CHALLENGES REMAIN AS COMMERCIAL REAL ESTATE SECTOR AWAITS SIGNS OF ECONOMIC RECOVERY

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SUMMARY In the U.S., market fundamentals continue to weaken for all asset classes. The capital markets continue to struggle, with a slowdown in investment sales and purchasers remaining on the sidelines. In Canada, companies continue to retrench and cope with the global recession with continued production and cost reductions. Vacancy rates for all product types continue to increase, and we are starting to see meaningful declines in rental rates. Meanwhile, Latin America is still experiencing low vacancy rates and has benefited from continued stable local demand for real estate. There has been some retrenching among select multi-national firms, but overall there has not been a loss of confidence in the region.

So now we wait. The G20 countries pledged to make available an additional US$1 trillion through the International Monetary Fund, in addition to the existing programs each country has already committed to—all of this to spur confidence and boost global economies. Meanwhile, interest rates are at the lowest levels on record, but their effect has been partly offset by banks' reluctance to extend credit in uncertain market conditions. Both Canada and the U.S. have established policy rates at 0.25%, or lower. Though credit is slowly beginning to move, consumers have been slow to add debt to their household balance sheets.

Industrial indicators appear to be at or near bottom, with inventory declines no longer accelerating and a slight increase in shipments. On the downside, the announcement of General Growth Properties filing for Chapter 11 protection—given its debt of US$27 billion, a pervasive loss of tenants and the inability to secure new financing—has implications not only for the real estate industry but also, and perhaps more profoundly, for the weakened state of the U.S. consumer-driven economy. Unfortunately, it is likely that real estate markets will endure similar events in the months to come, as market conditions and a struggling economy will apply more pressure on already stressed property owners.

The condition of the U.S. labor market is not helping matters. Although the worst of the job market losses appear to be behind us, there are no signs that businesses will be adding to payrolls during 2009, as firms continue with cost-cutting measures to ride out the remainder of the recession. The unemployment rate in the U.S. will likely approach double digits by year's end, with Canada not far behind.

Also adding uncertainty in the short-term is the effect of H1N1 (Swine) flu on economies worldwide, in terms of travel restrictions and decreased productivity in affected regions. This situation continues to evolve, and we will be watching it closely.

UNITED STATES

Gross Domestic Product contracted in the first quarter of 2009, dropping by another 6.1% after shrinking 6.3% in the fourth quarter of 2008, further highlighting the weakened state of the economy. On the positive side, consumer confidence is up by an astonishing 12.3 points to 39.2 for the month of April. This is encouraging, but the sentiment still remains low. The velocity of bad economic news is slowing compared to the beginning of the year, and there are signs that the recession may in fact end by the end of the year. Unemployment levels are expected to continue to increase to nearly 10% by the end of the year, while housing inventories shrink as new construction has slowed

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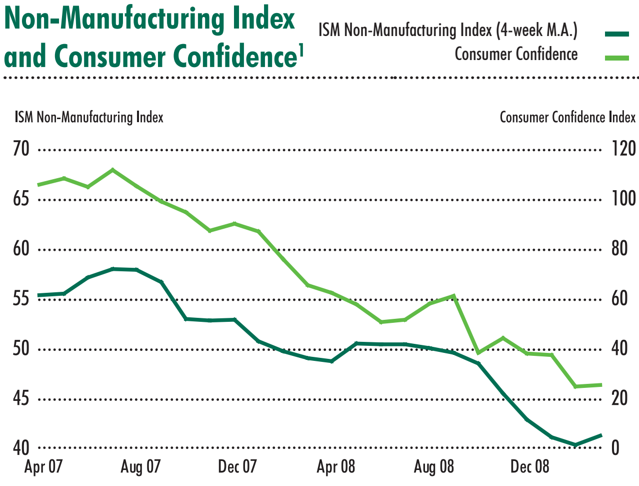
to a trickle, and industrial inventories approach bottom. The stock market is showing signs that it may be turning a corner as investor confidence is improving, if only modestly. It is too soon to declare an end to Wall Street's slump, as market performance remains choppy and somewhat inconsistent, but it is still an improvement over the prior 12 months.

Non-Manufacturing Index and Consumer Confidence[1]



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

Another positive for the economic outlook is that the Federal government's stimulus package will soon start to take hold. We expect to see some stabilization of employment in construction. As infrastructure projects get underway this spring and continue through the warm-weather months, there will be an increase in demand for workers, although not nearly enough to offset the losses experienced since the end of 2007.

National sales of existing homes declined by 3.0% in March, reversing what some analysts had hoped might be the beginning of a trend in February. The decline brings the annualized pace of sales from 4.71 million units in February to 4.57 million in March. The decline in existing sales is a sign that the economy remains extremely weak. However, we expect to see some improvement in the coming months as foreclosure sales will lift overall sales. According to the National Association of Realtors, distressed sales accounted for 40% to 45% of total sales in February; by comparison, distressed sales accounted for 35% to 40% of sales in the third quarter of last year. The rise in distressed sales continues to place downward pressure on home prices. According to the S&P/Case-Shiller report for March, which reports on data through February 2009, home prices declined by 18.6% for the 10 largest cities and 18.8% for the 20 largest on a year-over-year basis. It appears, however, that the rate of decline is slowing.

Retail sales fell unexpectedly in March by 1.1%, as consumer demand remained weak on lost jobs and declines in household wealth. As long as the economic situation remains uncertain, it is likely that consumers will continue their conservative approach to discretionary expenditures. It's likely that sales figures will remain volatile through year's end as the economy approaches bottom.

The labor market continues to shed jobs. Although job losses no longer appear to be accelerating, the labor market has lost 5.1 million jobs since the downturn began, and the unemployment rate has increased by 370 basis points to 8.5% since December 2007. The economy lost another 663,000 jobs in March, and there are no signs that hiring activity has picked up. The unemployment claims data, which foretell the direction of the labor market, remain elevated at recessionary levels. We would expect to see some downward movement in these data prior to any labor market recovery.

Market Overview

Market fundamentals continue to weaken for all asset classes, with increased vacancy levels and decreases in rental rates. The capital markets continue to struggle, with a slowdown in investment sales and purchasers remaining on the sidelines. It is expected that demand will remain weak as long as companies continue to reduce expenses and shed employees. To make matters worse for property owners, many companies—owing largely to heavy and sustained job losses—are carrying excess space, which will need to be absorbed before new space demand can take hold.

Capital Markets

The story in the capital markets is the steady increase in troubled commercial assets. General Growth Properties filing for Chapter 11 reflects the challenge to secure new or renew existing financing. According to Real Capital Analytics (RCA), distressed assets continued to increase in February to US$49.2 billion, comprising 2,293 properties, with US$5.7 billion of troubled assets that fell into default, foreclosure or bankruptcy, signaling possibly more trouble on the horizon. The ratio of offerings to closings remains high at five to one, resulting in further downward pressure in prices. As a result, cap rates will likely continue to increase. Cap rates for office alone are up 25 to 50 basis points since December overall, according to RCA, and are up even more for certain asset classes and locations. The increases in cap rates have moved the fastest and highest in the secondary and tertiary markets. The biggest challenge for purchasers and sellers is how to determine value in a falling market—whether based on cap rate, yields, borrowing costs or the expected disposition price in three to five years, depending on the purchaser's objectives. The limited activity also stems from the continued pricing expectation gap between purchasers and owners. Although this gap has narrowed compared with the beginning of the year, the lack of available financing continues to inhibit sales.

Office

The national office vacancy rate increased by 80 basis points from 14.7% at year-end 2008 to 15.5% in the first quarter. The decline corresponds to a 25 million-sq.-ft. decline in net absorption. The biggest increases in vacancy were in San Antonio (up by 320 basis points) and San Jose (up by 270 basis points). Job losses continued to reduce the demand for office space nationwide. The amount of sublease space on the market now accounts for 11.5% of all vacant space—a rise of 55 basis points. The net increase in sublet space occurred in downtown markets, as suburban sublet space actually decreased. It should be noted that the decrease in suburban sublease space had more to do with sublet terms expiring than an increase in demand. The overall vacancy rate continued to climb, with the national suburban office vacancy rate increasing by 90 basis points to 17.1% overall, and the downtown vacancy rate increasing by 70 basis points to 12.3% in the first quarter.

Industrial

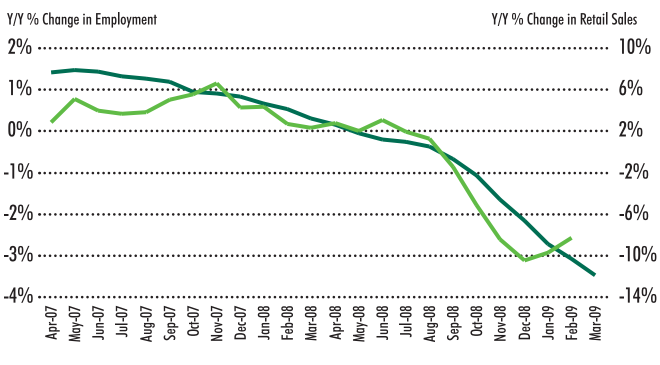
The national U.S. industrial availability rate increased by 100 basis points from year-end 2008 to 11.5% in first-quarter 2009, due to falling demand and a few new completions. As a result, net absorption fell to negative 36 million sq. ft. Among the top ten industrial markets, the biggest increases in availability were in Atlanta, rising 470 basis points to 16.5%, and Philadelphia, up 150 basis points to 13.7%. The highest availability rates remain in Austin, at 22.0%, and Stamford, at 21.4%. Rental rates continued to fall, but the range was different depending on the market.

The Institute for Supply Management (ISM) non-manufacturing survey decreased to 40.8 in March from 41.6 in February. The March ISM manufacturing index, released earlier this week, showed a modest increase. This reinforces the further weaknesses in the industrial sector.

Multi-Family Housing

Demand for U.S. rental apartments remained weak in the first quarter of 2009, amid sharp job losses and a glut of vacant single-family homes and condominiums for sale and for rent. The good news is that multi-housing completions are tapering off, falling to an annualized pace of 242,000 units, 50,000 below year-ago levels. Apartment rents and revenues will still be negatively affected by rising unemployment and vacancy rates in the near term, and it will take further major declines in new supply before the market can stabilize and fundamentals turn positive.

U.S. Employment and Retail Sales[1]



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

Retail

U.S. consumer confidence increased an astonishing 12.3 points to 39.2 in April, after hitting its lowest level in February, according to the Conference Board. Given the Federal government's various stimulus measures, we may see confidence increase in the coming months. Retail sales will likely continue to waver over the next few months, especially if the predicted job losses continue. Consumers for the most part will continue to focus on necessity items and defer big-ticket purchases. Many retailers will continue to struggle for the remainder of 2009, leading to more anxious moments for retail property owners and lenders.

Hotel

The hotel sector, perhaps the hardest hit in commercial real estate, is struggling with significant decreases in demand and an onslaught of new supply, resulting in lower occupancies and a loss of pricing power. Revenues per available room have declined approximately 18% year to date, with some segments and geographies experiencing declines in excess of 25%. Sector cash flows have taken a significant hit, given highly leveraged operating structures. U.S. transactions activity was down in excess of 80% for 2008 relative to 2007. Year-to-date activity is down compared to 2008; however, early signs of value capitulation are evident based on transaction activity. Further, special servicer and lender activity is increasing daily with an estimated quadrupling of loan defaults for the sector. This will likely cause more pressure to push cap rates upwards.

CANADA

The Bank of Canada reduced the overnight interest rate to 0.25%, on par with the U.S., in an attempt to stimulate the economy. Unemployment levels continued to climb across Canada, with the notable exceptions being in healthcare, government and education. The economy is expected to further weaken, as the U.S. and global economies continue to falter. The housing market is showing signs of turning with better sales in March, but activity remains weak, especially compared with a year ago. Manufacturing continues to be strained with uncertainty remaining in the auto sector, and there will be further restructuring. Exports were down by 9% in January, the largest drop since 1982.

Market Overview

Canadian companies continue to retrench and cope with the global recession with continued production and cost reductions. Vacancy rates for all product types continue to increase; we are starting to see meaningful declines in rental rates, although pricing erosion is limited to select properties and submarkets and is not yet widespread. New construction is grinding to a standstill as new projects are delayed and in some cases cancelled. Canadian owners are starting to feel the pinch in reduced values and subdued renewal activity, although not as severely as in the U.S.

Capital Markets

Investment activity continues to waver as vendors and purchasers adjust expectations. Similar to the U.S., the challenge is in pegging a price to the value of a property. Cap rates continue to climb, especially in the tertiary markets. REIT values are down 50% from their peak before dividends in 2007, and investors have shown increased interest over the past few months in the REIT sector. REIT values will likely be the first to return when the market upswing begins, based on risks that were already built into the market values.

Office

The national office vacancy rate increased from 6.7% as of year-end 2008 to 7.5% in the first quarter of 2009, with sublet space increasing to 20.9% of the total vacant space, an increase of 220 basis points. The biggest increases in sublease vacancies were in Vancouver and Calgary due to the softness in the commodities pricing and deferred capital expenditures. Rental rates have decreased moderately and will continue to fall as vacancy rates increase across all markets. Given the amount of new office completions occurring in 2009 in Calgary and Toronto, sublet space is expected to continue to increase in those markets, pushing rental rates downward.

Industrial

The national industrial availability rate increased to 6.7% in the first quarter of 2009, from 6.2% at year's end, the second consecutive quarter of increases. Rental rates decreased slightly, but only in select markets. The weakened demand for industrial space has been fueled by the diminishing demand for goods. Moreover, with imports exceeding exports, Canada's dependence on commodities is clearly apparent. With the decrease in oil prices and the slowdown in the U.S. economy, industrial demand will remain weak for the near term.

Multi-Family Housing

The multi-housing vacancy rate levels remain stable, with a slight increase in vacancy rates in the major markets in Vancouver and Toronto due to the completion of a number of condominium projects. Housing activity has increased moderately but still remains slow compared to a year ago. Low interest rates, coupled with decrease in price, should make home ownership more affordable and increase activity in this segment. This will likely have a minimal effect on the multi-housing sector as vacancy rates remain low and, with continued strong immigration flow into Canada, will likely remain so.

Retail

In February, retail sales edged up 0.2% month over month, following a 1.8% month-over-month increase in January. Compared to a year ago, retail sales are still up over 9.4% year over year. The increase was fueled largely by the building and outdoor building supplies segments; factoring out the auto sector, retail sales increased by 0.6%. While many new projects have been curtailed in 2009, there are a number of new retail developments proceeding. The further the recession deepens, the more challenges retailers will face to survive.

Hotel

The conservative nature of supply growth and lower debt leverage has enabled the Canadian hotel sector to record better first-quarter results than in the U.S. RevPAR declines were in the single digits in the majority of markets, unlike the many double-digit declines recorded in the U.S. As corporate expense budgets and group travel were slashed, the Upscale to Luxury segments suffered the deepest impact. Limited and Midscale Service hotels also felt these effects, but to a lesser degree in most markets. Companies, while continuing to monitor business and group travel, will realize that these are a necessity and not a luxury in conducting business, which should lead to increased travel in the near term. Credit markets continue to affect liquidity within the hotel sector, resulting in upward pressure on yields.

LATIN AMERICA

Latin America continues to feel the effects of the global recession, with GDP growth in 2009 expected to be only half of 2008 levels. Markets are seeking financing from both traditional and non-traditional sources for stimulus spending to restore investor confidence. Several Latin American countries are better positioned to withstand an economic downturn, given the prosperity they enjoyed over the past number of years. These countries include Brazil, Colombia, Mexico, Peru and Uruguay, all of which are running small fiscal deficits with ample reserves and enough foreign investment to finance their current deficits.

Market Overview

For the most part, Latin America is still experiencing low vacancy rates and has benefited from continued stable local demand for real estate. There has been some retrenching among select multi-national firms, but overall there has not been a loss of confidence in the region. It is expected that vacancy rates will continue to creep up slowly, but there will not be an implosion on real estate. The full economic impact of the H1N1 flu within the region cannot be determined at this time. In the near term, the Mexican government ordered all nonessential government offices and businesses closed for five days, beginning May 1. In the longer term, it is clear that tourism will suffer; however, it helps that this is occurring in the shoulder season and not during the prime winter months.

Capital Markets

Similar to the rest of the global market, Latin America continues to struggle with the lack of capital flow. Investors remain interested in the region, but cannot secure financing for real estate. Cap rates continue to climb, and there have generally been no distressed sales in the market. Among all commercial real estate segments, office, industrial and retail remain fundamentally strong, while weakness remains in the hospitality industry. This will be exacerbated by ongoing developments related to H1N1 flu, which is expected to further impact tourism negatively.

Office

Office demand remains weak, but we have yet to see any increase in sublet activity; for now, firms are still hanging on to excess space or have cancelled new and in some cases existing leases. Latin America is coming off record lows in vacancy rates, which will continue to increase marginally on the heels of a few new projects scheduled to come online. Continued softness in rents in select markets and properties is expected in the region. In the region's top office markets, the drop in demand has been more moderate.

Industrial

Industrial availability rates have increased marginally. The good news is that local demand for goods is still stable, propping up the manufacturing sector. In terms of Mexico's trade balance, while exports continued to decrease, imports declined at a faster pace.

Retail

Retail spending has been fluctuating in the region, but at varying degrees. Mexico had a decline in February of 8.6%, and Chile at 3.1%. In contrast, in Brazil, retail sales were up 3.8% in February compared to year ago, and Argentina was up 5.2% in March. The reduction in tourism has impacted certain areas more than others. The region's retail vacancy rates are up marginally, but for the most part we have not seen any drastic changes in the retail landscape. Retailers are adjusting to lower consumer activity with delayed new openings and strategic downsizing.

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