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### Table of Contents

1. Executive Summary .................................................. 3
2. European Real Estate Strategic Themes ......................... 4
3. Economy ...................................................................... 5
4. Real Estate Performance ............................................... 6
   4.1 Occupier Fundamentals ........................................... 6
   4.2 Capital Markets and Pricing ..................................... 7
   4.3 Real Estate Returns and Market Calls ....................... 9
5. Office Market Outlook .................................................. 12
6. Retail Market Outlook .................................................. 13
7. Logistics Market Outlook .............................................. 14
8. Residential Market Outlook ......................................... 15
9. Private Debt Outlook .................................................... 16
10. Listed Market Outlook ................................................ 17

Important Information .................................................. 18

Research & Strategy – Alternatives ................................. 20
1 Executive Summary

— In just a year, a continent once racked by uncertainty is riding high on a wave of confidence. Businesses are hiring, consumers are spending, exports are rising, and even governments are starting to loosen their purse strings. The immediate outlook for the economy is much improved, but we must be careful about giving too much weight to the short term. For many, it is the outlook for the next five to ten years that matters most. In time growth is set to moderate, while global monetary policy is already starting to tighten.

— Confidence among both businesses and consumers has put the wind in the sails of real estate occupiers. Aggregate European office take-up grew by 8% in 2017, surpassing the 13 million square metre mark and eclipsing the record total from 2007. Our forecasts for office rent growth have been revised upwards. With the French economy beginning to fire on all cylinders, we expect to see higher rental growth in Paris in the coming years. However, it is the German cities, driven largely by Berlin and Frankfurt, where we foresee the most impressive rental growth figures in Core Europe. Central London may likely see further rental decline, although under our base case Brexit scenario, rents should then pick up in the early part of the next decade.

— We have downgraded our near-term outlook for shopping centres significantly, with Continental Europe’s two largest markets both experiencing downward pressure on rents, particularly so in Germany. We expect core Europe and the United Kingdom to remain weak over the next five years, but Southern Europe and the CEE region should be stronger performers.

— In contrast, structural changes should drive broad rental outperformance in logistics. Paris is expected to be among the best-performing markets, although Germany, where prime rents held up well following the financial crisis, looks likely to see below-average rent growth. In London, although uncertainty surrounding the Brexit negotiations is having an effect on office rents, we expect the logistics sector to be better insulated.

— European real estate pricing has tightened further in the past six months. However, real estate remains attractive in a multi-asset context thanks to strengthening income growth and a still-significant yield spread over other fixed income products. According to a recent survey, two thirds of investors also plan to increase their European real estate allocations during the next two years, a greater number than a year ago.

— We expect that prime yields could reach a floor in 2018, but there may be differences between sectors and markets. Logistics has been closing the pricing gap to offices and retail over the past five years, and we expect this trend to continue looking ahead. Whereas on average, office yields were around 190 basis points higher than logistics in 2012, we are forecasting the gap to be approaching 100 basis points by 2022.

— There is still momentum in the European market. Nevertheless, returns are almost certain to moderate during the next five years as yield compression comes to an end and changes in capital value become more reliant on rental growth. Prime all property total returns have averaged close to 13% per year over the last five years, but we are forecasting a return of just over 8% in 2018 and an average of 5.2% per annum until 2022.

— The highest absolute returns are still expected in the CEE region, although on a risk-adjusted basis the Benelux countries and Finland are set to be the strongest performers across most sectors over five years, with the U.K. market also expected to outperform towards the end of the forecast period. At a sector level, logistics should be a relative outperformer, while exposure to other long-term growth sectors such as European residential and hotels could also help to improve portfolio returns.

— Market and sector selection may continue to have a strong bearing on relative performance. However, even in the better-performing markets, projected returns may not be sufficient to meet some investor requirements. In this case, we believe investors have three main options: 1) lower target returns 2) take calculated risks at the expense of more volatile returns or 3) focus on non-cyclical growth segments.

— All three strategies have their merits. However, on balance, we feel the third strategy is most attractive. While this is a temporary move up the risk curve, by overweighting locations and segments positioned to benefit from long term demand drivers, we expect to see higher risk-adjusted return over a sustained period of time.

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1 There is no guarantee the forecasts shown will materialise. Past performance is not indicative of future results.
2 PMA, February 2018
3 PMA, Deutsche Asset Management, February 2018
4 PMA, Deutsche Asset Management, February 2018

Forecasts are based on assumptions, estimates, opinions and hypothetical models or analysis which may prove to be incorrect. Past performance is not indicative of future results.
## 2 European Real Estate Strategic Themes

Pan-European real estate enjoyed yet another year of strong performance in 2017. Driven by both improving occupier markets and ongoing capital inflows, real estate markets across the continent are likely to have recorded returns well in excess of their historical average.

We see little evidence to suggest a rapid reversal in fortunes. Indeed, occupier conditions are set to improve further, while yields may not yet have reached a floor. Nevertheless, in many cases pricing at the prime end of the market is looking stretched, and taking our projections into consideration, we do not see investment into this type of property meeting the return requirements of many institutional investors.

Prime yields across almost all markets are well below their historical lows, while global central banks are starting to remove liquidity. The European Central Bank has indicated that it is preparing to cut its stimulus programme faster than anticipated, leaving investors to contemplate the potential impact on real estate prices. While we don’t see an immediate threat of price correction, it seems that most of the upside for prime real estate has been taken. Investors therefore not only are these assets likely to be attractive, while this does constitute a temporary move up the risk curve, by continuing to beat the bond market 2) take calculated risks at the expense of more volatile returns or 3) focus on non-cyclical growth segments. All three strategies have their merits, and their appropriateness may vary for different investors. However, on balance, we feel the third strategy is most attractive. While this does constitute a temporary move up the risk curve, by overweighting segments which are well positioned to benefit from long term demand drivers, we expect to see higher-risk adjusted return.

Not only are these assets likely to be less exposed to the supply and demand cycle, but over time they should be less exposed also to rising interest rates, as the yield spread over the current prime segment narrows.

This has led us to some notable adjustments to our themes over the past six months. We continue to believe that core investors should take a three-pronged approach: focusing on targeted investment in emerging locations and long term growth segments; maintaining a focus on risk; and optimising existing portfolios by selling weaker assets and increasing allocations to residential, logistics and hotels.

<table>
<thead>
<tr>
<th>Strategic Implications for Portfolio Management</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Target Investment</strong></td>
</tr>
<tr>
<td>1</td>
</tr>
<tr>
<td>2</td>
</tr>
<tr>
<td>3</td>
</tr>
<tr>
<td><strong>Risk Awareness</strong></td>
</tr>
<tr>
<td>1</td>
</tr>
<tr>
<td>2</td>
</tr>
<tr>
<td>3</td>
</tr>
<tr>
<td><strong>Portfolio Optimisation</strong></td>
</tr>
<tr>
<td>1</td>
</tr>
<tr>
<td>2</td>
</tr>
<tr>
<td>3</td>
</tr>
</tbody>
</table>

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5 Any forecasts provided herein are based upon Deutsche Asset Management’s opinion of the market at this date and are subject to change dependent on the market. Forecasts may not materialize.

Forecasts are based on assumptions, estimates, opinions and hypothetical models or analysis which may prove to be incorrect. Past performance is not indicative of future results.
3 Economy

In many ways the European economy today is unrecognisable from twelve months ago. In just a year, a continent once racked by uncertainty is riding high on a wave of confidence. Businesses are hiring, consumers are spending, exports are rising, and even governments are starting to loosen their purse strings. In sum, the immediate outlook for the economy is much improved and this should drive performance over the coming few years.

However, as real estate investors we must be careful about giving too much weight to the short term. For many, it is not the next one to two years that matters most, but the outlook for the next five to ten, and here we are more cautious. In time growth is set to moderate, while global monetary policy is already starting to tighten.

Why do we anticipate a moderation in growth? In short, demographics. While there are certainly upsides to this view, particularly around migration, on the whole the outlook is one of a gradually shrinking labour force.

However, it is important to remember that this could not be evenly spread. In Germany, despite the recent rise in immigration, the working age population is still due to contract over the coming decade. However, the difference between the largest cities and the country average is stark, with the working age population of Munich expected to expand by 5%, compared to a fall of 6% across the country as a whole.

<table>
<thead>
<tr>
<th>Working Age Population Growth (%)</th>
<th>2017-27f</th>
</tr>
</thead>
<tbody>
<tr>
<td>Germany</td>
<td>0</td>
</tr>
<tr>
<td>Berlin</td>
<td>1</td>
</tr>
<tr>
<td>Munich</td>
<td>5</td>
</tr>
<tr>
<td>Hamburg</td>
<td>0</td>
</tr>
<tr>
<td>France Ile de France</td>
<td>-5</td>
</tr>
<tr>
<td>Lyon</td>
<td>-5</td>
</tr>
<tr>
<td>Marseille</td>
<td>-10</td>
</tr>
<tr>
<td>UK</td>
<td>-5</td>
</tr>
<tr>
<td>London</td>
<td>-5</td>
</tr>
<tr>
<td>Birmingham</td>
<td>-5</td>
</tr>
<tr>
<td>Manchester</td>
<td>-5</td>
</tr>
<tr>
<td>Spain</td>
<td>-5</td>
</tr>
<tr>
<td>Madrid</td>
<td>-5</td>
</tr>
<tr>
<td>Barcelona</td>
<td>-5</td>
</tr>
<tr>
<td>Italy</td>
<td>-5</td>
</tr>
<tr>
<td>Rome</td>
<td>-5</td>
</tr>
<tr>
<td>Milan</td>
<td>-5</td>
</tr>
</tbody>
</table>

Sources: Eurostat, Oxford Economics, January 2018
Notes: f = forecast. There is no guarantee the forecast shown will materialise.

At the national level, the countries of Central and Eastern Europe are projected to be the top performers over the next five years, as convergence with Core Europe supersedes current political concerns. The bulk of Core countries are may by around 1.5% per annum, while Ireland and Spain may continue to outperform.

For London and the rest of the United Kingdom, growth has slowed but not collapsed as some had feared, although the outlook remains heavily dependent upon the Brexit negotiations. Here we continue to expect an outcome that includes a transition deal followed by comprehensive free trade deal, yet this is by no means certain.

The recent pick-up in growth has further eroded the cushion of economic spare capacity, and while we see little risk of inflation moving well above target any time soon, the process of monetary tightening is already underway. The ECB is set to taper its programme of quantitative easing throughout 2018, followed by a projected rate rise in 2019. Importantly, and in line with the assumption of lower trend economic growth, we anticipate that neither the base rate nor long-term bond yields could return to pre-recession levels.

Despite the fact that the Bank of England increased rates in November 2017, slower economic growth and ongoing Brexit risks should almost certainly limit the pace of future tightening. Clearly a high degree of uncertainty persists in the United Kingdom; but we do expect some clarity over the terms of Brexit as this year progresses.

This outlook of rising interest rates and reduced trend growth does suggest that we’re entering a less supportive period for real estate returns. That said, real estate is far from homogenous. Not only are there considerable differences between cities, but structural shifts could drive outperformance in sectors such as logistics, while real estate debt products should gain in attraction as interest rates rise. This environment may require investors to be more nuanced and selective in their approach, but there could still be plenty of attractive opportunities.

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6 Oxford Economics, February 2018

Forecasts are based on assumptions, estimates, opinions and hypothetical models or analysis which may prove to be incorrect. Past performance is not indicative of future results.
4 Real Estate Performance

4.1 Occupier Fundamentals

Occupier demand picked up further in the second half of 2017 thanks to the European economy performing beyond expectations. With annual GDP growth of 2.4%, almost a full percentage point higher than the outlook had suggested at the beginning of the year, confidence among both businesses and consumers has put the wind in the sails of real estate occupiers.

Aggregate European office take-up grew by 8% in 2017, surpassing the 13 million square metre mark and eclipsing the record total from 2007. And so far there has been relatively little sign of the over-supply that ultimately added to the severity of the previous two market corrections. However, the amount of space under construction is rising and stood at over 10 million square metres by the end of the year. While this represents a not insignificant 3.5% of the existing stock, it is not yet at worrying levels given that continued employment growth is expected to drive further demand.

The European office vacancy rate is also fast approaching a 15-year low, and this is being reflected in above average rental growth. By the third quarter of 2017, average prime rent growth had reached 3.1% year-on-year, with early indications suggesting that a number of markets carried that momentum into the fourth quarter. Portugal has been a notable strong performer, with rents up by 8% in the second half of the year, with the main Spanish and German cities seeing growth of 4% and 2%, respectively.

The logistics market also shows few signs of slowing, fuelled by ongoing demand from retailers and the e-commerce sector. And with take-up still comfortably exceeding new completions, availability remains low. One exception to this positive trend was the U.K. market, where demand in 2017 was markedly down on the unusually high total in the previous year. However, high quality space remains in relatively short supply, with current availability accounting for less than a year of average annual take-up in the grade A market. And while demand may moderate along with the economy this year, rents in London look set for further growth in the short term.

Retail conditions, on the other hand remain challenging, and it became clear during 2017 that the shopping centre market was still facing headwinds. Despite a limited construction pipeline, the overall European vacancy rate has continued to climb, and few markets saw rental growth during the first three quarters of the year. In France, which is some way behind the United Kingdom and Germany in terms of online sales penetration, the pace of online change, as well as competition from retail parks, has begun to affect rents even in large dominant shopping centres. Rents also remain under pressure in Germany, where take-up of retail space has weakened over the past year as retailers exercise more caution.

Given that GDP growth forecasts have been upgraded substantially for 2018 and 2019, our forecasts for office rent growth have also seen an uplift. Central London offices likely see further rental decline this year as vacancy rises, although under the base case scenario of a two-year transition period, rents should then pick up in the

---

Average European Vacancy Rates (%)  

<table>
<thead>
<tr>
<th>Year</th>
<th>Office</th>
<th>Logistics</th>
<th>Shopping Centre</th>
<th>High Street</th>
</tr>
</thead>
<tbody>
<tr>
<td>2011 Q4</td>
<td>11.0</td>
<td>10.5</td>
<td>9.5</td>
<td>8.0</td>
</tr>
<tr>
<td>2012 Q1</td>
<td>10.5</td>
<td>10.0</td>
<td>9.0</td>
<td>7.5</td>
</tr>
<tr>
<td>2012 Q2</td>
<td>10.0</td>
<td>9.5</td>
<td>8.5</td>
<td>7.0</td>
</tr>
<tr>
<td>2012 Q3</td>
<td>9.5</td>
<td>9.0</td>
<td>8.0</td>
<td>6.5</td>
</tr>
<tr>
<td>2012 Q4</td>
<td>9.0</td>
<td>8.5</td>
<td>7.5</td>
<td>6.0</td>
</tr>
<tr>
<td>2013 Q1</td>
<td>8.5</td>
<td>8.0</td>
<td>7.0</td>
<td>5.5</td>
</tr>
<tr>
<td>2013 Q2</td>
<td>8.0</td>
<td>7.5</td>
<td>6.5</td>
<td>5.0</td>
</tr>
<tr>
<td>2013 Q3</td>
<td>7.5</td>
<td>7.0</td>
<td>6.0</td>
<td>4.5</td>
</tr>
<tr>
<td>2013 Q4</td>
<td>7.0</td>
<td>6.5</td>
<td>5.5</td>
<td>4.0</td>
</tr>
<tr>
<td>2014 Q1</td>
<td>6.5</td>
<td>6.0</td>
<td>5.0</td>
<td>3.5</td>
</tr>
<tr>
<td>2014 Q2</td>
<td>6.0</td>
<td>5.5</td>
<td>4.5</td>
<td>3.0</td>
</tr>
<tr>
<td>2014 Q3</td>
<td>5.5</td>
<td>5.0</td>
<td>4.0</td>
<td>2.5</td>
</tr>
<tr>
<td>2014 Q4</td>
<td>5.0</td>
<td>4.5</td>
<td>3.5</td>
<td>2.0</td>
</tr>
<tr>
<td>2015 Q1</td>
<td>4.5</td>
<td>4.0</td>
<td>3.0</td>
<td>1.5</td>
</tr>
<tr>
<td>2015 Q2</td>
<td>4.0</td>
<td>3.5</td>
<td>2.5</td>
<td>1.0</td>
</tr>
<tr>
<td>2015 Q3</td>
<td>3.5</td>
<td>3.0</td>
<td>2.0</td>
<td>0.5</td>
</tr>
<tr>
<td>2015 Q4</td>
<td>3.0</td>
<td>2.5</td>
<td>2.0</td>
<td>0.0</td>
</tr>
<tr>
<td>2016 Q1</td>
<td>2.5</td>
<td>2.0</td>
<td>1.5</td>
<td>0.0</td>
</tr>
<tr>
<td>2016 Q2</td>
<td>2.0</td>
<td>1.5</td>
<td>1.0</td>
<td>0.0</td>
</tr>
<tr>
<td>2016 Q3</td>
<td>1.5</td>
<td>1.0</td>
<td>0.5</td>
<td>0.0</td>
</tr>
<tr>
<td>2016 Q4</td>
<td>1.0</td>
<td>0.5</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>2017 Q1</td>
<td>0.5</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>2017 Q2</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>2017 Q3</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
</tr>
</tbody>
</table>

Sources: PMA, Cushman & Wakefield, JLL, Deutsche Asset Management, January 2018

7 JLL, Deutsche AM Research, January 2018  
8 CBRE, January 2018  
9 CBRE, January 2018  
10 Centre for Retail Research, 2017  
11 JLL, Q3 2017.

Forecasts are based on assumptions, estimates, opinions and hypothetical models or analysis which may prove to be incorrect. Past performance is not indicative of future results.

Europe Real Estate Strategic Outlook | February 2018
early part of the next decade as business uncertainty fades, particularly given the likelihood of low construction activity. Office rents look to be stabilising in Warsaw, although high levels of new supply mean we still don’t anticipate rental growth until 2020. Rental growth in Central Paris slowed in 2017, but with the French economy beginning to fire on all cylinders, we expect to see rents pick up again in the coming years. However, it is the German cities, driven largely by Berlin and Frankfurt, where we foresee the most impressive rental growth figures in Core Europe.

We have downgraded our near-term outlook for shopping centres significantly, with Continental Europe’s two largest markets both experiencing downward pressure on rents, particularly so in Germany where a further correction is likely in the short term. We expect core Europe and the United Kingdom to remain weak over the next five years, while Southern Europe and the CEE region, where private consumption remains supportive and e-commerce is much less mature, should be stronger performers.

Structural changes would continue to drive broad rental outperformance in logistics, although there are still differences across markets. Paris is anticipated to be among the best-performing markets while in the short term, rental growth in Madrid is likely to be held back due to the strong supply pipeline. In Germany, where prime rents held up well following the financial crisis, we expect to see below-average rent growth looking ahead to reflect affordability constraints and the polycentric structure of the market, with land availability also a concern in certain regions. In London, although uncertainty surrounding the Brexit negotiations is clearly having an effect on office rents, we expect the logistics sector to be better insulated in this regard, thanks to a far more advanced e-commerce market and increased competition for space.

### Prime Rent Growth (% p.a.)

![Prime Rent Growth chart]

Source: Deutsche Asset Management, January 2018. Past performance is not indicative of future results.

#### 4.2 Capital Markets and Pricing

European real estate pricing has tightened further in the past six months. However, real estate remains attractive in a multi-asset context thanks to strengthening income growth and a still-significant yield spread over other fixed income products. And with investor interest remaining strong and monetary policy expected to adjust only gradually, we expect property to further gain in value over the rest of the decade.

Two thirds of investors plan to increase their European real estate allocations during the next two years, a greater number than a year ago. Nevertheless, private fundraising fell slightly in 2017, and European investors remain underinvested compared to their allocation targets, in part reflecting the limited array of suitable product in a market where pricing is beginning to look stretched in certain areas.

After a 15% fall in 2016, European all property investment volumes rebounded in 2017 and remained well above their long-term average. Total investment activity grew by 7% year-on-year, but there were marked differences between the sectors. Investment in industrial property saw its eighth consecutive year of growth, as volumes rose by an impressive 43% over the year, with investment demand for warehouse space growing even faster at 68%. On the other hand, a marked fall in shopping centre investment acted as a major drag on the retail sector, which saw volumes fall by 14%.

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12 Preqin, January 2018
13 INREV, January 2018
14 Real Capital Analytics, February 2018

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Activity was broadly stable elsewhere. In the office sector, mega deals during the second half of the year, such as the sale of Coeur Defense in Paris La Defense for around €1.8 billion, the Walkie Talkie in London City for €1.4 billion and the Sony Centre in Berlin for €1.1 billion all helped to push up the office total up to a similar level as that achieved in the previous year.

### Commercial Real Estate Investment Volume (rolling annual total, € billion)

![Graph of Commercial Real Estate Investment Volume](image)

Source: Real Capital Analytics, January 2018. Past performance is not indicative of future results.

According to the most recent INREV Investment Intentions Survey, the United Kingdom remains the preferred investment destination for investors, ahead of France and Germany, with London offices back on investors’ radars. Sweden, on the other hand, has fallen out of favour, possibly reflecting concerns about stretched pricing.

Signals of confidence in the U.K. market have not been universal though. PMA’s Survey of Investor Preferences balance dipped in the fourth quarter of 2017, with Central London offices and U.K. shopping centres moving further into negative territory. Nevertheless, sentiment towards industrial and logistics remains positive, and the tide of opinion has seemingly shifted towards retail parks.

While the overall balance of European sentiment remained below the long-term average, in Core and Southern Europe the average was well above historical levels, driven by interest in Spain, the Netherlands, Germany, France and the Nordic markets.

Current sentiment is also being reflected in pricing and transaction volumes. In the United Kingdom, there is still strong demand for large, prime assets in Central London, particularly from dollar-denominated high net worth investors from Hong Kong, given that London still looks good value compared to their home market. On a national level, U.K. office investment remains impaired compared to recent years, although industrial activity has soared to an all-time high.

Investment activity edged higher in both France and Germany and volumes remain at historically high levels, although there were fewer cross-border transactions in France than in recent years. Investors are still backing the Netherlands, where investment volumes have tripled over the last four years, while Finland has also seen a surge in interest due to its better-than-expected economic performance and the fact that prices have been slower to recover compared to its Nordic neighbours.

In response to investor demand, logistics yields were down by 40-50 basis points over the year. A 30 basis point fall in office yields over the same period led to a similar positive impact on capital values, although retail yields were down by just 20 basis points over the same period. The change in momentum was also visible in the fourth quarter, as two thirds of office markets and three quarters of shopping centre markets saw no change in pricing.\(^{15}\)

The logistics yield spread over offices is now less than 150 basis points, but in relation to the previous market peak, prime logistics properties are still affordable. On a nominal basis, prime logistics values have only recently broken through their 2007 levels, while offices are already 40% higher and high street as much as 70% above.

Prime shopping centre values have recovered since the crash, but a look at the wider shopping centre market reveals a less positive picture. The RCA Commercial Property Price Indices (CPPI) show that average transaction-based values are still 15% below their peak in Continental Europe, and as much as 40% below peak in the United Kingdom. So while prime dominant centres remain in demand among both occupiers and investors, secondary and tertiary centres are struggling.\(^{16}\)

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\(^{15}\) JLL, January 2018

\(^{16}\) RCA, November 2017

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One trend that has not materialised to the extent we had expected 12 months ago is the outward shift in U.K. yields. Despite a significant amount of uncertainty surrounding the Brexit negotiations, average all property initial yields moved out by just 20-30 basis points following the referendum, and have since returned to their previous levels. This is being supported by foreign capital for certain segments, such as logistics and Central London offices, but in the retail market the lack of foreign capital has reduced competitive pressure on pricing.

More than €22 billion of transactions have already completed in the first month of 2018, with a further €30 billion of pending deals. And with a large amount of dry powder targeting European real estate and continued momentum in many sectors and markets, the short-term outlook is for further price appreciation.

In general, we expect that yields with reach a floor this year; however, there could be differences between sectors and markets. Logistics has been closing the pricing gap to offices and retail over the past five years, and we expect this trend to continue looking ahead. Whereas on average, office yields were around 190 basis points higher than logistics in 2012, we are forecasting the gap to be approaching 100 basis points by 2022.

Equally, while yields in most continental European markets are set to move broadly in unison over the next five years, the United Kingdom looks likely to follow a slightly different path. Uncertainty around the Brexit negotiations could push yields out in the near term, but we would then expect to see convergence with the Continent again during the second half of the forecast period, leading to a period of potential outperformance.

4.3 Real Estate Returns and Market Calls

While real estate returns have peaked in the current cycle, recent performance has shown that there is still momentum in the European market. Nevertheless, returns are almost certain to moderate during the next five years as yield compression comes to an end and changes in capital value become more reliant on rental growth.

At the fund level, European property performance trended upwards over the year to Q3 2017, as returns reached 9.4% in September 2017, up from 6.5% a year earlier. While much of this was driven by a bounce back in the U.K. property market, Germany, France, the Netherlands and Finland also saw improving returns, although performance in the Italian market remains somewhat subdued.

MSCI’s Pan-European Quarterly Property Fund Index would also seem to confirm these trends, with annual returns growing to 7.9% in Q3 2017, up from 5.3% a year earlier. At the property level, a comprehensive dataset may not be available until later in the year, but the most recent data agrees with the INREV results in the United Kingdom, France, Italy and the Netherlands.

17 MSCI, January 2018
18 RCA, February 2018
19 INREV, January 2018

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Recent returns have been driven by a combination of falling yields and an improving occupier market. However, we expect that rising interest rates could begin to put the brakes on further capital growth through yield change this year. Prime all property total returns have averaged close to 13% per year over the last five years, but we are forecasting a return of just over 8% in 2018 and an average of 5.2% per annum until 2022.

Although this still looks relatively attractive compared to the returns on offer from a German Bund or a European corporate bond, there are a number of strategies that we believe can help investors to improve risk-adjusted returns and outperform the wider real estate market. A growing number of European markets would now be classed as ‘late cycle’ in our opinion, so our preferred target strategies are increasingly focused on specific segments, sub-sectors and sub-markets.

At a more general level, the highest absolute returns are still expected in the CEE region, although on a risk-adjusted basis we expect the Benelux countries and Finland to be the strongest performers across most sectors over five years, with the U.K. market also expected to outperform towards the end of the forecast period. At a sector level, we continue to expect European logistics to be a relative outperformer, while exposure to other long-term growth sectors such as European residential and hotels could also help to improve portfolio returns.

Below, we summarise our market-level calls for the three main commercial sectors over the next two years and over the longer term. As before, these numbers are based on our forecasts for prime property performance and also account for market risk. The table provides some guidance on market selection, as well as an indication of market timing for European real estate investors. However, the recommendations are not all encompassing within the real estate investment universe and therefore should be viewed in conjunction with the strategic themes shown in this document.

Forecasts are based on assumptions, estimates, opinions and hypothetical models or analysis which may prove to be incorrect. Past performance is not indicative of future results.
European real estate performance looks challenging in some respects, the asset class still looks attractive in relative terms, and we believe that there might be numerous opportunities to outperform the market through careful asset, market and sector selection.

For those investors that are not willing to reduce target returns, it would most likely be necessary to avoid most prime segments of the market. However, we still caution against drifting up the risk curve through higher leverage or looser investment standards. Instead, any additional risk should be premised on strong underlying growth fundamentals.

At the same time, with a narrowing gap between debt and equity returns, a larger allocation to debt has the potential to lower a portfolio’s interest rate sensitivity while also helping to stabilise valuations over time, without lowering absolute returns materially.

In general we have an underweight call on the office market. This is reflected in our return forecasts, with European prime office returns expected to be just 4.4% per annum, compared to 5.5% for prime shopping centres and 7.2% for prime logistics. Despite this, we have identified a number of emerging submarkets in major European cities, where we expect convergence with the wider market to lead to both rental and capital value outperformance. These would include, among others, Amsterdam Noord, Paris North-East, Solna in Stockholm and Porta Romana in Milan.

There are also a number of alternative sectors where we see potential value. Within the residential market, affordable housing in key cities with strong demographics, particularly within Germany, the Netherlands and Finland, should benefit from a secure income stream and above average rental growth, while still seeing limited void risk. There is also potential for sectors such as student living and apart-hotel to benefit from a significant demand overhang, leading to longer-term growth prospects, although market selection could be key here.

The retail sector could continue to face headwinds, but it would be imprudent to write off the sector as a whole. Shopping centres appear to be bearing the brunt of the switch to online sales, although a large performance gap has emerged between dominant prime centres and mid-sized, secondary centres located out-of-town. As shown recently in Germany and France, even the best large shopping centres are finding it difficult to increase rents, but we expect that urban shopping centres and retail parks may be better protected against online sales cannibalisation, and therefore have the potential to outperform the wider retail market.

So while the outlook for pan-European real estate performance looks challenging in some respects, the asset class still looks attractive in relative terms, and we believe that there might be numerous opportunities to outperform the market through careful asset, market and sector selection.

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5 Office Market Outlook

Current Conditions
Stronger broad-based employment growth in Europe translated into record office take-up in 2017, totalling over 13 million square metres for the year as a whole, and reaching a new record level during the last quarter. While the German cities and Paris continued to outperform, leasing activity in London also increased. Despite a general ‘wait-and-see’ approach to Brexit, take-up was supported by higher demand from flexible office operators.

Office completions have continued to pick up but are not yet at a level to halt the downward trend in the vacancy rate, which was approaching 8% across the main European cities by the end of 2017. Tighter office vacancy is increasingly pronounced in CBD markets, having reduced sharply compared to its long-term average.

Against this background, prime rent growth has accelerated beyond 3% year-on-year on average across European markets. The main Southern European cities, where prime rental values are still some way below their last peak, are seeing a particularly strong rental recovery.

Outlook and Investment Strategies
The latest employment growth forecasts bode well for occupier demand, with the creation of almost five million jobs due across the Eurozone between 2018 and 2022 – almost half of which should be office-based. However, by the end of the decade, the rise in office space under construction in Europe is set to push vacancy higher.

Nonetheless, the growth in new supply shouldn’t be overstated. With annual net completions set to average around 1.2% of stock over the next five years, this is well below the level recorded in the previous cycles. In this context, vacancy rates should increase only moderately in most of European markets, staying close to their long-term average by 2022.

As such, over the next five years, prime rents are expected to grow firmly compared to long-term average in the majority of the European markets, with factors such as space efficiency and workplace wellness supporting demand for high quality stock.

Southern Europe and Germany should see the strongest rental growth, with the Paris CBD, Amsterdam and parts of the Nordics also doing well. Warsaw should continue to suffer from oversupply for some time, but after five straight years of decline, we now feel rents have reached a floor.

While there have been some announcements of Brexit relocation plans to Continental Europe, the overall impact has so far been relatively minimal, although this could change in the event of an adverse Brexit outcome. For now we continue to expect a further fall in Central London rents, followed by a recovery from around 2020 as the supply pipeline lessens and business activity starts to pick-up.

Despite a relatively benign occupier market, prime yields in core Europe are edging towards 3% and even on a relative basis this segment of the office market is looking expensive. Excluding a handful of markets, we generally see better value in targeting asset repositioning in core locations and offices in major city emerging markets.

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<table>
<thead>
<tr>
<th>Office Strategies</th>
<th>1</th>
<th>Emerging locations: The current value gap between ‘gentrifying’ areas and CBDs leaves stronger rental growth potential, while yield convergence would limit any negative yield impact going forward. Target large and fast-growing cities such as Paris or London.</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2</td>
<td>Asset Repositioning: Sustained occupier demand near city centres where rents are cheaper than in CBDs. Very low grade A supply and a yield premium are set to drive outperformance over time, where replacement costs are high.</td>
</tr>
</tbody>
</table>

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20 PMA, Deutsche AM, January 2018  
21 CBRE, January 2018  
22 PMA, Deutsche Asset Management, January 2018  
23 PMA, November 2017  
24 PMA, November 2017  
25 Oxford Economics, January 2018

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6 Retail Market Outlook

Current Conditions

Paradoxically for a sector that is undergoing phenomenal disruption, it sometimes seems the retail story has been unchanged for years. Whatever the macro climate, the theme of online sales migration dominates the narrative.

Today is no different. Excluding the effect of online sales, the drivers of retail real estate are exceptionally strong: more people are in work, confidence is at record levels, and retail sales growth has accelerated across much of Europe.\(^26\) But with annual online sales growth of around 15%, only a fraction of this additional spend is occurring in-store.\(^27\) The unceasing march of online continues, capping the willingness of retailers to take physical space.

Many traditional retailers are struggling in this environment. Faced with online competition and the need to transform operating models, margins are stretched and store openings curtailed. In Germany, where total sales growth is set to have been close to 5% last year, landlords are still expressing difficulty in sustaining occupancy and achieving rental growth, a message repeated in France and to a lesser degree the United Kingdom.

This picture is present across much of Core Europe and the Nordics, and is reflected in relatively weak investor sentiment. However, this is not yet the case in Southern Europe and the CEE, where despite online growing quickly, they’re starting from a low base; and coupled with strong total sales growth, rents here are expanding.

Outlook and Investment Strategies

Retailing conditions in the United Kingdom and Core Europe would likely remain difficult over the coming five years. Even with a growing understanding that the value of the store is more than just money through the till, projections of very low in-store sales growth leads us to forecast prime shopping centre rent growth of just above 1% per annum between now and 2022.

The opposite is true for Southern Europe and the CEE; here we expect annual rent growth of more than 2%. In both regions online sales are little more than 4% of the total, giving landlords the chance to benefit from above-average total sales growth in Spain and Italy, and sustained growth of more than 5% per annum in Poland.\(^28\)

That said, we see little evidence to support the view that the proportion on sales going online may not converge. Already growing faster than the European average, as the Digital Single Market becomes a reality, consumers in Southern Europe and the CEE should have fast-expanding access to online products and services.\(^29\) As this convergence takes hold, the United Kingdom and Core Europe may well then offer the better opportunities.

When the dust settles, we’re confident that the retail landscape might look quite different from today. Retail should almost certainly shrink as a share of the commercial real estate market, while the definition of retail itself will become blurred as destinations increase the proportion of space given over to food, leisure and services.

Major high streets should be resilient to online, but today rents are high and at an average prime yield of near 3% we see fewer attractive opportunities. Better opportunities are found in urban shopping centres and retail warehouses. While more exposed to online, these assets – in built up areas with an immediate catchment – offer consumers easy access to a range of retail and services; retailers high footfall and lower rents; and investors a higher yield, above average rental growth and the possibility of an alternative use.

<table>
<thead>
<tr>
<th>Retail Strategies</th>
<th>Integrated Urban:</th>
<th>Retail Parks:</th>
<th>Factory Outlets:</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Grocery anchored centres that are well integrated into the urban community and cater for frequent, small-basket shops. Focus on areas of gentrification in major cities such as London, Berlin and Paris.</td>
<td>New generation proving attractive to retailers and consumers. Strong demand from value, bulky and traditional high street retailers. Focus on urban, affordable, flexible and accessible space, with options for alternative use.</td>
<td>Less sensitive to online migration and increasing focus on experience and a full-day shop. Options to reposition first generation outlets or target new markets with growing consumer demand.</td>
</tr>
</tbody>
</table>

\(^{26}\) Oxford Economics, January 2018  
\(^{27}\) Centre for Retail Research, June 2018  
\(^{28}\) Oxford Economics, January 2018  
\(^{29}\) European Commission, May 2017

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7 Logistics Market Outlook

Current Conditions
Logistics continues to go from strength to strength. Demand fundamentals remain solid as the shift to online retailing gathers pace and extends across Europe. With a broad-based economic recovery well underway – supporting private consumption and manufacturing, as well as strengthening exports – demand for logistics space remains elevated, pushing the European average vacancy rate down to around 5%.\(^\text{(30)}\)

Occupiers are increasingly focusing on big box distribution and e-fulfilment centres, with ever more space taken in large national distribution hubs and those close to major population centres. Demand for urban logistics is also accelerating. Poorly-located peripheral locations are falling out of favour, while older assets in corridor locations are at risk of obsolescence.

Furthermore, we are noticing growing demand for well-connected intra-urban ‘last hour’ logistics assets in locations from which distribution or deliveries can be undertaken within one-hour drive time to two or more major population centres.

Outlook and Investment Strategies
To date, not all European markets have seen firm evidence of rental growth for prime distribution assets, but the expectation is that growth may pick up and broaden over the coming five years. In total we expect annual prime rent growth to average 1.8% over the five years to 2022, with big cities such as Paris, London, Amsterdam and Milan outperforming as occupiers compete for the best located stock.

The availability of land in some areas could place a brake on rental growth, particularly in polycentric areas such as the Rhine-Ruhr in Germany, and parts of Poland where developers compete for tenants either through lower rents or significant incentive packages. While this is also the case in Madrid, we still expect above average rent growth from the Spanish capital, given the strength of demand.

We continue to favour XXL distribution assets, which are typically delivered on a build-to-suit basis. However the yield on these assets is falling sharply given their attractive lot size and long-lease profile, along with favourable structural demand drivers. Here, a focus on the less-advanced online retail markets of France, the Benelux, Iberia, Northern Italy and the CEE should be maintained along with select Nordics, where we see relative value. Where fundamentals are strong, investors could also look to benefit from funding build-to-suit developments or even speculative construction, particularly where modern stock is in short supply.

In our recently published paper, ‘Urban Logistics: What, Where and How’, we also discussed the attraction of ‘last hour’ logistics locations. While land availability could be a concern, low base rents, as well as a disciplined approach to market and site selection, should help to mitigate this risk.

Finally, urban logistics assets are an attractive investment. Not only is there exceptionally strong occupier demand for this sort of space, urban assets also provide the option for alternative use, particularly residential. While we prefer newly built urban logistics stock – particularly purpose-built cross-docked assets – we recognise that there is a limited pipeline of investment stock here and that pricing may also be becoming too aggressive for some investors. As such, we are increasingly observing that single or multi-let industrial estates are being repurposed for last mile use.

<table>
<thead>
<tr>
<th>Logistics Strategies</th>
<th>1</th>
<th>2</th>
<th>3</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Last Hour</strong></td>
<td>Acquire, forward fund or speculatively develop ‘last hour’ assets that can be used for either distribution or fast delivery to a wide catchment across two or more urban areas within one hour HGV drive time.</td>
<td><strong>Urban Logistics</strong></td>
<td>Acquire, forward fund or speculatively develop last-mile urban cross-docked customer or parcel delivery centres. Consider acquiring and refurbishing older, well-located single or multi-let industrial stock and benefit from alternative land use.</td>
</tr>
</tbody>
</table>

\(^{30}\) JLL, November 2017

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8 Residential Market Outlook

Current Conditions
European residential is increasingly becoming an institutional asset class. The investor universe continues to broaden and grow in size, becoming more diverse, and with cross-border capital playing a more prominent role. A total of €42 billion of residential deals were completed in 2017 throughout Europe, a rise of 12% year-on-year.31

Transaction volumes have increased significantly in recent years, growing by a factor of six between 2009 and 2017. However, the European figure hides a diverse regional picture. Over the year, Germany, Austria and Spain saw volumes increase significantly compared to the previous year, while countries such as Sweden, Finland and the Netherlands lost some ground.

Despite rising transaction volumes in the last decade, residential investment activity is still focused on a small number of European markets. Germany, the United Kingdom, Sweden and the Netherlands account for the lion’s share of the market – over 70% of European deals were concentrated in these four countries over the past year.

With ownership rates ranging between 45% and 95% in Europe, the number of rented residential units ranges from 200,000 to almost 20 million across national markets. Germany, the United Kingdom and France lead the pack in this respect. However, in general investors continue to struggle to access the market, particularly as most new supply is being absorbed by domestic players and large existing portfolios are rarely entering the market.

Outlook and Investment Strategies
As well as increasing investor interest, developers are also becoming more active. Across most European markets the level of new supply is rising, and although activity is often still below previous peaks, in many cases it is now above the 10-year average.

This trend is expected to continue in the coming years, as the number of building permits – an early indicator for future supply – is rising. However, in general we expect this additional supply to be absorbed. Particularly in the largest urban areas, where population growth has generally been running well above the national level, completions are often not keeping up with demand.

In addition to higher population growth, cities are often seeing some of the strongest economic and jobs growth. Furthermore, with high prices and a growing desire for housing flexibility from young professionals, the ownership share in major agglomerations is set to continue to trend downwards.

Rental growth is set to continue to be strongest in these urban agglomerations. Not only does this support the case for standard private rental investment, it is also likely to increase the need for affordable housing and other formats such as micro apartments.

In terms of investor demand, we expect European residential markets to retain their appeal as defensive investments for cash-flow oriented investors. Over the past decade, total returns have been higher than those for the main commercial market segments, but have also showed a lower volatility.32 This trend of strong and stable returns is likely to continue in the coming years, although like other sectors at a lower level.

| 1 | Standing Investments in Established Markets: Major agglomerations and key regional cities often benefit from a strong appeal among the younger population, supply shortages and lower replacement costs. Focus on affordable rents. |
| 2 | Defensive Investments in Emerging Markets: Some residential markets are becoming more institutionalised, featuring strong rental growth and further price increases. Focus on markets with strong economic and demographic growth. |
| 3 | Place Making & Emerging Sectors: Focus on cities with strong demand and political support for large scale assets. Further growth potential thanks to demographic change and urbanisation. Also focus on the mid-stay segment in integrated locations. |

31 Real Capital Analytics, February 2018
32 IPD, 2017

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9 Private Debt Outlook

Current Conditions
The non-bank lending market for private real estate financing has developed rapidly since the global financial crisis, offering a new set of opportunities to investors. Across Europe, banks still account for the largest share of private real estate financing, but the landscape has changed markedly, thanks in large part to regulatory changes. Lower availability of bank financing has created increased demand for alternative funding sources, while rising allocations to real estate debt and an influx of capital are leading to greater competition.

Currently, senior LTVs across Europe range from 55% to 75%, and while stiffer competition from alternative lending sources has meant that margins have come down some way from their peak five years ago, they are still generally above pre-crisis levels. Maximum LTVs for senior loans in the UK are currently under 60%, but it is also possible to obtain additional financing through a junior or mezzanine loan for up to 85%, with a margin close to 800 basis points. Lenders have increasingly carved out their position in the market as well. For example, banks will typically lend on a floating basis for five years, while longer-term fixed rate loans are largely provided by insurance companies. Debt funds and other alternative lenders can be slightly more expensive, but can potentially offer the borrower a wider range of options in terms of loan structure.33

Real estate debt can offer attractive performance characteristics to long-term investors. Historically, lower total return volatility has tended to support strong risk-adjusted returns, while investors can also see potential diversification benefits in a multi-asset portfolio. For investors with long-term buy-and-hold strategies, real estate debt represents a valuable source of duration within a fixed-income portfolio, and can offer a spread premium offered over similarly-rated corporate debt. From a fixed income perspective, CRE debt also offers an attractive credit profile in terms of default and recovery rates, and typically offers a spread premium over corporate debt.

Outlook and Investment Strategies
With real estate debt offering the potential to provide long-term cash flow predictability, strong credit quality, and a yield premium over other fixed-income opportunities, we expect that the private debt market may continue to expand as institutional investors look to increase their exposure.

Direct core property returns are expected to be below 5% over the next five years, and although returns from debt have also reduced, the spread between debt and equity has come down markedly. At the same time, the risks around debt investment remain fairly low, with conservative maximum senior LTVs offering downside protection, while lending over a floating interest rate allows lenders to hedge against rising rates, a concern on the equity side. And in the mezzanine market, a current spread of 600-900 basis points compares favourably to our expectations for direct returns over five years, while still benefiting from a reasonable downside buffer.

In general, we would recommend a focus on core assets and locations, seeking those with lower underlying market risk, given that we are later in the property cycle. In the United Kingdom, senior margins of 150-250bps and potential risk-adjusted returns of close to 3%34 still look attractive compared with much of Continental Europe, although hedging costs could be a factor for non-sterling investors. Conversely, we would be more cautious on U.K. mezzanine, particularly Central London offices where there is material risk of short-term value decline. We would focus mezzanine investments in Continental Europe, although higher LTVs for senior loans mean that it may require more work to source opportunities. In terms of sectors, we expect pan-European logistics to offer the strongest downside protection as yields continue to converge with other sectors, but would caution over secondary retail, where we expect weaker performance and greater risks.

<table>
<thead>
<tr>
<th>Private Debt Strategies</th>
<th>1</th>
<th><strong>U.K. Senior / Continental Mezzanine</strong>: In the United Kingdom, focus on senior lending to benefit from higher margins. On the continent, target mezzanine lending in order to boost returns in a strengthening occupier environment.</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2</td>
<td><strong>Mitigate Risk</strong>: Target assets that fit into the preferred direct investment strategies. Stick to core locations and seek assets where underlying void risk is low. Take selective bets on well-located assets that require asset management.</td>
</tr>
<tr>
<td></td>
<td>3</td>
<td><strong>Floating Interest Rates</strong>: Rising rates are set to hit direct property returns, but debt offers an opportunity to hedge against this.</td>
</tr>
</tbody>
</table>

33 DMU, May 2017
34 CBRE, January 2017

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10 Listed Market Outlook

Current Conditions
For most of 2017 the listed market behaved largely as expected with anything linked to e-commerce performing well (Segro +38.7%), while traditional bricks and mortar retail suffered (Unibail -3%). London office stocks rose (British Land +15.3%) with the direct market generally performing much better than expected, as U.K. majors sold around £4 billion of assets at significantly above book value, swiftly followed by return of capital through buybacks and special dividends. German residential also moved higher as the low bond yield environment continued to support pricing (Vonovia +38.2%).

In December three major M&A transactions were announced in quick succession, with Hammerson’s share offer for Intu, Unibail’s cash and shares offer for Westfield (both shopping centres) and Vonovia’s cash offer for Buwog (Residential) delivering some end of year excitement.

The EPRA total return index recorded a respectable +13.4% in 2017 (Stoxx 600 Index +7.7%), of which +4.2% came through in the last month.

Outlook and Investment Strategies
Looking forward, underlying real estate valuations do not seem overly stretched for listed companies and relative spreads remain attractive to investors searching for yield. Funding markets seem robust and occupancy is high, coupled with prime rents in almost all markets having structural support on top of modest underlying growth.

The direction of the U.K. direct property market and the quoted sector performance is difficult to predict from here, as was the case in 2017. Last year was characterised by continual estimate upgrades from the sell side as the property cycle failed to be cyclical. The search for yield, which drove income stocks outperformance, may well persist into 2018 but if the dislocation between the direct and indirect markets continues, there is the possibility of further M&A and de-listing/activism activity, narrowing the discount which has remained stubbornly above 20% since the referendum in 2016.

The occupier market remains a focus both for office landlords (Brexit concerns) and retail asset owners (margin pressure) and may continue to influence sentiment and share prices. Smaller companies focused on non-cyclical alternative asset classes (student accommodation, PRS) remain attractive and are likely to deliver sector leading EPS growth and NAV with a growing dividend yield.

The performance of Continental European listed companies is set to be a tug of war between the threat of rising bond yields and the continued improvement of many occupational markets. In 2018 we expect the latter to prevail, assuming the removal of central bank stimulus is measured. Office markets in France, Germany, Spain and Scandinavia look set to provide the strongest earnings growth and many companies currently offer this at a reasonable price. We expect retail to be the weakest sector overall, but retail stocks are likely to become more polarised, with higher quality names doing better.

Residential names are the hardest to call, as this is where the battle between very strong fundamentals and the perception of being a bond proxy is strongest. Politics and regulation also have the potential to cause an upset in this sector. Duration is almost certainly something to avoid in favour of growth, where it exists.

| Listed Real Estate Strategies | 1 | United Kingdom: Deep value in the well-capitalised and defensively-positioned U.K. Large Caps may drive further opportunistic M&A/activist activity and further return of capital. |
| 2 | Continental Europe: Growth at a reasonable price – we expect office companies in Paris, Germany and Spain to be towards the top of the performance list. |
| 3 | Non-cyclical alternatives: We expect student accommodation, healthcare and residential companies to deliver above-average earnings growth, higher dividends and ultimately superior returns. |

35 The mention of a specific security should not be interpreted as a recommendation to either buy, sell or retain a position in the security.

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The value of investments can fall as well as rise and you might not get back the amount originally invested at any point in time.

Investment in real estate may be or become nonperforming after acquisition for a wide variety of reasons. Nonperforming real estate investment may require substantial workout negotiations and/or restructuring. Environmental liabilities may pose a risk such that the owner or operator of real property may become liable for the costs of removal or remediation of certain hazardous substances released on, about, under, or in its property. Additionally, to the extent real estate investments are made in foreign countries, such countries may prove to be politically or economically unstable. Finally, exposure to fluctuations in currency exchange rates may affect the value of a real estate investment.

Investments in Real Estate are subject to various risks, including but not limited to the following:

- Adverse changes in economic conditions including changes in the financial conditions of tenants, buyer and sellers, changes in the availability of debt financing, changes in interest rates, real estate tax rates and other operating expenses;
- Adverse changes in law and regulation including environmental laws and regulations, zoning laws and other governmental rules and fiscal policies;
- Environmental claims arising in respect of real estate acquired with undisclosed or unknown environmental problems or as to which inadequate reserves have been established;
- Changes in the relative popularity of property types and locations;
- Risks and operating problems arising out of the presence of certain construction materials; and
- Currency / exchange rate risks where the investments are denominated in a currency other than the investor’s home currency.

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