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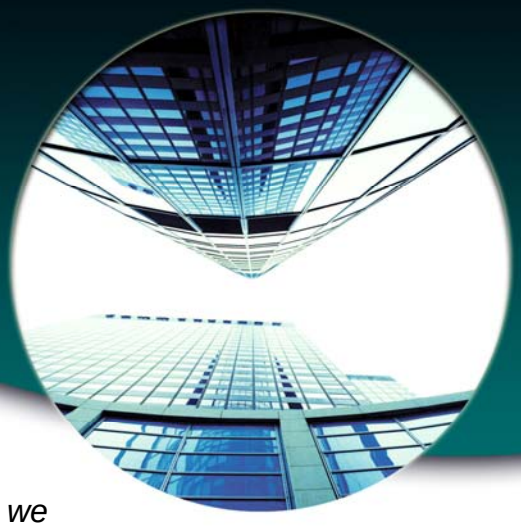

GLOBAL REAL ESTATE UPDATE

Our clients' real estate investments circle the globe and so do we

Winter 2010

Squire, Sanders & Dempsey L.L.P.

Inside:

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Welcome to the premiere edition of **Squire Sanders Global Real Estate Update** – aimed at providing perspectives and insights on today's dynamic real estate market.

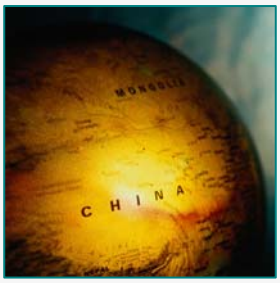
As we know, real estate investment and development is strongly driven now by the specific conditions and circumstances of the property's location. Yet capital and uses of real estate are often driven by factors outside the project's location. As a result, capital flows around the globe to where the best opportunities lie. And users – tenants, guests at a hotel, customers of a shopping mall and others – may come from far outside the borders of the city, state, province or country where the project site is located. Our clients require both specific information about localities and a broader perspective about how related business and legal issues affect this industry to help understand these dynamics in this global arena. That's where this publication will help.

Heading into a new year, it is certainly clear that 2009 played out as one of the most challenging years for the real estate industry and, as the issue's articles make clear, the economic downturn affected various markets in quite different ways. Looking ahead, 2010 may indeed turn out to be a year of opportunity and it is our intention that this and future editions will help you in evaluating some of the events and trends occurring in various regions where you may be active today or tomorrow and where we are already engaged. We do hope that you find this information of value and would encourage you to let us know what issues or opportunities you would like to hear more about as we strive to make this publication a timely and useful tool for you.

Our very best for a very successful year.

Michael D. Saad
Chair, Real Estate Practice Group

An Interview with Craig Shute, Senior Managing Director, Hong Kong, Macau and Taiwan for CBRE



Craig Shute is the Senior Managing Director of CB Richard Ellis' Hong Kong, Macau and Taiwan offices. He is based in Hong Kong and has more than 18 years experience, having held senior management positions in Malaysia, Australia and the American markets. In addition, Craig is a member of CB Richard Ellis' Asia Management Board.

Q: Which real estate sectors and specific geographies in Asia have been hardest hit by the financial crisis?

A: Prime office property witnessed the most severe decline beginning with Lehman Brothers' collapse where markets had greater exposure to the financial market particularly Hong Kong, Singapore and Japan. The industrial sector was also hit hard in terms of investor confidence and a low demand as the export trade sector suffered during the economic downturn. Asia's overall reliance on the export sector suggests that the recovery is likely to be slow.

Q: What are the recent office capital values in Asia? Are they getting better now?

For capital values, office property has been hit the hardest following the spike in prices during the pre-crisis period. Office capital values in Hong Kong, Shanghai, Seoul and India rebounded over the past few months, as overall sentiment turned more positive spurred by high liquidity, low interest rates and the business sector's general improvement.

Given the strong rebound in prices for prime commercial property and the stabilization of rental declines, investment activity in the office sector picked up considerably in recent months, particularly for prime quality office yield-accretive assets located in desirable locations.

Asia's largest transaction in Q3 2009 was the sale of the Nexxus Building in Hong Kong for approximately US$465

million. Investors continued to show interest in prime office properties attracting US$4.7 billion of investment or 52 percent of the total flow of capital in US-dollar term, accounting for seven of the 10 largest transactions including those mixed-use office properties recorded in the region. Acquisition activity in the office sector was seen mostly in Hong Kong, South Korea and China.

Q: What is the current economic situation and trend in China and Hong Kong? How does this affect the property market in China and Hong Kong?

Among key investment property markets in Asia, Hong Kong was most active, accounting for 36 percent of the total investment in the region. The US$3.2 billion worth of transactions completed in Hong Kong during the review period was only slightly less than the peak recorded in the territory in Q4 2007. Private and local buyers demonstrated a strong appetite for investment property while a number of foreign institutional investors took advantage of market conditions with the intent of making a profit or reducing their portfolio size.

Asia's office market down cycle neared its end in Q3 2009 as the stabilization of employment numbers clearly indicated the market was close to the bottom.

China enjoyed a strong rebound in transaction volume with deals totaling US$1.6 billion, up by 82 percent quarter-on-quarter. China-based buyers including insurance companies, banks and state-owned enterprises accounted for 80 percent of all transactions. In line with the overall trend witnessed around the region, investors in China demonstrated a preference for office and residential properties, with total investment in the two sectors accounting for more than US$1 billion.

Q: What is the outlook for office markets in Asia?

Asia's office market down cycle neared its end in Q3 2009 as the stabilization of employment numbers clearly indicated the market was close to the bottom. Corporations outside the export trade sector began expanding headcount and financial institutions began hiring staff to pursue high-margin businesses as economic conditions improved. Among Asia's developed economies, Japan, South Korea and Hong Kong all reported their first declines in unemployment since the Lehman Brothers collapse in September 2008.

Q: Is there any substantial increase in vacancy rates of the office market in Asia in 2009?

Historically, office vacancy has trailed closely behind the unemployment rate, and Q3 2009 saw overall vacancy for Asia's cities remain at 12.5 percent, unchanged from the previous quarter, but with Tokyo, Hong Kong, Beijing, Seoul and several Southeastern Asia cities all recording a minor decline in the amount of vacancies.

Office leasing activity gradually picked up during Q3 2009 after a quiet first half. Activity was characterized by companies seeking to reduce pressure on profit margins by relocating to more cost-effective offices and by others making a flight to quality by moving to prime buildings, more affordable now following the previous year's sharp rental correction. A few select companies were also looking to expand. Overall net absorption around the region increased 14 percent quarter-on-quarter with only three out of the 17 cities tracked still recording negative absorption – Singapore, Delhi and Manila.

Q: What are 2010 office market trends?

Despite the improvement in business sentiment, tenants remained cautious about real estate-related expenses and property owners continued to be flexible in negotiations, especially in cities with high vacancy rates and new offices entering the market. While office rents remained caught in the latter part of the down cycle, the CBRE Asia Office Rental Index found the pace of decline nevertheless slowed. Overall, Asia's office rents fell 3.1 percent in Q3 2009, decelerating from the 6.7-percent decline witnessed in Q2 2009, as rents either underwent a milder rate of reduction or started to pick up. It is expected that the rate of rental decline will ease further or bottom out in the coming months. Notwithstanding this fact, the threat of supply-side risk remained significant in Singapore as well as the major office markets of China and India, all of which are presently expecting a large amount of new office space to enter the stream over the next few quarters.

While it is highly likely that Asia's office market will exit the down cycle in 2010, past experience suggests companies will persevere with low-cost real estate solutions in the early phase of economic recovery. Rental levels are therefore likely to remain low for some time before finally returning to an upward track.

In Hong Kong, the office market benefitted from firmer leasing market conditions and the improved economic environment, with Grade-A office rents ending their year-long slide to hover at an average of HK$39.7 or US$5.12 psf per month.

Q: How were Beijing and Shanghai's office markets in 2009?

Demand for prime office space in China was driven by China-based large-cap corporations while multinational companies were comparatively quiet. Beijing saw the completion of a number of major leasing transactions in the Finance Street area by state-owned financial institutions. However, mounting new supply ensured vacancy remained above the 20-percent level for the fifth consecutive quarter. Shanghai witnessed a rise in leasing activity among companies from outside China less affected by the financial downturn, while leasing transactions in Guangzhou were dominated by local companies.

Looking ahead, transaction volume in Beijing will continue to rise and market confidence will gradually recover. Property owners will probably not be lowering rates, which should remain largely unchanged in the final quarter. China-based companies will continue to constitute the majority of demand, with China-based financial institutions also likely to turn to the leasing market as long as no suitable product is available on the sales market. Demand from multinationals should also gradually begin to recover. Supply pressure in Q4 2009 will ease somewhat following the decision by a number of developers to postpone the completion of their office projects until 2010. Nevertheless, three prime office projects are scheduled for completion in Q4 2009, bringing a total of 2.1 million square feet of new office space to the Beijing office market. Occupier demand for large floor plates was largely digested in Q3 2009 as reflected by the high volume of net absorption, and the take-up will reach the same levels in Q4 2009, thereby ensuring a comparatively quieter yet nonetheless stable market in the closing stages of 2010.

It remains uncertain when Shanghai's office market will recover completely, despite the fact that selected market indicators such as net absorption and rental growth showed some improvement in Q3 2009, the large number of new properties set to come on the market in Q4 2009 were a major concern. Although a number of projects have delayed handover for various reasons, 2.9 million square feet of new space were set to become available by the end of 2009. With this pressure from future supply, rents are expected to dip further in the short term, although the sharp declines witnessed earlier in 2009 are not likely to reoccur. Expect to see tenants take advantage of the current situation by securing relatively reasonable rents in quality buildings.

Q: What were the 2009 office market developments in Hong Kong?

In Hong Kong, the office market benefitted from firmer leasing market conditions and the improved economic environment, with Grade-A office rents ending their year-long slide to hover at an average of HK$39.7 or US$5.12 psf per month. However, despite this improvement in market sentiment, the quarter still saw a continuation of the trend of companies cutting costs by relocating to cheaper premises.

However, the overall vacancy rate in Hong Kong averaged 9.6 percent in September, down 65 bps compared to June. Vacancy rates have been edging downwards in recent months thanks to the rise in leasing activity amidst the more positive economic outlook and lack of major new supply. Vacancy in CBD rose 60 bps to 5.8 percent for the same period, as a result of companies relocating to other areas in order to achieve cost savings.

The decline in Hong Kong's office rents has slowed in recent months with some districts registering increases as landlords react to a more positive leasing environment. The rise in vacancy has also moderated during the same period as fewer companies are downsizing and a limited

new supply is entering the market. Key industry sectors have begun to hire staff again, with the finance and banking industry beginning to replace positions that were eliminated at the height of the financial crisis last year. New supply will be limited next year, estimated at around 1.2 million square feet. This is down from 1.6 million square feet forecast for completion this year and down significantly compared to the 4.6 million square feet completed in 2008. While it appears that rents may be nearing the bottom, there are some concerns surrounding the impact of a significant quantum of secondary space that may be entering the market in 2010 when several major tenants are scheduled to relocate out of Central. However the outlook for the office sector has definitely improved compared to the beginning of the year.

The gradual return of confidence to the business community and availability of competitively priced office accommodations compared to other key cities in Asia means Singapore is well positioned as the region takes its first steps towards recovery.

Q: What were the 2009 developments in Singapore's real estate market?

Singapore saw the number of transactions above S$15 million (approximately US$10 million) continue to edge up quarter-on-quarter, with total volume reaching more than US$900 million or about 10 percent of Asia's total volume. Major office transactions completed during the period included Aviva Building, Cecil House, Premier Centre and six floors of Prudential Tower. K-REIT Asia's acquisition of the six floors at Prudential Tower was the largest office sale during the quarter at US$75 million with a guaranteed 5.2-percent return on rental income.

The improved economic outlook ensured an active Q3 2009 for the Singapore office leasing market. Activity surrounding the planning of new premises increased as did occupiers' requests for proposals, many of which are likely to firm up in the near future. Office rents fell for the fourth consecutive quarter but it was evident that the pace of rental decline had eased following an improvement in business confidence. Prime office rents averaged S$7.50 (US$5.32) psf in Q3 2009, reflecting a 12.8-percent quarter-on-quarter decrease compared to the 18.1-percent decline recorded in Q2 2009 and the 18.6-percent contraction seen in Q1 2009. In all, prime rents have now fallen 53.4 percent since their peak in Q3 2008.

Approximately 575,000 square feet of new space was added to Singapore's office space supply (all non-Grade A or outside prime areas) during the quarter, thanks largely to the completion of 78 Shenton Way (South Tower), Mapletree Anson, The Spazio and Land Parcel B at Scotts/Anthony Road. The occupancy rate in the Tanjong Pagar submarket fell from 86.2 percent in the Q1 2009 to 80.1 percent in Q3 2009, primarily due to the completion of Mapletree Anson and 78 Shenton Way South Tower. Overall Grade A vacancy rose to 4.2 percent, up from 3.6 percent in the previous quarter, and well above the 1.2 percent recorded just a year ago in Q3 2008. Net absorption of Grade A space in the first three quarters of 2009 amounted to negative 223,397 sf.

The island-wide office market recorded a negative net absorption of 570,000 square feet for the first half of the year and demand is likely to remain in negative territory for the remainder of 2009. Vacancy rates will likely hover at current levels for the next couple of years due to the abundant supply levels, although the office market should begin to recover in 2010 rather than in 2011 as previously estimated.

It is encouraging to note that the rate of attrition in the banking sector has slowed over the past couple of quarters, and confidence in the advertising, IT and legal business sectors is also improving. The gradual return of confidence to the business community and availability of competitively priced office accommodations compared to other key cities in Asia means Singapore is well positioned as the region takes its first steps towards recovery.

Q: What about macro risks?

Until the global economy shows clear signs of a sustained recovery, governments around the world are unlikely to abandon their current easing of fiscal policies and implement exit strategies from their intervention. Following the three consecutive rate rises on October 6, November 3

and December 2 in Australia, the likelihood for Asia's countries to raise their policy rates in the coming 12 months increased. However, the fragile global economic conditions continue to prohibit any rate increase in major economies including the United States, the European Union and Japan. The overall low interest rate environment is therefore likely to persist with several countries less linked to the crisis able to bring a mild upward adjustment in interest rates. Meanwhile, the market has generally turned more positive and economists remain cautiously optimistic that the region will enjoy a mild improvement in overall economic conditions, even in the event of Western economies suffering a second dip.

Q: Is there over-investment?

Despite the strong price rebound in Hong Kong, Singapore and Guangzhou, which all witnessed a double-digit rebound in prices, while Beijing, Shanghai and Seoul also recorded a stronger surge in prices from Q2 2009, the market generally turned more quiet in recent months as the brisk investment activity and surging prices witnessed during Q3 2009 led governments in Hong Kong, Singapore, China and South Korea to worry that the residential property market was rebounding too strongly. Some took steps to contain risks associated with potential over-investment.

Q: What are the policy risks?

In July and August 2009, China's banks started to tighten up on their lending and extend credit more selectively. In the China residential sales market, which is very sensitive to changes in central government policy, residential sales volumes in Q3 2009 dropped by 25 percent quarter-on-quarter, although they were still 183 percent higher than Q1 2009.

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China Real Estate in the Wake of the Stimulus Plan

The Urban Land Institute (ULI) released its Emerging Trends in Real Estate 2010 in December and made a swing through Asia as it reported its findings. On December 4, 2009 Amy L. Sommers, of Squire Sanders' Shanghai office and Chair of the Real Estate Committee of the American Chamber of Commerce – Shanghai, welcomed representatives from ULI as they shared their findings on the US real estate market with the AmCham Shanghai Real Estate Committee. Among the Report's observations on the US market is that 2010 may hold once-in-a-lifetime opportunities for cash-rich investors to acquire premium properties.

What about China? The ULI Report notes the danger of complacency in Asia, as the region appears to have escaped the worst effects of the global downturn. In late 2008 anticipating the fallout from the financial meltdown triggered by Lehman Brothers' bankruptcy, China's government announced that it would adopt an aggressive economic stimulus plan beginning in 2009. This plan projects 4 trillion RMB (approximately US$570 billion) in spending over two years. It has been been criticized as being considerably smaller than advertised because the central government funded only about one-third of the expense (and 80 percent or more of that amount was already projected to be spent in the current Five Year Plan), with the balance expected from local governments, loans and private sector investment. Such observations have some validity, but what may not have been entirely clear to commentators at the outset of 2009 was the degree to which loosening of credit policies and growth in the monetary supply would be used as tools by China's policy makers to achieve their stimulus aims.

Following the close of Q3 2009, the Bank of China noted the beneficial role credit has played in contributing to resumption of economic growth for China in 2009. As of September 30, 2009, M1 in China showed year-on-year growth of 29.5 percent, which was 20.1 percent higher

than the same period in 2008. Aggregate loans grew at an even more rapid pace during this period, with the loan amounts in RMB at the end of September having grown 34.2 percent since 2008. This level of growth represented almost 20 percent higher growth in credit over the same period in 2008.[1] A total of 9.5 trillion loans are expected to have been made by year's end.[2]

By Q3 2009, most observers agreed that a significant amount of this credit had flowed into the equities markets and into real estate. As of December 8, the Shanghai Stock Exchange's composite index was up 54.8 percent from the year's start. And, real estate prices in various cities have been rising significantly. For example, housing prices in Shenzhen have doubled since the start of 2009. The economic crisis may have begun in the West with a credit bubble, but it did not start that way in Asia. Rather, the effects of the crisis in China were brought on by the interconnected nature of the world economy. Nonetheless, China's response to the crisis may inadvertently be leading to an increased risk of a real estate bubble in the country.[3] Observers expect therefore that in 2010 credit policies as to real estate will tighten.[4] Given that much of the stimulus funds (whether from the budget or via loans) has been committed to capital-intensive infrastructure projects, however, this tightening is expected be gradual, rather than through a sudden decline in commitments.[5]

For investors considering a China play, careful attention will be required to consider the effects that China's looser credit policy of 2009 (and to a slightly more limited extent), 2010 will have on the market's prospects. As of publication, the main impact of the world economic crisis in Asia's real estate markets, noted ULI's Stephen Blank, senior research fellow, in his remarks to AmCham Shanghai, has been local players taking advantage of the opportunity to snatch up premium projects owned by foreign investors. The news that HNA Group (the parent company of Hainan Airlines) is expected to acquire the two hotels under development in Shanghai's Xintiandi under the Jumeirah Group and Conrad Hilton brands reflects this trend. 2010 should provide a chance to see if it will continue. Additionally, will the rising prices in China's top cities lead to a renewed consideration of second and third tier cities? Finally, can China put the brakes on the rapid growth in credit and real estate prices observed in 2009?

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The State of the UK's Real Estate Market

Introduction

The credit crunch on the worldwide real estate market adversely affected almost every real estate asset class offering both traditional and more liquid forms. However, there have been some interesting trends developing in the UK market affecting buyers and sellers, landlords and tenants, and "adaptability" is a skill market participants must acquire – oftentimes just to survive. Squire Sanders' London office has been proactive in assisting both new and existing clients who have been looking to maximize or to defend their market positions. This article will review what we see as being the market changes and developing practices amongst asset class holders in the UK.

General Macro Market Trends

Today there is no doubt that there is an awful lot of cash circling the real estate sector, in particular, the London market. That cash seems to be predominantly based on investors from the United States, Middle East and Asia who appear now to be considering that the fall in the UK real estate prices means certain asset classes now represent good value. As an example, a well-known China-based bank has recently purchased its headquarters in

[1] http://news.hexun.com/2009-11-11/121657095.html
[2] http://finance.ifeng.com/roll/20091124/1500586.shtml
[3] http://finance.jrj.com.cn/opinion/2009/10/2316366315226.shtml
[4] http://house.21cn.com/estate/party/2009/11/03/7047721.shtml
[5] http://finance.ifeng.com/roll/20091124/1500586.shtml

London in a confidence-building boost to London's real estate market.

However, set against this is the significant lack of available "prime" real estate. This actually led to a shortening of yields and drove the price up by as much as 100 basis points in 2009 for those assets. Today this shortage of stock is combined with an unwillingness of the banking sector, generally, to liquidate on a wholesale basis vast portfolios of assets they hold. This arguably would adversely affect the price they could achieve and increase losses further. Therefore certainly in the prime investment market in the city of London, whilst buildings are coming onto the market, and indeed deals are being done off market, unless there is a compelling reason to sell, driven by banking covenant breach or financial pressures, many would-be sellers are hanging on to their real estate with a view to the market improving in the coming year. Indeed, some commentators in the real estate agency field expect positive growth in the year 2010, especially in the prime market.

The very prime sites have, according to some market commentators, not experienced any falls in value but have actually increased. One real estate agency, operating in the prime market, has reported that it has had its busiest trading period since it opened its doors many years ago.

Another area that is attracting investment into the UK is high-end residential property in London's traditional strong-holds. The very prime sites have, according to some market commentators, not actually experienced any falls in value but have increased. One real estate agency, operating in the prime market, has reported that it has had its busiest trading period since it opened its doors many years ago. Interestingly, it is not just in London but across the UK where the most desirable properties in each area are still selling. This is fueled principally by available equity and, once again, the availability of cheap debt. Even though the loan-to-value ratios have been reduced considerably, sometimes down to as low as 50/50 equity to debt, the desire to own prime residential real estate is still strong. In London areas such as Westminster, Chelsea and Kensington, properties are now attracting significant cash buyers who are looking to secure well-located quality stock with a view to leveraging in due course. That is a trend that is expected to continue, although perhaps not at the speed in past years when the payment of bankers' bonuses was a key generator of transactions in this market. Elsewhere, residential prices have, according to the UK Government Land Registry, actually risen by an average of 5.9 percent or thereabouts in 2009. This is driven by a shortage of stock, and increasingly assisted by a willingness of banks to lend as the UK government fiscal stimulus trickles through to those parts of the banking sector where individuals generally operate.

Other asset classes such as retail, industrial and shopping centers are all faring on a mixed basis. Suffice it to say that a number of institutions have been placed into administration by the banks, and this has presented large scale buying opportunities for Max Property (for the Industrious portfolio) and other institutions, such as those looking at the Kenmore portfolios. Those institutions willing to buy in Q2 2009 and take a risk on the market have seen their yields contract, and in some instances those properties are now being resold based on that yield contraction, which has generated a profit for its purchases. It is a trend that is also expected to continue.

In the hotel and leisure sector, in which Squire Sanders has a preeminent practice, once again we are seeing a number of potential purchasers for both distressed hotels as going concerns, and vacant hotels which have the potential for a different use. This interest is once again generated principally by overseas investors taking advantage of both currency fluctuations and value propositions. Our firm's connections mean that we have seen a number of opportunities that we have been happy to pass on to potential clients, purchasers and vendors as a way of assisting clients evolving their own businesses.

Going into 2010 we expect to be assisting buyers and sellers of physical real estate and liquid real estate investment funds, and assisting in more novel debt-based transactions and restructurings to acquire real estate for both national and multinational clients.

Micro Market Trends

Clearly the availability of credit has made it difficult for businesses to operate, and this affects landlords and tenants, as well as buyers and sellers. This part of the article concentrates on landlord and tenant relationship issues that have become far more prominent in the last 12 months, and which we expect to continue going forward into 2010.

The flip side of a termination right in favor of a tenant is that if, as should be the case, the termination rights are unconditional, then the tenants are more able to use this as a bargaining tool with their landlord to try to get better terms for themselves.

Rental Issues

In general terms payment of rent has become an issue as cash flow is being squeezed. Traditionally most UK leases are drawn on the basis that rent is paid quarterly in advance, and this has proven difficult for retail tenants. We have seen a growing willingness on institutional landlords' part to accept requests from tenants to pay rent monthly in advance, which has helped secure tenants' cash flow for the landlord. In addition, some of the big retail shopping center landlords have reviewed their service charge arrangements and have been reducing service charge requirements for tenants to assist them. However, almost always, this is on a temporary basis. Landlords' expectations are that those concession elements return to the terms of the lease as originally drawn and agreed, in due course.

Repair and Dilapidation Issues

The issue of dilapidations, and the tenant's obligations to put properties into the state of repair they were in at the time they took the leases, or, depending on the terms of the lease, into an almost brand new state, has always been a significant point for discussion between landlords and tenants. However in the current climate we have seen that it has assumed an even greater importance, in particular, when combined with the ability of a tenant to breaker a lease, by exercising a right of termination. We have seen developing trends where, if termination rights are conditional in any way, landlords tend to be looking to ensure that there is absolute compliance with the relevant lease terms. Any failure to do so is then utilized as a way forward to keep the tenant from exercising its right of termination successfully, i.e. leaving it contractually bound to continue paying rents and complying with its obligation under the lease – even if it is not in occupation. This behavior is driven principally by a poor tenant letting market which is of course dogged by the inability to raise finance to pay for moves, new equipment, removal costs and set up costs, by the tenants.

Rights of Termination Issues

Tenants are advised to look very carefully at their existing leases and lease terms to see whether or not any right of termination they benefit from needs to be strictly followed to achieve a break. We have counseled a number of tenants recently that they will have great difficulty in exercising their breaks unless stringent and expensive steps are taken to comply with the termination rights. These conditions can relate to minimum periods of notice that have to be given, where notices have to be served, on whom they have to be served, compliance with the repair and dilapidations covenants in the leases (which can be onerous), ensuring payment of rents – the list can be endless, and the property may remain empty. Clients who have attempted or who are attempting to mitigate their rental liabilities by subletting or licensing space to third parties need to carefully examine those arrangements if a termination right is to be utilized effectively.

The flip side of a termination right in favor of a tenant is that if, as should be the case, the termination rights are unconditional, then the tenants are more able to use this as a bargaining tool with their landlord to try to get better terms for themselves. In essence, a threat to exercise a termination right can often lead to a fruitful negotiation with the landlord that does not wish to lose its tenant. Reduced rental terms or obligations within the lease or indeed new leases for shorter terms may result. This does not always work, and must be balanced against commercial relationships between landlord and tenant and the tenant's desire to continue to do business at the site.

For some businesses a move is a major upheaval and great care should be taken when considering this sort of strategy. We are more than happy to review clients' leases to give an overview of potential benefits and pitfalls for entities wishing to consider using their lease termination rights for leverage purposes with their landlord, or indeed for clients generally needing to vacate space and relocate, often to cheaper premises. Such relocations or business closures can often be complicated by the need to comply with the stringent UK employment and labor laws but, again, we are well placed to advise clients in this respect.

Conclusion

Overall, going into 2010, our expectations are that the UK real estate market, especially prime property, will continue to harden and yields generally should start to move in. However, the degree to which that will benefit non-prime property is in part somewhat unknown and driven perhaps by the willingness of sellers to accept realistic prices for their property. Banks may, in the Q2 or Q3 2010, decide to be more aggressive in their treatment of what they would consider to be distressed assets in their portfolios. Increased transaction levels will also be driven by the willingness of the same banks to lend money, or indeed staple debt, to enhance the ability of buyers to purchase. Critical to the overall market will be the ability of the tenants to generate cash to pay rents, developers to start developing again based on that projected cash flow and landlords and tenants to be as flexible as possible to help their businesses survive and grow.

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Qualified Investor Funds in the Czech Republic – An Investment Opportunity

Qualified investor funds (QIFs) are tax-driven investment vehicle structures which were created in the Czech Republic in 2006. At that time, QIFs introduced significant potential tax benefits for property investors in the country but were not often utilized because of a number of structural restrictions and administrative burdens. In 2009, the Czech Republic parliament liberalized the QIF rules making them a more appealing investment or holding vehicle option. As a result, there was a significant increase in interest in QIFs in 2009, and we expect to see many more of them in the future.

A QIF is a joint stock company or mutual fund that receives a special license to operate as a QIF. The equity capital of a QIF must be at least CZK50 million (approximately €2 million) and must be contributed no later than the one year anniversary of the receipt of its license. The fund must also diversify its investments. According to a nonbinding paper of the Czech National Bank, a single asset (such as an office property or development project) may represent no more than 50 percent of the fund's total investments. Though the law does not provide a transitory period during which the fund may have a single investment, the Czech National Bank has previously allowed a substantial grace period in specific cases to diversify investments.

To invest in a QIF, an investor must be a financial or public institution or a legal entity or natural person which declares in writing that it has experience in capital market investments. Each investor must invest a minimum of CZK1 million (approximately €40,000) in the fund. A fund may have no more than 100 qualified investors. The law does not prescribe a minimum number of investors, but the Czech National Bank has stated through nonbinding papers that two investors are sufficient and that they may be related parties (and a QIF may even be established by a single founder for a limited period of time). The shares of a QIF cannot be offered for sale publicly.

A QIF is required to complete registration and obtain an approval from the Czech National Bank for its special status. Following the recent statutory amendments, this process has been simplified for a QIF that retains a registered investment company to manage the fund. One primary consequence of this recent change was to allow QIFs to satisfy the requirement to have certain specially qualified persons as executives of the fund – now, these individuals may work for an investment company that is retained by the QIF as well as by other funds. Additionally, the Czech National Bank's consent is no longer required for changing ownership of the fund which is managed by the investment company. Both of these changes have materially simplified the operation and ease of exit limitations that were established in 2006. The Act provides only general guidelines with respect to a fund's investments and operations, and therefore a fund has substantial flexibility in establishing its investment strategy, which is prescribed in the fund's governance documents.

The benefit of the QIF structure is that such funds are subject to a 5-percent corporate income tax instead of the standard 19-percent rate.

The benefit of the QIF structure is that such funds are subject to a 5-percent corporate income tax instead of the standard 19-percent rate. There is some discussion about the potential risk that in the case of a limited number of investors from one investment group, the financial authorities might try to set aside this beneficial tax treatment by arguing that the structure is only a circumvention of relevant tax laws. This argument has not been tested yet, but the most logical interpretation would seem to be that so long as the fund is compliant with the rules (and nonbinding recommendations) set forth by the Czech National Bank it is entitled to be taxed as a QIF. The same concern has also been raised with respect to funds with insufficient diversification of investments. Here, the argument for a higher rate seems more credible since the QIF in such case is essentially noncompliant with qualifying requirements.

As noted above, a QIF may operate as either a mutual fund or an investment fund. A mutual fund may be founded only by a licensed investment company, which then manages its assets and sells shares to investors. It is not a separate legal entity, but rather a pool of investments and property. A mutual fund may be open-ended (i.e. the owners of its shares have the right to sell them back to the investment company upon their request at their current value) or close-ended (i.e. the investment company does not buy back shares but rather settles investments upon dissolution of the fund). In either case, the investor may sell its investment in the QIF to a third party prior to dissolution. Unlike the case with investment funds, in-kind contributions by investors wishing to acquire shares in mutual funds are not permitted. Mutual funds are especially well-suited for individuals because no income tax applies at the time of disposition if the investor held the shares for a minimum of six months.

An investment fund (i.e. a separate legal entity) operates only on a closed-end basis. A new legal entity must be established and licensed prior to the inception of its business – an existing company may not obtain a license. It typically takes about four to five months to establish such an investment fund and obtain all the necessary approvals from the Czech National Bank. However, existing assets held by an investor may be contributed to a newly established investment fund as an in-kind capital contribution. This too is a substantial change in the law as investors now have both a tax neutral and more practical way to fund the capital requirements of a QIF in a restructuring transaction. Another tax neutral way to move existing assets into an investment fund is through a merger or other corporate reorganization, provided the investment fund is the surviving entity. In the case of an investment fund, an individual must hold the shares for a minimum of two years prior to exit in order to qualify for a tax exemption of profit, and its total shareholding cannot exceed 55 percent of all of the fund's shares.

Unlike the case with mutual funds, investors in investment funds have the option of managing the fund themselves (assuming they, or individuals the fund hires directly, meet the Czech National Bank requirements) or retaining a separate investment company to do so. Engaging an investment company as the fund manager enables the

investor to significantly reduce its direct administrative burden, though with some loss of control.

The only business activity an investment fund may engage in is collective investment. Accordingly, a QIF may not acquire trade licenses or directly perform development activities. It may only acquire and hold assets for the purpose of achieving profit. However, a QIF that has invested into property that is to be developed may engage a developer that would perform the development activities on its behalf. It is important to note that the 5-percent profit tax applies only to the QIF and not to any subsidiary companies in which the QIF may own an interest.

Regardless of whether a QIF is a mutual fund or an investment fund, it must make semi-annual filings with the Czech National Bank and contract with a bank to act as depository for the fund. The depository monitors certain fund activities and processes all fund payments.

At the end of the day, investors must weigh the benefits of lower taxation against the additional administrative and regulatory burdens of a fund structure. Given the tax differential today, more and more investors are taking a very serious look at QIF structures.

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An Overview Article of Germany's Current Real Estate Market

Introduction

In Germany the real estate market was rather unspectacular up to 2005. Munich, Frankfurt and Hamburg's real estate markets boomed while other regions had severe problems. From 2005 through 2007 to early 2008, Germany's property market joined the global boom, and in many regions prices for houses and land exploded or at the very least rose considerably. Purchase prices for office and residential buildings increased. In the second half of 2008 and into 2009, the financial crisis reached Germany's market and prices for real estate dropped, with prices returning back to those of 2005. In lesser-populated areas there were only modifications of a minor nature in prices for real estate, because these cities had not been the focus of any investor. In general, the property market in the nonbooming areas is mostly a reflection of regional economical and demographical changes rather than of the global crisis. With regard to Germany's top cities, several market players forecasted distressed sales in Germany's real estate market at the beginning of 2009. In a trend survey of Ernst & Young Real Estate 12 months ago, 98 percent of the people interviewed expected that the numbers of transactions under time pressure will significantly increase. Banks and listed real estate companies were expected to put a lot of offer price properties on the market. In view of the market developments at the end of 2009, it is obvious, however, that large sales with considerable discounts below the acquisition prices have not materialized.

This article summarizes today's real estate market in Germany. To understand the real estate market, segment distinctions need to be drawn. This article reflects the office market, the retail market, the logistics market, the hotel market, the investment market, the owner-occupied housing market and the residential rental properties market.

Office Market

Since mid 2008, office space rentals have decreased, both for the average and the prime segment. Even though the market was initially strong in the first half of 2008, there was a noticeable drop throughout the rest of the year leading to a result that was about 8 percent lower than the peak year, 2007. In the first half year of 2009, floor space demand decreased by approximately 26 percent compared to the same time period the year before. The drop in demand for floor space continued as companies scaled back their property needs as part of cost-cutting measures and by the lack of new lettings. In view of the higher building completion rates in 2010 and office tenants

ongoing space optimization, the vacancy rate will markedly increase. This prognosis is supported by the expected gross domestic product (GDP) growth of 1.5 percent for 2010; because economic growth requires effects on employment which arise only upwards a GDP growth of 2 percent. To attract new tenants, landlords have been offering rent-free periods and the payment of renovation and extension works and other incentives are becoming more common transforming Germany's office market into a tenants' market.

Retail Market

While Grade-A retail space remained stable in Germany's top cities, secondary retail locations and out-of-town shopping centers faced mixed market conditions. With retail turnover on a downward trend since the beginning of 2007, supply levels in these locations continue to rise, leading to rent increases. There is a contradiction with many national and international retail chains continuing to follow their expansion strategies while many department stores and owner-managed shops have to learn how to deal with shrinking market shares and poor profitability. This natural selection process was additionally intensified by the financial crisis. The number of new leases was, in 2009, declining and more space is available at the market. As a result of these negative developments at classic retail locations, retail floor space has become more selective and deals are taking longer. Since the best locations are still in demand, the prime rents witness a positive trend. Despite the financial crisis, planned projects were completed and a pipeline of new developments provides an increase by more than one million square meters for 2011. In 2010 it is expected that even in these top locations there will be no longer any willingness to pay compensation to the previous retail space user, so that the sellers will have to impress the potential buyers. The retail market in Germany is challenging, but is unique in Europe offering high-quality properties and a lot of available space. However, the retail market depends also on the consumers and their spending. Compared to those of other countries, Germany's consumers are not prone to negative wealth effects to any significant degree and are not faced with mounting debt. However, rising unemployment may entail lower consumer spending which, in turn, influences the demand for retail floor space.

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Logistics Market

The logistics market is probably most affected by the crisis. The drop in output and transport volume has enormous influence on the demand for logistics services and logistics facilities. The logistics market is characterized by falling rents in all major cities and an overall vacancy rate between 5 and 5.5 percent. Future demand must be adjusted to the new economic environment. As pressure on cost increases, logistics services will be more frequently outsourced. While the vacancy rates in modern facilities are relatively low and have not changed noticeably, older properties will be most affected by this trend: The weak state of demand and the growing shortfall in users will lead to rising vacancy rates, especially as recent years have seen shortened lease periods of three or five years, so that users can quickly terminate the lease agreement. However, falling levels of construction activity will have a stabilizing effect on future logistics market development. This reduction is caused not only by decreasing user demand but also by financing difficulties: Requirements for credit worthiness rose for both users and developers and lease terms were tightened. These criteria are likely to continue and will limit the supply of new developments.

Hotel Market

The number of foreign guests fell by about 8 percent in 2009 and the number of German guests also fell by approximately 2 percent. Due to the global recession, this trend will continue, but affect cities in different ways. While the markets of cities strongly visited by business travelers are suffering losses, the tourist cities like Berlin or Munich remained relatively stable. These last mentioned markets profit from consumer sentiment which has so far remained robust. However, the need for renovations and renewals as

well as a trend to build cheap accommodation facilities located some distance from the expensive centers of major cities will continue the weakened hotel market conditions.

In the last six to eight years, Germany's builders have been providing sufficient new houses and apartments. The reason for this is the tax situation, because all benefits for private home owners as well as for the investors have been either nullified or greatly reduced, and on the other hand, there is a low assumption of risks in financing of building projects by banks.

Investment Market

Due to the financial crisis, the investment market suffered dramatically. Transaction activity was continually reduced in recent quarters and close to a standstill. Investment volumes slumped by around 70 percent. The relatively low risk puts the focus on investments in core assets, i.e. real estate with long-term tenants. Despite everything, uncertainty due to the low numbers of transactions and the differing price expectations of buyers and sellers still exists and it will take some time to stabilize. Investors with a sound equity capital base, private individuals and open funds are concentrating on the highest quality office locations in Germany's major cities, using the new competitive environment to buy these Grade-A buildings for themselves. Even though portfolio transactions are now extremely rare, interest in rented residential property remains thoroughly intact. Additionally, peak yields in the retail market have stabilized so that a clear price level is given. In 2009 the total value of retail transactions was about €3.4 billion. What has not changed is that open funds, special real estate funds and sometimes closed-end funds as well as family offices and private investors determine the market development. Nearly 90 percent of invested capital came from local investors. This dominance is expected to continue into 2010. Furthermore, the recovery of banks will go on, but loan-to-value ratios will slowly begin to recover. This development is characterized by the noticeable restraint of banks to call the loans in and to push for a short-term sell – even in the event of a breach of contract. For banks to initiate execution proceedings it is quite simple and more convenient to restructure a problematic credit in a way that capital adequacy requirements not increase.

Owner-Occupied Housing Market

Compared to those in other countries, prices in Germany's owner-occupied housing market have been relatively stable over the last few years. Nevertheless, sales prices have started to stagnate in some regional hotspots such as Munich and Hamburg. In these locations, price increases have been noticed in recent years, which resulted from a relatively high investment activity and a lack of adequate supply. The low level of mortgage interest rates should sustain demand in the housing sector to some extent. However, the uncertainty regarding the development of the economic situation should deter significant price increases and thus the outlook for Germany's owner-occupied housing market remains relatively solid.

Residential Rental Properties Market

Germany's residential sector and its prices have been, up until now, not affected by the financial crisis. There are no apparent slumps in rents, prices or transaction volumes. The sought after cities continue to enjoy steady population growth and building activity in the multifamily housing sector is leveled low: In the last six to eight years, Germany's builders have been providing sufficient new houses and apartments. The reason for this is the tax situation, because all benefits for private home owners as well as for the investors have been either nullified or greatly reduced, and on the other hand, there is a low assumption of risks in financing of building projects by banks. Therefore, the 2010 outlook for residential rental property remains positive, at least in the major cities.

Conclusion

As a whole, Germany's real estate market has not been as affected by the economic crisis as other countries. Germany escaped rather unscathed because its assets are characterized by a slow upward trend, corresponding in the years of crisis to a relative stability on the downward motion. However, a high overall vacancy rate and increase in unemployment affect the real estate market by continuing to cause uncertainty. Sellers have to respond to

this situation by offering incentives and consequently ameliorating rental conditions. Regarding investments, in particular in retail real estate, 2010 is expected to be a good year with stable prices.

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Business Issues Affecting the Current Real Estate Market in Ukraine

Between 2005 and 2008, Ukraine became one of the most attractive markets for investing in real estate. In part, this was due to the high returns investors received that were sometimes 30 percent annually or more. Such big returns led many investors to ignore many real estate investment issues ranging from corrupt authorities to heavy tax burdens and a murky and burdensome regulatory system.

However, the global financial crisis caused weak demand in the real estate market and forced investors to reassess their attitude about such risky economies as Ukraine and become more cautious about investing in Ukraine's real estate market.

The Lack of Regulatory Framework in the Sale of Land Plots Through Auctions

Ukraine obtained its independence in 1991. It began transferring land from state to private ownership in earnest after the 2004 Land Code. State or municipal land, as well as the ownership and use rights to such land (lease, superficies or emphyteusis) including municipal or state-owned buildings and other structures, is subject to sale as separate lots on a competitive basis using land auctions. Land sales are to be conducted exclusively through auctions. Such land sale procedures are required by the 2004 Land Code and are to be further stipulated by a separate law. However, the required separate laws regulating the procedure of land auctions have not been adopted by the Parliament of Ukraine.

A license is required to conduct land auctions, but there are no legally approved licensing terms and conditions for carrying out land auctions (as provided by Article 8 of the Law of Ukraine on Licensing of Certain Types of Business Activity). Under such circumstances, properly organizing and conducting land auctions is impossible.

The lack of laws approving the procedure for selling land plots and providing the licensing terms and conditions for carrying out land auctions makes most land auctions illegal. However, such auctions are held in many regions in Ukraine on the basis of legally questionable land auction procedures developed and approved by local public authorities. Such unapproved practices may raise questions about the validity of such land transfers as evidenced by relevant decisions and warrants made by the State Land Department and General Prosecutor's Office.

While the law permits Ukraine-based subsidiaries to purchase land plots directly from private owners, there may be underlying defects in the chain of title to certain land sold under such transfers.

Restrictions on the Foreign Ownership of Agricultural Land in Ukraine

Non-agricultural land may be purchased by non-residents of Ukraine only if the land is located within the formal boundaries of a settlement or if the land lies under an existing construction that is acquired by such non-resident. The acquisition of agricultural land by non-citizens is strictly prohibited by the 2004 Land Code. In addition, an official moratorium (imposed by parliament) exists on the sale and purchase of certain agricultural land by anyone.

Notwithstanding the current prohibition on the acquisition of land under Ukraine's law, some non-residents acquire land by creating corporate structures that may allow them to conduct a lawful land transfer. Such practice includes the use of a questionable two-tier corporate structure; it is not clear that such a practice is failsafe. Theoretically, Ukraine's authorities may challenge the use of such two-tier structures. Such an imperfect and ambiguous practice may be viewed as quite risky and raise questions about

whether a project structured in such a manner is "bankable."

Complicated Regulatory System for Construction Projects

Although state authorities have attempted to simplify the procedure for receiving construction permits, it is still a very complicated process for real estate developers. The procedure for project documentation involves obtaining many approvals including town-planning documentation, official project requirements, the construction project itself, receipt of construction work permits and the beginning of building.

Although state authorities have attempted to simplify the procedure for receiving construction permits, it is still a very complicated process for real estate developers.

According to the Doing Business project (www.doingbusiness.org) of The World Bank Group, Ukraine is rated 181 out of 183 economies for the ease of obtaining construction permits. For example, to construct a warehouse, a developer must seek 30 different approvals. In Ukraine, under normal circumstances, it takes about 476 days to build a warehouse. This is almost twice as long as the average construction period for Eastern Europe and Central Asia, which takes only 264.2 days.

Contributions to the Social and Transportation Infrastructure and Investments in the Construction of Utility Systems

Before investing in real estate development projects in Ukraine, investors must carefully calculate the total costs of such projects. For example, in addition to obtaining the permits and approvals, investors are obliged to make contributions to the development of social and transportation infrastructure of settlements. Such contributions are regulated by law and may not exceed: (i) for non-residential structures 10 percent of the contract price of construction of a structure and (ii) for residential structures 4 percent of the contract price. Investors must enter into respective agreements with the local authorities before they may obtain a construction work permit. Investors must pay contributions in one installment or in several parts not later than one month after the project has been approved.

Further, a developer must obtain approval from different organizations to connect to electricity, gas, water supply and sewage utility systems. In many cases, the utility systems in Ukraine are very old or do not have enough capacity to meet modern demands. Thus, owners of the utility systems may require developers to build new utility systems, considerably increasing the costs of a project. Fortunately, a recently amended law allows developers to decrease the sum of contributions by the cost of construction of the utility systems outside of the developer's land plot.

Questions remain: Must a developer transfer the newly constructed utility systems or structures to the utility system's owners? The law does not provide a clear procedure for such transfer or address its tax consequences for the developer and the utility system's owner. Moreover, the law does not provide for a mechanism to decrease contributions that must be paid to the local government. Such ambiguity creates a potential risk that a developer will be unable to transfer the constructed utility systems or objects to the owners of such systems or that the local authority will not agree to decrease contributions.

Inconsistent Ukrainian Legislation

Inconsistencies and ambiguities in Ukraine's legislation raise many issues for even the most straightforward investment activity. Ukraine's legislative system consists of acts at different levels and authority, such as regulations and subordinated acts of the Cabinet of Ministers, the Ministry of Regional Development and Construction, the State Tax Administration and others. It is not rare for different standards to contradict each other. Sometimes special written clarifications from the state are required to begin working on a project. The inconsistencies and ambiguities and a slow court system may prevent investors from seeking assistance from the courts. Making one's way through the appeal process may bring some relief, but that process may take years.

Taxation Issues – Using Special Purpose Vehicles

The inconsistencies in Ukraine's law and taxation system including enforcement by tax authorities force investors to seek ways to optimize their tax liabilities, as well as to better protect their investments through special purpose vehicles (SPVs) created in offshore jurisdictions where laws are more consistent and corporate rights are better protected. Offshore SPVs are used to:

- Protect investors' corporate rights associated with assets located in Ukraine;
- Obtain more flexibility in making investment decisions and redistribution of financial returns; and
- Provide access to use legal remedies established in more mature commercial jurisdictions than Ukraine.

The use of offshore SPVs in the holding company structure allows investors:

- To hold assets in Ukraine indirectly through offshore SPVs, reducing the risk of hostile takeovers;
- To more easily transfer real property or land in Ukraine by selling the SPV that owns it rather than the real property or land itself; and
- To better attract funding from investors interested in investing in the Ukraine-based company indirectly, in an offshore jurisdiction, which provides them a much higher level of investment protection than in Ukraine.

Problems in Residential Construction

The financial crisis has exposed many problems in housing construction which were in place before. Some developers build their business relying on administrative access to land plots and fund their projects mainly at the expense of small investors seeking to own housing in the proposed development. Given Ukraine's population's drop in income, the lack of bank financing for housing purchases, the lack of confidence in developers and the resulting suspended market requirements, it is necessary to introduce new mechanisms for financing housing construction that will allow investors to build, using their own or secured funding, and sell new houses. Ukraine's law allows a developer to secure sales of housing premises and reduce the amount of its own capital by attracting investment, such as 10 percent of the construction costs, at the early stages of construction. However, this presents a great risk to the small investor who is not protected by the law.

Given Ukraine's population's drop in income, the lack of bank financing for housing purchases, the lack of confidence in developers and the resulting suspended market requirements, it is necessary to introduce new mechanisms for financing housing construction that will allow investors to build, using their own or secured funding, and sell new houses.

The other problem for developers in Ukraine is the quality of construction projects. In recent years, most projects in Ukraine were built without proper construction standards for housing, courtyards and infrastructure – often with obsolete construction technologies. Developers must now significantly improve the quality of projects, reduce the price by reducing the cost of construction and bring modern technology to the construction. Those who are able to meet such requirements will have a good chance to participate in the development of residential projects.

Financing Real Estate Projects

One of the biggest problems in the construction industry in Ukraine is the lack of confidence of foreign investors in Ukraine and the lack of private capital for financing real estate construction projects.

To attract foreign investors, Ukraine must reform the regulatory framework for investing in land and real estate projects and tackle the corruption at the state and local levels to simplify the procedures for obtaining various permits and approvals and bringing the construction rules and regulations within Europe's standards.

Further, to obtain the significant funds needed to finance real estate construction projects, there is a need to clarify

all laws and regulations so that ownership of land and real property is unambiguous and clear.

Conclusion

Due to the vast amounts of undeveloped land in Ukraine, the country is ripe for real estate investment. There have been some recent improvements such as a new simplified system of acceptance of the constructed structures being introduced in 2009. A new construction code is being developed. It attempts to combine many construction normative acts into one document making the design, development and construction process much more clear and less time consuming. However, much more must be done to bring in the investment and financing necessary to support real estate development. Ukraine must complete its land reforms and create a land cadastre and a land market. It must adopt new laws to create a more investor-friendly environment, considerably reduce the number of different permits and procedures in the construction sphere, unify the system of real property rights registration including unfinished structures and effectively fight corruption.

To work effectively in Ukraine, like in any other country, investors should not only understand the real estate construction business but understand potential problems to mitigate the risk factors and protect their investment.

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