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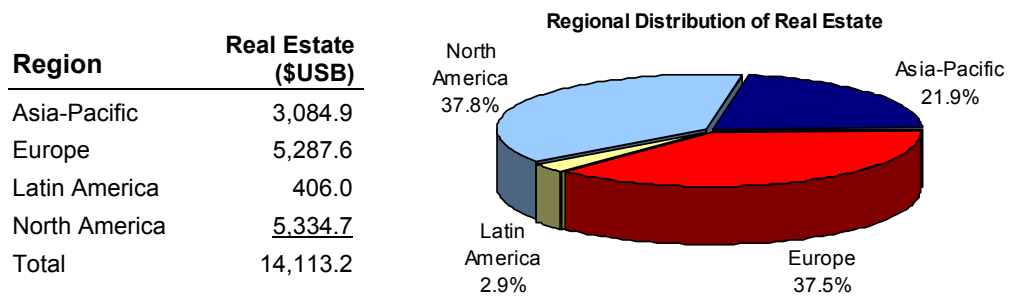
The global public real estate market is undergoing a transformation today. In countries throughout Asia, Europe and Latin America, authorities are introducing or considering new tax-transparent property investment vehicles similar to US real estate investment trusts (REITs) and Australian listed property trusts (LPTs). In markets where these vehicles have been introduced, and where they already existed, investors' demand for safety and yield has caused share prices to rise sharply over the last few years. As a result, the equity market capitalization of the global public property market has grown significantly since 2001, and tax-transparent vehicles (hereafter generically referred to as "REITs") have accounted for the lion's share of the growth.

The growth of the global REIT market stems from the confluence of powerful demand and supply forces: short- and long-term demand for stable, income-oriented investments and an expanding universe of real estate investment opportunities that offer relatively attractive yields and modest opportunities for capital growth. But the expanding global REIT market also means that real estate has gained acceptance as an asset class, which accounts for the demand side, and that the market infrastructure, the supply side, is developing rapidly to satisfy (and foster) increasing investor demand. This report examines the trends in the listed property sector, the key drivers of the recent REIT market growth and the implications of a vibrant global REIT market for the real estate capital and space markets and for investors.

Global Property Universe and Public Ownership

The global commercial real estate market is large and quite diverse. Although these obvious features make it difficult to measure the exact size of the investable universe of institutional-quality properties, we estimate the total size of the global commercial real estate market was about \$14 trillion as of year-end 2003, or roughly 12% of the global investment universe including stocks, bonds and property (see **Exhibit 1**). Europe and North America each accounted for about \$5.3 trillion of the commercial real estate universe, or nearly 38% each, followed by Asia-Pacific's roughly \$3 trillion (22%) and Latin America's \$406 billion, or 3% share.

Exhibit 1: Regional Distribution of Commercial Real Estate¹



Source: Prudential Real Estate Investors (data as of year-end 2003)

Despite the large size and diversity of the global economy and property markets, the investable universe of institutional real estate is concentrated in the major property markets. **Exhibit 2** shows the top-15 countries in terms of higher-grade commercial real estate and their respective market shares in our 50-country universe. Together, the top-15 markets account for nearly 88% of all commercial real estate in the 50 countries we track, and a slightly smaller share, about 84%, of the total economic output.

Exhibit 2: Top-15 Commercial Property Markets

Rank	Country	Population (mil.)	Higher-Grade Real Estate (\$USB)	Global Share	Cumulative Share
1	United States	290.3	4,944.5	35.0%	35.0%
2	Japan	127.2	1,934.7	13.7%	48.7%
3	Germany	82.3	1,084.9	7.7%	56.4%
4	United Kingdom	60.3	807.7	5.7%	62.2%
5	France	60.2	793.9	5.6%	67.8%
6	Italy	58.0	663.4	4.7%	72.5%
7	Canada	31.6	390.1	2.8%	75.2%
8	Spain	40.8	378.6	2.7%	77.9%
9	China	1,295.2	240.5	1.7%	79.6%
10	South Korea	47.9	233.5	1.7%	81.3%
11	Netherlands	16.2	230.9	1.6%	82.9%
12	Australia	19.9	227.5	1.6%	84.5%
13	Mexico	103.3	189.2	1.3%	85.9%
14	Switzerland	7.3	144.0	1.0%	86.9%
15	Belgium	10.3	136.2	1.0%	87.9%

Source: Prudential Real Estate Investors (data as of year-end 2003)

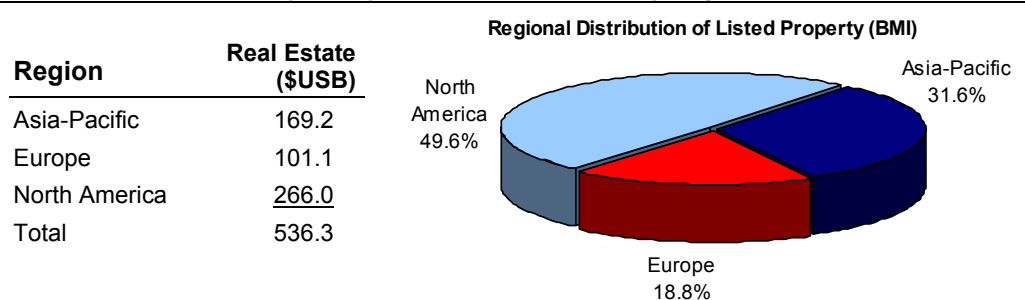
Private ownership has always dominated the real estate industry, in part because the underlying assets, the individual properties themselves, trade in the private transaction market and, in most

¹ The estimated size of the global market and individual market value estimates for the 50 countries in our coverage universe are based on each country's economic output (GDP) as a measure of the size and maturity of the economy, and on relative wealth, for which we use GDP per capita as a proxy. For more information, see "A Bird's Eye View of Global Real Estate Markets," Prudential Real Estate Investors, March 2003.

cases, are financed with private equity and/or debt. As a result, private investors (institutions and individuals) and owner-users (mostly large corporations) own most of the commercial properties that make up the investable universe. However, most countries with well-developed real estate investment markets also have publicly listed companies or funds that own property and offer investors an alternative indirect approach to investing in real estate.

Exhibit 3 shows the regional distribution of the listed property sector by available equity market capitalization (i.e., relatively liquid, publicly tradable shares). While equity market capitalization is not directly comparable to the aggregate market value estimates in the first two exhibits, the listed property sector clearly represents a small fraction of the total commercial property universe. Using the S&P/Citigroup BMI World Property Index, North America dominates the public real estate market with a 50% share, followed by Asia (32%) and Europe (18%).²

Exhibit 3: Listed Property Equity Market Capitalization By Region



Sources: S&P/Citigroup BMI World Property Index (available equity market capitalization as of Jan. 3, 2005); Prudential Real Estate Investors

The listed property market, not surprisingly, is also highly concentrated. The top-15 markets account for more than 99% of the sector’s available equity market capitalization (see **Exhibit 4**). Logically, considerable overlap exists between the countries with the largest real estate markets and those with the largest listed property markets. Eleven of the top-15 listed property markets are among the 15 largest commercial real estate markets. The US, which accounts for about 35% of the global real estate market, represents about 48% of the listed property sector’s available equity market capitalization, while Japan, with the second-largest real estate market, ranks 5th by equity market capitalization.

A few exceptions are noteworthy. For example, Australia has the second-largest listed property market (based on available equity market capitalization), but ranks 12th based on property market size. Hong Kong and Singapore rank 4th and 9th, respectively, based on listed property market capitalization, yet neither country appears in the 15-largest commercial property markets. Germany, however, falls near the bottom of the ranking by listed property market capitalization with less than 1% of the global listed property market, despite having the 3rd-largest commercial real estate market.³

² The S&P/Citigroup BMI World Property Index is a free-float weighted index comprised of public real estate companies that meet certain free-float market capitalization, trading volume and other criteria.

³ The BMI Property Index does not include the big German open-end and closed-end funds that represent a large share of individual (retail) and institutional property investment activity in the German market in recent years.

Exhibit 4: Top-15 Listed Property Markets

Rank	Country	Equity Market Cap. (\$USB)	Global Share	Cumulative Share
1	United States	255.1	47.6%	47.6%
2	Australia	63.3	11.8%	59.4%
3	United Kingdom	52.1	9.7%	69.1%
4	Hong Kong	50.6	9.4%	78.5%
5	Japan	45.4	8.5%	87.0%
6	France	12.4	2.3%	89.3%
7	Netherlands	12.1	2.2%	91.5%
8	Canada	10.9	2.0%	93.6%
9	Singapore	9.1	1.7%	95.3%
10	Sweden	5.2	1.0%	96.2%
11	Austria	4.1	0.8%	97.0%
12	Spain	4.2	0.8%	97.8%
13	Belgium/Luxembourg	2.9	0.5%	98.3%
14	Germany	2.6	0.5%	98.8%
15	Italy	2.5	0.5%	99.3%

Sources: S&P/Citigroup BMI World Property Index (available equity market capitalization as of Jan. 3, 2005); Prudential Real Estate Investors

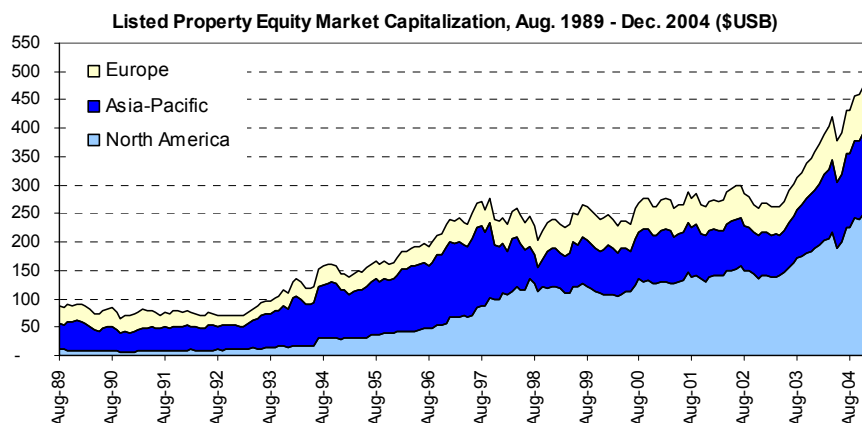
The structural features of the different listed property investment vehicles around the world are nearly as diverse as the markets in which they exist. At one end of the spectrum are vertically integrated operating companies that resemble non-real estate corporations except that their primary business is somehow related to property (e.g., development, financing, management, etc.). At the other end are relatively passive vehicles that own one or more assets and often are externally managed by a team that may also advise other, similar investment funds.

Many of these vehicles, though not all, are tax transparent, which means that most or all of the company or trust's revenues are exempt from corporate taxes as long as they are distributed to shareholders. As a result, and because of other common structural features (e.g., minimum distribution requirements), tax-transparent vehicles usually pay attractive, stable cash yields. The trade-off for this feature, however, is that REITs' ability to retain capital for reinvestment in existing assets and new acquisitions is somewhat limited.

Small Sector, Big Growth

Although the global listed property sector is still relatively small compared with the global commercial property universe, it has grown significantly over the last decade. Since January 1994, the sector's equity market capitalization has more than quadrupled from about \$130 billion to more than \$536 billion (see **Exhibit 5**). Much of this growth has occurred within the last two to three years and has been concentrated in the US and Australia, the two largest, most mature and transparent listed property markets. Together, the US and Australia account for about 61% of the growth in the BMI Property Index since the start of 2002.

Exhibit 5: Robust Growth in Listed Property Sector



Sources: S&P/Citigroup BMI World Property Index (available equity market capitalization); Prudential Real Estate Investors

Over the last decade, the equity market capitalization of the US and Australian listed property sectors has grown at a compound annual rate of more than 20%, much faster than the 6% annual growth rate for the rest of the listed market. Most of the recent growth has come from share price appreciation rather than a dramatic increase in the property holdings of REITs and LPTs. Over the last three years, US equity REITs have returned about 87%, or roughly 23% per year. Price appreciation over this period was nearly 55%, or a 15.7% annualized rate, with average annual dividends of about 7% accounting for the balance of the total return. LPTs have gained more than 130% in total over the last three years, a little more than 32% per year, including price gains of about 80%, or more than 21% per year.⁴

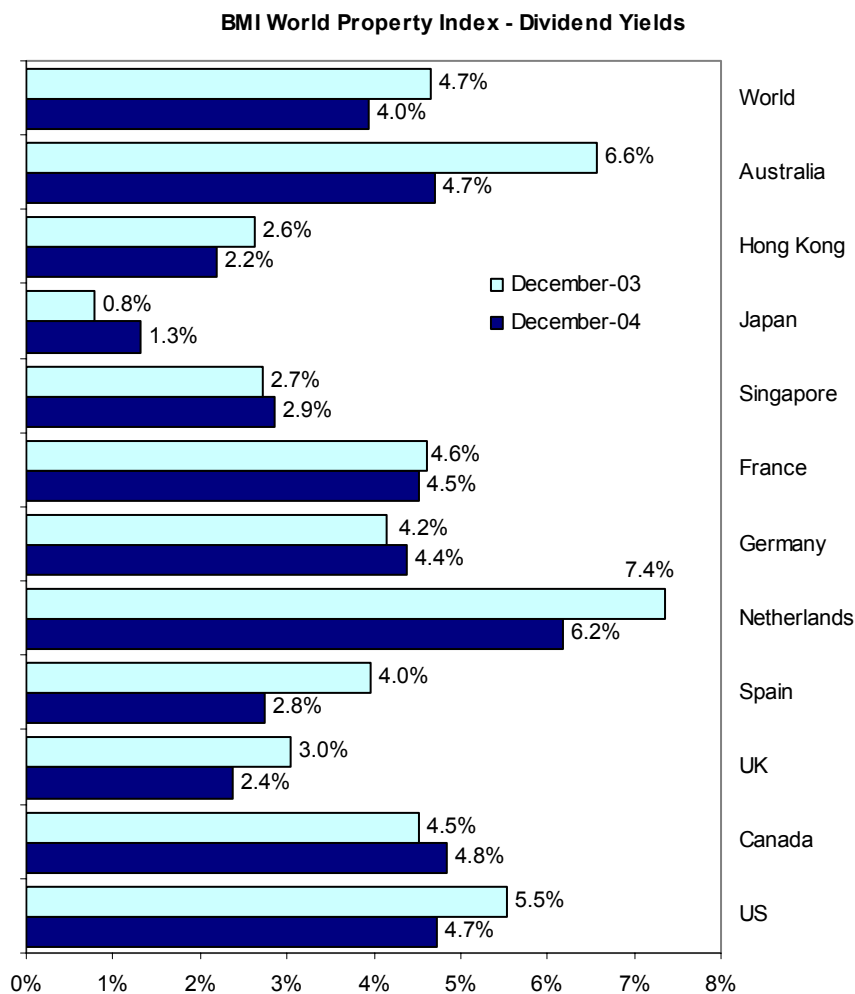
Although many factors have contributed to the robust investor demand for REIT and LPT shares, and for real estate securities generally, over the last few years, investors' thirst for yield has been and remains the biggest demand driver for REIT and LPT shares. Investor demand for secure, yield-oriented investments has driven share prices in the US and Australia higher and has caused yields to compress. Last year, yields fell nearly 190 basis points (bps) to about 4.7% in Australia and more than 80 bps, also to about 4.7%, in the US (see Exhibit 6).

While the new interest in real estate securities has made it relatively easy for REITs and LPTs to raise capital at historically low costs, increased capital flows to all types of real estate investments have made *deploying* capital in the US, and in most other markets, much more challenging in recent years. Intense competition for assets in the US private transaction market has led several REITs to pursue growth through alternative approaches – M&A, joint ventures and, increasingly, overseas investments. Currently, a handful of US REITs, mostly retail and industrial firms, are actively pursuing investments in Asia, Latin America and throughout Europe, including Central and Eastern European countries such as Poland and the Czech Republic.⁵

⁴ National Association of Real Estate Investment Trusts (NAREIT); S&P/Citigroup BMI Property Index – Australia.

⁵ Although current foreign holdings by most REITs and LPTs are relatively small, cross-border investment further complicates comparisons between countries' equity market capitalization and their underlying property markets.

Exhibit 6: Strong Investor Demand Causes Property Yields to Fall



Sources: S&P/Citigroup BMI World Property Index; Prudential Real Estate Investors

The Australian market dynamics are similar, except that LPTs account for a much larger share of both the domestic institutional property market (between 40% and 50% by some estimates) and the Australian stock market (about 9.7% as of year-end 2004). With fewer opportunities to grow their portfolios domestically through direct property acquisitions, LPTs have little choice but to pursue growth through consolidation and, like REITs, overseas investment. M&A activity in Australia has been feverish in recent years as more trusts have taken advantage of the liquidity in the capital markets to create the scale needed to compete in the global market. In 2004, for example, Westfield merged its three listed entities into one large listed property trust, the Westfield Group. At year-end 2004, the firm had an equity market capitalization of more than \$19 billion, about one-third of the Australian listed property sector, and a portfolio with over 30 million square feet of retail space in Australia, New Zealand, the US and Europe.⁶

⁶ Standard & Poor's Index Services, Global Index Review 2004.

Importantly, the current liquidity and competitive environment have also encouraged more LPTs, including the new Westfield Group, to migrate away from the externally advised, relatively passive model that historically dominated the Australian market toward self-advised real estate operating companies. This trend mirrors a similar shift in the US REIT market over the last 10 to 15 years in response to investors' more favorable view of internal management teams and the potential efficiencies and alignment of interests they offer.

REITs in the Making

The success and impressive growth of the REIT and LPT markets in the US and Australia, and in various other markets with tax-transparent vehicles, is helping to drive the proliferation of REIT-like vehicles worldwide. Government authorities in Asia, Europe and Latin America are introducing tax-transparent property investment vehicles, although the sheer scale of the REIT and LPT markets dwarfs the contribution that these new vehicles have made to the recent growth in the listed property sector. **Exhibit 7** shows a summary listing of selected REIT vehicles in the major property markets and the year they were introduced or, for Germany and the UK, the year they are expected to be introduced.

Exhibit 7: Selected REIT Regimes

	<u>Vehicle(s)</u>	<u>Year Introduced</u>		<u>Vehicle(s)</u>	<u>Year Introduced</u>
<u>Asia-Pacific</u>			<u>Europe</u>		
Australia	LPT	1971	Belgium	SICAFI	1995
Hong Kong	REIT	2003	France	SIIC	2003
Japan	J-REIT	2000	Germany	N/a	2006?
Korea	RETF, K-REIT, CR-REIT	2001	Italy	FII	1994
Malaysia	REIT	Late-'80s	Luxembourg	FCP, SICAV, SICAF	1988
Singapore	S-REIT	2002	Netherlands	BI	1969
Taiwan	REIT	2003	Spain	REIF, REIC	1994
			United Kingdom	N/a	2006?
<u>Latin America</u>			<u>North America</u>		
Brazil	FII	1993	Canada	REIT	1994
Mexico	Fibras	2004	United States	REIT	1960

Sources: EPRA/NAREIT; UBS; Bloomberg; Prudential Real Estate Investors

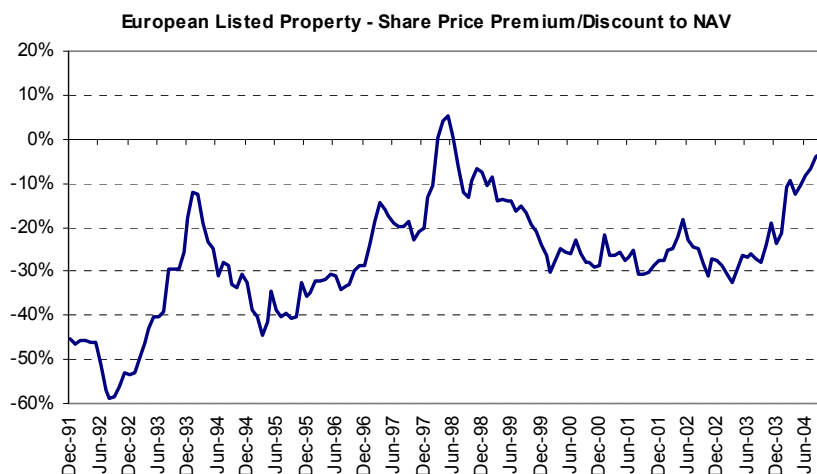
The legal and tax features of the various REIT regimes vary widely by country. However, a common motivation for the new interest among government authorities has been the desire to provide investors, particularly smaller institutions and individuals, access to real estate investments and to a significant and attractive part of the broader investment universe. Hence, their essential characteristics include a relatively high, stable cash yield that (1) passes directly through the entity, exempt from corporate taxes, to the shareholders, and (2) represents all (or a substantial share) of the capital gains and income from the real estate asset(s) owned and/or managed by the company or fund. Not all vehicles offer these features – Hong Kong REITs, for example, are not tax transparent.

In theory, tax transparency provides investors access to investments with the same cash flow characteristics as owning real estate directly, but through a more liquid (and volatile) structure. In practice, while shares of US REITs, LPTs and similar tax-efficient listed vehicles generally have delivered stable yields comparable to direct property, market forces such as investor sentiment have caused their performance to diverge at times from private, direct investment in the underlying assets.⁷

European REITs

Europe has a long history of listed property companies, and a few countries (e.g., Belgium, Luxembourg and the Netherlands) already have well-established tax-transparent vehicles. However, most European listed property companies have traded at persistent discounts to the net asset value (NAV) of their property holdings, at least until recently. Although many factors affect share prices, the discounts to NAV in the European listed property market are partly – if not mostly – a product of the corporate taxes that most European property companies must pay on income and capital gains. Corporate taxes represent an embedded tax liability for shareholders that they would not incur if they invested directly in property. As **Exhibit 8** shows, within the last two years this discount has narrowed considerably. Some European property companies in countries where REITs have been introduced are even trading at premiums to NAV.

Exhibit 8: Persistent Discounts to NAV Have Narrowed Recently



Source: UBS (data for Continental Europe only, thru Oct. 2004)

France, which launched a REIT-like structure, SIICs (société d'investissement immobiliers cotés), in 2003, is leading the new REIT movement in Europe and, therefore, the re-pricing of European property companies. In the nearly two years since SIICs were introduced, every major French listed property company has elected SIIC status. The early adoption of the SIIC structure by existing property companies already appears to be benefiting the property sector and investors. Rising share prices for French listed property companies, whose shares began to trade higher in anticipation of the formal launch of the new structure, have rewarded investors and

⁷ For more about public and private property market performance and pricing, see “Rational Differences Between Public and Private Real Estate,” Prudential Real Estate Investors, May 2004.

erased the discounts to NAV at which most companies' shares traded. According to UBS, French property companies traded at an average discount of about 25% over the last 12 years. As of November 2004, however, they were trading at nearly a 10% premium to NAV.

Although it remains to be seen how much influence SIICs will have in the real estate property and capital markets, the quick acceptance of the structure is a promising start for the newly minted and soon-to-be launched SIICs and for the French property markets generally. As important, the success in France should serve as a catalyst for other European countries that do not already have competitive REIT-like vehicles. Most REIT structures, including SIICs, allow at least some investment in foreign assets. If tax transparency rewards firms with a lower cost of capital, they should have a competitive advantage over local investors in markets that do not have a similar structure, especially as the global capital and investment markets become more integrated.

The increased competition from SIICs and from the growing number of REITs and LPTs that are expanding globally certainly increases the pressure on the UK and Germany, which have the largest developed property markets in the world without a REIT-like vehicle.⁸ Both countries are considering REIT legislation. In the spring of 2004, the UK Treasury solicited feedback from industry participants through a formal consultation process for the design of a tax-transparent vehicle, tentatively referred to as a Property Investment Fund (PIF), for the UK market. However, government officials indicated recently that the legislation will not be introduced in 2005, as many in the property industry had hoped. Nevertheless, UK property company shares rose in anticipation of the legislation, nearly halving the discount to NAV at which the shares had traditionally traded. According to UBS, UK property companies have traded at discounts to NAV of 30% to 40% in recent years but are now trading at about a 15% discount to NAV.

The idea of a REIT-like vehicle has gained momentum in Germany, however, in part because of bribery allegations at a few of the very large and influential open-end property funds. The ongoing scandal has cast a shadow over the open-end fund structure and has raised questions about its lack of transparency. But it may also have helped move German REITs closer to becoming a reality. Because the open-end funds already enjoy tax advantages over ordinary German listed property companies, fund managers, mostly German banks, have done little to promote a REIT-like structure that would compete with their fund products. Together, the calls for increased transparency and better corporate governance amid the turmoil in the open-end fund market and increasing competitive pressures could be the catalyst needed to launch a German REIT, possibly before a similar vehicle can be introduced in the UK. The German government is studying the tax issues associated with creating a REIT vehicle, and has expressed an interest in modeling the vehicle after US REITs and French SIICs.

Asian REITs

Most of the new REITs are from Asian countries, many of which also have long histories of public real estate ownership, usually through large conglomerates and property development

⁸ Although German investors can invest in property through relatively liquid open- and closed-end property funds, these vehicles are not listed and are not truly comparable to listed property companies such as REITs and LPTs.

companies. The potential market growth in Asia is enormous from a supply and demand perspective. On the supply side, if Asian REITs become established, the massive property holdings of the existing property companies, conglomerates and government authorities could provide a significant source of assets for the market's growth, particularly as the Asian economy gains strength and the property markets move into recovery. At the same time, the potential demand for new investment vehicles of almost any type that offer secure, attractive yields could be vast. A significant amount of investment capital – personal savings and institutional funds (i.e., national pension schemes) – is currently invested in money market and similar accounts, earning very little interest.

The current environment in many parts of Asia is similar to US conditions in the early 1990s, when the REIT market expanded rapidly. The US economy was recovering from the 1991-92 recession, and real estate market fundamentals were beginning to stabilize from the early-'90s market crash. But liquidity remained constrained because traditional private capital sources were either saddled with huge portfolios of non-performing real estate or had no appetite for real estate investments. With few alternatives available, the industry turned to the public equity and debt markets to re-capitalize, which resulted in a significant shift in property ownership from the private to the public market.

A similar pattern may already be emerging in Japan. The Japanese REIT market has grown quickly since J-REITs were introduced in 2000, making Japan the largest REIT market in Asia (excluding Australia) by a wide margin. Fifteen J-REITs have gone public since 2001, and many more are reportedly in the pipeline for 2005. As of year-end 2004, the total equity market capitalization of J-REITs was more than \$17 billion. To put this into perspective, the market capitalization of the US REIT market did not reach \$17 billion until 1992, nearly 33 years after REITs were first introduced. The J-REIT market already has injected liquidity, directly and indirectly, into the Japanese property market. Before J-REITs were introduced, many investors were reluctant to enter the market, even though prices had fallen sharply, due to exit strategy concerns. Today, after years of stagnation, transaction activity involving J-REITs and other investors has increased significantly.

The same factors that have created demand for real estate securities in markets everywhere have fueled the J-REIT market's rapid growth. The Bank of Japan's zero interest rate policy, intended to stimulate the economy and head off deflation, has depressed bond yields and savings rates. Since the start of 2000, the yield on 10-year Japanese government bonds has averaged about 1.4%. Although property yields have compressed since the first J-REITs were introduced to about 3.5% to 4% currently, they still compare very favorably with yields from bonds and other Japanese listed property companies.

Singapore REITs (S-REITs) have also enjoyed success in the first two years since they were introduced, making Singapore Asia's second-largest REIT market. Five S-REITs, with a total equity market capitalization of more than \$3 billion, have listed on the Singapore exchange since 2002. These include Fortune REIT, which owns retail assets in Hong Kong, and the recently launched Suntec City REIT. As in Japan, more IPOs are expected in 2005. However, retail (individual) investor demand is noticeably higher in Singapore than in Japan for at least two

reasons. First, retail investors have relatively easy access to the S-REIT market and can even purchase S-REIT shares through automated teller machines. (Recent changes by the Japanese government to allow banks and other outlets to sell J-REIT shares directly to retail investors should improve access.) More importantly, S-REIT dividends paid to individual investors are currently tax-exempt in Singapore, which makes their yields, now about 5% to 6%, even more attractive in today's low interest rate environment.

South Korea and Hong Kong also have introduced REITs in the last few years. However, the growth and development of the REIT market in both countries has lagged Japan and Singapore, largely because of their more restrictive REIT structures. Two REIT regimes, the General REIT (K-REIT) and the Corporate Restructuring REIT (CR-REIT), were created in Korea in 2001, but numerous restrictions in the initial legislation, including limitations on leverage and minimum capitalization requirements, have limited the market's growth. Although seven CR-REITs have listed on the Korean Stock Exchange, no K-REITs have been created yet. This is largely because K-REITs, while they are somewhat more flexible than CR-REITs, do not enjoy any tax benefits that justify the numerous other restrictions that the current legislation imposes.

Recently, the Korean government amended the REIT legislation, making it easier and more attractive for property owners and investors to take advantage of the REIT structures, particularly K-REITs. The amendment, which does not take effect until April 2005, will extend tax benefits to K-REITs and will ease borrowing and initial capitalization restrictions, among other things, for both types of REITs. While this should make both regimes more attractive and perhaps even tilt the advantage in favor of K-REITs, a third tax-transparent vehicle, the Real Estate Trust Fund (RETF), was introduced in 2004 and could overshadow both types of Korean REITs. Already, nine RETFs have been launched, including two unlisted funds.

Hong Kong's first REIT, the Link REIT, almost made its debut in December 2004 with a massive IPO of a portfolio of retail properties and parking facilities owned by the Hong Kong Housing Authority. However, the offering had to be withdrawn and postponed due to a legal challenge filed by a public housing resident who feared the sale of the assets would jeopardize low-income tenants' rent subsidies. Before the IPO was withdrawn, retail demand for the shares was very strong, in part because retail investors received a slight discount on share pricing. The retail allocation was reportedly 130 times oversubscribed.

Most market observers expect the Link REIT IPO will proceed when the appeal process has been exhausted. (The challenger has until the end of February to file a third and final appeal.) Assuming the legal issues are resolved, the Link REIT will put Hong Kong's REIT market on par with Singapore's in terms of equity capitalization. The IPO is expected to raise nearly \$3 billion, making it the largest REIT IPO ever. However, Hong Kong's REIT structure has several disadvantages that help explain why Fortune REIT opted for the S-REIT format rather than a Hong Kong listing. Most importantly, Hong Kong REITs receive no tax benefits and are not permitted to own assets outside Hong Kong. As long as these restrictions remain, little incentive exists for the many large listed property companies already in Hong Kong to adopt the structure.

Implications for Investors

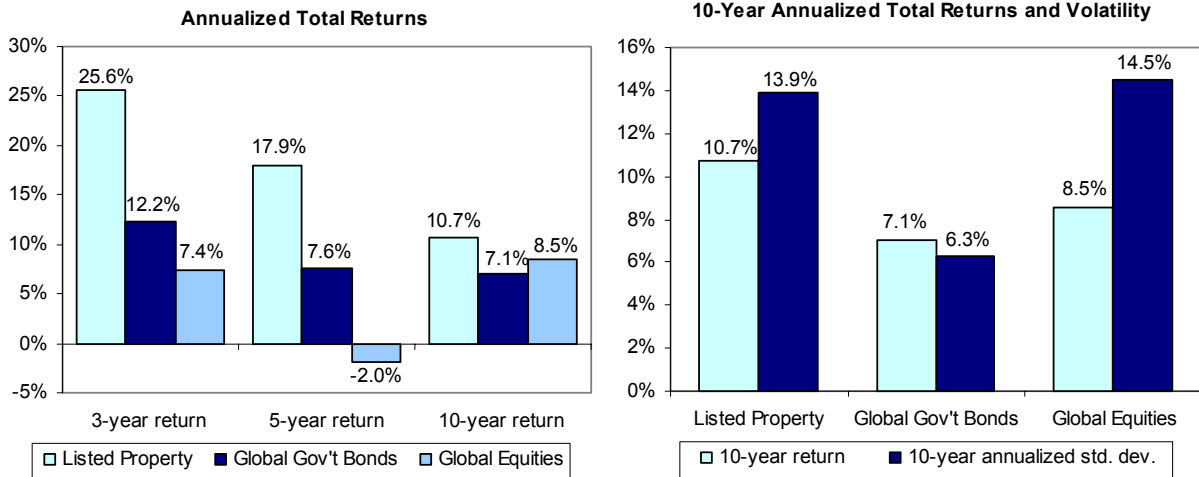
A handful of other Asian, European and Latin American countries either have or are considering REIT-like vehicles. Although many of the markets where these new REITs are being introduced are relatively small and/or will take years to develop, the global interest in REITs, and in real estate investments generally, is important for two reasons. First, it means that real estate is finally being recognized and accepted as an asset class. This acceptance should be more enduring than cyclical since it coincides with broad recognition that the characteristics that make real estate attractive in a diversified portfolio, namely stable cash yields with modest capital growth and low correlations with other asset classes, will become increasingly important as the world population ages.

As important, the global interest in REITs means that the infrastructure needed to support a global listed property sector is not only developing, it is gaining momentum. This infrastructure includes everything – the vehicles themselves, the investment benchmarks against which performance can be measured, the analysts and rating agencies that provide the research needed to make informed decisions about opportunities and risks, the investment banks and distribution networks of brokers and financial planners, etc. Infrastructure alone is not enough to make the promise of a global REIT market self-fulfilling. But it can be self-facilitating, particularly when combined with an increased awareness of and appreciation for real estate and the investment characteristics that property traditionally has delivered.

The growth and development of a vibrant, liquid listed property sector further expands the investment universe to an asset class that, historically at least, has been very attractive in a diversified portfolio but has been relatively difficult for smaller investors to access. As **Exhibit 9** shows, property shares have significantly outperformed stocks and bonds on a three- and five-year basis, and have delivered modestly higher returns over the last 10 years. Throughout this period, the broader market was a little more volatile than the listed property sector, making property shares even more attractive on a risk-adjusted basis.⁹

⁹ The Asia-Pacific region, which represents about 30% of the BMI Property Index, accounted for much of the volatility in the index. The region's returns were about twice as volatile as those for Europe and North America. Asia-Pacific also dragged down the listed property sector's 10-year returns with total returns of just 5.4%, compared with 15.5% for Europe and 14.8% for North America.

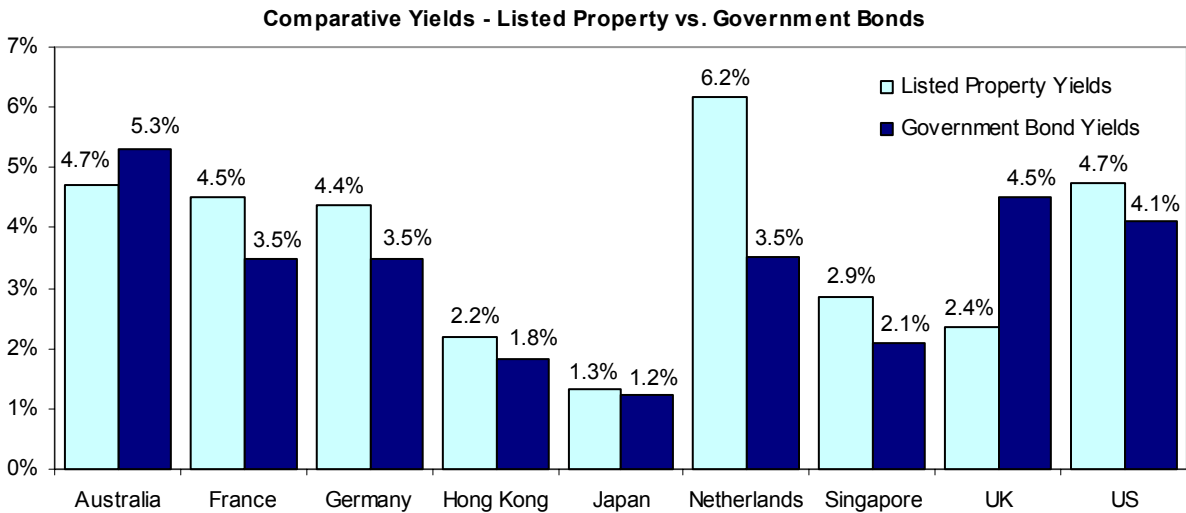
Exhibit 9: Attractive Absolute and Risk-Adjusted Returns



Sources: S&P/Citigroup BMI World Property Index; Ibbotson Associates (MSCI World Index and the Merrill Lynch Global Government Bond Index, data thru Dec. 2004)

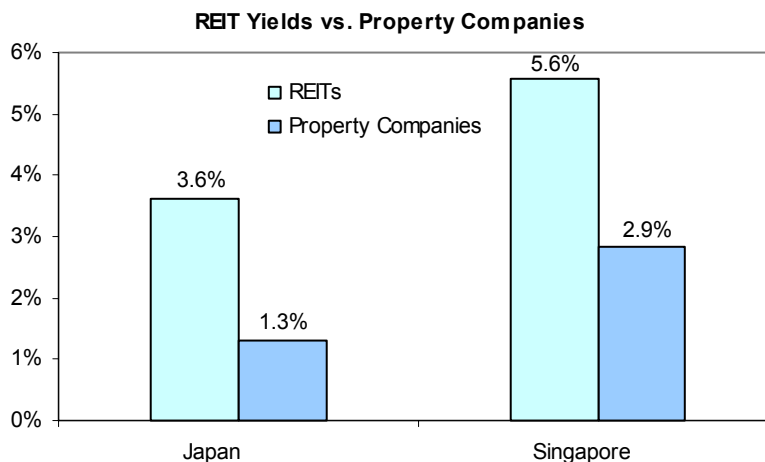
Although price appreciation has dominated the total returns for most listed property shares in recent years, the relatively stable yields that property companies typically offer, particularly REITs, LPTs and other tax-transparent vehicles, and that are largely responsible for the increased investor interest, are attractive for several reasons. First, listed property shares typically trade at positive spreads to other relatively low-risk, income-oriented investments. Although spreads have compressed sharply this year, the average yield spread between property and government bonds in the nine countries shown in **Exhibit 10** was about 41 bps at year-end 2004.

Exhibit 10: Attractive, Generally Positive Yield Spreads



Sources: S&P/Citigroup BMI World Property Index; Bloomberg (Merrill Lynch Global Government Bond Indices); Prudential Real Estate Investors (data as of Dec. 31, 2004)

Exhibit 11: REIT Yields Much Higher than Property Company Yields



Sources: S&P/Citigroup BMI World Property Index; Prudential Real Estate Investors (data as of Dec. 31, 2004)

Generally, the countries with the highest listed property yields, with the exception of Germany, have well-established REIT vehicles that require companies or trusts to distribute a substantial share of their earnings to qualify for whatever tax treatment and/or other benefits the vehicle offers. Listed property yields are least attractive, on a relative basis, in the UK, where the spread between property companies and government bonds is negative by a wide margin. The yields shown in **Exhibit 10** for Japan and Singapore, where ordinary (i.e., non-REIT) property companies dominate the listed property market, significantly understate the current yields from tax-transparent property vehicles in both countries. **Exhibit 11** shows the dramatic difference between the average dividend yields for the entire listed property sector in Japan and Singapore and the average yields for J-REITs and S-REITs. As long as investor demand for yield persists, the REIT markets in these and other Asian and European countries should continue to grow and capture a disproportionate share of the capital flows into listed real estate.

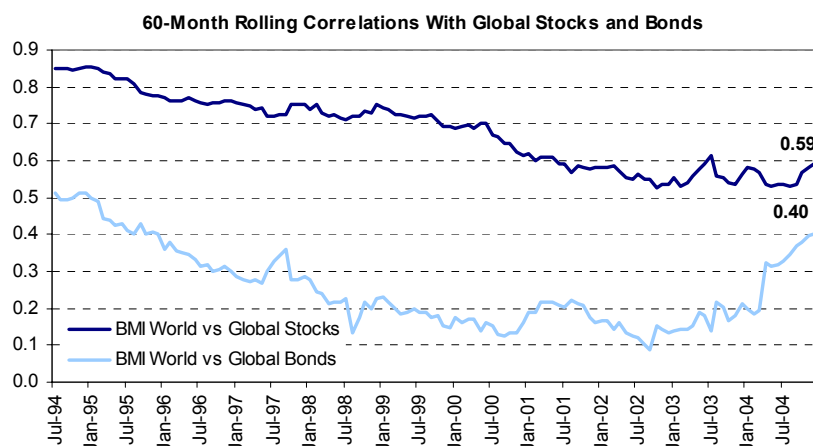
Importantly, the earnings from which these dividends are paid are also relatively transparent compared with the earnings of most corporations. The value of this attribute has appreciated significantly since the collapse of Enron and the high-profile accounting scandals at WorldCom, Tyco and other major corporations. Assuming disclosure is sufficient, REIT investors and analysts can usually get a good sense of the assets in a property portfolio, how well they are performing and their prospects for rent and value growth.

Property shares also provide an opportunity for investors to diversify their portfolios. **Exhibit 12** shows the correlations between listed property shares, government bonds and equities, along with the rolling correlations between property shares and the same equity and bond indices. Between 1990 and 2004, the correlation between property shares and bonds was relatively low, about 0.35, which suggests property shares may provide an attractive yield complement to bonds in a mixed-asset portfolio. While the correlation between property shares and the broader equity market was much higher over the 14-plus-year period, as one might expect since the world stock

index includes property shares, the relationship between stocks and property shares has weakened steadily over the last decade or so.

Exhibit 12: Low Correlations With Other Asset Classes

	Listed Property	Global Gov't Bonds	Global Stocks
Listed Property	1.00		
Global Gov't Bonds	0.35	1.00	
Global Stocks	0.69	0.23	1.00



Sources: S&P/Citigroup BMI World Property Index; Ibbotson Associates (MSCI World Index and the Merrill Lynch Global Government Bond Index); Prudential Real Estate Investors (monthly data Jan. 1990 – Dec. 2004)

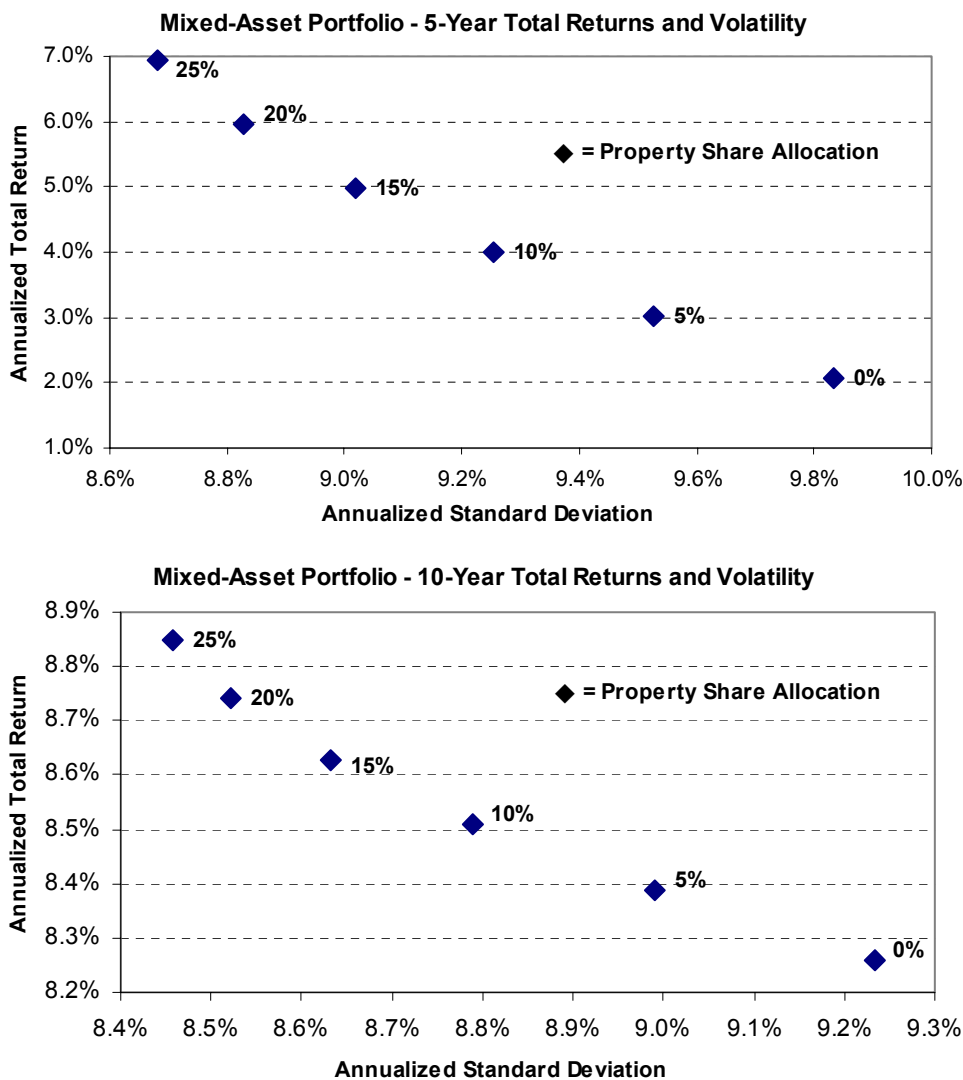
Notably, although we have not shown the correlations between property share performance and direct, private real estate investment in this report, historical correlations between public and private real estate investments are surprisingly low and are even negative in certain countries. Since 1990, for example, the correlation between REITs and private, institutional real estate investments in the US, as measured by the National Council of Real Estate Investment Fiduciaries (NCREIF), has been about -0.06 . Historically, therefore, REITs have been more of a complement to, rather than a substitute for, direct real estate investment in the US.

Together, these attributes – competitive returns with stable yields, moderate volatility and low correlations with other asset classes – can enhance the risk-return profile of a multi-asset portfolio. **Exhibit 13** shows the risk-return effects of different allocations to global property shares (in 5% increments) over the last five- and 10-year periods. Each point on the two graphs shows the total annualized return and risk (standard deviation) for a portfolio of assets comprised of 40% global government bonds and 60% stocks and property shares. The label for each data point shows the allocation to property shares.

As shown, an allocation from global equities to global property shares over the last five- and 10-year periods would have improved portfolio returns and reduced return volatility. For example, over the last five years, a 10% allocation to global property shares would have generated an

additional 193 bps per year in total return while reducing portfolio volatility by about 58 bps per year. The results are less dramatic on a 10-year basis, but still show a modest improvement in annual returns (25 bps) and a 44 bp reduction in risk.¹⁰ While past performance does not guarantee similar future results, the historical benefits of an allocation to property shares in a global mixed-asset portfolio are quite attractive in the context of an aging society with greater need for current yield and less tolerance for volatility.

Exhibit 13: Property Shares Improve Portfolio Efficiency



Sources: S&P/Citigroup BMI World Property Index; Ibbotson Associates (MSCI World Index and the Merrill Lynch Global Government Bond Index); Prudential Real Estate Investors

¹⁰ For illustrative purposes, we assumed that the allocation to property shares came entirely from the global equities allocation. However, if the property share allocation is taken equally from the initial stock and bond allocations (e.g., 10% allocation to property shares, 35% bonds and 55% stocks), the total returns improve by 143 bps over the 5-year period and 31 bps over the 10-year period. However, the standard deviation is slightly higher in both the 5-year (3 bps) and 10-year (13 bps) periods.

Caveats

A few caveats are worth noting, however. Most obviously, the sharp rise in property shares in many markets over the last 12 to 18 months means that real estate securities in these markets are probably not as attractive as they were before the current run-up. Rising share prices have depressed yields to historically low levels in some markets, which could limit share price appreciation in the near term. Over the longer term, the exceptional returns that US REITs, LPTs and other listed property vehicles have achieved in recent years are not sustainable. At some point, lower yields will create too much resistance to further share price increases, and listed property returns over the long term should revert to something closer to their annual dividend yield, plus a little growth.

But certain factors should help ease the transition from today's capital-driven investment cycle to one in which property market fundamentals have more influence. Most obviously, as the global economy gains strength, real estate market fundamentals should improve. Higher occupancies and rising rents should mitigate the effects of higher interest rates on property values. Further, although the contractual nature of the cash flows that make up the core part of most REITs' revenues is clearly a bond-like feature, REIT earnings usually benefit from upward revisions in contract lease rates. In the US, REITs have managed to grow dividends at an average annual rate of about 5.8% over the last 10 years, according to NAREIT, which is more than twice the annual rate of inflation. This embedded growth feature and the fact that property values have tended to appreciate at about the inflation rate over the long term make real estate investments a natural hedge against inflation and provide some protection against the adverse effects of rising interest rates, among other things.

The bigger risk to share prices is that the capital flows into the sector could reverse if investor sentiment changes suddenly. The listed property sector is still relatively small and is sensitive to changes in capital flows at the margin. Although yield spreads over other income investments remain relatively attractive by historic measures, a sharp rise in interest rates could dramatically slow or reverse capital flows into the sector. A sudden reversal of capital flows could cause the market to correct quickly, similar to the sell-off in April 2004 when US REITs lost more than 20% from peak to trough in one month amid fears of rising interest rates.

Investor favor could also diminish or shift away from property due to concerns about the industry's health and/or growth potential, or as part of a broader market rotation back toward growth investments. Neither appears particularly likely at the moment, however. Most property markets are in the early stages of a recovery, with falling vacancies and very little new supply in the pipeline. And short-term economic and geopolitical uncertainties and long-term demographic forces suggest investor demand for income-oriented investments will continue.

Transparency and governance have improved, but they are not perfect. Most of the new structures have not been tested through a complete property or capital market cycle. Ultimately, the industry must still rely on market participants' discipline to keep the supply of capital and properties from getting too far out of balance. Imbalances will occur locally, sometimes regionally or nationally and, rarely, globally. When and where these imbalances occur,

performance will suffer, and the results may be just as severe as in the past. But over time, as supply and demand move back toward equilibrium, markets tend to recover, and the cycle begins anew. Having dynamic public and private real estate markets provides an arbitrage mechanism that helps prevent asset pricing from getting too far out of line, at least on the downside. Over the long term, this should reduce the risk of a severe liquidity crisis and may shorten the cycle.

Lastly, the sweeping changes that have occurred and that are taking place in the global real estate industry, particularly in the capital markets, could fundamentally alter the investment performance characteristics of the listed property sector, making historical data and trends less relevant. The US REIT and Australian LPT markets have undergone significant structural changes over the last 15 years, and the transitional nature of the last decade alone may limit the relevance of the historical data. Both vehicles could perform differently in the future, particularly if a highly dynamic, fluid global listed property market develops.

Volatility and correlations with other asset classes could both be higher (or lower) than in the past. The public markets create a much stronger link between the real estate industry and the broader capital markets that can cause liquidity to ebb and flow. Future yields could also be lower if the public markets lead to better liquidity and transparency and reduce the risk profile of the asset class as a whole. But the sources and composition of investment returns from property should not change materially, and the fundamental performance characteristics of the underlying assets – stable, attractive yields, modest asset appreciation and low correlations – should remain appealing, particularly in the context of a diversified portfolio.

Closing Thoughts

The dramatic growth in the global listed property market in recent years marks an important step in the evolution of the real estate asset class. While the increasing market capitalization of the sector is significant in and of itself, the fundamental demand and supply drivers that have facilitated its recent growth – broad acceptance of the asset class and further development of the industry infrastructure – strongly suggest the industry is starting a long-term secular growth trend. Although separating cause and effect in the investment world can be challenging, increased demand for real estate investments should continue to drive the growth of the global listed property sector, and REITs in particular.

This evolution has several important implications for the real estate industry and for investors. For the industry, the continued development of the public capital markets for real estate should improve liquidity and transparency throughout the industry, and make capital allocation more rational and efficient. At the same time, the competitive pressures that accompany the emergence of professional and increasingly global public real estate operating companies will lead to improvements in the quality of goods and services that the industry provides to space users and investors. For investors, the growth of the public markets creates more opportunities to access the attractive return characteristics of property investments, while helping to mitigate many of the risks that historically have caused investors to avoid the asset class.

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