Australian Real Estate Capital Outlook 2010

Capital is scarce – how will you source and manage it?

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Executive Summary

The 2009 year has been a tumultuous one for real estate and the capital markets generally around the globe. In Australia we have seen a huge amount of equity value dissipated and a corresponding amount of capital raised to recapitalise equity markets. Financial markets appear to have stabilised but are we out of the woods?

In contrast to 2009, 2010 looks to be more promising; however, we believe the following themes are likely to continue to be the key driving forces for the property industry through the next twelve months:

- Establishing a floor for property values,
- Access to and pricing of equity and debt capital, and
- Heightened awareness of the impact of exogenous shocks on our markets.

Accordingly, the upcoming year is likely to be a challenging one for property owners, fund managers, investors and borrowers. Clearly prudent capital management will differentiate the quality real estate managers from the also-rans. In short, we believe those market participants that can successfully source and invest debt and equity capital from non traditional sources will prosper.

Introduction

Consensus is that the end of the Global Financial Crisis ("GFC") is near – but caution is still the name of the game. Australia has survived relatively unscathed from what was expected to be the most significant economic downturn since the great depression. Stock markets have recovered significantly from their March lows, property values are stabilising, unemployment appears to have peaked below forecast levels and many other economic indicators in Australia are now looking much better than they did at the beginning of 2009. So where to from here?

For the property industry, ***we believe this will mean a stabilising of property values leading to an increased volume of property transactions and capital markets activity in the A-REIT sector through 2010.*** However we believe:

- The cost of capital (both equity and debt) will remain higher than pre-GFC levels.
- The tiering of markets will become more profound;
    - high quality assets in better markets will be highly sought after by both equity investors and debt providers thus limiting value declines.

o secondary assets and assets in riskier markets, will experience a significantly reduced amount of interest from both equity investors and debt providers resulting in greater value declines for these assets.

- Equity and debt capital for new development will be significantly constrained and highly selective thus limiting new supply of assets.
- The focus will be on income returns driven by active asset management rather than cap rate compression and value appreciation.

Having said this, a word of caution is warranted. Historically, recovering markets have had a tendency to run ahead of fundamentals. We believe "the overshoot phenomenon" has just begun and investors should be wary of a rapid run up in asset values.

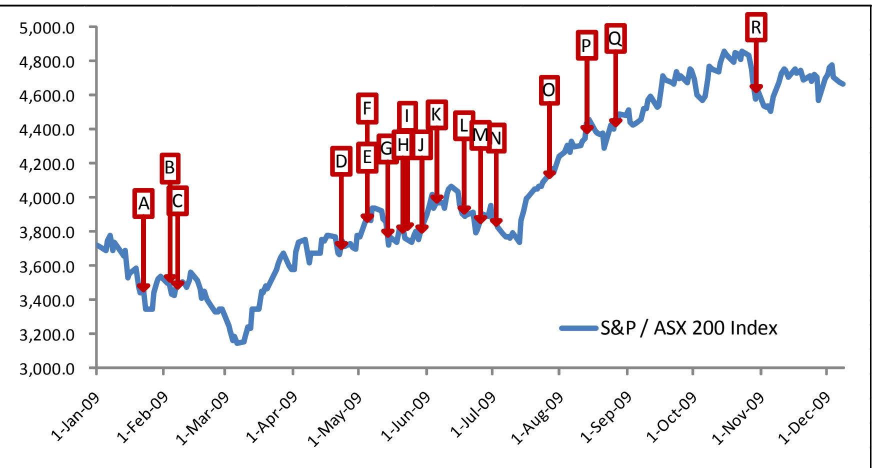
Equity Capital

Listed Sector [1]- During 2009 the A-REIT sector saw $12. 7bn of new equity capital injected. As evidence of the level of value destruction that has occurred since 2008, ***little if any of this $12.7bn was used to fund new acquisitions***. This equity was deployed predominantly to manage debt exposures (i.e. reduce gearing levels, meet debt repayments, assist with debt covenant compliance and ensure the support of bankers in extending maturing debt). Contrast this to the prior record year for A-REIT capital raisings ***being 2007 when $9bn in equity was raised to fund $15bn of acquisitions***.

Going forward we foresee additional equity raisings to support refinancing for those vehicles that still have significant debt expiry ahead, however, we also believe we will see further equity raised by quality managers in support of new transactions.

A-REIT 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
		$12,674.0m



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

[1] Aegis / PIR Research

Unlisted Sector - While wholesale funds and retail investor syndicates have not experienced the same wide unit pricing fluctuations as the A-REITS, they have had their own challenges. These include a significant increase in redemption requests (many of which have not and cannot be satisfied in the current market!), difficulty raising fresh capital and problems with the impact of declining values on gearing levels and debt covenant compliance.

Many unlisted funds and syndicates have been forced to reduce or suspend dividends in order to decrease debt or fund higher interest costs and we expect to see further restructuring and recapitalisation of the unlisted sector through 2010.

Notwithstanding this, we believe ***some retail managers and their funds will simply not survive*** as a consequence of;

- lack of interaction and communication with their investors and bankers,
- overly complex or highly structured funds incapable of efficient restructuring, and/ or,
- poor management of their client's funds, (i.e. poor capital management).

The effect of this is that ***many"Mum and Dad" investors in these funds and syndicates have not only lost income due to suspension of distributions, they have also lost their equity, but don't know it..................yet.*** We believe this will become more apparent during 2010.

We believe cashed up private investors and new syndicates are probably the best placed to take advantage of the dislocation in the markets, albeit the ability to buy assets at distressed level deep discounts has not materialised to the extent that many were expecting. Quadrant attributes this to the ability of REITs and fund managers to raise equity and the willingness of the banks to prevent the sale of assets at "fire sale" prices where alternatives were available (e.g. Centro and Allco). Having said this, during 2010 we expect opportunities to emerge from those retail investor orientated unlisted funds and syndicates referred to above.

Debt Capital

As anticipated, 2009 has seen the four major Australian banks dominate property lending, with 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 as lending conditions are stricter and pricing remains significantly higher than two years ago.

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 2010, 2011 and 2012 continues to increase, compounding future challenges.

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.

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, we believe 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. The Mortgage trusts (a $21bn[2] sector in 2008) are largely frozen and will need to address substantial structural issues over the next couple of years which could detract from their ability to fill the financing gap in the short term. According to Morningstar[3] funds under management in the sector has now fallen to around $15bn and further investor redemptions are likely. Accordingly, if and when the mortgage trusts reopen for lending it seems 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 $265m Macquarie CountryWide deal issued in September 2009, however, with $5.2bn to mature in the next 3 years and $2.4bn[4] to refinance in 2010 alone, 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. A positive sign recently reported is the refinancing of the Centro CMBS issue by a consortium of GIC and Macquarie Bank. We believe this 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, Mirvac 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.

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

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 A-REITs raised $12.7bn1 in fresh equity and we saw the likes of Goodman Group, GPT, APPF and Commonwealth Property Office Fund use hybrid structures to raise capital.

For Investors

We believe 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 how it is labelled.***

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 very strong.

For Borrowers

We believe the ***market will reward those asset owners who adopt prudent capital management strategies including diversifying their sources of capital and the duration of debt.*** This approach to capital will enable those market participants to more quickly respond to acquisition opportunities and manage future exogenous events.