Deutsche Asset
& Wealth Management

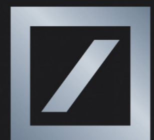
Research Report

U.S. Real Estate Strategic Outlook

February 2014

Passion to Perform

For registered representative and institutional advisory use only; not for public viewing or distribution



Prepared By:

Mark G. Roberts
Head of Research & Strategy
mark-g.roberts@db.com

Ross Adams
Industrial Specialist
ross.adams@db.com

Bill Hersler
Office Specialist
bill.hersler@db.com

Ana Leon
Property Market Research
ana.leon@db.com

Alexander Makarovski
Performance & Risk Analysis
alexander.makarovski@db.com

Andrew J. Nelson
Retail & ESG Specialist
andrewj.nelson@db.com

Jaimala Patel
Quantitative Strategy
jaimala.patel@db.com

Alex Symes
Economic & Quantitative Analysis
alex.symes@db.com

Brooks Wells
Apartment Specialist
brooks.wells@db.com

Jay Wengang
Assistant Vice President
Performance & Risk Analysis
jay.wengang@db.com

Table of Contents

Executive Summary 1
The Economy 3
Demand Drivers by Property Type 4
Capital Markets 4
Publicly Traded REITs 6
Implications to the Private Market 7
Debt Investment 7
Mezzanine Debt Outlook 8
Real Estate Return Performance 8
Property Market Fundamentals 11
Outlook for the Apartment Sector 12
Outlook for the Industrial Sector 14
Outlook for the Office Sector 18
Outlook for the Retail Sector 21
Real Estate U.S. House Portfolio 23
ESG Considerations 25
Appendix I: Real Estate Target Markets 27
Important Information 28
Research & Strategy Team – Alternatives and Real Assets 29

Executive Summary

The dawn of the post-credit crisis era has finally arrived. Business and consumer confidence has improved, job growth exceeded expectations, and with it, tenant demand for real estate has increased. Notwithstanding inevitable fluctuations in economic data, the weight of indicators now clearly shows that the U.S. economy is building sufficient momentum for a sustainable expansion. Our forecast calls for stronger and broader economic and employment growth in 2014 and beyond. As a result, we expect real estate returns to be driven more by strengthening property fundamentals and less by cap rate compression in the coming years, especially in light of already low cap rates and slowly rising interest rates. These returns will remain attractive, particularly relative to fixed-income investments.

As introduced in our last U.S. Real Estate Strategic Outlook,[1] we recommend investors give greater weight to assets, markets, and sectors that offer greater potential for income growth to offset capital value risks. Accordingly, our recommended allocations are now firmly more focused on the pro-cyclical sectors (industrial and office) at the expense of the more counter-cyclical sectors (apartments and retail). Relative to the investable universe as represented by the NCREIF Property Index (NPI), we maintain a strong overweight to industrial, though we have tilted slightly more to office than before to capture the expected improvement in office market conditions. Overall, we maintain a slight underweight to apartments, office, and retail.

With the economic and property market recoveries spreading to more markets, investors will be able to consider a broader set of metros for their investments. That is especially welcome news as "prime" properties – the best assets in a narrow set of leading markets – appear to be quite pricey. In some cases, investors may be more focused on preservation of capital and seeking a store of wealth. As such, these types of investors are out-bidding those more focused on relative total returns. With the recovery broadening to a greater number of cities and sectors, outperformance can be achieved by expanding investment selection beyond prime assets.

Though the specific strategies and nuances vary by sector, we still generally recommend investors avoid commodity space, particularly in secondary locations. Tenants, shoppers, and workers increasingly favor properties which offer appropriate amenities and are located in areas offering a true live/work/play lifestyle. These preferences are not limited to the downtowns of large cities. We recommend seeking out quality projects in desirable submarkets attracting less capital attention, particularly in dynamic growing metros. With vacancy rates recovering more broadly and new supply risk limited, value-add opportunities requiring more attentive leasing or innovative repositioning appear to offer attractive risk-adjusted returns relative to fully-leased prime assets in the most expensive markets.

Finally, with opportunities for direct equity investments declining in the best markets due to the concentration of capital market demand, investors seeking exposure to these markets may wish to consider other investment structures such as debt and preferred equity positions. Though pricing of equity investments for many prime properties may not justify their cash returns in the near term, the strong longer-term performance of these markets argues for at least some portfolio exposure.

[1]Available at: http://www.rreef.com/research/research_6767.jsp

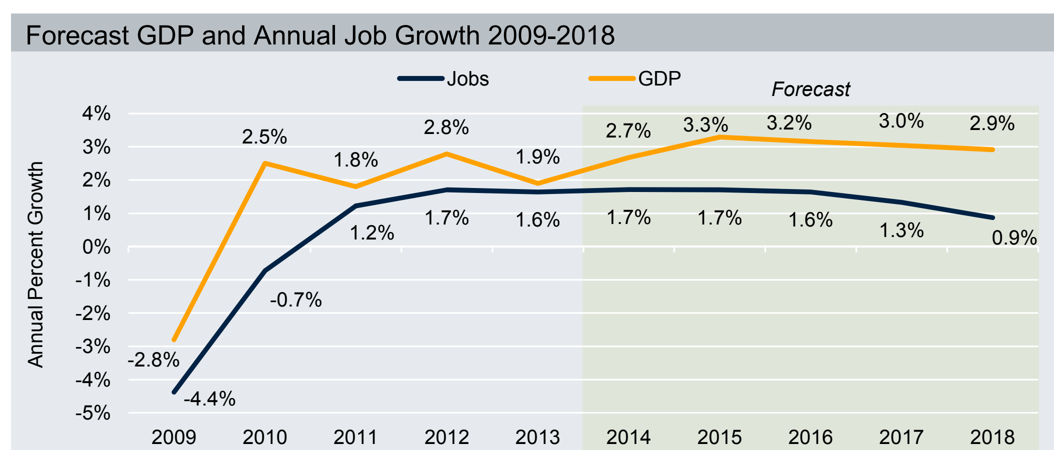
In summary, our updated outlook makes the following calls and recommendations:

- Expect rising occupancies and rents in most markets and segments as economic growth accelerates.
- The apartment sector by now is essentially fully recovered, with occupancy and rents exceeding prior peaks in many markets. Revenue growth will slow and even reverse in some key metros as high rent levels attract a surge in new supply.
- The industrial sector continues to outperform our previous forecasts, as all demand drivers are firing together. With supply still tame, surging demand will support strong income growth for several more years.
- Office sector demand continues to strengthen and broaden, but remains thin in many markets, as firms get more creative and efficient with their space usage; but with limited supply threats, rising demand will translate into greater occupancy and higher rent levels over the next two years.
- In the face of threats from online shopping and more restrained retailer growth strategies, the retail property sector remains resistant to a broad-based recovery. Yet retail demand should strengthen for top centers and markets, causing highly bifurcated performance.
- We expect cap rates to increase a modest 20 basis points to 30 basis points and cap rate spreads to treasury yields narrow through 2018 as interest rates rise. With moderating capital appreciation and strengthening property fundamentals, our forecasted five-year returns are essentially unchanged from mid 2013.
- Against the backdrop of rising cap rates, we continue to recommend overweighting those sectors, markets, and assets that can provide access to higher net operating income growth and provide better risk-adjusted relative performance.
- For benchmark-focused investors, we also recommend an underweight to investments that have bond-like qualities in order to minimize the risk of capital loss in a rising rate environment. Still, for low-risk investors, such properties can provide a consistent level of current income while protecting against downside risk of unexpected adverse economic conditions.

The Economy

Economic growth stabilized and strengthened in late 2013, and we expect current trends to continue into 2014 and 2015. GDP expansion is expected to accelerate during the next two years due to growing private demand and diminishing drags from the government. Consumer spending is stabilizing near a more normal rate of growth as consumer confidence has been boosted by rising stock and home values, lower fuel costs, and lower debt service levels, as well as from a strengthening labor market. Business investment also should remain healthy in 2014. Productivity gains are decelerating, but companies have both plenty of cash and access to cheap credit, which could be used to expand current production. Additionally, construction spending will continue to rebound off of a low base in 2014 and 2015, adding to investment growth. A rush of new apartment starts initiated the movement, but we should see a rise of construction activity in single-family, multi-family and commercial properties in 2014 and 2015 as vacancy rates in the commercial sectors decline.

Forecast GDP and Annual Job Growth 2009-2018



Sources: Oxford Economics and Deutsche Asset & Wealth Management.
As of February 2014.

Government spending may boost overall economic growth this year due to strengthening state and local governments, and fewer cuts from the Federal sector. Government spending has weighed on growth since 2011, first due to weak state and local government finances and then the unwinding of the fiscal stimulus from the Federal government. State and local governments are now starting to produce budget surpluses on the strength of rising tax revenue, and will be able to increase capital spending and other outlays during the next couple of years. Additionally, the new Federal budget reduced some of the cuts from the sequester. The budget recently passed also provides greater certainty to the capital markets for the near-term and should further improve business and consumer confidence.

The range and magnitude of risks appears to be declining in the near-term outlook. While overall global economic growth is expected to increase, tepid growth in Europe remains a drag on the global economy. While the pace and scale of the winding down of the Fed's stimulus program remains unclear, the result will most likely lead to rising interest rates over the course of our forecast. That said, a strong dollar, lower commodity prices, and elevated levels of unemployment should restrain inflationary pressures and limit the increase in interest rates. The for-sale housing recovery remains a key risk to the forecast. Should the housing recovery be weaker than projected, we can expect downstream hits to output and

employment growth. In addition, should strengthening economic fundamentals lead to a much stronger U.S. dollar, it would weigh down exports. Overall, potential downside risks to the outlook have diminished compared to previous years.

Demand Drivers by Property Type

Apartments: The apartment sector still shows healthy tenant demand, although the for-sale housing market is improving. Rising interest rates (increasing mortgage payments), growth in household formation, and a lower propensity to own will all support fundamentals during the near term, though for-sale housing remains affordable when compared to historic levels.

Industrial: Broad economic growth and solid employment gains should support healthy retail spending growth, trade, and domestic production in 2014, to the benefit of warehouse demand. Additionally, a rise in construction, both residential and non-residential, bodes well for demand for smaller multi-tenant industrial product in high barrier markets.

Office: Office-using job growth is slowly improving national demand fundamentals. Office-using job gains have been strong during the past couple years, especially from the professional and business service sector, and the absolute number of office-using jobs will exceed the previous peak in 2014. However, recovery is limited by a continuing overhang of shadow space and efforts by tenants to focus on improving space efficiencies.

Retail: Traditional drivers for retail space continue to improve, although structural changes within the sector are muting the demand for real estate. Household debt is falling as a ratio of income, while jobs and consumer confidence are rising. However, income growth has been minimal, limiting retail sales gains. Additionally, e-commerce is diverting away some of the growth that would have previously gone to physical stores. Tenants are currently demanding smaller store prototypes, further reducing space needs.

Capital Markets

U.S. commercial real estate (CRE) continues to see an increase in capital flows and prices. Improvements in market conditions, lending environment, and investor confidence, all drew more money into the asset class. The spike in interest rates in May and June has not had a significant impact on either volume or cap rates, and transaction volume topped $300 billion in 2013, its fourth consecutive year of double-digit gains. Prices continued to rise across all property types, with increased demand from overseas helping to push property values to record levels in major U.S. cities favored by global investors. The disconnect between bullish investor sentiment and hitherto restrained market fundamentals demand appears to be narrowing in the United States as the nation's overall economic recovery broadens.

The amount of active buyers continues to expand, although the composition of buyers has not shifted appreciably since 2012. The number of institutional investors, equity funds, and foreign entities actively buying in the United States has already surpassed 2006-2007 levels. Recent surveys of institutional investors (domestic as well as foreign) indicate a strong bias to either maintain or increase real estate allocations to the United States. A recent Kingsley survey reported that fund managers are well under their target allocations to real estate. As a result, CRE investment markets are well positioned for another strong year of capital growth in 2014.

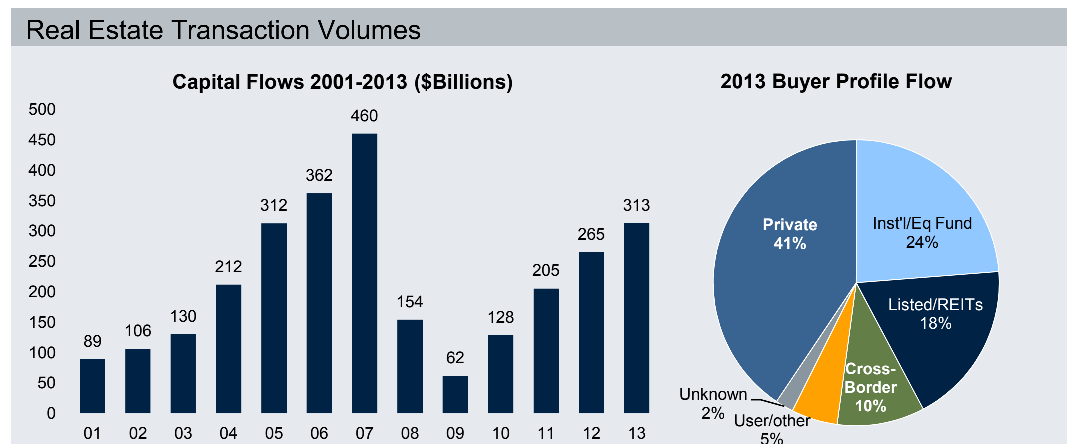
Cap rates were relatively stable during the year, even as 10-year Treasury yields increased by more than 100 basis points. Thus, the cap rate spread over the 10-year Treasury fell significantly, to about 280 basis points as of the third quarter, yet remains nearly 50 basis points above its long-term average. The prospects of further capital flows targeting prime properties – especially from well-capitalized foreign investors – will likely neutralize any upward pressure on cap rates from higher interest rates.

One trend that endured and even strengthened in 2013 is the concentration of capital in leading gateway markets. The gap between cap rates in the top six metros[2] favored by institutional investors and the average in the non-major markets rose to 107 basis points. This is well above its average 63 basis points since 2002 and even exceeds the prior peak of 92 basis points reached in the fall of 2008. Thus, capital continues to disproportionately target the top leading metros, impacting the pricing of prime properties.

The prospect of lower returns for prime properties appears to be impacting investor sentiment towards core. The aforementioned Kingsley survey found that investors intend to decrease their target allocations to core strategies in 2014. The top property sector favored by institutional investors in 2014 is industrial, followed by retail, office, and apartments (which had been ranked first in 2012).

The reduction in troubled real estate debt will help eliminate a major drag/risk to U.S. capital markets. New instances of distress have been falling rapidly this year, while workout activity continues at a moderate pace. Real Capital Analytics is reporting that approximately two-thirds of the $406 billion of commercial property loans that soured this cycle will have been resolved by the close of 2013. CMBS delinquencies now stand at three percentage points below their July 2011 peak of 9%. Fitch Ratings believes U.S. CMBS delinquencies could fall below 4% in 2014.

Key to watch in 2014: Given the Federal Reserve's gradual wind down its stimulus program, will investors factor in the possibility of rising interest rates into their buying decisions? Our view is that such considerations are inevitable, but that the tremendous capital demand in light of improving fundamentals for CRE will restrain cap rate increases.



Sources: Real Estate Capital Analytics and Deutsche Asset & Wealth Management.
As of February 2014.

[2]Top six markets include: New York, Boston, Chicago, San Francisco, Los Angeles, and Washington.

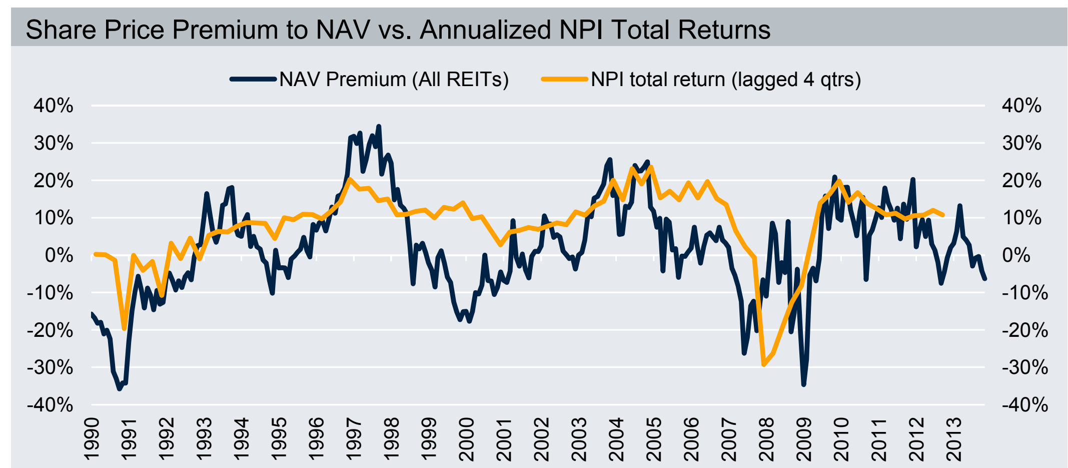
Publicly Traded REITs

Improving market fundamentals are strengthening the outlook for publically-traded real estate investment trusts (REITs). Real estate drivers are boosting tenant demand, but with little new construction—particularly in the office, industrial and retail sectors—vacancy rates are declining and rents are starting to grow. The result is improving earnings growth and rising dividends.

Although fundamentals and earnings advanced throughout 2013, the capital markets were less kind. Investors worrying about the end of the Fed's stimulus program resulted in a sell-off in interest rate-sensitive investments. The result was the first year of underperformance for the REIT sector since 2008, with the NAREIT Equity REITs Index returning only 2.5% during 2013, while the S&P 500 had its best performance in almost 20 years, with a total return of 32.4%.

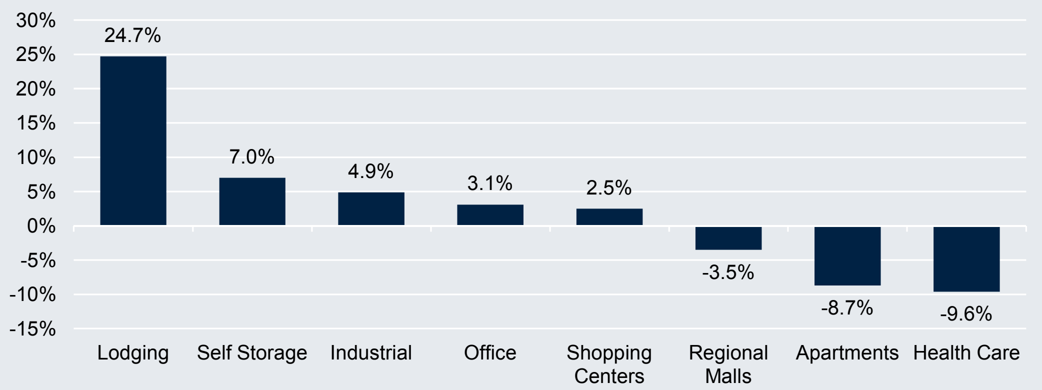
Investors will be able to focus on improving fundamentals this year as they become comfortable with rising interest rates. REIT premiums over the underlying net asset values (NAV) began 2014 in negative territory. REIT NAV premiums have historically averaged 3.1%, and negative NAV premiums imply that the public market will rise in the future, especially as earnings continue to climb.

Share Price Premium to NAV vs. Annualized NPI Total Returns



Sources: Green Street Advisors (pre-2001 NAV), NCREIF and Deutsche Asset & Wealth Management (post-2000 NAV).
As of February 2014.

Sub-sector performance has varied substantially. Apartments and regional malls, which led the recovery, underperformed in 2013, as REITs in both sectors saw income moderate in 2013. Industrial and office, on the other hand, outperformed the index as investors prepared for higher income growth anticipated in these two sectors.



Note: Excess returns compared to the NAREIT Equity REITs Index.
Sources: NAREIT and Deutsche Asset & Wealth Management.
As of February 2014.

The REIT sector is likely to perform well in 2014, but with fundamentals as the main driver of income and capital growth, and performance hindered by rising interest rates, we anticipate returns will fall slightly short of its 30-year historical average of 11%, likely in the high single-digits. Returns will continue to vary by sector and investors will likely favor the pro-cyclical sectors of office and industrial over apartments and retail.

Implications to the Private Market

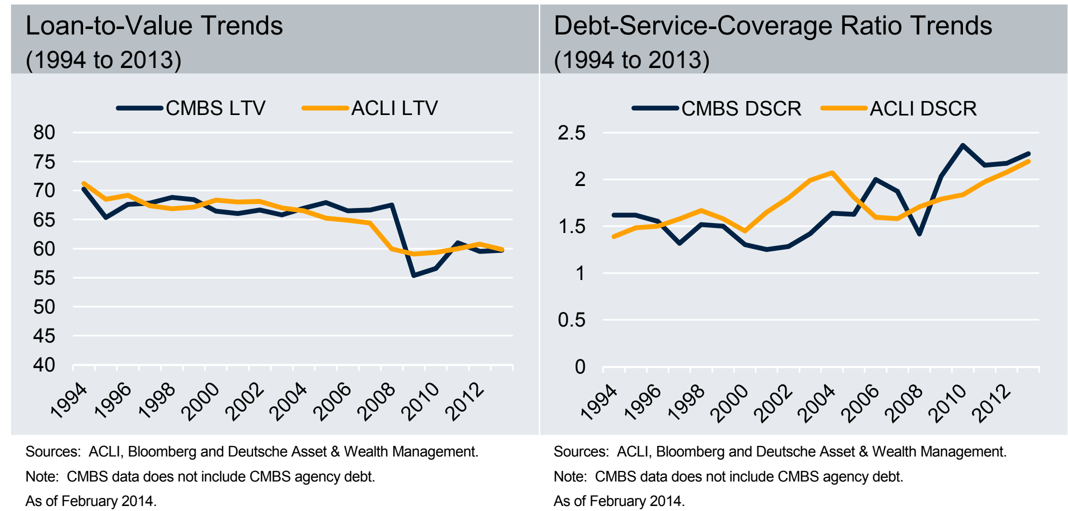
The public market tends to lead the private equity market by about four quarters, so private equity investors can gain some insight from the 2013 performance of listed REITs. Using the subsector performance as a guide, investors with heavier weights to industrial and office should outperform portfolios skewed more toward apartments and regional malls. The private market office sector has underperformed for the past six years, but improving fundamentals should help the sector outperform in 2014. On the other hand, apartment property fundamentals are decelerating, leading the sector to some underperformance going forward. The public market suggests that shopping centers will outperform modestly led by improving fundamentals.

Debt Investment

As exhibited in the capital markets section, opportunities still exist for equity investors in most core markets, even as yields compress. However, returns and going-in yields in the primary markets for many assets have declined far enough that many core investors cannot justify the risk-adjusted returns. Some institutional investors are alternatively seeking mezzanine debt to earn higher risk-adjusted returns to access assets in top performing markets.

Equity investors buying assets in primary markets are demanding higher amounts of leverage to finance acquisitions and reposition assets in top locations than senior lenders are willing to provide. Senior lenders need to put capital to work, but remain disciplined. As seen in the charts on the next page, LTV ratios remain lower and debt service coverage ratios are higher than they were prior to the credit crisis as traditional lenders remain cautious. Additionally, banks are preparing for a higher regulatory environment and are originating new loans under

conservative terms. The result is a gap between the high levels of debt desired from equity investors and the amount of capital senior lenders are willing to provide. Mezzanine investors have the opportunity to fill this market dislocation.



Sources: ACLI, Bloomberg and Deutsche Asset & Wealth Management.
Note: CMBS data does not include CMBS agency debt.
As of February 2014.

Sources: ACLI, Bloomberg and Deutsche Asset & Wealth Management.
Note: CMBS data does not include CMBS agency debt.
As of February 2014.

Mezzanine Debt Outlook

Core investors, unable to transact at current equity yields, may consider investing in mezzanine debt and preferred equity. The financing gap may provide borrowers with access to prime assets and the ability to participate in the top markets. Equity investors are willing to pay higher rates for mezzanine capital, and core investors can benefit from higher risk-adjusted returns. Generally, equity investors need a fraction of the value in mezzanine capital, so high interest rate subordinated debt, blended with a senior loan at a lower interest rate, result in an accretive effective cost of capital for the borrower. At the same time, the high interest rate provides the mezzanine lender a higher risk-adjusted return, compared to a low-leverage equity investment in the same asset.

Mezzanine financing can offer higher risk-adjusted returns, but as we learned during the previous downturn, lenders should be prepared to take the property back from the borrower and have the skills to manage properties. Lenders with property management experience will be able to handle an unexpected downturn better than others. Additionally, lenders who are also equity investors will be able to underwrite assets for either the base case hold-to-maturity investment, or a downside equity investment.

Real Estate Return Performance

Real estate should provide total returns on par with stocks and superior to bonds. Our current baseline forecast for the next five years shows stocks mildly outperforming real estate, and government bonds trailing. However, stress testing this forecast against a downside scenario with rising interest rates and cap rates, and falling P/E ratios, real estate outperforms both stocks and bonds during the next five years. On the other hand, if interest rates were to continue falling, despite stronger earnings and income growth, real estate returns would modestly underperform stocks, but greatly outperform bonds.

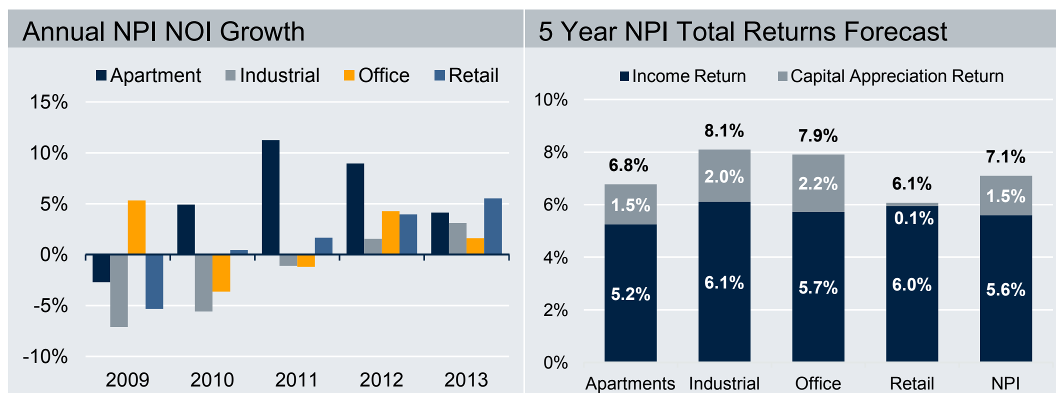
Forecast Total Returns (5-Year Annualized)			
	Bonds	Stocks	Real Estate
Downside	1.0%	-1.4%	3.3%
Base Case	2.8%	7.5%	7.1%
Upside	6.7%	9.3%	9.1%

Scenario Key Assumptions:

Bonds:	*Downside:* Interest rates rise. Higher ending yield (5.1%), assuming investor investing in on-the-run 10-year treasury bond indices at 2.8% coupon rate. *Base Case:* Assuming investor buying and hold today's 10-Year treasury until maturity. *Upside:* Interest rates fall. Lower ending yield (0.5%), assuming investor investing in on-the-run 10-year treasury bond indices at 2.8% coupon rate.
Stocks:	*Downside:* Interest rates rise. Assume a low P/E ratio of 11x for stock valuation 5 years from now. *Base Case:* Assume a same P/E ratio as current level. *Upside:* Interest rates fall. Assume a high P/E ratio of 19x for stock valuation 5 years from now. Current P/E = 16.4x, Current dividend yield = 2.0%, Annual dividend growth = 5.2%
Real Estate:	*Downside:* Interest rates rise. Long term average 5-year exit cap rates given current level plus one standard deviation (6.6%). *Base Case:* House View base case 5-year forecast. *Upside:* Interest rates fall. Long term average 5-year exit cap rates given current level minus one standard deviation (3.9%). Current Going-In Cap Rate: 5.5% Capital Expenditure: 2.3% Baseline Inflation = 2.5%

Sources: NCREIF, Bloomberg, Moody, and Deutsche Asset & Wealth Management.
As of February 2014.

Improving market fundamentals and rising investor demand are expected to offset upward pressure on cap rates as the primary source of property returns in the coming years. Capitalization rate compression drove performance during the past three years as investors anticipated the recovering property markets. Cap rates are currently near cyclical lows and it is unlikely that more compression will occur during the next few years, particularly in the better markets. At the same time, property fundamentals are improving, resulting in NOI growth and capital appreciation. When factoring in higher interest rates and slightly higher future exit cap rates, returns to unlevered real estate will likely moderate for investments made in 2014, producing an average annual return of 7.1% from 2014 to 2018, essentially unchanged from our prior forecast in mid 2013. The majority of return from core properties will come from yield, or income return, in addition to mild capital appreciation from NOI growth. Investors are unlikely to receive much return from cap rate compression. Beyond prime assets, we expect to see some capital appreciation gains as investors capitalize upon higher yields.



Sources: ACLI, Bloomberg and Deutsche Asset & Wealth Management.
As of February 2014.

Sources: ACLI, Bloomberg and Deutsche Asset & Wealth Management.
As of February 2014.

During our five-year forecast, industrial and office properties will likely outperform the apartment and retail sectors. Industrial and office income growth has so far underperformed, but will strengthen starting in 2014 and 2015, attracting more capital to both sectors. Apartment income growth will decelerate midway through the five-year period, resulting in lower overall expected total returns. While the retail sector will continue to experience steady NOI growth, gains will be lower than those of the cyclical sectors of office and industrial, resulting in retail underperforming in terms of total return.

Although we expect the pro-cyclical industrial and office sectors to outperform during the next five years, investors should maintain a diversified portfolio. Sectors rarely continuously outperform on an annual basis and single-sector portfolios of any sector will see periods of underperformance and higher risk. During the past decade, every sector has had its turn at both the top and the bottom of the earnings table, and no sector has lead for more than three consecutive years. Office has been the lowest performing sector in nine of the past 13 years, but investors shunning the sector would have missed two of the strongest returns since 2001, when office generate a cumulative return of over 40% during 2006 and 2007. Overall, because the sectors have led and trailed at different points in the cycles, an investor would have lower risk and/or higher returns with a diversified portfolio.

Quilt of Returns: The Benefits of a Diversified Portfolio
Annual Property Returns by Sector, 2001 to 2013

2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	**2013**
9.4%	13.7%	17.1%	23.0%	21.5%	19.2%	20.5%	-4.1%	-10.9%	18.2%	15.5%	11.6%	12.9%
9.3%	8.8%	8.9%	13.0%	20.3%	17.0%	14.9%	-5.8%	-17.5%	12.6%	14.6%	11.2%	12.3%
6.7%	6.7%	8.2%	12.1%	20.0%	14.6%	13.5%	-7.3%	-17.9%	11.7%	13.8%	10.7%	10.4%
6.2%	2.8%	5.7%	12.0%	19.5%	13.4%	11.4%	-7.3%	-19.1%	9.4%	13.8%	9.5%	9.9%

Apartment | Industrial | Office | Retail

Source: NCREIF.
As of February 2014.

Property Market Fundamentals

Real estate fundamentals are continuing to improve broadly, with the strongest forecast to come in the next two years. Demand drivers are strengthening while there is little new construction outside of the apartment sector. Vacancy rates are declining for all sectors, but each is at a different part of the cycle; apartment properties led recovery, office lagged and industrial and retail performed in-between.

U.S. Vacancy Rate Trends (%)

	Actual					Forecast					20 Yr Avg.
	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	
Apartment	7.3	6.0	5.1	4.9	5.0	5.2	5.5	6.3	6.1	5.4	5.5
Industrial	14.3	14.3	13.5	12.7	11.3	10.8	10.1	9.7	9.9	9.9	10.2
Office	16.7	16.6	16.2	15.6	14.9	14.1	13.2	12.9	13.2	13.4	13.9
Retail	12.7	12.9	12.9	12.6	12.0	10.7	9.9	9.5	9.5	9.7	9.7

Sources: CBRE-EA (History) and Deutsche Asset & Wealth Management (Forecast).
As of February 2014.

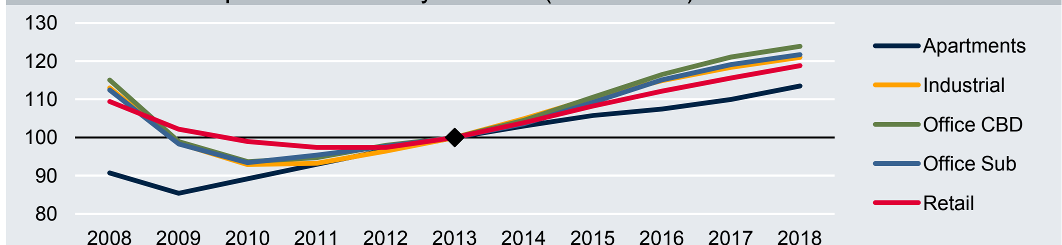
The apartment sector is firmly in expansion, as occupancy and rents are past prior peaks in many submarkets. Demand outstripped supply during the past few years, supported by employment growth and rising household formation. However, with rents now justifying construction in many metros, new supply is rising sharply, leading to rising vacancy rates in 2014 and 2015.

Last year, the industrial sector experienced its largest annual decline in vacancy in the past 25 years. With stronger tenant demand and little speculative development, rent growth will strengthen during the next couple of years and spread to more markets. Vacancy rates may begin to increase late in the forecast period as the construction pipeline grows.

Tenant demand for office space has yet to strengthen appreciably despite robust office-using job growth. Tenants are utilizing space with increasing efficiency, leasing less space per worker. However, capacity is being maxed out and occupancy should strengthen more notably in 2014 and 2015.

Retail fundamentals are improving, but rent growth remains elusive. Vacancy rates are declining only slowly, even with little new construction, due to weak space demand from retailers, who increasingly look online rather than in new stores for sales growth. Vacancy should decline moderately during the next few years, delaying stronger rent growth forecast until 2015 and 2016.

Sector Rent Comparison Summary 4Q2013 (2013 = 100)

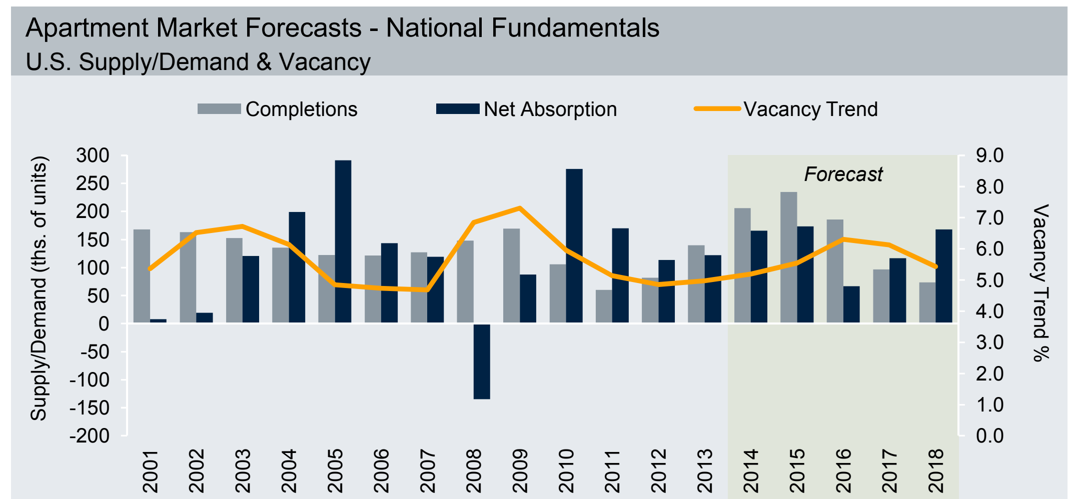


Note: All rents are NNN for consistency in comparing sector growth.
Sources: CBRE-EA (History); RREEF Real Estate (Forecast).
As of February 2014.

Outlook for the Apartment Sector

While markets remain tight, apartment returns continue to decelerate: With developers racing to deliver new supply, effective rent growth has been slowing. Annual rent growth for the United States was in the low-3% range during 2013, well below the 4.4% and 4.2% growths achieved in 2010 and 2011, respectively. Average effective rents are now 8% above pre-recession peak levels. Increasing rents, in the face of stagnant income growth, continues to raise affordability concerns. Undeterred, investors remain aggressive. Apartment cap rates declined modestly during 2013, boosting returns, even as sector NOI growth was moderating.

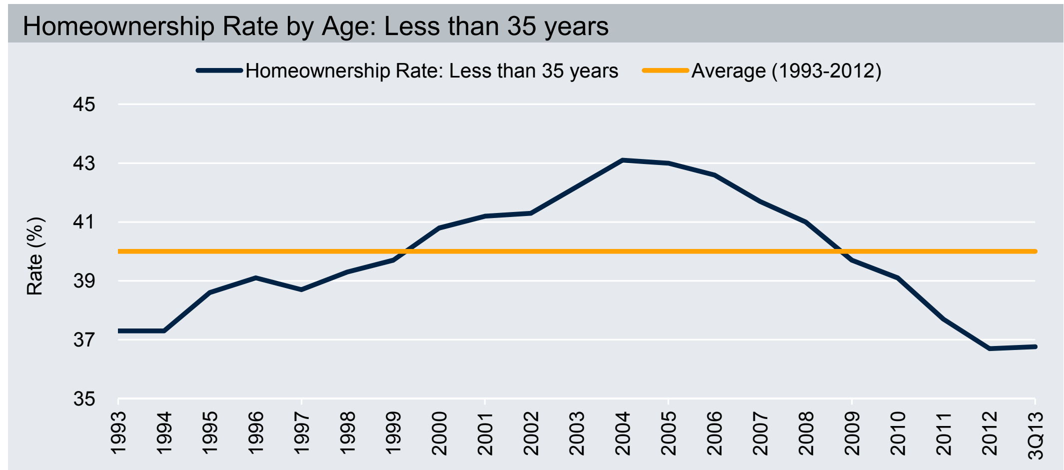
Apartment Market Forecasts - National Fundamentals
U.S. Supply/Demand & Vacancy



Sources: CBRE-EA and Deutsche Asset & Wealth Management.
As of February 2014.

Market Outlook: The expected surge in construction has arrived. Completions this year should total just over 200,000 units, roughly 50% higher than the sector’s long-term average. Though the current pipeline is similar to previous construction cycles in terms of total units delivered, completions will be concentrated in prime urban core areas – not the suburbs, which dominated previous cycles.

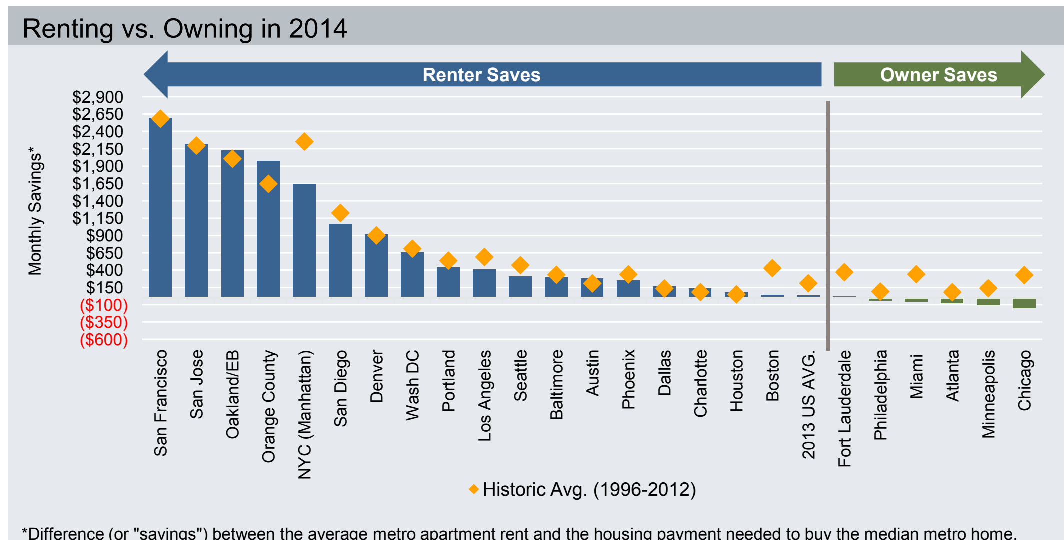
Demand for apartments remains strong. An improving job market and growth of single-person households continue to sustain healthy demand for rentals. Also, young people (the prime renter cohort) have been largely left out of today's housing recovery, especially given tight mortgage credit. They simply don't have the down payments or the credit scores necessary to qualify. As a result, the homeownership rate for Americans under the age of 35 is at a historically low level, averaging 36.8% during the first three quarters of 2013.



Sources: US Census Bureau and Deutsche Asset & Wealth Management.
As of February 2014.

The U.S. vacancy rate has been holding steady around 5.0% – 50 basis points below its 15-year average. Development is expected to outstrip demand going forward, resulting in modest increases in vacancy. Therefore, prospects for overall rent growth will continue to decelerate, averaging between 2% to 3% per year in 2014 and 2015. Multi-family permitting for rental units is expected to peak in 2014 allowing new completions to recede during the later years of the outlook.

Many of the best performing markets during the recovery (predominately transit-oriented urban districts in vibrant downtowns) are now experiencing the biggest pullback in rent growth. Developers rushed into these prime urban districts, targeting younger renters with highly-amenitized luxury product. The amount of luxury units expected to be delivered to prime downtown markets during the next several years is unprecedented. With near-term supply risks increasing, investors should focus on dynamic “youth-magnet” markets with high housing costs relative to renting, i.e. markets that attract renters-by-necessity. Markets with strong economic and demographic drivers, coupled with a low rent versus homeownership ratio, will likely sustain renter demand and provide the best prospects for rent growth.



Sources: US Census Bureau and Deutsche Asset & Wealth Management.
As of February 2014.

Low vacancies, strength in the technology sector and high-priced housing continue to favor Coastal California, Seattle, and Boston. With its high-value economy expanding, supply-challenged New York City (including the neighboring satellite markets of Hudson Waterfront and Stamford) will continue to see an influx of renters coping with tight market conditions. Improving demographic trends and a strengthening for-sale housing market are expected to provide strong tail winds for renter demand in the key South Florida markets. The historically stable Midwest markets of Chicago and Minneapolis currently provide better returns relative to the pricey coastal markets, though supply risks need to be monitored in their prime downtown districts.

Sector Strategies: Though their demand drivers remain impressive, caution is advised when investing the low-barrier Texas, Atlanta, Charlotte, Raleigh-Durham, Orlando, Tampa, and Phoenix markets where homeownership costs relative to renting are not as significant. The Mid-Atlantic will under-perform in the near-term with the once dominant Washington, D.C. market ranking near the bottom for rent growth given the amount on new supply expected.

Bullish investor sentiment, despite moderating NOI growth, is creating conditions for apartments to become over-valued in the near term, especially for prime assets. Therefore, the number of metros for core investment continues to dwindle. Investors should focus on the outperforming markets mentioned above and avoid commodity product at market pricing. Repositioning Class B communities in high-barrier markets remains a viable strategy – target assets that offer well-defined intrinsic value. Development remains a preferred strategy to own a next-generation apartment community – target downtown or close-in suburban locations in markets with dynamic economies. Demand for recapitalizations and fixing broken assets could emerge in markets that are currently facing significant near term oversupply. Acquisition of core apartments will likely re-emerge as a viable investment strategy in prime markets once multi-family permitting has peaked in 2015 and 2016.

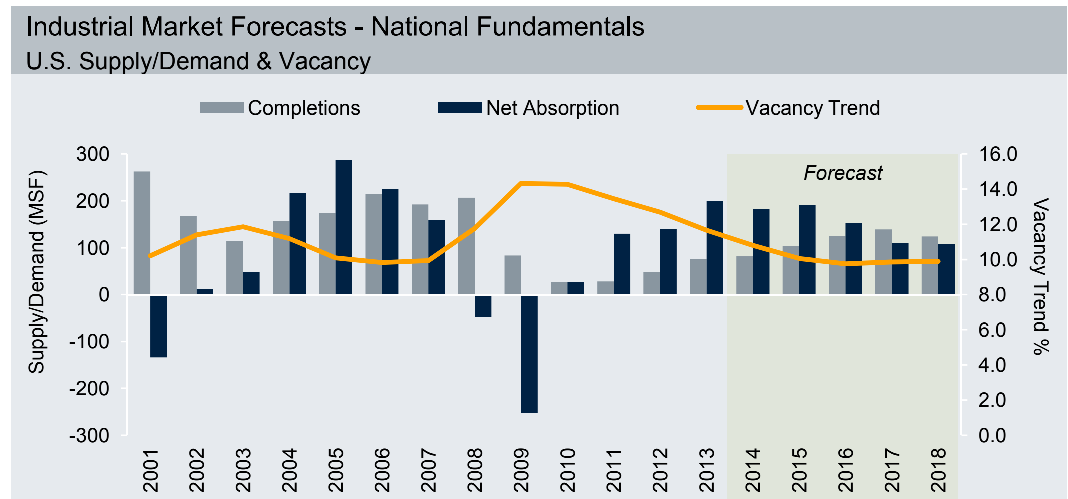
Outlook for the Industrial Sector

Surprising strength in 2013 and still room to run: The U.S. industrial property market ended 2013 on a high note with new demand in the second half so strong that the year ranks among the best since 2000. The national vacancy rate fell 40 basis points during the fourth quarter alone, to 11.3%. That brought the total decline for the year to 140 basis points, the largest single-year decline in the past 25 years. With the supply pipeline at record low levels, effective market rents grew by an estimated 4% during the year.

Investment performance was also notable. The industrial sub-index of the NCREIF Property Index posted year-end 2013 annualized returns of 12.3%, second only to retail. Industrial returns bounced back strongly after lagging the index broadly in 2010. There is still room for strong performance ahead as economic growth stimulates new demand and rising occupancies across our core markets. Expected rent growth and occupancy gains should fuel healthy NOI growth and total returns in the sector in coming years.

Market Outlook: Broader economic growth in 2014 bodes well for industrial property markets. Forecasted employment growth, expanding international trade and retail spending, as well as renewed home building should support industrial space demand broadly across

markets. An improved outlook for the global economy and business spending growth should also benefit high tech and globally-linked gateway economies.



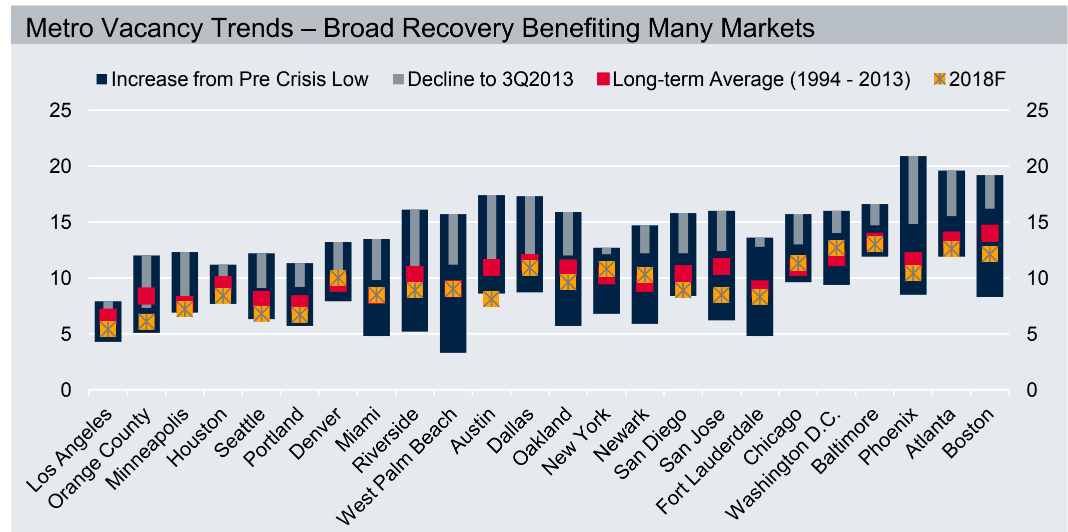
Sources: CBRE-EA and Deutsche Asset & Wealth Management.
As of February 2014.

We expect another good year for industrial fundamentals in 2014. Strong leasing momentum allowed recovery to progress at a robust pace in 2013, but most metro vacancy rates remain above long-term averages, so broad supply-side threats are not expected to rise until 2015. Markets with extraordinary demand, such as Riverside, Dallas/Fort Worth, and Houston, will likely see a rise in bulk warehouse development in 2014. Amazon.com and large retailers are slated to expand and refine their logistics footprints in other markets as well, but it will take further rent and occupancy gains to entice developers and investors to build speculatively in markets with weaker fundamentals.

The national vacancy rate is forecast to dip to 9.7% in 2016, slightly below last cycle's low watermark. But a supply response is expected to cause vacancy to stabilize near 10% as the growth cycle matures later in our forecast. Effective market rents have lifted off bottom in most markets and are growing more strongly in the class A warehouse segment. Large-bay warehouse rents are furthest into recovery, nearing replacement levels in the top distribution hubs and gateways, so future growth prospects will be tempered by new supply. Market rent growth for smaller and mid-bay multi-tenant warehouses should accelerate over the next two years and the prospects for higher-finish industrial space in tech-oriented markets are good as well. Overall, we expect market rent growth of about 5% annually for the next two years.

Market Strategy: Individual metro vacancy outlooks provide a foundation for our target market selection. The chart on the following page highlights the recent history and outlook for the investable universe of core industrial property markets. The left side of the chart contains many of today's preferred investment choices where recovery is well established and rent gains should reward industrial property owners. Several of these markets, notably Denver, Minneapolis, and Portland, have seen outsized improvements in fundamentals but attracted less attention from investors. Class A warehouses should see strong near-term performance in these markets. They have moderate supply-side barriers but still tend to maintain better supply/demand balance compared to the low-barrier metros that occupy the right side of this

chart. Nonetheless, caution is warranted in markets with less liquidity during down cycles, potentially hindering exit strategies.



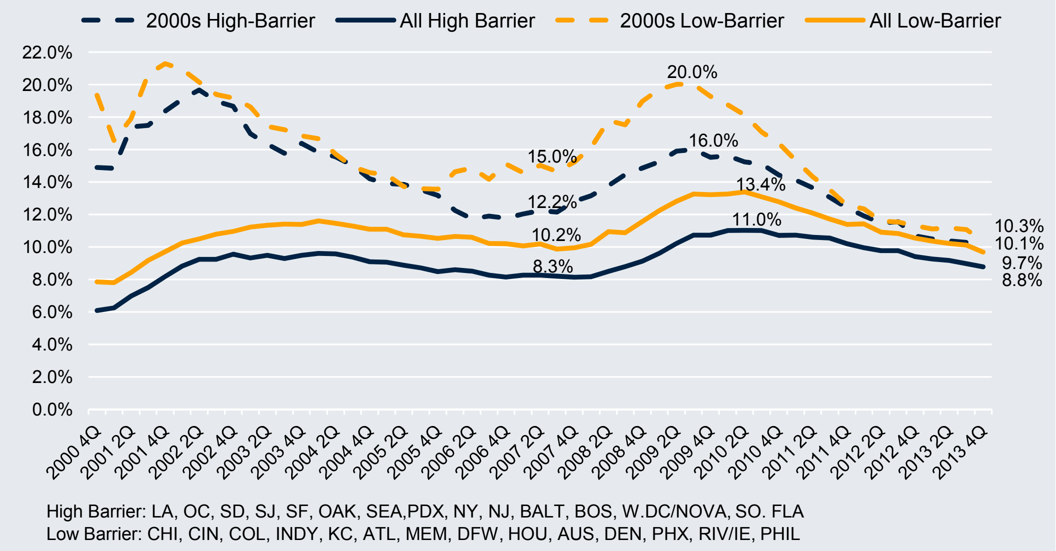
Note: Ranked from lowest to highest current vacancy.
Sources: CBRE-EA and Deutsche Asset & Wealth Management.
As of February 2014.

San Diego, Fort Lauderdale, Phoenix and Boston still have significant recovery ahead and represent relatively higher-risk, higher-return options today. They tend to have proportionally less warehouse and more flex in their industrial stock, and recovery has been uneven to date. Since recovery in these markets may well accrue only to superior-quality properties, prudence suggests investing more selectively.

The bulk warehouse hubs and gateways of Atlanta, Chicago and Newark also will need more time to recover, but large-bay warehouse fundamentals are healthier than metro averages indicate. We recommend targeting only modern Class A warehouse in these markets; though they may provide only average returns performance, prime warehouses have proven to be highly liquid markets and contain ample high-quality investment targets.

Riverside, Dallas and Houston have been star performers recently, and the two former markets remain good choices in 2014. Market rents and land values are coming back strongly in Riverside, and market fundamentals in Dallas are reaching levels not seen since the 1990s. Conversely, future outperformance in Houston appears unlikely, given lofty pricing today, relatively strong rent levels through the downturn, and future supply-side concerns.

Over the longer term, we advocate overweighting high-barrier markets and either market-weighting or underweighting in lower-barrier markets. During the past three years, both low- and high-barrier markets achieved strong vacancy declines, as exhibited in the chart on the following page, but high-barrier markets tend to perform better during growth cycles and recessionary times. Modern post-2000 construction experienced the greatest improvement in both high-barrier and low-barrier markets, in which vacancy has declined well below prior cycle lows.



Sources: CBRE-EA and Deutsche Asset & Wealth Management.
As of February 2014.

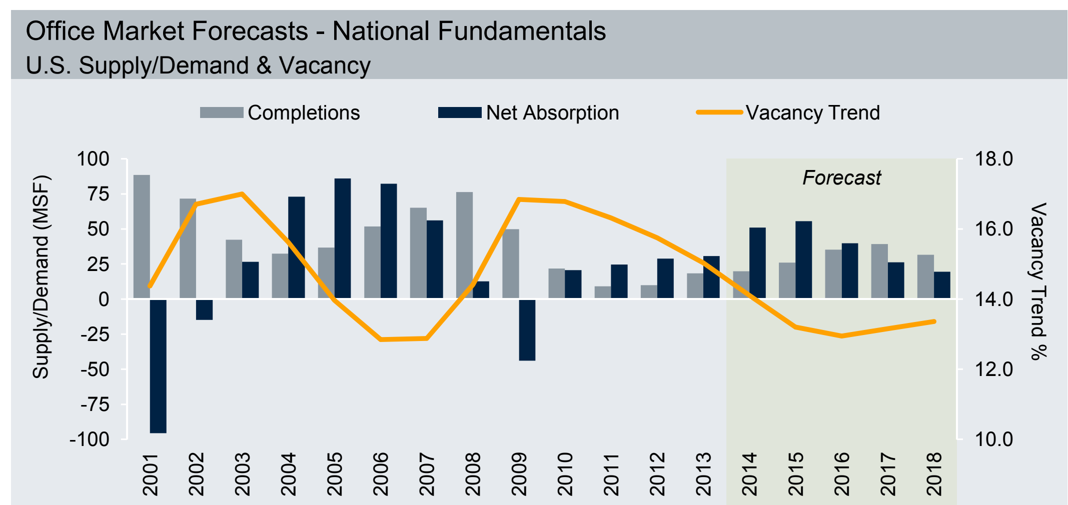
Sector Strategies: The industrial property sector is attracting intense attention from investors, and values have increased in anticipation of higher growth. However, core investors will still be able to find good opportunities in 2014 as the sector is still in recovery. Sustained momentum from demand drivers will continue to benefit well-located, modern bulk and multi-tenant warehouse in our investable universe, as well as functional class B properties in prime metros and submarkets. New multi-tenant warehouse supply will be limited in the near term as current lease rates cannot justify new construction, so there is potential for healthy rent and NOI growth. However, we continue to be cautious about the prospects of rent recovery for older vintage warehouses in low-barrier markets due to concerns about functionality for modern logistics.

In addition, market conditions have been stubbornly challenging within the flex sub-sector. Flex comprises about 35% of the U.S. industrial stock, but commanded only 18% of total demand since 2011, much weaker than the 26% captured in the mid-2000s and 28% in the late 1990s.

In summary, we prefer the prospects for markets with limited and expensive land supplies, high incomes, and vibrant economic activity. R&D/office and business park properties are favored over light industrial, manufacturing and more specialized facilities. Our target markets tend to have high tech drivers, comprising San Jose, Oakland, Los Angeles, Orange County, San Diego, Miami, Fort Lauderdale, Seattle and Portland. Global linkages, technology, renewed housing production and local spending growth should help revive trends in these markets over the next two years.

Outlook for the Office Sector

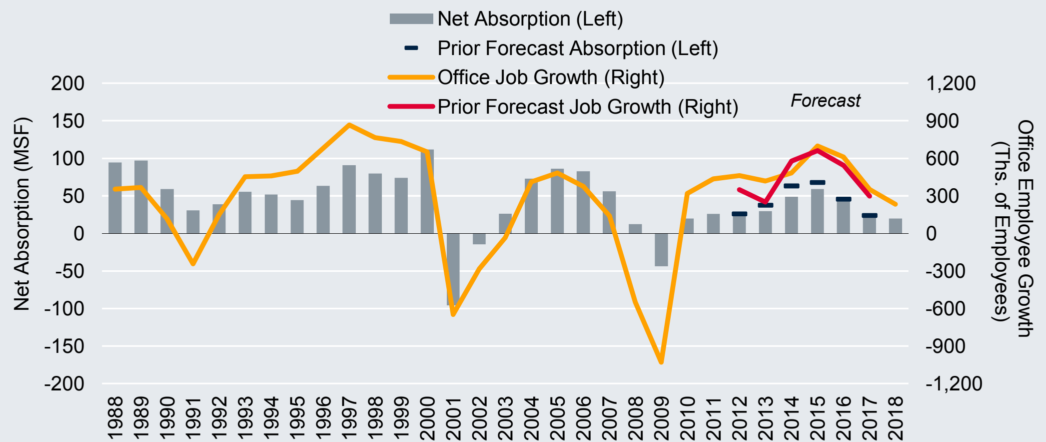
The Office Recovery Broadens – But Selectively: The U.S. office market recovery spread beyond tech and energy-rich metros to include a wider array of markets in 2013. But areas experiencing the strongest rent growth have been confined to the best submarkets; the common thread is the presence of live/work/play environments, whether located downtown or in inner suburbs. Construction added only 0.3% to stock last year, so new supply did not pose a threat for most metros, although several markets do have a significant pipeline underway. The largest challenge facing the sector remains weak demand growth – despite solid job gains – as tenants expand into existing shadow space while also making more efficient use of their space than before. As a result, absorption in 2013 remained well below its long-term average for a recovery year, and vacancy declined by only about 50 basis points to 14.9% during the year despite limited new development.



Sources: CBRE-EA and Deutsche Asset & Wealth Management.
As of February 2014.

Market Outlook: Construction levels remain low nationally, boding well for remaining vacancies as demand increases. The greatest supply is expected in 2015 and 2016, but the overall level should stay relatively tame, adding only about 1.0% to stock during each of those years. By contrast, the office market saw additions of 2.2% and 3.5% during the two prior cycles (peaking in 2008 and 1999, respectively). While the pipeline is very active in New York and San Francisco, these metros face low near-term risk since they have strong demand outlooks and long completion schedules. Nonetheless, New York warrants some near-term caution on the demand side due to continued financial sector retrenchment last year, causing negative absorption in 2013. Nevertheless, vacancy rates in New York are amongst the lowest in the country and supply risks are muted with the exception of the delivery of the Freedom Tower and Hudson Yards. Near-term risks continue in Washington, as a large pipeline is delivering. However, demand has reversed course and turned positive for the past three quarters, with downtown being especially strong. Austin has the second highest construction underway relative to existing supply, adding 6.4% to stock in total during the next two years, while Houston is also high on the list adding 3.7% to inventory during the same time, raising supply risk issues in these metros despite strong demand.

Office Absorption vs. Job Growth for Sum of Markets



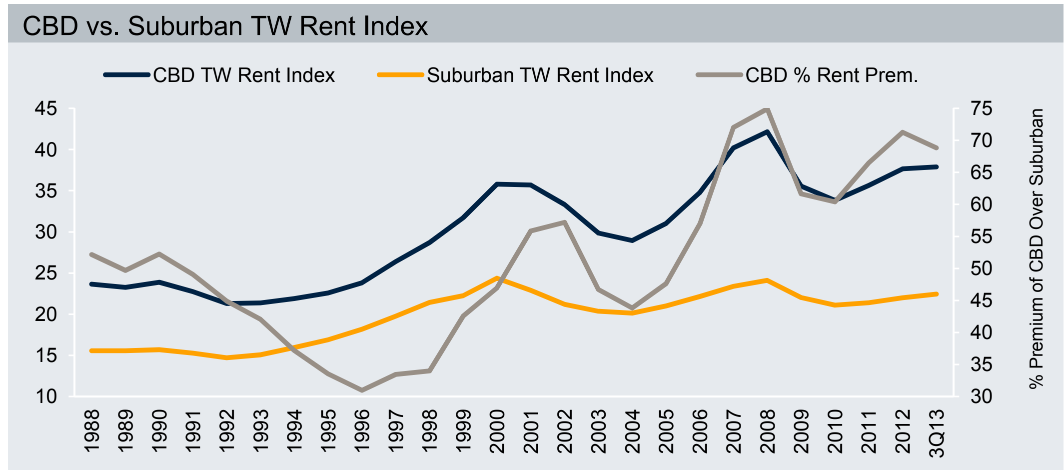
Sources: CBRE-EA, Moody's Analytics and Deutsche Asset & Wealth Management.
As of February 2014.

Business investment remains well below peak levels reached during the prior two cycles, and capacity utilization remains below its long-term average, suggesting upside for these key office demand drivers. Office absorption has grown in each of the past successive four years, albeit weakly, and is finally expected to begin showing larger gains in 2014 and 2015—the peak absorption years in our forecast—in response to accelerating job additions. Nonetheless, the re-absorption of shadow space and increased efficiencies in tenant layouts will continue to limit the amount of space demanded relative to job growth. Office tenants are absorbing space at less than half the long-term average of about 165 square feet per employee, making the shape of demand recovery similar to that of the mid-1990s.

As demand expands and supply remains relatively limited, vacancy is expected to reach its long-term average of 14% this year and decline below 13% in 2015, opening the way for accelerated rent growth and achieving the highest increases in 2015 and 2016.

Sector Strategies: While the earliest recovery submarkets had strong ties to high tech or energy, pockets participating in the newest wave of rent increases are typically in suburban nodes with strong live/work/play environments. Examples of such submarkets—achieving double digit rent increases during 2013—include Buckhead and Central Perimeter (Atlanta), Coral Gables (Miami) and Walnut Creek (Oakland). Functioning live/work/play environments are most commonly found in healthy downtowns, and our analysis indicates that the spread in rents paid for CBDs has been widening during the recovery. More importantly, the rent premium for CBD space over suburban space has generally increased from one cycle to the next. Thus, while suburban rents should rise as CBD rents rise, we believe the spread between CBD and suburban rents will continue to grow, to the benefit of downtown assets. A similar trend is expected for live/work/play centers over commodity locations.

CBD vs. Suburban TW Rent Index



Sources: CBRE-EA and Deutsche Asset & Wealth Management.
As of February 2014.

There are a half dozen markets that attract a disproportionate share of investment capital, but they face varying near-term prospects. San Francisco's Financial District and South of Market have fully recovered and show near-term continued demand expansion, but construction underway should begin to moderate rents soon. Washington, D.C.'s East End/CBD was another early recovery submarket – although stymied and set back lately by federal government woes – and should begin seeing more signs of rent growth later in the forecast. New York, which faced yet another retrenchment of financial tenants last year, is poised to start seeing appreciable rent movement after this year, while Downtown stands to benefit from spillover of now-pricey rents in Midtown South. Boston's rent recovery continued on a path from Cambridge to Back Bay to Seaport, leaving the Financial District poised to benefit next from the growing recovery. Finally, Los Angeles, while facing slow demand metro-wide, has already seen significant movement in West L.A.'s most desirable nodes, which is expected to continue as the recovery takes further hold.

In short, we expect the office market recovery to strengthen and spread during 2014 and beyond. Some metros most widely held by institutional investors still have room for fundamentals to tighten further, while others are at or near recovery. Suburban areas should participate more widely in the recovery, but the best performance will continue to be achieved in those submarkets with compelling live/work/play nodes.

Outlook for the Retail Sector

More of the Same: For a sector as dynamic as retailing, which is constantly reinventing itself with new products to sell and new ways of selling them, retail *property* markets have been remarkably consistent and almost resistant to improvement. As we have been reporting in our annual U.S. Real Estate Strategic Outlooks and midyear updates going back to 2011, the financial health of both consumers and retailers continues to strengthen, but these gains have yet to translate into a robust, broad-based retail property recovery. Based on CoStar data, occupancy in the fourth quarter was up for the sixth consecutive quarter, and for the 13th of the past 14 quarters. But for all that, vacancies at the nation's shopping centers have declined only 100 basis points since peaking in early 2010, and remain some 300 basis points above the long-term average.

With leasing chipping away at only perhaps a quarter of the excess vacancy, shopping center landlords have been unable to push rents, which fell again at the end of 2013, as they have for 17 of the past 19 quarters. Rents at malls, power centers, and community centers all ended the year lower than a year earlier, which in turn, were lower than in 2011. Overall, rents are still down 15% to 25% off peak, depending on the type of center.

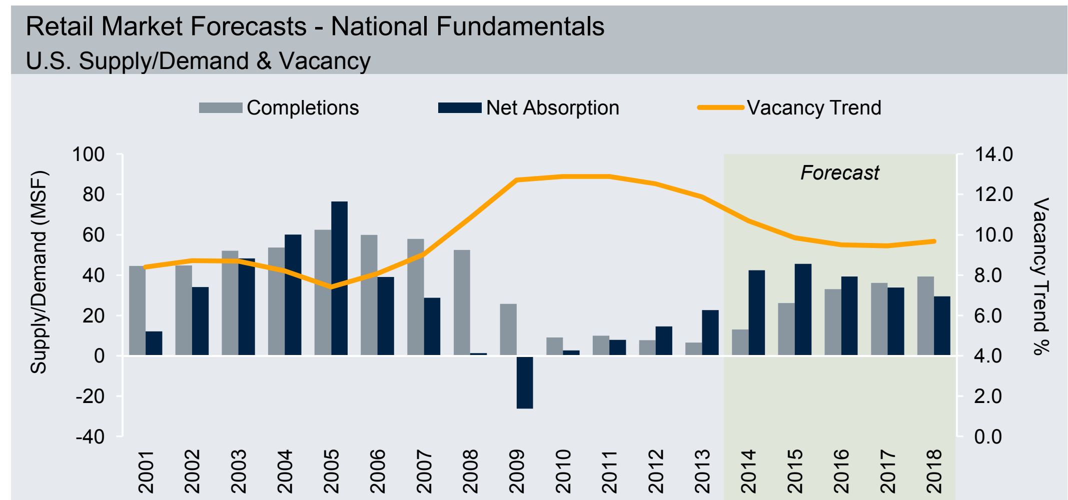
The conspicuous exception continues to be freestanding retail space, particularly the high street shops of leading downtowns in the United States. Occupancy has surged above its pre-recession highs, while rents have gained in eight consecutive quarters since the end of 2011. Comprehensive data for high street retail is not published, but we estimate these rents to be at or above prior peaks, especially in the top districts of New York, Los Angeles, Chicago, and San Francisco, among others, though still below prior peaks in many other metros.

Not all centers and markets are suffering equally, however. Another continuing theme is the bifurcated recovery, as the split between the best- and worst-performing shopping centers grows ever wider and seems to be enduring. A key driver here is e-commerce, which increasingly drains retail sales out of shopping centers, and both shifts and reduces retailer demand for space. National chains are embracing the showrooming phenomenon, carrying only a representative selection of products in their stores and encouraging their customers to shop online. Figures from the 2013 holiday season are telling: Retail sales (excluding auto-related and restaurants) during November and December rose an impressive 3.8% overall over 2012, but the in-store gains were limited to 2.9% while online sales rose 9.3%. Online sales captured virtually 16% of seasonal sales, and this figure would be larger if we exclude grocery and personal care items that rarely transact online.

In summary, the main story for the retail sector, once again, is that the traditional demand drivers are recovering faster than property fundamentals. Consumers are financially stronger and have the confidence to spend, driving sales – both in shopping centers and online – to record levels. And retail chains are again increasing their store counts. But retailers are content with fewer and smaller stores than before. Thus, the centers with high vacancy continue to have trouble attracting tenants. As a result, fundamentals at most properties continue to improve, if slowly, but many centers lag and will never catch up, blunting the overall recovery figures.

Market Outlook: Overall, the nation's retail property markets continue their frustratingly slow improvement. Our forecast still calls for very gradual market recovery in the near term

consistent with recent trends, with accelerating gains in the later years as retailers continue to strengthen and more have announced store openings. Vacancies in community and neighborhood shopping centers declined to 12.0% at year end, and our forecast calls for the rate to drop below 10% by 2015, as moderate demand absorbs existing vacancies and little new space is added to the market. With a pickup in deliveries starting in 2016, we expect vacancies to essentially flatten thereafter through the end of our forecast period in 2018. Rent growth will generally occur commensurate with occupancy strength, and peak rents will not likely be reached nationally until 2017 or later.



Note: Neighborhood and community centers only.
Sources: CBRE-EA and Deutsche Asset & Wealth Management.
As of February 2014.

Geographically, we expect the recovery to extend to more markets and submarkets, but not to the extent of prior expansions. Retailers are just being too selective in their store location strategies. Of the 142 metros tracked by CoStar, 115, or about 80%, had positive net absorption in 2013; excluding those with deliveries exceeding net leasing, the number of metros with declining vacancies falls to just under 70%. Thus, the recovery has been concentrated, with almost a third of metros continuing to see fundamentals deteriorate. A painful illustration: Struggling department store chain JC Penney just announced the closure of 33 stores, every one located in a secondary or tertiary market.

Sector Strategies: Once again high-street retail was the best performing retail type this past year, but it's hard to pick relative outperformers among the major types of retail centers: Power centers lost the most rent during the recession, but have gained the most occupancy during the recovery. Regional malls outperformed power centers early in the recession but have struggled more with rents and occupancy in recent periods. Meanwhile, neighborhood and community centers suffered the least rent erosion during the downturn, but have made the least progress in reducing excess vacancies.

We continue to prefer dominant regional malls and unique retail offerings, as retailers seek to showcase their wares in high-profile space and shoppers gravitate to the most exciting shopping experiences. Power centers pose the greatest risk of sales erosion to online shipping, particularly centers located in secondary markets. Investors also should beware of the growing risks to grocery-anchored neighborhood centers, as discounters, specialty stores,

and now online retailers eat away market share from traditional grocers, posing particular risk to weaker regional supermarket chains. With the loss of their anchors, such centers also could be doubly hit as the mom & pop shops that populate the in-line space already struggle with limited access to capital and greater threats from e-commerce. Centers that cater to lower-income households also may suffer disproportionately from recent federal legislation reducing unemployment benefits, cutting food stamp eligibility, and requiring households to purchase health insurance, all of which can reduce retail spending at the margin.

Market selection tends to be less important in retail than in other property sectors, as individual asset selection is especially critical: almost every submarket in America can support at least one successful retail center, but inferior centers can have trouble attracting tenants (and shoppers) no matter what the rent. Nonetheless, we still see relative outperformance in supply-constrained markets, particularly those in more affluent gateway metros. Our top picks this year include San Jose, Orange County, New York and Miami, as well as traditional retail leaders like San Francisco, Los Angeles, and Seattle. All of these metros are found on the coasts, to which we add Austin, Portland, and Denver – all dynamic, growing, young cities with relatively underdeveloped retail sectors.

Real Estate U.S. House Portfolio

The Deutsche Asset & Wealth Management House Portfolio (House Portfolio) is a recommended allocation by property sector for core portfolios in the United States for those investors seeking to outperform the NCREIF Property Index (NPI). We develop the House Portfolio as an unlevered portfolio of properties for a U.S. investor without regard to tax consequences. The House Portfolio is formulated using both quantitative and qualitative modeling, integrated with our House View. The resulting weights we believe aid in providing long-term risk-adjusted outperformance to our portfolios versus the market as a whole and against relevant benchmarks and indices. The analysis focuses on the four major property sectors and excludes hotels.

The following table summarizes the recommended weightings in comparison with the NPI. An active overweight is recommended for the industrial sector, with a slight (-1%) underweighting to the retail sector, and greater underweights (-2%) to the apartment and office sectors.

House Portfolio Construction – Sector Allocation							
Sector	**NPI Weights**	**Research Forecasts**	**Quantitative Input[1] Weights**	**Qualitative Inputs[2]**	**House Portfolio[3]**	**Active Bet**	**Recommended House Portfolio Range**
Apartment	25%	- Fully valued without additional cap rate compression - Strong demographic support from a prime renter age cohort - Well into the growth cycle, allowing limited future gains in NOI	Model suggests underweight	Well into growth cycle, supply risk growing	23%	(2%)	18% - 28%
Industrial	14%	- Expect relatively high going-in return and solid income growth as rents rise with occupancy - Benefits from expanding US population and job gains as well as housing production, technology consumption and trade - Rents rising, and gain momentum in next two years.	Model suggests overweight	Increased investor appetite for sector, in line with improved fundamentals	23%	9%	18% - 28%
Office	35%	- Increases in business environment and growing pace of job growth will increase space demand - During the forecast, 2015&2016 should turn in the highest rent growth for the US as vacancies tighten significantly - Rent recovery is spreading to more locations outside of tech, energy and gateway hubs.	Model suggests underweight	The number of metros in recovery is still limited, but more are turning the corner, portending entry into a more widespread growth cycle	33%	(2%)	28% - 38%
Non-Mall Retail	23%	-Higher yield will make long duration leases less attractive - Rent growth still slow to spread beyond top markets and retail centers -Bifurcation results in stronger winners while e-commerce will squeeze weaker retail centers further out of favor	Model suggests underweight	Limited upside in growth cycle; muted recovery forecast	22%	(1%)	17% - 27%
Hotel	2%	N/A	Underweight	N/A	0%	(2%)	0%

[1]Quantitative inputs based on RREEF Quantitative Allocation Model.

[2] Qualitative Inputs include inputs from Transactions, Asset Management and Portfolio Management teams.

[3] House Portfolio is the target allocation that incorporates both qualitative and quantitative views in addition to tactical and strategic considerations.

Sources: NCREIF and Deutsche Asset & Wealth Management.

As of February 2014.

Apartments – **Underweight:** Apartment property fundamentals are well into the growth cycle. Total returns are decelerating as supply grows rent growth slows. With this in mind, the House Portfolio suggests underweighting the apartment sector relative to the NPI with a 23% weighting.

Industrial – Overweight: We see accelerating momentum in both rent growth and capital market valuations. Industrial assets should benefit from expanding U.S. population and job gains as well as housing production, technology consumption and trade. The industrial sector is expected to outperform the NPI during the next five years and the House Portfolio suggests an allocation of 23%, fully nine percentage points above the NPI weight.

Office – Underweight: While the office sector is expected to outperform the NPI during the next five years, it is not yet at full strength. We recommend that investors should start investing more heavily to have a higher weighting in the office sector as it reaches its peak rent growth in 2015 and 2016. Thus, our House Portfolio suggests an allocation of 33%.

Retail – Underweight: The retail sector has slowed in terms of both total return performance and NOI growth. Higher treasury yields work against investing in retail properties, which have longer duration leases. The retail sub-index of the NPI is expected to underperform the overall index during the next few years. Thus, our House Portfolio suggests slight underweight of 22% to the sector.

ESG Considerations

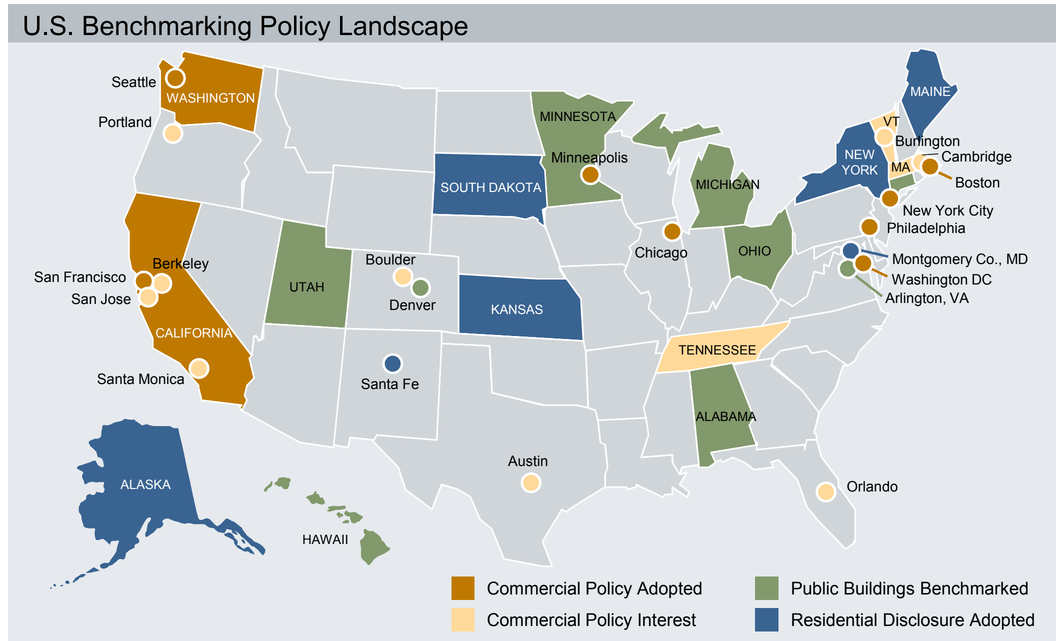
Investors are increasingly weighing ESG (Environmental / Social / Governance) credentials and capabilities of their managers and their investments in the belief that efficient, high-performance green buildings and green building practices are part of disciplined financial investment decision-making. The past two years have seen significant advances in sustainability research in the United States and globally.

Link between ESG, Financial Performance, and Risk. At least ten studies published between 2007 and 2011 found a positive correlation between sustainability and financial performance; we are not aware of any studies with results to the contrary. The number of studies demonstrating this link continues to grow. In an interesting nuance, at least one study now shows that achieving green labels and ratings reduces market beta, which translates into a reduced probability of incurring a loss.[3] On average, a one percent increase in the weight of green properties within an REIT portfolio was found to decrease market beta by 0.14 for LEED-certified properties and by 0.01–0.03 for Energy Star-certified[4] properties.

ESG Regulation Requirements. Energy benchmarking and disclosure requirements continue to proliferate in the United States. The Institute for Market Transformation tracks such regulations, which are now in nine major United States cities and two states – generally markets that attract a disproportionate share of investor interest and that generally rank high in our market outlooks. In some cases, such as in New York City and Washington, D.C., these disclosures are made public unconditionally, while in other jurisdictions (e.g., California) information must be disclosed upon sale, lease or financing, similar to requirements with regard to Energy Performance Certificate (EPC) in European Union member states. Low-performing and non-compliant buildings in the market face leasing and transaction challenges.

[3] Eichholtz, P., et al., Portfolio greenness and the financial performance of REITs, Journal of International Money and Finance (2012), doi:10.1016/j.jimonfin.2012.05.014.

[4] Energy Star-certified buildings indicate their energy consumption is in the top quartile (25%) of efficiency in the United States.


U.S. Benchmarking Policy Landscape

Sources: BuildingRating.org, maintained by The Institute for Market Transformation (IMT), a nonprofit organization promoting energy efficiency, green building and environmental protection in the United States and abroad.
As of February 2014.

Practical Impacts on Valuation. A main driver of the findings indicating lower risk associated with green ratings and energy labels is lower occupancy risk. Of course, there remain instances where stronger resource efficiency and certifications will not impact leasing, but what has become clear through industry guidance is that broader valuation frameworks are evolving to provide appraisers and investment professionals with practical approaches to determine which value drivers within a Discounted Cash Flow (DCF) model should be considered. Importantly, much of this guidance is irrespective of any “green” certifications.

In the past year, formal guidance has been issued by major industry associations regarding how to incorporate sustainability principles and related data into the appraisal and valuation process. In the United States, the Appraisal Institute issued guidance on how “green” fits into the four components of value (revenue, occupancy, operating expenses and risk), and how to incorporate these factors into assessments of local market comparables and tenant demand. This guidance also sheds light on how specific building characteristics improve building performance and tenant appeal. Similarly, the Royal Institute of Chartered Surveyors in Europe drafted a formal “guidance note” that sets out a valuation framework for sustainability issues.

These and other organizations have set a similar and broad framework within which ESG issues should be incorporated into property valuations. As these valuation frameworks are adopted, they can potentially nudge investor decisions further in the direction of outperformance.

Appendix I: Real Estate Target Markets

Investable and Target Markets

✓ Target Investable Metros ✓ (red) Investable Metros

Market	Apartments	Industrial	Office	Retail*
Atlanta	✓ (red)	✓ (red)	✓	✓ (red)
Austin	✓ (red)	✓ (red)	✓ (red)	✓
Baltimore	✓ (red)	✓ (red)		
Boston	✓		✓	✓ (red)
Charlotte	✓ (red)			✓ (red)
Chicago	✓ (red)	✓ (red)	✓	✓ (red)
Dallas	✓ (red)	✓	✓	✓ (red)
Denver	✓ (red)	✓	✓	✓
Fort Lauderdale	✓	✓	✓	✓
Houston	✓ (red)	✓ (red)	✓ (red)	
Long Island				✓ (red)
Los Angeles	✓	✓	✓	✓ (red)
Miami	✓	✓	✓	✓
Minneapolis	✓ (red)	✓ (red)		
New York	✓	✓	✓	✓
Northern New Jersey	✓	✓		✓ (red)
Oakland / East Bay	✓	✓	✓ (red)	✓ (red)
Orange County	✓	✓	✓	✓
Philadelphia	✓ (red)			✓ (red)
Phoenix	✓ (red)	✓ (red)	✓ (red)	
Portland	✓ (red)	✓ (red)	✓ (red)	✓
Riverside	✓	✓		
San Diego	✓	✓	✓	✓ (red)
San Francisco	✓	✓ (red)	✓	✓
San Jose	✓	✓	✓	✓
Seattle	✓	✓	✓	✓
Ventura County	✓			
Washington DC	✓ (red)	✓ (red)	✓ (red)	✓
West Palm Beach	✓ (red)	✓ (red)	✓ (red)	✓ (red)
Total	**28**	**24**	**21**	**23**

*For retail properties, the top two centers in most major markets would also be recommended in addition to the list of target metros.

Source: Deutsche Asset & Wealth Management.

As of February 2014.

Important Information

Deutsche Asset & Wealth Management represents the asset management and wealth management activities conducted by Deutsche Bank AG or any of its subsidiaries. Clients will be provided Deutsche Asset & Wealth Management products or services by one or more legal entities that will be identified to clients pursuant to the contracts, agreements, offering materials or other documentation relevant to such products or services. In the U.S., Deutsche Asset & Wealth Management relates to the asset management activities of RREEF America L.L.C.; in Germany: RREEF Investment GmbH, RREEF Management GmbH, and RREEF Spezial Invest GmbH; in Australia: Deutsche Australia Limited (ABN 37 006 385 593) an Australian financial services license holder; in Japan: Deutsche Securities Inc. (For DSI, financial advisory (not investment advisory) and distribution services only); in Hong Kong: Deutsche Bank Aktiengesellschaft, Hong Kong Branch (for direct real estate business), and Deutsche Asset Management (Hong Kong) Limited (for real estate securities business); in Singapore: Deutsche Asset Management (Asia) Limited (Company Reg. No. 198701485N); in the United Kingdom: Deutsche Alternative Asset Management (UK) Limited, Deutsche Alternative Asset Management (Global) Limited and Deutsche Asset Management (UK) Limited; in Italy: RREEF Fondimmobiliari SGR S.p.A.; and in Denmark, Finland, Norway and Sweden: Deutsche Alternative Asset Management (UK) Limited and Deutsche Alternative Asset Management (Global) Limited; in addition to other regional entities in the Deutsche Bank Group.

Key Deutsche Asset & Wealth Management research personnel are voting members of various investment committees. Members of the investment committees vote with respect to underlying investments and/or transactions and certain other matters subjected to a vote of such investment committee. Additionally, research personnel receive, and may in the future receive incentive compensation based on the performance of a certain investment accounts and investment vehicles managed by Deutsche Asset & Wealth Management and its affiliates.

This material was prepared without regard to the specific objectives, financial situation or needs of any particular person who may receive it. It is intended for informational purposes only. It does not constitute investment advice, a recommendation, an offer, solicitation, the basis for any contract to purchase or sell any security or other instrument, or for Deutsche Bank AG or its affiliates to enter into or arrange any type of transaction as a consequence of any information contained herein. Neither Deutsche Bank AG nor any of its affiliates gives any warranty as to the accuracy, reliability or completeness of information which is contained in this document. Except insofar as liability under any statute cannot be excluded, no member of the Deutsche Bank Group, the Issuer or any officer, employee or associate of them accepts any liability (whether arising in contract, in tort or negligence or otherwise) for any error or omission in this document or for any resulting loss or damage whether direct, indirect, consequential or otherwise suffered by the recipient of this document or any other person.

The views expressed in this document constitute Deutsche Bank AG or its affiliates' judgment at the time of issue and are subject to change. This document is only for professional investors. This document was prepared without regard to the specific objectives, financial situation or needs of any particular person who may receive it. No further distribution is allowed without prior written consent of the Issuer.

An investment in real estate involves a high degree of risk, including possible loss of principal amount invested, and is suitable only for sophisticated investors who can bear such losses. The value of shares/ units and their derived income may fall or rise. Any forecasts provided herein are based upon Deutsche Asset & Wealth Management's opinion of the market at this date and are subject to change dependent on the market. Past performance or any prediction, projection or forecast on the economy or markets is not indicative of future performance.

The forecasts provided are based upon our opinion of the market as at this date and are subject to change, dependent on future changes in the market. Any prediction, projection or forecast on the economy, stock market, bond market or the economic trends of the markets is not necessarily indicative of the future or likely performance.

© 2014 Deutsche Bank AG. All rights reserved. (01/14) I-026612-7.0

Office Locations:

Chicago
222 South Riverside Plaza
24th Floor
Chicago
IL 60606-1901
United States
Tel: +1 312 537 7000

Frankfurt
Mainzer Landstraße 178-190
60327 Frankfurt am Main
Germany
Tel: +49 69 71909 0

London
Winchester House
1 Winchester Street
London EC2A 2DB
United Kingdom
Tel: +44 20 754 58000

New York
345 Park Avenue
24th Floor
New York
NY 10154-0102
United States
Tel: +1 212 454 6260

San Francisco
101 California Street
26th Floor
San Francisco
CA 94111
United States
Tel: +1 415 781 3300

Singapore
One Raffles Quay
South Tower
Singapore 048583
Tel: +65 6538 7011

Tokyo
Floor 17
Sanno Park Tower
2-11-1 Nagata-cho
Chiyoda-Ku
Tokyo
Japan
Tel: +81 3 5156 6000

Research & Strategy Team – Alternatives and Real Assets

Global

Mark Roberts
Head of Research & Strategy
mark-g.roberts@db.com

Americas

Ross Adams
Industrial Specialist
ross.adams@db.com

Bill Hersler
Office Specialist
bill.hersler@db.com

Ana Leon
Property Market Research
ana.leon@db.com

Andrew J. Nelson
Retail & ESG Specialist
andrewj.nelson@db.com

Jaimala Patel
Quantitative Strategy
jaimala.patel@db.com

Alexander Makarovski
Performance & Risk Analysis
alexander.makarovski@db.com

Alex Symes
Economic & Quantitative Analysis
alex.symes@db.com

Brooks Wells
Apartment Specialist
brooks.wells@db.com

Jay Wengang
Performance & Risk Analysis
jay.wengang@db.com

Europe

Simon Durkin
Head of Research & Strategy, Europe
simon.durkin@db.com

Tom Francis
Property Market Research
tom.francis@db.com

Matthias Naumann
Property Market Research
matthias.naumann@db.com

Lisa Strohbuecker
Property Market Research
lisa.strohbuecher@db.com

Maren Vaeth
Property Market Research
maren.vaeth@bd.com

Simon Wallace
Property Market Research
simon.wallace@db.com

Asia Pacific

Koichiro Obu
Head of Research & Strategy, Japan & Korea
koichiro.obu@db.com

Minxuan Hu
Property Market Research
minxuan.hu@db.com

Natasha Lee
Property Market Research
natasha-j.lee@db.com