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# Global Real Estate Outlook 2009



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## Overview

The seismic shock, with the U.S. subprime sector at its epicenter, delivered to the global economy in the latter part of 2007 created a tsunami of economic and fiscal chaos that swept the globe in 2008. As we approach 2009, further aftershocks are emerging on a near daily basis and show little sign of abating. **It is the opinion of Pytheas that this is not an ordinary downturn, but rather a structural correction in global capital markets which will impact upon every sector of the economy and real estate market.**

GDP Forecasts (%)	2007	2008	2009
North America	2.0	1.4	-0.5
Euro Zone	2.6	0.5	-0.6
Japan	2.1	0.5	-0.1
Asia Pacific	10.5	8.5	6.7
Indian Sub-Continent	8.4	6.3	5.4
Eastern Europe	7.1	5.3	2.7
Latin & South America	5.7	4.4	2.1
M.E.N.A.	5.8	5.8	3.9
Sub-Saharan Africa	6.3	5.4	4.6
<b>Global</b>	3.7	2.5	0.9

Source: World Bank

This is reflected in a plethora of depressing forecasts around the globe. World Bank data records real, global GDP growth of 3.7 percent in 2007. Estimates for 2008 suggest a decline to 2.5 percent before a nosedive forecast to 0.9 percent in 2009.

**The turn-of-the-century economic boom has passed, and deflation now looms large on a once in-a-generation scale, impacting even the most buoyant international economies.**

The previous contention that emerging markets would largely escape the financial crises in North America and Europe looks to be overly optimistic. Double-digit GDP growth in China throughout much of this decade is forecast to be only 7.5 percent in 2009. This is still very high in international terms, but unemployment is now rising in China, corporate failures are increasing and corporate investment is tapering rapidly. In India, 2007 GDP of 9.0 percent is forecast to fall to 5.8 percent in 2009 with the residential and retail sectors

bearing the brunt of the impact. Highly dependent upon manufactured goods and international consumer markets, growth in emerging economies is stalling, and this will have a lagging effect on what has been a buoyant real estate sector.

**The economic impact of terrorist action**, terribly manifest recently in Mumbai, **is now lost in a far more profound wave of market correction.**

In Europe, Euro-Zone real GDP growth came in at 2.6 percent in 2007. This is projected to fall to 1.1 percent in 2008 and to an outright decline of negative 0.6 percent in 2009. The UK has been particularly hard-hit by a series of high-profile banking and corporate failures, plummeting home prices and escalating unemployment. Large sections of the UK economy are now in transition to state ownership as the government intervenes to support system-critical institutions and major employers. The unprecedented level of public debt inherent in these policies echoes perfectly the issues facing the U.S. The short-term outlook for the British pound, already sharply corrected against the Euro and the Dollar, is extremely challenging.

Elsewhere in Europe, Iceland faced fiscal Armageddon in the third quarter, and the decade-long economic bull-run in Ireland waned sharply. Germany, France and the Benelux nations are in the process of deploying public debt to prop up ailing organizations, notably including those with high exposure to real estate.

In Eastern Europe, Russia has been hit by a liquidity crisis and sharp downward corrections in commodity pricing. Rapidly rising output and prosperity in Poland, the Czech Republic, Hungary and Romania is now diminishing.

In the Middle East, capital reserves remain extremely high, leaving sovereign wealth capital a powerful driver on an international scale. However, the recent yo-yo correction in oil prices has reduced income and liquidity, and the extraordinary development boom which has characterized the region now looks unsustainable, especially in Dubai where wholesale fiscal intervention in real estate debt seems imminent.



In Latin America, real GDP is set to shift from 5.7 percent in 2007 to 2.1 percent in 2009. A dual reliance on agricultural commodities and exports to the U.S. leaves the region notably vulnerable.

In sub-Saharan Africa, low producer prices and commodity dependency have cushioned the region somewhat. Here, GDP is set to fall modestly to 4.6 percent in 2009 from 5.4 percent in 2008. Political turbulence in South Africa, unrest in the Congo and the pariah status of Zimbabwe provide an unsettled business environment overall.

In Canada, the reliance on energy and commodities, particularly in the western provinces, resulted in an economic boom in 2008, but the tank was running low by yearend. Nevertheless, the nation's financial institutions sidestepped the worst of the abuses witnessed by their U.S. and European counterparts, which should help cushion the slowdown.

One benefit of the global market correction has been the rapid evaporation of inflationary pressures in most key economies. The decline in inflation has left governments less reticent in using interest rates as a weapon in the battle to stave off sharp economic and commercial decline.

Almost unprecedented interest rate reductions on an international scale in the third and fourth quarters, especially in North America and Europe, reflect strong, cross-border political consensus regarding the severity of the current recession. Other fiscal measures, including VAT reductions and the suspension of real estate transfer taxes, have also been deployed on a multi-market basis.

A key issue for 2009 will be the extent to which these lock-step revisions to interest rates to 50-year lows will have the desired impact of de-icing the capital markets and reassuring the frightened consumer sector. Despite very strong political pressure, the inability or unwillingness of the banking sector to pass on interest rate reductions to debt-laden businesses and consumers is blunting government efforts to keep economies afloat.

#### Key forecasts for 2009 include:

- Unemployment looks set to rise on a global scale as the seismic events in the 2008 capital markets are played out in 2009.
- Further consolidation in the banking industry and wider financial sector pain is inevitable.
- State intervention in the private sector will continue to rise whether through direct, post bail-out control measures or indirectly through increased regulation. The tenets of the free market will be severely tested and mounting political controversy is assured.
- Interest rates will fall further and remain low as governments scramble to maintain a vestige of business and consumer confidence.
- The residential market will correct downwards on an international scale as over-gearing becomes yet more apparent in developed economies and as over-speculation and over-development become visible in emerging markets.
- A perfect storm of rising unemployment, high debt to income ratios, reduced investment product performance and falling home prices, amidst a general context of reduced confidence, will continue to impact savings ratios and consumer spending. A sharp reduction in spending seems inevitable.
- Headline-grabbing corporate failures look likely to continue, especially in the financial services, automobile, manufacturing and retail sectors.
- Taxes, both personal and corporate, will diminish as governments attempt to kick-start commercial activity, although the reduced revenue inherent in these policies, particularly within the context of burgeoning public debt, will provide cause for medium-term concern and higher taxation in the future.
- It will be a good time to buy just about anything subject to having access to appropriate finance.

Another key issue for next year will be the success or otherwise of the global injection



of public capital into the banking system, now running into several trillion dollars. This is designed to nullify toxic debt, bolster balance sheets and unblock the capital markets. Thus far, these efforts look to have been largely unsuccessful. It is reasonable to expect that, despite protestations to the contrary, the growing number of state controlled seats at the

global banking boardroom table will be used more aggressively in 2009 to badger the banking system to resume lending.

## Offices

Grade A Office Costs (€/m <sup>2</sup> /per Annum)			
Amsterdam	3.90	Madrid	6.37
Athens	4.59	Mexico City	2.95
Bangalore	2.98	Milan	6.28
Bangkok	1.71	Moscow	17.09
Barcelona	3.90	Mumbai	12.13
Beijing	3.79	Munich	4.33
Berlin	2.82	New Delhi	8.73
Birmingham	6.14	Nicosia	12.64
Brussels	4.27	Paris	9.63
Buenos Aires	3.80	Prague	3.86
Dubai	11.33	Rio de Janeiro	4.91
Dublin	7.77	Rome	4.94
Edinburgh	5.92	Seoul	4.33
Frankfurt	5.39	Shanghai	5.20
Geneva	5.68	Singapore	9.82
Ho Chi Minh City	6.64	Stockholm	5.44
Hong Kong	16.81	Sydney	4.35
Johannesburg	1.41	Taipei	3.26
Lisbon	2.90	Tokyo	13.19
London - City	10.59	Vienna	3.35
London - West End	17.82	Warsaw	5.15

Source: Pytheas Investors Service

In the face of mounting crises in the financial markets, the world's major office centers held up relatively well through the subprime meltdown of late 2007 and early 2008. This reflects the fact that market fundamentals in the office sector were comparatively healthy at the onset of the current down cycle relative to previous recessionary periods. Whereas the real estate recession of the early 1990s had much to do with over-speculation in office development, the current crisis stems from

excessive investment speculation and the over-deployment of debt in asset transactions.

In consequence, kick-off vacancy rates and rental dynamics at the start of this correction were much healthier than in previous recessions. This lent the market surprising and welcome resilience for much of 2008. However, near the end of 2008, vacancy rates began to track upward moderately in nearly all major world centers, and downward pressure on rental levels began to intensify. There are however, significant regional variations.

Although market conditions in Asian centers are softening, prime rental levels have reached stasis rather than decline, and although supply is rising, this is typically a result of constrained access to credit, giving some tenants a welcome uptick in choice. Shanghai, Seoul, Hong Kong, Singapore, Mumbai, New Delhi and Bangalore are approaching the top of their local cycles but are not yet in distress. These markets still occupy the upper echelons of the global rental market, and vacancy rates are generally still in single digits. Hong Kong and Seoul remain particularly constrained by supply with vacancy around 2 percent and edging up only very slowly. This is likely to support firm rental levels through the global downturn. In contrast, Singapore, Shanghai and Beijing are forecasting significant supply increases as pre-crisis construction initiatives come on line. This will moderate rental levels in 2009 and 2010.

In Europe, rental growth was still evident throughout much of the first half of 2008 despite the deteriorating fiscal climate. In all European markets however, a decline in new requirements is now leading to increases in tenant incentives, which is viewed as a precursor to softening rents in 2009. The financial centers of London, Paris and Frankfurt are naturally especially exposed in the current downturn and double-digit vacancy rates and a 20 percent decline in financial service area rents is predicted. The West End of London remains supply constrained and the world's most expensive market by far, but the disappearance of money-no-object hedge fund tenants will smooth rental spikes and



stabilize the core district at around £100 per square foot per annum.

Throughout Europe, and indeed the rest of the world, the vast majority of trophy skyscraper projects, threatening to deliver millions of square feet of new space to local markets, have been put into hibernation by the credit crunch. These schemes, for the most part, suddenly appear indulgent and fanciful and, more prosaically, totally un-fundable in today's market. Generally within Europe, with notable exceptions such as the City of London, the volatility in the supply/demand balance in the office sector is forecast to be relatively muted in comparison with previous cycles. This, however, reflects improved calibration in the delivery of new stock as opposed to strong underlying demand.

As an emerging market, Latin America has enjoyed a buoyant office market profile in recent years. Strong demand and limited supply have created low vacancy and firm pricing. Demand has been especially strong in Sao Paulo and Rio de Janeiro. Whilst market sentiment is undoubtedly weakening, the major markets of Mexico City, Santiago, Buenos Aires, Sao Paulo and Rio all have year-end vacancy rates of around 5 percent or less. Although multinational demand for space will certainly diminish in 2009 and supply will rise as new developments come on line, the overall prognosis for Latin American offices is relatively benign and considerably more positive than in more developed parts of the global economy.

In Canada, market conditions are expected to shift from very tight in many centers to a more balanced condition over the course of the coming year. The booming Canadian economy pushed demand above supply in several of the major centers, particularly in western Canada, during 2006 and 2007. Stagnant economic conditions in 2009 will reduce demand at the same time that new supply is coming online in several markets. Although overbuilding is not anticipated, the combination of new supply with thinning demand should bring market conditions more into balance by year-end, providing tenants with a better set of opportunities than they have enjoyed for several years.

In line with reduced corporate activity, off-shoring office-based activity in emerging markets is likely to slow markedly in 2009. Customer sentiment, security concerns, domestic job protectionism and a pronounced reduction in cost advantage, especially in India, suggest a leveling off in this part of the market.

It will be an unfortunate consequence of the recession that the drive toward environmentally sensitive office buildings with strong carbon credentials is likely to slow somewhat as developers and tenants take a more pragmatic approach to operations and costs. Looking to the longer term however, developments which address these key themes are still likely to enjoy market advantage.

## Industrial

As with the international office market, the effects of the current downturn in global economic growth on the industrial sector are re-differentiated by geography.

In the key emerging markets of Asia, production and trade volumes have generally fallen relative to 2007 but remain comparatively healthy. The Asian markets have attracted significant interest from Western developers and investors, most notably in both India and China. With property company fortunes now wavering, there are increasing signs of international developers mothballing Asian projects. This will intensify supply shortfalls in select locations.

Although export growth was slightly down from 2007, the key Chinese market remained fairly strong in 2008. However, the sharp decline in consumer expenditures and confidence in North America and Europe is bound to reduce demand for Chinese exports in 2009 and slower growth is therefore anticipated. From a real estate perspective, China remains constrained by a shortage of high quality floor space. While the lead markets of Shanghai, Beijing and Guangzhou have experienced a marked upturn in industrial and logistics development, supply remains constrained in many second and third tier cities. Park and campus-style facilities are in strong demand, and rents and prices are holding up accordingly. In Hong Kong,



Japan and Singapore, the manufacturing sector is slowing and the employment base is experiencing some contraction and consolidation. Rents are likely to plateau or experience modest decline in 2009.

In Latin America, Mexico's export market has recently slowed sharply in response to the correction in U.S. consumption. There is also a considerable volume of space held within the development pipeline in major Mexican cities, and this suggests rising vacancy rates in 2009. Rents and prices will moderate accordingly. Brazil has enjoyed strong economic growth in recent years with the industrial and logistics sector being a major contributor to commercial market expansion. Industrial development and investment have increased significantly on the back of rising demand and prices. Brazil is, however, at an interesting crossroads with respect to its automobile sector. Auto production and its associated supply chain investment have increased sharply in recent years, servicing rising domestic demand emanating from increased prosperity, together with the more affluent export markets of North America. Future investment plans from the major automakers of Japan and the U.S. do, however, now look less robust, and it seems certain that a portion of this investment will not be realized. Auto sector expansion will likely remain positive, but the pace of growth looks set to ease.

In Europe, most countries are recording annual growth in both imports and exports in the range of 5 to 8 percent. It is likely that activity will fall back in 2009 and 2010 as the recessionary climate impacts demand and consumption. The auto industry, which supports an extensive industrial and logistics market at multiple European hubs, experienced a sharp decline in demand in the third and fourth quarters of 2008, mirroring the U.S. trend. Auto dependent markets like the West Midlands in the United Kingdom may experience difficulties in 2009.

The structural transformation chains and distribution networks, emphasizing ever larger, purpose-built facilities at strategic infrastructure intersections continued in 2008. A more challenging retail sector in 2009 will drive out further efficiencies in supply chain management and distribution

to market. There are, however, now signs that many key European locations are fully supplied with accommodation and that the pace of new development is likely to slow, especially in the case of speculative development schemes.

The global upturn in soft commodity prices witnessed over the past two to three years within the farming and food sector has recently started to moderate, and agricultural prices appear to have peaked. Escalating global demand and multiple supply constraints have however, conspired to create a structural uplift in soft commodity pricing with new benchmarks being established in several key asset groups. In Europe, Latin America, India and Africa, this is stimulating agrarian investment and opening up new territories. In Eastern Europe, inefficient and aging infrastructure is impairing soft commodity production and distribution. In India and Africa, infrastructure needs to be created. A pronounced upturn in soft commodity related real estate development and investment is forecast in the form of new processing plants and modern storage and logistics facilities in multiple world markets.

In Canada, the precipitous decline in global oil and commodity prices has subdued the boomtown atmosphere in Calgary and Alberta. While oil prices are expected to rebound moderately in 2009, companies in all economic sectors are reducing capital spending plans, and growth will be modest at best. Space availabilities remain tight throughout Canada, but vacancy rates are expected to move higher due to an increase in sublease space offered on the market. Landlords may need to adjust their rent expectations accordingly. New construction starts will slow due to the economic deceleration and difficulties in obtaining financing.

## Retail

In Europe, of the three main commercial real estate sectors, the retail market looks set to be the most adversely affected by the global economic downturn, especially in the high street sector. In parallel with the U.S., 2009 in Europe will be characterized by several key factors:



- Ongoing and sharp falls in consumer expenditure, especially on discretionary purchases and luxury goods, reflecting a reversal in consumer confidence.
- Mounting retail failures as corporate debt conspires with falling sales to bring about the demise of even very large retailers.
- Further expansion in the budget and discount sector, especially groceries, as cost sensitive consumers seek regular savings.
- A dramatic escalation in online shopping, bolstering demand for logistics, but weakening demand for physical outlets.

These factors will have a number of impacts on retail real estate in 2009:

- Major new developments will be put on hold until trading conditions improve.
- Vacancy rates will rise, especially in the high street as retailers close underperforming outlets or go out of business altogether.
- Consolidation and mergers in the banking sector, especially in the UK, have created extensive duplication in branch networks and rationalization is assured; this will increase vacancy still further.
- Retail rents will plateau or fall in all but the most supply-constrained and prestigious locations.
- Retail investment capitalization rates will move outward, having been over-compressed in the investment boom years of 2004-07. Retail investment fund performance prospects look particularly bleak in Europe in 2009.
- In Eastern Europe, development and investment volumes, which have mushroomed in recent years, will ease. Mall openings will slow, and some pockets of oversupply will emerge.
- Landlords and tenants will selectively work together to revise rental payments and lease terms to assist cash-strapped retailers.

The prospects for Europe contrast with those of Asia. Despite some signs of caution, retail sales growth is running at

double-digit rates in all of Asia's main markets, stimulated by outright growth and rising inflation. China enjoyed especially strong growth in 2008 with the Olympics adding further impetus to an already buoyant sector. The retail markets of India and China remain profoundly underdeveloped. While economic contraction in the developed world will slow their growth to a degree, the structural transformation of these markets – driven by investors, developers and retailers from overseas – will continue. Although these markets lack transparency and have multiple barriers to entry, they represent significant growth prospects for a rising number of international retailers that are becoming increasingly beleaguered in their domestic trading markets.

Similarly, the markets of Latin America have experienced rapid growth in recent years. Enhanced disposable income levels have nurtured dramatic growth in retail development, especially in Mexico and Brazil where mall development continues apace in nearly all first and second tier cities. As with Asia, the markets of Latin America continue to represent expansion targets for international brands, especially in the grocery and consumer durables sector. With rapid development increasing supply against a backdrop of rising demand, rent and price movements are likely to be incremental in 2009. With many Latin American retailers reliant on U.S. originated debt finance, there is mild concern over corporate liquidity next year, and this may retard some growth and present selected retailers with more challenging balance sheets.

In the Middle East, Dubai has emerged as a global market for high-end retailing on the back of an unprecedented development wave that has delivered multiple, large-scale projects to the market. With its dependency on visitor expenditure, there is now concern that Dubai may be over-supplied with retail space, and it seems likely that retail spending will moderate in 2009. The forthcoming opening of Dubai Mall, the world's largest retail center, will provide a strong indicator of market strength in a more challenging economic climate.

Canada presents a tale of two regions, east and west. The retail markets in the energy



and commodity-driven western provinces – notably Calgary, Edmonton and Vancouver – enjoyed a banner year in 2008 with just a moderate pullback expected in 2009. The eastern region – anchored by the financial center of Toronto – is performing more similarly to the U.S., with retailers expecting a somewhat challenging 2009. Through much of 2008, the weak U.S. dollar drained a number of Canadian shoppers south of the border in search of bargains. Though the dollar strengthened in the fall and winter months, it once again appears on the ropes at the beginning of 2009.

### Investment

On an international scale, the evolution of real estate into a mainstream investment asset class, open to both the public and institutional sectors, has been adversely impacted by the events of 2008. The implications will be deep and long-lasting.

For most of this decade, real estate has been in the ascendancy as an investment medium, attracting vast sums of capital and debt, proliferated via an ever more diverse landscape of listed and unlisted structures underpinned by increasingly sophisticated financial vehicles, a secondary CMBS market and even a nascent derivatives platform. REIT-style legislation in multiple jurisdictions has broadened the investor market substantially while cross-border capital flows reached record volumes in both core and specialist sectors. This rapid, global evolution – less apparent in the already mature U.S. and Canadian markets – shuddered to a halt in the second half of 2008 with early warning signs stretching back to the first half of 2007.

Overshoot on both the upward and downward segments of the real estate cycle is a well established characteristic, and so it has proven to be this time around. Excessive capital and debt allocation produced unsustainable cap rates and prices in most world markets. The severe correction in debt pricing around the globe and the near cessation of lending in many key markets have left many investors extremely vulnerable. Several leading investors, especially in

Europe, have not survived, and there will be more casualties in 2009.

#### Key trends for 2009 include:

- A further softening in cap rates by up to 2 percentage points in core sectors with cap rates on secondary locations and specialist sectors looking especially prone to outward revision.
- An ongoing misalignment between seller expectation and buyer reality, creating a comparatively stagnant market at the asset transaction level.
- An increase in distressed property sales expected to begin in the second quarter of 2009 from all parts of the market, but most especially cash-strapped listed and unlisted funds, together with highly geared, opportunistic vehicles. This will be especially prevalent in Europe where escalating debt costs, rapidly weakening demand fundamentals and cash calls from nervous investors force owners to release product.
- Significant consolidation in the listed sector is anticipated in both North America and Europe as property and construction companies struggle with negative NAV ratios, capital adequacy and debt refinance challenges.
- As in the downward cycle in the early 1990s, banks will assume control of substantial portfolios of distressed and default assets. This will be most common in Western Europe and the Middle East.
- There will be considerable vacillation in the pension fund sector, especially in the developed economies, as funds try to placate crippling liabilities with asset allocation strategies within which plummeting equities have driven real estate thresholds higher than actuarial models would typically sanction.



**In emerging markets, stronger economic and demand fundamentals have lessened the impact of the credit crisis.** Downward capital value revision is, however, now underway in most sectors across Asia, the Middle East, Eastern Europe and Latin America.

**The development boom enjoyed in the emerging markets is now petering out as developers and their financiers review their core holdings and formulate downturn survival strategies.** On the upside, this will reduce the propensity toward over-supply which was becoming apparent in several markets, especially India and the Middle East.

**Inevitably, of course, distress brings with it opportunity for those investors who are well capitalized.** Although it is wrong to view the much-vaunted sovereign wealth sector as the purchaser of default and as the savior of the market, Middle Eastern and Asian funds are likely to target trophy investments in core world markets as early as the first half of 2009 as value write-downs come through and sales are forced.

Similarly, private equity vehicles with adequate resources will view the current correction as a prime, contra-cyclical buying opportunity, especially in the core metro markets of North America and Western Europe.

Opportunities will also abound in the debt sector and the current trend toward debt restructuring fund creation will continue into 2009 as one of the few growth points in the market.

Investment activity in 2009 is likely to gather momentum from a standing start as the year progresses. As asset values approach replacement cost, investors will be increasingly tempted back to the market.

**Although an awkward concept in real estate, markets which are manifestly returning to long-term fair value will also attract interest.** There will also be strong emphasis on core investments in major markets with minimal letting risk,

good specification and manageable leverage.

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**NOTES**