

U.S. Quarterly

Market Perspective

Executive Summary

- The near-term path for the commercial real estate market is clouded amid “unusual uncertainty” in the U.S. economy. Concerns abound that nascent economic growth may be stalled by weak job creation, possible deflation, the winding down of government stimulus and the potential impact of a downturn in Europe and lower growth in China.
- Space market fundamentals are heavily dependent upon the direction of job growth. Some 600,000 jobs have been created this year, but the pace of growth has to pick up greatly before real estate fundamentals can improve significantly.
- Prospects for the sector remain bullish over the longer term. There is an accelerating inflow of capital coming from a wide variety of sources, including institutions, foreign investors, private equity and REITs. Investors are attracted by the sector’s improved outlook, signs that prices have bottomed and the foreclosure crisis will not be as widespread as feared, and prospects for more-attractive returns relative to other investment options.
- Availability of debt capital continues to increase. Most commercial banks remain hamstrung by bad loans, but many large institutions are looking to lend. Life companies are very eager to book loans, while the CMBS market is slowly reformulating. With loan spreads falling and Treasury rates rallying to historic lows, loan coupons in the 5-6% range are common, and lower for some high-quality properties, particularly apartments.
- Although transaction activity remains modest, and focused on the opposing ends of the spectrum (core and distressed), sales volume is slowly gaining steam. The escalating number of vehicles looking to buy assets and the falling cost of debt are helping to produce an increase in the price of core assets. Second-tier properties and locations are not in as much demand, although there are signs that investors are starting to branch out to secondary markets and second-tier assets.
- REITs have retreated in recent months after a strong run that presaged the rally in the private markets. The FTSE NAREIT Equity REIT Index fell 4.1% during the second quarter and was up 5.6% through June 30. The direction of share prices depends on earnings growth and fundamentals.
- The outlook varies by segment. Growth in the near term looks strongest in the apartment and hotel sectors because they react relatively quickly to economic growth. Meanwhile, the industrial, retail and suburban office sectors are likely to rebound much more slowly.

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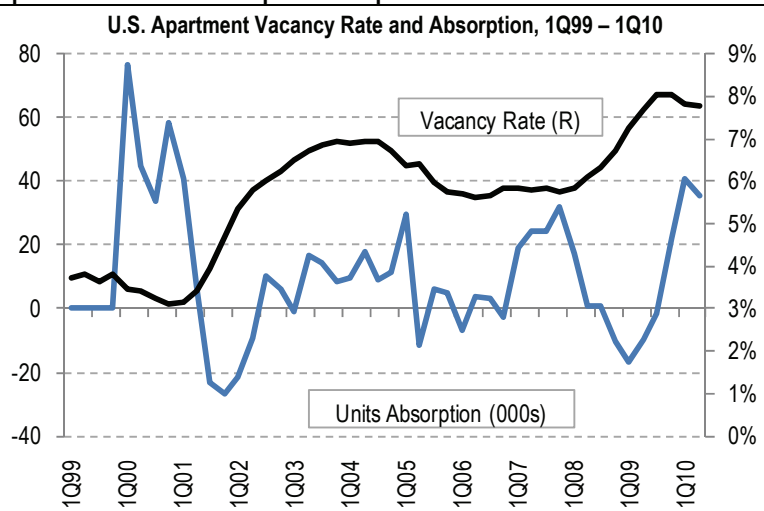
Property Markets

Real estate values are cyclical, so it's not surprising to see prices rebound after a deep trough. What is surprising in today's market is how fast the cycle is moving and how seemingly uncoupled the capital markets side of the equation is from the fundamental side. Although transaction activity is thin and skewed toward core assets, by some measures commercial property values have risen more than 20% over the past year. At the same time, vacancy rates remain at or near record highs in most segments in wake of the Great Recession, during which the economy lost 8 million jobs and consumer spending plunged. The economy is no longer in recession, but the recovery has been weak. Adding roughly 100,000 jobs per month is better than rising unemployment, but the pace has to pick up substantially before there is significant growth in space market demand that can move rents in a positive direction. What's more, the composition of jobs created is critical, and will play a role in determining the speed at which individual segments will recover.

The soft patch hit by the global economy means a continued recovery is not assured. Vacancy rates generally may have peaked, but they might not improve much in the near future. And the recovery is likely to be uneven across property segments. Apartments and hotels, which are more sensitive to economic swings because they have shorter-term income drivers, are expected to recover more quickly than other segments, such as suburban office, industrial and retail.

Apartments: Multi-family is ahead of other property segments in several respects, including fundamentals, availability of debt, pricing and development. Vacancies nationwide fell 20 bps (to 7.8%) in the second quarter due to the absorption of 44,200 units, according to Reis. With new supply down and pent-up demand from renters who were kept out of the market during the recession, units should fill with fewer concessions, putting landlords in position to raise effective rents going forward.

Apartment Vacancies Drop as Absorption Rises



Reis

Meanwhile, the presence of Fannie Mae and Freddie Mac has kept debt flowing to apartments. The two agencies in the first half issued \$11.9 billion of securities backed by multi-family loans, surpassing 2009's full-year volume record of \$8.7 billion, according to Commercial Mortgage Alert. Low-cost debt and the strong demand from investors eager to participate in the recovery have pushed acquisition yields of stable, well-located apartment properties to near-2007 peak levels. And while construction financing remains very limited, banks are more likely to finance projects for new apartments than any other sector.

Hotels: The good news in the lodging sector is in occupancy, which is rebounding strongly this year after two years of decline. Year-to-date through the end of May, hotel occupancy was up 3.9% from a year ago,

according to Smith Travel Research (STR). Revenue per available room (RevPAR) rose by only 1.1% because average daily room rates fell by 2.7% as hotels (particularly the luxury and upscale segments) attracted customers by discounting rates, according to STR. All indications are, however, that the sector is climbing up from its bottom. Hotel demand closely tracks factors such as GDP growth and employment, which are forecast to rise in coming years. What's more, with business activity increasing, corporations appear to be loosening the purse strings on travel, which provides a stable base of income for the industry. Hotel supply has continued to grow rapidly due to the remnant of projects started in recent years, but supply will fall to a trickle after the current wave of projects is completed. The confluence of positive factors projected for the next few years has attracted capital to the sector, but transactions remain scarce. The best way to source hotel investments may be through debt restructurings.

Office: Office vacancies are in the process of stabilizing after rising close to their highest levels ever. How quickly the segment turns around will depend to a large degree on the composition of jobs created in coming years, and how long it will take to absorb the inventory of shadow supply that has been created by corporate downsizings. Some 2.5 million office jobs, the equivalent of several hundred million square feet of office space, have been lost during the downturn, according to Property & Portfolio Research (PPR). It will likely take a couple of years before vacancy rates fall from today's high-teen percentages, and it could be longer before landlords have leverage to increase rents. There will be big differences among markets. The average vacancy rate is 13.1% for downtown markets and 18.6% for suburban markets, according to CB Richard Ellis. Central business districts with some combination of vital downtowns, connections to thriving industries and/or little room for new supply – such as New York, San Francisco and Washington – have suffered less and will revive more quickly. Secondary markets with few brakes on new supply will struggle much longer.

Retail: The retail sector has performed in line with weak expectations, and little change is forecast in the near future. Job losses, household deleveraging, the drop in household wealth, the collapse in house prices and high rate of foreclosures and low consumer confidence have combined to produce tepid consumer spending. The retail sector nationally had 1.85 million square feet of negative absorption in the second quarter, pushing the vacancy rate to 10.9%, the highest level since 1991, according to Reis. The oversupply of retail space and weak consumer sentiment creates an environment in which elevated vacancies will persist and rents remain flat. There are pockets of strength, but the outlook is dependent on factors, such as job growth and government stimulus, that do not appear to suggest robust improvement.

Industrial: The warehouse sector has limited capacity for rent growth due to record high vacancies and a large amount of excess capacity created by the precipitous decline in imports and trade. Demand for warehouse space should pick up due to the economic recovery and rising global trade, but the large amount of excess space and relative ease in starting build-to-suit projects will keep a lid on rent increases. The only good news is that supply has plummeted. According to PPR, new industrial supply increased at a 2.5% pace annually between 1982 and 2008, but fell to 0.1% in 2009 and is projected at 1% through 2014.

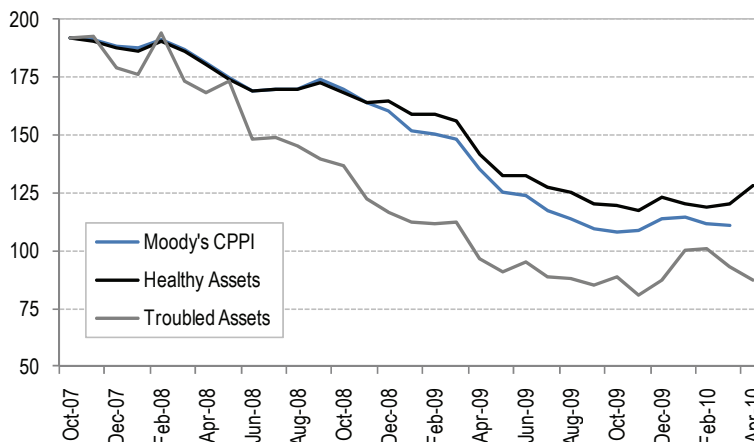
Despite the mixed outlook for space markets, capital is flowing to commercial real estate. Various sources estimate that private equity real estate funds are sitting on more than \$100 billion of capital, and public and private REITs, sovereign wealth funds and institutional investors also have cash to spend. All that money is chasing a smattering of product. Through the end of June, \$36.2 billion of transactions were completed in the U.S., up 67% from a year ago but still nearly 90% below 2007, according to Real Capital Analytics

(RCA). The low number of properties being marketed has created a seller's market, pushing prices higher. Prices of core properties in top-tier markets have bounced back quickly since last year. And there are signs that investors who are frustrated in their attempts to win core product are starting to branch out to lesser-quality assets and markets, which have been largely ignored since late 2007. The dichotomy is illustrated by the Moody's/REAL Commercial Property Price Index, which is down 41.1% since peaking in October 2007. Since October 2007 non-distressed properties in the index have dropped 33%, while distressed assets have fallen in value by 54%, according to RCA. Both types of properties have risen 8% from the index's trough in November 2009.

Healthy Properties Recovering While Troubled Properties Still Floundering

Capital is abundant for several reasons. Many investors believe prices and fundamentals have bottomed and are eager to take advantage of the recovery. Low borrowing costs increase the amount that buyers can pay for properties and meet yield hurdles. Real estate is also attractive compared to other investment options. The stock market is volatile and bond yields have dropped to historic lows, while commercial real estate provides steady income plus the prospect of appreciation. What's more, even though property yields are falling, spreads remain high by historical levels in relation to the risk-free rate.

Prices of Healthy and Troubled Assets vs. Moody's Price Index, Oct. '07 to April '10



Real Capital Analytics

With transaction prices firming since last year's bottom, total returns for appraisal-based indexes have begun to turn positive. After two years of negative appreciation, the NCREIF Property Index (NPI) produced a 1.7% appreciation return in the second quarter, putting total returns at 4.1% through the end of June. We anticipate that the index will post modest gains in appreciation in the second half, which combined with a 7% income return, will produce an 8-12% total return for the year.

REIT Market

The Phoenix-like rally in the U.S. REIT market finally ran out of steam in the second quarter, roughly 14 months after it began in March 2009. Equity REITs struggled in May and June, in sympathy with the broader equity market. But at its year-to-date peak in early May, the NAREIT equity REIT price index was up nearly 155% from the low point last spring, although it remains roughly 45% below 2007 peak levels. The price indexes for all major property types have more than doubled since the market hit bottom, with stunning increases in the lodging (379%) and mall REIT (303%) indexes.

Unfortunately, the REIT train derailed in early May as volatility returned to the equity market. After peaking just a few days before the "flash crash" on May 6, equity REITs tumbled more than 10% from their peak over the last two months of the second quarter to finish with a -4.1% total return for 2Q10 and a 5.6% year-

to-date total return through June. Apartment REITs were the lone exception among the major property types, posting positive returns in both the first and second quarters of 2010 and the highest returns year-to-date. Despite the pullback, REIT indexes still managed to outperform broader equity market indexes in the second quarter and maintain a healthy lead over large and small cap stocks on both a year-to-date and year-over-year basis.

Equity REIT Price Changes

	Eq REITs	Apartments	Industrial	Lodging	Office	Malls	Shopping Centers
Peak-trough (2/07-3/09)¹	-75.8%	-72.5%	-90.3%	-87.9%	-77.8%	-88.0%	-80.0%
Trough May 2010	154.7%	170.9%	208.8%	379.1%	164.2%	302.9%	124.5%
Δ Since 2007 Peak²	-43.6%	-30.1%	-76.5%	-54.1%	-47.6%	-56.2%	-60.1%
Quarterly Price Δ							
1Q10	8.9%	8.6%	2.3%	21.5%	7.9%	8.5%	12.8%
2Q10	-5.0%	5.1%	-17.3%	-9.6%	-8.1%	-3.9%	-10.3%
Year-to-date Price Δ							
YTD @ June 30	3.5%	14.1%	-15.4%	9.9%	-0.8%	4.3%	1.2%
YTD @ July 22	10.0%	23.5%	-13.7%	12.8%	5.5%	11.0%	7.5%

¹ Generally from early Feb 2007 through early March 2009 (lodging peaked in May 2007)

² as of 22-July-2010

FTSE NAREIT; Bloomberg

Where REITs will go over the near term depends largely on the near-term trajectory of the economy. Before the recent pullback, many REIT analysts were warning that share prices were getting ahead of the expected recovery in space market fundamentals. Earnings multiples looked rich, especially when compared with the S&P 500; dividend yields were averaging less than 4%, leaving a relatively narrow spread over benchmark rates; and implied cap rates recalled the boom years in the transaction market. Optimists argued that REITs were fairly priced, considering the above-average earnings and dividend growth that REITs should deliver over the next couple of years as the space markets recover, and after factoring in the potential for accretive acquisitions from distressed private market sellers – especially in a low interest rate, low inflation world.

REITs clearly look more reasonably priced after the declines in May and June – even after taking into account gains made in the first half of July. But to the extent that a weaker outlook for the economy and labor market was a catalyst for the sell-off, in the short term REITs may still look expensive by certain metrics, notably earnings multiples. At the very least, expectations of weaker GDP and job growth increase the risk that earnings estimates will be revised lower, which would put downward pressure on share prices.

Increased risk aversion among investors should turn the focus to earnings. It is not a coincidence, for example, that apartment and lodging REITs have outperformed this year. Earnings in both sectors will rebound earlier than most property types due to their shorter lease durations, and recent data regarding occupancies, room rates and rents has been positive. As a result, we expect performance over the next year will vary more widely by sector and company than is usually the case. Investor demand for yield remains very high, but the quality and durability of cash flows will be important factors. Although we are reluctant to revise our forecast of 7-10% total returns for the equity REIT market in 2010 that we noted in

our first quarter report, a rebound in share prices since the end of the second quarter has pushed the total returns for the NAREIT equity REIT index into the low double-digits through mid-July. If the market remains healthy, the index's total returns could end up higher than our original forecast.

Debt Markets

Like most of commercial real estate these days, the debt markets are bifurcated between class-A assets and everything else. The mortgage market for high-quality assets and sponsors is very liquid. For senior loans on class-A properties, lenders are becoming more aggressive on all fronts including spread, loan-to-value ratios and debt-service coverage. Loan spreads on many high-quality assets have dropped below 200 bps, which, when coupled with a roughly 3% rate for 10-year Treasuries, produces long-term loans with coupons of 5% or less. The lending environment for second-tier assets and sponsors is much less liquid than it is for class-A properties, but it is starting to grow as commercial banks and securitization programs attempt to restart platforms that have been largely inactive since 2007.

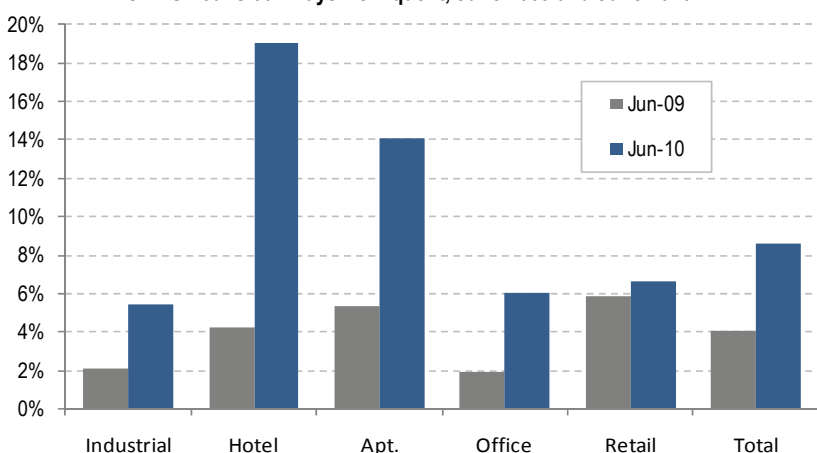
Life companies are driving the lending market on high-quality assets. Insurers by-and-large are thirsty to book mortgages on class-A properties because they represent safe investments at relatively high returns. But life companies have limited capacity, representing just 9% of the \$3.3 trillion commercial mortgage market.

Insurance company mortgage delinquency rates have climbed since 2007, but they continue to be miniscule – just 0.3% in 1Q10, according to the American Council of Life Insurers. Meanwhile, the delinquency rate of commercial mortgages held by banks in 1Q10 was 8.6%, according to the Federal Reserve, and CMBS delinquencies reached 8.6% at the end of June, according to Trepp, an analytics firm that tracks CMBS.

Many banks and CMBS special servicers are increasing efforts to restructure and liquidate problem loans, which is a needed step toward restoring the market. For example, so far this year the Federal Deposit Investment Corp. has sold a \$1 billion portfolio of commercial mortgages, has taken bids on two offerings totaling \$3.8 billion and has another \$1 billion-plus of sales in the works. Also, CMBS special servicer LNR Partners recently sold a \$1 billion portfolio of small-balance loans. The most encouraging aspect of the liquidations is the emergence over the past year of a pool of investors to buy problem debt. While the cycle of liquidations still has a long way to go, it is starting in a fairly orderly fashion.

CMBS Delinquencies Rising for All Property Types

CMBS Loans 30+ Days Delinquent, June 2009 and June 2010



Trepp

While many commercial banks, particularly smaller ones, continue to be preoccupied by non-performing land and construction loans, many are looking for new business. For example, Wells Fargo recently teamed up with a new capital source – Industrial and Commercial Bank of China – to sign up a \$550 million loan on the office tower at 650 Madison Avenue in Manhattan.

The CMBS market saw only \$2.4 billion of issuance in the first half, but volume should begin to pick up. During the second quarter, the market saw its first multi-borrower transaction in two years. CMBS spreads on existing senior triple-A paper dropped 150 bps during the first half, according to Morgan Stanley. The drop in spreads enabled securitizers to reduce loan rates, giving them impetus to start compiling loan pools. J.P. Morgan, Goldman Sachs and Citigroup are among those planning to participate in multi-borrower deals before year-end. CMBS programs still can't compete with life companies for loans on top-tier properties, but they are going after deals on second-tier properties and larger transactions that are too big for one portfolio lender.

The CMBS revival remains fragile and could easily be derailed by a number of factors, including regulatory changes, rising spreads and resistance from investors who are seeking more stringent deal terms. The market awaits the resolution by Congress of issues that include how much of each transaction must be retained by issuers or an approved third party, property-level financial disclosure and rating agency reform. Any of these issues could create a problem, although the probability is that regulators will ease mandates that prove to be onerous to the industry.

Closing Thoughts

Coming so close to the last capital-markets driven bubble, the speed at which the market is pumping up values is remarkable. Space market fundamentals in most sectors are weak following a brutal recession, and the market is facing the prospect of an extended feeble economic recovery. Yet investor demand and low interest rates have pushed down the acquisition yields of core assets close to 2007 peak levels, although prices remain roughly 25% below peak levels due to the drop in property incomes.

Investors see a sector that appears poised to rebound as it normally does following a recession. Although the process will be drawn out, the restructuring of problem loans appears to be headed for a more-orderly resolution than was thought possible a year ago. Real estate looks fairly priced or even cheap compared to other asset classes, and can be counted on to produce a stable income return. Meanwhile, interest rates are low, providing a backdrop against which the spread over the risk-free rate remains relatively high even as cap rates are falling.

Finding investment opportunities in this environment, however, will not be easy. The amount of capital available far exceeds the volume of properties that are available for purchase, and a large portion of opportunities are likely to be complex, especially those that involve some form of debt restructuring. Market players looking to participate in the recovery therefore will need to understand the complexity and possibly accept a higher level of risk than would have been thought necessary just a few months ago.

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