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Global Real Estate Securities – 2010 Outlook

Real Estate Securities

Marc Halle
Managing Director
U.S. Office
Tel. 973.734.1433
marc.halle@prudential.com

Executive Summary

- After a spectacular recovery in 2009, public real estate should continue to provide attractive returns in 2010 due to the improved tone in the capital markets and investors' increased appetite for risk.
- Commercial real estate fundamentals will likely remain weak throughout 2010, but the vast majority of the decline has already occurred. While it is difficult and dangerous to generalize, tenant demand in most major property markets around the globe should begin to firm this year.
- Given their attractive cost of capital and relatively low-leverage balance sheets, public real estate companies are poised to take advantage of distressed opportunities.
- Although total returns for publicly-traded real estate will have a hard time matching last year's outsized gains, real estate securities remain an attractive vehicle through which investors can participate in the recovery in the commercial property markets. Even with last year's gains, public real estate securities remain far below peak levels.

Global View

As 2009 began, sentiment toward commercial real estate and publicly traded real estate companies was uniformly negative, and the near-term outlook for the capital and space markets was grim. But real estate securities across all regions bounced back from the extremely challenging first quarter and delivered exceptional returns for the year. The healthy rebound and recovery was not unwarranted. After the precipitous decline in share prices in 2008, it seemed only a matter of time before investors recognized that the extreme pessimism reflected in share prices failed to account for the inevitable recovery in the capital and space markets. Real estate securities rose sharply when the capital markets began to mend and the global economy, led by China and a handful of other emerging markets, began to expand again.

Today, many of the systemic risks that stood front and center have receded. Equity investors are de-risking their portfolios, increasingly moving to dividend-producing companies with high-quality assets. Among the beneficiaries of this shift are listed real estate companies, which at year-end were still an average of 45% below their 2007 peaks. REITs would have to rise about 90% on average globally to return to those levels. While we are not suggesting that the sector will return to peak pricing anytime soon, current valuations provide room for normalized returns without coming close to the frothy 2007 levels.

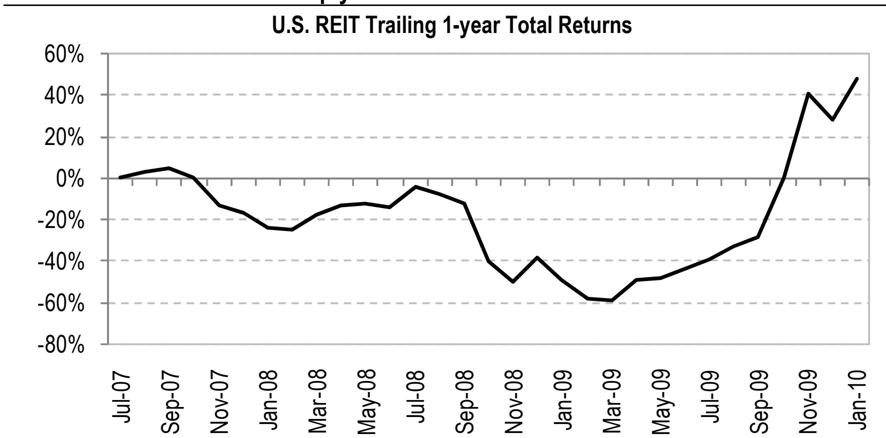
Pramerica Real Estate Investors
8 Campus Drive
Parsippany, NJ 07054
USA

www.pramericarei.com

U.S. REIT Market

The world did not end in 2009, as many investors feared at the peak of the financial and economic crisis. The dramatic relief rally in the global stock and bond markets from the March lows, when central banks and governments around the world took extraordinary actions to avert Armageddon, was especially good for REITs. After falling more than 40% in the first nine weeks of the year, the NAREIT Equity REIT Index more than doubled to finish the year with a 28% total return, narrowly edging the healthy total returns for the S&P 500 (+26.5%) and Russell 2000 (+27.2%) indexes. The recovery was broad-based, both within the REIT sector and across the broader market. Shopping center REITs held the unfortunate distinction of being the only major property type that not only failed to post double-digit returns last year, but actually delivered negative total returns (-1.7%) for the year. Total returns for the other major property types ranged from 12.2% for industrial REITs to 63% for mall REITs and 67.2% for lodging REITs.

REITs Have Rebounded Sharply Since Last Year

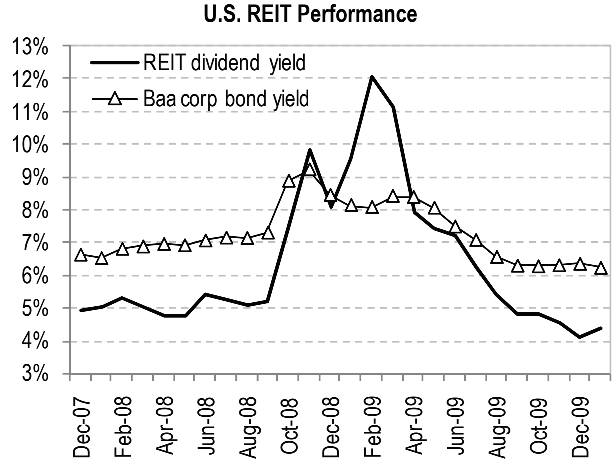


S&P U.S. REIT Index

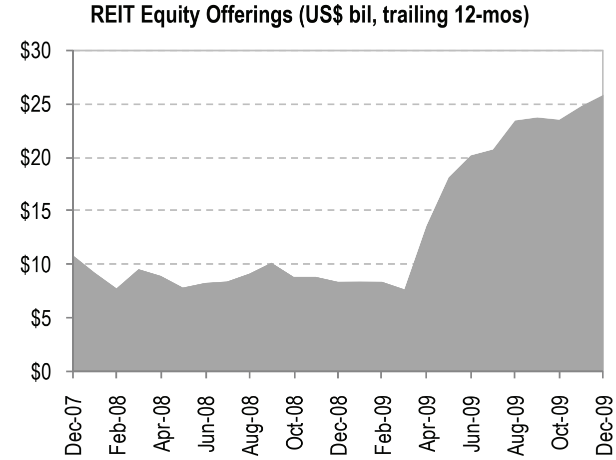
The real turning point for REITs came in March 2009, after some of the leading REITs demonstrated they could still access the capital markets, even under the most severe conditions. The initial recapitalizations were very expensive and highly dilutive to shareholders. However, they provided real price discovery – and a measure of the downside risk – in a market where values were highly uncertain. These successful capital offerings opened the door for more REITs to follow, setting into motion the first phase of a massive deleveraging process that eventually will spread across the entire commercial real estate industry.

REITs' access to capital improved significantly in the third quarter thanks in part to the rally in the corporate bond market, which caused yield spreads to narrow sharply. Amid strong demand from high-yield investors, both institutional and retail, REITs turned to the unsecured bond market. Most of the capital raised to date has been used to shore up balance sheets, for purposes such as refinancing maturing debt or paying down credit lines. All told, U.S. REITs raised about $37 billion in 2009, mostly through follow-on equity offerings and a few IPOs. Whether or not the market experiences an IPO wave similar in magnitude to the early 1990s, activity will certainly pick up in 2010. Roughly a dozen planned REITs were in the IPO pipeline at the start of the year, although not all will get done. A handful of last year's proposed IPOs fizzled out before they went public due to underwhelming enthusiasm from investors.

REIT Rally Caused Yields to Compress…



But Allowed REITs to Repair Balance Sheets



S&P (U.S. REIT Index); Moody's; SNL Securities; NAREIT; Pramerica Real Estate Investors Research

The positive momentum from the improvement in the capital markets was more than enough to offset the negative impact on share prices from the ongoing deterioration in operating fundamentals. Earnings estimates for 2010 were revised dramatically lower over the course of 2009 as the magnitude of the demand contraction became clearer. Consensus forecasts now expect most major property sectors will see further declines in earnings this year.

REITs finished 2009 in remarkably good shape considering where they started the year. The deleveraging process has further to run before leverage ratios reach the conservative levels (about 20-40%, on average) that investors believe are appropriate in a post-credit bubble world. But many companies have defused the immediate threat from near-term maturities and appear poised to begin looking for acquisition opportunities. Indeed, one of the bigger questions facing investors today is whether REITs have run too far, too fast. At year-end 2009, REIT earnings multiples were a little above their long-term average, which is appropriate at this point in the cycle, when earnings are depressed. But the deterioration in space market fundamentals has further to go before vacancies peak and rents stop falling, which means REIT earnings from their existing portfolios will likely continue to decline. How much of this decline will be offset by acquisitions remains an open question, and further dilution from additional equity issuance seems very likely as long as distressed opportunities remain scarce. Despite their stellar performance in 2009, U.S. REITs would have to rise approximately 100% in order to return to peak pricing levels.

REIT dividend yields also look a little skinny after a year of dividend cuts and other policy changes made to retain cash flow (i.e., stock in lieu of cash). However, as market fundamentals begin to improve, dividends should grow quickly as companies recapitalize and restore cash distributions. Dividend payout ratios are near historic lows (approximately 64% as of 2Q09, per NAREIT, well below the long-term average 73%), which should allow many companies to grow dividends even before earnings turnaround.

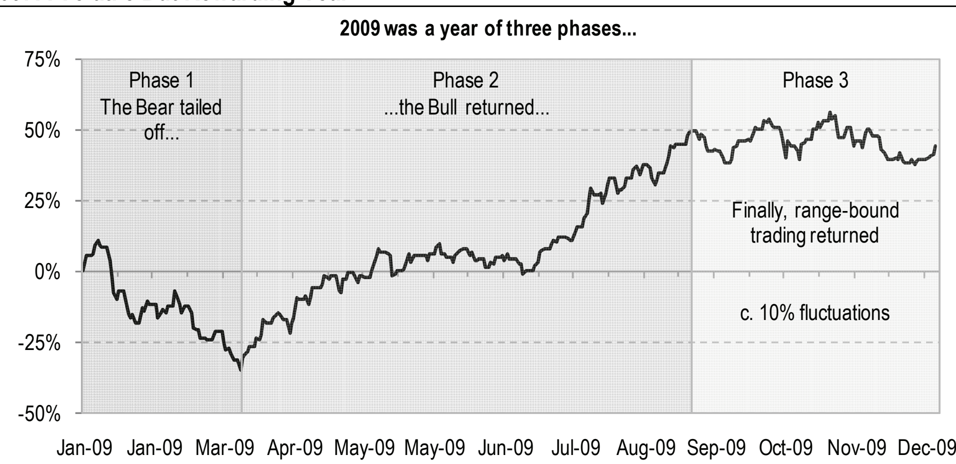
After the significant volatility and emphasis on defensive investing last year, we anticipate that real estate fundamentals and capital allocation decisions will be the focus of 2010. Given the low yields available on alternative investments, REITs' yield premium and favorable prospects for dividend growth should appeal to investors, especially those concerned about the impact of rising interest rates. Interest rates may very well remain at their depressed levels for "an extended period," but there is only one direction they can go. At some point, interest rates will rise, and spreads on corporate bonds and REIT dividend yields will feel the upward pressure. While higher interest rates (capital costs) would not be good for REITs, the impact on valuations would be offset to some extent by dividend growth and, since rising interest rates imply a pick-up in the economy, higher capital values. We believe that investors should focus on companies that have high-quality, sustainable dividends and the flexibility to grow their dividends over time. Look for companies with large cash balances that may be deployed for accretive acquisitions, reduce debt or raise dividends.

In sharp contrast to the environment at this time last year, sentiment toward REITs has become noticeably more positive recently. REITs are showing up on a lot of generalists' "best investment ideas" lists for 2010. Balance sheets should continue to improve as companies take advantage of rising stock prices and investor demand for yield to raise more capital. The future employment outlook generally looks positive, while the supply pipeline is almost non-existent in most major markets. And the combination of strong demand for unsecured debt and low interest rates has led to significantly tighter spreads and attractive all-in coupons for REITs. Although REITs may face further declines in earnings before the space markets reach bottom, there is far less uncertainty about the potential downside risk in both the capital and space markets. As long as the economy continues to expand and adds jobs by mid-year, we expect U.S. REITs will deliver modest positive total returns in the 7-10% range in 2010. But if recent history is any guide, returns could be fairly volatile, at least until investors have greater clarity on the pace of the job market recovery.

European Listed Property Companies

The European listed real estate sector rebounded strongly from its bottom in April last year. According to the S&P BMI Property Total Return Index, the listed real estate sector gained 40.3% in 2009, although it remains 53% below its April 2007 peak. The year had three distinct phases. The first quarter was characterized by a dramatic bear market, followed in the next two quarters by a staggering bull market as the deep discounts to net asset values from earlier in the year subsided. Stability returned in the fourth quarter, when prices were range-bound, up just 3.4%.

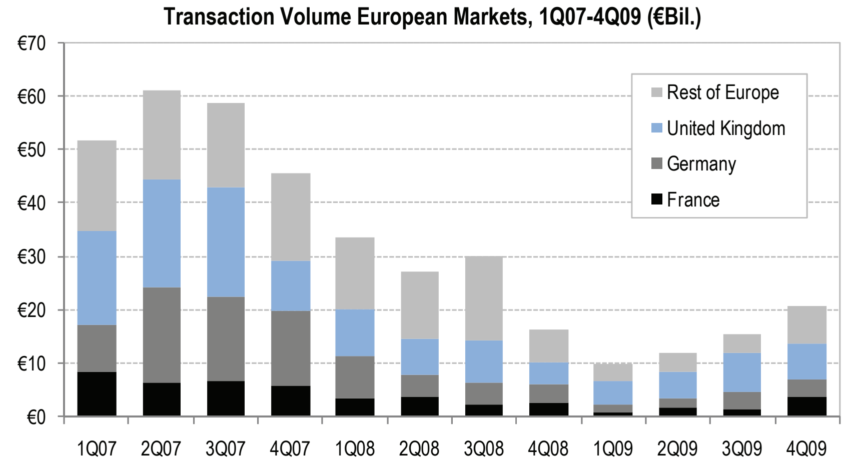
2009: A Volatile But Rewarding Year



S&P BMI European Property Total Return

Private-market transaction volume in Europe began to recover in 2009, fueled by the dominance of cash-rich investors. Some €20 billion of deals closed in the fourth quarter, up from just over €14 billion in the third quarter. Volume is focused on prime, well-leased assets in the deep and liquid markets of Western Europe.

Property Sales Rising After Hitting Bottom



DTZ Research

Although occupier markets held up remarkably well through the downturn, there is still a large amount of uncertainty as to the speed and shape of Europe's economic recovery over the coming quarters. This is in no small part due to extraordinary initiatives by the Continent's fiscal and monetary authorities. Yet investor sentiment appears to have gotten ahead of itself, given that a subdued recovery in the space markets is anticipated. Cap rates are sharpening across almost all sectors and prime markets now appear to be peaking below long-term averages.

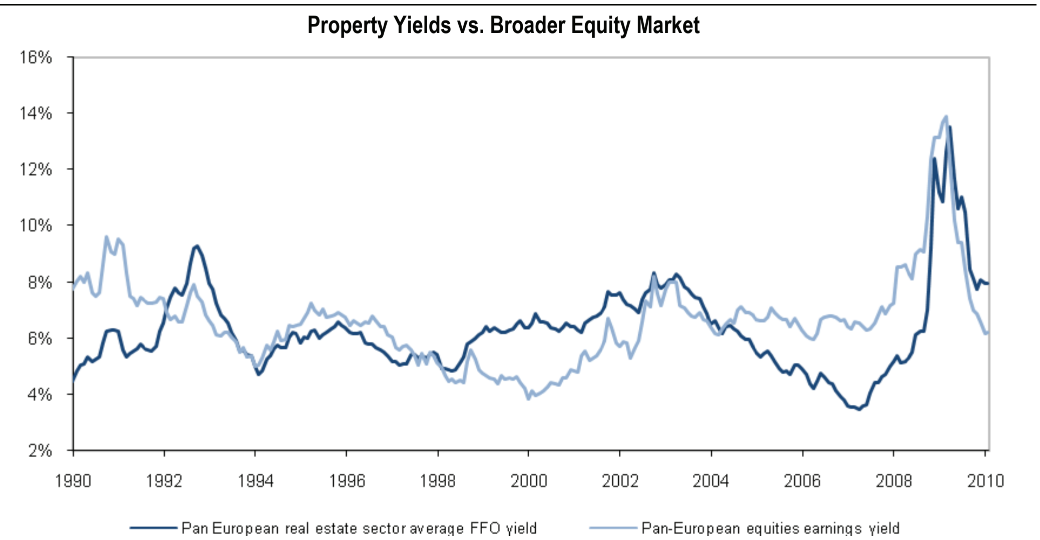
A number of downside risks to the occupier and investor outlook remain in place. Yet the globalization of the commercial real estate markets has produced demand from investors outside the region that may continue to help property values to recover more quickly than anticipated. On balance, investor interest and transaction volumes are set to continue to recover this year on the back of a modest potential recovery in rents, particularly in prime locations. But the path will likely not be smooth.

The European listed sector raised €11.4bn in fresh equity capital in 82 separate transactions during 2009. Interestingly, the intended purpose for the funds changed materially over the course of the year. Whereas earlier in the year companies were raising money to delever balance sheets and resolve covenant issues, by the end of the year the raisings became primarily offensive in nature and in a number of cases were targeted at specific investments. The listed sector is now looking to capitalize on the bumpy recovery that appears underway.

For the first time in several years, listed companies have been able to articulate to investors the opportunity and need to make selective purchases or build out their development pipelines. Given the strength of their balance sheets (the sector's average LTV is at 49%), listed participants are well positioned to make selective acquisitions. The majority of this capital seems focused on the retail sector both in the UK and on the Continent. Where assets have been marked-to-market, the development option is starting to look particularly enticing. With the unlisted pipelines limited by the withdrawal of construction financing and prime rental rates recovering, the recapitalized REITs are in a position to exploit their competitive advantage.

Better REITs boast an average lease length of 6.2 years which, in conjunction with the generally better quality assets owned by listed sector participants in Europe, provides substantial support for their income streams. Despite this, we still expect revenues in the listed and unlisted sectors to decline modestly over the near term. Fresh acquisitions will be accretive to cash flow in the majority of cases, particularly as REITs look to make investments that improve their revenue profiles and help shore up the attractive dividend streams that appeal to yield-hungry equity and bond investors.

Revenue Streams Retain Relative Attractions



Exane, Pramerica Real Estate Investors Research

Latin America

Capital markets in Latin America rallied at the end of 2009, and the positive trend is expected to continue this year. Strong performance by homebuilders and retailers boosted Latin American stock markets in 2009, while corporate debt issuance made a comeback after drying up earlier in the year.

The shockwaves of the global financial crisis affected Latin America on several levels in 2009. Real economic activity stalled during the first half of the year, leading to rising unemployment and economic deterioration. The financial markets were the first to hit bottom but also the first to anticipate the recovery that started to materialize toward the end of the year. The strength of the recovery has varied across countries in the region, and the recovery will continue to be uneven going forward. The critical factor will be local economic drivers – such as consumption growth and the availability of credit, which have driven the expansion in homeownership in Latin America. Home sales among higher-income consumers will probably slow down while demand for affordable homes should remain strong.

Commercial real estate values will continue to be depressed over the near term, as rental rates in all sectors are weak due to lack of demand. However, there are bright spots in certain corners of the market, with some industrial, retail and office activity picking up for the first time in more than a year.

Progress in the economic landscape of Latin America that began in 2009 should continue in 2010, albeit to varying degrees across different countries. Government stimulus measures and strong consumer demand created by a steady rise in employment served to boost growth to pre-recession levels in Brazil and Chile. Growth has stagnated in other countries, including Mexico, due in part to weak demand for exports from trading partners. Property markets are improving, although signs of a full recovery are not expected to surface until the second half of this year.

Despite the stellar gains from the Brazilian real estate equities last year, we are still cautiously optimistic for growth prospects in 2010. Housing sales could surpass pre-crisis levels. Demand for affordable housing is strong and will be boosted by government-backed mortgage initiatives and a growing middle class. Individual stock performance this year should be determined by the ability of companies to execute their business strategies, as construction capacity has caught up with development volume from new project launches and sales.

Asia Outlook

Having weathered the global credit crunch and the ensuing economic downturn, economies in Asia have emerged in reasonably good shape. The region's economy experienced a soft landing in the thick of the global economic downturn. Emerging markets such as China and India led the way out of the crisis with solid growth in 2009, thanks to government stimulus packages. Asia's economic prospects in 2010 will probably surprise on the upside, supported by the proactive measures of the region's governments. While the global credit crisis is likely in the rear view mirror, systemic risk will continue to be a sensitive issue in 2010.

Asset valuations in the region dipped in the early part of 2009, due to lower rent levels and rising cap rates. However, appraised values rebounded toward the end of the year and should remain stable in 2010, as cap rates trend back down and rents stabilize. Income-generating assets, especially retail properties, will regain investor confidence, supported by the vast population base and the growing affluence of Asian households.

Asian listed property markets ended the year on a strong note, and most outperformed major real estate markets globally. Real estate stocks in Singapore climbed 91%, while those in Hong Kong and China rose 73% for the year. On the other end of the spectrum, real estate stocks rose only 3% in Japan, which was the worst performing major real estate securities market globally in 2009. Asian REITs in 2009 posted their best returns in five years. Indeed, the 2009 annual returns of REITs in Hong Kong, Malaysia and Singapore more than recovered the losses in the previous year. Prices rebounded sharply from the early part of the year, when investors were concerned about delinquency risk and whether REITs could refinance maturing debt. With debt spreads high and property values falling, speculation was rife that REITs would be forced to sell assets to pare down debt. Sentiment began to stabilize in March, when Asian governments pumped fresh liquidity into the banking system.

The wider stock market rally has also helped REITs raise new equity, strengthening their balance sheets. REITs in 2009 focused on maintaining tenants, reducing overhead and sustaining the distribution rate of net income. In 2010, Asian REITs could re-emerge as buyers of income-generating properties. The increased competition for assets could put downward pressure on cap rates.

Total Returns, REITs vs. Property Equities

	2009	2008	2007	2006	2005
REITs					
Hong Kong	67.3%	-28.9%	10.4%	9.8%	2.0%
Japan	6.1%	-49.0%	-2.3%	29.7%	13.5%
Malaysia	30.7%*	-14.8%	17.8%	n/a	n/a
Singapore	82.2%	-56.1%	2.8%	58.0%	22.2%
Property					
Hong Kong	73.2%	-53.9%	57.1%	29.3%	6.1%
Japan	5.6%	-46.6%	-13.2%	21.3%	74.3%
Malaysia	37.5%	-38.5%	41.3%	55.2%	-9.9%
Singapore	85.9%	-57.3%	8.9%	75.7%	35.2%

Standard & Poor's Index Services (local currency)

*Data through Sept.18

There were no new Asian REITs formed last year. The total number fell to 82, due to the delisting of a Korean REIT in 4Q09. Market capitalization of Asian REITs totaled $61.2 billion, up 35% from the previous year, while the average dividend yield slid 210 bps to 6.4% at year-end. Asian REIT risk premiums may narrow in 2010. If REIT prices trend up, dividend yields will drop relative to government bond yields.

Market Capitalization and Dividend Yields of Asian REITs

	No. of REITs	Market Cap (US$ bil.)	Average Dividend Yield	Risk-free Rate*	Risk Premium (bps)
Japan	41	30.12	6.23%	1.30%	493
Singapore	21	19.96	6.50%	2.66%	384
Hong Kong	7	9.52	6.20%	2.58%	362
Malaysia	11	1.51	8.70%	4.29%	441
Korea	2	0.11	7.90%	4.92%	298
Total	82	$61.22	6.40%	(weighted average based on market cap)	

* Risk-free rate refers to long-term government bond yields

Various Stock Exchanges; CEIC; Pramerica Real Estate Investors Research (as of 4Q09)

Equity price performance in 2009 was largely driven by the effects of the highly positive stimulus policy measures implemented in concert by many Asian governments, led by China's massive $585 billion package. Policies promoting homeownership sparked a surge in residential property demand, driving residential real estate prices up across the region. Home prices in the top 70 large- to medium-sized Chinese cities rose 5.7% year-over-year in November, according to the National Bureau of Statistics. In Hong Kong, low mortgage rates, healthy affordability and strong demand from China pushed prices up 27% versus last year. This is an extremely strong showing in view of the weak economic environment. Likewise

Singapore transaction volumes are estimated to have reached nearly 15,000 units, on par with the previous peak in 2007. There even was a reprieve in Japan, which had been reeling from the effects of high levels of unsold condominium inventory. Condominium inventory halved to just 6,800 units in November from 12,400 units at the start of the year, according to data from CEIC.

The fundamentals for prime class-A offices were hit hard during the year. The lack of new demand and corporate downsizings prompted vacancies to rise and asking rents to fall significantly. The markets with the biggest decline in effective rents included Singapore (-51%) and Hong Kong (-36%). The financial and business sector, a key demand driver of office, absorbed little space in 2009. The scenario is the same in Japan, where increasing office vacancy rates in Tokyo, especially in newly-completed buildings, pushed rental rates lower in 2009. The vacancy rate rose to 8.1% at year-end, up from 4.7% the prior year. Large blocks of vacant space are increasingly common as corporations downsize their workforce. The lack of new demand drove down rents and put landlords in a difficult spot.

Nonetheless, leasing inquiries for class-A office space in central business district (CBD) areas increased in the fourth quarter, mostly driven by tenants' attempting to move up in quality. While we do not expect a V-shaped rebound in the office market, we believe that the rental correction has abated and further downside is limited. In markets such as Hong Kong where new supply is limited, asking rents have started to show signs of firming. The outlook for the office sector is starting to look a little more optimistic, especially in light of the improving conditions expected this year in most major economies.

Ironically, 2010 may prove more difficult for the residential sector in Asia, particularly after such a stellar performance last year. The stronger-than-expected surge in residential prices in 2009 has raised concerns among several governments that an asset bubble may be forming, prompting a reversal or removal of the some of the pro-property policies implemented at the height of the financial crisis. China in particular has started reining in mortgage lending for buyers of second homes, and has also tightened credit by requiring higher reserve requirements for banks. While these moves are not totally unexpected, the timing has surprised many industry participants. Most were not expecting credit to tighten until the second quarter, at the earliest.

Uncertainties relating to potential policy measures by governments in China, Hong Kong and Singapore have already triggered a pullback in share prices of listed property companies in the residential sector. We expect such concerns to continue to have an impact on the performance of residential developers in the first half of 2010. On the other hand, listed companies in the office and retail sectors in Hong Kong should outperform, particularly as the outlook for these sectors continues to improve with the economy. We remain positive on the prospects in China, although we also are mindful of the risks. The country's lack of transparency and high volatility may temper some gains there.

Overall, 2010 may prove to be a more challenging year for the Asian listed property markets than 2009, as investors are likely to take a breather and assess the economic situation more closely. Nonetheless, Asia will continue to be an important driver of the global economy, particularly as China, whose economy is forecast to grow 9.4% this year, rapidly emerges as the world's second largest economy. Despite our relatively more cautious outlook after the strong run in 2009, we still anticipate Asian real estate stocks will gain about 10% to 15% this year.

Investment Outlook for 2010

With many of last year's most worrisome risks no longer an immediate threat, the returns produced by real estate securities in 2010 are likely to be relatively normal, and certainly less volatile than the past two years. The threat of widespread insolvency no longer hangs over the sector. And while property values in many markets have declined by 30% or more from their peak, as they did in the 1990s, the write-downs in this cycle should be completed much more quickly than any prior cycle as a result of the increasing presence of capital markets in commercial real estate. It may take several years for asset values to recover to peak levels in some markets and sectors, but given the speed and magnitude of the correction, the downside risk in capital values should be limited.

To be sure, the road ahead may not be smooth. Investors already appear to be pricing in further deterioration in space market fundamentals. Valuations are not nearly as compelling as they were before last year's impressive rally, and many uncertainties abound related to the availability of debt and the impact of potential distressed asset sales. Debt that is maturing over the next 12 to 24 months still faces substantial refinancing risk. All of these qualms will hinder a full recovery, at least until we see some visibility.

Still, with listed property companies trading at levels that are 45% below their peak, it is evident that the sector retains significant value for the long-term investor. While we do not anticipate reaching peak pricing in the near future, real estate securities historically have delivered positive returns over a multi-year period once the economy returns to growth after a recession. As we look ahead, we believe that the stage is set for attractive performance by listed property shares.

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Pramerica Real Estate Investors	Tel	+1 973.683.1745
8 Campus Drive	Fax	+1 973.734.1319
Parsippany, NJ 07054	Web	www.pramericarei.com
USA	E-mail	research.reports@pramerica.com