

Market Perspective

Executive Summary

- Liquidity in the commercial real estate capital markets remains very accommodating despite considerable short-term volatility in the debt markets after the subprime mortgage meltdown.
- U.S. REITs continued to outperform the broader equity markets in the first quarter, but struggled in February and March after reaching an all-time high in early February.
- Property market fundamentals remain healthy, with occupancies in most markets at or near levels where rent growth should either continue or accelerate. Although new supply is still modest, development is increasing as the cycle advances.
- Transaction activity continued at a record pace in the first quarter, but large-scale deals have become increasingly important in sustaining momentum in all sectors.
- While the near-term outlook remains favorable, the slowing U.S. economy and weakness in the housing market underscore the potential risks to total return that today's low yields pose for commercial real estate investors. If tenant demand slows sharply as new supply accelerates, underwriting assumptions for rent growth and reversion cap rates could prove overly optimistic in some markets and property types.

Introduction

As remarkable as the pace and volume of activity in the commercial property and capital markets have been this year, the first quarter brought relatively few surprises for investors. As expected, property market fundamentals continue to improve, with more markets moving into the rent growth phase of the cycle. Tenant demand remains solid across all major property types. New supply is very modest, with relatively little space scheduled for delivery in the next 12 to 18 months. And

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despite volatility in the stock and bond markets, and ongoing turmoil in the subprime residential mortgage market, liquidity in the commercial real estate capital markets remains very high. Indeed, as the bidding war for Equity Office Properties (EOP) made abundantly clear, readily available and historically cheap equity and debt capital continues to provide plenty of high-octane fuel to finance commercial real estate transactions of previously unimaginable size and complexity.

While the first quarter mostly confirmed our outlook for U.S. commercial real estate this year, economic trends and capital market events brought into focus the increasing risks we observed at the start of 2007. Recent economic data clearly show the U.S. economy is slowing from the above-trend pace of the past few years. Fourth-quarter 2006 GDP growth was revised down from the initial 3.5% estimate released in late January to just 2.5% due to weaker-than-expected business investment and consumer spending. Most troubling, perhaps, the meltdown in the subprime mortgage market that began in late February with the rapid deterioration of credit fundamentals highlights the potential downside of the capital market integration that has benefited commercial real estate for several years now. As we noted in our 2007 outlook, the most serious near-term risks for commercial real estate investors today are capital market related. Although the problems plaguing the subprime market have nothing to do with commercial real estate fundamentals, any significant disruption in the capital markets that increases the cost of capital for commercial property investments, public or private, poses a serious risk at today's pricing levels.

The potential fallout from the subprime market is not limited to the capital market effects, of course. The wealth effect from the housing market boom provided a strong boost to the economy while the corporate sector was lagging. Obviously, the credit rationing that is already occurring at the subprime end of the market will exacerbate the correction in the U.S. housing market, particularly in areas where subprime borrowers compose an above-average share of borrowers. And job losses in the home finance industry could cause office vacancies to rise in markets where lenders occupy large blocks of space. But it's still too early to tell exactly how the subprime crisis will unfold or to assess how severe the consequences might be for the broader economy. With job growth still fairly healthy and wages rising, perhaps the biggest risk for the economy at this point is that a crisis in confidence could precipitate a dramatic slowdown if businesses suddenly become cautious about hiring and investing for fear that consumers are about to rein in their spending.

While a sharp slowdown in the economy would weaken tenant demand for most types of commercial real estate, the impact on investor demand would depend on the relative outlook for the major asset classes. Real estate may not be as relatively attractive today as it was just a few years ago. But as we noted when the year began, the asset class is not unattractive. In an increasingly uncertain world, the defensive characteristics of commercial real estate should be welcome in any diversified portfolio.

Debt Markets

The commercial real estate debt markets appeared to weather the initial shock from the turbulence in the subprime residential mortgage market with relatively little effect. New issuance

of commercial mortgage-backed securities (CMBS) continued to soar in the first three months of 2007. Although non-U.S. issuance slipped 16.2% from last year's first-quarter pace to \$11.6 billion, a surge in domestic issuance drove global volume to \$68.5 billion, according to *Commercial Mortgage Alert*, a 7.5% increase above last year's first-quarter volume. The first-quarter domestic issuance was notable not only for the total volume, which was second only to the record issuance in 4Q06, but also for the large size of the individual deals, which included four offerings of \$5 billion or more, the largest of which was nearly \$8 billion.

While CMBS issuance remained strong in the first quarter and the pipeline of deals suggests that new offerings will continue at a healthy pace at least through the second quarter, the commercial real estate debt markets did not escape the distress in the subprime market completely unscathed. CMBS spreads widened across all investment-grade tranches in late February, especially at the lower end of the investment-grade spectrum, the BBB and BBB- tranches. Senior investment-grade bond spreads then began to tighten as traditional investors stepped into the void left by the more aggressive capital sources (i.e., hedge funds) to take advantage of the apparent buying opportunity. But as the first quarter drew to a close, spreads widened again all along the credit curve, including the lowest-rated tranches, which initially had remained firm.

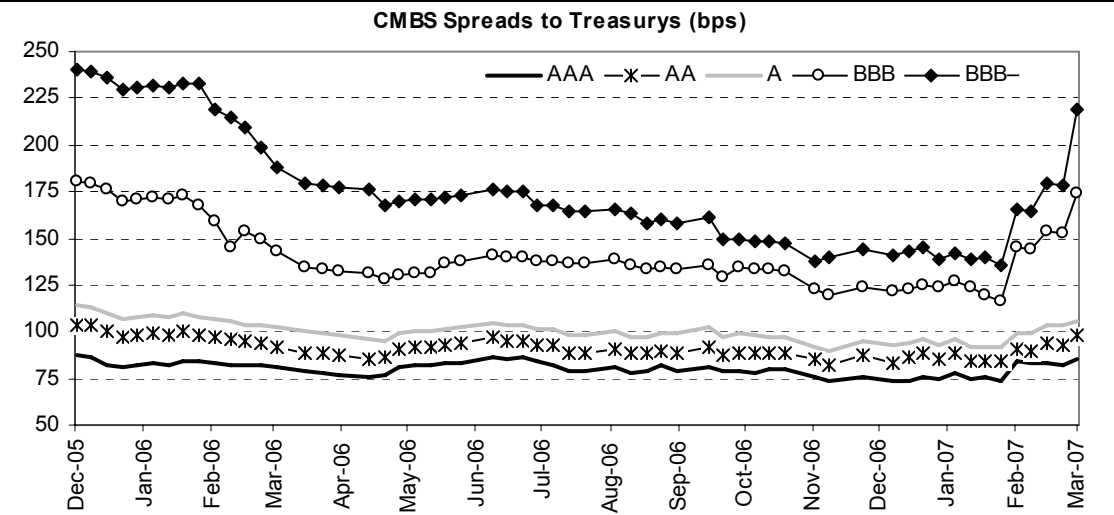
Subprime Market Woes Caused CMBS Spreads to Widen

	Fixed Rate CMBS Spreads to Treasurys						
	12-mo Avg.	28-Mar-07	21-Mar-07	14-Mar-07	07-Mar-07	28-Feb-07	21-Feb-07
AAA Super Senior 10-year	77	82	79	80	80	81	73
AAA Mezzanine 10-year	81	86	82	83	83	84	76
AAA Junior 10-year	84	89	85	86	86	87	79
AA 10-year	89	98	93	94	90	91	84
A 10-year	98	106	103	104	99	99	92
BBB 10-year	133	174	153	154	144	145	116
BBB- 10-year	160	219	178	179	164	165	136
BB 10-year	288	305	280	280	280	280	280
B 10-year	700	725	700	700	700	700	700

Source: Morgan Stanley (shaded column highlights the week of the subprime meltdown)

Although the turmoil in the subprime market provided the catalyst for the spread widening in the CMBS market, other factors likely contributed as well. Most importantly, spreads were at very tight levels when the subprime crisis sent tremors throughout the fixed-income market. As we've noted on numerous occasions, despite the massive growth in new issuance over the past several years, strong investor demand for CMBS has caused investment-grade spreads to tighten significantly. This is particularly true of lower-rated investment-grade CMBS, which have become a staple for investors who repackage the bonds into commercial real estate collateralized debt obligations (CRE CDOs). Just before the subprime market imploded, BBB and BBB- spreads were at or near all-time lows, and many of the traditional investors who were once active buyers had withdrawn. **With historically thin spreads and the heavy new issuance in late February and March, even the slightest pullback on the part of investors was bound to put pressure on spreads.**

Spread(s) Too Thin?



Source: Morgan Stanley

Obviously, the real question for commercial real estate investors is what happens next? The public debt markets play an important role in the real estate capital markets and have been a major factor in the ample liquidity in recent years. At least some of this liquidity can be traced to the rapidly developing CRE CDO market, which, among other things, has provided an outlet for the riskiest pieces of new CMBS offerings. Not surprisingly, the flight to quality in the wake of the subprime meltdown has taken a heavier toll on higher-yielding fixed-income products, including CRE CDOs. About \$9.7 billion in CRE CDOs (including re-REMICs) were issued in first-quarter 2007, according to RBS Greenwich Capital, a nearly 23% increase over the total volume in 1Q06. However, deal flow has reportedly slowed due to the much wider spreads that CDO investors are now demanding for the perceived higher risk of the underlying securities.

While the backup in the CDO market could take some of the momentum out of the CMBS market, it's hard to imagine the liquidity in the debt markets changing much, if at all, in the near term. Commercial property market fundamentals remain very attractive today as rent growth accelerates, new supply remains tame, and existing loans continue to perform well. Delinquency rates in both the CMBS market and insurance companies' mortgage portfolios continue to fall to historically low levels. According to the American Council of Life Insurers (ACLI), a scant 0.2% of the nearly \$230 billion in commercial mortgages held by life insurers was delinquent at year-end 2006. Similarly, according to Morgan Stanley, CMBS delinquencies declined to 0.36% in January, a record low that is less than half the rate at the same time last year. Against a backdrop of solid property and debt market fundamentals, wider spreads will likely appear as more of a buying opportunity for investors than as a sign of increasing risk.

Although the evidence at this point is mostly anecdotal, lenders do not appear to be pulling back from the commercial side of the real estate business. If anything, the downturn in the housing market has likely increased commercial mortgage origination goals for lenders who are active in both areas. Interest-only, nonrecourse loans remain readily available for most commercial property types, and more lenders appear willing to underwrite mortgages where the cash flows in

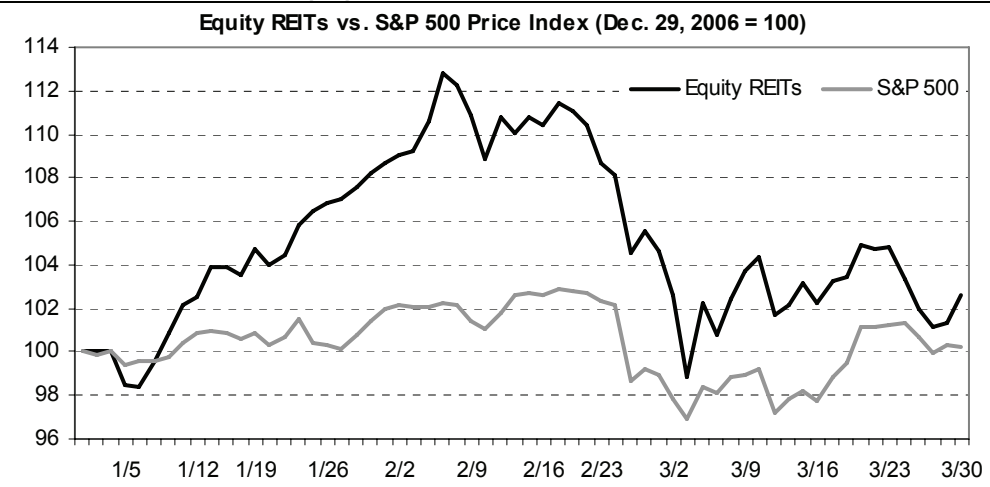
the initial year or two could be negative while the property is repositioned or below-market leases roll over to higher market rents. Lenders also continue to try to win borrowers on terms and increasingly are relaxing prepayment penalties. While loan-to-value ratios have not increased dramatically, **lenders clearly are betting more heavily on valuations continuing to rise or at least holding firm, a bet that naturally increases balloon risk, particularly when combined with non-amortizing loans.**

For borrowers, the current environment is about as good as it gets. Rising asset values, low interest rates and friendly borrowing terms continue to make refinancing attractive and new transactions of almost any size easy to finance. Hence, **despite the formidable challenges in the subprime mortgage market, the near-term outlook for the commercial real estate debt markets remains favorable.** Lenders clearly are taking more risk today, but most appear to be exercising restraint when it comes to lending on new construction and land. It may take time for investors in the CMBS market to determine where spreads should be today, especially in the BBB and BBB- tranches, but the market should be able to reprice far more efficiently than in the past, when it relied exclusively on private debt capital sources.

REIT Market

U.S. equity REITs managed to escape the first quarter with a modest average total return of about 3.5%, according to the FTSE NAREIT Equity REIT Index. **While the gains were more than enough to outperform broad market indexes such as the S&P 500 and Russell 2000, which delivered total returns of 0.6% and 1.9%, respectively, they did not come easily.** At their peak in early February, the FTSE NAREIT index was at an all-time high, with a year-to-date total return of more than 13%. But REITs struggled after their early-February peak, posting negative returns over five of the last seven weeks of the first quarter. During the last week of February, equity REITs tumbled nearly 5.6% after a sharp decline in the Asian stock markets and the crisis in the subprime mortgage market roiled investors. Broad market indexes also declined, though not as sharply as REITs.

Volatile First Quarter for Equity REITs



Source: Bloomberg (FTSE NAREIT Equity REIT Index, S&P 500)

REIT performance varied more widely by property type in the first quarter than has been the case recently. Retail REITs led all major sectors with a 9.8% average total return. A 13.9% average total return for mall REITs, which benefited from the resolution of the Mills saga and from relatively attractive valuations at the start of the year, was largely responsible for the retail sector's healthy gain. Industrial REITs also outperformed the equity REIT index, gaining nearly 4.4%, but office REITs returned just 0.8%, and apartment REITs declined 2.4%. Although all major property sectors fell sharply after the market peaked, apartment and office REITs suffered the most. The severity of the decline in the two sectors may have something to do with their sizable trailing 12-month returns. At the peak of the REIT market in early February, office and apartment REITs had the highest one-year total returns of the major property sectors, with average gains of about 50% and 40%, respectively.

Sell-Off in REIT Market Was Widespread

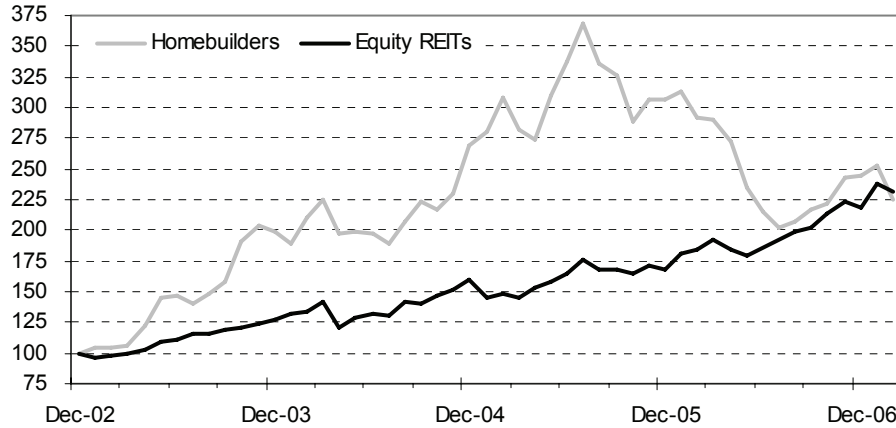
	Year-to-Date Total Returns		
	7-Feb-07	30-Mar-07	bps
Apartment	8.50%	-2.40%	1,090
Industrial	13.24%	4.35%	889
Office	12.80%	0.82%	1,198
Retail	17.83%	9.80%	803
Malls	22.52%	13.85%	867
Shopping Centers	13.98%	6.41%	757
Equity REIT Index	13.09%	3.46%	963

Source: FTSE NAREIT Equity REIT Index

The same dynamic may help explain why REITs fell more sharply than the broader stock market if investors reacted to the global sell-off by trimming positions in holdings that had gained the most over the past year or two. However, we suspect that “guilt by association” likely played a role as well based on the apparent confusion among nondedicated REIT investors and in the mainstream financial media between commercial and residential real estate. Investor reaction to the subprime market crisis was swift and indiscriminate, punishing all things real estate. However, as the chart below clearly illustrates, homebuilders and equity REITs behave quite differently. Indeed, based on monthly price-return data from December 1999 through March 2007, the correlation between homebuilders and equity REITs was just 0.32. This should not be surprising. **The demand drivers and supply cycles of commercial and residential real estate have little in common.**

Little Correlation Between Equity REITs and Homebuilders

Equity REITs vs. Homebuilders (Dec. 2002 = 100)



Source: SNL Financial (S&P Homebuilders, S&P REIT indexes, monthly price index data)

Not surprisingly, the REIT market endured another quarter of heightened volatility amid intense scrutiny in the financial press. The FTSE NAREIT Equity REIT Index advanced or declined by 1% or more on 26 of the 61 trading days in the first quarter, including three days on which the index moved 3% or more. To put this into perspective, the S&P 500 moved by 1% or more on just seven days, including just one day when the index moved (fell) by 3% or more. **At least some of the volatility in the REIT market today is a product of the maturation of REIT exchange traded funds, or ETFs, which allow investors to move in and out of the REIT market much more efficiently than ever.**

The slowing economy clearly poses some risk for REITs. However, **commercial property market fundamentals continue to support the generally favorable outlook for U.S. equity REITs.** Although conditions still vary widely by market and across the different property types, occupancies generally have reached levels where rent growth should either continue or begin to accelerate. The development pipeline is beginning to stir, but new deliveries in most markets will remain modest for another 18 to 24 months. Even the much maligned condo market is holding up much better than most people expected and, in some markets, is creating attractive opportunities for investors, including apartment REITs, to buy excellent quality assets at discounts to replacement cost. As a result, **while earnings growth for the broader market is slowing, equity REITs should generate healthy earnings growth in the high single-digits, on average, over the next 12 months before growth begins to moderate.**

Most importantly, **capital market forces remain very supportive of REIT valuations. REITs continue to figure prominently in the wave of M&A that has been sweeping through the public equity markets for the past few years.** More than \$60 billion in M&A deals involving REITs closed in the first quarter, including the mother of all REIT privatizations, the \$39.2 billion deal for EOP. Although all the deals that closed in the first quarter were announced in 2006, another \$28 billion in new M&A transactions have been announced this year, including the \$7.9 billion deal for Mills (which closed in early April), and two transactions involving takeovers of unlisted lodging REITs. But capital has also continued to flow into the REIT market. Public REITs have had little trouble raising capital, and funds flows into real estate funds remain strongly

positive. According to AMG Data Services, about \$4.2 billion flowed into real estate funds in the first quarter. Although the inclusion of ETFs and global funds has complicated historical comparisons, net fund flows in 1Q06 were about \$875 billion, according to Merrill Lynch.

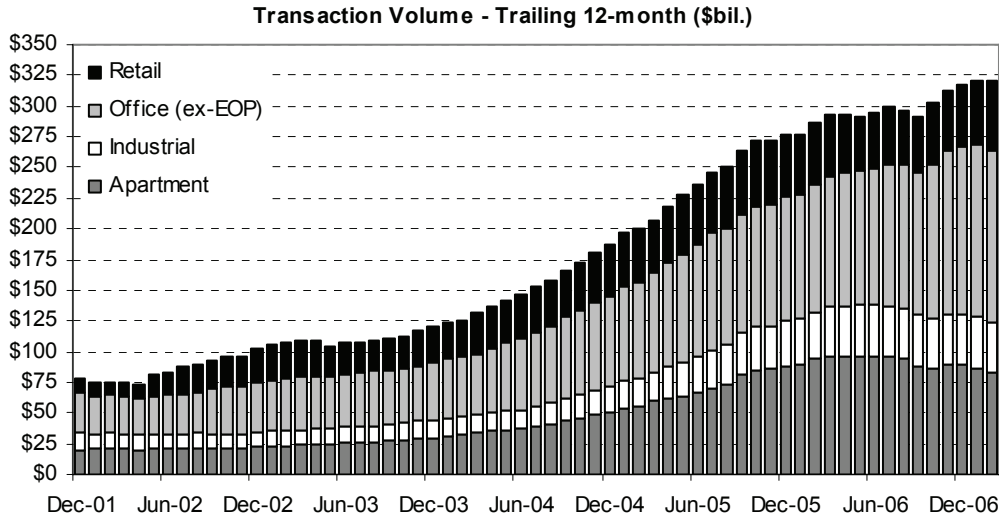
The surge in M&A activity in the REIT market underscores the incredible liquidity and investor demand for income-producing commercial real estate today. The structural changes in the real estate capital markets have significantly broadened and deepened the investor base for the asset class. As the competitive bidding for the massive EOP deal demonstrated, investors can amass huge sums of capital very quickly today. At the same time, recent transactions involving non-U.S. capital sources, most notably Australians, acquiring U.S. REITs and U.S. property companies acquiring foreign entities (e.g., Ventas's pending acquisition of Sunrise Senior Living, a Canadian REIT), confirm the global nature of capital flows today.

With the global REIT market continuing to expand, increasing allocations to real estate and more REITs being added to broad market stock indexes, investor demand should continue to support current REIT valuations. REIT share prices may remain volatile as short-term traders move in and out of the sector to exploit the considerable noise currently in the market, much of which appears to stem from a widespread misunderstanding about the differences between the commercial and residential markets. **But in today's capital market environment, absent some exogenous shock, it's difficult to make a case for a sustained sell-off or prolonged downturn in the REIT market.** Accordingly, despite the recent weakness in REIT share prices and high volatility, we see no reason to revise our forecast for 12% to 15% total returns for U.S. equity REITs in 2007.

Property Market

The volatility in the real estate capital markets did little to slow transaction activity in the first quarter. Commercial property transaction volume surged in the first quarter thanks to a flurry of massive transactions, most notably the aforementioned \$39.2 billion EOP privatization and the series of billion-dollar portfolio deals it spawned. Through February, total transaction volume across the four major property types soared to nearly \$92 billion, based on data compiled by Real Capital Analytics (RCA) and SNL Financial. **Although investor demand for large portfolios of quality assets does not appear to be waning, the risk that transaction activity could slow abruptly has naturally risen as megadeals have become increasingly important in sustaining momentum in all sectors.** In fact, RCA data indicates that transaction volume in the apartment sector through February declined more than 40% from the same period last year, when condo converters were beginning to exit the market, and industrial volume fell by about 8%.

Large Deals Continue to Drive Transaction Volume



Source: Real Capital Analytics (ex. \$39.2B EOP trans. and \$7B sale of EOP's NYC assets in Feb. 2007)

Transaction activity in the office sector continued at a feverish pace in the first quarter. Excluding the EOP deal, office transaction volume increased more than 30% in the first two months, according to RCA, and several large transactions are expected to close over the next month or two. Current conditions and the near-term outlook still vary widely by market and, in some cases, even by submarket (e.g., midtown and downtown Manhattan), which makes broad generalizations and aggregate statistics less meaningful than usual and potentially misleading. **But overall, the U.S. office market is at the point in the cycle where rents should grow nicely over the next two to three years while supply gradually accelerates.**

Although demand growth may be substantially lower this year than in 2005-2006 due to the slowing economy and low unemployment, absorption should still easily outpace supply for another two years in most markets. Space market fundamentals and rent growth prospects are strongest in supply-constrained coastal markets, such as New York, Boston and San Francisco. However, cap rates in most, if not all, of these markets have compressed sharply, leaving investors with very low initial cash yields and leveraged investors with little (or negative) cash flow in the initial year or two of the holding period.

With rents rising in many CBDs and low initial yields, tenants and investors are transitioning from urban to suburban markets, which usually means that supply will begin to pick up. While it will be a few years before meaningful amounts of new office space begin to come online in most markets, this office cycle will likely differ from past cycles. As we've noted before, office employment growth over the next five to 10 years will not reach the levels of the late-1990s boom in part because labor force constraints will temper job gains. Office vacancy rates, therefore, will not likely fall as low as they were at the peak of the last cycle. More importantly, while we've cautioned that future office cycles may be more compressed due to structural changes in the capital markets, **the EOP transaction and follow-on portfolio deals have clearly accelerated the current cycle by resetting cap rates and rents across the entire office market with unprecedented speed.** Although office property owners will clearly benefit

from the valuation and rent growth effects in the near term, the speed with which they are occurring and the magnitude of the value gains and potential rent spikes mean investors must adjust their underwriting assumptions accordingly.

Although transaction volumes in the industrial sector in the first two months of 2007 declined modestly year-over-year, tenant and investor demand for industrial properties remains healthy. Nationally, the warehouse vacancy rate dipped below 10% in the second half of last year, according to Torto Wheaton Research (TWR). Double-digit growth in imports and exports continues to create strong demand for warehouse and distribution space in and around the major ports and intermodal hubs. However, new supply has been quick to respond, which has limited rent growth in many markets, even though tenant demand has been very strong. Warehouse supply has been increasing steadily since 2003, according to TWR, and this year is forecast to exceed absorption.

With asset values continuing to climb and limited opportunities to move rents higher, warehouse returns for existing properties are very meager today. Warehouse properties in supply-constrained port markets and locations served by intermodal facilities appear to offer the best opportunities for sustained rent growth over the long term, and should provide some downside protection if demand slows. Investors can earn higher returns through development in select markets, but only by participating earlier in the development process with the acquisition and entitlement of land. The risks, however, can be much higher, and if demand slows more than expected and vacancies rise, development must also slow.

The apartment sector continues to benefit from both good and bad news in the U.S. economy. Healthy job growth and rising wages, obviously positive trends, together with the housing market downturn and collapse of the subprime mortgage market are driving solid tenant demand in most markets even as investor demand has slowed with the exit of the condo converters. **Acquisitions by condo converters fell sharply after 1Q06 and have slowed to a trickle this year. Yet apartment pricing has held up well thanks to the depth of liquidity in the market and to the favorable near-term outlook for apartment market fundamentals.** Indeed, the bursting of the condo bubble has been rather anticlimactic so far, with surprisingly little distress.

As in all property types, apartment supply-demand fundamentals vary widely by market. Generally though, **while rent growth will likely remain robust in supply-constrained markets, particularly in coastal areas, growth in some markets is beginning to decelerate now that concessions have become scarce and rents have moved higher.** Although new supply remains fairly modest, development is increasing, most notably in markets where rent growth has been strong and the barriers to new supply are relatively few. Clearly, as rent growth slows and supply increases, investors face higher risks. However, fears that falling home prices will weaken tenant demand for apartments by shifting the rent versus own equation back in favor of ownership seem unfounded. Lending to less creditworthy buyers should be curtailed in the wake of the subprime debacle, and in many of the most overheated markets, price corrections have been relatively modest compared with the run-up in values that occurred in the years leading up to the housing market peak in 2005.

Retail transaction volume through February was almost twice the volume at the same point in 2006. However, **the share of transactions involving retail properties clearly has declined as the focus has shifted to the office sector.** In fact, excluding the acquisition of private REIT Inland Retail by Developers' Diversified (DDR), a public REIT, which accounted for about \$6.2 billion of the \$7.6 billion total volume in February, retail transaction volume declined more than 5% year-over-year in the first two months of 2007, according to RCA. As in the apartment sector, retail pricing has remained relatively stable. Cap rates for inferior retail properties, due to either location or quality, have drifted somewhat higher as competition for assets has eased and investors have become more selective. But with retail market fundamentals still healthy and relatively few retailers struggling, retail properties continue to perform well. According to a recent Merrill Lynch study, store closings (including bankruptcies) in 2006 were nearly 30% below the average from 2001 through 2004, and in the first two months of 2007 closings were less than half the total in the same period last year.

As long as the economy continues to expand and create jobs, weaker investor demand for retail properties should create attractive buying opportunities for long-term investors looking for stable cash yields and modest value gains. Retail rent growth may lag the office sector over the next year or two, but it should still easily outpace inflation. Further, **the rapid repricing in the office sector is making retail yields relatively attractive again, particularly when capital expenditures are taken into consideration.** Lifestyle centers continue to attract the most attention from investors, retailers and shoppers. But malls have also demonstrated their competitive prowess and have largely been ignored by private capital sources due to their large scale, management intensity and the competitive advantages of dominant mall REITs. While these issues must still be considered, the current environment of ample liquidity and abundant joint ventures may create opportunities for private buyers to increase exposure to the mall sector.

Operating fundamentals and liquidity remain very healthy in the lodging sector thanks to strong room demand from business and leisure travelers, and a booming transactions market. Hotel transactions soared in 2006 to a record \$35 billion, according to RCA, and already this year three lodging REITs, including two unlisted companies, have been targeted for takeovers. Although occupancy rates were down slightly in February versus last year, healthy growth in average daily rates (ADRs) continues to drive revenue per available room (RevPAR) growth, particularly at the upper end of the chain scale (i.e., luxury, upper upscale and upscale) and in urban locations. According to Smith Travel Research, average RevPAR was 5.2% higher in February than at the same time last year, but was as high as 7.8% for luxury hotels and 8.6% for urban hotels. New supply is increasing. However, the development time required for full-service hotels should mean that supply will not be a factor in most markets for at least another 12 to 18 months. The bigger risks in the lodging sector today are the uncertain outlook for room demand and a potential surge in properties on the market. If consumers do begin to rein in spending, leisure travel is usually among the first discretionary items to go. As we've noted before, **the current hotel cycle may have further to run, and there undoubtedly may be attractive opportunities, particularly in supply-constrained markets, but it's awfully late in the game to be acquiring fully priced assets in the most volatile of property sectors.**

Self-storage operating fundamentals remain healthy but appear to have weakened somewhat at the end of 2006, perhaps due to the weakening housing market and reduced demand from individuals and businesses displaced by the hurricanes in 2005. According to Self Storage Data Services (SSDS), despite a 4.6% increase in the west region, asking rents declined about 1.1% nationally in 4Q06. However, a two-percentage point increase in median physical occupancy, which climbed to 92%, boosted rents per occupied square foot about 1% in the top-50 markets and allowed operators to continue to scale back concessions. **Importantly, investor demand for self-storage assets remains strong. The investor base continues to widen as more institutional investors and other buyers have been attracted to the sector's relatively high initial yields and high operating leverage.** Cap rate compression appears to have slowed, but yields remain stable. According to SSDS, cap rates for class-A properties averaged about 7.1% in 4Q06. Although weakness in the housing market adds some uncertainty to the outlook for tenant demand over the near term, it's far too early to tell how declining homeownership rates will affect demand for storage units. Monthly rent for a storage unit may be a discretionary expense for some, but for households moving from owning to renting, additional storage capacity may be necessary. With occupancy rates at healthy levels and relatively little new supply, self storage should continue to perform well in the near term.

The healthy transaction volumes and stable capitalization rates in the first quarter leave little doubt that private real estate investments should continue to perform well this year. If anything, the resetting of office cap rates and rents in the wake of the EOP transaction could push private market returns, as measured by the NCREIF Property Index, to (or slightly above) the upper end of our expected range of 9% to 12% this year. To be sure, a lot can change before this year is finished, and the stronger linkages with the capital markets mean that real estate can reprice more quickly than in the past. But if the implied cap rates in the EOP transaction and several other large deals, including the pending acquisition of retail REIT New Plan Excel and the pending sale of the CalWest industrial portfolio, exert enough downward pressure on market cap rates, appreciation returns could surprise on the upside again this year.

Closing Thoughts

The U.S. commercial real estate market is clearly off to a good start in 2007. Property market fundamentals are generally healthy across all property types, and capital is readily available throughout the industry. While the current favorable conditions seem unlikely to change in the near term, barring some unexpected shock to demand, they will not persist indefinitely. New supply is accelerating, more transactions involve negative leverage, and rising asset values have pushed yields to very low levels, increasing the risk that capital flows will begin to slow as expected returns in other asset classes appear relatively more attractive. Though the risk that increasing new supply or rising valuations will cause a sharp correction in investment returns is fairly remote, especially in the near term, it would be naive to expect core commercial real estate will continue to deliver total returns well in excess of its long-term potential, which should fall somewhere between stocks and bonds.

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