



Q2 2010

PARIS DIGEST

Commercial Real Estate Markets in Ile-de-France

Knight Frank

HIGHLIGHTS

- ◆ More than 1.04million sq m of office space was taken up in Ile-de-France during the first half of 2010. Transactional activity has increased by almost 16% compared to last year displaying a clear trend reversal.
- ◆ For the full year, transactional activity should be slightly over 2 million sq m, which will set 2010 as an average, yet reasonable year for the letting market in the Ile-de-France region.
- ◆ The letting market is characterised above all by companies rationalising their occupational costs. Companies are striving to reduce their overheads and are moving to cost-efficient buildings, whilst making the most of the favourable market conditions. However, the global growth in companies' office requirements has stopped.
- ◆ Businesses are targeting high-quality, modern buildings and are looking to avoid premises that are not energy efficient, or obsolete spaces that are perceived as costly and dysfunctional.
- ◆ Availability has stabilised for the first time since summer 2007. The vacancy rate in the Ile-de-France region at the end of June stood at 7%. As with the Paris office stock, availability is very much second hand with barely a quarter being new or restructured.
- ◆ The downward adjustment of prime rents has passed. Rents have stabilised since the beginning of 2010. There are early signs of upward trends however, particularly in the Central Business District in Paris.
- ◆ The investment market has accelerated rapidly. The increase in volumes invested stands at almost 77% compared to last year with almost 2.3 billion euros have been invested in the Paris region during the first six months of 2010.
- ◆ Prime yields began to fall towards the end of 2009, and this was further confirmed at the beginning of 2010 with a compression of almost 25 basis points. Prime yields currently lie between 5.25 and 5.50% for the Paris CBD.

THE LETTING MARKET: PROPERTY ELITISM

Office take up: Obsolescence saves the market

Transactional activity has continued its recovery throughout the first half of 2010. The upturn began in the last few months of 2009 and although not spectacular, it is clearly present. In Q2 2010, the take-up of office space in Ile-de-France region totaled just under 560,000 sq m, compared to 415,000 sq m last year. Based on the first six months of the year, transactional activity has increased by approximately 16%. This is a sizable change given that a year ago the occupational market in Ile-de-France had shrunk by 25%.

This upturn is due for the most part to the particularly high number of average sized transactions (2,000 to 5,000 sq m), during the first quarter of 2010. This phenomenon explains in part the success of the Paris occupational market, which has seen its share of transactional activity climb to more than 45% during the first six months of the year (compared to an average of 32% since 2004). Large transactions, over 5,000 sq m, have maintained their share in Ile-de-France. This sector represented 35% of transactional activity during the first half of 2010, compared with 37% on average since the beginning of 2004. While it is certainly essential, this force is not exclusive and the Ile-de-France market does not rely solely on the property decisions of a handful of key users. The large transactions have however seen an upturn in the second half of the year, with key signings in La Défense and in the Southern Bend. In total, 36 transactions exceeding 5,000 sq m have been concluded since the beginning of 2010, totaling 370,000 sq m.

Several negotiations are ongoing and should conclude in the coming months and the dynamic status of the large transaction sector should continue. The letting market in the Ile-de-France region is therefore quite reassuring, although it is wise to maintain a realistic view on matters. During the last 18 months, we no longer find ourselves in a market dictated by increasing business requirements for office space. Activity is now determined by businesses looking to rationalise office space and property expenditure and requirements in this sector are extremely active. New space and assets that have been heavily restructured since 2005 only represent 10% of regional office stock. Even when including the space supplied over the past decade, this sector does not exceed 19%. Obsolescence, together with subsequent costs and constraints, therefore threatens a significant amount of stock and penalises its occupants. Many judge that it is necessary to release themselves from the burden of inadequate facilities and they are encouraged to do so by the significant improvements in the technical quality of office space available alongside the downturn in rents observed in 2009.

Net absorption remains at its lowest level. Although it was marginally positive throughout 2009, the results were the weakest experienced throughout this decade. The situation seems to have improved slightly since the start of 2010 but this improvement is deceptive, as for the most part it is due to the time frame required for users to vacate their old premises once they have signed a lease for new office space.

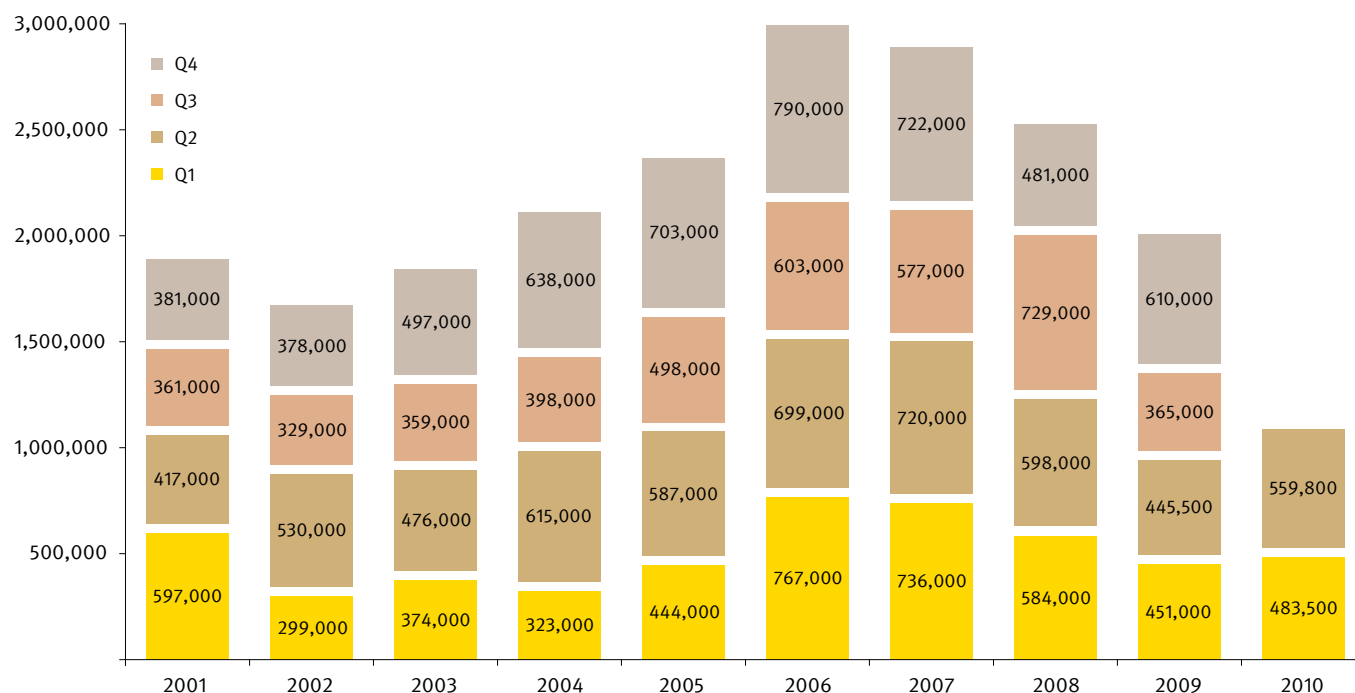
Example of leasing transactions (Q2 2010)

Address	Department	Tenant	Area (sq m)	Rent (€/sq m/annum)
Tour Horizons - Boulogne-Billancourt	Southern Bend	Laboratoires Roche	15,600	500
Coeur Défense	La Défense	Allianz	13,200	480
Parc du Millénaire - Paris 19 th	Paris 18/19/20	ARS Ile-de-France	13,000	300
Atlantis - Massy	Outer rim	Carrefour	10,600	205
23/25 rue de Provence - Paris 9 th	Paris CBD	Devanlay	5,400	520



Take-up in Ile-de-France (sq m)

Sources : Knight Frank, Immostat



Office supply: The increase is over

The amount of office space available has halted at 7%. For the first time since mid-2007, the upward movement of vacancy rates has stopped. This phenomenon is all the more encouraging given that the Ile-de-France vacancy figures are stabilising at a level which is at the envy of major European cities, where the norm is often above 10%. The stability of the Ile-de-France occupational market is evident once again.

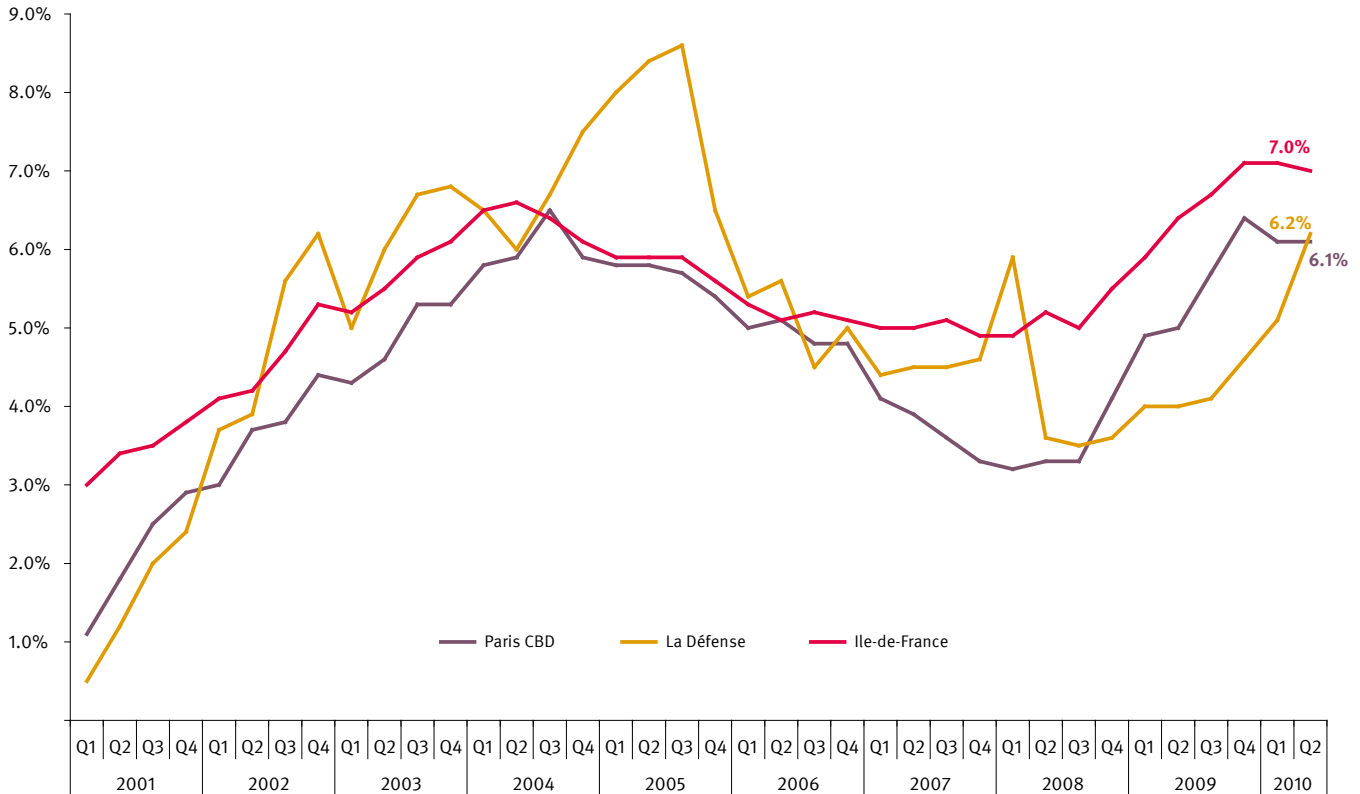
The stabilisation is due to the letting market holding up well and by the clear decrease in the supply of new or restructured space. In 2009 the market peaked with 1.28 million sq m delivered. This space, made up of building projects launched during a more euphoric period, may have given cause for concern due to the economic downturn. However, in reality, this peak has not generated the imbalances feared as the majority of this has been let: 63% to be precise.

In fact, looking at Ile-de-France office space in general, stock available is dominated by obsolescent space: new or restructured space only accounts for 25% of supply available. Even in the sectors in which high quoting rents had slowed marketing, such as the 15th district in Paris and in Boulogne-Billancourt, a significant number of leases were signed. New or restructured space is now a rare commodity.

However, not all markets in the Paris region are in the same situation. Certain sectors are displaying higher vacancy rates than the regional average, for example the Inner Rim region (9.2%) or Péri-Défense (14.1%) and the Northern Bend (14.3%). In these emerging markets, the letting of some major schemes can prove to take more time as the attractiveness of their pricing has been diminished by the downwards adjustments in the more well established sectors.

Vacancy rate in Ile-de-France

Sources : Knight Frank, Orié



Office rents: The sales have come to an end for prime space

The stability of average rents is one of the key characteristics of the Ile-de-France letting market. Since the beginning of 2001, the maximum difference between the low point in the third quarter of 2005, €268, and the high point at €322 in the fourth quarter of 2008, is only €54. At €304 in the second semester of 2010, the average rent in the Ile-de-France region is practically identical to average rents one year earlier (€308).

This global stability, an expression of an "invisible hand" of the market (users move spontaneously towards buildings adapted to the price at which they value property, and for the most part this price remains constant), should not mask the disparities within the Paris region. For example, the arrondissements outside Paris CBD performed well at the beginning of the year, so the average rental value can in turn perform well in a difficult market.

However, the difference in average rent between La Défense and the Central Business District, which is key to the interpretation of Ile-de-France, is still very volatile. In the first quarter of 2010 the difference returned to €97, more in line with the level observed in previous years, but in the second quarter of 2010, the difference dropped again to (€40) showing a very unsettled market.

With regards to the most expensive buildings, namely the best new or restructured buildings offered on the different markets, rent fluctuations have been much more significant. Prime rents in the Central Business District (CBD) have adjusted downward severely, losing almost €130 in 18 months. Of course, a market driven by cost rationalisation is not likely to favour high market values. Prime rents, which are judged to be the benchmark of the market, fell to €710 sq m/yr in the CBD at the end of 2009.

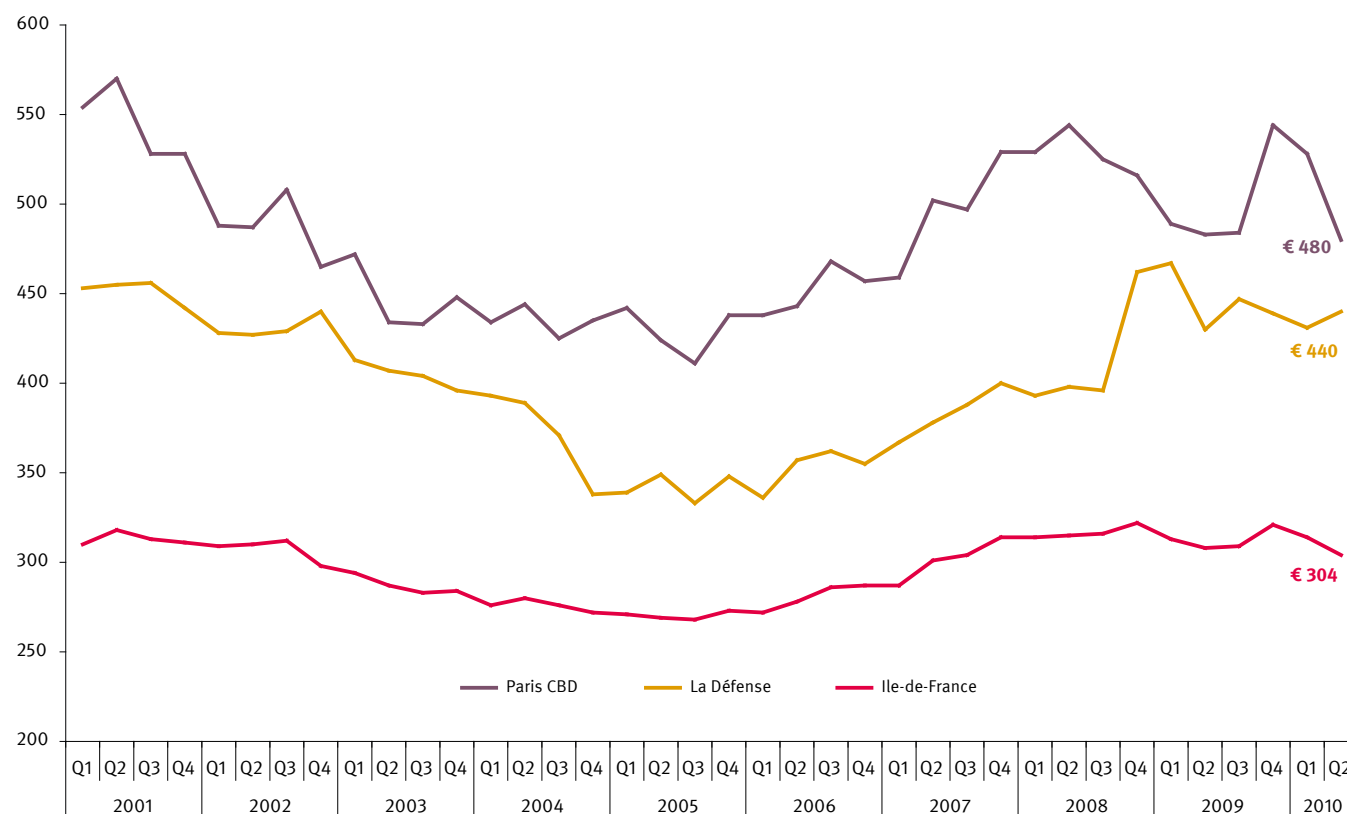


Since then, prime rents have not moved demonstrating that the adjustment was deemed sufficient and there are already signs of initial upward trends, driven by some exceptional transactions. The letting of Origami, on avenue de Friedland (Paris 8th), serves as the best example at a value of €830.

Other markets are not as advanced as the Central Business District and the most well established markets will likely follow the CBD trend within a few months.

Average rents in Ile-de-France (€ net/sq m/annum)

Sources : Knight Frank, Immostat



OUTLOOK: THINGS ARE PICKING UP

The neologism "rilance" was coined by the French Minister for Economic Affairs and Finance, Christine Lagarde, to define the French economic policy. This term is an oxymoron which links the French term "rigueur", (austerity), with the term some consider its antonym; "relance" (revival), and which when combined sum up current ambiguity and the questions we are faced with at present. While growth appears weak, combined with high unemployment levels and very real social tensions, two additional worrying risks have darkened our doorstep: bank failure and the incapacity of the state to honour its debts. The latter concern caused a wave of panic in financial markets in the spring with the Greek sovereign debt crisis and more widely, doubts raised about other PIGS (Portugal, Italy, Greece and Spain) that have not spared countries such as France and the United Kingdom.

The initial difficulties (poor growth, unemployment and social discontent) are fairly common and were rapidly anticipated. Revival measures inspired by Keynesian policy were called for throughout Europe and the United States and although they made a difference initially, the effects have petered out over recent months. The second range of difficulties however seem much more complex and much more alarming. They have driven an increasing number of countries including Spain, Germany and the UK, to adopt severe austerity plans. These plans are considered vital if confidence is to be restored in the financial markets prior to the creation of an environment in which growth will prosper. The problem now is that at least in the short term, these plans will force job cuts and a reduction in both individuals' purchasing power and businesses' order books. So many negative effects generated by the supposed revival measures just when the economy was beginning to find its feet.

Some experts are extremely concerned that although these measures are necessary, they are not being implemented at the right time. Others believe that it will be necessary to balance these measures with a flexible monetary policy across the Euro zone, indeed using Keynesian policy at the European Union level, to take over from financially exhausted states. There is a need for some sort of balance at the very least to ensure that the economies do not plunge back into recession.

This is the principal difficulty which hinders the revival of the office lettings market. It excludes the possibility of recovery of positive net absorption in the short term. The most which can be hoped for is the revival of transactional activity, lead by businesses located in buildings that are becoming obsolete and which are therefore looking to benefit from favourable market conditions to move. With more than 1 million sq m of office space marketed in six months, the first six-month period of 2010 supports this hypothesis. The number of offices consumed in 2010 should account for slightly more than 2 million sq m in the Ile-de-France region. Better results than 2009 will position 2010 as an average year, not unlike 2004.

The revival of transactional activity would encourage available rent volumes to stabilise particularly as there has been a significant drop in building and redevelopment activity. Almost 1.3 million sq m of office space was supplied in the Ile-de-France region in 2009, yet less than 730,000 sq m is expected in 2010 (of which only 355,000 sq m will be available.) and it looks likely that the picture will be much the same in 2011. Vacancy rates should stay around the current 7% level across the Paris region. This level is low compared to most other European cities, and is marked by the increasing lack of new and redeveloped supply.



Companies seeking new premises may be forced into buying new builds well in advance. Thales Communications for example have just signed for an 87,500 sq m site which will be available for use in Gennevilliers in 2012.

Due to the scarcity of new and redeveloped supply, the period of adjustment to the decrease in prime rents has well and truly come to an end. Tendencies towards increases should take shape in the near future, and the strength of these will depend upon the lack of this type of property in the various geographical sectors.

€800 is the value emerging on the horizon for the Central Business District and for some emblematic buildings on Paris' Left Bank. There is no reason, however, that these increases should extend to buildings which are energy inefficient, or to second hand buildings that are still subject to healthy competition.



INVESTMENT MARKET: MODEST IMPROVMENT

Volumes invested: Healthy increase

Between 2008 and 2009, the property investment market was a little bit like Sleeping Beauty. It started to wake up in the fourth quarter of 2009 but its real awakening did not come until the beginning of 2010. Almost 2.3 billion euros were invested in the Paris region during the first six months of 2010, marking an increase of 77% compared to last year. This increase has thrived throughout the past three months with a 45% increase on investment in the first quarter to 1.36 billion in the second quarter of 2010.

The results are particularly pleasing as activity was slowed somewhat by the delay in arbitration proceedings for a number of owners, which meant that not all deals ongoing since the beginning of the year were closed in time to be considered. News is therefore rather reassuring, especially as the restrictions that affected the investment market previously have changed significantly in one year. While the wait-and-see policy was favoured by the investors at the beginning of 2009, activity is now restricted by the lack of property available for sale.

The lack of assets available for sale compared with demand was compensated for in part during the second quarter of 2010 by the sale of large new build schemes offering a secure rental profile, for high investment volumes. The return of large transactions, for amounts close to or exceeding 100 million euros has been one of the key features of recent months and explains the positive results in the second quarter. This is a significant shift as the market was dominated by property transactions of

less than 25 million euros one year ago. Improved liquidity for larger buildings also explains why the Paris suburbs have become more attractive to investors for the first time since the market recovered. 509 million euros have been invested in the first and second peripheries (seven regions on the Paris outskirts) during the second quarter of 2010, accounting for 37% of volumes invested. Investors are continuing however to focus on high quality, well secure assets. The vast majority of interest lies in new buildings that meet the most specialised technical requirements and which are let on long-term leases to strong covenants.

Prices and yields: The address is no longer the be-all and end-all

The fourth quarter of 2009 marked a break in the trend with the first dip in prime yield after two years of falling yields. Although moderate, activity at the beginning of 2010 confirmed this. Care should be taken, however, as rates in several geographical sectors are mainly theoretical due to the reduced number of reference acquisitions.

In view of recent transactions, prime yields fall between 5.25 and 5.50% for the Paris Central Business District (CBD), a 25 basis point decline in six months. It is however understood that there are negotiations underway for prime CBD buildings at around 5.00%. The same trend is present across other inner Paris sectors (Paris 5/6/7, Paris 12/13, Paris 14/15) and in the majority of Western Crescent markets. Key markets in the Paris region have fallen to levels recorded in mid-2008 prior to the turmoil caused by the Lehman Brothers' collapse.

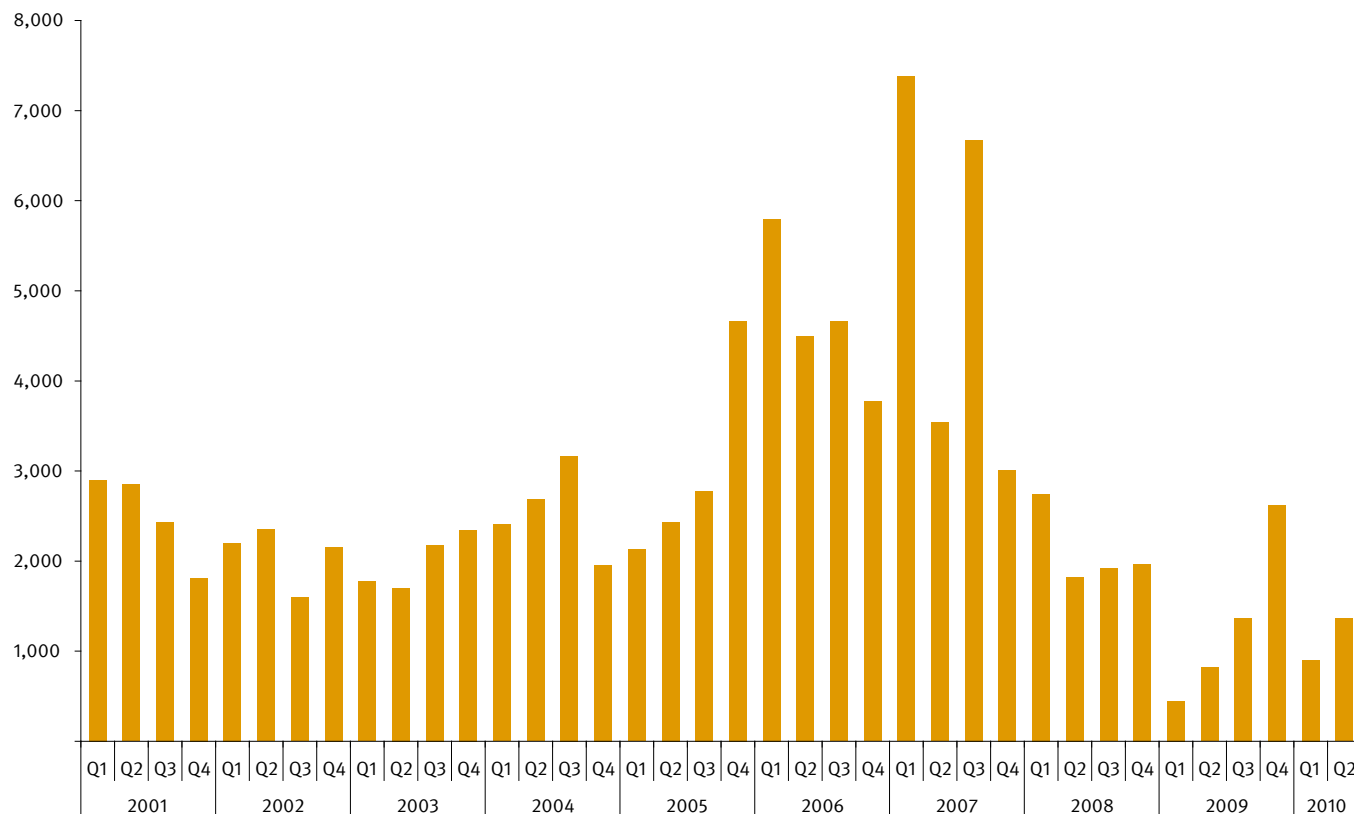
Examples of investment transactions (Q2 2010)

Asset	Department	Purchaser	Area (sq m)	Price (€ M)
Opéra Gramont - Paris 2 nd	Paris CBD	Deka	8,700	75.0
Cap Image - Montrouge	Southern Inner Rim	Viveris Reim	10,400	65.0
Terra Nova 1 - Montreuil	Eastern Inner Rim	Cardif Assurance Vie	15,100	59.0
Le Confluent - Maisons-Alfort	Outer Rim	UFG REM	8,800	42.0
24 rue Cambacérès - Paris 8 th	Paris CBD	Foncière Massena	2,800	26.3



Investment volumes in Ile-de-France (€ million)

Sources : Knight Frank, Immostat



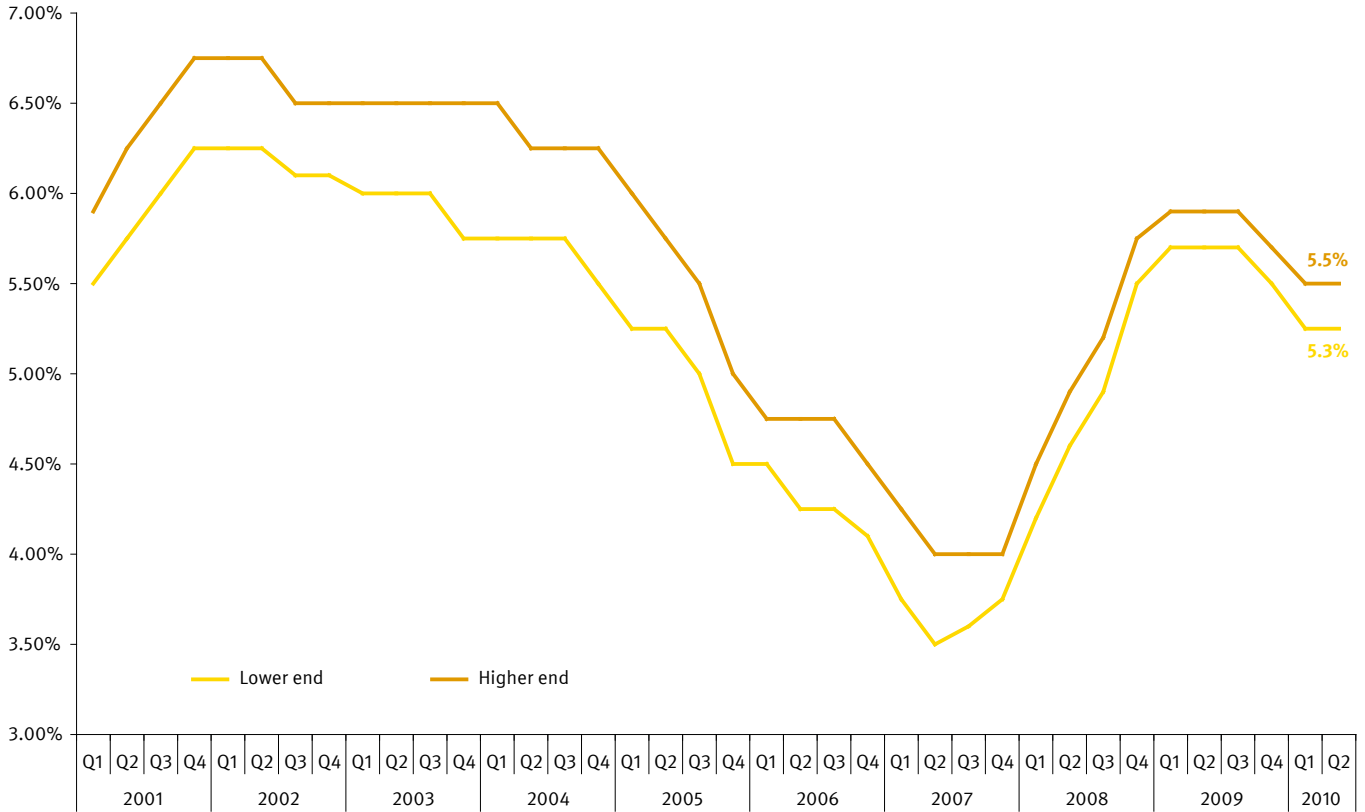
The most striking revelation is the subtle questioning of the idea of "key markets", as property location is no longer as important as the intrinsic qualities offered by a building and its tenant. Investors now place much more emphasis on the technical capabilities of a property together with the reliability of the tenant and the length of the lease. Geographic location has become just another factor in the equation. There is no longer such a significant gap between yields across different markets.

Several transactions of HQE buildings (that meet the French national standard for high environmental quality) in the first periphery around Paris, that have been let or pre-let to major operators have been transacted at yields inferior to 6.00% - yields that are normally associated with the much more traditional inner Paris markets.

Conversely, the gap is widening between "core" and other assets within each market. There is still strong competition for the best buildings but it is becoming much more difficult to transact assets that present problems.

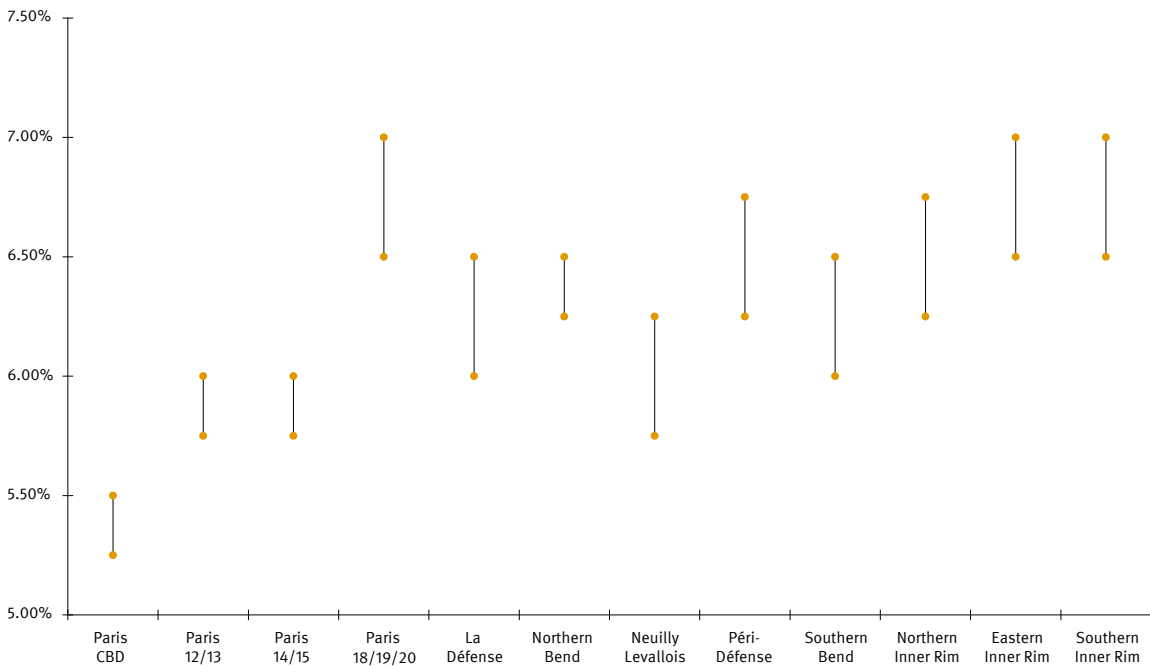
Prime yields band in Paris CBD

Source : Knight Frank



Prime yields in Ile-de-France

Source : Knight Frank





OUTLOOK: "CORE" TO "CORE" AND THEN SOME

July 1st 2010 is a date that made economists and financiers shudder. It was the date by which the European banks had to pay back the 442 billion euros loaned to them by the European Central Bank (ECB) in 2009 to avoid freezing the credit market. The date passed without too much trouble in the end as the banks only needed 243 billion euros in new loans to repay the amount owed to the ECB, with the outstanding amount covered using their own funds. The concerns raised however, show there is still an elevated level of economic and financial risk linked to public and private debt and doubts about state solvency and bank exposure. It is this risk that has undermined hopes of a financial revival and has led to the implementation of severe austerity plans across Europe. In France the solution is seen to lie behind the rather strange neologism "rilance" through which the plans implemented are likely to have significant counter effects on purchasing power, consumption and business order books. In the short term the plans may quash any hope of growth but are no doubt crucial to the recovery of calm over the financial markets and stock exchange. The confidence resulting from the calm will have more effect on the property investment market than the immediate impact of austerity on growth provided that it does not ruin the lettings market and does not provoke uncontrollable political and social movement. In conjunction with a flexible ECB policy, this new serenity can therefore ease credit conditions and remove some of the threats which burdened the future of the investment market.

While the next months appear positive, with a third quarter of 2010 which promises widespread investment with the conclusion of a number of deals already in progress, the medium term is under more threat.

In 2011 and 2012 numerous investors will have to meet significant settlement dates for purchases made prior to 2007. Some such investors will also find that the monetary value of their assets has dipped below the value of their outstanding debt. Lending institutions are therefore going to have to focus on refinancing for their clients so as to avoid missed payments, which means less time and money for new acquisitions. In terms of new acquisitions, it is likely that bankers will really focus on "core" assets and on investors with their own funds, so that they can reduce the "loan to value" ratio (LTV) to between 50 and 70%. These cautionary measures will be even more strict as negotiations are undertaken for the Basle III agreement, which could come into application at the end of 2012, limiting banks exposure to risks. As investors with their own funds, notably German funds, risk being restricted in parallel by new national legal clauses, this indicates that the investment market could run into a drought from 2011. 2010, with an annual volume close to 7 to 8 billion euros, would therefore seem like a brief upturn.

Such a market configuration should bring about a more and more intense competition for the best secure assets, favouring a new compression of prime yield rates. Conversely, the rates of less easily-financed assets could rise, thereby creating opportunities for those who could afford to take them...

Market breakdown as at Q2 2010

Area	Prime rents (€/sq m/annum)	Average rents (€/sq m/annum)	Take up in 2009 (sq m)	Estimated stock (sq m)	Vacancy rate	Prime yields band
Paris CBD	710	480	179,800	6,685,000	6.1 %	5.25 % - 5.50 %
Paris Centre West (excl. CBD)	500	359	49,800	1,811,000	5.5 %	-
Southern Paris	-	386	143,500	4,957,000	5.3 %	-
Paris 5/6/7	650	417	16,400	1,215,000	4.5 %	5.50 % - 5.75 %
Paris 12/13	450	390	52,500	1,833,000	6.1 %	5.75 % - 6.00 %
Paris 14/15	520	371	74,600	1,909,000	5.0 %	5.75 % - 6.00 %
North Eastern Paris	-	-	101,300	2,788,000	3.7 %	-
Paris 3/4/10/11	340	302	284,500	1,620,000	4.5 %	6.00 % - 6.25 %
Paris 18/19/20	320	-	72,800	1,168,000	2.6 %	6.50 % - 7.00 %
Total Paris	-	-	474,000	16,241,000	5.4 %	-
La Défense	500	440	56,900	3,187,000	6.2 %	6.00 % - 6.50 %
Western Crescent	-	280	235,400	7,561,000	10.9 %	-
Northern Bend	315	217	26,000	1,622,000	14.3 %	6.25 % - 6.50 %
Neuilly Levallois	480	371	50,000	1,375,000	5.9 %	5.75 % - 6.25 %
Péri Défense	400	222	70,700	2,158,000	14.1 %	6.25 % - 6.75 %
Southern Bend	500	295	88,700	2,406,000	8.5 %	6.00 % - 6.50 %
Inner Rim	-	198	97,900	5,706,000	9.2 %	-
Northern Inner Rim	300	161	41,200	2,332,000	8.2 %	6.25 % - 6.75 %
Eastern Inner Rim	280	226	8,100	1,205,000	10.5 %	6.50 % - 7.00 %
Southern Inner Rim	350	213	48,500	2,168,000	9.5 %	6.50 % - 7.00 %
Outer Rim	-	143	178,800	18,616,000	6.4 %	-
Ile-de-France	-	304	1,043,300	51,319,500	7.0 %	-

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