

U.S. Quarterly

Market Perspective

Executive Summary

- Economic trends are unfavorable for the commercial real estate market. Rising unemployment and reduced consumer spending translate into reduced demand for space and declining net operating incomes.
- Debt for commercial real estate continues to be scarce and expensive. Lenders remain largely on the sidelines as they slowly move to clean up balance sheets and monitor the impact of new government programs.
- Transaction activity remains at a snail's pace. Private equity players are reluctant to jump into the market, either due to a lack of capital or because they are waiting for prices to fall further.
- Despite historically low stock prices, many REITs have recently raised equity and debt in an effort to strengthen their balance sheets.
- Property values are falling rapidly. On the heels of its worst performance ever in 4Q08 (-9.5% appreciation and -8.3% total return), the National Council of Real Estate Fiduciaries' (NCREIF) index produced a -7.3% total return (-8.7% appreciation and 1.4% income) in the first quarter.
- Distress should begin to rise among property owners due to poor performance and/or the inability to refinance maturing debt. This should create opportunities for investors with access to capital.

Overview

The effects of weakening fundamentals and the end of the debt-fueled bull market were slow to hit the commercial real estate market in 2008, but now they are being felt in full force. Asset values are falling while distress among property owners is rising. The U.S. economy is losing jobs at a stunning clip and consumer spending is down to an extent not seen in decades.

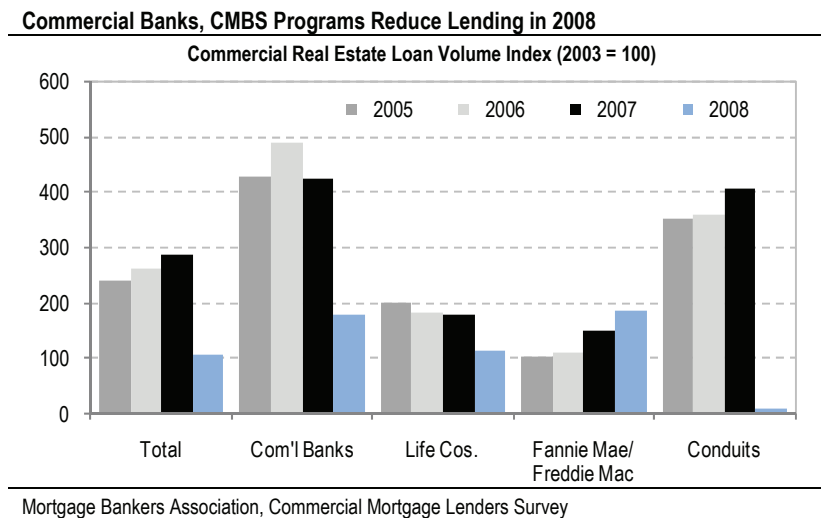
This cycle in the real estate markets goes beyond the ups and downs of normal market trends. With individuals concerned about job security and facing depleted retirement savings accounts and reduced home values, and banks more cautious in handing out credit, the consumer culture that has driven the economy for the past 25 years may not come back anytime soon. The high-leverage private equity model that was employed to buy commercial real estate in recent years will give way to a more conservative system. Financial institutions will no longer be able to use high leverage to build loan portfolios, nor will they be able to securitize loans through a structure that passes all of the risk to investors, as was the norm in the mortgage-backed securities markets. In addition, the regulatory environment is about to change, as the government prepares to impose a tighter rein on banks and other lenders.

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Debt Markets

Conditions in the real estate debt markets were so poor last year that some expected improved access to capital in 2009, as institutions would unveil fresh allocations. However, debt is just as difficult to arrange and just as expensive as it has been at any point since the credit crisis began in 2007. Lenders of all types are using their sparse capital on the best sponsors and properties. The only sector in which debt is readily available is multi-family, due to the direct presence of agency lenders. The government recently unveiled programs aimed at unfreezing the CMBS market and trying to free up bank balance sheets to write more loans. The plan could certainly help at the margin, but probably not enough to make a significant impact over the short term.



The reality is that the scarcity of debt is not a temporary situation. All major sources of debt capital have been deeply affected by the banking crisis and economic downturn. Life companies, which have been consistent lenders in recent years, are pulling back from the sector. Half of the 10 most-active life company commercial mortgage lenders have stopped lending entirely and may sit out the entire year, according to Commercial Mortgage Alert. Some are trying to preserve capital, while others want to reduce total exposure to real estate or they are concerned about the performance of loans originated in the middle of a downturn.

Commercial banks are reluctant to write new loans while they struggle to reduce exposure and deal with rising defaults in their existing inventories. Finding takeout financing for construction loans is a significant challenge at a time when demand for commercial space of all stripes is declining. Major banks continue to hold large inventories of unsold loans written for securitization at the peak of the cycle. Holding loans rather than selling them at deep discounts might allow banks to avoid (or delay) recognizing losses, but it reduces the amount of debt capital that is available, especially in the institutional property market. Debt is more readily available for owners of small- and medium-sized properties whose owners typically can borrow from small and regional banks that are not holding portfolios of troubled loans. But there is a distinct lack of debt for larger properties because banks are reluctant to increase their real estate exposure in general or their concentrations to individual assets or borrowers.

CMBS programs have been almost completely dismantled. With the most-senior classes of CMBS priced to yield 900-1200 bps over swaps in recent months, the break-even coupon for securitized loans would be uncompetitive, about 20%. There would not even be any hope of any securitized lending at all this year if it were not for the Treasury's Term Asset-Backed Securities Loan Facility (TALF) program, which will provide cheap government financing to buyers of triple-A rated bonds. CMBS has not yet been identified as a product that will participate in the program, but industry executives who are talking to the government widely believe that it will be included.

The expectation within the industry is that the government will offer financing of Libor plus 100 bps to buyers of triple-A rated CMBS, which could reduce the cost of financing to the point at which the lenders might once again offer competitive loans. Whether it works would depend on a host of factors, including what proportion of the debt qualifies for the triple-A rating, whether the cost and term of the financing would be attractive enough to entice investors and resolving the thorny issue of who controls the subordinate classes. Another big issue to be resolved before the CMBS market can get restarted is whether banks will take the risk of warehousing loans before securitization in the absence of a healthy derivatives market that CMBS programs previously used for hedging.

The government also introduced the Public-Private Investment Program (PPIP) to help banks clean up balance sheets, as a step toward renewed lending. The program would create partnerships between private investors and the government that would buy illiquid "legacy" loans and securities from banks' balance sheets, using cheap financing guaranteed by the Federal Deposit Insurance Corporation (FDIC). Presumably, banks would have incentive to sell legacy assets if the bids were above their current value.

Both the TALF and PPIP programs are works in progress and months away from implementation, so their impact on the commercial real estate debt markets is hard to assess. But it is possible that they will create some new CMBS lending, even if the form is different from past issuance, and free up some capital for banks to lend. Even if the programs are effective, it will take years for the debt markets to return to lending levels that might be considered normal.

Given the conservative stance taken by banks with regard to loan-to-value ratios and the decline in property values, the total volume of debt outstanding is set to shrink over the next several years. By our estimates, roughly \$400 billion of commercial mortgages are maturing this year and next, while just about half that amount will be available for new origination. The shortfall between the amount of debt coming due and the amount of new debt available will be one of the biggest issues that must be dealt with in the commercial real estate industry over the next several years.

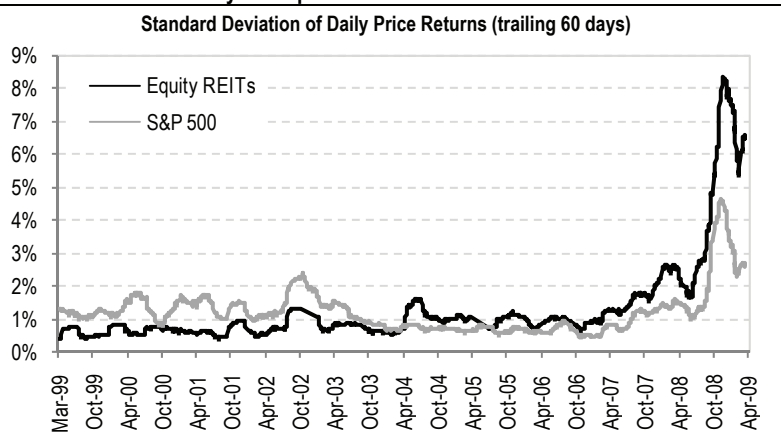
For now at least, most banks are extending maturing loans rather than forcing borrowers into default. At a time when originations are few, total commercial mortgage debt outstanding rose by a slim \$20 billion in 4Q08, to \$3.5 trillion, according to the Federal Reserve. Banks, however, will not be able to extend overleveraged loans indefinitely. Over time, borrowers will have to come up with more equity, sell assets, or will be forced to give the keys back. The market won't be fully healthy until the process is largely complete.

REIT Market

Investors in U.S. REITs endured another quarter of extreme volatility in the first three months of 2009. The FTSE NAREIT equity REIT index ended the first quarter with a dismal -31.9% total return, significantly underperforming large cap U.S. stocks, which tumbled 11% (S&P 500), and the -15% total return for small cap stocks (Russell 2000). As stunning as the first-quarter plunge in REIT share prices was, particularly after the 38% drop in 2008 and 16% decline in 2007, the results could have been much worse were it not for the relief rally over the last three weeks of the quarter. At its lowest point in the first week of March, the equity REIT index was down more than 42% year-to-date, trading at levels last seen in February 2001. Over the last three weeks of March, however, equity REITs rebounded nearly 18%.

Needless to say, the REIT market remains a volatile and shrinking place. Over the 61 trading days in first-quarter 2009, the equity REIT index rose or fell by 5% or more on 34 days, including 4 days of gains in excess of 10% and one day when the index fell by more than 10%. The dwindling size of the REIT market may be one factor contributing to the surge in volatility over the past year. Since January 2007, near the peak of the REIT bull market and just before the privatization of Equity Office Properties (EOP), the equity market capitalization of the U.S. equity REIT market has dropped about 70%, from roughly \$425 billion to less than \$120 billion at the end of March. But the volatility likely has as much (or more) to do with the unusually high correlation between REITs and the financial sector, short interest in the sector and increased trading volumes in exchange traded funds (ETFs).

U.S. REIT Market Volatility Has Spiked Since Mid-2007

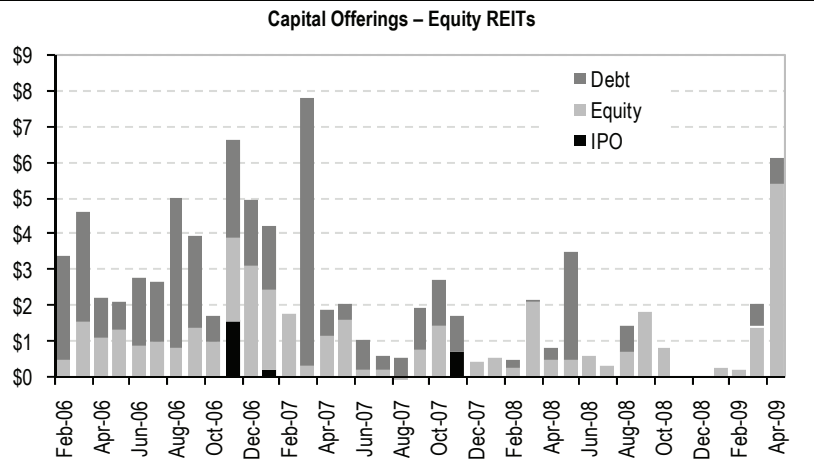


FTSE NAREIT; Standard & Poor's; Bloomberg

Rightly or wrongly, REITs have suffered dearly for their association with the financial sector and the residential real estate market. While we expect some decoupling between REITs and financials over the next year or so, greater differentiation between the sectors will not necessarily be positive for REIT performance in the near term. With banks' cost of funds close to zero and spreads on new loans at levels that would have seemed usurious (or laughable) two years ago, it's hard to imagine the group not delivering impressive earnings results over the near term, especially as the year-over-year comparisons become easier. The same cannot be said of REITs, unfortunately. The ongoing deterioration in space market fundamentals means REIT earnings growth will likely be negative for the next couple of years, at least on a "same-store" basis.

That said, the REIT market is showing renewed signs of life, and not just in terms of share price performance. Through the first two months of the year, equity REITs raised a little more than \$500 million in capital, all through follow-on equity offerings. Since then, however, REITs have raised more than \$8 billion, mostly equity. To be sure, the new capital has not come cheaply, even for the strongest companies with the best assets. For example, Simon Property Group (SPG) had to swallow a double-digit coupon for the \$650 million in unsecured debt the company issued at the end of March. And the dilution to existing shareholders of companies that have issued equity at today's depressed share prices has been significant. But so far, the market has rewarded companies for taking a proactive approach to de-risking their balance sheets and preparing for distressed opportunities that may arise.

Necessity Drives REITs to Raise Expensive Capital



NAREIT; SNL; Green Street Advisors (data as of April 27, 2009)

While the capital-raising activity is an important first step in the industry's road to recovery, the market has a long way to go before the healing can begin. REITs are still in survival mode and are not looking to expand their portfolios, although that day will surely come for those that survive. Most of the capital that has been raised this year will be used to shore up balance sheets – for example, paying down lines of credit and extending maturities on financing as far into the future as possible. Moreover, it remains to be seen how many REITs will follow in the footsteps of the early movers and return to the capital markets before the window closes. We suspect that many REITs – perhaps even a majority – are not in a position to raise capital today, and, barring some fairly dramatic improvement in the capital markets, have few options available in the near term.

Obviously, for REITs that find themselves in this position, the future is highly uncertain. Some companies will merge with other public REITs; some may be privatized; and others likely will be forced to liquidate. The process may take several years to play out, but eventually it should lead to a more concentrated REIT market comprised of fewer, better capitalized companies.

With commercial real estate space market fundamentals deteriorating rapidly, REIT prices will likely continue to struggle to gain traction in the near term. From a valuation perspective, U.S. equity REITs are about as cheap as they've been since the "modern REIT era" began roughly 15 years ago. According to Green Street Advisors, at the end of March equity REITs were trading at implied cap rates in the mid-9% range and at an average 27% discount to net asset value (NAV). However, the attractive earnings

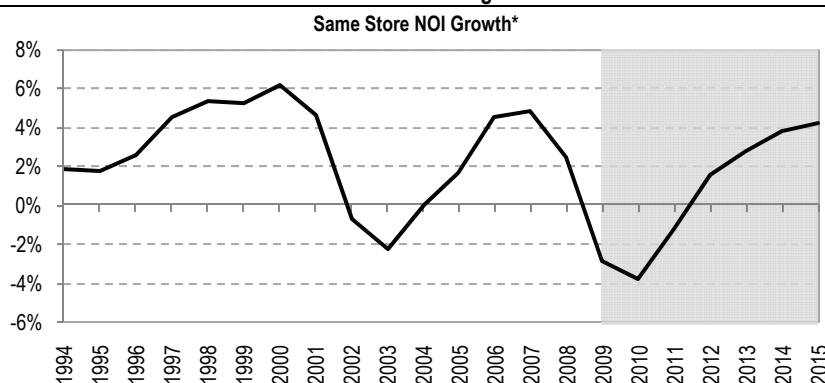
multiples, dividend yields and NAV discounts that many REITs offer today must be viewed with some skepticism. Not only are REIT earnings forecasts and NAVs likely to be revised down in coming months, but a growing number of companies are electing to pay at least a portion of their dividends in stock rather than cash.

For the next six months or so, we expect the REIT market will continue to be a trader's market, with daily returns lurching up and down. Until there is greater clarity on the economic outlook and the potential impact of federal stimulus programs, the same lack of urgency that has stalled activity in the debt, leasing and transactions markets will keep long-term investors on the sidelines. The recovery process is starting, however, which is not to say that conditions won't get worse before they improve broadly. Nevertheless, we believe that the U.S. REIT market overall has a chance of erasing the first quarter losses by yearend, provided the news from the credit, housing and job markets does not deteriorate significantly from here.

Property Markets

Space market fundamentals took a beating in the first quarter. Vacancies were up and rents were down virtually across the board among sectors and regions as a result of factors that include the persistently high (and rising) unemployment figures and sharp reductions in consumption and global trade. The question at this point is whether the economy has found a bottom, or if the worst is yet to come. In recent weeks, some statistical indicators – such as increased factory orders and applications for new home mortgages – have stopped declining or even shown incremental improvement. If nothing else, these “green shoots” suggest that the rate of the deterioration is slowing, which might herald a gradual turnaround.

Net Income of Commercial Real Estate Assets is Falling



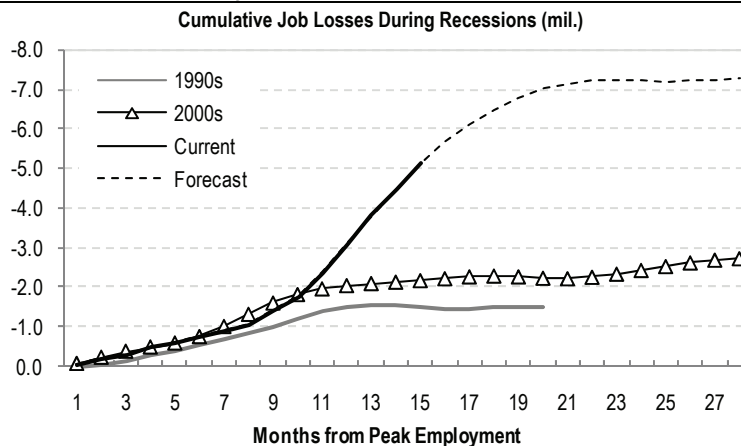
* Growth based on weightings of 40% office, 20% industrial, 20% apartment, 10% mall retail and 10% strip retail

Green Street Advisors; Pramerica REI

Transaction activity in commercial real estate remains very slow due to the persistent gap in bid-ask spreads and the lack of financing. Property sales in all sectors have dwindled to a fraction of the volume achieved in recent years, and asking prices are now falling. One well-publicized example of the decline in property prices is the distressed sale of the John Hancock Tower in Boston. The 790,000-square-foot trophy tower – which traded for nearly \$1.3 billion just two years ago, with a \$1.1 billion debt package that included \$427 million of mezzanine debt – was auctioned in early April to holders of its mezzanine debt. The sales price likely reflects a drop of nearly 40% from the market peak, although the exact amount is hard to say because of the involvement of the mezzanine partnership.

Office. Unsurprisingly, the rising unemployment rate is hitting the office market hard, particularly in markets with exposure to the financial services industry. Some 2 million jobs were lost in the first quarter, bringing the total since the recession began in December 2007 to 5.1 million jobs and raising the unemployment rate to 8.5%. According to flash estimates by Reis, the national office vacancy rate climbed to 15.2% in the first quarter, up 70 bps from year-end and 240 bps over the last 12 months. The 24.9 million square feet of negative absorption in the quarter was the largest quarterly decline since the Sept. 11 terrorist attacks and the fifth straight month of declining occupancy. Asking rents fell by 1.1% and effective rents fell by 2% during the quarter, according to Reis.

Dismal Outlook for Employment



Moody's Economy.com, Bureau of Labor Statistics

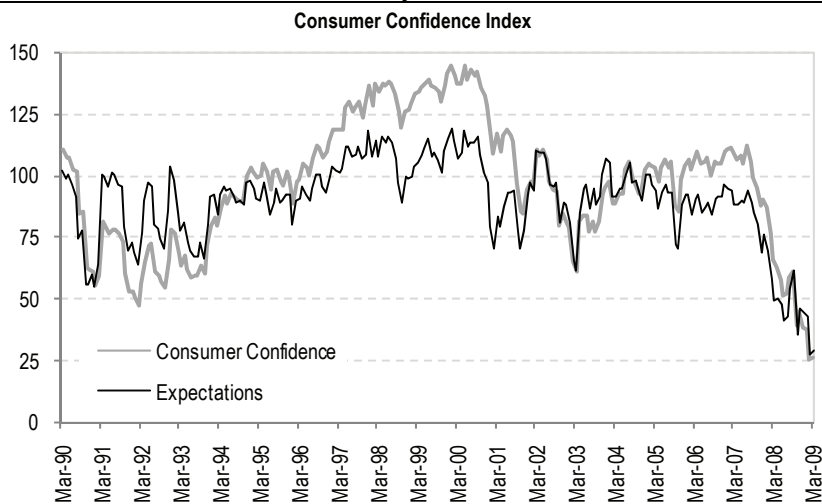
Prospects for the rest of 2009 do not appear to be much brighter. Total job losses in the current downturn are expected to surpass 7 million, which would drive the official unemployment rate to 10% or higher. Due to the combination of declining occupancy and increased supply, most analysts anticipate 200-300 bps increases in office vacancy rates this year. That would push office vacancies to their highest levels since the early 1990s, and will lead to declining rents in many markets. Fortunately, supply will be modest. Property & Portfolio Research (PPR) says 85 million sf of new office space, less than 2% of existing stock, will come online in 2009. But any new supply in an environment where demand is contracting is too much, which means rents will fall. One mitigating factor is that many leases that are now rolling over were signed before the run-up in rental rates in 2006 and 2007, which should protect property owners on the downside.

Retail. Americans are reducing discretionary spending and saving more as a result of the weak economy and significant loss of wealth that has occurred over the past two years. Since falling to zero in 2006, the savings rate has jumped to about 4%, according to the Bureau of Economic Analysis. Retail sales in recent months are down about 9% year-over-year, but have been relatively flat month-over-month, which could indicate that the consumer spending is stabilizing, albeit at a lower level. Consumer confidence, as measured by The Conference Board, rose slightly in March, but it still remains near February's all-time low since 1967. The trend toward thrift makes it likely that value-oriented retail chains and properties are likely to be impacted less than those oriented toward luxury shoppers, at least in the near term.

The decline in consumer spending combined with an increase in supply in 2008 led to higher vacancies and put pressure on rents. Reis said that the negative absorption in the retail sector in the first quarter was

8.7 million sf, the worst quarter since it began keeping statistics in 1997. While demand for space is expected to continue to decline this year, the freeze in construction lending and cancellation of projects by retailers will reduce new supply in the next couple of years.

Consumers Remain Worried About Economy



Moody's Economy.com, The Conference Board, Bureau of Economic Analysis, Census Bureau

Multi-family. Apartment vacancies have risen noticeably since this time last year and are expected to increase further due to the weak job market, competition from vacant single-family homes and slower household formation. Landlords may have to reduce rents and/or offer concessions through 2009 and possibly 2010 to keep occupancies up. However, once the economy stabilizes and job growth and household formation resume, landlords should be in a favorable position. Supply is expected to fall sharply over the next few years. Banks have largely cut off financing for new multi-family projects due to the credit crunch, and with many developers exiting the business, it may take several years to restart the pipeline.

Industrial. Being heavily dependent on economic growth and the production and consumption of goods, the industrial market is performing poorly relative to its historic standards. PPR reports that in 4Q08, warehouse vacancies rose to 11.3%, their highest level on record, and should rise another 100 to 150 bps this year. However, the supply pipeline for this year is well below historical average, which should relieve some pressure on the sector. According to Merrill Lynch, the average industrial rent fell 0.5% in 4Q08, with coastal markets falling 0.6%, while inland markets dropped only 0.1%. The discrepancy between the figures likely reflects the impact of falling global trade, which is expected to stay flat or drop in the near term. As a result, demand in the industrial sector may remain weak this year.

Hotel. The hotel sector is arguably the hardest-hit by the economic downturn, as both businesses and consumers cut back on travel. According to Smith Travel Research, hotel occupancy in the U.S. was down 10.1% (to 53.2% from 59.2%) in February 2009 from a year earlier, while revenue per available room (RevPAR) fell by 17.1%. Cities that saw particularly steep declines in RevPAR include Phoenix (-34.9%), San Francisco/San Mateo (-32.6%), New York (-30.8%) and Orlando (-25.7%). Not only have Americans reduced travel due to job losses and reduced discretionary spending, but the numbers reflect a decline in business and leisure travel from abroad.

The simultaneous impact of the credit crisis, escalating job losses and unprecedented reduction in consumer spending has prompted a steep, sharp drop in commercial real estate values across the board. No sector or region has been spared from the negative impact. Accordingly, we now expect a peak-to-trough drop of 40% to 45% in commercial property values. Although the appraisal-based NCREIF Property Index (NPI) historically has not captured the high and low points of past cycles, we are revising our outlook for the index to reflect unprecedented negative returns in the market. We now expect the NPI's appreciation return for 2009 will be in the range of -25% to -30%. With the income return likely to rise to about 7% as property values fall, the NPI's total return this year should be in the range of -18% to -23%.

Closing Thoughts

The commercial real estate market is in the midst of a correction that is painful, to be sure, but it also is a necessary step to moving in the right direction. Given how fast they are falling, property values should hit bottom within a few quarters. Declining values and distress can't be seen as positives, but they represent a correction to the unsustainable trend that marked the years between 2003 and 2007. Digging out of the hole that the market is in will not be easy, nor will it be quick. Many properties are in a "zombie" state – the equity is essentially wiped out on paper, but the owners can hold on as long as they pay debt-service and lenders are reluctant to foreclose.

Beyond that, however, investors need to recognize that the playing field is changed. Going forward, we will have a less-leveraged, more-regulated, higher-savings-rate economy. Though it still may be too early to act in response to the trends, players in the commercial real estate market must understand the new environment and plan accordingly.



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