

Overview

Portugal ended 2008 in a very bad shape, signalling that the economy has entered into a technical recession. In Q4 2008, economic activity contracted by 8.4% annualized rate, the steepest drop since 1989. The figures are a bit disastrous, by far worse than expected. Portugal is not likely to get out of the woods soon, as (i) the export sector has no window to rebound given the dreadful state of external demand, (ii) domestic demand is set to contract given the poor prospect, rising unemployment and shrinking investment.

The dreadful environment has taken its toll on the country's fiscal figures as elsewhere in the Euro zone. The deterioration of the fiscal figures¹ has already triggered downgrades to the country's sovereign rating - from AA- to A+ and its short-term rating from A-1+ to A-1- which makes it more difficult and costly for the government to raise capital in international financial markets.

Against this backdrop, the government's ability to take any significant action to boost activity level is very tight. Finally, the downgrade is also set to increase the cost of funding for domestic firms and Portuguese households. The continuous waning of order books has led to a marked fall in business confidence, an historical low since 20 years. The manufacturing confidence index dived to its lowest level in nearly 5 years. Employment in the manufacturing contracted further at the end of the year. Not surprisingly, the unemployment rate rose to 7.8% in Q4 and the trend is set to continue in the quarters ahead as companies will have to slash costs to avoid further erosion of their margins. Rising unemployment, gloomy environment and tougher credit conditions are likely to pressure further households' spending. As a conclusion, our scenario remains unchanged compared with September 2007: the Euro zone has now entered in a protracted recessionary phase and no silver lining is expected before 2010.

On the monetary front, the ECB has definitely turned to a more dovish stance as inflation has clearly ebbed. The ECB just decreased its interest rates to 1.50% in the wake of gloomy figures in the whole Euro zone. Despite this bright feature, both Portuguese investment and consumption are not likely to rebound as the prospects remain dark.

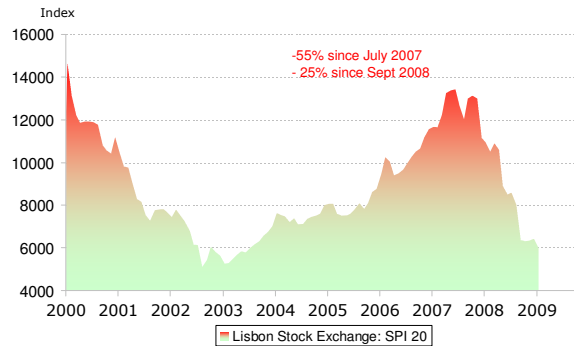
Demand

Consumer confidence has fallen to an historical low as fears related to unemployment are increasing. Digging deeper, households remained downbeat about their future personal and financial situation, and savings prospects as no real income gain is expected in the near term. Lingering concerns remained as household indebtedness rose substantially as most of households are indebted at a variable rate. In the near term, households' purchasing power will remain subdued as real wage are likely to ebb.

A survey published by the Bank of Portugal suggests that financial institutions are tightening their lending criteria as a ripple effect of (i) the financial turbulences, (ii) the downgrading of the sovereign rating. Portuguese banks will continue to limit the amount of credit available for both consumption and investment in order to edge the amount of bad loans.

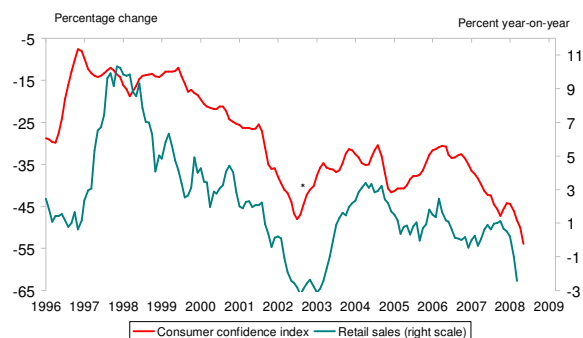
The cut in VAT from 21% to 20%, which began last July has not had significant positive impact on consumption so far, as household have taken a precautionary stance. The decrease in taxes combined with a slowdown in inflation might have avoided retail spending to plummet further like in other countries. Nonetheless, the ebbing inflation will not trigger any bandwagon effect towards consumption given the dreadful prospects. In 2009, private

The Lisbon Stock Exchange is trending towards its lowest value since 2003



Source: Global Insight.

Consumer Confidence fall to an historical low, retail sales to strongly suffer



Source: Global Insight.

¹ The current government has made impressive improvements to the fiscal accounts. The deficit decreased from 6.1% of GDP in 2005 to just 2.7% of GDP in 2007.

consumption is likely to decrease in the wake of contraction of the economic activity. GDP could contract by at least 1.9%. Given the deleveraging on stage at the world level, we keep thinking that there is a long way to go before a real recovery in the Euro zone. Portugal should renew with its potential by 2011, at best!

RETAIL MARKETS

Overview — The property market has entered a downward phase, in the wake of both a recessionary environment as well as an increasing supply. Although, the turnover indexation mechanism has been appealing to investors for years, it will run out of steam as consumption is set to decrease. The investment market has continued to loose momentum given the risk aversion towards property. Strong supply growth will continue to put downward pressure on rental and capital values in some regions in Portugal (in the wake of a cannibalization effect).

Consumer Demand — In spite of an easing inflation consumers have curtailed their spending. In the last three months to December, real retail sales continued to loose momentum given the lingering concerns of households. Health and personal goods are now trending by far below their long term average as well as textile and fashion. Household goods retail sales almost reached their level seen in 2003. Although the Christmas sales might have helped the overall level, retail sales are set to run out of steam in 2009. .

The song remains the same: households have been increasingly price-conscious since the subprime, most of them balancing their baskets according to their needs and purchasing power. As the world was poised to chaos, households have clearly held back their spending. The expansive cost of credit since the financial turmoil now enhanced since the rerating by S&P, have enhanced the heavy interest burden and pressure spending.

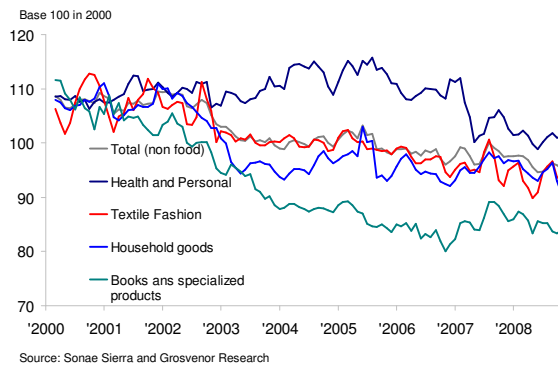
Retailer Demand — Letting activity in shopping centres is fading as concerns are increasing. Although no real distressed situation has been noticed, a u-turn has been visible. International brands have clearly now changed their timetable related to expansion, as in other markets. Retailer confidence's index has plummeted in the wake of a fall in retail sales.

Again, in the harsh atmosphere a good asset management will remain the cornerstone to keeping tenants "happy" and incentivize the weaker to stay (avoiding global vacancy to increase). Indeed, as effort ratios are likely to increase, asset managers will have to fine tune their lease in order to secure cash flows and ride the cycles. Retail parks is the real threat for shopping centres as they could appear as good alternative in a context of price-consciousness from both consumers and tenants' point of view.

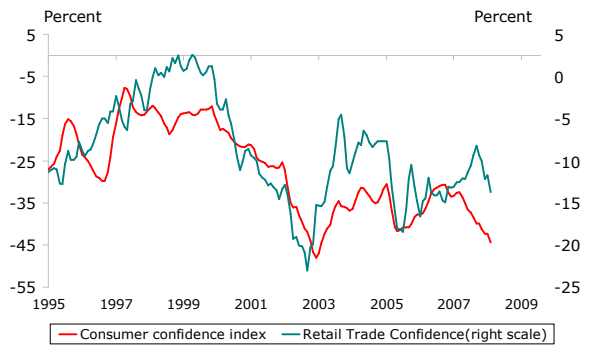
Supply — The amount of modern provision has continued to rise: large retail formats are expected to open in Greater Porto which will increase competition. Looking forward other completions will be seen in Viseu as well as in Guimaraes. Supply related to retail parks is also steady with 7 new units expected to open by 2009. The forthcoming supply in 2009 and 2010 will bring the Portuguese market to the maturity stage. Therefore, as seen in other more mature markets, the key will be to set up specialized retail outlook (lifestyle, mixed used...), although this might be of poor help in the current downturn.

Rental Movements — No sea change has been seen. Rents continued to be flat across submarkets with a level which averages €990m² in Lisbon compared with €750 in Porto. Nonetheless, such values are hiding rising commercial incentives triggered to keep tenants. Again, good asset management is key to avoid huge income fall. Fixed rent is likely to be increased, as the turnover rent is expected to fade.

Retail figures trending downward
More adjustment is set to be seen



Retailers to follow consumers' mood
Indexes to continue falling



Investment Market — Portugal has not remained immune from the global risk aversion and the downward adjustment in capital values although the high street shop fared better than its peers. Yields in high street shifted between [25bps;50bps]. Such a tiny change compared with other markets is highly related to the inexistence of supply. In both the shopping centre increased between [50bps,75bps] on average since their peak while the outward yield move was stronger in the retail warehousing submarket (+100bps in Lisbon). A new outward move is likely in 2009, as rents are likely to fall. As valuers want to head off the market, they will not wait for transactions to review their expectations. In such a context, there is a highly likelihood that yields will overshoot in 2009 and potentially in 2010.

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