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The Credit Crunch of 2007: Opportunities in Commercial Real Estate Debt

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Introduction

The dynamics of commercial real estate capital markets have changed for good. Gone are the days of cheap debt, high leverage and lax lending terms. In August of 2007, global financial markets seized up. Seemingly overnight, investors became highly risk averse and interest rates on a variety of assets, including asset-backed commercial paper, inter-bank lending, commercial mortgage-backed securities (CMBS), collateralized debt obligations (CDOs) and investment grade and high yield corporate debt rose sharply relative to the risk-free rate on US Treasury bills.

At the epicenter of the current financial crisis was the fallout from the US subprime residential mortgage market. Increasing subprime delinquency rates led to the sudden realization of the risk in these assets. This ballooned into a seizure in financial markets globally. Securities backed by subprime mortgages were so widely held that when they showed signs of distress, the credit markets froze, hurting other bonds as well. Even though the upheaval was concentrated in the US residential market, Wall Street also tightened its purse strings on commercial real estate.

Financial markets have experienced major dislocations in the past, but the scale of this credit market seizure appears virtually unprecedented. This crisis is not confined to a single debt vehicle, but has spread across almost all debt instruments. Despite repetitive liquidity injections by the Fed, credit spreads remain wide, with no signs of relief. No one knows for sure where the broader fixed income and real estate capital markets will end up. But if history is any guide, the current crisis should come to an end after a period of credit market adjustment and the US and global economies, global financial markets, and commercial real estate debt markets should normalize once again.

In this report, we look at the current fallout from the US subprime mess. Current conditions are assessed across the broad financial markets. A more focused analysis of conditions in the commercial real estate debt markets, both public and private, is also provided. This is followed by an analysis of past financial crises, with parallels drawn to the current state of the global capital markets. In order to gain some insight, an historical retrospective of the two most recent financial crises are presented.

Next, dislocations in the broader debt markets are highlighted with an assessment of any mis-pricing of debt, especially commercial real estate debt. Real estate capital markets, similar to the broader fixed income markets globally, are undergoing a major transition. Does this provide opportunities for investors? If past is precedent, investors may shun any risky asset class during episodes of financial market distress. But as the turmoil passes, investors will be quick to take on risk once more. For commercial real estate debt investors, the key will be the state of the global economy, real estate fundamentals, and appropriate yields. In the final sections of this report, RREEF's latest view on the prospects for the global economy and real estate markets will be presented. Concluding remarks and implications for investors will follow.

The Debt Markets in Perspective

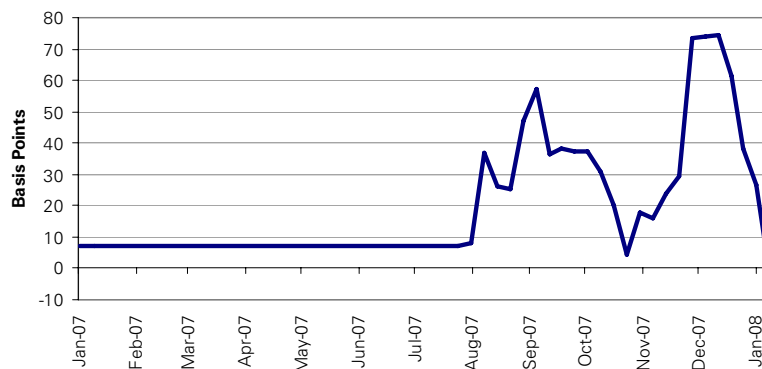
Benchmark Yields

The liquidity crisis of 2007 significantly reduced the supply of debt and increased risk premiums throughout global financial markets. Short-term debt spreads to policy rates widened in all major markets and CMBS issuance nearly stopped. The housing downturn and ensuing credit market turmoil continues to threaten the global economy. This has resulted in monetary policy easing around the world.

In this section, we provide a comparison between LIBOR - the interest rates banks charge each other - spreads over regional benchmark rates. A high LIBOR raises banks' cost of funds and thus the rates they charge borrowers. LIBOR is also an indicator of banks willingness to lend to counterparties. While LIBOR spreads were at levels well above historical averages in both September and December, recent central bank intervention and the Fed's implementation of a Term Auction Facility (TAF) has allowed liquidity to return to the market and spreads to come down.

US: The Federal Reserve's recent 75 basis point emergency fed funds rate cut has dropped its policy rate to 3.5%, down 175 basis points since September 2007. The financial markets, though, remain fragile. The 30 day dollar-denominated LIBOR spiked in August and September, and then again in December. The implementation of the TAF injected much needed liquidity into the market and allowed the LIBOR spread to drop back to a level more inline with historical norms. The spread between LIBOR and the Fed Funds rate has typically been less than 20 bps.

Exhibit 1
USD 30-Day LIBOR Spread Over Fed Funds Rate



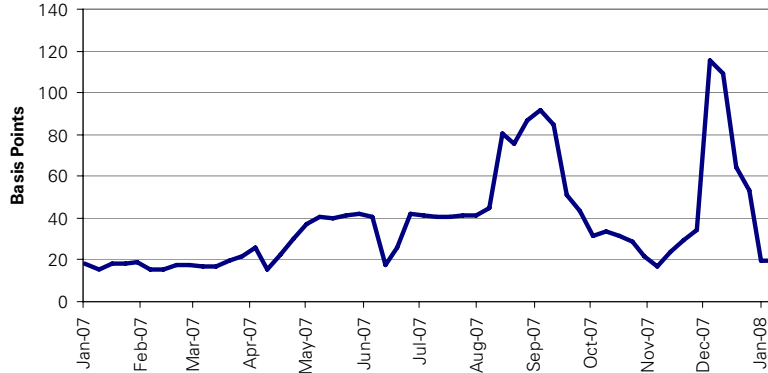
Source: Economy.com, Bloomberg and RREEF Alternative Investments

UK: The UK experienced solid economic growth in 2007, prompting the Bank of England (BoE) to raise the Official Bank Rate (OBR) to 5.75% in August. As the subprime meltdown in the US spilled over to the UK economy and similar threats to growth surfaced, the BoE cut its policy rate by 25 basis points in the first week of December to its current 5.5%. We expect another 25 basis point cut in both the first and second quarter of 2008; however, inflationary pressures are expected to keep the BoE from easing monetary policy further.¹ The 30 day pound-denominated LIBOR spread over the OBR experienced similar trends, albeit more dramatic, to that of its US counterpart,

¹ George Buckley, "UK Review & Outlook: You Can't Choose Your Relatives" Deutsche Bank Global Markets Macro Research, January 18, 2008.

spiking in September and December. While the spread over the benchmark remains high, it has come down from the peak levels experienced in December as liquidity has returned.

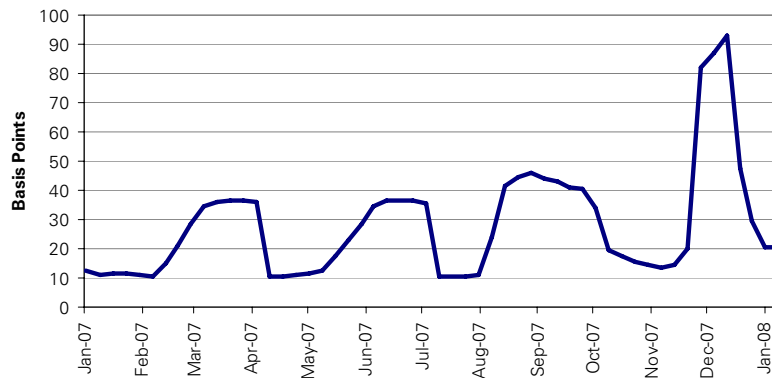
Exhibit 2
GBP 30-Day LIBOR Spread Over Official Bank Rate



Source: Bank of England, Bloomberg and RREEF Alternative Investments

Eurozone: The ECB has raised its policy rate 100 basis points over the past twelve months, due to concerns over inflation in a strong economic growth environment. The current market turmoil has not prompted a rate cut as of yet; however, we expect a 25 basis point cut in both the second and third quarter of 2008.² The Eurozone witnessed the sharpest increase in its regional inter-bank lending rate, the Euribor, in December, with the spread over the REFI rate widening to about 90 basis points. The return of liquidity back into the market allowed the Euribor spread to come down significantly over the past month; however, it remains elevated as compared to its trailing 10-year historical average of about 13 basis points.

Exhibit 3
EUR 30-Day LIBOR Spread Over REFI Rate

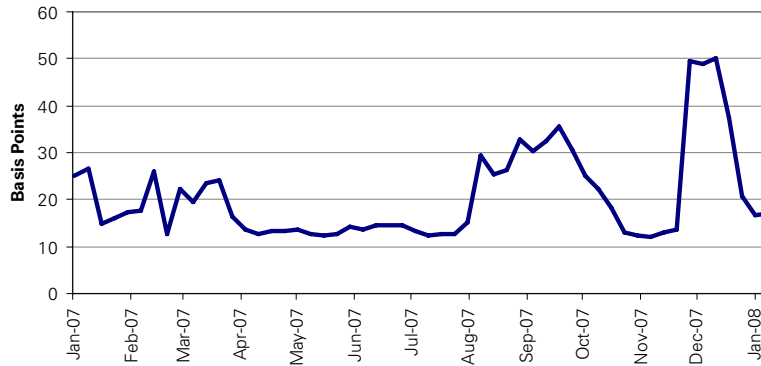


Source: European Central Bank, Bloomberg and RREEF Alternative Investments

Japan: Local financial markets have been relatively immune to the subprime crisis, but Japan has not escaped unscathed. Similar to the other industrialized economies, the 30 day yen-denominated LIBOR spread over the Benchmark Rate spiked in September and December. Reaching a high of only 25 basis points in December, the Japanese LIBOR spread experienced the mildest increase of the industrialized economies.

² Thomas Mayer, "Focus Europe - ECB: Starting to worry about growth?" Deutsche Bank Global Markets Macro Research, January 18, 2008.

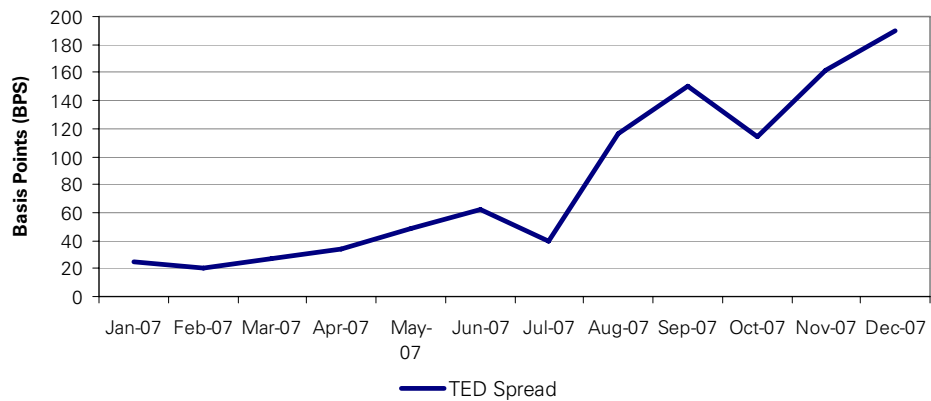
Exhibit 4
JPY 30-Day Libor Spread Over Benchmark Rate



Source: Bank of Japan, Bloomberg and RREEF Alternative Investments

Despite improvements in LIBOR spreads globally, TED spreads remain wide. The TED spread is a global barometer of financial market risk, measuring the difference between 90 day Eurodollar and US Treasury rates. This spread has ballooned over the past six months, up from its normal level below 50 bps to 190 bps. The renewed widening in the TED spread provides evidence of increased risk premiums and overall greater concern about risk worldwide.

Exhibit 5
TED Spread YTD



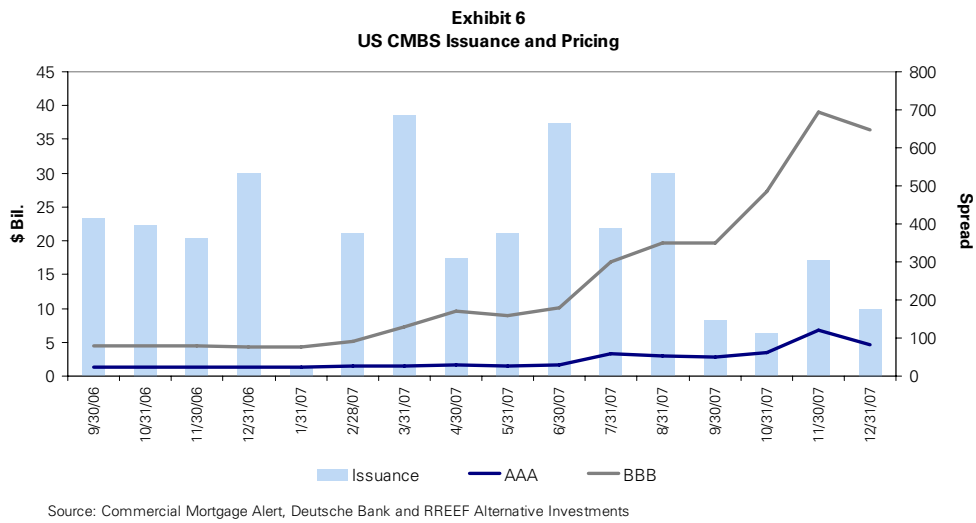
Source: Economy.com and RREEF Alternative Investments

Real Estate Debt Markets

The CMBS Market

Global credit market troubles that emanated from the US subprime market are also spilling over into the commercial real estate debt markets. CMBS spreads worldwide are up considerably over the past six months and issuance has dried up in some areas. There is a lack of capital in the market which makes some spreads theoretical as transactions have stalled. Current market prices are, in some cases, estimates of what the market-clearing price might be. An overview of the US, UK, Eurozone and Japanese CMBS markets is provided below.

The US was a pioneer in the development of CMBS. The nation has the most established and mature real estate debt market in the world with issuance volumes as high as the rest of the world combined. CMBS spreads started to move out in the US months before they did in the UK and Eurozone. Since August, CMBS issuance has virtually shut down in three months and spreads have headed up across all grades of debt. BBB pricing has witnessed the sharpest increase in spreads, as the traditional buyers of this product (including hedge funds) have exited the market. In some recent offerings, below investment grade tranches and even AAA rated tranches have not been able to sell. Current pricing for the AAA rated tranche is around 85 basis points over swaps, while the spread on BBB tranche is trading at roughly 650 basis points over swaps.



The CMBS market in the UK and Eurozone has effectively come to a halt as investors fail to differentiate between the CMBS and troubled RMBS markets, despite healthier underlying fundamentals in commercial real estate. Despite widening spreads across the risk spectrum, issuance has ceased over the past two months as issuers are not willing to accept current pricing levels investors demand. This supply and demand mismatch makes current pricing levels theoretical and we believe a market-clearing price would reflect a jump in spreads of a similar order of magnitude as that seen in the US.

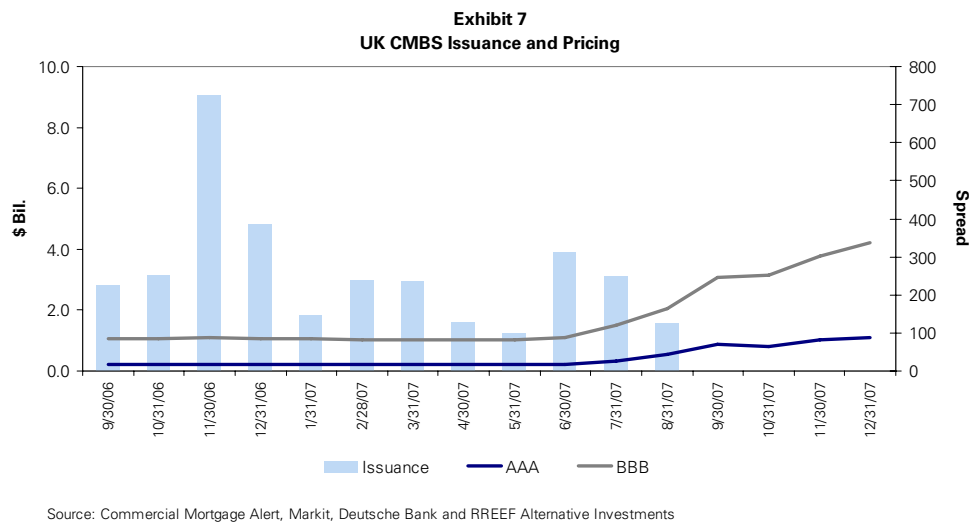
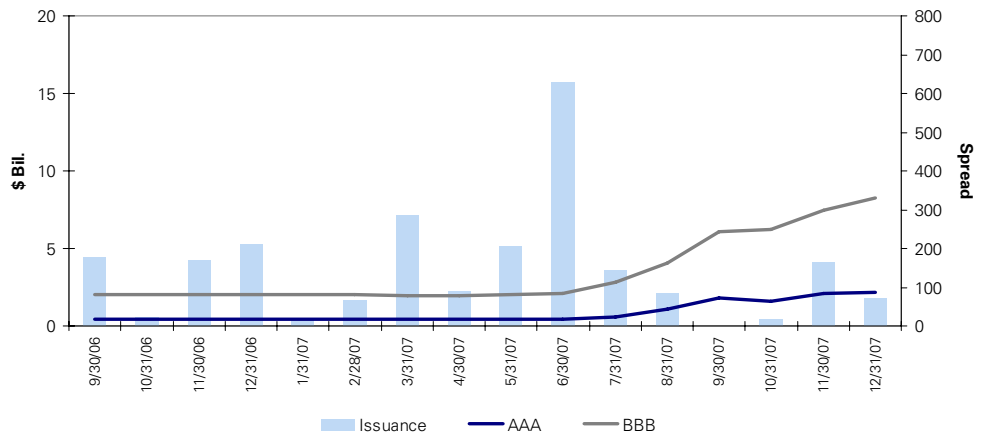


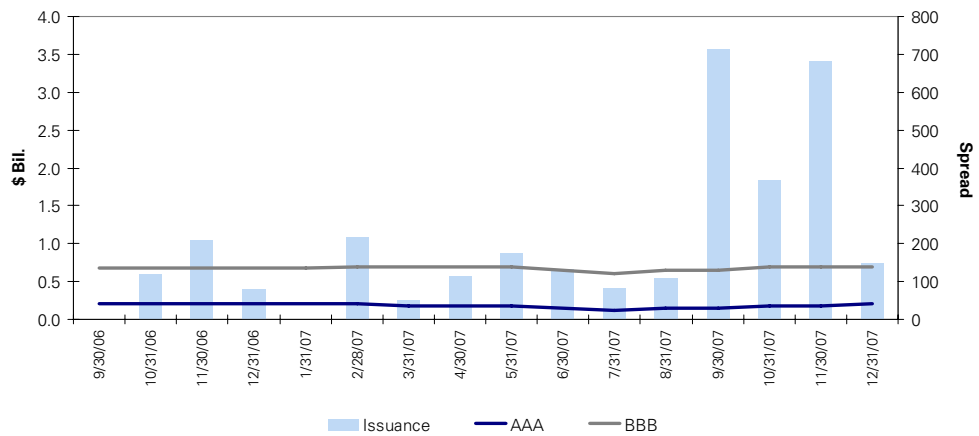
Exhibit 8
Other European CMBS Issuance and Pricing



Source: Commercial Mortgage Alert, Markit, Deutsche Bank and RREEF Alternative Investments

The Japanese CMBS market has been less impacted than the US or European markets. Real estate lending in Japan is characterized by low LTVs. There is a lack of a well-developed primary or secondary CMBS market, since the buy side is dominated by long-term investors. Spread widening has been modest to date. Less disruption in pricing has allowed for continued issuance in Japanese CMBS throughout the recent market turmoil; however, it is unlikely that Japan will remain immune to the increased spreads elsewhere.

Exhibit 9
Japanese CMBS Issuance and Pricing

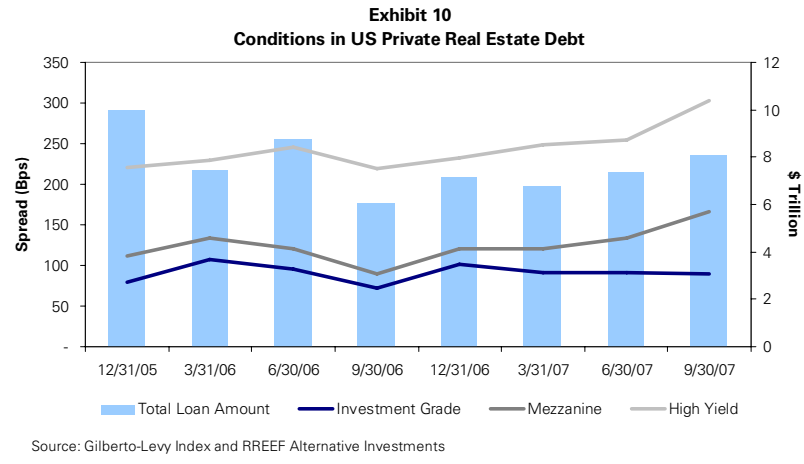


Source: Commercial Mortgage Alert, Deutsche Bank and RREEF Alternative Investments

The US Private Debt Market

The volatility in US private real estate debt pricing appears less dramatic than that of public real estate debt. This is partly due to the underlying collateral typically being a single-asset - versus the pool of assets dominant in public offerings - which allows for more realistic and conservative underwriting. In addition, the private debt investor is an on balance sheet investor, dominated by life-insurance companies, intending to hold the loans long-term. In contrast, the public market structure is driven by volume where originators and securitizers bundle loans and sell off the risk, collecting fees along the way.

As private debt is held by a more sophisticated investor pool with a better understanding of the collateral value there is an inherent lag in spread adjustments as compared to the public market. Over the past year, pricing of investment grade (LTV < 70%) private debt has remained relatively flat at around 100 bps over the 10 year Treasury. The mezzanine (70% < LTV < 80%) and high yield (85% < LTV) tranches, however, did experience some widening in the third quarter of 2007. The spreads on all private real estate debt are likely to move up further over the coming months to reflect comparable public market pricing.



In the next section, we compare current conditions in the fixed income markets to two past financial crises. This includes the S&L crisis of the late 1980s and the Asian financial crisis starting in 1997. In each case, TED and high yield spreads before and after the crisis are presented.

Past Financial Crises

As presented in the overview section, the global credit market is responding abruptly to the collapse of the US subprime mortgage market that began in August of 2007. How does the current crisis compare with past financial crises? As displayed in Exhibit 11, the global economy has witnessed a number of financial crises in post-war history. In each of the past episodes, while investors experienced short-term losses, the cyclical financial problems were resolved over time either naturally or through swift policy response by the monetary or government authorities.



Understanding the history of previous financial crises and their subsequent resolution can provide insight into today's crisis.

Past events, including the US savings and loan (S&L) crisis and the trifecta of the Asian financial crisis, Russian sovereign bond default, and the near-collapse of US hedge fund Long Term Capital Management (LTCM), evinced certain common characteristics, including:

- A major crisis in investor confidence.
- Huge degree of risk aversion.
- Widening spreads.
- Re-pricing of debt.
- Lack of liquidity in financial markets.
- Re-pricing of assets.
- Eventual policy response by the Fed and other central banks around the world.

Bottom line, recent financial implosions have all stemmed from the same basic cause: borrowing short-term and lending long-term without enough equity to weather periodic

shocks. The historical progression of previous shocks – the trajectory of spreads during the event and the re-normalization of financial markets after the crisis – may provide useful indications of what credit markets have in store this time around.

Previous financial crises, however, are not a perfect parallel to the current credit market turmoil. Each dislocation occurred during different points in the global economic and monetary policy cycles. Historical comparisons are rendered even more difficult as one considers the structural transformations that modern financial markets have experienced. For example, the majority of banks no longer hold mortgages on their books. More commonly, these mortgages are securitized and sold to institutional investors such as pension funds, insurance companies and foreign investors. This greater dispersion of risk across global financial markets should, in theory, have rendered the current subprime crisis less toxic and US banks should suffer less than they did during the S&L crisis. Yet the current credit market dislocation appears unprecedented, with inter-bank lending rates initially gapping at historic spreads. The suffering has been dispersed globally but banks remain severely impacted.

Despite cyclical and structural differences between past financial events and today's, investors may still be able draw some broad comparisons. In past liquidity crises, both the economy and equity/bond markets have recovered. The path to recovery has always provided opportunities to investors who see beyond the paralysis prevailing at the market's lows. While the timing and path of market recovery are inherently unpredictable in the near term, investors with a long term view are likely to profit from deals done today. The commercial real estate debt market, in particular, may be ripe with opportunities. There remain a series of strong underlying fundamentals, including solid global economic growth outside the US, healthy corporate balance sheets, and still solid real estate market fundamentals. This is in sharp contrast to the S&L crisis. This may give longer-term real estate debt investors the confidence to look past short-term fluctuations.

Poor financial management has plagued the global capital markets in the past. Two historical episodes are reviewed in depth in the section that follows. These two crises provide some notable parallels to where we are today. Episodes covered include the triple threat of the Asian financial crisis, Russian debt default, and LTCM blow-up of 1997 and 1998, as well as the S&L crisis of the late 1980s and early 1990s. Each event will be discussed in more detail below, focusing on the origins of the financial turmoil as compared with current conditions.

The S&L Crisis of 1989

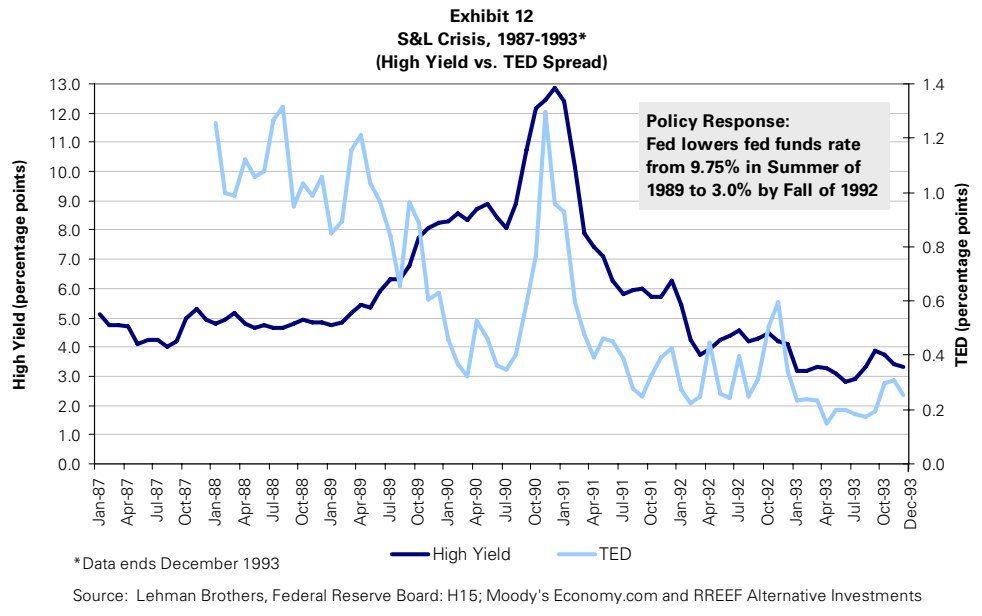
The Savings and Loan crisis of the late 1980s and early 1990s consisted of a wave of S&L failures in the US. Over 1,000 banks failed as the real estate collateral on bank balance sheets lost value. According to the FDIC, the ultimate cost of the bailout was estimated at \$160 billion, of which \$132 billion was directly or indirectly subsidized by the government (and taxpayers).

At its root, the S&L crisis stemmed from:

- A classic carry trade gone wrong. Shorter-dated liabilities (deposits) re-priced more rapidly than long-dated assets (mortgages).
- Flawed deregulation.

The collapse of the S&L industry in the US and the subsequent government policy response ("bailout") was intended to rectify a major lending debacle similar to the subprime crisis we are witnessing today. As part of the bailout, Congress passed legislation creating the Resolution Trust Corporation (RTC) to liquidate real estate and other assets of failed S&Ls through equity partnerships. The RTC was dissolved in 1995.

Similar to the impact of the current subprime crisis, the S&L crisis contributed to significant turmoil in the credit markets.³ Another parallel to today is that many of the problems in the S&L crisis originated in the residential housing market, leading to a housing recession and a significant spillover to the corporate credit markets. (Please refer to Exhibit 12.) The S&L crisis finally resolved with active policy response by both monetary and fiscal government authorities. TED and high yield spreads eventually normalized in the early 1990s, as investor confidence was restored.



The Asian Financial Crisis/Russian Sovereign Default/LTCM Implosion of 1997-1998

Taken together, these three exogenous events played out over a period longer than one year. First, the Asian financial crisis began in Thailand in July of 1997. This was a period of turmoil that gripped the world and raised the specter of a worldwide financial meltdown. Thailand's large current account deficit, huge amounts of international dollar-denominated debt and concerns over asset bubbles led speculators to exit the Baht, the Thai currency.⁴ The run on the Baht soon spread to most of Southeast Asia and Japan, leading the whole region to see slumping currencies, devalued stock markets and falling asset prices.

The Asian financial crisis led to a global recession, which resulted in a sharp retrenchment in commodity prices. Countries heavily dependent on the export of commodities and oil, like Russia, were hit the hardest. This environment made it very difficult for the Russian government to service its debt. This, in turn, placed considerable pressure on the Ruble, which at that time was pegged to the US dollar. In August of 1998, the Russian government was forced to devalue the Ruble and defaulted on its debt, temporarily prohibiting Russian banks from paying off foreign creditors.

³ Dirk Hofschire, CFA, "Can Stocks Survive the Credit Market Turmoil? Or will it trigger more volatility?," Fidelity Investor's Weekly, August 24, 2007.
⁴ Augustine Faucher, "Economic Shocks," Moody's Economy.com, Regional Financial Review, September 2007.

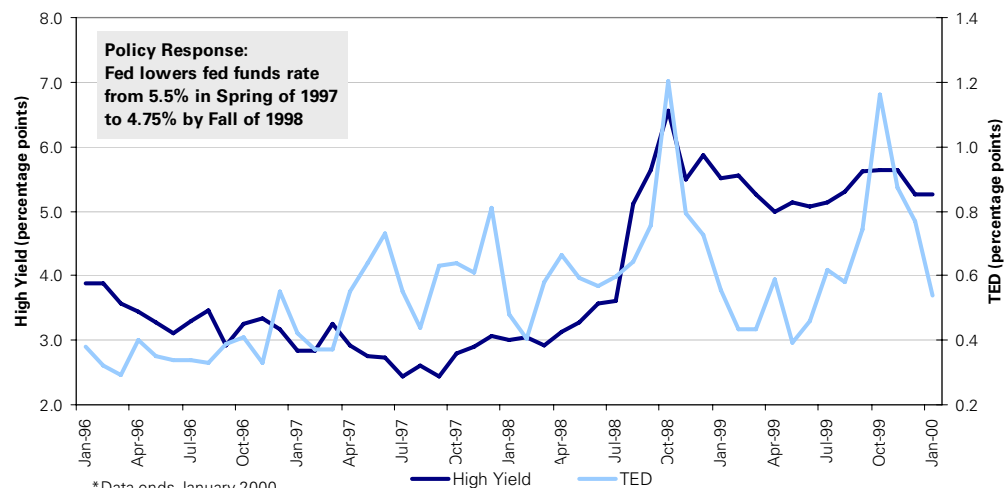
The Russian financial upheaval led to a global liquidity crisis where:

- Demand for cash increased sharply,
- 10 year interest rate swap spreads widened globally,
- The VIX index of stock market volatility – a gauge of investor risk aversion – spiked,
- There was a liquidity drought in the inter-bank and Eurodollar market,
- Higher cost and less availability of debt,
- Highly leveraged positions were de-leveraged, and
- The yen carry trade reversed.

This liquidity crisis, in turn, led to massive losses in September 1998 at LTCM, a US-based hedge fund. LTCM had certain trades that went wrong in the new economic order. Against their expectations, global spreads widened abruptly, resulting in a “flight to quality” into US Treasuries. The highly leveraged LTCM saw massive losses leading the US Federal Reserve to engineer a bailout of the fund’s obligations to creditors and counterparts.

These three events led to significant risk aversion, demonstrated by a dramatic widening of spreads. (Please refer to Exhibit 13.) The immediate policy response was the easing of monetary policy by the Fed and central banks globally, which simultaneously injected large sums of cash into the financial system.

Exhibit 13
Asian Financial Crisis/Russian Financial Crisis/LTCM, 1996-2000*
(High Yield vs. TED Spread)



Source: Lehman Brothers, Federal Reserve Board: H15; Moody's Economy.com and RREEF Alternative Investments

The policy response by monetary authorities has been rapid during the current crisis as well. The Fed and four other central banks – the ECB as well as the British, Swiss and Canadian central banks – recently coordinated efforts to free up credit in global financial markets. They are providing an initial \$40 billion in special loans at a low interest rate to banks, and these loans can be backed by a wide range of collateral. These steps, in addition to interest rate cuts, are very similar to the policy response the Fed took immediately following the last major financial crisis.

The recent coordinated actions by central banks were designed to correct the continued tightening of credit and liquidity conditions in the worldwide inter-bank markets. More specifically, the actions of the central banks are intended to alleviate the recent upward pressure on the LIBOR. The rise in LIBOR can be problematic if left unchecked since it is widely used as a benchmark for floating-rate borrowing, including adjustable-rate mortgages and short-term corporate and commercial borrowing lines. The “term auction facility” provided by the Fed has helped drive down LIBOR rates.

Massive risk aversion and dislocations in the global financial markets should impact the real economy, investment opportunities and returns. As displayed in Exhibits 12 and 13, during each event, financial markets became volatile and spreads widened. In each case, however, as central banks provided liquidity, credit spreads narrowed once again. The timing was different in each case but the end result was quite similar. Real estate markets actually did quite well following each event, and visionary investors who were willing to take risks during the height of market liquidity were compensated well. In the section that follows, opportunities in commercial real estate debt that may emanate from the current market dislocation are reviewed.

Dislocations in Real Estate Debt Markets: Where Are the Opportunities?

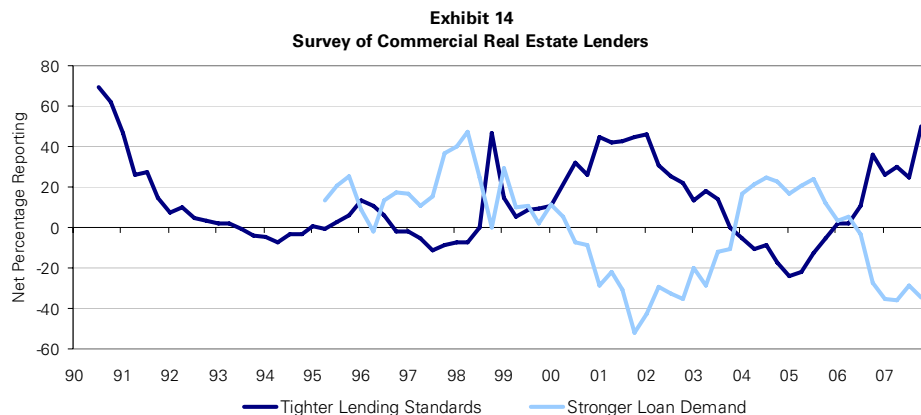
The real estate debt markets have not been immune to the ongoing capital market turmoil. CMBS conduits have retreated in the wake of the subprime meltdown. Market perceptions of risk have jumped, leading CMBS spreads to widen and origination and issuance levels to decline. Portfolio lenders, including insurance companies, have stepped up their lending activity. Yet this increase in origination is dwarfed by the dramatic drop in capital available from CMBS conduits.

Public trading of CMBS debt in all markets – new issuance, secondary trading, and derivatives – is reflecting a substantial re-pricing. The cost and terms of private real estate debt are adapting to this new landscape. After the borrowers' market of the past several years, real estate debt has changed virtually overnight into a lenders' market. Borrowers have fewer options, while those willing to make real estate loans today face reduced competition. Lending terms have tightened and the cost of debt has increased. Most market participants, including many borrowers, would likely agree that today's market reflects a more rational pricing of risk than has prevailed over much of this decade.

Is it possible, however, that the jump in commercial real estate debt spreads is an overreaction? Could fear be gripping the market and overly constraining the availability of commercial real estate loans? In order to address these questions, we look into the motivations and access to capital of important lender and investor constituencies. We identify several areas of market dislocation that we believe have created opportunities for real estate debt investors.

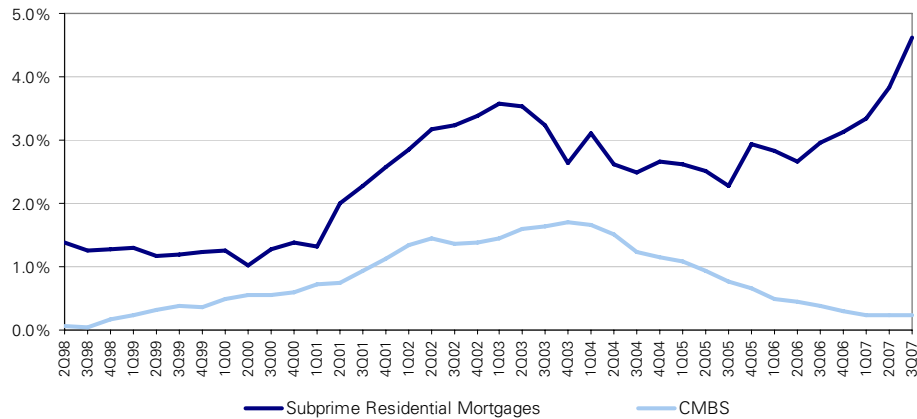
As CMBS conduits pull back, an opportunity is opening up for private real estate lenders and investors in non-securitized debt. Would-be borrowers of mezzanine debt and other riskier real estate loans are facing a scarcity of debt capital, creating an opportunity for knowledgeable investors. Senior loans typically fund up to 50% to 60% of property value. The gap in financing is likely to be most acute for the next layer of debt, known as "mezzanine" loans, up to 75% of asset value. The current cutback in mezzanine lending creates an opportunity for private real estate lenders. Access to debt is also limited today for developers and owners of value-added properties. Near-term refinancing of these projects is likely to create opportunities for real estate investors as well.

Lenders have pulled back dramatically from the commercial real estate sector. Some 50% of bank lenders indicated that they were tightening underwriting standards as of October 2007. Investor access to debt is reaching lows not seen since the last recession, as depicted in Exhibit 14.



In light of the fact that today's crisis began in the residential real estate market, it is worth pointing out several important differences between subprime residential mortgage-backed securities (RMBS) and commercial mortgage-backed securities (CMBS). The fundamentals of commercial real estate debt are considerably stronger now than those in residential lending. Exhibit 15 compares the current delinquency rate on commercial loans with those on subprime residential debt. Historically CMBS loan performance has held up better than that of RMBS, and continues to do so today. CMBS delinquencies are still low – though beginning to increase – while subprime delinquency rates have soared to uncharted heights.

Exhibit 15
Delinquency Rates on CMBS and Subprime Residential Mortgages



Source: Mortgage Bankers Association: National Delinquency Survey, CMSA, Trepp LLC and RREEF Alternative Investments

As outlined by a recent Deutsche Bank report, the advantages of CMBS include⁵:

- Debt service typically supported by cash flow on existing leases, not an individual's uncertain income stream.
- No hybrid adjustable-rate loans with a very low "teaser" rate.
- No low-doc or no-doc loans. Full financial information on a property – often including audited financial statements – is provided.
- Superior sophistication of commercial real estate borrowers vis-à-vis homebuyers, with very limited history of fraud.
- Deals evaluated not just by credit rating agencies, but by B-piece investors who purchase the riskier (non-investment grade) portions that are not securitized. These buyers tend to be experienced real estate investors who have the right to "kick out" loans they do not like.
- Stronger commercial real estate fundamentals, with a limited supply threat.

During moments of turmoil, such as we see today, market pricing may not accurately reflect the riskiness of commercial real estate debt. Certain buyers have disappeared from the market, leading their favored assets to go on sale. The departure of some real estate debt buyers has had more to do with exogenous factors than the underlying real estate assets. Furthermore, broad bets on benchmark indices appear to be influencing pricing of heterogeneous debt offerings across the board – implying that specific assets could be mispriced.

⁵ Richard Parkus and Jing An, "Recent Trends in CRE Underwriting and Fundamentals," Deutsche Bank Global Markets Securitization Research, November 27, 2007.

Opportunities in Real Estate Debt Markets

As a result of the current pullback in commercial real estate lending and the rapid repricing of debt, opportunities in debt investing appear to have emerged in the following sectors. Throughout this section, we rely on data from public real estate debt markets, especially in the US, because this information is available with less of a lag and superior market coverage. Yet many of these conclusions can be generalized to private and public real estate debt markets worldwide:

1. Subordinate debt on high quality assets and CMBS packages. Subordinate debt includes lower-rated tranches of CMBS, private mezzanine loans and other debt which gets paid back only after senior loans have been paid. In recent years, this subordinate debt has been purchased primarily by speculators and CRE CDO conduits. Exhibit 16 shows the distribution of US CMBS buyers for the riskiest investment-grade securities – the BBB tranche – and the least risky AAA tranche. In recent years, nearly 70% of all BBB securities have been sold to short term traders and CDO issuers. These buyers purchased over one third of AAA rated debt as well. Long term debt investors like insurance companies and pension funds saw their market share decrease.

At the onset of the current credit market turmoil, short term buyers virtually disappeared from the market. The commercial real estate CDO market has been shut down since the subprime crisis bloomed in August. CDO issuers are no longer able to purchase and repackage riskier debt. At the same time, hedge fund and proprietary traders have swung from a massive net long position on real estate debt (executed by purchasing CMBS) to a massive net short position (implemented by shorting CMBS derivatives). This will be discussed in more detail in the derivative section that follows.

In the US, where some new CMBS deals are still being issued, banks are holding on to non-investment grade debt because they cannot sell it at a price they are willing to take. Fixed rate spreads range from about 850 bps for BBB rated debt to 1400 bps for B rated securities, as of January 18, 2007, according to Commercial Mortgage Alert.

The blowout in spreads for subordinate debt – including both lower-rated CMBS and private mezzanine loans offered today – is attracting real estate investors who have not traditionally focused on debt. While spreads are unlikely to return to the historic lows seen earlier this year, demand appears likely to rebound somewhat – at least for loans with high quality collateral and/or strong underwriting.

2. Floating-rate debt on high quality construction loans and value-added properties. There is some new issuance in the fixed rate CMBS market, at least in the US and Japan, but floating rate issuance has stalled worldwide. Typically, floating rate debt finances loans for construction and value-added (also known as transitional) properties. Fixed rate debt is usually issued over longer periods of time, about 5 to 10 years, to buyers of stabilized properties. To some extent, the dry-up in the floating rate market reflects risk aversion, as properties without a stabilized income stream are more likely to miss payments.

**Exhibit 16
Composition of CMBS Buyer Pool**

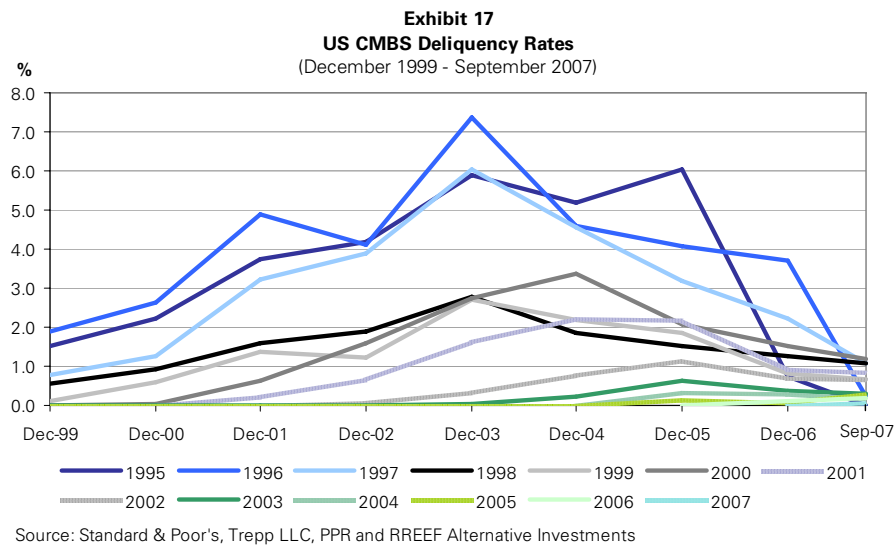
Super Size AAA (10-year) Investors		
	2002	2006
Insurance Companies	38%	18%
Money Managers	31%	38%
Banks	16%	6%
Endowment/Pension Funds	5%	3%
Hedge Fund/CDO Issuer/ Proprietary Trading Desks	10%	35%
BBB (10-year) Investors		
	2002	2006
Insurance Companies	21%	7%
Money Managers	16%	14%
Banks	2%	1%
Endowment/Pension Funds	19%	1%
Hedge Fund/CDO Issuer/ Proprietary Trading Desks	27%	69%
B-Piece Buyers	15%	8%

Source: JP Morgan, 2Q 2007, RREEF Alternative Investments

In the fixed rate sector, US CMBS issuers are selling off higher-rated securities and holding onto the riskier debt. In the floating rate domain, it is the investment grade debt that is proving more difficult to sell. This is partly due to the disappearance of structured investment vehicles (SIVs) and foreign banks. These buyers traditionally favored floating rate debt because it was a better match with their funding capital, not because they were interested in exposure to riskier real estate loans. Thus floating rate debt remains vulnerable to the implosion of SIVs and other exogenous factors that may not fairly reflect the value of this debt.

To the extent that developers and value-added buyers have lost access to fairly priced debt, this also creates an opportunity for private lenders and investors in non-securitized portions of the debt capital stack.

3. Debt underwritten during the credit crunch. If history is any guide, 2008 should be a great vintage year for real estate debt, both private and public. Exhibit 17 shows CMBS performance by vintage year since 1999. The highest-quality loans were issued during the weak real estate market beginning in 2002. Caution motivated conservative underwriting in these years. The shift in the balance of power from borrowers to lenders bodes well for loans originated today. Already, CMBS debt originated in the fourth quarter of 2007 has featured lower loan-to-value, higher debt service coverage ratios, and higher credit support for the BBB- tranche than loans done earlier this year, according to Standard & Poor's. Moreover, limited loan origination and CMBS issuance will create a positive technical factor for investors going forward. While we focus here on US public debt markets, due to data availability, this situation will likely prevail globally for both private and public debt.

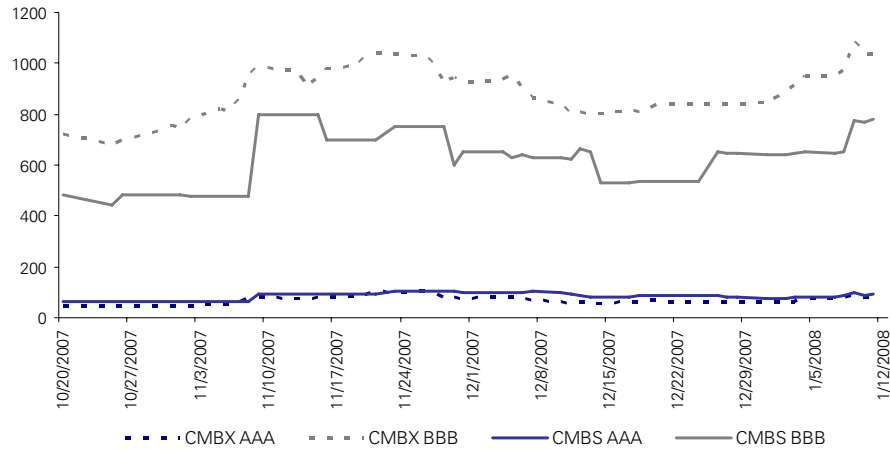


4. Deal-specific approach to take advantage of "blind" shorts. A key driver of the ongoing widening in CMBS spreads has been trading in related derivatives. Because cash CMBS trade relatively infrequently, derivatives provide pricing guidance to CMBS issuers and investors. Technically speaking, CMBS derivatives are credit default swaps offering protection on various tranches of securities, issued either by a single firm or representing a basket of CMBS. A commonly-traded benchmark index tracking issuance from several firms is the CMBX.

Spreads on the CMBX index have blown out far beyond the spreads at which CMBS issuers and investors have been willing to sell cash securities. Exhibit 18 compares the price of new CMBS issuance with the price of derivatives tied to the CMBX. For the

lowest risk AAA tranche, derivative spreads are roughly in line with cash issuance, but the difference across sectors increases further down the risk spectrum. At the BBB level, the CMBX is trading 300 bps above where any issuer is willing to sell securities. Issuance of below investment grade securities – rated BBB- and below – has come to a virtual halt in recent months, so pricing cannot be determined with any certainty. The spread on BBB-debt is trading at about 1000 bps in cash CMBS trades in the secondary market, compared with 1650 bps in the derivative CMBX market.

Exhibit 18
Spreads on Cash CMBS vs. Derivative CMBX



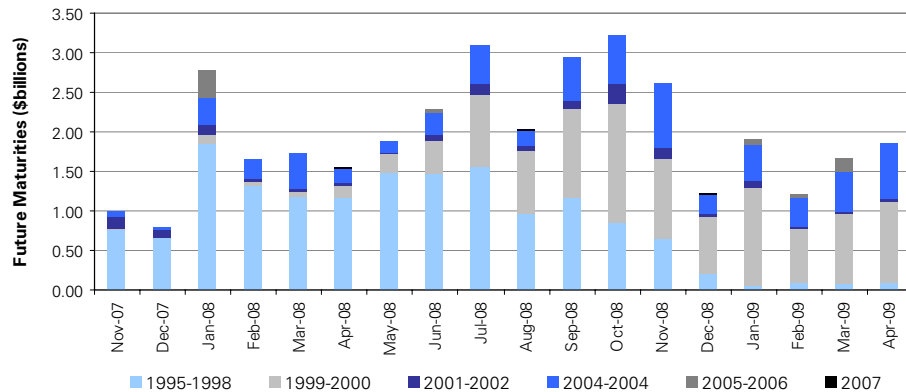
Source: Markit and Deutsche Bank

The derivative market is clearly pricing in a worse outcome for CMBS than the market in cash securities. Short-term investors, including hedge funds, appear to have piled into the CMBX market as a way to short commercial real estate⁶. Bets by these investors are in some sense “blind.” They discriminate across tranches but do not discriminate between individual CMBS deals. An asset-specific view on real estate fundamentals is absent. To the extent that hedge funds’ involvement in the market blows out spreads regardless of the quality of the underlying collateral or underwriting, there is an opportunity for real estate investors to cherry pick individual B-pieces and other debt that may be undervalued. There is also an opportunity for private lenders to take advantage of the current unfavorable cost of public capital. Private lenders should see their market share of mezzanine and bridge loans increase as senior lenders offer lower LTVs and less attractive terms.

5. Take advantage of the coming wave of refinancings to invest in B-notes and mezzanine debt. Several high profile real estate investors have made headlines with their inability to refinance maturing debt, including Macklowe Properties’ office and hotel holdings in midtown Manhattan. Roughly \$4 billion of loans packaged in US CMBS will mature during each month of 2008. Exhibit 19 plots upcoming loan maturities by vintage year for fixed rate debt, while Exhibit 20 shows similar data for floating rate debt. Facing a slowing transaction market, most borrowers will likely seek to refinance that debt. Yet loans are unlikely to be available on the same loose terms as prevailed when some of this debt was originated.

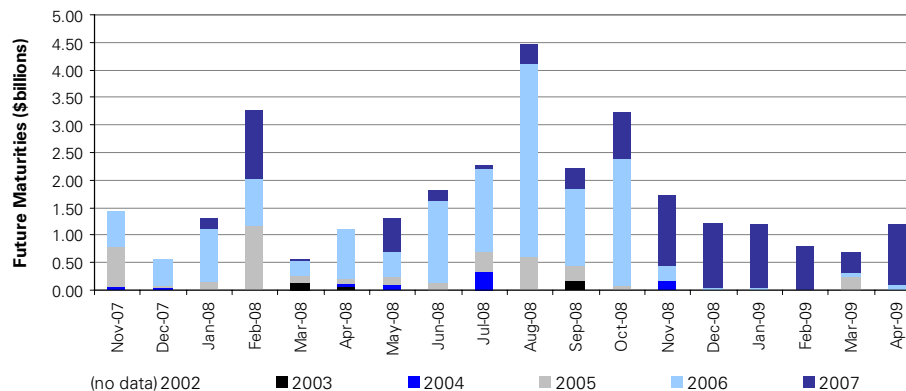
⁶ Tim Annett, “Fashionable New Shorts,” Wall Street Journal MarketBeat Blog, November 9, 2007.

Exhibit 19
Future US CMBS Fixed-Rate Maturities



Source: Wachovia Capital Markets, LLC, Intex Solutions, Inc., Trepp, LLC and RREEF Alternative Investments

Exhibit 20
Future US CMBS Floating-Rate Maturities



Source: Wachovia Capital Markets, LLC, Intex Solutions, Inc., Trepp, LLC and RREEF Alternative Investments

Maturing fixed rate debt over the next year is dominated by loans originated before 2003. This reflects the long-term duration of most fixed rate debt. Given the strong real estate appreciation gains of the past several years, this debt may not prove difficult for borrowers to refinance. Moreover, this debt was seldom issued interest only, so much of the loan balance is likely already paid down.

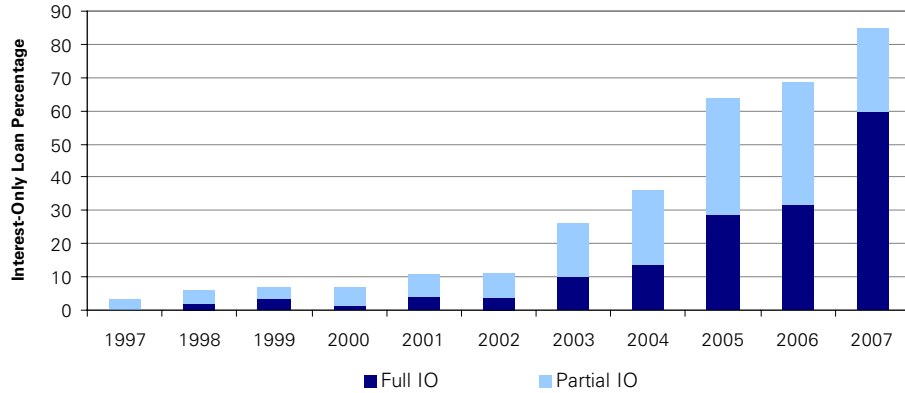
Tensions in the refinancing market are most likely to emerge on the shorter-term floating rate side. Most debt maturing over the coming 24 months was originated in the loose environment of 2005 to mid-year 2007. As shown in Exhibit 21, the great majority of loans during this period were full or partial interest-only. This means that the amount to be paid upon maturity likely equals the entire loan amount, or something close to it. Given the higher average LTV and pro forma underwriting that prevailed during this period, it is very likely that borrowers will not be able to refinance into loans of anywhere near the same amount as their expiring debt. These borrowers, mostly developers and value-added investors, will need to take out costlier senior and mezzanine loans to pay down their debt outstanding. This should increase the supply of B-note and mezzanine debt opportunities available to investors.

For the past several years, the gains of soaring real estate values have accrued primarily to equity investors. Competition for deals pushed real estate loan spreads to historic lows, which clearly benefits a borrower instead of a lender. Today, as loan underwriting

gets stricter and spreads widen, and as expectations of real estate value gains cool, the relative attractiveness of debt investing vs. direct real estate purchases is high.

Current dislocations in the commercial real estate debt markets can hence provide a variety of opportunities for savvy investors. Successful implementation of any debt investment will critically depend on the trajectory for the global economy and underlying real estate fundamentals. In the following section, RREEF's house view on prospects for global economic growth and the real estate fundamentals cycle is presented.

Exhibit 21
Interest-Only Share of US Securitized Commercial Real Estate Loans



Source: Intex Solutions, Inc., Deutsche Bank and RREEF Alternative Investments

Prospects for the Global Economy and Real Estate Markets

Benefiting from the current dislocations in the real estate debt market will also depend on the performance of the broader global economy and the national/local property market fundamentals. Investors need a thoughtful perspective on how credit market factors and real estate supply/demand fundamentals will evolve over the coming year. In this section, the current RREEF global economic and property market outlooks are briefly summarized.

Outlook for the Global Economy

There is much uncertainty regarding the trajectory of global economic growth. Much of the concern centers on the fallout from the subprime financial shock in the US. The seizure in global financial markets is impacting both risky and less risky investment grade assets, restraining growth further. Much of the current economic weakness, however, is centered in the US.

RREEF's baseline global economic forecast calls for weaker global growth in 2008. (Please refer to Exhibit 22). Weakness in the US including the possibility of a mild recession, however, should be offset by stronger economic fundamentals in China, India, and the Eurozone. Real World GDP growth should slow to 3.4% in 2008, down from 3.8% in 2007.

Exhibit 22
World Economic Overview: Forecast Highlights
Real GDP, % Growth

	2006	2007	2008	2009	2010
World	4.0	3.8	3.4	3.7	3.6
NAFTA	3.0	2.3	2.0	2.7	2.9
US	2.9	2.2	1.5	2.4	2.8
Eurozone	2.9	2.6	1.7	1.9	1.9
Central Europe	6.3	5.3	5.2	5.0	4.8
CIS	7.8	8.2	6.9	6.6	5.6
Asia-Pacific	5.5	5.8	5.5	5.5	5.3
Japan	2.4	1.9	1.3	1.9	1.5
China	11.1	11.5	10.4	9.4	8.8
Latin America & Caribbean	5.2	5.7	5.3	4.8	4.5
Middle East	5.3	5.0	6.0	5.4	5.0
North Africa	5.6	5.8	6.5	6.1	5.7

Source: Global Insight and RREEF Alternative Investments

As reflected in the forecast highlights above, most other regions of the world will decelerate. The sharp slowdown in the US will impact most regions in 2008 with the exception of commodity-exporting countries which will be less impacted. Europe in particular faces several shocks, including the global slowdown, a stronger currency, the on-going credit crunch, housing problems in some countries, and still elevated oil prices. Japan will also face some of the same issues, yet there is still little evidence of a sharp fallout from the subprime mess as in the US.

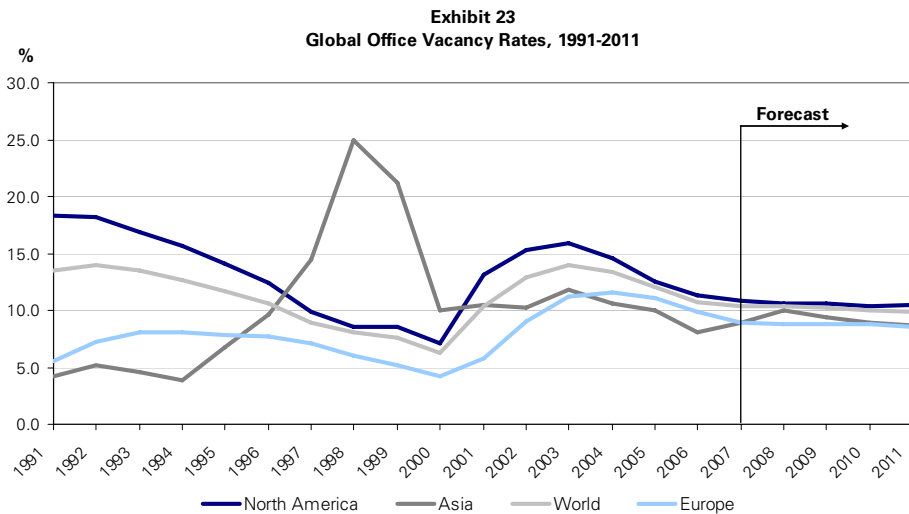
The trajectory of growth in many of the emerging markets is tied to the fate of China and financial events following the 2008 Beijing Olympics. China should see no significant slowing in its economy until after 2008. Credit growth remains strong and the tightening efforts by the Chinese government have had minimal impact on investment activity. After the Olympics, however, there is the risk that the Chinese government may have no

choice but to tighten credit conditions much more sharply, given nascent indications of asset bubbles and inflationary pressures. This may further slow Chinese growth. If the slowdown turns into a hard landing, this could then hurt economic prospects for the rest of Asia. India, however, should be relatively insulated from any Chinese hard landing since much of India's growth remains domestic-led.

Prospects for the Global Real Estate Markets

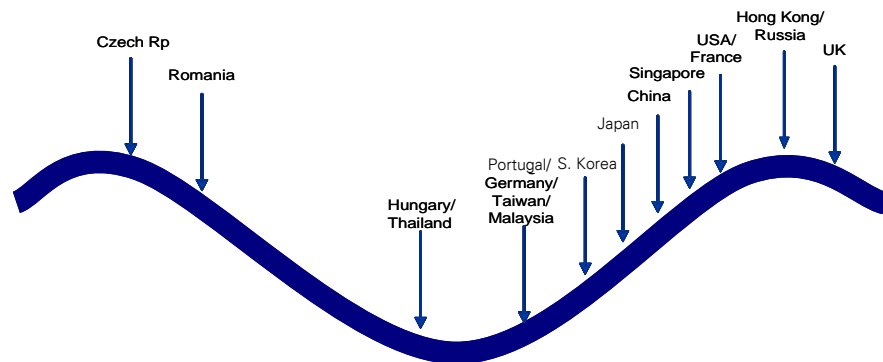
Despite the widespread uncertainty surrounding the on-going credit crunch, the outlook for the global economy remains one of slower growth than an all-out recession. The turmoil should slow global growth, but due to strength in regions outside of the US, the global economy should avoid a prolonged recession as suffered during the S&L crisis or the Asian and Russian financial crises. We now anticipate that a chance of an all-out global recession is 25%. Any correction in the commercial real estate market will be less painful than what has been witnessed in residential real estate. As a result, commercial real estate fundamentals and returns should soften going forward, but still provide equity and debt investors solid risk-adjusted returns.

Leading to the credit market turmoil, real estate markets had passed their growth phase and were already entering a post-growth stage of the cycle. Generally speaking, rapid declines in vacancy and increasing rental growth were already giving way to a pick up in new supply and slowing rental gains. (Please refer to Exhibit 23) After several years of strong growth, global office vacancy rates bottomed earlier this year. Strong economic growth following the 2001 recession, coupled with relatively low supply improved office market performance around the globe.



As world growth moderates, office absorption should moderate as well. Supply risks remain muted since it has become much harder to lock-in favorable construction financing in view of the global credit market woes. Indeed, there is a surprising lack of speculative development, a trend that had besieged commercial real estate markets in past cycles. Therefore, we have lowered our construction starts projections. Office vacancy rates should remain stable over the next few years. This should insure steady underlying rent and net operating income performance of office product on a global basis. This will vary by region. Different markets may not be adhering strictly to this global cycle. Exhibit 24 presents the various office markets and their position in the current property cycle.

Exhibit 24
Position of Global Office Markets in Property Market Cycle



Source: RREEF Alternative Investments

As long as economic and real estate supply/demand fundamentals remain healthy, the steady and fairly predictable cash flows of real estate should remain attractive. On a global basis, real estate space fundamentals remain healthy and excess supply is not a major risk in most markets and across most property types. Therefore, as long as demand does not shrink abruptly, as in a world-wide recession, the current dislocation in the credit markets should provide many opportunities for investors who can take advantage of the mispricing of risk that has been created by the retreat of many lenders. Real estate investments should also benefit from today's much stricter underwriting standards and borrowing terms longer term. With cap rate compression over, however, debt and equity investors must once again be careful to pick the right markets and assets that provide the greatest upside. Asset level due diligence will be key going forward.

Concluding Remarks

This report provided an overview of the current and ongoing credit crunch, placing it in historical context. The commercial real estate debt markets were not immune to this broader financial crisis, leading to a significant retreat of lenders for all types of real estate. If the past is any guide to the future, the liquidity freeze of today may be offering a short-term buying window to opportunistic investments. As long as real estate market fundamentals and global economic performance do not deteriorate sharply, the current dislocation in real estate capital markets should provide investors profitable opportunities. Investors who are willing to see beyond current weakness and the mispricing of risk should come out as winners when the dust settles.

As long as economic and real estate supply/demand fundamentals remain healthy, the steady nature of real estate as protected by long-term leases should continue to provide attractive opportunities for real estate debt and equity investors. Moreover, real estate investments under any future scenario should benefit from the more conservative lending and underwriting standards that prevail today.

The shape of short-term opportunistic buying prospects is beginning to emerge. The pullback in lending among packagers of CMBS and CRE CDOs is creating an opportunity for portfolio lenders, private providers of mezzanine debt, and investors in public and private subordinate debt to increase their activity on favorable terms. After years of debt pricing and terms that were favorable to borrowers, lenders now have the upper hand. From a real estate investor's perspective, this has unambiguously increased the attractiveness of debt investments vis-à-vis equity investments. (Of course, seizures in the real estate debt markets should lead to attractive opportunities to purchase discounted assets as well.)

Over the past couple of years, a surge in enthusiasm for real estate as an asset class fueled by cheap debt compressed cap rates across the board. The broad-based drop in real estate risk premiums did not always reflect asset risk. It appears today that broad market sentiment is pushing out spreads on commercial real estate loans with a similar lack of appropriate differentiation across assets.

For experienced real estate investors, the knowledge that certain loans were too generous in 2006 did not yield much of an investment opportunity. Today's blowout in real estate debt spreads, along with a lack of access to refinancing for some borrowers, offers an opportunity to those who think risk is being appropriately (or excessively) priced in the current real estate debt market.

The current repricing of real estate will likely be characterized by an asset-specific approach absent in the euphoria of recent years. This is as true for debt investments as it is for equity purchases. For investors knowledgeable about real estate fundamentals, cherry picking risky debt – including construction loans, value-added debt, B-pieces, and mezzanine (50% - 75% LTV) loans – appears likely to pay off. Loans underwritten this year may offer an attractive risk-reward profile to debt investors. The wave of refinancings to come over the next 24 months is likely to generate a measure of market distress. Well-capitalized investors comfortable with real estate fundamentals – those often priced out of deals in recent years – may be seeing long-awaited lending opportunities.

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