



DEARTH OF CAPITAL AND DECLINING LABOR MARKETS DAMPEN COMMERCIAL REAL ESTATE

by Raymond Wong
Director, Americas Research Operations

The global recession is having a deep and severe impact on labor markets worldwide. Unemployment continues to rise, as companies continue to respond to reduced demand with cost-cutting measures—including widespread reductions in payroll. However, while companies in 2009 are largely focused on survival, it is important that they also look to position themselves strategically to take advantage of market opportunities over the longer term, once the economic recovery takes hold. In terms of real estate strategy, this includes focusing on core assets and securing key locations for potential growth.

In an effort to stem the waves of negative economic momentum, governments worldwide continue to inject capital into their economies. While the U.S. government is at the forefront, with its US\$787 billion stimulus package, others are following suit with their own versions; notably, China implemented a US\$586 billion stimulus plan and, more recently, the Dubai economy was slated to get a US\$10 billion injection from the United Arab Emirates to stem a potential debt crisis in that once-booming economy.

While inflation was the primary fear through the first half of 2008, it has, for the most part, abated, at just 0.2% for

SUMMARY In the U.S., declines in labor markets and the frozen capital markets continue to impact real estate. Commercial real estate prices dropped by almost 15% in 2008, returning values to 2005 levels. Credit markets are improving marginally, although investors remain on the sidelines and lenders remain stingy with commercial real estate loans. Canadian market fundamentals are weakening, with vacancy rates increasing moderately and new supply diminishing quickly. The market will start to feel the full brunt of the economic slowdown, with diminished demand and increased cost-containment measures by tenants. In Latin America, market fundamentals for the most part remain stable, but a prolonged economic slowdown will impact the region, driving vacancy rates higher.

the month of January—a 1.7% increase from January 2008. Capacity utilization among major industrial countries is now sufficiently weakened that neither ‘cost-push’ inflation, caused by increasing costs of factor inputs, nor ‘demand-pull’ inflation, caused by significant increases in aggregate demand, are a factor at this point. On the horizon, however, is the specter of deflationary pressure, as asset valuations have taken a hit—particularly in real estate markets—and the recession has intensified. Although longer-sustained and broader-based declines in asset

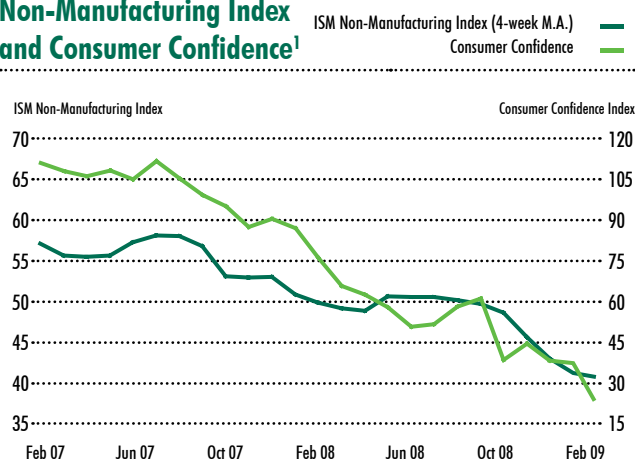
values would need to materialize prior to deflation taking hold, it is now on the radar of most economists as a risk to the outlook.

UNITED STATES

The flow of capital, paramount to economic recovery, is now one of the primary impediments to the economy finding its trough and entering recovery. One way the Federal Reserve is addressing this is by increasing the size of the Term Asset-Backed Securities Loan Facility (TALF) to US\$1 trillion, nearly five times its original size. The massive liquidity injections and monetary easing are having a noticeable impact on financial markets, with the TED and LIBOR-OIS spreads narrowing over the past several weeks. Moreover, the U.S.

President announced a US\$275 billion housing bailout for homeowners with loan-to-value ratios of less than 80% (capped at 105%) to refinance into lower-interest FHA loans backed by Fannie Mae and Freddie Mac. The plan would boost liquidity to the housing market, slow foreclosures for borderline households, and remove troubled mortgage paper from the market.

Non-Manufacturing Index and Consumer Confidence¹



1. Sources: Institute for Supply Management, Conference Board.

The Conference Board's Consumer Confidence Index continues to slide, reaching 25.0 in February, the lowest level since the index began in 1967. Despite a modest up tick in retail sales, consumers in the U.S. remain on the sidelines. Although January sales figures showed a 1.0% increase from December levels, year-over-year sales were down 9.7%. Similarly, core sales (excluding automobiles and gas) were weak, expanding 0.8% last month but declining 6.6% on a year-over-year basis. The decrease in home prices continued, according to the S&P/Case-Shiller report for December. On a year-over-year basis, the 10-city index decreased by 19.2%, based on transaction data through December 2008; the 20-city index fell by 18.5%. Oil continues to remain neutral as slack demand has kept prices hovering near the US\$40 threshold for the past few months. Over the past two months, upward pressure has been placed on gas prices, as refiners are reducing production after facing losses during oil's sharp decline late last year; still, this is expected to have a minor impact on consumers.

The unemployment rate continued to increase, rising to 8.1% in February, with a further loss of 651,000 jobs following the loss in January of 655,000 jobs.

Market Overview

For the year, commercial real estate prices in the U.S. dropped by almost 15% in 2008, on par with home prices, according to New York-based Moody's Investors Service; the price decline eliminated the gains of 2006 and 2007, returning values to 2005 levels, according to the Moody's/REAL Commercial Property Price Indices. In the month of December alone, prices fell 2.2% from November levels. Commercial values are now down more than 16% from their peak in October 2007. With capital remaining tight and the economy expected to worsen, commercial real estate values are projected to decline further over the near-term.

Capital Markets

The Fed's TALF program includes US\$200 billion of non-recourse funding with the Treasury providing an additional US\$20 billion. The TALF has been expanded to include CMBS, which has modestly improved sentiment among investors in this beleaguered market. Delinquencies for the CMBS market remain low but are expected to rise in 2009. Maturity defaults have been the cause of most consternation, although many lenders have been extending these loans if borrowers can provide additional equity or credit support. Concern for fundamentals is building as rental rates slide and vacancies increase.

Credit markets are improving marginally compared with the past few months, but investors remain on the sidelines as they try to sort out the challenges facing their own portfolios. Lenders remain stingy with commercial real estate loans. Loan-to-value ratios for deals continue to be suppressed, and credit conditions are far tighter than they have been in recent years. Several life insurance companies—normally a major source of liquidity—recently announced plans to significantly scale back lending, and others are holding back

significant portions of their allocations for maturing loans. According to Real Capital Analytics, real estate investment activity in 2008 was down by 74%, with cap rates continuing to increase across all sectors.

Office

The office market is fast becoming a tenant's market. The vacancy rate nationwide rose steadily through 2008, accelerating toward the latter part of the year, an indication that poor economic performance and continued layoffs were starting to impact property fundamentals. As vacancy rate increases are placing downward pressure on rents, occupancy costs are decreasing, with a marked increase in tenant inducements by landlords. Indeed, for tenants, the focus remains on cost-containment and delayed decisions. In the current budgetary environment, the tendency now is to renew rather than sign new leases, to avoid additional capital expenditures. It is an opportune time for tenants to review their existing leases, especially if this can result in lower expenses through early renewals.

In terms of office vacancies, we have not yet seen the full impact of staff reductions in financial services, and the ripple effect on the services sector will be significant. Moreover, as manufacturers look to reduce white-collar workers and further cut costs, we expect to see higher vacancy rates coast to coast.

Industrial

With the auto industry on the verge of an historic reorganization, Chrysler and General Motors announced shutdowns in January 2009, to curb production and preserve cash flow, a move affecting parts manufacturers and distributors as well. With the pervasive economic slowdown, the auto sector is expected to continue adding to the labor market's losses.

The Philadelphia Federal Reserve's general business conditions index declined 17 points in February to -41.3, the index's lowest point since 1990. The employment

index has declined 33 points since September, suggesting another massive decline in manufacturing payrolls. The Institute for Supply Management's manufacturing index will likely follow suit, as new orders were down and most capital expenditures have been deferred. Given the continued restructuring in the North American auto industry, further declines in manufacturing employment are expected.

Industrial real estate market fundamentals continue to slide, as both manufacturing and warehouse demand wanes. We expect further declines in rents and sale prices. In addition, the U.S. manufacturing capacity utilization dropped below 68% for the first time since World War II.

Multi-Family Housing

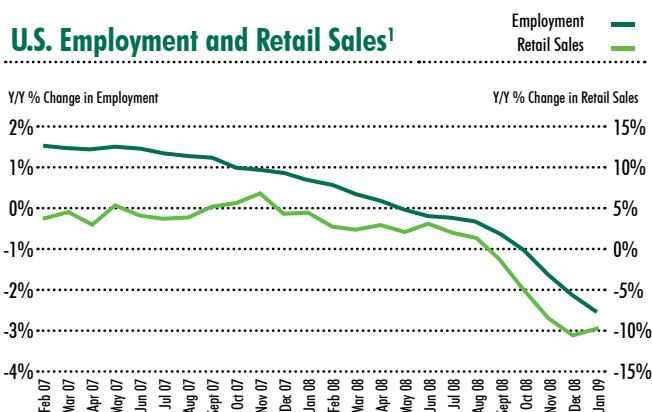
Multi-housing fundamentals continue to deteriorate amid mounting job losses and rising unemployment. The glut of vacant single-family homes and condominiums for rent and for sale is also negatively affecting performance of rental apartment properties. The vacancy rate for professionally managed apartments jumped by more than 100 basis points in the fourth quarter of 2008, surpassing the previous peak and marking the worst quarter for net absorption since the end of 2002. At the same time, multi-housing starts (of five or more units) in January 2009 were down 60% from year-earlier levels—an indication that completions will be sharply lower next year. Such major declines in new supply should help ease vacancy pressure on existing product but will not be sufficient to offset recent demand losses; as a result, effective rents are poised to decline in the near term.

Retail

U.S. retail sales increased in January by 1% compared to December, but were down by 9.7% compared to a year ago. Given the weakness in the housing sector, home improvement retailers continue to suffer, although Home Depot posted fourth quarter results that exceeded

analyst expectations. However, “necessities” retailers are benefiting from an increase in sales, with companies like Wal-Mart continuing to post good results. This is not viewed as a turn by consumer spending, but an anomaly in the data. Unemployment levels continue to rise, with companies focusing on cost reductions. The retail sector will continue to be battered in the coming months, as retailers struggle to reduce inventories.

U.S. Employment and Retail Sales¹



¹Sources: U.S. Census Bureau, Bureau of Labor Statistics.

CANADA

The key to the Canadian economic recovery will be the recovery in the U.S. and global economies. Canadian exports have fallen off dramatically, driven by the commodity and manufacturing sectors. The fall in the value of the Canadian dollar (the Loonie) has not helped either, reducing purchasing power and increasing the price of imports. Statistics Canada reported that the economy contracted at an annualized rate of 3.4% in the fourth quarter of 2008. This was the worst performance since the first quarter of 1991. The labor market will see further pressure, as unemployment rate levels are expected to increase dramatically over the next six months, with further weaknesses in business services and manufacturing.

Market Overview

Canadian market fundamentals are weakening, with vacancy rates increasing moderately and new supply diminishing quickly. The market will start to feel the full

brunt of the economic slowdown, with diminished demand and increased cost-containment measures by tenants. Tenants can expect more choice, but only for select markets and buildings. Investors will likely still stay on the sidelines, targeting only high-quality, select assets.

Capital Markets

Unlike in the U.S., Canadian properties have for the most part shown slightly higher returns. The ICREIM/IPD Canada Annual Property Index, which at the end of December 2008 covered C\$96.5 billion of commercial real estate, showed a total return for 2008 of just 3.7%, down sharply from the 15.8% recorded in 2007, and the lowest level since 1994. Despite the softening of investment yields, direct property still outperformed equities, which fell by 31.4% according to the MSCI Canada Index, and REITs, with returns of negative 39.3%, according to the FTSE EPRA/NAREIT Index. Activity is expected to remain slow in 2009, as potential investors adopt a “wait-and-see” attitude and purchasers adjust their expectations. Cap rates will continue to rise in 2009, while deals in general will be more challenging to complete. Total Canadian investment activity is down by 35% from C\$32 billion in 2007 to C\$20 billion in 2008.

Office

Office vacancy rates are expected to continue to increase based on weakened demand and new completions. Canadian companies have not gone through the same reductions as their U.S. counterparts over the past few months, but that is starting to change quickly. Landlords for the most part have tempered their rent expectations, and a few have aggressively chased renewals and new tenants to firm up vacancies. The availability of sublet space is increasing, as is shadow space.

Industrial

Canada’s manufacturing sector continues to be battered by the decrease in trade and the economic slowdown in the U.S. Until the demand for exports increases, this sector will continue to face challenges. The availability

rate remains relatively low across Canada, but continues to increase, especially for warehouse distribution space in the West. Rental rates are expected to decrease for older type buildings and decline more moderately for newer space.

Retail

In December, national retail sales declined by 5.4%, the largest decline in 15 years. This was felt in almost every sector and across the country. The largest provincial decline occurred in Alberta, with retail sales declining by 6.2%, and Ontario, by 6.0%. National retail vacancy rates will increase in 2009 based on weakened demand and delayed store openings. The focus is on U.S. retailers in Canada; given that a number of companies are close to filing Chapter 11, expect more changes on the Canadian retail landscape resulting from problems inherited from their parents. Wal-Mart just recently announced that it will be closing its Canadian Sam's Club division and will be focusing on the Super Center concept. The closures were not attributed to the economic slowdown but rather to a change in focus.

Multi-Family Housing

Average housing prices continue to decline across Canada, with housing starts down by 40% compared to a year ago. The largest declines occurred in the West, led by Vancouver and Calgary. Although the overall decline in prices has made housing more affordable for many potential buyers, the grim economic outlook has made most consumers reluctant to purchase. Residential condominium completion will likely increase multi-family housing vacancy rates slightly throughout 2009.

LATIN AMERICA

Latin America's economy continues to slow as global commodity prices languish. The good news is that inflation is now under control for most countries, but retail spending is rapidly decreasing. The region is not expected to go into a recession, but economic growth, which had averaged between 7% and 9%, will likely decline by half to 3% to 5% in 2009. Capital markets have

been especially hard hit, given the devaluing of the local currencies and reversal of foreign investors.

Market Overview

Market fundamentals for the most part remain stable, but a prolonged economic slowdown will impact the region, driving vacancy rates higher. An advantage for this region is that construction was constrained over the past several years, and markets are generally not over-supplied. Rental rates will fall for older buildings, but we are not likely to see significant declines or bankruptcies from ownership.

Capital Markets

Investment activity was down 2% in Latin America in 2008, compared to the U.S., which was down by 74%, according to Real Capital Analytics. While activity is down significantly compared to a year ago, there is still demand for properties priced under US\$10 million; demand has fallen off for the larger assets. As in other regions worldwide, property values in Latin America will likely decrease, based on diminishing demand and weakened market fundamentals.

Office

Despite lower demand for office space, vacancy levels remain at all-time lows. The sublease rate has held for the most part, as companies strive to weather the economic slowdown. The only real impact is in the business services sector, as companies implement cost-containment measures and reduce office supply and outside services.

Industrial

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

Ray Wong is CBRE's Director of Americas Research Operations, with responsibility for the strategic development and day-to-day operations of the company's local market research organizations across the Americas.

CBRE Global Research & Consulting Executive Committee

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

Andrew Ness
Head of 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