



GLOBAL INVESTMENT SALES AWAIT NARROWING OF BID/ASK SPREAD

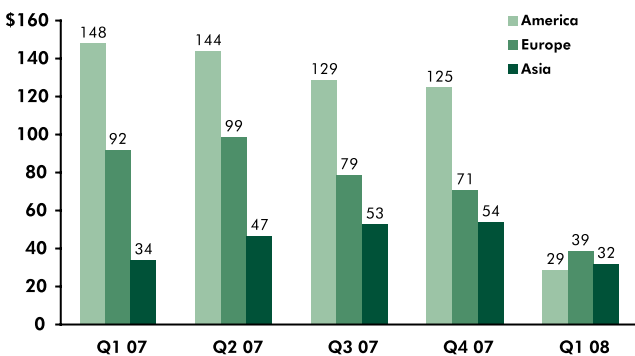
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Subprime lending has dominated the news and conversations globally for more than two years. What was initially a serious deterioration in lending standards concomitant with increased speculation in the U.S. housing market has evolved into a global credit shortage and economic slowdown.

SUMMARY Despite downward pressure on capital values and an uncertain economic outlook, rental rate increases in recent years mean that core properties are still achieving higher net operating income as leases roll over. This will allow many property owners in North America and Europe to weather the current storm.

Thus far, the biggest impact on commercial real estate markets is the decline in the volume of investment sales transactions. As shown in Figure 1, the volume of global transactions is down dramatically over the past four quarters. While investment activity is off in every part of the world, the decline is most severe in the Americas, especially in the U.S.¹

Figure 1: Quarter Sales Volume (\$ billions)



Source: Real Capital Analytics Global Capital Trends March/April 2008

¹ In the United States, the volume of transactions in the first half of 2007 is inflated due to the \$37 billion sale of the Equity Office Properties portfolio and subsequent re-sale of many assets that comprised the EOP portfolio.

While volume is down sharply, the same cannot be said of asset pricing in the U.S., expressed as cap rates. Figure 2 shows recent data on cap rates for the last two quarters

as compared with the first quarter of 2007.

Figure 2: Cap Rates Have Moved Slightly

Cap Rate%	Q1 2008	Q4 2007	Q1 2007
Office	6.5	6.1	6.2
Industrial	7.2	7.1	7.1
Apartments	6.4	6.1	5.9
Retail	7.0	6.9	6.8

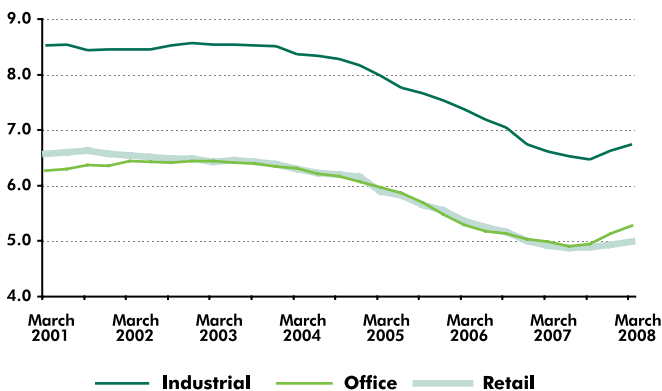
Source: Real Capital Analytics, Q1 2008

While there is some upward movement in these rates, most observers look at the data with a critical eye. First, as mentioned, the volume of transactions is down, so the data set is not robust. Second, better quality properties are primarily the ones selling right now. Therefore the sample is not representative of "normal" market conditions. Better properties sell at lower cap rates and may not provide an accurate comparison with last year's first quarter. Third, analysis of individual transactions shows that while the value of the very best "prime" space may be holding up well, secondary and tertiary property has seen much more significant reduction in values. All of these factors are obscured in the overall aggregate market data.

The situation appears similar in Europe, where the first impact of the credit squeeze was a sharp reduction in commercial real estate trading in the U.K. during the final quarter of 2007. The first quarter of 2008 confirmed that the widely expected slowdown in capital markets has progressively spread across the continent. No longer a “U.K.-only” phenomenon, the fall in investment activity is now evident across most European markets. In particular there have been far fewer transactions involving large assets or portfolio deals, which had dominated the market in 2006 and 2007.

Pricing across Europe has also started to adjust, although as in the U.S. the true picture is not always evident from the headline figures. In the first quarter, the CB Richard Ellis EU-27 Average Prime All Property Yield Index increased for the third consecutive quarter to 5.33%. A quarterly shift of ten basis points was recorded, with the office sector seeing the most change and the retail sector so far proving most resilient. The overall Index has now climbed 27 basis points from 5.06% at the end of the second quarter 2007.

Figure 3: CBRE EU-27 Average Prime Yields, %



As in the U.S., poorer quality properties have been hit far harder than the best buildings. Moreover, the definition of “prime” is shifting: investors are no longer prepared to overlook any deficiencies in building quality, location or leasing characteristics; buildings that would previously have traded at “prime” prices are

now being viewed more critically, with a consequent impact on value.

So far the price corrections across the continent appear to have been driven by the changes in the capital markets, rather than underlying market fundamentals of supply and occupier demand. As such, the biggest yield shifts have occurred in markets where yields relative to “risk-free” government bonds were lowest, such as the U.K., Ireland and Spain. This is because the market is now driven by yield-focused equity investors, such as the German open-ended funds. On the other hand, the less volatile markets, such as Vienna or Brussels, have proven more resistant to price corrections.

On both sides of the Atlantic, there is also a substantial gap between what a buyer will bid and what a seller will accept. Sellers do not feel a need to adjust their asking price since they have little desire to sell into this environment. The cash flows on most properties are good since occupancies are high and rents have risen fairly well in the last two years. Only owners with debt distress—debt rolling on properties whose incomes cannot meet the debt standards—are in a situation where selling or some kind of restructuring may be the only solution.

Interestingly, the sharpest price movements in Europe have been in the U.K., where a number of open-ended unit funds were forced to place some top-quality buildings on the market due to significant withdrawals from investors. The resulting transactions at the end of 2007 and early this year crystallized the movement in prices that many believed was occurring—but also provided clear evidence of significant investor demand at yields that were around 150 basis points higher than six months earlier.

While it seems obvious that the high level of debt used to finance purchases in recent years leaves some owners vulnerable as values start to fall, it is not clear to what extent this will actually result in forced sales. Interest rates are low compared with past cycles, meaning that it is easier for borrowers to maintain interest

payments even if they exceed loan-to-value covenants; and occupier markets are more robust, again meaning that borrowers are more likely to be able to maintain interest payments.

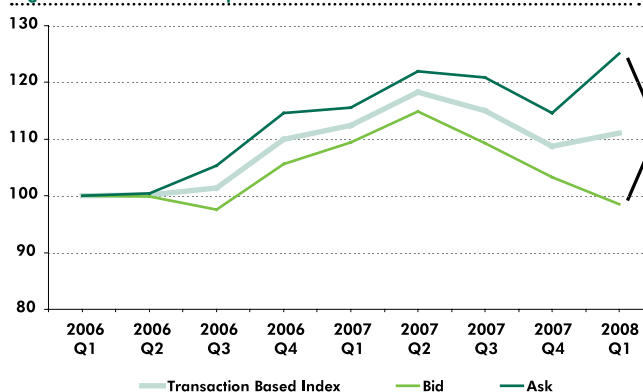
Our expectation, therefore, is that as long as occupier markets do not undergo a substantial downturn, lenders will pay more attention to interest coverage than loan to value covenants. With the current uncertainty in the property market, they are also less likely to force sale where there is only technical violation of loan covenants rather than actual default. This will limit the amount of forced selling (and indeed investment activity as a whole) in the current cycle and will also slow the rate of repricing.

It should further be noted that, in Europe, many leases have some form of annual indexation of rental income. Thus, particularly in an inflationary environment, short-term income growth through indexation will also help owners finance their debt payments irrespective of the underlying occupational fundamentals—provided, of course, that tenants remain solvent.

Buyers, on the other hand, demand higher risk premiums for their investments. If buyers are looking for debt, they know that both the cost will be higher and the amount of proceeds will be lower, making it impossible to buy properties at the prices of 2006/07 and still achieve higher return thresholds or hurdle rates for 2008. Buyers await the price adjustment; in most cases believing that prices still have further to fall.

Research at the MIT Center for Real Estate has documented the widening bid/ask spread for commercial real estate in the U.S. Using the National Council of Real Estate Investment Fiduciaries (NCREIF) database of properties, the research estimates the reserve prices—here labeled “bid”— of buyers versus the sellers’ asking prices. As shown in Figure 4, the bid has steadily declined from quarter to quarter, while the sellers’ prices (“ask”) have held steady. The market is represented by the middle line.

Figure 4: The Bid/Ask Spread



Source: MIT Center for Real Estate, Q1 2008

Interestingly, the bid line is now at 100 on the index, about the same level as in mid-2006, indicating that buyers are looking for prices that are about where they were two years ago. Most observers believe that the debt froth became prevalent about that time and into the first half of 2007.

In order to have transaction volumes pick up in Europe or the U.S., the bid/ask spread needs to narrow. However, buyers on both sides of the Atlantic remain reluctant due to the uncertain economic outlook and its impact on leasing revenues as well as concerns about future levels of long-term interest rates.

That said, it is our view that markets will bifurcate later this year. Core properties will see bidders moving toward asking prices, and opportunity properties will see sellers conceding more to buyers. Aggregate “market” statistics will need to be disassembled to determine if our hypothesis is correct.

Why will buyers need to move toward sellers for core properties and not the other way around? Our analysis of property fundamentals, in general, shows that office, industrial and retail properties with long leases in place (i.e., core properties) are advantaged. As leases roll over in the next few years, even into the slowing economy, tenants will find that their existing rents are below market rents. Hence, tenants will face a rising rental cost and property owners will see increased net operating income.

While it is clear that cap rates need to adjust upward, stable-to-increasing incomes allow many property owners to take a “wait it out” attitude toward selling. Why sell when the income streams that make up much of your total return today continue to deliver? To coax sellers out of complacency, buyers will need to raise their bids so that owners who may wish to sell will see a benefit in doing so. Sellers, however, should not expect that rising income streams will make them immune to write-downs, especially in an environment with slower economic growth, increased risk premiums, and higher interest rates.

In particular, sellers of opportunity assets, with more vacancy than occupancy or heavy on short term debt, will be more receptive to a buyer’s lower bid.

Thus in the U.K., for example, those owners who had to sell around the turn of the year were forced to accept lower prices. However, the high quality of the properties and the attractiveness of long U.K. leases (within which rental income is prevented from falling even if market rents decline) meant that buyer interest was healthy. The prices achieved were lower than the sellers would have achieved months earlier, but were still higher than many expected. In buyers’ minds, expectations of further price declines must be balanced against the ongoing desire to secure quality income-producing investments when they come to the market.

In other markets, an adjustment in pricing still needs to occur; and once it does, commercial real estate will return to its roots as an asset with income returns comparable to bonds, but with some upside in value growth that places total returns between those historically offered by bonds and stocks.

Crucial to the above analysis is the expectation that the global economy is in a period of a mid-cycle slowdown, not a protracted contraction, and that this slowdown

will not extend beyond 2009. Under such conditions, U.S. property markets will see only mild increases in vacancy rates, and rents will decline modestly, if at all.

In Europe, the outlook remains uncertain. In many markets the pricing corrections thus far do not fully take into account the changing outlook for supply and demand in the occupancy markets. On the supply side, as in the U.S., vacancy rates are generally low and the construction pipeline is relatively constrained for the late stage of a market cycle. One of the areas where European banks are being most restrictive is on funding development. Loan-to-value ratios have fallen rapidly across the board, and a high level of pre-leasing is now required for a developer to obtain development financing. Construction completions for London City offices in the 2009 through 2011 period

are likely to fall to half the level expected a year ago. Many projects have been shelved all together, with very few new schemes being given the go ahead.

Nevertheless, in the short term, projects already underway will add significantly to both the office stock and—in all likelihood—the vacancy rate.

The demand outlook for the occupier market has weakened too, as the U.S. economic slowdown is filtering through into Europe. What started as a phenomenon in the financial markets is spreading to the “real” economy. The restrictions on personal borrowing and loss of consumer confidence have affected economic growth, and thus occupier demand.

2008 is forecast to see slower economic expansion compared to 2007 across all European countries. Eurozone economic growth is subdued further by rising Euro exchange rates that reduce export competitiveness. Higher oil, food and commodity prices have increased inflation risk, limiting the ability of central banks to reduce interest rates to sustain economic growth.

SELLERS OF OPPORTUNITY ASSETS...WILL BE MORE RECEPTIVE TO A BUYER'S LOWER BID.

As in the U.S., the expectation is that the European economic slowdown will be relatively shallow and short-lived in comparison to other downturns of the last few decades. Some economies are likely to see signs of recovery during 2009, while in others the recovery will take longer to emerge.

Certainly there will be better and worse performing markets across both continents. Some markets, particularly in the U.S. Midwest, are suffering from the auto industry's woes, and markets that were heavily driven by local housing-market expansion, particularly on the U.S. West Coast and Florida, are now being negatively impacted by the contraction of single-family home prices and weakened economies. In Europe, it is the U.K., Spain and Ireland that are currently most exposed to a weakening residential market.

But generalizations are never absolute, always failing to capture the subtle nuances that characterize local conditions in any market environment, especially one in which investor apprehension runs high. Pricing movements in real estate have a strong tendency to overshoot—down as well as up—heightening the potential for attractive investment opportunities in the next couple of years. Particularly welcome will be the likelihood of a return to a more “traditional” real estate investment market, rather than one dominated by debt and financial engineering. Equity investors who truly understand local property markets and can add value through asset selection and active management will once again be able to generate excess returns—whichever side of the Atlantic they invest in.

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