

Research Report

# European Real Estate Strategic Outlook

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## Executive Summary

The European landscape has largely unfolded as forecast in our European Strategic Outlook that was published in August 2013. A gradual improvement in the underlying economy is driving differentiation as growth slowly emerges at different rates across the Continent. The strategies that were outlined 6 months ago remain largely relevant in the current market.

- Recovery is forecast to be led by the United Kingdom, the Nordics and Germany, but the clear division of Northern and Southern Europe, evident over the past five years and discussed in the previous paper, is becoming less defined by these metrics. The outlook for Northern Europe is more fragmented, with U.K. growth anticipated to be more than twice that of the Netherlands, the recovery in Southern Europe could see markets such as Spain regularly outperforming the rest of the Eurozone during the second half of the decade.
- Policy loosening in Europe is set to be in contrast to the Federal Reserve, where the tapering of quantitative easing is set to begin in 2014. Moves towards U.S. policy normalisation could be met with financial market volatility and higher global bond yields, and may also weigh upon the Euro, which has been surprisingly resilient in recent years.
- Downside risks to the economic outlook remain evident but upsides should not be forgotten. The positive momentum building across Europe is potentially leading to a stronger than expected near-term rebound.
- In the Core European markets, prime yields have moved in further chased lower by the large volume of capital targeting limited opportunities. While current spreads are comfortable, the rise in government bond rates finally seems to be arriving. In the short term, we do not expect this to have much effect on prime property yields, given the current spread, but further bond yield movement is likely to put a floor on real estate yield compression. In the longer term, expectations of rent growth should help to temper property yield rises, but at least in the core markets prime value growth is unlikely to be yield-driven.
- In line with our predictions earlier last year, 2013 marked a marginal further weakening of European occupier fundamentals. In the office sector, net absorption remained comfortably positive last year, the retail sector continues to be driven by structural change and retailer consolidation and improvements in the logistics market are selective, focussed at the end of the market where prime location remains a key consideration for success. As economic headwinds slowly begin to change, a certain level of optimism is beginning to return, which is forecast to filter through to real estate fundamentals.
- Strategies relevant for this cycle remain a focus on perceived safe haven locations for certain investors such as Central London and Munich. A focus on markets where low levels of supply have resulted in a constrained environment yet we see demand picking up due to improving job growth, exports and occupier confidence, including regional UK and second tier German Cities. A focus on high yield strategies where risks have reduced such as development of high quality logistics and certain CEE markets, or the provision of real estate debt, DTZ still estimate that the net debt funding gap in Europe is now down to \$42 billion.<sup>1</sup>

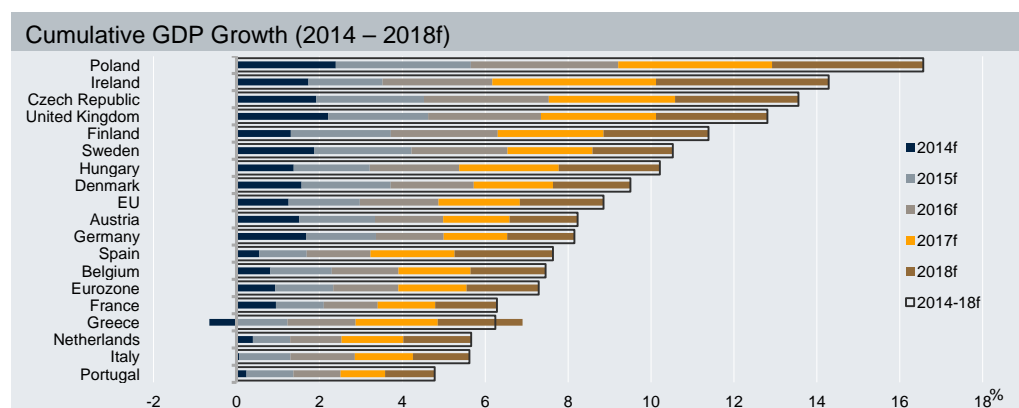
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<sup>1</sup> DTZ, Net Debt Funding Gap, November 2013

## The Economy

Europe returned to growth during the second quarter of 2013. The pace of the upturn has been expectedly modest, and as such total E.U. output growth is predicted to be zero over the year as a whole – compared to -0.3% six months ago. In response to this upturn, the outlook for growth has been upgraded, although the change has been relatively minor and the recovery will likely be slow and uneven. At a country level, larger adjustments are evident, with notable upward revisions in the United Kingdom and Iberia. An improved outlook has not been ubiquitous across the continent, but from 2014 onwards all countries bar Greece are set to return to a period of sustained growth.<sup>2</sup>

The recovery is forecast to be led by the United Kingdom, the Nordics and Germany, but the clear division of Northern and Southern Europe, evident over the past five years, is becoming blurred. Not only is the outlook for Northern Europe more fragmented, with U.K. growth anticipated to be more than twice that of the Netherlands, the recovery in Southern Europe could see markets such as Spain regularly outperforming the rest of the Eurozone during the second half of the decade. CEE countries remain some of the top performers, however recent volatility in emerging markets suggests risks exist in this region as global monetary policy starts to be tightened.<sup>3</sup>



Source: Oxford Economics, September 2013.

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

The probability of a disorderly Eurozone exit has fallen again to a point where this outcome is almost being discounted. Much remains to be done to ensure the long-term success of the Euro, but without the threat of a disorderly break-up, bond yields in the Periphery have declined further and confidence has been on an upwards trend. Less fiscal austerity should further support the improved climate, although growth will likely be held back by weaknesses in the banking sector, and the resulting credit constraints.<sup>4</sup> The ECB's Asset Quality Review and banking stress tests in 2014, may help the process of financial stabilisation, but does run the risk of bringing to light fragility within the banking sector, potentially further weighing upon the availability of real estate finance, particularly within Southern Europe and for less prime stock.

Despite the return of growth, most European economies are set to be operating well below their productive potential for a number of years to come. Spare capacity has been weighing upon prices during 2013, and with E.U. inflation at just 1.0% in December 2013, the risk of deflation has increased.<sup>5</sup> This is not our main forecast for Europe, as faster

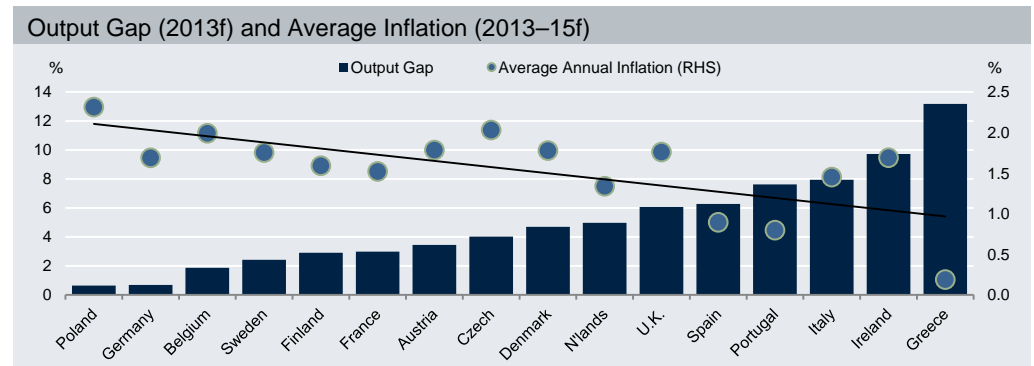
<sup>2</sup> Oxford Economics, September 2013

<sup>3</sup> Oxford Economics, September 2013

<sup>4</sup> Oxford Economics, September 2013

<sup>5</sup> Eurostat, January 2014

growth and a weaker Euro should support prices, while the structure of the European economy does not suggest a long period of Japanese style deflation. However at a national level price growth has stalled in Iberia, and is already negative in Greece. Given the already weak fiscal positions, the threat of deflation is particularly acute across the Periphery, increasing real bond yields and pushing up the debt-to-GDP ratio.



Source: OECD, Eurostat, Oxford Economics, December 2013.  
 Note: f = forecast. There is no guarantee the forecast will materialise.

With inflation below target, monetary policy is expected to remain loose across Europe for much of the forecast period. Having cut its main interest rate to 0.25% in November 2013, the ECB may look to provide additional support. Moves to loosen policy further could face opposition, particularly in parts of Core Europe where policy is deemed overly accommodative and leading to inflationary pressures on both consumer and asset prices.<sup>6</sup>

Policy loosening in Europe is set to be in contrast to the Federal Reserve, where the tapering of quantitative easing is set to begin in 2014. Moves towards U.S. policy normalisation could be met with financial market volatility and higher global bond yields, and may also weigh upon the Euro, which has been surprisingly resilient in recent years. With the global economy due to strengthen, the anticipated weakening of the Euro should help to support export growth, and in turn boost demand for associated logistics activities.<sup>7</sup>

European unemployment is now considered to have almost peaked, with tentative falls anticipated throughout 2014. Despite this improvement, the unemployment rate is set to remain above its historic ten-year average of 8.5% – declining to 8.8% by 2018 from around 10% today.<sup>8</sup> Rising employment would likely boost demand for business space, however this market may face excess capacity for some time, suggesting the need for caution when investing outside of the major Core city markets.

Having gained confidence in 2013 with the labour market starting to stabilise, consumers are forecast to increase retail spending across most economies from 2014 onwards.<sup>9</sup> Lower inflation may support real wages and spending, but could risk consumers delaying purchases and the realisation of pent up demand, however over recent years household balance sheets have largely been delivered and are currently in a more healthy state than in the recent past. The evolution of online shopping continues, not only diverting sales from traditional locations, but also complicating the consumer journey, changing retailer needs and disrupting retail space leasing models.<sup>10</sup>

Downside risks to the economic outlook remain evident but upsides should not be forgotten, with the positive momentum building across Europe potentially leading to a stronger than expected near-term rebound. Further out, the Pan-European and national reform

<sup>6</sup> BCA, Q4 2013  
<sup>7</sup> Oxford Economics, September 2013  
<sup>8</sup> Oxford Economics, September 2013  
<sup>9</sup> Oxford Economics, September 2013  
<sup>10</sup> Javelin, Q4 2013

programmes recently undertaken, and those still to come, could lead to a sustained period of rising competitiveness, faster expansion and a more stable economic environment.

## European Real Estate Strategic Outlook

As discussed in the Economic Overview, we are beginning to observe some clarity on the European landscape with the region returning to growth in the second quarter of 2013 and the risks of a disorderly exit from the monetary union significantly decreased. The picture across Europe is one of differentiation. Whilst the whole region has largely been shrouded in risk, individual countries, and markets within countries are emerging at different stages in the real estate cycle.

To support the wider DeAWM platform and our investors we consider the resulting opportunities in terms of three executable strategies as outlined below.

### 1. Defensive 'safe havens' for specific investors

Despite the thesis that Europe has emerged from recession and that recovery, albeit at different rates, is predicted over the forecast period, there are still significant risks around this view. In this table we summarise our thoughts for specific investors who remain focussed on individual markets that in the event of a major economic shock might offer some level of protection.

Recommendations focus on large, liquid, global cities and property types that are cash-flow generative and less reliant on an improvement in the wider economic environment to deliver performance. Total return expectation would see returns peaking in the near term, declining over the forecast period and delivering an average office return over the period of between 4.0% and 6.0%<sup>11</sup> per annum varying by market. Long term performance (upwards of 80%) is driven by the income component with capital growth driving market volatility.

<p><b>Selective core office locations in London, Munich, Hamburg, Paris CBD and Stockholm</b></p>	<ul style="list-style-type: none"> <li>▪ Defensive in the face of major economic shocks, emphasis must be on liquid markets.</li> <li>▪ Strong economic fundamentals for long-term investors looking beyond cyclical volatility.</li> <li>▪ Some markets looking expensive relative to bonds and historical spreads.</li> <li>▪ Asset level characteristics and investor requirements critical to underwriting.</li> </ul>
<p><b>Long let major high street retail, supermarkets and residential</b></p>	<ul style="list-style-type: none"> <li>▪ <b>Emphasis on the major retail destinations with access to high footfall and large catchments.</b></li> <li>▪ <b>Less affected by the economic downturn; steady cash flow.</b></li> <li>▪ <b>Pricing already aggressive in a number of markets.</b></li> </ul>

<sup>11</sup> DeAWM Alternative and Real Assets Real Estate Research, all returns quoted are gross of depreciation and costs.

## Markets offering cyclical opportunities

The key themes driving this view involve the recent focus of investors on markets with a perceived 'safe haven' status at the expense of all other markets despite their underlying fundamental strength. The combination of Europe emerging from a deep recession, accommodating monetary policy, and structural change including regulation, sustainability, globalisation of capital, demographic change and migration of activities online, leads to a varied view of where opportunities lie as discussed below. Return expectations vary considerably with prime Spanish markets offering rising returns across the forecast period as the macro picture improves. In these markets therefore there is a greater reliance on capital growth to deliver returns and hence this will be more sensitive to changes in the wider economic environment. As forecast, the improving economic environment will allow greater income growth to be captured as the occupier markets, particularly in the Periphery, continue to improve. These markets are capable of offering significant risk adjusted returns when compared with their larger city counterparts.

<p><b>Fundamentally strong secondary locations in UK</b></p>	<ul style="list-style-type: none"> <li>▪ Risk averse investors generally “punish” secondary locations, partially regardless of their individual fundamental strength, though rising risk-free rates change relative risks.</li> <li>▪ Already a well documented strategy and increasing signs that investors are becoming comfortable in this space - window of opportunity to acquire attractively pricing stock closing.</li> <li>▪ Very selective approach and deep market knowledge on a regional/micro level necessary.</li> </ul>
<p><b>Prime Eurozone Periphery: Madrid, Dublin and Italian retail</b></p>	<ul style="list-style-type: none"> <li>▪ Yields in Ireland have already fallen across prime Dublin offices and indications of significant rental growth in 2013. Limited availability of prime stock.</li> <li>▪ Significant risk adjusted value. Pricing adjustment in Spain and Italy accelerated in 2013; risks reduced and yields well above historic average levels.</li> <li>▪ Prolonged economic weakness and secondary supply overhang to prevent broad upswing before 2015.</li> <li>▪ Rebound likely to be limited to a small subsection of prime assets and locations - location will remain key.</li> </ul>
<p><b>Prime logistic in key transportation hubs including UK, Poland and Benelux</b></p>	<ul style="list-style-type: none"> <li>▪ High level of income return and less dependent on uncertain future value growth.</li> <li>▪ Micro location is key: Growth potential is strongest close to northern seaports, within growing conurbations and distribution hubs which will benefit from rising demand of e-commerce.</li> </ul>
<p><b>Second tier German cities (see below for detailed market discussion)</b></p>	<ul style="list-style-type: none"> <li>▪ Due to the polycentric structure of the German economy, there are a range of investment opportunities beyond the Top 7 markets across all sectors.</li> <li>▪ A number of medium-sized cities continue to benefit from rising population growth due to regional migration and a dynamic labour market.</li> <li>▪ Investors can benefit from a critical mass of investible stock, sufficient liquidity, an attractive yield spread as well as high income security.</li> </ul>

## 2. High Yield Strategies

The successful implementation of higher yield strategies<sup>12</sup> often relies upon some degree of market dislocation, be it driven by a changing regulatory environment, asset risk aversion or simply the real estate cycle. In the current environment change is being driven on many levels and hence the opportunities outlined below seek to benefit from many of these themes.

<p><b>Poland, to some extent also Czech Rep</b></p>	<ul style="list-style-type: none"> <li>▪ Strong fundamentals with good relative long-term growth perspectives, as they will continue to converge towards Western Europe</li> <li>▪ Still classified as “emerging” despite relative maturity resulting in an unjustified premium.</li> <li>▪ High levels of new supply can pose a cyclical risk in some markets.</li> </ul>
<p><b>Developments in supply constrained markets such as core UK logistic locations and key gateway cities and ports.</b></p>	<ul style="list-style-type: none"> <li>▪ Historical low levels of deliveries of new stock to many markets due to suppressed demand, falling rents and a challenging debt funding environment.</li> <li>▪ As demand returns and debt markets loosen, opportunities present for the delivery of new and refurbished stock.</li> </ul>
<p><b>Debt</b></p>	<ul style="list-style-type: none"> <li>▪ Poor availability of property debt from traditional sources opens attractive opportunities for both core (senior) and higher yielding (junior, mezzanine) investments.</li> <li>▪ Competition intensifying as debt funds successfully reach first close.</li> <li>▪ DTZ still estimate that the net debt funding gap in Europe is now down to \$42 billion.<sup>13</sup></li> </ul>

<sup>12</sup> RREEF Real Estate Research, November 2011, The Case for European Opportunistic Investing

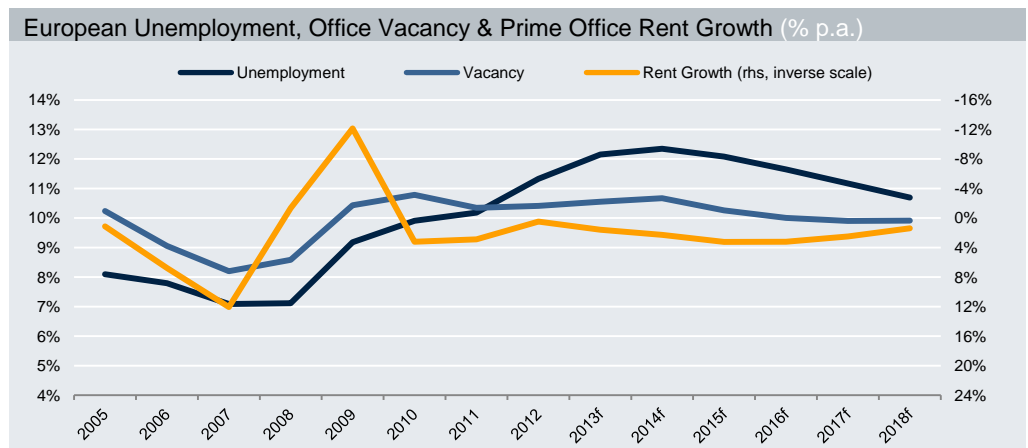
<sup>13</sup> DTZ, Net Debt Funding Gap, November 2013



# Real Estate Performance

## Property Market Fundamentals

In line with our predictions earlier last year, 2013 seems to have marked a further weakening of European occupier fundamentals. In the office sector, net absorption remained comfortably positive, but is likely to have fallen to its lowest level since 2009. Even with weak levels of new construction we expect average vacancy rates to have risen and rental growth to have remained fragile at around 1%-2%. Demand in Germany will fail to match that of the previous two years, while we also expect demand to have moderated in the Nordics and CEE. The United Kingdom and Ireland are set to have registered strong increases, but Southern Europe remained significantly below par. However, the economic headwinds are slowly beginning to change, and a certain level of optimism is beginning to return, which should begin to filter through to real estate fundamentals this year.

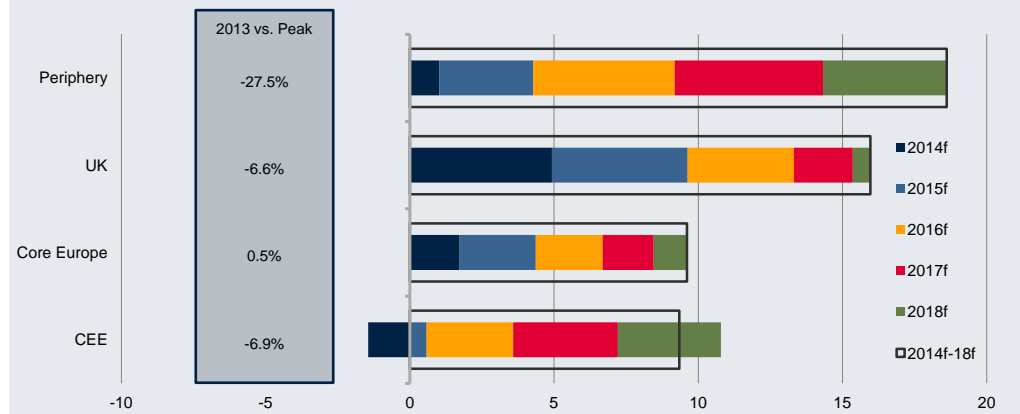


Sources: Deutsche Asset & Wealth Management, PMA, Oxford Economics, September 2013  
Note: f= forecast. There is no guarantee the forecast will materialise.

As the economy moves into recovery, we are forecasting an increase in net absorption across the board this year. But with a spike in net additions, vacancy is expected to increase further, before decreasing in line with a falling unemployment rate, as shown in the chart above. The United Kingdom is likely to show strength once again, both on the occupier and investment side, which should lead to another year of strong returns.

In Core Europe, we expect rent growth to remain subdued, but there will be a clear split between markets in stronger economies, such as Germany, and those markets with weaker economic outlooks, such as France and Benelux. It will not be until 2015 that we foresee a more widespread return to normal demand levels, and hence a decline in the Europe-wide vacancy rate and meaningful real rent growth. As shown in the chart below, next year should also mark a return to nominal rental growth for offices in the Southern European countries, after seven years of flat or falling rents. Over our forecast period we forecast circa 18% cumulative growth in these markets however in 2013 rents were still approximately 27% below their previous recorded peak. This compares with cumulative growth of 16% in the UK where rents in 2013 were only 7% below the last recorded peak.

### Expected Prime Office Rent Growth by Region (%)



Source: Deutsche Asset & Wealth Management, December 2013.

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

In a year of weak private consumption, the retail occupier market was understandably quiet. Prime high street units continued to be much in demand, with significant rent increases achieved in Paris and Germany. Shopping centre rent growth, on the other hand, was fairly flat, although the stronger consumer markets of Sweden, Germany and the UK were relative outperformers. Rents continued to fall in the Periphery, with the Netherlands also moving into the red. Shopping centre vacancy rates in major European cities rose in 2012<sup>14</sup>, and this trend is likely to have continued into 2013 given the challenging environment facing retailers. With E.U. consumer confidence reaching a five year high in December 2013, Oxford Economics is forecasting positive consumer spending in 2014, which we expect will help drive prime shopping centre rental growth of 1.1% over the year ahead.

In the logistics sector, demand in the first half of 2013 picked up slightly, with the majority of markets showing increased take-up on a rolling year basis<sup>15</sup>. Despite a weaker consumer story, demand was driven by supply chain reconfiguration in support of e-commerce and multi-channel retailing, with more occupiers beginning to focus on being close to customer markets in order to satisfy same-day delivery<sup>16</sup>. The supply pipeline, which is back to its highest level since 2008 according to JLL, gives some indication of the market returning to strength. Unlike in the previous cycle, however, construction activity will be driven by built-to-suit and owner-occupied properties. Rents showed little movement in most markets last year, yet this year should mark a return to positive growth, after six years of falling rents at the aggregate European level.

### Capital Markets and Pricing

The European commercial real estate investment market continued to show strength in 2013, as evidenced by the chart below. While annual data had not been finalised at the time of writing, figures from RCA suggest that commercial investment volumes increased by at least 12% in 2013 compared to a year earlier. Despite the first half of the year being relatively steady, an impressive fourth quarter gave the market a much needed boost.<sup>17</sup> The Q4 figure was buoyed in particular by the Central London market, which achieved its highest ever annual transaction volume last year according to Savills.<sup>18</sup> Particularly active within the London market were Asian and Middle Eastern buyers, although U.K. investors also played a major role. Elsewhere, activity in Germany edged higher, while France saw a fall of around 7%, even including a €1.4 billion Klepierre/Carrefour deal at the end of the

<sup>14</sup> PMA, September 2013

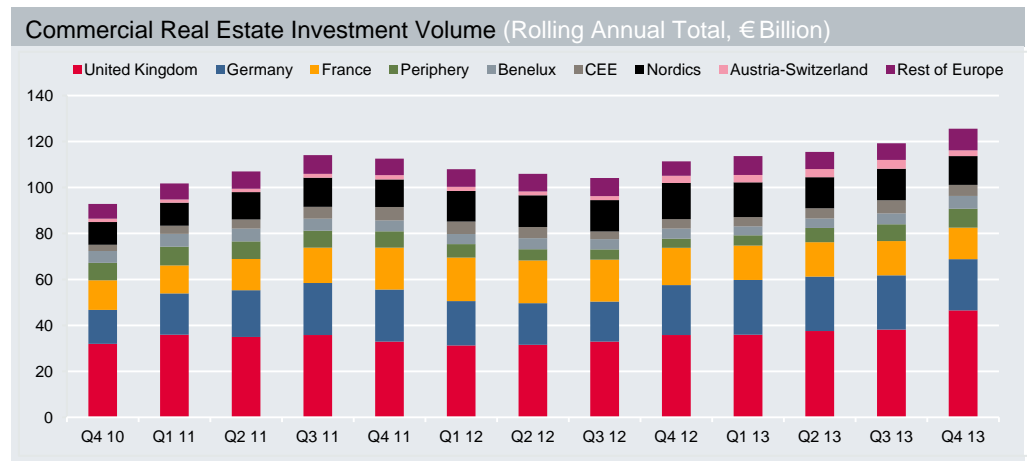
<sup>15</sup> BNP Paribas Real Estate, October 2013

<sup>16</sup> JLL, Q4 2013

<sup>17</sup> RCA, January 2014

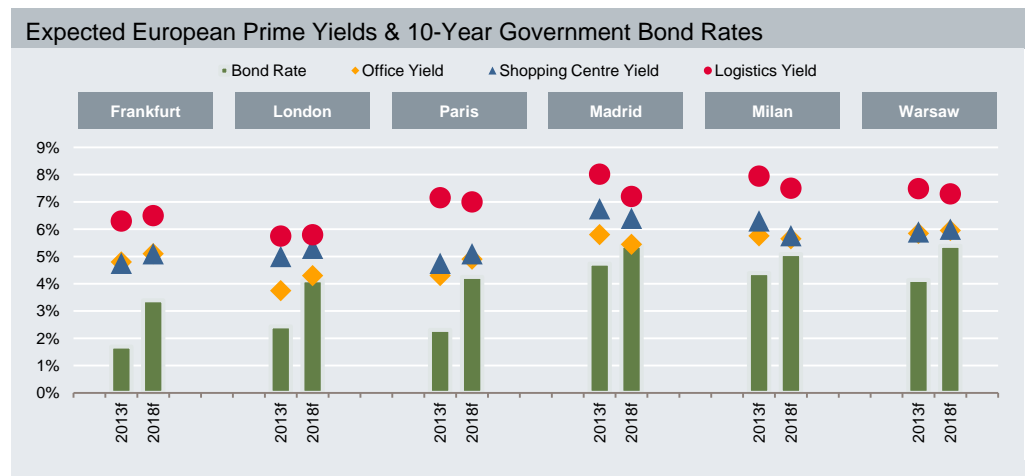
<sup>18</sup> Savills, January 2014

year. In the Periphery, there are clear signs of growing interest, evidenced by a doubling of investment activity in Ireland, Spain and Italy, a trend that is likely to continue.



Source: RCA, January 2013

In the debt markets, there has been further evidence of deleveraging in the banking sector, and increasing strength of non-bank lending. DTZ estimate that the net debt funding gap in Europe is now down to \$42 billion, less than half what it was a year earlier<sup>19</sup>. Loan portfolio sales from both banks and bad banks, such as SAREB in Spain, have played an important role, while insurance companies are still dominating non-bank lending. Over the next two years, debt funds are also expected to grow their share of property lending, with total non-bank lending capacity more than doubling.



f = forecast. There is no guarantee the forecast will materialise. Shopping centre yields are at the national level. Sources: Deutsche Asset & Wealth Management, January 2014; Oxford Economics, PMA, Q3 2013.

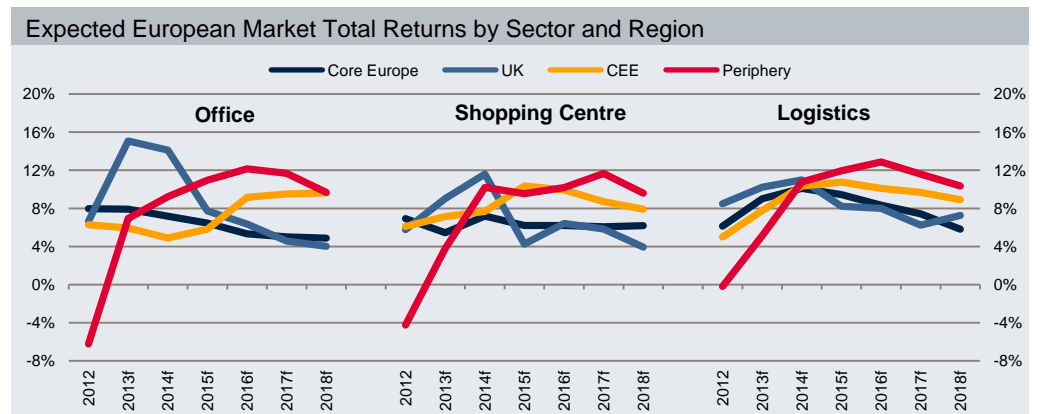
In the Core European markets, prime yields have moved in further over the course of the year, chased ever lower by the large volume of capital targeting limited opportunities. Average European prime office yields fell by approximately 10 basis points, and given the popularity of the U.K. investment market, it is hardly surprising that the most significant compression was seen there. Yields in the logistics sector also trended downwards outside the Periphery, while retail yields generally remained stable, with the exception of the United Kingdom, Ireland, and certain other core high street locations. Spreads over bonds are still considerably above their historical average outside the Periphery, making real estate continue to look cheap, but the rise in government bond rates, which many have been predicting for some years, finally seems to be arriving. In the short term, we do not

<sup>19</sup> DTZ, Net Debt Funding Gap, November 2013

expect this to have much effect on prime property yields, given the current spread, but further bond yield movement is likely to put a floor on real estate yield compression. In the longer term, expectations of rent growth should help to temper property yield rises, but at least in the core markets prime value growth is unlikely to be yield-driven.

### Real Estate Performance

The U.K.'s occupier market strength and investment market popularity combined last year to produce impressive prime return figures. We expect the United Kingdom to have outperformed every other region in 2013, with offices producing an impressive prime total return of 15.1%<sup>20</sup>. As predicted though, it was not only London that drove performance, with the U.K. regions also realising double digit returns. Outside London, commercial real estate investment volumes were up by almost 10% in 2013 according to RCA, driving stronger returns through increased competition and subsequent yield compression.

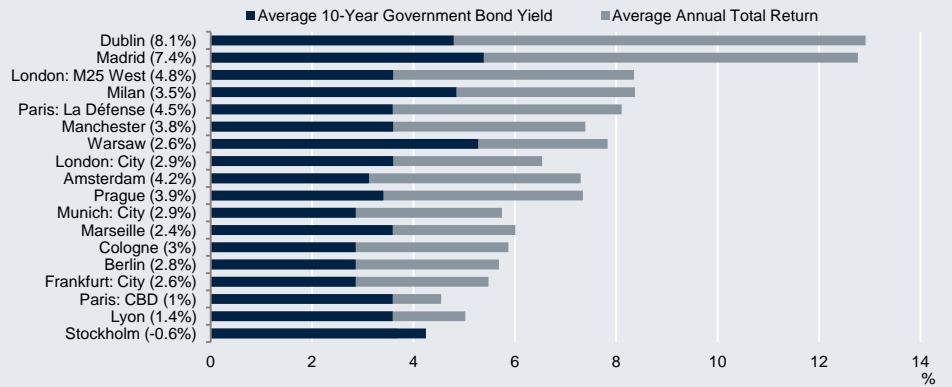


Source: Deutsche Asset & Wealth Management, December 2013.  
 Note: f = forecast. There is no guarantee the forecast will materialise.

Elsewhere in Core Europe, prime returns are expected to have remained generally positive, although at more moderate levels than the U.K. market. Germany was among the better performers in continental Europe, but was held back slightly by a flatter occupier market. After four or five years of weak or negative returns, 2013 looks to have marked a turning point in the Southern Periphery, as prime returns for the region shifted back into positive territory in all sectors. Looking ahead, it is this region that we expect to outperform as falling bond yields and the recovering occupier market begin to attract more investment, although for the time being there are clearly still risks. Generally speaking, given the low inflation outlook across Europe, real returns will be given a boost over the forecast period, although the effects of this will be relatively small.

<sup>20</sup> Source: Deutsche Asset & Wealth Management, December 2013

### Prime Office Total Returns and 10-Year Government Bond Yields (2014-2018f)

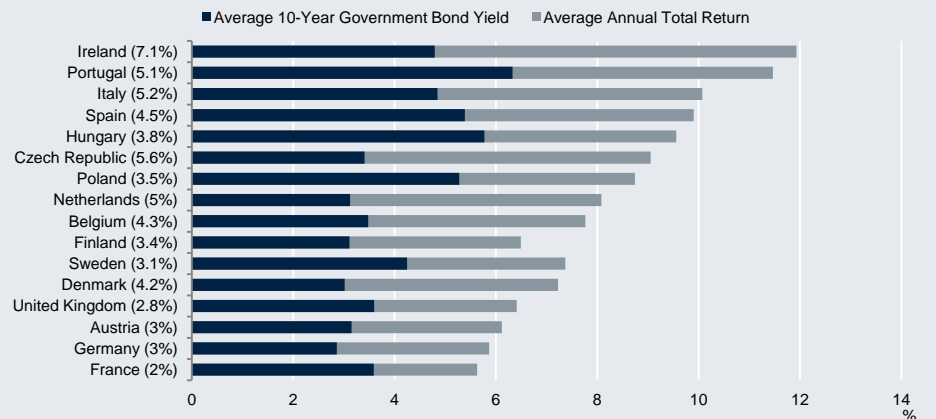


Sources: Deutsche Asset & Wealth Management, Oxford Economics, Q4 2013.

f = forecast. There is no guarantee the forecast will materialise.

While the office sector is forecast to fall behind, we expect the retail sector to hold the middle ground in terms of total returns between 2014 and 2018, as it has done over the previous five years. However, we still believe that there will be a wide gap in performance between the best high streets and dominant shopping centres, and older or secondary stock. Markets with robust consumer driven economies, such as Sweden and the United Kingdom, are forecast to outperform in the short term, but it is the Peripheral markets that are expected to take the lead from next year, buoyed by increasing confidence, economic progress and the prospect of prime yield compression.

### Prime Shopping Centre Total Returns and 10-Year Government Bond Yields (2014-2018f)



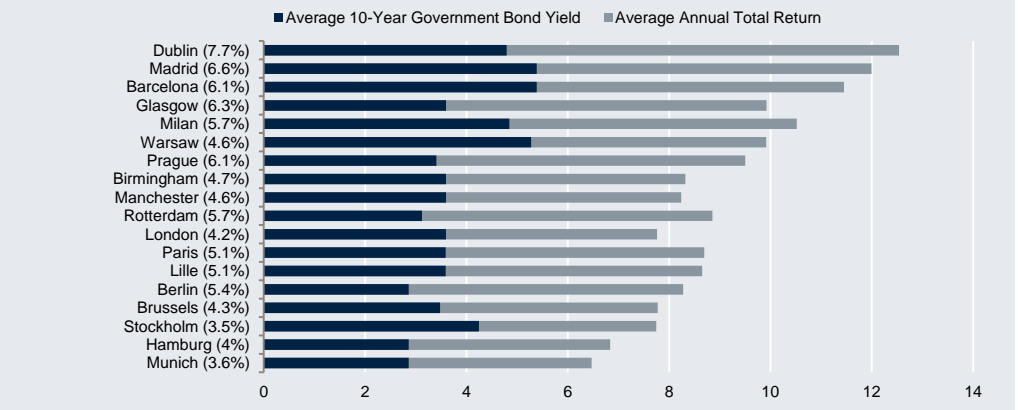
Sources: Deutsche Asset & Wealth Management, Oxford Economics, Q4 2013.

f = forecast. There is no guarantee the forecast will materialise.

As before, it is the logistics sector that comes out on top of our five year performance forecasts. With European industrial investment up by 20% year-on-year in 2013<sup>21</sup>, increased competition is starting to put downward pressure on yields. So far, yield compression has by and large been limited to the United Kingdom, Ireland and Germany, leading to strong returns in these markets last year, but we are forecasting more widespread inward yield movement over the next two to three years. After six years of declining rents, the sector should also benefit from rental growth this year, which will help to feed prime annual average total returns of 9.2% over the five years. Again, the Periphery markets should rise to the top of the pile, followed by the CEE, where infrastructure development and a fast-growing retail market could create interesting opportunities.

<sup>21</sup> Source: RCA, January 2014

### Prime Logistics Total Returns and 10-Year Government Bond Yields (2014-2018f)



Sources: Deutsche Asset & Wealth Management, Oxford Economics, Q4 2013.

f = forecast. There is no guarantee the forecast will materialise.

## Real Estate Securities

European real estate securities had a positive year in 2013. The property sector returned +11.2% (EPRA Europe Total Return) driven by the strong performance of UK listed companies (EPRA UK Total Return +23.8%). In 2014 total returns are expected in the region of 8%-12% driven by the solid outlook for the U.K. economy and its real estate sector. On the Continent the outlook is somewhat weaker, five years after the 2007/2009 down cycle the European property sector appears to be entering a period of laborious and differentiated improvement. Whilst much of Europe is already halfway through a lost decade, there are some pockets of good economic growth; the U.K. recovery is accelerating, whilst Sweden and Germany are experiencing healthy economic growth as well.

Whilst the sector trades near net asset value (NAV), the recurring earnings per share (EPS) yield for the sector is slightly below its long term average, despite this cycle being heavily affected by accommodating central bank monetary policy. The wide yield spread that the listed sector presently offers would likely provide a cushion for any potential rise in interest rates.

The relative case between the United Kingdom and the Continent is about either paying up for the growth opportunity in the United Kingdom or buying into the value opportunity on the Continent at a small discount. Going into 2014, U.K. stocks should be viewed positively, particularly relative to their Continental European peers. The sector on average trades at spot NAV, with the United Kingdom at a small premium (c.5%) and the Continent at a small discount (c.-6%). This valuation gap mostly reflects the different NAV growth outlook, with the United Kingdom set to see c.8% NAV growth in 2014 and the Continent likely to experience flat NAVs.

As discussed, the property market in London and Stockholm are supported by strong fundamentals and are expected to see healthy rental and capital growth in certain submarkets, the sector should further re-rate as more companies successfully restructure. An increasing number of companies are pro-actively enhancing shareholder returns via capital recycling, development and other value-add initiatives. The IPO market is also gaining momentum. Last year two Irish REITs listed on the Dublin exchange as management saw the time being right to capitalize on opportunities in (formerly) distressed markets.

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To conclude, the view remains positive on a large number of U.K. stocks that are covered versus Continental European stocks where growth prospects remain weaker. Not all is lost on the continent though, as stock picking with a focus on turnaround stories and company restructurings will provide ample opportunities for active managers.

# Markets Outlook

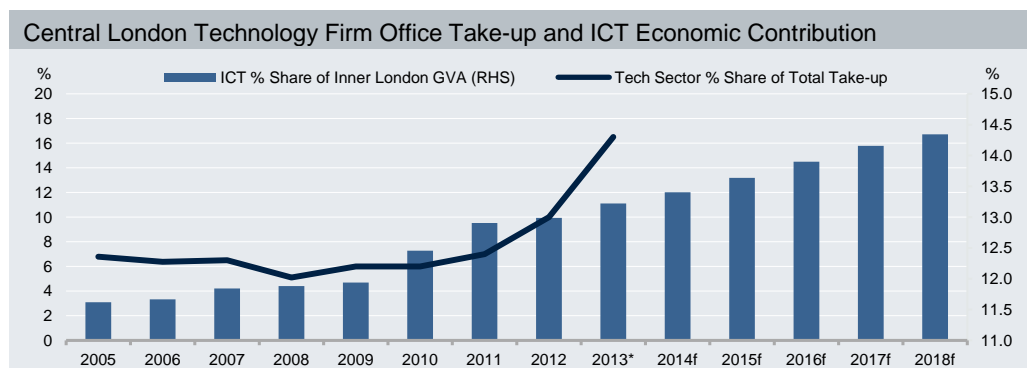
## United Kingdom

The U.K. economy has outperformed expectations over recent quarters. Returning to growth during the early part of 2013, the economy accelerated throughout the year, leading to upwards revisions to the GDP projections for 2013 and 2014. So far led by the consumer, the recovery is set to broaden next year as record high confidence and Bank of England support encourages the return of business investment. Over the next five years the United Kingdom is forecast to be one of the fastest growing countries in Europe.<sup>22</sup> Risks to this outlook are evident as deficit reduction plans continue to reduce demand for much of the next five years. Political risks will be aggravated by the Scottish Independence vote (2014), a general election (2015) and a potential referendum on E.U. membership (2017).

The improved economic outlook has brought forward our prime rental growth expectations across the major U.K. office markets. Central London, with its persistent outperformance of the national economy has already seen rental growth return. Over the coming three years we anticipate that rising demand will propel headline rents to pre-recession highs, particularly in the most prestigious areas of the West End where residential conversions are increasing the premium on office space. The delivery of Crossrail could rebase rents in some locations; however over the medium term a supply response to higher rents is likely to temper the pace of rental growth across Central London.

Still offering a premium over government bonds, alongside secure incomes and the prospect of near-term rental growth, investors will continue to target Central London, potentially reducing yields further in 2014. However, as bond yields rise, the rental cycle turns and the need for safe-haven investment fades, we see prime yields moving higher, leading to a period of modest capital value decline in the second half of the decade.

Improving demand drivers suggest asset management intensive properties in the best locations, or good quality stock in alternative central locations, may offer a higher risk-adjusted return over the forecast period. Alternative locations, such as Midtown, have tended to track City and West End rental growth and currently offer a yield premium of around 125 basis points over the West End.<sup>23</sup> The areas around Old Street, Kings Cross and Farringdon are of particular note, experiencing considerable regeneration, increased connectivity, and have recently seen sizable inflow of rapidly growing media and technology firms, forming a 'TMT Triangle' between the capital's traditional office markets.



Source: CBRE, Oxford Economics, December 2013.

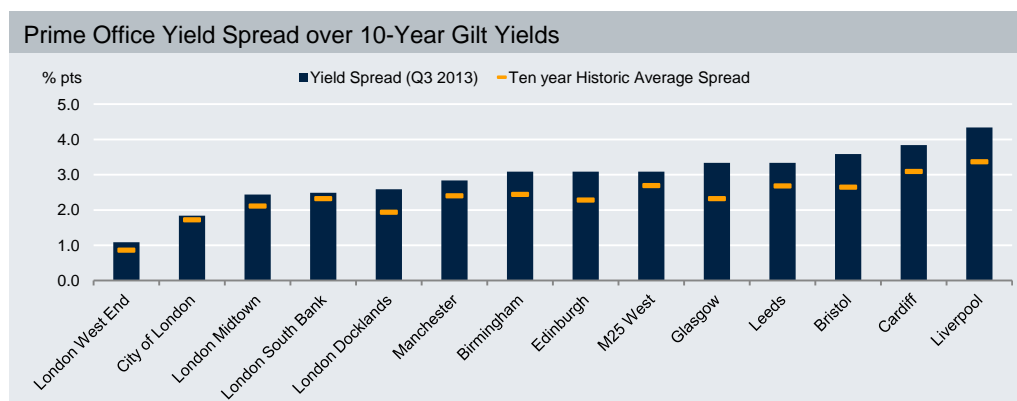
<sup>22</sup> Oxford Economics, September 2013  
<sup>23</sup> CBRE ERIX, Q4 2013



Note: f = forecast. There is no guarantee the forecast will materialise. \*Take-up for first 9 months of the year

Office investors broadened their focus in 2013, increasing the volume of transactions in the Thames Valley and the major regional cities. Yields on prime assets have moved lower as a result, falling further than expected to around 6%.<sup>24</sup> In part the fall in yield is supported by better fundamentals, with vacancy in these markets having peaked. Rental growth is forecast across the major regional cities in 2014. Supported by its close proximity to Central London and the delivery of Crossrail, the Thames Valley is set to be the best performing rental market outside Central London over the next five years, and of the regional cities, we anticipate that Manchester and Edinburgh will see relatively higher rental growth, than Birmingham and Glasgow. The return of rental growth is being supported by an historic lack of new building however the early stages of development activity are picking up, potentially curbing rental growth during the latter part of the decade.

The momentum of yield compression should continue into 2014 but regional markets could also start to look expensive by the middle of the decade. This may push some investors towards less prime stock in these markets, or into second tier cities such as Liverpool and Cardiff. Although offering a higher yield, given the elevated vacancy and modest demand outlook, investment into these markets should be cautious and asset specific.



Source: CBRE, Oxford Economics, Q4 2013.

Structural challenges continue to face many retail locations, with parts of the market encumbered by high vacancy rates. However the worst of the retail real estate downturn may now have passed. Despite this, both occupiers and investors are likely to remain cautious towards taking new retail space, focusing upon high footfall locations on major high streets and regional shopping centres, or fashion park space that offers an easily accessible alternative to the high street – although the pricing on these assets may soon start to look expensive. Selective opportunities in secondary locations will provide those investors with the necessary asset management skills, the potential to achieve high returns through the repositioning of an asset to meet the needs of the immediate catchment.

Logistics remains the best performing of the three main real estate sectors across our five year forecast period. Not only offering a higher income return and the possibility of further yield compression, demand for high specification space has been outstripping supply for a number of years, resulting in almost a quarter of all take-up being build-to-suit. This is laying the groundwork for rental growth to return in 2014, with London, the Midlands and the North West outperforming the Scottish cities. Although the growth of online retailing will not lead to a universal increase in logistics demand, particularly where direct delivery reduces storage requirements, it is likely to support demand for space close to major urban centres in order to accommodate same and next day delivery. Alongside the opening of the new Thames Gateway container port in Essex, this trend is likely to have a particu-

<sup>24</sup> CBRE ERIX, Q4 2013

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larly positive impact upon demand to the east of London, as retailers and logistics operators look to supply the large and fast growing population of the capital.

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## Germany

Compared to most of its European peers, the current state of the German economy remains in a relatively healthy position. The labour market is the strongest it has since reunification, leaving the unemployment rate at historical low levels. In particular the service sector continues to see the strongest growth as business services continue to expand. Sentiment indicators like the IFO and the GFK<sup>25</sup> are all improving as much needed confidence seems to become broader based. But there continues to be sluggish hard data too, which is a reminder of the ongoing weak macroeconomic environment in the Eurozone. Manufacturing output and new orders have yet to get back on a sustainable growth path, however the trend is positive and companies are operating closer to full capacity, which should result in a greater willingness to invest. In the short term, growth will be almost entirely driven by domestic demand, but foreign trade and investments are expected to pick up notably from 2015 onwards.

Given the relatively positive business outlook, recently announced policies by the elected coalition could potentially dampen the growth prospects of the economy in the medium to long-term. Partial reversals of earlier achievements with regards to labour market flexibility and sustainability of the pension system may well reduce some of the competitiveness the German economy gradually built up over recent years.

However, it remains difficult to predict how this – if at all - will impact the German real estate investment market in the short-term. In 2013, the market has been on track to record another strong year<sup>26</sup>. The amount of capital allocated to the market is still significantly larger than the prime product available. Yields continue to move downwards and prime stock already appears expensive, as a result, investors seem to slowly accept that there might also be suitable product beyond a very narrowly defined prime segment in core top cities. Investors are increasingly considering assets of older age, with shorter lease lengths or slightly non central submarkets in Top 7 locations.

Due to the polycentric nature of the German economy, opportunities in office markets do exist outside the basket of Top 7 office hubs. A selection of medium sized cities with a population in the bracket of 250,000-550,000, such as Bonn, Münster or Karlsruhe provide a critical mass of office stock with a strong underlying demographic trend, renowned universities and a strong historical presence of a combination of German blue chip and Mittelstand companies. In these markets, real estate performance generally tends to be relatively stable too as in particularly the supply side is less volatile. Local investors typically dominate these markets, providing a sufficient amount of liquidity, but a limited amount of suitable stock can make the entrance into these markets more difficult than the exit where a wide range of investors are looking for stock.

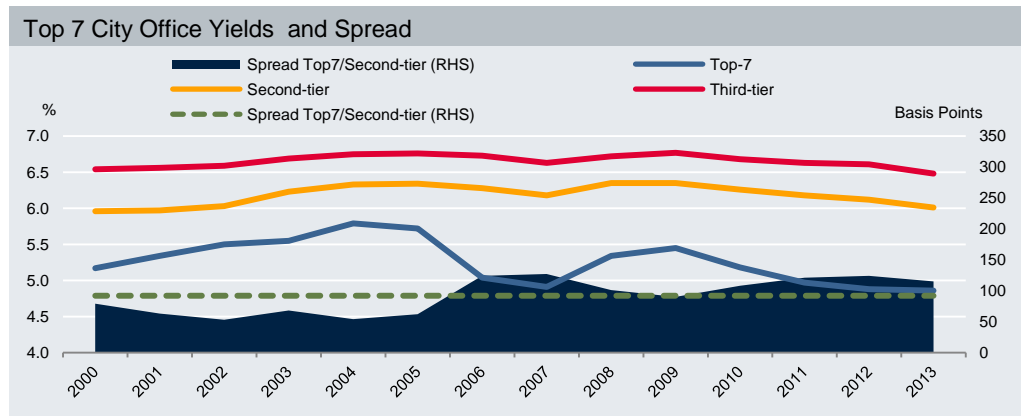
However, occupier activity can be proportionately lower than in the Top 7 cities, a yield discount between 80-100 bps currently being observed does seem justified<sup>27</sup>. But compared to the Top 7 markets many of these cities seem undervalued as yields spreads are currently still well above the long term average. While the inward yield shift potential will be limited to 10-25 bps in the current cycle, investors will continue to benefit from a safe macroeconomic environment and compared to the Top 7, a generally higher cash flow.

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<sup>25</sup> GfK Geomarketing Dec 2013, IFO Institute, January 2014

<sup>26</sup> Real Capital Analytics, January 2014

<sup>27</sup> Bulwien, Q4 2013



Source: Bulwien, Q4 2013.

There are also selective interesting markets in East Germany worth monitoring, a region which has been neglected for almost a decade by the majority of investors. Cities like Dresden, Leipzig, Jena, Potsdam or Rostock seemed to have achieved a turnaround in recent years and are well positioned to continue to grow above the average.

Prime office yields in the top 7 locations may reach their peak in the next 12-18 months, as further yield compression seems unlikely going forward. The German markets have now benefited from their safe haven status for nearly four consecutive years. Not surprisingly, the Munich office market is expected to have the strongest rental growth potential, followed by Berlin and Hamburg. Both are forecast to benefit from solid employment growth in the coming years. Berlin's reputation as a business location has improved greatly in recent years. Given its status as a prime tech hub, it's easy for companies to lure high skilled workers to the capital. The Frankfurt office market continues with its notorious over supply situation, however, a more detailed analysis suggests, that prime stock in the narrowly defined CBD is actually fairly limited. Tenants with more sophisticated requirements won't find it easy to secure larger floor plates in the coming quarters. Modern stock is arguably available in the CBD fringe areas but tenants have yet to become comfortable with these locations.

The retail market continues to see strong demand from international retailers. Over 70% of the total space has again been let to international operators in 2013, most of them in the prime high street segment.<sup>28</sup> The performance of shopping centres differs vastly within the segment, as individual parameters do play a much more important role compared to the high street. However, strongly positioned centres with easy access, long opening hours and a strong anchor tenant should continue to do well. Void periods are low and landlords are in a position to actively manage the property. However, the bottom half of the segment is already feeling the impact of worsening demographics and tenant market, as demand from retailers is limited and the quality of the tenants mix is somewhat lower.

The German logistics market continues to attract an increasing amount of investors. Distribution yields of up to 6% and a healthy balance of supply and demand contribute to this sector looking fairly priced. Due to the shortage of space, developers are even considering speculative construction again, something which has been absent for nearly four years. Vacancy rates in the strongest hubs, like Munich, Hamburg, Frankfurt and Cologne/Dusseldorf, have already dropped below 5%.<sup>29</sup> We can therefore expect rents to increase over the next five years, however, given that prime rental values are already quite high, in particular in the top end of the market, the low margin logistics business does not offer room for significant hikes above inflation going forward.

<sup>28</sup> Jones Lang Lasalle Research, Q4 2013

<sup>29</sup> Jones Lang Lasalle Research, Q4 2013

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## France

While parts of Europe are beginning a tentative recovery, French economic prospects remain gloomy. Real GDP growth slipped back into the red in Q3 2013, albeit marginally, with economic output for the year as a whole expected to have more or less stagnated. Consumers are still a positive driver of growth, but higher taxes and unemployment are holding back spending, and will continue to do so. Meanwhile, the industrial sector is dragging down overall performance, recent PMI surveys showing that France has decoupled somewhat from the rest of the Eurozone. Inflation remains below 1%, and with spare capacity in the economy, price growth is unlikely to approach the 2% target for some time yet.<sup>30</sup> Lack of reform and loss of competitiveness will hold the economy back, and if growth continues to disappoint, there is still the potential for further rating downgrades, causing bond spreads over other core European countries to increase. In his New Year's speech, Francois Hollande vowed to cut public spending, lower taxes and reduce labour costs for business, but polls show that the French population remains unconvinced<sup>31</sup>.

In the office sector, occupier trends observed during the first half of the year continued into the second half of the year. Take-up for the year was down by a huge 25% in the Ile-de-France region, and at the same time availability increased by almost 10% according to Immostat. In Central Paris a relatively strong increase in stock, combined with weaker demand, led to a significant rise in the vacancy rate. This was driven largely by La Défense, where several large speculative deliveries pushed vacancy up from 6.6% to over 10%, as well as the WBD, where vacancy rose from 13.3% to around 15%<sup>32</sup>. On the other hand, the fall in demand in the CBD was far smaller than in many other parts of the Paris region and a tight supply pipeline is helping to support stronger fundamentals there, relatively speaking. Rental performance was mixed across the three main Paris markets, with La Défense finally showing some signs of stability, despite weaker occupier fundamentals. Conversely, prime rents in the CBD adjusted downwards markedly, while rents in the WBD remained fairly flat year-on-year.

Economic weakness will continue to be a drag on office demand in the near term. The supply pipeline in the CBD is limited to refurbishments, and steady tenant demand should keep a lid on the vacancy rate and generate rental outperformance against other parts of Central Paris. In the WBD there are also relatively few new buildings in the short-term pipeline, although the record high vacancy rate there is likely to impact average rental growth to some extent. Saying that, demand for space in this fast developing market has been consistently strong, and we still expect the prime areas of the WBD to perform relatively well. On the other hand, La Défense will be saddled with further new space totalling around 4%<sup>33</sup> of the market stock in 2014, much of which is still available. And in the absence of a number of large lettings, which have generally been absent as firms postpone large moves amid the uncertain economic environment, vacancy could remain elevated, which will restrain rent growth until some of the new space is absorbed. Nevertheless, even with low inflation expected again this year, we are forecasting real rent growth to remain negative in all submarkets until 2015.

Last year the yield spread between the three Central Paris markets remained close to its highest ever level, as investors continued to favour the CBD and WBD over La Défense. There was some uptick in investment volumes in La Défense, although the sale of Tour

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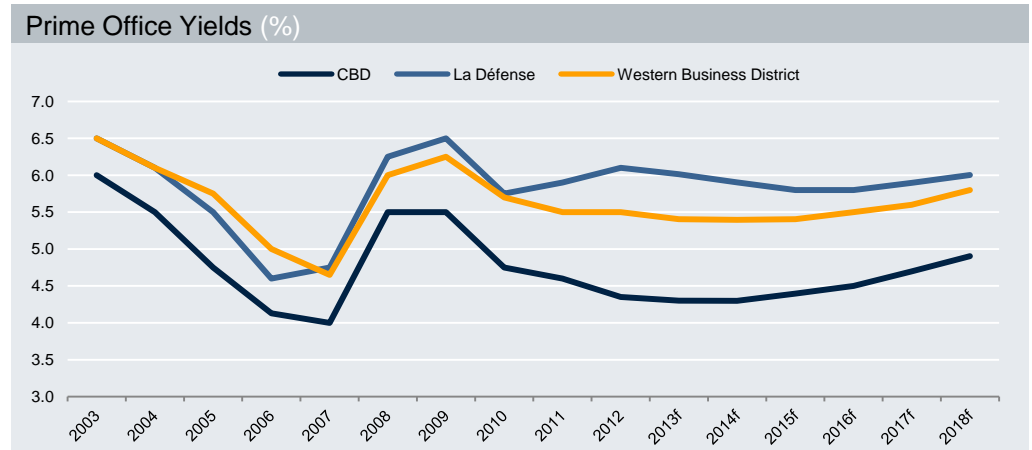
<sup>30</sup> Oxford Economics, January 2014

<sup>31</sup> BVA Poll, Le Parisien, January 2014

<sup>32</sup> PMA & Immostat, Q4 2013

<sup>33</sup> DeAWM, December 2013

Adria accounted for more than half of the annual investment total there, and confirmed the prime yield at 6%, just below where it started the year. The difficult La Défense occupier market has already been priced in, and the current large spread over government bonds still leaves room for inward yield movement. We expect prime yields in the CBD and WBD markets to have reached a floor now, and the changing bond rate environment will start to squeeze yield spreads. The Grand Paris infrastructure project is also likely to play a significant role in both investment and occupier decisions, particularly so in the Southern Bend of the WBD, one of the first districts to benefit from the new transport links.



Source: Deutsche Asset & Wealth Management, PMA, Q4 2013  
 Note: f= forecast. There is no guarantee the forecast will materialise.

The regional office markets have weathered the uncertainty relatively well to date, with low availability supporting stable prime rents. However, our outlook for the regional markets has been downgraded slightly given the gloomy near-term economic picture. In Lyon, strong demand has so far kept the market in equilibrium, but the market balance will shift somewhat over the next two years as the large pipeline of new space comes to light, putting the brakes on rental growth somewhat. Strong investor demand has meant that regional yields have already reached or even surpassed their previous lows, although the occupier market outlook seems unlikely to support any further compression.

With consumer confidence well below average, spending growth was anaemic once again in 2013, as the domestic economy showed little sign of recovery. This is clearly impacting the retail market, but the effects are not being felt uniformly across the sector. At the prime end, retailers are still expanding selectively, taking advantage of locations with stronger customer flows. However, secondary stock continues to struggle. Owners of smaller and less well-located centres are seeing reduced revenues, but are reluctant to invest given the uncertain future of such centres. Even rents in prime shopping centres are expected to have stagnated last year, and we do not foresee a return to meaningful growth until 2015. Conversely, rents for prime units on the best high streets in Paris have seen significant growth over the past 12 months as new retailers compete for a very small number of opportunities. Prime shopping centre yields appear to have bottomed out at around 4.75%<sup>34</sup>, and we expect to see this gradually drift out from next year. However, France is still very much on investors' radars and sharp outward yield movements look unlikely.

In the logistics sector, the weak consumer market is also weighing on occupier demand, and tax rises in the year ahead will continue to hold back consumers' ability to spend. During the first three quarters of 2013, logistics take-up was slightly up year-on-year, but was

<sup>34</sup> CBRE, Q3 2013

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still below previous levels<sup>35</sup>. However, in Ile-de-France provisional figures for the whole of 2013 suggest the lowest level of occupier activity for a number of years<sup>36</sup>. Likewise, the availability of logistics space nationwide actually fell over the first nine months of the year, but in the Greater Paris region availability rose by as much as 14%<sup>37</sup>, as second hand Grade A space was returned to the market. The growing e-commerce market will provide a longer-term impetus, particularly so in the Paris region, but rental growth is expected to remain relatively muted. Logistics yields are still higher than average, with a large spread over bond rates. This, along with increasing interest in the sector, mean that yields could contract in the medium term, creating the possibility for short-term capital value growth.

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<sup>35</sup> CBRE, Q3 2013

<sup>36</sup> Immostat, January 2014

<sup>37</sup> Immostat, Q4 2013

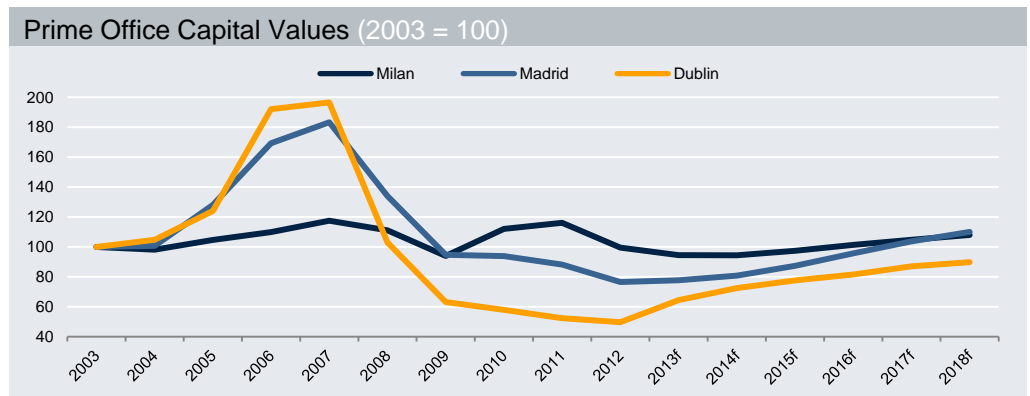
## Southern Europe and Ireland

Emerging from recession in 2013, Iberia, Italy and Ireland are entering a period of recovery. The pace of this recovery is likely to be uneven and modest, however when compared to the deep falls in output recorded since 2008 the outlook is much improved. Having recently left its bailout programme, Ireland is set to lead, followed by Spain where improving competitiveness is helping to support higher exports. Italy remains the laggard of the group, as political uncertainty, high public debt and banking sector weakness will continue to weigh upon demand.<sup>38</sup>

The stabilisation of the economic climate is starting to draw to an end the downturn in the office occupier market. Dublin is a step ahead in this process, with vacancy rates falling and prime rents already rising sharply – up an estimated 15% in 2013, although still almost 50% below their 2007 peak<sup>39</sup>. The other cities should follow suit in 2014, with Madrid due to record the highest rental growth in Europe over the next five years. The rebound in Madrid will be centred upon the CBD where a relatively low vacancy rate, lack of recent development and a 40%<sup>40</sup> correction in rents since 2008 should spur recovery as demand returns. Rental growth is set to return to Barcelona and stabilise in Rome and Lisbon in 2014; however there is a risk that Milan will see a further rental correction. Headline rents in Milan have not corrected by the same magnitude, while high vacancy and corporate office space consolidation continues to support occupier bargaining power.

Southern Europe and Ireland saw further falls in government bond yields during 2013 as the ECB's pledge of support overcame periods of political uncertainty in Italy, an economic crisis in Cyprus, and further GDP contraction during the first half of the year. This has helped to support the relative attractiveness of prime real estate in these markets.

Outside of Dublin, where prime yields fell sharply in 2013, office yields were broadly flat. By the end of the year the return of capital to the Spanish market had started to support pricing on prime Madrid offices, a trend which is expected to spread to all office markets in 2014. Although yield compression is forecast to be relatively modest, it is in contrast to Core European markets, and should ensure prime capital growth throughout the next five years. Over this period, Madrid and Dublin are forecast to be the best performing markets in terms of capital growth and total return, however as shown in the chart below, values are due to remain some way off their previous peak.



Source: Deutscher Asset & Wealth Management, PMA, Q4 2013  
 Note: f= forecast. There is no guarantee the forecast will materialise.

<sup>38</sup> Oxford Economics, Q4 2013

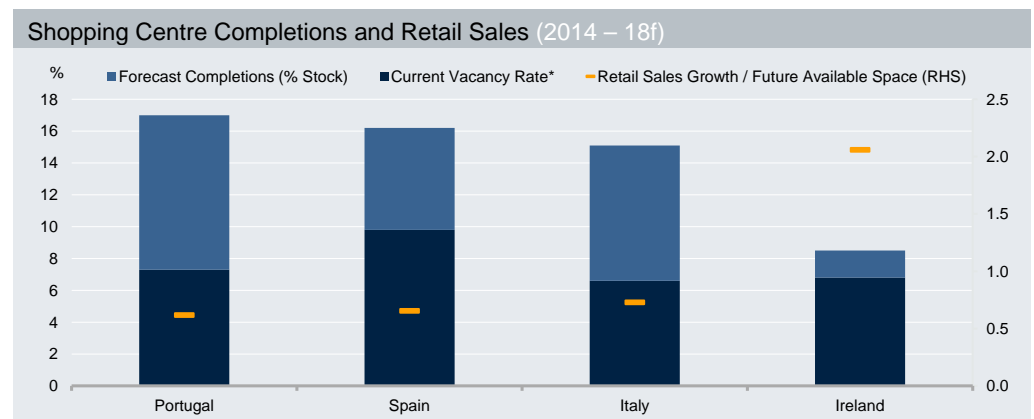
<sup>39</sup> PMA, Q4 2013

<sup>40</sup> PMA, Q4 2013



Given the severity of the downturns, spare capacity will remain evident across these markets for a number of years to come, increasing the risk of deflation. For real estate, spare capacity is manifest in above average vacancy rates. The impact of spare capacity is likely to be acutely felt across the retail market, where the real estate sector has faced the combination of a cyclical downturn and the structural impact of online sales growth. The proportion of spend going online in Southern Europe is some of the lowest in Europe, but nonetheless is growing quickly, and suggests that these markets could face a higher degree of sales diversion over the coming years, when compared to the likes of the United Kingdom or Germany.<sup>41</sup> As such, secondary retail locations, which cannot be successfully repositioned, are likely to struggle with high vacancy and rental decline for a number of years to come.

We expect prime shopping centre rents across Iberia and Italy to stabilise during 2014, and return modest growth thereafter. Despite rents in Spain having fallen far further than Italy, we expect prime rental growth in these countries to be broadly similar over the next five years, given the relatively low level of Italian prime vacancy, household debt and unemployment compared to Spain<sup>42</sup>. With an almost complete moratorium on new space, the prime part of the Irish market has been relatively resilient, and there are reports that some retailers are now finding it difficult to secure their preferred sites in certain parts of Dublin. With retail sales growth expected to accelerate, this suggests that the prospects for future rental growth are good, although next year's business rates revaluation is expected to lead to large increases in some prime locations, tempering growth.



Source: Deutsche Asset & Wealth Management, PMA, Oxford Economics, Q4 2013.  
 Note: f = forecast. There is no guarantee the forecast will materialise. \*Key Centres.

Demand for prime logistics space is expected to stabilise in 2014. Improving competitiveness and a stabilising Eurozone helped to support a sharp rise in exports from Southern Europe in 2013. Growth should be sustained in the coming years, as the global economy strengthens, boosting logistics demand around major centres of production and export hubs such as Barcelona. The return of retail sales growth should also help to sustain the return of prime rental growth; however following rental falls since 2008 of around 20% in Italy and 40% in Spain, this modest recovery will leave prime rents well below pre-recession levels by the end of the forecast period.

In terms of performance, Southern Europe and Ireland are forecast to see some of the highest prime commercial real estate total returns in Europe. Although risks remain elevated, they are lower than a year ago, and will continue to fall as the economic recovery becomes established. Investors returning to these markets will need to remain cautious.

<sup>41</sup> Centre for Retail Research, Q1 2013  
<sup>42</sup> PMA, CBRE, Q4 2013

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Non-core locations may be offering a considerable yield premium on history and the city centre, but also face extremely high levels of vacancy, weak demand and the prospect of further rental decline.

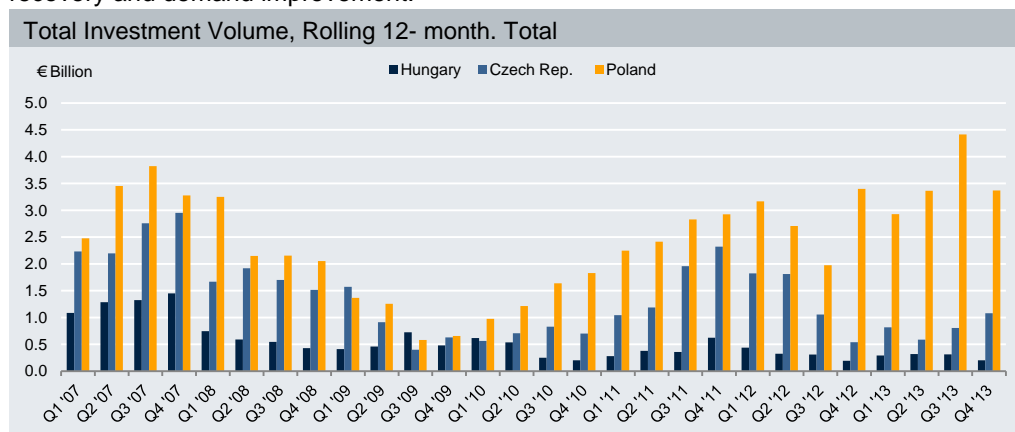
## Central Europe

The CE region, with its different countries, continues to emerge at very different paces. The convergence story, which has been the dominant argument for investing in the region over the last decade, may well continue, but it becomes more apparent that some countries struggle to maintain the momentum of those leading growth.

Indeed, Poland currently stand out as the most mature investment market in the region, as foreign investors remain confident about the long-term future. The forecast for the Polish economy remains strong and upside risks even prevail. While growth rates are not expected to reach pre-crisis levels again, GDP growth rates of above 3% are forecasted to bring the economy closer to Western European standards.<sup>43</sup>

The Warsaw office market has established itself as one of the most sought after investment locations in Europe, as foreign investors want to participate in the ongoing growth story. Poland has seen a rebound in interest from investors with volumes up over 300% on Q3'12 and volumes according to RCA, and have been steadily rising for the past few quarters as even the most prominent landmark buildings are brought to the market. Yields are currently quoted around 6% but downward pressure remains strong.

Over the longer-term, we feel comfortable with this level as a fair value; therefore no sharp yield adjustment over the forecast period is expected. While the current office stock is currently quoted at 4 million sq m, older pre-1990 buildings are not included, although a significant number of tenants (e.g. government) are still occupying space in this very opaque segment. Those buildings which were constructed between 1990 and 2002 are often of such poor quality that some of them are already becoming obsolete. This means that the actual prime segment in the CBD/City Centre is currently not larger than 400,000 sq m. Nevertheless, the relatively strong development pipeline is expected to let prime rents dip in the short term (2014), before rental growth turns positive again, driven by the economic recovery and demand improvement.



The performance of the Czech economy disappointed in recent years, but the office market has remained remarkably stable, despite lacklustre demand from occupiers. A number of international but also domestic investors are still feeling comfortable to allocate capital to this market, but the market has clearly lost momentum compared with Warsaw. Rents and yields have shown little volatility and we expect this to continue. As the number of modern buildings is still limited, prime rents are expected to get back to previous peaks in the coming years when the economic recovery becomes more sustainable.

<sup>43</sup> Oxford Economics, Q4 2013

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In contrast, Hungary remains trapped in stagnation according to Oxford Economics, as poor political governance continues to seriously damage investor's confidence. National elections will take place this year and the outcome will certainly have a significant impact on the medium-term developments in the Hungarian economy and real estate market recovery. There's little leeway for the Hungarian real estate market to improve significantly whilst political uncertainty remains high. The yield spread is not expected to narrow again against Warsaw and Prague, as investors seek to factor in uncertainties as they consider pricing in this market. In 2013, only a small number of properties were traded, according to Real Capital Analytics. Institutional investors have been predominately on the seller side as most funds are still trying to reduce their exposure to the market. We do not expect this situation to change soon, with the market increasingly dominated by opportunistic investors.

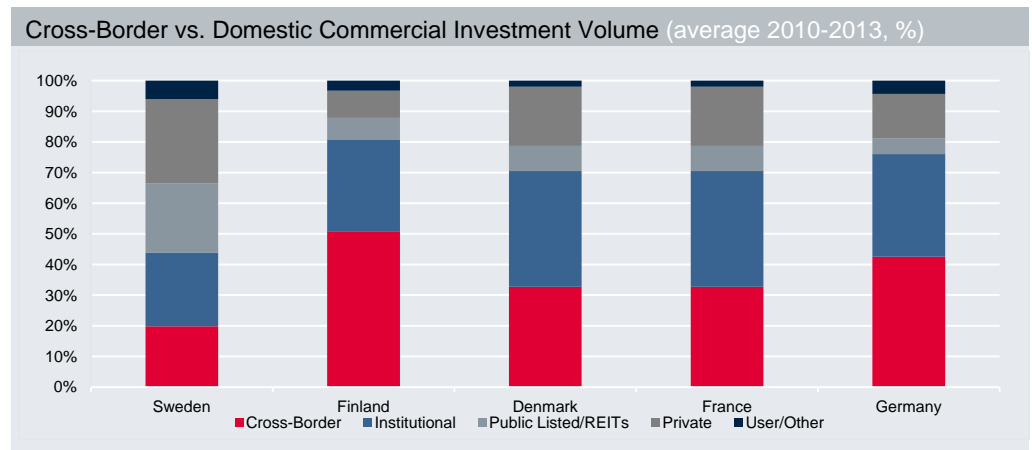
The Polish retail market has experienced ongoing construction activity in recent years. At the year-end nearly 300,000 sq m of stock has been released to the market and according to DeAWM Real Estate Research, more is predicted in the next 24 months. Across the country new schemes are currently being developed at different lot sizes and in a variety of locations and regions. So far, there is no sign that the market is over supplied, although some of the older schemes are now experiencing greater competition. However according to Real Capital Analytics the dominant centres with the most attractive tenants mix continue to experience high trading volumes. These schemes will also be able to achieve higher rental growth than the average market. While the prime end of the Czech retail market remains fairly liquid, in particular the high street segment, Hungarian schemes are still not in demand, and limited bank financing makes acquisitions difficult.

A similar story can also be observed in the logistics market. The Polish market has seen yields falling fairly rapidly over the last two years, as institutional investors aggressively bid for modern sheds with long lease contracts in good locations. As the new/future high-way systems becomes more visible, developers and investors continue trying to secure strategically located schemes around Warsaw, in the centre or in the southern transport hubs. The deep water seaport in Gdansk located on the Baltic Sea is well positioned to grow stronger than some of its rivals on the North Sea, as it has capacity for larger container ships. However, so far the infrastructure to connect the port to the hinterland has yet to be completed which has delayed the development of the market as a major northern hub.

## Nordics

The Nordic region recorded little economic growth during 2013, but is forecast to gain strength throughout 2014 as rising confidence and faster growth across key export markets spurs demand. The improvement in outlook is set to be led by Sweden, supported by fiscal stimulus and the continued support of the Riksbank which cut its main interest rate to 0.75% in December 2013. Finland is due to remain the laggard of the group in 2014, as sectors such as the electronics industry go through a period of structural decline, and planned austerity measures hit demand. Beyond 2014 the pace of recovery is forecast to quicken, with Sweden, Finland and Denmark all predicted to outperform Europe as a whole over the period to 2018.<sup>44</sup>

Domestic investors still dominate the Nordic markets, as measured by real estate capital flows, and are often outbidding foreign investors. The total investment volume was up in 2012, caused by a few large transactions in Norway and Sweden. However, activity in 2013 was particularly slow, with Denmark the only market to escape a significant drop in activity.<sup>45</sup>



Source: RCA, January 2013, Deutsche Asset & Wealth Management, Q4 2013.

In Stockholm, office occupier demand returned over 2013, supporting a slight decline in office vacancies. A shortage of prime office space maintained prime rental levels over 2013, but landlords remain aware that some large-scale tenants may be tempted to relocate from the inner city to out of town locations or reduce total work space. New office space and refurbishments are expected to be delivered over the coming five years, but speculative schemes will be uncommon as vacancy in the capital remains in double figures. Prime rental growth in Stockholm is forecast to return in 2014 as an improved economy supports demand. However, as rents are already at around pre-recessionary highs, the current availability of space is likely to curtail growth to around inflationary levels.

Copenhagen has seen demand for office space focused on the CBD and surrounding areas but less demand for space in the more expensive harbour areas. At best, prime rental values have remained stable over 2013 and it is forecast that the constrained supply pipeline in Copenhagen should support improving market fundamentals from 2015 onwards while the economy slowly improves.

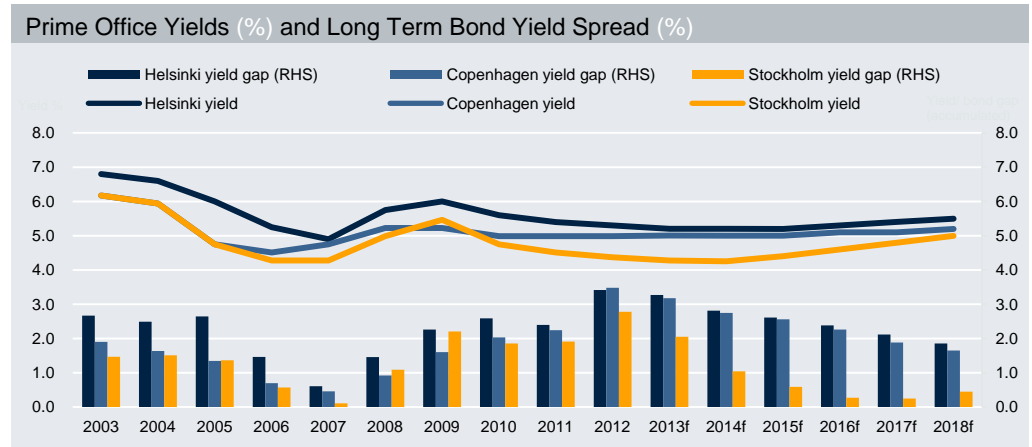
In Helsinki, tenants are consolidating in the most attractive submarkets, pushing vacancy higher across parts of the city. With developers responding to these market conditions by

<sup>44</sup> Oxford Economics, Q4 2013

<sup>45</sup> Real Capital Analytics, Q1 2014

reducing construction, prime office rental growth is expected to slowly return during the second half of the forecast period as demand side fundamentals start to improve.

For investors, the office sector remained the most popular over 2013, despite a lack of available prime product. Demand for prime office product is likely to sustain low prime yields over the first half of the forecast period, although we expect an upward adjustment in the second half of the decade due to rising long government bonds, leading to a period of moderate capital value decline. We expect Helsinki to post the highest total returns in the region, aided by a greater average income return and the return of rental growth from 2015 onwards. The higher anticipated interest rate environment in the Nordics is likely to reduce total office returns on average.



Source: Oxford Economics, PMA Q3 2013, Deutsche Asset & Wealth Management, Q4 2013.  
Note: f = forecast. There is no guarantee the forecast will materialise.

Higher shopping centre supply is expected over the forecast horizon; the short term focus will likely be on refurbishments and extensions but new construction is due to pick up in response to the low vacancy levels and an anticipated recovery in retail sales. Sweden awaits the delivery of its biggest shopping centre 'Mall of Scandinavia' in 2015; which when complete is set to draw spend from a large area across the northern part of Stockholm. Prime shopping centre rental growth is due from 2014 onwards, with Sweden the best performing market over the next five years. Despite expectations of accelerating retail sales growth, Finnish rents may be curtailed as planned new supply is delivered.

Resilient demand at the prime end of the retail market has sustained stable prime shopping centre yields in 2013. Similar to offices, yields are forecast to remain stable until rising long government bonds put upwards pressure on prime yields in the region during the second half of the decade.

Sweden's logistics sector is showing one of the lowest levels of vacancy in Europe. With demand expected to remain strong and supply limited, prime rental growth is forecast to accelerate over the coming few years. In Denmark demand for logistic space has been muted, resulting in a rise in vacancy rates. Large deals in Denmark have been scarce and space requirements are mainly driven by occupier consolidation. With little new supply, and demand expected to remain stable, modest rental growth should return in 2014. In Helsinki logistics vacancy has also been rising, reflecting the recent period of economic contraction, alongside structural decline in major industries such as electronics and paper.

Prime Nordic logistics yields are generally forecast to contract over 2014, before moving slightly outwards from 2017 onwards, as long term government bond rates start to rise.

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