ING Clarion Real Estate Securities

GLOBAL REAL ESTATE SECURITIES

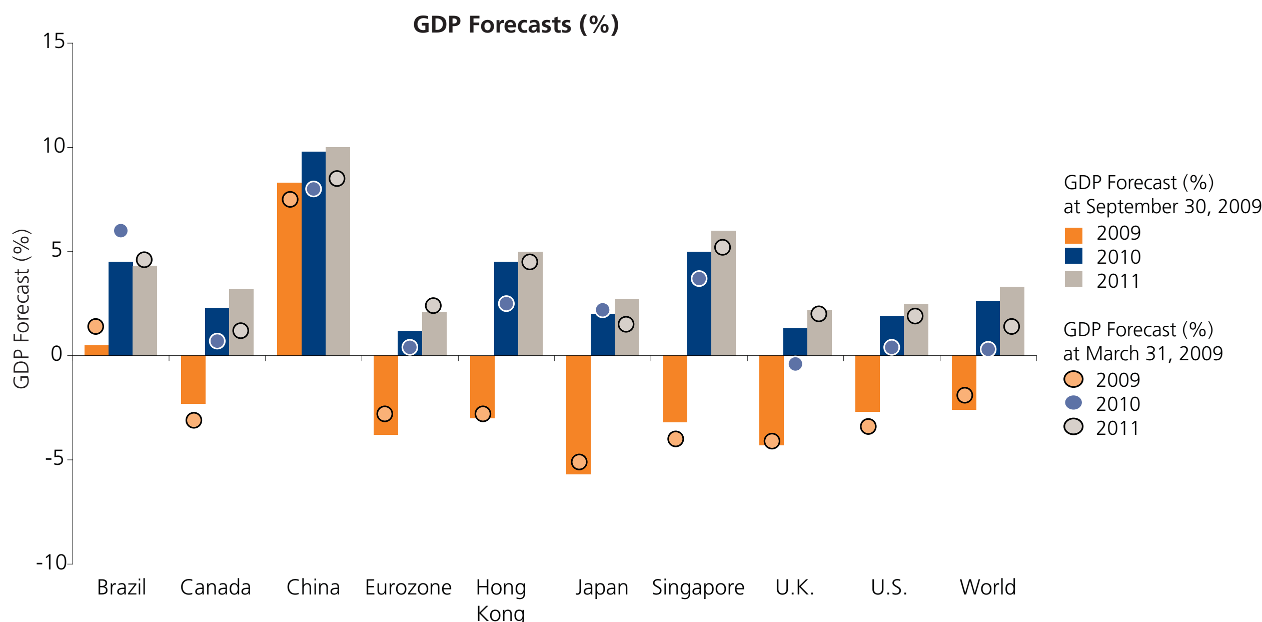
Market Commentary

Real estate stocks record a very strong quarter. Global property stocks finished a quarter fit for the record books with total return of over 25%. The rebound which began over six months ago has driven year-to-date total returns of 32%. Property company stocks are performing well as the result of improving economic news, a remarkable recovery in capital markets and the anticipation that REITs are increasingly well-positioned to benefit from the repricing of real estate over the next few years. By region, performance was led by property companies in Europe, which achieved a total return of +37.1%, followed by North America +34.5% and the Asia-Pacific region +15.6%.

Index Performance ($ USD)	1 Month	YTD	1 Year	3 Year	5 Year	10 Year
S&P Developed Property Index	5.5%	32.4%	-8.9%	-9.9%	4.0%	9.2%
Returns by Region						
Asia Pacific	5.3%	39.2%	11.3%	-4.0%	7.6%	8.0%
Europe	4.1%	42.4%	-7.3%	-15.9%	2.3%	8.7%
North America	6.6%	20.1%	-27.3%	-12.8%	1.3%	9.7%

Source: S&P Developed Property Index, as of September 30, 2009.

Recent economic news is generally better than expected. Signposts increasingly indicate that the global economic situation has stabilized as a result of the combined effects of accommodative fiscal and monetary policies by governments and central banks around the world. It appears that major economies may emerge from recession during the third quarter of 2009, marking the trough of this recession. In fact, Ben Bernanke, the Chairman of the U.S. Federal Reserve Bank, even went on record in September declaring that the recession was probably over in the U.S. Global GDP growth rates reflect this improved outlook as forward projections have materially improved over the course of the year. Global GDP projections for 2010 and 2011 have improved by 230 basis points and 190 basis points, respectively, since March 31, 2009 to 2.6% and 3.3%, respectively, reflecting a return toward long-term trend levels of economic growth. Recent stock price performance suggests that investors are clearly looking beyond 2009.



Source: ING Economics

REAL ESTATE INVESTMENT MANAGEMENT

In the U.S., which has witnessed one of its most severe recessions, there is a growing possibility that a recovery will surpass consensus expectations. History suggests that economic growth in the U.S. after a recession tends to be very strong. Excluding the periods after the relatively mild 1991 and 2001 recessions, the average GDP growth rate over the six quarters following the recession has been 7.1%. As the following table shows, generally the rule has been "the harder the fall the bigger the rebound." With the current contraction in U.S. GDP estimated to be -3.9%, the consensus rebound of about 2.5% remains far below the historical improvement in economic growth, suggesting that risks remain to the upside.

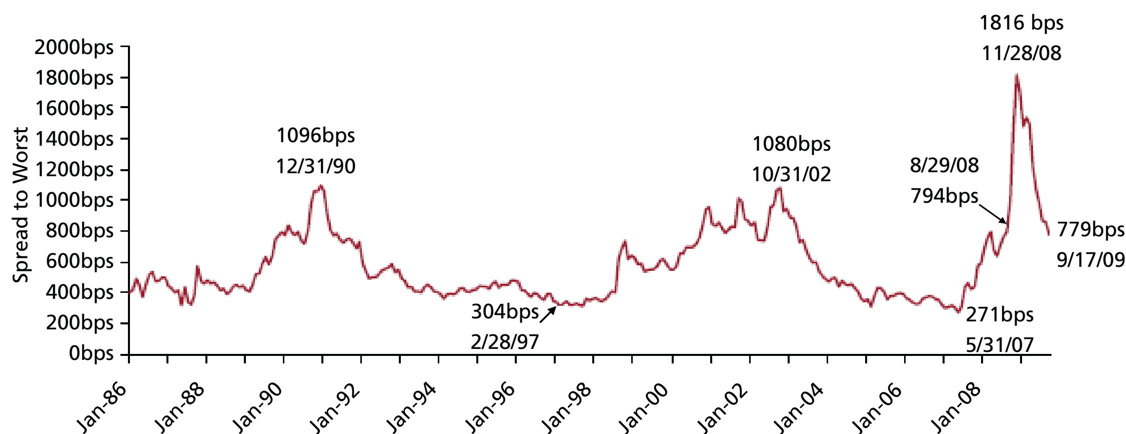
Recovery from Recession - Real GDP

	Recession	Strength of Recovery	
Trough Quarter	Contraction	First 4 Quarters	First 6 Quarters
March 1954	-2.6%	6.3%	9.5%
March 1958	-3.0%	7.5%	10.1%
December 1960	-1.6%	6.3%	9.4%
December 1970	-0.6%	4.5%	8.8%
March 1975	-3.2%	6.2%	7.5%
September 1980	-2.2%	4.4%	1.4%
September 1982	-2.3%	5.6%	9.9%
March 1991	-1.4%	2.6%	4.8%
September 2001	0.0%	2.3%	2.7%
June 2009	-3.9%	?	?
*Average**	*-1.9%*	*5.1%*	*7.1%*
Median	*-2.2%*	*5.6%*	*8.8%*
'91 & '01 Recoveries	-0.7%	2.4%	3.7%

**Average excludes the current trough quarter*
Sources: Mizuho Securities, ING Clarion Real Estate Securities, Bureau of Economic Analysis

Improvement in capital markets continues to underpin the rally. Even as experts debate what the "shape" and strength of the economic recovery may be, there is no denying the "V-shaped" recovery in the capital markets. The rapid improvement of conditions in the capital markets, which has enabled companies to address balance sheet concerns at increasingly competitive costs of capital, has been the critical driver of outperformance by property companies. The recovery has been dramatic in both the equity and debt markets. Over the past 10 months, global property companies have raised over US$45 billion of equity, nearly $20 billion of which has been in the U.S. In the debt markets, spreads have improved dramatically to the point that U.S. REITs are now regularly raising unsecured debt with yields-to-maturity in the 6% to 7% range, reflecting a spread to 10-year Treasuries of 250 to 350 basis points. The tightening of REIT debt spreads has been in-line with the improvement in spreads on the high yield index, which now have recovered to pre-Lehman bankruptcy levels.

Spread of the Credit Suisse High Yield Index



Source: Credit Suisse

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Outside the U.S., spreads are also tightening. In early September, European mall company Unibail-Rodamco successfully issued €500 million of 4.625% seven-year bonds. With an issue price of 99.661, the 4.625% coupon and current yield represent a very marginal 150 basis point spread to seven-year Euro swaps (3.115%). Notwithstanding Unibail's good credit profile (33% Loan-To-Value and an "A" credit rating with S&P), the spread obtained on their "plain vanilla" bond was materially below market expectations of 250 to 300 basis points.

European companies also continue to show a penchant for convertible secured debt as Dutch-based Wereldhave issued in August 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 the Asia-Pacific region, Australian industrial specialist Goodman Group completed a company-transforming A$1.9 billion capital raising during the quarter, consisting of a $1.3 billion rights offering, a $500 million placement of preferred shares with the China Investment Corporation and a $163 million joint venture with the Canada 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. More recently, mall giant Westfield raised US$2 billion in two tranches, a $750 million six-year note with a yield-to-maturity of 5.95% (5.75% coupon) plus a $1.25 billion 10-year note with a yield-to-maturity of 6.93% (6.75% coupon). Both bonds priced at a 350 basis point spread to respective Treasuries.

REIT IPOs – another healthy sign of the capital markets' recovery. With the fear of "insolvency risk" that depressed REIT stock prices from October 2008 through February 2009 now largely gone, investors are looking for the next opportunity to take advantage of capital market inefficiencies which remain. Several recent Initial Public Offerings (IPOs) of new companies may be a sign of things to come for listed real estate companies. For example, Starwood Property Trust raised $810 million in early August to search for double-digit IRR investments on the debt as well as distressed equity sides of the balance sheet. It may also buy discounted commercial mortgage-backed securities (CMBS), potentially using the U.S. Government's Public Private Investment Program to enhance returns.

Colony Capital, Apollo and other familiar names in private equity are also in various stages of going public. Although specific investment strategies differ, each of these prospective IPOs intends to take advantage of the continuing lack of capital for private real estate to capture above-average yields at various parts of the capital structure.

IPO activity has also picked up in China where a number of companies are coming to market. One of the larger IPOs is Glorious Property Holdings Limited, which comes to market in early October with a portfolio of commercial and residential properties located in Shanghai, Beijing and Tianjin, plus a handful of secondary cities. The size of the offering is in the US$1.5 billion range.

We have not participated in these IPO's thus far primarily since many of the companies remain unproven.

The "action" for commercial real estate will be in the public markets. We find the new IPOs and the continuing secondary offerings an encouraging 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. Equity and debt markets have dramatically improved for the publicly-traded companies, while remaining substantially shut for many traditional private market players (including the private equity funds) that were the dominant acquirers in 2006 and later. These are the same players that took several public real estate companies private in 2007 and 2008 and are now looking for exit options as they deal with the excessive levels of debt used in those takeovers. Ironically, it may be the public markets that provide the answers to their problems. The action will be in the public markets through a combination of new IPOs and public companies buying assets from the private market owners of overleveraged assets who need to pay down debt or return equity to investors.

It is time to look beyond "trough" cap rates. Real estate values rise and fall based on expectations of earnings growth and the return requirements of investors, given the returns available from other asset classes. For this reason, as economic growth turned down and capital markets collapsed, we increased cap rates by 220 basis points over the past two and a half years from 4.9% to 7.1% on a global weighted average basis. Our Gross Asset Value estimates fell by almost 30% and our Net Asset Value (NAV) estimates fell by nearly 50%. The combination of stabilizing economies and the dramatic recovery in capital markets both serve to improve the outlook for real estate values. In fact, if the capital market rally holds, there is a very good chance that "distressed pricing" becomes a theoretical construct which is actionable or realized on a less grand scale than once anticipated. The increasing availability of capital, at least for public real estate companies, coupled with improvements in the economic outlook and credit spreads, will continue to narrow the bid-ask spread between willing buyers and sellers. Consequently, we have decreased our cap rates by 60 basis points on average from peak levels, including 30 basis points within the last month, as we believe improving conditions will lead to some compression in global cap rates.

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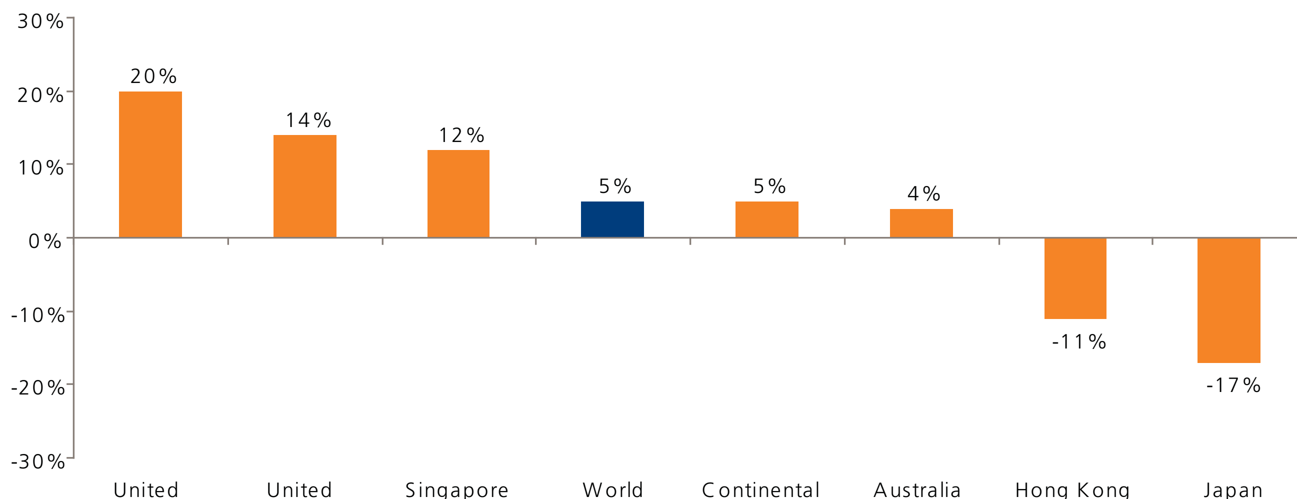
In the U.S., we have taken down cap rates from 8.6% to 8.0%. In the U.K., the cap rate compression has been the most significant, falling 120 basis points to an average quoted cap rate of 6.6%. Elsewhere, our cap rates are down 20 to 70 basis points. On average, the listed market is trading at a modest 5% premium to our estimated NAV per share, though the observations vary significantly by market as shown in the following chart:



	United States	United Kingdom	Singapore	World	Continental Europe	Australia	Hong Kong	Japan
CRES Underwritten Cap Rate	8.0%	6.6%	5.9%	6.7%	6.7%	7.3%	5.2%	5.2%
Implied Listed Market Cap Rate	7.2%	6.2%	5.5%	6.5%	6.5%	7.1%	5.8%	5.8%

Source: ING Clarion Real Estate Securities.

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. Global listed real estate companies trade at an average 5% premium to our estimates of NAV, but we are not alarmed about valuations in countries that trade at higher than average premiums. As discussed above, this may be partly due to NAV estimates which are still based on trough valuations. 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 up-cycles 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.

Near-term pause will not obscure positive long-term prospects. We expect real estate stocks to slow their torrid rise and consolidate some of their gains during the early part of the fourth quarter. All eyes will turn to the continued evolution of the budding economic recovery worldwide. If it holds as expected, we are very constructive about the prospects for listed real estate companies over the next few years and look for solid total returns in the intermediate term.

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The S&P Developed Property Index is unmanaged and constructed to include all developed market property companies with an available market capitalization of at least US $100 million and derive more than 60% of their revenue from property-related activities. Investors cannot invest directly in an index.

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