



MORE ROUGH TIMES AHEAD AS WEAKENING ECONOMY IMPACTS REAL ESTATE SECTOR

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The most often heard commentary so far in 2009 is, "It's going to get a lot worse before it gets better." Early indicators seem to be proving this right. Capital markets continue to languish; retail sales are abysmal; interest rates continue to fall; the U.S. gross domestic product posted a negative annual growth rate of 3.8% in the fourth quarter of 2008; and the yield on U.S. bonds remains near record lows

(and, in fact, dipped briefly into negative territory on one day in early December). The U.S. unemployment rate continues to rise, hitting 7.2% in December, a 16-year high. The U.S. alone lost 2.6 million jobs in 2008—the greatest single-year job loss since 1945.

Not surprisingly, consumer and business confidence are at all-time lows. Global economic indicators continue to weaken as governments worldwide struggle to develop tools and implement policies to cope with their own troubled financial institutions. Real estate fundamentals are following the economic trends and continue to weaken, and the stressed economy in the U.S. and around the globe will impact most real estate sectors.

UNITED STATES

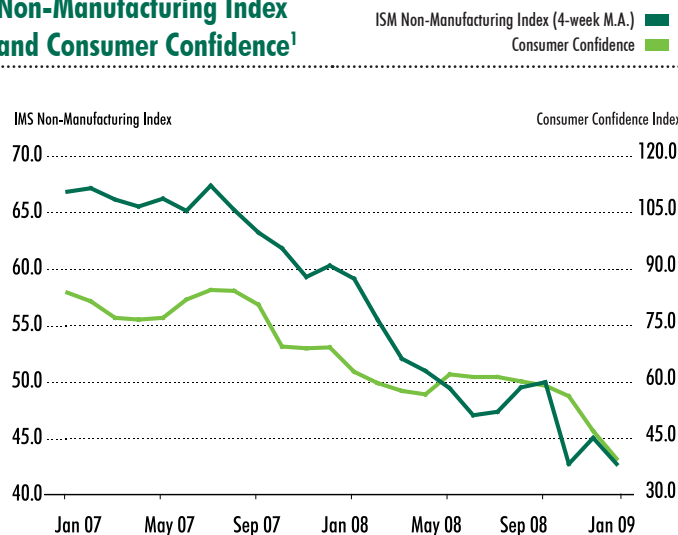
The Conference Board's Consumer Confidence Index continues to slide, reaching an all-time low of 37.7 in January. This was down from December's 38.6 reading,

SUMMARY In the U.S., real estate markets ended 2008 with a thud. Virtually all sectors experienced increases in available space and softening asking rents, while property sales activity stalled as both buyers and sellers entrenched their negotiating positions. In Canada, market fundamentals are starting to show weaknesses, underscored by a slight increase in sublease space in the office market. Vacancy and availability rates are up in almost every asset class. Across Latin America, market fundamentals for the most part remain stable, but a prolonged economic slowdown will drive vacancy rates higher.

which reflected the slowdown in retail sales, which fell an additional 1.8% in November. The incoming Obama administration has already made overtures that it will request the release of the remaining TARP funds to help bolster the ailing economy; however, it will take a number of months for the expected US\$350 billion spending plan to have a significant impact. Indeed, while the change of administration

may have an immediate impact on the nation's collective psyche, bringing—at least in the short-term—renewed hope and confidence, what is less clear is whether this will translate into economic growth.

Non-Manufacturing Index and Consumer Confidence¹



¹ Sources: Institute for Supply Management, Conference Board

The Federal government proposed a new US\$825 billion two-year economic stimulus package, including a mix of infrastructure and technology investment and tax cuts. All the various stimulus packages will result in massive budget deficits—reaching close to US\$1.2 trillion in 2009, according to early indicators. The commercial real estate sector has asked for Federal assistance in restoring liquidity, with approximately US\$400 billion of loans that will mature over the next 12 months. The likelihood that such a request can be fulfilled given the competing interests for existing stimulus dollars is low; failure to secure Federal assistance could prove detrimental to the industry and have a cascading negative effect on the sector.

The latest retail sales data shows that U.S. consumers remain on the sidelines, with December recording a decline in sales of 2.7%; excluding auto sales, sales fell 3.1% for the month. This marks the sixth consecutive drop in monthly retail sales. Moreover, consumers cut spending across the board in December, with only drug store sales showing an increase. The decrease in home prices continued, according to the S&P/Case-Shiller report for November. On a year-over-year basis, the 10-city index decreased by 19.1%, based on transaction data through November 2008; the 20-city index fell by 18.2%. Although oil prices increased modestly, they have once again retreated to less than \$40 per barrel in January, reflecting increases in inventory and falling demand.

The credit markets remain tight in the U.S.; however, creditworthy consumers are benefiting from plummeting interest rates. The 10-year Treasury yield fell to 2.2%, an historic low, and there is some indication that banks have shown more willingness to lend to each other. The three-month LIBOR—the interest rate banks charge each other—fell to 1.13%.

Market Overview

Real estate markets ended 2008 with a thud. Virtually all sectors experienced increases in available space

and softening asking rents. The industrial segment alone saw its national availability rate increase by 70 basis points to 12.1%, with almost 24 million sq. ft. of negative net absorption in the fourth quarter, compared to the previous quarter's positive 640,000 sq. ft. U.S. bankruptcies are up from a year ago, with consumer filings up 33% and business filings up 61%. The numbers themselves are staggering, but the reverberation in the market is even more significant, triggering a strain with existing suppliers through cancelled orders and delayed payments—or worse, no payments at all. This will likely put additional pressure on the already rising vacancy rates across all segments nationwide.

Capital Markets

The investment market ended 2008 in the doldrums. Property sales activity has stalled as both buyers and sellers entrench their negotiating positions. This is reflected in a precipitous fall in investment sales activity. According to preliminary estimates from Real Capital Analytics (RCA), North America property sales totaled just US\$151 billion in 2008, a 73% decrease from 2007. In the U.S., volume was off 64% to US\$141 billion, according to RCA.

At the moment, investors show little appetite for acquisitions unless they sense sellers are motivated. This reflects buyers' conviction that property values—already down 20% to 30% from their peaks—may 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 \$100 million-plus loan defaults, and Fitch Ratings projects they will reach 2.0% later this year.

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 due to the so-called “denominator effect”—which increases the percentage invested in real estate, as the value of their overall portfolio has fallen due to the sharp drop in the value of equities. This has caused some 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.

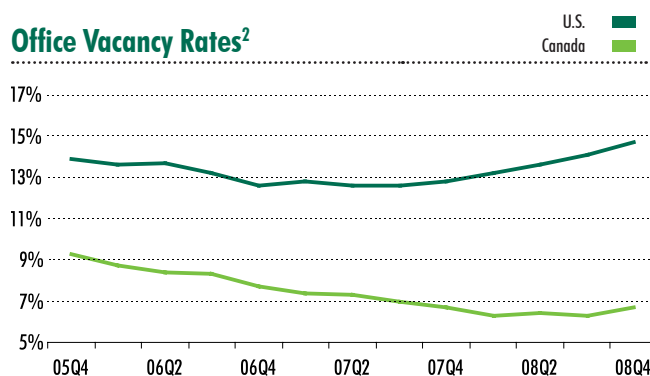
Credit markets have improved somewhat, but are still not functioning normally. The beleaguered CMBS market has settled down a bit. “Triple A” CMBS yields were recently 10% to 12%, compared with 16% to 18% in late November. Investors have been encouraged by word that a portion of the U.S. Federal Reserve’s Term Asset-Backed Securities Loan Facility may be used to purchase non-performing commercial real estate mortgages and that the 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.

Office

The national office vacancy increased to 14.7% in fourth quarter 2008, up from 14.1% in the third quarter. The 12.3 million sq. ft. of negative net absorption accumulated during the final quarter of 2008 pushed full-year negative absorption to nearly 26 million sq. ft. New completions totaled 14.7 million sq. ft. for the quarter, with only 33% of the new space pre-leased. Sublet as a percentage of overall available space

increased slightly to 12.0%, up from 11.2% in the previous quarter. However, there is a growing amount of shadow space, which will likely lead to increasing sublet availability over the coming months as the deleveraging of the U.S. financial system and fundamental re-ordering of the financial sector drive significant changes in the office landscape.

Office Vacancy Rates²



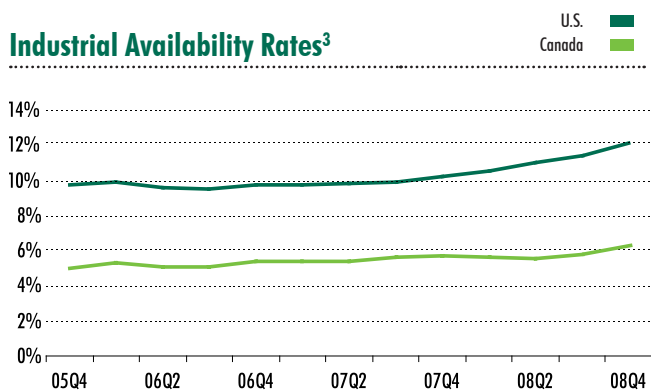
Meanwhile, occupancy costs are slowly decreasing, with a marked increase in tenant inducements by landlords to secure existing or new tenants. Indeed, for tenants, the focus remains on cost-containment and delayed decisions. The tendency is to renew rather than sign new leases to avoid increases in capital expenditures. Moreover, for all space decisions, the higher the chain of approvals, the less of a chance the deal will get done. Even if firms are not reducing their occupancy footprint, they are cutting expenses and reducing their dependence on contracts. The ripple affect on service firms is less business—and possible job losses.

Industrial

The national industrial availability rate increased from 11.4% to 12.1%, resulting in close to negative 24 million sq. ft. of net absorption. Availability rates for warehouse/distribution buildings continue to rise, largely due to falling retail sales, especially in markets that were most affected by the housing crisis, such as Florida and many coastal California markets. Furthermore, the global manufacturing slump has broadened.

² Source: CBRE Research

Industrial Availability Rates³



With the auto industry on the precipice of an historic reorganization, Chrysler and General Motors announced shutdowns in January 2009 to curb production and preserve cash flow. This move will affect 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 Institute for Supply Management's manufacturing index fell to 32.4 in December 2008—its lowest level since the early 1980s. New orders were down and most capital expenditures have been deferred. The industrial availability rate is expected to continue to rise, with rents softening. Manufacturing job losses continue to mount, totaling close to half a million for the year.

Multi-Family

Multi-housing fundamentals deteriorated substantially at the end of 2008, amid mounting job losses and rising unemployment. The national vacancy rate for professionally managed apartments jumped by more than 100 basis points, surpassing the previous peak and marking the worst quarter for net absorption since the end of 2002. The U.S. economy shed 2.6 million jobs in 2008, the worst one-year absolute loss since 1945. By comparison, total employment declined by 2.3 million during the two-year period after the 2001 recession, which also led to a rapid rise in apartment vacancy.

However, unlike the early part of this decade, when a flood of condo conversions helped suppress rental vacancy by effectively reducing total apartment inventory, the multi-housing segment today faces not just a slowdown in demand amid rising unemployment but also strong head-winds in the form of competing rentals in the condominium and single-family segments.

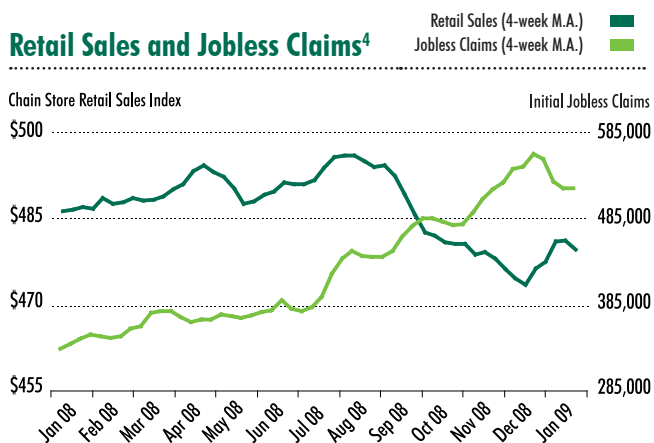
At the same time, multi-housing developers were slow to react to the recession, with 2008 completions slightly higher than the year earlier. In the near term, continuing job losses along with rising supply of rentable housing units—apartments, condominiums and single-family—will put pressure on existing properties to keep occupancies and rents at current levels. The drop in new supply expected in 2009 should ease the pain somewhat, but we still expect moderate declines in effective rents nationally and more tangible corrections in a dozen or so markets most affected by recent job losses and plunging home prices.

Retail

The retail sector continues to be battered by consumers who, except for necessity spending, remain largely on the sidelines. Retail sales in December fell by 2.7%, with consumers cutting spending in virtually all areas. A number of retailers such as Shoe Pavilion, Inc., Mervyns LLC, Boscov's Department Stores, Linens 'n Things and Circuit City Stores, Inc. have already filed for bankruptcies in 2008, with more expected in 2009. Other retailers are shuttering stores and reducing staff. Cost Plus, Inc. of Oakland, luxury department store operator Neiman Marcus Group, Inc., and Macy's, Inc. have already announced reductions and closures for 2009. A few bright spots include wireless technology sales and "fashionable cheap chic" stores like Forever 21 and H&M, which are expanding to address strong consumer demand.

³ Source: CBRE Research

Retail Sales and Jobless Claims⁴



Hotel

The hotel sector has experienced dramatic and expected change since our last report. Industry operating fundamentals are under heavy pressure, with supply growth outpacing demand growth, resulting in a dramatic shift in pricing power. Upper segments of the market (high Beta) are leading a strong fall in occupancy and RevPAR (revenue per available room). High single-digit RevPAR declines are expected for 2009, with positive RevPAR growth not likely prior to early 2011. Transaction volume in the hotel sector fell in excess of 80% in 2008 from 2007 levels, with the greatest decline experienced in the upper segments of the market, as a result of both declining revenues and profits and an utter lack of meaningful debt financing.

Cap rates are rising, driven by a significantly higher cost of capital, while income is declining—a formula resulting in significant decline in property values. Owners who can hold and do not wish to monetize and redeploy capital will wait for better times before considering a sale. Many owners are staving off monetary defaults as a result of all-time lows in underlying debt indices. Special servicers are experiencing a first quarter onslaught of maturity and financial defaults from the sector. In summary, the sector is proving its volatility, and many owners are being reminded of the fact that hotels are operating businesses.

⁴ Sources: International Council of Shopping Centers, Bureau of Labor Statistics

CANADA

The gross domestic product fell 0.7% for the month of November, with virtually all sectors in the economy being affected. This is a sharper decline from the 0.1% in the previous month. This trend is expected to worsen in the months ahead. In response to the rapidly weakening economy—and in an attempt to stave off a recession—the Bank of Canada dropped interest rates by 50 basis points in January to 1%, the lowest level since 1958, when interest rates were at 1.12%. Unemployment levels rose in December to 6.6% from 6.3% in November, reflecting a net loss of 34,400 jobs, mostly in the manufacturing and construction sectors. Full-time job losses totaled 77,000, while part-time employment increased by 34,000, more evidence of growing hesitation on the part of employers to add to full-time staff rosters. Meanwhile, the Canadian dollar is being battered with the weakness in commodity pricing and dismal economic news.

Market Overview

Market fundamentals are starting to show weaknesses, underscored by a slight increase in sublease space in the office market. 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.

Capital Markets

Interest rates continue to fall, but borrowing has been constrained by more stringent lending criteria. Owners of commercial property are struggling to secure mortgage renewals; if there is any hint of increased risk from a borrower, they may have a few challenges. For new deals, tenant covenant is increasingly important, and the loan-to-value ratio is much lower and the lender's requirement for recourse much higher. Most of the activity continues to be with smaller private investors in the range of C\$10 million or less. Investment activity is down significantly in 2008 as compared to 2007.

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.

Office

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 moderate levels of new supply and an increase in sublet opportunities. Canada’s unemployment rate increased modestly, and certain sectors such as financial services will continue to face challenges. 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.

Industrial

The national industrial vacancy 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, less than the loss of 130,000 in 2007. 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.

Retail

National retail vacancy rates increased modestly in 2008. Retail sales for November dropped another 2.4% from the previous month and 0.4% compared to the year earlier. U.S.-based retailers such as Linens ‘n Things and The Source by Circuit City continue to struggle, while other firms, including Office Depot, have announced layoffs and store closures. Additional similar announcements are expected as the economy worsens. Retailers will be focused on surviving 2009 and positioning themselves to capitalize on opportunities when the economy improves.

Multi-Residential

National multi-residential vacancy rates declined to 2.2% compared to 2.6% in 2007, according to the Canada Mortgage and Housing Corporation. The decline was partially due to dropping housing prices—although prices remain at high levels—and renters’ ability to purchase. Cap rates have increased moderately in the multi-residential segment, but not at the same pace as the other sectors.

Hotel

The hotel sector is projecting declines in occupancy across Canada in 2009. Markets which saw significant additions to supply, and those which rely on the commodities and manufacturing industries, will see steeper declines. The lack of available debt will hinder the segment, and we may see the return of vendor (seller) financing in order to meet this challenge. We anticipate a decline in transaction volumes in 2009. As the gap between vendor and buyer expectations narrows, we expect that strategic buyers will enter the market looking for opportunities. Cap rates are rising based on scarcer and more expensive debt and a weak outlook for hotel operations.

LATIN AMERICA

Latin America’s economy continues to be impacted by the effects of the global slowdown, especially the economic conditions in the U.S., with the equity markets falling anywhere from 2% to 8% since the beginning of 2009. 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.

Market Overview

Market fundamentals for the most part remain stable, but a prolonged economic slowdown will impact the

region, driving vacancy rates higher. The number of foreign companies seeking space has diminished, while investment activity has come to a virtual standstill.

Capital Markets

Latin America's investment market is largely inactive. Governments are trying to reassure the market with guarantees and possible bailouts; this may stabilize the region, but much of its fate depends upon external demand and global growth. The challenges for the investment market are the diminished number of foreign purchasers and the increased inventory available. Sales prices are expected to continue to decline, with most of the activity generated by local and private investors. Cap rates have increased slightly.

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 marginally in the coming months.

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