



US Quarterly Outlook

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Executive Summary

Macro Themes

- US economic growth looks to be stronger heading into 2012, as some of the early-year headwinds – including high commodity prices and automotive supply chain disruptions – have dissipated. However, weak job and income growth, ongoing household deleveraging, and the tight fiscal posture of many state and local governments will likely keep the growth rate subpar through 2012.
- The weak growth environment makes the US economy susceptible to event shocks. Adverse financial market conditions and increased volatility stemming from the European sovereign debt crisis creates substantial downside risks to the economy.
- Financial market volatility and economic uncertainty have put pressure on real estate fundamentals and created a strong demand for stable, secure cash flows.
- Demand for space is uneven across property types – strong for apartments and hotels, weaker for most everything else.
- With the exception of apartments, new construction will be very limited and should remain so for 2-3 years.

Implications & Outlook for Commercial Real Estate

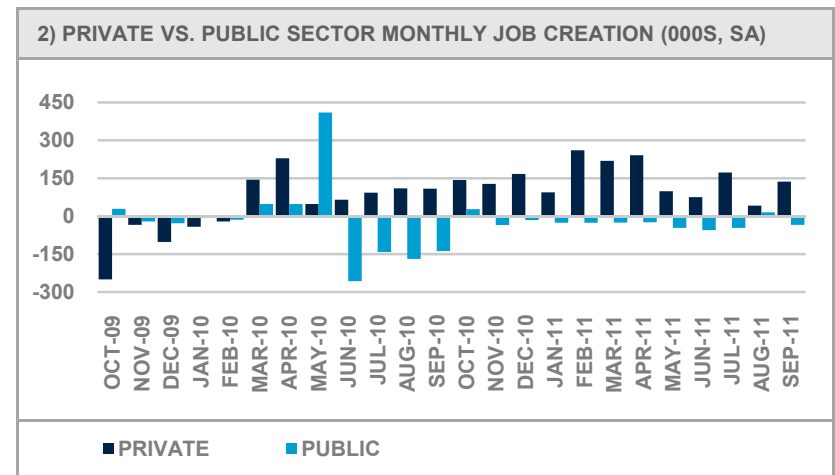
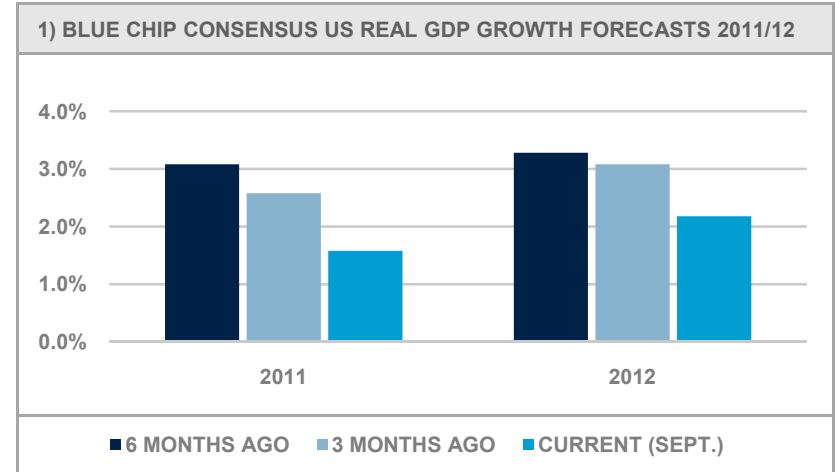
- Projections for a strong recovery in commercial real estate have been scaled back, with near-term demand growth expected to be tepid at best.
- The weak development pipeline across nearly all segments and markets will foster the property market recovery even with a modest recovery in demand.
- Risk-averse investors continue to seek core assets, sustaining relatively high valuations. However, commercial real estate yields remain attractive relative to risk-free rates.
- Opportunities beyond gateway markets may offer better risk adjusted returns, but meaningful capital flows to these areas have yet to materialize.
- A less aggressive lending market may limit options of borrowers, especially for the riskier portion of maturing debt. This should create opportunities for capital providers of high-yield mezzanine debt and equity.
- Strong recovery in demand and rich pricing for existing apartment assets make development attractive.



Economic Trends

Lackluster Economic Signals Prevail

- The US economy will probably continue to expand in 4Q11 and 2012, but growth forecasts have diminished from earlier in the year (CHART 1). Event-driven volatility clouds the economic outlook.
- The fall-out from the Eurozone sovereign debt crisis on the world financial markets and renewed slump in consumer confidence in the US suggest weak consumer spending.
- US political risk remains high as both parties struggle to compromise over the deficit and President Obama’s jobs plan, which could lead to significant fiscal tightening in 2012.
- A fog of uncertainty and a rise in negative sentiment have prompted businesses to take a “wait and see” approach to hiring and expansionary plans.
- Public sector employment is declining, and unhealthy public sector deficits will remain a drag on growth (CHART 2).
- Consumer spending growth will be limited by high unemployment and the ongoing deleveraging of households.
- Growth in developing economies, though slower, could provide some relief to the US economy through increased exports.



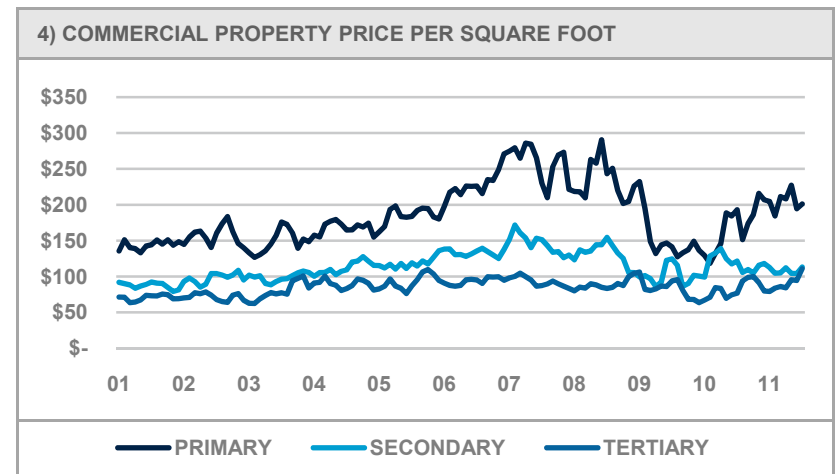
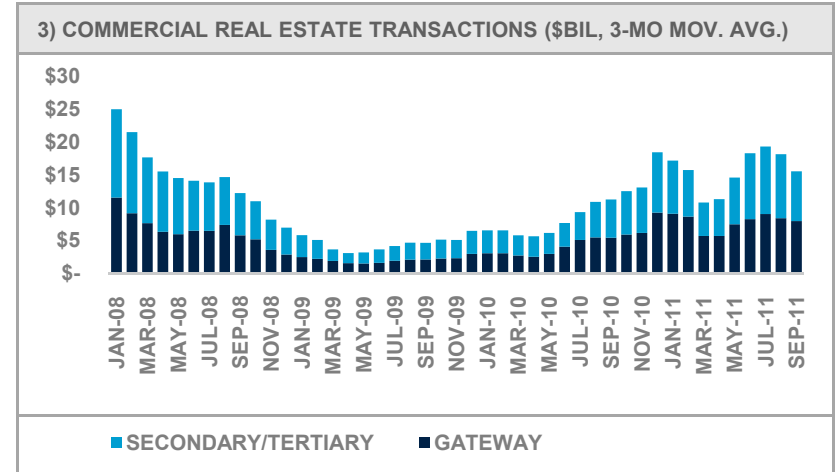
SOURCES: MOODY’S ANALYTICS (BLS, BEA); ECONOMIST INTELLIGENCE UNIT (EIU); PRUDENTIAL REAL ESTATE INVESTORS



Transactions and Pricing

Increased Desire for Yield and Security

- Year-to-date transaction volume through September was 80% higher than that of the same period last year (CHART 3), mostly owing to strong demand for offices and apartments. Shopping center volume was boosted by the trade of a \$9.2 billion portfolio in the third quarter.
- Property offerings have jumped to the highest level since 2008, as owners look to take advantage of strong investor demand. However, deal flow could be limited in upcoming months due to uncertainty in pricing and a more stringent lending environment.
- REITs, cross-border investors and institutional investors with strong access to capital are the biggest buyers. Lenders will remain significant sellers as they dispose of distressed assets.
- Investor thirst for yield creates strong demand for secure cash flow (i.e., core), but narrowly focused on core assets in prime markets.
- Increased risk aversion will likely strengthen demand for core assets. That should sustain high valuations and possibly push prices even higher (CHART 4).
- Investors had begun migrating to secondary and tertiary markets to capture higher yields. However, the weaker economic outlook and recent capital markets turmoil may curtail these capital flows.



SOURCES: REAL CAPITAL ANALYTICS, PRUDENTIAL REAL ESTATE INVESTORS

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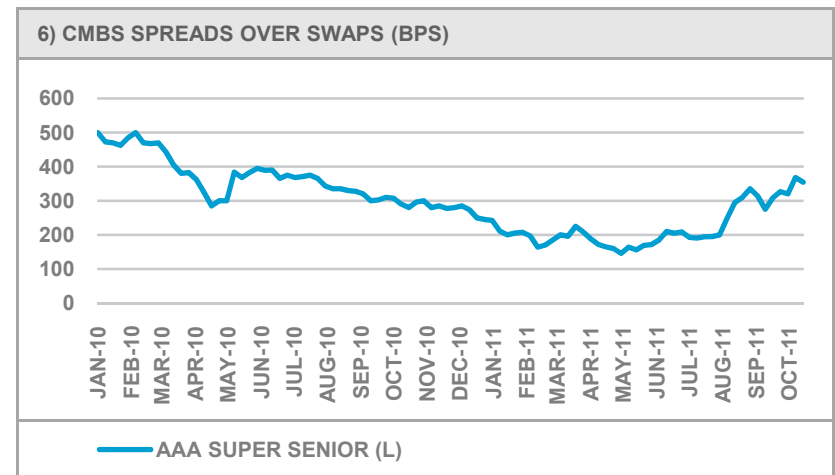
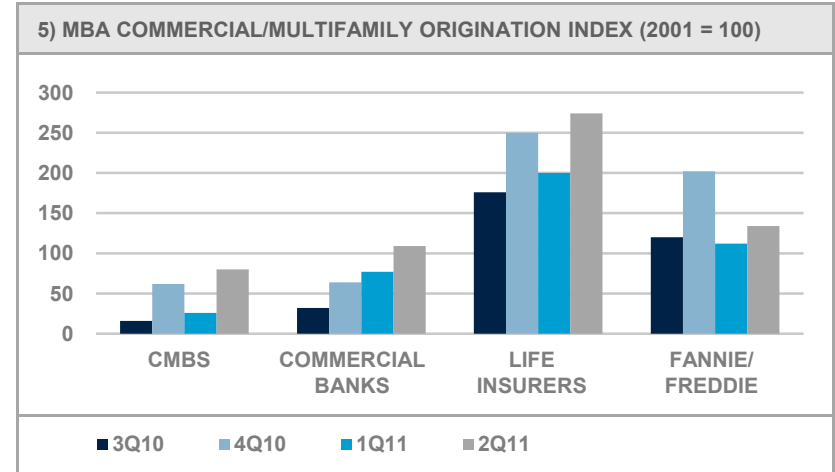
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Debt Markets

Lenders More Cautious Amid Volatility

- Lenders increased their activity in 2Q11 (CHART 5), but market volatility will increase caution and potentially reduce the availability of debt.
- The increasing aggressiveness of lenders that was manifested in higher LTVs and lower spreads in the first half of the year has been reversed for the time being. Although mortgage spreads have widened, low benchmark rates are keeping the cost of debt down.
- Life companies continue to be the best option for large loans and properties in core markets. The hoped-for recovery in the CMBS market has somewhat stalled as spread volatility (CHART 6) has made securitizations difficult to execute.
- Borrowers of underwater properties will be less able to refinance or restructure debt in a less aggressive lending environment, exacerbating the “funding gap.” The result will be more opportunities for providers of high-yield debt and “gap” financing.
- In the multifamily sector, agencies continue to originate loans at a record pace, but other lenders are growing more active.



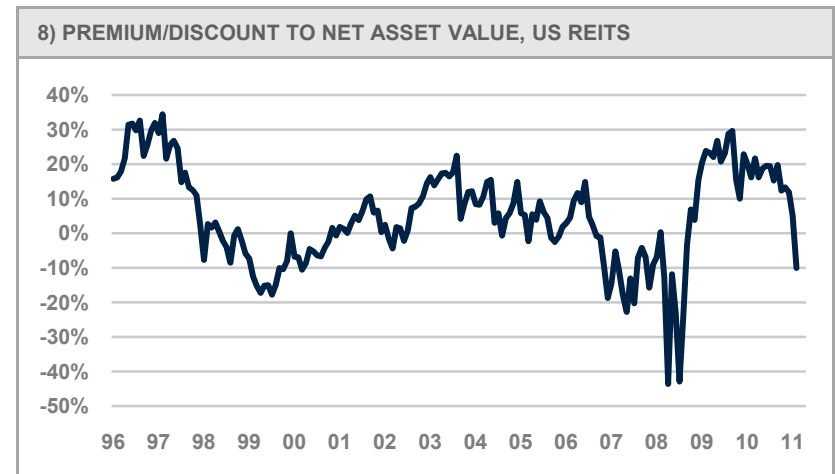
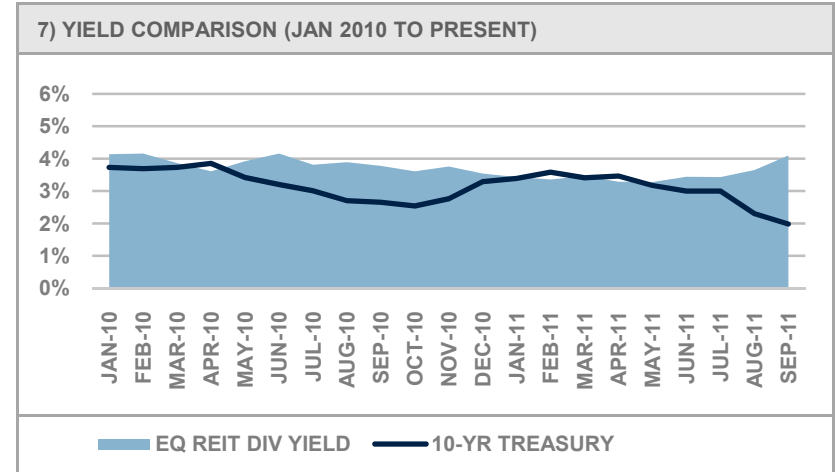
SOURCES: COMMERCIAL MORTGAGE ALERT; MORTGAGE BANKERS ASSOCIATION; PRUDENTIAL REAL ESTATE INVESTORS



REIT Market

REITs Lose Steam After Long Ride Up

- After raising capital at a torrid pace through the first half of the year, all but apartment and the highest quality REITs will have trouble raising new capital in the near term.
- REITs' potential for external growth is also diminishing due to limited availability of high-quality properties.
- Many REITs are shedding non-core assets to concentrate their portfolios on Class A properties in gateway cities, although that has been made more difficult by the diminishing number of buyers for non-core assets.
- Despite dropping 14.7% in 3Q11, REITs have outperformed other stock indices. Through 3Q11, REIT total returns were -6% for the year, while the S&P 500 Index was -8.7%.
- The recent pullback has made REIT valuations relatively more attractive versus private market bonds. Dividend yields are high in relation to Treasuries and other bond products (CHART 7), and REITs are trading at a discount to asset values for the first time since 2009 (CHART 8).
- Low interest rates gives quality REITs an opportunity to lock in debt at favorable rates, providing a potential for very accretive acquisitions.



SOURCES: SNL SECURITIES; ISI; UBS; REAL CAPITAL ANALYTICS; PRUDENTIAL REAL ESTATE INVESTORS

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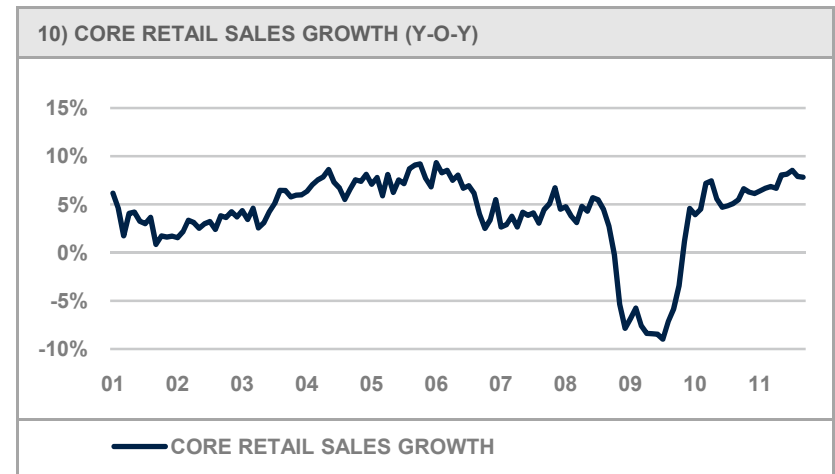
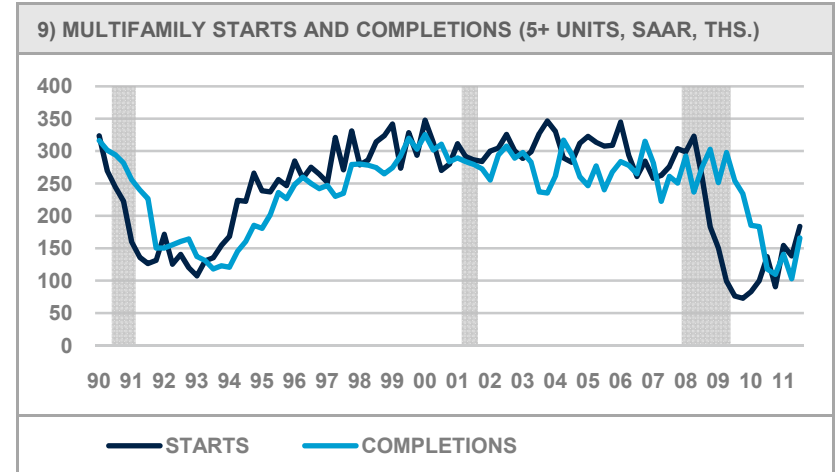
Property Markets

Apartment: Fundamentals Remain Robust

- Demand for apartments remains strong, driving occupancy gains and increasing effective rents in many markets.
- Declining homeownership has boosted renter household gains to nearly all-time highs and will remain a driver of rental demand for the next two years.
- Favorable demographics and pent-up demand as labor markets strengthen will provide additional support for improving fundamentals over the next few years.
- New development remains limited, but construction is picking up relatively rapidly (CHART 9).

Retail: Sluggish Recovery

- Retail sales have been resilient, as consumers continue to spend in spite of the decline in consumer confidence (CHART 10). The National Retail Federation is forecasting a 2.8% gain for holiday sales, slightly higher than the average gain over the past 10 years.
- Local merchants will be in a precarious position if the economy continues to stagnate or slips further. National retailers are likely to remain cautious about expansion.
- Vacancy rates across all formats are stable, but remain near all-time highs nevertheless. With new supply low, weak demand will produce a fragile recovery and modest rent growth potential.
- High-productive assets are in demand. Regional mall REITs are moving into the outlet market to capture consumers' focus on value.



SOURCES: CBRE-EA; NCREIF; MOODY'S ANALYTICS (BEA, CENSUS BUREAU); PRUDENTIAL REAL ESTATE INVESTORS



Property Markets

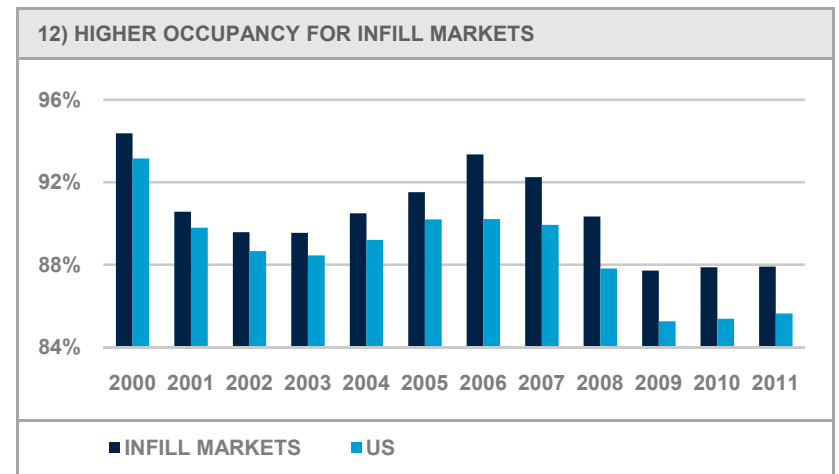
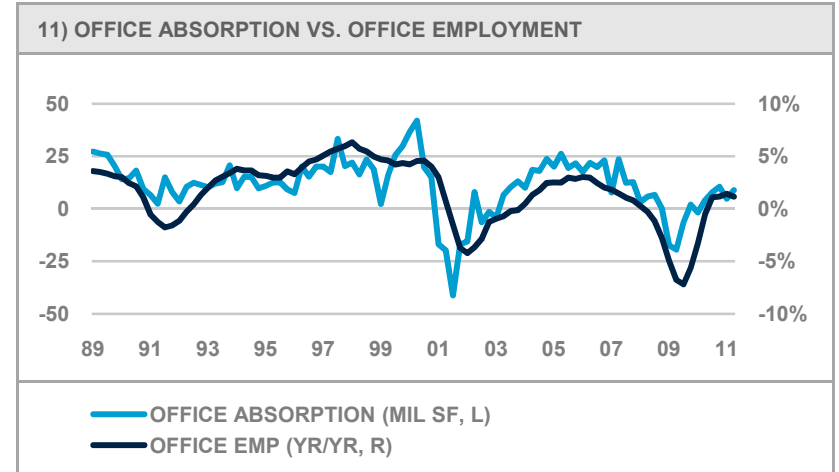
Office: Weak Recovery

- After five quarters of positive absorption, driven by job growth in professional and business services (CHART 11), the office recovery is at risk. Some financial firms have announced layoffs, and most firms are taking a cautious approach to hiring.
- Demand for space is bifurcated. Fundamentals are improving for Class A stock in top markets and deteriorating for B/C stock.
- Reflecting the flight to quality among investors, transaction volume for the top five gateway markets exceeds the rest of the country combined.
- Cap rates in gateway markets have dropped to below 6% on average, the lowest level since the peak in 2007 (source: Real Capital Analytics). Strong demand for safe harbor assets and low borrowing costs will keep prices high even as rent growth projections decline.

Industrial: Slowly Improving

- Industrial vacancies and rents improved during 1H11 due to the growth in warehouse demand drivers (e.g., employment, capacity utilization, trade). However, weaker economic growth will likely limit the near-term progress.
- Infill markets offer investors higher occupancies, limited threat of new supply, and more stable returns than less supply constrained markets (CHART 12). In a low-growth environment, infill markets should offer better risk-adjusted returns.
- Rising global trade volume will enable rents in coastal markets to rebound faster than the overall market.

SOURCES: PPR, CBRE, PRUDENTIAL REAL ESTATE INVESTORS





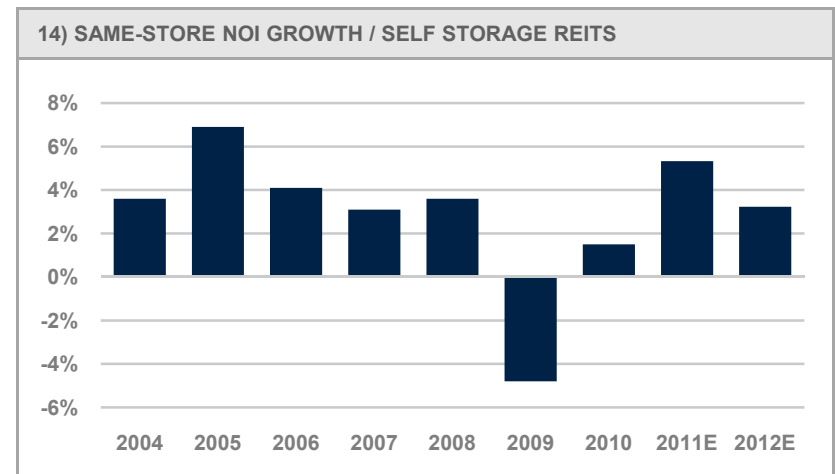
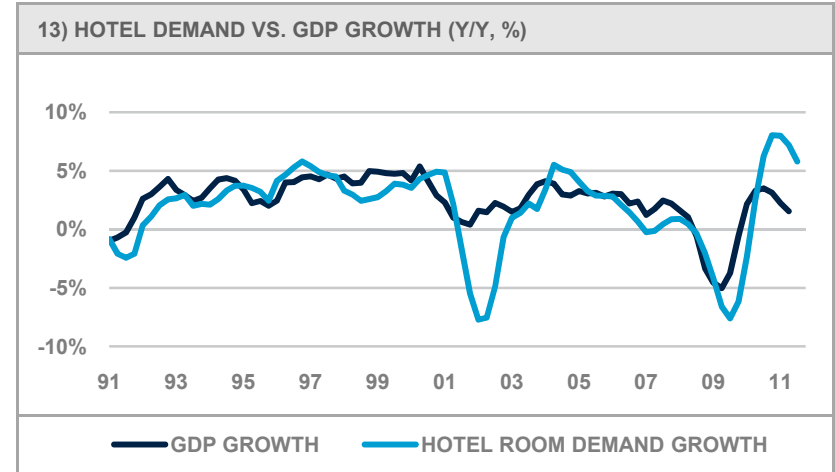
Property Markets

Hotels: Demand Strong, Supply Limited

- Demand for hotel room nights is at an all-time high. The rate of growth will likely subside, but should remain positive as the economy regains its footing (CHART 13).
- Room rates are rising at a solid clip, but hotel operators are hesitant to raise rates at an even faster pace due to fierce competition.
- Luxury and upscale segments have led the recovery, with midscale properties faring the worst.
- Development will be limited for several years.
- Revenue per available room (RevPAR) increased 8.1% year-over-year through August, according to Smith Travel Research, driven by a 3.6% improvement in occupancies and a 3.5% increase in average daily room rates. RevPAR is expected to keep growing through 2012, although at a slower rate.

Self Storage: Looking Up

- Self storage has seen a strong recovery in demand that should continue due to the decreasing homeownership rate and limited new supply.
- Occupancies have nearly recouped the entire decline seen during the recession, a faster recovery than any other property sector.
- NOI growth among storage REITs over the next five years should be strong (CHART 14), as property owners increase rents and scale back concessions.



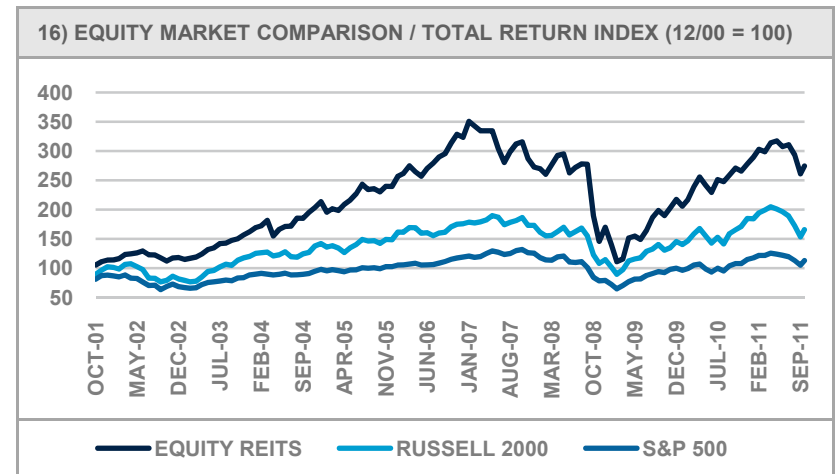
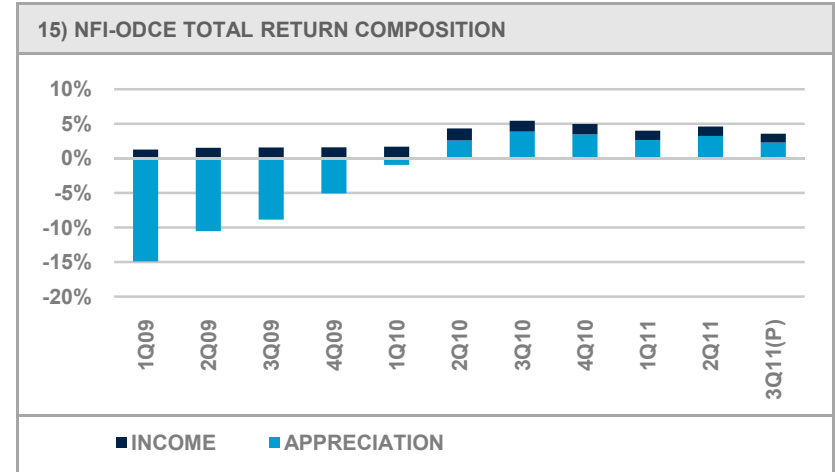
SOURCES: PPR; GREEN STREET ADVISORS; PRUDENTIAL REAL ESTATE INVESTORS



Investment Performance

Attractive Returns, Low Interest rate Environments

- The NCREIF Fund Index (NFI-ODCE) total return rose 3.6% in 3Q11 (gross total return, preliminary), its seventh straight positive quarter (CHART 15). That brings year-to-date total returns through 3Q11 to 12.2%, comprised of 8.2% appreciation and 4% income returns.
- The FTSE NAREIT Equity REIT Index fell 14.7% in 3Q11 and has posted a -6% total return year-to-date through September, outpacing the -8.7% total return for the S&P 500 index (CHART 16).
- As a result of the slowdown in the economy and job market, the outlook for CRE fundamentals and property values is less favorable than it was earlier in the year.
- Lower rent growth projections may have a negative impact on transaction values, particularly for non-core assets.
- We anticipate appreciation returns of about 2% in 4Q11 for the NFI-ODCE Index, which would bring the full-year appreciation return to about 10%.
- With interest rates almost certain to remain low for an extended time, commercial real estate will attract investors seeking relatively high dividend yields.
- Worries about the weak economy have replaced concerns about values being eroded by rising interest rates.



SOURCES: NCREIF; FTSE NAREIT; PREA; PRUDENTIAL REAL ESTATE INVESTORS

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Attractive Risk-Adjusted Investment Opportunities — United States

THEME	INVESTMENT IMPLICATIONS
Strong Demand for Core	<ul style="list-style-type: none"> Investors are eager to obtain assets with steady, secure cash flows. Core spreads remain attractive relative to fixed income alternatives. Focus on value – select acquisitions in markets where income growth and potential for capital appreciation justify low yields, and sell assets where pricing is overly aggressive relative to income growth expectations. Lock in long-term investments with fixed rates to match assets to liabilities.
Demand Recovery	<p>Multi-Family (Low Beta)</p> <ul style="list-style-type: none"> With many existing apartment assets priced at sub-5% cap rates and IRRs below 7%, development provides better risk-adjusted returns in many markets. Projects started early in the cycle will enjoy lower construction costs and stronger leasing activity. With the supply pipeline building, fund managers must have the discipline to sell assets in 2 to 4 years in markets without meaningful supply constraints. <p>Office (High Beta)</p> <ul style="list-style-type: none"> A near-term recovery is unlikely, but the outlook is still favorable 2 to 3 years out. While there is no sense of urgency to invest in this high-beta strategy now, contrarian investors may find attractive opportunities. Non-trophy offices in tech centers (Seattle, San Francisco, Austin, Portland) may offer better risk-adjusted returns.
Hedge Against Recession / Value Declines	<ul style="list-style-type: none"> Focus on apartment transactions in well-located areas, rather than chase “cheapest to build” suburban product. CBD office repositioning in strong markets and grocery-anchored retail with a strong tenants. Medical office buildings and targeted transactions near major health care centers. Reduce leverage levels and draw down capital from investors as we refinance floating rate loans. Address near-term floating rate exposure to mitigate any liquidity risk that may develop if financial market conditions worsen.
Deleveraging	<ul style="list-style-type: none"> More than \$1.5 trillion in commercial mortgage debt outstanding will need to be refinanced over the next five years. CMBS special servicers and banks are ramping up sales of loans and loan portfolios. As values and bank balance sheets recover and lenders are less inclined to extend underwater loans, recapitalizations will provide opportunities for equity and mezzanine debt. Debt on institutional-grade properties in the 70-85% portion of the capital stack generates high returns and provides a measure of protection because it is senior to the equity.



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