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Real Estate Home Bias – Investment Challenges and Opportunities

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Executive Summary

At the CIE Real Estate conference held in June 2011 over 87% of attendees indicated that they expect to maintain, initiate or increase their exposure to Australian core real estate in the coming 12 months[1]. Given many recent unsatisfactory forays into global real estate investment strategies this home bias is perhaps unsurprising, however, the implementation of this strategy is not without challenges including;

- **Competition for assets from other local and an increasing number of foreign investors,**
- **Limited long run supply of new core real estate assets,**
- **Asset concentration within a limited number of managers, and**
- **Expanding internal real estate teams to secure assets.**

In formulating a real estate investment strategy, investors need to be aware of the potential constraints on the implementation of a "home bias" core equity-only real estate strategy.

The demand for equity real estate assets will far outweigh supply and as a consequence core equity real estate returns for new investments will compress over time. Simultaneously, we are starting to see the re-emergence of commercial real estate backed debt as an "asset class" providing many of the attributes of an equity real estate investment with superior risk adjusted returns.

This paper examines some of the constraints of a home bias real estate investment strategy and outlines the investment attributes of both the publicly traded and privately placed real estate debt markets as a way for investors to achieve their desired long run real estate investment objectives.

[1] CIE Real Estate Conference 5-7 June 2011 Summary Report

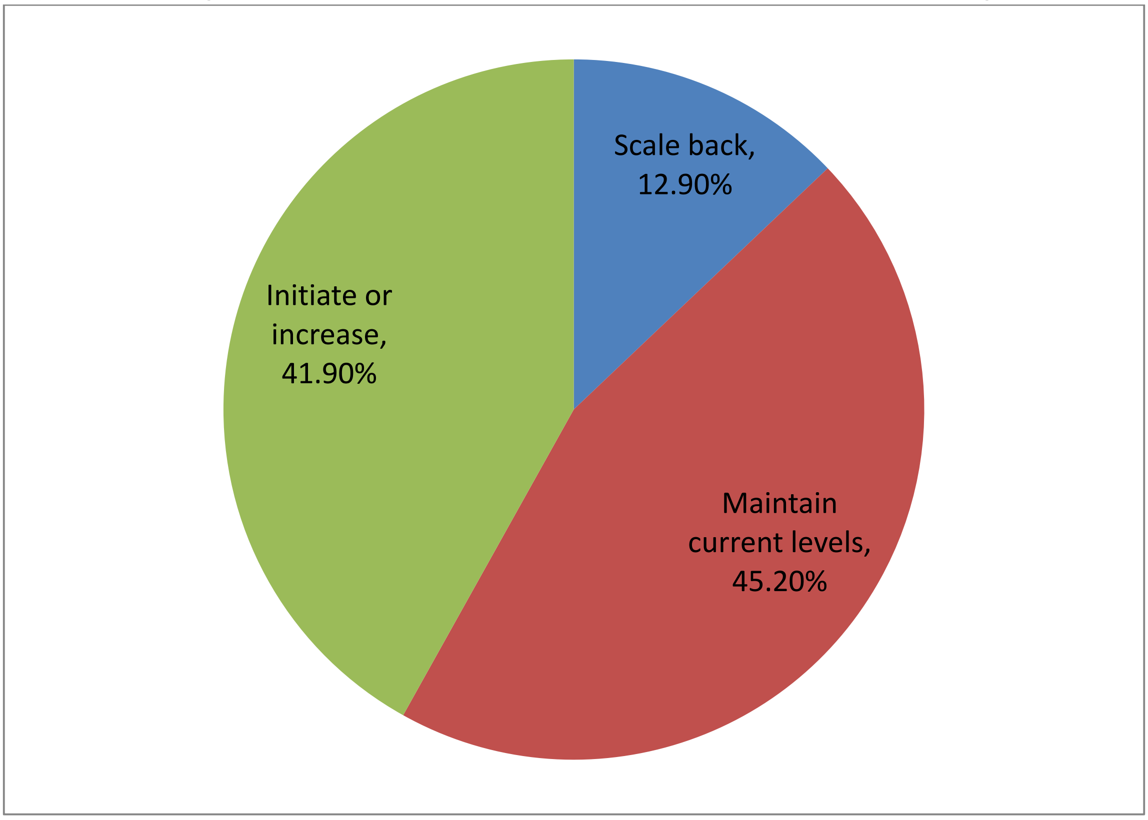
Background

Generally we understand that the objective of commercial real estate ("CRE") investment by institutional investors in Australia is to achieve an 8%-10% annualised (income plus capital growth) return from their core commercial real estate investment portfolio, preferably with as little volatility as possible.

The demand for domestic core real estate from Australian institutional investors (including superannuation funds) is high with a recent survey of 45 superannuation fund investors (representing $400 billion in funds under management) at the CIE Real Estate conference held in June 2011 indicating that 87.1% of attendees expect to maintain, initiate or increase their exposure to Australian core real estate in the coming 12 months[2] as illustrated in Exhibit 1.

Exhibit 1

Expected Change in Australian Core Real Estate Exposure over the coming 12 months



Source: CIE Real Estate Conference Summary Report

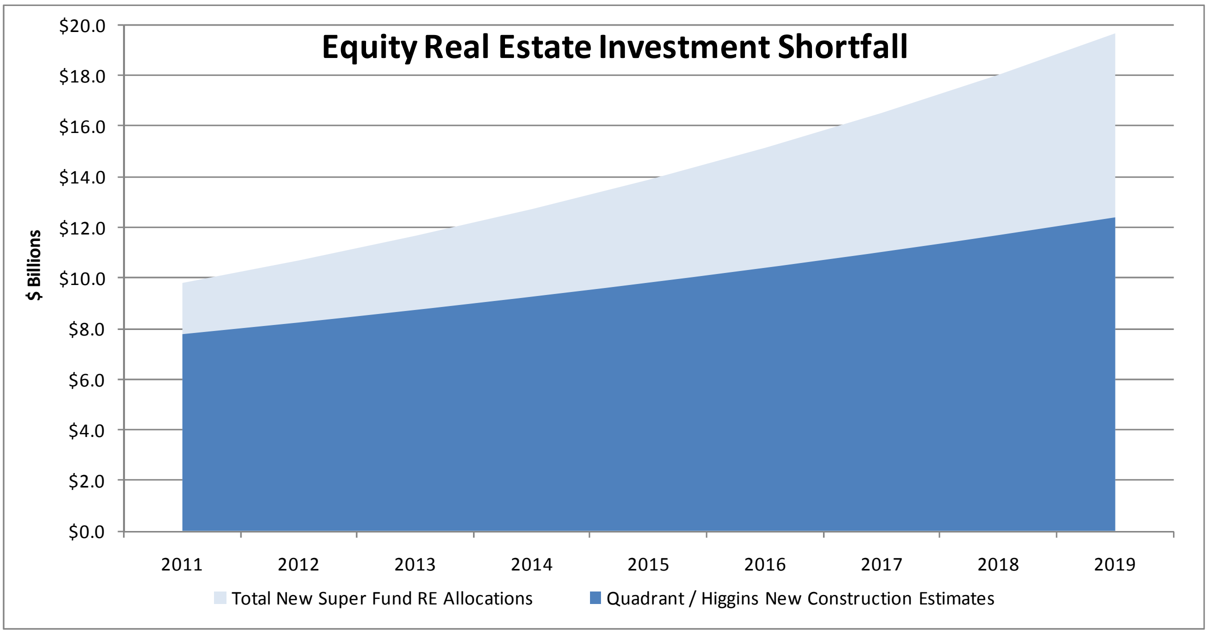
In earlier analysis[3] Quadrant forecast that new superannuation fund allocations to real estate are set to grow from the current circa $10 billion a year to approximately $20 billion per annum by 2019.

[2] CIE Real Estate Conference 5-7 June 2011 Summary Report

[3] The Australian Equity Real Estate Investment Supply Gap, Quadrant Real Estate Advisors, August 2010.

In comparison, total non-residential construction is forecast to grow from approximately $8 billion this year to approximately $12 billion per annum in 2019. This growing gap between the demand for real estate and the supply of new real estate is illustrated in Exhibit 2.

Exhibit 2
Australian Superannuation Real Estate Allocation Equity Investment Shortfall



Source: DEXX&R Market Projections Report November 2009, APRA Annual Superannuation Reports 2005 – 2009, Quadrant Real Estate Advisors, JLL Research, Construction Forecasting Council of Australia.

The forecast shortfall between the creation of new real estate stock and the funds available for real estate investment will contribute to the difficulties associated with Australian superannuation funds meeting their investment objectives from a core equity real estate strategy.

In order to investigate how this “excess” real estate allocation may be invested, it is important to firstly understand what investors are looking for from their real estate investments. Real estate has for a long time been a component of institutional investment allocation in the belief that it provides the following attributes:

- Relatively high and stable income returns from long dated contractual cash flows
- Attractive total returns
- Diversification to stocks and bonds
- Hedge against inflation
- Long term sustainable demand
- Inefficient markets allow superior relative value opportunities

The recent financial crisis has demonstrated that the above attributes are not always achieved by an equity only investment “through the cycle”. Accordingly, research shows that many institutional investors are now looking beyond the traditional equity only core real estate investment strategy to identify investments that fulfil their real estate allocation objectives.

In the United States ("US") institutional real estate investment market, privately placed fixed interest assets, collateralised by US income property have been a staple of US institutional investor core real estate portfolios for over a century. Beginning in the late-1800s the market for long-term, fixed rate financing of income properties in the US has been dominated by life insurance company lenders (banks continue to monopolise short-term, floating-rate lending)[4].

These "whole loans" often comprised 20 per cent or more[4] of an institutional investors entire general account mixed asset portfolio. These assets are perceived to be a good fit for institutional investors for three reasons;

1. a private mortgage typically offers a higher coupon than comparable credit corporate bonds,
2. delinquencies for privately placed whole loans are generally lower than publicly traded debt securities, and,
3. the duration of such whole loans is a good match for investors long-term liabilities[4].

Notwithstanding the above, what real estate investment products will best match the investment attributes required from real estate? Via an examination of both the equity and debt components of the real estate capital stack during the recent market dislocation we can examine "real time" the interconnectivity of the real estate capital markets and assess the return characteristics and relative value of each component.

Real Estate Investment Opportunity Set

An expanded range of investment products offers new opportunities and challenges to real estate investors and managers. The menu of real estate investment choices globally (core, core plus, value add, opportunistic) is lengthening rapidly and is now beginning to include real estate debt investments in addition to the traditional equity investments. As we have seen recently, however, the inherent real estate attributes that investors and managers are seeking do not apply to all real estate investments through the cycle.

As the global capital markets have converged over recent years one thing that has become evident is that while investment capital is mobile, real estate assets are not. At a time where Australia is in better relative economic shape than many of our peer developed nations our high comparative real estate yields are becoming increasing attractive to offshore investors, despite the relatively high Australian dollar.

For example acquisition yields on core office buildings in the large US markets such as Manhattan have recently been as low as 4%[5] whereas in Australia the same quality buildings

[4] Quadrant Real Estate Advisors, K Wright Opportunities Going Forward – Debt Securities
[5] Real Capital Analytics - 750 Seventh Avenue purchased by Fosterland Management May 2011

are yielding 6.5%[6]. This demand from foreign investors will further exacerbate the undersupply of domestic core equity investment opportunities in real estate available for Australian institutions. A comparison of key metrics for a select group of global markets is illustrated in Exhibit 3.

While the differential cost of risk free capital between the US and Australia (US 10 year Treasuries at 2.21%[7] vs. Australian 10 year Bonds at 4.43%[7]) goes some way to explaining these diverse yield expectations, we also believe that the return expectations of many Australian institutional investors are based on pre-GFC capital growth performance and these expectations may not be achievable in an extended low growth environment.

Exhibit 3
Select Global Commercial Office Market Statistics March 2011

	Economy		Real Estate Investment Markets			Real Estate Occupier Markets			
	National GDP	OECD Leading Indicator	National Investment Volumes	Prime Yield	Yield Gap	Rental Change	Net Absorption	Vacancy Rate	Supply Pipeline
Frankfurt	3.5%	-0.4%	+34%	4.9%	190	0.0%	-0.1%	14.3%	2.3%
Hong Kong	5.6%	na	+11%	3.5%	110	+32.2%	+3.9%	4.8%	4.2%
London	1.1%	-0.2%	+22%	4.0%	62	+11.8%	+3.0%	6.0%	2.5%
Moscow	4.4%	-0.1%	+115%	9.0%	87	+50.0%	+4.4%	16.8%	13.0%
New York	2.5%	0.0%	+117%	4.7%	154	+5.0%	+1.2%	10.8%	0.0%
Paris	2.0%	-0.6%	+30%	4.75%	134	0.0%	+1.5%	7.0%	2.5%
Sao Paulo	4.4%	-0.7%	+284%	10.0%	384	+32.5%	+6.5%	6.0%	27.3%
Shanghai	9.4%	-0.4%	+20%	6.1%	220	+31.2%	+12.3%	7.3%	36.5%
Singapore	3.8%	na	+233%	4.2%	185	+32%	+13.4%	6.3%	22.3%
Sydney	2.1%	-0.5%	+28%	6.9%	168	+7.5%	+2.5%	8.0%	1.6%
Tokyo	-1.2%	-0.4%	-26%	3.6%	246	0.2%	+6.5%	5.7%	9.9%

Definitions and Sources
National GDP: Change in Real GDP. National projection, 2011. Source: Global Insight
OECD Leading Indicator: Composite Leading Indicator: Month on Month % Change. Latest Month. Source: OECD
National Investment Volumes: National data. Rolling Annual % Change in Direct Commercial Real Estate Volumes. Source: Jones Lang LaSalle
Prime Yield: Indicative yield on prime/grade A offices. Latest Quarter. Source: Jones Lang LaSalle
Yield Gap: Basis points that prime office yields are above or below 10 year government bond yields. Latest Quarter. Source: Jones Lang LaSalle
Rental Change: Prime Office Rents. Year on Year Change. Latest Quarter. Source; Jones Lang LaSalle
Net Absorption: Annual net absorption as % of occupied office stock. Rolling Annual. Source: Jones Lang LaSalle
Vacancy Rate: Metro area office vacancy rate. Latest Quarter. Source: Jones Lang LaSalle
Supply Pipeline: Metro area office completions (2011-2012) as % of existing stock. Source: Jones Lang LaSalle

In order to compare the performance on a risk and return basis for the various real estate investment categories we have examined the annualised total returns for direct property investment, listed property trust ("AREIT") investment and senior real estate debt exposures over 3, 5 and 10 year timeframes in addition to IPD Index data from 1985 to the present.

[6] Jones Lang LaSalle
[7] Yields as at 29 August 2011, Bloomberg

We have then calculated the standard deviation of the returns for these same time periods as a measure of the relative risk of each investment type. A summary of these results is shown in Exhibit 4 below.

Exhibit 4
Australian Real Estate Total Return, Standard Deviation and Sharpe Ratio Data

	Annualised Total Returns to Jun-11				Standard Deviation				Sharpe Ratio
Asset Sector	3 Yr Returns	5 Yr Returns	10 Yr Returns	All Data Returns	3 Yr St Dev	5 Yr St Dev	10 Yr St Dev	All Data St Dev	**10 Years**
Retail Property	4.1%	8.8%	12.0%	12.6%	5.1%	7.4%	6.9%	5.9%	0.93
Office Property	1.8%	9.1%	9.8%	8.8%	7.0%	10.9%	8.7%	10.6%	0.49
Industrial	1.3%	6.6%	10.0%	10.9%	7.0%	8.7%	7.8%	8.0%	0.56
All Property	2.8%	8.8%	10.9%	10.1%	6.2%	9.1%	7.5%	8.9%	0.70
S&P/ASX AREIT 200	-11.9%	-3.8%	4.7%	9.6%	31.2%	30.6%	25.8%	17.8%	-0.03
Senior Investment Loans (non-development)	8.2%	8.0%	7.4%		1.0%	0.9%	0.9%	0.9%*	1.96

Source: IPD, Bloomberg, Quadrant Real Estate Advisors.

As illustrated above, the CRE debt sector showed the least volatility during the downturn due to its high income return component, secured nature and priority access to any income or capital flows from the property. Accordingly, when property values fell during the GFC the equity component of the capital stack bore the brunt of the capital losses whereas prudent leverage secured senior loans were better protected by the equity buffer.

A summary of the 1, 3, 5 and 10 years total returns for both listed and direct (unlisted) equity returns (pre-tax) in the US market are shown in Exhibit 5.

Exhibit 5
US Equity Real Estate Total Return Data

	Annualised Total Returns to Jun-11			
Asset Sector	**1 Year**	**3 Years**	**5 Years**	**10 Years**
NAREIT Equity REIT Index (Listed)	34.09%	5.38%	2.61%	10.68%
NCREIF Property Index (Direct)	16.73%	-2.57%	3.44%	7.64%

Source: Quadrant Real Estate Advisors, NAREIT and NCREIF.

So what are the options available for investors in the real estate space? In order to consider this we have examined the wide range of broadly defined domestic real estate investment categories available on the basis of the following:

1. Availability of Investment Opportunities – size of the market, trading volumes, ease of access to investments.
2. Risk/Volatility – the underlying risk of achieving the forecast target returns over the investment horizon and the volatility of those returns on a quarter by quarter basis.
3. Forecast Returns – QREA's forecast total return (income and capital) for the investment category over the 10 years to 2021.

Exhibit 6
Domestic Real Estate Investment Options

Category	Availability of Investment Opportunities	Risk/Volatility	Current Forecast Returns
Core Direct Equity	Low	Low	8-10%
Core Privately Placed Debt	High	Low	7-9%
Value Add Equity	High	Moderate	9-11%
Opportunistic/Development Equity	Moderate	High	11-15%
Listed REIT's	High	High	8-10%
REIT Bonds	Moderate	Moderate	7-9%
CMBS	Low	Low	7-9%
Subordinated Debt	Low	High	11-15%

Source: Quadrant Real Estate Advisors
Note: See Qualifications in End Notes

We have also constructed a comparison of the availability and risk metrics for major offshore regions across the same options (as shown in Exhibit 7).

Exhibit 7
Offshore Real Estate Investment Options

	North America		Western Europe		Emerging Markets*	
Category	Availability	Risk	Availability	Risk	Availability	Risk
Core Direct Equity	Moderate	Low	Moderate	Low	Moderate	Mod
Core Privately Placed Debt	High	Low	High	Low	Mod	Mod
Value Add Equity	High	Mod	High	Mod	High	High
Opportunistic/Development Equity	High	High	High	High	High	High
Listed REIT's / Property Companies	High	High	High	High	High	High
REIT Bonds	High	Mod	High	Mod	Mod	Mod
CMBS	High	Mod	High	Mod	Mod	Mod
Subordinated Debt	Low	High	Low	High	Low	High

Source: Quadrant Real Estate Advisors
Note: See Qualifications in End Notes
**Emerging Markets includes Asia, South America and Eastern Europe*

It should be noted that this matrix doesn't take into account taxation impacts which can be particularly onerous for direct equity property investment (in comparison to lower taxed investments such as listed REIT securities and debt investments). In addition, offshore investments carry currency costs and volatility which have not been factored into our comparison.

In reviewing the tables above, the investment sectors that would most closely match the risk and return attributes investors are seeking from real estate investment would be domestic core direct equity, domestic privately placed debt, domestic and offshore REIT bonds and potentially offshore CMBS (highlighted above).

We will discuss each of these in turn.

Domestic Core Equity

Given recent global capital markets volatility and the difficulties many funds have experienced in pursuing successful offshore strategies it is not surprising that they are currently seeking to expand their domestic core equity real estate portfolio. The implementation of this strategy is not without challenges including;

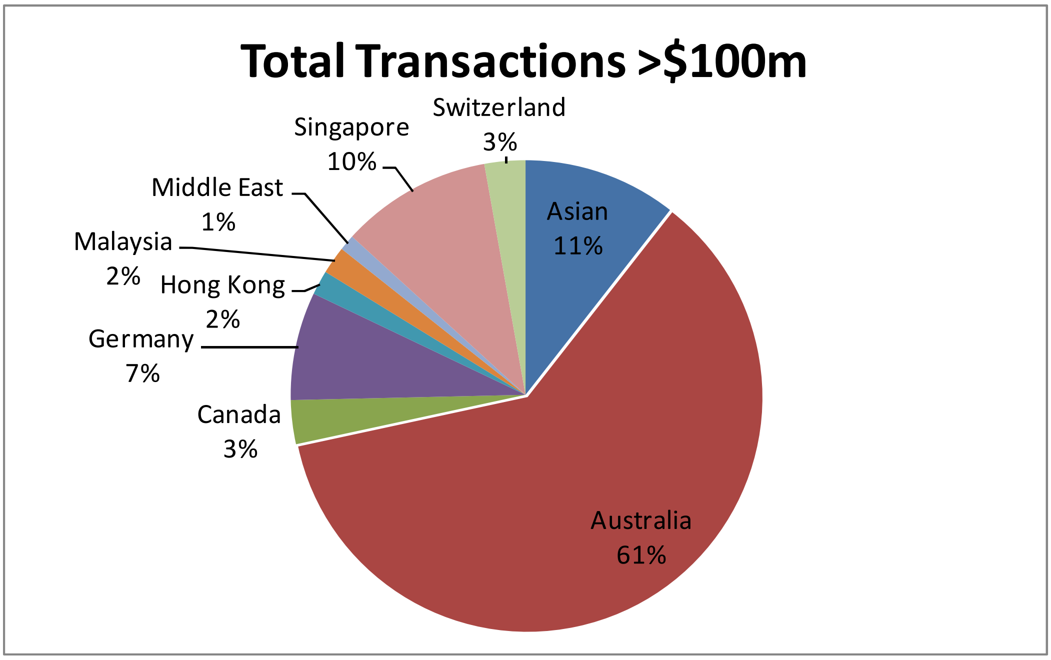
- Competition for assets from other local and an increasing number of foreign investors,
- Limited long run supply of new core real estate assets,
- A concentration of core assets with a limited number of larger managers, and
- Expanding internal real estate teams to secure assets.

Australia has one of the highest rates of institutional real estate ownership in the world with a reported 70%[8] of institutional core grade real estate currently owned by domestic and foreign institutions. Due to this high level of institutional ownership there are very few opportunities to significantly increase an investor's exposure to the core real estate sector.

Historic transaction data shows that on average $3.35 billion[9] of core real estate with asset values in excess of $100m occurs in Australia each year with approximately 40% or $1.3 billion[10] being purchased by foreign institutions (see Exhibits 8 and 9).

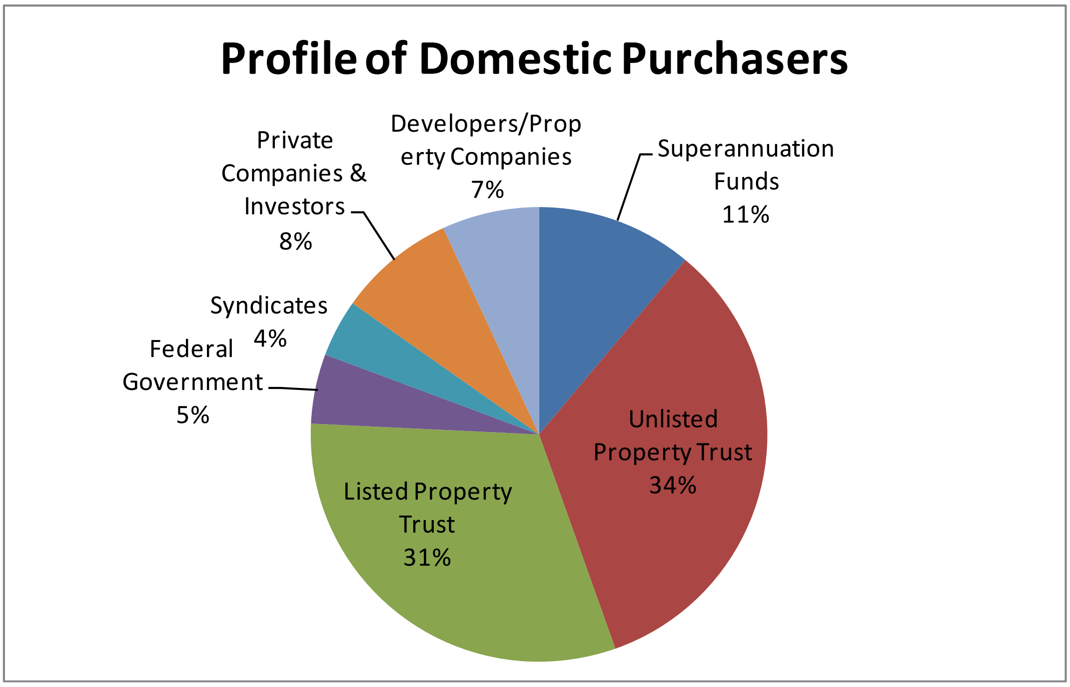
[8] The Australian Equity Real Estate Investment Supply Gap, Quadrant Real Estate Advisors, August 2010.
[9] Jones Lang LaSalle Research (average over the last 4 years to Q2 2011)
[10] Jones Lang LaSalle Research (average over the last 4 years to Q2 2011)

Exhibit 8
Total Australian Real Estate Transactions >$100m 2007-2011



Source: Quadrant Real Estate Advisors

Exhibit 9
Profile of Domestic Purchasers of Australian Real Estate >$100m 2007-2011



Source: Quadrant Real Estate Advisors

In addition, prior research undertaken by Quadrant[11] estimated that the average annual supply of new real estate investment stock is expected to be in the order of $7 billion per annum.

Given the

(a) limited supply of new stock,
(b) the high current institutional ownership,
(c) the limited transaction volumes for core real estate and
(d) competition from offshore investors

research shows that there is insufficient investment opportunity in domestic core equity real estate to satisfy demand from Australian superannuation funds. If the forecast real estate allocation funds were all to flow into Australian real estate equity investments it would have the effect of bidding up prices until the return on assets became unattractive.

Domestic Privately Placed Debt

In Australia investors have been focused on the equity component of real estate notwithstanding the fact that the privately placed real estate debt component comprises approximately 27% or $58 billion[12] of the investable real estate universe domestically.

While much of the privately placed debt market in Australia is intermediated by the domestic banks, this has not always been the case with life companies being major participants in the market prior to the late 1980's.

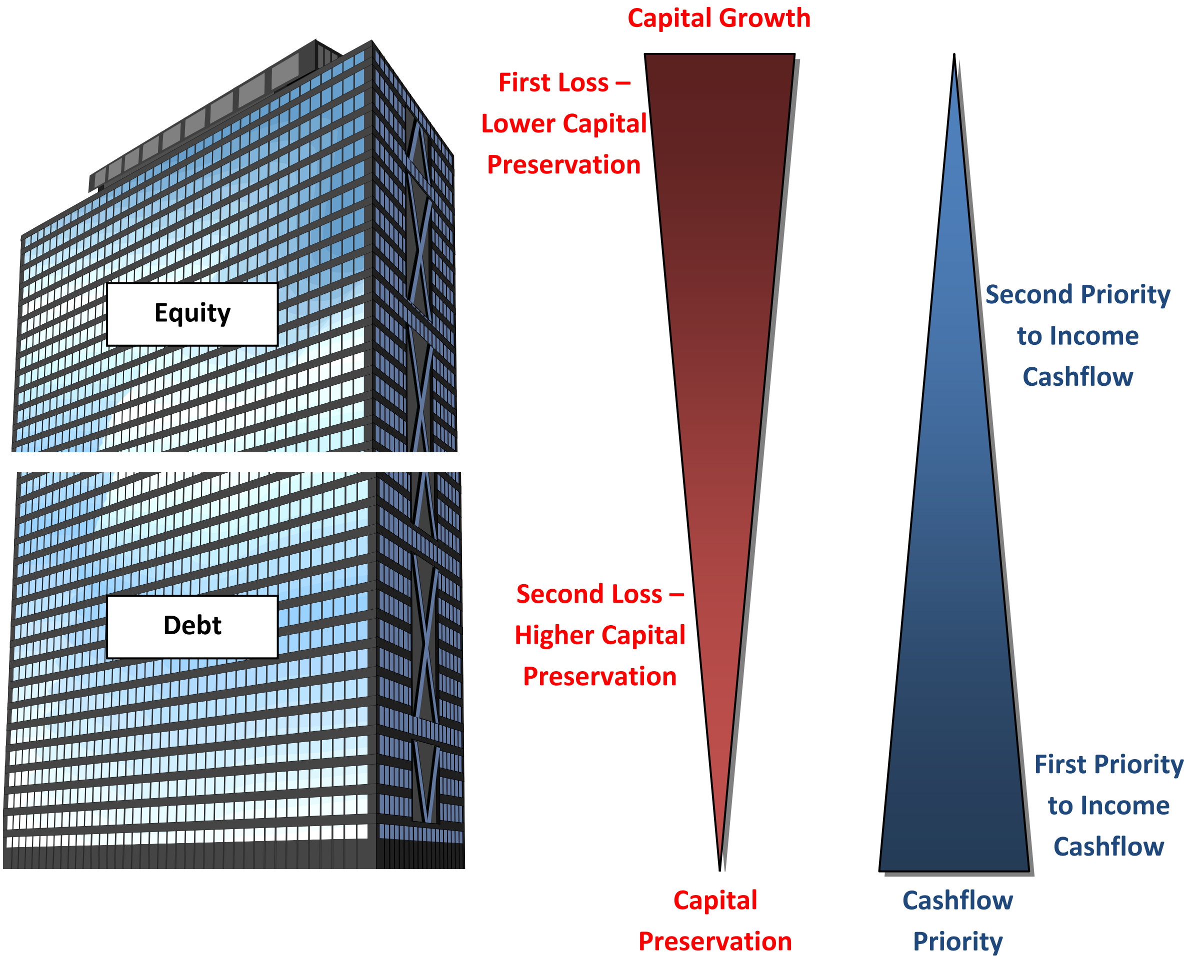
To underscore the opportunity in domestic CRE debt our ongoing research into the Australian commercial real estate capital markets has forecast the emerging gap in the real estate equity opportunity set to be more than offset by a corresponding multibillion dollar gap in the availability of CRE debt to finance properties[13].

The opportunity is therefore for institutional investors, including superannuation funds, to seek returns from the same domestic underlying assets with capital being deployed more conservatively within the capital stack.

The key for superannuation fund managers is that real estate debt investing involves investing in the same property types and markets that they are currently investing in (i.e. Sydney CBD office buildings, regional shopping centres, etc), merely using a structure that places the investor in a more conservative position in the capital stack.

[11] The Australian Equity Real Estate Investment Supply Gap, Quadrant Real Estate Advisors, August 2010.
[12] Quadrant Real Estate Advisors, Property Investment Research, Deutsche Bank, AFMA, Standard & Poors
[13] Quadrant Real Estate Advisors: CRE Debt Availability – July 2010

Exhibit 10
Real Estate Capital Stack



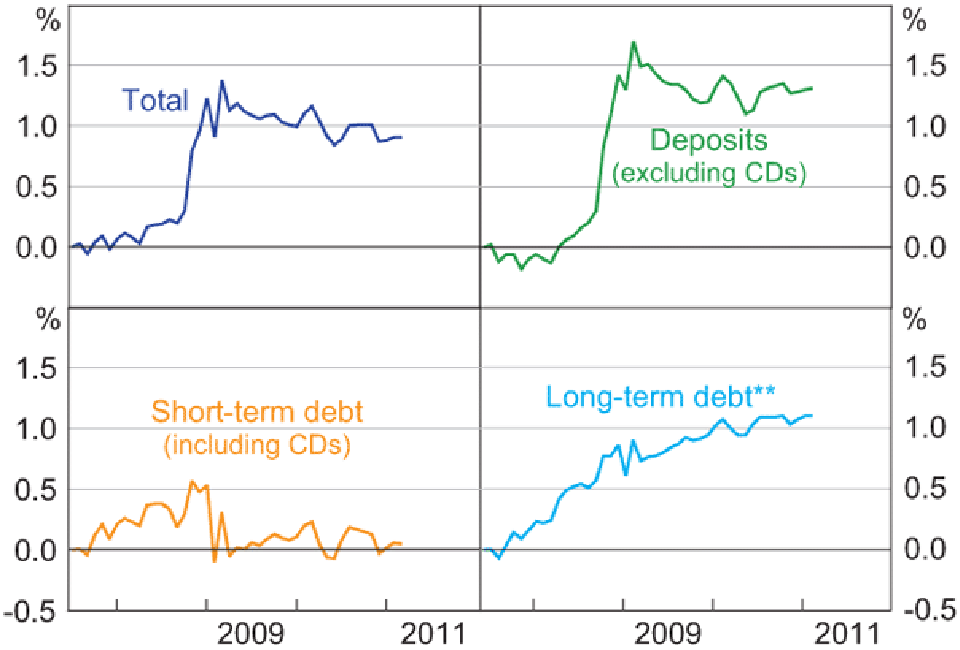
Borrowers need a diversity of debt capital sources as the traditional domestic sources (banks, mortgage funds and CMBS) are severely constrained. Furthermore, with the increase of bank facilities simply being extended for 12 months and the inability of many borrowers to get new finance beyond 2-3 years, the amount of debt due to be refinanced in any given year during 2011 and 2012 continues to increase, stretching resources further.

The issues for borrowers (and therefore the opportunities for lenders and debt investors) going forward are:

- the real estate sector has likely outgrown the capacity of the local banks;
- there is a duration mismatch between long term equity investments and short term bank debt facilities;
- while the banks provide floating rate loans to their borrowers they require those borrowers to enter into hedging strategies which may be costly to unwind if there is a change in funding requirements;
- the significantly increased cost of capital for the banks means sustained higher margins for borrowers (see Exhibit 11);

- the slow return of securitized markets reduces the sources of available capital;
- the costs and ratings requirements of bond issues make this capital source available to only the largest borrowers; and
- changes to bank regulations will impact how they assess risk, reducing their ability to tailor lending to specific borrower and/or asset needs.

Exhibit 11
Major Australian Banks Capital Funding Margins 2007-2011



* RBA estimates
** Weighted-average spread to cash rate and CGS for long-term variable rate and fixed-rate debt, respectively. Includes foreign currency hedging costs.
Sources: Bloomberg; RBA; UBS AG, Australia Branch

Privately placed real estate loans are underwritten in much the same way as a direct equity investment with a significant amount of due diligence undertaken reviewing leases, outgoings, capital expenditure, leasing markets, valuations, building condition, etc.

This allows investors to construct a portfolio of assets that they would otherwise be comfortable owning and that provides the required risk and return profile. Despite the ability to individually tailor asset selection, privately placed loans are “lumpy” assets that are resource intensive to originate, underwrite and close and do not provide the same diversification benefits that publicly traded securities can.

Due to the long dated nature of real estate leases and the significant equity capital buffer provided by the borrower, an investor should enjoy a relatively high income return with a strong capital preservation position.

Whilst privately placed loans are not as liquid as listed REIT securities or publicly traded debt, each of the loans has a stated maturity which allows for constant repayment and redeployment of capital.

REIT Bonds

Due to the limitations on the availability of debt capital from the more traditional sources many of the larger institutions have been turning to the use of Medium Term Notes (MTN) to source additional funding. These funding sources have been used effectively by the likes of Westfield, Stockland and Colonial First State, however, their broader adoption is limited due to the need for the issuing entity to be rated and the relatively low leverage levels that apply. Accordingly there are only 8-10 Australian REIT's who can issue bonds domestically resulting in a highly concentrated issuer market[14].

REIT bonds are generally classified as unsecured meaning that there is no underlying mortgage as the bonds are effectively secured against the issuing entity itself rather than the individual underlying real estate assets. This structure means that REIT bonds are more highly correlated to corporate bonds than the underlying real estate itself. Because of this, the bond pricing is also more capital markets related than real estate credit related which is why bond pricing for borrowers is currently more favourable than bank pricing.

As REIT bonds are publicly traded instruments they are naturally more liquid than privately placed loans, however, due to the relatively small size and the concentrated nature of the domestic market, the Australian REIT bond market is significantly shallower and less liquid than both the US and European REIT bond markets. The total AUD commercial real estate bond market is estimated at approximately $5.0 billion of which Westfield alone makes up 20%[15].

As the bonds are rated and unsecured there is very little asset due diligence undertaken with bond investors relying upon the rating agency due diligence process and the low leverage, high interest cover nature of the bond structures. The investment process is therefore less resource intensive than privately placed loans, however, there is limited ability for investors to modify or tailor the investment offering to suit their portfolio.

Australian CMBS

The Commercial Mortgage Backed Securities (CMBS) sector in Australia has shown tentative signs of life with the Colonial First State $370 million deal in March 2010 and the ALE Property Group $160 million transaction in April 2011, however, there has been a steady run off in CMBS on issue from $12.0 billion[16] in 2007 to the current total of approximately $1.4 billion[17].

To date refinancing of maturing CMBS has been largely filled by the proceeds from asset sales, refinancing by the domestic banks and an increase in REIT bond issuance.

[14] NAB A-REIT Research
[15] NAB A-REIT Research
[16] Australian Prudential Regulation Authority
[17] NAB A-REIT Research

In contrast to the REIT bond market, CMBS notes are secured against a pool of real estate assets rather than the borrowing entity. This allows both the rating agency and the investors to undertake more asset level due diligence, however, from the investors perspective given the number of assets and the timeframe for closing the transaction it can be difficult to match the level of asset specific due diligence undertaken in a privately placed loan transaction.

Accordingly, similarly to REIT bonds investors rely upon the rating agency due diligence process and the subordination in-built into the CMBS structures. The investment process is therefore less resource intensive than privately placed loans, however, there is limited ability for investors to modify or tailor the investment offering to suit their portfolio.

The domestic CMBS market has suffered due to a move away from asset backed securities following the GFC and the pricing dislocation compared to the REIT bond market. As the size of the market continues to shrink the advantages of publicly traded debt investments (liquidity, diversification, scale, etc) also diminish making the sector less attractive to investors which impacts on the pricing for borrowers.

US CMBS

The $750bn US CMBS market has yet to fully recover from the turmoil of 2008, despite $12.3 billion of new issuance in 2010 and $17.1 billion to 30 June 2011,net issuance of CMBS has been negative ever since 2007 leading to a decline in outstanding issuance[18]. Fitch Ratings noted that the default rate for fixed-rate US CMBS had increased to 12.9 per cent at the end of the second quarter of 2011, up 2.28 per cent from the end of 2010.

The challenges relating to new issue CMBS in the US include;

- Underlying collateral is mediocre to poor quality and largely located in secondary markets.
- Underwriting remains poor and credit support inadequate
- Underlying loans have a high level of maturity default risk assuming interest rate or cap rate increases (a prudent assumption)
- Risk adjusted returns are inadequate.

Most recently the market demanded higher credit enhancement on the GSMS 2011-GC4 new-issue CMBS stating the current structure was simply too close to levels seen in 2005 and alarming given the increase in loan to value ratio, the increasing use of interest-only loan structures, and B- and C-class quality collateral in oftentimes, non-prime markets[19].

This research shows the best opportunity for investors in US CMBS issuance is to focus on the secondary markets for pre-2006 vintage issuance that contain seasoned loans and prudent, soundly underwritten lending structures.

[18] CRE Finance Council Compendium of Statistics, 2011
[19] Goldman Sachs

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Conclusions

We contend that the capital growth prospects for new capital being deployed into core equity real estate investments in Australia will be significantly constrained well into the next broad based economic upswing. New core real estate acquisitions are expected to be dilutionary to existing core portfolio returns.

Notwithstanding the above, research indicates there are currently excellent investment opportunities within the commercial real estate market because of the recent capital market volatility. The nature, structure and position in the capital stack of the optimum investment for an individual investor will depend upon their stated risk and return objectives. Going forward we expect to see a return to fundamentals driven investment techniques in order to achieve real estate asset returns rather than the reliance upon market movements that was prevalent from 2002 - 2008.

In a period of uncertainty and volatility research shows a high relative income yield is a good risk mitigant as the investor is not as reliant upon achieving future capital growth in order to generate the required investment returns. Accordingly, whilst debt and hybrid investments may not have the same degree of “upside” growth potential as equity investments, the high probability of achieving an investor’s stated return hurdle on a regular income cash flow basis provides a high degree of comfort in an uncertain market and a “defensive alternative” to equity real estate. Research indicates that a high income orientation should always be an objective for core real estate allocations.

Our views on the outlook and opportunities for investing in commercial real estate in Australia are as follows:

Commercial real-estate market fundamentals are sound: The current risk aversion in the real estate markets reflects economic concerns in the capital markets and has little to do with the underlying commercial real-estate market fundamentals which are still relatively sound. There has been limited overbuilding in most markets, vacancies are within normal levels and pre-crisis rental levels and capital values have largely stabilised.

Focus on income and position for growth: During this volatile period investors should seek to identify opportunities to obtain solid income returns in a more conservative position up the capital stack and position themselves to take advantage of the next upswing in the commercial real estate markets.

Limited “easy wins”: The significant flow of distressed real estate and asset sales at deep discounts that was expected by many has not yet materialised. Accordingly, investors, managers and their advisors must be patient, highly selective and undertake a significant amount market research and due diligence in order to unearth the quality investment opportunities that will provide outsized risk-adjusted returns going forward. This is something we should have been doing all along.

Increased interconnectivity: The interconnectivity of the global capital markets that has emerged over the last two decades appears to be here to stay. This being the case, we expect to see a continually increasing level of connectivity between investment asset classes which will result in many more external shocks having an impact upon the commercial real estate market. This is expected to result in more volatile, short, sharp cycles rather than the traditional long run boom and bust cycles of the past.

In short we feel we are at the point where we will see the emergence of an institutional quality non bank real estate debt market to supplement our well established core real estate equity markets where assets are in short supply. With equity real estate values likely to be constrained for the medium term, research indicates institutional investors can expect to achieve excellent risk adjusted returns for real estate backed debt, particularly in the Australian privately placed markets.

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