Australian Real Estate Capital Markets Observed

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Executive Summary

2009 was a tumultuous year globally for all asset classes and Australian commercial real estate was not immune, however, despite continued distress in foreign real estate markets; Australian real estate seems to have turned a corner in early 2010.

Transaction markets have begun to thaw, property owners are seeking to maximise property cash flows by focusing on cost reduction and leasing strategies and the banking sector has cautiously returned to the lending market.

During 2009, the real estate capital markets have successfully undertaken a $20 billion partial recapitalisation of the sector[1]. Of particular note was that **approximately $4 billion[2] of this capital came from non-traditional "hybrid" funding instruments** as real estate owners sought to diversify their sources and nature of capital.

In doing so a broader definition (i.e. beyond equity) of real estate investment is emerging and will continue to provide investors the opportunity of determining where in the capital stack they wish to participate in order to achieve their real estate investment objectives.

Going forward the key themes that we expect for 2010 and beyond are:

- **To survive and prosper, owners and managers will need to possess excellent capital management skills and diversify their sources of capital beyond dilutive equity raisings and bank debt;**
- **As a consequence of the Australian banking sectors over reliance on foreign capital, local bank lending will continue to be constrained and highly susceptible to future market shocks. ;**
- **Hybrid funding instruments such as convertible notes and preferred equity will be increasingly common;**
- **Duration and basis (i.e. fixed rate to fixed rate) matching of assets and liabilities, and the prudent use of leverage are the keys to avoiding a repeat of the issues experienced in 2008/09;**
- **Australia's pool of superannuation savings represents a potential source of long dated debt capital to the real estate market and we expect to see them participate in this capacity in the medium term, and**
- **Investment strategies for either debt or equity are far more effective if implemented at the bottom of the cycle (i.e. today) rather than at the top of the cycle which is when the largest transactions are inevitably completed.**

[1] NAB, Aegis / PIR Research, Merrill Lynch, Quadrant Real Estate Advisors LLC
[2] NAB, Aegis / PIR Research, Merrill Lynch, Company Reports

Introduction

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 equity only investment "through the cycle".

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 relative value of each component.*** This relative value approach can be further enhanced by examining each available investment product with an appreciation of where we are in the economic cycle. ***Investment decisions and capital allocation can then be finessed by adopting an offensive or defensive posture as dictated by market conditions noting that irrespective of an investment being debt or equity – the best investments are those made at the bottom of the economic cycle.***

Market Overview

During the five year period preceding the Global Financial Crisis ("GFC") there had been significant growth in property values in Australia. The wall of capital chasing real estate investments through the mid part of this decade led to a highly competitive marketplace which bid down capitalisation rates. Because of the compression in cap rates, investors turned to increased leverage and highly structured deals in order to maintain nominal returns ***(i.e. investors were taking on materially higher risk without the commensurate increase in returns)***.

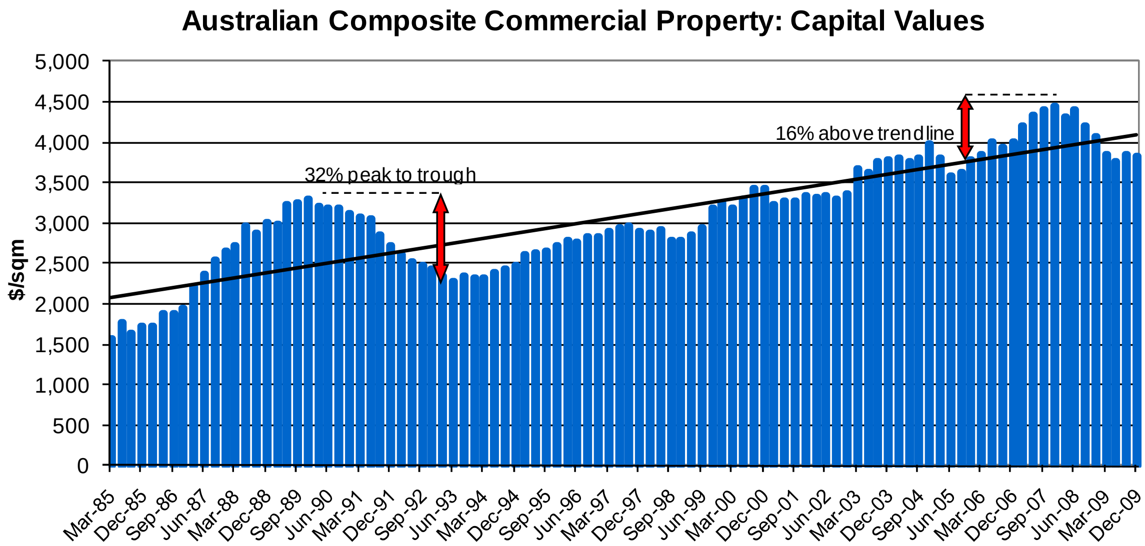
As the credit crisis hit, the market began the process of un-winding these structures and de-leveraging the high levels of debt within the system. This has led to a widening of cap rates as risk aversion re-entered the market and the availability of cheap capital dissipated.

We expect the conclusion of this cycle will see an average capitalisation rate expansion of approximately 175-200 basis points in total, however, the separation between the primary and secondary markets has become more profound;

- high quality assets in better markets have been highly sought after by both equity investors and debt providers thus limiting value declines; and
- secondary assets or riskier markets, however, have experienced a significantly reduced amount of interest from both equity investors and debt providers resulting in greater value declines for these assets.

As illustrated in Exhibit 1 below, prior to the last major downturn in the early 1990's the real estate market valuations on average peaked at approximately 27% above trend line values. By the time the trough was reached in December 1993 values had over corrected to the down side by dropping 32% from peak to trough. Using the same methodology property values in this current cycle peaked on average at approximately 16% above trend line values.

Exhibit 1



Source: IPD

In addition to possible further adverse movements in cap rates during this current downturn, property values are potentially further impaired by increasing vacancies and lease incentives resulting in lower effective rents through 2010 and 2011. These cash flow pressures are likely to continue to negatively impact on values in the short term even if cap rates stabilise. That said, in general the real estate markets entered this credit driven downturn in relatively good shape in terms of supply and demand fundamentals, particularly in prime markets such as Sydney and Melbourne. Because of this, we believe this downturn will not be as severe as the last major downturn in the late 1980's.

We believe the current reversion of approximately 20% in values (to March 2010) is close to the total peak to trough downturn in property values in this cycle of potentially up to 25%. In a market where declining values are prominent and property cash flows are constrained, we believe a more defensive, (income focused / capital preservation) strategy becomes a key theme to investment decisions.

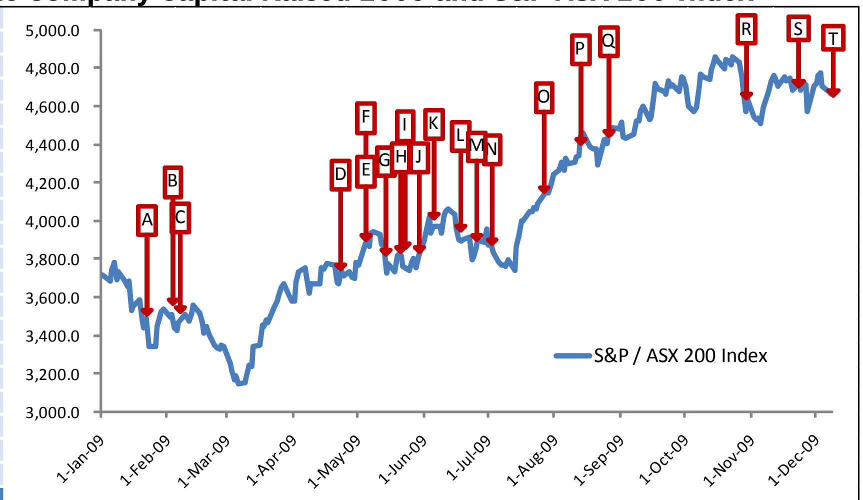
Real Estate Equity Capital

During 2009 the listed real estate company sector saw $12.9 billion of new equity capital injected (see Exhibit 2). As evidence of the level of value destruction that has occurred since 2008, ***little if any of the $12.9 billion of new equity was used to fund new acquisitions. Contrast this to the prior record year for listed real estate company capital raisings being 2007 when $9 billion in equity was raised to fund $15 billion of acquisitions.***

The equity raised during 2009 was deployed predominantly to manage the short duration debt exposures that are a characteristic of the Australian real estate finance market. Had longer term, duration matched finance been more widely available and utilised by the listed property company sector, we believe that there would not have been the same degree of fear and panic that debt could not be refinanced at maturity. The United States experience is very insightful given the decline in REIT values there was less than Australia notwithstanding their naturally higher leverage levels – debt duration being a key difference between the two markets.

Exhibit 2
Listed Real Estate Company Capital Raised 2009 and S&P ASX 200 Index

A	ABP (20 Jan 09)	$211.4m
B	WDC (3 Feb 09)	$2,898.0m
C	LLC (4 Feb 09)	$302.5m
D	DXS (21 Apr 09)	$749.0m
E	BWP (7 May 09)	$12.0m
F	GPT (7 May 09)	$1,700.0m
G	SGP (13 May 09)	$1,980.0m
H	OIF (18 May 09)	$200.0m
I	APZ (19 May 09)	$82.4m
J	CHC (27 May 09)	$73.0m
K	MGR (4 Jun 09)	$1,100.0m
L	IOF (17 Jun 09)	$415.0m
M	MLE (25 Jun 09)	$41.7m
N	FKP (29 Jun 09)	$324.0m
O	ALZ (28 Jul 09)	$475.0m
P	GMG (10 Aug 09)	$1,280.0m
Q	CDI (24 Aug 09)	$130.0m
R	IIF (28 Oct 09)	$700.0m
S	CPA (24 Nov 09)	$100.0m
T	ABP (11 Dec 09)	$91.4m
		$12,865.4m



Sources: NAB, Aegis / PIR Research, Quadrant Real Estate Advisors LLC.

Going forward we believe we will see additional equity raisings to support refinancing for those that still have significant debt expiry ahead, however, we believe we will also see an increase in equity raised by quality managers in support of new transactions (such as the recent $500 million equity raising from Mirvac in support of the Westpac Office Trust acquisition).

Whilst wholesale funds and retail investor syndicates have not experienced the same wide unit pricing fluctuations as the listed real estate companies, they have had their own problems to deal with in terms of a significant increase in redemptions requests, (many of which have not and cannot be satisfied in the current market) difficulty in raising fresh capital and problems with the impact of declining values on gearing levels and debt covenant compliance.

Many unlisted funds have been forced to reduce or suspend dividends in order to decrease debt or fund higher interest costs and we expect to see a continued restructuring and recapitalisation of the unlisted sector through 2010 as these issues are rectified.

We believe ***some managers will simply not survive*** due to a combination of lack interaction and communication with their investors and bankers and overly complex investment structures or poor management of their client's funds. ***In short - poor capital management and a lack of fiduciary orientation.***

Real Estate Debt Capital

During 2009 the A-REIT sector saw approximately $7.0 billion of new debt finance raised (see Exhibit 3).

Exhibit 3
A-REIT Debt Capital Raised 2009

Issuer	Amount ($M)	Date	Type of Debt
SGP	$A300	Dec-09	MTN
CPA	$A200	Nov-09	Convertible Notes
MCW	€ 85	Oct-09	Bank Facility
DXS	$US300	Sep-09	Bonds
WDC	$US750	Aug-09	Senior G'Tee Notes
WDC	$US1,250	Aug-09	Senior G'Tee Notes
IIF	$A1,630	Aug-09	Syndicate Facility
MCW	$A265	Aug-09	CMBS
ALZ	$A950	Jul-09	Bank Facility
BWP	$A100	Jul-09	Bank Facility
GMG	$A200	Jun-09	Bank Facility
MCW	$US166	Jun-09	US Bank Debt
CFX	$A125	May-09	MTN
GMG	$A300	May-09	Bank Facility

Sources: Merrill Lynch, Company Reports

As expected, the four major Australian banks dominated bank lending in 2009, but there was little or no new money available for property lending outside of existing strong relationships. Stronger market participants, with good banking relationships do not appear to have had any significant issues (other than doing the "bank waltz") in attaining new funding to refinance maturing debt. However, these transactions have taken longer to finalise, lending conditions are stricter and pricing remains significantly higher than two years ago.

Debt Constraints

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 well and truly outgrown the capacity of the local banks;
- there is a duration mismatch between long term equity investments and short term bank debt facilities;
- the significantly increased cost of capital for the banks means sustained higher margins for borrowers;
- 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.

Domestic Banks. The Bank amalgamations in Australia have resulted in there being fewer lenders to choose from and greater aggregation issues for those lenders that remain. Banks will also need to deal with implications of proposed increased liquidity requirements from Australian Prudential Regulatory Authority (APRA) (increase from 5 days to 20 days) and impacts of Basel II on pricing of risk capital. In addition, ***the sources of each of the bank's own capital act as a natural constraint on the duration of loans they are able to provide the real estate market. The result of this is a mismatch between the long dated equity and the short duration debt used to fund real estate investment.***

Foreign Banks. To further compound the lack of supply of debt in the real estate sector, the foreign banks (which had been major providers of capital in 2005-2007) have substantially retreated. Although there are some signs that foreign banks may be re-engaging with the Australian market again, it's still a long way from the easy availability of debt capital that was evident during the lead up to the GFC.

Mortgage Trusts. In addition, the Mortgage trusts (which were a $21 billion[3] sector) are largely frozen and will need to address substantial structural issues over the next couple of years which will detract from their ability to fill the financing gap in the short term. According to Morningstar[4] funds under management in the sector has now fallen to around $15 billion and further investor redemptions are likely. Accordingly***, if and when the mortgage trusts reopen for lending they will be substantially reduced in capacity with little capital available for new lending in the short term.***

CMBS Lenders. The CMBS sector has shown tentative signs of life with the $265 million Macquarie CountryWide deal issued in September 2009 and the Colonial First State $370 million deal in March 2010, however, with $4.2 billion to mature in the next 3 years and $1.4 billion[5] left to refinance this year after March 2010, unless the securitisation market returns rapidly a replacement capital source will need to be found. To date refinancing of maturing CMBS has been largely filled by the proceeds from asset sales and refinancing by the domestic banks, however, if the domestic banks continue to be the majority source for CMBS refinancing that means there is less bank funding available for other properties and borrowers. ***The refinancing of the Centro CMBS by a consortium of GIC and Macquarie Bank reported in December 2009 is a sure sign that very sound returns can be achieved from real estate backed debt.***

Other Debt Sources. 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) and the US Private Placement (US PP) markets to source additional funding. These funding sources have been used effectively by the likes of AMP and Dexus, 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.

It should be noted that debt from the majority of sources (excluding US PP) has to date been limited to very short duration of 1 – 3 years.

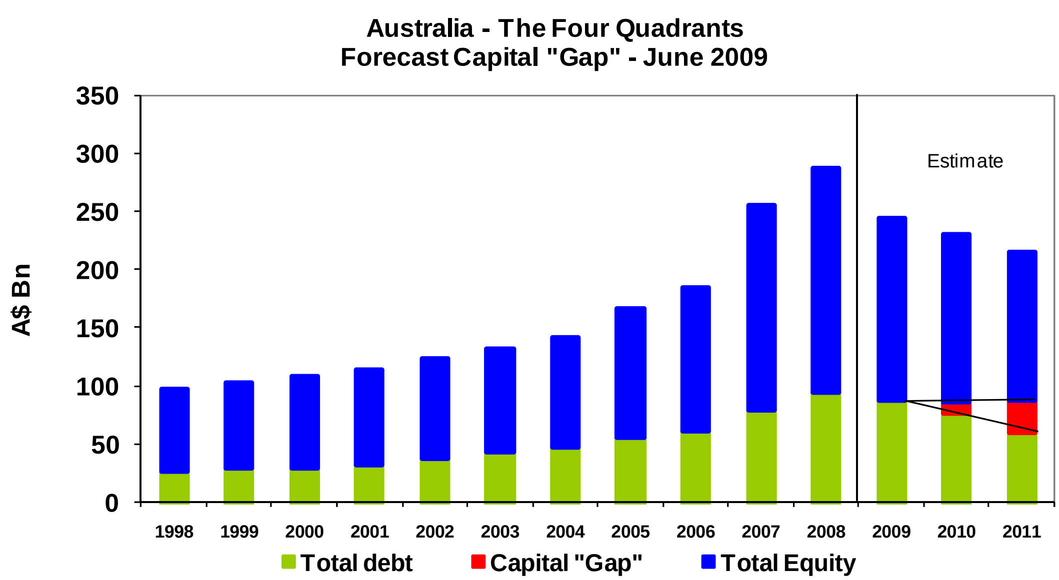
Accordingly***, we believe that due to the relative scarcity of debt capital available in the property market, 2010 will provide debt investors an excellent opportunity to obtain relatively high, stable and secured income returns on a risk adjusted basis.*** This opportunity will continue well beyond 2010 for lenders that are positioned to provide duration (greater than 5 years) to a duration starved market. Borrowers are becoming increasingly aware of the need to more adequately duration match their debt and equity.

[3] PIR Australian Property Funds Industry Annual Survey 2009, Mirvac Research
[4] Sydney Morning Herald, Frozen $15b mortgage funds still out of reach, December 2 2009
[5] Fitch Ratings, Australian CMBS The Door Re-opens 18 November 2009

The Capital "Gap"

During 2008-09, as a result of asset de-leveraging, constraints on the supply of new debt and the significant equity write-downs a capital "gap" opened up between the quantum of equity invested in commercial property and the reduced level of debt available to the sector as illustrated in Exhibit 4. In June 2009 Quadrant forecast a capital gap of $28 billion[6] from 2009 through 2011.

Exhibit 4



Sources: APRA, Westpac, Fitch, Property Investment Research, Deutsche, AFMA Standard & Poors, Mirvac

In order to calculate the size of this "gap", we applied our estimated 20%-25% peak to trough valuation discount to the total investment grade commercial property universe and have assumed that the majority of this loss will be applied to the equity component (being the first loss piece) of the capital stack. We then applied the pre-credit boom average gearing level of 28% to the value of total assets to size the debt component. The remaining balance $28 billion represented the quantum of new capital that needed to be injected into the system from 2009 onwards.

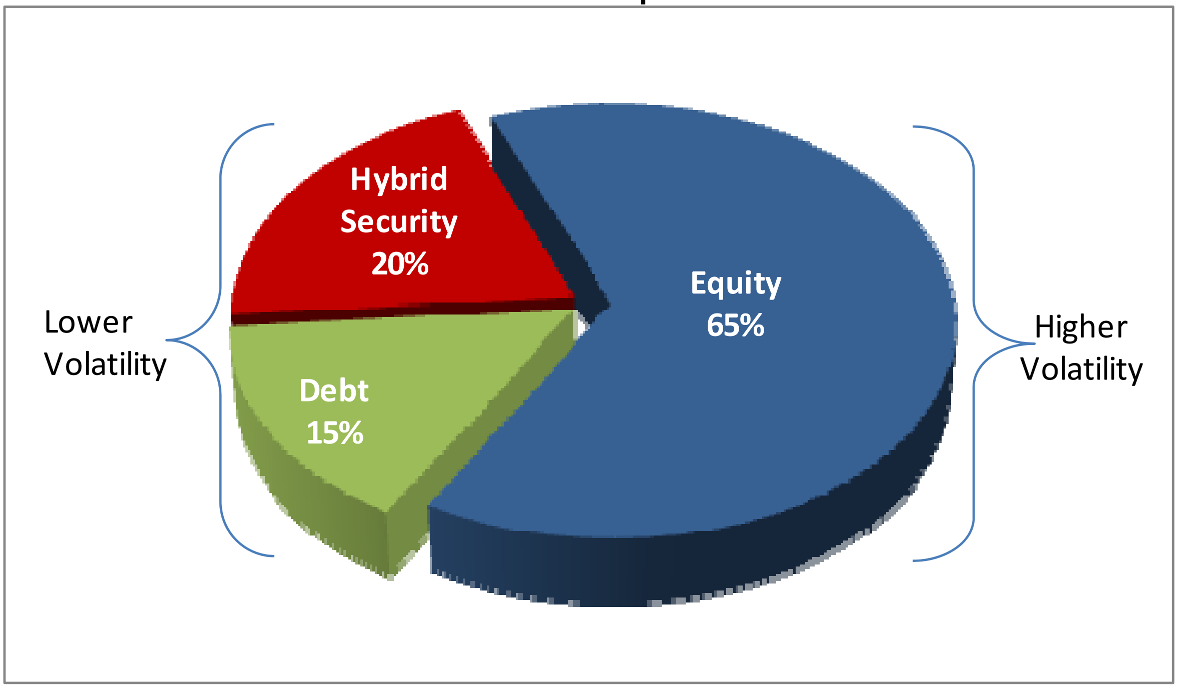
Of the approximately $20 billion (see Exhibit 2 and Exhibit 3) raised during 2009 we estimate that approximately $14 billion relates to capital for the Australian investment grade commercial market and accordingly goes halfway towards closing the $28 billion "gap". Accordingly, there is still a significant amount of capital required to complete the recapitalisation process.

[6] APRA, Westpac, Fitch, Property Investment Research, Deutsche, AFMA Standard & Poors, Mirvac

As noted above, the 50% of the gap filled to date has been sourced from a combination of capital types including equity, preferred equity, convertible notes, bond issues and secured lending. This provides investors enormous scope to choose where they would like to be positioned in the capital stack to most optimally deliver their stated risk/return objectives.

Exhibit 5

Australian Real Estate Capital Raised 2009



Sources: NAB, Aegis / PIR Research, Merrill Lynch, Company Reports, Quadrant Real Estate Advisors LLC.

As illustrated in Exhibit 5, a significant proportion of the capital raised in 2009 was via hybrid securities and non-bank debt effectively opening the door for institutional investors to invest in a variety of positions throughout the capital stack.

Sophisticated investors have been keen to utilise these hybrid structures as they provide capital protection and high relative income returns during periods of uncertainty yet still allow investors to participate in the "upside" once market growth in asset values commences.

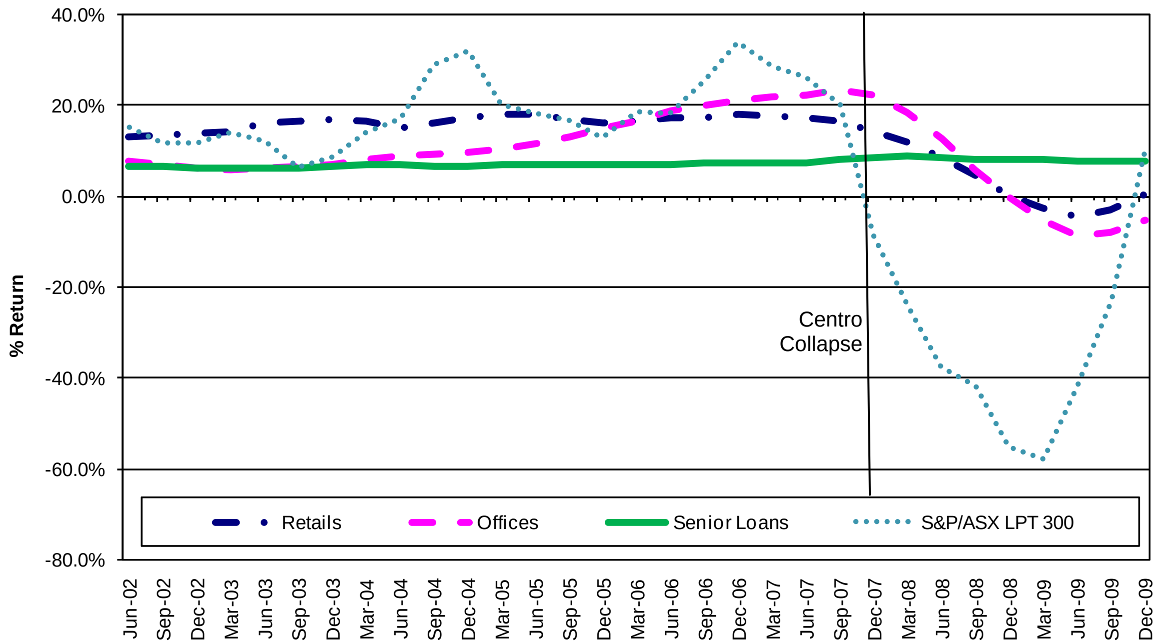
For those followers of our commentaries on the US and Australian markets you will be familiar with our strong desire to promote institutional investment in real estate backed debt. ***We have long held the view that the inclusion of a component of real estate debt within an institutional real estate portfolio can enhance portfolio performance and dampen volatility.***

While debt has long been the domain of the "fixed interest" allocation of investors we believe a bottom-up real estate fundamentals approach to asset selection and management can enhance returns.

Assessing Relative Value

In the lead up to the GFC the Australian investment grade property market had performed well (as shown in the Total Return chart in Exhibit 6 below).

Exhibit 6
Australian Real Estate Sector Total Returns Jun-02 to Dec-09



Sources: IPD Property Investors Digest, Quadrant Real Estate Advisors LLC.

As the credit crunch took hold, the performance of the listed sector (as represented by the S&P/ASX LPT 300) was the first and most severely impacted due to panic selling as investors struggled to ascertain the depth and severity of the downturn. In comparison the direct sector, due to the asset valuation cycle, was slower to react and suffered less distress as investors and owners had more time to assess the rapidly changing financial landscape. Furthermore the capital secured debt sector showed the least volatility during the downturn due to its secured nature and priority access to any income or capital flows from the property.

The comparative total returns for a selection of investment sectors over the last 3, 5 and 10 years are illustrated in Exhibit 7.

Exhibit 7
Annualised Total Returns to Dec-09

Asset Sector	3 Years	5 Years	10 Years
Retail Property	4.7%	9.5%	11.8%
Office Property	4.9%	10.0%	9.4%
Composite Property	4.9%	9.8%	10.6%
S&P/ASX LPT 300	-23.4%	-7.5%	4.1%
Senior Investment Loans (non-development)	8.0%	7.6%	7.2%*

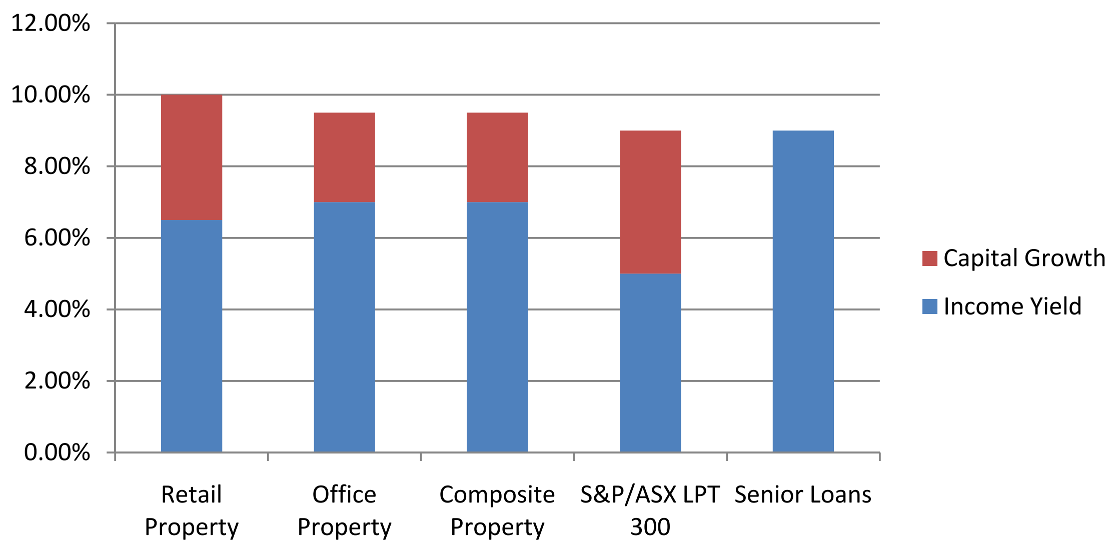
**Note: Data only available for 7.5 years from Jun-02*
Sources: IPD Property Investors Digest, Quadrant Real Estate Advisors LLC.

Current market metrics suggest 5 year fixed senior lending interest rates near 9.0% per annum which is very close to the 10 year average total return for property of 10.6%[7] p.a. and well ahead of the 2009 return of -2.2%[8] with nowhere near the same volatility as these equity investments.

Going forward, ***we are of the view that the majority of the returns for all sectors over the medium term will be derived from income as opposed to capital growth. Accordingly, it will be important for investors to understand not just the risk and return profile of their selected investments but also the composition of those returns.***

Our expectations of forecast income and total returns for various real estate asset sectors are shown in Exhibit 8.

Exhibit 8
Forecast Total Returns as at Apr-10



Source: Quadrant Real Estate Advisors LLC.

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[7] IPD Australian Digest December 2009
[8] IPD Australian Digest December 2009

In a period of uncertainty and volatility we believe a high relative income yield is a good risk mitigant as the investor is not 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 certainty associated with achieving an investor’s stated return hurdle on a regular income cash flow basis provides a high degree of comfort in an uncertain market.

Conclusions

It is likely we will see capital that may have previously been sourced as traditional debt being sourced from equity or more hybrid structures such as convertible notes or preferred equity. During 2009 the listed property companies raised $12.7 billion[9] in fresh equity and approximately $7.0 billion[10] of debt and hybrid structures of which Quadrant estimates a total of $14 billion has gone towards closing the estimated $28 billion capital “gap” in Australia.

For Investors

This blurring of the lines between equity and debt will mean that for investors to extract the optimal risk adjusted return from their real estate allocations they will need to look at opportunities across the capital stack (both debt and equity) and focus on the risk and return characteristics of the proposed investment - rather than just how it is labeled.

Given the lack of debt capital, we believe creative, prudent lending should generate excellent risk adjusted returns. Lending spreads are at historically high levels, whilst property values are stabilising, and fundamentals (vacancy and new construction levels) remain sound.

For Borrowers

The market will reward those asset owners who adopt prudent capital management strategies including diversifying their sources of capital and duration of debt to deal to both respond quickly to future opportunities and more adequately manage future exogenous events.

[9] NAB, Aegis / PIR Research, Quadrant Real Estate Advisors LLC
[10] Merrill Lynch