ANZ RESEARCH

AUSTRALIAN PROPERTY

AUSTRALIAN PROPERTY OUTLOOK

DECEMBER 2011

INSIDE

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UNCERTAINTY HIGH BUT FUNDAMENTALS SUPPORTIVE

OVERVIEW

The European debt crisis continues to destabilize financial markets and we see little hope of a workable resolution in the near term. The risk of a marked slowdown in China also weighs on market sentiment. Nonetheless, the key medium-term thematic for Australia remains the unprecedented surge in resource and infrastructure investment - although growth is likely to be increasingly 'two speed'.

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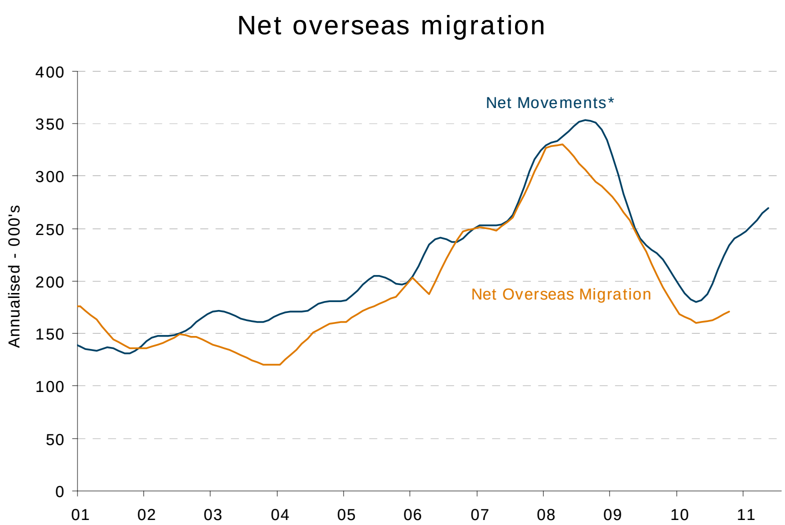
House prices have drifted lower in most capital cities and market sentiment remains weak. Declining auction clearance rates and rising days on market reflect the mismatch between buyer and vendor expectations. However, the absence of wide-scale 'forced' selling has, to date, protected measured price outcomes. While we expect prices to ease further into 2012, fundamentals support a cautiously optimistic medium-term house price view.

COMMERCIAL PROPERTY

The commercial property market is in the early stages of a multi-year cyclical upswing with rents set to rise strongly and yields to compress. A solid economic backdrop will underpin robust tenant absorption, while supply will be constrained by subdued developer sentiment and tight credit conditions. Low vacancy rates and elevated incentives present considerable upside to effective rents. Moreover, current yields belie the positive fundamentals and are expected to firm. The outlook, however, is not without risk. Considerable global uncertainties threaten economic and financial market stability and will continue to weigh on investor sentiment and property yields.

REBOUND IN NET ARRIVALS EXPECTED TO BOOST PROPERTY DEMAND



**Net permanent and long term arrivals*

Sources: ABS, ANZ

OVERVIEW

RISKS ELEVATED BUT AUSTRALIA TO CONTINUE TO OUTPERFORM

EUROPE ON THE BRINK

The European debt crisis continues to destabilize financial markets and we see little hope of a workable resolution in the near term. Coupled with US public debt issues, rising oil prices and concerns over Iran's nuclear program, European turmoil appears set to continue to drive ongoing market volatility that will weigh on asset prices and investor sentiment.

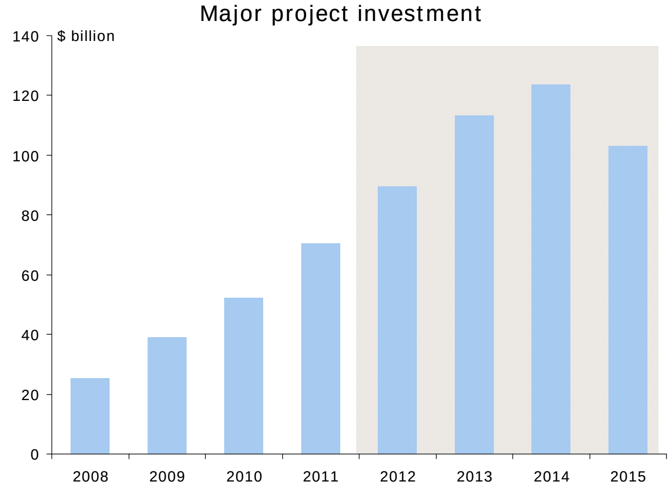
Notwithstanding weak growth prospects in Europe, the global outlook remains relatively sound with growth forecast at 3¾% in 2012 and 4½% in 2013 underpinned by rapid growth in China and the rest of developing Asia. While commodity prices have eased in recent months, investment-led growth in Asia is expected to ensure a continued solid backdrop for Australian exports and resource investment.

AUSTRALIA: INVESTMENT BOOM UNDERWAY

Despite a surge in business investment, Australian growth has slowed in 2011 led by reduced coal exports following the Queensland floods. Public demand has also slowed sharply as fiscal policy is re-tightened. Plus weak developer sentiment and falling house prices have weighed on dwelling investment.

However, the key medium term thematic remains the unprecedented surge in resource and infrastructure investment. The investment boom will lift aggregate growth back to trend and above in 2012 and 2013. While demand for skilled labour in construction, engineering and associated professional services will be strong, other sectors (including manufacturing and retail) are expected to remain subdued.

INVESTMENT BOOM TO DRIVE GROWTH



Sources: Access Economics, ANZ

The labour market holds the key to property market prospects. After softening this year, labour market conditions are forecast to strengthen into 2012/13.

HOUSING SUBDUED

House prices have drifted lower in most capital cities and market sentiment remains weak. Declining auction clearance rates and rising days on market reflect the mismatch between buyer and vendor expectations. However, the absence of wide-scale 'forced' selling has protected measured price outcomes. While we expect prices to ease further into 2012, we maintain a cautiously optimistic medium-term house price view supported by a robust economic outlook, limited forced selling, improved affordability and an ongoing tightening of the Australian housing demand/supply balance.

COMMERCIAL PROPERTY WELL PLACED

The commercial property market is in the early stages of a multi-year cyclical upswing with rents set to rise strongly and yields to compress. The office and industrial markets are particularly well placed.

A solid economic backdrop is expected to underpin robust tenant absorption, while supply will continue to be constrained by subdued developer sentiment and tight credit conditions. Low vacancy rates and elevated incentives present considerable upside to effective rents. Moreover, current yields belie the positive fundamentals and are (eventually) expected to firm, offering further upside to capital values. Conservative lending criteria and limited access to non-intermediated credit will restrict speculative development. This should avert the normal late-cycle speculative building boom and cap downside risks facing commercial property investors. Despite the strength of the Australian dollar, offshore investor interest in Australian commercial property remains strong. Favourable pricing and property fundamentals in Australia stand in stark contrast to the situation in much of the developed world and will continue to attract foreign capital.

The outlook, however, is not without risk. Considerable uncertainties in Europe, the Middle East, the US and China threaten economic and financial market stability and will continue to weigh on investor sentiment and property yields. Consumer restraint, reduced workspace ratios, employer caution and potential job shedding, all present significant risks to commercial property demand.

Nonetheless, our base case remains positive. Tight vacancies, limited capacity expansion and attractive yields will support growing investor interest and are laying the groundwork for a marked increase in valuations as rents rise and yields compress.

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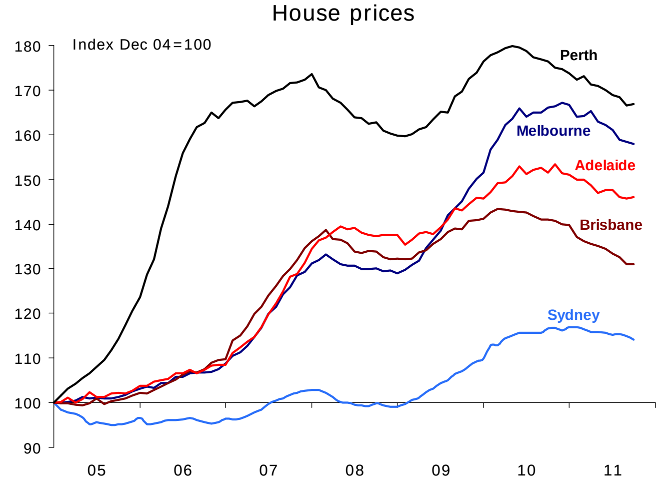
SENTIMENT TOXIC BUT FUNDAMENTALS STRENGHTENING

CONFIDENCE WEAK & PRICES ARE DOWN

Australian house prices have drifted lower in most capital cities over the past year reflecting increased stock for sale and weakened buyer sentiment. Economic and financial market uncertainty has been fanned by the European debt crisis, a slowdown in China and the threat of a renewed global downturn. This has combined with a marked slowdown in the domestic labour market to heighten concerns over job security. Furthermore, continued predictions of an imminent collapse in Australian house prices by some commentators have weighed on market confidence.

HOUSE PRICES HAVE FALLEN



Sources: RP Data-Rismark, ANZ

Initially, falls were concentrated in Perth and Brisbane and more recently Melbourne and Adelaide prices have declined. House prices in all these cities experienced outsized gains in earlier years and are now reverting to 'fair value'. Western Australia and Queensland are expected to lead the two-speed economy in the years ahead, and buoyant labour demand and rapid gains in household incomes will limit further downside to house prices and eventually drive them higher. However, the Victorian economy is forecast to slow sharply in 2012 placing further downward pressure on prices. Sydney home prices, in contrast, have been resilient, reflecting their softer run up in the past 7 years along with an unprecedented tightening of housing supply.

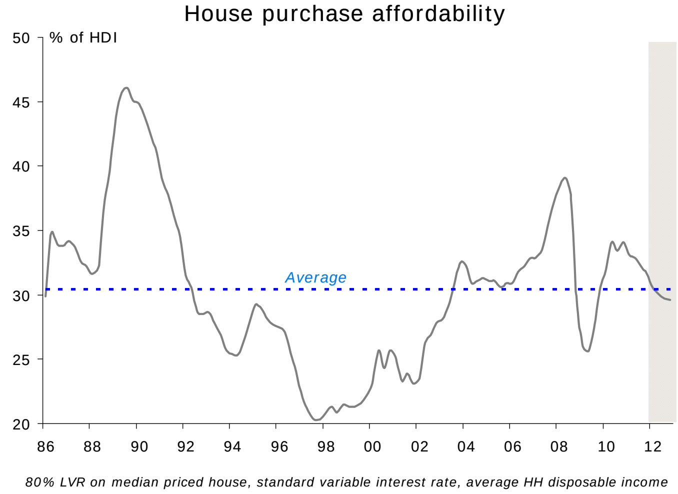
Declining auction clearance rates and rising days on market reflect the mismatch between buyer and vendor expectations. However, the absence of wide-scale 'forced' selling has, to date, protected measured price outcomes. Rising unemployment, however, presents a clear risk to loan delinquencies and house prices.

FUNDAMENTALS IMPROVING

While we expect prices to ease further in the 12 months ahead, we maintain a cautiously optimistic medium term house price view supported by a robust economic outlook, low unemployment, flat to falling mortgage rates, improved affordability and a further tightening of the housing demand/supply balance.

A combination of lower interest rates, falling house prices and rising household incomes has improved house purchase affordability. From a recent peak of 34% of income in 2010, average mortgage payments on the median priced home have declined to 32% of average household income at present and are expected to fall *beneath* the long term average of 30% by early next year.

AFFORDABILITY HAS IMPROVED



Sources: ABS, RBA, RP Data-Rismark, ANZ

A longer-term perspective on affordability shows *all* the growth in house prices since the mid-1980s is explained by just two factors: gains in average household incomes and a *structural* decline in the cost of borrowing.

The median house price has risen by almost 6 times from $93,000 in 1986 to $550,000 now. Over the same period, average household incomes rose by 3½ times. Simply using the house price to income ratio, many analysts conclude that Australian house prices are currently 40-50% overvalued relative to the 1980s. However, when the halving of mortgage rates is taken into account, the average household's purchasing power[1] over the median priced home is currently *almost exactly the same* as it was in the mid-1980s. A multitude of other factors also influence house prices, including population growth, dwelling supply, rents, investor

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[1] As measured by standard mortgage repayments relative to average household income

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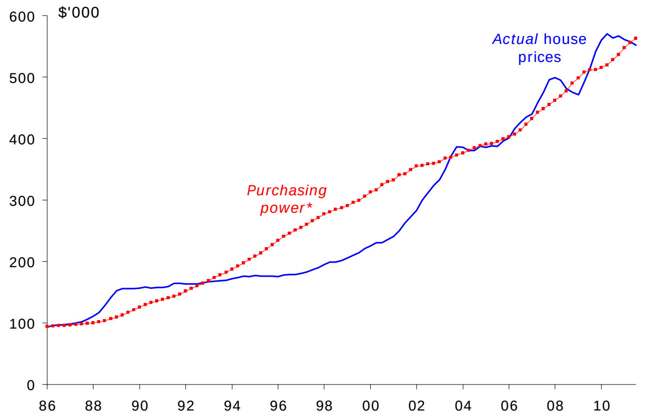
yields, tax incentives, the availability of credit and market sentiment.

VALUATIONS 'REASONABLE'

House prices vs. purchasing power



* Represents the average households purchasing power over the median priced home

Sources: ABS, RBA, RP Data-Rismark, ANZ

However, over recent decades, median values have tended to vary around home purchasing power[2], suggesting housing affordability is the key longer-term determinant of house prices. House prices were actually significantly *under*-valued for much of the 1990s before 'catching up' with purchasing power between 2001 and 2003. Buoyed by stimulatory public policy, house prices moved marginally above purchasing power in 2009-10, but have fully retraced this in the past 18 months.

RISING RENTS TO DRIVE RECOVERY

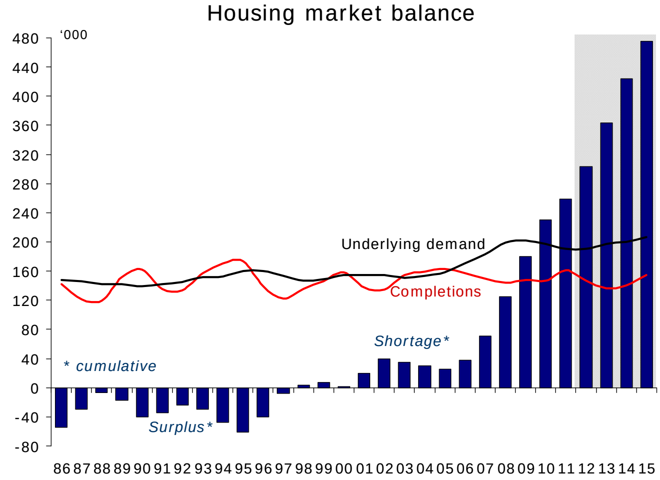
Five years of under-building relative to buoyant population growth has resulted in a clear shortage of housing in most capital cities.

Some analysts have agued there is no housing shortage given the rising stock of 'unsold' homes. However, this confuses the fundamental demand and supply of housing with the home *sales* market. In large part, home sales simply represents a 'shuffling of the deck chairs' within the existing market and tells us little or nothing about the number of households desiring homes (whether owner-occupied, rental or holiday homes) relative to the available dwelling supply.

The physical housing shortage is clearly reflected in rental markets where vacancies have been driven well below long-term averages, placing upward pressure on rents.

HOUSING MARKET BALANCE TO DETERIORATE

Housing market balance

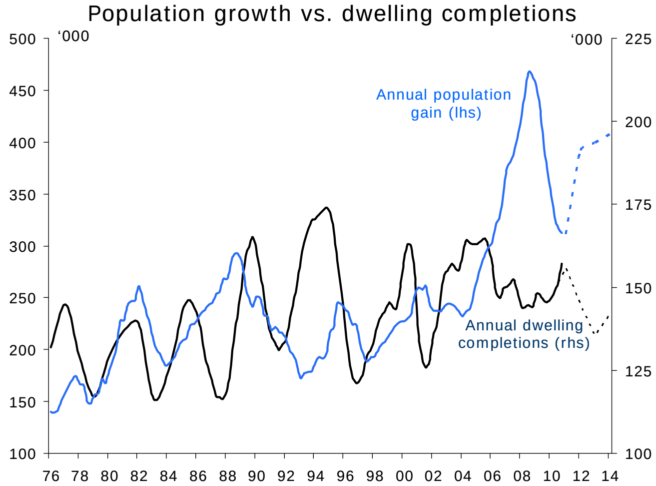


Sources: ABS, ANZ

In recent years, a marked reduction in net overseas migration combined with a modest rise in home completions to narrow the gap between housing demand and supply[3] (although the cumulative under-supply has continued to increase).

UNDER-BUILDING TO CONTINUE

Population growth vs. dwelling completions



Sources: ABS, ANZ

However, in 2011 dwelling approvals have fallen sharply and net overseas arrivals have rebounded suggesting the gap between underlying demand and housing supply will re-widen in the years ahead. With rental vacancies already at or near record lows in most capital cities, we continue to expect a strong acceleration of rents in certain parts of the market.

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[2] Underpinned by average household income and mortgage interest rates

[3] Although the cumulative under-supply has continued to increase

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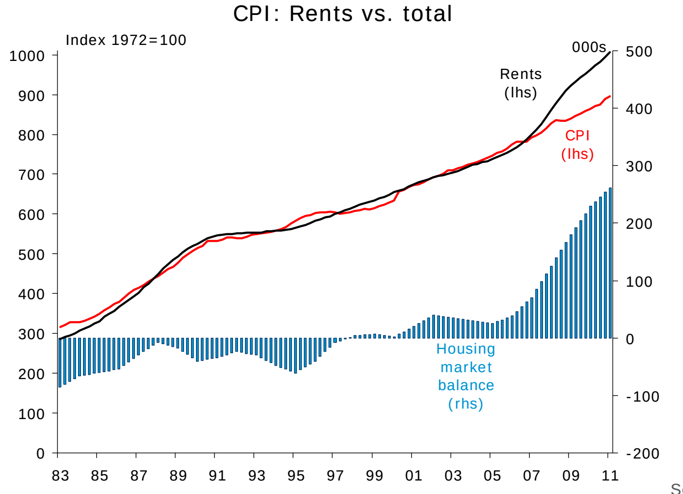
TIGHT VACANCY FORCING RENTS HIGHER



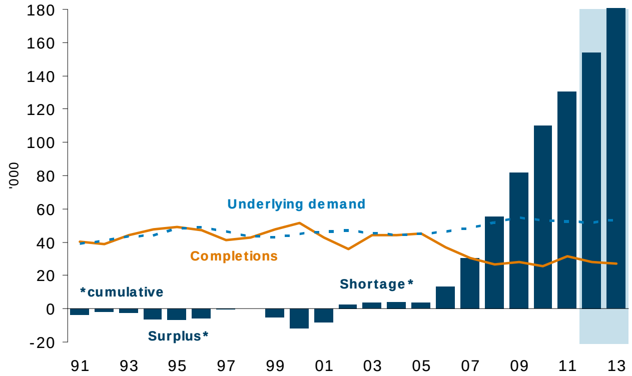
Sources: ABS, ANZ

Ongoing equity market volatility, a deepening housing shortage and improved rental yields should steadily attract investors back into residential property, particularly in NSW. Rapidly rising rents, supportive demographics and improved affordability should also drive a rebound in first-homebuyer demand.

NEW SOUTH WALES

The Sydney housing market has remained relatively resilient, with house prices declining by a modest 2.1% in the year to October, compared to an average 4.7% decline across the capital cities. House price falls have been concentrated in Sydney's blue chip suburbs, with the 20% most expensive suburbs recording declines of 3.2% over the past year.

NSW HOUSING SHORTAGE TO INCREASE



Sources: ABS, ANZ

While the resilience in Sydney's housing market can be partly explained by its relative price underperformance in the previous decade, it's the extremely tight fundamental conditions which have likely underpinned the market. Indeed, following a sustained period of under-building, we estimate that

Sydney currently has a housing shortage of around 130,000 homes. Despite the mild upswing that we have witnessed in approvals, they remain at depressed levels and we anticipate that completions will average 28,000 per annum to June 2013.

Housing affordability in NSW could be further dampened with the NSW government removing stamp duty concessions from 2012 for first home buyers looking to buy an existing home (despite maintaining the scheme for new houses). Currently in NSW, 38% of income is directed at mortgage repayments, compared to the national average of 32%.

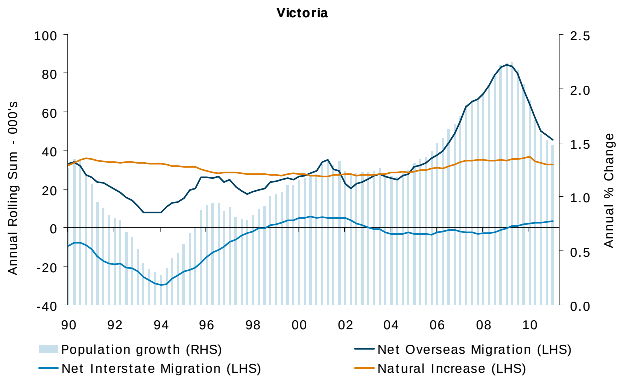
Rental vacancy rates currently sit at just 1.3%, reflecting the tight fundamental conditions of the Sydney housing market, and are likely to track even lower in coming years. Rental growth has already begun to accelerate, increasing by 5.9% over the year to June 2011, while advertised rents are running at 8% y/y.

Although weaker sentiment is likely to weigh on house prices in the near term, rising rents should encourage first home buyers back into the market, while investors will find higher rental yields increasingly attractive. As a result, we think prices should start edging higher through the second half of 2012.

VICTORIA

The Victorian housing market has retreated from the buoyant conditions of 2010, with house prices in Melbourne declining by 5.5% in the year to October. Underpinning this fall is a softer economic climate in Victoria, with unemployment reaching 5.3% in October from a low of 4.8% in May 2010. Population growth has also moderated, standing at 82,000 in the year to March 2011 from 102,000 a year earlier.

POPULATION GROWTH MODERATING



Sources: ABS, ANZ

With the strength of Victoria's construction cycle only recently beginning to wane, underlying tightness in Victoria's housing market is expected to continue to ease through 2011-12. Despite building approvals slowing since late-2010, dwelling

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construction has performed solidly in recent years, with annual dwelling starts to June 2011 at 59,000 (almost *double* NSW). Building approvals for both houses and other residential buildings in the year to September are down just over 22%, with finance approvals for the first home buyer segment almost 15% lower in the year to September.

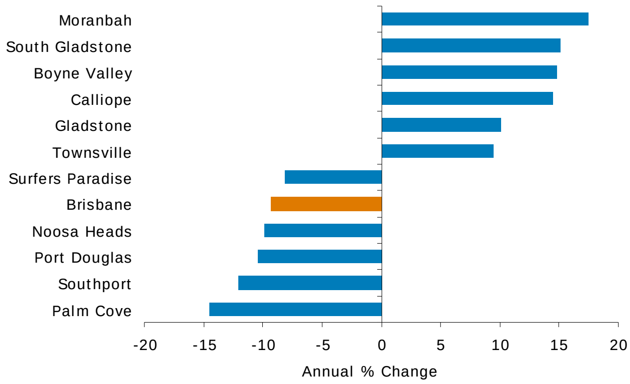
We see vacancy rates (1.9% in June 2011) easing slightly higher by the end of the year, taking some pressure out of the rental market. Moving into mid-2012 however, rental vacancies are likely to track lower, given the recent increase in net arrivals to Victoria driving population growth.

Ongoing pressure from yield-seeking investors to increase rents and moderate house price falls are making housing purchase affordability easier and we expect housing finance to the first home buyer segment to gain momentum. This will be aided by the Victorian government initiative to phase in stamp duty concessions for first home buyers, starting at 20% from July 2011 and reaching 50% by September 2014.

QUEENSLAND

The Queensland housing market continues to struggle, with soft economic conditions weighing on sentiment. This has seen house prices in Brisbane decline by 9.3% over the year to October, partly driven by the floods in the state earlier in the year. The two speed economy is clearly evident in Queensland, with mining regions experiencing robust price growth whilst other regions bear the brunt of much softer economic conditions.

MINING REGION HOUSE PRICES SHOW STRENGTH



Sources: ABS, ANZ

However, after a sustained period of decline, housing finance approvals appear to have passed their nadir, increasing by 7% over the six months to September. Over the same period, approvals for residential buildings other than houses have increased 25%, whilst approvals for houses are down almost 8%. Just below 30,000 dwellings were completed in the year to June 2011, the lowest level since 2001.

Economic conditions in the state are now improving as commodity exports rebound from the natural disasters earlier in the year and business investment ramps up. Based on the major resource and infrastructure projects pipeline for Queensland, we expect Queensland major infrastructure spending of around AUD28 billion in 2012 and AUD31 billion in 2013 (and a total of AUD120 billion by 2015). The combination of strengthening economic prospects and improved housing affordability should begin to encourage higher levels of interstate and overseas migration to the state.

An upswing in economic activity and continuing population growth will place downwards pressure on vacancy rates, which we expect to fall well below 2% by the end of 2012. Although we expect weaker sentiment to dominate fundamentals over the next 12 months, the positive economic outlook suggests house prices should begin to track higher thereafter.

SOUTH AUSTRALIA

The housing market in South Australia has remained broadly balanced over recent years, with softer economic sentiment driving house prices in Adelaide 5.5% lower. In the years ahead however, a very tight rental market and a solid pipeline for major mining and energy projects should see market conditions improve.

Rental vacancy rates are the lowest amongst all capital cities, sitting at just 1.2% in June 2011. Building approvals, of just 10,000 dwellings in the year to August 2011 are running at 10-year lows. With the housing construction outlook not promising, conditions are favourable for increased rents and moderate house price growth through the second half of 2012, with housing finance approvals expected to stabilise following a sustained period of decline since mid-2009. With just over 30% of household income spent on mortgage repayments, housing in SA remains relatively more affordable than the Australian average. However, the SA government has announced plans to phase out the First Home Bonus Grant from 1 July 2012, removing stimulus from a segment which has already experienced a 9% decline in finance approvals over the year to September.

We expect house prices to move sideways to lower through 2012, but with the expected boost to the SA economy from the proposed Clinton and Arckaringa Basin coal-to-liquid major projects, the SA market should see growth in rents and prices beyond 2012.

WESTERN AUSTRALIA

The WA economy continues to reap the benefits of mining infrastructure spending, with the domestic economy significantly outperforming most other states. Current unemployment in the state sits at just 4.3% and household incomes are growing remarkably strongly.

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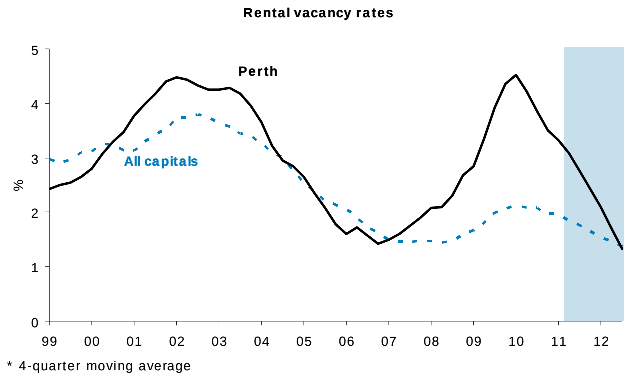
Future prospects are also very strong, with infrastructure spending in the state to total almost AUD200 billion over 2012-15.

Despite this, the housing market in Perth has experienced a 5.2% year-on-year decline in prices as at October, giving back some of the rapid price gains in the pre-GFC commodity boom. The combination of weaker house price sentiment and increasing disposable income has subsequently led to improved household affordability, with mortgage repayments as a percentage of income currently around 25% compared to the national average of 32%.

Since the highs of early 2010, building approvals for houses have trended downwards by 21%. This suggests the current housing shortage of around 26,000 dwellings is likely to increase to around 35,300 dwellings by June 2012 and 47,100 dwellings in the following year. This will further tighten conditions in the rental market, placing renewed upward pressure on rents.

The resultant improvement in rental yields should trigger a recovery in the Perth housing market and drive a rebound in house prices in the second half of 2012.

FUNDAMENTALS TO TIGHTEN



Sources: ABS, ANZ

TASMANIA

Economic conditions in Tasmania have weakened in 2011, bringing with it a period of softness in the housing market. Finance approvals have continued to trend down, declining 4% over the past year, whilst vacancy rates have risen to 2.5% to be at their highest rate since 2001. This increase can be partly explained by population growth, which slowed to 0.6% y/y, its slowest pace in four years. The housing shortage in the state as at June 2011 stands at 2,200 dwellings, and is likely to increase modestly, with 5,100 dwellings estimated for completion over the next two years whilst we see underlying demand over the same period to be 5,900 dwellings.

While Hobart house prices are 4.6% lower in the year to September 2011, a subdued economic outlook for the Tasmanian economy presents further downside risks. This outlook should ensure Hobart remains amongst the most affordable housing markets in Australia, with 24% of average household income spent on mortgage repayments on the median priced home in Hobart compared to the national average of 32%.

NORTHERN TERRITORY

House prices in Darwin have come under pressure, falling by 3.2% over the year to October due to slowing population growth and deteriorating economic conditions. With solid dwelling completions of 1,200 in the year to June 2011 and increasing population leakage through net interstate migration over the last two years, the underlying housing shortage is tipped to increase by only 350 dwellings in the year to June 2012 and an additional 370 dwellings in the following year. Finance approvals have begun to increase following a sustained downturn, rising by 6% in the eight months to August.

Plans for the commencement of a number of new large resource projects including the $29 billion Ichthys gas project in 2012 should give the NT economy a significant boost, and will promote housing market activity into 2013 and beyond. These projects will generate substantial demand for labour and stimulate net interstate migration. As a result, rental vacancies should grind lower, providing renewed support for the housing market.

Weak house prices have driven reduced residential building activity. We are forecasting completions to fall by 10.8% in 2011-12, adding further pressure to the Territory’s underlying housing shortage. Strong housing market fundamentals, a buoyant economy and relatively strong affordability will put a floor under house prices.

AUSTRALIAN CAPITAL TERRITORY

The ACT housing market has performed relatively well over the year to October, with house prices posting a modest decline of 1.2% compared to the national capital city average of -4.7% for the same period.

This is despite slowing population growth and a mini construction boom in the nation’s capital, with building approvals 37% higher in September from year-ago levels. Underpinning the resilience of the ACT housing market is a low unemployment rate, which sits at only 3.8%. With the highest average household disposable income across all states and territories, Canberra housing remains the most affordable across all Australian capital cities with just 20.5% of disposable income spent on mortgage repayments compared the national average of 32%.

Slower population growth and increasing housing supply will see the ACT housing shortage reduced to fewer than 1,000 homes by 2013 from around 2,600 at June 2011 and prices are expected to track broadly sideways over this period.

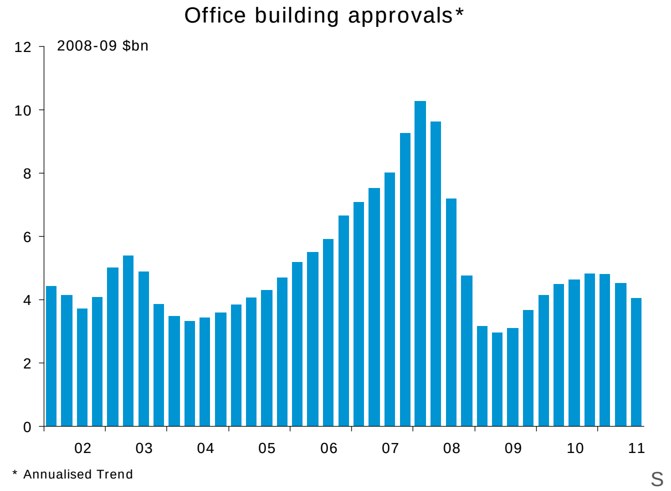
OFFICE PROPERTY

OFFICE MARKETS WELL PLACED

FUNDAMENTALS PROMISING...

Office market fundamentals have improved markedly, led by solid growth in tenant demand. Net absorption has been particularly strong in Perth and Brisbane and vacancies are now well below trend in all capital cities except Canberra.

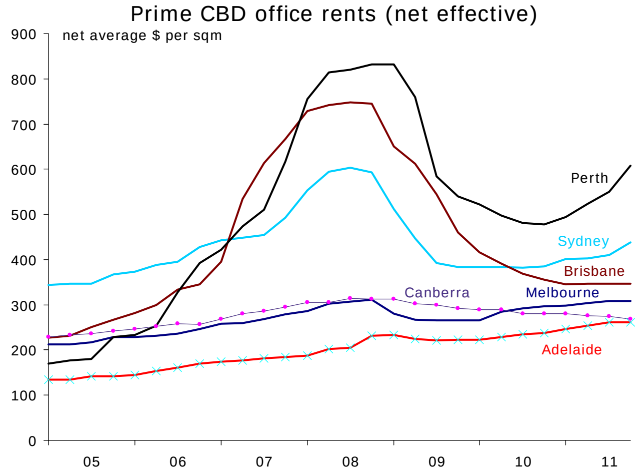
SUPPLY OUTLOOK CONSTRAINED



S
ource: ABS, ANZ

Weakening office building approvals foreshadow limited capacity expansion in the near term and medium-term supply additions will be constrained by subdued developer sentiment and tightened credit conditions.

RENTS REBOUND



Source: JLL

Rents have bottomed out in most cities and are already rising strongly in Perth and Sydney.

A return to trend economic growth and above in 2012 and 2013 should underpin further growth in tenant demand, which combined with limited new supply will maintain vacancies (particularly prime) at low levels. Tight vacancy and elevated incentives present considerable upside to effective rents.

...BUT INVESTORS REMAIN CAUTIOUS

However, despite a strong fundamental backdrop, investor sentiment remains cautious. Soft investor sentiment is reflected in capitalisation rates that remain near their post GFC highs and solid discounts to net tangible assets across the REIT market. The ongoing European turmoil is driving risk aversion higher for investors and financiers alike and maintaining pressure on both the cost and availability of funds.

However, given the turmoil in global financial markets, Australia has, to date, retained a relative safe haven status and the commercial property sector continues to attract significant offshore capital.

A resource and infrastructure investment led rebound in activity will continue to buoy tenant demand in Western Australia and Queensland. However, questions remain over demand in the non-resource states.

With Western Australia and Queensland set to grow at annual rates of 4-6% in the next few years, growth in the non-resource states is likely to be restricted to 1-2%. In addition, softening conditions in major employer industries (including retail and finance) could weigh on tenant demand.

Despite these risks, limited supply additions will maintain relatively tight vacancy rates in most markets and we expect flow on benefits for employment in construction, engineering and other associated professional services across the nation. Initially this should place downward pressure on incentives before eventually pushing face rents and valuations higher.

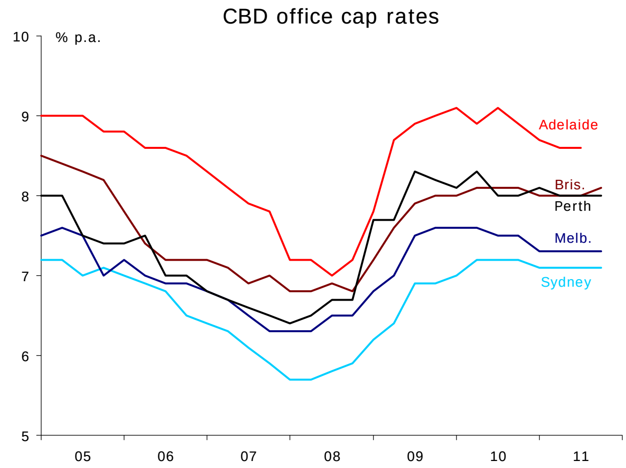
OFFICE PROPERTY

ELEVATED YIELDS BELIE FUNDAMENTALS

Solid office market fundamentals have, as yet, been insufficient to drive significant yield compression. In fact the gaps between office yields and the real risk free rate in most sectors remain near record highs reflecting the extreme uncertainty and risk aversion that dominates asset market pricing at present.

Elevated yields, relative to solid fundamentals, suggest good opportunities for (brave) investors. However, yields are unlikely to firm significantly until the present global financial market uncertainty has dissipated.

UNCERTAINTY TRUMPING FUNDAMENTALS



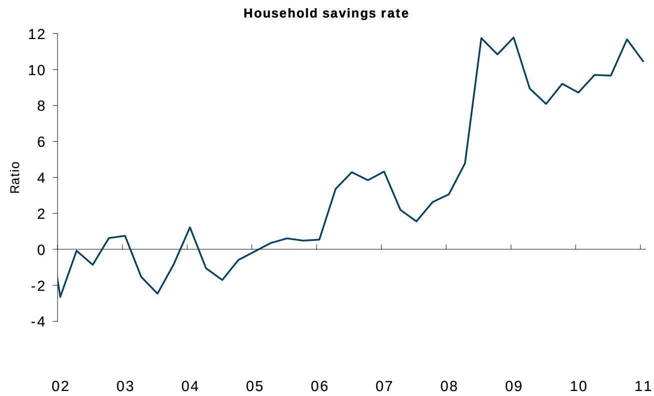
Source: IPD

RETAIL PROPERTY

CHALLENGES AHEAD

With ongoing concerns and uncertainty surrounding the stability of the global economy, the retail sector continues to experience a relatively challenging environment. Negative sentiment stemming from the European debt crisis and weak equity markets has weighed on Australian consumers, with consumer confidence in recent months at its lowest since the GFC (although recording a modest bounce-back after the November interest rate cut). The increase in household caution is evident with soft retail spending over the last year, particularly at department stores and clothing retailers. Combined with a moderate increase in the unemployment rate and the threat of a new era of online shopping, the retail segment is entering a period of vulnerability.

CONSUMER CAUTION CONTINUES

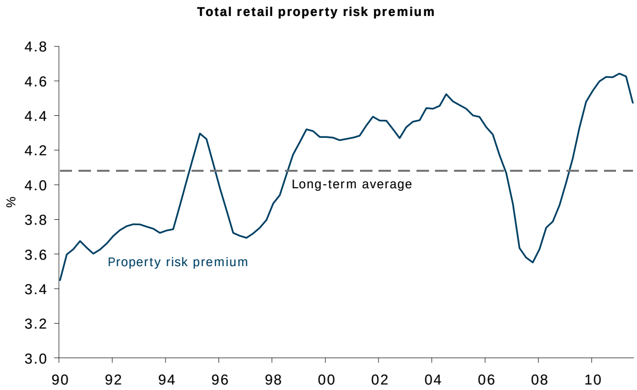


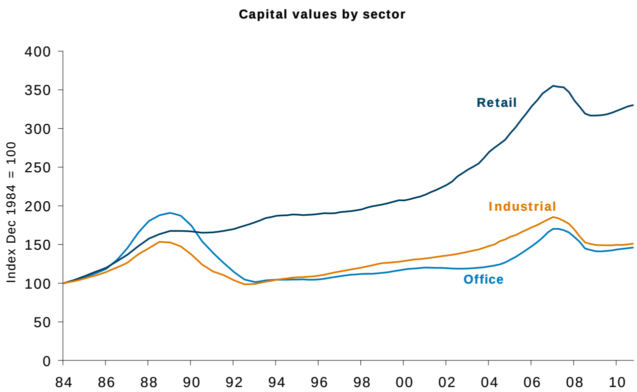
Sources: ABS, ANZ

However, amidst this fragile backdrop the retail property market is proving relatively resilient, underpinned by sound fundamentals. Despite easing from year-ago levels, vacancy rates remain historically low. CBD and regional properties retail segments continue to reflect very tight market conditions, particularly in the Melbourne and Sydney markets. Adding support to the retail property market outlook are relatively low building approvals, which are 25% below their peak from June 2008, albeit up 37% from their lowest point at December 2009.

Following both the GFC and the economic slowdown in the early-1990s, retail property performed relatively well compared to other commercial property classes, with capital values displaying greater resilience. However, due to the unique dynamics of the retail market (i.e. high rents/high occupancy costs, low profit margins), the outlook for growth in rents appears relatively limited at this time.

RETAIL PROPERTY VALUES WELL SUPPORTED





Sources: IPD, ANZ

The shift in consumer behaviour towards online retailing has accelerated recently, and will provide a key headwind to traditional 'bricks and mortar' retail property. The elevated AUD has acted to accelerate the migration of consumers towards online retailing. Any further strengthening in the AUD is likely to quicken this fundamental shift in consumer purchasing habits. As such, we anticipate that retailers will continue to 'build out' their online presence and distribution channels.

RETAIL PROPERTY

Although this trend raises concerns over the future prospects of the retail property market, it is unlikely to have a dominant impact on stores in less discretionary sectors, such as food and essentials. Consequently, we see stronger performance in properties backed by flagship stores in large developments, which will act as an anchor for customer flow.

Yields have retreated from the highs of the GFC but remain elevated compared to early 2008 levels with weighted average retail capitalisation rates at 6.9% in September 2011, compared to the low of 6.0% in March 2008. ANZ's 'retail property risk premium' indicates ongoing retail property investor caution, with the current risk premium well above its long-term average*. To return to long-term average premium levels would require a 9.6% upwards revaluation in capital values at current rental levels.

Despite current headwinds in the retail sector, the industry should remain resilient, underpinned by robust household income growth and a sound domestic economy. Further supporting the market, lending criteria for retail development are likely to remain cautious and funding costs are expected to remain elevated in the near term, limiting the pipeline for construction and keeping supply tight.

However in the longer term, the strength of future bricks and mortar retail demand is more uncertain. The current investment boom is expected to drive a solid medium-term outlook for the domestic economy and spur consumer spending. However, the ongoing structural adjustment to 'new age' retailing and the potential of global economic destabilisation present significant risks to the retail outlook. Given this uncertainty we see retail property potentially losing its status as the clear commercial property outperformer in valuation terms.

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*The PRP measures the gap between the retail property yield and the real risk-free rate. 'Fair' value requires measured PRP to equal long-term average PRP.

TOURIST ACCOMMODATION

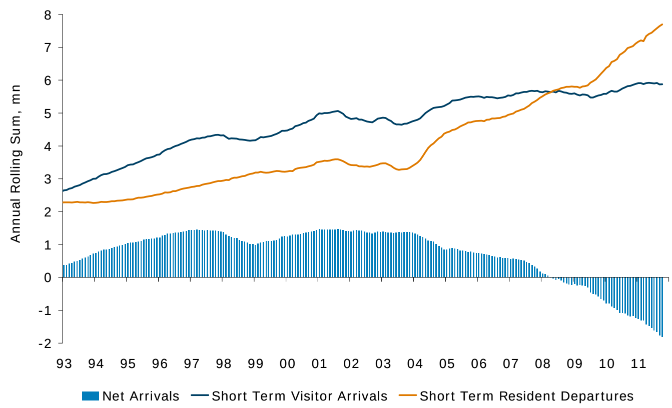
AUD STRENGTH WEIGHING ON TOURISM

Tourist accommodation continues to face headwinds, due to ongoing strength of the Australian dollar and uncertain global economic conditions. Despite this, the nationwide occupancy rate increased slightly in trend terms to 65% in June 2011 compared to 64% at the same time last year. This increase has driven a 4.5% increase in average room takings over the year, with employment in the sector increasing by 2.8%. There are contrasting trends however in the performance of regions within states, with capital cities generally displaying more robust performance due to capacity constraints and strong demand for business travel.

The value of building approvals has shot up significantly following a period of weakness. Compared to September last year, the value of tourist accommodation building approvals is 84% higher, its highest level since December 2008.

Strong income growth in conjunction with the elevated AUD, cheaper airfares and a rise in aviation capacity have been the driving force behind the upsurge in the number of Australians travelling overseas. Australians made almost 7.7 million short term overseas trips over the year to October, around double the number of trips that were made in 2004. Not surprisingly, Australians' penchant for international travel is adversely affecting domestic tourism operators. Short term international departures have increased by 10.2% in the year to October and domestic visitor nights are forecast to fall by 0.3% in 2011.

SHORT TERM DEPARTURES HAVE SURGED



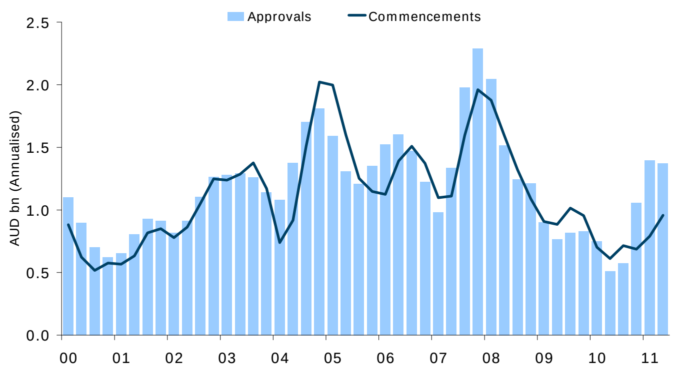
Source: ABS

In aggregate, short term international arrivals to Australia have fallen 2.3% in the year to June. However, this disguises significant differences between arrivals from the advanced and developing economies. Most advanced economies, for example, are plagued by weak growth, high unemployment, unfavourable exchange rates and ongoing economic uncertainty. Not surprisingly, arrivals from Europe and the US have declined throughout 2011. In contrast, arrivals from China and Indonesia have risen 23% and 24% respectively over the year, with the expanding middle and upper classes within these countries, proving increasingly willing to travel. Importantly, Chinese visitors tend to stay longer than average and are much more inclined to spend the majority of their nights in major cities. This is an important factor in explaining why city based accommodation, has been outperforming its regional rivals.

Encouragingly, business travel should continue to support the accommodation sector moving forward, with the Tourism Forecasting Committee estimating that domestic visitor business nights will rise by a little over 3.0% over 2012. This should continue to underpin the solid performance of properties in CBD areas.

Supply of accommodation has been weak over the last few years, with real approvals levels hitting 10-year lows in mid-2010. However since then real approvals have increased strongly, and are 70% higher since the beginning of the year. While building activity data shows slow growth in supply additions, the positive outlook in building activity will combat tight supply and increase the number of tourist accommodation establishments and tourism capacity.

TOURIST ACCOMMODATION APPROVALS TRENDING UP

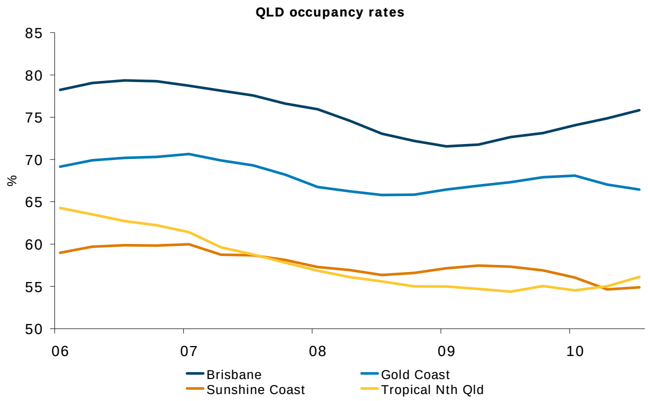


Sources: ABS, Bloomberg, ANZ

Performance in Queensland remains mixed over 2011. Occupancy rates in Brisbane in June 2011 averaged 76% compared to 73% last year, leading to a 12% increase in average room takings per room night available. In contrast, occupancy rates in the Sunshine Coast and Tropical North Queensland remain very depressed at an average of only 55% and 56% respectively. Part of the weakness in these markets most likely reflects a decline in travel to these regions following the floods and natural disasters earlier in the year. The Gold Coast is faring slightly better, albeit still struggling with occupancy rates at June averaging 67%.

TOURIST ACCOMMODATION

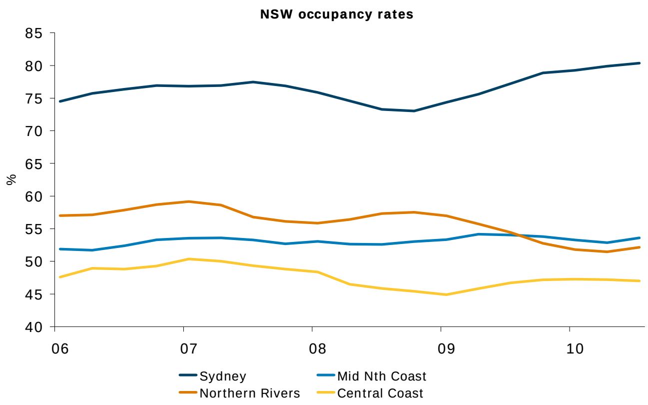
TOURISM AREAS ARE STRUGGLING



Source: ABS

New South Wales continues to perform relatively well, with average occupancy rates at June 2011 sitting at 66% from 64% in June 2010 and average takings per room night increasing by 9%. Underpinning this result is a strong Sydney market, which has occupancy rates of just over 80%. On the other hand, coastal regions in the state between Newcastle and the Queensland border remain in excess supply, with occupancy rates averaging only slightly higher than 50%.

SYDNEY LEADS THE WAY



Source: ABS

The Victorian and Western Australian markets continue to display solid performance. Occupancy rates in Melbourne increased to 76% in June 2011 from 72% last year, lifting takings per room night by 9%. Backed by strong business demand, these occupancy rates sit above the state's average of 65%, which is up from 63% in June 2010. Showing Western Australia is not just a 'one-trick pony', state occupancy rates have nudged above 66%, led by Perth reaching 76%. This has seen average takings per room night available in Western Australia increase by 8% from the same time last year.

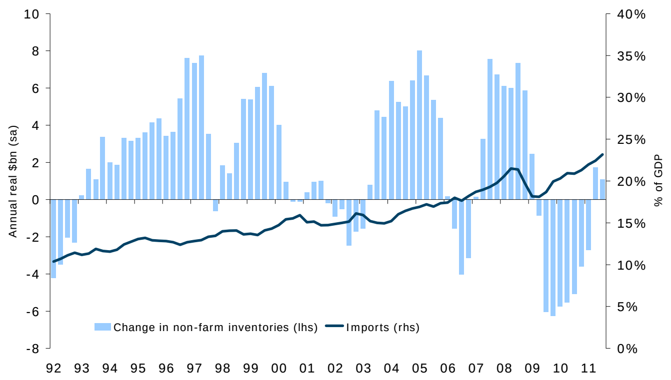
INDUSTRIAL PROPERTY

RECOVERY FLOUNDERING ON GLOBAL UNCERTAINTY

Despite soft domestic conditions in the 'visible' economy, the groundswell of activity from the 'hidden' commodity boom continues to present upside to the industrial property market. Major project activity in the mining and energy sector combined with continued strength in the Australian dollar and solid growth in household incomes present favourable economic conditions for industrial property.

While consumer confidence has remained weak and investor sentiment is being hard hit by global economic uncertainty, increased inbound trade activity has continued to rebuild non-farm inventories through 2011. Solid container traffic flow has pushed non-farm inventories $1.1 billion higher in the year to September 2011, with Australia's import-share of economic activity reaching a new long-term high (around 23% of GDP).

DOMESTIC DEMAND DRIVING INVENTORIES

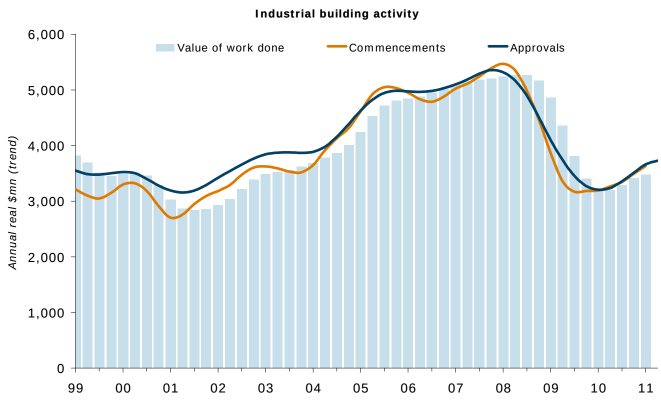


Sources: ABS, ANZ

Nonetheless, expansion of industrial property supply remains subdued. Industrial building activity is grinding higher from the 10-year lows of 2010. Speculative development activity is being put on hold with ongoing global financial and economic uncertainty, while committed projects are coming on-line slowly.

The value of completed projects in the year to September 2010 was a modest $3.3bn, well below the $5.3bn of completed industrial property construction in the year to December 2008. However, the outlook for industrial supply is positive. Industrial building approvals and commencements have both edged higher through 2011 (although annual commencements are still 11% below the 10-year average).

SUPPLY EXPANSION BUILDING SLOWLY



Sources: ABS, ANZ

Tight market conditions present the incentive for speculative development. Current limited supply is keeping take-up levels of existing space high, particularly in the Sydney, Brisbane and Perth markets. This market tightness is placing upward pressure on rents, which are marginally higher in the Sydney and Brisbane markets, while Melbourne industrial rents have remained broadly stable.

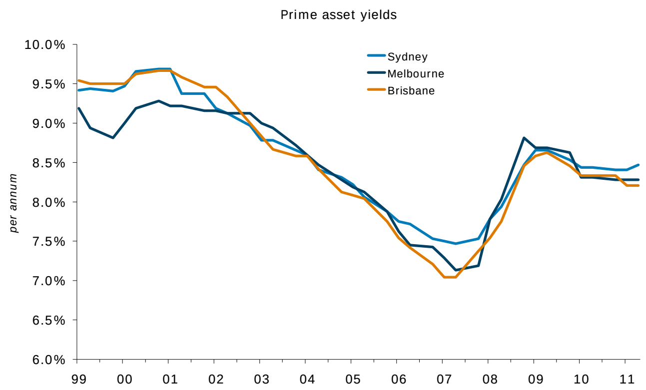
Industrial yield compression has been sidelined with the recent bout of global uncertainty and elevated funding costs spooking investors and weighing on capital growth. Following early signs of a renewed cycle of yield compression through the first half of 2010, industrial yields have largely tracked sideways. With moderate increases in rents matched by weak capital growth, industrial yields have largely remained unchanged in the year to September 2011.

Since December 2010 prime yields in both Sydney and Melbourne have remained largely unchanged, while Brisbane prime yields have tightened 12 basis points to 8.2% as the Brisbane market recovered from the early-2011 floods.

Despite higher vacancy rates, secondary grade asset yields held steady through 2011. The current secondary market imbalance has seen the yield premium over prime asset push out even further to around 155bps in the September quarter 2011. This is almost 100bps higher than pre-GFC yields, where the asset class premium was at a low of around 60bps at the end of 2007.

INDUSTRIAL PROPERTY

YIELD COMPRESSION TAKES A BREATHER

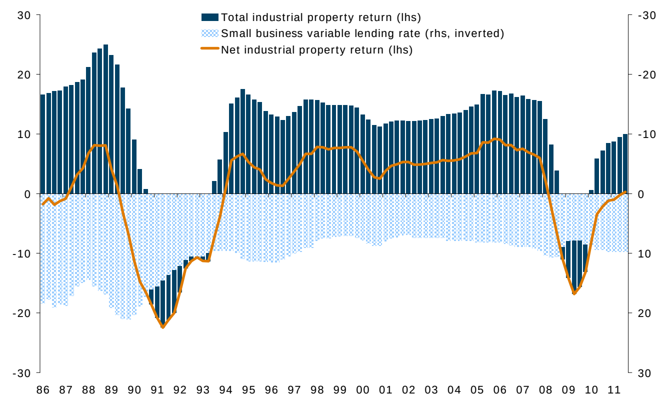


Sources: JLL, ANZ

In the short-term, weak investor sentiment and restrictive credit conditions are likely to limit yield compression. At the same time the existing pipeline of industrial building activity expected to come on-line through 2012 will also prevent any significant easing of industrial property yields.

Nonetheless, a solid medium term economic outlook, elevated yields and ongoing tight market fundamentals should eventually attract further pre-committed and speculative development of industrial property.

WEAK CAPITAL GROWTH WEIGHING ON RETURNS



Sources: IPD, ANZ

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