European Property Investment: Truly a "Jeux Sans Frontières"!

"German buyers dominated the cross-border property investment market in 2003, but will face stiffer competition from Middle Eastern and Irish investors in 2004"

Central London was Europe's most active office investment market last year

Foreign investors were responsible for 70% of investment in France in 2003

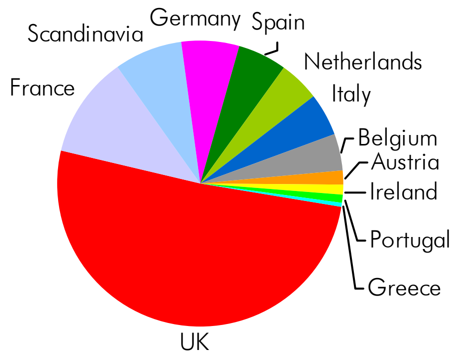
Foreign investment accounted for only 20% of acquisitions in Germany

OVERVIEW

During 2003, property investment activity across Europe once again defied weak occupational markets in the office sector, with international investors remaining particularly active. Whilst the European economic recovery began to gather pace towards the end of the year, vacancy rates have continued to rise and rents are still falling in the face of relatively weak occupier demand. Across the major European markets, a total of €82.4 billion of investment property was transacted, around 42% of which was acquired by overseas purchasers.

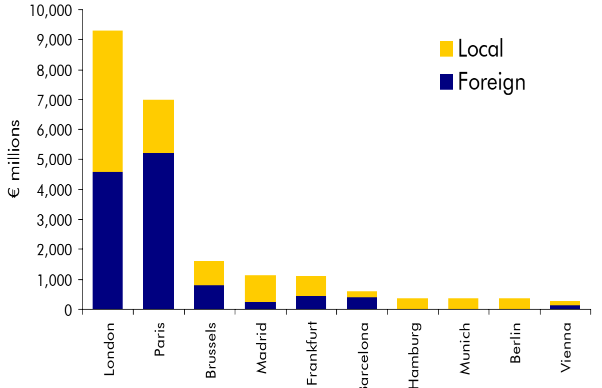
German capital, particularly from the open-ended funds, continued to dominate the market during 2003 in a pattern that has become familiar in recent years. Debt financed purchasers were also highly active, seeking to take advantage of the low interest rates prevailing across the continent. Coupled with a shortage of high quality product, this investment demand has supported capital values at levels above those which might be expected, given the weakness in the underlying occupier markets.

Total Investment Turnover 2003 Total Size: €82.4 billion



Source: CB Richard Ellis, Property Data, VastGoedMarkt

Office Investment Turnover 2003 – Local / Foreign



Source: CB Richard Ellis

Individual Market Analysis

Central London was Europe's most active office investment market during 2003, with investment turnover of €9.3 billion, marginally higher than in 2002. Demand was particularly strong in the final quarter of the year in both the City and West End markets. Always a cosmopolitan marketplace attracting significant overseas investment, international purchasers accounted for 49% of this total. This compares with an average of 31% over the last 3 years. The €4.6 billion they spent in 2003 was over €1 billion more than in either 2001 or 2002 – which were themselves record years. German capital dominated, accounting for 22% of acquisitions by value, with Irish and Middle Eastern investors each responsible for around 8% of purchases.

Often thought to be a market dominated by local players, as much as 70% of commercial real estate investments sold in France last year was purchased by foreign buyers. Of the €7 billion worth of transactions in the office sector alone, three quarters involved foreign purchasers There was a decline in the contribution from US funds, but a notable increase in purchases by Middle Eastern investors. Despite the relatively low yields in this market, German investors alone accounted for around 37% of purchases by value, compared with just 30% from domestic French investors. The relatively low levels of vacancy and development in the core Paris market offer the chance of an early return to rental growth once demand begins to recover. This should ensure healthy ongoing demand from international investors during 2004.

The balance between foreign and local investment was more even in Brussels, where the split of the €1.6 billion invested was close to 50:50; German funds accounted for over one third of total investment. In the Netherlands overseas companies were also responsible for acquiring around half the total investment turnover of €4 billion. Here too the market was dominated by German investors, who were responsible for over three quarters of the overseas property purchased, although there was also some interest from Irish, Israeli and American investors.

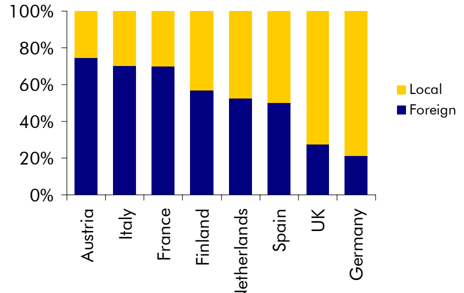
The overall picture was similar in Spain, where 50% of the €4.6 billion transacted across all sectors in 2003 was acquired by foreign-based companies. However, this pattern varies from sector to sector and particularly from city to city. Almost 80% of the €1.1 billion total investment in the Madrid office market was by Spanish investors, whilst only one third of Barcelona's total of €600 million was from local companies.

At the other extreme, few European markets are as dominated by local investment as Germany. The low level of transactions involving overseas parties partly reflects the significant weakness evident in the occupational markets and the wider economy, both of which are deterring interest from abroad. With GDP growth forecasts of under 2.0% for each of the next two years, this is unlikely to change in the short term. Domestic investors also receive tax incentives which serve to keep a significant proportion of the money invested in the German funds in the country. Of the €5 billion transacted in Germany last year, almost 80% was by local investors and of the four major real estate markets, only Frankfurt saw a stronger show of foreign interest.

Office Investment 2003	Size € m	Local Buyers %	Foreign Buyers %
Brussels	1,605	51	49
Frankfurt	1,113	60	40
London	9,289	51	49
Madrid	1,145	79	21
Paris	7,000	26	75

Source: CB Richard Ellis

Distribution of Acquisitions by Value 2003



Source: CB Richard Ellis, Property Data, VastGoedMarkt

Changes in Investment Demand

The last few months have suggested that the role played by the German open-ended funds in the European markets may change during 2004. German investors are estimated to have accounted for around 20% of the total property acquisitions in Western Europe in 2003.

During 2003 these funds received €13.5 billion to invest in property. However, they experienced a cash outflow to the tune of €1 billion in December. Then in January of this year the net capital inflow to these funds was €974 million, down from €3.4 billion in January 2003. Since the German funds tend to receive most of their new capital in the first three months of the year, this poor start indicates that the total amount they will be looking to invest in 2004 is likely to be lower than has been the case recently.

The other feature of the market has been the predominance of debt-financed purchasers. Here also, the outlook is unclear given that the future path of interest rates is uncertain. The economic recovery that started in 2003 appears to be gathering pace, and it is likely that the central banks will be looking to raise rates towards the latter part of this year.

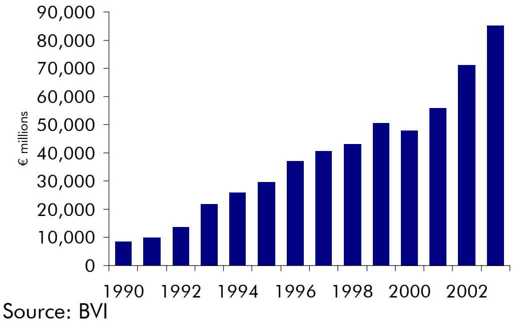
However, the recovery is dependent on continued growth in export activity, and this is being threatened by the strength of the Euro. In the short term, if the ECB were to cut interest rates this would boost the economic recovery, but it would also strengthen expectations of a more significant hike in rates later in the year. As in the UK, where rates are almost certain to rise, 2004 may therefore see debt purchasers less prevalent than in 2003.

Additional investment activity on the part of institutional investors over the coming years is anticipated. A recent survey of global fund managers by UBS suggested that the majority believe that the appropriate weighting for property is 15% or more. Given that recent rises in equity markets across Europe will automatically reduce their property weightings, pension funds could return to the market more quickly than might otherwise have been expected.

Whilst the impact of German capital may decline slightly, interest from Middle Eastern investors appears to be strengthening. This was evident in France and the UK, where some significant transactions appear to be an indicator of a much larger volume of underlying demand.

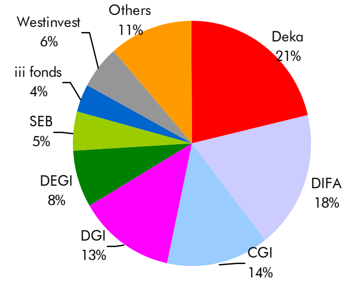
Another group likely to be more prominent across Europe this year is Irish investors. Of the €3 billion that the Irish invested in property last year, over 60% was directed at acquiring in the UK – more than twice the amount they invested in their own market. Only €250 million, barely 8% of the total, was invested in other European markets. This is likely to change in 2004 as the Irish consortia focus on some of the highly attractive investment opportunities available elsewhere on the continent. They could be amongst the stronger bidders for some of the larger investments that would previously have been targeted at the German open-ended funds.

Size of German Open-Ended Funds



Source: BVI

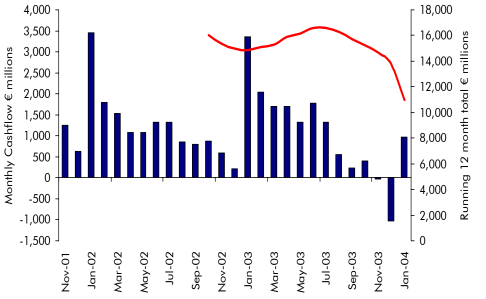
German Open-Ended Fund Distribution



Source: BVI

Total Size: €85 billion

Cash Inflows to German Open-Ended Funds



Source: BVI

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Outlook

On balance, therefore, the outlook for European investment remains positive. The economic and property fundamentals appear strongest in the UK and Spain, with positive investment stories also readily identifiable in Paris and Brussels. These markets are all likely to continue to see strong overseas interest. Scandinavia, particularly Stockholm, is also already being identified by many as a strong "recovery play". Interest is likely to continue during 2004, provided shortages of stock and pricing issues do not emerge to deter investors from further acquisitions.

Central and Eastern Europe has also attracted growing interest from investors in recent years, albeit that relatively little of this has resulted in completed transactions. With shortages of quality stock and strong investor demand across Europe, this could be the year when the anticipated flow of capital to the CEE region begins to gather significant pace.

Whilst the pattern of activity may change somewhat, 2004 will be another active year for the European investment market.

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