

# Property research note

## The real estate investment trust (A-REIT) market

Date: 13<sup>th</sup> September 2008

### Executive summary

→ Sector dynamics:

- Mature market with exposure to core sectors.
- Transformation of sector – the quest for growth has come with embedded risk.

→ Investment environment:

- Equity market volatility to persist with uncertainty surrounding credit crisis.
- Weight of capital – strong flow of capital from superannuation funds.

→ Focus on value proposition (performance attributes):

- Relatively high and stable income component.
- Potential to deliver favourable portfolio (diversification) benefits.

→ Pricing:

- Risk – general upward re-pricing across the property asset quality spectrum.
- Direct property yields to experience further (cyclical) softening.

→ Performance:

- Focus on defensive trusts unpolluted with aggressive growth strategies.
- Focus on quality (fund and asset) managers with proven track records.

## 1. Introduction

The period between early 2000 and the middle of 2007 saw commercial property markets post attractive returns, across both the listed and direct property segments. This period was characterised by a buoyant investment climate, underpinned by strong space market fundamentals (i.e. tightening vacancy rates and rising rentals) and favourable capital market conditions (i.e. low and stable interest rates and excess liquidity).

The exceptionally positive market sentiment attracted new players into the sector, triggering a proliferation of alternative investment vehicles. Many of the new products offered a range of investment styles beyond those of core holdings; aimed at providing exposure to higher return/higher risk assets. In all, strong capital flows coupled with relatively loose credit conditions led to a compression of property investment yields during this period – both between sectors and across grades.

The performance of the property sector has, however, deteriorated since August 2007, triggered by the global credit crunch. A lack of credit liquidity and higher domestic interest rates led to a general re-rating of investment risk across all asset classes. This, coupled with a looming slowdown in global economic growth, has put pressure on space market fundamentals, predominantly on the demand side.

This report provides a review of the Australian Real Estate Investment Trust (A-REIT) market in terms of the current market situation and short-term outlook<sup>1</sup>.

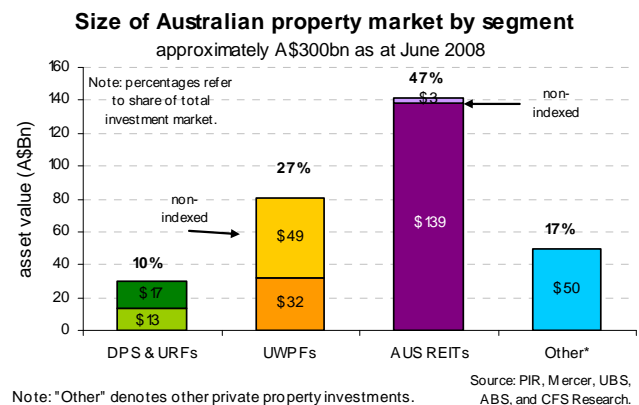
This report is structured into five parts. Section 2 will provide an overview of the A-REIT sector. Section 3 highlights some key features of the A-REIT market. Section 4 presents the investment performance for A-REITs in terms of total return and portfolio benefits. Section 5 briefly discusses some of the current pricing issues while Section 6 presents summary remarks.

<sup>1</sup> This report is part of a presentation delivered at the Association for Real Estate Securitization (ARES) Real Estate Investment Forum, held in Tokyo, Japan on 11th and 12th September 2008.

## 2. Overview of the A-REIT market

The Australian commercial real estate investment market, as shown in Figure 1, is estimated at around A\$300 billion (bn) (or ¥30.6 trillion) in terms of asset value. Due to the large scale of good quality real estate assets, investment is commonly accessed via three main types of property holding vehicles which include: direct property syndicates (DPS) and unlisted retail funds (URFs), unlisted wholesale property funds (UWPFs), and A-REITs. In addition, property assets are held on corporate balance sheets and by private investors; this segment, labelled 'other', is estimated to be A\$50bn.

Figure: 1



Real estate investment offers investors exposure to a wide range of property sectors. The main sectors include commercial office buildings, retail shopping centres and industrial warehouses. These sectors are referred to as 'core' property sectors.

DPS and URFs refer to small private investor funds and represent a small part of the property investment market with a gross asset value of A\$30bn and a share of around 10%. The attractive nature of property syndicates for retail investors arises from its relatively higher income yield (a level of returns associated with lower quality grade stock) and tax benefits.

UWPFs refer to large (private) real estate funds which cater for institutional mandates and superannuation funds. They are a significant part of the property investment market with an asset base of around A\$80bn and market share of approximately 27%.

A-REITs refer to real estate investment trusts which are listed on the Australian Securities Exchange (ASX). They comprise the largest component of the property investment space with an asset value around A\$142bn (or ¥14.4 trillion) and represent just under 50% of the total commercial property investment market and around 55% of the securitised property investment market.

The Australian real estate investment sector experienced exceptional growth from the late 1990s. Over the last 10 years, the sector recorded average growth of 20% per annum (pa). This strong growth is attributable to a variety of factors which include: the growth in superannuation investment (via the Federal government's compulsory pension scheme) into property, the growing popularity of annuity style investment funds, strong capital raisings as a result of a sector shift and rotation of investment funds from traditional investments (such as general equities and fixed-interest), and the access to liquidity relative to direct property offerings.

### The A-REIT market

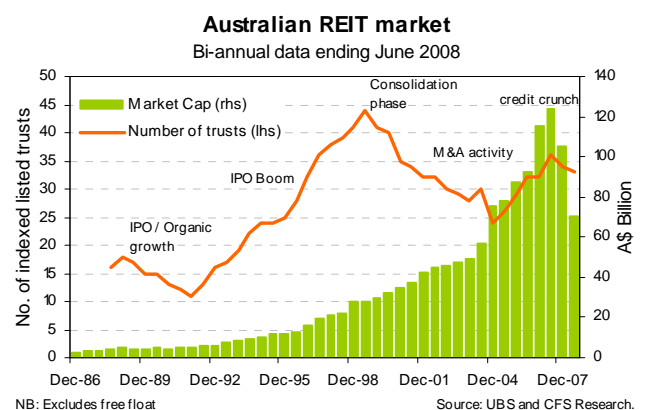
The A-REIT sector has become one of the most sophisticated and mature listed real estate investment markets in the world since its establishment in 1971. As at August 2008, the number of A-REITs within the S&P/ASX 200 Property Accumulation Index stood at 21 with a combined market capitalisation of A\$70.9bn. In terms of the S&P/ASX300 index, the number of A-REITs and market capitalisation were 33 and A\$72.7bn. The number of non-indexed trusts stood at 15.

Figure 2 shows the number of indexed listed trusts and their combined market capitalisation since 1986 to June 2008 for the S&P/ASX300 index. The IPO boom which began around the early 1990s reflected investor demand for liquidity and the capital inflows into the sector from superannuation. Notably, after the IPO boom of the early and mid 1990s, the sector went through a consolidation phase towards the late 1990s through to 2004 with a number of REIT takeovers reducing the number of trusts within the sector. Despite this, the sector continued to grow through new capital raisings and price appreciation.

More recently, the unfolding of the credit crisis has seen a consolidation in the number of trusts and a significant depreciation in market capitalisation.

It's also worth noting that the investor base for the sector has changed markedly over the last five years to 2007 with an increasing presence of global funds (with a share of around 30%) and a shrinking share of retail investors (around 12%). Property security funds also have a major presence with a share of 35%.

Figure: 2

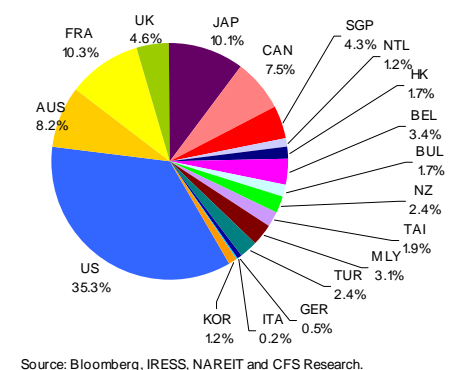


Furthermore, the A-REIT sector has comprised a growing proportion of the overall listed equity market. The market capitalisation of A-REITs to the S&P/ASX200 Accumulation Index has risen from 2% in 1986 to currently stand at around 7.0%, after reaching a high of 10% around mid 2007.

Figure: 3A

### Composition of the existing global REIT market

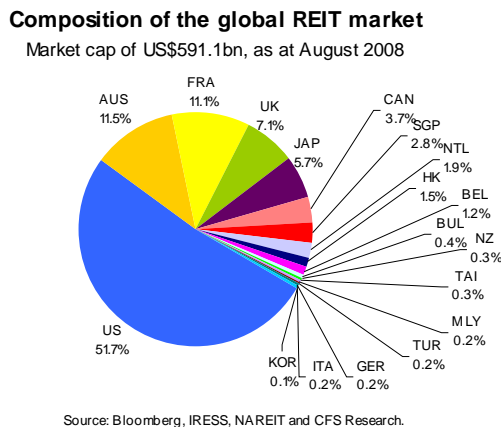
Number of REITs (416), as at August 2008



The global REIT market is valued at approximately US\$590bn (or ¥70 trillion). As noted in Figures 3A and 3B, the larger and

significant REIT markets include the United States, Australia, France, Japan, the United Kingdom and Canada. Australia's share of the global REIT market remains significant (with a share of 11.5% in terms of market capitalisation) despite the emergence of Asian REITs since the early 2000's.

Figure: 3B



### 3. Key features

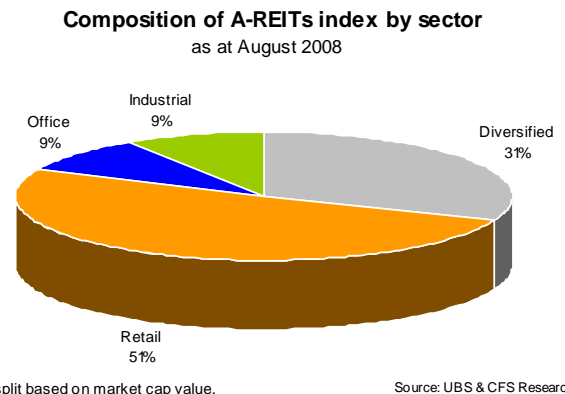
Some key features of the A-REIT sector include: i) greater sector diversity; ii) geographical diversity with greater exposure to offshore real estate; iii) trust manager concentration; iv) rising gearing levels; v) changing management structure; v) increased liquidity; and vii) high market transparency. These elements have reshaped the A-REIT market and exposed investors to non-traditional types of property investments and their associated risks. Each of these is briefly discussed below.

#### Property sector diversity

Property investment offers a diverse range of asset types, covering many sectors and sub-sectors, asset grades and geographical locations. Figure 4A shows the sector split for the A-REIT sector based on market capitalisation (as at August 2008). Notably, sector-specific trusts represent 69% of all A-REITs in the index. As with exposure to direct property holdings, A-REITs have a very large exposure to retail-sector specific trusts with a share of 51%. Over the last two decades the

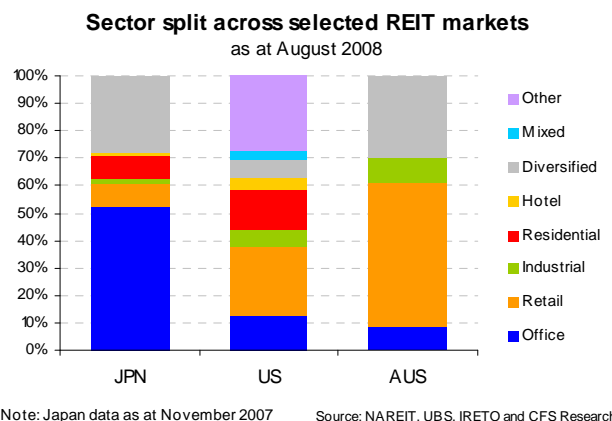
A-REIT sector has become increasingly specialised. Prior to 1992, the sector mainly consisted of diversified trusts. However, since 1992 the launch of new REITs has become increasingly sector specific. This has been primarily driven by investor demand with a preference for choosing which sectors to invest in themselves.

Figure: 4A



Interestingly, sector diversity varies across global REIT markets. Figure 4B compares the asset exposure for A-REITs with that of the US and Japanese REIT markets. As noted, Australian REITs have a high exposure to retail shopping centres; a reflection of the relatively high and stable income stream (with moderate capital growth); which is very attractive to core-style investors.

Figure: 4B



In contrast to the US, residential property investment (or multi-family apartment ownership) is yet to appear as a sector in A-REITs. This is due to the yield being significantly lower to that offered by commercial real estate. However, some A-REITs, such as Mirvac and Stockland, have

exposure to residential development from which they derive significant earnings.

While exposure to non-core real estate investments is small in terms of value, Table 1 highlights the diversity of this investment segment. Notably, a large part of the non-core investments reside in the unlisted vehicles.

Table: 1

Non-core real estate exposure				
as at June 2007				
Sector	Unlisted		Listed*	
	Number of funds	Asset value (A\$m)	Number of funds	Asset value (A\$m)
Agricultural property	16	403	4	560
Childcare/education	5	290	1	318
Car parking	3	257	-	-
Hotel	18	1,659	4	1,653
Leisure entertainment	6	521	2	628
Residential development	15	547	-	-
Residential property	42	849	-	-
Retirement	7	662	1	641
Serviced apartments	11	118	-	-
<b>Total</b>	<b>123</b>	<b>5,306</b>	<b>12</b>	<b>3,800</b>

\* Includes index and non-indexed trusts.

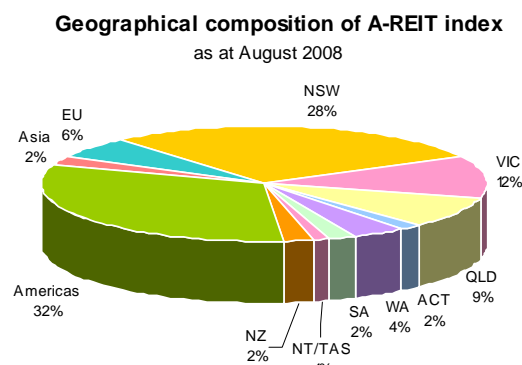
Source: UBS, PIR and CFS Research.

### Geographical diversity

As domestic trusts compete aggressively for local based assets, the lack of quality product has forced A-REIT managers to source product internationally. Figure 5A highlights the significant exposure to international real estate assets, which currently stands at around 43% of total asset value. A large share of these assets reside in North America (mainly the US) followed by Europe and then Asia. Furthermore, the asset exposure was mainly in core sectors, evenly split between office and retail assets. As such, an investment in the A-REITs offers investors exposure to domestic and/or international real estate markets but without the tax and management complication of investing directly offshore.

Figure 5B shows that A-REITs with assets located in Japan are valued at A\$3.8bn. Notably, assets mainly reside in core property sectors. Trusts with Japanese assets include: MOF (Macquarie Office Trust), RJT (Rubicon Japan Trust), CKT (Challenger Kennedix Japan Trust), GJT (Galileo Japan Trust) and BJT (Babcock & Brown Japan Property Trust).

Figure: 5A

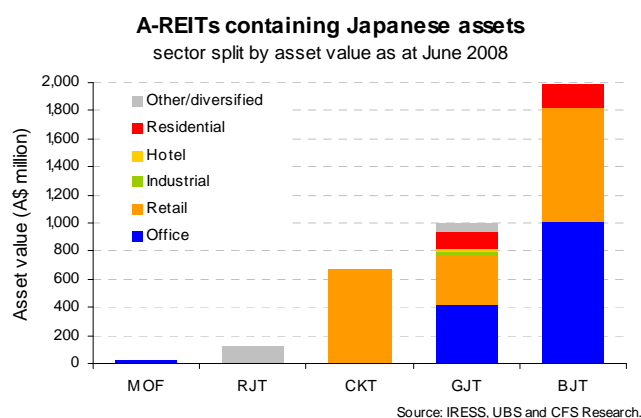


Nte: shares based on asset value.

Source: UBS & CFS Research.

One of the main drivers for investing in offshore property markets stems from the ‘the weight of capital argument’ (i.e., the limited availability of quality stock against the abundance of capital, both in terms of availability and placement). Hence, accessing offshore assets for domestic investors will help alleviate this imbalance.

Figure: 5B



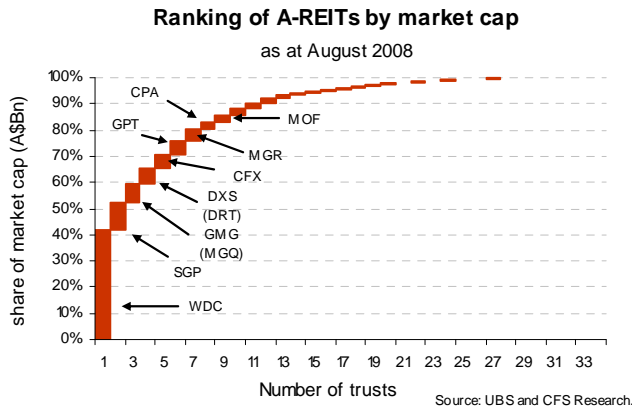
Source: IRESS, UBS and CFS Research.

Apart from the weight of capital explanation for investing offshore, other factors contributing to this push include the search for enhanced returns (where domestic opportunities become scarce) and for diversification benefits.

### Manager concentration profile

Figure 6 highlights the concentration profile amongst trust managers. Notably, WDC (Westfield Group) is the largest trust in the A-REIT index with a market cap of A\$30.2 and a sector share of 42%. The top ten trusts represent over 86% of the A-REIT index in terms of market capitalisation.

Figure: 6



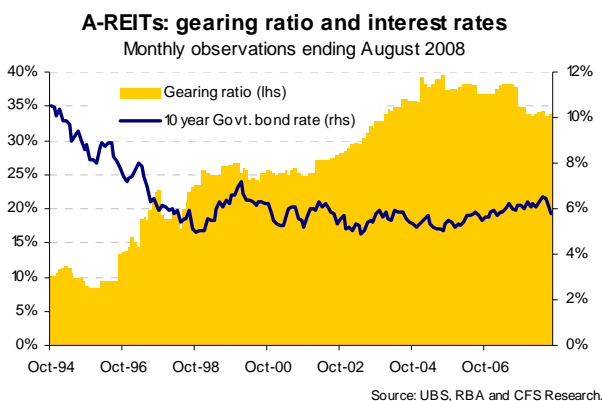
**Gearing levels**

Another changing feature of the real estate investment market is the level of gearing. Figure 7 shows the trend in the gearing level for A-REITs.

Gearing levels for the A-REIT sector has increased strongly since 1994 from 10% to stand around 34% at present, although it has reached as high as 38%. Until recently, higher levels of gearing tended to be more evident in trusts with offshore exposure.

The increased use of gearing is attributable to: i) a gradual reduction in the level and volatility of market interest rates; ii) greater use of capital management to expand and generate enhanced returns (strong distribution per unit growth); and iii) historical low levels of (perceived) risk in property investment. More recently, gearing levels have been declining with the unfolding of the credit crisis and the rise in market interest rates which forced a number of trusts to de-leverage themselves via asset sales and cuts to income distributions.

Figure: 7



**Management structure**

An emerging feature of A-REITs has been the emergence and popularity of stapled trusts or internally managed trusts (IMTs) as opposed to externally managed trusts (EMTs).

IMTs are where REIT units and shares in a corporation are ‘stapled’ together. Each stapled security comprises one unit in the trust stapled with one unit in the corporation. Such corporations engage in a range of property service, management, development and construction activities. Distributions from the trust typically include a tax-advantaged component and dividends from the corporation may be franked. While IMTs don’t have fee leakage (in terms of external management fees) they have company overheads.

EMTs outsource management of the assets to a third party. Under this arrangement, the asset manager receives a fee from the trust (on behalf of unit holders). Importantly, trust distributions to unit holders are net of management fees (leakage) and are typically tax advantaged.

The change in structure has given the IMTs the ability to bid higher prices on assets before acquisition becomes dilutive to expected income. With IMTs having a management fee arbitrage over EMTs, the response by EMTs has been to compete on performance and the cutting of management fees.

Figure: 8

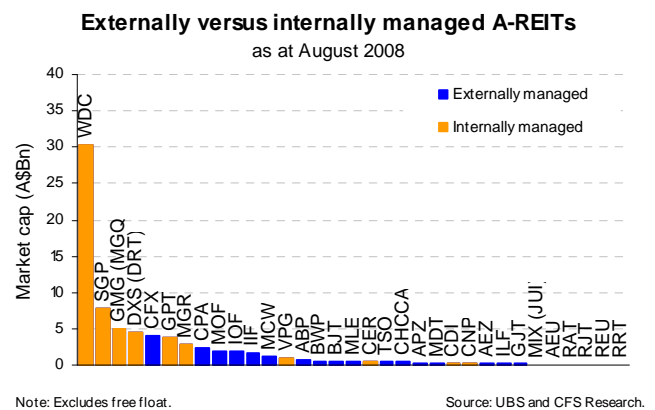


Figure 8 shows that as of August 2008 there were eleven IMTs with a combined market capitalisation of around A\$56bn, representing a significant 77% share of total A-REIT market capitalisation. This current wave of stapling A-

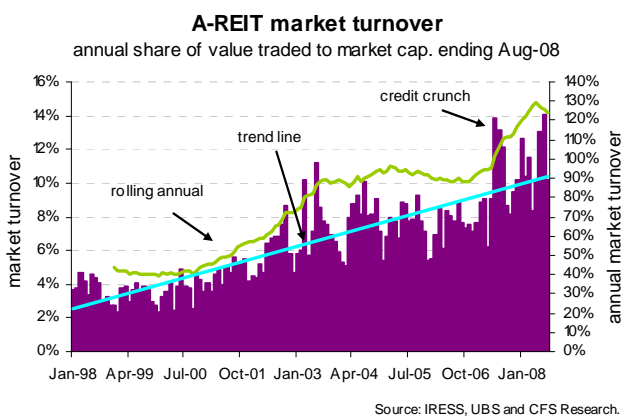
REITs has led to a diversification of earnings growth away from passive income towards more variable income streams (with exposure to funds management and development activities). While this exposure provided investors the potential for enhanced future EPU (earnings per unit) growth, it also embedded a higher level of risk. Nonetheless, a large component of the sector's income stream (about 90%) is derived from rental income.

Overall, while both structures have advantages and disadvantages, a large influence on overall performance depends on the quality of the management team, its strategy and ability to execute the strategy.

### Liquidity profile

A key appeal of REITs to investors is that they offer liquidity while obtaining exposure to real estate investment. In conjunction with a rising market capitalisation over recent years, liquidity (using turnover as a proxy) has also grown strongly in the sector as indicated in Figure 9. Since 1998 the average annual turnover as a share of market capitalisation has increased from around 40% to near 100% currently.

Figure: 9



### Market transparency

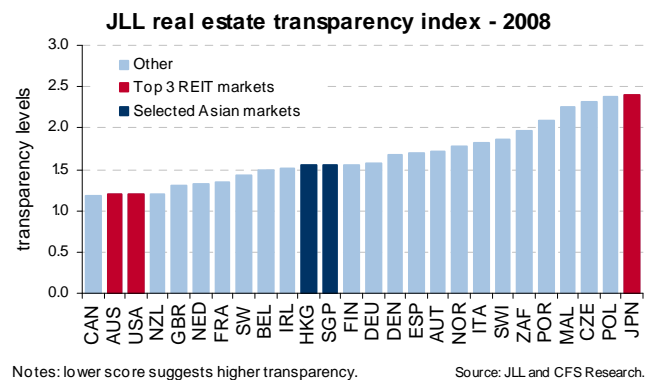
The Australian real estate investment market has a high level of property information that is publicly available. The transparency of information in the A-REIT market is supported by government legislation, ASX market rules and the extensive research undertaken in the

property industry. This is highlighted by the A-REIT market's high ownership (approximately 55%) of investment grade property assets.

However, in recent times, transparency in the sector has come under review with some A-REITs disclosing exposure to opaque financial structures.

As shown in Figure 10 Australia has one of the most transparent real estate markets as measured by the Jones Lang LaSalle (JLL) Real Estate Transparency Index (RETI). The RETI ranks selected countries on a scale of one to five in regard to how transparent the real estate market is. A score of one represents high transparency and a highly desirable investment market, while a score of five represents the lowest ranking.

Figure: 10



## 4. Investment performance

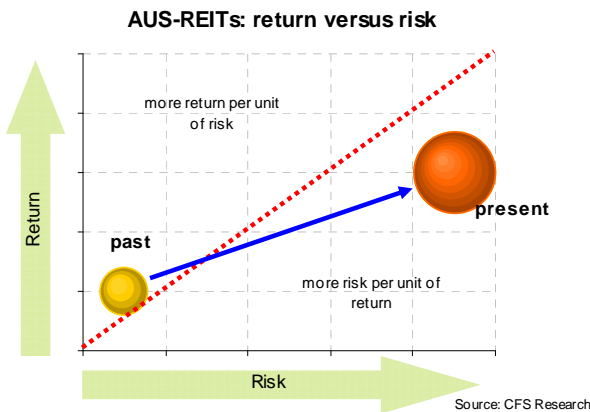
Investment in real estate delivers investors two main return attributes. It provides investors with a consistent income stream, secured by relatively long rental leases, which (arguably) provides an inflation hedge. This tends to give property returns a bond-like quality. It also provides investors with capital returns, underpinned by the macroeconomic environment. The combination of these return components characterises property investment as a 'hybrid' asset class, sitting between fixed-interest and shares.

Since around 2000, the offering of property investment products has expanded beyond the core region of the risk-reward space in an attempt to seek alpha (enhanced risk-adjusted) returns and the quest for growth initiatives.

They range from core products, which offer low risk and low return, to opportunistic products, that offer a higher level of risk associated with a wider range of return profiles. For instance, Australia has seen the development of investment products with international property exposure. Such products reside in the opportunistic region. In addition, the development of products with exposure to non-core real estate sectors (such as hotels and aged-care) is positioned in the value-added region of the risk-reward space.

Consequently, this has seen the A-REIT sector take on more risk. This has come about through: i) increased gearing levels; ii) growing offshore exposure; iii) the rise of stapled trusts; iv) increased market concentration; and v) poor capital management. Figure 11 depicts the transformation of the sector's risk-return profile.

Figure: 11



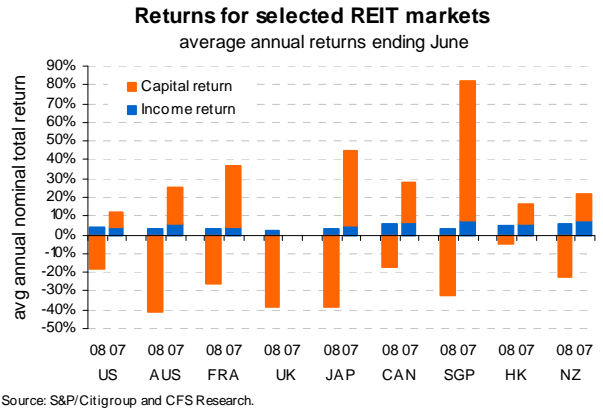
**Performance of A-REIT sector**

With the onslaught of the credit crisis, A-REITs (as well as equities) experienced substantial price falls. However, the A-REIT sector was not alone in this experience; as noted in Figure 12 other major REIT markets across the global also experienced negative capital return.

Focusing on A-REITs, total returns for the sector as a whole have declined by 35% over the year to August 2008. However, this varies across sub-sector. For example, the retail, office and industrial sectors experienced declines of 29%, 20% and 46% respectively.

The largest declines across individual trusts were Centro Properties Group (CNP) and Centro Retail Group (CER), declining by 98% and 85% respectively. This reflects their relatively poor capital management practices coupled with exposure to low quality offshore property assets which had uncertain income streams.

Figure: 12



Furthermore, as noted in Figure 13, A-REITs have under-performed against equities over recent times; general equities fell by only 14% over the last 12 months. This relatively lower decline partly reflects the price support from resource stocks associated with the current resource boom in Australia. Furthermore, the greater fall in A-REITs arguably reflects a re-adjustment for risk, after there was a disconnect in the two markets around 2001/02 at the time of the tech wreck which saw the A-REIT market forge ahead while the stock market took a step back.

Figure: 13

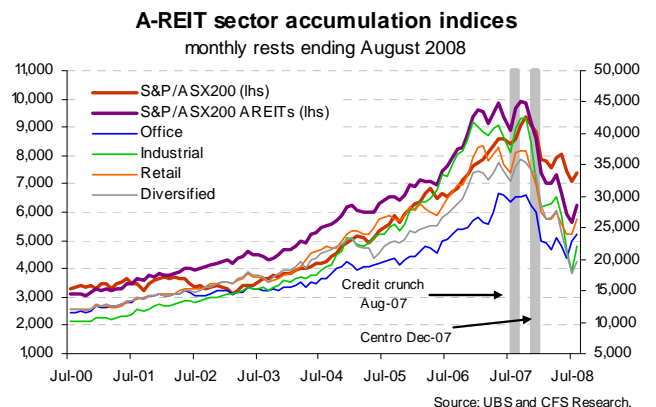
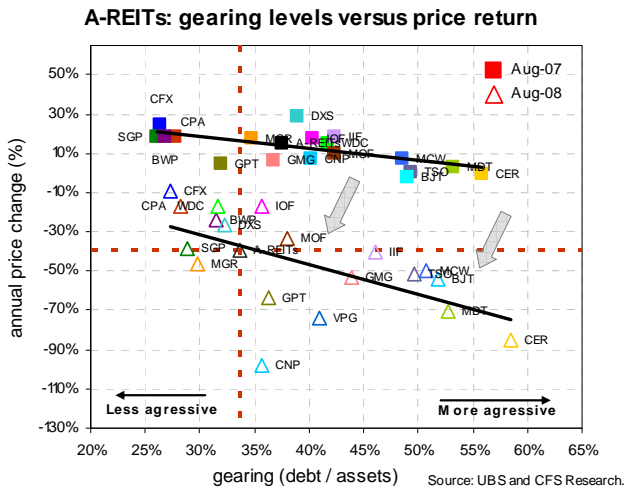


Figure 14 further highlights the price erosion for A-REITs by trust against gearing levels.

The two trend lines reflect the trade-off between price return and gearing level; the upper trend line for the 12 months ending August 2007 and the lower trend line for the 12 month period ending August 2008. Generally, it shows that trusts that were relatively highly leveraged were penalised more than trusts which were relatively less leveraged. Trusts which fared relatively well against the sector as a whole tended to have lower leverage and income streams supported by quality core property assets and unpolluted with aggressive growth strategies.

Figure: 14



**Portfolio benefits**

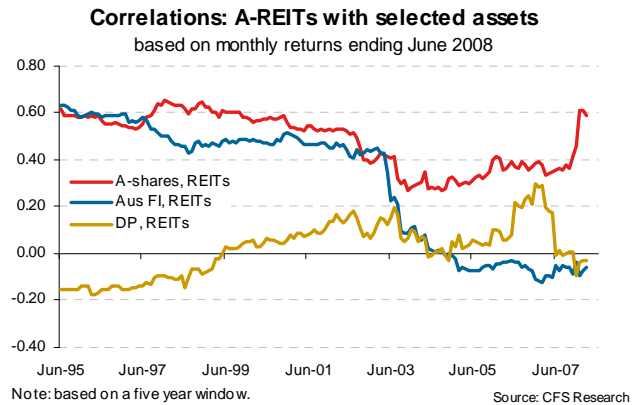
While much discussion has focused on the investment performance for the A-REIT sector, it's worth also reviewing some of its portfolio attributes.

It is commonly argued that A-REITs are 'defensive' in that they have a relatively low beta to the market and have low correlation with general equities. Figure 15 shows rolling return correlations (based on a five year sample period) for A-REITs against shares, fixed income (FI) and direct property (DP).

The Figure shows that A-REITs tend to have low to mild levels of correlations, depending on the asset class. Notably, while it has low correlations with direct property (DP), it has a moderate level of correlation with shares. The higher correlation between shares and A-REITs over recent periods reflects the

downward co-movement of both asset classes with the fallout of the credit crisis.

Figure: 15



Such correlation values suggest the potential for diversification benefits. In exploring this further, we consider augmenting a stylised balanced portfolio comprising of shares and bonds with A-REITs as shown in Table 2. Two sample periods are chosen to highlight the impact of the global credit crisis. Notably, over the last ten years to June 2008, an allocation of 10% (P1) or 20% (P2) to A-REITs in the base portfolio (P1) delivers only a marginal improvement to the portfolio risk-adjusted return measure (i.e., the Sharp ratio (SR)). In contrast, over the last ten years to June 2007, an allocation to A-REITs delivers a significant improvement in the SR. This coincides with A-REITs having a superior risk-adjusted return to both shares and bonds.

As such, while the short-term investment performance of A-REITs is considered to be unattractive to investors, in the long-term it should provide favourable risk-adjusted returns against competing asset classes.

Table: 2

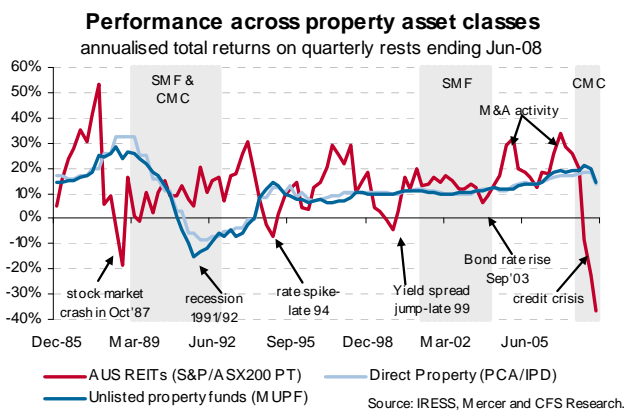
Portfolio construction using selected Australia asset classes						
based on monthly nominal total returns						
statistic	Asset class			Portfolio*		
	Shares	Bonds	A-REITs	P-1	P-2	P-3
Allocation to A-REITs				0%	10%	20%
<b>panel A: 10 years to June 2008</b>						
return	11.4%	10.1%	8.1%	10.7%	10.5%	10.2%
std dev	11.5%	11.3%	12.6%	2.7%	2.6%	2.5%
SR	0.99	0.89	0.65	4.04	4.09	4.07
<b>panel B: 10 years to June 2007</b>						
return	13.2%	7.3%	14.7%	10.3%	10.7%	11.1%
std dev	11.3%	11.1%	9.3%	2.6%	2.5%	2.4%
SR	1.17	0.66	1.58	3.93	4.29	4.64

Note 1: SR refers to Sharpe Ratio. Source: CFS Research.  
 Note 2: P-1 allocates 0% to A-REITs, P-2 allocates 10% to A-REITs and P-3 allocates 20% to A-REITs.

## A-REITs versus direct real estate

Focusing on real estate investment performance, Figure 16 compares rolling annual returns for A-REITs, direct property and unlisted wholesale property funds. The two investment segments display different return profiles. This divergence in the two return cycles can be attributable to different drivers for each property asset class. Price returns for REITs are generally underpinned by financial market considerations, such as prevailing market sentiment as well as movements in long term bond yields, while direct property capital returns are underpinned by real macroeconomic variables.

Figure: 16



Also, as highlighted in Figure 16, the property series exhibits a structural break around 1994/95. Prior to this, the return series are characterised by pronounced swings. This coincides with a period that saw adverse space market fundamentals (SMF) such as excess supply conditions and a contracting economy, as well as unfavourable capital market conditions (CMC) characterised by high interest rates). The long term bond rate has moved from a relatively high rate (average 13.1% in the late 1980s) to a moderately low rate, currently hovering around 6%. The headline CPI inflation rate has declined considerably over this period as well.

Around the early 2000's, the property market experienced sluggish SMF due to subdued demand conditions as a result of the bursting of the tech 'bubble' and the terrorist attacks in the US. However, investment returns remained solid due to very favourable CMC, i.e., strong

investor demand for property as an investment class.

More recently, the current property market is characterised by the opposite situation: deteriorating CMC while SMF remain relatively favourable. Consequently, with SMF remaining relatively solid, although with some weakening in demand, the direct property investment segment is set to experience only mild erosion in capital return. This will be further supported by limited rotation of capital out of unlisted property due to investors viewing this current crisis as cyclical.

## 5. Pricing considerations

### Trends in investment yields

Figures 18A and 18B show trends in the distribution yield for the A-REIT market and investment yields for the core direct property sector markets respectively. While yields have been firming (i.e., trending down) over the last decade, more recently they have experienced softening, largely triggered by the global credit crisis.

The drivers of this yield firming include: i) cyclical favourable space market fundamentals; and ii) strong investor demand for real estate investment. This latter point is underpinned by: i) a re-rating of risk (investor expectations of risk is down weighted against traditional asset classes); and ii) the weight of capital phenomena. These later two factors are structural in nature and set to continue unless capital markets experience a sharp tightening in liquidity (or credit conditions), such as the recent credit crunch scenario.

Figure: 18A

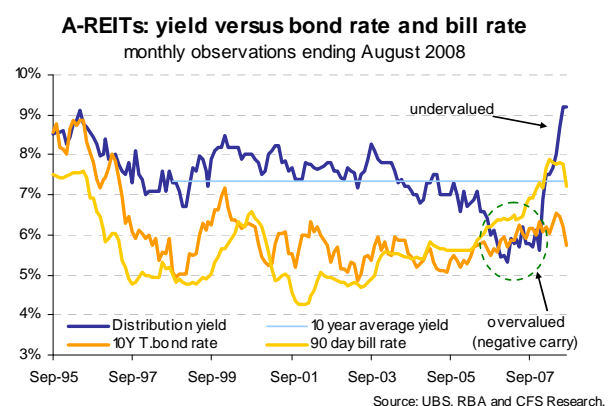
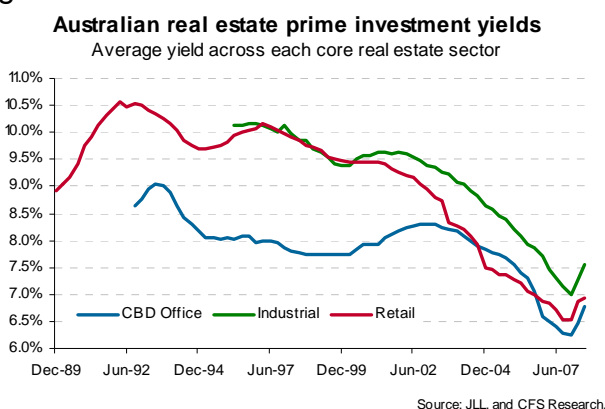


Figure 18A highlights the large movement in the distribution yield against market interest rates over the last few years. Around two years ago the distribution yield was very tight at around 5.5%. This reflected the intensive bidding for premium quality assets which has seen REITs refocus their pricing strategies (at least over the short-term), shifting from a yield play to a growth play based on (high) expected rental growth profiles, underpinned by the generally tight nature of the physical space market conditions. Currently, the yield is historically high at 9.2%; reflecting an overshoot position from the ten year average yield of 7.3%. Pricing of A-REITs is now currently below underlying real estate values with unit prices at a discount to net tangible assets (NTA).

In line with a softening in property yields (as shown in Figure 18B), discount rates are softening, reflecting: i) increased cost of debt (due to difficulty in sourcing finance and rising interest rates) and ii) an upward revision of the risk-premia. This latter point reflects: i) a lack of market depth (i.e., lack of liquidity and transactional activity); ii) a review of risk across asset quality; iii) reassessment of risk to earnings growth; and iv) a review of market transparency across trusts.

Figure: 18B



The softening in yields also reflects a flight to quality which should restore the spread in the risk-premium across asset grade, i.e., greater softening in yields for secondary grade than prime assets.

It is worth noting that to date the softening in yields has not reflected the secondary spill-

over effects; the impact on the real economy, and subsequently, space markets.

## 6. Summary remarks

The A-REIT sector is a mature market which offers asset exposure to core property sectors; office buildings, retail shopping centres and industrial warehouses. However, over the last ten years the A-REIT sector has gone through a transformation - the quest for growth has come with much more embedded risk.

The overall Australian investment environment is characterised by higher equity market volatility which is set to persist with uncertainty surrounding the credit crisis and turmoil in capital markets. However, investment flows are set to remain strong due to on-going capital sourced from superannuation funds.

Key investment attributes of A-REITs include: i) relatively high and stable income component; and ii) the potential to deliver favourable portfolio (diversification) benefits.

In terms of pricing, the sector has seen a changing risk profile due to structural changes. This has been reflected in a general upward re-pricing of risk across the property asset quality spectrum, and a cyclical softening in direct property yields. Yields are set to experience further (cyclical) softening, dependent on the spill-over effect on space markets.

In seeking (out) performance in the A-REIT sector, there will be a focus on defensive trusts unpolluted with aggressive growth strategies; renewed focus on quality (fund and asset) managers with proven track records; and identifying buying opportunities.

## 7. Research team

**Did you know CFS Research has a global reach and the expertise to tailor research to your needs?**

For further information about this report or our research capabilities, contact our Head of Research, Dr Anthony De Francesco or his assistant Mary Bonello.

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