

Australian Commercial Real Estate Returns – An Historical Perspective

Executive Summary

It has long been the objective of commercial real estate (“CRE”) investors in Australia to achieve an 8%-10% annualised return from their core commercial real estate investment portfolio, preferably with as little volatility as possible.

This historical review of CRE (both publicly traded and privately held) will examine whether CRE has delivered on the return objectives and examine the risk assumed in achieving those returns.

Further, by examining the historical performance of senior CRE debt (i.e. mature properties non development) against the more readily accepted and more widely understood investments of direct equity real estate and Listed Property Trusts (“AREIT”s), we are of the view that the inclusion of a component of CRE backed debt within an institutional investor’s portfolio, can assist in achieving the core CRE return objectives with lower volatility thus enhancing overall portfolio performance. In order to do so, a broadening of the traditional definition of CRE investment categories is required.

This broadening of the definition of real estate to include CRE backed debt is coincident with an equity real estate supply side constraint.

In earlier analysis¹ undertaken by Quadrant we determined that the high forecast growth of compulsory superannuation fund contributions combined with the already highly securitised equity real estate markets in Australia will result in a lack of domestic equity investment opportunities for super fund real estate allocations. In summary Quadrant predicts, demand for equity real estate assets will outstrip supply and further compress equity real estate returns over time, whilst CRE backed debt will face less competition and offer greater risk adjusted returns.

Introduction

Superannuation fund investors and managers have for a long time invested in CRE as part of their asset 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 (8 – 10% through the cycle)
- Diversification to stocks and bonds
- Hedge against inflation

¹ The Australian Equity Real Estate Investment Supply Gap, Quadrant Real Estate Advisors, August 2010.

The recent financial crisis brought into question the ability of real estate to deliver on these objectives and investor's patience has been sorely tested as fund level CRE investments, both public and private, exhibited significant value volatility. A broadening of the traditional definition of CRE investment is, in the view of Quadrant, inevitable.

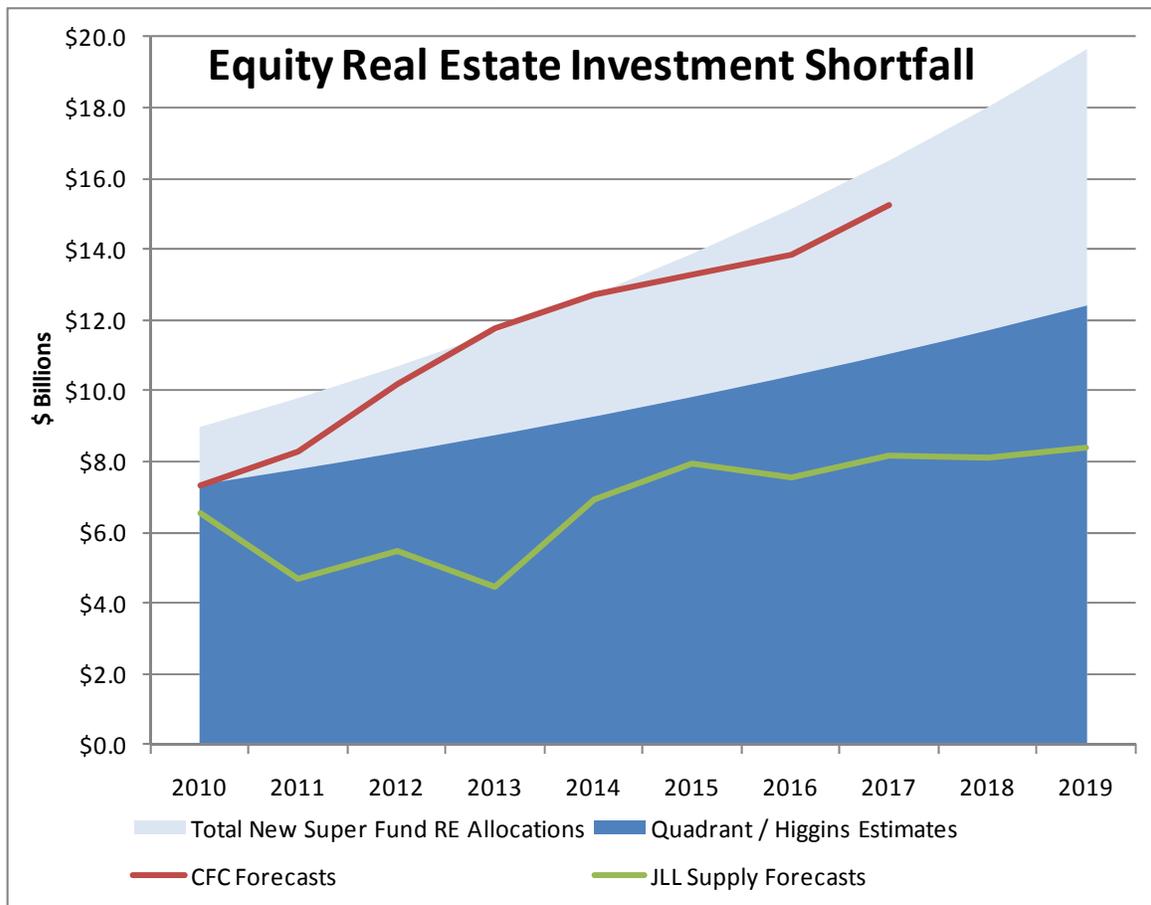
An expanded range of investment products offers new opportunities and challenges to real estate investors and managers. The menu of real estate investment choices in Australia (core, core plus, value add, opportunistic) is lengthening rapidly and is now beginning to include real estate debt investments 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.

Quadrant predicts the high growth forecast² of compulsory superannuation investment in Australia will be a major issue for Institutional Investors, particularly in relation to their real estate allocation.

The challenge of prudently investing the institutional real estate allocation is set to become increasingly difficult as Quadrant forecasts the current \$1.7 billion Australian domicile equity investment opportunity supply "gap" to grow to be a \$7.3 billion per annum gap within the next 10 years (as shown in Exhibit 1).

Exhibit 1
Australian Superannuation Real Estate Allocation Equity Investment Shortfall

² DEXX&R Market Projections Report November 2009



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.

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 prudently finance properties. The opportunity is therefore for Institutional Investors, including superannuation funds, to seek excellent risk adjusted returns from similar domestic underlying assets with capital being deployed more conservatively within the capital stack.

Australian Real Estate Return Data

The objective of this paper is to examine the historical risk and return profiles for different categories of CRE in order to establish relative performance differences. The analysis is based on the following data sources;

- "IPD" (Investment Property Databank) Index that provides investment performance information on Australian commercial property as at September 2010. The IPD Index is our benchmark for private equity investment and is composed of 1,393 office,

retail, and industrial properties, valued at \$A105.8 billion which is a significant proportion of the institutional grade commercial real estate market in Australia.

The Index data is compiled from information supplied by Australia's largest superannuation funds (pension funds), life insurance companies, public sector agencies, and listed property trusts. The IPD Index data series commenced in December 1985 and is reported on a quarterly basis.

- ASX data for the S&P / ASX LPT 200 index, (publicly traded AREITs),
- Bloomberg, Quadrant Real Estate Advisors LLC database and Banking Industry data for the real estate debt return analysis.

The data regarding the debt indices has been compiled by using Bloomberg BBSY data overlaid with banking industry data and Quadrant's loan database. In establishing these returns we have incorporated current banking industry default ratios and loss given default data.

To the extent available we have also overlaid the Mercer IPD Pooled Property Fund data as a representation of the wholesale fund performance, however, it should be noted that this information is only available for a period of 3 years which is not considered an adequate reflection of long term performance.

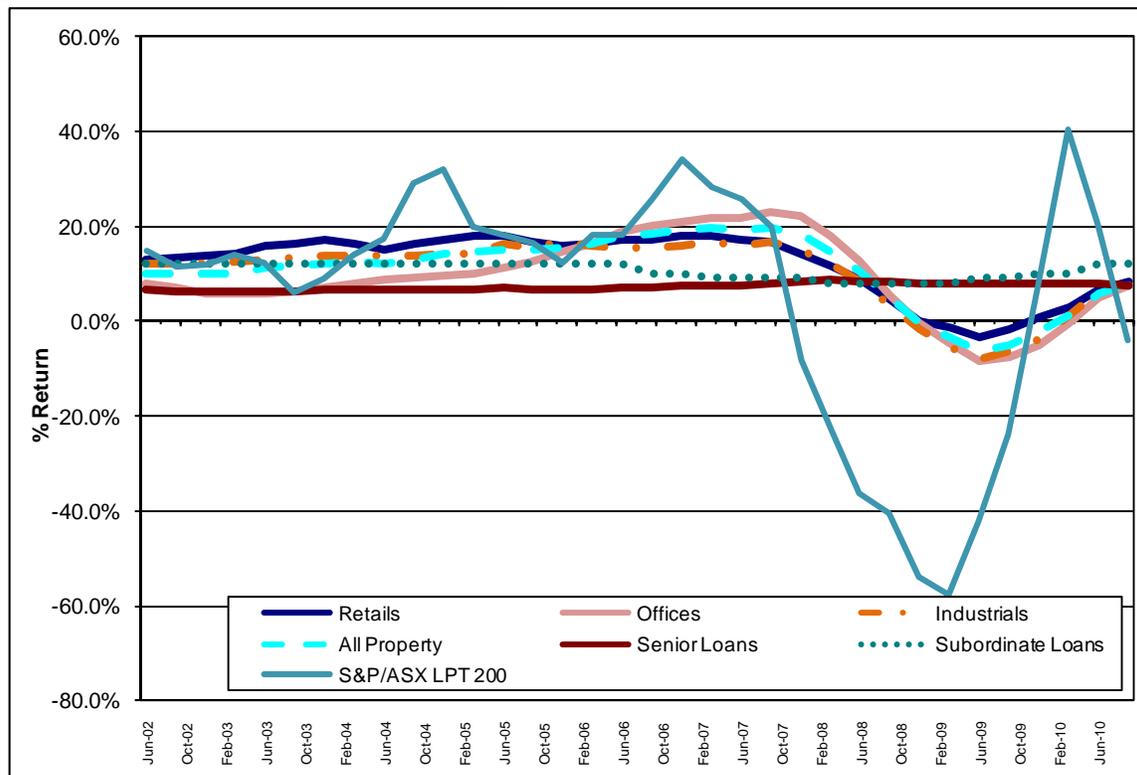
Our analysis breaks the relative total return performance into income return and capital growth as dependent variables.

While macroeconomic factors, such as the interest rates, GDP and inflation clearly impact the overall performance of real estate markets these are systemic risks and are not investigated in this paper.

Total Returns

Annualised total return for each of IPD (representing unlisted CRE), REITs and CRE backed debt from 2002 illustrated below in Exhibit 2.

Exhibit 2 Annualised Total Return Chart 2002-2010



Source: IPD, Bloomberg, 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 200) 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 CRE 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. 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.

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 and subordinated real estate debt exposures over 3, 5 and 10 year timeframes in addition to IPD Index data from 1985 to the present.

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 3 below.

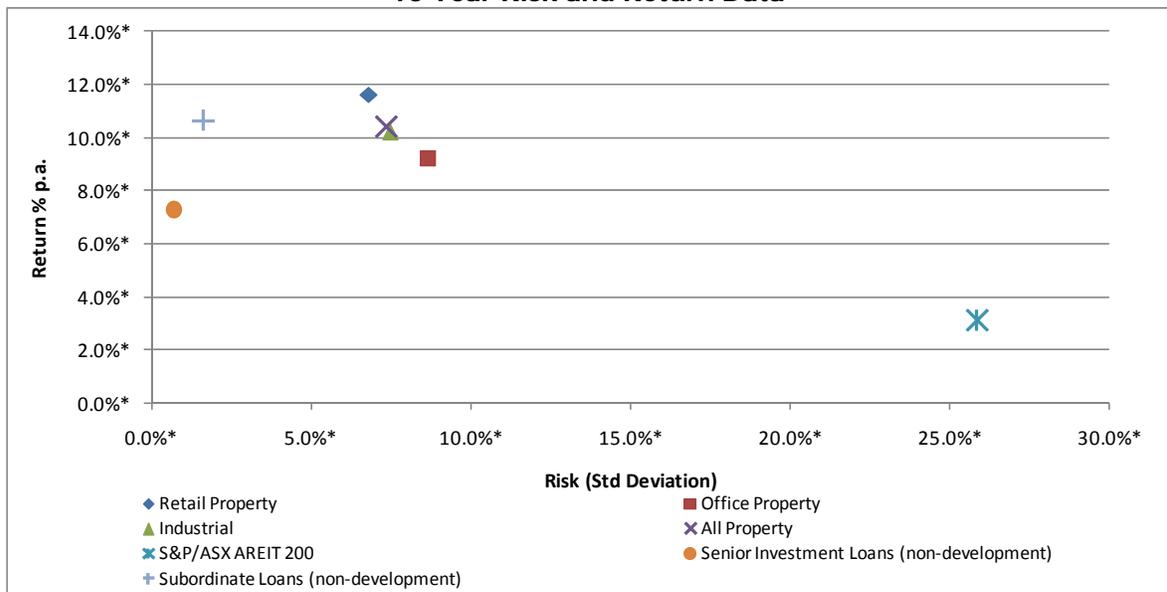
Exhibit 3
Total Return, Standard Deviation and Sharpe Ratio Data

Asset Sector	Annualised Total Returns to Sep-10				Standard Deviation				Sharpe Ratio
	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	3.60%	8.70%	11.60%	12.68%	5.74%	7.81%	6.81%	5.92%	0.89
Office Property	1.7%	9.3%	9.2%	8.86%	9.9%	11.2%	8.6%	10.8%	0.42
Industrial	1.2%	6.9%	10.2%	11.19%	7.6%	9.0%	7.5%	8.0%	0.62
All Property	2.6%	8.9%	10.4%	10.16%	7.9%	9.4%	7.4%	9.1%	0.66
S&P/ASX AREIT 200	-24.2%	-8.1%	3.1%	10.36%	30.5%	31.4%	25.8%	18.0%	-0.10
Senior Investment Loans (non-development)	8.1%	7.8%	7.3%*		0.4%	0.5%	0.7%*		2.37
Subordinate Loans (non-development)	9.3%	9.7%	10.6%*		1.5%	1.5%	1.6%*		3.11

Source: IPD, Bloomberg, Quadrant Real Estate Advisors LLC.

* Note: Data only available from Jun-02

Exhibit 4
10 Year Risk and Return Data



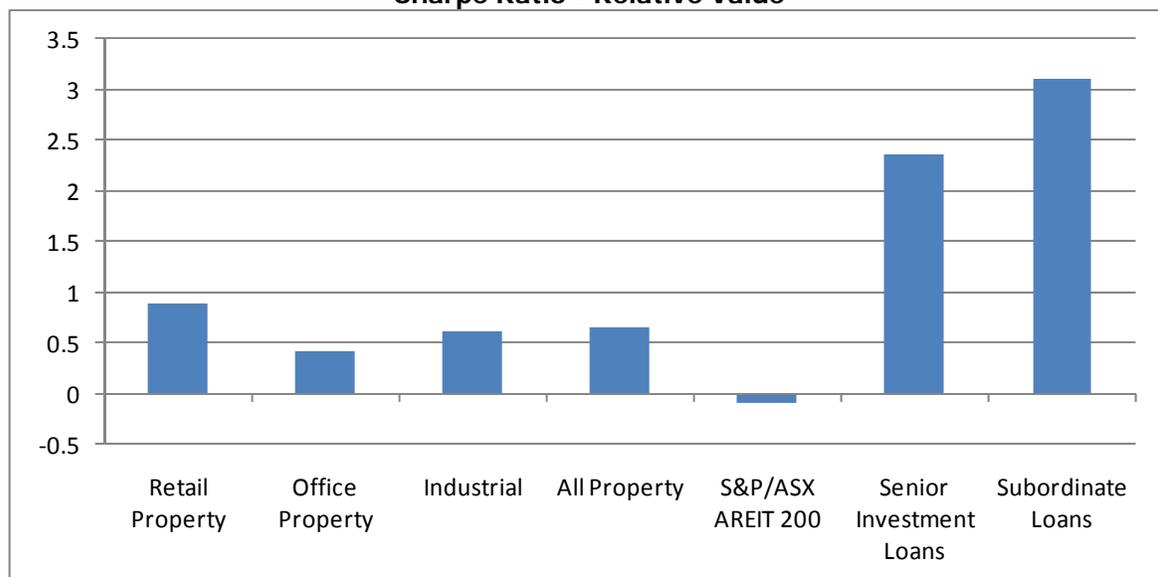
Source: IPD, Bloomberg, Quadrant Real Estate Advisors LLC.

The data and chart in Exhibit 3 and Exhibit 4 show that over a 10 year period for the population of investments in our analysis (including the recent global financial crisis) returns for commercial property investment have for the most part remained within the range of 8-12% with the major exception being AREITs (at 3.1% p.a.). Using volatility as the measure of risk there is a significant difference in the risk associated with achieving the average returns across the various investment types with debt exposures showing

standard deviations of less than 2%, direct property standard deviations averaging 7.4% and the standard deviation for AREITs being the outlier at 26%.

In order to compare the relative value of the various investment categories we have calculated the Sharpe Ratio. The Sharpe Ratio is used to characterise how well the return of an asset compensates the investor for the risk taken, the higher the Sharpe ratio, the greater the return achieved per unit of risk. To calculate the Sharpe Ratio we have taken the above return and standard deviation data and used the 10 year Australian Government bond rate as a risk free proxy. The relative value on a risk return basis for the various asset classes is illustrated in Exhibit 5.

Exhibit 5
Sharpe Ratio - Relative Value



Source: IPD, Bloomberg, Quadrant Real Estate Advisors LLC.

Wholesale Fund returns as calculated by the Mercer/IPD Australian Pooled Property Fund Index are not available for the same timescale as the other asset classes, however, the annualised returns over the three years to December 2010 are shown in Exhibit 6.

Exhibit 6
Wholesale Fund Returns

Annualised Total Returns to Dec-10			
Asset Sector	1 Yr Returns	2 Yr Returns	3 Yr Returns
All Pooled Fund Index	9.50%	-0.20%	-0.50%

Source: Mercer / IPD Pooled Property Fund Index

It should be noted that valuation (appraisal) smoothing has long been highlighted as a significant factor to consider when comparing the inherent risk and the level of statistical variance between listed and direct real estate investment performance. While it is

acknowledged that liquidity (or illiquidity) is a critical element in portfolio management this analysis does not consider this element.

As shown in Exhibit 7, AREITs whilst the most volatile of the asset classes, are ranked by Quadrant as the most liquid, whereas subordinated loans whilst showing low volatility are ranked the least liquid of the asset classes in an Australian context.

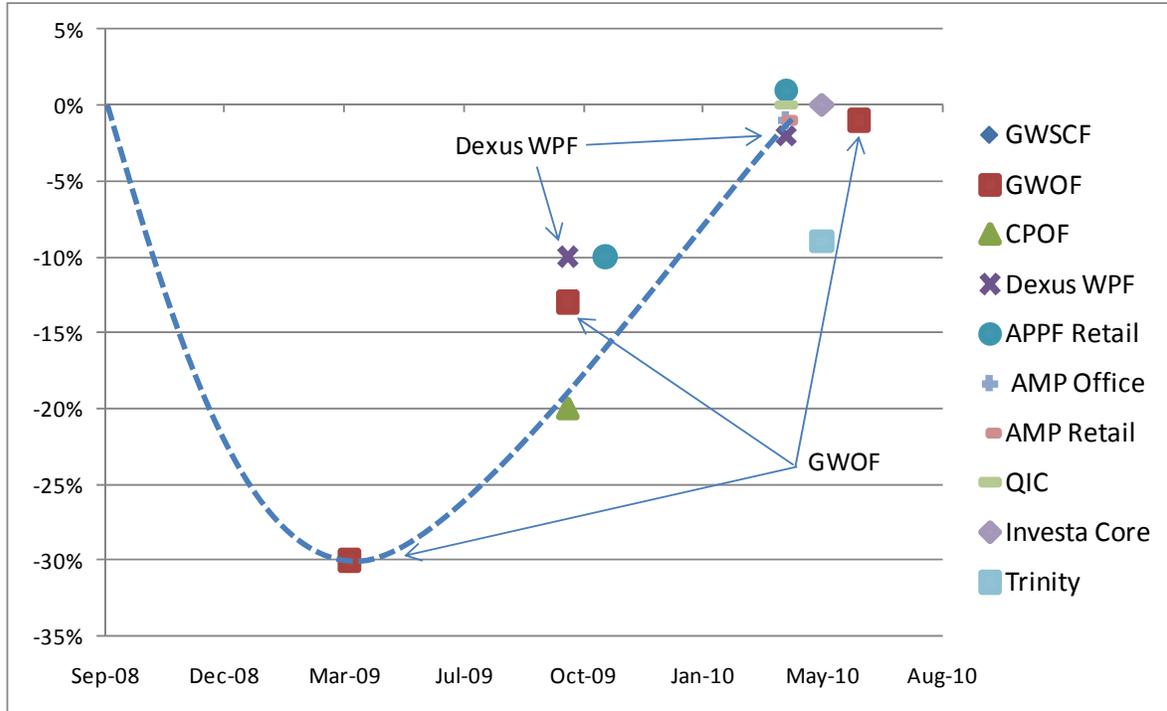
Exhibit 7
Asset Sector Liquidity

Asset Sector	Liquidity
Retail Property (fund and direct)	Moderate
Office Property (fund and direct)	Moderate
Industrial (fund and direct)	Moderate
All Property	Moderate
S&P/ASX AREIT 200	High
Senior Investment Loans (non-development)	Low
Subordinate Loans (non-development)	Low

Despite the relatively limited trading of debt investments in Australia (and the corresponding low liquidity rating) it is important to note that unlike most equity investments, debt investments have a stated maturity date (i.e. loan terms are generally 3 or 5 years) at which time the loan is repaid thereby providing an alternative exit strategy to the sale process required for the other asset classes. These stated payoff dates provide the ability to prudently redeploy capital through the cycle.

Direct property asset and wholesale fund unit liquidities rank in between the AREITs and debt investments. Even during the depths of the recent GFC, sales for investment grade direct property assets were still being achieved within a 3 to 6 month selling period, albeit at prices up to 20%-25% below pre-GFC book values. At the same time, whilst most wholesale funds were closed to investor redemptions (the usual liquidity mechanism for investors) sales of wholesale fund units were able to be traded on the secondary market as illustrated in Exhibit 8 below.

Exhibit 8
Wholesale Fund Unit Sales - Discount to NTA

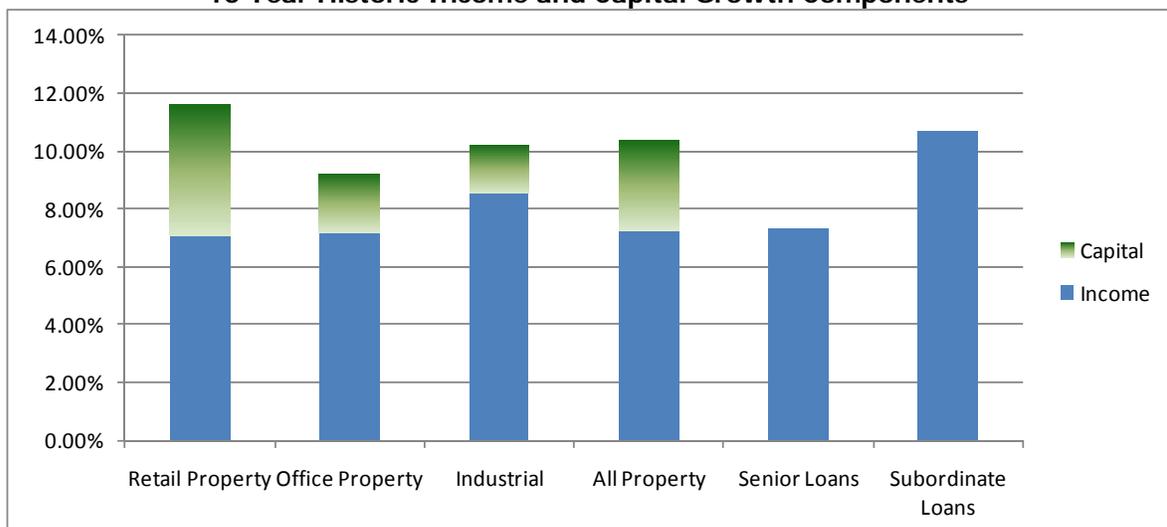


Source: JP Morgan Estimates.

Income and Capital Returns

In order to further examine the role of various property investment types in the construction of a property portfolio, it is also important to examine the component parts of the total return, namely income and capital returns as illustrated in Exhibit 9 below.

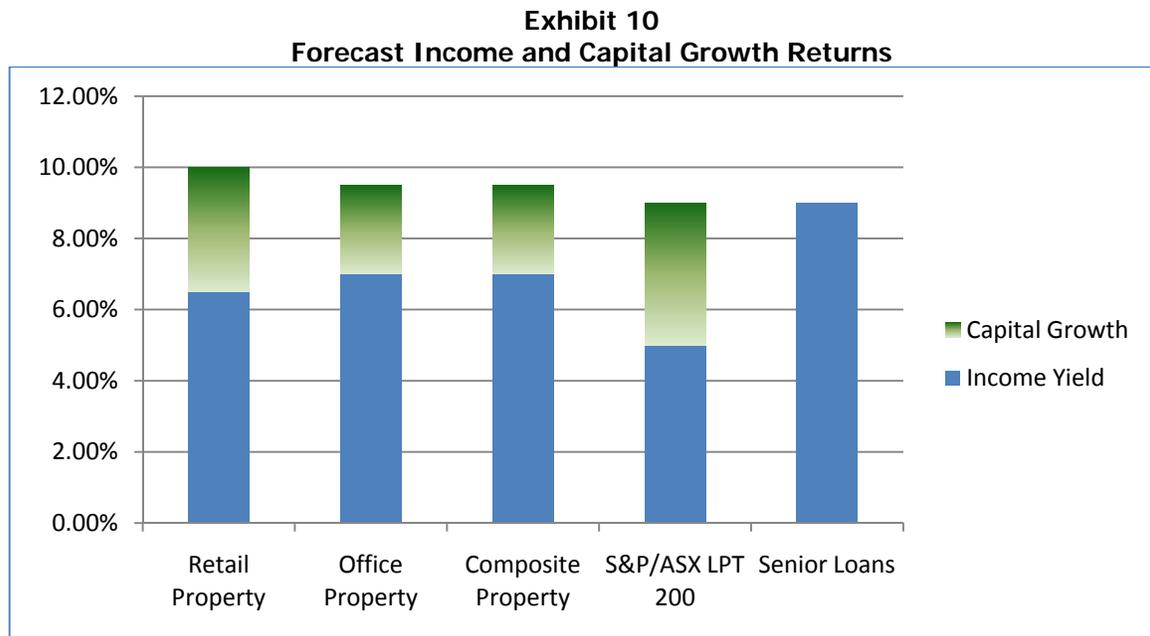
Exhibit 9
10 Year Historic Income and Capital Growth Components



Source: IPD, Bloomberg, Quadrant Real Estate Advisors LLC.

Going forward we are of the view that capital growth will be somewhat subdued in the medium term in comparison to the pre-GFC years. Accordingly we believe that it is more important than ever for investors to maximise the income component of their investment returns and reduce their reliance on capital growth to ensure that they meet their performance targets. CRE investment strategies that focus on income (including CRE debt) provide the opportunity to achieve your objectives at all points in the cycle.

Quadrant's forecast income and capital growth returns from the various available property investment types over the next 3-5 year period is illustrated below in Exhibit 10.



Source: Quadrant Real Estate Advisors LLC.

As illustrated in the above chart, we expect that Australian real estate debt with its relatively high current income yield will allow investors to obtain greater certainty and lower return volatility in the medium term in comparison to the other more traditional Australian commercial real estate equity investment types.

One of the perceived challenges for real estate debt in the Australian Institutional Investor context is the question of allocation in an investment portfolio (where it fits in a diversified portfolio context). Real estate debt investments are generally perceived as having more bond-like investment characteristics, however detailed consideration is warranted given,

- the underwriting of the real estate asset is very similar to a real estate equity investment, and,
- a low leverage debt investment can be structured to be bond-like or as preferred equity/convertible notes thus demonstrating more equity like attributes.

Conclusions

The generally accepted objective of commercial real estate investors in Australia is to achieve an 8%-10% annualised return from their core commercial real estate investment portfolio, preferably with as little volatility as possible. Historically over the life of the IPD index data this has been most consistently delivered from direct real estate investment. Recent data has shown, however, that commercial real estate debt investments (non-development) have the potential to deliver investors with a core real estate type return at much lower volatility levels and with a significantly higher current income yield.

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 probability 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. Quadrant believes that a high income orientation should always be an objective for core CRE allocations.

To date, a large proportion of institutional real estate investment in Australia has focused on the equity component only, however, going forward we believe that the significant forecast undersupply of Australian real estate equity investments means that Institutional Investors in Australia will need to look beyond the traditional listed and unlisted real estate equity investments and source a broader range of investment products in order to meet their core real estate allocation objectives.

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 CRE debt. We have long held the view that the inclusion of a component of CRE debt within an institutional real estate portfolio can enhance portfolio performance and dampen volatility.

CRE debt carries many of the attributes of fixed interest, real estate and alternatives and offers good risk adjusted returns. Accordingly, Quadrant believes it is worthy of discussion as to where an allocation belongs within a diversified Institutional Investment portfolio.

This report does not constitute or form a part of, and should not be construed as an offer to sell or solicitation of an offer to buy investments or any fund and does not constitute any form of commitment or recommendation on the part of Quadrant Real Estate Advisors ("Quadrant"). Investments offered and/or solicitations will be made only through a confidential private offering memorandum subject to at all times to revision and completion. Each recipient should consult its own legal counsel, tax advisor and other appropriate consultants as to the business, legal, tax and related matters concerning an investment advisory relationship with Quadrant, but not limited to, the risks associated with investing in any Private Placement.

Quadrant is an Australian Securities and Investments Commission (ASIC) Foreign Registered Corporation (ABN 39 123 863 963) and United States Securities and Exchange Commission (SEC) Registered Investment Advisor. This presentation does not form part of, nor should it be construed as an offer or solicitation of any offer to buy investments or any fund. Any offer when made by Quadrant would be made under ASIC Class Order Exemption number 03/1100. Under Class Order Exemption number 03/1100 Quadrant is exempt from the requirement to hold an Australian Financial Services Licence (AFSL) in respect of any offer to wholesale investors.