

Market Perspective

Executive Summary

- While the business cycle is maturing, forward-looking indicators have been declining but are still consistent with reasonably healthy economic growth. Future GDP growth could surprise on the downside, since uncertainty has risen due to the recent turbulence in the financial markets and tighter credit conditions.
- Space market fundamentals across all major property types remain healthy, and little evidence suggests supply will outstrip demand in the coming months.
- Investment volumes will likely moderate since liquidity, and hence yield compression, has probably peaked in this real estate investment cycle. Limited credit provision and stricter lending criteria will generate a repricing of risk. Markets with poor rental growth prospects, especially in the secondary segment, will be most vulnerable.
- While space market fundamentals continue to support pricing in most markets, investor sentiment becomes crucial in setting prices against the backdrop of increased market uncertainty.

Economic Context

While still above trend, the European economy grew less than expected during 2Q. Annualized GDP growth eased to 2.8% in the EU 27 and to 2.5% in the euro area, from 3.3% and 3.2%, respectively, in 1Q. The slowdown suggests that the business cycle is maturing and may have passed its peak. Growth patterns, however, continue to vary significantly, ranging from 0.6% in Denmark to 11.3% in Latvia. Among the five largest economies, only the UK and Spain outperformed the European average, achieving growth rates of 3.1% and 4.0%, respectively. The German economy expanded 2.5%, but in Italy and France growth rates fell below 2%.

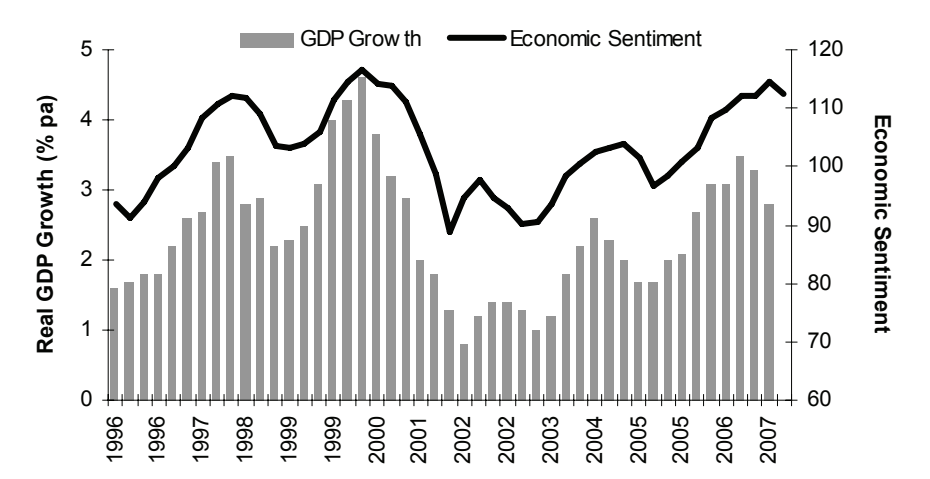
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Private consumption replaced investments as the main driver of growth in 2Q. At the same time, world trade continues to support growth in the EU; export growth accelerated to 6.2% in the euro zone and to 3.8% in the EU 27 on an annual basis. The growth in household consumption reflects improving labor markets fueling household income. EU employment grew by 0.5% in 2Q to 222.1 million. In 24 of the 27 member states, the unemployment rate in August 2007 was lower than in August 2006. The strongest decline occurred in Poland, where the unemployment rate fell by more than four percentage points to 9.1%, followed by Bulgaria (9.2% to 6.5%) and Germany (8.4% to 6.3%). This contrasts with Portugal, where unemployment rose from 7.5% to 8.3%. Overall, the EU 27 unemployment rate was 6.7% in August, down from 7.8% a year ago. Against the backdrop of improving labor market conditions, nominal wages increased by 3.3% in the EU27 over the past 12 months. Variations ranged from 0.3% in Portugal to 17.2% in Romania.

Looking ahead, most market participants have revised their growth forecasts marginally downward. Uncertainty has risen in light of the recent turbulence in world financial markets, which triggered a tightening of credit conditions prompted by a repricing of risk. Tighter credit conditions are likely to dampen construction investment and private consumption growth. Meanwhile, the recent sharp appreciation of the euro will hinder export growth. Additionally, business and consumer confidence will suffer, if the financial market crisis continues. This suggests that growth forecasts could surprise on the downside. These uncertainties, plus a mature business cycle, are reflected in the recent decline in the forward-looking economic sentiment indicator for the EU27, which slipped to 110.8 in September from 115 in May (see Exhibit 1). While this could suggest that the growth peak has passed, the indicator remains well above its long-term average, consistent with robust economic expansion. Overall real GDP growth for 2007 is projected to be 2.6% in Western Europe and 5.9% in Central and Eastern Europe, both slightly lower than in 2006.

Exhibit 1: EU 27 Annualized Real GDP Growth and Economic Sentiment Indicator



Sources: DG ECFIN; Eurostat; Prudential Real Estate Investors

Capital and Real Estate Investment Markets

Monetary policies have varied over the past month. The Bank of England left its main policy rate unchanged at 5.75%, whereas the Central Banks of Sweden, Switzerland and Norway have continued to raise rates. The European Central Bank (ECB) was widely expected to raise interest rates at the September meeting, but given the high uncertainty associated with the turmoil in the financial market, it left interest rates unchanged at 4%. The ECB now faces conflicting pressures between the upside risks to price inflation and the downside risks to growth. However, the ECB emphasized that it continued to see upside risks to price stability. In fact, the flash estimate for September showed an inflation rate of 2.1%. That said, interest rates are unlikely to change this year. This also applies to the Bank of England, which is expected to leave rates unchanged.

Because of the financial market turmoil, investors' risk appetite has greatly decreased. Thus, investors shifted funds from risky asset classes into government bonds, which lowered 10-year government bond yields to 5.0% in the UK and to 4.3% in the euro area at the start of October.

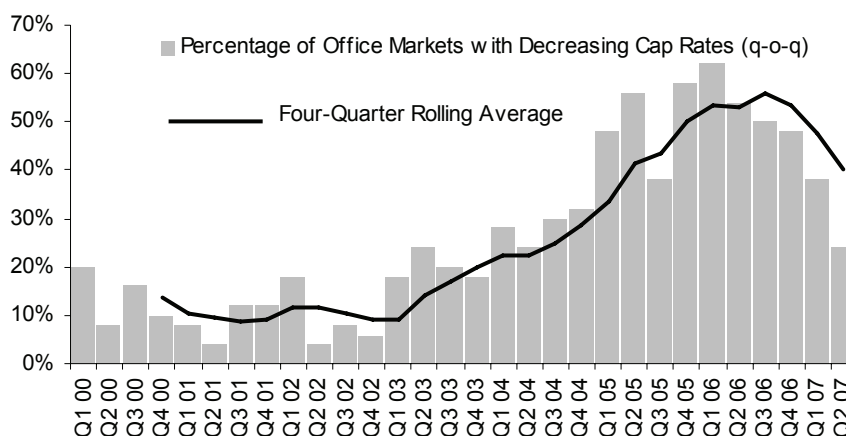
The interbank markets are currently characterized by a breakdown in trust and uncertainty regarding counterparty risk among market players due to the exposure of many European banks to U.S. subprime mortgages via special vehicles. Thus, following the turbulence in the summer, money market interest rates have risen. For example, in September the three-month EURIBOR rates stood at 4.74%, 59 bps higher than in June. Short-term market interest rates are high compared with key interest rates, reflecting the ongoing lack of confidence in the banking sector and reduced liquidity in the interbank market. Banks have started to tighten lending to the real estate sector due to the reduced liquidity in the interbank market. Moreover, banks are reassessing default risks and are faced with increases in balance sheet assets due to limited opportunities to offload their risks via securitizations. After having peaked in June with about €15 billion, CMBS issuances have fallen sharply from July to September, as several banks have withdrawn from CMBS deals. In fact, with no CMBS issuance, the securitization market remained closed in September. Consequently, real estate investments will become more difficult to finance as liquidity has evaporated. Anecdotal evidence suggests that some banks have pulled out of deals. Several large deals have been postponed, credit margins have widened, especially for highly leveraged investments, and banks have started to require more equity in deals. On the whole, the provision of credit to property companies is likely to moderate.

Nevertheless, direct commercial real estate investment activity continued to remain strong during the first half of 2007, driven by portfolio deals and trophy assets. According to Jones Lang LaSalle, about €121 billion of commercial property investments traded during the first six months, up 9% over the same period in 2006. Although declining, at €41 billion, the UK continued to receive the largest amount of investment, followed by Germany (€27 billion) and France (€15 billion). Given the high investment volumes during the first half, property yields compressed further, by roughly 15 bps, during 2Q. For example, weighted net office initial yields in major European cities stand now at about 4.4% in the prime segment.

While yield compression continued in 2Q, it appears to have reached its peak in 1Q06. Since then, the percentage of markets with declining yields compared with the previous quarter has

followed a downward trend from more than 60% to 24% during 2Q07, reaching the lowest level since 2Q04 (see Exhibit 2). During the past few months, the number of active bidders in general, and for portfolios in particular, has continued to fall, partly reflecting a withdrawal of debt-driven investors. A growing number of deals have been postponed, as uncertainty about the market's direction has risen. Moreover, several deals have been withdrawn, as buyers refused to accept the selling conditions. This applies, to a greater extent, to the UK market than to the rest of Europe. According to IPD UK, the average total return for UK commercial property fell by 1.2% in September, with capital growth turning negative at -1.6%.

Exhibit 2: Yield Compression Has Passed Its Peak



Source: Prudential Real Estate Investors

European real estate stocks have continued to underperform the wider equity markets. The FTSE EPRA/NAREIT Europe Index continued its downward trend. As of October 10, the sector saw an annual price decline of 19.6%. Highly leveraged companies have seen stronger price declines than lower-levered companies, suggesting that the correction is at least partly driven by concerns about rising cap rates. The ongoing correction regarding property shares should limit capital inflows into real estate securities. Thus, the listed sector is not likely to remain a major driving force behind direct real estate investments in the near term. This contrasts with the private real estate equity markets, where institutional investors seem to remain well disposed toward the sector, as investment managers still raise large sums of capital relatively rapidly. Conservatively leveraged equity investors, including pension funds, insurance companies and German open-end funds, will play an increasingly dominant role in direct property investment for the rest of the year.

In the coming months, investment volumes are likely to moderate. More limited credit provision and stricter lending criteria will generate a repricing of some properties as deals become harder to close. This applies especially to big portfolios, which become more difficult to finance as securitization becomes more challenging. While uncertainty about the market's direction prevails, the pricing in markets with poor rental growth prospects, particularly in the secondary segment, will be most vulnerable. This in turn indicates that markets that have been dominated by financially driven investors are most likely to face a downward correction in pricing.

Real Estate Space Markets

The European office market recovery has persisted. Most locations have continued to see declining, or at least stable, vacancy rates. The average European office market has a vacancy rate of 7.8%, which is about 110 bps lower than one year ago. With a vacancy rate of 1.5%, Geneva marks the lower end of the scale, whereas Frankfurt, with 15%, represents the upper end. While vacancy rates have persistently fallen since 2004, they are still more than 300 bps higher than at the peak of the last rental cycle in 2000. However, with vacancy rates of less than 4%, an increasing number of central business districts in cities like Paris, London and Madrid have scarce supply. Driven by above-average office employment growth, take-up in Europe's major office markets reached 6.7 million m² in the first half of 2007, according to Jones Lang LaSalle, up by 9% compared with the same period in 2006. With no market showing falling rental levels, prime rental growth is spreading throughout Europe. During 2Q, prime rents rose about 10% y-o-y. While prime rental growth in some markets, including Milan, continued to be flat, several cities like Oslo, Warsaw and Moscow have seen annual growth rates of more than 25%. While the recovery gained momentum in the prime segment, the rental upswing applies only to a very limited extent to the secondary segment.

Looking forward, uncertainty in the office sector has increased. While office demand is running at a robust pace, employment in financial services could surprise on the downside from the turbulence in the global financial markets. This risk is especially evident in locations like Zurich, the City of London and Luxembourg, where financial services account for 33%, 24% and 21%, respectively, of local GDP. Office construction activity is picking up but is still at relatively low levels for this stage of the rental cycle. Over the next two years, net additions are estimated annually at roughly 1.5% of total stock. This compares with about 2.6% during the rental upswing in the late '80s/early '90s and with 1.9% during the upswing from 1997 to 2001. Moreover, bank lending for development projects should decrease, which in turn will slow completions. In total, we expect the rental upswing in the prime office rental markets to continue in the medium term, albeit at more moderate rental growth rates.

Over the first half of 2007, trade between the EU and most of its major partners grew, creating tenant demand for warehouse and distribution space. While Central and Eastern Europe continue to register double-digit growth in their trading volumes, import and export growth in Western Europe is projected to expand more slowly in 2007 than expected, at 3.5% and 2.5%, respectively. An annual decline of exports to the U.S. by 2% during the first six months of 2007 suggests that the sharp appreciation of the euro should continue to dampen the euro area's export growth. This, however, is increasingly offset by strong trading activity with emerging markets. During the first half of 2007, the strongest increases were in exports to Russia (+30%), India (+20%), China and Brazil (both +14%) and imports from China (+20%), Brazil (+17%), India (+16%) and Turkey (+14%). Rental growth in the logistics sector, however, remained more mixed than the strong tenant demand would suggest. With regard to annual rental growth, 42% of major markets across Europe have seen rising rents, 39% stable rents and 20% falling rents in 2Q. Oslo, Seville, Sofia, Barcelona, Istanbul, Ankara, Vienna, Madrid and Paris lead the upper quartile of markets showing double-digit rental growth. While these growth dynamics remain intact, especially in and around major ports and intermodal hubs due to increasing global and

pan-European trade, future rental growth should be limited in many markets as new supply continues to respond quickly to demand.

After years of strong house price increases, downside risks in several markets have risen. In the euro area, building permits have declined greatly since January 2006, and mortgage lending has decelerated. This indicates that the housing market has started to weaken. This is also in line with European annual house price growth, which has decelerated to an estimated 2.8% over the first half of 2007. While markets like the UK or Spain have remained surprisingly robust on a national level, regional markets paint a more diverse picture. In Spain, for example, 11 out of 45 major cities registered falling house prices on a quarterly basis from July to September. The largest decrease (2.2%) was in Zaragoza, while in Córdoba, house prices rose by 2.2% in 3Q. Strong regional differences were also highlighted by a Eurostat survey, which examined the perception of housing opportunities. The survey showed that Paris, Luxembourg and Dublin have a demand overhang for housing, while a strong supply overhang exists in Leipzig, Germany; Aalborg, Denmark; and Braga, Portugal. This partly reflects wide variations in income levels and job prospects across European cities. Overall, while the extent and timing remains uncertain and should differ widely, Europe's housing markets are expected to soften.

In the retail sector, despite falling unemployment rates and rising incomes, consumer confidence decreased in 3Q, according to the European Commission's consumer confidence indicator. This reflects the worries of European consumers about the potential impact of recent financial turbulence on the economy. However, the outlook for households varies: European households, as net savers, could even benefit from higher interest rates triggered by a reassessment of credit risk. On the other hand, tighter lending standards, reduced credit provision and the potentially negative development of the housing market in some countries could have a negative wealth effect.

Eurostat reports that the annualized growth in retail trade from June to August 2007 is up by 2.6% in the EU27, but this masks wide variations. Retail trade volumes fell over the same period in Hungary, Germany and Italy, but rose sharply in Romania (19.2%), the Baltic States (16.1%) and Poland (13.7%). Further outperformers included Sweden, Ireland, the Czech Republic and Finland, all growing in the upper single digits. Non-food sectors including textiles and household goods have continued to outperform retail sales overall, generating strong occupier demand in the high street and shopping center segments. Despite a recent decline, this is also reflected by still-positive retailer confidence, according to the European Commission's retail trade indicator. With the exception of Hungary, retailer confidence in Central and Eastern Europe is the highest, followed by the Nordic region. Building activity should continue to remain above trend in the shopping center segment over the next two years, reflecting the ongoing structural shift toward modern retail formats throughout Europe. Regarding provision of shopping center space adjusted by real disposable income, it appears that several Central and Eastern European markets face the highest risk of pockets of oversupply, whereas Belgium, Norway, Denmark, Germany and France look like defensive plays. On an aggregate level, shopping center rental growth should continue to expand moderately, slightly above the inflation rate.

Conclusion

While commercial occupier market fundamentals should continue to support asset pricing, the capital market environment has changed since this summer. Liquidity has most likely peaked in this real estate investment cycle, as highly leveraged buyers are becoming less active, and negotiation power is shifting from sellers to equity-rich buyers. Given the healthy real estate fundamentals in most markets, the biggest downside risk is the repricing of assets as a result of shifting capital market conditions.

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