Caisse de dépôt et placement du Québec

APPENDIX II

REAL ESTATE MARKET

MARKET SITUATION

Difficult situation throughout the world

The real estate market has been hit hard, first by the financial crisis that began in 2007, then by the resulting economic crisis. The result has been a chain reaction fuelled by the deterioration in both economic and financial conditions.

- Deterioration in economic conditions leads to job loss and a drop in consumption, which translates into decreased demand for commercial rental space, including offices.
- The vacancy rate for buildings increases, which leads to pressure toward lower rents.
- A rising number of landlords who face declining income end up defaulting on payments. In many cases, the solution is to sell assets or even have them repossessed by lenders.
- The pool of property buyers diminishes because of the difficulty in obtaining the required financing, and combined with higher rental risks, the result is increased downward pressure on the market value of properties. At the same time, the decrease in market value is exacerbated by an economic outlook that remains pessimistic in terms of employment and consumption.

Although the phenomenon is worldwide, its scale and the prospects for a recovery vary from one region to another. Investment opportunities remain in all markets, however, especially for the acquisition of undervalued assets.

United States

The American market remains one of the most affected. According to Moody's, real estate values have plummeted an average 35% from their peak in 2007. Experts predict that this trend will continue into 2010-2011.

All of U.S. real estate sectors and regions face difficult market conditions. The increase in the unemployment rate and the relative stagnation of household consumption will further weaken the demand for rental space. In the industrial sector, the vacancy rate reached its highest level since 1989 in the second quarter of 2009. The situation is also deteriorating in the case of office buildings where the vacancy rate exceeds 10% in most major business centres. The sharp increase in the sublease rate – which reached 30% in New York City – adds downward pressure on market rents. As a result, the erosion in operating income for building landlords should continue through to 2011.

Furthermore, given the significant decreases in property values, a growing number of mezzanine lenders will be forced to post losses. Meanwhile, the real estate loan market is stagnant, due to a lack of capital, and that has a direct impact on the entire commercial real estate market.

Canada
Until now, Canada’s real estate market has fared better than its U.S. counterpart, mainly because our banking system is more stable and most buildings are owned by institutional investors. Canada’s labour market and retail statistics are also better. The effects of the global crisis, however, have been more noticeable in the past few months in the Canadian market. At the cyclical low, according to market indices, buildings in the Canadian market could be expected to post an average 20% drop in value compared to the 2007 peak.

Europe
The situation in Europe is more divided. The United Kingdom and Ireland were more swiftly and severely affected, a situation comparable to what is currently happening in the United States. Property values seem to have almost reached the cyclical low, which is close to 50% of the 2007 peak. Elsewhere on the continent, property values are posting a more modest drop. For example, according to market indices for France and Germany, this drop could reach 30%, which is less severe than the situation in the United States and United Kingdom, yet less attractive when compared with Canada.

Asia and Pacific
The situation in Japan and Australia paints a portrait similar to other major developed markets. The main emerging countries, such as China and India, remain less affected. This is despite greater construction activity stemming from less exposure to the financial crisis. Furthermore, these markets offer good long-term prospects due to potential growing demand.