
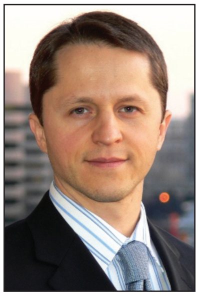

SIOR Index—Office and Industrial Markets Point to Signs of Stabilization

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NAR Economic Overview

The close of 2009 brought a measure of relief to global economies. The worst of the recession was behind, with several measures of economic activity having recorded positive changes in the latter part of the year. In fact, for many Asian economies, the recession proved shorter and shallower, positioning them for quicker recoveries. A main reason for this upswing was the concerted implementation of massive fiscal and monetary stimulus packages across a broad range of major and emerging economies.

As we stand at the dawn of 2010, a mood of cautious optimism is rising. However, there are signs that continue to point to a fragile recovery, fraught with volatility and potential pitfalls. Macroeconomic activity is still hampered in some regions of the globe by high unemployment, restrictive credit policies, and over the medium term, the consequences of weak national balance sheets.

In the United States, the pace of economic activity has picked up slightly. Industrial production rose for the last six months of the year, following a year and a half of declines. As of December 2009, production was up 0.6 percent, on the heels of an additional 0.6 percent increase in November. Following a stretch in 2008 and part of 2009 in which manufacturers cut production and inventories, the second half of 2009 witnessed a steady rise in industrial production and capacity utilization. The capacity utilization rate increased from 68 percent in June 2009 to 72 percent in December. To put it in perspective, the 10-year average has been close to 80 percent.

In addition, both imports and exports have been steadily rising as international trade grows. Based on the latest monthly data, imports of foreign goods were up 3.1 percent in November 2009, driven by a surge in crude oil imports. Meanwhile, exports rose by slightly over 1.0 percent. While the growth in the trade deficit widened, a weak dollar has been shoring up exports.

Yet, despite encouraging signs of economic recovery, employment continues to affect the U.S. economy. The job market still struggles despite recent respectable gains in production. Companies coming out of recession push their existing workers to do more rather than hire new workers to raise production. Based on the latest data from the Bureau of Labor Statistics, in December, payroll jobs fell 85,000 and are now down by 7.2 million since the beginning of the recession two years ago.

Construction employment fell by 53,000. Compared with December 2008, construction employment had fallen by almost one million as of December 2009. Construction jobs are now down by nearly two million from the peak. In other noteworthy sectors, manufacturing continues to take a hit. From a high mark of 17.5 million workers, the manufacturing sector now employs only 11.6 million workers. Jobs in the professional business service sector (like accounting, management consulting, and law offices) rose by 50,000, which may hint at a potential recovery for office space demand for commercial Realtors®. Temporary help employment rose for the fifth straight month. Because many companies first turn to temp jobs when coming out of a recession, the rising trend should imply permanent job creation starting in a few months.

Jobs at state and local governments fell slightly in December. There will be pressure throughout this year for further job cuts as most state and local governments are running relatively high budget deficits and generally required by law to balance the books.

The average hourly wage fell by three cents to $18.82 in December. From one year ago, wages are up by only 2.3 percent, the slowest gain in about five years. However, because the cost of living as measured by the Consumer Price Index fell slightly in 2009, the low wage gain still implies a gain in purchasing power. Of course, that is no solace for people without a job.

The unemployment rate could easily peak at 10.5 percent, particularly if many of the discouraged workers re-enter the labor force and start applying for jobs. The peak will likely be within the first quarter of 2010. Because of Census 2010, the government will hire about one million people this year to collect and process the data, which is likely to push the unemployment rate lower later in the year. However, most of these jobs will be temporary.

In light of these factors, it is not surprising that consumer demand has been weak. Consumers have been struggling with unemployment, stagnating wages, and lack of credit. In turn, they have been increasing their savings, paying existing debt, and shifting toward lower spending levels. Consumer sentiment has reflected these realities. The Conference Board consumer Sentiment Index reached a yearly high of 54.8 in May 2009, then dropped to 48.7 in October and closed the year at 52.9. Most of the volatility was driven by a continual decline in consumer confidence with present situation. The Index measuring consumers' confidence with the present situation declined from 29.7 in May 2009 to 18.8 by December. This is the lowest index value since February 1983 and a far cry from the 10-year average of 105.

Commercial Real Estate

Against this economic backdrop, U.S. commercial real estate closed the books on a difficult 2009 with weak fundamentals but with improved investment activity and a more hopeful outlook for 2010. The good news is that global commercial real estate seems to have turned a corner. Based on yearly numbers, sales activity was down about 38 percent compared with 2008. However, looking at quarterly data, global sales transactions rose steadily for three quarters following the first quarter low.

The growth was driven by a strong push for development deals in China, and adjacent markets, like Taiwan and Hong Kong. However, the number of deals also rose in Europe, where France, the U.K., and a few Eastern European countries posted positive growth. The property of choice for international investors has been office space. In fact, office sales made up 50 percent of global transactions in 2009. Along with an increase in sales volume, the size of deals has also been on the upswing. While billion-dollar sales numbered only five in 2009, the average size of deals increased for two consecutive quarters. In another sign of positive change, cap rates across much of the international markets have been declining, signaling an improvement in pricing conditions and buyers' expectations.

The areas of remaining concern for commercial real estate in 2010, particularly in the United States, continue to be fundamentals and distressed properties. Demand for space is still low, with most properties posting negative absorption for the year. Vacancy rates continue to rise, adding downward pressure on rents.

At the same time, the number of distressed properties in the United States has been steadily growing. As of December 2009, commercial properties in distress— delinquent, bankrupt, foreclosed, or modified/restructured—accounted for $150 billion. The figure represents an almost 200 percent jump in distress from January 2009. While the retail and hotel sectors account for about half of troubled assets, office and multifamily properties account for 30 percent of distress.

> *...global commercial real estate is facing a year of stabilization and uneven recovery.*

Given the growing volume of maturing debt, banks have adopted a policy of modifying many of the loans for performing assets, with the hope that a turnaround will elevate property values and allow them to refinance the loans without the hit to their balance sheets. For properties with poor fundamentals, there has been an increase in liquidation activity. In the Unites States, about 22 percent of troubled loans have been restructured, 9 percent have been resolved, and 10 percent have gone into lender REO. The noticeable side effect of these actions has been a decline in recovery rates on loans liquidated. As of the fourth quarter 2009, the average recovery rate dropped to 59 percent (59 cents recovered for every dollar outstanding) from 65 percent in the first three quarters of the year.

Looking ahead at 2010, global commercial real estate is facing a year of stabilization and uneven recovery. For U.S. markets, the year is likely to bring a modest improvement in fundamentals and continued growth in sales transactions.

SIOR Index Results

The results of the December 2009 SIOR Index survey point toward signs of leveling. Based on respondents' information and comments, the industrial and office sectors continue to face weak fundamentals. But, SIOR members' expectations for next quarter are growing more positive.

The Commercial Real Estate Index, representing fourth quarter 2009 data, was virtually unchanged, with a slight 0.2-point increase in value. The national Index, based on 10 variables pertinent to the performance of U.S. industrial and office markets, reached 35.5. The Index underscores difficult conditions in the commercial real estate industry. The national economy continues to weigh on the office and industrial sectors—the office index was up 0.4 points while the industrial index remained unchanged. Except for the Midwest, which was unchanged, the other regions experienced declines in index values.

SIOR Commercial Markets

The slight uptick in the index value is a welcome sign, as it may point toward stabilization. However, it does not mask the fact that conditions are still challenging. Office and industrial fundamentals continue to be weak, characterized by low demand, high vacancy rates, and dropping rents.

Leasing activity is still down in 94 percent of the markets, while high vacancy rates continue to plague many properties. Sublease space is also a factor that drives vacancy rates up, in turn adding downward pressure on rental rates. Tenants are in a strong position to negotiate lease contracts, and SIOR members are reporting lower rental rates and significant concessions.

Investment activity is low for most respondents, driven by a lack of available credit. Although prices have been dropping, SIOR members still find that investors are sitting on the sidelines. Meanwhile, even though distressed property listings have risen, they are coming on the market at a slower pace due to banks' efforts to restructure maturing loans.

In keeping with previous quarters, development and construction activity continues to be nonexistent for most of the country. Members point to the fact that acquisition costs are low and dropping, and it is certainly a buyer's market for development sites. Considering that available space is plentiful and that credit for new construction is scarce, the outlook for new construction is dark.

Weighing the fourth quarter survey results, it is obvious that commercial real estate conditions are still difficult. However, respondents find that markets may be reaching the bottom of the decline. Based on fourth quarter activity, SIOR members are feeling more optimistic about the outlook for the next quarter—55 percent expect the market to improve, compared with 47 percent in the third quarter. Only 17 percent of respondents indicated that business was going to be down from current levels, which represents a significant improvement from the first quarter 2009, when 66 percent of SIOR members surveyed expected conditions to be down.

SIOR Outlook

The fourth quarter of 2009 confirmed continued difficult conditions in commercial real estate, closing a tough year. While the economic conditions are improving, employment and business investment hold the key to a significant recovery. A more confident consumer is more likely to spend and generate increased demand for products and services. However, consumers will regain confidence only when the employment situation improves.

For the long term, private sector job creation on a sustainable basis will be the key to a steady and healthy economic recovery and expansion. Right now, that is not happening. But with overall production continuing to gain, the private sector should begin to generate jobs in the second half of this year.

Methodology

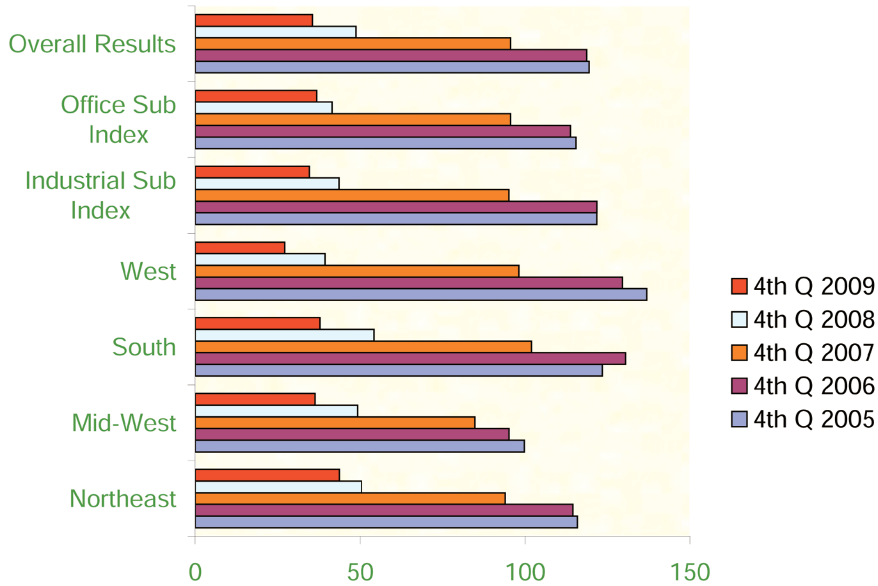
The SIOR Commercial Real Estate Index is constructed as a "diffusion index," a very common and familiar indexing technique for economic measures. Other examples of diffusion indexes include the Index of Leading Economic Indicators, the Consumer Confidence Index, and the Institute of Supply Management's Purchasing Managers' Index. In the SIOR Commercial Real Estate Index, a value of 100 represents a well-balanced market for industrial and office property. Values significantly lower than 100 indicate weak market conditions; values significantly higher than 100 indicate strong market conditions. The theoretical limits of this Index are a low of zero, and a high of 200, though it is unlikely that such limits would be approached as long as the property markets are operating efficiently.

The Index is based on a survey questionnaire with ten topics. The topics covered are (1) recent leasing activity; (2) trends in asking rents; (3) trends in vacancy rates; (4) subleasing conditions; (5) levels of concession packages in leases; (6) development activity; (7) site acquisition activity; (8) investment pricing levels; (9) the impact of the local economy on the property market; and, (10) the effect of the national economy on the property market. Survey respondents are given five choices. For each topic, five choices are provided, corresponding to conditions that are very weak, moderately weak, well-balanced, moderately strong, or very strong.

For each question, answers are tallied and the percentage of responses for each of the five choices is calculated. If survey panelists indicate "very weak" conditions (the "a" choices in the questionnaire), the answer is assigned 0 (zero) points; "moderately weak" ("b" answers) earn 5 points; an indication of "market balance" ("c") receives 10 points; "moderately strong" indications ("d") score 15 points; and "very strong" ("e") responses receive a maximum 20 points. Thus a score of 10 for a given question can be earned if responses are evenly distributed across all five choices, if all responses were "c", or if the answers form a "bell-shaped curve" centered around the "c" choice. The total index value is derived by summing the scores for all ten questions. Index values for each of the two property types are similarly calculated.

The survey was developed by Hugh F. Kelly, CRE, clinical professor at New York University, who worked with SIOR on research projects since 1989.

SIOR Commercial Real Estate Index 5-Year Results



The chart above shows 4th Quarter results of the SIOR Commercial Real Estate Index over a period of five years. A score of 100 equals a balanced market.

U.S. Office Rental Rate and Operating Cost Information Now Available

Annually, SIOR conducts an Office Rental Rate and Operating Costs Survey for a government consultant. So that SIOR members can better serve their clients, SIOR has negotiated permission to distribute this information to its members to keep all SIORs abreast of market conditions across the United States.

To get a copy of this information, contact Linda Nasvaderani, Senior Director of Communications, at 202.449.8226 or e-mail her at Lnasvaderani@sior.com.