

THE CURRENT STATE OF GLOBAL REAL ESTATE

FOREWORD

The world economy and commercial real estate markets have been roiled by events unimaginable 90 days ago. Economies around the world are sagging, and capital investment flows are minimal. As a result, local property fundamentals are weakening, although they begin this weakening in a generally strong position.

How did this happen? One of my colleagues put it succinctly: The problem is bad lending decisions, compounded by leverage. This crisis started with sub-prime loans in the housing market, and escalated when it became clear that these loans were made without regard to whether a borrower could meet his/her obligations. Rather, the assumption was that housing prices would always rise, and if the borrower couldn't pay, the house would be sold and the lender would be repaid.¹

But the original lender didn't hold the loan. Rather, he/she packaged and sold it to investors all over the world, who in turn trusted the institutions in the United States, especially when the securities were rated AAA, and leveraged their investments. The sub-prime distrust evolved into counterparty distrust (Bear Stearns), to inter-bank distrust (widening TED spreads)², to money markets distrust ("breaking the buck"), even to distrust that an insurance company can pay on its insurance contract (AIG). Each of these has eroded trust in the financial system and has led to systemic risk—not just in the U.S. but across the global economy.

This CBRE Global ViewPoint looks at the effects of the credit turmoil on commercial real estate around the globe on both the leasing and investing sides of the market. I am indebted to our terrific colleagues around the globe for sharing their insights and knowledge.

Please let us know if we can be of assistance.

Regards,



Raymond G. Torto, CRE, Ph.D.
Global Chief Economist

1. It was not only bad decision-making but also sometimes fraud, as we are discovering.

2. TED spread is the difference between the 3-month LIBOR rate and the 3-month U.S. Treasury rate and reflects the risk that banks see in the banking system.

THE CURRENT STATE OF GLOBAL REAL ESTATE

by Raymond Torto, Nick Axford, Alan Dalglish, Andrew Ness, Kevin Stanley and Raymond Wong

IT'S ALL ABOUT MAIN STREET

With the financial system frozen, there is no lending activity, which means that global businesses have found it increasingly difficult to finance their day-to-day activity, buy new equipment and invest in their own futures. As businesses pull back, jobs are lost. These job losses and the absence of credit in the market impact commercial real estate through lower leasing volumes, less lending activity and reduced investment performance.

This is reflected in the recent GDP growth figures available through the second quarter (see Figure 1), and there is every expectation that GDP growth will decelerate—or turn negative—for all regions of the world.

GLOBAL CAPITAL MARKETS

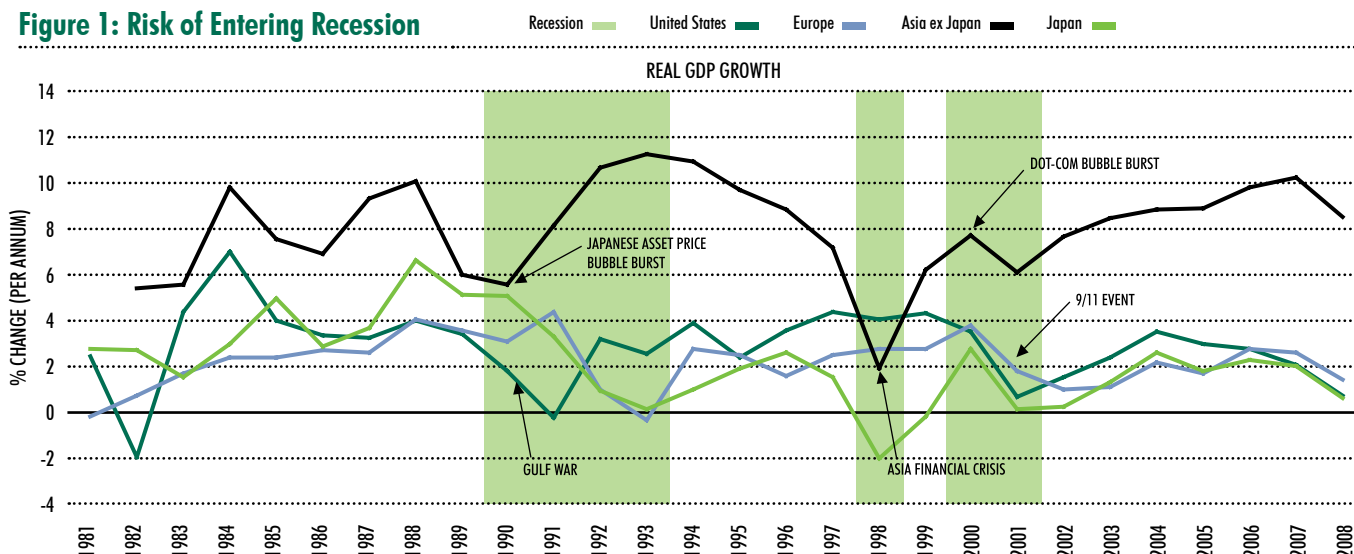
Most recently, it has been encouraging to see the coordinated moves by the world's central bankers to inject liquidity in banks and restore liquidity and lending to the financial system. The programs instituted by the central

banks will help, but they are not a panacea. At best, they will accelerate and shorten—and not prevent—the cycle time for flushing bad debt from the banking system and allowing normal lending to resume. Commercial property prices—like all assets—will remain under pressure, and their stabilization will depend in great measure on the number of sellers that are in the market.

Preliminary data for third quarter shows investment volume down across the globe in all property types, according to Real Capital Analytics. All parts of the world registered declines except the Middle East and Eastern Europe.

Aggregate data by region is shown in Figure 2, showing a steep drop quarter to quarter in transaction volume. This drop reflects in part the wide spread between bid-ask prices as buyers look for distress and sellers hold off with, in some cases, deep pockets.

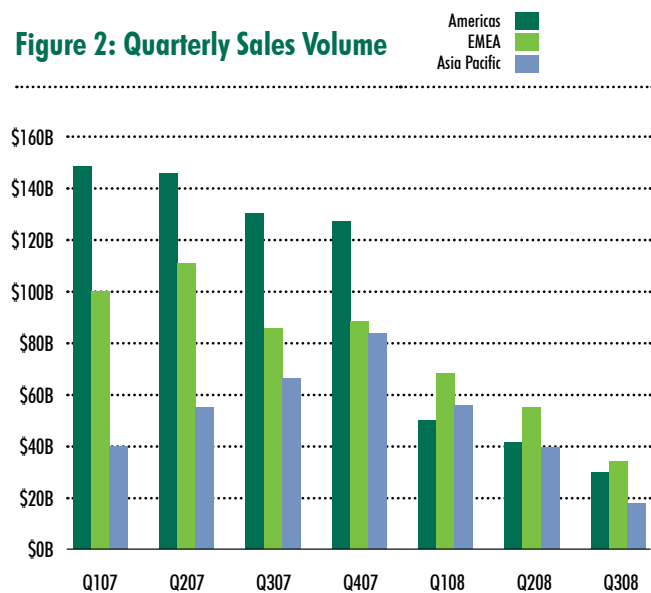
Figure 1: Risk of Entering Recession



Source: Economist Intelligence Unit

While there is a most pronounced drop in volume in the Americas and Asia in contrast to EMEA over the last year, bear in mind that the U.K. has been hit harder than continental Europe. Further, these volume flows are measured in U.S. dollars, and currency movements are affecting comparisons. Also, some observers believe that European investors initially thought that the credit crisis would be contained to the U.S.

Figure 2: Quarterly Sales Volume



Source: Real Capital Analytics

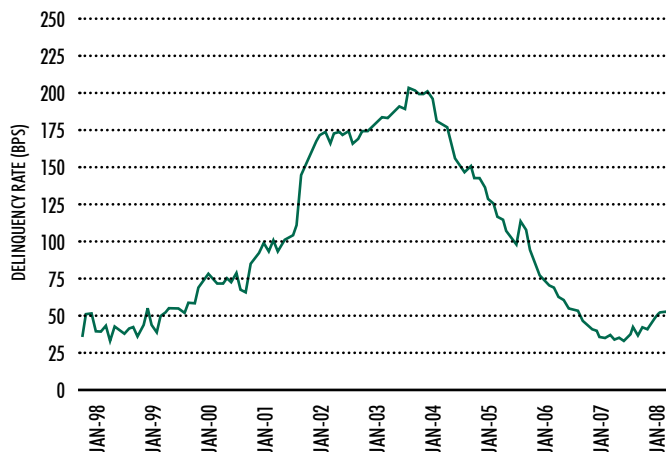
With increased economic concerns and diminished transaction volumes, cap rates or acquisition yields are rising across all regions as property prices are falling. Most observers believe that prices are down at least 15% from the peak in late 2007, but market participants have observed transactions ranging from zero price adjustment from year-ago levels to decreases as high as 40%, all depending on the location and quality of the asset.

AMERICAS

While there are pressures on pricing, it is ironic that many property owners, with a few highly leveraged exceptions, enjoy good cash flow and are paying their debt obligations. Delinquencies in the U.S. remain at microscopic levels compared to history, as shown in Figure 3.

Despite this, the credit crisis continues to cull the field of players—both equity and debt—and severely constrain

Figure 3: US CMBS Delinquency Levels



Source: Trepp

capital. For instance, in the U.S., several well-capitalized lenders have suspended their real estate programs for the remainder of the year. Lenders who remain in the market—including some life insurance companies, private equity funds and Fannie and Freddie for multi-family—have sharply tightened terms.

Even a year ago, quality product was being underwritten at 65–85% loan-to-value and spreads of 125–150 basis points. Today, loan-to-value ratios have dropped to 50–65% and spreads widened to 260–400-plus basis points. As a consequence, loan origination volumes are approximating 2003–2004 levels. Increasingly, we are seeing transactions done with partial seller financing or assumable debt. The former has been increasingly employed by financial institutions where they finance a significant portion of the purchase price. Other deals are happening where sellers have debt contracts which allow them to transfer the property debt to a new owner. In many cases, the assumable debt increases the value of the transaction.

On the equity side, substantial capital is still looking for opportunities, but not at today's asking price. A recent institutional fund survey estimates equity commitments to commercial real estate of approximately \$300 billion. However, some pension funds are planning to become net sellers of commercial property due to the "denominator" effect. The steep value destruction in their stock

portfolios has caused real estate holdings—which are marked to market on an annual basis—to exceed overall asset allocation thresholds. In theory, these pension funds will have to bring properties to market in order to return their real estate allocations to required levels. However, one could argue that this is the wrong time to sell assets with long-term value. Investment managers will be watching this closely as fund managers approach year end and the usual review of portfolio allocations are undertaken.

ASIA PACIFIC

The story in Asia is similar. The worsening state of global financial markets has further impacted capital flows into the Asian real estate sector, and investment volume suffered a steep decline in the third quarter, as shown in Figure 2.

Asian asset prices have begun to adjust downward at a measured pace for some properties in certain sectors. In spite of the minor uptick of yields following recent price adjustments, investors are now generally more risk averse, so sellers will need to make concessions to restore market liquidity.

In the Pacific Region, property markets remain fundamentally sound, although business and consumer confidence

has now reached a very low level. The high cost and difficulty in obtaining debt is noticeably impacting sales activity and pricing. Investment activity has plummeted well below long-term averages.

By the end of third quarter 2008, the overall stock weighted yields for the major cities across Australia reached 6.82% for prime CBD office property (an average softening of 14 basis points over the quarter), 5.88% for regional retail centers (an average softening of 18.2 basis points) and 7.74% for grade A industrial warehouse stock (an average softening of 16 basis points over the quarter).

EUROPE

In Europe, the key feature of the investment market also continues to be the lack of market transactions, due to the stand-off between buyer and seller expectations. Investment activity across Europe remained muted in the third quarter. The three main markets of the U.K., Germany and France continue to be affected, with third quarter activity falling to \$15.7 billion, or 43% of the European total, compared with a more usual 65–70%, according to CBRE proprietary transaction data. By contrast, third quarter activity was most robust in some of

Figure 4: EU Yields Rising Across All Sectors

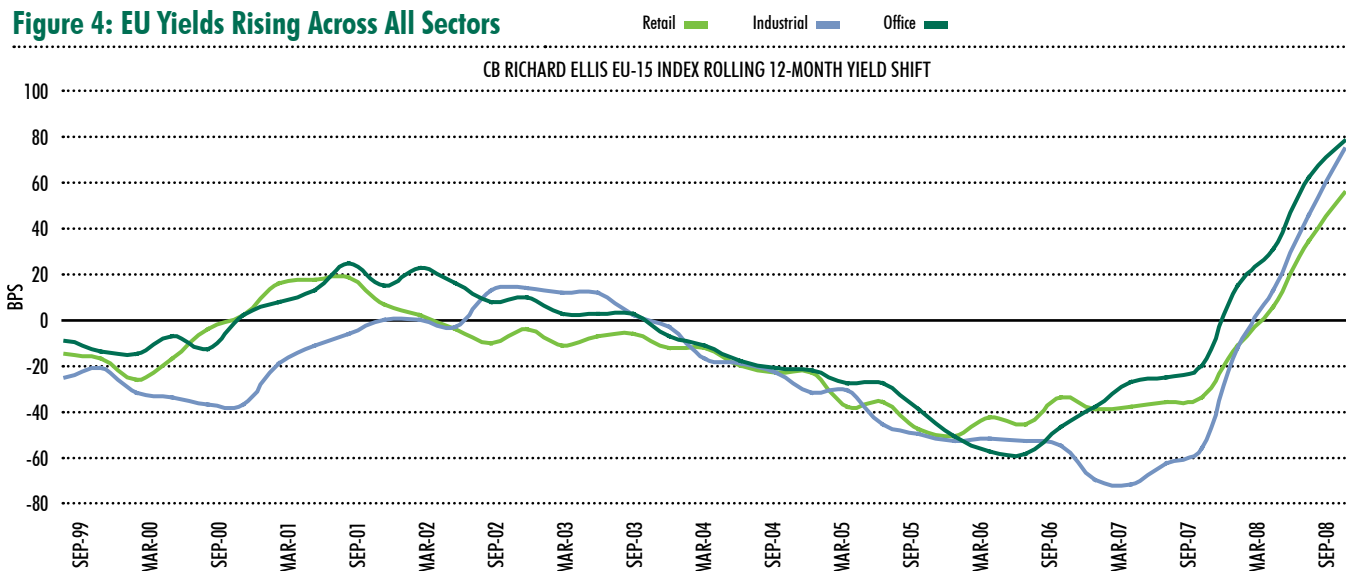
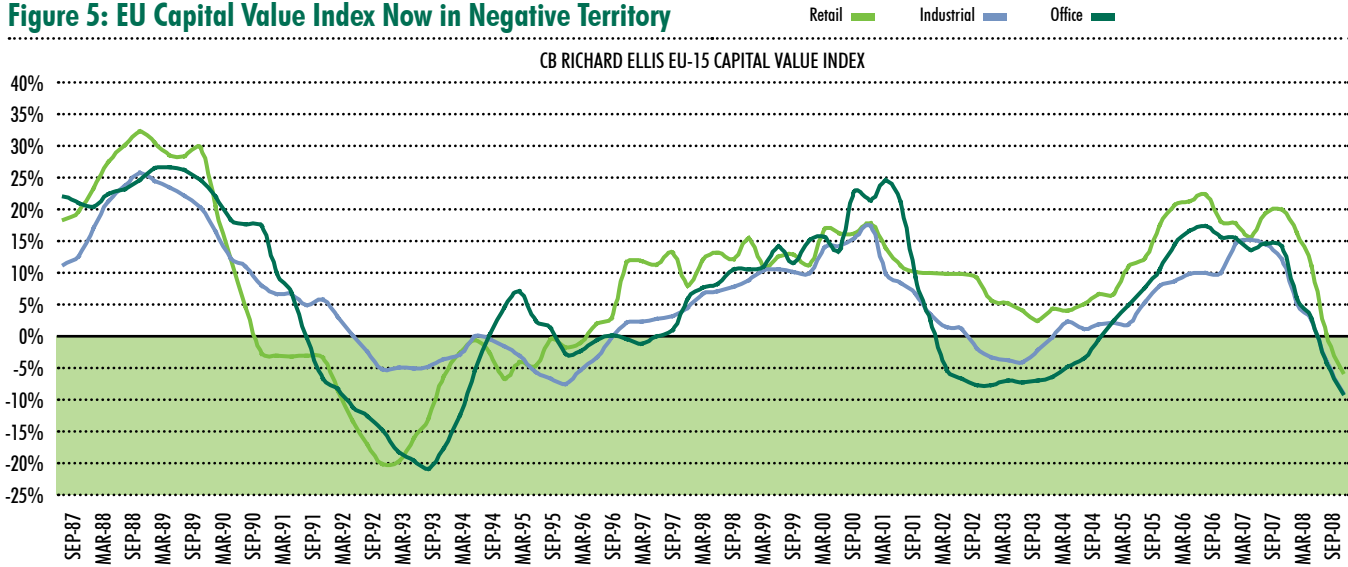


Figure 5: EU Capital Value Index Now in Negative Territory



the Nordic and CEE markets, namely Poland, the Czech Republic and Russia.

Yield increases of 25 basis points were recorded in many markets this quarter, with several seeing sharper increases. In the key markets of London, Paris and Madrid, prime office yields are now 125–150 basis points higher than they were a year ago.

We show the change in yields through third quarter for the CBRE EU-15 Yield Index for the three major property types in Figure 4, while Figure 5 translates this change into an estimate of the annual change in capital values, which are now negative in the EU-15.

Today's movement into negative values is unlike previous investment cycles. In the past, investment cycles have generally been driven by economic cycles. Today it is the other way round. The investment cycle is driving the economy and, as we said before, it's all about Main Street.

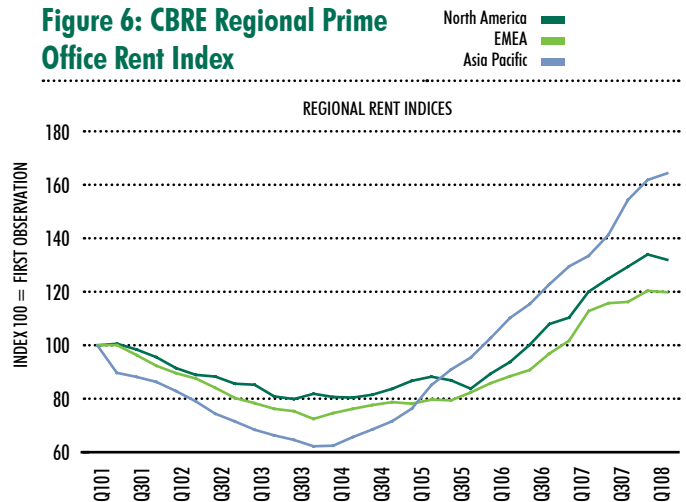
For the future, in Europe as well as other parts of the globe, investors are going "back to basics" for property investment: less debt, and more focus on fundamentals including stock selection, property/asset/tenant

management and rental growth. This means we need to focus clearly on demand—difficult given the uncertain outlook for the economy—and supply, which is generally in better shape from an investor's viewpoint than at the equivalent stage of previous cycles.

GLOBAL LEASING MARKETS

All regions are showing leasing weakness following a rapid rise in prime office rents in the 2005–2007 period. The CBRE Prime Office Rent Index for larger cities across the globe shown in Figure 6 reflects this weakness as rents are poised to decline or are already declining.

Figure 6: CBRE Regional Prime Office Rent Index



ASIA

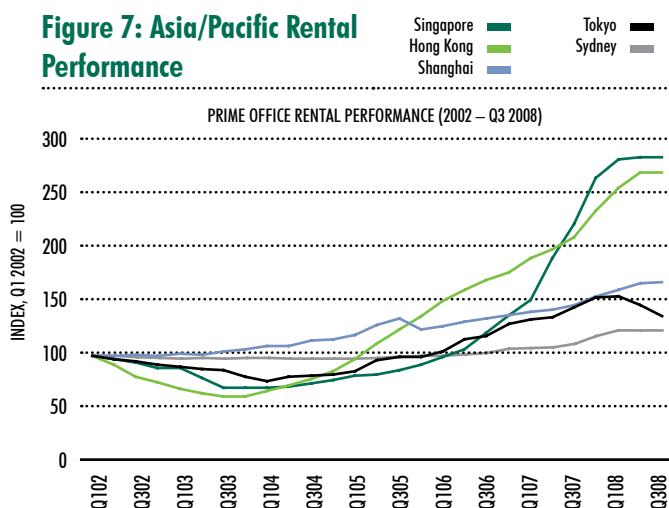
As the CBRE Prime Office Rent Index shows, Asia saw the fastest growth in rents in the 2005–2007 period, reflecting the booming economies of this region during this time. It's important to note that this was at a time when there was severe lack of supply in certain markets—the roots of which lie in the dismal bottom of the market in 2003, with SARS, etc. It was some considerable time before developers and bankers regained the risk appetite to build speculative developments, by which time demand had ballooned.

Today, however, real estate market fundamentals are weakening and office leasing momentum has eased. Increases in office vacancy rates were recorded in the third quarter in leading markets across Asia, paced by Bangkok, up 6.8 percentage points, and Shanghai, up 2.8 percentage points. Overall vacancy increases were recorded in 14 out of 16 markets. The impetus for further rental growth for prime office space is expected to diminish as potential occupiers become more cautious about committing to premium space.

Meanwhile, a growing number of corporations, particularly in the financial sector, have started to reduce operational costs and relocate their non-core operations to outlying business locations. The effect of this is most apparent in cities such as Hong Kong, Singapore and Tokyo, where growth in financial sector demand had been a major factor propelling the appreciation of office rents.

Tokyo registered a 7.1% decline in prime office rent in the three months ending September—its third straight quarterly decrease—marking the end of a positive cycle in which rates had risen continuously for four years. Average prime office rents also started to fall in Mumbai (down 10.5%), Shanghai (down 2.3%) and Manila (down 3.8%). Elsewhere, prime office rents remained static in major CBDs including Beijing, Hong Kong, Seoul, Ho Chi Minh City and Singapore.

Figure 7: Asia/Pacific Rental Performance



The CBRE Prime Rent Index for several Asian cities is shown in Figure 7. Until recently, a rapid rise across Asia is also reflected here, particularly for Hong Kong and Singapore. But all markets have at least reached a plateau in 2008, with declines evident in Tokyo.

PACIFIC

Leasing activity and enquiries slowed dramatically in the third quarter across all major cities of the Pacific Region. While office vacancy is now rising in most cities, it's off the lowest base ever recorded and mostly still supply-driven. This is a trend we had been expecting. Unfortunately, the recent loss of business confidence and a slowing in the broader economy may now exacerbate the rise in vacancy through contraction in occupied stock, especially in the battered Finance & Insurance sector.

Exposure to U.S.-based finance groups is limited in the Pacific Region, and most local companies in this industry are in solid shape; still, we remain alert to the imminent creation of sublease vacancy. Sydney is likely to be most impacted by this trend, where exposure to the Finance & Insurance sector is as high as 35% of the CBD workforce.

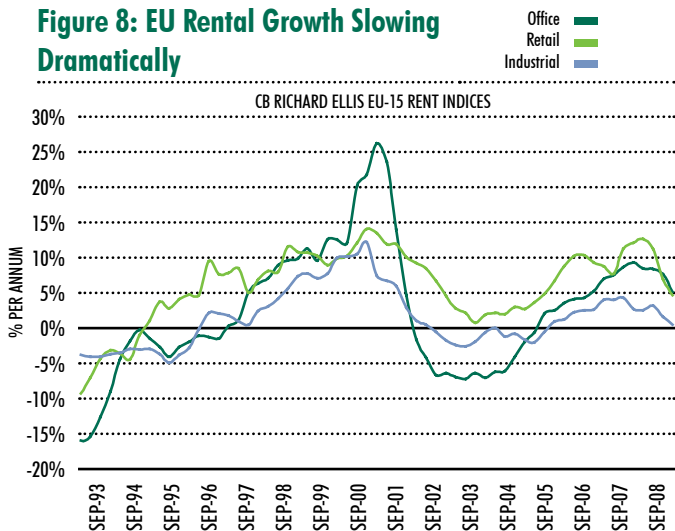
Elsewhere in the region, demand for office space from the mining sector had driven office vacancy in Perth and Brisbane to below 1.0%. There are now concerns that

as Chinese growth slows and the demand for Australian commodities eases, so too will the demand for office space in these cities, and a rise in vacancy will also be led by contraction in occupied stock from these industries. While this is a plausible connection, there's no evidence of this yet. As of the third quarter, rents in most cities have stopped growing, while leasing incentives have increased. Rents have started to fall in Auckland.

EUROPE

Leasing activity and rent movements in the main European retail, office and industrial markets increasingly reflect weaker economic activity. Figure 8 tracks the change in the CBRE index of EU-15 prime rents, which shows that rents are flat, at best.

Figure 8: EU Rental Growth Slowing Dramatically



Although the Index is flat overall, the major European office markets are split increasingly between those seeing actual rental declines—notably London but also Dublin and Barcelona—and those where prime rents are currently holding firm, such as Paris, Frankfurt and Madrid. In several markets in the latter category, there is a strong expectation that rents will come under downward pressure in the fourth quarter or early next year.

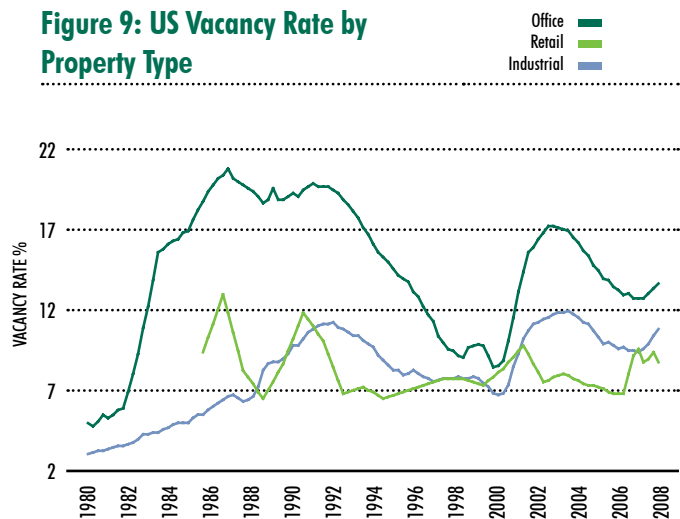
Much of the leasing activity concluded in the third quarter had been in negotiation for some time. Amid growing occupier caution—and more activity driven by consolidation

and cost-efficiency, rather than expansion—office leasing for the full year is likely to be 20–25% below 2007 levels.

UNITED STATES

Figure 9 shows the history and recent uptick in vacancy rates for three property types in the U.S. Focusing just on the office vacancy rate, it increased once again for the third quarter of 2008, this time by 30 basis points to 13.5%. Downtown vacancy held steady at 9.7%—10 basis points over its year-ago level—but suburban vacancy posted its second straight 40-basis-point increase and now stands at 15.5%. This is the fifth consecutive quarter that suburban vacancy rates have increased.

Figure 9: US Vacancy Rate by Property Type



That downtown markets are holding steady is not to say that they are immune from weakening office fundamentals. The fallout of the financial crisis is already being felt as major downtown markets such as Charlotte, Los Angeles, Raleigh and San Francisco all posted increases of 60 basis points or more. Although New York was, for the most part, spared this quarter, it is a matter of time before the mergers, consolidations and bankruptcies among Wall Street's elite financial firms translate into rising vacancy rates. However, to date we have seen relatively little tick up in sublease space.

As was the case last quarter, a majority of markets—35 out of 57—experienced a rise in vacancy rates. Once again, markets hardest hit by the housing downturn and heavily exposed to mortgage-related finance—such as Fort Lauderdale, Riverside and San Diego—continued to post significant increases; however, smaller markets in the Midwest and Southwest also posted large increases this quarter. That small Midwest markets experienced vacancy increases in excess of 50 basis points is a sign that the weakening economy is having a more pervasive impact on the office market nationwide.

Surprisingly, net absorption trends thus far this year perhaps compare favorably to previous recessions. This trend, along with other employment data, suggests that market conditions have reflected more of a state of paralysis—where leases are simply renewed for the same amount of space without the space give-backs that are typical in a recession. The deepening of the financial crisis in mid September, however, could force the hand of some companies to reduce their space needs. During the quarter, office rents managed to increase 1.4% from a year ago, based on preliminary data.

CANADA

Canadian office vacancy rates decreased marginally to 6.3% in the third quarter from 6.4% in the second quarter, with 5.9 million sq. ft. of absorption year to date. Similar to the U.S., demand has fallen off. Office space under construction is at 19.5 million sq. ft., which represents 5% of the Canadian inventory, with the majority of the activity in Calgary and Toronto. The new completions will be spread over the next five years and will cause the vacancy rate to rise. Office rental rates have for the most part stabilized, as companies try to grapple with the changing economy and the possible impact to their business.

LATIN AMERICA

The Latin America market fundamentals have been relatively strong; office vacancy rates are at all-time lows,

from 0% in Lima to 6.6% in Mexico City. There is currently a real shortage of modern office buildings; new construction activity has increased in most countries. Rental rates for the most part remain stable, while demand has slowed in response to global economic concerns.

CONCLUSION

The commercial real estate investment market waits for the unfreezing of the global capital markets and discovery of new trading prices for real estate across the globe. Hitherto investors squabbled to buy good investment-grade property and the extent to which this market blows up a few good opportunities will be viewed positively by some investors, perhaps allowing them not just entry to the market, which was very competitive before, but entry at a lower price. Of course, each investor approaches the market from where he or she sits. So we await price discovery and when this happens, we expect the large volume of capital idling on the sidelines to enter.

We expect the credit-induced recession will further hobble the global leasing market. However, unlike the single-family market in the U.S.—where this sordid chapter of financial history began—there is currently no glut of excess space in the commercial real estate market across the globe, and the development pipeline is modest in most places. We will watch for sublease space coming into the market, which was a big factor in the deterioration of the 2001 downturn, particularly in the U.S. Overall, the commercial real estate market is in a position to take the forthcoming pain from a position of general strength. Of course, this statement is not universally true. Some regions are already weak, and a recession will cause serious dislocations in some markets.

FOR MORE INFORMATION PLEASE CONTACT:

Raymond Torto, CRE, Ph.D.
 Global Chief Economist
 CB Richard Ellis
 617 912 5225
 raymond.torto@cbre.com

CBRE Global Research & Consulting Executive Committee

Raymond Torto, CRE, Ph.D.
 Global Chief Economist
 Chair
 617 912 5225
 Raymond.Torto@cbre.com

Andrew Ness
 Executive Director, Research
 Asia
 852 2820 2845
 Andrew.Ness@cbre.com.hk

Nick Axford, Ph.D.
 Head of Research and Consulting
 EMEA
 44 20 7182 3039
 Nick.Axford@cbre.com

Kevin Stanley
 Executive Director, Research and Consulting
 Pacific Region
 61 2 9333 3490
 Kevin.Stanley@cbre.com.au

Alan Dagleish
 Executive Director, CBRE Consulting
 Asia
 65 6326 1237
 Alan.Dagleish@cbre.com.sg

Raymond Wong
 Director of Research Operations
 Americas
 416 815 2353
 Raymond.Wong@cbre.com

Statistics contained herein may represent a different data set than that used to generate National Vacancy and Availability Index statistics published by CB Richard Ellis' Corporate Communications Department or CB Richard Ellis' research and Econometric Forecasting unit, Torto Wheaton Research. Information herein has been obtained from sources believed reliable. While we do not doubt its accuracy, we have not verified it and make no guarantee, warranty or representation about it. It is your responsibility to independently confirm its accuracy and completeness. Any projections, opinions, assumptions or estimates used are for example only and do not represent the current or future performance of the market. This information is designed exclusively for use by CB Richard Ellis clients, and cannot be reproduced without prior written permission of CB Richard Ellis.