



# Real Estate Market Outlook 2012: A Year of Selective Opportunities

**Appraisal Institute, Sacramento Sierra Chapter**

**2012 Economic Forecast – January 20, 2012**

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## Outline

- I. Economy – National and California
- II. Capital Markets and Property Sectors
- III. Apartments
- IV. Industrial
- V. Office
- VI. Retail



Section I

## Economy - National and California

# The U.S. economy: year-end 2011 showing underlying private sector strength

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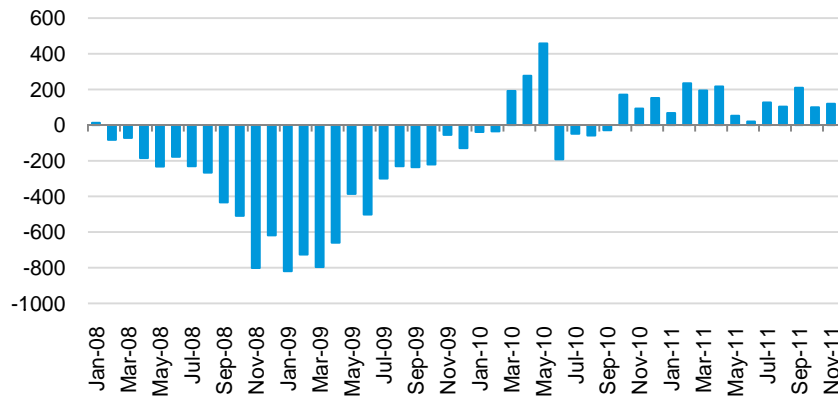
- 2011 was a rough year for recovery.
  - External shocks (Japanese tsunami, Greek debt, Middle East/oil, etc.).
  - Slow nature of recovery from major financial crises.
  - Fiscal stimulus ending plus retrenchment in government budget.
  - European debt crisis.
  - Inability for the U.S. government to raise the debt ceiling and pass a budget.
  
- Underlying U.S. private sector economy is showing strength.
  - 1.6 million non-farm jobs added through November (even after 300,000 cuts in public sector).
  - 1.9 million jobs added in private sector in 2011 (150,000 per month).
  - Broad-based economic recovery through many sectors.
  - Consumer confidence and spending is up and household debt is down.
  - Business sector profitability is healthy and business have cash.
  - Further U.S. credit downgrades have not occurred.

*Source: RREEF Real Estate and BLS. As of January 2012.*

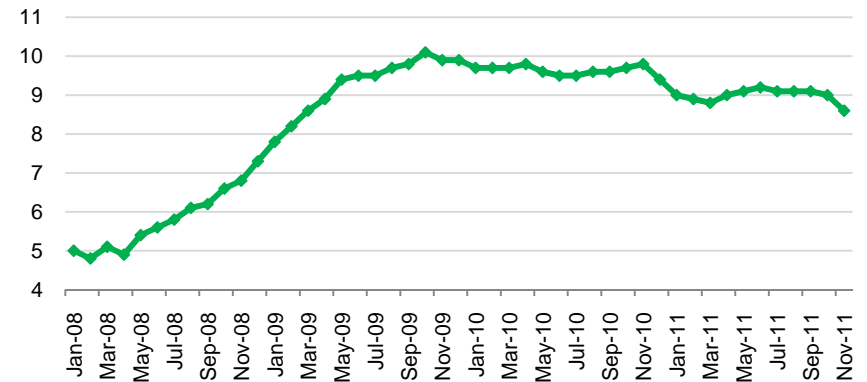


# Leading indicators are positive for moderate near-term job growth

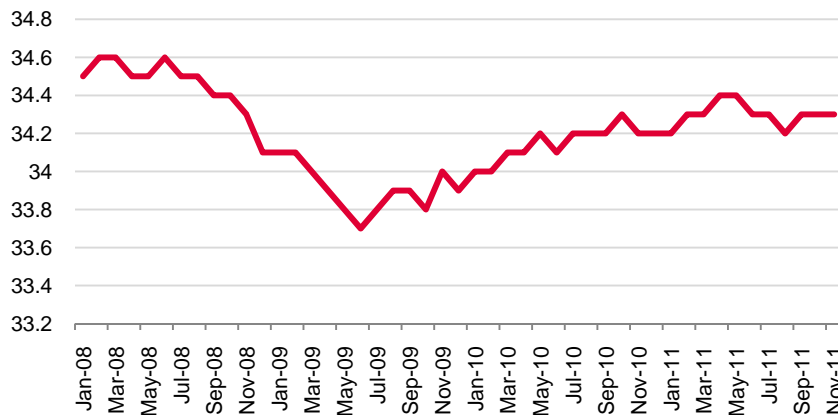
**Payroll Employment (Thousands)**



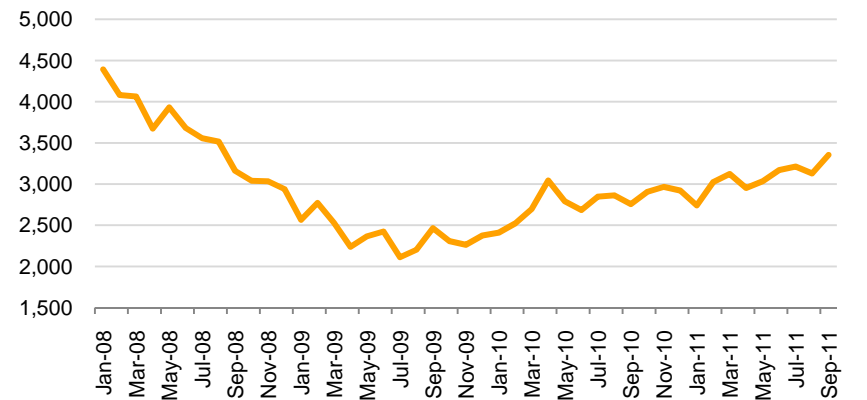
**Unemployment Rate (%)**



**Length of Workweek (Hours)**



**Job Openings (Thousands)**

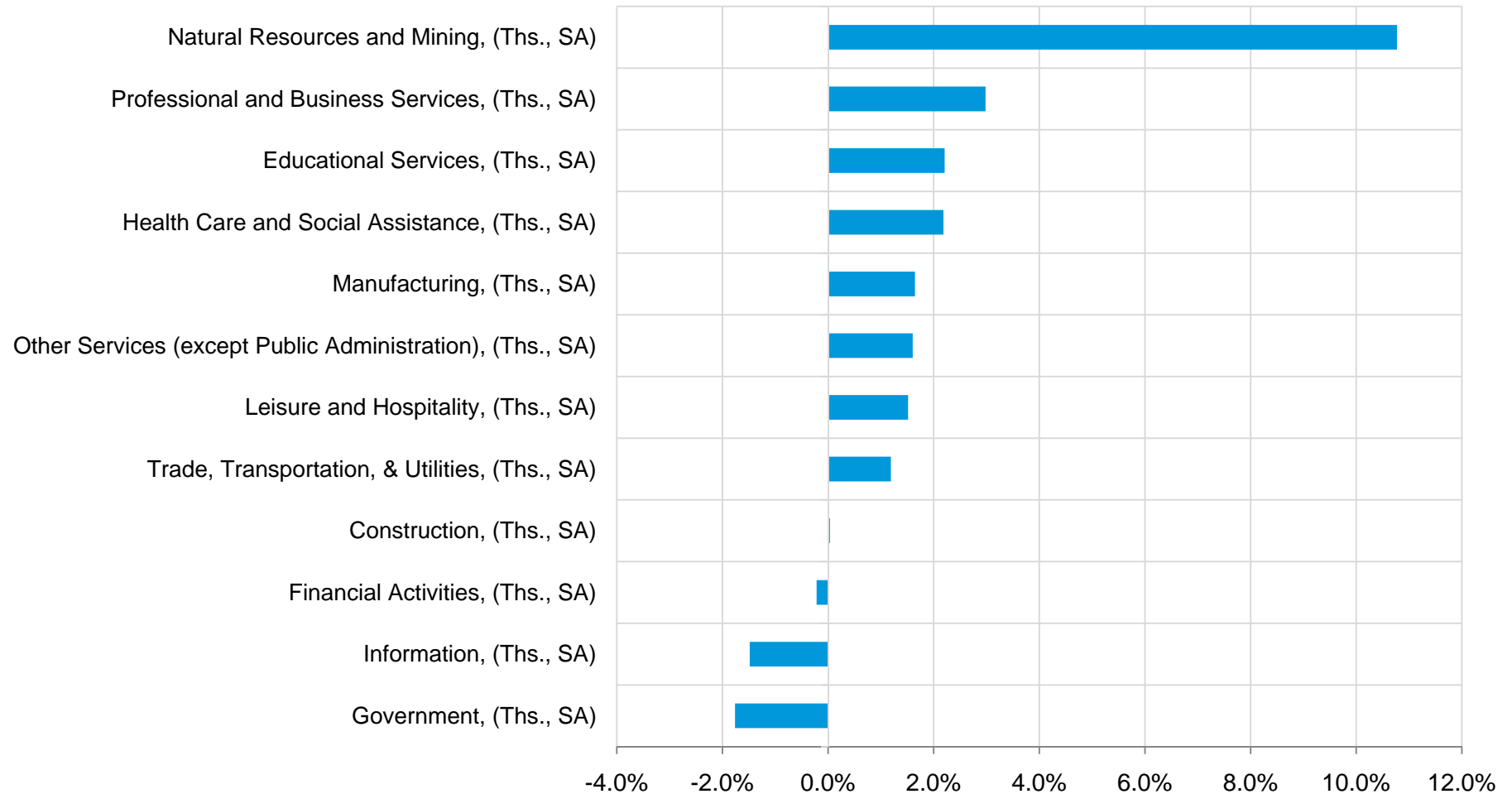


Source: BLS. As of November 2011.



# The recovery is slowly becoming broad-based

**Year Over Year Percent Change in Employment  
(December 2011)**

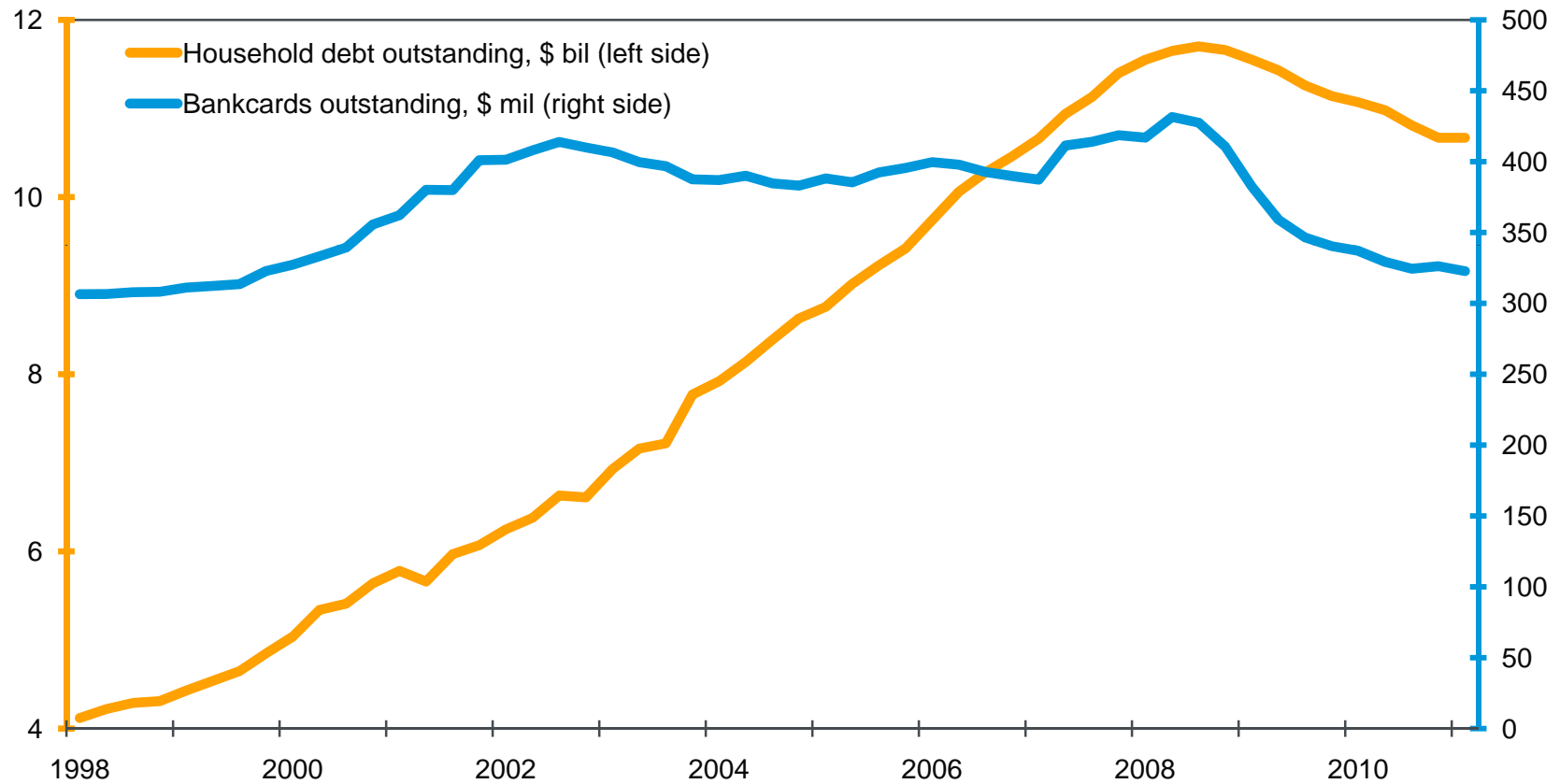


Source: BLS. As of December 2011.



# Household debt levels are improving

**Household Debt vs. Household Delinquency**



Sources: Equifax, Moody's Analytics, RREEF Real Estate. As of November 2011.



## Near-term economic outlook for 2012-2013

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- Significant headwinds will limit growth the next couple years.
- European debt crisis could be much worse for U.S. than expected.
- U.S. banking sector is increasing caution.
- The U.S. could feel a fiscal drag in 2012.
  - Election year: few decisions will be made
  - Public sector contraction and stimulus are all expiring totaling \$261 billion in cuts, or 1.4% of GDP
  - If unemployment insurance and payroll tax is not extended, another \$160 billion in cuts, or 1.1% of GDP
- Housing market is still finding its bottom, and will provide modest boost in 2013.
- Jobs forecast: 1.6 million jobs in 2012 and 1.9 million in 2013.

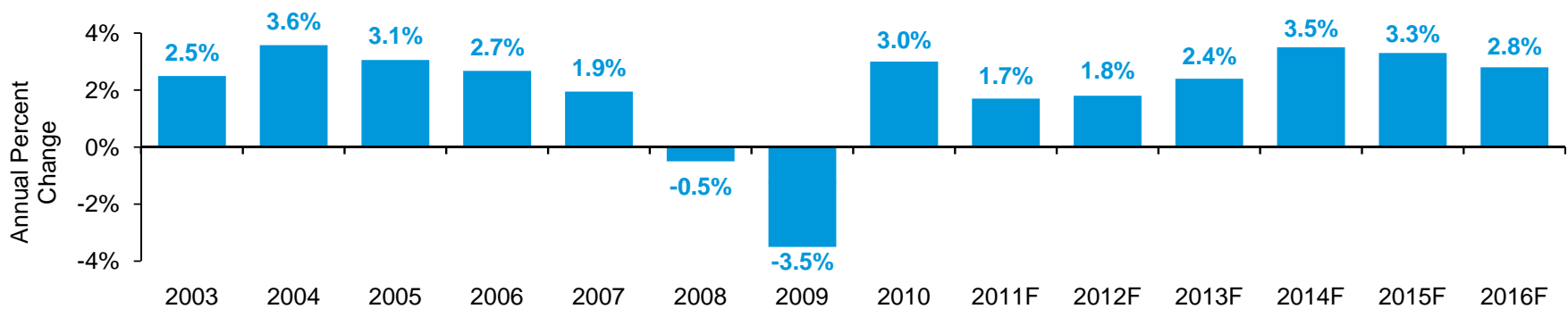
*Source: RREEF Real Estate and The Economist. As of November 2011.*



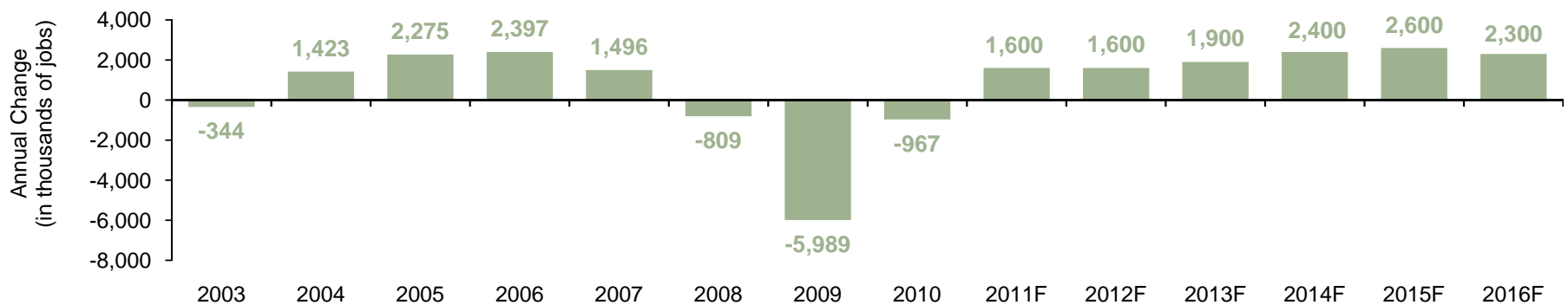
# 2012 – 2016 economic outlook

Slow growth through 2013; stronger recovery begins in 2014

**2003 to 2016 Annual GDP Growth**



**2003 to 2016 Annual Job Growth**

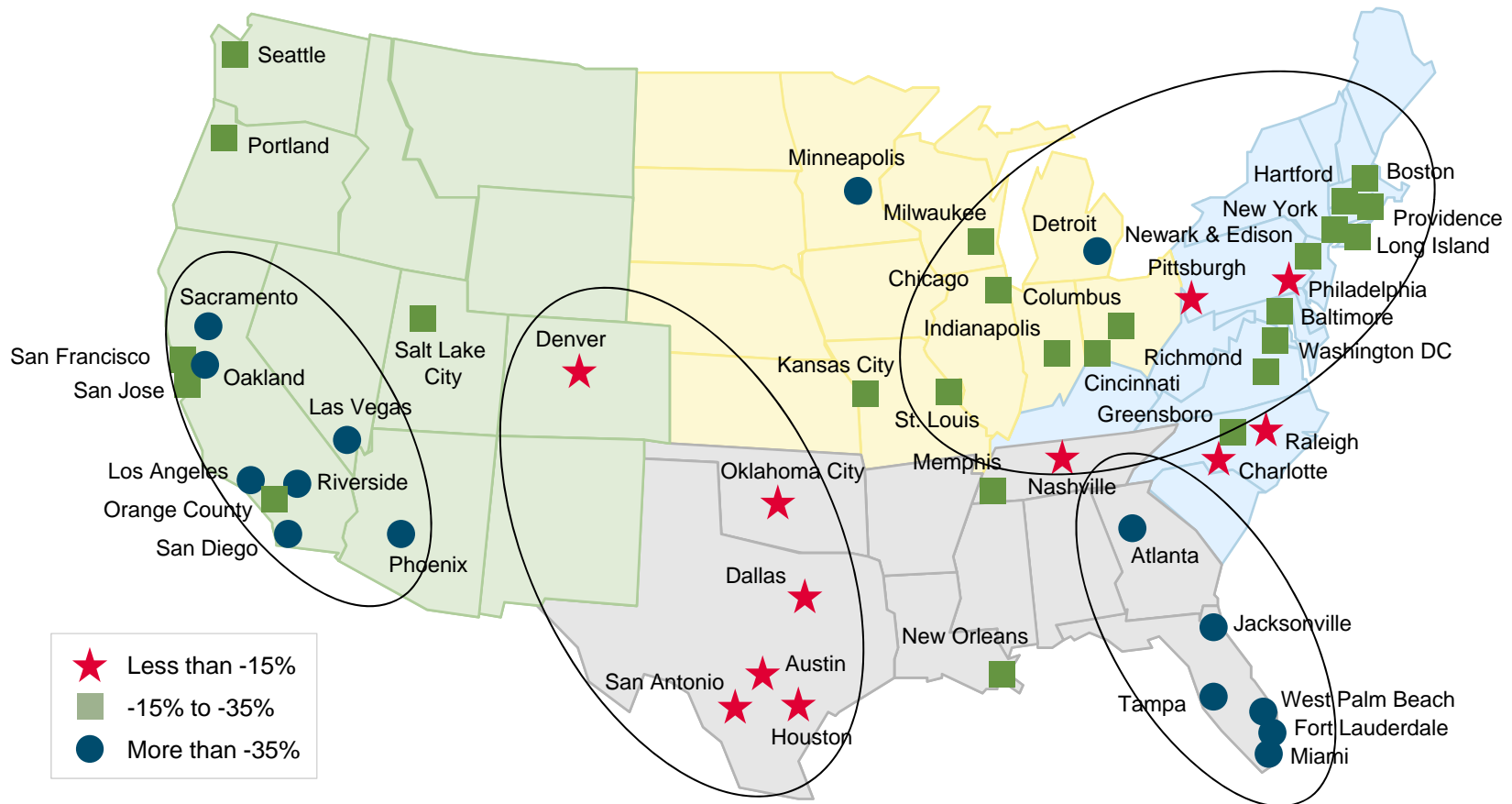


F = Forecast.  
Sources: IHS Global Insight, RREEF Real Estate.  
As of December 2011.



# Metro by home price depreciation: Steepest decline in Southeast and Southwest

## Median Home Prices Metro Peak to Current Total Change



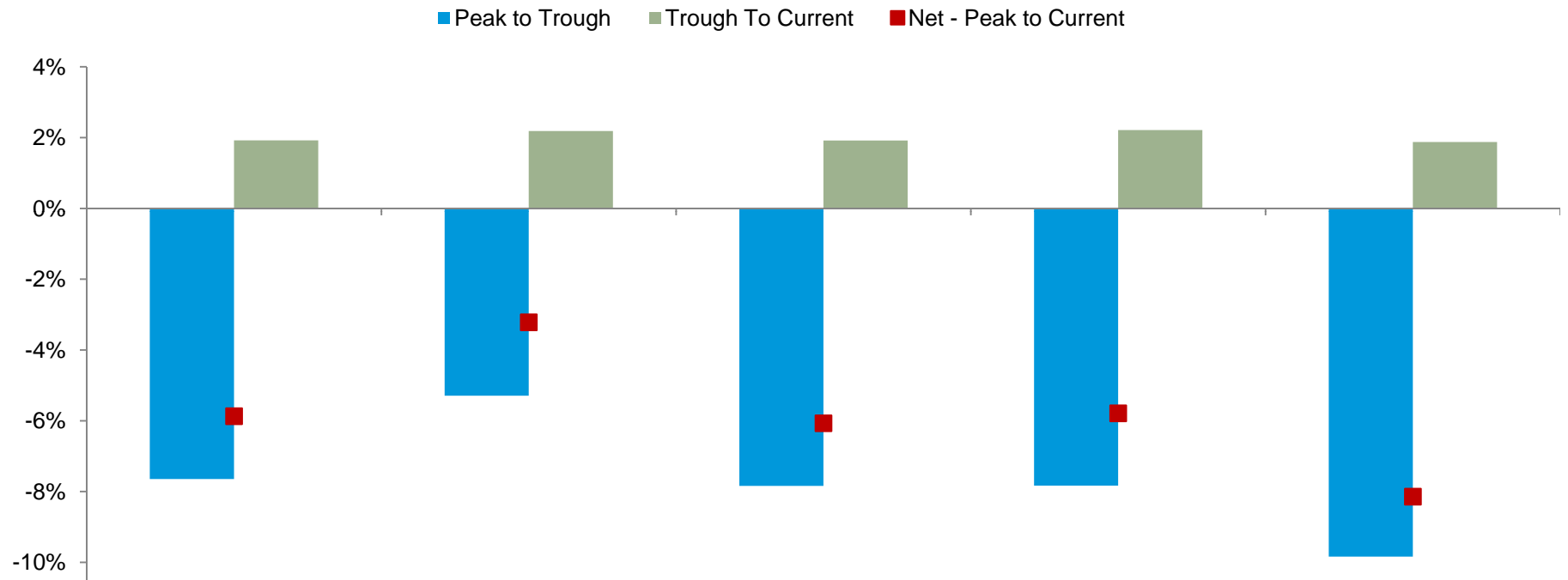
Note: Includes cities with over 500k jobs. States colored by NCREIF Region.  
Source: Economy.com, FHFA & RREEF Research, as of November 2011.





# The West is beginning to bounce back, but has furthest to go

## Peak to Trough change in Employment



	United States	Northeast	Midwest	South	West
Peak Unemployment	10.1%	9.0%	10.1%	9.5%	11.1%
Current Unemployment	9.0%	8.1%	8.5%	9.0%	10.3%

Source: BLS, as of November 30<sup>th</sup>, 2011.



## Unemployment across key California markets

Unemployment in most California metros rates well above US average (but should fall below)

Unemployment Rate (%)				
	CYCLE LOW	PEAK	CURRENT	FORECAST (4Q16)
<b>US</b>	4.4	10.0	8.6	5.2
<b>Los Angeles</b>	4.3	12.1	10.9	5.8
<b>Oakland</b>	4.3	11.4	10.2	5.0
<b>Orange County</b>	3.3	9.8	8.6	5.0
<b>Riverside</b>	4.8	14.5	13.3	6.6
<b>Sacramento</b>	<b>4.6</b>	<b>12.7</b>	<b>11.6</b>	<b>5.3</b>
<b>San Diego</b>	3.9	10.6	9.8	5.1
<b>San Francisco</b>	3.7	9.3	8.1	4.7
<b>San Jose</b>	4.5	11.7	9.9	4.9

Source: Economy.com



## Economy conclusions

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- 2011 surprisingly strong given significant headwinds.
- Private sector is leading the recovery, with 1.9 million jobs; offset by 300,000 public sector losses.
- Consumers a modest positive; housing a minor negative; government continues to be a significant drag.
- Below-trend economic growth will continue 2012 to 2013.
- Solid recovery beginning in 2014 with above-trend growth through 2016.
- Peak employment achieved by 2014.
- 12 million to 13 million additional jobs by 2016.
- Sectors driving recovery:
  - Natural resources energy
  - Professional and business services
  - Health care
  - Manufacturing
  - Technology

Source: RREEF Real Estate and Global Insight

Section II

## Capital Markets and Property Sectors



## Capital markets: market summary

### What is different?

- Even more aggressive pricing for prime assets in top locations
- Pricing even strong for such properties with leasing risk
- Interest rates have fallen further
- Financial institutions are beginning to work through distress
- Increased interest in Class B properties in “A” locations
- Global capital markets are at risk, although U.S. cap rates have been stable.

### What is the same?

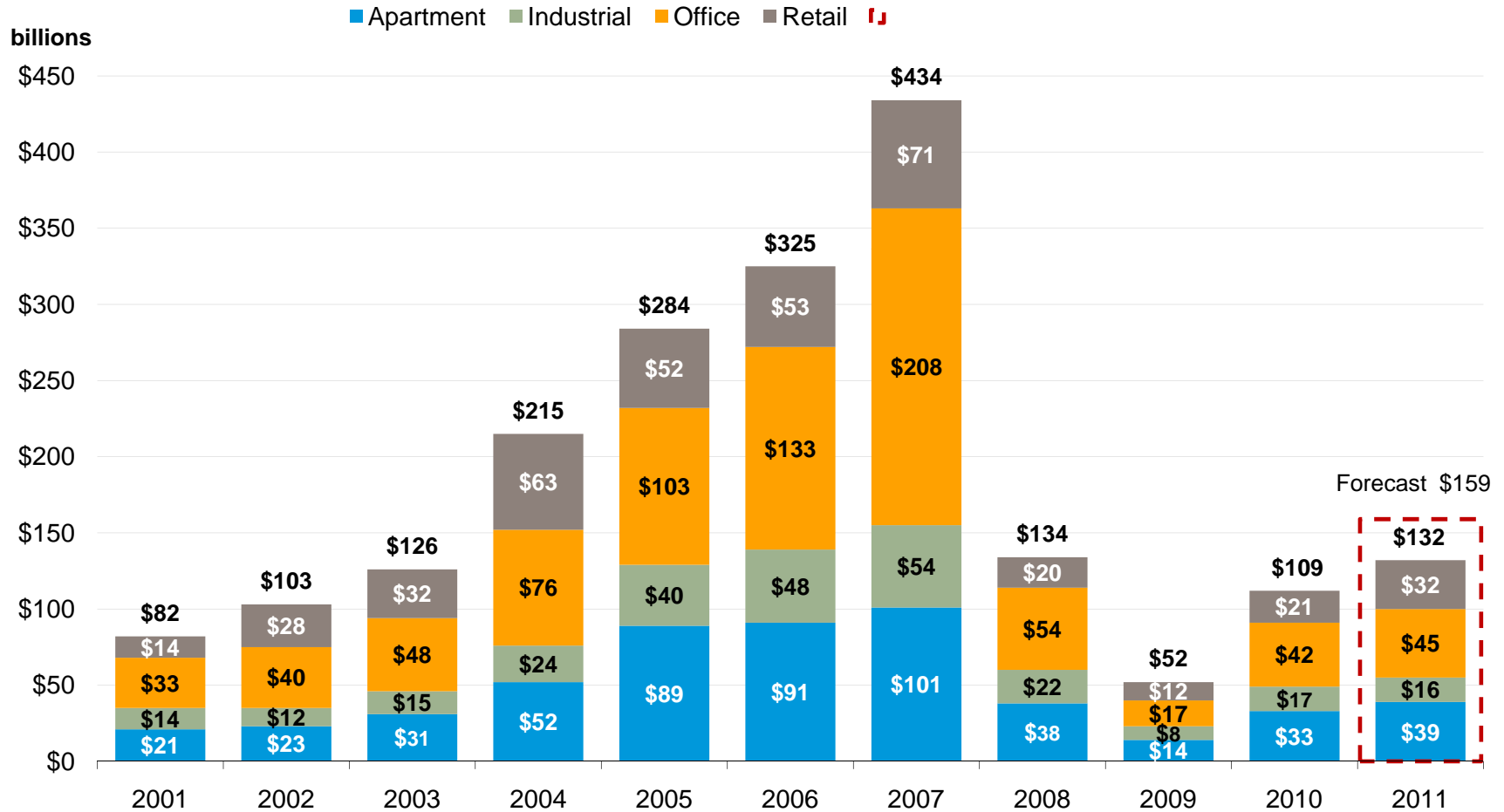
- Investors continue to seek high-quality, core, gateway metro real estate assets
- Little demand for properties in non-prime locations
- Little demand for suburban office and warehouse/flex product
- Debt is highly available for low risk properties

Source: RREEF Real Estate. As of January 2012.



# Transaction volume just starting to build

**Transaction Volume in \$Billions**

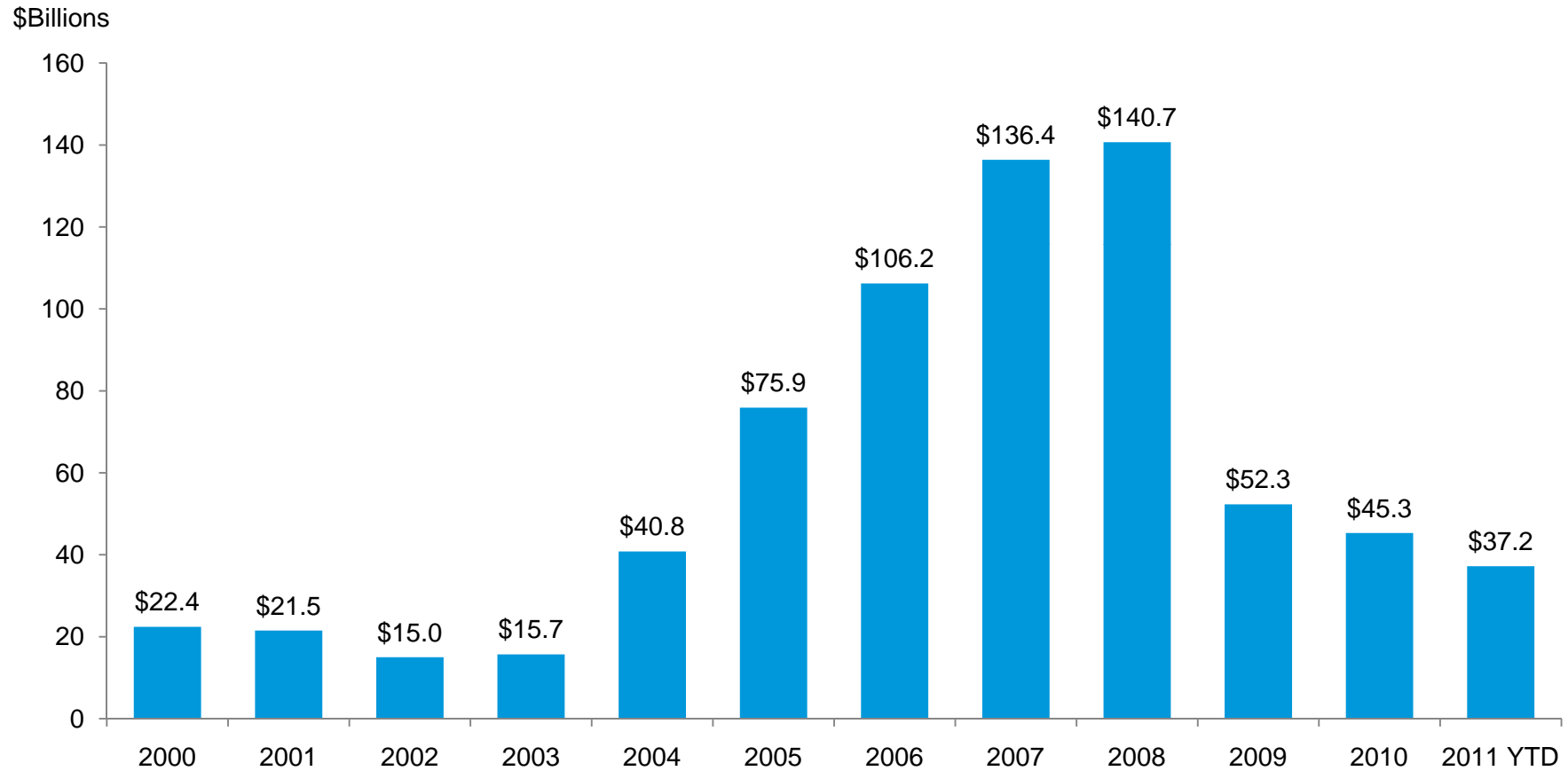


Note: \*4Q 2011 data is through October.  
 Source: Real Capital Analytics. As of November 2011.



# Capital raising for real estate is still depressed

## Historical Real Estate Fund Raising

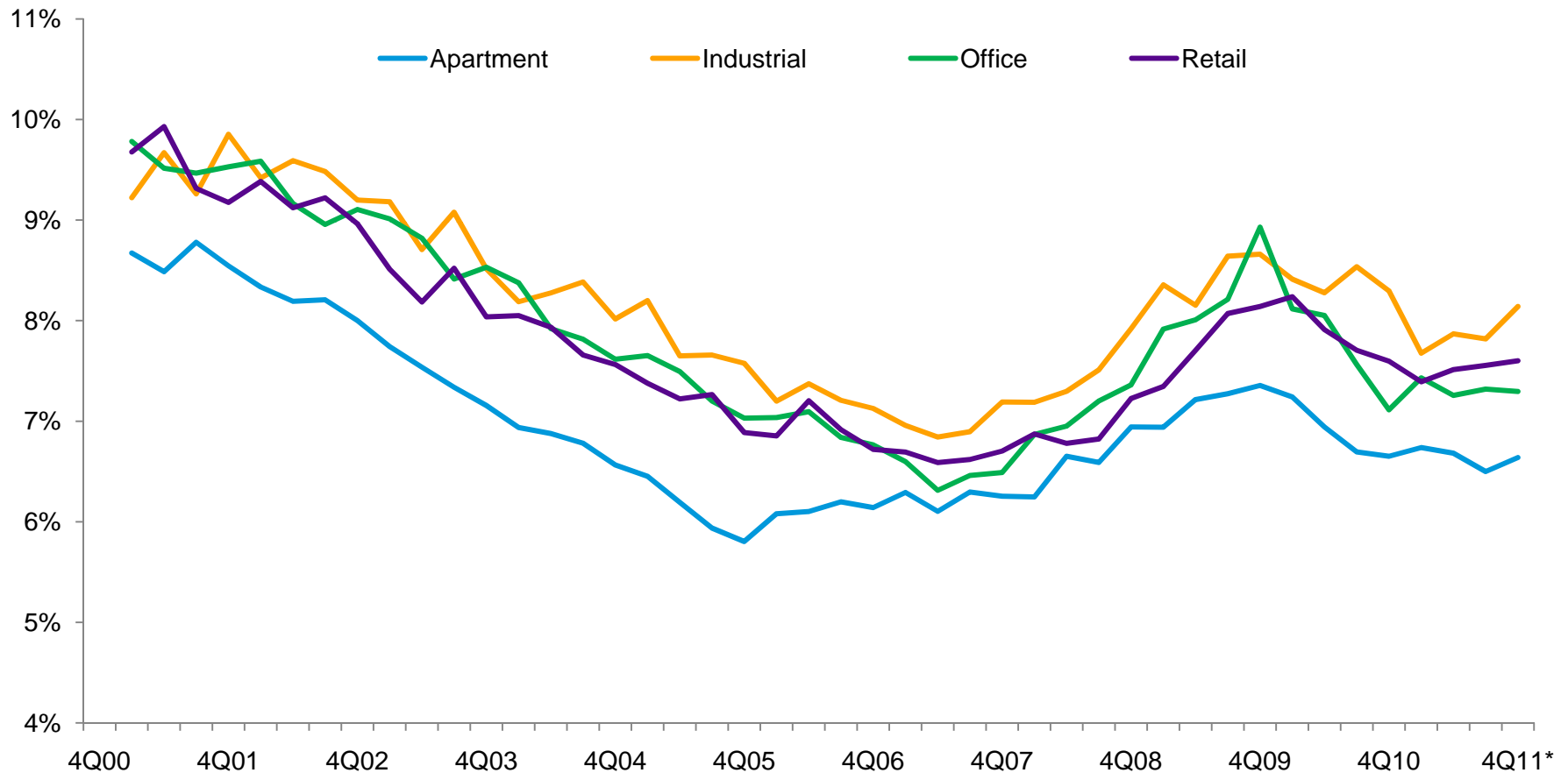


Source: Preqin. As of November 2011.



# Capitalization rates are flattening after re-compression

**U.S. Transaction Capitalization Rates 2001 to 4Q2011\***



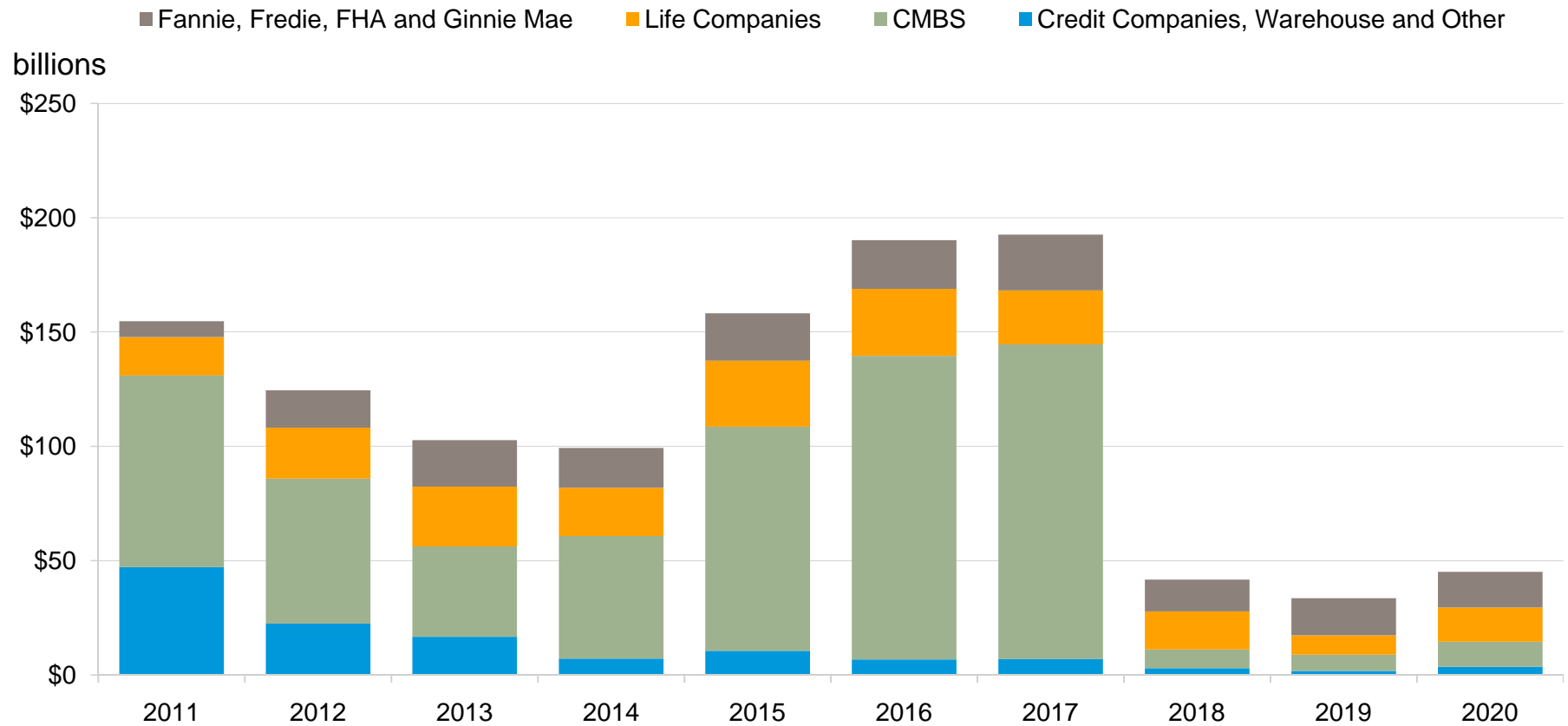
\*4Q 2011 only includes October data.  
Sources: Real Capital Analytics and RREEF. As of November 2011



# Commercial mortgage maturities peak

Too early to say we have “dodged the bullet!”

**CRE Mortgage Maturity Schedule – Not including Banks**



Sources: MBA. As of 2011.



## Vacancy rate forecasts: 2011 - 2016

### National Vacancy Rate Trends

	2008	2009	2010	Forecast 2011	Forecast 2012	Forecast 2013	Forecast 2014	Forecast 2015	Forecast 2016
Apartment	6.8%	8.2%	6.7%	5.3%	4.5%	4.1%	4.0%	4.9%	5.5%
Industrial	11.8%	14.3%	14.3%	13.5%	12.3%	11.1%	10.3%	10.2%	10.2%
Office	14.2%	16.6%	16.5%	16.1%	15.5%	14.2%	12.6%	12.0%	12.3%
Retail	8.7%	10.3%	10.7%	10.8%	10.3%	9.6%	9.3%	9.0%	9.1%

*\*Office properties experienced higher vacancy rates during the 1990's downturn, but all other properties hit historical highs.*

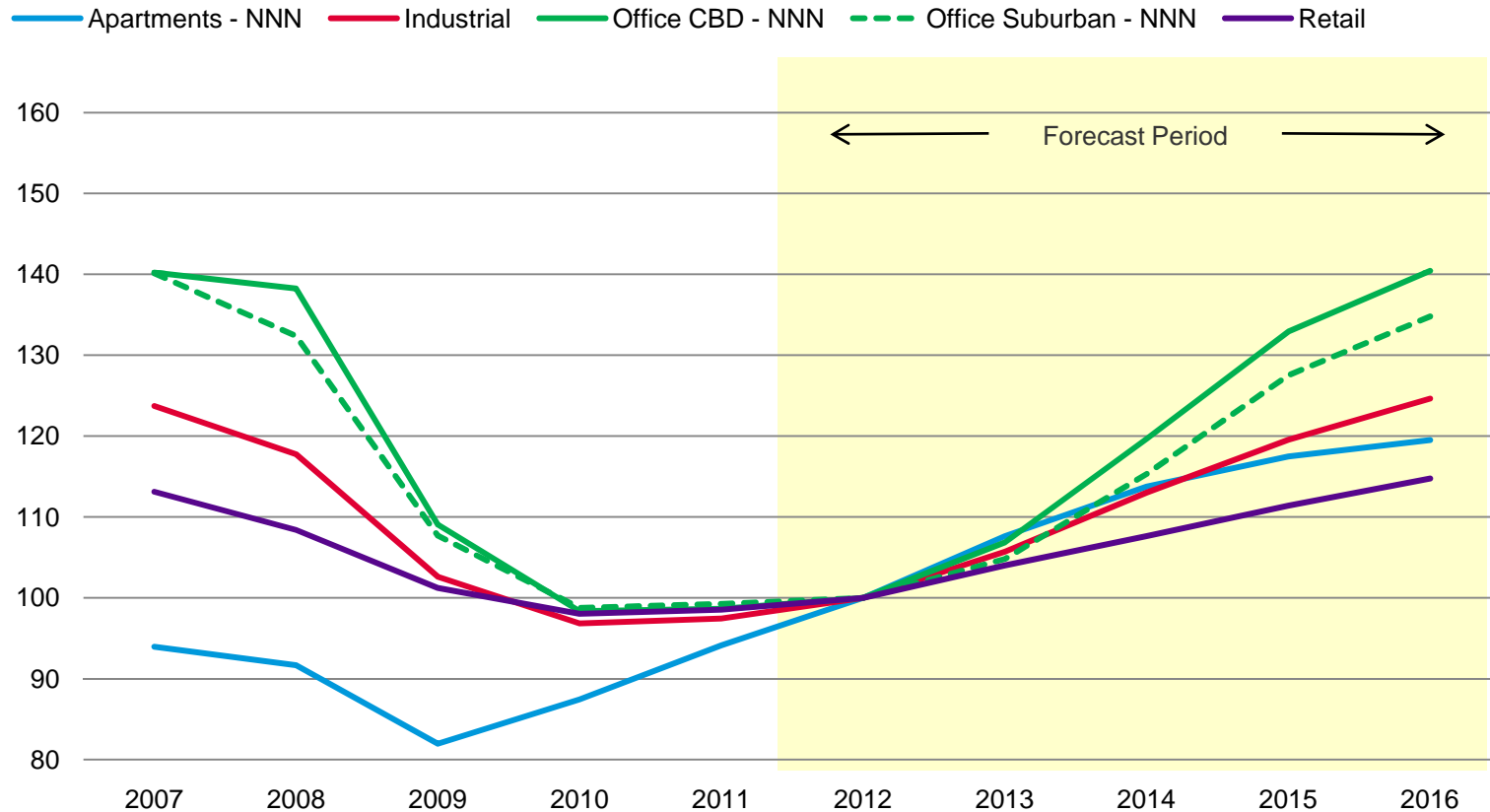
*Forecasts are of the market and not of a RREEF product.*

*Sources: REIS Reports, CBRE-EA, RREEF. As of January 2012.*



# U.S. rent growth markets surveyed, by sector (2012 = 100)

Rent growth from market peak: office to outperform in the longer term



*\*Industrial and Retail are forecast on NNN basis. Apartments and Office are forecast based on Gross Rents, and these are converted to NNN equivalent, assuming 2% per year expense increases, for consistency in comparison across sectors. Data represents the unweighted average of markets surveyed by RREEF. Source: RREEF Research. As of January 2012*



Section III  
**Apartments**



## Apartments: pros & cons

### The Pros

- Best performing property sector to date , with strong near-term prospects due to strong drivers of demand.
- Strong demographic support from prime renter-age cohort (“echo boomers”), and stronger job growth forecast 2014+ will accelerate demand.
- The spread in cap rates relative to the other property sectors has narrowed.
- Continued distress in the for-sale housing market encourages a sentiment that favors renting over buying.
- Attractive debt is readily available from multiple sources, and no longer dependent upon the GSEs.

### The Cons

- Well into the growth cycle, allowing for less future increase in NOI than other sectors.
- Rent levels, already past their previous peak, will experience affordability issues after a few more years of growth.
- Although strong demand is forecast, new deliveries are expected to ramp up between 2014 and 2016, dampening rent growth.
- The cost differential between owning and renting has narrowed significantly, and in some metros, it has reversed.
- Low cost markets could particularly slower growth in rents, as new supply competes with a resurgent for-sale market.

### Wildcards

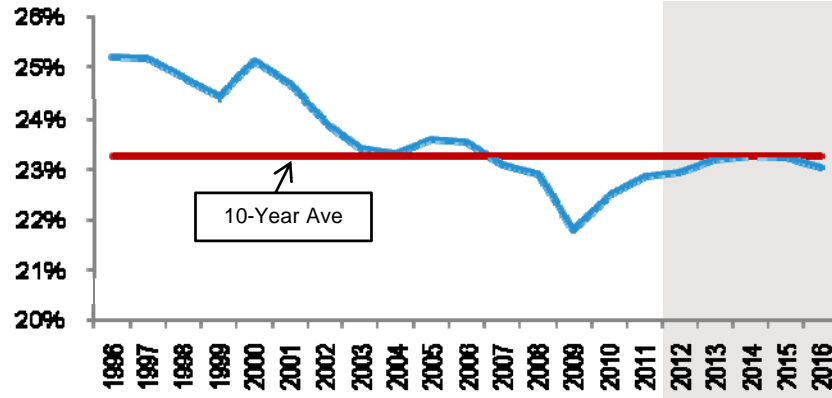
- At some point, households will take advantage of a highly favorable for-sale market?
- The pipeline for new apartments is growing quickly, and could lead to over-building in some markets.
- The GSEs are likely to be altered after the 2012 election, in ways that could negatively impact debt for rental and/or for-sale housing.

Source: RREEF Real Estate. As of January 2012.

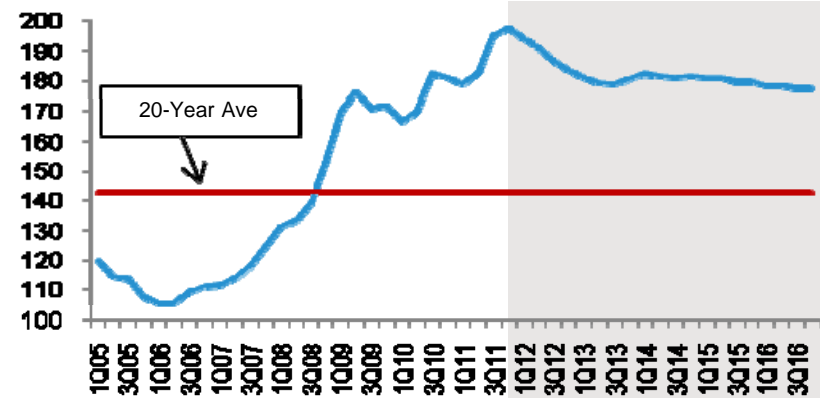


# Apartment market indicators remain favorable

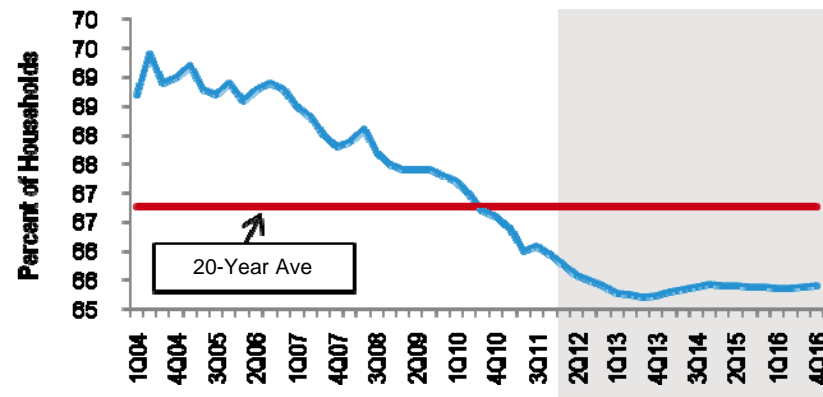
Rental Affordability



Housing Affordability



Homeownership Rate



- The current homeownership rate of 66.1% is at its lowest level since 1998 and is 3.3 percentage points below the 2004 peak.
- Home foreclosures and tightening mortgage credit are keeping households in the rental market.
- Home prices continue to fall ensuring lack of confidence in home ownership.
- Home ownership affordability is at a record high.
- Single family home construction is at record lows, while new multifamily starts are ramping up dramatically.

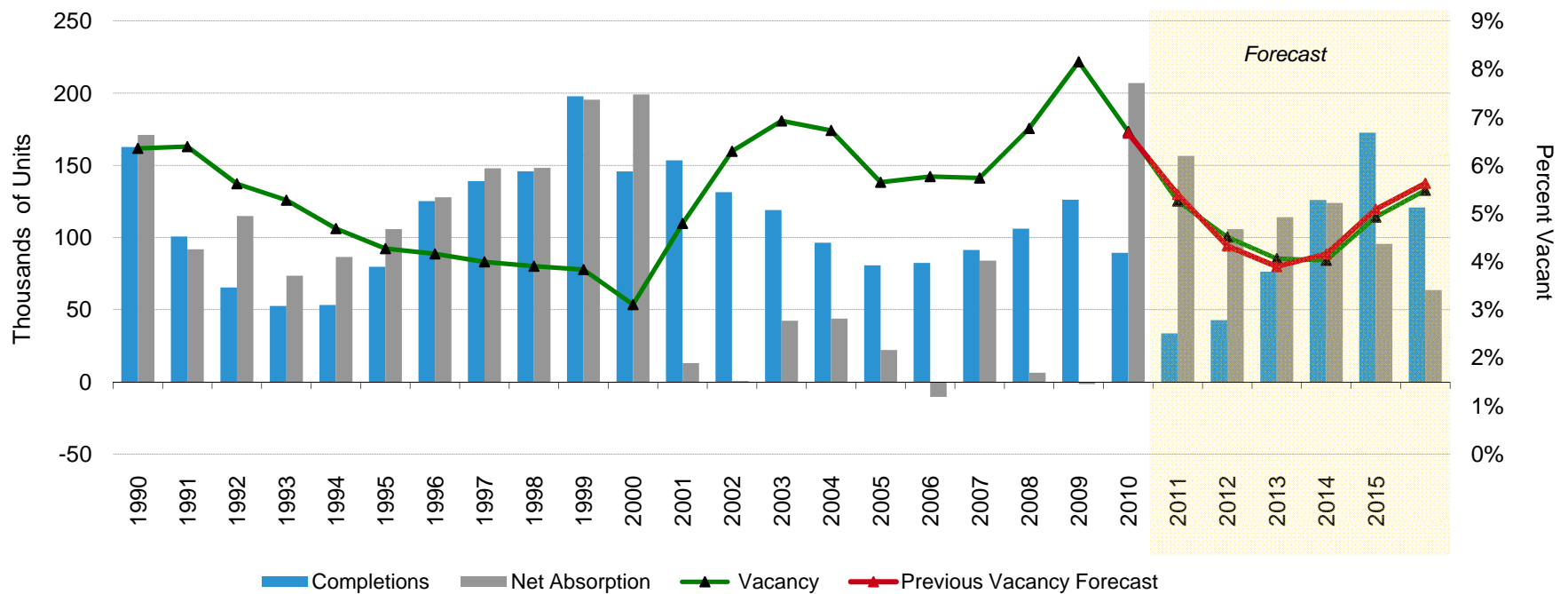
Note: (\*) A value of 100 means that a family with the median income has exactly enough income to qualify for a typical mortgage on a median-priced single-family home. An index above 100 signifies that the family has surplus income.  
 Source: Census, NAR, Moody's Analytics, RREEF. As of December 2011.



# Apartments: entered rent growth cycle

Development pipeline ramping up in outer years as demand moderates

U.S. Sector Supply and Demand, 1990-2016

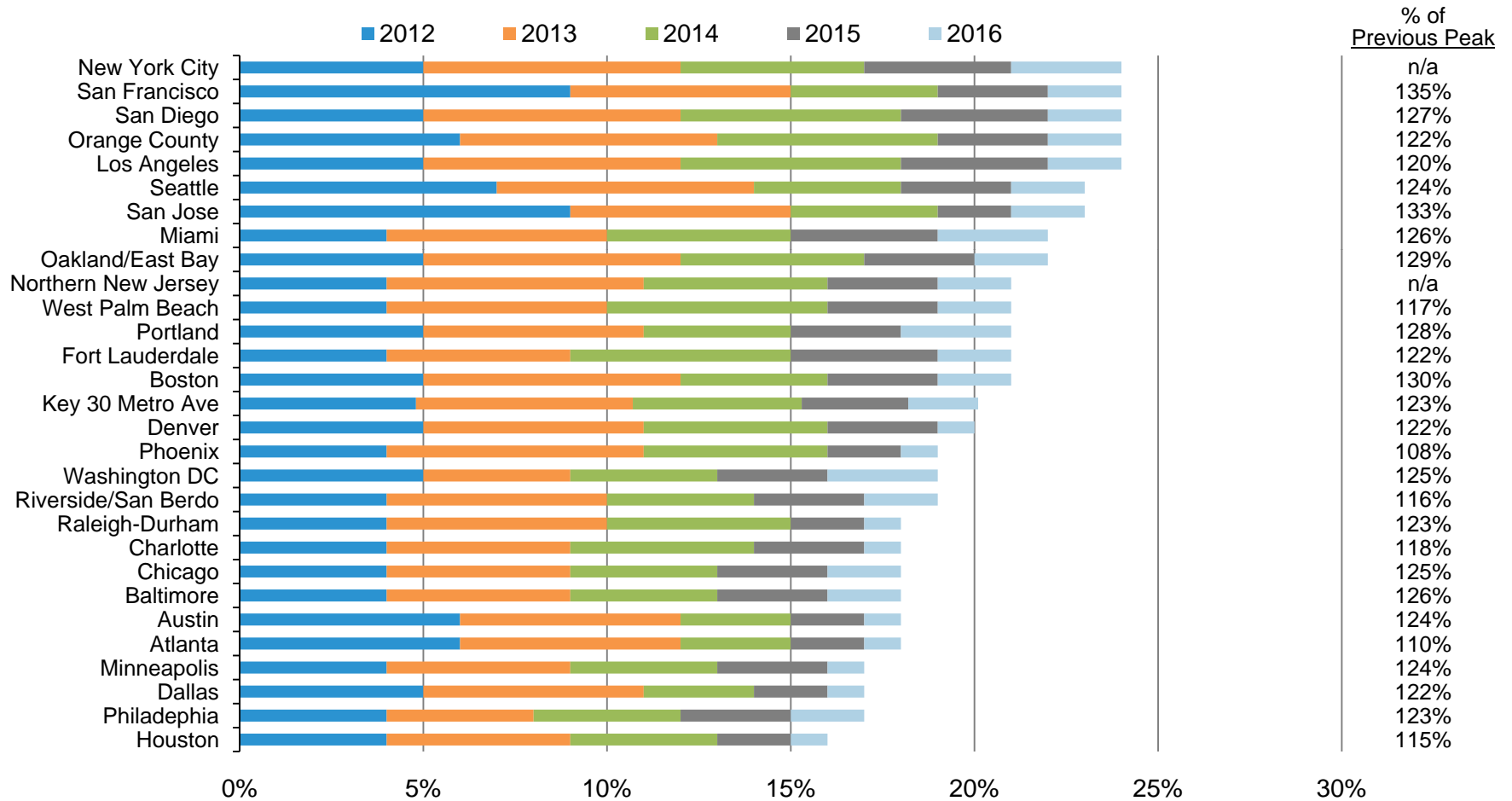


Source: Reis and RREEF Research.  
As of December 2011.

# Apartments: growth frontloaded – affordability could be an issue in outer years



Cumulative Rental Growth Rate (%), 2012-2016

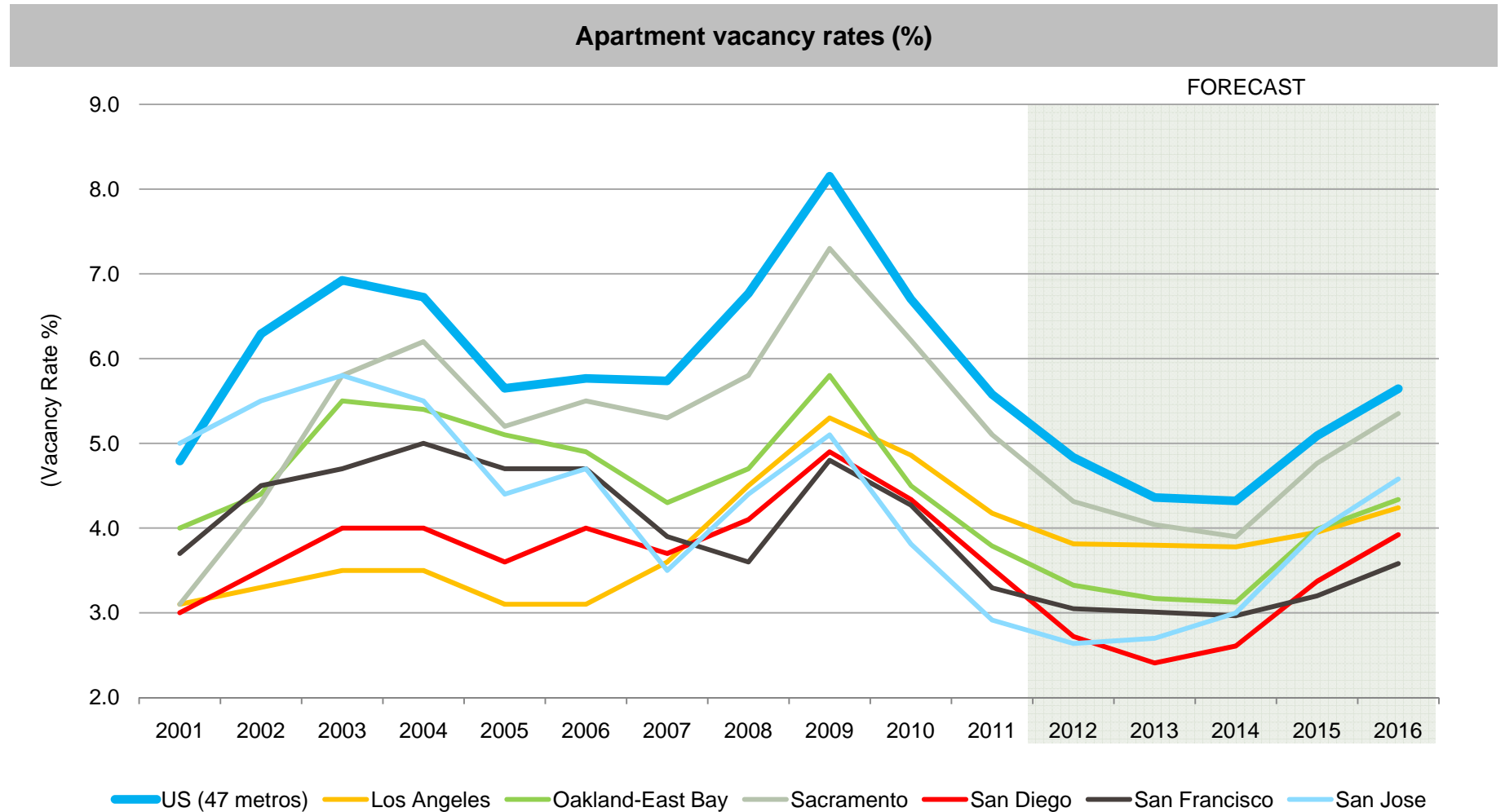


Source: RREEF Real Estate. As of December 2011.



# California historical apartment vacancy trends

Apartment vacancy in California markets generally well below U.S. averages



Source: REIS, RREEF Research



## Conclusions: apartments

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- Indicators remain favorable.
- “Perfect storm” still has two to three more years to run.
- Investors covet the sectors “stability”.
- Although the sector’s recovery in rents has not relied on job growth, employment will matter in order to justify higher rents.
- Continue to focus on Gateway markets, targeting prime urban and infill locations.
- With cap rates in Gateway markets likely to remain in the low-4% range and premier Class A communities trading above replacement cost; repositioning Class A-/B+ communities in urban and infill areas becomes a more viable strategy.



Section IV  
**Industrial**



## Industrial: pros & cons

### Pros

- Market fundamentals decidedly in recovery, with occupancy increasing across the majority of US metros in 2011.
- Rents stabilized 20% to 30% below peak levels, allowing for substantial growth in recovery.
- Recovery drivers for industrial linked to favorable parts of economy; expanding US population, forecasted job gains, linkages to growth in Asia and Latin America, manufacturing, high tech, exports and industrial services.
- Investor demand is highly selective currently, creating favorable price opportunities in some excellent markets. Higher yields and lower capital expenditures than other sectors make this a good income vehicle.
- Institutional quality assets available in relatively small capital chunks, unlike other sectors, allowing for high quality diversification in smaller portfolios. Larger bulk warehouses provide stable bond-like income streams for larger portfolios.

### Cons

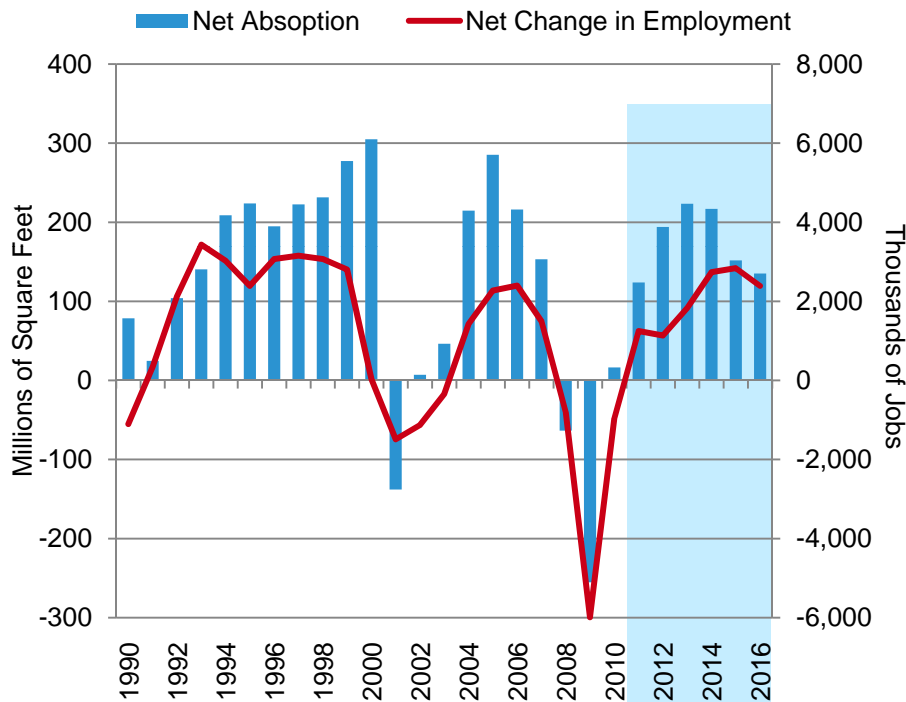
- Moderate consumer spending growth and lean inventories are dampening bulk warehouse space demand in near term. A weak dollar will slow growth in imports, a major driver for bulk warehouse
- Small-tenant industrial product is linked to lagging growth drivers, employment and housing. Tight credit environment, although improving, limits growth for such businesses.
- Continued weak housing market is tempering upside for industrial space demand.
- Changes in trade routes (Panama Canal opens in 2015) will make large bulk warehouse hubs more competitive, giving retailers and 3PLs more location options.
- Large-bay warehouses, especially in commodity locations, will incur significant lease-up risk due to functional obsolescence or substitutable locations.

Source: RREEF Real Estate. As of December 2011.



# Industrial: demand drivers more balanced this cycle than last

**Industrial Space Demand vs. US Employment Growth**



**Initial lift off bottom for industrial in 2011 provided by normalized trade levels and inventory rebuilding, renewed economic growth and job gains (albeit modest gains). Stronger job gains and housing market recovery will contribute more in 2013 and 2014.**

**Macro Drivers of Demand**

	2003 -2007	2008 -2010	2011	2012 -2016
GDP	2.7%	-0.3%	1.7%	2.8%
Consumption	2.9%	-0.1%	2.3%	2.2%
Non- Res Investment	5.7%	-4.7%	8.7%	6.2%
Imports (goods)	6.3%	-1.5%	5.7%	3.4%
Industrial Production	2.3%	-3.2%	3.9%	3.2%
Inventory Change	2.8%	-2.3%	2.2%	2.7%
Total Employment	1.1%	-1.9%	1.0%	1.7%
Manufacturing Employment	-1.9%	-5.9%	1.7%	1.6%

**Composition of recovery this cycle compared to the early 2000s will give rise to healthier industrial fundamentals in more markets, although modest overall economic growth will temper the pace and level of demand. Notably slower import growth could temper big box warehouse demand.**

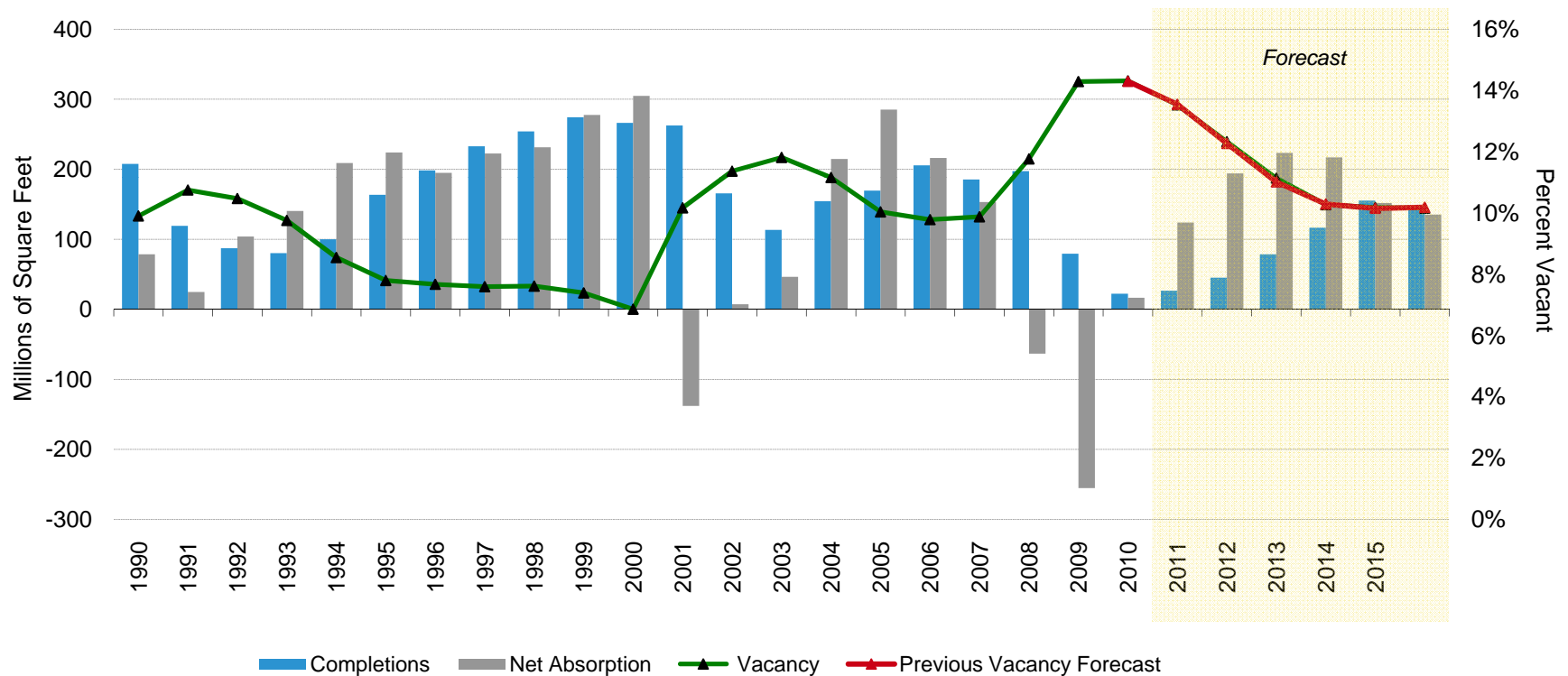
Sources: BLS, BEA, IHS Global Insight, and RREEF Research. As of December 2011.



# Industrial: rising demand and modest supply boosts occupancy

Slow U.S. economic growth in 2012 will drive increased new demand, but risks have elevated

U.S. Sector Supply and Demand, 1990-2016

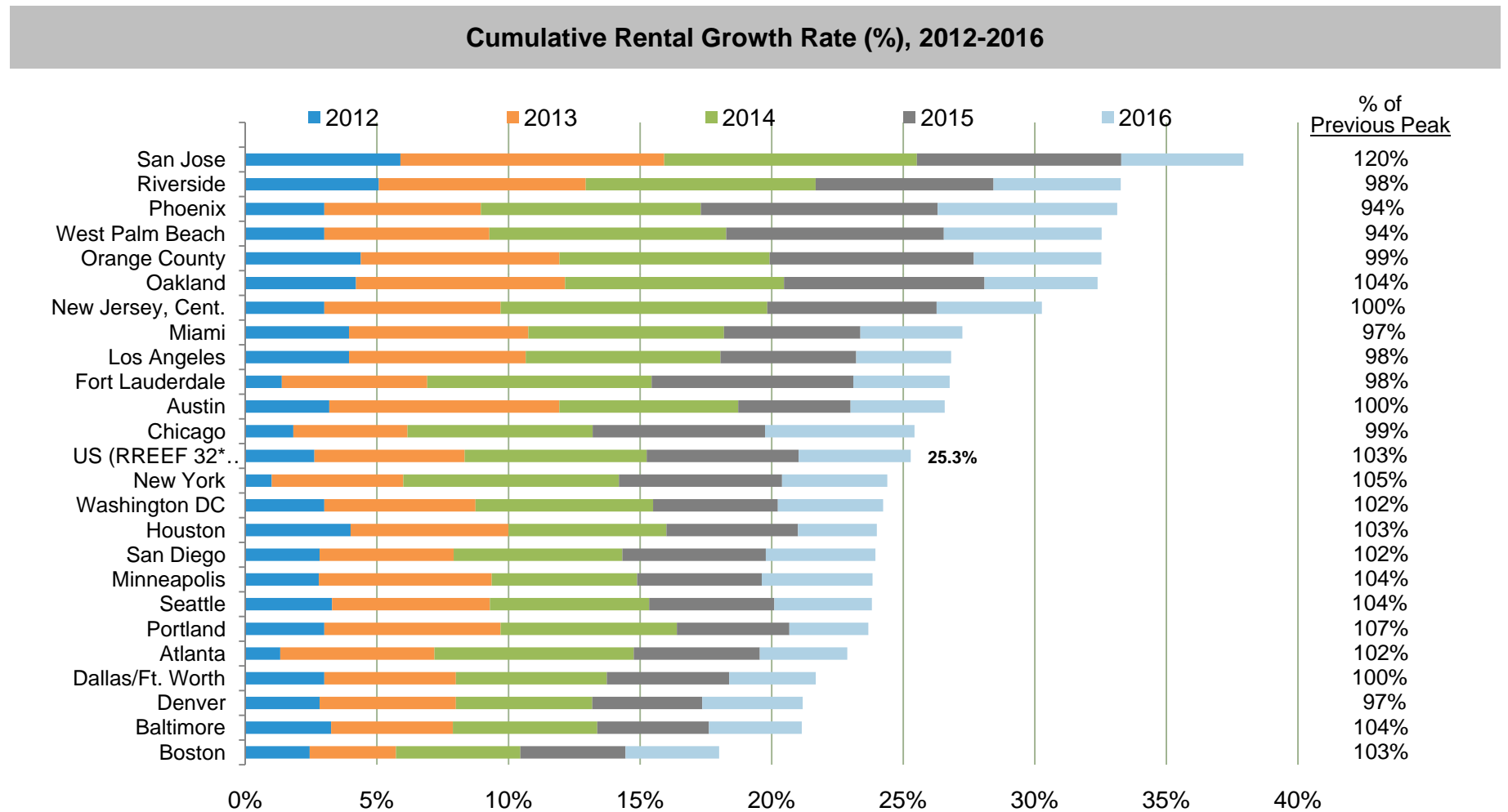


Source: RREEF Research, CBRE-EA. As of July 2011.



# Industrial: 2012 – first year of broad rent growth and stronger gains in 2013-2015

Markets with lower average growth are closer to prior peaks and replacement rent levels

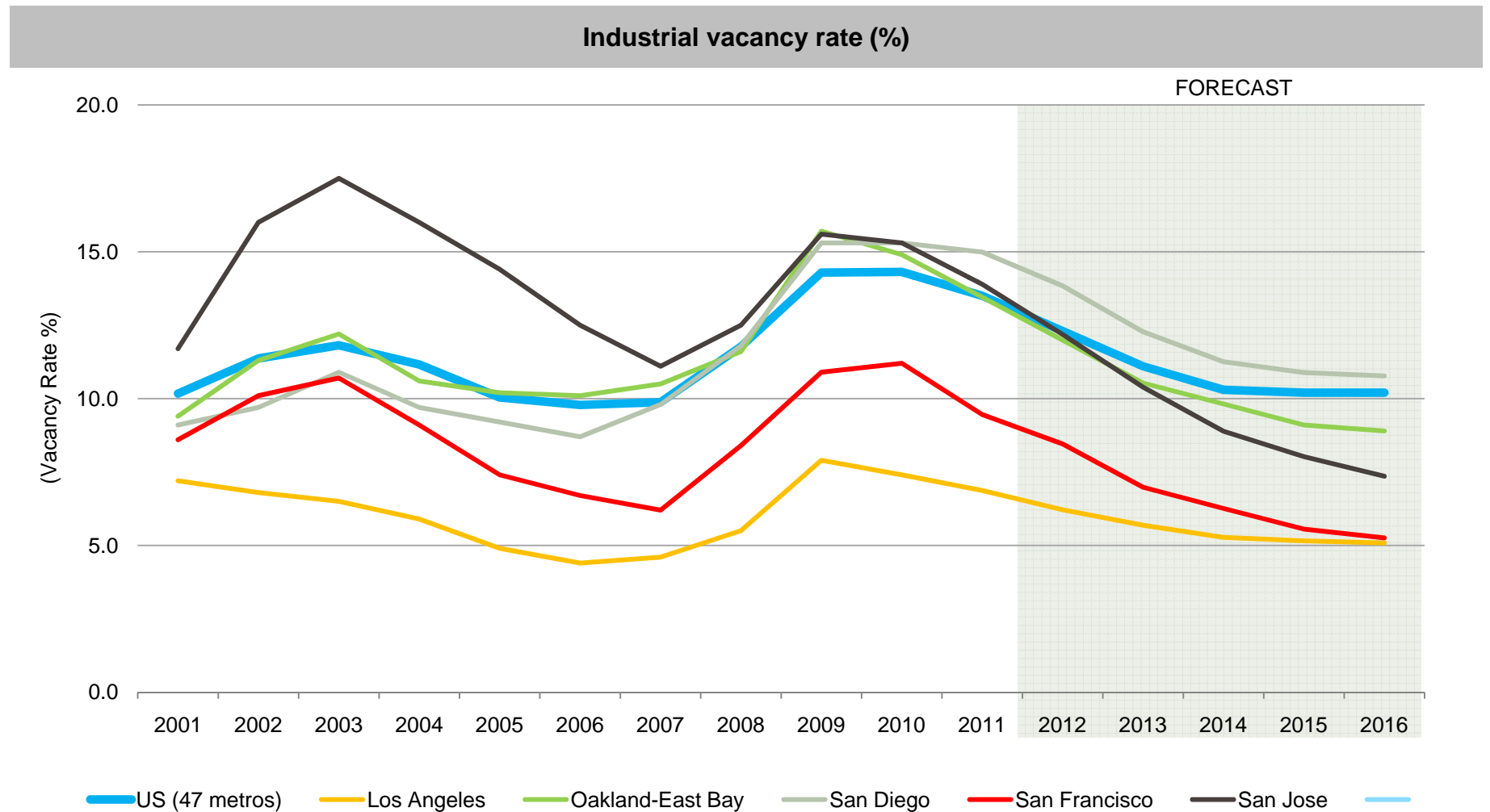


Source: RREEF Research. As of July 2011.



# California historical industrial vacancy trends

Industrial vacancy in California markets below avg. on top metros (LAX,SFO), higher elsewhere



Source: REIS, RREEF Research



## Conclusions: industrial

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- New demand will help stabilize a greater number of markets, but performance is still bifurcated. Previous rent peaks are still not expected to be achieved until 2015 .
- Leading markets should break into single-digit vacancy in 2012-13, all other markets will lag into 2014 and beyond.
- Class A assets in top coastal markets will see the most lift in 2012, but pricing is nearly perfect.
- Functional Class B assets in solid infill submarkets should also strengthen strongly in the near-term.
- Atlanta, Dallas and Chicago will benefit in the near-term due to the supply gap and renewed demand, but longer-term return performance will revert back to historical norms.
- Flex is definitively out of favor, even in core coastal markets. Modern assets may present good opportunities on a highly selective basis - Northern California and South Florida.
- Relatively high going-in returns and improving leasing fundamentals make industrial a good long-term bet.



Section V  
Office



## Office: pros & cons

### The Pros

- Leading submarkets posted rent gains in 2011 ahead of the pace forecast a year ago, with San Francisco, Austin, San Jose, New York, Boston and Houston as the top metros .
- Office was not oversupplied during the last cycle, but markets heavily impacted by the recession will require time to recover.
- Select suburban submarkets are poised for high rent growth recovery, providing investment opportunities.
- As in other periods of economic recovery, office employment growth is occurring at a faster pace than average job growth.
- The office sector is approaching a point in the cycle where it historically generates the highest returns of all property types.

### The Cons

- The sector is the most directly dependent on job growth, which is expected to be only modest during the next two years, despite office jobs growing at a faster pace than overall US employment.
- Recovery is not yet widespread, and is limited to specific submarkets, even within the healthiest metros.
- An increased emphasis on space efficiencies by tenants, along with shadow vacancy, is a drag on future absorption.
- Markets that have been leading the recovery are already richly priced.
- Lagging markets still have a long way to go to recover.

### Wildcards

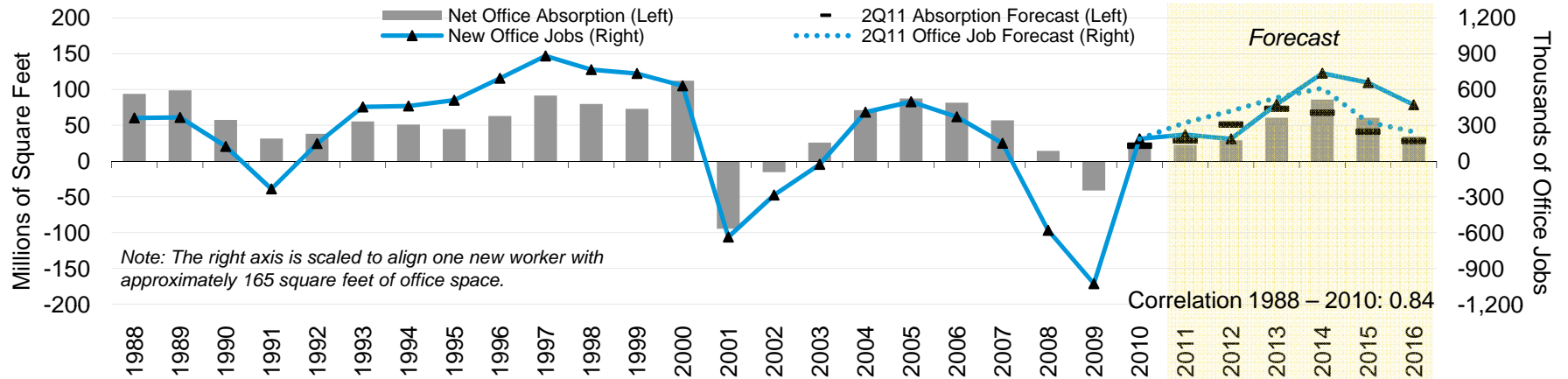
- Cuts in government spending could be more significant than forecast, negatively impacting forecasts for some metros.
- A global financial crisis, most likely in Europe, could negative impact US banking more than forecast.
- Tenants may adjust their space demand even more than forecast, as employees utilize space differently.

Source: RREEF Real Estate. As of December 2011.

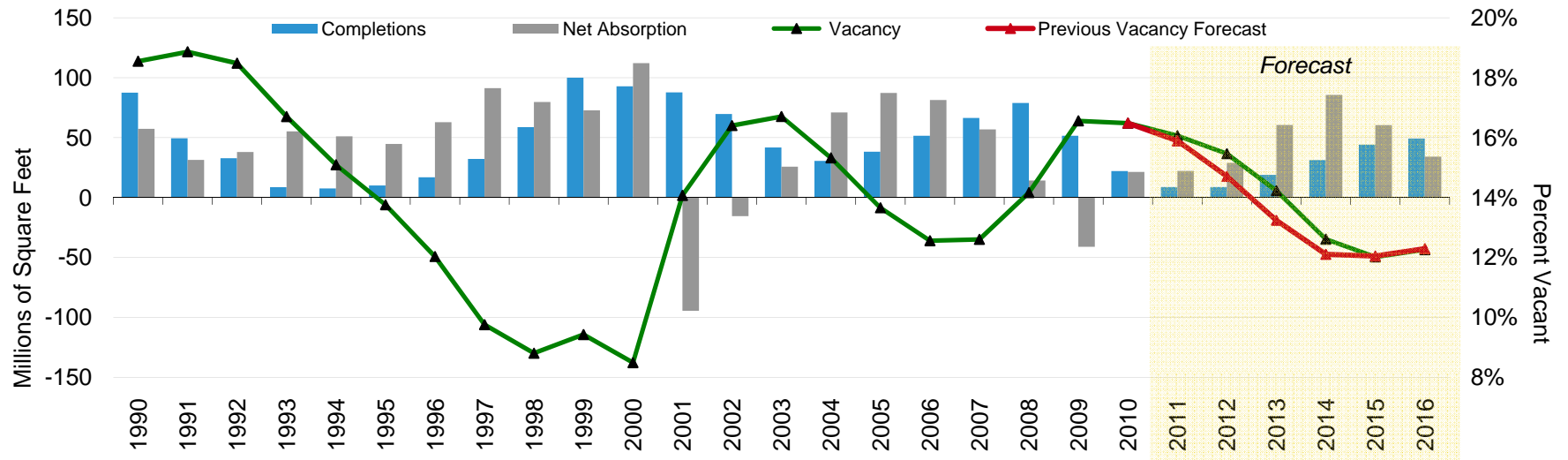
# Office: downgrade of near-term office jobs forecasts dampens absorption through 2013, pushing peak absorption to 2014



Office Space Demand Growth Vs. Employment Growth – 52 Major U.S. Metros



U.S. Office Supply and Demand, 1990-2016

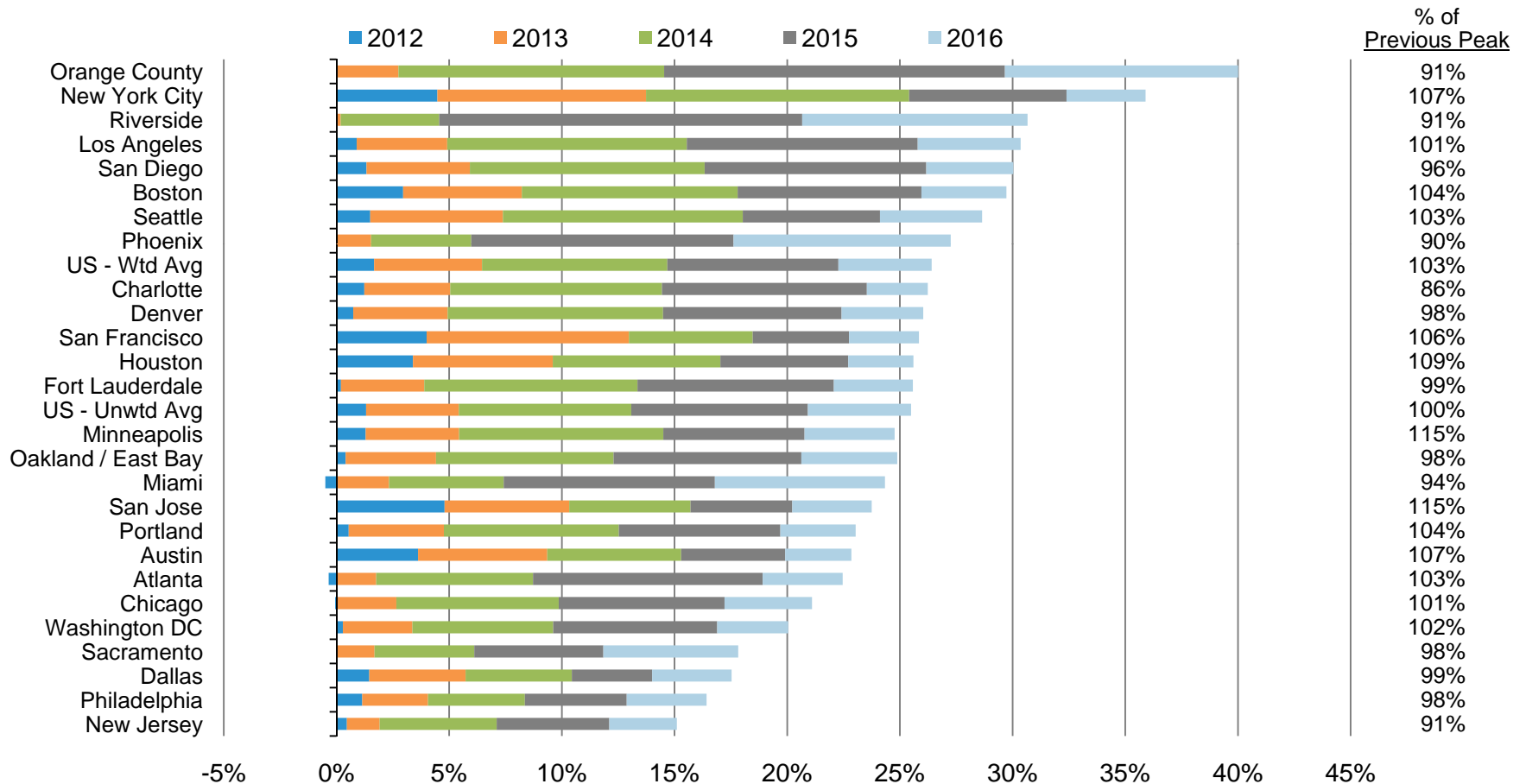


Sources: RREEF Real Estate, Moody's Analytics and CBRE-EA. As of December 2011.

# Office: early recovery metros like San Francisco and Austin move down in ranking as rent growth is now behind them



Cumulative Rental Growth Rate (%), 2012-2016

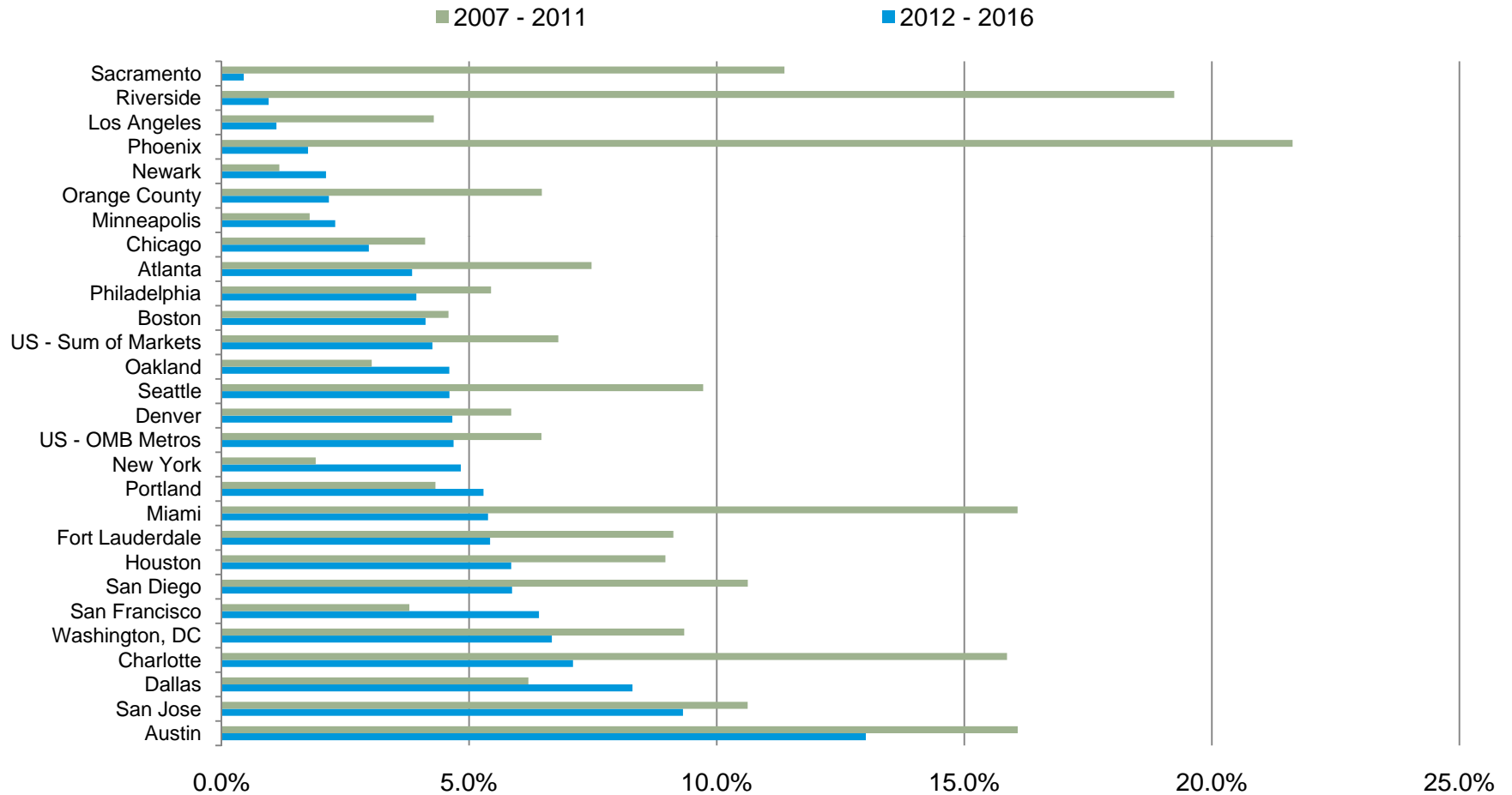


Source: RREEF Real Estate. As of December 2011.



# Office: new supply – largest supply additions typically within recovery metros

Sector Supply as % of Stock, 2007 - 2016

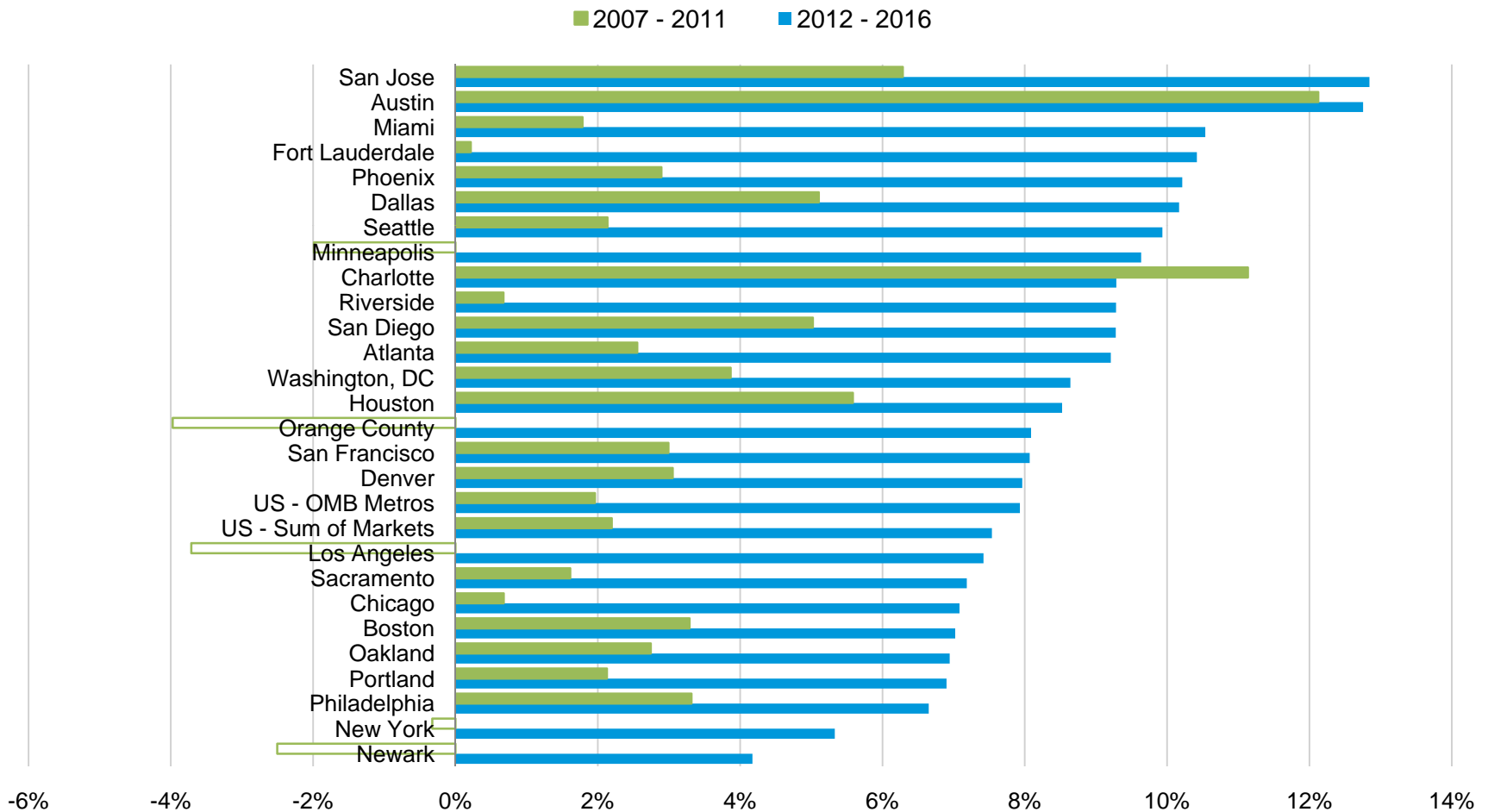


Source: RREEF Real Estate, CBRE-EA. As of December 2011.



# Office: demand – tech and traditional growth metros lead

Sector Demand as % of Stock, 2007 - 2016

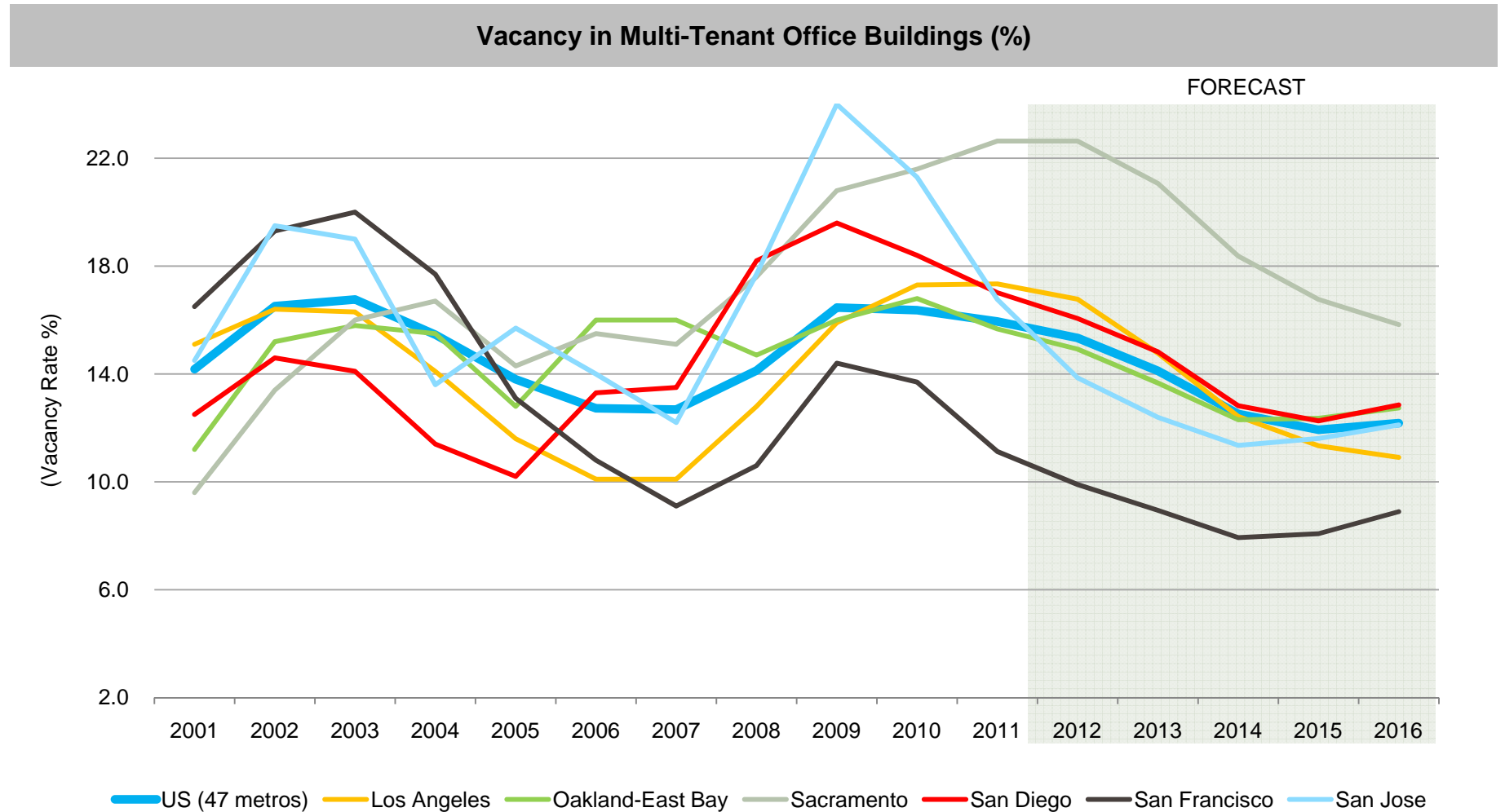


Source: RREEF Real Estate, CBRE-EA. As of December 2011.



# California historical office vacancy trends

Office vacancy in California markets near U.S. averages



Source: REIS, RREEF Research



## Conclusions: office

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- Near-term demand downgrade increases the desirability of targeting CBDs and key submarkets.
- As the strongest metros achieve rent growth, they will become increasingly competitive for investment capital as this risk element is diminished.
- Washington, DC and New York's risk profiles are up due to increased concerns with federal government and finance sectors.
- Key suburban submarkets offer opportunities for significant rent growth, such as in Southern California, but carry higher risks and offer longer recovery timing than core CBDs.



Section VI  
Retail



## Retail: pros & cons

### The Pros

- Retail properties have stabilized, and higher quality properties are experiencing rent and occupancy growth.
- Retail sales are recovering, with total retail sales now exceeding pre-recession levels and comparable-store sales at the nation's chain stores up now for 24 consecutive months
- Construction at historic lows and even more restrained than forecast, allowing for gradual sector recovery.
- The majority of large national retailers are experiencing strong financial health, even including some department stores.

### The Cons

- Recovery, especially rent growth, slow to spread beyond top markets and retail centers.
- Online retailers increasingly compete with bricks-and-mortar stores, placing downward pressure on space demand
- Downsizing of store prototypes and restrained growth by retailers is blunting recovery of lower quality centers.
- Sector forecast to underperform in rent growth.
- Strong neighborhood centers and malls are aggressively priced.
- “Zombie” retailers and restaurants, bankrupt or very weak but still operating, are likely to create future vacancies.

### Wildcards

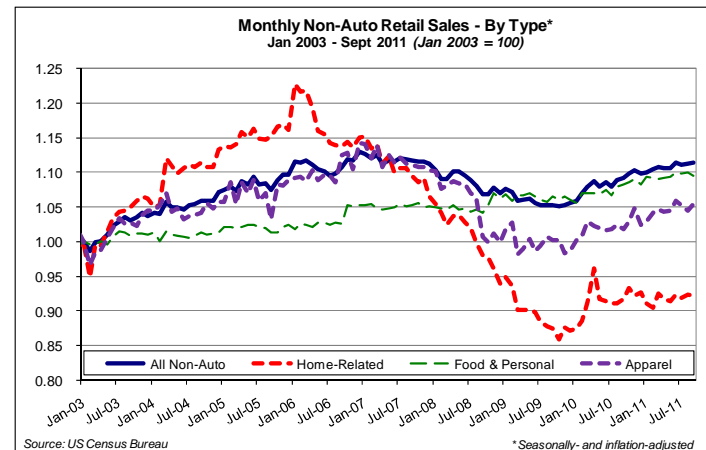
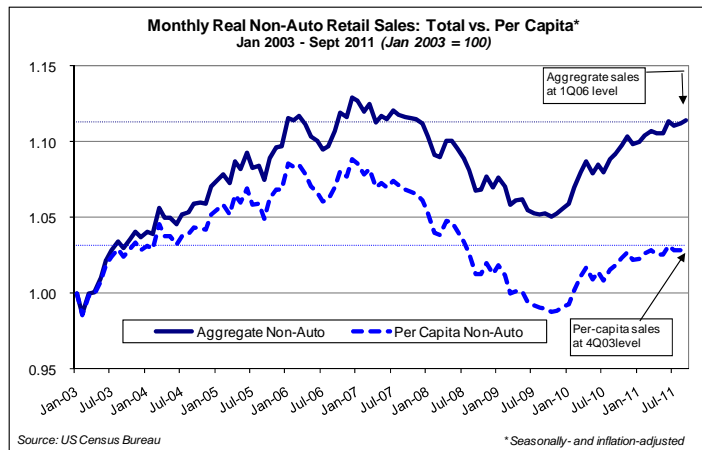
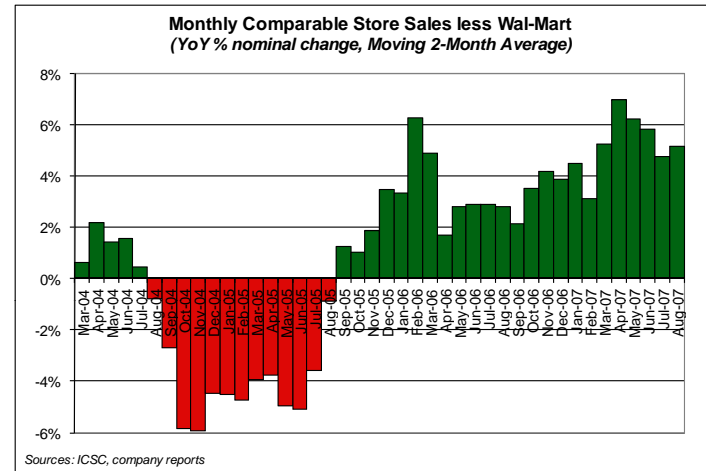
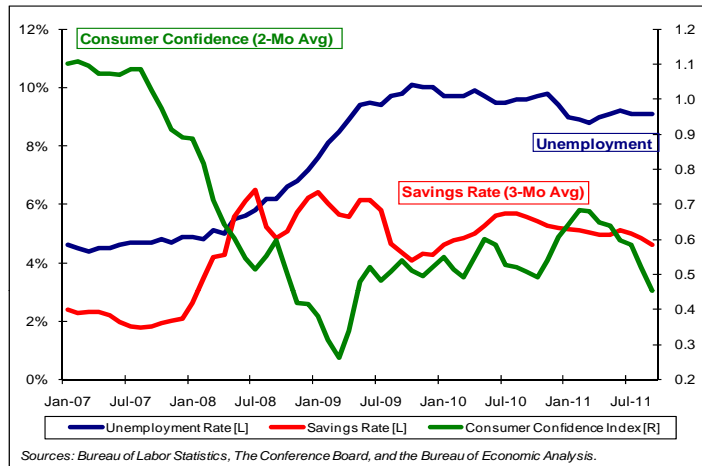
- Online retailing could increase its market share more than forecast, at the expense of bricks-and-mortar stores.
- Retail sales could rebound more vigorously than forecast, providing support for second-tier retail properties.
- The housing sector could recover more quickly than forecast, fueling new greenfield retail development.
- Investor bias toward “super-core” retail may yield superior investment opportunities in overlooked markets.

Source: RREEF Real Estate. As of December 2011.



# Retail: demand drivers

## Retailers Stronger but Consumers Still Weak (Though Trending in Right Direction)

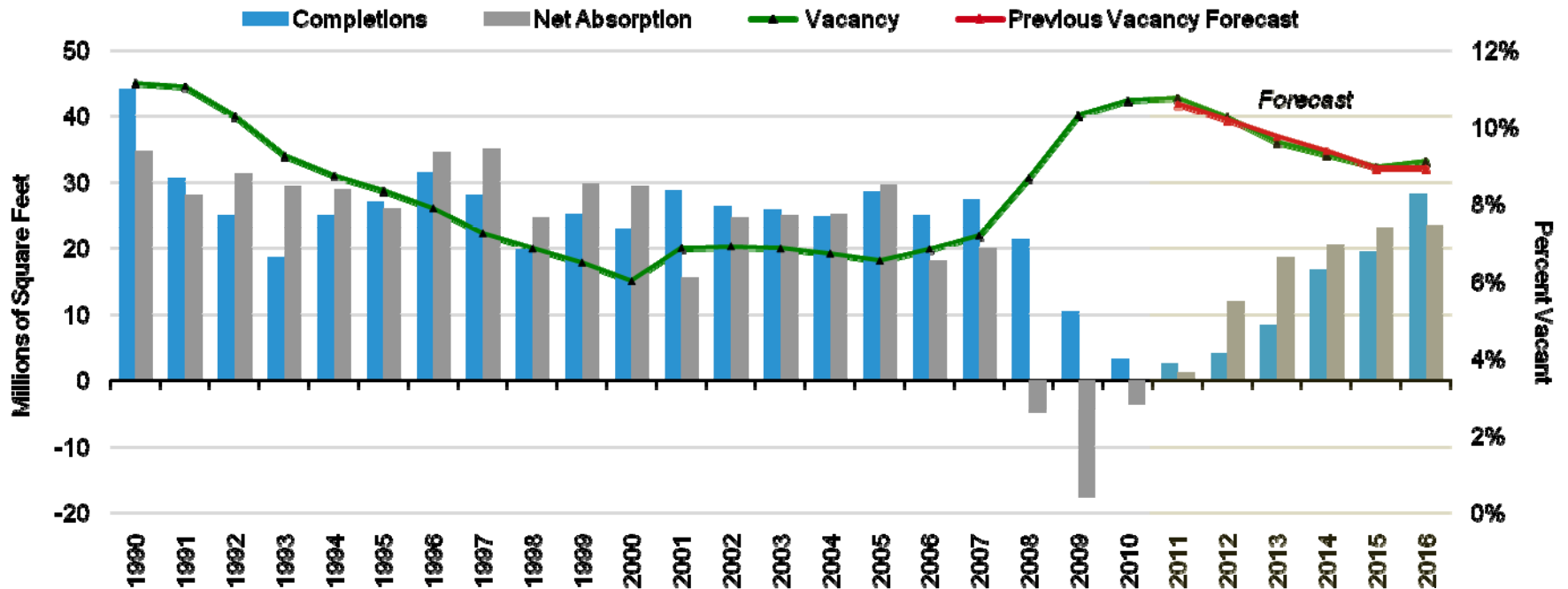


The consumer scorecard essentially unchanged since firming in early 2009. Persistent weakness in the job and housing markets, limited credit availability, and lack of direction in the stock market, all limit consumer confidence. Meanwhile, real non-auto retail sales remain flat, and well below peak levels, particularly on per-capita basis.

# Supply halt and weak demand growth will result in gradual retail market recovery



U.S. Retail Supply and Demand, 1990-2016\*



**Forecast Highlights:**

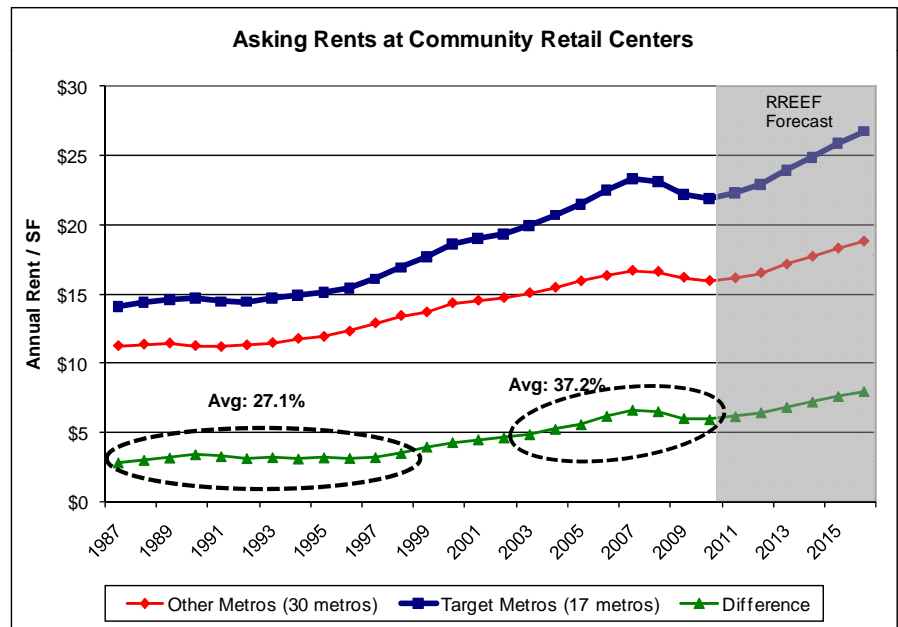
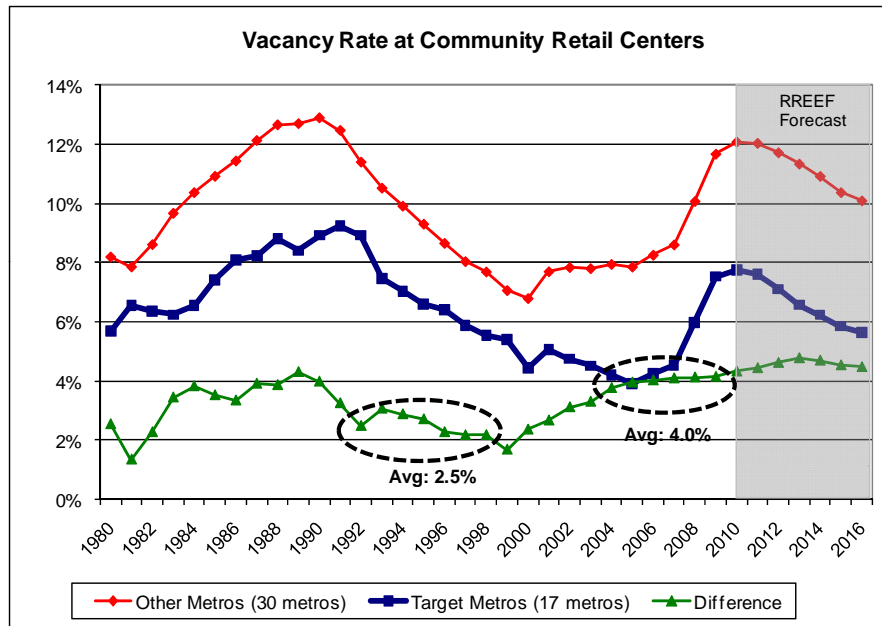
- Slightly later recovery is forecast compared to prior forecast.
- Demand far below historical average until 2014.

\*Neighborhood and community centers only.  
 Source: RREEF Research and CBRE-EA. As of November 2011.



# The rising spread between target and non-target markets

The quality divide continues at the metro level (as well as the asset level)

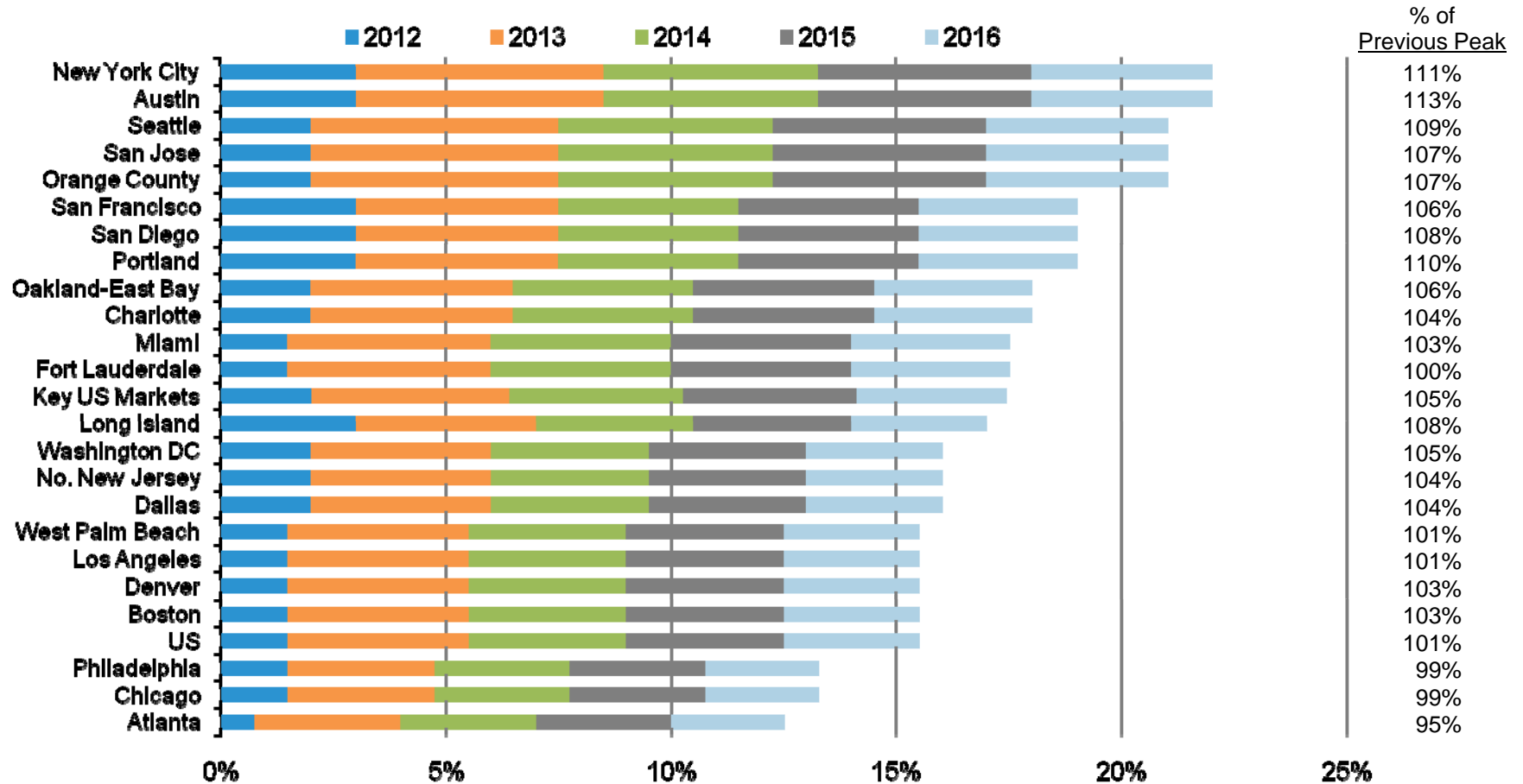


Source: RREEF Research. As of November 2011.



# Retail: historically low rent/sales ratios fuel greater rent growth

Cumulative Rental Growth Rate (%), 2012-2016

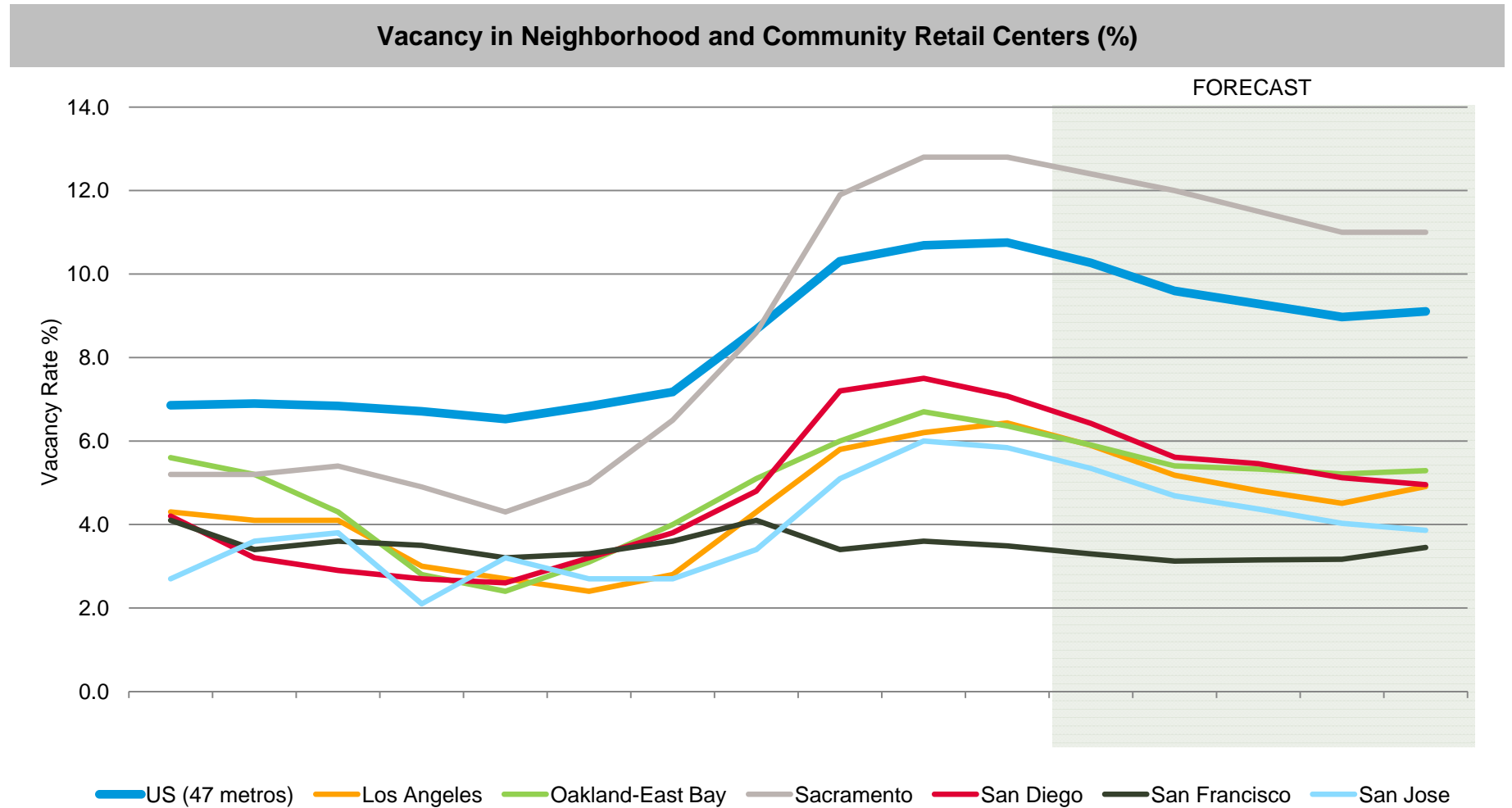


Source: RREEF Research. As of November 2011.



# California historical retail vacancy trends

Retail vacancy in California markets consistently below US averages



Source: REIS, RREEF Research



## Conclusions: retail

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- Gradual, moderate market recovery for retailers and retail centers in line with expectations and recent trends.
- A growing divide between top tier and bottom tier markets and between superior and inferior centers will continue.
- Rent growth will be slow to spread beyond top markets and retail centers, with peak rents still not reached nationally until 2015.
- “Hour-glass recovery” continues, with luxury and discount retailers thriving, middle-market retailers struggling.
- More downsizing of store prototypes reduces demand at traditional locations, but also opens up new markets for big box retailers.
- Investors will increasingly favor dominant, stabilized centers in top markets, potentially creating opportunities in overlooked secondary markets.



## Important Notes

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