

Global Real Estate Securities – 2009 Outlook

Real Estate Securities

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Executive Summary

- In 2008, the real estate securities market was devastated not only by the general decline in the equity markets and the deterioration in the outlook for commercial real estate, but by the misperception that commercial property suffered from the same supply excesses as the residential market and the perceived association with financial companies.
- Property operating fundamentals weakened in 2008, and will likely worsen in 2009, but public share prices have already priced in much of the expected deterioration. De-leveraging and disinflation will remain key themes in 2009. The first part of the year will be a struggle for many commercial real estate players as the market is adjusting from a hangover of excess liquidity to one in which debt is scarce.
- The steep decline in asset prices globally, especially real estate and equities, has significantly reduced household net worth. Many assets are already priced at depressed levels that have factored in extremely negative scenarios. The pendulum has swung too far on the way down and there is a definite disconnect between the valuations of direct real estate, even assuming a further material increase in cap rates, and the pricing of real estate equities.
- As the economic recovery gains traction, we anticipate a supply-demand imbalance in favor of landlords who will be in an enviable position given the long lead-time to create new supply. We expect that the public real estate companies will be significant beneficiaries of capital flows as investors look to take advantage of the distress in the market.
- The first half of 2009 is likely to remain volatile, but signs of an economic recovery in 2010 should – provided the debt markets stabilize – prompt a rebound in stock prices and provide the opportunity for very compelling risk-adjusted returns from the sector.

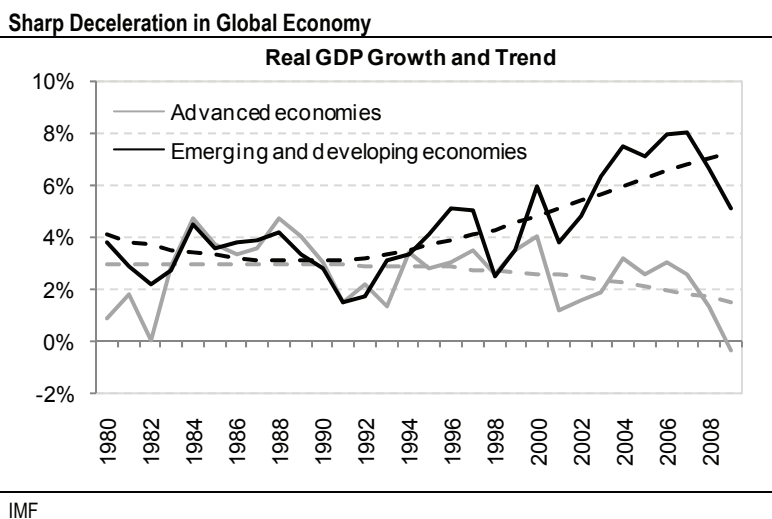
The Global Financial Markets

The global economy is experiencing a recession that should last well into 2009. For the short term, the specter of inflation has been replaced by the fear of deflation. Commodity and asset prices are in a downward spiral exacerbated by the deleveraging of the financial sector, decelerating economic activity and the lack of liquidity in the global financial markets. Unconventional monetary policy, government intervention and fiscal stimulus have stabilized the major financial institutions; however, they have not alleviated the acute stress and lack of liquidity in the global financial markets. Despite monetary and fiscal policy

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intervention, the financial markets remain dysfunctional and investor confidence remains weak. Regrettably, the slowdown is no longer confined to developed economies, but has now spread to emerging and developing economies around the world. Weak demand for goods and services has caused global trade to slow sharply.



De-leveraging and disinflation will remain key themes in 2009. The weakening economy and negative market sentiment have become a continuous, self-reinforcing feedback loop. Deteriorating confidence in the mortgage and banking system has prompted consumers and businesses to retrench leading to falling demand for goods and services and increased unemployment. Among the consequences of the downward spiral are dramatic reductions in household net worth and significant declines in asset prices, including real estate and equities. Many assets are already priced at depressed levels that have factored in extremely negative scenarios.

Negative news from the economy and corporate earnings announcements will likely continue to cast a long shadow during the first half of 2009. While caution is warranted, positive signs with regard to increased liquidity, falling inter-bank and corporate spreads, a slowing pace of U.S. home price declines, and a resultant rebound in confidence could cause a reversal from the dismal market performance last year. Additionally, the latent inflationary impact of the massive fiscal stimulus and highly accommodative monetary policy should not be discounted. The potential inflationary effects on the economy should be quite beneficial to the owners of hard assets, especially real estate in a supply constrained environment.

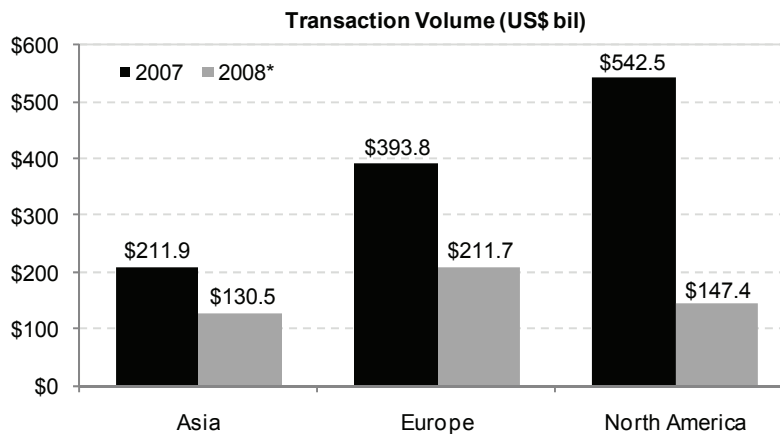
Where Have We Been? Where Are We Going?

The start of a new year often brings fresh hope, but as 2009 commences, optimism is in short supply in the commercial real estate market. The sector suffered through its worst returns in decades in the fourth quarter, and more price declines in the direct real estate market are expected this year. Deteriorating economic conditions, which are likely to get worse before they get better, will continue to undermine real estate fundamentals, prolonging the time before we begin to see a recovery. Deleveraging is working its way through the system as the market adjusts from a high-leverage system to one in which debt is much more scarce. Taken in combination, these conditions will make 2009 a very challenging year. Even so, low

interest rates and falling energy prices, which are good for both the consumer and business, and aggressive stimulus programs from the U.S. and other governments, offer glimmers of hope that the recovery is not too distant.

It is not yet clear when the banking crisis will end and commercial mortgage debt will be readily available. The CMBS market is out of the picture and traditional lending sources are trying to preserve capital. The dislocation in the capital markets and the lack of reasonably priced debt has made it difficult to complete direct real estate acquisitions.

Transaction Activity Has Ground to a Halt



* estimate

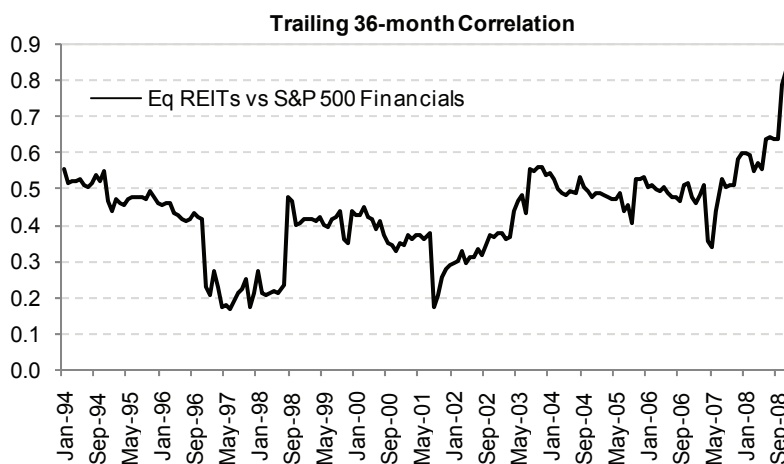
Real Capital Analytics

The commercial real estate market has followed the larger economy into a downturn that is likely to last through 2009 and possibly into 2010. With unemployment rising to its highest level in decades, a sharp drop in home prices and commensurate decreases in consumer confidence and spending, the recession will impact all sectors of the direct real estate market. After falling to historical lows, typically in the 5-6% range, on average, cap rates are returning to levels more in line with historical averages. The result is a steep decline in property values. The benchmark index for direct real estate in the U.S. is likely to record the sharpest drop in its 34 year history during the fourth quarter and appears poised to fall further in 2009.

The prospect of distress brings the potential for opportunities. The disconnect between the pricing of different types of assets in the commercial real estate market creates inefficiencies that investors who have the capital and conviction to execute can exploit. In this regard, as the economic recovery takes shape, we anticipate that public real estate companies will be significant beneficiaries of capital flows as investors look to take advantage of distress. Similar to the early 1990's experience in the U.S., we expect that the public markets globally will be the least expensive form of capital, which should give public companies a competitive advantage in capitalizing on the economic recovery. For equity investors anticipating an economic upturn, real estate securities should offer an attractive way to profit from the embedded value in the underlying assets and to participate in the potential earnings growth that should accompany renewed growth in tenant demand. As share prices increase, we anticipate that the public companies will issue new equity and that we will experience a resurgence in IPOs of real estate companies.

Shares of real estate securities fell around the world amid unprecedented volatility in 2008. Despite having relatively stable cash flows, the sector was tarred with its association with the housing market, financial firms, a global economic slowdown and the consequential lack of availability of debt in the capital markets. Once again, we have witnessed the manic-depressive nature of the equity markets, especially with regard to real estate securities.

REITs Have Become Inextricably Linked to Financials Since 2007



* Based on monthly price-only return data

Ibbotson Associates; S&P; FTSE NAREIT

On the way up, momentum carries the pricing of the equities well beyond fair value based upon, as seen with hindsight, overly optimistic underwriting assumptions. On the way down, negative sentiment abounds and apocalyptic scenarios pervade market sentiment. What is clear is that the pendulum has swung too far to the downside, creating a sizable disconnect between the valuation of direct real estate, even assuming a further material increase in cap rates, and the pricing of real estate equities.

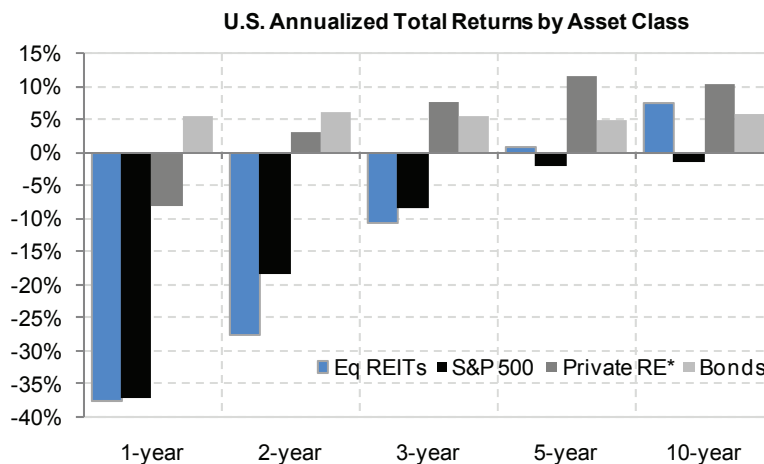
While we are less sanguine regarding the valuation of direct real estate, we are optimistic about the prospects for significant outperformance by real estate equities in 2009. The anticipatory nature of the public markets means that share prices of public companies should respond relatively quickly to signs of a turn in the underlying fundamentals within the direct property markets. We envision that, in 2009, the equity markets will transition from macro to micro drivers for investment returns. Bottom-up stock selection will become the preeminent driver of investment returns as general equity market correlations diminish from historically elevated levels. While the real estate equities market remains subject to the performance of the economy and the debt capital markets, we are encouraged that the current level of valuations will reward patient investors

Real Estate Markets

The real estate equity market suffered through its worst year ever in 2008. The U.S. index for REIT securities (RMS) dropped 38% during the year, and that marked a recovery of sorts after being down more than 60% at one point in the fourth quarter. In spite of decidedly positive monthly returns in December in most major markets, the fourth quarter will go down as one of the worst on record. Only one of the 77

geographic S&P Global BMI Property sub-indexes reported a gain for the fourth quarter. Fourth quarter 2008 returns of -30% for global property companies dominate the year-to-date loss of -49%. The sector was devastated not only by the general decline in the equity markets, but by the misperception that commercial property suffered from the same excesses as the residential market and the perceived association with financial companies. Macroeconomic investment programs resulted in extremely elevated levels of correlations among equity markets around the world. Real estate equities became linked with the financial sector that experienced the brunt of the collapse in equity pricing. Additionally, the closure of the debt capital markets led to further price corrections as concerns about refinancing risk elevated fears of foreclosure and bankruptcy for some companies.

Disconnect Between Public & Private Real Estate Returns



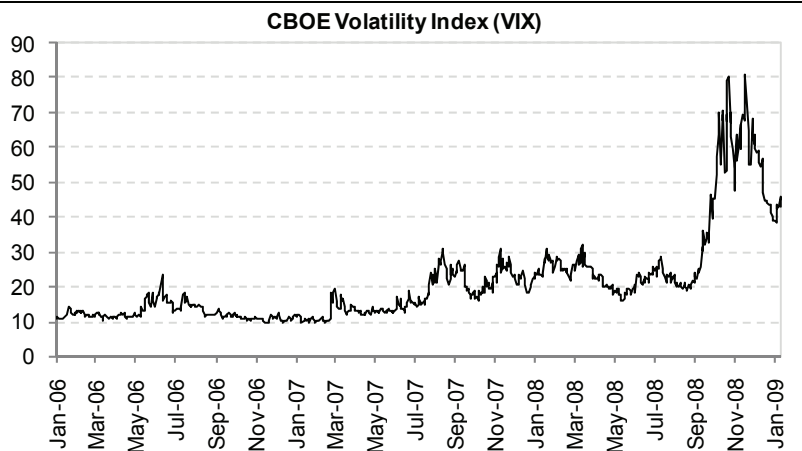
* assumes total return of -10% for private real estate in 4Q08

Ibbotson Associates; FTSE NAREIT; S&P; National Council of Real Estate Investment Fiduciaries (NCREIF); Barclays (former Lehman Bros. Agg. Bond Index). Data as of 31-Dec-08.

The pricing of real estate securities was heavily dependent on balance sheet strength. Companies with significant near to intermediate-term refinancing volume were hard hit due to concerns that they would have trouble refinancing maturing debt. Not only will it be a problem to find banks willing to provide copious amounts of debt, but any debt originated in 2009 is likely to have much higher coupons than the debt it is replacing, which could create cash-flow issues in some companies.

Extreme volatility was the rule rather than the exception in 2008. The 23 worst days in the RMS Index's 13-year history all took place in 2008, all but two of those between September and December. Similarly, all of the index's 25 most-positive days occurred during the year, with most of those in the fourth quarter. The wild swings were reflected in the RMS Index, which declined 32% in October and 24% in November before rising 18% in December. Sharp reactions over negative news about individual companies and the capriciousness of the general equity market intensified volatility in the sector. A surge in short-term trading via exchange-traded funds (ETFs) and a relatively high number of real estate shares held by short-sellers compounded the problem for long-term investors. If excessive volatility continues, which seems unlikely, it could reduce investor confidence in the sector. Real estate securities were long considered a haven from volatility because their income is derived from long-term contractual rental streams.

Please Pass The Dramamine...



Yahoo!; Chicago Board Options Exchange (CBOE)

The question remains whether, after two years during which the global real estate securities index has dropped a combined 52%, the shares are priced appropriately. In the U.S., real estate stocks are priced at a level that implies an approximate 9% cap rate and a dividend yield of over 10%, according to Citigroup, a compelling discount to estimated net asset value. Despite announced and projected dividend cuts, investors are being paid a compelling current return to wait for the market recovery. In today's direct real estate market it is hard to say whether real estate securities are trading at a level that represents true market value as property transactions are few and far between. Direct real estate cap rates are moving higher from historical lows, but where rates settle is not yet clear.

No doubt that commercial real estate will be impacted by the general macroeconomic environment including rising unemployment, tepid retail sales and decreased travel. The question remains as to how much further the market may fall. Property operating fundamentals weakened in 2008, and will likely worsen in 2009, but share prices have already priced in much of the expected deterioration. Although public companies have experienced some decreases in net operating income, property occupancy remains high by historical standards. Additionally, due to the peak commodity prices experienced over the past few years as well as the lack of availability of new debt for development, the supply of future real estate is extremely low. As the economy recovers, we anticipate a supply-demand imbalance in favor of landlords who will be in an enviable position given the long lead-time to create new supply.

Investment Outlook for 2009

The bottom line for real estate equities is that with the debt markets in flux and transaction activity stalled, 2009 is likely to be more about positioning for the economic rebound rather than aggressively acquiring assets. While that time will likely come as private market values adjust to the new realities of the capital markets, the coming year will be a good opportunity for companies to concentrate on stabilizing net operating income and improving the balance sheet. As asset prices decline and the outlook for the economy improves, public real estate companies will be in an excellent position to capitalize on investment opportunities. The public companies are generally much more conservatively leveraged than their private

peers. The few public companies that did lever themselves more aggressively are likely to be taken over or restructured during the year. Our public sector investment strategy will be to focus on undervalued, large cap real estate companies with strong balance sheets and a proven ability to return capital to shareholders through dividends.

Ultimately, we believe that the long-standing virtues of investment in real estate, both directly and through securities, will prevail in distinguishing the asset class from other segments of the market. Most notably, transparency of business plans, visibility and consistency of cash flows, relatively attractive dividends and real assets should find favor with investors as confidence gradually returns.

Predicting a return for public real estate equities in an environment with such pronounced volatility is difficult at best. On some days in 2008, the sector's market value changed – both up and down – more than it has changed in some years. Still, after two down years in which negative sentiment has been priced into the sector, we see some light at the end of the road. The first half of 2009 is likely to remain volatile, but signs of an economic recovery in 2010 should – provided the debt markets stabilize – prompt a rebound in stock prices and provide the opportunity for very compelling risk-adjusted returns from the sector.

If it was unrealistic at this time last year to hope that the commercial real estate market would suffer no more than collateral damage from the subprime residential mortgage fallout, it may be equally mistaken to take this year's pessimism to extremes. Market players who study recent cycles know that there is greater potential for outsized returns when prices are low, as they are likely to be for the next year or two. Of course, knowing such a proposition intellectually and being in position to act upon those convictions are two different things. Assets for sale may be cheap, but few have the capital to buy. Institutions are reluctant or unable to invest more money into the sector and debt, if it can be found, is expensive. What's more, prices in other asset classes have fallen sharply, which provides competition for opportunistic investment dollars. Still, chances to buy distressed assets will be plentiful for those who have the inclination, the expertise and the capital. Public real estate companies may not be the only game in town, but we anticipate that they will be among the most attractive real estate investment vehicles as the market inevitably recovers.

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Total returns of the S&P Global Real Estate Index, an unmanaged market-weighted total return index which consists of many companies from developed markets whose floats are larger than \$100 million and derive more than half of their revenue from property-related activities. Periods greater than one year are annualized. Past performance does not guarantee future results. This information is not representative of any Pramerica Investment Management account and no such account will seek to replicate an index. You cannot invest directly in an index.

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