

THE QUARTER THE GLOBAL ECONOMY STALLED

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

Beginning with the U.S. sub-prime dislocation in the summer of 2007, market conditions deteriorated into a severe global credit crisis, which effectively shut down the global economy in the fourth quarter of 2008.

No part of the world has escaped the spreading crisis, but each region suffers varying degrees of market angst. Some stand in relatively good positions, while others face severe problems. CBRE's Global ViewPoint for fourth quarter 2008 reports on the global status of the commercial real estate markets.

GLOBAL ECONOMY AND COMMERCIAL REAL ESTATE

GDP reports are mainly negative across the globe, and in some cases, record-setting levels of decline reflect the degree to which economic activity has stopped. In our view, the credit and economic crisis was aggravated by policymakers across the globe reacting in a tentative and confusing manner, and making the wrong policy moves with regard to the U.S. Government Sponsored Enterprises—Fannie Mae and Freddie Mac—and Lehman Brothers.¹

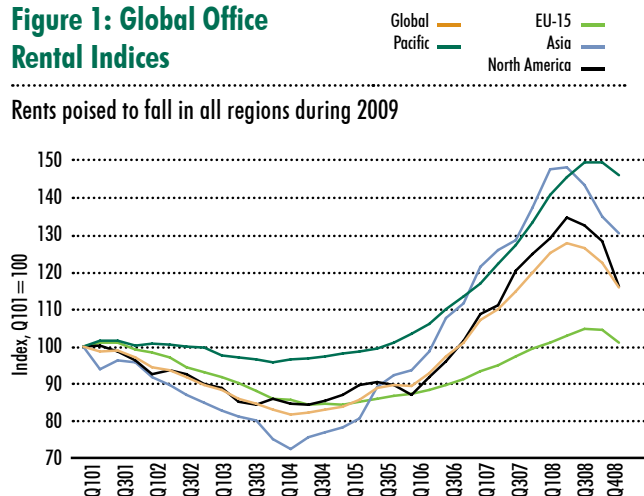
GDP reports or estimates for the world's major economies are all down, and most nations are reporting declining industrial production and falling exports, the latter being quite severe in the largest exporting nations. For instance, all of Asia's major exporters have recorded a sharp fall in exports.

Taiwan's total export for December fell 41.9% year over year, as corporations and consumers slashed their consumption of electronics and investment in IT products. Although Korea's manufacturers have gained

competitiveness from the cheaper Won, exports plummeted by 17.4% in December following an even bigger fall of 18.3% in November. Furthermore, the high degree of external dependency of the region's most internationalized economies, Hong Kong and Singapore, means that they too will be unable to avoid being severely impacted by the global downturn in demand.

No leasing market has been spared from the effects of waning economic activity. In the fourth quarter, rents softened further, vacancies rose and net absorption, or take-up, plummeted. A clear indicator is the CBRE Global Office Rent Index, shown in Figure 1.² The impact on prime rents began initially in North America and Asia in the second quarter of 2008, and has since migrated into the Pacific region and Europe, the Middle East and Africa (EMEA).

Figure 1: Global Office Rental Indices



Source: CB Richard Ellis Research & Consulting (Feb 2009)

² This CBRE Global Index is based on a selection of large cities in the North American and Asian markets; the EMEA Index includes a larger sample of cities. All rents are office prime rents.

¹ This opinion will be argued in another paper.

The most significant declines have been in Asia and North America, with declines in the index of about 12%. Also of interest is to compare how high and fast rents rose in Asia, North America and the Pacific in the 2005-to-2007 period inclusively. By contrast, EMEA prime rents rose modestly in the EU-15. The index is restrained by rental increases on the Continent compared to what was happening in the U.K. and in London, in particular.

EMEA LEASING MARKET

The main characteristics of the European office market are generally weakening leasing demand, increasing vacancy, and falling rents.

Eurozone GDP fell in the last three quarters of 2008, with a drop in the fourth quarter of 1.5%. The tone of economic data has become increasingly negative in recent months, and none of the major European economies is expected to escape a contraction in 2009, with declines of 1% to 3% expected this year. There is clearly great uncertainty about the likely length and depth of the recession—with the British Prime Minister even making a “slip of the tongue” in early February, referring to the downturn as a “depression.”

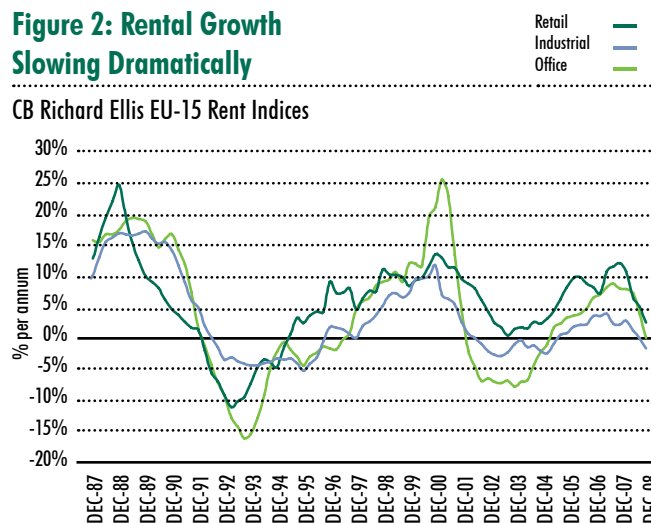
Against this backdrop, leasing activity has weakened in the major markets. Paris, Frankfurt and Madrid saw considerable reductions in take-up, or gross activity, in the final quarter. London experienced an increase, but it was attributable to one very large transaction, and underlying demand is clearly easing. This trend is working to the advantage of cheaper decentralized areas in some cities, as companies become increasingly cost-conscious. Vacancy is generally drifting up, although at very different rates: Increases are more pronounced in London and Madrid than they are in the German markets or Paris, for instance.

This is increasingly affecting rents. The CBRE Office Rent Index for the EU-15 fell by 2% in the fourth quarter,

although the year-on-year rate of growth remains marginally positive at 0.4%. Prime rent declines were not universal, but were notably evident in London, Madrid, Frankfurt, Paris and some of the Scandinavian markets. It is also clear that the recent strong growth in major Central and Eastern European markets, particularly Moscow and Warsaw, has now been reversed.

Figure 2: Rental Growth Slowing Dramatically

CB Richard Ellis EU-15 Rent Indices



Source: CB Richard Ellis Research & Consulting

ASIA LEASING MARKET

Throughout Asia, the unprecedented events of the past six months have eroded investor, occupier, consumer and business confidence, resulting in falling property prices and reduced investment activity, retail spending and external trade. Japan, Singapore, Hong Kong, South Korea and Taiwan entered into recession, while formerly robust markets such as China and India, which have also been severely impacted by the slowdown, are expected to continue to expand, but at slower pace than over the past decade. The regional slump prompted a number of Asian governments to revise domestic policies and announce stimulus plans to support their faltering economies.

The effects of global financial market upheaval were increasingly apparent throughout Asia during the fourth quarter. Reflecting the deteriorating economy and challenging business environment, prime office

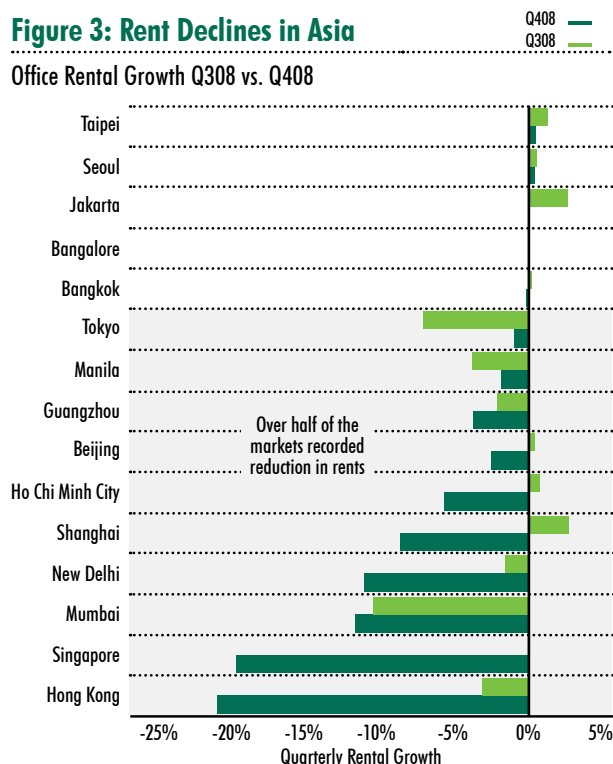
leasing activity slowed dramatically during the fourth quarter, and some buildings in major regional centers encountered difficulty filling vacant space. The office vacancy rate rose at a rapid pace, with 14 of the 17 markets tracked by CBRE recording a rise during the quarter. Five markets ended 2008 with double-digit vacancy rates, led by Beijing, at 21.9%. Year-over-year office vacancy in Asia rose by 334 basis points from fourth quarter 2007 to 2008.

Moving into 2009, the Asian office market has now entered into a broad-based downward cycle. As demand for office space has subsided, further significant, unavoidable corrections in the office market are forecast throughout the economic downturn.

The downward pressure in office rents felt in most markets across the region during the second half of 2008, will likely be exacerbated by the contraction of the finance and banking sectors and, even more significantly, by the overhang of a substantial pipeline of prime office projects. Evidence of this overhang is borne out by the number of large-scale office projects currently under construction and approaching completion in many of the region's major financial centers, including Hong Kong, Singapore, Shanghai, New Delhi and Mumbai. While the vacancy rates in these cities remain relatively low overall, it should be noted that should financial market conditions continue to deteriorate, some markets could experience a peak in supply at the same time as the economy remains in a low-growth or even negative-growth period.

Moreover, in the few markets where pricing held in the second half of 2008—most notably Seoul and Kuala Lumpur, where a dearth of available space sustained pricing levels—it remains to be seen whether pricing will hold in 2009.

Figure 3: Rent Declines in Asia



Source: CB Richard Ellis Research & Consulting (Feb 2009)

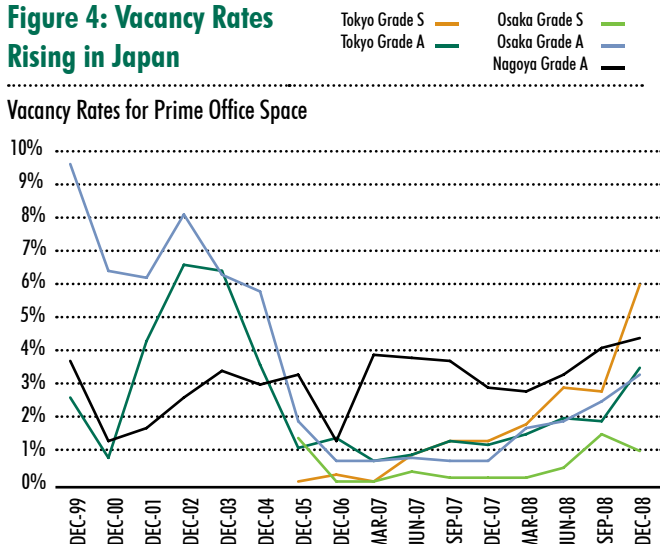
The Asian retail market is poised to peak in the near-term, as consumers concerned by mounting job losses and possible downward salary adjustments cut back on discretionary spending. Preliminary retail sales figures suggested that retail market momentum weakened considerably in Japan and Singapore, where negative growth in retail sales was recorded in the fourth quarter. The slowdown in domestic demand was also visible in Hong Kong and South Korea.

Meanwhile, retail leasing activity generally mirrored consumer confidence and the business environment at large. Prime retail rents in Tokyo's Ginza district were significantly down due to weakening demand, while Shanghai, Beijing, Guangzhou, Hong Kong and Singapore also registered a decline in retail rents amid an increasingly difficult business environment.

Focus on Japan

Japan is the world's second-largest economy, and its banking system has deftly sidestepped the credit crunch malaise because many of its institutions avoided buying toxic U.S. mortgage assets. Nevertheless, Japan has not escaped the economic downturn, with industrial production and exports plummeting and the vacancy rate in Tokyo's central five wards district rising 80 basis points from the previous year to 3.2%.

Figure 4: Vacancy Rates Rising in Japan



Source: CB Richard Ellis Research & Consulting

Vacancy rates in Class A and Class S³ office buildings in Tokyo climbed sharply to 3.5% and 6.0%, respectively, as shown in Figure 4. This is the highest rate reported for Class A buildings since December 2004. The rate for Class S buildings is the highest since these statistics started being compiled. Specifically, about 30% of the 121 Class A and Class S buildings in Tokyo had vacancies as of December 2008. Moreover, the addition of one new Class S building to inventory also fueled much of that segment's increase.

3 Class A buildings are generally new, meet new earthquake-resistant standards, and are in mature office districts. Class S buildings meet the criteria of Class A and are usually landmark properties with distinctive functionality.

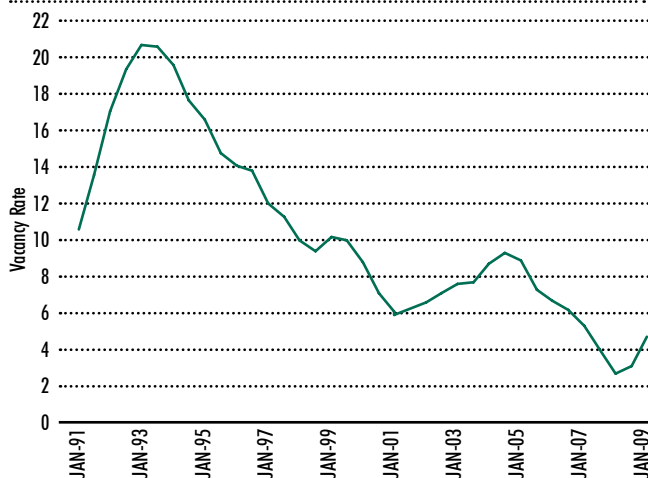
Note that in Osaka, vacancy rates in both classes have risen and it is only in Nagoya where rates fell in the fourth quarter.

PACIFIC LEASING MARKET

The global economic downswing and the high cost and difficulty in obtaining debt have significantly impacted tenant demand within the Australian property markets. Indicative of further challenges in the marketplace, contractions in the finance sector have been followed by significant job cuts announced in the recently booming resources sector. Nevertheless, the office sector overall witnessed positive leasing demand through 2008, although much of this activity was from deals agreed to in earlier years. Vacancy started to rise in the Sydney CBD, and by the end of the year it was still well below the long-term average.

The vacancy rate increased more significantly over the second half of 2008, as shown in Figure 5, driven by a rise in sublease space offerings and the completion of some major new buildings in many markets. Overall growth in face rentals has fallen slightly, by 0.4%, and incentives have increased, resulting in lower effective rents. Adelaide was the only office market to consistently buck the downward trend, experiencing growth of 5.7% over the fourth quarter and 8.3% over the past year. This is due to a lag in the effects of the economic slowdown reaching from a global to a local level.

Figure 5: Australian CBD Vacancy Rate



Source: CB Richard Ellis Research & Consulting

While consumer spending may be down, continued low levels of shopping centre vacancy drove positive rental growth across most markets and retail types in Australia through much of 2008. Overall, Adelaide showed the strongest quarter-to-quarter retail rental growth, at 6.0%, while Sydney was strongest year-over-year, at 9.3%. The outlook for 2009 is less positive, with unemployment expected to rise throughout the year and consumer spending likely to fall.

Industrial property has shown mixed results in terms of rental growth, as the sector's recent momentum stalls in a staggered fashion across the country. Rental growth ranged from a decline of 4.7% for Grade A distribution centers in Adelaide to positive 1.6% for Sydney Grade A warehouses. Across the country, Sydney (0.4%) witnessed the strongest overall rental growth over the past quarter, while Perth achieved the strongest growth over the past year, at 6.1%.

New Zealand's economic downturn exerted greater influence on the property occupier market. While leasing activity remained positive, in most cases, this did not reflect expansion. Hesitation on the part of tenants to commit to additional space, coupled with ongoing, albeit moderate, supply growth, resulted in increasing vacancies in many submarkets. The most adverse market conditions were also reflected in an increase in sublease space. Face rents have been relatively stable in the fourth quarter, with the level of incentives continuing to increase.

AMERICAS LEASING MARKET

United States

The U.S. economy shed 2.6 million jobs in 2008, with about 40% tied to office-related workers. By comparison, total employment declined by just 2.3 million during the two-year period after the 2001 recession. Further declines in office-occupying employment are expected in 2009.

The office vacancy rate increased by 40 basis points to 14% in the fourth quarter of 2008. Earlier in the year, downtown markets had weathered the decline in office demand better than suburban markets; this was not the case in the fourth quarter. The downtown vacancy rate increased by 50 basis points to 10.2%, which marks its highest level since early 2007.

The sharp increase in downtown vacancy rates during the fourth quarter comes as little surprise. While downtowns had experienced modest increases in the amount of vacant space to date, it was only a matter of time before the effects of the financial crisis began to have a more measurable impact on leasing fundamentals. Financial centers such as Boston, New York (Midtown), Miami and Dallas all registered vacancy increases of 50 basis points or greater in the fourth quarter, as the demand for office space continued to weaken.

National office net absorption was positive for the year, but downtown absorption in the fourth quarter was at negative 4.8 million sq. ft., with 2.4 million sq. ft. of that in New York. This in itself was not a significant decline, but with office absorption's propensity to trail employment growth, we would expect coming quarters to be worse.

As in the third quarter, a majority of markets—36 out of 57—saw a rise in vacancy rates. Although a distinction is still apparent between the markets affected most by the housing crisis—such as Las Vegas, Phoenix, Riverside and West Palm Beach—and those once considered more balanced in terms of supply and demand fundamentals, that gap is closing as more markets show increased signs of distress. Markets such as Austin and Raleigh, which outperformed just a year ago, were among those that experienced significant vacancy increases during the fourth quarter, as the economy continued to place increasing pressure on office markets nationwide.

At 14%, the office vacancy rate continued to move from an equilibrium state—which would reflect a healthy balance of power between tenants and landlords—to one where slack is building in the market. As the recession continues to unfold, office properties will continue to feel the strain of waning demand. Though risks to the economic outlook remain through 2009, the office market has already started to clear its pipeline of new supply, which will help during the months to come.

Figure 6 shows the current vacancy rate, the previous peak and the equilibrium vacancy level or natural rate for all property types. As can be observed, all property types are now above the equilibrium rate except for office.

Figure 6: U.S. Real Estate Fundamentals...Vacancy

	2008 Q4	Previous Peak	"Natural Rate"
Office	14.0	19.1	13 to 15
Industrial	11.3	11.8	9 to 10
Retail	10.7	10.7	9 to 10
Multifamily	6.9	6.8	5 to 6
Full-Service Hotels	40	44.2	32 to 34

Source: CBRE Torto Wheaton Research, Spring 2009

In the industrial sector, the availability rate rose 60 basis points to 11.3% in the fourth quarter; this marks the fifth consecutive quarter with an increase in rates and the largest quarterly jump in industrial availability since the first quarter of 2002. Although the national availability rate has not yet reached its previous peak of 11.8% (in 2004), it will likely do so in the coming quarters, as the recession shows no signs of easing.

Availability rate increases are widespread, with 52 out of 63 markets showing increases over the previous quarter. Among the larger industrial markets, Chicago's availability rose 60 basis points to 12.6%, Los Angeles' increased 10 basis points to 5.5%, and Atlanta's rose 110 basis points to 14.6%.

With the anticipation of continued declines in U.S. industrial production, and with the global economy quickly starting to match U.S. declines, both domestic demand and international trade provide little promise as drivers of industrial demand in the coming few quarters.

Other property types show the same deterioration. Retail availability rates increased 60 basis points, from 10.1% to 10.7%, from the third quarter and 190 basis points from a year ago. In the multi-family segment, preliminary data show a dramatic deterioration in apartment performance. The vacancy rate for the nationwide same-store sample of 2.4 million professionally managed apartment units soared to 6.9% in the fourth quarter of 2008—a 110-basis-point increase from last quarter and a jump of 210 basis points from a year ago. This marks the worst single quarter since the end of 2002.

Canada

Market fundamentals also are showing weaknesses in Canada, reflecting the slowing economy. Vacancy and availability rates are up in almost every asset class with the exception of multi-residential. Rental rates for the most part have not fallen, but softening rents are expected as vacant space lingers on the market for longer periods of time.

The national office vacancy rate increased from 6.3% in the third quarter to 6.7% at year's end on the heels of slight negative absorption, reflecting an increase in sublet opportunities. New supply will be more of a factor over the next two years, especially in Calgary and Toronto. Tenants will be in a position to negotiate lower rents in most markets.

The national industrial availability rate increased to 6.3% at year's end, up from 5.8% in the third quarter. In 2008, manufacturing job losses totaled 32,000, down from 2007's loss of 130,000. It is expected that further job losses will be reported, especially in the auto and auto-related sectors. New supply has been tapering off slowly, with availability rates rising modestly.

National retail vacancy rates increased in 2008 and are now above their equilibrium levels. U.S.-based retailers such as Linens 'n Things and Circuit City are going dark, while other firms, including Office Depot, have announced layoffs and store closures. Retailers will be focused on surviving 2009 and positioning themselves to capitalize on opportunities when the economy improves.

Latin America

Latin America's economy also reflects the effects of the global slowdown, especially the economic conditions in the U.S. There is a belief that the growth in the middle class over the last ten years will soften the blow of diminished foreign demand for goods. However, similar to the U.S., credit availability has tightened and will further hamper local economic activity.

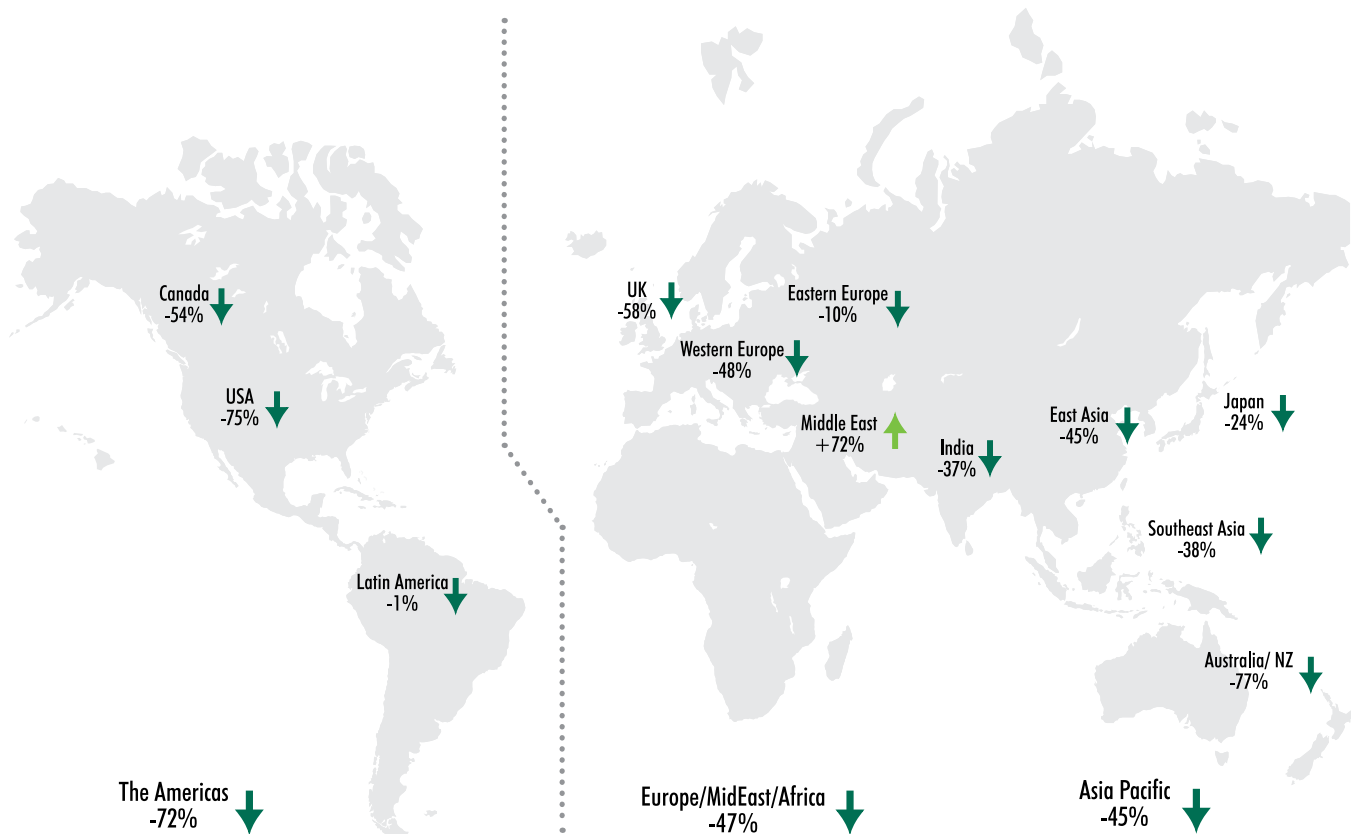
Despite falling office demand, vacancy levels remain near all-time lows at the moment, and the sublease rate has yet to rise. The major impact is in the business services sector, as companies implement cost-containment measures and reduce outside services.

The industrial market is typically the first commercial real estate segment hit during an economic slowdown in Latin America, and this time is no different. Availability rates across the region are rising fastest in Mexico. Nevertheless, Latin America benefits from lower currency and labor costs, factors that continue to attract firms into the region. Rental rates are expected to decline in the coming months.

GLOBAL CAPITAL MARKETS

Globally, real estate capital markets reflect the scarcity of debt and the yawning bid-ask spreads between buyers and sellers. This is reflected in the volume of transactions

Figure 7: Global Transaction Volume Changes



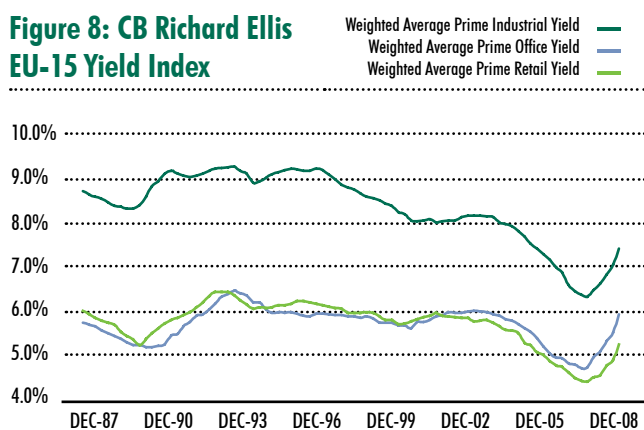
Source: Real Capital Analytics (Jan 2009); 2008 compared to 2007

in 2008, which were down by 60% globally as yields were rising across the board. This is shown in Figure 7.⁴

EMEA

As expected in the aftermath of Lehman Brothers' collapse in mid-September, activity in the European property investment market was at a much lower level in the final quarter of the year. Total turnover in Europe fell to around €19.5 billion from around €27.5 billion in the third quarter, and investors were noticeably very nervous about committing to transactions in the first half of the quarter. There were even examples of buyers pulling out of transactions that had been agreed to before mid-September. However, by the end of the year, the nervousness had subsided and several large deals were concluded in the last few weeks of December. For the year as a whole, the total value of deals concluded came to €116 billion (US\$150 billion), returning activity to the levels of 2004.⁵

Figure 8: CB Richard Ellis EU-15 Yield Index



Source: CB Richard Ellis Research & Consulting

The impact of the slowdown in investment activity on property prices was quite marked. The CBRE EU-15 Prime Yield Index saw an increase of 39 basis points, with the average prime yield of the three property types

shown in Figure 8 now standing at 6.07%. This is the biggest single-quarter increase so far in this cycle. However, hopefully this is a sign that buyer and seller price expectations are moving closer in line. In some cities, yields are starting to approach levels seen during the recession in the early 1990s and, as a result, investor enquiries are starting to pick up in those markets that have seen the biggest property value reductions.

Asia

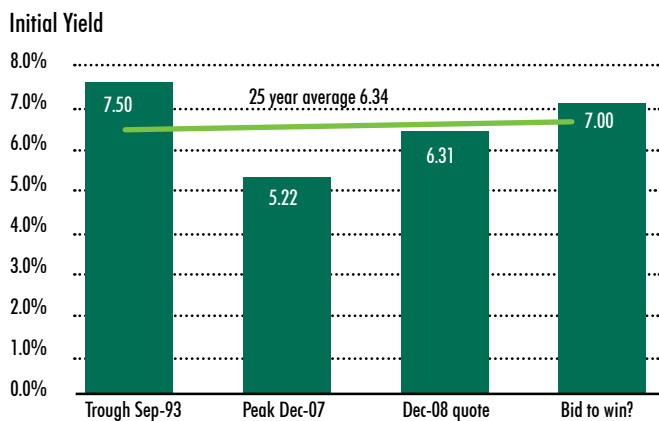
With banks lending very conservatively for property acquisitions, the Asian investment market continued to suffer from low investment volumes, with many prospective buyers putting off acquisitions until the market stabilizes. Investors and lenders are continuing to re-assess their appetite for risk, as raising capital remains difficult and a widespread correction in property prices is ongoing. Despite the challenging investment environment, there was evidence that some investors were actively looking for bargain deals, as some credit-short developers sought to raise cash and institutional investors attempted to dispose of real estate assets to replenish liquidity.

Pacific

Across Australia and New Zealand, investor confidence continued to fall during 2008, with many investors taking a wait-and-see approach and others not able to invest due to difficulty in obtaining credit. Investment activity has plummeted to well below long-term averages, leading to a softening of indicative yields across most markets. During the fourth quarter of 2008, the overall stock weighted yields for the major cities across Australia reached 7.30% for prime CBD office property, reflecting an average softening of 39 basis points over the quarter; 6.10% for regional retail centers, an average softening of 21 basis points; and 8.22% for Grade A industrial warehouse stock, an average softening of 24 basis points over the quarter.

⁴ In the Pacific region, CBRE collects its own transaction volume including deals below the US\$10 million threshold in RCA. The CBRE data shows a decline of 60% and not 77% in volume. This is consistent with evidence that smaller deals have been able to be transacted even in the credit crisis.

⁵ Transaction volumes in this paragraph are from CBRE's EMEA proprietary database and not the RCA database used in Figure 7.

Figure 9: Sydney CBD Prime Office; Where's The Market

Source: CB Richard Ellis Research & Consulting

Yields for office property are believed to have softened further over the fourth quarter, although there were few closed transactions, as a differential in price expectations between buyers and sellers was still evident. For example, as shown in Figure 9, the Sydney Prime Office yield was at 6.31% at the end of the year; however, it is our belief that a yield of 7.00% is closer to the mark.

North American Investment Market

As elsewhere, the North American investment market ended 2008 in the doldrums. Property sales activity stalled as both buyers and sellers continued to entrench their negotiating positions. This is reflected in a precipitous fall in investment sales activity as shown in Figure 7.

At the moment, investors show little appetite for acquisitions unless they sense sellers are in distress. This reflects buyers' conviction that property values—already down 20% to 30% from their peaks—have further to fall. Concerns are increasing about the strength of underlying property fundamentals, especially in the retail sector, which has suffered from a spate of bankruptcies, most recently Circuit City's plans to liquidate. Overall, CMBS delinquency rates remain modest at 0.88% for all property types, but these rates

have climbed sharply recently in the face of US\$100 million-plus loan defaults and will reach 2.0% later this year, Fitch Ratings projects.

Reflecting the increased conservatism, pension fund plan sponsors expect to commit only US\$29 billion to commercial real estate in 2009, according to an annual survey by Institutional Real Estate, Inc. and Kingsley Associates. This represents a 30% decline from actual allocations of US\$42 billion last year. Many pension funds now find themselves over allocated to real estate and will be net sellers of property. Exacerbating this trend is the so-called "denominator effect": As the value of their stock portfolios has fallen sharply, these funds have been forced to trim their real estate portfolios to stay within required target allocation levels. Some are also deciding to lower their allocation targets for real estate outright.

Credit markets have improved somewhat, but are still not functioning normally. Three-month LIBOR fell below 1.2%. Even the beleaguered CMBS market has settled down a bit. Triple A CMBS yields were recently 10% to 12% compared with 16% to 18% in late November. Investors have been encouraged by word that a portion of the U.S. Federal Reserve's Term Asset-Backed Securities Loan Facility (TALF) may be used to purchase non-performing commercial real estate mortgages and that the U.S. Federal Accounting Standard Board may suspend mark-to-market accounting for certain mortgage securities. However, lenders are increasingly stingy with commercial real estate loans. For example, several life insurance companies—normally a major source of liquidity—recently announced plans to significantly scale back lending. Property owners with large loans maturing this year will find it difficult to roll these over, although some lenders have been amenable to negotiating loan extensions rather than become "accidental" property owners.

The economy and the commercial real estate market across the globe cratered in the fourth quarter of 2008 and the outlook for 2009 is for a very rough year in leasing and sale activity. Governments across the

globe are moving quickly to provide stimulus packages and to restructure their financial systems. These actions may help commercial real estate; as more is known, we will provide our analysis to clients.

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