

Property Market Review

6th April 2009

Australian hotel sector on a temporary vacation

- In period between 2002 and late 2007 the hotel sector has performed extremely well due to favourable economic conditions and limited new supply. However, in 2008 the accommodation market has been adversely impacted by the global and domestic economic slowdown. We expect signals of economic recovery to appear within 12 months, which is likely to have some positive flow-on effects on the hotel sector.
- The demand for hotel rooms softened in 2008. The hotel demand was impacted by a reduction in tourist demand due to a decline in consumers discretionary spending and cuts to non-core business expenditure. We expect signs of demand recovery to emerge in 12 to 18 months.
- In recent years the Australian hotel market has been characterised by relatively limited new supply, despite strong demand across most capital cities. In the near term we expect new supply to remain limited across most Australian CBDs as tight lending conditions will continue to force hotel developers to defer many planned projects whilst demand conditions remains weak.
- The deterioration in demand in 2008 has adversely impacted occupancy rates - now falling from the peak reached in the late 2007. We expect occupancy rates to soften further in 2009. However, the limited supply pipeline for hotels nationally should, to some extent, buffer significant softening in occupancy rates.
- Weakening space market conditions have caused pricing indicators, such as average room rate (ARR) and revenue per available room (RevPAR) to soften. We expect growth in RevPAR to remain sluggish throughout the remainder of 2009 and into 2010, as demand conditions are expected to remain generally soft.



1. Introduction

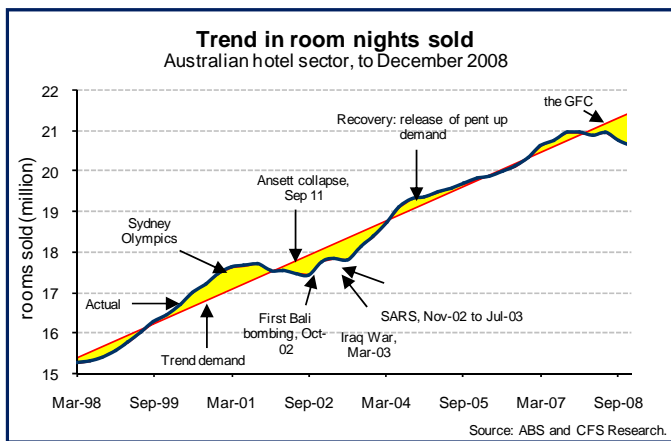
Over the five years prior to late 2007 the hotel sector has performed remarkably well due to favourable economic conditions and limited new supply across the nation. However from early 2008, similar to other commercial property sectors, the accommodation market has been adversely impacted by the global economic slowdown, particularly in Q408. Tourist and business demand for accommodation slowed as a result of the reduction in consumers discretionary spending and the cost cutting in corporate expenditure, respectively. Consequently, the hotel sector has moved into the cooling phase of the cycle with softening occupancy levels and lower hotel yields.

2. Space market indicators

Demand

After a period of solid growth, demand for hotel accommodation across Australia softened in 2008. Figure 1 shows the Australian annual number of Room Nights Sold (RNS), split into trend and cyclical components. It highlights a steady increase in national demand growth (trend) in the period from Dec-98 to Dec-08 at a compound average growth rate (CAGR) of 3.0% per annum. This indicates the change in the depth of the Australian hotel market.

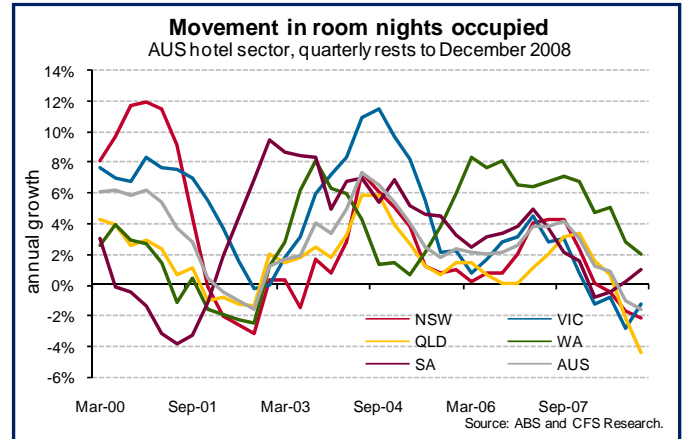
Figure 1



The cyclical nature of demand across states, using movements in the room nights occupied (RNO), is highlighted in Figure 2. The chart shows that demand generally reached a cyclical peak during 2007 (although it varies by state), followed by a sharp downturn across the nation in 2008 with the RNO growth turning negative for major states. Note that Western Australia's different profile is attributable to Perth's supply expansion in the period 2004-06 enabling demand to

grow, and the rise in business travel due to the resources sector boom.

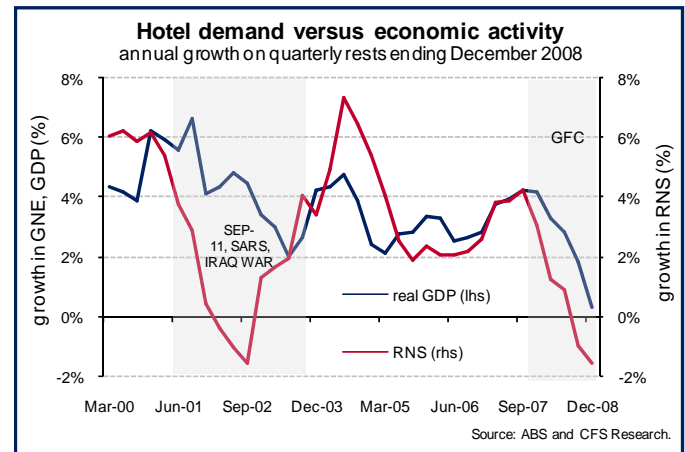
Figure 2



Hotel demand is either driven by domestic market or international market factors. From the domestic perspective, hotel demand (represented by RNS) exhibits a positive relationship, with some lead/lag timing, with real GDP growth as seen in Figure 3. Note that the only disconnect in 2001 was caused by an external shock. An increase in real GDP growth above trend generally leads to a rise in consumers' discretionary income and business confidence¹ which, in turn, have a positive spill-over effect on demand.

We expect signs of economic recovery to appear within 12 months, underpinned by expansionary fiscal and monetary policy, leading to a pickup in hotel demand.

Figure 3



The effect of international market on the hotel demand can be gauged using international visitor arrivals as a proxy. Figure 4 shows a positive relationship between RNS and international visitor arrivals (IVA), whilst also highlighting demand's sensitivity to external shocks

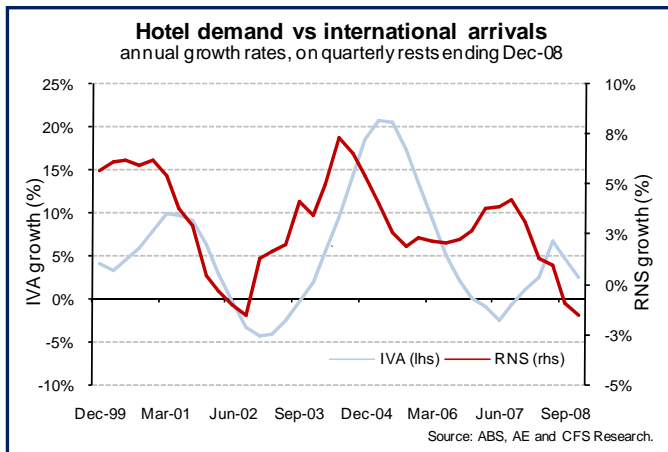
¹Consumer confidence generally fuels weekend, holiday and event related demand. Corporate confidence usually stimulates weekday, conference and event related demand.

such as the September 11 attack in 2001. On an annual basis, the corporate and leisure (inbound tourism) arrivals contracted over 2008, the first contraction since 2001, undoubtedly a result of many of Australia's major tourist markets falling into economic recession². Apart from the external shocks, additional pressure on the hotel demand was caused by the aggressive marketing by cheaper destinations, which diluted the market share of long haul leisure destinations such as Australia³. Consequently, the slowdown in visitor arrivals was witnessed in the period 2004-06.

Tourism Research Australia (TRA) forecasts that 2009 inbound tourist arrivals will decline by 4.1% despite the support provided by a lower Australian dollar and fuel costs. Importantly, TRA expects an inbound tourism to recover in mid to late 2010 with a growth of 5.3%.

In line with deterioration in both domestic economic activity and IVA, we expect hotel demand to moderate during the remainder of 2009. Signs of recovery in demand are expected to emerge in 2010, corresponding to a pickup in the domestic economy and an improvement in IVA.

Figure 4



Accommodation supply

In recent years the Australian hotel market has been characterised by relatively limited new supply, irrespective of strong demand in most capital cities. Figure 5 traces out the supply cycles using annual movements in available guest rooms since 1999. The chart clearly highlights the three distinct phases with high, moderate and steady-low supply, respectively. The period of high supply, between 1997 and 2000, is attributable to the Sydney Olympics. During this period

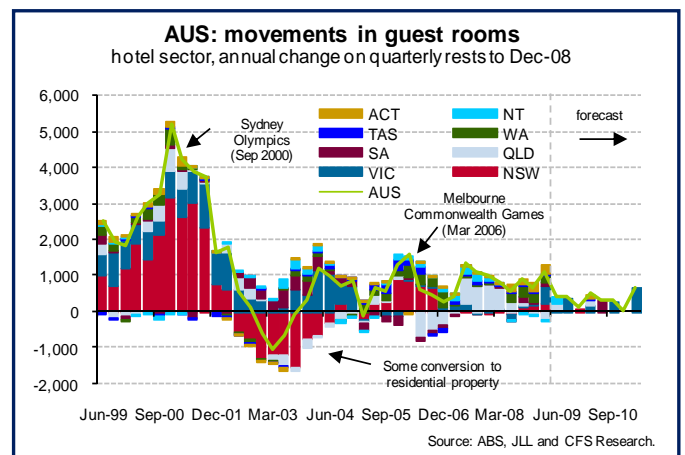
² Particularly New Zealand, UK, USA, and Japan.

³ The one off event, such as the recent natural disaster in Victoria, can also put some additional downward pressure on demand. Also, appreciation of the Australian dollar against its major tourism partners decreases the purchasing power of overseas visitors, making domestic holidays less affordable.

new gross supply averaged 780 rooms per quarter, representing a 4.1% annual growth. In contrast, a period of moderation in supply from Dec-00 to Dec-04, recorded on average just 116 rooms per quarter, reflecting diminishing supply in Sydney with conversions to residential uses. The period after Dec-04, was characterised by a low and steady national gross new supply, apart from the period before the Melbourne Commonwealth Games. In recent times (2H08), the majority of supply came online in Melbourne, outer Sydney and the Gold Coast⁴.

New supply is expected to remain limited across most Australian CBDs (refer to Figure 5) in the near term, as a result of the sharp slowdown in the hotel development pipeline⁵ and weak demand. Moreover, future supply limitations will occur due to: i) tight lending conditions, which are likely to continue to force developers to defer many planned projects; ii) the high cost of CBD sites, particularly in Sydney and Brisbane, which presents significant barrier to entry; iii) site availability; iv) a fierce competition for prime CBD locations across major Australian cities by other commercial sectors, mainly office and residential; and v) natural barriers, in terms of geographic layout, to entry, particularly in Sydney and Brisbane. Moreover, the feasibility of a large scale CBD development in most capital cities is contingent on a significant rise in average room rates and improved hotel profitability.

Figure 5



Occupancy rates

In period between 2002 and late 2007 market fundamentals for hotel markets were relatively tight,

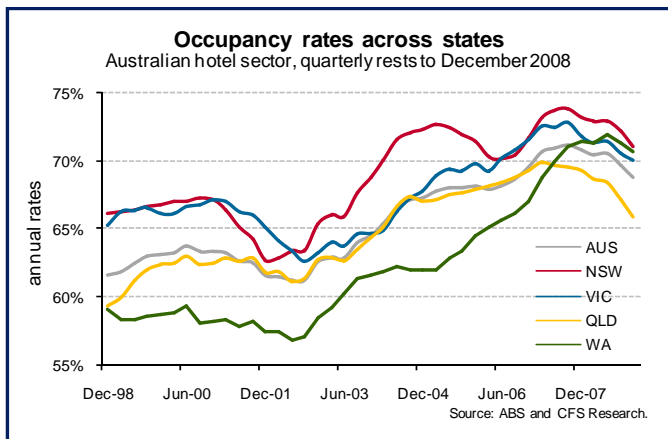
⁴ The largest additions include Intercontinental - Melbourne (253 rooms), the Pullman - Sydney (212 rooms), Mantra Sierra Grand Resort & Spa - Gold Coast (239 rooms).

⁵ For example, Brisbane's large supply pipeline scheduled for 2009 was deferred, relatively better positioning Brisbane in the short term. However, Brisbane will likely be impacted in the medium term once development activity recovers.

resulting in rising occupancy rates. However, the deterioration in demand has adversely affected occupancy rates (refer to Figure 6). The limited supply pipeline for hotels nationally, with the exception of the Melbourne CBD which has a moderate supply pipeline in the near term, should to some extent buffer significant softening in occupancy rates.

During 2009, occupancy rates are expected to weaken further in line with subdued aggregate demand, but we expect them to stay above 1990s recessionary levels. A pickup in global economic conditions in 2010 should result in stabilisation of occupancy rates.

Figure 6



3. Investment performance

The mismatch between supply and demand generally translates into pricing. This is reflected in the common indicators of sector pricing, average room rate (ARR) and revenue per available room (RevPAR).

Average room rate (ARR)

ARR has a strong and positive correlation⁶ with occupancy rate, particularly if occupancy rate is lagged by three quarters⁷. Recent movements in the ARR for selected state markets are shown in Figure 7. Note that the jump in the ARR around mid 2000 reflects the Sydney Olympics. Clearly, since late 2000, the general trend in ARR has been slowly falling in real terms with signs of slight improvement⁸ after 2003. Consequently, this has prompted operators and owners to seek efficiency gains. This has been achieved by controlling operational costs, and increased flexibility with better

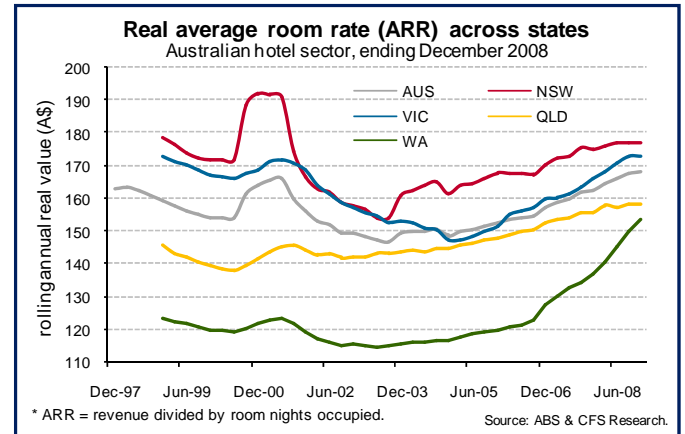
⁶ 0.77 in the period between Sep-01 and Dec-08.

⁷ The occupancy rate was lagged to allow prices to adjust in response to changes in capacity.

⁸ Apart from WA where supply-demand mismatch resulted in the strong growth in ARR, however coming from a low base.

work practices. In turn, this has enabled the sector to more easily adapt their practices and response times to changing market environments. However, more recently, the real ARR has started to increase, although moderately.

Figure 7

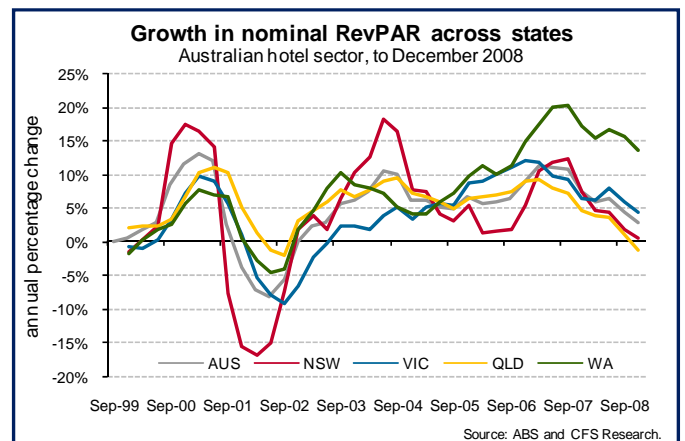


Revenue per available room (RevPAR)

The main indicator of hotel revenue is the hotel revenue yield, as measured by RevPAR (the combination of occupancy and ARR). In recent years RevPAR growth has been fuelled by generally tight market conditions. However, since late 2007 growth in RevPAR has slowed (refer to Figure 8), reflecting falling occupancy rates and softening ARR.

We expect growth in RevPAR to remain sluggish throughout the remainder of 2009 and into 2010, as demand conditions are expected to remain generally soft, although to some degree offset by a relatively limited national supply pipeline. A recovery in occupancy during 2010 is expected to result in an upturn in RevPAR growth.

Figure 8



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