A supplement to *The Institutional Real Estate Letter*

THE INSTITUTIONAL REAL ESTATE LETTER

Sponsor Interview

Prudential Real Estate Investors Global Merchant Banking Group

Robert Falzon

Marc Halle

John Gregorits

Robert Falzon, managing director and head of PREI's (Prudential Real Estate Investors) Global Merchant Banking Group, is a senior portfolio manager, a member of PREI's investment committee's in the United States and Europe, chairman of PREI's currency hedging committee, and a member of PREI's global management committee. He is also a member of the Prudential Investment Management (PIM) investment committee.

Marc Halle is a managing director for PREI, where he is an executive partner in the Global Merchant Banking Group. Halle is the senior portfolio manager for the all global real estate securities funds and oversees all public real estate securities investments. Halle is also the portfolio manager for the Prudential Retirement Real Estate Fund.

Halle joined Prudential from Alpine Management & Research, LLC, where he was a founder of the company as well as the portfolio manager for the real estate funds.

John Gregorits is a managing director and group head of the private business in the Global Merchant Banking Group of PREI. He is chairman of PREI's global investment committee.

Before joining PREI in October 1998 from The Prudential Realty Group, Gregorits was responsible for the asset management and disposition of office, hotel, retail and industrial properties on behalf of Prudential's General Account.

CORPORATE OVERVIEW

PREI® (Prudential Real Estate Investors) is the global real estate investment management division of Prudential Financial, Inc., one of the world's most widely respected financial services companies.

PREI is a leader in the global real estate investment management business. PREI has been managing real estate investments for institutional clients since 1970, when the firm 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 Dec. 31, 2007, PREI globally manages more than $42.5 billion in gross assets ($30.1 billion net) on behalf of over 400 clients and is ranked among the largest real estate investment managers.

In March, ***Geoffrey Dohrmann,*** *publisher and editor-in-chief of* The Institutional Real Estate Letter, *met with* ***Robert Falzon, John Gregorits*** *and* ***Marc Halle*** *of PREI's Global Merchant Banking Group. The following is an excerpt from that conversation.*

Dohrmann: *What is the focus of PREI's merchant banking group?*

Falzon: The group originated because Prudential wanted to co-invest alongside our clients in the higher-returning strategies that we were developing. Through our Merchant Banking Group, we take on a principal role as well as an advisory role. We have a substantial amount of house capital invested alongside our clients in all the private funds that the group manages. We've done some of that in the public arena as well, although less extensively. The group has steadily expanded its role so that today we are PREI's primary team making "opportunistic" and REIT securities investments for our clients.

Dohrmann: *How is the merchant banking group different from PREI's other business units?*

Falzon: PREI is generally organized regionally and generally focused on making direct investments in real estate. Merchant Banking runs funds that invest globally, across regions, and we have a particular expertise in making investments in and through real estate operating companies. The Merchant Banking Group's two primary activities are PREI's listed global real estate securities funds and its global opportunity funds — the Prudential Real Estate Companies or PRECO funds.

Dohrmann: *Where in the world do you see the opportunity to make money today in public markets?*

Halle: Global securities are very attractively priced today. There has been a massive correction globally in the pricing of real estate securities that appears to be unrelated to property fundamentals or private real estate valuations. While we do anticipate further cap rate expansion, we don't really subscribe to the theory that the public real estate sector is a predictor of private value. We know in some markets property prices will be coming down, but there's been an overcorrection in the securities markets. Real estate markets typically overdo it on the way up, and they overdo it on the way down. The pricing of real estate securities, in the short term, is driven not by the real estate fundamentals, but by capital market flows. As a global player in both direct real estate and real estate securities, we are uniquely positioned to look around the world and shift our investments to where we see compelling values. So today we are more bullish on the public real estate sector but nevertheless see opportunities to make money in the traditional bricks and mortar real estate business as well.

Dohrmann: *Where do you see value in the public markets today?*

Halle: Within Asia, Japan is the most attractive market from a valuation standpoint. Developers are trading at 40 percent discounts to NAV and JREITs trade at over 400 basis points spreads to local Treasuries. The market is down almost 50 percent over the last 12 months despite good fundamentals and a more resilient economy than many might have projected in light of the problems in the U.S. Rents for prime office space have climbed almost 20 percent, and NAVs have increased approximately 30 percent over the same 12-month period. Private valuations could be vulnerable as vacancies rise and rent growth moderates, but we still believe that there is a major disconnect.

The largest discounts to NAV in Europe can be found in the U.K., where real estate equities trade at almost 30 percent below break-up value. These values persist, despite the fact that the private market has already experienced a large correction in real estate pricing. The U.K. looks interesting to us from both a public and private standpoint.

At north of 20 percent discounts to NAV, the U.S. REITs are the cheapest that they have been relative to NAV in many years and are yielding 230 basis points over Treasuries. We anticipate that the NAVs will decline, but the market seems to have dramatically overshot, thanks in no small part to the incredible level of short selling by hedge funds.

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We've seen this movie before and we know how it ends. Unless the doomsayers are correct in forecasting 20 percent to 30 percent declines in real estate values, and we don't think they are, we believe that this will look like a huge buying opportunity.

Dohrmann: *Where do you see the opportunities on the private side of the market place to capture opportunistic returns?*

Falzon: Many investors believe there are opportunities in emerging markets to make 20 percent-plus returns. We believe we can also earn comparable returns for our clients by taking controlled real estate risk in developed countries. While real estate pricing has not necessarily corrected, the distress in the capital markets will ultimately force the recognition of that revaluation in real estate, and that will provide a good entry point for us into the markets.

Dohrmann: *Which of the emerging markets are most attractive?*

Falzon: We like Central and Eastern Europe. The liquidity in those markets continues to climb. Vacancies are dropping despite additions to stock, and yields, while lower than a year or two ago, are still at significant premiums to those that you're finding in Western Europe. The further east you go, the higher the yields. We believe that economic growth will be relatively robust in Europe, particularly in the Central and Eastern European countries, but we do recognize that growth is going to be muted by what's happening in the U.S.

Dohrmann: *Are there specific countries that present better opportunities than others?*

Falzon: We like Turkey quite a bit and agree with those who refer to it as the "Mexico of Europe." Turkey has a very young, growing population with a median age of 27. It's the second largest emerging economy in Europe, just after Russia, with projected GDP growth of about 5 percent annually over the next five years. Istanbul is the third most populous city in Europe, just behind London and ahead of Paris, yet its per capita stock of retail, housing and office space is a fraction of that in the rest of Europe. Asian markets of interest include China and India. We're entering into India via a venture to provide mezzanine financing to local developers and operators. In China, we're involved in developing properties. We're particularly interested in retail, given the growing middle class, and we like residential, due to the urbanization. Finally, in Latin America, we've been active in Mexico, although that market is quickly maturing in many respects. Brazil is also interesting as the industrial distribution gateway to the rest of South America. It also has a growing middle class that now has access to mortgage financing, something relatively new to that economy, and that's fueling demand for residential.

Dohrmann: *You've omitted Korea and Russia.*

Falzon: South Korea is on our list and we've made a number of investments there, but we rank it behind China and India. It is a much shallower market and doesn't present as many opportunities. We also have strategies for investing in Russia, which is a huge market but one that is a toggle switch for many investors. Russia is either something that they are very interested in doing, or it's something they want to stay as far away from as possible — there's not much middle ground for experimentation.

Dohrmann: *Is the looming recession in the U.S. having an impact on these emerging markets?*

Falzon: Yes, even the emerging markets are linked to the U.S. But, many have such a high level of growth that they should be able to absorb a slowdown associated with the U.S. economy and continue to show very respectable GDP growth. However, we are very cautious in emerging countries that post a combination of more modest GDP growth, a current account deficit and a budget deficit, because that means they're likely to be financing their economies with debt instead of equity. We believe those markets are going to be most impacted by the contagion in the capital markets associated with the U.S. debt crisis. A number of Eastern and Central European countries fall into that box.

Dohrmann: *How do you generate 20 percent–plus returns in developed economic markets?*

Gregorits: First, the credit crunch has allowed us to provide mezzanine financing at very attractive rates, although we don't know how long this window will remain open. In time, we also think we'll be able to pick up distressed properties. In addition, we're continuing to selectively pursue repositioning, redevelopment and development strategies partnering with the most capable local firms. This strategy is what we believe to be our sustainable model for generating opportunistic returns throughout the real estate cycle. There's no free lunch in the world of opportunistic investing. You get paid for taking risk. And if you're not taking market risk, like investing in the emerging markets that we talked about before, then you need to take real estate risk, such as entitlement and development risk, to achieve your objectives.

Dohrmann: *How do you find your investment deals?*

Gregorits: Our operating partners help us source deals and execute the strategies for creating value. In our global opportunity funds, we apply what we call a "private equity model" to real estate. We invest through controlling interest or outright ownership of operating partners, who in turn are getting us into real estate properties. This model is at the extreme end of control, alignment and exclusivity, all of which we think are necessary ingredients to prudently execute opportunistic strategies. We're seeking to create or enhance value through development or redevelopment. If we're acquiring something, we're acquiring it to reposition it, lease it up and stabilize it. The operating partners we target for that private equity strategy have a demonstrated track record for executing within their own particular property type niche, and we jointly pursue the strategy that we've identified.

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Dohrmann: *What makes a successful operating company investment?*

Falzon: There are at least two key ingredients. The first is focus on the asset value. When we invest through operating companies, we're not assigning a value to the operating platform. We're not investing in the operating company; we're investing in real estate through an operating company. Where some of our competitors have gone wrong is that they've ascribed value to the operating entity, which in a bull market looks like it has lots of value, and in a bear market is more of a liability than an asset. The second key ingredient is having the proper level of control over the investment. We're always a majority investor to retain complete control over investments, dispositions, financings, operating budgets, capital budgets, development budgets, personnel — all of these are critical to successfully investing at an operating level. We are not prepared to simply make a minority investment and sit back and watch it happen — or not.

Dohrmann: *Do you locate the operating partner and then develop a strategy, or do you develop a strategy and then find an operating partner to help you execute that strategy?*

Gregorits: We've taken both approaches. There are instances when we target a specific strategy or market in a top-down way, and then we look for operators to help us execute that strategy. On the other hand, we are an opportunity fund, and we have a fairly extensive network that comes across all sorts of interesting opportunities with uniquely positioned firms that are willing to work with us in this entity-type format. So sometimes the investment thesis comes first, and sometimes the operating company comes first.

Dohrmann: *So if you're looking at it from the top-down perspective, what's interesting to you right now?*

Gregorits: We feel very good about Europe. Despite the E.U., Europe is still fragmented with less than optimum transparency, and that lends itself to finding value. With the U.K. correction, we may be able to actually invest in more traditional property types there for the first time in years. We've had a lot of success there in higher-end assisted living and look to expand in that area. We also like residential in Stockholm and retail in Zurich. The office market in Germany is interesting — you've got a lack of recent development and a surprisingly resilient economy. We think that might be a place to be active in the future. We've also done a significant amount of self-storage in Europe. In the U.K. we were an early investor in a company called Big Yellow, which became the premier operator in that country. We have a company in Spain, through which we hope to become the largest self-storage provider in Spain. And we're looking at that theme in other parts of Europe as well. In the U.S., we like Manhattan, where we have a few operating platforms focused on retail and residential strategies. If the New York office market corrects the way some are predicting, we are poised to jump in. We're still bullish on industrial development and actively developing with a company called Ridge Properties out of Chicago. We're focused in all the major U.S. intermodal and port markets and some in Mexico. And we've been really active in the medical office sector with a company called Lillibridge, one of the premier operators and developers in that sector.

Dohrmann: *Is investing through an operating platform the only way you are investing now?*

Gregorits: It's not the only way that we're investing for our opportunity funds. We will also consider mezzanine and certain other direct real estate investments that complement our strategies and/or diversify our portfolios. But the private equity model is what we're focused on because of our strong conviction in aligning ourselves with the management teams to achieve the control that we might not otherwise exert. And, most importantly, it has worked for us over the past 10 years. When we're out talking to investors about what we do, they find it a relatively unique strategy. There are other funds that are dabbling in this strategy, but our primary focus on this form of investing really is unique relative to most of our competitors. So while we do consider other opportunities, the private equity strategy is what we know and what we do best, and we plan to stick to it for the foreseeable future

Dohrmann: *What's in it for the operator to have you as their controlling partner?*

Gregorits: They see a lot of advantages in this approach. First, the operators no longer need to spend time looking for capital. We provide sufficient capital to let the operator develop a really good pipeline of projects and to close deals quickly. We add a lot of value in terms of reputation as well. When one of our operators can represent that their money is coming from Prudential, that makes a big difference with sellers, tenants, banks and intermediaries, and enhances their bargaining power. And because we do all of the things that one would expect from a private equity investor, including being active in business and strategic planning, capital allocation and sourcing, budgeting, research, etc., we take on some of the risk associated with running the operation. So yes, they are giving some things up, but we feel they're getting some things in exchange, and at least 25 major companies in the U.S. and Europe, including some of the premier players in their respective markets, have decided that that's true.

Halle: We are real estate people; we understand real estate markets. We're not passive members on the boards of these companies; we are actively involved in the decision making for acquisition, disposition and financing. And we bring the knowledge base of our entire organization to these companies. We tell them what's happening around the country, what's happening in their markets, what's happening in capital markets, and what's happening on development costs. We are really partners when it comes to running these businesses together.

Dohrmann: *How much of this type of investing have you done?*

Falzon: We've done in excess of $12 billion in gross asset value of this type of investing during the past 10 years. We've got over 25 different private equity platforms that we've funded over that time, both in the U.S. and Europe.

Dohrmann: *How are your deals structured?*

Gregorits: These investments all have certain characteristics. One is that we maintain a controlling investment at the entity level, typically 80 to 90 percent. This gives us affirmative control over all major decisions. Two is that we require a material co-investment from the management team, something that is substantial in comparison to their personal net worth. We think that's really important for creating alignment. Three is that we have some form of exclusivity, so that our partnership is the exclusive entity through which the management team operates and invests. Finally, management is compensated on the same basis as are we, and they realize on their investment when we exit.

Dohrmann: *How long would you typically hold one of these investments and how do you exit?*

Falzon: Our holding periods vary from days in certain arbitrage situations to five or more years. We've done an IPO of the operating company; we've done a private sale of the operating company; we've sold the underlying real estate portfolio without the operating company; and we have sold the real estate through a series of individual or sub-portfolio sales. Because we control both the operating company and the assets underlying the operating company, we have the flexibility to arbitrage the markets to get the most efficient exit.

Dohrmann: *If you could get them financed, is it a good time for public-to-private deals?*

Halle: This would be an excellent time. Real estate is cheaper on Wall Street than it is on Main Street in a lot of different markets. The disruption in the debt markets has curtailed the LBO market for REITs, particularly for larger companies. If debt were available, we think that you would be seeing a significant volume of transactions. Selectively in the U.S., in the U.K., in Singapore and Japan, there are great opportunities today to capitalize on our knowledge of both the public and private markets. And when we look at these opportunities, we see that somewhere down the road there's going to be people making a lot of money on this arbitrage when liquidity returns and capital flows back into the market. We and our investors expect to capitalize on these opportunities. ❖

CORPORATE CONTACT

Prudential Real Estate Investors
8 Campus Drive
Parsippany, NJ 07054

Lester Lockwood
Managing Director
lester.lockwood@prudential.com
Tel: (973) 683-1713
Fax: (973) 683-1790

www.prei.com