

US Market Outlook – Second Quarter 2003

Market Perspective

For most investors, the second quarter was a welcome reprieve from the dismal market conditions of the past few years. With the end of the major fighting in Iraq and increasing optimism among consumers about the economy in 2004 and beyond, the US stock market enjoyed one of its best quarters since the tech bubble burst three years ago. All major US stock indices finished the second quarter with strong gains, led by the Nasdaq's 21% rise and the S&P 500's 15%-plus total return, its best quarterly performance since fourth-quarter 1998. The rally was particularly impressive for its breadth – according to Standard & Poor's, 469 of the 500 stocks in the S&P 500 delivered positive returns averaging more than 24%.

REITs, somewhat uncharacteristically, also participated in the broad market rally. The Morgan Stanley REIT Index (RMS) returned 12.6% in the second quarter. Even bonds rallied, encouraged by the improving corporate credit environment and in anticipation of the Federal Reserve's quarter-point rate cut in June. And although the second quarter results for NCREIF, the benchmark for US private real estate investment, won't be known until later this month, the recent activity in the transactions market suggests that cap rates have continued to trend lower even as property market fundamentals weakened further.

The strong second-quarter showing for stocks, bonds and real estate came despite continued sluggishness in the US economy and tepid consumer confidence about *current* economic conditions. First-quarter GDP growth was revised down to a 1.4% annual rate from the initial estimate of 1.9%, and second-quarter growth is not expected to be much better. The labor market is still very weak. The unemployment rate in the US rose to 6.4% in June, its highest level since April 1994. Although employment typically lags changes in the economy, most companies remain reluctant to invest and continue to shed jobs. The Fed is closely watching the lingering excess capacity and lack of pricing power in the economy, and its resolve to keep interest rates low until the economy shows real signs of strength has provided a lift to most asset classes. Clearly, investors are anticipating a recovery. It's just not yet clear when businesses will begin to invest and what sector(s) will lead the way.

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Oddly, despite the weak economy and uncertain shape and speed of the recovery, the near-term outlook for the real estate sector has crystallized since the year began. As we explain in the following commentary, interest rates and jobs will largely determine whether real estate investment performance can bridge the lag between the bottom of the economic recession and the point at which property-market conditions improve without a broad correction in asset values. Although the timing and sequence of when rates rise and job growth resumes clearly matter, we are optimistic that the downside risks are generally fairly limited, assuming unemployment does not rise sharply. At the same time, however, certain investments seem likely to disappoint investors under almost any scenario. Assets that are trading significantly above replacement costs or, in the case of some REITs, significantly above net asset value (NAV), have a real risk of suffering value declines, particularly if interest rates rise and demand remains weak.

The Debt Markets

Interest rates and capital flows continue to drive the real estate debt markets. With short-term rates now lower than they were at the start of the year and investors focused intently on secure current yield, liquidity remains high in the real estate debt markets. Capital sources are becoming more aggressive in their search for yield, but so far appear to be competing mostly on spreads rather than relaxing underwriting standards. The most recent data available from the American Council of Life Insurers (ACLI) for new mortgage commitments from life insurance companies (through first-quarter 2003) indicate that average loan-to-value ratios have declined and debt-service coverage ratios have increased since the third quarter last year, reversing troubling trends we observed in the first quarter. While some of the improvement may be attributable to rising asset values and lower debt service as interest rates have fallen, the data suggest a more conservative approach to underwriting, at least in this segment of the debt market. With so much capital in the market today, underwriting standards could deteriorate over the second half of 2003 as insurers come under increasing competition from conduit lenders to make their production goals this year.

Mortgage and CMBS spreads continued to narrow in the second quarter as competition for deals intensified. CMBS spreads are now approaching levels not seen since 1998, before the collapse of Long Term Capital Management and the Russian bond default. Corporate bond spreads also tightened recently as conditions in the credit markets are beginning to improve. Increased demand for higher-yielding corporate bonds, which offer wider spreads than comparably rated CMBS and which should benefit from the improving credit environment, could alleviate some of the pressure on CMBS spreads. But for now, investors' thirst for attractive yield-oriented investments is creating plenty of demand for the ample supply of new CMBS issues. Through the first half of 2003, more than \$41 billion of new CMBS have been issued versus about \$33 billion at this time last year. Forecasts for the second half expect total CMBS volume this year will reach a record \$98 billion, eclipsing the \$97.1 billion level reached in 2001.

The strong investor demand and tight spreads also highlight the lack of distress in the real estate markets today. While loan delinquencies and defaults have continued to rise, both remain well below the peak rates that accompanied the market collapse in the early 1990s. Despite rising in four of the last five quarters, the delinquency rate on commercial mortgages held by insurance companies stands at just 0.4%, according to ACLI. Delinquency rates in CMBS portfolios are also quite low, less than 2%, but are three to four times higher in the healthcare and hospitality

sectors. Although debt-market fundamentals are healthy, analysts have grown increasingly concerned about the higher loan-to-value ratios, lower subordination levels and decreasing diversity in CMBS pools. According to Moody's, downgrades of CMBS issues outnumbered upgrades 48 to 34 in the second quarter. These trends, combined with tighter spreads, leave less room for error, particularly if interest rates rise and property values weaken.

Construction lending remains fairly subdued in most sectors. Pre-leasing requirements and improved underwriting standards have kept speculative building to a minimum in this cycle, quite unlike the last time the industry was awash in capital. The FDIC remembers the early '90s crisis vividly, however, and continues to warn regional banks about their exposure to real estate loans despite relatively little deterioration in bank portfolios. Capital is selectively available for retail development. But the fundamentals in the retail sector, where the consumer side of the economy drives demand, are healthier than most property types. Only the multifamily sector, where no pre-leasing is required, has not seen a slowdown in new supply as market conditions have weakened. With interest rates at their current levels and strong investor demand for apartment properties, developers are taking advantage of the arbitrage between the cost of developing new projects and the premium pricing in the transactions market.

While the low interest rates and attractive yields in the real estate sector are the primary reasons for the liquidity in the debt markets today, at least some of it is due to structural changes over the past decade. Currently, it appears that the enhanced flexibility and transparency of the real estate capital markets are working fairly well. The debt markets seem to be providing neither too much nor too little capital to most segments of the industry. However, as long as interest rates remain low and the opportunities for safe and attractive yields outside of the real estate sector are perceived to be scarce, the risk of excess capital flowing to the industry clearly outweighs the risk of a liquidity crisis. If interest rates rise and demand remains weak, most likely as a result of no job growth, loan-to-value ratios would increase and debt service coverage would suffer, particularly on floating-rate debt. Debt capital would certainly become more expensive. But, with the infrastructure that exists today, the chances of a complete withdrawal of capital, like in the early '90s, are extremely remote.

The REIT Market

The second-quarter REIT rally was impressive. After returning just 1% in the first three months of the year, the RMS returned 12.6% during the second quarter as capital continued to flow into the sector in search of yield. The REIT rally was as broad-based as the rally in the broader market. Through the first half of the year, only the lodging sector was in negative territory, with an average total return of -3.3%. Apartment and self-storage REITs were the only other sectors that failed to produce double-digit gains, returning 8.3% and 8.6%, respectively. Retail REITs continued to lead the major property types, with an average total return of 19.6%, followed by office REITs, which gained 15.8%. The strong performance in the first half of this year is similar to the first half of 2002. Last year the RMS finished the second quarter with a 13.5% return, then sold off sharply in the third quarter, at one point falling as low as -6.7%, before finishing the year with a modest 3.6% gain.

While it's certainly possible that REITs could continue their winning ways in the second half of this year, the warning lights on the dashboard are getting harder to ignore. The most obvious

warning signs concern valuations. Most REITs are now trading above NAV, depending on whose estimates (or cap rates) you believe. Data from Green Street Advisors show that only manufactured-home REITs, a small niche, are trading at a slight discount (-1.9%) to NAV, while the industry as a whole is trading at a 9.8% premium to NAV. The average premium today is roughly where it was in early 1996. REITs proceeded to trade above NAV for nearly two years before the sector fell out of favor with growth-minded investors and shares traded below NAV. Unlike today, the property markets at the beginning of that last run were recovering, and rents were rising in most sectors and markets.

But beyond the controversial measure of NAV, REITs look richly priced today, particularly in light of the weak property market fundamentals and lack of visibility in earnings growth in most sectors, with the possible exception of malls. According to our colleagues at Prudential Securities, although REITs are still trading slightly below the average price-to-FFO multiple for the group, FFO growth this year is expected to be negative for the second year in a row, before turning modestly positive next year. By comparison, analysts are now expecting earnings growth for companies in the S&P 500 to be 16.6% this year and 13.5% in 2004.

Further, average REIT-dividend yields have now fallen to about 6.5%, or 50 basis points below the long-term average. While the yield spread between REITs and the S&P 500 remains about 40 basis points above its long-term average, the spread is actually narrower than the historical average, after adjusting for the effects of the recent changes concerning taxes on dividends. REIT investors, therefore, appear to be paying more dearly for income that is less certain, or taking more risk for less reward. As long as yield is king and REITs continue to deliver their attractive dividends, investors may look past some of these issues. Investor sentiment often overwhelms real estate market fundamentals in the REIT market, so it's not surprising that REITs have performed well. But if investor sentiment changes, or if REIT yields look relatively risky versus other investments, property market fundamentals alone will not make a compelling case for the sector in the short term.

Capital-raising activity in the REIT sector has also heated up this year. Through the second quarter, REITs raised about \$12.5 billion, according to NAREIT, already more than was raised in all of 2000 and well over half the total amount raised in each of the last two years. Nearly \$7 billion of the new capital raised this year has been unsecured debt, as companies continue to take advantage of the low interest rates to reduce their cost of capital. Equity deals also picked up in the second quarter. Notably, the second quarter included two REIT IPOs that together raised about \$1.5 billion, ending a four-year drought during which REITs raised just \$900 million in five IPOs.

As in the debt markets, investor demand has been more than sufficient to absorb the healthy supply of new REIT securities. Capital flows into the REIT sector were strongly positive in the second quarter. Mutual fund inflows were nearly \$1.3 billion, bringing the year-to-date total to about \$1.7 billion, and closed-end funds raised more than \$1.5 billion in equity. Not everyone is a buyer, of course. GE liked the premium pricing of its Regency Centers stock so much it decided to sell all 34.3 million shares, which were snapped up by the market. Although we suspect some non-dedicated real estate investors have been actively selling as REIT share prices have traded higher, the robust selling among REIT insiders is worth noting. REIT insiders sold

nearly \$210 million worth of shares in the first half of this year, versus \$238 million in all of 2002. According to Lehman Brothers, among the 33 REITs they cover, sellers outnumbered buyers 12 to 1 in the second quarter, and 29 to 1 when option sales are included.

The two IPOs, American Financial Realty Trust and Maguire Properties, reveal a lot about investor sentiment in the REIT market today. The American Financial IPO was reportedly more than six-times oversubscribed and finished its first day of trading 14% higher than the IPO price, according to SNL. The company's strategy of acquiring bank facilities, mostly bank branches, and leasing them back to financial institutions on a triple-net basis found an eager following among investors searching for secure current yield. The Maguire deal, however, launched amid controversy over the disclosures and transparency in the prospectus and analysts' lack of access to management during the road show. Although the shares priced at the bottom end of the range, and investor demand was much lighter than for American Financial, the IPO was oversubscribed despite analysts' concerns that the attractive 8% dividend yield may prove to be optimistic.

The successful launch of the Maguire IPO and a second-quarter rotation into the apartment sector, where property-market fundamentals are continuing to deteriorate, raise questions about how much risk investors are pricing into the yields they are now clearly chasing. The risks of downward earnings revisions and dividend cuts vary by property type but are probably most severe in the apartment and office sectors. According to Smith Barney, 11 of the 16 apartment REITs and five of the 13 office REITs in their coverage universe are paying out dividends that exceed the companies' adjusted funds from operations (AFFO). It's hard to see how these companies can continue to pay their current dividends unless they fund them through asset sales.

The current market environment could create some interesting M&A opportunities. The ongoing battle between Simon and Taubman could be a black eye for the industry before it's resolved, particularly since it comes while the alignment between management and shareholder interests is under scrutiny everywhere. Kimco's planned acquisition of Mid-Atlantic shows how creative and flexible the real estate capital markets have become. Kimco plans to divide the portfolio into at least two different vehicles with very different risk characteristics. This allows Kimco to obtain a lower cost of capital for the low-risk portion of the portfolio and take advantage of the increased leverage of the higher-risk portfolio to compete with other potential acquirers. With many REITs trading at a premium to NAV, and plenty of willing and creative capital providers and scores of investment bankers eager for any sign of life from the M&A market, REIT M&A activity could accelerate over the second half of the year.

Our outlook for REITs for the remainder of 2003 is decidedly more cautious than it was in the first quarter. For the moment, the search for yield is winning the struggle with market fundamentals. Low interest rates continue to make the spread on real estate yields very attractive, even though spreads have compressed. Rising interest rates would put upward pressure on real estate yields. But the bigger risk for the REIT sector is a shift in investor sentiment. Growth stocks have already turned sharply higher this year, which could indicate that investor sentiment has already shifted away from value stocks. Negative news from the REIT market – downward earnings revisions, dividend cuts, corporate governance questions – could change investors' perception of REITs quickly, especially if the prospects for earnings growth do not improve. Earnings growth must wait until demand has recovered, which isn't likely until some time after

job growth has resumed. We expect the REIT sector will retrench over the second half of the year as investors digest the increasing probability of weaker earnings growth in 2004, and we still believe returns for the year will be in the mid-single digits.

The Property Markets

The conditions and dynamics in the property markets changed very little in the second quarter. The same low interest rates and thirst for yield that are driving the debt and REIT markets are affecting asset pricing, despite extremely weak tenant demand in most sectors and markets. With the possible exception of the consumer-driven retail sector, tenant demand is barely visible, and both the office and industrial sectors have significant excess capacity that must be absorbed before rent growth can resume. But competition from leveraged buyers is making the transactions market extremely challenging. Local buyers are actively competing for and winning deals, using as much leverage as possible to maximize returns on equity.

Transactions involving properties in the NCREIF database were very slow in the first quarter of this year. The annualized turnover rate (by market value) was just 2.5% through the first three months of this year, the lowest level since 1992. While this represents just one-quarter's worth of data and may reflect a slower pace of transactions in the first quarter generally, the contrast between the market environment then and now is stark. A decade ago, the transaction market was paralyzed by a lack of liquidity and widespread distress from the severe overbuilding in the late 1980s. Today, *excess liquidity* and the *lack of distress* are making transactions difficult. Unlike the capital glut of the late-'80s, the capital flowing into the industry today is causing rising asset values rather than speculative development.

Investors seem to be expanding the range of markets they will consider and generally seem more receptive to "stories" for a particular investment, but are still focusing on core, well-leased assets. Many of the investors who are winning transactions today appear to base their decisions almost entirely on current cash yield. Replacement cost and discounted cash flow analyses have become relatively less important, perhaps even irrelevant in extreme cases. As long as pricing doesn't deviate too far from replacement costs, the risk of an asset bubble developing should be minimal. Values could certainly decline, and appreciation could go through a period of slower growth, but a severe correction seems unlikely. However, buyers paying significantly above replacement cost could suffer steeper losses in asset values even if tenant demand strengthens. If renewed demand spurs new construction, investors who paid a premium to replacement cost could be at a significant competitive disadvantage in the leasing market.

The near-term outlook for the office sector depends more heavily on when and in what sequence interest rates rise and job growth resumes than it does for most other property types. The recovery in the office sector seems to be receding further into the future, however, as the employment picture in the US remains weak. Job growth will lag growth in the economy; office demand will lag job growth; and rent growth will lag office demand growth. Along the way, owners will spend more on capital expenditures to keep and attract tenants and perhaps significantly more in local property taxes due to rising state and local deficits.

Clearly, the office recovery will take time, but it could take much longer than expected due to the uncertain overhang of shadow and sublease space in the market today. Changes in accounting

rules concerning the treatment of operating leases may be discouraging some companies from putting more unwanted leased space on the sublease market. All of this excess capacity must be absorbed before landlords regain pricing power with tenants. Torto Wheaton recently extended by five quarters its forecast of when employment will fully recover to its pre-recession peak, from first-quarter 2004 to second-quarter 2005. Some of this adjustment is due to downward revisions to employment readings last year.

While most forecasts of job growth offer little hope for a quick recovery, a recent study by Smith Barney indicates some positive gains recently in office jobs. According to the report, the economy has added more than 200,000 office jobs since it bottomed in July 2002, and temporary employment accelerated in May. While these are welcome and positive signs, there's still a long way to go before the economy fully recovers the 780,000-plus office jobs that have been lost since the peak in December 2000. Further, analysts and investors may not be factoring in the full effects that continued international outsourcing may have on office-employment growth. The potential cost savings are too compelling to ignore, particularly in the current cost-conscious environment, so clearly the trend will continue to drain some office employment growth from the US economy.

The good news for the office sector continues to be on the supply side. Based on Census Bureau estimates of new construction put in place through May 2003, new office construction has fallen nearly to the depressed levels of 1992. Vacancy rates in downtown and suburban markets have continued to creep upward, increasing about 50 basis points in both market segments to 13.7% and 18.8%, respectively, according to first-quarter data from Torto Wheaton. With new supply down sharply, the current pipeline almost assures that deliveries of new space will be very low in 2004 and 2005.

Very little has changed in the apartment sector. The national average apartment vacancy rate in first-quarter 2003 increased to 7.1% from 6% a year earlier, according to M/PF Research. New supply continues to come online despite weak tenant demand, and new permit activity shows no relief in the near term. Multifamily completions hit an annual rate of 345,000 units in May, a 20% increase from a year ago and its highest level since March 2000, according to Banc of America. The new supply may be the only factor keeping cap rates from falling faster than they are, although some of the decline recently can be attributed to declining income levels. Economic occupancies are continuing their downward trend as expenses and property income move in opposite directions. Insurance costs seem to have leveled off, but other expenses – e.g., marketing, rent concessions and taxes – are increasing.

Low interest rates and weak job growth continue to weigh on apartment demand. While job growth is critical to the recovery in tenant demand for apartments, apartment properties would likely benefit from rising interest rates, which would make housing more expensive and may be the only way to slow new construction. The recent shake-up at Freddie Mac and increased scrutiny of all the agencies' lending activities and their implicit guarantee from the federal government could disrupt the mortgage market somewhat. If the inquiry results in increased borrowing costs or less accommodative lending programs, marginal buyers, who would otherwise be renters, would likely feel the effects most directly. Even without a material change in the agencies' practices, however, we are beginning to wonder how far the home ownership

rate can rise before it runs into friction from those who rent by choice and others who live in markets where the cost of owning is prohibitive to the majority of residents (e.g., Manhattan). Until the balance between supply and demand corrects, we believe the current market conditions offer an excellent opportunity to sell multifamily assets.

Investor interest in industrial warehouses also remains strong despite increasing vacancy rates that now stand at their highest levels in more than two decades. According to Torto Wheaton, the national warehouse vacancy rate increased to more than 12% in the first quarter from 11.2% a year earlier. The national vacancy rate for the depressed R&D segment, which collapsed along with the tech sector, has increased 200 basis points since the first quarter of last year, to 17.4%. Unlike the apartment sector, however, new supply is not contributing to the weak fundamentals in the industrial market. New construction put in place is now 65% below its 10-year average, and we suspect that most of the new supply involves build-to-suit projects.

In the second half of last year, we hoped that our observations of more “tire kicking” on the part of prospective industrial tenants would translate into increased demand and some positive absorption in the first half of this year. Unfortunately, the anticipated increase in demand did not materialize, and the prospective tenants now seem to be re-assessing how soon they will need to expand. Industrial activity contracted again in June for a fourth straight month. A weaker dollar could increase demand for US exports, but for now the recovery in the warehouse sector looks weak. Although demand for warehouse space does not depend on a recovery in job growth, it could take more than two years of normal warehouse demand growth and no new supply before vacancy rates move back to 8% or so, where rent increases become possible.

Performance measures in the lodging sector remained sharply negative through the second quarter. Businesses are still trying to wring out more efficiencies and are still traveling less than before the recession; and weather, terrorism and SARS have continued to take a toll on room demand. The terrorism threat level has been raised for nearly every holiday since it was introduced, which adds yet another distraction to already wary potential travelers. Hotel occupancy rates and average daily room rates are still trending down from very weak levels a year ago. Through the end of April, the average occupancy rate for the lodging sector as a whole was 55.7%, while revenue per available room was down 5.1%, according to Smith Travel Research. Occupancies have continued to hold up better in the luxury and upscale segments, which have been stealing demand from the lower-priced economy segment. The average occupancy rate among economy hotels fell to its lowest level in more than 13 years at just over 52%.

Remarkably, even the lodging sector shows few signs of distress. Low interest rates and the improved flexibility of the capital markets have helped owners weather the weaker cash flows without a severe liquidity crisis. FelCor’s CMBS offering in June, which helped the company avoid a potential liquidity crisis, demonstrates how the real estate debt markets can now accommodate a much broader range of capital needs. But operating margins have been under severe pressure for about two years now. The Internet continues to put pressure on room rates and to undermine hotel operators’ competitive advantage in marginal bookings. Most hotel operators made significant reductions following 9/11 to save costs, but hotels are notoriously capital intensive. Maintenance and repairs cannot be deferred indefinitely. Operators can’t do

much more at this point except hope for a recovery in demand. Although supply is down sharply this year and is expected to remain at very low levels in 2004, the fundamentals in the hotel sector have a long way to go before occupancy and room rates recover to pre-recession levels, and some observers question whether the industry will ever return to “normal.” That said, the hotel sector is the one property type where investors can probably find opportunities to buy at below replacement cost. However, we’re not convinced that replacement cost is relevant for many of these hotels, which might never be productive enough to justify their cost.

The retail sector continues to be the strongest of the major property types in terms of investment performance and market fundamentals. Conditions are probably most favorable in the mall sector. Mall REITs have shown strong internal growth as in-place leases signed five to seven years ago roll into much higher market rents today, and the balance between supply and demand remains very healthy. Importantly, mall operators seem to have gained the upper hand in their long struggle with weak department-store tenants. Losing an anchor department store increasingly is viewed less as a threat than it is a potential opportunity to enhance cash flows and traffic. In many instances, mall owners are re-tenanting dark department stores with category killers like Bed, Bath & Beyond and others.

Similarly, the power center segment is benefiting from the slower pace of development in recent years, after the burst of new supply in the early 1990s kept investors wary of the format. As the pace of new construction has slowed and many of the weaker big-box tenants that helped fuel the construction boom have failed, the power-center segment seems to have matured. Dominant power centers appear to have some of the defensive characteristics that large fortress malls possess. Like malls, well-established, large, dominant power centers seem to repel direct competition from similar types of centers in the local market, making their relatively high, stable yields much more attractive.

Although market fundamentals are weaker in the strip-center segment, where anchor-tenant risk remains a serious concern, investors of all types are still pouring capital into the sector. Most investors acknowledge the risk that Wal-Mart poses to any center located within close proximity to one of the discount retailer’s supercenters, but it’s not clear how much risk they are pricing into their investment decisions. Although the company reportedly has slowed the rollout of its grocery-only “Neighborhood Market” format, it plans to open between 200 and 210 supercenters in the United States during the current fiscal year, which ends in February 2004. This growth, combined with the development pipelines of Target and other big-box retailers, will only increase the rising pressure on strip-center anchor tenants and on grocers in particular. If Kmart, which emerged recently from bankruptcy leaner but not necessarily meaner, is unable to compete in its scaled down version of its former self, an additional 150 million square feet of big-box space could be returned to the market. The good news is that the remaining portfolio of Kmart stores presumably includes the most productive assets, which should make re-tenanting them somewhat easier if the need should arise.

With the Fed apparently determined to keep short-term interest rates low until it sees real evidence of strength (and inflationary pressures) in the US economy and with investors still chasing yield, we find ourselves in the odd position of raising our return forecast for the NCREIF Property Index (NPI) despite weakening property market fundamentals. The NPI produced a

total return of 1.88% in the first quarter, which included a nearly 2% income return and a modest decline (-0.08%) in asset values. Although the appreciation component remained negative, the total first-quarter return was the best quarterly performance since second-quarter 2001, which, not coincidentally, was the last quarter during which appreciation was positive. Tenant demand remains weak, but the sharp reduction in supply in most sectors should keep vacancy rates from rising much from their current levels. The office sector, with its overhang of sublease and shadow space, and the apartment sector, where new supply continues unabated, could see further deterioration in fundamentals and falling asset values. But investors' focus on current yield is keeping downward pressure on cap rates for the time being. We now expect NCREIF will return between 6% and 8% this year and would not be surprised if the Index had its best year since 2000.

Summary

Although the investment environment today has very little in common with the bull-market days of the late 1990s, exuberance is alive and well. Only now, investors' enthusiasm is for current yield rather than growth. As we noted at the end of the first quarter, whether or not it's irrational is impossible to tell at this point. It's hard to find fault with a renewed interest in concepts like cash flow, earnings and dividends, especially after seeing more than \$7 trillion evaporate from the public-equities market between the peak in March 2000 and the nadir in October 2002. But the thirst for yield today clearly is affecting pricing for real estate in ways that often are unfamiliar to dedicated real estate investors.

Too much capital creates imbalances in any asset class. In the 1980s, excess capital flows into real estate led to massive overbuilding. The greater risk in the current cycle is that too much capital is pushing asset values unrealistically high. Are investors whistling past the graveyard? The answer will depend on the timing and shape of the economic recovery and on the outlook for job growth and interest rates in particular. If interest rates rise and job growth remains flat, the consequences for most property types would be negative. The combined effects of increasing debt service costs and falling rents likely would create more distress in the office sector and, to a lesser extent, the industrial market.

Alternatively, a recovery in job growth in a low-interest-rate environment would help close the gap between property market fundamentals and asset pricing. While this admittedly is a best-case scenario for real estate generally, the Fed's promise to "leave rates low for as long as necessary" and the excess capacity in the economy should provide the stimulus needed for the economy to grow without inflationary pressures. And with the robust productivity gains in recent years, renewed job growth seems a prerequisite to increasing output. However, such an outcome may not be enough to bail out investors who have lost sight of replacement costs. With very few exceptions, investors paying significantly above replacement cost for assets today face potentially serious risks of value declines when the unusual conditions in the capital markets dissipate and the more familiar relationship between property market fundamentals and asset pricing re-emerges.

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