

Market Perspective

Executive Summary

- During the first half of 2007, Europe's economy remained relatively strong. Despite a tighter monetary policy and new record highs of the euro against the U.S. dollar, forward-looking indicators are still consistent with solid economic growth in the coming months. Given strong consumer confidence and a very strong labor market, consumption should make an increasingly significant contribution to growth.
- The solid economic growth is feeding through to demand for real estate. Fundamentals are improving rapidly across the major commercial real estate sectors, and rental growth should strengthen further.
- As yield compression abates, underlying tenant demand fundamentals will increasingly drive real estate performance. Therefore, the degree to which rental growth expectations support current pricing will be more crucial than ever in determining investment demand.

Economic Context

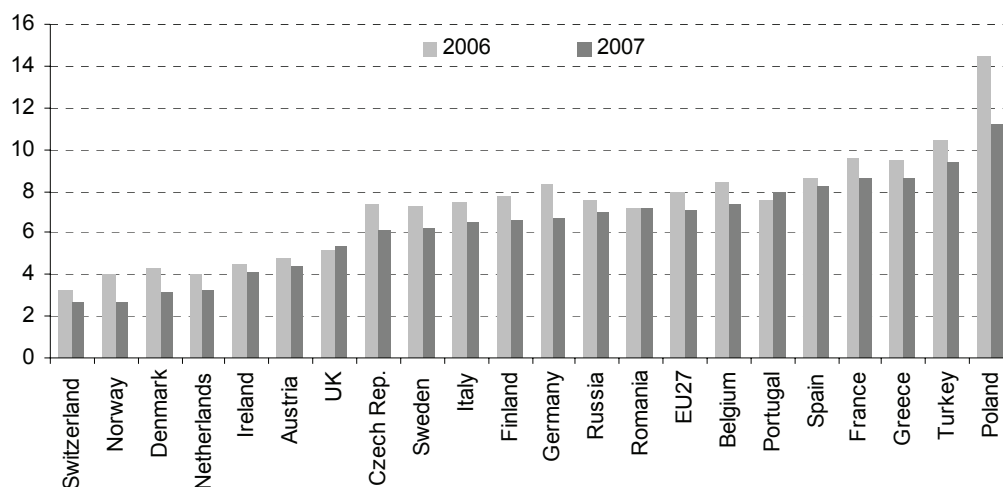
With an annualized growth rate of more than 3.0%, the EU's economy continues to grow above trend. As always, this aggregate masks wide national disparities ranging from an annualized GDP growth of 1.8% in Denmark to 11.3% in Latvia. Outside the EU, the boom in Russia continued, with annualized GDP growth reaching 7.9% during 1Q07. Looking at the four largest EU27 economies, the 1Q GDP growth rate in France, Italy and the UK was below the EU average, with only Germany outperforming the average.

EU household consumption remained stable in 1Q. While imports rose by more than 1% in the EU, exports slowed to 0.3%. The solid economic growth was mainly driven by investments, which rose about 2.5%. The combination of high corporate profitability and a capacity utilization running at about 84%, well above the long-term trend, supported the brisk investment growth.

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Exhibit 1: Unemployment Rate, Annual Change as of May 2007



Sources: Eurostat; FSSS Russia; AMSTAT Switzerland; Prudential Real Estate Investors

While private consumption was somewhat subdued during 1Q, high levels of consumer confidence are still pointing toward a clear increase in household spending growth, according to the monthly consumer confidence survey of the European Commission. One major contributing factor is the broad-based upswing in the labor markets. Annualized employment growth reached 1.2% in the EU27 during 1Q. The unemployment rate in the European Union fell from 8% in April 2006 to 7.1% in April 2007. Again, broad variations exist, ranging from 11.2% in Poland to 3.3% in the Netherlands (see Exhibit 1). That said, the lowest unemployment rates can be found outside the EU. In Switzerland, the unemployment rate stood at 2.7% in May 2007. The European Commission expects a total of 5.5 million new jobs in the EU in 2007-2008. The unemployment rate is expected to fall further, to 6.7% in the EU by 2008. Despite moderating effects on wages due to the ongoing competitive pressures from globalization, the improved labor market outlook should contribute to growing wages. Real disposable income is expected to rise this year by 1.9% in Western Europe and by 4% in Central and Eastern Europe.

The Commission's industrial confidence indicator rose in June in the EU27, indicating a further expansion in the industrial sector. At the same time, service-sector confidence slipped slightly but is still pointing to an upturn. The European Commission's assessment of export order books in manufacturing improved in May in the euro zone, which could indicate strong export growth driven by strong global demand. However, given eroding competitiveness due to the continued appreciation of the euro against the dollar and the slowdown in the U.S. economy, the growth contribution from net exports could be limited.

An appreciating exchange rate and a tighter monetary policy may have a dampening effect on economic growth, but forward-looking indicators suggest that growth should remain solid in the coming months. Given strong consumer confidence and a very robust labor market, consumption should make an increasingly significant contribution to growth. Overall real GDP growth in 2007 is forecast at 2.9% in the EU.

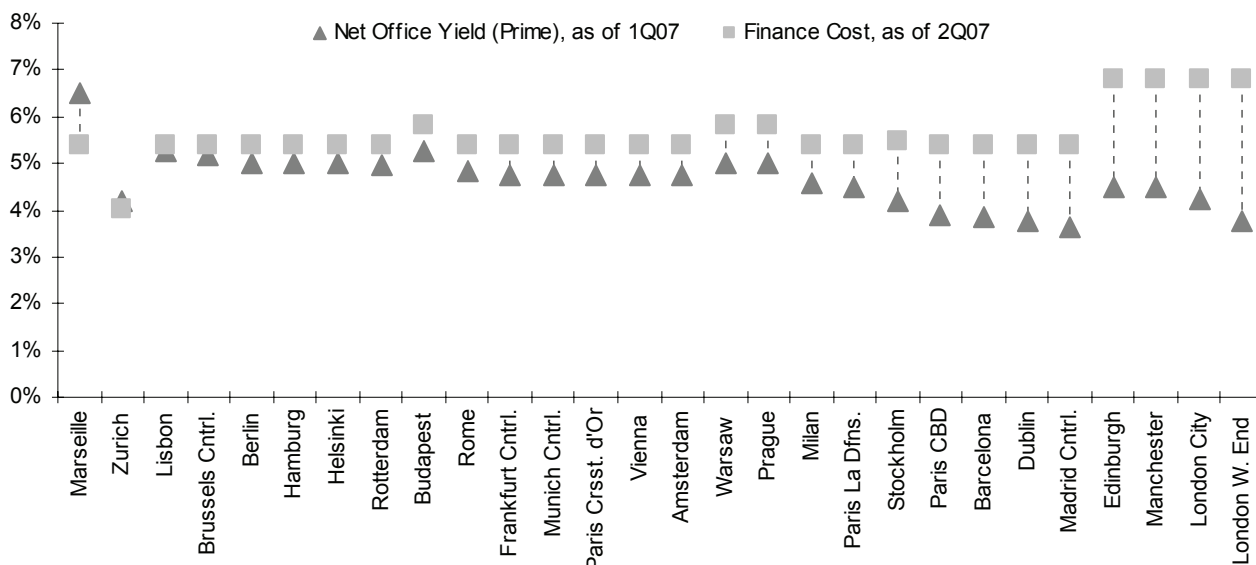
Capital and Real Estate Investment Markets

The past few months have seen continued tightening of monetary policies across Europe, including hikes in Sweden, Switzerland, Euroland and the UK. The Swedish Riksbank surprisingly moved toward a hawkish monetary policy stance, hiking interest rates to 3.5% and raising its policy rate forecast for this and next year. The Bank of England took its key rate to 5.75%. Underlying inflationary pressure remains evident, suggesting that another hike is likely in the near future. The European Central Bank raised interest rates, in line with expectations, by a quarter percentage point to 4.0%. The tightening of the monetary cycle should continue, and a further interest rate hike to 4.25% in September is expected.

An upward movement in rates has also occurred at the long end of the curve. Since their trough in June 2005, long-term government bonds in the euro zone have increased by about 140 basis points (bps), standing now at 4.6%. In the UK, long-term bond yields rose since the start of 2006 by about 150 bps to 5.5%. Five-year swap rates rose to 4.8% in the euro zone and to 6.2% in the UK.

As the search for yield continues, property yields compressed by roughly 10 bps in the prime segment during the first quarter. Net office initial yields, for example, now stand at 4.6%. **Given higher interest rates and lower initial yields, it is becoming increasingly challenging to find a property yield premium over estimated finance costs (see Exhibit 2). Thus, the opportunity to leverage income returns has disappeared in most markets, and the number of debt-driven buyers is decreasing, which should contribute to yields finding a floor.**

Exhibit 2: Net Prime Office Yields vs. Estimated Finance Costs (%)



Sources: Colliers; Goldman Sachs; PMA; Prudential Real Estate Investors

In the meantime, yield compression has been slowing. In a sample of 50 prime office markets, 36% showed falling yields and 64% exhibited stable yields during the first three months of 2007. This compares with 70% of all centers having falling yields and 30% having stable yields in the

same period last year. **As yield compression fades, underlying demand fundamentals increasingly drive investment in property.** While there is still excess demand for prime assets, the number of active bidders is declining. Secondary properties were more affected by the movement in bond yields, especially as their potential for rental growth tends to be more limited than in the prime segment. Several secondary property deals were reported as delayed or renegotiated, indicating a return to a more normal investment environment. **Moreover, as tenant demand becomes the major driver for real estate performance, investors should become more discriminating in their property selection criteria.**

The abating opportunities to leverage income returns are dampening the demand from core investors. Simultaneously, banks are still very eager to provide financing to property companies. Growth in bank lending to the sector has been strong. Benign economic conditions and fierce competition between lenders are encouraging greater risk taking. While default rates have been low recently, banks have become more aggressive in their underwriting standards in the recent past. Lending terms and conditions have eased, which includes thin credit margins and a rise in the maximum loan-to-value ratio.

Banks are increasingly using securitizations to offload their risks. Last year, CMBS issuances in Europe achieved a record volume of approximately €60 billion. According to the Bank of England, the CMBS market in the UK grew by over 270% between 2002 and 2006. This year, CMBS issuances continued their upward trend, totaling €28 billion at the end of June. At 19 bps, the average spread of AAA tranches over benchmarks remained tight compared with a spread of 22 bps in 2006.

With an average total return performance of about 34% per year (measured in euros), the European public real estate markets performed strongly from 2003 to 2006, according to the FTSE EPRA/NAREIT Europe Index. Since 2004, property companies have been trading at a premium to NAV. However, **the combination of high valuations and rising interest rates has resulted in a correction in share prices. Overall, the sector realized a -10.5% return in euros as of the end of June 2007.** As a consequence, real estate underperformed the wider equity markets. Although during the first half of 2007 property companies raised about €10 billion representing 14 IPOs and 21 secondary offerings, according to Kempen, the recent decline in share prices should dry up IPO activity and limit capital flows into real estate securities for the rest of the year. Several IPOs have already been postponed this year, including that of Vector Hospitality (set to become the UK's first hotel REIT), Shurguard and Uni-Invest.

Institutional investors remain well disposed to the private real estate equity markets. At the upper end of the risk spectrum, a survey by Private Equity Intelligence confirmed that fund-raising conditions should remain favorable for private equity real estate funds. According to the survey, this bodes well for the 24 Europe-focused funds seeking to raise an aggregate of US\$12 billion in new commitments.

The largest challenge, however, is to deploy committed capital. Research from INREV, based on a sample of 128 funds, showed that those funds have a total target GAV of €85.8 billion but only a current GAV of €49.2 billion. While the gearing level may be lower than initially planned, this

indicates that these funds still need to invest up to roughly 40% of their capital to reach their targets. In particular, newly launched funds are reported to be having difficulty finding suitable investment opportunities. Therefore, investment pressure from non-listed real estate vehicles is expected to continue.

German open-end funds were net sellers over the past 12 months and continued to diversify their portfolios. While international acquisitions accounted for 80% of all transactions, dispositions were largely driven by the sale of German assets worth €8.3 billion. Accordingly, the German allocation of those funds decreased from 43% to 38%. During the first four months of 2007, net inflows accounted for €3.3 billion. Net assets under management increased to about €79 billion, reflecting renewed investor confidence.

Overall, liquidity from public and private sources has remained high in 2007. According to Cushman & Wakefield, about €56 billion worth of commercial property investments traded during 1Q07. At the upper end of the risk spectrum, debt-driven, value-added and opportunistic strategies are gaining a greater portion of real estate capital allocations. In the lower risk segment, however, a shift has occurred from debt-driven to equity investors.

Geographically the investor base continues to widen. European demand has remained strong, but investors from North America, the Middle East and the Far East are increasingly playing a key role.

Property Markets

The robust economic growth is fueling the demand for real estate, which is rising rapidly across the commercial real estate sectors. As sound demand fundamentals are expected to persist in most markets, the major downside risks to future rental growth are mainly associated with the supply side.

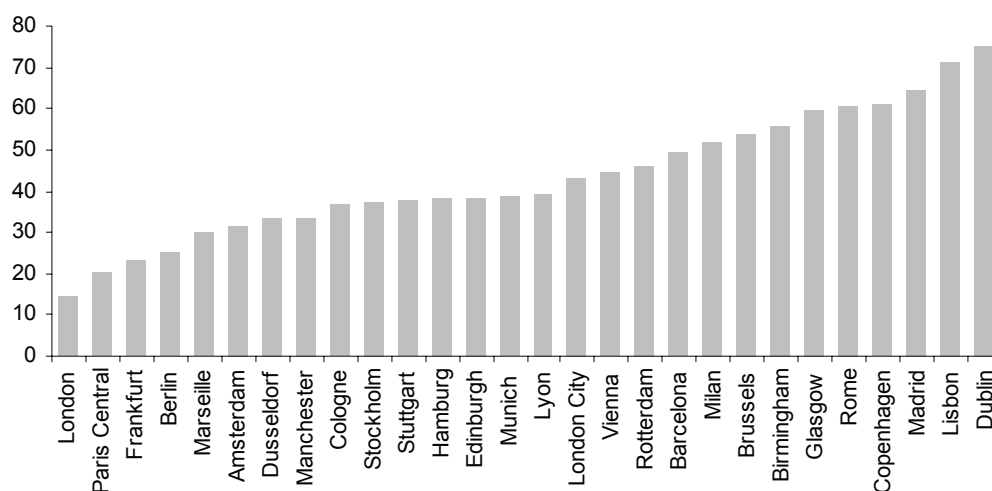
Office

The broad-based labor market upswing is generating high demand for office space. Over the past year, office-related employment rose by more than 4% in the EU27, with the employment rise in the business-oriented sector outperforming financial services. According to Jones Lang LaSalle, compared with 1Q06, total European absorption increased by 6% to 3.2 million square meters. Demand was especially strong in Paris and Moscow, which together accounted for more than one-third of total demand. While M&A activity in the financial sector could dampen tenant demand, business confidence is running high, and office employment growth is forecast to continue. This should have a positive impact on absorption.

Since their peak in 2004, vacancy rates have continually fallen. During the first months of 2007, most cities and locations saw declining or at least stable vacancy rates. In about three-quarters of the major European office markets, vacancy rates have returned to single-digit territory. However, despite the overall downward trend, wide variations persist. While vacancy rates are below 4% in Moscow, London's West End, Madrid and Warsaw, Frankfurt has a vacancy rate of 15%.

Given the high demand and falling vacancies, it's no surprise that prime office rents rose by 7.2% year-on-year during the first three months of 2007, according to CBRE, which was the highest increase in the past five years. However, the current rental upswing applies mainly to the prime segment in CBDs. With higher vacancy rates and lower levels of tenant demand in the secondary segment, a rental upswing there remains a moot point.

Exhibit 3: Net Five-Year Supply (as % of five-year historical take-up), as of 1Q07



Source: Prudential Real Estate Investors

As office employment is expected to expand in the medium term, the major downside risks to future rental growth are mainly associated with the supply side. Current estimates suggest that levels of completion are expected to rise but should still stay at moderate levels for the rest of the year. The expected annual net addition over the next five years as a ratio of historic annual absorption over the past five years can be used as a proxy to assess the risk of oversupply in mature markets (see Exhibit 3). In most markets, historic absorption outstrips estimated future net additions by far. Dublin, however, faces the highest risk of oversupply, while Central Paris and London's West End look like defensive plays.

That said, the benign economic and rental growth prospects could increase the appetite for risk among developers. Moreover, investors could cause a development boom due to a lack of investment product. For the time being, most indications point to fairly low building activity, especially for the current stage of the rental cycle. This bodes well for a continuation of the rental recovery, especially for high-quality office space, which should continue to outperform the rental growth of secondary-quality space.

Industrial

The robust economic environment, an increasing import and export volume, and consumer spending growth are driving tenant demand for industrial property. Expanding global and pan-European trade bodes well for the sector, where high multimodal accessibility remains a key success factor. In Central and Eastern Europe, export and import volumes are expected to expand this year by 13.2% and 12.7%, respectively. In Western Europe, export and import growth in

2007 is forecast to be 4.6% and 4.9%, respectively. This is reflected by the strong expansion of the transportation and communication sector, which should grow in the European Union by 4.7% this year, strengthening the demand for modern distribution space. As always, wide variations exist, ranging from a shrinking transportation sector in Berlin (-1.7%) to high growth of more than 8% in the Baltic countries.

Despite very favorable overall industrial tenant demand, rental growth remained mixed across Europe. Regarding annual rental growth, 34% of major markets have rising rents, 52% stable rents and 14% falling rents. Modular building techniques and more lax town planning regimes in out-of-town areas generally allow the supply side to react faster to increasing tenant demand than in any other major commercial sector. This bodes especially well for rental growth in countries with tighter town planning regulations. Thus, the Nordic region performed well in terms of rental growth, especially Oslo, with its double-digit rental growth rates. While rents remained stable in German logistic hubs, they have risen in most major French and British markets. Moreover, according to Jones Lang LaSalle, Vienna continues to establish itself as a major gateway for Central and Eastern Europe, achieving an annual rental growth of 11%. Net additions in 2006 in Central and Eastern Europe accounted for one-third of total industrial stock. Although demand should remain strong throughout the region, rental growth prospects in Central and Eastern Europe continue to suffer due to brisk building activity, which is expected to continue.

Retail

Labor market tightening and real income growth have boosted consumer confidence in Europe. The negative effects of the value-added tax (VAT) hike in Germany seem to be slowly fading and, according to GFK, the upward trend in German consumer confidence continued in June. However, there may be bad news ahead for consumers in the euro zone, as the French government has proposed to raise the VAT by five percentage points. While the VAT hike is still far from certain, it would surely have negative implications for household spending. Notwithstanding this potential rate hike, overall consumer confidence in Europe remains high. This, in turn, has a positive impact on retailer confidence, which is reflected by the very high levels of the European Commission's retail trade confidence indicator.

Eurostat reports the volume of retail trade in April 2007 up by 2.7% in the EU27 and up by 1.6% in the euro area compared with the same month a year earlier. Looking ahead, retail sales could surprise on the upside, given rapidly improving labor markets and a high gross household saving rate of 13.7% in the euro area and 11% in the EU27. During the first months of 2007, the strongest sectors were textiles and household goods, which continued to outperform retail sales overall. This has resulted in strong tenant demand in the high street and shopping center segments. A sample of more than 30 high street locations across Europe showed that in 1Q07, rental growth was either stable or rising compared with the same period in the previous year. In fact, 88% of all markets registered rental growth in the high street prime segment. Shopping center rents mirrored the positive rental growth of high street retail but to a lesser extent. In a sample of 25 major European cities, 68% of all locations showed positive rental movement.

An ongoing structural shift toward modern retail formats is still driving the European retail sector. While annual shopping center net addition has averaged about 6% of total stock since the early nineties, per capita provision is still about eight times lower than in the U.S. Building activity in the shopping center segment over the next two years should clearly be above the long-term average. However, nearly half of the new supply will be in just four countries – Russia, Turkey, Italy and Poland. According to Jones Lang LaSalle, Turkey and Russia alone account for one-third of all new shopping center space. This reflects the current low per capita shopping center provision as well as high retail sales growth, which the Economist Intelligence Unit forecasts will increase by an annual average of about 9% and 5% over the next five years in Russia and Turkey, respectively. **Despite the positive consumer outlook, robust shopping center building activity should limit rental growth prospects in an expanding number of markets.**

Residential

With the exception of Germany, broad house price growth has occurred across most European countries since the mid-nineties. Since 2000 alone, house prices rose in the euro zone overall by about 50% in real terms, ranging from a decrease of about 5% in Germany to an increase of more than 100% in Spain. However, quarterly data from the European Mortgage Federations indicates that annual house price increases decelerated in several countries in late 2006. With home price increases having reduced affordability and the ECB expected to hike rates, further risks of a downturn have grown. While house prices in the UK have remained surprisingly robust, there is anecdotal evidence of declining house prices in some of the more vulnerable locations of the Spanish housing market. The risk of a downward correction, however, does not apply to Germany, where the correlation of house prices with the rest of Europe has been very low since the early nineties. Thus, the German residential market could surprise on the upside. Despite an uptick in building activity last year, levels of completions have been falling in Germany since the mid-nineties and probably cannot meet long-term demand in economically prospering regions.

Further east, major parts of Central and Eastern Europe are still characterized by the relatively poor quality of existing stock. Moreover, despite increasing levels of outward migration, housing demand remains high. This is mainly due to a projected rising real income level of about 4% over the next five years, according to EIU, and to decreasing household size. In Poland, for example, it is estimated that two million new dwellings will be needed to match the demand for housing.

Outside the European Union, Switzerland has eased limits on European immigration by dropping the decades-old quotas on foreign workers. As of June 1, workers from 20 countries in the European Union and the European Free Trade Association will have unlimited access to the Swiss labor market. Thus, the country's shortage of skilled labor and its high income levels should spur immigration, which in turn should give the residential sector an additional boost.

Conclusion

Despite an expected upturn in income growth in private real estate, total returns should moderate this year, as abating yield compression limits the potential for appreciation. In fact, the bond

yield rise should reduce the level of capital targeting the real estate sector. As real estate investor demand should increasingly slow to more normal levels, markets with poor rental growth prospects and higher risk are the most likely to face a downward correction in pricing. For the time being, therefore, demand fundamentals, prudent property selection and risk-aware underwriting remain, more than ever, major performance factors.

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