



Invesco Real Estate House View

North American Market Outlook

H1 2012

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Table of Contents

3 Executive Summary

5 Economic Conditions and Outlook

8 Real Estate Market Outlook

13 Property Sector Allocation and Strategic Implications

24 Appendix



Executive Summary

Invesco believes that an uneven economic recovery and long-term structural shifts will create divergent performance across sectors, markets and assets.

“The more things change, the more they stay the same.” That old saying could describe the transition of US investment conditions from the midpoint of last year to where we are today. The downgrade of the US government as a debt issuer and fears of a European debt default in the third quarter of last year caused many investors and businesses to play it safe, evidenced by a subsequent rush of capital into US Treasuries and slower job growth. As the end of 2011 transitioned through the first quarter of 2012, still low Treasury yields turned upward and job growth increased. Moreover, the recent improvement of consumer and business confidence provides a hopeful gauge for the economic outlook. Yet, some things have not changed, namely the sovereign debt risks in Europe and the US that still have the potential to damage the strengthening US recovery.

That said, some things have changed. Throughout this latest edition of Invesco’s North American House View, we will note the key drivers that we believe place the US economy on firmer footing today compared to the second half of last year and how those drivers provide favorable opportunities for investing in institutional real estate. Taken together, the primary drivers of the recovery are expected to produce uneven growth across industries, which should create divergent investment performance across sectors, markets and assets.

The following summarizes our views and targeted investment strategies:

Economy

- **The economic “elevator” is rising gradually.**
US real GDP growth in 2012 is forecast to average 2.5%, close to the long-term trend. Growth in 2013 is expected to improve further, yet remain lighter than past recoveries.
- **The economic elevator has a ceiling.**
Macro risks including the European debt crisis, high US federal government debt, a potential economic hard landing in China, political unrest in the Middle East and rising energy prices reinforce caution and temper risk taking. Deleveraging is likely to be prolonged, serving as another governor on growth.
- **Uneven growth across sectors is expected.**
New media and energy should drive growth, along with steady contributors including health care and education. Financial services and government will likely lag other sectors. Sector differences impact market selection.
- **Low Treasury yields expected for next three years or longer.**
Assurances by the Federal Reserve to keep the federal funds rate at “exceptionally low levels” through late 2014 suggest that, while Treasury yields could rise from current levels, they are likely to remain artificially low for at least the next three years.

Pricing and relative value

- **Investment performance outlook has improved from six months ago.**
Total returns for institutional real estate are expected to average 7.2% per year from 2012 to 2016, a stronger forecast versus six months ago, reflecting the resiliency of the US recovery in the face of escalating risks in the second half of last year.
- **Commercial real estate today appears appropriately priced.**
Cap rate spreads today are either higher than or aligned with long-term average spreads relative to Treasuries, corporate bonds, and mortgages, supporting the proposition that real estate pricing today is appropriate relative to lower risk assets.

- **Stable yields are expected over the next five years.**

Improving economic conditions should cause benchmark Treasury yields to rise and spreads to real estate to fall, resulting in little net change in absolute cap rates. Expected differences on the margin across sectors benefit office and industrial.

Sector allocation

- **Apartments approaching an inflection point, but not a tipping point.**

The best revenue growth in the strongest markets will likely occur this year with some tenants moving from Class A or Class B+ product as rents escalate. While tenant demand is expected to remain strong, the sources of demand are likely to shift, and a wave of new deliveries should start to moderate the sector's relative performance by 2014. The sector target has been reduced from 33% to 31%, while maintaining an overweight to the NCREIF Property Index (NPI) (26%) since the stable income attributes of apartments are attractive in light of lingering macro risks.

- **Office offers best mid-term opportunity for revenue growth.**

Office is expected to see uneven performance across markets, yet as a sector is anticipated to outperform in three to five years when below-market rents on expiring leases roll-up to market rates. Thus, we continue to move our office allocation upward to 32%, while maintaining an underweight position relative to the NPI (36%).

- **Industrial shaped by cyclical recovery and structural shifts.**

Fundamentals are improving as the economy improves. Macro trends related to online retailing, international trade flows and the Panama Canal expansion are expected to impact market performance and the types of industrial space expected to be in greatest demand. The target allocation has been raised to 17%, above the weight in the NPI (15%).

- **Structural shifts require a focused retail strategy.**

Cyclical headwinds appear to have abated, yet long-term shifts in demographics, use of consumer credit, discounting, and online retailing should continue to challenge the sector, causing us to focus on stellar locations. We have further reduced our target weight to 20%, below the weight in the NPI (23%).

- **It's still a "stock picker's game" along with market selection.**

Our expectation of uneven job growth across sectors means that the drivers of tenant demand will likely be divergent across markets and micro locations. Thus, asset and market selection may trump the importance of sector allocation in the near term, particularly among the commercial sectors, as best locations and low near-term exposure to lease expirations are likely to produce better relative performance.

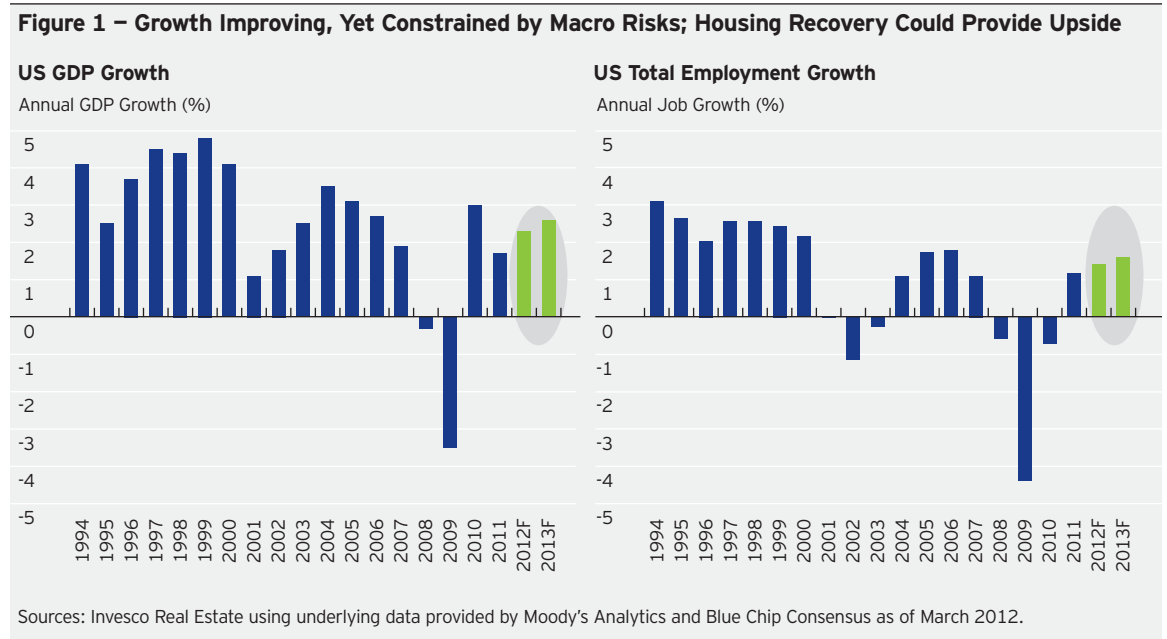
Economic Conditions and Outlook

The US economy appears to be on firmer footing today, but significant uncertainties are constraining the pace of growth.

Key points

- US GDP growth in 2012 is forecast to average 2.5%, close to the long-term trend.
- 2013 growth is expected to improve further, yet remain lighter than past economic recoveries.
- Uneven job growth is anticipated across economic sectors and markets.
- Significant downside risks remain, yet upside risks are emerging.
- Near-term deleveraging should also constrain growth and push inflation risk into the mid-term horizon.
- Benchmark 10-year US Treasury yields of roughly 2% today are expected to rise and approach 4% by 2016.

Economic outlook. Our baseline view of US GDP growth for 2012 is 2.5%, which is mildly above consensus estimates and close to the long-term trend. GDP growth is anticipated to strengthen in 2013 while remaining lighter than past economic recoveries. Total employment is expected to grow on average by 200,000 per month in 2012. Since roughly 200,000 jobs per month are needed to push the unemployment rate downward, unemployment is expected to remain elevated. The following provides the rationale behind our views.



The economic “elevator” is rising gradually. No one will accuse the US economy of rocket-speed expansion in the early stages of this recovery. That said, 10 consecutive quarters of positive GDP growth and 16 consecutive months of positive job growth as of this writing depict consistent, albeit mild, economic improvement. In the face of substantial macro risks, the US economic elevator continues to rise gradually for at least five reasons:

- **Monetary policy remains accommodative.** The Fed's commitment to keep rates low through late 2014 should provide sufficient capital liquidity to support growth.

- **Consumers are finding room for spending.** Initial deleveraging and historically low interest rates have pushed the ratio of household debt obligations to disposable income down to levels not seen since the mid-1980s. Moreover, a mild rise in consumer credit and current savings rates that are twice as high as in the last decade depict a consumer market with moderate room to increase spending.
- **Corporations face pressure to put cash to use.** As of the third quarter of last year (most current data available), the ratio of corporate profits to nominal GDP was at 13%, up from the 6.9% trough at the end of 2008 and the highest level since 1950. Companies have held cash for the past two years as significant risks threatened the durability of the economic recovery. But now, antsy investors want to see that cash put to work, placing pressure on companies to invest and hire to grow revenues. While a large portion of this cash is held overseas, the deployment of these resources should contribute to US growth.
- **Reduced slack compels investment and hiring to spur business growth.** Economic tightness metrics including rising capacity utilization and above-average hours worked in manufacturing reflect that the strong productivity gains of 2009 and 2010 have more recently reached a limit, collectively indicating that businesses will need to invest and hire in order to spur business growth.
- **Changes in global labor costs benefit the US.** Unit labor costs globally have shifted meaningfully to the US's favor over the past decade, driven by below-average growth in US manufacturing wages and currency weakening relative to other countries. As a result, the long-term trend of a declining manufacturing presence in the US appears to be reversing, creating production jobs early in this recovery.

Added to these drivers is the potential upside of better-than-expected near-term performance of the housing sector. New home inventories are at historic lows and existing home inventories could decline to below-trend levels by the end of 2012, which could help prices find a floor and thus motivate the buying and building of homes. The key impediment that could keep near-term home prices in check is the elevated level of home foreclosures. Despite moderating recently, foreclosure levels remain high by historical standards and could ramp up again temporarily given the recent \$26 billion settlement between five major banks and several state attorneys general over past foreclosure practices, clearing the path for dealing with lingering delinquencies. While housing production is expected to contribute more meaningfully to economic growth in 2013, this contribution could come sooner.

The economic elevator has a ceiling. Despite these drivers, US economic growth is constrained by a number of factors.

- **Fiscal policy.** An uncertain regulatory and federal spending environment combined with the tax implications of high government debt form a cloud of caution for business decision making. These factors are compounded by the expectation of political gridlock in this election year.
- **Consumer balance sheet repair.** Persistently high unemployment should prevent meaningful near-term income growth, and households will need years to deleverage and rebuild wealth, all of which place governors on consumer spending.
- **Global risks.** Other factors include the ongoing European debt crisis, the threat of an economic hard landing in China, political instability in the Middle East, and rising energy prices.

Risk aversion is the expected response to these uncertainties, placing a constraining ceiling on growth.

We anticipate uneven growth across sectors. Economic growth is not broad-based at present and will likely remain uneven in the near term.

- **Leading sectors.** Beyond the growth typically found in health care, education, and professional services, we expect economic growth to be driven by two macro trends. The first is the further development of Internet business platforms including social media and related e-commerce, which should continue to spur venture capital investment and job creation in the innovation industries. The second is an upward secular shift of energy production in the US and Canada, driven by the emergence of hydraulic fracturing technologies (a.k.a., fracking) that make energy extraction possible in reserves that previously were inaccessible. Metropolitan areas with outsized exposures to these industries are expected to see comparatively stronger job growth over the near to mid term.
- **Lagging sectors.** Federal, state and local segments of government are anticipated to undergo a prolonged season of deleveraging and reduced spending growth that should lead to flat-to-declining employment trends in coming years. Bank balance sheets are improving, yet macro uncertainties and low bond yields are driving institutions to reduce short-term employment. Metropolitan areas with outsized exposures to these industries could see comparatively weaker job growth in the near term, particularly in markets that serve as secondary locations for these industries.

Deleveraging pushes inflation risk to mid or long term. While the ratio of debt to nominal GDP has declined from peak levels, the ratio remains substantially elevated and will necessitate a prolonged season of deleveraging across the broad US economy, particularly in the consumer and government sectors. Deleveraging by its very nature dampens the pace of economic growth, and moderated economic growth could translate into slow money velocity, which should result in low inflation over the next two years or longer. That said, money supply today is at elevated levels relative to nominal GDP, which could stir inflationary pressures if economic growth accelerates materially. We believe that prolonged deleveraging pushes the risk of higher sustained inflation (i.e., levels materially above the Fed's 2% target) into the mid to long term.

Low Treasury yields expected for next three years or longer. With the yield on 10-year US Treasuries bumping along the historical basement of 2% late last year and early this year, it seems that the only direction that yields can move over the next few years is up. This expectation was reinforced in March as yields quickly rose above the 2.3% mark. Yet, assurances by the Federal Reserve to keep the federal funds rate at "exceptionally low levels" through late 2014 suggest that while Treasury yields could rise from current levels they are likely to remain artificially low for at least the next three years. As such, the eventual rise in yields that would normally accompany the progression of economic growth will likely be stretched further into the future.

Our forward five-year yield expectation on the 10-year Treasury bond remains at 4.0%.¹

1 We arrived at this expectation via three considerations: (1) Pricing yields of 10-year Treasury bonds in the futures market for the end of 2016 ranged from roughly 3.30% to 3.75% throughout March. This range going forward seems low, given that the futures market had been pricing Treasury yields above 5% about a year ago. (2) The long-term spread between 10-year Treasury bond yields and inflation (as measured by the CPI) averages roughly 250 basis points. If inflation averages between 1.5% and 2.0% over the next five years, an implied range for Treasury yields by 2016 would be 4.0% to 4.5%. The upper end of this range seems too high because a shift from recent yields of 2% to 2.3% up to 4.5% would constitute a five-year change exceeding three standard deviations. (3) The spread between the federal funds rate and the 10-year US Treasury yield has averaged roughly 185 basis points over the past two decades when the spread of Treasuries to federal funds was positive. If the federal funds rate is raised from near 0% today to 2% in the next five years, the implied US Treasury yield at year-end 2016 would be 3.85%. Taken together, a projection of 4.0% bridges these three considerations and is applied in our total return forecast as described in the next section.

Real Estate Market Outlook

While macro risks have reset return expectations, improved confidence and flight-to-quality appear to have strengthened the foundation for institutional real estate performance.

Key points

- Unleveraged total returns of the NCREIF Property Index (NPI) from 2012 to 2016 are forecast to average 7.2% per year.
- Commercial real estate today appears appropriately priced.
- Capital flows should favor pricing support on core assets in primary and secondary markets above other segments.
- Flight-to-quality could further compress yields in the near-term for core assets in leading markets across sectors.
- Best relative performance is expected to be led by apartments in the near term and office in the mid term.
- Invesco intends to balance our selection of low-cap rate, high-growth markets with less aggressively priced markets expected to produce moderate growth.

Real estate pricing conditions

Commercial real estate today appears appropriately priced. Wide cap rate spreads relative to benchmark US Treasury yields have historically signaled a buying opportunity and marked favorable vintage year periods for future returns from a capital markets perspective. Yet, highly accommodative monetary policy by the Federal Reserve has pushed Treasury yields to what could be artificially low levels, necessitating that cap rates be evaluated across multiple comparative metrics.

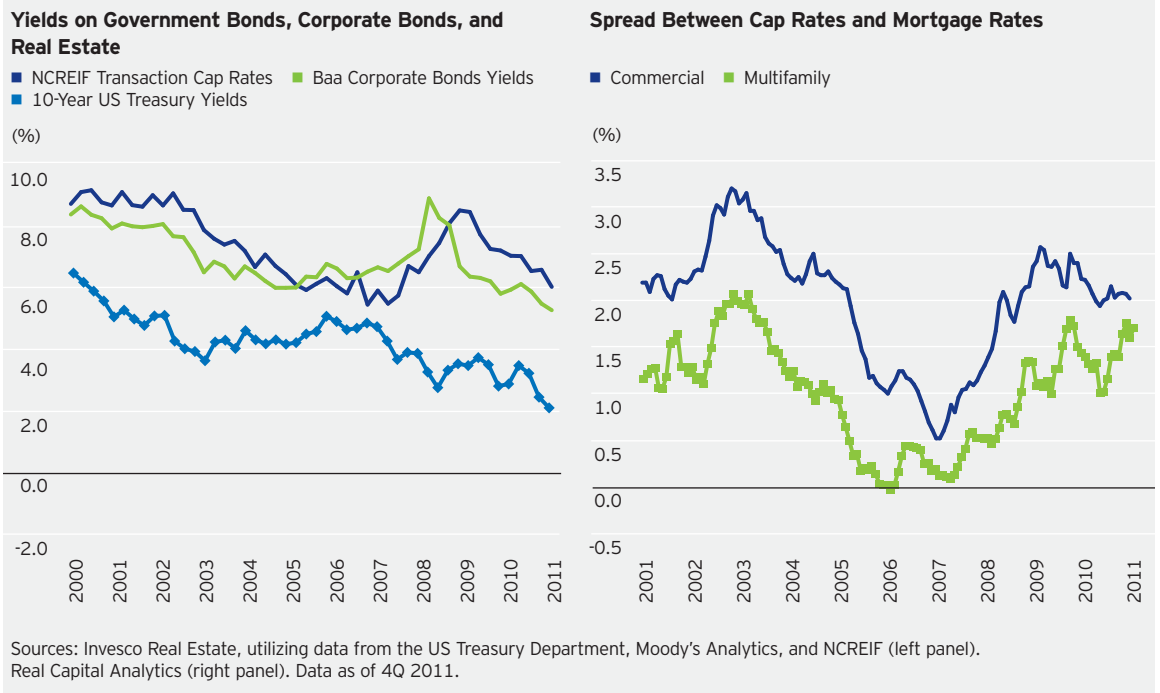
- **Spread to Treasuries.** The spread between NCREIF transaction cap rates and the yield on 10-year US Treasury bonds in fourth quarter 2011 was 395 basis points, substantially higher than the 300 basis point average since 1994.
- **Spread to Baa corporates.** The spread between NCREIF transaction cap rates and the yield on Baa corporate bonds in fourth quarter 2011 was 75 basis points, which is down from 200 basis points two years ago and 100 basis points one year ago, but still exceeds the 62 basis point average since 1994.
- **Spread to mortgage rates.** The spread between multifamily cap rates tracked by Real Capital Analytics and mortgage rates in fourth quarter 2011 averaged 173 basis points, substantially higher than the 107 basis point average since 2001. Commercial cap rate spreads in the fourth quarter averaged 198 basis points, in line with the 202 basis point average since 2001.

Taken together, cap rate spreads today are either higher than or aligned with long-term average spreads relative to Treasuries, corporate bonds, and mortgages, supporting the proposition that real estate pricing today is appropriate relative to lower risk assets. Moreover, assets today are typically trading at prices that are below replacement cost, prices remain 8% to 25% below pre-recession peak levels¹ and NPI values remain 15% to 25% below prior peaks as of fourth quarter 2011² (most current data available), leaving room for further value recovery relative to pre-recession conditions.

1 Based on US aggregated price per unit across the four major property types through fourth quarter 2011 according to Real Capital Analytics. The 8% to 25% range is represented by apartments on the low end and office on the high end.

2 Based on indexed values from NCREIF. The range of 15% to 25% represents apartments and retail on the low end compared to office and industrial on the high end.

Figure 2 – Cap Rate Spreads Appear Appropriate Compared to Treasuries, Corporates, and Mortgages



Economic progress should boost transaction activity and support pricing. While economic growth has been less than robust, the persistence of growth in the face of escalating macro risks last summer and fall has strengthened investor confidence to look beyond low risk, low yielding bonds for better returns in other asset classes, as reflected in real estate capital flows. Public REITs in 2011 raised a record \$51.3 billion in equity, debt, and IPO capital.¹ Private equity institutional real estate managers raised \$48.3 billion in 2011.² While this constitutes only one-quarter the pace experienced prior to the recession³, it is meaningful in light of a \$68 billion overhang of previous commitments waiting to be invested.⁴ Add to this a record 2011 in life company lending⁵ and momentum appears strong for commercial transaction activity in 2012 to materially exceed last year's volume of \$233 billion.⁶

Divergent debt availability and uneven job growth reinforce flight-to-quality. The resurgence of life company volume and re-entry of bank lending is contrasted with the still struggling CMBS market, whose 2011 issuance of \$31 billion is a mere shadow of volume during the credit boom.⁷ While improving economic conditions should spur moderately higher issuance levels in 2012, uneven growth across industries and markets coupled with the imbalance of debt capital across the risk spectrum should continue to drive flight-to-quality among tenants and investors.

Total return assumptions and forecast

Flight-to-quality could spur near-term yield compression for core assets. Flight-to-quality among tenants and investors coupled with further improvement in real estate fundamentals could place downward pressure on cap rates for institutional quality assets over the near term as investors seek attractive risk-adjusted returns relative to the low yielding bond market.

Mild mid-term yield compression is anticipated for office and industrial. Over the next five years, real estate yields are expected to be affected by improving economic and real estate conditions in two particular ways. First, the base-level risk-free yield on the US Treasury bond is likely to rise (as addressed in the economic section). Second, the spread between real estate and Treasury yields is likely to compress as investors become less risk averse, attracted by what should be better

1 Source: National Association of Real Estate Investment Trusts (NAREIT).

2 Source: Fund Tracker, Institutional Real Estate: Fourth Quarter 2011 edition, page 1.

3 Source: Fund Tracker, Institutional Real Estate: Third Quarter 2011 edition, page 1.

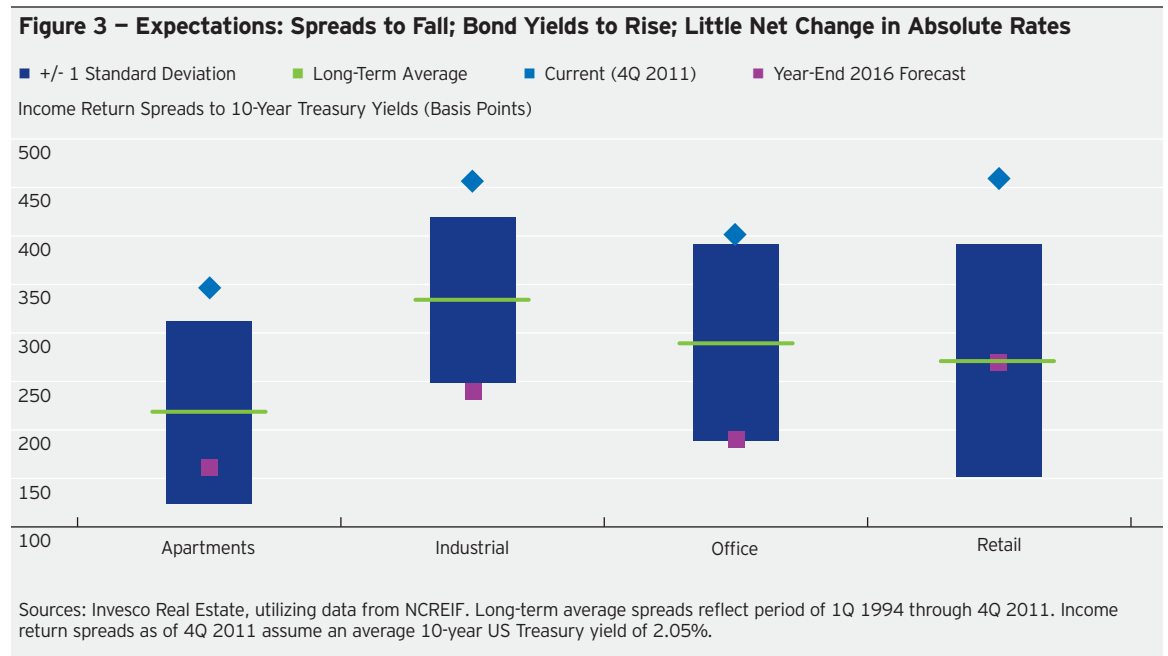
4 Source: Fund Tracker, Institutional Real Estate: Fourth Quarter 2011 edition, pages 1-3.

5 \$45.5 billion for 2011, according to the American Council of Life Insurers.

6 Source: Real Capital Analytics. Volume in 2011 was similar to the early credit boom year of 2004.

7 Source: Credit Suisse. Roughly \$200 billion were issued on average annually from 2005 to 2007. A range of \$50 to \$90 billion was issued annually from the late 1990s to 2004.

fundamentals than what we see today in commercial real estate. The net result of these two effects is expected to be little net change in absolute cap rates. Yet, we do expect to see marginal variations across the four main property sectors.

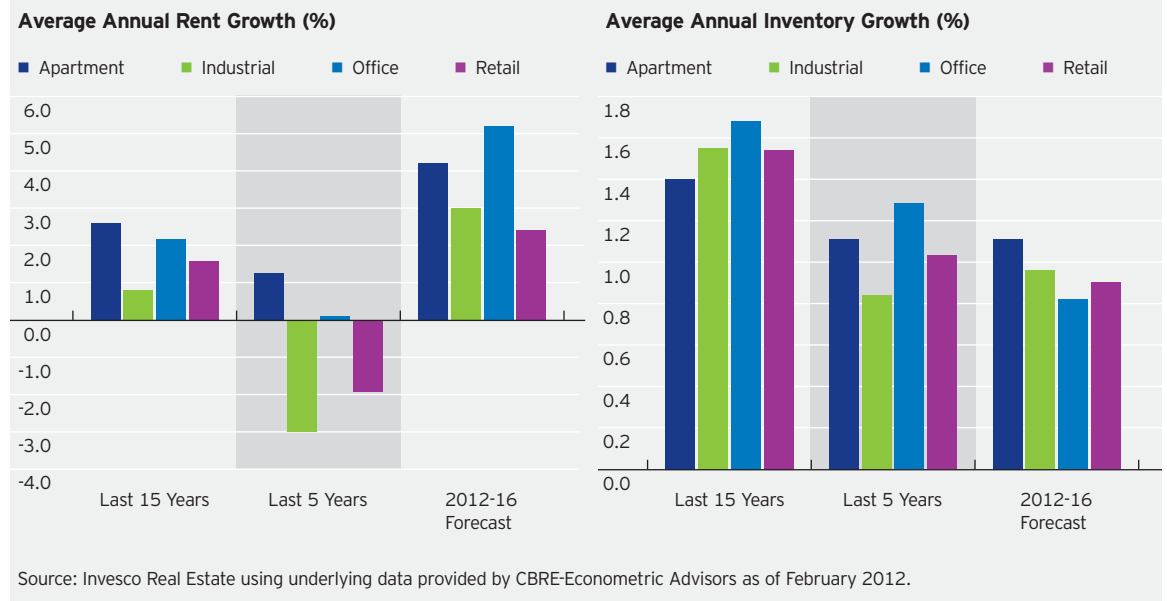


Apartment fundamentals are very strong today and expected to perform well going forward, yet are anticipated to moderate over our five-year outlook horizon. Given the substantial rent growth that has already occurred in the strongest apartment markets and the current push by landlords to further increase rents, the capacity for tenants to absorb continued rent bumps will likely subside if household income growth does not keep pace. Also, the escalation of new apartment deliveries starting next year and more significantly in 2014 should temper landlords' ability to push rents upward. As such, while we expect yield spreads to compress as economic conditions improve, spread compression for apartments may not be as strong as that for the office and industrial sectors which are anticipated to see a rise in tenant demand with a comparatively modest supply response in the outer years of our five-year horizon. Retail yield spreads, in broad sector terms, are expected to compress in line with long-term average spread levels, yet asset quality and market liquidity should drive highly divergent patterns in retail spread compression.

The net result of these expectations on absolute yields over the next five years is a mild rise for apartments; a mild decline for office and industrial; and stable yields for retail at the broad sector level. Hence, appreciation across sectors over the next five years should be driven largely by net income growth, while office and industrial should receive a modest appreciation contribution from yield shift.

Apartments expected to lead income growth in near term; office in mid term. Given our view that cap rates should remain relatively stable over the outlook horizon, fundamentals are largely expected to differentiate performance across property sectors. Our outlook for fundamentals is connected to our baseline economic expectations for continued recovery where growth is constrained by lingering uncertainties related to the European sovereign debt crisis, US fiscal conditions, and other risks previously noted. The following summarizes our assumptions for net operating income (NOI) growth per sector nationally over the next five years (2012-2016). Sector-specific drivers of fundamentals and growth are addressed in the following section on sector allocation.

Figure 4 – Office Expected to Post Best Rent Growth as Mid-Term Construction Moderates Apartment Rent Growth



- Apartment NOI growth is forecast to average 4.5% per year, with the strongest years on the front end of the outlook horizon prior to the emergence of new supply.
- Office NOI growth is forecast to average 4.2% per year as annual rent growth and expiring leases lead to rents rolling higher by 2013.
- Industrial NOI growth is forecast to average 2.7% per year. Like office, industrial NOI growth is weighted more strongly in the latter half of the five-year outlook horizon.
- Retail NOI growth is forecast to average 2.2% per year. NOI growth is anticipated to vary considerably across the retail spectrum as Internet retailing reduces the demand for certain bricks-and-mortar formats and drives divergent performance between the best positioned centers and commodity locations.

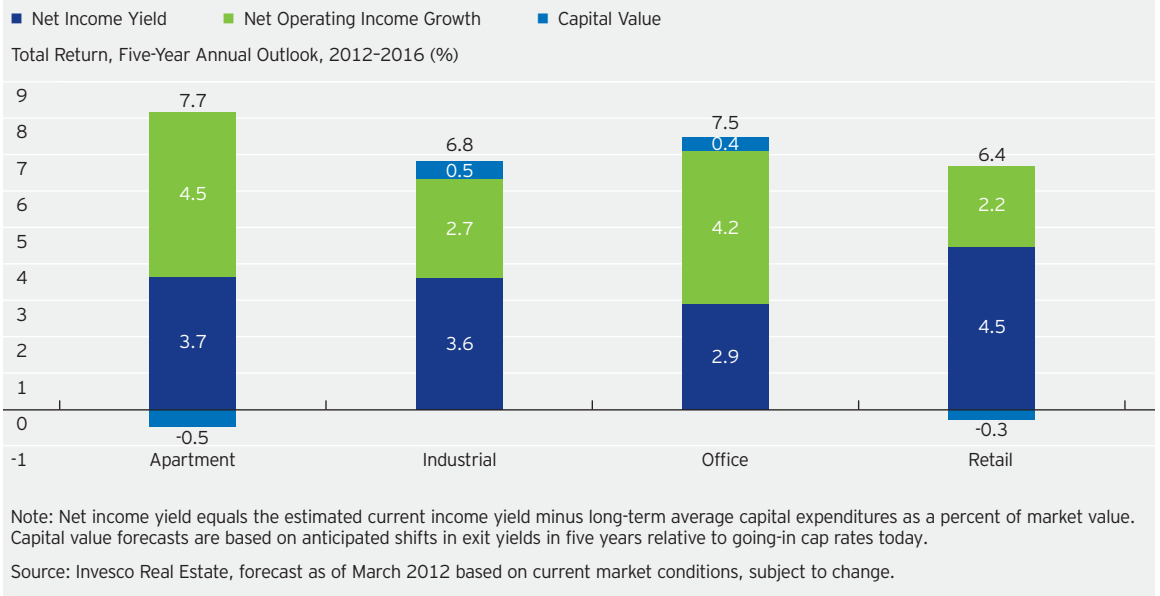
Best relative performance led by apartments in near term; office in mid term. Based on our view of capital markets and the shape of market fundamentals, we believe that:

- Aggregated total returns for the unleveraged NCREIF Property Index are expected to average +/- 7.2% from 2012 to 2016, based on our assumptions of going-in cap rates, future versus initial valuation-based income yields, expected income growth, and capital expenditures.
- The apartment sector offers the best opportunity for investment performance over the next one to two years, followed by the office sector.
- Beyond the one- to two-year horizon, we expect that office returns will overtake the other sectors to deliver best relative performance.¹
- Invesco believes that +/- 100 basis points of excess performance can be realized through superior market selection (see next section) focused on the top projected two-thirds of Invesco's qualified markets over the next three to five years.
- Additional excess performance may be realized through further narrowing of market selection and by superior asset selection (i.e., market segments, submarkets, asset characteristics, and lease structures most aligned with generating better relative income growth).

¹ Performance of individual assets can vary widely due to location, quality, rents in-place relative to market rents, expected capital expenditures, etc.

The quantitative assumptions underpinning our national outlook for total returns are provided in the Appendix.

Figure 5 – Outlook for Total Return Components Shows Best Relative Value in Apartments, Followed by Office



Implications for asset segments and market selection

Debt, growth and quality portend deviating paths for mortgage maturities. In the next five years, some \$1.7 trillion of commercial real estate loans are scheduled to mature.¹ A substantial portion of these loans was originated in the 2005 to 2007 period when underwriting quality was comparatively poor. The combination of uneven job growth, flight-to-quality in fundamentals and pricing, and the lack of an imminently significant resurgence in CMBS means that poorly located assets, particularly in tertiary markets, should continue to face challenges meeting loan requirements, resulting in a high percentage of maturing loans that may not be eligible for refinancing, which could push more distressed assets into the transaction market.

In contrast, “pretend and extend” on loan modifications may not be a pretender’s game for higher quality assets in primary and secondary markets with higher quality lenders underwriting further extensions on their best assets and markets.

Cap rate gap between primary and secondary markets could narrow. As the improvement of fundamentals extends beyond primary markets into secondary markets, capital flows are anticipated to broaden and could cause the cap rate gap between the two market segments to compress in 2012. For this reason, Invesco intends to balance our selection of low cap rate, high-growth markets with less aggressively priced markets with a propensity for better relative growth.

¹ Source: Trepp, LLC. Data as of 4Q11.

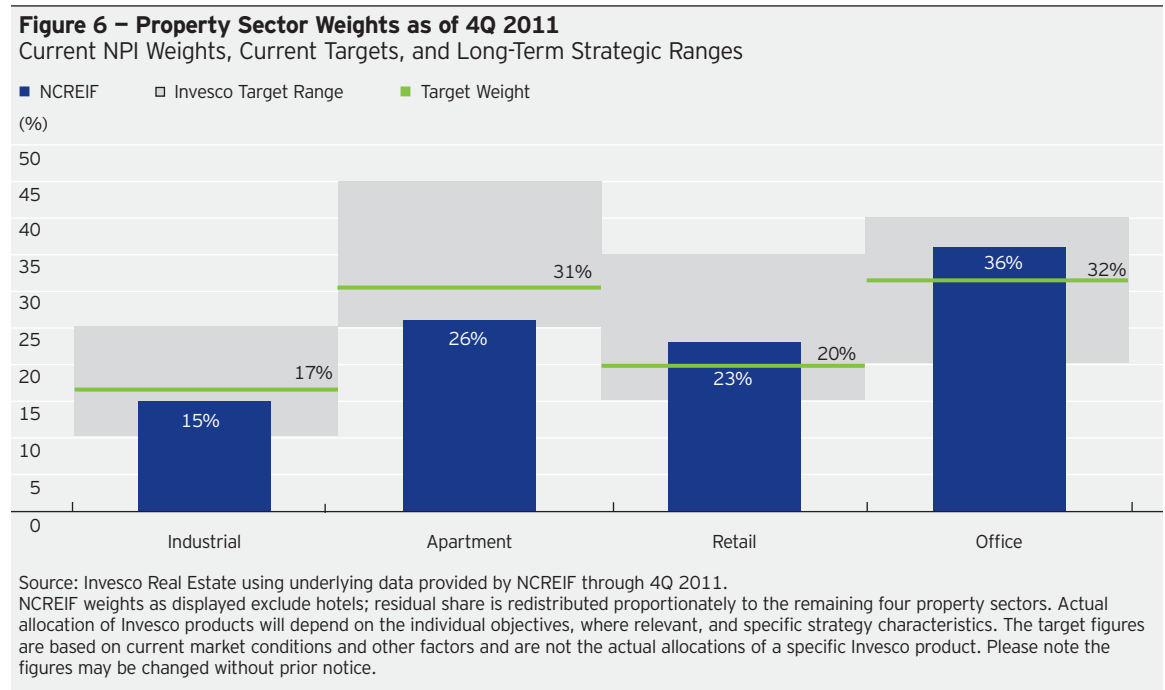
Property Sector Allocation and Strategic Implications

Invesco is moderating our overweight to the apartment sector while positioning our office and industrial weights for improving performance over the next five years.

Key points

- The growth of jobs, household incomes, and new supply comparatively across apartment markets is expected to influence relative performance.
- Most primary markets and metros with outsized exposures to new media and energy are anticipated to produce better relative performance in the office sector.
- Industrial strategies are expected to be shaped by e-commerce, Asian trade, and widening of the Panama Canal.
- Shrinking store formats and an uneven recovery in fundamentals necessitate a focused retail investment strategy.

Our allocation shifts since the Autumn 2011 House View are reflected below and are driven by two primary assumptions. First, we believe that the superior relative performance of apartments over recent years will moderate as new supply escalates and relative performance of office and industrial improves. Second, while economic conditions appear to be on firmer footing today compared to last fall, we believe that prevailing macro risks support a continued meaningful overweight to the apartment sector, which historically has provided more favorable risk-adjusted returns.



Apartments

- Invesco has decreased our target weight to the apartment sector from 33% to 31% while maintaining an overweight position to the sector's weight in the NPI (26%).
- We may further reduce the apartment target weight in the future because pricing has become aggressive across several market segments and today's robust fundamentals are anticipated to attract strong levels of new development.
- Yet, we are currently maintaining an overweight position to the NPI given the attractiveness of the sector's stable income profile in the face of lingering macroeconomic risks.

Office

- We have increased our target weight to office from 30% to 32% while maintaining an underweight position relative to the NPI (36%).
- The office target weight was increased because we expect better relative growth in office starting in the next one to two years and through the back end of our five-year forecast horizon.
- Yet, we are maintaining an underweight position because rents on expiring leases signed at the peak of the market could dampen average revenue growth in 2012 and our belief that a mid-term office recovery will be uneven across markets.

Industrial

- We are increasing our industrial target weight from 15% to 17%, representing a slight overweight relative to the NPI (15%).
- The industrial target weight was increased because we expect better relative growth in industrial starting in the next one to two years and through the back end of our five-year forecast horizon.
- Our target reflects the expected cyclical recovery of the sector as well as the long-term structural shift of consumer-driven tenant demand from retail to industrial.

Retail

- Invesco has reduced our target weight for retail from 22% to 20%, representing an underweight position relative to the NPI (23%) in light of long-term headwinds from shifting consumer trends.
- We believe that these headwinds will lead to sharply bifurcated performance at the asset level, thus, Invesco holds a favorable view on best located assets.

Our allocation target weights are supported by our views of current pricing relative to stabilized fair value, as well as our views on net income growth as described in the previous section.

It's still a "stock picker's game" along with market selection. While the outlook for economic growth has improved, our expectation of uneven job growth across industries means that the drivers of tenant demand will likely be divergent across markets and micro locations. Thus, as we stated in the Autumn 2011 House View, asset and market selection may trump the importance of sector allocation over the near term, particularly in the office, industrial and retail sectors where leases signed at the peak of the cycle roll down to lower rent levels. We believe that high-quality assets with the best location characteristics and low near-term exposure to lease expirations are likely to produce better relative performance. From the perspective of currently held assets, managing lease expirations is crucial to strengthening the durability of income for the next one to two years.

Our sector target weights and expected returns represent our broad views across the national commercial real estate sectors, yet a number of factors are expected to produce divergent investment performance across markets, product segments, and assets. The following property sector sections provide additional support for our allocation target weights, expectations of market and segment differentiation, and strategies.

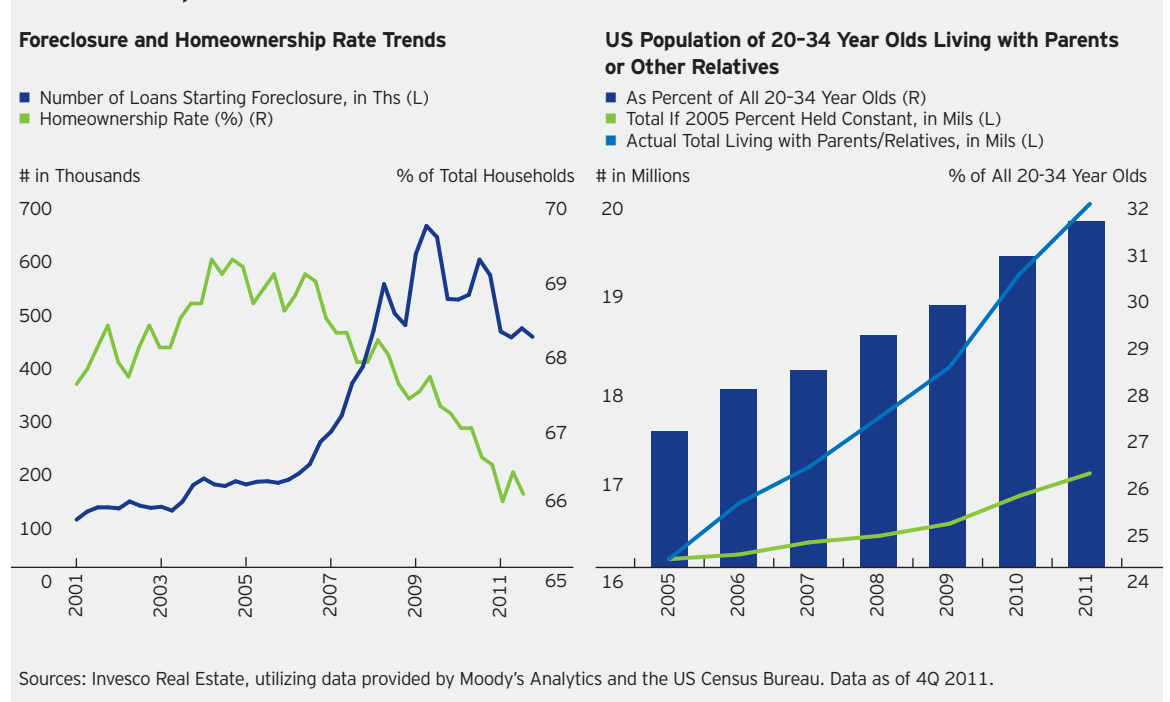
Apartment

After steady occupancy gains over the past two years, apartment dynamics are anticipated to undergo change. The best revenue growth in the strongest markets will likely occur this year with some tenants moving from Class A to Class B+ product as rents escalate. Mild near-term construction is anticipated to give way to escalating deliveries by 2014. While tenant demand is expected to remain strong, the drivers of demand will likely shift away from declining homeownership and toward rising job growth and the unbundling of echo boomer demand as hiring increases. The ability of landlords to push through additional rent bumps will in some measure rely on the strength of local employment and household income growth.

Apartments appear to be approaching an inflection point. Apartments appear to be near an inflection point for six key reasons:

- **Moderating revenue growth expected.** The best revenue growth in the strongest markets (primarily the coastal markets) has likely occurred already or will occur this year. Markets next in line in the fundamentals cycle will likely see revenue growth peak over the next two years. As rents escalate deeper into the apartment cycle, successive rent bumps will likely become more difficult for tenants to absorb unless they see a commensurate increase in household incomes, which is further addressed later in this section.
- **Quality shifts.** Some tenants in high-cost housing markets experiencing the strongest rent growth have started to move from Class A to Class B+ product as rents escalate. While job growth is expected to largely backfill the turnover, some Class A tenants who leased during the recession or early in the recovery are now getting priced-out, representing a transition in market conditions.
- **Re-entry to home market.** Some apartment properties are starting to see a mild rise in tenants being lost to home buying. While this mild uptick remains well below long-term attrition levels, it could serve as an early signal of changing conditions.
- **Shadow rentals.** Single-family homes are reported as a source of rental competition in the toughest housing markets, namely Phoenix, Southern California's Inland Empire, and the Florida markets (as well as markets outside Invesco's qualified universe such as Las Vegas and Detroit). In addition, the rollout of the Federal Housing Administration's REO-to-rental program could increase the inventory of single-family rentals proportionally more in these markets than others.
- **Slower foreclosures mean less homeownership declines.** While we expect foreclosures to ramp up temporarily as large banks refocus on lingering delinquencies, we also believe that foreclosures will moderate meaningfully over the next two to three years. Thus, the impact of foreclosures on the powerful trend of sharply declining homeownership in recent years will likely moderate and contribute less to rental housing demand in the back end of our five year outlook horizon.
- **Apartment construction is coming.** Fundraising for new development remains active and prevailing trends in multifamily permitting point to 2014 being the first year when the level of new deliveries is expected to exceed the long-term average trend.

Figure 7 – Homeownership Should Stabilize as Foreclosures Eventually Diminish; But Young Adults Provide Pent-Up Rental Demand



Mitigating factors suggest apartments are not at a tipping point. This inflection point in the apartment sector, however, does not at this time represent a tipping point in light of four important factors:

- **Near-term deliveries are low.** While construction is expected to escalate by 2014, new apartment deliveries in 2012 and 2013 are anticipated to be quite low relative to long-term trends, which should lead to even tighter occupancies and higher rents over the next two years.
- **Balance sheet repair means longer duration in rental housing.** While historically low interest rates have reduced mortgage payments for households able to qualify for new loans and refinancings, absolute debt levels as a percent of incomes remain high by historical standards.¹ As such, we expect that household deleveraging and the broad recovery of creditworthiness will temper, although not stop, the transition of former homeowners out of the rental market for another two years.
- **Improving job growth to support tenant demand.** While shifts in housing tenure will likely play a diminished role in the growth of rental housing demand going forward, tenant demand is expected to remain healthy as the employment recovery persists.
- **Job growth to unlock pent-up echo boomer demand.** Roughly 27% of 20 to 34 year olds were living with parents or relatives² in 2005; that number rose close to 32% in 2010, with the differences in percentages representing roughly 2.9 million untapped rental tenants.³ This demographic segment is expected to contribute more meaningfully to apartment demand going forward as employment conditions improve, partially mitigating the impact of new construction.

Rent growth could be constrained by incomes. The ability to sustain rent increases will depend largely on the relationship between rent and household incomes across individual markets. Metros with higher unemployment rates and/or greater concentrations of lower skilled workers will likely face constraints in their ability to increase rents persistently. Markets benefiting from the growth of higher quality jobs (e.g., Bay Area, Seattle) will have a deeper capacity for achieving rent increases. Markets that have already experienced a “first wave” of significant rent growth, such that rents relative to incomes have become high, will need to generate high-quality jobs at a healthy pace to enable the passage of subsequent rent bumps.

Strategies

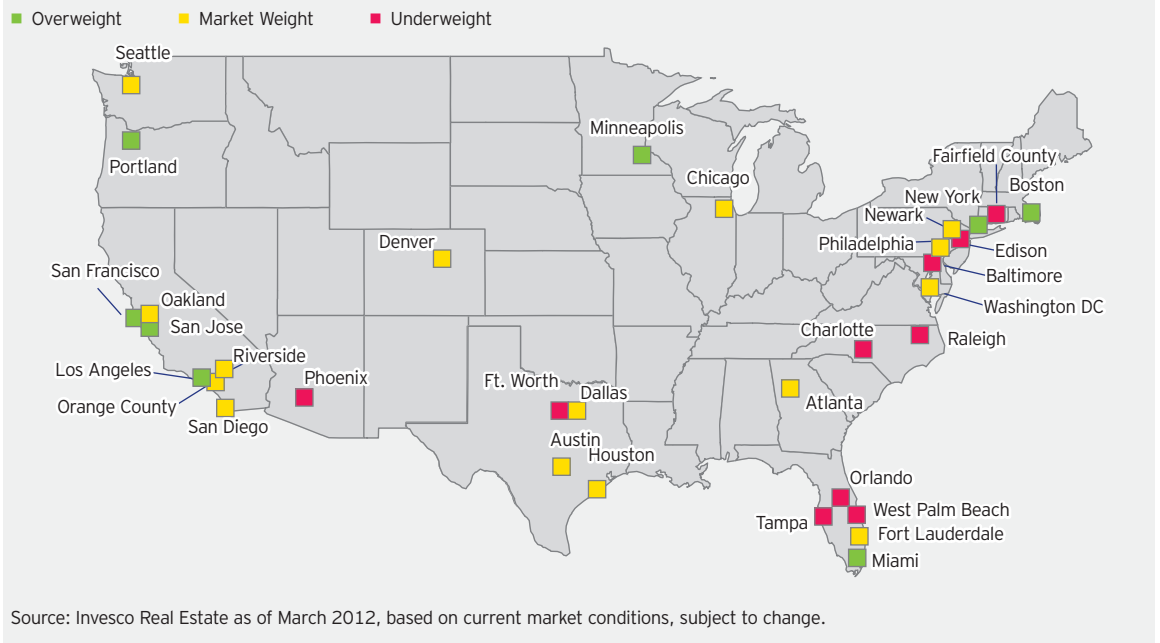
- Invesco prefers markets that present the best combination of strong occupancy trends, high relative housing costs, high barriers to construction and the entitlement process, and high household incomes relative to rent levels. These markets include San Francisco, San Jose, Oakland, Los Angeles and New York City. Within these target markets, Invesco will:
 - Focus on well-located Class A and B+ assets.
 - Selectively consider assuming more leasing risk.
 - Consider well-located Class B assets in the strongest locations to take advantage of high occupancy rates and the spread to Class A rents.
 - Selectively consider development and value-added opportunities in the most durable supply constrained locations.
 - Seek to raise rents for both new leases and tenant renewals.
- We also intend to target markets presenting an attractive combination of less aggressive pricing and better relative NOI growth. These markets include Portland, Boston, Miami, Denver, Chicago, Minneapolis, Philadelphia and Northern New Jersey.
- We will consider dispositions:
 - Of assets requiring higher levels of capital improvements in order to manage cash, particularly older assets in less-than-best locations.
 - Of non-strategic assets proximate to micro locations where new construction is expected to rise materially. Markets where mid-term construction could ramp up more quickly include Washington DC, Houston, Dallas, Austin, Orange County and Seattle.

1 According to data from the Federal Reserve and the Bureau of Economic Analysis, US mortgage debt outstanding peaked in 1Q 2008 at \$10.6 trillion or 74% of nominal GDP. Levels have since reduced to \$9.8 trillion as of 4Q 2011, or 64% of nominal GDP, which remains above the 50% ratio of 10 years ago.

2 Living with “relatives” in these numbers excludes 20-34 year olds living with a spouse.

3 Data provided by the US Census Bureau. Implications for rental housing demand estimated by Invesco Real Estate. Data as of November 2011.

Figure 8 – Qualified Apartment Markets



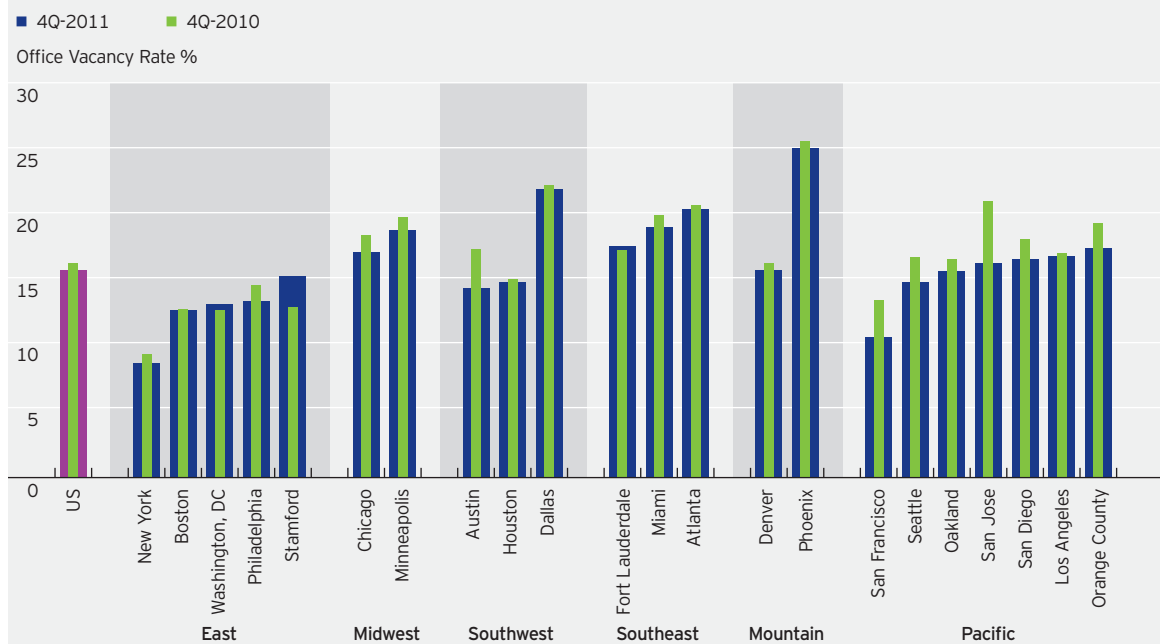
Office

Office fundamentals are anticipated to reflect the uneven nature of job growth across industries in this recovery. Software development and new media firms are expanding and energy is experiencing a new growth cycle, while financial service firms and tenants with ties to government spending are more cautious. The combined influence of higher expected business costs and the impact of technological changes on the use of space are also expected to slow the marginal demand for office space. The lack of meaningful new construction over the foreseeable future should partially mitigate these effects, allowing fundamentals to tighten further and for rents to escalate in the strongest markets.

Uneven tenant demand expected across office markets. Tenant demand is expected to reflect the uneven nature of job growth across industries in this recovery, thus favoring markets with greater relative exposure to growth industries and less exposure to weaker industries.

- The best growth segments among office-using industries are expected to be software development, new media and energy. This implies demand growth in the Bay Area, Seattle, New York, Boston, Austin, Houston and Denver.
- Bank balance sheets are improving, bringing more stability to the sector but not much growth at present due to the overhang of the European debt crisis and related contagion concerns. The depth of the New York market, the tech/venture capital orientation of San Francisco and Boston, and bank merger consolidation in Minneapolis allow for near-term tenant demand growth, while growth may come later for other financial centers and regional markets such as Charlotte, Chicago, Dallas and Atlanta.
- Biotech benefits from long-term demographic trends and should see growth, yet this industry typically is not a major producer of jobs. Markets to benefit on the margin include Boston, San Diego, New York, New Jersey, Houston, San Jose, Baltimore and Washington DC.
- International trade should favor markets with the strongest linkages to Asia (Los Angeles, Bay Area and Seattle) and emerging markets (New York, Houston and Miami).
- Federal government with its planned defense cuts, budget deficits, and unsustainable levels of debt will likely dampen or impair growth in Washington DC.

Figure 9 – Recent Office Vacancy Declines Have Been Strongest in Tech Markets



Source: Invesco Real Estate, utilizing data from CBRE-Econometric Advisors as of 4Q 2011.

Marginal demand for office space will slow. Higher expected business costs and more efficiency-promoting technologies are anticipated to shift the way companies use office space and lead to a slowdown in the growth of marginal space demand. This should impact the demand for office space in two ways. First, near-term absorption will likely lag office-using job growth as tenants expand operations into currently unutilized leased space. Second, gains in office-using jobs will likely produce less proportional space demand compared to past trends. While these trends should exert broad effects across markets, the uneven nature of job growth and tenant demand further accentuates the market selection priority of metros with greater relative exposure to growth industries.

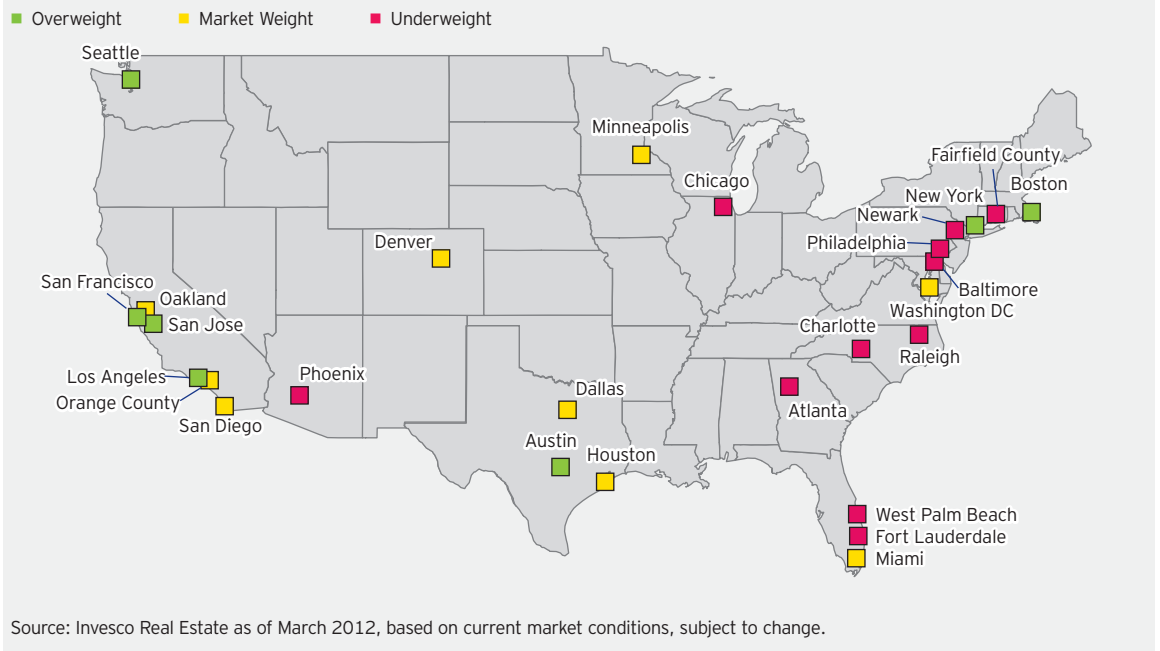
Economic uncertainties could push broad leasing gains into 2013. Despite the apparent improvement in economic conditions, several risks should continue to give pause to potential expansion plans of office space tenants. Euro risk, election year gridlock, burn-off of the 100% depreciation of business investment at year-end 2011, burn-off of the 50% depreciation at year-end 2012 and higher expected employer health care costs are a few of the reasons why companies may delay leasing decisions, even with rising job growth.

Strategies

Invesco intends to:

- Target three sets of markets: primary markets with the best prospects for NOI growth (New York, San Francisco, Los Angeles and Boston); markets with outsized exposure to the technology and innovation industries (San Jose/Bay Area, Seattle, Austin, and most of the primary markets); and markets with strong exposures to the energy industry (Houston and Denver).
- Target assets in dominant high density locations in our preferred markets with limited lease expirations over the next one to two years.
- Focus on higher-quality, Class A assets in urban locations since occupancy recovery has progressed further in these segments and they are expected to continue to be favored by occupiers in recovery.
- Selectively consider Class B space in tech markets where supported by tenant demand.

Figure 10 – Qualified Office Markets

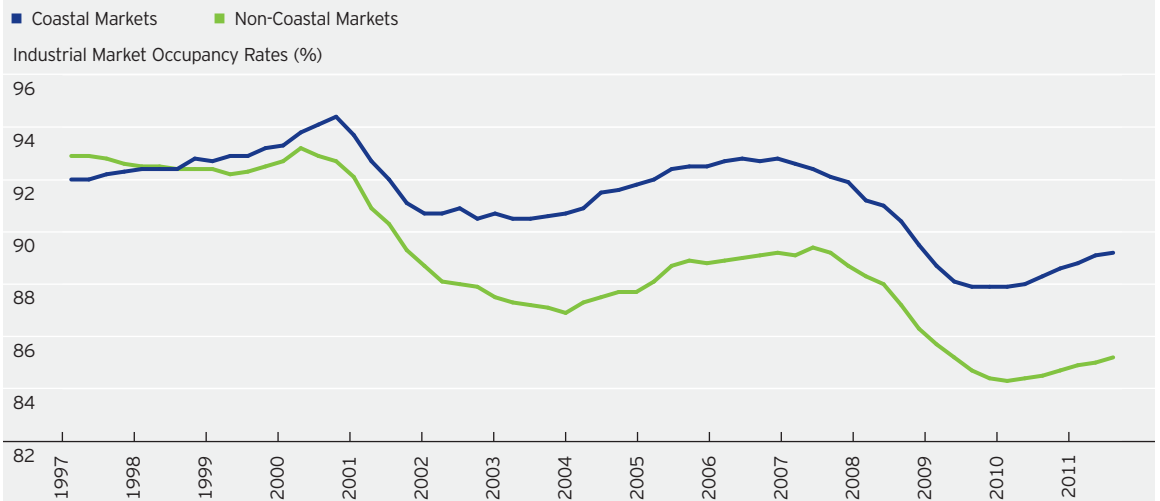


Industrial

Industrial occupancy today is at a two-year high, early evidence of a fundamentals recovery supported by growth in industrial production and consumer spending. Vertical integration, online retailing, the comparative strength of international trade flows and the anticipated expansion of the Panama Canal are key trends impacting market selection and the types of industrial space expected to be in greatest demand. Construction remains light and concentrated in only a few markets, clearing the path for further recovery in the near term.

- **Recovery has focused on consolidation into large spaces.** While moderate consumer spending spurred slightly below-trend absorption levels nationally last year, the uneven demand recovery strongly favored big box markets proximate to the most active ports. Large blocks of space are in high demand as tenants focus on economies of scale through bigger boxes that can vertically integrate their supply chain and/or house a wider variety of products for Internet order fulfillment. This ongoing trend is increasing the demand for industrial space as technology drives structural changes in how consumers spend. This is why, in part, absorption in Riverside is exceeding Los Angeles, and why absorption in Edison is exceeding New York and Newark.
- **Online retail should benefit industrial demand.** The rising penetration rate of mobile devices and cost competitiveness of online retailers are driving a structural shift in how consumers buy and how businesses transact and operate. While these trends are reducing the demand for bricks-and-mortar retail, the other side of the coin could be a demand shift toward industrial. Initial beneficiaries from this trend appear to be secondary and tertiary markets in low tax, low wage states with favorable e-commerce sales tax treatment and tech markets like the Bay Area and Seattle, which are home to the companies driving these trends (e.g., Amazon). Going forward, we anticipate that the largest metropolitan areas will see a related rise in marginal demand as online retailers attempt to boost penetration rates in the most densely populated consumer markets.

Figure 11 – Industrial Fundamentals Have Favored Global Trade Gateways with Large Consumer Markets



Source: Invesco Real Estate, utilizing data from CBRE-Econometric Advisors. Coastal markets include Edison, Fort Lauderdale, Houston, Los Angeles, Miami, New York, Newark, Oakland, Orange County, Riverside, San Jose and Seattle. Data as of 4Q 2011.

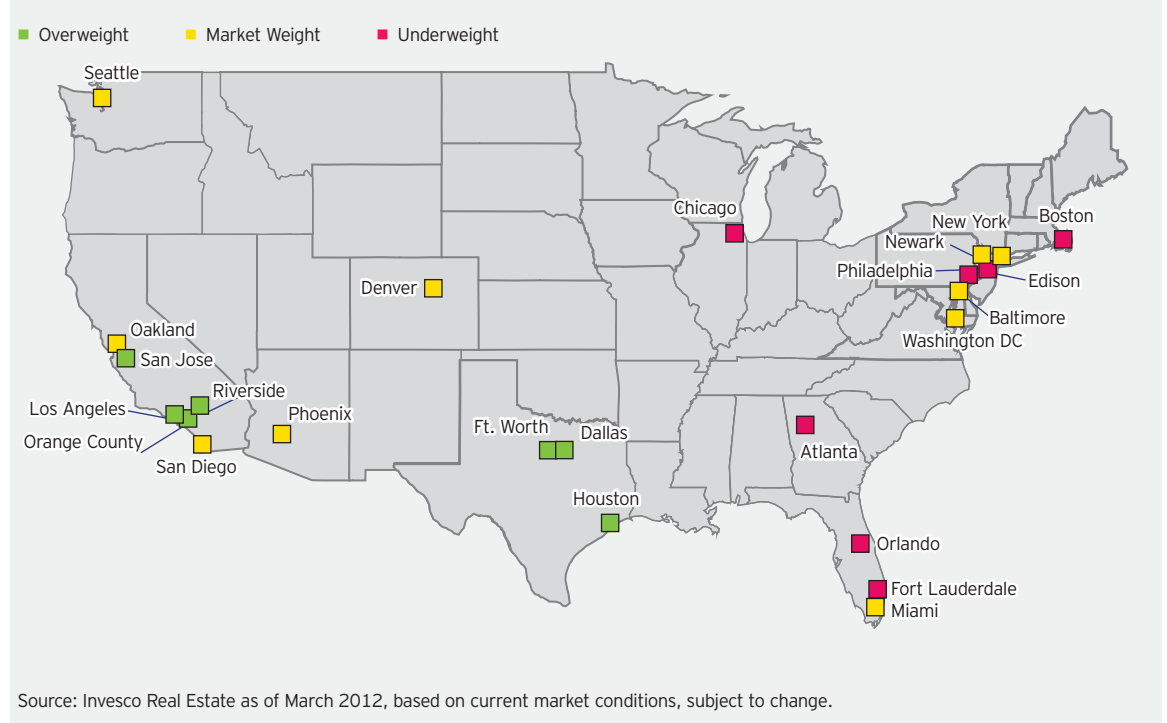
- **West Coast to outperform.** Despite concerns over a hard landing of China's housing market and broader economy, China's rapid growth rate (along with other parts of Asia) compared to Europe should benefit west coast US markets in the near term on a relative basis. East coast markets with their greater exposure to Europe are not, in general, expected to match the performance of the west coast markets.
- **Production shifts back to US could benefit south markets.** As previously noted, unit labor costs globally have shifted meaningfully to the US's favor over the past decade, resulting in an expansion of manufacturing jobs early in this recovery. Key markets to benefit from this trend are likely low tax, low wage, and regulation friendly states in the Southeast. Among Invesco's qualified markets, Houston could benefit due to its port linkages, while Dallas-Fort Worth's concentration of higher value-added manufacturing coupled with competitive business costs could also attract production jobs, spurring industrial demand.
- **Panama Canal opening in 2014; impacting leasing now.** International industrial tenants are making decisions today in light of expected impacts of the 2014 widening of the Panama Canal, allowing for the re-direction of shipping traffic from Asia to US ports beyond the West Coast. While deep water ports along the eastern seaboard stand to benefit by varying degrees, only Norfolk (not qualified by Invesco) and Baltimore currently have the bridge heights and water passage depths that can accommodate post Panamax ships. Dredging and/or bridge expansion projects in the ports of New York/New Jersey, Miami and markets not qualified for investment by Invesco (e.g., Savannah and Jacksonville) are not scheduled for completion until after 2016. In the meantime, a market that already can accommodate post Panamax ships and should see an outsized benefit is Houston, the preeminent port of the Gulf Coast, and by extension, Dallas-Fort Worth, particularly at key intermodal and rail-served locations. The market most at risk in the mid term is Seattle, which tends to serve as an overflow market for the high-intensity Ports of Los Angeles and Long Beach.

Strategies

Regarding markets, Invesco intends to:

- Acquire assets in major port markets linked strongly to global trade and serving large populations, such as Los Angeles/Orange County, Riverside, New York/New Jersey, Houston and Miami.
- Selectively acquire assets in preferred inland markets like Dallas-Fort Worth with key transportation linkages to port markets.
- Consider warehouse opportunities in tech-oriented markets, namely Oakland and San Jose, as well as low cost markets serving as a low cost production location alternative (e.g., Phoenix).

Figure 12 – Qualified Industrial Markets



Regarding location characteristics, we prefer:

- Infill urban locations in large population centers to provide better relative opportunities for rent growth.
- Locations highly proximate to major seaports, airports, intermodal hubs, and rail service.
- Easy access to well-developed infrastructure such as highways and interstates to facilitate quick access and egress.

To align best with prevailing utilization trends for warehouse space, we desire asset characteristics best suited to facilitate throughput:

- High ceilings
- Large truck turning radius
- Cross-dock
- Trailer storage

Retail

Retail occupancy has seen only marginal improvement from its record low despite recovering retail sales. Although short-term headwinds have eased, sales are still challenged by high unemployment, limited wage growth and rebuilding of household wealth. In addition, demographic trends, less debt-fueled spending, consumers' shift to discounters and the rise of electronic shopping all pose formidable challenges to tenant demand over the coming decade. Taken together, these forces are expected to drive shrinking store formats and an uneven recovery in fundamentals, necessitating a focused investment strategy.



Short-term headwinds have lessened, yet remain. Debt payments as a percent of disposable income have fallen to levels not seen since the mid-1990s due to low interest rates, creating room for households to spend more. Also, household savings rates have fallen in recent months and use of consumer credit has modestly increased, signaling that consumers are of a mind to spend again. Yet, persistently high unemployment will limit the growth of incomes, and economic uncertainty will likely constrain stock market performance, limiting consumers' ability to grow spending from either income or wealth.

The "Four D's" pose long-term constraints. The "Four D's" of demographics, debt, discounts, and digital retailing pose formidable challenges to retail tenant demand over the coming decade. Aging boomers are expected to slow their spending, use of credit is unlikely to return to levels seen in the credit boom, the shift toward lower-cost warehouse clubs and Supercenters will likely persist, and Internet retailing and mobile devices are cutting deeply into bricks-and-mortar space demand and changing the way people shop.

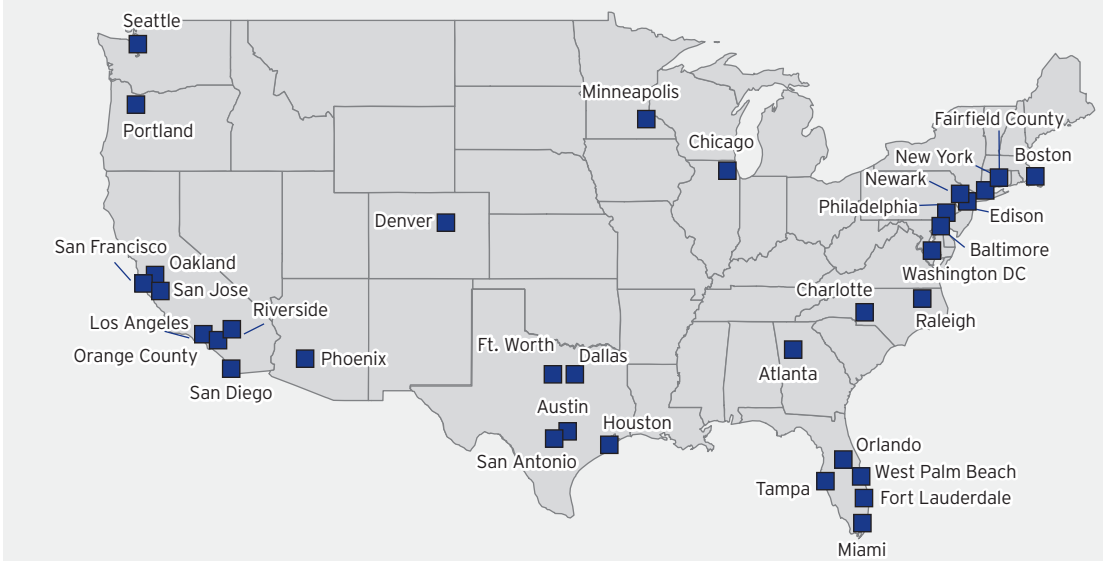
Winners and losers. With retail vacancy today still at a record high, tenants will continue to face considerable challenges as described above. Thus, only the most competitive retail properties are likely to deliver the stable attributes normally expected from the sector.

Strategies

Invesco intends to:

- Focus acquisitions to stellar locations. We believe anything less bears outsized risk.
- Target densely infill grocery-anchored centers, fortress malls, and high street retail.
- Avoid periphery location power centers and grocery-anchored centers that compete more directly with warehouse clubs.

Figure 14 – Qualified Retail Markets



Source: Invesco Real Estate as of March 2012, based on current market conditions, subject to change.

Total Return Forecast, 2012 to 2016

	Apartment	Industrial	Office	Retail	Weighted Average
Value Change Via Yield Shift					
Initial Income Yield, 4Q 2011	5.47%	6.56%	6.02%	6.60%	6.08%
10Y US Treasury Yield	2.05%	2.05%	2.05%	2.05%	2.05%
Current Income Return Spread to Treasury Yield	3.42%	4.51%	3.97%	4.55%	4.04%
Historical Spread Comparison, 1994-2011:					
Long-Term Average Spread	2.18%	3.34%	2.90%	2.72%	2.74%
Plus 1 Standard Deviation	3.12%	4.19%	3.92%	3.92%	3.75%
Minus 1 Standard Deviation	1.24%	2.48%	1.89%	1.52%	1.72%
Projected Income Return Spread, YE 2016	1.60%	2.40%	1.90%	2.70%	2.08%
Projected 10Y US Treasury Yield, YE 2016	4.00%	4.00%	4.00%	4.00%	4.00%
Projected Income Yield, YE 2016	5.60%	6.40%	5.90%	6.70%	6.08%
Capital Value Change Via Yield Shift	-2.41%	2.46%	2.02%	-1.47%	0.12%
Value Change Amortized Over 5 Years	-0.49%	0.49%	0.40%	-0.30%	0.02%
Net Operating Income (NOI) Growth					
NOI Growth Forecast	4.51%	2.71%	4.20%	2.22%	3.62%
Net Income Yield					
NCREIF Current Value Cap Rate, 4Q 2011	5.15%	6.11%	5.39%	6.26%	5.63%
Less: Cap Ex as % of Market Value	1.50%	2.50%	2.50%	1.80%	2.08%
Net Income Yield Forecast	3.65%	3.61%	2.89%	4.46%	3.55%
Total Return Forecast Components					
Net Income Yield	3.65%	3.61%	2.89%	4.46%	3.55%
NOI Growth	4.51%	2.71%	4.20%	2.22%	3.62%
Capital Value Change Via Yield Shift	-0.49%	0.49%	0.40%	-0.30%	0.02%
Total Return Per Sector	7.67%	6.81%	7.49%	6.38%	7.19%
NPI Sector Weights, 4Q 2011	26.5%	14.7%	36.2%	22.6%	100.0%
Sources: Invesco Real Estate using underlying data provided by NCREIF and CBRE-Econometric Advisors through 4Q 2011. Five-year outlook by Invesco Real Estate (March 2012). Table above illustrates our assumptions related to broad market expectations and is not indicative of specific transactions. Projections and five-year outlook represent years 2012-2016. Long-term represents years 1994-2011. Assumptions are identified in the "Real Estate Market Outlook" narrative and reflect current market conditions as of December 2011, subject to change.					

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