



US Quarterly Outlook

APRIL 2012

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Executive Summary

Macro Economic Themes

- The recovery in the US finally appears to be self-sustaining, although economic growth should be moderate this year. Job growth has spread from the tech-related markets and has become broad-based across many industry segments.
- With inflationary pressures contained, the Federal Reserve remains committed to an accommodative monetary policy to boost economic growth.
- As the recent performance of the equity markets demonstrates, the potential for flare-ups from the eurozone crisis pose considerable risk for the US economy. Fortunately, the economy appears better positioned to handle shocks than a year ago.
- There are near-term concerns about rising gas prices impacting consumer spending. Industry experts expect higher prices to be short-lived, barring any supply disruptions in the Middle East.

Implications & Outlook for Commercial Real Estate

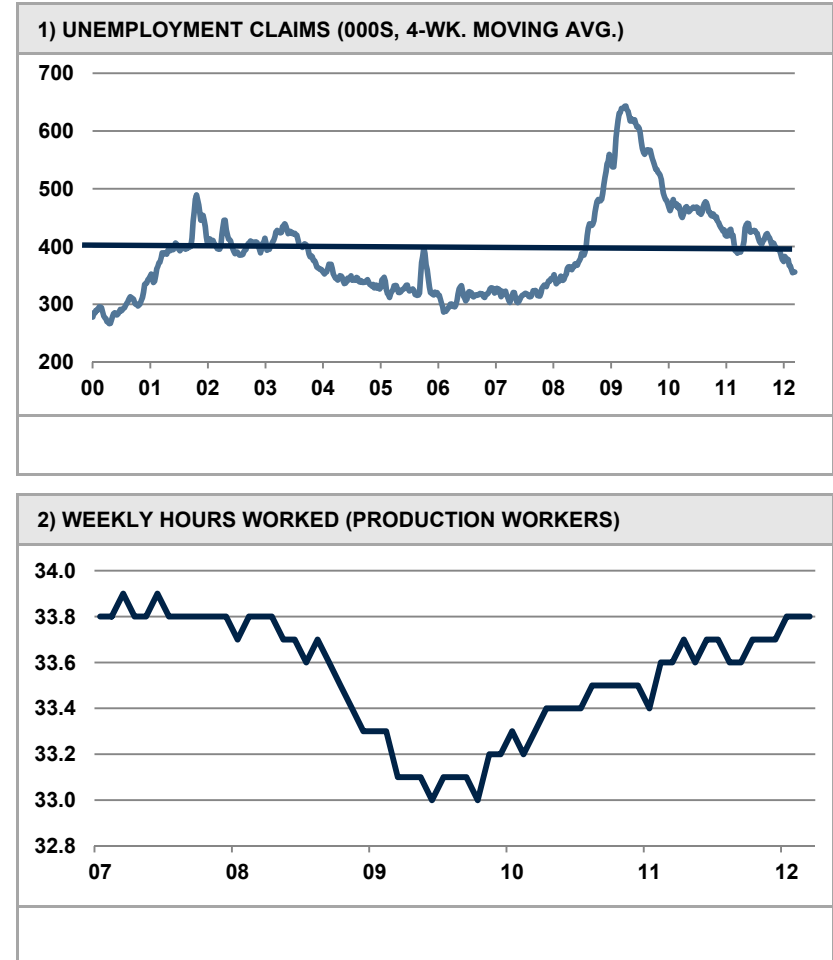
- Job growth should support a modest recovery in demand. Combined with historically low supply, that will produce a moderate improvement in commercial real estate fundamentals in upcoming quarters.
- Vacancy rates are slowly declining in most sectors, though they remain high in many markets, cutting into the bargaining power of landlords. Many leases are rolling over from the 2005-2007 period, when rents were at their peaks.
- Apartments and hotels are leaders in terms of improved demand and pricing power. Demand is positive in the office, industrial and retail sectors, but well short of the level needed to drive significant gains in operating income.
- Transaction activity should grow in 2012, driven by demand for income-producing assets and the slow liquidation of distressed assets. Commercial real estate remains attractive relative to alternative investments, such as fixed-income instruments.
- The debt markets are gaining traction. Life companies and agency lenders continue their record pace while CMBS staged another mini-revival and some banks are regaining their appetite.
- REITs are on pace for another record year of capital raising as their share prices soar, putting them in position to make accretive acquisitions.



Economic Trends

Déjà Vu All Over Again, or Sustainable Recovery?

- The US economy continues to expand at a modest pace. US GDP growth is forecast to grow 2.3% this year and accelerate slightly to a still-below-trend rate of 2.6% in 2013 according to the Blue Chip consensus. The economy is not forecast to reach 3% until 4Q13.
- The economy gained 635,000 jobs in 1Q12, the strongest quarterly gain since 1Q06. The recovery is spreading to a greater number of metro areas and is broad-based across industries.
- March's weaker employment gains have many fearing a repeat of last spring's bump in job growth. But there are signs that this year is different, including: fewer initial unemployment claims ([CHART 1](#)), increased weekly hours worked ([CHART 2](#)), less drag from state and local governments and increased bank lending activity.
- The biggest near-term threats to growth in the US are a flare-up of the Eurozone crisis, which would result in lower exports and higher financial market volatility, and an event-driven surge in oil prices.
- Over the medium-term, contentious federal budget negotiations could fail to produce an agreement regarding scheduled automatic tax increases and forced spending cuts. Financial markets might lose confidence if the deficit is not adequately addressed.
- US economic growth could yet prove to be underestimated. Balance sheets of businesses and many financial firms are in their strongest shape in years.
- With the US economy on firmer footing, corporations may unleash a wave of capital investment and hiring that would expand the consumer sector, the lynchpin for the overall economy.



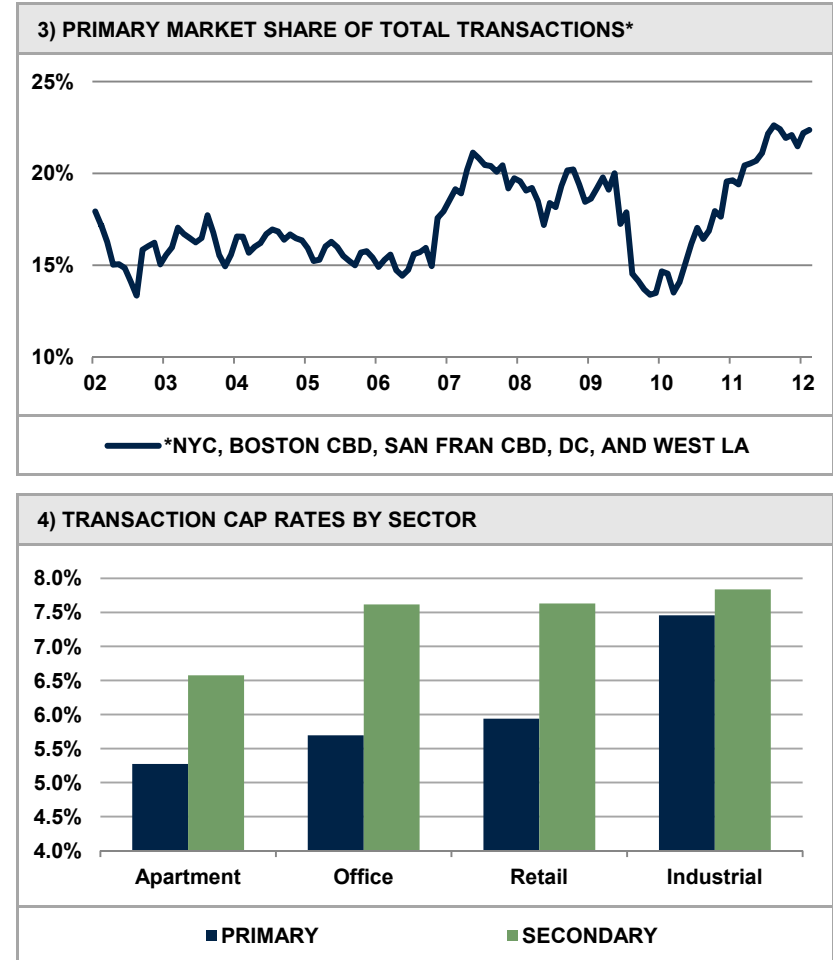
Source: Bureau of Labor Statistics, Prudential Real Estate Investors



Transactions and Pricing

Foreign Buyers and REITs Fueling Rise in Acquisitions

- Sales activity is on track to exceed last year's \$207 billion total. Through February, US transaction volume totaled \$25.5 billion, up 27% from the same period a year ago, according to Real Capital Analytics.
- Interest in select primary markets remains high (CHART 3).
- Foreign investors and REITs are fueling the increase in acquisitions, while private buyers and institutional funds have been net sellers. Institutional funds will likely add to their portfolios this year after three years of being net sellers.
- Foreign investors are flocking to US real estate for the stability of cash flows, the lure of a safe haven and the search for yield. REIT activity is driven by strong access to capital.
- Real estate will remain attractive relative to investment alternatives this year. Growing demand for space will improve real estate fundamentals, while a modest economic recovery will dampen development in most sectors, limiting downside risk for property owners.
- Apartment continues to dominate the investment spectrum, and rich pricing for apartments is driving development. We expect increased focus on office and industrial acquisitions over the next few years as the recovery progresses.
- Robust demand and low interest rates have prompted a drop in primary market acquisition yields to their lowest levels since 2007.
- Opportunities beyond primary markets may offer the best risk-adjusted returns (CHART 4).



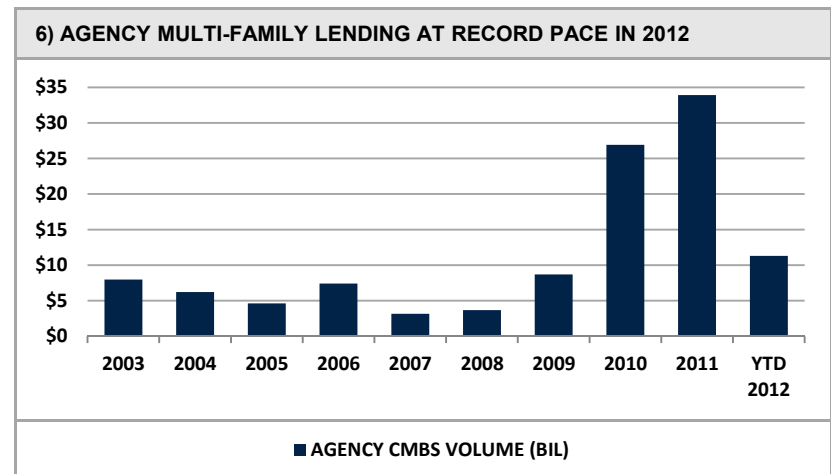
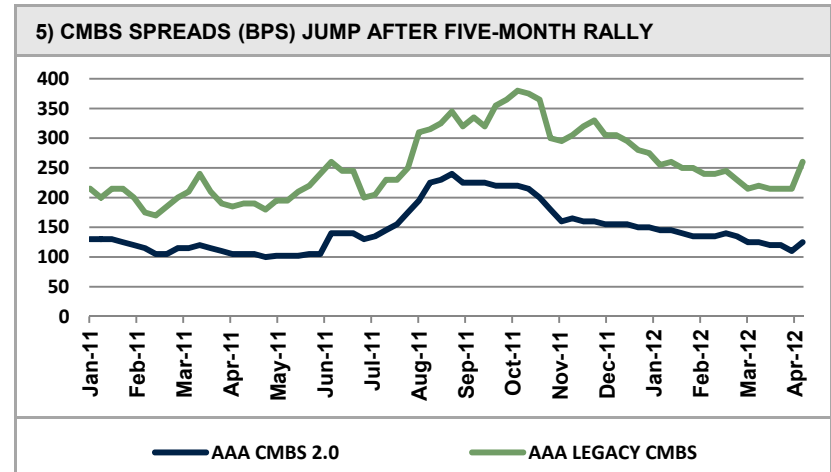
Source: Real Capital Analytics, Prudential Real Estate Investors



Debt Markets

CMBS Reviving While Life Cos and Agencies Roll

- All segments of the debt markets are gaining traction. Commercial banks and CMBS programs are taking positive steps to increase lending, while life companies and agency lenders are continuing to thrive.
- After a weak second half of 2011, CMBS programs started the year strong due to a six-month rally in spreads that enabled them to lend at lower rates, making them more competitive with insurers.
- However, an increase in spreads in mid-April is threatening to make the first-quarter bump in lending short-lived ([CHART 5](#)). The CMBS spigot by its nature can be turned on and off quickly.
- US CMBS issuance in 1Q12 was \$6 billion, down 32% from volume in the first quarter of 2011, according to Commercial Mortgage Alert (CMA). Issuance will pick up in the second half if the 1Q12 lending trends hold.
- With a large amount of cash in hand and shrinking construction-loan portfolios, money-center banks are increasingly interested in originating long-term commercial mortgages.
- Life companies may face more challenges from CMBS programs and banks in 2012 than in 2011, but their competitive position remains favorable and they are likely to continue dominating the market for quality loans. Lifecos see commercial mortgages as safe investments that provide relatively high yields.
- Lending in the multifamily sector is on pace for another record year. Agency lenders securitized \$11.3 billion in 1Q12, a pace that would top last year's record issuance of \$33.9 billion, according to CMA. ([CHART 6](#)).



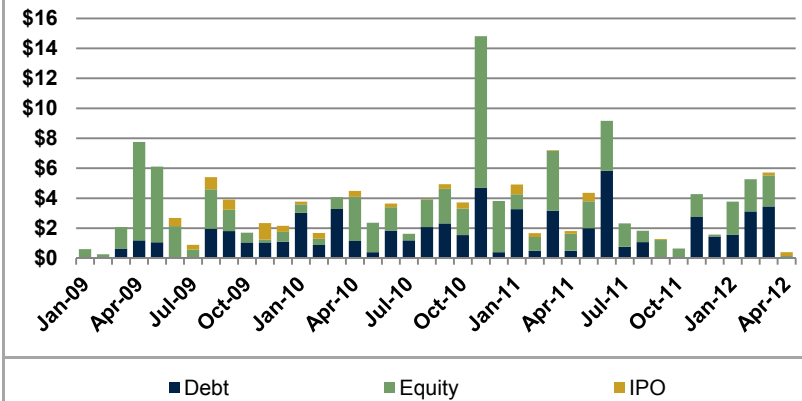


REIT Market

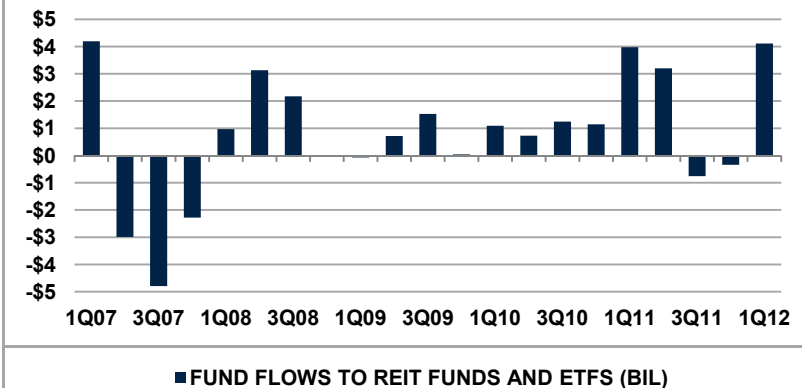
REITs Flying High

- Capital is flowing into the REIT sector. REITs raised nearly \$20 billion of debt and equity in 1Q12, putting the market on pace to top 2010's record \$51 billion of capital-raising ([CHART 7](#)).
- With access to low-cost equity and debt, REITs are positioned to make accretive acquisitions and developments.
- After an 8.3% total return in 2011, the FTSE NAREIT Equity REIT Index was up about 6% through mid-April. US REITs are on pace to produce a total return in the mid-teens this year.
- Fund flows to REITs have been strong in 2012, after negative flows in the second half of 2011 ([CHART 8](#)).
- Apartment REITs have recently underperformed other sectors as concerns crop up about the sustainability of revenue growth and development in core markets.
- REIT investors are rotating to other property segments. Through April 9, self-storage (29.3%) and retail (23%) led sectors in trailing one-year returns. That has reduced the pricing gap between large- and small-cap companies, which had been near historically wide levels.
- Rising rents will translate into dividend growth. Dividends could grow up to 20% if net operating income produces in line with expectations.

7) REIT CAPITAL RAISING STRONG IN 2012 (BIL)



8) MONEY FLOWED TO REIT FUNDS IN 1Q12





Property Markets

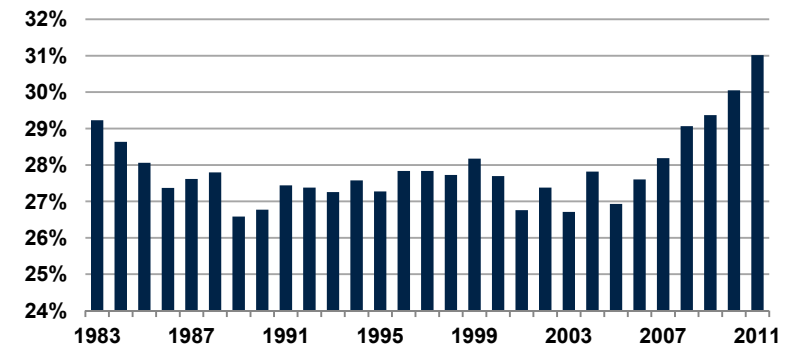
Apartment: Positive Fundamentals Continue

- Demand for apartments has strengthened even further this year with nearly all US markets firmly entrenched in recovery. Vacancies will likely drop below 5% this year, and rent growth will continue.
- Pent-up demand from young adults living at home, along with rising demand from baby boomers, will help push rents and occupancy ([CHART 9](#)). Plus, the homeownership rate should continue its decline, despite the pricing disparity between renting and owning, due to demographics and tight mortgage credit.
- Supply is increasing, but from four-decade lows. Developers received permits for 210,000 units (SAAR) in 1Q12, 40% lower than the historical norm.
- Some markets are further along in the construction cycle, but demand for units should produce favorable fundamentals for the next several years.

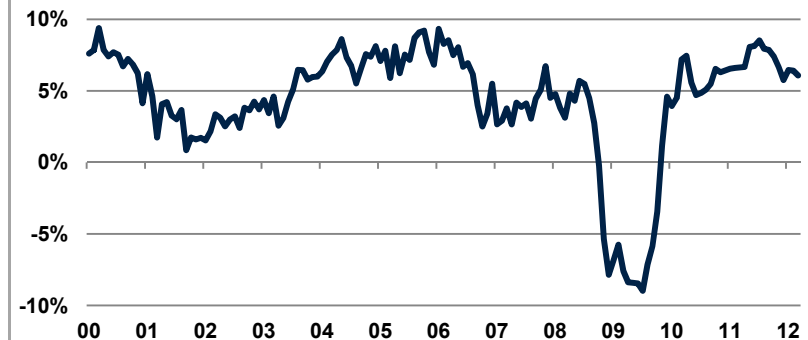
Retail: Weak Absorption Limits Rent Growth

- Consumer confidence and spending are rising. First quarter retail sales (excluding auto) increased by 6.3% year-over-year ([CHART 10](#)).
- Total absorption has turned slightly positive, but rent growth is likely to lag.
- Retailers are generally reluctant to take on new space, although high-quality centers have no trouble attracting tenants.
- Some chains are moving to formats with smaller store footprints. Mom and pop retailers are still struggling due to restrictions on credit.
- Outlet stores, which attract bargain-hunters, and high-end malls, which attract wealthy shoppers, are outperforming community and neighborhood centers.
- Grocery-anchored centers in secondary markets are attractively priced.

9) % OF AGE 18-34 ADULTS LIVING AT HOME



10) RETAIL SALES (EX. AUTO) CONTINUE TO EXPAND STRONGLY



Source: Census Bureau, NCREIF, Prudential Real Estate Investors



Property Markets

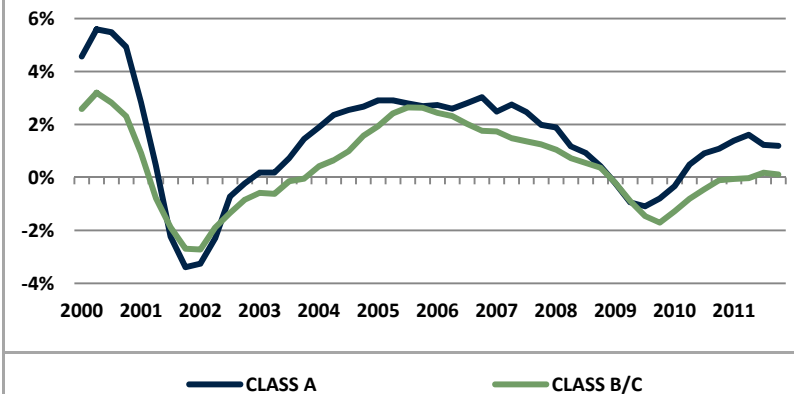
Office: Tepid Job Growth Producing Slow Turnaround

- Absorption of office space is positive and vacancy rates are coming down in many markets. Class-A properties dominate the net absorption of space (CHART 11).
- Effective rents are growing slightly, but in most markets remain far below 2007 peaks. Rent growth will remain weak for another year or more.
- The outlook generally is better in gateway cities, particularly tech-driven markets. However, Manhattan's outlook is dampened by the financial sector's struggles and Washington DC must deal with the federal government's fiscal restraints.
- Properties beyond core markets may offer better returns.

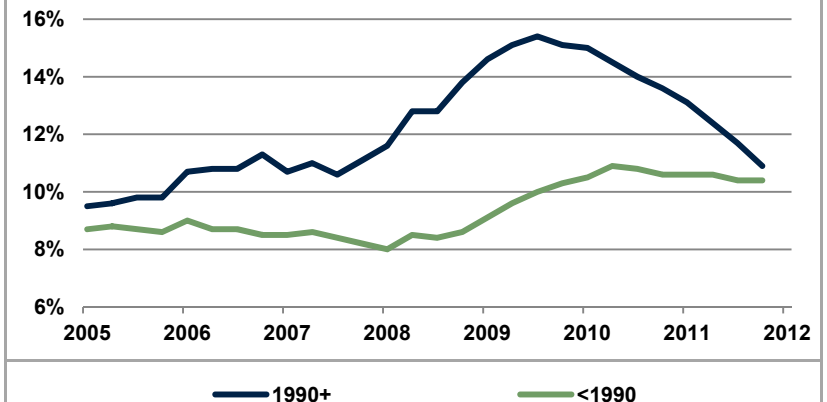
Warehouse: Fundamentals Starting to Turn

- Demand for space is slowly growing due to increased consumer spending, manufacturing and global trade.
- Users are focused on buildings built after 1990. The vacancy rate for newer warehouses has dropped considerably, close to pre-recession levels, while older buildings have been slower to recover (CHART 12).
- In most markets, demand growth will lead to a strong occupancy and rent cycle until supply becomes a factor. Development is mostly build-to-suits, but some speculative projects are beginning to crop up in strong markets, such as Southern California's Inland Empire, Seattle and Southern Florida.

11) NET ABSORPTION AS % OF STOCK: MORE DEMAND FOR CLASS A



12) WAREHOUSE VACANCY DECLINE CENTERED ON NEWER BUILDINGS





Property Markets

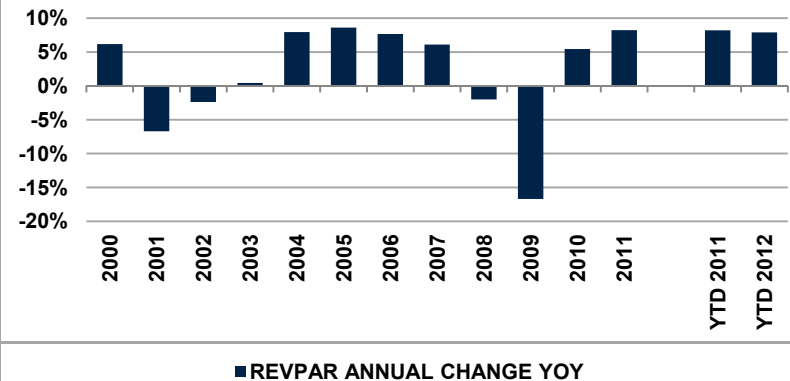
Hotels: Strong Demand, Limited Supply May Fuel ADR Rise

- Hotel fundamentals show no signs of slowing down after strong years in 2010 and 2011. In 1Q12, the average occupancy rose 3.8%, average daily rates increased 4% and revenue per available room (RevPAR) rose 7.9% (CHART 13) over the same period a year ago, according to Smith Travel Research (STR).
- The third straight year of strong occupancy increases and lack of new supply is enabling hotel operators to raise rates. STR has raised its 2012 RevPAR forecast to 4.3%, from 3.9% just a few months ago.
- Luxury and upscale segments and the top markets are the strongest performers.
- Distress is an ongoing factor for hotels. Roughly 30% of hotel sales involve distressed properties, more than any other property segment, according to PPR (CHART 14).

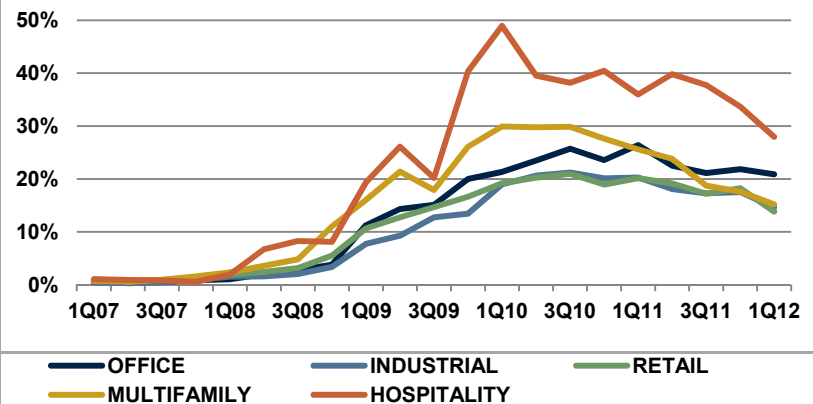
Self Storage: Strong Performance

- With occupancies improving, the outlook for rent growth is strong.
- Institutional acceptance of this asset class has strengthened.
- Consequently, public company valuations have soared. Implied REIT cap rates are in the low 5% range, comparable to apartment, and the lowest among the sectors. Self-storage REITs are likely to aggressively expand their portfolios through purchases.
- Many investors are clamoring for private market transactions as private portfolios are trading some 150 bps above the public market implied cap rate.

13) US HOTEL REVPAR RISING STEADILY AGAIN IN 2012



14) HOTELS LEAD IN PROPORTION OF DISTRESSED SALES



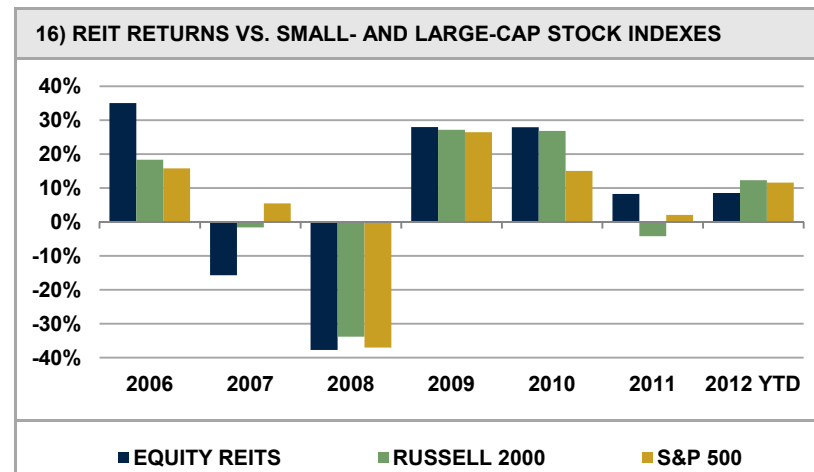
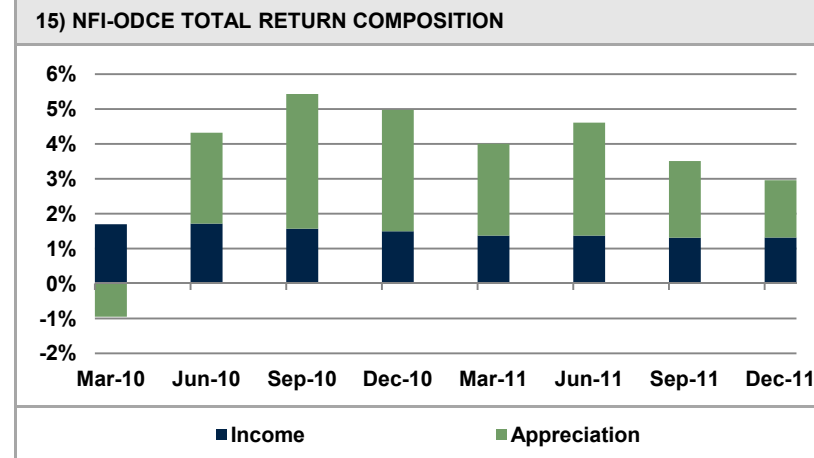
Source: Smith Travel Research, PPR, Prudential Real Estate Investors



Investment Performance

Steady Returns as Fundamentals Improve

- The NCREIF Fund Index (NFI-ODCE) total return rose 2.8% (gross total return, preliminary) in 1Q12, consisting of 1.46% appreciation return and 1.34% income return (CHART 15). Over the last four quarters, ODCE produced a 14.6% total return (5.4% income and 8.8% appreciation).
- Our forecast calls for the NFI-ODCE to produce high single-digit returns for the full year in 2012.
- The NCREIF Property Index (NPI) produced a 2.6% total return (1.4% income and 1.2% appreciation) in 1Q12, which pushed trailing one-year returns to 13.4% (6% income and 7.1% appreciation). Apartment (14.8%) led over the past four quarters, followed by industrial (13.9%), retail (12.9%), office (12.8%) and hotel (9.4%).
- Through April 18, the FTSE NAREIT Equity Reit Index produced a 10.1% total return, while the S&P 500 returned 10.8% and the Russell 2000 returned 8.8%. The REIT index outperformed the S&P and Russell indexes each year between 2009 and 2011 (CHART 16).
- Year-to-date, REIT returns are led by the industrial sector, which has returned 15.6%. Other property sectors that have outperformed the overall index include mixed (15.3%), retail (11.9%) and lodging (11%). Sectors that have underperformed include health care (-0.9%), apartments (5%), self-storage (5.3%) and office (6.1%).
- With the Federal Reserve pledging to keep interest rates low for another two years, commercial real estate should be attractive to domestic and foreign investors looking for safety and attractive yields. The US remains a safe haven as Europe experiences sporadic bouts of instability.





Attractive Risk-Adjusted Investment Opportunities — United States

THEME	INVESTMENT IMPLICATIONS
Strong Demand for Core	<ul style="list-style-type: none"> Investors are eager to obtain assets with steady, secure cash flows. Core spreads remain attractive relative to fixed-income alternatives. Focus on value – select acquisitions in markets where income growth and potential for capital appreciation justify low yields, and sell assets where pricing is overly aggressive relative to income growth expectations
Deleveraging	<ul style="list-style-type: none"> More than \$1.7 trillion in commercial mortgage debt outstanding will need to be refinanced over the next five years. With bank balance sheets recovering and an increasing number of loans able to sell above the outstanding loan balance, recapitalizations of distressed assets will provide opportunities for equity and mezzanine debt. The lack of momentum in CMBS reinforces the need for alternative capital sources. CMBS special servicers and banks are ramping up sales of loans and loan portfolios. Banks will look to shed underperforming loans, and rebuild their loan books with today's better-quality deals. Debt on institutional-grade properties in the 70-85% portion of the capital stack generates high returns and provides a measure of protection because it is senior to the equity.
Apartment Development	<ul style="list-style-type: none"> The outlook for apartment fundamentals remains strong over the next several years, and debt financing is cheap and readily available. With many existing apartment assets priced at sub-5% cap rates and IRRs below 7%, development provides better risk-adjusted returns in many markets, providing a 150-200 bps spread over stabilized assets in most markets. Projects started early in the cycle will enjoy lower construction costs and stronger leasing activity. With the supply pipeline building, fund managers must have the discipline to sell assets in 2 to 4 years in markets without meaningful supply constraints. Markets with higher barriers to entry provide long-term hold opportunities.
Demand Recovery	<ul style="list-style-type: none"> The US economy is improving, fundamentals for most property sectors are improving at varying degrees, and supply risk is muted. Non-trophy offices in tech centers (Seattle, San Francisco, Austin, Portland) may offer strong risk-adjusted returns. Core-plus and value-add properties in prime locations that are underperforming for any number of reasons (e.g., high vacancies, below-market rents, near-term lease rollovers and a need for capital improvements or being overleveraged) can be acquired at higher initial returns and at steeper discounts to replacement costs than core properties.
Low Beta/Stable Investment Platforms	<ul style="list-style-type: none"> Medical office buildings and targeted transactions near major health care centers. Self storage fundamentals will likely continue to improve this year, and institutional acceptance has increased steadily. Senior housing real estate values remain strong, and operating fundamentals should support slow, but steady, NOI growth.



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