

Market Perspective

Executive Summary

- Mexico's disputed presidential election was resolved in the third quarter, with the country's electoral court affirming the centrist candidate's narrow victory. In Brazil, the presidential election will be decided in a second round, after no candidate received more than 50% in the initial vote. The region's new leaders face the challenge of amassing support among opposition parties to advance key reforms.
- Latin American capital markets began the third quarter on the rebound from downward corrections in May and June.
- Mexico's housing market is still moving at full speed after more than five years of robust growth. Financing sources, both public and private, are strong, and developers are expanding across the country and across income levels.
- A lack of widely available credit has not hindered Brazil's homebuilders, who are focusing on higher-income homebuyers. Although mortgage financing is less important to those buyers, it is becoming more accessible.
- Retailers are riding a wave of strong consumption and expanding consumer credit. Foreign investors, lured by the dynamic consumer base, are backing shopping center development in Mexico and Brazil.
- Office markets continue to work through the oversupply that hit the region a few years ago. Improved economic conditions and lower rates of construction are leading to higher levels of absorption and rising rents in Mexico City and Sao Paulo.

Introduction

The aftermath of Mexico's July 2 presidential election was much more complex than expected. Mexico's electoral court, which has the final say in the country's elections, eventually confirmed the victory of Felipe Calderon, with 14.7 million votes, or 35.89% of the total.

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The main challenge for Mexico's new president will be to amass support among opposition parties to advance key reforms, mainly those involving sensitive issues such as social security, labor, energy and taxes. These reforms are considered necessary to unlock the economy's potential to grow at a rate of over 6% per year.

Calderon will inherit a country with a rapidly expanding economy. Mexico registered second-quarter economic growth of 4.7%; the economy is expected to grow 4.0% in all of 2006. Industrial output is still increasing at an annual rate of nearly 6%, driven by double-digit growth in automotive production. Mexico's auto output in August rose 19.5% from the same month in 2005.

Foreign direct investment in Mexico in the first half of 2006 reached nearly \$8.7 billion, which was 16.5% higher than during the same period in 2005. At the same time, cash transfers from Mexicans living abroad continue to grow.

Elsewhere in Latin America, Alvaro Uribe, the first-ever president to be re-elected in Colombia, began his second term in August. President Luiz Inacio Lula da Silva, who is running for re-election in Brazil, maintained a comfortable lead in the polls during the third quarter and remains the favorite to win. He enjoys high popularity, a large part of which is due to positive (though far from spectacular) economic readings.

Brazil's economy grew 1.2% in 1Q06 and is expected to grow 3.6% in the full year. Although these figures are modest, particularly when compared with growth rates of other emerging markets, some sectors of Brazil's economy are expanding robustly, including trade. Exports, despite a decline at the end of the third quarter, have lifted the trade balance into record territory of \$29.6 billion through August.

In what could be a move to weaken the local currency and boost exports, Brazil's central bank has repeatedly purchased dollars in the spot market. As a result, the country's foreign reserves ended September at \$73.33 billion, just short of the record \$74.66 billion set in April 1998. Industrial activity has picked up and in August grew 5.3% on the year.

Despite concerns regarding Hugo Chavez's growing support in Latin America, most of the region's governments have been cautious about aligning themselves with the charismatic Venezuelan leader. With the notable exception of Bolivian president Evo Morales, presidential hopefuls in a number of Latin American countries have suffered from their outright (Ollanta Humala in Peru) or purported (Lopez Obrador in Mexico) ties with Hugo Chavez.

Capital Markets

Emerging countries' capital markets, including Latin America's, entered the third quarter on the rebound from downward corrections during May and June. Investors who had reacted to increasing inflation and interest rates in developed economies by pulling out of riskier assets gradually returned to Latin American markets in the third quarter. In August, foreign investment in Mexican stocks reached an all-time high of \$129 billion, or 45% of total market capitalization.

During the third quarter of 2006, Mexico's stock market gained 14.57% (17.83% in dollar terms); in the year to September 30, Mexican stocks were up 23.22% (20.05% in dollar terms).

Sao Paulo's stock market, the largest in the region, has seen a spate of new equity offerings since 2005. In the first half of the year, equity offerings amounted to \$6.2 billion, a level of activity never seen before. Although the corrections of late May had resulted in the postponement, and even cancellation, of some IPOs and secondary equity offerings, activity resumed by the end of the third quarter. In August, Brazil's largest bank, government-run Banco do Brasil, announced that it had raised just over \$1 billion in equity after reopening its secondary offering in response to strong demand. In early October, local real estate developer Klabin Segall raised \$220 million through a primary and secondary offering. Brascan Residential Properties, the real estate arm of Brazilian conglomerate Brascan (a unit of Canadian firm Brookfield Asset Management), raised \$490 million via an IPO in October. Other companies with real-estate-related operations, including developers Camargo Correa and Tecnisa and broker Lopes, have registered their IPO intentions with the local securities regulator.

Brazil is not the only focal point of surging foreign demand for equity in real estate companies. In Chile, housing developer Paz Corp., which is capitalized by a U.S.-based real estate fund, announced plans to carry out an IPO in the fourth quarter. In August, the Sao Paulo stock exchange started trading the shares of 14 Mexican companies, in a first step toward regional capital market integration. In addition, the Colombian stock market has expressed interest in trading Mexican and Brazilian shares and could let some Colombian shares trade in those countries.

Shifting investor sentiment during the quarter also affected sovereign bonds. Sovereign risk spreads on Brazilian debt narrowed to record low levels halfway through August; Brazil's sovereign debt spread, as measured by the EMBI+ index, reached an all-time low of 206 bps on August 14. The same day, Mexico's sovereign debt spread dipped to 102 bps, nearing the all-time low of 95 bps registered in February. Mexico saw its sovereign risk narrow 24 bps between the start of the year and mid-August. Sovereign risk spreads ended the quarter at 233 bps in Brazil (down 78 bps on the year and 21 bps on the quarter) and 121 bps in Mexico (down 5 bps on the year and 17 bps on the quarter).

Brazil has continued its slow but steady progress toward an investment-grade sovereign debt rating. In early September, Moody's upgraded Brazil's foreign debt rating to Ba2, which is two notches below investment grade. Chile, which has had an investment-grade rating since 1992, was upgraded another two notches to A1 by Moody's during the period, in line with the other rating agencies' assessment of its debt.

Brazil's government continues to pay one of the world's highest nominal interest rates on its local-currency-denominated debt, which has pushed real rates in the country to even higher levels. The short-term benchmark lending rate was cut 10 times between September 2005 and September 2006, with the most recent cut bringing the rate to 14.25%. Consensus forecasts point to a nominal rate of 13.75% by the end of the year and 12.75% by December 2007.

Mexico's short-term interest rate since April has held steady at 7%, down from a peak of 9.75% in August 2005. A pick-up in inflation in September, however, prompted central bank officials to confirm that there is no further room for interest rate reductions in the short term.

Local currencies were virtually unaffected by political noise (the disputed presidential election in Mexico and the approach of Brazilian elections) or by brief bouts of emerging-market volatility (spurred by isolated, country-specific events, such as a military coup in Thailand) during the third quarter. Brazil's currency lost just 0.19% during the quarter and was up 7.76% in the year through September 30. The Mexican peso, meanwhile, gained 3.26% on the quarter and was down 3.17% on the year.

Residential

Housing was among the top priorities of outgoing Mexican President Vicente Fox, and his policies to boost the sector were the bright spot in an otherwise lackluster presidency. It therefore comes as no surprise that Fox's successor, Felipe Calderon, promises to continue government policies to boost the housing sector.

Mexico's housing market is still moving at full speed after more than five years of strong growth. Financing sources, both public and private, are strong, and developers are expanding across the country and across income levels.

Infonavit, Mexico's largest provider of mortgages, with a 60% market share, had set its target for this year at 435,000 mortgages, of which over 60% were already committed by September. Next year, Infonavit, which focuses primarily on middle- and lower-income homebuyers, plans to provide 540,000 mortgages, or 24% more than in 2006.

Commercial banks, which have a middle- and upper-class clientele, are rapidly expanding their mortgage lending activities. In June, banks provided 79% more in mortgages than during the same month a year earlier. Banks have been expanding their mortgage portfolios at an annual rate of more than 80% since December 2005, albeit from a low base.

Nonbank mortgage lenders, known as sofols, constitute another source of mortgages in Mexico. Sofols are a major force driving the creation of a market for mortgage-backed securities (MBS), along with Infonavit, issuing such securities regularly. During the third quarter, sofols such as Su Casita, GMAC and ING made several successful placements of MBS in Mexico.

Government agency SHF expects MBS issuances will top \$650 million during the second half of 2006. Infonavit is also a major issuer in this market, with over 40% of the country's total outstanding MBS. This institution alone is targeting issuances worth \$550 million for 2006 and more than twice as much in 2007.

The availability of financing is a crucial factor supporting the expansion of homebuilders in Mexico, particularly those that operate nationwide. The third quarter was a good one for these firms: publicly traded homebuilders such as Ara, Geo, Homex and Urbi all posted impressive growth in net profits ranging from 20% to 50%.

Urbi intends to establish joint-venture partnerships in markets where the company does not yet have a presence, partnering with small, local developers that can originate supply. Urbi, which has been a publicly traded company since 2004, is one of the main participants in the sector. Another large, publicly traded company, Ara, carried out a secondary equity offering in September in which it raised \$200 million. Sadasi, also a prominent homebuilder, boosted its coverage last year with the acquisition of the Mexican operations of U.S.-based Pulte Homes. The company is now considering an IPO in 2007.

The development of second homes for foreign (mostly U.S. and Canadian) vacationers and retirees is gaining steam in Mexico. It is estimated that nearly 10,000 second homes are sold to foreigners each year in Mexico, and the government expects this figure to double in the next few years. Well-established coastal destinations such as Cancun, Acapulco and Puerto Vallarta are receiving part of this influx. Other areas, such as the border states of Baja California and Sonora, are particularly attractive as vacation destinations for residents of California and Arizona. For example, large housing and hotel developments are being planned for the Pacific Coast city of Rosarito, Baja California, which lies a couple hours south of San Diego by car.

In addition to his pledge to continue supporting the housing sector, Calderon made a commitment to boost tourism in Mexico through government investments and incentives. He plans to make the country one of the top five tourist destinations in the world by the time he leaves office. The UN's World Tourism Organization currently ranks Mexico seventh in terms of countries visited, with 20.6 million international tourists in 2004. Improvements in tourism infrastructure may not just serve to attract more foreign tourists but could draw foreign residents as well.

On a much smaller scale than in Mexico, foreigners (in this case, Europeans) are buying second homes in Brazil, largely on the country's sunny northeastern coast. Housing projects are typically part of resort complexes that include hotels and are often sold as timeshares.

Brazil's traditional housing sector is experiencing strong growth. Private sector loans to housing in the first half of 2006 doubled with respect to the same period a year earlier, although total volume is still modest compared with the market's potential. In August, only 11,500 homes were financed by these sources, which provided \$465 million to homebuyers. Between January and August, this volume totaled \$2.8 billion. In a country of 190 million inhabitants, who generate new housing demand of over one million units per year, there is still a very long way to go.

In the third quarter, Brazil's government announced a series of measures to attack the main problem associated with mortgage financing: high costs. Even with incentives, financing remains expensive. Brazil's two largest private commercial banks, Bradesco and Itau, both announced lower mortgage rates for the acquisition of new homes. Itau cut rates to 14% from 18%. A midsize local bank, Panamericano, became the first institution to provide a straightforward home equity loan – but rates start at 1.98% per month. The bulk of mortgage financing is still provided by government savings and loan Caixa Economica Federal, which focuses on a lower-income clientele than banks. Caixa is expected to account for nearly 60% of all mortgages placed in Brazil this year. Though Caixa plans to provide \$4.8 billion in financing to the housing sector in

2006 (25% more than in 2005), its mortgage lending activity has been uneven in the past few years.

The relative scarcity of credit has not hindered local homebuilders. These companies are choosing to focus on higher-income homebuyers, for whom mortgage financing is becoming more accessible, hence the recent investor interest in shares of these firms. Four companies tapped the equity market during the last half of 2005 and the first half of 2006, raising \$1.4 billion. Between July and early October, two more firms did the same. The first was Abyara, one of Sao Paulo's largest residential brokers. The firm's IPO raised \$87.5 million based on a new business plan that focuses on co-investments in housing projects developed by companies with which the firm has a relationship through its role as a broker. Residential real estate developer Klabin Segall raised \$220 million via a secondary equity offering in early October. Two weeks later, Brascan Residential raised \$490 million in an IPO. Next in line with formal IPO requests in place are Camargo Correa, Tecnisa and residential broker Lopes.

These firms are using the proceeds of their equity offerings to finance construction, to accumulate land, and, increasingly, to establish co-investment joint ventures with smaller developers in cities other than Sao Paulo and Rio de Janeiro. These firms sometimes acquire existing projects: earlier this year one developer purchased residential projects under development from Redevco, part of Dutch group C&A, which decided to end its real estate development activity in Brazil.

Industrial

Industrial activity in Mexico is growing at a faster rate than the economy as a whole. Manufacturing output has been the main driver of growth in industrial production. In the first seven months of 2006, industrial output grew an average annualized 5.5% each month, led by growth in manufacturing output of over 6%. Long gone are the years of an industrial deceleration that tracked a slowdown in U.S. manufacturing output and consumption.

The closing of Hanesbrands' operations in the northern state of Coahuila in September served as a reminder of the way Mexico suffered from recession in the U.S. The firm is the latest to leave Mexico in search of lower labor costs, a trend that had devastating effects on Mexico's textile and apparel industries as companies relocated to Central America, Southeast Asia and Eastern Europe. Although Hanes is laying off 1,700 employees in Monclova, jobs are being created elsewhere as the country positions itself to more effectively leverage its proximity to the U.S.

Mexico's skilled labor, lower production costs compared with its NAFTA partners and its proximity to the U.S. mean that manufacturers stand to gain from establishing facilities in the country. Automakers have taken particular advantage of these benefits, in addition to Mexico's growing domestic demand. The automotive industry has regained steam this year after a drop in output in 2005, when several of the largest manufacturers were retooling their production lines. Output is now growing rapidly (19.5% in August, boosted by 38.2% growth in automotive exports).

International automakers continue to invest in their Mexican operations, though some, such as GM and Ford, face serious threats at home. GM is breaking ground on a \$650 million production facility in the state of San Luis Potosi. Toyota is establishing a new training facility in the same state. GM is also investing over \$600 million to revamp production lines at its existing facility in the central Mexican state of Guanajuato. Volkswagen announced investments in Puebla, Hyundai announced a \$650 million investment in a new facility in the Gulf of Mexico port city of Veracruz, and DaimlerChrysler will channel resources into its existing facilities in Toluca and Saltillo.

Just north of Saltillo, in Ramos Arizpe, U.S.-based Whirlpool plans to invest \$100 million to expand its refrigerator and washing machine production facilities. Like the large automakers, Whirlpool is an original equipment manufacturer that requires several suppliers with operations nearby.

Information technology companies and electronics manufacturers also suffered from the post-2001 slowdown and the burst of the Internet bubble. Five years ago, the central Mexican city of Guadalajara, at the heart of Mexico's Silicon Valley, saw companies move to Asia. But the city's industries were resilient and shifted their focus from the production of commodity electronic components (a sector in which they could not compete with China) to more specialized production. In August, Hewlett-Packard announced a new round of investments totaling \$2 billion in its operations there.

The industry that epitomizes Mexico's transformation into a value-added manufacturing destination is aerospace. This highly specialized manufacturing activity, which requires skilled labor but has higher margins than automotive manufacturing, is still incipient in Mexico but is receiving a good deal of attention. Labinal, a French company that began producing wire harnesses a few years ago in Chihuahua for clients including Airbus, Boeing and Bombardier, announced in July that it will open an aircraft parts design office in the same city. Small firms and limited operations have been the norm for the sector in Mexico, which underscores the importance of Bombardier's announcement in October 2005 that it would establish a manufacturing facility in the central Mexican city of Queretaro. The company chose this location based on characteristics ranging from a new airport to a good quality of life but placed greater weight on the availability of skilled labor. The company made its decision after the state government committed to the creation of an aircraft engineering school. Bombardier plans to gradually increase the complexity of its production lines in Mexico and is working to bring suppliers to a nearby industrial park that is being established.

Brazil, on the other hand, is home to Bombardier's main competitor in the regional jet segment, Embraer. The company's operations concentrate near Sao Paulo. General Electric has announced it will start producing aircraft turbines in Petropolis, outside Rio de Janeiro. Unlike in Mexico, manufacturing facilities in Brazil are largely user-owned, and the rental market is largely based on new build-to-suits. For this reason, a \$2 billion semiconductor facility planned in the state of Minas Gerais has limited implications for real estate investors.

Brazil's logistics sector is a more active market for rental properties. The construction of the second phase of the Sao Paulo beltway has major implications for local logistics operations. The first of four phases has been completed, and the improved access to the largest consumer market in South America has already influenced distribution locations. Land prices were affected, and the same trend is expected in the areas surrounding the newest phase as construction progresses over the next four years.

Although distribution space has just recently appeared on the radar screen of Brazil's industrial real estate investors, it is a mainstay of investors in the Mexican market. Industrial parks established by local and foreign developers have been around for over four decades in Mexico. This market is now experiencing an accelerated process of consolidation spurred by foreign institutional investors. In July, Prologis, which has been active in Mexico's northern region since 1997, closed the acquisition of a portfolio of buildings totaling 3.1 million square feet, plus 140 acres of developable land, for \$238 million. With this acquisition, the U.S. REIT established an important foothold in central Mexico.

Retail

Retailers are riding a wave of strong consumption in Mexico. The country posted relatively mild retail sales growth in August (2.8%), but the figure includes all retailers. Members of ANTAD, a proxy for the largest firms, registered sales growth of 14.3% in August, compared with the same month in 2005. Retail floor space of these firms grew 13.1% during the period, reflecting expansions undertaken by retail firms of all sizes.

Oxxo, a local convenience store chain, opened 700 units during the past 12 months and now operates over 4,300 units throughout Mexico. Another example of the country's rapid retail expansion is Famsa, the discount department store that last May raised \$230 million in an IPO on the Mexican stock exchange. The company plans to open 25 new stores in 2006 and an additional 30 stores in 2007, close to a 10% expansion of its more than 320 stores in Mexico and the U.S. The company also recently received approval from Mexican authorities to open a bank to finance the purchases of its middle- and low-income clientele. One of Famsa's main competitors, Elektra, has been successful in offering vendor financing through its Azteca bank unit.

Wal-Mart is also seeking approval to open a bank unit to operate under similar terms. Wal-Mart has over 800 stores and restaurants in Mexico, and is the country's largest grocery retailer. A focus on northern Mexico has proven successful for Texas-based grocery chain HEB, which opened its 25th store in July. Other retailers of U.S. origin expanding their operations in Mexico include Costco, which now has 30 stores in the country following new openings in July, and Home Depot, which is opening 10 stores this year and plans to have 60 units in the country by year's end.

A local retailer, Sanborns, announced in September that it acquired the rights to represent Saks Fifth Avenue in Mexico and will open the upscale New York-based retailer's first Mexican store in the Mexico City district of Santa Fe in 2007. Sanborns, which operates Sears department stores as well as stores under its own brand, is a thinly-traded public firm whose controlling

shareholder, Grupo Carso, launched a tender offer worth over \$350 million to take it private during the quarter.

A significant part of Mexican retailers' expansion is occurring inside shopping centers of all sizes. New retailing formats and current consumer needs are creating demand for new properties. A number of groups, most of which are financed by foreign capital, are in development mode. One example is Planigrupo, which has announced plans to open 24 new shopping centers over the next three years.

Foreign capital is entering Brazilian retail real estate just as robustly as in Mexico. In its initial phase, this capital is seeking local groups that control and operate high-quality retail portfolios.

Canadian groups have been particularly active in the sector. Earlier this year, a property company owned by a Canadian pension fund acquired a 46% stake in Brazilian shopping mall operator Multiplan. In September, a competing shopping mall company, Ancar, received investments of about \$75 million from another Canadian pension fund. During the same month, a Toronto-based asset management firm closed a \$700 million fund that will initially acquire shopping malls the firm already owns in Brazil, and will later venture into new development and acquisitions in the country's retail sector.

A Portuguese company, Sonae Sierra, is also active in Brazilian shopping center development and operations. In July, the company finished its ninth property in Brazil, in Sao Paulo. Local groups are also investing in expansions of existing shopping centers and the construction of new malls.

Office

The positive momentum evident in most of the largest Latin American real estate markets is also occurring in the office sector. Markets continue to work through the oversupply that hit the region from Mexico City to Buenos Aires just a few years ago. In these markets, improved economic conditions and lower rates of construction are leading to higher levels of absorption and increasing rents.

In Mexico City, a slowdown in new construction plus growth in demand has brought the market into balance. Vacancy, which topped 20% in 2003, has gradually fallen to below 10%. As a result, rents are recovering to the levels of two years ago. On the other hand, a more balanced market, along with rapid absorption in the very few new buildings that have been completed in the past year, is already prompting new development. Developers have shown a preference for large projects in well-established areas of the city such as Polanco, Insurgientes and Reforma, to the detriment of newly developed areas where vacancies remain relatively high. The largest property now under development is the 540,000-square-foot Torres Arcos, the second phase of a distinctive project in the western part of Mexico City. Among the project's developers is GICSA, which, in the third quarter, announced it had secured a \$1 billion loan from GE Capital to finance office (it is aggressively venturing into retrofits), retail and residential projects. Most new development in the city is being undertaken speculatively.

Vacancy in Sao Paulo is also dropping and is now below 15% for class-A space, after having reached more than 25% in 2004. Vacancy in the market overall is also down to near the mid-teens, although it never stood above 20%. The decline in vacancy is a result of steady absorption and, more importantly, fewer completions of new office projects. According to CBRE, the volume of class-A stock absorbed per quarter has held steady at 500,000 square feet, while the last recorded quarterly figure for new construction was just 100,000 square feet. Class-A buildings' share of total absorption has grown from 29% in 2004 to 44% in the third quarter of 2006. Major transactions completed thus far in 2006 include the lease of 176,000 square feet of space in the International Plaza building (Faria Lima district) to Unilever and the lease of 22,000 square feet of space in Plaza Centenario (Marginal district) to Merck. As higher levels of absorption, and declining supply and vacancy rates, accelerate the Sao Paulo office market's recovery, developers are resuming construction. Delivery of new office stock is forecast to grow 37% this year; class-A buildings are expected to account for 41% of the new stock. Rents have risen only slightly, but they are expected to increase further.

Rio de Janeiro, a market physically constrained by geographical barriers and a limited supply of developable land, saw its vacancy rate fall to 8.8% in the third quarter from 9.5% during the same period a year earlier, according to CBRE. Only 12% of the city's downtown office stock is of the highest quality, and the few class-A buildings delivered in recent years were rapidly absorbed. Though absorption has declined steadily over the past year (down 65% on the year and down 14% from the second quarter of 2006), there have been no deliveries of new space to-date. Just one new building (a retrofit in downtown Rio de Janeiro) is scheduled for completion this year.

Conclusion

In the next few years, the region's new leaders will likely engage in structural reforms to sustain higher economic growth and to better protect their countries against inevitable external shocks. To achieve this objective, they must build coalitions in divided legislatures and unite the citizens that elected them.

With interest rates in Brazil trending down, all types of financing, but particularly mortgages, should become more accessible. In Mexico, the growing sophistication of the country's mortgage lenders is increasing the availability of financing to the housing sector, as is the government's continued commitment to the sector.

Growth in consumption, which is both a result of economic expansion and the increased availability of consumer financing, should continue to boost retail activity. Foreign capital is increasingly finding its way into industrial and retail markets. Widespread improvements in the region's office markets, meanwhile, could lead to renewed investor interest in the sector.

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