

August 2010

## European Property Cycle Monitor

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### Executive Summary

After a promising start in early 2010, financial markets experienced renewed volatility in May and June as restless investors fretted about the ramifications of sovereign debt management in southern Europe. This quickly led to questions about the stability of European banks as well as the broader implications of the sovereign debt crisis on the euro itself. Meanwhile, a fragile U.S. economic recovery began to show signs of softening. Yet these compounding downside risks seemed to be matched, if not outweighed, by more positive developments. European policy responses, for example, have been quite encouraging, with national reform initiatives to tackle budgets (UK), labour (Spain), and pensions (France). Plus, the European Council stands prepared to deliver banking stress tests and peer reviews of national budgets in an effort to boost confidence and transparency. Elsewhere, emerging markets, especially those in Asia, continued to outperform economic expectations in the first half of the year, and this boosted prospects for the overall global economy in 2010 from 4.0% growth, which had been expected as of January, to 4.5% by mid-year. Heading into the second half of the year, the risk of a double-dip global recession appeared unlikely.

With **Europe's office markets** showing resilience under challenging economic circumstances, fundamentals have generally held up better than anticipated six months ago. A flatter office cycle has emerged driven by the more muted supply pipeline of this cycle which will ultimately allow any resurgence in demand to drive a recovery. Near term demand prospects are however limited due to the weak underlying economic environment. Weak prospects for both rents and capital values will hold office returns back in 2010, but over the remainder of the forecast, rental prospects for the office sector are expected to perform relatively well, providing investors with more market differentiation to pick through than either the retail or industrial sectors. Office rents will likely recover earlier in London and Warsaw, with later bounces to come for Paris and, later still, for Madrid. Regional cities in the UK and France, along with much of German-speaking Europe, will provide less volatile, more moderate opportunities.

**Europe's shopping centre markets** continue to move through an ongoing period of readjustment. In the first half of 2010, hesitant consumers showed little interest in kick starting retail sales volumes. Subdued retail sales growth is expected over the five-year forecast, but with some differentiation across markets. In those economies where household and government budgets suffered most in this downturn (Spain, Hungary, Ireland, the UK) consumers may take a little more time to rebuild their spending habits. Where economies have shown more resilience (CEE, Nordics) retail sales will pick up sooner. Value retailers continue to capitalise on opportunities in the down cycle, but other chains have been left to rethink their store networks. The retail sector's construction pipeline has been cut back significantly, although a few markets – especially Italy, Spain, and Poland – still have substantial new spaces delivering. Properties offering good location and modern schemes can expect to fare better than more marginal properties.

Rents continue to fall in many **European industrial markets** in 2010, but by year-end, rents in most markets should stabilise, with Iberia being the primary exception. RREEF Research expects a relatively mild recovery for the industrial market overall, with the timing varying significantly across markets. Although supply overhangs linger in a few markets like the UK and Spain, speculative construction has essentially ended. The industrial market's cyclical turning point will therefore be driven by the timing of a recovery in occupier demand. External trade flows have begun to recover, and this typically benefits the gateway markets first. Currency movements will continue to impact these trade flows over the near term. RREEF Research now anticipates that the industrial sector will stabilise sooner than we assumed in the previous forecast, thus taking some of the later momentum out of a pent-up recovery.

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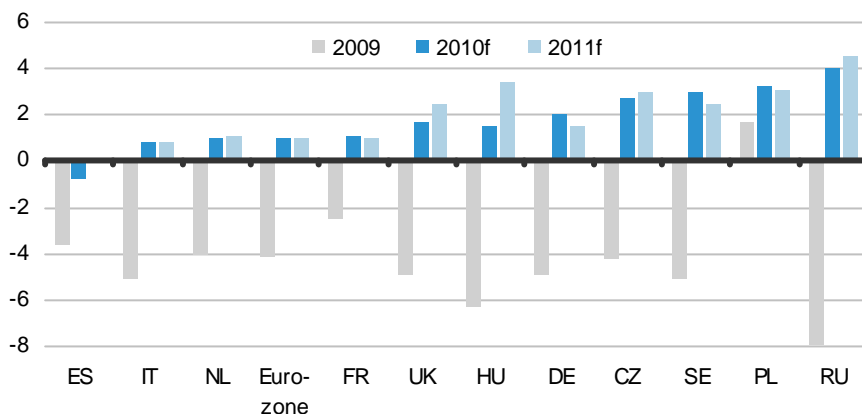
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## 1. Economic context

After a promising start in early 2010, financial markets stumbled later in the spring. In the first four months of the year, the VIX index, a measure of market volatility, coasted along near its long-term average of 20, but during May and June the index averaged just over 30, indicating a heightened sense of market anxiety. Much of the underlying concern stemmed initially from the management of sovereign debt, particularly in southern Europe, but the crisis also raised questions about the stability of Europe's exposed banks as well as the broader implications of the sovereign debt crisis on the euro itself. Then from across the Atlantic, a fragile American recovery seemed to be sputtering by mid-year.

Yet this flare-up of downside risks in late spring seemed to be matched, if not outweighed, by more positive developments. Emerging markets, especially those in Asia, continued to outperform economic expectations in the first half of the year, and this boosted prospects for the overall global economy in 2010 from 4.0% growth, which had been expected as of January, to 4.5% by mid-year. Meanwhile, European policy responses have been encouraging, with national reform initiatives to address budgets (UK), labour (Spain), and pensions (France). Plus, the European Council stands prepared to deliver banking stress tests and peer reviews of national budgets. In the short term, interest rates are likely to remain low, but we expect them to be rising over the longer term as Europe steadily resolves its fiscal challenges and the economic growth gains more speed.

**Exhibit 1: Real GDP growth (%)**



Source: DB Global Markets Research, "Focus Europe," 30 July 2010

f indicates forecast

Within the Eurozone, economic forecasts for Greece and Spain, which were already weak at the start of the year, have been further downgraded, thus pushing back the timelines for recovery in both countries. Tighter fiscal policies and access to bank credit in these and other affected peripheral countries will weigh on domestic demand and cut into near-term growth prospects. While the 2010 outlook for many national Eurozone countries has been downgraded, the prospects have been enhanced for many of these same European countries to see a stronger long-term rebound as they rebuild economic momentum atop a sturdier fiscal foundation.

Not all European countries experienced downgrades to their forecasts in 2010. As the sovereign debt crisis eroded some of the euro's strength during the spring, it enhanced the economic prospects for the more export-oriented economies. Deutsche Bank's 2010 forecast for Germany, for example, has changed little since the start of the year. And outside the Eurozone, the 2010 economic prospects for Sweden, Switzerland, Denmark, Poland, and the Czech Republic have all risen since the beginning of the year.

Moving into 2011, economic forecasts break largely along geographic lines. Within the Eurozone, the southern economies (Greece, Spain, Portugal, Italy) will still be struggling to regain economic momentum in 2011, while the northern ones (Germany, France, the Netherlands, Belgium, Austria, Finland, and even Ireland) will likely see at least modest 1-2% growth. Western European countries outside the Eurozone (the UK, Sweden, Denmark, Norway, Switzerland) should be recovering faster, with 2-3% economic growth likely by next year. Prospects are even better in the CEE region, where Poland, the Czech Republic, and even Hungary are likely to break above 3% GDP growth by 2011.

This economic forecast translates to a guardedly optimistic outlook for European property markets, but the opportunities will differ by geography, property sector, and investment grade. Rents are expected to decline less in this cycle than was expected in the previous forecasting round, resulting in a flatter overall cycle. This will impact the *timing* of the rental recovery more than anything else. Six months ago we had anticipated stronger, more back-loaded growth to offset a severe near-term trough. Since most of RREEF's current forecasts for individual markets show that the magnitude of total rental growth over the five-year forecasting period has not changed materially from six months ago, the difference then lies in the loading of the rental change amid a less severe downturn and, thus, a weaker bounce back.

Looking ahead, a number of potential obstacles could impact the current economic forecast. The most likely downside risks to Europe's near-term economic outlook are largely internal to Europe itself. A sovereign default, should it occur, would push bond rates up faster than expected. Other risks include a significant deterioration of the euro, credit implications of overhanging bank debt, or perhaps just errors in the timing of policy rate decisions by central banks. Though the likelihood remains low, a Japanese-style scenario of lingering economic weakness and deflation could feasibly produce more harm over the long-term than any near-term crisis.

## 2. Office

The primary change in RREEF's office forecast in the past six months concerns the shape and timing of the overall cycle rather than the relative positions of the individual markets. The pipeline of office construction remains well under control across most of Europe, while office demand has shown more resistance to downward pressure than expected. For one thing, firms have been able to jettison surplus employees faster than surplus office space. Europe shed nearly 3% of its office-using jobs in 2009, but the volume of occupied space in major markets fell by less than 1%, implying a sizeable block of committed office space caught up in a grey zone still controlled by occupiers. With office rents down by 10% across Europe in 2009, rental levels have become generally affordable to many potential new occupiers. This is especially true in London where rents fell even harder and subsequent take-up from financial and business services (FBS) firms has exceeded expectations.

With Europe's office market fundamentals showing resilience under challenging economic circumstances, vacancies and rents have generally held up better than first expected. The result is slightly flatter overall office cycle than RREEF anticipated six months ago. The upside is that we see rents improving a little faster than expected, but with the trajectory of recovery losing some of its upward momentum by the latter years of the forecast. The downside is that most markets are unlikely to regain their cyclical peak rents within our five-year forecast window. Weak prospects for both rents and capital values will hold office returns back this year, but over the remainder of the forecast, rental prospects for the office sector will perform relatively well, providing investors with more market differentiation than either retail or industrial.

Cap rates have compressed significantly in the UK, but compression has been more muted across Europe. Indeed, a degree of compression had been anticipated for the UK, but just as occurred with fundamentals, compression came faster and with more vigour than RREEF Research initially anticipated. At this point in the cycle, compression should begin to stabilise, and we expect mild outward movement through 2011.

The combination of diverse rent and yield profiles creates a very mixed picture across Europe over the next five years. We see the European office markets falling roughly into four performance groups based on the timing and extent of their rental recoveries through 2014.

### ***Group 1: Strong, front-loaded growth***

With few exceptions, the timeline of rental recovery for Europe's office markets has shifted forward over the past six months. Of the core European markets, **London** has already become the first to recover. Under our baseline scenario, rents in both the City and West End should move into double-digit growth this year following an extraordinary surge in take-up in late 2009. With little in the supply pipeline beyond this year, the City could feasibly sustain double-digit growth a year or two beyond 2010 as the vacancy rate eases back into single-digit levels. Other variations on this scenario are possible. On the downside, concerns still persist about the extent of London's near-term growth potential amid recent economic and political uncertainty. One possible, more upbeat, scenario is for the market to coast through the remainder of 2010 without significant change, but then see fundamentals tighten in 2011 as a number of major leases expire and the very limited supply of prime stock is burned off. This would push rents up again by 2011 and into 2012. Yet even if this upside scenario were to unfold, its depth would be limited to prime stock, with secondary properties facing less rosy prospects.

Outside Western Europe, a resilient Polish economy is working to **Warsaw's** benefit. The city's office rents are stabilising after losing more than 15% from their 2008 peak. Good prospects for steady net absorption and dwindling construction levels point toward healthy rental growth of 5-10% p.a. by 2011-2012.

### **Group 2: Strong, back-loaded growth**

Differences persist across Europe in the depth of economic recovery as well as the extent of business confidence and the degree of imbalance in property fundamentals. As a result, the timing of recovery varies significantly across markets. Job growth will be slower to pick up in **Paris**, for example, than in London. While London has recently pulled in new demand from FBS firms, Paris has experienced more of a shuffling of existing occupiers, as La Defense and the CBD both face competitive pressures from the suburbs. A number of high profile tenants have recently announced deals to move out of the city centre. This has disrupted short-term fundamentals of Central Paris in general, and La Defense in particular. Rents were still falling in both the CBD and La Defense during the first half of 2010 but are showing signs of stabilising in the CBD – especially for new high quality space. Paris CBD is expected to see a strong office market recovery in the medium-term, but recovery in the broader Ile-de-France region will likely be delayed until the latter years of the forecast period.

Other European office markets also hold the necessary volatility to present strong upside potential in the latter years of the five-year forecast, but with higher inherent risk than in Paris. The office markets most closely fitting this profile include **Madrid** and **Dublin**. Rents are still falling in both markets and are unlikely to stabilise fully until 2011, by which time they are expected to have lost more than 40% of their 2007 peak levels. Six months ago, Dublin and Madrid appeared to be on similarly delayed timelines for recovery. With recent downgrades to Spain's near-term economic outlook, however, its office market recovery has now been pushed back, leaving room for Dublin's fundamentals to regain balance slightly ahead of Madrid. With one in five of its workers now unemployed, Spain's economy is still shrinking, leaving little opportunity for near-term stimulation of new office demand. A supply overhang in Madrid's suburbs also complicates fundamentals. We expect the significant correction to rents in Madrid to abate in 2011, but by the outer years of the forecast, the market should be positioned for a vigorous rebound. Spain's relatively late recovery should provide attractive rental growth prospects just as London's front-loaded rental cycle winds down.

### **Group 3: Steady, moderate growth**

The next tier of Europe's recovering office markets includes those economies with relatively solid but less dynamic economic bases. Such markets generally produce less volatile property cycles. This can limit downside risk to some degree, but it also means trading away return potential as well. This is a broad group of markets that generally includes all of **German-speaking Europe** plus the **regional cities of the UK and France**. **Amsterdam, Brussels, Prague, and Stockholm** are also forecast to fit this profile over the coming cycle.

Of these markets, Prague faces perhaps the best prospects for overall growth. Cumulative rents could rise as much as 10% over the five-year forecast period, underscored by upbeat economic prospects and a manageable supply pipeline. Most of the regional cities in the UK and France will see cumulative rental gains of 5-10% over the forecast period. The major office markets in Germany proved their reputation of being among the least volatile in Europe. The remarkably stable German labour market supported the demand for office space and prevented more substantial rent drops. The key centres could expect to see rental gains in or near the 5-10% range over the forecast, though these cities may be slightly more back-loaded than the others. Berlin, and Frankfurt, in particular, could ease back up to 5% by the end of 2011. Rental prospects for Vienna, Amsterdam, Dusseldorf, Brussels, and Stockholm will be more subdued.

### **Group 4: Weak, lagging growth**

The last group includes those markets with weak or lagging rental growth. Several of these markets are in Southern Europe (**Milan, Rome, Barcelona, Lisbon**). Others include **Budapest, Helsinki, and Copenhagen**. Of these, the Southern European markets offer the best prospects for back-loaded rental growth, but with a bounce occurring so late in this recovery cycle, the rental gains in these cities are unlikely to match the back-loaded growth we expect in Paris, Dublin, and Madrid within our five-year forecast window. By 2013, we expect Milan, Rome, and Barcelona to resume rental growth of at least 5% p.a. Lisbon and Helsinki could follow by 2014, with Copenhagen and Budapest unlikely to break out of the range 2-4% p.a. range within the forecast window.

## Capital markets & performance

European investment activity stabilised in 2009, but transaction volumes remain well below the heady days of 2007. Still, investor sentiment towards European real estate has picked up, and this has put downward pressure on cap rates across most markets. Significant further compression remains unlikely. RREEF Research expects a combination of rising interest rates and relatively moderate rental growth prospects to put modest outward pressure on cap rates by 2012. The property markets currently enjoy broad real yield spreads that exceed the 10-year average in most markets. As bond yields and inflation are forecast to rise during the forecast window, we expect these spreads to narrow below the 10-year average across most of Western Europe.

### Exhibit 2: European office rental cycle

Office Market Cycle		Forecast Years					
Western European and Nordic Cities		YE09	YE10	YE11	YE12	YE13	YE14
		GRW				GRW	
		PGW					
		REC	CON	REC	REC		GRW
Office Job Growth	-2.8%		-0.7%	1.1%	1.6%	1.8%	2.0%
GDP Growth	-4.0%		1.1%	1.6%	1.8%	2.0%	2.2%
% Vacant	10.7%		12.0%	11.7%	10.9%	10.0%	9.2%
Rent Momentum	Decrease+		Decrease	None	Increase	Increase	Increase
Central and Eastern European Cities		YE09	YE10	YE11	YE12	YE13	YE14
		GRW				GRW	
		PGW					
		REC	CON	REC	REC		GRW
Office Job Growth	-1.7%		-0.6%	1.1%	1.7%	1.8%	1.7%
GDP Growth	-1.2%		1.9%	3.1%	4.5%	4.4%	4.3%
% Vacant	13.8%		14.6%	12.1%	9.0%	7.4%	7.0%
Rent Momentum	Decrease+		Decrease	None	Increase	Increase	Increase

Key: REC = Recovery GRW = Growth PGW = Post-Growth REA = Re-adjustment STA = Stable

Source: RREEF Research, and Global Insight, July 2010, data as of 15 July 2010

## Office sector outlook

### Drivers

- Relatively low rents by historic standards expand affordability for occupiers and spur demand.
- A manageable construction pipeline tames the threat of oversupply.
- Vibrant growth in emerging markets pulls Europe toward an earlier-than-expected economic rebound.

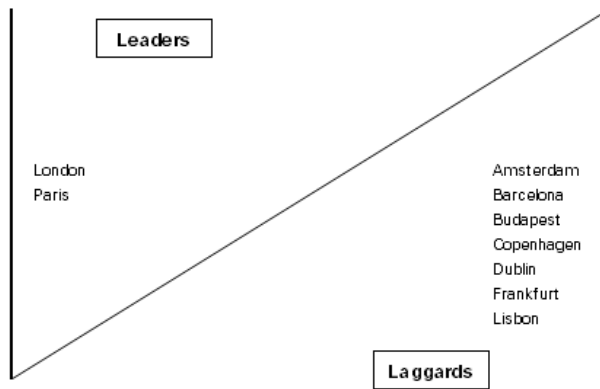
### Constraints

- Rising unemployment limits office market recovery even more than expected.
- An abundance of "grey space" slows down the rate of net absorption.
- Financial markets continue down volatile path, eventually cutting into business confidence.

### Implications: Timing of changes

- Extensive market differentiation in terms of timing (front-loaded vs. back-loaded) as well as magnitude (strong bounce vs moderate recovery)
- Rising inflation and interest rates after 2010 cut into yield spreads.

**Exhibit 3: European office markets through the current rental cycle**



*Note: Classification based upon rental growth through the current cycle*

*Source: RREEF Research, July 2010*

### Exhibit 4: European office market cycle

			Forecast				
			2010	2011	2012	2013	2014
Western Europe incl Nordic	Stage	Contraction	Contraction	Recovery	Recovery	Grow th	Grow th
	Vacancy	10.7	12.0	11.7	10.9	10.0	9.2
	Rent Momentum	Decrease+	Decrease	None	Increase	Increase	Increase
London: West End	Stage	Contraction	Recovery	Recovery	Grow th	Grow th	Grow th
	Vacancy	7.9	7.5	6.7	6.4	6.3	6.2
	Rent Momentum	Decrease+	Increase+	Increase	Increase+	Increase	Increase
London: City	Stage	Contraction	Recovery	Grow th	Grow th	Post Grow th	Post Grow th
	Vacancy	12.6	10.7	8.6	8.3	9.4	9.5
	Rent Momentum	Decrease+	Increase+	Increase+	Increase+	Increase	Increase
Paris: CBD	Stage	Contraction	Contraction	Recovery	Grow th	Grow th	Grow th
	Vacancy	7.8	8.6	8.5	8.0	7.3	6.6
	Rent Momentum	Decrease	Decrease	None	Increase	Increase+	Increase
Frankfurt	Stage	Contraction	Contraction	Contraction	Recovery	Grow th	Grow th
	Vacancy	17.7	19.5	20.0	18.8	17.2	16.2
	Rent Momentum	Decrease	Decrease	Decrease	None	Increase	Increase
Berlin	Stage	Contraction	Contraction	Recovery	Recovery	Recovery	Grow th
	Vacancy	10.4	11.3	11.0	10.6	9.7	9.0
	Rent Momentum	Decrease+	Decrease	Decrease	Increase	Increase	Increase
Munich	Stage	Contraction	Contraction	Recovery	Recovery	Grow th	Grow th
	Vacancy	8.7	10.8	10.7	9.1	7.4	6.6
	Rent Momentum	Decrease+	None	None	None	Increase	Increase
Hamburg	Stage	Contraction	Contraction	Recovery	Recovery	Grow th	Grow th
	Vacancy	9.7	12.1	11.8	10.1	8.3	7.2
	Rent Momentum	Decrease	None	None	None	Increase	Increase
Brussels	Stage	Contraction	Contraction	Recovery	Recovery	Recovery	Grow th
	Vacancy	11.2	12.3	12.0	11.3	10.2	9.3
	Rent Momentum	Decrease	Decrease	None	None	Increase	Increase
Amsterdam	Stage	Contraction	Contraction	Recovery	Recovery	Recovery	Grow th
	Vacancy	18.8	20.7	20.4	19.3	18.3	17.8
	Rent Momentum	Decrease	Decrease	None	None	None	Increase
Stockholm	Stage	Contraction	Contraction	Recovery	Recovery	Recovery	Grow th
	Vacancy	12.5	14.4	14.1	13.5	12.9	12.5
	Rent Momentum	Decrease+	None	None	None	None	Increase
Copenhagen	Stage	Contraction	Contraction	Recovery	Recovery	Recovery	Grow th
	Vacancy	8.6	10.0	9.5	9.0	8.0	7.0
	Rent Momentum	Decrease+	Decrease	Decrease	None	None	Increase
Helsinki	Stage	Contraction	Contraction	Recovery	Recovery	Recovery	Grow th
	Vacancy	11.3	13.2	13.0	12.0	10.8	9.8
	Rent Momentum	Decrease	Decrease+	None	None	Increase	Increase
Milan	Stage	Contraction	Contraction	Recovery	Recovery	Recovery	Grow th
	Vacancy	11.7	13.9	14.2	13.2	12.4	11.4
	Rent Momentum	Decrease+	Decrease+	None	Increase	Increase	Increase
Madrid	Stage	Contraction	Contraction	Recovery	Recovery	Grow th	Grow th
	Vacancy	9.6	10.9	10.4	9.5	8.3	6.3
	Rent Momentum	Decrease+	Decrease+	None	None	Increase	Increase+
Barcelona	Stage	Contraction	Contraction	Contraction	Recovery	Recovery	Grow th
	Vacancy	11.1	13.3	14.1	14.2	13.6	12.5
	Rent Momentum	Decrease+	Decrease+	Decrease	None	Increase	Increase
Lisbon	Stage	Contraction	Contraction	Contraction	Recovery	Recovery	Grow th
	Vacancy	10.1	12.3	12.7	12.2	12.0	11.6
	Rent Momentum	Decrease	Decrease	None	None	None	Increase
Dublin	Stage	Contraction	Contraction	Recovery	Recovery	Grow th	Grow th
	Vacancy	22.5	23.7	21.3	19.4	18.5	17.4
	Rent Momentum	Decrease+	Decrease+	None	Increase	Increase+	Increase+
Vienna	Stage	Contraction	Contraction	Recovery	Recovery	Grow th	Post Grow th
	Vacancy	4.9	5.6	5.4	4.8	4.2	4.4
	Rent Momentum	Decrease	None	Decrease	None	None	None
Central and Eastern Europe	Stage	Contraction	Contraction	Recovery	Recovery	Grow th	Grow th
	Vacancy	13.8	14.6	12.1	9.0	7.4	7.0
	Rent Momentum	Decrease+	Decrease	None	Increase	Increase	Increase
Prague	Stage	Contraction	Contraction	Recovery	Recovery	Grow th	Post Grow th
	Vacancy	13.7	14.2	12.0	9.6	8.3	9.5
	Rent Momentum	Decrease	Decrease	None	Increase	Increase	None
Warsaw	Stage	Contraction	Contraction	Recovery	Grow th	Grow th	Grow th
	Vacancy	9.3	10.2	7.9	5.1	4.1	3.4
	Rent Momentum	Decrease+	Decrease	Increase	Increase+	Increase	Increase
Budapest	Stage	Contraction	Contraction	Contraction	Recovery	Recovery	Grow th
	Vacancy	19.8	20.6	17.8	13.4	11.0	9.1
	Rent Momentum	Decrease	Decrease	Decrease	None	None	Increase

Source: RREEF Research, July 2010, data as of 15 July 2010

### 3. Shopping centres

Europe's shopping centre markets continue to move through an ongoing period of readjustment. In the first half of 2010, hesitant consumers showed little interest in kickstarting retail sales volumes. Over our five-year forecast period we expect retail sales growth to remain subdued, but with some differentiation across markets. In those economies where household and government budgets suffered most in this downturn (Spain, Hungary, Ireland, the UK) consumers may take a little more time to rebuild their spending habits. As economic recoveries unfold and unemployed workers ease back onto regular payrolls, pent-up consumer demand will eventually give way to an uptick in sales of big-ticket household items like furniture and appliances. Where economies have been relatively resilient (CEE, Nordics) retail sales will pick up sooner.

Besides consumers, the demand picture is further complicated by the occupiers. While value retailers (i.e., discount chains) have capitalised on opportunities in the recession, changing consumer spending patterns have caused most other retailers to rethink their store networks and scale back expansion plans. Shopping centres have been particularly vulnerable to these re-engineered store strategies, with the fallout resulting in distinct winners and losers among various schemes. Schemes with good location and modernised product typically fare better than more marginal properties.

On the supply side, the retail sector's construction pipeline has been cut back significantly, although a few markets – especially Italy, Spain, and Poland – still have substantial new spaces delivering. While these fundamentals create a mostly unfavourable shopping centre outlook in the near term, prospects improve from the medium term onward. Performance is expected to vary significantly across markets, however, with additional intra-market differentiation by retail format and location.

Despite the currently weak fundamentals, retail returns have outperformed office and industrial properties in a majority of European markets over the past decade. With a lower volatility than the office sector, the shopping centre cycle offers a comparatively flatter shape, especially during a recession, as more predictable cash flows cushion retail returns for owners. As a share of total property investment, the retail sector held up well during this cycle and has surged in 2010 as investors have shown interest in core European markets. This led to some moderate cap rate compression in the first half of the year. Looking ahead, we expect rents to stabilise over the next year, with a modest acceleration in rents from 2012 onward.

Of the 16 shopping centre markets covered by RREEF Research, we expect only five (**Poland, Sweden, Finland, France, Czech Republic**) to achieve cumulative rental growth of 10% or more over the five-year forecast period. Of these five markets, France's rental cycle will be the flattest. It is the only major European market with any rental gain expected in 2010, and French shopping centres are unlikely to break out a modest 1-3% range over the forecast period. Rents in Sweden and Finland will likely stabilise this year, and then begin a gradual acceleration to 3-4% p.a. by the end of the forecast period. Cross border retailers continue to show interest in Stockholm, where retail modernisation initiatives have kept the market attractive to occupiers. Though Poland and the Czech Republic face near-term obstacles (Poland is working through a substantial construction pipeline and rents are still falling in the Czech Republic), both countries share favourable economic outlooks which will bolster retail demand toward the latter years of the forecast, allowing both markets to move into 4-5% p.a. rental growth by 2013-2014. Cross border retailers continue to show interest in the CEE region. The Japanese retailer Muji opened its first CEE store in Warsaw in the spring.

Five other markets (**Portugal, Denmark, Austria, UK, Germany**) will see relatively moderate cumulative rental gains of 5-10% over the five-year forecast period. Rents are stabilising in Germany, Austria, and Denmark, but will lose more ground in 2010 in the UK and Portugal, setting the stage for a back-loaded recovery. In both the UK and Portugal, rents are expected to rebound to 3-4% p.a. by the end of the forecast period. Even as British consumers have held back, a weaker currency has pulled in more tourists than expected and this has recently helped buoy London's core high streets. As the economy recovers some of the UK's regional cities like Manchester and Birmingham, which were oversupplied in the past decade, should be better positioned for outperformance. In the Portuguese market, Lisbon's retail rents will benefit not only from economic recovery in the coming years but also from strict new planning regulations introduced in 2009 that limit shopping centre development. In Denmark, Austria, and Germany, we expect weaker recoveries, with rents unlikely to

break above 3% p.a. by the end of the forecast. The German retail markets have performed better in the downturn than originally expected. With less pent-up demand, there will be less opportunity for a bounce in the later years. Munich's combination of constrained supply, high incomes, and retailer appeal, gives it potential to outperform other German markets.

RREEF Research expects cumulative rental growth in the remaining six markets (**Netherlands, Hungary, Italy, Belgium, Ireland, Spain**) to lag below 5% over the next five years. Rents are still falling in all six markets, and are not expected to begin to stabilise until 2011, and possibly later for Hungary, Spain, and Ireland. This implies a more back-loaded rebound for these markets, though even in the outer years, rents are unlikely to rise above the 2-4% p.a. level. Spain and Ireland have already shared significant rental declines over this cycle and their relatively high cap rates (among Western European markets) imply their higher levels of risk.

<b>Exhibit 5: European retail rental cycle</b>							
<b>Retail Market Cycle</b>							
<b>Western European and Nordic Countries</b>			<b>Forecast Years</b>				
	<b>YE 09</b>		<b>YE10</b>	<b>YE11</b>	<b>YE12</b>	<b>YE13</b>	<b>YE14</b>
	GRW	PGW				GRW	
	STA	REA		STA			
Retail Sales Growth	-2.5%		0.1%	0.8%	1.0%	0.9%	0.8%
GDP per capita	39,348		36,527	37,474	41,200	44,919	48,433
Rent Momentum	Decrease+		Decrease	None	None	Increase	Increase
<b>Central European Countries</b>			<b>Forecast Years</b>				
	<b>YE 09</b>		<b>YE10</b>	<b>YE11</b>	<b>YE12</b>	<b>YE13</b>	<b>YE14</b>
	GRW	PGW			GRW		
	STA	REA		STA			
Retail Sales Growth	-3.8%		1.0%	1.4%	4.1%	4.2%	3.6%
GDP per capita	13,171		13,156	13,899	16,111	18,302	20,749
Rent Momentum	Decrease+		Decrease	None	Increase+	Increase+	Increase+

Key: REC = Recovery GRW = Growth PGW = Post-Growth REA = Re-adjustment STA = Stable

Source: RREEF Research and Global Insight, July 2010, data as of 15 July 2010

## Retail sector outlook

### Drivers

- Development pipeline slows quickly, allowing solid rental recovery by 2011.
- Consumer spending holding up better in some countries (Poland, Sweden, France) than others (Spain, Ireland, Hungary).
- Cross-border retailers continue to show interest across several markets (Sweden, CEE).
- Restrictive new planning regulations constrain future supplies (Portugal).

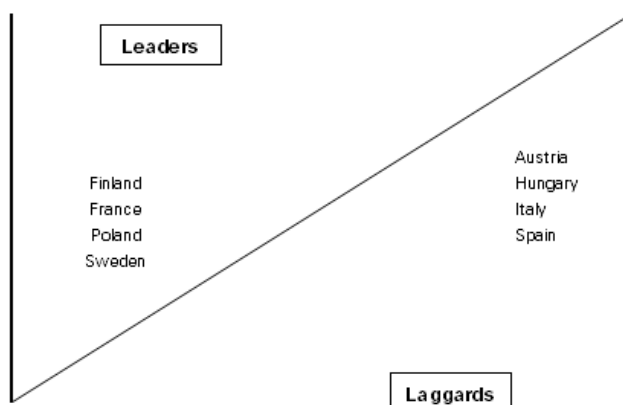
### Constraints

- Persistent worries of pending joblessness stifle consumer spending (France, Germany).
- Retailer bankruptcies, reorganizations, and consolidations impact timing and patterns of tenant demand.
- Near-term construction deliveries outpace demand (Italy, Spain, and possibly Poland).

### Implications: Timing of changes

- Solid, early rebounds with upward momentum as cycle is restored (CEE, Nordics).
- Relatively flat, steady cycle with modest incremental gains, but little bounce (France).
- Moderate, back-loaded retail recoveries in markets where household or government budgets have been severely strained (Spain, Ireland, UK, Hungary).

**Exhibit 6: European retail markets through the current rental cycle**



Note: Classification based upon rental growth through the current cycle

Source: RREEF Research, July 2010

**Exhibit 7: European retail market cycle**

			Forecast					
			2009	2010	2011	2012	2013	2014
Western Europe and Nordic	Stage	Re-adjustment	Re-adjustment	Re-adjustment	Stable	Stable	Growth	Growth
	Rent Momentum	Decrease+	Decrease	None	None	None	Increase	Increase
UK	Stage	Re-adjustment	Re-adjustment	Stable	Stable	Growth	Growth	Growth
	Rent Momentum	Decrease+	Decrease+	None	None	Increase	Increase	Increase+
France	Stage	Re-adjustment	Stable	Stable	Growth	Growth	Growth	Growth
	Rent Momentum	Decrease+	None	None	Increase	Increase	Increase	Increase
Germany	Stage	Stable	Stable	Stable	Stable	Growth	Growth	Growth
	Rent Momentum	None	None	None	None	Increase	Increase	Increase
Netherlands	Stage	Re-adjustment	Re-adjustment	Stable	Stable	Growth	Growth	Growth
	Rent Momentum	Decrease	Decrease	None	None	Increase	Increase	Increase
Sweden	Stage	Re-adjustment	Stable	Stable	Growth	Growth	Growth	Growth
	Rent Momentum	Decrease	None	None	Increase	Increase+	Increase+	Increase+
Italy	Stage	Re-adjustment	Re-adjustment	Stable	Stable	Growth	Growth	Growth
	Rent Momentum	Decrease+	Decrease+	None	None	Increase	Increase	Increase
Spain	Stage	Re-adjustment	Re-adjustment	Re-adjustment	Stable	Stable	Growth	Growth
	Rent Momentum	Decrease+	Decrease+	Decrease	None	None	Increase	Increase
Austria	Stage	Growth	Re-adjustment	Stable	Stable	Growth	Growth	Growth
	Rent Momentum	Increase+	None	None	None	Increase	Increase	Increase
Belgium	Stage	Post Growth	Re-adjustment	Stable	Growth	Growth	Growth	Growth
	Rent Momentum	None	Decrease+	None	Increase	Increase	Increase	Increase
Central and Eastern Europe	Stage	Re-adjustment	Re-adjustment	Stable	Growth	Growth	Growth	Growth
	Rent Momentum	Decrease+	Decrease	None	Increase+	Increase+	Increase+	Increase+
Czech Republic	Stage	Re-adjustment	Re-adjustment	Stable	Growth	Growth	Growth	Growth
	Rent Momentum	Decrease+	Decrease	None	Increase+	Increase+	Increase+	Increase+
Poland	Stage	Re-adjustment	Stable	Growth	Growth	Growth	Growth	Growth
	Rent Momentum	Decrease+	None	Increase	Increase+	Increase+	Increase+	Increase+
Hungary	Stage	Re-adjustment	Re-adjustment	Stable	Growth	Growth	Growth	Growth
	Rent Momentum	Decrease+	Decrease+	None	Increase	Increase	Increase	Increase+

Source: RREEF Research, July 2010, data as of 15 July 2010

## 4. Industrial

Rents continue to fall in many European industrial markets in 2010, but by year-end, rents in most markets are expected to stabilise (Iberia being the primary exception). RREEF Research expects a relatively mild recovery for the industrial market overall, with the timing varying significantly across markets. Supply has largely shut down, so – the overhang in a few markets like the UK and Spain notwithstanding – the upside for this sector is that in the near term, new supply prospects are limited. The industrial market's cyclical turning point will therefore be driven by the timing of a recovery in occupier demand.

External trade flows have begun to recover, and this typically benefits the gateway markets first. Currency movements will continue to impact these trade flows over the near-term. Upward momentum for gateway markets may be tenuous if a weaker euro makes the continent's imports more expensive for an extended period of time. While the recent decline in the euro provides an unexpected boost for manufacturers, it is not necessarily a net "wash" with imports where the industrial property sector is concerned. A weaker currency holds little benefit for logistics providers since manufactured goods move along a relatively simple factory-to-port path as they leave the continent. Logistics demand, on the other hand is sustained by imports which move in a more complicated one-to-many (i.e., port-to-customer) pattern. Manufacturers account for only a small slice of logistics demand while 3PLs and retailers together account for nearly three-quarters of take-up. Thus, Europe's recent economic uncertainties could further delay recovery of the logistics sector if the euro becomes significantly re-valued.

RREEF Research now anticipates that the industrial sector will stabilise sooner than we assumed in the previous forecast, thus taking some of the later momentum out of a pent-up recovery. Furthermore, with a relatively short build time, a recovery in demand is likely to result in an earlier supply response in comparison to the office or retail markets. Across Europe rental growth prospects vary markedly. **France** and the **UK** are forecast to see cumulative rental gains of 7-9% over the forecast window. These markets have already begun to stabilise in 2010, although in **London**, the gap between headline and effective rents remains wide, as incentives remain prevalent. Prospects for France are somewhat better. Investor activity focuses mainly on the primary industrial markets of **Paris** and **Lyon**. Rents should begin to inch upward in these two cities by 2011, with a gradual escalation of 1-3% p.a. in the years following.

The **Benelux and German** markets should experience more moderate cumulative five-year rental gains of 5-6%. **Rotterdam** was one of the few European industrial markets that could point to an uptick in rents in the first quarter of 2010. Rotterdam World Gateway, a 4 million TEU terminal now under way at Maasvlakte 2, remains on schedule for a 2013 completion. The substantial increase in throughput capacity at this terminal occurs in the latter years of our forecast and should stimulate ancillary logistics and distribution demand in constrained surrounding regions. **Amsterdam** has struggled more than Rotterdam in this cycle. Schiphol Airport was forced to lower fees in an effort to raise its competitive profile. In 2009, it announced plans to forego an IPO, then later in the year it delayed a planned €1 billion terminal expansion until at least 2014 when demand conditions improve. We expect industrial rents in Amsterdam and Rotterdam to recover at a modest pace of 1-2% p.a. from 2011 forward. **Frankfurt's** airport forms the locus for much of this market's logistics activity. A proposed ban on night flights at Frankfurt Airport in exchange for a new, fourth runway recently triggered clashes between local officials and cargo carriers and created an air of uncertainty about the Frankfurt area's infrastructure for industrial expansion. **Hamburg** plans to spend €1 billion on port upgrades over the next five years, but in the short-term it has been forced to cut its handling fees as an incentive to help it maintain competitiveness. Speculative industrial construction remains limited in Germany, but so does occupier demand. In this weak environment for fundamentals, we expect a modest rebound in Frankfurt, Hamburg, and Munich of just 1-2% p.a. rental growth after this year.

In **Milan**, where recent developments focused on the city's ring road and along the A1, A4, and A7 motorways, the bounce is also expected to be modest. For now, developers have postponed most speculative schemes, paving the way for a quick, albeit mild, recovery. Rents should turn positive again by 2011, but despite a gradual escalation, are still not likely to reach 3% p.a. before the end of the forecast period. Neither **Warsaw** nor **Prague** is likely to see rents rise again before 2012. Although the CEE markets avoided a severe disruption of fundamentals in this cycle, it was

nevertheless enough turmoil to push rents down by double-digit margins in 2009 as demand dried up. The upside is that tight lending conditions helped bring speculative construction to a rapid halt. With Poland avoiding recession entirely and with the a solid economic rebound also expected for the Czech Republic, industrial rents in Prague and Warsaw should begin gradually accelerating again by 2012, with both markets to see rental growth of 1-3% p.a. in the outer years of the forecast.

In the **Nordics** cumulative gains will be held to 2-4% over the five-year forecast.. Rents fell in 2009 in **Stockholm, Copenhagen**, and especially **Helsinki**, where the downturn in demand followed closely on the heels of the 2008 opening of the new Vuosaari harbour. Ample new logistics development has centred not only on a park adjacent to Helsinki's new harbour; it also spills up the E18 motorway through Vantaa and toward the airport. Industrial rents have begun to stabilise in Stockholm, but continue to slide in Helsinki and Copenhagen. None of the three cities are likely to see industrial rents rise again until 2012, at which point they should resume a modest acceleration of 1-2% p.a.

Some of Europe's most volatile industrial markets in this cycle have been in Spain. Rents in **Madrid** and **Barcelona** had fallen 20% from peak by year-end 2009 and continue to slip further in 2010. The high level of risk and volatility in these markets has kept cap rates stable even as they have begun to compress marginally in other markets. In a sector with the flattest of cycles, Madrid and Barcelona are the exceptional markets, with strong potential for back-loaded recovery. Rents are unlikely to stabilise here until 2012 but after that, rental growth has the potential to accelerate rapidly to 3-4% p.a. by the end of the forecast window.

### Exhibit 8: European industrial rental cycle

Industrial Market Cycle		Forecast Years					
Western European incl Nordic Cities		YE10	YE11	YE12	YE13	YE14	
GRW	PGW				GRW		
REC	CON		REC	REC		GRW	
Industrial Production	-13.2%	3.9%	3.4%	3.1%	2.6%	2.0%	
GDP Growth	-4.0%	1.1%	1.6%	1.8%	2.0%	2.2%	
Rent Momentum	Decrease+	Decrease	None	None	Increase	Increase	

Central and Eastern European Cities		Forecast Years				
YE09	YE10	YE11	YE12	YE13	YE14	
GRW	PGW				GRW	
REC	CON		REC	REC		
Industrial Production	-7.7%	6.4%	5.4%	5.9%	5.2%	
GDP Growth	-1.2%	1.9%	3.1%	4.5%	4.4%	
Rent Momentum	Decrease+	Decrease	None	Increase	Increase	

Key: REC = Recovery GRW = Growth PGW = Post-Growth REA = Re-adjustment STA = Stable

Source: RREEF Research and Global Insight, July 2010, data as of 15 July 2010

## Industrial sector outlook

### Drivers

- Confidence rises, causing consumers and businesses to unleash pent-up demand.
- A depreciating euro and resurgent economic growth in emerging markets benefits Eurozone manufacturers in places like Germany and the Netherlands.
- Because industrial buildings have the shortest construction schedules of all major property types, speculative construction has wound down abruptly in most markets, and tight credit conditions have kept the pipeline at bay.

- Limited supplies of modern logistics buildings constrain some major markets in the Eurozone.

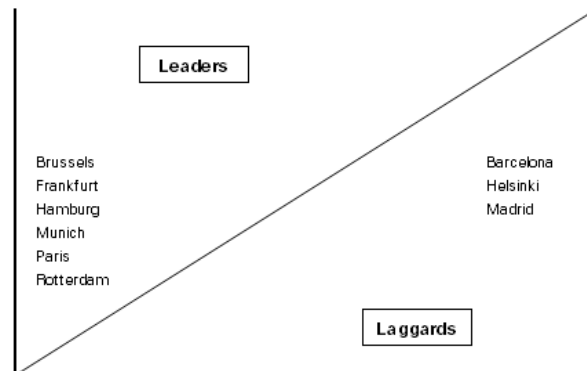
### **Constraints**

- Financial market volatility continues, eroding the forward-looking sentiments of businesses and consumers.
- Fiscal pressures cause governments to postpone or cancel long-term infrastructure investments in airports, seaports, tunnels, bridges, railways, and motorways.

### **Implications: Timing of changes**

- Volatile markets like Madrid and Barcelona stage relatively strong recoveries.
- Relatively soft landing for the French economy cushions Paris and Lyon, paving the way for an early, solid recovery.
- Logistics markets near gateway airports or seaports respond more quickly to currency movements and external economic forces.

### **Exhibit 9: European industrial market through the current rental cycle**



*Note: Classification based upon rental growth through the current cycle*

*Source: RREEF Research, July 2010*

**Exhibit 10: European industrial market cycle**

			Forecast					
			2009	2010	2011	2012	2013	2014
Western Europe incl Nordic	Stage	Contraction	Contraction	Recovery	Recovery	Growth	Growth	
	Rent Momentum	Decrease+	Decrease	None	None	Increase	Increase	
London	Stage	Contraction	Recovery	Recovery	Growth	Growth	Growth	
	Rent Momentum	Decrease+	None	None	Increase	Increase	Increase	
Paris	Stage	Contraction	Recovery	Recovery	Growth	Growth	Growth	
	Rent Momentum	Decrease	None	None	Increase	Increase	Increase	
Lyon	Stage	Contraction	Contraction	Recovery	Recovery	Growth	Growth	
	Rent Momentum	Decrease	None	None	None	Increase	Increase	
Frankfurt	Stage	Contraction	Contraction	Recovery	Recovery	Growth	Growth	
	Rent Momentum	None	None	None	None	Increase	Increase	
Munich	Stage	Contraction	Contraction	Recovery	Recovery	Growth	Growth	
	Rent Momentum	None	None	None	None	Increase	Increase	
Hamburg	Stage	Contraction	Recovery	Recovery	Recovery	Growth	Growth	
	Rent Momentum	None	None	None	None	None	Increase	
Brussels	Stage	Contraction	Recovery	Recovery	Growth	Growth	Growth	
	Rent Momentum	Decrease	None	None	Increase	Increase	Increase	
Amsterdam	Stage	Contraction	Contraction	Recovery	Recovery	Growth	Growth	
	Rent Momentum	Decrease+	None	None	None	Increase	Increase	
Rotterdam	Stage	Contraction	Recovery	Recovery	Recovery	Growth	Growth	
	Rent Momentum	Decrease	None	None	None	Increase	Increase	
Stockholm	Stage	Contraction	Contraction	Recovery	Recovery	Recovery	Growth	
	Rent Momentum	Decrease+	None	None	None	None	Increase	
Copenhagen	Stage	Contraction	Contraction	Recovery	Recovery	Growth	Growth	
	Rent Momentum	Decrease+	Decrease	None	None	Increase	Increase	
Helsinki	Stage	Contraction	Contraction	Recovery	Recovery	Recovery	Growth	
	Rent Momentum	Decrease+	Decrease	None	None	None	Increase	
Milan	Stage	Contraction	Contraction	Recovery	Growth	Growth	Growth	
	Rent Momentum	Decrease+	Decrease	None	Increase	Increase	Increase	
Madrid	Stage	Contraction	Contraction	Contraction	Recovery	Growth	Growth	
	Rent Momentum	Decrease+	Decrease	Decrease	None	Increase	Increase	
Barcelona	Stage	Contraction	Contraction	Contraction	Recovery	Growth	Growth	
	Rent Momentum	Decrease+	Decrease	Decrease	None	Increase	Increase+	
Central and Eastern Europe	Stage	Contraction	Contraction	Recovery	Recovery	Growth	Growth	
	Rent Momentum	Decrease+	Decrease	None	Increase	Increase	Increase	
Prague	Stage	Contraction	Contraction	Recovery	Recovery	Growth	Growth	
	Rent Momentum	Decrease+	Decrease	None	Increase	Increase	Increase	
Warsaw	Stage	Contraction	Contraction	Recovery	Recovery	Growth	Growth	
	Rent Momentum	Decrease+	Decrease	None	Increase	Increase	Increase	

Source: RREEF Research, July 2010, data as of 15 July 2010

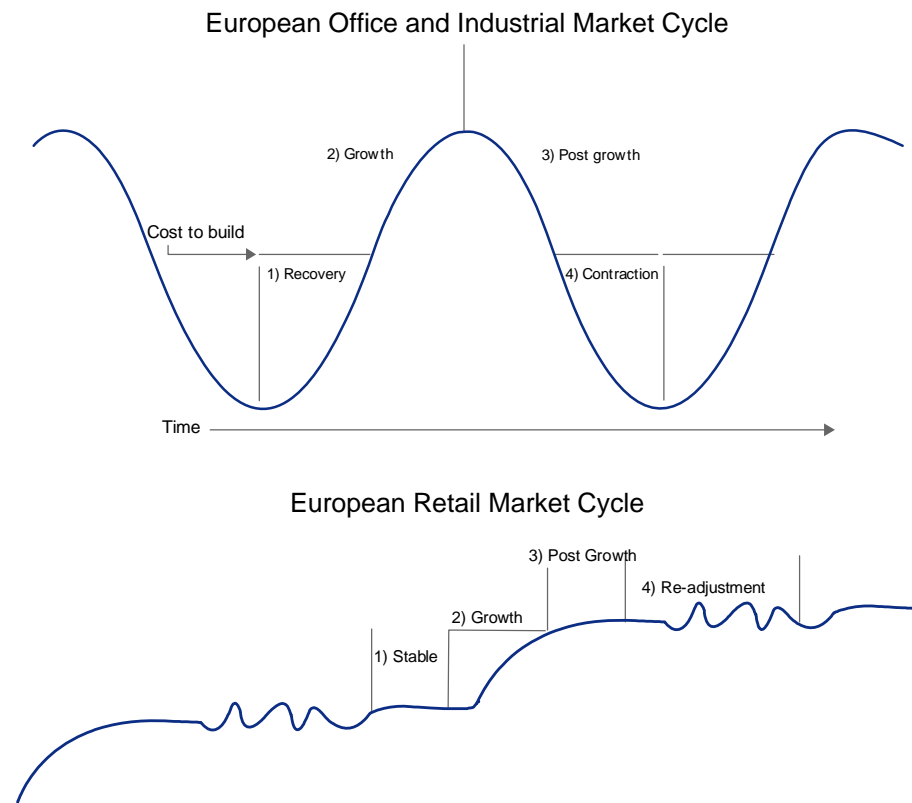
## 5. Appendix

### Classifying the markets

Each property sector has a clearly identifiable cycle. While the office market has the greatest volatility, it shares a similar pattern and is characterised by the same phases as the industrial market cycle. In contrast, the shopping centre market cycle has lower downside risk and tends to take the form of progressive steps. This reflects supply constraints which creates excess demand for limited space, reducing the risk of vacancy.

The property market cycles are considered in four distinct stages shown in Exhibit 11.

**Exhibit 11: Property market cycle**



Source: RREEF Research, July 2010

## Office and industrial market cycle

Stages	General conditions
1. Recovery but declining vacancy rates – stable to rising rents	High
2. Growth and declining vacancy rates – rising rents supportive of construction	Low
3. Post Growth but increasing vacancy rates – rising/flattening rents	Low
4. Contraction or increasing vacancy rates – falling rents	High

The position in the cycle is based on a combination of factors including change in vacancy rates and rental growth. It is important to recognise that the analysis is based on 'headline' or 'face' prime rents. In general terms, effective rents will lead the recovery of headlines, as the reduction in incentives tends to occur before any movements in headlines.

## Retail market cycle

In mature European markets, supply tends to be relatively constrained and, as developing markets mature, supply restrictions tend to be introduced. As a result vacancy rates tend to be very low. Although there is a clear cyclical pattern, the contraction phase, characterised by rising vacancy rates and falling rents, is neither significant nor prolonged. Rather, demand softens while rents plateau or they may even decline. This is reflected in the different stages in our specific retail market cycle:

Stages	General conditions
1. Stable rents, up turn in consumer spending	Stable
2. Growth rents, strong consumer spending and/or retailer demand	Rising
3. Post Growth stabilising, slowed consumption growth	Rents
4. Re-adjustment stable or declining, slowed or declining consumer spending	Rents

## Rental momentum

A rent category is assigned to each of the markets for every year of the forecast period. This rent momentum, which helps establish the rate of growth at different stages of recovery, is based on the typology displayed in Exhibit 2. It is intended to show the general momentum behind potential changes in rent, not an absolute variation in rates.

**Exhibit 12: Rent categories and the property cycle**

European Office and Industrial Market Cycle

<b>Momentum Category</b>	<b>Cycle Stage</b>			
	<b>Contraction</b>	<b>Recovery</b>	<b>Growth</b>	<b>Post Growth</b>
Increase+			√	
Increase		√	√	√
Stable	√	√	√	√
Decrease	√			√
Decrease+	√			

European Retail Cycle

<b>Momentum Category</b>	<b>Cycle Stage</b>			
	<b>Re-adjustment</b>	<b>Stable</b>	<b>Growth</b>	<b>Post Growth</b>
Increase+			√	
Increase		√	√	√
Stable	√	√	√	√
Decrease	√			√
Decrease+	√			

Source: RREEF Research, July 2010

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