

Pinehurst

After nearly four years of deteriorating space market fundamentals, the US commercial real estate market is poised for recovery. At least that was the overwhelming consensus of attendees and participants at Prudential Real Estate Investor's 16th annual Real Estate Seminar in Pinehurst, North Carolina. Solid evidence of renewed job growth and strength in the corporate economy should create demand for all types of commercial property over the second half of 2004 and into next year.

However, while the brighter outlook for the property markets is a welcome change, the unusually strong capital flows into the sector throughout the cyclical downturn, which created an apparent disconnect between asset pricing and space market fundamentals, raise questions about the investment opportunities in the years ahead. In the following summary of this year's proceedings, we examine some of the more important features of the investment environment in recent years and a few of the lessons learned from this unusual market cycle. We conclude with some thoughts on how the opportunities (and risks) likely will change as the property markets recover and the disconnect gives way to more familiar relationships between the real estate space and capital markets.

Features of the Disconnect

The recent real estate market cycle has been unlike any the industry has ever seen. Despite a sharp decline in tenant demand, falling rents and soaring vacancy rates in most property types, real estate pricing has shown few, if any, signs of weakening. Instead, strong capital flows into the sector have continued to support asset values and drive investment performance even as space market fundamentals have weakened. Although analysts and investors disagree as to whether these divergent trends are appropriate or not, many of the key features that have contributed to the peculiar trends in recent years are undeniable.

As Charlie Lowrey, PREI's CEO, described in his presentation at this year's conference, the most influential feature of the investment landscape over the past few years has been the low interest rate environment engineered by the US Federal Reserve to stimulate the ailing economy. Between January 2001 and June

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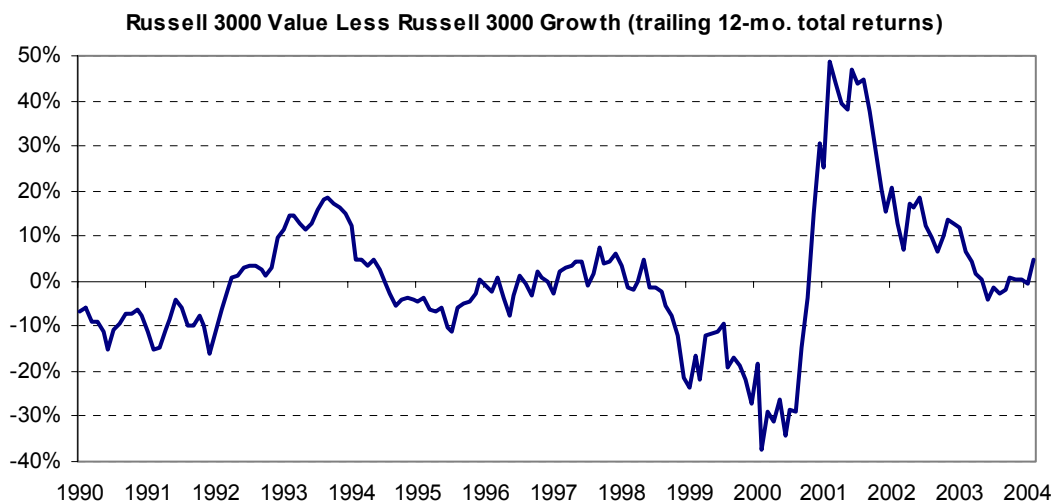
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2003, the Fed lowered short-term interest rates 13 times, dramatically reducing the Fed Funds rate by 500 basis points from 6% at year-end 2000 to just 1%, where it has remained for more than a year. The lower interest rates reduced borrowing costs throughout the economy. But the effects were particularly pronounced in the notoriously capital-intensive real estate industry, where narrower spreads for real estate debt caused mortgage rates to fall sharply.

The lower interest rates directly affected the real estate investment market in several ways. First, as the cost of debt fell below cash yields for core properties, the positive spread encouraged buyers to bid aggressively for certain assets using cheap debt to boost return on equity and make up for higher prices. At the same time, lower interest rates and ample liquidity in the real estate debt markets enabled property owners who were unwilling or unable to sell their assets to refinance them instead. In many cases, property owners could reduce their debt service burden, which helped to offset weaker property income and to avoid distress.

But the sharply lower interest rates also caused bond yields to fall just as investor sentiment shifted from growth to value. The downturn in the US economy and bursting of the tech bubble triggered a rotation among investors from growth investments, like tech stocks, to higher-yielding value investments, like REITs. This second feature of the investment environment, investor flight to safety, is dramatically illustrated in the following chart, which shows the difference between the trailing 12-month total returns for value and growth stocks in the Russell 3000 index. Before the tech implosion in March 2000, growth stocks significantly outperformed value stocks on a trailing 12-month basis. Once the bubble burst, however, investors' demand for yield and security propelled value stocks higher while growth stocks suffered sharp declines.

Severe Shift in Investor Sentiment



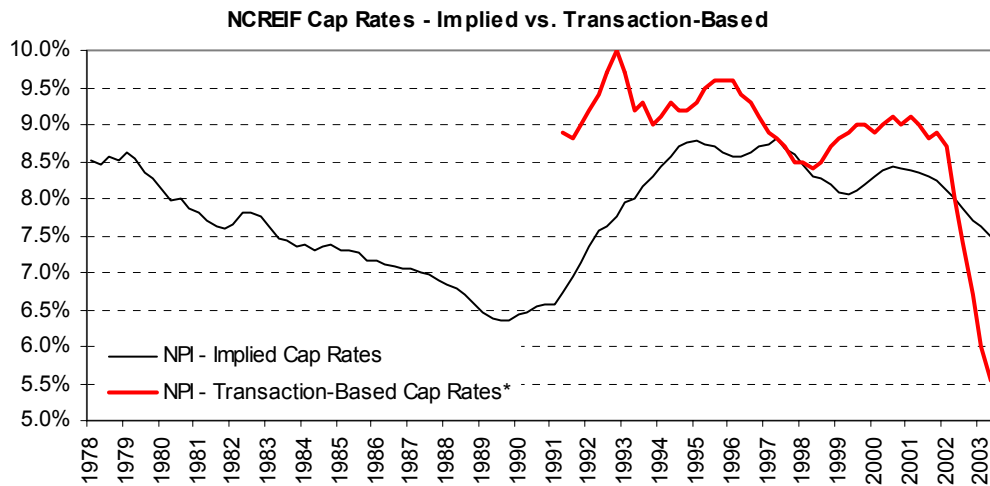
Source: Ibbotson Associates

The shift in investor sentiment and increasingly attractive real estate yields relative to other investment alternatives greatly increased demand for the most bond-like real estate assets from non-traditional and traditional real estate investors. As capital poured into the real estate sector from non-dedicated real estate investors, uncertainty regarding the timing of the recovery in tenant demand caused a flight to safety within the real estate asset class. To lock in attractive

yields until the prospects for a recovery in tenant demand improved, many real estate investors sought the same types of core assets that investors from outside the asset class were determined to acquire – well-located assets with credit-worthy tenants and long-term leases.

While the intense investor demand for core assets was driving prices higher and cap rates lower, relatively little demand existed for properties with weaker tenants and/or near-term lease rollovers. However, because property owners could often refinance their properties, usually at a lower interest rate, rather than having to sell at discounted or distressed prices, completed transactions in recent years largely reflect the competitive market (and rich pricing) for core assets. As the following chart shows, cap rates based on actual transactions involving properties in the NCREIF Property Index (NPI) have diverged from the implied cap rates based on reported property income and appraised values. Presumably, the lower transaction cap rates reflect some selection bias in the types of properties (i.e., stabilized core assets) that have traded most in recent years and the increasingly competitive transaction market.

Selection Bias and Investor Demand Drive Transaction Cap Rates Lower



*Data not available before 1991.

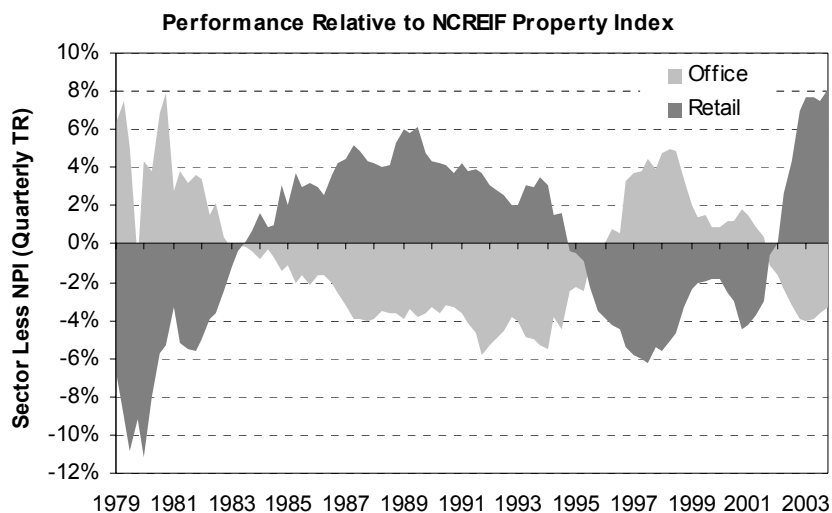
Source: National Council of Real Estate Investment Fiduciaries (NCREIF)

Finally, the US economy itself has exhibited some rather unusual features in recent years, most notably the stark contrast between the corporate and consumer sectors. The economic recession in 2001 was primarily a corporate recession. Although millions of people lost their jobs between the spring of 2001, when employment peaked at more than 132 million, and the fall of last year, when employment growth finally turned positive, most of the weakness in the economy was concentrated in the corporate sector.

The weakness in the corporate sector directly affected demand for office and industrial space, causing vacancy rates to increase and market rents to fall in both sectors, and exacerbated the already weak demand for hotel rooms. The office sector was hit particularly hard. As the tech bubble burst, new construction was beginning to accelerate for what proved to be phantom demand in many markets. According to Property and Portfolio Research (PPR), the office market suffered through eight consecutive quarters of negative absorption. This pushed the national vacancy rate to about 18%, or nearly as high as in the early-1990s market crash. But even during the depths of that crash, office absorption was never negative in any quarter.

Despite the weakness in the corporate sector and significant job losses, consumers weathered the economic downturn fairly well thanks to low interest rates, a booming housing market and generous tax relief. The continued strength of the consumer economy during the corporate recession provided a big boost to the retail market. Unlike the office and industrial sectors, retail vacancy rates did not rise sharply as the economy weakened. Instead, sustained consumer spending created demand from retailers seeking to increase market share by expanding their store base and trying new retail concepts and store formats. Retail real estate returned to favor with investors, many of whom had avoided the sector during the late '90s. As the chart below clearly shows, real estate investment performance has been a mirror image of the economy in recent years, with the consumer-driven retail sector of the NPI outperforming the corporate-driven office sector by a wide margin since the 2001 recession.

Relative Strength of Consumer Economy Drove Retail Performance



Sources: NCREIF; Prudential Real Estate Investors (PREI)

Lessons of the Disconnect

While the apparent disconnect between pricing and fundamentals has produced some seemingly counterintuitive results, it has also reinforced some very important relationships in the real estate market. As Dr. Youguo Liang, PREI's head of research, noted in his presentation at Pinehurst, although the US real estate market is very large and diverse, three distinct sectors of the economy ultimately drive investment performance across the major property types – office, industrial, retail and apartments – that account for most of the institutional investment market. These include the corporate and consumer sectors, described above, and the housing sector, which drives the apartment market.

Although the different sectors of the economy are not totally independent and do influence each other, the demand drivers of real estate stemming from each sector differ and, at times, can diverge. The corporate sector, for example, shed more than 2.5 million jobs after the recession officially ended. Weak employment, the key demand driver in the office market, caused office vacancy rates to rise and market rents to fall. On the other hand, consumer spending, which drives demand for retail space, has stayed remarkably strong. Clearly, employment affects consumers' ability to spend, but other factors – low interest rates, the booming housing market

and federal tax cuts – have more than offset the negative effects of the weak labor market on consumers. Similarly, although employment affects the housing market and individuals' ability to purchase homes or rent apartments, low interest rates and longer-term forces, such as demographics, have increased demand for homeownership and reduced demand for apartments.

The lesson for real estate investors, therefore, is that a diversified real estate portfolio should have exposure to all three sectors – corporate, consumer and housing. At times, investors may want to overweight or underweight certain property types in their portfolios based on the outlook for the different sectors of the economy. But exposure to all three sectors should help minimize portfolio volatility over the long term.

The disconnect also confirms that certain segments of the real estate market are highly sensitive to interest rates. In particular, assets with secure and predictable cash flows from long-term leases to credit-worthy tenants behave similarly to bonds. Since the timing and magnitude of the cash flows are known with relative certainty and typically account for a large share of the total return to the investor, changes in property market conditions have relatively little impact on investment performance. However, changes in capital market conditions, such as a rise or fall in interest rates, for example, can dramatically affect the attractiveness of the investment, similar to how changes in interest rates affect the value of a bond.

The opposite is true for properties with higher vacancy rates and/or shorter-term leases, where the value of the investment is much more sensitive to property market conditions. When property market fundamentals are deteriorating, assets with relatively less certain cash flows, due to higher vacancies, near-term lease rollovers or weaker tenants, expose investors to much greater market risk than well-leased assets with fixed (or known) contractual cash flows. However, when market conditions are improving, the potential upside can be much greater if the property can participate in the recovery, particularly if the initial yield, or going-in cap rate, reflects a premium for the higher market risk. At the very least, the relatively high, fixed operating expenses of most commercial properties mean that any incremental income generated through rent increases or improvements in occupancy goes disproportionately to the bottom line.

The most important and perhaps obvious lesson from the recent market cycle, however, is the potentially awesome power of capital flows in the real estate industry. Ironically, the same could be said in the early 1990s. Then, the *lack* of capital and liquidity exacerbated the weak conditions in the physical space markets rather than the *excess* liquidity that has created distortions in today's market. Both the physical space markets and capital markets have always, separately, driven real estate investment performance. Although intuitively most investors expect conditions in the space and capital markets to be aligned, this is certainly not the first time the two have diverged. The REIT market went through back-to-back years of negative total returns in 1998 and 1999 despite the strong recovery in the property markets. Capital flows out of REITs, which were relatively unattractive to the growth-oriented investors who then dominated the stock market, caused REIT share prices to fall sharply. But rarely, if ever, has the might of the capital markets been so readily apparent in the much larger private real estate markets.

While the powerful influence of capital flows in recent years confirms the importance of the cost and availability of capital in the real estate industry, it also highlights a long-term fundamental

change in the real estate markets that should have a lasting impact on the pricing and performance of real estate. As Mr. Lowrey noted, what appears to be a disconnect between the real estate space markets and real estate capital markets may in fact be a stronger connection between the real estate capital markets and the broader capital markets brought about by the growth of the public equity and debt markets for real estate. Unlike a decade ago, significant sums of investment capital can now flow freely into and out of the real estate market through the public and private equity and debt markets. Although the more complete capital market for real estate has greatly expanded the asset class's potential investor base, it also means that real estate increasingly will be priced relative to alternative investment opportunities. As the last few years have shown, inevitably certain real estate assets or securities at times will attract or repel capital (at the margin) for reasons having very little to do with the real estate space markets.

For investors, the implications of the more complete real estate capital market are many and widespread. Clearly, the growth of the public capital markets for real estate has greatly improved industry transparency. But the emergence of the REIT and CMBS markets has also provided the infrastructure needed to access a more diverse range of capital sources with a similarly wide array of risk-return preferences. That hotel companies could access the capital markets in 2002, when the near-term outlook for hotel demand and hotel firms was most bleak, shows the flexibility of the real estate industry's capital structure today. With access to more diverse sources of capital and a broader range of investment vehicles targeting specific risk-return strategies, the risk of a liquidity crisis in the real estate sector should be greatly reduced. But real estate yields may be lower than in the past, and finding attractive value-added investment opportunities may be more challenging as investors and investment strategies become more focused and sophisticated.

Life After the Disconnect

With the corporate recovery well under way, certain features that have dominated the investment environment in recent years will dissipate, and new forces will emerge to shape the property and investment markets. The first of these will be a recovery in demand for space. As Josh Scoville of PPR noted, the "job-loss recovery" has finally ended. Although the recent job growth has been widespread throughout the economy, outside of the manufacturing sector, the more favorable employment data this year is particularly good news for the office sector, where the recovery in tenant demand should provide opportunities for investors to participate in occupancy gains and, over time, rental increases. However, job growth will not be uniform across markets. In higher-growth markets with fewer barriers to new supply, such as Phoenix, the recovery-play investment opportunities will be shorter lived than in otherwise similarly supply-constrained markets, such as Washington, DC.

The recovery in the corporate economy should also lead to improving fundamentals in the warehouse market. According to PPR, the national warehouse vacancy rate peaked last year at 10.5%, or nearly as high as during the early-'90s market downturn. With corporate profits soaring and business investment rising, demand for warehouse space should accelerate as businesses rebuild inventories in anticipation of increasing demand for goods and services throughout the economy. Unlike the office sector, however, the warehouse market can respond quickly to changes in demand, which could limit the sector's appeal as a recovery play.

Likewise, more efficient inventory management systems could lead to a secular decline in warehouse demand, as businesses become more adept at managing inventory levels.

The corporate recovery will not necessarily create more investment opportunities in the retail sector, however, since retail space market conditions have remained fairly healthy throughout the market downturn. Few economists expect much of an increase in consumer spending as the economy recovers, and higher interest rates could actually cause the many consumers who have taken advantage of the easy credit terms in recent years to rein in their spending. While the strengthening economy will create demand for real estate, overwhelming evidence that the economy has finally turned the corner likely will compel the Fed to raise interest rates to head off inflationary pressures. Although inflation has been modest for several years, the massive federal deficit, sharply higher energy prices and increasing global demand for everything – from natural resources to finished goods and services – from high-growth emerging markets such as China and India have raised concerns that inflation will accelerate in the near term.

The impact of higher interest rates will depend on the timing and magnitude of interest rate increases. Initially at least, the Fed likely will show restraint in raising interest rates to avoid derailing the economy by raising rates too quickly. Nevertheless, higher interest rates will make real estate yields less attractive in the short term, especially for the most bond-like core properties whose prices have been bid higher in recent years. The strengthening economy may also dampen investors' enthusiasm for yield, which has attracted significant capital flows to the real estate sector for the last few years. Competition for assets may become less intense as interest rates rise and the most aggressive leveraged buyers withdraw from the market, which could cause cap rates to rise even as conditions in the space markets improve. But plenty of equity capital appears to be waiting if and when one or more sources of capital depart. At the same time, if rates rise too quickly, before space market fundamentals improve, more property owners could be forced to sell at discounted or distressed prices, which would put upward pressure on cap rates.

Finally, renewed demand from the corporate sector will set the stage for a new supply cycle in the real estate industry. Although new development has continued at a moderate pace in the consumer-driven retail sector and housing-driven multifamily sector, the development pipelines in the office, warehouse and hotel sectors virtually shut down as the corporate economy struggled. Historically, the bottom of the supply cycle has been an excellent time to buy existing assets positioned to capture the recovery in occupancy and rents, particularly in the office sector, with its long construction lead times. This time, however, the supply cycle could resume more quickly. Asset prices generally have not fallen significantly below replacement costs (and in many markets remain well above them), which should shorten the lag between the recovery in demand and renewed supply, particularly in markets with few barriers to supply. Developers have also managed to survive the recent market downturn much better than the early-'90s market collapse, when many firms were forced out of business, at least temporarily.

Concluding Thoughts

The next 12 to 18 months will be a critical time for the US real estate market. The recovery in the corporate economy and the increasing likelihood of higher interest rates should help close the wide gap between the real estate capital markets and physical space market fundamentals.

Vacancy rates should fall as tenant demand recovers and new supply remains modest, while rising interest rates and an improving outlook for other asset classes diminish the appeal of real estate yields. For investors, these events signal a shift in investment strategy from the credit-driven investing that has dominated the market in recent years to strategies that focus on the opportunities created by the recovery in demand and, eventually, rents.

Although we expect many of the unusual features in the real estate market over the last few years to give way to more familiar relationships between the property and capital markets, the recent market cycle has shown that the real estate industry is fundamentally different today than it was in the last market downturn. Most importantly, the increased linkage between the real estate capital markets and broader capital markets means that real estate must compete with other investment opportunities for capital. While this potentially exposes real estate investors to greater volatility in the pricing and availability of capital, access to more diverse capital sources with a broader array of risk-return preferences should improve the alignment between capital sources and capital users. Over the long term, more rational and efficient capital allocation should reduce the liquidity risk premium for real estate. So while the cyclical forces that have caused real estate pricing and market fundamentals to diverge will dissipate, longer-term forces will continue to make real estate attractive in a diversified investment portfolio.

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