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Revisiting the Case for Commercial Real Estate

Research

Philip Conner
Principal
U.S. Office
Tel. 973.734.1339
philip.conner@prudential.com

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

Tel 973.683.1745
Fax 973.734.1319
Web www.prei.com

Executive Summary

- Commercial real estate presents a compelling opportunity in today's market, albeit not entirely without risk. Property values are far below the peaks of late 2007/early 2008, reducing the potential downside.
- Operating performance at commercial properties is likely to remain weak for another year or so. However, with renewed job growth, space market fundamentals should improve steadily in coming years.
- The commercial real estate industry still must solve the massive financing gap problem caused by the overleveraging in the last property cycle. While the sector has attractive long-term potential, it will take some years to resolve all the distress.
- Commercial real estate's fundamental investment characteristics – high cash yields, low correlations with stocks and bonds and a hedge against inflation – should appeal to investors seeking stable current yield and some protection against unexpected inflation.

The fallout from the credit market crisis and severe global recession in late 2008 and early 2009 has taken a heavy toll on commercial real estate. Property values have plunged as risk and capital have re-priced, while vacancies have soared as tenant demand has contracted. For properties that were acquired or refinanced with high leverage during the peak of the market cycle, the decline in property values has wiped out most or all of the equity that was invested. Even assets that have equity remaining will face challenges at refinancing due to the deterioration in property income and more conservative underwriting by banks.

Yet, despite real near-term challenges – and in some ways because of them – there is a compelling case for private real estate in a diversified portfolio today. The economy is adding jobs again, and most major asset classes are up sharply from the lows during the crisis. Real estate values and tenant demand will follow, and the only questions relate to the timing and strength of the recovery. This report looks at the arguments for investing in commercial real estate today, along with some of the risks and challenges investors will likely face over the next few years. Although the risks and challenges of executing an investment program in the current environment are real, the dramatic correction in commercial property values since the market peak in late 2007 provides an attractive entry point for long-term investors seeking exposure to the asset class.

Traditional Arguments Still Valid

The sharp correction in commercial property values since 2007 has been painful and surprising in terms of both magnitude and speed. But it did not invalidate the fundamental arguments for real estate in a diversified portfolio. By definition, the strategic case for including any asset class in a portfolio should derive from enduring characteristics that change relatively little over time regardless of market conditions. Historically, the principal arguments for including "core" real estate (i.e., fully-leased, income-producing properties with little or no leverage) have included the following:

- *Market Portfolio.* Commercial real estate comprises a large share of the investment universe in the U.S. and globally. For investors seeking to replicate the "market portfolio," the strategic allocation to real estate should range from 5% to 15%.[1]
- *Diversification.* With its low correlations to other asset classes such as stocks and bonds, private real estate is a proven diversifier in a mixed-asset portfolio.
- *High Yield.* Commercial property investments provide investors with stable, bond-like income from contractual leases, a characteristic that is particularly important to investors such as retirees who rely on current cash yield to meet expenses.
- *Attractive Long-term Performance.* Private real estate has exhibited significantly lower volatility and competitive absolute and risk-adjusted returns compared with bonds and stocks.
- *Potential Inflation Hedge.* As a "real" asset with cash flows that, in most cases, are marked to market periodically, commercial real estate may provide a hedge against high inflation.

For all the turmoil in the investment markets over the past few years, the traditional arguments for real estate are as valid today as ever. The correction in property values and sharp bounce back in other asset classes has had a noticeable impact on historical returns, but real estate's long-term performance is still competitive with stocks and bonds on an absolute and risk-adjusted basis; and property yields are attractive, especially when compared with other fixed-income instruments. True, real estate did not provide much downside protection during the financial and economic turmoil of the past two years. However, the sharp re-pricing that took place across all asset classes was largely due to market (or systematic) risk, which is not diversifiable. The global flight to safety that accompanied and exacerbated the meltdown in the financial markets and economy caused correlations between all risky asset classes to spike. While the recent crisis was an extreme case, the immediate re-pricing of risk, which produced the spike in correlations, was typical of a severe market shock.

It may well be that private real estate performance will become more highly correlated with the economy and the broader capital markets than it has been in the past. Transparency has improved significantly since the early 1990s downturn, and the real estate capital markets are much more integrated into the broader capital markets than ever before. Clearly, the speed with which asset values have corrected over the past two years strongly suggests a more responsive valuation cycle. But over the longer term, correlations will still be imperfect. The real estate cycle lags the broader economy for good reasons. Supply and demand understandably respond relatively slowly to changes in the economy and financial markets; transactions typically take months to consummate, during which time the terms of a deal can change; and private market valuations rely heavily on transaction activity to reflect pricing adjustments, which creates a lag

[1] At year-end 2009, PREI estimates that commercial real estate's share of the $49.8 trillion U.S. investable universe, including stocks, bonds and alternative investments, was approximately 13%.

even under normal conditions. Critics often cite the appraisal-based valuation process of the private markets as a deficiency of the asset class relative to more efficient pricing of the public markets. However, when the Dow Jones Index can shed nearly 10% of its value, or roughly $1 trillion, during the course of a day, there is something reassuring about the inherently long-term perspective of appraisal methodology.

Cyclical Case

The case for investing in commercial real estate over the next 12 to 24 months looks particularly attractive when viewed in the context of the current market environment, although it is not without risk. Perhaps the most obvious reasons why commercial real estate merits a closer look today are cyclical. Real estate performance has always been a function of capital and space market forces. Although the two are sometimes aligned, in a positive or negative direction, they often diverge and can remain disconnected for surprisingly long periods. For instance, after the tech market crash in 2000 and the brief but deep corporate recession that followed, favorable capital market forces helped support and ultimately drive up property prices in the face of steadily deteriorating space market fundamentals. Today, however, after two years of capital market turmoil and contracting tenant demand, the real estate capital and space market cycles both are at or near the bottom of a deep trough and should be moving together in a positive direction.

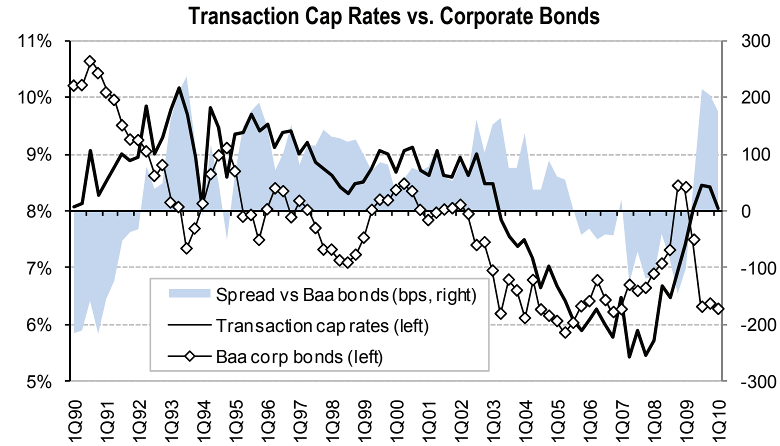
Capital Markets Recovering

The capital markets still have far to go before conditions return to “normal.” The capacity of the debt markets remains constrained, especially in financing assets that do not fall in lenders’ “sweet spot” – namely, core assets in prime markets with credit-quality tenants and solid sponsors. But for properties with cash flow, the cost and availability of equity and debt have improved significantly over the past six to nine months. U.S. REITs have raised a tremendous amount of capital through equity and unsecured bond offerings, and can mobilize large sums of capital on very short notice; many traditional lenders are active again; new sources of capital are beginning to emerge; and even the shuttered CMBS market is stirring to life.

Part of the reason for the improvement has been the ongoing rally in the bond market, which has created an attractive spread between property yields (i.e., cap rates) and bond yields. Cap rates remain below the peak levels seen during the mid-1990s, when the asset class was out of favor with investors and both inflation and benchmark interest rates were much higher than today. However, the spread between cap rates and bond yields has widened dramatically over the past year. Transaction capitalization rates for institutional-quality properties averaged about 175 bps higher than corporate bond yields during the first quarter of 2010.[2] That is below the all-time gap of 237 bps in 1993, but is well above the long-term average. Since 1982, Baa corporate bond yields have averaged 59 bps more than NCREIF transaction cap rates.

[2] Institutional cap rates refer to average transaction yields for properties in the National Council of Real Estate Investment Fiduciaries (NCREIF) property database of institutionally-owned, income-producing, unleveraged “core” properties. Corporate bond yields refer to Baa corporate bonds, as rated by Moody’s.

Yield Spreads Are Near Record Levels

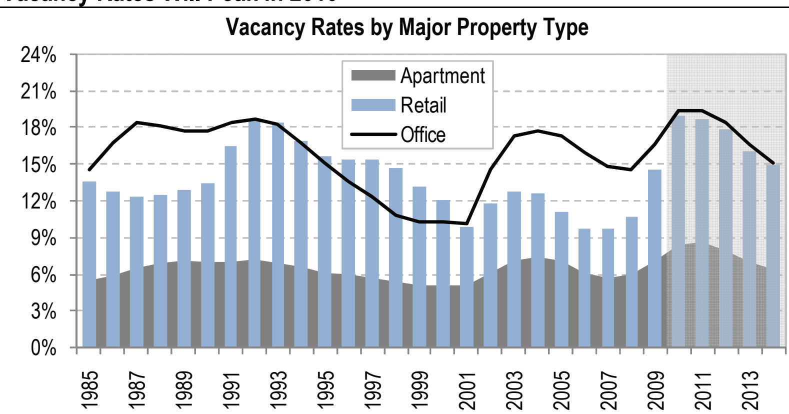


National Council of Real Estate Investment Fiduciaries (NCREIF); Moody's Investors Service; PREI Research

Space Market Cycle Bottoming

The other reason capital market conditions have improved, and a key reason why private real estate is attractive today, is greater visibility and confidence in the outlook for tenant demand and property cash flows. Market fundamentals still vary widely by location and property type, but the space market cycle is clearly reaching bottom. Generally speaking, vacancies are peaking and asking rents are near the low point for this cycle. Indeed, there are increasing signs that sectors with shorter duration leases, such as apartments, self-storage and hotels, already are seeing some improvement in demand now that the economy is creating jobs again. Operating performance of many commercial properties may deteriorate further over the next year or so as leases are renewed at lower market rents. But if employment has reached bottom, tenant demand should be stabilizing as companies look forward to adding employees to meet growing demand for goods and services.

Vacancy Rates Will Peak in 2010

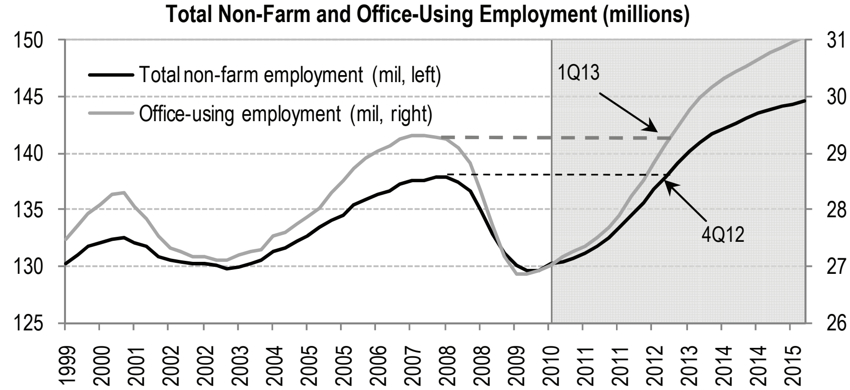


Property & Portfolio Research (PPR); PREI Research

Productivity gains so far have allowed businesses to increase output without adding full-time workers, which has led to a surge in corporate profits. However, recent evidence from the economy and labor market suggests that companies are investing and hiring again. In the first four months of 2010, the U.S. economy created more than 570,000 jobs, according to the Bureau of Labor Statistics' establishment survey. But that may understate the recovery. The BLS household survey, which tends to be more volatile and is used primarily to measure unemployment, shows year-to-date gains of more than 1.6 million jobs. Sources of job growth are never obvious in the early stages of an economic recovery. But after the deep cuts in capacity in late 2008 and early 2009 amid fears of a global depression, even modest economic growth will create jobs. Recent forecasts from Moody's Economy.com show a broad-based employment recovery with job growth accelerating in 2011 and 2012, and total employment returning to its December 2007 peak by early 2013.

Jobless Phase of the Recovery Is Ending

Total Non-Farm and Office-Using Employment (millions)

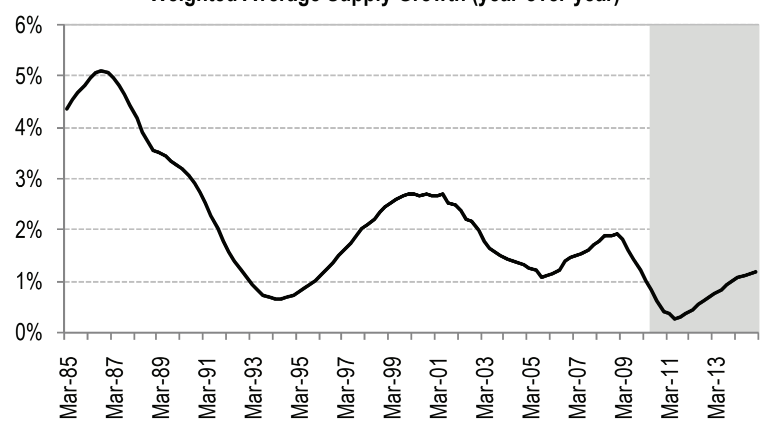


Moody's Economy.com (Bureau of Labor Statistics); PREI Research

Although the industry as a whole will continue to struggle with excess capacity in the near term, demand will outpace supply growth in most property types for several years. The recent downturn has severely disrupted the supply cycle. With few projects in the pipeline, little appetite among lenders for construction loans and the long construction lead times required to develop most major property types, new development is not likely to resume for at least two or three years. Multifamily and warehouse development could resume sooner, but supply growth overall will remain very subdued at least until rents begin to move materially higher. Replacement costs are notoriously difficult to pin down. However, in a global economy led by strong growth in emerging markets such as China and India, it is not hard to envision a scenario in which commodity prices for construction materials rise at least as fast as property values.

Downturn Has Severely Disrupted the Supply Pipeline

Weighted Average Supply Growth (year-over-year)



Supply growth is based on weightings of 40% office, 20% retail, 20% apartment, 15% warehouse and 5% hotel

PPR; PREI Research

In markets and property types where demand growth outpaces supply for an extended period, the recovery in occupancies and rents could surprise on the upside. Unlike the early 1990s, the oversupply in the current cycle has been due largely to a collapse in demand rather than a speculative building boom. In the short run, vacancy is vacancy, regardless of whether demand or supply is to blame. Yet the fact that rising vacancies in this cycle generally were not caused by overbuilding has important implications.

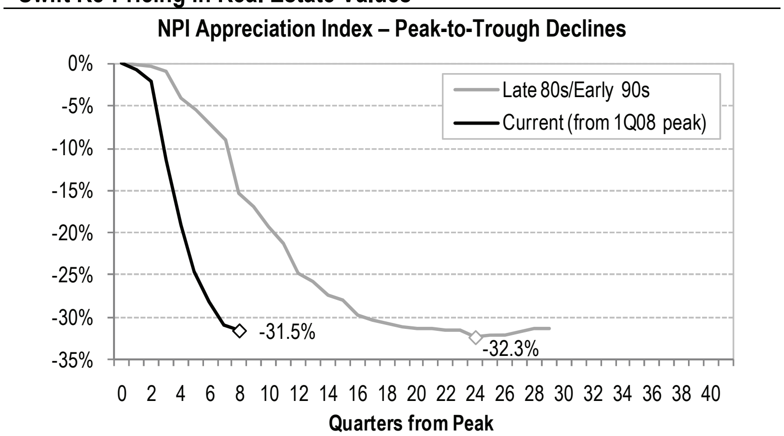
First, it helps explain why the number of distressed transactions has not been higher. In the 1990s recession, city skylines across the country were dotted with empty "see-through" buildings, many of which eventually traded at a fraction of what it cost to build them. Today, in virtually every major U.S. market, the majority of assets have some cash flow, even if it has declined from the peak. It certainly helps that most loans originated during the boom years carry low interest rates. More importantly, regulators have encouraged lenders to work with borrowers to avoid foreclosures, which is another stark contrast between today and the 1990s. But loan extensions and modifications only work with assets that are generating income, which is why distress is most acute among non-cash flowing assets – land loans, broken condo developments and in the lodging sector, where property income turned down quickly and sharply with the economy.

Second, as tenant demand recovers, the differences between supply-induced and demand-induced vacancy will become more apparent. The prospect of absorbing space that was well-occupied before the 2008 recession is far less daunting – and probably much less expensive in terms of capital expenditures – than having to absorb huge slugs of space that have never been occupied. Clearly, absorption will take time. But with relatively few assets acquired at distressed prices competing for tenants and little supply in the pipeline, rent growth could be stronger and longer-lasting than current forecasts indicate.

Favorable Risk-Return Tradeoff

With the capital and space market cycles both near trough levels, there would appear to be less downside risk for property values. Most measures of commercial real estate prices and anecdotal evidence indicate that property values probably fell by 30% to 40% from the market peak in late 2007 or early 2008 to a trough in the first half of 2009. Although some indices have shown modest gains recently, transaction activity is too thin and deal-specific to generalize broadly about values except to say that they are well below their peak. Property values in the current cycle have corrected much faster than in previous cycles.

Swift Re-Pricing in Real Estate Values

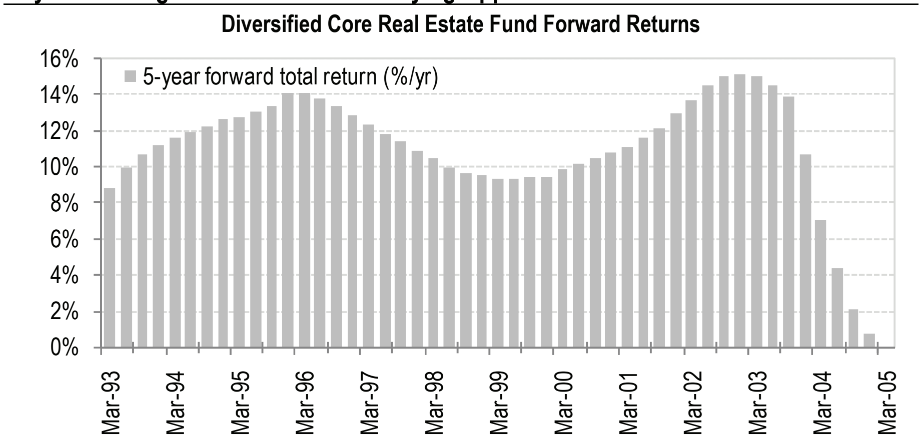


NCREIF; PREI Research

In the early 1990s market crash it took six full years for values, as measured by the NCREIF Property Index (NPI), to reach bottom at about 32% below the peak. Although the recent decline in the NPI nearly matches the drop in the 1990s, the industry has been much quicker to write down asset values. In just two years since peaking in 1Q08, the NPI has declined nearly 32%.

What makes investing in real estate at the bottom of the cycle attractive is not much different from in the stock market. Investors can acquire assets at relatively low multiples (i.e., high cap rates) based on depressed earnings, and capture gains from both the improvement in income and the higher multiples (i.e., lower cap rates) investors assign to that income. Looking back again to the early 1990s downturn, private "core" real estate funds, as measured by the NCREIF ODCE Index, posted healthy 5-year forward total returns beginning several quarters before property values reached bottom.[3] For example, over the five years from 4Q94, a full year before the NPI appreciation index finally reached bottom, the ODCE Index delivered a compound annual total return of about 12.7% per year. And for the five-year period from the bottom of the valuation cycle in 4Q95, when the appreciation index recorded its lowest level, through 4Q00, the ODCE Index gained more than 14% per year.

Cyclical Troughs Create Attractive Buying Opportunities



NCREIF; PREI Research

With today's prices far below the high-water mark in late-2007/early-2008 and the economic recovery gaining momentum, long-term investors should find attractive opportunities to add or increase exposure to commercial real estate before property values reflect the improvements already taking hold in the broader economy and other major asset classes. However, given the speed with which property values adjusted on the downside and apparent lack of urgency on the part of lenders to foreclose and liquidate overleveraged assets, the window of opportunity may not open as wide or remain open as long as in previous downturns.

[3] The NCREIF ODCE Index is a composite of a group of open-end diversified core equity real estate funds invested on behalf of institutional investors in U.S. commercial real estate.

Non-cyclical Factors

Perhaps the most compelling arguments for investing in commercial real estate today derive from non-cyclical factors – specifically, the favorable long-term outlook for real estate demand, from both users and investors, and real estate's potential inflation hedging characteristics. Occupier demand for real estate ultimately depends on two basic and closely related variables: economic activity and demographics. Although economies go through periods of expansion and contraction, the long-term path clearly is toward growth, especially with emerging markets such as China and India now fully engaged in the global economy. Similarly, while the populations of a few developed countries, most notably Japan, will begin to shrink over the next decade or two, most countries will experience growth for the foreseeable future.[4]

Together, economic and population growth create demand for all types of real estate, from basic housing in emerging markets to luxury hotels in developed and developing countries alike. The opportunities for investors to participate in the value creation and cash flows that come from this growth can take many forms, ranging from relatively low risk "core" investments in income-producing assets to high risk speculative development projects. Investors must obviously be aware of the capital and space market cycles that determine investment performance as well as the local and regional market dynamics that can affect relative performance. But the long-term growth trajectory of the global economy and world population will underpin tenant demand, particularly in urban areas.

Demographic trends will also create demand from investors for property and property-related products. The world's population is not just expanding, it is aging. Many developed countries, including the U.S., are projected to see a meaningful rise in the number of elderly individuals in coming decades, which should create an ample supply of capital for investments that offer stable cash yields and, ideally, protection against capital loss. Over the long term, income-producing property, including multifamily housing, is an excellent source of current yield because it provides a way for investors to tap directly into the economy's cash flows. And because commercial property leases tend to be fairly long-term contracts, cash flows for most property types generally are stable and predictable.

Whether real estate provides a hedge against inflation is less clear. The "real" nature and income characteristics of commercial property make a strong intuitive case for real estate as an inflation hedge. Property owners benefit not only from rising asset values, which over the long term tend to track increases in replacement costs, but also from increasing rents. Unlike bonds, which typically pay a fixed coupon, property cash flows generally offer some protection against inflation, since most commercial leases contain rent escalation clauses and/or pass expense increases through to tenants. However, most studies of the link between inflation and real estate performance have been less conclusive than intuition might suggest.

Part of the problem stems from the fact that there is relatively little performance data for private real estate during periods of high inflation. The U.S. economy and most developed countries have not experienced sustained high inflation since the 1970s, before the inception of the NCREIF Property Index (NPI) in 1978.

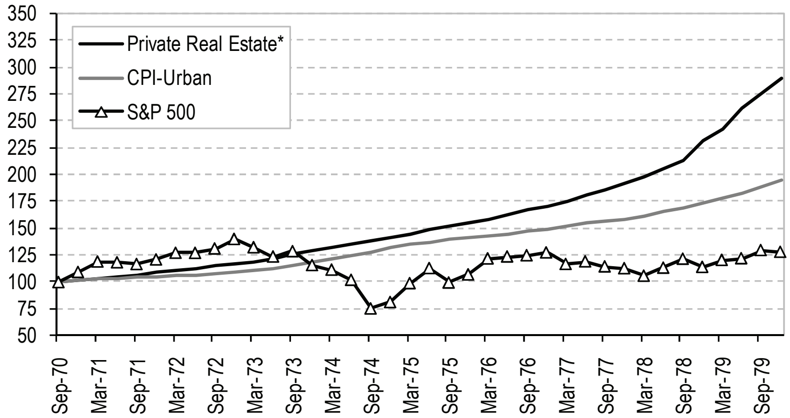
Although the data is admittedly imperfect due to the relatively small sample size, the chart below compares the price performance data for a Prudential-managed core real estate fund, which was launched in 1970 and was one of the original data contributors to the NCREIF Property Index, with one measure of inflation

[4] In the U.S., for example, population growth averages a little less than 1% per year, or about three million people annually. To put this figure into perspective, that's roughly equivalent to creating a city the size of Chicago each year.

and the S&P 500 stock index. Despite its limitations, the data strongly suggest that commercial real estate provided an effective hedge against inflation during the 1970s, easily outperforming the S&P 500 and CPI. From 3Q70 through 4Q79, private real estate delivered a compound annual appreciation return of 12.2% per year, or about 470 bps over inflation, while the S&P 500 price index gained just 2.7% per year.

Commercial Real Estate Offers a Potential Hedge Against Inflation

Private Real Estate and S&P 500 Appreciation vs. Inflation (Sept 1970 = 100)



* Private real estate reflects the performance history of a Prudential-managed core real estate fund.

Moody's Economy.com (Bureau of Labor Statistics); Bloomberg; PREI Research

Real estate's inflation-hedging characteristics have not been an important factor over the past three decades, but that could change in the years ahead if inflation expectations turn higher. Although inflationary pressures today are quite modest globally and are not expected to become worrisome until some of the excess capacity has been wrung out of the economy, it is impossible to ignore the massive liquidity that has been pumped into the global financial system over the past two years. Economic theory would suggest that at some point huge increases in the supply of money will lead to higher inflation and, accordingly, higher interest rates. Investors have few options that have a proven track record in hedging against inflation. The menu includes commodities and precious metals, which typically do not pay cash dividends, and inflation-linked bonds such as Treasury Inflation-Protected Securities, or TIPS. After the sharp rise in commodities and gold prices over the past year and with TIPS trading at yields below 2%, real estate could attract capital from a broader investor base seeking protection from inflation risks.

Challenges and Risks

The biggest risk facing the commercial real estate industry today is the financing gap that exists for the sizable inventory of overleveraged assets that were acquired or refinanced during the run-up to the market peak in late 2007. Estimates of the aggregate size of the "financing gap" have been shrinking from the initial projections, but the amount of capital that will be needed to re-capitalize these assets is still massive.

Exactly how the financing gap gets resolved is not yet clear; but this is not the first time the industry needed to raise a huge amount of capital from constrained capital markets. The real estate crash in the 1990s served as a catalyst for the rapid growth of the public real estate sector and the CMBS market. This time around, the industry already has the tools it needs to recapitalize. Although the CMBS model is badly broken and pieces of the old infrastructure have been dismantled, REITs have demonstrated their ability to raise capital under even the most challenging conditions. If history is any guide, CMBS will also come back once investors have confidence in the structure and in their ability to underwrite risk. Getting there will require simpler and more transparent structures with a clear alignment of interests between originators, investors and servicers.

The other major risk that cannot be discounted is the uncertain outlook for interest rates. The U.S. Federal Reserve has been very clear about its intention to hold benchmark interest rates effectively at or near zero for the near term. But interest rates can only go up, and if they increase too quickly before the space market recovery gains some momentum, commercial real estate values could face renewed downward pressure. Interest rate risk must always be viewed in context of its potential impact on other asset classes, however, and neither bonds nor stocks will be spared from some adverse effects when rates increase. Assuming economic growth is the main catalyst for higher interest rates in the future, stocks and real estate would be expected to fare better than bonds due to higher growth in earnings and the demand created by the expanding economy.

Lastly, although it may not qualify as a "risk" per se, investors face serious challenges deploying capital today. Transaction activity remains depressed across the board, but the volume of distressed deals in the direct market is a tiny fraction of the amount of distress known or believed to exist in the U.S. alone. Much of the distressed activity to date has involved trading paper – particularly investors buying discounted positions in the debt capital stack, from senior debt to mezzanine. Deploying capital may get easier as more troubled assets come to market, but the more complex capital structures that became commonplace during the height of the boom will make it far more difficult to acquire properties directly than was the case following the 90s market crash.

Closing Thoughts

The financial market crisis that began in 2007 and spiraled into a severe global recession destroyed a tremendous amount of wealth across all asset classes, including commercial real estate. Looking back, there are many lessons to be learned about issues such as pricing and leverage, but it also remains clear that most traditional strategies continue to be valid for long-term investors. Commercial real estate continues to provide diversification, relatively high income yields and a potential hedge against inflation. Clearly, the commercial real estate industry faces challenges over the next couple of years. But the worst appears to be over as far as the cost and availability of capital and the contraction in demand are concerned, which means that property values are at or near the low point for this extreme cycle. Capital, both equity and debt, is returning, and the demand cycle is nearing the bottom, which greatly reduces the downside risk for investors putting capital to work today.

Ultimately, whether commercial real estate is viewed as attractive today depends on one's view of the appropriate risk premium for the asset class. Many argued during the boom years that the structural changes in the real estate capital markets and improvements in transparency since the early 1990s warranted a lower risk premium. That cap rates for core real estate appear to be peaking at lower levels than many expected speaks to the acceptance that private real estate has achieved with investors since the early 1990s downturn. But it also supports the positive longer-term outlook for the asset class as a source of stable cash flows and inflationary capital appreciation.

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

Tel 973.683.1745
Fax 973.734.1319
Web www.prei.com
E-mail prei.reports@prudential.com