RREEF Research

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Investment Outlook: A Mid-Year 2010 Review
The Bulls Have Taken Over the Investment Market!

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Introduction

The strength of the investment market for real estate was the big surprise during the first half of the year and we will be looking for transaction volume to leap as we enter the second half of 2010. Capital and pricing for core real estate is aggressive in this early stage of economic recovery, coming in advance of real estate market fundamentals reaching bottom.

Outside of the surprisingly strong capital inflows, the economy and property markets have generally behaved in line with our prior forecasts during the first half of the year, and so our updated forecasts remain similar to our previous outlook.

RREEF Research recently completed its current semi-annual economy and capital and property market forecasts for the US and this paper will focus on changes from the previous strategic published in March for the economy and capital and property markets. In conclusion, we will discuss implications for investment in the second half of 2010. We believe that real estate fundamentals are on the mend, and that investments made during the early stages of the recovery will outperform, but at the same time, underwriting must be performed with discipline.

Economic Forecast

Economic prospects today are about the same as was forecast in early 2010, when GDP growth was forecast at 2.2 percent for 2010 and 2.9 percent for 2011. Currently, we are anticipating 2010 growth at 2.8 percent and 2011 growth at 2.4 percent. These changes continue to reflect a recovery which is slow compared to past business cycle recoveries. Employment growth was forecast at about 500,000, whereas we are currently forecasting around 700,000 for 2010, a very modest improvement.

A number of positive factors are now more evident in this recovery. Most importantly, the financial markets that were the primary cause of this recession have largely stabilized and bank balance sheets continue to improve as the steep yield curve makes lending profitable once again. Global economies, especially emerging markets, did not experience the severe recession that hit the US and Europe, and are growing at a surprisingly strong rate. Home prices stabilized more quickly than anticipated. And possibly more importantly, consumers are somewhat more upbeat, having made substantial strides in rebuilding their balance sheets through savings, stock market recovery and home price stabilization. Fears about job layoffs are receding. Consumption including discretionary spending has picked up more quickly than anticipated, at least during the first half of the year.

Notwithstanding the above, there is considerable gloom in the current economic and financial markets, although some of this gloom appears to be abating. During the first half of the year, the market turned unrealistically positive. The stock market continued a steep upward trajectory that had begun in 2009, initial first quarter GDP estimates were strong, while most of the negative events that had dominated headlines in 2009 seemed to recede. Even homebuilders began to ramp up construction, competing against a substantial inventory of existing homes. In addition, the Federal Reserve in keeping its rates low has facilitated more abundant low cost debt. Consumer spending and retailer health saw surprising improvement.

For the most part, this optimism turns out to have been premature. The stock market has since corrected, first quarter GDP figures have been re-adjusted downward, a sovereign debt crisis emerged in the Euro Zone, and worries have escalated about a marked slow-down in the second half with the end of the stimulus programs. Housing starts have plunged downward, and consumer spending has slowed. The markets have taken this gloom as a sign of a double-dip recession.[1] An election year compounds considerable bear market rhetoric.

Forecast Highlights: US Economy 2009–2011
(Annual Percent Change, Unless Noted)

	2009	2010	2011		2009	2010	2011
Real GDP	(2.6)	2.8	2.4	Consumer Price Inflation	(0.3)	1.6	1.3
Consumption	(1.2)	1.6	2.4	Payroll Employment Growth	(4.3)	(0.6)	0.9
Business Fixed Investment	(17.1)	4.8	6.5	Unemployment Rate (%)	9.3	9.7	9.5
Equipment & Software	(15.3)	14.2	11.3	Federal Funds (%)	0.2	0.2	0.2
Exports	(9.5)	12.4	7.7	Ten-Year Treasury (%)	3.3	3.3	3.1
Imports	(13.8)	11.9	6.7	30-Year Fixed Mortgage (%)	5.0	4.7	4.6

Source: Global Insight and RREEF Research, As of August 2010

We do not expect a double-dip recession in the US, but an economic recovery that is modest in comparison to past business-cycle rebounds.

Property Market Outlook

Our second quarter forecasts for the property market are modestly more positive than those produced two quarters earlier. Rent growth forecasts through 2014 are largely unchanged from the previous forecast for all four sectors, with the outlook for apartments being the most optimistic, followed by industrial, then office and finally retail.

US Vacancy Rates by Property Type

				Forecast					
	2007	2008	2009	2010	2011	2012	2013	2014	2015
Apartment	5.7%	6.8%	8.1%	8.5%	7.8%	6.6%	5.6%	5.5%	6.0%
Industrial	9.5%	11.4%	13.9%	14.2%	13.4%	12.0%	10.8%	10.2%	10.2%
Office	12.6%	14.0%	16.3%	17.2%	16.7%	15.3%	13.7%	12.5%	12.2%
Retail	7.2%	8.7%	10.3%	10.7%	10.4%	9.8%	9.1%	8.6%	8.2%

Source: CBRE-EA, REIS (History), RREEF Research (Forecast), as of August 2010

Apartment Market Outlook

The outlook for apartment market fundamentals remains the most positive of the four sectors. In fact RREEF Research brought previous growth forward somewhat in the current iteration. US apartment rents that were forecast in fourth quarter 2009 to decline by 2 percent in 2010 are now forecast to increase by 1 percent. Apartment demand was stronger in the first half

[1] RREEF Research believes that the probability of a double-dip recession is low, as documented in "A Double-Dip Recession and US Commercial Real Estate," published in July 2010. Our forecasts in January were for slower growth in the second half of 2010, when stimulus programs were expected to end; this forecast still holds.

than previously thought and impact from competition from the over-built for-sale market is softer than was expected. Modest income growth is still forecast to return in 2011, the earliest recovery of all property types due to short, one year lease structures. Growth in NOI should be robust from 2012 through 2014, benefiting from both occupancy and rent gains. Excellent demographic trends will especially favor this sector over the forecast period. An upbeat market outlook, availability of attractive debt, and indications that prices are reaching bottom places apartments at the top of the list for investment in 2010. These positive trends are attracting significant investor capital to the sector, leading to aggressive pricing and likelihood of a new construction cycle.

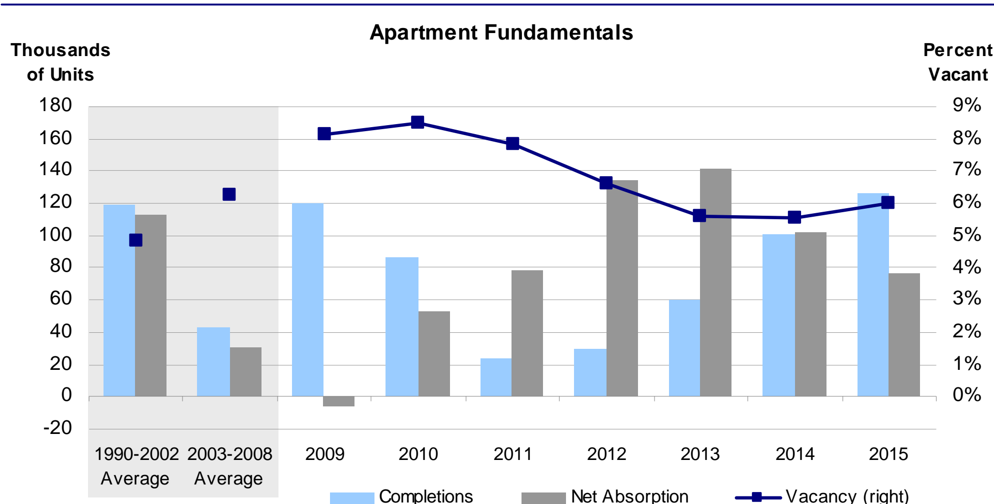
Rent growth for apartments is forecast to average over 20 percent cumulatively for the US between 2010 and 2015 and is forecast to approach 30 percent in favored metros. Apartment starts set a post-World War II record low in 2009 and similar low levels of construction are expected in 2010. Completions are projected to remain muted through 2013, allowing for a sharp recovery in occupancy and adding upward pressure on rents. Demographic, as well as behavior trends, are emerging that will likely produce robust apartment demand beginning in 2011. There are 75 million “echo boomers” entering the market over the next decade that will rapidly expand the prime renter age cohort (20 to 29 year-old households). Also, a fundamental shift away from the “American Dream” of homeownership is emerging as millions of failed homeowners reconsider the benefits of renting and also show a preference for infill urban locations, where for-sale housing tends to be expensive, over the suburbs. Tightened lending standards will make it harder for would-be buyers to qualify over the next several years. Limited new supply and accelerating demand drivers should create strong performance for the sector in the short and mid-term. Rent growth longer-term remains uncertain as expectations of improved occupancy and escalating rents is motivating developers to ramp up the construction pipeline over the next 6 to 12 months, ensuing a potential surge of new supply towards the end of the forecast period.

RREEF Research particularly favors the high-priced infill markets of the Northeast and West Coast for longer-term investment, including Baltimore, Boston, Los Angeles, New York, Orange County, San Diego, San Francisco, San Jose, Seattle and Washington, DC. These markets are forecast to rebound earliest with prospects of strong rent growth over the next several years.

Additional markets may provide attractive returns over the short- to medium-term. We have identified specific markets that provide similar or better near-term rent growth, but typically have longer-term stability issues. These include the strong economies of Austin, Dallas, Denver, Houston and Raleigh-Durham, which with few barriers to entry, usually have supply issues. Investments in these markets should be held only until signs of supply ramp-up appear, resulting in a shorter hold period. As strong early recovery candidates, these markets could provide the near-term opportunity to acquire Class A properties below replacement cost in a high growth market.

Markets that are expected to be strong, steady markets in the long-term, but have weak fundamental issues in the short-term include Chicago, Northern New Jersey, Oakland/East Bay, Portland and South Florida. These markets should provide steady long term performance, due to supply constraints, at a fairly good risk adjusted basis. However, given near term weakness, care should be given to selecting properties in superior submarkets.

Particular caution will need to be exercised in the cyclical markets of Atlanta, Charlotte, Orlando, Phoenix, Riverside and Sacramento which still have supply challenges to work through along with poor near-term economic fundamentals. In addition, these markets typically face few barriers to entry. RREEF Research does not view these as core target markets. However, strong asset specific opportunities could emerge for consideration in their strongest submarkets or for value-added investment.



Source: REIS (History); RREEF Research (Forecast), as of August 2010

Industrial Sector Outlook

The US industrial market is nearing bottom after two years of sharp contraction. Negative demand trends are abating and vacancy is stabilizing, albeit at a record level of 14 percent. This forecast is essentially unchanged from what we expected in the fourth quarter of 2009. During the first half of 2010 one-third of the 53 largest US industrial markets registered positive net absorption, but on balance total new demand for the year is expected to be slightly negative.

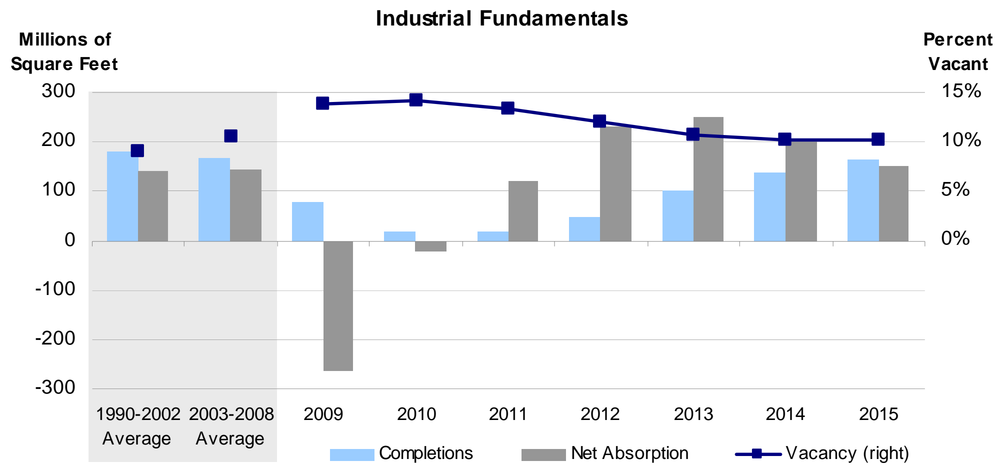
Most if not all traditional demand-side drivers should lift off bottom in 2010. Primary US trading partners are experiencing growth, aiding recovery in globally-linked regions and increasing demand in markets located in major US ports. Recovering venture capital investment and business spending should give a boost to technology oriented metro economies. However, tepid retail sales growth and housing-related drivers will temper the pace of recovery in some Sunbelt markets over the near-term.

Recovery in the industrial sector should take hold nationally in 2011, resulting in demand for that year consistent with historical averages. A prolonged supply-side gap and stronger demand-side gains beginning in 2012 should mark the start of sharp increases in occupancy, but it will take until 2015 before broad US trends fully recover. High barrier markets and prime locations of large core markets should lead overall US trends.

Market rent growth in 2010 is expected to remain modestly negative, falling around 4 percent, and should remain flat in 2011. New supply will sink to all-time low levels until demand strengthens. Stronger rent growth is projected thereafter, for a cumulative total rent growth of 20 to 25 percent from 2011 through 2015. New supply will not likely become a risk until 2015, as high vacancy and stricter bank lending should serve to limit speculative construction.

During this market recovery, RREEF Research favors quality assets in core locations, as back-filling below-average space is problematic in a high vacancy, low cost environment. A flight to quality during recovery, while rents are low, will benefit Class A buildings and locations first. We continue to prefer warehouse, multi-tenant flex and business park space in core locations over big-box warehouse in less constrained markets and submarkets. Improved airfreight volumes should support better fundamentals at the nation’s primary airport hubs. Higher fuel prices, port diversification strategies and growing congestion could shift the logistics industry back to a greater number of regional distribution facilities versus the consolidation trends of the past decade that pushed them into fewer super-sized warehouse facilities.

Markets favored by RREEF Research for the most part sit on the East and West Coasts, but a few mid-continent markets could also provide attractive risk-adjusted returns. International trade will be the primary driver in recovery, promoting the port markets in the West and Northeast over both the near-term and long-term. Surging export growth should also produce economic benefits in core manufacturing markets in California, Chicago and parts of the Midwest and Northeast. Core business hubs and technology markets face near term challenges, but well located, modern vintage product should outperform. High quality of life areas with favorable industries or global linkages, such as Austin, San Jose, Seattle, Southern California and South Florida, should perform well over the long term.



Source: CBRE-EA (History); RREEF Research (Forecast), as of August 2010

Office Sector Outlook

Despite more than twice the job losses as in the dot-com downturn, less office space was given back this downturn than the last, and vacancy is forecast to peak in 2010 at 17 percent, similar to the previous high in 2003. While this appears to be relatively good news, it obscures that significant pockets of underutilized shadow space remain lurking as a result of the low volume of give-backs and limited amount of sublease space. As a result, the effective vacancy rate inclusive of shadow space is much higher than the stated rate, producing an effective vacancy similar to that previously forecast. This shadow space will place a drag on net absorption generated from job growth recovery in the near term.

On the positive side, new supply is not a concern nationally, although overhangs of new construction from the last cycle present challenges for some metros, particularly those with low barriers to entry. As building comes to a near halt, new deliveries in 2010 will fall to their lowest level in 14 years and construction activity recedes even further to a record low in 2011.

While the slowdown is welcome news to landlords, more than half of new deliveries are concentrated in a half-dozen metros – Atlanta, Chicago, Miami, New York, Seattle, and Washington DC – each adding a million square feet or more. These completions will contribute to further near-term downward rent pressure, except in New York and Washington DC, where the magnitudes of additions are relatively benign compared with the size of these markets.

As negative net absorption reverses course, rents are reaching bottom in 2010, with stable to slight increases expected the next two years. Sharper recovery growth should occur in subsequent years, with rents reaching their last peak level by 2015. Coastal markets should generally outperform, while housing-related and low barrier to entry markets beset with greater slack, will require longer for vacancy to tighten. The greatest risks are the magnitude of shadow space's effect on net absorption and the subsequent timing of rent recovery during outer years.

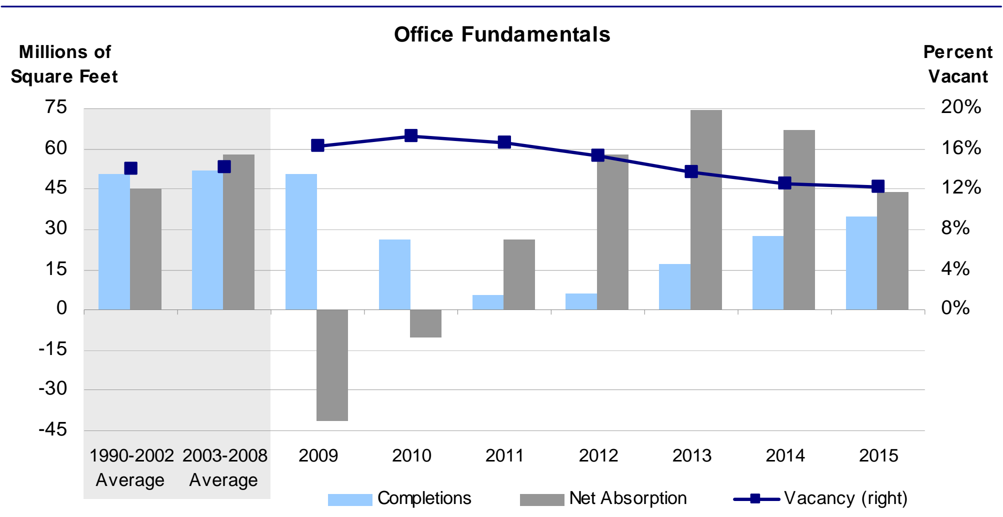
Contrary to expectations, Wall Street outperformed US office markets, suffering a shallower and less protracted downturn than expected. As a result, the outlook for New York rent growth has been upgraded to number one in the country. As the office sector finishes its shakeout in 2010, most metros will reach bottom and begin showing signs of improvement as well. Metros still sliding in 2011 will generally be those with high deliveries relative to stock.

With double-digit rent declines now in the past, effective rents will likely subside to about negative four percent in 2010 before reaching bottom, consistent with our prior forecast, bringing the total peak-to-trough decline to around 20 to 25 percent. Blend-and-extend remain a common renewal tactic by tenants with expirations as far as three years out seeking to negotiate rates near the bottom of the market.

Late 2010 should mark the bottom of the cycle, followed by a leveling of rents in 2011. Significant rent recovery in the sector should start by 2013 when national vacancy finally tightens under 14 percent and much shadow space is absorbed. Cumulative rent growth is forecast to total between 20 and 25 percent by 2015, with growth of between 30 and 40 in a few particularly strong recovery markets. However, the timing of recovery in rent growth is heavily skewed toward the latter years – more so than other sectors.

All but one (Austin) of the top ten outperforming metros during the next five years will be in coastal markets, while nine of the ten most underperforming metros will be in interior markets. Metros positioned to benefit earliest from recovery include Boston, New York, San Francisco and Washington, DC.

Shadow space remains a looming nationwide concern in the office sector recovery equation. Office space has not been given back to the market as much as the job losses would infer, creating underutilized shadow space and obscuring the effective underlying vacancy by as much as six to eight percent. The drag on absorption during the recovery period is a significant risk factor with regard to the timing of recovery in rent growth, although metros with the strongest fundamentals typically contain less than average shadow space.



Source: CBRE-EA (History); RREEF Research (Forecast), as of August 2010

Retail

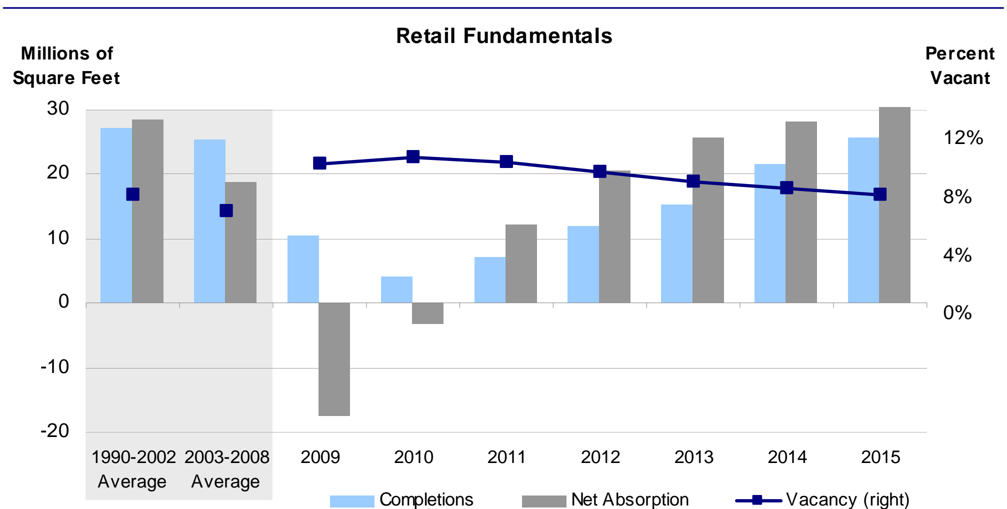
Retail sales hit bottom last year after their most precipitous fall ever and are beginning to climb back to pre-recession levels. Sales growth started the year relatively strong, but off of an extremely low base. The rate of growth waned as the year progressed. Still, consumer confidence improved as the economy moved from job losses to job gains, even if modest. Stronger, sustained improvement in retail sales will not likely take hold until households make

more progress on deleveraging and rebuilding their decimated balance sheets. A vigorous rebound is not expected until at least 2012, when the economy should generate stronger job growth.

Although construction nearly halted in 2010, retail property conditions continued to weaken in most markets during the first half due to continuing retailer downsizings. However, the rate of deterioration moderated during the summer, and there are finally signs of stabilization in many markets. We expect the national vacancy rate will peak at a record high 10.9 percent, 440 basis points higher than the market peak in 2005. The housing market contraction and consumer pull-back hit the retail sector earliest of the four property sectors in terms of fundamentals, but the recovery will be protracted and so vacancy will likely remain elevated longer than in previous recoveries. In addition to the expectation of only a moderate consumer recovery, retail leasing will be constrained by fundamental changes among retailers, including experimentation with smaller store prototype and greater focus on profitability rather than market share.

After the significant rent declines of the past two years, additional, but modest losses are forecast for 2010 in most markets and product types. While current rent levels are difficult to determine where few retailers are signing new leases, rent decline probably exceeded 20 percent from peak to trough for most markets. Power centers have been especially impacted.

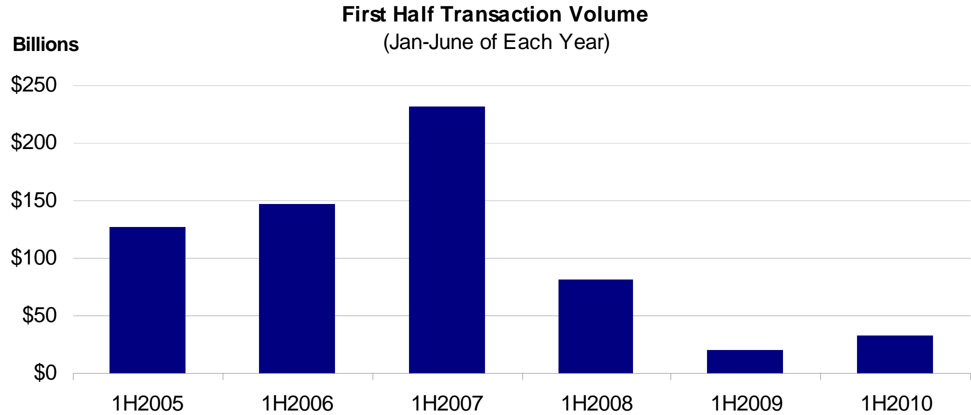
Since national retailers have been reluctant to give up space in the nation's fortress malls and stronger lifestyle centers, these properties are outperforming. Nevertheless, they experienced significant sales declines, and the luxury sector will likely take the longest to rebound than more affordable and value-oriented sectors. Weaker malls and lifestyle centers will continue to experience severe stress, and many will not survive in the long term. After a significant shake-up in the discount retail sector, most of the remaining retailers are likely to remain viable and some will thrive. With consumers likely to remain in a thrifty mode for the next few years, well-located power centers anchored by strong discounters should perform well. Grocery-anchored retail centers, which have generally survived the recession fairly well, will likely continue to perform well into recovery.



Source: REIS (History); RREEF Research (Forecast), as of August 2010

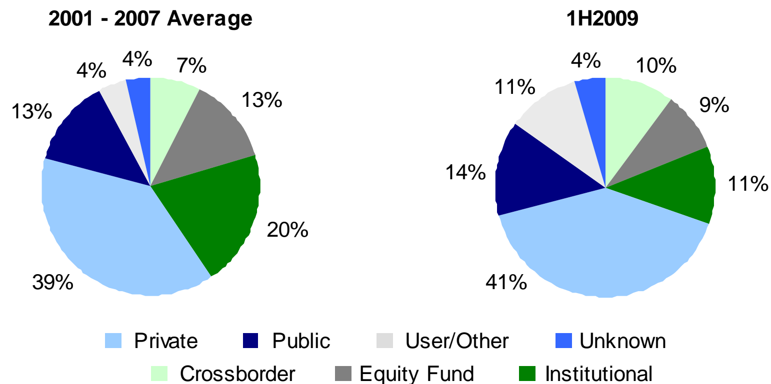
Investment Market Outlook

In our January outlook, RREEF Research identified 2010 as offering a historic opportunity to make superior real estate investments. The economy appeared to be safely on the rebound, allowing for stronger real estate performance over a long-term core investment horizon. However, as debt markets remained mostly closed and equity players looked for either extreme safety or highly opportunistic deals, 2010 was expected to be a year in which limited capital would be pursuing high quality assets in need of liquidity, and therefore available at attractive pricing. Opportunities for equity buyers appeared to be particularly advantageous, given an anticipated shortage of debt.



Source: Real Capital Analytics, as of July 2010

As of mid-year 2010, few deals are transacting, but the quantity of equity and debt chasing these deals is high, driving pricing upward and yields back down to pre-recession levels. Initially private equity and private REITs comprised most of the buyer pool, but foreign buyers also entered the market in early 2010. A bull market in public REIT stocks, which extended through first quarter, resulted in substantial buying by this sector as well. With higher valuations and access to public debt, REITs have been able to buy aggressively during the first half of the year. While it is unlikely that public REITs will continue to buy at this pace, pension funds have recently started allocating funds for new core acquisitions, and this sector will likely fill the void left by the public side. Banks are beginning to lend as well, as they return to profitability and mend their balance sheets, putting more capital at the hands of investors. Life insurance companies are also aggressively pursuing high quality debt deals. All together, these sources of capital have exceeded the supply of truly core product available in desired locations within top major metros. We expect to see a greater deal flow in the second half of the year, however, as owners take advantage of capital demand by selling their properties.

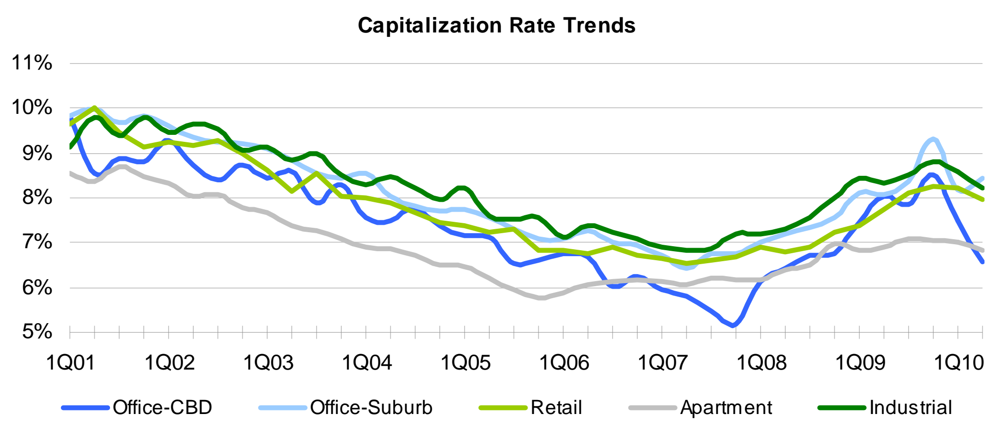


Thus far, core real estate properties have been the primary beneficiary of this run-up in pricing. Investors are aggressively pursuing apartment, office, industrial and retail properties (generally in that order) that have strong occupancies with minimal tenant risk exposure during the next two to three years. Activity is most heavily focused on the stronger submarkets in major coastal metros, primarily the Northeast Corridor and the West Coast. To a lesser extent, South Florida is receiving attention, while Chicago is also experiencing activity. Not coincidently, these are also generally the markets most favored by RREEF Research for having the strongest performance prospects over the next few years. However, strong investor demand is resulting in falling yields, with going-in cap rates of sub-5 percent common for the highest-quality apartments. Cap rates for office in the best markets like Washington DC and Manhattan are often now in the sub-6 percent range, while elsewhere yields are sub-7 percent. Yields on retail and industrial properties are compressing as well. Frequently, these aggressive yields produce values that are approaching the cost of new construction. At this early point in the economic and property market recoveries, such high pricing is surprising given that property market fundamentals lag economic growth.

Looking forward, the aggressive bidding taking place in the market carries risks of reversing the recent value gains. A continuing backlog of about $1 trillion in maturing commercial mortgages, which could push a greater supply of product to market, and projected pressures on inflation and interest rates as the economy moves into a more sustained recovery, transactions currently being made at low yields may encounter valuation risk over the next few years.

Implications for Investing

RREEF Research recognizes the risks of paying prices that generate extraordinarily low near term yields for properties at this early stage of the recovery cycle. For most properties, an extended period will be required before significant income growth can be achieved to allow for more normalized yields. For all four sectors, we forecast the bottom of the market in 2010 for most metros, when occupancies reach their cyclical low. However, some metros will continue their decline into 2011. Even though some prime markets are beginning to experience improvements in occupancy and rents, new multi-year leases will usually roll to lower rents upon renewal or new tenancy than current or prior leases that were consummated in a better market. As a result, net operating income (NOI) may continue to fall even as market rent growth returns. Since apartments typically offer one-year leases, early recovery markets will experience modest growth in income in 2011, the first sector to do so. Industrial, office and retail markets are unlikely to experience NOI growth until 2012 at the earliest, and most likely not until 2013 to 2015. Given how far rents have fallen from the peak, this income effect will be substantial until market rents recover much of this loss.



Source: Real Capital Analytics, as of July 2010

Further impacting valuations longer term, financial markets are not likely to continue to support the low cap rates cited above. Currently the Federal Funds rate is 0.25 percent and the 10-Year Treasury bounces around 3 percent, which provides some of the rationale for these low cap rates. Macro risks regarding sluggish growth and possible near-term deflation seem to be holding bond rates low. Farther into the future, however, there are inflationary concerns. Stronger and sustained economic growth is forecast to become better established in late 2011, when solid employment growth should also kick in. As this growth matures, it is expected to clash with the substantial debt that governments, especially the US Federal government, have piled on during the recession. A stronger economy with the monetization of government debt should create inflationary pressures, which the Federal Reserve will likely counter with higher interest rates. Our forecast for the 10-Year Treasury in 2014 and 2015 is between 5 percent and 6 percent. Although buyers of real estate in the current market will benefit from substantial income growth in a recovery market, a rising cap rate environment will negate some of this benefit. RREEF Research urges caution in underwriting properties at highly aggressive pricing at this early stage of recovery.

The recovery in commercial real estate capital markets have decoupled from fundamentals. Capital is flowing back to US commercial real estate. Availability of cheap debt, demand for capital placement and better recovery prospects in terms of income increased investor demand for Class A apartments early, and tightened cap rates in the best markets to as low as 4.5 percent. Class A CBD office in prime early recovery markets have also become aggressively priced, starting with Washington DC and New York, and then spreading to other coastal markets. While retail and industrial have been slower to benefit from yield compression, high quality properties in these sectors are also starting to be aggressively priced.

Navigating the current investment market will be tricky for core investors. The following are strategies that should be considered in this environment. A key consideration that investors have recognized is that investment in real estate during the early years of economic recovery have typically produced superior long term returns. Property income, which has been negatively impacted by the recession, is likely to rebound in response to economic recovery. Low current yields, therefore, do not generally reflect the longer term yield potential for high quality properties. In this environment, a number of core investment strategies could make sense:

- “Pay up” for high quality fully leased assets in core markets that are forecast for early recovery. Even though current yields have been compressed, properties that have the highest potential for long term income growth could make sense for long term investment. The higher income growth potential of these assets will offset the valuation drag from forecast rising cap rates in the longer term. These are properties

that could anchor a core portfolio over a long-term hold, possibly exceeding the traditional 10-year long term investment horizon.

- Apartments in top urban coastal markets provide the greatest potential for near-term growth. Since cap rate compression has been greatest for these Class A products, underwriting for acceptable returns has been problematic. Class B product in these same markets might be an attractive strategy, given that renter demand will be particularly strong for these lower cost options. Assuming that a sufficiently better yield can be achieved, a Class B apartment in a Class A location strategy could make sense.

- Pre-commitments to purchase new apartment developments could be an excellent means of acquiring high quality apartments in top locations, while maintaining a yield premium for the timing and lease-up risk.

- Student housing located on or adjacent to a large university campus could provide superior investment opportunities, given the demographic bulge that benefits the student age group and the growing demand for university education. Thus far, there appears to be a yield premium for such investments over those for traditional apartments.

- Investment in core office product should be limited to properties with strong rent rolls, given that this sector will take the longest to recover, even in the best early recovery markets. Any vacancy should be underwritten very conservatively. Except for truly trophy assets, office should be considered for a medium term investment horizon, given the risk of the next market downturn.

- Medical office buildings are highly appropriate for a core portfolio, given their stable nature. For high quality leased properties located on or adjacent to a dominant hospital campus, tenancy and income tends to be quite stable. Given growing demand for medical services by an aging population, this sector should experience healthy growth.

- Well leased industrial properties in the best coastal urban markets should continue to be a core investment strategy. While small to medium sized businesses are not leading this economic recovery, they provide prospects for strong growth over a medium to long-term hold. Therefore, we recommend infill multi-tenant warehouse and business park properties oriented toward these location-sensitive businesses. Cap rates thus far have not compressed as much as for office and apartment properties, reflecting lesser investor focus, allowing for somewhat better yields.

- Larger warehouse properties close to ports or in other infill locations could be an attractive investment strategy.

- Well-anchored retail properties in the best locations should continue to be an important part of a core investment strategy. Anchors should include only those with the strongest financials and highest market share, whether grocers or discounters. Given our forecasts for continued weakness in this sector, given our forecasts for weak growth in consumer spending, second tier properties should not be considered. However, extremely high quality properties in the best locations in second tier metros should be considered. Over the long term, high quality retail properties have proven to be the most core of investments, providing income stability through long term leases. All product types should be considered, including grocery-anchored, power, lifestyle and mall properties. Joint ownership of fortress malls with a major mall operator should be considered, given their stable income prospects. As with industrial, cap rates have thus far not compressed as much as for office and apartments.

- A “dry powder” strategy would be reasonable in the current heated market for core

product. Given that transaction volume of truly core properties remains limited, pricing has been bid up. As investors who desire liquidity for various reasons observe this frothy pricing, they are likely to bring more core product to market. In addition, a large volume of loan maturities are scheduled for the next few years, where loan take-outs for existing balances will be difficult to source. Although many of these loans are likely to be worked out, some properties will inevitably be taken to market. As more core assets become available for sale, pressure should be lessened on yields currently being paid.

- In certain situations where allowed, debt should be considered on core assets. Currently, debt is widely available at 50 to 60 percent loan-to-value levels on core properties at very compelling rates. In fact, these rates are a significant factor that is driving yields downward. This has been particularly true for apartments, given particularly attractive agency mortgages. In this environment, equity investors are at a disadvantage. Adding some leverage to acquisitions would lessen this disadvantage.

To summarize our view on core investment during the next couple years that comprise the early stages of recovery, we suggest gradual, dollar-cost-averaging through incremental investment over the next few years. If history is a guide, purchasing real estate assets at the bottom of an economic and real estate cycle offers some of the best vintage years.

Core plus and value-added properties remain less liquid at this early stage of economic recovery, as is typical in such cycles. Debt for such properties with low current cash flow is very limited, contributing to this illiquidity. As a result, demand for such product is significantly less than for core and pricing remains attractive for high quality properties, although this investment style is beginning to receive more attention. During past recoveries, investors have achieved outsized returns through investments in illiquid properties, with substantial discounts to peak market pricing. While we urge extreme caution given the time and expense that can be involved in stabilizing these assets, core-plus and value-added investment will provide some attractive opportunities. The following general strategies might make sense:

- Acquire Class B apartments in prime urban locations in need of renovation or new apartments that have not yet leased up in top market locations. This is a relatively low risk value-added strategy, given our strong forecasts for apartment demand in these top markets.

- Given that apartment incomes are likely to be the first to recover, with rents already beginning to rise, an investment strategy of developing new apartment properties in the best markets should be considered.

- Acquire partially leased office properties in top markets forecast for early recovery. Such properties should be underwritten to cash flow positive after operating expenses, but should not be encumbered with debt. Underwriting should assume an extended lease-up period to stabilization, and at terms that reflect the currently weak market.

- Multi-tenant industrial warehouse and business parks with substantial vacancy, located in top infill markets, could be an attractive value-added investment. Compared with the office strategy above, cash flow should be more positive, given the lower operating and tenant improvement costs of industrial. But as with office, debt is unlikely to be available and underwriting should assume extended lease-up at weak pricing.

- Given a short-fall of debt availability for properties facing loan maturity at high loan to value ratios, a debt strategy could fill this void offering loans at these higher ratios to value on high quality assets in top markets. In some cases, this debt could become a "loan to own" strategy. Preferred equity strategies could be utilized on prime over-leveraged assets.

- Failing development joint ventures could be restructured by taking out a partner, bringing in new equity and reducing debt , while providing the project sponsor with a potential for positive returns.

For the most part, at this early stage of recovery, RREEF Research recommends focusing primarily on a core strategy, with highly selective value-added or core-plus acquisitions. The relatively high level of risk at this point of recovery, when substantial uncertainty still exists, currently favors core investing. Whether for core or value-added strategies, the investment focus should be on primary submarkets within major metro markets identified by RREEF Research as having the best prospects.

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