RESEARCH

PROPERTY INVESTMENT
in Australia and the UK

AUSTRALIA AND THE UK

Looking at the UK and Australian property markets we see elements of both similarity and divergence.

Key areas of similarity are:

- Two tier regional economies impacting property demand. For the UK this is London and the South East versus the other regions. For Australia it is the resource driven states (Queensland and Western Australia) versus the more financial and business services weighted states (New South Wales and Victoria).
- Historically low interest rates and government bond yields, which are pushing investors to look at other investments with bond-like income streams.
- There is a shortage of development finance and often a pre-lease is needed to kick-start a scheme.
- Fast changing retail habits, with the rise of internet commerce and move towards big mall and retail warehouse shopping. This is reducing demand for standard shops on local high streets.
- Within city centre retail there is a shift towards a mix of shops, cafes, food outlets, and leisure.
- Growing interest from overseas buyers, particularly from Asia-Pacific.

Key areas of divergence are:

- The relative economic performance and outlook. The UK economy has contracted by 0.5% in the twelve months to June 2012. The Australian economy in contrast has expanded by 3.7% in the same period.
- The Australian market offers exposure to emerging markets, whereas the UK market is correlated to the big developed western economies. This is interesting from an investor perspective, as a property in one market could act as a hedge on assets held in the other.
- Greater progress towards compulsory pension schemes in Australia comparative to the UK, where nationwide superannuation schemes have been in place since the 1990s.
- For secondary assets pricing is beginning to stabilise in Australia; whereas for the UK secondary outside of London in our view has further to correct, probably stabilising in mid-2013.
- Debt availability remains more constrained in the UK than Australia.

THE OFFICE MARKETS COMPARED

	London (West End)	London (City)	M4 Corridor	Edinburgh	Sydney	Melbourne	Brisbane	Perth
Stock (million sq m)	8.5	10.9	6.1	2.0	4.9	4.2	2.2	1.6
Vacancy Rate (%)	5.3%	8.5%	9.6%	7.5%	8.2%	5.6%	7.9%	4.2%
Prime Rent per sq m p.a. AUD	$1,585	$918	$501	$450	$741	$462	$578	$805
Rent outlook (1yr)	Up	Steady	Up	Steady	Up	Down	Steady	Up
Prime yield	4.00%	5.25%	6.00%	6.50%	6.83%	7.00%	7.60%	8.00%

NB: M4 Corridor prime rent is Reading
NB: Aust Rents are Net Face or Headline Rent

KEY FACTS

- The UK and Australian economies in recent years have been on divergent courses, with the UK suffering from a high exposure to the global debt crisis. Australia has avoided recession thanks to growing exports to the East, particularly China.

- Australia's merchandise exports to China have more than trebled in value in the last six years despite the global economic uncertainty, rising from A$20.4 bn to 2006 to A$71.5 bn in 2011 .

- The resources sector has underpinned the resilient performance of the Australian economy, due to rising demand for commodities from Asia-Pacific. Non-OECD nations now account for 56% of exports, compared to 46% in 2006, demonstrating the rising exposure to emerging markets.

- The UK economy is now reweighting away from a previous over exposure to financial services and consumerism. A new wave of IT companies is emerging, while the devaluation of Sterling is attracting foreign investment, although the impact has been focussed on certain regions, such as London.

- Australia is expected to out-perform the UK economy in the next twelve to eighteen months, but concerns are growing over the potential impact of a China slowdown. For the UK the Euro area crisis is casting a shadow over near-term prospects.

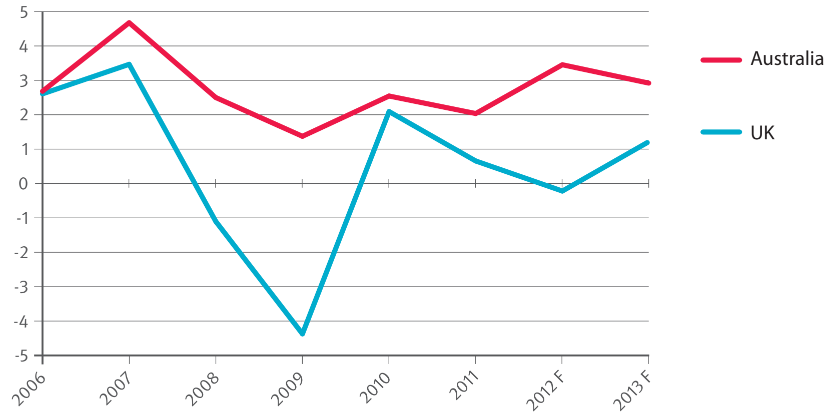
- We believe that property assets in both countries offer interesting hedging opportunities for investors, as both markets offer high levels of transparency, but with differing levels of exposure to emerging and developed markets.

- Thus Australian property can offer UK buyers an investment in the long-term growth prospects of Asia-Pacific, but in a market where they will encounter similar business and accounting standards as those in their home market.

- Equally, for Australian investors, the UK is an investment in the medium-term recovery for Western developed economies. While the UK economy has struggled to grow, the unemployment rate has fallen. This suggests underlying strength, with the recession caused by external factors.

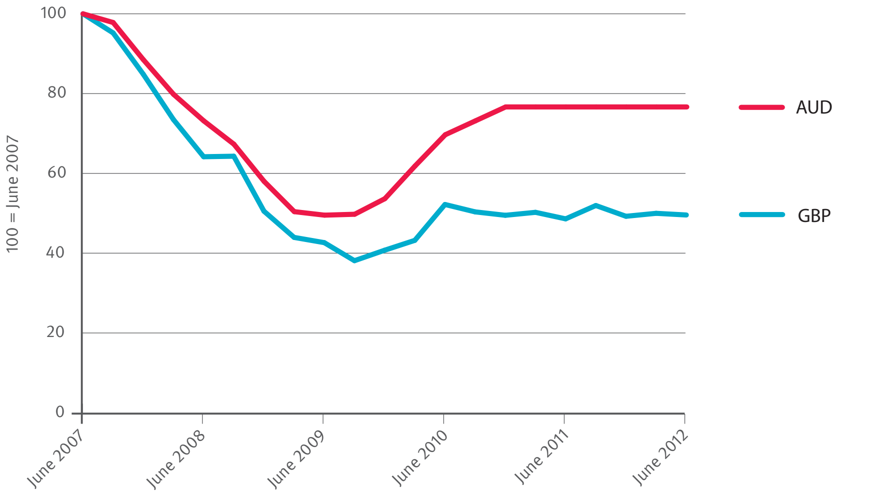
- Also, there is the opportunity to leverage the currency advantage – when priced in Australian dollars City of London prime office capital values are 50% lower than June 2007 (i.e. pre-credit crunch) levels.

% GDP GROWTH PER ANNUM: FORECASTS 2012 AND 2013



Source: The International Monetary Fund

CITY OF LONDON PRIME OFFICE CAPITAL VALUE INDICES: STERLING VS AUSTRALIAN DOLLAR



Source: Bank of England, Knight Frank Research

THE UK

The economic backdrop

At present the UK is adapting to three post-2007 realities. Firstly, the financial services power-house, a useful source of jobs and foreign exchange, is unlikely to enjoy the levels of growth recorded previously. Secondly, much of the economic growth in previous cycles came from consumerism underwritten by house price growth, which also is unlikely to be the case going forward. Thirdly, debt availability will remain constrained for years to come, making it important to attract equity investment.

The government's solution has been to seek opportunities overseas, taking advantage of the devalued Pound Sterling, to generate export driven growth. This has been successful in drawing inwards investment to the UK. Around 68% of London commercial real estate by sales volume sold in the year to Q2 2012 was to foreign buyers, while the likes of Google and Facebook are expanding their offices in the capital. In the previously embattled car industry, BMW, Honda and Nissan are expanding their UK production plants.

However, the GDP figures for the UK in 2012 have been disappointing, as the timing for this 'reweighting' away from consumerism and towards exporting has coincided with the Euro sovereign debt crisis. Also, China moved into a slowdown, hitting global trade. The UK economy is struggling to grow, but this will not last forever, with the consensus forecast being slow but gradually accelerating growth emerging from 2013 onwards. Nevertheless, a two-tier economy has developed. In the higher growth upper tier are locations that traditionally attract high levels of foreign investment, and with a large exposure to global trade or technology and scientific innovation. These include London, the M4 corridor (a series of prosperous towns to the West of London), and parts of the West Midlands. In the slow growth lower tier are those parts of the UK which rely heavily on public sector jobs and struggle to attract overseas investment.

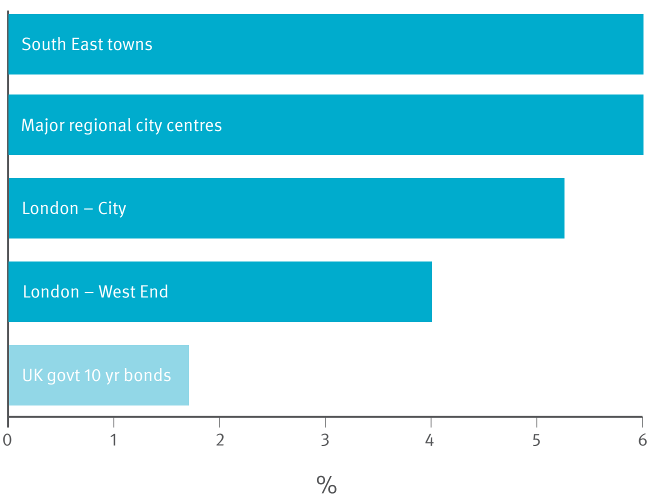
The implications for commercial property

Inevitably conditions in the property market have mirrored the two-tier split, both on a geographical level, and within the main property sectors of office, retail and industrial. A reweighting from consumerism to trade favours offices and industrial property, and created sharp extremes of performance within retail property. A major feature of the market is investor risk averseness, with demand heavily weighted towards property let on long leases to the best tenant covenants.

The result is that while prime office assets in central London have seen yields compress over 150 basis points since 2009, vacant obsolete commercial properties in regional towns with high unemployment are close to unsellable. Higher prices in London have prompted some investors to look at other markets, but this means adopting a higher risk strategy, which at the time of writing is something many would rather avoid.

Future improvements in the economic backdrop in our view will give investors the confidence to move beyond the safest assets, but we also believe many want to see the economic recovery underway in the GDP figures before buying. The dilemma faced by the buyer is how to exploit a future recovery, in order to buy into those markets which are expected next to see yield compression,

UK PRIME OFFICE YIELDS VERSUS 10 YEAR GOVERNMENT BONDS



Source: Financial Times, Knight Frank Research while avoiding any additional price correction which may occur in the more embattled parts of the UK property market.

Offices

We see offices as the sector which is best placed to exploit the next economic cycle, given that the UK compensates for a trade deficit in visibles with a large surplus in invisibles. Historically, the financial and business services (FBS) sector has been the driving force behind that invisibles surplus, although we expect other office-based activities to assume a bigger role going forwards. In particular, we are seeing more demand for office space from the technology, media and telecoms (TMT) sector, a trend being replicated in many other advanced Western economies.

London's City district has historically been the dominant FBS location in the UK, yet in the last twelve months demand for office space from TMT firms has expanded. Tech companies like Skype and Expedia have acquired offices in the Northern City, where there has also been growing demand from start-up companies. Google recently established a start-up incubator in the area, while Amazon is opening a development facility. On a London-wide level, Microsoft is looking to expand its X-box operations and seeking office space, Google is seeking a new headquarters, and Facebook and Ebay also have searches in the market.

While activity has shown a strong London bias lately, the experience in the US is that tech demand has spread from Silicon Valley to other cities such as Manhattan and Austin, Texas. We believe there could be a similar ripple effect as tech firms move to secure local talent in those UK cities with strong technology and scientific credentials, thanks to leading universities, such as Birmingham, Bristol, and Manchester. The M4 corridor should also benefit thanks to historic links to the electronics industry, particularly as it has the transatlantic air link via Heathrow.

Moreover, in the long-term we expect the UK to draw more inwards investment beyond the TMT sector thanks to recent cuts in the rate of corporation tax. This has fallen from 28% in 2010 to 24% currently, and a further reduction to 21% by 2014 is proposed. Compared to France on 34.4% and Germany on 30.2% the UK appears an attractive place to locate a business, although Ireland at 12.5% will remain a strong competitor for overseas investment. Given the UK offers a large pool of well-educated knowledge workers, we expect to see more foreign firms establish office-based operations in Britain main CBDs.

THE UK

Retail

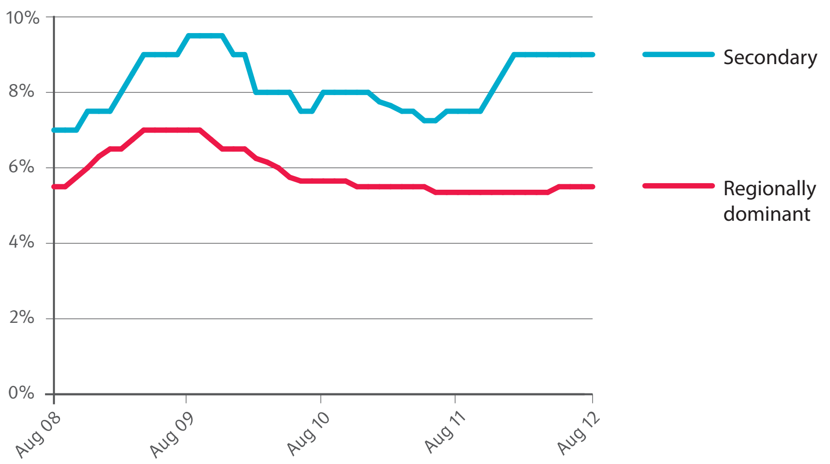
Even had there not been a credit crunch in 2007 the UK retail sector would have faced major challenges in recent years. Consumers are shopping more on the internet, at out-of-town retail parks, and at big mega malls, and smaller high streets with standard shops are losing footfall as a consequence. The debt famine has exacerbated the problem, pushing big name retailers into pre-pack administrations, and Local Data Company estimates the national retail property vacancy rate at 14.5%. There are also huge geographic differences with some towns with high unemployment reporting vacancy rates of over 30%; while for the main central London retail thoroughfares vacancy is below 5%.

The type of stock which has suffered most is that located on small to medium-sized high streets, particularly units in the lower footfall fringes, and our view is that there is over capacity of such stock. The simplification of the UK planning rules may now result in more stock switching to other uses. However, we would expect gradual rather than seismic change, given that the recession has sharply reduced development activity for most other uses.

It should also be remembered that the retail market has polarised not slumped, as large regionally dominant shopping malls are still drawing in shoppers, often by offering a mix of retail and leisure. The mega malls typically offer restaurants and bars, sometimes with a multi-complex cinema integrated, to draw shoppers in for a day-out. Another bright spot is retail units in prosperous CBDs, who have benefited from the rise of coffee shop culture in the UK, which has continued throughout the recession years.

Nevertheless, the internet is steadily growing as a proportion of UK retail sales, which is bringing about root-and-branch reform to the retail market. It is also benefiting another form of commercial property, namely sheds.

UK SHOPPING CENTRE YIELDS:
REGIONALLY DOMINANT MALLS VS SECONDARY



Source: Knight Frank Research

Industrial

Industrial property has inevitably suffered price correction as a result of the global economic downturn, although recent years have seen the emergence of new trends that favour this property sector, particularly logistics stock. Firstly, there is a retail dimension, with the rise of internet shopping, with firms like Amazon (who are currently expanding in Australia) and Asos taking more space. Also, the growing role of the big supermarket groups in UK retailing has created more demand for modern sheds. Secondly, there is the already mentioned drive by the government to reweight the UK economy towards exporting, which in the long-term should create more demand for logistics property. Thirdly, there is growing demand for sheds from the automotive industry, creating demand in areas with large car assembly plants, such as the West Midlands.

Like offices and retail, there has been the polarisation of the industrial market along geographical lines, and a bias towards

modern stock. Availability of development finance is mostly limited to schemes with a pre-let in place. One other factor to consider is that the airports in the South East dominate air traffic coming into and out of the UK – in fact, London Heathrow airport handles more air freight than all the other UK airports combined. Sheds close to or well connected to Heathrow have generally outperformed the wider industrial market in recent years.

The Investment Market

The factors highlighted above – two tier economy, restructuring of retail, and flight to safety – have shaped the investment market in recent years. The market for central London property is liquid with a steady inflow of foreign money supporting pricing. Yields in prime assets offering stable income streams are down by over 150 basis points on 2009 levels, pushing investors who require higher yields to consider older buildings with shorter income streams. Consequently, central London is one of the few parts of the UK where there is a normalised market for secondary assets, while the term tertiary has almost disappeared from use. As one moves further away from London the situation changes rapidly.

The dominance of foreign money in the market has created new pressures. A lack of knowledge of the wider UK regions has kept overseas investment mostly focussed on London, although there are examples of some investors now looking beyond the capital. We expect those who now want to invest outside London to target the M4 corridor. This market has good transport links to London and Heathrow airport, and is popular with big corporations and technology firms. Canadian investor, Oxford Properties, last year purchased Green Park, a business park near Reading, in a £400 m deal on an 8% net initial yield.

Where foreign buyers do invest outside of London it is typically prime assets, and beyond the capital the market for secondary assets is thin and biased towards better quality and longer leases. Yields for secondary property outside London are drifting upwards, while pricing for tertiary is close to guess work as transactional evidence is scant. In particular, there is the concern that repossessed stock in the control of the banks will be drip fed back to the market over the coming years, which is acting as a brake on values.

However, we expect a number of factors to act in the favour of UK commercial property as an investment. Firstly, interest rates appear anchored at historic lows, and we expect this to remain the case for some time into the future, in order to support households in the slower growth parts of the UK. Quantitative easing is holding bond rates at sub-inflation levels, and therefore the yields on property appear high compared to bonds or money in the bank. Secondly, compared to pre-credit crunch levels Sterling remains low, with the potential upside over a ten year lease that both rents will rise at review and the Pound may strengthen further down the line. This will in our view continue to draw foreign money into the UK. Thirdly, as the UK economy returns to growth, we expect more recovery play money to look for competitively priced stock in the regions.

AUSTRALIA

Two-Speed Economy

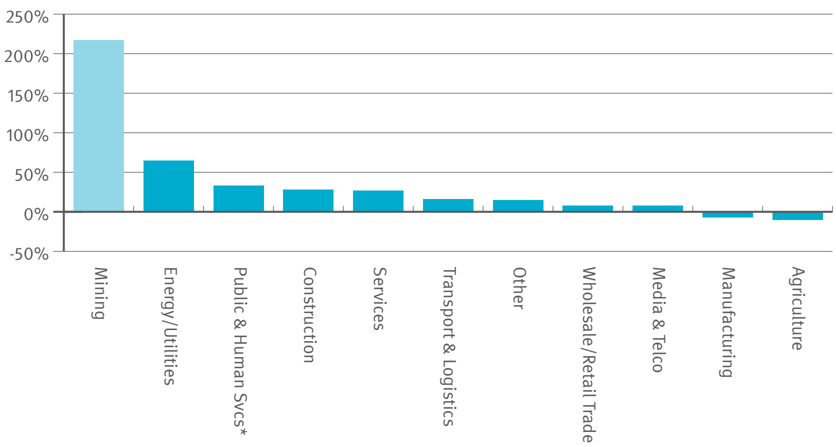
The composition of the workforce is markedly different across Australia so, to the extent there is any growth in employment, we need to understand who is growing and where they are located. The mining, infrastructure and utilities sectors dominate the office markets in Brisbane, Perth and to a lesser extent Adelaide. Whereas the traditional clusters for the banking, finance and technology sectors are Sydney and Melbourne. Employment growth in the "resource" states (using Brisbane and Perth as a proxy) was 3.4% in the year to August compared with 0.4% for the "services" (using Sydney and Melbourne as a proxy).

Breaking down recently released employment data shows that, unsurprisingly, mining and professional services (including engineering and other industries servicing the mining sector etc) continue to outperform. Detailed labour force data from the ABS for the six months to August 2012 for Queensland (Qld) and Western Australia (WA), showed that these two sectors combined recorded strong gains in employment (adding 20,900 and 17,800 jobs in the period respectively), while in all "other" sectors, the net change in Qld was a loss of 15,000 jobs, while WA added a modest 1,700 jobs. This is exacerbated in the "non-mining" states, as the conditions in banking, finance and the services employment sectors are far more modest which has been illustrated by recent reports of cut backs at the banks and property companies. The Public sector is also striving for more efficiency, as is the case around the world, as austerity measures and retiring debt continue to bite.

The uneven distribution of growth (and contraction) across the employment market has created a divergence in office market conditions across the major CBDs. Brisbane and Perth continue to experience relatively tight vacancy rates and rents in Perth continue to climb. It must be said that over the past few months, there has been a noticeable pause in the resource sector which will undoubtedly flow through to the employment market in Brisbane and Perth, driven predominantly by the recent fall in coal and iron ore prices. The cancellation or deferral of various marginal resource projects, such as the Olympic Dam expansion, has impacted confidence. However there is still a large pipeline of resource projects under construction to be completed over the next few years, with over 80% of these in the booming LNG (gas) sector. Sydney is likely to see a very gradual decline in vacancy from here, although this is initially a function of supply constraints rather than demand. The long awaited recovery in the Sydney office market will lag improving employment conditions in the banking and finance sectors, which will be signalled by stability (and then recovery) in the global equities markets, while vacancy rates in Melbourne will rise in the near term, due predominately to excess supply.

The industrial sector continues to be impacted by the two-speed economy, with the traditional industrial sectors such as manufacturing and wholesale/retail trade struggling, meanwhile the mining and engineering sectors remain relatively robust. The logistics sector is also benefiting from the strong $AUD (assisting growth in imports notwithstanding a cautious consumer) and the increase in online retailing is also driving logistics demand as requirements from freight forwarders continue to grow and fulfilment stores are also likely to become increasingly more common place.

EMPLOYMENT GROWTH BY INDUSTRY SECTOR:
TOTAL GROWTH SINCE 2003



*Public Sector, Education & Health

Source: Knight Frank, ABS

Property Market dynamics

Recent benchmark CBD office sales that have occurred have implied a degree of yield compression for "trophy" or newly constructed prime, passive assets. In Sydney, the recent internal transfer sale of 126 Phillip Street (6.35% core yield) implied up to a 50 basis point tightening in prime CBD yields since the peak in the yield cycle in late 2009. Similarly in Melbourne, the recent "fund through" sale of 150 Collins Street (6.75% initial yield on completion), also provides further evidence of a tightening in yields for prime CBD assets.

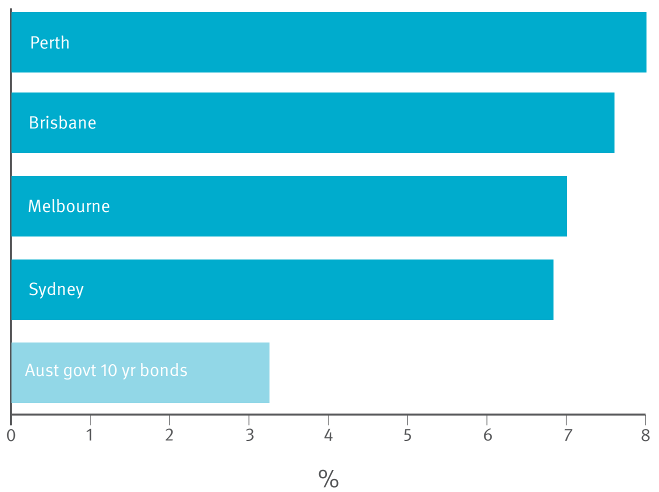
Some secondary and suburban asset yields have the potential to remain soft as the depth of purchasers remains thin relative to prime, passive assets and investors generally price in slightly higher risk. This has presented opportunistic buying and we expect syndicates, wholesale investors and private investors to increasingly seek high yielding secondary CBD and/or suburban assets as they represent good relative value.

The industrial sector is going through a structural change with the likes of Stockland (AREIT) and various wholesale funds such as AMP and Colonial divesting their non-core industrial assets and reweighting their portfolios to other sectors. At the same time groups such as Goodman (the only pure AREIT industrial owner left), GPT, DEXUS and Australand are focusing even more attention on the sector via acquisition and growing their development pipelines. As domestic demand picks up and investor interest continues, we expect prime industrial cap rates will firm in 2013, with the most highly sought after precincts being those in close proximity to the main capital city ports and road infrastructure.

Secondary industrial assets will remain generally soft over the coming 12 months, as occupiers continue to seek modern, well located properties. There will be pockets of stress, which will be exacerbated by the recent and ongoing weakness in the manufacturing sector, with many of the older style facilities located in the traditional inner industrial precincts likely to be vacated over the medium term.

Whilst the macro drivers of the economy and capital market conditions may allude to minimal cap rate tightening in the near term, the longer term historical data suggest a tightening bias over the medium to long term. With the spread between real bonds and current property yields being at historical highs, the cost of debt continuing to fall and yields remaining above their longer term average, we expect cap rates, especially in the office and industrial sectors, to have a firming bias over the next 12-18 months.

AUSTRALIAN PRIME OFFICE YIELDS VERSUS 10 YEAR GOVERNMENT BONDS



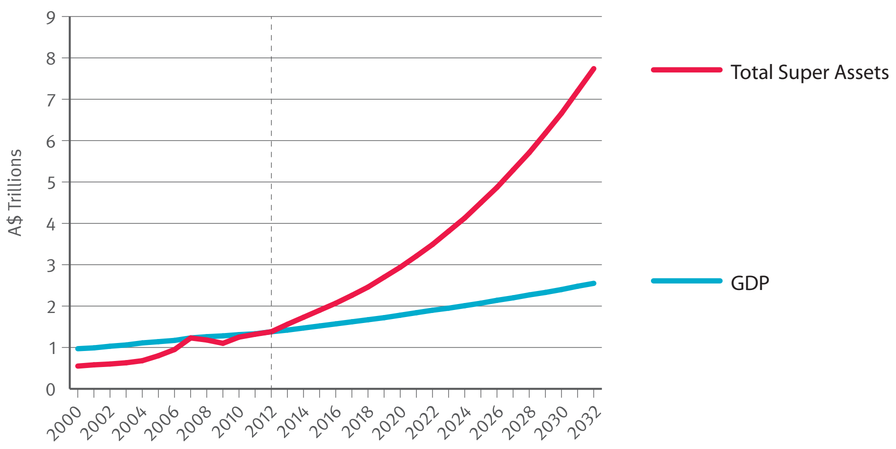
Source: RBA, Knight Frank Research

AUSTRALIA

Superannuation Funds

Total estimated assets, which include the assets of self-managed superannuation funds, rose by $47.4 billion (3.6 per cent) to $1.38 trillion over the 12 months to March 2012 (APRA) or around 100% of GDP. There are 230 major super funds (>$50 million in assets) in Australia. The largest sector by asset value is the Retail funds sector ($373 bill), followed by Industry funds ($259 bill), Public Sector funds ($209 bill) and Corporate funds ($54 bill), with the balance of superannuation assets being predominately held by Self-Managed Super Funds (SMSFs).

AUSTRALIAN SUPERANNUATION ASSETS VS GDP: 2000 TO 2032 (FORECAST FROM 2012)



Source: Knight Frank, APRA, Rainmaker (projections)

Superannuation assets are expected to more than double by the end of this decade and projected to grow more than five-fold by 2032 to reach $7.7 trillion (9% per annum growth). Assuming GDP growth of circa 3%, this would see super assets increase from 100% of GDP to over 300% of GDP over the next 20-years.

With Australia having the largest pool of funds under management in the Asia-Pacific region, and the 4th largest in the world, this growth in superannuation assets will be a direct driver of the funds management industry in the future. A large portion of super money is also invested directly, including into property, which will see an increased flow of capital into the sector. Assuming an ongoing 10% allocation to property, super funds will become an increasingly important player in the transactional market over the medium to long term.

Overseas Investor Demand

Australian CBD office transactions sales activity has been relatively subdued over the first 9 months of 2012 when compared with the very active 2011 calendar year, with Knight Frank data showing investment activity totalling $3.09 billion from 41 transactions (over $10 million) to the end of September. After making up 36% of all CBD transactions in 2011 (and 50% in both Sydney and Melbourne), offshore investors took a slight pause in the middle of this year; acquiring 27% of all CBD sales driven predominantly by Brisbane (29% of deals) and one major sale in Canberra to CIMB Trust. Offshore investment was dampened slightly due to three main factors: the volatility but persistently high $AUD, the global economic uncertainty and undoubtedly the sudden change to the MIT tax regime (increase in withholding tax from 7.5% to 15%), which was announced in May following the Federal Budget.

This sentiment has changed significantly over the past quarter, with overseas investors once again trawling the market for large, prime CBD assets, which have been favoured by offshore groups and there is now evidence that they are prepared to look at more core plus, value-add opportunities also, the most recent being the acquisition of 6 O'Connell Street, Sydney for $105.1 million by MGPA Asia Fund III. We expect investment demand from offshore groups will continue to build, however 2012 also saw domestic listed groups return to acquisition mode, with recent purchases by Investa (IOF) in Perth, Growthpoint in Brisbane and Canberra, DEXUS in Melbourne, Brisbane and Sydney and Commonwealth Property Office Fund (CPA) in Brisbane. This is expected to be the first of a number of domestic AREIT purchases in the office market across the major capital cities, as the lower cost of capital allows these investors to return to the market and make purchases which are income accretive for their shareholders.

Online Retail implications

The growth in online retailing as a percentage of total retail spending has had a significant impact on both the retail and industrial sectors in recent years. Retailers and retail landlords have needed to adapt to this structural change and further strategic planning will be required to drive their relative success in the years to come. On the other side of the equation, this structural shift is creating demand from transport companies servicing online purchases from both domestic and off-shore retailers. Even the "leakage" of retail spending overseas which Australian retailers are currently rallying against, will actually be a positive influence for industrial/logistics courier operators.

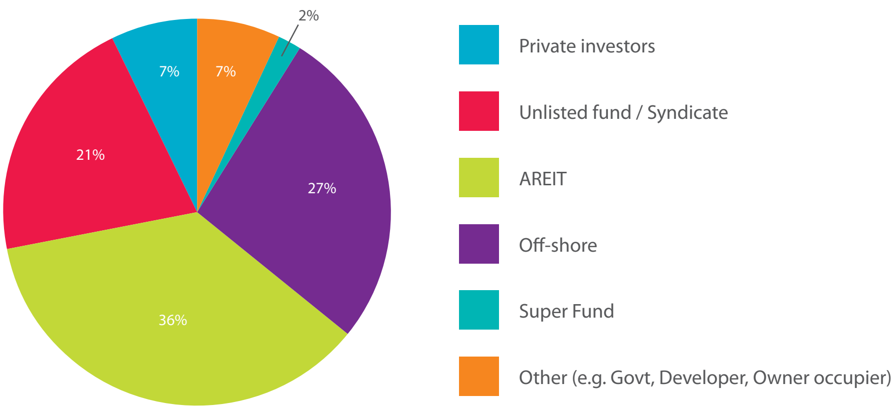
The retail and logistics sectors have been the major drivers of demand in the industrial market over the past 12-18 months. Major retailers such as K-Mart, Coles, Woolworths and Metcash and logistics operators such as DHL, Toll, Linfox and QLS have leased or pre-committed to major industrial facilities on the eastern seaboard.

The strong $AUD will continue to make imports attractive, fuelling demand for distribution centres and warehouses. Internet retail sales have been rising rapidly in Australia, recording growth of 23% over the year to September, but still only account for 5.5% of the traditional retail sector, (compared with the UK which is over 8.0%). As online retailing in Australia continues to mature, some economists expect this market share as a proportion of total retail sales to reach 10% within the next 5 years.

Another interesting trend that could emerge in Australia is what is referred to in Britain as "dark stores" which are essentially superstores exclusively to service online orders and have no physical customers. Shopping giant Tesco and Asda have a number of these superstores in the UK. In Australia, most retailers still service orders from existing stores, but in time there may be a trend towards large big box sites that only cater for online shopping orders.

Opportunities will arise in Australia for industrial landlords/developers over the next few years to capture this shift to online retailing, even if the $AUD does revert back to mean over this period. The share of online spend as a percentage of total retailing will continue to increase, and not only do the retailers and retail landlords have to continue to adapt, but the industrial players can capture the demand that will come from transport and logistics groups, select large occupiers and of course the major retailers.

AUSTRALIAN CBD SALES TRANSACTIONS - ›$10 MILL: 2012 CALENDAR YTD BY PURCHASER TYPE



Source: Knight Frank Research

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