

February 2010

Global Real Estate Insights 2010

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Introduction

Last year’s Global Insight report, prepared in the midst of a “significant market downturn and massive uncertainty”, explained the way the credit crisis and economic recession would lead to severe real estate losses across markets and property types. At the same time, the report pointed out that, as in previous cycles, the “current downturn should provide an exceptional vintage for investing in real estate across risk styles and across markets”. Both these themes, severe downturn and attractive vintage for investing, have unfolded over the past 12 months. Losses have been large across most real estate markets but there has also been an astonishing recovery in a number of markets. REIT markets globally are nearly double their levels of March 2009, and certain direct markets such as those in China and the UK have posted record-breaking performance in recent months. These trends, and the continued momentum behind the recovery, suggests that 2009 did, indeed, represent an excellent vintage for real estate investing

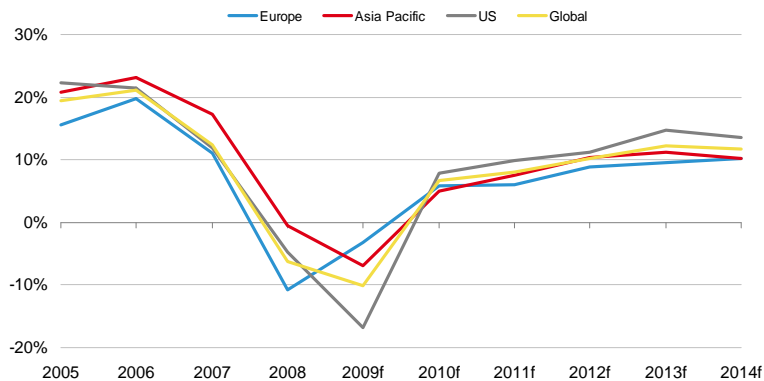
During the early months of 2010 the outlook is, if anything, more complex than a year ago. The global economy and property markets are back from the brink of a potential depression, and the prospects for performance have improved over the past twelve months. Despite this, there remain profound risks facing the outlook, and the market is susceptible to a range of shocks. More significantly, the recent improvement has been driven by a turnaround in real estate capital markets, well ahead of a sustained improvement in fundamentals. This capital market improvement is serving to “front load” the strong performance of real estate that is expected during the cyclical recovery, as shown by the expectations of relatively strong returns in 2010. This front loading of performance raises the question of whether real estate capital markets are correctly pricing in the risks to the outlook, with an increased possibility that the markets overshoot leading to weaker performance during the period 2011-14.

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Exhibit 1: Total Real Estate Market Returns by Region



Note: Based on unlevered “market” returns for the 10 key markets in each region (Americas, Europe and Asia Pacific), weighted by market size at end 2009. f=forecast.

Note: Total markets returns refer to prime market returns

Source: RREEF Research, February 2010



It is within this context that this year's report has been prepared. The report commences by explaining trends in performance over the past 18 months, and moves on to explore the outlook for 2010 and beyond. The report then focuses on a range of implications of the current conditions including the pricing of real estate markets, the changing scale of the market and the consequences for different styles of investing.

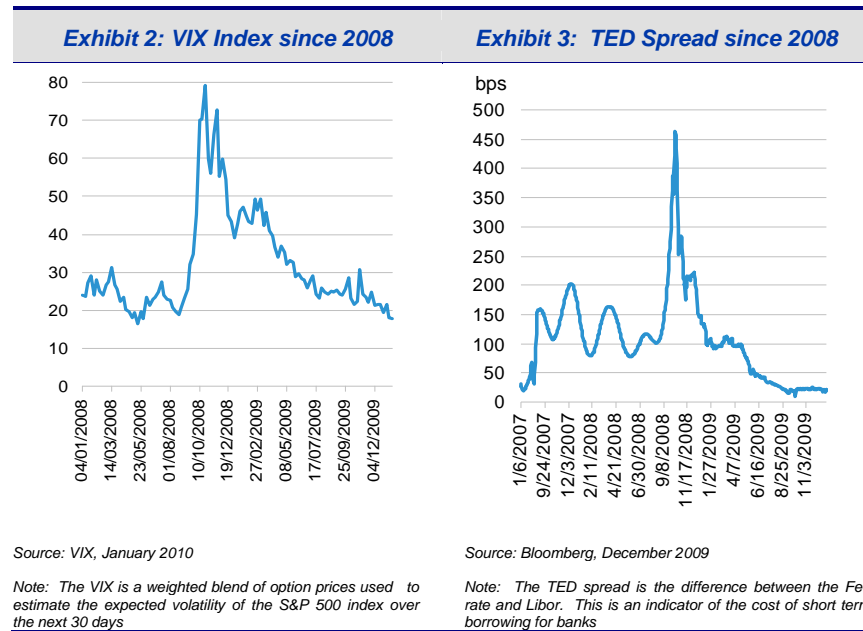
The report covers a range of issues with two particular themes being highlighted throughout the paper. First, the prospect of 2010 remaining an attractive vintage for investing in real estate, despite the recent improvements and front loading of performance expectations. Markets should benefit from relatively high income returns given the re-pricing of the market, as well as the prospect of value recovery driven by rental growth and cap rate compression. Second, despite this outlook, the increased need for effective risk management throughout the investment process. Given the susceptibility of the market to a range of macro risks, all those involved in real estate should monitor and review the outlook, and its implications, on an even more frequent basis than usual. It is within this context, that RREEF's Real Estate Pricing Indicator (REPI) explained in the paper proves valuable as an absolute and forward looking measure of the pricing of real estate markets. This indicator provides a useful tool in assessing the value offered by real estate markets during these times of exceptional uncertainty.

2009 Overview of the Global Economy and Real Estate Market

Global Economy

The year 2009 kicked off amid great angst and trepidation about the state of the world economy, but by summer, it was clear that the dire worst case scenarios had been avoided. Keynesian prescriptions proved reasonably effective, with governments doling out ample stimulus packages for everything from motor vehicle trade-ins to physical infrastructure development. Governments also unleashed a host of new programs and schemes designed to shore up troubled banks and stabilise credit flows.¹

The stabilisation of credit markets over the course of 2009 eased investors' fears and helped to mitigate the market volatility that spiked in late 2008. The VIX index (Exhibit 2), a barometer of volatility in the S&P 500, soared to a record 80 points in October 2008 but a year later it had settled back into its normal range of 20-30 points. The TED spread (Exhibit 3), a key measure of short-term borrowing costs for banks, shot up to 450 basis points in late 2008, but by late 2009 it had eased back into a much more comfortable range of 20-30 basis points.

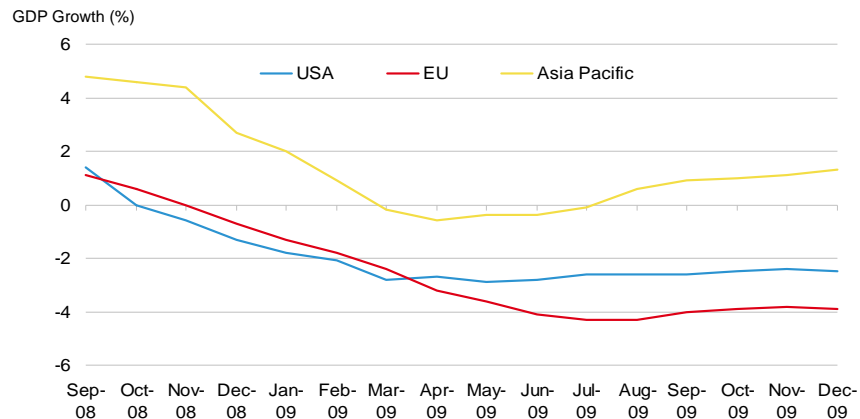


The peak of the credit crisis in early 2009 led economic forecasters to lower their growth forecasts with each passing month. By spring the forecasts for the US and Asia Pacific had begun to bottom out, with Europe's forecast stabilising during the summer months. By late summer, economists turned cautiously upbeat on Asia's prospects and for the first time in months predicted modest economic growth in the region for 2009, mainly due to stronger economic indicators in China, Hong Kong and South Korea (Exhibit 4). Although the finalised year-end numbers are still forthcoming, they will show that the US and European economies contracted in 2009,

¹ These included, for example, the Troubled Asset Relief Program, the Term Asset-Backed Securities Loan Facility, the Asset Guarantee Program, and the Public/Private Investment Program (US), SoFFin (Germany), the Asset Protection Scheme (UK), the Orderly Bank Restructuring Plan (Spain), the Emergency Credit Guarantee Program (Korea), and National Asset Management Agency (Ireland)

but economists now anticipate the degree of decline to be less severe than had been predicted at mid-year 2009. Asia Pacific's relative outperformance is not enough to offset the other big economic regions, however, and Deutsche Bank economists still expect that the world economy contracted by 1.1% in 2009.²

Exhibit 4: Consensus 2009 Monthly GDP Growth Forecasts, September 2008 – December 2009



Source: Consensus Economics, monthly between September 2008 – December 2009

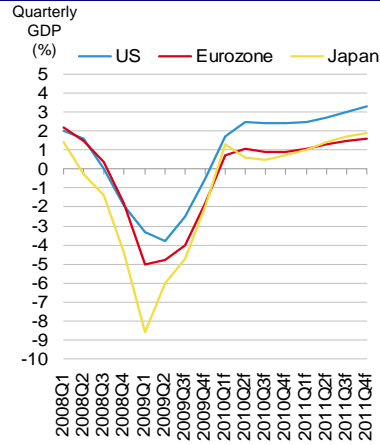
As quarterly national statistics for GDP growth were rolled out during 2009, it became clear that the worst of the downturn had indeed occurred in the early months of the year. Consensus Economics anticipates an economic bounce for Japan in the first quarter of 2010, followed by a return to below-trend growth. Europe is also forecast to recover in 2010 at a below-trend pace. The US is expected to turn in economic growth during the recovery of 2-3%, also below-trend, but higher than either Japan or the Eurozone (Exhibit 5).

Improvements in GDP growth and the stabilisation of the credit markets shored up investor confidence over the course of the year. This was certainly clear in the equity markets in general, but there were hints of recovery in some real estate markets, especially in the UK. IPD's closely watched return index for real estate showed sharp improvement on a monthly basis. By year-end, even the rolling 12-month index had turned positive, a dramatic change on the negative 25% at mid-year (Exhibit 6). This turnaround in the UK was notable for several reasons. First, London's position as a global financial centre makes its recovery especially important given the nature of this downturn. Second, London's real estate prices were among the first worldwide to crumble in 2007. Because London took a leading position in the global property cycle, the length of its recovery time and the strength of its rebound provide a benchmark for other markets that have followed London's cyclical path. Market fundamentals remained weak in the UK during 2009, but it was a range of capital market factors that led the recovery³. These capital market factors included the very wide spreads between government bond yields and property yields the reversal of the denominator effect that enabled institutional investors to return to the market, the recapitalisation of the REIT market and the strong demand from a series of overseas investors.

² Deutsche Bank, *Global Economic Perspectives*, 13 January 2010, page 2

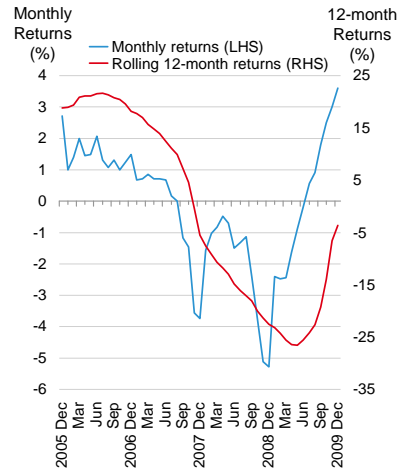
³ RREEF Research, *UK Real Estate Quarterly*, December 2009

Exhibit 5 : Quarterly GDP Forecast, 2008-2011 (% year on year)



Source: Global Insights, February 2010

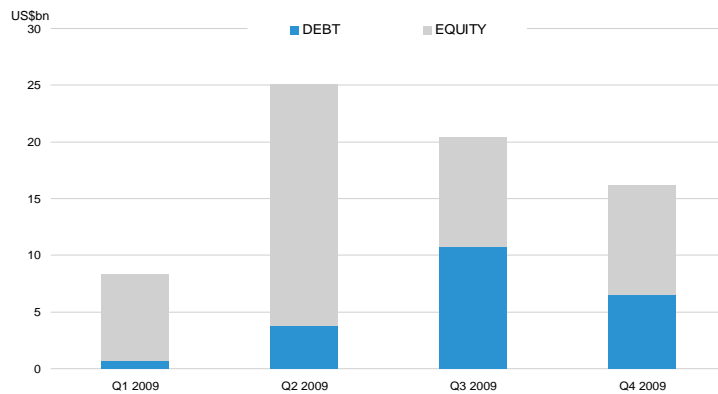
Exhibit 6 : UK Unlevered Direct Real Estate Returns, Monthly and 12-Month Rolling, 2005-2009



Source: IPD, December 2009

The improving performance of UK real estate returns was foreshadowed by an improvement in the REIT market. After a two-year decline, global REIT securities showed marked improvement from March 2009 (Exhibit 8). By November, REIT securities in the UK, along with REITs in the US and Eurozone, had risen more than 80% from their cyclical low (Exhibit 9). This sharp improvement came from a relatively low base. The credit crunch led to debt pressure for REITs and created a catalyst for asset dispositions, but REITs are now positioned with available capital for new acquisitions after a series of successful recapitalisation programmes across the global major REITs markets (Exhibit 7).

Exhibit 7: Global REIT Debt and Equity Issuance during 2009

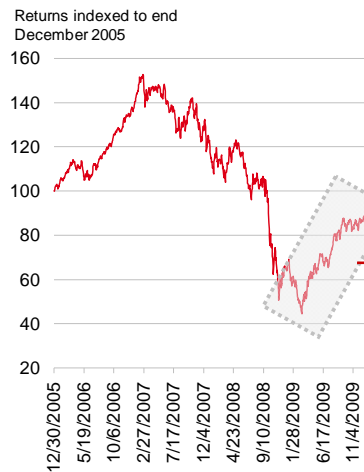


Source: SNL and RREEF, January 2010

RREEF estimates that with realistic leveraging of new cash raised, UK REITs are sitting on roughly £8-12 billion in purchasing power that could be used over the next 12-18 months as this sector moves from being a net seller to a net acquirer.⁴

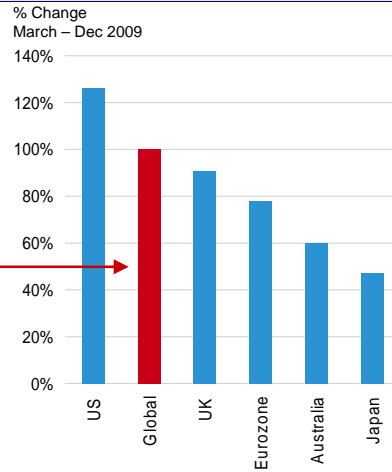
⁴ RREEF Research, *UK Real Estate Quarterly*, December 2009, page 13

Exhibit 8 : Real Estate Securities Performance: Global



Source: EPRA/NAREIT as of 31 December 2009

Exhibit 9 : Real Estate Securities Performance: Selected Countries



Source: EPRA/NAREIT, % change from the low point reached in each country in March 2009 to December 2009

Global Real Estate Market

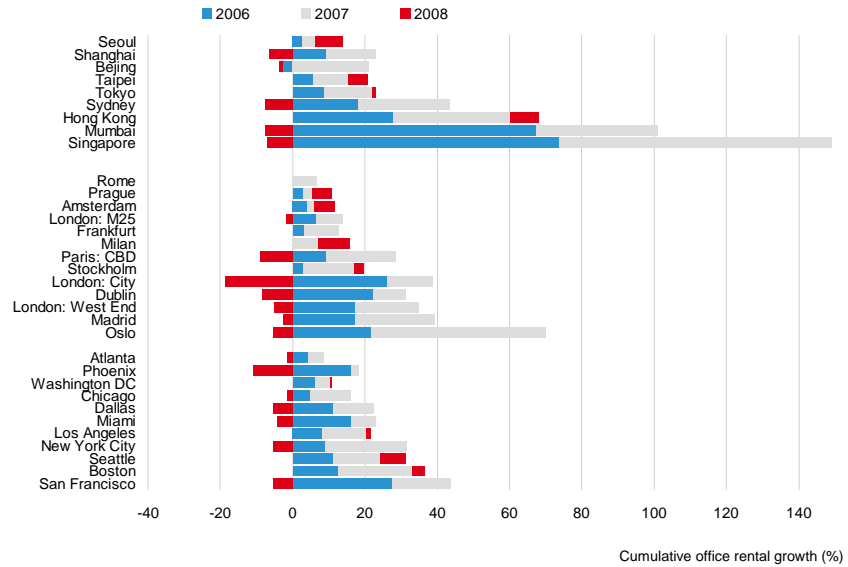
Property fundamentals

Even though London's property fundamentals began unravelling before the end of 2007, other office markets held strong well into 2008, especially in parts of Asia. Over the boom years of 2006 to 2008, Hong Kong, Delhi, and Mumbai saw office rents rise by more than 20% annually, and Singapore's rents climbed even faster, averaging 40% p.a. growth during this period. In Europe and North America, office rents also experienced strong growth, but the comparable three-year averages for office rents in most of these markets held in the single-digits.

While three-year averages offer a broad perspective on the comparable performance of office markets, they tell us little about cyclical dynamics. Only by disaggregating the annual data can we begin to understand the timing and geographic nuance of the global office cycle.

Exhibit 10 shows the London office market's plunge in 2008. In London's City submarket, rents fell so sharply in 2008 that they more than negated the net rental gains of the previous year. Dublin was the only other market that came close to erasing its 2007 gains in 2008. Rents in most global office markets began to fall in 2008, but many cities managed to eke out net gains for the year. Even as turmoil swept through capital markets in 2008, the impact on office workers and occupiers was delayed in some markets.

**Exhibit 10: Office Rental Growth across Major Global Markets, 2006-2008:
Cumulative by Year**

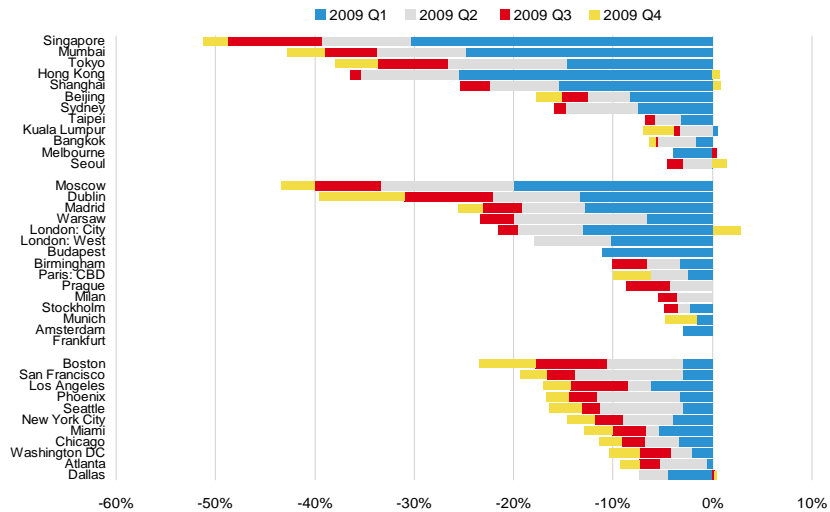


Source: RREEF Research; REIS; PMA, January 2010

By 2009, every major global office market had been impacted by the economic downturn (Exhibit 11). European and Asia Pacific markets were especially affected. After averaging more than 40% annual growth between 2006 and 2008, rents in Singapore's office market collapsed by more than 50% in 2009. Rents in Mumbai, Hong Kong, and Moscow also took hits of 40% over the same period.

At the same time, there were signs by the end of the year that these rental adjustments were beginning to wind down. Almost all of Hong Kong's 2009 rental declines came in the first two quarters. By the fourth quarter, every global region could point to a handful of office markets where rents had flattened or even turned in modest growth. These office markets included Hong Kong, Shanghai, and Seoul in Asia Pacific; London (West End), in Europe. US office markets are still searching for the bottom.

Exhibit 11: Office Rental Growth across Major Global Markets, Q1 to Q4 2009



Source: RREEF Research; JLL; REIS; CBRE, February 2010

Debt and lending activity

Although the economic weakness led to a rapid deterioration in property fundamentals, it was the credit crisis that had a more profound impact on market performance. Healthy credit markets are particularly important to the property sector given the role that leverage plays in the real estate investment process. By most measures, public and private debt make up more than half of the global real estate market although this share varies considerably by country (Exhibit 12). When we consider the regional exposure of the global real estate market, it is helpful to think of the four quadrants of real estate:

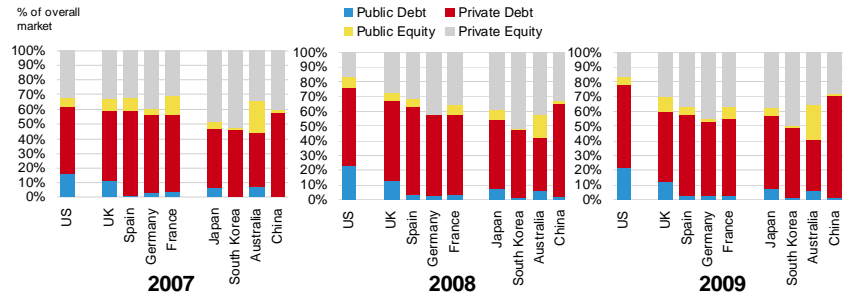
1. **Private equity**, including pension fund/insurance company equity capital
2. **Public equity**, including the listed or REIT-type capital – only about 10% of the global market
3. **Private debt**, including loans to buildings or to companies
4. **Public debt**, including securitised products like CMBS

The differences in capital market structures across national economies shed light on the regional impacts of the global financial crisis as well as the varying paths to recovery. In emerging markets like South Korea, India, and China, for example, public markets for both debt and equity are relatively undeveloped, leaving most market activity to private deals. On the other hand, Australia's well-developed REIT market pushes public equity to a higher share of overall real estate than is seen in any other major market. The US does the same with its public debt market which is significantly larger (in percentage terms) than in any other major country.

Exhibit 12 also underscores US reliance on debt, both public and private, as an overall share of the property market. At the peak of the market in 2007, debt accounted for just over the 60% of the US property market, but as the financial crisis unwound in 2008 and 2009 this share rose to nearly 80% of the overall market. This contrasts strongly with the UK and Australia where overall debt shares have fallen as public equity markets have been successfully recapitalised.

The changing structure of China's capital markets merits attention as well. Greater liquidity has created an environment for debt to rise as a share of the overall property market. As of 2009, the weight of China's private debt market exceeded all other major countries in percentage terms, partly because banks continued to lend to developers and property companies. The large exposure to private real estate debt makes the market particularly susceptible to monetary tightening, such as the recent requirement from China's governing State Council to require a 40% down payment for property purchased by institutional or private investors as well as increasing its 1-year government bill rate by 16 basis points (bps) since January 2010.⁵

Exhibit 12: Share of Real Estate Market, by 4-Quadrants, 2007-2009



Source: DTZ; ULI, RREEF Research, February 2010

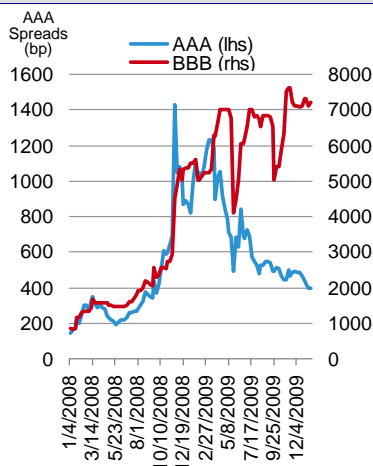
Debt continues to be an important component of real estate capital markets, but pricing has diverged across regions in 2009. In the US, rapid government intervention in the form of the TALF and PPIP programmes⁶ has helped to narrow the spread for Grade A CMBS (Exhibit 13). Although this spread has come down significantly, it still remains wide for Grade B CMBS in the US. More recently, there has been some new issuance of plain vanilla type CMBS in the US, which could be a turning point for the US public debt market.

The situation in Europe is different in that Government interventions on the order of TALF and PPIP have been absent. The European public debt markets continue to struggle with weakening market fundamentals, structural issues, wide spreads, and low levels of new issuance. On a positive note, the European CRE financing environment is benefiting from a functioning Pfandbrief market which is providing low leverage loans to an otherwise credit starved investment market.

⁵ Deutsche Bank Research, *January Update on China and Hong Kong Economies*, 10 January 2010

⁶ TALF = Term Asset-Backed Securities Loan Facility
PPIP = Public/Private Investment Program

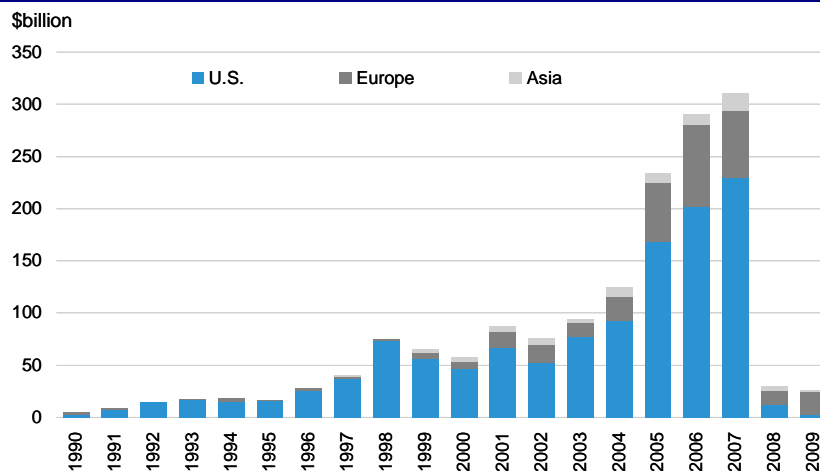
Exhibit 13: CMBS Spreads, 2008-2009: US



Source: Morgan Stanley, Bloomberg, RREEF, January 2010

The challenge facing CMBS market means there has been a shutting down of new issuances over the past two years, as clearly shown in Exhibit 14. Moreover, banks remain cautious about lending to commercial real estate in light of their legacy loan books and overexposure to construction and land loans.⁷ The limited supply of commercial real estate lending activity in the current market is reserved for well-leased properties with stable cash flows in good locations and with loan-to-value (LTV) ratios below 60% and high coverage ratios.

Exhibit 14: Global Issuance of CMBS (in US\$ billions)



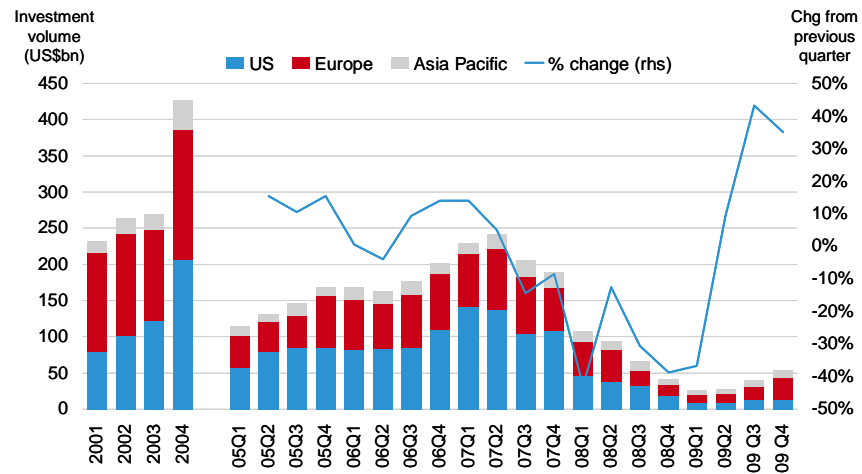
Source: Commercial Mortgage Alert, January 2010

⁷ According to Deutsche Bank, *Q4 2009 CRE Outlook: Searching for a Bottom*, 1 December 2009, page 37: "The dramatic growth of CMBS during 2004-2007 came at the expense of banks, particularly regional and community banks. For higher quality properties with relatively stable cash flows, CMBS offered lower borrowing costs and greater all-in leverage. This siphoned off the better lending opportunities, pressuring banks to become more concentrated in riskier types of lending, e.g. construction, condo development, land loans. The situation in commercial real estate is the opposite of that in residential real estate: banks hold the riskiest CRE debt."

Weight of capital

Compared to the peak of the market in 2007, investment activity in 2009 was barely a trickle (Exhibit 15). There are signs, however, that activity is reviving. After seven consecutive quarters of decline, investment activity rose 9% between the 2009Q2 and 2009Q3, and then popped up 35% more in 2009Q4. Though the percentage increases are impressive, the overall volume of global transaction activity remains low – less than US\$60 billion in 2009Q4 compared to nearly US\$250 billion at the peak of the boom in 2007Q2. Moreover, this uptick in transaction volume is not widespread geographically. During the course of 2009, it was China, UK, Japan and France that were the most active markets in the world⁸, although most of deals in China were related to residential land sales.

Exhibit 15: Real Estate Investment Activity across Global Regions



Source: RREEF Research based on DTZ; REIS; Real Capital Analytics (RCA), February 2010

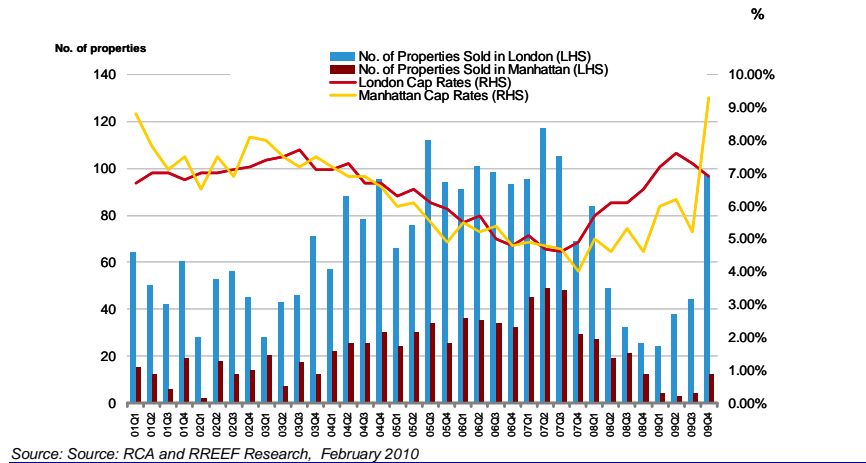
Note: UK and European investment volumes have been converted to US\$ based on a constant exchange rate of €1,000 = US\$1.472

⁸ Real Capital Analytics, *Global Capital Trends*, December 2009

Relative pricing

Global cap rates have shown mixed signals across markets. The contrast between the London and New York office markets is a case in point. London's cap rate began its outward movement in late 2007 just ahead of New York. By 2009, New York was still moving out amid a noticeably quiet transaction market. But as Exhibit 16 shows, London's cap rate began to compress as a flurry of relatively small transactions enlivened the market's deal landscape.

Exhibit 16: Office Transactions and Average Cap Rates, London and Manhattan 2001-2009



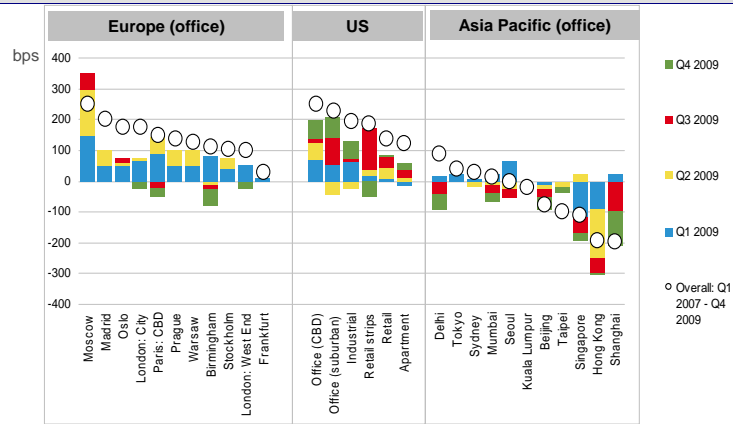
Source: Source: RCA and RREEF Research, February 2010

The mixed signals for cap rates extend beyond London and New York. In Europe there are marked differences between cities. Paris, like London, has shown recent signs of compression, while in other cities the rate of outward movement appears to have slowed. Cap rates in Germany have held relatively stable.

In the US, the deal market was unusually quiet in 2009 and cap rates continued to move out for much of the year. Current US pricing trends are perhaps more easily distinguished by property sector than by city. Only in the CBD office market have cap rates shown recent signs of compression, and this occurred only after very sharp increases earlier in the year. Cap rates also rose quickly for suburban offices, retail strip malls, and industrial properties, all of which tend to be on the urban periphery rather than city centres (Exhibit 17).

Cap rates in the Asia Pacific region have followed yet another pattern. Rents in this region fell dramatically, but capital values held up well. This led to record compression in some cities like Hong Kong and Shanghai. Banks are still lending, and with inflation widely anticipated, there is no shortage of buyers ready to make capital value plays.

Exhibit 17: Global Cap Rate Movements, Q1 2007 – Q4 2009

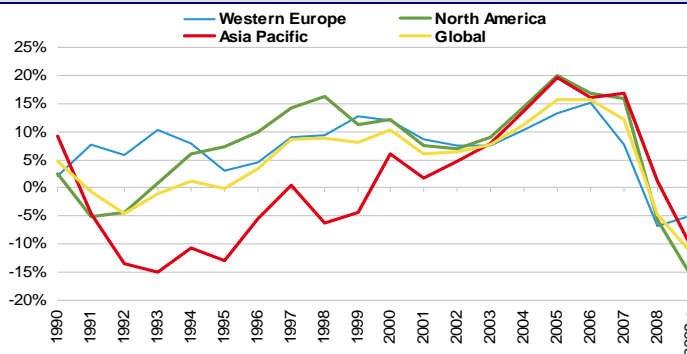


Source: CBRE (Europe); Real Capital Analytics (US); REIS (Asia), February 2010

Performance

The signals for property markets remain mixed across global regions, across property sectors, and across return drivers of rents and values. But regardless of these market nuances, the underlying story is the same worldwide, with negative returns for most markets during 2009. Although IPD and NCREIF results for 2009 as a whole are not yet released for most markets, it is likely that all-property returns will have fallen by more than 10% globally in 2009. The decline will have been slightly less in Europe due to the bounceback in the UK and the mildness of the decline in Germany, and slightly more in North America (Exhibit 18).

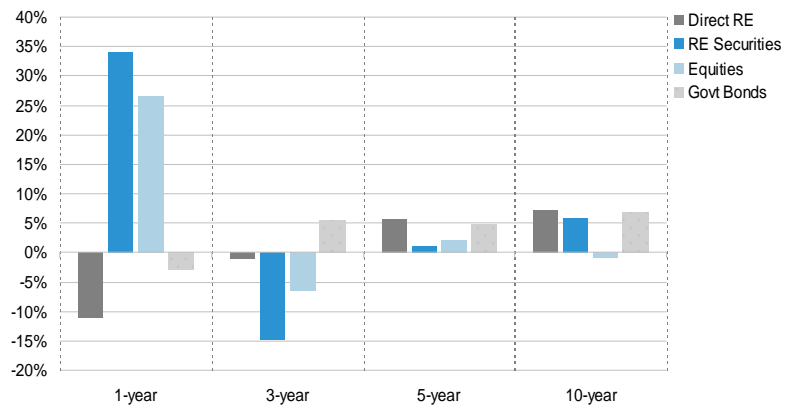
Exhibit 18: Regional All-Property Total Returns, 1990 through 2009



Source: RREEF Research; Investment Property Databank (IPD); NCREIF; ICREIM; PCA; MTB – IKOMA; Property Council of New Zealand, February 2010

With returns still declining and with many global property markets scraping near the bottom of this cycle, investors have reappeared in a few markets, most notably London and parts of Asia, but also in other major global cities including Paris, Washington DC, New York, and Tokyo. This return of investors to core markets is to be expected at this stage of the cycle, as markets start to bottom out and the opportunities become increasingly compelling. Although direct real estate markets underperformed most asset classes during 2009, their long run performance remains attractive (Exhibit 19). More fundamentally, the recovery in the equity markets and the aggressive pricing of the bond markets seem to be a major reason for investors to return to real estate in greater volumes during the coming year. The example of the London market (as explained earlier in this paper, see Exhibit 6) is likely to be repeated in other markets in 2010.

Exhibit 19: Total Global Returns by Asset Class, 1999 to 2009



Source: RREEF Research; FTSE/EPRA NAREIT; Investment Property Databank (IPD); NCREIF; ICREIM; PCA; MTB – IKOMA; Property Council of New Zealand; MSCI; JP Morgan Global Government Bond 10+Y

Note: Aggregates for total returns of real estate securities have been calculated by RREEF Research based on market cap-weighted total returns in local currencies

2010-2012: Outlook for Global Real Estate Markets

The previous section reviewed activities in 2009 for the global economy and property markets. We showed how the global economy had stabilised over the course of the year, and we reviewed the cyclical downturn in the property markets from the perspectives of fundamentals, capital markets, and overall performance. At the close of 2009, we found the global property markets showing mixed signals. This was true across regions, across property sectors, and across the property return drivers such as rents and capital values. But amid these mixed signals, we saw signs that the cycle is beginning to turn as investors start looking ahead. Improvements in capital markets (London) and anticipation of future inflation (Asia) had already drawn investors back into property at year-end 2009. In this section, we provide our outlook for global real estate in the years ahead.

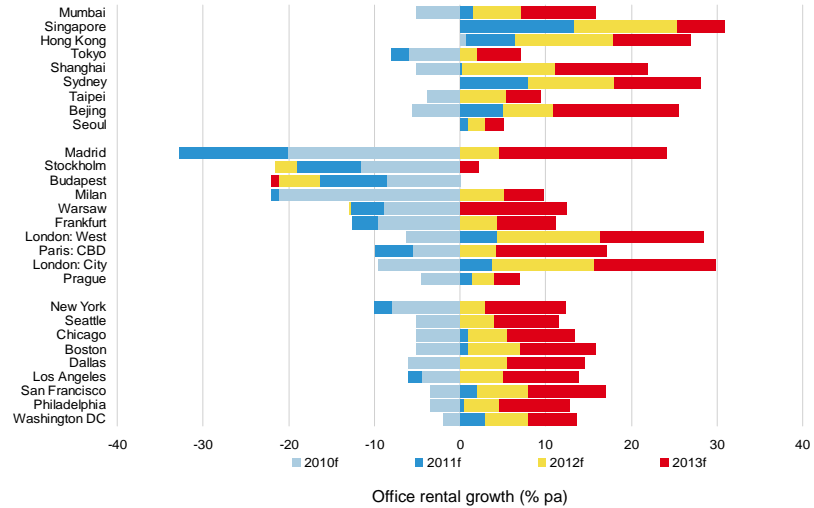
Property Fundamentals

Rents and Vacancies

In the previous section, Exhibit 10 showed annual office rental growth for the pivotal years 2006-2008 that marked the top of the cycle. Exhibit 20 picks up in 2009 and carries the RREEF forecast forward through 2013. The downturn this time was as severe as the early 1990s. The combination of locked credit markets, financial instability, and sudden economic turmoil disrupted real estate fundamentals, investment activity, and overall performance. The downturn caught Asia in an oversupply situation, especially in markets like Singapore, India, and parts of China where massive construction pipelines were in progress. In Europe and the US, the problems fell more on the demand side as the economic recession quickly dashed any hope of new take-up from occupiers.

A few office markets may begin trickling into their recovery phases in 2010, but not really until 2011 will there be a significant number of markets with rental levels advancing again. By 2012, only a few markets will still be struggling with rental deterioration. Cyclical timing varies considerably across global markets. The Asia Pacific region, in general, will lead the cycle, with rental growth in most markets stabilising in 2010 and then advancing in 2011. Europe and the US will generally be slower to turn.

Exhibit 20: Office Rental Growth across Major Global Markets, 2010-2013f

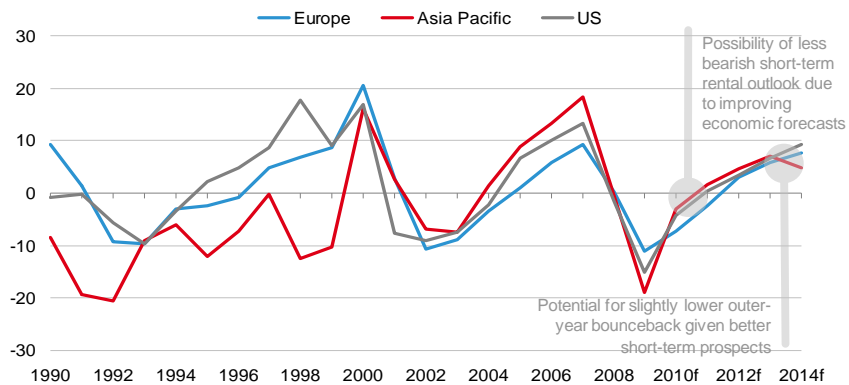


Source: RREEF Research, February 2010

Note: f=forecast

We anticipate 2010-2011 as the primary transition period when most markets shift from declining to rising rents. Rental growth from 2012 will be stronger across all three major regions (Exhibit 21). As always, other scenarios are plausible. Economic forecasts and jobs reports in late 2009 have often surprised on the upside. If this should continue, it is feasible that markets will transition to rental growth sooner rather than later. A shallower downturn, however, would also increase the likelihood of a softer bounceback in the outer years of the forecast.

Exhibit 21: Office Rental Growth across Global Regions

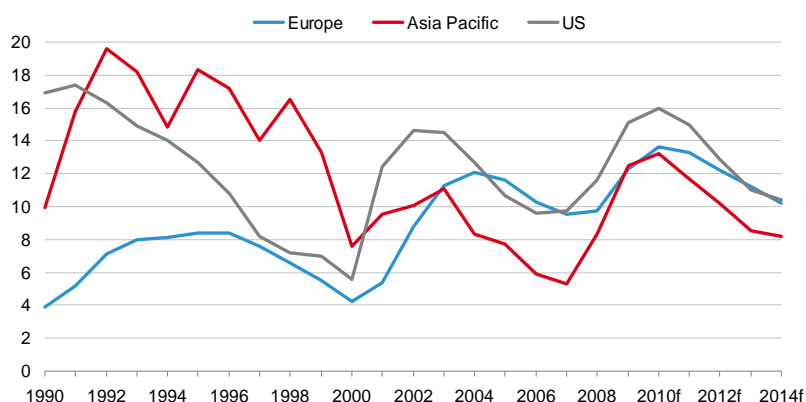


Source: RREEF Research, February 2010

Note: f=forecast

Vacancy rates underscore the current outlook for office rents. The Asia Pacific region will be the first to see broad improvements in 2010 as oversupplied markets like Singapore begin to pick up new occupiers (Exhibit 22). Vacancies in the US and Europe should follow in 2011, but again, improvements in these office markets will depend largely on job-related momentum since their vacancies rates have been driven up by a lack of demand rather than by oversupply.

Exhibit 22: Office Vacancies across Global Regions



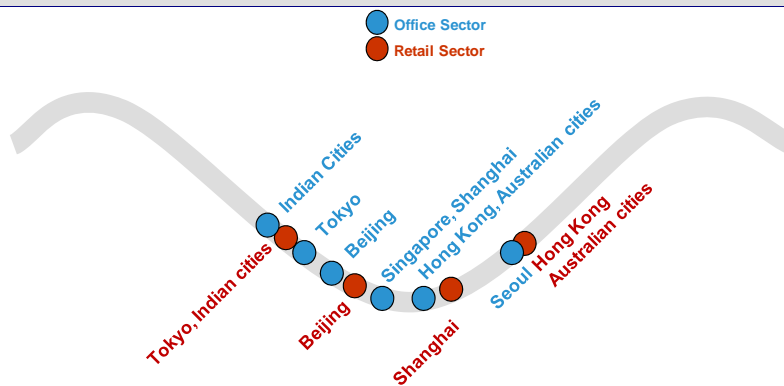
Source RREEF Research, February 2010
 Note: f= forecast

Property cycles

Among the Asia Pacific office markets, Seoul will lead the recovery in 2010 (Exhibit 23)⁹. The strong weight of capital in Seoul led to cap rate compression during 2009, and this has pushed the market ahead of the Asia Pacific region in terms of its cyclical position. The weaker value of the Korean won in 2009 also worked to the advantage of Seoul's export-oriented companies at a time when exporters in other countries were struggling. Hong Kong, Sydney, and Melbourne will follow Seoul into recovery during 2010. Although heavier supply pipelines slow the office recovery in other cities in the region, it may prove less of a drag in some markets than originally feared. Even Singapore appears positioned to shake off its oversupply problem with a relatively quick recovery.

Asia Pacific retail markets vary considerably. Unfavourable demographics, reluctant consumers, and a sharp economic recession will deter a near-term recovery in Tokyo's retail market. Hong Kong may fare better in attracting external retail demand in 2010. Its retail recovery will be boosted by increasingly wealthy visitors from mainland China. In Australia, where economic recession proved relatively mild, the Sydney and Melbourne retail markets should move quickly into recovery in 2010.

Exhibit 23: Asian City Positions in Property Market Cycle, 2010



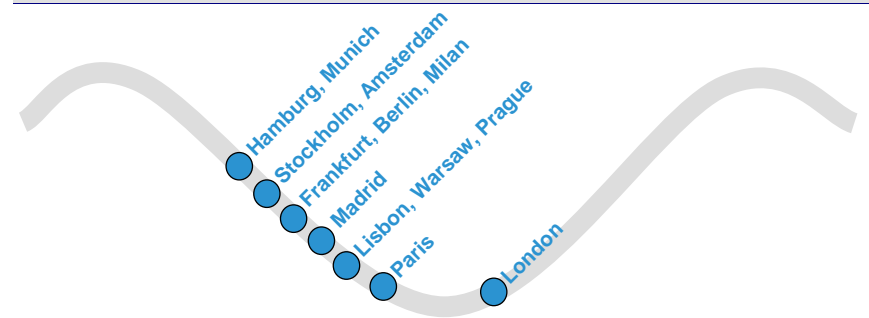
Source: RREEF Research, February 2010
 Note: Schematic representation of position of office market fundamentals through the cycle

⁹ RREEF Research, Asia Pacific Property Cycle Monitor, January 2010

Europe's office markets are unlikely to see recovery in 2010, with London and perhaps Paris being the major exceptions (Exhibit 24)¹⁰. Rejuvenated capital markets in London will add vigour to transaction activity in that city's office market in 2010, with a number of key players, including domestic REITs and institutions as well as German OEFs, preparing to unleash purchasing power.¹¹

Oversupply has been a problem in parts of Eastern Europe, but better than expected economic performance in Poland and Czech Republic will support earlier recovery in the Warsaw and Prague office markets. Economic hangovers in Madrid, Barcelona, and Dublin will cause a drag on their office market recoveries, with rents continuing to decline in all three markets through at least 2011. The office markets with flatter cycles are centred mostly in North Central Europe where supply never spun out of control and demand never plummeted as it did in the faster moving markets.

Exhibit 24: European City Positions in Office Market Cycle, 2010

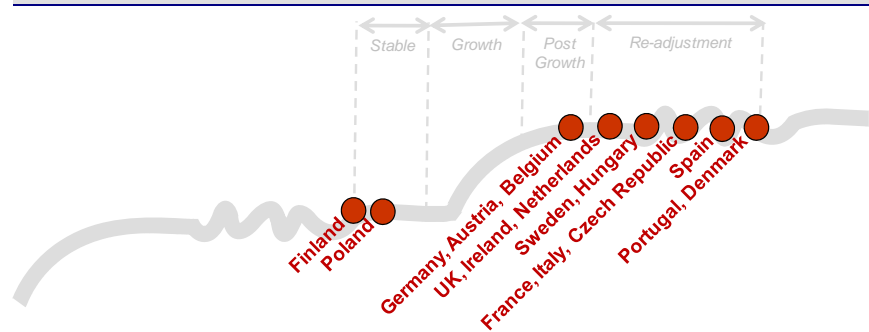


Source: RREEF Research, February 2010

Note: Schematic representation of position of office market fundamentals through the cycle

Most of Europe's shopping centre markets moved into a period of readjustment in 2009 and will spend the remainder of 2010 in this phase (Exhibit 25). Investors can expect a flatter cycle for shopping centres relative to office properties. Volatile markets with significant rent disruption (e.g., Spain, Portugal, and the Czech Republic) hold better prospects for eventual rental growth later in the recovery. Rental prospects for Germany are modest overall, but Munich's fundamentals position it for longer-term outperformance compared with its German peers. City centre rents have held relatively up well in Munich, as they have in other major cities such as Milan, Paris, and London.

Exhibit 25: European Country Positions in Shopping Centre Market Cycle, 2010



Source: RREEF Research, February 2010

Note: Schematic representation of position of office market fundamentals through the cycle

¹⁰ RREEF Research, *Europe Property Cycle Monitor*, January 2010

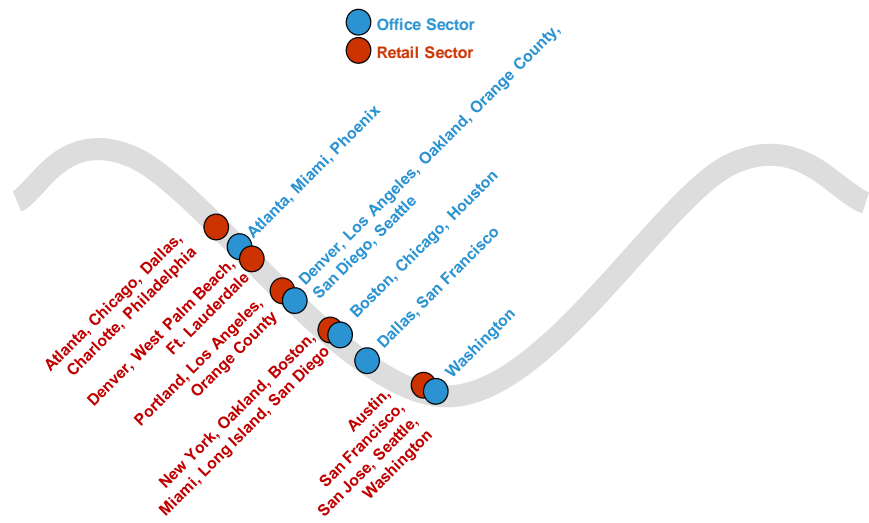
¹¹ RREEF Research, *UK Real Estate Quarterly*, December 2009

The US office market was late in taking a cyclical tumble, so few US cities, if any, will be ready to move into recovery in 2010 (Exhibit 26)¹². The US office markets generally best positioned for quicker recovery in 2011 will be those that were less impacted by the current recession. Many of these cities have specialised economies in technology (San Francisco, Boston, Austin) or policy administration (Washington). The US cities most exposed to the US housing crisis (Miami, Phoenix, Las Vegas, Detroit, and parts of California) have taken severe economic hits and their office markets will likewise take longer to rebound.

The US recession brought a game-changing blow to American spending habits. Savings rates shot up to levels not seen in years, and consumers have been resistant to opening their wallets again with the same enthusiasm as they had before the crisis. Restrained demand will hold back the retail recovery in 2010 across most US cities. Technology-oriented economies like Austin will be among the few markets where the retail sector will move into recovery in 2010. Extremely favourable demographics and a relatively mild economic recession make cities like Austin retail anomalies among most of their US peers.

The overall U.S. forecast includes positive macroeconomic trends for 2010. With investor confidence rising, interest in commercial real estate will likely accelerate during the year. Greater liquidity in the real estate market will increase bidding and begin to push yields downward. With value declines now better reflected in the current transactions market, cap rates have begun to compressing for stabilised core properties. But this period of downward pressure on cap rates may be short-lived as the monetary policy environment is likely to begin shifting in 2011.

Exhibit 26: US City Positions in Property Market Cycle, 2010



Source: RREEF Research, February 2010

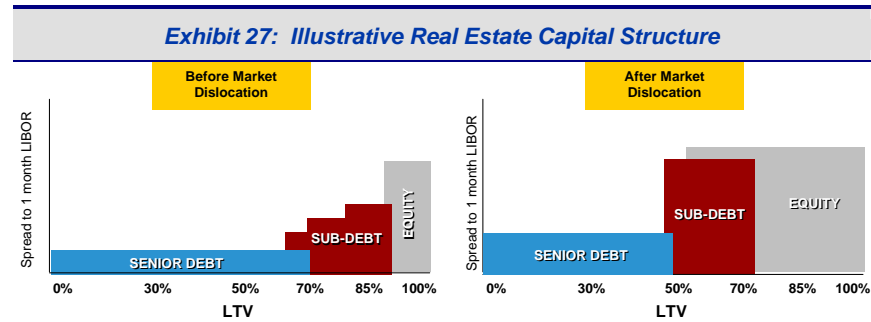
Note: Schematic representation of position of office market fundamentals through the cycle

¹² RREEF Research, 2010 U.S. Real Estate Investment Outlook and Market Perspective, Forthcoming in February 2010

Capital Markets

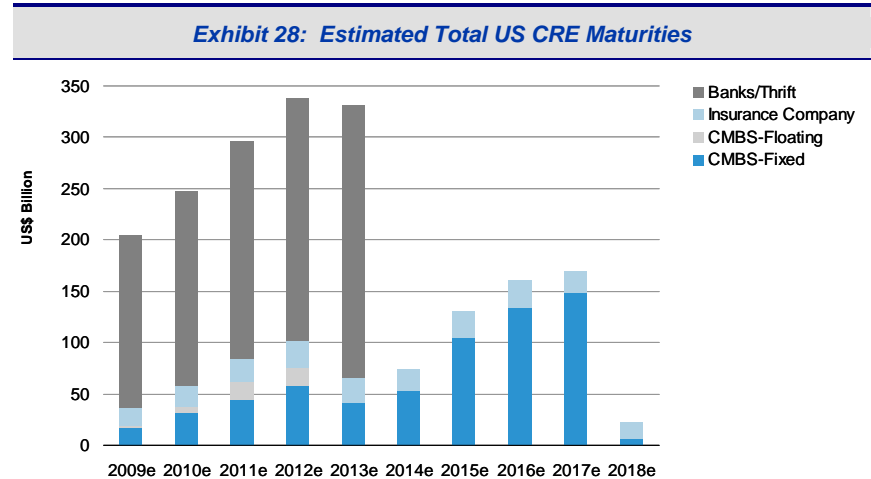
Debt and Lending Activity

Although the credit markets might be showing signs of some stabilisation, there remain significant concerns over the real estate debt markets. With debt representing close to 60% of the value of the global real estate market, the prospects for overall performance are closely related to the ways in which banks continue to lend to the market. In this respect, banks face two significant challenges: (1) reducing exposure to real estate and, (2) working through the large scale of bad loans. This results in debt that is less readily available and also more expensive than before the credit crisis (Exhibit 27).



Source: RREEF Research, February 2010

US banks find their current balance sheets top-heavy with commercial real estate loans. The maturity profiles for these loans (Exhibit 28) suggest that bank earnings over the next two to three years could be significantly curtailed. Deutsche Bank estimates that commercial real estate losses for US banks could probably be held to about US\$200-300 billion if maturity extensions are provided relatively liberally.¹³ Even if this maturity crisis is effectively managed, real estate credit will remain a critical issue for the US real estate market over the next few years.



Source: Deutsche Bank; Intex; Trepp; Mortgage Bankers Association; U.S. Federal Reserve, Q3 2009

CRE = Commercial Real Estate

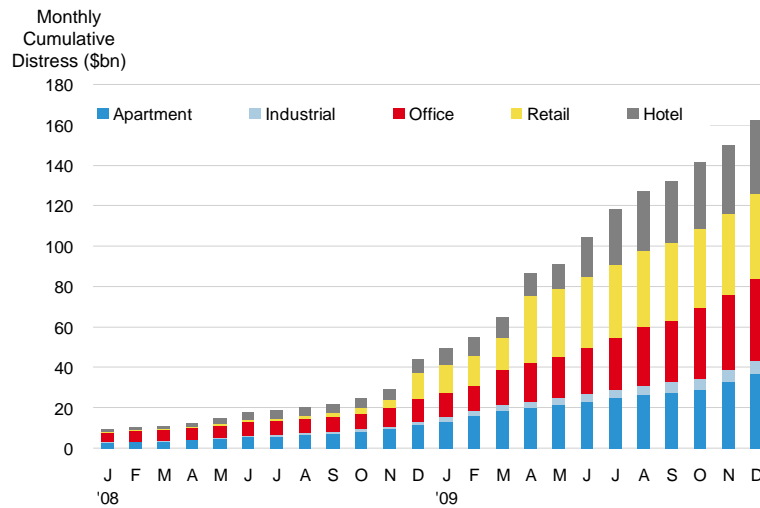
¹³ Deutsche Bank, *Q4 2009 CRE Outlook: Searching for a Bottom*, 1 December 2009, page 67

US banks with portfolios weighted toward hotel and retail loans may face relatively tough challenges. Hotel and retail are the two property sectors that continue to emerge as most distressed. Unusually high levels of unemployment and high household debt burdens have stifled American consumers who have curbed retail spending and leisure travel.

Distressed debt levels in the US were rising by as much as US\$10 billion per month through much of 2009 (Exhibit 29), with much of the increase coming from the retail and hotel sectors. Suburban shopping mall operators were particularly vulnerable to the crisis in the US, and one of the largest, General Growth Properties, fell into bankruptcy by spring 2009.

The unfolding situation leaves some regional markets in the US particularly exposed to distress, especially Las Vegas with its large portfolio of hotels and shopping venues, but only marginal levels of office and industrial space.

Exhibit 29: Monthly Cumulative Distress Across US Markets by Property Type



Source: Real Capital Analytics, February 2010

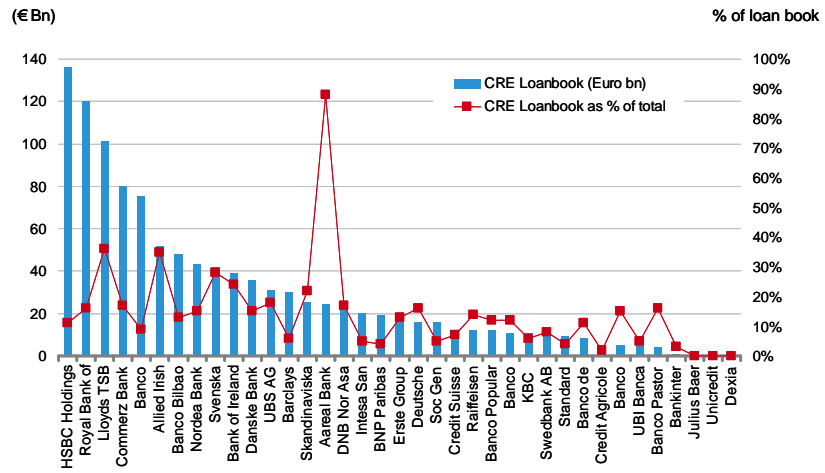
Exposure to commercial real estate loans casts a shadow over European banks as well. Much of the problem stems from the high exposure of many banks to real estate markets (Exhibit 30) and the high levels of cross-border lending activity in Central and Eastern Europe (Exhibit 31). The high exposure to real estate and the prospect of significant refinancing over the coming five years will reduce the appetite of banks to issue new loans. These challenges are compounded by the exposure to Eastern Europe where the web of lending activity is complex: Swedish banks have a Baltic problem; exposure for AIB and Commerzbank is isolated largely to Poland; and Raiffeisen and Unicredit – the most exposed banks – have loan portfolios strung across the CEE from the Arctic to the Adriatic.¹⁴

Beyond the overexposure to real estate, an increasing number of loans are in breach of their covenants. This is well-illustrated in the UK where nearly 10% of commercial real estate loans were in breach by mid-year 2009.¹⁵ These broken covenants touched more than 4,300 loans at an aggregate value of £18.7 billion. By mid-year 2009, the number of loans in breach had levelled off to some degree, but the aggregated value of loans in breach continued to soar, indicating a subtle shift toward larger properties.

¹⁴ Various Companies Reports, and Deutsche Bank

¹⁵ De Montfort University (2009), *The UK Commercial Property Lending Market – Research Findings 2008 Year end*, August 2009

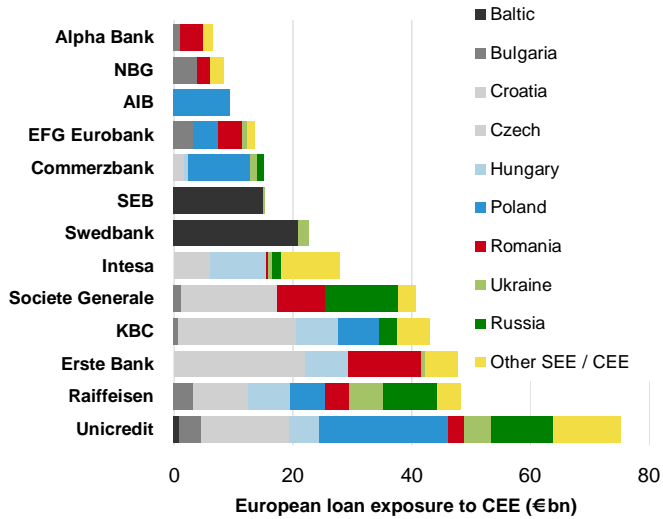
Exhibit 30: European Banks Exposure to CRE



Source: Deutsche Bank; company reports, February 2010

Note: Excludes certain European banks such as Deutsche Bank

Exhibit 31: Loan Exposure to CEE from Major European Banks at Year-End 2008



Source: Deutsche Bank; company reports, February 2010

Note: CEE = Central Eastern Europe

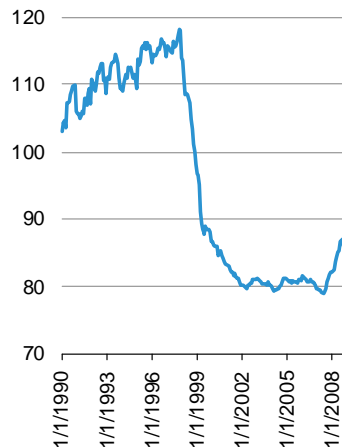
Economic turmoil can change management cultures and policy environments. This could certainly be argued about Asia's financial sector. The crisis of 1997 remains fresh in the minds of Asia's bankers and policymakers. When global financial crisis erupted in late 2008, a generation of experienced bankers and policymakers in the region was better prepared for the challenge. Loan-to-deposit ratios have fallen significantly in Asia since the late 1990s (Exhibit 32), and writedowns and losses for the region this time around are estimated to be less than US\$43 billion, or barely more than 2.5% of the global total (Exhibit 33).

Asia's banks overall have been relatively less exposed to bad loans, and no country in the region has experienced anything comparable to the lending problems in, say, the US, Spain, or Ireland. Of all the Asian countries, the situation in Japan is the most

severe, but even here the bad loans were less likely to have originated from Japan's conservative local banks than from banks in Europe or the US.

During 2009, concerns also arose that liquidity in China could lead the country's state-run banks into trouble. By year-end, however, the country's policymakers were already signalling their intent to curb lending activity with higher interest rates and stiffer capital reserve requirements in the coming year, ostensibly in an attempt to discourage frothy asset price increases.¹⁶ Indeed, in early 2010, new policies followed without delay.¹⁷

Exhibit 32: Loan to Deposit Ratio, Asian Banks



Source: CLSA Asia-Pacific Markets, April 2009

Note: Average of 11 markets including China, Hong Kong, India, Indonesia, Japan, Korea, Malaysia, Philippines, Singapore, Taiwan, and Thailand

Exhibit 33: Credit Losses and Capital Raised (in US\$ billions)

	Writedowns & Losses	Capital Raised
Worldwide	1,719.9	1,509.3
Americas	1,114.5	778.5
Europe	562.9	607.8
Asia	42.5	123.1
Mizuho Financial Group	9.0	12.2
Other Asian Banks	6.5	20.9
Bank of China Ltd	6.0	5.9
Mitsubishi UFJ Financial Group	4.4	26.9
Nomura Holding Inc	4.4	9.1
Australia and New Zealand Banking Group	3.4	4.4
Industrial and Commercial Bank of China	2.1	0.0
Bank Hapoalim B.M.	1.9	2.4
Sumitomo Mitsui Financial Group	1.2	33.2
Sumitomo Trust and Banking Co.	1.0	3.2

Source: Bloomberg, February 2010

Note: Credit losses include the increase in the provisions for bad loans, impacted by the rising defaults in mortgage payments. Capital raised includes common stock, preferred shares, subordinated debt and hybrid securities which count as Tier 1 or Tier 2 capital as well as equity stakes or subsidiaries sold for capital strengthening. Capital data begins with funds raised in July 2007. All numbers are in billions of US dollars, converted at today's exchange rate if reported in another currency

Weight of capital

The bull market for property investment kept real estate allocations unsustainably high through 2007. The subsequent fallout in property markets, coupled with the broader denominator effect, drove down the appetite for real estate during 2008-2009. During the boom years, two-thirds of investors held real estate allocations exceeding 10% of portfolios, but in 2008 and 2009 the share of investors with allocations exceeding 10% fell to about one-third (Exhibit 34).

This is clearly a wide swing of the pendulum in a short period of time, and there are already clear signs that allocations have once again started to increase. A range of industry-based surveys demonstrate the way in which investor sentiment toward real estate has warmed over the course of 2009. For Europe, this includes the PMA survey of investors and the INREV investor intentions survey, both of which reveal an increased appetite for real estate¹⁸. These surveys are echoed by Asian surveys, as well as those in the US.¹⁹

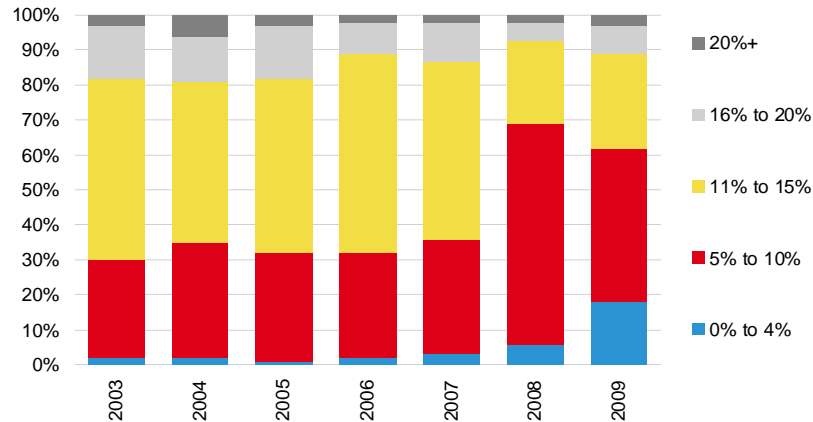
¹⁶ Reuters, *China gently hints ready to rein in growth policies*, 8 December 2009

¹⁷ Deutsche Bank Research, *January Update on China and Hong Kong Economies*, 10 January 2010

¹⁸ PMA, *European Investor Sentiment Survey*, November 2009; INREV, *Investor Intentions Survey*, January 2010

¹⁹ ANREV, *Investment Intentions Asia Survey*, 2009; AFIRE, *2010 Foreign Investment Survey*, 2010

Exhibit 34: Allocations to Real Estate



Source: UBS, December 2009

This weight of capital towards real estate has started to broaden across investor groups (Exhibit 35). For much of 2009, US and European institutional buyers had largely stepped back from the global stage, ceding the roles of active cross-border acquisition to Asian institutions, sovereign wealth funds, and German open-ended funds. These active cross-border investors remain very active, and they have now been joined by a series of other investors including institutional investors, REITs and high-net-worth (HNW)/retail investors.

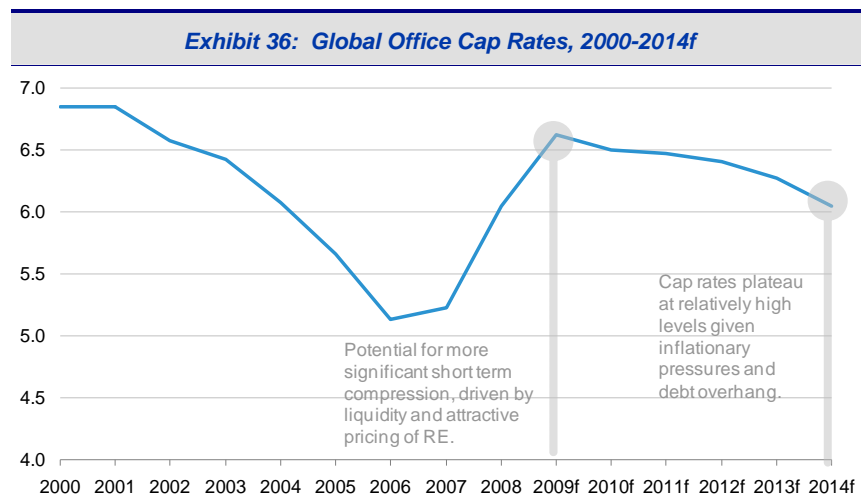
Exhibit 35: Weight of Capital Towards Real Estate, 2009 Year End

Source of Capital/Debt	Major Trends
Institutional investors	<ul style="list-style-type: none"> Denominator effect has reversed leading pension funds and insurance companies seeking to increase exposure to real estate Marked variations in appetite globally, with most dominant investors being 1. Asian Institutions (although from a very low base and focused on domestic and major global markets); 2. Germany Insurance Companies; 3. European pension funds.
Sovereign Wealth Funds (SWFs)	<ul style="list-style-type: none"> SWFs continue to allocate significant funds to real estate, and are increasing the scale and sophistication of their platforms.
REITs	<ul style="list-style-type: none"> Successful recapitalizations across global markets has overcome most of their debt-related challenges, and created significant buying power
Private/Retail	<ul style="list-style-type: none"> Family offices and HNWIs seeking to exploit dislocations in real estate markets and relative attractiveness versus other asset classes Retail investors attracted to real estate, whether via REITs or other vehicles such as German Open End Funds.
Users/others	<ul style="list-style-type: none"> Sharp rise in sublease availabilities, no demand for new facilities
Debt providers	<ul style="list-style-type: none"> Huge pressure to reduce exposure to real estate Selective lending – good location and well-leased properties Reduced LTV across most markets

Source: RREEF Research, February 2010

Performance prospects

Given the re-pricing of real estate during 2008-2009 and the more recent improvements in investor sentiment, it is likely that global cap rates had, by the start of 2010, reached a peak and started to compress. It is difficult to gauge precise levels of cap rates due to the low levels of transaction activity, significant variations in quality of product as well as methodological differences in the cap rate being measured (whether for in-place rents, or market rents, etc.). Despite these difficulties it is likely that market cap rates have already reached a peak and are set to compress over the coming years (Exhibit 36). As shown in the chart, it is possible that cap rates could compress more than expected due to high levels of liquidity, but this will not be true for all markets and, if it should occur too far ahead of market fundamentals, would not be sustainable. A more likely scenario is for cap rates to compress more gradually over the coming years, but to remain relatively high driven by upward pressure on bond yields and the considerable challenges that remain in the debt markets.

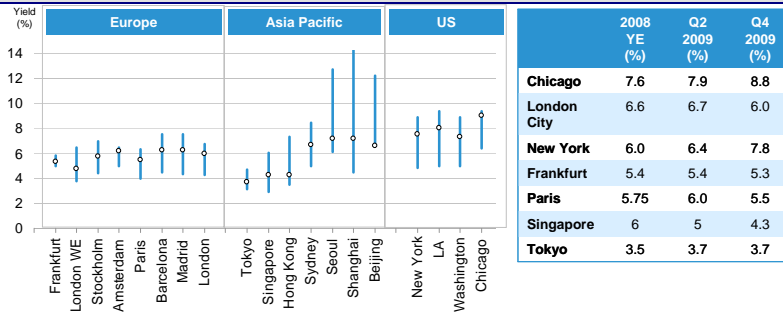


Source: RREEF Research, February 2010

Note: Based on 30 key markets in each region, weighted by market size at year-end 2008, f=forecast

Relative pricing trends vary considerably (Exhibit 37). Cap rates in Europe historically move within a narrower range than the Asian and US markets where cap rates have a history of greater volatility. True, many European markets have moved closer to the top of their historical ranges than the US or Asia, but this relative position means less when the historical ranges are so much narrower. In the US, although cap rates have risen sharply over the past two years, they have not come close to their upper historical boundaries. The Asia Pacific region shows the most diverse cap rate patterns across individual markets. Seoul’s cap rate, for example, moved toward near-record lows. Hong Kong’s cap rate also moved near the lower end of its historic compression range. Even Singapore’s oversupplied market has quickly corrected and experienced a notable degree of cap rate compression in 2009.

Exhibit 37: Cap Rate Q4 2009 Relative to its Range Since 1990



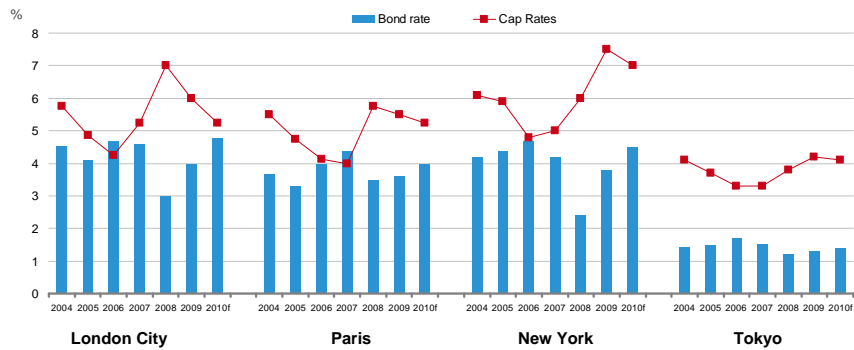
Source: RREEF Research; CBRE (Europe); RCA and REIS (USA); JLL (Asia Pacific), February 2010

Note 1: Data series starts in 1990 for all cities except Shanghai (1995), Beijing (1998), Tokyo (1997), and Seoul (1999). Data series ends 2009Q4 in all cities except Los Angeles (2009 Q3)

Note 2: Date as of February 2010

As previously noted, liquidity and competitive pricing are drawing early investors to selected markets, and it is in these markets where cap rate compression has first appeared. Cap rates for the best quality assets in London, Paris and New York have, for example, already compressed significantly over recent months, and others are starting to follow.

Exhibit 38: Cap Rate and Bond Rates for Key Global Office Markets

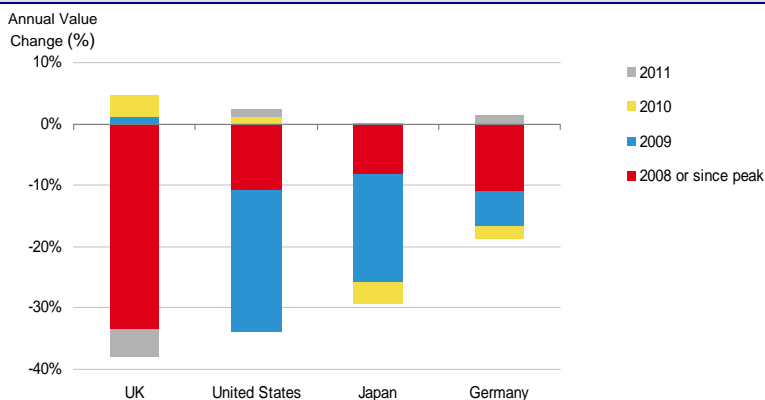


Source: RREEF Research; Global Insight, Deutsche Bank, February 2009

Notes: Year-end data points; 10-year yields for all countries; f= forecast

Based on the topping out and compression of cap rates, many markets have moved a long way through their cycle of value decline. Rents may still be under pressure in many markets, but the compression of cap rates is more than compensating for these declines. Exhibit 39 shows value decline over a four year period, 2008-2011. This demonstrates not only the severity of the decline in the UK market but also the timing of value losses in the current cycle. Declines in other markets began later and moved more slowly through the cycle. The US and Japan took even bigger hits to commercial real estate values in 2009 than they did in 2008. In Germany, where the real estate downturn has been mild by comparison.

Exhibit 39: Value Change across Major Real Estate Markets, 2007-11

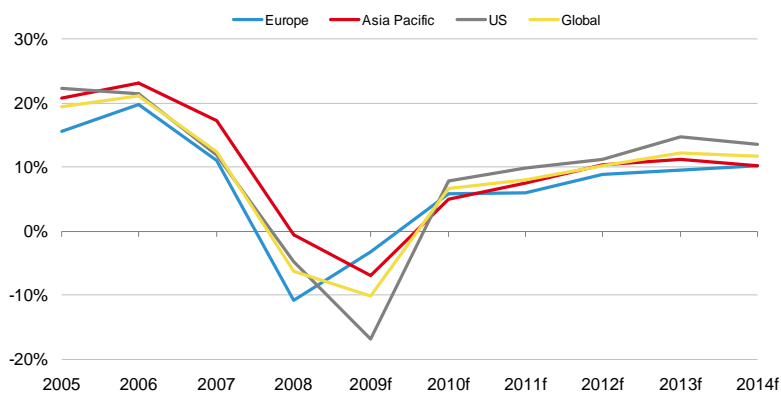


Source: RREEF Research, February 2010

Note: Value change based on unlevered market returns

The outlook for expected returns has shifted markedly over recent months, as it became more likely that cap rates would peak and compress earlier than originally expected. For much of 2009, most analysts had expected 2010 to be another weak year for real estate performance, to be followed by a gradual recovery in 2011 and stronger performance in 2012-2014. Earlier cap rate compression implies a recovery that will likely be more front loaded, with positive returns expected across all regional markets in 2010, and a weaker recovery during the outer years. This revised outlook for returns means that real estate should generate relatively attractive performance over the coming three to five years, although there remain significant risks around this outlook, as explained in more detail later in the paper.

Exhibit 40: Total Market Returns by Region



Source: RREEF Research, February 2010

Note: Based on 10 key markets in each region (Americas, Europe and Asia Pacific), weighted by market size at end 2009, f=forecast

Note: Total markets returns refer to prime market returns

Post-Crisis Implications: Real Estate Pricing and Market Scale

Although significant uncertainties overshadow the outlook for global real estate markets, stabilisation should begin to take hold and spread across markets during 2010. The turn of a real estate cycle at peak or at trough always has important implications for real estate and for investors in the market. With that in mind, this section of the paper focuses on post-crisis implications in two related areas: the pricing of real estate and issues relating to market size.

Real Estate Pricing

First, we turn to the pricing of real estate, the timing of which can trigger entry (or re-entry) into property investment. At this stage of any property cycle, limited transaction activity makes it difficult to assess pricing levels across real estate markets. This has been especially true in this cycle, as a combination of illiquidity and distress caused transaction activity to grind to a near-halt in many markets.

But as explained earlier in the paper, global transaction activity has resumed, rising from US\$ 54 billion in Q1 2009 to US\$110 billion during Q4 2009.²⁰ This sharp increase in deal volume is somewhat misleading since nearly half of total global transactions in Q3 2009 occurred in China. Still, the other regions of the world – Americas, EMEA, and Asia Pacific ex-China – all saw modest increases in deal activity over the same period, and it illustrates how the broader, overall market is stabilising. As investor confidence recovers and spreads, transaction volumes will rebound further and provide greater certainty over the pricing of markets.

As cap rates start compressing and markets start to recover, attention quickly turns to whether and when markets will start to become “too expensive” given the risks facing the outlook. It is within this context, that RREEF Research has updated its indicator of market pricing across countries and over time. This tool illustrates how most real estate markets “overheated” during the period 2006-2008, but then became attractively priced during 2009-2010. The tool can also help understand how the pricing varies from market to market, and over time.

The “Real Estate Pricing Indicator” (REPI) explained in this report is based on four key components of market pricing:

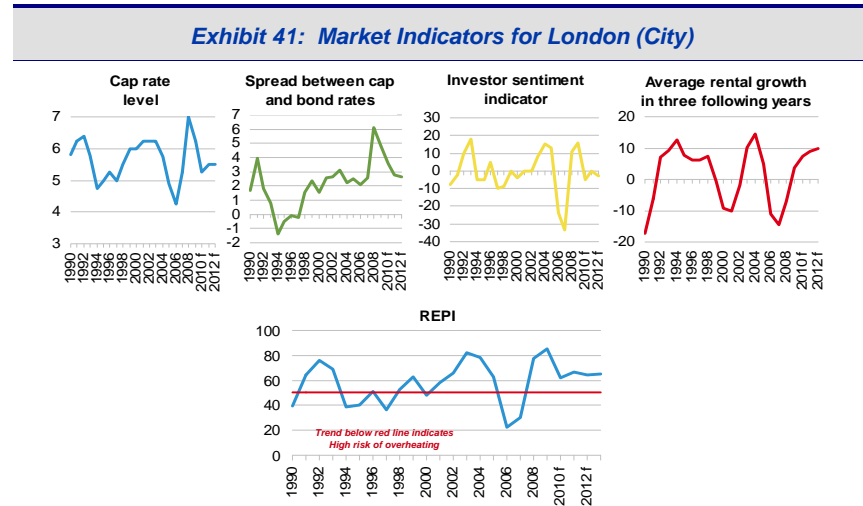
1. **The level of cap rates** relative to the historical range of an individual city. The lower the cap rate, the lower the income return and the more highly/aggressively priced the market is.
2. **The spread between cap rates and government long-term bond yields**, as a proxy for the pricing of real estate relative to the risk-free rate and to other asset classes.²¹
3. **The prospect for future rental growth over the coming three years.** Everything else being equal, lower cap rates or higher prices can be justified when there is the prospect of stronger rental growth and vice versa.
4. **The weight of capital towards real estate**, as implied by future movements in cap rates. Movements in cap rates are a useful proxy of the weight of capital, with strong cap rate compression being associated with increased appetite to invest in real estate.

The analysis involves comparing all four of the variables in each city with the long-term average for the city, and then normalising and aggregating the scores. This

²⁰ Real Capital Analytics, December 2009

²¹ The spreads have been calculated using real bond yields to enable longer run comparisons, given the generally higher levels of bond yields and inflation during the early 1990s.

process identifies the degree of over/under-heating relative to each city's own behaviour and history. The way in which the four components behave over time is illustrated for the case of London in Exhibits 41 and 42. The first exhibit shows the performance of the City market in each of the four indicators between 1990 and 2012, and the aggregate REPI for the City over the same period. These indicators clearly show the aggressive pricing of the market in 2006 (low cap rates, low spreads, weakening investor appetite and weak prospects for rental growth), and the rapid corrections of the market over the following two years.

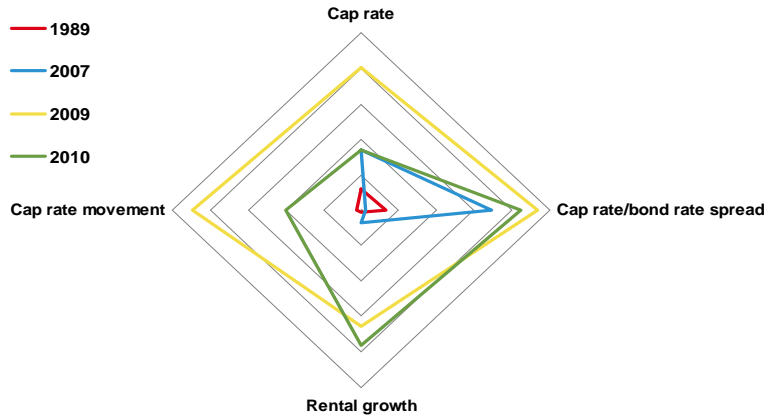


Note: REPI indicator shows the average of the normalized scores for each of the four components for the London Office market.

Source: RREEF Research; Deutsche Bank Research; Global Insights; PMA; CBRE, February 2010

The lower chart in Exhibit 41 and the cobweb chart in Exhibit 42 illustrates the cyclical trends in the London market over the past two decades. London has moved through a series of cycles with three periods when it was aggressively priced (1988-1990, 1994-1997, and 2006-2007) and three periods when it appeared to offer significant value (1992, 2003 and 2009). The recent correction in pricing of the London market, and the prospect of a return to rental growth in 2011-2013, lay the basis for the market becoming attractively priced in 2009, and this is set to continue in 2010.

Exhibit 42: The Real Estate Pricing Indicator Cobweb for London (City)

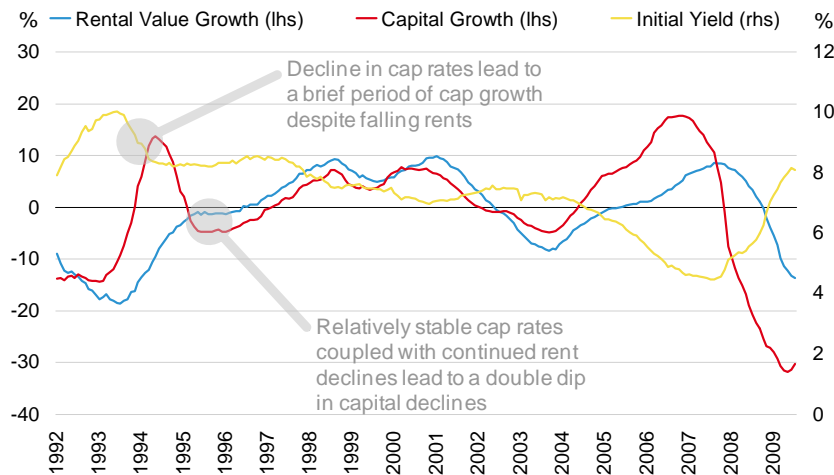


Source: RREEF Research, February 2010

Note: Chart shows normalized score for each variable at different points in time with positions close to the centre implying relatively aggressive pricing, and those further to the edge indicating relatively attractive pricing

Although the London market remains attractively priced, the high levels of liquidity and the lowering of cap rates over recent months suggest that the market could become overpriced fairly quickly, as has occurred during other cycles.²² Exhibit 43 shows how a premature recovery in UK pricing in the early-to-mid 1990s led to a double-dip situation. In short, cap rates began to compress while rents were still falling. This triggered a brief period of value growth, but with rents continuing to decline, cap rates finally stopped compressing. As a result, capital values took a second dip until the market reached equilibrium a couple of years down the road. The lesson here is that the market could, as in the early-1990s, suffer from a double dip if pricing gets too far ahead of rental recovery.

Exhibit 43: Monthly UK IPD Office Yields, Rent Growth and Capital Growth Index



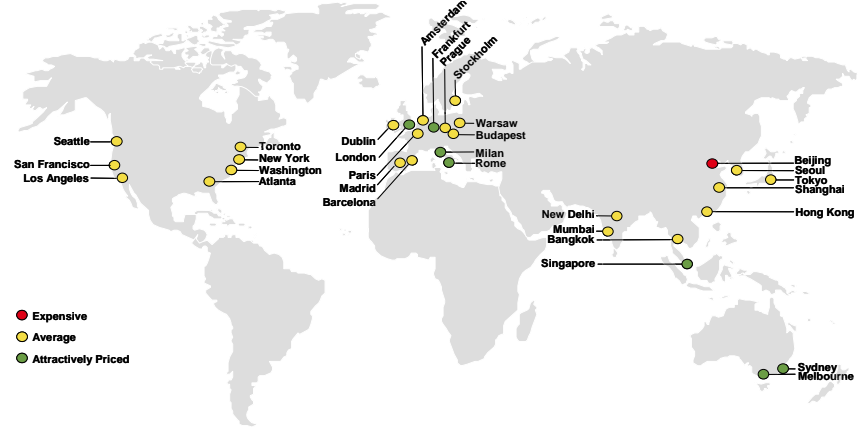
Source: IPD, RREEF Research, February 2010

Throughout this paper, we have pointed to signals of cyclical movement in markets

²² Hobbs, P., *What will property offer in a post-recessionary environment*, IPD/IPF Conference, November 2009

like London and parts of Asia. RREEF's calculation of 2009's REPI scores for major world markets highlights this point. Indeed, the office markets in London, Frankfurt, Sydney, Melbourne, and Singapore appeared, through 2009, to be very attractively priced. On the other hand, some other markets were closer to "average" pricing levels, but often for different reasons. For instance, many of the US cities were still in the process of a correction while in Seoul, cap rates had already compressed significantly during the year. By the end of the year only one city, Beijing, was shown as being aggressively priced based largely on the current levels of cap rates and the prospects for rental growth.

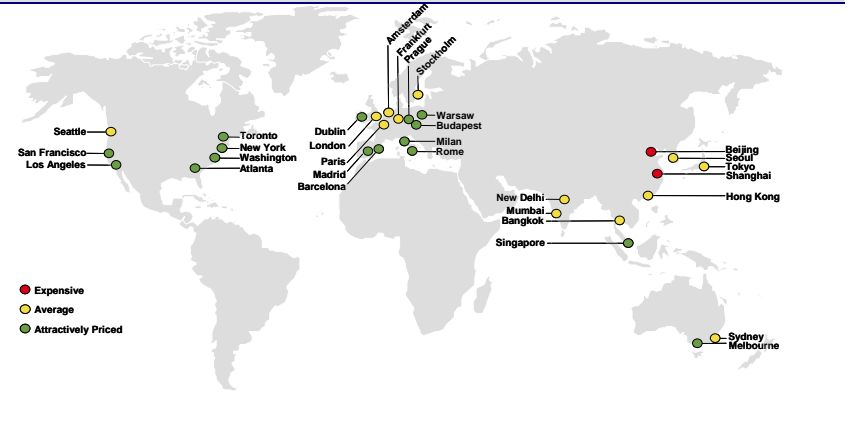
Exhibit 44: Global Real Estate Pricing Indicator, 2009



Source: RREEF Research, February 2010

Given the movement of markets through their cycles, the REPI is set to change across global markets during the course of 2010. Aggressive cap rate compression in Asia Pacific will limit the attractively priced opportunities that were apparent during the course of 2009. The attractive pricing that existed in London and other parts of Europe such as Paris and Frankfurt, during the course of 2009 will be reduced. Unless markets overshoot during the course of the year, their pricing should be in line with historic average levels, but they will become less compelling as investment destinations. Another major change relates to many of the US markets that are shifting towards being very attractively priced during the course of 2010.

Exhibit 45: Global Real Estate Pricing Indicator, 2010

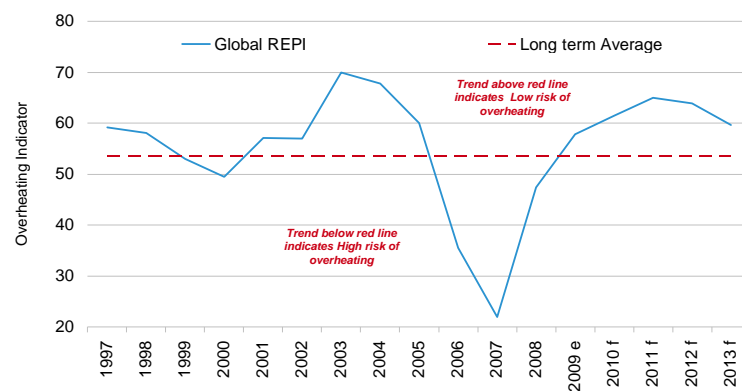


Source: RREEF Research, February 2010

This analysis clearly demonstrates the way in which most real estate markets have

moved through a major cycle over the past five years (Exhibit 46). After being attractively priced in the early years of the decade, real estate markets became aggressively priced during the period 2006-2008. This aggressive pricing started to reverse, driven by frozen credit markets and overleveraging, as well as the global economic recession. The REPI global model suggests that the market had worked through much of the pricing correction by the end of 2008 and started to provide attractively priced opportunities during 2009. These opportunities are set to continue during 2010, and as they do so, the REPI indicator can help provide an absolute measure of market pricing that can alert investors to the prospect of markets once again becoming overpriced. Even though generally more positive pricing environment is anticipated in 2010, outstanding risks remain. These include troubled debt markets (US), conditions conducive to a double-dip real estate recovery (UK), aggressive cap rates (Asia Pacific, in general), and excessive liquidity and weight of capital (China).

Exhibit 46: Global Real Estate Pricing Indicator



Note: REPI indicator shows the global average of individual city REPI scores which, in turn, are based on the average of the normalized scores for each of the four components described in the text.
 Source: RREEF Research, February 2010

Scale of the Global Market

For years, analysts have debated the actual size of the invested global marketplace for real estate, and RREEF Research has contributed to this debate by developing a systematic methodology for estimating and tracking the size of the invested market.²³ We continue to monitor and forecast the scale of the real estate market, even through the times of economic turbulence as experienced in 2008-2009. Understanding the scale of the market allows investors to gauge the extent and distribution of the global “neutral” portfolio against which many individual portfolios are benchmarked.

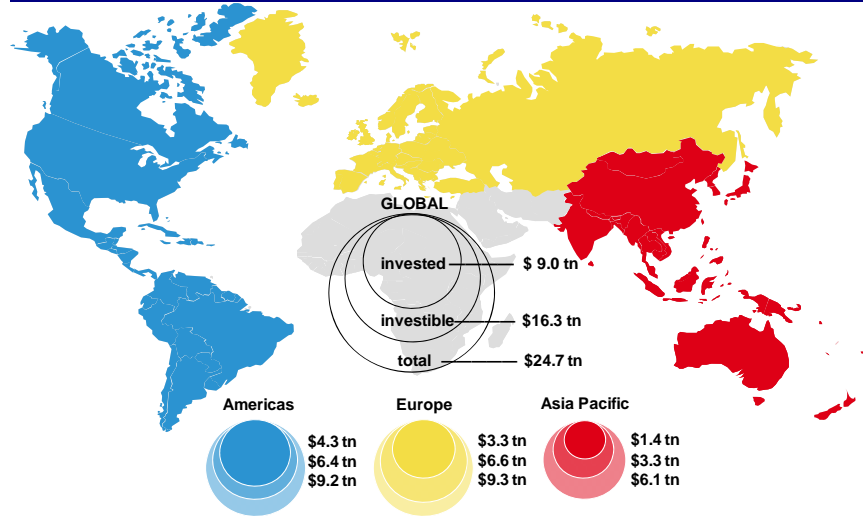
Our updated analysis for 2009 (Exhibit 47) shows the current value of the invested global real estate market to be US\$9 trillion. The invested market represents all commercial property owned by professional real estate investors, i.e., money managers, funds, private investment vehicles, listed companies, institutions etc. The larger investible stock includes all investment-grade properties regardless of whether ownership is by investor or occupier/end-user. By our calculations, the global investible commercial property stock totals to US\$16.3 trillion as of year-end 2009. This is almost double the amount of the invested stock, i.e., the current market controlled by property investors. Estimates of total stock, which we calculate at US\$24.7 trillion, are included for reference purposes only since this sum includes all commercial property worldwide regardless of either quality or ownership. In other

²³ RREEF Research, *The Future Size of the Global Real Estate Market*, July 2007

words, it includes all non-investment grade commercial property.

Changes over time in physical stock, capital value, and ownership status impact the calculations for the size of the invested commercial property market. While construction and transaction activity shut down in 2009, valuations proved more volatile, moving in line with the sharp changes in rents and cap rates.

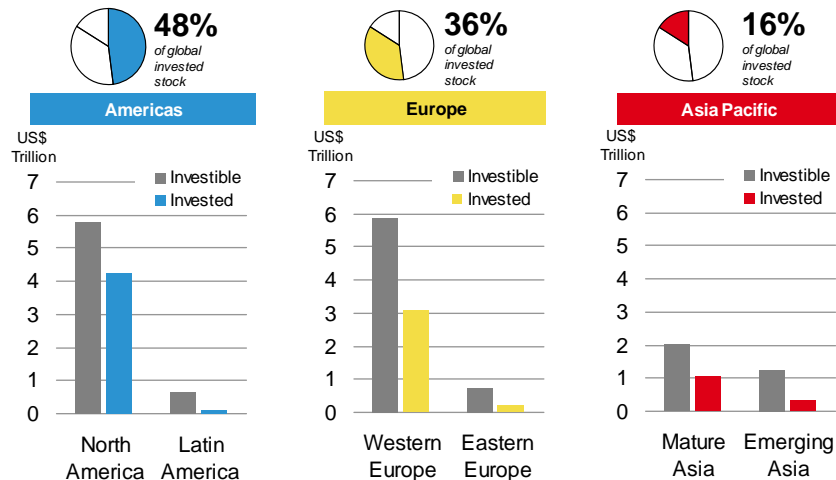
Exhibit 47: Scale of Total, Investible and Invested Real Estate, by Region, 2009 Year End



Source: RREEF Research; ULI/PWC; DTZ, February 2010

Nearly half of the invested market (48%) lies in the Americas, with just over one-third (36%) in Europe and the remainder (16%) in the Asia Pacific region. As Exhibit 48 shows, North America's invested market is already quite extensive and takes up a larger share (in percentage terms) of the greater investible market than do other regions. In the rest of the world, the ratio of invested-to-investible space shows more potential for untapped expansion. In most regions outside of North America, the invested market represents 50% or less of the overall investible potential.

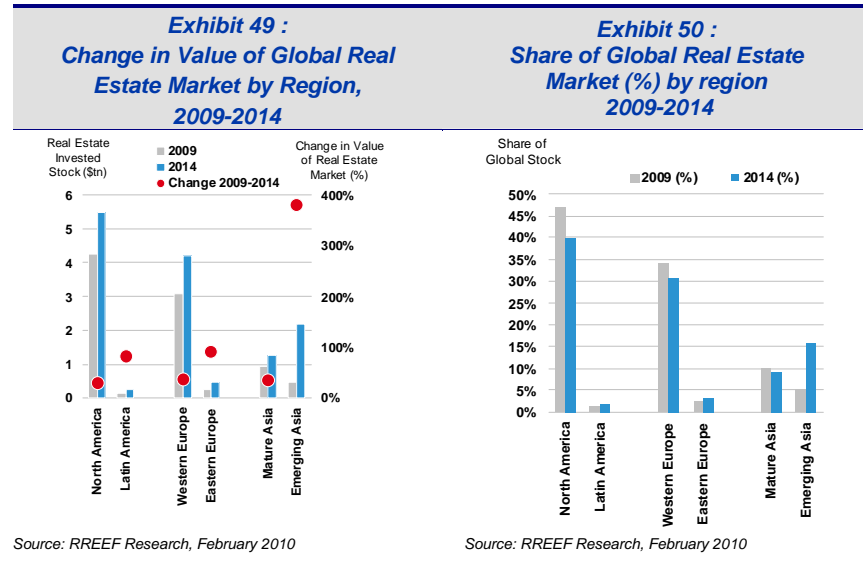
Exhibit 48: Global Real Estate Market Value, Year End 2009



Source: RREEF Research, February 2010

Over the next five years, the Americas will remain the largest invested region. We expect the invested market in the Americas to surpass US\$5 trillion by 2014, with Europe topping the US\$4 trillion mark by the end of the forecast period. The growth in these two regions will be backloaded, with the gains coming in the latter years of the forecast. Asia Pacific will provide the fastest growth and the largest net gains. We anticipate the size of the invested market in Asia to more than double over the 2009-2014 period. By 2014, the Asia Pacific region's invested commercial property market is likely to exceed US\$3 billion, putting it very close in size to Europe for the first time. The size of Asia Pacific's real estate market will narrow the gap with the other regions during the next five years.

Asia Pacific's extraordinary gains in its invested stock will come less from mature countries like Japan and Australia than from emerging markets where growth is currently led by China and India. By 2014, the invested stock for Asia Pacific's emerging markets is expected to increase by a net US\$ 1.7 trillion, a 380% increase from 2009 (Exhibit 49). Other emerging markets will experience gains as well but not on this scale. As a share of the global invested commercial real estate market, Emerging Asia Pacific is expected to rise from 5% today to 15% by 2014 (Exhibit 50). This rapid gain in global market share foreshadows potentially significant impacts on portfolio allocations for investors.



Post-Crisis Implications: Investment Strategies

Review of Strategies

Although real estate is in the process of a deep and long correction, it remains a large and attractive asset class for many investors. The market has been particularly impacted by its exposure to the debt markets at a time of a global credit crisis. Despite this, most markets are showing clear signs of moving through the downturn with some having relatively strong performance during the second half of 2009. These signals suggest that the downturn is precisely that – a “cyclical downturn” rather than the end of the asset class. Over recent decades real estate has matured as an asset class, and the current cycle is working as a catalyst to help the asset class mature yet further. The intense questions raised by investors and industry bodies over alignment of interest, transparency, fees, liquidity and reporting will lead to a strengthening of the asset class that will likely increase its attractiveness to institutional investors.

One of the major ways in which this cycle is leading to a maturing of the asset class is through more explicit assessments of the risks associated with investing in real estate. These risks vary considerably according to the nature of investment, but they can best be understood around the four classic investment styles, as follows:

Core/core+ strategies generally offer lower risk with a relatively high income return and a focus on more mature, transparent and liquid markets. Core-type strategies are exposed to market movements as there tends to be little scope to manage assets through the cycle. These strategies also tend to be exposed to greater liquidity or redemption risk as many Core funds are Open-ended. This scope for greater liquidity has created challenges over the past couple of years when many investors sought to redeem their investments at a time of market weakness.

Opportunistic strategies tend to be riskier than core-type strategies because they have a higher proportion of return coming from value growth, they tend to be more highly leveraged, and they usually focus on more volatile or emerging markets. Although Opportunistic strategies have more scope to manage their way through market cycles, they suffer from inherent weaknesses. First, reliance on high levels of leverage can lead to cyclical problems of increased debt costs, reduced availability, which makes it difficult to execute investment programs or to refinance existing loans. Second, a strong focus on development or asset-repositioning programs can require high levels of cash flow – something that has been difficult to maintain during the recent downturn.

Value-added strategies tend to fall between the two extremes, in terms of return targets, leverage, and appetite for risk. Value-added strategies face similar challenges with regard to leverage, but the levels of finance tend to be lower and the income return tends to be higher, thus making refinance somewhat less of a hurdle. Value-added strategies also face the challenge of being more exposed to movements in market value, but active management policies make it easier to guide their way through the periods of declining value.

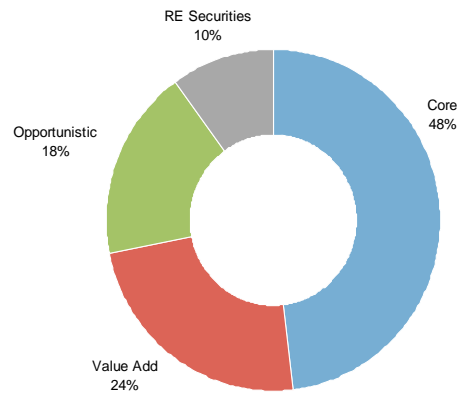
The listed real estate sector (REITs or LPTs and listed developers) possesses many of the characteristics of real estate as well as the broader equity markets. As has been clearly demonstrated through the current cycle, real estate securities suffer from a high degree of volatility compared with the direct real estate market. Despite this volatility, real estate securities have a series of strengths including their liquidity and scope for diversification, whether relative to broader equity and real estate markets, across countries and across real estate portfolios.

These four broad investment strategies capture the range of ways most equity investors participate in the real estate asset class. They help understand the nature

of the strategy as well as the distinct types of risk. There are, however, important variations in the risks, and the returns, that can be expected on two important dimensions, geography and time.

Although difficult to arrive at precise figures, it is estimated that nearly half of the global real estate market (48%) comprises less risky Core-type assets. The riskier Opportunistic segment make up a relatively small sub-20% of the overall marketplace, and Value Added a further 25% or so (Exhibit 51). The Securities market, at 10%, is the smallest segment of the market. Geographically, as we saw earlier (Exhibit 47), North America dominates the global real estate market, with 46% of the total invested market. In Europe, the UK is a major component of the market, accounting for just over one-third while its GDP accounts for around 10% of the total. In the Asia Pacific region, Japan dominates, with the value of its real estate assets exceeding the rest of Asia Pacific combined.

Exhibit 51: Global Market Value by Product



Source: RREEF Research, February 2010

Note: Estimated share of the total \$9trillion global real estate market

Beyond the geographic variations in the scale of the four key investment styles, are important differences in the nature of returns that the strategies have generated across the regions, as summarised in Exhibit 52²⁴. There are significant analytical limitations relating to the paucity of data, particularly for Value Added and Opportunistic investing, but also relating to the appropriate time period that should be used. For instance, although the UK and US have robust long term performance series for Core real estate, the long run averages (11.5% for UK 1971-09, and 9% for US 1978-09) are not appropriate due to the inflationary pressures in the early years. There are also marked variations in average returns according to the property cycle with, for instance, the average returns of the past 15 years being 20% or so higher than the past ten years. These limitations make it hard to draw firm conclusions from a comparative analysis, but Exhibit 52 still helps provide a number of important insights, three of which are summarised below.

1. Real estate has tended to generate relatively attractive returns, both in nominal and real terms. The comparison suggests that exposure to the global real estate market according to its investment style (Exhibit 52) would have generated a long-term return of 10%, well ahead of average CPI of 3%.²⁵

²⁴ PERE, *Risky Business*, February 2010

²⁵ Global Insight, *World Overview Q4 2009*, based on OECD CPI

2. Opportunistic strategies have generated generally higher returns, although the recent very poor performance means this is lower than the conventional 18-20%+ target often quoted for such strategies.
3. Important regional variations exist for the different strategies. For example, there has been a tendency for Western Europe and the US to generate higher Core returns than in Japan or Asia.

These returns, of course, represent broad past performance and do not necessarily reflect current or future expectations nor do they represent any single point in time. Returns and markets are never static; rather, they are in constant cyclical movement. The implication for investors is that cyclical timing is important when allocating across these strategies.

Exhibit 52: Historical Return Profile across Regions and Strategies								
	Europe			America		Asia		Global
	UK	Continental Europe	CEE	North America	Latin America	Japan	Asia ex Japan	
Core	7%	7%	9%	7%	9%	5%	6%	6.9%
Value added	10%	9%	11%	9%	11%	7%	11%	9.1%
Opportunistic	12%	14%	16%	15%	17%	12%	17%	14.8%
RE securities	7%	10%	11%	10%	13%	7%	10%	9.3%
	Global aggregate							10.0%

Source: RREEF Research, IPD, NCREIF, FTSE EPRA/NAREIT, Townsend, PERE, February 2010

Note: Indicative returns for different investment styles across different markets based on historic data where available. Global aggregate is based on weighted average of returns according to market size and performance across regions and strategies. Returns are purely indicative and should not be taken as forecasts of actual performance

The volatile and changing nature of the real estate markets are well-illustrated by the long run IPD and NCREIF returns for the US and UK markets (Exhibits 53 and 54). These charts demonstrate that even for this least risk-tolerant of real estate strategies, returns have shown considerable volatility over time. By comparing the current year performance (in the blue bars) with the return for the next three years (red line), these charts also demonstrate the importance of adopting a counter-cyclical investment strategy. In the UK, for instance, high returns of close to 20% were generated in 2006 but investments in this year would have suffered from negative 23% returns over the following three years. Conversely, investments in 2008, a year of negative 22% returns, are set to benefit from a positive return of around 20% over the following three years.

Exhibit 53 : IPD Core Unlevered Total Returns (UK), 1971 to 2011f

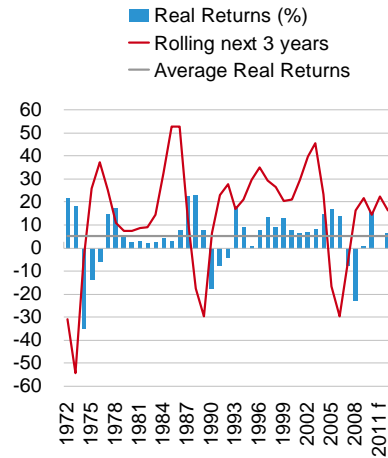
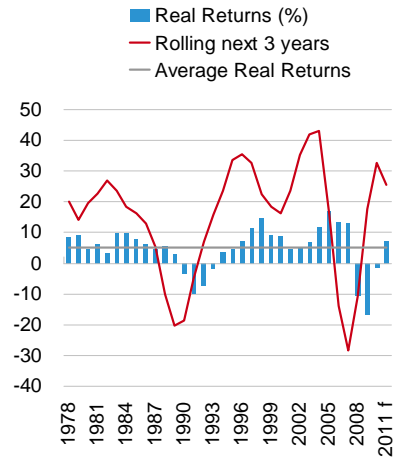


Exhibit 54 : NCREIF Core Unlevered Total Returns (USA), 1973 to 2011f



Source: IPD, PMA, RREEF Research, Global Insight, February 2010

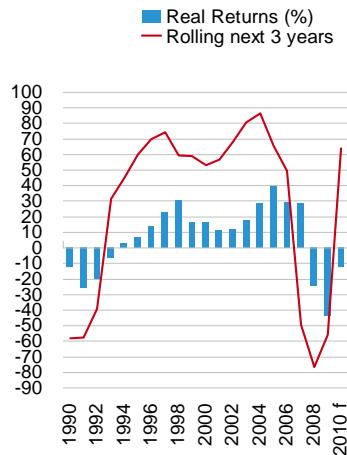
Source: RREEF Research, NCREIF, as of February 2010

Note: Returns are purely indicative and should not be taken as forecasts of actual performance, f=forecast

Note: Returns are purely indicative and should not be taken as forecasts of actual performance, f=forecast

This volatility of returns is also apparent for other risk/return appetites, as shown for Opportunistic investing in the US in Exhibit 55. The time series here is a bit shorter, but the pattern of even greater volatility is unmistakable nonetheless. And as previously shown in this paper (see again Exhibits 7 and 8), volatility in the global real estate securities markets has been widely documented.

Exhibit 55: Opportunistic Returns as Indicated by NCREIF with 60% Leverage, 1990-2011f



Source: RREEF Research, NCREIF, February 2010

Note: Based on NCREIF returns leveraged to 60% to illustrate returns to opportunistic investing. Returns are purely indicative and should not be taken as forecasts of actual performance. f = forecast

Given the inherent cyclical nature of the real estate market, it is necessary to revisit the expectations for returns when developing real estate investment strategies. Relative to historical performance (Exhibit 56), we anticipate that real estate investment in 2010 will generate attractive returns with the global weighted returns set to approach 13% compared with 10% historically. Within the real estate asset class, returns for Core and Value-added strategies in 2010 are likely to provide relatively good cyclical opportunities from among the real estate strategies available (Exhibit 56). Opportunistic strategies will still produce the highest overall returns just as they have

historically, but of course, these strategies also carry the highest risks.

Exhibit 56: 2010-2014 Forecast Return Profile across Regions and Strategies

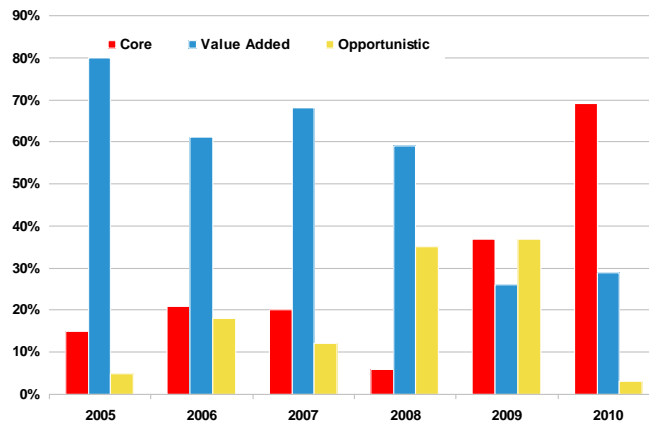
	Europe			America		Asia		Global
	UK	Continental Europe	CEE	North America	Latin America	Japan	Asia ex Japan	
Core	9%	8%	8%	10%	9%	9%	7%	9.2%
Value Add	11%	13%	11%	13%	15%	13%	14%	13.0%
Opportunistic	15%	17%	18%	18%	19%	16%	20%	17.8%
RE Securities	8%	11%	12%	11%	13%	8%	12%	10.5%
	Global Aggregate							12.6%

Source: RREEF Research, February 2010

Note: Indicative net returns for different investment styles across different markets. Returns are purely indicative and should not be taken as forecasts of actual performance

In 2010, with the crucial turn of the cycle unfolding unevenly across markets and sectors, investors are likely to consider opportunities ranging across the investment spectrum from Core to Opportunistic. Current investor sentiment seems to be focused on Core strategies, as demonstrated by INREV's latest Investor Intentions Survey summarised in Exhibit 57. This survey reveals that 70% of investors are targeting Core investing during 2010, up from an average of 20% over the previous five years. In contrast, the appetite for value added and opportunistic strategies is significantly lower than in previous years. This survey reflects the sentiment of investors towards the end of 2009, but as the markets improve and investor confidence returns, it is likely that appetite for higher yield strategies will resume. Given the potential opportunities across the risk styles, the remainder of the section explores some of the options at two ends of the spectrum, Core and Opportunistic.

Exhibit 57: Investor Intentions for Different Investment Strategies



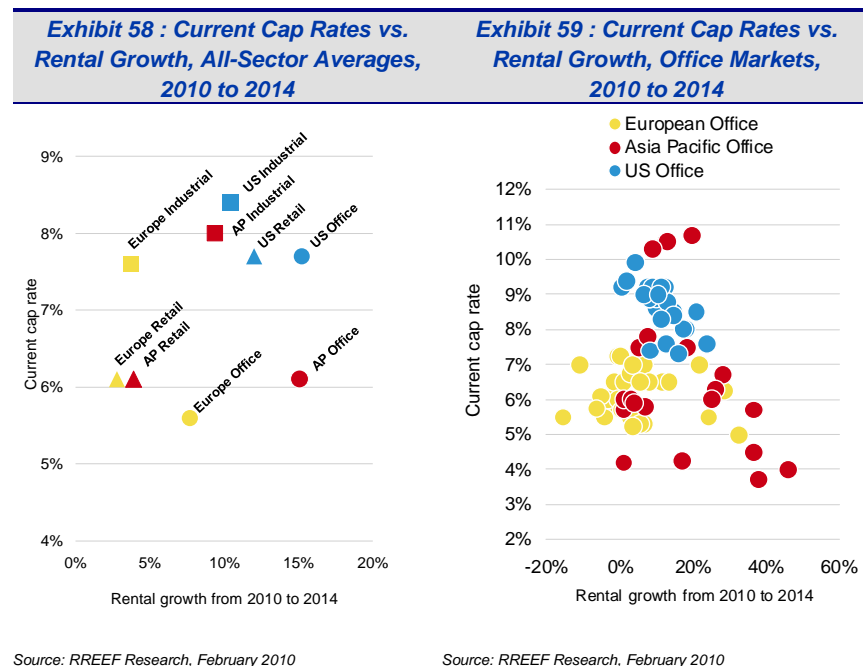
Source: INREV, Investment Intentions Survey, 2006-2010

Note: Based on investors' preferred investment style in coming year, so 2010 results based on survey carried out at end 2009 and published early 2010

Core Investment Themes during 2010

Core-type investments (by definition) focus on the prime, rather than marginal, markets and properties. Among the property sectors, industrial properties currently show high cap rates across all regions, while the office sector is well positioned for solid rental growth over the period 2010-2014, especially in Asia Pacific and the US.

In both Europe and Asia, current office cap rates are low relative to other regions and property sectors (Exhibit 58). In prime European and US cities, office markets tend to produce more homogeneous performance as a region, but this rule of thumb applies less to Asian cities where office performance tends to be more heterogeneous (Exhibit 59). Recent forecasts by RREEF Research indicate that a handful of prime office markets are positioned for relatively swift rental growth potential during the recovery phase of this cycle.



Building on the information in Exhibits 58 and 59 three core investment opportunities emerge. The first includes the volatile markets of this cycle where the recovery is expected to be strong and yields will be above average (Exhibit 60). These would include mostly the severely battered office markets like those in Ireland, Spain, and Singapore, but could extend to other office markets as well and might include particularly volatile markets from other sectors like industrial, residential, and retail.

The second opportunity would also target volatile markets with strong bounceback potential, but where yields are relatively low. These would include the major office markets of the major industrial countries, i.e., mostly the top of the global hierarchy – London, Paris, Tokyo, Sydney, Washington, and the San Francisco Bay Area. It would also include the blue-chip industrial markets of the world’s major container ports like Singapore and Hong Kong as well as the handful of US apartment markets along the East and West coasts where residential development tends to stay perpetually supply-constrained.

The third opportunity lies in high yielding markets where solid rental growth is expected. This group would include a broader, more diverse range of sectoral targets rather than an office-weighted group of markets.

Exhibit 60: Key Core Investment Themes for 2010

Investment Themes	Europe	Asia Pacific	US
Volatile market with strong bounceback and relatively high yield	<ul style="list-style-type: none"> Volatile office markets adversely impacted by current downturn such as Dublin, Barcelona, Madrid, La Defense, M25West and Warsaw. Volatile industrial markets of London and Madrid 	<ul style="list-style-type: none"> Singapore office market 	<ul style="list-style-type: none"> Industrial markets in Oakland, and Miami. Apartment markets in Denver. Retail markets in Seattle
Volatile market with strong bounceback but low yield	<ul style="list-style-type: none"> Major office markets of Paris CBD, Hamburg, London City Nordic retail markets 	<ul style="list-style-type: none"> Sydney, Melbourne, Tokyo and Seoul and office markets Singapore and Hong Kong retail and logistics 	<ul style="list-style-type: none"> Strong recovery office markets such as San Francisco, San Jose, and Washington Apartment markets in San Francisco, San Diego, New York City and Washington
High yielding with solid rental growth	<ul style="list-style-type: none"> Industrial markets in general, with specific focus on port-related and consumer-dominated markets such as Rotterdam, Hamburg and Paris, and CEE markets Emerging retail markets such as Czech Republic, Poland and Portugal 	<ul style="list-style-type: none"> Industrial markets in China and India. Secondary office markets in Australia and Japan 	<ul style="list-style-type: none"> Industrial markets in San Francisco, Orange County and San Jose. Office markets in Boston. Retail markets in Boston, and Washington.

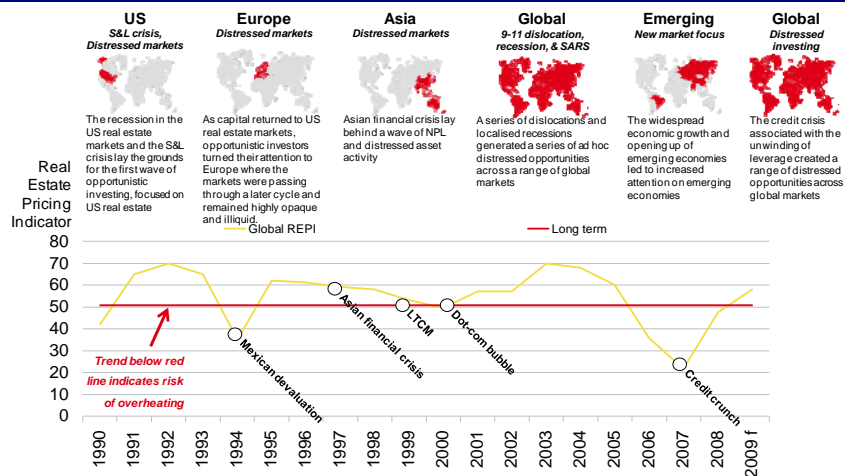
Source: RREEF Research, February 2010

High Yield Investment Themes during 2010

Although many investors are currently focusing their investment strategies on “Core” and “Domestic” markets, 2010 is set to be an excellent vintage for Opportunistic investing. As well-document through this paper, credit-induced market dislocation persists, with many owners and banks facing challenges with their real estate exposure, and many sectors significantly out of favour.

Opportunistic investing tends to benefit from cyclical downturns, but the nature of the opportunities vary from cycle to cycle. These variations are demonstrated in Exhibit 61 in which the REPI is overlaid with a series of external global shocks and implications for investing over the past 20 years. This timeline of Opportunistic investing demonstrates the way in which the challenges, and the opportunities, were regionally specific during much of the 1990s. More recently, and particularly through the current cycle, the external shocks, and opportunities, have taken on greater geographic scope.

Exhibit 61: 20 Years of Opportunistic Real Estate Investing



Source: RREEF Research, February 2010

Note: f = forecast

Beyond the increasingly global nature of Opportunistic investing, the current cycle is generating a specific set of investment themes, as summarized in Exhibit 62.

Exhibit 62: High-Yielding Investment Themes for 2010	
2010 Investment themes	Relative attractiveness
1. Over-leveraged distressed debt	
2. Corporate or government's owner occupied real estate	
3. Recapitalising highly geared RE private funds and REOCs	
4. Dislocated markets and sectors	
5. Emerging markets	

	Limited rationale for investing
	Good potential for investing
	Excellent vintage for investing

Source: RREEF Research, February 2010

Based on the current position of the market cycle, two of the investment themes laid out in Exhibit 62 stand out above the others. One of these is distressed debt related opportunities, whether directly through working out troubled loans, or indirectly, through working with borrowers who need to refinance or recapitalise their operations/assets. Global deleveraging continues to be a challenge particularly for European and US banks which are under pressure to reduce exposure to commercial real estate. These pressures mean that distressed debt will generate significant investment opportunities during 2010 and beyond. Another investment theme involves dislocated markets and sectors, where significant pressures on both real estate fundamentals (negative absorption, rising vacancies and falling rents) and capital markets (capital vacuum, rising cap rates) creates historic acquisition opportunities across markets.

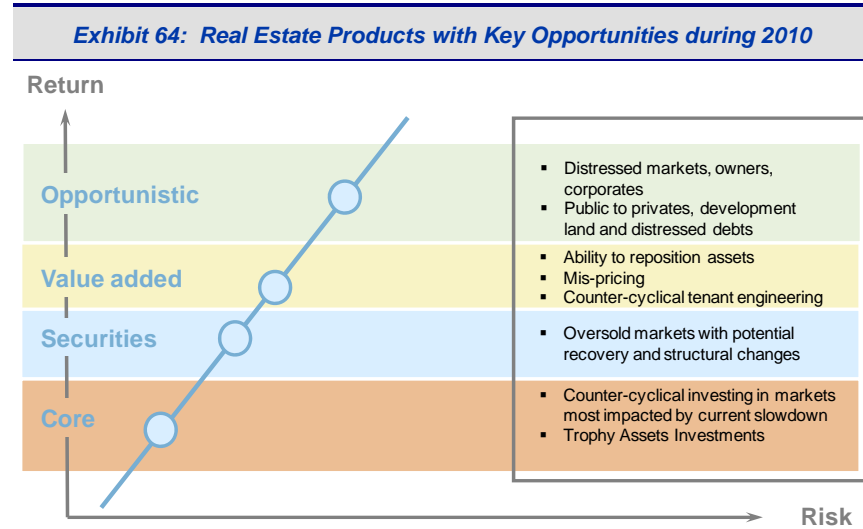
Exhibit 63 shows examples of how some of these opportunistic investment strategies might be focused across cities, property sectors, and capital markets. Singapore, for example, stands out as a classic dislocated market amid a deep cyclical correction in 2010.

Exhibit 63: High-Yielding Investment Themes for 2010			
Investment Themes	Europe	Asia Pacific	Americas
Deep market correction but with strong rebound potential	<ul style="list-style-type: none"> Office markets in Spain, Greece, Ireland and Eastern Europe 	<ul style="list-style-type: none"> Office markets in Singapore, Hong Kong and Indian cities 	<ul style="list-style-type: none"> Cyclically impacted metros and property types in the US
Strong macro-economic fundamentals with possible structural shift of cap rate	<ul style="list-style-type: none"> Central Eastern European retail and office markets 	<ul style="list-style-type: none"> Office markets in Shanghai and Beijing China Industrial markets Office, Industrial and Residential sectors in India 	<ul style="list-style-type: none"> Brazil office markets
Distressed real estate debt exposure from banks	<ul style="list-style-type: none"> Banks seeking to reduce CRE exposure in Europe Workouts from failed and failing banks. Distressed loan books 	<ul style="list-style-type: none"> Workouts from failed and failing banks in Japan Distressed loan books 	<ul style="list-style-type: none"> Banks seeking to reduce CRE exposure in the US Workouts from failed and failing banks. Distressed loan books
Out of favour sectors/countries	<ul style="list-style-type: none"> Hospitality in Western Europe Emerging markets in Central Eastern Europe 	<ul style="list-style-type: none"> Hospitality in Japan Emerging markets, esp China and India 	<ul style="list-style-type: none"> Hospitality in the US Emerging markets, i.e. Brazil
Development	<ul style="list-style-type: none"> Pre-leased developments in Western Europe 	<ul style="list-style-type: none"> Mid to high end residential development in China and India 	<ul style="list-style-type: none"> Pre-leased developments in the US

Source: RREEF Research, February 2010

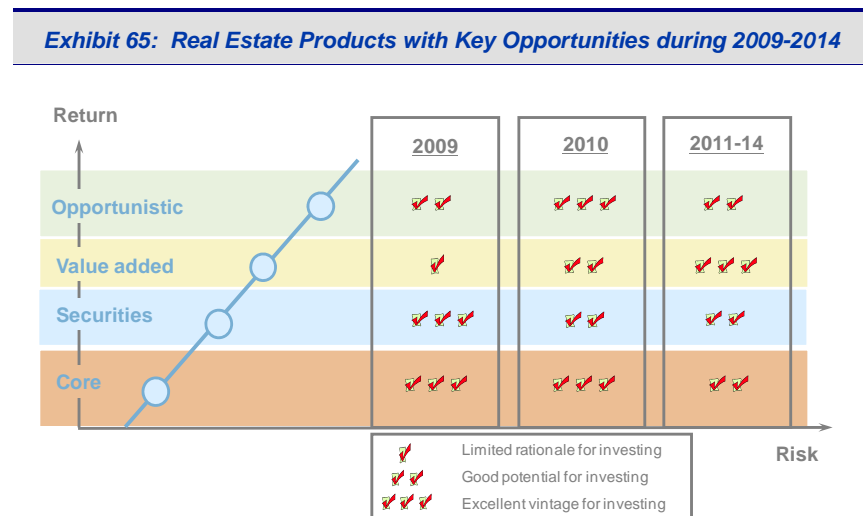
Conclusion

As shown in the opening section of this paper, 2009 proved a turbulent year for property markets across the world. This paper also demonstrates that, given the turnaround in markets over recent months and the prospects for the next two to three years, this turbulence is laying the ground for a profound set of investment opportunities, as illustrated in Exhibit 64.



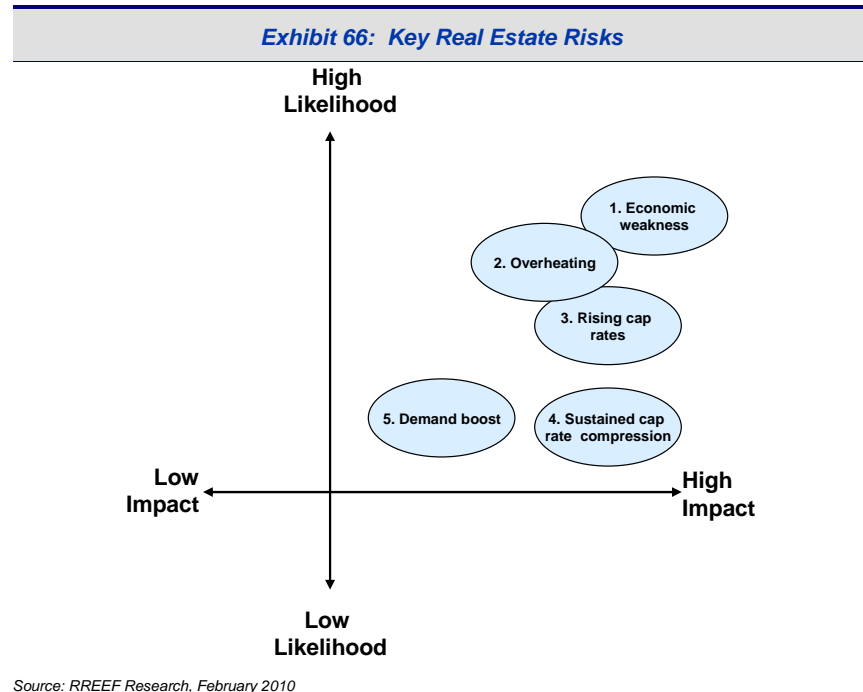
Source: RREEF Research, February 2010

Although opportunities exist along the investment spectrum, they vary in importance over time, as illustrated in Exhibit 65. Strategies that may be less compelling in 2009 (such as Value-added) should become more enticing as initial core investors become more prepared to take on leasing risks. Meanwhile, as more investors are drawn into the real estate asset class and as pricing becomes more aggressive, core strategies may lose some of their current strong appeal.



Source: RREEF Research, February 2010

Although 2010 is set to remain an attractive vintage for real estate investing, there remain a series of important risks and uncertainties facing the market. The fragility and susceptibility of the market outlook to a range of shocks therefore calls for a highly cautious and incremental approach to investment strategy. Risks exist in a range of areas including the economic outlook, the prospects for fundamentals and the real estate capital markets. Some of the most significant risks are summarised in Exhibit 66, and explained in more detail below:



Economic weakness: Although back from the brink of a depression, the global economy faces a series of risks that could lead to weaker than expected growth in 2010 and beyond. Specific risks relate to the way in which governments are able to withdraw from the stimulus packages of the past 18 months i.e. China (too early or too late?), regulatory risks, continued challenges in the credit markets, country specific risks (as recently illustrated by a series of countries in Europe including Greece, Portugal, Ireland and Spain) and challenges to global trade.

Overheating: The risk of excess liquidity and significant cap rate compression over the coming 12 months driven that could lead to markets overshooting and, as a consequence, yield decompression in 2011 and 2012.

Rising cap rates: Spiking inflation, interest rates, and bond yields in 2012-2014 could drive cap rates higher than expected. Inflation and interest rates are set to rise over the coming three to five years, but there is a risk that they could rise even further causing upward pressure on cap rates.

Sustained cap rate compression: More of an upside risk relates to the prospect of a structural compression of cap rates in an extended low interest environment.

Demand boost: A further upside risk relates to a stronger than expected recovery that would boost demand – a scenario that is not currently incorporated into most economic forecasts.

Given these risks, and with markets changing so rapidly, all those involved in real estate share a professional obligation to monitor and review the evolving outlook for this asset class so as to fully understand its implications. This should be done on an even more frequent basis than usual and such analysis should be fully integrated into the investment process, at the portfolio and asset-specific level.

It is within this context, that the Real Estate Pricing Indicator, or REPI (Exhibit 46), developed through the paper is likely to be of significant value, in providing an absolute and forward looking measure of the pricing of real estate markets. This indicator provides a useful tool in assessing the relative value offered by real estate markets during these times of exceptional uncertainty.

Beyond these market-related risks, there is a need to consider a range of additional risk-related factors associated with investing in real estate. On the one hand, these relate to portfolio-specific factors such as portfolio concentration and diversification, as well as leverage levels and, where appropriate, currency management. On the other, they relate to execution risks, such as counterparty risks, alignment of interests, and decision-making experience and capabilities. These broader risks associated with investing in real estate have come under great scrutiny during the current investment cycle. This attention, and the changes that are underway throughout the industry, suggest that the current cycle will come to be seen as a catalyst to help the asset class mature yet further. Increased awareness of the full spectrum of risks associated with real estate investing, including the market-related risks covered in this paper, is essential. Such awareness better prepares investors for understanding the appropriate role of real estate as a component of their broader investment portfolios.

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