



# GLOBAL REAL ESTATE SECURITIES 2012 MARKET OUTLOOK

JANUARY 2012

ABU DHABI

ATLANTA

BEIJING

CHICAGO

HONG KONG

ISTANBUL

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LONDON

LUXEMBOURG

MADRID

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MIAMI

MILAN

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## What a Year it Was....

Natural disasters. Arab Spring. Political brinksmanship. Credit rating deterioration. Sovereign debt crisis. Currency angst. Deflation, inflation, deflation. Deleveraging. Decoupling. Bank solvency. Risk-on, risk-off. Hard landing, soft landing. Geopolitical risk. Volatility. Apprehension. And the list can go on.

A year ago at this time, most market strategists were forecasting an improving US economy, which drove stocks to their peak in April. The tenor of the market was relatively serene. As the year progressed, the world was assailed by a devastating natural disaster in Japan, Congress' debt-ceiling stalemate, fears about sovereign stability and the future of the euro. S&P's downgrade of the US government's credit rating added fuel to the fire.

Undeterred by the consternation in the global economy, the S&P 500 index closed out the year at exactly the same place it started. This implausible outcome did not occur calmly. During the year, the S&P 500 bounced between a low of 1,099 and a high of 1,363. There were four straight days in August when the Dow Jones rose or declined by 4%, or 400-point fluctuations per day. The S&P 500 declined 14% in the third quarter only to rise by 12% in the fourth quarter.

While North American REITs returned 7.9% for the year, most other regions experienced dramatic price declines,<sup>1</sup> as the turbulence and macro fundamentals exacted their toll on share values. In Europe, the FTSE 100 (-2%), CAC 40 (-16%) and DAX (-17%) all suffered negative returns in 2011. Italian equities were down almost 24% for the year. Stocks in Asia, buffeted by fears of a hard landing in China, also were down. Japan's Nikkei 225 (-11%), Hong Kong's Hang Seng (-17%) and MSCI China (-18%) all lost ground during 2011.

|               | INDEX PERFORMANCE (\$USD) |       |        |       |
|---------------|---------------------------|-------|--------|-------|
|               | 1 YR                      | 3 YR  | 5 YR   | 10 YR |
| NORTH AMERICA | 7.9%                      | 21.8% | -1.8%  | 9.6%  |
| ASIA PACIFIC  | -20.7%                    | 10.6% | -3.0%  | 7.7%  |
| EUROPE        | -13.4%                    | 11.5% | -13.5% | 10.2% |
| AUSTRALIA     | -3.0%                     | 16.7% | -8.7%  | 7.9%  |
| TOTAL RETURNS | -5.6%                     | 16.5% | -4.7%  | 9.4%  |

*Source: S&P Developed Property Index, 31-Dec-2011*

Regionally, real estate indexes<sup>2</sup> exhibited a wide disparity in returns. Real estate equities were down in the UK (-9.1%) and Europe (-14.7%). Asia was much the same, as values plummeted in Japan (-17%), Hong Kong (-22.8%) and Singapore (-25.1%). All told, the global real estate securities index returned -5.6% for the year.

Global real estate returns in 2011 were driven by macro headwinds and government policy intervention. The gradually improving US economy fueled gains in luxury retail, high-end malls and apartments. The

<sup>1</sup> Source: Bloomberg

<sup>2</sup> S&P Developed Property Index



self-storage and health care sectors benefitted from their stable income sources, which was sought by investors.

Developers in Hong Kong and China with mainland China exposure underperformed due to the government's actions to cool rising housing costs. Policy easing late in the year in China may augur increased future policy easing, which would produce gains for real estate companies. The catastrophe in Japan resulted in a considerable economic response from the government through increased liquidity and asset purchases of J-REIT equities. The Bank of Japan's purchases set the stage for significant equity offerings and M&A activity. Although total returns in Singapore were negative, the retail and industrial segments outperformed based on their perceived defensive nature.

European real estate shares experienced a tale of two cities. The first half of the year was strong, driven by German residential, prime London office and compelling returns from real estate in Switzerland. During the second half, eurozone macro issues commanded center stage as the potential for sovereign defaults and euro angst resulted in dramatic negative returns across all geographies and asset classes.

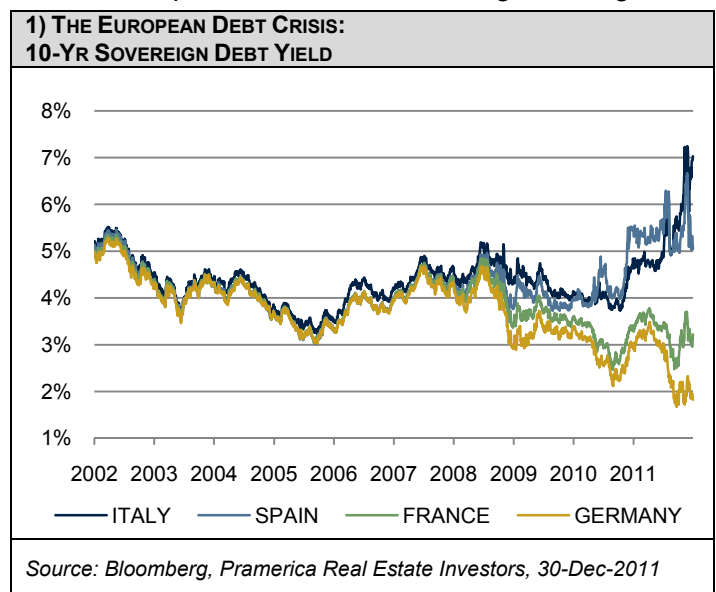
## The 2012 Global Outlook

The outlook for global real estate securities is fundamentally intertwined with the performance of the global economy as well as the economic factors of each local market. While local market supply and demand should drive long-term valuations, the near-term returns for real estate securities will be dominated by the macroeconomic environment. Despite the unique nature of regional economies, there are several consistent themes which we anticipate will influence equity performance during the year.

Our outlook for the year can be summarized by the "Five Ds:" Debt, Deleveraging, Dividends, Discounts and Demand and Supply. While underlying fundamentals will be paramount in determining the long-term valuation of the sector, the global economic environment will influence near-term pricing.

### Debt

The European sovereign debt crisis is at the forefront of the market. While the eurozone problems are far from being resolved, it is clear that the markets will require deleveraging and increased austerity that will slow the economy and increase short-term deflationary pressures (CHART 1). The proverbial elephant in room is the US debt. Despite the respite from the headlines of the financial media, the US must confront its own overleveraged economy (CHART 2). The upcoming elections and divided Congress will likely keep this issue on the

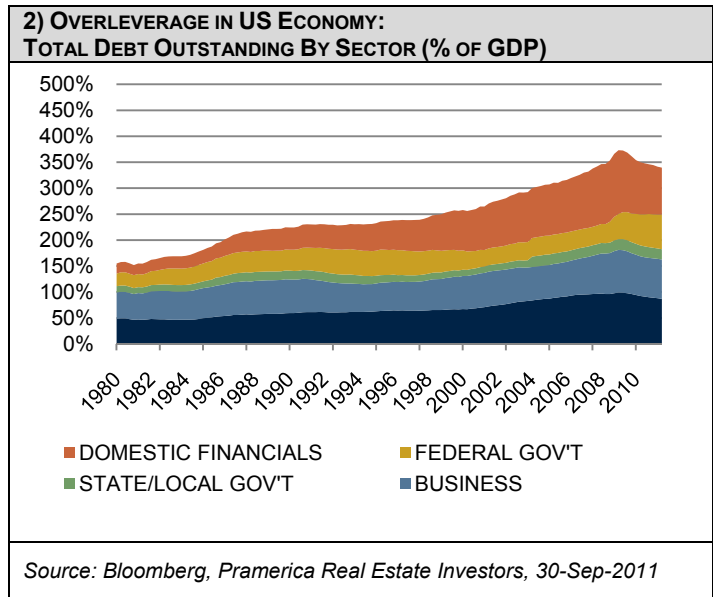




sidelines until 2013. However, the lack of economic growth and lessons to be learned from Europe should be at the forefront of the economic agenda.

### Deleveraging and Deflation

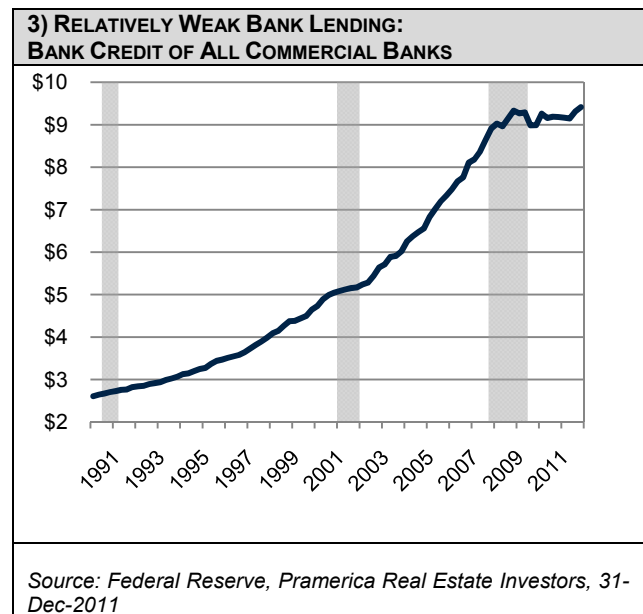
As a consequence of global deleveraging, we expect to be in an environment of low growth, low rates and low returns. Consensus forecasts<sup>3</sup> of 2.1% GDP growth and a 2012 recession in Europe should provide a continued focus on the importance of income-producing vehicles for investors. In Europe, sustainability of these income streams should become paramount to valuation for real estate equities. In the U.S., historically low payout ratios coupled with improving economic fundamentals could provide a backdrop for double-digit increases in REIT dividends.



Globally, banks have become parsimonious in their lending, which will impact the growth of business (CHART 3). It is anticipated that European banks must raise \$115 billion in new capital by mid-2012 to meet new regulatory requirements. The deleveraging will result in dramatic deterioration in lending to real estate companies in Europe. For example, in the UK, bank debt on commercial property is already down 25% from peak levels.<sup>4</sup>

Real estate companies will have limited options with reduced funding for a capital-intensive business. As alternative sources of capital will remain scarce, companies will need to either sell assets or raise additional equity. Both alternatives are likely to result in downward pressure on asset values. Negative growth forecasts in Europe will not be favorable to real estate. Economic growth drives employment, which ultimately drives rental growth and capital values.

The US appears to be at the start of a recovery (albeit modest, at best) from the stagnation of the past two years. Although this progress has come more from lower interest rates than broad reductions in debt, it is a meaningful improvement and an important factor in



<sup>3</sup> Bloomberg consensus forecast, 10-Jan-2012.

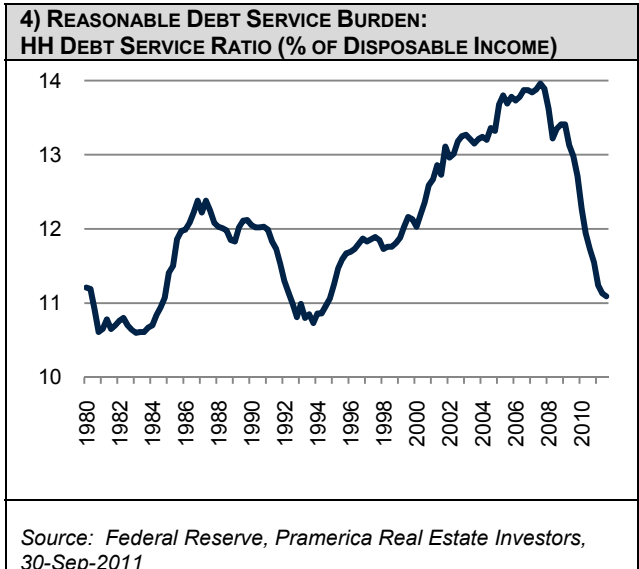
<sup>4</sup> Morgan Stanley Research, 4-Jan-2012



strengthening consumer sentiment. Household balance sheets have been improving due to a number of factors (CHART 4). Household spending has also improved and there has been resurgence in capital spending by businesses. Job growth has reduced the unemployment rate, a net positive for the US economy.

The eurozone has been battling the specter of potential inflation for the past two years. However, growth forecasts started to turn down in mid-2011, when business and consumer confidence started to moderate. It is widely anticipated that European governments will institute some form of quantitative easing to offset weak economic growth.

At the start of the year, most governments in Asia were grappling with rising inflation, largely triggered by rising commodity and real estate prices. Abundant liquidity and low interest rates continued to fuel property transactions and prices for most of the year, which prompted aggressive tightening measures from Asian governments. However, the inflationary threat during the first half of the year has now given way to concerns of a slowdown in domestic markets in Asia, prompting some governments to begin to cut or maintain interest rates.



## Dividends

In the absence of visible growth, investors should continue to favor income-producing stocks. Companies that can produce strong, sustainable cash flows with demonstrable growing income streams should be rewarded by the market, especially with the scarcity of compelling growth scenarios around the world. The aging global demographic should also provide sustained demand for dividend-paying equities.

## Discounts

As we enter 2012, global real estate securities around the world trade at discounts to the underlying value of the real estate. However, not all discounts are equal. For value investors, the discount to realizable net asset value (NAV) is important, although calculating this variable is not as straightforward as one would expect. On the public side, we can calculate an implied cap rate by dividing the current income by balance sheet liabilities.

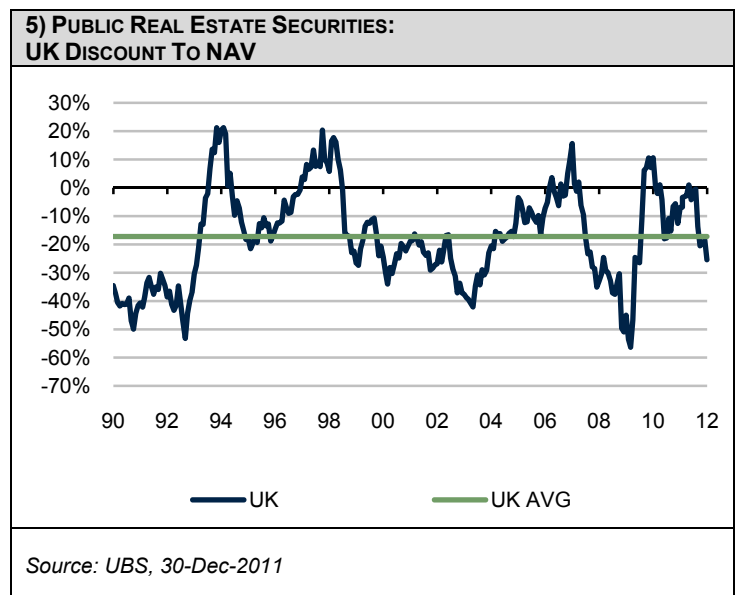
However, at the trough or peak of a market, a better gauge of potential net operating income may be a time-series discounted cash flow (DCF). In some markets, the private valuation of assets is readily available based upon an abundance of empirical data from open market transactions. In less-transparent regions or markets in which transactions are few, the private valuation metric may be less apparent.



Furthermore, international public real estate companies provide an external appraisal-based calculation regarding the valuation of the underlying assets. The veracity of this calculation is also subject to interpretation based upon the frequency, timing, and methodology of the review.

US REITs trade at discounts of approximately 15% to private values. We can look at the portfolios of the US REITs and compare value estimates to private transactions as well as third-party data. US REITs are inexpensive relative to their private market valuations. Strong demand for core real estate in gateway cities across the country has resulted in cap rate compression. The long-term leases in place on well-occupied properties are attractive to investors who are discouraged by bonds and equities, and are considering real estate as a bond substitute with an equity kicker.

While European public real estate companies trade at discounts to their market value, we believe that private real estate appraisals may be low due to the lack of transactional data and a more conservative outlook on future rent growth (CHART 5). Additionally, the scarcity of available debt will continue to inhibit transactions and obscure the valuation of the portfolios. We anticipate that forecasts of negative economic growth will result in decreased earnings for some companies. While many European public real estate companies already reflect some of this downside in their current pricing, we do not believe that there is an imminent catalyst to propel these stocks.



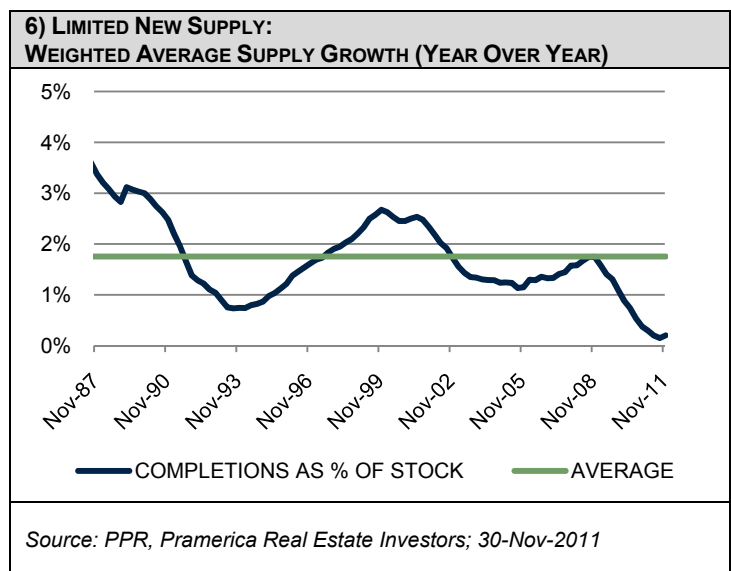
Asian real estate equities trade at discounts of 30%-40% to RNAVs, which is similar to the levels at which they traded at the trough of the recent global financial crisis. Steep discounts reflect the impact of recent government policy measures aimed at curbing demand for residential properties, as well as fears of falling office demand stemming from a global economic slowdown. We expect further downward revision in RNAVs as residential prices drop. We expect private prices to fall and narrow the gap to the RNAV discount. Asian REITs are also trading at very attractive spreads estimated at 500 bps over government bonds. With Asian economies expected to slow down on the back of the global economic downturn, governments may start to relax some of their policies in the latter half of the year, providing a catalyst for share price performance.



## Demand & Supply

Real estate fundamentals are important. Sometimes investors lose sight of the basics and get caught up in macro market momentum. But despite the global nature of capital flows and markets, real estate is the ultimate local market business, predicated on local supply and demand fundamentals. Just as we experienced in the US downturn of 2008-09, economic uncertainty in Europe will clearly deter companies from entering into leases and longer term contractual obligations, if the decision can be postponed for another time.

Commercial construction was limited in the US coming into the 2007 downturn. The main reasons were heightened commodity prices, which increased the cost of construction, and the fact that residential real estate captured many potential commercial sites. Now, with anemic GDP growth over the past three years, new construction as a percent of existing stock has reached historic lows. As one can imagine, banks have not been in the market to make new loans to commercial real estate (CHART 6). Due to the duration of the construction cycle, which could be 3-5 years in major cities, we do not anticipate significant commercial deliveries in core gateway cities for the next several years.



## United States: 2011 Review

After finishing up 2011 with a respectable 7.9% return,<sup>5</sup> US REITs have outperformed the S&P for eight of the last 10 years. Returns for the group last year were characterized by the “risk-off” trade where investors were seeking income, visibility in earnings and safety. Outperforming were defensive sectors – self-storage (32%), health care (12%) and multi-family (9%). Economically sensitive sectors such as lodging (-15%) underperformed. Large capitalization REITs outperformed small capitalization REITs, as investors sought liquid companies with access to the capital markets. REITs with market caps greater than \$5 billion were up approximately 12%, while REITs with market caps of \$2 billion or less declined by about 5%.<sup>6</sup> REITs with lower debt ratios outperformed REITs with higher debt ratios<sup>7</sup> by approximately 1400 bps. Finally, REITs with higher cash flow growth rates outperformed REITs with lower cash flow growth.

<sup>5</sup> S&P Developed Property Index

<sup>6</sup> Stifel Nicolaus, *Real Estate Securities Outlook, Jan-2012*

<sup>7</sup> Citigroup Real Estate Investment Research, *Jan-2012*



Risk appetite seemed to return in the fourth quarter, based on strong returns for lodging (29%) and self-storage (22%). The return of the risk-on trade and reversion toward the mean of some of 2011's biggest underperformers combined with improving economic news in the US to drive fourth-quarter performance for real estate companies. Investors sought value in 4Q11 as pricing gaps between large- and small-cap companies neared historically wide levels. Additionally, property sectors that underperformed during 2011 tended to outperform in the fourth quarter. As a result, hotel and industrial REITs outperformed multi-family and office REITs.

Once again, REITs demonstrated strong access to capital sources. They raised more than \$51 billion

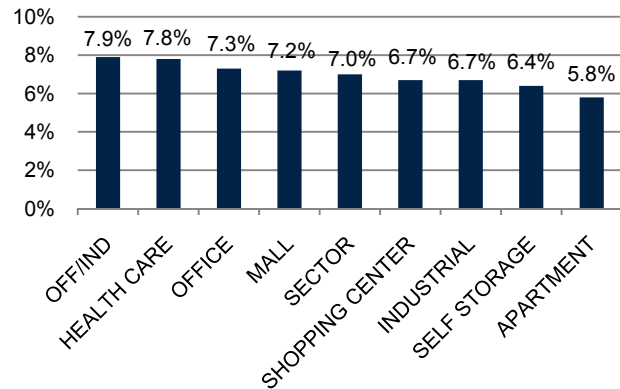
of equity and debt in 2011, employing the capital to fortify their balance sheets. At year-end, US REITs maintained debt-to-equity ratios of approximately 41% with a fixed charge coverage ratio of 2.9 times.

**Valuation:** Annualized trailing returns for REITs are 23.3% for three years, -1.5% for five years and 9.8% for 10 years. REITs are still 18% below the February 2007 peak on a total-return basis. REITs traded at an implied cap rate of 7% as of year-end (CHART 7), which arguably is a 15% discount to comparable private market valuations. However, there are wide variations between property sectors. For example, large cap health care REITs trade at premiums to NAV. REITs are inexpensive relative to bonds, which have seen unprecedented demand that has increased their value while yields declined to historic lows. However, REITs are relatively expensive versus general equities. Investors are willing to pay a higher multiple for REITs due to the contractual nature of their income, visibility in earnings, and strong current income characteristics.

### United States: Outlook 2012

REITs enter 2012 with a balance of fundamental tailwinds and global macroeconomic headwinds. The improving jobs picture in the US is fueling demand in the space markets. With the exception of some apartment markets, commercial real estate supply is at historically low levels. Pricing power has returned in some markets and property types, such as apartments and hotels, but has remained challenging in others, such as suburban office and retail space in grocery anchored centers. The Federal Reserve has telegraphed its intent to keep interest rates low through 2013. Should the economy be able to post positive growth and maintain momentum in adding jobs, we anticipate that we may be at the start of a sustainable expansion in which pricing power will shift dramatically in the favor of the landlord.

7) IMPLIED CAPITALIZATION RATES BY SECTOR



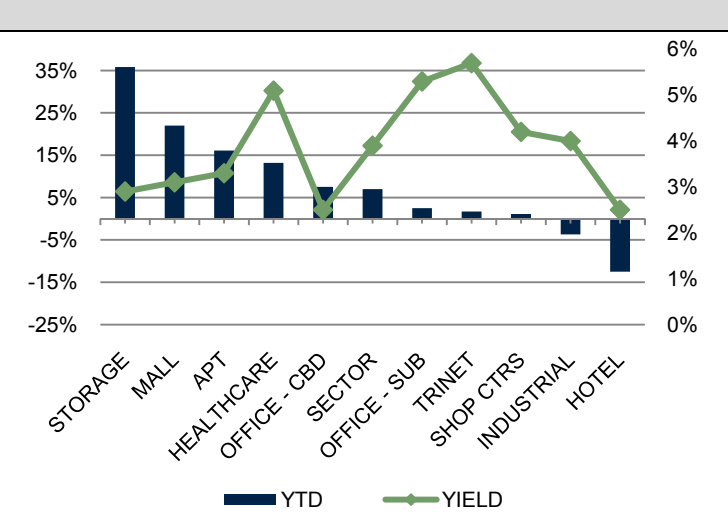
Source: PPR, Pramerica Real Estate Investors; 30-Nov-2011



The combination of low supply and improving demand with low, stable interest rates should position US REITs favorably for those seeking income opportunities with dividend growth (CHART 8). US REIT dividends increased about 12% in 2011, and given the current historically low dividend pay-out ratios for the group (55% vs. long term average of 80%), we anticipate that dividends are poised to increase by a double-digit percentage again in 2012.

Global macro-economic headwinds will persist in 2012, as no short-term fixes appear likely for Europe and concerns regarding China's growth will remain. But US REITs proved to be a beneficiary of the flight to quality or risk-off trade that prevailed for much of 2011. US REITs finished 2011 outperforming the S&P 500 and international real estate markets in a flight to quality environment.

8) U.S. REITS: 2011 TOTAL RETURNS BY SECTOR

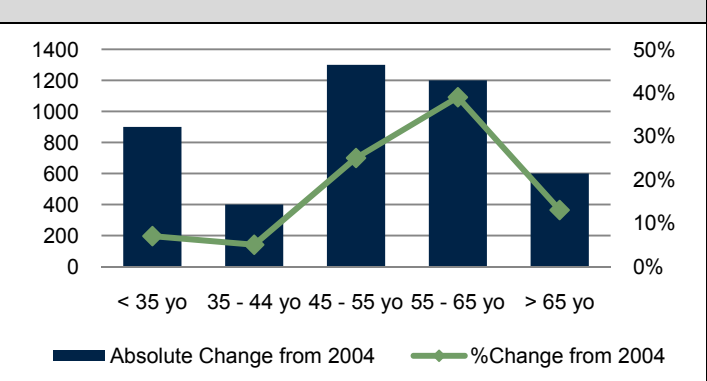


Source: Macquarie, 30-Dec-2011

### Apartments

Apartments should continue to see strong revenue growth in 2012, aided by continued jobs growth and declining homeownership. Apartment companies that have the ability to deliver early cycle developments in 2012 and 2013 should outperform. Additionally, apartment companies in markets that lagged early in the recovery, such as the Sunbelt and Southern California, are likely positioned to show accelerating revenue growth. Investors should continue to keep an eye on markets that show any strength in the single-family housing market, particularly in areas of the country with low barriers to entry on new construction. Home affordability is historically attractive in low-barrier-to-entry markets, which favors home ownership over rentals.

9) OLDER COHORT A GROWING SEGMENT AMONG RENTERS: ABSOLUTE AND PERCENTAGE CHANGE OF RENTER HOUSEHOLDS



Source: PPR, 2010-Dec-31

The impressive occupancy gains for the apartment market have been driven more by a decline in homeownership rates than by population growth. Since peaking at 69% in 2004, the homeownership rate has declined to 66% (source: US Census Bureau). During that time, the 20- to 34-year-old apartment



cohort has swelled by 2.8 million.<sup>8</sup> However, the young adult cohort was affected disproportionately by the employment recession, which impeded household formations (CHART 9). Even so, more than 1.2 million new renter households between the ages of 20–34 were formed between 2004 and 2010, as existing renters delayed new home purchases longer and former owners fell back into the rental pool. For this age cohort, home ownership is viewed as more of a burden than as a means to accumulate wealth.

In both the public and private markets, apartments trade at wide premiums compared to other property types. As a result, the sector will likely come under pressure with any signs of decelerating revenue growth.

## Hotels

Based on stock performance, investors might infer that hotel fundamentals were poor in 2011. Yet hotel companies delivered some of the REIT sector's strongest revenue growth. RevPAR (revenue per available room) grew by about 5% on average. Hotel companies in 2011 were the victims of headline and macroeconomic risk, real or perceived.

Hotel companies trade at their historical average cash flow multiple, while cash flow remains 25% below 2007 peak levels. The story improves when one considers that hotel supply additions are expected to remain at historically low levels of less than 1% of existing rooms for the next few years. RevPAR growth estimates have moderated for 2012 to a range of 3-8%, leaving room for upward analyst earnings estimates if corporate travel remains robust.

## Health Care

Health care REITs outperformed in 2011 due to their defensive demand characteristics, strong balance sheets and attractive dividend yields. The superior performance of large-capitalization health care REITs has created a wide valuation gap versus their smaller peers, with large caps trading at a cash flow multiple that is 2.5 points wider than the historical average. We would expect some reversion to the mean in 2012. Health care REITs, while defensive, were not immune to headline and government policy risk.

Fundamentals in senior housing and assisted-living facilities improved in 2011, and given limited supply, are expected to continue to improve in 2012. Investors should keep an eye on the housing market in 2012 as many prospective senior housing tenants must first sell their homes to move in to a facility and finance rental payments. From a valuation perspective, the large-cap health care stocks trade at large premiums to net asset value. While this provides the companies the luxury of making accretive acquisitions to fuel earnings growth, it also puts the stock prices at risk if deal volume decelerates or decreases.

The health care space may be one of the few areas where we see further consolidation in 2012. Consolidation may be driven by the low cost of capital and need for acquisitions of the large caps, and the high cost of capital and limited access to the capital markets of the small caps. In 2011, this played out

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<sup>8</sup> PPR, *Basement Lurkers to Drive Apartment Demand*, 11-Jan-2012



when Ventas acquired National Healthcare Properties. Ventas then announced plans in late December to acquire Cogdell Spencer, an owner of medical office buildings, a property type that should show relative strength based on supply and demand.

## Retail

The risk-off trade was also apparent in the retail sector, in which higher quality regional malls outperformed shopping centers. Regional mall occupancies have held up through the downturn, so future occupancy gains may be modest, although mall owners may find opportunities to raise rents through re-leasing spreads. While valuations and pricing for shopping centers look much more attractive on a relative basis, they have weaker prospects. Future NOI growth expectations for regional malls are about 100 bps per year higher than for shopping centers.<sup>9</sup> Still, the high-end portion of the market looks expensive (trophy malls are trading at sub-5% cap rates<sup>10</sup>). Reasonably cheap debt capital is readily available for quality real estate, but acquisition activity is expected remain muted in the near term.

## Office/Industrial

Public office companies in the US produced dismal returns relative to the rest of the sector last year. Total returns were approximately -0.4%, and ranged from -40% to 18% within the sector.<sup>11</sup> The wide range demonstrated how investors differentiated between owners of class A urban properties and their suburban peers. The spread between urban and suburban office REITs was north of 250 bps, while the historical range is normally 100-150 bps. The suburban discount reflects weaker fundamentals and the potential for NOI roll-downs in the next several years. Additionally, job growth is weaker in many suburban markets, a trend that will likely enable CBD offices to outperform suburban offices again in 2012.

In Washington DC, uncertainty about federal spending and weaker tenant demand related to the military Base Realignment and Closure act will cause setbacks for companies positioned to gain occupancy from these moves. Demand growth in Manhattan will likely be flat as growth in technology, media and health care will be offset by job losses in financial services. Companies that are diversified between office and industrial may fare well as US industrial fundamentals strengthen, driven by modest GDP growth and the rebuilding of inventories.

<sup>9</sup> *International Strategy and Investments Group, 18-Dec-2011*

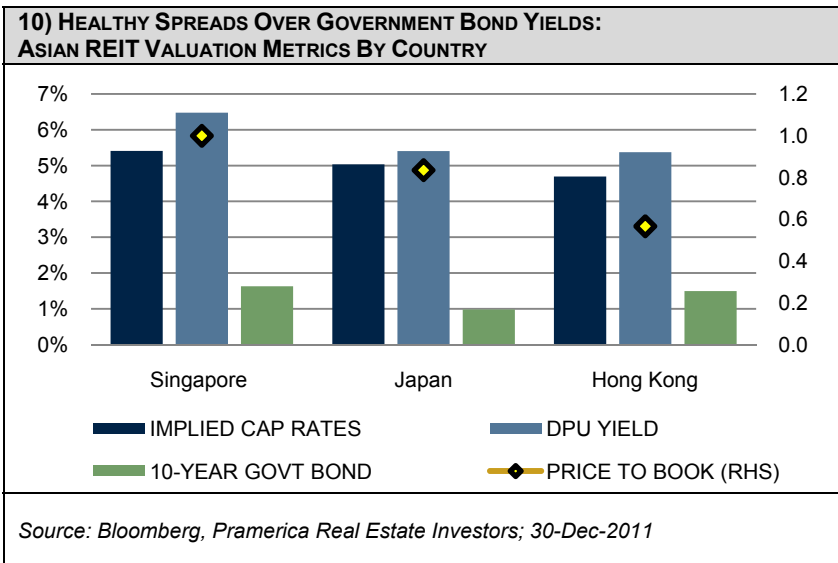
<sup>10</sup> *Citigroup Real Estate Research, 16-Dec-2011*

<sup>11</sup> *Bloomberg, 31-Dec-2011*



**Asia**

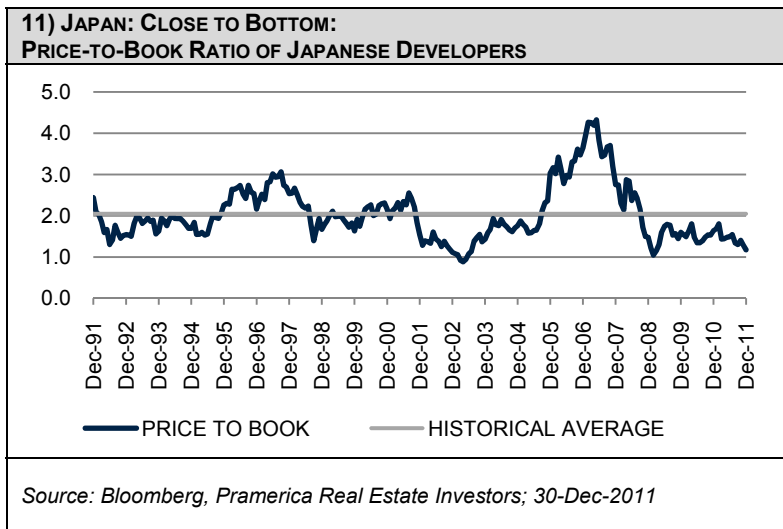
2011 was a turbulent year for Asian equities, which ended the year on a disappointing note as values in the key markets of Japan, Hong Kong and Singapore declined by 15-20% (CHART 10).<sup>12</sup> Most governments in Asia started the year grappling with rising inflation, largely triggered by rising commodity and real estate prices. Abundant liquidity and low interest rates continued to fuel property transactions and prices for most of the year, which prompted aggressive tightening measures from governments across Asia. To curb soaring property prices, governments in China, Hong Kong and Singapore increased the requirement for mortgage down payments and committed to increase land supply significantly, while China resorted to draconian measures such as Housing Purchase Restrictions (HPR), price controls and increasing construction of social housing.



However, the inflationary threat during the first half of the year has now given way to concerns of slowdown in domestic markets in Asia and some governments have begun to cut or maintain interest rates in the face of a global slowdown.

**Japan**

The devastating March earthquake/tsunami, coming at a time when the economy was slowing, was Japan’s defining event in 2011. GDP growth was positive most of 2010, albeit moderating on a quarterly basis, before ending flat in 4Q10.<sup>13</sup> However, GDP contracted by 1.7% in 1Q11 due to the earthquake/tsunami. Japanese developers (-28%) and J-REITs (-27%) declined in 2011 as proxied by their respective indices (CHART 11).<sup>14</sup> Daito Trust stood out as one of the best performers in Japan on the back of the



<sup>12</sup> Bloomberg  
<sup>13</sup> Bloomberg  
<sup>14</sup> Bloomberg



earthquake reconstruction theme. Fortunately, most if not all developers and J-REITs emerged relatively unscathed from the earthquake/tsunami, both in terms of financial loss and casualties.

The Bank of Japan responded immediately to the crisis by pumping liquidity into the market. Three days after the earthquake, the BOJ announced that it would double its asset-purchase program to Y10 trillion yen (US\$119 billion). The amount allocated to J-REITs has doubled to 100 billion yen (US\$1.2 billion).<sup>15</sup> The BOJ purchase set the stage for more public offerings and acquisitions by the J-REITs, which raised a total of Y411.4 billion via public offerings in 2011,<sup>16</sup> triple the total in 2010. The additional capital enabled J-REITs to accelerate acquisitions, prompting a spate of mergers. For example, in August J-REITs FC Residential and Ichigo REIT announced a merger to create a diversified REIT with office and residential properties. In December, two mergers were announced: one between Hulic and Shoei and the other between Nippon Hotel Fund and Japan Hotel & Resort.<sup>17</sup>

The Tokyo condo market has been relatively resilient, even after the tsunami. The contract exceeded 70% for 18 consecutive months until August, when it briefly dipped below the psychological level before recovering to more than 70% in September and October. The Real Estate Economic Institute (REEI) forecasts that condo supply will increase by 17.6% in 2012, following a flat 2011 as some project launches were postponed for a year in wake of the tsunami.<sup>18</sup>

## China

The Chinese government mandated the HPRs in January in all first-tier cities and some second-tier cities, by far the harshest curbs to cool its overheating market. Subsequently, price controls were initiated in March 2011 on luxury projects in first-tier cities.

China real estate stocks came off their peak in early August following the announcement of the restrictions targeted at second- and third-tier cities. The tightening measures and the limited availability of mortgages have led to a sharp slowdown in residential sales since October, which resulted in cash flow and liquidity concerns for developers. Mindful of the consequences of a collapse in property prices on the overall economy, the government cut the rates for banks in early December, effectively ending the monetary tightening cycle which began back in January 2010. Banks subsequently lowered mortgage rates in selected cities. While the government is not likely to take its foot off the pedal before the end of 1Q12, we think some loosening may be in the offing toward the middle of the year should the economy and inflation slow down faster than expected.

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<sup>15</sup> Bank of Japan

<sup>16</sup> Nomura, Company data

<sup>17</sup> Company announcements

<sup>18</sup> Real Estate Economic Institute



## Hong Kong

Hong Kong property stocks peaked in January 2011 and have since declined by almost 30%.<sup>19</sup> This was largely due to a confluence of the global debt crisis, China's slowdown and tightening policy measures. Invariably, the January peak in Hong Kong property stocks coincided with the fact that secondary market housing prices reached or even surpassed all-time highs seen in 1997 in several districts. Residential rents also have declined since October.<sup>20</sup>

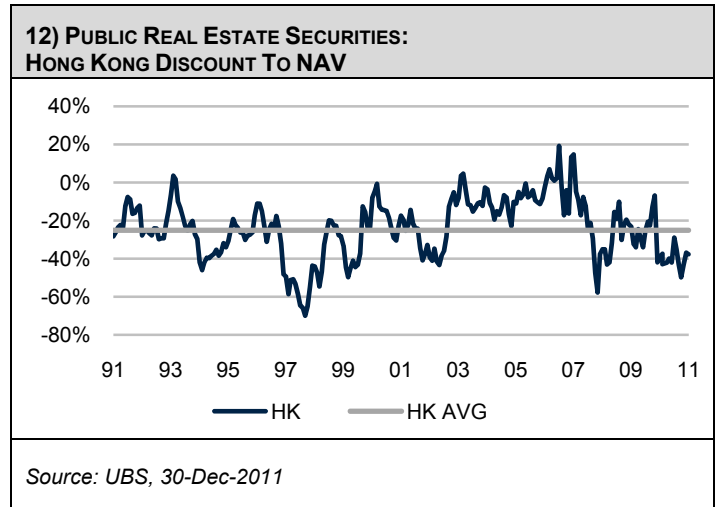
In June, a hawkish Hong Kong government followed up on its warning of an emerging property bubble by tightening mortgage requirements. For house prices above HK\$7 million (US\$900,000), the minimum down payment ratio has been raised to 40-50%.<sup>21</sup> The government has vowed to increase land supply and may consider restarting public housing development.

The tightening measures and increasingly uncertain global climate has prompted developers to accelerate sales. Indeed, in Hong Kong the price premium of primary sales over secondary units has narrowed from 30%-40% to 5%-20%.<sup>22</sup> However, Hong Kong developers have become cautious in buying land bank, evidenced by recent low bids at auctions.

## Singapore

The big news in January was the announcement of further tightening measures in Singapore to cool an exuberant property market. The market was surprised by the severity of the measures, which included raising the seller's stamp duty (SSD) from 3% to 16% if a property is sold within a year of purchase; progressively reducing the SSD over the subsequent three years; extending the SSD to a fourth year of sale; lowering the permitted LTV for second mortgages to 60% from 70%. The government also has imposed an additional 10% SSD for foreigners and corporate entities that buy residential properties, and a 3% levy on each additional home purchased by residents.<sup>23</sup>

The thrust of the policy is to address stubbornly high property prices, which have been driven in no small part by foreign buyers. The government's renewed resolve to cool property prices, which came after an election that disappointed the ruling party, has resulted in significant underperformance of developer stocks.



<sup>19</sup> Bloomberg

<sup>20</sup> CBRE

<sup>21</sup> Hong Kong government

<sup>22</sup> Centaline

<sup>23</sup> Singapore government



Developers in Singapore have also become cautious in buying land bank. The number of bids and bid prices have softened in recent land sales.<sup>24</sup> Two en bloc sites failed to receive any bids at auctions in November, despite the fact that prices were dropped from the first attempt to auction the developments in 2007.<sup>25</sup>

In the commercial space, retail REITs in Hong Kong generally outperformed their country peers as they ride on continued robust spending by the mainland Chinese consumer. Retail and industrial REITs in Singapore also outperformed their developer peers as robust spending and longer lease contracts offered more defensiveness. On the other hand, office plays and REITs in Hong Kong and Singapore were among the worst performers, spooked by slow growth in the US and the European debt crisis. Indeed, class A office rents in Singapore were flat in 4Q11 and are expected to decline up to 14% over the next year.<sup>26</sup> Despite the low 4.2% vacancy rate in Hong Kong's Central district, rents are expected to decline 10-20% in 2012 as demand wanes and leases expire on 20% of space.<sup>27</sup>

The Tokyo office market showed signs of recovery post-tsunami, with declining vacancy rates in the five central wards through the rest of 2011. However, following six months of month-over-month declines in vacancy rates, the market reversed course and vacancies increased by 12 bps in September, October and November, ending at 8.9%.<sup>28</sup>

## Asia Outlook

Asia will not be spared from the uncertainties in the eurozone and the US, which are likely to create volatility in global equity markets in 2012. Asia is still highly dependent on global trade for its economic growth. The global economic malaise has prompted in downward revisions to GDP growth expectations for 2012 in Asia, and corporate earnings downgrades are likely to follow suit.

Valuations, however, are looking attractive for both developers and REITs. NAV discounts for REITs are estimated at 30-40%, while yield spreads to government bonds are now estimated at 400-500 bps on average. Our portfolio is therefore positioned in undervalued developers as well as defensive REITs with secure income streams and attractive valuations.

## Europe

Economic growth has deteriorated in Europe as governments struggle to devise a credible solution to resolve the sovereign debt crisis. Policymakers have taken initial measures, such as writing down Greek debt, the recapitalization of European banks and increasing funds available for the European Financing Stability Facility (EFSC), but fears continue to loom regarding implementation and scale of these reforms.

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<sup>24</sup> *Singapore URA*

<sup>25</sup> *Local press*

<sup>26</sup> *Jones Lang LaSalle*

<sup>27</sup> *CBRE*

<sup>28</sup> *Miki Shoji*



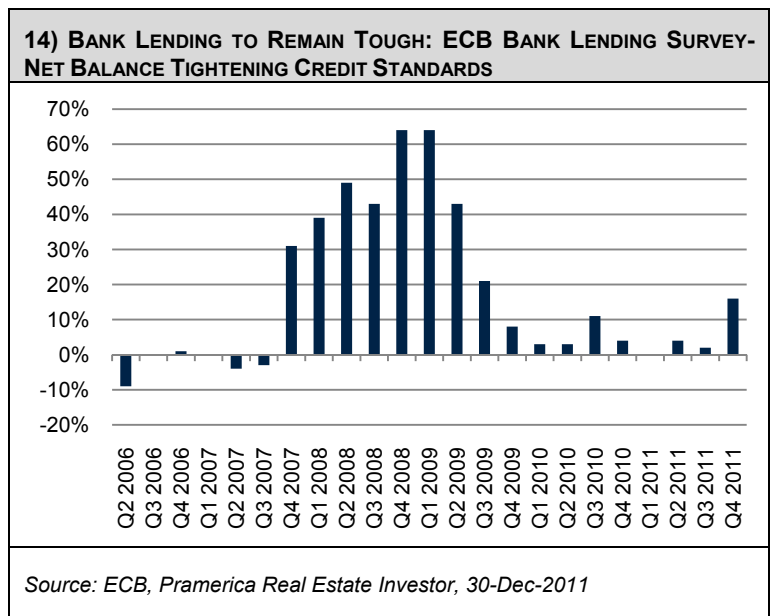
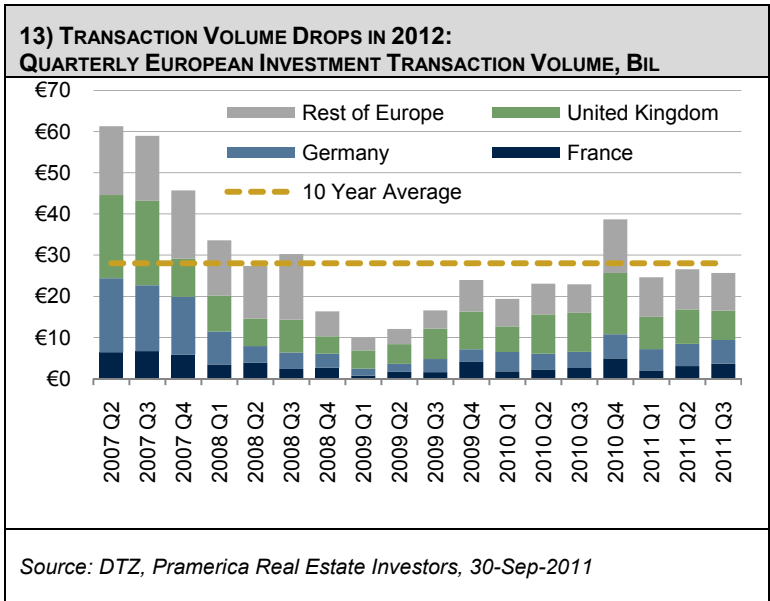
And contrary to the consensus from just a few months ago, interest rates are now expected to remain low for a long period, which proposes deflation as a greater threat than inflation. As a result, forecasts of GDP growth in Europe continue to get revised down.

Economic growth has been sluggish in most areas of the world in the past year; Japan is still recovering from the natural disasters; export-oriented emerging market countries are struggling due to the weakness in the more advanced economies; and in China and India, slower internal growth due to a high inflationary environment will take time to play out. All of these factors will weigh on the recovery of the eurozone.

Commercial real estate investment activity declined in Europe in the fourth quarter, as banks reduced lending and cross-border investors become increasingly nervous about Europe's growth prospects. While the lack of new supply will ease the cycle, leasing activity will most likely continue to slow down as decisions continue to get forestalled in conjunction with economic uncertainty. While transaction volumes held steady in the second and third quarters, deal flow pulled back in 4Q11 due to the turmoil in Europe (CHART 13).

Demand will be focused on the top-quality assets in cities with higher barriers to entry, which have traditionally been in Northern Europe. With little new supply and increased demand, some rent growth can be expected even in these volatile conditions.

The retreat of the debt markets creates long-term issues for the region as Europe's banks remain at the heart of the crisis (CHART 14). While the European Central Bank (ECB) has taken measures to prevent further distress, lending options are scarce. With CMBS markets inaccessible, demand for lending will be met by tougher terms and conditions set by those banks that are able and willing to provide capital. Additionally, while some maturing loans





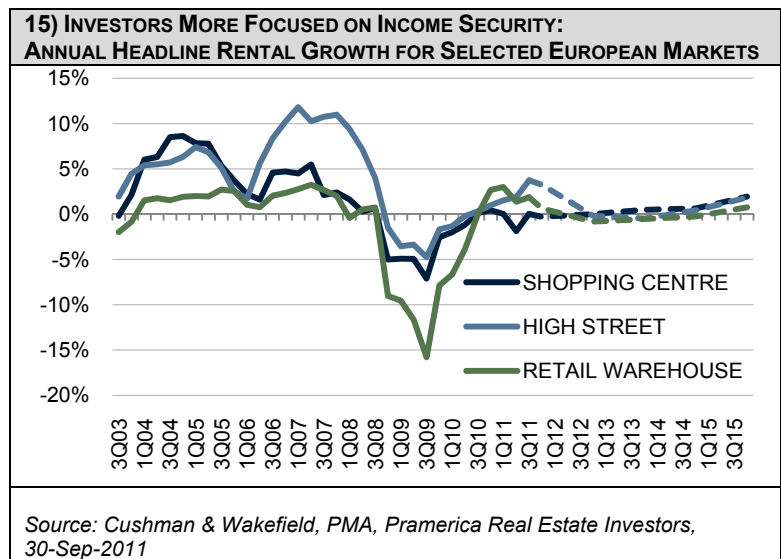
may get refinanced with additional concessions from borrowers, a funding shortfall in excess of \$115 billion remains a challenge. The scarcity of debt could have a negative impact on direct real estate values.

In the public markets, share prices have already corrected. Listed property markets returned -13% in 2011, versus the listed broad market return of -11%.<sup>29</sup> While property stocks continue to look inexpensive and trade at significant discounts to NAV, there is no catalyst in the near term for upside. Volatility was high in 2011, when total returns changed by 2% or more in 54 days, including 42 in the second half.<sup>30</sup> Currently, EBITDA averages 5.8%, earnings yields are 7.8% and dividend yields average an attractive 6%.<sup>31</sup> Listed share prices are trading almost 50% below the 2007 peak.<sup>32</sup> Investors await possible quantitative easing measures and/or definitive plans by the ECB.

In an uncertain economic outlook, investors are once again focused on the security of achieving returns through income-producing assets such as office, industrial and retail properties in prime locations in larger cities in within Europe. With the prospect of low interest rates for an extended period, and development at historic lows, the opportunity for long-term rent growth exists in these primary markets.

**UK**

For an economy which conducts nearly 60% of its trade with its continental neighbors, the eurozone crisis may compel additional quantitative easing to spur internal growth and increase risks of inflation. However, with weak domestic consumer demand and poor wage growth, the outlook for a near-term inflationary environment is highly unlikely. There is a clear bifurcation in the UK that favors prime locations (CHART 15). The UK majors (high quality, core locations) are trading at a 200 bps higher implied cap rate than their London City specialist counterparts.<sup>33</sup> Higher-quality assets, with secure cash flows, access to financing and quality balance sheets, will continue to prevail. Indeed, the gap between primary and secondary markets may widen. Similarly, the UK is considered to be a safe haven within Europe, evidenced by the fact that it outperformed continental listed property in 2011's unpredictable landscape.

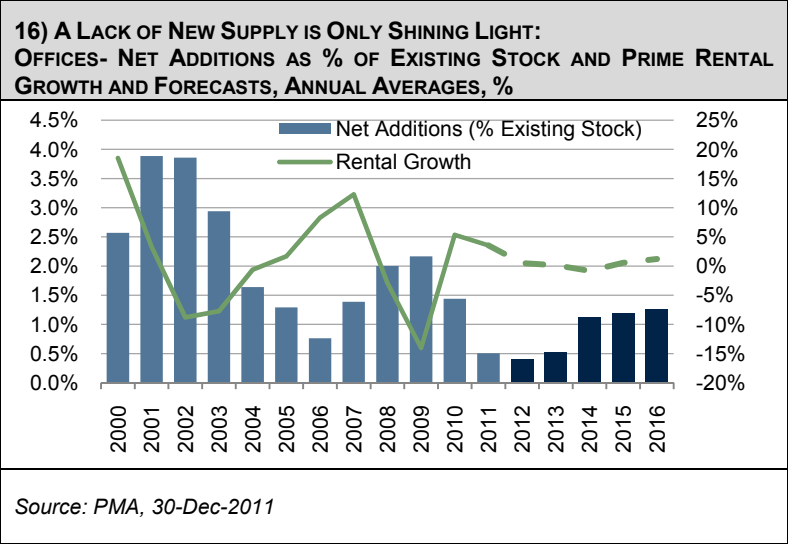


<sup>29</sup> Standard & Poors, 31-Dec-2011  
<sup>30</sup> Pramerica Real Estate Investors, Bloomberg, 10-Jan-2012  
<sup>31</sup> Goldman Sachs, 9-Jan-2012  
<sup>32</sup> Pramerica Real Estate Investors, Bloomberg, 10-Jan-2012  
<sup>33</sup> Green Street Advisors, 3-Jan-2012



### Continental Real Estate

Despite underperforming in 2011, continental REITs may still not be attractively priced. While these names trade at a 20% average discount to their NAV's, a weak economic environment and potential further deleveraging may result in decreasing NAV's (CHART 16). Continental retail and storage sectors are the most attractively priced segments. Despite a weak macro economy, high-quality Paris shopping centers – such as those of Unibail-Rodamco and Klepierre – may have potential to produce positive growth. On the office front, consensus forecasts for low-to-negative GDP growth may result in higher unemployment, which would decrease demand for space. Moreover, continental listed property companies have, on average, some of the largest development pipelines, which account for a significant portion of total development of all public market participants.





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