

Centre Capital Comments Regarding Change in Orchard Unit Price

You will have seen from the Orchard notice that the unit prices for the Orchard property funds have changed primarily as a result of decreased property valuations. Our article titled [Revaluations of Commercial Property](#) will help explain this revaluation process so you can understand what it means for you (if anything).

Usefulness of changing valuations

From a practical perspective, the Chairman's report from the Westfield AGM sums it up. "...A few years ago when Australia adopted new accounting standards it required companies to attribute rises or falls in asset revaluation to the income statement". "In my view the ...approach does not show an accurate or relevant measure of company performance. The ups and downs of property revaluations from year to year have little short term relevance". This is basically the same reason why the unit price in an unlisted vehicle such as Orchard is always being changed to reflect changing property valuations.

We buy commercial property for its income producing capabilities and the fact that over time rent increases with at least inflation. This rental income producing capability has remained unchanged inside the funds.

It is also important to consider what makes a suitable valuation. It involves "an arms length transaction between a willing buyer and willing seller". Realistically, any transaction done over the last year could hardly be classified as a willing seller thus making the process flawed and the relevance of the information questionable.

The commercial property market has not had many transactions over the last 18 months, resulting in a lot of argument about the usefulness of such valuations. Gerry Harvey (from Harvey Norman Ltd) has refused to revalue his property portfolio as he believes it serves no purpose putting a valuation on these properties that may or may not be correct. The value only matters if the properties are being bought or sold and over time the value of the property will rise as rents rise.

Managing Director of Westfield, Peter Lowy, said in a phone interview with Bloomberg Television at release of their results on 26 Aug 2009, "We think asset values have probably bottomed out, and should stabilise from here on". There are also a number of high profile fund managers and financial commentators pointing out the value in the commercial property sector and are accordingly increasing exposure.

Impact of internal gearing

The level of gearing in the funds then magnifies these movements in the underlying value of the equity. For example, if a property is 50% geared, meaning the bank has a loan worth 50% of the value and equity holders have the other 50%, then a 25% devaluation in the total value of the property will result in a loss to equity holders of 50%. This is because the trust always owes the bank the money they have borrowed, however it works on the way up as well as down so we just need to sit tight and ride these “valuation changes” out.

The only practical application the revaluations have in the day to day operation of the fund is in regards to the banks. Banks will only lend a set amount against property assets, say 65%. Any deterioration in property value may see these loan covenants breached which involves renegotiating with the bank. The banks take advantage of such opportunities to increase the margin on the interest rate as well as charging renegotiation fees and demanding principal repayments. This in turn uses the cash reserves of the trusts meaning there is less money available to distribute to unit holders, hence in most cases distributions have dropped or deferred. The respective details regarding orchard funds and bank adjustment to loan facilities including charges are set out in the “[Orchard Update - Winter Outlook 2009](#)”.

Where are the Orchard Funds at?

The underlying characteristics of the funds include:

- Weighted average lease profile of 3.15 years for the Commercial Office Fund (across 13 properties) and 7.5 years for the Diversified Property Fund (across 453 properties).
- 95% occupancy for COF and 97% for DPF with no arrears for both funds.

Both funds have strong rental cash flow and are backed by strong portfolios of real estate assets and continue to meet all their commitments to their banks. In the teleconference with Orchard on 2 September 2009, Orchard confirmed that all portfolios had seen an increase in rental income over the last 12 months.

The funds gearing levels are too high given the decrease in property valuations and they are working with their banks in order to devise a strategy. Orchard indicated that their relationship with the banks is “as good as ever” and have not been forced into any course of action that would detriment unit holders. With their main banker, NAB, Orchard has reduced debt by some \$400 million.

The Commercial Office Fund has recently sold 350 Collins Street for \$52.5 million to reduce debt levels. This will now allow them to raise capital of some \$30-\$50 million

which will enable distributions to be resumed. They are in the late stages of finalising the details of this capital raise with their banks and a key supporter of the fund, PIS.

Orchard management have recognised the mistakes in the past and are making sure that these mistakes will not be repeated going forward. However, their first priority is stabilising the funds and then setting them up for the new environment going forward. This process will be one that takes time and we just need to ride through it.

What do we need to do going forward?

Basically, sit tight and ride it out. Orchard will be releasing capital management initiatives shortly to sure up the financial security of the funds.

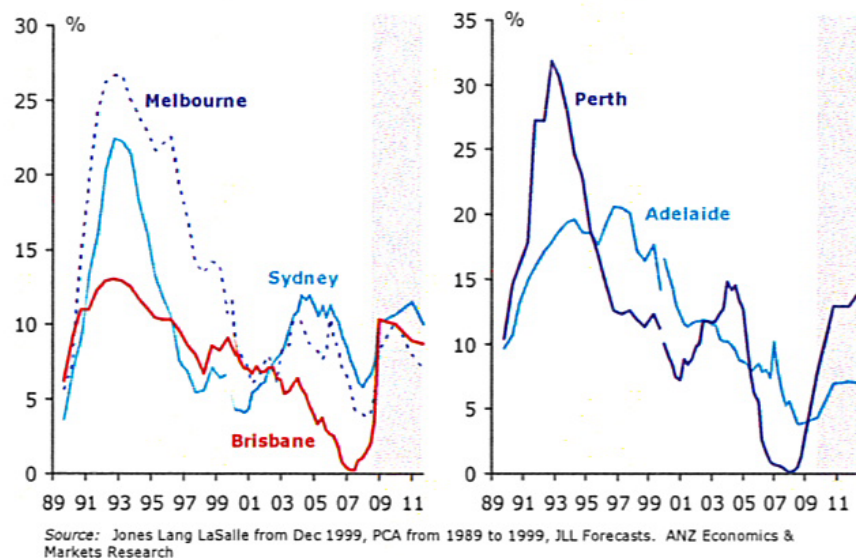
The funds are collecting rent (which is increasing over time) and paying the trusts bills - the rest will work itself out over time. The new Fund Manager at Orchard, Bryce Mitchelson, indicated that he believed valuations were currently being depressed by the lack of finance available for prospective buyers, not the underlying property fundamentals which are quite sound. He indicated that once finance started to flow again the market could pick up quite rapidly especially in light of the fundamentals (low vacancies) and the fact new supply will not be entering the market. This is collaborated by numerous reports and expert opinions (some detailed below), but more importantly makes sense.

As long term investors we need to put the following into perspective:

- While the underlying fundamentals and the assets held in investments managed by Orchard Funds Management remain sound, the continued market volatility and the higher than desired level of gearings within the funds has seen the larger than expected unit price movements.
- Nationally, office vacancies rose to 7.5% for the quarter ending June. Andrew Ballantyne from Jones Lang LaSalle stated in the Australian Financial Review, “Generally when we have 5% vacancy we say it’s a landlords market; and when it’s over 10%, that’s when we say it’s a tenants market. The headline vacancy figure should not favour anyone at the moment”. In the 1990’s vacancies were in the vicinity of 20%.
- Managing Director of Jones Lang LaSalle, Michael Fenton told the AFR that vacancy rates would likely peak at about 10% or 11% well below that of the 1990’s. “The supply and demand equation is more in balance this time, resulting in limited risk of an oversupply in CBD markets. These factors support a quicker recovery than last time”.

- From a fundamental basis, Perth and Brisbane have experienced the largest declines in rent due to a massive increase in supply. Orchard doesn't have any exposure to these markets, which is a credit to their property portfolio management as they deliberately moved away from these markets.

CBD office vacancy rates



Sentiment in property markets is already improving

It should be noted that investments in the listed property space had fallen dramatically over the previous 18 months but have rallied back in last few months as sentiment improves towards the state of the economy and the property market in particular. It is important to note that valuations in the unlisted sector tend to lag that of the listed sector.

- Westfield (WDC) had fallen 63% from peak to trough and has subsequently risen 29%.
- Stockland (SGP) had fallen 78% from peak to trough and has subsequently risen 52%.
- General Property Trust (GPT) had fallen 96% from peak to trough and has subsequently risen 143%.
- The broader Property Index had fallen 79% from peak to trough and has subsequently risen 41%.

There have been a number of large private investors and overseas investors showing increased interest in acquiring property assets in Australia. The traditional players, the property trusts themselves, have to date not been buying as they are all in similar positions to Orchard. However, especially the listed property companies have recapitalised their balance sheets by some \$16 Billion and will once again look to move forward.

What is Orchard doing?

Orchard has engaged KPMG to assist in reviewing the funds and dealing with the banks. They advised us they are in the process of selling some property assets (subject to receiving suitable prices), the proceeds of which will assist to reduce gearing levels within the funds. They are also working on other capital raising initiatives.

This was confirmed last week by the sale of 350 Collins Street for \$52.5 million the proceeds of which will reduce debt.

Orchard have appointed Bryce Mitchelson as the new Head of Funds Management and they are also about to appoint a new independent Director to the board.

Centre Capital summary

We have been in contact with Orchard and expressed our disappointment that these issues are not being addressed quickly enough as we need to get these issues resolved so distributions can be returned.

While the movement in unit prices is disappointing, based on information provided by Orchard we are comfortable that the underlying quality of the assets will see this corrected through a return to more normal market conditions over time as rental income increases. The funds will also benefit from appropriate capital management initiatives.

If you have any questions about the effect the unit price movements is going to have on your strategy, please contact our office.