Deutsche Asset & Wealth Management

__Geoffrey Dobrmann__ and __Jonathan Schein__ of Institutional Real Estate, Inc recently spoke with __Todd Henderson, Gianluca Muzzi__ and __Georg Allendorf__ of Deutsche Asset & Wealth Management for a roundtable discussion on real estate investment opportunities in their respective parts of the globe. The following is an excerpt of that conversation.

Todd Henderson is managing director and head of real estate, Americas, at Deutsche Asset & Wealth Management, where he has been responsible for all facets of the direct real estate investment management business in the Americas. From 2009 to 2012, Henderson served as the CIO of RREEF Real Estate, Americas. Prior to joining RREEF Real Estate in 2003, Henderson was director of acquisitions for The J.E. Robert Co.

Gianluca Muzzi is managing director and head of real estate, Europe ex-Germany, at Deutsche Asset & Wealth Management. In addition, Muzzi heads the global opportunity funds, with global responsibility for high-yields products. Previously, Muzzi headed up Deutsche Bank Real Estate Investment Banking in Italy for three years, and he worked with Lazard Real Estate as an adviser in major Italian real estate transactions.

Georg Allendorf is managing director and head of real estate, Germany, at Deutsche Asset & Wealth Management. He was formerly responsible for client management in Germany, Austria and Switzerland at RREEF along with the special funds for institutional investors. Prior to joining RREEF Germany in 2003, he served as head of real estate portfolio management at R+V Versicherung.

Geoffrey Dobrmann: *Todd, can you give an update on Deutsche Asset & Wealth Management?*

Todd Henderson: We are doing quite well. Midway through the year, we have raised more capital for our real estate and infrastructure business on a global basis than we have in any years past. Midway through, we were at about $10 billion of gross capital raised. The U.S. real estate business, which I am responsible for, is experiencing quite good performance both from the standpoint of investment returns as well as capital raised, which go hand in hand. Our core composite, which is how we measure ourselves from a performance perspective, is beating the NCREIF ODCE Index on a three-, five-, 10-, 20- and 30-year basis. We are excited about the opportunities ahead of us. We think the combination of how we are positioning our portfolios and the current low-yield environment, which we think will last longer than some might expect, has the potential to be positive for investors and the organization.

Dobrmann: *What do you see as the primary needs and concerns for your U.S. investor clients today, and how are you addressing those needs and concerns?*

Henderson: Clients are still very interested in the core space, looking for income and diversification in their portfolios. Real estate portfolios as a percentage of the overall institutional client portfolio continue to expand as does the retail market for real estate. While the lion's share of the focus for our client base was core real estate over the past couple of years, we are seeing them expand their risk appetite. Our clients are beginning to participate with us both in value-added and opportunistic transactions through separate accounts. They are also actively looking at funds for deploying capital up the risk curve.

Jonathan Schein: *What do you think is driving that?*

Henderson: Clearly the economic backdrop and the recovery in certain sectors is providing investors with increased comfort level to add some additional risk. If you look at the supply picture, the United States is very undersupplied relative to demand for every major property type except multifamily. We have seen significant absorption, which is the first derivative of NOI growth. We are into the second derivative of NOI growth — rental rate increases — but still far from peak rents in the commercial sectors. In a pro-cyclical economic environment, we would expect the two pro-cyclical sectors, office and industrial, to outperform so long as the forward supply curve remains balanced.

Dohrmann: *Gianluca, Where do you see European markets heading over the next three to five years?*

Gianluca Muzzi: I think investors are not going to successfully invest in Europe through complicated, high-yield financial structures. I think successful real estate investment will require the old brick-and-mortar skills — having the right team on the ground and delivering performance by intensively asset managing the portfolio for clients. There will not be any shortcut to this. One of the ways Deutsche AWM is well positioned is we have local people on the ground across Europe in six local offices, in addition to across the globe. Especially in the near future, the fly-in, fly-out model will not work.

Dohrmann: *What do you see as the primary needs and concerns for your investor clients focusing on Europe, and how is Deutsche AWM attempting to address those needs and concerns?*

Muzzi: Investors are very interested in the euro area, which still provides investment opportunities, and I think we can be quite successful in providing them with the right strategies to access the markets. Deutsche AWM's ability to access, deploy and manage international capital flows has been proven by our success, for example, investing in the U.K. on behalf of Asian investors. There is still a lot of risk adversity or, at least, prudence regarding the southern part of Europe. Investors are still very inclined toward core and core-plus strategies. While we see some desire for value-added and high-yield strategies, we need more time to see critical mass there.

Schein: *And, Georg, what do you see as the primary needs and concerns for your German investor clients today?*

Georg Allendorf: Right now, we have seen an increased interest in real estate, fueled by the low interest rate environment and the view that this environment is probably going to continue. Many institutional clients have asked us to support them in increasing their real estate allocations. We have also noticed that German retail investors are increasing their interest in real estate, but they want home market exposure rather than exposure to international real estate.

"We think the combination of how we are positioning our portfolios and the current low-yield environment will translate into continued good performance."

Dohrmann: *Where do you see the vulnerabilities for real estate in the current economic outlook?*

Henderson: There is still significant slack in the wage market here in the United States. China is underperforming. Europe is underperforming. Japan is underperforming. It is not a pretty picture globally from an economic performance perspective, and the U.S. in some ways has decoupled from the rest of the world. The greatest risk is the potential for exogenous shocks, which is very possible given what is going on in the Middle East and with Russia. Furthermore, some of the larger global economies are not faring as well at the moment, with a few pockets of strength such as the U.S., which adds risk.

Dohrmann: *How do you insulate your clients from those vulnerabilities?*

Henderson: It requires taking a portfolio view, ensuring that we are investing our clients in assets where we have had good market and good asset selection, where we have defensible income and where we are not taking risks on assets in markets that are two or three concentric circles out from the economic engines that have led us out of recession. It is really about asset selection. It is about market selection. And that gets back to the core of what we do. If you look at our organization, in the U.S. we have 200 people. The 16 people in our Transactions Group have so far this year done almost $5 billion in transactions. We have 100 million square feet that our asset managers are running every day. We have one of the largest research groups in the real estate business globally, and we have 40 people within our Portfolio Management team that are connected to most of the largest investors in the world. The signals that we get from the portfolio, from the capital, from our top-down and bottom-up research, from the $5 billion in transactions that we have done this year and the $50 billion that we have done over the past eight years help us to position our clients in a way that is defensive relative to some of the potential exogenous shocks, but also not underweight the pro-cyclical sectors, given the economic environment that we see here in the U.S. and we expect going forward.

Allendorf: In a sense, Germany has been going very strong. Certainly it is strong within the broader European context. Germany is an export-driven market, so anything that threatens that situation will have a negative impact. So a very strong euro could become a problem for Germany. Or, as Todd mentioned, an exogenous shock such as the Ukraine crisis developing further could certainly have a negative effect. Also German consumption has slowed down, and if geopolitical fears decrease consumption and increase the German tendency to save not spend, then that would be a threat to the retail markets in Germany.

Dohrmann: *What is the momentum in the underperforming markets? Are there opportunities?*

Henderson: For the most part, several major economies are currently struggling, but some of these real estate markets have presented some unique opportunities. For example, in Europe, and Gianluca and Georg can say more about this, there is a lack of debt capital in the market. We think there is a significant opportunity, much like there was here in the U.S. over the past couple of years, to deploy subordinate debt on new originations on stable assets. We are looking at 75 percent loan-to-value and significant cash flow coverage, which provides tremendous risk-adjusted returns. That is a defensive strategy in the face of a relatively choppy world economy that, frankly, has underperformed expectations.

Schein: *How is the debt business progressing?*

Muzzi: Todd is correct, there is significant opportunity, and we are getting a lot of traction on the debt business. Historically, we have been an equity house on the real estate side, but we have started deploying client capital on behalf of debt strategies with great success. We are getting significant mandates from insurance companies, pension funds and other institutional clients, both in senior and in junior strategies, and this is another example of how we can successfully execute on risk-adjusted return strategies where we can pursue relatively safe, prudent, conservative strategies of core and core-plus with successful results. Clearly on the debt side there is still an opportunity in light of the demand that is still in the market for financing.

Henderson: Today, in the subordinated debt market, it is possible to lend up to 75 percent LTV against stabilized properties and get 500 to 600 basis points over the corresponding index for taking that risk — this strikes us a good risk-adjusted return on values and NOIs that are below peaks.

Schein: *Does debt have a long-term role in your real estate portfolios?*

Allendorf: Yes, it has a long-term role. We started doing this a couple of years back in the U.S. with the first transaction, then expanded to Europe. From our perspective, it has always been a diversification play within our existing, more core-oriented real estate portfolios. Our general approach, and why I think Deutsche AWM can add value to the process, is that we go into such a lending situation as if we would buy the equity. The diligence that we do for debt transactions matches pretty closely with what we would do on a direct real estate investment. So, even if not everything runs perfectly, we have underwritten the loan in a way where we feel very comfortable owning the property outright.

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Dohrmann: *Is the interest for the debt side of the market coming from your pre-existing investors who are trying to fill a different bucket, or is the interest coming from investors who feel that that is a better way to play the European market opportunity?*

Muzzi: Both. We started with an equity client who asked us, rather than targeting a purely core/core-plus direct property strategy, to deploy some of the allocated capital into junior debt strategies on a risk-adjusted return basis. And then once we started to do

CORPORATE OVERVIEW

Deutsche Asset & Wealth Management's real estate investment business has been investing in real estate assets for more than 40 years. As part of the Alternatives and Real Assets platform, the business has more than 450 employees located in 22 cities around the world. It manages €35.2 billion in assets under management as of June 30, 2014, on behalf of institutional investors and private clients worldwide.

that and we saw the traction, then even new clients came to us.

Dohrmann: *Todd, are you seeing those same kind of debt opportunities in the United States, and are you planning to start to exploit that for your clients as well?*

Henderson: We have exploited it fairly significantly over the past few years. We have done approximately $2 billion of what we would call mezzanine or preferred equity to exploit that particular opportunity. More players have entered the debt space in the U.S., but we still think subordinated debt opportunities remain, and we are pursuing them with our separate account clients.

Dohrmann: *Where, from your vantage point, do you see the greatest opportunities in the European markets and the greatest risks?*

Muzzi: The European market is very fragmented, and each country provides investors with very different value proposition. For example, the U.K. market still provides very interesting opportunities. The London market is a bit heated, but secondary locations in the U.K. are picking up. The U.K. economy is doing extremely well. U.K. GDP growth is about 3 percent while the rest of Europe struggles at just above 1 percent. And while the yield gap between primary and secondary locations is shrinking, the U.K. is still very attractive. If you move toward continental Europe — and I will leave aside Germany for the moment, and Georg can say more about that — the Polish market is also very interesting. Poland is a good proxy for the German market, with a very solid economy and an institutional real estate market. We have invested over €1 billion over the past six or seven years, not only in Warsaw, but also in secondary Polish locations, and not only in office, but also in retail and logistics outside of Warsaw. Poland is a very attractive and actually quite stable market. France is viewed by most investors with scepticism because of taxation and the macroeconomic outlook. But we think the greater Paris real estate market is actually very attractive and provides good risk-adjusted returns. A lot of opportunities can be seen as well in southern Europe, but the situation is quite complicated because there are many investors, especially those targeting high-end strategies, and limited properties on offer in the market, so it is challenging to find good opportunities. Italy has started to be on the radar screen of investors, especially the ones more geared toward high yield, but again there is a very limited amount of properties on the market.

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Allendorf: Germany is a very diverse economy. The country does not have a single city that dominates the economy or the real estate market. Any of the top seven German markets — Hamburg, Berlin, Düsseldorf, Cologne, Frankfurt, Stuttgart and Munich — will not account for more than 25 percent of the transaction volume in any given year. We are also buying in the top seven but, at the moment, we favor cities that are not part of those top seven. So much international money is flowing into those top seven markets that, from a risk-adjusted basis, we find the secondary markets interesting.

Schein: *Some might be concerned and ask, is there a bubble in the German market?*

Allendorf: Generally speaking, no. For a bubble to occur, we would expect asset prices to increase ahead of rental levels, and that is not what we have seen. We have seen rising rents and have seen value increases that correspond to those rising rents, even in the residential sector.

Dohrmann: *Most people seem to think interest rates will go up, but not right away and not very much. What is your read on that issue, and how are you dealing with it in your portfolio strategy?*

Henderson: That seems to be the risk that everyone is concerned about. If it happens significantly faster than expectations, then we could have some deterioration in real estate values. It is a question of whether or not NOIs can grow fast enough to keep up with the pace of rate increases. Our view is that, five years from now, we are going to be in a low 4 percent 10-year Treasury. So keeping that in mind, we are looking at assets that have good economic drivers behind them and good capability for NOI growth — this includes some late recovery markets that are demonstrating an ability to grow NOI. ❖

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