Prudential
Real Estate Investors

Global Real Estate Securities

Market Review | Second Quarter 2015

Region	Index Performance ($USD)[1] 2Q 2015	YTD	1-Year	3-Year	5-Year	10-Year
North America	-10.1%	-6.0%	2.9%	8.3%	13.9%	10.2%
Asia Pacific	-1.3%	2.6%	-1.0%	11.2%	11.6%	8.8%
Europe	-3.0%	3.3%	-1.3%	15.4%	14.3%	8.7%
Total Return	**-6.1%**	**-1.6%**	**0.9%**	**10.4%**	**13.1%**	**9.4%**

Market Review

A Market Disconnect

We still believe that real estate securities offer a compelling investment opportunity around the globe. When it comes to pricing REITs, the markets can be very inefficient. About 85% of the world's real estate is private and 15% is in the public market. Private real estate fundamentals will drive the value of the underlying real estate in REIT portfolios, not stock prices. At various points in the cycle, the equities market tries to apply technical analytics to forecast stock values. However, these "strategists" are ignoring the basic fundamentals of supply and demand. When is the last time you heard a real estate broker quoting a "head and shoulders pattern" or a "double top" for housing prices? Today, there exists a disconnect between stock prices and underlying real estate values.

REIT values are derived by an assessment of the real estate assets in the portfolio and future cash flow growth. The property values are determined by the private market and the cash flow growth is influenced by economic variables driven by local market fundamentals. Because many of these private market data points are not readily available to the "Street," tacticians are utilizing deficient data points to reach an investment conclusion. This disparity can lead to pricing anomalies and compelling investment opportunities. Recently, some of this technical market sentiment has been expressed through the ETFs. The weight of the money flows from these investors is not inconsequential. Today, ETF's represent approximately 30% of the US REIT market; however, outflows YTD from the ETF's represents 60% of the total sector outflows. REIT ETFs are significantly more volatile investment vehicles (no surprise) than other investors.

A Wall of Institutional Capital

Through the end of 2Q2015, values in the US institutional real estate market are up about 6%[2]; however, the US REIT market is down -6%. Over 60% of the companies in our US REIT universe trade at a discount to their underlying real estate values (NAV)[3]. There is a wall of capital on the sidelines to be invested in real estate. Firms managing closed-end and private real estate funds have a record $254 billion in dry powder available, up 37% from December 2014[4]. The majority of this capital, over $133 billion, is focused on the US markets. During the second quarter of this year, 62% of funds reached or exceeded their target size. There are an additional 415 private real estate funds in the market competing for institutional investment seeking an additional $150 billion in capital. Institutional investors have "backed up the truck" and are looking to get into real estate around the globe. Globally, REIT markets are down or moving sideways. The institutions represent a vast majority of the market and are the determinant of real estate values.

A Worry of Interest Rates

So, what is causing this divergence between stock prices and underlying values? In the US, concerns over rising interest rates have pushed REIT correlations with bonds above historical levels. A series of rate increases that are disconnected with economic growth would be detrimental to real estate values. While rates are projected to increase at a "measured" pace, the Street has been primed by the Federal Reserve that these bumps will be "data dependent" and nominal in nature. We are not in the era where we anticipate a protracted series of future increases. In the short-term, rising bond yields will likely result in a negative market reaction and somewhat lower share prices. However, in a growing economy, increasing demand driven by job growth, and measured new supply, has often resulted in increasing real estate values. This confidence in rising values is reflected in the abundant institutional capital flows to the sector.

A Look at Fundamentals

Declining real estate values due to the market expectations for rate increases in the current macroeconomic environment is counter to the direct real estate fundamentals: 1) supply is still limited and increasing rates will serve to further diminish new supply; 2) there is abundant capital in queues and on the sidelines to invest from both domestic institutions and foreign capital sources to purchase real estate assets in the U.S.; 3) tenant demand for new space continues to outstrip new supply; and 4) real estate returns are very competitive and look attractive versus equities and bonds. The imbalance between supply and demand may signify continued REIT cash flow growth and higher corporate earnings.

Many of the public REITs are in an excellent position to increase earnings, dividends and asset values given: 1) low payout ratios; 2) stellar balance sheets; 3) improving economic fundamentals (restrained inflation); 4) lack of major new supply pipelines in most institutional markets coupled with increasing demand. Additionally, many of the industry analysts and investors have already priced in rising interest rates into their valuation models. Granted, we do not expect to continue a period of excess returns due to cap rate compression, but values in the REIT market seem evident.

We project that we are at the beginning of the M&A cycle due to the confluence of a number of variables: 1) some REITs are cheap relative to private market valuations; 2) bifurcation in the REIT market between "Haves" and "Have Nots" - the latter group are companies ripe for consolidation or privatization; 3) abundance of debt and equity capital; 4) low cost of debt and equity capital. Fitch recently speculated that there could be 30-40 LBOs in the next few years. While magnitude of these projections may be a bit optimistic, we anticipate that when deals are announced, they are typically at premiums of 15%-20% above current stock levels.

A Market Opportunity

Over time, the performance of the REIT market will be driven by the underlying real estate fundamentals of the properties and management of the company balance sheets. We believe that the current market correction and the divergence between real estate stock prices and underlying real estate values represents an attractive opportunity to build long-term positions in the REIT market.

EXHIBIT 3: US SECTOR P/NAV[6]

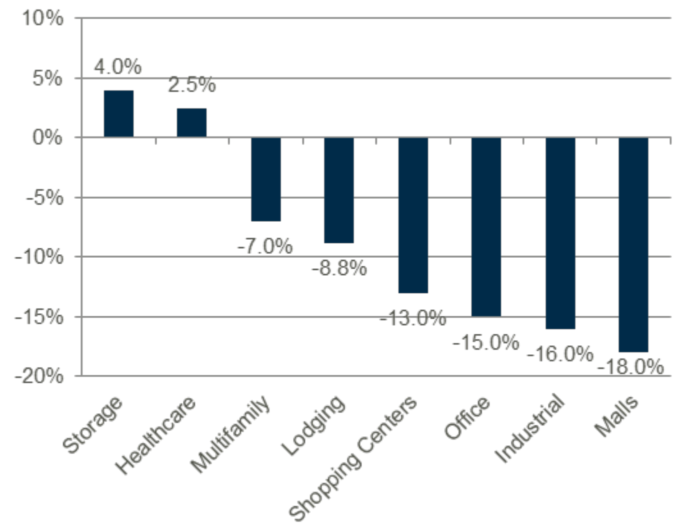
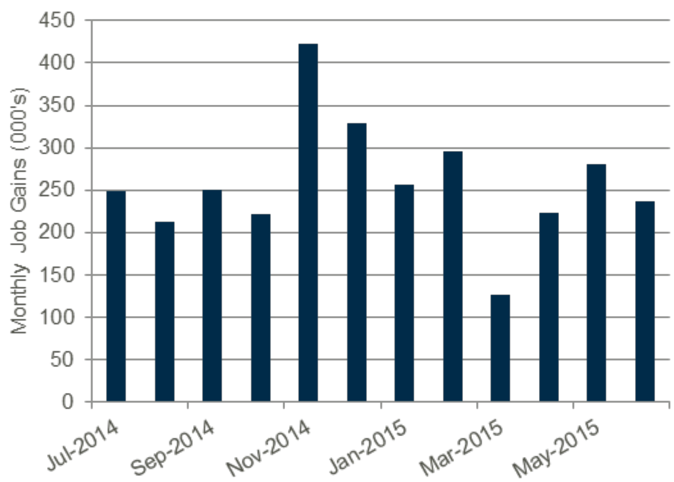


EXHIBIT 4: MONTHLY GAINS ('000) FOR OFFICE/NON-OFFICE USING JOBS[7]



United States

Market Review

US REITs delivered a -10.5% total return in the second quarter of 2015[5]. Despite real estate fundamentals remaining strong, investors continue to focus on the impact and timing of interest rate increases. Investors, however, appear to be classifying REITs as a yield only investment in their haste to sell first and ask questions later and seem to be assigning little or no value to the cash flow growth characteristics of real estate investments. REIT investment characteristics are hybrids of stocks and bonds with yield + growth features. We are at the point in the real estate cycle where landlords have pricing power and rent growth exceeds inflation in most property types and geographies in the US. This, combined with little additional supply, should lead to cash flow growth from REITs above historical averages.

The economic backdrop remained favorable for REIT fundamentals in the second quarter of 2015, with the economy averaging approximately 233,000 jobs per month, a slight deceleration from last year's second quarter average of 268,000 jobs. Year to date jobs growth has averaged 214,000 compared to 222,000 for the same period last year. The level of jobs growth continued to create ample real estate demand to absorb vacancies and create pricing power in a growing number of property types and markets. However, it was not so much that it created material supply additions, with the exception of apartments, select industrial markets and select hotel markets. REIT aggregate occupancy remains near peak levels at 94.4% at the end of 1Q15, down slightly from a year ago[6]. Office and industrial remain the only property sectors below record levels. New supply, while trending up, hovers near historical lows at 1.1% of existing supply compared to a historical average of approximately 2%. Additionally, REIT dividend payout ratios remain near historical lows at 74% versus a long term average of 81%, providing the potential for double-digit dividend growth again in 2015.

Small capitalization REITs outperformed large capitalization REITs by 300 basis points in the second quarter as the valuation gap between small and large cap REITs that we identified in our first quarter 2015 report begins to narrow. Year to date, small cap has outperformed large cap by 150 bps. We still believe small and mid cap REITS appear relatively attractive in 2015. Growth outperformed value for the quarter as well as year to date. We would expect cash flow growth to continue to be highly valued by investors; however, we are distinguishing our investments by focusing on growth at reasonable prices and sticking to a value discipline versus chasing growth at any price.

REITs continued to take advantage of the availability and relatively low cost of capital. REITs issued $29 billion in equity and debt capital so far in 2015. The pace has slowed considerably in the second quarter considering the increase in equity cost of capital as REIT share prices have moved lower.

We are now on track to reach similar levels of capital issuance as last year[7]. With REIT balance sheets in good shape, the majority of equity issuance is focused on funding acquisitions, funding re-development pipelines and funding development pipelines. REIT development pipelines currently aggregate $42 billion and position REITs well to deliver additional mid-cycle growth.

Fund flows from US individual investors were negative in the second quarter at approximately -$4.7 billion of net flows, including those from exchange traded funds. Fund flows from Japanese investors into US focused real estate funds were strong at $1.8 billion[8].

The best performing sectors during the quarter were the apartment, self-storage and hotel sectors. Apartment, self-storage and hotel fundamentals continue to improve as the economy further expands and landlord pricing power increases. Year 2015 apartment and self-storage company guidance for earnings growth was well received by investors and 2015 mid-quarter updates indicate continued strength.

The healthcare and net lease sectors were the worst performing sectors during the quarter. These companies trade at premiums to their real estate net asset value and have long term interest rate sensitive leases. Additionally, they rely on a low cost of capital to fund acquisitions and maintain their cash flow growth rates.

Market Outlook

In the 6th year of an elongated economic cycle, REITs continue to improve operating fundamentals and are again poised to deliver double-digit dividend and high single digit cash flow growth in 2015.

From a relative valuation perspective, REITs ended the quarter trading at a 13% discount to their underlying real estate value, well below the historical average premium of 2%[9]. Implied cap rate spreads of REITs relative to the 10-year Treasury remain wide at roughly 370 bps[10]. That level of spread provides REITs with a cushion if interest rates increase, as spreads could contract without any deterioration in real estate value. Additionally, REIT cash flow multiples are slightly higher than the S&P 500 multiple, an attractive level relative to the 2010-2013 period and to where we are in the cycle.

REIT occupancies and rental rates are expected to continue to improve in 2015. At this point in the cycle, we would expect the majority of revenue growth to come from rental growth versus occupancy gains. Supply is expected to remain muted in most markets and property types, with the exception of apartments, industrial and select hotel markets. Employment centers that focus on technology, healthcare, and media/entertainment are expected to deliver relatively strong jobs growth. We continue to monitor markets that are dependent on government employment and expect to see some improvement in market conditions later in 2015. Markets that are dependent on the financial sector also continue to improve in 2015. We are underweight energy related markets as the impact of lower oil prices weighs on demand and keeps private real estate investors on the sidelines. We are seeing an impact in hotel revenue growth in energy dependent cities like Houston where revenue growth has turned flat to down. We have not yet seen a material negative impact in apartment rents in Houston, but we are seeing some moderation and continue to monitor current rent trends for signs of weakness.

With a dividend yield of 4.1% and estimated earnings growth of 6-8% in 2015, REITs are poised to deliver a consensus return of approximately 11%, assuming no expansion or contraction in the earnings multiple. However, given continued economic concerns, volatility spikes remain likely.

As we get deeper into the real estate cycle, we expect more of a stock pickers market in the back half of 2015. Given the uncertainty around the direction of interest rates and global economic growth, we would expect that sector rotation or large sector bets could be tempting but not likely to consistently pay off for investors. We will focus our strategy on picking the best names within sectors.

Additionally, we will not chase cash flow growth at any price and remain focused on a disciplined value investment approach. We believe M&A and privatization activity will heat up, in spite of Macerich's rejection of Simon's bid, as we are coming off $21 billion in deals in 2014, the highest level since 2007. We are in an environment where Net Asset Value matters and discounts are likely to get resolved or arbitraged. There continues to be a wall of private real estate capital focused on acquiring high quality US real estate. The US REIT market provides a nice shopping list for those investors. During the quarter, one of our large overweight positions, Home Properties, announced it was selling itself to private equity firm Lone Star Capital. Media reports also indicate that another of our large overweight positions, Parkway Properties, is pursuing strategic alternatives including a sale of the company.

We are positioned to focus on companies with strong relative internal cash flow growth and select re-development and or development opportunities that trade at reasonable valuations relative to their private market value. In many cases, we are finding companies with undervalued re-development and development pipelines. We have increased exposure to high quality shopping center companies and storage as revenue trends remains favorable.

Europe[11]

Market Review

The European public real estate market returned 3.4% (USD gross total return) in the second quarter, despite a sharp pull-back in May and June. European equity markets and the listed real estate sector rallied strongly following the European Central Bank's January quantitative easing announcement. Share prices climbed dramatically until late April, when they suddenly went into reverse as the German 10 year government bond yield rocketed from a low of 7 bps to nearly 100 bps over only a few weeks.

Currency movements significantly dampened returns in the eurozone over the first half of the year. The euro fell from 1.22 to 1.11 against the USD in the first six months of the year. The GBP, despite falling sharply against the dollar to mid-April, finished the first half of the year almost unchanged.

Italy was the best performing European market with a USD total return of 12.1% through June, though its size in the European index is very small. The UK (+8.9%), Spain (+8.4%), Switzerland (+7.3%), and Ireland (+6.9%) all followed closely behind.

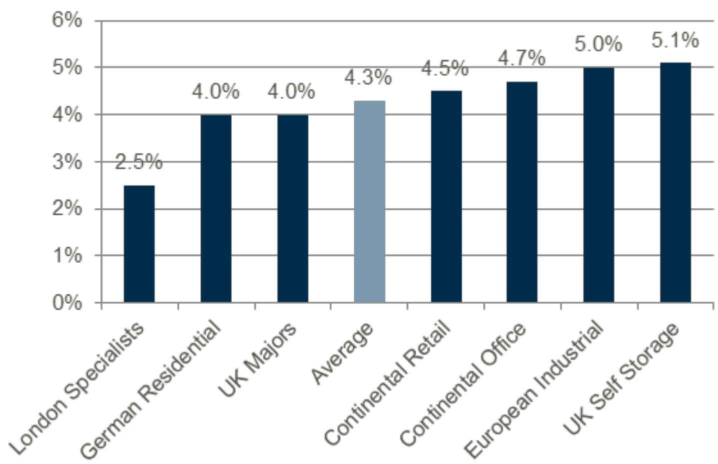
Though the UK did not benefit from the ECB quantitative easing announcement and experienced a brief period of uncertainty around the May election, its economy and real estate market continue to perform extremely well. Spain has seen definite improvement in its macroeconomic figures and its commercial real estate rental market has stabilized, but rental growth evidence is still very limited. The surprise revaluation of the Swiss currency against the euro in January was primarily responsible for lifting returns in this market. Dublin's office and residential markets maintained their position as the best performers in Europe against solid demand and scarce new supply.

Performance was certainly more mixed across European markets in the first half of 2015 with many markets showing negative total return: Finland (-10.4%), Belgium (-7.1%), the Netherlands (-6.0%), Sweden (-3.1%), Germany (-2.7%) and Austria (-2.7%). While all eurozone countries were clearly in positive territory in 1Q15 following the ECB QE announcement, the positive momentum could not be sustained once bond yields started to move back up from the end of April.

Market Outlook

The pace of the rally in European equity markets this year in 1Q15 surrounding the ECB's quantitative easing announcement in January was very surprising, pricing in a high degree of future cap rate compression and rental growth while discounting potential risks. The loosening of credit and monetary policy designed to combat deflationary trends has already pushed up financial asset prices significantly, drovecore government bond yields dramatically lower for a while and intensified the search for yield in Europe. The large scale of asset purchases planned by the ECB over the next two years, combined with the still significant amount of foreign and domestic capital seeking real estate yield, is expected to result in further cap rate compression across the wider Eurozone.

EXHIBIT 5: EUROPE SECTOR/COUNTRY IMPLIED CAP RATES[12]



However, the persistent Greek crisis that is again taking center stage at the moment demonstrates the potential for external risk factors to emerge and knock the support from underneath demanding valuations. We expect a period of greater volatility to prevail for some time until a final outcome on the Greek crisis is clear, though obviously odds on Greece staying in the euro are getting longer. Despite the potential for short term volatility and market corrections, we see little risk of wider contagion and systemic collapse in the eurozone this time around from a Greek euro exit. Peripheral bond yields have moved in significantly over the last two years as these counties have implemented reforms and their economies have responded. The ECB has powerful tools in place that it is ready to use if any signs of wider contagion appear.

From a real estate perspective we would look through short term market volatility and focus instead on the fundamental health of the core European real estate markets both outside and inside the eurozone. If anything, this crisis will cause interest rates to stay lower for longer within the eurozone, extending the positive conditions for owning real estate further.

Asia Pacific

Market Review

Asia Pacific equity markets saw mixed fortunes in the second quarter. In US dollar terms, Hong Kong developers rose 8.8%, while Japanese developers fell 4.1% and Singapore developers declined 0.1%. As for REITs, both the S-REITs and J-REITS posted negative returns in the quarter, -1.5% and -5.2% respectively[12]. Perhaps the highlight for the quarter is China's stock market, whereby the Shanghai market rose 38% between April and mid-June, only to correct 17% in the second half of June and end both the month and quarter up 14%. The Hang Seng Index in Hong Kong also enjoyed the roller coaster ride. It rose by 14% in April before correcting 8% in May and June, ending the quarter with a net increase of 5%[13].

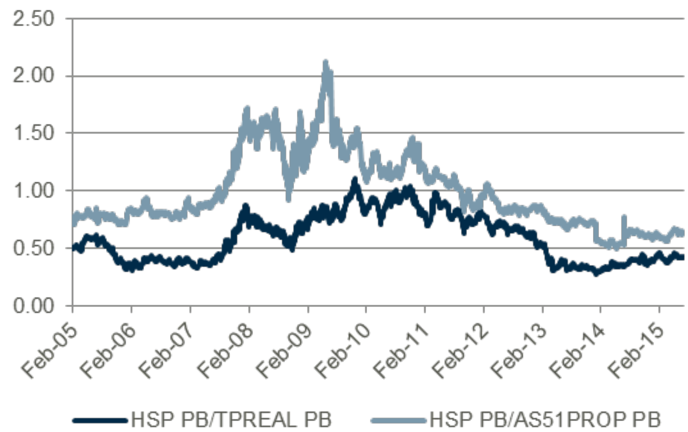
For the second quarter, there were a few themes in the Asia Pacific region that had significant bearing on the region's equity markets. First is the monetary easing by the central banks in a bid to reinvigorate the various economies to achieve better growth, specifically Australia, China and South Korea.

China cut the interest rate twice in the second quarter - 25bps each (and four times since November 2014 totaling 115bps), and reduced the banks' reserve requirement ratio (RRR) by 150bps (100bps in April and 50bps in June). The lower interest rate environment, coupled with the lower down-payment requirement for housing, is expected to have a positive impact on the residential market going forward. Indeed, more easing measures are expected, and that will create a more conducive environment for potential home buyers to enter the market.

A lower interest rate is also beneficial to Chinese developers, who are either repairing or ramping up their balance sheets. More interestingly, a new avenue (or an alternate funding option) has arisen for corporate China in the form of crowd-funding. Dalian Wanda Group (parent of Dalian Wanda Commercial Properties) successfully raised RMB5 billion (USD 805 million) within a day from a crowd-funding scheme conducted in June 2015. Additionally, China's market liquidity is impressive; stock market daily turnover in both Shanghai and Shenzhen, exceeded US$300 billion in May and the first half of June, which is almost thrice that at the beginning of the year.

The second theme, office leasing activity, is seeing meaningful improvements during the quarter. Of note is the pick-up of leasing demand in key markets such as Hong Kong, Singapore and Tokyo. In Hong Kong, Citibank Plaza is achieving more than 90% occupancy, up from 80% just a few months ago, thanks to demand from new tenants. The Singapore new office buildings such as the CapitaGreen and South Beach are seeing more than 90% leasing commitments, a positive sign leasing demand is improving. In Sydney, a fair number of significant leases were signed and more importantly, tenants are upsizing rather than moving towards smaller leases. Twitter quadrupled its space in GPT/CHC's 2 Park St (to 2,000sqm), while Navitas leased 24,000sqm in Investa's 255 Elizabeth St, some 35% larger than their initial requirement. LLC also announced leasing in Barangaroo (12,700sqm in Tower 1), with the precinct now 66% committed (with completion towards the end of 2016 or early 2017). Lastly, in Tokyo, the central 5 wards continued to see rental improvements in April and May against the backdrop of declining vacancies.

EXHIBIT 6: PRICE TO BOOK (HONG KONG/JAPAN, HONG KONG/AUSTRALIA)[13]



Finally, retail spending appears to be following the path of the Chinese tourists away from Hong Kong to Japan. Tourist arrivals from mainland China have been negatively impacted by the limitation of visits by Shenzhen's permanent residents to once a week compared to an unlimited visit pass previously. Mainland outbound demand has been re-directed to Japan, which has witnessed a 45%[14] year over year increase in tourist arrivals for the first five months of this year, benefitting from cheaper yen. This momentum appears to be accelerating with the number of Chinese tourists rising 134% in May. Of significance is China's tariffs reduction on popular imported consumer goods such as apparels, shoes and skin care products, by an average of more than 50%. This move appears to be the government's effort to bring home some of the spending that has gone offshore.

On Japan, besides the improving office market, the macro headlines reported in the June quarter were also enlightening. Private sector machinery orders (a leading indicator of capex) grew by 2.9%[15] year over year in March, better than the consensus growth of 1.8%. Household spending in May expanded by 4.8% year over year[16], above the consensus of growth of 3.6%, an indication that consumer spending is recovering.

Market Outlook

In an environment of monetary easing and abundant liquidity looking for a home, we expect cap rate compression to continue, particularly for Australia, Japan and possibly China. Foreign appetites for assets in Australia remain strong with several Singapore and Chinese companies turning to Australia for higher yields. In China, easier access to financing, such as crowd funding, would lower the cost of capital for developers with positive implications on cap rates.

From a valuation perspective Hong Kong stands out as the market with the cheapest valuation, relative to its historical trading band as well as its regional peers. It is also our belief that policy easing of the equity market and property sector by the Chinese government would underpin the re-rating of Hong Kong equities (especially names with exposure to China). Within Hong Kong, we like the office landlords for its favorable supply demand dynamics.

Disclosures

[1]S&P Developed Property Gross Total Return Index, 30-Jun-2015.

[2]Green Street Advisors, Commercial Property Price Index, 7-Jul-2015.

[3]Prudential Real Estate Investors. 31-May-2015.

[4]Preqin, 3-Jul-2015

[5]US REITs total return taken from MSCI US REIT Index (RMZ). As of 30-Jun-2015.

[6]Citi. As of 30-Jun-2015.

[7]Citi. As of 30-Jun-2015.

[8]Evercore ISI. As of 30-Jun-2015.

[9]ISI. As of 30-Jun-2015.

[10]Citigroup. As of 30-Jun-2015.

[11] All performance data appearing in this “Europe” section is sourced from the S&P Developed Property Gross Total Return Index and regional constituent indices. The country returns quoted below in this section are quoted from the individual country indices within the S&P Developed Property Index using gross total returns (ie S&P United Kingdom Property Index, etc.). Investors cannot invest directly in an index. Please see end of document for index definitions.

[12]Bloomberg. As of 30-Jun-2015

[13]Bloomberg. As of 30-Jun-2015

[14]Japan National Tourism Organization

[15]Japan Cabinet Office

[16]Family Income and Expenditure Survey

Disclosures

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Data shown in the narrative section of the report is presented on a gross net. Data for property companies is drawn from the S&P BMI Global Property Total Return index, various regional and country-specific sub-indexes. Data on the equities market is drawn from S&P BMI Global Total Return index, various regional and country-specific sub-indexes. The S&P Global Indexes include both developed and emerging markets.

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The S&P Developed Property Index is a free-float weighted index comprised of public real estate companies in North America, Asia and Europe that meet certain free-float market capitalization, trading volume and other criteria. The Developed Property Index excludes emerging markets. The return series is calculated daily using both gross and net cash dividends reinvested. Cash dividends are normally applied on the ex-date of the dividend. Net return reinvested is reflective of the return to an investor where dividends are reinvested after the deduction of withholding tax. The net index excludes foreign withholding taxes. The tax rate applied is the rate to nonresident institutions that do not benefit from double taxation treaties.

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