

## Global Market Perspective

### January 2010

### Solutions, surprises and strategies for a cool recovery

The New Year is unfolding, for the most part, with a more orderly and thoughtful approach in the international real estate markets, where caution is still the dominant sentiment. Debt markets are easing, distressed assets have not overwhelmed, and rents are bottoming out in most countries. Now that the problems have largely been quantified the search for solutions is on. For example, occupiers are thinking strategically about what the new reality can offer.

The old year passed with a few pleasant surprises. Leasing activity in **Asia Pacific** continued to gather pace in the fourth quarter and across the region yields in most office markets started to compress as asset prices increased. Ample liquidity in the market sparked more transactional activity and led to the start of rising capital values. In **EMEA** there was steady improvement in activity during the year from the low point in quarter one. Investment volumes edged close to €70 billion in 2009 and are expected to increase by nearly 20 percent this year, albeit only bringing them back to 2002 levels. **US** still faces challenges. Although sales activity bottomed out in the second quarter of 2009, the recovery to date continues to be very muted and uneven. Only in top-tier coastal cities do supply and demand patterns seem to indicate a return to stability. In other U.S. office markets vacancy will continue to rise and rents will fall throughout most or all of 2010 as many corporations accelerate their space rationalization and consolidation activities.

Momentum may have arrived for the global real estate market at last, and any further upside surprises will be welcome. Last year's shadow may still cloud many markets, but its effect has, so far, kept the recovery cool and orderly.

#### Highlights

- Upside surprises close out 2009
- Banks and investors pursue orderly work-out of assets
- Cross-border investing and lending are showing signs of life
- Return of the billion-dollar deal
- Opportunities for corporates to rationalize and consolidate
- Global real estate outlook

### Global Economy

As 2010 begins the global economic recovery remains fragile. Risks to progress include ongoing bank failures, rising default risk amongst highly leveraged economies such as Greece and Portugal, the impact of new governmental regulation, interest rate rises and the possibility of future asset bubbles. Yet, in the final months of 2009, a number of data points suggested that the global economy was improving at a better-than-expected pace. As the economic recovery gathers more strength, it is time to turn our attention toward the potential upside surprises that could support a rebound of world property markets earlier than previously anticipated.

Jones Lang LaSalle's **Global Real Estate Health Monitor** highlights improvements in several indicators, which could feed through to positive results for the global commercial real estate markets

2010	US	UK	Germany	France	Japan	China	Australia
Official Interest Rate	0.13%	0.50%	1.00%	1.00%	0.10%	5.31%	3.75%
GDP QOQ %	+0.6%	-0.2%	+0.7%	+0.3%	+0.3%	+8.9%*	+0.2%
CPI YOY%	+1.8%	+1.9%	+0.8%	+0.4%	-1.5%	+1.1%	+1.3%
Consumer Confidence MOM %	+4.5%	-6.8%	-8.3%	-3.3%	n/a	+0.1%	-3.8%
Employment YOY %	-3.9%	-1.5%	-0.8%	-2.5%	-1.6%	+1.0%	+0.6%
Retail Trade MOM %	+1.4%	+0.4%	0%	+0.1%	+0.2%	-4.5%	+0.3%
Housing Starts YOY %	-12.4%	-15.6%	n/a	-15.2%	-19.1%	n/a	-6.0%
OECD Leading Indicator MOM%	+1.1%	+1.1%	+1.3%	+1.2%	+1.2%	+0.2%	+0.6%
Manufacturing PMI, Index level	55.9	54.1	52.7	54.7	53.8	56.1	48.5
Stock Market, MOM to 31 Dec	+ 1.8%	+ 4.3%	+ 5.9%	+ 7.0%	+ 12.8%	+ 2.6%	+ 3.6%
REIT Market, MOM to 31 Dec	+ 6.4%	+ 5.2%	- 1.0%	+ 2.8%	+ 8.5%	n/a	+ 1.9%
General trend	Recovery	Recession/ Slowing	Recovery	Recovery	Troughing	Growth	Recovery

**General Trend:**

**Worsening**

Neutral

**Improving**

Note: China GDP YOY

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

The latest data indicates employment prospects and consumer confidence improving across Asia Pacific. According to the global Manpower Employment Outlook survey released in December, hiring plans are strengthening across all major Asia Pacific economies, except Japan, with the strongest prospects in India, Singapore, Taiwan and Australia. According to the third quarter 2009 Nielsen Global Consumer Confidence survey, confidence improved across all Asian countries except Japan, with Hong Kong and South Korea improving the most among 54 global markets. Retail sales in Hong Kong and Singapore resumed growth in September on the back of improving consumer confidence and tourist arrivals. However, Japan's retail sales fell 1.0 percent year on year to November 2009, marking the 15th consecutive monthly decline. In China, retail sales grew 15.3 percent year over year in the first eleven months of 2009, while the Manufacturing Purchasing Managers' Index stood above the 50-level mark for the tenth month in a row in December, indicating a solid expansion in the sector.

Although downstream inflation pressure remains muted, regional policy makers have started to worry about fast-rising asset prices in some markets, and policy interest rates have begun to increase in the Asia Pacific region earlier than in Europe and North America. Prompted by strong economic conditions, Australia became the first G20 country to raise rates in October. The Chinese government has started to rein in bank lending though signaling that it would not make the mistake of ending stimulus policies too soon.

Moving to Europe, economic sentiment encouragingly rose for a ninth successive month, taking it to an 18-month high in December. As the European economies move slowly into a growth phase, both businesses and consumers are generally more upbeat on recovery prospects. While the improvements in economic sentiment (notably in the services and retail sectors) are obviously positive news for future real estate activity, confidence is now approaching long-term averages on many indicators, but businesses are likely to remain cautious in their employment and investment plans over the short / medium term. Hard data continues to show muted recovery; third quarter 2009 GDP growth was 0.4

percent, the Eurozone unemployment rate had risen to an 11-year high at 10 percent (November) and European retail sales remain flat.

There are therefore strong arguments for the European Central Bank to only gradually withdraw its emergency liquidity measures and to keep interest rates down at 1.0 percent well into 2010. There also continues to be downside risks relating to the sovereign debt position of several Eurozone economies, not only Greece, but including countries such as Ireland, Spain and Portugal. The UK has also seen a marked deterioration in its public finances, which will weigh on future growth prospects. While the UK economy should have finally returned to growth in fourth quarter of 2009 after six quarters of overall deep contraction, the recovery still looks likely to be gradual and prone to relapses.

In the United States, the economy could now be in the early stages of turning the job market corner. The pace of layoffs slowed dramatically in the second half of 2009. Hiring, however, has remained very weak, yet it may be on the verge of reviving by mid-year as businesses become unable to boost productivity among their existing payrolls. Even as employment bottoms out and slowly increases, commercial occupancy increases at the national level will not likely begin to rise until 2011 at the earliest.

Corporate profits are providing another potential 2010 upside. Beginning in the second quarter of 2009, earnings have rebounded with surprising vigor. The strength in corporate performance has been bolstered by the return of the equity and corporate bond markets. As many corporations enter 2010 with strong cash positions, the stage is set for better-than-anticipated business investment levels, with benefits for capital spending and possibly hiring. However, medium and small business still need a restoration in confidence, and access to the capital markets needs to extend to the building blocks of the economy at the household level.

It is widely believed that US government policy will continue to be highly accommodative through 2010. The Federal Reserve, however, plans on discontinuing its asset purchases in the first half of 2010 and will need to shrink its massive balance sheet. Such measures will have the consequence of causing longer-dated US Treasury yields to rise, which is a potential risk to the nascent and still fragile stabilization of the US housing market. Later in 2010, or perhaps as late as early 2011, the Federal Reserve will also likely begin boosting short term interest rates, as a probable self-sustaining economic expansion cycle will be underway, increasing inflation risks.

## Global Property

### Drivers of recovery

Leasing activity in Asia Pacific continued to gather pace in Q4 2009, underpinned by increased domestic expansions and relocations. Along with a slight pullback in new supply additions in Q4 2009 rents in most office markets were still declining. Chennai and Tokyo posted the largest quarterly declines of about 7 percent. In contrast, Hong Kong and Shanghai markets recorded positive rebounds of up to 5 percent from Q3 2009. Other markets such as Sydney and Melbourne are likely to bottom out near current levels. Although corporate occupier conditions have improved, take-up of office space is expected to lag the general pace of economic recovery. Except for those markets that face a large supply pipeline such as Singapore, Beijing and cities in India, regional office markets are likely to turn the corner by the end of 2010 and return to their normal growth trend from 2011 onwards.

Underpinned by the low interest rate environment and general abundance of liquidity, investment activity should continue to improve while yields may hold or compress in most markets. In Asia, ample liquidity in the market has sparked more transactional activity and led to rising capital values. In particular, buoyant investor sentiment prompted prices for Grade A property in Shanghai to jump 25 percent from Q3 to Q4 with yields compressing sharply by nearly 140 basis points. Domestic investors are still on the lookout for undervalued prime assets in anticipation of rental growth. On the other hand, Tokyo saw a further fall in capital values of 6.3 percent quarter to quarter, albeit at a declining rate.

In Europe, preliminary data indicate that while leasing volumes in 2009 were down by 25 percent compared with 2008, there has been a steady improvement in activity during the year. Investment volumes grew for 3 consecutive quarters in Europe, reaching close to €70 billion in 2009, with almost €25 billion transacted in Q4 alone. Investor confidence has improved significantly from the historic lows at the beginning of 2009.

Across Europe, the number of active investors continues to grow and funds have had more success with capital raising. There has also been some easing in the European debt market, particularly credit for new purchases of prime buildings. In the UK a lack of quality investment product has meant a significant amount of capital remains frustrated and prime investments are scarce. With such multiple bids for the best product, many markets are seeing a hardening of prime yields. Germany has also seen more limited yield compression in the final quarter of 2009 although, in contrast to the UK, the market continues to be dominated by domestic institutions. Investment volumes across Europe are expected to increase by near 20 percent in 2010, which will bring them back to 2002 levels, still well below the long term trend.

In the United States, many corporations are accelerating their space rationalization and consolidation activities. As a result, leasing activity increased during the second half of 2009. Interestingly, sublease space in aggregate declined for the first time in more than two years; however, vacancy will continue to rise and rents will fall throughout 2010.

United States property values are still declining on average under the weight of these fundamentals. Although national average cap rates are expected to reach their cyclical peak as early as Q1 2010, capital values will continue to decline during the first half of the year before stabilizing by Q3 at a total peak-to-trough average decline of near 50 percent. The supply and demand dynamics in the top-tier, coastal office markets for prime assets appear to be working in favor of quicker stabilization of cap rates and some limited compression. Values may actually bottom early in the year and potentially even experience a slight increase in these specific market segments.

Although sales activity in the US bottomed out in Q2 2009, the recovery to date continues to be very muted and uneven. During Q4, preliminary data indicate that total volume increased by 8 percent over Q3 to reach just over \$13 billion and bring the early estimate of full year 2009 overall volume to a mere \$45 billion. This depressed level is 44 percent lower than the low volume recorded in 2001, as well as just 11 percent of the record office volume of 2007. The office sector experienced the sharpest decline in transaction volume for the second consecutive year, with a 74 percent decline by value.

### **A comment on Dubai**

The opening of Burj Khalifa, the tallest built structure in the world, marks the end of a 'transformational' decade in Dubai real estate. As part of its ambitious plans to establish Dubai as a truly global city, the government embarked upon a hugely ambitious program of both physical construction and legal / regulatory reforms. The fruits of this investment created a thoroughly modern and efficient city, but have also resulted in a burgeoning level of debt (conservatively estimated to be in the range of \$80 to \$100 billion), primarily from infrastructure and real estate projects.

A significant amount of this debt has been incurred by real estate developers such as Nakheel (which forms part of the government-owned Dubai World Group). It was the controversial circumstances surrounding the repayment of a major tranche of this debt that placed the spotlight of the global financial community firmly on Dubai in the final months of 2009. This bond was eventually repaid in full on the due date (December 14), with resource rich neighbour Abu Dhabi providing \$10 billion for Dubai's financial support fund, thereby avoiding an embarrassing default. This repayment provides firm evidence of the unity of the main states, in the United Arab Emirates, and has been interpreted as a significant change in the operation of this moderate, 38-year old Federation.

Given the current oversupply in many sectors, we will see a shift this year from asset creation to asset management as the market moves into a period of more controlled and regulated growth. We also expect to see a greater emphasis on corporate governance and market transparency, with the increased recognition that improvements in these areas are no

longer optional but essential in avoiding the uncertainties that surrounded the recent debt restructuring. The future of Dubai is a subject of substantial interest in itself, as well as for the implications for the region and the rest of the world. We will be writing more on this in the coming months.

## Real estate market capital: sources and progress

### CMBS revival?

In Q2 2009, investors started gaining confidence in the US economy by selling Treasuries and moving back into riskier assets. Investors' growing appetite for risk is evidenced by the change in credit spreads. For example, in November 2008 yield spreads on the most-senior 10-year commercial-mortgage securities originally rated AAA were a record 14.26 percentage points by the first week of January 2010 they had contracted to 3.99 percentage points. By November 2009, new-issue CMBS had re-emerged in the United States with three deals pricing within a one-month period. While difficult to project CMBS volumes beyond this year, in 2010 we are likely to see volumes totalling less than \$30 billion in the range of the mid-to-late 1990s. That said, there will be sharp differentiation between primary and secondary trades, suggesting that investors are carefully considering underlying collateral.

In Europe, the gradual return of the CMBS market in 2009 was evident in three major CMBS transactions done by Tesco Property Finance and Land Securities. However, to underpin a healthy real estate investment environment, the European CMBS market will need to recover much further. The challenge is that while further CMBS issuances are anticipated this year, they are expected to be at a low level. Although banks are being encouraged by government schemes to participate further in the market, there will be limited reliance on CMBS to spread the risk. Those that do occur will be uncomplicated "vanilla" deals characterized by low risk, high regulation and low leverage.

Existing bondholders across Europe continue to be nervous about the CMBS market because, in many cases, their exposures and outcomes of refinancing/extensions remain unclear and because the need to unravel exposures is likely to prove complex and time consuming. Meanwhile, banks in 2010 will be looking primarily to repair their balance sheets rather than originating new loans. Given these circumstances, 2010 will likely only represent the beginning of the rejuvenation process for the European CMBS market.

### Insurance

Other positive developments will likely occur in 2010. For example, life insurance companies - which effectively sat out the commercial property markets during 2009 - are expected to be large debt lenders during 2010. A recent report by Barclays validated life insurance company statements that they will take little if any losses on their CMBS investments given their high position in the capital stack and substantial subordination to absorb losses. As a result, life insurers are expected to deploy billions of dollars into the US commercial real estate markets this year.

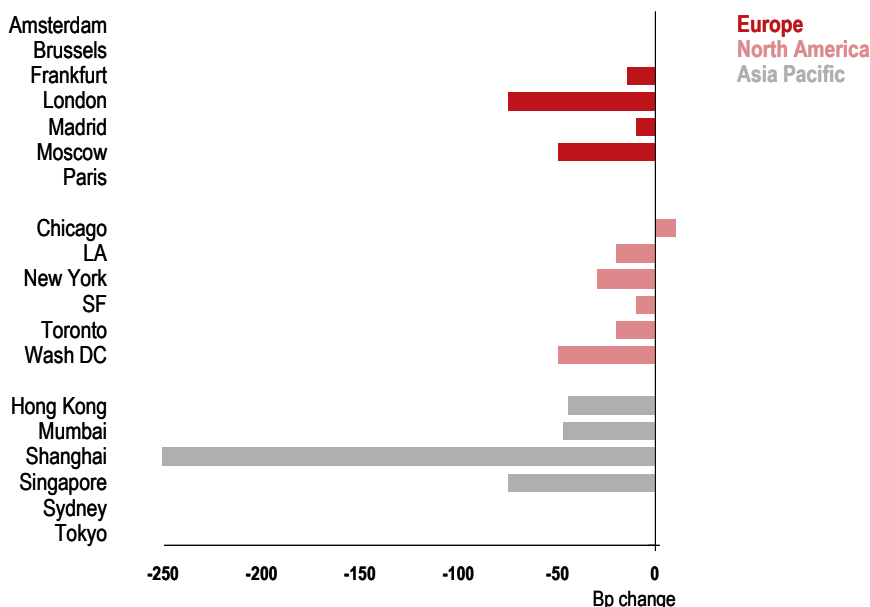
### REITs

On the public equity side, global REIT equity prices have rebounded by well over 100 percent since their March 2009 lows and REITs were able to raise near record amounts of capital through the debt and equity markets. Strong demand sent debt spreads for investment grade US REITs down approximately 900 basis points in 2009 to approximately 280 over Treasuries. In fact, the top 10 US REITs by market capitalization have more cash on hand and availability under credit lines than they had at the top of the market.

## Orderly transaction flow for high quality assets

During the past three months investors have shown interest in transactions for prime real estate with solid cash flow in good locations. Among these assets, yields have tightened, but lesser demand for secondary assets is likely to keep their yields high in 2010.

### Global Offices: Prime yield shift Q2 2009 - Q4 2009



December 09 Preliminary Data

Source: Jones Lang LaSalle, January 2010

The year ended with the resumption of cross-border investment and the return of the billion-dollar transaction. In Asia, late last year Jones Lang LaSalle assisted Secured Capital Japan in the acquisition of Pacific Century Place, a grade A office property in the prime business district of Marunouchi, Tokyo. The price, which was in excess of \$1.5 billion, makes it the largest transaction in Japan since the start of the global financial crisis - and the largest in the world in 2009. In Australia, on behalf of the Commonwealth Property Investment Trust, Jones Lang LaSalle sold RBS Tower @ Aurora Place in Sydney to South Korea's National Pension Fund. This iconic office building sold for A\$685 million, one of the largest transactions in the country in more than a decade (initial yield of approximately 6.6 percent).

In Scotland Hammerson and Canada Pension Plan purchased Glasgow's Silverburn shopping mall for £297 million at a net initial yield of 6 percent. In Germany, Deutsche EuroShop acquired a Berlin shopping center, the A10 Center, from the liquidator of the previous owner for €265 million including planned modernization and new development.

In the global hotels sector, transaction activity also has begun and Jones Lang LaSalle Hotels is projecting the first rise in volumes for two years, increasing by up to 40 percent to reach \$13 billion globally in 2010. Jones Lang LaSalle Hotels is marketing several hotel deals in Japan, London, Geneva and Los Angeles where the top bidders are cross-border buyers. Initial bids for these properties came in at the top end of pricing expectations in recognition that occupancies are beginning to improve at the same time that business cost-cutting measures are starting to yield real results.

For the most part, recent transaction flow in the global investment markets has been recovering and the trend toward increasing sales velocity is anticipated to continue in the year ahead. The flow of asset sales from failed banks and other distressed portfolios will lead to some market volatility. Sale prices of these transactions will be heavily discounted.

By conducting highly structured, orderly dispositions regulators will attempt to minimize disruptive impacts on the market as well as avoid the type of fire-sale prices seen during the US savings and loan crisis in the early 1990s

In the United States, transaction activity is forecast to rise significantly from the very low base established in 2009. As a base case, overall transaction volume is projected to increase 30-50 percent, while offices, which were the hardest hit over the past two years, may outperform by increasing 50-70 percent in dollar volume. If lenders begin to call in their loans this could lead to a sales surge which in an extreme scenario could drive US transaction volume beyond \$100 billion in 2010.

In the UK, a couple of major property groups were recently placed into the hands of receivers. While these failures may result in more supply hitting the marketplace, that supply is not likely to be made up of the kind of prime, well-leased, investment-grade assets that investors are currently seeking. So far, bank dispositions have been orderly. A combination of rising market capitalization and a partial recovery in real estate values for prime assets could lead banks to release more stock for sale.

## Options open up for strong corporate occupiers

Corporate profits around the globe have shown some resilience over the past year, but a full corporate recovery will depend on the ease of credit availability. In 2009, global companies issued a record amount of corporate debt, both investment-grade and high-yield. In the United States, issuance totalled \$1.24 trillion, compared to the previous record of \$1.17 trillion in 2007, and to date shows no sign of slowing down. Additionally, the rate at which companies defaulted on their debt fell for the first time in two years in the fourth quarter. The global speculative-grade default rate also dropped to 12.5 percent from 12.6 percent the previous quarter. In another positive development, corporate borrowing costs are at a five-year low and non-financial companies had more than \$700 billion of cash at the end of the third quarter, up 40 percent over the 2004-to-2008 average.

Strengthened balance sheets may help bolster merger and acquisition activity (according to a survey by UBS and Boston Consulting Group, one in five European companies say they plan to be involved in a merger in 2010). Cost saving will still be a clear objective. But the catalysts for action – consolidation, integration and potentially the upgrading of space requirements – are different from the headcount reductions of 2009. Brand mergers and the relocation of staff into single facilities will offer more strategic benefits.

As confidence returns, a number of important cultural and operational shifts in the procurement and utilization of corporate real estate are set to emerge:

### **1. Upgrading but cutting deep into core space**

Market conditions around the globe are allowing tenants to consider upgrading their space and locations at zero or little cost, but this opportunity will narrow in 2010 as rental rates bottom out in many markets. Financially strong corporations can use their leverage to enhance non-economic lease provisions, which will drive an improvement in leasing volumes in 2010. But such activity will be tempered by a strong and sustained attack on occupiers' core space as better "line of sight" regarding real estate costs and ambitious saving targets are put in place.

We have witnessed this trend across industry groups and in many geographies. In the US insurance sector clients have been rapidly downsizing their core portfolio through space consolidation, subleasing, early terminations and placing space into reserve. These initiatives have led to the carving away of as much as 10% of their total portfolio – driving down total occupancy costs and assisting improvements in the corporate P&L. We have also seen occupiers

consolidating multiple brands and associated staff into single facilities not only to achieve headcount and cost reductions but also to facilitate a more collaborative working culture.

## 2. Alternative workplace strategies finally coming of age?

Linked to space rationalization is the rekindling of interest in alternative workplace strategies (AWS). AWS have been in the corporate real estate lexicon since the early 1990s but there is a sense from many markets that now is the time to activate these initiatives. There is no doubt that major corporates from across sectors are implementing workplace programs designed to provide flexible work space and reduce space needs. They are doing so in the context of strong portfolio planning that delivers global consistency and competitive real estate solutions that are attuned to the wider rhythm of the business and planning processes.

## 3. Reassessing own vs lease decisions

The direction of typical corporate real estate tenure will also be challenged over the next decade. Corporate occupiers, whose balance sheets are in much better shape than some real estate investors, are increasingly exploring the possibility of using their lower-cost capital to drive down long-term occupancy costs by acquiring distressed facilities at deep discounts. Furthermore, proposed lease accounting changes will eliminate the traditional objections to ownership.

## 4. Sustaining cost avoidance will be key

Real estate costs are more transparent and better understood post downturn. Cost consciousness is likely to remain part of the corporate DNA even as growth returns. However, the focus will shift steadily from direct, short-term savings to some targeted investment aimed at longer-term cost avoidance. For example, in Asia Pacific a return to headcount growth has led to a renewed interest in the potential cost efficiencies of campus developments.

Many global corporations activated a lean operating agenda through the difficulties of 2009 but kept issues of strategic importance in their longer-term thinking. Sustainability is one such important issue, not least because of the cost saving opportunities of implementing energy efficiency programs, as is well documented in the recent CoreNet Global and Jones Lang LaSalle survey. While outside of Australia action on wider sustainability measures remains at low levels, interest remains high in the growing evidence of the quantifiable commercial benefits.

## A Look Forward

The coming months will be a challenging mixture of upside surprises tempered by continuing caution in the market. In particular the outlook will be influenced by:

**How fast policy interest rates rise and where** - Australia and Asia Pacific are likely to be out in front given the vigor of economic recovery in the region combined with asset prices showing some initial signs of froth. The pace of recovery in the property markets around the world will be affected by the timing of central banks withdrawal of financial interventions.

**The depth, extent and timing of the “makeovers”** to financial regulation in different markets.

**The stock shortage - in the majority of highly developed markets in 2010**, there will be an imbalance in volumes of available capital to invest and the numbers of desirable assets on the market. The search for yield will intensify against a backdrop of weak fundamentals and these shortages of stock will lead to limited opportunities to acquire institutional-grade assets.

**Occupier strategies in search of solutions** that balance short term cost savings with medium to longer term strategic needs. Outsourcing will figure strongly on the agenda as will a rethinking of workplace strategies and the opportunities of M&A.

**The larger emerging markets (China, India, Brazil) are being looked to for speedy recovery** and for new opportunities as the rest of the world regains its confidence.