SPECIAL REPORT

Are your property investments safe as houses?

Dear Investor,

Back when George Foreman was known for sparring, rather than sizzling, it was pretty easy to get the measure of most listed property trusts. You just asked the obvious questions: are the assets decent, diversified and stable? Is the debt level acceptable? Is the yield more attractive than bank interest, to compensate for the risk involved? Tick those boxes and you probably had an attractive proposition. But it's all changed in recent years, thanks to several factors.

First and foremost, the sector has been basking in the economic sunshine of cheap money. Banks have been lending like mad and today's property managers aren't short on ideas of how to spend it. Top of the list is international expansion—Australian funds are currently the largest foreign purchasers of US property, eclipsing the cashed-up Chinese and oil-rich sheiks—but moves into property development and funds management aren't far behind.

In fact, it's often wrong to use the term 'property trust' nowadays anyway. Many of the modern incarnations are 'stapled securities'—financial Frankensteins of companies and trusts lumbering away from traditional property ownership towards riskier activities. And these monsters are piling on huge slabs of debt, sending gearing levels through the roof.

While we think something fishy probably happened on the grassy knoll, we happily accept that Neil Armstrong landed on the moon rather than in a Hollywood studio. So we don't go in for every conspiracy theory that does the rounds. But we recognise that financial incentives have a kind of magnetic pull on human behaviour. And observing the expansionary moves of these property groups in recent years, it looks to us like many of their managers have been strongly magnetised.

Throughout these pages you'll note the extraordinary growth in fees paid to external managers. The individuals managing these funds are hopelessly conflicted between their fiduciary duties to securityholders and the huge financial incentives to increase the profits flowing to the financial giants that directly employ them.

When deciding on that next massive acquisition, will the individual manager make the call that benefits you, the owner of the stock, or the decision that will secure a huge personal bonus payment from his direct employer by increasing funds under management? And what if everyone else seems to be taking the latter option and getting away with it?

This special report is a compilation of the individual analyses I've conducted in recent months, so bear in mind that the prices will have changed since the date each review was first published. I hope you find it useful in figuring out whether your property investments really are as safe as houses.

Yours sincerely,

Nathan Bell

OFFICE TRUSTS

ING Office ups the ante

Blissful ignorance may have earned you a pretty penny in the property market over recent years. But the risks have changed.

SNAPSHOT

ING OFFICE FUND (IOF)	$1.64
INFORMATION CORRECT AT	19 Apr 2007
STOCK CATEGORY	PROPERTY TRUST
MARKET CAPITALISATION	$2.0bn
12-MONTH SHARE PRICE RANGE	$1.29—$1.685
BUSINESS RISK 2.5 out of 5	SHARE PRICE RISK 2.5 out of 5
OUR VIEW	BETTER VALUE ELSEWHERE

Imagine you're the chief executive of a large office trust. Relaxing in your office, feet on the desk, revelling in the successful settlement of another tenancy agreement. You can see next year's annual report now: profits and distributions up and a longer average lease term to expiry (the longer the leases have to go, the more secure their income).

You reflect on the improving office rental environment—rents are up and job growth is creating huge demand for office space across the country. Large spaces in particular are drying up as big companies struggle to keep their growing workforces together. And with interest rates low, it's not hard to find funding.

Then the phone rings. It's your global head office from across the ocean with another foreign landmark building up for sale. The opportunity seems compelling—a 7.5% yield stacks up nicely beside current low borrowing rates. You'll increase diversification in a larger market which promises more opportunities. And there's easy access via your global real estate support team (for a fee of course).

Gung-ho times

Then there are the perks—international travel, and larger assets for the company means a larger salary for you. These might not be at the front of your mind, but surely they lurk somewhere towards the back. Who can begrudge you for thinking this way in such gung-ho times?

Not me for one. But lets remove our CEO hat for the moment, and replace it with our unitholder cap. Because if you're going to enlist these guys as stewards of your capital, you'd better make sure you understand the risks involved. If you've been blissfully ignorant, subscribing to the dividend reinvestment plans and ignoring your annual reports, then you may be in for a surprise.

We cover three office funds, ING Office Fund, **Macquarie Office Fund** and **Commonwealth Office Property Fund** and each of them will fall under our microscope in this three-part series. We'll kick off with ING Office Fund.

Big changes

In the past, ING Office has offered all of the qualities we seek in a property trust: long average lease expiries, 99% occupancy rates, good regional diversification, blue chip clientele and debts that were more than manageable with its very reliable cash flows. And that's not to mention a reasonable yield.

That's in the past, though, and there have been some big changes. CEO Tino Tanfara has more than doubled the assets of the trust since 2002. In the latest half-year report, total assets stood at $3.2b. The net tangible asset (NTA) per unit figure for the trust, though, has grown much more slowly, from $1.10 in mid-2002 to $1.52 at the end of calendar 2006. This is because huge piles of debt have been used to acquire assets. At the same time, in what now seems to be an annual event, fresh capital has been raised, substantially increasing the number of units on issue.

From the table you can see that the NTA figure grew 19% in 2006, before rising another 9% in the recent half-year. This was due to revaluations and further acquisitions. But while revaluations might increase accounting profits (AIFRS accounting rules now require revaluations to be shown in the income statement) and boost NTA, they don't increase cash.

So even though assets have more than doubled in five years, distributions per unit have remained stagnant. Not exactly a great outcome for income-hungry investors.

ING Office Fund: Key financials

	2002	2003	2004	2005	2006	CAGR*
Total assets ($m)	1,316	1,473	1,555	2,096	2,575	15.8%
Management fees ($m)	7.0	7.8	8.2	9.6	11.5	22.2%
NTA per unit ($)	1.10	1.11	1.12	1.17	1.39	4.6%
Net debt-to-equity	46%	56%	49%	66%	62%	
Interest cover	4.2	3.8	4.0	4.0	3.5	
Distribution per unit (c)	10.6	10.6	10.2	10.2	10.35	–0.4%

*Compound annual growth rate

But perhaps most concerning of all is the increasing risk profile of the trust. Not content with acquisitions in the US, it has since invested in Prague and Paris, before taking a 20% stake in the ING Dutch Office Fund.

Management has been successful in the past at refurbishing buildings and driving occupancy rates higher. And great qualities remain with an average lease expiry of 5.6 years and a 96% occupancy rate. But with a net debt-to-equity ratio of 62% and a skinny prospective yield of 6.4%, today's price is not compensating you for the substantial risks involved.

With a recent round of revaluations, the chances are that the NTA figure is not conservative. And it pays to remember that valuations, and therefore NTA figures, can go down as well as up when economic conditions and interest rates are not as accommodating as they are today. The share price is up 18% since last year's annual property review on *20 Jun 06 (Better Value Elsewhere—$1.385)* and we still think there's **BETTER VALUE ELSEWHERE**.

Commonwealth keeps its cool

In a rare act of nationalism within its industry, Commonwealth has ignored the allure of international property markets. But it hasn't resisted temptation completely.

SNAPSHOT

COMMONWEALTH PROP. OFFICE (CPA)	$1.44
INFORMATION CORRECT AT	26 Apr 2007
STOCK CATEGORY	PROPERTY TRUST
MARKET CAPITALISATION	$2.3bn
12-MONTH SHARE PRICE RANGE	$1.32–$1.535
BUSINESS RISK 2.5 out of 5	SHARE PRICE RISK 2.5 out of 5
OUR VIEW	BETTER VALUE ELSEWHERE

In the last of our three-part series covering Australia's listed office property sector, we're running the rule over Commonwealth Property Office Fund.

Although Commonwealth hasn't expanded overseas like its major competitors, it has made up for it at home. The trust's portfolio consisted of little more than a dozen properties until it merged with Colonial First State Property Trust in 2002. Today its 29 office buildings are worth more than $3bn and are spread throughout our major cities.

Fortunately, though, the trust has maintained a significant exposure to Sydney. When tenants are scarcer than they are today, the geographical constraints imposed on Australia's largest office market will likely make it a safer place than most. The trust also owns many properties outside the major business centres, however, and this reduces the quality of its portfolio somewhat.

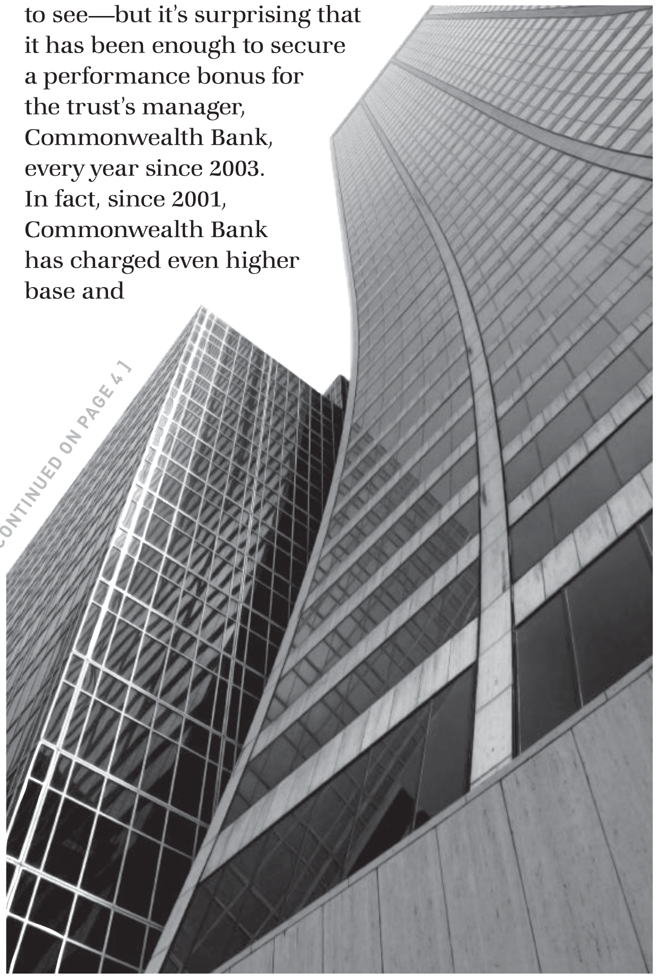
Free kick

Commonwealth does get a big free kick because its parent, **Commonwealth Bank**, actually leases 25% of its available space. And strong relationships with large tenants make for more secure income. The trust is currently developing a new home for Commonwealth Bank at Homebush, in Sydney's west. This will leave quality premises in the heart of the city vacant, which is not a problem in today's environment.

Refreshingly, Commonwealth has mostly stuck to its knitting. Its net debt-to-equity ratio is a relatively comfortable 38%, which is not as low as the old days, but nevertheless pretty comfortable. And the trust's leases have 5.3 years on average left until expiry and 98% of its floorspace is tenanted. These figures provide a lot of confidence in the security of distributions, even though annual growth in distributions per share has been just 2.8% over the past five years, while net tangible assets per unit have grown at just 3.4%.

Fees

So the performance has been steady rather than spectacular, which is what we like to see—but it's surprising that it has been enough to secure a performance bonus for the trust's manager, Commonwealth Bank, every year since 2003. In fact, since 2001, Commonwealth Bank has charged even higher base and



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performance fees than its competition at **Macquarie Bank** (the generally acknowledged master of fee generation). The performance fee is paid in additional units, instead of cash, and has helped Commonwealth Bank become the trust's major unitholder.

Listed office property trusts: Distributions

	2002	2003	2004	2005	2006	CAGR*
ING Office Fund (c)	10.6	10.6	10.2	10.2	10.4	–0.4%
Macquarie Office Fund (c)	10.9	11.0	10.3	10.8	11.2	0.8%
Commonwealth Office Fund (c)	8.9	10.4	9.6	9.6	9.7	2.8%

*Compound annual growth rate

The trust currently trades at a 11% premium to its net tangible assets of $1.30 and is yielding 6.7%. The unit price is up 5% since *20 Jun 06 (Better Value Elsewhere—$1.37)* and we're sticking with **BETTER VALUE ELSEWHERE**.

Summing up on the office sector

Using the past five years as a guide, and taking account of the current upswing in global property prices, it's difficult to make a case against our largest office trusts. But it's important to note that much of the recent growth has been the result of additional gearing. Meanwhile, as you can see from the table below, growth in distributions has been negligible.

So these trusts have become riskier propositions and distributions have disappointed. But the market has sent the unit prices up anyway, making the yields less attractive than they used to be and the overall investment package much less so. If you own one of these trusts, you should consider your position carefully.

Commonwealth Property Office Fund: Key financials

	2002	2003	2004	2005	2006	CAGR*
Total assets ($m)	909	2,204	2,617	2,541	2,890	30.3%
Management fees ($m)	2.2	13.6	12.8	15.5	16.0	50.3%
NTA per unit ($)	1.08	1.14	1.14	1.15	1.23	3.4%
Net debt-to-equity	29%	27%	52%	41%	36%	
Interest cover	4.7	4.0	4.1	3.3	3.6	
Distribution per unit (c)	8.9	10.4	9.6	9.6	9.7	2.8%

*Compound annual growth rate

Macquarie Office's soft underbelly

This property trust has an air of great financial stability, but increasing debt has made it vulnerable.

SNAPSHOT

MACQUARIE OFFICE TRUST (MOF)	$1.585
INFORMATION CORRECT AT	26 Apr 2007
STOCK CATEGORY	PROPERTY TRUST
MARKET CAPITALISATION	$3.1bn
12-MONTH SHARE PRICE RANGE	$1.275–$1.70
BUSINESS RISK 2.5 out of 5	SHARE PRICE RISK 2.5 out of 5
OUR VIEW	BETTER VALUE ELSEWHERE

For a small population, Australia punches well above its weight in global property markets. At least that's what the recent explosion in foreign property acquisitions would suggest. But will recent purchases prove to be knock-out investments, or have we been dealt a sucker punch?

In the second of our three-part series covering Australia's listed office property sector, we turn our attention to Macquarie Office Trust, which has led the Aussie assault on foreign property markets, particularly the US.

Brandywine small beer

The foreign expansion started in December 2003 when Macquarie Office paid US$113m for an 80% interest in a US joint venture with Brandywine Realty Trust. But that investment was soon shown to be small beer. Seven months later, Macquarie took a much larger bite by purchasing Principal America Trust.

The impact of the deal is clearly visible in the 2004 and 2005 figures in the table below. Total assets increased 61%, but net tangible assets (NTA) per unit actually fell 5%. This was due to all the new unit issuance needed to fund the deal.

The debt situation looks like it improved in 2005, with a lower net debt-to-equity ratio and a much higher level of interest cover, but it's actually due to a numerical shortcut known in the business as joint venture accounting.

To explain, Macquarie Office is under no obligation to report its share of joint venture assets and liabilities separately—as it would for any of its normal transactions. The accounting rules actually require something quite different.

Trusts like Macquarie simply add up their share of joint venture assets, subtract all the related liabilities and report the net figure as an asset in their accounts. There's no compulsion to report the assets and liabilities separately.

Powerful

This knocks the accounts sideways, because it means the joint venture's debt and interest bill don't get added to those of Macquarie Office. So the net debt-to-equity ratio and the interest cover don't take account of all the debt housed in the joint ventures.

This effect was given another boost in 2006 with Macquarie's new joint venture partner, Maguire Properties. The deal was initially worth $1.6bn, providing exposure to the 'high growth market of Southern California'. The joint venture's US dollar debt has now surpassed $1bn, but you wouldn't know it from a look at Macquarie Office's balance sheet.

As the trust has grown, so has the annual management fee. There hasn't been a performance bonus since 2002, but that year's fee shows how well **Macquarie Bank** does in the good times. On top of the annual fees, there are other payments to Macquarie Bank companies. In 2006, for example, Macquarie Office paid Macquarie Capital Partners LLC (an advisory arm of Macquarie Bank) $10m in fees for advisory services.

This growth explains why we've been such avid supporters of Macquarie Bank, but it's done little for unitholders: distributions were only 4% higher in 2006, for example, than they had been in 2001.

There's no doubt Macquarie Office owns many first-class buildings, but we can't help feeling it's paying top dollar at a time of lofty valuations. A foray into Europe is also under way, with the group having recently splurged nearly $400m.

Vulnerable

The one thing the growth has done for unitholders is increase their financial risk, because of all the debt that has been accumulated to fund it (both on and off balance sheet). Putting on so much weight has given Macquarie Office something of a soft underbelly—it might give an impression of great financial strength, but a combination of blows to its weaker parts could put it in real trouble.

With the stock up 17% since last year's property sector review on *20 Jun 06 (Better Value Elsewhere—$1.35)*, the stock yields 7.1%, and that's not enough margin of safety for us. **BETTER VALUE ELSEWHERE**.

Macquarie Office Fund: Key financials

	2002	2003	2004	2005	2006	CAGR*
Total assets ($m)	1,503	1,605	1,955	3,144	4,052	30.3%
Management fees ($m)	18.4	6.9	7.6	10.1	10.5	18.4%
NTA per unit ($)	1.14	1.12	1.14	1.08	1.29	2.9%
Net debt-to-equity	42%	37%	61%	41%	44%	
Interest cover	4.4	3.1	2.8	6.2	7.6	
Distribution per unit (c)	10.9	11.0	10.3	10.8	11.2	0.8%

*Compound annual growth rate

INDUSTRIAL TRUST

Macquarie Goodman eyes industrial revolution

Greg Goodman has an interest in this industrial property group priced at more than $910m. But far from idling and taking in the scenery, he's put the pedal to the metal.

SNAPSHOT

MACQUARIE GOODMAN GROUP (MGQ)	$7.16
INFORMATION CORRECT AT	31 May 2007
STOCK CATEGORY	PROPERTY TRUST
MARKET CAPITALISATION	$12.0bn
12-MONTH SHARE PRICE RANGE	$5.52—$7.68
BUSINESS RISK 2.5 out of 5	SHARE PRICE RISK 4 out of 5
OUR VIEW	AVOID

Greg Goodman crossed the Tasman for Australia in 1985. Ten years later, he listed his first trust, Goodman Hardie Industrial Trust, comprised of eight properties worth $73m. In 2000, the fund merged with Macquarie Industrial Trust and became known as Macquarie Goodman Industrial Trust. In February 2005, the trust merged with its manager, Macquarie Goodman Management, to form Macquarie Goodman Group, the second largest industrial trust in the world.

Before the merger, the trust focused on owning and managing Australian industrial assets, although it has gradually invested in New Zealand since 2001 and it retains an interest in a Singaporean funds management joint venture established in 2002.

Local expansion

In 2003, Macquarie Goodman expanded rapidly, acquiring an industrial portfolio from **Commonwealth**

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Macquarie Goodman eyes industrial revolution

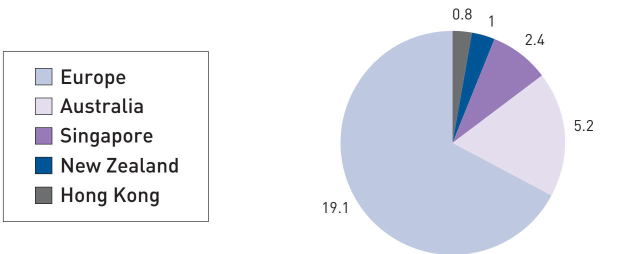
Property Office Fund for $475m, another from Linfox for $207m and 27 properties from AMP Industrial Trust for $615m. Goodman's ability to increase distributions throughout this period is testament to his ability to manage assets profitably.

The direct property portfolio consists almost entirely of Australian assets. It's a quality portfolio with a current occupancy rate of 98%, customer retention rate of 77% and a weighted average lease expiry of 4.9 years.

Bigger ambitions

Following the merger with Macquarie Goodman Management in 2005, the newly combined entity has designs on becoming a global funds manager. The attractiveness of managing property, rather than owning it, is in fees that can be generated without having to hold the assets on your own balance sheet—as a traditional property trust does.

Assets under management ($bn)



It also allows more rapid growth. And Goodman is currently expanding globally at a rate of knots, particularly in Europe. Assets under management ballooned during the 2006 financial year. This was primarily due to the purchase of UK property fund manager Arlington for $457m, followed closely by European logistics property developer Eurinpro for $705m. The second pie chart shows that the result is a portfolio now heavily skewed toward Europe—something of a trend for Australian property trusts of late.

More acquisitions

Three more large international acquisitions have been made this financial year. UK business park owner Akeler was bought for $1,489m (cost split between entities), $840m was paid for UK logistics property manager Rosemound, and there was a $162m outlay for a Japanese logistics business called J-Rep (in partnership with **Macquarie Bank**).

The strategy is clear: secure local knowledge in a given market; have the ability to develop assets from the ground up; bundle the completed assets into funds and market them through the global distribution channels, all the while retaining the management rights.

While investor demand for such financial products remains strong, this strategy may be very lucrative. But when markets turn down, 'flipping' assets might not be so profitable and growth could come to an abrupt halt—although the group's own portfolio of high-quality Australian direct property offers a degree of financial stability in the event that the funds management strategy hits a snag.

Lofty expectations

In the past, backing Goodman has been a good move. But success has brought with it lofty expectations. Management has a long track record, its own money is on the line and the trust is diversified both geographically and by property type. What it lacks is an attractive price.

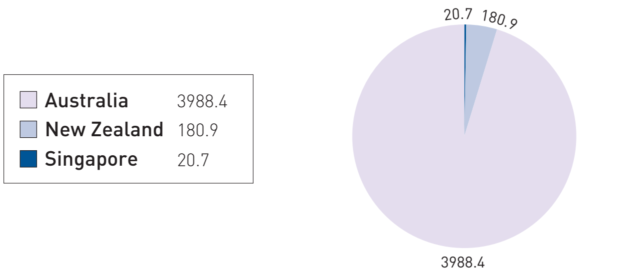
It currently trades at a 287% premium to its net tangible assets (NTA) of $1.85 per unit—although it must be remembered that its funds management operations should be valued separately and added to the NTA figure. And the yield's a paltry 4.4%.

The global strategy is still evolving and recent purchases need time to prove their worth. Permanently unfulfilled ambitions at this lofty price, however, would be a disaster for today's purchaser (or would-be seller). This isn't to say that Goodman can't achieve his global ambitions, but we'd rather wait for more tangible evidence, or a substantially lower price, before getting involved in this situation.

Geared up and getting more so

The net debt-to-equity ratio of 65% also increases risk and this figure doesn't take account of the recent billion dollars' worth of debt used in acquisitions, or the liabilities hiding in the accounts of associate investments (see note 15 in the annual report if you'd like to explore this further).

Direct property portfolio ($m)



If you're comfortable with huge licks of debt (both obvious and hidden) and are prepared for the sort of white-knuckle ride you'd expect from a risky stock rather than a steady property trust, then perhaps this one is for you. But if not, then today's gung-ho market is offering an attractive price to cash in and wait for the next opportunity. The stock price is up 20% since last year's annual property review on *20 Jun 2006 (Better Value Elsewhere—$5.98)* and we're adjusting the recommendation slightly, to **AVOID**.

RETAIL TRUSTS

Macquarie CountryWide chases American dream

In this, the first of a five-part series covering Australia's retail property trusts, we lift the hood on Macquarie Bank's retail offering, Macquarie CountryWide Trust.

SNAPSHOT

MACQUARIE COUNTRYWIDE (MCW)	$2.25
INFORMATION CORRECT AT	1 Jun 2007
STOCK CATEGORY	PROPERTY TRUST
MARKET CAPITALISATION	$2.9bn
12-MONTH SHARE PRICE RANGE	$1.785—$2.30
BUSINESS RISK 2.5 out of 5	SHARE PRICE RISK 3 out of 5
OUR VIEW	SELL

If you want to understand the soul of any Macquarie fund, then the fees are a pretty good place to start. In this case, as we set out in our review of *31 May 2002 (Buy for Yield—$1.68)*, the basic structure involves a fee of around 0.4% of total assets under management, plus bonuses of up to 15% of any outperformance.

But the full picture unfolds on page 82 of the 2006 annual report, which lists all the intercompany transactions. Macquarie Asset Services (a subsidiary of Macquarie Bank), for example, received $9.4m for its advice.

Macquarie Bank shareholders lick their lips at such arrangements, because, as the fund grows, so do the fees. But larger size doesn't automatically translate into higher distributions and it can mean higher risk when trusts use debt to expand—which is what's been happening here.

Hidden debts

Back in 2002, we were positive on Macquarie CountryWide. We liked its long-term leases, broad geographic diversification, sound financing and high-quality portfolio. Good management and access to Macquarie's expansive property network were also advantages.

But recently, through a joint venture with Regency (one of the US's largest retail trusts with a market capitalisation of US$5.3bn), management has borrowed heavily to dramatically increase the trust's focus on the US (as you can see from the pie charts below).

Don't be fooled by the benign net debt-to-equity figure and the steadily increasing interest cover (which are shown in the table below). There's another $2bn of debt in joint ventures which doesn't show up on the balance sheet (for an explanation of joint venture accounting, see the recent **Macquarie Office Trust** article of *26 Apr 2007 (Better Value Elsewhere—$1.585)*).

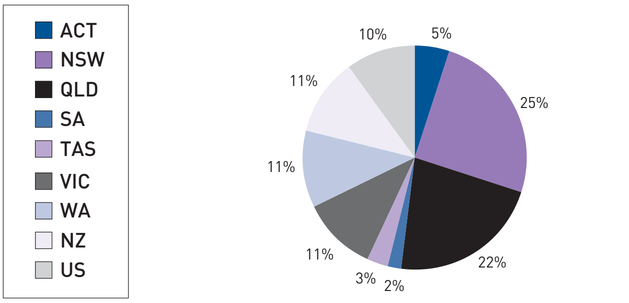
It's also interesting that while US investments total 74% of the book value of the portfolio, they only contribute 52% of total net income. The Australian assets appear to be much more profitable.

Who's who of supermarkets

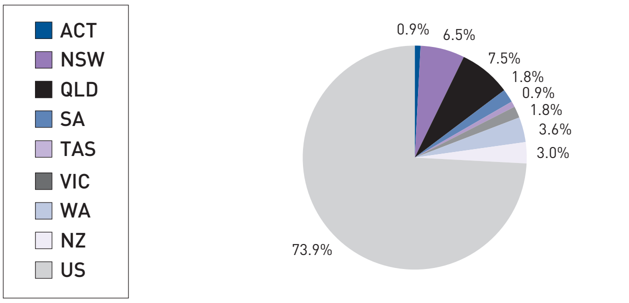
Overall, though, Macquarie CountryWide has a high-quality portfolio, with rents from 241 shopping centres anchored by the who's who of supermarkets in Australia, New Zealand and the US. In total there is over 2 million square metres of floor space and the trust manages over $5bn of assets.

After its splurge in the US, management now appears to be turning its attentions to Europe and Asia. After selling a 50% share of its New Zealand properties, it has recently announced a $571m investment in Poland and Germany. Trading reliable, low-growth assets for higher-growth opportunities has been crucial to the trust's success. But this strategy works best in rising markets—it's tough to buy and sell property profitably in a downturn.

Geographic diversification 2002



Geographic diversification 2006



Macquarie CountryWide has generated significant value for unitholders so far, but it's no longer suitable for conservative investors. It currently trades at a 14% premium to its net tangible assets of $1.97 per unit. And while the 6.9% yield may appear attractive, it's crucial to understand the risks involved in that higher return.

The unit price is up 17% since last year's annual property review *20 Jun 2006 (Sell—$1.92)* and without adequate compensation for the large risks involved, we

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continue to recommend that unitholders **SELL**.

Look out for the rest of this five-part series in coming weeks, with reviews of **Westfield Group**, **CFS Retail Property Trust**, **Centro Retail Group** and **Bunnings Warehouse Property Trust**.

Macquarie CountryWide Trust: Key financials

	2002	2003	2004	2005	2006	CAGR*
Total assets ($m)	789	1,018	1,357	2,557	3,062	35.8%
Management fees ($m)	4.9	7.0	6.9	6.9	7.5	22.7%
NTA per unit ($)	1.29	1.40	1.62	1.73	1.92	9.0%
Net debt-to-equity	48%	33%	28%	22%	24%	
Interest cover	3.6	4.4	5.0	5.4	6.7	
Distribution per unit (c)	13.4	13.7	14.3	14.8	15.4	3.3%

*Compound annual growth rate

Gandel sends a signal on CFS Retail

In the second of our 5-part series covering the retail property trust sector we turn our attention to CFS Retail Property Trust and its founder John Gandel.

SNAPSHOT

CFS RETAIL PROPERTY TRUST (CFX)	$2.33
INFORMATION CORRECT AT	7 Jun 2007
STOCK CATEGORY	PROPERTY TRUST
MARKET CAPITALISATION	$5.2bn
12-MONTH SHARE PRICE RANGE	$1.855—$2.51
BUSINESS RISK 2.5 out of 5	SHARE PRICE RISK 3 out of 5
OUR VIEW	SELL

John Gandel's $2.3bn property fortune earned him 12th spot on this year's BRW Rich 200, which lists Australia's 200 wealthiest people. But what really caught our attention were two recent sales. The first was his $300m stake in the management company of CFS Retail Property Trust. The second, a $100m deal to sell part of his retirement home portfolio to a joint venture between **Macquarie Bank** and **FKP**.

And Gandel hasn't been the only property magnate in sell mode. Lang Walker, whose impeccable market timing has taken him to 13th on the BRW list, also sold $1.1bn of his property empire to **Mirvac** in November last year.

So far, Gandel's 33% stake in the CFS Retail Property Trust itself has remained untouched, but you have to wonder whether its time is nigh.

Grander plans

After emigrating from Poland in the late 1930s, Gandel's parents established a clothing store on Collins Street in Melbourne. It was the forerunner to women's fashion chain Sussan, and John assumed management responsibility for it in the 1950s. In 1983, however, he sold the company to his brother-in-law and this provided him with the funds to purchase Chadstone Shopping Centre in South East Melbourne for the princely sum of $37m.

Over recent years, Chadstone has consistently been Australia's highest-grossing shopping centre and, in 1994, it became the cornerstone investment of a newly listed property trust named Gandel Retail Trust. In total it contained six properties valued at around $647m.

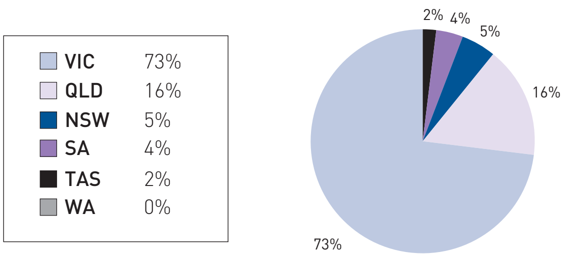
Skip forward 13 years and, after many developments and acquisitions (including the $369m purchase of the Myer Centre in Brisbane in 1999) and a couple of name changes, the portfolio now exceeds $5.8bn.

The trust's heavy reliance on the Victorian economy, however, is one thing that hasn't changed, as you can see from the pie charts. Indeed, Chadstone still generates over 10% of the trust's rental income on its own.

One of Australia's best

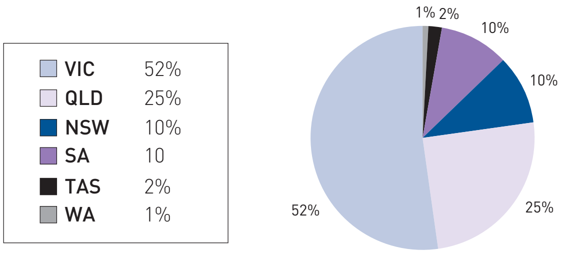
But when your portfolio has a near-perfect occupancy rate of 99.9%, with only one vacancy, as does CFS Retail today, the large Victorian exposure doesn't represent much of a problem. The portfolio is undoubtedly one of Australia's best.

Geographic diversification 2002



Management has increased its geographic diversification by acquiring assets in Queensland and, to a lesser extent, New South Wales. The current focus, however, seems to be on expanding existing centres. The development pipeline is currently valued at $1.1bn, with yields expected to be at least 8% on completed projects.

Geographic diversification 2006



This is significantly higher than the yields available by acquisition in a market where asset prices have skyrocketed. It also highlights the potential value of a trust's internal development pipeline, which is one reason why we like Westfield.

Capital raisings

Pursuing an acquisition and development program of this size has required multiple capital raisings. Even so, the net tangible assets (NTA) per unit have increased at a respectable annualised rate of 8.1% since 2001. Recent favourable revaluations won't go on forever though. More importantly, distributions have increased at an annualised rate of 5% over the same period. This is well in excess of the rate of inflation and far superior, for example, to anything we've seen in the office sector. Although rather than demonstrating superior operational performance, it probably reflects the benefit of a low interest rate environment.

Unfortunately, the external management seems only too aware that simply increasing the size of the trust is an easy way to increase fees. This has encouraged the liberal use of debt, which has pushed net debt-to-equity up to 42%—almost double its level of five years ago. With the large pipeline of work planned, the level of debt is unlikely to subside any time soon.

In last year's annual property review, on *21 Jun 06 (Take Part Profits—$1.91)*, we suggested that a Sell recommendation may not be far away. That time is now.

Unitholders over recent years have had a great run, but there are a number of red flags waving. They include large property sales by experienced entrepreneurs, rising debt, the stock trading at a 15% premium to its NTA and an unattractive, if not downright ugly, yield of just 4.9%. That's 1.35% below what you can earn at the bank without any risk.

We don't know what John Gandel will do with his personal stake in the trust, and we're not inclined to hang around to find out. Mr Market is offering you a great price for your investment today and we suggest you accept. **SELL**.

CFS Retail Property Trust: Key financials

	2002	2003	2004	2005	2006	CAGR*
Total assets ($m)	2,164	3,180	3,813	4,626	5,325	22.6%
Management fees ($m)	11.8	17.5	16.8	16.8	27.6	20.0%
NTA per unit ($)	1.22	1.29	1.37	1.52	1.71	8.1%
Net debt-to-equity	25%	28%	38%	42%	42%	
Interest cover	6.5	4.7	4.0	3.5	3.5	
Distribution per unit (c)	8.96	9.66	10.06	10.51	11.1	5.0%

*Compound annual growth rate from 2001

Westfield mystery is no puzzle

In the third of our five-part series covering the retail property trust sector, we look at the risks that could potentially undermine this retail juggernaut.

SNAPSHOT

WESTFIELD GROUP (WDC)	$20.90
INFORMATION CORRECT AT	14 Jun 2007
STOCK CATEGORY	PROPERTY TRUST
MARKET CAPITALISATION	$37.1bn
12-MONTH SHARE PRICE RANGE	$16.88–$23.49
BUSINESS RISK 2 out of 5	SHARE PRICE RISK 3 out of 5
OUR VIEW	LONG TERM BUY

Malcolm Gladwell recently published an article in the *New Yorker* titled *Enron, intelligence, and the perils of too much information*. In it he suggests that people in certain professions, such as that of investment analysis, would be better served thinking in terms of mysteries rather than puzzles.

Accumulating information can solve puzzles. 'Mysteries', Gladwell explains, 'require judgments and the assessment of uncertainty, and the hard part is not that we have too little information but that we have too much … Puzzles come to satisfying conclusions. Mysteries often don't.'

Westfield has a seemingly bulletproof franchise. And it's worth bearing in mind that in trying to predict what might derail the juggernaut, we're probably dealing with a mystery rather than a puzzle. It's probably the risks we cannot see today that have the greatest potential to cause harm, and there's not a lot that can be done about it.

And despite its undoubted quality, Westfield has a net debt-to-equity ratio of 78% as well as off-balance sheet finance, so it operates on a fairly thin slice of equity. So

[CONTINUED ON PAGE 10]

Westfield mystery is no puzzle

small shocks could cause relatively big waves.

Westfield's capital requirements have been highlighted by the recently announced 2 for 23 rights issue to raise $3bn, which will provide funds for development activity. (The securities are now trading ex the rights, and given our recommendation and the discount to the share price of $19.50, we recommend you take them up, as long as you're comfortable with the increased holding.)

Succession

In terms of the known risks, with so much experience concentrated in chairman Frank Lowy, succession risk is an obvious place to start. Lowy's three sons, David, Peter and Steven, have spent decades in the business already. But perhaps the boys will lose the urgency to increase and preserve what their father has spent a lifetime building. Or perhaps they'll have trouble working together when Frank is no longer there to keep order.

Eldest son David no longer holds an executive position at Westfield. But he is deputy chairman, as well as being a board member of **Publishing & Broadcasting** and the founder and president of Temora Aviation Museum (he's also an accomplished acrobatic pilot). If his younger brothers were to follow in his footsteps and stand back from the operational side of the business at some point, it would be a big blow to the group.

Compounding large numbers

Frank's lifetime of hard work has generated returns for shareholders unparalleled in Australian history. But success on such a large scale brings with it many challenges.

Growth at past rates will be impossible, especially in Australia. Most of the prime locations have already been snapped up and extreme competition for the remainder could make development much less attractive, if not uneconomic. This could force Westfield into new markets, bringing with it a range of new risks: less developed markets can be unstable and it may not be possible to replicate Westfield's brand and reputation.

Shoppers depart

What about the risks that might keep shoppers away? An outbreak of bird flu could cause immense short-term damage to Westfield's business. When a visit to the shops increases the odds of contracting a fatal flu, people will soon find other ways to entertain themselves.

Terrorism is also worth considering. That could be an actual act of terrorism at a Westfield or other shopping centre, or even just a publicised threat to damage these bastions of capitalism. Thinking back to the poisoned Mars Bar episode, even empty threats can damage a company's image and profitability.

Currency and interest rates

With 49% of group's revenues earned in the US and UK, a sustained appreciation of the Aussie dollar would devalue repatriated profits. Although hedging is usually in place for a few years at least, beyond this hedging becomes less practical and more expensive.

Higher interest rates tell a similar story. Management can only fix borrowing costs out so far before it becomes impractical. And, in a double whammy, higher interest rates also curtail shoppers' discretionary income. Lower profits from tenanted stores means lower profits for Westfield.

Worse, though, would be a long and protracted economic slowdown. When unemployment levels rise, shoppers peg back their spending on non-essential items. Looking around our local Westfield, there's a lot of frivolous trading that's bound to dry up in a tougher environment. The Japanese economy of the past decade is a good example of this 'death by a thousand cuts' scenario.

Not bullet-proof

Any sign of the risks we've discussed here could cause jitters in Westfield's stock price. Its premium rating could evaporate quickly if interest rates suddenly increased, for example. But this is a market risk, not a business risk, and if the stock price fell to $15 tomorrow, we wouldn't be all that concerned. In fact, all things being equal, we'd upgrade to Buy.

Good management can do a lot to prepare for knowable risks, but other risks remain outside its control. For those risks, the best defence comes in the form of a low purchase price for the stock. Westfield's stock doesn't currently represent a major bargain, but the price is fair and we're comfortable with it. The Lowys have done a wonderful job over the years, and this counts for plenty. The stock price is down 4% since *28 Feb 07 (Long Term Buy—$21.75)* and Westfield remains a **LONG TERM BUY**.

Bunnings' higher prices

With property trusts across the globe expanding like Selleys No More Gaps, Bunnings Warehouse Property Trust remains firmly nailed to Australia.

SNAPSHOT

BUNNINGS W'HOUSE PROPERTY (BWP)	$2.30
INFORMATION CORRECT AT	21 Jun 2007
STOCK CATEGORY	PROPERTY TRUST
MARKET CAPITALISATION	$693m
12-MONTH SHARE PRICE RANGE	$1.92–$2.52
BUSINESS RISK 2.5 out of 5	SHARE PRICE RISK 3.5 out of 5
OUR VIEW	AVOID

As we explained on *31 Oct 03 (Better Value Elsewhere—$1.50)*, the Bunnings Warehouse Property Trust owes its existence to the Bunnings Warehouse hardware chain. It doesn't participate in the retail side of the business, but instead owns the land and enormous green sheds which house 50 of Bunnings' 147 established stores.

The portfolio also includes two Bunnings distribution centres, two pieces of development land and three properties leased to Blackwoods (a wholly owned subsidiary of **Wesfarmers**), Australia's leading supplier of industrial and safety products.

Strong relationships

Because of the trust's sole reliance on Bunnings Warehouse for its revenue, there's no tenant diversification. But, on the flipside, strong relationships between the groups allow long leases to be struck. This has resulted in a current weighted average lease expiry of 8.9 years. Although it's still much higher than most other property

Wesfarmers, which owns the actual Bunnings Warehouse business, also remains the trust's major unitholder with 23% of issued capital.

The national roll-out of Bunnings Warehouse has been hugely successful so far and it has recently expanded into New Zealand. With the trust only owning roughly a third of the retail chain's locations, it could continue to grow for some time yet—even if Bunnings Warehouse doesn't.

Simply adding stores to the portfolio, though, is not necessarily a good thing. If the returns from additions fall short of those enjoyed currently, then this actually becomes a negative. Distributions could also suffer.

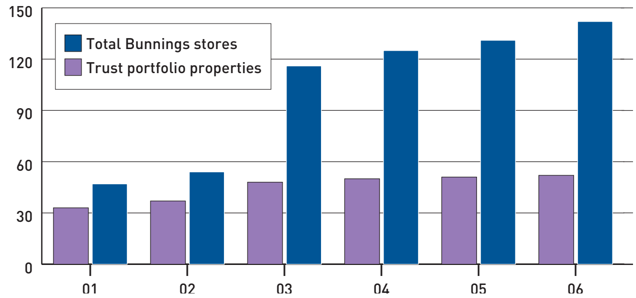
Slower pace

It's interesting that the number of locations in the trust's portfolio has failed to keep pace with new store openings by the Bunnings retail chain. After several purchases in 2002–03, which included four properties from Wesfarmers' acquisition of Howard Smith (owner of BBC Hardware), growth in locations has stalled (as you can see from the chart below).

This is partly because management has focused on upgrading its existing locations, many of which are very old. Some sites have also been developed from the ground up, which explains the current land holdings. Given that distributions have grown 6.6% annually since 2001, history suggests that the strategy has been relatively successful.

It also shows, perhaps, that management isn't being bullied into acquiring existing sites. With such an incestuous relationship with Wesfarmers, that's always a risk. Wesfarmers is wearing more hats than you'd find at a two year-old's birthday party. It manages the trust, thereby receiving management and performance fees; it determines which sites are to be sold to the trust—a potential conflict given that it sits on both sides of the deal; and it's the trust's major unitholder. If you were Wesfarmers, would you sell your most profitable sites to the trust?

Growth in store numbers



Not cheap

Despite the big box roll-out, which has been repeated umpteen times, development and acquisitions don't come cheap. The net debt-to-equity percentage has remained consistently in the high 30s over recent years, which

Bunnings Warehouse Property Trust: Key financials

	2002	2003	2004	2005	2006	CAGR*
Total assets ($m)	349	472	575	657	732	20.5%
Management fees ($m)	1.9	2.4	3.0	3.5	4.0	21.2%
NTA per unit ($)	1.10	1.14	1.34	1.54	1.67	10.4%
Net debt-to-equity	32%	48%	38%	35%	39%	
Interest cover	5.5	5.4	4.8	4.4	4.3	
Distribution per unit (c)	9.77	10.50	11.38	11.96	12.61	6.6%

*Compound annual growth rate from 2001

Bunning's higher prices

is pretty conservative compared to the figures for other trusts. And there are no huge slabs of off-balance sheet debt, as at **Macquarie CountryWide** for example.

There have been several capital-raisings in the past, but the dividend reinvestment plan ceased operation in February 2005. Nonetheless, net tangible assets (NTA) per unit have increased at a respectable 10.4% per year since 2001. Unfortunately, much of the increase is due to favourable, and likely unrepeatable, revaluations.In summary, if you're only going to have one tenant, it had better be a good one, and Bunnings Warehouse is just that. Unfortunately for potential investors, this fact isn't lost on the market and, with the price up 17% since *20 Jun 06 (Better Value Elsewhere—$1.96)*, the units currently trade at a 16% premium to their NTA value of $1.98 and provide a 5.6% yield (tax advantaged to 24% last year). **AVOID**.

Centro's American shopping spree

Centro has recently filled its trolley with regional US shopping centres and it's busy unpacking them for investors. We wonder who'll be left holding the empty shopping bags.

When we last reviewed Centro, on *18 Jul 06 (Hold for Yield—$6.82)*, it had announced a $4.3bn takeover of an American group, Heritage Property Investment Trust. It turned out to be the beginning of an acquisition frenzy that has turned the group into Australia's largest manager of American property (no mean feat in today's climate).

We didn't think much of the Heritage assets, but we took comfort from the fact that they were destined to become feedstock for several new unlisted funds, rather than additions to Centro's own direct property portfolio. The deal had another effect, though. To help fund it, management decided to demerge $2.5bn worth of its own shopping centres into a new listed vehicle called Centro Retail Trust, which we'll discuss in more detail in a moment.

New Plan

Without any hint of indigestion following the Heritage acquisition, management announced the US$3.7bn purchase of New Plan Realty in April. New Plan manages 467 American neighbourhood and community shopping centres across 38 US states, including a direct portfolio of 290 centres that Centro has bought on an average yield of just 6.75%. That doesn't leave much wiggle room for higher borrowing rates.

The New Plan deal increased Centro's funds under management (FUM) dramatically to $23.1bn. But still not content, it recently bought out the interest of its American joint venture partner, Watt Companies Inc, thereby further increasing FUM to $25.5bn. It's a huge change from being a dominant Australian owner of niche regional shopping centres with a fledgling property and fund management business on the side.

Comparative information

COMPANY	ASX CODE	PRICE AT REVIEW	BUSINESS RISK	SHARE PRICE RISK	OUR VIEW
Centro Properties Group	CNP	$9.01	3	3.5	Avoid
Centro Retail Trust	CER	$1.75	3	3.5	Avoid

Institutional appetite

With the current institutional appetite for all things property, Centro has willingly purchased assets quick-sticks to satisfy the demand. The assets barely make it on to Centro's balance sheet before they are hived off into funds and syndicates for institutional investors.

Even though it's usually a co-investor in its funds, management prefers the fees it can generate over long-term ownership of the assets. So high prices, particularly in the US, haven't been a deterrent. The focus has instead been on finding willing investors for its funds and syndicates. It's a great business as long as the punters' dollars keep rolling in. While the rewards for a fund manager are potentially higher than for a staid property trust, the risks are also higher. Mass redemptions, for

Centro Properties Group: key financials

	2002	2003	2004	2005	2006	CAGR*
Total assets ($bn)	1.58	2.34	3.52	6.15	5.15	32.8%
Total FUM ($bn)	2.40	3.00	6.40	9.10	11.50	45.3%
NTA per unit ($)	2.71	3.09	3.42	3.60	3.63	7.1%
Net debt-to-equity	42%	17%	49%	83%	39%	
Interest cover	4.2	3.9	3.9	4.8	3.7	
Distribution per unit (c)	26.25	27.40	30.55	33.60	36.80	8.0%

*Compound annual growth rate from 2001

example, could force Centro to sell parts of its own portfolio to raise cash.

Occupancy almost perfect

Centro's strategy has worked a treat in the current economic environment. Whatever Centro has paid for assets, the next year's revaluations have sent them higher, thereby improving the asset backing and performance of its funds.

Occupancy rates remain almost perfect in Australia and hover around 94% in its US centres. While interest rates stay low and shoppers keep spending, Centro can increase rents and distributions.

But at some point this self-reinforcing scenario will be challenged and then we'll see how shrewd the recent acquisitions have been. For now, though, it's hard to know what the likely impact on Centro might be, because it's continually shuffling assets between itself and its funds. Perhaps this is a warning sign in itself.

Fortunately for securityholders in Centro itself, the fees will keep rolling in even if the assets' underlying performance suffers. It's the investors in the various funds that will likely end up carrying the can. But ultimately, of course, poor fund performance would reflect badly on the manager.

Frequent capital raisings

As you might expect with this level of activity, there have been frequent capital raisings. In the latest half-year result, net tangible assets (NTA) per unit had fallen 98 cents to $2.65 (although this included a 75 cent special distribution for the Centro Retail Trust demerger) and net debt-to-equity was hovering around 90%. Remember that this is before the latest round of acquisitions.

The stock currently trades on a forecast yield of 5.2% and expectations for the property and funds management business continue to increase. Debt is sky high and American property owners must be thanking their lucky stars for Australia's willingness to fatten their wallets.

Centro has been Australia's best-performing listed property trust over the past decade, but this company has rapidly transformed into a much different beast, and both the new assets and the new strategy will struggle when the cycle turns. With risks mounting and expectations high, we're happy to sit this one out for the time being. **AVOID**.

Centro Retail Trust

At the half-year end, the separately listed Centro Retail Trust was invested almost equally between Australian and American shopping centres. Its NTA was $1.0bn, or $1.88 per share; net debt-to-equity was 139% and interest cover was just 2.3 times. It also paid almost $15m in management and performance fees to Centro as manager, which says something about the relative merits of the two businesses.

But, as part of the New Plan acquisition, Centro Property Group passed on US$1.8bn of assets, priced on a yield of just 6.6% (from a pool bought for 6.75%, remember—it's nice business if you can get it), to Centro Retail Trust. The latter raised $1bn of fresh equity capital to pay for them and, while its net debt-to-equity ratio could fall to less than 90% as a result, the fund now has over 70% of its portfolio located in the US.

The trust currently trades on a forecast 2008 yield of 7.8%, which seems relatively attractive. But on the opposite side of the ledger, the trust remains highly leveraged, is very acquisitive, pays high fees and its US acquisitions look expensive—not to mention the extra risk involved in running an international business. As much as anything else, it also appears to be a bit of a pup for its manager. **AVOID**.

DIVERSIFIED TRUSTS

General breaks its rules of engagement

In the first of our four-part series covering the diversified property trust sector, we find GPT Group getting carried away with itself in the US and Europe.

SNAPSHOT

GPT GROUP (GPT)	$4.89
INFORMATION CORRECT AT	9 Jul 2007
STOCK CATEGORY	PROPERTY TRUST
MARKET CAPITALISATION	$10.0bn
12-MONTH SHARE PRICE RANGE	$4.25—$5.64
BUSINESS RISK 2.5 out of 5	SHARE PRICE RISK 3 out of 5
OUR VIEW	HOLD FOR YIELD

Let's pretend for a minute that it's 2004 and that you're a board member of GPT Group, Australia's oldest and proudest listed property trust. Despite your conservative leanings, you've agreed to meet with the boffins from investment banking group **Babcock & Brown**.

While sipping their decaf macchiatos at the exclusive Café Sydney, the financial alchemists run you through some apparently huge opportunities available in Europe and the US. They suggest a joint venture to tap into them, and you take the idea back to HQ to discuss with your fellow board members.

As a group, you agree that GPT's financial clout could be put to great use overseas, but it's risky. So you set a maximum limit on your exposure to the joint venture of 15% of the group's capital—a prudent amount given the risks. Why then, barely three years later, would you

[CONTINUED ON PAGE 14]

General breaks its rules of engagement

suddenly discard this safety net?

In our review of GPT Group on *2 Aug 06 (Hold for Yield—$4.53)*, we discussed the sweeping changes that management is undertaking, which rely heavily on huge slabs of debt. The analysis explained the $6bn joint venture with Babcock & Brown and it's worth reviewing if you own the stock.

In summary, the joint venture is purchasing assets in Europe and the US faster than my five-year old son scoffs chocolate biscuits. But the intention is to 'flip' them into funds from which the partners will derive management revenue (a business model copied straight from the **Macquarie Bank** and Babcock & Brown play books).

More recently, the joint venture exceeded its original goal of creating a $5.5bn portfolio. But it failed in the second phase: an attempt to open a European retail fund. Additional acquisitions, however, suggest that fresh attempts to open new funds are imminent. Owners of the stock should keep an eye on these attempts. More failures would be a real worry.

Massive investment

Despite the joint venture's massive investment so far, GPT appears to want more. It recently agreed to a $3bn expansion of the joint venture, which also included a host of structural changes. This is when GPT dispensed with the original 15% capital limit, and it now has about 25% of its capital at risk in the vehicle. This new-found confidence is also reflected in GPT's recent purchase of Halverton and Hamburg Trust from the joint venture.

Much of GPT's investment in the joint venture has been funded by disposals from its portfolio at home. Last year, the group established its first managed fund, GPT Wholesale Office Fund, which was seeded with some of Australia's best office property. Hot on its heels came the April launch of the $1.9bn GPT Wholesale Shopping Centre fund. Talk about selling the family silver.

In with the old-aged

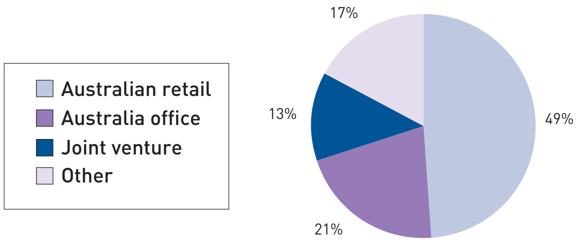
In a case of out with the old and in with the old-aged, GPT has also announced a $331m expansion of its US retirement housing portfolio. This comes on top of an investment of $545m last year. Both purchases have been 95% stakes in portfolios previously owned by US group Benchmark Assisted Living. For an extra $4.5m, GPT also took a 20% interest in Benchmark Assisted Living itself.

GPT's US retirement housing portfolio now includes 34 assets, most of them in the 'Northeast Corridor', which is home to 26% of Americans aged over 75. They're mostly in affluent locations and have above-average occupancy rates and rents, but the purchase yields were a skinny 6.8%. Most of the assets are assisted living or Alzheimer's-assisted living units, which competitors can't replicate overnight, but controlling costs will be vital if the debt used to fund them isn't to become a problem.

Chicken feed

GPT Group has never been more diversified and the proceeds from the GPT Wholesale Shopping Centre Fund will help reduce debt, at least initially. But its net debt-to-equity ratio was hovering around 57% before this year's acquisitions and the joint venture's leverage makes this look like chicken feed.

Sector diversification (31 Dec 2006)



So the risks are rising, but GPT's huge size and diversity will continue to support its distributions. It's still a stalwart of the Australian property landscape and retains some great assets, which competitors would be only too happy to take off its hands should cash ever need to be found in a hurry.

The yield is currently an uninspiring 5.7% and it's trading at a 36% premium to its net tangible assets of $3.60 per unit. Put on your GPT Group board member hat one last time and ask yourself this: if accepting all this risk was going to be so beneficial, wouldn't you love to be a substantial securityholder yourself? So far we haven't seen any mass security purchases from management or the board, despite their increasing salaries.

We deliberated long and hard about downgrading this stock, but in the end we've decided to procrastinate some more. **HOLD FOR YIELD**.

GPT Group: Key financials

	2002	2003	2004	2005	2006	CAGR*
Total assets ($m)	6,697	7,695	9,097	10,432	12,002	13.6%
Management fees ($m)	33.9	25.6	35.5	15.4	0.0	
NTA per unit ($)	2.60	2.73	3.02	3.16	3.60	6.9%
Net debt-to-equity (%)	26	39	43	55	57	
Interest cover	6.2	5.1	3.9	3.0	3.0	
Distribution per unit (c)	20.4	21.2	22.0	24.4	27.5	6.9%

*Compound annual growth rate from 2001

DB RREEF chases growth overseas

You don't have to sell the family silver to create a funds management business, as we see in the second of our four-part series on the diversified property trust sector. But the urge to expand internationally seems to be irresistible.

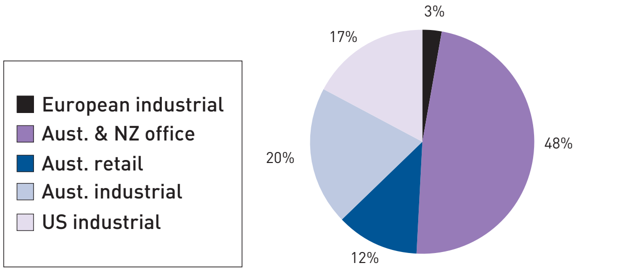
SNAPSHOT

DB RREEF TRUST (DRT)	$1.895
INFORMATION CORRECT AT	16 Jul 2007
STOCK CATEGORY	PROPERTY TRUST
MARKET CAPITALISATION	$5.5bn
12-MONTH SHARE PRICE RANGE	$1.505—$2.10
BUSINESS RISK 2.5 out of 5	SHARE PRICE RISK 3 out of 5
OUR VIEW	HOLD FOR YIELD

Imagine you're the managing director of a property trust management company. You currently manage four separate listed property trusts, each focused on a different sector of the market. But they're relatively small and therefore vulnerable to being taken over. Although the takeover of a trust would mean a windfall for its unitholders, it would mean the end of your lucrative management contract.

So you propose to merge the trusts into a much larger entity. You can justify the deal in terms of greater diversification for unitholders, and the much greater size of the new entity will hopefully keep the wolves at bay.

Direct portfolio diversification (31 Dec 2006)



Skewed in management's favour

This situation isn't purely hypothetical. In September 2004, DB RREEF management stapled together DB RREEF Diversified, Industrial, Office and Operations Trust to form Australia's seventh-largest listed property trust, DB RREEF, with over $13bn of assets under management. We did some fanciful thinking on the motivation behind the merger on *19 Aug 04 (Sell—$1.25)* and concluded that the rewards were heavily skewed in management's favour. Three years since the merger, has anything changed?

The merger proposal also provided for the 50% internalisation of the management structure. The other 50% remains owned by DB Real Estate, one of the world's largest property managers. Normally we'd view this as a positive development, but DB Real Estate accepted $65m from unitholders for the privilege. Potentially good in the long-run, certainly expensive in the interim.

Also approved was the $1bn acquisition of an 80% interest in a US Industrial portfolio. This was followed in May 2005 by the creation of a six-centre domestic retail joint venture with **Westfield Group**, which also manages it. There have also been over $300m of industrial acquisitions in both France and Germany, with purchase yields on average in the mid-sixes, and a $600m investment program with US giant Whirlpool Corporation will see DB RREEF's tentacles spread to Canada and Poland.

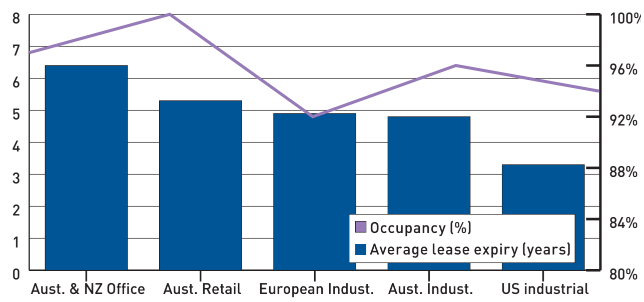
More money than sense

But if you were a DB Real Estate executive sitting in New York or Frankfurt, why would you send even your more marginal investment ideas down to your colleagues in Australia? Because Australia is the powerhouse of the international real estate sector? Or because you once saw *Crocodile Dundee* and feel like helping out Mick and his mates? Or because you reckon Aussie property investors have more money than sense? We think there's a large element of the latter – it's just a lot easier to get some of these more marginal deals away in Australia than it is elsewhere.

So, after all this activity, what does DB RREEF's portfolio look like and how's it performing? The pie chart shows that the group is heavily concentrated in office and industrial property. While the office property is mostly in Australia, the industrial portfolio is distinctly global.

While it's not as diversified as the likes of **GPT Group**, its domestic assets are performing well. Occupancy rates are up, especially among its retail assets (thank you Westfield), and average lease expiries are long (as you can see from the second chart ??). Although the industrial portfolio's average lease expiry of 4.8 years is 1.6 years less than its retail sibling, it still provides unitholders with a degree of comfort. The same cannot be said for its international portfolio though.

Portfolio statistics (31 Dec 2006)



The European industrial portfolio's average lease expiry of 4.9 years is satisfactory, but its occupancy rate is only 92.2%. And while the US industrial portfolio has a higher

[CONTINUED ON PAGE 14]

occupancy rate of 94.1%, its average lease expiry is a worrying 3.3 years.

These statistics have also improved significantly since their original purchase, but it's difficult to know whether it's because of good management or a strong economy. One thing's for sure, though, you have to question the quality of the opportunities that DB Real Estate is proffering.

Outside investors

Aside from its direct portfolio, DB RREEF's partnership with DB Real Estate also sees it managing $4.3bn of property assets for outside investors, including the DB RREEF Wholesale Fund and portfolios owned by insurance provider AXA Group.

Recent property reviews may have you thinking that we have something against property funds management businesses, but we like this one. Why? Because it doesn't involve selling the family jewels. They're external mandates, which produce additional fee income without increasing the group's risk.

When you're as active as DB RREEF you need access to capital. Debt has reached a massive $3.5bn, forcing the net debt-to-equity ratio up to 73%, and the number of times the interest bill is covered by operating cash flow down from 3.1 in 2005 to 2.9—in a period where interest rates have fallen. These are far from conservative levels.

There were $686m in positive revaluations alone in 2006, so we doubt there's much conservatism there either. And compounding the problem is DB RREEF's price tag, which currently sees it at a 15% premium to its net tangible assets per unit of $1.65.

History suggests trouble ahead

The valuation isn't attractive, but it's management's goal of having 35% to 50% of the group's assets invested overseas that really makes us cringe. Such ambitions aren't usually in the best interests of unitholders, and experience suggests that most trusts currently expanding overseas will return with their tails between their legs and large holes in their balance sheets. Even if it is different this time, and we don't see a blow-up, the high prices being paid for assets suggest a sustained period of low returns ahead.

Back on 22 Jan 04, we quoted some comments by **Mirvac Group**'s Robert Hamilton on why Australian property trusts were expanding overseas: 'It beats me. I don't see why they are smarter than the rest of the world. The risks far outweigh the attraction.' His comments have never been more pertinent.

Despite DB RREEF having some attractive qualities, the bad far outweighs the good. The yield of 6.0% would need to increase substantially to offer sufficient compensation for the risks.

We had a SELL recommendation on the individual DB RREEF trusts before they merged and if you ignored our advice back then, we recommend you **SELL** now.

Is Stockland safe as houses?

Scratching beneath Stockland's surface reveals a company more vulnerable than its size might suggest. In the third of our four-part series covering the diversified property sector, we find out why.

SNAPSHOT

STOCKLAND TRUST GROUP (SGP)	$8.16
INFORMATION CORRECT AT	25 Jul 2007
STOCK CATEGORY	PROPERTY TRUST
MARKET CAPITALISATION	$11.8bn
12-MONTH SHARE PRICE RANGE	$6.70—$9.16
BUSINESS RISK 3 out of 5	SHARE PRICE RISK 3.5 out of 5
OUR VIEW	SELL

Property Trust For Sale: 24 consecutive years of profit growth with total annual returns exceeding 15% over the past 10 years. It also comes with an enviable 55-year track record and is Australia's largest diversified property trust and residential developer, with a market capitalisation of $11.8bn. The managing director's seat has only ever been occupied by two individuals and safety features include a $9.5bn property portfolio diversified across various property sectors and geographies.

If Stockland were up for sale, the paragraph above is how its sales pitch might read (although perhaps it says more about why I failed Marketing at university). If nothing else, it sounds like an investment that's as safe as houses. But when you start to scratch beneath the surface, you find that, like most advertising, the reality fails to match the hype.

Stockland is a stapled security, which means it's part property trust and part operating company. The trust's portfolio exceeds $7.6bn and combines shopping centres ($3.9bn), office towers ($2.6bn) and industrial properties and office parks ($1.2bn) all across our wide brown land.

With occupancy rates of 99.7% for the shopping centres and 98.0% for the office and industrial properties, it's tempting to overlook the trust's dependence on Sydney and Brisbane, which produce over 75% of its rental income.

More than a landlord

But Stockland's chief executive, Matthew Quinn, is ambitious and he expects the company to be much more than a landlord. Stockland's operating company, Stockland Corporation, houses the riskier development side of the business. It's Australia's largest residential property developer and it also manages and maintains the assets in the trust.

Development profits have been a boon for investors over recent years. In 2006, and for the first time, they exceeded the strong profits made by the shopping centres, and the combination of the office and industrial properties.

Have no illusions, though, residential development is risky business. The $2.0bn of inventory currently sitting on the balance sheet could easily halve, or worse, should interest rates spike. History is littered with failed developers that have gorged themselves on debt, so is Stockland likely to follow? We'll come back to this question in a moment.

Stockland also recently bolstered its retirement home management ambitions by acquiring Australian Retirement Communities for $329m. It's a private company that manages 17 retirement villages with another nine in planning (three are currently under construction). There's a bit of a land rush in the retirement housing sector at the moment and Quinn wants it to deliver 15% of Stockland's development profits by 2010.

Possibly Quinn's most significant move, though, is the $427m acquisition of UK property manager Halladale, following in the footsteps of his rivals at **GPT Group** and **Goodman Group**, amongst others. We analysed the pros and cons of this strategy in our review of Goodman Group on *31 May 07 (Avoid—$7.16)*.

Where's the money coming from?

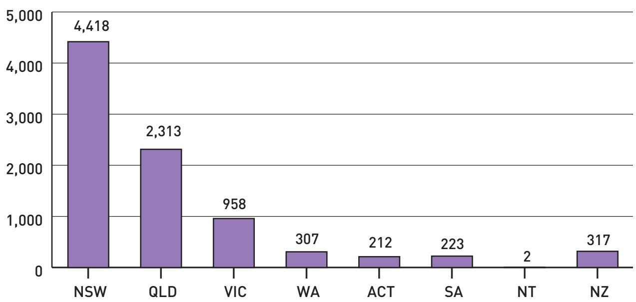
With money racing out the door in all directions, you might wonder where it's all coming from. First up, securities on issue have risen by more than 60% since 2002 (as you can see in the table on page 12), and there's no sign of it slowing down. Secondly, debt has increased substantially. And the third source has been to seed an unlisted managed funds business with some newly completed developments and some assets previously owned by the trust (a popular industry strategy in recent years). Assets under management include about $800m of Australian property spread across various sectors.

None of these moves are particularly appealing to conservative investors, though. Share issues dilute existing shareholders and higher debt increases risk. Ramping up a development and funds management business also increases the risk of owning Stockland, despite the higher returns that they potentially generate. For the safety-conscious, development profits are lumpy, unpredictable and far less reliable than a rent cheque.

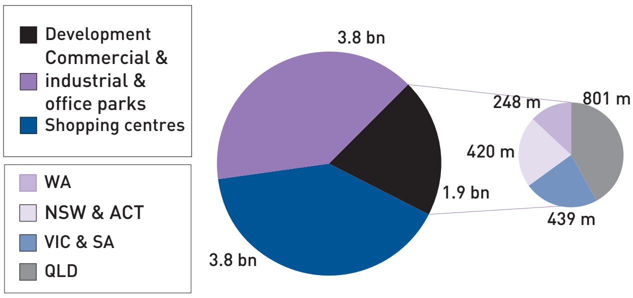
Staggering revaluations

The property values in the trust's portfolio have also been assisted by a staggering $1.1bn of revaluations over the past 18 months. With **Centro Properties Group** also recently reporting a $1bn increase in its property values, it's important not to become accustomed to it. Valuations can just as easily go backwards in less frothy conditions.

Geographical diversification of assets $m (30 Jun 06)



Estimated sector diversification of assets ($m)



So, to answer our question from earlier, Quinn is not putting the company on the road to ruin. Net debt-to-equity of 42% is typical of the industry and the trust's $7.6bn portfolio offers a fair degree of safety even in the worst of times. But does it stack up as a good investment?

[CONTINUED ON PAGE 14]

Is Stockland safe as houses?

Well, after reading Stockland's hypothetical 'for sale' advertisement, you'd then need to consider its increasing reliance on development profits, its paltry yield of 5.1% and its 65% premium to its net tangible assets per unit figure of $4.96. None of which is appealing to an investor that is being asked to bear some significant risks.

The group itself may, in some respects, be as safe as houses, but the security price certainly isn't. We think it's vulnerable at these levels and Mr Market is offering you an attractive price for your securities. The price is up 18% since last year's property review *21 Jun 06 (Sell—$6.91)* and we suggest you **SELL**.

Stockland: key financials

	2002	2003	2004	2005	2006	CAGR*
Total assets ($bn)	3.33	5.95	7.21	8.40	9.60	23.2%
Units on issue (m)	832	1,039	1,266	1,321	1,353	11.9%
NTA per unit ($)	3.14	3.41	3.76	4.00	4.54	8.6%
Net debt-to-equity (%)	15.7	36.3	29.1	40.7	35.5	
Interest cover	8.8	3.6	2.2	4.0	1.4	
Distribution per unit (c)	29.7	32.1	37.0	38.9	41.4	7.9%

*Compound annual growth rate from 2001

Mirvac makes others' dreams come true

Mirvac has helped several property entrepreneurs realise large fortunes in the past two years. In the last of our four-part series covering the diversified property sector, we suggest you cash in as well.

SNAPSHOT

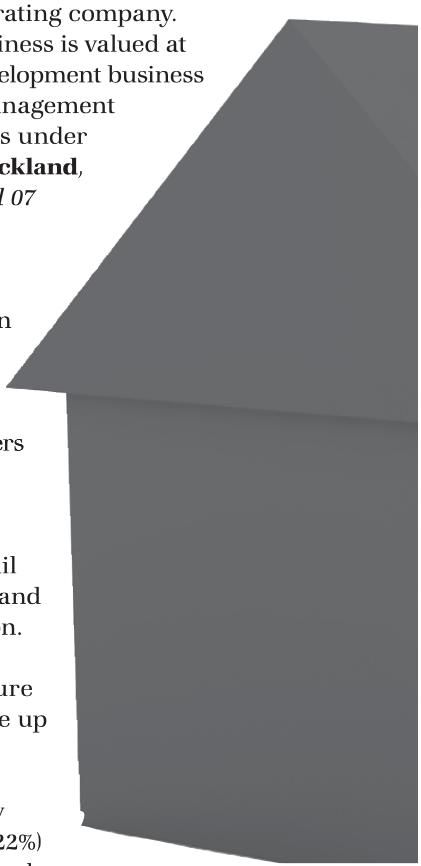
MIRVAC GROUP (MGR)	$5.18
INFORMATION CORRECT AT	2 AUG 2007
STOCK CATEGORY	PROPERTY TRUST
MARKET CAPITALISATION	$5.3bn
12-MONTH SHARE PRICE RANGE	$4.19—$6.06
BUSINESS RISK 3.5 out of 5	SHARE PRICE RISK 4 out of 5
OUR VIEW	SELL

It's party time in the property business. Cheap debt and insatiable investor demand, not to be confused with tenant demand, have pushed property prices to record levels around the globe. And yes, tenant demand is also strong, judging by the extremely low reported vacancy rates.

But property market veterans know how these parties tend to end and, like grandparents at an 18th birthday party, they've left early. Among those ducking out for a cup of cocoa is Robert Hamilton, who co-founded Mirvac 35 years ago, and whose telling departure we'll return to shortly.

Mirvac is renowned for its high-quality residential developments, but it also owns a significant portfolio of office and retail property. In January 2005, Mirvac acquired James Fielding Group to add property funds management to its CV. James Fielding's founder, Greg Paramor, was also invited to succeed Hamilton as managing director of Mirvac.

Paramor now oversees $24.7bn of activities under a stapled security structure, which means Mirvac is part property trust and part operating company. The staid property trust business is valued at $3.8bn, the much riskier development business at $12.6bn, and the funds management business has $8.3bn in funds under management. It's akin to **Stockland**, which we reviewed on *25 Jul 07 (Sell—$8.16)*.



Failing to keep pace

Mirvac refers to its $3.8bn of property trust assets as its Property Investment and Management division. Although office towers represent half the portfolio ($1.9bn), its occupancy rate of 91.8% has failed to keep pace with its rivals. The retail portfolio is valued at $1.1bn and the industrial assets at $0.3bn. Hotels, investments in listed property trusts, infrastructure funds and parking lots make up the remainder.

The entire portfolio is heavily skewed towards New South Wales (55%), Victoria (22%) and Queensland (16%), although it would be more accurate to replace the states with the names of their capital cities. Mirvac's investment portfolio earns the bulk of the group's profits, as you can see from chart 2 below. This income is also the most reliable.

The portfolio recently expanded by more than a billion dollars as famed property investor Lang Walker (renowned for his exceptional timing of property markets) sold the bulk of his company's portfolio to Mirvac. Walker is certainly not one to relinquish his assets on the cheap, so we view this deal as a big red flag.

Residential development

The Property Development division focuses on large residential developments throughout Australia. It became truly national in March 2001 with the purchase of Western Australian property developer Fini Group. Its CEO, Adrian Fini, is now an executive director of Mirvac and holds 8.8m shares. He also acquired 2.7m shares last December as part of his long-term incentive plan.

Although Mirvac is known for quality, development profits can be volatile. Take a look at the 2005 profit in chart 2. As we said about Stockland, development is risky business and historical downturns in the sector have brought many companies to their knees. Fortunately, Mirvac's own investment portfolio provides something of a safety net.

Funds management

Before late 2004, Mirvac didn't have a funds management business to speak of. Not wanting to miss the gravy train, however, it bought James Fielding Group for $478m. Today Mirvac manages $8.3bn, and increasing this figure is a major focus. Although Mirvac proclaims the 'sustainable earnings' that funds management offers, it's not without risk. We discussed this issue in our review of **Goodman Group** on *31 May 07 (Avoid—$7.16)*. It has also invested in property funds managers in the UK, which introduces a further risk factor.

Mirvac: key financials

	2002	2003	2004	2005	2006	CAGR*
Total assets ($bn)	2.78	3.64	4.31	5.52	6.06	20.7%
Units on issue (m)	618	678	717	854	891	8.0%
NTA per unit ($)	2.76	2.98	3.12	3.26	3.38	4.3%
Net debt-to-equity (%)	44.4	58.8	59.0	68.1	72.0	
Interest cover	3.2	(1.3)	3.6	0.8	2.7	
Distribution per unit (c)	26.20	29.00	32.20	33.80	31.00	4.5%

*Compound annual growth rate from 2001

Now let's return to the management changes. As we mentioned earlier, Greg Paramor has replaced Hamilton as managing director. In a telling move, Hamilton also sold his remaining stake in the company. With both Hamilton and Walker, two prominent industry veterans, selling significant stakes in the companies they've spent a lifetime building, this is another warning sign. Paramor and Fini also received tidy sums from Mirvac for their businesses, but they still have some skin in the game. It seems that Mirvac has made a few people's financial dreams come true. But if you're going to realise your own financial dreams, who should you follow: the elder statesmen who have cashed in their chips, or the new breed pursuing possibilities in funds management?

Summing it up

Mirvac is an aggressive property group operating in some very risky areas. Its expansion plans require plenty of capital, and this prompted a $375m capital raising last year. The net debt-to-equity ratio has also grown from 31% in 2001 to 53% at the end of last year and you can bet this figure will increase further (it blew out to 72% last year).

distribution yield is an uninspiring 6.2% and the stock trades at a 30% premium to its net tangible assets per unit of $4.00. That's no dot-com valuation, but it's no bargain either.

Chart 1: Portfolio statistics (30 Jun 2006)

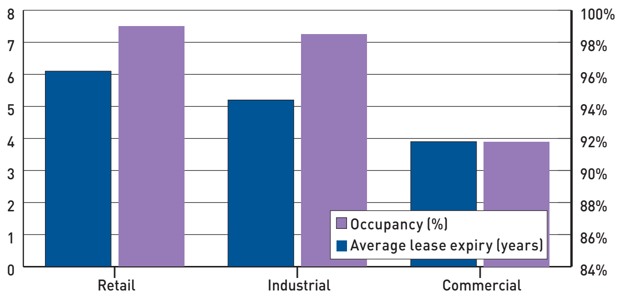
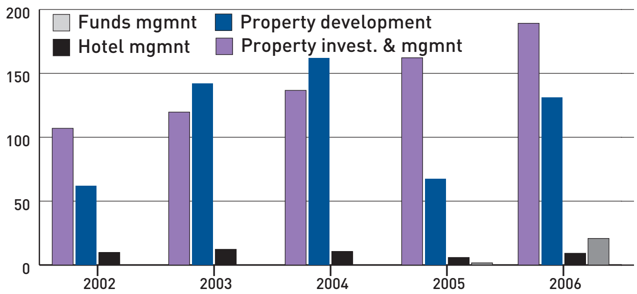


Chart 2: Segment operating profits



If you're a conservative property investor looking for a reliable yield, there are safer alternatives to Mirvac. And even if you're prepared to assume a degree of risk at the right price, the stock looks unappealing. The

The unit price is up 17% since last year's property review on *21 Jun 06 (Sell—$4.41)* and, despite recent falls, we recommend you **SELL**.

IN THIS REPORT

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