THE GRI CHAIRMEN'S RETREAT 2003

THE CHAIRMEN'S CONCLUSIONS

REPORT FROM THE PROCEEDINGS

GLOBAL REAL ESTATE INSTITUTE

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THE GRI CHAIRMEN'S RETREAT 2003

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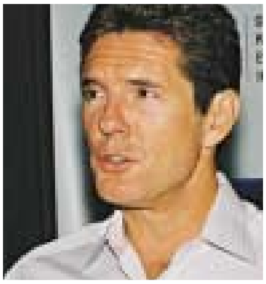

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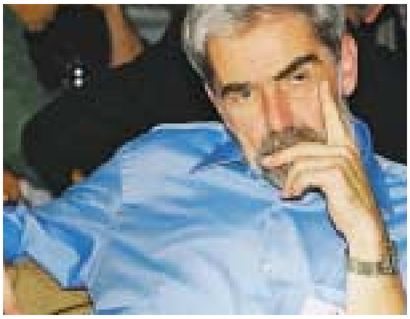

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W E L C O M E

The GRI Chairmen's Retreat 2003 brought together the leadership of the real estate industry in Europe in St Moritz this past January 17 to 19, as it does annually.

The Retreat is a collegial conversation on a first name basis between friends on strategy and industry developments.

It is reserved for the chief real estate executive within any organisation or the immediate second-in-command and limited to the top 100 real estate investors, owners, developers and lenders from across the world, active in greater Europe.

We are pleased to bring you in these pages a summary of deliberations and conclusions reached by some of the best brains and most talented achievers in the industry.

Henri

Henri Alster
President, American European Investment Bankers, Inc.
Chairman, GRI – Global Real Estate Institute

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P R O G R A M

Sponsored by Morgan Stanley

Thursday, January 16

18h30 – 22h30 **Cocktail party sponsored by Morgan Stanley**

Friday, January 17

08h30 – 08h45 **Welcome and Introduction**

08h45 – 10h00 **Europe: Dying Giant or Tomorrow's #1 Economic Power?**
Russell Jones Chief International Economist, Lehman Brothers
Gerard Lyons Chief Economist, Standard Chartered Bank
Henri Alster Chairman, GRI *moderator*

A debate with the audience

10h15 – 12h45 **Europe: Alternative Futures**
Nicolas Turner Executive Director, Morgan Stanley *co-moderator*
Karen Gerringer Executive Director, Morgan Stanley *co-moderator*

Breakout discussion on four possible scenario's and their implications
Report group findings in plenary and discuss

12h45 – 14h00 Lunch

14h00 – 15h15 **Global Forces Affecting European Real Estate**

Professor Tim Congdon Chief Economist, Lombard Street Research
Mike Gonzalez Deputy Editor, Wall Street Journal Europe
Gerard Lyons Chief Economist, Standard Chartered Bank
Professor Michael Stürmer Chief Correspondent, Die Welt
Pam Woodall Economics Editor, The Economist
Michael Pralle President, GE Capital Commercial Real Estate *moderator*

- **Deflation:** who cares?
- **Housing Bubble:** will it cool or crash?
- **Germany:** is it the next Japan?
- **Terrorism, Iraq and a blurry Axis of Evil:** can the West cope with elusive enemies?
- **EU Expansion:** the blind leading the gullible?
- **The Emergence of China:** will it dwarf all else?
- **Demographics, Immigration and the Pension bomb:** does the future work?

15h30 – 17h30 **Implications for European Real Estate**
Group Discussions
Report group findings in plenary and discuss

19h00 – 22h30 Cocktails & Dinner

Saturday, January 18

15h45 – 16h45 **The future of European Real Estate**
Alastair Ross-Goobey Senior Advisor, Morgan Stanley

Keynote address

16h45 – 18h15 **Where are the opportunities?**
Group Discussions
Report group findings in plenary & discuss

- **Quoted Companies**
- **Money for development**
- **Debt Financing**
- **Corporate Outsourcing**
- **Distressed Real Estate**
- **Office Markets**
- **Retail & Entertainment Properties**
- **Industrial/ Warehouses**
- **Hotels & Resorts**
- **Residential**

18h15 – 18h45 **Closing Summary**
John Carrafiell Head of Morgan Stanley Realty, Europe

Sponsored by NOMURA

19h00 – 20h30 **Cocktail party sponsored by Nomura**

Sunday, January 19

Networking time, late check out

The Future of European Real Estate - "Optimistic Outlook in Stormy Weather"

Being in one of the most volatile economic and geopolitical periods in recent history is a poignant reminder of the high degree of uncertainty that exists in the world. A stalling global economy struggling to identify an engine for growth, the lingering threat of terrorism and strained political alliances in western democracies all provided the backdrop to this year's GRI Chairmen's Retreat in St Moritz. However, despite this uncertain and volatile environment, Retreat members found plenty to be optimistic about in the European real estate industry.

The Retreat is an invitation only event involving over 100 of the most influential participants in the European real estate industry. Now in its second year, the Retreat facilitates an annual forum to discuss the key issues facing the sector. It is an event "run by the industry, for the industry", and is regarded as one of the most important dates in the European real estate calendar.

An energetic level of discussion was encouraged through debating a combination of macroeconomic, geopolitical and real estate themes presented and moderated by leading experts in each field. In addition, a scenario-based framework was used to assist participants to think divergently about the future, and to help them develop strategies in response to a range of potential outcomes. Although discussions on macroeconomic themes gave rise to concerns over the medium-term economic and political outlook, there was strong consensus that real estate markets would remain viable, and able to respond opportunistically in a turbulent wider market. The following themes emerged.

General Concerns and Risks

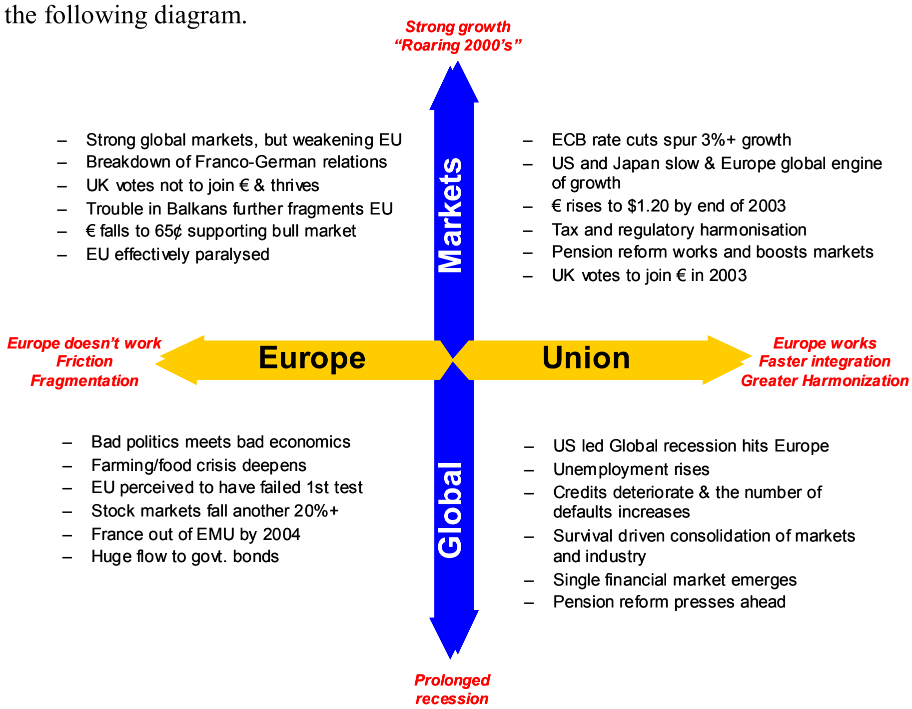
- ***Divergent views on success of Europe*** - Delegates were divided as to both the success of the European economy to date, and its prospects for the future. Concern was voiced regarding the ability for Europe to achieve political unity, not simply economic co-operation, due to member states' desire to retain individual state sovereignty.
- ***Fears of stagnation and crisis in Germany*** - A parallel was drawn between German and Japanese economies, with stalling economic performance, an impending banking crisis and minimal government intervention. There was the hope and expectation, however, that a pragmatic German government would eventually reform labour laws and tax policies.
- ***Potentially deflationary environment*** - In light of the current low level of economic growth there was a case put forward for the real possibility of a deflationary environment, which could potentially restrict options for effective fiscal stimuli.
- ***Concern over housing bubble*** - The low interest rate environment and the associated "wealth effect" were seen as the main drivers of house price growth. There was divided opinion on the risk of a housing price collapse due to strong residential demand potentially out-weighing the effects of increased interest rates or a shock to consumer spending.
- ***Increasing dependency ratio and pension bubble*** - Declining population over the next 20 years and an aging population are leading to an increase in the dependency ratio, putting upward pressure on tax rates and pension fund capacity.
- ***Uncertainty over conflict with Iraq*** - Less concern over the initial outcome of war; more over the aftermath - a springboard for growth or the source of greater geo-political tension and uncertainty. The end of the war was seen as a potential catalyst for growth.
- ***Increasing competitive threat from the East*** - A low inflation, low growth world economy could potentially drive investment towards the East. The economies of China and India would pose an increasing competitive threat due to low labour costs and increasing levels of sophistication.

Reasons for Optimism

- ***Low interest rate environment*** - The continued availability of debt capital at historically low interest rates is positive for both the development and investment markets, and has facilitated a significant rise in the number of financial buyers.
- ***"Yield is King"*** - The search for income will be a driving force in this low growth environment. Real estate's high cash flow characteristics are appealing, however more tax-efficient products are required to satisfy investor demand.
- ***Rationale for increasing allocations to real estate*** - Institutions still recognise the need to increase allocations to real estate, despite some of this rationale being derived from a historical view of relative performance.
- ***Anticipated economic growth*** - In the exercise where Retreat members predicted where the real estate markets were heading over the next four years, there was strong consensus towards economic growth, although there was concern over the performance and harmonisation of Europe.
- ***Steady flow of real estate opportunities*** - Opportunities were anticipated to take the form of distressed corporate asset sales, corporate outsourcing, and public-to-private transactions, with little expectation of development or growth opportunities emerging in the short term.
- ***Continued structural change*** - The building pressure on governments to implement tax reform, such as the French REITS, was seen as a medium-term area for opportunities, as were more sophisticated methods of financing which would benefit from structural harmonisation of European banking systems.

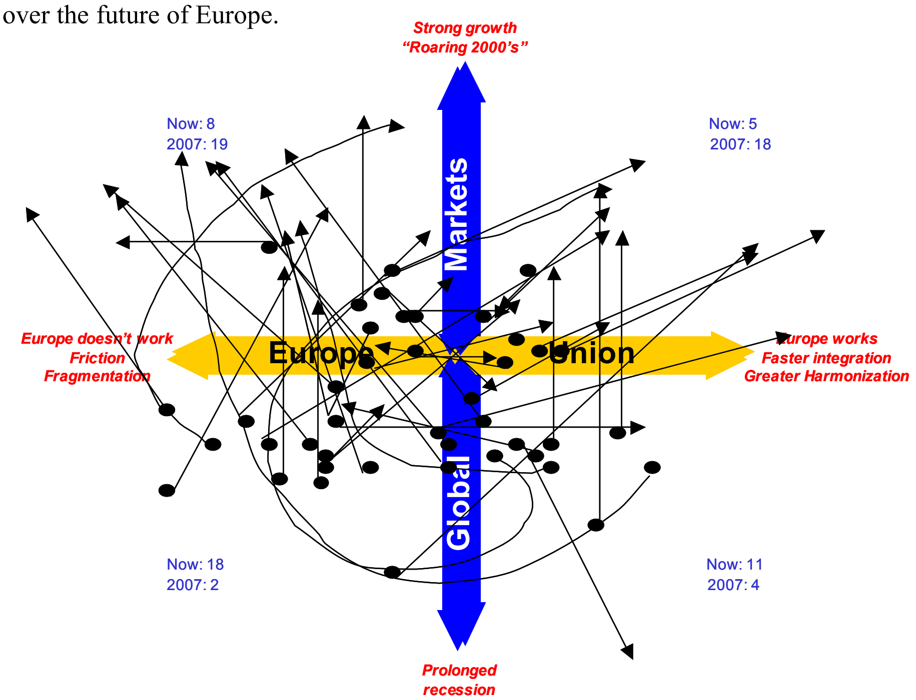
Scenario Framework - Future(s) of European Real Estate

To facilitate debate, the Morgan Stanley "Future(s) of European Real Estate" scenario framework was utilised, which identified four alternative, challenging, yet plausible futures for the evolution of the European real estate, economic and political landscape over the next four years. Built around the key uncertainties of global economic recovery (or not) and European Union governance (cohesive vs. fragmented), the different futures challenged any sense of an "official future" and encouraged the Retreat members to think divergently about what is to come. The adopted futures for each quadrant are summarised in the following diagram.



Where Europe is now and where it will be in 2007 (Retreat member responses)

Participants were asked to place a dot where they thought European real estate markets were in 2003 and draw an arrow to where they thought the market would be in 2007. The results show a strong consensus towards economic growth, and an equal division over the future of Europe.



Markets

Anticipated Press Headlines

- "Trouble in Euroland caused by expansion"
- "Conservative leader dumps EU for NAFTA"
- "Problems in German elections cause EU commitment concerns"
- "Franco-German relations deteriorate"
- "EU President resigns over breakdown in political agreement"
- "Financial pressure on German banks"
- "War in Balkans causes fragmentation"

Issues for European Real Estate

- Liquidity crunch, finance may be localised
- Government incentives will stimulate market
- Reallocation of capital between US and UK
- Industrial and up-market hotels will do well
- Office sector down - capital hard to obtain
- Retail and residential will suffer
- Greater divergence between regions
- Steeper investment cycles
- London becomes a more important city
- Slow pace of reform in Germany negative
- Potential opportunities for offshore investors

Anticipated Press Headlines

- "Thatcher-like chancellor elected in Germany to start turnaround. Needs to get worse before it gets better"
- "Germany addresses labour regulations and becomes EU engine of growth"
- "Nine months after catastrophic blackout, demographic problems solved"
- "Russia joins EU in return for long-term price of oil at €20"

Issues for European Real Estate

- Positive for real estate from a demographic and consumer standpoint - residential and retail will do well
- Risk of a pendulum swing of over-building in period of optimism and overloading infrastructure
- Tax structures/treatment in France and Italy will become important
- Higher exposure to the cyclical nature of the real estate cycle (more volatile)

Europe

Union

Anticipated Press Headlines

- "Euro exchange rate soars to $2"
- "Prolonged war and high oil prices lead to global recession"
- "US hit hardest in global slowdown as consumer stops spending"
- "EU companies less competitive"
- "EU is slow to cut rates and abandons stability pact"
- "Germany leaves EU"
- "UK stays out of EMU"

Issues for European Real Estate

- Global down turn will force investors to become defensive
- Look for consolidation plays
- Capital will flow out of equities and into fixed income and some types of real estate
- Secular vs. cyclical driving forces - still opportunities in longer term secular trends (service retail, good covenant tenants)
- Expected to be similar to the 1970's
- Property values will fall the most in Europe, and less so in the UK. Recovery will not occur until circa 2007

Anticipated Press Headlines

- "Blair elected EU president with reform mandate"
- "UK housing market collapses"
- "UK economy more attractive than EU"
- "Aznar elected EU president - growth and social programmes on agenda"
- "Franco-German dominance is unwound"
- "EU President Putin announces trade pact with China - waning influence of US on world stage"

Issues for European Real Estate

- Weak economy will be poor for all real estate sectors
- However, there will be winners and losers
- Winners in niche markets (Brussels, London, Milan). Regional approach
- Rising unemployment will lead to rising vacancies
- Real estate could be the most positive sector, and will attract capital
- Europe will expand increasing the influence of newcomers. London and Brussels should prosper

Global

Global Forces Affecting European Real Estate - Notes from Working Session

EU de-regulation / harmonisation - Reality or fantasy?

Harmonisation by law is bad; should be by market forces. Not much tax harmonisation expected. Will have an effect on where people work and thus on demand for property. No prospect for Germany to change retail laws or social regulations. Don't see as the driver for significant change.

Deflation and the housing bubble - Cool or crash?

Economists are from Mars; real estate executives are from Venus! The very low interest rates that come with deflation could help real estate keep its value. Noted that Japan has had ultra low rates and that hasn't helped their property values. There would be no single housing market in Europe. Susceptible to unemployment and a lack of consumer spending. What would really hurt the market is a decline in confidence. What would happen to the equity investment culture in a deflationary environment? Where supply is tightly controlled, e.g. Spain, this might help put a floor under prices. Will institutions re-enter the residential market? Expected that governments would intervene to limit deflation.

Germany - The next Japan?

There's more than one Germany. They don't have access to the controls that would usually be relied on to inflate economy. Needs to get worse before it can bet better, for policy to change. Unlike Japan, if it gets really bad, it can get better - government would reform labour laws; they can control this. Still dreaming of yesterday's values; unwilling to take the losses. Government not allowing trades to happen that could free up capital. Government tax policies are restricting entry of foreign capital. If Germany goes, it will be saved by or will hurt the rest of the Euro-zone (unlike Japan which is isolated). Banks have a problem, not a crisis; however some are struggling. Leverage levels have been declining, banks getting back to basics. Really comes down to a political crisis in Germany. Companies are not restructuring; bankruptcy is concept of "sin" in West, and concept of "shame" in Japan - very different; you can live down your sin faster than your shame. Retail flat to up; office down; hotels up; industrial up; residential flat to up. Vote: Germany the next Japan: 10, Germany the EU powerhouse: 20, undecided: 60.

War and terrorism - Can the West cope?

War will be over quickly and will lift remaining cloud on economic recovery. Although terrorism now a fact of life, it has mixed effect on investment decisions. Don't foresee any major changes, regardless of what unfolds. Would have negative effects on hotels, and possibly positive for some types of retail. Patterns of travel have changed, not sure if long term. A lot of people trying to short New York, expecting another attack; if that occurs, many could rethink living/working there - domestic capital is nervous. How much reduction in civil liberties will people accept if terrorism escalates? How would capital flows change, vis-à-vis Japan?

EU expansion - Blind leading the gullible?

Better for accession countries than Western countries. They have too little of everything. A lot has been done over last years but they are still way behind. Do not see large movement of labour; did not happen with Portugal; already easy for Polish workers to cross borders. Have seen too little demand and too much supply of real estate stock; demand has declined dramatically over last 4 years and now see levels of rent in East that are more comparable to West. West looking to invest in properties in the East but not finding the institutional quality they are looking for. Credit now readily available in accession countries. East and west should both generate investment, however not one to the detriment of the other. Losers will be where an industry is moving from one country/area to another (industrial and offices).

Demographics and pensions - A ticking time bomb?

Demographics impacted by immigration, changes in working age. Strategic investors with long-term view should be concerned with demographics. Otherwise just one of the risks you need to consider - not a huge impact. For now - location, location, location. Pensions: transfer of burden from state to private would mean greater need for stability of returns, good for real estate, need for public sector to maintain assets may lead to acceleration of PFI spread. Would establishment of public sector pension funds lead to more need for asset management or consolidation of pension funds? Too late for conventional pension schemes in Germany and France, however there may be alternatives (e.g. French REITS)

Europe, US, China - A new global re-order?

Modest growth and low inflation will drive shift to East (including India). Negative side: deflation in manufacturing and big adjustment problems in financial sector. Positive: pressure for reform. Even if there is reform, it might not offset negative factors facing Europe. Near term boom for real estate, re-adjust portfolios to get out of certain markets. Take advantage of anomalies. Industrial clusters in different parts that will help certain areas. Regional play from public sector to help ailing regions. Real estate might be seen as relatively optimistic area for investment. Expect inflow of US capital over time.

European Real Estate Opportunities and Risks - Notes from Working Session

Topic	Opportunities	Risks
Quoted Companies	• Public-to-private opportunities for buy-out funds • Need to explore alternatives to narrow the discount • Time to lobby for tax consistency across Europe, and for incentives in countries like the UK	• Poor transparency generally across Europe • Lack of correlation between markets • Share prices and fundamentals often de-coupled • Alignment of interests critical • Companies need a strategy for attracting public investment
Money for Development	• As the traditional bank lenders become more difficult to access, institutions may be a source of development capital • Capital available for niches in classes or regions • Limited other opportunities	• Some developments may be too risky for institutional capital • Reducing availability of traditional development finance • Lenders becoming less aggressive
Distressed Real Estate	• Italy still a large supplier of distressed real estate • Asset sales from distressed corporates (although feeling that there is not as much on the market as there should be) • In certain countries, banks may be forced by regulators to sell assets	• Market is likely to be more distressed than it seems • Governments don't seem to be encouraging work-outs, and are not providing the necessary incentives • Bid/ask spread widening
Debt Financing	• Securitisation is still the key opportunity • Ability to increase liquidity, get loans/assets off balance sheets, good tool to manage risk • B or BB tranches of securitisations - potential demand from German banks, and new investor entrants - need increased supply	• Liquidity of traditional debt market is poor • Decreasing availability of credit, depending on type of product • Cross boarder securitisations will require standardisation of loans
Retail and Entertainment	• Extended opening hours for retail trading, encouraged by legislation • Easing of regulations to build larger centres (reversal of current trend) • Adding increasing degree of leisure to existing offering	• Assets caught in the middle between secondary and prime or between in-town centre and super-regional mall • High leisure component may be too risky for incremental benefit
Office Markets	• Potential arbitrage to extract value from unoccupied space - solve sublet problem for corporates and let the space more efficiently • Corporate outsourcing - not as much activity as there should be	• Pace of economic recovery • "Hidden" sublet space • Nature of demand from tenants burnt in last boom - effect on lease length, conditions

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O'CONNOR GROUP	uk	**kevin l reid**	head europe
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PRICOA REALTY GROUP	uk	**jonathan o short**	managing director
GOLDMAN SACHS INTERNATIONAL	uk	**edward siskind**	md, head europe whitehall funds
ERNST & YOUNG	uk	**richard smee**	managing partner
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NOMURA	uk	**gary wilder**	md & co-head, real estate finance group
AEW CAPITAL MANAGEMENT	usa	**joseph f azrack**	president & ceo
COLONY CAPITAL	usa	**thomas j barrack jr**	chairman & ceo
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