



RESOLUTION CAPITAL GLOBAL PROPERTY SECURITIES FUND

MARCH 2009

QUARTERLY INVESTMENT REPORT



GLOBAL REAL ESTATE SECURITIES

Fund Performance

The Resolution Capital Global Property Securities Fund outperformed the UBS Global Investors Index (AUD Hedged Net TR) by 725 basis points for the quarter ended March 2009.

Period Ending 31 March 2009*

	Quarter %	6 Month %	Since Inception [#] %
Fund	-17.26	-41.62	-41.62
Benchmark	-24.51	-53.48	-53.48
Difference	7.25	11.86	11.86

*Returns are expressed after deducting investment management costs.

[#] 30 September 2008

Resolution Capital Global Property Securities Fund Unit Price

	Entry	Exit
31 December 2008	\$0.7077	\$0.7035
31 March 2009	\$0.5857	\$0.5821

Market Overview

	31 Mar 2009	31 Dec 2008	Quarterly Accumulation Return
S&P/ASX 300 (GICS) Property	13,374	17,622	-24.1%
S&P/ASX 300 Index	24,193	24,649	-1.9%
UBS Global Investors Index AUD	618	826	-25.2%
UBS Global Investors Index AUD (Hedged)	576	764	-24.5%
10 Year Bonds	4.6%	4.0%	
90 Day Bills	3.1%	4.3%	
AUD/USD	\$0.691	\$0.691	0%



REIT Markets

The UBS Global Investors Index (AUD Net TR) produced a total return of -23.8% in the quarter ended 31 March 2009. North America was the worst performer, down -32.0%, closely followed by the UK with -29.2%. Bucking the trend the strongest performance came from Hong Kong, up 4.4%, followed by Japan, up 1.6%.

Global REITs raised over AUD \$ 15bn this quarter (see the table on the next page.) The majority of the raisings were to strengthen the balance sheet and deal with debt refinancing, rather than to take advantage of distressed sellers whom seemed omnipresent.

As Citigroup analyst Michael Bilerman succinctly observed following a recent Citi hosted conference *“gone is the rhetoric of distressed opportunities and external growth; in its place, a focus on survival (aka, “crossing the valley”). In the interim, most companies are working singularly toward capital/platform preservation.”* (Source: 2009 Global Property CEO Conference Review, 6 March 2009).

The defensive position most REITs are forced to take is unfortunate, because as Steven Roth, Chairman and CEO of Vornado Realty Trust (VNO.US), remarked in their just published 2008 annual report:

“An enormous adjustment of values has already occurred. The price of everything has been rolled back ten years and price does matter – a lot. I recently was quoted for a remark that I made at an industry conference... “a bottom will not be made until asset values are stupid, stupid, stupid cheap.” This is a necessary, but not a sufficient condition, and I think we are now on the third and last stupid.”

In response to expected debt refinance challenges a number of US REITs have raised equity via placements this quarter, including: Alexandria (ARE.US) which increased its equity base by 22% (raising \$267m), Simon Property increasing its share capital by 6% (raising \$576m) and AMB (AMB.US) increasing its outstanding shares by 40% (raising \$543m). Many more REITs have followed suit in April.

Global Equity Capital Raisings Q1 2009

Ticker	Month of Issue	Amount raised local (million)	Amount raised AUD \$ (million)
CPA	Jan-09	\$192	\$192
ABP	Jan-09	\$211	\$211
<u>WDC</u>	<u>Feb-09</u>	<u>\$2,900</u>	<u>\$2,900</u>
Australia		A\$3,303	\$3,303
WKP	Jan-09	£87	\$184
HLCL	Jan-09	£28	\$59
HMSO	Feb-09	£609	\$1,287
BLND	Feb-09	£767	\$1,622
LAND	Feb-09	£785	\$1,660
<u>SGRO</u>	<u>Mar-09</u>	<u>£524</u>	<u>\$1,108</u>
United Kingdom		£2,800	\$5,921
GFC FP	Jan-09	€20	\$40
GFC FP	Feb-09	€21	\$42
<u>COFB BB</u>	<u>Mar-09</u>	<u>€72</u>	<u>\$143</u>
Continental Europe		€113	\$224
MPW	Jan-09	\$72	\$108
HCN	Jan-09	\$214	\$322
SNH	Feb-09	\$101	\$152
DLR	Feb-09	\$85	\$128
ARE	Mar-09	\$268	\$402
SPG	Mar-09	\$543	\$815
<u>AMB</u>	<u>Mar-09</u>	<u>\$576</u>	<u>\$865</u>
United States		US\$1,860	\$2,790
AREIT	Jan-09	\$400	\$396
CAPL	Feb-09	\$1,840	\$1,822
<u>CT</u>	<u>Feb-09</u>	<u>\$1,230</u>	<u>\$1,218</u>
Singapore		S\$3,470	\$3,435
Global total			A\$15,674

Source: company press releases, Resolution Capital

Meanwhile many of the US REITs have taken advantage of the option given by the IRS to pay part of their dividend in stock rather than cash. Companies which have taken advantage of this option include: Simon Property Group (SPG.US), which will pay 90% in stock and Vornado which will pay 60% in shares.

In property related news Boston Properties (BXP.US) suspended construction on a \$980m development in midtown Manhattan, after a law firm abandoned its plan to pre-lease the majority of the space. In Boston the John Hancock Tower, New England's tallest skyscraper, was sold at auction for \$661 million, about half the price it sold for less than three years ago. The new owners bought the building for \$20.1 million, plus the assumption of the \$640.6 million mortgage.



In Continental Europe major news items included Cofinimmo (COFB.BB) who raised €72 million through the placing of treasury shares with institutional investors. Unibail (UL.FP) also published comparatively solid 2008 full year results, with like for like rental growth of 7.7%. The company continues to have a lowly levered balance sheet and management gave EPS guidance of +7% for 2009. Meanwhile, Orco Property Group (OPG.FP), the once highflying Central European property developer and investor, filed for protection from creditors.

In the UK property capital values have fallen by 41.4% from the top of the market in June 2007 till March 2009 according to IPD. With gearing covenants based on appraised valuations, many UK REITs were close to breaching. Therefore we saw this quarter a flurry of rights issues collectively raising an amount equivalent to 18% of the sectors equity market capitalisation as at the beginning of the quarter. All of the UK majors, except Liberty (LII.LN), raised equity: British Land (BLND.LN) raised £740m, Land Securities (LAND.LN) raised £785m, Hammerson (HMSO.LN) raised £584.2m while SEGRO (SGRO.LN) raised £500m. Furthermore Workspace's (WKP.LN) announced a £87.2m rights issue, while Helical Bar (HLCL.LN) raised £27.5m in a placement. Only the latter could be considered opportunistic.

In Hong Kong Link REIT (823.HK) raised HK\$3bn of unsecured debt from a consortium of banks. The all-in cost for this three year loan is 175bps above HIBOR. This compares to for example Simon Property Group in the US which issued in the same month a US\$650 million unsecured 10 year bond at an effective interest rate of 10.75%. Later in the month Simon completed two secured financings for seven and ten years with high 7% interest rates, highlighting the difference between unsecured and secured borrowings. The difference between the costs of Link's loan and Simon's bond issue in the US are notable, although Link's loan has a shorter maturity. This is further evidence that the credit markets in Asia are working better than in the US, resulting in a lower cost of capital for Asian companies.

In Japan Creed (8888.JP), one of Japan's major asset managers, filed for bankruptcy when it was unable to repay its debts. Furthermore the government is considering plans to establish a ¥1 trillion investment fund to acquire properties from JREITs and provide loans.

In Singapore, CapitaLand (CAPL.SP) and its listed satellite shopping centre fund, CapitaMall Trust (CT.SP), announced rights issues. CapitaLand's "pre-emptive" raising was ostensibly to "pursue acquisitions" however inevitably a significant portion of the funds raised went to meeting its commitment to subscribe to 60% of the right issue of CapitaMall, including its pro-rata 29.7% share.



At a recent forum hosted by the Australian Financial Review, RCL was given the opportunity to present our view of the way forward for the REIT sector. Below we reproduce the speech.

The Way Forward For Property Trusts

By way of background, the team at Resolution Capital has been investing in REITs since the early 90's and commenced investing in offshore listed REITs 5 years ago. We are fortunate therefore to have a global perspective of how the financial market turmoil has affected the real estate industry, testing the mettle of strategies and challenging the meaning of "worst case scenarios". Whilst extreme, and without wishing to downplay the harmful impact it is having on people's livelihood, the current environment of a contracting economy and tight credit is not unprecedented. These circumstances serve to give meaning to the word risk and are a reminder to investors to better appreciate reward.

The harsh reality is that this environment is resulting in a ruthless, Darwinian-like, clean out of bad ideas and poor execution of which several in the REIT space are now casualties. Today, I will address why the AREIT industry is in poor shape, put in perspective the long term merits of REITs and how investors, particularly those in the superannuation industry, are likely to approach investment in real estate.

Resolution Capital has been wary of the increasing risks associated with AREITs for some time. Recently I was pleased to see that Kaplan is republishing a piece we did in 1999 for the Securities Institute on the ramifications of increasing debt levels within the REIT sector. The paper serves to demonstrate that, eventually, fundamentals matter.

Early in 2008, after privately discussing the consequences of deteriorating credit market conditions and Centro's collapse with numerous other AREITs, Resolution Capital publicly called for the sector to expeditiously reduce gearing and dividends. In our view this was necessary to improve the security of its equity investor's capital base. Whilst the industry has made some progress, I believe the response was too slow and significant risks persist. The sector still has much to do to rebalance itself in order to restore confidence and generate competitive long term performance.

Nevertheless, doubts surrounding the survival of the AREIT are over done. It is worth highlighting that Westfield Group, ASX listed and Australian based, is now the largest REIT in the world by equity market cap and enjoys a revered reputation.

Furthermore, recent short term REIT price volatility has resulted in near hysteria about the category with some experts claiming that listed REITs are not like real estate. In response I could suggest the simplest solution for the AREIT sector is immediately de-list and slink into the shadowy world of unlisted investments. Existing investors would enjoy an immediate uplift in pricing of circa 30% being the current average discount to stated NTA. The perception of volatility would disappear overnight. Then, of course, the previously listed REITs can suspend redemptions, officially or unofficially, as virtually every other unlisted real estate vehicle has done over the past 12 months.

I am not recommending such drastic action but it puts in perspective some of the absurd criticisms of the listed market. The simple fact of the matter is that listed REITs have continued to provide the very thing some investors need at this point – liquidity!

The current AREIT pricing environment reflects this liquidity together with the market's real view of asset prices and the amount of risk that has been introduced to the equation for what should be a relatively stable asset class. Listed REIT investors who do not have liquidity pressures should remember that price does not always equal value. If they believe current prices are not realistic they can choose to ignore them or use it as an opportunity to buy more. In some cases they should sell.

There are other benefits of the public environment. As my colleague Peter Hartigan often reminds me of the old saying - sunlight is the best disinfectant. Being listed has meant transparency; the problems are widely known and are being addressed. Whilst unpleasant, the sector now is taking its medicine.



This pragmatic view does not excuse significant segments of the REIT industry for the unardonable breakdown of responsible capital management in terms of excessive leverage and financial engineering. In light of the state of affairs, the natural question to pose is: If REITs are so good in terms of liquidity and transparency, how did we get into this position? Ultimately not enough respect was given to the history of cycles and the dangers of excessive use of leverage.

The seeds of the sector's success can be traced back to the demise of the unlisted sector in the early 1990's which was ironically the result of a property crash and poor capital management. By contrast, in the lead up to and during the 90's property crash, AREITs held significant cash reserves which acted as a buffer against the property crash.

As a consequence, AREITs were re-rated thanks to their liquidity and then financial conservatism. This reputation would endure and later impair the judgement of many investors who failed to recognise the changing AREIT risk profile. Buoyed by low interest rates and rising property prices, AREITs began to utilise modest amounts of debt from the mid 90's.

Fuelled by market leading returns, particularly post the events of 2001, the AREIT sector was encouraged to take on more risk in pursuit of higher returns on equity and growing distributions. Borrowing more and raising minimal equity was applauded. Scrutiny gave way to complacency. Asset and capital management strategies were poorly conceived and woefully executed. Too few management teams understood sensitivity analysis, the significance of accounting changes, principles of asset-liability duration matching, appropriate borrowing covenants and the lack of depth in the local debt markets.

Many REITs became little more than geared momentum asset accumulators which paid lip service to risk management.

At worst, some vehicles were established simply for a bull market and the financial benefit of opportunistic participants who could demonstrate compelling financial gymnastics which was viewed, in some quarters, as a sign of superior intellect.

Whilst history suggests that the impending problems were foreseeable, somewhat disconcertingly, as highlighted by Jack Gray at UTS Centre for Capital Market Dysfunctionality, history also proves the case that most of us won't see the correction until it's too late. The boom bust cycle rolls on.

Market participants find ways of explaining why it is different this time and how the good times will continue. At the end of the day it is easier to lever up and let the good times roll than it is to lock-in profits and de-lever which typically results in short term earnings erosion and lower management fees. In practice publicly quoted vehicles don't have a good record of managing debt through cycles. Poor judgement is usually to blame as management misread the changing mood of asset and credit markets. Furthermore, the natural course of management change often brings with it a change in capital management and investment strategy or a weaker understanding of the market dynamics. Finally, and most importantly, public vehicles such as REITs have the difficulty of successfully appeasing the various stake holders who have different agendas, investment return expectations and time horizons. This serves to cloud management's judgement in dealing with the often short-term negative aspects of de-leveraging.

In light of this, when managing debt, picking market tops and bottoms seem foolhardy. The issue is how we allow for the extremes of the cycle and management deficiencies. In response to this issue, Warren Buffett observed recently:

“Over the past 50-60 years we've suffered quotational loss, 50% movements. That's why you should never borrow money. We don't want to get into situations where anyone can pull the rug from under our feet.”



In my opinion, consistent with this view, leverage should be used to provide capital funding flexibility and enhance returns rather than be the driving force. Bottom line it seems the only sure fire way for most REITs to avoid a repeat of the current problems is to have permanently low gearing regardless of the time in the real estate cycle.

I do not believe one can be prescriptive but if I was pinned down I would suggest it should be a maximum half of the LTV covenant prescribed by the lenders. Based on today's LTV covenants of 40-60%, this suggests REITs gearing should be a maximum of 20-30%. I stress this is a maximum, not a target. To be fair, some participants in the wholesale unlisted market adopted these constraints following the previous property crash but, as I will discuss later, have not addressed the liquidity issue.

The issue of debt and capital management is critical to the key question confronting asset allocators: assuming real estate deserves a separate allocation, what form should it take? This issue is vitally important for Australia's superannuation industry which represents our largest and most precious pool of investment capital. This industry will continue to have a significant influence in shaping the Australian real estate investment market.

For the commercial real estate and financial services industry, it is our most important client with, thanks to its compulsory nature, a guaranteed steady in-flow of funds. With this comes a responsibility to invest in real estate products which are capable of delivering long term practical solutions that prudently maximise the retirement savings.

To appeal to this investor set, and most other large providers of capital for that matter, real estate vehicles will have to offer, in no particular order:

- liquidity;
- scale or a sustainable niche;
- a clear investment objective with reference to quality income streams and a focus on return on assets;
- a management structure capable of delivering on these objectives over the long term; and
- low leverage.

I should add that this is not an exhaustive list. Furthermore, it is not to say that one can't succeed with alternate strategies, it's just that more than likely they will have to do it with someone else's money, preferably their own.

I believe the real estate product that ticks the most boxes for Australian super funds is a Global REIT allocation.

Whilst AREITs by themselves serve a purpose, the reality is that the superannuation industry has outgrown the local real estate industry.

Of course the issue of AREIT stock concentration is telling. Westfield now accounts for over 50% of the sector benchmark and the top 5 AREITs represent over 80%. Put simply, the local sector does not provide satisfactory vehicle diversification nor depth of management. For reasons I will explain, solving this issue in the Australian capital market is not practical.

The current superannuation pool is valued at approximately One Trillion Dollars. A figure of 5% could be viewed as a minimum to justify a separate allocation to real estate. Today this equates to \$50 billion which by itself exceeds the current entire equity market capitalisation of the AREIT sector. Furthermore, annual inflows suggest that the sector would need to create new product of over \$2 billion per annum. Hence, without embarking on a costly and unnecessary building boom, there simply isn't enough domestic products to safely satisfy ongoing investor demand.



Suggested alternative solutions for AREIT expansion do not stack up. For example, the sum total of non-traditional commercial real estate categories such as golf clubs, prisons and storage would not be big enough to move the needle and ignores some basic structural flaws with these assets. Residential and retirement properties are competitively valued by owner occupiers and small investors.

Meanwhile, hotel return volatility is difficult to manage. As an aside, I will be greatly disappointed if GPT's hotel and resort portfolio is broken up – it is an amazing portfolio which gives GPT a real point of difference. That said I appreciate managing the asset size, volatility and ongoing capital needs of this sector is enormously challenging.

Hence, the majority of securitised real estate is likely to remain focused on the traditional areas of office, industrial and retail. If there is insufficient domestic product the question has been asked whether AREITs should recommence their offshore real estate acquisitions to augment the dearth of domestic investment grade real estate.

Much has been said about the merits and the notable failures of AREIT international expansion. For the record, we are not opposed in principle.

However, the existence of offshore listed REITs makes it largely unnecessary and we can see practical issues which make it a very risky proposition for AREITs. Whilst financial engineering has been a common theme in the offshore invested AREIT disasters, our greatest concern relates to the structure of ownership and management as well as resourcing.

The method adopted by many AREITs of partnering and joint ventures with local operators in offshore markets was used to counter the perceived major risks of culture and the tyranny of distance. As a general rule the practice of partnering and joint ventures rarely work. Usually at least one of the partners is incompetent, trying to rip the other off or both. Very rarely do jvs produce happy outcomes for all involved – flaws are painfully exposed and relationships torn apart usually in times of duress. As it turned out, AREITs were little more than a cheap source of finance for the offshore partner, not to mention a great fee generator for the middle men.

Rather than partnering, the time and cost of establishing a meaningful and successful in-house overseas asset management platform is enormous and beyond the means of most AREITs. To stand any chance of success I believe offshore expansion needs to be focused on successfully choosing key markets or assets- not generic countries or regions. Westfield and the Lowys in part prove this thesis as it took them over a decade of focusing on malls in particular markets with key attributes before the Westfield expansion strategy could be considered a success.

So how can Australian investors efficiently gain exposure to the world's best real estate? In our view it is now a case of taking Mohammed to the Mountain. Australian institutions went global with equities and fixed interest long ago, they must now venture meaningfully into global real estate. Indeed, we are already seeing this trend with the increasing number of global REIT mandates.

The global listed REIT market is valued at over \$450 billion, roughly 9x that of Australia's market. There are over 225 REITs with the biggest vehicle, ironically Westfield, being less than 7% of the benchmark. Investors are thereby able to achieve real diversification and choice. No doubt part of the problem is getting people comfortable with the players. Overseas real estate investment groups such as Simon, Federal, Public Storage, Unibail, Hang Lung and Boston Properties are not household names like Johnston & Johnston, Coca Cola, IBM, Toyota and Microsoft. But within real estate circles they are best in class with excellent track records, have low to moderate gearing and provide exposure to largely premium quality real estate.

So what place do AREITs have and what is their future? I believe that AREIT property securities mandates are now niche products that are not a meaningful solution by themselves to Australia's institutional investment needs. This does not mean that individual AREITs don't serve a purpose other than in a global REIT context nor provide solutions for different circumstances.



In fact I'm optimistic that AREITs will enter into another growth phase over the next 5 years which will manifest itself in a number of ways, particularly as a solution for institutions facing liquidity issues associated with their unlisted exposure.

For example, I believe it is reasonable to expect that we will see super funds swap their direct real estate for REIT securities in a win-win outcome. For the super funds, exchanging direct and unlisted real estate securities for listed securities will generate liquidity and divisibility while providing exposure to leading asset management platforms and diverse portfolios. For the AREITs it will be an efficient way to reduce gearing and improve debt refinance negotiations.

Of course the greatest challenges to this scenario will be agreeing price, control issues and the mindset against listed given recent capital management debacles. Providing undertakings on a more disciplined investment and capital management strategy together with greater information disclosure will assist in raising confidence. Why is it that the lenders seem to have access to more information on the REITs than equity owners?

Furthermore, part of the mindset against listed REITs is focused on the term "stapled securities". The creation of the first stapled structure, Stockland Trust Group, in the 1980's by the late, under-recognised, Ervin Graf was a major positive for the industry and investors. Among numerous benefits, the stapled structure allows investors to mitigate some of the inherent conflict of interest issues associated with closed end externally managed trusts and allows the REIT to undertake activities which should be considered core to long-term real estate investment such as property management, leasing and dare I say it development. It is my firm belief that a long term real estate investor must undertake development, which includes refurbishment, in order to keep their property attractive for tenants and therefore maximise returns.

Unfortunately, the term stapled has become synonymous with volatility and negative aspects of development, construction, trading and funds management. I do not agree that all of these activities detract from the merits of REITs but I do agree that they are a major distraction for investors. Generally the proportion of income generated by these activities was less than 20% of the sector's income. The critical issues that created the volatility were unrealistic investor valuations, accounting hocus-pocus and poorly considered acquisitions funded by excessive leverage.

Before I conclude I want to address the role of unlisted real estate and the importance of liquidity. I want to once again stress that my comments are focused on solutions for the superannuation industry. I'm sure unlisted real estate can play a valuable part in other types of investment portfolios if properly structured and priced.

Nevertheless, history amply demonstrates the risks. The early 90's is a prime example when over-valued and illiquid real estate contributed to the crippling of some of Australia's leading investment and banking institutions.

I also have to say, those who espouse the recent performance of unlisted real estate fail to mention that in periods of extreme overall market volatility, sub-optimal decisions are taken in other more liquid parts of the overall portfolio to compensate for the lack of liquidity in unlisted investments.

Most importantly, the risks for the super industry of direct real estate investment have been magnified since the 90's crash thanks to the introduction of investor and fund choice.

In reality the super fund has become an open ended fund which should be extremely cautious when investing in illiquid assets such as unlisted real estate. We have the makings of some major disasters which the superannuation industry can ill afford in light of recent returns.

Conclusion

In conclusion, the Australian superannuation industry will continue to be a significant influence on the structure of the real estate investment market through the products it demands. To serve this important client, real estate products must use low levels of debt as a means of enhancing rather than driving returns from the sector. Consequently greater REIT management and investor discipline must be exercised in relation to the capital structure to ensure long term investment security is assured.

We believe global REIT mandates provide the necessary scale and quality for a long term meaningful solution. Despite mismanagement by significant parts of the sector and consequent recent poor performance, the local listed REIT structure represents an important and efficient means of investing in high quality real estate. The stapled AREIT, the reputation of which has been unfairly tarnished, will provide an important avenue for investors to maximise realisable and measurable returns from real estate.



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