THE INSTITUTIONAL REAL ESTATE LETTER – NORTH AMERICA

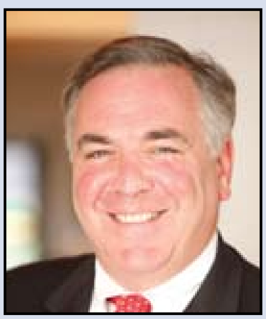
Sponsor Interview

Prudential Real Estate Investors

Global High Yield Debt Group

KEY PERSONNEL

Jack Taylor, managing director and head of PREI's Global High Yield Debt Group, has 24 years of experience in real estate finance. Before joining PREI, he was a partner at Five Mile Capital Partners LLC and the portfolio manager for its flagship fund. Earlier he was co-head of real estate investment banking for the Americas and Europe at UBS. He previously led the real estate group at PaineWebber and served on the firm's operating committee. Prior to that, he was head of the CMBS businesses for Kidder, Peabody & Co., Inc. He is a founding governor of the Commercial Mortgage Securities Association and a member of the President's Council of the Real Estate Roundtable.



Steven Plust, managing director in PREI's Global High Yield Debt Group focused on the United States, has over 25 years of experience in real estate finance and capital markets. Before joining PREI, he was a senior member of Five Mile Capital Partners and served on its investment committee. Prior to that, he held senior positions at UBS, PaineWebber, and Kidder, Peabody. At these firms he was responsible for the structured finance elements for both proprietary lending and capital markets activities.

Stephen Alpart, managing director in PREI's Global High Yield Debt Group focused on the United States, has worked in real estate finance and investing for over 20 years. He has had a wide range of responsibilities, including sourcing, underwriting, closing, and asset management of debt investments. Before joining PREI, he was a senior member of the debt funds business at Capmark Investments (previously GMAC Commercial Mortgage). Earlier he was a senior member of real estate finance groups at UBS and PaineWebber. Previously he was at Kenneth Leventhal & Company in the 1980s, active in workouts, restructurings, loan sales and advisory assignments.

*Recently, **Geoffrey Dohrmann**, publisher and editor-in-chief of* The Institutional Real Estate Letter – North America, *spoke with **Jack Taylor, Steve Plust** and **Stephen Alpart** of Prudential Real Estate Investors. The following is an excerpt of that conversation.*

Where does PREI's new debt platform fit in today's investment world?

Taylor: The credit crisis and the ensuing liquidity and economic crises have created an historic investment opportunity in commercial real estate debt. The CMBS market has virtually shut down, and most traditional first mortgage lenders have been sidelined, either because of their troubled loan portfolios or overall financial distress. Furthermore, we estimate that half of the $3.5 trillion of commercial mortgage loans outstanding cannot be refinanced without an infusion of new capital into the assets. All of this translates into a tremendous need for debt capital.

So, attractive returns will be available through the purchase of disgorged existing assets as well as through the provision of new debt capital to a secularly deleveraging, liquidity constrained and re-priced commercial real estate market. These trends have created an ideal situation for PREI, with its substantial resources, to establish a dedicated debt investment platform. As the global debt platform is unencumbered by legacy assets, its entire focus will be on the substantial investment opportunities that will unfold in the coming years.

How large is the opportunity you are talking about?

Plust: Approximately $2 trillion of commercial mortgage debt in the United States alone is coming due over the next five years. Much of it is either over-levered or underwater. Both first mortgage and gap capital will be needed. Even if all the debt and distress funds in the market today reached their targeted raise amounts, they would not begin to meet the need. The problem is so vast, it is no longer about having the network to source the deals; it is about investment judgment and the ability to select the best opportunities to pursue.

How is your platform organized?

Taylor: I head PREI's newly-formed global debt platform with dedicated teams based in the United States and Europe. We will be looking to expand the platform to include Asia and Latin America. As a global real estate debt platform, we serve the needs of our institutional clients by offering branded, "one-stop global shopping" for commercial real estate debt investments. The regional businesses benefit (and in turn our investors benefit) from our shared debt investing perspective, cross-border information flows, combined resources and unified culture. The dedicated teams are fully integrated with PREI, taking advantage of the resources our full-service real estate funds management platform has to offer. Clients can expect consistency in the overall investment philosophy, as well as in reporting and transparency.

Why did you join PREI?

Taylor: PREI offers an excellent cultural and organizational fit. We share a fiduciary mind-set and a respect for our investors' capital, taking a similar long-term perspective on the market and our business. We believe strongly that this cycle is not just an opportunistic moment to take advantage of distress in the debt markets. While tremendous near-term opportunities will unfold, more significantly, we believe the deleveraging of the market will continue over a long period of time and so will provide attractive investment opportunities for our clients over many years.

Alpart: PREI made a strong commitment to dedicate the resources necessary to support a global debt platform over the long term. PREI offers a truly global commercial real estate business with over 500 professionals (260 in the United States) that includes research, origination, underwriting and asset management capabilities. In any given local market, you will find that PREI owns, or has owned and managed properties, and so provides tremendous "boots on the ground" and local market knowledge. With the addition of our dedicated debt team, PREI can offer unparalleled real estate and capital markets expertise to serve the needs of our institutional clients.

> *"The problem is so vast, it is no longer about having the network to source the deals; it is about investment judgment and the ability to select the best opportunities to pursue."*

How are you different from other managers in this space?

Taylor: We distinguish ourselves in a several ways. We have both buy side and sell side experience in the commercial real estate debt market. Many of the groups that are seeking to raise funds have never managed third-party capital as fiduciaries. Also, many have been simply CMBS issuers, or are equity players trying to step into the commercial real estate debt space for the short-term who do not understand the intricacies of the debt markets. We are one of the few teams that has the experience of managing third-party funds in debt investment strategies, with an audited track record.

Alpart: We have been extensively involved in evaluating real estate and in understanding how capital structures work from a debt investor's perspective. We are a seasoned team, having been through multiple market cycles. Each of us has been in this business for over 20 years, and we have worked together for much of that time. Having been on both the buy side and sell side, we have a deep understanding of how these structures work and how to best align the interests of all parties to a transaction.

Plust: Experience is critically important. Many of the people in the market today have never seen a major downturn and therefore do not fully appreciate the challenges and opportunities this brings. We were very active during the early to mid 1990s in assisting the Resolution Trust Corporation in developing its strategies. We also participated in the opportunities created by the RTC, restructuring and refinancing properties, and we were early movers in the development of the commercial mortgage backed securities market. Most importantly, we were very active in proprietary investing in commercial real estate debt, and recognized early on the need to respect our capital. That seasoned experience, combined with the funds management perspective, brings a unique skill set.

How would you characterize your investment philosophy?

Alpart: We focus on underlying real estate values, avoiding sector bets and momentum trades, which are often based on the notion that in a rising market, somebody will pay more than you did. Instead, as value-oriented investors, we pursue a ground-up, detailed, analytical approach. We look to create a diversified portfolio by carefully selecting investments on an asset-by-asset basis, whether it is obtained individually or in bulk, with each asset underwritten individually and standing on its own merits. In addition, by assessing relative value — by property type, across markets, and up and down the capital stack — we appropriately price each instrument on a risk-adjusted basis.

Plust: We believe that, for loans on commercial properties, cash flow is as critical as "blood to the brain." We target high-quality, income-producing real estate with visible cash flows and executable business plans, while tending to avoid "by-the-pound" investments where the exit is based solely on a sales strategy. We favour markets that have been strong and resilient over the long term. We invest only with well-regarded sponsors that have exhibited significant expertise in the property type and market — and these sponsors also need to invest substantial risk capital subordinate to our investment.

Alpart: Our investment decisions are microeconomic, rather than macroeconomic. While we are constantly assessing the macroeconomic dynamics of the market in which we are investing, we make our investment decisions based upon an evaluation of the specifics of the situation: this particular building in this particular sub-market, with this sponsor's business plan, all in the context of the structural elements unique to each investment.

Plust: We look for multiple exits and also multiple strengths, so that you are not relying upon the momentum of the market continuing, but instead looking at fundamental cash flows that a property can generate even in a distressed or declining market.

Taylor: Overall, investing in real estate debt is not "formulaic," especially in today's dislocated markets; there is no single valuation template that should be pursued. Rather, the merits of each investment constitutes a "narrative" of elements, (e.g., sponsor, property, market, etc.) that must be evaluated, diligenced and documented.

What is your strategy and focus?

Taylor: Our strategy is to produce investments that have high current cash income, and due to the protection provided by the equity beneath us, lower volatility. Because of the scarcity of capital in today's environment, we intend to participate in a share of the upside appreciation in the underlying properties as well.

The opportunity we see today is to provide debt capital to a capital-starved market and, particularly, to exploit the ongoing funding gap. The funding gap can be seen as the difference between the face amount of the mortgages coming due and the new mortgages that may be available to refinance those loans. To be clear, the funding gap capital needed is in addition to the substantial capital also required for first mortgage debt refinancings.

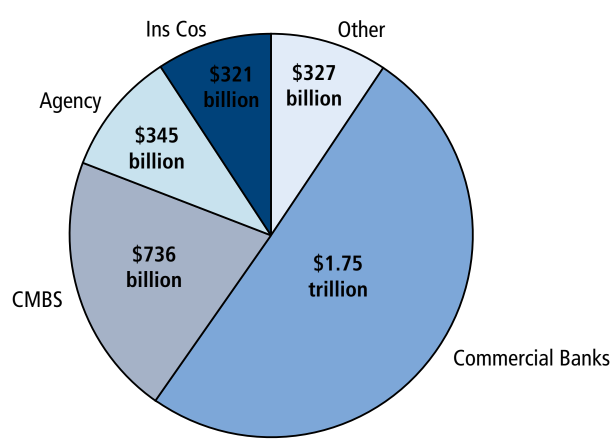
"Looking at the approximately $2.8 trillion of loans made between 2005 and 2008 alone, when the market was the most overheated, the funding gap could be as large as $600 billion to $900 billion."

Alpart: Underlying property values have fallen by about 25 percent so far with an estimated additional 15 percent or more yet to come. Meanwhile, many lenders are so impaired or focused on managing their current loan portfolios that they are unable or unwilling to write new loans. Where debt funding is available, advance rates have declined dramatically from the levels we saw in the overheated markets of recent years. So, between lower property values and reduced leverage ratios, a borrower who financed at the peak of the market may be facing a 30 to 40 point shortfall when their loan comes due.

Plust: In aggregate, this dynamic has produced a huge funding gap. Looking at the approximately $2.8 trillion of loans made between 2005 and 2008 alone, when the market was the most overheated, the funding gap could be as large as $600 billion to $900 billion. So we are talking about a very significant problem, which in turn creates the opportunity.

Taylor: In attacking this opportunity our focus will be on high-quality income-producing properties in the major property types (office, retail, multifamily, indus-

Commercial Mortgage Debt Outstanding, 1Q09
Total: $3.5 trillion



Source: Federal Reserve

trial and hospitality) as opposed to, say, land and busted condominium conversion projects.

Are you focused on newly originated loans or the secondary markets?

Plust: Actually, both. We will originate mortgage loans, mezzanine loans and other instruments — preferred equity for example. Also, because of our extensive institutional relationships, we will co-originate these instruments with major financial institutions. We also will buy debt assets from compelled sellers in the distressed secondary market. The underlying theme, however, whether or not we buy an instrument that already exists or we originate it ourselves, is that we will be targeting institutional-quality assets with sustainable cash flow. This is true whether we are buying from a distressed seller or we are providing rescue capital for a borrower that needs to recapitalize.

Are you confident you can find value in today's market?

Alpart: Absolutely, and in fact, we believe that 2005 to 2008 was a much more treacherous market from the debt investors' perspective than today. Back then, lenders did not have pricing power or the power to impose credit terms, and were living in a world where there was an excess amount of capital chasing deals. And, whether they knew it or not, people were involved in momentum trading. Today, because capital is scarce, as a debt investor, we have immense pricing power and can impose rigorously protective credit terms. Then, debt investors took equity risk while receiving poor debt-like returns; today, the situation has reversed and debt investors can take much more secure positions and obtain superior returns.

> *"We believe that 2005 to 2008 was a much more treacherous market from the debt investors' perspective than today. ... Today, because capital is scarce, as a debt investor, we have immense pricing power and can impose rigorously protective credit terms."*

What returns are you seeing?

Taylor: In the U.S. we are seeing unlevered mid- to high-teens gross returns on subordinate debt investments, with a high percentage of current cash income. Secondary sales of distressed paper can range well north of 20 percent, with newly originated first mortgage loans producing single- to low-double digit returns depending upon the extent of leverage and the specifics of the situation. Most importantly, we believe that while 20 percent, 30 percent and higher returns will be available in the near term, the dramatic market corrections we have discussed should make gross returns in the mid- to high-teens available in debt investments for many years. ❖

CORPORATE OVERVIEW

Prudential Real Estate Investors is a leader in the global real estate investment management business. PREI® has been managing real estate investments for institutional clients since 1970, when it introduced the industry's first commingled, open-end equity real estate fund to U.S. pension plans. Today, PREI offers its clients a broad range of real estate investment strategies in the United States, Europe, Asia and Latin America. As of March 31, 2009, PREI globally managed more than $42.1 billion in gross assets ($25.3 billion net) on behalf of over 400 clients and is ranked among the largest real estate investment managers.

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