

U.S. Quarterly

Market Perspective

Executive Summary

- After a long period of fits and starts, conditions finally seem ripe for an extended recovery in commercial real estate. The recovery is firmly established in the apartment and hotel segments, while the office, retail and industrial sectors are starting to turn around after hitting near-record levels of vacancies. Still, the improvement in market conditions remains dependent on the fragile economy and will probably be inconsistent in coming months.
- Rising interest rates could temper optimism about property fundamentals. Historically low interest rates have been a boon to the sector, keeping the cost of capital low for real estate owners and making property returns attractive in comparison to fixed-income instruments. Rates rising too quickly or too high would have a negative impact on property values, which have recovered with unprecedented speed for core assets.
- Transaction activity is rising from trough levels, but investor demand for core assets still exceeds the supply available for sale. Demand remains focused on the core and distressed ends of the spectrum. Activity involving assets in the middle will rise this year as financing for second-tier properties becomes more available, banks and special servicers shed bad loans and investors become more confident of a broader recovery in the economy and look for higher yields.
- Debt markets are growing healthier by the day, led by the revived CMBS market, which is sprouting new deals after three years of inactivity. Investor demand for CMBS is high, and life companies are actively seeking new loans on high-quality properties. Lenders are beginning to expand beyond core assets.
- The bank market remains a mixed bag, with larger banks more likely to have made progress in resolving troubled loans and restarting their lending machines. Regional and local banks remain mostly inactive as they slowly work through defaults. Regulators are not pushing banks to liquidate, prompting a slow-motion resolution of overleveraged assets.
- REITs will be hard-pressed to improve on 2010, a year in which they strengthened balance sheets, raised a record amount of capital and posted solid returns, with the FTSE NAREIT Equity REIT Index rising 28%. Still, REITs remain relatively attractive. Their earnings should improve with real estate fundamentals, they have prospects for external growth and are likely to be an attractive target for investors seeking income returns with the potential for appreciation.

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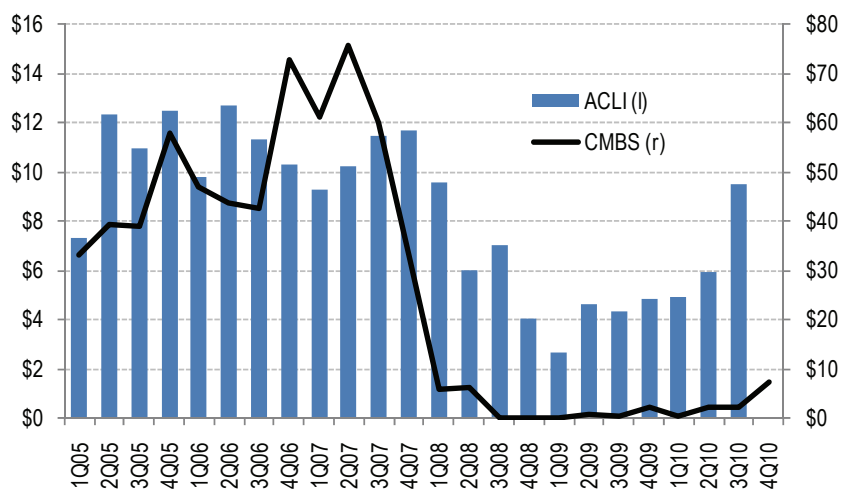
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Debt Markets

The lending environment has changed quickly, and while activity is far from pre-crisis levels, a new normal appears to be emerging. One measure of this is lenders' treatment of less conventional property types. It wasn't too long ago that most lenders would avoid all debt on hotels and health-care properties, and now they are fighting for assignments that involve restructurings of failed high-profile 2007-vintage transactions. To be sure, the deals are not as frothy as they were a few years ago. Lenders are offering fewer proceeds and have tightened terms in a number of ways. However, there is an unmistakable shift in the tone of the debt markets, with a bias toward trying to get deals done as opposed to being overly cautious.

Lending of Life Companies and CMBS Conduits is Trending Up

Quarterly Life Insurer Loan Commitments, CMBS Volume



American Council of Life Insurers, Commercial Mortgage Alert

That bias is most evident in the CMBS market, which saw \$7.6 billion of deals in the fourth quarter after only \$4 billion was floated in the first nine months. The first quarter pipeline exceeds \$10 billion, and many market players are anticipating \$40 billion or more of issuance in 2011. The revival stemmed from a variety of factors. Most importantly, low interest rates and the ongoing rally in CMBS spreads enabled securitization programs to offer attractive coupons to borrowers. Earlier in the year, lenders were willing, but loan rates were higher than most borrowers were willing to accept. Tightening CMBS spreads reflect increased demand from investors, who are attracted to the relatively higher yield CMBS offers versus other fixed-income product. Investors are willing to pay up for newly issued CMBS as compared to legacy bonds because the new deals have better underwriting standards. The triple-A classes of multi-borrower CMBS issued in 4Q10 were priced to yield 120-140 bps over swap spreads, about 100 bps tighter than comparable pre-crisis deals trading in the secondary market. And newly issued triple-B CMBS is priced to yield about 360 bps over swaps, compared to 7,000 bps for pre-crisis legacy deals.

CMBS will maintain its pace as long as investor demand is strong and market conditions enable lenders to quote competitive rates. That's good news for commercial real estate, because CMBS is an important element in improving access to debt across the entire spectrum of the market. CMBS historically has financed a broad type of properties in a diverse cross-section of markets, which is necessary for commercial real estate to regain full health. To put volume in perspective, though, projected 2011 levels are

equivalent to the late 1990s. Before 2008, the last year volume was shy of \$50 billion was 2000. But with this resurgence caution is in order. Competition for deals has resulted in substantial reduction in underwritten debt yields, raising some concern about the speed with which underwriting standards are being relaxed.

Life companies also increased their appetite for mortgages by a healthy amount last year, which will carry over into 2011. Insurers originated \$9.5 billion of loans in 3Q10, nearly as much as the first two quarters combined and the most-active quarter since 1Q08. Total life company volume in 2011 should easily exceed \$30 billion, which would be the highest total since 2007 and roughly double the \$16.4 billion produced in 2009, according to the American Council of Life Insurers. Insurers are largely focused on conservatively underwritten medium-sized loans on stable properties, which is why they have so few defaults compared to other lender types. Government-sponsored enterprises continue to produce consistent volume in the multi-family market. GSEs issued a record \$26.9 billion of bonds in 2010, up from \$8.7 billion in 2009. The long-awaited reform of the agency market will begin this year, but it is unlikely to produce changes in the way they operate for at least a year, and possibly not until after the next presidential election.

Commercial banks will be the last lender segment to fully recover from the crisis, which is no small thing considering they are the biggest lender by outstanding volume. There is a wide disparity in recovery among banks, largely divided by how well the institution is dealing with its portfolio of delinquent loans. The largest banks generally have made the most progress in addressing problem loans, not to mention that commercial mortgages represent a smaller portion of their total assets. A handful of the biggest banks are originating permanent loans for securitization and for their own portfolios. Regional and local banks, some of which have yet to repay TARP money to the government, are less likely to have resumed activity in part because their underwater loan portfolios represent a larger portion of their asset base. Construction financing remains subject to strict underwriting, but it is slowly becoming more available, particularly for apartments.

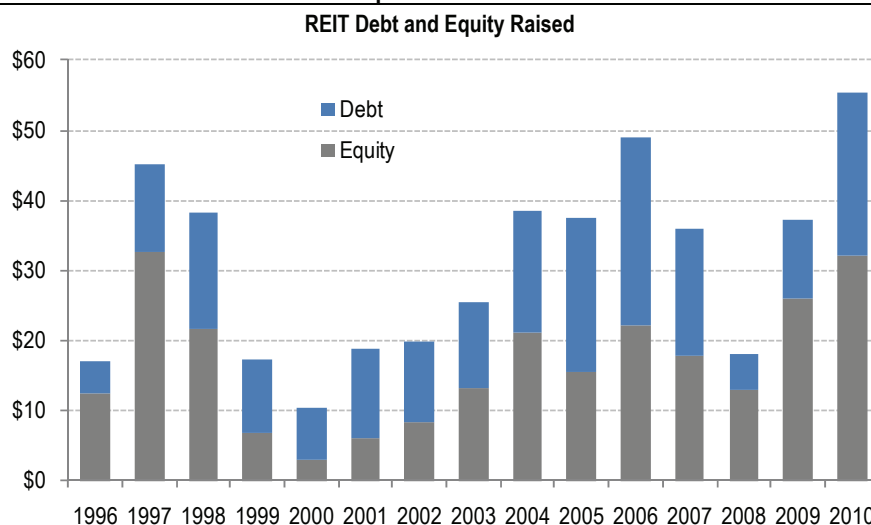
REIT Market

If 2009 was a year of recovery for REITs, 2010 proved to be the year that the sector fully stabilized. The NAREIT Equity REIT Index posted its second straight year of 28% total returns, with each segment making significant gains. Apartment REITs led the way with a 46% return for the year, followed by lodging (42.8%), retail (33.4%), self-storage (29.3%) diversified (23.8%), industrial (18.9%) and office (18.4%). However, the positive developments went beyond outperforming broader indices such as the S&P 500. REITs strengthened their balance sheets, raising huge sums of capital at attractive prices, and saw their correlation to financial stocks drop for the first time since the onset of the financial crisis. Through the combination of asset sales and paydown of debt, REITs start 2011 with an average debt-to-asset-value ratio to roughly 40%, compared to about 60% at the trough in 2008.

The most important development of 2010 was the solid improvement in investor sentiment toward REITs, which enabled them to raise a record \$55.4 billion of capital, including \$32.1 billion of equity and \$23.3 billion of debt. That has put the sector's fundraising at \$89 billion over the past two years, quite a turnaround after many REITs seemingly were on the ropes. The REIT story is resonating with investors, who are shifting money from bonds to equities and see REITs as a vehicle that will benefit from the economic recovery in coming years. Investors' quest for yield also helped REITs. Demand for their paper

was so strong that average REIT bond spreads fell nearly 100 bps during the year, with recent long-term bond offerings carrying coupons in the 4-5% range.

REITs Raised a Record Amount of Capital in 2010



Bloomberg, NAREIT, SNL Securities, Prudential Real Estate Investors Research

Maybe the biggest issue going into 2011 for REITs is how much they will grow, both internally and externally. Internally, REIT cash flows should improve with space market fundamentals. Demand for apartments and hotels has been on the rise in recent quarters, and the office, retail and industrial segments are no longer moving in a negative direction. While the extent of the rebound is dependent on the market and property type, for the most part REITs will start to see an improvement in cash flow in 2011. Dividend payouts are relatively low – just over 60% of funds from operations as opposed to the normal 80-85% – which will allow REITs to raise dividends even before earnings growth accelerates in 2012 and 2013.

REITs also are likely to see an increase in external growth through IPOs and acquisitions. A number of IPOs are in the pipeline, and while most are not likely to make the cut, volume should exceed that of recent years. The possible IPOs include some of the assets of former REITs that were privatized in the buyout frenzy of late 2006 and early 2007. Another possibility is mergers among REITs that would provide economies of scale or a reduced cost of capital. REITs' low cost of capital relative to many private peers certainly gives them an advantage in competing for transactions. However, even this advantage has been diminished by the lack of supply and intense competition for deals.

The wildcard for REITs, as always, will be investor sentiment. REITs are no longer undervalued after two outstanding years in which the sector outperformed the broader equity markets. And there is concern that a sustained rise in interest rates would make dividend yields less attractive, drive up REITs' cost of capital and/or reduce property values. But there is room for growth, especially if cash flows improve more than anticipated. With the fixed income market likely to face headwinds in the near term as interest rates rise, the stock market should see strong capital inflows over the next 12 to 24 months. REITs are attractive by virtue of their potential inflation hedging benefits and attractive dividend yields. As a result, we expect REITs to produce a total return of 10-15% in 2011.

Property Markets

Despite a slowing in the economy in the second half of 2010, the commercial real estate market is healing from the severe downturn in 2008 and 2009. Space market fundamentals, which always lag changes in the broader economy, remain weak but are beginning to improve in some sectors and markets. Property types with relatively short lease durations (apartments and hotels) have seen broad improvements in performance, while those with longer leases (retail, office and industrial) have stabilized at or near record vacancy levels and will begin to improve in coming quarters. The job outlook is crucial. About 1 million jobs were created in 2010, which is encouraging after the economy shed 8.4 million jobs during the recession, but not nearly enough to create significant demand for commercial real estate. A meaningful recovery in fundamentals will not occur until job growth accelerates, which is not expected for at least another six months. With construction virtually shut down, vacancies will decrease once demand begins to rise.

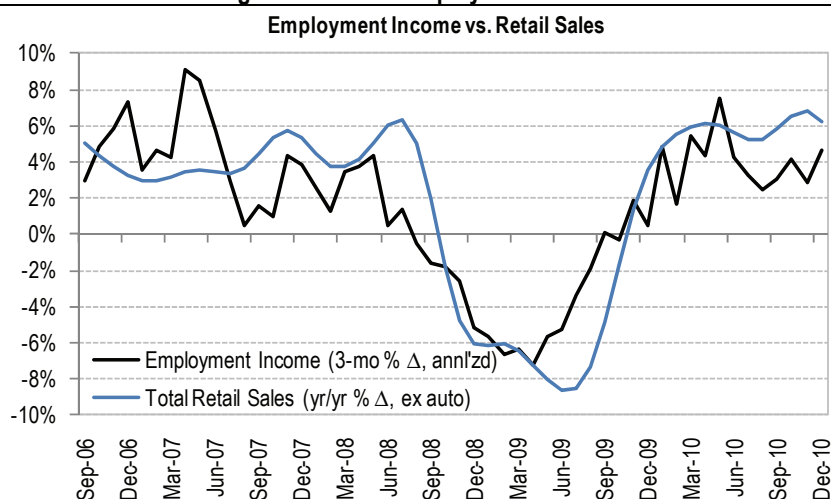
The steady but moderate economic growth expected in 2011 does have positive implications for commercial real estate, particularly with regard to the interest rate outlook. Low rates have factored in the market's rebound by lowering the cost of debt, pushing down acquisition yields and making property yields more attractive relative to the risk-free rate. Even after climbing nearly 100 bps in recent months, the 10-year Treasury rate was an extraordinarily low 3.3% in mid-January. Interest rates are likely to rise further, with the impact on commercial real estate depending on how much they rise and why. The market can absorb some increases with minimal impact, but a large or rapid increase would start to erode asset values. If rates rise because of a strengthening economy, the impact on values would be offset to some extent by the corresponding improvement in rents and income. But rising rates from fears of stagflation or an exogenous event would be an unmitigated negative. The optimal scenario might be moderate growth that produces improved demand for commercial space and does not cause rates to rise too quickly or too much.

Apartments: Demand for apartments was robust throughout 2010, prompting national vacancy rates to plunge, and the trend is expected to continue for several years due to demographic and economic factors. According to Reis, healthy absorption last year served to reduce the U.S. vacancy rate to 6.6% in 4Q10, a 150 bps drop from a year earlier. Asking and effective rents are on the rise. The growth is due to pent-up demand from the recession, the increase in jobs, the decline in the rate of homeownership and the mounting population of the 20-something prime rental age cohort. Pricing for core assets has become aggressive, although that is bound to be curbed by rising interest rates. Even though there is competition for renters from empty single-family houses, the halt to new apartment development in recent years will lead to a shortage in some markets, particularly in the Sunbelt where population growth is the strongest. That has prompted some firms, including REITs, to ramp up development activity.

Hotels: Demand for hotel rooms was running high in the second half of 2010, approaching the record levels reached in 2007. While average hotel occupancy remained below 2007 levels due to the wave of supply that has been delivered over the past few years, and room rates have been slow to increase, the trends are increasingly moving in a positive direction. The number of hotel rooms sold in the U.S. rose 10.5% year-over-year in November, while occupancy was up 9% and revenue per available room (RevPAR) was 11.8% higher, according to Smith Travel Research (STR). Hotel transaction volume is growing, with the \$12 billion of sales through November 2010 more than triple the 2009 total, according to Real Capital Analytics (RCA). Meanwhile, debt for hotels is once again available, mostly via CMBS lenders and foreign banks.

Retail: The retail segment hit historic high vacancy rates in 2010, with rents falling to their lowest level in a decade. The deterioration of fundamentals slowed in recent months, however, and the rebound in consumer spending is a welcome trend. Seasonally adjusted core retail sales in 3Q10 totaled \$3.6 trillion on an annualized basis, up from 1Q09's cyclical low of \$3.4 trillion, according to the Bureau of Census, and should top 3Q08's record high of \$3.7 trillion in the first half of 2011. Still, shopping centers face competition from online retailers and must deal with bankruptcies of some major chains, such as A&P and Blockbuster. Neighborhood and community centers are under more pressure than regional malls, which saw a slight uptick in occupancy in the fourth quarter, according to Reis. There is little development of community centers, and even less for large malls.

Retail Sales Are Growing With Gains in Employment Income*



*Employment income = (total employment) x (average weekly hours worked) x (average weekly wages)

Bureau of Census, Moody's Analytics (forecast as of 12/9/10), Prudential Real Estate Investors Research

Office: With the exception of a few core markets, offices are at the bottom of the cycle. Vacancy rates are at record highs, although they are improving slightly. In 4Q10, the U.S. office vacancy rate decreased by 20 bps, to 16.4%, according to CBRE. Absorption will lag job creation, which means that demand for space will be tepid until hiring picks up substantially from current levels. Investor demand for office properties has narrowly focused on gateway cities such as New York, Washington and Boston. As a result, in some instances prices in these markets are approaching pre-crisis price levels. Suburban and second-tier cities have remained out of favor, but this will likely change as confidence in the recovery grows and investors' risk appetite improves. Development will not be an issue for several years.

Industrial: Demand for warehouse space picked up in the second half of 2010, focused on the largest national logistics hubs, while new supply has all but stopped. Recent increases in global trade, retail sales and manufacturing output are all good signs for the sector. However, before the segment recovers, it must deal with the overhang of excess capacity. Not just vacant space, which is near record levels, but the underutilization of currently occupied warehouse stock. Also, new rent levels are lower in many cases than leases rolling off, which will offset increases in occupancy.

Capital poured into the asset class in 2010 as investors become more confident in the demand outlook, although the capital was focused almost exclusively on core assets. That produced a mismatch between

the demand for core properties and supply, prompting acquisition yields to drop sharply for core assets in top-tier markets and favored property segments. Core assets will continue to be popular, but investors are likely to begin to expand the scope of their targets in anticipation of the improvement in fundamentals.

Transaction volume is on the rise. Sales in 2010 topped \$130 billion, double the 2009 total, with \$25 billion in December and more than \$20 billion already in the 2011 pipeline, according to RCA. Deal flow will be restrained by the ongoing reluctance of banks to liquidate overleveraged properties, but the pace of resolutions by special servicers and banks picked up during the course of the year. There should be a steady volume of workouts for a few years, even if many are done off-market.

The appreciation returns for the NCREIF Property Index rose a little more than 3% in 4Q10, the third straight positive quarter after dropping 32% over the previous two years. The NPI produced a total return of 13.1% for 2010. We anticipate that the Index will continue to appreciate in 2011, although rising interest rates will cancel out some of the improvements in performance. Nonetheless, we expect NPI total returns in the 10-14% range.

Closing Thoughts

It is neither the best of times nor the worst of times to invest in commercial real estate. Generally speaking, the market has moved fairly quickly through the bottom of the cycle, and still provides an attractive entry point for investors. Fundamentals are poised to improve with little new construction on the horizon in most markets and segments. However, like most asset classes, real estate is not particularly “cheap” by historical standards. The sector’s combination of yield and security helped to produce a flood of demand for the safest properties, while distressed assets remain caught in the cycle of “extend and pretend.” Finding bargains is no easy task given the highly competitive environment and the reluctance of banks to take losses on underwater properties.

In the absence of broad momentum that drove the market in the 2000s, investors will need to continue to be highly selective. But it seems likely that transaction activity and risk-taking will increase in 2011, broadening the opportunities available to investors.

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