Research Report

Europe Real Estate Strategic Outlook: Mid-Year Review

September 2016

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1 Executive Summary

- We have upgraded our total return outlook for the European real estate market. While this may seem at odds with the recent result of the U.K. referendum on E.U. membership, we believe that the combination of a reduced supply pipeline, looser monetary policy and an increased desire for safe-haven assets will more than compensate for what is expected to be only a modest hit to occupier demand.

- While the referendum is likely to have short-term economic implications, over a five year period the outlook for Eurozone GDP growth has been revised down by just 10 basis points per annum. Understandably the impact is set to be greater in the United Kingdom, which is not expected to enter recession but is forecast to see a marked reduction in growth. Even here, the combination of looser monetary policy, weaker sterling and subject to clarity over the Brexit settlement, we should see growth accelerate by the end of the decade.

- On average across Europe, we are expecting supply and demand fundamentals to remain balanced in the office and logistics markets. Continued office-using employment growth should support robust demand once again this year, and in the logistics sector strong supply chain activity is expected to lead to an increase in take-up. Despite a restrained pipeline of new shopping centre space, average vacancy is not expected to see any great improvement. That said, the gap in performance between large dominant centres and smaller secondary stock is expected to continue, and the outlook for the best centres remains positive.

- On average we predict all property prime rent growth to average 2% per annum over the next five years. Logistics rents are forecast to grow at slightly lower rates than shopping centres and offices, but compared to the sector’s historical performance this is a remarkable improvement, and stresses the important influence that structural long-term changes can have upon occupier fundamentals.

- Following the referendum, some appraisers are already suggesting a 25 basis points rise in Central London office yields in the weeks after the referendum, and we are predicting a further increase over the next 12 months or so. Conversely, the impact on pricing in other parts of Europe appears to have been largely positive. Government bond yields in Germany and a number of other European countries have fallen sharply, and while there are always more factors influencing real estate pricing than the spread over bonds, this further widening of the gap has made property look more attractive on a relative basis.

- All property prime returns are set to average 6.3% over the next five years, with logistics (7.6%) and shopping centres (7.5%) outperforming offices (5.9%) and high street retail (5.3%). Following further yield compression this year and next, returns are forecast to be increasingly driven by rental growth.

- On a risk-adjusted basis, we still see Spain, the Netherlands and the Top 7 German cities offering the most attractive returns, with Regional France, parts of Paris and Belgium also presenting interesting opportunities. While the immediate outlook for Central London has been downgraded, we see potential for considerable outperformance during the latter part of the decade.

- Strategically, core real estate is offering attractive opportunities. Not only are these investments defensive against tail risks, the income return spread over bonds remains close to a record high, while further rent growth and yield compression provides room for capital appreciation. Here we recommend a focus on prime CBD offices, dominant shopping centres, cross-dock logistics and German residential.

- While warning against style drift, we also favour investments that focus on longer-term trends such as demographics, urbanisation and technology and their impact on occupier demand for new micro locations and real estate segments. Generally focusing on near city centre and urban in-fill locations within Core European countries, these trends will affect all sectors as work, live and play preferences evolve. With this we see room for sustained outperformance, as rents and yields converge with more established locations.
2 European Real Estate Strategic Themes

The Alternatives research team has developed a proprietary quantitative model that forms the foundation of our understanding of future real estate market performance and how it reacts to economic developments. This is combined with qualitative insights from our investment teams and also considers sentiment and a number of risks, and provides in total the basis for our market views.

Current conditions: European real estate markets

- European real estate markets have continued to perform strongly during the first half of 2016, experiencing both improving fundamentals and further yield compression.
- The U.K. referendum on E.U. membership has altered the outlook and increased uncertainty.
- The impact of the vote is already being felt in the United Kingdom. While we do not expect the rest of Europe will be immune, the impact is likely to be significantly less pronounced.
- The Brexit vote, alongside a sharp reduction in sovereign bond yields, has further enhanced the attraction of the secure and relatively higher income returns associated with core real estate markets and assets.
- Market performance is diverging across the continent, with distinct cycles emerging. Core Europe and Southern Europe are mid-cycle, with the United Kingdom and CEE expected to outperform by the back end of the decade.
- There are however very clear tail risks to this assumption. Political risk is high across many parts of Europe, and so we expect market volatility to persist for some time – potentially weighing upon sentiment, yet providing further support for relatively safe, income yielding investments.

Outlook: Focus on long-term growth trends, rather than predicting future interest rates

These trends mentioned above are expected to lead investors to focus again on Core European countries and assets. This is reflected in early indications from the bond markets, with German and Swiss bond yields falling and German prime property yields edging lower.

However, basing investment strategies purely on the long-term outlook for sovereign bond yields and the relative attractiveness of real estate income is only one part of the analysis. Real estate investment must also focus on the fundamentals of occupier demand. With this in mind, our investment recommendations closely follow our outlook for supply, demand, vacancy and rental growth, while also analysing longer-term trends such as urbanisation, demographics or technology.

These recommendations encompass both the buy and sell views. Minimising risk through portfolio optimisation and targeted sales should continue to be a priority, as some segments will face weakening occupier demand, and the least competitive will be threatened by obsolescence at some point in the future.

Our recommended investment strategies can be clustered into four broad categories:

1. **Established Core**: Rising uncertainty is pushing investors towards defensive core segments. These assets are expected to benefit from continued demand, and should see sustained NOI growth. The opportunity for further yield compression has increased, while the assumed exit yield is now also lower. Expected returns may be lower than historical returns, but in a world of negative interest rates they should remain attractive on both a risk-premium and inflation-adjusted basis. Given sustained demand, investors looking for higher returns may also wish to take on assets with modest voids or re-letting risk, and to consider forward funding. Investors should have a flexible approach to holding periods as short term holds (3-4 years) may also start to look attractive.

2. **Selective Bets**: Investors should focus on longer-term trends such as demographics, urbanisation and technology, and their continued impact on occupier demand for new micro locations and real estate segments. Clear evidence of emerging locations such as Kings Cross in London and segments like retail parks recording sustained outperformance.

Generally focusing on near city centre and urban in-fill locations within Core countries, these trends will affect all sectors as work, live and play preferences evolve. Yield spreads over mature core segments

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1 Any forecasts provided herein are based upon Deutsche Asset Management’s opinion of the market at this date and subject to change dependent on the market. Forecasts may not materialise.
should narrow in the long term as rents grow stronger than their established counterparts. Investors may need to accept that future tenants could have different requirements in respect to design, fit out, technical specifications and floor plates.

3. **Avoid Style Drift:** Lower yields may tempt some investors to move further up the risk curve and outside their defined fund style. We strongly advise investors to consider the intrinsic value of an asset versus chasing yields. Historically, style drift has led to underperformance, as downsides are most acute in those markets and assets that do not have the support of fundamental demand drivers. While we do advise making selective calls on emerging micro locations and occupier trends, this is – in contrast – not entirely about the attractive entry yield, but rather about the underlying growth story, which weaker locations/segments often lack.

4. **Portfolio Optimisation:** Current pricing indicates that risks are no longer being fully reflected on less secure markets, locations and assets. Investors should consider reducing exposure to these assets, which may offer an attractive income return but will likely be exposed to larger price corrections if investor demand softens. Investors need to be aware that the typical window for disposals of non-core assets is much shorter than for core/prime properties and a missed opportunity to sell could mean that the assets will need to undergo additional major – and often difficult – lease events. However, this is not necessarily about building age, but rather about micro location and specific usage.

Within these broad categories we specify a number of compelling investment calls. These are listed in the table below:

<table>
<thead>
<tr>
<th>Strategy Overview</th>
<th>Description</th>
<th>Markets</th>
<th>Top Picks</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Established Core</strong></td>
<td>Established markets benefiting from further yield compression and rent growth on low supply.</td>
<td>Germany Top-7, Madrid/Barcelona, Benelux, La Defense</td>
<td></td>
</tr>
<tr>
<td><strong>Prime CBD Office</strong></td>
<td>Inner city and regional centres that dominate large urban catchments, with growing footfalls and high dwell times.</td>
<td>Germany, Spain, Netherlands, Ireland, UK (2018)</td>
<td></td>
</tr>
<tr>
<td><strong>Dominant Shopping Centres</strong></td>
<td>Logistics remains the top performing sector. Focus on cross-dock and national distribution in Overweight markets.</td>
<td>Berlin, Munich, Frankfurt, Amsterdam, Antwerp, Dublin North West</td>
<td></td>
</tr>
</tbody>
</table>
| **Established Logistics** | Very low void risks and significant long term upside risk for rental growth. | Germany (Lower/Medium Price Segment) | *
| **Residential Portfolios** | | |

<table>
<thead>
<tr>
<th>Selective Bets</th>
<th>Description</th>
<th>Markets</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Urban Office</strong></td>
<td>Central, but non CBD 24/7 locations, integrated with residential, leisure and shopping, with a focus on infrastructure supported growth</td>
<td>Emerging Micro Locations in Paris, Berlin, Hamburg, Amsterdam, Madrid, Barcelona, London (2018)</td>
<td>*</td>
</tr>
<tr>
<td><strong>Residential Construction</strong></td>
<td>Take full development risk in the medium price apartment sector in return for very low leasing risk</td>
<td>Germany; Top 7 and Swarm Cities</td>
<td></td>
</tr>
<tr>
<td><strong>Integrated Urban Retail</strong></td>
<td>Urban retail serving and integrated into an immediate catchment that is seeing from Neighbourhoods with strong growth in population</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Online Potential Logistics</strong></td>
<td>Expect pent up demand to be released in the medium term, as online trade is about to gain traction</td>
<td>Madrid, Barcelona, Zaragoza, French logistics corridor, Milan</td>
<td>*</td>
</tr>
<tr>
<td><strong>Growing Residential Segments</strong></td>
<td>Segments set to grow in response to demographics and sector institutionalisation.</td>
<td>Germany, France, Benelux, Nordic, UK</td>
<td>*</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Portfolio Optimisation Sell Calls</th>
<th>Description</th>
<th>Markets</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Economic Risk</strong></td>
<td>Markets where pricing has increased but fundamentals remain weak</td>
<td>Helsinki, Milan, Rome (Prime and non prime)</td>
<td></td>
</tr>
<tr>
<td><strong>Political Risk</strong></td>
<td>Optimise portfolio (or don’t expand exposure) in markets with increased political/regulatory risk</td>
<td>Warsaw/Poland (Non-Prime), Budapest</td>
<td></td>
</tr>
</tbody>
</table>

Source: Deutsche Asset Management, August 2016
3  Economy

The first six months of 2016 were broadly positive for the European economy. Despite financial market volatility at the start of the year, and concerns about Brexit in the run up to the vote in June, the pace of recovery accelerated for much of the period, while unemployment continued to fall. However, following the United Kingdom’s vote to leave the European Union in June, the immediate outlook has weakened.

Early evidence suggests that the vote has had a material impact upon economic activity in the United Kingdom, with sharp falls in both sentiment and lead indicators such as the closely watched Purchasing Managers’ Survey (PMI). The impact has been less pronounced in the rest of Europe – GDP growth looks to have eased in July, although is likely to have remained positive.

It is still difficult to fully assess the impact of the vote. Many questions remain over the future relationship between the European Union and the United Kingdom and until Article 50 of the Lisbon Treaty is invoked (expected early 2017), starting the process of withdrawal, we are unlikely to get much further clarity.

This uncertainty will likely have the greatest immediate impact on economic performance, with many investment decisions put on hold. The outlook for European GDP growth has been downgraded in response to the June vote, yet this is very much skewed towards the United Kingdom, where average annual growth has been revised down by 75 basis points over the next five years, compared to a 10 basis points reduction in the Eurozone.

After slowing in 2017, the majority of markets are set to see growth accelerate again at the back end of the decade. Core Europe is forecast to expand at a modest but respectable 1.5% per annum – with Sweden continuing to outperform. In Southern Europe, Italy remains an underperformer with growing downside risks, while Spain is currently one of the fastest growing economies in the developed world. Poland’s trend outperformance should continue but there are some concerns that recent policy announcements could hit business investment.

Central banks are expected to act in response to the increased market uncertainty. While not cutting interest rates immediately following the referendum, the Bank of England cut its base rate in August, and is now expected to keep policy extremely loose for much of the rest of the decade. Having already cut rates in 2016 and with some concern over the impact of negative rates, the ECB has taken a wait and see approach, but looks ready to loosen further should growth slacken.

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2 Markit, July 2016
3 Oxford Economics, July 2016
4 Oxford Economics, July 2016
Throughout Europe, long-term government bond yields are now running at extremely low levels, in some cases negative. Importantly for real estate investors, a dramatic flattening of the yield curve over the past six months suggests that these rates will remain very low for the foreseeable future, further enhancing the record income return spread between property and bonds.\(^5\)

Having previously expected the Bank of England to raise rates in 2017, this reversal in outlook has led to a sharp fall in the forecasts for both sterling and Gilt yields, again supporting the relative attractiveness of real estate investment, particularly for overseas investors.

![10-yr Government Bond Yields](chart.png)

**10-yr Government Bond Yields (Year End, %)**


Note: f = forecast. There is no guarantee that the forecasts will materialise

Low inflation has given central banks room to act. While inflation is likely to rise over the next year as the base impact of falling energy prices fades, continued spare capacity and potential productivity gains from recent reform programmes should prevent a strong increase in prices.\(^6\)

Unemployment in the E.U. is falling – down over two million in the 12 months to May 2016 – with an additional drop of four million expected over the rest of the decade. The bulk of new jobs are expected to be created in the service sector, supporting demand for new office space, and in conjunction with a projected increase in retail sales of 2.8% per annum, this should also prove positive for retailer space requirements.

Recent events reinforce our view that political risk should not be treated lightly. Following the referendum, the United Kingdom will be buffered by the withdrawal process and concerns over a second independence vote in Scotland. The Italian constitutional referendum, scheduled for later this year, has seen Prime Minister Renzi staking his political future on its success. In addition, both France and Germany face major elections next year with the possibility of a change of leadership.

Political risk in Europe is intimately linked to key economic and financial risks. Elections could call into question major programmes such as free trade negotiations, Eurozone integration and domestic reforms. The Italian banking sector in particular looks like a point of stress, and we will be monitoring this closely.

In summary, while the outlook for the European economy has been revised down and political risks remain evident, the change in outlook is relatively modest. Following a short period of disruption we expect GDP growth to re-accelerate into the final part of the decade, supporting jobs, consumption and the flow of trade, in turn providing support for additional occupier demand across the continent and across sectors.

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\(^5\) Macrobond, July 2016

\(^6\) Oxford Economics, July 2016

\(^7\) Oxford Economics, July 2016
4 Real Estate Performance

4.1 Occupier Fundamentals

While the European occupier market continues to progress, the Brexit vote has brought about increased uncertainty. Negative consequences will be most keenly felt within the United Kingdom, where we expect demand for real estate space to weaken significantly in the short term. Given the strong pipeline of space under construction, vacancy is forecast to rise and rents are set to come under pressure, particularly in Central London. However, a sharp decline in construction starts during the second half of this year should provide some relief to the medium-term outlook.

While there are also likely to be short-term implications for wider European demand, based on heightened risk aversion among occupiers, the longer-term impact on the rest of Europe is expected to be relatively limited, particularly given a reduction in expected new supply. A number of locations could even benefit from potential relocations out of London.

Recent trends have been broadly positive. Consumer spending and retail sales – key drivers of demand in both the logistics and retail markets – are growing healthily at more than 2% per year.8 Demand for office space has continued to increase in the main European cities, with rolling annual take-up totalling more than 12 million square meters in the second quarter of 2016, the highest level for eight years.9 And logistics demand over the same period easily surpassed levels recorded at the previous market peak.

However, demand is only one side of the story. Development activity can be equally important in determining the occupier balance, as strong supply has the potential to derail rent growth in even the strongest growing economies. The Warsaw office market is a good example of this. While the Polish economy has been one of the fastest growing in Europe for the past two years, office stock has increased by around 7% per year, and prime rents have fallen by 16% since the end of 2012.10

Warsaw is not reflective of the wider European situation though. In fact, despite a period of steadily rising rents, strong capital value growth and falling vacancy, particularly at the top end of the market, developers have been more cautious compared to previous cycles.

In the shopping centre market, stock is expected to grow by just 2% per year over the next two years; in both of the previous cycles it grew by more than 5% per annum for a number of years.11 In the office sector, construction starts in major markets have been increasing over the past year, but have still equated to only 2% of existing stock on a rolling annual basis. For comparison, this figure reached 3% in 2007 and 4.5% in 2001.12 Nonetheless, rising confidence in the construction sector, which has a strong lagged correlation with

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8 Eurostat, Oxford Economics, August 2016
9 CBRE, August 2016
10 PMA, May 2016
11 C&W, Deutsche Asset Management Research, May 2016
12 PMA, Deutsche Asset Management Research, May 2016
construction starts, suggests that over the next few years the so far modest pick-up in development activity will continue.

Building activity in the logistics sector, on the other hand, is already close to peak levels. This trend is showing no signs of abating either. Space under construction in Europe reached nine million square metres in the second quarter of 2016, a rise of more than 40% year-on-year. Yet two factors help to explain why in the face of such strong development, logistics rents are rising at their fastest rates for years.

First, structural changes in the retail market have led to significant e-commerce-led demand. European logistics take-up has increased by 40% over the past two years, with retailers and third party logistics operators accounting for a significant proportion of demand. Second, although total construction volumes are high, speculative development still accounts for a relatively small proportion of total activity. In 2006/07, around 70% of all logistics construction was speculative. Currently, that figure lies at just 30%.

Despite some increase in building, European vacancy is in general continuing to fall. Aggregate vacancy rates in the office and high street retail sectors have returned close to their long-term averages, and while longer time series are not available for logistics, it is here that we have seen the highest rise in occupancy over the past five years. On the other hand, the same megatrends that have benefitted logistics are creating challenges for shopping centres, leading to a long-term upward trend in vacancy, particularly in secondary centres.

We are expecting the balance of fundamentals to remain favourable in the office and logistics markets. Continued office-using employment growth should support robust demand once again this year, and in the logistics sector strong supply chain activity is expected to lead to an increase in take-up.

Risk aversion following the Brexit vote has led to a reduction in new construction activity in the United Kingdom. However, there will be increased pressure from development activity in the short term. The volume of European logistics space currently under construction suggests that completions next year could be significantly higher than this year. At the same time, the pipeline of potential future office construction remains quite large, and while speculative development still accounts for a relatively small proportion of activity in Western Europe, further declines in vacancy among the major cities could spur an increase.

Despite a restrained pipeline of new shopping centre space, average vacancy is not expected to see any great improvement. That said, the marked gap in performance between large dominant centres and smaller secondary stock is expected to continue, and the outlook for the best centres remains positive.

Generally speaking we expect the slight downgrade to European GDP growth to hold back rent growth across all sectors in the short term. On average we predict all property rent growth to average 2% per annum over the next five years — although with significant variation between markets. Logistics rents (1.6%) are forecast to grow at slightly lower rates than offices (1.8%) and shopping centres (2.0%), but compared to the sector’s historical performance (-0.5%) this is a remarkable improvement, and once again stresses the important influence that structural long-term changes can have upon occupier fundamentals.

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13 JLL, July 2016
14 JLL, Q1 2016
15 JLL, June 2016
4.2 Capital Markets and Pricing

While we expect to see a marked price correction in the United Kingdom following the referendum, the expectation of sustained low bond yields is making real estate in Core Europe look more attractive on a relative basis. In Core Europe, we are forecasting prime property yields to fall further and remain lower than six months ago, leading to improved capital growth.

Following six years of rising investment volumes, culminating in a record €300 billion in 2015, the European investment market cooled during the first half of this year. The drop in activity was not attributable to one particular source of capital, as volumes were down from all types of investor. Non-European investors have pulled back during the year to date, accounting for just 21% of total volumes, compared to 35% a year ago. The fall in investment from U.S. investor’s accounts for a large proportion of this drop, but Middle Eastern and Asian money has also retreated. 17

It is also clear that most investors are exercising more caution. Value-add deals are making up a much lower proportion of transactions than in the previous market cycle. Given the increased levels of uncertainty at the moment and investors’ preference for safer investments, a lack of core product in major markets such as Germany is also likely to be holding the market back somewhat.

On a rolling annual basis, investment in Europe excluding the United Kingdom was in fact very similar to the previous 12 month period. The quarterly trends reveal more of a slowdown, with volumes in the first half down by around 25%; however, this fall comes after an exceptional period last year and activity is still comfortably above the long-term average. 18

There were relatively few markets that escaped a slowdown during the first half of this year, although there were still some better performers among the pack.

Activity in Sweden, the Netherlands and the CEE region held up relatively well. For Central Europe in particular, this accompanies a marked increase in investor sentiment, with almost a quarter of investors surveyed choosing the region as the most attractive place to invest in Europe this year, up from just 6% last year. 19

Investors so far seem relatively undeterred by the increased regulatory uncertainty in Poland.

In the United Kingdom just €30 billion was transacted during the first half of the year compared to over €50 billion during the same period last year. In the lead up to the E.U. referendum, perceptions of the U.K. real estate market had already softened, with concerns about pricing adding to uncertainty surrounding the vote, and the surprise result of the referendum has brought even more uncertainty. A snap survey following the result suggests that sentiment towards U.K. property is at its lowest level for at least 20 years. 20

Currency will almost certainly play an increased role. U.S. investors are already able to buy in the United Kingdom at a 10% discount compared to before the referendum, based purely on the fall in sterling. What’s

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16 Core Europe is defined as: Germany, France, Benelux, Nordics, Switzerland and Austria
17 RCA, July 2016
18 RCA, July 2016
19 CBRE Investment Intentions Survey, March 2016
20 PMA, June 2016
more, foreign investors could also receive a boost to future returns should the pound gradually strengthen from its current 30-year low against the dollar.

Following the referendum, a number of U.K. open-ended funds were forced to suspend trading following a large rise in redemption requests. However, lower levels of debt than in the past should mean that in general the number of forced sales is more limited than during the global financial crisis. Still, some valuers are already suggesting a 25 basis point rise in Central London office yields in the weeks after the referendum, and we are predicting yields to move out by a further 50 to 75 basis point in the next 12 months or so, before falling towards the end of the decade as confidence returns and rents move back in to growth.

Conversely, the impact on pricing in other parts of Europe appears to have been largely positive. Government bond yields in Germany and a number of other European countries fell sharply after the Brexit vote, and while there are always more factors influencing real estate pricing than the spread over bonds, this further widening of the gap has made property look more attractive on a relative basis. This is an important point, as in absolute terms property is looking expensive, with yields well below previous historical lows levels in many cases. However, compared to bonds, property still offers an attractive income return, and given the reduced medium-term outlook for bond yields this should allow property yields more room to remain lower over the five year horizon.

![Core Europe Prime Office Yield Spreads (%)](image)

Sources: PMA, Oxford Economics, Deutsche Asset Management, July 2016

In Germany average prime office yields are now below 4% and expected to fall further, having previously bottomed out at around 4.5% in 2007. And yet, the spread over the ten-year Bund is almost as high as it ever has been at around 400 basis points. Yield declines in other Core European markets have paused during the first half of the year, but we expect to see average prime yields fall by around 25-30 basis points over the next 12-18 months.

In Southern Europe, the pace of capital value increases has decelerated, and in Italy we see increased risks both political and surrounding the banking sector. However in Spain rental growth prospects are still proving highly attractive. In Poland, the fall in prime yields has accelerated over the past 12 months. However, with oversupply leading to rent declines and growing risk aversion, we expect yields to move out over the next couple of years, before convergence with Western Europe resumes.

One of the other factors likely to influence pricing is the large amount of capital waiting to be deployed across Europe. German open-ended funds saw net inflows of €3.3 billion in 2015, but inflows during the first five months of this year had already reached €3.8 billion.²¹ A look at the private real estate fund market reveals a similar story.

Last year funds with a focus on Europe had raised an aggregate $26 billion of capital, with a total of $56 billion of dry powder at year end. During the first half of 2016, $18 billion had already been raised, with dry powder increasing by a further 20% to $68 billion.²² With this amount of cash acting as a drag on returns, fund managers will be under pressure to deploy capital, which will also add to the downward pressure on yields.

²¹ BVI, July 2016
²² Preqin, July 2016
Full-year data for 2015 showed a further strengthening in European real estate returns. Data from MSCI/IPD, tracking institutionally held stock across major European markets and providing a good estimate of the market average, showed that all property pan-European total returns increased to 10.0%, from 9.4% in 2014. Virtually all counties experienced an improvement in property performance, with the exception of the United Kingdom and Ireland, which nevertheless maintained double digit returns. Returns in France rose to 9.0%, the strongest since 2010, while German returns of 8.1% were the best since the index began there in 1998. Southern Europe also saw a sizable jump in performance, although there was a clear divide between the stronger markets of Spain and Portugal and the weaker Italian market.

That said, higher-frequency data points to a slight slowing in performance. The quarterly MSCI/IPD Global Property Fund Index suggests asset level performance in Europe may now have peaked, with both the United Kingdom and Continental Europe moderating into the early part of 2016.\(^{23}\)

The prime market, which tends to match the MSCI/IPD trends closely at the aggregate European level, saw a similar trend. The first three months of the year marked the first slowdown in annual prime returns for more than three years, with all of the main sectors seeing a slight drop in performance. This underlines our view that 2015 is likely to have marked the peak for European property in this cycle.

![MSCI/IPD Property Fund Index (Annual Asset Level Returns, %)](image)

Source: MSCI/IPD, July 2016

During the four quarters to the first quarter of 2016, the strongest performing sector was once again high street retail, which has maintained its defensive nature, despite the challenges faced by the retail sector in general. While we expect rental growth on the high street to remain ahead of the other commercial sectors, strong investor demand and limited stock has pushed yields down far below previous historical lows. Not only does this indicate lower income returns, but at such low yields, capital values are more susceptible to sizeable corrections, even with relatively small yield movements.

This risk is most keenly manifested in London, where a lack of confidence in the U.K. economy following the Brexit vote means we are expecting prime high street yields to move out by up to 100 basis points from their current level of 2.5%, equivalent to a fall in values of close to 30%. Nevertheless, rent growth in other parts of Europe outside London should be robust enough to fend off value declines as yields begin to edge out from 2018 onwards.

Returns are typically driven by a combination of factors, although the construction market, the economic cycle, and the level of interest rates in the economy are among the most influential drivers. The slight downgrade in the economic outlook should be counterbalanced by reduced construction volumes and lower interest rates, leading to even lower property yields over the five-year forecast period. With this in mind, we are forecasting all property prime returns to average 6.3% per year between 2016 and 2020, up from below 6.0% six months ago. What’s more, the return cycle has also flattened due to the delay in expected rent growth and more modest outward yield movement towards 2020.

\(^{23}\) MSCI/IPD, June 2016
The performance outlook for shopping centres relative to the other sectors remains attractive. Over the past 10 years prime high street retail has returned 12% per year on average, comfortably outperforming shopping centres at just over 8%. However, as domestic spending has strengthened, shopping centre performance has begun to improve, particularly in large dominant centres. Smaller secondary centres often still suffer from high and rising vacancy, but the ability of the largest centres to maintain high occupancy and increase rents is proving attractive to investors. Average prime shopping centre rents grew by 1.5% in 2015,24 the highest increase since 2007, and growth is expected to average 2% per year looking ahead. What’s more, shopping centres generally offer an income return premium and present the opportunity to deploy significant amounts of capital given their size, although such investments require detailed specialist knowledge and asset management expertise.

Overall, we still believe that the strongest prime returns could be found in the logistics sector, where retail megatrends continue to drive investor demand. Annual prime total returns reached almost 20% in 2015, and although this is likely to drop into the low double digits this year, the five year outlook remains positive, with returns of over 7% per annum.

In the office sector, our forecasts at the beginning of this year suggested that most office locations would fail to meet their return target, based on our estimates of a typical institutional investor’s required return (ungeared) over the period 2016-20. While this is still largely true six months later, absolute return forecasts have improved by 75 basis points per year on average, and most of the German cities are now forecast to meet or exceed their estimated return requirements, in addition to the Dutch cities and Paris La Défense25.

Over the next five years we are forecasting shopping centres and logistics to outperform in terms of total return, with the best risk-adjusted returns available in Core and Southern Europe, followed by the CEE region. Short-term price corrections in the United Kingdom mean that average returns will underperform over the five year forecast period, but should prove very attractive during the latter part of the decade.

![Prime Office Total Returns & Required Returns (% p.a. 2016-20f)](source: Deutsche Asset Management, July 2016)

Notes: Markets ranked by excess return. f = forecast. There is no guarantee the forecast will materialise.

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24 C&W, July 2016
25 Deutsche Asset Management, July 2016
4.4 Market Positioning Calls

The table below provides a regional summary of suggestions for market positioning given the performance outlook for real estate across cities and sectors.

Based on our forecasts for prime real estate, these calls provide guidance on where investors are likely to find the highest risk-adjusted returns over the next five years, and where they should currently be looking to position their exposure to real estate.

Our 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.

<table>
<thead>
<tr>
<th>Market</th>
<th>Office</th>
<th>Shopping Centres</th>
<th>Logistics</th>
</tr>
</thead>
<tbody>
<tr>
<td>Spain</td>
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<td>Overweight</td>
<td>Overweight</td>
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<td>Overweight</td>
</tr>
<tr>
<td>German Top 7</td>
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<td>Overweight</td>
<td>Overweight / Neutral</td>
</tr>
<tr>
<td>Regional France</td>
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<td>Neutral</td>
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</tr>
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<td>Neutral / Underweight</td>
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</tr>
<tr>
<td>Central London</td>
<td>Underweight</td>
<td>n/a</td>
<td>Underweight</td>
</tr>
</tbody>
</table>

Source: Deutsche Asset Management, July 2016
5 Office Market Outlook and Strategies

5.1 Current Conditions

During the first half of 2016, the European office occupier market built on a robust performance in 2015. Before the Brexit vote, economic sentiment improved across European countries to stand comfortably above long-term average. Meanwhile the rate of annual employment growth in the Eurozone increased to 1.4% in the first quarter of 2016, led by strong momentum in Spain and Ireland.26

Against this positive economic background, demand for office space continued to increase across European cities. Aggregate office take-up totalled more than 12 million square metres on a rolling annual basis in the second quarter of 2016, the highest level since 2008.27

At the same time, development activity in Western Europe remains low and net new space totalling just 0.5% of stock was completed in 2015. This is leading to improving occupancy rates in the majority of cities, with the sharpest falls occurring in Dublin, Amsterdam, and in the Spanish and German cities. However, new building activity has already begun to stall in London. In addition, the high level of new office deliveries in certain CEE markets has weakened the occupier balance, with vacancy in Warsaw reaching 15%, its highest level since 2004.28 Geographic disparities also remain strong within each city; in general, CBDs are characterised by limited supply whereas structural vacancy continues to weigh on peripheral locations.

![Decline and Recovery of Prime Office Rents](chart)

Source: PMA, May 2016
Note: Last peak between 2006-2009; Trough between 2008-Q1 2016

In central locations, the positive imbalance between demand and supply has put further upward pressure on prime rents. Having been one of the stronger performers in recent years, Central London activity stalled in the run up to the referendum. In contrast, the Central Paris market continued to firm and is now recording positive rent growth. Spanish cities have continued to recover from their pre-crisis trough and the scarcity of office premises across the German Top 7 cities is pushing up rents, especially in Berlin, which saw rents jump 9% year-on-year in the second quarter. Elsewhere, in the likes of the Benelux countries and Italy rents have generally been fairly stable.

5.2 Outlook

While an anticipated loss of momentum in the economy may slow rental growth over the next year or so, European office occupier demand should strengthen again by the end of the decade, driven by an improvement

26 Oxford Economics, July 2016
27 Oxford Economics, July 2016
28 CBRE, August 2016
in the labour market and continued low levels of good quality space. Indeed, unemployment in the Eurozone is expected to maintain its downward trend.

For some markets, the U.K. referendum may prove positive if financial and business service jobs relocate into the European Union. While it shouldn’t be overstated, the likes of Frankfurt, Paris, Dublin, Luxembourg and Amsterdam could all be net beneficiaries.

<table>
<thead>
<tr>
<th>Average Prime Office Rental Growth (% LHS)</th>
<th>Average Office Vacancy Rates (% RHS)</th>
</tr>
</thead>
<tbody>
<tr>
<td><img src="image1.png" alt="Graph1" /></td>
<td><img src="image2.png" alt="Graph2" /></td>
</tr>
</tbody>
</table>

Sources: PMA, April 2016 (historical data); Deutsche Asset Management, July 2016.
Note: f = forecast. There is no guarantee the forecast will materialise.

Net office completions will stay relatively low in Western Europe over the next five years, representing 1% of total stock annually, and will be mainly limited to prime locations. Occupancy levels are also set to improve further, with aggregate European vacancy falling below 9% by the end of this year. This should keep rents under upward pressure in most markets, with strong growth foreseen in La Défense, Stockholm, Madrid, Barcelona the major German cities. Conversely, oversupply of existing and future office space in Warsaw will continue to act as a drag on rental growth.

We were already anticipating a rental correction in Central London, but the impact of the referendum vote is expected to accelerate and amplify the cycle. Exposed to international occupier demand, office take-up should weaken in the short term, causing higher vacancy and falls in rents.

However, over the medium term we remain optimistic for the London market. Central London should remain one of the world’s global financial centres with access to an unprecedented abundance of talent. Coupled with a probable reduction in supply, we anticipate that rents will once again be rising by the back end of the decade.

The Top 7 German cities, Madrid and Barcelona, some parts of Amsterdam and La Défense are expected to show the most attractive risk-return profiles over the second part of the decade. French regional cities should also offer good returns with yields well above the European average, while London should start to provide significant opportunities by the end of 2017.

5.3 Strategies

— **Focus on prime CBD offices:** We are forecasting CBD Offices to perform much better than expected six months ago. This is mainly driven by yield compression, as interest rates have turned negative post-Brexit as a result of flight to safety. Central locations should also continue to benefit from strong fundamentals. Speculative development will likely remain subdued for longer and modern space will become increasingly scarce, creating room for rental growth. Accordingly, we recommend targeting primarily core locations in the major German and Spanish cities as well as La Défense.

— **Select office locations in new urban centralities:** Areas close to the CBD offer better affordability for occupiers and high accessibility in a mixed-use urban environment. These alternative locations in the city centre are suitable for the shifting occupier demand consisting of start-ups and new technology companies and their new generation of employees. We expect to see above average rental growth and yield convergence in this type of location, particularly in cities such as Paris, Berlin, Amsterdam, Madrid and Stockholm.
6 Retail Market Outlook and Strategies

6.1 Current Conditions

Retailing conditions remained robust across much of Europe during the first six months of 2016. Supported by falling unemployment and growth in real disposable incomes, consumer and retailer confidence has remained well above historical average levels. The volume of retail sales expanded at a rate of 2.5% in the year to June 2016. Importantly for retail real estate, this was led by non-food and non-fuel sectors, providing evidence that the positive benefits of lower commodity prices have started to filter through across the wider economy.

Early indicators have shown a significant decline in consumer confidence within the United Kingdom in the period following the June referendum. With considerable discussion in the lead up to the vote around slower growth and job cuts, and with almost half the electorate voting to remain, this is not surprising. However, for Europe as a whole, the impact of the U.K. vote has been much more muted. While the flash consumer confidence indicators for July did fall, they were still well above their historical average.

One thing that is clear is that there has been no slow down in the pace of online sales migration, which continues at double-digit rates of growth. While reducing the total demand for retail space, the majority of retailers still see significant benefits in having a physical presence, and there is a growing body of evidence that a physical store has a halo effect, enhancing online spending within the catchment.

The growth of online sales is typically leading retailers to focus their store expansion strategies on a select number of major city and shopping centre locations. In Germany, almost two thirds of overseas retailers entering the market since 2008 have opened their first stores either in Berlin, Hamburg or Munich.

Given sustained low levels of new supply, vacancy rates have remained in the low single digit levels across most major city high streets and the largest shopping centres. While prime high street rents have been growing strongly for a number of years now, this trend has now broadened to include shopping centres.

6.2 Outlook

The outlook for European retail sales were downgraded in response to the U.K. referendum. However, for the most part the impact is expected to be modest, front-loaded and focused upon the United Kingdom.

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29 European Commission, July 2016
30 Eurostat, August 2016
31 International Council of Shopping Centres, April 2016
32 PMA, July 2016
Despite the downgrade, the outlook for retail sales growth over the next five years is a considerable improvement on the previous five years. The value of annual retail sales growth is projected to average around 3% in countries such as Germany, France Spain and the Netherlands, and 4% in Sweden, the Czech Republic and Poland. Although Italy is likely to remain an underperformer, at an estimated 2% per annum, this is a marked step up from almost no increase since 2008.33

Development is increasing but sales growth and focused retailer demand should be more than enough to push rents higher across major high streets and prime shopping centres. Although revised down slightly, we still expect annual prime shopping centre and high street rent growth to average 2% and 3% respectively.

Having been one of the best performing retail markets, the outlook for U.K. sales growth is now in line with that of Italy. The recent failure of a major retailer like once again highlights the U.K. retail market’s vulnerability in the face of strong competition and changing consumption habits. With sales growth to slow, further retail failures cannot be ruled out. As such, U.K. shopping centre rents are not expected to grow over the next five years.

The retail sector has experienced mixed fortunes over recent years. While major high streets have seen extraordinary value growth, shopping centres have been a consistent return underperformer. Over the next few years, we see this trend reversing, as rent growth and a higher income return result in shopping centre outperformance.

Within the shopping centre sector we see Germany, Spain and the Netherlands recording some of the highest risk adjusted returns. However, even within these markets the longer-term risks to occupier demand are clear, and as such we continue to stress a focus on large, dominant centres, and those retail locations which form an integrated part of a growing urban area.

### 6.3 Strategies

- **Dominant shopping centres:** Even in markets with the highest online sales rates, large dominant shopping centres are proving resilient. Focus on centres in large urban areas that dominate a growing catchment. Consider fashion-focused centres, with high levels of F&B and niche retailers, and with potential for asset management to refresh experience and drive higher sales and rent growth.

- **Urban integrated locations:** Unlike large shopping centres, these urban centres cater for their immediate catchment and the overflow from prime high streets. They have a far more intimate relationship with their shopper, supporting loyalty and frequency of visit. With urbanisation supporting population growth and consumer spend, these successful locations should see strong sales growth, above average rent growth and by understanding catchment needs should prove defensive against online.

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33 Oxford Economics, July 2016
7 Logistics Market Outlook and Strategies

7.1 Current Conditions

Logistics market fundamentals continue to be supported by an improvement in underlying economic conditions. Private consumption has generally firmed, underpinned by a labour market recovery. Inflation is trending at historically low levels, supporting the emergence of real wage growth and increased disposable incomes, in turn translating into rising retail sales. However, manufacturing and exports have remained volatile, given susceptibility to weakening global trade conditions, exposure to economic volatility and currency movements.

The retail sector’s shift towards omni-channel retail continues to gather momentum. Major retailers are focusing on core markets that not only support sales activity but also aid product showcasing and help project their brand. The trend towards online-to-offline is broadening with more pure-play retailers taking physical retail space to showcase products and gain new customers.

![Online Retail Share and Growth (%)](image)

Source: Centre for Retail Research, March 2016
Note: f = forecast. There is no guarantee the forecast shown will materialise.

Shifting consumption patterns and behaviours are emerging, driven by the megatrends of technological change and urbanisation. Rapidly growing mobile commerce (m-commerce), social shopping and rising appetite for fast fashion are shaping the retail landscape and resulting in widening expectations for same/next-day delivery. This is leading to an acceleration in supply chain re-configuration.34

These changes are driving demand for ever larger distribution and e-fulfilment centres in key distribution hubs with excellent infrastructure connectivity, in addition to urban ‘last mile’ logistics facilities. And with increasing obsolescence of outdated stock, this has led to sharp falls in vacancy and sturdy rent growth in recent times.

7.2 Outlook

In the near-term, we expect further global economic uncertainty to dampen trade volumes, lowering expectations of strong take-up from export-orientated occupiers, although this is projected to recover over the medium term. However, domestic demand is likely to remain supportive across much of Europe as labour markets recover. As internet and smartphone penetration continues to rise, we expect to see online sales growing by double digits over the next five years, particularly in Southern Europe and the CEE. This should sustain demand for high quality, well-located XXL distribution / e-fulfilment centres as well as edge-of-town urban assets geared towards parcel deliveries.

34 DHL, Omni-channel Logistics, December 2015
Availability of modern grade A logistics stock continues to decline across most European markets. This is prompting renewed speculative activity beyond Poland, the United Kingdom and Germany, although current demand levels suggest that much of this new delivery will be absorbed relatively quickly. Build-to-suit (BTS) will remain the preferred route to market for many occupiers requiring a customised solution. Across most markets, it is likely that we will continue to observe rental growth propelled by rising demand and limited availability. Prime yields will continue to decline in most logistics markets, with the sector further institutionalising, leading to further convergence with other commercial sectors.

With online retail firmly established, we see value in core markets in Germany, such as Munich, Frankfurt and Berlin. The Benelux markets along the Antwerp-Brussels axis and the greater Amsterdam market also offer opportunities while Dublin remains one of our key logistics market buy calls. In the Nordics, Copenhagen is primed to benefit from a healthy yield premium although we see slightly less value in Stockholm due to keen pricing and lower prospects for rent growth due to affordability constraints. While the United Kingdom is an underweight market, we see an opportunity to re-enter in the medium-term following a price correction and reduction in new supply, maintaining a focus on the Golden Triangle, South East and Urban London locations.

There are opportunities to take selective bets in France, targeting Paris and Lyon. In Southern Europe and the CEE region, online retail penetration remains well below more mature markets. Madrid, Barcelona and Milan with their large catchments present attractive opportunities, while Prague is also seeing healthy activity. The Czech capital is expected to perform well given its connectivity to Germany, investors should remain selective considering the high levels of development. Warsaw is currently an underweight market, though is projected to outperform later in the cycle and we would continue to monitor this market closely.

7.3 Strategies

— **XXL Distribution / E-Fulfilment**: Target infra-linked well-connected XXL (50,000 sqm+) distribution / e-fulfilment assets in key hub locations near to major population centres. Entry routes may include single / portfolio acquisitions and forward funding of “Build to suit” schemes occupied by excellent covenants on long leases. Investors should benefit from a stable income stream, yield convergence, low levels of asset management and potential for rent growth particularly in supply constrained locations.

— **Urban Last Mile Logistics**: Focus on urban cross-docked last mile logistics properties, primarily geared towards deliveries to the end consumer. Both omni-channel and pureplay e-tailers alongside specialist parcel delivery operators are seeking sub-10,000 square meter assets in edge-of-town ‘infill’ locations. These assets offer good prospects for strong rent growth while competing land uses preserve value. Consider portfolio acquisitions, forward funding of BTS and selective speculative development.

— **Avoid**: Secondary locations with high availability of stock, ample supply of land for development, poor infrastructure connectivity and/or lack of a diverse occupier mix. Avoid grade B / C assets at risk of obsolescence. Be cautious of trade-linked logistics and small-to-mid-size distribution assets (10-50k sqm).
8 Residential Market Outlook and Strategies

8.1 Current Conditions

Residential has developed into an institutional asset class across a number of European markets over the last decade and is increasingly drawing the interest of investors. At a time of heightened economic and political uncertainty, these investments with safe-haven characteristics are increasingly sought after.

As a defensive sector, which has limited exposure to major market downswings and is mainly driven by local demand and supply fundamentals, residential markets certainly belong into this category. Generally, residential investments are characterised by a non-cyclical and persistent housing demand with limited void risks and stable income streams. Over the medium term, residential investments also offer a moderate inflation hedge and provide diversification potential.35

In terms of total return, residential has also been a strong performing sector, being the only sector to avoid negative performance for the whole of the last decade. However, performance drivers have differed significantly, with countries like the United Kingdom and Sweden featuring high but volatile returns and the likes of Germany and Finland recording lower but steadier returns.36

Market differences seem to support different investment styles; however, suitable investment product may not always be available. The homeownership rate gives some indication of the availability of investable stock, suggesting that opportunities would be limited in many markets. Ownership in the United Kingdom, France, the Netherlands and Sweden stands well above 60%, while in the other Nordic markets, Southern Europe and Eastern Europe the rate is closer to 80%.

German speaking countries are an exception, with historically low ownership rates of around 50%. The high share of multi-family homes, which require less intensive management, is also an advantage. This factor is visible in the European residential transaction volumes, which are highest in Germany, although down in 2016 following record breaking volumes in 2015.37

In addition to country level differences, demographic structures and the economic situation, two of the major drivers behind residential demand, differ greatly between European cities and regions as well. Urbanisation trends in particular have a strong impact on rent levels and the supply situation. Although supply is increasing in some countries, the gap between demand and supply is still significant, particularly in metropolitan regions, which often benefit from positive migration. In Germany, while supply is increasing, currently at 250,000 units per annum, it is well short of the required estimate of 400,000 new homes.38

<table>
<thead>
<tr>
<th>Building Permits – Index of Multifamily Homes (2010 = 100)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Source: Eurostat, August 2016</td>
</tr>
</tbody>
</table>

35 IPF, Residential Investments in International Markets, November 2014
37 Real Capital Analytics, July 2016
38 Pestel Institut September 2015
8.2 Outlook

With economic and political uncertainties set to persist, residential investments will continue to offer stable returns and limited void risks, leading to broader investor interest in the sector. Long-term, cash-flow oriented investors are especially likely to enter the European residential markets.

In line with this expectation, residential real estate prices are forecast to rise in most European markets, with the exception of the United Kingdom, where a market slowdown is expected in the wake of the country’s decision to leave the European Union.

Besides absolute price increases, investors must also take into account rental growth. In markets like the United Kingdom, Germany and Sweden, incomes and rent levels are rising but have failed to keep pace with house price growth, leaving landlords in a favourable position as the affordability of homeownership declines. On the other hand, the likes of France, the Netherlands and Spain are becoming relatively more affordable as rents and household income are rising faster than house prices.

![House Price Index (2010=100)](chart)

Source: Oxford Economics, July 2016
Note: f = forecast. There is no guarantee the forecast shown will materialise.

In urban agglomerations, the trend of strong price increases is likely to be more pronounced as the ownership rate is generally below the country level and housing stock for purchases limited, thus favouring landlords. Despite rent regulation in many European countries, rental increases are also expected to be steeper here too, as the population in major agglomerations across Europe is growing, whereas new construction is often subdued in these markets.

8.3 Strategies

- **Large Agglomerations:** Persistent focus on European metropolitan regions and key regional cities as many rental markets are characterised by supply shortages and a demand backlog.

- **Swarm Cities:** Widening investment scope beyond large markets, focus on smaller cities with population growth and strong appeal for young people. Examples include university cities and cities with a strong share of inhabitants in the 20-35 year age band.

- **Residential Developments:** Consideration of large-scale development projects in selected German cities with significant population growth, and in co-operation with local municipalities to strengthen the supply in the mid-market range.
Real estate securities experienced significant volatility in June following the referendum result in the United Kingdom, which caught most market participants by surprise.

Overall, the listed real estate sector posted negative performance for most of the first two months of the year before seeing a strong rebound towards the end of February and in March following the ECB’s announcement that it would step up its quantitative easing programme. Following that and until mid-May, the sector saw a lack of conviction from investors before seeing a more positive trend until the 23rd of June.

Following the referendum the sector has experienced large swings in performance. U.K. names fell 22% as the market discounted much greater uncertainty, but have since rallied to halve the fall. Significant political risk remains and warrants caution in the United Kingdom, especially regarding those names with a high exposure to the London office market given its perceived dependence on the financial services sector. However, for U.K. REITs in general, leverage is low, development exposure is limited, income yield is well above funding costs and most real estate is almost certain to provide an income of 5% or more over the next decade.

In the rest of Europe, the situation tends to look better than in the United Kingdom even though these countries are not insulated from volatility. Italy and its banking system in particular has been a collateral victim of Brexit and could represent a risk for the markets until at least November when the referendum on the Constitution is scheduled. Spanish names also appear risky due to political uncertainty in the country. Conversely, French and German names in the office and residential markets have outperformed since the referendum, in part reflecting a flight to safety.

In general the residential sector has benefited from a significant drop in bond yields following the referendum as investors moved capital to perceived safe havens. Despite a recent widening in bond yields from extremely low levels – the 10-year German bund yield reached a low of -0.19% before rising to a level close to 0% in early August – it seems that rates will stay very low, which should continue to benefit the German residential market.

Over the first half of 2016, the listed real estate sector (EPRA Europe -5.1%) outperformed the broader equity market (MSCI Europe -9.3%). Country wise, the outperformers were Germany (+14.4%), Norway (+14.0% in EUR), Switzerland (+13.0% in EUR), France (+4.9%), Sweden (+2.6% in EUR), while the underperformers were the United Kingdom (-23.2% in EUR / -13.3% in GBP), Italy (-16.0%) and Spain (-12.6%).

Looking ahead the listed property sector remains attractive for the following reasons:

- Even in a scenario of credit spread widening, the yield spread over bonds will remain attractive;
- The real estate property sector is mostly domestic with no revenue exposure to emerging markets;
- The real estate sector benefits from defensive features such as long-term visible secure cash flows.

Source: EPRA, Macrobond, August 2016. Past performance is not indicative of future returns.

EPRA Real Estate H1 2016 Equity Returns (Local Currencies, %)

<table>
<thead>
<tr>
<th>Country</th>
<th>Equity Returns</th>
</tr>
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<tbody>
<tr>
<td>Italy</td>
<td>-16.0</td>
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<tr>
<td>UK</td>
<td>-13.3</td>
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<tr>
<td>Spain</td>
<td>-12.6</td>
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<td>N. Ireland</td>
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<td>Austria</td>
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<td>Norway</td>
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</tr>
<tr>
<td>Germany</td>
<td>14.4</td>
</tr>
</tbody>
</table>

Source: EPRA, Macrobond, August 2016

39 EPRA, Macrobond, August 2016
10 Overview of Key European Markets

Strategic Outlook: United Kingdom

Following the vote to leave the E.U, a period of heightened uncertainty will likely transmit into slower GDP growth and weak occupational demand for U.K. property. We expect falling take-up combined with rising availability to lead prime office rents lower in Central London, although retail and logistics may prove resilient. Investors are cautious, as sentiment towards the U.K. is generally negative. The reaction in the aftermath of the vote saw sharp falls in the equity values of the major U.K. REITs, while some retail funds gated redemption requests. Investment volumes are expected to remain subdued in the near-term and prime yields are likely to move upwards. However over the medium term we see a high likelihood of a strong bounce back as economic uncertainty fades and new supply is curtailed. This is set to create an attractive opportunity to re-enter the U.K. market next year, offering potential to generate strong IRRs for early movers.

**Occupier**
- Solid occupational demand observed throughout 2015 across most commercial sectors and markets. Prime rents in London are reaching new heights and prompting increased supply.
- Take-up slowed in the first half of 2016 in the run up to the E.U. referendum given increased market uncertainty. Following the vote to leave, occupational demand is likely to reduce.
- The twin effects of falling demand and rising availability are to put downward pressure on rents, with Central London seeing greater falls. Retail and logistics to remain relatively defensive.
- The economy should recover towards the end of the decade as uncertainty fades. With new development activity likely to stall, this sets the scene for a strong medium-term rental recovery.

**Investment**
- While record investment flows were registered in 2015, the first half of this year indicates a significant slowing in activity, with survey sentiment negative towards the United Kingdom.
- Investment to remain subdued in the near-term. U.K. funds have been hit by redemption requests post-referendum. Demand from U.S. and Asian investors benefitting from weaker sterling.
- Investment property databank (IPD), all property returns were already slowing pre-Brexit, with the pace of yield compression decelerating and rent growth insufficient to compensate.
- Early signs from the listed market suggest an impending price correction, with a greater impact on London offices. Outlook for lower bond yields and rising property yields set to widen the spread.
- Capital value correction of 30% over the next 18 months to create stronger return opportunities in Central London by 2017.

**U.K. Prime Total Return Forecasts (%)**

<table>
<thead>
<tr>
<th></th>
<th>2016-17f</th>
<th>2017-20f</th>
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</tbody>
</table>

Sources: Deutsche Asset Management, July 2016
Note: f = forecast. There is no guarantee the forecast will materialise.
Strategic Outlook: Germany

We continue to hold an overweight position on the German market. The German economy remains resilient after the U.K. referendum, while business sentiment is still strong, positively influencing tenant demand, take-up volumes and vacancy rates. The ECB is expected to keep interest rates low over the medium term and is likely to extend its quantitative easing policy beyond 2017. Due to the low yields in alternative asset classes, high institutional investment demand and a potential shift of investor focus to Germany with its safe-haven characteristics, prime property yields are expected to compress further to new all-time lows. Going forward, we expect further rental growth to more than compensate for a slight outward yield movement from 2018 onwards.

### Occupier
- After a strong finish to 2015, take-up levels for German office properties remained high in the first half of 2016, with Berlin the top-performer.
- In line with strong tenant demand, vacancy levels in the top-7 markets have come down further, reaching the lowest level for more than a decade. With a vacancy level of around 5% in some markets, supply appears to be increasingly constrained. In the light of this limited availability, the high take-up levels are particularly positive.
- In terms of development, the volume of new space coming to the market is increasing, but only to around historical average levels.
- There is more evidence of speculative development in the office market, which could start to slow rental growth by the back end of the decade, although at 2.3% per annum over the next five years, the German market is set to clearly outperform the European average.

### Investment
- As elsewhere in Europe, German transaction volumes declined in the first six months of 2016, mainly due to limited product availability, smaller deal sizes and fewer portfolio deals.
- However, record low yields and ongoing yield compression indicate continuing strong investor demand from national and international investors alike. For the large number of international investors, Germany is considered a safe haven and alternative investment destination.
- Core investment remains in focus for investors. However, given the scarcity of available product in some markets and segments, active asset management and development are also offering attractive opportunities.

### Office Net Completions (% of existing stock) and Rent Growth (%)

Sources: PMA, JLL, Deutsche Asset Management, July 2016.
Note: f = forecast. There is no guarantee the forecast will materialise.
Strategic Outlook: France

Despite some increase in uncertainty, the impact of the Brexit vote on the French economy should be limited. GDP growth forecasts remain positive at 1.6% per annum, above the long-term average. The French economy continues to be supported by domestic demand, and although unemployment is still at high levels, it is now starting to fall. The French real estate market has proven resilient in this context. Office and logistics market fundamentals are still improving while retail is still facing challenges. Stiff competition amongst investors is sustaining downward pressure on prime yields, which are likely to see further compression. We expect yields in Paris to reach the 3.0% mark in the office sector, as spreads with government bonds (OAT) remain historically wide.

Occupier

- Office markets performed well in France during the first half of 2016, as Inner Paris and La Défense recorded record take-up levels. The gradual improvement in French economic growth is starting to impact business strategy, as more occupiers begin to seek office space expansion. Occupier demand in the regional markets is also strengthening.
- Vacancy continued to fall in Central Paris and the increasing office pipeline to be delivered from 2017 onward, encompassing a growing share of speculative schemes, should not be sufficient to push vacancy upward. La Défense and the CBD should see the strongest rental growth, but incentive levels remain high in general in Central Paris.
- The French logistics market continues to post healthy take-up figures along the central logistics backbone, keeping vacancy relatively low. Rents are forecast to grow faster than most of its European peers, with Greater Paris leading the rise.
- While rental growth for shopping centres is constrained by the notable number of future developments, the shortage of high street retail supply in prime locations should sustain further increases in rents.

Investment

- Investment activity in France was broadly stable in the first half of 2016 compared to the buoyant activity in the same period last year. Domestic investors, primarily SCPIs and insurers, have reinforced their presence in the market. Nonetheless, France remains one of the most liquid markets in Europe, offering a sizable investable stock for foreign investors to deploy their capital.
- Although already below their pre-crisis levels, prime office yields are seeing further falls in Paris, sustained by increasing flight to safety and low bond yields. This leaves a good premium for regional markets, with a spread of more than 100 basis points over Paris.
- Logistics continue to benefit from healthy fundamentals and offer attractive yields compared to other asset classes, both in Ile-de-France and the regions.

Average Prime Yields in France by Sector (%)

Sources: PMA (historical data), April 2016; Deutsche Asset Management, July 2016
Note: f = forecast. There is no guarantee that the forecasts will materialise
We continue to hold an Overweight position on the Spanish market. The economy is one of the fastest growing in Europe, and while occupier demand was below expectations in the first half of 2016, minimal development activity means that vacancy is falling and rents continue to recover. Our rental outlook for the next five years is little changed from six months ago – Madrid and Barcelona remain among the top performing markets. However, with an expectation of yields remaining lower, our outlook for total returns has improved. We remain cautious on out-of-town office locations, as despite a growing rental premium on city centre space, there is little evidence to suggest this is supporting increased occupier demand. For the retail and logistics sectors we suggest taking a lead from Northern Europe, where e-commerce is more advanced, and focusing on the types of assets and locations that have performed well in the face of rapid online sales growth.

### Occupier

- Spain grew at an annualised pace of over 3% in the first quarter of 2016 and, while slowing in the coming years, should remain one of the top performers over the rest of the decade.\(^{40}\)
- Over one million new jobs are forecast by the end of the decade, driving demand for business and retail occupier demand.
- Office vacancy in Madrid and Barcelona is falling. Growing evidence of shortages of good quality space, creating opportunities in central infill locations and for asset management.\(^{41}\)
- Prime rents recovering strongly across sectors. Signs of increased demand in well connected in-fill locations such as Madrid A1, and prime locations within regional cities like Zaragoza.
- Most out-of-town locations are still suffering low demand, structural vacancy and no rent growth.

### Investment

- After a slow start to the year, transaction activity picked up in the second quarter. Led by Madrid, Spain was the fifth most active market in Europe.\(^{42}\)
- While survey evidence has shown increased investor risk aversion, the strength of recovery and depth of domestic capital should continue to support investor demand.
- Prime yields continue to compress across most sectors. While Madrid offices now look to be nearing a trough, we see a further 18 months of compression across other cities and sectors. However, total returns are still set to be led by NOI growth.
- We remain overweight towards all sectors. For investors looking for above market returns, the strength of demand and lack of new supply is supporting opportunities within emerging in-town office and retail, while e-commerce is supporting demand to create high specification logistics.

### Prime Rental Levels (Q1 2008 = 100)

Source: CBRE, July 2016

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\(^{40}\) Oxford Economics, July 2016

\(^{41}\) CBRE, July 2016

\(^{42}\) Real Capital Analytics, July 2016
Strategic Outlook: Italy

Demand for real estate space is starting to recover in line with the gradual return of economic and employment growth. However, in general we recommend investors take an underweight position on the Italian market. With GDP growth projected to be some of the lowest in Europe, and with yields now more closely aligned with the European average, we see a clear risk of underperformance – particularly given the possibility of further stress in the banking sector and in response to the upcoming referendum. Having previously seen value in Milan offices, we have downgraded our position. We see the most value today in dominant shopping centres and parts of the logistics market benefitting from online growth.

Occupier

- The Italian economy continues to grow at a modest pace. This growth is leading to job creation which is starting to support increased levels of occupier demand.
- There are evident financial and political risks to the Italian market, but upsides should not be ruled out if recent economic reforms increase productivity and labour participation.
- Vacancy is trending lower across sectors and is below the European average in both logistics and retail. Office vacancy remains high, and unlike much of the rest of Europe, the availability of good quality space is relatively plentiful.
- Prime rent growth is forecast to be in line with the European average over the rest of the decade, growing at between 2-3% per annum across sectors.
- In terms of rental growth, Milan is expected to outperform Rome over the coming few years. Not only is the Milan economy growing much faster, Rome is suffering local governance issues.

Investment

- After a slow start to the year, investment picked up in the second quarter of 2016. In total €5.3 billion was transacted in the first half, making Italy the 7th most active European market.\(^{43}\)
- Having fallen sharply in 2015, prime yields have been broadly unchanged during the first half of 2016.\(^ {44}\) We see room for further yield compression on logistics and shopping centre assets, but offices in Milan and Rome now look to be nearing a trough.
- With yields lower, an average outlook for rental growth and rising levels of risk, the level of transaction activity may soften going forward.
- We see few attractive opportunities in the Italian office market. Not only have yields compressed, low demand growth and high vacancy suggests less room for accretive active management.
- We see better opportunities from Milan logistics and prime shopping centres. Shopping centre yields remain attractive compared to history, while falling vacancy is now inducing rental growth.

Office Net Completions (% Stock)

Sources: PMA (historical data), April 2016; Deutsche Asset Management, July 2016

\(^{43}\) Real Capital Analytics, July 2016
\(^{44}\) CBRE.
Strategic Outlook: Poland

The Polish real estate market has held up very well over the past six months, despite growing concerns over the government’s economic policy. The E.U. executive has given Poland an official warning that changes to its constitutional court endanger the rule of law, in an unprecedented decision that could ultimately lead to sanctions against the country. But so far this does not have unnerved investors or occupiers to such an extent that they would hold back purchases or demand less space. Arguably our main scenario suggests that the government will eventually take a step back to avoid any profound activity from the E.U. commission, but downside risks are elevated. In total we have downgraded the office and logistics sectors to underweight as the markets looks overpriced in risk adjusted terms, while we remain more positive on the retail sector (overweight/neutral).

### Occupier
- After a very strong 2015, demand in Warsaw held firm in the first six months of 2016 as take-up reached 360,000 square metres, a similar level to the same period in 2015.
- Nevertheless, availability in Warsaw has increased further, as extensive supply was released to the market, much of it in the CBD. And there is more to come: in 2017, 300,000 square metres is already under construction, almost all of which is speculative.
- Vacancy rates stand at 17.1% in the Warsaw CBD and may well continue to rise. A fair amount of the available space is of relatively low quality and not competitive, but even for the most prime space, availability is considered to be in the double digits.
- Prime rents have been stable at €21 per square metre per month but occupiers are clearly in control of the market as incentives often eat up more than 30% of the headline rents.
- In the short term, we do not see a recovery of prime rents and risks are clearly to the downside in case business sentiment worsens.

### Investment
- At the beginning of the year, we were expecting the Warsaw office investment market to take a pause, expecting investors would first try to make sense of the new political and regulatory situation. However, interest remained strong and yields have dropped further in the meantime. Already close to 5.0%, we think these levels are unjustified, in particular as the occupier markets will remain out of balance for at least another 24 months.
- However, we do not expect a strong correction in yields, as investors will wait for the cycle to improve and as yields are even lower in most other European markets. In the latter part of the decade, we expect Warsaw offices to look more attractive when vacancy rates eventually trend lower.

### Office Occupier Fundamentals (%)

*Sources: Deutsche Asset Management, July 2016*

*Note: f = forecast. There is no guarantee the forecast shown will materialise.*
Strategic Outlook: Nordics

The Swedish economy continues to motor ahead, powered by domestic consumption, while Finland remains challenged by structural issues. Norway has struggled recently in light of lower oil prices and although the domestic climate is improving the external sector will likely cap short-term GDP growth. A weaker external climate has led to a downward revision of Denmark’s growth prospects over the next two years. Capital continues to flow into the Nordics, supported by attractive financing options, low bond yields and safe-haven characteristics. Yields should continue to fall in the near-term, albeit modestly in some markets given stretched pricing levels, particularly for Stockholm offices. Rising bond rates are projected to put upward pressure on prime yields towards the end of the decade – although to a lesser extent than previously forecast. Given long-term demand drivers and relative pricing, retail and logistics continue to offer the best risk-adjusted opportunities with the office segment underperforming.

Occupier

- Sweden’s economy is outperforming, supported by solid private consumption. Finland remains challenged, while Norway and Denmark are exposed to external weakness.
- Occupancy is buoyant across all Swedish property segments, supported by solid economic expansion in Stockholm and low vacancy. Helsinki’s office market is characterised by high vacancy.
- Speculative development activity remains limited in Helsinki and modest in Stockholm, but is rising in Copenhagen.
- Strong medium-term rent growth is expected in Stockholm, although decelerating towards the end of the decade. Helsinki is seeing rising rental incentives granted to tenants.
- Growing consumption is supporting retail and logistics demand in Stockholm and Copenhagen, underpinning the positive rental outlook.

Investment

- Investment volumes are trending above the historical average, supported by low bond yields, attractive financing and flight to safety.
- Bond yields are projected to rise gradually from next year, putting a floor on property yields and leading to a slight outward shift from 2018 onwards.
- Prime offices across the Nordics are set to underperform given already stretched pricing levels. Secondary cities and development projects no longer offer attractive spread.
- Focus should be maintained on core logistics, high street retail and shopping centre assets.
- Possibility to consider alternative sectors benefitting from long-term trends such as residential although entry yields are extremely low but significant potential for rent growth and low void risks.

Nordics Investment Volumes (€bn)

Sources: RCA, July 2016, Deutsche Asset Management, July 2016
Strategic Outlook: Netherlands

The economic situation in the Netherlands has improved significantly since 2014 and GDP growth should remain robust in the coming years. The improving labour market has ensured a gradual recovery in the office market, with retail benefiting from stronger private consumption. The logistics sector gains considerable benefits from the strategic location of the country within European distribution channels. Investor interest in the Dutch real estate market has risen, seeking long-term and secured returns with more attractive yields compared to some European neighbours. This has supported further falls in yields, which will remain under pressure, especially in prime locations. It is noteworthy that investors are increasingly taking positions in other type of assets offering higher yields, such as residential and hotels, characterised by robust market fundamentals.

Occupier

- Office take-up in Amsterdam has been stabilising since 2009, below the long-term average.
- The combination of low levels of deliveries and the broadening of office conversions into hotel or residential properties have supported large falls in vacancy over the last two years.
- Given the modest pipeline and resilient demand, the lower office vacancy trend should extend over the decade, falling back to pre dot-com crisis levels.
- The retail segment is being supported by stronger consumer spending and demand from international retailers. Several new comers have already entered the market in recent years, although the bankruptcy of V&D may lead to an increase in vacancy in certain locations.
- The rise in demand for logistics space is still driven by the ongoing reconfiguration of the supply chain, given the rise of ecommerce, and favours a reduction in vacancy.

Investment

- Investors’ appetite for real estate in the Netherlands has surged since 2013, on the back of improving occupier market conditions and abundant liquidity. This performance was boosted by numerous sales of portfolios and involved a growing share of foreign buyers in the Dutch market.
- Investor interest in prime locations has strengthened and fostered prime yield compression that should continue over the next 12-18 months.
- Value-add and opportunistic strategies are being implemented in the non-core segment, such as in peripheral areas and for non-performing assets, although we continue to stress caution here given sustained levels of structural vacancy in some sectors.

Investment Volumes (€bn) and Prime Yields (%) in the Netherlands

Sources: Oxford Economics, July 2016
Note: f = forecast. There is no guarantee the forecast shown will materialise.
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