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Capital Markets Outlook - 2010

Uneven Terrain

Investment markets in Europe are past the worst of the downturn and market drivers are trending up from all time lows, however, 2010 will likely be another challenging year for investors.

Values are likely to be under downward pressure, but investor sentiment should remain positive during 2010 as capital seeks opportunities ahead of a recovery even though occupational markets remain weak.

Refinancing will continue to worry the market and the availability of new debt, although increasing, will provide a drag on investment volumes.

It will also remain difficult for investors to place capital due to increasing competition and, we suspect, a lack of opportunities. Although banks will ensure a slow but steady flow of product, investors will need to be committed and creative to make deals happen.



Capital Markets Outlook 2010: Uneven Terrain

European investment markets are now past the lowest point of one of the worst investment downturns in history. Investor confidence has improved from the historic lows at the beginning of 2009 and market drivers are trending up. Economies remain weak but the majority have returned to growth, albeit at a pace which is considerably below trend.

We expect 2010 to be a challenging year for investors to navigate and the recovery will be uneven. Investors will find it difficult to secure product, to identify value and to establish pricing levels. Many investors and banks will still be working through legacy issues and refinancing remains a major concern. The impact of the downturn will continue to be felt across much of the continent and where recoveries emerge they will be uneven in speed and strength.

The early upside of the investment market cycle has in the past, proven to be one of the most profitable times in the cycle to invest but it also has its risks. This cycle is no different to others in that respect, the start of profit taking in the UK has demonstrated that there will be winners in 2010, but the uneven pattern of recovery and the widespread downside risks will ensure that being one of them will not be easy.

The Economic Recovery

The outlook for recovery is patchy but improving for all economies. Most European countries returned to positive growth by Q3 2009 but this was largely driven by government support packages and restocking with limited signs of an underlying strengthening in consumer demand and corporate investment.

Fiscal and monetary tightening is a likely theme for 2010 on a European scale and has the potential to slow the recovery. This will, however, be uneven as budget deficits and national debt levels vary widely across Europe. For example the UK is set to see a 13.3%¹ deficit in 2010 whilst Germany and France will see deficits of 4.8%¹ and 8.7%¹, respectively. In addition, it will also be uneven in terms of governments' actions to reduce deficits with some, such as Ireland, who will address deficits and national debt levels aggressively and others will take a longer term approach.

The Wall of Capital and Pricing

Despite the fact that occupier markets have remained weak and will stay that way during 2010, we will see a growing wall of equity selectively targeting the sector. The main focus of this capital will remain on well-let, prime assets and due to a lack of suitable

opportunities, this has the potential to exert downward pressure on prime yields—as it has done in the UK in the second half of 2009. Investment volumes will remain low compared with long term trends but we still expect an increase of up to 20% on 2009 taking us back to 2002 levels of around €85 billion.

The list of buyers will grow with funds having more success with capital rising and international private wealth capital will continue to show interest in the sector.

In 2010, the larger French and German markets will show higher levels of liquidity than in 2009; however, relative pricing will be back in fashion and will start to move capital around Europe as pricing in London and other core investment markets becomes too keen for some investors at this phase of the cycle. Other beneficiaries are likely to be Stockholm and Warsaw, for example, as they can offer prime products and have relatively strong market fundamentals.

Investment Product and Appetite for Risk

Prime investment product will remain scarce during 2010 with an imbalance of capital chasing product. If market pricing is to approach clearing levels and satisfy most of the available capital there are two potential scenarios: one, investors will need to move up the risk curve, or two, investors will continue to bid prime yields down.

Dealing with the first point to date investors have been largely focussed on well-let, income producing assets, however, as confidence in a recovery grows we should start to see more cautious risk taking by some investors. We have already seen investors looking at shorter leases, an element of void or over-rent and secondary assets. We expect this trend to develop in 2010 but only to a limited extent.

On the second point, we believe a combination of factors should ensure that pricing does not bubble up in some markets. Firstly, the market crash is still fresh in investors' minds and they are displaying considerably more caution than during the boom years; secondly, prices are still some way off peak levels and look realistic when compared with historic benchmarks against bonds or equities and thirdly, banks have already begun to bring product to market and as the work-out process gathers pace during 2010, they will provide an element of controlled asset release onto the market and absorb some of the capital overhang. In Europe developers who have held

assets through the worst of the crisis will also begin to bring product to market as pricing recovers.

Overall the lack of product and increasing competition will likely frustrate investors, and they will need to work hard to do deals in 2010. We expect to see investors becoming more creative in deal making and more complex deals happening through equity injections into existing investments, asset swaps, club deals, share deals and a combination of all of the above. We will also see more platform deals in 2010 as investors look to efficiently place larger volumes of capital into a single deal.

Occupier Markets Follow a Different Cycle

The investment market has stabilised ahead of occupational markets, as in previous cycles—in the early 1990s the rental market recovery lagged the investment market recovery by three years. We believe that this time it will be different and we are already seeing those markets which are furthest ahead in their rental cycles, begin to reach the bottom such as London, Oslo and Warsaw [prime office markets].

One reason why office rental markets will recover more quickly in this cycle is the tightening of the development pipeline (the highest levels of development being postponed or cancelled in Frankfurt, London, Paris and Warsaw). We expect the pipeline in 2010 to be down almost 30% on 2009 and this will, in part, provide impetus for the eventual recovery in rents. On the other side of the equation, although the recovery in demand will be slow we believe we have already seen the bottom of the office take-up cycle. We expect gross leasing to be up 15% in 2010 from 2009 (2009 was down 30% on 2008) but over the next five years take-up is unlikely to recovery even to historic average levels.

Prime office rents in Europe in 2010 will be down around 3% overall, but the slow recovery in demand combined with supply constraints will set the scene for broad but limited rental growth in 2011, with unspectacular growth rates beyond that. The exception to this trend will be markets which corrected the most during the downturn, some of which could see the start of a more significant bounce-back driven by supply shortages.

Good quality retail space in both high streets and shopping centres is still sought-after. The sector will be resilient and although prime high street rents will see a fall of around 2% in 2010, some high street markets such as Hamburg, London and Munich will prove the exception and we expect to witness rental growth. Prime shopping centre rents across the region will remain largely stable.

Refinancing Continues to Overshadow the Sector

There is gradually more capacity coming into new lending and competition between banks has recently driven debt margins down for prime assets although changes to capital requirement ratios and Basel II have the potential to limit thinner margins, and LTV ratios

will remain relatively modest. Generally domestic lending is likely to predominate, partly driven by the demands of national governments who are now increasingly more active shareholders in several banks. German banks, supported by the Pfandbriefe market, will remain active cross-border lender, active in the UK and France in addition to Germany.

The massive overhang of refinancing of both balance sheet and CMBS loans will continue to be one of the most pressing issues throughout 2010 with £35 billion² of maturing loans in the UK alone. Despite the uptick in new lending, current capacity is insufficient to refinance the sector. Banks continue to work with clients and roll over loans but the medium term perspective is uncertain and new lending will remain below trend levels. Recent events in Dubai have demonstrated that after shocks from the credit crunch still have the potential to upset investor confidence.

In terms of working out their legacy issues banks now have more clarity around their real estate strategy than they had at the start of 2009 and this situation will only improve during 2010. A clearer strategy means that banks will begin to take the opportunity to start a steady release of saleable assets onto the market. Although this process has already begun we expect a greater flow of bank controlled assets being brought to market throughout Europe.

Conclusions

Almost every aspect of the market will appear uneven in 2010 including economic recoveries, bank lending and occupier demand and the market will continue to witness seemingly contradictory events such as yields hardening in markets which are seeing falling rents. However, the mood is decidedly more positive at the start of 2010 despite the considerable issues facing the industry. The reasons for this are more clarity and certainty over the future, an apparent recovery in the wider economy but it is also a bounce back from the depths of early 2009 and as such represents relief as much as it does hope.



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Sources:

¹ IHS Global Insight

² Fitch Ratings, DeMontford University

Capital Markets Outlook – 2010

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