

Market Perspective

Executive Summary

- The European economy continues to see growth well in excess of trend. Forward-looking survey data suggest that growth will remain very strong over the short term.
- While inflation remains subdued, inflation expectations have risen markedly over the past few months, as reflected in higher bond yields.
- Movements in bond yields have not yet affected real estate pricing. Moreover, despite increased volatility in the market, the volume of capital targeting real estate (from all four quadrants) remains robust, if more discriminating, than 12 months ago.
- Property market fundamentals continue to improve, with vacancies falling and rental growth accelerating in most segments of the market. This will help offset the negative impact of a potential abating yield shift on capital value growth.
- The short-term outlook remains favorable, although in most segments total returns in 2007 are likely to be significantly below those seen last year. The principal risks to performance remain further adverse movements in bond yields in the short term, which will most severely affect the secondary end of the quality spectrum, and the volume of development starts over the next couple of years.

Economic Context

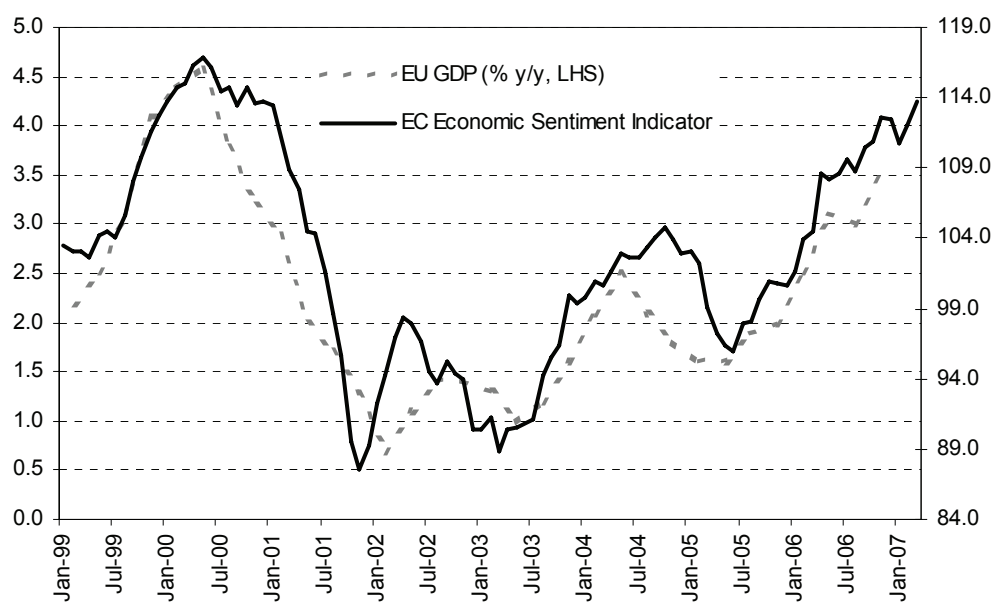
The European economy continues to see growth well in excess of trend. Official data show that EU GDP expanded by an annualized rate of about 3.3% in 4Q06 (up from 2.7% in 3Q) with investment and export growth being key contributors to the improvement. Household spending growth was fairly healthy, at 0.6% per year, although this was somewhat disappointing given earlier expectations of a surge in German spending ahead of January's VAT increases. Activity data for this year have also been robust.

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Indeed, given the rise in economic confidence in recent months and the further improvement in labor market conditions, few signs indicate that the recovery is running out of steam. **The European Commission's Economic Sentiment Indicator for the EU stands at a cyclical high and is consistent with GDP growth of about 4%.** Importantly, this indicator has improved in each of the four largest economies (Germany, UK, France and Italy) and has been fairly broad based, with both business and consumer confidence remaining high. The Purchasing Managers' Index also remains high and consistent with strong GDP growth.

Exhibit 1: GDP Growth and Economic Sentiment



Source: European Commission

In Germany, business indicators remain robust, although they have arguably passed their peak. The headline business climate index of the German Ifo is near a 16-year high. The expectation components of the Ifo and ZEW surveys have risen in recent months, suggesting that German businesses remain fairly upbeat about underlying conditions, despite tighter fiscal and monetary policy. In Italy, consumer confidence is improving rapidly, even with a significant increase in the household tax burden announced in the 2007 budget, and points to a rise in retail sales growth. Labor market trends support this picture: official estimates put unemployment at its lowest level in 14 years in 4Q06. This is especially encouraging since weak consumer spending growth has been one of the key factors underlying the poor performance of the Italian economy in recent years.

The labor market continues to strengthen across Europe and will likely remain supportive of consumer confidence and household spending growth over the course of this year. EU27 unemployment fell to 7.4% in February, down from a cyclical peak of 9.1% three years ago. This represents an all-time low for this series and is now below most estimates of the nonaccelerating inflation rate of unemployment. Employment growth, which of course is the main driver of demand for office space, is currently running at about 1.5% per annum. While this remains fairly

subdued (especially in the context of the previous cycle), the EC measure of employment intentions suggests that employment growth could strengthen further in coming months.

Either way, the improvements in the labor market to date suggest that a pick-up in wage growth should be expected soon. While the official data shows that pay settlements remain restrained (rising at just 2.8% per annum in the year to 4Q06), there are tentative signs of a pick-up, with several recent trade union settlements well above this level. Nevertheless, given fairly healthy rates of annual labor productivity growth, unit labor cost growth is set to remain fairly modest across Europe as a whole.

Importantly, considerable variations exist in pay growth across countries. While the average across the EU27 countries is only 2.8% per annum, unit labor costs in several countries such as Romania and the Baltic States are spiraling. Economic growth in these countries has been quite strong, increasing the demand for skilled labor very greatly. At the same time, these countries have seen significant outward migration (particularly of skilled workers) to parts of Western Europe (principally the UK and Sweden). While this has had a positive impact on the supply of skilled labor in the countries in which these workers have settled, the countries they leave are experiencing acute shortages of skilled labor and very rapid wage inflation, which is contributing to accelerating price inflation. Wage growth is particularly severe in the construction sector (more than 30% in Latvia, Lithuania and Romania) and is becoming a constraint on development activity in these markets.

Notwithstanding the acceleration in price inflation in parts of emerging Europe, inflationary pressures, in general, remain subdued. Headline inflation is running at about 1.9% in the euro zone and 2.1% in the EU. Pipeline inflationary pressures might also be easing. In the euro zone, producer price inflation has fallen for six consecutive months and now stands at its lowest rate in almost three years. Moreover, the EC survey suggests that producers' inflation expectations are falling in line with consumers' inflation expectations, which have been declining for several months now.

Against this background, the tightening phase of the monetary policy cycle appears to be maturing. Following the ECB's decision to increase rates to 3.75% in March, euro-zone rates are now approaching neutral levels. Recent global stock market turbulence resulted in a fall in interest rate expectations, despite the continued strength of economic data. **However, the ECB continues to provide fairly clear signals that interest rates will rise further, and this, in conjunction with the revival of equity markets and some strong data, has helped to reverse the drop in rate expectations.** Currently financial markets are pricing in a 25-bps rise to 4% by the summer, with a 60% chance of a further rise by year-end. Market expectations imply a similar profile for UK rates, which now stand at 5.25%, although with a slightly higher probability of a second increase.

In general, analysts are beginning to raise their forecasts for GDP growth this year in response to continued positive economic data and a firm near-term outlook. Outturn growth of 2.5% (although currently above consensus view) looks increasingly achievable. Beyond this year, most projections assume that European GDP will grow broadly in line with trend (circa 2.2% per

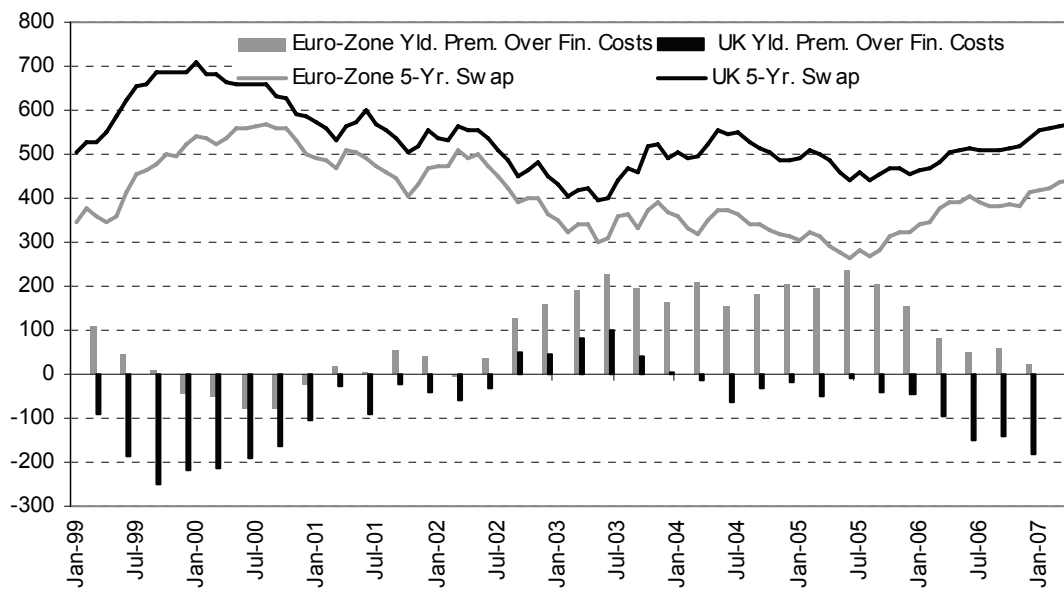
annum) as consumption growth becomes more sustained, underpinned by an improvement in labor market conditions. Among the downside risks are lower global demand, a significant fall in asset prices (or an increase in risk aversion), and further rises in interest rates if, for example, business surveys do not start to show firmer signs of a slowdown in the coming months.

Capital Markets

Real estate pricing is increasingly determined exogenously, i.e., by investor enthusiasm for real estate as an asset class relative to bonds and equities. **Movements in yields for longer-term maturities over the past few months have not been supportive of real estate pricing.** In the euro zone, 10-year government bonds yields have increased by almost 50 bps since the beginning of December and now stand at their highest level since the summer of 2004 (4.2%). UK rates have risen by 60 bps over the same period and now stand at about 5.1%. Movements of similar magnitude can be seen in five-year swap rates, which currently stand at 4.4% in the euro zone and 5.7% in the UK.

At the prime end of the market, property yields continue to fall, reflecting the continued strength of investor demand in this segment. Prime office yields, for example, fell by 10 bps in the fourth quarter of last year to a European average of 4.75% (net). Assuming a 50-bps credit margin over swap rates, **the opportunities to positively leverage cash flow (or income return) at the prime end of the European office sector are limited.** It is especially difficult in the UK, where prime net office yields are around 190 bps below finance costs. Investors targeting prime offices therefore believe that, relative to secondary-quality product, prime offices offer considerable upside in the form of income growth and are fairly defensively priced. Secondary-quality assets are likely to see weaker rental growth and are more vulnerable to a bond-market-induced weakening of sentiment toward real estate.

Exhibit 2: Five-Year Swaps and Yield Premium Over Finance Rates (bps)



Sources: Bloomberg; Cushman & Wakefield; PMA; Pramerica Real Estate Investors

The gap between prime and secondary yields has compressed to all-time lows of about 40 bps to 50 bps, according to Lehman Brothers research, which compares with a long-term average of between 100 bps and 150 bps. At the same time, the spreads between AAA-rated and junk-rated debt instruments have also tightened aggressively over the past three years. **However, with many analysts of the view that corporate default rates (which are also at an all-time low currently) are likely to rise as higher interest rates start to bite, secondary property spreads are vulnerable.**

Anecdotal evidence supports the hypothesis that investor demand for secondary-quality assets has deteriorated markedly over the past six months. This deterioration is most notable in the retail and industrial sectors, particularly in the UK, but is evident in several segments across Europe. **Further adverse movements in bond yields would certainly affect secondary assets more severely.**

Given the more challenging interest-rate environment, conditions in private debt markets have become more difficult. In general, existing loans continue to perform, but concerns are mounting about the terms some lenders are willing to extend to maintain loan books and market share in an increasingly competitive environment. Banks have been moving up their risk curves in a variety of ways, such as moving into nontraditional sectors and emerging locations, and offering more flexible terms (thinner margins and less stringent loan covenants). Recently, however, a number of large, high-profile loans have been made on superthin equity commitments from the borrower, suggesting that lenders are not fully pricing residual value risk. This suggests that the volume of nonperforming loans could rise significantly going forward, particularly if property market fundamentals were to weaken slightly.

In the public debt markets, European CMBS issuance year-to-date amounts to about €14 billion, which is broadly in line with the same period last year. **Spreads continue to tighten on the back of strong investor demand, partly due to the introduction of CMBS credit default swaps and increased liquidity following the introduction of new indexes: spreads now stand at a record low of about 16 bps for AAA pieces.** Loans continue to perform well, delinquencies remain low and rating agencies continue to upgrade CMBS more than downgrade. Assuming property market fundamentals remain strong, CMBS volumes for 2007 are expected to exceed last year's total, perhaps by as much as 20%, as public debt becomes an ever more important source of debt capital in Europe.

It is notable that RMBS spreads have increased in recent weeks, especially on tranches at the lower end of the investment-grade spectrum. This, however, is likely to be as much related to concerns about housing affordability and personal insolvencies in the UK and the Financial Services Authority's announcement that it will focus the second stage of its review of the UK mortgage market on the specialist, high-risk products (including subprime and lifetime mortgages) as to the recent turbulence in U.S. subprime mortgage markets.

Public real estate markets modestly underperformed the wider equity markets in the first quarter with a 1.1% total return (compared with 2.75% for the Eurofirst 300). Moreover, **the market has seen increased levels of volatility since the start of the year, with daily fluctuations of 2%+**

being almost four times more frequent than usual. To some extent, this is consistent with increased volatility and risk aversion in the wider equities and bond markets, but is also indicative of increased investor nervousness among generalists about the future performance of the real estate sector: NAV growth is expected to slow markedly, dividend yields are low, and many companies are priced as though their development pipelines have already been built out, delivered and well let.

The UK has significantly underperformed the wider European market with a total return of –4% compared with +7% for Europe ex-UK, according to EPRA. Much of the underperformance was attributable to weakness in the first two weeks of the year, which in part reflected profit-taking by generalist investors seeing better value elsewhere following a strong year-end for the UK real estate sector, the successful conversion of many companies to REIT status and smaller than expected increases in dividend yields from newly formed REITs. Ten of the largest 12 companies have now converted to REIT status, and these account for around 75% of the UK sector's market cap. The dividend yield offered by the UK sector averages about 2.1% compared with 3.7% for the wider UK equities market.

The UK market has also underperformed since the beginning of this quarter due largely to a downgrading of the sector by equity analysts on the back of a relatively low dividend yield and ongoing slowdown in the direct real estate market (All Property Total Returns have fallen from a cyclical peak of 26.6% to 9.3% over the past 15 months). Positive yield shift is slowing and has begun to undermine (rather than reinforce) capital growth in the retail sector, and rental growth (on which much of the positive yield shift over the past couple of years has been predicated) appears to have slowed slightly in each of the main sectors over the past few months. Even the prime City office market (about which equity analysts have been universally bullish during the past few years) is starting to see a weakening of sentiment amid concerns about the supply pipeline from 2009 onward and investors' ability to capture reversionary potential in buildings with rent reviews beyond a three-year horizon. As a result, some investment agents have moved prime city office yields up a bit: the notional index of prime yields assumes a rack-rented building let (to an investment-grade tenant) today on a 15-year institutional lease with the first rent review being five years from now.

Outside the UK, the public real estate sector has performed relatively well, up 7% in the first quarter, partly on the back of improving fundamentals and robust investor demand (largely from specialist funds). Speculation about corporate activity has also supported values and for some was rewarded with the merger of Unibail and Rodamco Europe – two of Europe's largest listed retail specialists – to create the first pan-European retail company. The combined market cap of these companies is about €19 billion, which will make it the largest listed European real estate company.

M&A rumor and speculation continues to surround a number of other companies, and given current valuations, this is what the sector needs to remain interesting to generalist investors. Potential acquirers continue to include Australian listed property trusts, whose international competitiveness has grown via tax changes that will enable them to more easily

justify potential transactions to their investors on the grounds of more attractive after-tax return on equity.

German real estate stocks were largely unaffected during the passing of the G-REIT bill through the parliamentary system, following more than three years of contentious discussion. In the final legislation, which will apply retrospectively from Jan. 1, 2007, residential assets are not permissible, and for the most part, the conditions remain a mixture of the French SIIC and UK REIT regimes – albeit with a lower maximum permissible gearing ratio and a more onerous condition of hold periods.

Several companies have already stated their intention to convert to REITs and with €200 billion of property assets held by the 60 largest German corporations, considerable scope exists for companies to unlock balance sheet value by selling into the market. A recent survey of 36 DAX companies reported that one in four have made specific plans to launch REITs.

Existing property companies, however, are likely to wait for details of a tax reform package before committing to the structure since, in the current conversion charge, 50% of the deferred tax charge will be at the current corporate tax rate of 25%, which could be reduced in the reform. Moreover, many existing companies are already relatively tax efficient (Eurocastle, Deutsche Euroshop, IVG, DIC Asset, Dawnay Day Treveria), so the requirement to pay for REIT status (in the form of a conversion charge) is less compelling. Either way, the German listed sector will benefit from a more liquid/transparent market. That said, the share prices of a few companies may be hurt by the removal of the scarcity premium they currently enjoy.

Although the REIT structure may be used as an exit for closed-end funds reaching the end of their lives (as general managers seek to maintain a fee stream through external management of a REIT), the German government's expectations for tax revenue from conversion might have to be downgraded. However a viable REIT structure increases the liquidity in the direct market and could drive investment yields lower, which would provide a boost for government finances in the form of increased revenues from transfer tax.

As the importance of specialist property investors in the real estate securities market increases, demand for specialist stocks (which allow this investor group to better implement focused sector and geographic allocation strategies based on their views of the future performance of the underlying market) is also increasing. **The introduction of REITs in a number of markets in Europe has raised the speculation that some of the larger diversified portfolios will be reorganized into separate sector-specialist REITs.** While this is a potential catalyst for a re-rating of stocks, a limited number of companies can do this. Two significant constraints are size (whether the more focused REITs will have sufficient liquidity) and the existing structure of debt finance (other things being equal, it is easier and less costly to break up a company when debt is secured at the asset level rather than at the corporate level). Nevertheless, a small number of companies in the sector may find this strategy an important source of shareholder value and outperformance.

Private equity capital flows remain strong. According to the IMF Global Financial Stability Report, the private equity industry is expected to raise \$500 billion this year, having raised \$430 billion in 2006. A significant proportion of this will be targeting European real estate. Real estate continues to prove particularly attractive to private-equity groups because of its recurring cash flows and the availability of appropriate underlying assets as loan security in leveraged buyouts. The past few months have seen heightened speculation surrounding the acquisition of property-rich retailers by the private equity business. These transactions, while subject to increasing public scrutiny, will serve to raise liquidity in the investment market over time and support transaction activity.

At the other end of the risk spectrum, German open-end funds have seen significant inflows (€1.9 billion) for the first time in three years, although January's numbers are typically boosted by the timing of dividend payouts and the fact that January represents the start of the financial year, when the German public reviews investment portfolios. While many funds, particularly those with a German focus, are still being restructured or rebalanced in light of a sustained period of net redemptions and will remain net sellers of real estate over the course of this year, the January data indicate renewed public confidence in these vehicles and suggest that they may return to being net accumulators of real estate (albeit with a more sophisticated approach to portfolio management) as early as next year.

On the whole, liquidity in the public and private real estate markets remains high. Anecdotal evidence suggests that transaction activity remains similar to the record levels seen last year. However, large transactions (mainly opportunistic, such as leveraged buyouts and sale-leasebacks) are helping to maintain current activity rates. This is helping to offset what appears to be the start of more subdued activity at the lower end of the risk spectrum. Although demand for prime property remains strong, it has softened for secondary-quality assets in some segments, the buyers of which have been dominated by leveraged investors of late. Given the weaker growth outlook for secondary-quality assets and a more challenging interest-rate environment, the continued strength of transaction activity is likely to be increasingly reliant on the completion of larger, more opportunistic deals.

Recent falls in asset prices have been highly correlated across a range of asset classes. Increased market volatility and more widespread concern about the correlation between asset classes have both increased overall portfolio risk levels. However, over time investors are likely to raise exposure to government bonds as a defensive strategy amid higher levels of portfolio risk, which should help support bond prices at current levels, perhaps at the expense of equities. This should help limit any decline in real estate pricing (particularly at the prime end) that might be expected given the near 100-bps increase in real long-term bond yields since the start of last year.

Property Markets

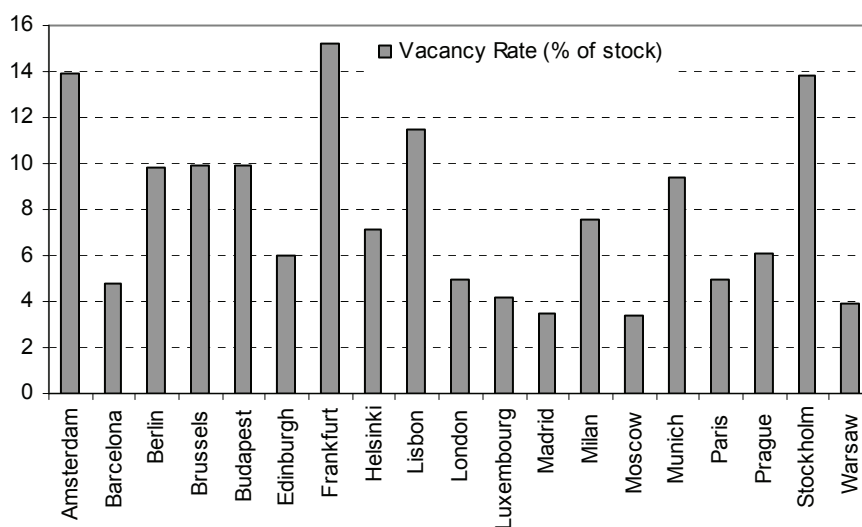
In general, property market fundamentals continue to strengthen. This is most apparent at the prime end of the quality spectrum and in the more volatile office sector. Here, more rapid rental growth should help offset the impact of slowing yield shift on capital value growth. In parts of this and other segments, there is scope for further yield compression, while in the rest of the market, acquisition yields have reached a floor.

Offices

The European office market is now well into its expansionary phase, and rents will likely grow strongly this year. Against a background of strong economic growth, particularly in the financial and business services sector, gross take-up increased to its highest level in six years last year to stand at about 9.5 million square meters in the core Western European markets. While relocation to better-quality space to lock in relatively low rents remains a feature of the market, expansionary demand is becoming more widespread. With business confidence still running at very high levels and investment banks seeking to increase headcount aggressively, net absorption should rise further over the course of 2007.

Outside the early-recovery markets of London, Madrid and Paris, increased net absorption manifested itself in falling vacancy rates, with rental growth being modest and largely confined to the prime end of the market. Across Western Europe as a whole, vacancy has fallen by 150 bps since the beginning of last year to stand at about 7.5%. Occupiers have rather limited choices in markets such as Moscow, Madrid and Luxembourg, where vacancy rates stand well below 5%. **In the early-recovery markets, however, prime rental growth has been strong, averaging more than 15% in the year to the end of 1Q07, and while incentives remain fairly generous in order to attain new rental levels, in general they are tightening quickly along with vacancy rates.**

Exhibit 3: Office Vacancy Rates (1Q07)



Source: Jones Lang LaSalle

As stronger rental growth has emerged, the development pipeline has increased. Currently, six of the main European markets have a supply pipeline (defined as currently available space plus the two-year development pipeline) exceeding 15% of stock. In the Spanish cities of Barcelona and Madrid this exceeds 20%, with the majority of the pipeline comprised of space currently under construction. While this will certainly affect rental growth in these markets as early as next year, more worrying is the volume of potential completions further out.

Developers have, on the whole, been relatively cautious over the past few years, having focused on putting together sites and gaining planning permissions. In some markets the pipeline of potential projects is very substantial indeed (in excess of 20% of current stock in Central London, Milan, Madrid and Barcelona). With the demand side moving along very nicely right now, space constraints emerging and rental growth accelerating, developers will certainly feel more comfortable starting these projects today than at any point during the past few years. Assuming the European economy continues to perform well over the next 18 months or so, a substantial volume of this space will be started, and if demand were to remain robust thereafter, the majority of this space would likely be absorbed. The risk, however, is that demand weakens in the window between the start and completion of this supply bubble – the extent of oversupply being determined by the nature of the slowdown in demand. **While considerable uncertainty exists regarding the extent and timing of oversupply, the next year to 18 months represents the key phase in the development cycle. An early surge in building will prevent the sharp fall in vacancy that lay behind the rental boom of the late 1990s.**

Against this background, many analysts are forecasting front-loaded rental growth (strong growth this year and next, followed by weaker growth toward the end of the forecast horizon). This is particular true of the City of London for which PMA forecasts negative rental growth of about 6.5% per year in the three years from the end of 2008. In German cities, amid the rapid improvement in labor market conditions and high levels of business confidence, the outlook for rental growth has become markedly better in the past six months. Paris and Stockholm remain among the top performers – the former due to a modest supply pipeline and the latter due largely to strong demand dynamics.

Industrial

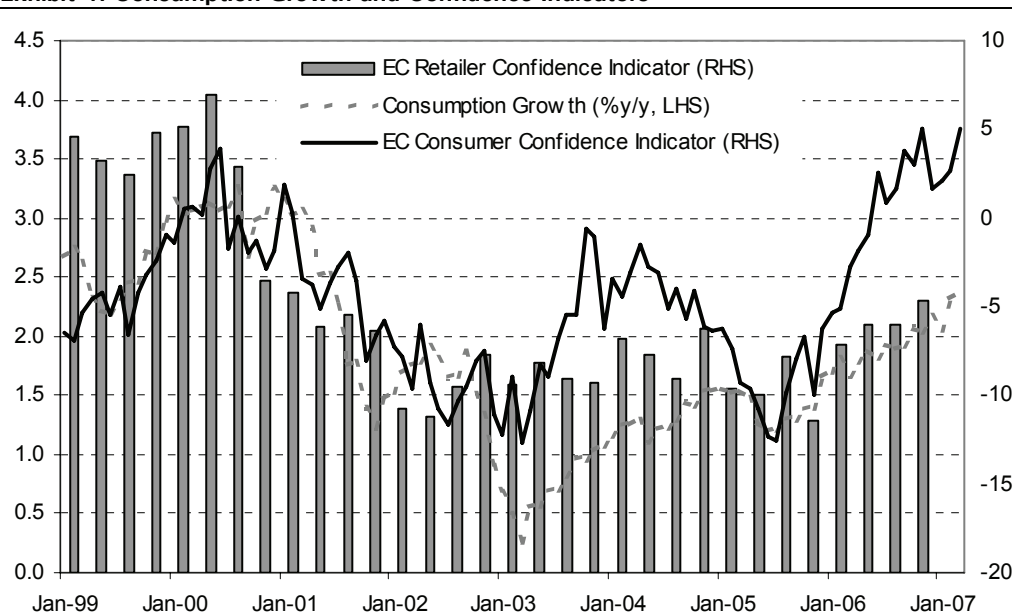
Demand for industrial and logistics space picked up in 2006 with the majority of markets seeing take-up significantly in excess of 2005 levels, according to King Sturge, in part driven by a resurgence in demand from manufacturers, reflecting high levels of confidence in the sector. In Western Europe, occupier demand was especially strong in France, with growth in take-up stronger in emerging locations such as Bordeaux than in more established locations such as Lyon. Demand growth, however, has been strongest in Central and Eastern Europe, where strong rates of economic growth and rapidly improving infrastructure are having a major impact on the logistics geography in the region. The Prague area, Poland and Russia were the markets with the most significant demand growth last year.

In broad terms, however, prime industrial rental growth remains subdued at around 3.5%, according to Cushman and Wakefield. While a few areas such as Vienna, Barcelona and a number of markets in the UK have seen some uplift, improving conditions are being reflected more in terms of reduced incentives rather than headline rental levels. In Central and Eastern Europe, where the level of completions has been high (and the development pipeline remains full), rental growth has been weaker. With prime rental growth expected to outperform inflation only modestly, the emphasis for investors must remain on assets offering intensive asset management angles.

Retail

The improvement in labor market conditions, increased consumer confidence and strengthening retail sales growth in the second half of last year contributed to more robust prime retail rental growth last year (around 5.8% on a weighted average basis compared with 4% in 2005, according to PMA). These dynamics continue to support the retail sector this year, and survey evidence suggests that confidence among European retailers is running at exceptionally high levels – witness the European Commission’s Retail Trade confidence indicator, which currently stands at its highest level since October 1988.

Exhibit 4: Consumption Growth and Confidence Indicators



Source: European Commission

Encouragingly, retail sales growth is being driven by the fashion and household goods sectors, respectively the key occupier groups for prime high street/shopping center units and retail warehouse parks. This has been one of the key drivers of prime retail rents in most countries in recent months, with the principal exception of Germany, where earnings growth remains low and retailer confidence is broadly in line with the long-term average. Although forecasts for German consumer spending growth are being revised upward for 2007 and beyond, it is still expected to underperform the European average.

The increasing market share of pan-European multiple retailers (at the expense of independent retailers) has also boosted rental growth. The multiples tend to be less price sensitive and more inclined to bid up rents in an effort to secure prime pitches with a view to increasing market share.

Last year 3.6 million square meters of shopping center space was completed, slightly lower than expected at the start of the year. The majority of this was in Italy, Spain, Germany and Poland. Development activity is expected to reach a new peak this year with 5.4 million square

meters expected to be completed. Again, the focus is on the same four countries, although as a result of many starts in the UK, the volume of space under construction in this country is second only to that of Russia. Much of the new space in the UK is in city center locations (due to tight out-of-town planning constraints) and will therefore compete more closely with prime high-street units.

Due to the relatively full development pipeline (and relatively weak demand-side dynamics), UK cities are expected to rank toward the bottom end of the rental growth spectrum over the next five years. The greater cost sensitivity of high-street retailers will also affect UK markets, given deflationary pressures and increasing competition for alternatives such as retail parks, e-commerce and leading grocery chains expanding their ranges of fashion and household goods. German cities also appear at the bottom end of the spectrum, largely due to a comparatively weak outlook for retail sales growth.

At the top end, strong rental growth is anticipated in Stockholm, Iberian cities (particularly Barcelona) and French cities (particularly Lyon), while the key Italian cities are also expected to perform well. The main driver of this growth is robust retail spending and ongoing demand from expansionist, pan-European retailers, combined with tight availability and relatively little new supply. **In general, with a benign consumer and retail spending outlook and relatively stable supply environment for most markets, modest but sustainable rates of rental growth are expected for both prime unit shops and Europe's major shopping center markets.**

Residential

According to the European Mortgage Federation, signs indicate a slowdown in the rate of growth of house prices in Europe. The slowdown was particularly marked in France and Spain, which are now seeing house price growth of less than 10% for the first time in several years. To some extent, this reflects the impact of rising interest rates on affordability and in Spain, overbuilding in some regions.

In Sweden, the rate of house price growth has also fallen (but still stands at about 12%). Again, rising interest rates are affecting the volume of mortgage lending. However, the recent announcements by the Swedish authorities on the abolition of the wealth tax (currently an annual charge of 1.5% on net assets in excess of 1.5 million SEK for a single-person household and 3 million SEK for multiperson households) and the property tax (currently 1% on the value of property, with caps according to income and occupancy) should boost disposable income, raise mortgage affordability and increase demand for owner-occupied housing. This should help offset the negative impact of further rises in interest rates, which are expected given the current pace of economic growth.

Elsewhere, the Turkish government has finally passed legislation to establish a legal framework for a more liquid mortgage market as a response to the severe housing problems associated with the lack of a properly functioning housing finance system. The new mortgage law is regarded as a long-term way to increase access to homeownership for middle- and lower-income citizens. Significantly, the law provides lenders with access to new funding mechanisms, such as securitization and covered bond issues, which are currently uncommon in Turkey. For the

consumer, the new law provides access to variable-rate mortgages; currently only fixed-rate mortgages are available. It also introduces early repayment fees of up to 2% of the outstanding balance of the loan. Interest rates in Turkey are currently very high (17.5% per year), reflecting the Central Bank's commitment to longer-term price stability and stubbornly high inflation (10.4% in the year to the end of March). Against this background, demand for mortgage products is currently low but is expected to increase very rapidly as rates fall to the levels seen before the mini-financial crisis last May/June.

Conclusions

Following the recent revival in the European economy, property market fundamentals are improving rapidly in many markets. Rising occupancy rates are beginning to feed through to more widespread rental growth, although for the most part this remains constrained to the prime end of the market. Lower rates of job growth than in the previous cycle, combined with a rapidly filling development pipeline, will ensure that rental growth remains more modest this time around. Over the short term, with demand growth rapid and supply tightening, rental growth is expected to accelerate, particularly at the prime end. This should help offset the effect of the marked slowing in yield shift. Over the medium term, rental growth is expected to weaken in line with slower demand growth and a higher level of development completions: the slowdown will be especially acute in the early-recovery markets.

Although the real estate market and its capital sources have expanded enormously over the past few years, the asset class remains small in comparison to equities and bonds. As such, small changes in investors' appetite for other assets, particularly bonds, can have a large impact on investor demand for real estate. For the time being, investors remain well disposed toward real estate, with flows of debt and equity capital from both public and private sources relatively high. However, the principal risk to investment pricing is exogenous – bonds yields have increased considerably over the past few months, and with valuers typically slow to capture turning points in the investment cycle, further rises might encourage some investors to reappraise the case for real estate.

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