ING Clarion Real Estate Securities

GLOBAL REAL ESTATE SECURITIES

Market Commentary

Real estate stocks excel in an up month for stocks. Real estate stocks around the globe delivered positive returns in August, thus extending a rebound which began over five months ago. Property company stocks are performing well as the result of mounting evidence: global economic prospects are brighter looking forward; financial market conditions are improving; and a realization that REITs may be well-positioned for a period of favorable performance over the next few years. By region, performance was led by property companies in Europe, which achieved a total return of +18.2%, followed by North America +13.9% and the Asia-Pacific region +1.7%. U.S. REITs recorded a particularly strong month with a total return of +14.1%, catalyzed by credit markets, which continue to be accommodative, and 2Q09 earnings releases which demonstrate that public company management teams have successfully navigated the worst of the recession with an eye to being opportunistic looking forward.

Index Performance ($ USD)	1 Month	YTD	1 Year	3 Year	5 Year	10 Year
S&P Developed Property Index	8.5%	25.5%	-21.9%	-10.8%	3.1%	8.2%
Returns by Region						
Asia Pacific	1.7%	32.3%	-11.4%	-5.3%	6.7%	6.8%
Europe	18.2%	36.8%	-22.9%	-15.7%	2.2%	8.1%
North America	13.9%	12.7%	-32.5%	-14.1%	0.0%	8.6%

Source: S&P Developed Property Index, as of August 31, 2009.

Real estate stocks are up on the year and many are asking, "What now?" Following a five-month rally, real estate stocks are up over 20% for the year but are still down almost 50% from their peak valuations in most regions. Though we do not see a return to peak valuations, we do not believe real estate stocks will fall precipitously from current levels. The combination of an improving view of the prospects for a global economic recovery, improving capital market conditions and the potential for both an improved operating and investing market for real estate companies next year supports current valuations. In fact, we anticipate that real estate stocks will once again lead the private markets and expect, for several reasons discussed later, that stock prices may trade at sustainable premiums to Net Asset Value (NAV).

Recent economic news is generally better than expected. The global economy remains a huge variable affecting the outlook for commercial real estate. Using a weather analogy, the hurricane has passed but the damage has been severe. For now, it appears that there are no more economic hurricanes in the near future – although this forecast could prove too optimistic as we may have a few tropical storms breeze by our coasts over the next few years. Despite the "wall of worry" which typifies equity markets coming out of a recession, the latest economic news, on balance, has been favorable relative to expectations. Globally, GDP numbers for the second quarter have generally been better than expected. In the U.S., 2Q09 GDP came in slightly better than expected (down 1% year-on-year versus -1.5% expected). Also, the French and German economies each expanded by +0.3% versus consensus expectations for a modest contraction. In Hong Kong, 2Q09 GDP declined by 3.8% year-on-year, but this was better than expected and caused the government to revise higher its 2009 annual GDP forecast range to -3.5% to -4.5% from -5.5% to -6.5%. Housing markets show signs of having bottomed as U.S. new home and existing home sales in July handily beat expectations and were the best they have been since September 2008 and August 2007, respectively. Tempering the enthusiasm for a sustained economic rebound is concern that the recovery may be gradual in nature, given the enormity of the de-leveraging process and the temporary nature of government stimulus programs. With unemployment levels in the U.S. approaching 10% (9.7% reported for August), all is not rosy. Nonetheless, it remains difficult to refute the argument that forward-looking economic signposts appear encouraging.

ING CLARION REAL ESTATE SECURITIES
201 King of Prussia Road, Suite 600, Radnor, PA 19087
www.ingclarion.com

Property company earnings for the second quarter generally met or beat expectations. With 2Q09 earnings season behind us, we have a clearer picture of how listed property management teams have navigated and intend to manage through the remainder of the economic recovery. While property companies generally met or beat expectations for the quarter, all eyes remain on the balance sheet and how management teams intend to capitalize on opportunities coming out of the current recession. From an operational perspective, pressure on operating earnings could continue for another 12 to 18 months in most regions. Positive earnings growth, which we anticipate will return in 2011, is a tailwind for valuations.

Capital markets continue to open. A critical driver of the recent outperformance of property companies has been the thawing of capital markets. Property companies continue to demonstrate an increased ability to access capital as spreads and liquidity continue to materially improve. With bank lending restrained, company management teams have accessed the capital markets via equity issuance, unsecured debt issuance as well as joint ventures (JV). Equity issuance in the U.S. alone during August totaled over $2.2 billion as Tanger Factory Outlets, Federal Realty Trust, Hospitality Properties Trust, Brookfield Properties and U-Store-It issued equity during the month. Total year-to-date equity issuance in the U.S. through August now totals $16.3 billion or nearly 9% of the aggregate equity market capitalization of U.S. REITs. Perhaps more significantly, REITs have continued to enjoy increasing access to debt markets. REITs' access to unsecured debt was demonstrated most recently by U.S. industrial giant ProLogis and Southwest-focused shopping center company Weingarten Realty Investors. ProLogis issued $350 million of 5-year unsecured notes priced at 7.75% while Weingarten issued $100 million of 10-year paper priced at 8.1%. This takes total unsecured debt issuance among U.S. property companies to $5.6 billion on the year. Secured debt and JV money are additional capital sources as demonstrated recently by mall company Macerich. In August, Macerich announced a JV on New York City mall Queens Center, which generated $150 million of cash. When combined with two new secured financings totaling $170 million on two previously unencumbered assets, management is well on its way to achieving the goal of generating $500 million in total proceeds by the end of September.

Outside the U.S., European companies continued to show a penchant for convertible secured debt as Dutch-based Wereldhave issued a €230 million convertible expiring in 2014 with a 4.375% coupon (150 basis point spread to a five-year swap) with a strike price 15% out of the money. In Australia, Goodman Group completed a company-transforming A$1.9 billion capital raising consisting of a $1.3 billion rights offering, a $500 million placement of preferred shares with China Investment Corporation and a $163 million JV with Canadian Pension Plan Investment Board, specializing on real estate in China. While dilutive to existing shareholders, the recapitalization puts Goodman on the right foot looking forward.

REIT IPOs – a sign of opportunities on the horizon for listed real estate companies? The great news for real estate companies is that "the insolvency risk trade" that occurred from October 2008 through February 2009 is over for most companies. To the extent there are continuing liquidity issues for commercial real estate, it is highly likely to be the private owners that have the problems, and it may be the public markets that offer some attractive answers. Several recent Initial Public Offerings (IPOs) of new companies, focused on taking advantage of attractive pricing in the real estate markets, may be a sign of things to come for listed real estate companies. For example, Starwood Property Trust raised $810 million in early August and intends to make loans or buy discounted loans on distressed commercial real estate. It may also buy distressed commercial mortgage-backed securities (CMBS), potentially using the U.S. Government's Public-Private Investment Program to enhance returns. It is expected that a handful of additional similar companies in the U.S. will go public over the next six months or so. This follows the IPOs of several companies out of London over the past several months, formed to make opportunistic investments (primarily equity) in the U.K. market. Though we have not invested in these recent IPOs, we find their successful launches encouraging as a sign of how new and existing listed real estate companies may be particularly well-suited to raise capital for investing in the large volume of real estate expected to come to market during the next few years at attractive prices as real estate loans made in the "go-go days" of the last few years (2005 to 2008) come due.

The listed market will be "where the action is" for commercial real estate for the next several years. The capital markets appear to have christened the publicly-traded real estate stocks as the real estate capital market leaders for the next several years. Equity markets and debt markets (secured and unsecured) are wide open for the publicly-traded companies, while being substantially shut down for the core private market players, private equity funds, and any entity that purchased core real estate in 2005 or later. The public markets will be where the action is, in terms of new IPOs as well as public companies buying assets from the private market players who need to raise capital to pay down debt and/or return equity to investors. For listed real estate companies worldwide, the next several years may resemble the period 1991 to 1997 in the U.S. (i.e., the capital formation of the modern REIT era).

Investors should not be alarmed if real estate stocks trade at premiums to NAV. Listed markets lead private markets. As the economic news improves and the potential looms for real estate fundamentals to improve as well, it is logical that stock prices for listed real estate companies begin to anticipate the improved earnings potential. We now observe that global listed real estate companies trade at an average 8% premium to our estimates of NAV but we are not alarmed about valuations. It could also be that our cap rates are too high and that we were overly conservative in estimating how constrained capital would be for real estate and, therefore, too conservative about trough NAV levels – only time will tell. However, the much more likely reason for the stocks trading at premiums to NAV is that the stock market is discounting an accelerating earnings growth story. The improvement in the capital markets, as discussed earlier, is also a catalyst for improved valuations. The stock market is discounting a period of accretive acquisitions where the public players have the capital market tailwinds.

Currently, given where the stocks are in context of the real estate capital markets (position of strength), and given that we are probably at a bottom from an economic perspective, we do not believe that listed real estate stocks are fundamentally overvalued.

There is a precedent for real estate stocks to trade at premiums for sustained periods during upcycles for real estate markets. In the U.S., real estate stocks traded at premiums to NAV for much of the period from 1991 to 1997. The sustainability of prices above NAV broke down only when the acquisition environment changed and became much more constrained as private market buyers accessed cheaper equity and debt in scale and when the accretive acquisition binge from the RTC/private market sellers wound down.

At some point, possibly very soon, we will have a correction in REIT prices, which will be healthy in our opinion. However, we expect that this pull-back is likely to be greeted with net buying as opposed to the significant net selling (and short selling) we saw last year during the fourth quarter.

REAL ESTATE

ING

ING CLARION REAL ESTATE SECURITIES
201 King of Prussia Road, Suite 600, Radnor, PA 19087
www.ingclarion.com