

Research

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For the past year, a recovery in the office market has been under discussion. National non-farm employment had hit its trough in the summer of 2003 after falling for more than two years, and vacancy rates had finally started to stabilize and recover. In the first half of 2004, optimism reached its peak, as non-farm employment was better than expected, and talk of a recovery gained momentum. But by the summer of 2004 that momentum had slowed, and the employment figures did not meet expectations. By October, the employment data became positive again, and optimism returned. The ride has been more like a roller coaster than a smooth sail, but the recovery finally seems to be on the right track.

Recoveries seldom, if ever, are linear, but the data pertinent to the office market's recovery had not been encouraging. The market had been seeking clear signs of a rise in demand for office space to show that the recovery had truly begun because of the critical role demand plays in recovery. During the downturn, as employment suffered, so did office development. New office supply overall has fallen since 2001 and is expected to be limited over the next few years. Given the current imbalance between office supply and demand, demand growth is paramount before making office investments.

As the economy continues to recover, opportunities in the office sector will occur as new jobs appear, thus creating demand for space. The demand data shows that while the Sun Belt and California will lead the way in employment growth, a broad market recovery should present many recovery play opportunities, even in strong markets.

The Recent Recession

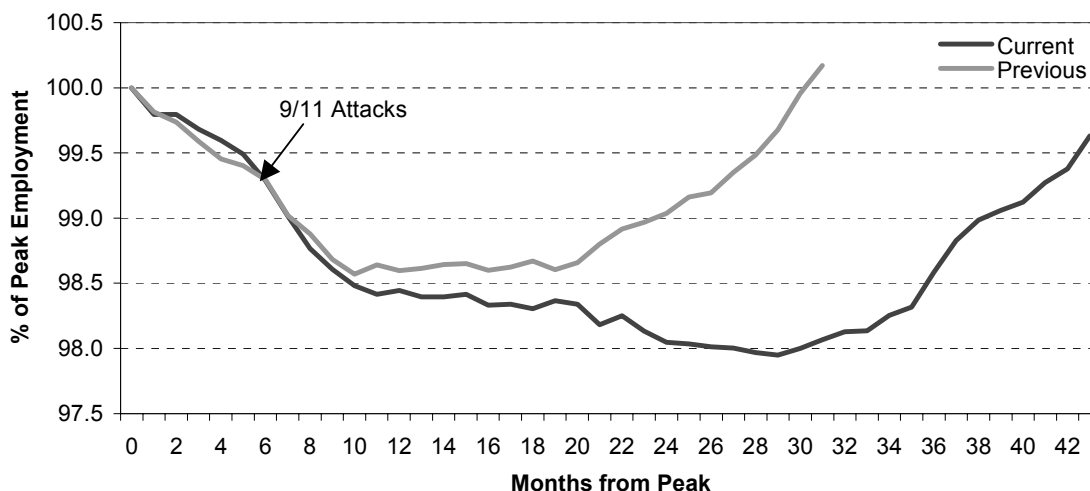
During the most recent recession, 2.7 million jobs, or roughly 2%, were lost in the US. This is more than the 1.6 million jobs, or 1.5%, that were lost during the previous recession in 1991. However, the salient point in comparing the severity of these two recessions in the labor market is not the relative severity but the relative duration.

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Exhibit 1 displays the non-farm employment level as a percentage of the peak level achieved during the current and previous recessions. The current recovery in the employment market has taken far longer than the previous recovery. Not only did it take 19 months longer to reach the trough, but the current trough was realized in the 29th month after the peak employment level. By the 29th month in the previous recession, the employment level had almost returned to the peak level. The current labor market recovery has yet to return to the peak achieved in February 2001. Now that the labor market is nearing its full recovery, the likelihood of recovery play opportunities is much more realizable than it was even six months ago.

Exhibit 1: Length of Contraction/Recovery in Last Two Recessions



Source: Economy.com

The decline in the labor market in both contractions looks quite similar until the 7th or 8th month after the respective peak employment levels. This would be about the time that the effects of the 9/11 attacks, which took place in the 6th month after the peak, would begin to show in the labor market. Although the specific effect of the 9/11 attacks is difficult to quantify, and they certainly cannot be blamed for the entire downward trend from that point forward, they nonetheless had an unprecedented impact on the severity and duration of the employment contraction. However, this impact was not consistent across markets.

Differences in Local Labor Market Performance

Although the recession’s impact on employment was obviously severe, the magnitude of job loss was not uniform throughout the US. In fact, some metro areas actually experienced job growth during this time, while other areas suffered job losses in excess of 20% of their employment base. **Exhibit 2** provides a more detailed look at the job losses for the 60 largest US markets by population, which have been grouped into clusters. The clusters are based on the markets’ economic characteristics, geographic location and size.¹ This chart details the trough employment amount and month, the peak employment amount and month, and the amount and

¹ For a more detailed discussion of our clustering methodology, see *Size-Tiered Economic Geography: A New View of the US Real Estate Markets*, October 2004.

Exhibit 2: Employment Peak to Trough

Top 60 MSAs by Cluster	Trough	Trough Month	Peak	Peak Month	Lost Pk.-Tr.	% Lost
Tech Centers						
San Jose	840.1	Mar-04	1,055.4	Dec-00	215.2	20.4%
San Francisco	942.8	Nov-03	1,096.5	Dec-00	153.7	14.0%
Seattle	1,337.5	May-03	1,426.8	Dec-00	89.3	6.3%
Boston	3,091.1	Dec-03	3,292.8	Feb-01	201.7	6.1%
Portland	921.3	Nov-03	977.3	Jan-01	55.9	5.7%
Austin	651.8	Sep-03	685.2	Jan-01	33.5	4.9%
Oakland	1,017.5	Oct-03	1,067.7	Feb-01	50.2	4.7%
Raleigh	676.5	Apr-03	694.0	Mar-01	17.5	2.5%
Heartland Markets						
Detroit	2,021.4	Sep-04	2,210.6	Mar-00	189.2	8.6%
Cleveland	1,104.2	Jan-03	1,179.9	Feb-00	75.7	6.4%
Kansas City	938.9	Apr-03	987.0	Oct-00	48.0	4.9%
Chicago	4,078.0	May-04	4,254.0	Dec-00	176.0	4.1%
St. Louis	1,290.0	Oct-03	1,336.3	May-00	46.4	3.5%
Columbus	871.1	Mar-04	902.1	Feb-01	31.0	3.4%
Cincinnati	861.5	Jun-02	890.6	Dec-00	29.1	3.3%
Salt Lake City	703.3	Mar-03	724.8	Dec-00	21.5	3.0%
Minneapolis	1,717.2	Aug-03	1,762.1	Feb-01	44.9	2.5%
Memphis	582.5	Jun-02	596.4	Oct-00	13.9	2.3%
Nashville	668.1	Apr-02	681.7	May-00	13.6	2.0%
Indianapolis	883.0	Mar-02	896.7	Mar-01	13.8	1.5%
Southern Growth						
Denver	1,132.7	Feb-04	1,219.6	Dec-00	86.9	7.1%
Dallas	1,897.8	Jul-03	2,015.3	Feb-01	117.5	5.8%
Fort Worth	774.7	Jul-03	799.5	Jul-01	24.8	3.1%
Charlotte	823.2	Feb-02	847.1	May-00	23.9	2.8%
Atlanta	2,150.4	Apr-03	2,205.9	Mar-01	55.5	2.5%
Houston	2,089.2	Sep-03	2,124.7	Jul-01	35.5	1.7%
New York Corridor						
New York	4,071.7	Sep-03	4,318.7	Dec-00	247.0	5.7%
Middlesex	636.7	Apr-03	673.9	Apr-01	37.3	5.5%
Bergen	650.3	Mar-03	673.7	Sep-00	23.4	3.5%
Newark	1,006.3	Sep-02	1,026.1	Nov-00	19.8	1.9%
Nassau	1,213.5	May-02	1,228.3	Nov-00	14.8	1.2%
Philadelphia	2,404.8	Nov-01	2,417.5	Feb-01	12.7	0.5%
Monmouth	394.5	Mar-01	395.8	Dec-00	1.4	0.3%
Lifestyle Centers						
Miami	1,002.3	Jun-03	1,031.2	Mar-01	28.9	2.8%
Orlando	898.2	Dec-01	920.2	Jan-01	22.1	2.4%
Las Vegas	772.6	Dec-01	790.2	Aug-01	17.6	2.2%
Phoenix	1,580.5	Dec-01	1,605.8	Feb-01	25.3	1.6%
Tampa	1,207.5	Mar-01	1,220.3	Nov-00	12.9	1.1%
San Antonio	722.8	Dec-01	730.4	Jul-01	7.6	1.0%
Fort Lauderdale	698.6	Dec-01	702.9	Jul-01	4.3	0.6%
West Palm Beach	524.1	Feb-03	525.3	Nov-02	1.2	0.2%
Sacramento	751.8	Jul-03	752.3	May-03	0.6	0.1%
Southern California						
Los Angeles	3,984.2	Oct-03	4,114.0	Feb-01	129.8	3.2%
Orange County	1,396.8	Feb-02	1,425.7	Mar-01	28.9	2.0%
San Diego	1,218.7	Jul-01	1,219.0	Jun-01	0.3	0.0%
Riverside	1,066.6	Jul-02	1,066.7	Jun-02	0.1	0.0%
Capital Metro						
Baltimore	1,244.2	Sep-03	1,264.6	Dec-00	20.4	1.6%
Washington, DC	2,784.8	Sep-01	2,804.5	Dec-00	19.7	0.7%
Opportunistic						
Greensboro	630.3	May-04	674.3	Feb-01	43.9	6.5%
Grand Rapids	558.2	May-03	593.5	Mar-00	35.3	5.9%
Hartford	590.1	Sep-04	624.6	Jul-00	34.5	5.5%
Milwaukee	828.4	Jan-04	870.1	Jul-00	41.8	4.8%
Oklahoma City	529.2	Oct-03	550.0	May-01	20.8	3.8%
Pittsburgh	1,104.6	Feb-04	1,143.3	Feb-01	38.6	3.4%
New Orleans	610.5	May-04	631.0	Feb-01	20.5	3.3%
Buffalo	542.3	Nov-01	559.6	Aug-00	17.2	3.1%
Providence	437.0	Nov-01	444.4	Dec-00	7.4	1.7%
Jacksonville	558.7	Feb-01	564.5	Oct-00	5.8	1.0%
Norfolk	719.9	Dec-01	721.5	Aug-01	1.7	0.2%
United States	129,801.7	Jul-03	132,490.1	Feb-01	2,688.4	2.0%

Source: Economy.com, units in thousands

percentage of jobs lost from peak to trough for each market. On a percentage basis, the Tech Centers cluster suffered the most serious job losses. For example, San Jose and San Francisco, respectively, lost 20.4% and 14.0% of their employment during each market's descent from peak to trough. Given the concentration of technology-related jobs and companies in these metro areas, such drastic losses in the wake of the economic downturn and the collapse in technology investment made sense. The Heartland Markets fared second worst. This also makes sense given the concentration of industrial jobs in these areas and their continuing decline as many of these jobs relocate to countries with lower labor costs. The markets with the largest employment decreases also generally had longer downward trends in employment, which echoes the national trend. Most of the top 60 markets reached their peak employment levels in 2000 or 2001. However, the areas that experienced the worst percentage change in employment also reached their troughs much later, typically in 2003 or 2004.

But many markets among the top 60, predominantly in the Lifestyle Centers and Southern California, not only avoided job losses but also experienced employment growth during the period of national job loss. Several markets in California, Texas and Florida attained new non-farm employment highs within the first two quarters of 2004. Many of these markets have trough dates and employment amounts listed in **Exhibit 1**, but their peak to trough losses are very small. The trough dates listed represent the lowest level of employment following a peak in late 2000 or early 2001, but these were temporary setbacks. The resilience of these markets stems from their underlying growth. This growth, which weathered the recession, will also persist through the next economic expansion.

Projected Growth

Exhibit 3 shows the projected five-year employment growth rates and amounts for the top and bottom 10 markets ranked by projected percentage change. Over the next five-year period, beginning November 2004, US non-farm employment is expected to grow by 7.3%, or 9.7 million jobs. Although lower on a percentage basis than previous recoveries, the quantity of jobs projected over this period is equivalent to the amount created during similar five-year intervals over the last two decades. It is projected to take only a few months for employment to return to its peak of 132.5 million jobs, reached in February 2001.

As the economy grows over the next five years, the markets with the highest projected growth rates (among the 60 largest markets) are essentially the same markets that experienced the least severe job losses despite the economic downturn. Markets in the Lifestyle Centers in particular are expected to have some of the highest growth rates in the nation over this five-year period. These markets have recently experienced greater job growth than the rest of the US. Although it will take technology-dependent markets like San Jose and San Francisco more than five years to return to their peaks, they will nevertheless experience 8% to 9% job growth. However, secondary markets, such as Pittsburgh, Newark and Buffalo, are expected to generate only modest job growth of 3% to 5% over the next five years.

Exhibit 3: Employment Growth

Rank	Top 10 MSAs	5-Year Projected Growth	% Change
1	Austin	123.79	18.8%
2	Orlando	163.85	17.1%
3	West Palm Beach	92.05	16.9%
4	Riverside	186.26	16.7%
5	San Antonio	117.93	16.1%
6	Phoenix	258.14	15.5%
7	Fort Lauderdale	113.10	15.3%
8	Las Vegas	129.05	14.9%
9	Tampa	177.77	14.2%
10	Seattle	187.75	13.7%

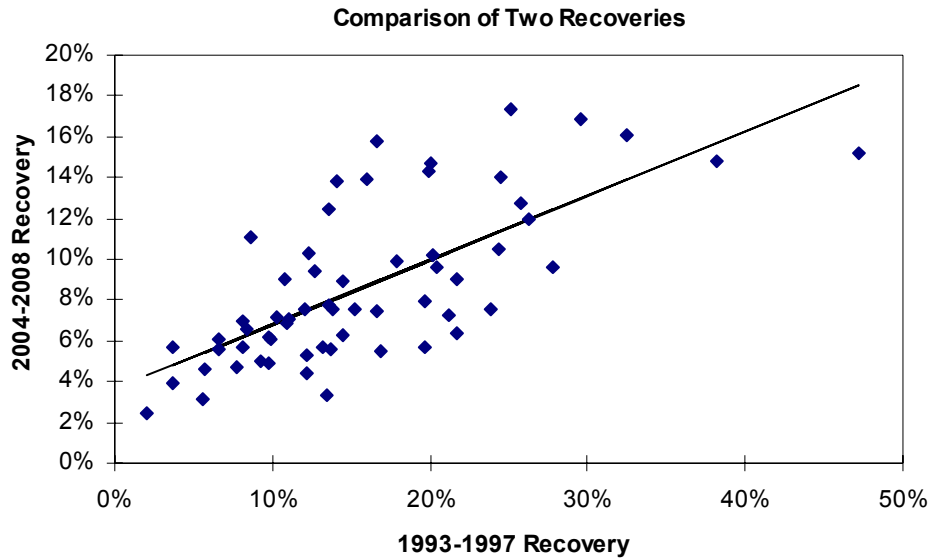
Rank	Bottom 10 MSAs	5-Year Projected Growth	% Change
1	Pittsburgh	35.06	3.2%
2	Greensboro	25.01	3.9%
3	Hartford	25.58	4.3%
4	Newark	44.60	4.4%
5	Buffalo	24.90	4.6%
6	Bergen	31.32	4.7%
7	Philadelphia	121.69	5.0%
8	Milwaukee	42.72	5.1%
9	New Orleans	32.70	5.3%
10	Cleveland	62.37	5.6%

Source: Economy.com, units in thousands

The markets with the strongest employment performance during the most recent recession are also the markets with the highest projected five-year growth rates. This shows that their growth is fundamentally strong, not just high growth rates from small bases. Quite the contrary – these are high growth rates from employment bases that are the highest they have ever been for many of these markets. Many more are a mere few months away from reaching new peak employment levels. The Lifestyle Centers and Southern California markets have ordinarily fared the best in economic downturns and should see the highest employment growth rates, continuing their trend of the last couple decades.

The US employment recovery is forecast to be strong, but the data shows that the projected employment recovery of 2004-2008 will not be as strong as the recovery of 1993-1997 on a percentage basis. **Exhibit 4** plots the regression of the five-year forecasted employment growth rates for the top 60 markets versus the 1993-1997 recovery's growth rates for the same markets. The trend is that the markets with the highest growth rates in the last recovery will have the highest growth rates in the current one, even if they are not as robust. This trend is observable because the changes taking place in these markets (change in employment being the most relevant) are occurring over long periods. Barring a significant traumatic event, markets grow and recede over relatively long time horizons. If a change in this trend were to take place, it would also occur over relatively long periods and would be spotted in the regression analysis in the form of an outlier that deviated from the observed trend. However, given the lack of significant outliers, this continued growth pattern is readily observable. Understanding where and when this growth is occurring will underlie any effective investment strategy. In recovery play investing, timing is critical.

Exhibit 4: Regression of Future Five-Year Growth Rates on 1993-1997 Growth Rates



Sources: Economy.com; Prudential Real Estate Investors

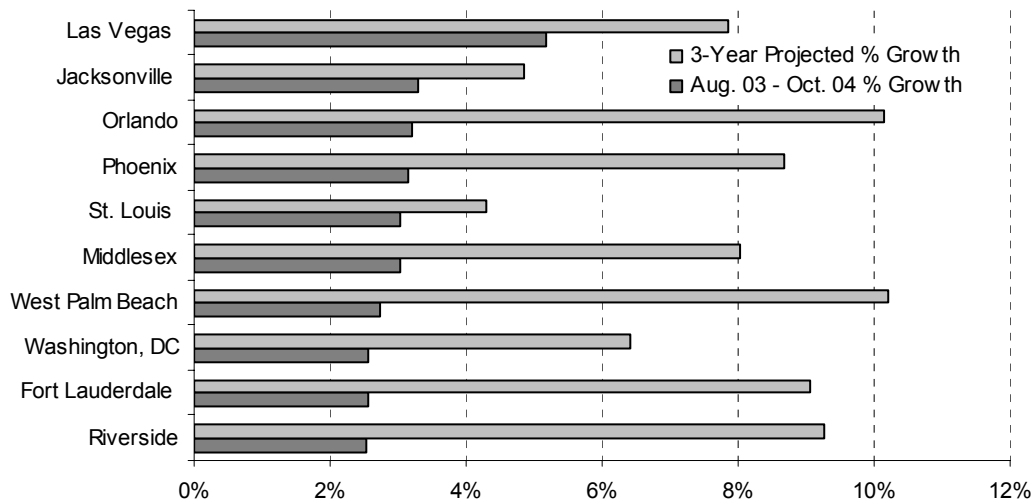
Early Starters

Because of the current supply/demand imbalance and lack of new office development, the most attractive markets for recovery play investing are those that are projected to have high growth sooner rather than later. Therefore, it is useful to track the progress of the markets that have successfully created jobs since August 2003 and determine which are also likely to maintain employment generation.

Exhibit 5 examines the markets with the highest growth rates (among the same 60 markets) from August 2003 through October 2004 and charts this against their three-year projected growth rates (from October 2004). These top-20 “early starters” are ranked using their August through May growth rates. Many of the markets among the top-20 early starters also have high three-year projected growth rates. This indicates that these markets have already experienced significant job growth, which is a good harbinger for future growth. It also signals that these markets could see a near-term increase in office demand with growth anticipated to continue. Most markets with high three-year growth rates exhibit this characteristic.

The chart shows the potential timing differences in job growth, even among markets with high projected growth rates. Although the need to analyze a longer period for growth still exists, given the potential holding period of office investments, the early starters offer some reassurance that the longer-term projections have already begun to materialize for most high-growth markets. This timing is crucial for investment opportunities that capitalize on employment recovery.

Exhibit 5: Early Starters – Job Growth Rates



Source: Economy.com

Focus on Office Employment

While the outlook for total non-farm employment growth looks positive, especially in certain markets, it will mean little to investors if the employment growth is not the type required for successful office investing – namely, growth in the office-using segment of the labor force. General employment growth does not assure that office employment (and consequently, demand for office space) will rise. However, as the US continues to transition to a post-industrial service economy, more of the employment growth will be from the office-using segment. Thus, it is necessary to thoroughly examine office-using employment projections. A comparison of forecasts from four independent data providers reveals insights into which markets are likely to have the highest growth rates of office-using employment between 2004 and 2008. We can also learn which forecasts are the most consistent and thus present a lower relative forecast risk compared with other markets with high but inconsistent growth projections.

Exhibit 6 details the markets that all four data providers cover, ranked by the coefficients of variation (CV) for their office-using employment projections. The CV is defined as the standard deviation (Std. Dev.) divided by the mean and provides a measure of relative consistency. The exhibit also displays each data providers' projections, the standard deviations and the means of the projections. This data shows that projections are not necessarily equal. For example, Columbus and Indianapolis have very similar mean office-using employment growth rates (11.5% vs. 11.4%), however, their CVs differ quite substantially. Columbus has a CV of only 4.7%, while Indianapolis has a CV of 12.2%. Although this promises nothing, Columbus offers much more consistent forecasts than Indianapolis. The CVs allow valuable comparisons that the absolute level of the mean growth rates would obfuscate.

This analysis can be helpful when comparing high-growth cities. The high-growth cities with the lowest CVs, such as Dallas, Orlando and Atlanta, offer much more consistent outlooks than the high-growth cities with higher CVs, such as Austin and Seattle. Although the goal is to focus on

cities with high growth rates, the consistency of views provides some reassurance that the forecasts are grounded in sound research and are not skewed by one or two overly optimistic assessments. However, forecasts with a high mean and CV might indicate that not all of the views on a particular market are the same and that an investor should thoroughly review this before making an assessment of the market's growth prospects.

Market Stress

The data on office employment growth is encouraging, but it paints an incomplete picture. One cannot fully understand the impact that employment growth will have on a market without knowing the current level of market stress and how long it is expected to last. To accomplish this, a measure of the duration of market stress, years of supply, is needed. Years of supply is calculated by taking the current vacancy rate in the market, subtracting the natural vacancy rate, which is assumed to be 10%, and then dividing the difference by the average annual demand growth rate for the next four years. This assumes the supply in each market is constant, which seems reasonable, given the limited supply of new office space expected over the next few years.

Exhibit 6: Forecast Consistency, 2004 to 2008

MSA	PREI Office Index	TWR	REIS	PPR	Std. Dev.	Mean	CV
Dallas	15.40%	14.20%	15.10%	15.10%	0.50%	15.00%	3.50%
Orlando	20.30%	20.80%	18.90%	20.20%	0.80%	20.00%	4.00%
Atlanta	18.50%	19.40%	17.50%	18.00%	0.80%	18.30%	4.30%
Columbus	12.00%	11.20%	10.90%	12.00%	0.50%	11.50%	4.70%
Chicago	10.60%	10.70%	9.60%	9.80%	0.60%	10.20%	5.60%
Phoenix	23.20%	24.10%	20.30%	23.60%	1.70%	22.80%	7.50%
Orange County	19.10%	21.30%	17.80%	20.50%	1.50%	19.70%	7.80%
Boston	8.70%	9.20%	7.60%	8.50%	0.70%	8.50%	7.90%
Houston	12.60%	10.40%	12.70%	12.50%	1.10%	12.10%	9.00%
W. Palm Beach	23.50%	19.50%	19.60%	20.60%	1.90%	20.80%	9.10%
Tampa	24.00%	25.40%	19.90%	24.30%	2.40%	23.40%	10.30%
Riverside	24.80%	23.10%	19.80%	20.60%	2.30%	22.10%	10.30%
Charlotte	17.50%	16.30%	13.60%	16.30%	1.60%	15.90%	10.30%
Hartford	6.30%	4.90%	5.40%	5.90%	0.60%	5.70%	10.90%
Detroit	8.40%	9.90%	7.80%	8.10%	1.00%	8.50%	11.40%
Las Vegas	27.20%	22.70%	20.80%	22.90%	2.70%	23.40%	11.50%
Fort Lauderdale	27.10%	24.80%	20.50%	23.40%	2.80%	24.00%	11.60%
Minneapolis	10.70%	11.00%	8.40%	10.50%	1.20%	10.10%	11.70%
Nashville	16.50%	16.80%	12.90%	14.30%	1.80%	15.10%	12.10%
Indianapolis	13.50%	10.40%	11.00%	10.90%	1.40%	11.40%	12.20%
Portland	12.10%	12.80%	9.80%	12.90%	1.40%	11.90%	12.20%
Cincinnati	12.90%	12.10%	9.60%	11.20%	1.40%	11.40%	12.40%
New York	8.00%	6.20%	6.10%	6.40%	0.90%	6.70%	13.40%
Los Angeles	10.50%	9.10%	7.50%	8.60%	1.20%	8.90%	13.60%
Cleveland	12.00%	11.80%	8.80%	10.20%	1.50%	10.70%	13.80%
Kansas City	11.90%	12.40%	8.80%	11.00%	1.60%	11.00%	14.40%
San Diego	17.60%	20.50%	14.30%	18.60%	2.60%	17.70%	14.70%
Miami	13.10%	12.30%	9.10%	11.60%	1.70%	11.50%	15.20%
Raleigh-Durham	23.60%	26.60%	18.40%	26.80%	3.90%	23.80%	16.50%
Jacksonville	17.20%	18.10%	12.40%	14.60%	2.60%	15.60%	16.60%
Sacramento	21.50%	22.90%	15.30%	19.20%	3.30%	19.70%	16.90%
Philadelphia	7.50%	7.90%	5.60%	5.90%	1.20%	6.70%	17.20%
San Francisco	12.30%	14.10%	9.10%	12.80%	2.10%	12.10%	17.70%
San Jose	14.90%	17.90%	11.60%	16.30%	2.70%	15.20%	17.70%
St. Louis	12.60%	11.20%	8.20%	9.80%	1.90%	10.50%	17.90%
Salt Lake City	15.60%	19.30%	12.60%	18.10%	3.00%	16.40%	18.10%
Austin	30.00%	19.90%	24.10%	21.80%	4.40%	24.00%	18.30%
Denver	11.70%	14.90%	9.40%	12.60%	2.30%	12.20%	18.70%
Washington, DC	17.40%	15.40%	11.90%	11.90%	2.70%	14.10%	19.00%
Baltimore	11.20%	12.40%	7.70%	9.20%	2.10%	10.10%	21.00%
Memphis	17.10%	15.50%	11.40%	11.00%	3.00%	13.80%	21.70%
Seattle	21.60%	19.20%	12.10%	16.10%	4.10%	17.30%	23.80%
Pittsburgh	4.10%	6.90%	4.10%	5.40%	1.30%	5.10%	25.90%

Sources: Economy.com; Torto Wheaton Research; REIS; Property and Portfolio Research

Exhibit 7 details the results of this analysis. This ranking is more geographically diverse than the employment growth rankings previously discussed. Some of the markets with high employment growth projections, such as Riverside, San Diego and Orange County, also have very low years of supply, indicating that they have a relatively low level of market stress. Yet other markets with high employment growth projections, such as Austin and Dallas, have high years of supply, indicating a relatively high level of market stress.

Exhibit 7: Years of Supply

	Current Vacancy	Projected Demand Growth	Years of Supply
New York City	8.4%	1.5%	-1.10
Riverside	11.5%	4.7%	0.33
Washington, DC	10.9%	2.2%	0.42
San Diego	11.5%	3.5%	0.44
Orange County	11.8%	2.4%	0.72
Fort Lauderdale	13.8%	3.9%	0.98
Las Vegas	14.7%	4.3%	1.10
Nashville	13.0%	2.6%	1.16
West Palm Beach	12.5%	2.1%	1.22
Orlando	15.5%	3.8%	1.44
Baltimore	13.2%	1.9%	1.68
Sacramento	17.1%	4.2%	1.70
Seattle	14.9%	2.8%	1.75
Tampa	15.9%	2.8%	2.13
Charlotte	17.2%	3.2%	2.21
Fort Worth	15.2%	2.2%	2.34
Phoenix	18.3%	3.4%	2.42
Raleigh	19.5%	3.9%	2.42
Northern New Jersey	16.4%	2.5%	2.57
Oakland	16.0%	2.3%	2.60
Jacksonville	18.9%	3.4%	2.65
Memphis	17.0%	2.5%	2.78
Miami	14.3%	1.5%	2.82
San Francisco	17.9%	2.7%	2.98
Atlanta	19.9%	3.1%	3.25
Cleveland	17.5%	2.1%	3.62
Salt Lake City	19.9%	2.5%	3.92
Philadelphia	16.0%	1.5%	3.94
Los Angeles	14.5%	1.1%	4.23
Minneapolis	19.6%	2.1%	4.54
Boston	17.5%	1.6%	4.81
Columbus	20.3%	2.1%	4.85
Chicago	17.8%	1.5%	5.08
Denver	20.5%	2.0%	5.19
Indianapolis	18.2%	1.5%	5.35
Kansas City	19.4%	1.7%	5.41
San Jose	14.9%	0.9%	5.56
Houston	18.3%	1.4%	5.76
Detroit	20.4%	1.7%	6.00
St. Louis	18.5%	1.4%	6.19
Dallas	26.9%	2.7%	6.26
Portland	17.6%	1.2%	6.33
Cincinnati	18.9%	1.3%	6.61
Austin	20.8%	1.6%	6.77
Hartford	18.5%	1.1%	7.85
Pittsburgh	19.0%	1.0%	9.19

Sources: Torto Wheaton Research; Prudential Real Estate Investors

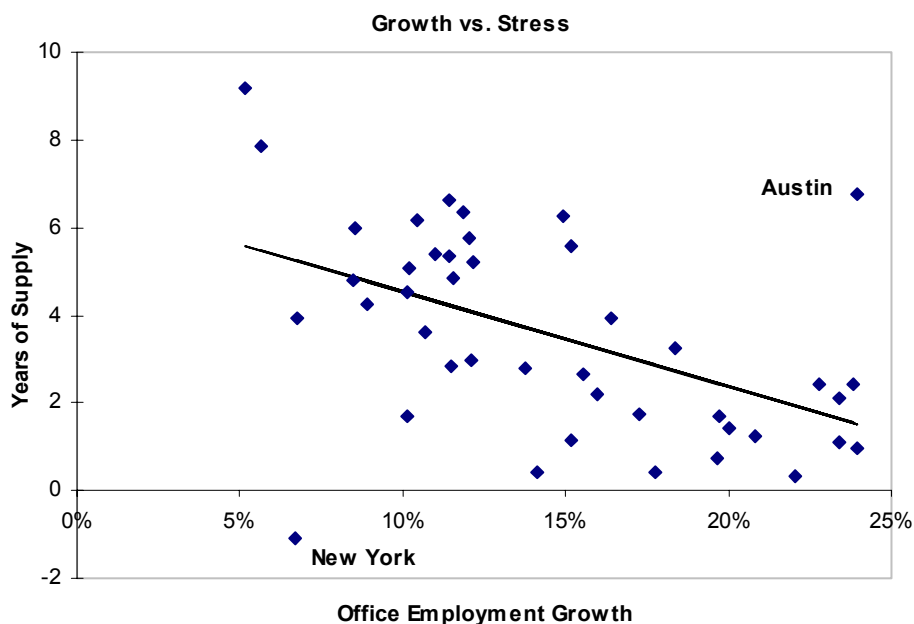
Note: Natural vacancy for all markets assumed to equal 10%.

Nonetheless, an interesting trend emerges from the data. The top 10 markets with the lowest levels of stress generally exhibit both relatively low current vacancies and relatively high projected annual demand growth (12.4% and 3.1%, respectively), while the bottom 10 markets with the highest levels of stress generally exhibit both relatively high current vacancies and relatively low projected annual demand growth (19.4% and 1.4%, respectively).

A Composite View

By pulling together the analyses of market stress and office employment growth, a composite view emerges. As shown in **Exhibit 8**, a relationship exists between the stress level of the markets and their projected five-year office employment growth prospects. Generally speaking, markets with lower years of supply are anticipated to have the strongest growth rates, while those with the higher years of supply are anticipated to have the weakest growth rates.

Exhibit 8: Regression of Years of Supply on Office Employment Growth Rates



Source: Prudential Real Estate Investors

The outliers demonstrate why this type of analysis is beneficial. New York and Austin both deviate greatly from the observed trend. In the case of New York, the years of supply is the lowest of the markets analyzed (negative since the current vacancy in New York is below the assumed natural vacancy rate of 10%), but its office employment growth is not projected to be among the strongest. In contrast, Austin has strong office employment growth forecasts but has a high years of supply figure. These two outliers demonstrate the need for detailed market analysis. High growth levels or stress levels mean little in isolation. Only together can we formulate a view about demand.

Concluding Thoughts

Employment recovery has taken far longer in this recession than in the previous one. It seemed as if a corresponding recovery in the office market would never arrive. But the job market has recovered after reaching its trough in August 2003 and has almost recaptured all of the jobs lost during the downturn. It now stands poised for new growth.

The projected growth rates are not as robust as during the 1993-1997 recovery, but growth rates still appear heartening, particularly in the office-using part of the economy. The regression analysis indicates that we can use growth rates from the previous recovery to help understand where future growth is likely to arise because the long-term growth trend persists. The southern half of the US, particularly the Lifestyle Centers, leads the way in the job market recovery. In these high-growth markets, the downturn in employment was not tremendously severe, and recovery began relatively quickly. Although many of these markets have experienced strong job growth to date despite the national downturn, they are expected to continue to do well for the next few years as the economy grows.

Despite job growth over the last 14 months, realized and projected growth needs to be considered within the context of market stress. Strong markets can perform well without stellar employment growth, much like weak markets can continue to struggle even with strong employment growth. Many, though not all, high-growth markets are also anticipated to have relatively few years of supply, which is encouraging.

All these signs indicate that the timing is finally right, after the long wait, for recovery play investing. Although some investors may have already purchased vacancy in anticipation of this, opportunities should still be available. Opportunities will exist in the markets that can capitalize on the employment growth quickly as supply and demand work their way back to a normal equilibrium level. Ultimately, pricing and an investor's current holdings will determine which markets to invest in.

The returns from the impending recovery are likely to be lower than in the last recovery, but an economic resurgence will provide investment opportunities in the office market that have not been prevalent for the last few years. If employment expands as expected in 2005, recovery play investing will finally return.

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