

US Market Outlook – First Quarter 2005

Market Perspective

The US real estate market showed few signs of slowing in the first quarter, despite rising long-term interest rates and mounting concerns about inflation and the booming housing market. With capital continuing to flow into the asset class from a wide array of sources, real estate yields have not only compressed further, they have also continued to converge as equity and debt capital sources search for markets and property types where any premium exists.

While investors clearly are taking more risk today, increasing evidence of a recovery in property market fundamentals warrants some movement further out the risk curve. Rent growth in most property types and markets will take a while, but national occupancy rates have improved across all property types since this time last year. This is not true everywhere. However, in most major markets, the worst of the real estate downturn is behind us, and the expanding economy should continue to create demand for all property types.

The outlook for real estate over the next 12 to 18 months is not without risks, of course. Excess liquidity, rising interest rates and the potential fallout from condo fever in select areas could have repercussions throughout the real estate investment markets. The following updates our outlook for the US real estate market this year based on our observations in the property and capital markets through the first quarter.

Debt Markets

Despite the record loan origination volumes in 2004 and the threat of rising interest rates over the next year or so, the capital spigots remain wide open in the real estate debt markets. According to the Mortgage Bankers Association, commercial loan originations (including multifamily) topped \$136 billion in 2004, a 16% increase over the record volume in 2003. Commercial bank originations, which accounted for about half of the rise, soared 54% last year, far outpacing the 20% jump in originations by life insurance companies.

Although data on private capital flows through the first three months of 2005 will not be available until well after the end of the quarter, we expect lenders will be at least as active this year,

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barring a sudden spike in long-term interest rates or a random external shock. Surveys of commercial bank lenders indicate their appetite for real estate loans will grow in 2005 as property market fundamentals improve, a sentiment we suspect most other lenders share. Likewise, a considerable amount of mezzanine capital remains readily available, allowing borrowers to increase leverage at relatively little incremental cost.

Evidence from the commercial mortgage-backed securities (CMBS) market so far this year suggests origination and issuance volumes could even surpass 2004's records. Through March, *Commercial Mortgage Alert* reports that more than \$43 billion in new CMBS were issued globally, a 62% increase over first-quarter 2003. Issuance of real estate collateralized debt obligations (CDOs), which were first introduced only a few years ago, has also increased sharply this year. Total CDO issuance reached a record \$8.3 billion last year, according to *Commercial Mortgage Alert*, but is on pace to exceed that in the first half of 2005. The surge in real estate CDOs, which typically are backed by mezzanine loans and subordinate CMBS tranches, demonstrates the depth and breadth of liquidity in today's debt markets, as the CMBS and mezzanine markets have grown in tandem. The CDO market growth also illustrates the increasing flexibility and complexity in the debt markets, which, in theory, should provide a better alignment between risk and reward, but not necessarily better alignment between issuer and investor.

As surprising as it might seem after four years of robust capital inflows from the public and private debt markets, the current liquidity in the real estate capital markets makes sense in an environment of improving property market fundamentals, an expanding economy and generally lackluster investment opportunities elsewhere. Data from the real estate debt markets show no signs of trouble. Delinquencies among seasoned CMBS (those aged one year or more) fell slightly to 1.78% in February, according to Morgan Stanley, and are expected to decline to about 1.30% by year-end.

Loan delinquencies in life insurers' commercial mortgage portfolios have also continued their downward trend. According to the American Council of Life Insurers (ACLI), loan delinquencies at year-end 2004 were barely measurable at just 0.08%. While the ACLI data may be more indicative of ongoing investment strategy and policy changes within the life insurance industry, the low delinquency rates underscore today's lack of distress in the real estate markets, despite the weak property market fundamentals in recent years.

That said, delinquency and default data are, by definition, backward-looking. And since loans rarely encounter problems in the first year or two, today's low rates may not say very much about how the loans originated now will perform in the future. As competition between lenders has intensified in recent years, underwriting standards have deteriorated, which could spell trouble as interest rates rise.

ACLI data show only a modest deterioration in average loan-to-value and debt service coverage ratios on new commercial mortgage originations. But lenders have become more aggressive in recent years. Interest-only loans are more common, and loan terms (e.g., reserves for items like leasing commissions and capital expenditures) are more borrower-friendly. Improving property

market fundamentals warrant more risk-taking. However, the recent underwriting trends leave lenders with considerably less protection if the recovery does not go exactly as expected.

This is particularly true in the CMBS market, where the intense competition for deals has weakened whatever alignment of interest existed between conduit lenders, who make their money originating loans for securitization, and the investors who buy the securities. As mortgage spreads have continued to compress, lenders have increased lending volumes to make up for the lower margins. At the same time, lenders have expanded into niche sectors that offer premiums over core property types. For example, recent CMBS issues have included more hotel loans and, perhaps most troubling, condo-conversion loans.

The economics of the CMBS market have always encouraged this type of behavior to some extent. However, in years past, the relatively few buyers of the unrated tranches, the “B-pieces,” have imposed discipline on lenders through the buyers’ ability to kick out any loans they deemed unacceptable. Today, competition within an increasingly crowded field of B-piece investors, which now includes players from the rapidly expanding CDO market, may actually be encouraging lenders to originate riskier loans. The fact that few originators actually retain any exposure to their loans seems to exacerbate the risk that lenders’ production goals could overwhelm their discipline.

At the same time, robust demand from investors has caused CMBS yield spreads to narrow, which means less return for more risk. Leverage within CMBS pools has continued to drift higher over the last few years even as credit rating agencies have reduced the subordination levels required to support the investment-grade tranches. To be fair, the historical performance of CMBS in recent years makes a strong case that risk has been overpriced – that is, spreads have been too wide and subordination levels have been too high for the realized risk reflected in the low delinquency rates. But markets, like pendulums, seldom stop at a new equilibrium point without first swinging too far in the opposite direction. The thin spreads and less rigorous underwriting today leave little margin for error.

Further, the current low delinquency rates also probably understate the true level of distress that would exist in lenders’ portfolios today were it not for the strong equity markets. Typically, when property cash flows fall below break-even debt service coverage levels, lenders can sell the collateral at a premium and avoid workouts and foreclosures. Theoretically, we’ve reached the point in the real estate cycle where equity should replace debt in the capital structure, as investors increasingly anticipate the recovery and future growth to drive total returns. As a practical matter, however, investors should not be overly complacent because delinquency and default rates are low today.

The expanding economy and improving outlook for property market fundamentals justify continued liquidity and a fair amount of optimism in the real estate debt markets. But the frothy conditions and rising-interest-rate environment also warrant perhaps more than a little anxiety. Property market fundamentals should continue to improve as the economy expands, but the narrow spreads and looser underwriting mean that a lot is riding on the recovery going as expected. The downside risks if something, internal or external, disrupts the debt markets have

also increased, particularly as the debt markets have grown more complex. The CMBS market has survived formidable tests in the last few years, but most events have been fairly isolated. It remains to be seen how the market would handle widespread distress. Although the chances of such a scenario unfolding seem quite remote, sorting out the claims of the many different layers of creditors and equity investors could be a legal nightmare.

REIT Market

The US REIT market got off to a rough and volatile start this year. The Morgan Stanley REIT Index (RMS) tumbled 8.6% in January, then rallied nearly 3% in February as the 10-year Treasury bond yield sank from 4.25%, where it began the year, to 4% in early February. The REIT rally was short-lived, however. Soaring oil prices and worries about inflation and a potentially more aggressive Fed caused bond prices to fall, pushing the 10-year Treasury yield to more than 4.6% in late March before drifting back to about 4.5% by the quarter's end. The RMS slipped nearly 1.7% in March, ending the first quarter with a total return of -7.4%. REITs were not alone in their suffering, however. Most broader market indexes also struggled in the first quarter. Both the S&P 500 and the Dow fell more than 2%, while the Russell 2000 lost more than 5%, and the Nasdaq tumbled about 8%.

Of the major property types, apartment and industrial REITs suffered the largest declines in the first quarter. According to the National Association of Real Estate Investment Trusts (NAREIT), industrial and apartment REITs lost more than 10.5% and 9.2%, respectively. Retail REITs, which have outperformed all other sectors for three years, fell about 7.8%, while office REITs slid about 3.3%. Only the small self-storage sector managed to avoid a negative total return, gaining less than 1%.

Several factors contributed to the poor performance and volatility in the REIT market in the first quarter. At the start of 2005, many questioned whether REITs could continue their impressive run after back-to-back years of 30%-plus total returns. The outsized returns, which were mainly driven by capital flows chasing yield rather than underlying property market or operating fundamentals, pushed REIT pricing to lofty heights, which likely caused some investors to realize their gains and rotate out of the sector.

Although many investors and analysts cited high earnings multiples and premiums to net asset value among their worries, concerns about yield compression have weighed most heavily on the market this year. By the end of 2004, the average dividend yield for equity REITs had fallen below 4.7%, according to NAREIT, or about 50 basis points (bps) higher than the 10-year Treasury bond yield. While this was well within the historic range during the "modern" REIT era, it was about 80 bps below the average spread over the last 11 years (from January 1994 through December 2004).

Whether the yield spread should be narrower in the future than it has been historically is an interesting and, over the longer term, relevant question. Structural changes in the real estate industry and capital markets and a broader, more diversified capital base make a compelling case for narrower spreads, particularly in an environment of improving property market fundamentals and limited new supply. However, for the last few years REITs have been a yield play, and the

recent spread compression combined with growing concerns about REIT pricing and rising interest rates has caused REITs to trade in lock step with 10-year Treasury bonds. The yield spread widened somewhat in March. By the end of the first quarter, falling REIT share prices pushed the average dividend yield for the RMS to about 5.3%, or roughly 50 bps higher than its yield at the end of 2004. By comparison, the yield on the 10-year Treasury bond, 4.5% at the end of the first quarter, has risen about 25 bps.

Despite weak first-quarter performance, REITs continued to attract capital, albeit at a much slower pace than last year. According to AMG Data Services, more than \$1 billion flowed into dedicated real estate mutual funds through March 30, about one-third of the net capital inflows in first-quarter 2004. Although new capital flows from closed-end funds have slowed dramatically since last year, the expanding global REIT market has spawned several global funds that should continue to drive capital to the US market this year. The US REIT market represents about 50% of the total equity market capitalization of most global public real estate benchmarks, which means fund managers will maintain considerable exposure to the US market. Likewise, the inclusion of more US REITs in broader market indexes in the US and abroad should keep REITs on index fund managers' radar screens, which was not the case a few years ago.

The combination of higher interest rates and volatile REIT equity markets could make raising capital more difficult for REITs this year. REITs raised more than \$56 billion in 2004, surpassing the previous record of \$45 billion in 1997, when the REIT market was significantly smaller. Through first-quarter 2005, REIT capital offerings totaled about \$8.4 billion, roughly half of last year's first-quarter volume, according to SNL Securities. The slowdown this year may be due in part to the challenges REITs face deploying capital. Competition in the transaction market has made it harder for REITs to make accretive acquisitions, which has encouraged more companies to look for other ways to grow earnings and rebalance their portfolios. Overseas investments, property swaps and new business initiatives, ranging from merchant building to private funds management, have become more common in recent years.

While rising interest rates may diminish REITs' appeal to yield-oriented investors who are focused on their relative attractiveness versus fixed-income benchmarks, like the 10-year Treasury, REITs should remain attractive to equity investors. Investors still value yield and safety, and most REITs offer both. Even after the last two years of rising share prices, REIT dividend yields are much higher than the dividend yields on most stocks. The dividend yield for the S&P 500, for example, was about 1.6% as of year-end 2004, or more than 300 bps lower than the average REIT dividend yield. Further, improving property market fundamentals will make REIT dividends more secure and, eventually, should lead to dividend growth. Certain property sectors, like office, will take longer to recover. However, according to Prudential Equity Group, after two years of declining FFO in 2002 and 2003, REIT earnings growth turned positive last year and should accelerate to about 6.7% this year from 3.6% in 2004.

Nevertheless, the outlook for REITs over the remainder of 2005 remains challenging. As always, capital flows will determine REIT performance, and in the near term, we expect REITs will continue to track movements in 10-year Treasury bond prices. If long-term rates continue to rise, REITs will likely suffer further short-term declines as yield-oriented investors rotate out of

REITs. However, as REIT earnings growth becomes more visible and translates into the potential for increases in dividends, REITs should adjust to the upward shift in the yield curve and regain lost ground. This is particularly so as the stocks should become more attractive to equity investors, whose alternative investment opportunities seem relatively uninspiring. Hence, while the first-quarter returns for REITs fell short of our expectations at the start of the year, we still believe that total REIT returns could reach 8% to 10% for 2005.

Property Markets

As the activity in the debt markets through the first three months suggests, transaction volume in the property markets continued at a feverish pace in first-quarter 2005. Improving property market fundamentals and the threat of rising long-term interest rates created more incentive than usual for buyers and sellers to get deals done. According to Real Capital Analytics (RCA), transaction volume remained very robust in January, with nearly \$14 billion in sales completed. Although activity slowed somewhat in February to about \$9 billion, the pipeline of deals reportedly under contract and a surge in new offerings leave little doubt that transaction volume will remain healthy this year.

Renewed job growth has been the most important driver of both the recovery in the property markets and the increased transaction activity since the start of 2004. The labor markets achieved an important milestone in January when total non-farm employment finally surpassed the pre-recession peak of February 2001, before the economy stalled. With the additional job growth in February and March this year, the US economy has created more than three million jobs since May 2003, when employment reached bottom. Although jobs affect consumers and businesses, employment is a critical barometer of conditions in the corporate sector of the economy and, therefore, in the office and industrial property markets. Not surprisingly, transaction activity in both sectors increased sharply last year and in the first two months of this year, according to RCA, even though property fundamentals improved only modestly.

The severe recession in the corporate sector hit the office market hardest. After peaking at 17% in second-quarter 2003, the national office vacancy rate has slowly receded. According to Torto Wheaton Research (TWR), the office vacancy rate at year-end 2004 was 15.4%. Leasing activity in the first quarter should push the overall rate lower still. Suburban office markets showed the greatest improvement last year, if only because they had further to go. The suburban vacancy rate declined 200 bps to 16.6% in 2004, while CBD office vacancies improved modestly to 13.2% from 13.7%.

The slow pace of the recovery in the office markets thus far is partly due to the protracted job market recovery and partly to the considerable amount of shadow space – underutilized leased space that companies choose to hold rather than to offer for lease or sublease – in many of the office markets where vacancies soared. While it's virtually impossible to measure how much shadow space existed at the bottom of the office market cycle, anecdotal evidence suggests it is less of a problem today. The disappearance of shadow space, if true, might explain why absorption has not responded much to job growth yet and may portend an acceleration in absorption over the rest of this year.

The balance of power in the office space markets appears to be shifting back toward landlords. Over the last 12 months, more tenants have seized the opportunity to trade up to better quality space or to “blend and extend” their leases – i.e., negotiate new leases with rents at or slightly above current market rates, but below their existing contract rates, in exchange for extending their leases beyond the current term. Investors seem to share tenants’ sentiment that the turnaround in the office market is at hand or will be soon. RCA reports office transaction volumes increased 57% in 2004, including a 67% jump in suburban sales and a 47% increase in CBD volume. Although RCA’s transaction data shows that average office cap rates declined the most among the major property types last year, unlike other sectors, unit prices increased only modestly, which suggests that lower income explains much of the recent downward trend in office cap rates.

Nevertheless, competition for office assets is fierce, and buyers have become more aggressive to win deals. Multiple full-price bids, large non-refundable deposits and shorter, if any, due-diligence periods have become common for major assets in the strongest office markets over the last 12 to 18 months, while debt financing has become a secondary concern to be addressed once deals are won. Clearly, this type of behavior presents risks for equity investors as well as lenders, and raises questions about liability should something go wrong, particularly when the loans financing such deals find their way into securitizations.

The outlook for the office market is generally positive, as long as the job market recovery continues to advance at a healthy pace. Investors still face rent roll-down risks for existing leases signed at the peak of the market, when rents in some markets were significantly higher than today. But new office supply remains subdued in most markets, and the long lead-times for office development should provide an opportunity for a rebound in rents before the supply pipeline can respond to increasing demand. However, as we’ve noted before, new development could resume much more quickly than in the past. An increasing number of markets now have relatively few large blocks of office space available, and although speculative office development does not appear to have resumed yet, capital is available and eager to finance new development for build-to-suit projects – and not just for office projects.

Although demand for warehouse space does not depend on job growth per se, the recovery in the corporate sector directly affects the industrial market. Through February, industrial production had increased at a seasonally adjusted annual rate of more than 3% for 12 consecutive months as advanced durable goods orders (for non-defense capital goods, excluding aircraft) continued to climb after reaching a six-year low in March 2002. Although new orders fell slightly in February, January’s reading nearly matched the pre-recession peak level in June 2000. The recovery in the industrial sector has helped pushed inventories to their highest level since August 2002. Inventories have been growing for 12 months as businesses continue to rebuild in anticipation of stronger demand. This is welcome news, obviously, for warehouse demand, and reverses the 31-month downward trend that began after inventories peaked in March 2003.

As in the office sector, the improving outlook for industrial demand and generally higher yields attracted more investor capital in 2004. According to RCA, industrial transaction volume increased 42% last year and remained very strong through the first two months of 2005.

However, unlike the office sector, average unit prices for industrial properties increased sharply last year amid intense competition for assets.

While the industrial market undoubtedly offers attractive investment opportunities, the risk that investment results will fall short of expectations seems relatively high. Despite increasing demand for warehouse space, industrial vacancy rates improved only modestly last year and remain well above their long-term average levels. Warehouse vacancies declined to 11.6% at year-end 2004 from 12.3% at the beginning of the year, according to TWR. Excess space and continued new supply, mostly build-to-suit projects, have kept downward pressure on rents, which TWR reports declined for a fourth year in 2004. As always, the short construction lead times in the warehouse sector limit the opportunities for rent growth except in supply-constrained markets.

Investor demand for apartment properties also remains very high, despite the sector's uniquely challenging dynamics. Apartment sales volume increased 63% in 2004, according to RCA, the biggest year-over-year gain among the major property types. Transaction activity continued at a brisk pace in January 2005 before slowing somewhat in February. Condo converters have been a major factor in the multifamily transaction market in recent years, along with the swelling ranks of TIC (tenants-in-common) buyers. RCA reports that condo converters accounted for 22% of total apartment sales (by dollar volume) in 2004, and 45% of total volume in January 2005. Because cap rates are essentially meaningless to condo converters, and timing, from the initial acquisition to the sale of the units, is critical, condo converters often are willing to pay a premium to complete transactions quickly.

As housing prices soar, comparisons between the housing market today and the dot-com bubble during the late '90s tech bull market grow more frequent by the week. Although condo fever is more of a coastal phenomenon than a national epidemic and is more bubble-like in some markets than others, the warning signs are getting harder to ignore. Among the troubling parallels between today's housing market and the tech market a few years ago, a recent article in *The New York Times* cited "day-trading" – i.e., houses being sold twice in one day – in Naples, Fla., and lavish parties for potential condo buyers hosted by developers.

The potential fallout from a meltdown in the condo market is unquestionably one of the biggest risks facing the real estate industry. While we believe the excesses are fairly concentrated within a few markets, the effects of a shock would reverberate throughout the industry. Most obviously, apartment property values likely would suffer as cap rates rise. This would not only affect apartment property owners, but it could disrupt the multifamily debt markets, particularly since Fannie Mae and Freddie Mac are in a much weaker position today. Apartment loans account for a disproportionate share of the loans that have fallen below break-even debt service coverage ratios in recent years but have been bailed out by the strong equity markets. If a condo bubble develops (or already exists) and bursts as interest rates rise, loan delinquencies could increase sharply, and liquidity in the debt markets could dry up very quickly, at least until lenders can assess the impact of falling property values.

Overall, the outlook for the apartment market is mixed, which is somewhat surprising given its challenges. Excess housing supply and increasing operating costs, particularly for property taxes, utilities and insurance, will continue to make the operating environment difficult for apartment owners over the next year or so. However, while the national apartment vacancy rate remains stubbornly high, the job recovery is already creating new demand for apartments in markets like Las Vegas, Phoenix and Orlando, where employment growth has been strongest. Household formation has also accelerated since mid-2004, and higher interest rates should help tilt the rent versus own decision more strongly in favor of renting. Falling apartment rents and home price appreciation have already shifted the advantage to renting in many markets, and as mortgage rates rise, the gap should widen further.

A slowdown in the condo market could also have some positive effects on the apartment market, or certain segments of it. While condo units can compete with rental units for potential tenants if owners decide not to occupy their units, renting condos typically is more expensive and more cumbersome for tenants and unit owners, who often must get approval from the condo association before leasing their units. In the near term, a slowdown in the condo market could create demand for rental apartments and provide an opportunity for apartment owners to raise rents and reduce concessions. This may not be the case for lower-quality apartments or properties in secondary markets or locations, which, incidentally, face greater risks if cap rates revert to their historic mean. However, for quality, class-A apartments, which have suffered significant rent declines in recent years, even a modest recovery in demand could have a meaningful impact on property income. Additionally, new supply could slow dramatically if the condo market loses steam, which would have obvious long-term benefits for the apartment market.

As the last few years have shown, retail real estate is relatively disconnected from the corporate economy. Although the retail sector has continued to perform extremely well – vacancy rates remain stable, and rents continue to trend upward – retail transaction volumes increased a modest 30% last year, according to RCA, as investors shifted strategies to take advantage of the recovery in the corporate sector. Sales activity slowed in the first two months of 2005, though this was more likely a result of the timing of transactions than a slowdown in investor demand. While the job market recovery bodes well for continued consumer spending, the retail sector is the most interest-rate-sensitive of the major property types. Consumers have taken on considerable debt in recent years, and the spike in gas prices may have contributed to declining consumer confidence in the latest surveys.

Retail real estate faces interesting challenges in the next few years due to the shifting landscape of retailers. Several major M&A transactions involving retailers have been announced within the last 12 months that highlight retailing's intensely competitive nature. The recently completed Kmart-Sears merger, which was announced last year, likely will affect malls and strip centers. The combined entity will restructure and close underperforming stores to compete more effectively with Wal-Mart, Target and others that have been eroding both retailers' sales for years. Likewise, the \$11 billion merger announced at the end of February between department store rivals Federated, which owns Macy's and Bloomingdale's, and May, which owns Lord &

Taylor and Marshall Fields, continues the consolidation trend among department store anchors that has presented opportunities for some mall owners and risks for others.

The most recent deal, the acquisition of Toys “R” Us by a group of investors that included Vornado, a diversified REIT, shows the increasing appreciation for the value of the real estate that is either owned or controlled by retailers. Although this aspect of the deal is not unique to the Toys “R” Us transaction, speculation surrounding the deal, in the months leading up to it and in the weeks since it was announced, focused at least as much on the value of the underlying real estate as on the value of the business itself.

Although retail real estate should continue to perform well over the next few years, assuming new supply remains in check and consumers keep consuming, the risks and opportunities will differ across the various segments. In the near-term, the risks seem to have grown in the grocery-anchored neighborhood segment. Much of the recent M&A activity in the retail business, including the Toys “R” Us transaction, is a reaction to the increasing competitive threat of discount retailers and Wal-Mart in particular. Nowhere is this more apparent than in the grocery sector, where weaker players like Winn-Dixie, which filed for bankruptcy in February, continue to struggle. Standard & Poor’s recently placed Albertson’s, Kroger and Safeway on their CreditWatch list, with negative implications, due to competitive pressures in the grocery business and labor struggles that have affected all three.

Grocery-anchored centers are the most bond-like of retail assets because they typically derive most of their income from long-term leases to the grocery anchor. The combination of rising interest rates and continued expansion by Wal-Mart and Target into the grocery segment underscore the importance of owning centers anchored by grocers that are the dominant player in their local market or that do not compete directly with the supercenters (e.g., Whole Foods, Trader Joe’s, etc.). At the other end of the spectrum, lifestyle centers continue to offer opportunities to tap into underserved markets with attractive demographics but constrained new supply. In fact, one of the most common features of most lifestyle centers, a substantial restaurant component, takes advantage of the recent trend toward dining out that has adversely affected the grocery business.

The recovery in the lodging sector should continue to gain momentum this year as the economy expands. Although the industry still has not fully recovered to the peak occupancy and income levels of 2000, all performance measures have improved dramatically in the last 12 months. New supply slowed to its lowest level in more than a decade last year and should remain extremely low in 2005. In fact, in a handful of markets, such as New York City, condo converters may be removing hotel rooms from inventory faster than new supply can keep up. So far this year, Smith Travel Research reports that year-to-date revenue per available room (RevPAR) through February increased 7.7%. Importantly, most of the RevPAR gains have come from increasing room rates rather than improving occupancy, which suggests hotel operators are regaining pricing power. Year-to-date, average daily rates (ADR) increased 4.2% versus last February, while occupancy increased 3.9%. Business travel has continued to strengthen this year, and the weak dollar continues to make US destinations attractive for US and non-US travelers.

The biggest risks in the lodging sector, as usual, are random shocks – e.g., another terrorist attack, a sudden economic slowdown or an event like SARS, which cause businesses and individuals to curtail or postpone non-essential travel. Although these types of risks can have severe consequences for investors, the fundamentals in the hotel sector are very favorable. Limited new supply combined with improving occupancy rates across all segments of the industry should produce exceptional operating results again this year. Although valuation multiples based on trailing earnings make hotel properties seem pricey, hotels remain one of the few property types where investors can still buy at below-replacement cost, which likely helps explain the recent interest from condo converters.

Through first-quarter 2005, the trends in the economy and real estate markets continue to support our favorable outlook for private real estate investment this year. Although rising interest rates and the potential fallout from the overheated condo market could adversely affect liquidity in the real estate markets, the chances of a liquidity crisis seem remote. Rather, the abundance of equity and debt capital competing for real estate deals probably poses a greater risk for investors. Private real estate investment performance, as measured by the NCREIF Property Index, exceeded our expectations last year, with total returns of about 14.5%. While we expect returns will moderate this year, we still believe total returns will be 10% to 12% for the year.

Summary

With the US economy continuing to expand and add jobs, the outlook for the US real estate market remains favorable. Although certain features of the current environment feel a bit like the late 1980s, this hardly seems like the time for investors to panic. The real estate market truly is different today, cyclically and structurally, than it was 15 years ago. Unlike the late '80s, when excess liquidity chased asset prices to unsustainable heights despite widespread evidence that the property market cycle had peaked, the US real estate market is recovering, and new supply remains subdued, at least for now. The structural changes in the real estate capital markets also provide some downside protection should an external shock disrupt the economy and property market recovery. As the last few years have shown, the real estate capital markets are more closely linked with the broader capital markets. If some event triggered a flight to safety, similar to what occurred in 2001, the stable and secure yields and tangible quality of the underlying assets should still be relatively attractive versus other asset classes.

That said, the favorable outlook for the US real estate market is not without risks. Rising interest rates, the condo market, potential new supply and deteriorating underwriting standards and due diligence all represent risks that could derail the property market recovery and adversely affect investment performance. While we do not expect a sudden correction in asset pricing or investment performance, if long-term interest rates rise, we would not be surprised if the differentiation that once existed by market and asset quality re-emerges.

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