Number 41
December 2004

The Grocery Wars: What They Suggest for Retail Property Investment

Table of Contents:

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Overview

The grocery industry in the US is witnessing a significant amount of change. A larger number of competitors, more and bigger stores, urban format retail, and new concepts are at work reshaping the market. These and other changes are giving rise to a growing uncertainty surrounding the survival of traditional grocery store anchors. In turn, it has created considerable anxiety among retailers, retail analysts, and real estate investors. As much as any factor, this consternation has been brought about by the growth and rising dominance of Wal-Mart.

It is ironic that at the same time that traditional grocery stores are being challenged by Wal-Mart and other discount chains, real estate investors continue to direct significant amounts of capital to retail properties, including grocery-anchored neighborhood and community centers. While some are wary of grocery-anchored centers because of pricing concerns and compressed going-in returns, retail shopping centers remain a highly favored pick among investors. Total return performance has, in fact, been stellar. The retail sector has driven total returns for privately-held core real estate (unlevered) since 2002. For the year-ending third quarter 2004, the sector posted a 21.2% total return, tops among all major property sectors (see Exhibit 1).

With Wal-Mart's introduction of the "Super Center" concept, which includes a full grocery section along with its hard and soft goods, the grocery industry has entered a virtual price war. Wal-Mart has a much vaunted cost structure that has allowed them to undercut their competition and garner the dominant market share in certain metro areas. Some fear that Wal-Mart is destined to wipe out the grocery industry as we have known it.

Until this past year, the rollout of the Super Center concept had proceeded quietly. Having opened approximately 1,400 general merchandise discount stores nationally since its founding in the 1960s, Wal-Mart began constructing Super Centers in 1988. Combining a general merchandise discount store with a full-service grocery store, Wal-Mart has opened nearly 1,600 Super Centers to date. It has clearly become their preferred format which has been embraced by consumers due to the unsurpassed value offered and the convenience of multi-purpose shopping in a single store. To track this expansion, RREEF

Exhibit 1
Retail Property Sector Total Returns
Year-ending 3Q/2004
(Privately-held, unlevered)

	1-Year Return	5-Year Return	10-Year Return
Retail	21.2%	12.4%	10.0%
Neighborhood	17.4%	12.8%	11.6%
Community	19.1%	12.6%	10.9%
Regional	22.4%	12.4%	10.0%
Super Regional	24.6%	12.5%	9.3%
NPI Composite	12.4%	9.5%	10.6%

Source: NCREIF Property Index

Research examined the impact Wal-Mart has had on the grocery industry in 60 metro markets. This review is based upon grocery market share data compiled by Trade Dimensions International (see Appendix).

We do not expect Wal-Mart to completely dominate the national grocery market. That said, the retailer is making serious inroads into an increasing number of metro areas. The following three points summarize the extent of Wal-Mart's Super Center strategy:

- Wal-Mart is a dominant grocer (first or second in market share) in 42% of the nation's major metro areas
- Wal-Mart appears to show saturation when it reaches a capture rate of 40% of grocery sales in low barrier to entry markets, with possibly up to 50% in a few especially weak grocer markets
- Strong grocers can effectively compete against Wal-Mart

For investors it is important to be aware of these and other potential effects and what they imply for retail property investing.

The Wal-Mart Invasion

Wal-Mart Dominant Metros

Wal-Mart is the nation's largest grocer, with a 15.2% market share. Moreover, the retailer is the dominant grocer in 11 markets located in the Sunbelt and the lower Midwest where the barriers to entry are minimal (see Map 1). Generally, these metro areas have low land costs, comparatively easy entitlement processes, and reduced labor costs, given that unions are weak or non-existent. Wal-Mart's market share in these dominant markets ranges between 23% and 43%. Most of these metro markets also have relatively low average income levels by national standards.[*]

Map 1
Wal-Mart Dominant Metropolitan Areas

Metro	Market Share
Albuquerque	33%
Birmingham	32%
Dallas-Fort Worth	29%
Houston	25%
Kansas City	23%
Knoxville	34%
Memphis	31%
Nashville	33%
New Orleans	28%
Oklahoma City	41%
Tulsa	43%

Source: Trade Dimensions International

Despite the similarities of these markets, there are some notable differences in these competitive environments. For example, Dallas-Fort Worth and Houston, which are highly competitive markets, have numerous major national and regional grocers grappling for market

[*] Dallas-Fort Worth and Houston are the exceptions.

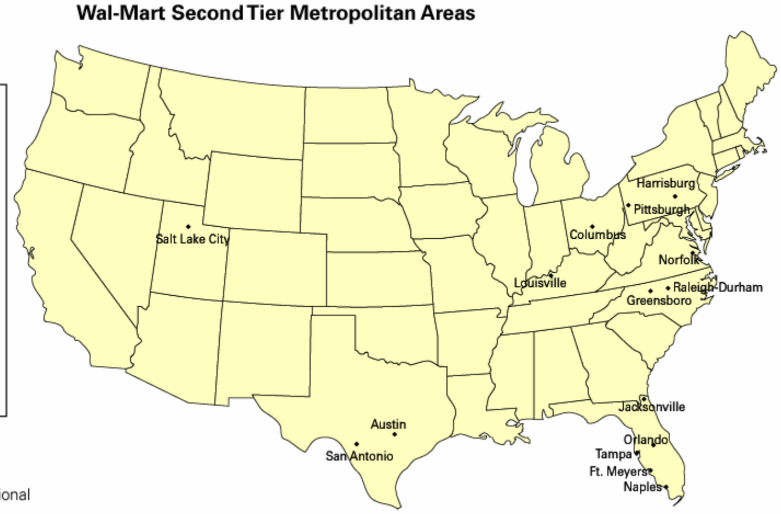
share. With the major grocers dividing market share between them, Wal-Mart was able to capture the largest market share. At the higher end of the capture range are metros that have not traditionally been served by strong grocers that elicit customer loyalty. These markets are typified by Oklahoma City and Tulsa, with 41% and 43% capture rates, respectively.

Second Tier Wal-Mart Metros

Wal-Mart is the second largest grocer in 14 other metro areas where its market share ranges from 12% to 26% (see Map 2). Somewhat similar to the first group, these are mostly Sunbelt or Mideast metro areas with below average incomes. They are classified as second tier because Wal-Mart's dominance is second to particularly strong, traditional grocers present in each metro. These include operators such as Publix in Florida, HEB in Texas, and Giant Eagle in Pittsburgh. Interestingly, Kroger, who most analysts would not place in the same qualitative category with the above, is dominant in several of these metros, including Columbus, Louisville, and Salt Lake City. Food Lion, an even more unlikely candidate for dominant grocer, is in first position in Greensboro, Norfolk, and Raleigh-Durham.

Map 2
Wal-Mart Second Tier Metropolitan Areas

Metro	Market Share
Austin	13%
Columbus	12%
Fort Meyers/Naples	21%
Greensboro	19%
Harrisburg	20%
Jacksonville	22%
Louisville	21%
Norfolk	21%
Orlando	26%
Pittsburgh	17%
Raleigh-Durham	19%
Salt Lake City	21%
San Antonio	23%
Tampa	19%



Source: Trade Dimensions International

Achieving Market Saturation

Wal-Mart is the first or second strongest grocer in 25 markets, or 42% of the total. This is significant and very different from what most retail market pundits anticipated. The discount concept in its early years was expected by many to be a niche play rather than a dominant product. It has now clearly gotten the attention of the grocery industry, if belatedly.

Within those markets where Wal-Mart is strongest, the company has been pursuing a policy of market saturation. Wal-Mart has attained saturation through the development of Super Centers, an approach which is proving to be phenomenally successful. In addition to the lack of barriers, the lower income profiles of these metros makes the Super Center concept even more appealing, where cash strapped consumers are willing to travel farther to a crowded store to save a significant amount of money.

Beyond building Super Centers remarkably close together, Wal-Mart is also looking to achieve dominance through their Wal-Mart Neighborhood Market concept. These are typically 42,000 square foot traditional grocery stores in neighborhood locations that feed off the Super Center distribution system that is already in place. While Super Centers are nearly fully built out in most of these mature markets, the Neighborhood Market concept continues to be rolled out. Since Wal-Mart Super Centers achieve most of their profits from their non-grocery items, it is yet unclear how profitable this smaller concept will be for Wal-Mart, but they are certainly enhancing market share.

A market share of between 35% and 45% is probably nearing saturation for Wal-Mart within these low barriers to entry markets. In some markets with weak grocer competition, Wal-Mart might achieve a 50% share. By comparison, the average market share for dominant grocers in 60 markets nationally is about 34%, ranging from 19% to over 62%.

Dominant Grocer Metros

There are 14 markets where the major grocers enjoy market shares between 40% to over 60% (see Exhibit 2). These dominant grocer markets have competed effectively against Wal-Mart by providing more service and selection than is typically available in a discount store. Most stores are in the 40,000 to 60,000 square foot size range, and are conveniently located to customers. In most cases, they are perceived to have high quality fresh foods. Historically, these grocers have been reasonably profitable in spite of low margins, and have grown into national operations.

Exhibit 2
Dominant Grocer Market Share

Metros	Grocer Market Share
San Antonio - HEB (private)	63%
Austin - HEB (private)	60%
Rochester - Wegmans (private)	59%
West Palm Beach - Publix (private)	53%
Columbus - Kroger	52%
Miami-Ft. Lauderdale - Publix (private)	50%
Hartford - Stop & Shop (Ahold)	49%
Milwaukee - Pic N Save/Roundy's	46%
Pittsburg - Giant Eagle (private)	45%
Providence - Stop & Shop (Ahold)	44%
Louisville - Kroger	43%
Buffalo - Tops (Ahold)	42%
Chicago - Jewel (Albertson's)	42%
Fort Meyers/Naples - Publix (private)	41%

Source: Trade Dimensions International

Thus far, Hartford, Providence, and Chicago remain insulated from the Wal-Mart saturation strategy. Their dominant grocers have yet to feel the impact. It is impressive that in six metros where Wal-Mart has established a major presence -- San Antonio, Austin, Rochester, West Palm Beach, Columbus, Miami-Ft. Lauderdale -- the dominant grocers have maintained a market share exceeding 50%. This suggests that grocers who understand their markets can compete effectively against Wal-Mart.

Coastal Metros

Thus far Wal-Mart has achieved limited success in gaining market share in the nation's coastal markets. In Los Angeles and San Francisco, for example, Wal-Mart's market presence is effectively zero. Similar, though somewhat larger shares, are evident for Wal-Mart in Seattle, Portland, New York/New Jersey, Miami, and Washington, DC (see Appendix). High barriers to entry, including strong labor unions, have precluded more rigorous development plans. The company is, nonetheless, forging ahead with Super Centers at the periphery and in opportunistic infill locations in selected markets of the Pacific Coast as well as locations in the Northeast and the upper Mid-West. These stores should be highly productive for Wal-Mart given the demographics and growth potentials of the markets involved, thereby justifying their added cost. An eventual capture rate of 10% to 15% is probable in each metro market, but will depend on how aggressive Wal-Mart wants to be.

Confronting the Wal-Mart Invasion

Outside of Wal-Mart, the U.S. is dominated by four major grocers. In order of size, these are Kroger, Albertson's, Safeway and Ahold. Other publicly-traded, traditional grocers have had a significant impact on certain local markets. These include A&P, Food Lion, and Winn-Dixie. Collectively these traditional grocers have watched in horror as Wal-Mart has developed a significant market share in groceries in selected metro markets. In an effort to head off Wal-Mart's growing dominance of the grocery business, traditional grocers are attempting to adopt Wal-Mart's operational approach. Put another way, traditional grocers are trying to save money the way Wal-Mart saves money by:

- Buying inexpensive real estate
- Implementing an efficient distribution system which, due to scale, allows for the purchasing of goods at a lower cost
- Maintaining low labor costs

Inexpensive Land

Real estate is a fixed cost for most grocers. Buying inexpensive land places most grocers in inferior locations – trade areas with low- to moderate incomes or underdeveloped greenfield areas that are unproven – and does not hold much promise for traditional grocers. Wal-Mart, as already noted, has thrived in areas such as these because of the retailer's appeal as a discount operator. Market dominance for traditional grocery stores comes about by offering service and convenience in proximity to middle- and upper income households. Such locations have above average land costs more often than not.

Distribution Systems

Safeway has been the most aggressive in implementing an efficient warehouse/distribution system by jettisoning its in-house unionized system for contracted services, reportedly at significant cost savings. The retailer endured a bitter strike over this issue, but ultimately won the fight. Next, they established a national platform for buying and inventorying groceries, similar to Wal-Mart's model. This strategy back-fired spectacularly. Shoppers resented the one size fits all formula to stocking, and sales fell dramatically at its subsidiaries where a local flavor and buying model had previously been preserved. This consumer backlash was most dramatic at Dominick's in the Chicago area, but it also occurred in Texas at Randall's and Tom Thumb, and in Philadelphia at Genuardi's. In response, Safeway is revising its approach, while still scrutinizing the bottom line.

Albertson's is starting to embrace Radio Frequency Identification tracking systems, similar to Wal-Mart's. Kroger also seeks savings from more efficient distribution systems. While grocers are unlikely to ever match Wal-Mart on distribution costs, they will be able to produce enhanced cost savings over time. Further consolidation of the industry will also help in this regard.

Labor

The four major grocers have been locked in highly confrontational labor negotiations for the past few years, and see curbing their labor costs as the only way to hold the line with Wal-Mart. Labor sees the issue as retaining the gains made in wages and benefits over the past several years. When benefits are included, the labor cost differential for the traditional grocers versus Wal-Mart can be as high as 250%.

The first major strike in late 2003 targeted Kroger at 44 stores in West Virginia, Kentucky and Ohio. Within a region where Wal-Mart was aggressively invading with Super Centers, Kroger estimated labor costs that averaged about $6 per hour more than Wal-Mart, including benefits. The strike ended in January, with some reduction in this wage differential, and was generally considered to be more of a win for the grocer than for the union.

The next major contract renewal was for the Southern California grocers. Following an announcement by Wal-Mart of its intent to blanket California with Super Centers, Safeway (Von's), Kroger (Ralph's), and Albertson's, the three major grocers in the region, banded together. In this market, labor cost differentials were much greater. While the average Wal-Mart wage was about $9 to $10 per hour, the grocers were paying an average $23 per hour, including benefits. The strike was extremely bitter, affecting 852 stores and 59,000 workers and lasting 4.5 months. When the strike finally ended in late February, the grocers were once again viewed more the winners than the unions, with the labor cost differential narrowed. Nevertheless, both sides sustained significant damage. Even months after the strike, grocers are still experiencing reduced sales and workers have been laid off.

Similar wage conflicts loomed just one month later in Washington DC where Giant Food (Ahold) and Safeway dominate, and in Seattle where Safeway and Kroger dominate. Major strikes were threatened, but the union was in a much weaker financial position after the Southern California strike. Once again, the majors banded together and, by summer, agreements were reached on terms similar to those reached in Southern California. This was more clearly seen as a victory for the grocers.

Currently contract negotiations have been on-going for several months with the unions in Northern California and more recently in Denver. Given the more sympathetic view of unions by residents of these regions, the unions are fighting for a better deal than they received in Southern California. If strikes are once again called, which seems likely, the results are far from certain.

These labor conflicts have not slowed Wal-Mart, however. In Denver, Wal-Mart has already captured 12% of total grocery sales. In spite of their high profile defeat at the ballot box in Inglewood near Los Angeles and other defeats in jurisdictions that have enacted legislation targeted against their stores, Wal-Mart is nonetheless successfully building new stores in California. Even in Northern California, which is famous for its intense planning reviews and strong union sentiment, they are having success. In Gilroy, a bedroom community south of San Jose where residents and City Council representatives are not particularly pro-union, the first Super Center is being developed. Others are following, generally in fringe locations or where a city council can be enticed with the benefits of a store, especially where local tax bases are weak. Farther into the future, it remains to be seen if they will attempt to move into more infill locations where union power is stronger. The prospect of bloody battles at union-controlled city councils, growing anti-big box sentiment, along with the high costs and non-availability of sites in close-in locations may give them pause. If they are successful in opening more California stores, the result will be Wal-Mart nibbling away at grocery market sales given that price-sensitive shoppers will drive distances to these stores. However, Wal-Mart will have great difficulty in becoming dominant in these markets as they have in Sunbelt markets.

Final Observations

Wal-Mart will likely continue to work on market saturation with Super Center and Neighborhood Market concepts, designed to achieve market shares as high as 40% to 50% in low barriers to entry markets like those in the Sunbelt and Mid-West.

Wal-Mart Super Centers are proving strongest with lower-middle and middle income markets, but penetrates more affluent markets as well, particularly where new families are feeling financial stress. Once lost, it will be very difficult for traditional grocers to regain these markets. In expensive major markets on the two coasts, Super Centers will be less available, but target consumers will nonetheless drive long distances to save money.

For more affluent markets, lessons can be concluded from the strong performance of the nation's best grocers, including Giant Eagle, Harris-Teeter, HEB, Publix, Raleys, and Wegmans. Even in markets where Wal-Mart is strongest, these grocers thrive. They provide an exciting experience, convenience, excellent service and value. They also carefully pick locations that serve upper middle income markets where consumers will pay a differential for their product.

The major grocery stores that continue to operate profitably will learn this lesson. While the Big Four are currently distracted with other issues, such as union contracts and accounting (in the case of Ahold), they will need to focus on improving their product. Already, there are some signs, such as promising new store prototypes being rolled out.

In the next decade, we expect there will be a new wave of consolidation. Some of the existing weak national operators will disappear through mergers or liquidations. Grocers will continue to vacate markets where they are weak. Some of the Big Four will either be bought out or will buy other firms. The "best grocers", who are largely family owned, will make acquisitions and/or will eventually go public. The industry will benefit from these consolidations, as the traditional grocery industry continues to lose market share to Wal-Mart.

The Wal-Mart invasion and the ensuing grocery wars hold a number of implications for retail property investors. These include:

- Centers anchored by Wal-Mart Super Centers will have favorable prospects, particularly in middle and lower-middle income markets
- Centers anchored by the dominant traditional grocer will have the best prospects
- Centers anchored by traditional grocers should only be considered in above-average income areas

Appendix
Grocer and Wal-Mart Market Share by Metropolitan Area
December 2004

	Metro	Dominant Traditional Grocer	Market Share	Wal-Mart Market Share
1	**Albuquerque**	Smith's (Kroger)	16.7%	32.5%
2	Atlanta	Kroger	31.0%	17.4%
3	Austin	HEB	60.2%	13.4%
4	Baltimore	Giant Foods (Ahold)	30.6%	0.0%
5	**Birmingham**	Bruno's (Ahold)	22.7%	31.8%
6	Boston	Stop N Shop (Ahold)	25.0%	2.8%
7	Buffalo	Tops Friendly Markets (Ahold)	41.9%	4.4%
8	Charlotte	Food Lion (Delhaize)	27.4%	17.0%
9	Chicago	Jewel (Albertson's)	41.9%	1.9%
10	Cincinnati	Kroger	52.0%	4.9%
11	Cleveland	Giant Eagle	26.6%	6.0%
12	Columbus	Kroger	52.0%	12.3%
13	**Dallas-Fort Worth**	Albertson's	15.5%	28.7%
14	Denver	King Soopers (Kroger)	39.6%	12.0%
15	Detroit	Kroger	23.6%	0.9%
16	Fort Myers/Naples	Publix	41.3%	20.7%
17	Fresno	Save Mart	36.8%	0.0%
18	Greensboro	Food Lion (Delhaize)	31.5%	19.2%
19	Greenville-Spartanburg	Bi-Lo (Ahold)	24.2%	22.7%
20	Harrisburg	Giant Food/PA version	31.3%	20.3%
21	Hartford	Stop & Shop (Ahold)	48.9%	2.4%
22	**Houston**	Kroger	25.4%	24.5%
23	Indianapolis	Marsh Supermarkets	24.1%	22.4%
24	Jacksonville	Publix	24.9%	22.3%
25	**Kansas City**	Hy Vee	14.7%	22.7%
26	**Knoxville**	Kroger	21.2%	33.6%
27	Las Vegas	Albertson's	27.4%	16.9%
28	Los Angeles	Ralph's (Kroger)	18.6%	0.2%
29	Louisville	Kroger	43.2%	21.1%
30	**Memphis**	Kroger	30.4%	30.5%
31	Miami-Ft. Lauderdale	Publix	50.2%	4.3%
32	Milwaukee	Roundy's/Pic N Save	46.2%	7.0%
33	Minneapolis-St. Paul	Cub Foods (Supervalu)	19.9%	3.7%
34	**Nashville**	Kroger	32.3%	33.2%
35	**New Orleans**	Winn-Dixie	26.5%	28.0%
36	New York/New Jersey	Stop & Shop (Ahold)	14.2%	1.3%
37	Norfolk	Food Lion (Delhaize)	36.9%	21.0%
38	**Oklahoma City**	Albertson's	10.6%	41.3%
39	Omaha	Kroger (Dillon)	17.0%	14.9%
40	Orlando	Publix	34.5%	25.5%
41	Philadelphia	Acme (Albertson's)	21.9%	2.3%
42	Phoenix	Fry's/Smith's (Kroger)	27.2%	14.3%
43	Pittsburgh	Giant Eagle	45.3%	16.6%
44	Portland	Fred Meyer/QFC (Kroger)	29.9%	1.2%
45	Providence	Stop & Shop (Ahold)	44.4%	2.2%
46	Raleigh Durham	Food Lion (Delhaize)	32.7%	18.8%
47	Richmond	Food Lion (Delhaize)	26.1%	23.5%
48	Rochester	Wegmans	58.9%	4.6%
49	Sacramento	Raley's/Bel Air	23.0%	0.0%
50	Saint Louis	Schnuck's	29.9%	14.9%
51	Salt Lake City	Smith's/Kroger	25.1%	20.9%
52	San Antonio	HEB	62.6%	22.7%
53	San Diego	Von's (Safeway)	24.8%	0.0%
54	San Francisco	Safeway	37.4%	0.0%
55	Seattle	QFC/Fred Meyer (Kroger)	29.1%	0.9%
56	Tampa	Publix	35.1%	18.9%
57	Tucson	Fry's/Smith's (Kroger)	26.3%	11.7%
58	**Tulsa**	Albertson's	11.4%	42.5%
59	Washington DC	Giant Foods (Ahold)	33.5%	5.5%
60	West Palm Beach	Publix	53.0%	13.1%
		Average:	*31.9%*	*14.7%*

Note: Metros in bold are Wal-Mart dominant markets

Source: Trade Dimensions

ANALYST CERTIFICATION

The views expressed in this report accurately reflect the personal views of the undersigned lead analyst. In addition, the undersigned lead analyst has not and will not receive any compensation for providing a specific recommendation or view in this report.

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