

## Overview

- Listed real estate companies delivered strong returns across all regions in December, after a somewhat shaky October and November. This led to an annual performance of 30.5% (fully hedged to AUD) for global REITs.
- Given the successful remediation of company balance sheets, ability to access capital in debt and equity markets and a return to earnings stability, we believe the bear market for real estate stocks has ended.
- Looking to 2010 we are confident that real estate fundamentals will continue to improve. However, we are cognisant of the fact that occupancies and rents may remain soft until 2011 and that the market will experience low levels of new construction.
- Listed real estate often delivers positive returns in periods of economic improvement, which should underpin investor appetite in this asset class.

December 2009

FOR PROFESSIONAL INVESTORS ONLY

ING INVESTMENT MANAGEMENT

# Global Property Securities Update



## Market review

### Global Property Securities Performance – 31 Dec 2009

Region	Dec Return %	Quarterly Returns 2009 %			
		Dec	Sep	Jun	Mar
Americas	7.4	10.0	34.4	29.2	-32.8
Asia Pacific	5.7	2.5	10.4	20.8	-2.7
Europe	4.0	3.3	35.8	16.6	-15.7
<b>TOTAL</b>	<b>6.2</b>	<b>7.1</b>	<b>31.0</b>	<b>24.4</b>	<b>-24.3</b>

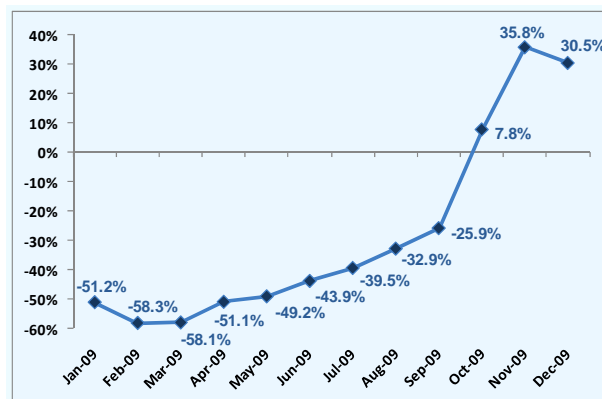
Returns are UBS Global Investors Ex-Australia Total Return Index (Gross) and hedged to AUD. Note: Asia Pacific excludes Australia.

We believe that the bear market for real estate stocks has ended. We noted a year ago in our 2009 outlook that the bear market for real estate stocks was as deep and long as any of the previous declines in real estate stocks, surpassing any of the draw-downs in the last 15 to 20 years, including the early 90s when real estate went through what some have labelled a depression for our industry. As with past bear market periods, REITs have avoided experiencing three consecutive calendar years of negative returns.

After a tough start, real estate stocks recovered strongly. Our forecast for -5% to +10% returns a year ago proved too conservative. We correctly predicted that “when (not if) the economic outlook improves and the debt markets show some return to normalcy real estate stock prices will show some meaningful improvement”. At the start of 2009 we were unable to predict if improved sentiment would occur within calendar year, though we felt confident it would take place within 12 to 24 months.

We correctly predicted that volatility would persist in the first half and that investors’ expectations for real estate would likely remain pessimistic. During the first quarter, real estate stocks fell 33% before bottoming in early March. In hindsight, we underestimated the speed of the recovery as global real estate stock indices provided returns in excess of 30%.

### UBS Global Real Estate ex Australia (Hedged) Rolling 12 Month Return



Source: ING Investment Management

Three major factors contributed to the turnaround and rally of listed property companies. Firstly, property companies moved decisively to repair their balance sheets as companies raised material amounts of equity. The equity raisings were generally well supported given the cheap valuations and began in earnest during the first quarter in Australia and the UK, and then during the second quarter in the US.

Secondly, debt markets began to open up for property companies due in part to the equity raisings, but also as a result of broader credit market improvements. In particular US listed property companies began to access unsecured debt in the capital markets. Spreads tightened materially during the second quarter and the required interest rates on unsecured debt dropped significantly. Many property companies also sold properties as an additional source of capital. The balance sheet repair and refinancing of debt continued during the second and third quarters.

Thirdly, the rally in property stocks came as investors turned their attention to potential acquisitions. With newly repaired balance sheets, listed property companies were correctly perceived as being able to potentially take advantage of “buying opportunities” should attractively priced real estate be brought to market. In hindsight, the improvement in sentiment during the year has been stunning in its speed but, in some respects, unsurprising given the pattern of past recessions and recoveries.

### The economic outlook improved

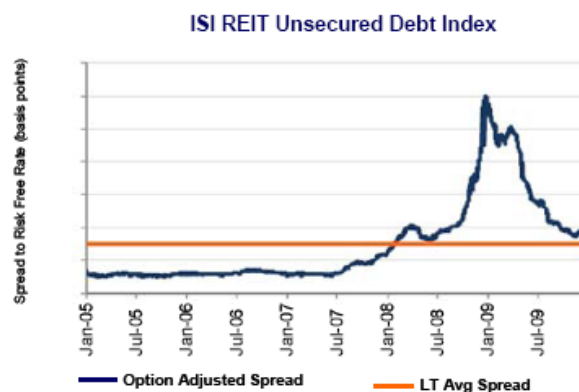
We entered the year with considerable uncertainty in the forecast for the economy and debt markets. Economic conditions began to improve and most developed countries began to emerge from the worst recession in decades by the end of the year. Recent indicators show that an economic recovery is underway, although it is still hard to determine the strength and sustainability of the recovery. However, GDP numbers over the past six months have generally surprised to the upside.

Growth in the Asian region has been particularly robust. China’s economic growth accelerated to an annualised rate of 8.9% during the third quarter compared to the same quarter the prior year and versus 6.1% and 7.9% during the first two quarters of 2009, respectively. By the end of September, Singapore had revised its GDP growth forecast range for 2009 to -2.0% to -2.5% from the previous forecast range of -4% to -6% and finished the year closer to -2.0%.

The outlook for global economic growth has improved over the course of the year. Compared to projections made at 31 March 2009, ING Economics’ forecast for global GDP growth for 2010 and 2011 has improved by 270 basis points and 200 basis points, respectively, to 3.0% and 3.4%, reflecting a return toward long-term trend levels of economic growth. Central Bank policy has started to tighten in certain geographies (such as Australia) as growth prospects improve. Sentiment toward property stocks has improved as the market correctly anticipates that economic growth will eventually translate to greater demand for real estate.

### Debt market recovery has been an important driver of real estate securities returns

The rapid recovery of the debt markets was an important driver of real estate securities’ returns. One of the more dramatic developments during the year was the speed at which the world’s credit markets recovered from last year’s financial crisis, which had a direct bearing on real estate asset values and proved a stimulus to real estate stock prices. The timing and extent of this recovery can be seen via the improvement in spreads in the US unsecured debt market as shown in the following chart.



Source: Bloomberg, ISI Real Estate Research

US mall giant, Simon Property Group (SPG), serves as an example for how quickly this market improved. In late March SPG helped to re-open the unsecured debt market by successfully issuing US\$650 million of unsecured 10-year debt with a 10.75% yield to maturity. This marked the first debt issuance by a US real estate company from a post-crisis standpoint, but was achieved at a high cost of capital. SPG followed up with an additional US\$600 million in May with a 5 year unsecured debt at 7.0% yield to maturity as spreads had improved dramatically. In July, SPG re-opened its unsecured bond deal issued in May with an aggregate US\$500 million issuance at a 5.5% yield to maturity. Therefore, SPG’s spreads improved by over 400 basis points over the course of four months.

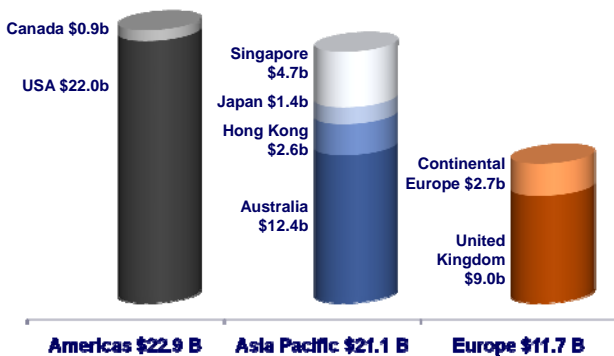
Spreads for 5 and 10 year unsecured debt in the US currently reside in the 250 to 300 basis point range. More broadly, over US\$10 billion was raised among US real estate companies via the unsecured debt markets in 2009.

In Europe, companies tended toward convertible debt deals with tight spreads. For example, in August Dutch-based Wereldhave issued a 5-year €230 million unsecured convertible debt with a 4.375% coupon (150 basis point spread to the five-year swap rate at time of issuance) with a strike price 15% out-of-the-money. As with the pattern seen over the past several years, the debt markets during 2009 appeared to be leading the equity markets.

## Equity raisings helped drive expansion

Equity capital raisings were significant during the year, driving multiple expansion. Over US\$55 billion of equity was raised over the past 12 months. The breadth and scale of the equity raisings was surprising as many more companies were able to raise equity than we believed possible. The negative aspect of balance sheet repair was earnings dilution since most of the equity was raised at a discount (i.e., higher yields and lower valuations than the underlying real estate owned by the companies). However, the dilution was often more than offset by the increase in stock prices that resulted as companies removed the threat of insolvency and bankruptcy. Particularly active geographies included the US, UK, Australia and Singapore. The chart below shows equity raisings by region over the course of 2009.

**Global Equity Raised by Listed Property Companies in 2009  
(Total \$US55.7 Billion)**



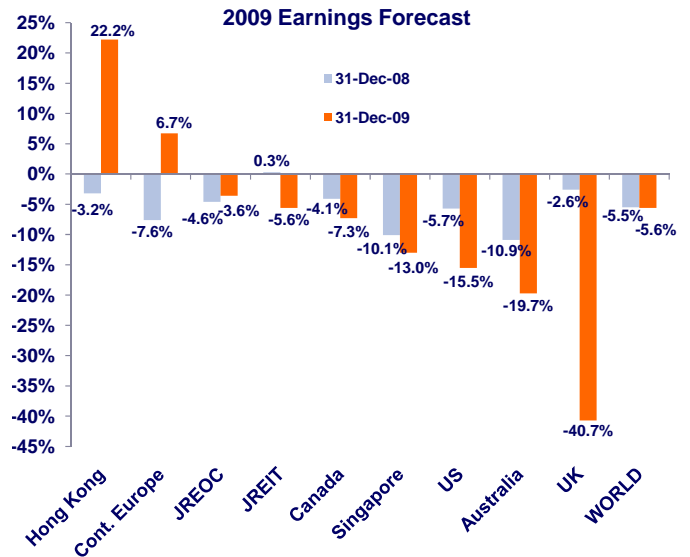
Source: ING Clarion Real Estate Securities

## Earnings stability supported the recovery

Earnings were surprisingly stable and revisions explained much of the performance variation across regions. Overall global property stock earnings came in close to our expectations. We had forecast a -5.5% weighted average decline, which we now expect will come in at -5.6%.

Earnings came in better than expected in Hong Kong and Continental Europe, which were two of the best performing regions for 2009. Canada and Singapore were also better performing regions and had less dramatic negative revisions to earnings growth. With the exception of Japan, the worst performing regions were those with the most negative revisions to earnings growth. In the US, Australia and the UK, much of the decrease was the result of dilutive equity issuance. This was often offset by significant multiple expansion, However, these three regions still underperformed the market for the year.

Dilutive equity issuance was especially severe among the UK property companies, many of which had issued significant equity at 40% to 50% discounts to underlying real estate value in February-March, which in hindsight probably marked the bottom of the credit crisis.



Source: ING Clarion Real Estate Securities as at 31 December 2009

As a result of the dilution, the decline in projected cash flow per share overstates the weakness in underlying property fundamentals, which are soft but not as bad as the earnings numbers suggest.

## Volatility declined as confidence returned

Real estate stocks showed an increase in volatility during 2007 and 2008, a characteristic shared with the stock market in general. Volatility remained high early in 2009 but decreased materially as the year progressed and uncertainty about the future dissipated. The rolling 30-day standard deviation of total returns for the S&P Developed Property Index is now close to 1% after peaking during the depths of the credit crisis about at approximately 4%. While current volatility remains above the long-term average (going back to 1989) it is well under peak levels. Two typically stabilising characteristics remain true of real estate stocks:

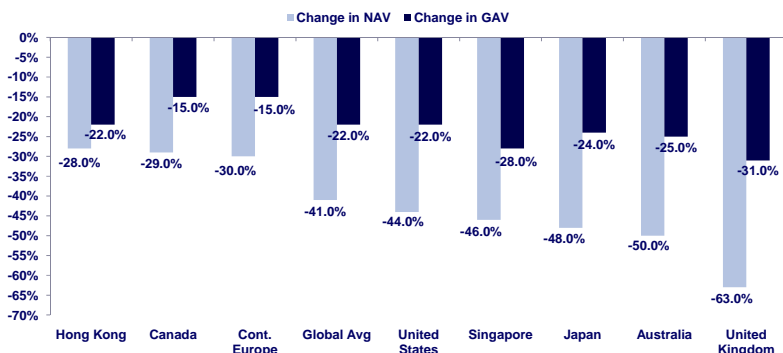
- (1) underlying core earnings remain fairly visible, and
- (2) dividend yields are higher compared to other equities on average.

We believe these characteristics will cause property companies to trade with lower volatility than they have during the period of market dislocation we have seen over the past few years.

## Property values have fallen

We estimate the decline in real estate asset values during this downturn to be about 30% peak-to-trough. After taking into account leverage (global property companies on average utilise leverage of approximately 40% debt to total assets), we estimate the decrease in equity value to be in the 50% range.

Projected Change in Real estate Asset Values Peak-to-Current



"We believe the decline in real estate values from peak to trough bottomed in the middle of 2009 and that values may be on the rise again."

Peak Cap Rate*	3.7%	6.5%	5.2%	5.0%	6.0%	4.0%	3.8%	5.7%	4.6%
Current Cap Rate*	5.1%	7.5%	6.3%	6.5%	7.6%	5.8%	5.2%	7.1%	6.3%

We believe the trough occurred mid-year 2009 but that values may be on the rise again. There are reasons to believe that commercial asset pricing has already begun to move higher. Transaction activity is picking up but is still at low levels compared to history. Yields have started to decline again as a result of a confluence of factors including an improvement in credit markets; an increase of equity capital seeking attractively priced real estate; a continued low interest rate environment driven with accommodative monetary and fiscal policies; and a general improvement in the economic outlook.

Potential buyers of property include listed property companies, sovereign wealth funds, newly-formed blind pools of investment capital (both listed and unlisted), well capitalised pension funds and private equity vehicles.

We estimate the global weighted average yield implied by the listed markets to be in the 6.5% range versus peak implied yields in 2007 below 5%. Additionally, appraisal-based yields in direct markets now have largely "caught up" to implied yields in the listed markets, which suggests the worst may be behind us. For example, in the US, direct property yields are currently 6.8% versus an implied yield of 6.9% for US REITs.

## OUTLOOK

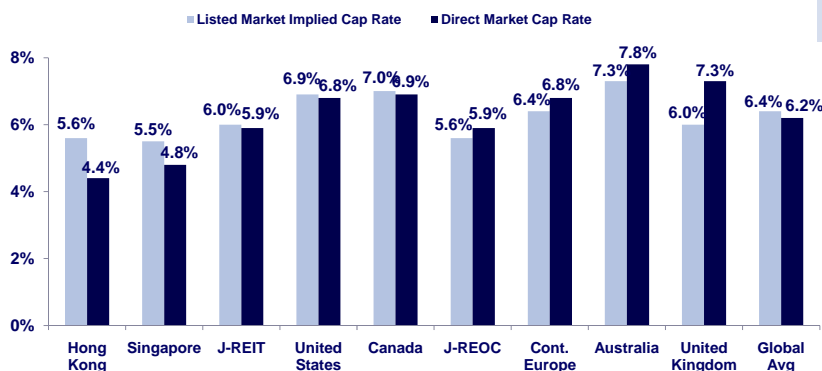
### Earnings growth to resume

The backdrop as we start 2010 is significantly better than a year ago. Economic growth is improving, though still fragile. Even though occupancies and rents may remain soft in 2010, fundamentals are expected to firm going into 2011.

Residual effects of earnings dilution from equity issuance and still soft fundamentals will put pressure on real estate company earnings in the US, Canada, the UK and Australia. However, the effect on underlying cash flows is often lagged and muted relative to changes in the economy because of the contracts/leases, which determine underlying cash flows.

As such, we project real estate company earnings to decline only 2% to 3% in 2010. More importantly, we think the market will increasingly focus on the prospects of a return to more normalized growth for listed real estate companies of 6- 7% in 2011 with potential upside, should an interesting investment environment emerge for well-capitalised listed property companies. We expect total returns will be in the 5-15% range in 2010, driven by steady and growing dividends yielding approximately 4%.

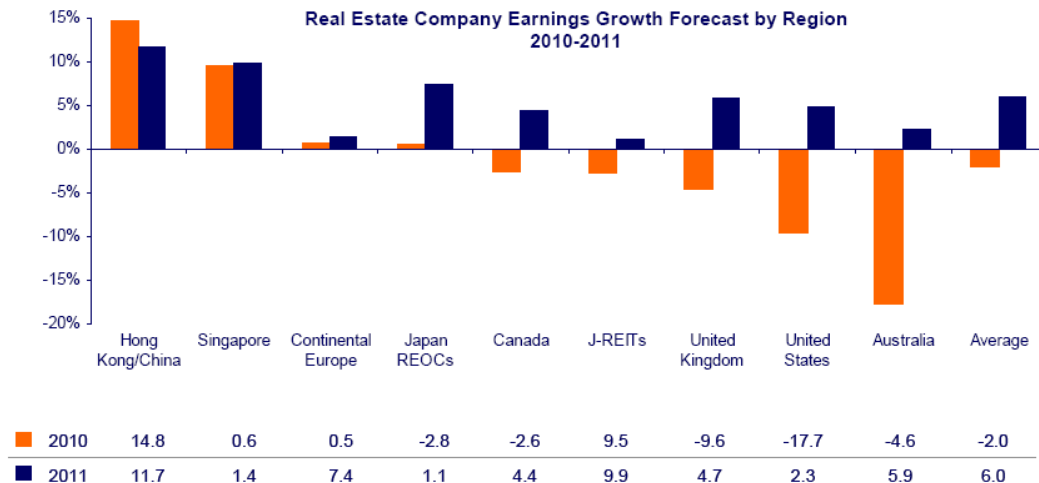
Projected Change in Real estate Asset Values Peak-to-Current



"Appraisal based yields in the direct property markets have largely caught up with listed property markets, which suggests the worst may be behind us."

Valuation Gap	-21%	-13%	-2%	-2%	-1%	5%	6%	7%	22%	-3%
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Source: ING Clarion Real Estate Securities and ING Real Estate as at 31 December 2009



Source: ING CRES as of 12/31/09.

We believe that the income component of total return via the dividend will return as a defining investment characteristic of the total return prospects for listed property companies. We also expect multiple expansion (i.e., stock price appreciation) as sentiment continues to improve during the year.

### Dividends are expected to grow

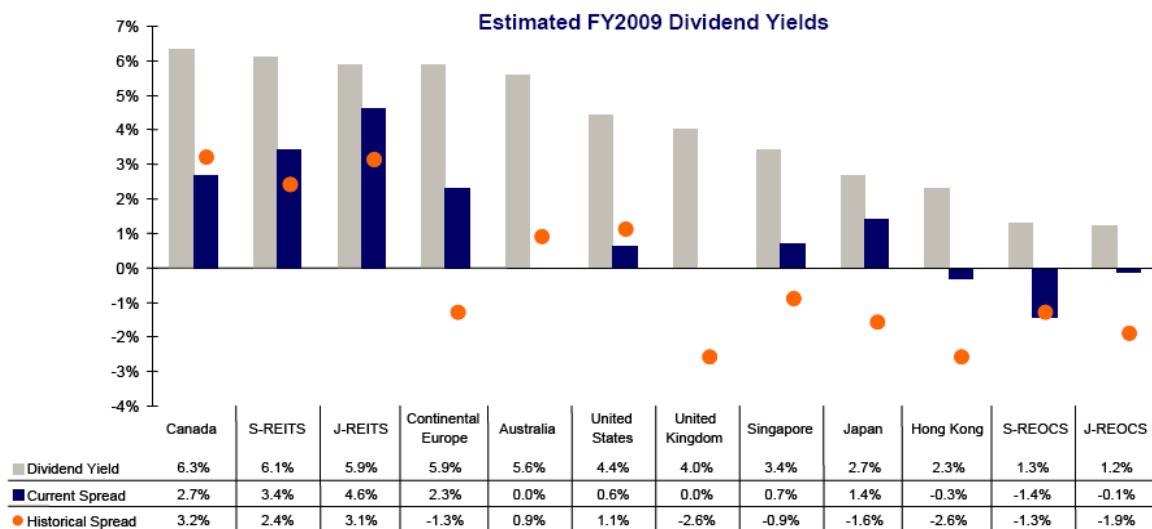
Dividends were right-sized in 2008 and 2009 as companies increasingly turned to internally-generated cash flow as the cheapest form of capital in an environment where capital remained scarce and expensive.

However, with improved capital markets and economic conditions, we expect these companies to increasingly restore dividends to levels that reflect their expected earnings. As a result, we expect dividends to grow in 2010 despite the forecast for modestly declining earnings.

Even before factoring in potential dividend increases, real estate stocks have offered attractive dividend yields relative to government bond yields. The yield spread of property companies to the yields on respective 10-year sovereign debt by country is still favourable despite the narrowing of spreads from the historically wide levels seen early in the year.

### Rising interest rates should not be feared

Listed real estate often delivers positive returns in periods of economic improvement. 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.



Source: ING CRES and Bloomberg as of 12/31/09. Not all countries included.

## IPOs and equity raisings to continue

We believe there will be a shift away from defensive and expensive dilutive capital raisings aimed at improving balance sheets and towards opportunistic capital raisings designed to improve a company's capacity to take advantage of growth opportunities.

The capital would most likely be put towards acquisitions and in some cases development and re-development projects. Property company management teams are typically effective at looking at future opportunities and should not disappoint this economic cycle.

Equity raisings will include IPOs. In 2009, we saw aggregate IPOs of property companies for the year of over US\$12 billion on a global basis. The trend is building and we see a meaningful pipeline of aspiring new listed real estate companies.

## M&A appetite is likely to increase

There is enough spread between valuations of some public companies 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.

Whether through M&A or liquidations, these difficult times will force the marginal owners of real estate from the market. Some owners may prove too leveraged or too weak to survive another tough real estate cycle.

We believe that the surviving real estate companies from this cycle are going to become some of the opportunistic buyers capitalising on the distress of forced sellers. This should lead to outsized earnings growth and attractive total returns.

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## Regional outlook

Within our global strategy, we expect relative outperformance in 2010 from the Asian region as well as the UK. We are more cautious on the Americas and Continental Europe, which are at valuation levels that merit some caution.

In the Asian region, we believe that Kong-based property companies that specialise in Mainland China will outperform based on continued strong demand emanating from the Mainland. This comes with the caveat that regulatory risk out of Beijing remains difficult to underwrite and that demand is fuelled partly by what some analysts view as excessive liquidity.

We believe that Japanese property companies have reached attractive valuations after underperforming in 2009 and that these companies will do at least as well as the overall benchmark return in 2010. Japanese property companies, however, continue to have few visible catalysts. 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 as 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. In the US, we favour the regional mall, industrial and apartment companies over the office, healthcare and the shopping centre sector. We may become more positive on the cyclical office and lodging companies on lower valuations.

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### About the Author

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