

# Investment Outlook for 2010

ING INVESTMENT MANAGEMENT

## Global Property Securities

January 2010

As we enter 2010, we believe that the worst of the economic downturn is behind us. In this report, we review key themes that will impact earnings expectations and investment returns for Global Real Estate Investment Trusts (REITs) over the next 12 months.

### KEY MARKET THEMES

#### Earnings growth to resume

Even though occupancies and rents may remain soft in 2010, fundamentals are expected to firm in 2011. The residual effects of earnings dilution from equity issuance in 2009 and soft fundamentals will put pressure on earnings in the US, Canada, the UK and Australia. However, the effect on underlying cash flows is often lagged relative to changes in the economy because of leasing contracts which determine underlying cash flows. As such, we project real estate company earnings to decline only 2-3% in 2010. We think the market will focus more on the prospects of more normalized growth for listed real estate companies of between 6- 7% in 2011 with potential upside, should investment opportunities transpire for well-capitalised companies. We forecast total returns of between 5-15% in 2010, supported by dividends yielding approximately 4%.

#### Dividends likely to grow in 2010

We believe that dividends will be a core investment characteristic of the total return prospects for listed property companies. Dividends were right-sized last year as companies increasingly turned to internally-generated cash flow as the cheapest form of capital in a funding constrained environment. However, with improved capital markets and economic conditions, we expect listed property companies to restore dividends to levels that reflect their expected earnings. As a result we expect dividends to grow in 2010 despite our forecast for modestly declining earnings.

#### Rising interest rates should not be feared

Listed property companies have demonstrated the ability to achieve a positive total return during periods of interest rate increases. We believe that property companies have the capacity to outperform during periods of rising interest rates as long as investors believe the negative effects of rising interest rates are more than offset by the positive effects of economic growth.

#### IPOs and equity raisings to continue

Property company management teams are typically effective at looking at future opportunities and should not disappoint this economic cycle. We believe there will be a shift away from defensive and expensive dilutive capital raisings aimed at improving balance sheets towards opportunistic capital raisings designed to improve a company's capacity to take advantage of growth opportunities. We also see a meaningful pipeline of IPO activity coming to market this year.

#### M&A appetite is likely to increase

The spread between valuations of some public companies is large enough to stimulate possible public-to-public takeover activity. As implied cap rates have reverted to long-term historical averages and are well above current debt costs, acquisitions done with much lower levels of debt might also begin to emerge at present valuation levels. The impact of this weak economic cycle may force marginal owners of real estate to leave the market. The stronger surviving real estate companies are likely to become opportunistic buyers capitalising on the distressed forced sellers. This should lead to outsized earnings growth and attractive total returns.

### REGIONAL OUTLOOK

We expect relative outperformance from Asia and the UK in 2010. We are more cautious on America and Continental Europe, based on their current valuation levels. In Asia, we believe that Hong Kong-based property companies which specialise in Mainland China will outperform based on continued strong demand. We believe that Japanese property companies have reached attractive valuations after underperforming in 2009. We remain cautious on development companies in Hong Kong and Singapore, which we believe are fully valued. In Europe, we prefer the UK over the Continent. London is entering the sweet spot of yield compression versus the Continent, which is lagging. We like property companies in the Americas for a healthy balance between yield and growth but believe that valuations merit some scrutiny.

ING Investment Management (INGIM) utilises the security selection skills of ING Clarion Real Estate Securities (ING CRES) for its Global Property Securities portfolios. Investors seeking further information about investment opportunities regarding global REITs should contact INGIM.

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# ASIA-PACIFIC

## Hong Kong

### Macroeconomic

Hong Kong's GDP growth is projected to rebound to the 6% range in 2010 from approximately -3% in 2009 as Asia responds to improving economic conditions globally via increased exports and increased domestic demand. Economic growth out of Mainland China should continue to be underpinned by fiscal and monetary stimulus.

### Property Markets

Property values in Hong Kong, both commercial and residential, are rebounding from a 20-30% peak-to-trough drop in value. Residential values have regained most of this drop while office rents and values are just beginning to turn the corner. As such, we increasingly favour office over residential and continue to favour retail, based on resilient demand from Mainland Chinese tourists. We are cautious on property markets in China in the short-term as the result of regulatory risk out of Beijing but remain positive longer term as a result of continued urbanisation trends.

### Valuation

Stocks were up significantly in 2009 and now trade at an approximate 11% discount to our estimate of private real estate valuations (NAV). This compares to a long-term average discount in the 18% range. Earnings growth among property companies remains highly dependent on development profits and is expected to be in the 15% range in 2010. We believe that companies focused on Mainland China have more potential upside than those focused on Hong Kong.

### Other

The Central Government in Beijing plays an active role as a catalyst or dampening the property sector, which will bring volatility to an otherwise healthy demand/supply relationship.

### Total Return

With projected earnings growth in the mid-teens and dividend yields in the 2-3% range, we expect Hong Kong/China property companies to outperform in 2010.

## Japan

### Macroeconomic

GDP is projected to rebound to 1.9% in 2010 from a nearly 6% decline in 2009. The Bank of Japan continues to fight deflationary forces with low interest rates and quantitative easing. The Bank of Japan is likely to keep interest rates low at their current level of 0.1%.

### Property Markets

Tokyo remains the strongest property submarket in Japan at the expense of regional cities. Residential fundamentals have been stronger than office in 2009 supported by expanded tax-relief on residential transactions introduced by the government. Tokyo remains among the world's largest office markets and office vacancy rates in Central Tokyo are approaching historical highs in the 8% range. However, they are expected to peak during H1/10, which should test the historically high correlation between office vacancies and listed property company performance.

### Valuation

Japanese property companies are trading at an approximate 20% discount to NAV, which represents reasonable value relative to historical relationships to NAV. With office markets projected to reach an inflection point in 2010, we expect property companies to outperform. Average dividend yield for the J-REOCs is 1.2% versus the yield on the 10-year bond of 1.3% whilst J-REIT dividend yields average 5.9%. Both are well above long-term average relationships to the yield on the 10-year bond.

### Other

Equity issuance by property companies has recently increased as companies repair balance sheets and position themselves for external growth. Internal growth remains tepid as office rents remain flat to negative. More J-REIT M&A transactions are expected as smaller companies seek to strengthen corporate credit by merger or replacing the corporate sponsor.

### Total Return

We project a 5-10% total return for real estate companies over the next 12 months, consisting primarily of capital appreciation for J-REOCs and of dividend yield for J-REITs.

## Singapore

### Macroeconomic

Singapore's economy is expected to rebound in 2010 to a projected 5-6% range after contracting approximately 2% in 2009.

### Property Markets

Residential property outperformed office markets in 2009 as office rents declined over 40% versus residential values, which increased in the 5-10% range. With a bottoming of rents currently underway, we are increasingly positive on the office sector as rents approach an inflection point. New office supply in 2010 and beyond remains a concern although new casinos, plus increased visibility to the pre-leasing of Marina Bay Financial Centre, should mitigate some of the supply overhang.

### Valuation

Singapore property companies are trading at an approximate 10% premium to NAV after significantly outperforming in 2009. Average dividend yield for REOCs is 1.3% versus a yield on the 10-year bond of 2.7%, which is in-line with the historical spread. The average dividend yield for S-REITs is 6.1%, which is well above the historical spread.

### Other

Singapore property companies include pan-Asian platforms, which offer better long-term growth prospects than companies focused solely on Singapore proper.

### Total Return

We expect S-REITs to generate a 5-10% total return over the next 12 months, anchored by the dividend yield. Operating company performance will depend on continued earnings growth, which has increasing headwinds. We expect a 0-5% total return for the operating companies as earnings multiples contract.

# EUROPE

## Australia

### Macroeconomic

GDP growth is projected to increase from 1% in 2009 to the 2% range in 2010 as the Australian economy continues to improve. The unemployment rate has improved and stands between 5.7-5.8%. The strength of economic growth has led to the Reserve Bank of Australia to raise interest rates by 75 bps over the last few months to 3.75%. We expect further interest rate rises throughout 2010 as the economy improves.

### Property Markets

We believe office and industrial property are at a turning point. Evidence is growing of office rents bottoming after almost a 30% peak-to-trough correction in prime rents in Sydney and 10% in Melbourne. Industrial landlords should benefit from limited new supply and higher than average growth of Australian and Asian economies. Residential property should continue to rebound in-line with the economy, though it could face the headwinds of higher mortgage rates. Retail fundamentals have remained resilient throughout the downturn but rental growth is not likely to return to peak levels.

### Valuation

Valuations are an attractive 5% discount to NAV versus the long-term average. Dividend yields are roughly 5.6%, in-line with the 10-year bond yield of 5.6%. In comparison to the long-term historical spread of +90 bps in dividend yields, this reflects a more conservative payout policy being adopted.

### Other

Australian REITs have undergone a dramatic recalibration of business models, balance sheets and dividend policies in 2008 and 2009. They are now positioned for growth as they balance growth (through acquisitions or development) with capital recycling to improve shareholder value.

### Total Return

We expect a total return of 10-15% over the next 12 months, consisting of a dividend yield of 5-6%, with expanding multiples as the NAV discount closes and expectations of positive earnings growth looking out 1-2 years.

## Continental Europe

### Macroeconomic

Economic growth in the Eurozone is projected to rebound from negative 4% in 2009 to the 1-2% range in 2010. The European Central Bank is expected to maintain accommodative fiscal policies for the intermediate future.

### Property Markets

We prefer retail and industrial over office and residential. By geography, we prefer Western and Northern Europe over Eastern and Southern Europe. We are also biased towards companies based in France, Norway and the Benelux countries, many of which are pan-European.

### Valuation

Valuations are attractive at an approximate 5% discount to our estimate of underlying real estate value (NAV). Average dividend yield of 5.9% compares favourably to the yield on the 10-year bond of 3.6%. This spread in yield is significantly above the long-term average of -130 bps. Yield compression is occurring among better located and higher quality properties, particularly in France and the Nordic countries.

### Other

We prefer companies with strong balance sheets that have access to equity and debt markets, with firepower for potential acquisitions as a source of earnings growth. We continue to avoid companies with poor disclosure and/or corporate governance issues, particularly in the German-speaking countries.

### Total Return

We expect a 5-10% total return over the next 12 months consisting of a dividend yield in the 5-6% range, constant multiples and flat to modestly positive earnings growth both in 2010 and 2011.

## United Kingdom

### Macroeconomic

GDP growth is set to rebound from -4.6% in 2009 to the 1-2% range in 2010 as the UK economy continues to demonstrate its above-average sensitivity to economic change. The Bank of England has moved aggressively in lowering policy rates, now at a post-war low of 0.5% and is expected to keep rates low until economic recovery proves to be sustainable.

### Property Markets

Sentiment in London has turned from extremely negative a year ago to somewhat positive. Yields have compressed by about 150 bps from the trough just 9 months ago and the IPD index (the bellwether private market index) has been positive for several months. Rents continue to be soft but appear to be bottoming. We prefer office and industrial over retail and residential.

### Valuation

Property companies are trading at an approximate 9% premium to our estimate of fair value NAV, which is above the long-term average. However this represents reasonable value at this stage of the cycle, with asset values so close to their trough levels. Average dividend yield of around 4% compares to a 10-year bond yield of 4.0%. This zero spread is significantly above the long-term average spread of -260 bps, which reflects in part the adoption of the REIT structure in the UK three years ago.

### Other

The UK property market is characterised by long leases (10-15 years) which remain favourable to the landlord, a tight planning regime and a high proportion of long-term fixed rate debt, which effectively matches assets with liabilities. UK property companies have largely adapted to the REIT structure, in place since early 2007, and are increasingly offering attractive yields in addition to prospective capital appreciation.

### Total Return

We expect a 10-15% total return in 2010 consisting of dividend yields in the 4% range, expanding earnings multiples and positive earnings growth looking out 1-2 years.

# NORTH AMERICA

## United States

### Macroeconomic

GDP growth should improve from -2 to -3% in 2009 to around +2-3% in 2010 as the economy continues to improve. The US Federal Reserve is expected to maintain an accommodative monetary policy with a target Fed Funds rate of nearly zero (0-0.25%). The US economy will likely rebound at a more sluggish rate than from previous recessions, but nonetheless will return to growth.

### Property Markets

We favour dominant regional malls and industrial companies over cyclical property such as office, healthcare and shopping centres. We are warming to apartments as improvement in the economy could improve rental demand.

### Valuation

US REITs are trading at ~15% premium to NAV - consistent with this stage of the property cycle. US REITs currently have an average dividend yield of 4.4% versus the 10-year US bond yield of 3.8%. This spread between yield is modestly tighter than the long-term average of 110 bps.

### Other

US REITs have successfully repositioned balance sheets with over US\$21 billion of equity and over US\$10 billion unsecured debt raised in 2009. Companies are increasingly positioned to take advantage of potential acquisitions.

### Total Return

We expect a total return of 5-10% in 2010 consisting of a dividend yield of 4-5%, constant to modestly contracting earnings multiples, and expectations of positive earnings growth looking out 1-2 years.

## Canada

### Macroeconomic

With projected 2010 GDP growth of 2-3% (from -2% to -3% in 2009), the economic rebound looks to be comparable to its southern neighbour, the US. The nature of the downturn, however, was more shallow than the US given the more favourable supply/demand balance for commercial property in Toronto and other major urban markets. The Bank of Canada has remained accommodative in its monetary policy as its policy rate remains at 0.25%.

### Property Markets

Western Canada remains dependent on the commodity market and has stabilised. Toronto remains stable. Apartment rents remain regulated in most provinces and therefore, there is a degree of predictability.

### Valuation

Property companies trade at an approximate 15% premium to NAV versus a historic modest premium. An average dividend yield of 6.3% is well above the 3.6% yield on the 10-year bond and above the historical spread. Dividend yields are well above the global average and remain attractive for an investor seeking income.

### Other

Regulatory announcements are being refined to leave REIT business models largely intact, although hotel and health care REITs will have to make structural changes by 2011.

### Total Return

We expect a total return of 0-7% over the next 12 months consisting of a dividend yield in the 6% range, constant to modestly contracting earnings multiples and flat to modestly positive earnings growth looking out one year plus.

## About ING CRES

ING Clarion Real Estate Securities (ING CRES) is a registered investment advisor specialising in the management of equity real estate securities. ING CRES is the real estate equity management arm of ING Real Estate, the global real estate business within ING Investment Management. ING CRES has offices in the United States, the United Kingdom, Hong Kong and Japan and has been managing investments in real estate securities for institutional investors since 1984.

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