

European Real Estate Outlook

J.P. Morgan Asset Management

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At a Glance

Recent economic uncertainty will inevitably lead to a flight to quality in terms of location, asset and manager. Whilst real estate will inevitably be affected by the continuing turmoil in the market, the defensive qualities of income producing real estate will be particularly attractive to investors.

The weight of capital chasing real estate is set to grow with investment transaction activity likely to rise by 25-30% over the year. The focus will continue to be on income producing, core real estate.

Investment performance will become increasingly polarised as the drivers of value growth shifts towards the occupier market.

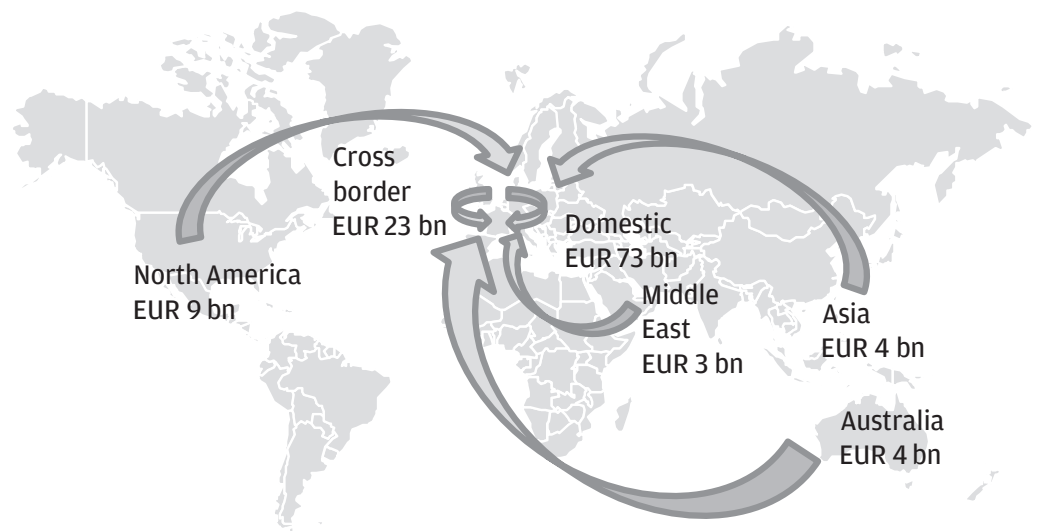
The office sector was the first to recover and will continue to lead the process of recovery in 2011-12.

London, Paris and Warsaw will outperform the European average in terms of rental growth.

Whilst there is less scope for yield compression going forward compared to the recent past, this could still be an important driver of values in a small number of European markets.

Core market total returns are expected to be in the 8-10% range with performance led by markets such as Warsaw (capital appreciation) and London (rental growth).

Chart 1: Investment flows in 2010



Source: Real Capital Analytics, data as of June 2011

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European Economy

Whilst core European economies emerged out of recession and whilst some of the smaller peripheral markets have recorded outstanding rates of growth, Europe is still a long way from being in a sustained recovery.

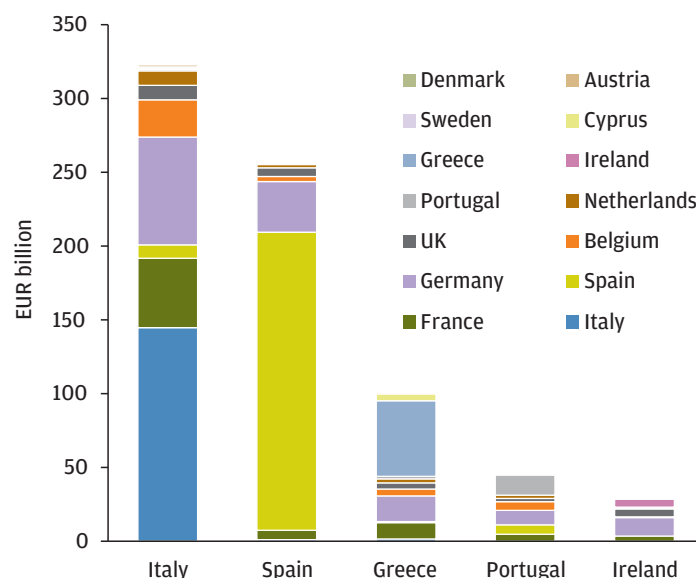
The sovereign debt issue is NOT a peripheral European problem. The virus is highly contagious and could be easily transmitted to core markets unless a credible and coherent strategy is implemented.

Doomsday Scenario

Default, whether in Greece or Italy for that matter isn't necessary. It simply needs the present turmoil and, eroding confidence, to continue before the European market begins to look like a very different place:

1. Flight to quality with a focus on the largest, most liquid and transparent European markets.
2. Continued devaluation of the Euro forcing an increase in interest rates.
3. A real likelihood that the economic and leasing market recovery could be delayed if not de-railed.
4. Less availability of debt in core markets.
5. A drift out of property yields and less bank debt could lead to a softening of real estate prices.

Chart 2: Bank holdings of sovereign debt



Source: FT, data as of November 2010

Sovereign default may be an extreme scenario but it is not inevitable. However a semblance of stability will require:

1. A coherent and credible stance in both Frankfurt and Berlin.
2. Confidence that the various austerity packages are not just approved by the respective Parliaments but actually stand a chance of being implemented.

Table 1: European economic outlook (GDP %)

Economic Outlook (GDP %)		2010	2011	Comment
Core Markets	Germany	3.5	3.5	Exports remain the prime driver of economic growth - consumer confidence is high - unemployment continues to fall
	France	1.4	2.1	Less affected by the crisis - slow but steady growth - unemployment is falling slowly
	UK	1.4	1.3	Steady growth despite fiscal consolidation - inflation remains a concern - big divergence between London and the rest of the UK
Star Performers	Sweden	5.4	4.2	Strong growth driven by consumer spending and exports - expected to slow down as financial conditions become tighter
	Poland	3.8	4.2	Only country to record positive growth in 2009 - strong performance in 2010 and 2011 - gradual appreciation of zloty erodes comparative advantage
	Turkey	8.9	6.7	Strong consumer demand and business investment - investor appetite will grow as government bonds are expected to be re-rated investment grade
	Russia	4.0	4.7	Strong growth set to continue off the back of commodity prices
Economic Laggards	Greece	-4.4	-4.8	Major concern over the sustainability of overall debt burden
	Ireland	-0.4	-1.0	Austerity package will continue to bite
	Spain	-0.1	0.7	Sluggish economic growth - doubts about the health of local savings banks - unemployment has peaked
	Portugal	1.3	-2.0	Austerity measures expected to hold back growth

Source: Oxford Economics, JP Morgan Asset Management, as of June 2011

Occupier Market

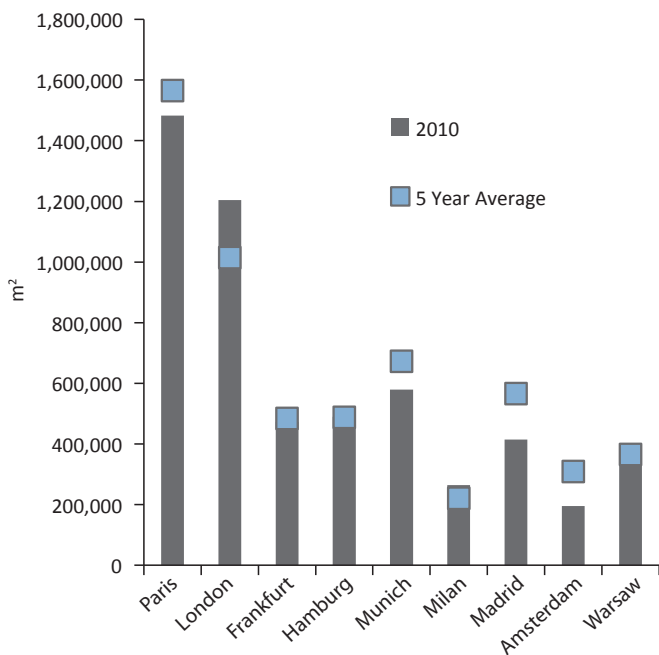
Office Sector

Despite the rate of economic growth, leasing activity has recovered relatively well in major markets over the last year or so. Vacancy levels have stabilised or continue to fall leading to tight market conditions in a number of key office markets.

The improvement in occupier demand has been almost entirely restricted to the prime end but could easily be blown off course in the second half of the year.

The primary driver of demand has tended to be lease renewals and consolidations rather than employment growth and net absorption and that will prolong the lag in rental growth.

Chart 3: Take-up levels in key European cities



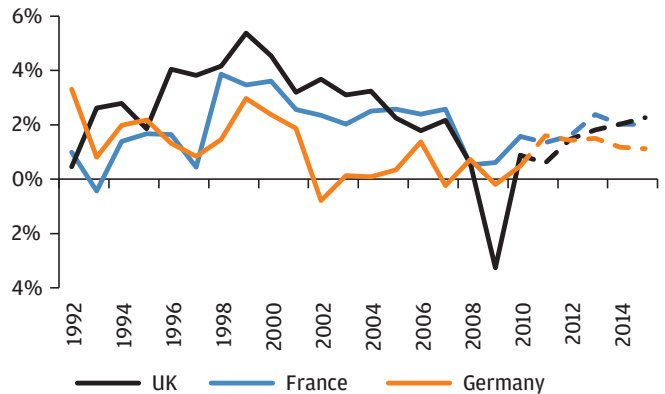
Source: DTZ Research, data as of June 2011

Whilst rents in central London, Paris and Warsaw have enjoyed substantial growth, most office markets will continue to experience very modest rates of rental growth of 5% or less.

Retail Sector

High unemployment, consumer debt, increased taxation, and a growing number of retail bankruptcies are all dampening recovery in the sector.

Chart 4: Consumer spending growth, y/y



Source: Experian, data as of June 2011

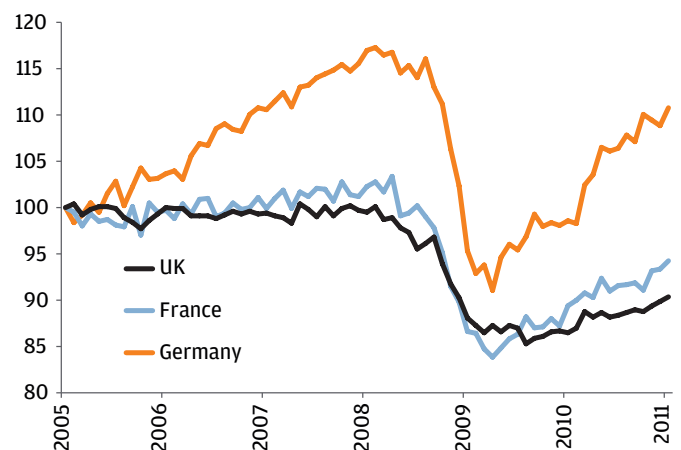
Nevertheless, performance has been polarised with large, dominant, shopping centres with good operators continuing to perform well despite the problems associated with the retail sector. Such centres offer both a degree of protection on the downside and significant income and capital appreciation potential on the upside.

Industrial Sector

The relatively high and stable income return of the industrial sector should make it increasingly attractive to a broad range of investors. However, the sector will continue to lag the recovery in other commercial markets.

The growth in world trade has been a positive driver of demand in the logistics sector but it has not been enough to counteract both the level of over-capacity in the market and sluggish domestic demand, circumstances which are unlikely to change in the short/medium term.

Chart 5: Industrial production index



Source: Datastream, data as of June 2011

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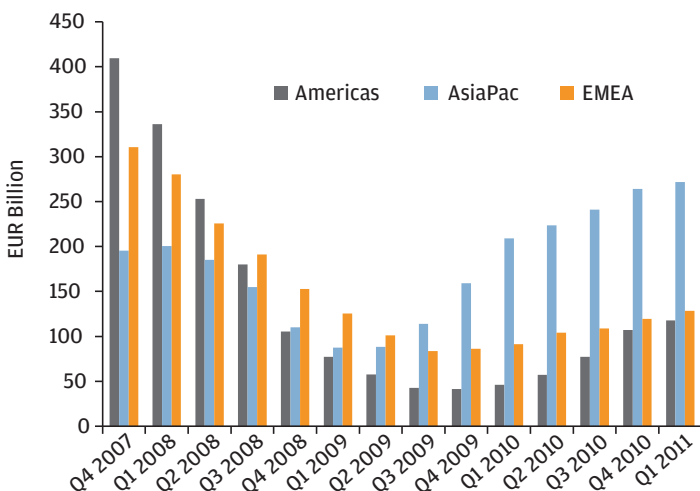
Investment Market

Investment activity exceeded EUR 100bn in Europe during 2010. Overall, it is expected that the level of activity could increase by 25-30% in 2011 from a range of diverse capital sources including unlisted funds, REITs, sovereign wealth funds and high net worth individuals.

Most investors continue to be attracted by core assets with good quality tenants. Investment activity is somewhat constrained in these core markets by both competitive pricing and the perceived lack of investment stock.

New opportunities are likely to come from banks selling distressed assets, German open ended funds redeeming and insurance companies who may need to rebalance portfolios in the face of significant regulatory changes.

Chart 6: Investment volume, 4 quarters rolling



Source: Real Capital Analytics, data as of June 2011

The recovery in liquidity has been the dominant driver of real estate pricing across most European markets over the course of the last few years. 2011 will, however, be a year of transition with the occupier market becoming increasingly important in driving growth in real estate values.

Prime yields have stabilised in most office markets. Whilst the scope for further yield compression is less than it was, there are still a number of markets across Europe where further yield compression is likely and responsible for most growth in value.

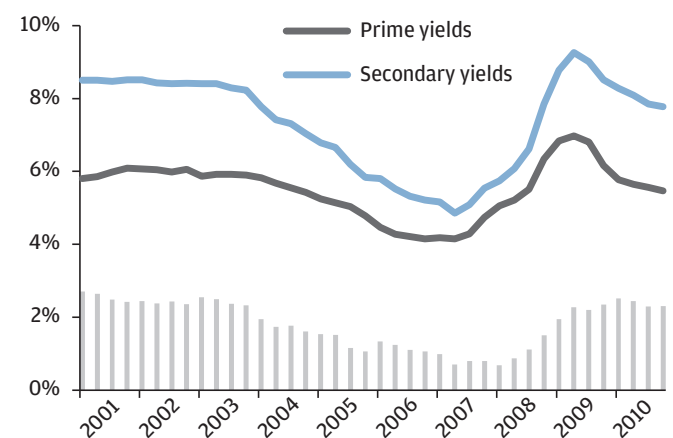
Table 2: Prime office yields

	Peak	Trough	Today	2015
Paris	3.75%	6.00%	4.50%	5.00%
London	4.25%	7.00%	5.25%	5.75%
Frankfurt	4.55%	5.50%	5.05%	5.15%
Hamburg	5.00%	5.55%	5.00%	5.25%
Munich	3.90%	5.05%	4.70%	5.00%
Milan	5.15%	6.25%	6.00%	6.15%
Madrid	4.00%	6.25%	5.75%	5.45%
Stockholm	4.25%	5.40%	4.85%	5.25%
Amsterdam	5.25%	6.40%	5.90%	6.25%
Warsaw	5.40%	7.00%	6.50%	6.25%

Source: DTZ Research

The spread between prime and secondary yields is currently at an all-time high, reflecting the lack of investor interest for secondary properties. This spread offers opportunities for value-add investors with access to debt and who are willing to take calculated risk in the secondary market. This is also the segment of the market most vulnerable to further economic turmoil and falling confidence.

Chart 7: Office yields in the UK



Source: DTZ Research, data as of June 2011

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Market Statistics

Table 3: Standard office lease terms

Country	Term length years	Break rights	Other notes
UK	10-15	Rare	5-yr upward-only review; tenant's right to renew
Germany	10	Every 5 years	Annual indexation
France	9	Every 3 years	Annual or 3-yr indexation; tenant's right to renew
Italy	12	Every 6 years	Annual indexation (79% of index)
Netherlands	5-10	No	Annual indexation
Switzerland	5-10	No	Annual indexation; renewable for further 5 years
Spain	3-5	No	Annual indexation
Sweden	3-5	No	Annual indexation; tenant's right to renew
Austria	5-10	No	Annual indexation
Belgium	12	Every 3 years	Annual indexation
Portugal	5	No	Annual indexation

Source: JP Morgan Asset Management, data as of June 2011

Table 4: Investment volumes and market size, EUR billion

Country	Investment Volume 2010	Estimated size of the market
UK	39.3	272
Germany	18.3	270
France	11.5	210
Sweden	7.1	104
Netherlands	5.1	115
Norway	4.2	40
Spain	4.2	40
Italy	4.1	84
Poland	1.9	15
Belgium	1.5	42
Finland	0.8	40
Czech Republic	0.6	11
Ireland	0.2	3

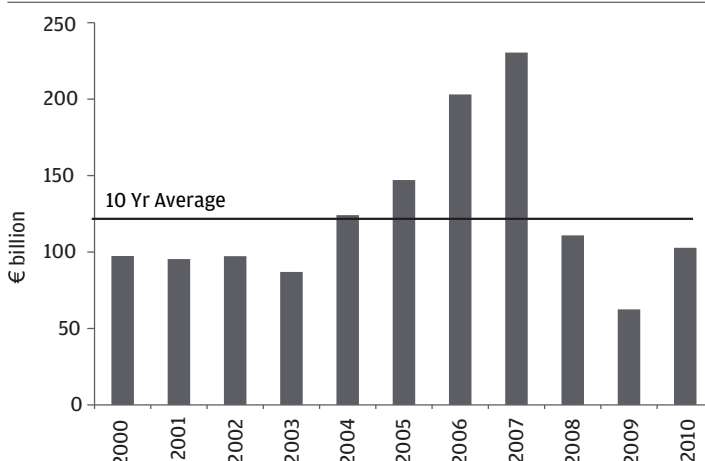
Source: DTZ, IPD, data as of June 2011

Table 5: Major cities – size, yields and rents

Country	City	Population Million	% of country	Yields		Rents			
				Prime initial yield % pa office	retail	Prime rental level EUR/m ² /year office	10yr average	retail	10yr average
UK	London	7.4	12%	4.5%	4.3%	1,100	1,014	8,561	7,398
	Birmingham	1.0	2%	6.3%	4.8%	336	343	3,730	3,808
	Manchester	2.2	4%	6.0%	5.0%	354	349	3,238	3,265
Germany	Frankfurt	5.6	7%	5.1%	5.0%	414	415	3,000	2,935
	Munich	6.1	7%	4.7%	4.3%	360	361	3,720	3,602
	Hamburg	4.6	6%	5.0%	4.8%	282	289	2,760	2,700
France	Berlin	6.0	7%	5.1%	5.0%	264	265	2,640	2,597
	Paris	11.2	18%	4.5%	4.8%	750	723	7,350	7,350
Italy	Lyon	1.6	3%	6.0%	5.3%	240	235	2,413	2,413
	Rome	3.7	6%	6.3%	5.4%	420	389	2,200	2,200
Netherlands	Milan	7.4	13%	6.0%	5.3%	520	489	2,400	2,400
	Amsterdam	7.5	46%	5.9%	4.9%	380	353	2,700	2,765
Switzerland	Zurich	2.5	33%	4.3%	n/a	850	868	n/a	n/a
Spain	Madrid	5.6	13%	5.8%	5.8%	287	313	2,000	2,080
	Barcelona	4.9	11%	6.0%	5.8%	214	240	2,040	2,040
Sweden	Stockholm	2.2	24%	4.9%	4.9%	499	450	1,572	1,550
Belgium	Brussels	3.8	36%	6.2%	5.0%	265	267	1,650	1,613

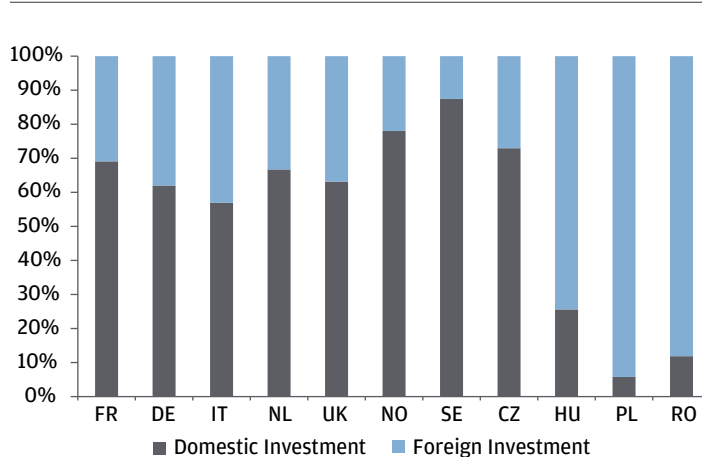
Source: DTZ, OECD, JP Morgan Asset Management, data as of June 2011

Chart 8: Investment volume in Europe



Source: DTZ Research, data as of June 2011

Chart 9: Source of capital by country in 2010, %



Source: DTZ Research, data as of June 2011

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