LaSalle Investment Management
Real estate experience. Investment expertise.

The Credit Crisis of 2008

We are watching the disintegration of the financial system. Finance is the web of intermediation binding economic agents to one another across both space and time. Without it, no modern economy can survive. Yet that is now threatened with the ongoing collapse in trust and flight to safety.
Martin Wolf Financial Times October 1, 2008

When we see a half-off sale at our favorite retailers, we rejoice. When we see a half-off sale in the capital markets, we do not. The only investors who should rue falling capital market prices are those who are in the process of selling assets. Those who are net buyers of financial assets will have wonderful opportunities to lock in a meaningful risk premium on their investments, for the first time in years. That's a good thing.
Rob Arnott FTfm October 6th, 2008

Even if, as the Europeans claim, the crisis was made in America, it now belongs to everyone. The Economist October 4th 2008

Making Financial History

The month of September was the most tumultuous in the past 75 years of financial history for G7 economies. And financial history is still being made in October, as these three quotes demonstrate. The global banking system, thought to be safe and secure due to redundancy and diversification, has proved to be extremely unstable. Some of the most respected financial companies around the world either no longer exist or are in the process of merging into presumably stronger entities. The banking crisis has now begun to hit the real economy. As of September, the U.S. has lost 750,000 jobs; another 500,000 job losses could be expected before year-end, with continued job losses in 2009. Great Britain, France, and Japan are also losing more jobs than they are creating. The contagion and distress are spreading from the housing, auto, and financial services sectors to the household, corporate, and government sectors. Exports, a recent bright spot in the US and German economies and a driver of growth in the "BRIC" countries, will likely weaken as the global economy rapidly slows and international trade falls for the first time since 2001.

Even though the financial crisis may have its origins in the US, Europe is feeling the effects too. Banks in Belgium, Germany, Italy, the Netherlands, and the UK have all had to be supported with public money while inter-bank lending has dried up, just as in the US. Europe's economy is also slowing fast. In Q2 GDP growth was negative in the Eurozone and flat in the UK; expectations are that the region will be in or close to recession for the remainder of the year. Central banks have, to date, kept interest rates high to counter global inflationary pressures. As inflation subsides, rates are expected to be cut sharply, which should help a recovery.

Nevertheless, the lack of liquidity in the inter-bank lending markets has had far-reaching effects. Tighter lending conditions arrived in the Asia-Pacific markets in the second quarter of the year. Thus, economic growth in these fast-growing countries slowed by about 100-300 basis points. The Asia-Pacific region goes into the slowdown from a higher baseline rate of growth relative to Europe and North America. As a result, Asia-Pacific is still experiencing relatively respectable expansion, relative to the West, with the notable exception of Japan. Intra-regional trade has become increasingly important, with China

having become the leading trading partner for other significant economies in the region such as Japan, Korea, and India. Trade between countries in Asia-Pacific is helping to soften the impact of weaker global trade. There have not been significant job losses across Asia, but multinational companies have materially slowed expansion plans. We are concerned that Asian markets with plenty of office construction in the pipeline will start to see rising vacancy rates and falling rents.

Global Investment Performance through the Downturn

We can report that the credit crisis is having a negative impact on commercial real estate values across all 23 of the countries where LaSalle Investment Management is active in direct investment markets. In fact, we see real estate performance facing the double whammy of worsening economic conditions and a pricing correction as cap rates rise significantly from the debt-driven run up of the past three years.

In the US, transaction volumes have fallen dramatically, making price discovery difficult, but prices for core properties in better markets appear to have fallen on the order of 10% (from the fall 2007 peak) based on the few reported trades. Many more deals have been pulled from the market based on bids that would have suggested even larger declines. And the market is essentially in a “no bid” situation for weaker assets in secondary markets. Our view is that there will be continuing downward pressure on US real estate prices. While it is extremely difficult to peg a bottom, we would not be surprised to see a further price correction of 10% for core product (20% from the peak). Further downside is possible if the economy and capital markets do not stabilize over the next twelve months. And non-core product will continue to suffer to an even greater extent as investors seek income and quality.

Pricing in Europe is following a similar pattern to the US, except in the UK. There capital values have already fallen by 25% since June last year and we expect that prices will adjust by up to a further 10%, particularly for secondary assets. The remarkable speed of this price correction is due to more regular and robust appraisal processes and domestic open ended funds having to meet redemptions and being forced to sell properties. While the banks do have bad loans, they have not been forced sellers to a significant extent so far.

Yields are also moving outward and values are falling in many secondary Japanese and Australian markets. Both countries are likely to experience modest write-downs commensurate with their income yields in 2008. This leaves two of the most important Asia-Pacific markets with unleveraged total returns close to zero this year and probably next. Nevertheless, income growth (as leases roll to elevated levels) provides support for values in the major Asia-Pacific markets of Singapore, Hong Kong, and Tokyo.

Capital flows across Asia have slowed, albeit to a less severe extent than in the US or Europe. However, tighter debt conditions have made larger transactions difficult to finance and non-prime properties have seen a correction in pricing especially in smaller, secondary markets. In the large emerging markets, India has witnessed a severe correction in land values after a speculative run-up in 2007; the trend in China has been more mixed, with residential transaction volumes down sharply in response to the government’s austerity measures, while commercial markets have generally maintained values and occupancies. Development pipelines for office buildings and shopping centers are still very active across both China and India, but so is demand. We are now concerned that demand could drop in a global recession.

Putting this Cycle in Perspective

Despite all the dire news, we see several bright spots in the current situation.

- First, commercial real estate is in better shape than many other sectors of the economy. Most real estate assets have long term leases that will provide income until the economy and capital markets recover.
- Second, the most recent pricing surge did not last long enough to lead to over-development. The construction pipeline is modest and falling rapidly in Europe, North America and mature markets in Asia-Pacific. [There has been a lot of development and large pipelines in emerging markets] High commodity prices have helped discipline the supply-side, in contrast to previous cycles.
- Most of the excessive leverage in the US and Europe over the past few years was long-term in nature. The majority of the loans originated in 2006 and 2007 had either five or ten year terms, resulting in two peak refinancing periods (2011/2 and 2016/7). Owners with good in-place debt can be patient, and the market and prices could recover before these loans mature.
- As the introductory quote from the respected investment strategist, Robert Arnott, suggests-- those with deep equity will be able to buy strong assets at steeply discounted prices over the next one or two years.

The whole world is watching to see if the credit crisis drags the global economy into a massive recession. But, unlike the 1930s, economic policy makers are acting swiftly and decisively to avoid the worst-case -- a multi-year depression. In a world of global finance, Central Banks are working together (sometimes imperfectly) to coordinate their responses. Compared to the isolated world of the 1930s, the ECB, the Bank of England, The Bank of Japan, the Bank of China, and the Federal Reserve (to name a few), have all shown a remarkable willingness to work together.

Other North American Markets affected by the US Debt Crisis

Canada and Mexico are faring better in the spreading global capital crisis, but are not immune to problems in the United States.

- Canada's GDP growth has been weak in 2008 (+0.4% YTD at July) due to negative impacts on trade from a U.S. slowdown and softening commodity prices. Job growth has remained positive with 87,000 jobs added year-to-date at August, but is well below 2007 levels. Canadian banks are heavily regulated, have strong capital ratios and have largely side-stepped the sub-prime meltdown thus far. None are considered to be at risk of failure. Greater difficulty in obtaining financing has pushed property transaction volumes down but anecdotal evidence suggests core pricing is holding firm for now at least, while Class B and secondary markets have seen cap rates move out up to 50 basis points.

- Mexico’s economy is more resilient to a US recession than in the past; however growth is still dependent on the US economic cycle. In sharp contrast with the US, credit growth should continue in 2009 due to low-credit penetration and healthy balance sheets in the financial sector. As a result, GDP is expected to slow from 3% in 2008 to grow around 1.5% in 2009 as investments, exports and consumption decelerate. Job growth will slow to around 1.3%. Real estate pricing visibility is low, given the slowdown in transaction volumes. However, higher financing costs (higher spreads and base rates) and lower growth expectations point towards higher capitalization rates in 2009 across all property types. And development opportunities are being squeezed at present by the combination of higher construction costs and slowing tenant demand across property sectors.

Indices in Denial

U.S. institutional real estate investors have yet to recognize the distress that underlies the real estate market. The US-NCREIF property index (NPI) has only shown one quarter of negative appreciation so far and that was less than one percent. Our view is that appreciation in the NPI will stay negative through 2010, with a cumulative value decline, as noted above, of about 20% (for unleveraged, stabililized assets). We project total returns to be flat in 2008 (implying a 6% writedown, although the reality is that prices have already fallen 10% or more) and negative 6-8% in 2009 before turning slightly positive in 2010. Income returns in this scenario would rise from 5.3% today to approximately 7% in 2011.

Our forecasts for the UK IPD Index more closely reflect the rapid change in values there. Returns in 2008 are likely to be a negative 15-17%, and could well be the worst returns ever recorded in the UK (returns in 1974 were -15.9%). Returns will be similar to the US-NPI in 2009 (at negative 6-8%) but thereafter we expect a strong bounce back with double-digit unleveraged performance into the new decade. IPD returns have been declining steadily over recent months in Japan, and the index has an embedded lagged effect due to the timing of valuations in Japan. Rising cap rates in the absence of growing revenues most notably in Japan and Australia may result in negative returns in some segments of these markets, especially in non-prime properties. Returns in the large emerging markets will be mixed, with a wide range of outcomes, but generally speaking 2007 vintage investments will have lower returns than were previously projected.

Returns for higher risk strategies that invested in 2006-2007 will look worse than the unleveraged core NPI and IPD indices. Deteriorating market conditions and rising exit cap rates will be magnified by high levels of debt. Refinancing problems could force some groups to sell into a very illiquid market. More recent value-add funds, capable of actually getting leasing accomplished, will be able to partially offset the effects of rising cap rates and higher debt costs.

Investment and Portfolio Management Advice

What should institutional investors with a diversified mix of direct assets, core and higher-return funds and REITS do now? There are no easy answers and obviously decisions need to be made in the context of portfolio-wide risk and return objectives as well as liquidity needs. But we have a few suggestions for the rest of the year.

- For those with pressing liquidity needs, there are no great options. Selling stablilized core assets in preferred markets is probably the safest choice.
    - To attract buyers, assets will need to have strong and safe cash flow, and preferably have attractive assumable debt. This strategy of selling the strongest assets will be painful, but it is unlikely that prices will be better in six or twelve months.
    - Moderate amounts of debt are still available in mature markets for fully-leased buildings. It is possible to extract cash without selling assets, by leveraging up to approximately 60%. Spreads are near record-wide levels, as are lender fees. So, this method of raising funds should not be treated lightly. But, it still might be preferable to trying to sell a building during one of the most difficult capital markets since the early 1990s.
- Focus on operations. Assuming an extended economic downturn, all effort should be devoted to keeping existing tenants and attracting new ones, even if it means breaking the pro forma.
- Focus on liquidity. It is especially important to keep debt to manageable levels and to communicate regularly with lenders to stay ahead of any changes in how they may treat loan covenants and extensions.

- Be defensive. Though portfolio rebalancing is difficult now, some parts of the real estate universe will perform better than others. Strong assets with long leases to financially sound tenants and recession resistant niche sectors (medical office, student housing) will outperform the market as a whole.
- Go Green. This is still a good time to focus on improvements that will enhance a property's sustainability rating, but also reduce operating costs. Many green initiatives are surprisingly low cost and have short pay-back periods. And notwithstanding the broader capital markets distress, the interest of corporate tenants in sustainability will only continue to rise in the years ahead.
- Think about the next up-cycle. Some of the best investment opportunities of the past fifty years were in the aftermath of previous financial crises, like the US S&L crisis of the late 1980's or the Asian Contagion of 1998-99. Similar opportunities are likely to come to market over the next year or two as the credit crisis puts stress on highly-leveraged owners.

Reversion to the Mean

Unleveraged real estate produced an average total return in the US and the UK of 15% to 20% from 2004 to 2007, compared to its long term averages in both countries of close to 10% (nominal) or 7% (real). Much of the excess return was triggered by unsustainable levels of cheap debt. The unwinding of this debt will take several years. Re-pricing of equity will also take place in fits and starts. Institutional owners should avoid selling at "fire-sale" prices, but some over-leveraged owners will be forced to sell or to hand keys back to banks, who will then sell the collateral quickly to raise needed cash.

There is now no doubt that commercial real estate has entered one of its periodic down-cycles. How severe and protracted will this down-cycle be? It is way too early to know for sure, and a lot depends on the effectiveness of the TARP legislation passed on October 3rd and the efforts of the Bank of England and the ECB to inject liquidity in European markets.

In the US, a reasonable scenario would be a drop in unleveraged values of 20% (half of which has already occurred) and a mild recession. A down-side scenario is that the US enters one of the worst post-war recessions and values fall as far (or further) than the last significant down-cycle in the 1990s (when US-NPI values fell approximately 32%).

The economic 'wild-card' will be what happens to the BRIC countries. In the past, emerging markets have been very vulnerable to slowdowns in G7 demand for their exports. Circumstances are different now, with higher levels of domestic demand partially able to offset falling levels of G7 demand. For example, in China there are growing expectations the government will ease on austerity measures to help stimulate growth, which would provide much needed support for many of the economies throughout the AP region. But even these efforts will not fully mitigate the effects of lower demand for manufactured goods from China and India, or commodities from Brazil and Russia.

Prepare for Pain

Our primary message to investors in commercial real estate is that fundamental markets are going to get worse before they get better. Ultimately, though, history teaches us that an economic recovery does eventually rise from the ashes of any severe financial crisis. Moreover, a time of maximum fear has nearly always proven to be an excellent buying opportunity for those with the fortitude to act counter-cyclically.

We advise our colleagues and clients who have money to invest, to wait patiently until financial pain rises from "low-stress" to "high stress" and eventually to "distress" before jumping back in. The exact timing and nature of these opportunities will vary greatly from

country to country, but astute investors should be prepared for them before they arrive. We believe that such opportunities have already surfaced in the UK and are starting to emerge in Continental Europe, but it is still too early (by 6 to 12 months) for the US. It makes sense, though, to get prepared now, because when these opportunities to come to market, the best ones will go to the swift.

Across Asia-Pacific, the pain levels are rising in Australia, Japan and China. However, we expect that financial pressures will continue to build for six months or more, before truly distressed sellers come to market. Moreover, development projects in many parts of the world are being pulled from the market. The net result will be that projects hitting the market in 2010 or 2011 will have very few competitors. These projects are just about impossible to finance now, so they have to hit target returns based on a period of all (or nearly all) equity.

Finally, we would advise our clients to avoid panic selling. Commercial real estate is a strategic part of any investment portfolio. A long-term perspective is hugely important when dealing with the current crisis. Values are falling, but dysfunctional credit markets have made the task of finding buyers especially difficult. As Federal Reserve Chairman Ben Bernanke explained in the September US Congressional Hearings, "There is a significant difference now between the 'hold to maturity' value and much lower 'fire sale' price of certain asset-backed securities." This statement also holds true for most high quality commercial real estate, especially when it has contractual, income-generating power that persists through both up and down cycles in the broader economy.

Global Strategy Team

Jacques Gordon
Global Strategist

Robin Goodchild
International Director
European Research and Strategy

Bill Maher
International Director
North American Research and Strategy

David Edwards
Regional Director
Asia Pacific Research and Strategy

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