QUADRANT REAL ESTATE ADVISORS



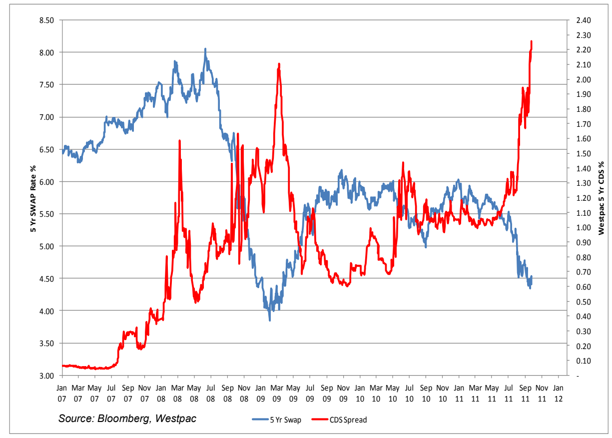

Australian Commercial Real Estate Market Update [1]

Market Overview:

- Macroeconomic events continue to dominate financial markets, with Greece's debt crisis continuing to be the main focus for investors and the potential for contagion to spread through the European region. This has resulted in a heightened degree of risk being priced into the market, which is clearly illustrated in the adjacent chart where we have plotted the current 5 year swap rate (blue) against Westpac's (and indicative for all major Australian Banks) 5 year Credit Default Swap (CDS) Spread (red). This highlights their strong inverse relationship over time.

- A CDS is a financial instrument designed to transfer the credit exposure of a fixed income product between 2 parties. That is, the buyer of the CDS receives protection for the credit worthiness of a product for a fee. It is also used as a good indicator of current indicative funding margins.

- As illustrated by the chart, while the swap rate (or interest rate) has reduced since May 2011, the CDS spread increased significantly over the corresponding period. Should this spike retrace in the near term (i.e. 2 months) there is likely no substantial impact on the Australian Banks' cost of capital as you would expect they would delay 'tapping' wholesale funding markets. On the flipside, should the CDS spread remain elevated for an extended period (i.e. into 2012) the banks will have to enter the wholesale term funding market to refinance their facilities at these elevated rates. In this circumstance you will see the cost of debt for local borrowers would increase substantially.



Source: Bloomberg, Westpac

Across the Markets:

- The chart below represents a construct of Quadrant Australia's reading of the current state of each of the sectors and the near term outlook. So how do you read this? Taking Residential Sydney as an example (top left), it is our view that the market is Weak with a stable outlook.

- The shift in Sydney Commercial to "Fair" from "Good", leaves only 4 markets showing a current status of "Good". Three of the markets are in the Hotels and Tourism Sector, which continue to benefit from high occupancy levels in capital city CBD locations but with weakness persisting in resort areas. We believe Queensland and Western Australia in particular, continue to benefit from the impact of resource investments in their States.

	Sydney	Melbourne	Queensland	Perth
Residential	Weak →	Weak →	Weak →	Weak →
Commercial	Fair →	Good →	Fair ↑	Fair ↑
Retail	Weak →	Weak →	Weak →	Fair →
Industrial	Fair →	Fair →	Fair →	Fair ↑
Hotels and Tourism	Good ↑	Good ↑	Fair →	Good ↑

Quadrant's Sub-sector Views:

Private Debt:

- The Australian commercial lending market is currently dominated by the big four major Australian banks, as foreign banks have largely withdrawn and the smaller banks have either been acquired by the big four or have dramatically scaled back their property lending activities on the back of a substantial rise in their commercial property loan impairments. Whilst the large domestic banks have assured the market that they have sufficient funding in place for the balance of calendar 2011, we are of the view that the cost of wholesale funding is likely to be significantly higher when they do need to raise debt capital early next year. (See Market Overview above).
- We believe tighter credit conditions will result in an increase in borrowing costs as maturing historically cheap pre-GFC issued term debt is refinanced. It is our view that due to the relative scarcity of debt capital available in the property market, the coming 2 year period (at a minimum) will provide debt investors an excellent opportunity to obtain relatively high, stable and secured income.

Public Debt:

- For many corporate borrowers the Private Placement (PP) market has provided a cheaper source of debt funding to bank financing or CMBS. This is particularly the case for those with high credit ratings. As a result, public debt markets remain extremely quiet, especially when coupled with the ongoing uncertainty in global markets.
- CMBS issuance continues to be almost non existent in the Australian debt market and is showing no signs of re-emerging in the short to medium term.

Private Equity:

- Offshore Asian capital continues to seek out quality real estate, evidenced by the sale of 259 George St, Sydney and also Mirvac's sale of a 50% interest in their office development at 8 Chifley Square, Sydney to K-REIT.
- Large inflows of foreign capital will likely continue and even accelerate as Australia offers returns well wide of their home markets and in the case of buyers from Switzerland, China, Taiwan and Singapore their currencies have been either stable or appreciated against the AUD. We do however expect secondary grade assets to continue to be overlooked, with vendor expectations not fully reflecting their inherent risk coupled with the reluctance of many banks to lend against the second tier assets.

Public Equity:

- Despite continuing to trade at a reasonable discount to NTA, the recent reporting season, while solid, guided to much more subdued market conditions in their outlook statements which is likely to impact growth going forward. That said, a weakening AUD, sound balance sheets and a relatively attractive yield approaching 9% should underpin the sector to a certain degree from current levels.

[1] *Data Sources include Quadrant Real Estate Advisors, Westpac-Melbourne Institute Survey of Consumer Confidence, Jones Lang LaSalle Research, Deloittes' Australian Hotel Market Outlook, AIG-PWC Performance of Manufacturing Index, ABS, RBA Financial Stability Review, Knight Frank Market Overview, IMF World Economic Outlook, Housing Industry Association, RP Data Rismark, ACCI-Westpac Survey of Industrial Rends*

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