

## Market Perspective

### Executive Summary

- Although capital remains readily available and relatively inexpensive for a broad range of commercial real estate investment opportunities, the volatility in the debt markets stemming from the collapse of the subprime mortgage market is beginning to affect borrowing costs and terms.
- U.S. REITs continue to struggle to find support among dedicated and non-dedicated investors. After falling sharply in 2Q07, REITs are trading at deep discounts to net asset value (NAV), and yields have moved higher. However, the risks remain weighted to the downside in the near term.
- Commercial space market fundamentals in most sectors and markets remain healthy. However, tenant demand for most types of commercial property has weakened somewhat due to the recent slowdown in the U.S. economy.
- Despite weaker tenant demand, private commercial real estate performance has been surprisingly strong this year thanks to the booming transaction market. Barring a shock to demand in the second half of 2007, average total returns this year for the NCREIF Property Index (NPI) may even surpass last year's results.

### Introduction

The U.S. commercial real estate market weathered another quarter of heightened volatility and uncertainty in the capital markets in 2Q07. As aftershocks from the collapse of the subprime mortgage market earlier in the year continue to reverberate through the debt markets, lenders and investors have become increasingly wary of risk and, evidently, most things “real estate.” Although capital remains readily available and relatively inexpensive for a broad spectrum of commercial real estate opportunities, increased risk aversion and higher benchmark interest rates have reduced liquidity at the margin and have raised the cost of capital throughout the industry.

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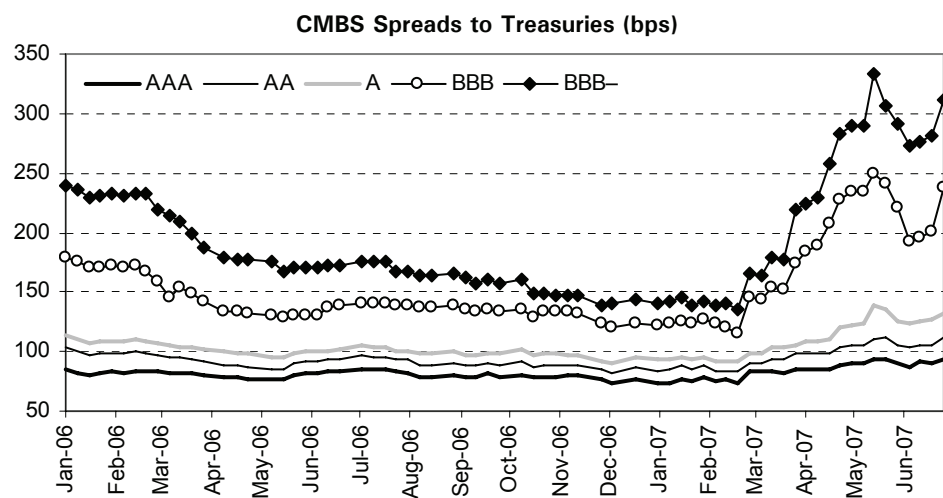
For the most part, capital market conditions have changed only at the margin so far. Buyers can still raise large sums of capital relatively quickly and efficiently, as the thinning ranks of the public REIT market readily attest; and healthy space market fundamentals should continue to support asset pricing in the near term. But with higher capital costs and rent growth likely to slow over the next few years as the real estate cycle matures, the risk that asset prices will overshoot and future returns will disappoint clearly has increased, especially for inferior-quality assets and properties in secondary markets. The following commentary updates our outlook for the U.S. commercial real estate market over the second half of 2007, based on trends and events in the real estate capital and space markets since the year began.

## Debt Markets

For the first time in years, **the commercial real estate debt markets became somewhat less liquid and less accommodating to borrowers during 2Q07.** Soaring subprime mortgage delinquencies, along with rising home foreclosure rates and the near-meltdown of two large hedge funds, exacerbated and confirmed fears that the fallout from the struggling U.S. housing market will be more severe and widespread than expected. The fallout has already upset the debt markets, which are trying to work through the crisis while digesting a massive amount of paper financing rampant M&A activity and, thankfully, a decent amount of investment spending by businesses. These events have lowered investors' appetite for risk, which, at the very least, makes the capital markets more vulnerable to further shocks.

While the full effects of the subprime collapse will not be known for some time, **increasing risk aversion on the part of investors has been transmitted relatively quickly to the commercial real estate debt markets through the CMBS and CDO markets.** The spread widening in the CMBS market that began in late February continued throughout most of 2Q07, especially in the lower-rated investment-grade tranches (BBB and BBB-), where demand from CDO issuers had caused spreads to tighten significantly. According to Morgan Stanley, BBB- spreads jumped in May to their widest levels since 2000 before narrowing slightly before the end of the second quarter.

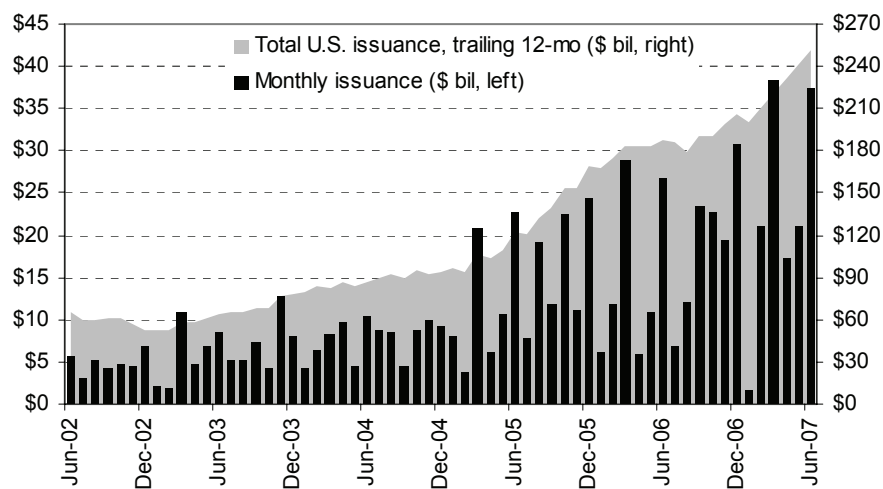
### Investors Are Demanding Higher Yields



Source: Morgan Stanley Fixed Income Research

The impact of the wider spreads on the overall CMBS market has been fairly modest so far, partly because the tranches that have been most affected form a relatively small piece of the capital stack. While wider spreads have eroded profits for CMBS issuers, continued investor demand for senior investment-grade CMBS has kept issuance from easing much. **Despite slowing in April and May, CMBS issuance remained on record pace in the first half of 2007.** According to *Commercial Mortgage Alert*, more than \$190 billion in new CMBS were issued globally in the first six months of this year, nearly 60% higher than the previous record of \$120.3 billion issued in the first half of 2006. Domestic and non-U.S. volumes both soared to record levels. U.S. issuance rose more than 50% to \$137 billion, while non-U.S. issuance jumped 75% to \$55 billion.

**CMBS Issuance Remains on Record Pace**



Source: Commercial Mortgage Alert

**Although global volume this year is still expected to top last year's record \$297.9 billion, new issuance will likely slow over the second half of 2007.** The CMBS market is already seeing evidence of more discipline, which should take some froth out of the market. The credit rating agencies are examining their models, partly in response to sharp criticism over the CDO debacle; and at least one of the major agencies, Moody's, has indicated it will require increased credit enhancement for newly issued CMBS to compensate for the steady deterioration in commercial loan underwriting standards in recent years. The rating agencies have downgraded billions of dollars worth of residential mortgage-backed bonds, but upgrades continue to far outnumber downgrades in the CMBS market.

**Additionally, B-piece investors have re-emerged recently as agents of discipline.** In May, B-piece buyers kicked out a handful of loans deemed too risky from at least one securitization. Several years ago, before their ranks swelled with hedge fund investors and CDO issuers, B-piece buyers wielded considerable power in the securitization process. Their ability to kick out loans provided some level of accountability for originators who strayed too far out on the risk curve, since any loans removed from a CMBS pool would wind up back on the originator's balance sheet. As demand for unrated paper increased, however, kick outs became increasingly

rare, until they finally disappeared altogether. Encouragingly, kick outs appear to be back, at least for now.

**Signs of renewed discipline in the CMBS market have created both a need and an opportunity for lenders to tighten underwriting standards.** Lenders are under considerably less pressure today, and, therefore, are less willing to write 10-year interest-only loans (I/Os). Although I/Os are still common, they increasingly adjust to amortizing loans after the initial I/O period (typically five years). Likewise, lenders are becoming more conservative when underwriting property cash flows. Until fairly recently, lenders were willing to base interest coverage ratios on speculative future cash flows, which allowed borrowers to obtain higher proceeds in anticipation of improving property and/or market fundamentals. For now at least, more lenders are basing their underwriting on actual cash flows.

**While it appears liquidity may have finally peaked for this cycle, it would be premature to declare that the recent changes in the commercial real estate debt markets mark a reversal of fortune.** Traditional lenders continue to have an appetite for commercial property. Space market fundamentals remain quite healthy across all major property types, and commercial loan delinquencies are extremely low. In fact, anecdotal evidence suggests traditional lenders (e.g., insurance companies) view the recent spread widening in the CMBS market as an opportunity to regain some of the market share they lost to conduits in recent years.

The near-term outlook for the debt markets may depend as much on sustained demand from borrowers as it does on the still-uncertain fallout from the subprime turmoil. **Stricter underwriting standards and more discipline in the CMBS market may reduce demand at the margin. But the bigger dampening effect may come from the higher cost of debt since the year began.** Although long-term interest rates have retreated from their peaks in early June, when the 10-year Treasury yield climbed to about 5.3%, long-term rates have increased since the year began, and they remain volatile. At the end of 2Q07, the 10-year Treasury yield was hovering around 5%, about 30 bps higher than at the start of the year. With initial yields for commercial property at very low levels and long-term rates rising globally, opportunities for positive leverage are becoming increasingly scarce.

Over the longer term, a slowdown in the debt markets should be a positive development for the commercial real estate industry as a whole, since it would likely extend the current market cycle by tempering new supply and discouraging riskier investments generally. **More importantly, a deceleration at this point, before any real signs of distress in the commercial markets, would provide pretty convincing evidence that the transparency of the public markets is working.** If the misfortunes of the residential markets provide enough warning about the risks that accompany excess capital and poor underwriting to avert a similar crisis in the commercial markets, the asset class will have delivered on its promise to “not make a mess of things the next time around,” at least for now.

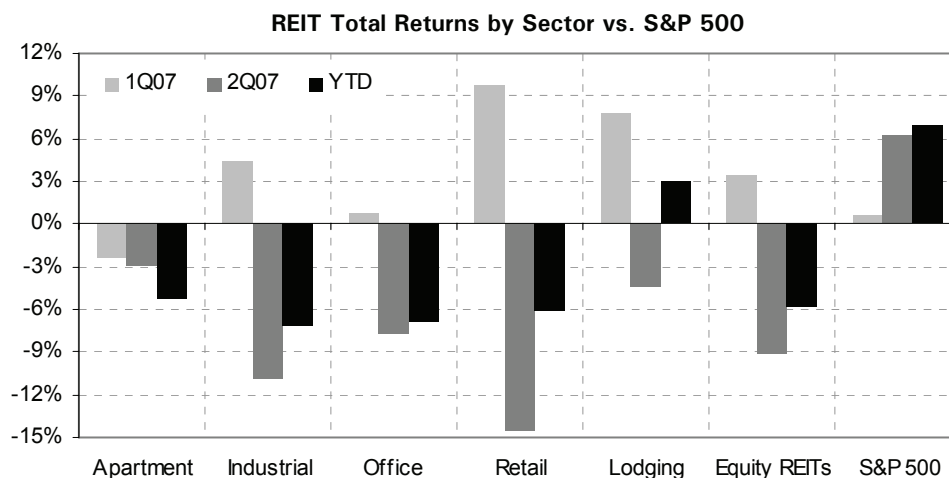
## **REIT Market**

Despite continued improvement in space market fundamentals in most major property types and across most markets, and an unprecedented volume of transactions validating current asset

values across the country, REITs have continued the slide that began in February, just before the closing of Blackstone's \$39 billion buyout of Equity Office Properties. At the REIT market's February peak, equity REITs held a commanding lead over most broad market indexes, with a 13%-plus average total return. Since then, however, REITs have stumbled, falling far behind the broader market. **After plunging more than 9% in June, the FTSE NAREIT Equity REIT Index ended the first half of the year with a dismal -5.9% total return, well shy of the 6.3% and 4.4% total returns for the S&P 500 and Russell 2000, respectively.**

All property sectors have struggled this year. Midway through 2007, apartment REITs held a narrow lead over all major property types, despite being the only major sector with negative total returns in the first and second quarters. The -5.2% average total return for the apartment sector at midyear was more than enough to overtake retail REITs, which gained nearly 10% in 1Q07 before tumbling 14.6% in 2Q07 to finish the first half of the year with a -6.2% average total return. Office and industrial REITs also finished in negative territory at midyear, with total returns of -6.9% and -7.1%, respectively. In fact, only two sectors of the REIT market, specialty and lodging, managed to post gains in the first half of 2007.

#### Dreadful Second Quarter for Equity REITs

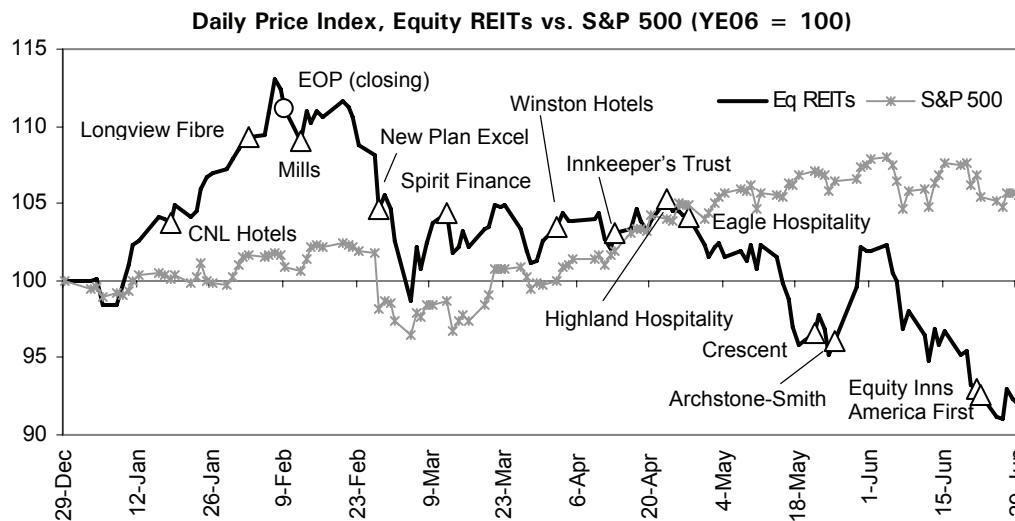


Sources: NAREIT; Bloomberg

**M&A is at least partly responsible for the positive year-to-date returns in the lodging sector.** So far this year, two non-traded lodging REITs, five public lodging REITs, one formerly public lodging REIT (privately held Extended Stay America) and Hilton Hotels, an operating company, have all agreed to be acquired by private capital sources. While the premium prices that the public lodging companies have commanded and rumors that almost every remaining hotel REIT may be in the crosshairs of private buyers have continued to support share prices in the lodging sector, the flurry of deals has only managed to slow the decline in the overall REIT market this year. Equity REITs, particularly apartment companies, rallied after the \$26 billion deal for Archstone-Smith, the second-largest apartment REIT, was announced in May. But the rally faded quickly as long-term interest rates began to rise in June and the prospects for continued M&A appeared to diminish.

As expected, **REIT share prices remained volatile in the second quarter.** The FTSE NAREIT Equity REIT Index rose or fell by 1% or more on 27 of the 63 trading days in 2Q07, including six days when the Index moved 2% or more. The S&P 500, by contrast, rose or fell by 1% or more just nine times, none of which involved a one-day move of 2% or more. While M&A activity likely accounts for some of the volatility in the REIT market this year, increased volatility in the bond market probably explains most of it. All but four of the days when the REIT market moved by 1% or more during 2Q07 came in May and June, when the 10-year Treasury bond was most volatile.

#### M&A Rallies Have Been Short-lived at Best



Sources: FTSE NAREIT; Bloomberg; SNL; Prudential Real Estate Investors

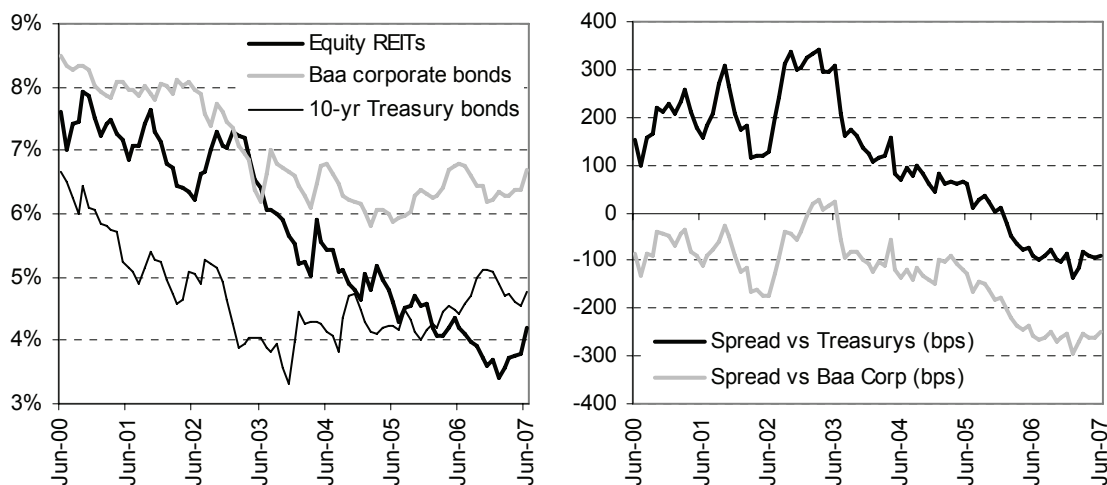
The volatility and underperformance of the REIT market this year highlight the formidable headwinds that U.S. REITs face despite favorable space market conditions and strong investor demand for investment properties. Although REIT M&A activity shows no signs of ending, concerns that the subprime mortgage crisis will stifle further deals in the REIT market have likely caused some investors to place their bets elsewhere for the next privatization. **Likewise, REITs continue to suffer from guilt by association with the struggling housing market.** The subprime issue has elicited extensive commentary and analysis from the mainstream media and financial press that, unfortunately, often fails to distinguish between the commercial and residential markets.

The effects of the negative sentiment toward real estate are impossible to quantify, but it certainly has not helped to have equity REITs lumped in with homebuilders or mortgage REITs. **While commercial real estate clearly will feel some adverse effects from the housing-induced slowdown in the economy, fears that the commercial market is on the same trajectory as the residential market ignore obvious differences between residential and commercial space market fundamentals.** Most importantly, unlike the residential market, which saw housing starts soar from 2000 to 2006, new supply of commercial space has been very modest since tenant demand collapsed in 2000. Commercial development has accelerated recently, but tenant demand should continue to outpace supply over the next few years.



The bigger problem for U.S. REITs may be that the sector has lost support among dedicated and non-dedicated investors – not entirely, but at the margin. Increasingly, dedicated REIT investors are looking overseas for higher growth and a broader opportunity set. The interest in foreign property stocks, particularly in developing REIT markets, may not have caused an outflow of capital from the U.S. market. But it compounds the current lack of enthusiasm for REITs among non-dedicated investors, where REITs appear to be in limbo between investor constituencies. **REITs have lost their appeal with growth and momentum investors, who see less opportunity for continued multiple expansion and potentially slower earnings growth in two or three years. However, they are not cheap enough yet to get the attention of value investors.** Although the steep decline in REIT share prices in June pushed REIT dividend yields back above 4% at the end of the second quarter, REIT yield spreads versus Treasury and corporate bonds remain near historic lows.

**Equity REIT Yields Are Still Relatively Low**

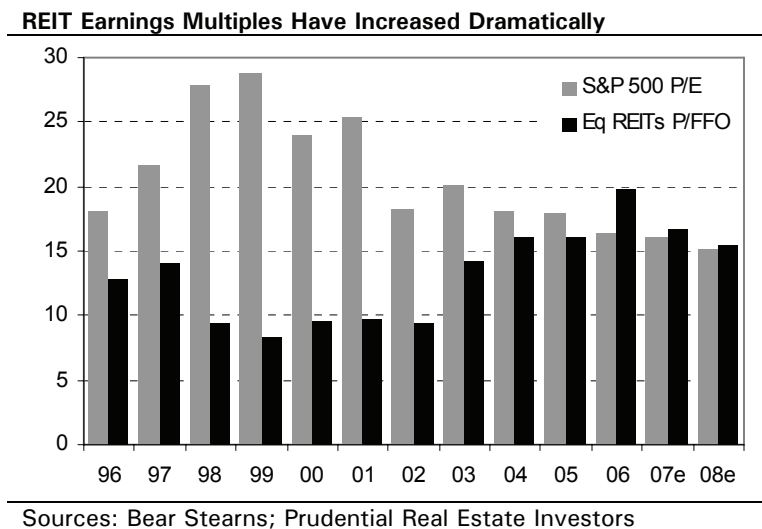


Sources: NAREIT; Federal Reserve; Moody's Economy.com

The near-term outlook for the U.S. REIT market will depend on whether or not REITs can restore some of the investor enthusiasm that has been missing recently. **From a pure real estate perspective, REITs appear cheap today, particularly after the June sell-off.** According to Green Street Advisors, equity REITs were trading at an average 9.9% discount to net asset value (NAV) at the end of the second quarter, well below their long-term average 4.8% premium to NAV since 1994. With commercial space market fundamentals still very healthy and a significant amount of private capital searching for investment properties, the steep discount to NAV should be a catalyst for more privatizations and stock buybacks over the second half of the year, both of which should provide a lift to REIT share prices.

However, even with more M&A and aggressive share repurchases, REITs face an uphill battle in closing the gap with the broader market before year-end. As the two-year bear market in REITs from 1998 through 1999 made abundantly clear, investor sentiment does not change easily, even when markets overshoot. Moreover, **while REITs may look relatively cheap compared with commercial property in the direct (private) market, they still appear fairly expensive relative to many stocks based on historic metrics.** Most notably, REIT earnings multiples have

increased dramatically since 2002, when REITs were trading at about 10x funds-from-operations (FFO). Last year, and at the peak of the market in early 2007, REITs were not only trading at record high multiples (about 20x), they were trading at a slight premium to the price-earnings ratio for the broader market.



While the broad re-pricing of commercial real estate that has occurred globally over the past few years and the favorable cyclical position of the U.S. property markets justify higher multiples for U.S. REITs, the premium to the broader market makes REITs more sensitive than usual to changes in earnings growth rates and expectations. REITs should continue to generate above-average earnings growth in 2007, and should outpace earnings growth in the broader market over the next year or two. However, **with REITs trading at a higher multiple than the broader market, the risks are skewed to the downside. If REIT earnings growth falls short of expectations or if growth in the broader market exceeds expectations, as in 1Q07, the REIT market will have a hard time winning back investors.**

As always, it is impossible to predict with any confidence where REITs will actually end the year. However, with a -5.9% average total return in the first half of the year and few catalysts, other than M&A, likely to drive REIT share prices significantly higher, it looks very unlikely that REITs will deliver the 12% to 15% total returns we initially forecast for 2007. **Continued strength in the private transaction market should provide a floor beneath REIT valuations over the near term. However, it now appears that equity REITs will substantially underperform private real estate and will struggle to achieve positive returns this year.**

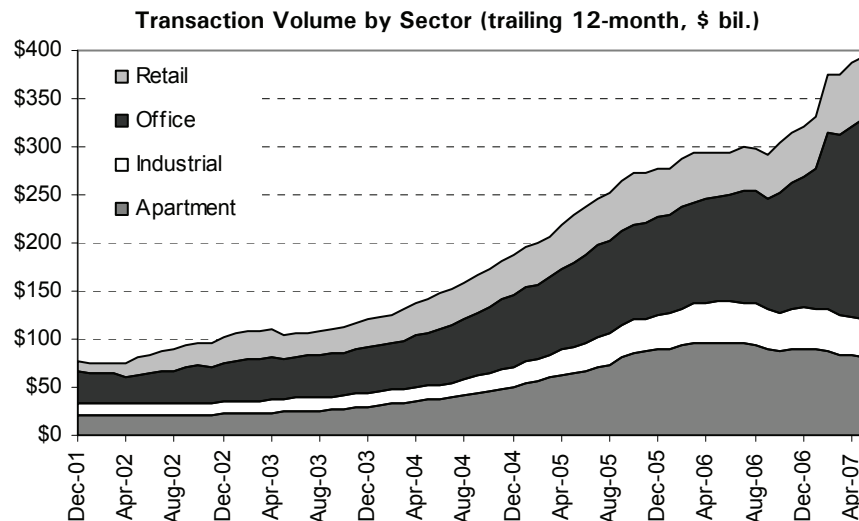
### Property Markets

Space market fundamentals continued to improve in most major sectors in the first half of 2007. While the improvement was broadly distributed geographically, it was far from uniform. Across all major property types, however, more markets are healthy than weak, and vacancy rates generally are stable to improving. Transaction volume remains very strong but is still dominated by megadeals. According to Real Capital Analytics (RCA), year-to-date volume through May



soared to nearly \$190 billion, a 60%-plus increase over total volume in the first five months of 2006. The Equity Office privatization and subsequent sales and re-sales of the former REIT's assets are responsible for much of the growth in volume, which increases the risk that total transaction activity could slow sharply, particularly if troubles in the debt markets make privatizations and large portfolio deals unattractive.

#### Transaction Activity Continues Apace



Source: Real Capital Analytics

It remains to be seen whether the recent rise in long-term rates and tighter underwriting standards will cause transaction volume to slow in the near term. But with a massive pipeline of announced deals and rumors of a new wave of REIT privatizations, there should be more than enough activity to sustain transaction volume through the end of 2007 and probably well into next year. That does not mean, however, that sellers will continue to hold all the cards when negotiating with potential buyers. **Although few seem willing to acknowledge it, deals increasingly are falling apart before closing over financing issues or are being re-traded.** Higher interest rates are almost always cited as the cause, regardless of whether the prospective buyer is using much or any leverage. So far, the discounts have been relatively small, and asset values have continued to climb, just not as quickly as they might have otherwise. Quality assets in all sectors still attract very competitive bidding, but certainty of closure is becoming more important.

Most of the transaction activity this year has been in the office sector, of course. In fact, excluding the \$112 billion in office deals in the first five months, year-to-date total volume is only about 5.8% higher than last year, according to RCA. The hugely successful EOP privatization highlights the depth of capital searching for regionally specific deals in the one to several billion-dollar range, particularly for quality, stabilized office assets, the kind that EOP, Reckson, Arden, CarrAmerica, Trizec and all the other office REITs that have been privatized held in their portfolios. **Surging transaction volume has produced an instantaneous mark-to-market for the entire office sector and a nearly nationwide write-up in valuations that will likely have a big impact on the performance of office portfolios and private market benchmarks like NCREIF.**

The strong investor demand that has been driving the competitive bidding is largely a function of the sector's attractive space market fundamentals. According to preliminary data from Torto Wheaton Research (TWR), vacancy rates continued to fall in 2Q07 in most major markets. The average vacancy rate across the 57 markets in their coverage universe has declined roughly 70 bps since last year to 12.4%. Notable exceptions included Orange County, where a high concentration of subprime lenders caused vacancy rates to rise, and other metropolitan areas where the housing downturn is pronounced – e.g., Las Vegas, San Diego and all six Florida markets. At the other extreme, a handful of markets will see rent spikes before supply and demand regain their balance. Midtown Manhattan, where the average vacancy rate has fallen to just 3.8%, has emerged as the poster child for investor optimism that rent spikes will more than compensate for today's low cap rates. Rising rents and limited availability of large blocks of space appear to be shifting some demand to neighboring markets and sub-markets.

Although office development is picking up, high construction costs and tighter lending standards should keep new supply from accelerating too quickly, especially in downtown markets. More of the projects in the pipeline today are “green,” or are being built to some LEED (Leadership in Energy and Environment Design) certification standard. If energy prices remain at their current levels or continue to rise at a faster rate than overall inflation, anything that is not built to green standards today could face much higher cap ex and/or exit cap rates than otherwise similar but green buildings.

With new supply still a year or two away in most major markets, office properties should enjoy solid NOI growth over the next few years. However, investors must be very careful with underwriting assumptions, particularly about rent growth and exit cap rates. Today's low cap rates are a function not only of the low-interest-rate environment in recent years, but also of the above-average rent growth that should occur over the next few years. It's hard to know where interest rates will be in five or seven years, but it seems unlikely that the outlook for NOI growth will be as robust a few years hence, which means exit cap rates should be higher.

**The weak housing market remains the biggest near-term challenge for the U.S. economy and, therefore, the biggest risk in the favorable outlook for commercial real estate.** Though it's not yet clear if the housing market is playing a significant role or not, the apartment sector is one of the major property types where space market fundamentals have weakened somewhat over the past several quarters. Apartment vacancy rates have increased modestly since last year, which is surprising given the decrease in the homeownership rate since it peaked two years ago. Apartment transaction volume is also down this year, although that should change when the Archstone-Smith deal closes later this year. According to RCA, \$29 billion in apartment deals closed through May, about 22% lower than last year, when condo converters were winding down their activity.

However, apartment cap rates and unit prices have held up well, presumably due to the positive supply-demand fundamentals. Although rent growth has already slowed in many markets, particularly where the effects of eliminating concessions have burned off, supply remains modest, in part because development yields offer little reward for the additional risk. As in the office sector, investors must use caution when underwriting rent growth and exit cap rates,

especially in markets where the shadow vacancy from the condo market could erode tenant demand and pricing for traditional rental apartments.

**Although concerns about the potential effects of the weak housing market on consumers continue to cast a shadow over the retail sector, retail transaction volume is higher this year than in 2006, and pricing has remained firm.** Total retail volume through May was nearly double last year's volume, according to RCA. The pricing trends in the private market contrast sharply with those in the public REIT market, where the steep decline in retail REIT share prices has increased speculation that one or more public retail REITs will be privatized before the end of the year. While more M&A is certainly possible, opportunities are not terribly constrained in the retail sector today. A lot of retail product is on the market, and development continues at a fairly robust but healthy pace.

**The outlook for retail properties over the next few years depends on how consumers weather the housing market downturn and other challenges, including high energy costs.** Retail sales and consumer confidence have been volatile this year, with surprises on the upside and downside from month to month. The housing market is clearly affecting retail sales in certain categories and for certain retailers – home furnishings and building supplies, for example. But for the most part, the consumers who have been hurt worst by the housing market slump, subprime borrowers, account for a small share of total consumption. In fact, most retailers are doing fairly well despite weaker sales growth this year, and retailer bankruptcies are very rare. If the housing market downturn worsens dramatically, which would have broad implications for the overall economy, consumer spending could very well fall. But **as long as the economy continues to add jobs, retail sales growth should remain healthy enough to support tenant demand and asset values.** That said, with the breadth of opportunities in the retail market today, investors can afford to be more selective, which should lead to greater differentiation between quality markets and assets and inferior ones.

The favorable outlook for consumer spending and retailers should be welcome news for the warehouse market. Supply narrowly outpaced demand in 2Q07, according to preliminary data from TWR. Although the national average industrial vacancy rate ended the second quarter about 40 bps lower than at the same time last year, vacancy held steady at 9.3% in 2Q07. Tenant demand continues to grow, but at a slower pace than in past years. As in the office sector, warehouse space market fundamentals have weakened somewhat in markets where housing has slowed sharply. But the bigger near-term challenge is new supply, which, as is usually the case in the warehouse sector, has kept pace with demand.

**Investor enthusiasm for warehouse properties still seems to be running a little ahead of tenant demand.** Excluding the privatization of former industrial REIT Centerpoint Properties in the first quarter of last year, industrial transaction activity through May increased nearly 8% year-over-year, according to RCA. And with several large portfolio transactions likely to close in the second half of 2007, total volume this year should be very healthy. However, capital pressures may be driving new supply too quickly at this point in the economic cycle. At the very least, **current supply levels probably mean that the warehouse sector is more sensitive than usual to a slowdown in the economy.** While a sharp slowdown does not appear imminent, at

today's low yields, investors must pay special attention to supply trends and, for that matter, replacement costs. If replacement costs fall, industrial supply and demand fundamentals can change quickly.

**As the M&A activity in the first half of this year readily confirms, investors have also continued to devote considerable attention to the lodging sector, where supply-demand fundamentals are about as healthy as they have been since the peak of the last cycle.** Supply growth remains very modest, and occupancy rates are generally at or near their early-2001 levels, though they vary by market and segment. This is especially true in the upscale and luxury end of the market and in urban locations, where average occupancy rates were in the low 70s in May (per Smith Travel Research). From an operational perspective, however, the hotel cycle has probably peaked. Average daily rates (ADRs) and revenue per available room (RevPAR) are expected to grow more slowly this year than in recent years. Smith Travel Research forecasts a modest deceleration in RevPAR growth in 2007 to 5.3% from 7.7% last year, largely due to a similar slowdown in ADR growth.

**Even though hotels should continue to perform well until new supply increases or demand contracts, as we noted last quarter, it's getting pretty late in the hotel cycle to be acquiring fully priced assets.** Hotel operating and capital expenses will likely continue to increase at an above-average pace in the near term, if only because travelers' patience for deferred maintenance at current room rates is understandably thin. More importantly perhaps, **recent data shows some evidence of potentially weaker demand from leisure travelers.** Resort occupancies dipped slightly in May, and RevPAR has been materially weaker than for business-oriented hotels. It's too early to say for certain whether the weakening is a trend, but at today's pricing, any softening of demand poses a risk. **With hotel assets trading at rich valuations in the private market and most lodging REITs trading at steep discounts to NAV, the public market may offer the most attractive near-term opportunities for investors looking for exposure to the lodging sector.**

The outlook for the U.S. housing market and for consumers may also have implications for the self-storage industry. **Self-storage space market fundamentals appear to have weakened somewhat since this time last year. However, operating fundamentals remain healthy.** According to Self Storage Data Services (SSDS), median occupancy declined about 200 bps year-over-year to 90% in 2Q07, and concessions became more widely available. But asking rents and average rents per occupied square foot both rose. New supply may be partly to blame for the modest deterioration in occupancy. According to *Self-Storage Almanac*, although the total number of self-storage facilities increased just 4.5% in 2006, total square footage grew 12.4%. This year, however, new starts are down sharply versus 2Q06, according to SSDS.

While it is not yet clear exactly how the slowdown in the housing market will affect demand for self-storage, operating data from the public self-storage REITs show weakening fundamentals in markets where housing is struggling, particularly in Florida and Southern California. **So far, the modest weakening in self-storage space market fundamentals has not affected pricing for Class-A facilities. According to SSDS, average cap rates for Class-A properties are holding steady at 6.5% to 7%.** However, weaker demand for Class-B and Class-C facilities could cause

cap rates for inferior-quality assets and facilities in secondary markets to drift higher over the second half of this year.

Although final results for the NCREIF Property Index (NPI) in 2Q07 are not yet available, it appears increasingly likely that private real estate performance this year will not moderate from last year's healthy pace, as we initially expected. Last year, the NPI delivered an average total return of 16.6%, well below the 20.1% total return in 2005 but still very robust for unleveraged core real estate. **The surge in transaction volume this year, especially in the office sector, produced surprisingly strong gains in the first half of the year, and with numerous large transactions still pending, private market returns should easily exceed the 9% to 12% range we forecast at the start of 2007.** While the ongoing volatility and uncertainty in the debt markets could cause transaction volume to slow in the second half of the year, we now expect the NPI will deliver a total return of 15% to 18% this year before moderating in 2008.

### Closing Thoughts

Midway through 2007, it looks as though private commercial real estate in the U.S. will deliver another year of outstanding results for investors in most property types and markets. Although new supply is increasing and tenant demand has moderated as the U.S. economy has slowed, strong capital flows into the asset class continue to drive asset values higher as investors look forward to strong NOI growth over the next few years. While private capital flows show no sign of abating any time soon, the capital market environment has changed since the year began. Higher long-term interest rates and volatility in the capital markets have reduced liquidity at the margin and have increased the cost of capital. So far, these changes do not appear to be affecting demand or pricing for private real estate investments. However, if they persist, they may exacerbate one of the bigger challenges that commercial real estate faces today: after years of exceptional performance and rising asset values, commercial property is no longer attracting capital purely on the basis of its relative attractiveness versus other asset classes. While private real estate should continue to attract capital from investors seeking to build or enhance strategic allocations to the asset class, liquidity has probably peaked for this investment cycle.







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