

UK Firms De-Lever; CEE Property Investment Plummet

EQUITY MARKETS CONTINUE DOWNWARD SPIRAL

During IQ 2009, losses in the European public equity markets continued, with real estate companies sustaining the largest share price declines. The FTSE 100 and Dow Jones EuroStoxx 50 fell by 13.9% and 15.3%, respectively, while the EPRA index fell 20.8%. While the listed real estate market fell drastically, by the end of the quarter there was evidence that the market had started to appreciate the early-stage steps that some of the major property players had taken to strengthen their balance sheets.

	2003	2004	2005	2006	2007	2008	IQ 2009
EPRA	5.4%	36.4%	21.8%	45.0%	-34.4%	-50.4%	-20.8%
FTSE 100	11.7%	6.7%	15.9%	9.5%	2.3%	-30.9%	-13.9%
DJ EuroStoxx 50	6.3%	3.3%	20.1%	10.0%	-1.7%	-42.7%	-15.3%

Source: Bloomberg.

PRIVATE EQUITY FUNDS STRUGGLE TO REACH TARGETS

In IQ 2009, seven real estate private equity funds contributed 15% of the total capital raised by European-focused funds, raising \$3.1 billion of capital commitments. At the end of the quarter, 70 funds remained in the market looking to raise an aggregate of \$32 billion. It's become increasingly evident to many fund managers, however, that their initial funding targets may be out of reach given the state of Europe's economies and the overall allocation to real estate being experienced by most of the traditional private equity investors. Many LPs are struggling to balance protracted and declining distributions with pending capital calls. Consequently, a number of opportunity funds have halted, downsized or completely withdrawn their product offerings.

Sources: Preqin, Private Equity Real Estate.

UK PROPERTY COMPANIES AIM TO REPAIR BALANCE SHEETS

Under intense pressure to clean up their balance sheets, saddled with punitive near-term debt maturities, many large public property companies in the United Kingdom were forced to de-lever via rights offerings. Since the beginning of the year, more than £3 billion of capital has been raised by UK real estate companies, including British Land, Land Securities, Hammerson, and SEGRO.

Equity Issuance	British Land	Hammerson	Land Securities	Liberty	SEGRO	Workspace
Announced	Feb-09	Feb-09	Feb-09	Apr-09	Mar-09	Jan-09
Amount Raised	£740 M	£584 M	£755 M	£620 M	£501 M	£87 M
% of Company	40%	58%	38%	54%	92%	83%
Rights Price	225p	150p	270p	310p	10p	10p
Discount	53%	62%	52%	22%	88%	59%

Speed, as well as proactive and significant actions by management, signalled to the market which public property companies were confident that they could survive the downturn. The companies that reacted to their balance sheet needs have been able to significantly lower their gearing. They have also made strategic dispositions at favourable yields. With balance sheets shored up and cash on hand, these companies are better positioned to take advantage of the market when it begins to turn.

Companies that have not addressed current market conditions find themselves with limited options. Aside from poor public perception, many are breaching loan-to-value and interest-coverage covenants and may find it difficult to access capital in the public market at this stage of the downturn. For example, Brixton recently had to sell property at distressed prices and is now rumoured to be looking to private equity for rescue.

Sources: Bloomberg, Bank of America-Merrill Lynch, Financial Times, M3 Capital Partners.

CEE HIT HARD BY DECLINES IN PROPERTY INVESTMENT

Direct investment into European real estate totalled €11.5 billion in IQ 2009, a decline of 44% from 4Q 2008. The slowdown in investment activity was experienced in almost all markets across Europe, however, Central and Eastern Europe (CEE) markets fared particularly poorly.

Property investment turnover in CEE slowed to approximately €220 million, one-third of the volume transacted in 4Q 2008. It is estimated that yields have now moved out significantly across CEE since 3Q 2008, and the differences between yields within the CEE markets varied greatly. However, the absence of meaningful transaction volume makes it difficult to verify actual spreads.

The majority of CEE investment activity during IQ occurred in Russia and the Czech Republic, while countries such as Poland and Romania, which had been recent drivers of CEE investment, recorded low property investment.

Lack of liquidity is being felt throughout CEE. Investors have gravitated back to western markets where risk-adjusted returns have become more attractive. Foreign investors, who account for approximately 80% of all CEE investment volume, have retreated to the sidelines due to pricing uncertainty. The growth in property financing in CEE had been sponsored predominantly by German and Austrian banks, which have been hit particularly hard by the credit crunch. The corresponding decline (virtual halt) in their lending activity has negatively impacted property transaction activity.

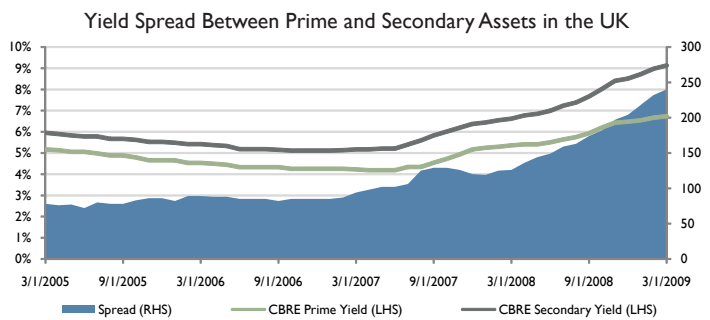
Lastly, uncertainty surrounds many CEE currencies. For example, the Polish zloty fell 11% against the Euro in IQ. While investing in Poland has become cheaper on that basis, investors have been shying away from the risks associated with construction and tenancy contracts drawn in local currency.

Sources: CBRE, Jones Lang LaSalle, Europe Real Estate, Bloomberg, M3 Capital Partners.

INVESTORS DIFFERENTIATING BETWEEN UK ASSET TYPES

In the period of yield expansion from IQ 2007 to IQ 2008, the difference in yields between prime and secondary assets in the United Kingdom held steady at around 100bps. The difference between yields remained constant as they shifted because investors were considering the general rise in risk of property coupled with the deterioration of wider economic conditions.

Over the last 12 months, the yield gap between prime and secondary assets has widened, reaching nearly 250bps at the end of IQ 2009. While prime yields are beginning to stabilise, secondary yields continue to move out, demonstrating that investors are again differentiating between the two asset types. Of particular interest are the differences in underlying occupier fundamentals between prime and secondary assets. Across all core sectors, financially healthy tenants are taking advantage of rental declines and moving into prime assets, leaving secondary assets vulnerable to increased vacancies.



Sources: CBRE, Jones Lang LaSalle, Bank of America-Merrill Lynch.

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