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Property Investment in the Current Environment

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The Market

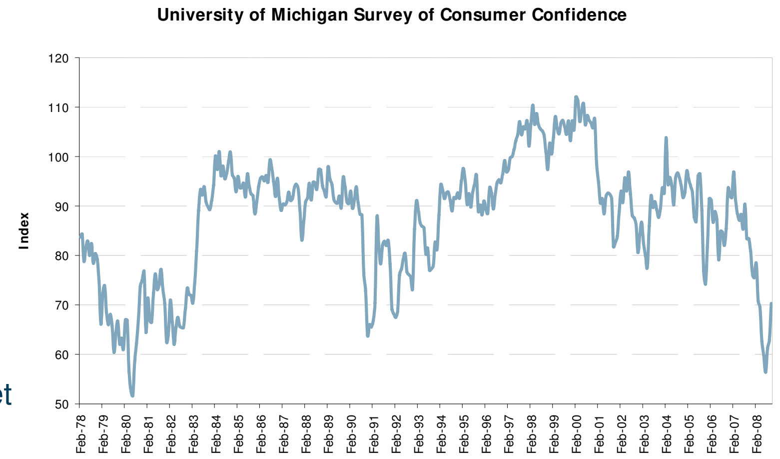
More than any other time in history, mankind faces a crossroads.
One path leads to despair and utter hopelessness.

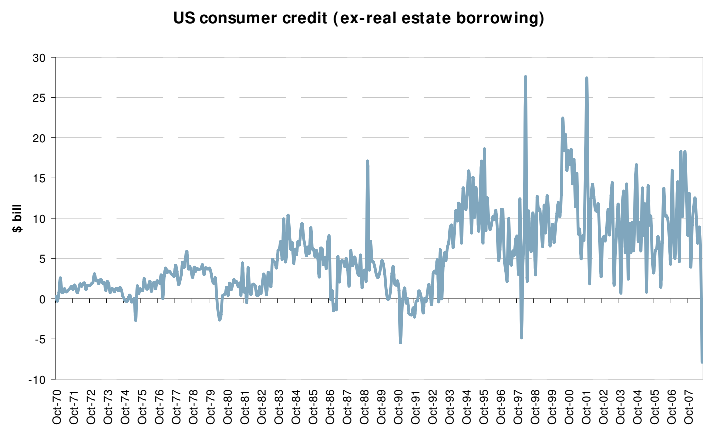
The other, to total extinction.
Let us pray we have the wisdom to choose correctly.

Woody Allen

Economic Issues

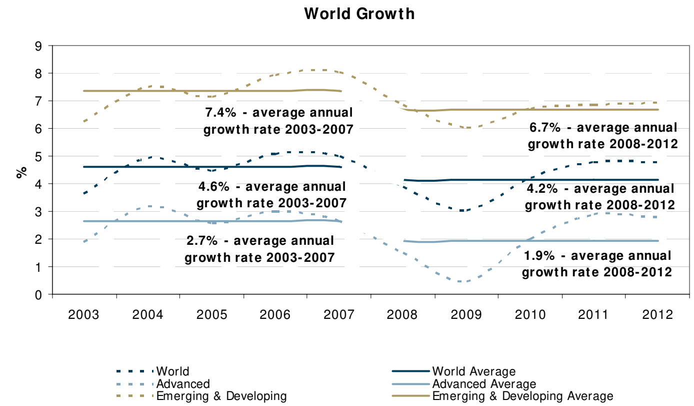
- The Financial market stopped functioning.
- Major Banks almost defaulted.
- US$5.0 trillion has been pumped in.
- This has brought the system back from the brink.
- Following near death experiences, banks are hoarding cash.
- Borrowing (but can only access short term).
- Not lending long.
- Consumer 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.

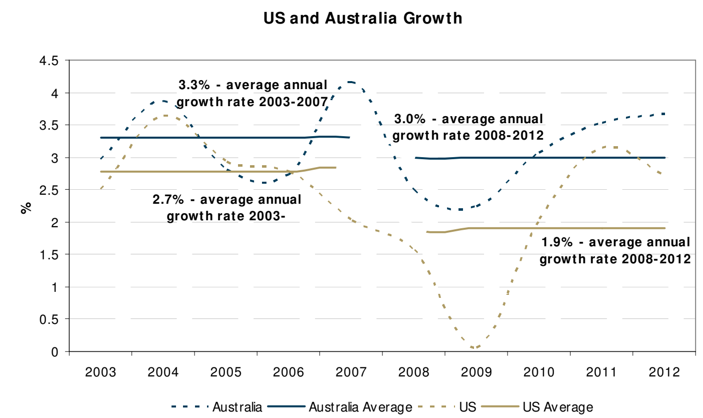




Economic Issues

- 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.





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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.

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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 occuring.
  - 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.

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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

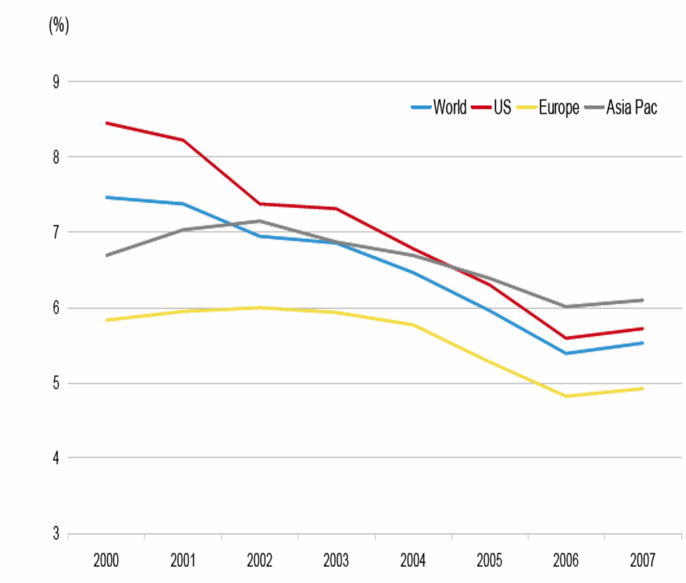
- ☒ Listed Property Trusts/Companies
- ☒ Retail Investors
- ☒ Property Syndicators
- ☒ Superannuation Funds
- ☒ Endowments
- ☒ Middle East
- ☒ Leveraged Private Investors
- ☒ Hedge Funds

- 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

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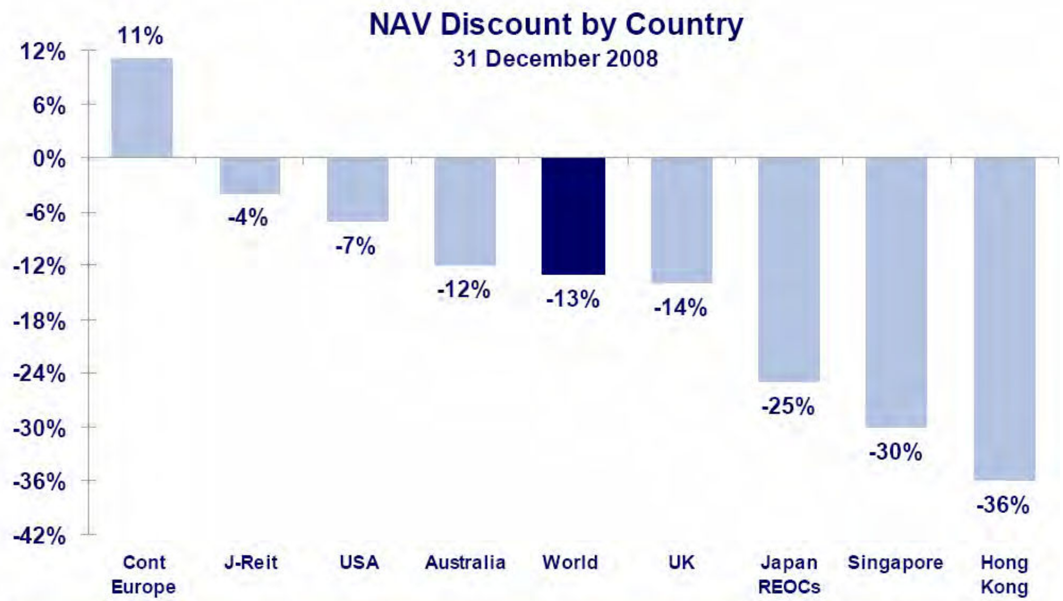
REITs have responded



	Cont Europe	J-Reit	USA	Australia	World	UK	Japan REOCs	Singapore	Hong Kong
Assumed Cap Rates	7.4%	5.8%	8.1%	7.5%	7.0%	7.0%	5.5%	5.7%	5.2%
Implied Listed Market Cap Rate	7.2%	5.9%	8.4%	8.4%	7.7%	7.4%	6.8%	6.9%	7.4%

Source ING Clarion

- 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.

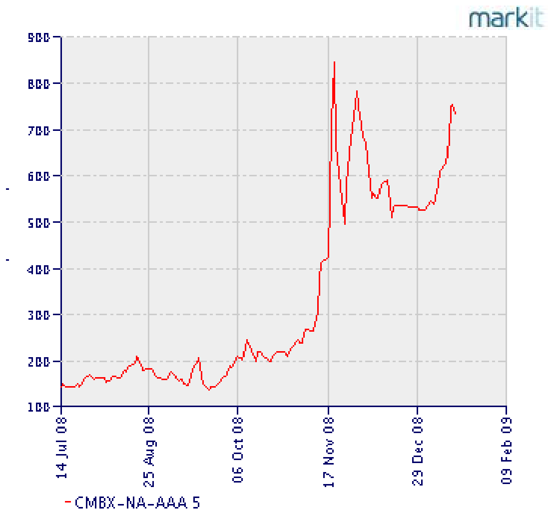
REITs – The Vicious Equation

- 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.

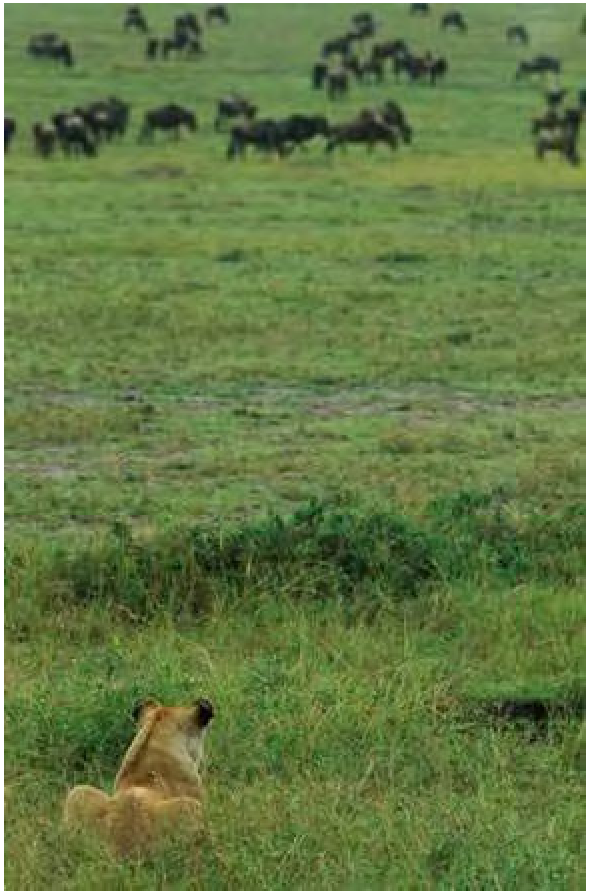
- Credit spread have moved out.
- Financial Institutions of all persuasions – need to shift debt off balance sheet.
- Priced to sell.
- Credit returns are materially better than those provided by equity.
- Total return from low risk property debt > 10%.
- Compare this to equity even forgetting valuations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



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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.

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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-actvely 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.

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Questions?