

# Market Perspective

### Executive Summary

- The European economy continues to strengthen, and forward-looking indicators suggest that consumption and employment growth should remain robust over the short to medium term.
- Monetary conditions have tightened and look set to tighten further over the next few months. However, inflation expectations are moderating, and long-term rates have stabilized.
- The volume of capital seeking exposure to real estate remains high from all quadrants of the market. However, evidence suggests that yield compression is abating in some segments of the market.
- Improving occupier demand will likely result in a strengthening of rental growth for prime property over the next few quarters, but secondary stock remains vulnerable to real rental decline.
- As ever at this stage of the cycle, property selection, asset management and a heightened awareness of risk will be key ingredients in achieving outperformance.

### Introduction

The European economy continued to strengthen in the second quarter of this year. Quarter-on-quarter GDP growth in the EU25 amounted to 0.9%, the highest rate in six years. This contributed to an annual growth rate of 2.8%, much higher than estimates of trend growth (circa 2.2%). A breakdown shows that a sharp acceleration in investment growth supported this expansion, while the contribution to GDP growth from consumption fell markedly (although this followed a strong contribution in 1Q).

Prudential Real Estate Investors  
8 Campus Drive  
Parsippany, NJ 07054  
USA

Ph 973.683.1745  
Fax 973.734.1319  
Web [www.prudential.com/prei](http://www.prudential.com/prei)  
E-mail [prei.reports@prudential.com](mailto:prei.reports@prudential.com)

Forward-looking indicators suggest that growth will remain above trend over the short term at least. For example, the composite PMI indicator is consistent with quarter-on-quarter GDP growth of about 0.8% in 3Q; surveys in the manufacturing and services sector are consistent with an acceleration of annual output growth; and the European Commission's Economic Sentiment Index stands at its highest level in almost six years.

The slowdown in consumption growth to 0.3% from 0.7% in 2Q, although somewhat disappointing, is likely to prove temporary. Consumer and retailer confidence are at their highest levels in at least five years and continue to strengthen. The retail PMI increased modestly in September, and consumer-spending intentions indicate an increased willingness to undertake major purchases. Moreover, recent retail sales data suggests that consumption growth will rebound in 3Q, while conditions in the labor market continue to improve, lending further support to a robust outlook for spending.

Despite unexpected growth in euro-zone unemployment in August (from 7.8% to 7.9%) the European labor market continues to strengthen. The increase, which will likely prove temporary, was almost entirely attributable to Germany (where the unemployment data has been particularly volatile of late). Other indicators of labor market conditions support an outlook of continued tightening. Employment growth, although modest at about 1.7% per year, has been accelerating, and the recent upticks in the EC indicator of employment intentions suggest a sharper improvement to come. Hourly labor costs have risen over the past three quarters to about 3.1%, but this is hardly consistent with an overheated labor market.

That said, the current unemployment rate in the euro zone is broadly in line with conventional estimates of the sustainable rate. If recent labor market reform, most notably in Germany, France and Italy, has not yet been successful in reducing the natural rate of unemployment, then increased wage pressure will likely emerge next year. Currently, however, the EC's survey measure of labor shortages, while rising, remains consistent with the long-term average, supporting the hypothesis that the labor market is not particularly tight. In any event, improved employment growth, a reduced fear of unemployment and increases in real wage growth will likely provide support for household spending well into 2007.

Nevertheless, with EU25 GDP growth anticipated to be roughly 2.8%, 2006 may prove to be the peak year for economic growth in this cycle. EIU, for example, anticipates growth will fall back to trend next year (and remain there until 2010), and consensus estimates for the euro zone support this profile. Several factors underpin this scenario: a very strong euro and weaker global demand (whether or not oil prices continue to fall back to more normal levels) are anticipated to negatively affect production and export growth; more restrictive fiscal policy (particularly in Germany and Italy) will dampen the consumer recovery; and higher interest rates may result in more moderate rates of investment growth.

Were these projections to transpire, the implied annual GDP growth rate in the five years to the peak of this cycle would amount to about 1.6%. This compares with 2.7% in the five years to 2000 and 3.0% in the run-up to 1988. Clearly, such an outcome would be weak in the context of previous economic cycles and would not bode well for real estate performance.

The past three months have seen continued tightening of monetary policy. The ECB and Swedish National Bank have raised policy rates by 50 bps since July, while the UK and Swiss central banks have raised rates by 25 bps. While further tightening is expected, the improved near-term outlook for headline inflation (due to the rapid fall in oil prices in the past few weeks) and recent softening of some forward-looking activity indicators suggests that short-term rates may not be too far from their peaks. Nevertheless, financial markets continue to predict more restrictive monetary conditions, with ECB rates expected to peak at 4% in the middle of 2007 and UK rates likely to peak at 5.25% in the spring of next year.

### **Capital Markets**

Having increased substantially in the first half of 2006, longer-term interest rates remained fairly constant during 3Q. In the euro zone, 10-year government bond yields stand at 3.8%, and five-year swaps stand at 4.1%. In the UK, these instruments respectively yield 4.6% and 5.2%. As evidence of modestly slowing growth next year mounts and inflation expectations moderate, longer-term bond yields may not rise much above current levels.

While the absence of further increases in swap rates will be welcomed by highly leveraged investors as well as by lenders, the continued fall in property yields is still softening demand for loan finance. In increasingly few markets in Europe can the income return from prime real estate be enhanced through leverage. Credit margins continue to grow thinner, loan terms are becoming more flexible, and the markets and deal types on which loan providers are willing to lend become ever more exotic in the struggle to maintain loan book sizes.

The relative importance of the public debt markets continues to grow. This year looks likely to be another record year in terms of CMBS issuance, with new issues expected to top €60 billion (compared with €56 billion in 2005). Strong investor demand for the instrument, which stems in part from relatively subdued levels of corporate bond issuance over the past few years, has supported European CMBS issuance growth. Also, the number of new lending conduits has grown rapidly and with it the volume of pan-European deals. Furthermore, a trend toward increasing transparency has enhanced the CMBS industry, including market-led initiatives to launch a European CMBS index to hedge risk exposure before and after issuance of new CMBS. Improving property market fundamentals and low delinquency rates continue to contribute to tight spreads. In 3Q, the average spread of AAA tranches over benchmarks fell to just 19 bps. This compares with more than 60 bps in 2000, when the European market was still in its infancy.

The performance of the public real estate sector strengthened in 3Q with a total return of 13%. This takes the performance for the first three quarters to about 27%. The market wobbles of May and June have become a distant memory. The improved performance has resulted in the re-emergence of an active IPO market, with many of the postponed issues returning or about to return to the market. Several factors drove third-quarter performance. Sentiment in the wider equity market was more positive, the performance of private markets showed little sign of slowing, and leasing market fundamentals in the office sector continued to improve. M&A activity, particularly among Spanish companies, however, had a much larger impact on equity prices.

Most notable were the successful privatizations of Immobiliare Colonia (at the end of 2Q) and Urbis, and an attempted privatization of Metrovacesa. Immobiliare Colonia and Urbis were bought at significant premiums to NAV (circa 30% and 32%, respectively). Metrovacesa continues to trade at a 100% premium, with a free float of less than 15% after the company's two largest shareholders launched rival takeover bids that ended in neither gaining the requisite number of shares. These developments highlight the (arguably irrational) strength of domestic demand for Spanish real estate (not to mention the fact that a number of rules governing takeover activity in Spain are poorly conceived). While the concomitant increases in the share prices of these companies had a direct impact on sector performance, a second-round effect on performance occurred, as dedicated property investors redeployed capital previously invested in Spain to other European companies, in line with changes in benchmarks. At the start of the year, Spanish real estate companies constituted 6% of the EPRA Europe Index by market cap: today they carry a zero weighting.

Since the end of the third quarter, performance has drifted somewhat, partly due to the fact that most of the positive news in the sector has now been priced in by the market. While inflows from dedicated property investors remain strong, increasing evidence shows that generalist investors have become less well disposed to real estate (relative to other sectors), which would be in line with the recent downgrading of the sector by some analysts. While the introduction of REITs in the UK and Germany and companies' development pipelines and capital structure continue to underpin valuations, several factors concern analysts. Price-earning ratios suggest that valuations are stretched: currently they are more than two standard deviations greater than the long-run historic average. In addition, the dividend yield offered by the sector is near historic lows and now about 20% lower than the rest of the market, compared with a traditional premium of 30%. Moreover, the past few years have seen the sector's beta rise above one, which suggests that real estate may not display its usual defensive characteristics in adverse market conditions.

Some developments regarding REITs have occurred, most notably in the UK and Germany. In the UK, it is reported that the Treasury is to relax the 10% shareholding limit, targeting only corporations that seek to exploit double taxation treaties. The decision, confirmation of which is expected shortly with the publication of the final details of the structure, bodes well for the growth of the sector since privately held portfolios or property companies will be able to convert to REIT status without incurring tax penalties.

In Germany, the Ministry of Finance circulated a draft of the REIT Act to other government departments at the end of September. Despite the short time frame, the Ministry of Finance is still aiming to launch the structure in the next few months. While subject to change, many of the parameters were broadly in line with expectations: restrictions on the portion of assets held in the form of real estate; the proportion of income to be generated from real estate; the proportion of income to be distributed; and restrictions on the free float, shareholdings and ownership periods. The draft stipulates that development activities are not allowed; listing will be mandatory; and, despite strong political opposition, residential REITs will be permitted. Since the release of the draft, however, senior politicians have given mixed messages regarding whether residential REITs are to be allowed. This uncertainty, however, has not dampened investor appetite for listed residential vehicles, some of which were viewed by the market as natural candidates for

REIT conversion. It is notable that GAGFAH, a Luxembourg vehicle recently listed by Fortress, continues to trade at a premium to NAV of more than 90%.

German property companies account for a relatively small share of the European real estate market cap (less than 4% at the end of 3Q, according EPRA). As such, the success of the REIT vehicle depends very much on whether property-rich corporations (70% of all commercial real estate in Germany is owner-occupied) use the vehicle as a means of taking real estate assets off their balance sheets to redeploy capital back into their core businesses. As an incentive to convert to REIT status, the exit tax (effectively an entry tax to the REIT regime) will be reduced to 20% for four years (from the 40% charge on capital gains upon liquidation that now applies).

Net inflows into German open-end funds have been broadly neutral over the past three months, indicating that confidence in the vehicle is starting to return. Nevertheless, a net outflow has occurred in the year to date of €8.3 billion, and a number of funds, predominantly those whose portfolios have a high weighting of German real estate, continue to experience net redemptions. These funds remain net sellers of real estate, generating sales proceeds of more than €6 billion in the first half of this year. While these funds are selling significant volumes of German assets, not just to meet redemptions but, in the case of multicountry funds, to reduce their exposure to Germany, they have also been very active sellers in Europe's most liquid investment markets, namely London and Paris. Acquisition activity remains subdued, and sales activity is expected to continue throughout much of next year, even if these funds start to see consistent capital inflows between now and then.

Arguably, more private money is now in the market than ever before (from private property companies, vehicles, family offices and high-net-worth individuals), despite the reduced potential for leveraging income. Buoyed by continued strong inflows, international private equity investors (both highly and modestly leveraged) continue to view the selling by German open-end funds as an opportunity to raise their exposure to Germany. Against a background of improving economic and property market fundamentals, investor demand is now very strong in most segments of the market, and yields have fallen significantly in the past year. Corporate real estate disposals, often structured as sale-leasebacks, are also providing international investors with a route into the German market. While the (temporary) mispricing of German real estate has eroded over the past 12 months, these acquisitions remain attractive to investors (not least due to the asset management angles they offer and, in some cases, the potential to exit through a REIT structure should legislation be passed).

Strong investor demand, not just in Germany, but across Europe, is evident in transaction data. CBRE notes that almost €90 billion of assets were transacted in the first half of this year (almost half of which were cross-border acquisitions). This represents an increase of about 40% on the same period a year earlier. It is notable, however, that transactions volumes in the UK are down significantly from the start of the year, particularly in the shopping center market. Agents are reporting a shorter queue of buyers and, moreover, it has been reported that several deals involving very large assets have fallen through or have been renegotiated at prices significantly below those initially sought. These trends are consistent with a peaking investment market cycle, but demand for good-quality, more digestible assets remains strong.

Increasing evidence shows that investors are repositioning portfolios to capitalize on the improvement in office leasing market fundamentals, with retail accounting for a lower share of acquisitions across Europe. Data indicates an enhanced appetite for larger deals, with almost 60% of acquisitions (by value) constituting lot sizes of more than €100 million. These trends are expected to continue, with strong equity inflows, rather than debt, increasingly supporting investor demand, in contrast to the past few years.

## **Property Markets**

The principal driver of performance in the European real estate sector remains yield decrease driven by weight of money. However, real estate fundamentals are beginning to play a more important role. Improvements in economic activity and labor market conditions suggest that rental growth should strengthen and become more widespread during the early part of next year.

### **Office**

Anecdotal evidence suggests that the improvements seen in office leasing market conditions in 2Q have since accelerated. Corporate profitability and business confidence remain high, and companies' willingness to hire new staff is increasing. Sentiment among occupiers has improved, and more evidence exists of expansionary take-up emerging across a wider range of markets.

Even Frankfurt and Amsterdam, two of the weakest markets in Europe, have seen significant increases in gross take-up and net effective rents recently, although this comes after a period of very generous incentives as landlords sought to preserve headline rents. While the supply of new or high-quality space has fallen as companies have sought to lock in low rental rates and upgrade the quality of the space they occupy, vacancy rates remain very high in both markets (circa 15%). Moreover, both Frankfurt and Amsterdam will remain oversupplied well into 2008.

Encouragingly, in recognition of the oversupply problem, planning authorities in Amsterdam have frozen permits for new office buildings and are reportedly trying to take back some outstanding consents to promote change of use (in most cases to residential). Nevertheless, the greater coordination with other municipalities in the Randstad region will be necessary before meaningful structural supply tightening begins to emerge in this market.

While occupiers' flight to better quality space at this stage in the recovery cycle is reducing the vacancy rate for prime space, the stock of vacant secondary-quality space remains stubbornly high. Moreover, in several markets, projections for office-based employment growth and/or an earlier than usual resumption of development activity suggest that prime space looks likely to remain more readily available than over equivalent stages of previous cycles. These dynamics could lead to a shorter rental growth cycle for prime property, while the high vacancy rates and rental voids associated with secondary-quality buildings will persist for longer. As a result of the weak outlook in the secondary segment of the market, these assets are likely to become obsolete more quickly, resulting in a shorter life cycle. In recognition of this potential scenario, owners and developers need to increasingly consider the potential for change of use.

With aggressive rental growth fully priced in, it is increasingly difficult to find value in the early-recovery office markets. Prime offices in Madrid and Barcelona, in particular, look overvalued on most metrics, and pricing would appear to be especially vulnerable to a change in sentiment among local investors. Against this background, investor demand is increasingly focusing elsewhere. Investors continue to target the next tier of recovery markets, such as Stockholm and Helsinki, and interest is growing in several provincial office markets in the UK and France. While these provincial markets tend to be less volatile in terms of leasing market and development activity, fundamentals are improving, and rental growth projections suggest that these markets will outperform the average for European office markets over a five-year horizon. In general, target IRRs for acquisitions in these markets can be underwritten with less aggressive assumptions than the more cyclical early-recovery markets of London, Paris and Madrid.

Investor demand for offices in Dutch and German cities is increasing and is no longer just being driven by long-term investors taking a countercyclical view. With domestic investors in both countries less well disposed to the sector following several years of underperformance, yield compression in these markets has been much less rapid than average over the past two years (circa 75 bps compared with an average of 100 bps for Europe as a whole). Moreover, as noted above, these markets are seeing the early stages of improvements in leasing market conditions.

At the prime end, yield compression continues across a wide range of markets. Anecdotal evidence from investment agents suggests that the pace of compression is slowing in Central London, and investors are increasingly concerned about the pricing of the main Central European office markets, namely Warsaw, Prague and Budapest. Net initial yields in these markets are between 5.0% and 5.2%, according to PMA. Recent events in Budapest highlight that these countries still carry some additional political/economic risk. Moreover, they are among those with the weakest rental growth prospects in Europe, due largely to the volume of space in the development pipeline. At the same time, yields are just 20 bps higher than the European average.

## **Industrial**

Rental growth in the industrial sector has been slow to recover despite strong demand for prime logistics property and shortages of facilities in some locations. According to Cushman and Wakefield, prime rental growth, which has now been positive for the past two years on a European-wide basis, averaged just 1% in the year to the end of 2Q. This is largely due to the fact that higher levels of demand in many markets have been met by increased development activity. Although new construction has resulted in an acceleration of the rate of functional obsolescence for secondary space, it has raised the average quality of stock and has resulted in greater standardization by quality across markets, both of which have made the sector more appealing to investors.

Increased sophistication of international third-party operators seeking to benefit from economies of scale and efficiency gains has resulted in robust demand for high-quality, larger facilities in strategically important locations. These occupiers are typically willing to accept the higher rents associated with high-spec units in return for the lower total operating costs that this space offers (due, among other things, to the potential for lower labor, energy, security and insurance costs). That said, these operators are highly cost sensitive, and lease lengths are shortening as operators

tie them to the duration of their operating contracts to try to eliminate any residual rental liability.

Demand is also strong from retailers for both cyclical and structural reasons. From a cyclical perspective, consumption growth this year will likely be higher than any year since 2000, with both retailer and consumer confidence now high. (This is also contributing to increased import volumes, which also have a direct impact on logistics demand). Structurally, consumption is becoming an ever-important driver of economic growth, partly as a result of rising wealth (most notably in Central and Eastern Europe) and partly due to the relocation of production to low-cost countries outside Europe. The globalization of the retail sector, driven by large food retailers and major fashion chains, is also affecting the level and type of demand for logistics space. The rapid growth of online retailing, together with aging and migrating populations, is also influencing the nature of retailers' logistics requirements. Although these trends make for a dynamic sector, they are also likely to shorten the life span of European logistics facilities.

The pricing of industrial assets across markets has converged rapidly over the past few years. Increased demand for industrial assets (both in absolute and relative terms) has resulted in a maturing of the sector and an erosion of the pricing inefficiencies that existed in some markets. With scope for further yield compression limited and prospective rental growth likely to prove modest, ungeared total returns in the industrial sector are likely to fall toward levels consistent with the income return. By implication, the variation of performance across different locations will likely be much narrower than in other sectors. Nevertheless, industrial assets are expected to remain in high demand as investors seek to rebalance portfolios in favor of sectors offering attractive income returns, as this period of yield compression comes to an end and capital growth abates.

This is one of the trends on which the recent IPO of ProLogis European Properties aims to capitalize. This externally managed vehicle, structured as a Luxembourg FCP, represents the first genuinely pan-European listed prime logistics play. The portfolio comprises 281 properties diversified across 11 countries with a triple-net NAV of €2.3 billion. The attractive dividend yield on equity (expected to exceed 6%) contributed to a high level of investor demand for the primary issue: the shares currently trade at a premium of 16% to the prospective end of 2006 triple-net NAV, although this is, to some extent, a function of its access to ProLogis's development pipeline.

## **Retail**

European retail markets are benefiting from increased consumer confidence on the back of better labor market conditions (increased job security and the re-emergence of real wage growth) and rising housing wealth. More rapid growth in household debt has also enhanced purchasing power. This has resulted in a resurgence of retail sales growth (driven by the fashion and household goods sectors, which are the key occupiers of prime space) and increased confidence among retailers. Although evident in the euro-zone area (particularly in the Netherlands), this improvement is most evident in countries, such as Poland, Hungary and the Czech Republic, where wealth levels are rising quickly and credit is increasingly available.

One of the main drivers of the demand for prime space, particularly on the high street, has been a relatively small number of pan-European operators. This group continues to enjoy healthy profit margins and strong sales growth. However, the competitive nature of the retail market is highlighted by the fact that the vast majority of sales growth of these retailers is driven by store expansions or new openings rather than like-for-like sales. These retailers are highly efficient, and their drive for market share and concomitant store openings in new markets is eroding the profitability of local and national retailers and slowly affecting the occupier composition of prime pitches. This is also contributing to a widening of the performance differential between prime and secondary-quality space.

The vast majority of city markets in Europe are seeing positive rental growth. More importantly, this rental growth is expected to improve during the course of next year, as improving retail confidence is converted into additional space requirements. The key exception is the UK, where performance is expected to deteriorate in the coming months, despite a robust outlook for retail sales growth.

While goods price deflation over the past few years has not been confined to the UK, it has not only been most severe there, but it has also been more prolonged. The price of fashion goods, where deflation has been most evident, continues to fall by about 4% per year in the UK. Other major European countries have seen a recovery to the point where modest price appreciation (on average less than 1% per year) is now occurring.

Sales growth and the margins of UK retailers are also under pressure for several other reasons. First, the impact of the Internet has been more pronounced in the UK, with average online spending now more than twice that of any other European country. Second, major food retailers continue to diversify their product base to include nonfood merchandise such as fashion goods. Third, high street retailers are increasingly taking space in out-of-town formats such as retail warehousing, traditionally the domain of the bulky goods sector.

As a result, UK retailers are increasingly sensitive to occupational costs, particularly on high streets and in shopping centers. At the same time, supply is increasing and will continue to do so over the next few years: the volume of space under construction in town centers is now higher than at any time over the past decade, and the volume of shopping center space in the development pipeline with consent but not yet under construction is also higher than it has been for many years.

Major owners of UK retail and agents have noted these challenging leasing market conditions. Lease-up rates have slowed, and a significant increase in the number of vacant units has occurred, even in prime pitches and in the best shopping centers. According to IPD, average rental growth has slowed to an annualized rate of 2.5% per annum over the past three months. At the same time, yields in the sector stand at all-time lows – initial yields for average-quality retail stand at about 4.3%, while prime shopping centers have commanded a yield of between 4.25% and 4.5%. Transactional volumes for retail property in the UK have fallen significantly on last year, and CBRE reports that retail yields (unlike office and industrial yields) have stabilized following four years of consistent compression.

## **Residential**

The EU residential markets continue to boom. According to the European Mortgage Federation, the EU mortgage market grew by 12% last year, and similar rates of growth have been recorded in the first half of this year. These increases take the volume of mortgage debt as a share of GDP to about 50%, which, although higher than ever, is still considerably below U.S. debt levels (circa 70% of GDP). Importantly, the growth is accompanied by good credit quality throughout most of Europe, with defaults at historically low levels in many countries. In fact, according to the ECB, the proportion of income needed to service mortgage debt has barely risen over the past 10 years, due largely to lower real and nominal interest rates.

Liberalization of the financial services sector has resulted in particularly strong growth in outstanding mortgage debt in the Central and Eastern European economies. According to Knight Frank, mortgage debt has increased 15 fold in Latvia, Lithuania and Bulgaria in the five years to the end of 2005, albeit off a very low base. As with commercial property, these markets are undergoing significant structural change. In many Central and Eastern European countries, the existing stock of residential buildings is in a poor state of repair as a result of decades of underinvestment. Many markets in the region are also characterized by acute shortages of good-quality, affordable housing. At the same time, rising wealth levels are increasing demand for better-quality housing, particularly in major city centers. These dynamics have not gone unnoticed by international developers and investors, and land and sales prices are increasing rapidly.

Although Europe as a whole continues to see only very modest increases in the number of housing units (circa 1% per annum), supply conditions vary enormously across countries. Rapid house price inflation in Spain and France (two markets in which there is a high propensity to own second homes) has contributed to a development boom, which will likely result in oversupply and price corrections in some markets. In other countries, most notably Germany, completions remain below long-run required levels. According to Germany's Institute for Urban Planning, 200,000 housing units will be completed this year, well below the target level of 350,000. Clearly, such a deficiency will likely contribute to housing shortages in some markets over the medium term, thereby supporting the investment strategies and target returns of many of the international investors that have gained exposure to this sector over the past few years

## **Conclusions**

Most market participants continue to be surprised by the duration and speed of the yield compression in European real estate markets. Although the rate at which yields are falling has slowed (and leveled off in some segments), many markets continue to see rapid capital growth, driven principally by weight of money. Pockets of value remain but are becoming more difficult to find, and an increasing number of segments appear overvalued on conventional metrics. However, the volume of capital seeking exposure to real estate remains high (and importantly, diversified), suggesting capital appreciation has further to run in some markets.

European real estate still looks reasonably priced relative to bonds. The key issue for investors seeking to place capital in the market today, however, is whether the pricing of the specific assets

under consideration can be justified by real estate fundamentals. Despite a general lowering of return expectations, these justifications are increasingly difficult to make in a number of segments. In precisely this environment, astute property selection skills become of paramount importance.

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Prudential Real Estate Investors  
8 Campus Drive  
Parsippany, NJ 07054  
USA

Tel 973.683.1745  
Fax 973.734.1319  
Web [www.prudential.com/prei](http://www.prudential.com/prei)  
E-mail [prei.reports@prudential.com](mailto:prei.reports@prudential.com)

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