

## Gradual economic stabilization amidst conflicting signs

The past several weeks have delivered more signs of global economic stabilization, prompting a growing list of world leaders and economists to predict a recovery—or, at minimum, a stabilization—in the second half of 2009. As with any battle back from the brink, the road to recovery hasn't been smooth, nor has it taken hold in equal measure across geographies. Further improvements in the global economy and financial markets are needed before they can have a discernible positive impact on property market sentiment. In addition, the speeds at which various property markets will recover remain uncertain. This edition of the *Global Market Perspective* examines the effects of economic stabilization on the global property market and the prospects for its recovery.

### Government, rating agency reversals could forestall property market recovery

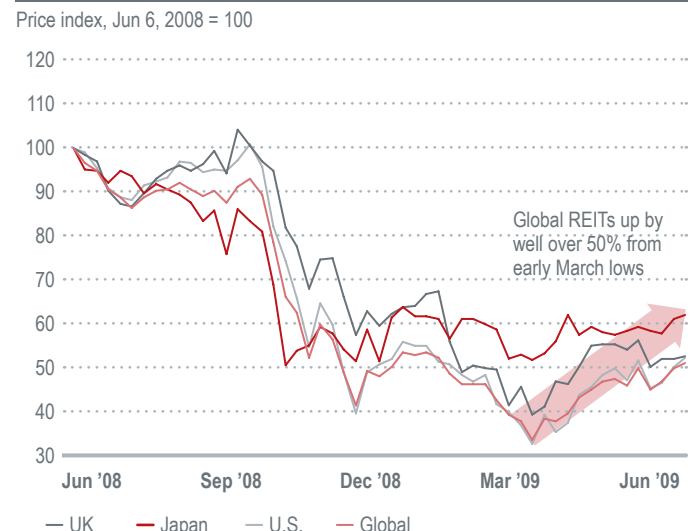
Even with good news about the global economy spreading, market observers are beginning to wonder which indicators to believe. Banks are performing better than expected and the public equity markets continue their recovery. However, conflicting economic data is being reported, and there have been a number of surprising administrative program reversals. In the United States, many are questioning whether any of the administrative programs ultimately will help real estate lending, apart from the Term Asset-Backed Securities Loan Facility (TALF), in which the government's investment in asset-backed securities has been reducing credit spreads in the market for those securities.

A good case in point is the recent about-face by rating agency Standard & Poor (S&P). At first, S&P reported that AAA-rated commercial mortgage-backed securities (CMBS) weren't likely at risk

for downgrade. Now some of these issues are, which could make billions of legacy CMBS bonds ineligible for TALF funding. Although many investment professionals believe that the original rating will be used to determine TALF eligibility, nothing is certain. The CMBS market reacted negatively to this new development, sending CMBS spreads significantly higher. The new underwriting guidelines that S&P will use going forward could be even more telling as they will determine the way future loans are originated in order to be eligible for TALF financing.

In another reversal, the Federal Deposit Insurance Corporation (FDIC) announced on June 3 that the Public Private Investment Program's (PPIP) Legacy Loans Program may no longer be needed. Financial institutions appear to have raised sufficient funds without having to sell bad assets through the program's proposed mechanisms. With the pressure to sell toxic loans through PPIP eliminated and fresh capital helping to strengthen balance sheets, some argue banks might now increase their workout activity, or hold

**Figure 1** REITs begin long road back



U.S.: Morgan Stanley REIT Index, UK: FTSE 350 Real Estate Index, Japan: Tokyo Stock Exchange REIT Index, Global: Dow Jones Global REIT Index

Source: Bloomberg, Jones Lang LaSalle

or roll over loans on their books until a market recovery occurs in the future. Others, however, worry that the death of PPIP may further constrain lending and negatively affect property markets. For now, market participants are taking a wait-and-see approach.

Many investors think that buying legacy CMBS directly continues to be a better alternative to making new loans. With new TALF-financed issuances set to officially begin later this month, activity should increase, with single-issuer deals emerging by August 2009.<sup>1</sup> TALF remains an important ingredient in the consumer asset-backed sector, where demand remains strong and spreads continue to recover. However, a real program for re-energizing CMBS and increasing credit availability for real estate is still a way off.

Meanwhile, a global property securities rebound is occurring, providing hope for a similar rebound in property prices. Since their recent lows in March, property securities indices have risen quickly in Singapore, up to 114 percent, and in Hong Kong, they've reached 76 percent. Real Estate Investment Trusts (REITs) in Europe and the UK (up 35 percent) also are amassing significant capital, though they are still a primary asset seller (see Figure 1 on previous page).

U.S. REITs have raised a massive \$14 billion in new debt and equity capital in 2009, leading to a very buoyant sentiment in that segment of the market.<sup>2</sup> Many of these REITs have indicated that the funds will be used to shore up balance sheets and take advantage of opportunities in the next 12 to 18 months. While U.S. REIT prices have risen by 60 percent since March, they remain well below 2008 levels (Figure 1). However, the recent rally is a strong positive sign as the publicly traded market has served as a leading indicator of property prices. In contrast to the optimism on the public sector, private equity remains cautious, still taking write-downs, preferring instead to wait for what they believe will be further re-pricing.

### **Re-pricing fuels increased activity in select global markets**

Although the global economy is demonstrating some signs of stabilization, property market recoveries generally lag the broader economy. Recent Jones Lang LaSalle analyses of U.S., UK and Australian commercial property data show that capital values and tenant demand can lag the economy by one to three years. The extent of the lags is highly dependent on local conditions including the degree of value decline, supply and demand fundamentals, and the nature of local industry drivers.

Jones Lang LaSalle's Global Real Estate Health Monitor analyzes the leading health indicators of global commercial property market activity. In June's reading, indicators point to slowing recession signals and signs of stabilization (Figure 2). Across most of the world, the largely negative monitor figures are the lagging indicators.

In Asia Pacific, some hopeful signs are evident. For the first time in more than a year, there were meaningful commercial property transactions in the region, most notably in Singapore, Korea and Japan. For example, the AIG Otemachi Building in Tokyo sold for \$1.2 billion in May at a net initial yield between 3 and 4 percent. Anson House in Singapore transacted the same month at \$58 million at a net initial yield of 6.37 percent. Recent transactions have been driven primarily by interest from private, rather than institutional, investors. However, there is a sizable gap in yields depending on debt levels. In Melbourne, for instance, two comparable office properties recently sold at widely disparate cap rates. One went to a private investor who received a 6.5 percent cap rate while a similar building was sold to an institution at a 9 percent cap rate.

#### **Australia investment and leasing outlook**

The Australian real estate markets improved significantly in recent weeks as the country avoided a technical recession and consumer and business confidence indicators saw strong gains. Many large A-REITs, including Westfield (A\$2.9 billion), Stockland (A\$1.7 billion) and GPT (A\$1.7 billion), successfully raised equity capital, bringing total raisings for the year to A\$7.8 billion. Offshore investors also exhibited strong interest in the direct commercial property market as evidenced by Real IS's purchase of the Edmund Barton Building in Canberra for A\$123 million at a 7.8 percent initial yield. Private Asian-sourced capital purchased assets in Melbourne and Brisbane, while Deka-Immobilien purchased the Australian Tax Office building in Perth for A\$95 million.

Economic growth is forecast to remain below trend over the remainder of 2009, office vacancy rates will rise and effective rents will be under pressure. However, vacancy rates in most markets are not expected to go much above long-term averages (around 8 to 10 percent) due to limited new supply. Despite relatively solid fundamentals, ambitious valuations applied to secondary-grade assets during the boom years will be called into question, and many institutional investors will look to reposition their real estate portfolios. The next 12 months represent a rare window of opportunity for long-term investors to enter the Australian property market.

The Hong Kong residential market has heated up dramatically during the past month, with prices rising around 20 percent from previously depressed levels. This rally has been driven by very low interest rates, the rising stock market and renewed investor interest from China. Given the still-weak economic fundamentals, it remains to be seen whether this rise in Hong Kong property values can be sustained.

In Europe, more than €4 billion of commercial property changed hands during the past month, a return to the monthly pace of first quarter 2009 volumes. However, roughly three-quarters of those transactions took place in the UK, particularly in London, with a

significant share resulting from sovereign wealth funds purchasing re-priced assets from troubled owners.

The Middle Eastern sovereign wealth funds are sending mixed messages with their investments. Many seem to be adopting a two-pronged strategy of refocusing on domestic investment priorities while simultaneously seeking opportunistic foreign investments in London. For example, the government of Oman acquired a 75 percent interest in Bishops Square, a 71,900-square-meter office building in the Spitalfields area of London's financial district for £445 million (€505 million). This month, a joint venture between Al Salam

Figure 2 Global Real Estate Health Monitor

	U.S.	UK	Germany	France	Japan	China	Australia	General trend
Official interest rate	0.13%	0.50%	1.00%	1.00%	0.10%	5.31%	3.00%	Down, stabilizing
GDP QOQ	-1.5%	-1.9%	-3.8%	-1.3%	-4.0%	+6.1%*	+0.4%	Recessionary trend
CPI YOY	-0.7%	+2.3%	+0.6%	+0.1%	-0.5%	-0.3%	+2.5%	Slowing
Consumer sentiment MOM	+34.6%	+3.9%	0.0%	+2.4%	NA	+0.1%	-4.3%	Generally stronger
Employment YOY	-3.6%	-1.3%	-0.4%	-0.7%	-1.3%	+1.0%	+0.1%	Generally falling
Retail trade MOM	-0.4%	+0.8%	+0.9%	-0.8%	+0.6%	+0.6%	+0.3%	Generally stronger
Housing starts YOY	-54.2%	-44.2%	NA	+3.1%	-32.6%	+1.4%	-19.5%	Very steep falls
OECD leading indicator MOM%	-0.6%	+0.3%	-0.4%	+1.2%	-1.1%	+0.9%	-0.6%	Mixed
Manufacturing PMI, index level	42.8	45.4	39.6	43.4	46.6	51.2	37.5	Increasing
Stock market, MOM to May 29	+5.3%	+4.1%	+3.6%	+3.7%	+7.9%	+6.3%	+1.0%	Continued gains
REIT market, MOM to May 29	+1.7%	-4.7%	+40.5%	+5.4%	+6.7%	NA	+3.6%	Generally up
<b>General trend</b>	Recession	Recession	Recession	Recession	Recession	Slowing growth	Skirting recession	Signs of stabilization

Data represents most recent period available.

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

\* Chinese GDP equals YOY

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

Bank (based in Bahrain) and Evans Randall purchased Milton Gate in London from UBS for £127 million at a 7.45 percent yield. The sovereign activity overseas possibly reflects reduced pressures at home due to higher oil prices, which have nearly doubled to almost \$70 per barrel (Figure 3).

Warburg-Henderson KAG also has identified the UK as a specific target for immediate direct commercial property investment, with up to €200 million scheduled for investment in the UK this year. It purchased No 1 & No 7 Exchange Crescent from Standard Life Investments for approximately €60 million at an initial yield of 6.75 percent. There also were minor increases in France, where Hammerson sold Les Trois Quartiers, a 30,000-square-meter retail and office building in the Madeleine Quarter of Paris, to a private equity advisor for €210 million.

Many observers are keeping a close eye on Aviva's attempts to dispose of a large UK portfolio. At present, market consensus suggests that pricing will need to come down to reflect the fact that the offering comprises largely non-core assets.

There has been a notable trend of foreign owners—facing their own troubles at home—beginning to sell. Germany also is moving closer to nationalizing real estate lender Hypo Real Estate AG.

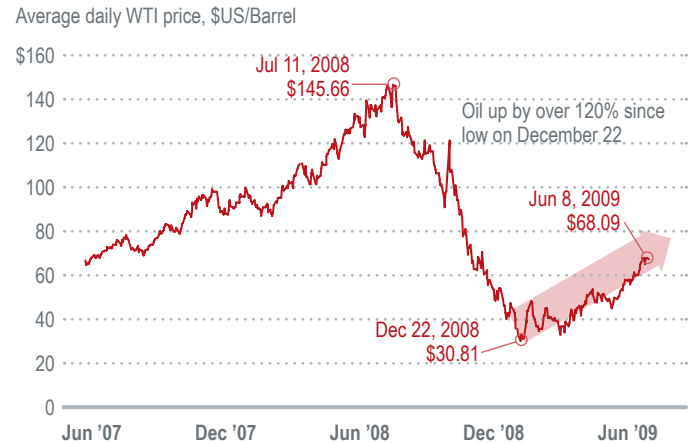
As in Europe, conditions in the Americas are mixed. In Mexico, opportunities abound to purchase lower-priced assets at 13 to 20 percent returns, but these offerings are generally unattractive product to institutional buyers. There is some evidence that banks are in the process of activating their real estate lending departments with multiple offers on a recent \$50 million loan request. In Brazil, transaction volume remains muted. Transactions that have occurred have been very selective and at a cap rate of approximately 12 percent.

In the United States, capital values have fallen nearly 50 percent, and a growing number of properties are listing for sale. The key to transaction success is assumable or seller financing. Deutsche Bank is selling Worldwide Plaza in New York City to an investment group led by RCG Longview and George Comfort & Sons, which reportedly will put up \$165 million in equity and assume a \$450 million mortgage.<sup>3</sup>

### Dual forces affecting hotels

A set of “good news/bad news” factors presently is driving the hotel market. On the one hand, the ability of U.S. REITs and Australian property funds to raise capital has made them less willing to sell, resulting in reduced transaction volumes. On the

**Figure 3** New world with oil back on the march?



Source: Wall Street Journal, Moody's Economy.com, Jones Lang LaSalle

other hand, private equity owners are returning more product to the market, although the sense is that they need to reduce their pricing expectations. As with other sectors, hotel buyers seem quite willing to wait for better pricing, which many believe will not occur before 2010. High-net-worth investors, however, have been seeking out opportunities in Japan and Australia and on the West Coast of the United States. There is also strong interest in London hotels, although there is currently limited quality stock available for sale.

### Corporate consolidation presses on

Corporations continue to consolidate, driven partly by their need to reduce space freed up by downsizing and partly by merger and acquisition activity. However, many corporations are actively seeking to restructure by divesting from specific business lines and exiting certain emerging markets that they entered during the boom years. This corporate restructuring will create disposition activity and competitive acquisition options for strong corporations. The need for corporations to dispose of vacated space could bring billions of dollars of assets to the market in the second half of the year and into 2010 as companies continue to clean up their balance sheets. That activity is happening across a wide array of businesses. For example, Lloyds Banking Group reportedly is shedding eight regional offices along with 1,000 retail outlets in an effort to cut £1.5 billion in operating costs.<sup>4</sup>

### Signposts in the battle back

The ongoing improvement in economic indicators increasingly points to an economic recovery by year end. However, these

short-term cyclical moves make it very difficult to conclude that property markets have hit bottom. Watch for these indicators to come:

- **Government programs:** In many ways, government programs have been successful in restarting capital flows and restoring confidence to the market. They have not, however, been as successful in helping banks remove residential and commercial mortgages from their balance sheets. The markets seem to be healing themselves, as corporations are able to tap the bond and equity markets, financials are clearing toxic loans privately and global stock indices are rallying. It is clear that it will take more time before everyone is on the same page for a program that addresses the looming commercial mortgage refinance crisis. It wouldn't be surprising if the capital markets found a way to restart lending without government help.
- **Macro economic developments:** The doubling of oil prices from a mid-March depth to a \$70-per-barrel price in mid-June could slow the economy's recovery. Another potential blow to the economy is a surge in U.S. Treasury yields and mortgage rates. A sustained run-up in both could further hamper the real estate debt markets as the cost of capital increases and fundamentals further deteriorate.
- **A reversal of the "denominator" effect:** The recent rally in global equity and corporate bond prices has somewhat reversed the "denominator" effect, whereby institutional investors were left with an over-allocation to real estate and an underweighting in equities and bonds. To the extent that equities and corporate bonds continue to rally, the pressure slowly will be lifted from institutional investors, who previously might have been forced to dispose of real estate investments. A full recovery in equity and corporate bond prices would likely mean that institutional investors ultimately could be underweighted in real estate and become buyers once again.
- **Pricing trends:** The approaching onslaught of loan maturities will drive the trend toward deleveraging. This, in turn, will force more sales and recapitalizations. Investors in many quarters have

indicated that they will not become buyers until they are satisfied that the current cycle of re-pricing is at or near its end, which they view as at least a year away.

- **Covered bond relief:** In a sign that credit market liquidity continues to improve, some large banks have issued covered bonds as an alternative funding source to tapping government-guaranteed issues. For example, Deutsche Bank recently issued its inaugural €1 billion Pfandbrief (German covered bonds), an issue that was oversubscribed more than five times. There is also much discussion that the dormant covered bond program in Canada will be revived soon and that U.S. banks may begin to issue covered bonds as well.
- **Future securitization model:** All U.S. eyes will be on the rating agencies as they give guidance on future underwriting standards and on private equity firms that plan to create funds designed around writing loans for securitization. Buyers of the super-senior bonds would be eligible for TALF, and the private equity firms would continue to hold the remaining classes. How these funds play out may serve as a model for future securitization programs.

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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](mailto: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.joneslanglasalle.com/globalmarketperspective](http://www.joneslanglasalle.com/globalmarketperspective). 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.

<sup>1</sup> Citigroup Global Markets Inc, Fixed Income Strategy & Analysis Securitized Products Strategy, June 10, 2009

<sup>2</sup> Morgan Stanley US REIT Index

<sup>3</sup> Wall Street Journal, "Investor Group to Buy Troubled New York Office Tower", Lewis/Corkery, June 4, 2009

<sup>4</sup> "Property Week, "Lloyds to Close 1,000 Branches," Rigby, 5/6/09