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## 2008 U.S. Real Estate Investment Outlook and Market Perspective

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### Overview

The out-sized returns and unprecedented capital flows to real estate have run their cyclical course and returned to earth over the second half of 2007. Although the historical average return for real estate, based upon the NCREIF property index, is around 10% annually, total returns outperformed over the past four years, peaking at 20% in 2005. Total returns remained robust during the past two years, totaling 16.6% in 2006. We forecast an NPI total return of approximately 14% in 2007. Although the first three quarters of the year were very strong, we anticipate a dramatic slowing in the fourth quarter.

These strong returns reflect a recovering real estate market following the 2001 recession, where a healthy economy fueled occupancy and rental rate gains. In addition, yields were being dramatically bid down for the asset class, as investors discovered or rediscovered the attractive performance characteristics of real estate. The NCREIF income returns, which can be viewed as an approximation of capitalization (cap) rates, declined from 8.7% in 2001 to 5.5% in the third quarter of 2007. Similarly, cap rates reported by Real Capital Analytics, reflecting a larger universe of transactions, declined at a similar rate between 2001 and 2007 from 9.3% to 6.6%.

Strong capital flows to real estate drove this significant compression in cap rates. Between 2001 and 2006, transaction activity increased at an average annual rate of 33%. Preliminary data indicates that transaction volume for 2007 produced another 26% increase.

Such returns, appreciation, and increases in capital flows to real estate were clearly not sustainable in the long term. A bubble in the credit markets burst in August 2007, prompted by the recognition of poor underwriting of bonds securitized by subprime mortgages. Once markets for those bonds froze, investors quickly realized that similar, although far less severe, problems exist in the commercial real estate backed bond market. Much of the run-up in pricing of commercial properties was based upon high levels of leverage. Some of these high loan-to-value properties, which were underwritten based upon unrealistically aggressive income growth, may potentially fall delinquent in debt servicing. Lenders, who can no longer securitize new loans and must keep them on their books have re-implemented prudent lending standards in the second half of 2007. This has had a material impact on new real estate transactions, eliminating highly leveraged buyers.

At the beginning of 2008, we find ourselves in a period of profound adjustment on a number of fronts. Real estate assets are being repriced beginning in the fourth quarter 2007 and with relatively low levels of new transaction volume, it is difficult to see where this pricing will settle. Markets for securitized debt remain frozen, with all tranches difficult to sell. And finally, concerns about a slowing economy, or even a potential recession, dominate the financial news. RREEF Research forecasts a 50% probability of

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recession in 2008. While the economy still exhibits many positive fundamentals, a number of events could push the economy from slow to negative growth.

However, the outlook for real estate investments is not entirely gloomy. Following a slow economy predicted for early 2008, 2009 through 2011 should rebound with healthy growth. Thus, while leasing activity at many properties will be muted in the near term, we believe absorption and rent growth will resume an upward course in 2009, and supply fundamentals look generally attractive as well. Commercial construction starts, however, which had been picking up steam in 2006 and 2007, are now being reined in by financial and market forces. As a result, vacancy rates, which are expected to increase noticeably in 2008, should resume their downward trajectory, albeit modestly, in 2009 or 2010.

A significant challenge for investors who appreciate this longer term outlook for real estate is to find pricing that makes sense. During the past few months, most properties traded were at pricing and terms 5% to 10% below those achieved during the first half of 2007. Truly prime properties in strong growth markets are projected to hold on to their value. Nevertheless, we believe that pricing will become more transparent during the next six months, and reach bottom within the next six to 18 months.

The following are our top predictions for the US real estate market in 2008:

- **Capital Flows.** Capital flows to real estate in the US in 2008 will undoubtedly be significantly lower than the record volumes reached in 2006 and 2007. Buyers requiring high levels of debt will be out of the market for a substantial period of time as lenders reapply more demanding underwriting standards. Equity-oriented buyers, requiring 70% or less of debt, will dominate the market. With mortgage rates expected to stay low during the year and with better yields than were achieved in the past two years, debt will still provide a boost to returns. Foreign buyers, who are likely to appreciate the attractive fundamentals of the real estate and the lower value of the dollar, could well dominate transaction activity in the coming year. Institutional investors will likely retain their current allocations to core real estate, however, should raise allocations to value-add, opportunistic and international real estate strategies.
- **Pricing.** Between mid-year 2007 and January 2008, pricing for most real estate assets declined, with effective cap rate increases of between 25 and 50 basis points, producing a 5% to 10% decline in value. Investment style, value-added properties adjusted the most, given the greater difficulty of obtaining attractive financing for assets with low initial cash flow. By location, properties in secondary locations experienced the most adjustment, with fewer buyers pursuing such assets. Similarly, Class B and C properties experienced greater price adjustment than high quality Class A properties. The best properties in the best markets and submarkets have adjusted the least, with some evidence that they are largely holding their value. However, with less capital flowing to real estate and tougher lending standards, pricing is likely to fall further. In the longer term, we expect interest rates to rise, which will place further downward pressure on pricing. As a result, we expect another 25 to 50 basis points rise in cap rates over the next six to 18 months.
- **Private Real Estate Equity Returns.** Total returns from the NCREIF NPI should range between 6% and 8% in 2008, down from around 14% in 2007, as values adjust downward and cap rates move upward. It should be noted, however, that the NPI tends to lag the transaction market significantly, as annual valuations catch up with market changes. We believe that pricing has adjusted sufficiently that core real estate, purchased in early 2008, can achieve attractive unleveraged annual returns of between

7.5% and 8.0%. With attractive interest rates currently on conservatively-underwritten properties, total leveraged returns of between 8.5% and 9.5% can be achieved.

- **Publicly Traded REITs.** The public REIT market, which has produced several years of very high returns, experienced a sharp correction in 2007. As they are already trading at a 20% discount to their net asset value (NAV) and with strong balance sheets and asset quality, REITs should rebound with modest returns of 5% to 10% in 2008, with larger gains occurring in the second half of 2008.
- **The Economy.** Real GDP growth will decline to a mid-cycle trough in 2008 to approximately 1.9%, well below trend for the US economy. During the first half of the year, the economy will be particularly slow, dangerously close to recessionary levels.
- **The Property Markets.** Primary consideration should be given to those metropolitan areas where economic growth should be the strongest. The strongest markets have high exposure to international financial and professional services, defense, trade, medical, and high-tech industries. The US will have comparative advantages in these industries on a global basis. Such "Globally-Linked" markets should achieve particularly strong economic growth. This economic growth will continue to produce broad-based activity and increases in space demand. These markets also typically provide above-average income levels, reflecting their "knowledge-based" foundation. They include: Boston, New York, Washington DC, Raleigh, Charlotte, Miami, Fort Lauderdale, Austin, Houston, Seattle, Portland, San Francisco, San Jose, Los Angeles, Orange County and San Diego. However, not all of these markets are supply constrained or achieve balanced supply-demand fundamentals for all property types in all submarkets.
- **Apartment Properties.** This sector has some of the best prospects in an environment of declining economic growth. However, there is a bifurcation between strong steady markets and those that are experiencing excess supply. Vacancy rates increased only modestly in 2007, largely due to a severely over-built for-sale housing market, which also included failed condominium conversions. In many markets, these excess units are entering the rental pool, thereby adding to supply and competing directly or indirectly with institutional properties. However, some supply-constrained markets suffer only modestly from home over-building, and have otherwise strong apartment fundamentals. These markets should produce strong rental gains, even with a slowing economy and should outperform other markets. Such markets include: New York, Washington, DC, Baltimore, San Francisco, San Jose, Los Angeles and Seattle. Desirable infill locations in metros with strong economies should also experience superior growth. As the economy resumes stronger growth in 2009; demographic trends create increasing renter cohort household formations and the excess home supply is absorbed; apartment market fundamentals are excellent over the next two to three years. In the near term, constrained supply apartment markets are expected to be one of the strongest sectors for rent growth.
- **Industrial Properties.** After exhibiting solid improvements over the past four years, with vacancy rates trending down to 9.4% in 2006 and 2007, industrial real estate is poised for some weakness in 2008. Gateway markets continue to be the most resilient to the economic slow down with foreign trade and high tech as the key drivers for the sector. Major land constrained port markets, such as Southern California, South Florida, the San Francisco Bay area, Seattle and New York/New Jersey will continue to outperform. Inland distribution markets, such as Dallas, Chicago and Atlanta are now strengthening at a later point in the cycle. In general, new development is driven by large distribution

users. As a result, in some of the major distribution markets where land is available and affordable, such as Atlanta, Chicago, Dallas/Ft. Worth, and the Inland Empire, big-box warehouse construction activity is approaching levels last seen in the late 1990s, so caution should be used in these markets. Nevertheless, infill locations within these markets should continue to fare well.

- **Office Properties.** The office market experienced a further, albeit modest, drop in vacancy in 2007 in spite of a ramp up in new supply coming on-line. New completions will continue through 2008, but for the first time in five years, office fundamentals are showing weakness as office employment growth moderates. As a result, vacancies are forecast to increase by 50 basis points in 2008. There will be a noticeable difference between the strong CBD globally-linked markets with better economic fundamentals and the weaker or suburban markets that will underperform. Central locations within Manhattan, Washington DC, Boston, Miami, Austin, Seattle, San Francisco, San Jose and West Los Angeles will continue to outperform.
- **Retail Properties.** The retail property market, which was the strongest sector through 2005, experienced rising vacancy rates. As a result of historically high retail sales growth and retailer profitability over the past several years, retailers aggressively expanded new store openings in 2007, with additional openings already committed for 2008. With modest retail forecasts, retailers will be cautious in planning new store openings for 2009 and beyond. A slower consumer spending environment will result in slower growth for this sector in the coming year, with further increases in vacancy as the current supply pipeline is completed. A significant disparity in markets will continue, with supply constrained markets, where land is expensive, outperforming and exhibiting continued low vacancy rates. This includes primarily coastal metro markets and strong infill locations in major metros. Retailers will continue to seek out locations in such areas.
- **Implications.** Real estate capital markets have clearly retreated from their over-exuberance of recent years. As a result, pricing is adjusting to levels that were achieved approximately two years ago, based upon prudent assumptions of future growth. As this repricing settles, we expect attractive buying opportunities to emerge in a less competitive transaction market. Utilizing realistic growth assumptions, 10-year unleveraged IRRs should range between 7.5% and 8.0% for core properties, with the high end of this range easier to achieve than in recent years. Leveraged returns of 12% to 17% are achievable from value-added and opportunistic strategies, with low mortgage rates expected to hold for conservative loan-to-value ratios. Rising cap rates will have negative impacts on existing portfolios, as evidenced by our projected lower NCREIF NPI returns for 2008. Those properties with healthy income growth will fare the best as appreciation stalls.

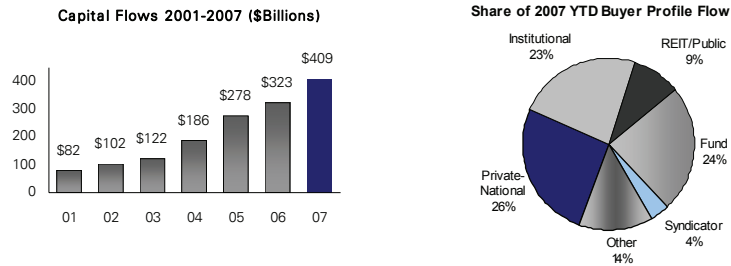
## Real Estate Returns: A Paradigm Shift?

### Capital Flows

Capital flows into US real estate once again reached a new record in 2007, growing 26% as presented in Exhibit 1. Additionally, institutional investors and private national buyers increased their acquisitions over 2006 volume, while REITs retracted from the market as net sellers. Condominium converters participated in only a handful of transactions during the year.

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**Exhibit 1**  
**Real Estate Transaction Volumes**  
**as of Third Quarter 2007**



Source: Real Capital Analytics, and RREEF Research

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Capital flows to real estate in 2008, especially during the first half of the year, will most likely be well below that of the past few years, leading to the first decrease in transaction volume in a decade. The credit crisis in August 2007 significantly reduced debt availability. Lenders reapplied prudent standards that they had largely abandoned in the past couple years. As a result, buyers providing substantial equity, who maintained a relatively limited role in the frothy debt-induced markets of the past two years, should once again be major players. Foreign buyers, who are likely to appreciate the attractive fundamentals of real estate and can take advantage of the low value of the dollar, could become important buyers in the coming year.

Going forward, real estate investments should revert to their long-term role as income generators. Appreciation will be muted, as cap rates revert to levels seen two to three years ago. Investors will focus on properties that provide the strongest income growth. In the near term, interest rates are expected to remain low by historical standards, and will facilitate investments utilizing conservative loan-to-value ratios.

Demand for real estate shifted from core to more value-added and opportunistic assets over the past couple of years, as investors sought higher yields in a growing economy. With the ongoing repricing of core real estate and greater concern for risk, we believe that the core investment style will become increasingly attractive. Nevertheless, value-added will continue to be a promising sector for investors with substantial equity. This sector has been more dramatically repriced than core, given the increased difficulty of obtaining significant leverage. Opportunistic investments, generally involving ground-up development, are more difficult to execute in the middle stage of the market cycle and are becoming more difficult to finance. Some well-capitalized investors will continue to seek this enhanced yield, and fundamentals in select markets are sufficiently strong to bear the increased risk.

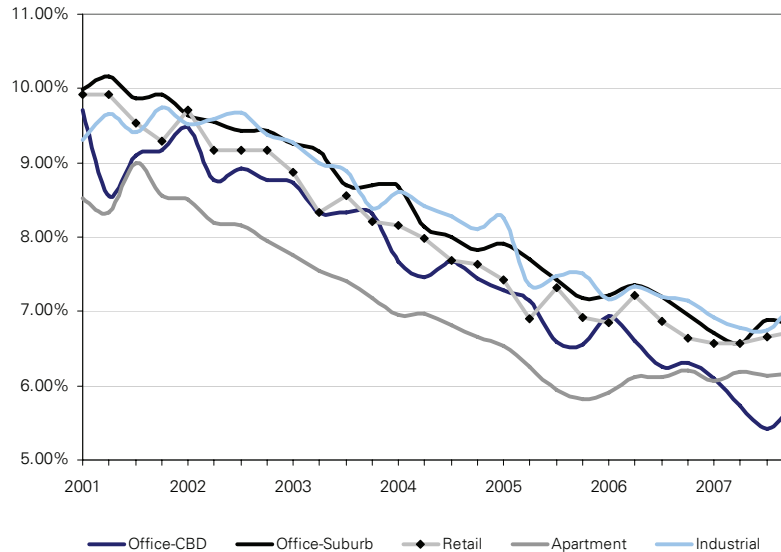
### Pricing & Cap Rates

Effective cap rates increased about 25 to 50 basis points over the past six months as property values decreased. With more modest capital flows to real estate projected for 2008, RREEF Research expects cap rates will increase further. Properties in secondary markets and locations are experiencing the most price adjustments, as are Class B and C properties. High quality Class A properties in top-tier markets continue to attract significant buyer interest and are, in some cases, holding value.

Typical in times of price adjustment, transactions have slowed due to differing opinions of value between buyers and sellers. Once market values are better understood, we believe that transaction volume will increase, but at lower prices and higher cap rates. RREEF Research projects that cap rates will increase by another 25 to 50 basis points over the next six to 18 months. This rise in cap rates coupled with falling interest rates, in

the near term, will allow the risk premium for commercial real estate to increase to a level more in line with historical averages.

**Exhibit 2**  
**Capitalization Rate Trends**  
**(Average Rates)**



Source: Real Capital Analytics and RREEF Research

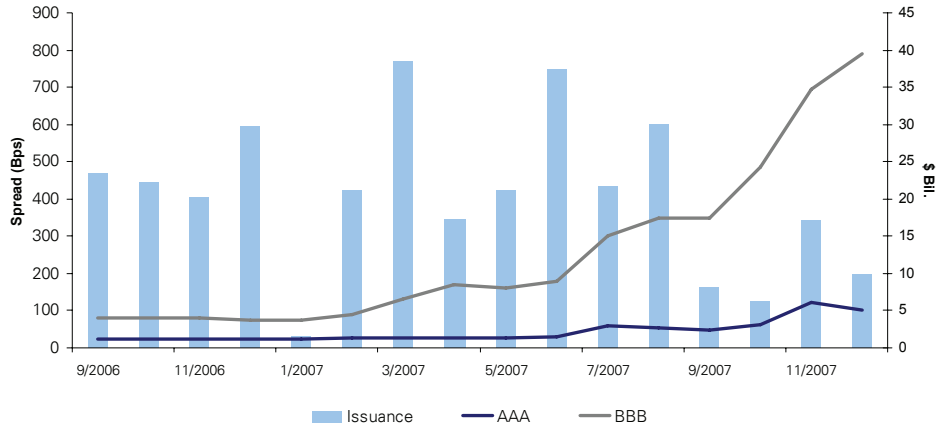
## Debt Market

From July to December of 2007, commercial real estate interest rate spreads over Treasuries increased as fewer lenders participated in the market. Despite relatively healthy fundamentals, pessimism exists in the commercial mortgage market, stemming from the subprime fall out and the ongoing financial crisis. Although loan activity should return to trend levels, prudent underwriting standards will also hold; attention will focus on active management of leasing and operating expenses, rather than dependence upon strong rent growth prevalent during the past few years.

CMBS spreads are up considerably over the past six months and issuance is down sharply. BBB pricing witnessed the greatest increase in spreads as the traditional buyers of this product, including hedge funds and Structured Investment Vehicles (SIVs), vacated the market (Exhibit 3). US private debt pricing has adjusted much less dramatically than the public market. Mezzanine and high yield tranches experienced some widening in spreads during the third quarter 2007, while investment grade debt maintained flat spreads (Exhibit 4). Economic uncertainty and investors' continued risk aversion should further increase the spreads on mezzanine and high yield tranches of private real estate debt.<sup>1</sup>

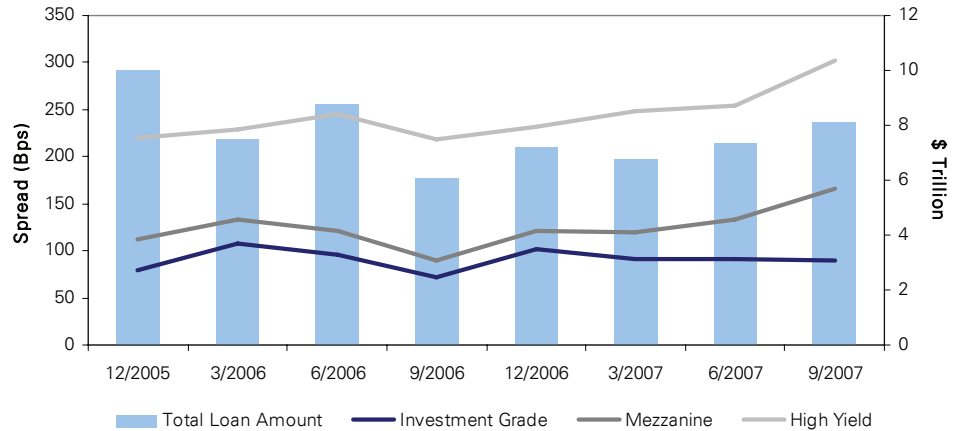
<sup>1</sup> See forthcoming RREEF Research, "The Credit Crunch of 2007: Opportunities in Commercial Real Estate Debt"

**Exhibit 3**  
**US CMBS Issuance and Pricing**



Source: Commercial Mortgage Alert, Deutsche Bank and RREEF Research

**Exhibit 4**  
**Conditions in US Private Real Estate Debt**



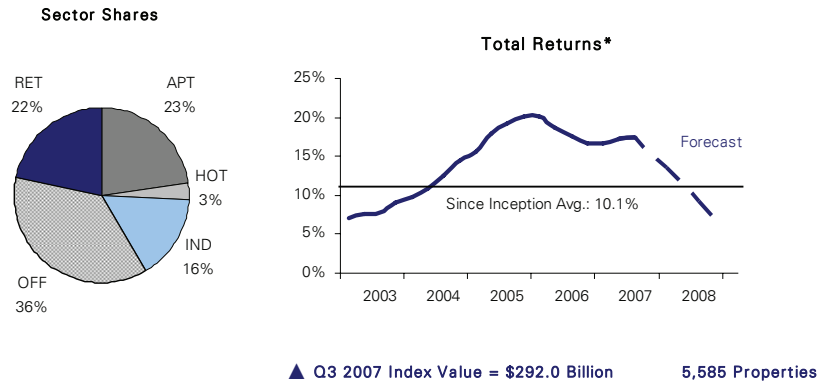
Source: Gilberto-Levy Index and RREEF Research

## NPI Returns

Annual total returns for privately-held properties in the NCREIF Property Index are expected to drop nearly 50% in 2008 from their 2007 returns. Exhibit 5 shows that returns in 2007 have exceeded the long-term average; we expect this to change in 2008. RREEF Research expects total NPI returns of between 6% and 8% in 2008, down from approximately 14% in 2007.

Income should once again take the lead from appreciation as the key driver of returns. Historically, about 80% of the NPI's average return since inception has come from income, but in recent years appreciation has driven NPI total returns to new heights. In 2008, appreciation should cool and possibly turn negative due to rising cap rates. Any depreciation is likely to remain muted, as healthy NOI growth gets capitalized into property value.

**Exhibit 5**  
**NCREIF Property Index**  
**as of Third Quarter 2007**



\*Unleveraged Rolling Four Quarter Returns  
 Source: NCREIF & RREEF Research.

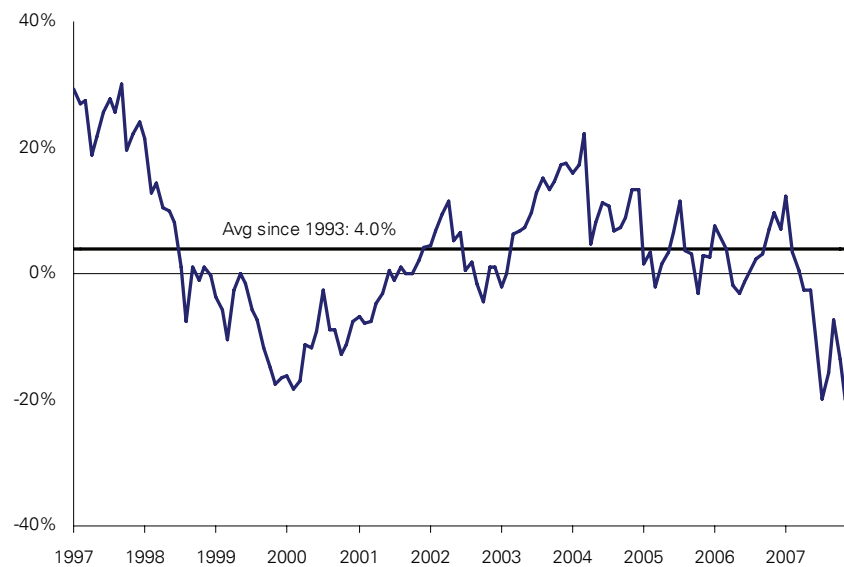
## Publicly-Traded REITs

**Performance Review:** REITs underperformed the broader equity markets in 2007 for the first time in eight years and this underperformance was below our expectations. For the year end 2007, the Dow Jones Wilshire REIT Index posted a total return of negative 17.6 percent, the Dow Jones Industrial Average posted a positive total return of 8.9 percent, and the Standard & Poor's 500 Index posted a total return of 5.5 percent and the tech heavy NASDAQ Composite Index posted a total return of 10.8 percent. At the beginning of last year, we forecasted 5% to 10% return for the year, predicated on earnings growth of 7% to 9% on an initial yield of 4.0%. From this, we subtracted 5% to 10% as we believed the M&A fueled multiple expansion would not sustain itself through the year.

The multiple expansion that occurred early in the year, fueled by speculation of a continuation of the privatization trend of 2006, came to a halt as the subprime mortgage market started to unravel and risk appetite declined. In the ensuing months Hilton Hotels and Archstone Smith, one of the largest apartment REITs, were privatized by Blackstone and Tishman Speyer, respectively. Surprisingly, 2007 total M&A volume matched 2006 with over \$80 billion of real estate being privatized. It was not until early summer that the contagion related to the subprime meltdown began to impact the capital costs of commercial real estate companies. Specifically, spreads on CMBS widened materially and CMBS desks, strapped with underwater commitments on M&A deals that had yet to close, essentially stopped providing bids for mortgage originations. The bank loan market and life companies picked up some of the slack in the back half of the year, but incremental buyers of real estate had fewer capital options as each month passed. From the February 2007 peak of 13.7% year-to-date total return, to year end 2007, REITs fell roughly 31% in price. It is our contention that the market has too greatly discounted the sector and today provides an attractive entry point.

**Valuation:** The slowing of private market transactions in the second half of the year makes assessing underlying value increasingly difficult. Due to this complication we have added conservatism to our valuation process by both increasing the base IRRs we are employing as well as incorporating a recession scenario into our growth rate assumptions. We have increased our IRRs by over 75 to 100 basis points since July and have meaningfully scaled back our expected growth rates. After factoring in these adjustments, our valuation models still suggest REITs are trading at a 20% discount to NAV. Similar discount levels have not been available to investors since early 2000.

**Exhibit 6**  
**Share Price Premium to NAV**



Source: Green Street Advisors

In last year's outlook we stated:

"If we have a valuation concern it is that highly leveraged real estate plays are being made in many markets whereby the buyers' leveraged return hurdles can only be met through appreciation. To date most REITs have steered clear of these types of transactions and therefore we are comfortable with the current risk profile in the public market."

REITs continued to steer clear of these highly levered transactions in 2007 (with the exception of Maguire Properties), but it was a banner year for such transactions by private buyers. The result is a market that will need to work through loans that were made with aggressive underwriting and loose covenants. Fortunately in most cases underlying values have not eroded significantly, but instead the capital structures are suboptimal. REITs could very well be the beneficiaries of this de-leveraging process as many companies in this universe have significant liquidity. Currently REITs are trading at implied cap rates in the low to mid 7% range relative to the private market that continues to transact in the 5% to 6% range. Additionally most REITs still have a comfortable cushion between current in-place rents and the market rents which should provide them with internal cash flow growth even in a slowing economy.

**Performance Outlook:** The base case economic assumption for most REIT management teams remains a mid-cycle slowdown. U.S. REIT market valuations are discounting operating fundamentals, reflective of a recessionary assumption. They are clearly assuming a higher risk environment, as evidenced by higher implied IRRs in the public market. The most pronounced changes in REIT business models, as a result of a slowing economic backdrop, have been a pullback in development starts, an increased focus on redevelopment opportunities, capital conservation, and in some cases, the utilization of their cyclically strong balance sheets to engage in share buybacks. We expect a healthy number of assets to be taken to the private market in 2008, although transaction activity is likely to remain substantially below 2007 activity due to wide bid and ask spreads. The primary culprits of this widening of buyers' and sellers' pricing are the uncertain economic environment and the scarcity of debt capital. We want to stress that although debt capital may impact underlying pricing, we contend the benefits it will have in constricting supply will assist fundamentals going forward. The private market, based on NCREIF valuation data and ongoing transaction activity, has yet to reflect the magnitude of the asset value declines being forecasted by the public market. We are wary that private market valuations have to adjust to a more restrictive financial environment. As this unfolds, negative news flow from the direct real estate markets will weigh on the already discounted public securities. However, with liquidity on the sidelines, an already discounted asset valuation in the public market, and strong balance sheets and asset quality, we believe that the 12 to 18 month forward risk/reward balance is in public real estate's favor and therefore expect public REITs to return 5% to 10% in 2008 with gains being back end loaded.

## General Economic Outlook

The near term outlook for investment in US properties is clouded by the prospect of a recession. The probability of recession has increased to 50%, given financial market volatility and lack of investor confidence. Economic growth is expected to be very slow from the end of the third quarter 2007 through mid-year 2008. Unfavorable events could easily tip the economy into recession during this slow growth period. In such a climate, investors are likely to remain cautious. Volume and pricing of real estate transactions are likely to remain restrained, with capitalization (cap) rates moving upward due to reduced liquidity, more conservative underwriting assumptions, and lender reversion to disciplined standards.

**Exhibit 7**  
**Forecast Highlights: U.S. Economy 2007-2009**  
(annual percent change)

|                           | <u>2007</u> | <u>2008</u> | <u>2009</u> |                            | <u>2007</u> | <u>2008</u> | <u>2009</u> |
|---------------------------|-------------|-------------|-------------|----------------------------|-------------|-------------|-------------|
| Real GDP                  | 2.6         | 1.5         | 2.4         | Consumer Price Inflation   | 2.9         | 2.2         | 1.6         |
| Consumption               | 2.9         | 1.3         | 2.1         | Payroll Employment Growth  | 1.3         | 0.7         | 1.0         |
| Business Fixed Investment | 4.5         | 2.2         | 2.5         | Unemployment Rate (%)      | 4.6         | 5.3         | 5.2         |
| Equipment & Software      | 1.2         | 3.7         | 6.4         | Federal Funds (%)          | 5.03        | 3.00        | 3.75        |
| Exports                   | 8.0         | 9.6         | 8.5         | Ten-Year Treasury (%)      | 4.63        | 3.50        | 4.00        |
| Imports                   | 2.0         | 2.1         | 5.0         | 30-Year Fixed Mortgage (%) | 6.33        | 4.50        | 5.00        |

Source: Global Insight and RREEF Research

Longer term, assuming the US goes through a period of slow growth, or even a slight recession, market fundamentals for property should retain their position of strength. Currently, all four property sectors including apartments, industrial, office and retail, are in relatively healthy balance with respect to supply and demand. Although vacancy rates are expected to rise in the coming year, reflecting weak demand growth, the supply/demand balance is forecast to improve as the economy and demand drivers resume stronger growth in 2009.

The following provides key assumptions underlying our outlook for US economic performance:

- An outlook of sustained, if slowing, global economic growth;
- A healthy business economy, with strong corporate financials and rapidly expanding exports, with business investment forecast to grow by 2.2% in 2008;
- Interest rates that are expected to remain restrained, which will be further eased by the Fed, who after lowering the Fed Funds Rate to 3.5% in mid-January is expected to cut another 50 basis points;
- Continued low, albeit modestly rising, unemployment rate;
- Energy prices that appear to be stabilizing, particularly in view of a slowing global economy;
- A consumer market that is expected to maintain modestly positive growth; and
- Swift accommodative monetary policy by the Federal Reserve and other major central banks.
- Some fiscal stimulus; and
- A correction of the US trade deficit, with exports increasing at a much faster rate than imports.

For 2008, we forecast GDP growth of 1.5%, most of which will be back-loaded during the year. Employment growth is forecast to slow to 0.7% for the year, which will lead to an unemployment rate that peaks at 5.4% in the fourth quarter. Although substantially higher than the robust 4.5% achieved in mid-2007, this will remain a low rate of unemployment by historical and global standards.

With the negative impacts of the housing, financial and consumer markets receding later in 2008, and solid underlying business fundamentals, renewed healthy economic growth is forecast beginning in 2009. For the period 2009 through 2011, GDP growth is forecast to average 2.4% annually; with employment growth averaging 1.0%. The unemployment rate is forecast to stabilize at 4.8% by 2011.

Our outlook for sharply weaker economic growth in the near term means lower levels of net absorption for all property sectors through 2008. Beginning in 2009, however, job creation should support new demand for office and industrial space. Further, a rising number of new household formations along with job growth should sustain apartment demand. Retail could be the sector most at risk in this economic environment, but our baseline forecast calls for sustained, albeit slower, consumer spending and modest net positive retail demand.

Significant risks exist to this forecast, primarily on the down side. The consumer is a wild card, and could cut consumption more than forecast in response to housing's negative wealth effect. Given the dominant role of consumption in the US economy, this is clearly a worry. In addition, inflation is a concern. Although weaker economic growth should moderate inflationary pressures, the Federal Reserve will have a difficult role devising a monetary policy that moderates inflationary pressures rising from a declining dollar, continuing high oil and commodity prices, and a high fiscal deficit, while also stimulating growth.

## Outlook for Regional Economies

The overall economic slowdown is affecting all areas of the US, but some regions will continue to lag more than others. Near term jobs losses will be greatest in Southern California, Florida, New York City and at-risk pockets around the country. Factors increasing a likelihood of a regional recession are excessive housing supply, current overvaluation of housing stock, high reliance on at-risk industries, the percentage of previous equity withdrawal and overall default rates. Although our overall job growth forecast is lower compared to last year's, our outlook continues to remain strongest for the South (1.5% p.a.) and the West (1.4% p.a.), and we continue to view the Midwest (0.7% p.a.) and the North East (0.6% p.a.) as lagging the national average. The following is a breakdown of economic outlooks for the four main census regions.

**South:** Although Florida is experiencing the brunt of the subprime fallout, the region as a whole is positioned relatively well for the next five years. The South benefits from continually strong population growth and lower business costs compared to other parts of the US. In addition to modest manufacturing gains, the region is successfully increasing its exposure to business and financial services, leisure and travel services, and international trade. With large deposits of natural gas and oil, higher energy prices are beneficial for the region, specifically to the south-central. Remaining risks include lingering housing turmoil, largely affecting Florida and the Eastern Coast, and the Defense Department's BRAC movements which may negatively affect some markets.

**West:** The housing downturn and the current financial market turmoil puts the western region of the country at significant risk in the near term, but fundamentals provide a stronger long term forecast. The downturn in housing will continue to strain exposed markets in southern California, Phoenix and Las Vegas, while markets exposed to the mortgage industry and debt securitization will feel the effects of the banking crisis. Over the long term, the region benefits from strong population trends as well as upswings in aerospace, technology, travel and tourism, international trade and financial and professional services. Stronger global demand will also benefit this region as a whole.

**Midwest:** Although overall the Midwest is expected to perform below the national average over the next five years, pockets of the region will perform relatively well. Low exposure to financial markets and higher exposure to commodities is cushioning the Midwest during the current economic downturn. Current risks in the Midwest are associated with high employment costs, making it a less attractive destination manufacturing and weak demographic trends. Near and long term benefits are from higher-skilled industrial machinery manufacturing, exports and the continual shift to service sector industries. The declining US automotive industry will continue to have a negative impact on the region.

**North East:** The current banking crisis will be a drag on the North East, but underlining fundamentals of the region will keep long term economic growth closer to the national average. The costs of near term job losses in financial services will drag on economic growth in the near term. Other risks associated with the region have to do with the high cost of employment and the overall high dependence on oil. The region benefits from a higher than average level of education, which encourages growth in research operations and business and financial services. In addition, strong global ties will cushion the loss of manufacturing as well as assist with the recovery of the financial sector.

**Map 1  
Regional Job Growth in 2008  
Percent Change**



Source: Economy.com and RREEF Research

The benefits and risks of each of these regional economies highlight the factors that will support certain metros over others during the forecast period. Metros particularly exposed to information, professional and business services, education and health services and the tourist industry are positioned to perform well. Those with highest exposure to global linkages and international trade will benefit from the ongoing trend of globalization. Structurally, metro areas that possess low business costs and population growth will outperform over the longer run. Exhibit 8 summarizes the drivers shaping superior regional performance in the US in the age of globalization.

**Exhibit 8  
Key Drivers of Regional Performance**

**Industrial Linkages**

High-tech  
Global Trade  
Leisure & Hospitality  
Health & Education

**Structural Characteristics**

Strong Demographic Flows  
Low Business Costs  
Availability of Skilled Labor  
Warm Climate  
Pro-business Regulatory Environment

Source: RREEF Research

At this mid stage of the economic and property market cycles, market selectivity is more important than was the case earlier in the recovery stages of these cycles. As a result, primary consideration should be given to those metropolitan areas where economic growth should be the strongest, based on above average activity in international financial and professional services, defense, trade, medical, and high-tech (see Map 2). RREEF Research believes these sectors will be the strongest for the US economy during the next several years. These “Globally-Linked” locations should achieve particularly strong economic growth and should be primary targets for investment. This economic growth will continue to produce broad-based activity and increases in space demand. These markets also typically provide above-average household education and income, reflecting their “knowledge-based” foundation.

**Map 2**  
Globally-Linked Markets



Source: RREEF Research

## Property Markets

Changes in the economic outlook that occurred in the second half of 2007 lowered our expectations of all property types. The next four sections highlight current market conditions and our outlook for the next couple years.

**Exhibit 9**  
National Vacancy Rate Trends

|            | - Actual - |        |        |        | Trend |
|------------|------------|--------|--------|--------|-------|
|            | 2006       | 3Q2007 | YE2007 | YE2008 | 06-08 |
| Apartment  | 5.7%       | 5.6%   | 6.0%   | 6.1%   | ↔     |
| Industrial | 9.4%       | 9.2%   | 9.4%   | 9.8%   | ↑     |
| Office     | 12.6%      | 12.5%  | 12.5%  | 13.2%  | ↑     |
| Retail     | 7.1%       | 7.4%   | 7.5%   | 7.7%   | ↑     |

Source: REIS, CB Richard Ellis/Torto Wheaton, & RREEF Research

## Apartments – It's all good, right?

**The Issues.** The debt crisis of 2007 brought renewed prudent lending standards to the US for-sale housing market. As a result, fewer households will have access to homeownership going forward. Once again, home buyers must provide an equity down payment, verification of income, and a reasonably good credit history. This re-discovered underwriting stringency has required that many newly formed households enter the rental, rather than the ownership, housing market. This has occurred in tandem with foreclosures, resulting in significant and rapid slippage in the US homeownership rate to 68.2% as of third quarter, 2007 from 69.0% one year earlier. Overall, renters increased by over 1.1 million households in the past year; we expect the homeownership rate may slip further during 2008.

Some of these reversion renter households moved to institutional grade apartments, thereby boosting absorption in most markets. Exceptions include markets with relatively high exposure to a worsening shadow supply of single family homes and condominiums, offering renters a surfeit of possible housing options. Notably, apartment performance in the majority of Florida markets, Phoenix, Inland Empire, and Orange County now lag in the US due to the high concentration of unsold inventories of homes that are being rented. Numerous other markets have been impacted as well. The high growth, lower cost Sunbelt markets, in particular, attracted strong speculator interest. These “flippers” created severe market imbalances and, with fewer buyers willing or able to purchase homes and little financial investment in the property, are exacerbating unsold inventories and foreclosure problems.

Against a backdrop of weakening economic growth, positive demographic trends and job growth boosted demand for rental housing and apartment absorption in 2007 to an estimated 75,000 units, the strongest since 2000. Demand remains low relative to trend but, given that many condo conversions failed and thousands of units reverted to competitive rentals, in essence returning far more supply to market than anticipated, the vacancy rate increased within a narrow band in 2007. RREEF Research estimates that vacancy stood at approximately 6.0% as of year end 2007.

This relative market health also is reflective of restraint in new construction activity of rental apartments. Apartment construction has declined for the past seven consecutive years. However, about 96,000 new units delivered in 2007, a significant increase over the past four years. Nevertheless, this remains well below the historical average, and we expect construction to remain at similar restrained levels in 2008. Many markets nationally will be double-impacted by even moderate new apartment supply, along with significant numbers of intended for-sale housing converted to rental.

**Regional Disparity in Performance:** The relatively benign vacancy rate masks some distressed regions nationally. In particular, the South Florida markets, including Ft. Lauderdale, West Palm Beach and Miami, suffer from an excess supply of new and condo conversion units, some of which are transitioning to the rental market. In addition, the region now has an excess of single family homes for sale and a reversal in previously positive migration trends. The double-digit rent growth for the past three years was driven by strong economic growth and net losses to rental stock as the blistering pace of converting rental units to condominiums far exceeded new rental deliveries, tightening vacancy rates. Rent growth abruptly halted when condo sales stalled, resulting in a “reversion” trend, characterized by a reversal of condo conversions back to rental units in 2007. Similarly, stalled sales activity in new construction has property owners scrambling to fill units by offering steep, but most likely temporary, discounts from asking rents.

Longer-term, we expect South Florida's excellent demographic trends and renewed job growth to stabilize local housing market conditions in the next 18 to 24 months.

While South Florida is the "poster child" for excessive condominium conversion and construction activity, numerous markets are significantly overbuilt in for-sale housing product, primarily single family homes. The most heavily impacted markets include Orlando, Tampa, Phoenix, Las Vegas, Inland Empire, and Sacramento. Other markets, particularly in the South and Southwest, were also substantially overbuilt relative to household growth, and virtually all markets are being impacted to some extent. Many homes in these markets are entering the rental market, and impacting demand for rental apartment stock, particularly larger two and three bedroom apartment units.

Markets tied to energy, technology and global trade exhibit significant improvement in demand conditions, but are experiencing a decided ramp up in supply as well. For example, Boston, Atlanta, Phoenix, Houston and Austin reportedly led the US in apartment completions over the past 12 months. New York and Los Angeles also report higher construction volumes relative to recent years, but frictional vacancy rates and low affordability support above inflationary rent growth.

Supply constrained markets with low housing affordability will continue to out-perform affordable markets, such as New York, Washington, DC, Baltimore, San Francisco, San Jose, Los Angeles and Seattle. In fact, we expect a widening bifurcation in performance between supply constrained and most low barrier-to-entry markets. Land and construction costs remain elevated and, with higher financing costs factored into the equation, sponsorship of development deals may be central to viability. It is hard to go wrong with value add Class B and C properties in these markets.

In dynamic markets with strong population trends and job growth prospects, look for infill submarkets to remain the preferred resident locale, i.e., LoDo in Denver, Uptown in Dallas, Medical Center in Houston, and Buckhead/Midtown in Atlanta.

From a property operations perspective, RREEF Research notes that shadow rentals have posed a serious challenge to Class B apartments in some markets, notably Baltimore and Washington, DC. Class A properties continue to face greater challenges from the lower point of entry into homeownership offered by condominiums, particularly as declining home prices, incentives and continued low mortgage rates improve affordability for credit-worthy applicants. Finally, following a refreshing period of transparency in market data in the late 1990s and early 2000s, market data is increasingly opaque. In the absence of an actual rent roll, LRO systems and daily pricing can make it difficult to "true up" market rents when benchmarking performance.

**Risks and Outlook:** The correction in the housing market, and its impact on consumers, is the biggest cloud to any forecast of performance. If it tips the US into recession, the impact will be felt in all property sectors. The full magnitude of this adjustment is still emerging, and it is one reason our outlook for apartments is tempered with caution. If the economy severely falters, echo boomers will wait to leave their parents' homes or will double-up so that household formations will wane until employment growth resumes.

Our forecast for apartment fundamentals reflects an outlook for slower US economic growth in the coming year, recent changes in the mortgage markets and lending requirements, and a growing inventory of homes on the market. We expect the US vacancy rate to tick up by year end 2008 before declining in 2009. Apartment demand is strongly correlated to new household formation, which is made possible by a healthy job market. We expect continued improvement in fundamentals as the US shakes off the

detrimental housing effects and echo boomers leave their parents' home or schools in increasing numbers. In addition, with the US still at strong levels of employment, we expect continued immigration to remain a critical component of US apartment demand.

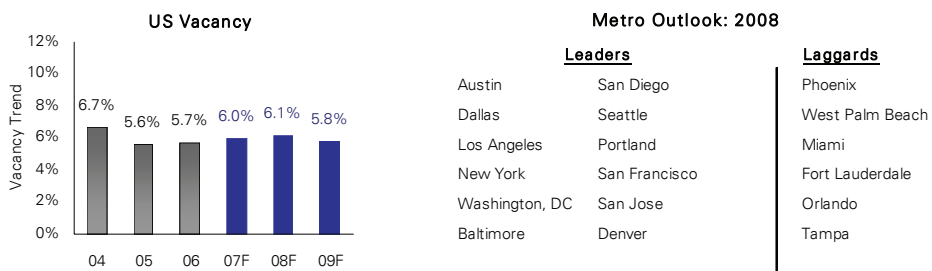
On the positive side of the supply outlook, costs of new development and less attractive construction financing should moderate future construction of apartments beyond 2008. Overall costs remain elevated. Higher financing costs suggest that some of the development pipeline currently planned or proposed may not prove out, which would result in a greater tightening of vacancy rates.

RREEF expects apartment market fundamentals will be amongst the strongest of the property sectors in 2008. Longer term, with resumed economic expansion, and absorption of the excess supply of for-sale housing, an improving institutional rental market is forecast, which should drive above-inflationary rents.

Other risks and expectations, some of which were noted in our 2007 Strategic Outlook, follow:

- Attractive interest rates and eroding home prices will improve affordability in many markets. Although tougher lending standards will limit home sales, significant declines in prices in some markets will attract buyers and provide a countervailing force to apartment demand.
- Excessively restrictive immigration policies may diminish a vital component of apartment demand.
- We expect continued regional differences in apartment performance in 2008, particularly in markets heavily influenced by condominium development and an over-supply of affordable single-family homes. The good news is that many of the markets at highest risk for more severe adjustments are also some of the fastest-growing in the country, both in jobs and population growth. This may help assuage the overbuilt condition much quicker than slow growth markets. In addition, our apartment forecasts have already assumed a high level of for-sale new home over-supply.
- Higher replacement costs drive up pro forma rents for new development, but recessions prove that apartments are not immune to economic malaise, with Class A rents often most vulnerable. Further, rental demand will increasingly depend upon echo boomers and immigrants, who tend to be younger and earning less money than other rental cohorts.
- The short term nature of leases in apartments allows owners to roll to higher market rents in growth periods, but also means they are less protected in a highly competitive housing market. Also, in weak employment markets, echo-boomers move home or double-up, thereby reducing housing demand. If the jobs market stalls more than forecast in this outlook, effective rent growth may under-perform expectations.
- Assuming the US homeownership rate declines another 50 basis points and stabilizes in the range of 67.5% to 68% between 2008 and 2010, the cumulative net increase in renter households for the same time period could total between 1.0 and 1.6 million. Further, given projections of household formations, new owner occupied households would increase by 2.0 to 2.7 million units, both of which suggest more balanced housing market conditions over the next 24 months.

**Exhibit 10**  
**Apartment Snapshot**

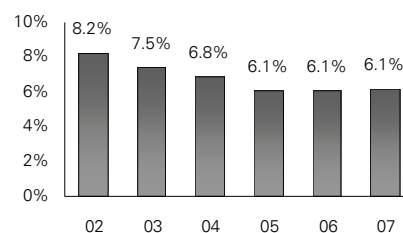


Source: REIS and RREEF Research

**Transaction Market**

Real Capital Analytics (RCA) reported sales of apartment properties totaled \$92.2 billion in 2007, comprising approximately 19% of all commercial sales, including hotels. The \$22 billion privatization of the Archstone portfolio accounted for nearly 22% of sales. RCA further reports that 3,515 properties were exchanged for a weighted average price per unit of \$118,426. This reflects a 20% increase over 2006, which had been flat compared to 2005. The weighted average cap rate was a low 6.13% compared to 6.08% last year. Cap rates in the top tier markets are holding firm, while some decompression is occurring for lesser quality assets in secondary markets. A flight to quality has emerged and even though sales are declining, new offerings have increased by 10%. Changes in credit markets have eliminated some buyers and distress has added new sellers.

**Exhibit 11**  
**Average Apartment Cap Rates**  
**2002-2007**



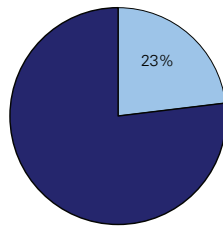
Source: Real Capital Analytics & RREEF Research

**Performance**

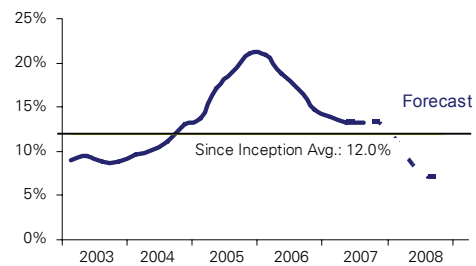
The NCREIF Apartment Index finished the year ending third quarter 2007 with a total return of 13.3%, trailing office and industrial properties. Declines in both appreciation and income returns contributed to a lower overall return. The income return notably was the weakest of all the property types. High-rise and garden properties posted total returns of 14.7% and 12.4%, respectively. High-rise properties posted higher appreciation but somewhat lower income returns than garden style. Regionally, in a reversal from one year ago, the South was a drag on the Index with the lowest returns of 10.9%, while properties in the West and East led total returns, posting 14.9% and 14.3%, respectively, boosted by appreciation. We expect total returns for apartment properties as measured by the NPI to range between 5% and 7% in 2008.

**Exhibit 12**  
**NCREIF Apartment Index**  
 as of Third Quarter 2007

**Apartment Share of NPI**



**Total Returns\***



▲ Q3 2007 Index Value = \$67.2 Billion      1,259 Properties

\*Unleveraged Rolling Four Quarter Returns  
 Source: NCREIF & RREEF Research.

## Industrial Properties: A Mid-Cycle Balancing Act

**Market Highlights.** As an indicator for the health of the US economy, the industrial sector confirmed the economic slowdown that emerged towards the end of 2007. Reflecting a decelerating economy, industrial demand cooled during the second half of 2007, posting its lowest net absorption totals for two consecutive quarters since 2003. After declining to 9.2% in the third quarter, the industrial sector’s vacancy rate closed 2007 up 20 basis points to 9.4% - ending its impressive three and one-half year span of tightening. Confirming a typical recovery cycle pattern, the R&D/flex segment has now replaced the warehouse segment as the strongest performing industrial asset class. While warehouse demand stalled during the second half of 2007, R&D/flex produced fairly steady net absorption during the year that pushed the segment’s vacancy rate down to 12.7% at year-end – a 50 basis decline from a year ago and a 450 basis point drop since the beginning of the recovery (first quarter 2004). With demand and supply in relative balance during 2007, the warehouse segment ended the year with a vacancy rate of 9.7% – unchanged from a year earlier. Low availability rates kept the development pipeline fairly active in 2007, particularly in the big box warehouse segment. However, as leasing activity slowed and credit tightened, developers have begun to postpone their speculative projects – a trend we expect to see continue in 2008.

The critical factors that drive industrial demand remained intact during most of 2007 despite the negative economic shocks, but are now showing some signs of pressure. The bright spots remained global trade and technology, although industrial use that supported the residential builders is contracting. The gateway markets along the West Coast continued to lead the overall US industrial market in terms of rent growth during 2007, while the technology hubs of San Jose, Austin, Seattle, and now Boston led the recovering R&D/flex segment. After a robust recovery that began in 2004, market fundamentals were fairly balanced during 2007 for the overall industrial sector, which bodes well for the sector as it enters a more uncertain economic outlook.

With the economic conditions reflecting a mid-cycle slowdown, leading indicators for industrial demand point to some weakness. The pull back in consumer and business spending, coupled with the ongoing slump in the housing market is expected to depress industrial demand during the first half of 2008. Despite these challenges, strong corporate balance sheets, growing demand for exports resulting from the falling US

dollar, and healthy global economy, will help offset current weakness and provide the foundation for a rebound in industrial demand as the US economy regains its footing in late 2008. With the credit markets tightening, developers will likely have to build speculative construction to much higher required returns, which should contain the amount of new supply delivered to the market. Expectations of restrained speculative construction is likely to help offset weakening industrial demand, setting up a balancing act for the sector as the US economy enters into its mid-cycle slowdown in 2008. Here's our view for the year ahead:

- Supply/demand fundamentals are expected to tilt towards some weakness, especially during the first half of the year. Although tighter credit markets will curtail speculative development, new supply (forecast of 140 million square feet) is expected to outpace a projected 80 million square feet of net absorption. The national vacancy rate increases to 9.8% by year end 2008 (see Exhibit 13).
- Foreign trade and high tech will continue to be the key drivers for industrial demand as the ongoing global growth story remains in place. Metro markets that can capture that demand will continue to benefit, outperforming metros that only rely on the domestic economy for growth.
- The recent cycle of industrial development that was driven by large distribution users looking for ever larger floor plates is winding down. Another trend is that speculative development is expected to shift to more build-to-suit opportunities. Higher return requirements and tighter credit is expected to reduce speculative big-box warehouse construction in the major distribution markets of Atlanta, Central New Jersey, Chicago, Dallas/Ft Worth, and Southern California's Inland Empire, which should help stabilize these markets as demand softens during the first half of the year.
- Technology continues to be a bright spot for the US economy, improving the prospects for the recovering R&D/flex segment. The tech hubs of San Jose, Austin, Seattle, Boston and Washington, DC are all expected to benefit from sustained bio-tech and high-tech demand.
- The large and culturally diverse markets of Southern California, San Francisco Bay Area, Seattle, New York, and South Florida remain the prime entry points from Asia, Europe and Americas. All these markets benefit from coastal locations, providing industrial firms proximity to some of the busiest cargo seaports and airports in the US.
- The emergence of the Savannah, Norfolk, Houston, and Charleston seaports as viable entry points for expanding Asian trade to the East Coast has made the industrial markets of Atlanta, Houston, Charlotte, and Chicago (via the 2010 completion of the Heartland Corridor from Norfolk) an attractive option to West Coast ports.
- Although the US vacancy rate is forecast to rise in 2008, it will remain under 10%, which should allow effective rents for warehouse and general industrial space to post modest increases – ranging between 2% and 3%. Providing the most upside, R&D/flex space in strengthening tech markets could see above average gains in effective rents in the 3% to 5% range.

**Exhibit 13  
Industrial Snapshot**

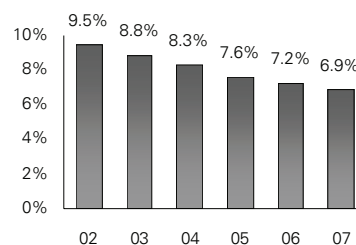


Source: CBRE, Torto Wheaton and RREEF Research

**Transaction Market:** Transaction volume for industrial properties leveled off in 2007, after four years of particularly strong growth averaging 39% annually between 2002 and 2006. Although the first three quarters had been particularly strong, turmoil in the credit markets interrupted potential deals and caused transaction volume to tumble. The sales volume fell in the fourth quarter, for a total of \$44.5 billion in 2007 – up 3.7% from 2006. With financing more expensive and difficult to find, the acquisition pendulum has swung back to institutional investors and public REITs, which are able to perform with a higher percentage of cash. Tenancy-in-Common syndicates and private equity funds that relied more on financial engineering have lost market share.

A flight to quality and fewer deals has allowed average cap rates for warehouse and flex properties to remain low, but a pricing correction is becoming apparent as the risk premium (spread between cap rates and Treasuries) is widening for both warehouse and flex properties. The average industrial cap rate dropped 36 basis points from 2006 to 6.9% in 2007 (see Exhibit 14). More expensive debt and economic uncertainty has put upward pressure on cap rates. Regionally, while the Midwest has already experienced an increase in cap rates, the coastal, global gateway markets, where institutional buyers remain active, have so far resisted upward pressure.

**Exhibit 14  
Average Industrial Cap Rates  
2002-2007**



Source: Real Capital Analytics & RREEF Research

Industrial property pricing in 2008 is expected to begin to reflect the full impact of tightening credit as sellers adjust to the new paradigm. Our expectations are as follows:

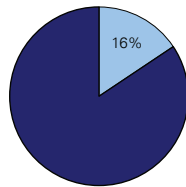
- Industrial properties become more desirable as a core holding in institutional property portfolios during economic uncertainty, which keeps pricing relatively firm.
- Now at an inflection point, cap rates will rise by an average 50 basis points for both warehouse and R&D/flex.
- There will be a continued flight to quality as investors evaluate weakening market fundamentals.
- Cap rates for value-added transactions will experience the greatest price correction since lenders are no longer willing to underwrite speculative income and aggressive rent growth assumptions.

**Performance:** The NCREIF Industrial Index posted a total return of 12.0% for the first three quarters of 2007, similar to the NPI composite return (see Exhibit 15). Reflecting its strong recovery, R&D properties were the best industrial performers, while the total returns for the warehouse and flex segments slipped. Regionally, the West achieved a stellar total return, while the South underperformed the NPI composite return. For the calendar year, we project a total return for industrial properties of around 14%, similar to our forecasts for the overall index.

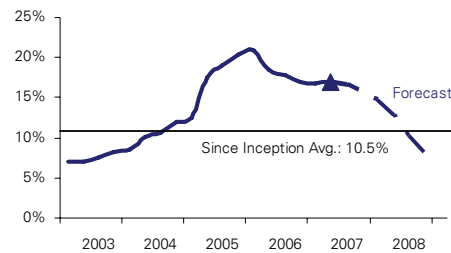
After posting several years of exceptional growth, we expect total returns for the industrial sector to continue to trend downward in 2008 below the sector's historic average return of 10.7%. We anticipate total returns to range between 7% and 9% during 2008, the highest of the four property sectors. Core industrial product's ability to produce above average income returns will become more attractive to institutional investors as the US economy weakens, which should produce a steady year of

**Exhibit 15**  
**NCREIF Industrial Index**  
 as of Third Quarter 2007

**Industrial Share of NPI**



**Total Returns\***



▲ Q3 2007 Index Value = \$45.4 Billion      2,008 Properties

\*Unleveraged Rolling Four Quarter Returns  
 Source: NCREIF & RREEF Research.

performance.

## Office Properties: The Morning after the Party

**The Issues.** Even more so than a year ago, the US office market is at a critical point in the cycle. The first half of 2007 saw heady times for the US office sector. In the wake of the break-up of Equity Office Properties' landmark portfolio and subsequent re-trades, capital values reached a record high.

Total returns reached the high-teens – the best of all four main property sectors – driven not only by capital appreciation but also by double-digit percentage rental growth in the nation's leading office submarkets. Demand was holding steady and vacancy continued to fall.

All of this has now changed. The closing months of 2007 saw vacancy stalling, subdued demand in the face of economic uncertainty and new owners being challenged to achieve the high pro-forma rents upon which they had underwritten their acquisitions. In essence, the music has stopped – which markets and owners are still left sitting at the best chairs?

Short-term economic indicators point to a significant downturn in demand. On the supply side, there has been an increase in speculative construction which is set to outstrip demand by a sizeable margin in 2008.

**Market Highlights:** The US office market's performance slowed in 2007, with only a 10 basis points drop in the national vacancy rate over the year. The office sector produced 53.4 million square feet of net absorption for the year overall – down from 80.2 million square feet in 2006 and the lowest national total since 2003.

Solid office job growth, forecast at 1.7% for the year as a whole, underpinned the 2007 demand total, but was notably lower than the 2.9% rate achieved in 2006. National office vacancy closed out 2007 at 12.5% down marginally from 12.6% one year earlier. National office vacancy now stands at 430 basis points below the peak level of 16.8% reached at year-end 2003. Downtown vacancy continues to fall and stands at 9.6%, while suburban vacancy rose by 30 basis points in 2007 to 14.2%.

The supply-side continued to gear up again, albeit not to alarming levels. National multi-tenant office completions rose by 9.0 million square feet in 2007 to 61.2 million square feet. This was the first time that annual completions had outpaced absorption since 2003.

On a geographic basis, the office sector's performance remains far from even and has shifted considerably from 18 to 24 months ago. Only five major metro markets closed out 2007 with a vacancy rate of 10.0% or below; Los Angeles, New York, San Francisco, Seattle and Washington DC.

Markets which had led the recovery, most notably Orange County, Phoenix and San Diego, have seen their fortunes change as high-levels of new speculative construction and a drop in demand driven by the housing slowdown and subprime collapse have driven up vacancy and placed downward pressure on rents.

Markets now picking up the pace include Austin and San Jose, while those that continue to lag include Atlanta, Dallas, New Jersey and Philadelphia. Dallas, at 21.6%, has the dubious honor of having the nation's highest vacancy rate.

The year ahead should deliver a modest overall decline to the office market. The major risk facing the sector rests with the demand-side, at least in the near-term. The immediate outlook for office job-growth is poor and the gap between new supply and demand is set to widen. Here's our take on the sector during 2008:

- Sector fundamentals show their first softening in five years as demand falls well below new supply – 35.0 million square feet compared to 59.7 million square feet. The national availability rate rises by 70 basis points to 13.2% by the close of the year (see Exhibit 16).
- Office employment growth will slow considerably to 0.6%, resulting in the addition of around 200,000 new jobs and accounting for the slowdown in absorption back to around 15.0 million square feet below its long-term average.
- Demand will be the critical issue to track in 2008. The recent slowdown in the economy and the headline-grabbing write-downs made by major investment banks suggest that, in a worst-case scenario, absorption could fall to even lower than our projected 35.0 million square feet.
- New office development, at 59.7 million square feet, will remain at a relatively containable level on a national basis.

- Growth in Class A effective rents should slow. Average Class A effective rental growth across the 21 metros tracked in RREEF Research's US Office Market Book is forecast at 3.0% for 2008.

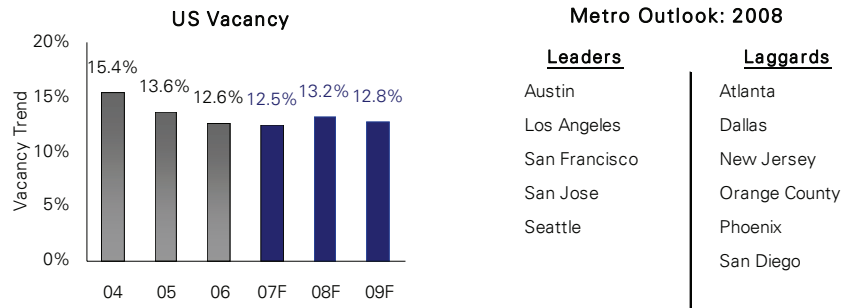
The new generation of office owners will have to become more creative in their leasing strategies in order to achieve the high pro-forma rents underwritten at the time of acquisition. At the same time, tenants with lease expirations may be more aggressive and price-sensitive in their negotiations.

New development will remain concentrated in a handful of metros – most notably Washington DC, New York, Phoenix, Chicago, Los Angeles, Dallas and Seattle. Among the major markets, only five will close out 2008 with an availability rate of around 10% or below: Boston, Los Angeles, New York, San Francisco and Seattle.

While there will be significant submarket-level variations, in broad terms, the strongest percentage appreciation in Class A rents is expected in Austin, Los Angeles and San Jose. Conversely, effective rental declines of up to 10.0% are projected in parts of Orange County, Phoenix and San Diego.

2008 will be the bottom of the cycle. Looking in to the medium-term, we forecast that national office vacancy will return to the 12.0% mark by 2010 to 2011.

**Exhibit 16**  
**Office Snapshot**



Source: CBRE Torto Wheaton and RREEF Research

**Transaction Market:** Further rises in pricing characterized the office sector in the first half of 2007. In most major markets it has been nearly impossible to acquire well-leased Class A properties at a discount to replacement cost.

New records were again set with capital values breaking through the \$1,250 per square foot barrier in Midtown Manhattan and to over \$800 per square foot in Downtown San Francisco. However, with exception of a handful of trophy submarkets such as Midtown Manhattan, the downtowns of Boston, San Francisco and Seattle plus West Los Angeles, there is sentiment – if not much transaction evidence – that this pricing frenzy may be waning.

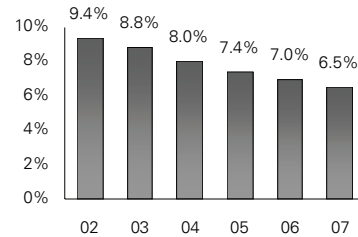
The most significant change in investor strategy in 2007 was the shift to a value-added approach. Investors became more willing to take on leasing risk, undertake capital improvements, consider secondary markets or create value through new construction.

This will still occur for the high-risk/high-return player but in general we anticipate a more cautious approach to valued-added opportunities in the office sector – especially where there is considerable short-term leasing risk.

Average cap rates for office properties fell by 50 basis points in 2007, from 7.0% in 2006 to 6.5% in 2007 (see Exhibit 17). Cap rate spreads between CBD and suburban office have increased in the past year, rising from 65 basis points in 2006 to 89 basis points in 2007. Major Class A CBD transactions have clearly driven transaction volume and cap rates in the past year.

Although reported cap rates for office transaction reflect downward movement in cap rates, we believe that effective cap rates moved upward in the later part of the year, particularly for Class B and suburban properties. Office property pricing is expected to witness further change in 2008. Our expectations for the transaction market are as follows:

**Exhibit 17  
Average Office Cap Rates  
2002-2007**



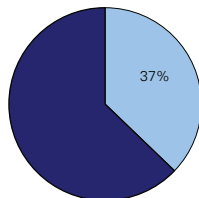
Source: Real Capital Analytics & RREEF Research

- Reduced investor demand and slower rental growth will see office pricing and cap rates increase slightly from current levels for most institutional product.
- Although remaining attractive to some, fewer investors will undertake value-added acquisitions, particularly where there is short-term leasing risk.
- The flow of capital into new development will slow.
- As overall market fundamentals decline, cap rates on some lesser quality assets may increase by 50 or more basis points by the end of the year, particularly if interest rates rise.

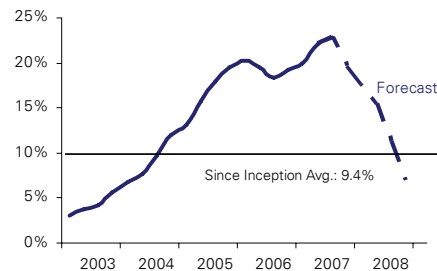
**Performance:** The NCREIF Office Index posted a 16.1% total return for the first three quarters of 2007, nearly 400 basis points above the NPI composite return (see Exhibit 17). CBD properties registered a particularly strong return, while suburban office buildings lagged. For the calendar year, we expect total returns for office properties as measured by the NPI to total between 16% and 18%. For 2008, we forecast a total return of between 6% and 8% for the office sector, in line with our projections for the overall NPI.

**Exhibit 18  
NCREIF Office Index  
as of Third Quarter 2007**

**Office Share of NPI**



**Total Returns\***



▲ Q3 2007 Office Index Value = \$108.2 Billion 1,343 Properties

\*Unleveraged Rolling Four Quarter Returns

Source: NCREIF & RREEF Research.

## Retail Properties: Tampered Expectations

**The Issues:** The long-expected slowdown in consumer spending that began in late 2006 continued through 2007 and accelerated at the end of the year, though consumers have showed greater resilience through the housing market downturn than many analysts anticipated. Nominal retail sales growth averaged over 7% annually from the end of 2003 through 2006 – even in the face of high energy prices, rising short-term interest rates, and then the slowing housing market. This pace, well ahead of inflation, was not sustainable, and sales growth, though still positive, has been decelerating.

Nonetheless, until very recently retail sales have held up even in the face of sharply deteriorating housing market conditions nationally. Nominal retail sales grew 5.9% year-on-year through November, largely on the basis of continued job and personal income growth, effectively offsetting the negative wealth effect from falling home values. Still, Christmas 2007 proved disappointing and a sharp contrast to recent Christmas seasons, as sales in December were anemic nearly across the board, shrinking by 0.4% for the month and yielding a year-end sales growth of 4.1% for all of 2007<sup>2</sup>.

A further slowing to around 3%-4% is projected for 2008 and 2009 – in line with inflation – in response to a slowing economy and reductions in home values nationally.

Within the retail industry, we are seeing generally greater strength among luxury retailers (December notwithstanding) while middle-market retailers continue to struggle. High-end department stores such as Saks, Neiman-Marcus, and Nordstrom, all recorded strong comparable-store sales this year, though these tailed off at the end of the year, while Macy's Kohl's, and especially Dillard's have suffered sales losses or weakening sales. However, middle market discount retailers, such as Sears and K-Mart, are more heavily impacted by shoppers who are feeling the pain of losses in their home values and rising energy costs. These trends continued through year end, as high-end department, apparel and leather-goods stores and restaurants posted a 7.1% growth for the 2007 Christmas season over 2006, while same-store sales for all U.S. chains grew only 3.6%. However, market leader Wal-Mart, which showed signs of distress earlier in the year, seem to find its footing by year-end and recorded a relatively strong Christmas season.

While no markets will be immune to the economic slowing in 2008, the luxury market, generally served by downtown boulevards, upscale malls, and lifestyle centers, will be less impacted. However, more middle- and lower-market retailers have been hit harder by the subprime mortgage fallout. Hardest hit have been the home improvement centers (Home Depot, Lowe's), and several smaller chains (Pier 1, Bombay Company), reflecting the slowdown in housing sales that fuels furniture sales.

**Market Highlights.** The retail property market has peaked as well. Net absorption of retail space has been very strong the past three years, achieving levels similar to those achieved during the 1997 through 2000 economic boom. New construction was restrained during the past several years, but ramped up in 2006. With strong absorption, vacancy rates for neighborhood and community centers remained healthy, ranging between 6.5% and 6.7% during the prior three years. More recently, however, retail completions have consistently outpaced net absorption, driving vacancy rates upward to 7.5%, the highest level since 1996 and the eleventh consecutive quarter of flat or deteriorating retail occupancy at the national level.

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<sup>2</sup> Note: November had an extra week after Black Friday in 2007, which boosted November sales and reduced December sales.

Looking forward, however, most retailers are placing renewed focus on profitability over growth. They are decidedly paying attention to the weakening of retail sales growth and negative economic news. As a result, we expect new store openings to be more muted in 2008 and 2009. While this shift in supply and demand dynamics is an indication that the retail market has peaked, this vacancy rate is still quite healthy by historical standards. By contrast, as a result of significant overbuilding, vacancy rates remained above 10% between 1987 and 1992.

New retail construction activity is largely focused on three markets: (1) value retailing, (2) lifestyle retailing, and (3) mixed-use. Relatively few grocery anchored neighborhood or community retail centers or super-regional malls are being developed. Value-retailing, or **power center retail**, is being driven by major retailers who have been in an aggressive expansion mode, though most retailers are now moderating their growth plans. Wal-Mart, for example, plans to open 250 stores in FY08 (down from 340 in FY07) and falling to 220 in FY09. Many successful value retailers are also expanding, including Target and other power center retailers. The value retail sector is now quite concentrated, so that most are bottom-line rather than market share focused. Thus, if over-expansion produces declining sales, they are likely to adjust their growth plans.

**Lifestyle retail** centers are also expanding at a rapid pace. These centers range from unanchored centers of 100,000 square feet or less to centers nearly as large as regional malls. An increasing number include one or two down-sized department stores. In nearly all cases, they are open air formats. The convenience and ambience of these open-air lifestyle centers has proven quite popular, particularly with time-pressed affluent households. Department stores are still refining their prototypes, but are finding these centers to be desirable venues. Several upscale apparel retailers find these formats especially appealing to their customers. These retailers tend to focus on the baby boom generation market. In addition, restaurants and home furnishings retailers perform well in these centers.

Enthusiasm for lifestyle centers may result in over-building, however. A few centers have opened in the past year in locations where support has been weak, thereby providing some caution to retailers. Many long-planned projects have been delayed as major retailers and anchors reconsider their expansion plans. Nevertheless, we expect to see some weak centers open in the next few years.

In addition to the trend toward outdoor venues, other formats are emerging in the shopping center industry. Perhaps the hottest product is the **mixed-use town center**, generally incorporating residential, and sometimes office and/or hotel, into the development. Consumers seem to prefer these visually exciting active environments, and the higher density allows for development in costly infill locations that are often under-retailed. In other cases, existing super-regional malls are being retro-fitted with mixed-use development. Another popular concept is the hybrid of a lifestyle and power retail center in a single development. This allows for maximum shopping flexibility within a single trip.

Grocery anchored **neighborhood or community retail** centers are currently in a position of strength. The traditional grocer is emerging from a period of consolidation and redefinition, and is once again a strong anchor in appropriate markets. Once mass market retailers, grocers have been challenged by lower cost operations, led by Wal-Mart, with their Super Centers and Neighborhood Markets. As a result, the grocers have repositioned themselves to target affluent markets. Although sensitive to cost, they are also sensitive to the shopping experience and quality of the offerings. The industry is now dominated by national and a few strong regional operators. Neighborhood and

community retail centers anchored by the more successful operators in strong demographic locations will continue to be robust, and are unlikely to face major new competitive development.

Few new **super-regional malls** are being developed. Using a strict definition of a minimum of three department stores (or at least two full-sized department stores), not a single enclosed mall is anticipated to be completed during 2008 – repeating the experience of the past two years – while several existing enclosed malls will go “topless.” Large lifestyle centers, as described above, with one or two downsized department stores, have taken their place in the construction pipeline. With a dramatically consolidated department store industry, and the difficulty and cost of developing full-sized super-regional malls, few are likely to be developed in the future. Nevertheless, many of the strongest established malls are in the midst of renovation and/or expansion, indicating that this segment is alive and well.

**Exhibit 19  
Retail Snapshot**



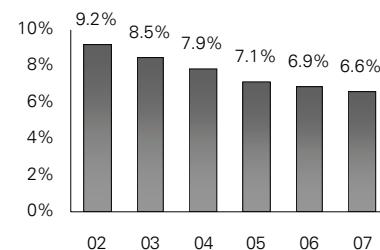
Source: REIS and RREEF Research

Though we anticipate construction will moderate in the near term, retail condition will continue to weaken most in low barrier-to-entry markets having low land costs. These tend to be focused in Southeastern (excluding Southern Florida) and Southwestern metros. Higher-density infill markets, with strong incomes, high land costs, and restrictive planning controls, will generally be insulated from excess supply. Northeastern and West Coast metros provide the greatest concentration of favorable markets.

**Transaction Market:** Retail properties continued to appreciate in 2006 and into 2007, as cap rates continued to decline. Although the retail sector had experienced healthy income growth over the past five years, most price appreciation has come from a fall in cap rates from 9.6% in 2001 to 6.6% in 2007 (see Exhibit 20).

Sales volume of retail properties continued to escalate, growing from approximately \$12 billion in 2001 to \$51 billion in 2005, for an average annual increase of 44%. Increases have moderated since, but nonetheless reaching \$65 billion in 2007.

**Exhibit 20  
Average Retail Cap Rates  
2002-2007**



Source: Real Capital Analytics & RREEF Research

Although cap rates in 2007 moved modestly upward during the latter part of the year, according to data from Real Capital Analytics, RREEF Research believes that effective cap rate movement has been more substantial, with underwriting reflecting higher going-out

cap rates, lower NOI growth and a higher IRR. With slowing growth in consumer sales and rising vacancy rates, there will be little pressure to produce NOI growth above an inflationary 2% to 4% annually. As a result, cap rates will need to rise to reach investor hurdle rates for total returns in the transaction market.

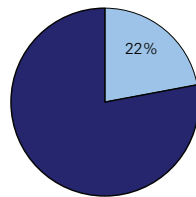
We expect modest upward movement in cap rates over the next six to 18 months of between 25 and 50 basis points. Sales will evidence an increasing divergence between commodity or second-tier shopping centers and those that are market dominant. Class A malls, centers anchored by dominant grocers in affluent markets, power centers in strategic locations with strong anchors and well-conceived lifestyle centers should continue to perform best, but most centers will experience some value loss. Lesser quality assets could experience greater cap rate increases.

**Performance:** The NCREIF Retail Index produced a total return of 9.2% for the first three quarters of 2007 (see Exhibit 21), lagging the composite NPI by 300 basis points. Between 2002 and 2004, the retail index beat the composite by a substantial margin. In 2005, the two indices approximated each other. During the past two years, retail lagged the composite. Regional and super-regional malls led the sector in 2007, community centers approximated the index, while neighborhood and fashion/specialty centers lagged. Power centers trailed in performance by a wider margin.

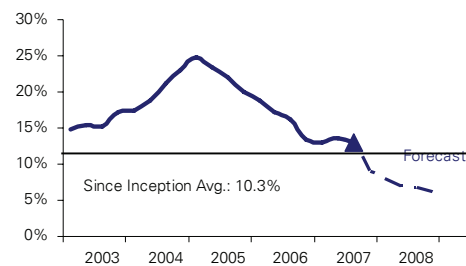
We expect total returns for retail properties as measured by the NPI to range between 5% and 7% during 2008, thereby lagging the other three property sectors in performance. This reflects our expectation that retail sales growth will moderate over the coming year and that appreciation in the retail property sector has reached its peak.

**Exhibit 21**  
**NCREIF Retail Index**  
**as of Third Quarter 2007**

**Retail Share of NPI**



**Total Returns\***



▲ Q3 2007 Index Value = \$63.9 Billion

886 Properties

\*Unleveraged Rolling Four Quarter Returns

Source: NCREIF & RREEF Research.

## Implications for Investors

The investment market for real estate has gone through significant change in the past few months. Although market fundamentals still look generally positive, particularly in the longer term, the size of the capital market pursuing acquisitions has decreased substantially. We are currently at a transition point where the dominant investors of the past two years, private highly-leveraged entities, who bid pricing up to historically high levels, have largely disappeared. Such leverage is no longer readily available. Equity buyers who utilize relatively low levels of leverage that conform to most financial institutions' criteria are in a prime position to buy. However, at this point in the transition, many sellers are not yet accepting the new lower pricing, and equity buyers have not stepped in to fill the void.

We believe this is a typical transition period following the bursting of a credit bubble, which also produced unsustainably high prices. Over the course of the next year, the markets will find equilibrium again, but at pricing that is lower than that achieved in 2007. While the historically high volumes of capital that flowed to real estate in 2006 and 2007 are unlikely to be repeated in the near term, substantial potential capital is poised to take advantage of more reasonable pricing. Institutional and foreign capital are the most likely sources of such equity-oriented capital.

The convergence of this dramatic change in capital markets unfortunately coincides with a significant slowing of the economy, with fears of a possible mild recession. As a result, investors will remain skittish, particularly during the first half of 2008. At the same time, whether or not there is a recession, leasing activity for most real estate product will be depressed in nearly every market, making deals much more competitive and taking pressure off previously rapidly rising rents. Acquisition underwriting will need to take into account lower income growth during the initial portion of the hold period than had been previously presumed.

In the longer term, however, we believe economic growth will resume, thereby fueling renewed absorption and rent growth. Vacancy rates, which are likely to rise in many markets in the near term, should begin to firm up in 2009 and beyond, allowing for renewed healthy income growth. Construction activity, which is partially responsible for rising vacancy rates, is beginning to tail off, given a more difficult market for financing new development.

Prices for core properties reached highly-inflated levels in 2006 and 2007, driving many equity investors from the market. With repricing well under way, opportunities are beginning to emerge for acquisitions, while using underwriting assumptions reflecting our belief that cap rates will increase further in the next six to 18 months. Given our longer-term positive outlook for real estate fundamentals, acquisitions utilizing realistic assumptions should be attractive. Some sellers are highly motivated, and the pool of buyers is currently thin, notwithstanding the ongoing disconnect between seller expectations and buyer offers. However, given concerns that growth could be slower than forecast, even recessionary, a defensive strategy is warranted. This would generally favor industrial and apartment properties over office and retail, as the latter two sectors fare particularly poorly in a declining economy. More importantly, it would favor high-quality properties in strong primary markets.

Although the best products in the best markets remain highly sought after, most core properties are being repriced downward. As new pricing becomes clearer and the economy reaches firmer ground, core properties will once again be in demand. In the meantime, they could provide attractive buying opportunities at healthy yields.

Value-added properties, whose prices fell more than those of core assets, will provide particularly attractive investment opportunities. As lenders now offer lower levels of leverage for these properties that generate lower current income, pricing has become particularly attractive for low-leverage buyers. In addition, since we view the current environment as a pause in a 10 to 12 year economic cycle, sufficient growth is forecast in most markets to justify a strategy based upon rent and occupancy growth over a four to eight-year hold period.

Development strategies are more limited than they have been in recent years, given the recent ramp up in construction activity combined with a slowing economy. In addition, construction costs remain elevated, making the economics of development more challenging. Nevertheless, for highly-desired supply-constricted markets, particularly in the globally-linked metros that maintain the strongest growth prospects, attractive development opportunities remain.

Strategies to consider across regions and product types are as follows:

- **Geographies:** Buy the best product in the leading markets. These include the globally-linked metro markets that will continue to generate jobs and attract population. These metros provide above average activity in international financial and professional services, defense, trade, medical, and high-tech. In particular, focus should be given to infill locations within these and other strong metro markets.
- **Apartments:** Core multifamily investors should stick to supply-constrained markets. High-barrier-to-entry markets with high housing costs include New York, Washington DC, Seattle, coastal California, and most other coastal and mountain markets. The buy back of unsuccessful condominium projects and leasing as apartments is also an emerging opportunity.
- **Industrial:** Industrial remains a popular core asset due to its low rental volatility and modest NOI leakage from turnover. It is more recession proof relative to other property sectors as well. Acquire industrial warehouses around major ports and airports. Port congestion around Los Angeles and the East Coast may create opportunities in secondary ports, such as Oakland, Savannah, and Tacoma.
- **Office:** Acquire Class A CBD product in the nation's money centers to take advantage of the expanding business and professional services industry in the US. In many markets, "green" product will fare the best. Buy the best office product in recovering tech markets to take advantage of strong business spending, both domestically and globally.
- **Retail:** The retail sector has peaked and should be the first to show a supply/demand imbalance in 2008. Some retail opportunities still exist, including mixed-use retail, urban-infill retail, retail in tourist-oriented markets and Hispanic retail that caters to the changing US demographics.
- **Mixed-use:** Mixed-use properties in dense infill settings are becoming popular with consumers, and evidence suggests that they can produce superior income returns over comparable single-use properties. Typically, mixed-use combines retail with apartment or office uses, which provide synergistic benefits. For new development, or

existing product for a long-term hold, mixed-use investments have the potential to generate superior returns.

- **Asset-specific investing:** With historically low cap rates and a slowing economy, acquisitions will need to be highly opportunistic in 2008. While all acquisitions are asset-specific, acquisition officers will be particularly challenged during the next year to find those opportunities that afford an attractive price and/or growth prospects in order to achieve desired risk adjusted returns.
- **Late-cycle markets:** Since going-in yields are low in prime markets nationally, opportunities could present themselves in markets that are in the early phases of their growth cycle. With several years of strong income growth projected, properties in these markets have the potential to yield the desired long-term total returns.
- **Value-Added Strategies:** The wave of capital committed to value-added and opportunistic strategies is exerting downward pressure on returns. Prices, however, remain less frothy than for core deals, generating a significant premium of 100 to 200 basis points on total return, unleveraged. Given that we are in the growth phase of the real estate cycle, value-added investment is appealing. In this low-interest rate environment, leverage will remain a key component of value-added returns.
- **Development:** As with value-added, a development strategy makes sense during the growth phase of the real estate cycle, particularly in high growth supply constrained markets. A premium of approximately 300 to 400 basis points should be expected for new development, with additional returns provided by favorable leverage.
- **Disposition Strategies:** With demand for real estate assets at a high point, investors should accelerate the pruning of their portfolio. In particular, portfolio managers should take advantage of the surge in investor demand for value-added and opportunistic properties. Investors can sell assets that have leasing challenges at highly competitive pricing in 2008. Similarly, properties that are nearing their cyclical peak in their income producing potential might be sold today, with the funds redeployed for higher-growth opportunities.
- **Publicly-Traded REITs:** Although they underperformed equities and bonds, the deep NAV discount on REITs brings a positive outlook for the new year. Expectations are that the Wilshire REIT should deliver a total return of between 5% to 10% this year. Although we are cautious near term, we believe that REITs will to enjoy healthy demand given the lack of compelling alternatives. With that backdrop, we continue to view the relative returns of real estate securities attractive in 2008.

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