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Global Commercial Real Estate Debt: Deleveraging into Distress

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1. Executive Summary

The quantity of distressed commercial real estate (CRE) will continue to increase globally as the deleveraging process unfolds over the coming years. Implosion of the global financing market coupled with the economic recession has increased stress on both properties and their owners. Seizure of the commercial mortgage backed securities (CMBS) market is increasing the demand of properties needing to refinance but the dislocated financing market is limiting the supply of new loans available.

Global real estate market fundamentals continue to deteriorate in light of the prolonged economic recession placing significant stress on the ability of buildings to generate cash. A number of assets purchased during the peak years of 2005-2007 were underwritten with aggressive lease-up and rent growth schedules. The investment strategy for these assets involved considerable building vacancy which in the current economic downturn has put a number of loans in default of their interest coverage covenants. The markets furthest along in their economic contraction are already seeing signs of distress and should experience higher levels of property liquidations over the next 12-24 months, barring significant government support.

Downward pressure on asset values globally and the limited financing available are placing significant stress on borrowers needing to refinance loans at the lower loan-to-value (LTV) ratios available. Balance sheet lenders across the globe continue to provide new loans, albeit at higher margins and lower LTV ratios; however, the bulk of their lending activity is focused on existing clients and legacy loan books. Lack of new CMBS issuance has halted conduit originations creating a glut of maturing CMBS loans which will struggle to refinance given the limited appetite and stricter underwriting standards by balance sheet lenders. As a result a number of loans securitised into the CMBS market will enter various stages of distress and will likely be foreclosed upon over the next few years with a second wave occurring in the peak maturity years of 2010-2013.

While it is clear that distress will continue to emerge this paper focuses on the regions and financial structures that will experience the most near-term distress. The paper begins with a review of recent financing and highlights key trends in the global CRE debt market. It is then followed by a regional analysis of the areas of distress emerging in the US, Europe and Asia Pacific. We conclude that recent vintage and maturing CMBS loans in both the US and the UK will show this distress first with liquidations expected to begin later this year. This is largely due to the degree of asset repricing which has occurred, the deteriorating fundamentals and the increased growth and reliance on CMBS.

Given the likely increase in distressed opportunities expected to occur over the next 18 months it is not surprising that there has been a surge of interest from investors seeking to exploit this. Prequin recently reported that US\$30 billion (bn) was raised in private equity funds globally during 2008 with investment plans targeting debt and distressed debt opportunities. As fund raising in the segment continues, this wave of capital will likely help reduce the funding shortfall and, in due course, competition among investors seeking to close on distressed opportunities will intensify.

2. Introduction

This paper focuses on potential areas of distressed CRE assets across the globe deriving from structural and locational maladies. Key to this distress is the recent over gearing of commercial property and aggressive underwriting assumptions which are being challenged by deteriorating fundamentals. This paper covers a range of different types of distress in private and public debt markets. Across both forms of debt, the paper covers the distress coming from maturing loans which will need either an additional equity infusion or a loan extension/modification as well as recently underwritten loans which will likely breach loan covenants and default prior to loan maturity. Loans packaged into CMBS are expected to start liquidating first, although there will be complex loan workouts stemming from the inherent conflict of interests amongst various levels of bond holders and the testing of relatively uncharted waters in this space. The pressures on the public debt markets, coupled with those on balance sheet lenders will likely create a global pool of distressed assets which will place downward pressure on CRE valuations.

Importance of Debt to the Commercial Real Estate Capital Structure

Real estate investing is a capital intensive asset class which has become increasingly reliant upon the availability of debt capital. RREEF Research estimates that the global CRE debt market accounted for about 58% of the \$12 trillion (tn) or so real estate investable universe at year-end 2008. The bulk of this debt (around 50% of the total) is held by commercial banks and other lending institutions, and approximately 7% or so is held in the form of CMBS. In the US, the role of debt and CMBS in particular, is even more significant, with DTZ estimating that debt accounts for 70% of the total market, and CMBS close to 20%¹. The scale of the CMBS market is particularly significant for a number of reasons. Firstly, its growth was associated with ever more aggressive underwriting standards. At the height of the market the lenders would typically lend up to 80% LTV, with generally lax underwriting standards, leaving the loans exposed to a deterioration of market fundamentals². Secondly, the structure of the CMBS market means, as explained later, that there is less scope to roll-over or extend the financing. This is particularly the case given that the implosion of the securitisation process has effectively dried up a major exit strategy for the fastest growing segment of CRE finance.

Despite more conservative underwriting standards and reversion to debt yield as a metric for new loan originations, new primary loans remain of limited appeal to most market participants. This is partially due to the denominator effect many are suffering from and the resultant over exposure to the CRE sector. In addition, despite primary loan originations currently providing a more attractive risk adjusted return investment, many investors that are not over allocated to CRE are chasing higher yields elsewhere in the capital structure. This has left the more conservative lenders (those lending up to 55% LTV) who tend to hold to maturity to dominate the senior portion of the capital stack.

As equity investors are unable to fill the resultant gap in the real estate capital structure this seizure of the debt capital markets has numerous implications for the CRE investment market including:

- Falling property values as a result of deleveraging
- Change in strategy for current investors with near term loan maturity
- Resultant distressed investment opportunities in both the debt and equity markets.

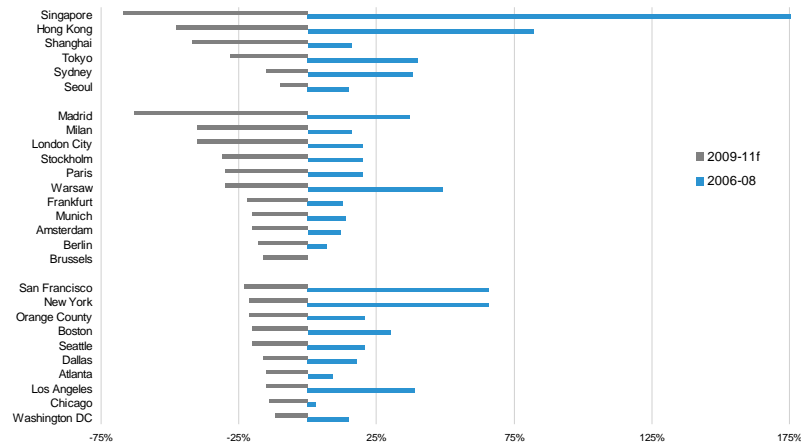
¹ DTZ, "Money into Property," 2009.

² Urban Land Institute, "ULI Emerging Trends US" and "ULI Emerging Trends Europe," 2008.

Global Space Fundamentals and Property Investment Markets

Commercial real estate market fundamentals globally continue to deteriorate. The worst hit areas in terms of office rent declines are expected to be the financial hubs of London City, New York, Singapore and Hong Kong and hard hit housing markets such as Madrid and Southern California. Additionally, the retail and leisure sectors are struggling from the abrupt slowdown in consumer spending and travel as a result of the continued contraction of the global economy³.

Chart 1: Office Rent Growth across Major Global Markets, 2006-08 and 2009-11f



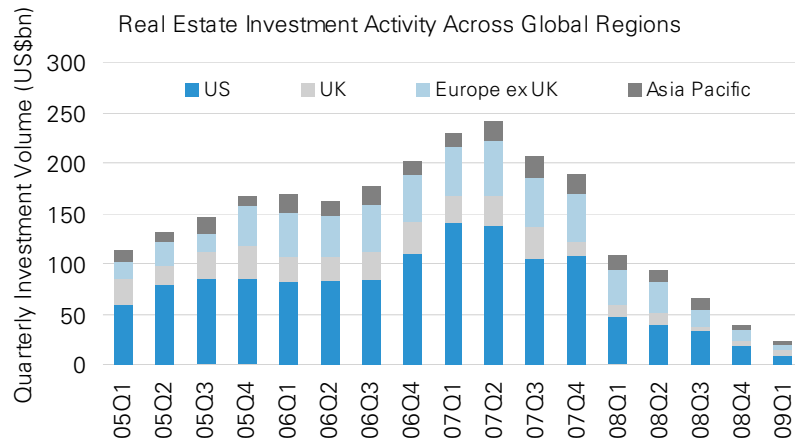
Note: Shows rent growth over three year periods, 2006-08 and 2009-11. "f" indicates forecasts at Spring 2009
Source: RREEF; REIS; PMA

Due in large part to the scarcity and cost of debt capital in addition to the deteriorating CRE market fundamentals, the volume of global commercial real estate transaction volume is down significantly and pricing is in a state of adjustment. The expectation that future pricing will only look more attractive has limited the number of equity buyers. Those investors who remain active are now underwriting with higher cap rates, lower initial rents, declining rent growth projections as well as requiring an increased internal rate of return (IRR). A large portion of capital in the market is seeking opportunistic returns and unlevered IRRs above 15% which is increasingly difficult to achieve in the direct core market. As a result, this capital is tending to focus on borrowers in distress, loans which are likely to become troubled (i.e. loan-to-own strategy) and secondary CMBS. As fundamentals stabilise and lending resumes, spreads will narrow and we would then expect equity transaction volume to see a proportionate increase. As explained in a recent RREEF Research paper, the severity and length of the current downturn mean it is unlikely that these volumes would increase significantly before the end of 2010⁴.

³ For more on CRE fundamentals see RREEF Research, "Global Real Estate Investment and Performance 2008 and 2009," May 2009.

⁴ RREEF Research, "Global Real Estate Investment and Performance 2008 and 2009," May 2009.

Chart 2: Real Estate Investment Activity Across Global Regions



Source: RREEF Research based on DTZ; REIS; Real Capital Analytics, May 2009

Emerging Signs of Distress Across the Globe

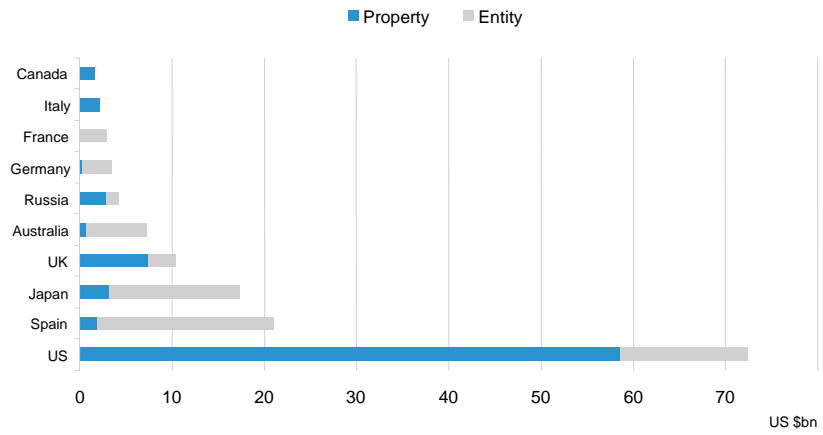
The deterioration of the CRE market fundamentals is placing significant stress at both an asset and entity level. Especially hard hit are development deals which are nearing completion or recently completed. Other value-add strategies are also falling behind schedule as most global CRE markets have experienced a shift in the balance of power from landlords to tenants. Owners with vacant properties are entering a competitive leasing environment with falling rents and tenants few and far between. Add to this the fact that a number of these deals included pro forma loans with aggressive rent increases and it becomes clear that a number of assets will be coming under increased pressure over the coming years.

Recent evidence shows that signs of distress are emerging across the globe with particular deterioration occurring in the Americas and Europe as reported in the 'Troubled Asset Radar' published by Real Capital Analytics. According to the report, distressed assets in the Americas increased from US\$49bn to US\$75bn while Europe saw a similar percent increase of 53% bringing it to US\$51bn. Asia accounts for the smallest absolute dollar amount of distressed assets at US\$27bn but is experiencing the highest growth rate at 68% in the first quarter of 2009⁵.

As this paper later discusses, a significant amount of distress is expected to arise out of the aggressive underwriting across all lending parties. However, the structure of CMBS and the inherent difficulty arising from the differing interests amongst the various bond holders means that this sector will account for the bulk of near term liquidations. Balance sheet lenders are more willing and able to extend loans in order to mitigate losses. As CMBS will likely account for the most near term liquidations we begin by looking at the epicentre of CMBS lending – the US – and then briefly discuss the pressures on the market in both Europe and Asia.

⁵ Real Capital Analytics, 'Troubled Asset Radar,' April 2009.

Chart 3: Value of Distressed Real Estate by Type and Country (2008-Q1 2009)



Source: Real Capital Analytics, April 2009

3. US CRE Loan Market

This section focuses on the US CRE loan market with particular focus on the CMBS market. The rationale for this focus is the likely greater incidence of distress in the market as well as the ready availability of data to analyse loan performance. Despite accounting for only 20% to 25% of total loan origination volume in the US, CMBS provides the best proxy for the relative health of the industry. The emphasis is on explaining the main dimensions of the market, including seasoning trends and the likely performance of recent vintage loans over the coming years. The section also explores upcoming CMBS maturities broken out into the floating and fixed rate conduit segment. We conclude with some remarks on the US private loan market.

US CMBS Seasoning Trends

Commercial real estate loans typically enter their prime default period about 3 to 7 years after origination as shown by the Snyderman study which used American Council of Life Insurers (ACLI) data to analyse commercial real estate loan performance⁶. The original study focused on balance sheet lenders and concluded that defaults were highly correlated with timing of loan origination within the real estate cycle. Given that recent CMBS underwriting standards were more aggressive and originated at the peak of the real estate cycle these deals are expected to experience their distress earlier than the 3 to 7 year horizon implied by the Snyderman study.

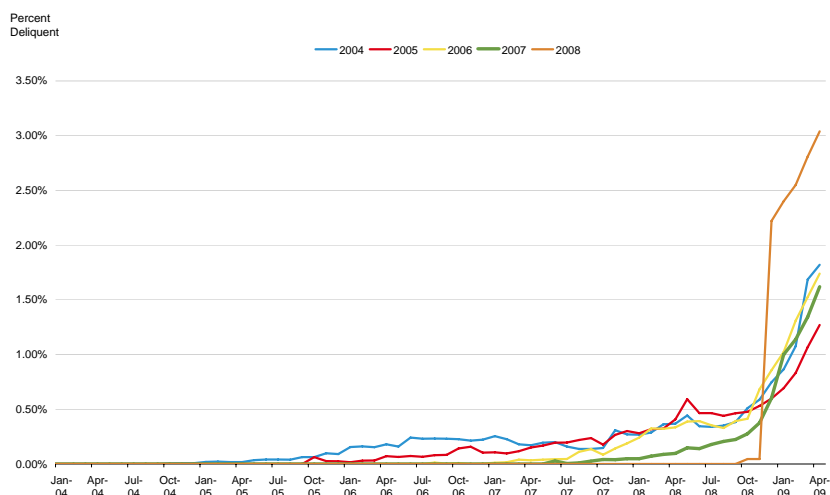
In looking closer at recent CMBS deals, a large cohort of borrowers utilising this funding source for their financing needs were small to mid sized local investors. These investors were looking to maximise proceeds at the lowest cost which led to the aggressive underwriting performed in a manner which attempted to push up the appraised property value in order to maximise borrower loan proceeds. In addition to these smaller loans a similar strategy was being employed on the opposite end of the spectrum, that of large trophy office buildings in major cities. Competition among issuers whose business model was driven by increased volume drove many conduit desks to use ever lower cap rates. This ultimately led to loan proceeds of 90%+ LTV for first mortgages (when analysed on an average/stabilised cap rate basis versus current market) in an effort to secure the business. Additional measures to boost loan proceeds included low initial debt-service coverage ratios (DSCR) based on aggressive rent growth assumptions and/or optimistic lease-up schedules⁷.

These underwriting assumptions, coupled with the sharp deterioration in rents, occupancy and pricing of the direct market, have led to increasing distress on recent CMBS transactions. This is particularly the case for the heady 2004-2007 vintages as shown in Chart 4. We expect the historical peak default rate of about 6% to 7% experienced in the early 1990s will likely be matched or even surpassed by year-end 2010. While deterioration has historically been centred on smaller lot sizes the aggressive underwriting in recent vintages for larger trophy assets is expected to lead to distress for even the largest and best quality assets. As these assets tend to have strong sponsorship, there is a possibility of loan extension. Despite this, the sophistication of these borrowers coupled with non-recourse lending may lead some investors to walk away in order to minimise losses thus providing the rare opportunity to acquire trophy buildings in prime markets.

⁶ Snyderman, Mark P., "Commercial Mortgages: Default Occurrence and Estimated Yield Impact," *Journal of Portfolio Management*, Fall 1991.

⁷ ULI "Emerging Trends, 2007," and see also 2008 and 2009 editions.

Chart 4: US CMBS 2004-2008 Vintage Conduit Delinquencies

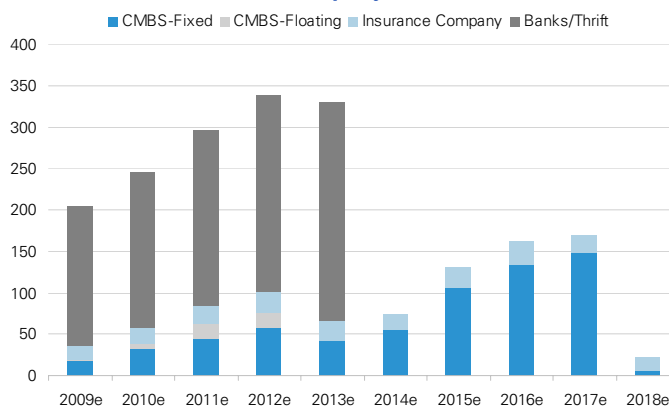


Source: Bank of America Securities; RREEF Research, May 2009

Upcoming US CMBS Maturities

The bulk of near-term US CMBS maturities occur from 2011 through 2013. However, it is important to note, as outlined in the previous section on seasoning, that a number of loans from the 2004-2007 vintages will likely default prior to maturity. These term defaults will only add to the sizeable near term refinancing pool. A recent research piece from Deutsche Bank estimated the total maturity schedule in the US for CRE including CMBS, life companies and banks/thrifts⁸. This highlights the magnitude of near term refinancing needs in the sector as nearly US\$750m of loans mature before the end of 2011 (Chart 5)⁹. As data is unavailable on the private loan market this section focuses on the floating and fixed rate CMBS maturities and potential areas of distress within both segments of the market.

Chart 5: Estimated Maturity Profile of US Commercial Mortgages in CMBS, Bank and Life Company Portfolios



Source: Deutsche Bank; Intex; Trepp; Mortgage Bankers Association; US Federal Reserve, April 2009
e= estimate

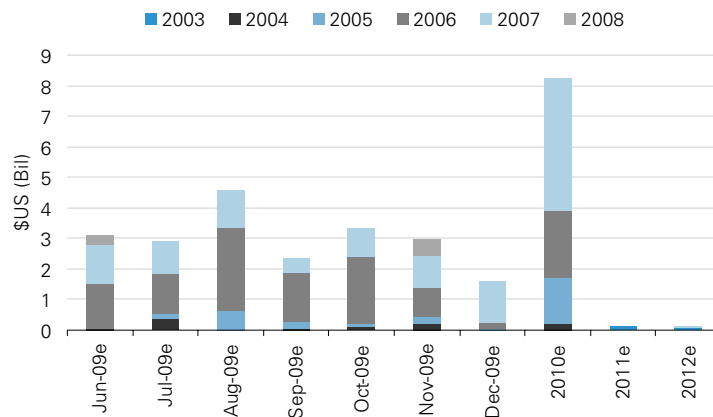
⁸ Parkus, Richard and Jing An, "Potential Refinancing Crisis in Commercial Real Estate," Deutsche Bank, 22 April 2009.

⁹ Parkus, Richard and Jing An, "Potential Refinancing Crisis in Commercial Real Estate," Deutsche Bank, 22 April 2009.

The floating rate sector warrants particularly close attention when looking for distress as it tends to finance transitional properties including value-add and development deals. In light of the economic environment and the complex structures which included mezzanine loans these loans are forecast to experience increasing stress in the near-term and will likely not qualify for refinancing. As shown in Chart 6 the bulk of large loan floating rate maturities are rapidly approaching as more than US\$25bn mature in 2009. This is an alarming number on the face of it but the vast majority of these loans have extension options. Assuming all extension options are exercised the bulk of maturities would be in 2011 and 2012. Loans do not automatically qualify for an extension; however, as certain LTV and DSCR hurdles typically need to be met.

A particular area of distress in the floating rate side is in the hotel sector. There were a number of hotel deals done in 2005-2007 which were financed with 5-year floating rate loans. These loans were made with aggressive pro forma assumptions at the peak of values. Despite the natural macro hedge stemming from declining LIBOR in times of economic stress which lowers interest payments, cash flows in this segment will unlikely be able to weather the sharply deteriorating hotel demand. This will limit extensions in this segment and provide good opportunities for well capitalised buyers with hotel management expertise able to weather the economic storm. Additionally, opportunities will be rife for investors with development expertise and the ability to recapitalise/take over trouble developments across all property sectors which also will be unable to qualify for extensions for similar reasons.

Chart 6: US Large Loan Floating Rate Future Maturities by Vintage Year



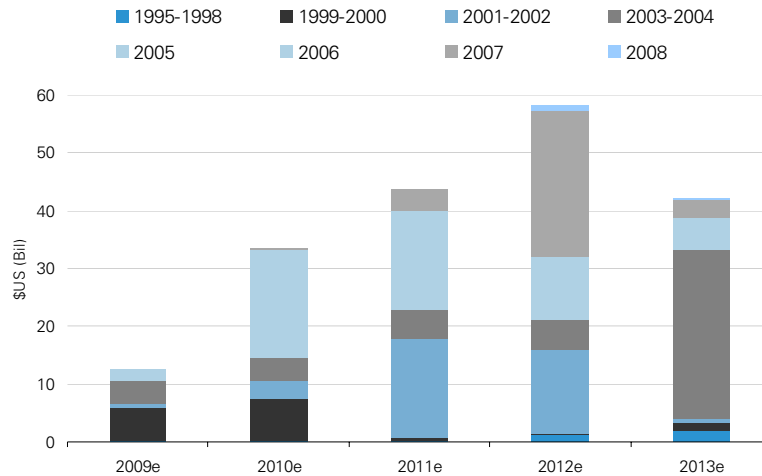
Source: Wachovia Capital Markets; Intex Solutions; Trepp, May 2009
 Note: Excludes defeased loans
 e= estimate

On the fixed rate side a major source of upcoming troubled loans lies in about US\$5.7bn of NYC apartment loans made to borrowers whose business plan focused on a rent conversion strategy. A number of these loans included pro forma underwriting based on converting rent-regulated units or upgrading existing properties to achieve higher rents. Most of these deals are behind on their aggressive conversion schedules and are burning through their reserves. The meltdown of the financial industry has had a significant impact on the NYC metro economy. It is expected to cause more than 70,000¹⁰ net layoffs in the finance sector alone and lead to a total of 214,000¹¹ job losses. This will hamper the rent conversion strategy assets' ability to generate underwritten cash-flows. While this multifamily rent conversion strategy is focused on NYC, it is worth noting that there are similar problems across other markets especially those feeling the impact from the housing bubble.

¹⁰ Moody's Economy.com, May 2009.

¹¹ Moody's Economy.com, May 2009.

Chart 7: US Fixed Rate Conduit CMBS Future Maturities by Vintage Year



Source: Wachovia Capital Markets; Intex Solutions; Trepp, May 2009

Note: Excludes defeased loans

e= estimate

In addition to the multi-family market there were a number of 5-year fixed rate interest-only loans originated for office properties in late 2004 to 2007 which will be another concentration of distress. These loans were typically used for transitional properties with pro forma underwriting which are underperforming expectations. They also included trophy assets which are suffering from occupancy declines due to the financial industry shake out. While stories in the press are abundant, broad-based evidence of trouble is only beginning to emerge in reported data. Partial interest-only versus full term interest-only loans will likely see the bulk of distress as the underwriting assumptions were particularly aggressive on the exit values. As these loans begin to amortise not only will cash flows be inadequate to cover the debt service but LTV ratios will likely also under perform expectations leading to more immediate liquidations.

US CRE Private Debt Market

While loan level data is not available for the private debt markets in the US this section provides some brief anecdotal information on the health of the balance sheet lenders. It was previously thought that portfolio lenders would fill a large part of the void left by the CMBS market implosion. However, the limited annual allocations which characterise this source of financing are far too small to satisfy the refinancing needs currently facing the industry in light of the CMBS market closure.

Commercial banks collectively hold about 50% of all outstanding CRE loans on their balance sheets making them the largest provider of CRE debt in the US. The total of US\$1.5tn bank loans is comprised of about 36% construction and development and 64% CRE¹². The large exposure to development and construction will likely lead to significant volumes of distressed assets given the difficult leasing environment these assets are being faced with upon completion. As lending for new construction has dried up there will likely be a significant gap in new supply during the coming cycle. This should allow for a faster rental recovery when demand does return, but this recovery is likely three or more years away so there will be significant challenges for existing developers and lenders in the meantime.

While we are 18 months into the credit crisis there has been limited evidence of

¹² Mayo, Mike, Rob Rutschow, and Chris Spahr, "U.S. Banks," Deutsche Bank, 5 January 2009.

distressed sales from commercial banks due to a number of contributing factors. First, a main characteristic of the real estate asset class is that repricing takes time and the resulting dislocated investment market during the period of price adjustment, which we are currently in, does not provide an attractive exit strategy for lenders should they foreclose. Many lenders have sought to avoid foreclosing on a number of loans which are in breach of covenants as it is not in their best interest to force liquidations into the dislocated investment market. Commercial banks would rather waive covenants in the near-term (in some cases raising margins in exchange for this consideration) given the option as compared to liquidating. While we have only seen limited forced selling until now, foreclosures and liquidations will likely accelerate going forwards.

Second, another important source of debt finance, that of insurance companies are currently over exposed to real estate due to the significant value declines in their overall portfolio over the past year. The more rapid decline in their other holdings compared to the slow-to-reprice real estate sector has caused these firms to suffer from the denominator effect. This has left them less willing to increase 2009 commercial real estate allocations and in many cases limited lending to refinancing of loans coming due on their own books. However, it is worth noting that a limited group of life companies are quoting new deals in an attempt to take advantage of the favorable terms currently available.

Third, current lenders are now able to “cherry pick” the deals they want to make and they have responded by lending selectively, cautiously, and predominately to existing relationships. There is also a preference for smaller loans, making property sales with a value greater than US\$100m difficult to finance and often requiring a syndicate of lenders. Finally, most commercial banks continue to work through their own loan books and lending, while present, is far more limited by comparison.

The limited appetite of balance sheet lenders coupled with the implosion of the CMBS market has created the opportunity for private equity players to enter the market and originate primary loans at historically attractive risk-adjusted returns. The relatively low interest rates have limited investor interest; however, we feel this space will provide healthy returns at a much more limited risk threshold compared to alternative real estate investments. For those with a solid understanding of real estate markets and less aversion to risk, mezzanine loan opportunities will continue to arise in the coming years as the gap between senior debt and desired equity positions remains unfilled.

The US government has responded to the banking crisis and resultant freeze of the credit markets with the Fed’s Term Asset-Backed Securities Loan Facility (TALF) and the Treasury’s Public-Private Investment Program (PPIP). TALF for new issue CMBS will provide financing for purchasers of newly issued CMBS bonds creating a market for the securities and reducing lender’s cost-of-capital¹³ while TALF for legacy CMBS seeks to improve liquidity in the secondary CMBS market by providing financing to buyers of existing CMBS bonds¹⁴. Both facilities provide a much needed source of capital to the market but the current terms and conditions will likely limit their near-term effectiveness. In addition to the Fed’s TALF, the Treasury is developing PPIP to create funds which would purchase a variety of assets including legacy loans (commercial mortgages which are clogging bank balance sheets) and legacy securities (AAA CMBS bonds). The implementation of PPIP will undoubtedly take time, as evidenced by the recent indefinite postponement of the Legacy Loan Program by the FDIC, so it is too early to determine if the combined initiatives will prove successful. In establishing these programs the US government is sending a positive message to the market by showing it understands the scope of issues facing the industry and exhibiting its commitment to restoring credit to the sector.

¹³ For more on new issue TALF see Deutsche Bank research “TALF for New Issue CMBS: Fed Releases Terms,” May 2009.

¹⁴ For more on legacy TALF see Deutsche Bank research “TALF for Legacy CMBS: Fed Releases Terms,” May 2009.

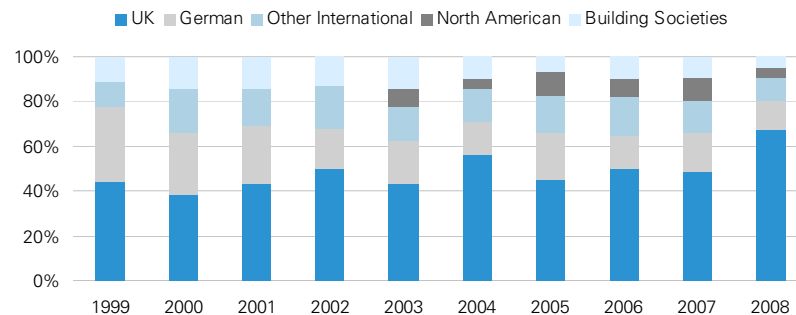
4. European CRE Debt Market

The European CRE debt market has historically been dominated by commercial banks and only over the past three to five years has CMBS grown to become a sizeable player. In most Western European countries the largest domestic banks tend to dominate local CRE lending. Due to the limited availability of loan level data from the major lenders across Europe this analysis focuses on the UK lending market and the European CMBS market and then seeks to address implications and differences across other markets/geographies throughout the region.

The De Montfort University study of UK lending shows that UK banks account for the largest share of UK commercial property lending. While historically followed by the German banks¹⁵, recent growth in the CMBS market has pulled market share from both German lenders and building societies¹⁶. This is evidenced in the growth of the loan origination volume since 1999 of other international lenders (including North American), as this constituency accounts for the bulk of lending intended for securitisation¹⁷.

Over the past few years the European CMBS market provided a significant amount of financing for large schemes, with particular emphasis on the segment exceeding US\$70m. Terms for loans intended for conduit CMBS appealed to large loan borrowers as they offered 5-year interest-only, and floating rate loans at attractive spreads. Similar to the situation in the US, as the securitisation industry in the UK and across Europe grew, underwriting standards became more aggressive and account for some of the most aggressive loans underwritten over the past few years.

Chart 8: Market Share of UK Loan Originations 1999 to 2008



Source: De Montfort University, June 2009

As the CMBS market has essentially seized, the CRE industry has increasingly focused on commercial banks. According to a recent Savills survey which interviewed more than 100 global lenders only about 40 currently have an appetite to lend in the UK. While most of this is focused on the refinancing needs of existing customers, it is worth noting that only 12 lenders will consider deals above US\$35m. This select group of lenders is dominated by the German banks who continue to favour the UK¹⁸.

As CMBS loans begin to season the previously mentioned aggressive underwriting

¹⁵ Maxted, Bill and Trudi Porter, "The UK Commercial Property Lending Market: Review of lending 1999 to 2004," De Montfort University, December 2005.

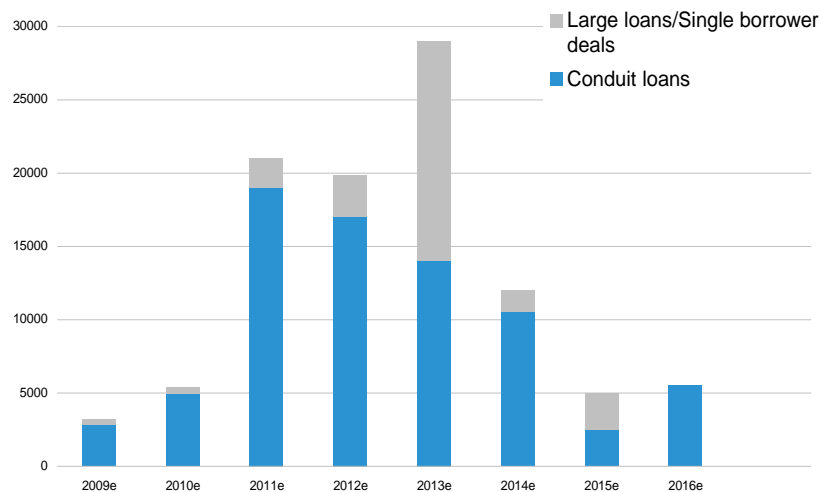
¹⁶ Maxted, Bill and Trudi Porter, "The UK Commercial Property Lending Market: Review of lending 1999 to 2004," De Montfort University, December 2005.

¹⁷ The De Montfort University study pulled North American lending out of the Other International Cohort in 2003.

¹⁸ <http://www.savills.co.uk/news.aspx?category=latest%20news&id=10332&page=0>, accessed April 2009.

standards will begin to expose themselves and term defaults will continue to grow. This will likely generate significant opportunities for investors seeking distressed assets as actual cash flow comes in well below underwritten/pro forma expectations and LTV breaches become ever more commonplace. Evidence of this is beginning to emerge, with Barclays Capital reporting there are 20 loans in European and UK CMBS deals which are in default, 80% of which are in conduit transactions¹⁹. This highlights the commonly held industry view that these deals carry a higher risk profile due to more aggressive underwriting and weaker tenant and borrower quality. Additionally, 35 out of 65 loans that mature from 2008 to 2010 would likely find it difficult to refinance in the current environment as current LTVs are greater than 75%²⁰. It is important to note that this is the initial maturity which is less important than the final legal maturity and most performing loans will be extended as long as possible assuming properties continue to perform and service interest payments. The recent fall in LIBOR is helping to facilitate this by reducing the debt service payments.

Chart 9: European CMBS Refinancing Risk



Source: Standard & Poors; Morgan Stanley Research
 Note: As of November 2008
 e = estimate

Maturity default is expected to be another major source of distress in both Europe and the UK as borrowers may be unable to extend loans. This will likely be due to recent appraisal-adjusted LTVs measuring up to 125% as the recent decline in commercial properties, especially in the UK which leads the region in terms of price adjustment, has significantly lowered the denominator of this metric. An example of the expected stress to come is the Cherry loan from ABN Amro's Talisman-6 Finance Plc deal. This loan, secured by a portfolio of residential properties spread across East Germany, saw its LTV increase to about 120% from 84% at closing due to a new appraisal resulting in a 30% drop in value²¹. While maturing loans in the UK are expected to provide attractive investment opportunities it is important to note that only 10% of outstanding loans mature in each of the next four years so the overall investment scope is somewhat limited²².

¹⁹ Nichol, Mark and Hans Vrensen, "European CMBS Loan Monitor," Barclays Capital, 24 October 2008.

²⁰ Nichol, Mark and Hans Vrensen, "European CMBS Loan Monitor," Barclays Capital, 24 October 2008.

²¹ Fitch Ratings, "2008 Global CMBS Bond Transition and Default Study and 2009 Performance Outlook," March 2009.

²² Maxted, Bill and Trudi Porter, "The UK Commercial Property Lending Market: Year-End 2007 Research Findings," De Montfort University, May 2008.

Outside of the UK covenant breaches and loan defaults will likely be lower as commercial property price declines are expected to be less severe. An exception to this is Spain which is suffering from a housing-driven recession resulting from a massive overbuilding programme that was fuelled by significant leverage. The major Spanish banks have been reluctant to foreclose and continue to grant borrowers extensions, all the while ignoring the fundamentals and delaying the inevitable in hopes of government support. Similarly, current opportunities throughout Europe are restrained as loans are being extended; however, significant distress is expected to arise in the coming years particularly in Spain and Eastern Europe. While distress is likely to arise across Europe the most attractive risk-adjusted returns will likely be those in the developed Western European markets whose economies and capital markets are likely to rebound more quickly.

However, as previously outlined a number of these loans are in distress despite the lower debt service payments and are close to or in breach of their interest coverage ratio covenants. Data provided by the De Montfort University study shows that in the UK most of the North American lending which tends to be securitised falls into the 3-7 year term. There has been an increase recently in the 0-3 year cohort which may be due to ever aggressive underwriting and the search for deals leading to riskier transitional properties which need the shorter term financing before stabilising a property and placing attractive longer term debt in place²³.

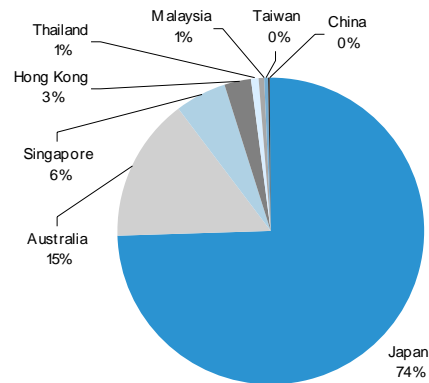
Before the recent growth in CMBS German balance sheet lenders accounted for the largest share of this market and given that the CMBS exit strategy for the North American lenders has dried up, the appetite of German lenders will likely determine the amount of financing available for lot sizes in excess of US\$70m. As previously mentioned, there is currently limited appetite amongst German lenders for large lot sizes and availability of capital for large loans will remain scarce. As a result there is increasingly limited competition as deal size increases, providing cash-rich investors and funds the opportunity to purchase prime buildings in trophy markets with high equity going in at historically attractive yields and the ability to place increased leverage once the debt market returns.

23 Maxted, Bill and Trudi Porter, "The UK Commercial Property Lending Market: Year-End 2007 Research Findings," De Montfort University, May 2008.

5. Asia Pacific CRE Debt Market

The spread of the credit crisis to the Asia Pacific region has reduced the availability of CRE financing in the region as foreign lenders have left and, similar to other regions in the world, local banks are limiting lending. Benefiting from a limited dependence upon CMBS compared to the US or Europe and more conservative lending from investors the region is experiencing lower levels of borrower distress. Due to data constraints in this region of the world this section focuses on anecdotal information to infer the likely sources of distress and investment opportunities in the region. As highlighted in previous sections the CMBS structure will likely be the source of the most near term foreclosures. As Chart 10 shows the top markets for cumulative CMBS issuance volume were Japan, Australia and Singapore so particular focus is placed on these markets.

Chart 10: Cumulative CMBS Volume by Country



Source: Commercial Mortgage Alert; RREEF Research, May 2009
Note: Since beginning of the market

Similar to the situation in Europe the CMBS market in Asia has been dominated by US investment banks. While the lending focus is also on office buildings, the underwriting standards were less aggressive, albeit not conservative, as compared to their US or European counterparts. This is evidenced in the fact that no Asia Pacific CMBS bonds became impaired during 2008. As deteriorating economic conditions intensify and real estate market fundamentals erode, distressed opportunities will likely emerge in 2009 due to the increasing refinance risk for loans in CMBS. Loans with the most refinance risk are large balance loans while higher losses are expected on small balance CMBS²⁴. Recent evidence of this distress is showing up in Tokyo where plummeting property values are leaving some borrowers owing more on their mortgage than current estimated market value.

Fueled by a booming securitisation market, albeit much smaller when compared to the US or Europe, lending practices in Japan became increasingly aggressive leading into 2007. At the peak of the market a number of CRE loans were carried out with 80%+ financing which has left lenders with a number of troubled loans. This is evidenced in the CMBS market where the amount of defaulted loans has grown from US\$72m as of end-September 2008 to US\$1.1bn as of end-March 2009²⁵. Distress at the entity level accounts for a large part of this as the number of bankruptcies continues to grow. These bankruptcies are centred on companies with exposure to the ailing residential

²⁴ Fitch Ratings, "2008 Global CMBS Bond Transition and Default Study and 2009 Performance Outlook," March 2009.

²⁵ Sukigara, Mitsuru, "Profile of Japan CMBS Loans: Updated as of End-March 2009," Moody's Investors Service, 26 May 2009.

and construction markets. While defaults have recently been at the entity level there are currently US\$12.7bn in outstanding loans, at end-March 2009, which carry an LTV ratio greater than 70% - 11% of which matures in 2009²⁶. The exit of CMBS lenders coupled with the limited capacity of Japanese banks will likely increase near-term asset level distress in Japan as loan performance continues to deteriorate and maturities are faced with limited sources for refinancing.

In addition to Japan, evidence of distress has emerged in Singapore where falling capital values and tight credit market conditions are placing pressure on both owners and potential investors. The extreme lack of credit in the market is evidenced by the number of deals which have recently been terminated due to the buyer's inability to obtain financing. While there have yet to be any sizeable distressed sales, according to DB GM research about 75% of all 2008 office transactions in Singapore, amounting to about US\$2.6bn, involved foreign buyers and peak pricing. Given the likely problems these buyers are facing in their home country portfolios and the forthcoming steep drop in values currently forecast for the Singapore office market, the deleveraging process will likely cause distress. Investors with strong balance sheets or cost-of-capital advantages in the midst of increasing funding costs will be best positioned to take advantage of what will likely be attractive investment opportunities as these positions are unwound. In addition to these recently acquired deals which may run into trouble over the next few years, it is estimated that of the US\$3.7bn of debt due this year about US\$1.6bn has been refinanced, leaving about US\$2.1bn left through year end 2009 and a further US\$2.1bn for 2010²⁷.

China is experiencing much less distress as authorities stepped in and directed banks to cut lending to both developers and consumers in late 2007 amid increased speculation and rampant property price appreciation. Following a 30% lending decline in the first half of 2008 the Chinese government has eased lending pressure and restored credit to a number of major developers²⁸. This has limited, to a great extent, the amount of distressed deals in the market, but failure of the stimulus efforts to restore economic growth to more normalised levels may lead to distressed opportunities from 2011. It is important to note this government intervention is not expected broadly throughout the region. However, given the size of the Chinese real estate market it is important to address the issues facing this market.

The Australian property market is in the midst of a significant price adjustment. This is only beginning to be recognised in the CMBS space as shown by the modest drop of 5.5% in the revaluation of over 45% of properties in Australian CMBS during the second half of 2008²⁹. As cash flows decline and evidence of repricing becomes more prevalent this market is likely to account for a significant share of the region's distress, despite relatively low original LTVs and more seasoning. In addition to Japan this market will likely present some of the most attractive risk-adjusted investment opportunities for investors looking to take advantage of distress stemming from overleveraging in the Asia Pacific region.

Overall distressed CRE opportunities are much fewer in Asia than in the US and Europe and similar to some European countries are currently centred more on the entity level than the property level. The limited amount of distress in Asia is due in part to the more conservative underwriting standards in the region and the lagged impact of the economic crisis to the region. While market fundamentals are expected to get worse, distressed borrowers will likely remain contained, the exception being the Japanese and Australian markets which will continue to be impacted by exposure to CMBS and the aggressive underwriting that came with it.

²⁶ Sukigara, Mitsuru, "Profile of Japan CMBS Loans: Updated as of End-March 2009," Moody's Investors Service, 26 May 2009.

²⁷ Lui, Gregory and Elaine Khoo, "Singapore REITs," Deutsche Bank, 17 Feb 2009.

²⁸ Estates Gazette Group, "Asia Property," April 2009.

²⁹ Standard & Poor's, "Australia & New Zealand CMBS Performance Watch," 31 December 2008.

CRE financing across Asia remains available for large well capitalised companies with solid track records, albeit at higher margins and lower LTVs. As financing remains limited for smaller CRE companies and fundamentals deteriorate, the best opportunities may not be at the asset but at the entity level. This dynamic may lead to increased merger and acquisition activity in the region as there is attributable value in the ability to acquire a company with a portfolio of commercial real estate assets and the personnel in place to manage them.

6. Conclusion

The most attractive opportunities for investors wanting to take advantage of distressed borrowers/sellers will likely be located in markets bearing the following characteristics:

- Furthest along in their price adjustments;
- Experienced the greatest run-up in lending over the past 5 years (especially CMBS); and
- Most aggressive foreclosure regimes.

The US and UK lead in terms of price adjustments as evidenced in both reported transactions as well as property indices such as the NCREIF property index (NPI) in the US and the IPD index in the UK. While aggressive underwriting allowed both the US and UK to experience significant asset bubbles this type of underwriting was also experienced across Continental Europe, especially Spain. Most markets in Asia will likely have limited distressed opportunities as government intervention was quick to respond to the crisis, but within the region Australia, Japan and Singapore will likely experience above average levels of distress.

The regions most heavily tied to the expanding housing markets and ailing financial sectors are clearly leading the economic downturn and experiencing the greatest loan deterioration. Recent evidence of this stress is shown in Real Capital Analytics' 'Troubled Asset Radar' report which shows about 85% of all distressed assets being located in either the US, UK, Japan, Spain or Australia³⁰. It is worth noting that EMEA and Asia are experiencing the bulk of distress at an entity level as the 'Troubled Asset Radar' report pointed out³¹.

In addition to identifying which markets will likely experience the most distressed assets this research paper has also outlined the way in which loan structures will impact the loan workout process as well as investors ability to capitalise on this distress. Borrowers who have relied on CMBS financing will experience more difficulty in refinancing as they must answer to a trust with various tranches of interest and special servicers who must act in the best interest of all parties/investors involved. This becomes ever more complicated in cross-border European securitisations as the documents are in many cases vague and untested which will likely result in a longer workout period. Balance sheet lenders on the other hand, are expected to continue to grant extensions in the near term in hopes of minimising losses which would be much greater were assets in default to enter a forced liquidation in today's dislocated investment market. Additionally, many banks are not selling unless they have to or an asset is not generating cash; better to hold out for the eventual recovery than to sell now and allow another investor to profit from it instead.

As this paper has outlined, opportunities will continue to arise over the coming years with CMBS structures likely to lead near-term liquidations. However, it is important to keep in mind that competition among investors looking to take advantage of these investment opportunities will make closing deals challenging. Preqin recently reported that US\$30bn was raised in private equity funds globally during 2008 with investment plans targeting debt and distressed debt opportunities³². While little of this money has been placed fund raising continues to be focused on this segment. So as forced sellers emerge the competition among investors will intensify.

³⁰ Real Capital Analytics, 'Troubled Asset Radar,' April 2009.

³¹ Real Capital Analytics, 'Troubled Asset Radar,' April 2009.

³² Preqin, "Real Estate Spotlight," March 2009.

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