The Role of Australian Real Estate in Investment Portfolios - Risk or Reward?

Portfolio Construction Conference 28 August 2008

Two major themes…

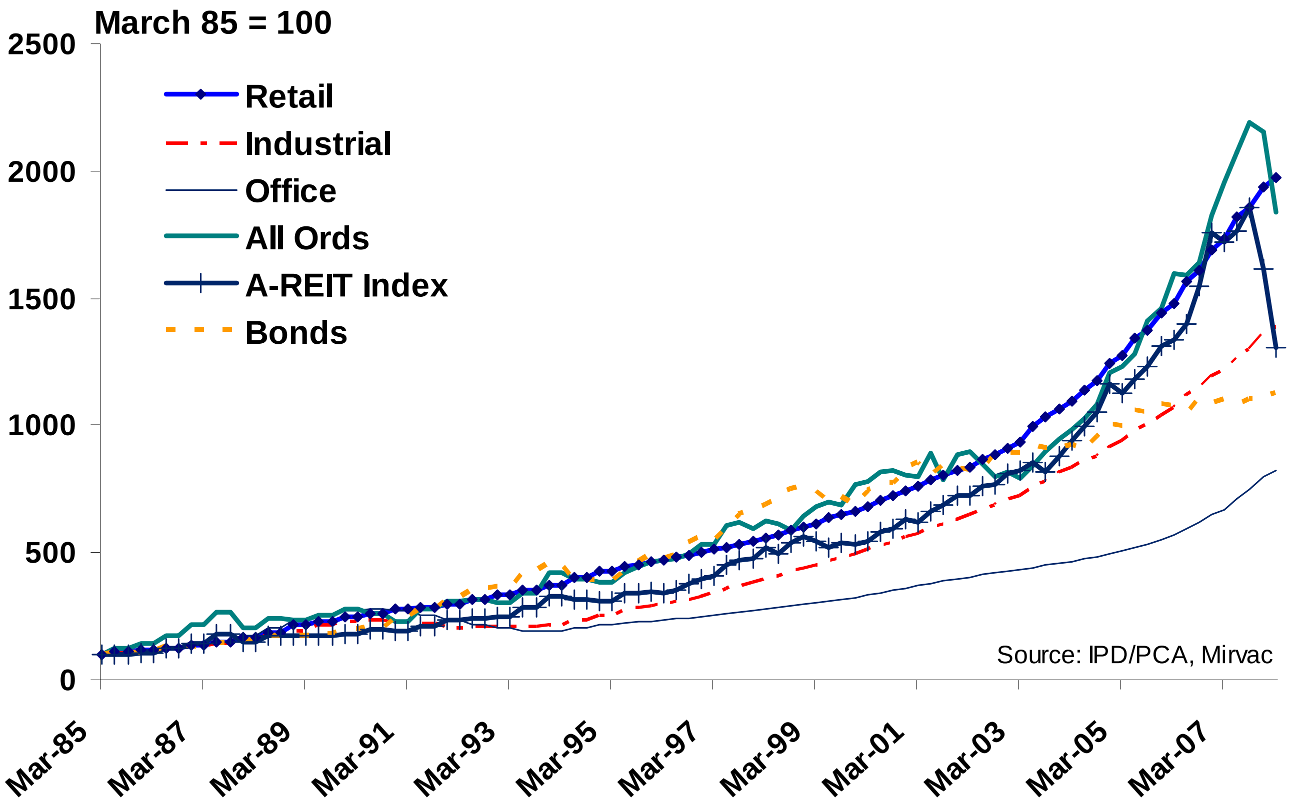
- The strong performance of direct real estate markets in recent years is due to growth generated by a one-off and probably permanent decline in yields (or capitalisation rates) that broadly corresponds with a decline in the real cost of capital.
- The sharp decline in the A-REIT sector can be in large part explained as a reflection of activities extraneous to passive ownership, not as a predictor of the domestic real estate asset values.

…and consequences

- Investment returns and asset values
- “Left of field” risks
- Opportunities

Direct property performance to March 2008

Direct real estate remains robust so far in contrast to listed securities



Risk/return trade-off: some surprises

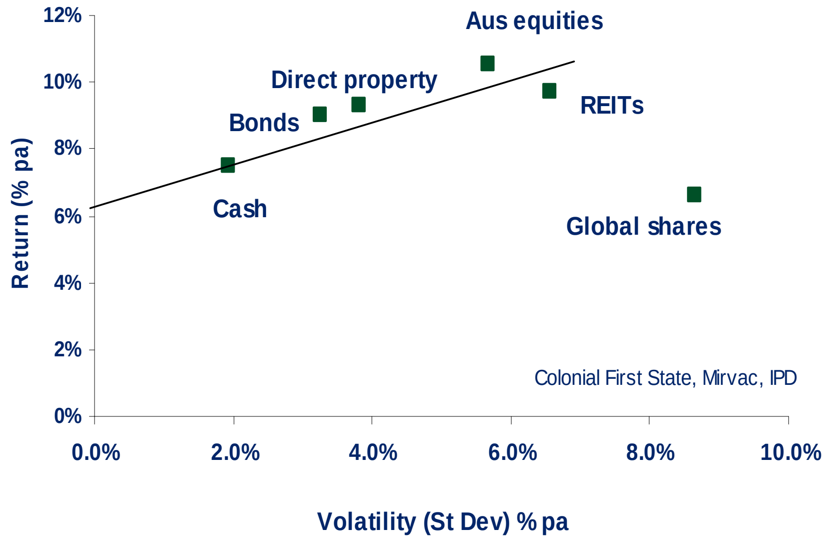
Returns on asset classes (1988 to 2008) (% pa)

	Australian shares	Global shares	Australian property securities	Australian fixed interest	Cash	Direct property
Jun-89	3.5	17.9	-1.1	5.3	16.0	25.0
Jun-90	4.1	1.9	15.2	17.3	18.5	11.3
Jun-91	5.9	-1.8	7.7	22.4	13.5	-5.7
Jun-92	13.0	7.2	14.8	22.0	9.0	-7.3
Jun-93	8.7	31.3	17.1	13.9	5.9	-3.9
Jun-94	15.5	0.2	9.8	-1.1	4.9	8.6
Jun-95	6.4	14.1	7.9	11.9	7.1	10.3
Jun-96	14.3	6.7	3.6	9.5	7.8	7.8
Jun-97	26.8	28.5	28.5	16.8	6.8	8.8
Jun-98	1.0	41.6	10.0	10.9	5.1	10.5
Jun-99	14.1	8.2	4.3	3.3	5.0	10.2
Jun-00	18.2	23.7	11.9	6.2	5.6	10.7
Jun-01	9.1	-5.8	13.9	7.4	6.1	11.1
Jun-02	-4.5	-23.3	14.9	6.2	4.7	9.5
Jun-03	-1.6	-18.3	12.1	9.8	5.0	10.9
Jun-04	21.7	19.4	17.2	2.3	5.3	11.1
Jun-05	26.0	0.6	18.1	7.8	5.6	14.4
Jun-06	24.0	20.0	18.0	3.4	5.8	15.5
Jun-07	29.2	8.2	25.9	4.0	6.4	17.4
Jun-08	-13.7	-21.0	-36.3	4.4	7.3	18.1*
Average (% pa)	**10.5**	**6.6**	**9.7**	**9.0**	**7.5**	**9.0**

Source: Colonial First State, IPD, Mirvac

** Year to March 2008*

RISK/RETURN TRADE-OFF (1988 to 2008)



Percentage return over rolling 1 year. UBS Australia Bank Bill Index (91 day Commonwealth Treasury Note Index pre Jan 1989), UBS Australian Composite Bond Index (CBBI All Series pre Oct 1989), S&P/ASX 200 Property Accumulation Index (ASX Property Accumulation Index pre April 2000), S&P/ASX 300 Accumulation Index (ASX All Ordinaries Accumulation Index pre April 2000), MSCI World Net Index (A$). All dividends reinvested excluding fees and charges.

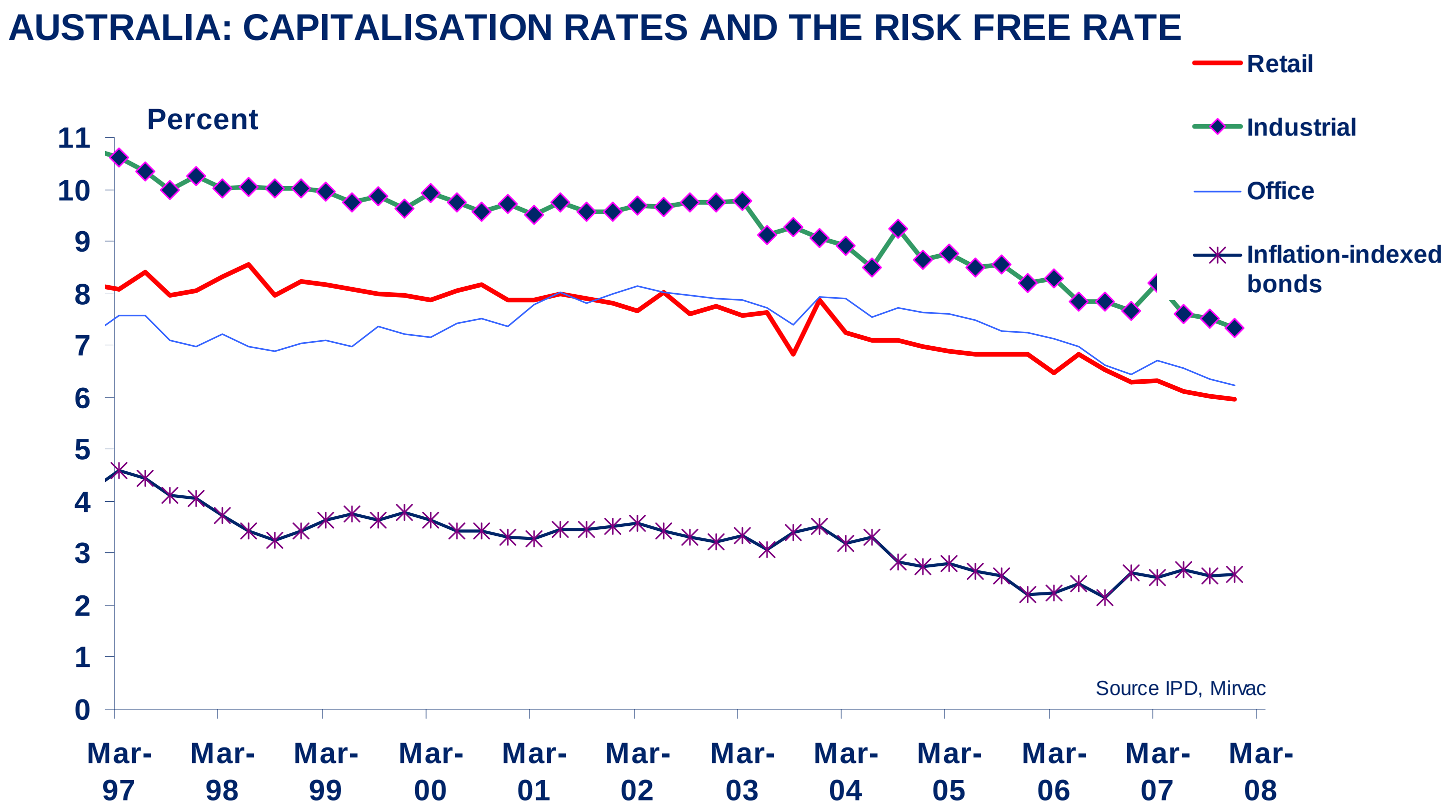
Direct property performance
High returns – but what is the driver?

Sectors - One year to March 2008	Capital % pa	Income % pa	Total % pa
Retail - direct	7.4	6.3	14.0
Office - direct	15.3	6.5	22.7
Industrial - direct	6.1	7.3	13.8
Composite - direct	11.0	6.4	18.1
S&P/ASX A_REIT index	-28.6	6.2	-24.2
ASX All Ords	-9.5	3.9	-6.0

> In recent years direct property performance dominated by capital growth

Where did the growth come from?

- risk premium (spread to indexed bonds) relatively stable for premium grade assets

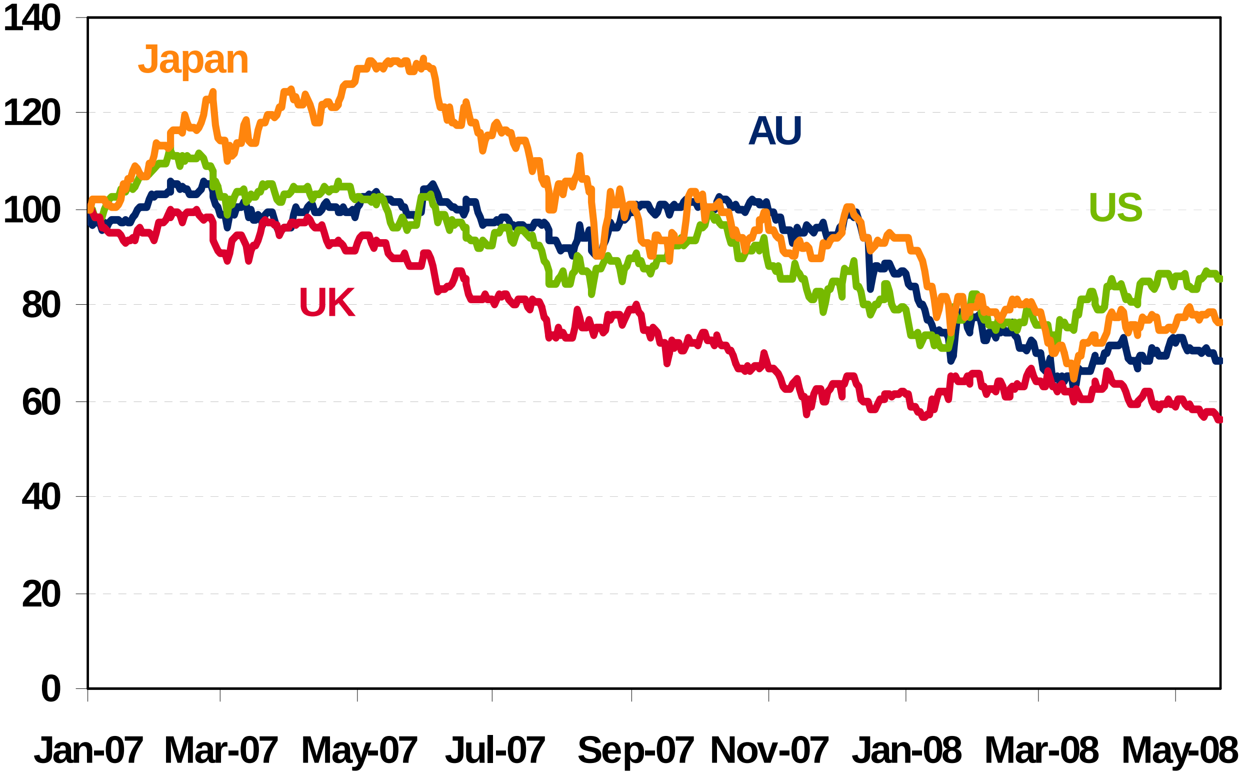


Sources of growth

- Yield compression was the key driver of capital growth in direct property (1995 to 2007)
- The yield compression approx. equal to decline in underlying cost of capital for prime grade assets
- So property "risk premium" for prime grade assets relatively stable (in Australia)
- Therefore underlying values of prime (institutional grade) assets look reasonable – modest yield decompression expected
- BUT the yield compression process has now ended - though the long-term impacts have yet to emerge fully

Listed real estate

REIT Performance Index = 100 January 2007



Source: Bloomberg

Performance very similar across all major public listed markets

But is it the same story in every market?

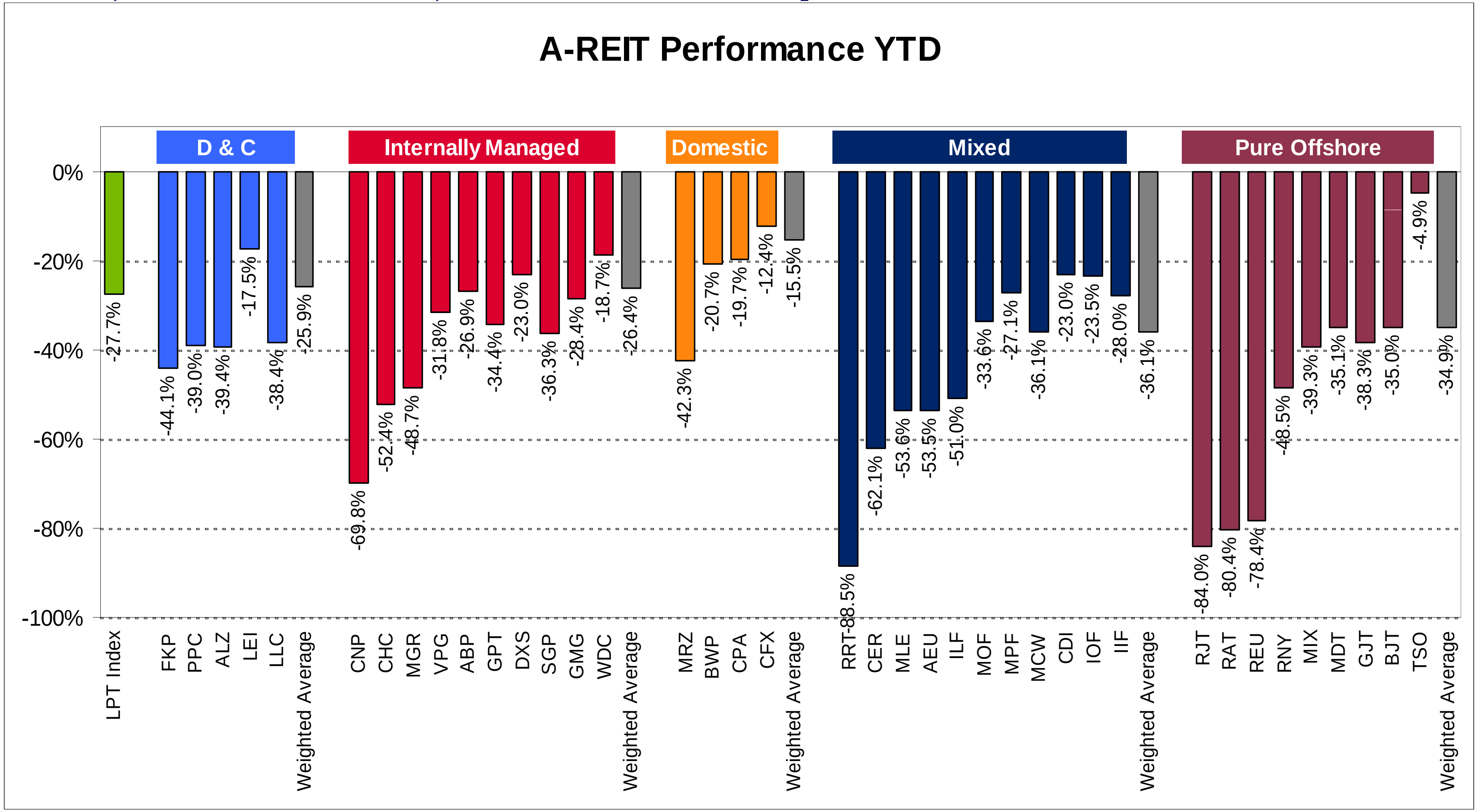
Australian market is

> global

> stapled

> real assets less expensive

A-REIT performance YTD
Very discriminating: debt, offshore exposures, corporate activity



REIT performance

- Sharp fall in Australian REIT sector does not necessarily predict future fall in underlying real estate asset values
- Market performance clearly reflects impact of
  - Offshore market exposure and FX risk
  - High levels of debt and expiry profile
  - Exposure to higher risk corporate activities – eg. development, hotels & tourism, residential market
- Contrast this with performance of UK and US REIT markets
- Remaining questions
  - Investment returns
  - "Left of field" risks
  - Opportunities

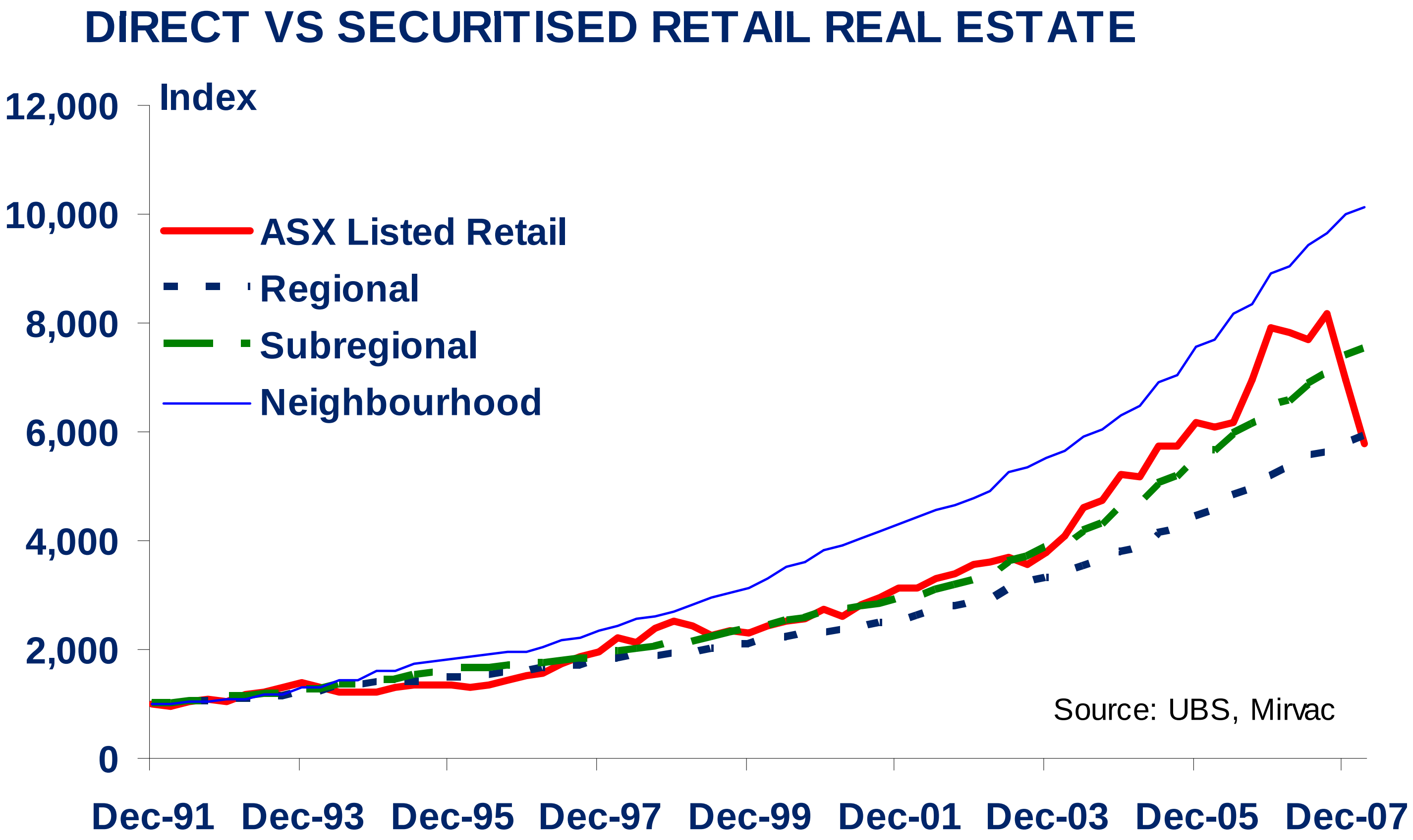
Investment returns: back to 10 percent pa

	Capital	Income	Total
Sectors - One year to March 2008	**% pa**	**% pa**	**% pa**
Retail - direct	7.4	6.3	14.0
Office - direct	15.3	6.5	22.7
Industrial - direct	6.1	7.3	13.8
Composite - direct	11.0	6.4	18.1
S&P/ASX A_REIT index	-28.6	6.2	-24.2
ASX All Ords	-9.5	3.9	-6.0
Sectors - Twenty-three years to March 2008	**% pa**	**% pa**	**% pa**
Retail - direct	5.1	8.0	13.0
Office - direct	2.2	7.0	9.2
Industrial - direct	2.4	9.1	11.4
Composite - direct	3.3	7.3	10.6
S&P/ASX A_REIT index	3.3	7.6	11.2
ASX All Ords	8.6	3.8	12.7
Inflation	3.2		
Source: IPD			

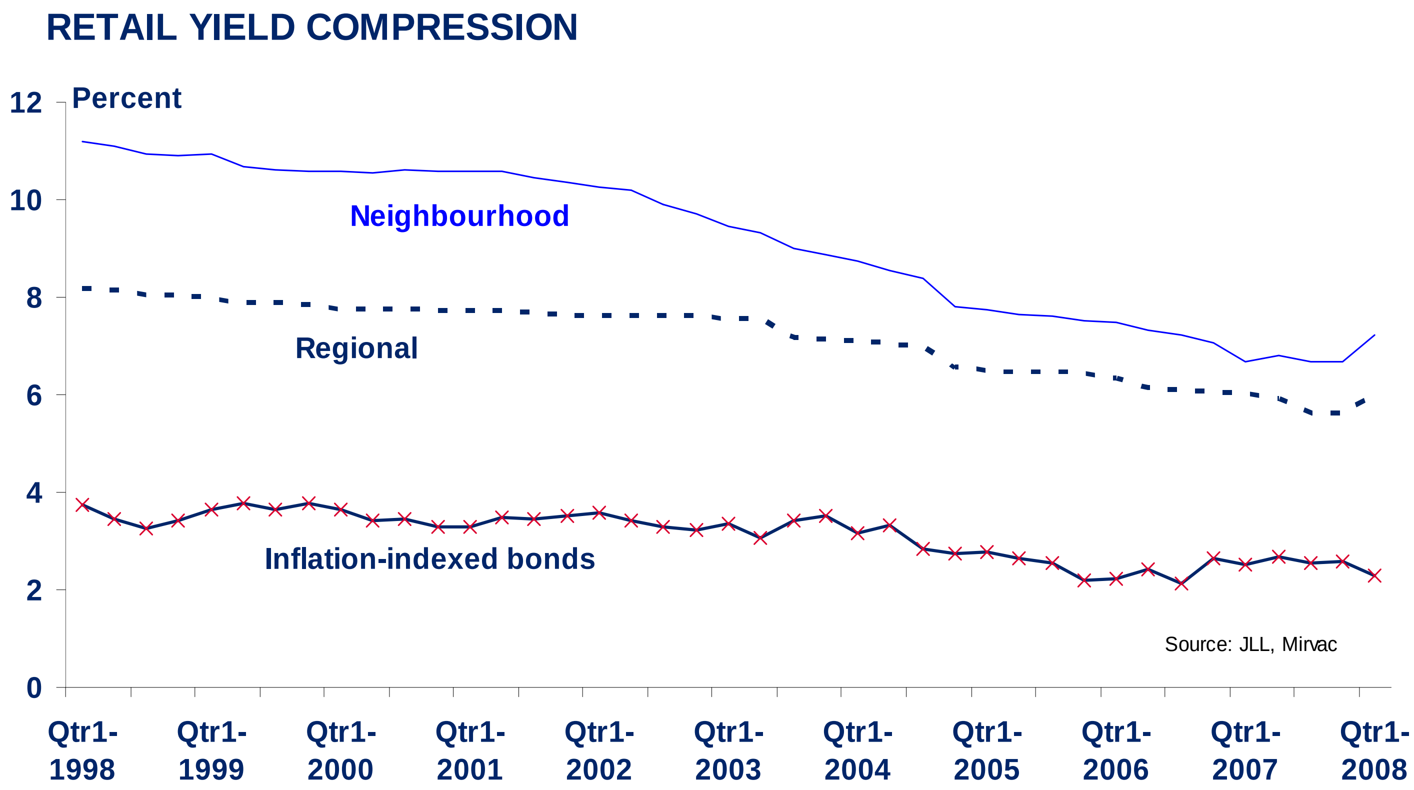
> In recent years performance dominated by capital growth

> But real estate is in fact a high yield, low growth asset, long term

"Left of field" risks
Small is (was?) beautiful



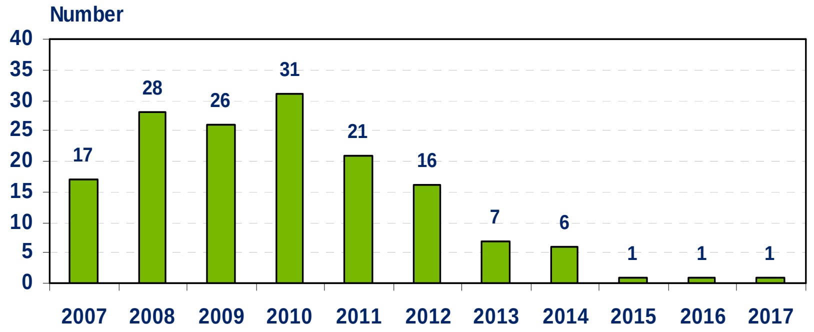
Yield compression greater for smaller, often 2nd grade assets



Liquidity, leverage key issues for 2008/9

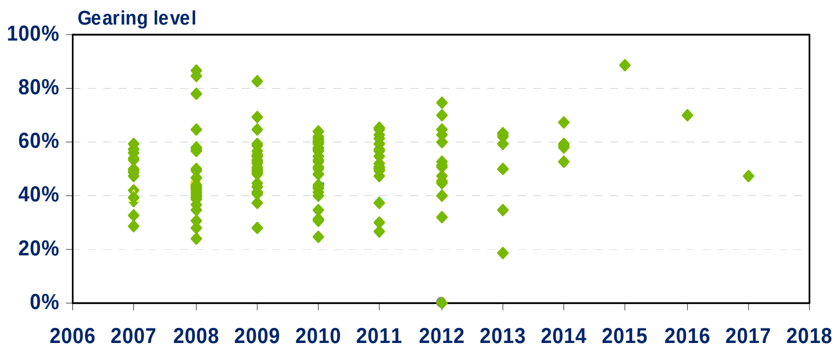
- Syndicate sector $13 bill gross assets, 260 funds: Centro 25%, Multiplex 6%
- Many maturities 2008 to 2010
- High gearing, liquidity and performance issues (esp. if economy slows)
- Asset sales, price pressure in secondary market

Anticipated syndicate maturity dates - number of maturites



Source: PIR 2007

Anticipated syndicate maturity dates and gearing levels



Source: PIR 2007

Areas of risk

> Rules for success in real estate (1995 to 2007)
  - Invest in 2nd grade assets – capital growth the greatest
  - Use leverage to enhance returns, reduce tax
  - Borrow short because interest rates, risk premia falling
> Now: 2008 onwards
  - Cost of debt higher, availability falling
  - Growth cycle has ended, investment returns will be lower
  - Liquidity preference has risen
  - Economy slowing, risk of vacancy, lower rental growth
> In many market sectors values will be under pressure and assets will require careful management

Other "left of field" risks

- Tax and regulatory shifts – probably a positive
- Obsolescence – eg. impact of green ratings on older buildings
- Technology – work space ratios, shopping from home
- Supply – location specific

Opportunities

- REIT sector
  - Valuations currently discount sharp decline in underlying asset values (yield decompression)
  - Consolidation and restructuring of the sector
- Non-core assets, eg
  - Hotels – sector consolidation, vertical integration
  - Retirement – demographics but robust financial model required
- Debt products (if well managed)
  - Banks, many mortgage lenders have downsized or exited the industry
  - Institutions cashed up and looking for high yield assets – they will be the new lenders
  - Generous spreads currently available with limited downside – spreads to remain wide for the forseeable future

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Any questions?

Mirvac Funds Management