

Market Perspective

Executive Summary

- The credit market troubles that began with the collapse of the subprime mortgage market in February caught up with commercial real estate in the third quarter, upsetting the debt markets and slowing transaction activity.
- Despite rallying over the second half of 3Q07, U.S. REITs remain well behind the broader market and will likely finish 2007 with negative total returns for the first time since 1999.
- Commercial property market fundamentals in most markets and property types remain healthy, but could weaken if the economy slows and businesses become reluctant to hire and invest.
- Private real estate should still deliver healthy returns this year as appraised values catch up with the strong value gains in the first half of 2007. While returns will still be positive next year, performance will likely slow significantly as appreciation slows and cap rates drift higher.

Introduction

After years of increasing liquidity and leverage pushing asset values higher and yields lower, the U.S. commercial real estate capital markets finally lost momentum in the wake of the summer's subprime-induced credit crisis. Although no one believed the good times would last forever, the speed with which the market has slowed and the environment has changed is almost without precedent. Over much of the past few years, the biggest challenge for investors was securing access to deal flow. Thanks to the alchemy of increasingly complex financial engineering, capital was cheap, and those who could mobilize the largest sums usually won the day, be it for M&A deals or property acquisitions. The fallout from the subprime debacle clearly has discredited this "science," which had seemingly transformed risk into pure opportunity. The market is now experiencing an understandable transition – working off the excesses of the easy money era and searching for the pricing levels at which the market will find its new balance.

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Unlike many periods of transition created by dislocations in the capital markets, this one is noticeably lacking in distress. Market fundamentals are relatively healthy, additions to new supply are under control, mortgage delinquency rates remain near historic lows, and, generally speaking, both debt and equity capital are still available. However, although distress may not be widely evident today, repercussions from the subprime meltdown, most notably in the debt markets, will greatly alter the investment market for the foreseeable future. With remarkable speed, underwriting standards have tightened significantly, resulting in lower loan proceeds available to borrowers. Further, one of the conspicuous casualties of the summer's credit crisis has been commercial real estate CDOs, whose voracious appetite for the riskiest tranches of CMBS made possible the high LTV loans that drove marginal pricing of real estate assets and led to other excesses, e.g., full-term interest-only loans and overly aggressive DSCRs. How the market reacts to this withdrawal of liquidity, which is unlikely to return any time soon, will tell much about how and where the market finds its new equilibrium level.

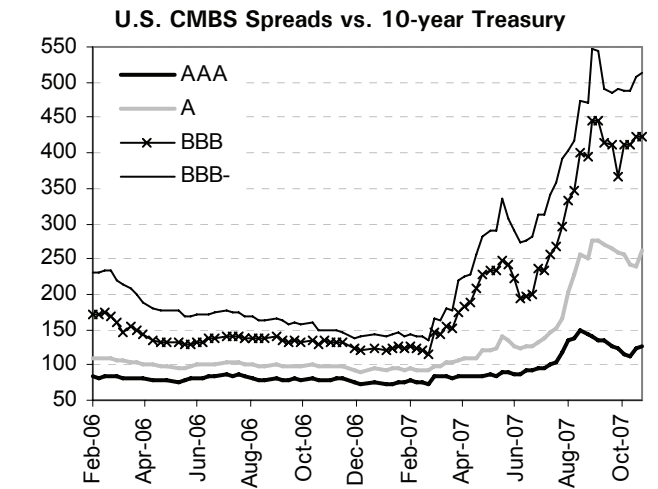
The confidence of many market participants remains shaky, at least in part because of concerns that the magnitude of the problems are not well understood and the worst is not yet behind us. That confidence is likely to be further tested as "bad news" continues to capture the headlines in the weeks and months ahead, be it layoffs at investment banks, write-downs of loan portfolios, rising residential foreclosures or bleak reports from homebuilders. The most critical questions for commercial real estate investors are when will the debt capital markets regain their footing and can the economy avoid a recession in light of the ever-worsening conditions in the housing market, the rising price of oil and the tightening of consumer credit. The resilience of the capital markets leads us to believe that a new state of normalcy – whatever that may be – can be achieved in a matter of months, not years. As for the economy, a housing-induced recession would be a first, but we are in uncharted territory for which the past may not be a good guide. However, if the economy can avoid recession, which appears reasonable to assume, commercial real estate should weather the turmoil in the credit market fairly well, or at least better than some might expect.

Debt Markets

Until the fixed-income markets stabilize, the commercial real estate debt markets will not be operating anywhere near the capacity we've become used to in recent years. Spreads in some sectors have begun to tighten, and banks are taking steps to assuage investors' fears. But it will likely be months before the markets really start to normalize, and even then it's still not clear what the "new normal" will be. Some things are certain, however. Underwriting will be different, and leverage levels will fall for the first time in 15 years. Gradually, the CMBS market and even the CDO market, in some form, will come back, and liquidity will return. Until then, it will be a lenders' market.

The ongoing capital market turmoil is one of the biggest tests yet of the "modern" real estate capital market. In some ways, the current market environment recalls the conditions in the fall of 1998, after the Russian bond default and near-collapse of Long Term Capital Management. As in 1998, a crisis in confidence, this time from the uncertainty surrounding losses in bonds backed by subprime mortgages, has caused spreads throughout the credit market to widen quickly and dramatically. Everything has been or is being re-priced or re-traded, not unlike what occurred in 1998. Only this time, not only have spreads widened, but underwriting standards have also tightened with remarkable speed. Lenders have all but eliminated full-term interest-only loans and now require lower LTVs, higher debt service coverage ratios and more stringent reserve requirements.

Dramatic and Swift Re-Pricing

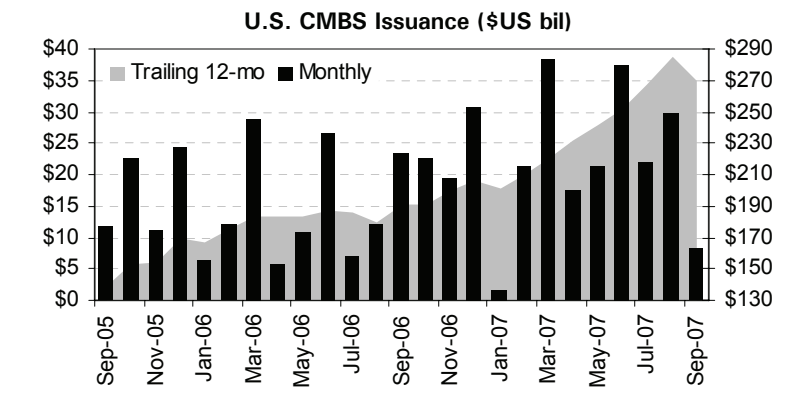


Source: Morgan Stanley Fixed Income Research

Notwithstanding lenders’ quick retreat from the market in recent months, the CMBS market should easily eclipse last year’s record volume, but only on the strength of issuance in the first half of the year. **Issuance for the coming months should slow dramatically, as evidenced by the precipitous decline in September 2007.** With the CDO market shut down completely and securitization activity outside of the U.S., where the market is less developed, all but ceased, the outlook for global issuance in the fourth quarter and early 2008 is weak at best.

One problem facing the CMBS market in the near term is the large inventory of unsecuritized loans warehoused on the balance sheets of investment banks. While the precise size of this exposure is hard to determine, it appears to be in the tens of billions of dollars. Many of these loans, originated and priced when underwriting standards were loose and spreads were tight, can now only be sold at a loss in light of recent changes in the market. Until these loans are sold or marked-to-market, as some banks are doing, the volume of CMBS issuance will be constrained. Consequently, although recent announcements by banks of losses associated with loan portfolios have added to volatility in the market, it is an important and welcome step in the market’s recovery from the current crisis.

New Issuance Has Slowed Sharply But Remains on Record Pace



Source: Commercial Mortgage Alert

Even when the market does recover, however, **the abrupt closure of the commercial real estate CDO market raises significant questions regarding how and if the capital that, until recently, flowed freely through the CDO market is replaced.** Having peaked in 2006 at nearly \$40 billion, CDOs had grown to about 20% of the size of total CMBS issuance in the U.S. With the CDO market closed indefinitely, many of the investors who were driving the market are no longer in the game. While their departure greatly reduces the capital available for the riskiest pieces of new deals, other capital sources, including traditional B-piece buyers who have largely been crowded out in recent years by more aggressive investors, should be able to pick up some of the slack. They, along with others, will likely find some very attractive opportunities to deploy capital, especially in the mezzanine segment of the capital stack. But the void in the market today is larger than the current field of players can fill.

Although borrowers clearly find themselves in a much weaker position with lenders, **debt capital is still available at rates that are relatively attractive historically.** Because the recent flight to quality has driven benchmark rates such as the 10-year Treasury sharply lower, mortgage interest rates have increased only modestly despite much wider spreads. After peaking at about 5.25% in June, the yield on the 10-year Treasury bond fell as low as 4.34% in early September before drifting higher to end 3Q07 just below 4.6%. With the 10-year Treasury bond yield down another 20 bps or so since the quarter ended, the decline in long-term interest rates more than offsets the increase in commercial mortgage spreads, which, according to Prudential Mortgage Capital Company, widened by about 65 bps in 3Q07.

Portfolio lenders (e.g., insurance companies) remain active, and for good reason. Less competition has allowed lenders to demand wider spreads and better terms, including features like amortization. With property market fundamentals still relatively healthy and more conservative underwriting, commercial mortgages are attractive today. In fact, **for balance sheet lenders with capacity to lend, it's a great time to be in the market.** But like their counterparts in the CMBS market, they will have a difficult time making up the origination volume that recently has come from conduit lenders. Construction financing is also still available, but terms have become noticeably tougher. Lenders increasingly are demanding credit enhancements to limit their exposure to execution risks, such as cost overruns, and are looking much more closely at sponsorship. Generally speaking, the more conservative underwriting and increased cost of capital have made it much harder to do speculative office and industrial development, which should help extend the market cycle by further postponing new deliveries.

The big difference for borrowers today, of course, is that loan proceeds are down significantly. The new realities of the debt markets undoubtedly will reduce borrower demand in the near term, which, in turn, should ease some of the upward pressure on spreads as supply and demand find a new equilibrium. But it means that transaction volume and velocity will also slow, and distress will increase. Highly leveraged owners who need to refinance in the near term will find the new environment particularly challenging. Reports of “hung” bridge loans financing some of the large transactions that took place late last year and in early 2007 have become fairly common, though no one seems to know exactly how the problems will be resolved.

While no one expects the uber-liquidity that prevailed before the subprime meltdown to return anytime soon, if ever, CMBS issuance should pick back up once the outlook becomes clearer and investors regain confidence in how risk is being priced. Investors do not need to know exactly how much has been lost and by whom, just enough transparency to feel confident there won't be any more surprises. **As long as space market fundamentals remain healthy, the predictable and transparent contractual cash flows of commercial real estate should look relatively attractive under almost any economic scenario, especially with more conservative underwriting and borrowing terms.**

REIT Market

The capital market forces that have been wreaking havoc on U.S. REITs for much of the year relented somewhat in the third quarter. After struggling throughout the second quarter and first half of 3Q07, equity REITs rebounded strongly from their August lows. **The third-quarter rally, which began in mid-August, was enough to help equity REITs outperform the S&P 500 for the quarter but left them far behind the broader market year-to-date.** Through 3Q07, the FTSE NAREIT equity REIT index delivered a total return of -3.5% versus a 9.1% total return for the S&P 500. Industrial and retail REITs, which suffered the biggest declines in 2Q07, led all property types and, in fact, were the only sectors with positive returns for the quarter.

U.S. Equity REITs Continue to Lag the Broader Market

U.S. Equity REIT Total Returns by Sector							
	S&P 500	Eq. REITs	Apartment	Industrial	Lodging	Office	Retail
1Q07	0.2%	3.5%	-2.4%	4.3%	7.7%	0.8%	9.8%
2Q07	5.8%	-9.0%	-2.9%	-11.0%	-4.4%	-7.6%	-14.6%
3Q07	1.6%	2.6%	-3.6%	13.1%	-4.6%	-2.6%	7.5%
YTD	9.8%	-4.0%	-12.5%	12.1%	-1.0%	-8.4%	-1.9%

Source: FTSE/NAREIT; Bloomberg (year-to-date returns as of 26-Oct-07)

M&A, or lack thereof, may be partly responsible for REITs' weak performance in the second quarter and first half of the third quarter. Equity REITs posted huge gains in the first six weeks of 2007, prior to the closing of the EOP transaction in February. With many REITs trading at all-time highs and ample capital eager to finance large deals – the bigger the better, or so it seemed – the prospects for continued M&A activity helped propel REIT shares upward. However, as the troubles in the credit market cast doubt on the near-term outlook for M&A and on the fate of deals already in the works, whatever capital that remained in REITs in hopes of catching a nice M&A pop exited the market.

Unfortunately, REITs are not nearly as attractive after their strong rally as they were in early August, and we see few catalysts that could drive REIT shares higher in the near term. At the market bottom in August, the FTSE NAREIT equity REIT index was nearly 30% off its February high. The sharp decline in share prices against a backdrop of healthy space market fundamentals and abundant private capital targeting commercial property made REITs attractive again, particularly on a relative basis. The sell-off drove equity REIT dividend yields to more than 4.5% and left REITs trading at an average discount to net asset value (NAV) of nearly 20%, according to Green Street Advisors.

Since then, however, the FTSE NAREIT index has gained more than 10%, and the average dividend yield has fallen nearly 25 bps to about 4.25%. Although many REITs continue to trade at sizable discounts to NAV, analysts are revisiting their NAV estimates and will likely begin marking NAVs down in anticipation of rising cap rates. Likewise, REIT multiples (price-to-FFO) and earnings growth forecasts both are now roughly in line with the S&P 500. And M&A activity, while still possible, seems less likely as long as the debt market remains in disarray and REIT shares continue to trade at large discounts to their 52-week highs. Even if the financing can be arranged, REIT boards will be reluctant to approve any deal that involves selling the company at a discount to the recent share price high.

Several REITs have taken advantage of the recent rally to raise equity, which, if nothing else, should raise warning flags for investors. The success of these offerings shows that the public market is willing to direct capital to the real estate industry when valuations and operating fundamentals look relatively attractive. And **while valuations are not as attractive as they were two months ago, operating fundamentals for most REITs are very solid.** Most REITs remain modestly leveraged (40% to 50%, on average), and dividend payout ratios are near historic lows. But it remains to be seen how companies will put the capital to work in a way that is not dilutive to existing shareholders. Strategically, the decision to raise equity today, while the market is cooperative and in anticipation of more attractive buying opportunities in the transaction market, makes sense. The execution risks, however, are not insignificant.

While the upside potential for REITs appears limited in the near term, the downside risks also seem modest. Dedicated real estate mutual funds and ETFs continue to see net outflows. According to AMG Data Services, investors have withdrawn nearly \$3.6 billion in capital from real estate funds this year, and nearly all of that has occurred in the second half of the year. In fact, **since May, more than \$7 billion has flowed out of dedicated REIT funds.** However, outflows appear to be slowing. After seven consecutive weeks of outflows, dedicated REIT mutual funds and ETFs posted positive inflows in the final two weeks of 3Q07.

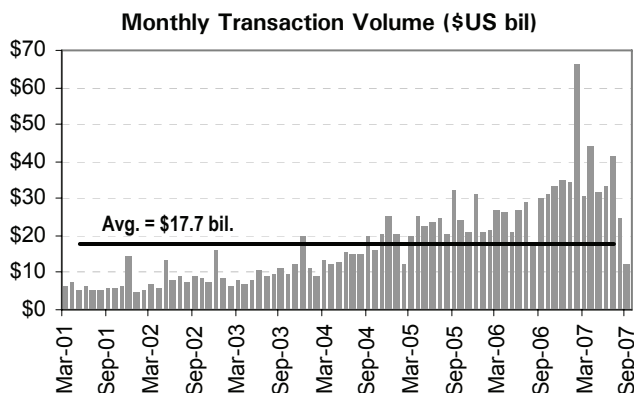
With all the volatility in the market this year, it's hard to tell how REITs will end 2007. On any given day, the FTSE NAREIT equity REIT index is capable of gaining or losing 200 bps or more. Most likely, **REIT performance between now and year-end will depend on the economic data that will filter in over the final months of the year and on the headlines from the housing and financial markets.** REITs could get a lift if the Federal Reserve eases short-term interest rates again before the year ends; but they could just as easily fall if the Fed disappoints investors. Although the heightened volatility will persist, with the space markets and REIT operating fundamentals still relatively healthy, we expect U.S. equity REITs will deliver total returns in the mid-single digits over the next 12 months or so, which assumes modest earnings growth and some multiple contraction.

Property Markets

Although evidence of rising cap rates remains limited mostly to transactions involving inferior-quality assets and properties in secondary and tertiary markets, the combination of capital market volatility, slowing economic growth and a maturing property market cycle leaves little doubt that the days of cap rate compression are over. **In most property types and markets, the question is**

not whether cap rates will rise, but rather the timing and magnitude of the increases. This is not true of all markets or assets, but transaction activity has slowed dramatically since the first half of the year, while the volume of aborted deals has risen sharply. According to Real Capital Analytics, total transaction volume this year has already surpassed last year's record \$320 billion. But as in the debt market, most of that volume reflects deals that were either closed or under contract before midyear.

Sharp Slowdown in Transaction Activity



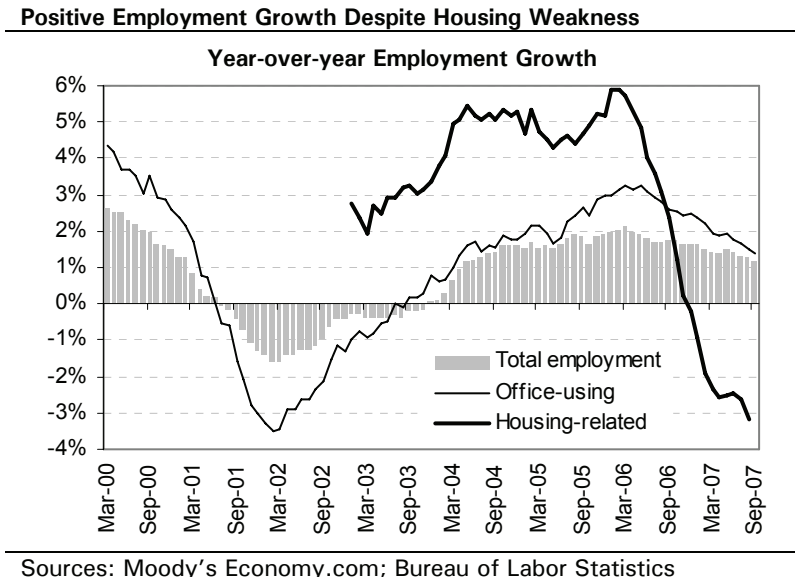
Source: Real Capital Analytics

With highly leveraged buyers largely out of the market and capital flows into core funds slowing, the depth of buyers competing for deals has been cut in half, if not more. Most offerings still attract multiple serious bidders, but bid-ask spreads have widened and transaction velocity has slowed. Deals that are closing today almost always involve some re-trading, which buyers invariably attribute to adverse changes in capital market conditions. In our own experience on both sides of the transaction, re-trading has reduced sale prices by 3% to 7%, on average, depending on the asset and market. Understandably, some would-be sellers are choosing to withhold properties from the transaction market until the debt market stabilizes. But for others, a modest discount from asking or contract prices will have little effect on the generous IRRs that commercial property investments have generated in recent years. While few industry players expect commercial property values will fall sharply, **IRR for most investments made over the past three to five years have likely peaked now that cap rate compression has ended, and income growth will be responsible for driving appreciation.**

Capital market forces will continue to overshadow property market fundamentals until the credit market normalizes and the CMBS market re-opens for business. But the capital market troubles are not the only – or even the most important – challenges the commercial property markets face today. **The housing slump remains the most menacing problem, both for its contribution to the ongoing turmoil in the capital markets and for the threat it poses to the health of the economy.** Although economists still put the chances of a recession in the U.S. at about 30%, the surprising severity and duration of the downturn have increased the odds that the economy will weaken further before it improves.

Whether the economy actually contracts or not, real estate investors face a very different kind of economic slowdown than in 2001. The 2001 downturn was a corporate recession that began with the collapse of the tech sector. Office and industrial vacancies rose sharply as businesses shed jobs and cut back on spending. The apartment market struggled, due to weak demand caused by job losses and the booming housing market. But retail prospered thanks to robust consumer spending.

The current slowdown is different in part because the housing market affects the corporate *and* consumer sectors of the economy. **So far, the impact on the corporate sector, which largely determines demand for office and industrial space, has been limited mostly to housing-related businesses.** The housing sector has been hemorrhaging jobs since December 2006, and, based on the latest data on housing starts and permits, it will continue to contract well into next year. Outside the housing sector, job growth has held up fairly well. The rate of growth has slowed, however, as businesses have become less sanguine about the near-term outlook for the economy.

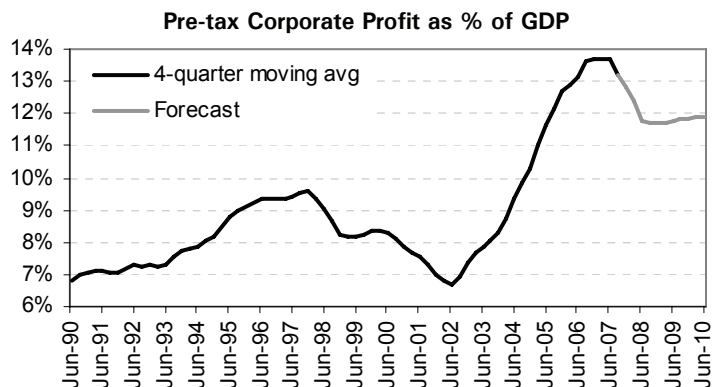


The slowdown in hiring this year has produced some short-term weakness in office demand. According to Torto Wheaton Research (TWR), the average office vacancy rate rose 10 bps in 3Q07 to 12.5%. But it remains about 40 bps below 2006's level, and vacancy rates in most markets are at or near equilibrium. The weakness this year has concentrated in suburban markets where the housing downturn has been most pronounced. With a few exceptions, CBD office markets remain very tight. TWR's average vacancy rate for CBD space actually declined another 30 bps during the third quarter to 9.6%, its lowest level since 2Q01. How long the weakness will persist is hard to predict. But few markets are at risk of new supply ramping up sharply anytime soon. Weak demand may cause vacancies to rise in the near term, but supply is not a major risk at this point, and a collapse in demand, similar to what occurred in 2001, seems unlikely.

Fortunately, the recent demand weakening comes at a time when space market fundamentals and corporate balance sheets are generally healthy. Corporate profits may have peaked for this business

cycle, but as a percentage of GDP, they remain near their recent high. Companies can afford to continue hiring and investing, therefore, and most seem inclined to resume both just as soon as the credit market settles down. But businesses clearly have become more circumspect. As a result, while the weakness in tenant demand should be temporary, the effects of the slowdown on rent growth may be more enduring. **A few supply-constrained markets may still see office rents spike, but both the number of markets where rent spikes occur and the magnitude of the increases will be smaller than was expected when the year began.**

Corporate Profits Remain Healthy



Sources: Moody's Economy.com; Bureau of Economic Analysis

Tenant demand for warehouse space also seems to have weakened somewhat this year as business spending has slowed and spec development has kept pace with absorption. Although warehouse vacancy rates in most markets changed little during the third quarter, rent growth has moderated. As in the office sector, the current weakness in demand should be temporary. But as demand resumes, it will be interesting to see how or if demand patterns change. The steep decline in the U.S. dollar has made American goods and services more attractive abroad. Exports have been growing about three times faster than imports this year, and container traffic leaving U.S. ports is suddenly brisk. While the U.S. economy is not about to shift from a trade deficit to a surplus, increasing demand for American goods overseas, particularly in developing Asian markets like China, is likely to be a long-term trend that could have implications for how the distribution network is configured and where warehouse stock should be located. Most of the existing infrastructure was designed and built around an import-oriented flow of goods, and with export volumes increasing, distribution logistics could change as well.

The recent deceleration in the economy has had little effect on the hotel market. Strong demand from business travelers and, to a lesser extent, from leisure travelers has kept hotel occupancy rates at very high levels. Growth in revenue per available room (RevPAR) has moderated as occupancies have leveled off, but it remains healthy across most segments of the lodging industry and in most markets. Upscale and luxury hotels in urban markets continue to deliver the best results, but operating and space market fundamentals are remarkably healthy across the industry. RevPAR growth will be lower this year. According to Smith Travel Research, through September RevPAR for the U.S. lodging industry was 5.7% higher versus the same time last year, and analysts expect growth will moderate further in 2008. With little room to push occupancies higher,

increases in average daily rates (ADRs) will account for virtually all RevPAR growth over the rest of this cycle. While revenue growth should remain healthy in the near term, higher room rates inevitably increase cap ex as travelers' expectations rise. Hence, **with hotel properties trading at rich multiples and operating fundamentals unlikely to improve, the risks in the lodging sector clearly are weighted to the downside.**

The potential impact of the housing market on the consumer sector poses the greatest challenge for the economy and commercial real estate. Consumers ultimately will determine whether the economy can avoid a recession. While job losses obviously affect consumers' *ability* to spend, the negative wealth and sentiment effects of the housing market downturn probably have a greater impact on their *willingness* to do so and, therefore, on the outlook for retail real estate. **Unlike the financial losses that accompanied the bursting of the tech bubble and 2001 recession, the erosion in wealth from the ongoing housing market correction will reduce consumers' propensity to spend.** No longer able to tap equity in their homes and faced with high energy costs, consumers have little choice but to reduce spending in the near term, which means retail sales growth will remain weak. Tenant demand for retail space has held up well so far. However, analysts have become increasingly bearish about the near-term outlook for retailers.

Despite growing concerns about consumers and the broader economy, retail asset values have remained firm this year. According to Real Capital Analytics, average unit prices for retail properties (through August) were about 20% higher than last year, and cap rates were slightly lower (25 bps) than a year ago. Nevertheless, **retail properties in the NCREIF Property Index (NPI) have underperformed the Index for nine of the past 10 quarters (since 2Q05), and there is little reason to believe the trend will reverse over the next year or so.** Evidence from the nascent U.S. property derivatives market supports this view. According to Merrill Lynch, the pricing on two-year contracts to swap total returns for retail with office or industrial implies 75 to 100 bps (per year) of underperformance for the retail component of the NPI. Whether the spread is too wide or too narrow remains to be seen – the U.S. property derivatives market is still very small, and liquidity is limited. However, it illustrates the negative investor sentiment toward retail today, which will make appreciation gains difficult to achieve in the near term.

The weakness in the housing market is clearly affecting demand for apartments, particularly in markets where the supply of housing units has increased sharply in recent years. Roughly one-half of all renter households occupy single-family homes or condos, so an excess supply of either (or both) can easily erode apartment demand in the short term. Although conditions vary widely, vacancies have increased and rent growth has slowed in a few markets. Like the boom that created today's excesses, however, the housing downturn will not be uniformly distributed across all markets. The most severely affected markets include high-growth markets – e.g., Southern California, Arizona (Phoenix), Nevada (Las Vegas) and Florida – that have significantly outperformed the national housing market in recent years, and long-suffering, low-growth (or contracting) markets, mostly in the Midwest, that did not participate in the boom but have nevertheless been dragged lower by the downturn. In the case of the former, the medium- to long-term outlook for apartment demand remains positive. Homeownership, which peaked at 69.2% in 4Q04, has already fallen about 100 bps and is expected to continue to slide before stabilizing. As the excess inventory of housing units is absorbed over the next 12 months or so, the falling

homeownership rate, together with the growing ranks of echo boomers entering the workforce, should generate healthy, sustainable demand for apartments in markets where the long-term outlook for job growth is most promising.

The slowdown in the transaction market since June will not affect private real estate performance this year, at least not as measured by the NPI. With the highest concentration of property appraisals occurring in the fourth quarter, the Index will deliver above-average total returns again in 2007 as appraised values continue to catch up with the re-pricing (upward) that took place early in the year, especially in the office sector. The NPI posted a total return of 12.2% through the third quarter and should easily make it into our revised forecast range of 15% to 18% for the full year.

Next year, however, core real estate performance will likely slow significantly even if asset values remain firm. The key factors responsible for driving cap rates lower in recent years – robust NOI growth expectations, generous proceeds for borrowers and the relative attractiveness of the asset class – have weakened since this time last year. Hence, the potential for further write-ups for core assets will be limited over the next 12 to 18 months, meaning that NPI appreciation returns, which recently have been running in the low double-digits, will contribute little to total returns in 2008. With annual income returns below 6%, total returns next year for the NPI will likely be in the high single digits for the first time since 2003. This will be a return to “normal” results for core real estate from the unsustainable levels of recent years.

Closing Thoughts

While it's clear that the days of the highly leveraged megadeals are over, it remains to be seen just how the current capital market crisis will affect commercial property values. In the near term, the sharp slowdown in transaction volume will make price discovery more difficult and will force investors (and appraisers) to focus on property income and replacement costs to assess asset values. Fortunately, space market fundamentals are relatively healthy, and new supply poses little risk in most markets and property types. Hence, as long as demand does not contract sharply, the current dislocation in the capital markets should provide attractive opportunities for well-capitalized investors to exploit mispricings of risk that have been created by the withdrawal of highly leveraged buyers and other capital sources. For years now, investors have enjoyed an environment in which the only bad deals have been those left undone. In most instances, cap rate compression has been more than enough to rescue deals that fell short of expectations for whatever reason. With cap rates no longer falling, underwriting and execution skills will once again separate the winners from the losers.

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