

The Future REITs

Today I want to talk about the state of the local A-REITs and the fundamental issues driving investment in global real estate investment trusts.

Before addressing my topic, a disclaimer. I am involved in the business of funds management focused on investing in listed real estate securities. As the saying goes, to a tradesman who only has a hammer – everything looks like a nail. Whilst it is not my intention, the risk is that I am the REIT sector's cheerleader, so please make your own judgements about my comments with this in mind. Nevertheless, I would encourage you to visit www.resolutioncapital.com.au to find my previous presentations.

Let me begin by saying last week I was disheartened to see the Financial Review sponsored Morningstar REIT Manager of the year Award was given to an index fund. Index funds ultimately promise mediocrity and offer little else. The REIT sector's corporate governance standards are not being helped by their growth as they do little to add to the debate within the industry or undertake normal due diligence which is in effect outsourced to active managers. To be fair I will open up the floor to representatives of the index funds now to respond [presumed silence].

Perhaps index managers would care to come to a real estate industry day and participate in a discussion with more than some bland statistics put together by a broker, or provide their own view on real estate investment best practice and corporate governance rather than outsourcing it to a third party Corporate Governance nanny. If the judging panel believed no active manager deserved it – and this could be the case - then I would suggest it would be better not giving the award at all.

So back to the topic at hand.

Over the past 2 years of presenting at this forum, Resolution Capital has focused on best practice principles within global REITs and what A-REITs could do to restore confidence and competitiveness

within the global environment. Today, I'm prepared to report that A-REITs are in the best fundamental shape for perhaps a decade. So I will use this time to reinforce a couple of issues and highlight some of the current market dynamics.

From a macro perspective, the resources boom combined with the Anglo financial crisis has resulted in imbalanced capital flows, creating a shortage of capital for Australian commercial real estate, particularly development.

Needless to say, whilst it may be a super cycle, the resources boom will not last forever. Hence, it is vital that investors are offered a range of quality investment alternatives that can at least partially offset the fallout from the inevitable resources bust. Real estate, particularly global REITs, should be part of the solution.

However, the heightened price volatility and equity like returns experienced by global REITs over the past 5 years has left superannuation funds and their asset consultants struggling to interpret the meaning. Two important questions have emerged:

- Are listed REITs a surrogate for direct real estate; and associated with this
- Do investors need to have a separate allocation to listed REITs?

These are the major issue confronting the sector today.

In search of investments that offer the promise of lower volatility, we are witnessing many institutional investors return to unlisted wholesale real estate funds. At the moment core strategies are in fashion, a trend not just in Australia but also overseas as evidenced by CALPERs recent decision to terminate listed REIT and opportunistic real estate mandates in favour of core unlisted strategies. A number of sovereign wealth funds appear to be on the same tack. Apart from the obvious question about timing, this trend has major implications for Australian superannuation for reasons I will elaborate on later in my presentation.

Unfortunately, the behaviour of a small number of A-REITs continues to do REITs in general no favours. Having stabilised the sinking ship in 2008-09 with emergency capital raisings, some recent unnecessary, ill-conceived equity raisings and related party transactions have served to further test the local market's already stretched credibility. I'm not going to name and shame, suffice to say they are an embarrassment and a blight on the reputation of Australia's stewardship standards for publicly listed enterprises. Whilst some of these transactions may have been entirely legitimate, the industry is in no condition to be undertaking transactions with even the slightest sense of impropriety. As the saying goes, not only must it be clean, it must be seen to be clean.

Despite evidence of recidivism on the part of some and uncharacteristic lapses of judgment by others, the optimist in me survives. Overall much of the hard work has been done to restore the investment proposition of many A-REITs as part of equities and global REIT mandates.

Recapping the current state of play, A-REITs have recapitalised balance sheets and recalibrated dividends, the A-REIT dividend pay-out ratio is 80% compared with over 100% 3 years ago. As for balance sheets, the average Loan to Value Ratio is approximately 25%, well within banking covenants of 40-60%. Management also is working on improving the structure and duration of its debt; GPT's 7 year Australian bank debt was a major breakthrough in the local market.

The combination of these factors means that investors can budget with a great deal of confidence on the reliability of the A-REIT income stream and should have limited concern about the prospect that their capital will be permanently impaired through A-REITs breaching debt covenants.

More importantly, the financial crisis has been a catalyst for A-REIT managers to think about the value proposition of their real estate platforms. Today's management has recognised the need for targeted investment strategies such as geographic or sector focus and capital recycling.

Furthermore, A-REITs are among the world leaders in environmental sustainability.

Hence, by and large, there has been encouraging progress by A-REITs to provide a sound investment case. With prices barely recovering from their lows, A-REITs currently represent a credible investment proposition. For these reasons, a limited number of A-REITs currently represent a disproportionate exposure in Resolution Capital's global fund.

Having wiped the slate clean, the greatest headwinds for local REITs seems to relate to our elevated A\$ and interest rates, and a matter of trust that management will deliver on promise of this new found mojo. There is a sense of dejavu with the current conditions. I've been around long enough to know that sentiment changes but over the long term fundamentals triumph. In 1999 I felt like I was wasting my time talking about REITs as most investors only wanted to hear about the latest internet story that they were sure would go up 30% over the next 12 months.

In light of the current sentiment, I think a fundamental question should be considered: why be listed?

If we accept protecting and growing the value of an investment should be the motive of any management, public or private, the primary motive for listing on a stock exchange should be for the benefit of shareholders in terms of liquidity and transparency. Bottom line, management should seek to ensure that the shares trade as close as possible to underlying value of the investments for as long as possible.

Unfortunately history suggests that many managers seem to believe that being listed is a means of raising more capital. Due to the relative ease of tapping the market for equity, management is vulnerable to various temptations: to allay their anxieties, relieve pressure or to increase their own bank accounts and egos. In these circumstances, the long term interests of investors can easily be explained away which manifests itself in raising equity at discounts to both market price and underlying asset values.

Naturally this reduces shareholder wealth and creates a discount mentality for investors: why buy now when I know management do discounted issues. Sellers bargaining power is similarly compromised. The discount becomes ingrained when management regularly undertake such raisings and have no demonstrable track record in adding value to the underlying assets.

It's not unconnected that investment banks love discounted issues. There is a myth being perpetuated in some circles that rights issues don't hurt, even when deeply discounted, because existing shareholders don't get diluted. This supposes that investors have spare cash sitting around. The fact is that most investors will need to sell other assets to fund the commitment, thereby triggering opportunity and transaction costs. Often the stock takes time to soak up the excess supply giving bargain hunters the opportunity to exploit the weakness at the expense of long term investors. Hence, rights issues should never be undertaken lightly.

As well as the risk of poor capital management, being a closed end listed vehicle comes with the risk of sudden changes in investment as well as capital management strategy. We should never forget the decision by a number of previously domestic focused REITs to suddenly lever up to invest offshore, seriously altering the nature of shareholder returns. This had important consequences for those investors that had targeted securities with Australian assets and cash flows to match their own Australian liabilities. Perhaps this was a major motivation for Westfield's recent decision to spin-off a low leverage, moderate fee Australia and New Zealand portfolio on the ASX.

Whilst a sudden change of strategy is an ongoing risk, currently I would rank it low on the current list of things that keep us awake at night.

If that's the case, many A-REITs seem to be underappreciated by the market. This is apparent in reference to three benchmarks.

One, several AREITs are trading at significant discounts to stated NTA. Two, they trade at discounts to offshore listed peers and three, and most bizarre of all, A-REITs are trading at discounts to

Australian unlisted wholesale vehicles. This third point is particularly significant as several of the unlisted wholesale funds have raised significant capital at NTA over the past 12 months despite having very similar property portfolios and capital structures to their listed counterparts which are trading at discounts.

When A-REIT price deviates from value for a prolonged period it is time for boards to consider if current management is in fact capable of generating a satisfactory return on the assets and shareholders equity?

Put simply, not all REITs are born equal. A discount should be factored into the price of some vehicles because appraised valuations are wrong or management are serial value destroyers. Boards either don't understand this or are unable to exert control over management. That being the case, we hope more investors will join us in voting against the overly generous remuneration levels of some executives at next year's AGMs.

On the other hand, where boards and investors have cause for confidence and faith in management, they must wait for normal market forces to take effect and refrain from doing silly deals.

Nevertheless, there are some initiatives currently being considered to more quickly close the gap to fair value.

For example, some investors are calling for A-REITs to lift dividends through increasing the pay-out ratio. I do not believe this is appropriate. Dividends and dividend yields are an outcome of value, dividends don't determine value. The dividend pay-out ratio today of 80% allows for necessary reinvestment in keeping the properties attractive to tenants. Indeed the current 60% dividend pay-out ratio of US REITs has not constrained performance or rating of the sector.

Meanwhile some AREIT Boards are considering whether it might be in the best interests to downsize REITs by selling assets. This provides evidence of the underlying value of the portfolio and might facilitate using the sales proceeds to pay special dividends and or buy back shares without resorting

to gearing up the fund. If carried out in this fashion we believe it is sensible but we are concerned that the arbitrage may not be that great to make it meaningful. The time to consider share buy-backs was 2 years ago when of course few managers had the financial capacity to do so.

If A-REITs continue to trade at discounts, it may then be worth considering the old maxim, if you can't beat em join em. In a nut shell, some A-REITs should delist and become unlisted wholesale funds and/or retail syndicates. I do not believe it will come to this for the majority of the sector but it does highlight the value buffer that underpins A-REITs provided management remain disciplined. Perhaps then people might stop talking about volatility and focus on the more important issue of liquidity.

In relation to liquidity and unlisted real estate, I discussed this issue last year in great detail. I'm not going to repeat what I said, it's on our website. However, I firmly believe many in the superannuation industry dodged a bullet during the financial crisis. Under the fund choice framework, in effect today's superannuation funds are promoted as open ended funds from which investors can change their mix or withdraw at anytime, with the discreet proviso, subject to liquidity. Unlisted real estate often experiences significant volatility of liquidity. Thankfully, in an operational sense, commercial real estate generally performed quite strongly in the latest crisis due to limited new building supply flooding the market, which no doubt took some pressure off investors decisions to reduce exposure to unlisted property. The recent challenges facing members of MTAA and Bookmakers Superannuation are perhaps a taste of things to come.

We continue to believe that the superannuation industry should at least have a balanced approach to its real estate exposure by investing in select, and I stress select, global listed REITs. The extreme price volatility of the recent financial crisis was a relatively short term aberration through which all markets remained open. Volatility in listed markets often represented liquidity and this short term volatility did not change the long term fundamentals of the underlying investments of global REITs. Compared with investment in offshore unlisted real estate, global REITs are transparent in many

ways - including fees and taxes as well as pricing and liquidity. They provide exposure to dynamic economies and deep capital markets. For example US REITs are currently securing 10 year finance at an all-in cost of circa 4%, with no LTV covenants, from a range of debt providers.

We continue to argue that Australian investors remain cautious about global REITs because of a fear of the unknown. They are unfamiliar with skilled listed operators such as Simon, Link, Avalon Bay, Unibail, Federal Realty, Boston Properties, Derwent London and Shaftesbury. The strategy and performance of these vehicles is exemplary.

These vehicles provide exposure to portfolios containing some of the world's best real estate experiencing a deep and expanding pool of tenant demand. It would be extremely difficult to replicate these portfolios in an efficient manner through unlisted products.

Indicative of the quality of the platforms, listed global REITs dominate the ownership of the world's fortress malls in the US, UK, western Europe, Brazil, Singapore, Australia and New Zealand. REITs and listed real estate companies own large parts of key global cities including Marunouchi in Tokyo, west end and the city of London, mid-town Manhattan, Hong Kong and Singapore. REITs are now among the major providers of space to logistics companies that are being called upon to service the expanding e-tailing sector. REITs own apartments in major cities which continue to benefit from urbanisation.

It may be a surprise to some of you to know that US apartment REITs have been among the strongest performing property stocks in the world over the past couple of years. The reason is that the majority of US apartment REITs own property in cities like New York, Washington DC, Boston and San Francisco, cities which were not subject to overbuilding that brought about the housing induced finance crisis. The lack of building combined with declining home ownership rates and migration of people to these vibrant 24 hour cities has created an accommodation shortage that has led to relatively strong rental growth. Combined with ongoing access to relatively cheap debt provided by

Freddie and Fannie, the multi-family REIT share prices have grown strongly and are now within sight of record highs.

As evidence of the strength of demand for REITs in offshore markets, we expect to see the biggest REIT IPO in history during 2011. Archstone, an apartment stock taken private in 2006 by interests associated with Lehman Bros, is expected to raise more than \$5bn to refloat the platform on the New York Stock Exchange. Blackstone also is working toward major US REIT IPOs of office, industrial and, following the Centro transaction, retail platforms.

To be fair, the greatest challenge to offshore REIT investment at this point is pricing. Unlike A-REITs, many US REITs currently are trading at premium valuations thanks to low interest rates and historically low levels of new supply. US construction activity is at 40 year lows. Low construction activity, a feature of many real estate markets, also is underpinning the outlook for Hong Kong real estate stocks. Even UK REIT prices are doing well, not least of which is due to spending on infrastructure projects that go beyond the 2012 London Olympics.

Finally, and quickly, over the next decade we expect to see REITs will be responsible for proportionately more development activity given increased constraints on bank lending and REITs will continue to increase their control of real estate markets globally.

In conclusion, it is both a challenging and exciting time for REITs.

A-REITs are striving for a sustainable improvement in performance which means they are well placed to compete with their global peers. Nevertheless, there is frustration that these improvements are not being appreciated by the market. This is not the time for management to panic into ill-timed capital raisings or deviate from their long term investment plan. Ultimately fundamentals will count.

It is important that the Australian superannuation industry is provided with long term investment strategies suitable to the current framework which promotes liquidity. Local investors must put aside their perceptions of volatility to recognise the liquidity and quality of select Global REITs is a

sensible means for Australians superannuation funds to effectively diversify portfolios to achieve superior long term investment outcomes.

Thank you and I'd now be pleased to take questions.

Andrew Parsons

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