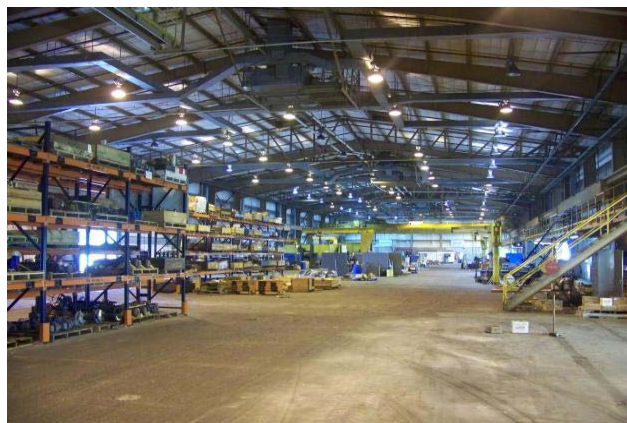


Property Market Review

27 August 2009

Australian core property sectors: overview and outlook

- Domestic and international economic conditions remain subdued, although a proactive policy response from the Reserve Bank of Australia and the Federal Government's stimulus package led to a moderately improved outlook for the domestic economy during the June quarter. However, the economic recovery is likely to remain subdued for the rest of 2009, leading to a softer labour market and, in turn, weaker property space market fundamentals.
- The property investment climate remains challenging, with the global financial crisis causing a rapid decompression in investment yields. Initially, yields were primarily impacted by a deterioration in capital markets, but further erosion in space market fundamentals will be the key driver to yields softening going forward.
- CBD office markets across Australia are expected to remain weak as a result of rising unemployment and reduced demand for office space. Vacancy rates are expected to rise above 10% in most markets, although the peak will differ between markets. The prospect of rental growth will be low, with negative effective rental growth forecast in all markets in the short term.
- Turnover growth from retail property assets has so far remained resilient and consumer sentiment has improved. However, this is likely to moderate in the months ahead, with the domestic labour market softening further, direct government stimulus to wane and talk of higher interest rates. The outlook will vary across sub-sectors with regional and sub-regional centres expected to be the best performers.
- Rising vacancies, coupled with subdued demand, will result in rental growth weakening further in the industrial property sector.



1. Economic environment

Domestic and international economic conditions remain subdued, although the outlook for the domestic economy moderately improved during the June quarter.

Australia appears to have avoided one definition of a technical recession¹ with positive economic growth of +0.4% in March quarter 2009, following the -0.6% decline in December quarter 2008. This stands in stark contrast to other developed economies such as the United States, the United Kingdom, Europe and Japan who experienced significant contraction in economic activity.

This was partly due to a pro-active policy response from the Reserve Bank of Australia's (RBA) which substantially eased interest rates (by about 425 basis points), and the Federal government's \$A52 billion fiscal stimulus package, which was handed out in two lots in December 2008 and March/April 2009. Further support came from the export sector, primarily from solid demand from China whose own stimulus package has sparked a rebound in economic activity in that country.

So far the Australian labour market has held up relatively well, with the unemployment rate increasing from 4.2% in June 2008 to 5.8% as at June 2009. Most of the impact has come from falls in full-time employment given part-time employment has remained relatively solid.

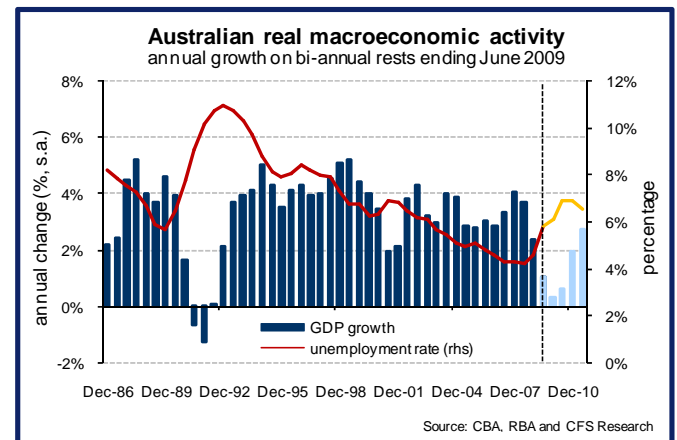
In the June quarter, the principle concerns remained the outlook for unemployment and economic growth, rather than inflation. The Consumer Price Index² increased by 1.5% during the year to June 2009 compared to 4.5% for the year to June 2008. The difference was attributable to lower costs for energy and financial services.

Nevertheless, given the flow of better than expected economic and market news in recent times, the RBA has signalled that a 3% official cash rate may be too stimulatory and that it may need to start raising interest rates back towards 'normal' levels. Markets are priced for a tightening in policy as early as late 2009.

Economic activity is expected to remain subdued for the remainder of 2009. The Commonwealth Bank of Australia (CBA) is forecasting GDP growth of +0.3% for the year to December 2009 and +1.9% for the year to December 2010. Subdued GDP growth will weigh negatively on employment growth, leading to a gradual increase in the unemployment rate. The unemployment rate is forecast to peak at around 7% by the end of

2010, before starting to fall as economic conditions strengthen. This is illustrated in Figure 1.

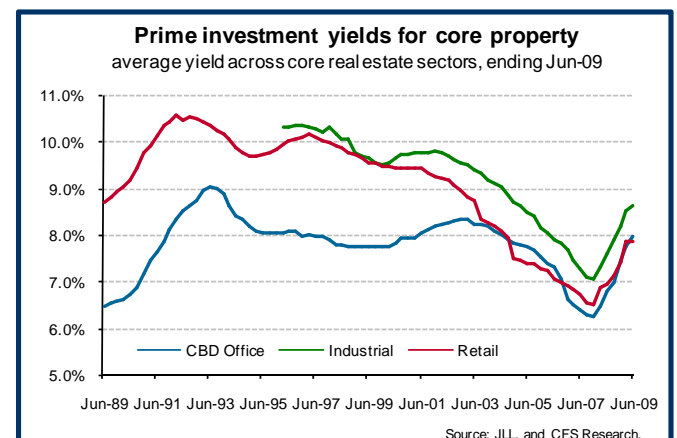
Figure 1



2. Property investment overview

The investment climate for property remains challenging with the ongoing global financial crisis causing a rapid decompression in investment yields, as highlighted in Figure 2. Initially, investment yields were primarily impacted from the deterioration in capital markets (which has seen a rise in the risk premium and cost of capital). This driver of weakening yields seems to be coming to an end; however, investment yields are still to show the full effect from declining space-market fundamentals, particularly falling rental growth due to rising vacancy rates.

Figure 2



Investment yields will continue to soften over the next 12 months, resulting in further weakness in prime asset values (falling in the range of around 20-30% from peak to trough) due to rising discount rates, increased investor redemptions, and limited access to finance. Importantly, we expect that secondary assets will

¹ A 'technical recession' is defined as two consecutive quarters of negative real GDP growth.

² Headline index figure.

experience greater yield softening than prime grade assets.

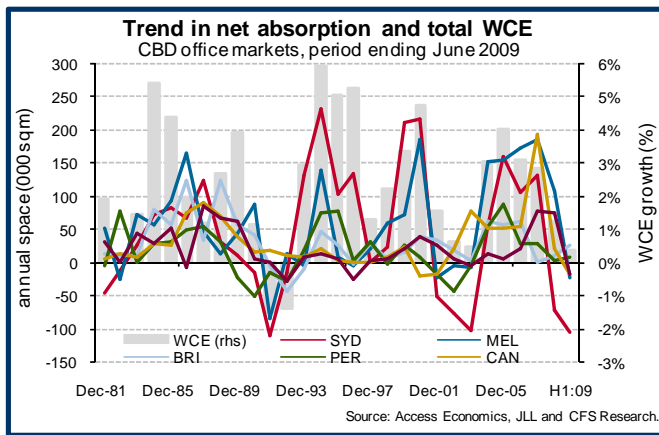
3. CBD office sector

The weakening real economy has resulted in slowing employment growth, particularly in white collar sectors. As such, growth in demand for office space has significantly weakened across the majority of CBD office markets.

Demand

Figure 3 shows the close positive relationship between annual white collar employment (WCE) growth and annual net absorption. Notably, office demand has slowed across all major CBD markets over the year to June 2009.

Figure 3



The Sydney CBD market, with large tenancy exposure to the financial and banking sector, has been most impacted by the global economic downturn. Negative net absorption of 104,000 sqm was recorded during the six months to June 2009, on top of the 72,000 sqm decline recorded in 2008. During this period similar falls occurred in Melbourne (-24,000 sqm), Adelaide (-19,000 sqm) and Canberra (-17,000 sqm).

While still showing positive net absorption during the first-half of 2009, both Brisbane (26,000 sqm) and Perth CBD (9,000 sqm) markets are dealing with the negative impact from the downturn in the resources sector. The rapid slide in commodity prices resulted in a number of planned expansions and mining operations being postponed or cancelled.

Supply

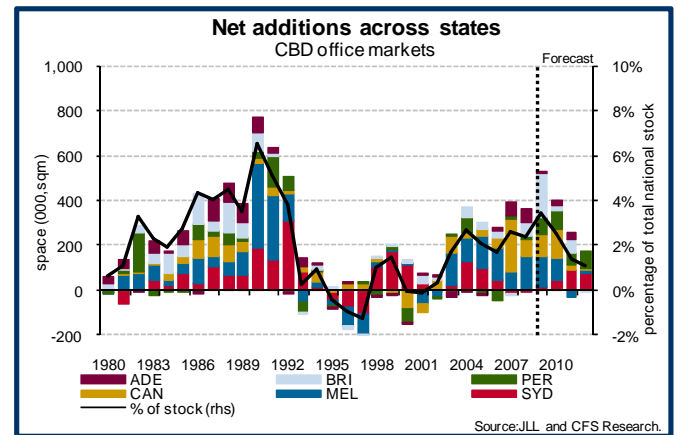
Across CBD markets, the short-term construction pipeline is expected to be the largest since 1992 with a

significant amount of supply concentrated in Brisbane, Melbourne and Canberra as shown in Figure 4. Already in H1:09, approximately 300,000 sqm of new and refurbished supply was added onto the market, of which the largest projects were completed in Brisbane (130,000 sqm) and Perth (87,000 sqm).

Of concern is the significant supply earmarked for Brisbane, Perth and Canberra during the next three years. Of note, Perth's CBD is expected to increase by 20% (286,000 sqm) between 2009 and 2012.

While much of the upcoming stock is pre-committed to the end of 2010, there is likely to be issues involving back-fill space as tenants move to new buildings. Importantly, a number of proposed office developments across major CBDs have already been shelved due to increased funding costs, constraints on accessing funding, and the lack of pre-commitments.

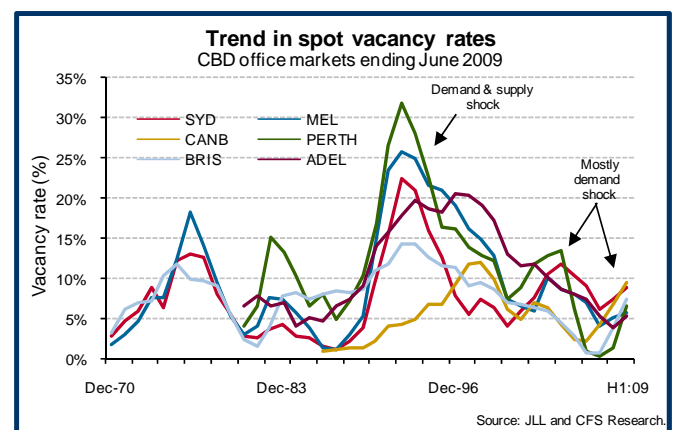
Figure 4



Vacancies and rents

A combination of weak demand coupled with a relatively solid supply pipeline worked to push vacancy rates higher across the major CBD office markets during the first half of 2009. This is shown in Figure 5.

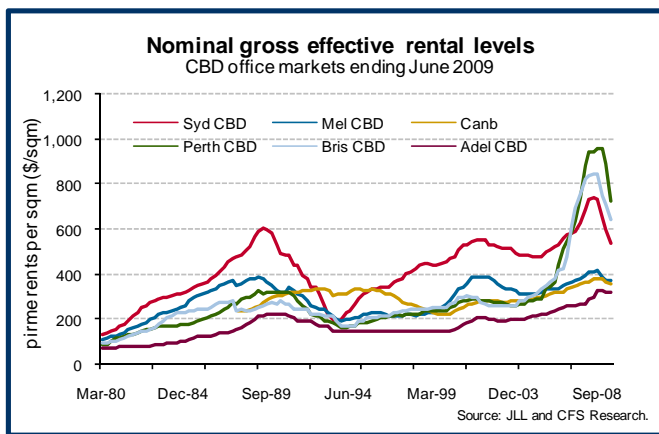
Figure 5



Sydney's overall vacancy rate rose to a two-year high of 8.8% in June 2009. A strong rise in vacant sub-lease space has put upward pressure on A-grade vacancies. Agents estimate that the amount of sublease space available is close to 100,000 sqm, although it appears to have recently stabilised. Significant increases in vacancy occurred in Brisbane and Perth, while relatively smaller rises took place in Adelaide and Canberra. Melbourne remained a standout, with vacancies rising modestly from 5.3% to 5.9% for the same time period.

As a result of rising vacancies, the very strong positive rental growth seen in recent years across capital cities has slowed dramatically, particularly in Sydney, Perth and Brisbane CBD office markets as shown in Figure 6. During the remainder of 2009, effective rental levels are expected to continue to fall. Face rents will outperform effective rents as incentives rise with rising vacancies.

Figure 6



Outlook

The CBD office sector is expected to remain weak as a result of rising unemployment and reduced demand for office space. Falling net absorption, coupled with a relatively high amount of new supply, particularly in Brisbane and Perth, will result in vacancy rates rising over 10% in most markets, although the peak will differ between markets. The prospect of rental growth is low, with negative effective rental growth forecast in all markets during this time. Figure 7 summarises the short-term (three year) outlook for key space-market indicators for the major Australian CBD office markets.

Figure 7

Short-term outlook for CBD office markets						
Market	Demand	Supply	Vacancy	Rents	Incentives	Yields
SYD	↓	↑	↑	↓	↑	↑
MEL	↑	↑	↑	↓	↑	↑
BRIS	↔	↑	↑	↓	↑	↑
PERT	↔	↑	↑	↓	↑	↑
CANB	↑	↑	↑	↓	↑	↑
ADEL	↔	↑	↑	↓	↑	↑

Source: CFS Research.
Note: the size of the arrows indicate the relative strength of expected movement in the indicator.

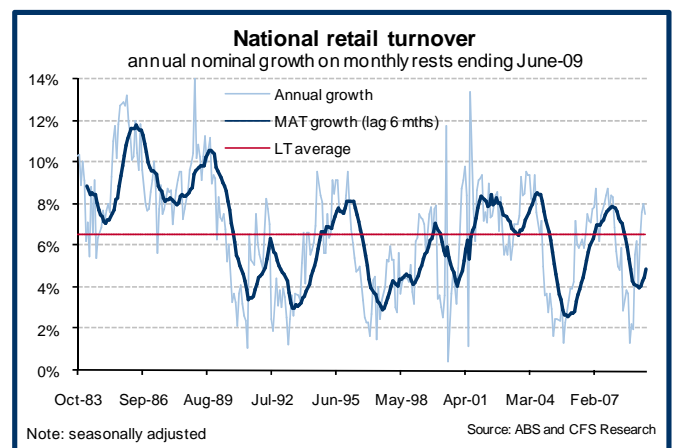
4. Retail sector

The slowdown in the macro-economy continues to adversely impact the retail sector. However, the fiscal stimulus package instigated by the Federal Government has helped to provide support to retail turnover, as have lower interest rates and lower petrol prices.

Retail turnover and consumer sentiment

Turnover growth has surprised most with its resilience during the first half of 2009, as highlighted in Figure 8. Most attributed the result to the fiscal stimulus provided by the Federal government as well as substantial reductions in mortgage interest rates.

Figure 8



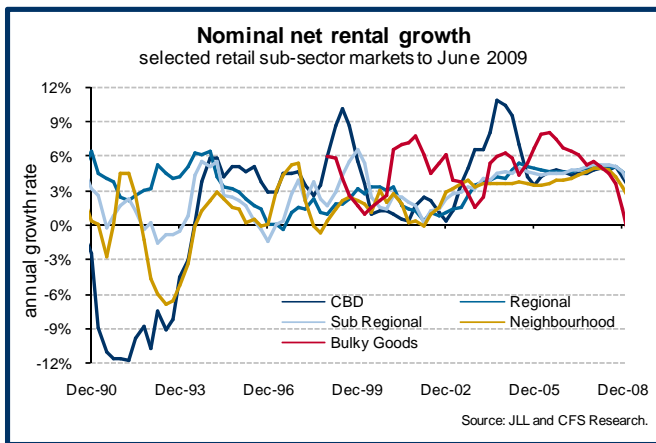
As a result of the relative solid run of good news in relation to the Australian economy and the recent positive performance of equity markets, consumer sentiment has rebounded strongly from the lows observed in late 2008/early 2009. Rising consumer sentiment should provide support for turnover growth, especially for more discretionary expenditure. However, we have some concerns for the remainder of 2009 as

the impact of the fiscal stimulus wanes and the unemployment rate rises.

Rents

The slowdown in retail turnover has led to deterioration in retail rental growth rates as seen in Figure 9. Face rents have come under pressure as tenants experience subdued spending conditions. The dominance of the landlord has dissipated and the re-introduction of incentives is occurring as landlords start fighting to keep occupancy levels high.

Figure 9



Across the sector, bulky goods and neighbourhood centres have suffered the most, while rents for regional and sub-regional centres have held up relatively better. Nevertheless, rental growth has at least remained in line with inflation.

Outlook

Although turnover growth has so far remained resilient and consumer sentiment has improved, the impact from rising unemployment over the remainder of 2009 is likely to negate some of these positive effects. Nevertheless, the outlook will vary across sectors with regional centres (particularly those focused on non-discretionary items and competitive pricing) expected to relatively outperform other retail sub-sectors as consumers reduce discretionary spending. Sales turnover in sub-regional centres, which are generally anchored by a discount department store, will also show a degree of resilience due to consumers substituting department store goods with those from discount department stores. However, they will still experience downward pressure given their exposure to discretionary spending. Neighbourhood centres face greater downside risk to income streams due to a greater threat of tenant bankruptcy and the fact that they are located in areas dominated by income-

sensitive populations. Bulky goods will also come under pressure from reduced consumer demand on large and highly discretionary items. Figure 10 summarises the short-term (three year) outlook for the Australian retail sector

Figure 10

Short-term outlook for retail markets

Retail Market	Demand	Supply	Rents	Yields
CBD	↔	↑	↔	↑
Regional	↑	↑	↑	↔
Sub Regional	↑	↑	↑	↔
Neighbourhoods	↔	↑	↔	↑
Bulky Goods	↔	↑	↔	↑

Source: CFS Research.

Note: the size of the arrows indicate the relative strength of the expected movement in the indicator.

5. Industrial sector

The industrial sector has weakened with the softening in economic activity, especially in the manufacturing and transport and logistics sectors.

Demand

Since 2008, the demand for industrial space has fallen, firstly as a result rising interest rates in the early part of 2008 and, secondly, by the moderation in economic activity following the global financial crisis.

Figure 11

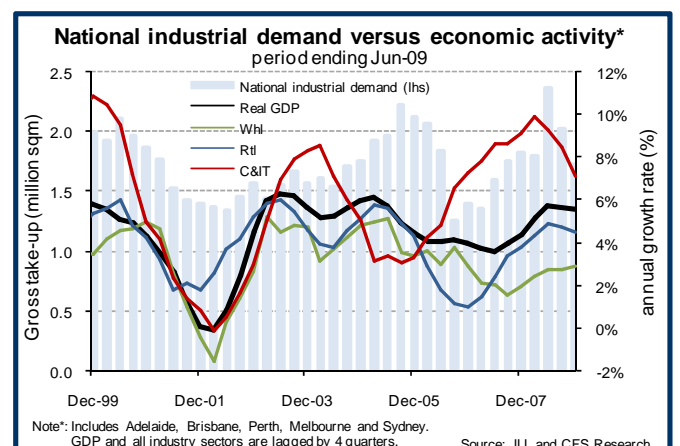


Figure 11 highlights the close positive correlation between real GDP growth (lagged four quarters) and gross absorption. Notably, as economic activity has

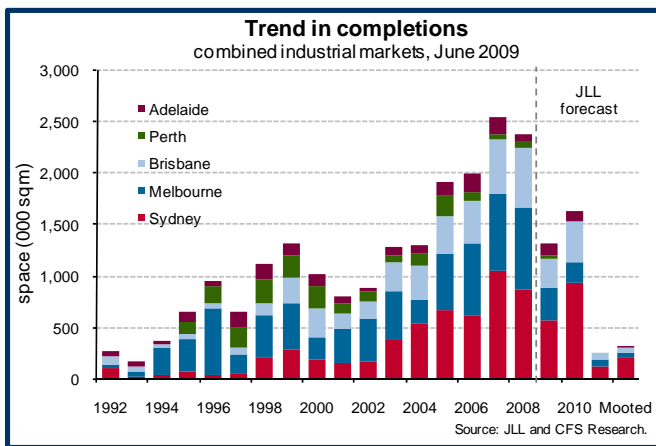
started to wane, so too has the take-up of industrial space.

Industrial demand is expected to remain sluggish in the near term as firms wind back new space requirements on weaker economic activity. However, the timing of the rebuilding of inventories following their rapid decline in Q4:08 and Q1:09 may mitigate this weakness to some extent.

Supply

Industrial construction activity remains strong, although the peak was reached in late 2008 as seen in Figure 12.

Figure 12



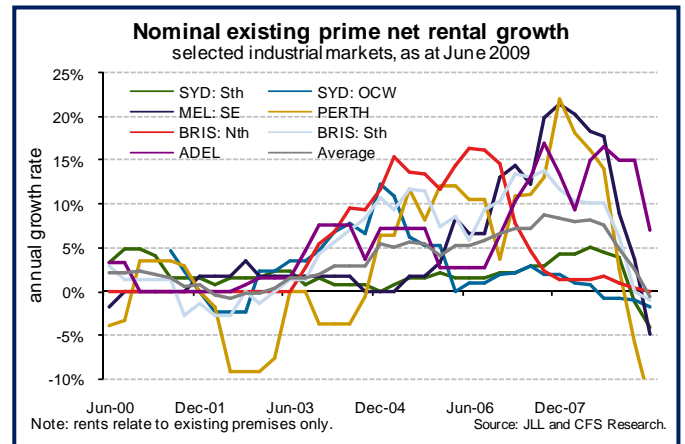
Analysis of the industrial supply pipeline suggests a rapid shrinkage in the supply pipeline occurred during 2009. Industrial construction across the East Coast markets will fall sharply in 2009 from 2.2 million sqm in 2008 to around 1.1 million sqm in 2009. In part, this decline reflects delays or the postponement of projects with the inability to secure pre-commitments forcing developers to shelve development plans.

Rents

Figure 13 shows rents for a variety of industrial markets across Australia. Rising land values, increasing construction costs, and demand generally outstripping supply were the key reasons behind the strong rental growth that most industrial property markets experienced in the 2003-08 period. However, a deterioration in demand and strong supply conditions resulted in a rise in vacancy rates and incentives in 2008. Consequently, rental growth eased from 2008. In H1:09, both prime and secondary rental growth across national industrial markets has on average been either flat or negative. Generally, markets with the strongest

growth in 2008 are reporting the steepest declines in 2009.

Figure 13



Outlook

A continued soft macroeconomic environment is expected to cause negative rental growth in most markets during the remainder of 2009, particularly in less mature markets. Positive rental growth is expected to return in line with a recovery domestic economy in the short-term. Figure 14 provides a snapshot of the short-term (three years) outlook for the main Australian industrial markets.

Figure 14

Short-Term outlook for industrial markets				
Industrial Market	Demand	Supply	Rents	Yields
Sydney	↓	↑	↓	↑
Melbourne	↓	↑	↓	↑
Brisbane	↓	↑	↓	↑
Adelaide	↔	↑	↓	↑
Perth	↔	↔	↓	↑

Source: CFS Research.

Note: the size of the arrows indicate the relative strength of expected movement in the indicator.

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