

Property Research Paper

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Changing Nature of Listed Real Estate in Australia

- The Australian Real Estate Investment Trust (AREIT) sector displayed positive returns between early 2000 and mid 2007. This period was characterised by a relatively buoyant investment climate, underpinned by robust property space market fundamentals and favourable capital market conditions. However, the performance of the sector has deteriorated substantially since August 2007, triggered by the global financial crisis. This event caused a general re-rating of risk across all asset classes.
- The AREIT sector underwent significant change in the five years prior to the GFC, with a shift from passive investment to more active investment strategies. These changes included: rising gearing levels; an increase in offshore exposure; evolving management structure towards stapled trusts; and increased market concentration. These changes dramatically increased the risk profile of many of the trusts in the sector.
- The main issue facing the AREIT sector now and into the short term will be dealing with debt covenant issues. Weakening direct property valuations coupled with high gearing, have caused a number of trusts to rapidly approach their loan-to-value and interest-cover ratios. Methods of overcoming these challenges include: asset sales, cuts to income distributions and capital raisings.
- While the recent period has been very challenging, it must be framed within the context of the sector's overall life cycle which can be broken down into four unique phases; growth, contraction, consolidation and recovery. The sector is currently positioned at the tail-end of the contraction phase of the AREIT cycle; with the sector set to recover in the medium to long term. When this occurs the AREIT landscape is going to be much more polarised, with a clear distinction in pricing metrics observed between the traditional passive AREITs and the more growth-orientated (and higher-risk) AREITs.



1. Introduction

The Australian Real Estate Investment Trust (AREIT) sector post positive returns in the period between early 2000 and mid 2007. This period was characterised by a relatively buoyant investment climate, underpinned by robust property space market fundamentals (tightening vacancy rates and rising rents) and favourable capital market conditions (low and stable interest rates and excess liquidity).

The exceptionally positive market sentiment attracted new participants into the sector, triggering a proliferation of alternative investment vehicles. Many of the new products offered a range of investment styles beyond those of traditional 'core' holdings; aimed at providing exposure to higher return (and higher risk) assets. The combination of strong capital flows and relatively loose credit conditions resulted in significant compression of property investment yields during this period – both between sectors and across asset grades

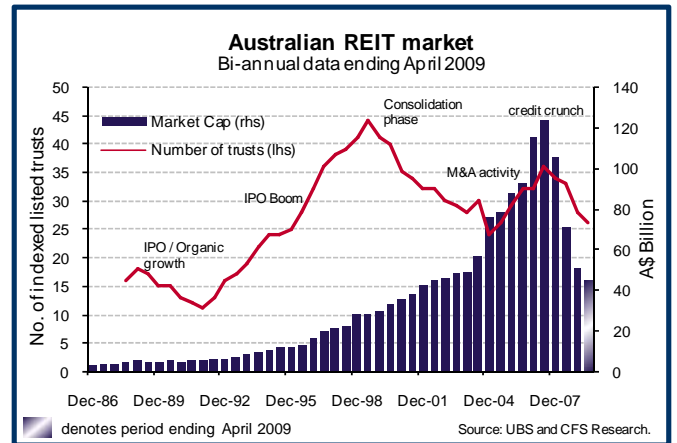
However, the performance of the sector deteriorated substantially since August 2007, triggered by the US-led credit crunch which developed into a global financial crisis. These events lead to a general re-rating of risk across all asset classes. This paper looks at the changing nature of the listed real estate sector; where it is currently positioned, how it got there and the outlook for the sector.

2. Evolution of the AREIT sector

The AREIT sector has become one of the most sophisticated and mature listed real estate investment markets in the world since its establishment in 1971. The AREIT sector comprises the largest component of the Australian property investment landscape, with more than 40% of the \$340 billion sector residing in listed vehicles.

The ten year period from the late 1990s to mid 2007 can be called the 'golden era' for the AREIT sector. During this time, the sector experienced average growth of 22% per annum (p.a.) and reached a peak market cap of \$127 billion in May 2007. With a total of 36 trusts, the sector represented 8% of the overall share market as measured by the S&P/ASX200 All Property Accumulation Index, as highlighted in Figure 1.

Figure 1

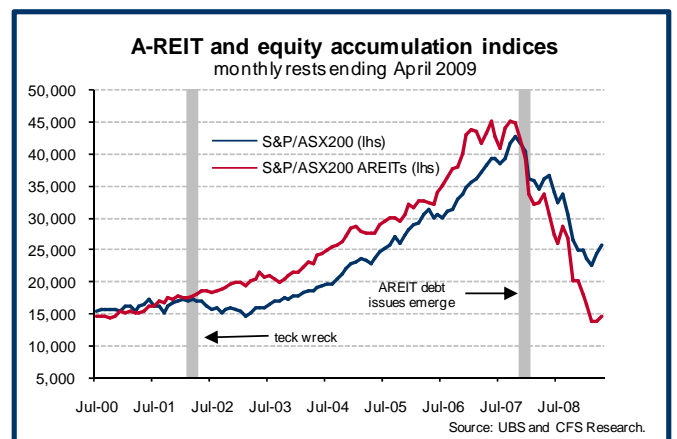


The strong growth was attributable to a variety of factors, including: growth in superannuation investment into property, increasing popularity of annuity style investment funds, solid capital raisings as a result of a sector shift and rotation of investment funds from traditional investments, such as equities and fixed-interest, and the access to liquidity relative to direct property offerings. However, during the past two years the sector has undergone a significant contraction in the aftermath of the credit crisis, with the market cap of the sector falling 65% to \$44 billion (comprising 26 trusts) and accounting for just over 5% of the share market.

3. Changing risk profile of AREITs

As illustrated in Figure 2, since December 2007, when a major AREIT announced it was having difficulties rolling over some maturing debt, the AREIT sector has underperformed the general equities market. From December 2007 to April 2009, AREITs fell 63%, compared to 36% for equities.

Figure 2



The greater fall in the AREIT sector arguably reflects a re-adjustment for risk after a disconnect emerged between the two markets around 2001/02 at the time of the bursting of the IT-induced share market ‘bubble,’ whereby the AREIT sector forged ahead unaffected by the retreat across the broader equity market. The question to ask is how did AREITs become more risky? The answer lies in the onset of the credit crisis which highlighted embedded risk within the AREIT sector – risk which was not well understood nor accurately priced by market participants.

Originally, the AREIT sector aimed to provide unitholders with a passive investment strategy, characterised by a quality property/lease-backed income stream, which was considered to act as a defensive investment. However, a majority of the AREIT sector moved away from its traditional roots to a more active investment strategy in an attempt to deliver higher returns. This reshaped the sector and exposed investors to non-traditional types of property investment and their associated risks. Some of these included raising gearing levels, greater exposure to offshore property markets, a movement towards the internal management structure, and increasing sector concentration. Each of these is briefly explained below.

Rising gearing levels

Gearing levels in the AREIT sector have risen dramatically since 1994. Increasing from around 10% to 34% as at April 2009, although it has reached as high as 38%. The increased use of gearing in the sector is attributable to a low and stable interest rate environment, greater focus on capital management to expand and generate enhanced returns, and low levels of ‘perceived’ risk in property investment.

Figure 3

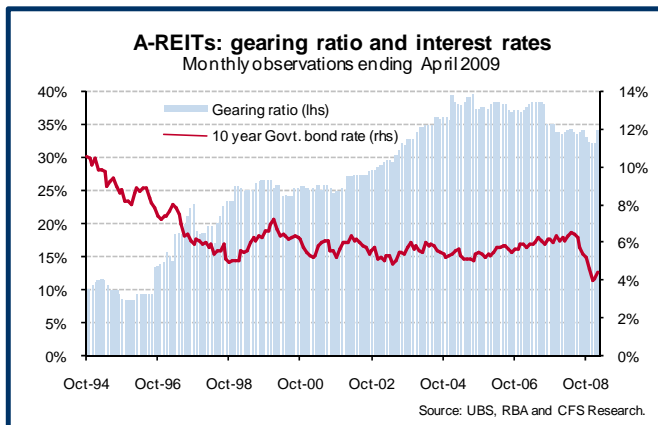


Figure 3 plots the trend in the gearing ratio against the 10 year Commonwealth bond rate. The primary

concern with increased gearing levels is that it directly alters the risk profile of sector and makes it much more sensitive to capital market conditions

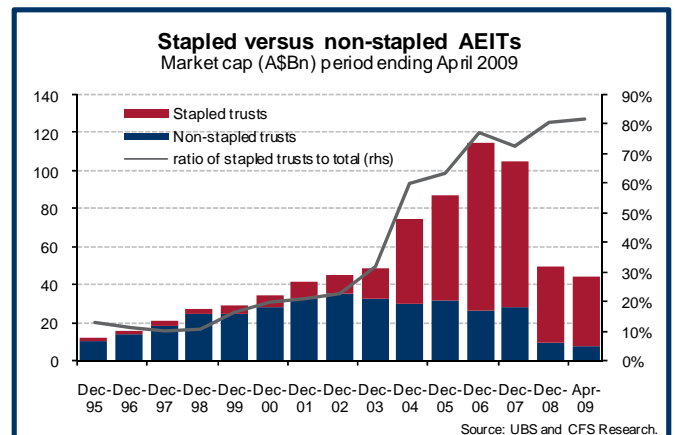
Greater offshore exposure

A relative lack of quality product in the local market coupled with a growing volume of investable capital from compulsory superannuation savings encouraged a number of AREIT managers to seek assets internationally. As of April 2009, this figure stood at \$93 billion or 60% of the sector’s total asset value compared with \$4 billion, or 10% of total asset value ten years ago. A large proportion of these assets reside in North America, mainly the US. While there are diversification benefits and enhanced growth opportunities available from having international exposure, one needs to temper this against the extra risks such a strategy brings, such as: exchange rate movements, country risk, different market conditions and operational risk.

The movement towards internal management structures

There are two main management structures used in the AREIT sector: internally managed trusts (IMTs) and externally managed trusts (EMTs). While EMTs distribute income derived from ownership of property assets, management of these assets as well as overall strategy of the trust is outsourced to a third party or external manager. In contrast, a majority of IMT vehicles staple together units in a trust with shares in a corporation that engages in a range of property services, management, and development/construction activities. Under this arrangement, investors receive distributions jointly from both entities.

Figure 4



The proportion of trusts with the internal management structure rose rapidly during the past five year period,

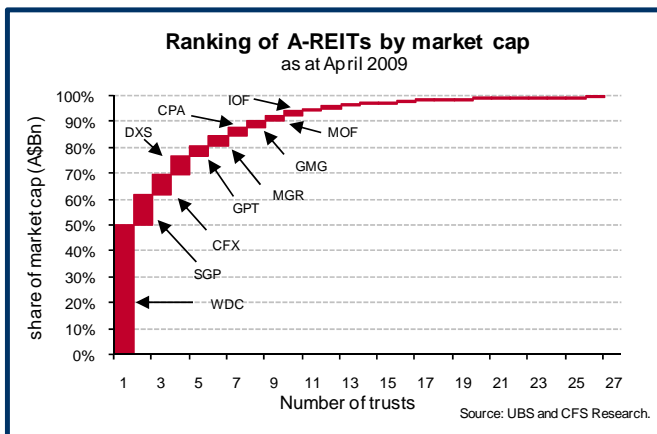
as illustrated in Figure 4, from 18% of the sector's market capitalisation in April 2004 to above 80% as at April 2009. The main benefits of the stapled structure involve the alignment of interests between manager and unitholders as well as the non-leakage of fees to third parties.

The inherent risk in this segment of the sector arises not due to the management structure per se but rather through its exposure to higher-risk property activities such as development, exposure to non-core property sectors and funds management.

Increasing sector concentration

Consolidation in the sector has been largely driven by limited organic growth opportunities as well as the need for greater liquidity. However, with this consolidation came an increasing degree of market concentration amongst the major trusts.

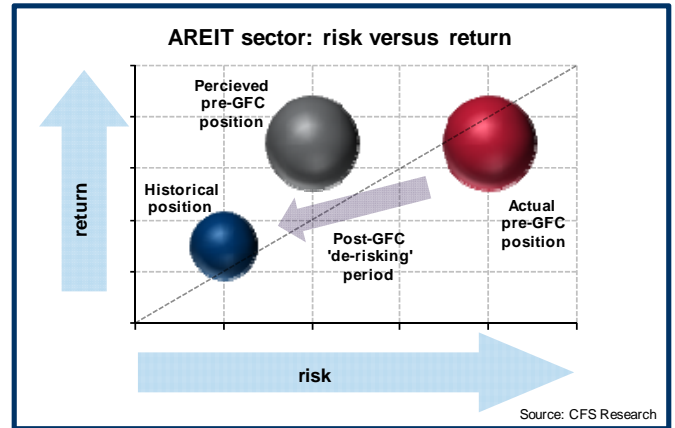
Figure 5



For example, Figure 5 shows that as of April 2009 the top ten trusts made up 94% of the AREIT sector by market capitalisation, with one trust alone comprising around 50% of the sector. By comparison, the top ten trusts held 78% of the sector by market capitalisation five years ago. The associated increased risk arises from a potential lack of diversity in the sector as a whole and could result in less efficient pricing.

Figure 6 depicts the AREIT risk/reward space and how the sector has grown (size of spheres) and evolved as a result of the previously mentioned changes. Post the credit crisis, the sector is currently in a de-risking phase, characterised by a flight to quality and a shift back towards the 'core' end of the risk/reward spectrum. This has been evident by many trusts actively trying to lower their gearing ratios and divest non-core businesses.

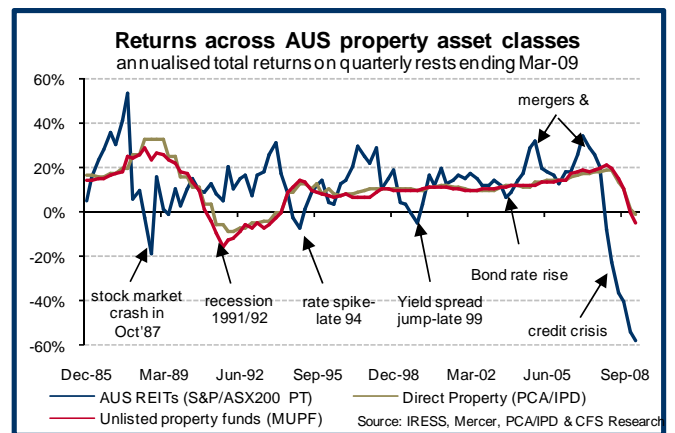
Figure 6



4. Pricing considerations

Turning towards the outlook for pricing in the AREIT sector, it is useful to compare the investment performance of REITs to those of unlisted wholesale funds and underlying direct property. This is done in Figure 7, which shows rolling annual total returns for each of these from December 1985 to March 2009.

Figure 7

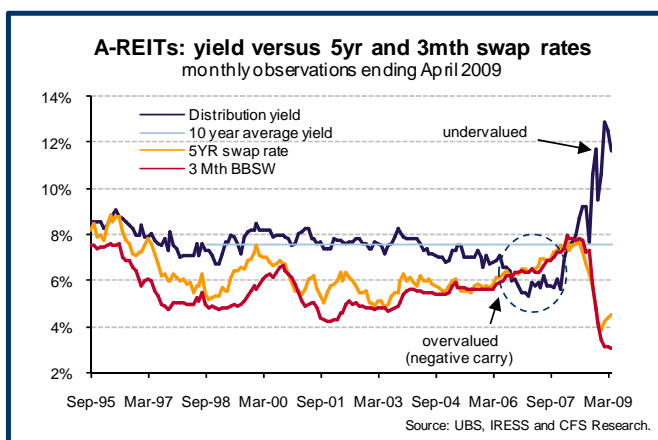


The two property investment vehicles display different return profiles, with the unlisted/direct property returns tending to lag the listed sector. This is due to different pricing mechanisms - AREITs are exchange-traded, whereas unlisted/direct use appraisal-based valuations which tend to be relatively infrequent. However, there has been a synchronised fall in recent times as a result of the global financial crisis which has also negatively impacted property space market fundamentals such as rental growth and vacancy rates.

Direct property asset valuations are not likely to see the same level of re-pricing as indicated by the AREIT sector; simply because it does not have the same level of de-leveraging to undergo as the AREIT sector has.

Nevertheless, further weakness is expected in space markets which will weigh on valuations. As such, AREIT pricing has probably overshoot on the downside. This overshooting in pricing is further supported by examining the AREIT distribution yield over time as shown in Figure 8. This highlights movements in the distribution yield against market interest rates (bank bill swap rate, BBSW, and the 5 year swap rate). While yields have been firming, that is, trending downwards during the past decade, the recent period has resulted in substantial softening in REIT yields. In the short-term, there is likely to be some moderation in AREIT distribution yields as rental income weakens with deteriorating space market conditions.

Figure 8



What caused yields to firm as much as they did? Primarily it was driven by very aggressive earnings forecasts based on cyclically strong space market fundamentals as well as solid investor demand for real estate investment. This latter trend was underpinned by: i) a re-rating of risk, with investor expectations of property risk down-weighted against traditional asset classes, and ii) the weight-of-capital argument. Points one and two are structural in nature and should persist in the medium-term, barring another significant shock such as the credit crisis. Currently the distribution yield is at a historical high of 12%, significantly above the 10-year average yield of 7.6%. Any major improvement in AREIT pricing in the short to medium-term will depend largely on a stabilisation of property asset pricing.

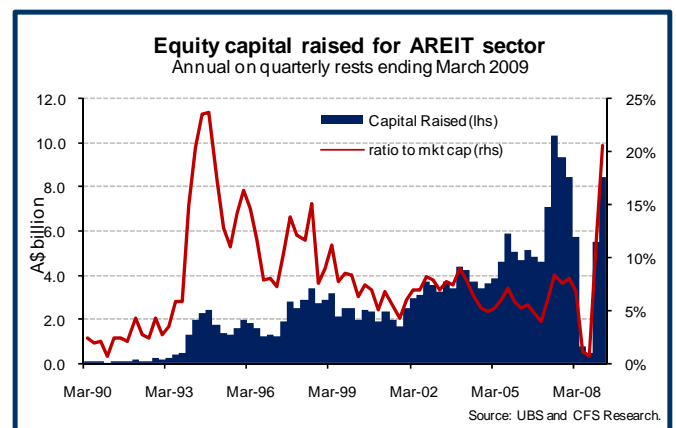
5. Current issues and outlook for AREITs

The central issue facing the AREIT sector now and into the short-term will be dealing with debt covenant issues. As noted, direct property pricing are softening. This, at a time when the sector confronts problems with excess gearing, has seen a number of trusts rapidly

approach their loan-to-value and interest-cover ratios. This is more of an issue for those AREITs with weaker balance sheets and more complex financial structures. Methods put forward to overcome these challenges have included: asset sales, cuts to income distributions and capital raisings. However, with a significant drop-off in commercial property transactions volumes in Australia, it is really the latter two options which have received the most attention.

Focusing on this final point, the AREIT sector has been one of the first regions in the world to embark on significant capital raisings as a means to strengthen balance sheets. Beginning in December quarter 2008 with \$5.1 billion, or 10% of the AREIT market capitalisation, raised and a further \$2.3 billion, or 5% of market capitalisation, raised in the three months to March 2009 as highlighted in Figure 9. To give these numbers some perspective, the 10-year average for capital raisings per quarter is approximately \$1 billion. Nevertheless, these raisings have usually come at a steep discount.

Figure 9



Where is this fresh equity coming from? Increasingly, it is coming from offshore. Data compiled by UBS highlights how the AREIT investor base has changed from 2002 to 2008. During this time, the share of offshore investors increased from 6% to 30%. At the same time, the share held by domestic property security funds fell from 42% to 29%. As the sector becomes increasingly concentrated, this trend is likely to continue. As such, the aim for AREIT managers will be to create sufficient scale to attract overseas investors. However, it is important to emphasise that this should not be at the expense of long-term performance.

Fresh equity is not the sole answer for the sector. Alternatives could include negotiations with lending institutions, strategic capital partners, preference

capital/equity at different levels of the capital structures, debt for equity swaps, and mergers and acquisitions.

Where to for the AREIT sector going forward? While the recent period has been very challenging, it must be framed within the context of the sector's overall life cycle. The AREIT cycle can be broken down into four unique phases:

- **Growth phase** – This is characterised by rising asset values, increasing risk appetite and easy access to debt.
- **Contraction phase** – This is signified by falling asset values, deteriorating risk appetite and restricted access to debt and/or covenant breaches.
- **Consolidation phase** – The third phase is typified by asset value stabilisation with investors attracted to the positive yield spread to borrowing costs and mergers and acquisitions start to occur.
- **Recovery phase** – The final phase is associated with an improvement in asset values, building risk appetite and debt being more readily available as well as emerging initial public offerings (IPOs).

With this in mind, it is more comforting to think of the sector currently positioned at the tail-end of the contraction phase of the AREIT life cycle, given the sector will recover in the medium to long term. When this occurs; however, the AREIT landscape is going to be much more polarised, with a clear distinction being made in terms of pricing between the traditional passive AREITs and the more growth orientated (and higher-risk) AREITs.

6. Summary

The AREIT sector is a mature market which offers asset exposure to core property sectors. However, over the past couple of years the sector has gone through a transformation – the quest for growth has come with much more embedded risk including greater use of leverage, increasing offshore exposure, a movement towards stapled management structure, and greater sector concentration.

The key investment attributes of AREITs include a relatively high and stable income component, liquidity, and potential to deliver (some) portfolio diversification benefits. This contraction phase will end and is likely to be followed by a period of consolidation before a recovery in the sector emerges. Nevertheless, investor confidence in the sector has been damaged and investors are likely to continue to prefer simpler and lower-risk trust models, at the expense of the higher-risk, growth orientated trust model.

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