



JONES LANG  
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Capital Markets Outlook 2009

## Time for Decisions

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Operating conditions in 2009 for those in real estate will be as challenging as many in the market will have ever encountered.

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Market conditions will encourage the trading of assets that rarely come to market and these will likely command premium prices.

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We judge there is no shortage of equity capital or eagerness amongst investors to deploy, but this will be at pricing levels which are still to be established.

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We believe investors stand to benefit, not from a passive investment approach to real estate, but by positioning themselves to take advantage of the range of opportunities that will begin to emerge in 2009.



## Capital Markets Outlook 2009: Time for Decisions

Severely restricted debt facilities, wide bid offer spreads and reduced transactional activity in the direct real estate markets across Europe characterized much of the past year. Investors confidence was severely shaken whatever the asset class, and a wait and see attitude has taken hold in the real estate sector as values have fallen significantly across virtually all of Europe's commercial real estate markets.

It is quite likely that the early part of 2009 will bring more of the same, however as the year unfolds we believe investors stand to benefit, not from a passive investment approach to real estate, but by positioning themselves to take advantage of the range of opportunities that will begin to emerge in 2009. These will result from the unique economic, financial and market conditions that confront us all as we prepare for the new business year.

### Operating Conditions

We enter 2009 with more clarity about the direction of change and prospects for the world's economy and the real estate market than for some months. Paradoxically there is a heightened level of uncertainty, resulting from the unprecedented turmoil in the world's financial markets since early September 2008. This has contrived to undermine faith in conventional wisdoms and standard business relationships and practices. The world has turned upside down. The predictable has become the unpredictable and real estate owners and investors are seeking to understand how to effectively navigate through the uncertainty that confronts each and every one of them.

As if overnight, we are now faced with economic recession in 2009 in all the advanced economies. There are widespread concerns and growing risks of deflation, all time low interest rates, extreme volatility in the world's foreign exchange and stock markets, huge levels of public debt, rising unemployment, and government ownership of the world's major banks. Some of the banks themselves have unexpectedly joined the ranks of the world's largest property companies, with vast portfolios of non performing loans and distressed real estate, where borrowers are in default or in technical breach of loan conditions as values have reduced. Outstanding real estate debt in Europe totals billions of euros and reflects the easy credit conditions of the early part of this decade. This cocktail of market conditions provides the backdrop for real estate investors in 2009.

### The Banks

The major unknown for 2009 is how the region's banks will deal with their real estate liabilities and what lending practices they will adopt in the face of a plethora of new influencing factors. These will include Basle II Core and Tier 1 capital adequacy requirements, new and inevitably greater levels of governmental involvement, more determined oversight from the regulatory authorities, the dividend requirements of their own shareholder base faced with big write-downs, and their overstretched customer base, which extends far beyond the real estate world.

We fully expect that it will take 3-5 years for banks to repair their balance sheets and that they will only begin to address this problem in 2009. They will most likely be ultra cautious and conservative in the handling of their outstanding real estate exposure and highly selective in their lending criteria. This all points to a year of limited real estate debt finance, low LTV's at around 60% and high margins until that time when interbank lending is more free flowing and at traditional margin levels.

The banks however will be unable to ignore their real estate exposures. There is likely to be limited appetite to foreclose where debt servicing is adequate, even if the loans are in technical default. However the proportion and absolute magnitude of delinquent loans will grow in the face of expected recessionary economic conditions, corporate failures and increased tenant defaults. This process will most likely gather pace during 2009 as values decline further, and as a result we anticipate many attractive buy side opportunities for those with sufficient equity and established banking relationships.

### The Investors

Whilst we believe the "war chest of equity" waiting to pounce on distressed assets is overblown we are aware of over €50bn of equity capital which is targeting Europe in 2009. Institutions and third party money managers with capital to deploy, along with opportunity funds, international wealth entities and some German open and closed end funds will be looking for appropriate opportunities to enter the market.

Real estate investors in Europe today however represent a broad and sophisticated spectrum of stakeholders from many countries across the globe, with varying investment styles and performance requirements. 2009 will not be the year to generalise and assume

conditions are affecting all in the same way. For the highly leveraged who bought in 2006-07, when €500bn of commercial real estate changed hands, and those needing to refinance or repatriate capital, there will be no hiding place. Values across Europe overall have already fallen by up to 40% from their peak in summer 2007 in a number of markets and more value erosion is a certainty in 2009. For some it will be better to sell now where markets have further to fall. There are also many investors still booking large paper profits from investments acquired or owned well before the peak. For those some may wish to take profits in anticipation of new opportunities to enhance their portfolios as the year proceeds.

### Pricing

Pricing and valuations will be fully in the spotlight throughout 2009. Current evidence of market pricing is thin and valuations are sentiment based or reflective of times past rather than values in a deteriorating market. Low central bank interest rates and swap rates will inevitably be a feature of the lending market throughout the year and this will help to induce more liquidity and transaction activity if debt is available and if the bid offer spread that exists today converges. We believe it will, but only as acceptance of the significantly higher yields and lower capital values, become recognised as the new reality. The different geographic markets will not adjust in step or always to the same degree. As at Q4 2008 some markets across Europe have recorded yield decompression since the peak in excess of 200bps for prime offices and shopping centres, whilst others have yet to experience more than a 50bps correction. Relative pricing will drive further yield decompression throughout 2009 as it did compression in 2006-07.

Some markets like London, Paris and Madrid are well advanced in their market corrections and will no doubt attract increased investor interest if the fundamentals are judged to support the new price levels. Fair value estimates, likely yield ceiling indicators and asset pricing will become crucial decision tools in 2009 for investors timing their market entry, and judging price and value trade-offs. We also expect market conditions will contribute to the trading of increasing numbers of assets that are seldom brought to the market and these will most likely reflect premium prices or change hands irrespective of whether the market has hit a recognised price floor.

### The Rental Markets

The rental markets and the strength of tenant demand will be the critical components of pricing and value assessments in 2009. The supply side of most markets is not expected to be a problem

because the pipelines are generally not swollen with schemes which are committed or under construction. Attention will focus on the resilience of demand in the face of some of the weakest economic fundamentals for decades. In some markets though, weak demand will lead to subletting and grey space will result in ever higher vacancy rates. Throughout 2009 corporate Europe will experience contraction and negative net absorption and this will drive rents lower in many markets. Already increasing rent free periods and tenant giveaways are evident in many markets and these will be an increasingly important feature of tenant negotiations in 2009 as landlords compete to limit voids, maintain occupancy levels and rental income across their portfolios during the downturn.

Our latest forecasts suggest that all sectors will experience falling rents through 2009 and 2010. However the pattern is not uniform and Europe retains its many local operating characteristics and market dynamics. In 2009 we expect these to become more pronounced and investors will be advised to carefully assess local market dynamics and prospects when reviewing their real estate decisions. Income security will be high up on investors' agendas for a few years at least but equally 2009 will be the year to begin to spot income and growth opportunities arising from the credit crisis, and to target assets at price levels that will drive performance over the next five years at least.

### Conclusions

No doubt operating conditions in 2009 will be as challenging as many in the market will have ever encountered, but for those able to see beyond the long grass and with partners to work alongside them or with their own capital to deploy it is likely to be seen as the year when the market began to clear and opportunities were too good to miss. We expect banks to be supportive of their borrowers and governments to continue to protect their fragile economies and key industries. Both will be important in providing stability to the real estate sector as it further adapts to difficult market conditions that could not be more different than the heady days of 2003-07. In 2009 watch carefully for signs of changing sentiment and improving confidence even in small segments of the market and watch for pricing in the evolving real estate derivatives market and the public markets to provide early indications of optimism returning to a sector that has more pain to come but will survive and deliver improving returns based on decisions made in 2009.



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**Jones Lang LaSalle offices:**

**London**

Jones Lang LaSalle  
22 Hanover Square  
London W1A 2BN  
Tel: +44 20 7493 6040  
Fax: +44 20 7408 0220

**Tony Horrell**

Head of European Capital Markets  
London  
+44 (0)20 7399 5171  
[tony.horrell@eu.jll.com](mailto:tony.horrell@eu.jll.com)

**Nigel Roberts**

Chairman EMEA Research  
London  
+44 (0)20 3147 1193  
[nigel.roberts@eu.jll.com](mailto:nigel.roberts@eu.jll.com)

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