Executive Summary

- Fears about a slowing economy and its effect on commercial real estate fundamentals are growing, while the impact of the credit crisis continues to loom over the market.

- Transaction activity on all levels remains stalled, making it difficult to ascertain property values.

- Demand for debt is tepid, due to a lack of property sales and discretionary refinancing. The CMBS market has almost completely shut down, with portfolio lenders and commercial banks financing a small number of deals.

- New supply is relatively low and falling, which will moderate the impact of the downturn and help real estate markets snap back quickly when the economy rebounds.

- The U.S. REIT market remains extremely volatile. Although REITs outperformed the broader equity markets in the second quarter, the sector plunged in June, erasing year-to-date gains.

Overview

The real estate market was stuck in neutral as 2008 began, but market participants took comfort in the thought that fundamentals in the commercial sector were strong. The troubles were seen as technical rather than fundamental, caused by spillover from the subprime residential mortgage market. Such comfort is deteriorating, as the daily economic news has turned relentlessly negative.

Still, weaknesses in the space and transactions markets are likely to be limited. Job losses in the financial services sectors will have a proportionately larger impact on financial centers such as New York. The housing slump is severe in markets with rapid supply growth, such as Southern California, Nevada, Florida and Arizona, and states with weak economies, such as Michigan and Ohio, but is less pronounced in markets where new supply was not excessive. Vacancy rates will rise moderately across the spectrum in the next year, but they are unlikely to spike. Likewise, rents in many markets will be weak, and there is potential they will decline in some locales. We expect weakness to continue into 2009, followed by a healthy recovery.
Debt Markets

The whole business world is deleveraging, with credit rationed to the strong, and the commercial real estate sector is no exception. High leverage is a thing of the past, as banks are desperately trying to pare balance sheets of anything risky, and most real estate. **The sudden chill in the debt markets is contributing to a drop in real estate prices, although the weakness has yet to show up in the NCREIF Property Index, which is a lagging indicator.** Opportunistic buyers can no longer buy assets at low cap rates and meet yield hurdles by leveraging to the hilt. Loan-to-value ratios no longer exceed 60-65%, while banks insist on higher debt-service coverage and increased reserves and no longer underwrite big increases in rental income.

Very few loans are being originated at the moment. Demand has been sapped by the lack of property sales and fallback in property prices. The annualized turnover rate among commercial properties in the NCREIF index in the first quarter was 4.4%, the lowest level since 1993. Property owners are no longer refinancing properties to take out cash. In recent years, they gladly paid penalties to retire existing debt that was not scheduled to mature, because the proceeds were sky-high. Many loans originated five to 10 years ago that would naturally have matured this year were replaced in recent years with securitized long-term loans.

Last year, CMBS programs securitized $230 billion of debt in the U.S., and probably originated another $70 billion that was not securitized during the year. This year, CMBS shops have written only a handful of loans. U.S. CMBS volume in the first half dropped to $12.1 billion, from $137 billion a year ago. Some institutions have made a decision to opt out of the market. Others would lend if they could, but widening of CMBS spreads has increased their cost of capital and left them unable to compete with portfolio lenders. Senior triple-A rated CMBS are priced to yield about 160 basis points (bps) more than they did in the spring of 2007. Banks won’t allocate much capital to the sector until volatility declines. That is not likely to be soon, given how the market has experienced wide swings in prices in reaction to recent events.

CMBS is not likely to come back strong for at least a year, and probably longer. Once origination restarts, it takes months or more to originate enough loans to create a package large enough to securitize and then get through review by rating agencies and subordinate-bond buyers. Consequently, it is unlikely there will be more than an odd CMBS deal or two this year, and no sustained activity before 2010.
With CMBS out of the picture, the fixed-rate market mostly falls to life companies, while floating-rate loans are the purview of commercial banks. The exit of CMBS programs creates a big void. The largest insurance companies combined have the capacity to provide up to roughly $60 billion of debt. What’s more, some portfolio lenders themselves are sidelined for various reasons. Some are reluctant to add to their commercial-mortgage exposure, despite the attractive spreads available on new loans. Some insurers have decided to overweight other investment sectors that provide better relative value. Others, that have faced mark-to-market losses in CMBS and residential MBS, are sitting out until the market seems less volatile. **Lenders that are active are being rewarded with loans that carry wide spreads and prudent terms in relation to the product that prevailed in recent years with lower spreads and more-aggressive terms.**

In the floating-rate market, small and middle-market deals are typically getting done by regional lenders and the portfolio arms of large banks, while foreign banks are willing to syndicate larger deals. But there are concerns that commercial banks are going to be under pressure in the near future due to rising delinquency rates in the construction, condominium and land-loan sectors. And property owners will undoubtedly have a harder time arranging take-out financing on projects secured by short-term, high-leverage debt, which could be another source of trouble for bank loans. If this scenario plays out, some commercial banks may join CMBS programs on the sidelines.

Construction debt is hard to arrange, even if the sponsor is highly regarded. For example, *Commercial Mortgage Alert* reported that two banks were unable to put together a syndicate for a $545.5 million construction loan for a Vornado Realty partnership on a $719.4 million mixed-use project in Boston. The partnership has agreed to supply more equity, reducing the loan proceeds to $400 million, and the loan spread was widened by 50 bps, but even more-generous terms may not be enough to entice banks to join the syndicate.

**The upheaval in the debt markets is producing an opportunity for mezzanine loans.** Banks freely dispensed mezzanine debt in recent years, but will no longer do so, creating an opening for players to provide capital between the senior loan and equity. The capital markets crisis has driven up the yield of mezzanine debt. According to DTZ Rockwood, mezzanine debt with a 65% to 75% loan-to-value range and term of one to three years carries a yield of between 13% and 18%, which is significantly more than a year ago.

**REIT Market**

It would be unduly optimistic to expect any broad-based rally in REIT share prices given the state of the economy and jitters on Wall Street. REIT stocks are highly correlated with financials and are often lumped together with other real estate stocks such as homebuilders. These battered sectors are likely to experience a high level of volatility until the capital market crisis works its way through the system.

After posting healthy gains in March and April, equity REITs slowed noticeably in May and then plunged in June. The nearly 11% decline in the FTSE NAREIT index during June left equity REITs with a negative total return (−3.6%) in the first half of the year, a far cry from the positive 8.2% year-to-date total return through May. While the June collapse was obviously disappointing, equity REITs remained well ahead of
the broader stock market at midyear, easily outperforming the S&P 500 and Russell 2000, which were
down 11.9% and 9.4%, respectively, through June.

Steep Decline in June Wipes Out Year-to-date Gains

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<th>U.S. Equity Market Monthly Total Returns</th>
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<tr>
<td>Jan-08</td>
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<tr>
<td>S&amp;P 500</td>
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<td>-14%</td>
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Ibbotson Associates; Standard & Poor’s; Frank Russell; NAREIT

Coming on the heels of widespread underperformance in 2007, in which equity REITs dropped in value by 15.7%, REITs now look undervalued. REITs are trading, on average, at prices that imply that the properties they own would trade at cap rates of 6.8%, according to Bloomberg and Citigroup. Cap rates on commercial properties as a whole are closer to 6%, which indicates that REITs are trading at a roughly 10-11% discount to their net asset value. To be sure, property sales are rare, making it difficult to gauge cap rates, but the few transactions getting done do not indicate cap rates have risen more than 50-75 bps.

While REIT stocks have been fairly volatile over the past couple of years, their operating performance has been stable. Same-store NOI for REITs was growing at a 4% rate in the first quarter, and it has consistently been above 3% since the beginning of 2006, according to Bank of America. Falling share prices have made REIT dividend yields more attractive. The average dividend yield rose to 5.3% at the end of the second quarter, about 30 bps higher than at the end of March. Of course, with the economy slumping, REIT operating performance is likely to slip. REIT occupancy levels fell to 93.7% in the first quarter, down from 94.2% at the end of 2007, according to BofA. The occupancy levels remain high by historical standards, and it would not be a serious cause for concern if vacancies increased slightly, as expected.

Prudence dictates caution when predicting performance in such a volatile market. **REIT stocks are undervalued by historical standards, but it would be rash to predict a rally when investor sentiment is so poor.** Therefore, we still believe our forecast from the beginning of the year to be valid: REITs will produce a moderate total return between 5% and 8% in 2008. REIT dividends alone should be a good bet to produce about 2.5% in the second half of the year, and after the sharp decline in June, share prices could move higher.
Property Markets

Measuring commercial real estate trends is dependent on the collection of many points of data, which presents a problem in the commercial real estate market due to the lack of sales and leasing activity. Property sales are rare due to the wide bid-ask spread between buyers and sellers. Buyers want to pay less than peak value for assets, but that gives property owners little incentive to sell if they are not in distress. Asset values reportedly have dropped 5% to 20% from their peaks. Yet anecdotal evidence indicates that buyers continue to pay up for core properties in major metropolitan areas. In recent months, disparate assets such as apartment buildings in Atlanta, a B-grade office building in Manhattan and offices outside of downtown San Diego have traded at cap rates of roughly 5.5%. A portfolio of high-quality Manhattan office buildings sold under duress by Macklowe Properties fetched a price that translated into a cap rate of about 4%. Owning core assets represents a hedge against inflation, and core properties are relatively safe vehicles to produce steady income.

Transaction Volume Plummets

The lack of activity signals a return to a market that will operate closer to historical standards, one that rewards investors with a long-term view rather than speculators chasing short-term arbitrage gains. In the overheated market of the last few years, demand to buy properties was so strong that investors paid up for just about everything. Going forward, however, there is sure to be a greater differential in pricing between core and value-added real estate. That could create a buying opportunity in out-of-favor sectors or regions that are inefficiently priced due to a lack of liquidity.

The economic downturn has an impact on all property sectors. Demand for office space is weak in many markets, as the economy lost 438,000 jobs during the first six months of the year, according to the U.S. Department of Labor. Torto Wheaton Research (TWR) reports that the national office vacancy rate average climbed by 30 bps, to 13.2%, during the second quarter. Big jumps were recorded in markets that include San Francisco (to 9.7% from 8.6% at the end of the first quarter), Miami (12.7%, up from 11.7%), Philadelphia (12.3%, up from 11.3%) and Orange County (17.1%, up from 16.1%). Some major markets remained solid, including New York City (6.1%, compared to 6%) and Seattle (9.6%, from 9.8%). Few corporations are looking for space, which could dampen expectations for office rent increases in the next few years.
The good news is that office construction has remained subdued. In 2008, some 63 million square feet of new office space will come online nationally, about half of the level developed annually between 1999 and 2001. And construction is expected to decline further in the next couple of years. As a result, vacancy rates are not likely to spike, which should put property owners in good stead whenever the economy starts to recover.

The outlook for the retail sector is gloomier. Retail spending is forecast to climb a slim 2.5% this year, down from 4.1% last year and 6.6% in 2006, according to Marcus & Millichap. The Consumer Confidence Index dropped in May to its lowest level since the early 1980s, which is not surprising. Spending power is down due to corporate layoffs, inflation and the drop in home prices. Homeowners can no longer use their home equity as an ATM. With the price of goods rising, consumers will be limited in what they can purchase, and they will gravitate toward discount chains and essential items. Rising costs put retailers in a bind, but many are reluctant to raise prices because that would turn away budget-conscious shoppers. To survive the challenging environment, some retailers are closing stores or limiting expansion, which is likely to push up vacancies in malls and power centers. Future rent increases will likely be less than projected by property owners.

Fundamentals continue to deteriorate in the hospitality sector. Fuel prices have prompted a spike in the cost of air and automobile travel, reducing demand from vacation travelers. Smith Travel Research (STR) reports that national hotel occupancy was down 2.5% in May from a year ago, although revenue per available room (RevPAR) rose by 1.1%. Cities such as New York and San Francisco that are destinations for foreign tourists and business travelers are less affected due to the weak dollar. Meanwhile, according to STR, supply climbed by 2.5% from a year ago, although hotel construction will slow down starting next year.

Demand for industrial space has also softened, due to the slowdown in consumer spending and the weak dollar, which has a negative impact on imports. U.S. companies are exporting more due to the devaluation of the dollar, but exports do not create as much demand for retail space as imports. According to TWR, vacancies in industrial properties rose by 50 bps, to 10.3%, in the second quarter, the third straight quarter in which the vacancy rate has increased. Excess new supply continues to pose a challenge. According to
TWR, new deliveries again outpaced absorption in the second quarter, and the trend is forecast to continue throughout 2008 and into 2009.

Apartment-market fundamentals look good over the long term, although the sector faces some short-term challenges. Recent years have seen an unprecedented shift toward home ownership, peaking at 69% in March 2005, according to Moody’s Economy.com, but the collapse of the subprime mortgage market has reversed that trend. The homeownership rate slipped to 67.8% in early 2008 and is expected to decline to 67% by the end of the year. The drop in homeownership drives demand for apartments, but apartments face added competition from single-family homes and condominiums that are finding their way to the rental market. Over the next decade, the coming of age of “echo boomers,” the children of baby boomers, will result in a surge of individuals moving into prime rental age. At the same time, the supply of new apartments is weak, dropping to its lowest levels since the early 1990s, according to Property & Portfolio Research. That should spur increases in apartment occupancy and rental rates.

With all the negative economic indicators likely to continue for the rest of 2008, private real estate will fall short of the sector’s stellar performance of recent years. The NCREIF index has produced an average 16.6% total return between 2004 and 2007, with no year lower than 14.5%. At this point, we are not moving far from our projection for total returns this year in the range of 4% to 7%, although there is potential that returns could fall below the bottom of the range. The index produced a 1.6% return in the first quarter, including 1.3% of net income and 0.3% price appreciation. NCREIF is a lagging indicator of property prices, so it may not reflect the extent of weakness in the transactions market.

Closing Thoughts

The commercial real estate market is in the midst of a correction, one that is not likely to end in the next few months. But if it seems time to fear the market, well, it’s not. True property distress remains rare. Commercial mortgage delinquencies remain at historically low levels, in both the portfolio-loan and securitization industries. If the delinquency rate doubles or even triples – which is unlikely in the near future – it would still be reasonable by historical standards. The biggest factor, however, is that unlike other real estate booms in the recent past, construction across most sectors has been restrained, and the current downturn will further dampen supply. When the economy turns around, the demand for space will outstrip supply, leading to healthy increases in rental rates.

To be sure, before the market fully recovers, there will be upheaval for firms that made risky bets and lost. Since some of the biggest bets involve high-profile assets and investors, the bad news will be splashed across headlines. But we see this as a unique opportunity for smart investors to find sectors that are illiquid and offer outsized risk-adjusted returns (perhaps temporarily) compared to historical levels. One example is mezzanine debt, where yields jumped significantly over the span of a few months, during a time when there was little change in the performance of the underlying assets. Other niche sectors may produce attractive risk-adjusted returns because many investors are avoiding all but core assets. These include property types such as seniors housing or medical offices or buildings that meet green environmental standards. Investors who are patient and do their homework tend to be rewarded, no matter what the market environment.
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