Strategy

Tapping Into Economic Growth

Commercial real estate, both public and private, presents a compelling opportunity for investors today. Not only does the sector provide many long-term investment benefits, including healthy income returns and a hedge against inflation, but in coming years fundamental factors such as the supply/demand cycle are set to turn positive while demographic forces look to be favorable. The growth associated with rising economic activity – including job creation and increased consumer spending – should translate into higher demand for commercial properties.

Real estate enables investors to tap directly into the economy’s cash flows more directly than stocks or bonds, which are filtered through the performance of companies. There is potential downside if the global economy does not perform as well as expected, but it is limited by the fact that property values remain significantly below the peaks of the last cycle.

While all real estate benefits from economic growth, public companies that own and sometimes operate real estate (commonly known as REITs) are positioned to take advantage by virtue of their ability to raise abundant amounts of low-cost capital in the public debt and equity markets. Moreover, public companies also have access to the traditional sources of equity capital provided by the private markets. The ability of public real estate companies to tap multiple sources of funding may provide for considerable risk reduction, especially in down markets, when sources of capital can become constrained.

REITs trade on many of the major stock exchanges around the world, which serves to provide diversity, liquidity, transparency, and strong corporate governance. Public real estate equities enjoy a competitive advantage in that they are subject to the scrutiny of the public markets. We believe that ongoing diligence by market participants (such as analysts, investors and rating agencies) normally leads to lower risk for long-term investors. Although daily pricing of the public markets can lead to higher volatility, price fluctuation can be an asset for long-term investors who capitalize on trading opportunities to purchase shares below Net Asset Value (NAV) and thus produce higher risk-adjusted returns.

Real estate should be considered an integral component of any well-diversified portfolio, and the public markets provide a unique opportunity for most investors to participate and access this sector.
Benefits of Real Estate Securities

**Attractive Absolute Performance:** Publicly held real estate has produced compelling returns over the past 10 years, despite the impact of the Great Recession, outperforming stocks, bonds and private real estate during that time. Since the trough of the recent financial crisis in March 2009, public real estate equity markets have partially rebounded, producing very attractive returns. On a cumulative basis, the returns from public real estate equities over the past decade have outpaced the returns from other investment alternatives, including direct real estate indexes.

According to research from the National Association of Real Estate Trusts (NAREIT), the difference in timing of returns between public and private real estate investment vehicles creates an opportunity to diversify real estate asset holdings in a manner that can reduce volatility. The study notes that an optimally blended portfolio with both public and private real estate produced positive annual returns for all rolling five-year periods over the past 22 years without a single period of negative returns – even during the most recent real estate market crisis. As a result, global public real estate securities have provided an attractive return on both an annualized and cumulative basis versus other investment alternatives over the past decade.¹

**Superior Risk-Adjusted Performance:** Investors need to be mindful to the risk associated with an investment, even ones with a strong performance history. When we calculate returns in relation to risk over an extended period, measured in terms of volatility (or standard deviation) real estate produces superior risk-adjusted returns to other equity investments.

Conventional wisdom looks at the volatility of a security or index and equates price movement with risk. Certainly daily price fluctuations are key to a short-term investor, but they are somewhat less important to investors who are holding an asset for a longer-term horizon. In fact, investors who are purchasing shares as part of a strategic long-term allocation may welcome limited share price volatility as an opportunity to

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¹ Returns for various indexes as follows: Global Real Estate: S&P Developed Property Index; US Small Caps: Russell 200; Investment-Grade Bonds: BarCap US Aggregate Bond Index; and Commodities: DJUBS Commodities Index. Data as of March 31, 2011.
increase their investment during times when prices fall. REIT stock prices are driven by a combination of factors that include private market pricing and general equity market sentiment, which can lead to volatility that produces inefficiencies. REITs will alternately trade at premiums and discounts to their NAV, providing investors with a compelling opportunity to exploit the differences between values on “Wall Street” (the public markets) and “Main Street” (the private markets). Similar to investments in private real estate, the investment characteristics of public real estate equities should be considered over the long term.

Real estate is unique within the public markets because it is one of the few asset classes in which pricing is driven by private markets, not necessarily industry group valuation metrics. Public real estate represents only about 5% of the world’s investment-grade stock. Therefore, private transaction values are usually used as the benchmark for the pricing of most public real estate companies.

While there are always risks in investing, some uncertainties can be moderated by the public markets. REITs benefit from the daily valuation and liquidity provided by the public markets. The ability to adjust portfolio holdings on a daily basis can provide investors with an opportunity to manage risk, especially in times of economic uncertainty. Public companies are also subject to multiple levels of disclosure and regulations, which require that investors have access to management teams on a regular basis. Plus, public firms are subject to regular scrutiny by independent agents such as equity analysts and rating agencies.

**Healthy Distributable Current Income:** Most commercial real estate investments provide investors with stable, bond-like income from contractual leases. Typically, commercial properties are occupied by tenants that have long-term leases, making the cash flow fairly predictable, even during economic downturns. Unlike bonds, there is no prepayment risk, so income returns can flow as long as a property is operating.

In order to maintain their tax status, REITs around the globe often pay out 90% or more of their taxable income to shareholders in the form of dividends. REIT yields compare favorably to stock and bond yields over time. Since 1986, US REITs have produced average annual income yields of roughly 7.4%, according to NAREIT. US REIT dividends averaged 3.6% at the end of 1Q11, according to Barclays Capital, and many REITs are expected to increase payouts in the near future to comply with regulatory requirements.

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2 Bloomberg, Prudential Real Estate Investors. Data is for 10-year period ending March 31, 2011.
**Diversification:** Diversity is a fundamental component of reducing risk. Real estate securities have demonstrated a low correlation to other asset classes such as stocks, bonds and even direct real estate, which means that they do not perform in tandem. As such, real estate securities can be an important element in creating a less-volatile multi-asset class portfolio. Expanding into investment classes other than stocks bonds and cash “typically improves the risk-return characteristics of a strategic asset allocation,” according to Ibbotson Associates.

The scale and characteristics of commercial real estate affords an investor several layers of diversification. The income stream it produces is different than the income generated by other types of investment products. Although it varies by property type, income typically comes from multi-year leases.

A second layer of diversification comes from the real estate itself, as a result of the variety of property types and different geographic regions around the globe. The major property types are office, retail, multi-family, industrial and hotel, but there are others, such as self-storage, seniors housing and health care. Each property type has different fundamental drivers that provide some diversification for investors. Geography works in the same way. Even though economic fundamentals operate under the same broad framework, performance of commercial real estate in markets across the world usually varies at any given time, for reasons that include local economic factors and supply dynamics. Public real estate securities can provide meaningful property type diversification for a small investment. With public REITs, investors can diversify by product and gain exposure to multi-billion dollar portfolios.

A third layer of diversification comes from the multiplicity of investment types available within commercial real estate. Investors can choose to buy properties directly or via public property companies. Another choice is between equity and debt. Equity carries with it the most risk but also the highest potential returns. Debt carries less risk but fixed returns without upside, even if the property performs above expectations. What’s more, investors can choose vehicles that employ differing strategies, including mezzanine investments that capture higher fixed returns with an increased level of risk.

A fourth layer comes from the fact that commercial properties often are occupied by multiple tenants, providing diversification of cash flow on the property level.

**Liquidity:** Public real estate securities are bought and sold on major stock exchanges around the globe. In the US alone, the average daily dollar trading volume has grown from about $100 million in 1994 to more than $4.9 billion today, according to NAREIT. The liquidity of public real estate equities provides investors the most efficient means to obtain exposure to commercial real estate markets globally. The ability to trade daily not only provides a useful tool for investors to create tactical allocations to the sector and global regions, but – perhaps more importantly – it also provides a means to efficiently rebalance allocations as market conditions change. The ability to rebalance investments makes portfolios more efficient.

**Transparency & Governance:** Public real estate companies are subject to quarterly earnings releases and disclosure of information on a scale rarely experienced in the private real estate markets. Public equities are subject to multiple levels of scrutiny by analysts, investors and rating agencies. The abundance of information provides investors with substantial assistance in underwriting purchases, which is especially comforting in times of economic uncertainty.
Why Invest Now?

Supply/Demand Cycle: Commercial real estate has pronounced supply/demand cycles, a product of the long construction lead times required to develop most properties. In wake of the Great Recession, which prompted banks to almost completely turn off the spigot of lending for new projects, commercial real estate construction is at historically low levels in the US and many other countries. That means as the global economy recovers, vacant space in existing buildings will be absorbed by growing demand without much competition from new buildings. As vacancies shrink, landlords will regain the ability to increase rents, leading to higher operating income and boosting property values.

Currently, commercial construction as a percentage of total supply is at historically low levels due to low demand in wake of the recession and the lack of available financing. New commercial space is being added at about 0.5% of supply annually, lower than any period in recent history except the early 1990s, according to Property & Portfolio Research. However, over the next few years the economic recovery is likely to push the level of demand much higher than new construction. The result is that building occupancies will increase before construction ramps up, which will enable landlords to raise rents and boost property values.

Improving Fundamentals: The US economy is growing at a healthy pace, and commercial real estate fundamentals are moving in a positive direction in all sectors. Although turmoil in the Middle East and the disaster in Japan are reminders that exogenous events are always lurking, the global economy is generally performing well. The prospect of rising interest rates, which might impact property values by pushing acquisition yields higher, loom over the market. However, to the extent that rising rates are a harbinger of a stronger economy, upward pressure on property yields could be moderated by increasing risk appetite and expectations of higher income.

United States: REITs proved their resiliency coming out of the financial crisis. With their flexible financial structure and multiple sources of capital, REITs were able to quickly access the equity and debt markets to stabilize their balance sheets. Since the bottom of the cycle, REITs have raised more than $100 billion of capital and dramatically reduced their debt levels. REITs primarily used capital raised over the past two years to pay down and extend debt, but new funds are mostly directed toward growth.

As the global economy recovers and moves into the expansion phase, public companies should be well positioned to take advantage of investment opportunities, as they have ample capital available on their balance sheets and continued access to the public markets. As of the end of 1Q11, REITs are paying as dividends an average of about 60% of funds from operations (FFO), well below their long-term average payout ratio of 80-85%. Many REITs will be forced to increase dividends to comply with regulatory

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3 Prudential Real Estate Investors.
requirements, and the payout could be even greater if earnings are strong. With access to both internal and external growth opportunities, the market is anticipating that REITs should produce better than expected earnings and a strong likelihood that dividends will increase.

Asia: Notwithstanding the repercussions from the earthquake in Japan, the leading economic indicators for Asia are generally positive, which translates into robust demand for commercial real estate among investors and tenants. Demand for office space in markets such as China, Hong Kong and Singapore is pushing rents higher. Commercial property values are rising in office markets such as Hong Kong and Singapore, as investors eye the improving rental outlook and greater liquidity.

The region’s growth in 2011 is likely to decrease to a more sustainable level. The tightening labor market is creating upward pressure on wages, while rising energy and food prices have the potential to diminish the region’s growth in the short term. Heightened inflationary expectations may prompt Asia’s central banks to step up interest rate increases or allow further local currency appreciation.

The risk premium between REIT dividends and long-term government bond yields is fairly attractive, although that will be challenged if interest rates rise as expected. Going forward, with the exception of Japan, the heightened inflationary concerns for the rest of Asia will likely prompt REIT investors to become more yield-driven. That puts pressure on REITs to deliver higher dividends, which they can do if net operating income grows at a robust rate.

Asian real estate may warrant more weight going forward for a number of reasons. The region’s strong growth has produced a cyclical upturn in demand for commercial real estate. Bank lending in the region remains conducive for borrowers. Meanwhile, property values are rising steadily, reflecting the growth in rental income and transaction activity. Acquisition yields of class-A office properties in Australia, Hong Kong and Singapore are gradually compressing. Property values are rising faster than rents at the moment, but rental increases should eventually catch up. China’s growth story remains intact, and there are signs that residential prices are moderating in response to government measures. Such stability is a positive development for the market in the long term.

Europe: Europe’s commercial real estate markets are recovering. Investment volumes are picking up, and banks continue to work through their loan books. Although it has some way to go, the rental market is also improving, in large part due to the continued lack of new development. Regulatory reforms and macroeconomic events add downside risks to the outlook. Investors remain committed to chasing secure income in the deep and liquid markets of the faster growing cities in northern Europe, which reflects an ongoing need for income security amid market uncertainty. The amount of equity targeting real estate creates a danger that pricing is getting ahead of fundamentals.

The publicly listed real estate sector has been performing moderately better than the wider equity markets, according to the European Public Real Estate Association (EPRA) index. The sector is attracting investors that are drawn to its focus on prime assets and long-term income stability. The listed sector’s volatility has been low, with the well-documented sovereign debt issues having little impact on pricing. As in the private markets, countries or sectors with supply constraints or those that are seen as prime remain in favor. At the same time, a large number of companies that have exposure to southern Europe remain heavily discounted. The flight-to-quality strategy is no doubt inspired by the uncertain outlook, regardless of sector.
**Attractive Valuations:** Currently, global real estate companies trade at a discount to net asset value. At this point in the cycle, most REITs have opportunities to grow externally by making acquisitions that are accretive to NAV and earnings. REITs continue to enjoy access to low-cost debt and equity capital. In the US alone, REITs raised more than $50 billion of debt and equity in 2010 for acquisitions, refinancing and deleveraging, according to SNL Financial.

While price-to-NAV ratios remain the most universal valuation metric for global real estate equities, in Asia the primary valuation tool for REITs is dividend yield spreads in relation to government bonds. Currently, developed Asia REIT dividend yields are attractively priced relative to government bonds. Dividend yield spreads are high for REITs in Singapore (380 bps) Japan (375 bps) and Hong Kong (335 bps), according to Bloomberg.

**Favorable Demographic Trends:** Population growth and other demographic shifts ensure that demand for commercial real estate will grow over time. The US population is set to grow by some 2.7 million people per year between 2010 and 2020, roughly the equivalent of adding a development the size of metropolitan Denver each year, according to the Economist Intelligence Unit. That projection translates into continued demand for buildings in which people live, shop and work.

Demand will grow even faster in developing nations, as a greater proportion of the population joins the ranks of the consumer class, or those with the economic wherewithal to use commercial real estate. The size of the consumer class in developing nations is projected to more than double to 865 million in 2020 from 389 million in 2010. Likewise, growth of public real estate in developing nations is expected to mushroom. Public real estate markets in developing nations are currently small or non-existent because the legal infrastructure is not yet in place. However, countries such as Turkey and Brazil have adopted or are looking to adopt REIT structures, which could provide investors with an opportunity to get in on the ground floor in markets that are forecast to have robust economic growth in coming years.

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**Inflation Hedge:** Commercial real estate has the potential to provide a hedge against inflation. Property owners benefit from increasing rents and property values when inflation rises. Many long-term leases contain built-in rent increases over time, while shorter-term leases will roll over at the current market rate. With few exceptions, bonds provide no such opportunity to increase coupon payments or principal over the life of the investment, leaving investors exposed if inflation exceeds expectations. A study by Morningstar, Ibbotson Associates found that real estate securities outperformed other asset classes during periods of high inflation, beginning in 1976.5

![Real Estate Performs Well When Inflation is High](image)

Morningstar, Ibbotson Associates

With the exception of a few red-hot economies in Asia and Latin America, inflationary pressures today are quite modest globally and are not expected to become worrisome until some of the excess capacity has been wrung out of the system. However, at some point huge increases in the supply of money and rising commodity prices will lead to higher inflation and increased interest rates. Given the current position of the real estate property and capital market cycles, commercial property should be well-positioned to serve as an inflation hedge.

**Large and Growing Listed Sector:** The value of commercial real estate in the top 55 nations globally was $23.9 trillion as of year-end 2010, and is expected to double to $46.7 trillion by 2020, with almost half the growth coming from China and the US.6 In the US, commercial real estate is the third largest asset class, representing some $6.5 trillion of market value, or roughly 12.4% of the $52.8 trillion investable universe.7

Public real estate vehicles are relatively new and growing fast. In the US, the REIT market didn’t gain traction until the mid 1990s, and many countries around the world didn’t have laws enabling the creation of public real estate companies until recent years. The market value of public real estate didn’t top $100 billion globally until 1993, and didn’t rise to $300 billion for another decade after that, according to S&P.

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5 Source: Morningstar, Ibbotson Associates. High inflation periods are calendar years when inflation was over 3% or more (1976-1985, 1987-1991, 1996, 2000, 2004, 2005, and 2007). Average annualized returns were calculated by taking the average of all 20 years. Real estate securities are represented by the FTSE NAREIT Equity REIT Index, commodities by the S&P GSCI Index, stocks by the S&P 500 Index, and bonds by the Barclays Capital U.S. Aggregate Bond Index.


7 Prudential Real Estate Investors, as of year-end 2010.
The public universe of real estate equities in developed markets encompasses more than 400 companies in 23 countries with a market capitalization of more than $825 billion, according to S&P’s Developed Property Index. When emerging markets are included, the global public real estate market encompasses more than 540 companies in 36 countries with a market capitalization of approximately $1 trillion. Listed real estate should grow especially rapidly in emerging markets, where the first wave of vehicles are now being formed and economic growth is projected to be robust. Developing nations will continue to experience uncertainty with regard to legal infrastructure and property rights, and growth can be derailed by economic events, but the general trend is toward long-term growth.

Public real estate typically involves large companies with institutional-quality assets and experienced management teams. Many have earned investment-grade credit ratings, which enables them to issue low-cost bonds. The size and scope of the market enables investors to participate in a wide range of strategies. The commercial real estate universe can be broken into components delineated by public and private vehicles that invest in equity and debt and various hybrid strategies. Public markets can add volatility, as demonstrated during the recent recession, when REIT stock price movements were dictated in part by broader equity market trends rather than the underlying value of real estate.

**Public Real Estate Sector Is Growing Globally**

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<th>Listed Property Equity Market Capitalization (US$ Bil)</th>
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S&P, Prudential Real Estate Investors Research

**Individual Investing in Commercial Real Estate**

Investing in commercial real estate requires more capital and expertise than most individuals possess, mainly because commercial properties require large equity investments and must be operated by professional managers. Public securities, however, provide individuals – even those with limited means – access to a broad range of commercial real estate.

As we have seen, public real estate securities are an attractive investment. Most importantly, they have produced solid absolute returns over an extended period while paying healthy dividends. Public markets also provide investors with diversification, liquidity and the comfort of transparency and strong governance.

Meanwhile, although investors always should be careful about timing investments, there are many reasons why commercial real estate should perform well over the next economic cycle. Property fundamentals across the globe are moving in the right direction, as supply is generally at historic lows while demand for space seems due to bounce back following the recession. The public real estate sector globally is relatively new and growing, especially in developing countries, where the institutional real estate markets are poised for rapid growth. And real estate offers a hedge in the event that rapid growth leads to higher inflation. Certainly real estate performance depends on global economic growth, which is no sure thing, but there are many reasons that public real estate presents an attractive option for investors today.
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