More than any other time in history, mankind faces a crossroads. One path leads to despair and utter hopelessness.

The other, to total extinction.
Let us pray we have the wisdom to choose correctly.

Woody Allen
Economic Issues

- The Financial market stopped functioning.
- Major Banks almost defaulted.
- US$5.0 trillion has been pumped in.
- This has brought the system back from the brink.
- Following near death experiences, banks are hoarding cash.
- Borrowing (but can only access short term).
- Not lending long.
- Consumer sentiment is at severe bear market levels, hovering at 30 year lows.
- US domestic consumption under threat – 70% of GDP (just trending down):
  - Europe 55% (steady).
  - UK 62% (just trending down).
  - China 35% (trending down).
- US by far the biggest consumer in the world – 20% to 25% of global consumption.
Economic Issues

- The globe is in widespread recession and expected to remain subdued.
- The expected down turn over next two quarters = top 10 weakest qtrs in 50 years.
- Impact of financial dislocation causing rapid deterioration in the ability of the system to maintain activity levels.
- Private consumption being replaced by public consumption.
- Budgets moving to deep deficit – material risk.
Property Issues

- Diminishing capital to the sector.
- Cost of capital is increasing.
- General market adjustment occurring:
  - Risk premia relative to the underlying “risk free” bond yields do not currently reflect sector risk.
  - The risk premia of secondary properties relative to prime properties is not sufficient.
- Decreased availability and increased cost of credit (in many jurisdictions) has reduced buyer demand.
- Increased debt costs and falling values are pushing investors holding material debt towards limits imposed by debt covenants. They need to sell assets or raise equity.
- Limited capital to shift to the market.
Squeeze on Equity

- The Denominator effect.
  - Direct Property values have generally held up.
  - Most other listed asset classes have declined (illiquids are lagging).
  - Most Funds are overweight to property (and illiquids generally).
  Beware of the numerator.

- Pension Funds have committed to Private Equity Fund Structures (inc property):
  - Commitment to Managers to provide capital over term of the Fund – Drawdowns continue.
  - Commitments - 2x required level of investment – Expectation of early capital repatriation from Funds – little prospect of occurring.
  - Therefore the exposure to illiquids is increasing.

- Australian Funds
  - Were impacted by fall in AUD$ relative to US$ – most commitments were unhedged to US.
  - In Australia we have Member Investment Choice. There has been a shift to the defensive options.
  - Endowments are having calls on capital.

- Oil revenue to some sovereigns is also reducing.

- The collective is that many Funds are overweight to illiquids.

- Material discounts are appearing in the global secondaries markets
  - Declining values.
  - Forced sellers.
Pressure on Debt

- Bank Debt credit has contracted:
  - Banks are hoarding cash.
  - Banks have limited borrowing capacity.
  - Focus on repairing own balance sheets.
  - Overweight to property sector.
  - Increased bad debt provision.
  - Fewer Banks.
  - Retraction to home markets.
  - Capital Rationing.

- CMBS notes about to roll over – Market has evaporated (soft default options).

- Declining valuations – reduced borrowing capacity.

- Income volatility as the real economy declines.
Where is the Capital for Property Coming From?

☑ Selected sovereign funds
☑ High net worth families
☑ Private Equity Funds (with existing commitments)
☑ New debt funds

☒ Listed Property Trusts/Companies
☒ Retail Investors
☒ Property Syndicators
☒ Superannuation Funds
☒ Endowments
☒ Middle East
☒ Leveraged Private Investors
☒ Hedge Funds

• Not enough capital to fill the gaps.
• The cost of capital is increasing as rises in risk premia outstrips the falls in the risk free rate.
• Capital for property is opportunistically competing with the other asset classes.
Direct Markets Crunch Time on Value

- From 2000 to 2006 global cap rates compressed by around 35%.
- 2007 the trend reversed.
- Risk Premia will move out further than many expect.
- Risk free rates are shifting down.
- General views we will see cap rates ease by:
  - 100 bps for prime
  - Up to 200 for secondary.
- 25% shift – is it enough - UK 40% (cap rates for prime property from 4% to 7%).
- Rental growth will partially protect some markets in short term.
- This hope is rapidly falling away.
- Demand by property users in most markets has been strong until very recently. Initially this was cushioned as a result of most markets having low vacancy levels. This is now rapidly softening as the lack of liquidity is leading an economic slow down.
- Valuers have not seen the direct evidence
- This will emerge this year.

World and Regional Office Capitalisation Rates 2000-2007 (% year end)

Note: Aggregate weighted Average performance based on twenty four global markets – 10 in US, 10 in Europe and 4 in Asia-Pacific

Source: RREEF Research, NREI, CBRE, JLL
REITs have responded

Global REIT markets have responded quickly to the changes. Sector remains volatile due to the lack of investor confidence in company forecasts and pressure to raise additional capital in a capital constrained environment.

High debt levels increasing the REIT’s.

Valuation of non investment steams have been hit hard.

Paradox – the valuations of the low risk pure plays are holding up.

Source ING Clarion
REITs – The Vicious Equation

- Increased cost of capital.
- Decreased asset values.
- Need to repay debt.
- Cannot sell assets to repay debt.
- Need to raise very expensive capital on market, materially diluting the current shareholders interests.

- Australia reacted quickly to the capital raising conundrum.
- UK and US about to follow.
Credit – the winner.

- Credit spread have moved out.
- Financial Institutions of all persuasions – need to shift debt off balance sheet.
- Priced to sell.
- Credit returns are materially better than those provided by equity.
- Total return from low risk property debt > 10%.
- Compare this to equity even forgetting valuations correction.
The assessment of risk

- The focus has been on:
  - Determining the risk premia to be attributed to property – relative to the other asset classes.
  - Determining the risk premia to be attributed across the property sector – the specific risks of one property type compared another.

As a buyer we will ultimately set our value level.

- Sustainability and durability of income streams is now the key concern.
Structuring

**The Drivers**

- Avoid complex vehicles.
- Avoid excess borrowing.
- Fewer investors.
- Greater investor control over key decisions.
- Improved commercial terms – more equitable risk sharing.
- Focus on Fees.
- Focus on the viability of the manager –
  - Financially
  - Commitment of people (A lot of performance hooks are now out of the money).
  - Alignment of interest.

**The Outcomes**

- Clubs v Funds.
- Small funds v big funds.
- Emergence of the mandate.
- Greater incidence of partnerships – direct investing with a partner - who will also be the asset manager.
- Listed property companies are less relevant than they were.
- The teams in the global investment banks losing control of their own destiny.
- Investors are now dictating the market.
The Opportunities

- Debt – providing superior risk adjusted returns to equity.
- Listed – leading the repricing – structural risk
- Corporate recapitalisation.
- Opportunistic acquisitions at compelling prices flowing from sell stress.
- Acquisition of very high quality (rarely sold assets) at fair prices showing appropriate risk premia.
- Markets where that accept the changed environment.
- Secondaries (not for the faint hearted).
- Actively managed investments – cap rate compression will not save you.
What to avoid?

- Complicated structures.
- High leverage.
- Near term debt expiry.
- Weak tenants.
- Managers/Partners operating in markets outside their expertise.
- Managers/Partners with legacy issues.
- Market participants who are not pro-actively facing up to the market issues.
- Development.
How Things Change

In 2005

- Strong retail demand for syndicates.
- Superannuation Funds
  - Below property allocations
  - Struggling to invest cash flows
- A lack of appropriate property product available for investment.
- No property on the market.
- Borrow, borrow, borrow
- Prices increasing – many thought for ever.
- Property fundamentals excellent.

The application of inappropriate risk premia to unsustainable growth assumptions.
Questions?