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State of the US Industrial Market: Global Gateway & National Distribution Hubs Dominate

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Introduction

The US industrial market improved rapidly last year. Near-record demand, paired with a relatively modest supply pipeline, resulted in tightening market conditions. The national vacancy rate dipped 140 basis points last year, ending 2005 at 9.9%, reaching the single-digit level for the first time since 2001.

Continued US economic expansion, vis-à-vis robust consumer and business spending, as well as surging trade flows, supported over 280 million square feet of positive net absorption last year. Increased construction costs and competitive market rent levels held speculative development in-check, notable metro exceptions being Chicago and Riverside.

In this report we summarize the current state of the US industrial market and discuss its outlook based on the underlying national and global economic trends. The report is organized into several sections. Following the Industrial Market Highlights, we discuss the key economic drivers that underpin industrial real estate fundamentals. We then discuss the impact of expanding international trade flows on regional and metropolitan markets. The prospects for the national market and specific metropolitan markets and property types are then presented. In conclusion we present the implications for investors and identify the regions and property type sectors that should out-perform overall trends.

Industrial Market Highlights

The outlook for the US industrial market is bright. Two years of economic expansion have translated into solid real estate supply and demand fundamentals. Market vacancy is in the single digits, the supply pipeline is expanding, but at reasonable levels, and rents are rising.

Surging trade flows should continue to fuel robust demand for large warehouse product over the next two years and sustained local economic growth is expected to provide solid demand for multi-tenant industrial space in core metro markets. A cooling US economy later this year will dampen demand industrial trends beginning in 2008.

Elevated land and construction costs should temper the flow of new construction at closer-in locations, and given sustained demand, drive above average rent growth for functional space. The development pipeline of large warehouse product at the land-rich national distribution hubs will continue to flow.

Southern California and South Florida markets are at or near record rent levels. Buoyed by recovery in the tech sector, San Jose and Oakland should achieve some of the highest annual rent growth in the country over the next five years; but as is true for other metros with high

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manufacturing concentrations, functionally obsolete space, not able to accommodate efficient distribution or high tech operations, will lag recovery.

The East and West Coast markets will continue to maintain the healthiest market fundamentals. Land-rich markets in the Midwest and South will attract a steady flow of large distributors, but rent growth prospects are less attractive. Functional multi-tenant properties should afford above average rent growth prospects.

Key Drivers of Industrial Markets

Transitioning Economy Supports Demand for US Industrial Real Estate

The outlook for US industrial real estate depends, in many ways, upon the well-being of the national and global economies. Some of the key economic drivers influencing the industrial sector are discussed below and displayed in Exhibit 1.

Exhibit 1
Macro Drivers of Industrial Space Demand: 2005-2010
(annual percent change)

	<u>History</u>			<u>Forecast</u>		
	2005	2006	2007	2008	2009	2010
Real GDP	3.5	3.4	2.6	3.2	3.3	3.0
Consumption	3.5	3.1	2.7	3.1	3.4	3.2
Goods Consumption	4.4	3.5	2.2	3.2	3.9	3.8
Business Spending	8.6	9.4	6.6	4.6	4.7	3.8
Exports	6.9	8.4	8.8	9.1	9.0	7.7
Imports	6.3	6.7	4.3	4.6	5.7	5.5
Industrial Production	3.2	4.3	2.5	2.3	2.3	2.4
Factory Operating Rate	78.9	80.8	80.3	79.9	79.3	78.8
Inventory Change*	25.0	38.9	28.8	37.6	43.7	42.7
Employment:						
Total	1.5	1.5	1.3	1.4	1.3	0.9
Trade, Transportation, Utility**	1.5	0.8	1.1	1.9	1.1	0.4
Information	(1.7)	0.6	1.9	0.0	1.5	1.4
Manufacturing	(0.6)	0.1	(0.0)	(1.0)	(0.9)	(0.7)

*In Billions of 2000 dollars

**Includes wholesale and retail trade, transportation and warehousing, and utilities

Source: RREEF Research and Global Insight

The US economy kicked off 2006 with robust GDP growth of 5.6% in the first quarter. On the job front, the first five months of the year have seen average employment gains of nearly 150,000 per month. To date, the national economy has sustained the above-trend growth experienced over the past two years. Consumers and businesses alike have posted impressive spending growth in the face of rising interest rates, a slowing housing market, and gas prices over \$3.00 per gallon.

The drivers of US economic growth are in a state of transition, however. Consumer spending growth and homebuilding activity are slowing as the rapid run-up in home prices comes to an end. At the same time, business investment and exports should accelerate in response to strong global economic growth and pristine corporate balance sheets. The current forecast depends upon businesses taking up the slack from consumers and homebuilders.

Real GDP growth is forecast to average 3.4% in 2006, nearly on par with 2005's 3.5% expansion. 2007 should see below-trend growth as housing becomes a drag on the economy and the full impact of higher interest rates becomes apparent. Employment growth should charge forward despite the slowdown in economic expansion; job gains of 1.5% this year should decelerate only modestly to 1.3% over the forecast horizon. The unemployment rate should remain below 5.0% through 2010, providing support for growth in wages and consumer spending.

Consumers

Low interest rates combined with rapidly rising home values supported impressive consumer spending growth during 2004 and 2005. In 2006, with interest rates rising, elevated energy prices, and home price appreciation slowing, consumption growth of 3.3% is expected. By 2007, as these effects intensify, spending growth should slow to 2.7%. Consumption of goods, a subset of total consumption, is expected to fall from 4.4% in 2005 to 2.2% in 2007. Spending on consumer goods should rebound to average 3.3% over the forecast horizon.

On the upside, steady employment growth and a pickup in wage growth should take the place of housing wealth gains in supporting consumer spending. Sustained tightness in the labor market should keep income growth steady.

Businesses

As consumer spending growth slows, business investment should emerge more clearly as a critical driver of economic expansion in 2006. Investment is forecast to expand nearly 10% this year. This rate of growth should be made possible by strong profitability, solid balance sheets, high capacity utilization rates, and a cost of capital that remains low by historical standards.

As investment rises, inventories should expand over the forecast horizon, with an inventory increase of \$38.9 billion this year. A pickup in industrial production growth to 4.3% in 2006 should lead to steady hiring in goods-producing and trade sectors.

Jobs

Employment growth has averaged 150,000 jobs over the first four months of 2006, and this rate should continue over the balance of the year and through 2007 and 2008. A maturing economic cycle should see a slowdown in productivity growth alongside rising job gains. Businesses are in a favorable position to hire, enjoying strong profitability and high credit quality. With an unemployment rate of 4.7%, the US economy is very close to full employment. The unemployment rate should remain below 5% over the next five years.

Technology firms, ranging from relatively established sectors like computers to nascent sectors like biotechnology, should be among the primary drivers of the economy and the industrial sector long-term. Information hiring, which includes software makers, should turn positive in 2006, with growth of 0.6%. In 2007 and beyond, average annual growth in tech jobs should reach 1.4%, outpacing total employment growth.

Manufacturing employment is expected to continue its secular decline. Certain types of manufacturing, however, should continue to grow in the US, at least over the next several years. This contributes to a positive short-term outlook for manufacturing, with 0.1% job growth forecast for 2006. Growth sectors include aerospace and machinery manufacturing.

Trade Flows

Exports and imports alike should increase over the next five years, boosting the volume of goods moving into, out of, and throughout the United States. The US trade deficit is forecast to continue widening through 2007, as the deficit with China grows ever larger. In 2008 and thereafter, the deficit should begin to narrow. Several forces should unite to weaken the dollar and increase global demand for US goods. Cooling consumption growth should dampen imports, while robust global economic growth should boost demand for US exports. At the same time, the dollar is forecast to weaken due to the large trade deficit and narrowing spread of US interest rates over foreign rates. The weakening trend will be reinforced if the Chinese pursue the expected path of allowing the yuan to appreciate, slowly but surely, against the dollar.

Current State of the US Industrial Market

Top US Port and Inland Distribution Hub Markets Lead

Global gateway markets and national distribution hubs dominated the industrial demand profile of the nation in 2004 and 2005. The top six metros, in terms of industrial space demand, were also primary beneficiaries of trade with Asia, Mexico and Canada. The Los Angeles and Riverside industrial markets as well as those in Atlanta, Chicago, Dallas/Ft. Worth and Houston, combined for a total of 115 million square feet of net absorption last year, 41% of the US total. They also accounted for over 64 million square feet of new construction in 2005, a 48% share of the US total.

The impact of trade through the nation's major ports is far-reaching. Asian imports flowing to the Ports of Los Angeles and Long Beach (POLA/LB) not only benefit Los Angeles and Riverside, but drive demand for state-of-the-art big box distribution facilities at major distribution hubs in Chicago and Dallas/Ft. Worth.

As shown in the Exhibit 2 – 34.9% all US container traffic flowed through the POLA/LB. This has supported robust industrial absorption across the greater Los Angeles metro area for the past five years.

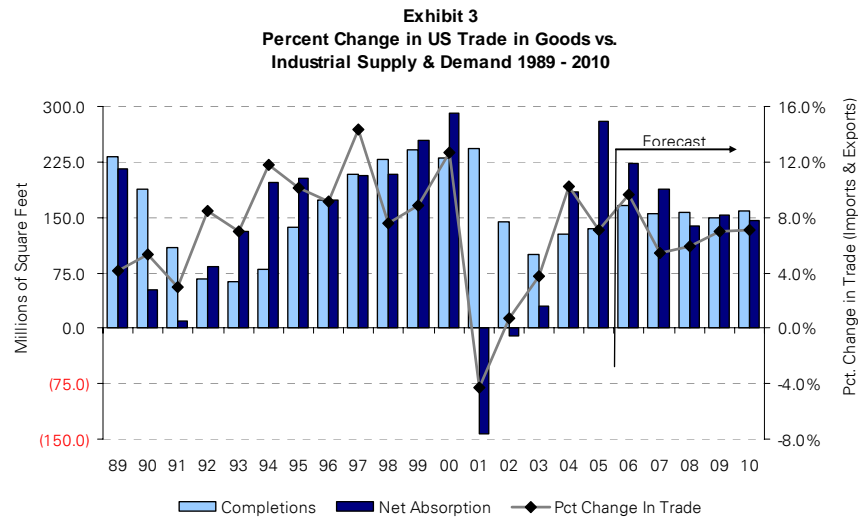
Exhibit 2						
Top 10 Most Active U.S. Container Ports						
REG.	RANK	SHARE OF U.S.	PORT	TEU'S 2001	TEUS 2005	CAGR '01 - '05
West	1	18.3%	LOS ANGELES *	3,379,410	4,867,073	9.5
West	2	16.6%	LONG BEACH *	3,158,890	4,395,942	8.6
West	6	5.2%	OAKLAND	912,098	1,372,231	10.8
West	7	5.0%	SEATTLE	820,903	1,339,641	13.0
West	10	4.3%	TACOMA	602,108	1,154,350	17.7
		49.4%	Total	8,873,409	13,129,237	10.3
Southeast	4	5.7%	CHARLESTON	1,121,926	1,511,935	7.7
Southeast	5	5.6%	SAVANNAH	802,955	1,482,728	16.6
		11.3%	Total	1,924,881	2,994,663	11.7
Gulf	9	4.6%	HOUSTON	762,926	1,231,186	12.7
		4.6%	Total	762,926	1,231,186	12.7
Northeast	3	12.8%	NEW YORK	2,296,506	3,390,308	10.2
Northeast	8	5.0%	NORFOLK *	903,211	1,318,831	9.9
		17.7%	Total	3,199,717	4,709,139	10.1
		83.1%	Top 10 Ports	14,760,933	22,064,225	10.6

Source: Piers/Journal of Commerce

Rapid trade growth, however, over the last four years, particularly with Asia, created congestion at POLA/LB and also stretched rail and truck transportation systems to capacity. Delays and the risk of disrupted supply chains, as occurred in 2001 and 2002, gave rise to port diversion strategies, which benefited smaller west coast ports, such as Seattle and Tacoma as well as east coast ports.

Trade growth is expected to continue at a rapid pace and leading ports are actively seeking ways to expand and become more efficient. The Nation's largest retailers and logistics firms are accommodating the expected growth in part by routing their container traffic to newly expanded port facilities in Seattle, Tacoma and Houston. Multiple water-route options also exist leading to rapid growth of east coast ports at Charleston, Savannah, Norfolk and New York/New Jersey.

As shown in Exhibit 3 below, warehouse space demand is highly correlated to trade volumes, as measured by the sum of US imports and exports. The growth in the dollar volume of trade and industrial supply and demand are highly correlated. Clearly in 2001, the US recession negatively impacted trade flows and resulted in imbalanced market conditions. In the 1991 recession, however, trade flows were impacted but grew nonetheless. Industrial net absorption remained positive, but an elevated speculative supply pipeline overshot demand by a wide margin and caused a sharp divergence between supply and demand.



Source: RREEF Research, Torto Wheaton & Economy.com

In prior cycles, the US industrial market, specifically warehouse product, was not as highly dependant on international trade; it depended on both trade and US manufacturing activity. The nation's distribution infrastructure was spread over a greater number of locations than it is today. Outsourced manufacturing and efficiency gains in the US logistics industry, has led to consolidation of distribution hubs, fewer but larger facilities. This model is now facing challenges today as security risks, new regulations and trucking laws, as well as transportation infrastructure funding and robust port expansions, have caused distributors to balance supply chain cost efficiencies with reliability risk. This may give rise to further port diversification and a greater number of distribution facilities closer to end users.

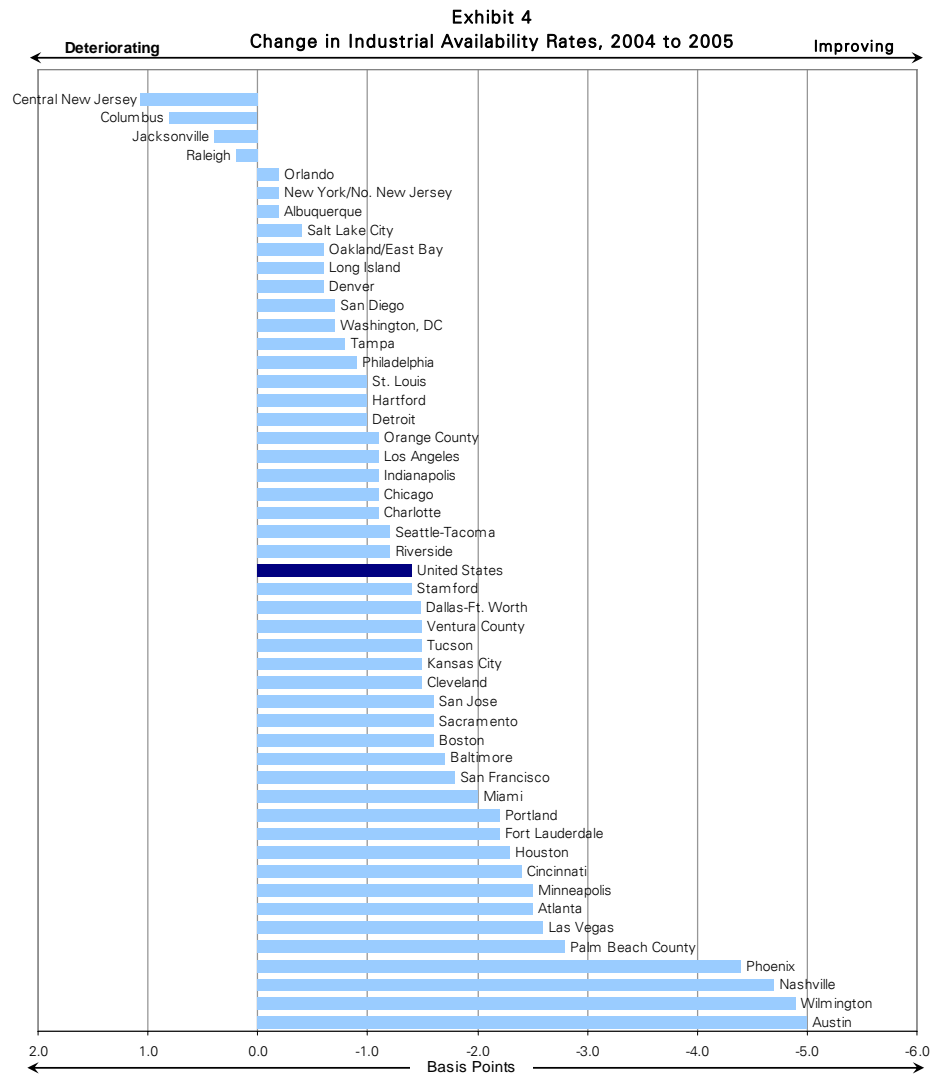
Dynamic international trade bodes well for future industrial space demand, but also carries with it risks of volatility. As shown in Exhibit 3, US trade growth is forecast to moderate in

2007 with a cooling US economy. Although longer term trends will remain robust, this near term deceleration should in turn have a moderating impact warehouse space demand.

The Regional Perspective

Surging trade flows were not the only contributor to strengthening industrial market fundamentals. Demand is broadening in most metros, supported by local economic growth and recovery in the high tech sector as well. As shown in Exhibit 4, below, all but four of the top forty-nine metros tracked in this report posted occupancy gains in 2005.

In the west, only Denver, Oakland, Sacramento and San Jose carried vacancy rates above 10% at year-end. In the major Eastern markets, only Baltimore, Boston and Philadelphia posted double-digit vacancy rates. Major Midwestern markets continued to lag, with only Minneapolis and Cleveland posting single-digit vacancy.



Among the tech markets, Seattle gained momentum first, due to strength at Boeing and Microsoft in addition to solid growth at the Ports of Seattle and Tacoma. Austin and San Jose gained traction in 2004, aided by healthy semiconductor, software and internet industries. Boston, Dallas and Denver, with large exposure to the telecom industry, lagged recovery and did not show meaningful improvement until mid-2005.

Local economic growth fueled leasing momentum for a wide array of space. The national vacancy rate for manufacturing space improved 80 basis points in 2005, on more than 40 million square feet of net absorption, ending the year 7.5% vacant.

The R&D/Flex sector also fared well, with about 46 million square feet of net absorption – far outpacing the 17 million square feet of construction. This resulted in a 220 basis point drop in the vacancy rate, ending the year at 14.5%.

As would be expected, the warehouse sector dominated the broader industrial trends, posting nearly 196 million square feet of net absorption. About 111 million square feet of new development offset some of the occupancy gain, but the sector tightened 120 basis points, ending 2005 with a 10.3% vacancy rate. Demand for large bulk warehouse space in Los Angeles, Riverside, Dallas, Houston, Atlanta and Chicago was robust and overall net absorption outpaced new construction by over 51 million square feet.

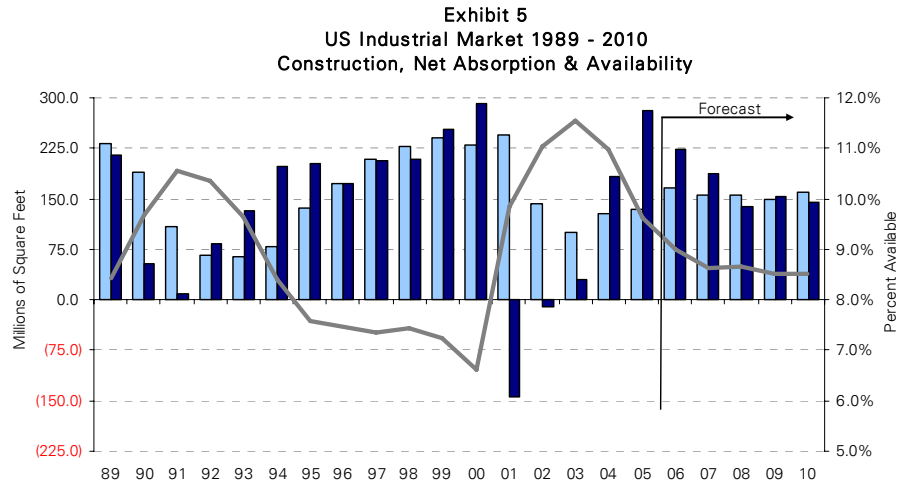
Well-located multi-tenant industrial parks in core submarkets have gained occupancy, lowered concessions and increased contract rents. Generally, distribution bays of 100,000 square feet or less in core submarkets are seeing improved demand. Warehouse and flex buildings that divide into 10,000 to 30,000 square-foot units are seeing better demand. Current market rents in most cases remain well below today's expensive replacement rent. Early recovery markets in Southern California, Seattle and South Florida have reached replacement rent levels.

Older large manufacturing and functionally challenged distribution buildings lagged overall market trends. Although demand trends favor core national hub markets like Atlanta, Chicago, Dallas/Ft. Worth, older mid-continent hubs like Columbus, Cincinnati and Cleveland are also seeing surprisingly good leasing traction. An ample supply of cheap land and compressed investor return requirements have allowed new development to occur at lower rents than several years ago. Older product in these markets must discount rents to compete. To the contrary, land supply constraints on the east and west coasts and in prime submarkets of the national hubs can generate rental rate appreciation for second-generation space.

Prospects for the US Industrial Market

Two More Years of Strong Demand with Supply Catching up by 2008

The outlook for the US industrial market is bright. Continued expansion of international trade will continue to fuel robust demand for larger warehouse product, and national and metro level economic growth should lead to above average demand for multi-tenant warehouse, flex and R&D space.

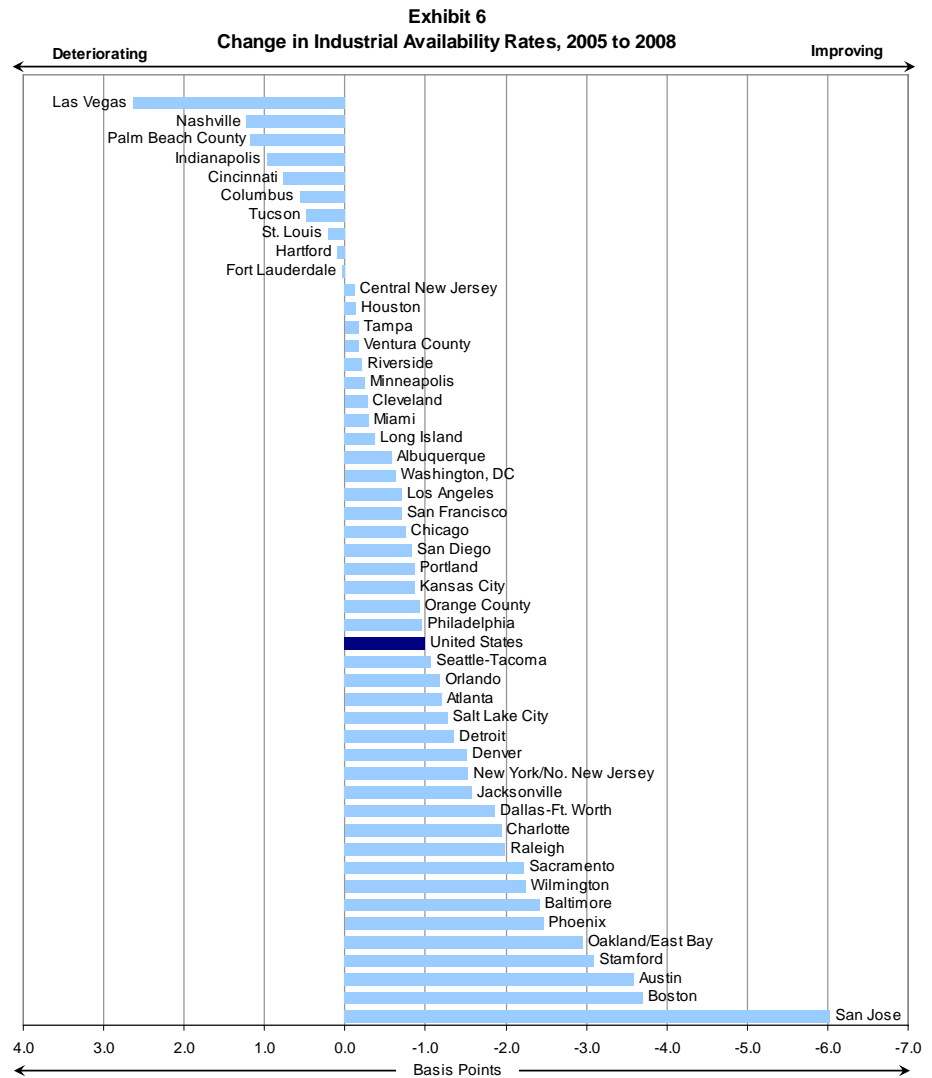


	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Completions	231.2	188.8	109.7	66.9	63.8	78.9	136.9	173.2	208.2	228.5	241.5
Net Absorption	215.4	52.6	9.0	83.9	131.5	197.1	201.8	172.4	206.7	208.0	253.6
Availability Rate	8.4%	9.7%	10.6%	10.3%	9.6%	8.4%	7.6%	7.5%	7.4%	7.4%	7.3%
	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Completions	229.6	243.8	143.1	99.6	127.5	134.6	165.0	155.3	156.3	148.8	159.0
Net Absorption	291.0	(143.6)	(11.1)	30.8	183.5	280.7	223.5	187.8	139.3	152.8	145.0
Availability Rate	6.6%	9.9%	11.0%	11.6%	11.0%	9.6%	9.0%	8.6%	8.6%	8.5%	8.5%

Source: Torto Wheaton & RREEF Research

We expect demand will outpace new supply for another two years, resulting in a national vacancy rate below 9% by year-end 2007, as shown in Exhibit 5. Moderating US economic growth over the next few years is expected to translate into reduced industrial space demand, leveling in 2008 and averaging about 146 million square feet between 2008 and 2010. Although somewhat off the pace of the last two years, it is above the long term US annual average of 139 million square feet.

Tech-heavy markets of Austin, Boston, San Jose and Oakland/East Bay, which took longer to gain momentum, stand to post the sharpest occupancy gains over the next three years. Exhibit 6, below, outlines our projection for the change in industrial availability rate for each of the 49 individual metro markets we track. We expect the majority of markets to gradually improve occupancy through 2008, but as market rents increase, new supply will temper gains.



Healthy real estate fundamentals will allow for rental rate appreciation throughout the forecast period, averaging about 4.2% per year for larger warehouse space, about 4.7% per year in the smaller warehouse and flex segments and about 5.6% per year in the R&D or Office/Service and Business Park segments. Rent growth prospects vary widely between metro markets and submarkets depending on current supply and demand balance, existing rental rates and industrial land cost and availability.

Implications for Investment:

Implications of Economic Growth for Industrial Real Estate

Early in the US economic cycle, consumer spending fueled growth and the pick-up in real estate demand was felt first in the retail sector. Demand for industrial real estate picked up later in the cycle. To date, the strongest industrial markets have been “global gateway” distribution centers that benefited from strong growth in consumer imports. Southern

California, Oakland/East Bay, Seattle/Tacoma, South Florida, and Northern/Central New Jersey were among the key beneficiaries of a consumer-driven economy.

As the economic expansion matures, benefits are accruing to a more diverse set of industrial property types and regional markets. Positive import and export growth should continue to support demand fundamentals in the global gateway markets. National distribution hubs like Atlanta, Chicago, and Dallas/Fort Worth should also benefit from rising trade flows. Strong demand for heavy machinery and construction materials is providing some support for Midwestern manufacturing, despite lagging industries like autos. The return to positive growth in technology employment at a national level bodes well for an imminent recovery in tech hubs like San Jose and Boston. All of these markets will be covered in greater detail below.

Risks to the Economy

Key risks to future growth include a housing market that cools more than expected, rising inflationary pressures, higher oil prices, intensifying Mideast tensions, and the continued threat of another terrorist attack.

Moreover, acceleration in inflation in 2006 and 2007 may force the Fed to raise interest rates at a time when economic growth is decelerating. Such rate increases have the potential to set off a recession within the next two years. The baseline forecast is that the Fed will be able to keep interest rates at a neutral level, allowing economic growth to continue unchecked while keeping inflation contained.

The Warehouse Sector

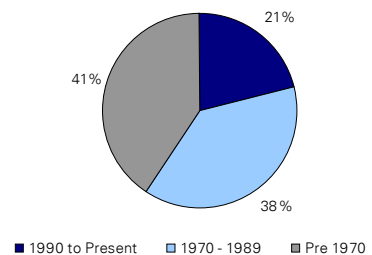
An aging industrial stock, in the context of a growing economy, will help drive new supply in markets where demand and rents justify it. At present the national supply pipeline is dominated by larger bulk warehouse product in the top six metro markets. Only 21% of current US stock was built after 1990, 27% of larger warehouse product (over 200,000 square feet) was built after 1990.

The relative lack of modern stock will keep the development pipeline of larger warehouse facilities on trend, even with relatively high metro vacancy figures, because older stock cannot accommodate the requirements of modern, large-scale retailers and logistics firms.

The industry will continue to adapt to swelling international trade flows. And so long as growth is maintained, net absorption of industrial space will continue. A negative exogenous shock to trade flows could stifle or reverse demand and cause a supply imbalance in the sector as occurred back in 2001.

Markets that should see the greatest demand over the next five years are the well established east and west coast global gateway markets and primary national inland distribution hub markets as shown in Exhibit 8. These top 10 metro markets, which comprise about 43% of

Exhibit 7
Age of US Industrial Stock



Source: Torto Wheaton Research (4Q 2005) and RREEF Research

**Exhibit 8
Top 10 Metros for
Industrial Space Demand**

	Industrial Base	5-Year Supply Forecast	5-Year Demand Forecast	YE 2005 Avail. %	Ind. Land Supply / Cost	Stock % Post-1990	Metro Type
Atlanta	524,994	53,000	55,500	12.6%	High / Cheap	35.2%	Inland Hub
Central New Jersey	521,489	27,600	29,100	8.4%	Med. / Expensive	13.1%	Tri-Coastal
Chicago	1,060,053	63,000	69,000	10.8%	Ample / Mixed	21.4%	Inland Hub
Dallas-Ft. Worth	669,398	57,000	66,000	11.8%	Ample / Cheap	26.0%	Tri-Coastal
Houston	401,492	29,000	25,000	8.8%	Ample / Cheap	17.1%	Combo
Los Angeles	914,943	38,800	43,900	4.7%	Low / Expensive	12.2%	Tri-Coastal
Phoenix	222,835	29,100	31,000	8.6%	Ample / Mixed	34.5%	Inland Hub
Riverside	332,717	89,000	79,500	5.4%	Ample / Mixed	54.1%	Tri-Coastal
San Diego	182,095	23,300	25,600	8.8%	Low / Expensive	33.7%	Tri-Coastal
Seattle-Tacoma	261,031	22,150	25,700	7.3%	Med. / Mixed	26.2%	Tri-Coastal
Top 10 Metros	5,091,047	431,950	450,300				
Pct. Of US total	43%	55%	53%				

Source: Torto Wheaton & RREEF Research

total US industrial stock, are forecast to capture 53% of total space demand and about 55% of new development over the next five years.

In terms of outright space demand, Chicago, Atlanta and Dallas/Ft. Worth will join Riverside as the top high-demand markets. Plentiful and inexpensive land, as well as new and expanding intermodal facilities, will continue to draw large distribution requirements to the Midwest and South. With few constraints on new supply however, rent growth prospects for larger warehouse product are limited.

Land supply constraints and tight market conditions in Los Angeles and New York/Northern New Jersey will limit future net absorption potential, but help drive rent growth for warehouse product. South Florida, San Jose, Oakland/East Bay, Phoenix, Riverside and Orange County should post the highest rent growth over the next two years for large-bay warehouse product.

Rent growth prospects for smaller-bay warehouses are encouraging over the next two years. Soft market conditions caused market rents for multi-tenant space to fall far below those required to justify speculative construction. New supply of for-lease space has been modest since 2001, as most new development was geared towards larger users or smaller for-sale buildings or condos.

Future demand should tighten vacancy of smaller-bay product in core submarkets of the major metro markets. The key in this dynamic will be sustained local economic growth. High land values, will temper industrial supply at prime locations, and should support accelerated rent growth. California and Florida will lead rent gains, but the Texas metros should also fare well.

The R&D and Flex Sectors

Continued recovery in the tech sector, supported by robust business spending and general economic growth stands to benefit higher-finish industrial product. Leading markets, as shown by their relatively low vacancy rates in Exhibit 9, include Seattle, Portland and San Diego. Markets that continued to lag in this segment were Dallas and Boston. San Jose and Oakland made positive strides in 2004 and 2005, but recovery was uneven across submarkets. Austin and Washington D.C. are closer to balanced conditions and are on track for solid occupancy and market rent gains.

**Exhibit 9
Selected Tech-Related Markets**

	Industrial Base	5-Year Supply Forecast	5-Year Demand Forecast	YE 2005 Avail. %	R&D Land Supply/Cost	Base % R&D/Flex	High Tech Emp. %	5-Year Emp. Growth
Austin	66,339	7,100	10,600	13.5%	Med. / Mixed	26.5%	9.2%	3.7%
Boston	377,817	12,900	24,500	15.3%	Med. / Expensive	28.8%	4.0%	0.9%
Dallas	435,653	57,000	66,000	12.4%	Ample / Cheap	23.2%	7.4%	2.5%
Oakland	266,631	13,700	19,500	11.2%	Low / Expensive	22.2%	7.5%	1.3%
Portland	185,657	13,000	13,000	8.2%	Med. / Mixed	16.4%	7.2%	1.9%
San Diego	184,306	23,300	25,600	8.8%	Med. / Expensive	22.4%	7.1%	1.8%
San Jose	226,084	5,950	21,000	13.8%	Low / Expensive	56.4%	23.8%	1.1%
Seattle	270,683	22,150	25,700	7.6%	Low / Expensive	10.7%	8.0%	2.3%
Washington, DC	182,639	13,300	12,900	10.0%	Med. / Expensive	34.5%	9.1%	1.7%

Source: Torto Wheaton, Economy.com & RREEF

The tech markets are generally leveraged on manufacturing, information and engineering and to some extent business services employment, and are sensitive to US and global trends in the semiconductor, telecommunications, and computer, software, internet and biotech/medical industries. Many of these industries are experiencing healthy growth. Recent book-to-bill ratios and capacity utilization figures bode well for the semiconductor industry. Rising internet firms like eBay, Google and Yahoo are not only profitable but expanding. Apple and HP appear to be on a good track. Biotech and medical technology firms have been solid performers. The telecom industry is the primary laggard in the tech group.

Unlike the period between 2001 and 2004, when many high tech markets did not see meaningful job growth, the next few years should bring increased hiring, which increase demand for higher-finish flex, R&D and office-service space. Effective market rents generally remain well below replacement levels, which limits potential speculative supply. As such, marginal increases in demand serve to directly increase market occupancy rates and support substantial upward pressure on rents, as occupancy gains are achieved and functional space becomes scarce.

Metro markets that are expected to experience the strongest occupancy gains and rent growth over the next several years include San Jose, Oakland/East Bay, Austin, Portland, Orange County, and selected areas in Minneapolis and Chicago. Lower finish flex product in Fort Lauderdale is also expected to see sharp near-term rises.

Asset Specific Risks

Asset selection, despite broadly improving market conditions, is vital. The phrase, 'a rising tide lifts all ships' may not apply to 'all ships' during this recovery. Important tech-heavy metros, like San Jose, Dallas and Oakland lagged overall recovery, in part because of their relatively high manufacturing concentrations. It is important to delineate between functional multi-tenant Flex and R&D product, and larger R&D/manufacturing facilities. The former should perform well over the next three to five years as mid-sized and smaller firms grow, especially in the tech-hubs noted above in Exhibit 9. Recovery of the latter segment will be impaired as larger high tech manufacturers continue to outsource production to cheaper areas, domestically and overseas.

In most cases, older R&D/manufacturing facilities are best suited for redevelopment into other uses, as opposed to repositioning, as land values, parking issues and the high cost of improvements work against a profitable industrial re-use.

Vital hurdles for an acquisition strategy of higher-finish industrial product should include a minimum parking ratio of 3.5/1000, divisibility into smaller-bays (which can garner rent premiums as they are more costly to reproduce), image (75% glass-line) and location. Access to decision-maker housing and proximity to important industry clusters are key considerations in the high tech hubs. Firms often prefer to locate in close proximity to leading anchor companies in their industry, thus a location supported by a booming sector like Internet or Software, should see better demand than one with a contracting industry like Manufacturing.

Capital Markets and Investment Returns

As an asset class, industrial properties tend to provide stable returns, based primarily on income. Improving industrial market fundamentals and significant capital in-flows during the last two years have supported exceptional returns recently. Exhibit 10 outlines total NCREIF Property Index (NPI) returns for each of the four major property types over the last year as of March 31, 2006 and since 1978 (since inception).

Exhibit 10					
NCREIF Total Returns					
as of March 31, 2006					
	<u>Total NPI</u>	<u>Apartment</u>	<u>Industrial</u>	<u>Office</u>	<u>Retail</u>
Returns					
1 Year	20.2%	21.0%	20.9%	20.2%	18.8%
Since Inception*	10.1%	12.0%	10.5%	9.3%	10.4%
Standard Deviation					
Since Inception*	6.4%	6.2%	6.2%	9.0%	5.8%
* Average of annual returns since inception in 1978.					
Source: NCREIF					

The NPI posted an exceptional 20.2% one year total return, double the since inception average. Industrial returns over the last 12 months of 20.9% were on par with the office and apartment sectors, but outperformed retail.

Current trends in the industrial property market suggest we will experience tightening supply, allowing landlords to garner above-average rental rate growth over the next several years. Given balanced market conditions, a low cost-to-lease should help the industrial sector provide a stable return platform and potentially outperform other sectors in the near term. Well-located multi-tenant product in core submarkets stands to benefit the most from local growth.

Segregated by property type within the industrial sector, since inception returns have been highest for the Flex sector, followed by R&D and Warehouse. Returns have been the most volatile for R&D, as shown in Exhibit 11. Coming off of a cyclical bottom, the R&D and Flex property sectors in the major tech hubs should provide opportunities on both the core and value-added front.

Exhibit 11				
NCREIF Industrial Returns by Type				
as of March 31, 2006				
	<u>Warehouse</u>	<u>Flex</u>	<u>R&D</u>	<u>Total</u>
Returns				
1 Year	20.5%	23.3%	21.0%	20.9%
Since Inception*	10.5%	9.3%	10.8%	10.5%
Standard Deviation				
Since Inception*	5.7%	7.6%	9.0%	6.2%
* Average of annual returns since inception in 1978.				
Source: NCREIF				

Functional but under-leased Class A and Class B properties in the core submarkets of San Jose, Seattle, Portland and Austin are timely opportunities. In markets with fewer land constraints, such as Austin, Dallas, Chicago and Minneapolis, greater submarket, location and quality selection is required, but opportunities for above average income growth are available.

On a regional basis, the West broadly outperforms all other regions – registering 12.1% since inception returns. Industrial property investments in the East provided for double-digit returns as well. Comparatively, the South and Midwest have lagged, both registering since inception returns of 8.8% (see Exhibit 12).

Exhibit 12
NCREIF Industrial Returns by Region
as of March 31, 2006

	East	Midwest	South	West	Total
Returns					
1 Year	19.7%	16.0%	18.0%	24.5%	20.9%
Since Inception*	10.7%	8.8%	8.8%	12.1%	10.5%
Standard Deviation					
Since Inception*	6.2%	4.3%	6.0%	7.9%	6.2%

* Average of annual returns since inception in 1978.

Source: NCREIF

This history of industrial sector returns matches our view of current and future real estate market conditions; dynamic international trade, fast growth industry concentrations and high quality-of-life dynamics, in markets with generally constrained and expensive land supplies, experience stronger supply and demand and rental rate fundamentals, leading to superior returns. As such we continue to favor property investments in Tri-Coastal markets, with the West and East Regions providing higher return potential, as well as in select 'inland-hub' markets in the South and Midwest.

ANALYST CERTIFICATION

The views expressed in this report accurately reflect the personal views of the undersigned lead analyst. In addition, the undersigned lead analyst has not and will not receive any compensation for providing a specific recommendation or view in this report.

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