

# Market Perspective

### Executive Summary

- Despite higher long-term interest rates in the second quarter and a modest slowdown in transaction activity, commercial real estate loan origination and securitization activity in 2006 should surpass the record levels set last year.
- REITs rebounded sharply in the third quarter from their relatively weak second-quarter showing and should outperform the broader equity markets for a remarkable seventh consecutive year.
- Although the near-term outlook for the U.S. property markets remains healthy, slower economic growth will affect investor and tenant demand for most, if not all, property types.
- With space market fundamentals across all major property types healthier than they have been in years and with little evidence that supply will outstrip demand in the next 12 months or so, private real estate should continue to perform well. This year, we expect the NCREIF Property Index (NPI) will deliver a total return at the high end of our forecast range of 12% to 15%. Returns will likely moderate further next year, but as long as the economy does not weaken suddenly and long-term interest rates do not stray too far from the 4.5% to 5.25% range they've been in for most of 2006, the NPI should still deliver 9% to 12% in 2007.

### Introduction

Abundant liquidity and improving property market fundamentals continued to support commercial real estate investment performance, public and private, in the third quarter, despite increasing signs that the U.S. economy is slowing. Although economists seem more divided than usual over the economy's expected near-term trajectory, recent data from the housing market leaves little doubt that the housing boom is over. The housing market has been a critical driver of job growth and

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economic activity in recent years. Whether the widely anticipated slowdown in the residential market will overwhelm the generally strong fundamentals in the corporate sector of the economy is not yet clear. Corporate balance sheets remain very healthy, margins are wide, and profits continue to soar, all of which suggest businesses have ample capacity to continue investing and hiring. But if weakness in the housing sector – or any of the other formidable challenges now facing the domestic and global economies – undermines business confidence, fears of the economy stalling would be realized.

The less-certain outlook for the economy has not yet affected demand for commercial real estate from users or investors. However, another quarter of strong performance, together with the improving long-term outlook for other asset classes, has further eroded the relative attractiveness of core real estate. While real estate is not unattractive today, long-term expected returns for real estate are now more aligned with stocks and bonds on a risk-adjusted basis. Total returns for core, private real estate have peaked and should continue to moderate as transaction activity and value gains slow and cash flow becomes a more important return driver. The transition will not happen overnight, but core real estate returns should continue to decelerate over the next 12 to 18 months to levels that are more consistent with the asset class's long-term historical performance. The following commentary updates our outlook for the U.S. real estate capital and property markets over the rest of 2006 and for the longer term.

#### **Debt Markets**

**With just three months left in 2006, a lot would have to go wrong for loan origination and securitization activity to fall short of last year's record volumes.** According to the Mortgage Bankers Association, commercial mortgage originations rose more than 23% in the second quarter versus the first three months of 2006 and year-to-date were more than 24% higher than at the same time last year. The steady increase in long-term interest rates throughout the second quarter may have caused lending activity to slow somewhat in the third quarter. But with the Fed abstaining for now from further rate hikes to allow the economy time to digest the 17 quarter-point increases since June 2004, long-term rates have tumbled. After peaking at 5.25% in late June, the yield on the 10-year Treasury bond fell to about 4.6% at the end of the third quarter, or roughly 25 basis points (bps) higher than at the start of the year.

If the higher long-term interest rates in June caused origination activity to slow in the third quarter, it has yet to show up in the commercial mortgage-backed securities (CMBS) or real estate collateralized debt obligation (CDO) markets. CMBS issuance through the first nine months of 2006 grew about 20% versus the same period last year, according to *Commercial Mortgage Alert*, thanks in part to continued high levels of defeasance. U.S. issuance totaled about \$133 billion through September, a 23% gain year-over-year, while non-U.S. issuance increased more than 14% to \$56.4 billion. The pipeline of deals expected in the U.S. alone over the next three months should push global CMBS volumes above last year's record \$238 billion. Activity in the rapidly growing real estate CDO market has been just as feverish, though on a much smaller scale. Real estate CDO volume is expected to top \$35 billion this year, more than 60% higher than the \$21.3 billion record volume in 2005.

Although the increase in global CMBS issuance this year won't be nearly as dramatic as the 86% year-over-year growth from 2004 to 2005, the market's continued expansion highlights the broad acceptance of real estate debt securities in the massive fixed-income market. Outstanding credit performance and innovations such as CDOs and "super-senior" tranches of CMBS, which offer very high levels of subordination that make the securities more bond-like, have continued to drive the expansion of the investor base for real estate debt securities. The resulting breadth and depth of investor demand has kept spreads from widening, despite the surging supply of new issues. CMBS spreads to Treasuries on most tranches have widened somewhat since 3Q05 as swap spreads to Treasuries have moved out. However, CMBS spreads to swaps have narrowed since last year, most notably at the BBB- level.

While a major shock to the financial markets could cause investor demand for CMBS and CDOs to dry up quickly, the risk of spreads widening much in the near term seems remote. With a broader and deeper investor base, CMBS continue to benefit from their relative attractiveness versus corporate bonds. **Despite low delinquency rates and a steady stream of upgrades from the rating agencies, CMBS still offer a modest yield premium over most comparably rated corporate bonds, with less volatility.** And with the ongoing property market recovery and the recent surge in defeasance, the risk profile of new and outstanding CMBS issues should continue to improve in the near term, creating the potential for CMBS spreads to narrow further.

As long as investor demand holds up, it's hard to imagine lenders closing off the spigots to borrowers, especially at this point in the property market cycle. Competition between lenders remains as fierce as ever, particularly with the slowdown in the housing market. Residential mortgage activity has declined as home sales have slowed and higher interest rates have made refinancing less attractive, and more lenders are hoping to make up for the lower volumes with increased production on the commercial side. As a result, **outside of the condo market, where lenders rightfully have become very cautious, debt is readily available for almost any property type at very attractive terms.** Although borrowing costs have increased since this time last year, with looser underwriting standards, increasingly generous terms and more lenders willing to underwrite interest-only loans, borrowers typically can still secure the proceeds needed to justify acquisitions and refinancing.

Hence, the outlook for the real estate debt markets over the rest of 2006 and into next year remains largely unchanged from earlier in the year. Debt capital is plentiful and still relatively cheap, and borrowers can usually dictate the terms on most deals, even when lenders hesitate. **The near-term risks remain concentrated in the relatively small condo segment of the lending market. Distressed condo loans may inflict some pain on lenders and investors with exposure to markets where supply has gotten too far ahead of demand. However, the impact on the overall debt markets for real estate should be very modest.** Longer term, more aggressive underwriting could create refinancing risk if new supply accelerates or interest rates rise sharply.

#### **REIT Market**

REITs rebounded sharply in the third quarter from their relatively weak second-quarter showing. After giving back 1.6% in 2Q06, the FTSE/NAREIT Equity REIT Index posted a total return of

9.3% in the third quarter, pushing the year-to-date total to 23.4%. **The robust third-quarter performance all but assures that equity REITs will outperform the broader equity markets for a remarkable seventh consecutive year.** Although most broad market indexes delivered healthy gains in 3Q06, led by the S&P 500's 5.7% total return, year-to-date performance still lags far behind the equity REIT market. Outside the REIT sector, total returns through September ranged from a modest 3% gain for the NASDAQ to 10.8% for the Dow Jones Industrial Average. Small cap stocks, as measured by the Russell 2000 Index, gained just 0.4% in 3Q06 but remained slightly ahead of the S&P 500 year-to-date with a total return of 8.7%.

**REIT performance was uniformly strong across all major property types in the third quarter.** In fact, the spread between the average quarterly total returns for the best-performing sector (apartments) and worst-performing sector (office) was just 243 bps, the narrowest it's been since 1Q97. Apartment REITs edged out industrial REITs by about 25 bps to lead all major sectors with a 10.8% average total return in 3Q06. They remain comfortably ahead year-to-date, with an average total return of 34.1%. Retail REITs surged 9.3% in the third quarter, more than making up for their 5% second-quarter decline. But the retail sector still trails the other major property types year-to-date with a 16.3% average total return. Office REITs gained 8.3% in 3Q06, the weakest showing among the major property types. However, office remained the second-best-performing sector with a 29.7% average total return year-to-date.

**M&A activity continues to play a big role in REIT performance this year.** Nearly \$44 billion in real estate M&A transactions have closed in 2006, including about \$24 billion in deals that were announced in 2005. Another \$43 billion in deals have been announced but have not yet closed. Classifying transactions as public-to-public mergers or privatizations has become more challenging as deals have grown more complex, with public and private capital sources often working together. However, it's clear that **the majority of transactions this year and last involved either outright privatizations of public companies or the transfer of substantial assets from public to private ownership.**

The wave of M&A has a powerful multiplier effect in the REIT market. In most transactions, the target companies have commanded attractive premiums over their share prices when the deals were announced, providing an immediate lift to the REIT market. But the secondary, indirect effects have probably been even more significant. A healthy share of the proceeds returned to shareholders of the companies that have disappeared from the public market has been reinvested in the REIT market. Likewise, as the range of potential takeover targets has expanded in terms of transaction size and property type, the expectation that more deals will occur has attracted even more capital to the REIT market, all of which must be invested in a shrinking universe of companies.

Consolidation and rationalization should have a positive impact on the REIT market as a whole since it should result in fewer but better companies. With the volume of capital that is available for real estate and the potential scale that capital sources can achieve, especially when they work together, any REIT that trades below or near net asset value (NAV) is potentially "in play" as a portfolio of high-quality assets. As long as the private capital markets are so flush with liquidity, companies whose management teams fail to add value will become prime takeover candidates.

**Although all sectors of the REIT market have benefited to some extent from the increased M&A activity, the effects have been most pronounced in the apartment and office sectors, where the cyclical recovery in occupancies and rents is well under way, and where private capital sources are actively acquiring assets.** As the wall of private equity has turned increasingly to the REIT market as a source of large-scale acquisitions of high-quality assets, apartment and office REITs have emerged as attractive targets. As a practical matter, apartment and office are the two largest sectors of the U.S. REIT market by equity market capitalization and by number of companies. Therefore, the range of potential takeover candidates in the apartment and office sectors is wider and more diverse than in most other property types. More importantly, apartment and office REITs are trading at relatively attractive valuations, especially when compared with private market pricing. According to Green Street Advisors, both sectors have been trading fairly close to NAV for most of this year and were trading at steeper discounts last year.

The retail sector best illustrates the influence that M&A and, more generally, private equity are exerting in the REIT market. **Performance within the retail sector has diverged this year. Retail's surprisingly strong third-quarter performance was driven mostly by shopping center REITs, which gained 11.6% in 3Q06, surpassing even apartments, and have returned more than 23% year-to-date.** Two large M&A transactions, Kimco's acquisition of fellow public REIT Pan Pacific and Australia-based Centro Properties Group's acquisition of Heritage, a shopping center REIT, undoubtedly contributed to the healthy gains in the shopping center sector. The deals not only confirmed continued investor demand for retail properties, they also helped fuel speculation that more transactions were possible.

Although mall REITs delivered a respectable 7.2% third-quarter return, the sector continues to lag far behind all major property types, with a relatively modest 11.1% average total return year-to-date. To some extent, the relative weakness in the mall sector is due to fatigue. Malls have been among the top-performing sectors of the REIT market for several years. However, the divergence between mall and shopping center REITs is due at least in part to private investors' relatively limited appetite for mall assets. From a space market perspective, malls offer compelling long-term supply and demand fundamentals, particularly when compared with nonmall retail formats. However, the scale and operational intensity of malls, especially large regional malls, preclude many investors who are active in other property types from owning them, and are enough to discourage even those who have the financial capacity and requisite expertise from investing more actively.

By most metrics, mall REITs should be at least as attractive as shopping center REITs, if not the most attractive sector in the equity REIT market. According to Green Street, mall REITs were trading at a 6.2% average discount to NAV at the end of the third quarter (on a market-cap-weighted basis), versus an 18.1% *premium* for shopping center REITs and a 6.1% average premium for equity REITs overall. Earnings growth rates are a little higher in the apartment and office sectors, but dividend coverage ratios are higher in the mall sector and price-to-FFO multiples are lower. According to Merrill Lynch, mall REITs were trading at a 15.2x forward earnings (2007) multiple as of September, considerably lower than the 17.9x average multiple for all equity REITs. However, with relatively little chance that the next M&A transaction will

involve a mall company, investors may be more inclined to underweight mall REITs today, if only to shift their retail allocation to shopping center REITs where M&A activity is more likely.

M&A is certainly not the only factor driving the REIT market today. **The steady downward trend in long-term interest rates in the third quarter likely provided a boost for REITs, or at least helped to ease concerns about the negative spread between REIT dividend yields and benchmarks like the 10-year Treasury bond.** According to NAREIT, the average yield for equity REITs at the end of September was just 3.9%, or about 65 bps lower than at the start of 2006. Although REIT yields are very low by historical standards, REIT dividend growth should remain healthy as property income continues to recover along with rents and occupancies.

Equity REITs have already exceeded our return forecast for 2006 by a wide margin and should easily deliver 20%-plus average total returns this year. However, REIT returns should moderate next year as higher valuations begin to limit the opportunities for more M&A activity. Although many companies still trade at discounts to NAV, particularly in the apartment and office sectors, NAV estimates have slowly been catching up with private market valuations. REIT NAVs should continue to provide something of a floor beneath REIT share prices. But with higher valuations, M&A should be less of a factor in 2007. **While we expect REITs will continue to outperform private real estate over the near term, total returns should fall within the range of 12% to 15% over the next 12 months or so.**

### **Property Markets**

**As the activity in the real estate debt market and the U.S. REIT market confirms, capital continues to flow freely in the transaction market.** Transaction activity has slowed somewhat from last year's record pace, and institutional investors now account for a larger share of the total acquisition volume, according to Real Capital Analytics (RCA). But the overall level of activity remains well above average across all property types. With property market fundamentals continuing to improve and high construction costs keeping new development from accelerating quickly, the near-term outlook for the U.S. property markets remains healthy. The U.S. economy appears to be slowing, however, which could weaken investor and tenant demand for most, if not all, property types.

The most obvious area of weakness in the U.S. economy is in the housing market. Home sales have slowed sharply since last year, and median sale prices of new and existing homes have declined from their peaks. According to the National Association of Realtors, the 1.7% decline in the median sale price for existing homes in August marked the first year-over-year decline in more than a decade. But it comes after several years of robust home price appreciation. With the inventory of unsold homes nearly 40% higher than last August, home prices could fall further before stabilizing. In the meantime, the psychology of buyers in the housing market clearly has changed as sales activity has slowed. In a growing number of markets, prospective buyers no longer feel pressured to bid aggressively for homes and seem content to wait for the right home at the right price.

The effects of the housing market slowdown on the apartment sector have been mostly positive so far. **Tenant demand for apartments remains healthy, rents are rising as vacancies fall,**

**and concessions are becoming the exception rather than the rule.** Although capital remains plentiful for apartment properties, investor demand is not nearly as strong as it was a year ago when condo converters, who had been the most aggressive source of capital, were active buyers. According to RCA, total apartment transaction volume through August increased 4% year-over-year to nearly \$53 billion. But transaction volume in July and August was 34% lower than in the same period last year, just before condo converter activity peaked.

With the condo game all but over and solid rent growth expected in an increasing number of markets, apartment supply growth should accelerate as the share of “for-sale” units in the supply pipeline shrinks. However, development sites are often too expensive for the economics of “for-rent” multifamily development to work in markets where development is most attractive. **Until land and construction costs retreat from their lofty levels, existing multifamily assets should offer the most attractive investment opportunities.** Investors must be realistic about rent growth assumptions and exit cap rates when underwriting deals today. Initial yields (cap rates) in the apartment sector remain near historic lows, and the narrow spreads between primary and secondary markets and between class A and class B or C properties may not adequately compensate investors for their risks when liquidity is not as high as it is today. A serious correction in the housing market, though unlikely, would change the positive dynamics in the apartment market, especially in markets where condo developers have been most active in recent years. In cities such as Miami, Orlando and Las Vegas, for example, supply and demand fundamentals would deteriorate quickly if the condo market were to crash.

The retail sector appears to be weathering the downturn in the housing market relatively well so far. Investor demand for retail properties has been trending down for several quarters as investors have rotated into other property types where the cyclical recovery should drive near-term rent growth. **Retail remains the only property type where year-to-date sales have declined from last year.** Through August, retail transaction volume totaled about \$24.7 billion, according to RCA, nearly 25% lower than in the first eight months of 2005. However, the transaction data indicates that unit sale prices and cap rates on completed transactions and new offerings have remained firm. Indeed, as the performance of shopping center REITs suggests, capital has not abandoned retail, and for good reason. Retail space market fundamentals have been remarkably stable over the past few years, and real rents have continued to grow.

**The recent pullback by investors should create some attractive buying opportunities in the retail sector for long-term investors.** Retailer demand has remained consistently strong across all formats, and opportunities still exist to buy assets with below-market leases and to improve operating fundamentals through lease rollovers and redevelopment or repositioning. Likewise, **retail continues to offer attractive development opportunities, particularly in markets where residential development has been expanding rapidly and retail supply has not kept pace with growth.** Although retail development yields have compressed, the margins on retail projects are still relatively attractive compared with other major property types.

Whether consumers will continue spending in the near term likely depends more on the outlook for jobs over the next year or so than on the housing market. The initial reading of job growth in September was surprisingly weak, even though unemployment declined slightly, and the retail

sector itself has been losing jobs most of this year. Neither trend is good news for retail real estate. Falling gas prices may have boosted consumer confidence and spending in September, but with a contentious election season approaching, consumers could become less optimistic about the near-term outlook for the economy and cut back on spending. Longer term, however, the outlook for consumer spending over the next several years is very favorable. The crest of the baby-boomer generation will be moving through their peak spending years over the next five to 10 years and should continue to underpin consumer spending.

**Hotels are enjoying another outstanding year across all segments.** Although new supply is increasing in the limited service sector, overall room supply has been growing at less than 1% of existing inventory for about three years, according to Smith Travel Research, while demand growth has averaged more than 3% per year, and revenue per available room (RevPAR) growth has averaged 8.2% per year. Through August, year-to-date occupancies were higher in every market segment than at the same time last year. The highest occupancies by chain scale segment were at the upper end of the market, in the luxury and upscale segments, where occupancy rates averaged more than 72%. Year-to-date occupancy rates were similarly strong by location, with resort, urban and airport markets all reporting average rates of 69% or more.

**The exceptional demand/supply and operating fundamentals in the hotel sector have attracted significant capital over the past 12 to 18 months.** Total transaction volume at midyear was more than 60% higher this year than in 2005, according to RCA, and cap rates were about 100 bps lower. Although near-term risks in the lodging sector seem few and far between, slower economic growth will eventually mean slower room demand and RevPAR growth, especially as new supply resumes. Capital expenditures will also creep higher over the next few years to keep properties competitive as growth slows. However, **barring a sharp slowdown in the economy or some random shock, hotels should continue to perform very well over the next year or two.**

**Historical data makes a very compelling case for a rotation into the office sector at this point in the property market cycle, which explains why capital continues to flow into the sector.** According to RCA, year-to-date office transaction volume through August surged 17% to more than \$73 billion. Unlike the other major property types, office sales activity did not slow in July and August. The \$19.6 billion in transactions closed during those two months marked a 20% increase over last year's volume in the same period, and anecdotal evidence suggests the buying spree has continued with the ongoing recovery in office space market fundamentals. Based on preliminary data from Torto Wheaton Research, the average vacancy rate in their 56-market coverage universe declined another 20 bps in 3Q06 to 12.9%, the lowest level since 3Q01. The improvement was more pronounced in downtown markets, where the average vacancy rate declined to 10.9% from 11.3%, than in the suburbs, where vacancies averaged about 14%.

**Office demand is closely tied to job growth, and while the economy has created fewer jobs this year than most economists had expected when the year began, year-over-year growth in office-using jobs has been much healthier than the disappointing headline numbers would suggest.** In September, for example, office-using jobs accounted for more than half of the 51,000 new jobs created. That said, the current growth rate is not nearly as strong as it was in the

mid-1990s office market recovery and may not be sustainable if other sectors of the economy slow further. With a less robust job recovery, investors must be realistic about their return expectations and be very careful with underwriting assumptions regarding rent growth, leasing costs and absorption rates. Sharply higher costs for construction materials and labor continue to discourage new supply, but they also increase the cost of tenant improvements, which, at current cap rates, can make cash yields seem meager.

Investor demand for warehouse properties also remains very strong this year. Through August, transaction volumes for industrial properties, including flex space, totaled more than \$25.5 billion, according to RCA, an increase of 9.4% over the year-to-date volume at the same time last year. **Although transaction activity slowed in July and August from 2005 levels, industrial space market fundamentals showed more improvement in the third quarter than in the first half of the year.** Preliminary data from Torto Wheaton Research shows a 20-bps decline in the average industrial vacancy rate in 3Q06 to 9.6%, the lowest level since 3Q01. Tenant demand for warehouse space has been fairly robust for the past couple of years, but smaller users and owner-occupants seemed to have accounted for a disproportionate share of the incremental demand. This year, however, **strong demand from larger tenants appears to be driving rent growth, especially in and around port markets and intermodal hubs.**

The risk that new supply will stifle rent growth is almost always greater in the warehouse sector, where development lead times are relatively short, than in the other major property types. However, as construction costs have soared and development sites have become surprisingly scarce and, hence, surprisingly expensive, landlords have been able to raise rents without driving tenants away. Higher fuel costs may also be a factor as convenient access to ports and transportation hubs becomes more important. **While the near-term outlook for industrial real estate remains favorable, recent weakness in the manufacturing sector, including a surprising two-month decline in durable goods orders, could cause tenant demand to slow in the near term.**

Space market fundamentals in the self-storage sector have continued to improve since the start of 2006. As in most other property types, increased costs for land, labor and materials have limited new development, allowing self-storage operators to increase rents and occupancies. According to Self Storage Data Services, median asking rents increased 4% year-over-year in 2Q06, and median physical occupancy increased 200 bps to about 92%. **Increasing rents and higher occupancies helped drive revenue per occupied square foot 7% higher year-over-year and net operating income per occupied unit 9.7% higher.** While limited new supply and increasing awareness among individuals and business users should continue to support demand for self-storage units in the near term, long-term demand and supply are harder to predict. American consumption patterns alone should continue to generate demand for storage of some type. But supply will remain a potential risk in markets where suitable development sites are available and affordable. However, existing self-storage facilities typically benefit from the less-than-enthusiastic reception that newly proposed self-storage properties often generate with local planning and zoning authorities.

**With space market fundamentals across all major property types healthier than they have been in years and little evidence that supply will outstrip demand in the next 12 months or so, private real estate should continue to perform well.** The NCREIF Property Index (NPI) delivered a 7.8% total return in the first half of 2006 and has returned 18.7% over the past four quarters. We expect returns will continue to moderate over the second half of the year as appreciation slows. Total returns this year should fall at the upper end of our forecast range of 12% to 15% but should continue to trend lower in 2007. As long as the economy does not weaken suddenly and long-term interest rates do not stray too far from the 4.5% to 5.25% range they've been in for most of this year, the NPI should deliver total returns of 9% to 12% in 2007.

### **Closing Thoughts**

While the U.S. commercial real estate market appears to be managing the unprecedented liquidity of the past few years remarkably well, transitioning to a lower return environment is never easy. Public and private real estate investments will enjoy another year of stellar performance in 2006. But as private market returns continue to moderate next year, some of the capital that has helped drive the impressive performance over the past few years will likely begin to look elsewhere for opportunities. So far, the modest slowdown in transaction activity and the deceleration of private market total returns have been orderly and relatively painless. How it unfolds from here will depend partly on capital flows and partly on property market forces. While some allocations to real estate in recent years have been tactical, short-term commitments, we suspect that a healthy share of the new capital that has flowed into the asset class has been part of a strategic allocation based on real estate's traditional characteristics as an asset class. As long as the property market recovery remains on course and new supply does not accelerate too quickly, real estate should continue to deliver the attributes that have made the asset class so attractive in diversified portfolios.



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