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Americas Commercial Real Estate Markets

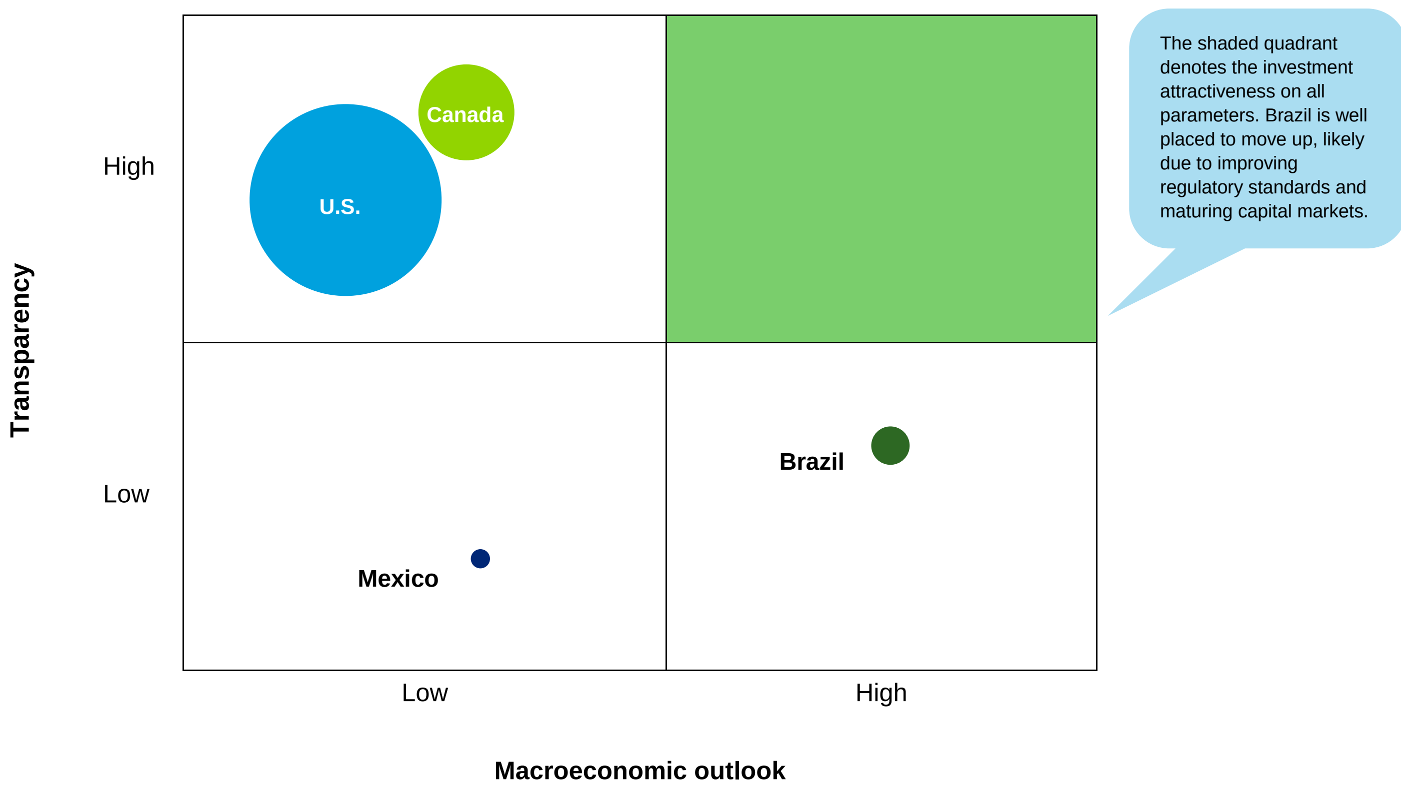
Contents

Americas Commercial Real Estate

Brazil emerges as the potential growth engine

U.S. dominates the Americas commercial real estate (CRE) market with respect to legislative scope, capital markets maturity, and transaction flows. However, following the 2008-09 recession and emergence of Latin American countries as the Americas growth engine, investors' interest in Brazil and Mexico increased. Brazil is likely to continue to attract more investors as it develops its capital markets and increases regulatory transparency (See Chart 1). However, the U.S. remains the most mature CRE market and will continue to experience increased investments as the economy gradually recovers and investors target attractive opportunities. This report examines CRE market trends across four key Americas markets — Brazil, Mexico, Canada, and the U.S. — with a focus on the comparative investment attractiveness of a country.

Chart 1: Comparative investment attractiveness by country (see Appendix 1: Methodology)



Legislation

Jones Lang LaSalle's (JLL) Global Real Estate Transparency Index 2010 shows that Canadian and U.S. CRE markets lead the Americas in regulatory and information transparency. Fast growing CRE markets such as Brazil continue to standardize real estate laws, increase the depth and transparency of CRE finance, and introduce more performance measurement tools. Public CRE companies are typically organized as real estate investment trusts (REITs), which are eligible for tax benefits if certain criteria are met. With the oldest REIT legislation, the U.S. eligibility norms are comparatively strict. For instance, in the U.S., REITs have stricter asset level requirements and foreign players are required to pay higher withholding tax, compared to the other Americas markets.

Table 1 — Comparative REIT legislations

	Brazil	Mexico	Canada	U.S.
Enacted (Year)	1993	2004	1994	1960
Legal Form	Fundo de Investimento Imobiliario (FII)	Fideicomisos de Inversion de Bienes Raices (FIBRAS)	Mutual Fund Trust (MFT) in practice	Any legal U.S. entity that will be taxable as a corporation
Minimum Share Capital	No	No	No[1]	No
Shareholder Requirements/ Restrictions	• Construction companies involved in any activity of FII may not hold more than 25% in the FII	• At least 10 unrelated investors with no investor holding more than 20%[2]	• Minimum of 150 unit holders • Must not be maintained primarily for non-residents	• At least 100 shareholders • Five or fewer entities not to hold more than 50% of the value of the shares
Listing — Mandatory	No	No	No	No
Asset Level Requirements/ Restrictions	• Effective 2008, no requirement of a minimum level of investment into real estate. New regulations set out a list of authorized real estate investments; however, it is not entirely clear whether FIIs may invest into any type of non-real estate assets under the new regulations	• At least 70% of assets invested in income earning real estate • No more than 30% invested in Mexican government debt or debt mutual funds	• At least 75% of the equity value must be in real estate and cash equivalents • At least 95% of revenue must be from specified passive types of revenues	• At least 75% of assets in real estate, government securities, or cash • No more than 5% of assets can be securities of any one issuer • Cannot own more than 10% of another corporation's stock • Not more than 25% of the value of the REITs total assets is represented by securities in taxable REIT subsidiaries

[1] Only closed-end funds are required to be listed on a designated stock exchange

[2] Only required for private FIBRAS

	Table 1 — Comparative REIT legislations			
	Brazil	**Mexico**	**Canada**	**U.S.**
Leverage Restrictions	No	3-to-1 debt/equity ratio	No	No
Profit Distribution	At least 95% of net operating income to be distributed bi-annually	At least 95% of the taxable income to be distributed annually	No requirement to distribute, but trusts usually distribute 100% to avoid taxes	At least 90% of the taxable ordinary income must be distributed to maintain statue; retained income is taxable at REIT level
Tax Treatment	Real estate income, including capital gains, is tax exempt, but other income may be subject to withholding tax	Tax-exempt at FIBRA level, however tax computed and withheld on behalf of beneficiary	Tax-exempt to the extent distributed	Tax-exempt to the extent distributed
Tax Treatment of Foreign REITs	15% withholding tax on income and capital gains	28% tax withheld on earnings[3]	25% withholding tax; nonresident unit holders may be reduced to 15% by treaty	Generally 30% withholding tax on ordinary dividends, subject to reduction by treaty; capital gain dividends subject to tax at applicable capital gain rates

[3] This rate has increased to 30% for tax years 2010 through 2012, 29% for tax year 2013 and returns to 28% in 2014.

Investments

Gradual economic recovery and increased capital availability resulted in favorable price discovery, cap rate compression, and increased transaction activity. In 2010, transaction volume rose 130.9 percent year over year (YoY) to $135.7 billion, led by the U.S, which accounted for 82.9 percent of the total. While investment volume grew in Canada (192.5 percent YoY) and Brazil (243.2 percent YoY), it declined in Mexico (12.3 percent YoY). Office CBD markets reported the highest volume as investors targeted core properties in gateway markets. Further, cap rates tightened considerably in the U.S. and Brazil, due to cash rich investors chasing trophy assets, which led to a more favorable transaction market. In Canada, cap rates were stable, as the financial system was relatively less affected by the recession. In 2011, growth in the Americas overall will likely continue, albeit at a slower pace, due to higher inflation in emerging economies and slow GDP growth keeping unemployment high in developed economies.

Chart 2 — Americas' CRE transaction volume and pricing levels

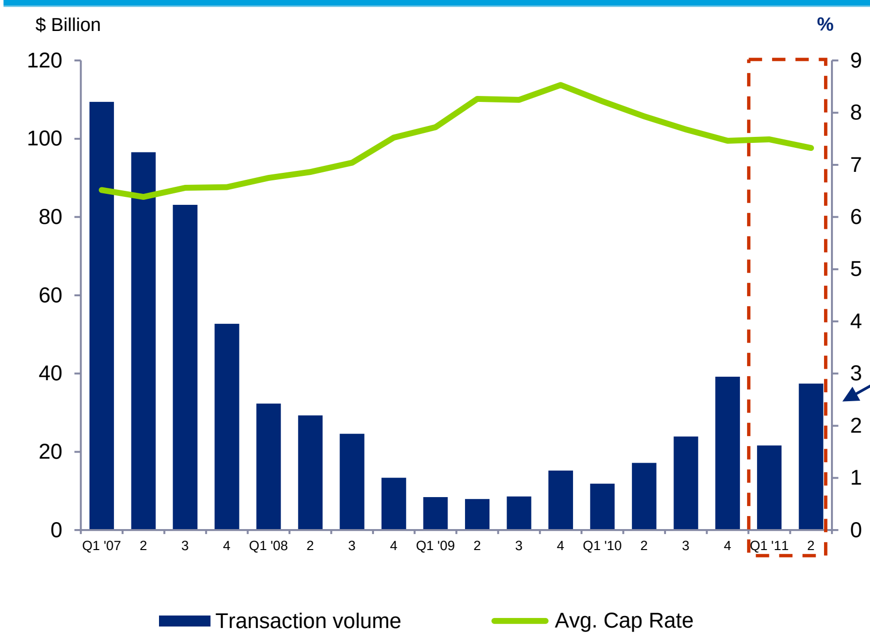


Table 2 — Americas' CRE volume by property type, 1H11

Property Type	Sales volume ($ Billion)	% Change (YoY)
Office	27.0	78.6
Retail	21.7	155.1
Industrial	10.4	90.9
Sub-total	**59.1**	**103.1**
Apartment	21.1	104.8
Hotel	8.9	176.8
Land	3.6	40.6
Total Volume	**92.7**	**105.4**

Brazil

Brazil's 2010 investment volume increased 243.2 percent YoY to $5.7 billion, as favorable macroeconomic fundamentals drove capital flows, particularly in the prime office markets segment. Capital flows to Sao Paolo and Rio de Janeiro grew 274.0 percent YoY and 127.0 percent YoY to $2.5 billion and $1.7 billion, respectively. As a result, capital values increased and cap rates compressed. Brazil's CRE investments will likely further benefit from an infrastructure build-up ahead of the 2014 FIFA World Cup and the 2016 Olympics. In addition, in May, S&P revised its ratings outlook on Brazil to positive from stable, and maintained the BBB- rating, which potentially adds to the attractiveness of the country as an investment destination.

Mexico

CRE investments in Mexico suffered due to risks associated with political violence, which led to a 12.3 percent YoY decline in transaction volume to $293.0 million[i] in 2010. Despite this fact, CRE investments will potentially benefit from an ongoing manufacturing sector recovery, led by the industrial space. According to Cushman & Wakefield, approximately $18.0 billion in capital (local and U.S. investors) was raised in 2010 for investment in Mexican CRE, with nearly 80.0 percent slated for industrial real estate. In addition, higher disposable incomes and private consumption are expected to boost demand for retail real estate in the medium to long term[ii].

Canada

In 2010, Canadian transaction volume rose 192.5 percent YoY to $15.7 billion[iii], driven by a strengthening economy and increased capital availability. Retail properties led with nearly $5.0 billion in investment volume, followed by industrial and office. While property yields remained comparatively stable due to conservative lending practices, large investors sought attractive international opportunities, particularly in the U.S., due to limited domestic supply of high quality assets and a stronger currency[iv]. In 2011, investment growth is expected to be moderate compared to 2010, mainly due to a weaker U.S. economic outlook, Canada's largest trade partner[v].

U.S.

U.S. CRE deal volume rose 140.7 percent YoY to $112.5 billion in 2010 with office properties reporting the highest volume[vi]. Most transactions were for high-quality assets, especially those with stable rent rolls in top-tier cities, whereas only a few deals involved low-end properties in tertiary markets. REITs drove transaction activity in 2010 with acquisitions of $24.7 billion in property values and a 20.7 percent market share of total transactions, up from 6.0 percent in 2009. Further, distressed property transactions climbed 273.4 percent YoY to $23.9 billion or 21.2 percent of the total U.S. CRE sales, up from 9.9 percent in 2009[vii], driven by improved financing conditions. While CRE transaction activity is expected to grow, a broad-based recovery will depend on a pick-up in "non-trophy" asset sales.

Financing

The more developed markets such as the U.S. have matured financial systems, which offer varied CRE financing options, while emerging markets such as Mexico rely heavily on traditional sources (banks and equity issuances) to meet their funding requirements. In an improved financing environment in 2010, traditional lenders strengthened balance sheets and maintained conservative underwriting standards, particularly in the U.S. and Canada. However, increased investor interest in Brazil and Mexico resulted in government efforts to develop alternative CRE financing sources (CRI[4] and CKD[5]). Given the anticipated high capital flows in the Americas, North America is likely to see a recovery in structured financing and Latin America will continue to deepen its capital markets.

Brazil

Demand for CRE credit continues to rise, driven by high development activity which is fueling the growth of structured real estate finance. Real estate companies continue to tap equity markets and structured finance sources such as CRIs. CRI issuance in the country rose 124.5 percent YoY to $5.1 billion[6] in 2010[viii]. Further, total asset-backed securities (ABS) originations rose 76.6 percent YoY in 2010 to $11.4 billion, 54.1 percent more than the 2008 issuance of $7.4 billion[ix]. Brazilian CRE financing is expected to improve in the future as transparency and depth of the country's capital market increases.

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[4] Certificates of Real Estate Receivables (CRIs) are mortgage-backed securities which are securitized and issued on a company's receivables

[5] Capital Development Certificates (CKDs) are trust securities certificates issued by trusts with a specific duration, and uncertain and variable returns. CKDs are partially or completely linked to the underlying assets of the trust

[6] Conversion rate taken as on December 31, 2010 (1 R$ =.60288 US $)

Mexico

After muted growth in financing in 2010, credit availability will likely expand in 2011-12, as Mexican banks are expected to increase mortgage debt issuance and construction financing[x]. In addition, CKD is a commonly used funding source, with nearly $130.0 million[xi] in 1Q11 issuance. In the future, CKDs are expected to be used extensively to fund CRE activities, particularly in the industrial sector. Further, the first public listing of a FIBRA (REIT equivalent) in March aggregated $300.0 million in proceeds, thereby opening up another financing option for the CRE industry.

Canada

In 2010, banks, credit unions and insurance companies drove CRE financing in Canada[xii]. In addition, credit performance remained strong due to consistent and conservative lending regulations. Further, CMBS issuance re-emerged in early 2011 as investors look for re-investment opportunities in these markets. Issuance as of YTD May was $207.4 million, compared to none in 2010[xiii]. CMBS delinquencies also kept low at 0.7 percent of outstanding balances in July.[xiv] Overall, CRE mortgage lending will likely grow due to increased liquidity and lower mortgage rates.

U.S.

In the past year, increased investor demand drove a recovery in U.S. CRE lending, which resulted in higher loan sales, amid varied financing options. Lenders' balance sheets strengthened due to loan modifications and extensions and fewer write-offs, through the "amend and extend" strategy[7]. In addition, improved property fundamentals led to lower delinquency and default rates and improved loan quality. Life insurance companies led commercial mortgage originations (volume growth of 168.8 percent; Mortgage Bankers Association (MBA) origination index at 250.0 in 4Q10 versus 93.0 in 4Q08), followed by government-sponsored entities (GSEs) Fannie Mae and Freddie Mac[xv]. In addition, the CMBS market (coined as CMBS 2.0) showed signs of recovery with 2010 issuance of $15.0 billion, which is expected to triple to $47.0 billion in 2011[xvi]. However, high debt maturities remain a concern, with nearly $1.7 trillion due during 2011-2015 (60.0 percent of which is potentially "underwater")[xvii]. Prospects for a broad CRE market recovery likely will be enhanced when lenders resume loan originations for "non-trophy" assets and refinancing options increase to stabilize debt maturities.

[7] Also referred to by the media as "extend and pretend," and the even less optimistic "delay and pray"

Macroeconomic and CRE fundamentals

The Americas continues to experience a bifurcated recovery, with robust growth in developing economies and comparatively slower expansion in developed nations. Similarly, CRE fundamentals have strengthened in the Latin American countries and stabilized in mature markets such as the U.S. Going forward, Brazil will potentially demonstrate comparatively favorable macroeconomic and CRE fundamentals in the Americas, despite fears of overheating, due to high domestic demand and consumption coupled with increased foreign investor interest.

Chart 3 — GDP growth rate

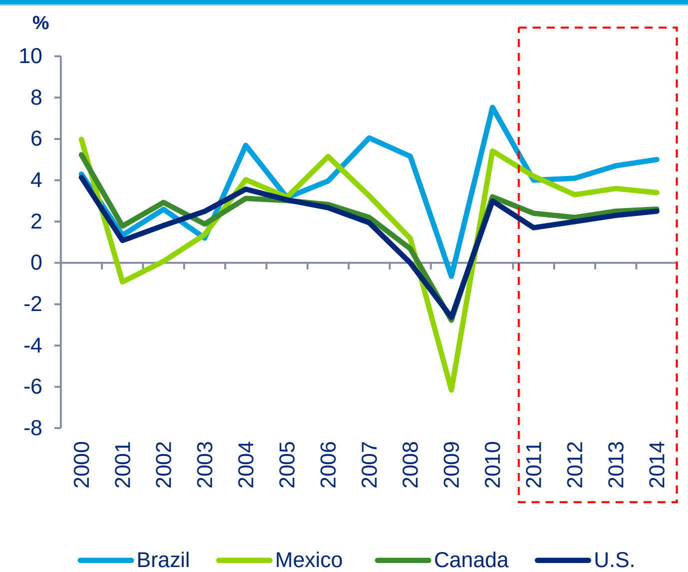
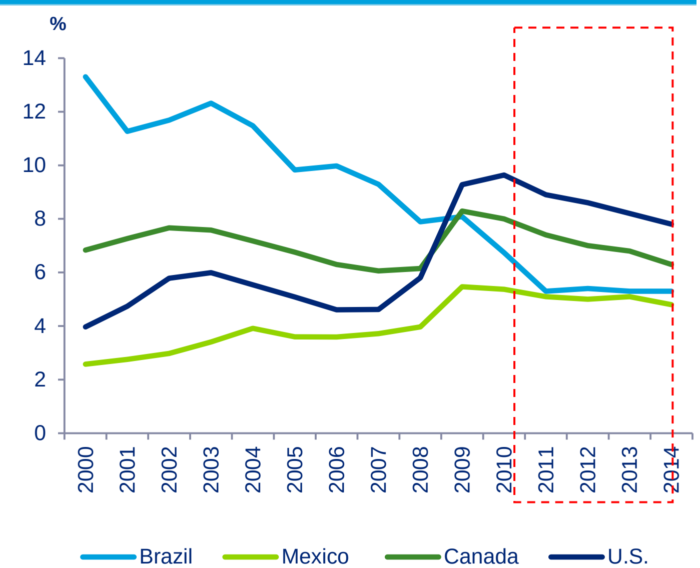


Chart 4 — Unemployment rate



Source: Economic Intelligence Unit, August 2011

Brazil

Expansion in wages, the labor market and credit drove GDP growth in 2010 to 7.5 percent compared to -0.7 percent in 2009. However, tightening monetary policy will likely drive interest rates higher, which given a strong currency will result in a wider current account deficit and modest GDP growth of 4.0 percent in 2011. Further, the unemployment rate is expected to decline to 5.3 percent in 2011, after improving to 6.7 percent in 2010 on robust domestic demand.[xviii]

Mexico

A recovery in GDP growth to 5.4 percent in 2010 compared to -6.2 percent in 2009 was driven by an increase in U.S. exports. However, 2011 GDP growth will likely be modest, given Mexico's close trade ties with the U.S. and comparatively weaker trade relationship with Asian economies. Further, the unemployment rate is expected to trend lower to 5.1 percent in 2011, compared to 5.4 percent in 2010.[xix]

Canada

GDP growth rebounded in 2010 to 3.2 percent compared to -2.8 percent in 2009, due to increased private consumption. In 2011, GDP is forecast to be 2.4 percent[xx], on high commodity prices which will boost export income. Further, unemployment declined in 2010 and is expected to decline 60 basis points YoY to 7.4 percent in 2011[xxi].

U.S.

Despite successive quarters of positive GDP expansion, growth is below expectations due to higher imports, low personal consumption expenditure, and reduced federal government spending. Economic Intelligence Unit (EIU) expects GDP growth of 1.7 percent in 2011. Further, with the addition of nearly 1.3 million jobs in the past ten months (Oct 10 — Jul 11), unemployment is improving, yet the economy still needs to add another 7.6 million jobs lost during the recession. EIU expects an unemployment rate of 8.9 percent in 2011 compared to 9.6 percent in 2010.

Source: CB Richard Ellis, Cushman & Wakefield, and Prudential Real Estate Investors

	Table 3: CRE fundamentals
Brazil	Strong domestic demand, driven by consumer credit expansion and enhanced purchasing power, boosted manufacturing activity and foreign investor interest in the Brazilian economy. Consequently in 2010, rents increased and vacancies decreased for all CRE property types. In fact, Rio de Janeiro's office space was the most expensive in the Americas, on a 47.0 percent YoY increase in rental rates in 2010. Overall, the Brazil CRE industry's momentum is expected to continue in 2011, due to robust demand.
Mexico	Demand for CRE space in Mexico is closely tied to U.S. growth. Hence, the tepid U.S. recovery led to higher Mexican exports and demand for office and industrial space. However, retail recovery has been muted due to sluggish domestic growth. Increased construction activity in the industrial and residential sectors bodes well, especially in light of higher demand and government investments. However, there are excess supply concerns in the office space, which will likely pressure vacancy levels.
Canada	While Canadian CRE fundamentals recovered in most property markets, growth skewed toward the energy-rich Western region, particularly in the office and industrial sub-sectors. Despite a slow pick-up in domestic consumer spending, the retail sector is benefitting from enhanced foreign investor interest and lower supply. Also, an improved unemployment rate is fueling demand for multifamily properties leading to rental growth and lower vacancy levels. Western Canada is likely to experience space shortage across property types, which will result in resilient demand and favorable rent and vacancy trends.
U.S.	In 2010, property fundamentals showed signs of stabilization, with multifamily and office leading the recovery. Both sectors are benefitting from comparatively tight underwriting conditions amid record low supply of new deliveries, as apartment landlords are gradually regaining bargaining power and there is a flight to quality in the office space segment. Although retail fundamentals are improved, vacancy and rental rates will likely be impacted by margin pressure for retailers and cautious consumer spending due to continued housing weakness. The industrial sector will continue to benefit from a rebound in manufacturing and global trade activity, although record-high availability is likely to exert downward pressure on rents.

Source: CB Richard Ellis, Cushman & Wakefield, and Prudential Real Estate Investors

Appendix 1: Methodology

Bubble size

Bubble size has been used to represent the comparative market size by factoring 2010 CRE deal volume in each country. In order to assess the bubble size, we have allocated weights for a range of investment volume. The range and corresponding weights are:

Country	2010 CRE deal volume	Investment range	Allocated Weight
U.S.	$112.5 billion	Above $50.0 billion	10
Canada	$15.7 billion	$10.0 — $50.0 billion	5
Brazil	$5.7 billion	$1.0 — $10.0 billion	2
Mexico	$0.3 billion	Below $1.0 billion	1

Transparency

Transparency, as defined by JLL's Global Real Estate Transparency Index (GRETI), includes the following factors:

- Regulatory and legal environment
- Performance measurement
- Market fundamentals
- Listed vehicles
- Transaction process

The 2010 GRETI ranking of the four Americas markets are below:

Market	2010 World Rank
Canada	2
United States	6
Brazil	38
Mexico	46

Macroeconomic outlook

Economic growth forecast is based on data from Economic Intelligence Unit (EIU) and our assessment of macroeconomic factors. Below is GDP growth and unemployment data for each country.

GDP growth	2010 (A)	2011 (E)	2012 (E)	2013 (E)	2014 (E)
Brazil	7.5	4.0	4.1	4.7	5.0
Mexico	5.4	4.2	3.3	3.6	3.4
Canada	3.2	2.4	2.2	2.5	2.6
U.S.	3.0	1.7	2.0	2.3	2.5

Unemployment rate	2010 (A)	2011 (E)	2012 (E)	2013 (E)	2014 (E)
Brazil	6.7	5.3	5.4	5.3	5.3
Mexico	5.4	5.1	5.0	5.1	4.8
Canada	8.0	7.4	7.0	6.8	6.3
U.S.	9.6	8.9	8.6	8.2	7.8

Appendix 2: Top 20 Americas' markets by deal value

Table 4 — Volume in dollar millions (March 2010 — March 2011)

Rank	Markets	Apartment	Industrial	Office	Retail	Hotel	Dev Site	Grand Total
1	NYC Metro, U.S.	4,082	975	9,627	2,064	2,481	851	20,080
2	DC Metro, U.S.	3,698	456	7,522	1,391	1,131	327	14,525
3	SF Metro, U.S.	1,436	1,376	4,855	1,339	1,307	450	10,763
4	LA Metro, U.S.	3,086	1,861	2,794	1,635	923	152	10,451
5	Chicago, U.S.	780	631	2,832	750	478	19	5,490
6	Toronto, Canada	538	1,278	1,580	1,333	46	548	5,321
7	South Florida, U.S.	1,669	871	1,292	784	525	143	5,284
8	Dallas, U.S.	1,530	1,103	1,142	473	332	20	4,600
9	Boston, U.S.	820	186	2,540	259	599	13	4,417
10	Houston, U.S.	884	373	1,493	400	151	64	3,365
11	Sao Paulo, Brazil	93	370	2,169	232	30	421	3,315
12	Phoenix, U.S.	1,099	529	657	550	196	132	3,163
13	San Diego, U.S.	583	341	926	229	788	73	2,940
14	Seattle, U.S.	808	354	1,349	194	124	108	2,937
15	Atlanta, U.S.	1,046	541	471	278	248	49	2,633
16	Rio de Janeiro, Brazil	17	199	920	607	326	408	2,477
17	Denver, U.S.	606	115	906	57	195	20	1,899
18	Austin, U.S.	499	111	287	454	195	93	1,639
19	Orlando, U.S.	681	60	88	415	290	50	1,584
20	Minneapolis, U.S.	236	196	604	114	367	0	1,517

Source: Real Capital Analytics, May 2011

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End notes

[i] "Impressive Global Growth as Momentum Shifts Westward", Real Capital Analytics, January 2011

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[iii] "Impressive Global Growth as Momentum Shifts Westward", Real Capital Analytics, January 2011

[iv] "International Investment Atlas — 2011", Cushman & Wakefield

[v] "Country Forecast — Canada", Economic Intelligence Unit, August 2011

[vi] Real Capital Analytics, April 2011

[vii] Real Capital Analytics, February 2011

[viii] "Brazilian Structured Finance: Year in Review 2011", Uqbar, a Brazilian financial knowledge company, 1Q11

[ix] "2011 Latin American Structured Finance Review and Outlook", Fitch ratings, Feb 14, 2011

[x] "Latin American Quarterly", Prudential Real Estate Investors, April, 2011

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[xii] "Canadian Debt Sector", Otera Capital, April 2011

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[xiv] "Monthly CMBS Surveillance Report", Dominion Bond Rating Service (DBRS), July 2011

[xv] Mortgage Bankers Association, 4Q10 update; refers to life insurance index

[xvi] Commercial Mortgage Alert, January 7, 2011

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[xviii] Economic Intelligence Unit, August 2011

[xix] Economic Intelligence Unit, August 2011

[xx] Economic Intelligence Unit, August 2011

[xxi] Economic Intelligence Unit, August 2011