APN | Property Group

An update on APN real estate securities funds that are currently closed to withdrawals

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This update provides information on the current status of the APN property securities funds (Funds)[1] which were suspended to applications and withdrawals in October 2008 due to the unlisted portion of the Funds reaching unacceptable levels. As our investors would be aware, the Funds became technically illiquid under the provisions of the Corporations Act forcing the Funds to be suspended to withdrawals.

A recap on why the Funds closed

The fall-out from the Global Financial Crisis (GFC), initially caused by the US sub-prime mortgage crisis delivered a particularly painful blow to the Australian Real Estate Investment Trust (AREIT) sector which led to major declines in the value of the listed property trusts. Furthermore, the introduction of the Federal Government's bank deposit guarantee in October 2008 led to an additional surge in redemptions of investments in non-guaranteed funds. Regrettably, our Funds were not immune to these exceptional external factors and resulted in the proportion of unlisted property trusts (illiquid assets) in the Funds reaching unacceptable levels.

Market backdrop

It's important to consider the performance of the Funds against the dramatic economic backdrop over the last couple of years. The Global Financial Crisis (GFC) resulted in Australian share markets dropping by 54% from their peak in late 2007 to the trough experienced in March 2009. And even with the recent rebound, equities are still a long way from their pinnacle, down by approximately 28%. AREITs not only followed suit, but in fact fared worse than the broader equities market, having dropped by more than 78% from peak to trough. Whilst the AREIT market has demonstrated a sharp bounce from the March 2009 low, having increased 59% to the end of March 2010, the sector still remains a long way from the highs of 2007.

Why was listed property impacted so severely throughout the economic downturn?

The answer primarily boils down to debt. In the lead up to the GFC, many AREITs increased their level of debt as they were enticed by the prospect of generating higher earnings. As the financial crisis hit, debt became difficult to procure, property values plummeted and banking covenants were at risk of being breached. Furthermore, derivatives liabilities (due to the collapse in the $A and interest rates) caused additional pain. And the huge volume of subsequent capital raisings ($17 billion in 2009) that took place to help relieve pressure on debt levels over the course of 2009 in turn caused AREIT prices to drop even further.

Market outlook

Most industry observers agree that the last few years have been atypical for the sector; a traditionally defensive asset class which has acted anything but defensively throughout 2008/2009.

After a tumultuous couple of years, pleasingly many AREITs are gradually reshaping their business to reflect their original intended form: low risk, low growth income investments that rely on regular income streams from the rent collected on commercial property.

The commercial property sector's outlook is certainly brighter that it was 12 months ago. The sector has confronted the extraordinary period of global financial market upheaval by restoring balance sheets, reducing debt and scaling back riskier style earnings. We see this return to basics (and lower risk structure) as a very positive sign.

We believe several key factors underpin an improved sentiment in the AREIT sector:

- The predominantly strong domestic macroeconomic indicators (particularly stronger than expected employment and retail sales);
- Stabilising asset valuations; and
- Credit markets are also starting to normalise (credit spreads have stabilised and now appear to be trading lower).

AREIT returns are reverting to what they should always have been - they will be lower and increase at a steadier rate. Longer term, we can expect total returns of around 9-11% pa.

Asset allocations

As at 31 March 2010 the portfolio weightings to unlisted property trusts (illiquid portion) for APN Property for Income Fund and APN Property for Income Fund No.2 are 26.90% and 26.16% respectively. These allocations fall well outside the mandated maximum long term asset allocation of 20% and fall significantly outside the indicative strategic asset allocation of 15%. The Funds are thereby classified as illiquid within the meaning of the Corporations Act 2001 (Act) and it would be unlawful for us to fully reopen to withdrawals.

Performance

We understand that investors may be disappointed with the total performance of their investment over the last 18 months. However, distributions have continued to be paid every month (albeit at lower levels reflecting decreased income and payout ratios) providing investors with relatively high, tax effective income. APN Property for Income funds are both generating high yields above 7.4% based on current unit price.

APN Property for Income Fund – as at 31 March 2010

	Total	S&P/ASX 200 AREIT Index
1 year	20.59%	40.55%
3 years pa	-16.88%	-22.83%
5 years pa	-2.61%	-6.95%
10 years pa	6.88%	3.65%
Since inception pa (08/98)	6.95%	4.18%

APN Property for Income Fund No. 2 – as at 31 March 2010

	Total	S&P/ASX 200 AREIT Index
1 year	24.99%	40.55%
3 years pa	-23.43%	-22.83%
Since inception pa (07/2007)	-9.34%	-7.75%

[1] APN Property for Income Fund, APN Property for Income Fund No.2 and APN Diversified Property Fund

Creating liquidity

Whilst the Australian economy remains remarkably resilient, uncertainty continues to pervade the global markets. It's against this challenging backdrop that we continue to do everything possible to provide investors with an opportunity to redeem their investment at the earliest opportunity without compromising the value or portfolio structure for remaining unitholders.

We continue working hard to manage the Funds back to "business as usual" by reducing the unlisted portion of the Funds to less than 20%. When the real estate market stabilises and optimal asset allocations and cash flows return, normal application and redemption procedures are expected to be restored. We have investigated multiple strategies to create liquidity (including listing and splitting the Funds, which after careful analysis, were determined to be inappropriate). We have however, subsequently undertaken the following activities to support liquidity:

1. Limited Liquidity Offer

In September 2009 we offered a Limited Liquidity Offer (LLO) for those investors who wished to withdraw some of their investment. We would like to offer investors a further LLO, however, this will be dependent on market conditions – in other words, AREITs will need to continue rising and unlisted assets will need to be sold down in order to offer an LLO.

Over the last calendar year quarter, the AREIT sector has remained stable and the proportion of liquid assets in the Funds has therefore not materially increased. Offering an LLO this quarter would only exacerbate the Funds' illiquidity and accordingly, the LLO scheduled for May will not be made.

We continue to closely monitor the situation and will provide ample notice to investors of any future LLO event.

2. Opening to applications

We reopened APN Property for Income Fund and APN Property for Income Fund No.2 in November 2009 to new applications, which will help improve liquidity levels over the long term.

3. Preparing to sell unlisted property trusts

Selling unlisted assets in the current market environment remains extremely difficult as buyers demand large discounts (in the order of 30-50%). In saying this however, we expect the situation to improve throughout 2010 as recent valuations of commercial real estate indicate property values are stabilising and in some cases beginning to increase. We are carefully monitoring the market in order to assess the most suitable time for liquidating unlisted assets at fair value. We are in constant dialogue with all relevant market participants (managers, investors, advisers) to identify potential purchasers of some of our unlisted property assets.

4. Hardship applications

We lodged an application in April 2009 with the Australian Securities and Investment Commission (ASIC) seeking relief for financial hardship applications* which was subsequently granted by ASIC to facilitate withdrawals for investors who qualify as suffering from hardship.

5. The way forward

We are well progressed in developing a solution which we believe will provide liquidity for those wishing to exit whilst preserving value (by avoiding selling assets at a large discount to create that liquidity) for those who wish to remain invested in the Fund. We are currently progressing through due diligence, involving regulatory and market bodies and aim to have a final solution announced by June 2010.

What's next?

We acknowledge the situation is far from ideal and you can be assured that we are working hard on finding ways in which to improve liquidity of the Funds. Importantly, monthly distributions continue to be paid and neither the temporary suspension of Fund redemptions or a limited liquidity offer should impact investment performance. We believe that the high quality of the underlying assets should provide resilience in the medium to long term and we remain confident that the Funds will achieve their investment objectives over the long term. We will keep investors well informed of progress.

*APN Property for Income Fund and APN Property for Income Fund No.2

The future

With the strong recovery in AREITs since March 2009 and improvement in the underlying conditions for direct property, we would expect to see unlisted property emerge as a strong performer as the cycle moves into its next phase. Indeed, we are already seeing Net Tangible Asset values increase in various unlisted holdings within the Funds.

The Fund portfolios contain quality assets and we expect ongoing stabilisation in unlisted and listed real estate markets through 2010. The rebuilding of the real estate sector and positive economic outlook provides a solid foundation for steady capital appreciation.

Investors with a medium to long term investment horizon can expect to benefit from continuing monthly, tax effective income as well as future capital growth.

New applications and Distribution Reinvestment Plan (DRP)

Whilst the APN Property for Income Fund and APN Property for Income Fund No. 2 remain closed to withdrawals, investors can apply for new investments in the funds.

To apply for additional units or make a regular monthly investment, simply download the Supplementary Product Disclosure Statement (SPDS) from www.apngroup.com.au. Alternatively, contact APN Investor Services on 1800 996 456 to order a hard copy. The SPDS provides important information and should be read in conjunction with the PDS.

Investors can also opt to reinvest monthly distributions in the form of additional units in the Funds. By reinvesting monthly distributions, investors are taking advantage of the well known investment technique known as 'dollar cost averaging'. Regularly buying units in the Funds ultimately averages out the entry price at which you invest, thereby smoothing out market volatility.

Please note that if investors had a DRP in place prior to the temporary suspension of the Funds, monthly distributions have been paid in cash since 24 October 2008 and the DRP will not automatically be reactivated. To reactive the DRP, please complete an election form which is available to download from **www.apngroup.com.au**.

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