

June 2009

UK Real Estate Quarterly: June 2009

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1. Summary

The UK commercial real estate market is experiencing a period of unprecedented adjustment. Leasing activity has slowed as business expansion has given way to cost cutting. Landlords with available space are having to offer reduced rents and increased incentives in order to attract tenants. Real estate investment activity has remained low in Q1 2009, with investor interest focused on good quality buildings let to tenants with long unexpired terms. By the end of April, real estate capital values had already declined by 43%, driven primarily by rising cap rates. The dramatic slowing of economic activity is now impacting rental levels, and this is set to push values even lower over the coming months.

Although this adjustment is unprecedented and causing significant challenges for existing owners and managers of real estate, it is starting to be seen to provide attractive opportunities on a range of dimensions. Most fundamentally, the UK seems to have corrected more significantly and more rapidly than other European and Global markets. In addition, the UK's real estate market continues to be one of the world's most transparent and liquid markets, with specific characteristics, such as its lease structures, that reinforce its attractiveness to many investors. It is within this context that this paper reviews the latest market trends and outlook for the UK commercial real estate market.

This quarterly review of the UK's property markets begins with a 'Market Outlook' covering the latest events in the macro economy, the fundamentals of the real estate markets and the capital markets. This includes both a review of the first quarter and a discussion of the likely short term prospects. The 'Research Topic' section explores a real estate related issue in more detail each quarter, focusing on timely, relevant subjects and their likely impact on the UK real estate market. In this quarter, the topic focuses on debt and, in particular, the role of bank lending to the commercial real estate sector.

Outstanding debt attached to UK commercial real estate has grown from around £70 billion (bn) in 1999 to an estimated £225bn at the end of 2008. This high level of exposure coincides with a period of unprecedented turbulence for the UK banking and property sectors. For this reason, the approach banks take to addressing problems in their legacy loan books will have profound implications for the UK property market.

The 'Research Topic' section gives a brief review of the growth of lending to the UK commercial real estate market before considering the current prospects for the UK banks given their importance to the property sector. It then considers the options for dealing with the legacy loan book and the prospects for new lending. The section concludes by assessing the likely impact on the UK property markets highlighting both base and downside scenarios.

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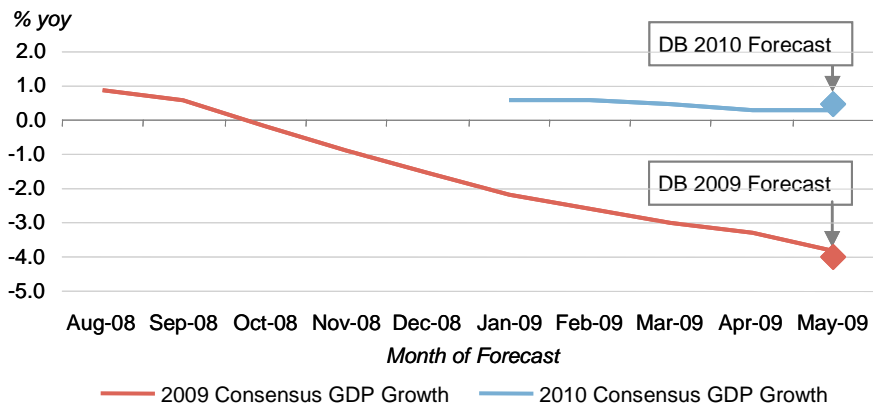
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2. Market Outlook

Macro Economy

The first quarter of 2009 has seen economists continue to revise down their UK GDP forecasts for both 2009 and to a lesser extent 2010. In its April Budget report¹ the Treasury suggested UK GDP would now decline by 3.5% in 2009 while Deutsche Bank (DB)² remained more pessimistic, forecasting a fall of 4%. The poor economic environment is putting considerable pressure on occupiers, with company liquidations up by 13% on the last quarter of 2008 and up by 57% on the first quarter of 2008³. Consensus forecasts for 2010 predict no more than a mild recovery with current expectations for GDP to grow by 0.3%.

Chart 1: Change in GDP Expectations



Source: Consensus Forecasts; DB Global Markets, May 2009

Inflation has not fallen as much as the Bank of England and DB expected in the first quarter of 2009. Inflation is however forecast to trough later this year and annual CPI is currently expected to be 1% for 2009. The Bank of England has expressed concerns over the impact the decline in sterling may have had on inflation. By mid March sterling was 25% cheaper against the Euro than at the start of 2007⁴. As Chart 2 shows, this has made the UK increasingly attractive to overseas buyers but the ongoing re-pricing as well as the poor economic outlook has meant that overseas investment into UK property has been limited in the first quarter of 2009. As yields for prime UK property stabilise through 2009 the more favourable exchange rate will likely be an additional factor encouraging overseas buyers to consider investment into the UK.

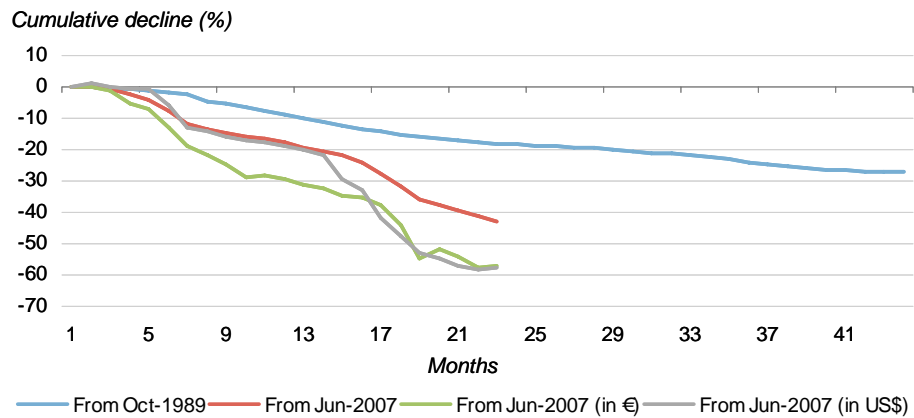
¹ http://www.hm-treasury.gov.uk/d/Budget2009/bud09_complereport_2591.pdf, accessed April 2009.

² Deutsche Bank Global Markets Research, *World Outlook*, March 2009.

³ <http://www.insolvency.gov.uk/otherinformation/statistics/200905/table1.pdf>, accessed May 2009.

⁴ Deutsche Bank Global Markets Research, *Exchange Rate Perspectives*, April 2009.

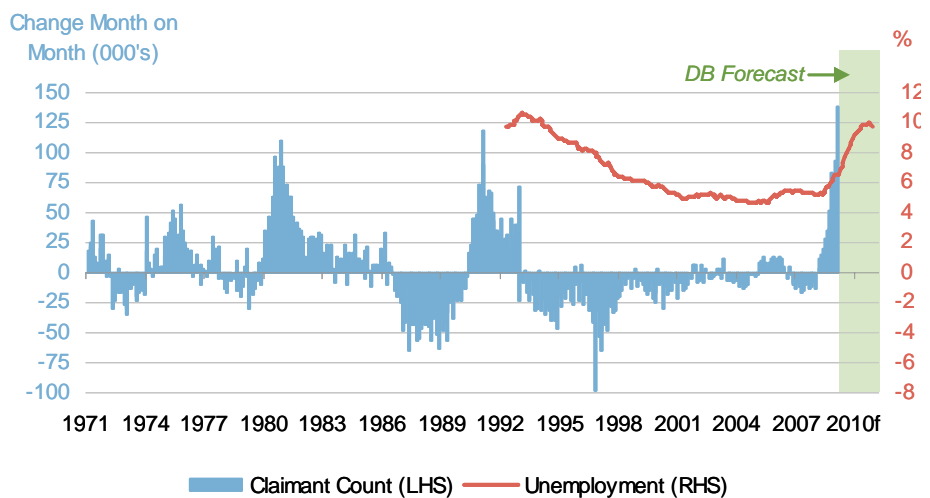
Chart 2: UK All Property Value Decline



Source: IPD; XE; RREEF Research, April 2009

Private consumption continues to be a key driver of the current downturn and is being driven by the global nature of this recession. This is causing significant increases in unemployment which DB expects to peak at 10% in Q3 2010⁵. Consumption is being further impacted by both the inability of the consumer to borrow against future earnings, as they have done in previous recessions, and an overdue increase in the savings ratio.

Chart 3: Historic and Forecast Unemployment



Source: ONS; DB Global Markets, March 2009
f = forecast

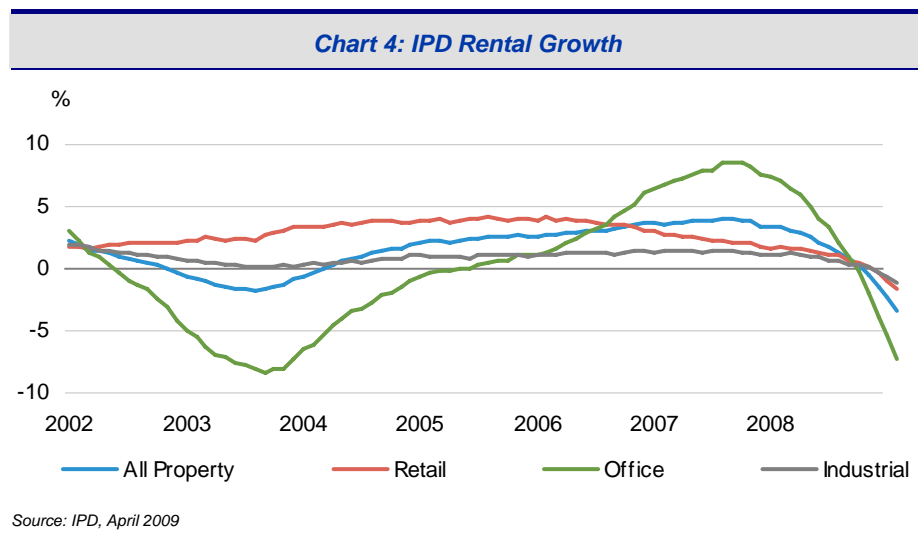
The outlook for private consumption and ultimately retail sales remains poor. If the savings ratio increases further consumption will suffer accordingly and with unemployment continuing to increase both savings and consumption will be impacted. The impact on the property market has already been seen with vacancy in town centre retail units rising significantly and this trend is expected to continue through 2009. Weaker retailers will continue to struggle and margins across the sector as a whole will remain under pressure. Efforts to trim costs, reduce inventories and ultimately increase efficiency will likely encourage retailers to continue to keep both their business and property strategies under review.

⁵ Deutsche Bank Global Markets Research, *World Outlook*, March 2009.

While the economic environment remains challenging and further business failures should be expected, the raft of insolvencies seen in Q4 2008 and Q1 2009 have resulted in a number of weaker retailers ceasing to trade. Where this has been the case the impact on landlords is indiscriminate. Going forward business reviews resulting in leases of underperforming units not being renewed is likely to become increasingly common while further insolvencies should be expected. In this environment the importance of monitoring all levels of business performance from entity down to unit level is accentuated.

Market Fundamentals

The sharp deterioration in the UK economy has led to an increasingly difficult business environment. This is having a direct impact on all three major property sectors as tenants are looking to cut costs and position themselves for a difficult 2009-2010. Leasing activity has slowed as business expansion has given way to cost cutting. Landlords with available space are having to offer reduced rents and increased incentives in order to attract tenants. IPD data⁶ shows rental declines gathering pace through the first quarter of 2009 in all three sectors. Offices continue to under perform with a Q1 2009 decline of -5.7%, compared with -2.0% for retail and -1.3% in the industrial sector.



Office rents are expected to decline significantly through 2009 and into 2010 across all the major submarkets. The speed and extent of the decline has varied considerably with the London City and West End markets leading the way with headline rents down almost 30% from their peaks. Aside from the fall in headline numbers, effective rents are being hit by an increase in incentives on offer. JLL⁷ suggests rent-free periods in the City have increased from around 12 months in 2007 to 30 months by Q1 2009. Anecdotal evidence suggests rent-free periods for A/A-space may be as much as 3-4 months for every 12 months granted. While market conditions may appear favourable to occupiers, poor business confidence and reluctance to incur relocation costs are encouraging tenants to negotiate extensions on existing leases. While landlords with empty space in their portfolios will increasingly subsidise these costs, for many occupiers the low cost option is to extend existing deals.

Development completions in the London City market will remain high through 2009 and into 2010 but will then tail off dramatically in 2011. Drivers Jonas⁸ suggests an estimated 4.3 million square feet of speculative space are however currently under construction which will add to the 3.2 million square feet of new space already

⁶ IPD UK Monthly Index, April 2009.

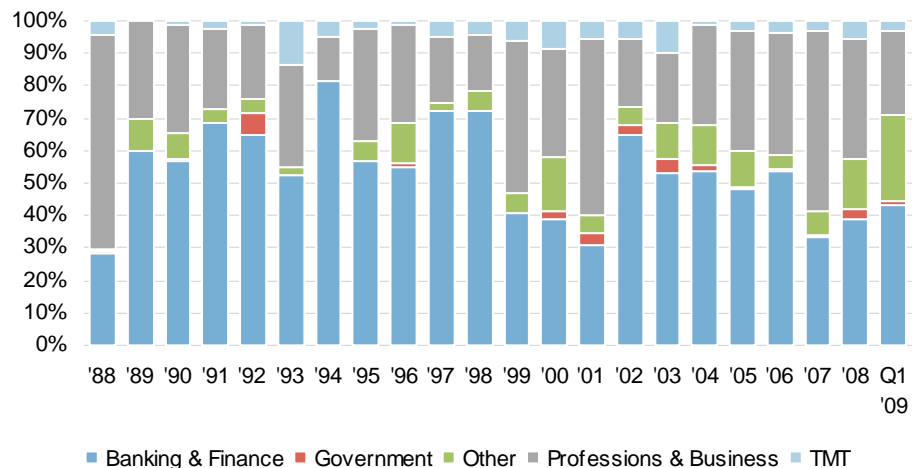
⁷ Jones Lang LaSalle, *The Central London Market Q1 2009*, April 2009.

⁸ Drivers Jonas, *Central London Crane Survey First Quarter 2009*, May 2009.

complete and available to let. Grey space⁹ will also become increasingly available through 2009 and according to PMA¹⁰ will likely help push availability above the 11 million square feet seen in the 2003 peak.

Of particular concern for the City market is the decline in take up emanating from the professional and business services sector and signs that these tenants are looking to sublet excess space. While not necessarily achieving top rents, this sector often takes well located, good quality space at the higher end of the market. The importance of banking, finance, professional and business services tenants to the City and their interconnectivity means this market will once again experience the most volatile cycle.

Chart 5: City Take Up by Sector



Source: PMA, April 2009
 Note: 2009 to end Q1
 TMT = technology, media, & telecommunications

Rents in the West End are expected to come under severe downward pressure through 2009 with declines in excess of 20%. While the prime end of the market will continue to suffer from an absence of financial sector occupiers, the slowdown in the wider economy will increasingly impact the broader base of tenants through 2009-2010. This is expected to lead to rental declines across the market and not just in the prime areas.

The industrial sector continues to be impacted by the struggling manufacturing sector as well as retailers looking to make cost savings. Take up has declined dramatically to the extent that activity is largely confined to lease expiries or consolidation. Over the next 18 months occupiers are expected to look for lower headline rents, greater incentives and more flexibility in their lease terms, particularly with regard to lease length.

While industrial rents across the UK will remain under downward pressure through 2009 and 2010 the sector is expected to see a smoother cycle than offices or retail. This does however mask significant differences across the country with those areas with the greatest oversupply of stock or exposure to sectors which are experiencing particularly severe slowdowns expected to under perform significantly. Conversely strategic locations where supply has not been excessive and fundamental drivers remain intact are expected to see some of the smoothest rent cycles of any sector.

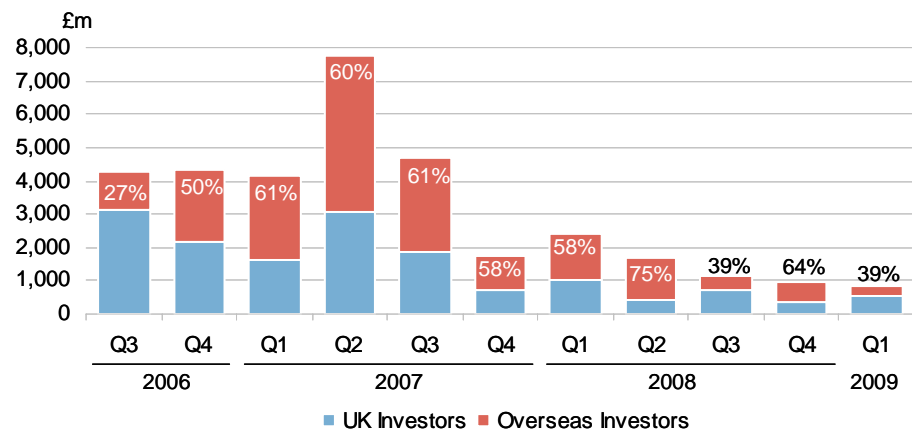
⁹ Grey space (often referred to as shadow space or phantom space) is the portion of leased space which is vacant but has not yet been turned back to the market.
¹⁰ PMA, *European Office Occupier Forecasts*, April 2009.

Capital Markets and Performance

Real estate investment activity remained low in Q1 2009 with DTZ¹¹ estimating transaction volumes at £3.5bn. This is in line with the last quarter of 2008 but down on the previous quarters of 2007 and 2008.

As Chart 6 shows, the net volume of capital transactions in the London office market fell in Q1 2009 to £854m, down 10% on Q4 2008 and 65% lower than Q1 2008. Investor interest has focused on good quality buildings let to tenants with long unexpired terms. In some cases, the presence of these assets on the market is likely to be a consequence of entity level distress where the need to raise funds in a weak market has resulted in better quality assets being offered for sale. Property level distress is expected to increase as tenant defaults rise but the importance of covenant strength to potential investors will likely continue to limit the number of assets transacted.

Chart 6: London Office Transaction Volumes



Source: JLL, April 2009

Note: Figures quoted refer to % of transaction volume attributable to overseas investors

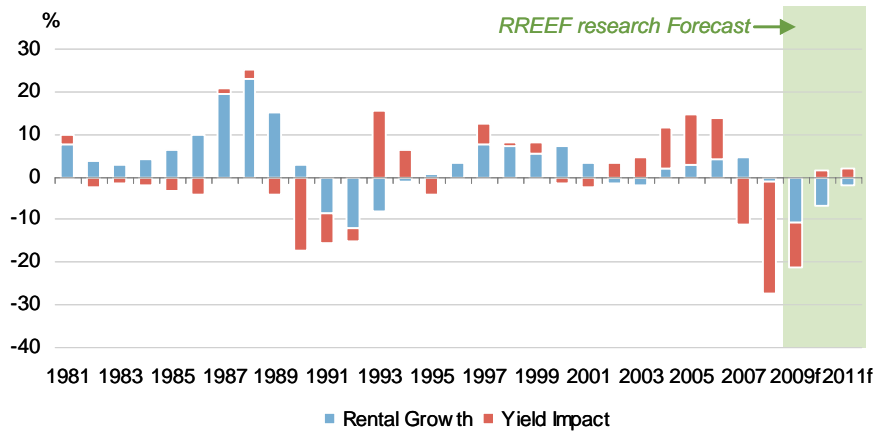
While the bulk of real estate investors remain focused on managing existing portfolios and are in no position to consider new acquisitions, the difficult financing environment and deteriorating fundamentals are continuing to deter potential investors from entering the market. For larger lot sizes the difficulty of assuming in-place financing or securing seller-provided finance is hindering their marketability. JLL¹² suggests that at the end of Q1 2009 prime yields for City offices in excess of £125m have a 75 basis point (bp) premium to those under £40m. This differential may widen further as investor confidence increases but financing constrains activity to the smaller lot sizes.

Many investors are waiting on the sidelines as capital values continue to decline and the uncertainty over falling rents remains. What is less clear and will become an increasingly important issue as rents decline further, is whether those currently buying into the market are adequately pricing the potential impact of owning over rented property into their underwriting models. Going forward rental value declines will increasingly become the driver of further declines in capital values.

¹¹ DTZ, *Real Estate Markets Outlook*, May 2009.

¹² Jones Lang LaSalle, *The Central London Market Q1 2009*, April 2009.

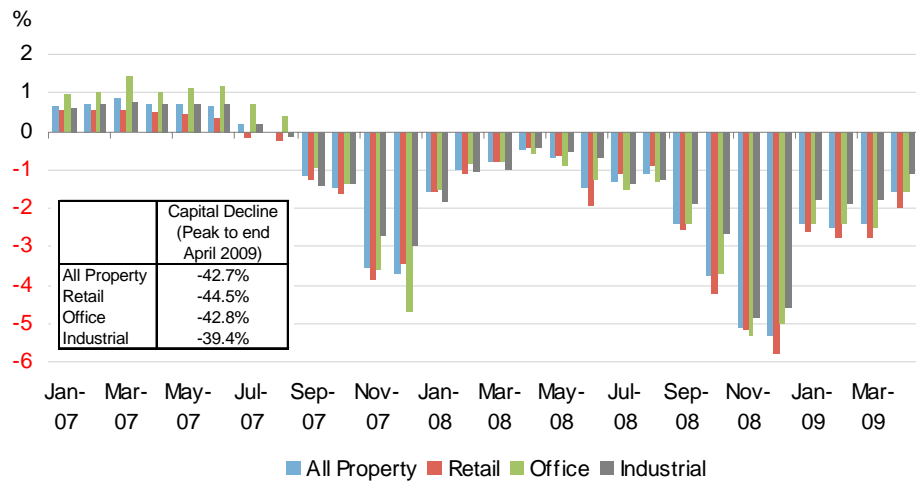
Chart 7: Components of Capital Growth



Source: IPD; RREEF Research, May 2009
f = forecast

Despite signs that yields may be beginning to stabilise for very prime assets, the overwhelming trend continues to be for weakening performance. As Chart 8 indicates, IPD monthly returns across all three major sectors remain negative, albeit at levels less severe than in Q4 2008. Transaction activity is thin, with debt financing remaining tight and at reduced loan-to-value ratios (LTVs) and increased margins. Investors are looking at deals but requirements are very specific.

Chart 8: IPD Monthly Total Returns

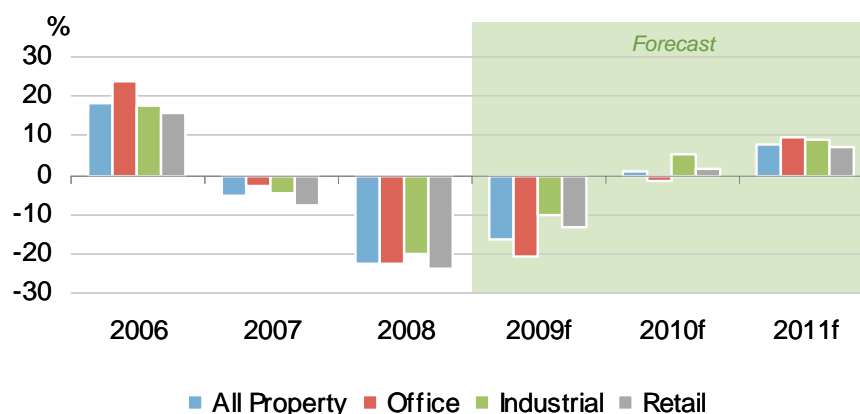


Source: IPD, April 2009
Note: Bars represent actual monthly total return and not an annualised monthly return.

Returns across all sectors are expected to remain weak in 2009, as shown in Chart 9. Although the short term prospects remain weak, the UK benefits from having corrected more significantly and more immediately than most global markets¹³. This correction, coupled with the prospects of a cyclical recovery in 2012/13 means that many investors are seeing the UK as providing attractive investment opportunities over the next 18 months or so.

¹³ RREEF Research, *Global Real Estate Investment and Performance 2008 and 2009*, May 2009.

Chart 9: UK Total Returns by Sector



Source: IPD; RREEF Research, May 2009
f = forecast

Although the UK market does appear to provide compelling counter-cyclical investment opportunities, a specific concern should be with the ongoing stress being seen in the banking sector. As section 3 of this paper explores in greater depth, lending to the UK market has grown significantly over the last 10 years and banks now face stress across their existing portfolios. This is a result of ongoing capital value declines as well as the weakening economy and occupier markets increasing the likelihood of tenant defaults and the presence of vacant units. The approach taken by major banks to their real estate portfolios will have an important bearing on the future direction of pricing.

3. Bank Lending to the UK Commercial Property Sector

Introduction

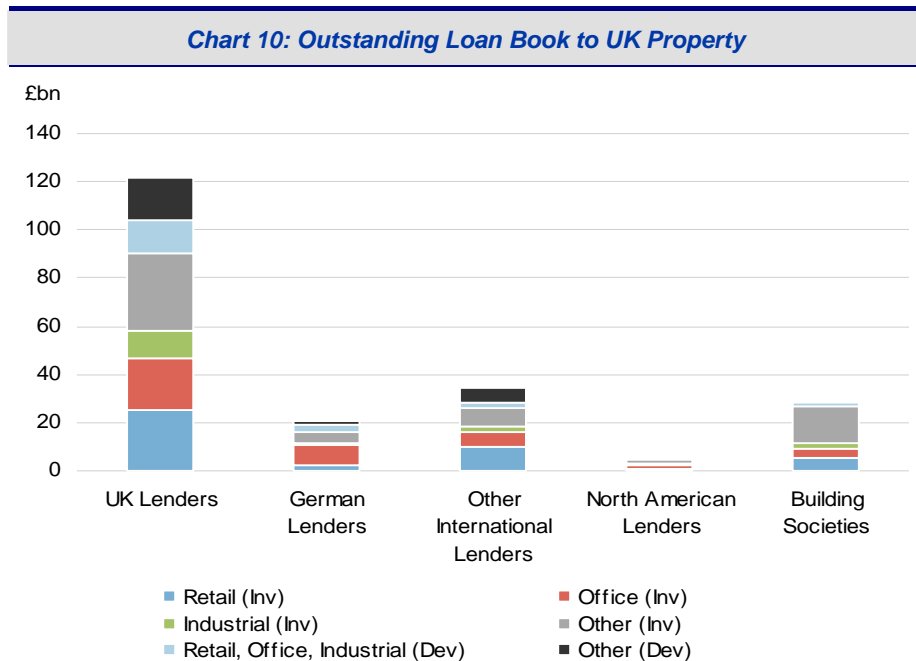
Debt has played an increasingly important role in the real estate capital structure in recent years with public and private debt estimated to account for 60% of the UK real estate capital market¹⁴. Of this, private debt in the form of commercial banks and other lending institutions contributes 48% of all capital. This compares to the 33% provided by private equity and 8% allocated to public equity.

The credit crunch of 2007 brought to an end a period of unparalleled lending to the UK real estate market. With capital values declining since mid 2007 and more recent falls in rents, the outlook for debt secured on real estate has steadily worsened. The focus has shifted from originating new loans to dealing with the legacy debt mountain and for those holding debt on their balance sheets, ensuring they have the financial means to survive.

The topic covered in this section focuses on the scale of the problem in the UK property lending market. In order to understand this issue, the paper focuses on the broader prospects for the UK banks as they comprise the largest single group of lenders to the UK market. The paper goes on to attempt to identify the likely options for the UK's legacy loan book and considers the impact this may have on new lending. Finally, it takes a look at the options for lenders as loans reach maturity in the coming years and considers the impact this may have on the property markets over the next 5 years.

UK Loan Book

At the end of 2008 the estimated value of outstanding debt secured by commercial property was £225bn¹⁵; Chart 10 shows the breakdown at the end of 2007 between sector and lender group.



Source: De Montfort University, 2008

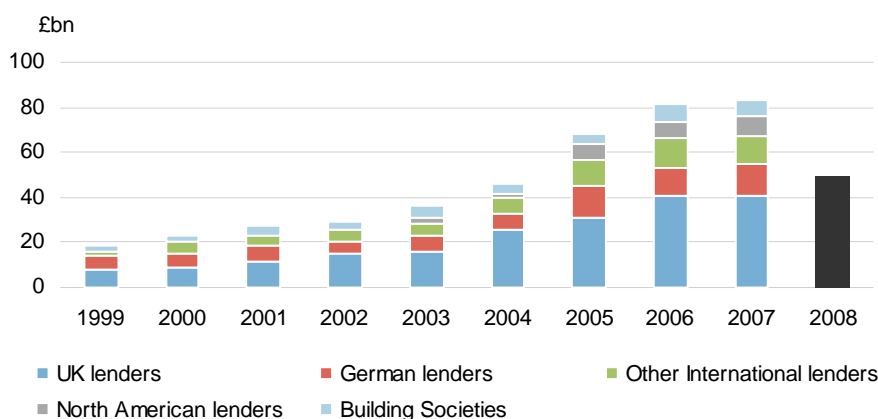
¹⁴ DTZ, *Money into Property*, 2009.

¹⁵ De Montfort University, *The UK Commercial Property Lending Market: Year-End 2008 Research Findings*, reported in *Property Week*, 15 May 2009.

While a detailed analysis of commercial real estate lending in the UK is outside the scope of this report it is important to note a few key themes from De Montfort University's recent bank lending survey¹⁶ which are particularly relevant to the outlook for the commercial property markets:

- 70% of the outstanding loan book at end 2007 is attributable to investment property lending, down from circa 80% at the beginning of the decade.
- Of the 2007 year end outstanding debt to investment property, 29% was allocated to the retail and retail warehouse sector. 27% is office and business parks and 10% industrial and distribution.
- The loan maturity profile at the end of 2008¹⁷ shows that 69% of the £225bn outstanding matures by end 2013.
- While North American and German lenders held relatively small proportions of the total outstanding loan book at end 2007 they have been active loan originators. North American business models have largely been structured around selling on their debt.

Chart 11: UK Loan Originations



Source: De Montfort University, May 2009

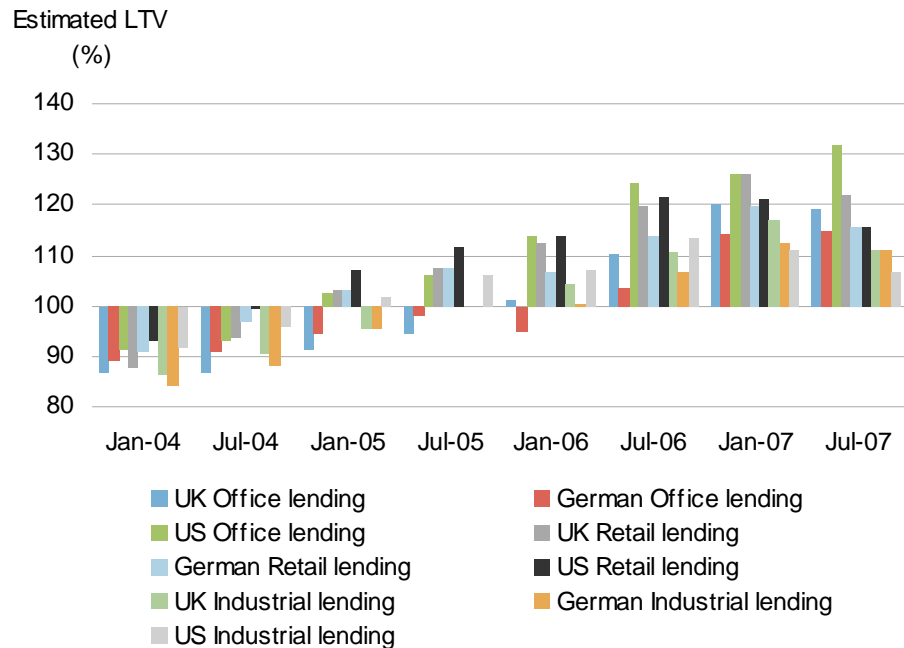
Loan Performance

Between mid 2007 and end March 2009, the IPD UK All Property monthly index has seen a 41.4% decline in capital values. Combining monthly performance data by sector with typical loan terms by lender and sector at various points between 2004 and 2007 gives an indication of the position of a typical loan at the end of 2008; the results are shown in Chart 12.

¹⁶ De Montfort University, *The UK Commercial Property Lending Market: Year-End 2007 Research Findings*, 2008.

¹⁷ De Montfort University, *The UK Commercial Property Lending Market: Year-End 2008 Research Findings*, reported in *Property Week*, 15 May 2009.

Chart 12: Theoretical LTVs at end 2008 by Origination Date



Source: IPD; De Montfort University; RREEF Research, May 2009

Note: Bars show suggested LTVs at end 2008 of a theoretical new loan originated at each point between Jan 04 and July 07. Performance is based on typical loan terms by type of lender at that point in time and subsequent capital value performance as per IPD monthly index i.e. 'Jan-04 UK Office lending' shows the suggested LTV at end 2008 of a theoretical loan made in Jan 04 by a UK lender to an office investment based on average loan terms for UK lenders at that point in time as reported to De Montfort University's annual lending review.

RREEF Research currently expects further capital decline across all sectors in 2009 which will only worsen the current position. With rents under downward pressure and the general business environment remaining difficult, the prospects for existing loan performance over the next two years remains poor.

Prospects for UK Lenders

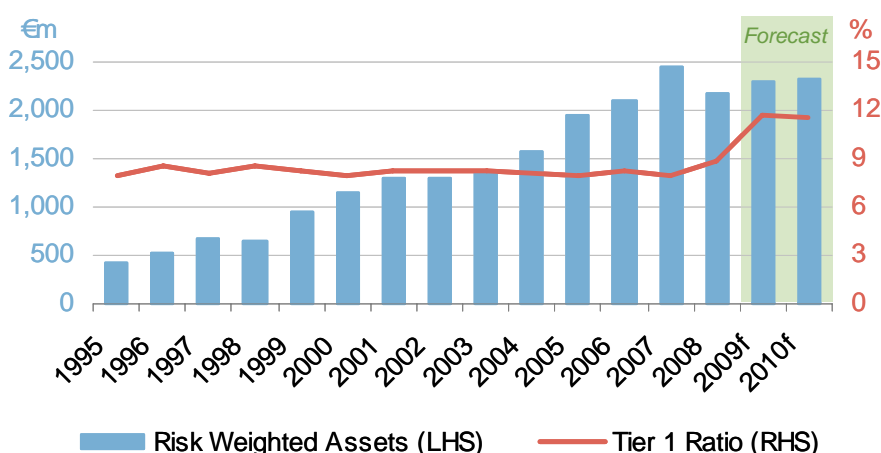
After a torrid 2008 the UK banking sector faces many challenges in 2009 and amongst the most important are likely to be:

- Ongoing concern over funding, generating uncertainty as to the strength of balance sheets and the ability of banks to absorb write offs on existing loan books,
- Increasing credit risk impacting earnings as the global economy slows,
- The ability to fund new lending through a sustainable business model.

Banks have an ongoing need to finance both their existing and new lending. While they have a range of options available; such as deposits, debt issuance and the use of wholesale markets (with or without Government backing and largely substituted by repo funding in 2008), the credit crunch proved just how unsustainable some of these options are. If banks are unable to roll existing debt forward then a funding shortfall is liable to result in them being forced sellers of assets. According to DB Global Markets,¹⁸ banks worldwide were ultimately able to issue new debt equal to their debt maturities in Q4 2008. This was a much improved situation from the start of Q4 and significantly reduces the likelihood of forced redemptions. As Chart 13 indicates, capital adequacy, as measured by the core tier 1 ratio, is expected to rise significantly through 2009 and 2010.

¹⁸ Deutsche Bank Global Markets Research, *European Banks Strategy*, January 2009.

Chart 13: UK Banks Capital Adequacy



Source: DB Global Markets, January 2009
f = forecast

Despite this, the overall situation facing the banking sector remains weak; credit risk is expected to become an increasingly significant issue through 2009 and will place further strain on the banking sector. Income covenants on real estate lending will come under further pressure and elsewhere in the economy the overleveraged UK consumer is likely to see rising levels of default which will be magnified by further increases in unemployment. Corporate profits will also come under downward pressure. DB Global Markets¹⁹ highlights the potential risk of defaults from smaller cap corporates and they conclude that this will be an especially harsh sub-investment grade credit cycle.

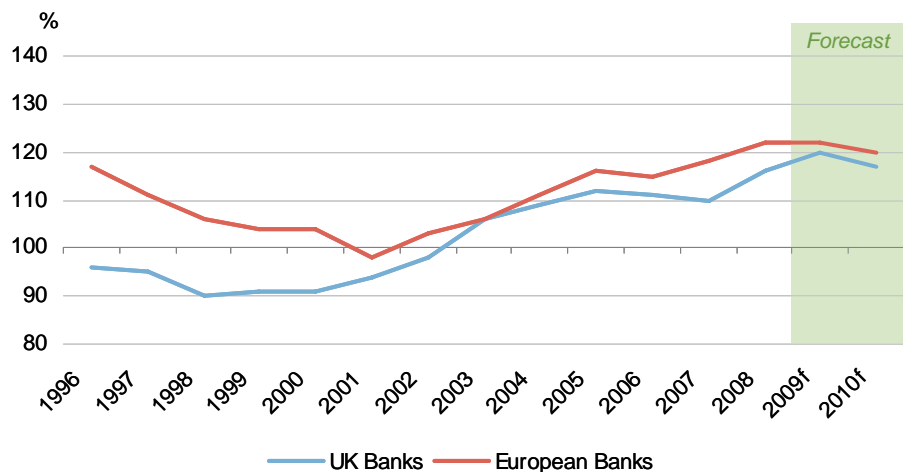
For the UK banks a significant step was taken in Q1 2009 when the Government made available the Asset Protection Scheme (APS), which RBS and Lloyds Banking Group subsequently signed up to. By limiting their loss on a combined £585bn of risk exposures to a first-loss piece of 6% and 10% respectively (plus a participation fee) the hope is that the banks have limited the potential for further hits to capital, allowing them an element of certainty in their business planning and funding requirements. Those banks not participating in the scheme must believe they have sufficient capital, or the scope to raise sufficient capital, to absorb further write downs. The record breaking HSBC rights issue and Barclay's proposed sale of iShares are two recent examples of banks taking steps to enhance their capital base.

Beyond this the banks need to establish a sustainable method of funding their lending activities and crucial to this will be the relationship between loans and deposits. At the end of 2008 DB Global Markets²⁰ estimated the UK banking sector's loan to deposit ratio stood at 116%, up from 110% a year earlier. While corporates and customers paying higher margins will help generate profits, if loans continue to grow faster than deposits then banks have to look to alternative funding sources, such as the wholesale market. As was shown in 2007 this raises funding concerns if for any reason liquidity in these markets is reduced.

¹⁹ Deutsche Bank Global Markets Research, *European Banks Strategy*, January 2009.

²⁰ Deutsche Bank Global Markets Research, *European Banks*, March 2009.

Chart 14: Total Loans as a Proportion of Total Debt



Source: DB Global Markets, January 2009
f = forecast

Banks are therefore likely to want to reduce this ratio through either raising their deposit base or cutting lending. The savings ratio in the UK has belatedly started to rise and stood at 4.8%²¹ at the end of March 2009, a rise of 6 percentage points since the start of 2008. While this will be of benefit, the banks themselves have control over their lending activities and can therefore make a more immediate impact by cutting the volume of business they write.

Options for Legacy Loan Books

Given the issues banks still face, the prospects for new lending look bleak. Volumes are likely to be cut further in the short term as banks look to reduce their balance sheets and strengthen their capital base. The funding environment does however appear to be improving which reduces the risk of banks being forced into redemptions.

The key lenders face massive issues in their legacy lending portfolios and while this risk has to some degree been alleviated by the introduction of schemes such as the APS, the prospects of capital values relieving the pressure on loan losses remain limited in the near term. At best there are signs that prime properties in a small number of submarkets and sectors may be seeing stabilisation in values but the full impact of the economic downturn on the occupier market is yet to be felt. In the wider real estate market price movements are still weakening.

Banks therefore face the issue of existing loans maturing with LTVs in excess of 100% and few options available to them. In many cases equity participants will have seen their investments wiped out and have a limited ability or desire to inject new capital. This leaves the banks with four likely scenarios:

- Disposal of the asset and recovery of a proportion of their original loan;
- Taking possession of the asset and retaining it on balance sheet;
- Agreeing a loan extension and workout program; or
- Sale of the debt to a third party.

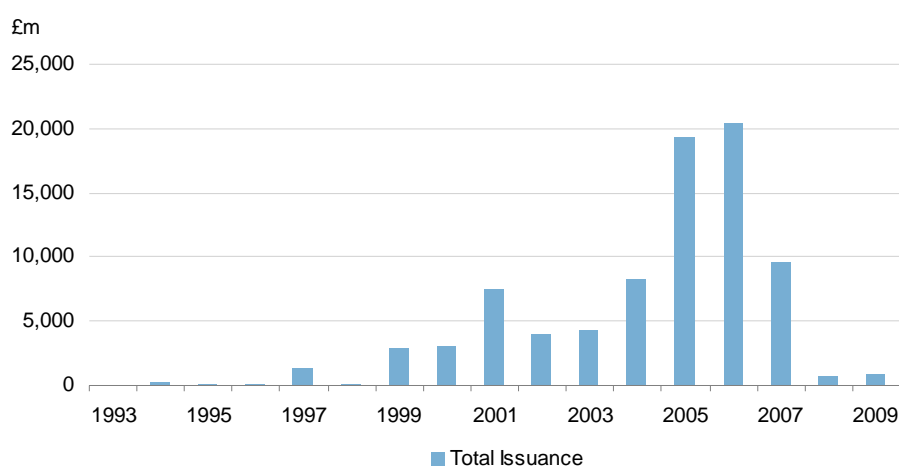
With financing conditions improving, loan extensions and workout programs appear the most likely route for many assets where income covenants remain intact. While this may be the only option available in the short term it is also a relatively attractive solution for the banks as it does at least allow them to increase their margins on existing lending. For legacy lending held by single providers debt sales are likely to

²¹ Deutsche Bank Global Markets Research, *UK Review & Outlook*, 6 April 2009.

be largely unattractive due to both pricing and the damage to relationships.

In the CMBS space, because of the inherent conflicts of interest between different tranche holders, extensions are only likely to be granted within the parameters of the existing legal structure. It is likely that many assets will be forced to the market to resolve an unworkable capital structure caused by the asset's under or non performance. With CMBS issuances peaking in 2005-2006 the refinancing risk will be most acute in the period 2011-2013 but weaker fundamentals and value decline are also likely to contribute to increasing levels of distress over the next 18 months. The likely distress and opportunities emanating from the CMBS market is explored further in a forthcoming RREEF Research paper²² looking at the global debt markets.

Chart 15: CMBS Origination



Source: Commercial Mortgage Alert, May 2009

Outlook for New Lending

For banks generally, property lending faces significant challenges. On the one hand, there is the prospect of ongoing capital and rental declines as well as the potential for tenant default. On the other, banks already have a significant volume of property loans on their balance sheets. The combination of these factors means property lending will likely be muted for many months to come. In some cases political pressure may motivate lending, with SMEs and the private consumer likely to be the beneficiaries. For instance, as part of the APS deal Lloyds Banking Group agreed to lend an additional £14bn to creditworthy borrowers, split £3bn residential mortgages and £11bn business customers. Although such measures will encourage lending, they tend to be focused on the consumer and small business market, rather than commercial property.

Where new lending is undertaken or loans extended, the new, increased cost of bank funding will have to be passed on. While this may decline over time, in the short term it will help keep property yields high as income will remain at a premium in order to service more expensive debt.

New lending will not only see changes in the capital and income covenants on offer but the increasingly risk averse nature of lenders is likely to see stricter terms being placed on repayment schedules. This may for example include a requirement for higher amortisation payments over the life of the loan. With a higher cost of debt and a more limited refinancing environment, investors will again need higher income yields to generate sufficient free cash flow to meet amortisation payments. This will make asset selection and pricing increasingly important in an environment where rents are

²² RREEF Research, *Global Commercial Real Estate Debt: Deleveraging into Distress*, June 2009.

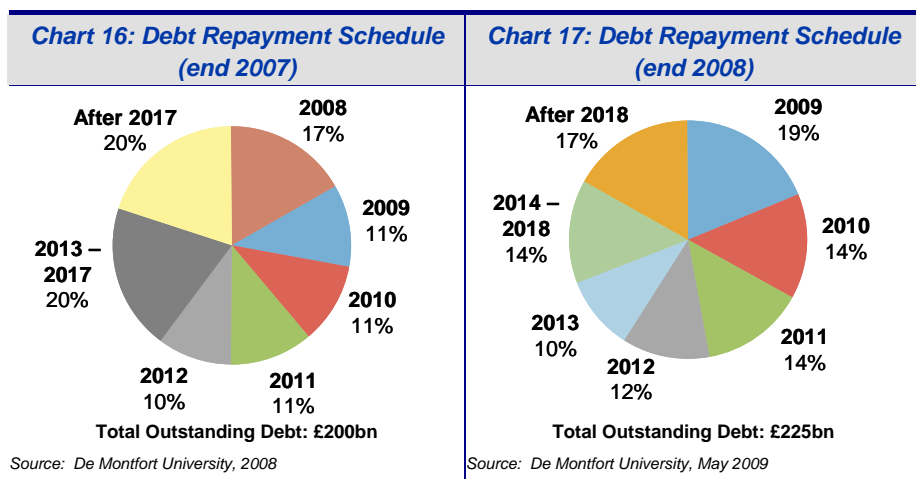
under downward pressure and income is at a premium as the risk associated with acquiring over-rented property increases substantially.

While the amount of debt being lent to the property sector has dropped considerably with loan originations²³ in 2008 down 41% on 2007 at £49.2bn, many lenders are still active but in a reduced capacity. Banks such as RBS²⁴ have expressed a willingness to lend to core relationships and a recent Savills report²⁵ highlighted 40 banks that are doing business in the UK property sector, 12 of which were lending in lot sizes in excess of £25m. German lenders who are able to utilise the Pfandbrief market have the capacity to be among the more active loan originators going forward. There is also evidence that some institutions may once again be looking at debt investments where the risk / return balance now meets their requirements.

On balance, although there are signs of some lenders becoming more active in the market, the overwhelming trend will be for relatively low levels of new property lending over the coming months. Loan originations will be low, and the conditions on which loans are provided will remain tight.

Impact on Property Markets

The unwinding of the debt-driven property boom which reached a peak in mid 2007 will have a major impact on pricing over the next 3-5 years. Lenders currently have limited options available as to how to deal with both loan expiries and assets falling into distress. As Chart 17 shows, at the end of 2008 the proportion of the UK loan book now maturing within 5 years has risen to 69%²⁶.



Transaction volumes reflect investors' interest in only the very best product which they believe can weather the extremely weak market environment that will exist through 2009-2010. With limited investor interest those needing liquidity will be forced to consider sales of prime units. Interest in purchasing secondary property is expected to remain extremely limited in the medium term.

Beyond this, the outlook depends largely on the performance of the wider economy; if a recovery takes shape, real estate fundamentals will improve in a period of low supply. This should result in increased real estate investment activity with investors utilising more expensive debt at lower LTVs (50-65%). Furthermore, a rally in the equity markets will help reduce the denominator effect seen through 2007-2008 allowing investors to increase their allocations to real estate. In this environment

²³ De Montfort University, *The UK Commercial Property Lending Market: Year-End 2008 Research Findings*, reported in *Property Week*, 15 May 2009.

²⁴ <http://www.propertyweek.com/story.asp?sectioncode=297&storycode=3138239>, accessed April 2009.

²⁵ <http://www.savills.co.uk/news.aspx?category=latest%20news&id=10332&page=0>, accessed April 2009.

²⁶ De Montfort University, *The UK Commercial Property Lending Market: Year-End 2008 Research Findings*, reported in *Property Week*, 15 May 2009.

those with legacy loans on their balance sheets should have increased options available to them in order to reduce loan books. With market fundamentals in better shape, value-add strategies will once again be viable which will broaden the range of products investors will consider purchasing. As well as banks taking the opportunity to sell down legacy assets which they either own or effectively own due to covenant breaches / re-financing through 2008-2010, a wave of CMBS related assets will come to the market as a sale is the only solution available to unwind the complex financing structures. The volume of product, investor return requirements and where applicable increased costs of financing will however likely contribute to keeping yields at elevated levels. Even in such a scenario, where there is increasing equity allocated to property, the sheer volume of debt that will need to be replaced is likely to prevent any strong downward adjustment in yields.

If the economy is either slow to recover or the extent of future growth is limited, the outlook for the real estate sector appears much worse. In this environment pricing will be significantly impacted by the ability of existing holders of debt to continue to finance their legacy loan books. Data from the 2008 De Montfort report²⁷ shows banks have been extending existing financing and this trend will need to continue to prevent an excessive amount of property being forced onto the market.

Even if existing debt holders are able to continue to roll the problem forward, the market is still likely to see significant product forced to sale by the unwinding of securitised positions. With 2005 to mid 2007 representing the peak of originations, this issue is likely to reach a nadir in 2011-2013. It is conceivable that if investment activity remains weak, the volume of product being offered to the market could see yields remain at levels above their long term average. In a worst case scenario, with securitised product being unwound and banks facing maturities on loans that have been extended in 2008-2009, commercial real estate could see another bout of outward yield movements in the period 2011-2013. This is very much a downside scenario at present but with loans currently being extended and the CMBS overhang looming the current situation is doing little more than pushing the problem further down the line.

Conclusion

The banking sector has made significant progress in recent months with funding conditions improving, debt issuance increasing and extreme stress tests on legacy loan portfolios resulting in further Government support. The sector is now in a position where funding appears sufficient to reduce the potential for disastrous forced deleveraging. A further deceleration in loan growth is however likely and where possible banks will attempt to reduce their existing loan books. Despite the seemingly attractive investment opportunities available, debt finance will remain tight and will need to be substituted by increased levels of equity.

Loan extensions and new business will be undertaken on significantly revised terms which reflect a new level of risk aversion. The banks will also pass on their increased cost of funding through higher margins. The limited new lending available in the immediate future will be directed towards core clients where relationships have proven successful over a long time period.

The current situation of offering loan extensions is doing little more than pushing the problems in the legacy loan book further down the line. Asset distress is likely to increase through 2009-2010 when breaches of income covenants are expected to have more severe consequences than the LTV breaches seen to date. In our base case scenario we assume these challenges can be overcome without destabilising the broader market. Within this context 2009-2010 is likely to be an excellent vintage for investing in UK real estate. If, however there are more widespread difficulties in unwinding legacy loan books then the downside scenario outlined above becomes a greater possibility.

²⁷ De Montfort University, *The UK Commercial Property Lending Market: Year-End 2008 Research Findings*, reported in *Property Week*, 15 May 2009.

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