

Is commercial real estate on the recovery path?

Highlights

- REITs raise significant capital and debt spreads narrow
- Retail is on some investors' shopping lists
- Investment trading returns in some markets despite lack of improvement in fundamentals
- Cost-conscious corporations recognize rental opportunities and are beginning to act
- Eight recovery signs to watch

Concrete evidence that the global economy is on the path to recovery has been building since March, though the improvements have largely been confined to leading indicators (see Jones Lang LaSalle's Global Real Estate Health Monitor, Figure 1 on page 2). While Germany, France and Japan have come out of the recession, the United States and the UK remain in recession, and sustained growth in China is in question. Property demand fundamentals remain weak, and the commercial real estate sector's problems are far from over. Yet more preconditions for global economic recovery were met in the second quarter, and real estate is showing small signs of following suit.

Yields are beginning to compress in select markets while the number and size of institutional investment transactions are increasing. Bargain-hunting investors are beginning to transact, particularly in Asia. Rental rate drops are slowing, causing cost-conscious occupiers to stir. This edition of the *Global Market Perspective* examines these developments and analyzes how they are expected to shape a future real estate recovery.

REITs raise significant capital and debt spreads narrow

Although high-grade corporate credit markets have shown marked improvements during the past year, global real estate debt markets

have proven slow to follow as deteriorating fundamentals offset improving liquidity. In the United States, the commercial real estate loans on bank balance sheets recently dropped by a modest \$32 billion to \$1.7 trillion, and the securitization market remains shut down. In Europe, RBS and Lloyds are beginning to write down some of the troubled loans in their combined £180 billion commercial property loan portfolio.

Nevertheless, evidence of a reduced cost of borrowing in the unsecured real estate debt markets is also emerging. In the United States, Simon Property Group sold bonds at 5.45 percent, and in Europe, ProLogis completed three financings for €280 million with yields ranging from 4.40 to 5.24 percent. In addition, most real estate owners with property-level loans that have the potential to recover their equity in the not-too-distant future are working to extend or modify their loans with their existing lenders. Workouts generally result in better terms than those currently available in the capital markets.

Property companies are taking advantage of a slight ease in the credit markets and the rebounding equity markets to raise funds for potential acquisitions and reduce debt levels. Since their late-February trough, global real estate investment trusts (REITs) are up 82 percent through the end of August¹. Globally, REITs have raised \$33 billion of equity and issued \$5 billion of debt through August 2009.

Sensing opportunity, U.S. investment firms are rushing to raise capital through initial public offerings (IPOs) to buy underrated real estate-related debt securities. More than a dozen sponsors have filed to launch mortgage REITs. Starwood's IPO raised \$810 million, far exceeding the expected \$500 million. If successful, most of these REITs plan to originate or acquire commercial mortgages, which will add much-needed liquidity to the lending markets. In Asia, more than 40 Chinese and Indian developers are also planning to tap the equity markets through IPOs in the next six to nine months. Chinese banks, flush with liquidity, are stepping up their lending to these developers. In Europe, Max Property raised £220 million in a May IPO, while an early mover in the recovery, London & Stamford, has announced an intention to convert to REIT status.

Figure 1 Jones Lang LaSalle's Global Real Estate Health Monitor

	General trend	U.S.	UK	Germany	France	Japan	China	Australia
General trend	Signs of recovery	Recession/ slowing	Recession/ slowing	Bottoming	Bottoming	Bottoming	Bottoming	Bottoming
Official interest rate	Down, pausing	0.13%	0.50%	1.00%	1.00%	0.10%	5.31%	3.00%
GDP QOQ	Recovery commences	-0.3%	-0.7%	+0.3%	+0.3%	+0.9%	+7.9%*	+0.6%
CPI YOY	Contracting	-2.1%	+1.8%	+0.0%	-0.7%	-1.2%	-0.1%	+1.5%
Consumer confidence MOM	Generally stronger	+14.1%	+1.7%	+8.8%	-5.4%	NA	+0.7%	+3.7%
Employment YOY	Contracting	-3.8%	-1.9%	-0.2%	-2.5%	-1.4%	+0.7%	+0.3%
Retail trade MOM	Generally weaker	+0.1%	+0.4%	-1.7%	+2.2%	-0.3%	+8.1%	-1.4%
Housing starts YOY	Steep falls, slowing	-37.2%	-8.9%	NA	+3.1%	-32.4%	+1.4%	-22.5%
OECD leading indicator MOM	Generally stronger	+1.4%	+1.1%	+1.8%	+1.4%	+0.3%	+1.4%	+0.1%
Manufacturing PMI, index level	Increasing	52.9	47.0	49.0	50.2	53.6	55.1	51.7
Stock market, MOM to August 31	Continued gains	+3.4%	+6.5%	+2.4%	+6.6%	+1.3%	-21.8%	+5.5%
REIT market, local return MOM to Aug 31**	Solid rises	+10.5%	+12.0%	-3.4%	+15.7%	+2.8%	+29.9%	+2.4%

GREEN = Improving trend **BLACK** = Neutral trend **RED** = Worsening trend

QOQ = Quarter-over-quarter, YOY = Year-over-year, MOM = Month-over-month

* Chinese GDP equals YOY

** GPR 250 REIT

Source: Global Insight, Global Property Research; FRB; BOE; ECB; BOJ; PBC; RBA, Yahoo Finance, Jones Lang LaSalle

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Banks that have taken back properties are a source of both investment properties for sale and attractively priced financing for REITs and private investors. For example, Deutsche Bank recently provided seller financing to trade Worldwide Plaza in New York for \$600 million to a group of highly capitalized private equity firms including DRA Advisors and George Comfort.

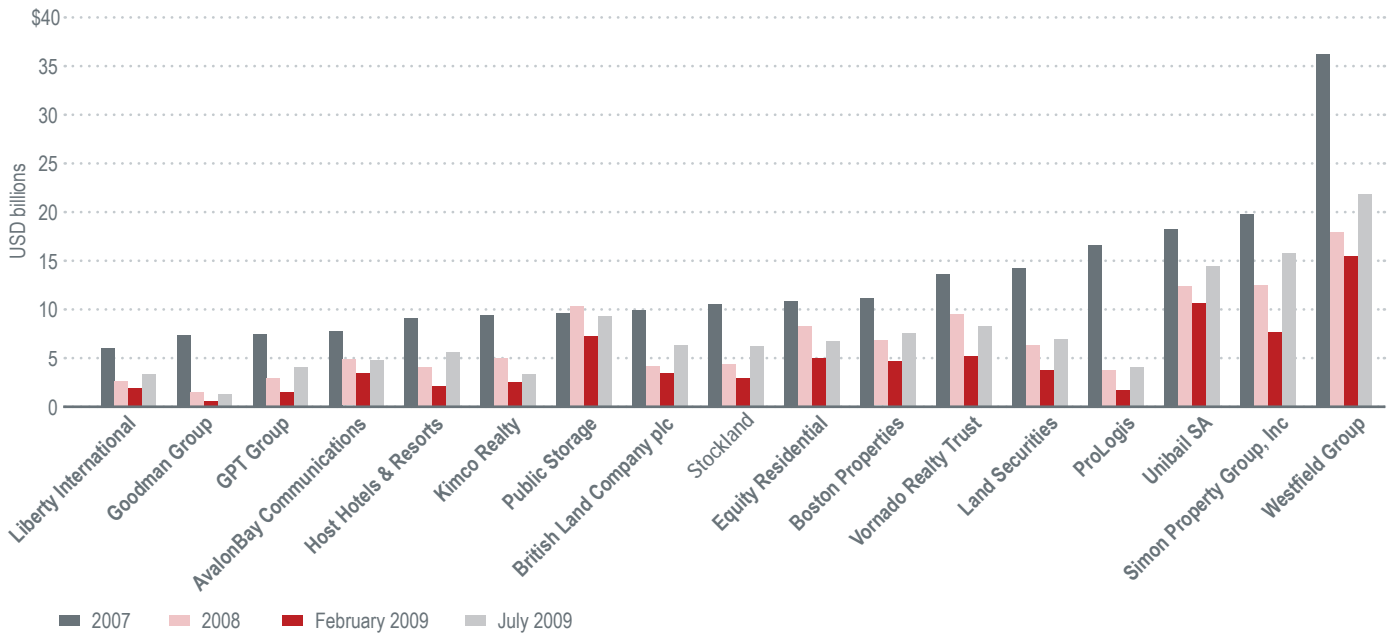
Retail is on some investors' shopping lists

As prime retail shopping center yields have risen in major global centers (see Figure 3 on page 4), there is active interest from numerous buyers in acquiring shopping centers at aggressively

discounted market prices. Australian Macquarie CountryWide announced an agreement to sell its 75 percent interest in a U.S. portfolio of 86 retail properties for US\$1.3 billion at a 9.1 percent yield. In Asia, Jones Lang LaSalle advised Merrill Lynch in its divestiture of three Hong Kong retail mall properties to a mainland fund for HK\$1.6 billion. Nearly 20 entities bid on the portfolio. In Germany, Jones Lang LaSalle advised Hines on the sale of a 20,000-square-meter shopping center, "Die Mitte" in Berlin, to Commerzreal for €126 million. In Bergamo, Italy, Antegnate shopping center also sold to Axa Investment Management Deutschland GmbH for €50 million in August.

Figure 2 Global REIT recovery

The world's largest REITs' market capitalization increased by 88% on average from February 28 to July 31, but remains 49% below December 2007 levels.



Source: UBS, LaSalle Investment Management (Securities)

Investment trading returns despite lack of improvement in fundamentals

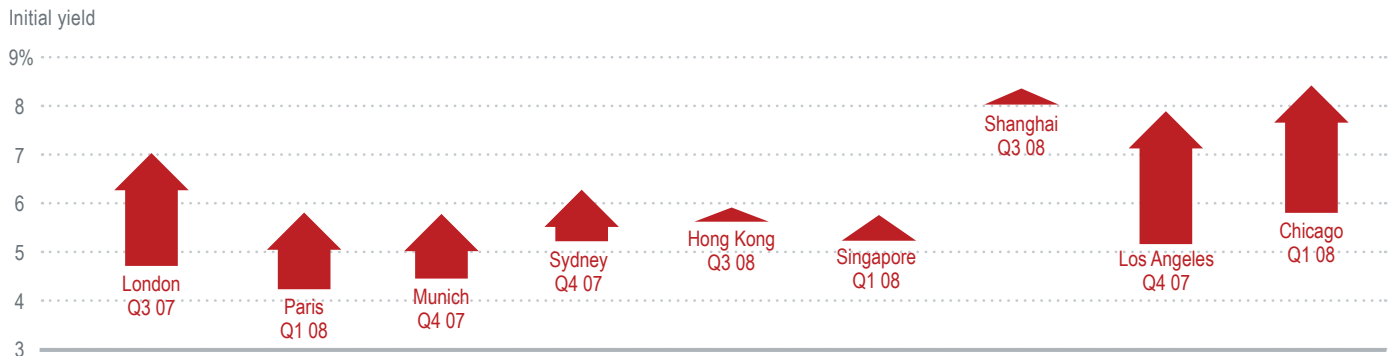
Global transaction volumes in the first six months of 2009 totaled \$76 billion, down 45 percent from the second half of 2008². However, there are signs of a trading bounce in some markets—though this activity is driven by relative value investing rather than by improving fundamentals.

In the **Asia Pacific** region, most countries posted higher transaction volumes in the second quarter of 2009 compared with the first quarter. In China and Australia, second quarter USD volumes rose by 113 percent and 69 percent, respectively. The bulk of the region's recent transaction activity occurred in China and Hong Kong, which have enjoyed marked improvements in investor sentiment. A slew of major U.S. investment banks are rushing to sell Chinese properties, given the liquidity available in the market. Premium properties in the region are now beginning to trade with domestic capital being the most aggressive. South Korea is particularly active as evidenced by the sale of ING Tower in Seoul to KB Real Estate Trust Company for a much higher-than-expected 400 billion won and a yield near 5.9 percent. Similarly, Korea's National Pension Service purchased the Keukdong Building from Macquarie Bank in Seoul for 310 billion won at around a 7 percent yield.

High-net-worth buyers from Southeast Asia are purchasing hotels globally including Malaysia-based TA Enterprise's purchase of the Swissotel Merchant Court Singapore for S\$250 million. Asian conglomerate Keck Seng Investment purchased the W San Francisco for US\$90 million. Thai-based TCC Land acquired the Hyatt Hotel Canberra and subsequently the Hyatt Regency Adelaide in a joint deal for a total of A\$155 million. In Australia, a number of premium-grade office properties, such as Sydney's Aurora Place, have come to market.

Regional activity is pushing spreads down between 100 and 150 basis points (bps) in Seoul. In Hong Kong, yields have fallen to the low 4 percent level. Yields in Singapore, India and Australia have remained flat. Notwithstanding the improvements in other parts of Asia, transaction volumes in Japan, the region's biggest investment market, were down by more than 50 percent in the second quarter, impacted by mounting concerns about the health of the economy and deflation.

In **Europe**, transaction activity rose marginally from the first to the second quarter of 2009, with the latter recording around €12 billion in transactions. This improvement is a significant shift in the market. Over the past seven quarters, transaction volumes had been declining at an average quarterly rate of 22 percent. Transaction

Figure 3 Q2 2009 global prime retail yield correction: an expansion from recent lows

Non-CBD, large center with at least one department store, +200 specialty shops; for U.S. markets: all shopping centers

Source: Jones Lang LaSalle

volumes approached €3 billion in July and August, a predictable slowing from €5 billion in June, given the lull that historically accompanies the summer holiday season. Prime product with good long-term income is most in demand and garnering cross-border interest. Jones Lang LaSalle advised Grosvenor on the cross-border sale of 73 & 74-75 Grosvenor Street in London for €26.84 million at an initial yield of 6.2 percent.

German and French funds are purchasing institutional-quality assets with long leases. Deka Immobilien acquired the First Hotel Goteburg in Sweden for €41 million in a sale-leaseback transaction and also purchased the Rosenquartier complex in Hanover, which includes the InterCity Hotel. However, hotel deals with long-term management contracts (where income risk is with the owner rather than the occupier) are almost impossible to finance. London remains the most active market in the world, bolstered by UK banks, which posted net new lending of about €3 billion. However, France recorded the largest increase in quarterly volumes, almost doubling investment activity to €1.2 billion.

Other major European markets that enjoyed an increase in second-quarter trading volumes were Germany, Italy, the Netherlands, Spain and Sweden. To date, the competition for prime assets has led to a drop in yields in only two markets. Glasgow yields fell by 50 bps to 7 percent, and London City dropped by 25 bps to 6.5 percent during the second quarter. While secondary market yields continue to move out, this drop was driven by a surplus of bidders on some of the few top-quality prime assets to come to market.

A turnaround in volumes and yield compression has yet to reach the **Americas**, where first-half 2009 transaction volume was just \$17.2 billion, down 77 percent from the same period in 2008. Given the

significant stress remaining in the banking industry, financing is still difficult to obtain and closings are arduous. Overall closed transaction volume in the United States remained at or near record-low levels in July and August at \$3 billion to \$4 billion per month. On the upside, a larger quantity and size of properties for sale by institutional investors signaled the potential that serious sellers are re-emerging in the United States. TIAA-CREF is reportedly pruning its portfolio and entering the market with six domestic properties that could fetch more than \$200 million in aggregate³. In Washington, DC, Vornado sold a newly completed, fully leased prime office asset to Deka Immobilien for \$208 million at a mid-6 percent yield. In a sign of expanding distress, Maguire Properties handed over the keys to eight Southern California properties to servicer J.E. Roberts. The properties were immediately listed for sale and represent meaningful institutional investment opportunities.

In Mexico and Brazil, transaction volumes remain down by roughly half since their peak, with yields ranging from approximately 11 to 12 percent in local currency. Transactions that are U.S. dollar-denominated in Mexico, which are not allowed in Brazil, have been very scarce and may command rates of 100 to 200 bps below the local currency rates. Recent transactions include the disposition of the Samba Vallarta by Pueblo Bonito Hotel in Puerto Vallarta, where Jones Lang LaSalle served as the seller's advisor; the Sofitel in Salvador; and the InterContinental Hotel in São Paulo. Also in São Paulo, the Portuguese hotel group Porto Bay acquired the 80-room boutique hotel L'Hotel.

VALIA, one of the country's largest pension funds, acquired part of the Continental Tower under development in São Paulo for R\$208 million. BR Malls, a group formed by GP Investimentos and Equity

International, acquired a shopping center for R\$188 million. In July, San Carlos, a local real estate company listed in the Bovespa, sold two warehouses in Rio de Janeiro and one in Pernambuco for a total of R\$107million.

Cost-conscious corporations recognize rental opportunities and begin to act

Global rental levels continued to fall in the second quarter, although at a less precipitous rate than seen in the first quarter. With the exception of the United States, there are recent signs that the rate of rental decline is slowing in many markets and that some could be approaching a period of rent stabilization. In Europe, Jones Lang LaSalle's prime rental office index fell 4.6 percent, following a decline of 8 percent in the first quarter. Rental rate declines have been particularly severe in London, Moscow and Dubai. In London, prime rents are now a third lower than a year ago, at a level last seen in 2005. Moscow rents have now fallen by about two-thirds year over year, and Dubai rents have declined 50 percent since their highs recorded in the fourth quarter of 2008.

In Asia Pacific, landlords continue to cut asking rental rates and offer attractive incentives to maintain occupancy levels. The largest quarterly declines in office net effective rentals were seen in the mature markets of Hong Kong Central (-13.4 percent) and Singapore Raffles Place (-13.0 percent). In the United States, office rent declines were still accelerating at the end of the second quarter. Effective rents decreased 15.3 percent over the course of the past year, with the New York, Los Angeles, San Francisco, Boston and Washington, DC markets showing the greatest declines. Some segments of those markets reported nearly 40 percent declines.

Until now, corporations have been unwilling or unable to commit to transactions despite the market presenting huge opportunity. Uncertainty, lack of confidence and limited access to financing either internally or from the wider markets all have contributed to historic lows in terms of occupier activity. Corporations have also been unwilling to commit to deals while waiting for signs that markets have bottomed out. Although short of a turning tide, economic stability and associated improving corporate earnings and confidence are leading to further market testing and preparation for transactions over the next three to six months.

To encourage action now, landlords are offering remarkable incentives as evidenced by Japanese investment bank Nomura, which secured six years free rent in its London headquarters transaction, albeit on a 20-year lease. Rent-free periods typically

range from three to five months for a five-year lease in German cities to up to 30 months for a 10-year lease in London. Apart from offering generous incentives, landlords in Asia continued to adjust gross rents over the second quarter of 2009. In the United States, rent abatement continues to escalate and has reached 4.5 months nationwide as of the second quarter.

Eight recovery signs to watch

Several key forces are likely to characterize the global commercial real estate markets in the months ahead. Watch these eight indicators:

Government intervention

- The FDIC, with just \$10 billion left in its fund, may gain more leeway to allow domestic and global capital sources to take lucrative equity positions in banks rather than relying on bank nationalization. The FDIC should begin to more rapidly dispose of loans and commercial properties taken over from failed institutions.
- Later this month, the Irish government will debate the proposed creation of the National Asset Management Agency, a state-owned bank initiative designed to solve the Irish banking crisis and provide banks with the necessary capital to begin lending and kick-start the economy.

Liquidity restoration

- Capital-raising has increased with strength in the REIT markets while secondary market commercial real estate security spreads continue to narrow. The recapitalization of REITs may bolster their purchasing power and lead to an acquisition wave of distressed properties and the deleveraging of their balance sheets.
- The U.S. CMBS delinquency rate of 3.14 percent in July is more than six times the level it was a year earlier. The pace of increase slowed a bit from July to August. While this development was a small positive, delinquencies and defaults are likely to rise into 2010.

Investor interest return

- Multi-asset funds generally have preset allocation targets that dictate how much they should invest in stocks, bonds, commercial real estate and other asset classes. Given the rise in their stock and bond portfolio values in 2009, some institutional portfolio managers find themselves overweighted in stocks and bonds and underweighted in real estate. This phenomenon is known as the "denominator effect" and could result in institutional investors adding to their real estate holdings in order to maintain their target allocations to the sector.

- Sovereign wealth funds and returning foreign investors could take the lead in purchasing distressed assets. China's \$200 billion sovereign wealth fund (CIC) plans to invest up to \$2 billion in U.S. mortgages and recently announced an equity investment in Songbird Estates PLC, which owns about 61 percent of London's Canary Wharf Group. Billionaire real estate investor Sam Zell, whose \$39 billion sale of Equity Office Properties in February 2007 marked the peak of the real estate boom, is back in the market to buy distressed assets through a privately raised fund.
- The sustainability of Asia's residential real estate recovery will be a key sentiment driver. Jones Lang LaSalle's recent survey of investors found that 91 percent believe there is an asset bubble developing in China's property market.

Corporate confidence

- As the global economy begins to recover, look for occupiers to dust off and implement their strategic real estate plans with greater confidence. Some may make bold opportunistic plays and switch locations within the next three to six months.

There are many obstacles to overcome before the global commercial real estate markets complete their path toward full recovery, but new signs suggest the sector may have crossed an early line into recovery. As this uneven journey progresses across the world, astute investors and corporate occupiers who begin to assess, and eventually exploit, near-term opportunities will be best-positioned to benefit from long-term improvements.

You've heard our opinion, so now give us yours. What recovery signposts do you see in today's markets? Send your viewpoints to global.perspectives@am.jll.com. Also, if you prefer not to receive the *Global Market Perspective* in the future, you may make that request using this same e-mail address.

Do you have concerns about the issues raised in this economic review? For more information about how Jones Lang LaSalle's global Value Recovery Services experts can help, visit www.us.joneslanglasalle.com/vrs. We draw from diverse disciplines to help corporate occupiers, owners, lenders, special servicers and governments address the operational and financial difficulties associated with challenged assets.

¹ Dow Jones Global REIT Index

² Jones Lang LaSalle Global Capital Flows data Q1 2009

³ Realpoint, LLC