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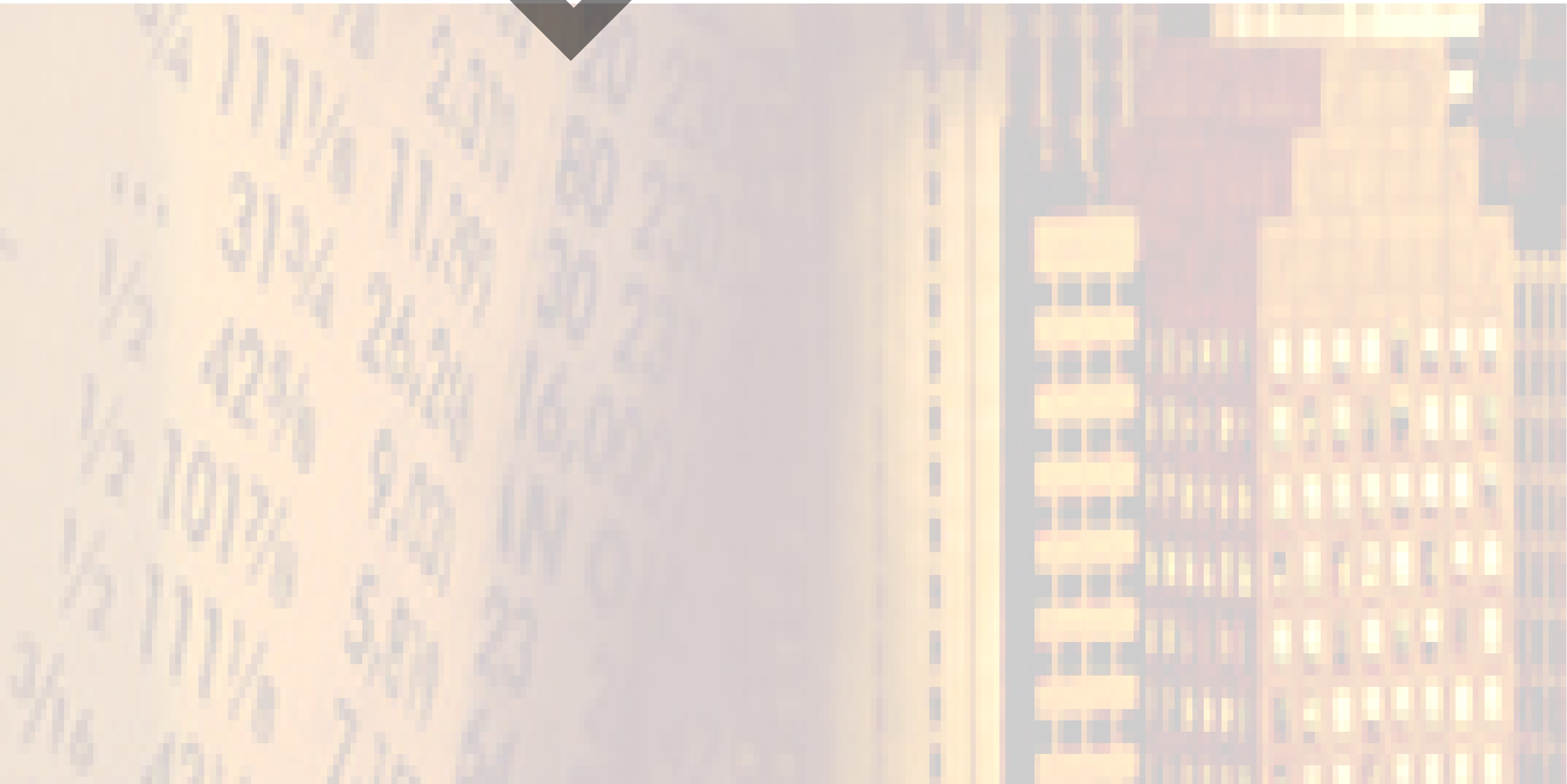
PROPERTY – BACK ON THE DEFENCE

JUNE 2010



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Synopsis

The fundamentals of the REIT sector have arguably not been as strong for quite some time:

- Construction supply is low

- REIT balance sheets are strong

- Dividends are sustainable

- Investment strategies have been simplified

- Superior access to capital

This paper discusses how these fundamentals underpin a stable environment for property and, combined with the strength of contractually-bound income from real estate leases, provide an attractive and relatively secure return profile during a period of uncertainty.

A dose of reality during the upwind grind

Following the strong rebound off March 2009 market lows, REITs experienced what might euphemistically be described as a period of consolidation during the quarter ended 30 June 2010. The Hedged UBS Global Property Investor Index produced a total return of -4.84% for the quarter but should be viewed in the context of an overall +39.05% total return for the year ended 30 June 2010.

The dip in the market was triggered by ongoing macro challenges, notably in the European Union, which served as a reminder of the longer term issues associated with profligate spending.

Whilst quarterly returns were weak in an absolute sense, relative to broad equities markets, REITs are benefiting from the prolonged economic malaise which is delaying a corporate earnings recovery.

REITs vs Equities Quarter End 30 June 2010*

	UBS Global Investors	General Equities
US	-3.8%	-11.4%
Continental Europe	-9.6%	-7.9%
UK	-12.3%	-12.3%
Japan	-8.2%	-15.4%
Australia	-1.2%	-11.2%
Singapore	1.2%	-0.7%
Hong Kong	0.5%	-3.5%

*Local currency total returns
Source: UBS

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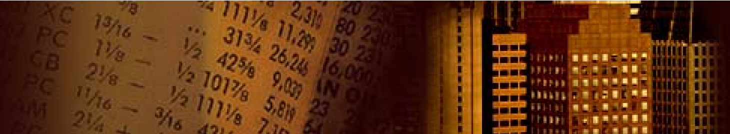
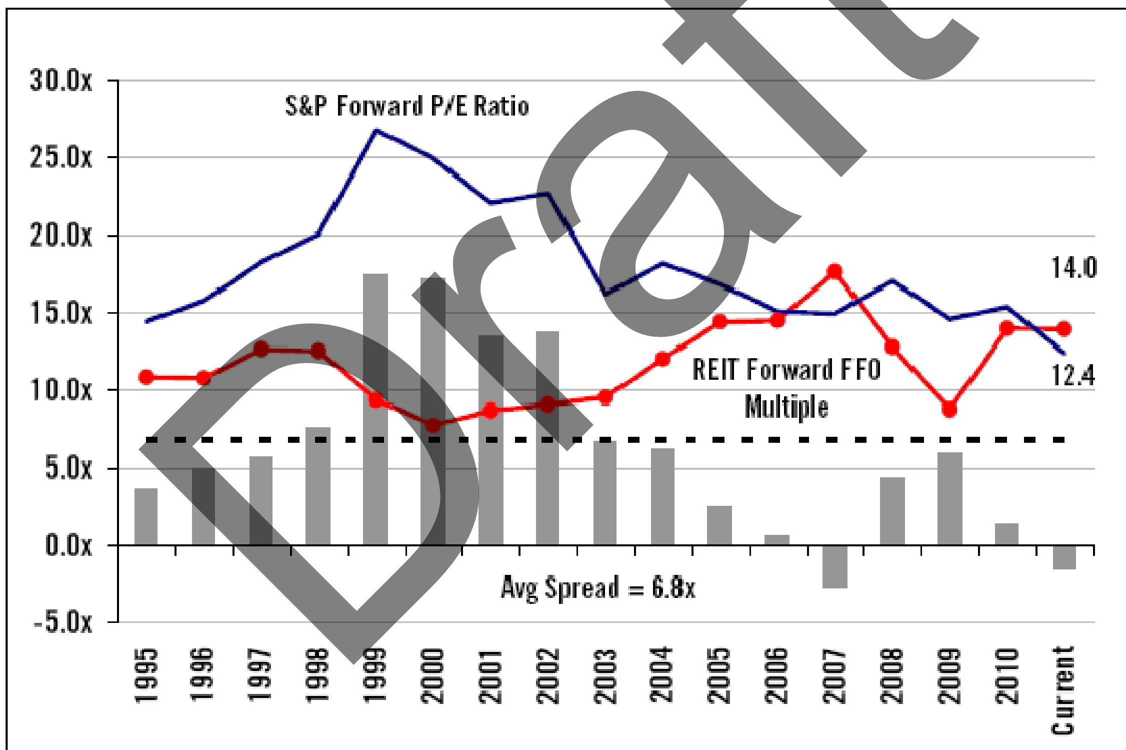


As highlighted in the chart below, US REIT earnings (as measured under Funds From Operations – FFO – which in simple terms equals net income plus depreciation), are now afforded a similar multiple to that of equities (measured after depreciation).

In light of the lack of property construction activity allaying increasing vacancy concerns, the strength of contractually bound income from real estate leases provides an attractive, relatively secure, return profile during a period of uncertainty. Hence it could be argued, with restored balance sheets, REITs are, for once at least, delivering on the theoretical promise of a defensive role in a diversified portfolio. It might also suggest REIT prices are relatively unattractive IF the outlook for corporate profitability should improve materially.

The US REIT Forward FFO Multiple Is Essentially In-Line with the S&P 500 P/E Multiple



Source: Company reports, FactSet, Reuters and Citi Investment Research and Analysis

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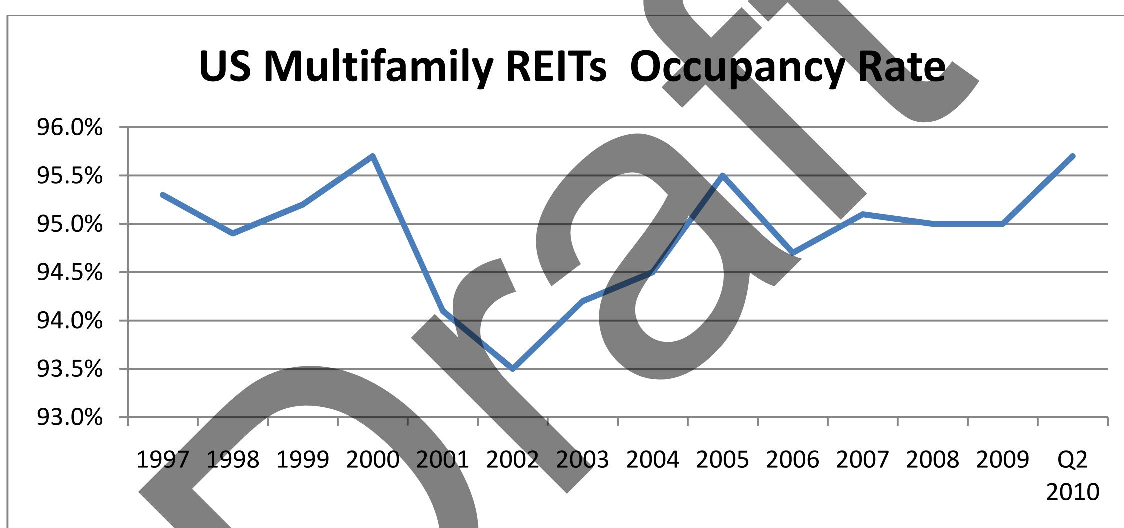
During the quarter, US Multi-family REITs (rental apartments) were among the best performers globally thanks to mounting evidence that US residential for lease accommodation will experience improving rental rates over the next 12-36 months as vacancy levels are low (particularly compared with previous economic downturns as highlighted in the chart below), supply is benign and demand for accommodation is showing signs of recovery. With no apparent appetite to buy a home (US home ownership levels have fallen from a peak of 69% in 2004 to 67% currently) and having combined with friends to share accommodation or moved back home with parents in order to save money, many occupants appear to be tiring of these living arrangements preferring to rent independently. With this backdrop, major US multi-family REIT Avalon Bay Communities announced an increase to its previous 2010 guidance and that it would ramp up development activity.



Source: RCL, US Multifamily REITs

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The difficulty in securing “distressed” real estate is an ongoing theme within the real estate sector globally. The combination of low interest rates and relatively high occupancy means that many highly leveraged borrowers are able to service their debt. No doubt many lenders view it as better that professional owners, although highly leveraged, should continue to operate the assets. Managing real estate is not the primary business of banks and financial institutions and certainly not, if history is any guide, a core competency. In addition to avoiding liquidity issues associated with loan defaults, banks have been able to reap higher returns in the form of penalty fees and interest rates typically extracted from “extend and pretend” arrangements.

US REIT Simon Property Group’s (SPG) futile efforts to acquire General Growth Properties (GGP) highlights the challenges in securing quality real estate. As a reminder, GGP owns a significant portfolio of malls and shopping centres in the US and became one of the world’s largest real estate bankruptcies when it entered Chapter 11 (a form of bankruptcy in the US that allows an organisation the ability to restructure itself) in April 2009. Despite having arguably the highest, and we believe a generously priced bid, SPG’s offer for GGP was thwarted reportedly on the grounds of uncertainty as there were concerns that regulatory anti-trust (ie competition)

issues could jeopardise the deal. The Brookfield supported recapitalisation was considered preferable. Perhaps the Bucksbaum family's (which is a major stakeholder in GGP) determination not to be taken over by the Simon family's REIT may have also played a vital part in the process.

The anti-trust issue came as a surprise to many, ourselves included, as there had been a belief that real estate is exempt from this sphere/issue, on the grounds that it is a large and diverse market difficult for any participant to dominate. Whilst acquiring GGP would cement Simon as the largest single owner of malls in the US, and arguably dominant in some cities, it still would own less than 50% of the malls in America and a fraction of the overall retail space if other types of shopping centres are included, not to mention the advent of internet retailing.

This issue has precedents in other countries. In Australia, a market with much lower retail space per capita, Westfield is believed to have run into ACCC obstacles in this area following its takeover of AMP Retail Trust in 2003, forcing it to pass up ownership and or management of certain assets. Furthermore, post 30 June, Unibail has had difficulty closing on a transaction to add to its Polish shopping centre portfolio for similar reasons. In the case of Simon's bid for GGP, whilst nothing was officially decreed by US regulators, it is certainly a significant milestone for US mall landlords.

Combined with the lack of buying opportunities, the constrained supply conditions and improved prospects for global economic growth is encouraging a number of REITs with the financial capacity to increase their development pipelines: Westfield, Land Securities, GPT Group and Avalon Bay prominent on this list. The development equation is arguably marginal but is assisted by a trend of firming cap rates, declining construction costs and stabilised rents showing signs of improvement.

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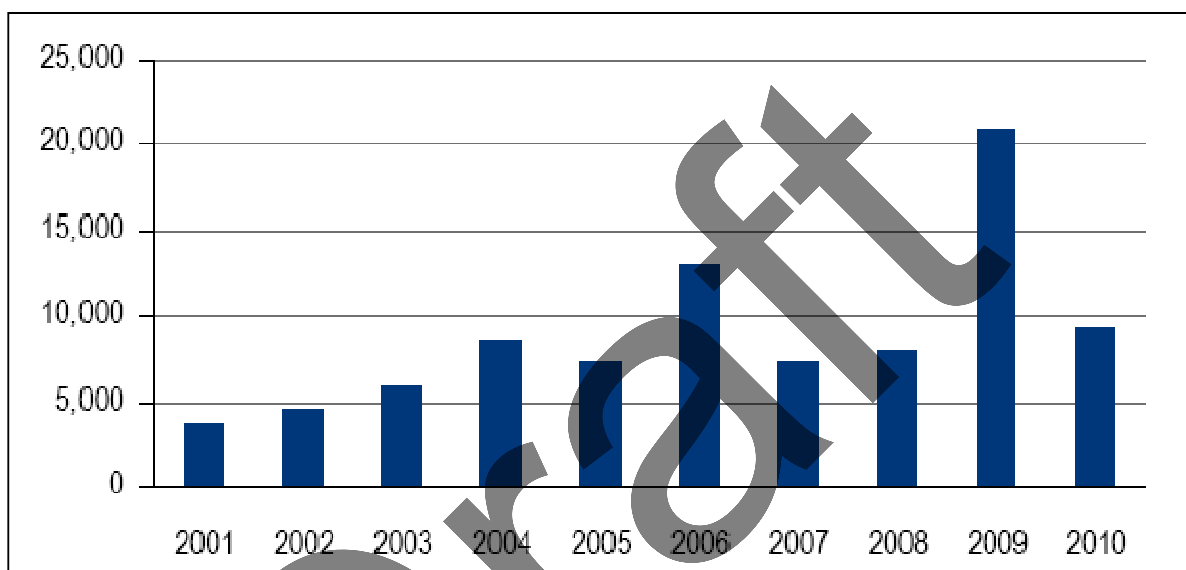
Whilst real estate equity capital raisings slowed to a trickle in many regions, the steady stream of US REIT secondary capital raisings continued during the quarter. Macerich undertook the largest US REIT secondary offering when it raised US$1.23 billion equity in April – surprisingly modest when one considers raisings of this magnitude or greater were not uncommon in Australia over the past decade.

U.S. Public REIT common equity offerings by calendar year (US$000,000)



Source: SNL

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Meanwhile, securitised real estate Initial Public Offerings (IPOs), particularly of any scale, remain difficult to execute. The decision to withdraw the Swire Hong Kong real estate spin-off during the quarter is evidence of widespread investor reluctance to support new vehicles at unrealistic vendor expectations, particularly as the listed market has had plenty to choose from existing vehicles with many issuing at deep discounts. That said there were a couple of smaller vehicles launched including:

- In the US, Hudson Pacific Properties, an office REIT launched by management previously associated with Arden.
- In Asia, Malaysia hosted the listing of Sunway REIT containing a portfolio of shopping centres and hotels. The Chairman of the vehicle's manager reportedly told the media "the whole purpose is to grow it" with the aim believed to be to double the assets within 7 years.

In light of the difficulty in securing assets or launching sizeable IPOs, we expect corporate activity will focus on mergers, particularly of smaller vehicles which do not have the economies of scale to properly resource themselves and have no access to competitive capital – Mirvac's bid for Westpac Office Trust during the quarter and earlier takeover of M-REIT indicative of this trend.

Although bank and institutional debt is becoming less difficult and expensive to secure, securitised debt markets, particularly commercial mortgage backed securities (CMBS), continue to be restrained by structural and ownership complexities and the uncertainties over how the 2011-13 maturities bulge will play out in terms of default rates and refinance options. Whilst real estate values have at least stabilised and the outlook for rent cash flows appears improved, there are some unresolved poorly conceived loans which will result in some significant losses/casualties. Sam Zell, the noted US real estate grave dancer, recently argued that “dilution is the solution”, meaning these stakeholders must accept their position is untenable without significant new capital which values the assets more realistically.

Excluding the US, REITs in markets consumed by debt issues were among the worst performers during the June 2010 quarter, particularly those in the UK, Continental Europe as well as Japan where political instability has also weighed heavily of investor confidence.

French listed Unibail (pronounced “oonibuy”) Rodamco is the most attractive opportunity in this debt troubled region – Unibail’s portfolio and management are of exceptional quality, its balance sheet strong, fundamentals which have not greatly altered because of the weak macro environment in some parts of Europe. Indeed the French consumer, to whom the majority of Unibail’s shopping centre portfolio is directed, remains lowly indebted.

In the case of the UK, we have been encouraged by the new government’s austerity measures.

UK REITs are relatively well positioned thanks to the security of long term leases (in most cases over 7 years with upward only rent reviews), combined with development opportunities that the market is putting little or no value on. Somewhat surprisingly the London office market, principally through Land Securities and Derwent London, is experiencing moderate vacancy rates (7-10%), evidence of improving letting demand and, consequently, rents. Indeed, supply is starting to emerge which is designed to exploit a bulge in tenant lease expiries in 2013-2015 many of which will take place in functionally obsolete properties.

Like Australia, we attribute part of the UK’s recent lacklustre market performance to a lack of confidence in REIT management’s intellect and commitment to consistently maximise the value of equity investor positions. The fact that many REITs in these regions raised substantial amounts of dilutionary equity to resolve the risks of their over-leveraged balance sheets, in no small part due to wayward ill-disciplined investment strategies, highlights why investors should rightly be cautious about investing in a generic portfolio of listed REITs as a surrogate for a supposedly lower volatile investment category. These investment and capital management strategies not only destroy value outright, they reduce the likelihood that stock will trade at fair value so that investors can have confidence that they can realise their investments in an orderly market at close to a fair price.

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Thanks to the financial crisis the strategies of many of these vehicles are being refined. While there are signs of promise, problems remain. Averaging greater than 45% debt to assets, we continue to believe that UK REITs are at the top end of manageable leverage – particularly in light of their Loan To Value covenants and mandated high dividend pay-out ratio[1]. In their favour, UK REITs have access to longer term debt than available in Australia: the average debt maturity for the former is over 7 years versus 3 years for A-REITs.

Whilst UK management can be partially forgiven for coming to grips with the dynamics of a REIT vehicle and REIT legislation, there are no such excuses for A-REITs. We suspect the motives for REIT management that continually fail their shareholders include selfishness (particularly those externally managed REITs remunerated by gross asset value), self-preservation (to limit takeover attractiveness) and incompetence.

The dividend yield of A-REITs has been a topic of market discussion recently with the low pay-out ratio fingered for holding back investor appetite. I think "foolhardy" is one word to suggest that dividends determine REIT value. Indeed it is clearly the opposite. Combined with the restoration of balance sheets (see Appendix I), dividend pay-out ratios in many regions, particularly the US and Australia, have been cut to levels which provide a buffer against any further economic shocks and potential to grow as economies recover. Hence, whilst nominally low, the quality of dividends is relatively high. At 30 June 2010, we estimate the global dividend yield of the sector is circa 4%, the dividend pay-out ratio equating to 65-70%. Investors should be confident that the current dividend level is, barring a major economic downturn, maintainable so that they can reasonably budget for a reliable income stream well into the future.

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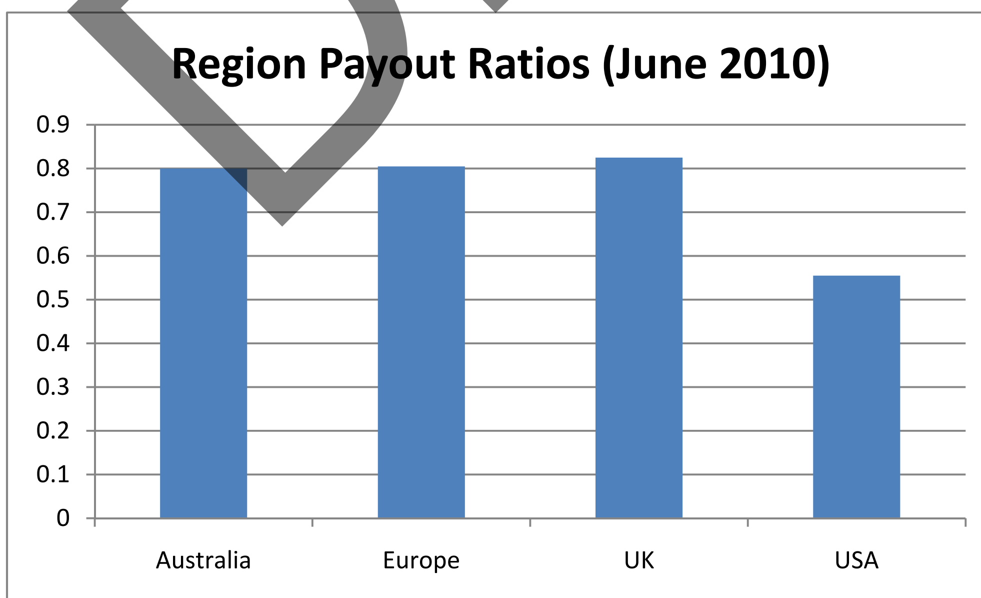

Source: RCL

[1] UK REIT legislation came into effect in January 2007 and among other rules requires a 90% pay-out ratio of rental income after allowable deductions. This compares with A-REIT and US REITS which require >90% payout of **taxable** income, thereby allowing them to retain depreciation.

In conjunction with improved capital ratios (i.e. leverage) and mindful of REIT taxation pay-out requirements, we continue to assert that A-REIT payout ratios are broadly appropriate although in some exceptional cases we acknowledge the payout should in fact be raised as we have low confidence in management's ability to responsibly re-invest the retained capital. Nevertheless, the temptation will be there for some to increase the payout, perhaps with the help of financial engineering, if management believe it will hood-wink the market into giving them a lower cost of capital. More often than not, this lower cost of capital will then be exploited to raise equity to acquire more assets that, in many cases, detract from the value of the existing portfolio. This will probably be the case in externally managed vehicles where the manager is remunerated on the size of the vehicle as well as a mechanism to defend against takeover.

In light of questions surrounding management competence together with a number of macro factors (e.g. UKs financial strength and Australia's proposed resource tax placing question marks over sovereign risk), A-REITs and UK REITs are trading at among the highest discounts to our assessed Net Asset Valuations.

A value discrepancy is evident in Australia between listed REIT prices and appraised based valuations as measured by discounts to NTA and, more intriguingly, the prices at which unlisted wholesale vehicles in Australia have been able to raise capital. Unlike several listed A-REITs, which have undertaken massively discounted capital raisings, we note that the Lend Lease managed APPF Retail Fund not only raised new equity at NAV during the period, its manager Lend Lease disposed some of its units in the vehicle at a 1% premium to the 31 March 2010 valuation. Meanwhile the closest comparable listed vehicle CFS Retail Trust (CFX), which also is externally managed, continues to trade at a 5-10% discount to its appraised based valuation. Furthermore, GPT's Wholesale Office Fund raised equity at Net Tangible Asset (NTA) whilst the leading office A-REIT trades at 15% discounts to NTA. Indeed, GPT itself trades at a 15-20% discount to its NTA.

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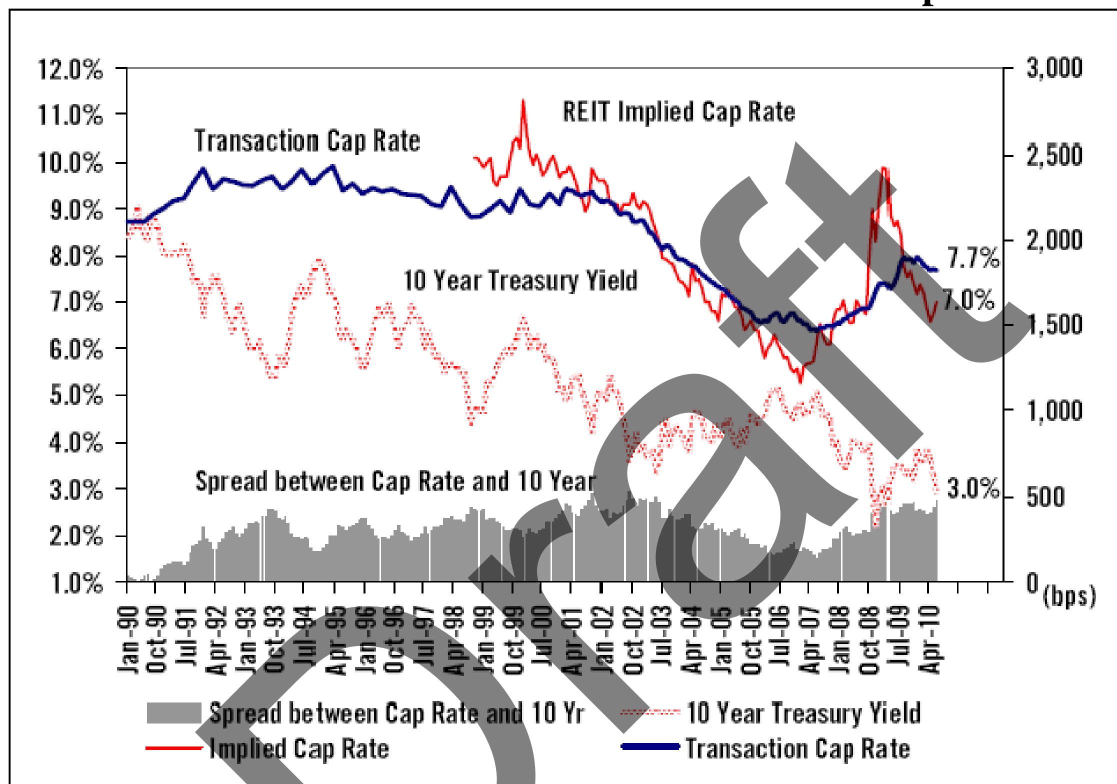
Listed v Unlisted Pricing Comparison

	CFX (listed)	APPF Retail (unlisted)
Independent Valuation Cap Rate	6.57%	6.59%
Current NTA per unit	$2.02	$1,634
Unit Price 30 June 2010	$1.89	$1,634
Price to NTA	-6.40%	0%

Source: Company Reports

As illustrated in the following graph, this appears to be somewhat at odds with the US environment as US REITs appear to be trading at a premium to direct market valuations as supported by the chart below. Combined with the earnings multiple parity (premium if depreciation is taken into account) of US REITs versus equities, discussed earlier, we remain cautious about values within this region.

US REIT Yields vs Real Estate Transaction Cap Rates



Source: Real Capital Analytics and Citi Investment Research and Analysis

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We firmly believe that on a select basis, global listed vehicles provide exposure to some of the world's leading real estate platforms, providing transparency, long term competitive returns and the ability to liquidate or add to positions at opportune times.

Government interference in real estate markets is an emerging issue. The risk is that real estate will be viewed as:

a. An easy target by virtue of its immobility from which to extract additional tax revenues. Evidence of the emerging threat could be seen in a number of recent tax changes including:
   - NZ – removed depreciation allowances on buildings
   - France – introduced levies on real estate associated with the funding of additional infrastructure spending in urban areas

Perhaps highlighting the vulnerability of real estate, it is interesting to observe that the proposed resource super profit tax was ultimately defeated by the resources industry threatening to invest in other markets.

b. A means to stimulate construction activity which inevitably leads to an oversupply and the next property bubble.

In an example of reverse stimulus, China experienced its own government's intervention during the quarter designed to curb excessive speculative demand in the residential property market. The cooling measures were mostly aimed at limiting the ability of people to buy a second residential property. Again the reaction of market participants to the Chinese changes makes an interesting contrast to that experienced in Australia to the resources tax.

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Outlook

In the short to medium term, the confidence and focus of investors is likely to be periodically tested by the varying rate of the recovery of corporate earnings, restoration of public sector finances and consequent effect on interest rates and inflation. Our position is to recognise that economic fortunes rise and fall, but well managed well located real estate remains relatively constant.

The fundamentals of the REIT sector have arguably not been as strong for quite some time: construction supply is low, REIT balance sheets are strong and, whilst dividend yields are historically low in nominal terms, dividends are at the very least sustainable thanks to a more responsible pay-out ratio.

Identifying the combination of positive macro dynamics together with price to value remains our greatest challenge but at least we have a relatively secure industry base to work from.

By and large, those vehicles with higher quality real estate managed by teams that have honoured their fiduciary responsibility are trading at premiums to underlying asset values. Because of their discipline they continue to raise capital (debt and equity) judiciously. We remain committed to these platforms as we believe they afford the most secure returns in the current macro uncertainty and will provide the strongest through cycle long term returns.

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Contact Details

Andrew Parsons
Managing Director - Senior Portfolio Manager
Direct Line: 02 8258 9122
Email: andrew.parsons@resolutioncapital.com.au

Pinnacle Investment Management
Call 1300 010 311
Email: distribution@pinnacleinvestment.com.au

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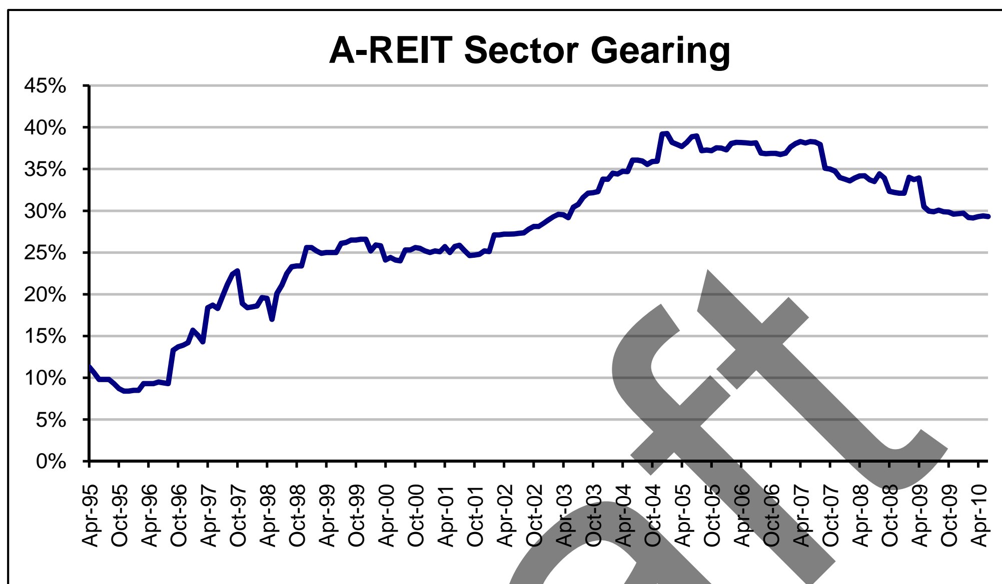
Appendix I – Miscellaneous

As highlighted in the chart below, A-REITs have restored balance sheets albeit largely through dilutionary equity raisings.



Source: UBS

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US REIT Returns Have Been Competitive

Index	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010 YTD	Average
REITs (*)	35.9%	18.6%	-16.9%	-4.6%	26.8%	12.8%	3.6%	36.6%	31.5%	12.1%	35.9%	-16.8%	-38.0%	28.6%	5.7%	11.5%
S&P 500	23.0%	33.4%	28.6%	21.0%	-9.1%	-11.9%	-22.1%	28.3%	10.9%	4.9%	15.8%	5.5%	-37.0%	23.5%	-7.9%	7.1%
NASDAQ	23.0%	22.2%	40.2%	86.1%	-39.2%	-20.8%	-31.5%	50.3%	8.6%	1.4%	9.5%	9.8%	-40.5%	43.9%	-7.4%	10.4%
Russell 2000	16.5%	22.4%	-2.5%	21.3%	-3.0%	2.5%	-20.3%	43.7%	18.3%	4.6%	18.4%	-1.6%	-34.8%	25.2%	-3.3%	7.2%
Russell 2000 Value Index	21.4%	31.8%	-6.5%	-1.5%	22.8%	14.0%	-11.3%	42.7%	22.2%	4.7%	23.5%	-9.8%	-35.9%	17.7%	-3.3%	8.8%
S&P Small Cap 600	21.3%	25.6%	-1.3%	12.4%	11.8%	6.6%	-15.3%	39.0%	22.6%	7.7%	15.1%	-0.3%	-31.1%	23.8%	-2.1%	9.0%
S&P Mid Cap 400	19.2%	32.2%	19.1%	14.7%	17.5%	-60.0%	-15.4%	35.6%	16.5%	12.6%	10.3%	8.0%	-36.2%	35.0%	-2.6%	7.1%
S&P Utility Index	3.1%	24.8%	14.7%	-8.9%	59.5%	-30.4%	-33.0%	26.2%	24.3%	7.7%	21.0%	19.4%	-29.0%	6.8%	-9.5%	6.4%

Source: BofA Merrill Lynch Global Research; (*) Morgan Stanley REIT Index - ticker RMS; priced as of 07/01/10