 jobs)**



Sources: GARP, AEW Europe

GDP growth expectations are positive again in 2010 (according to the latest Consensus Forecasts).

Situation in the office space markets in Europe

In Germany, the unemployment rate is rising and we are expecting a sharp fall in GDP growth in 2009 (-1.2% according to the latest Consensus Forecasts). Vacancy rates are relatively high (the lowest vacancy rate was recorded in Hamburg at 8.2% in the 4th quarter 2008). However, apart from Dusseldorf where the construction of offices reached a relatively high level in 2008 (over 4% of the office stock in Dusseldorf), construction starts have been modest over recent years.

All these elements indicate that although we expect to see the consequences of the economic recession on the German office market, we are not expecting sharp falls in rent. The impact of the crisis is visible in the rise in the investment risk premium, which must take into account less investment flow and slightly negative expectations of rent growth.

In France, the unemployment rate has also increased but the contraction of GDP forecast in 2009 remains less important than the average for the European Union. Office rents in the principal sectors (La Défense and Paris central business district) are volatile and high compared with the Euro Zone. Furthermore, standards and regulations will be more restrictive in the coming years, to improve access to disabled persons and to protect the environment. This will specifically affect the Paris central business district with its large proportion of Haussmann constructions. Construction starts have been regulated over the past few years (under 2% of the Parisian office stock).

The total vacancy rate in the Ile-de-France region was low in the 3rd quarter 2008 (5%) but the latest figures from Immostat show that it increased during the last quarter (around 5.5% in December 2008). Office take-up reached 2,360,000m² in 2008 (a result that satisfies the majority of observers, because they expected a lower volume), compared with 2,756,000m² in 2007 (-17% between 2007 and 2008). The recent change in the employment market shows that industry (the construction sector particularly that of cars and capital goods) is down and that the creation of jobs in the service sector has slowed

In Paris region, given the pessimistic employment market prospects, we anticipate negative net job creations in 2010

down. Given the economic forecasts, we are expecting a sharp fall in prime office rents in 2009 and 2010 (-12% to -15% per year), but these rents should increase over the following years. Investment in commercial property fell to 8.5 €bn in 2008 in the Ile-de-France region, compared to 20.4 €bn in 2007.

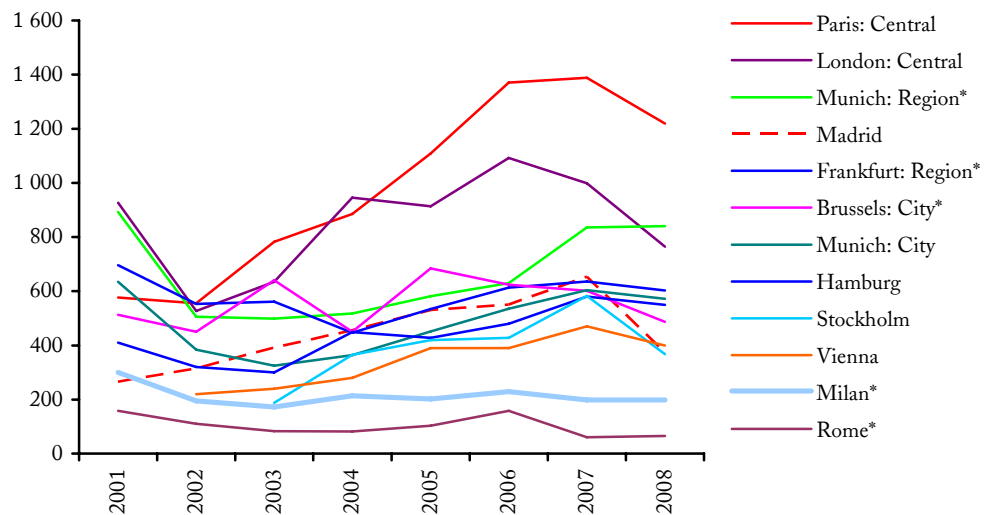
In Spain, we are expecting a negative GDP growth in 2009 (-1.3%), the lowest GDP growth forecast in the EU. The unemployment rate is high. Office rents are volatile and have begun to fall since the end of 2008. Vacancy rates are low in Madrid and Barcelona while these markets enter into the tumult of the crisis. However, as office construction was high in 2007 and 2008 (6% in Madrid and 5% in Barcelona), we are expecting a sharp increase in vacancy rates over the next two years and these could reach 10%. Consequently, prime office rents should fall (by nearly 50% in Madrid by the end of 2010 and 40% in Barcelona). But office rents in these markets are volatile and could increase from 2011-2012.

Italy has the relative advantage of a low unemployment rate. Negative GDP growth is forecast in 2009. At the office space market level, the vacancy rate in Rome is low (6% towards the end of 2008), but this indicator is higher for the other principal market in Italy, Milan (9%). Take-up has fallen in Rome over the past two years. Rents could fall sharply in 2009 and 2010 (22% in Milan and 20% in Rome). During the coming years, forecasts are more optimistic in Milan (over 20% expected from 2011 to 2013) than Rome where a further fall in rents is expected.

Overall, the slowdown in the office job market has repercussions that are already visible on office take-up in Europe. The first falls in take-up have been noted in London, Paris, Madrid, Brussels and Stockholm.

The first falls in take-up have been noted in 2008 in London, Paris, Madrid, Brussels and Stockholm

Annual take-up (thousands of sqm) in the principal European cities

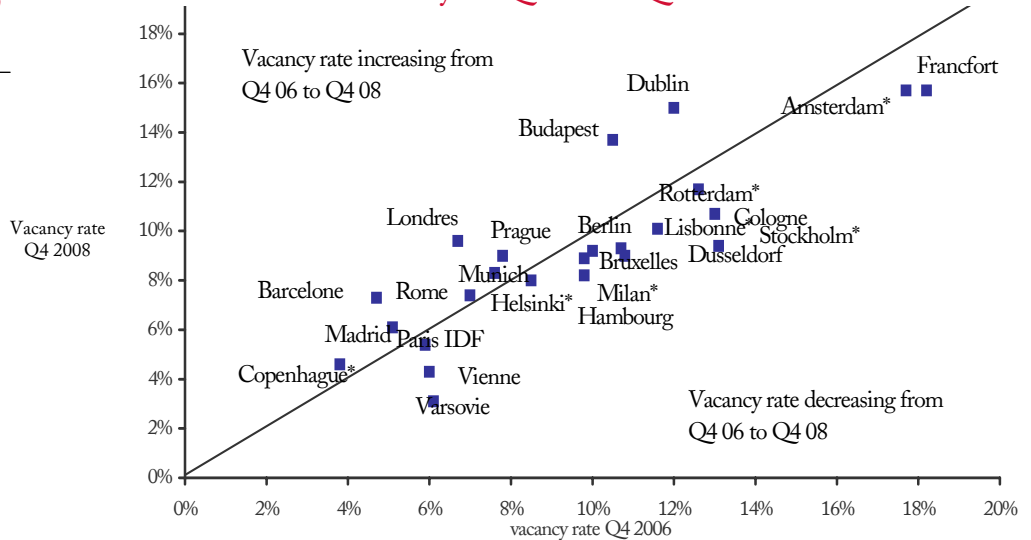


Sources: PMA, AEW Europe
* Q3 annualised data

On the supply side, vacancy rates have increased since the 4th quarter 2006 in certain markets. This is the case in London, Barcelona, Budapest and Dublin. Vacancy rates in Amsterdam and Frankfurt remain at a high level (over 15%).

But actually, in most European cities, vacancy rate kept on decreasing or increased just marginally.

Vacancy rate Q4 2008 vs. Q4 2006

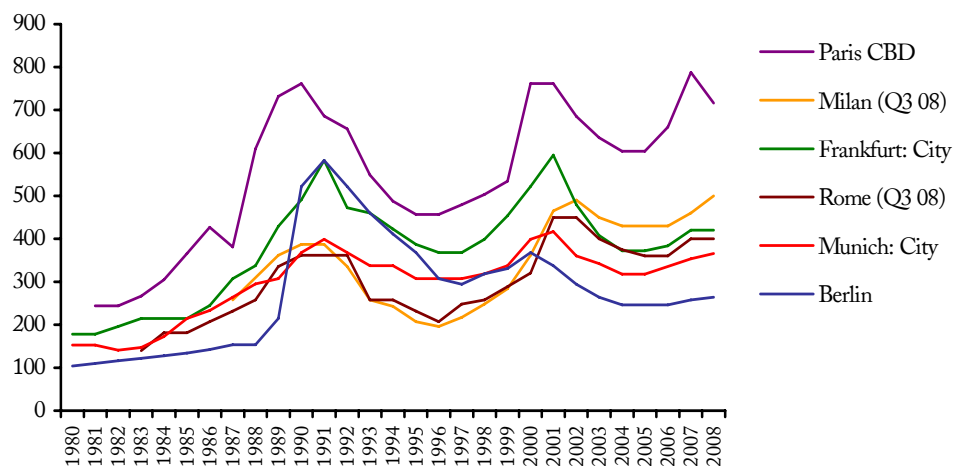


Sources: PMA, AEW Europe
* Q3 data

In most European cities, vacancy rate kept on decreasing or increased just marginally from 2006 to 2008

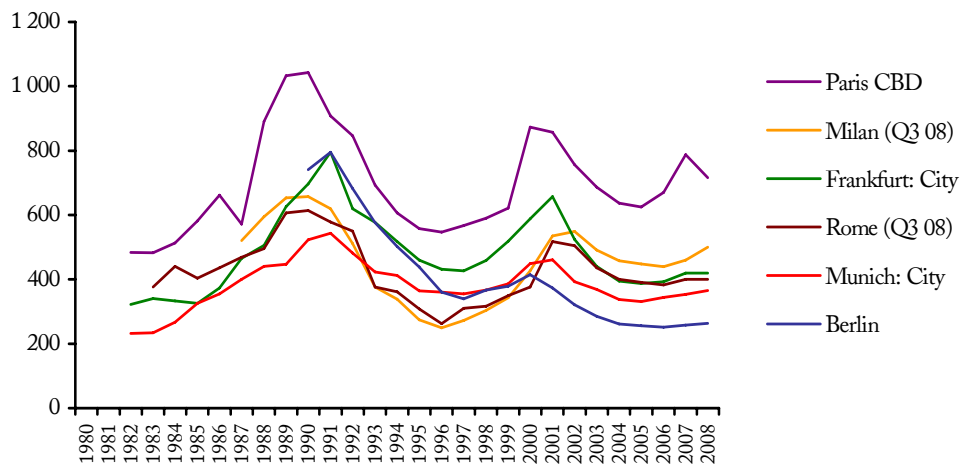
A certain inertia still keeps the prime face rental values at a stable level. In London, the market has begun to adjust (-19% between the 4th quarter 2007 and the 4th quarter 2008 in the City).

Change in nominal prime office rents in Europe (€/sqm/year)



Sources: PMA, AEW Europe

Change in real prime office rents in Europe (constant 2007 €/sqm/year)

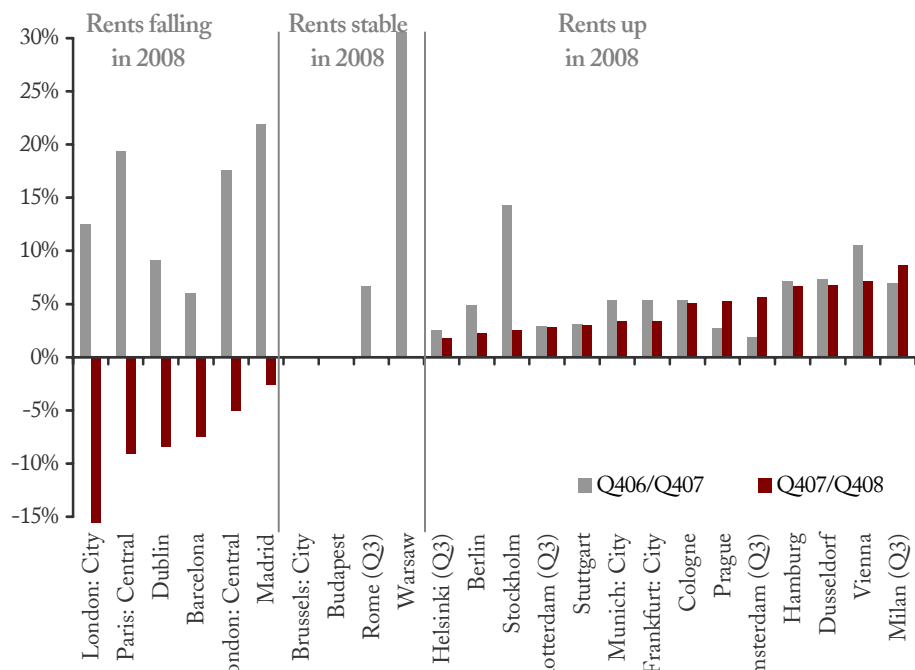


Sources: PMA, AEW Europe

Looking at prime nominal rents, it appears that some office markets, such as Paris CBD, have reached a record high. However, the assessment differs somehow with real values, corrected from inflation (see graphs above). Thus, with constant 2007 euros, prime rents in Paris CBD were still 10% lower in 2007 than in previous peak, in 2000.

Looking at prime nominal rents, it appears that some office markets, such as Paris CBD, have reached a record high. However, the assessment differs somehow with real values.

Comparison of the changes in "prime" rental values of the principal European cities Q4 2006-Q4 2008

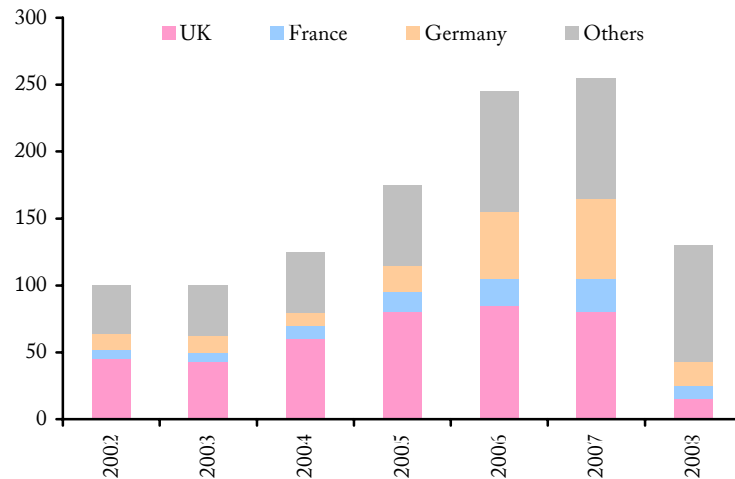


Sources: PMA, CB Richard Ellis, AEW Europe

Investment activity marked time in 2008. Prime yield rates are already up in the European markets, with substantial risk premium showing. We expect further rises in the coming years (until 2010) then a moderate compression in subsequent years. They varied between

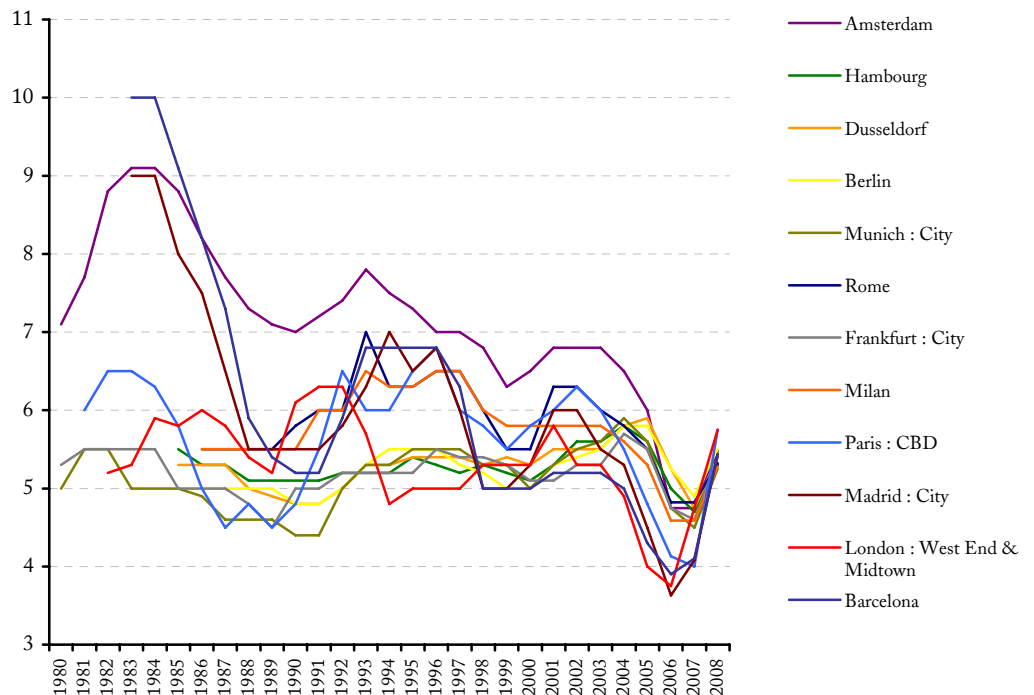
5.75% and 6.25% in Paris central business district in January 2009, and totalled 5.4% in the 4th quarter 2008 in Frankfurt.

Change in the investment volumes in commercial property (2002-2008, billions of €)



Sources: PMA, DTZ, Catella, CB Richard Ellis, Atis Real

Change in the prime yield rates in Europe 1980-2008 (%)



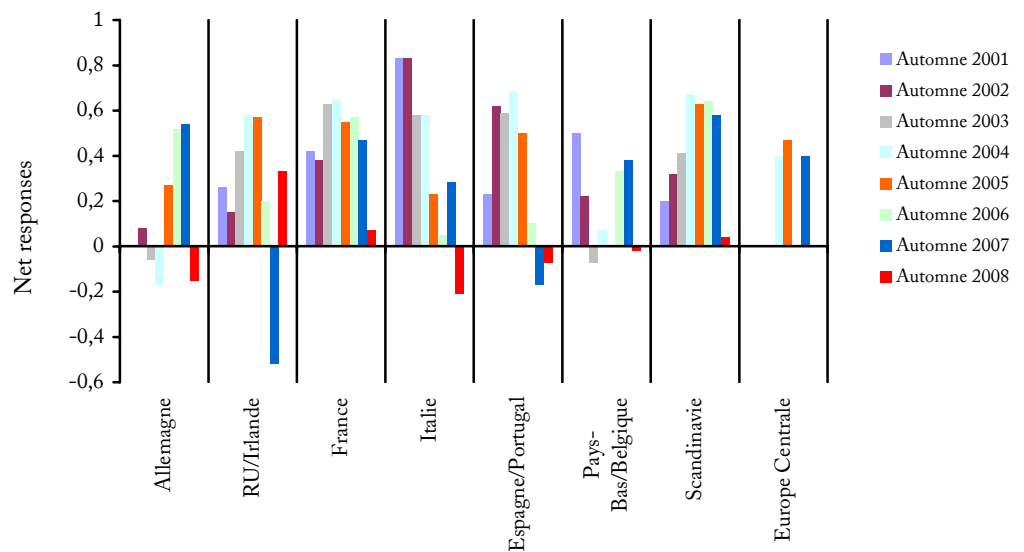
Sources: PMA, AEW Europe

Prime yield rates are already up in the European markets, and have started pricing in substantial risk premiums...

Forecasts

We note in the analysis of the latest survey of a sample of investors carried out by PMA, that their investment intentions are down in Italy, Spain, Portugal and Germany. This illustrates a wait-and-see policy exacerbated by the restriction on the credit markets. Only the investment intentions in the United Kingdom and in Ireland are rising clearly, proof that investors are ready to reposition themselves when they consider the "repricing" to be sufficient.

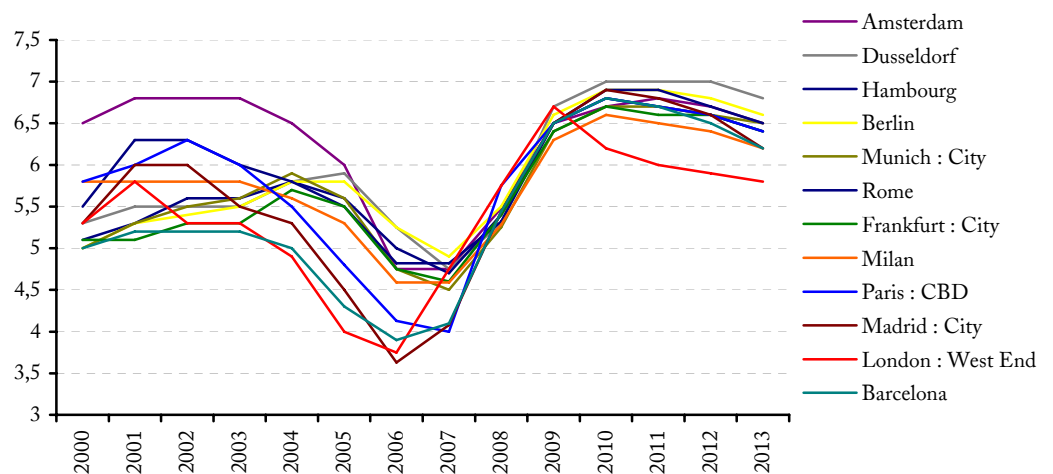
Office investment intentions in different periods – by country



Source: PMA survey of a sample of 33 investors

The following forecasts take into account the last investment market and macroeconomic data:

Forecasts of the change in prime yield rates in Europe 1980-2008 (%)
Central scenario



Sources: PMA, AEW Europe

... and we expect further rises in the coming years (until 2010) then a moderate compression in subsequent years

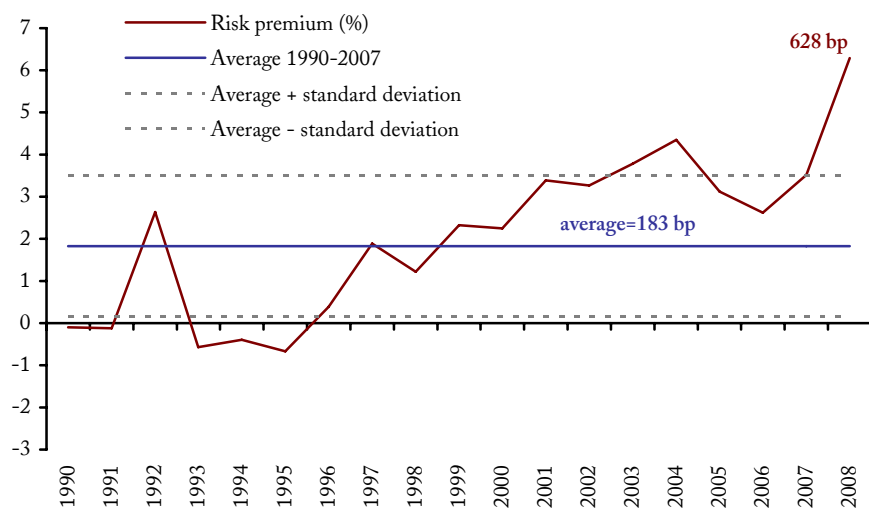
Below we look at the historical movements in the long term of risk premiums in prime office property in nine key markets in Europe. We can see that the correction (repricing) of the risk started in 2007 in the British cities and in 2008 in continental Europe. We note that the correction of the risk premium is the most severe in GB, and even greatly exceeds the historic average + a standard deviation over the long period.

Risk premiums are calculated with the formula: $RP_n = Y_n(1 + \hat{I}_n) - (R_{fn} - \hat{I}_n)$

where RP_n is the risk premium at year n, Y_n is the yield, \hat{I}_n is the geometric average expected inflation over the next four years, and R_{fn} is the 10 year Government bond yield (risk free).

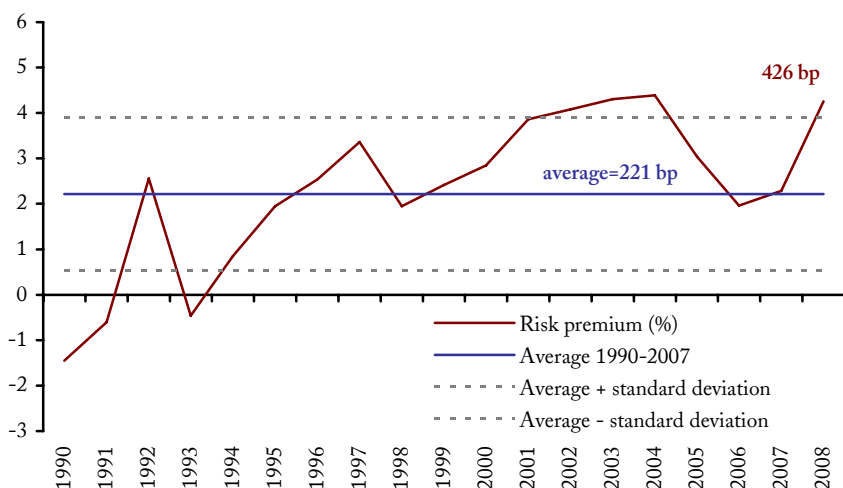
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Change in the risk premium in London City



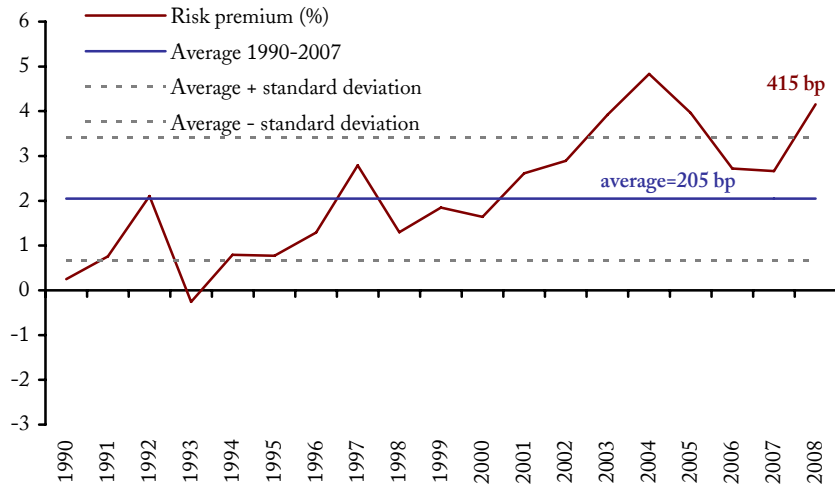
Sources: PMA, AEW Europe

Change in the risk premium in Paris CBD

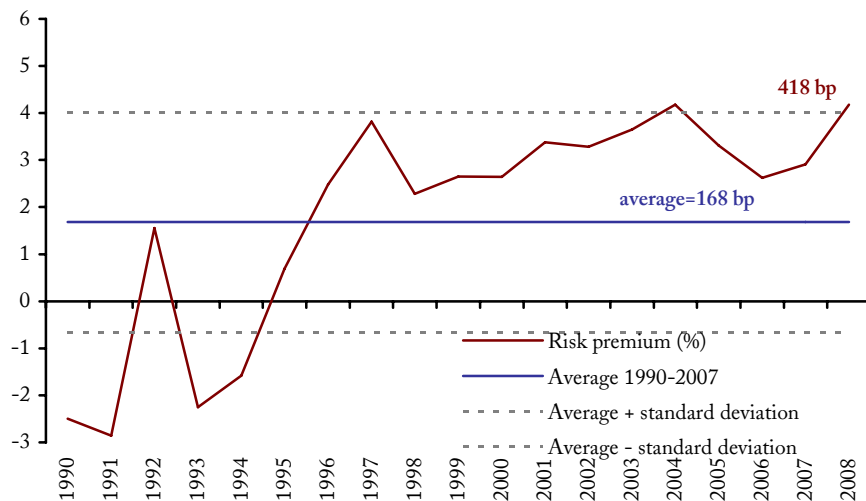


Sources: PMA, AEW Europe

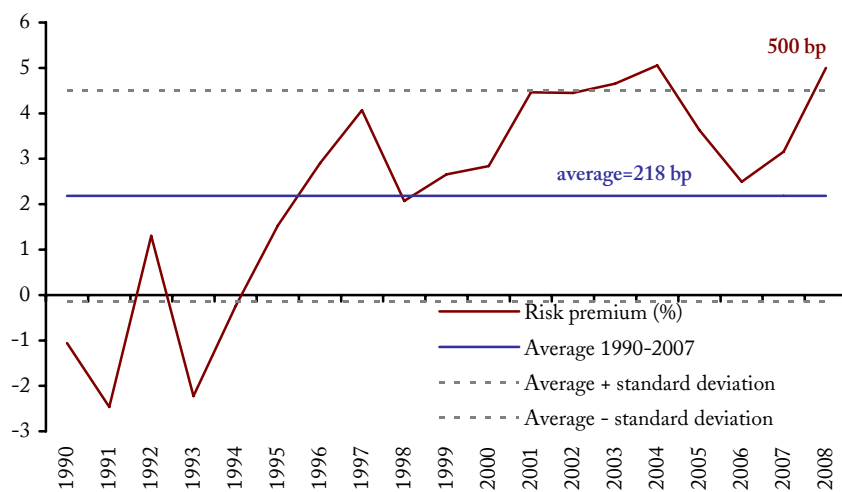
Change in the risk premium in Munich



Change in the risk premium in Milan



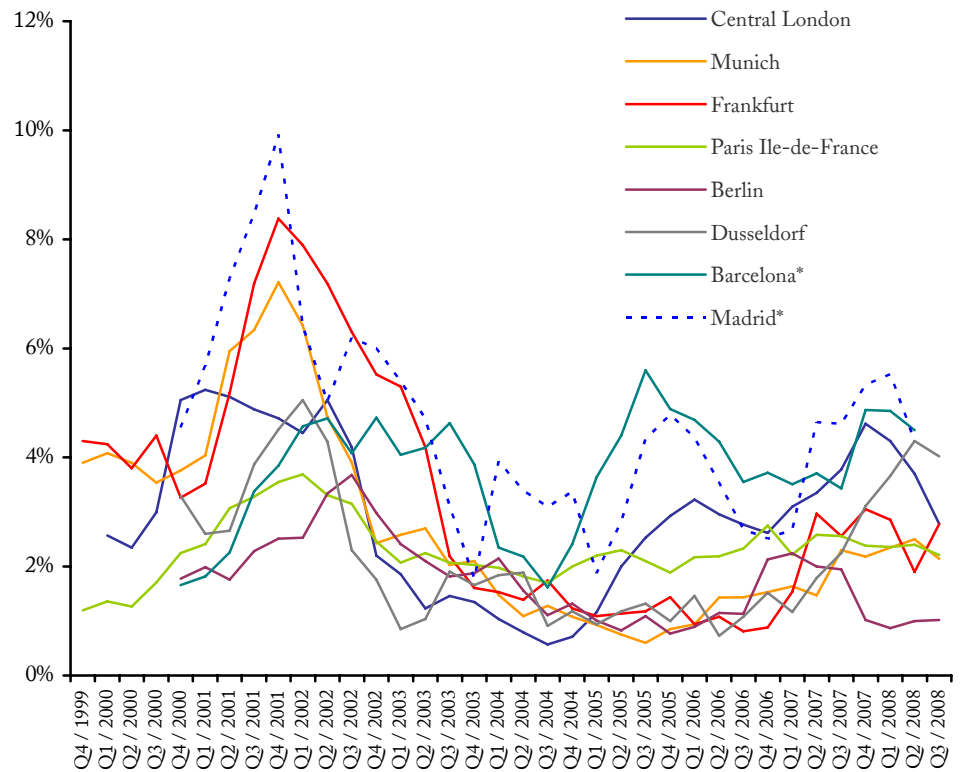
Change in the risk premium in Madrid



Sources: PMA, AEW Europe

Construction starts have tended to progressively decrease, even if Madrid and Barcelona are still characterised by construction site levels among the highest in Western Europe (over 3.5% of the stock per year in each of the two cities). In Madrid, 80% of the construction supply is situated in the suburbs. However, there were far fewer construction starts in 2008 than in 2000/2002.

Annual construction starts (% stock)

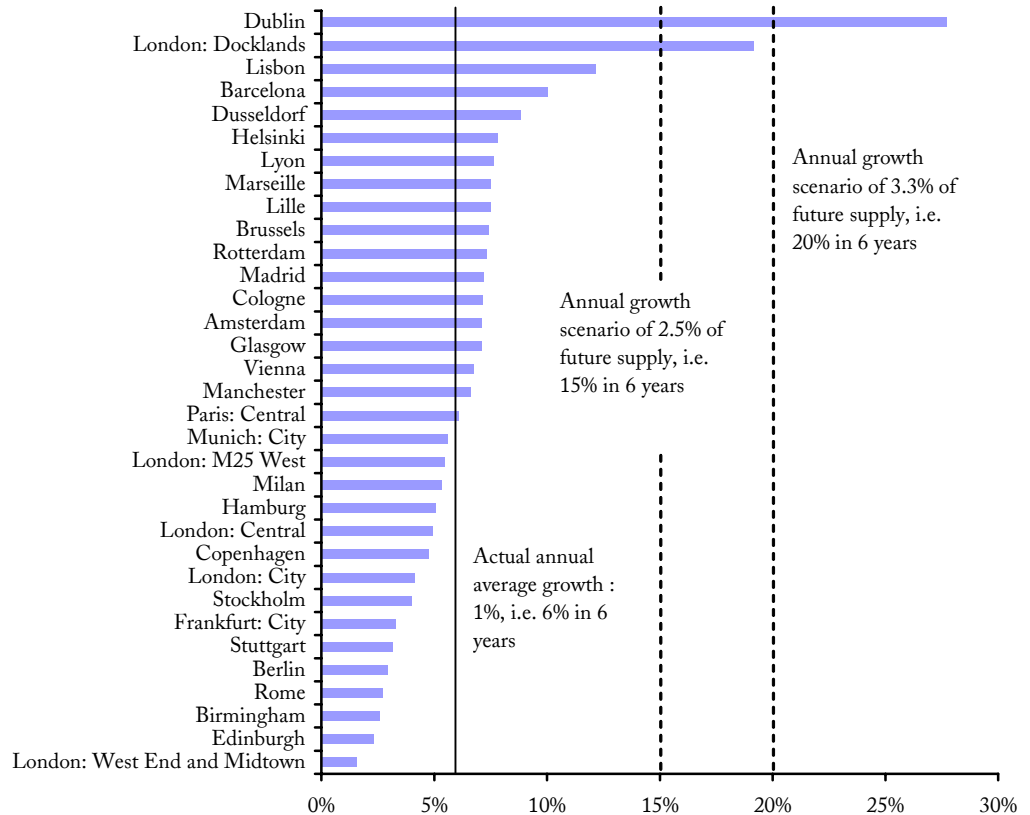


Construction starts have tended to progressively decrease and remain moderate on average in Europe

Sources: PMA, AEW Europe

At the current pace... It would take 100 years to replace the entire existing office stock

**Accumulated future supply of offices under construction
(% stock 2007)
6 years forecast**



Sources: PMA, AEW Europe

At the current pace, future supply of offices in Europe rate of growth is 1% on average of total existing office stock annually. It would take 100 years to replace the entire office stock. This is quite moderate compared to other possible scenarios. If future new supply grew by 2.5% of total office stock annually, the total office stock would be renewed within 40 years. If future new supply grew by 3.3% of total office stock annually, the total office stock would be renewed within 30 years.

Forecast of change in nominal prime office rents in Europe (€/sqm/year)

On the basis of key elements (macro-economy, future supply, creations of office jobs), it appears that during the 2009-2010 period, London City, West End, Madrid, Barcelona, Dublin and Manchester should experience more significant rental values correction that the other markets (falls of over 15% per year on average). The Rome, Paris and Budapest markets should undergo less significant corrections (between -10% and -15% per year). The Vienna, Helsinki, Stockholm, Milan, Brussels, Frankfurt and Lisbon markets should undergo a moderate fall (between -10% and -5% per year). The prime rental values in markets such as Munich, Hamburg, Berlin, Dusseldorf, Copenhagen, Athens, Prague, Warsaw, and Amsterdam should remain relatively stable (between -5% et 0% per year).

Our analysis shows that the change in the parameters of the office space investment market (the wait-and-see policy of investors, fear of a deep recession, credit restrictions) will result

in a rise in yield rates in 2009, and in our opinion, probably an over-reaction to the rise in these same rates.

**Average annual change forecast
for prime rents in Europe 2009-2010 (% pa)**

Change forecast	Cities
Stability (between -5% and 0% pa)	Munich
	Copenhagen
	Hamburg
	Athens
	Berlin
	Warsaw
	Dusseldorf
	Prague
Moderate fall (between -10% and -5% pa)	Amsterdam
	Vienna
	Helsinki
	Stockholm
	Milan
	Brussels
	Frankfurt
Correction (between -15% and -10%)	Lisbon
	Rome
	Paris La Défense
	Paris Central Business District
	Budapest
Sharp fall (over 15% pa)	Manchester
	Madrid
	Barcelona
	Dublin
	London West End
	London City

Source: AEW Europe

The expectations, even if very low, of economic growth rates, service sector jobs, combined with control of the new supply of office space, with a progressive return to normal of the credit markets, and with downward inflation in 2009-2010, will globally not lead to sharp falls in nominal rents

An over-reaction, because we show that the expectations, even if very low, of economic growth rates, service sector jobs, combined with control of the new supply of office space, with a progressive return to normal of the credit markets, and with downward inflation in 2009-2010, in the majority of European metropolises, will not lead to sharp falls in nominal rents (with the exception of certain markets, as we saw in the previous paragraph). An illustration of our analysis is the recent return of positive investment intentions targeting London offices for 2009 (after a highly negative year in 2008), as we saw on page 10, whereas these intentions have become negative for the rest of Europe (for 2009). Despite the impact of the economic contraction, the French and particularly the German (except Frankfurt) office markets seem to us the most resilient in the current context.

However, a threat in France could be the indexing of the current commercial rents, the ICC, which has sharply increased recently (+10.46% per year to 3Q08): Article L.145-39 of the French Commercial Code could be applied for certain tenants, granting them a new negotiation of the rental values at the market values, if the accrued growth from the indexing of their rent exceeds 25%. In March, representatives of landlords and tenants signed a draft treaty defining a new index for rents in the service sector, including office rents: the ILAT (Indice des Loyers d'Activités Tertiaires). This new index, which is long awaited by the actors in the market, is composed of 50% of the French IPC (Consumer Price Index, exc. tobacco and residential rents), 25% of the annual average of the ICC and 25% of the annual average of the French GDP. The ILAT, being less volatile than the ICC, could reveal as an alternative to the latter. The index is yet due to pass legal validation.

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AEW Europe is integrated with North American-based AEW Capital Management with aggregate gross assets under management of over €32 billion.



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www.aeweurope.com

AEW Europe
1-3 rue des Italiens
75009 Paris
France
Fax +33 (0)1 78 40 66 18

AEW Europe
33 Jermyn Street
London SW1Y 6DN
England -UK
Fax +44 207 016 4700

Mahdi Mokrane
Tel. +33 (0)1 78 40 92 60
mahdi.mokrane@aeweurope.com

Ken Baccam
Tel. 33 (0)1 78 40 92 66
ken.baccam@aeweurope.com

Laurence Tauzin
Tel. 33 (0)1 78 40 92 63
laurence.tauzin@aeweurope.com

Marc Langenbach
Tel. 33 (0)1 78 40 92 62
marc.langenbach@aeweurope.com

Nigel Allsopp
Tel. +44 207 016 4868
nallsopp@aeweurope.co.uk

Chao Zhou
Tel. 33 (0)1 78 40 92 64
chao.zhou@aeweurope.com

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