

ECONOMIC PULSE

A REPORT ON THE EUROPEAN ECONOMY AND
ITS IMPACT ON COMMERCIAL REAL ESTATE

INFLATION OR DEFLATION? WHAT SHOULD WE PLAN FOR IN EUROPE?

Inflation is one of the most fundamental variables studied by financial authorities and one of the most emotive terms in the language of economics, implying uncertainty and the destruction of value, but generally being desirable at low levels. As a result, the issue is rarely absent from the media, but 2009 has seen the debate become more prominent and polarized than usual, causing a problem for tenants and investors alike as they ask what inflation scenario they should plan for.

Summary

Europe is currently in transition from relatively strong inflation in 2008 to much lower inflation or even deflation now. Headline inflation may pick up in the coming months as the impact of lower energy costs fall out of the annual measure but looking further ahead, there are conflicting pressures acting on pricing. However, our analysis of the situation emphasises the differing timeframes over which these will impact, with most inflationary forces only likely to take root once economic growth is firmly re-established. In summary therefore, our view on the key issues and the outlook are:

- In the short term, which may mean 1, 2 or even 3 years, price pressures look set to be volatile but generally subdued.
- Even allowing for a contraction in capacity and growth potential, Europe can support more activity than we are now seeing, or indeed expect in the year ahead. This will bear down on the rate of inflation.
- Whilst not sustained or widespread, deflation will be an issue for parts of Europe in 2010 as domestic demand remains muted, government and central bank stimulus run their course and internal deflation provides a route to restore competitiveness.

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- Deleveraging by banks, businesses and individuals will also suppress demand and pricing.
- Generally, the structure of the Eurozone implies imbalances country by country, as monetary policy may be too tight for some but too loose for others.
- A range of factors have altered the balance of power between producers and consumers, often resulting in pricing being more downwardly flexible than in the past. New capacity creation in Asia and strong export competition certainly suggest producers will struggle to raise prices in the short term. However businesses will remain keen to rebuild margins, resulting in a mixed landscape of pricing gains and falls.
- Eventually though, current policy stimulus and natural economic forces will generate a stronger recovery that will eat away at the negative output gap – leading price levels to rally, urged on by growth in energy and some commodity prices.
- The exit from quantitative easing looks likely to be cautious, also raising the risk that inflation will pick up before policy is tightened. Moreover, measures to raise revenue through tax and duty increases will push up prices.
- The next few years could therefore include markedly different phases of inflation, with low but volatile short term inflation giving way to stronger price pressures by 2013/14.
- We should also expect a marked polarisation between countries, both in their susceptibility to short term deflation and to higher medium term inflation.

For real estate therefore, strategies will clearly need to vary market by market and few strategies will have a life span less than five years, hence occupiers and investors face not just the issue of how to deal with inflation or deflation, but how to deal with both.

This calls for flexibility and compromise – in seeking for example an indexed lease with a cap and a collar or a turnover lease that shares risk between occupier and owner. It also demands a focus on the right real estate and the right management.

For investors, other than in extreme periods, prime property will cope best with either

inflation or deflation, in safeguarding liquidity and maintaining or growing income. Investors should also seek to vary their debt strategy depending on the inflation outlook.

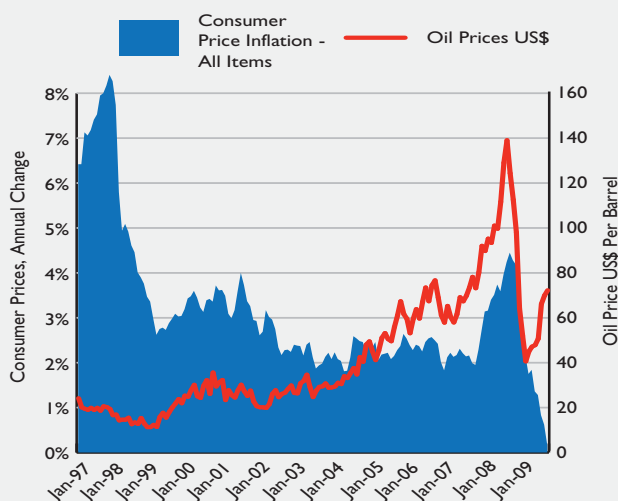
For occupiers, it demands the complete integration of a robustly tested real estate strategy with business needs, prioritising locations and facilities and aligning ownership and lease structures to give the flexibility to change with the business.

NOT NEW, BUT STILL DIFFERENT

Europe has seen its fair share of economic and political turmoil, the most significant of which often resulted in or coincided with high levels of inflation. For example, much of Eastern Europe suffered a number

of years of double-digit inflation during its re-entry into the free market, and the strong rates of growth seen subsequently were never likely to result in what might be considered low inflation for a Western economy. However, it is also worth remembering that many Western economies still posted inflation of more than 5% well into the 1990s. In fact, for most, inflation only began to approach the 2% mark once the adoption process for the

FIGURE I | PRICE TRENDS ACROSS EUROPE



Source: Eurostat, Cushman & Wakefield

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Euro got underway at the end of that decade. All the same, it still possible to point to a period from mid-1998 to mid 2008 in which inflation did fall steadily across Europe (see Figure 1). During this time central bankers enjoyed increasing support thanks to their perceived ability to 'target' a given inflation rate. Consequently, many people were surprised when, after rising oil and food prices began to stoke inflation in mid 2008, central

bankers appeared unable to fight back, although to be fair, they were fighting the Credit Crunch at the same time, which curtailed their ability, or willingness, to tighten policy.

Figure 2 highlights how each country has fared more recently, with most seeing month by month a decline in inflation and a number now suffering outright deflation.

Those countries with structural weaknesses, such as Spain, Ireland and the Baltics, are forecast to see very weak inflation for some time, as are markets with subdued local demand, such as Germany. Outside the Eurozone, Norway and the UK are

forecast to have slightly stronger inflation than elsewhere in Western Europe, mainly due to currency weakness.

Over time, demographic trends will need to be factored in, with markets with a declining workforce likely to see their growth potential reduce – thereby increasing the risk of deflation unless capacity is cut.

THE FEARS BEHIND INFLATION

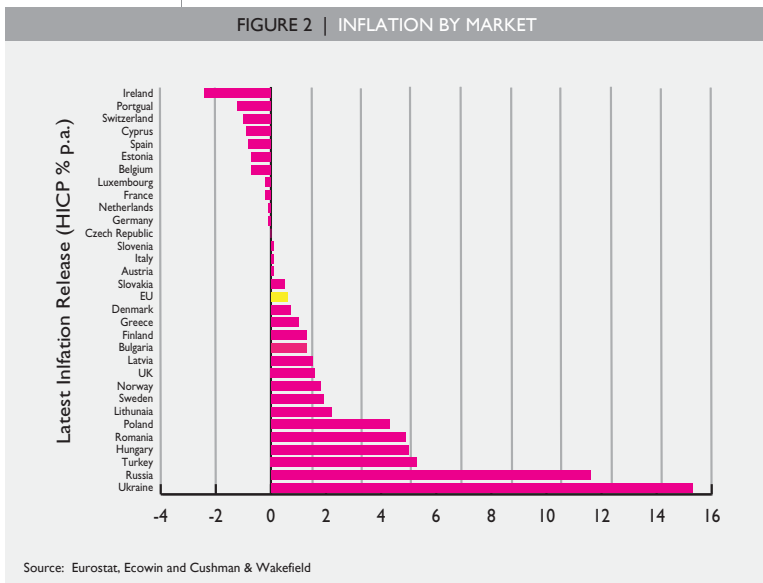
I. Government Action

Higher government spending in the last two years, forecast to continue in 2010, could clearly add to inflation once the economy picks up. However, there is no evidence yet that this is out-weighting the disinflationary impact of the recession. Moreover, the scale of government excesses will soon need to be reversed, which will dampen demand and act as a break on inflation, other than if revenue raising is via sales taxes, duties or price subsidy reductions.

Some commentators still caution that inflation may be chosen as a deliberate route to reduce the real debt burden held by governments. However, the risk to a country's credibility, and hence ability to service their debt, makes this unlikely, at least unilaterally.

While Italy, Greece and Belgium will continue to run the highest overall public deficits - at over 100% of GDP in 2010 – the biggest increases are forecast to be in the Baltics, Ireland, the UK and Spain. Barring the UK, these are all currently suffering deflation and, hence, the extra spending poses a limited threat. The UK has above average inflation however and could therefore be at risk.

FIGURE 2 | INFLATION BY MARKET



Source: Eurostat, Ecwin and Cushman & Wakefield

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During the recovery meanwhile, low-debt nations such as Denmark, Bulgaria, Czech Republic, Finland and Slovakia, which have seen relatively modest debt increases, face the least threat. In contrast, markets with higher-than-average debt and debt increases will see policy subduing activity in the years ahead, notably the UK and Ireland, but also Spain, France and Portugal. Markets such as Greece, Hungary and Italy will be under pressure due as much to past debt as recent increases.

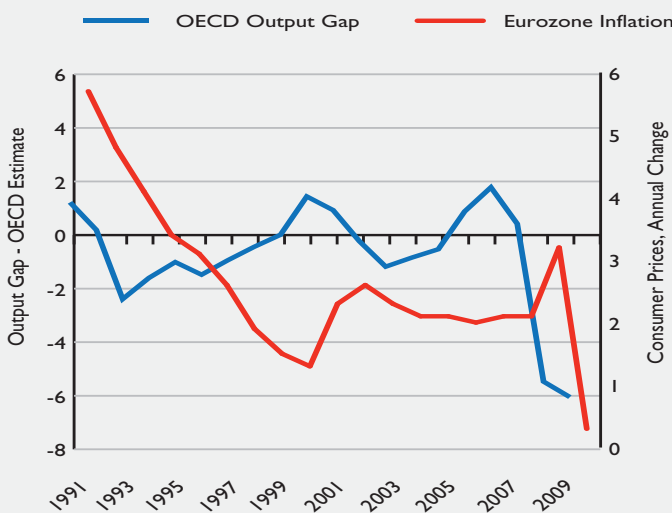
2. Central Bank Action

Central bank interest rates at record lows in much of Europe have raised fears that a lax monetary policy will create a bubble in asset prices and inflation. However, it is not necessarily the case that inflation will take-off if the economy is weak. Moreover, with both credit supply and demand still low, at the very least the transmission mechanism from low interest rates to higher inflation will operate more slowly than usual.

Another key driver of inflation expectations has been central banks' newfound inventiveness in raising financial liquidity. Quantitative easing has been characterised as "printing money". This accusation may be most frequently levelled at the Bank of England, but the sums injected more widely are large enough to ignite fears of runaway inflation that stem partly from historical experience.

However, concluding that quantitative easing will automatically trigger high inflation overlooks the severity of the recession and the significant wealth-destruction that has taken place. Moreover, unconventional policy measures are not, yet at least, showing up in bank lending or money supply data, with much of the stimulus reportedly "hoarded" by banks as they improve their capital base. Indeed, the greater risk may be that the combined efforts of governments and central banks are not be enough to fend off deflation.

FIGURE 3 | THE OUTPUT GAP IN THE EUROZONE



Source: OECD, Cushman & Wakefield

3. Spare Capacity

If an economy has capacity standing idle and is growing at a slower rate than its potential, this will bear down on the rate of inflation. Estimating the output gap and growth capacity of an economy is far from easy however, particularly after the destruction wrought by the recession and the weaker financing environment.

Figure 3 shows OECD estimates of the Eurozone output gap over the past two decades, supporting a relatively good relationship with inflation, particularly when sharp changes to the output gap have occurred. Moreover the sensitivity of prices to the output gap may have increased - assuming central banks

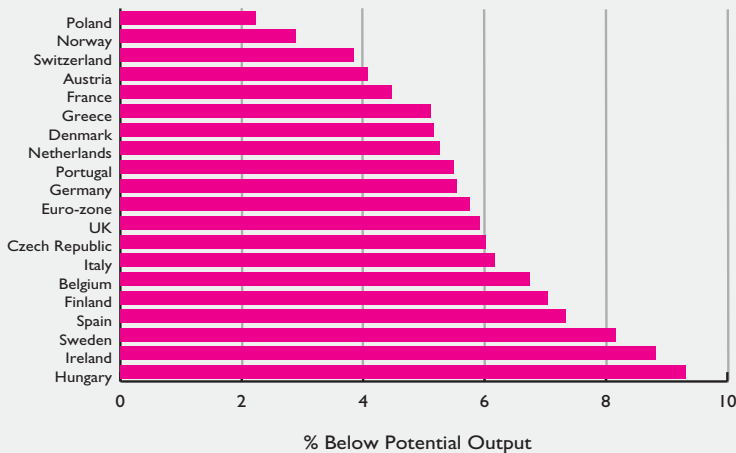
credibility as inflation fighters has not been impaired.

Looking ahead, the OECD estimate that the size of the output gap could be unprecedented. Figure 4 shows OECD estimates for selected countries, underlining the very different pressures each faces, with some of those with high output gaps already suffering deflation.

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One may still question whether these estimates take adequate account of the scale of capacity reductions seen in this recession. For economies such as Spain or Ireland, this may be of only theoretical concern given their large output gaps, but for the likes of Poland or Norway there is potential for their relatively small output gaps to be more than cancelled out by a stronger than expected recovery, thereby leading to a quicker return of inflation.

FIGURE 4 | OUTPUT GAP BY MARKET, 2009/10



Source: OECD and Cushman & Wakefield

4. Consumer Spending

Subdued consumer demand will reduce the ability of retailers and others to raise prices. In much of Europe, demand has held up well but as the slowdown has worsened, spending has become increasingly reliant on government-sponsored schemes, such as incentives to replace old cars. The end of these schemes may herald a period of lower growth and could amplify the slowdown as consumers have brought forward purchases.

Consumers may find their personal financial situation worsening even as economic indicators improve, and demand, therefore, may be further

hit by the need to reduce household debt. While some countries, such as Spain, the UK and Ireland, are more reliant on consumer debt than others, savings rates have risen even in places where credit was less abundant. This won't last forever of course, and there are signs that the process is slowing, albeit perhaps as a result of rising unemployment or government incentives to spend. However, with banks demanding greater security from their customers, meaning that major purchases now require larger deposits, savings levels are likely to increase further, thereby subduing spending.

Like cholesterol however, deflation comes in good and bad forms; mild deflation could boost spending power, adding to the greater pricing power enjoyed by purchasers due to a range of factors such as the internet, reduced regulation and increased global competition.

5. Currency Movements

Some parts of Europe may see further exchange rate weakness as they seek to restore competitiveness and this will impact on inflation expectations country by country.

Some of those in the Eurozone such as Spain, Italy and possibly Portugal and Ireland, or those with currencies pegged to the Euro, such as Latvia, are struggling with an overvalued output. This will ease if the Euro weakens but some would still face the need for significant further devaluation to restore competitiveness. In a fixed exchange-rate regime, this means devaluing internally by raising productivity or reducing costs, with the labour force often the first to suffer. Whether this is achieved via wage cuts or lower employment may make little difference, as the impact in both cases will be deflationary.

An additional issue for the Eurozone will be setting interest rates when differing economies are recovering at different speeds. There is clearly a risk that rates will be set to help the laggards and this will mean policy is too loose in faster recovery markets.

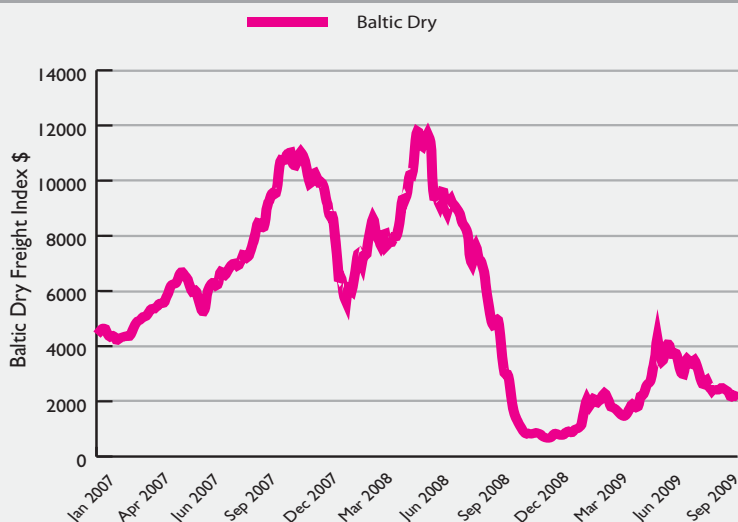
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6. What About China?

China, along with other Asian producers, has played a conflicting role in global inflation, with both a deflationary impact from its growth as a major low-cost exporter and an inflationary impact due to greater competition for raw materials. The region's influence has also been felt, alongside some European countries, from its high trade-surplus, which, alongside relatively limited domestic demand, generates a glut of savings which fuels lower global interest rates.

Over the longer term, it is hard to dismiss the likely impact of such emerging markets in heightening inflation through increased competition for resources. They are likely to remain very low-price producers for some time however, at least until domestic demand increases. Much of the recent recovery in China has focussed on investment spending, which will increase productive capacity and boost export competition even further. Hence, for now at least, China and other Asian markets look likely to add to deflationary pressures.

FIGURE 5 | BALTIC DRY FREIGHT INDEX



Source: Baltic Exchange, Cushman & Wakefield

7. Commodities

A recovery in commodity prices, notably oil, is taken by many as a sign of inflationary pressures to come. With demand still subdued in many world markets, renewed interest from China is singled out as a big factor behind the rise, although this may reflect the authorities taking advantage of cheaper prices to stockpile resources. Certainly, the continued rise in commodity prices is not necessarily supported by signals on global demand given in the Baltic Dry index. There is also evidence of a divergence between different commodities,

with oil stronger than gas for example. Moreover, higher commodity prices will only feed into inflation if they result in wage growth. Without this, they are likely to be deflationary as they cut purchasing power.

CURRENT OUTLOOK

Even though a number of forces are at work, which, if left unchecked, could lead inflation to accelerate in the longer term, the immediate outlook is more likely to be one of much lower inflation, albeit with prices, like growth, following a volatile path.

Consensus views on Western European inflation peaked in late 2008, since when they have steadily dropped back, from 2.6% to just 0.6% for 2009 and from 2.3% to 1.3% for 2010. As signs of economic recovery have emerged however, expectations have levelled off.

In Central & Eastern Europe, trends are very mixed, with some of the worst deflation and most excessive inflation being seen.

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However, it is worth noting that setting the Baltics aside, these markets are generally less exposed to sustained deflation than lower-growth Western markets.

In terms of GDP expectations, these have now started to edge up in most Western markets. In Eastern Europe, in part on the back of an upturn in their key export markets,

the outlook for recovery has also now strengthened.

Support for the strength of recovery comes from an increasingly broad base across industry, services and consumer markets (see Figure 7). An east west divide is nonetheless still reflected in the degree to which sentiment has improved, with the most positive markets being the UK, Denmark, Sweden and Italy, while the laggards include Romania, Bulgaria and Latvia.

To a degree these patterns reflect the depth to which the different markets fell. Italy for example has seen a strong bounce in sentiment whereas France has not – but the French recession has been much less severe and it is also expected to out perform in 2010 (see table 1).

The most deflationary conditions are being seen in the Baltics as well as Ireland, Luxembourg, Portugal, Spain, Sweden and Switzerland. In 2010, the threat is forecast to remain highest in the Baltics but could feature in Belgium, Germany, Ireland, Spain, the Netherlands and Switzerland.

PROPERTY MARKET IMPLICATIONS

Historically, inflation has been thought to be good for property performance but in truth, the historic record is not clear cut.

Prices do react to periods of high inflation when sensitivity to

higher rents is reduced by rising prices in most areas of the economy but evidence of an automatic link is less impressive. Indeed, in some markets for certain periods property has had a negative correlation and the reaction of property will depend on the scale of the price shock, on future expectations and, fundamentally, on what is driving inflation or deflation.

FIGURE 6 | CHANGING EXPECTATIONS FOR INFLATION

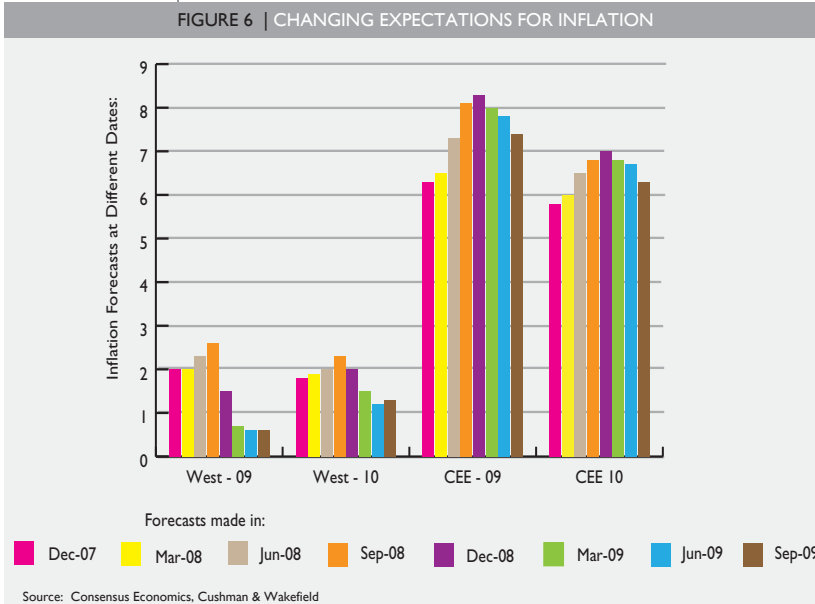
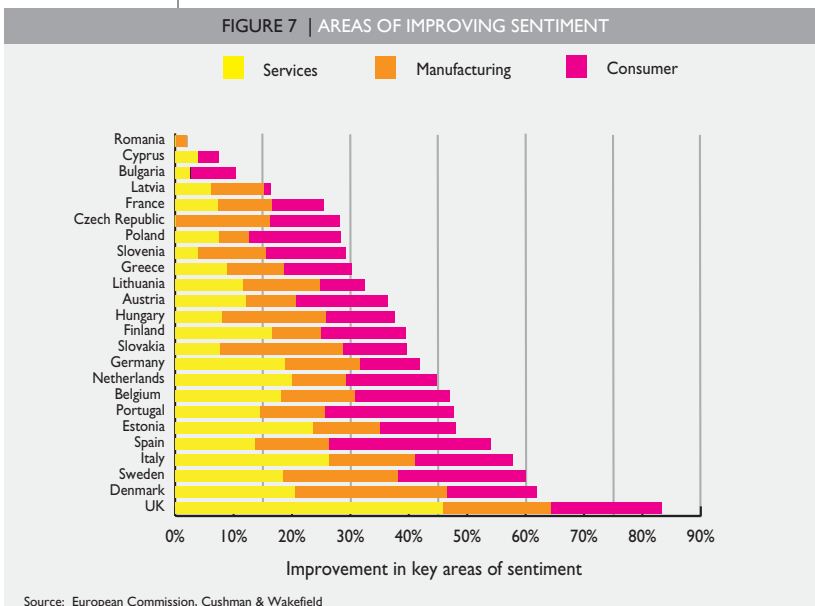


FIGURE 7 | AREAS OF IMPROVING SENTIMENT



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TABLE 1 | MARKET FORECASTS (Sep 2009)

	GDP % pa		Inflation % pa		Comment
	2009	2010	2009	2010	
Austria	-3.8	0.1	0.3	1.1	Lacklustre recovery in 2010 likely to keep inflation at relatively low levels
Belgium	-3.3	0.0	0.0	0.9	Limited scope for fiscal boost and a slow recovery will restrain inflation
Bulgaria	-4.7	0.4	2.8	2.7	Fall in domestic demand and stable currency is bringing inflation down quickly
Czech Republic	-4.0	1.4	1.2	1.6	Modest pick up in inflation forecast as GDP gradually improves
Denmark	-3.2	0.6	1.2	1.6	Inflation stabilising but consumers still cautious as housing market bottoms out
Estonia	-13.4	-1.7	-0.3	0.2	Steady deflationary pressures to continue in 2010 as the economy rebalances.
Finland	-5.3	0.5	0.7	1.1	Inflation to rise slowly with better consumer confidence despite unemployment
France	-2.2	1.1	0.1	1.1	Nil inflation despite relatively modest recession but set to rise with GDP in 2010
Germany	-5.0	1.3	0.3	0.9	Disinflation rather than deflation now forecast thanks to economic stabilisation
Greece	-1.6	0.3	1.2	2.0	Price pressures easing as economy bottoms out but limited pick up in 2010
Hungary	-6.5	-0.4	4.6	4.0	Interest rate cuts and exchange rate weakness have kept inflation relatively high
Ireland	-8.5	-2.5	-2.5	0.5	Severe downturn has led to deflation necessary to help restore competitiveness
Italy	-5.0	0.5	0.8	1.5	Inflation has stagnated with limited external or domestic demand pressure
Latvia	-18.0	-3.9	3.5	-1.7	Deflation forecast for 2010 if currency peg is maintained
Lithuania	-16.9	-3.4	4.2	0.1	Government spending cuts to hit demand further, forcing inflation down
Luxembourg	-4.4	0.5	-0.6	1.6	Financial sector stabilising helping labour market and set to end recent price falls
Netherlands	-4.3	0.4	1.0	0.8	With a weak recovery forecast, inflation expectations for 2010 have been cut
Norway	-1.1	2.0	2.1	1.7	A relatively shallow downturn has averted the threat of deflation
Poland	1.0	1.9	3.6	2.5	Robust performance but fiscal restraint in 2010 will push inflation down
Portugal	-3.7	-0.2	-0.6	1.0	Domestic weakness has significantly lowered the expected path of inflation
Romania	-6.6	1.0	5.5	4.0	Weak demand is pushing prices down despite the falls seen in the currency
Russia	-7.0	3.0	10.7	9.1	Inflation is above target and interest rate cuts may sustain this in 2010
Slovakia	-4.9	1.5	1.9	2.1	Euro adoption has aided price stability compared to others in the region
Spain	-3.8	-0.6	-0.1	0.4	Expected weak wage growth will add to deflationary pressures
Sweden	-4.7	1.7	-0.3	1.2	Sharp recession and prices decline but deflation not expected to become ingrained
Switzerland	-1.9	0.9	-0.5	0.7	Interest rates near zero have not been enough to stave off modest deflation
Turkey	-5.8	3.1	6.2	6.2	Relatively robust recovery but lower interest rates may push up inflation
UK	-4.3	1.1	1.9	1.8	Recovery starting but weak Sterling has kept inflation above Western average
Ukraine	-13.7	1.3	16.0	11.9	Despite sharp slowdown, currency falls and fuel prices have kept inflation high
Western	-4.1	0.8	0.6	1.3	Disinflation rather than persistent deflation for most through 2010
Central & Eastern	-8.4	0.4	5.0	3.6	Slowly stabilising but the outlook for growth and inflation is still very polarised

Source: Consensus Economics Inc, Oxford Economics and Cushman & Wakefield

Occupiers and investors, therefore, face a number of problems in working out their strategy, not helped by the fact that lease structures can complicate the relationship between inflation and rents. They also face the added problem that inflationary conditions could be quite different within the five to seven year time horizon for which many will plan – with a period of low but volatile inflation in the short term possibly giving way to higher inflation in two to three years.

THE IMPACT FOR PROPERTY OCCUPIERS

In either a deflationary or an inflationary environment, occupiers run the risk of seeing their rental commitments move at a different pace to their revenue and profitability. Under deflation, this can be particularly damaging.

Table 2 highlights the issues that tenants may face, with nearly half of the countries shown not usually allowing rents to fall even if inflation is negative, and a number not allowing rents to fall below the starting rent or applying only a portion of the rate of deflation/inflation. In some cases, however, there is considerable flexibility in standard terms. Moreover, in some

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markets where a restriction against a downward review is the norm, its enforceability may be untested. Clearly, therefore, occupiers need to study their lease commitments in detail and be alert to the limitations or opportunities they present.

The need for businesses to control and align their cost base has already led to changes in the terms occupiers prefer, with a move away from upward-only reviews unless in a cap and collar arrangement. Given the uncertain outlook and potential volatility ahead, this may be the best approach for occupiers going forward.

Businesses must also look carefully at the tax treatment of their lease – with long, and relatively certain-rental commitments potentially being seen as a finance lease rather than an occupational lease and, hence, attracting a different accounting treatment. This can make a variable increment – such as CPI – more attractive than a fixed increase, albeit for risk management, tenants should seek to ensure the indexation is capped. In exchange, most investors will seek a floor to be included to limit their downside risk.

Occupiers should clearly play close attention to property commitments and look to gain as much flexibility as possible in the amount of space they occupy and in lease terms. This requires thinking ahead and examining the impact of possible future cost scenarios to identify particular pressure points and look to address or hedge against these at an early stage.

In some situations tenants may look to buy-in space to give them more occupational flexibility, or to use hedging outside of real estate to provide protection against a worst-case scenario.

Some may seek a stronger turnover link within the lease, possibly extending beyond the retail sphere for business-space users, which to a degree is starting to happen in French indexation, with the Construction Cost index superseded by a blended index of inflation, construction and retail sales for retail leases and potentially GDP for business space. Occupiers however should be mindful of the impact such hybrid indices could have on value – with a straightforward CPI-linked lease being of greater value to many investors.

Where standard inflation indices are used, occupiers should pay close attention to the nature of each index – with varying inflation measures sometimes being available and based on what is included or excluded from each (eg housing related or energy costs), they may have a stronger or weaker correlation with different business sectors.

As ever, it is much easier for occupiers to seek flexibility when signing a new lease than to cater for their existing space. Nonetheless, tenants do currently have an advantage that may allow such flexibility to be negotiated, for example, in exchange for an increase in the lease term.

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TABLE 2 | LEASE INDEXATION TERMS

	Indexation	Up and down?	Base	
Austria	CPI	Yes	Initial Rent	Lease indexation is usually subject to an agreed step, eg when prices change by 5% over a period, therefore falls are unlikely unless deflation is severe.
Belgium	Health Index	Yes	Initial Rent	The Health Index is a sub-set of the general CPI index, with items such as alcohol, fuel and tobacco removed from the index basket.
Bulgaria	US CPI	Up only	No	Indexation is not common for shorter leases or for Euro-linked leases, which are increasingly prevalent in the market.
Czech Republic	Euro zone CPI	Yes	No	Typically there is no explicit wording that rents cannot go down, but it may be inferred, eg rents will be "increased" or "increased by a minimum of 1%".
Denmark	Net Price Index	Yes	No	Whilst in theory rents could fall through deflation, many leases have a clause setting a minimal annual lease price increase of 2-3%.
Finland	CPI	Yes	No	
France	CCI or ICL for retail	Yes	Initial Rent	Indexation is changing from only the cost of construction (CCI) to a blend of CPI, CCI and either sales for retail or possibly GDP for offices. Some leases include clauses to protect against rental falls but these are not generally enforceable.
Germany	Portion of CPI	Yes	No	Usually subject to a step, eg of 5 or 10%, and may then be proportional, eg rents rise or fall by 75% of the change in the index.
Greece	CPI +1%	Up only	Initial Rent	Indexation is usually capped to be upward only at 1% over the annual CPI rate.
Hungary	Euro zone CPI	Up only	Initial Rent	Leases typically include clauses to ensure indexation is upward only.
Ireland	No	Up only	Na	Some indexed leases do exist but these are so rare there is no standard form.
Italy	ISTAT	Up only	Initial Rent	The indexed value is usually capped at 75% of the ISTAT rise, other than for shopping centres where it is 100%.
Netherlands	CPI	Up only	Initial Rent	
Norway	Portion of CPI	Yes	No	Indexation tends to be a proportion of CPI, usually between 60 and 100%.
Poland	CPI	Up only	Initial Rent	Indexation clauses are generally but not exclusively, upward only.
Portugal	IHPC	Yes	No	General lease law provides for indexation mechanisms to be agreed freely between parties. Market practice is to adjust rent in accordance with inflation, up or down. In some shopping centre leases, the landlord has the option but not the obligation to index the rent.
Romania	Euro zone CPI	Up only	Initial Rent	Market norms are being tested with an increasing number of lease renegotiations occurring as open market rents drop below indexed values.
Russia	Variable	Yes	No	Indexation is very complex and may be US or Russian CPI, fixed % or fixed value uplifts and usually involve spreading currency as well as inflation risk
Slovakia	Euro zone CPI	Yes	No	Typically there is no explicit wording that rents cannot go down, but it may be inferred, eg rents will be "increased" or "increased by a minimum of 1%
Spain	CPI	Yes	No	Dependent on the lease contract and while some leases have clauses stating rents can be reviewed upwards only, such clauses may not be enforceable.
Sweden	CPI	Yes	Initial Rent	
Switzerland	CPI	Yes	No	Rents can be indexed to the Swiss CPI where the initial lease term is 5 or more years.
Turkey	CPI or fixed %			US\$ lease contracts often have a fixed percentage increase of 3-5% pa.
UAE	No	Na	Na	Rent regulations differ by Emirate. Indexation is rare and leases are short and hence reviewed to market. In Dubai the previous government-imposed 5% pa rent increase cap has been removed and rents can be adjusted up or down on expiry or renewal.
UK	Usually none	Up only	Na	Indexation is increasingly used, notably in sale & leasebacks, linked to RPI, CPI or fixed increments. Some more recent leases will be capped but, whilst it is hard to generalise, most have historically not allowed rents to fall.
Ukraine	No	Na	Na	Indexation is not commonly seen and leases are short

Source: Cushman & Wakefield and Alliance/Associate Partners

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THE IMPACT FOR PROPERTY INVESTORS

Property may be a good store of long-term value but its role as an inflation hedge varies over time, by market and as a function of the level and volatility of growth and inflation. Moreover, the impact of inflation and deflation will differ on income versus capital. Over short or long periods therefore, investors need to consider property quality and supply, lease structures, tenant and tenant-industry strengths, gearing and, finally, liquidity, both for occupation and investment.

In a highly deflationary environment, if cash is king, then secured cash is divine! Investors should seek low gearing and top-quality assets with long leases and triple A covenants. With milder deflation, investors can take a little more risk on covenant and lease length-but should still focus on security and look for the best and most demanded types of property to reduce re-letting risk.

Capital preservation will take precedence over growth, meaning depreciation must be understood, again urging a focus on prime property. A range of lot sizes should be targeted to try to ensure some liquidity in the event of capital raising. Investors should also be alert to the potential for deflation to bring a short period of sharply-improved performance as yields compress – possibly offering good opportunities to dispose of stock.

In an inflationary environment, capital growth will take precedent and higher gearing may be advantageous. If inflation is strong, greater risk can be taken as most properties will benefit from rising prices, but in a milder inflationary environment, only property most in demand relative to supply would be sure to command higher rents. Other than in times of near hyperinflation therefore, a focus on quality property and locations will be most rewarding, especially if we see stagflation, with strongly rising prices but flat economic activity.

In the case of deflation, long, secure income streams will be in strong demand, while in an inflationary environment, shorter leases may be preferred although good lease terms will be key in raising debt.

Some EMEA leases clearly offer better protection against deflation than others, with, for example, a rental floor and good general security. Nonetheless, a rigid lease that holds the rent up runs the risk of helping to drive a tenant out of business – so flexibility is key.

UK leases will be attractive in a deflationary environment, but indexed-linked leases will attract greater interest if inflation picks up. New lettings and sale and leaseback deals will offer landlords an interesting opportunity to shape and protect their income profile, albeit with a higher level of risk sharing with tenants than in the past – eg with a cap and collar on indexed leases. For existing and new investments meanwhile, landlords should be alert to the potential for deflation to cut their incomes, possibly leading to covenant breaches on their loan terms.

Investors will need to assess the impact of inflation or deflation on the business sector of their occupiers. In an environment in which mild inflation is driven by energy prices for example, it will be clear which companies offer most security.

With deflation investors should look to sectors that are not too capital intensive, operate with low gearing and preferably deal with essential goods and services such as food and energy.

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Service sector inflation is typically higher and “stickier” than goods price inflation, implying that office occupiers may be less vulnerable to deflation than retail or logistics operators. A note of caution is needed, since this reflects the fact that a greater portion of service sector costs are in labour, and wage rates rarely fall in outright terms. In today’s economy, however, that assumption is being tested.

Top quality retail could in fact be a fair bet in a deflationary environment since retailers have had to cope with deflation for some time and the best have shown they can adjust their strategy to win out – with top streets and schemes remaining a key part of their marketing and sales platform.

The public sector may be favoured in a deflationary environment and with governments needing to raise cash, an increased flow of privatizations may be seen to feed demand. Some caution is once more needed however, with central and local government spending expected to fall in the coming years, employment and property may be under pressure.

The prospect of a period of mixed inflationary pressures points to investors holding good quality property that has “pricing power” in either environment, offers risk protection and has the best possible levels of tenant demand, preferably for a broad range of tenants and user types. Differing levels of debt may also be used through the period – with limited debt in deflationary times when real debt costs increase, but increasing leverage to boost performance when inflation picks up.

Finally, investors need to look carefully at their management arrangements and ensure they have strong and reliable systems in place to monitor cash flow, be alert and responsive to tenant needs and maximise the value of the cash they hold in the business – eg through regular cash sweeps.

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TABLE 3 | MARKET VALUES (Q3 2009)

	Rental Growth (yr to Sep 09)				Yield levels (Q3 2009)				
	Retail	Office	Industrial	Trend - All Sector	Shoping Centres	Shop Units	Office	Industrial	Trend - All Sector
Austria	0.0	3.5	0.0	↘	6.50	4.70	5.50	7.50	→
Belgium	-0.3	-2.7	0.5	↘	5.50	5.25	6.25	7.75	→
Bulgaria	-21.9	-24.6	-15.4	↘	10.50	9.00	11.00	13.00	↗
Czech Republic	-5.0	-7.2	-4.5	↘	7.00	7.00	7.00	8.50	↗
Denmark	-5.9	-6.8	-10.3	→	6.00	5.00	5.75	7.50	→
Finland	-16.1	-9.9	-2.4	↘	6.25	6.50	6.50	8.00	→
France	0.0	-2.7	0.4	↘	5.50	5.00	5.75	8.25	→
Germany	2.1	-4.0	0.0	↘	5.40	4.20	5.10	6.90	→
Greece	-19.4	-3.3	-13.0	↘	6.50	5.80	7.10	7.80	↗
Hungary	-20.0	-2.3	-17.4	↘	7.50	7.75	7.50	9.50	↗
Ireland	-20.4	-34.5	-9.8	↓	7.50	6.30	7.25	8.25	↗
Italy	-2.5	-7.1	2.1	↘	6.50	5.00	6.00	8.00	→
Luxembourg	0.0	-11.4	n/a	↘	5.75	5.75	6.00	n/a	→
Netherlands	-2.0	-3.1	-5.2	↘	7.00	5.25	6.75	7.90	→
Norway	-13.8	-16.2	0.0	↘	6.50	6.00	6.50	8.50	→
Poland	-3.7	-14.2	-0.7	↘	7.75	9.50	7.00	8.50	→
Portugal	-1.0	-4.9	0.0	→	6.50	6.75	7.50	8.50	→
Romania	-42.7	-14.8	-4.3	↘	9.00	9.25	8.75	9.50	↗
Russia	-33.0	-43.9	-28.6	↘	13.00	n/a	13.00	14.00	→
Slovakia	-37.5	-5.3	-12.7	→	7.75	7.75	8.00	8.75	↗
Spain	-0.9	-13.5	-8.9	↘	6.25	5.50	6.00	8.00	→
Sweden	-6.3	-11.3	-7.7	↘	5.75	5.75	5.75	7.50	→
Switzerland	0.0	-3.2	-1.8	→	5.50	4.50	4.75	6.75	→
Turkey	-17.9	-20.9	-24.4	↘	9.50	8.75	8.75	9.25	→
Ukraine	-40.5	-56.3	-30.0	↓	14.00	17.00	16.00	17.00	↗
UK	-9.8	-15.3	-0.3	↘	6.75	5.75	5.50	6.50	↓

Note: Yields are headline levels for the prime market in each country and are quoted on their local market basis. Those shown in red are calculated net, to include transfer costs of tax and legal fees. Rental growth reflects value movements in a sample of locations across each country.
Source: Cushman & Wakefield

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