

## Research

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The UK government's interest in creating a tax-efficient property investment vehicle is a positive step for the UK property and investment markets. In preparing our response to the HM Treasury's open request for comments regarding the creation of such a vehicle, we have reviewed the Consultation document and the "Barker Review of Housing Supply" published by the HMT and Inland Revenue as well as several recent reports by industry analysts (see "References" at the end of this report).

As detailed below, we believe that a properly structured, tax-efficient investment vehicle, tentatively called a "Property Investment Fund" (PIF), can help achieve the government's stated objectives for the UK property and investment markets. But such a vehicle alone will not be a panacea for all the market inefficiencies cited in the Consultation document. Instead, creating a tax-efficient property investment vehicle is one important step on the long road to a more efficient and flexible UK property and investment market.

### **Objectives**

The proposal to create PIFs is part of a wide range of reforms being considered to improve the UK property and investment markets and to promote long-term economic growth and productivity.<sup>1</sup> According to the Consultation document, the objectives of the reforms are to:

- Improve the quality and quantity of finance for investment in both commercial and residential property in a manner that promotes economic stability and market flexibility and helps to increase the supply of property;
- Expand access to a wider range of savings products on a stable and well-regulated basis, and therefore promote long-term savings for individual investors;
- Protect all taxpayers by ensuring that a fair level of taxation continues to be paid by the property sector, and reduce opportunities for tax avoidance; and

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<sup>1</sup> The "Barker Review of Housing Supply" provides a detailed examination of the inefficiencies in the UK residential market and offers policy reforms and recommendations to achieve the government's housing market objectives. Among the many recommendations in the report, the authors suggest creating "investment vehicles along the lines of US Real Estate Investment Trusts" to increase the supply of rental housing.

- Support structural change in property markets to reduce the costs and improve the quality and flexibility of commercial property to business users, and to improve efficiency and professionalism in the private rented sector for residential tenants.<sup>2</sup>

While the creation of PIFs is just one of many reforms being considered, we believe they would play an integral role in helping to achieve the government's ambitious goals. As a framework for our discussion, this report describes the potential capital market and physical space market benefits that could be realized over time with the successful design and launch of a tax-efficient property investment vehicle, and concludes with some ideas on how PIFs might be structured to achieve the stated objectives.

### **Persistent Industry Challenges**

The Consultation document cites a number of inefficiencies in the UK commercial and residential property investment markets, including:

- Lack of choice for small investors;
- Poor liquidity;
- Potential for more efficient use of property;
- High levels of debt financing;
- Tax distortions; and
- Variable standards of provision in the private rented sector.

Nearly all of these inefficiencies, with the exception of tax distortions, are related directly or indirectly to the real estate capital markets or physical space markets. The importance of the capital markets in the real estate industry should not be surprising. Real estate, after all, is a capital-intensive business. Property investments generally are large, "lumpy" assets that require substantial sums of capital to acquire and/or develop, and regular capital infusions to operate and maintain. And because no two properties are exactly alike, direct investments in property are not fungible. As a result, individual assets are relatively illiquid. At the very least, transactions take longer and are more costly to execute than in other asset classes, particularly stocks and bonds.

Clearly, these features pose a challenge for investors and property owners and managers. The relatively large size of most property investments is particularly challenging for smaller investors who would like to have some exposure to property in their investment portfolios, but who are limited in their ability to invest in a diversified portfolio of properties. Historically, the lumpiness of individual assets has also discouraged many institutional investors from allocating more than a small share, if any, of their investment portfolios to the asset class. But the industry's appetite for capital also poses a potentially severe liquidity risk for the industry itself. If capital becomes scarce, as it did in the US during the early 1990s market downturn, properties can be difficult or impossible to sell, except at very distressed prices. The quality of the existing stock can also suffer when capital availability is constrained and the cost of capital increases as investors defer routine maintenance and capital expenditures.

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<sup>2</sup> "Promoting more flexible investment in property: a consultation, March 2004," HM Treasury and Inland Revenue, pp. 14-15.

The physical space markets are also inherently inefficient. Transparency has improved greatly over the past decade or so as countries around the globe have introduced new structures for property ownership, but it remains a challenge due to the local nature of space markets and fragmented ownership. Even in the most developed markets, property ownership is highly diffused, which makes it difficult for property owners to achieve economies of scale. And although significantly more information is available now about supply and demand for property and the pricing and availability of capital, local market dynamics ultimately drive demand for individual property assets. The long construction lead times required to develop most properties exacerbate these space market inefficiencies, creating a natural and unavoidable lag in the industry's response time to changes in demand.

To a large extent, the familiar boom-bust pattern of the property market cycle is the unfortunate product of these persistent industry challenges. Because the property sector is such a large and important part of the UK economy, property market downturns are destabilizing not only for the real estate sector, but also for the broader economy.<sup>3</sup> Although few if any of these features can be “cured” entirely with a more liquid, tax-efficient vehicle for property ownership, a well-designed vehicle would provide the industry with much greater flexibility to address the challenges these characteristics pose.

### **Capital Market Benefits**

A tax-efficient property investment vehicle will benefit the property capital markets immediately and directly. The severe real estate depression in the US in the early 1990s demonstrates the potential risk of having concentrated capital sources in such a capital-intensive industry. The collapse of the US savings and loan industry and subsequent withdrawal by traditional private capital sources, mostly commercial banks and insurance companies, compounded the real estate market downturn brought about by excess supply in the late 1980s.

However, the liquidity crisis did produce overwhelmingly positive structural changes for the industry, most notably in the capital markets. Although REITs and mortgage-backed securities were not new concepts at the time – REITs were created in 1960 and the residential mortgage-backed securities market was already very large and highly developed in the early-'90s – the public equity and debt markets adapted to fill the void left behind when the private capital sources withdrew. Since then, the REIT and commercial mortgage-backed securities (CMBS) markets have grown geometrically.

The growth of the public capital markets has benefited the US real estate industry in several ways that may be instructive in the context of a similarly well-developed market like the UK.<sup>4</sup> Most obviously, the REIT and CMBS markets provide substantial alternative sources of capital, which alone should mitigate the risks of another severe liquidity crisis. If PIFs gain acceptance and a relatively liquid market for their shares develops, the UK property market should benefit from access to a broader capital base. Depending on the structure of the vehicle, particularly whatever constraints are placed on leverage, a vibrant PIF market could also encourage further

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<sup>3</sup> According to the Consultation document, commercial and residential property represents about two-thirds, or roughly £3.3 trillion, of the nearly £5 trillion in non-financial assets in the UK.

<sup>4</sup> For a detailed discussion of the effects of the growth of the public real estate capital markets in the US, see “Pension Funds and Real Estate: Still Crazy After All These Years,” Prudential Real Estate Investors, Fall 2001.

development of the public debt markets for property, which represents another, potentially vast, source of capital for the industry. In the US, for example, REITs have moved away from using project financing to more efficient entity-level financing, and have relied on the corporate bond and CMBS markets as a source for flexible, competitively priced capital.

A key benefit of the US public equity and debt capital markets has been the increased scrutiny and transparency that have accompanied their growth and development. The constant monitoring and reporting of space market conditions and industry and corporate balance sheets by equity analysts, credit rating agencies and others has greatly enhanced transparency in the US market and improved underwriting throughout the industry. Similarly, greater scrutiny and a proactive shareholder base have promoted better corporate governance, not only within the REIT market, but also across the entire industry.

A more subtle benefit of the REIT and CMBS market growth has been the broader spectrum of investors who can now supply capital to the industry and, by implication, their much wider array of risk-return preferences. The public markets, and the almost unlimited range of property-related investment products that can be created, allow investors to more finely segment the real estate capital structure. The tranching structure of the CMBS market, for example, allows investors to buy different “slices” of pools of mortgages with different risk-return characteristics.

In theory, a more complete capital structure should provide a better alignment of interests between capital sources and capital users, and allow the market to price risk more appropriately.<sup>5</sup> Alternatively stated within the context of the Consultation document, the public capital markets have improved the quantity and *quality* of finance for property investment in the US. Over the longer term, more rational and efficient capital allocation should lower the industry’s overall cost of capital and encourage more competition and professionalism across the industry.

The growth of the public markets has also benefited investors in the US. Investors of all types – individual and institutional – have much better *access* to property investments through the REIT market by purchasing shares directly or by investing in REIT mutual funds. And within the REIT market itself, investors can choose from a broad array of strategies and types of investments. Although many US REITs have evolved to invest nationally or, in a few instances, internationally rather than regionally to enhance portfolio diversification and leverage their expertise, most companies focus on a single property type, including multifamily residential.

From an investor’s perspective, specialization allows investors to construct and rebalance portfolios based on their own views of the relative attractiveness of different property sectors, management teams and/or valuations by sector and company. At the same time, specialization has intensified competition within the various property sectors, which has helped increase the quality of service and professionalism across the industry. Increasingly, property companies must offer a better value proposition – better quality space, more attractive lease terms, improved tenant services and so on – to differentiate themselves from their peers and to compete for tenants and capital.

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<sup>5</sup> See “The Expanding Frontier of Institutional Real Estate,” Prudential Real Estate Investors, May 2003, for further discussion of the proliferation of property investment opportunities and its effects on the industry and property investment market.

Many institutional investors, by virtue of the relatively large size of their portfolios, can invest in property through commingled funds and similar vehicles or by purchasing property directly. However, the public markets afford much greater flexibility (and a broader range of risk-return characteristics) in how institutional investors satisfy their allocations to the asset class. As the recent trend of institutional investor and REIT joint ventures shows, their involvement is not limited to share purchases. Although many drivers have contributed to this recent trend, the motivations for such partnerships are compelling. Joint ventures provide institutional investors with access to REIT portfolios and development pipelines as well as REIT management expertise, while REITs gain access to a potentially significant and consistent source of long-term capital at a competitive price.

### **Space Market Benefits**

Many of the potential space market benefits of a vibrant public property market derive directly from the capital market benefits described above. Improved transparency and liquidity and more efficient and flexible real estate capital markets should make the property markets more responsive to changes in supply and demand and dampen the boom-bust cycle. Likewise, the more competitive investment and operational environment should improve the quality and flexibility of commercial property and professionalism in the residential sector.

Issues of supply and affordability are more complicated. PIFs alone will not necessarily lead to an increase in the supply of property, particularly if their ability to participate in development activities is constrained. But if PIFs succeed in tapping into new capital sources, including otherwise reluctant institutional investors, demand for property investments must increase to accommodate the growth of the capital base. And with a more competitive and efficient property market, increased demand for assets offering attractive yields should encourage more value-added investment. Since development and redevelopment activities are the primary sources of value creation in the real estate industry, increased demand for value-added investments should encourage both. Thus, PIFs could contribute to improving the quality and quantity of commercial and residential stock, particularly if the broader land use and planning reforms outlined in the Barker Report on housing are implemented and succeed as envisioned.<sup>6</sup>

An increase in redevelopment activities would also help achieve the government's long-term goals of more efficient property use and regeneration of existing stock since at least some of the value-added opportunities, whether they are undertaken by PIFs or not, are likely to involve repositioning underutilized assets. Corporate and institutional owner-occupiers control a relatively large share of the property markets in the UK compared with most other countries with highly developed property markets. Although it's difficult (or impossible) to measure, some of this space is likely not being used as efficiently as it might be if the assets were owned and managed by an entity motivated to optimize the return on equity in the assets.

One of the primary catalysts for the broader property tax reform initiative is the need for more flexible rented and affordable housing in the UK. As detailed below, it seems likely that requiring each PIF to have some residential component would do more to thwart the growth of PIFs than to encourage new housing development. Improving and expanding the rental housing

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<sup>6</sup> "Barker Review of Housing Supply," March 2004.

stock requires new development and redevelopment of existing stock – residential, commercial and industrial. Obviously, the higher returns associated with these value-added activities reflect higher risks. In an efficient market, higher risks are typically borne by specialists who use their expertise, in this case in housing and/or development, to capture excess returns. To realize the highest benefits for the housing sector, therefore, the optimal vehicle structure should encourage specialization.

While the quality and supply of property may increase with more dynamic capital and property markets, improving affordability is a more elusive goal that will take much longer to achieve. This is particularly true in the housing sector. Despite the booming housing market in the US, for example, most metropolitan areas still lack adequate affordable housing. And in the commercial sector, gains in affordability ultimately may be measured only by improvements in “value” rather than lower rents. That is, rents and prices may continue to rise over the long term, as they have in the past, but improvements in the quality of commercial (and residential) space and the services that are provided to occupiers may result in more value for property users.

### **Possible Structures for a PIF**

The structural characteristics of the vehicle will be critical for PIFs to realize the capital and space market benefits outlined above. While the “PIF market” does not have to grow terribly large (as a share of the total UK property market) to have a meaningful impact on the industry, it does need to achieve some as-yet-undetermined critical mass. In the US, REITs accounted for only about 12.5% of the institutional property investment universe at year-end 2002, yet they exert considerable influence throughout the industry and investment markets.<sup>7</sup> In the remainder of this report, we describe some of the specific structural characteristics that we believe will help PIFs to gain acceptance from investors and property investment managers and operators. To facilitate the discussion, we address our specific comments to the questions raised in Chapter Two of the Consultation document.

We offer a few general comments, however. First, the UK already has a well-established public property market with a longer history than most markets. According to Global Property Research, the UK has the fourth largest public property market in the world (see table). So why has the existing market failed to produce the kinds of benefits envisioned in the Consultation document? While the majority of our report is devoted to how a well-designed, tax-transparent vehicle can *help* in achieving the government’s goals for reforming the property and investment markets, it may be helpful to examine how and why the existing market has not achieved these goals to date.

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<sup>7</sup> “Finding Niches – Trends in Public-Market Commercial Real Estate Penetration From 1997 to 2002,” Prudential Real Estate Investors, August 2003.

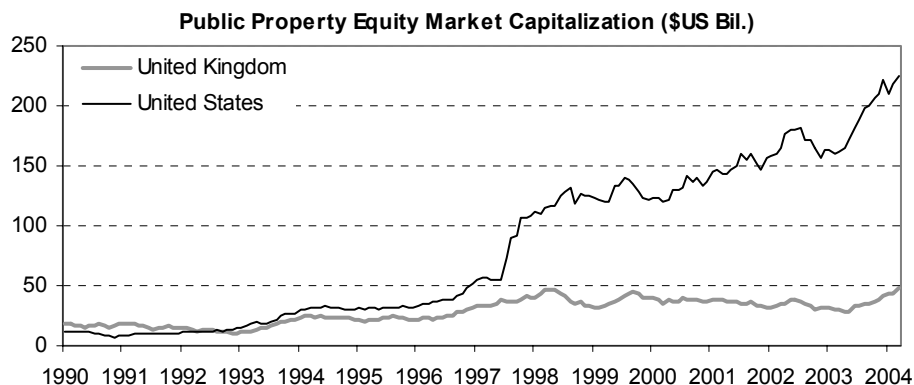
### Top Ten Largest Public Property Markets

Rank	Country	Equity Market Capitalization (\$US Bil.)
1	United States	221.2
2	Germany	103.8
3	Hong Kong	48.4
4	United Kingdom	40.9
5	Japan	33.0
6	Australia	31.4
7	France	16.9
8	Switzerland	13.3
9	Netherlands	12.0
10	Canada	9.8

Source: Global Property Research (data as of year-end 2003)

Although the UK public property market is relatively large compared with most other countries, it has experienced relatively little growth for most of the last decade while the public markets in other countries, particularly in the US and Australia, have grown rapidly. In January 1991, the total equity market capitalization of the UK public property sector was about \$17.6 billion, or nearly \$10 billion larger than the US REIT market. By year-end 2003, however, the US REIT market had grown to more than \$225 billion, or more than four times the size of the \$48 billion UK market.<sup>8</sup>

### Big Market, Relatively Little Growth



Source: Global Property Research (data as of year-end 2003)

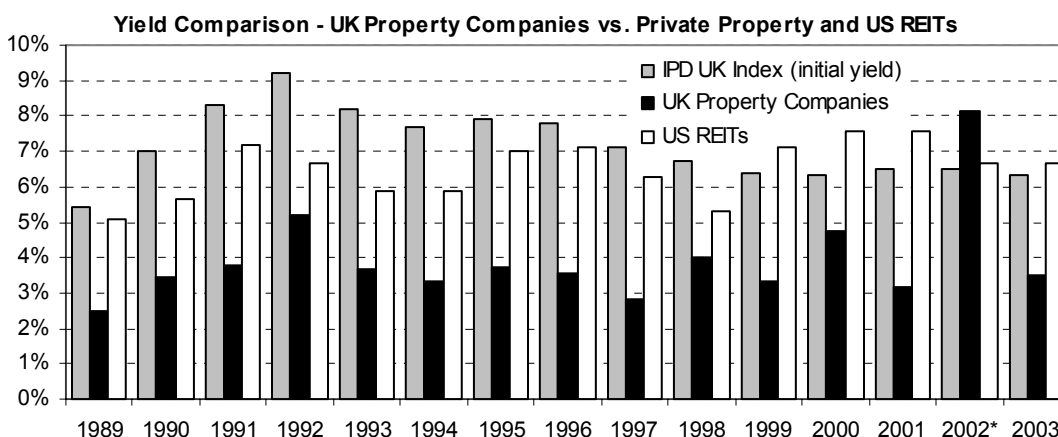
The lackluster growth of the UK market does not mean that UK property companies are necessarily flawed. It suggests, however, that property companies are not attracting strong capital inflows from investors or investment product from property owners, which may have something to do with the features, or lack thereof, of existing property companies' corporate structure. The biggest impediment to property companies gaining broader acceptance, and the main reason for the persistent discount to net asset value (NAV), is the tax inefficiency of the corporate structure. This is particularly problematic for tax-exempt institutional investors who, by investing through

<sup>8</sup> References to market capitalization based on data from Global Property Research.

public property companies, incur a tax liability they would not face if they invest in properties directly or through other investment vehicles. For these investors, the tax liability must be weighed against the potential value that property company management teams can add.

The embedded tax liability is also an issue for individual investors, but its effects on individuals may be more indirect. UK property companies traditionally have paid much lower yields than either direct property investments, as measured by the IPD Property Index, or US REITs (see chart below). While the initial yields for the IPD index and dividend yields for property companies are not perfectly comparable, since the IPD index is unlevered, the disparity suggests that property companies do not distribute property income and capital gains to investors as efficiently as other investment vehicles.

**Lower Yields Attract Fewer Investors**



\*Note: Two events, Land Securities' return of capital in September 2002 and Canary Wharf's special cash dividend in November, are largely responsible for the unusually high dividend yield in 2002.

Sources: Global Property Research (data as of year-end 2003); Investment Property Databank

One reason for their lower yields, of course, is that property companies are not *required* to pay out a high proportion of revenues. Property companies also tend to engage in more development than US REITs, for example, due to how they are taxed. Further, because property companies tend to trade at a discount to the NAV, which increases their cost of equity capital, they have a greater need to retain income for ongoing capital expenditures and new acquisitions. Although a more tax-efficient investment vehicle tailored to appeal to currently strong investor preferences for high-yield investments should make PIFs relatively attractive to a broader array of investors, many hurdles stand between creating the vehicle and realizing many of the reform objectives.

Obviously, a new investment vehicle will do little to achieve the government's goals unless the structure gains broad acceptance from investors *and* existing property owners and managers. Within the context of the investment markets, the challenge can be thought of as finding an appropriate balance between the *demand* for a high-yield, transparent and relatively liquid property investment structure and the *supply* of investment opportunities, or property and PIFs specifically. For parties on both sides of this supply-demand equation, the new vehicle must be competitive with other forms of property ownership and investment. In fact, one of the primary

reasons for the lack of growth and limited influence of existing UK public property companies is that the structure is not competitive with other forms of ownership and investment.

The importance of finding an acceptable balance between demand for PIF securities and an adequate supply of PIFs to produce a viable investment market is illustrated quite clearly by the experience in the US REIT market. Although REITs were created in 1960, they remained a relatively obscure niche of the US equity market and a minor player in the property markets throughout most of the 1970s and 1980s. In fact, not until the early 1990s liquidity crisis, when public capital markets stepped into the void left by private individual and institutional investors, did REITs grow rapidly and gain influence in the property and investment markets.

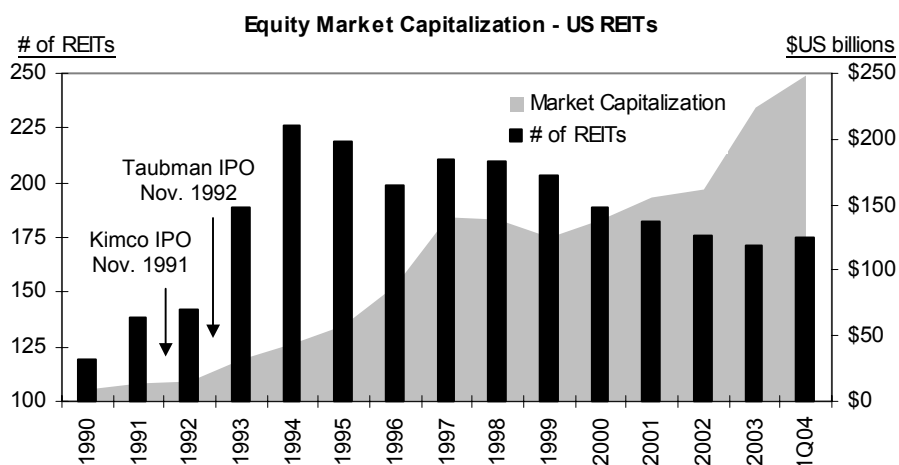
A confluence of events provided the essential supply and demand catalysts for the growth of the REIT market in the early 1990s. While the liquidity crisis created an urgent need for property owners to find alternative sources of capital, the distress in the private property markets created *demand* from public equity investors for the arbitrage and growth story that real estate securities offered. With institutional-quality property assets trading at steep discounts to replacement cost due to the withdrawal of private capital sources, Wall Street investment bankers and their distribution networks of brokers could easily make a compelling case for REIT shares offering relatively high cash yields and the potential growth that would be realized as the space markets recovered from the 1980s building boom. Kimco Realty Corporation (KIM), one of the largest retail REITs in the US, successfully tapped into this investor demand when the company first offered shares to public investors in its IPO in November 1991.

But not until the introduction of the Umbrella Partnership REIT, or UPREIT, the following year was the *supply* side of the equation sufficiently resolved to encourage the transfer of assets to REITs. At that point, the market began to grow and gain influence. The UPREIT structure, first used in the IPO of Taubman Centers (TCO), another large retail REIT, effectively enabled property owners to exchange their illiquid equity interests in real property assets (e.g., limited partnerships) for operating partnership units in an UPREIT without triggering a tax event.<sup>9</sup> The UPREIT, in turn, could then re-capitalize the properties and raise additional capital by selling shares through the public equity markets.

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<sup>9</sup> In many cases, properties were carried at very low book values and would have triggered substantial capital gains taxes if they were sold outright.

## Two Events Triggered Growth of US REIT Market



Source: National Association of Real Estate Investment Trusts (NAREIT)

As the above chart clearly shows, REIT market growth accelerated sharply once property owners had some mechanism for efficiently transferring assets to a publicly traded vehicle. Of the 95 REIT IPOs during the REIT market IPO boom in 1993 and 1994, 58 used the UPREIT structure. Further, while we will never know how quickly and large the REIT market could have grown without the UPREIT structure, the innovation enabled major private owners of property to consider using a public vehicle to monetize their holdings while retaining an ownership interest.

With the growth of the REIT market and many of the larger individual REITs in almost every property sector, the *availability* of the REIT structure as an alternate form of ownership, or as an exit strategy, has enhanced market liquidity. Assets and portfolios can trade between the public and private markets, greatly reducing the risk that capital will be completely shut off to any property sector. Asset pricing should, therefore, be more stable, since investors in both markets should respond more quickly to arbitrage opportunities when the pricing in one market gets too far out of line with the other.

The early-1990s market distress and UPREIT structure helped solve the REIT market's supply and demand issues. The severe depression in the private property market created an attractive investment opportunity for public equity investors, but only if the assets could be moved from the private to the public market. The UPREIT facilitated the transfer of assets from relatively illiquid private ownership vehicles to publicly owned investment trusts, creating both a supply of assets and a tool for future growth. From an industry perspective, the market growth that followed these events provided access to opportunistic investment capital that was willing to bear risks that other capital sources were avoiding to earn higher returns.

To replicate the success of the US REIT market in the UK, the challenge will be to create a tax-efficient, high-yield investment vehicle for individual and institutional investors that is attractive enough to existing property owners and investment managers to encourage its adoption over alternative structures. However, differences between the US and UK marketplace must be taken into consideration. For example, since institutions dominate the UK property market, the features

of any UPREIT-like mechanism for transferring assets to PIFs must address the specific needs of institutional owners rather than the individual owners who dominate the US market.

While we do not address the tax implications and transitional issues raised in the Consultation document, we strongly believe the potential benefits of dynamic public capital markets – equity and debt – warrant a progressive approach to taxation. This applies not only to the PIF vehicle’s stamp and corporate tax obligations, but also to any conversion tax assessed when an entity or fund elects PIF status. At the very least, there must not be any tax *disincentives* that might discourage the development of a viable PIF market. Further, to the extent that PIFs are intended to provide shareholders transparent access to investment property cash flows with much greater liquidity than direct ownership would afford, PIFs should be as efficient as possible in passing property income and capital gains directly through to shareholders. Losses in tax revenues at the corporate level can be offset by increased taxes at the shareholder level, particularly if a vibrant, liquid PIF market develops.

Finally, sound reasons exist for modeling PIFs along the lines of Australian limited property trusts (LPTs) and US REITs. It is not a coincidence that REITs and LPTs share many common characteristics. Among the more compelling reasons for designing PIFs to resemble these structures:

- LPTs and REITs are widely recognized as successful models with relatively long track records;
- In their current forms, LPTs and REITs reflect three decades of evolution and reforms to improve the vehicle structures;
- Although LPT and REIT shares have traded at discounts to NAV for prolonged periods, on average both vehicles have traded at a premium to NAV, which suggests that the vehicles provide an opportunity for managers to add value to the underlying property portfolios; and
- Institutional investor acceptance of both vehicles should facilitate the adoption of a similar vehicle in the UK market, which could accelerate market growth, encourage cross-border capital flows and allow PIFs to potentially tap into a much larger capital base.

In the comments below, we respond directly to the questions raised in Chapter Two of the Consultation document. While both LPTs and REITs have features that should be considered in designing a similar vehicle for the UK market, most of our references below to structural features of existing vehicles refer to REITs, with which we are more familiar.

## Response to Consultation Questions

**To what extent would a listed PIF close the gap with net asset value and enable a wide retail investor base? How would an unlisted PIF meet these objectives? What additional investor restrictions might be necessary?**

The Consultation document states quite clearly the government's preference for a publicly listed, closed-end vehicle that would make property investments more accessible to small investors. We agree that publicly listed PIFs are essential for achieving the principal objectives of the reforms and that a closed-end structure allows more efficient use of investors' capital than an open-end structure. But requiring that PIFs be publicly listed may hamper the growth of the PIF market and acceptance of the vehicle and potentially deprive investors of an alternative property investment option. Rather, the benefits of public ownership should be self-evident to the types of PIFs that the government envisions, namely property companies (or portfolios) that own well-leased, income-producing core assets.

Although unlisted PIFs may ultimately do little to increase small investors' access to property investments, they may provide an attractive property investment alternative with performance characteristics that more closely resemble private market investments over the short term. Private PIFs would allow individual investors, who may have difficulty or be precluded from investing in commingled funds and limited partnerships, to invest in property without the volatility of daily pricing in the public markets. While the objectives of public and private real estate vehicles are often similar and the underlying assets in which they invest may be the same, the performance characteristics of the vehicles themselves can differ dramatically.<sup>10</sup> Generally, private vehicles offer greater stability but are less liquid than public vehicles. For some investors, the liquidity-volatility trade-off of public vehicles is not sufficient to justify an allocation to the public property market. Private PIFs, therefore, may provide an alternative for certain investors whose access to property is limited.

A flexible structure that allows for unlisted or listed PIFs may also benefit the property industry and investment markets in other ways. For example, a public listing may not be appropriate for companies or portfolios at certain points in their life cycles. Private REITs have been used quite effectively in the US to "seed" a REIT before going public, allowing the management team to build a track record, grow and refine the asset portfolio and articulate a clear strategy. Additionally, a private PIF structure might provide a more efficient mechanism for repositioning and recapitalizing underperforming companies or portfolios.

As the Consultation document rightly observes, one of the main benefits of a publicly listed vehicle is the increased market scrutiny that comes with raising capital in the public markets. While this is certainly true, the vehicle structure should not overly constrain management's ability to retain cash flow or access the capital markets quickly when the need arises. More scrutiny is better than less. But if PIF managers must return to the capital markets for every transaction or capital need, the inefficiency of the capital-raising process in such a capital-

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<sup>10</sup> For a more detailed discussion of differences between the public and private investment markets, see "Rational Differences Between Public and Private Real Estate," Prudential Real Estate Investors, May 2004.

intensive industry likely would discourage adoption of the PIF structure and limit managers' ability to grow and maintain their portfolios.

Determining how best to distribute rental income and capital gains to investors without compromising the ability to maintain assets and prudently grow the portfolio to benefit the shareholders is a key challenge in designing an efficient pass-through income vehicle. In the US, REITs have much greater flexibility in how they raise and deploy capital today than they did initially. The REIT Modernization Act of 1999 (RMA) changed the minimum distribution requirement to 90% from 95%, allowing REITs to retain more income to reinvest in new properties or recycle into existing assets. But as they have evolved into operating companies, rather than relatively passive investment portfolios, many REITs have migrated away from project-based financing to entity-level financing. REITs frequently issue corporate debt to meet their ongoing capital needs, all under the watchful eyes of the credit rating agencies.

Whether publicly listed PIFs will help narrow the persistent discount to NAV that has been a hallmark of public UK property companies will depend heavily on how PIFs are taxed. If PIFs are exempt from corporate income taxes, assuming they meet certain qualifications, and income distributions are taxed only at the shareholder level, PIFs would avoid an extra layer of taxation that public property companies currently face. The corporate income taxes that UK property companies must pay currently represent an imbedded tax liability that makes property company shares relatively less attractive than other property investment vehicles. Removing the tax disadvantages does not, however, mean that the discount will disappear entirely or that the market will not go through periods during which PIFs trade at even steeper discounts than property companies do today. But the sources of any discount (or premium) should be market-based. That is, they should reflect the strength or weakness of management, assets and/or property and capital market conditions.

Additional organizational features and investor restrictions that may help achieve the government's objective of ensuring a wide investor base include requirements for a minimum number of investors and maximum ownership concentrations by individual investors, both of which are cited in the Consultation document. US REITs must satisfy two ownership tests to qualify for REIT status: they must have at least 100 different shareholders, and five or fewer individuals cannot own more than 50% of the value of the REIT's stock.<sup>11</sup>

While we favor similar requirements for a minimum number of shareholders and an ownership concentration limit for PIFs, we believe the more restrictive ownership concentration rule referenced in the Consultation document could be problematic. Specifically, the document mentions a "20/49" rule, which states that 20 or fewer investors could not own more than 49% of the shares. Such a restriction could significantly limit the appeal of PIFs for existing property owners, whose interest in a newly launched PIF initially could represent a significant share of the PIF's total assets, as well as a PIF's ability to attract large institutional investors. In addition, we believe the ownership concentration test for a PIF should include a "look-through" provision similar to the US rules that would allow the PIF to include the individual investors that an institutional fund investor (mutual fund or pension plan) represents.

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<sup>11</sup> National Association of Real Estate Investment Trusts (NAREIT)

## **Should the property management arrangements of a PIF be prescribed through legislation?**

The organizational structure of US REITs has evolved considerably since they were first introduced. Initially, REITs were relatively passive investment trusts, which, in most cases, were externally managed. Since then, however, most public REITs have evolved into fully integrated real estate operating companies with internal management teams. Investors and the market generally perceive internally managed US REITs as having a better alignment of interests between shareholders and REIT management. In theory, internal management teams should be motivated to maximize shareholder value and can be held accountable if their performance falls short of shareholder expectations.

Internally managed REITs have also encouraged specialization in different property sectors, allowing the best companies to attract talented industry professionals. As discussed earlier, specialization has intensified competition within the various property sectors. This has encouraged property investment managers and operators to improve the quality and efficiency of their product offerings and to adopt industry best practices to attract capital and tenants.

We do not believe, however, that requiring PIFs to be internally managed is the optimal solution. Rather, the market should dictate which type of management structure is appropriate. In the US, the market has a preference for internally managed REITs. The few externally managed REITs tend to trade at a discount to their internally managed peers. But in Australia, externally managed LPTs dominate the market and are accepted by investors. Fewer restrictions should make PIFs more attractive as an alternative to existing, less efficient vehicles and promote a more dynamic, self-regulating market.

## **Should the minimum gross income distribution requirement be 90 per cent (before depreciation)?**

Most of the tax-efficient property investment vehicles that exist in different markets around the globe require some minimum income distribution, ranging from as low as about 80% in Belgium to as high as 100% (before depreciation) in Singapore. In the US, REITs are required to distribute at least 90% of their taxable income, which allows companies to make an allowance for depreciation and thereby retain some free cash flow. However, if a REIT retains more than 10% of its taxable income, the income that is not distributed to shareholders is subject to the same tax treatment as any other (non-REIT) corporation.

While a high payout ratio is necessary to create a high-yield, tax-efficient income vehicle for investors, we believe the payout requirement for PIFs should apply to income after depreciation, rather than before depreciation, as referenced in the Consultation document. The PIF requirements must balance the need to create a transparent vehicle with a relatively high current yield for investors with property owners' and managers' capital access needs. PIFs should be able to retain some income and capital gains to ensure that companies have the balance sheet capacity to make the necessary investments to maintain assets and improve operational efficiency. As discussed above, requiring PIFs to return to the public equity market for every capital need is an inefficient and potentially expensive way to finance a capital-intensive

business. Furthermore, the public capital market windows (debt and equity) open and close, sometimes for reasons that have nothing to do with real estate market fundamentals. This increases the risk that capital may be unavailable (or very expensive) for prolonged periods.

**What level of borrowing should be permitted in order to best deliver increased market scrutiny and stability in the property investment market?**

The Consultation document makes frequent references to the potential risks of debt financing in the property sector and indicates a clear preference for PIFs to be financed almost entirely with equity so that “borrowing would only be needed as a contingency margin.”<sup>12</sup> Clearly, gearing increases the risk that cash flows will be more volatile and, in a worst-case scenario, the potential risk of default. But these risks alone do not necessarily make gearing bad. Rather, they confirm the potential danger of using debt inappropriately or imprudently. When underwritten properly, well-leased, income-producing properties are ideally suited to long-term financing with modest amounts of debt, particularly when the cost of debt falls below property cash yields.

The ability for PIFs to use debt conservatively and retain some income and capital gains could actually help achieve many of the government’s objectives. Requiring PIFs to return to the public equity markets for every transaction or capital need may, in theory, lead to more scrutiny. But it will almost certainly make PIFs less efficient and most likely will increase their cost of capital. Long-term debt financing, along with the ability to retain some portion of earnings, would make PIFs much more flexible and efficient in how they raise and deploy capital, and ultimately make them more competitive in the market for both investments and investors.

Further, some use of debt by public property companies may enhance the level of scrutiny while promoting the further development of other capital sources (e.g., the CMBS market) for the property industry. In the short term, increased availability of debt capital and innovations in the debt markets may encourage development and redevelopment activity. In the US, debt capital has always been a prerequisite for new development, and debt market innovations, such as the government-sponsored entities Fannie Mae and Freddie Mac, which play a key role in promoting residential development, have made it easier to manage risks by aligning capital users with capital sources. As long as projects are underwritten conservatively, and the debt and equity positions are structured properly, the risks can be managed, particularly as market transparency improves. Over the long term, more diverse capital sources should make the industry more stable and less prone to the boom-bust pattern of the past.

While we would not object to some regulatory limit on gearing for PIFs, we strongly believe the market is capable of regulating the appropriate use of borrowing, just as it has in the US and Australia. The greater risk seems to be that an overly restrictive structure would put PIFs at a competitive disadvantage with other property investment vehicles, which could discourage the adoption of PIFs and greatly reduce their effectiveness in achieving the government’s goals.

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<sup>12</sup> Section 2.32 of the Consultation document (pg. 22).

**In order to meet the Government’s stated objectives, and as a condition for different corporation tax treatment, should there be restrictions on the development and investment activity of a PIF, and the definition of allowable property? How should this be achieved?**

Promoting new development and regeneration of existing properties is a key objective of the reform initiative, especially in the residential sector. Although public property companies in the UK today are not precluded from development, and some public companies are relatively active developers, collectively they are not creating enough commercial or residential property, at least not according to the Consultation document and Housing Review.

The apparent reluctance of existing companies to do more development may stem from the lack of differentiation between companies that undertake riskier value-added projects, like development and redevelopment, and those that do not. UK companies that are involved in development generally do not trade at a premium to their peers. Their willingness to develop properties to grow their portfolios, despite not being rewarded for taking more risk, may say something about their competitiveness within the transaction market for existing assets. If property companies’ cost of capital is higher because they generally trade at discounts to the underlying NAV of their portfolios, they may have difficulty competing in the transaction market for assets.

A tax-efficient vehicle alone will not necessarily increase development activity directly. If the new vehicle makes companies that adopt the structure more competitive in the transaction market, it may slightly reduce the development and redevelopment activities of public property companies. But a viable PIF market should encourage development and redevelopment indirectly. In the US, for example, few REITs actually develop new properties, in part due to restrictions on developing properties for immediate sale rather than for their own portfolios. But they have become an important and fairly consistent source of “take-out” equity capital for private developers. (In this respect, REITs play a role similar to Fannie Mae and Freddie Mac in the debt markets for the residential sector.)

Over the longer term, a vibrant PIF market should also encourage more development and redevelopment by helping to complete the industry capital structure. As discussed earlier, the US REIT market has facilitated the development of a wide array of investment vehicles with different investor strategies and risk-return characteristics. The theoretical benefits of a more complete capital structure include more efficient allocation of capital, potentially lower overall cost of capital, and better alignment between risk and return for capital sources and capital users. However, a practical benefit has been the emergence of largely private development companies with national and international platforms whose scale and expertise can attract capital from many sources at competitive prices.

From a practical perspective, vehicles like REITs, which appeal to investors’ desire for stable, relatively high cash yields, are not ideal as development platforms. PIFs should, therefore, be somewhat restricted in their ability to develop properties to ensure that the vehicle offers investors performance characteristics similar to investing directly in income-producing investment properties. But this need should be balanced with the desire to encourage a more dynamic public market for property. REITs, for example, are not explicitly restricted from

engaging in development activities. However, operational restrictions regarding the sources of income that qualify for favorable tax treatment, along with the 90% income distribution requirement, effectively limit the extent to which REITs can participate in development. This balance allows REITs to maintain a development capability, primarily as a means to grow their own portfolios, without compromising the risk-return characteristics of the vehicle.

Although the benefits for the broader property market and industry as a whole are more subtle, REITs' ability to participate in a wide range of property-related activities, including development, has encouraged the evolution of REITs from passive investment trusts to real estate operating companies. This, in turn, has helped attract more entrepreneurial talent and expertise to the REIT sector than if the structure were more restrictive. Some of these activities were not permitted until the passage of the RMA, which allowed REITs to own up to 100% of the stock of a taxable subsidiary that could provide tenant services, such as leasing, space planning, landscaping, etc.

The US REIT experience argues strongly in favor of allowing PIFs to participate in development and redevelopment projects, directly or indirectly, and to create and own taxable subsidiaries to engage in property-related activities beyond collecting rents. While many of these activities go beyond the scope of the objective for creating PIFs as a means for smaller investors to access property investments, they are consistent with the broader objectives of increasing the supply and quality of commercial and residential property and the level of professionalism in the industry.

Similar flexibility in the activities that PIFs can undertake will not, however, immediately increase the supply of property. Since many of the property market reforms being considered are aimed at encouraging residential development, it may be advisable to modify certain restrictions on development and/or income and capital gains distribution for PIFs that specialize in the residential sector. To encourage development of single-family homes, for example, it might be necessary to exempt residential PIFs from the restrictions on developing assets for immediate sale. Likewise, a lower income distribution requirement for residential PIFs might encourage companies to reinvest more retained income and capital gains in new development.

Ultimately, investor preferences will determine the extent to which PIFs can engage in development and other property-related activities, and the types of properties that are appropriate for the PIF structure. For this reason, we do not believe that limiting the types of properties in which PIFs could invest would be necessary. Rather, allowing the market to determine which types of properties are suitable for a PIF should help promote the growth of non-traditional property types whose access to capital would otherwise be constrained.

**How could the structure of a PIF be designed to ensure better quality of stock? Is a minimum holding period appropriate, and if so how long should the period be?**

While PIFs may satisfy the government's objectives for increasing small investors' access to property investments, a passive vehicle may do little to promote better quality stock, particularly if the vehicle is limited in its ability to maintain the assets due to income distribution requirements and/or leverage restrictions. As noted earlier, REITs have evolved from passive investment trusts into real estate operating companies that actively manage their portfolios and

assets to increase return on equity or invested capital. In the process, increased competition from REITs, many of which have developed expertise in one or more property sectors, has encouraged more efficiency and professionalism across the US property and investment markets.

To meet the objective of improving the quality of stock, therefore, we strongly recommend granting PIFs enough flexibility to function as active property companies rather than merely as passive investment trusts. While we do not believe a minimum holding period would benefit shareholders or the industry, since real property assets by their nature are difficult to trade quickly, we would not object to a pro-rated capital gains tax scale that would encourage PIFs to hold properties for a minimum of three to five years. As noted above, it may be necessary to relax these restrictions for residential PIFs to encourage more development of single-family housing.

**How could a PIF deliver high quality residential property for the entire range of rented accommodation, and what features of a PIF would help to achieve this aim, while meeting the objective to ensure no overall cost to the Exchequer?**

The stated objectives for the UK residential sector, which were the real impetus for the Consultation document in the first place, are a direct challenge to the property industry. The interim report of the Barker Review recommended that the government consider “a vehicle, based on the US Real Estate Investment Trust model, to encourage institutional investment” in the residential sector. By encouraging greater institutional investment, the government hopes to improve the quantity and quality of rental housing stock in the UK and to provide an alternative, less risky approach to investing in housing for smaller investors in particular. To achieve these goals, the Consultation document inquires “whether it would be practical to require a percentage of a PIF’s investment be in residential property.”<sup>13</sup>

While a minimum residential investment requirement is a relatively simple and straightforward idea that might increase institutional investment in the housing sector, we do not believe such a requirement would be effective in achieving the government’s broader objectives. As a practical matter, unless the minimum residential investment requirement is quite large, merely requiring PIFs to invest in the residential sector will not necessarily provide investors with an alternative approach to investing in residential property unless one or more residential-focused PIFs emerge. Likewise, assuming the minimum residential investment requirement is a relatively modest share of the overall portfolio, PIF managers could view the requirement as a cost of doing business as a PIF. If so, rather than devoting significant capital and resources to adding value through the residential portion of the portfolio, PIF managers may be more inclined to passively invest only in stable, income-producing residential properties where the risks are relatively limited. Finally, requiring all PIFs to invest some portion of their portfolios in the residential sector would limit investors’ ability to manage their portfolio allocations by property sector.

Designing a structure that would encourage the creation of specialized residential PIFs is probably the best opportunity for addressing the housing sector’s deficiencies through a new investment vehicle. Dedicated apartment REITs in the US have helped increase the supply and quality of rental housing while promoting industry best practices, and have provided much easier

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<sup>13</sup> Section 2.44 of the Consultation document (pg. 23).

access to residential investment opportunities for all types of investors. Obviously, dedicated residential PIFs would allow individual investors to invest in the housing sector with much greater liquidity and diversification than directly buying individual assets. And institutional investment in the housing sector could also increase.

Most importantly, perhaps, specialized PIFs should promote a more competitive rental housing market, as PIF management teams with residential expertise exploit the inefficiencies in the housing market. In theory, dedicated residential PIFs should increase investment in the rental housing sector and create more demand for value-added opportunities. Again, since development and redevelopment are the primary sources of value creation in the real estate business, increased demand for value-added investments should encourage new development and the regeneration of existing stock.

The challenge, therefore, will be to design the structure so that dedicated residential PIFs are economically attractive to investors and managers. At a minimum, the structure should be as transparent as possible. If any requirements for residential PIFs differ from those for PIFs generally, there should be fewer or less restrictive requirements for residential companies or funds. Further, to encourage new development and renewal of existing stock, residential PIFs should also have some ability to engage in these activities directly or indirectly. Finally, the vehicle should encourage managers to actively manage their assets and, when appropriate, to re-invest in properties to make them more competitive.

While a number of structural features could help achieve the government's housing sector objectives, reforms aimed at financing rental housing seem more likely to succeed without creating too much complexity or direct costs to the Exchequer. For example, if PIFs are allowed to use long-term debt financing to meet some of their capital needs, it might be possible to design a bond-like security for housing development and redevelopment that would help lower the cost of capital for such projects by reducing the risks to the bondholders. In the US, government-regulated entities like Fannie Mae and Freddie Mac, which originate and buy single-family and multifamily residential loans, have been a tremendous and reliable source of liquidity.

Although we are not advocating creating similar government-sponsored entities in the UK to help finance the housing market, we believe programs that target the financing of development and redevelopment may offer the best opportunity for increasing the supply and quality of rented housing stock while encouraging the creation of specialized residential PIFs. We should note, however, that achieving the affordable housing objectives likely will require more creative and complex solutions, as affordable housing remains a serious challenge in most developed countries.

**How could a PIF be structured to encourage greater flexibility for occupiers in the commercial sector? What conditions could be set for PIF landlords to ensure high standards in both residential and commercial sectors?**

We believe the best way to encourage more flexibility in the commercial sector and higher standards in both the residential and commercial property sectors is to promote a more competitive property market. This has certainly been the experience in the US, where internally

managed, specialized REITs have been a source of innovation, expertise and transparency across all property types.

### **Summary**

The UK property and investment market would benefit greatly from a carefully designed, tax-efficient property investment vehicle. The success of the vehicle, however, will depend on its ability to attract investors and talented industry professionals who can use their expertise to realize attractive returns for themselves and their investors while promoting a more competitive and efficient property market. If the structure is not competitive or is overly complex, the market will never achieve critical mass, and PIFs' influence will be limited.

At the very least, simplicity should be a guiding principle in designing PIFs to make the structure as transparent and self-regulating as possible both for investors and potential PIF managers. To this end, the structure should be relatively unencumbered by restrictions and should encourage PIFs to be more than merely passive investment funds. While such a vehicle alone will not cure all of the deficiencies in the UK property market, we believe PIFs would play an integral role in helping to achieve many of the objectives outlined in the Consultation document.

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