

European Quarterly Property Snapshot



The economy

Overview

The global economic recovery has gathered pace, led by Asia, with Q3 on course for the largest increase in activity in two years. Very aggressive monetary and fiscal policy loosening since last autumn has successfully put a floor under foreign trade and production which had suffered badly in response to a closing of credit markets. In Europe, stronger foreign demand and better credit availability have resulted in positive growth in Q3. Consumer spending remains subdued, mainly due to rising unemployment.

The eurozone economic downturn, which is the longest on record since WWII, has been mainly driven by falling business investment and exports, with consumer spending holding up well, reflecting the impact of government transfers and support measures for the labour market. Countries undergoing the bursting of home grown housing bubbles, such as the UK, Ireland, Spain and Denmark, have recorded a marked drop in household consumption. Economies of Central and Eastern Europe are still being weighed down by poor export demand from Western Europe, and restraint of capital inflows after a massive credit binge in recent years.

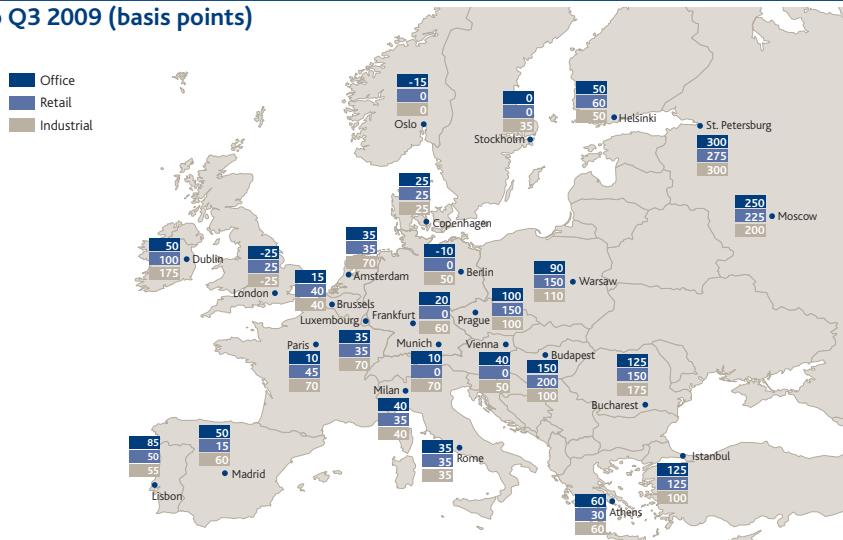
Prospects

European GDP is expected to fall by 3.9% in 2009, but to rise by 1.5% in 2010. We expect a moderate recovery, driven by rising external demand from Asia and a positive inventory cycle. Manufacturing activity and exports have shown tentative signs of improvement since mid-year which, will be sustained into early 2010, but domestic demand conditions are likely to stay subdued as fiscal policy stimulus wanes. As a result, the labour market will stay difficult, though more positive eurozone consumer confidence suggests that savings rates may fall back from current extremely high levels, giving a mild lift to household spending.

Short-term growth prospects remain strongest in the non-eurozone economies of Norway, Sweden and the UK, reflecting gains in export competitiveness from weak currencies and the impact of very loose monetary policy conditions. Within the eurozone, the outlook differs markedly by country, with export dependent Germany to benefit from a revival in global trade. On the other hand, southern Europe faces a period of subdued growth as lack of competitiveness can only be resolved through below average inflation or even deflation. The economies of Central and Eastern Europe (CEE) and Russia have witnessed a rapid deterioration in growth as Western European banks and investors have withdrawn finance.

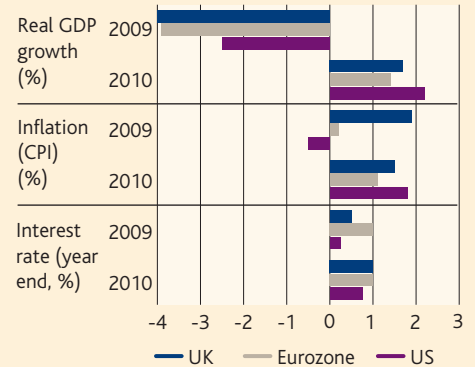
However, European growth is at risk of a relapse in 2010 as global growth will be hindered by continued de-leveraging of US households, while domestic demand in Europe will be muted by rising unemployment and the start of fiscal consolidation to contain exceptionally large public deficits.

Prime yield shift: year to Q3 2009 (basis points)



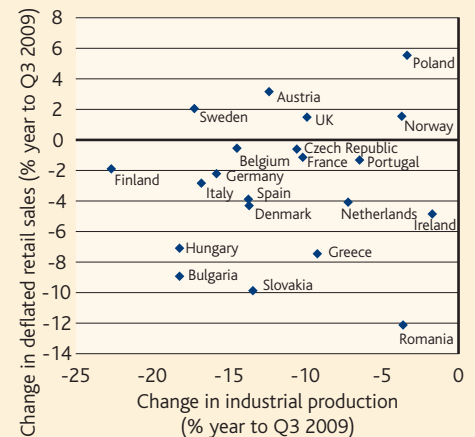
Source: Aberdeen Property Investors

Economic outlook



Source: Aberdeen Property Investors

Change in retail sales vs. industrial production, (% year to Q3 2009)



Source: Eurostat, Aberdeen Property Investors

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Recent property market trends

Offices

Take up levels remained weak across Europe as a whole in Q3. However, there is a very diverse picture between markets. Take up in London and Paris picked up sharply. As prime rents have fallen by as much as 40% in London, and are starting to bottom out, many occupiers are now starting to relocate, to take advantage of some extremely attractive terms on offer. In Spain, Italy, Holland and Central and Eastern Europe take up levels have remained weak. Germany, in contrast, has not experienced as pronounced falls in take-up as elsewhere in Europe over the past year.

Vacancy rates have continued to rise throughout Europe. Some of the sharpest increases are currently being experienced in Ireland, Spain and Poland (although the last is coming from a very low base). In London, vacancy rates are starting to peak, aided by rapidly slowing completion levels. Some of the smallest increases in vacancy rates have been seen in the German cities, reflecting take-up levels that have not fallen substantially, and modest levels of completions in recent years.

Rental declines have been most pronounced in London and Ireland, falling by nearly 40% since the peak. Sharp deterioration in rental levels has also been seen in Spain, which has also suffered from oversupply. Rental decline has slowed dramatically over the last quarter in London for prime assets, and looks set to stabilise. The German and Nordic cities have tended to experience a lower level of rental decline, aided by lower development levels in previous years.

Retail

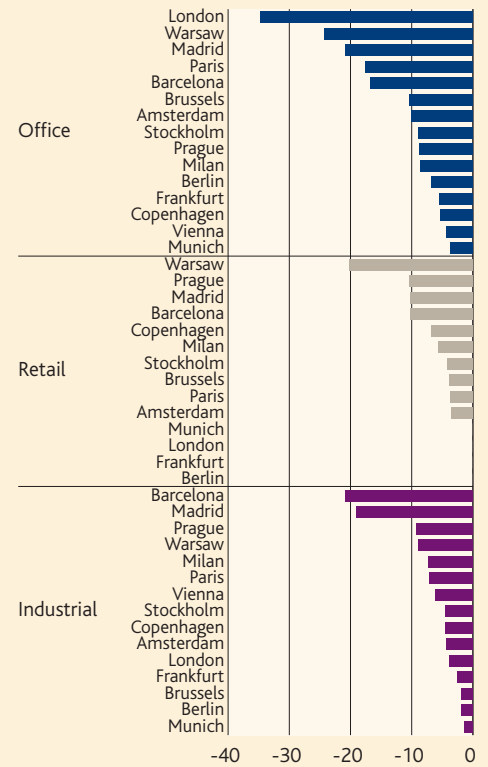
Retail sales in the eurozone have been deteriorating for over a year now, but the pace of decline has slowed in recent months. Discretionary spending remains at a very low level and a number of retailers are now in administration (most numerous examples in the UK and Germany).

In the nine months to Q3, prime European retail rents have declined by an average of 6%. The steepest declines were to be found in CEE but Italy, Greece, Spain and Norway also saw rents decline by over 10% on average. There is currently evidence of more generous incentives being used to attract and retain tenants, while key money is close to zero in Spain and has decreased somewhat in Belgium and France. Expansion plans have been halted by most retailers, with the exception of discounters. Secondary locations are bearing the brunt of the fall in tenant demand.

The pace of yield rises for prime shops slowed in Q3, particularly in France, Germany and the Nordics. In CEE, further repricing has occurred, in the range of 10-25 bps. At the peak of capital values, yields for prime shops, shopping centres and retail parks had compressed to very low levels and the gap in pricing among the formats had narrowed. In the last 12 months we have seen that trend reversed, with the gap in yields opening up again.

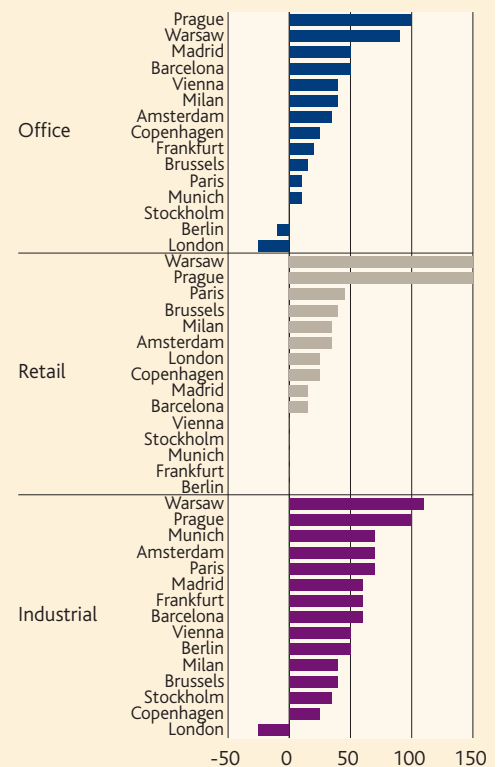
Shopping centres have repriced by an average of 100 bps in the mature European markets. In some markets (London, Paris, Oslo) prime yields for smaller assets have now stabilised. We expect that by the end of this year rises in prime retail yields in most markets will have levelled off. Driven by investor sentiment, rather than market fundamentals, some yield compression is likely to occur for prime assets in the course of 2010.

Prime rental growth: year to Q3 2009 (%)



Source: Aberdeen Property Investors

Prime yield shift: year to Q3 2009 (basis points)



Source: Aberdeen Property Investors

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Industrial

The key drivers of industrial property demand appear to be stabilising. Growth in international trade, industrial order intake and production have picked up recently, indicating the slump is bottoming out. Nevertheless, demand for industrial property remains subdued. Take up has been limited as occupiers remain conscious of costs and prefer to improve efficiencies within existing supply chains. Of the few sectors still active, waste management companies, food retailers and discounters continue to take units, aided by the attraction of signing new deals with large incentives at low rents.

New development volumes have fallen considerably. Only 30% of schemes have started speculatively so far in 2009, down from 70% during 2007 and 2008. While the outlook is for tighter supply levels due to low development starts, vacancy rates in the majority of markets are currently high. Many occupiers are downsizing or going into liquidation, further fuelling the increase in vacancy. In the light of these market conditions, rental values are now falling across all of the key markets, and incentives are rising. Non-core markets, or those markets which have seen large development booms, are experiencing the greatest correction in rents.

The most mature and liquid markets, led by the UK, are now starting to see yields stabilise or even fall. Prime distribution warehouses let on long leases are the main focus of investors in this sector. The situation in Central Europe is more fragile. Yields have risen by as much as 275 bps since their lowest point, although the pace of increase has slowed.

Residential

By late summer, residential property values across Western Europe have shown signs of declining at a slower pace compared to early 2009, helped primarily by low mortgage rates. In the case of the UK, France and parts of the Nordic region, homes prices have been rising over the past six months, underpinned by low borrowing rates and a lack of forced property sales. Home prices have also bottomed out in Germany, a market which has not experienced a housing boom in the past decade, and where supply levels are now matching household formation rates. On the other hand, downward price adjustments continue in Ireland and Spain, as huge excess inventories of homes are worked-off, having both undergone huge residential building booms in the past decade.

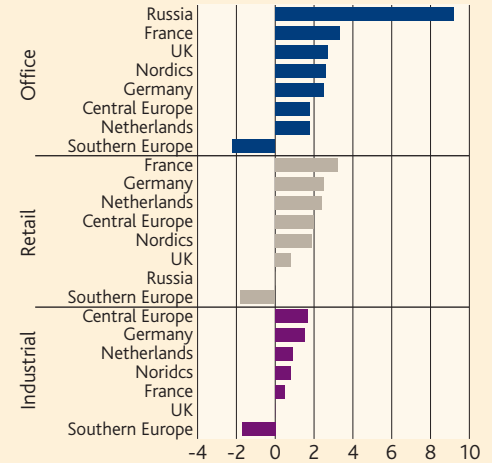
Investment market

Investment volumes appear to be stepping up slightly, albeit from very low levels. In the first three quarters of 2009, €43.3 billion was invested in European property, with Q3 investment increasing by 35% over the previous quarter. The growth in investment volumes seen in the last quarter has largely been fuelled by German investors and international investors focusing on the UK. In the UK, 80% of investment in the first three quarters of 2009 was by overseas investors. Property values in the UK are continuing to rise, but the re-pricing from their peak, combined with the weak position of sterling, makes UK property highly attractive to overseas investors. We expect investment volumes to continue rising, particularly in France, as investors begin to look outside the UK.

Prime yields are subsequently falling in a growing number of markets, led by the UK, and followed by the more mature and liquid European markets, such as Germany and France. Norway, Sweden and Denmark have also seen stability return. As property yields have risen sharply from their base, the sector is looking more attractive relative to the yield on cash, which is at historically low levels.

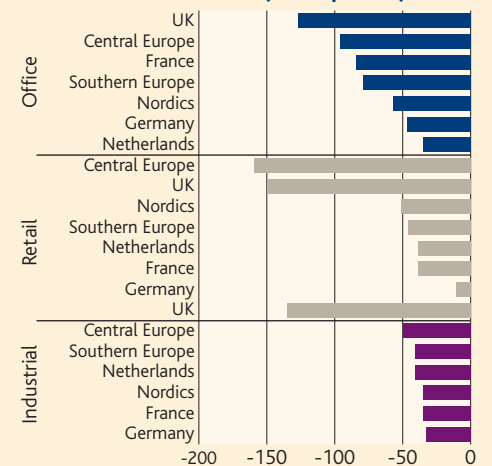
Across all sectors, prime units let on long leases to financially robust tenants are the main targets for investors, with competition placing pressure on prime yields. While secondary property is more risky, the divergence in yields between secondary and prime has increased its attractiveness for the less risk-averse investor.

Five year prime rental growth forecasts: 2010 - 2014 (% p.a.)



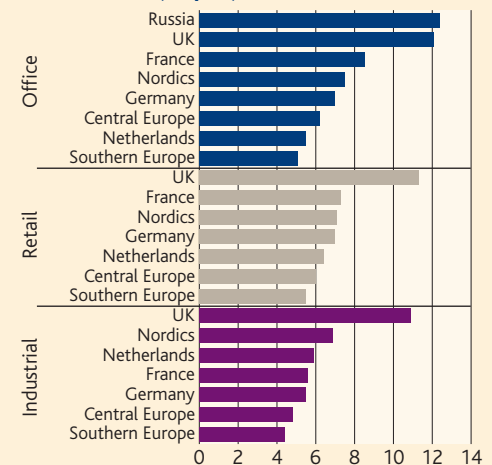
Source: Aberdeen Property Investors

Five year prime yield shift forecasts: end 2009 to end 2014 (basis points)



Source: Aberdeen Property Investors

Five year prime total return forecasts: 2010 - 2014 (% p.a.)



Source: Aberdeen Property Investors

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Outlook

Property markets in Europe have reached a turning point. The performance outlook continues to recover, largely driven by improving capital market conditions, and with the UK setting the trend for the rest of Europe. Property looks cheap now, from an historic perspective and relative to other asset classes.

There is mounting pressure on prime yields to come down, particularly given the wide gap in property yields relative to equities and real bonds. This process has already started in leading property markets such as London, Paris and Oslo, where prime properties in particular are in strong demand and yields are falling.

Although occupier market conditions are still weak, the pace of decline regarding tenant demand no longer seems to be deteriorating in many markets, and there is the 'risk' that office rental growth may come back sooner rather than later. Outside the prime areas, the situation is quite different. The demand for secondary property is relatively low and secondary yields are stabilising at best.

The five year average total return forecast (2010 - 2014) for all property in the eurozone now stands at 6.7%, which compares to 6.4% last quarter. Office yields are likely to compress a little more than retail yields in 2010, due to the more cyclical nature of office markets and also due to stronger price correction in many office markets across Europe. In terms of capital value decline, most European markets will bottom out between late 2009 and end 2010.

In geographic terms, we continue to favour property markets in the UK and the Nordics. The stability of returns in key countries such as Germany and France also look attractive in the context of volatile economic conditions. The Russian property market, although being significantly more risky, is expected to become more attractively priced next year. Property markets in Southern Europe and in Central Europe are expected to underperform in the short term.

Property lending rates have improved, but the willingness by banks to fund property investments has remained low, and commercial property lending is unlikely to be prioritised by banks in the short term. Property investors will have to rely less on leverage, as a driver of performance in future, as banks need to re-capitalise drastically and in view of the collapse of debt securitisation markets. However, less gearing in property investment products will also help institutional investors, of whom many are looking for the liability hedging qualities of property investing: high income returns, return stability, inflation protection and portfolio diversification.

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Investment Policy

The table below show Aberdeen's recommended positions for "All Property", relative to European market weights, in order to achieve outperformance over the coming five year period.

Market	Strategy
Benelux	Neutral
CEE	Underweight
France	Overweight
Germany	Neutral
Nordics	Overweight
Southern Europe	Underweight
United Kingdom	Overweight

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