

U.S. Quarterly

Market Perspective

Executive Summary

- The tone of the commercial real estate market improved markedly in the first quarter, despite the ongoing uncertainty about the economy and the prospects for employment growth. While the outlook for property fundamentals remains weak over the short term, capital is once again flowing into the sector.
- The decline in property values has stopped, and capitalization rates are starting to drop, particularly for high quality properties in good markets. Property value indexes as measured by advisory firms such as Moody's and Green Street Advisors have risen in recent months, reflecting the strong demand for stable, core assets in the best markets.
- Although vacancy rates are at historical high points, in some markets and sectors the trend was better than expected in the first quarter. Net absorption of apartments in 1Q10 was at its highest first-quarter level in a decade. In other sectors, some tenants are locking in long-term leases in anticipation that lease rates are as low as they will get.
- Debt is more available than it has been since the start of the credit crisis, although lenders that are active are focusing on better properties in better markets with stable income streams. Competition for such deals is growing, as evidenced by tightening spreads and somewhat more favorable terms for borrowers. Property types or assets viewed as risky are nearly impossible to finance. Commercial banks continue to struggle with problem loans.
- REIT prices are slightly expensive relative to historical levels after another solid performance in 1Q10, in which the NAREIT Equity REIT Index gained 10%. REITs by-and-large have strengthened their balance sheets and have cash or the ability to raise debt and equity at attractive terms.
- REITs' low cost of capital should make them "winners" in competing for acquisition opportunities, although the lack of transaction volume and the competition for the few transactions coming to market has limited their activity.
- Coming off a year in which transaction activity was depressed, a growing number of investors are looking to buy primarily core assets at what is perceived to be a low point in the cycle. Property sale prices grew moderately in the first quarter and should keep rising.

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

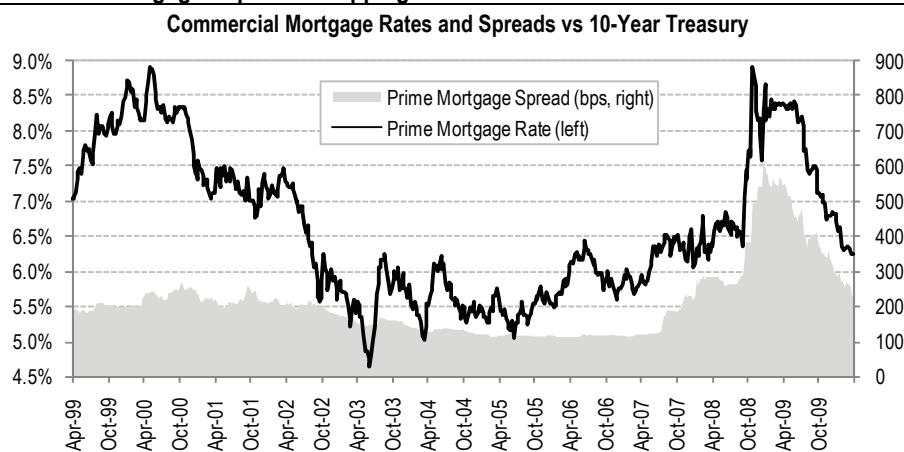
Tel 973.683.1745
Fax 973.734.1319
Web www.pramericarei.com

Debt Markets

The commercial mortgage market is more active than it has been since the onset of the credit crisis in 2007, although lending remains limited. Some banks are tentatively dipping their toes back into the loan pool, while a dozen or so CMBS operations are being reformulated. Coming off their least-active year in a decade, life companies are competing hard for high-quality loans, although they have limited capacity.

The commercial bank sector, which represents half of the \$3.4 trillion commercial-mortgage industry, remains largely stuck in neutral while it deals with underwater loans originated during the peak of the cycle. Banks that are not overexposed to the sector are quoting loans, but the deal profile has changed significantly from the height of the market. Bank loans carry a maximum 65% loan-to-value (LTV) ratio that is based on conservative underwriting, often with recourse from the borrower. Banks that do lend are sticking to favored loan types and markets, and debt for risky assets – e.g., development, hotels and properties with vacancy – remains nearly impossible to find.

The Cost of Mortgage Capital is Dropping



Federal Reserve, Pramerica Mortgage Capital Company, Pramerica Real Estate Investors Research

Banks by-and-large continue to extend maturing loans, barring a default. Anecdotally, extensions are getting shorter, a sign that banks are a little more optimistic about being able to lend in the future. However, under the best circumstances it is hard to imagine that the supply of debt this year will be anywhere close to the volume of maturities, which is scheduled to top \$500 billion in 2010. What's more, because of the drop in property values, many maturing loans are overleveraged, which will make it difficult for borrowers to refinance without an equity injection or other form of recapitalization. All these factors point to a continuation of the loan extension cycle, unless banks aggressively pursue foreclosures. Most banks, though, are trying hard to avoid taking control of properties with cash flow.

The CMBS market is showing signs of perking up. Some \$500 million of large loans originated for securitization in March and early April were recently listed by Commercial Mortgage Alert. For the first time since the market essentially collapsed in mid-2007, there are at least a dozen securitization programs trying to originate loans. CMBS shops encompass a range between money-center banks and newly formed specialty lenders. While those numbers aren't very much in context of the last peak, they represent a giant leap compared to the last three years, when essentially no new loans were originated.

Just a few months ago CMBS spreads were so wide as to preclude much lending. Today spreads have rallied to the point that securitization programs can offer loans with average coupons of about 6%, which is attractive to many borrowers. The most-senior triple-A classes of a \$310 million five-year offering led by Royal Bank of Scotland this month were priced to yield 90 bps over swap spreads. That is 50 bps less than the comparable class of a transaction that priced in November. Meanwhile, spreads of senior AAA-rated bonds in the secondary market fell 100-150 bps between January and April. Declining spreads are good for the market, but pricing can change at any moment. And the renewed activity comes as Congress and regulators are proposing new rules for securitization and banks that could potentially have a large impact on the market. Issues such as how much of the underlying loan collateral must be held by lenders or buyers of the first-loss classes, the amount of deal-level disclosure or how much capital institutions must set aside for CMBS holdings have the potential to prevent the market from rebounding.

Despite the challenges and barring an unforeseen shock, the CMBS market will slowly come back to life. Robust demand exists for fixed-income product, as few bonds have been issued in the past two years and investors need product for new allocations. Meanwhile, the demand for debt outstrips the supply. With CMBS programs wading back into the market, all these factors point to an increase in securitized lending.

Life companies originated \$16.4 billion of mortgages in 2009, down 38.5% from the previous year and the lowest total in more than a decade, according to the American Council of Life Insurers (ACLI). However, this year insurers are looking to load up on mortgages because today's product carries a better return with lower risk than at any time in recent memory. The average spread of 2009 loans was 441 bps over Treasuries, compared to average spreads of 300 bps in 2008 and 144 bps in 2007. Meanwhile, the average LTV in 2009 was 58.7%, down from the mid-60% historical average. Already the competition for product is pushing down spreads of high-quality mortgages that are favored by insurers.

REIT Market

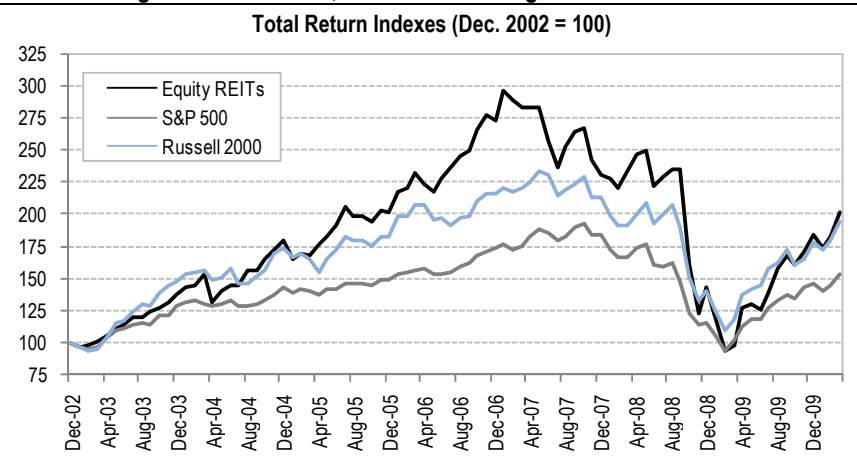
After taking a bit of a breather in January, the U.S. REIT market shifted back into rally mode for the remainder of first-quarter 2010. The FTSE NAREIT Equity REIT index gained a little more than 10% in the first quarter, outperforming the 5.4% total return for large cap stocks, as measured by the S&P 500, and the 8.9% return for small cap stocks, as measured by the Russell 2000. The healthy first-quarter results capped a remarkable 12-month cycle for REITs. A year ago, the future of many REITs and, perhaps, the REIT structure itself was very much in doubt largely due to worries about liquidity. REIT share prices bottomed in early March 2009, just before Simon Property and a handful of other brave REITs stepped into the frozen capital markets and began raising bits of expensive and precious capital. The capital offerings helped to stabilize the REIT market. From the end of March last year through the first quarter this year, the equity REIT market gained more than 106%, led by a 230% one-year total return for lodging REITs and a 183% return for mall companies.

The ongoing improvement in the capital markets clearly has been a key driver of the rally in REIT share prices last year and in the first quarter. Meager government bond yields have translated into huge demand for corporate bonds. Demand began spilling over to REITs sometime around August of last year and has built as REIT shares have recovered. Through the second week of April, REITs had raised roughly \$8 billion through unsecured bond offerings this year alone, just shy of the \$10 billion raised in all of 2009. The

market has also been receptive to follow-on equity offerings, which totaled about \$4.4 billion as of mid-April, but there appears to be very little appetite for IPOs of blind pool REITs.

Whether REITs will be able to use their lower cost of capital advantage to acquire quality assets at discounted prices (relative to 2007) remains an open question. In fact, a big part of the reason why investor enthusiasm has waned for blind pool REITs is the lack of investment opportunities in the direct transaction market. Much of the capital that has been raised over the past year has been used to deleverage balance sheets and extend debt maturities as far into the future as possible. However, with REITs trading at implied cap rates that appear to be below transaction cap rates, we suspect it is only a matter of time before REITs become more active acquirers. As the first quarter closed, there was some evidence that transaction activity was already beginning to accelerate, with several large deals announced and a heated battle in the works over struggling mall REIT General Growth.

After Leading the Market Down, REITs Are Leading the Rebound



Bloomberg

With the sizeable gains in the first quarter and triple-digit one-year total returns across virtually all property sectors, REIT share prices could face some headwinds in the near term, at least until the outlook for space market fundamentals improves. Operating performance at the property level continues to deteriorate and will remain on a downward trend in most property types throughout this year and into 2011. Although rents appear to be bottoming and vacancy rates are nearing the peak for this cycle, many properties will see income decline over the next year or two as current leases expire and are renewed at lower market rents.

Capital flows to REITs remain positive, suggesting that retail investors are warming up to the sector again now that volatility has eased. Dedicated real estate mutual funds and ETFs took in a little more than \$1 billion (net) in the first quarter, according to Citigroup. Short interest in the REIT market has fallen noticeably since this time last year, from a peak of 13.1% in March 2009 to 7.5% as of the end of the first quarter, according to Barclays.

As always, investor sentiment will determine whether capital market forces will continue to overshadow fundamentals. REITs look pricey by most metrics. As of mid-April, the average dividend yield for the FTSE NAREIT Equity REIT index was hovering around the same level as the yield on the 10-year Treasury bond. Likewise, REIT earnings multiples look dear compared with the broader equity market, and most REITs

were trading at healthy premiums to the net asset value (NAV) of the underlying properties. Given where REITs are in the cycle, with earnings likely to trough over the next 12 months and dividend growth rates likely to rise smartly as companies restore cash dividends and increase payout ratios, it should not be surprising to see these metrics where they are today. But it means investors are betting more heavily on the ongoing recovery in the economy and capital markets than was the case even a few months ago. Over the next 12 months, we expect REITs will deliver modest total returns of about 7%-10% as long as the economy continues to expand in line with expectations, although we see more potential for upside than downside.

Property Markets

After more than two years of worsening conditions, there appears to be light at the end of the tunnel for space market fundamentals. The economy in March saw the first significant increase in job production since the end of 2007, amid a surprising rise in consumer spending, an improved outlook for business orders and a rebound in the apartment market. To be sure, vacancies have yet to peak in many segments and rents are likely to remain flat or decline. However, initial data for the first quarter indicates that the rate of decline in many sectors is slowing, or, in the case of apartments, the numbers are slightly positive. With construction volume at or near historical lows, little new supply will be added for years, which will help speed the absorption of vacant space once the economy turns positive again. A prolonged period of anemic supply growth seems likely, since market rents will not justify new construction for years and – save for apartments – lender appetite for construction loans will be weak for the foreseeable future.

Office: Vacancies in office buildings are approaching 20%, levels last seen in the early 1990s, and they will likely keep rising this year. However, the rate of deterioration has slowed and a recovery appears to be on the horizon. The overall economy added 162,000 jobs in March, which isn't much compared to the 8.4 million jobs that were lost during the recession, but it was much-needed movement in the right direction. Another encouraging sign for the sector is that the number of office-using jobs increased in both 4Q09 and 1Q10. According to Property & Portfolio Research (PPR), total leasing volume rose 23% in the last three quarters of 2009 from the previous year. Most likely tenants want to lock in low lease rates before overall demand starts to pick up and rates start to rise. Effective rents are expected to drop nearly 20% from the peak in 2008, and the numbers would be worse if not for the lack of new supply.

Retail: Consumer spending is showing surprising resiliency, although improvements are fragile and dependent on the uncertain economy. Core retail sales in March were 4.9% higher than the January 2009 bottom, although they remain about 4% below the peak level achieved in July 2008. The core sales figures demonstrate some measure of rising confidence by consumers, whether it is caused by the improved employment outlook, the rising stock market or the impact of the federal stimulus. Retail properties continue to experience deteriorating fundamentals, although the rate of the decline is slowing. The 10.8% national retail vacancy rate is the highest since 1991, prompting effective rents to drop to 2005 levels, according to Reis. That gives tenants the upper hand in wringing concessions and lower lease rates from landlords, and consequently rents are unlikely to rise for at least another year or two.

Industrial: The industrial sector has struggled badly but is seeing progress. The Institute for Supply Management's monthly index in March rose to its highest levels in five years, reflecting the fact that a majority of manufacturers surveyed are seeing increases in new orders and business activity. Other

positive signs include the increase in retail sales in the U.S. and the weak-dollar driven rise in exports, particularly to emerging markets where economic growth is strong. Still, coming off two years of falling absorption and a large increase in supply, the national warehouse vacancy rate is at a record high of 13.2%, according to PPR. Development is set to drop by 80% or more in 2010 and following years.

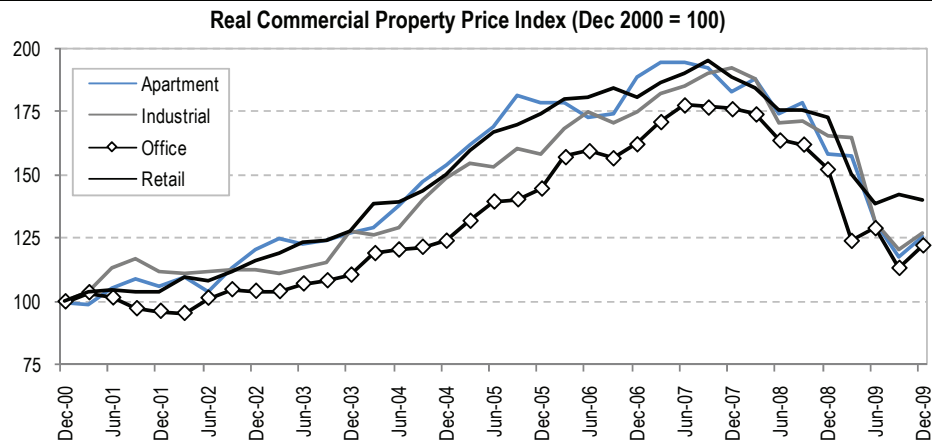
Hotel: Hotel revenues continued to slide in early 2010, but the market appears close to the bottom. Revenue per available room (RevPAR) for hotels nationally was down 5% in January and February from a year ago, according to Smith Travel Research. Location is important, as some large urban centers such as Washington, D.C., San Francisco and Boston have outperformed most secondary markets. Distress will play a big factor in the near term. A sizeable pool of buyers has formed trying to get their hands on overleveraged and distressed hotel properties, although few deals have materialized to date.

Apartments: Apartments stand alone from other sectors for several reasons. One is that the sector saw net absorption in the first quarter, and positive fundamental news has been in short supply in the commercial real estate market. The vacancy rate of CB Richard Ellis's apartment universe dropped 80 bps in 1Q10. According to Reis, although the national vacancy rate was unchanged at 8%, net absorption in 1Q10 surged nationally by 20,400 units, the highest first-quarter number in a decade, while asking and effective rents posted slight increases. Much of the absorption came from demand that built up during the recession, and an improving job market and low supply should sustain improvement in operating fundamentals over the next couple of years. The apartment sector also benefits from stable low-cost financing from government agencies Fannie Mae and Freddie Mac, which has helped keep property values relatively high compared to other property types. In fact, demand for assets with stable income has enabled some high-quality properties in major metropolitan areas to trade in the low-5% cap rate range, close to levels at the peak of the previous cycle.

Despite the poor space market fundamentals that are likely to worsen in most sectors over the short term, property values have actually firmed. For example, the Moody's Real Property Index – which fell 43.7% between October 2007 and October 2009 – rose 6.3% between October and January, and other indices suggest an earlier trough and stronger recovery. A contributing factor is no doubt the mismatch between deal flow and investable capital. Investors are acting on the belief that today is a great entry point in the cycle, offering the potential to purchase assets on trough earnings and at discounts to replacement cost. Demand at the moment is focused on a relatively narrow segment of the market – i.e. income-producing, institutional-quality assets. It is not uncommon for upwards of 35 bidders to vie for such properties. The robust demand is therefore bolstering pricing in that segment of the market.

The opportunities to take advantage of distress are proving to be more difficult than expected. A large portion of properties financed during the go-go years between 2005 and 2008 are overleveraged and must be recapitalized because current lending standards will not support the same level of debt. But the anticipated deluge of property transactions has not happened. Banks are making every effort to avoid foreclosures, including extending loan maturities in exchange for partial principal paydowns and/or higher interest rates. This may change as more loans experience monetary defaults or lenders gain greater conviction about the value they can salvage by foreclosing and moving assets quickly to the market. Sales of stabilized “core” properties remain at a relatively low volume but are picking up due to strong investor demand. According to Real Capital Analytics, sales volume in the first quarter was \$15.4 billion, a 50% jump from 1Q09's \$9.6 billion, although totals still pale in comparison to the recent peak years.

Property Values Have Started to Rise from Bottom



Moody's Investors Service, Real Capital Analytics, Pramerica Real Estate Investors Research

The upturn in the transactions market enabled the NCREIF Property Index to stabilize in the first quarter. The 0.8% total return (-1% appreciation return) in 1Q10 was the index's best performance in two years. The index has dropped 31.5% since peaking in 1Q08, and is likely at or near the bottom. We previously expected property values to drop slightly for the year, but today it seems more likely that the appreciation portion of the index will be slightly positive, while income returns should remain steady at about 7%.

Closing Thoughts

The commercial real estate market regained a little of its mojo in recent months, mostly connected to the capital markets. REIT prices have rebounded amid strong demand for both debt and equity investors. Mortgage spreads are falling at a steady rate, and lenders are much more active, although debt is available for a relatively narrow segment of the market. Property values in major markets are recovering more quickly than could have been imagined a year ago, driven primarily by the mismatch between deal flow and available capital as well as the more buoyant mood of the capital markets.

After more than two years of strong headwinds, market players are naturally relieved at the turn of events. But the upswing is fragile. For one thing, a good portion of the improved capital markets equation comes from low interest rates. Property yields and mortgage rates are low relative to historical norms, but high relative to the risk-free rate. Although policy makers have made clear that interest rates will remain low this year, increases in 2011 and beyond could negatively impact the market over the medium term. What's more, space market fundamentals in every segment are connected to jobs, and to date there has been one month of significant employment growth that leaves the economy more than 8 million jobs behind its peak. A sustained recovery requires sustained growth in many areas, particularly employment.

Still, coming out of recessions it is natural to underestimate the upside, and the worst part of the cycle appears to be over. Recent real estate downturns were exacerbated by the lack of capital. That capital is available to the degree it is today may not reduce the amount of pain brought on by the last bubble, but it could help the market return to equilibrium more quickly.

The Investment Research Department of Pramerica Real Estate Investors publishes reports on a range of topics of interest to institutional real estate investors. Individual reports are available by e-mail or via the Web at www.pramericarei.com. Reports may also be purchased in quantity for use in conferences and classes. To receive our reports, change your contact information, or to be removed from our distribution list, please e-mail us at research.reports@pramericarei.com, or telephone our New Jersey office at +1 973.683.1745.

Important Disclosures

These materials represent the views, opinions and recommendations of the author(s) regarding the economic conditions, asset classes, securities, issuers or financial instruments referenced herein. Distribution of this information to any person other than the person to whom it was originally delivered and to such person's advisers is unauthorized, and any reproduction of these materials, in whole or in part, or the divulgence of any of the contents hereof, without prior consent of Pramerica Real Estate Investors ("Pramerica") is prohibited. Certain information contained herein has been obtained from sources that Pramerica believes to be reliable as of the date presented; however, Pramerica cannot guarantee the accuracy of such information, assure its completeness, or warrant such information will not be changed. The information contained herein is current as of the date of issuance (or such earlier date as referenced herein) and is subject to change without notice. Pramerica has no obligation to update any or all of such information; nor do we make any express or implied warranties or representations as to the completeness or accuracy or accept responsibility for errors. These materials are not intended as an offer or solicitation with respect to the purchase or sale of any security or other financial instrument or any investment management services and should not be used as the basis for any investment decision. Past performance may not be indicative of future results. No liability whatsoever is accepted for any loss (whether direct, indirect, or consequential) that may arise from any use of the information contained in or derived from this report. Pramerica and its affiliates may make investment decisions that are inconsistent with the recommendations or views expressed herein, including for proprietary accounts of Pramerica or its affiliates.

The opinions and recommendations herein do not take into account individual client circumstances, objectives, or needs and are not intended as recommendations of particular securities, financial instruments or strategies to particular clients or prospects. No determination has been made regarding the suitability of any securities, financial instruments or strategies for particular clients or prospects. For any securities or financial instruments mentioned herein, the recipient(s) of this report must make its own independent decisions.

Conflicts of Interest: Key research team staff may be participating voting members of certain Pramerica fund and/or product investment committees with respect to decisions made on underlying investments or transactions. In addition, research personnel may receive incentive compensation based upon the overall performance of the organization itself and certain investment funds or products. At the date of issue, Pramerica and/or affiliates may be buying, selling, or holding significant positions in real estate, including publicly traded real estate securities. Pramerica affiliates may develop and publish research that is independent of, and different than, the recommendations contained herein. Pramerica personnel other than the author(s), such as sales, marketing and trading personnel, may provide oral or written market commentary or ideas to Pramerica clients or prospects or proprietary investment ideas that differ from the views expressed herein.

In the Americas, PREI® is a business unit of Prudential Investment Management, Inc., a US SEC registered Investment Adviser and an indirect wholly owned subsidiary of Prudential Financial, Inc., Newark, New Jersey. In Europe, Pramerica Real Estate Investors and Pramerica Investment Management are trading names of Prudential Investment Management, Inc. the principal asset management business of Prudential Financial, Inc. ('Pramerica Financial') of the United States. Pramerica Real Estate Investors is the real estate investment management business of Pramerica Investment Management. Prudential Financial, Inc. is not affiliated in any manner with Prudential plc, a company incorporated in the United Kingdom. In Asia, information is presented by Pramerica Real Estate Investors (Asia) Pte. Ltd. ("Pramerica Asia"), a Singapore investment manager that is registered with and licensed by the Monetary Authority of Singapore.

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

Tel +1 973.683.1745
Fax +1 973.734.1319
Web www.pramericarei.com
E-mail research.reports@pramerica.com