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US Quarterly Outlook

JULY 2011

ABU DHABI
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HONG KONG
ISTANBUL
LISBON
LONDON
LUXEMBOURG
MADRID
MEXICO CITY
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Executive Summary

Macro Themes

- The US economy continues to expand, albeit at a slower pace than in previous quarters. We expect GDP and job growth will accelerate in the second half of the year.
- Low interest rates and strong demand for stable, secure cash flows have caused cap rates for core assets in prime markets to further compress.
- Demand for space is uneven across property types – strong for apartments and hotels, weaker for most everything else.
- With the exception of apartments, new construction will be very limited and should remain so for 2-3 years.

Implications & Outlook for Commercial Real Estate

- Core real estate is expensive, which is causing investors to consider investing beyond gateway markets and alternatives that may offer better risk adjusted returns.
- Strong recovery in demand and rich pricing for existing apartment assets make development attractive.
- Office fundamentals remain weak, but the high-beta nature of the sector should reward investors as job growth resumes. CBD markets are healthier and are recovering more quickly than suburban markets.
- As real estate values recover and lenders are less willing to extend underwater loans, recapitalizations will provide opportunities for high-yield debt and equity investments.
- In the absence of a broad-based recovery in demand, some niche or sector specific strategies are attractive.
- Appreciation returns for the NCREIF Fund Index (ODCE) will likely average 2% to 3% per quarter over the balance of the year.

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Economic Trends

- Positive Factors:
  - Significant pent-up demand from corporate and consumer sectors, especially wealthier households
  - Strong corporate balance sheets and healthy profits
  - Robust export growth due to weak US dollar
- Negative Factors:
  - Deleveraging likely to continue for several years as growth in credit lags economic expansion
  - Unhealthy public sector deficits will be a drag on growth
  - Wide disparity in job growth outlook, and real potential for persistently high structural unemployment
- Key Issues & Takeaways:
  - Job growth is the most important factor in the outlook
  - Whether job creation is as robust as Moody's anticipates or as weak as EIU forecasts, we believe fundamental trends will produce a healthy recovery for commercial real estate
  - Under either job growth scenario, there will be winners and losers

CHART 1

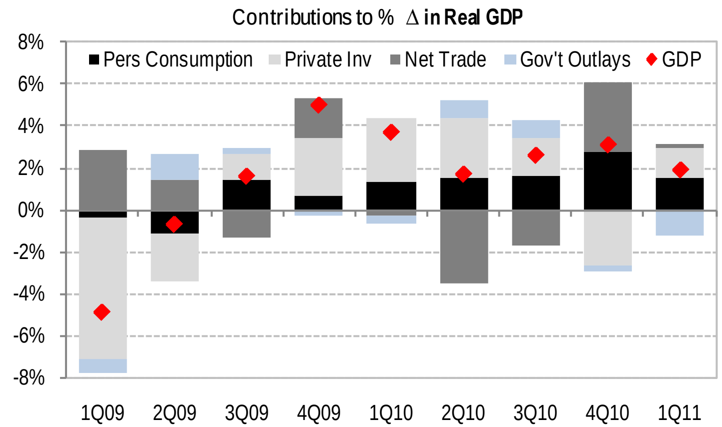
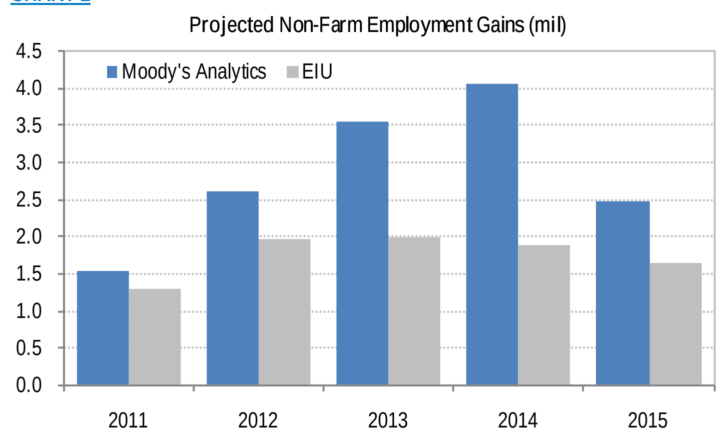


CHART 2



SOURCES: MOODY'S ANALYTICS (BLS, BEA); ECONOMIST INTELLIGENCE UNIT (EIU); PRUDENTIAL REAL ESTATE INVESTORS

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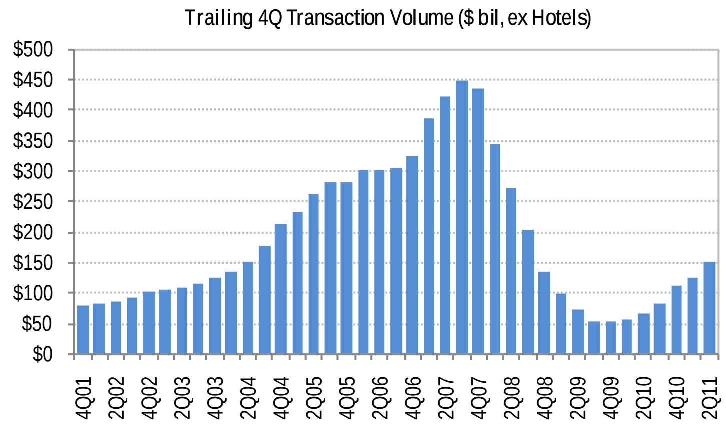
Transactions and Pricing

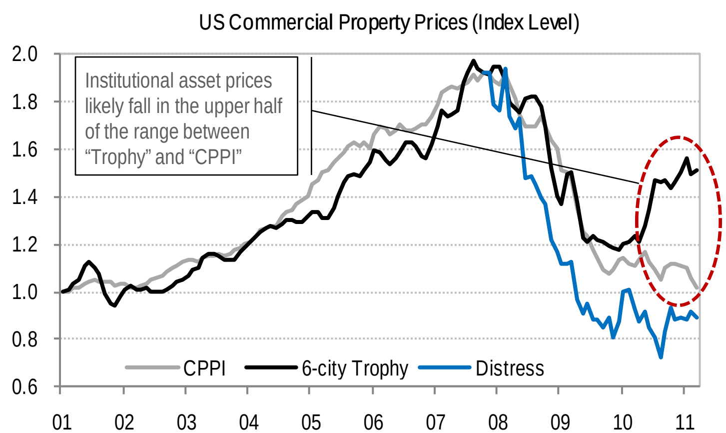
- Transaction activity has increased, as investor thirst for yield creates strong demand for secure cash flow (i.e., core)
- Transaction volume through 2Q was up 132% year-over-year, owing to strong demand for offices and apartments and a surge in retail transactions (mainly due to a $9.2 bil portfolio acquisition)
- On a trailing 4-quarter basis, total volume has returned to 2004 levels (Chart 3)
- Activity remains focused on core assets in prime markets, but improving fundamentals, low interest rates and greater credit availability are encouraging investors to consider secondary markets and non-core assets
- Property offerings have jumped to the highest level since 2008, as owners look to take advantage of strong investor demand
- Property values of trophy assets have rebounded quickly, but the recovery in the broader market has been weaker due to limited transaction activity and distressed sales (Chart 4)

CHART 3



** 2Q11 transaction volume through May*

CHART 4



SOURCES: REAL CAPITAL ANALYTICS (6 CITIES INCLUDE BOSTON, CHICAGO, DC, LA, NYC, SAN FRANCISCO); PRUDENTIAL REAL ESTATE INVESTORS

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Debt Markets

- With transaction activity still recovering, little development and only a trickle of distressed assets finding their way to the market, the availability of debt capital exceeds lending opportunities
- Competition among lenders is leading to increased risk appetite evident in higher LTVs and narrower spreads (Chart 5)
- Low benchmark rates are keeping the cost of debt down (typically less than 6%)
- Life companies remain active for high-quality product and should easily exceed last year's origination volume (Chart 5)
- CMBS market is reviving (Chart 6), but spreads have widened recently amid concerns about the Eurozone and US debt ceiling
- Large banks are becoming increasingly active, but small and regional banks continue to struggle with troubled loans
- Construction financing is readily available for multifamily, but lenders still require a healthy amount of equity (≈35%) and strong sponsors
- Agencies continue to provide significant capital to multifamily sector, but life companies and other lenders are actively lending as well

CHART 5

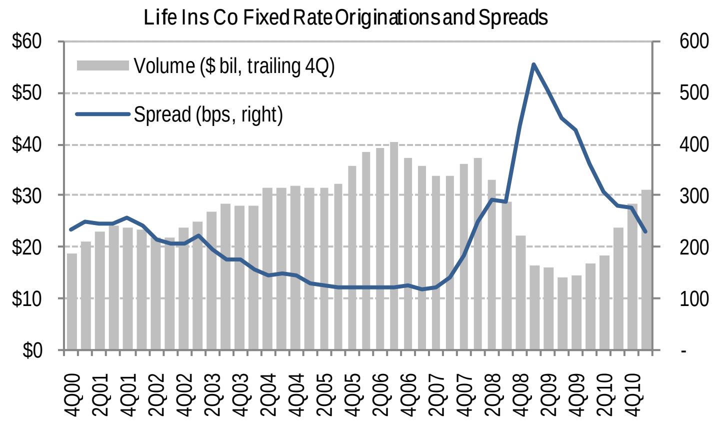
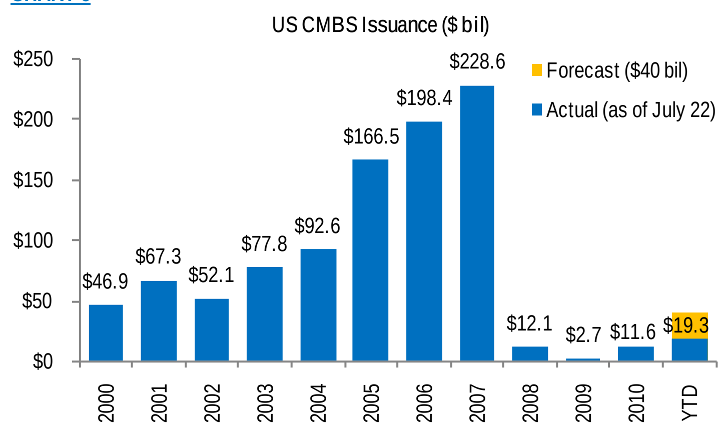


CHART 6



SOURCES: COMMERCIAL MORTGAGE ALERT; AMERICAN COUNCIL OF LIFE INSURERS (ACLI); PRUDENTIAL REAL ESTATE INVESTORS

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REIT Market

- REITs continue to enjoy extraordinary access to capital at attractive pricing (Chart 7) and are in a strong position to expand their portfolios
- Investors have not been terribly receptive to IPOs, with only 5 deals done in the first half of the year raising $1.8 billion
- Through 2Q, REITs were net buyers, accounting for 12% ($9 bil) of acquisitions (per Real Capital Analytics), but their market share has fallen and dispositions have increased from 2010 levels
- While many REITs are trading at premiums to NAV (Chart 8) and share prices look expensive relative to stocks, earnings and dividend growth may justify high multiples
- Capital flows into dedicated REIT mutual funds have been positive, with YTD inflows of about $3.6 billion (through 3rd week of July)
- REITs outperformed the boarder equity market in the first six months of 2011 posting a 10.2% total return versus the 6% gain for the S&P 500 index

CHART 7

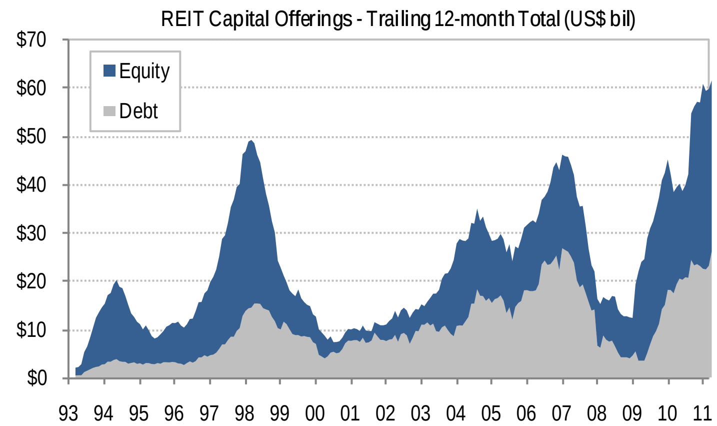
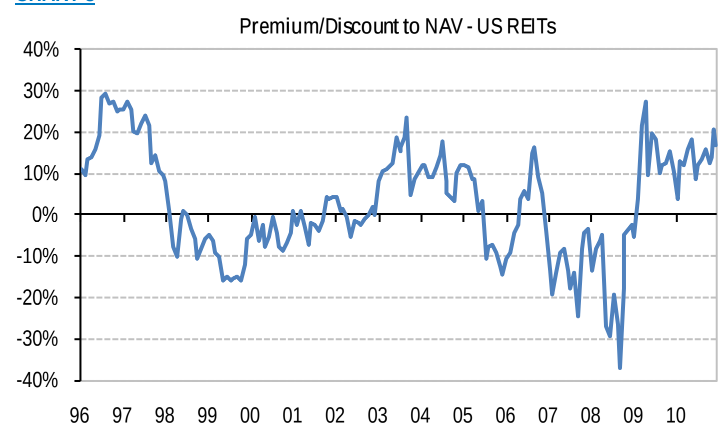


CHART 8



SOURCES: SNL SECURITIES; ISI; UBS; REAL CAPITAL ANALYTICS; PRUDENTIAL REAL ESTATE INVESTORS

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Property Markets

Apartment

- Healthy absorption is driving strong occupancy gains (Chart 9), and effective rents are increasing rapidly in many markets
- Favorable demographics, pent-up demand from the recession and the ongoing shift from owning to renting have turbo-charged demand
- New development remains limited, but permitting activity is picking up and starts will accelerate in 2012-13

Retail

- Market is bifurcated – strong demand for high productivity assets and defensive formats, such as grocery anchored centers, and tepid demand for most everything else
- Power centers face the biggest near-term challenges due in part to the competitive threat from online retailing
- Gains in employment income (Chart 10) have helped offset headwinds from increased savings, weak confidence, higher gas prices and lack of home equity
- Local merchants continue to struggle, but national retailers are well positioned to generate strong profits as spending rebounds

CHART 9

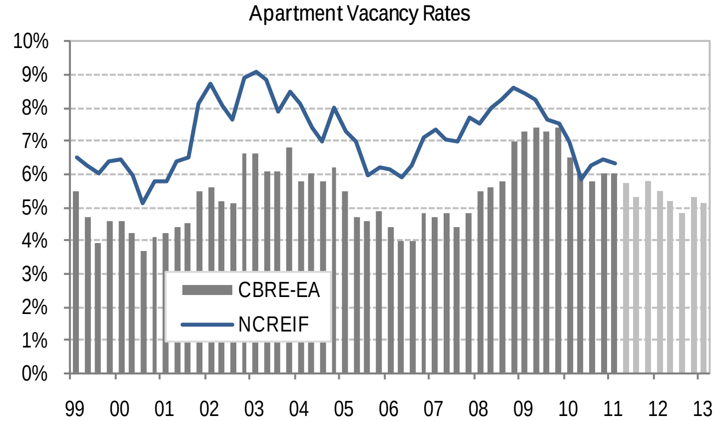
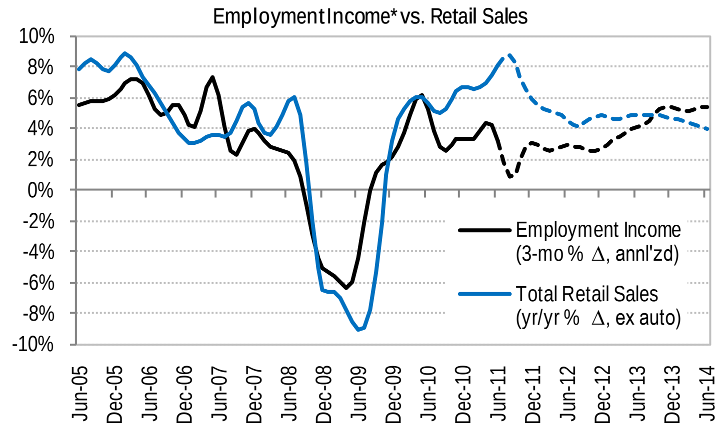


CHART 10



SOURCES: CBRE-EA; NCREIF; MOODY'S ANALYTICS (BEA, CENSUS BUREAU); PRUDENTIAL REAL ESTATE INVESTORS

**Emp Inc = Total Emp x Avg Hourly Earnings x Weekly Hrs*

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Property Markets

Office

- Vacancy rates have stabilized and are beginning to decline in select CBD markets as office employment recovers (Chart 11)
- Tenant demand is strongest in gateway cities and tech markets (e.g., New York, Washington DC, Boston & San Francisco)
- Recovery in most suburban markets will lag CBD recovery by two years or more, but the widening yield gap is looking more attractive
- Record corporate profits bode well for investment spending and hiring, especially in knowledge-based industries (e.g., tech)

Industrial

- Industrial rents have dropped to their 1Q99 levels, but in real terms rents are at their lowest levels recorded (since early 1980s)
- Medium-term warehouse demand drivers (e.g., total employment, capacity utilization, industrial employment, retail sales and foreign trade) favor a healthy recovery in the warehouse market (Chart 12)
- Strong rent growth and occupancy gains are forecast for the next five years, but threat of new development could temper recovery

CHART 11

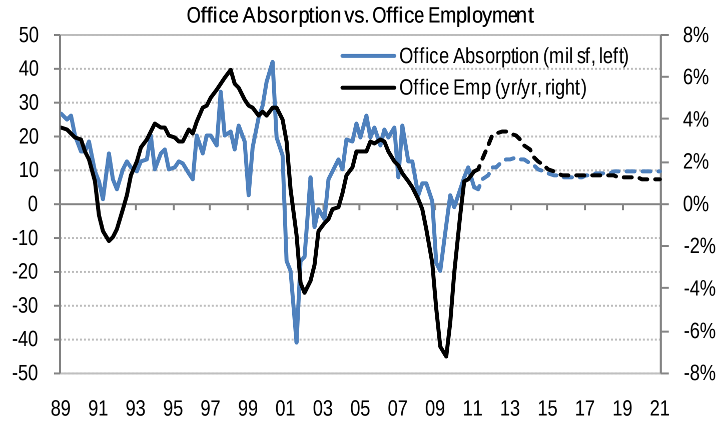
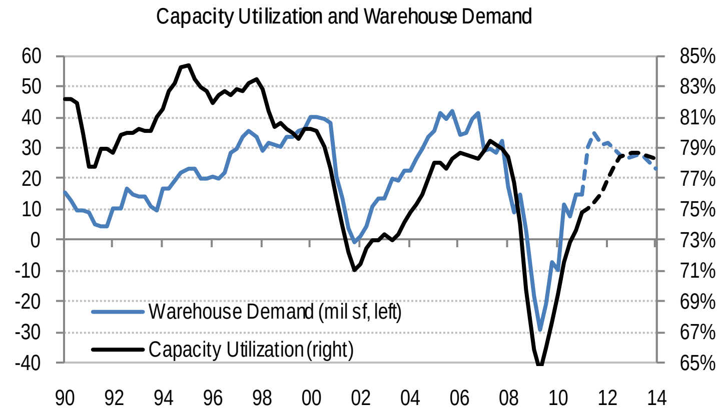


CHART 12



SOURCES: PPR; MOODY'S ANALYTICS (FEDERAL RESERVE); PRUDENTIAL REAL ESTATE INVESTORS

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Property Markets

Hotels

- Increasing business and leisure travel is pushing hotel demand to peak levels, but group travel has yet to rebound
- Occupancy levels are steadily rising (Chart 13), while new supply is at its lowest level in 20 years, enabling hotels to raise rates
- Revenue per available room is growing at well above average rates (Chart 13), and is expected to keep rising for the next few years
- Hotel transaction volume is accelerating, driven by lodging REITs

Self Storage

- Self storage is highly correlated with apartment fundamentals and has seen a similar, though more muted, recovery in demand
- Property owners are beginning to increase rents and scale back on concessions
- NOI growth among storage REITs over the next 5 years is expected to be stronger than average for the major sectors, but weaker than apartments (per Green Street)
- Implied valuations for storage assets based on REIT market pricing suggests further cap rate compression and continued consolidation

CHART 13

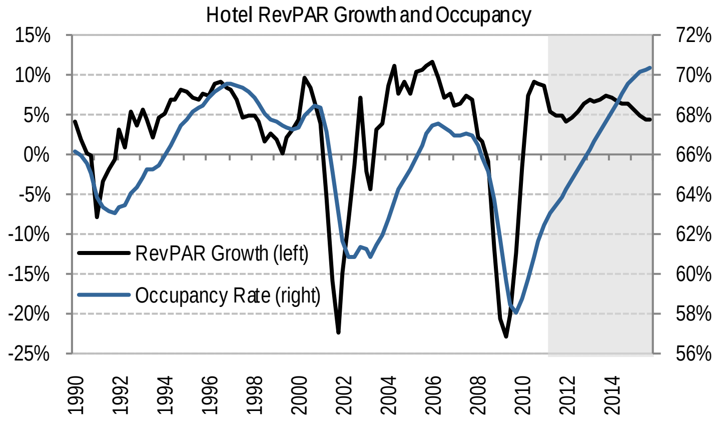
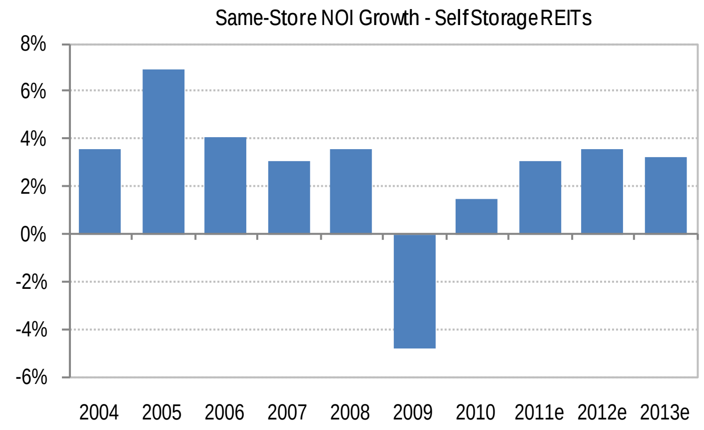


CHART 14



SOURCES: PPR; GREEN STREET ADVISORS; PRUDENTIAL REAL ESTATE INVESTORS

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Investment Performance

Recent Performance

- The NCREIF Fund Index (NFI-ODCE) rose 4.7% in 2Q11 (gross total return, preliminary), its sixth straight positive quarter
- Equity REITs gained 3.6% in the second quarter, and have returned 33.6% over the last year

Outlook

- Despite the slowdown in the economy and job market, outlook for CRE fundamentals and property values remains positive
- REITs look somewhat expensive compared with private real estate and the broader equity market, but enjoy excellent access to capital and should deliver strong dividend growth over the next year or two
- We expect appreciation returns of 2% to 3% per quarter for the NFI-ODCE Index over the balance of 2011 as appraisers chase the transaction market
- Beyond 2011, cap rates will encounter resistance and may rise if interest rates begin to climb, but improving income and sentiment will mute the impact of rising cap rates on property values

CHART 15

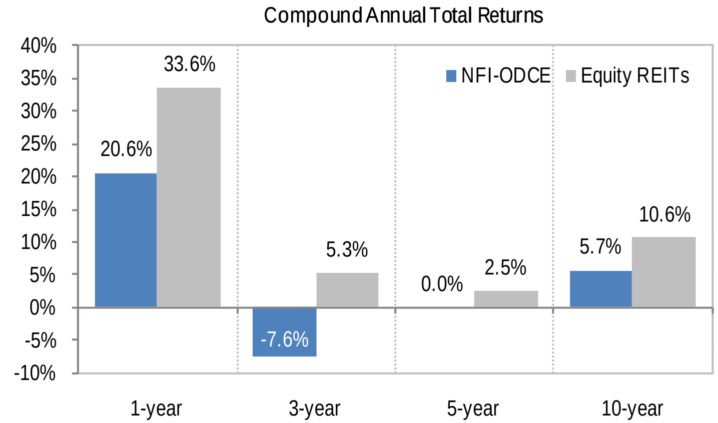
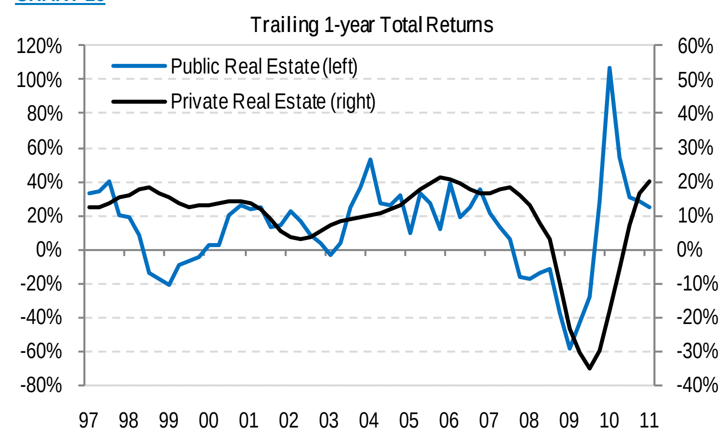


CHART 16



Private real estate returns based on preliminary release of NFI-ODCE Index for 2Q11

SOURCES: NCREIF; FTSE NAREIT; PREA; PRUDENTIAL REAL ESTATE INVESTORS

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Investment Opportunities

ATTRACTIVE RISK-ADJUSTED OPPORTUNITIES	
THEME	**INVESTMENT IMPLICATIONS**
Strong Demand for Core	• Core is expensive, particularly in gateway markets, where yields have been bid down in anticipation of a recovery in property income. • 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. • Hedge against a possible future correction – as cap rates decline further and the risk of a pricing correction increases, reduce leverage levels and replace floating rate with longer-term fixed-rate debt.
Demand Recovery	Multifamily (Low Beta) • With existing apartment assets priced at sub-5% cap rates and IRRs below 7%, development provides better risk-adjusted returns in many markets. • Projects started early in the cycle will have the advantage of lower construction costs and stronger leasing activity, but the discipline to sell assets (2-4 years) in markets without meaningful supply constraints will be key. Office (High Beta) • As demand recovery gains momentum and investor risk appetite improves, non-trophy office assets in core markets may offer better risk-adjusted returns. • With virtually no new supply and limited distress, renewed job growth should drive absorption and turbo-charge rent growth through 2014/2015.

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Investment Opportunities

ATTRACTIVE RISK-ADJUSTED OPPORTUNITIES	
THEME	**INVESTMENT IMPLICATIONS**
Deleveraging	• More than $1.5 trillion in commercial mortgage debt outstanding will need to be refinanced over the next five years. • CMBS special servicers and banks are ramping up sales of loans and loan portfolios. • As values and bank balance sheets recover and lenders are less inclined to extend underwater loans, recapitalizations will provide opportunities for equity and mezzanine debt.
Niche Strategies	• In the absence of a broad-based recovery in demand, some niche or sector specific strategies are attractive – e.g., senior housing, self storage. • Long-term secular trend toward broader institutional exposure will lead to re-pricing in non-core sectors. • Explore opportunities in healthcare-related real estate and urban living (e.g., retail, ethnic-focused opportunities).

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