US Quarterly Outlook

JANUARY 2012

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Executive Summary

Macro Themes

- A year-end improvement in economic indicators gives rise to hope that sustainable economic expansion will finally take root. However, markets remain wary of another shock caused by the unresolved sovereign debt crisis in Europe and political infighting in the build-up to the 2012 election.
- The likelihood is that the recovery will continue at a moderate pace for another year or more until a full-fledged recovery takes root.
- Reasons for optimism on the economy include the fairly robust December job growth, especially in the private sector; continued strong corporate profits and balance sheets; pent-up demand for consumer products; low interest rates and inflation; and progress in deleveraging that has reduced the debt burden of families and corporations.
- The good news is tempered by factors that include persistently high unemployment rates; ongoing volatility in financial markets; weak growth in personal income; the struggling housing market; the high public debt burden; and tight credit conditions, especially for small businesses.

Implications & Outlook for Commercial Real Estate

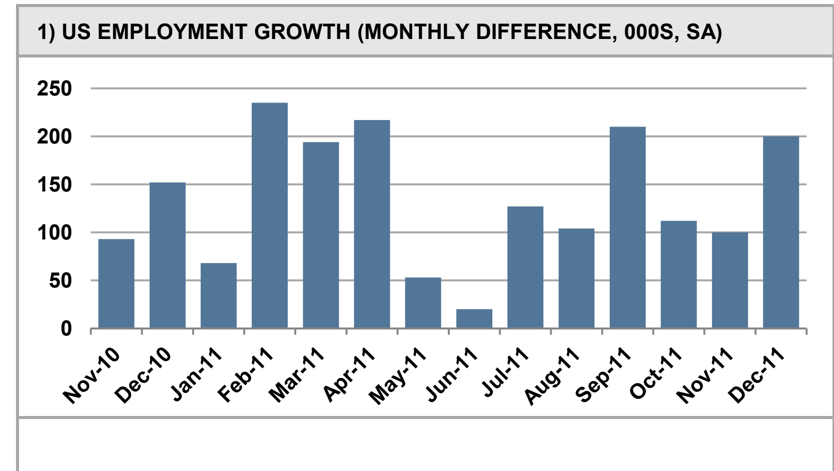
- Demographics and pent-up demand will drive strong demand for apartments for several years, while demand for hotels and self-storage units should continue to grow at a solid pace.
- Office and warehouse fundamentals will see more modest improvement, while retail will struggle with high vacancies, weak store expansion and competition from online retailers.
- Commercial real estate values will hold up, and even move higher for core assets, as investor demand for income and security remains strong. Europe’s troubles have led a growing number of non-US investors to seek safety in core assets in gateway markets in the US.
- Development will remain at historic low levels in all segments. Apartment development is increasing, but it may take another year or two before a meaningful number of units can be completed.
- Life companies and agency lenders are expected to originate record levels of debt, which is good news for class A assets and apartments. Lending by CMBS programs and commercial banks stalled late in 2011 due to the volatile financial markets, and will remain skittish early in 2012.

Economic Trends

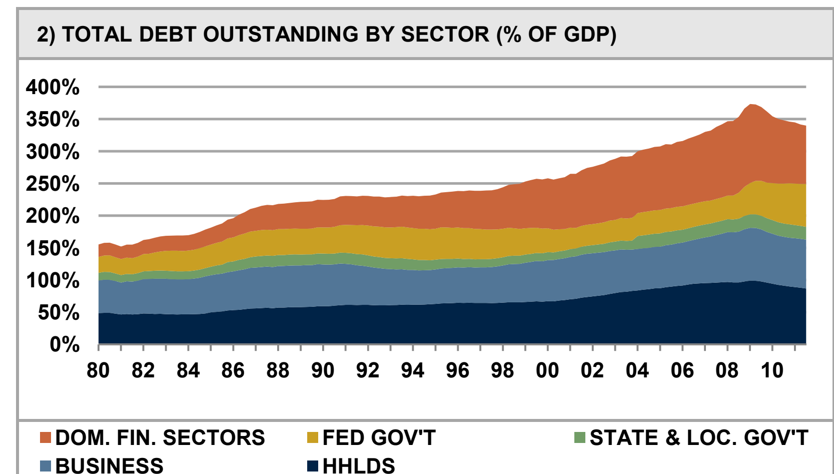
Outlook Improved For 2012, But Risks Remain

- The US economy regained momentum late in 2011 and will likely continue to expand at a moderate pace this year. Recovering employment, pent-up demand, and a prolonged low interest rate environment will help power the US economy in the new year. The Blue Chip Consensus Forecast calls for 2.2% GDP growth, up from 1.7% in 2011.
- Signs of hope re-emerged in the labor market in recent months. Payrolls expanded by 200,000 in December, and the unemployment rate dropped to its lowest level since 2009 (CHART 1). We expect payrolls to expand by 1.7 million jobs this year, slightly more than the 1.6 million jobs created in 2011.
- Businesses are sitting on $1.1 trillion in cash, corporate profits are at record levels and credit conditions are moderating. While uncertainty has discouraged firms from making significant hiring/investment decisions, any signs of sustained recovery could lead to significant upside potential for the US economy.
- Risks around the forecast appear balanced. Any full-scale disruption in the European markets would lead to a significant tightening of credit conditions, creating a strong impact on the US economy and financial system. Yet, the consumer debt picture has improved dramatically, and improving labor market conditions could unleash significant pent-up demand.
- The public sector remains a drag on the economy. Fiscal restraint will remain paramount as the federal government looks to combat the rising deficit, though state and local government setbacks appear to have subsided as the economy improves (CHART 2).

1) US EMPLOYMENT GROWTH (MONTHLY DIFFERENCE, 000S, SA)



2) TOTAL DEBT OUTSTANDING BY SECTOR (% OF GDP)



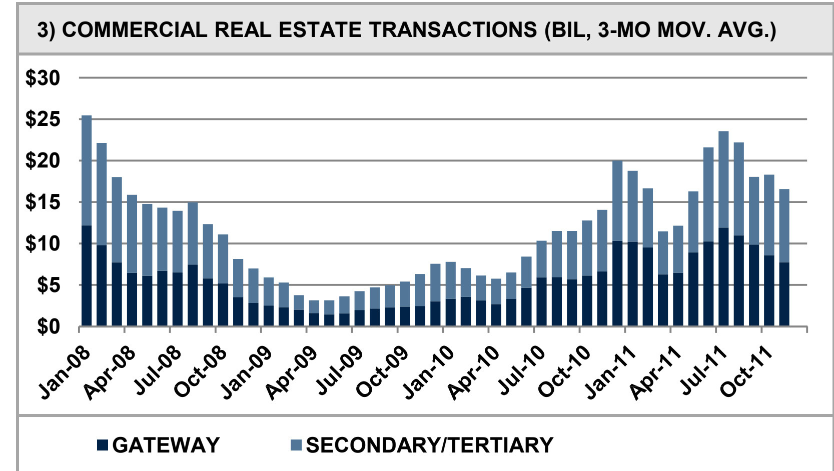
Sources: Moody's Analytics (BLS, BEA); Blue Chip Economic Indicators; Federal Reserve Board; Prudential Real Estate Investors

Transactions and Pricing

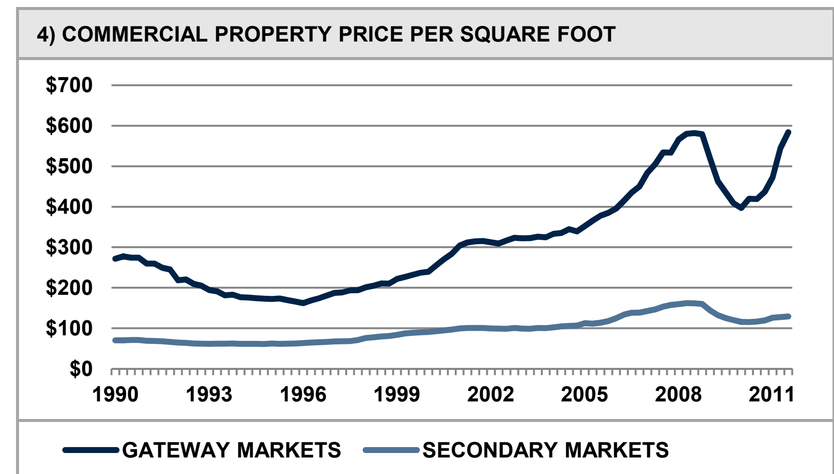
Desire for Yield and Security Will Continue to Drive Market Higher

- Transaction volume in 2011 totaled $200 billion, two-thirds higher than in 2010. This was slightly less than the 2004 level, a period in which the markets were in similar stages of recovery.
- Volume slowed in the second half of 2011 as risk appetite waned in wake of worries about the debt crisis in Europe and investors became more cautious in their underwriting (CHART 3). Office and apartments dominated the transaction market, though retail saw the strongest growth compared to 2010 owing to significant portfolio trades.
- A multitude of factors will support modest price growth in 2012 (CHART 4). Cap rates will likely decrease as a result of low-rate debt financing, an abundance of equity capital from both home and abroad, and the likelihood of improving market fundamentals. And US real estate returns remain attractive compared to most asset classes.
- A small group of gateway markets accounted for about half of all transactions last year as investors clamored for stabilized assets with secure cash flow. Some investors began to look more at secondary markets due to the high price differential in mid-2011, but they pulled back because of concerns about the US economy and increased capital market turmoil.
- If recent public market activity offers clues about the private market, investors may soon begin to refocus on risk-on opportunities, such as properties in secondary markets.

3) COMMERCIAL REAL ESTATE TRANSACTIONS (BIL, 3-MO MOV. AVG.)



4) COMMERCIAL PROPERTY PRICE PER SQUARE FOOT

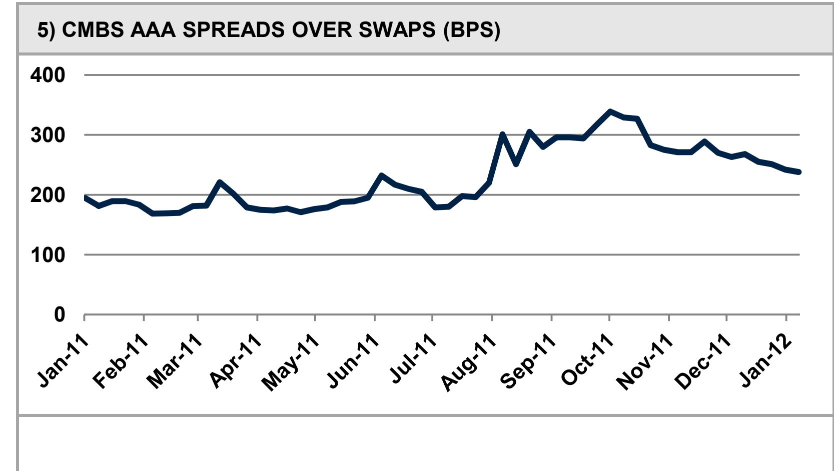


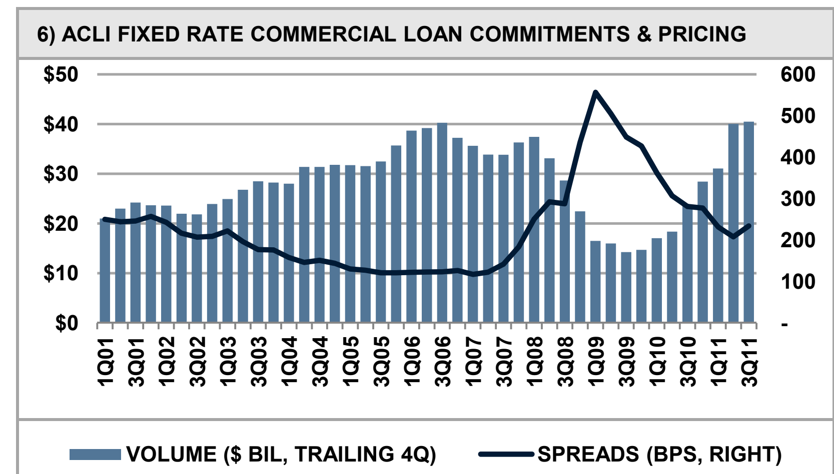
Sources: Real Capital Analytics, NCREIF, Prudential Real Estate Investors

Debt Markets

Life Cos & GSEs Will Remain the Main Game in Town

- Capital markets' volatility in the fall stalled the nascent recovery in CMBS and commercial bank lending. After a strong first half, CMBS activity slowed later in the year. Even so, 2011 CMBS volume of $32.7 billion was triple the $11.6 billion issued in 2010, according to Commercial Mortgage Alert.
- Market pros are forecasting a slight increase in CMBS volume this year. More than $50 billion of CMBS loans mature in 2012, but some can't be refinanced while others will picked off by other lender types. Although CMBS spreads have rallied recently, new origination will be tested by high loan spreads that are not competitive with insurers (CHART 5).
- Life companies, whose portfolios remained relatively free of defaults throughout the past few years, are eager to book mortgages. Lifeco lending activity hit a record $50 billion in 2011, and many expect their loan books in 2012 to be on par or increase from last year's level (CHART 6).
- Caution re-emerged among commercial banks, particularly among foreign banks, in the second half of 2011 due to concerns with capital and possible new regulations. Liquidations of troubled assets may increase slightly in 2012, as banks are better able to absorb losses and loan values continue to recover.
- With proposed changes to their business models still a long way from fruition, agency lenders Fannie Mae and Freddie Mac will continue to dominate the multifamily sector. Fannie and Freddie should easily top a combined $40 billion in 2012 via their traditional guarantee and CMBS programs.





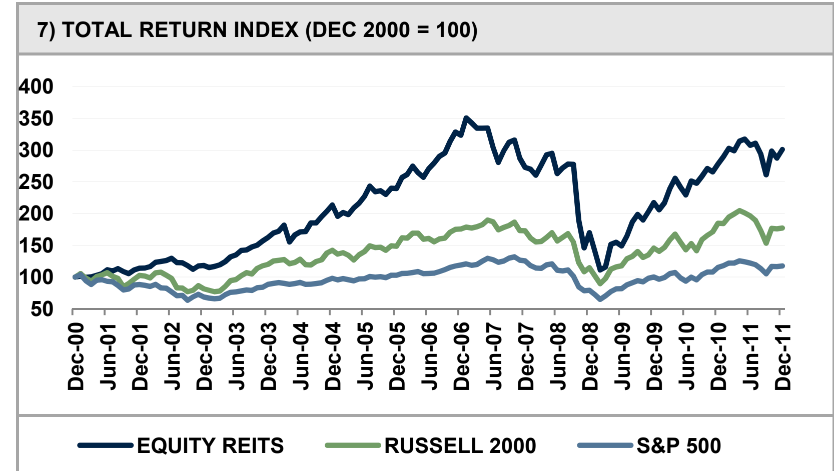
Sources: Commercial Mortgage Alert; Mortgage Bankers Association; Prudential Real Estate Investors

REIT Market

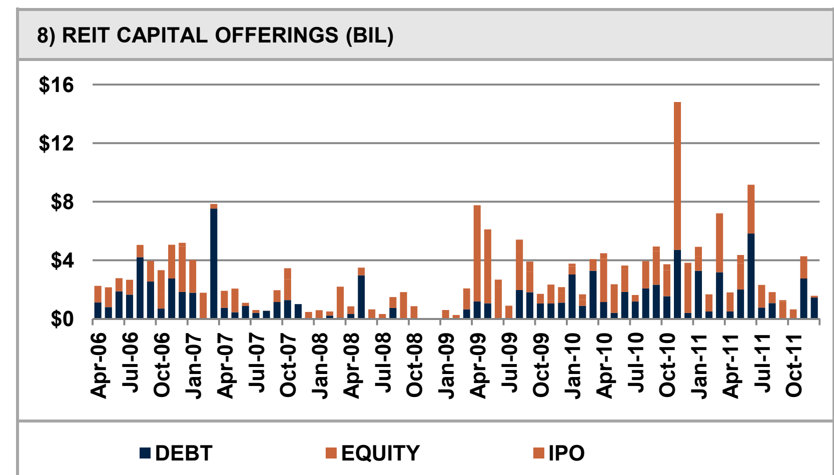
Favorable REIT Sector Outlook

- We project US REITs to produce a return in the 8% to 12% range this year, about the same as the 8.3% return produced by the FTSE NAREIT Equity REIT Index in 2011 (CHART 7).
- Net operating income growth should be strong in 2012. Like many companies, REITs have hoarded cash in the uncertain environment, but they will likely begin to pay out more as the outlook improves.
- Dividend yields average 3.7%, which is high in relation to Treasuries and other bond products, and they are expected to increase by 15-20%.
- REITs have deleveraged and are well-positioned to service their debt, even if there are dislocations in the credit markets. REITs raised $47 billion of equity and debt in 2011, about 10% less than in 2010, but finished the year on a strong note with $4.7 billion of debt issued in November and December (CHART 8).
- REIT balance sheets continue to improve, and many are shedding non-core assets to concentrate their portfolios on Class A properties in gateway cities. With low debt costs, REITs will likely remain active buyers, supporting valuations for Class A properties.
- Low interest rates gives quality REITs an opportunity to lock in debt at favorable rates, providing the potential for accretive acquisitions.

7) TOTAL RETURN INDEX (DEC 2000 = 100)



8) REIT CAPITAL OFFERINGS (BIL)



Sources: NAREIT; Frank Russell; S&P; Prudential Real Estate Investors

Property Markets

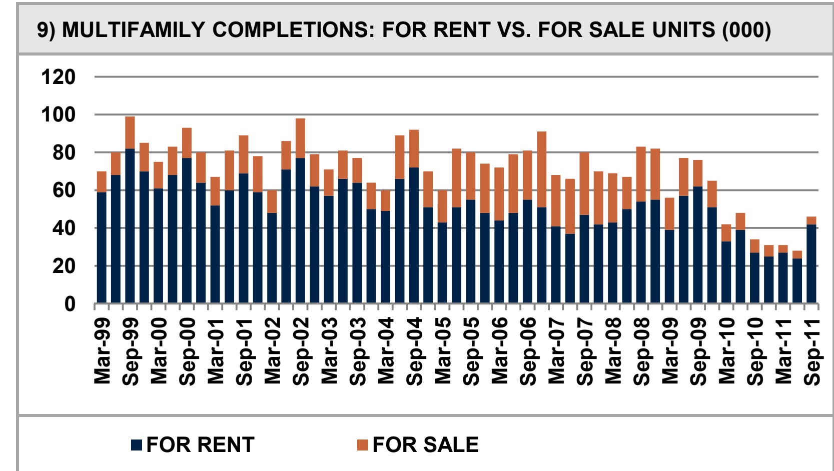
Apartment: Fundamentals Remain Robust

- Demand for apartments remains strong, driving occupancy gains and increasing effective rents in many markets. Vacancies dropped to the low 5% range in 2011 and will likely edge down below 5% over the next few years. Many analysts are increasing their NOI projections for the next two years.
- Favorable demographics and pent-up demand as labor markets strengthen will provide additional support for improving fundamentals in 2012 and 2013.
- New development remains limited, but construction is picking up relatively rapidly, particularly as completions focus on the for-rent segment (CHART 9).

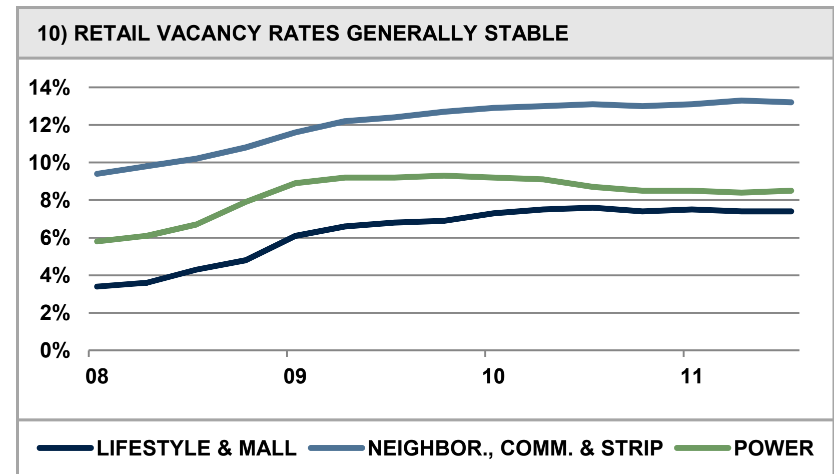
Retail: Sluggish Recovery

- Vacancy rates across all formats are stable (CHART 10), but remain near all-time highs. With new supply low, weak demand will produce a fragile recovery and modest rent growth potential.
- Retailers are likely to remain cautious about store expansion this year. The conservative bank lending environment and ongoing housing market troubles have discouraged local merchants from opening new stores. Holiday sales increased over 2010, but consumer confidence remains fragile, and there are signs that spending growth will be curtailed in 2012.
- High-end retail sales strength is supported by job and income gains among higher-income workers. That boosts the outlook for Class-A malls, which are seeing solid growth in net operating income.
- Opportunistic investors are focusing on redeveloping weaker assets or, in some cases, finding relative value plays in strip centers.

9) MULTIFAMILY COMPLETIONS: FOR RENT VS. FOR SALE UNITS (000)



10) RETAIL VACANCY RATES GENERALLY STABLE



Sources: CBRE-EA; NCREIF; Moody's Analytics (BEA, Census Bureau); CBRE-EA; Prudential Real Estate Investors

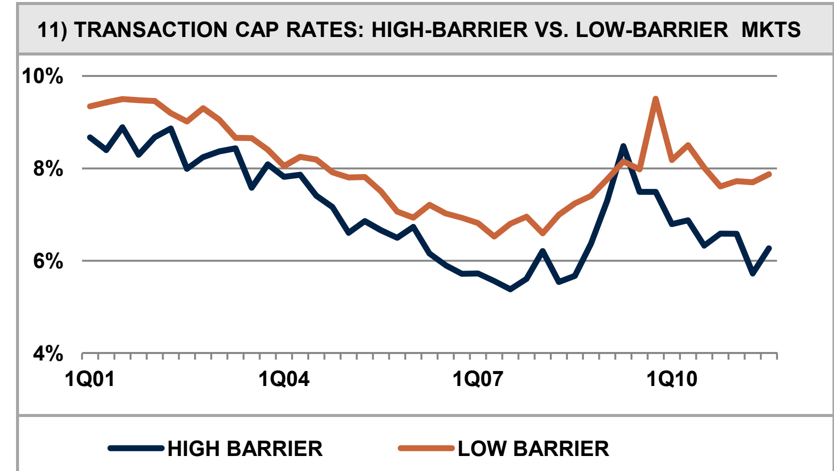
Property Markets

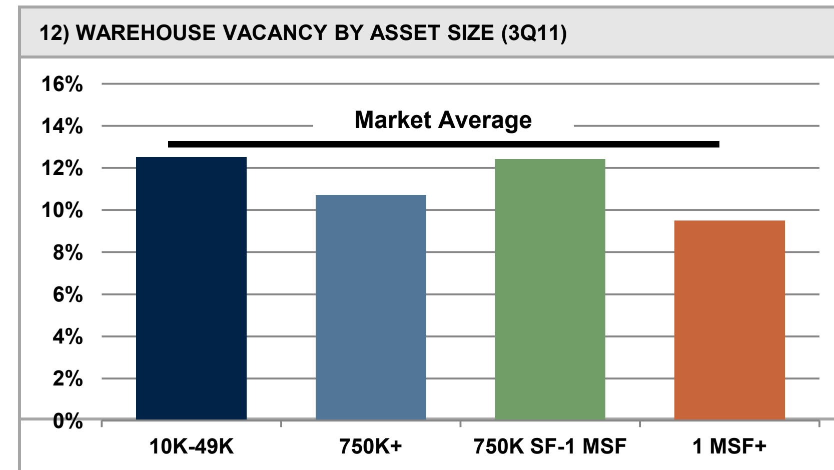
Office: Fundamentals Moving in Right Direction

- Office vacancies continue to drop, albeit slowly. Absorption should remain on par with 2011 (0.6% of stock, according to Property & Portfolio Research), as firms backfill existing space with new employees. Markets with tech exposure will continue to perform well.
- The flight to quality continues. Fundamentals are improving for Class A stock in top markets, and stabilizing for Class B/C stock in secondary markets.
- Transaction volume in primary markets tripled in 2011, as investors accepted lower return expectations in recognition of the low interest rate environment.
- Strong demand for safe harbor assets and low borrowing costs will sustain the strong appreciation gains in gateway markets. The large spread between high- and low-barrier markets will entice some investors into riskier markets as the economy improves (CHART 11).

Warehouse: Slowly Improving

- Warehouse fundamentals will continue to improve in 2012. Demand has been strongest for research and development (R&D) and warehouse space, but weaker for manufacturing.
- New construction is minimal (0.3% of total stock: PPR), so even a modest recovery in demand will drive further gains in occupancy this year. Rent reductions are beginning to wane, and rent growth is forecast to be slightly positive in 2012.
- Demand for large, modern warehouse units may spur speculative construction. Availability rates in the segment are below average (CHART 12).





Sources: Real Capital Analytics, PPR, CBRE, Prudential Real Estate Investors

Property Markets

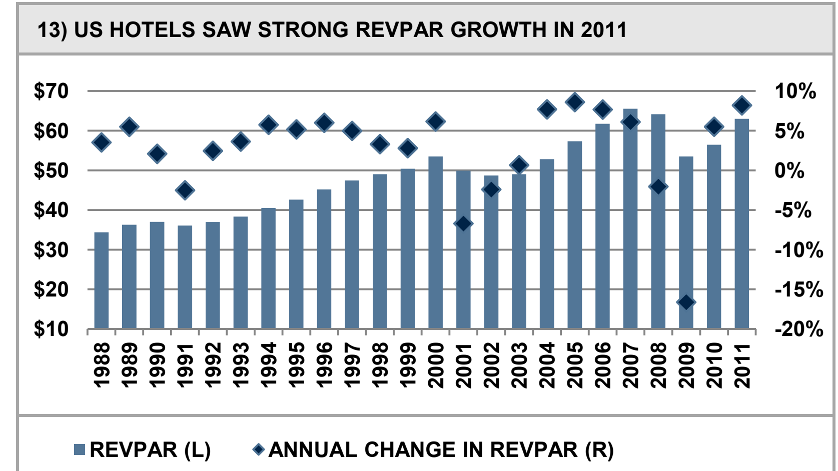
Hotels: Demand Strong, Supply Limited

- Hotel fundamentals should improve further in 2012, though the rate of growth may moderate after two strong years. In 2011, the average occupancy rose 4.4%, average daily rates rose 3.7% and RevPAR rose 8.2%, according to Smith Travel Research (STR) (CHART 13).
- The Aug.-Oct. economic slump prompted most industry analysts to downgrade 2012 forecasts. STR, for example, reduced its 2012 RevPAR projection to 3.9% in November, down from 8.6% in April. We would not be surprised to see forecasts revised higher as the year progresses.
- Luxury and upscale segments continue to lead the recovery, and the primary markets are faring the best. Development will be limited for several years, though activity is increasing in markets such as NYC and Houston.
- A large portion of hotel debt is overleveraged, and will need to be recapitalized over the next few years. Opportunities will abound for investors to provide debt and equity capital to repair underwater loans.

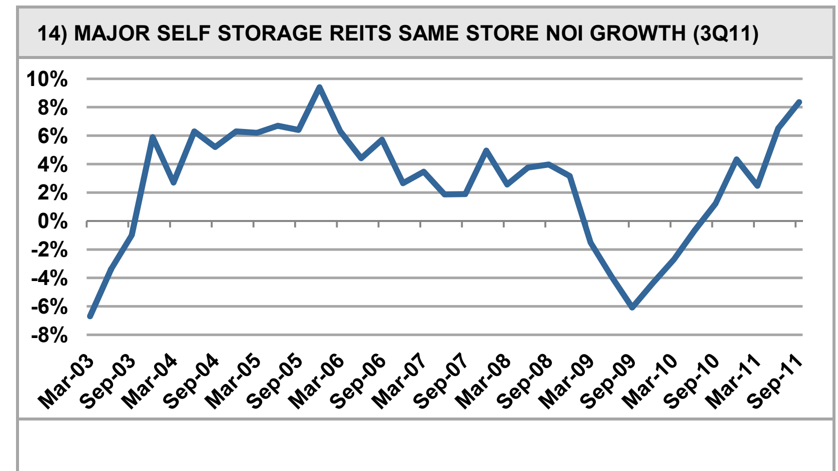
Self Storage: Strong Performance

- Self storage outperformed many other asset classes last year and should continue to be a strong performer this year owing to a declining homeownership rate and muted new supply.
- Occupancies have nearly recouped the entire decline seen during the recession, a faster recovery than most property sectors.
- NOI growth among storage REITs over the next five years should be strong (CHART 14), as property owners increase rents and scale back concessions.

13) US HOTELS SAW STRONG REVPAR GROWTH IN 2011



14) MAJOR SELF STORAGE REITS SAME STORE NOI GROWTH (3Q11)

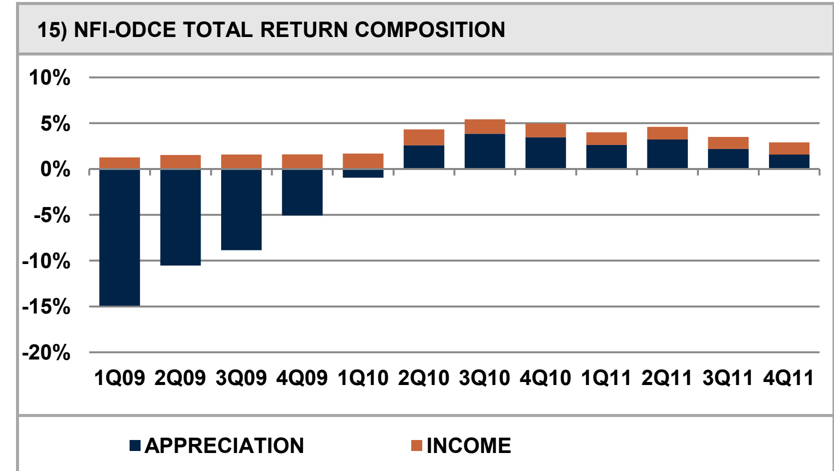


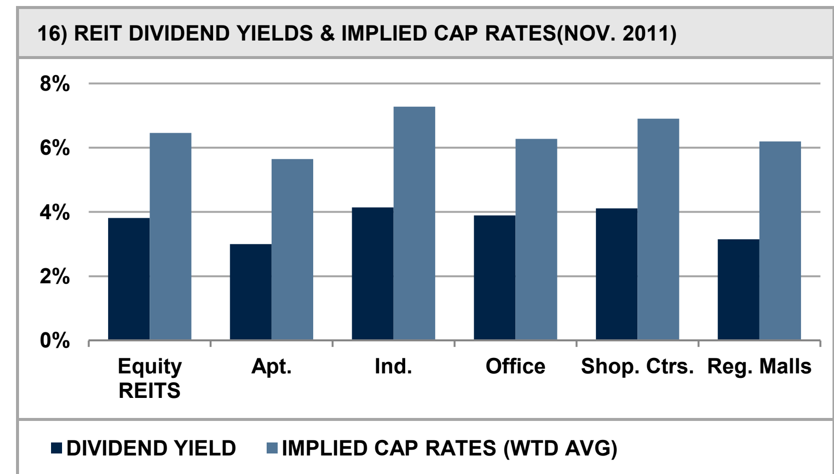
Sources: PPR; Green Street Advisors; Prudential Real Estate Investors

Investment Performance

Attractive Returns, Low Interest Rate Environment

- The NCREIF Fund Index (NFI-ODCE) total return rose 2.9% in 4Q11 (gross total return, preliminary), its eighth straight positive quarter (CHART 15). 2011 total returns were 16%, comprised of 10% appreciation and 5.5% income returns.
- The NCREIF Property Index (NPI) produced a 3% total return in 4Q11 and 14.3% for the year, which slightly exceeded the 14% top end of our forecast a year ago. We expect NPI and NFI-ODCE total returns in the 8-10% range this year, with the potential for upside surprise.
- The FTSE NAREIT Equity REIT Index rose 15.2% in 4Q11 and posted an 8.3% total return for the year.
- Private real estate's projected 5-6% income yield in 2012 offers investors a significant spread over treasuries with limited downside risk at this stage of the economic and real estate market cycle.
- Commercial real estate will attract investors seeking relatively high dividend yields (CHART 16). Last year's strong bond market returns were fueled by Treasury rates declining to historic lows, a performance that will be difficult to repeat.
- With global real estate investors still anxious about Europe, many will continue to find the US a safe haven in 2012. Real Capital Analytics expects foreign acquisitions of property in the US to double this year.





Sources: NCREIF; FTSE NAREIT; PREA; Prudential Real Estate Investors

Attractive Risk-Adjusted Investment Opportunities — United States

THEME	INVESTMENT IMPLICATIONS
Strong Demand for Core	• 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	• 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	• 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	• 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	• Medical office buildings and targeted transactions near major health care centers. • Self storage was recession-resistant and strongly outperformed in 2011. Fundamentals will likely continue to improve this year. • Senior housing real estate values remain strong, and operating fundamentals should support slow, but steady, NOI growth.

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