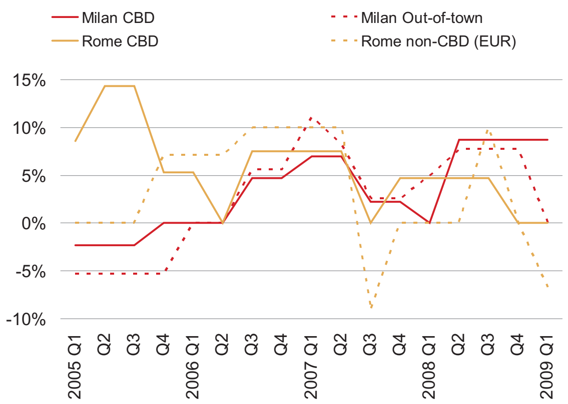
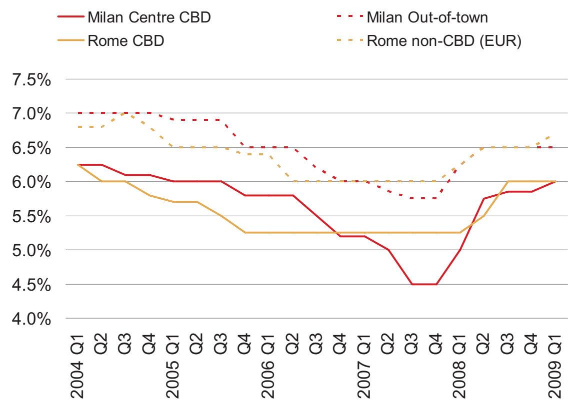
Milan and Rome
Office market report

Spring 2009

Prime office rental growth is slowing down



Prime office yields have moved out



"Investment activity has come to a relative standstill due to restricted lending and the uncertainty around pricing. We consider the current conditions favourable for investors as competition is limited and prime Milan and Rome occupier markets remain stable."

Lionello Rosina - Head of Italy

- The economic downturn has caused a slowdown in **Milan** leasing activity, however the number of enquiries is rising driven by the need for more efficient and cost effective space.
- A balance between demand and supply of high quality premises keeps Milan prime rental levels stable. Slight rental falls have been noted in the secondary segment of the market and are expected to continue.
- Consolidation and the relocation to modern buildings will leave a rising proportion of available space in second hand premises in both centres.
- Office rents in the **Rome** market have remained stable in 2008, but we expect the secondary segment to come under pressure this year.
- Investment activity has come to a standstill since the middle of 2008. Italian funds and private buyers will remain the protagonists of investment activity this year, although there is still some reluctance to enter the market due to the uncertainty around pricing levels.
- We consider the current conditions favourable for investors, as competition is limited and prime assets in the Milan and Rome CBD markets can come on offer at lower prices than last year.

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Italy Economy

Economy

The Italian economy is expected (Oxford Economics) to contract by 4.5% and stagnate in 2010. This weakness is driven by falling domestic demand and a significant drag from net trade. Industrial production in the first two months of 2009 was 5% lower than in November and December, and an even larger drop is estimated in March. In the year to February, industrial orders fell 31% and business confidence was at historic lows.

Unlike during the recessions of 1974-75 and 1992-93, exports are unlikely to provide any support to production, given the weakness of global demand and the lack of the devaluation option. So a scenario in which industrial production falls by over 20% this year is not unlikely.

Data for the first few months of 2009 suggests a rapid deterioration in the labour market. The unemployment rate is expected to rise to 8.1% this year (from an average of 6.8% in 2008) and to reach 9% in 2010, lagging behind the expected feeble recovery in activity. Inflation fell to 1.2% in March, its lowest since 1969.

Household consumption fell 0.8% in Q4, yielding a 0.9% drop for 2008 as a whole, with all components except services posting a decline. The beneficial effects of falling inflation and interest rates on household income have not yet shown up in consumer confidence, which dropped again in March, dragged down by the worsening employment outlook. Falling confidence is weighing on sales and, according to Oxford Economics, household consumption is expected to fall by 1.9% this year.

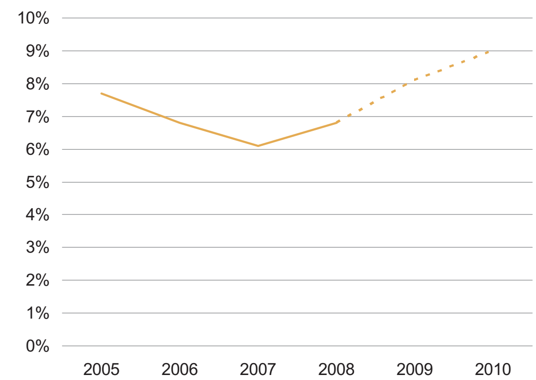
Last year government deficit reached 2.8% of GDP, up from 1.6% in 2007, with a significant deterioration occurring in Q4. And early-2009 data points to falling revenues. The high level of public debt limits the scope for the authorities to engage in fiscal stimulus, with measures introduced so far likely to have only a broadly neutral impact on the deficit.

However, the 4.5% fall in GDP now forecast for 2009 will push the budget deficit up to 5.6% of GDP, with a further rise seen in 2010. And these projections do not include the funding needed for the reconstruction of the area hit by the severe earthquake on 6 April – initial estimates suggest this will be over €12bn, or nearly 0.8% of GDP.

GDP and Industrial production

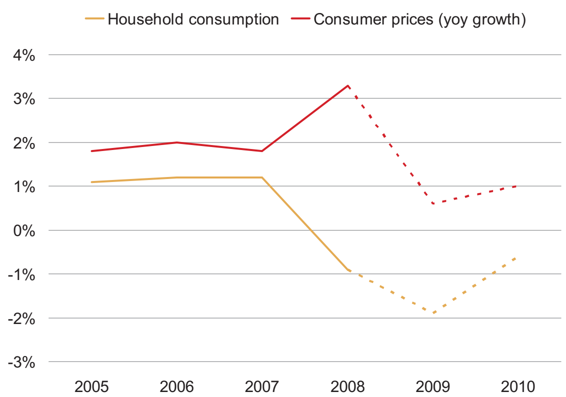
Source: Oxford Economics

Unemployment rate



Source: Oxford Economics

Household consumption and CPI



Source: Oxford Economics

Milan office market

Milan office market

Demand

At the beginning of 2008, the occupier market was stable with the majority of enquiries based on actual requirements and translating into leasing agreements. Since then the economic downturn has caused a slowdown in leasing activity and a lot of office occupiers are limiting themselves to exploring the market opportunities for consolidation and cost savings.

In 2008 total take-up of office space was over 350,000sqm. In sqm terms, the IT / Technology sector accounted for over a quarter of occupational space turnover followed by the Services and Industrial sectors at around 17% and 12% respectively.

The movement in the volume of occupier activity (in sqm terms) over the last 12-15 months reflects an interaction of three main factors: the market, the economic situation and seasonal trends.

Trend in occupier demand and letting activity

Source: Savills

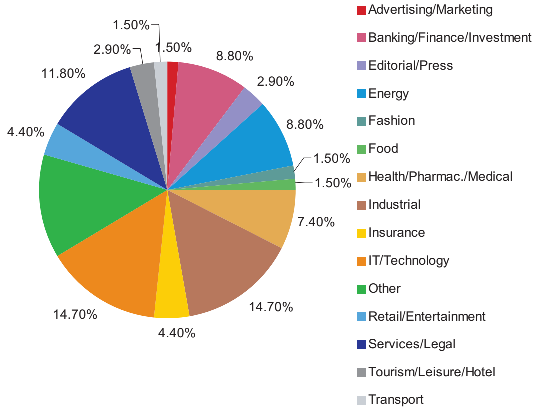
After a notable increase in leasing activity in the last quarter of 2008, the volume of lettings dropped by more than half in the first quarter of 2009. On the other hand we have noticed a rising level of demand compared to 6 and 12 months ago. The number of enquiries for office premises almost tripled in the final quarter of 2008, while the total volume of space in request almost doubled. At the end of the first quarter, there was an increase in the amount of space in demand by nearly 33% on an annual basis. The reason behind this significant growth is attributable to the large portion of office occupiers that are reviewing their real estate options, in the light of a reduced headcount and / or the need to maximise space efficiency through consolidation.

Although the unit size mostly in demand is still between 500 sqm to 1,500 sqm (unchanged since the start of Savills' surveys), the area mostly in demand now falls at the lower end of this range. An increase in the interest for larger sized units was seen at the end of 2008 but this has now fallen back to average levels.

As occupiers' attention has shifted towards space occupational costs, one of the highest cost items for any company, the focus is on premises which are not only competitive in terms of rent, but also efficient in terms of both layout and specifications. But the fact that the gap between enquiries and lettings has widened so significantly is an indicator of the changes that need to occur in the Milan office market supply.

The proportion of enquiries that will lead to leasing contracts depends on the market's ability to satisfy the above prerequisites. This need for new or refurbished premises is already fuelling occupier interest for the new development projects underway (both linked or not to Expo 2015), which are slowly but surely redefining the plan of Milan's office market. The combined result is a constant shift of interest towards new non-central, but still competitive developments and locations.

Occupier demand analysis (in sqm - Q1 2009)



Source: Savills

Supply

Despite the fact that the need for consolidation and cost-cutting is leading to a rising number of enquiries, the net absorption of office space is expected to be negative, leaving more available second hand space in the market. Occupiers are looking for newly built, well connected offices, which allow for further optimisation of space and savings. Energy efficiency is also increasingly becoming a prerequisite. As a result, not only availability on the wider Milanese marketplace is growing, but it is increasingly composed of older, less efficient, relatively poorly connected accommodation.

New development projects tend to be located within the Milanese periphery, starting from the edge of the semi-central district defined by the 3rd ringroad, or in out-of-town locations. The provision is that, to allow successful marketing, they are well linked by road and public transport routes and have competitive asking rental levels. By and large, although we have not seen any

Milan and Rome office markets

new projects being postponed, there is a slowdown in development activity due to the lack of availability of funding.

Rental levels

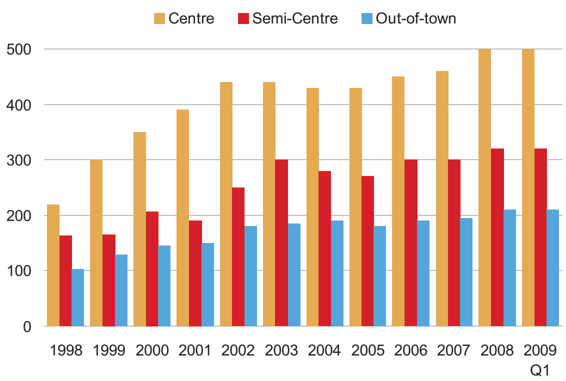
Although over 2008 as a whole rental values showed growth with respect to the previous year, the first quarter of 2009 saw rental levels stabilising, having at the worst fallen slightly at the end of 2008, especially with regards to secondary rents. The persisting imbalance between demand for high quality premises and their availability in attractive locations is the main reason behind the stable prime rental market, while at the same time average prime European office rental growth has turned negative. Nevertheless, incentives, such as longer rent-free periods, capital contributions and stepped-rents have increased leading to lower effective rents.

As at the end of Q1 2009, prime Milan office market rents stood as follows:

Zone	Prime annual rent	Secondary annual rent
Centre (CBD)	€500	€380
Centre (non-CBD)	€400	€300
Semi-centre (Fiera-Sempione)	€320	€220
Periphery (Outside 3rd ring)	€260	€130
Out of town	€220	€190

Source: Savills

Milan prime office rents



Source: Savills

Rome office market

Demand and supply

In 2008 and at the start of 2009, Rome's office occupational market was characterised by reduced take-up volume and fewer new requirements.

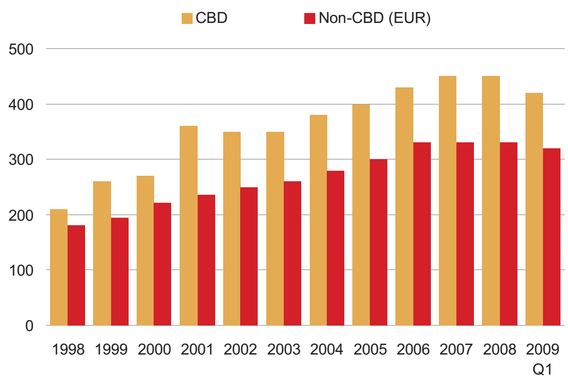
The majority of new demand tends to fall within the 500-1,500sqm range, with requests for larger units being relatively rare. Demand, particularly in central locations and/or for larger unit sizes, is still driven by the public sector, which has demonstrated the need for large-scale space for consolidation. On the other hand private sector enquiries tend to be smaller and, in the weakening economic environment, they can often be satisfied in their existing space. The focus of the public sector is the CBD area, while the priority for the private sector is the specification and the location of the accommodation, with the area of EUR being the most sought after area.

In the context of weaker demand and with the main driver of leasing activity being modernisation and consolidation, net absorption is estimated to be negative leaving vacant second hand buildings in the main submarkets. Although the number of new development completions is low, a reduced level of demand leads to rising availability of space. Moreover, many of the new developments are located in less established locations, and it is more difficult to attract occupiers. This year we expect developers to focus on the redevelopment / restoration of second hand accommodation which, when well located, has higher chances of being absorbed.

Rental levels

The Rome office market was characterised by entirely stable prime and secondary rental levels throughout 2008, falling slightly at the start of 2009. We expect prime rents to remain substantially unvaried, although secondary rents will come under continued pressure due to rising availability in this segment.

Rome prime office rents



Source: Savills

Italy investment market and Outlook

Investment Market

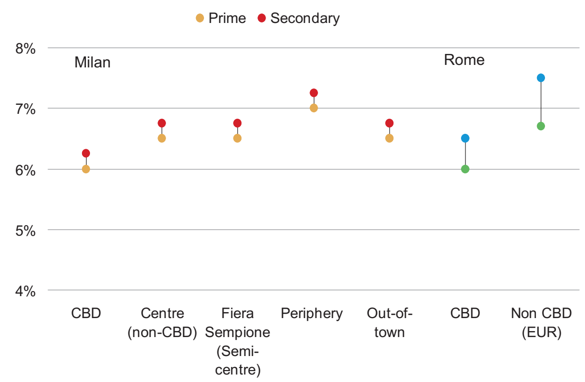
Investment activity has come to a standstill since the middle of 2008 and is characterised, as elsewhere in Europe, by restricted lending conditions and uncertainty around pricing.

With leveraged investors leading investment activity during the peak of the market, the limited availability of finance now has led to virtually no investment transactions. The major international banks, such as Hypo RE, ING Finance, Eurohypo, Royal Bank of Scotland and Aareal have eliminated their activity in the market, and the Italian banks that remain active are lending for much smaller investment volumes and lower Loan to Value (LTV) ratios. By and large they do not consider amounts higher than €50m and effectively it is more realistic to obtain financing for amounts up to €20m. With regards to LTV ratios although up to 80% was common before the credit crisis currently leverage is more likely to be obtained on a maximum of 60-70% of the value.

Last year national and international property funds such as Schroders, Cordea Savills, Aedes and Beni Stabili were amongst the most active sellers, while Italian funds were the most active buyers. We expect the Italian funds and private buyers to remain the protagonists of investment activity this year, although there is reluctance to enter the market due to the anticipation of further capital value drops and the unfavourable lending conditions.

Prime yield levels in today's Milan market stand at 6.00% in the central CBD area, moving out to 6.5% in the semi-centre, 7.0% in the periphery and reducing again to 6.5% in the prime out-of town locations. In Rome prime office yields similarly range between 6.0% and 6.7% depending on the location. It should be noted however that yields are in continual evolution and can be difficult to pin-point due to the market uncertainty and lack of actual market transactions being closed.

Milan and Rome office yields



Source: Savills

Outlook

According to Oxford Economics forecasts, service sector employment creation in Italy is going to slow down to 1.8% in 2009 before turning negative in 2010 and 2011 at -0.6% and -0.2% respectively. The Milan region, being the financial and business centre of the country, is forecast to avoid negative employment growth in the service sector in 2009 and 2010 and grow by an average of 0.9%pa. On the other hand, Rome is expected to suffer more from the economic downturn especially in 2010 when a -2.0% drop in service sector employment is forecasted. The overall unemployment rate in Milan region is expected to jump from 3.8% in 2008 to 4.6% in 2009 and in Rome region from 7.2% in 2008 to 8.7% in 2009.

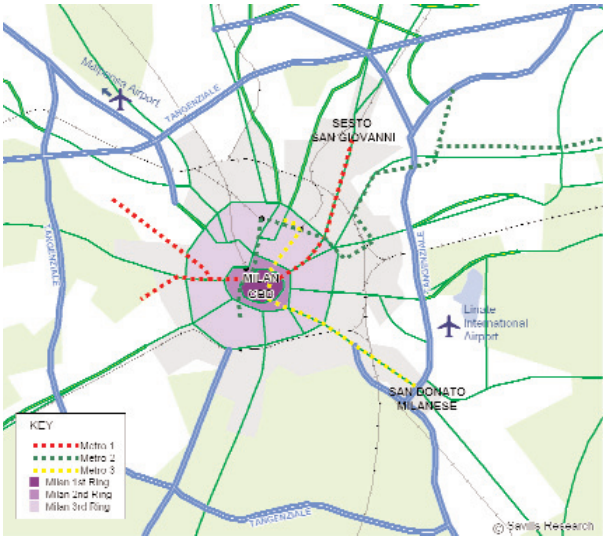
Inevitably the above should lead to further downsizing and consolidation in the office sector. Therefore, although we may see stability or even growth in the number of enquiries, leasing agreements will continue to take longer to conclude and net absorption is unlikely to be positive. Rents in prime locations with high demand and a low supply of space, mainly in the CBDs of both cities, should not change significantly. However second-hand offices and buildings located in areas with higher availability and wider choice, mainly in peripheral locations, will see reduced rental levels. We also expect incentives to rise, leading to lower effective rents.

With regards to new supply, this should remain subdued due to the lack of financing and the reluctance of developers to commence a project without a pre-let. Developers in Rome may focus on the redevelopment of second-hand buildings in good locations, with high chances of being re-let. In Milan, on the other hand, developers are beginning to look towards Expo 2015 and ways of raising the equity that will be required to be involved in the associated developments.

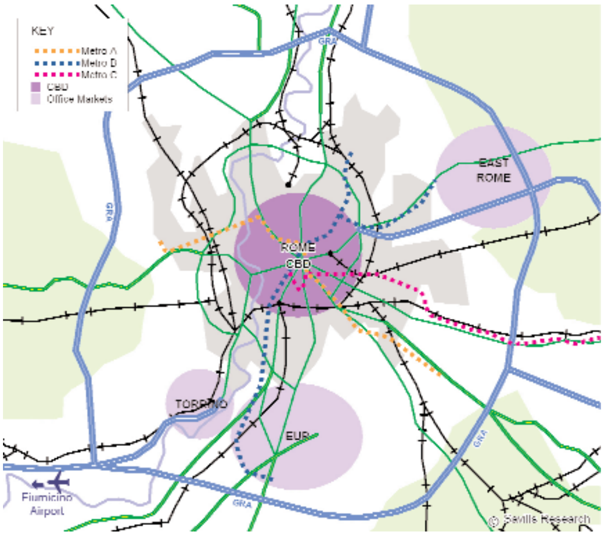
The investment market is going through a transition period, where less demand and limited financing is driving prices down. We believe that yields could continue to move out during 2009, due to the weakening economy and the uncertainty about the timing of the recovery. However, current conditions are also favourable for investors, as competition is limited and prime assets in the Milan and Rome CBD markets can come on offer at lower prices than last year.

Milan and Rome survey areas

Milan survey area



Rome survey area



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