

Are we there yet? Overview of the European real estate markets

February 2010

As we progress through 2010, the contrast in sentiment to the beginning of 2009—both for the broad European economy and the commercial real estate sector—could hardly be larger. While we feared the worst, the European economy proved to be more resilient than expected in 2009. Corporate bonds and equities rallied strongly and real estate benefited too: the volume of real estate transactions increased across Europe, capital values in the UK bounced back and some of the worst-hit markets seemed to stabilise. However, the bigger picture remains unclear since there is considerable divergence between countries, secondary assets are still under pressure, and the lending market has not completely recovered.

In this paper, we offer a number of guideposts to measure how far we have come and how much further we have to go to see a full recovery in European real estate. We also highlight some of the major risks and give our view on the prospects for real estate. But to put our views on the outlook upfront, we think that 2009 will represent a trough for property prices and fundamentals, though the extent and pace of recovery remains unclear.

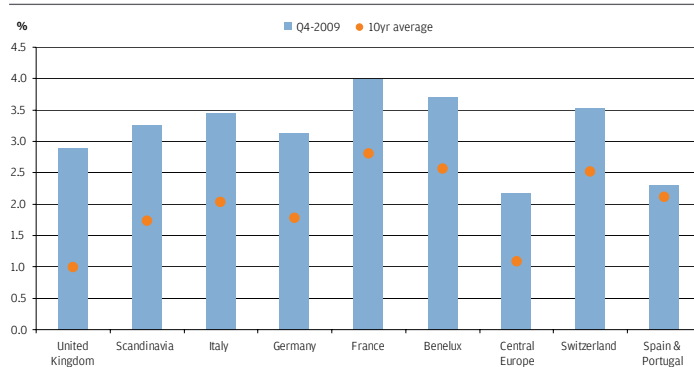
Guideposts for Recovery

We can get a sense of where we are in the recovery cycle by looking at the historical recovery paths of real estate and similar risky asset classes. The market for commercial real estate in Europe has already come a long way. Capital values have fallen sharply, the lending market is not completely frozen anymore and the number of transactions has picked up. In our opinion, these are all prerequisites for a recovery. Our guideposts are specifically:

1. An improvement in relative value
2. A greater availability of debt
3. A pick-up in transaction volume
4. A floor in the decline in capital values
5. A resurgence in the occupier market

The first guidepost, an improvement in relative value, is a key condition for investors to consider real estate again. The recent price declines—40% in the UK, 20-30% on the continent—appear to have accomplished that already. The spread between property yields and government bonds is well above its 10-year average. The spread of UK prime property yields over gilts, for example, is currently around 3.7% which is significantly higher than its long-term average of 0.9%. This is the case for all European markets as illustrated on Chart 1.

Chart 1 | Spread between property and government bond yields

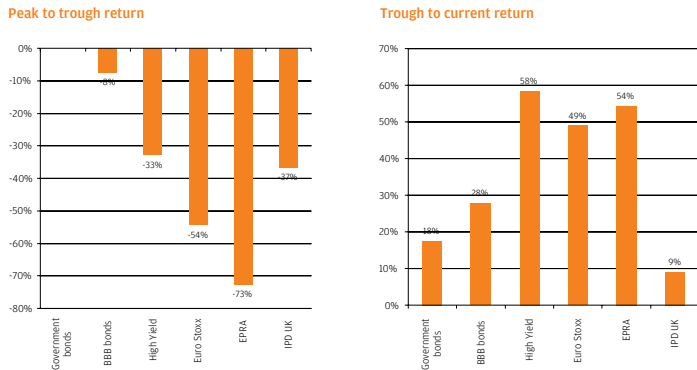


Source: DTZ Research; J.P. Morgan Asset Management.

Another way to look at the emerging relative value is shown in Chart 2. The decline in bond yields is evident by the hefty trough to current return in sovereign bond yields. But it is also evident that risky assets in general have rallied, with corporates, the broad stock market and the REIT market also rallying sharply. Indeed, European private real estate stands out as one of the few asset classes that have not already had a substantial move from trough pricing.

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Chart 2 | Capital growth across asset classes

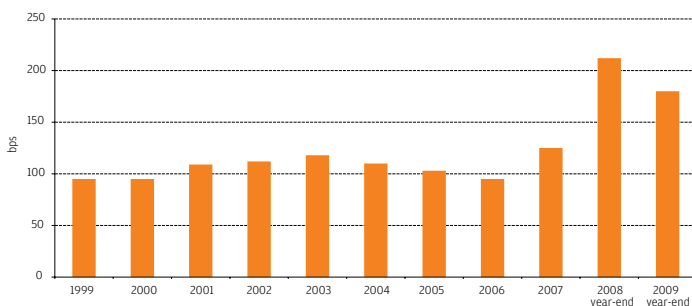


Source: Morgan Markets; IPD; J.P. Morgan Asset Management.

The key takeaway from the preceding charts is not to say that real estate values have to rise. The key point is that real estate is not an investment island. We know that real estate recovery tends to lag the general economy, but it's hard to make the case that we could sustain a situation where credit markets and asset prices stage a broad and decisive recovery across risky asset classes—which all have to price in weak economic assumptions—yet real estate does not get any benefit as global capital allocators look at their options.

The second guidepost is an improvement in the availability of debt. Beginning in the latter half of 2007, the lending market froze and it became extremely difficult to have access to financing. This situation was exacerbated by the collapse of Lehman Brothers in September 2008. As a result, the interest rate margin charged by banks, which are the biggest lenders in the European market, jumped to very high levels as illustrated below.

Chart 3 | Interest margins for prime office in the UK

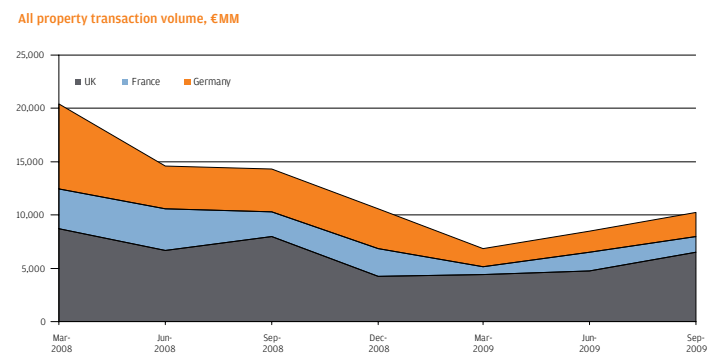


Source: De Montfort University; J.P. Morgan Asset Management

Chart 3 shows the interest rate margin charged for a regular loan on a prime office investment in the UK. By the end of 2008, the margin had risen to 215 basis points, which was more than double the margins recorded in previous years. At the time, banks were unwilling to lend and the securitized market was completely shut. The deadlock lasted for a few months until some of the banks started lending again towards the middle of 2009. The interest rate margin came down to 180 basis points by the end of 2009 and continued to decrease in 2010.

Admittedly, the lending market for UK prime property is not fully representative of the whole European market. Most prime markets have experienced a similar improvement as in the UK, but it hasn't been the case for secondary markets. We believe, however, that we are moving in the right direction and that the lending market will improve further.

Chart 4 | Investment transaction volume



Source: DTZ Research; J.P. Morgan Asset Management.

The third guidepost is a pick-up in the volume of transactions. This is an important condition because it allows price discovery to happen and improves confidence. The main investment markets have seen an increase in the volume of transactions in the last two quarters. Whilst this increase takes place from a very low level, it is quite significant for most markets as illustrated above in Chart 4, and it suggests that at some point in the second half of 2009, investors came to believe that then-current prices were at or below fair value, particularly in the UK, where prices fell earliest and most and where the subsequent recovery is most advanced.

That said, the modest improvements in transaction volume and spot pricing have been concentrated in prime properties that have what might be termed “bondable” cashflows: Class A locations fully leased for long periods to quality credit tenants. So the pick-up in the volume of transactions is not—yet—representative of the whole market since the share of secondary assets, which make up the bulk of the market, has been very low. It is, however, a notable improvement and we believe the market is moving in the right direction. We think a key indicator will be when transactions in non-core assets and locations return in earnest. We have yet to see that and that will be necessary to consider real estate investment markets to be normal.

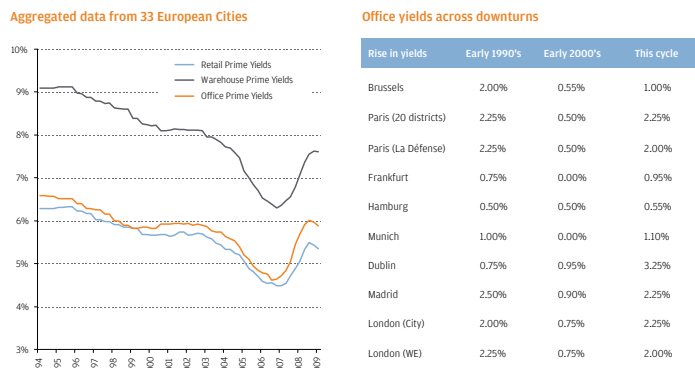
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The fourth guidepost is a reversal in the decline in capital values. Chart 5 shows both the dramatic rise—150-200 basis points—in prime transaction yields that has pushed capital values down throughout Europe, but also indicates that they appear to have peaked and actually moved lower in the third and fourth quarters. Again, positive price momentum appears to have come to an ever broadening portion of the European real estate market, with France and now Germany joining the UK rebound.

In the case of the UK, capital values recorded by the IPD all-property index have risen by 3% over the last three months. Other measures also suggest that capital values are bottoming: UK-focused REITs are now trading at a premium to NAV and property derivative pricing implies a further gain.

We expect the French market to be the next market to recover after the UK. Prime property yields in Paris have already started to decline and expectations for rental growth might be revised up if the economy holds up better than expected.

Chart 5 | Prime office yields



Source: DTZ Research; J.P. Morgan Asset Management.

Caveats about the breadth of the rebound notwithstanding, we should draw some confidence from the fact that this is the path we would expect to be followed given real estate history and given what has happened in other asset classes this cycle. The recovery in transaction volume and pricing occurs first in the lowest risk assets, followed by the rest of the market. Absent another set of negative shocks like the Lehman collapse (and we should not get overconfident that such shocks cannot happen given what we have just been through), it would be surprising if real estate prices turned back down as long as we remain on the path of healing in the credit markets and broad economy.

So is it all over? We can not know for sure, but we can get some comfort from historical experience. The table on the right in Chart 5 shows prime office yields in a number of markets in three business cycles. If we take the rise in yields in the early 1990s real estate depression as a benchmark of how much pricing has fallen historically, today's rise in yields in most markets has been about in line with that period, despite a much more benign supply side. So that is supportive of the notion that price adjustments to date may be over.

That said, as was the case with transaction volumes, it is key to note that these are "prime" yields, not average yields. Again, a true measure of broad normalcy returning to markets will be when transaction volume and pricing gains broaden out from the most prime properties to average properties.

Moreover, there is also a clear divergence between the different markets of the speed of the re-pricing. The UK, for example, has seen capital values bottom while Germany is still experiencing capital declines.

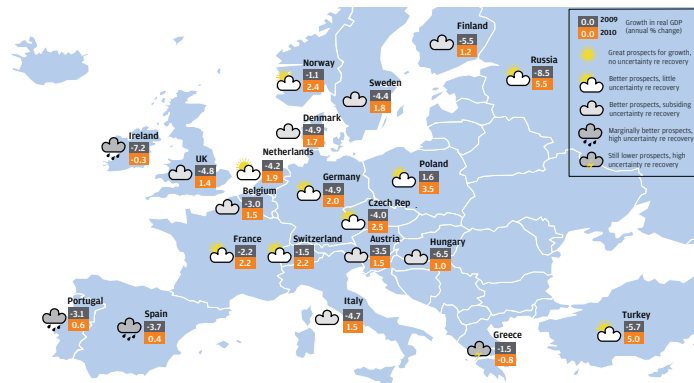
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Occupier Markets

The final guidepost is the resurgence in the occupier market. Take-up has already shown some signs of improvement, and new supply has corrected faster than we expected. However, the occupier market is still under pressure and it is unlikely to recover quickly. This section lays out our view on how we expect the fundamentals picture to develop in 2010.

On the fundamentals, the broad theme is that the worst fears of the Spring have not come to pass and the recession appears to have ended for Europe overall, though recovery is halting and uneven.

Chart 6 | Real GDP forecasts



Source: J. P. Morgan Securities; J.P. Morgan Asset Management.

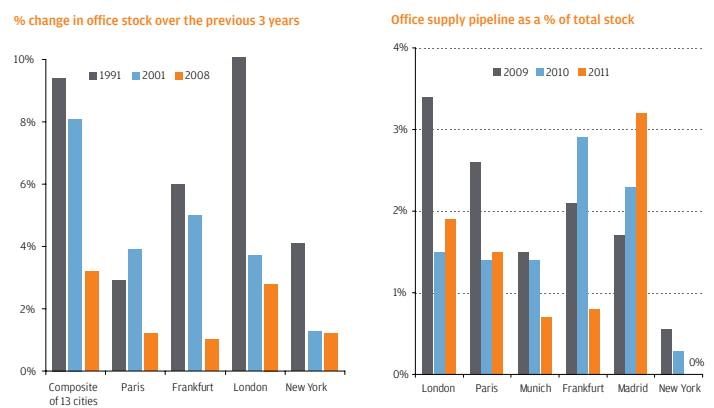
Of the big three European economies, the strongest near term growth is expected in Germany, which benefits from manufacturing and export exposure to Asia. The weakest is the U.K., which is constrained by its high finance exposure and the bursting of its consumer credit bubble. Nearer to German prospects is France, which has benefited from generally resilient domestic demand and lack of exposure to asset bubbles seen in the UK, Spain and Ireland.

Looking across the rest of Europe we see general strength in the Nordic and Benelux countries, which tend to have well balanced economies and solid consumer and government balance sheets; and relative weakness in southern and emerging Europe, which are struggling with large budget deficits, which limit the ability to use fiscal stimulus; with the reversal of foreign investment flows; and with the end of the “devaluation put” (problems evident in Greece in particular right now).

Before moving on to the property markets, it should be pointed out that while we do expect divergent growth across Europe, even for the expected outperformers in 2010, the previous fall in output has had a lasting effect which will be felt on hiring and unemployment, for some time. And that ultimately may cause the property market recovery to lag.

That said, it is equally important to note that while occupier markets have obviously deteriorated, they have not deteriorated to the extent that the decline in jobs might suggest they should have. It is striking to note, for instance, the extent to which not only office leasing has picked back up in some of the cities hardest hit by the financial crisis (London in particular), but that overall vacancy rates already show signs of peaking. This is a surprising development that cannot be explained by a contained supply side conditions (see chart 7 below), but rather appears to reflect more resilient demand. Indeed, third party forecasts have generally been revised up throughout the year not simply because economic forecasts have improved, but because tenants have held onto space to a greater extent than might have been expected.

Chart 7 | Change in office stock and supply pipeline

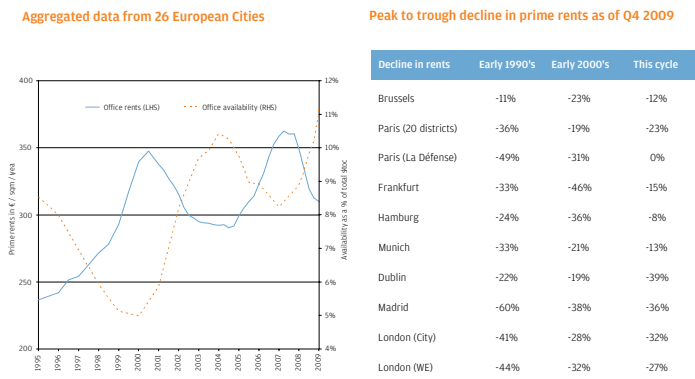


Source: DTZ Research; J.P. Morgan Asset Management.

We see this divergence between the economic and property market performance most clearly in the office sector. While overall take-up is still well below long-term averages, leasing volume was up in every major European market in the third quarter. In the 21 largest markets, leasing volume rose roughly 10% from the second quarter and 30% from the first quarter.

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Chart 8 | Prime office rents



Source: DTZ Research; J.P. Morgan Asset Management.

Office availability rates ticked up, crossing 10% for the first time since 2004, and rents remain under pressure. The pace of rent declines has moderated overall (you can see that at the end of the chart), but they remain under pressure and concession packages remain very high.

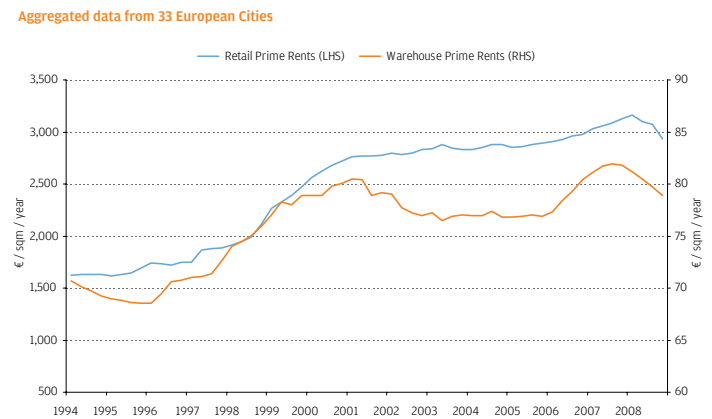
So how do we reconcile these two somewhat contradictory observations—strong rise in leasing with ongoing weakness in rents? First, as we saw in a previous chart, there is some new supply working its way through the pipeline. Moreover, many of these are just relets of existing leases, which do not represent true net absorption.

But there is some important forward looking information even in the increase in relets. The stabilization in the economy has obviously increased business confidence and broken some decision making paralysis. More tellingly, tenants are voting with their agents; they increasingly sense that rents are bottoming and this may be as good as it gets, particularly for large blocks of space.

The table on the right of chart 8 shows some historical support for this view. Among major markets, rent declines have been large and broadly comparable with peak to trough declines experienced in the last two real estate downturns, with the notable exception of La Defense and the German markets.

So have office rents bottomed? We can't know, but the stabilization in the economy, rising business confidence and leasing and historical precedent suggest that if we are not there, we are probably close.

Chart 9 | Prime retail and warehouse rents

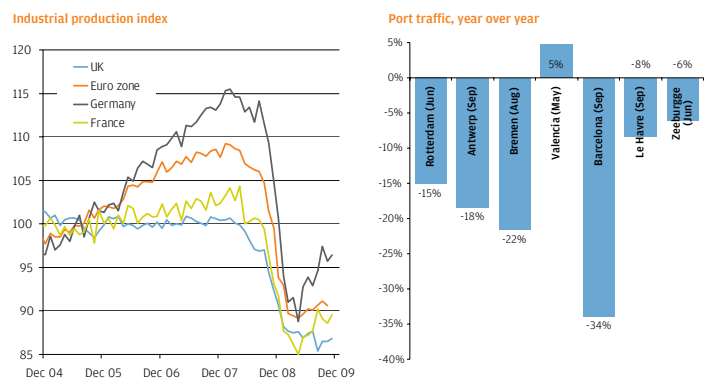


Source: DTZ Research; J.P. Morgan Asset Management.

As with the office market, the logistics market has been hard hit in the last six months, the result of weak demand from manufacturers and distributors, amid the sharp declines in industrial output, trade volumes and retail spending. As in the office market, gross take-up has fallen sharply, and the decline in rents has accelerated, even given the quick moderation in new supply that is typical of the logistics market.

We do think that substantial downward pressure on rents and leasing remains, but an anticipated rebound in both consumer spending and industrial production will likely stem the tide in 2010. We think that rebounding trade and industrial production favour key trading hubs such as Rotterdam, Amsterdam, and Hamburg, while any rebound in consumer spending and distribution will favour relatively supply constrained principal cities, such as Milan, Lisbon, and Paris.

Chart 10 | Industrial production and port traffic

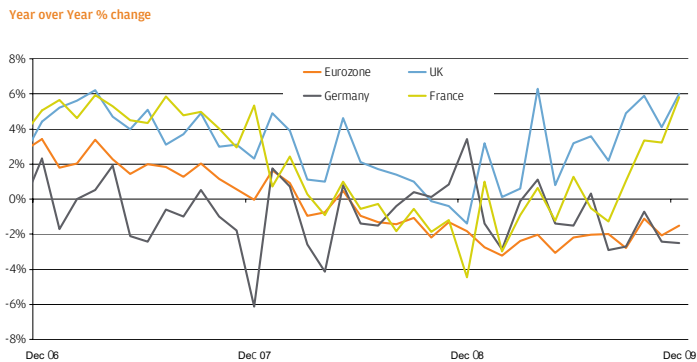


Source: MorganMarkets; individual ports, J.P. Morgan Asset Management.

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The retail story is a bit more positive. In fact this is another example where tenants have been surprisingly willing to sign deals on a relatively attractive basis. The key for retail, obviously, is how soon and how strongly consumer spending rebounds. Elevated unemployment will be a headwind throughout most of Europe, but we do think some regions will do better. In particular, regions with high savings rates and minimal domestic credit bubbles, such as France and Germany, face the fewest structural adjustments to household balance sheets. At the opposite end are countries like the U.K., Spain and Ireland, where consumers face not only a bad job market, but the need to increase their savings to rebuild lost wealth (though the data actually do not yet bear that out as retail spending in the UK has proven surprisingly resilient).

Chart 11 | Retail sales



Source: Morganmarkets; J.P. Morgan Asset Management.

Conclusion

So to sum up where we are on our recovery track, lower prices and falling bond yields have generated relative value, a development which, along with the revival of real estate debt markets, has increased transaction volume and pricing for prime core assets. Occupier markets will lag, but there are signs that leasing activity is picking up in key markets.

The biggest risk that the occupier market faces in our view is the risk of a double-dip recession in 2010. Although the economy seems to be on the right track, it could still relapse as governments reduce their fiscal stimuli and central banks raise their interest rate targets. However, as an investor, we remain cautious and are willing to price in this risk in our future acquisitions. We think the market currently offers great investment opportunities provided that the risks are correctly priced.

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European Snapshot

Standard office lease terms

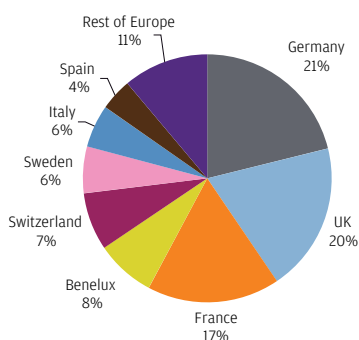
Country	Term length	Break rights	Transfer tax	Indexation	Market size* (EUR billion)
Germany	10 years	Every 5 years	3.5%	Annual indexation	268
UK	10-15 years	Rare	4%	5-year upward-only review; tenant right to renew	249
France	9 years	Every 3 years	4.8%	Annual or 3-year indexation; tenant right to renew	219
Switzerland	5-10 years	No	3%	Annual indexation; renewable for a further 5 years	95
Sweden	3-5 years	No	3%	Annual indexation; tenant right to renew	78
Italy	12 years	Every 6 years	4%	Annual indexation	71
Netherlands	5-10 years	No	6%	Annual indexation	68
Spain	3-5 years	No	3%	Annual indexation	54
Belgium	12 years	Every 3 years	12.5%	Annual indexation	31
Austria	5-10 years	No	4.5%	Annual indexation	17
Portugal	5 years	No	6.5%	Annual indexation	13

* IPD estimates

Major cities

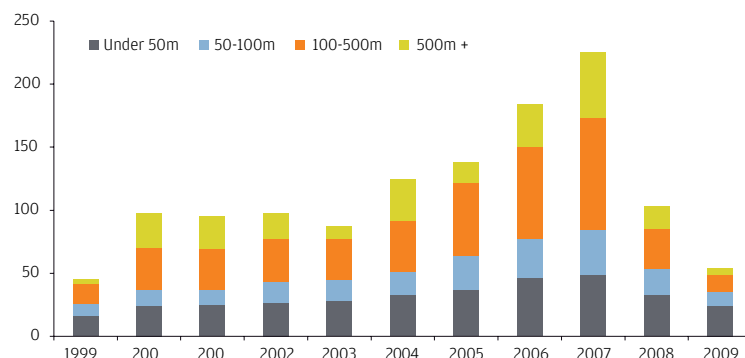
Country	City	Prime yields						Prime rents (EUR /sqm/year)			
		Office			Retail			Office		Retail	
		As of end of 2009	Change in 2009	10-year average	As of end of 2009	Change in 2009	10-year average	As of end of 2009	10-year average	As of end of 2009	10-year average
Germany	Frankfurt	5.5%	0.25%	5.3%	5%	0.00%	5.1%	410	460	2,940	2,500
	Munich	5%	0.25%	4.9%	4.25%	0.00%	4.8%	360	370	3,600	2,970
	Hamburg	5.5%	0.25%	5.6%	5.25%	0.25%	5.3%	290	270	2,700	2,300
	Berlin	5.5%	0.25%	5.3%	5.50%	0.25%	5.4%	260	290	2,590	2,300
UK	London	5.25%	-0.75%	5.1%	4.75%	-0.50%	5%	980	930	6,740	6,050
	Birmingham	6.25%	-0.75%	6.1%	5.0%	-1.00%	5.2%	340	330	3,980	4,030
	Manchester	6.25%	-0.50%	6.2%	5%	-1.00%	5.1%	330	320	3,430	3,700
France	Paris	5.75%	0.25%	5.3%	5.2%	1.00%	5.3%	700	710	7,350	8,070
	Lyon	6.5%	0.00%	7%	6.25%	0.00%	7%	230	210	2,410	1,900
Sweden	Stockholm	5.5%	0.25%	5.5%	5.4%	0.50%	5.5%	380	390	1,400	1,320
Italy	Rome	6.5%	0.25%	6%	5.5%	0.25%	5.5%	380	370	2,200	1,700
	Milan	6.25%	0.75%	5.6%	5.5%	0.25%	5.4%	480	470	2,400	1,900
Netherlands	Amsterdam	6.5%	0.00%	6.5%	5%	0.00%	5.6%	340	330	2,750	1,900
Spain	Madrid	6.25%	0.25%	5.4%	6.25%	0.00%	5.6%	319	360	2,100	1,600
	Barcelona	6.25%	0.25%	5.5%	6.25%	0.00%	5.9%	240	290	1,750	1,500
Belgium	Brussels	6.5%	0.50%	6.2%	5.25%	0.50%	5.3%	260	270	1,600	1,300

Market size as a percentage of total Europe



Source: IPD, J.P. Morgan Asset Management

Investment volumes in Europe by lot size (EUR billion)



Source: DTZ Research, J.P. Morgan Asset Management

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