

ANZ Australian Commercial Property Outlook

Markets to settle as fear subsides

September 2009

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Inside

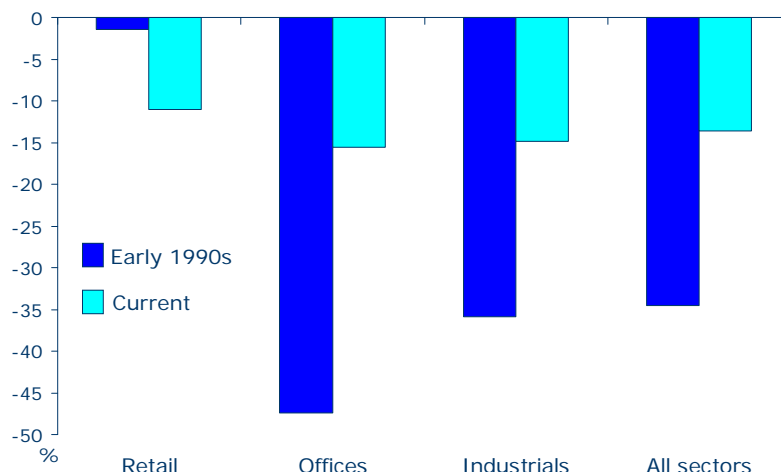
Light at the end of the tunnel brightens

Significant hurdles and risks still exist and there are many structural impediments to a rapid acceleration of economic activity in the developed world. Nonetheless, re-capitalisation of the banking sector, narrowing credit spreads and a rebound in China combined with positive developed world data flow of late suggests the worst is now behind us and that 2010 will mark the beginning of a renewed cyclical upswing in global economic growth and risk appetite.

This is not the early 1990s revisited

Industrial and office markets have been hit the hardest in the current downturn while retail property has performed relatively well. Prime assets have also fared better than secondary assets as investor risk aversion increased and yields decompressed. The key differentiator between this cycle and the late 1980s/early 1990s meltdown has been the relatively subdued supply response. Very low office vacancies and solid rental growth in Brisbane and Perth in recent years drove a renewed surge of development activity but while market fundamentals will weaken in the years ahead the expected deterioration is nowhere near the scale of that experienced in the early 1990s. Rising incentives, falling rents and access to credit do pose ongoing risks to market valuations but yields are unlikely to deteriorate much further. The listed property market was punished early in the recent crisis as real asset valuations were reduced and gearing and distribution policies quickly became unsustainable. However, a renewed focus on capital management has seen distributions reduced and a recapitalisation of balance sheets has lowered gearing and coincided with a rebound in investor appetite that has lifted equity valuations significantly in recent months. The recapitalisation of the sector has substantially reduced the risk of widespread 'forced' property sales which should limit further downside to asset valuations.

There's no comparison
 % change in capital values, peak to trough early 1990s, peak to present value in current cycle



Source: Property Council/IPD

Economic overview

Light at the end of the tunnel brightens

The risk of a complete global financial system meltdown loomed large in late 2008. However, the unprecedented global policy response appears to have gained traction and the doomsday scenario has been averted. In 2009, global credit spreads have narrowed sharply, equity markets have rallied and the process of global financial market 'healing' is now well underway. While global GDP will fall in 2009 for the first time since the Second World War, forecasts for 2010 have been revised up substantially in recent months.

Significant hurdles and risks still exist and there are many structural impediments to a rapid acceleration of economic activity in the developed world (reduced risk appetite, credit cost and availability, public debt financing, rising protectionism, etc). Nonetheless, re-capitalisation of the banking sector, narrowing credit spreads and a solid rebound in China combined with positive developed world data flow of late suggests the worst is behind us and that 2010 will mark the beginning of a renewed cyclical upswing in global growth and risk appetite.

Australia's resilience silences the bears

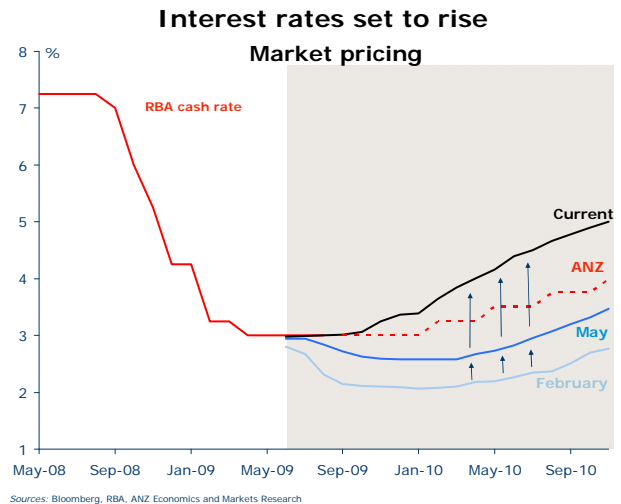
As we have long argued, Australia has been insulated from the worst of the global turmoil by its strong financial sector, conservative lending practices and a rapid and substantial policy response. The Australian economy has been remarkably resilient, defying the doomsayers, and has been one of the few major developed economies to avoid 'technical' recession. The underlying strength of the domestic housing market (and household sector more generally) has been a key reason for Australia's out-performance relative to other countries where house prices and household wealth have fallen sharply.

While present forecasts suggest a relatively subdued recovery profile, expectations are being slowly ratcheted upwards. Household spending has accelerated, buoyed by sharply reduced debt service costs, public largesse and an extraordinarily resilient labour market. Moreover, the marked rebound in Chinese fixed asset investment and industrial activity suggest that commodity exports and prices will hold up better than expected. Strong public demand and a renewed rise in major mining project investment will also be supportive.

Interest rates set to rise...

Both consumer and business sentiment have improved sharply and with underlying inflation remaining stubbornly high, the Reserve Bank has shifted its policy rhetoric substantially in recent months. Further interest rate cuts are off the agenda and the Reserve Bank is increasingly focused on returning monetary policy settings back towards 'neutral'. The market has priced in rate

hikes from November this year, totalling 200 basis points of by the end of 2010. We continue to believe that this profile is overly aggressive and that the Reserve Bank will be wary of crushing the fledgling upturn in the economy.



...but market is 'mis-priced'

The direct fiscal stimulus to households will wane over the second half of 2009 and despite the positive impact of further income tax cuts, household disposable growth is expected to fall sharply. At the same time, first homebuyers are likely to be few and far between early in 2010 and rising interest rates could pose a serious threat to the nascent recovery in dwelling investment economic activity more generally. A large and persistent 'output gap'¹ will exert significant downward pressure on inflation in the years ahead. Consequently, we suspect that the Reserve Bank will proceed with more caution than the market currently expects and we are forecasting 100 basis points of official interest rate hikes between February and November 2010. Even this will prove to be a strong test of the resilience of household spending, house prices and dwelling investment. The labour hoarding experienced in the past year suggests any recovery in employment will be relatively subdued and softening income growth and rising interest rates will weigh on retail spending.

Nonetheless, we believe the Australian economy has successfully avoided the worst of the global crisis and growth will recover in 2010, providing an improving backdrop for commercial property markets. Risk aversion is receding and we are seeing a lift in sales activity below \$30 million and recapitalisation has reduced the risks at the upper-end. However, rising vacancies, falling rents and ongoing difficulties with the cost and availability of credit will continue to present headwinds.

Paul Braddick

¹ Economic activity running well below 'potential'

Commercial property overview

Danger period over?

Australia's commercial property markets have had to withstand the toughest economic environment presented since the early 1990s recession. So far, the sector as a whole has escaped major blood-letting, although there have been some casualties in the listed sector, emanating not so much from property market weakness itself but from business models reliant upon excessive gearing. There has been some contagion stemming from such entities having to adjust balance sheets but by and large, commercial property has insulated itself relatively well in this environment, even though activity centres linked to commodities markets have displayed greater volatility.

According to IPD, the composite commercial property index (all sectors) fell 13% in the year to June quarter, taking values back to late-2006 levels. The reason for this relatively muted 'correction' so far stems in the first instance from an economy performing relatively well against a dire global backdrop. Further, underlying financial strength in key property market stakeholders (institutional investors, financiers etc.) has minimised the level of forced transactions in the marketplace. Whilst this makes confident price determination almost impossible as valuers struggle to find reliable benchmark evidence, it has protected market outcomes.

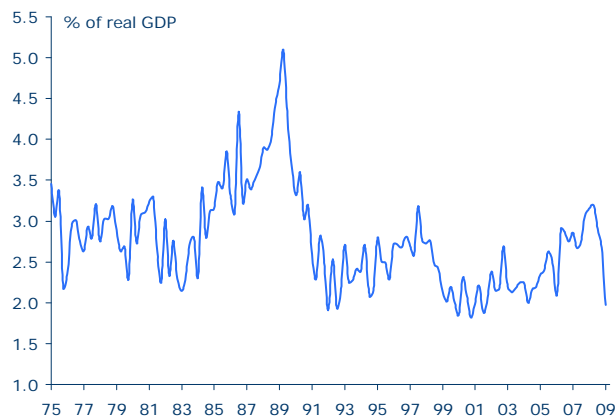
The listed property market was punished early in the recent crisis as real asset valuations were reduced and gearing and distribution policies quickly became unsustainable. However, a renewed focus on capital management has seen distributions reduced and a recapitalisation of balance sheets has lowered gearing and coincided with a rebound in investor appetite that has lifted equity valuations significantly in recent months. The recapitalisation of the sector has substantially reduced the risk of widespread 'forced' property sales which should limit further downside to asset valuations.

This is not the early 1990s revisited

Industrial and office markets have been hit the hardest in the current downturn while retail property has once again performed relatively well. Prime assets have also fared well compared to secondary assets as investor risk aversion increased and yields decompressed. The key differentiator between this cycle and the late 1980s/early 1990s meltdown has been the relatively subdued supply response as reflected in non-residential building share of GDP. Very low office vacancies and solid rental growth in Brisbane and Perth in recent years drove a renewed surge of development activity but while market fundamentals will weaken in the years ahead the expected deterioration is *nowhere near* the scale of that experienced in the early 1990s.

Supply side has not 'kicked' for 20 years

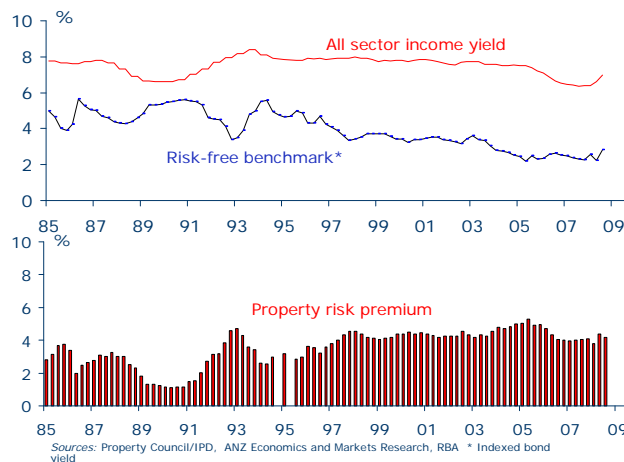
Real non-residential building starts as % of real GDP



Source: Australian Bureau of Statistics

Rising incentives and falling rents do pose an ongoing risk to market valuations but yields are unlikely to deteriorate much further. Deteriorating investor sentiment and heightened risk aversion have been powerful drivers taking primary control of capital value outcomes since the onset of global financial crisis. Whilst it is not surprising to see fundamentals cede to more powerful drivers, such pessimism will run its course, at which stage a rebalancing in the market drivers should occur.

All sector property risk premium



Sources: Property Council/IPD, ANZ Economics and Markets Research, RBA * Indexed bond yield

The earlier 'weight of money' support for commercial property markets rapidly reversed during the GFC. Access to finance will continue to be a key headwind for commercial property for the foreseeable future and with the CMBS market effectively closed, the rollover of existing debt facilities presents further downside risks for prices.

Nonetheless, property investors/developers will be re-assessing fundamentals as risk aversion diminishes but financiers too will be relying increasingly on investment and property market fundamentals to assess project viability. Whilst the market is not out of the woods, there is a definite light filtering through the trees.

Mr. Ange Montalti & Paul Braddick

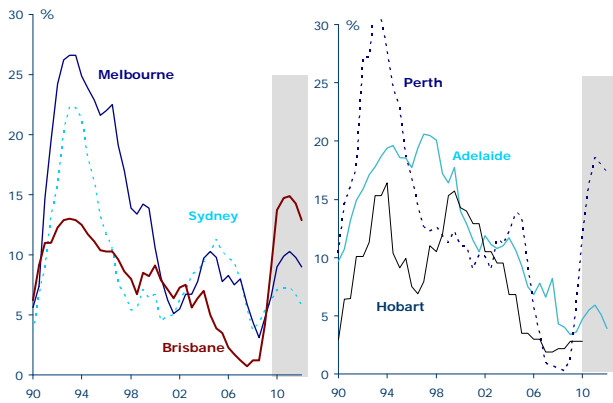
Office property

Office fundamentals to soften a little

As expected, CBD office market fundamentals have weakened through to mid-2009 with vacancy rates rising in all mainland capitals (Hobart was steady at 2.8% on the latest read). Net office absorption for the mainland capitals has turned negative and will remain so for the full 2009 year (estimated -330,000sqm). This will coincide with a solid supply line (+500,000sqm) that had already got underway ahead of demand slowing. Consequently, the vacancy rate for these capitals is expected to rise further from around 7% in mid-2009 to around 10% by year's end. However, any further significant deterioration is unlikely as marginal demand and supply flows begin to realign over this period. ANZ expects the "5 CBDs" vacancy rate to peak at over 11% by the end of 2010, below its long-term average (11.6%). This contrasts starkly with a peak vacancy rate of 23% in the first half of the 1990s.

Vacancy rates on the rise

CBD office vacancy rates



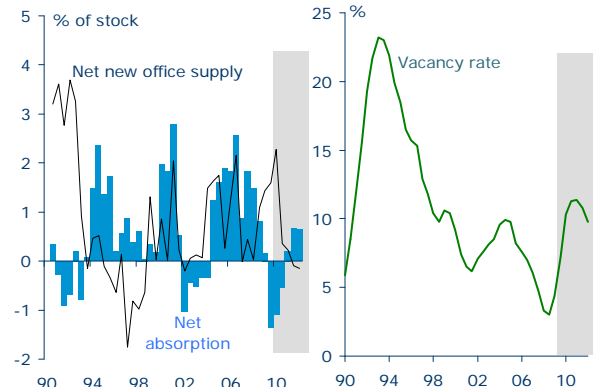
Source: Property Council of Australia. ANZ Economics & Markets Research forecasts

The supply-side has been the overwhelming differentiating factor through this activity cycle, being curtailed by rising interest rates until mid-2008, then by a tightening in lending standards and developer caution, both of which were born out of the global financial crisis. Luckily, supply-side risks to weaker market conditions will be limited as lenders and developers both to this day maintain high hurdle rates to engage the marketplace.

That said, expectations of weaker office market fundamentals ahead are already reflecting in rental incentives and to a lesser extent, face rentals. Further short-term rental weakness is in store as landlords attempt to protect existing tenancies and create demand for back-fill space.

Fundamentals protected by subdued supply

5-CBD prime office sector*



Sources: Property Council of Australia. ANZ Economics and Markets Research forecasts. * Includes Melbourne, Sydney, Brisbane, Adelaide and Perth.

Conditions vary significantly across the capitals with Brisbane and Perth likely to revert to considerably lower market rentals following weaker commodity markets and in Sydney due to ongoing economic weakness.

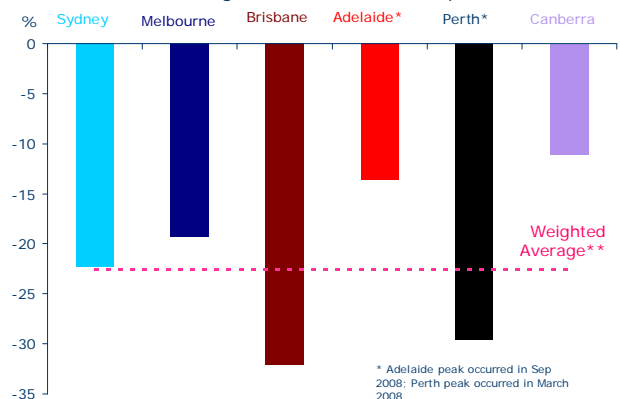
Encouragingly, yield decompression which commenced through 2008 has abated somewhat into 2009, suggesting support to prices is not far away, particularly for centres with more stable rental prospects.

Prices near bottom?

Capital values rose steadily in real terms from 2005 until peaking in late 2007. "Commodity" capitals have been hit hardest but on average, values have declined 22% since then. In an historical context, peak values in real terms in 2007 were still 17% below the peak level achieved in 1989. In the June quarter of 2009, real values were 16% below pre-1980s boom levels and some 40% below the 1989 peak levels.

Office prices fall in all capitals...

Prime CBD office prices
% change since December 2007 peak*

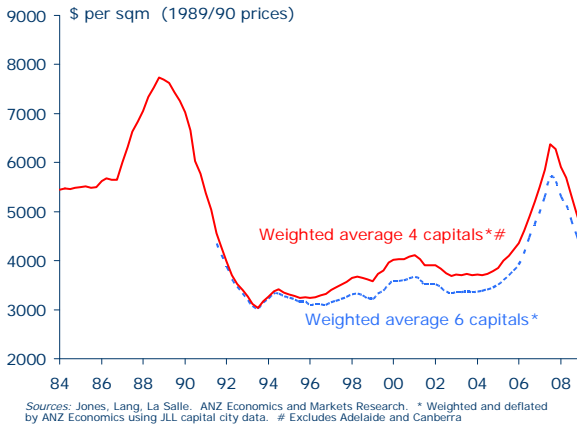


* Adelaide peak occurred in Sep 2008; Perth peak occurred in March 2008

Source: Jones Lang LaSalle, ANZ Economics and Markets Research. ** Weighted by ANZ

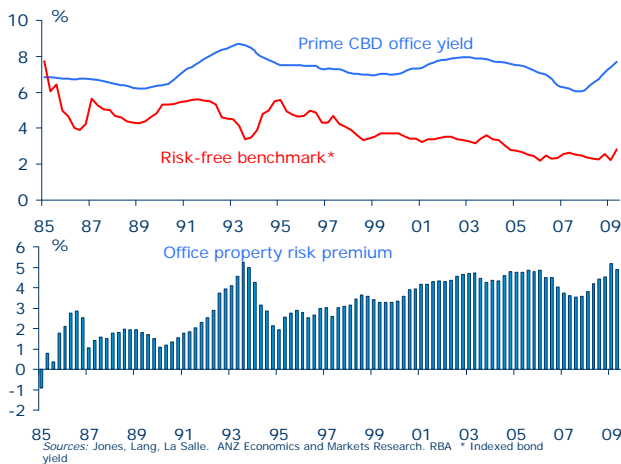
...and were not that high to begin with

Real Prime CBD office prices



At face value and on these very simple historical comparisons, office prices appear anything but overvalued. Using a more sophisticated “property risk premium” approach to analysing values reveals the risk premium in the June quarter has surpassed the historic high reached in the early 1990s when office prices had collapsed. In other words, the market has already priced in as much risk premium in 2009 as it did in the depths of the previous office price bust².

“Property risk premium” at record high



Nonetheless, we may see further intra-market realignments over 2009/10 with middle-market and secondary quality stock being more susceptible to tougher financing conditions than prime market propositions.

Sydney's office market fundamentals are weakening but are not expected to deteriorate significantly as new supply remains subdued. This should avert more considerable dislocation given there has already been surprising weakness in rentals recently (primarily via higher incentives). Prices have fallen by around the national average.

Melbourne's CBD office market is in a relatively strong position. The vacancy rate has lifted only slightly to mid-2009 and is set to rise further but will be kept in check as new office supply is projected to remain moderate. Absorption, while negative will be minimised on the back of a relatively robust economic performance.

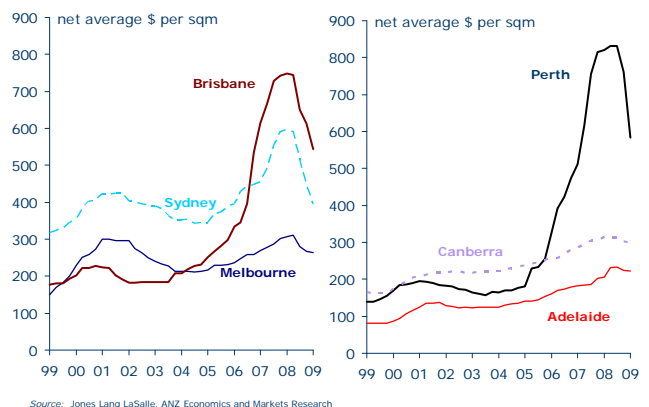
Importantly, Melbourne's rental market peaked at **\$310/sqm** in September quarter 2008 and has come off 15% (this is market rentals, not average rentals on lease) which is around the same level as reported in **1988 (\$300/sqm)**! Rentals in Brisbane and Perth, on the other hand, peaked at \$744/sqm and \$831/sqm respectively last year. As a consequence, rental affordability in Melbourne remains very favourable, suggesting the Melbourne market will remain an attractive option for relocation. This also implies limited downside risks to rents and prices compared to most other, but especially 'commodity' capitals

Brisbane has an unprecedented supply line to digest over 2009 that will send vacancies from record lows in 2008 to record highs in 2009. **Perth** is in a very similar position. Given the very rapid growth in Brisbane's prime rents (trebled in three years to June 2008), there is every prospect of a sharp and severe reversal over 2009/10. This has already translated into markedly lower market rentals which had been partly pre-empted by early decompression of income yields.

Adelaide's office market is in reasonable balance and is expected to remain so through the cycle. The moderate run-up in market values and rentals (while others were booming) in recent years, together with solid fundamentals suggest good protection for values and rentals compared to other centres in the years ahead.

Rentals in “commodity” capitals in for big adjustment

Prime CBD office rents (net effective)



Mr. Ange Montalti

² Property risk premium is the extra income return that is earned over and above the real risk free rate to compensate investors for the inherent risk in commercial property investment. Real risk-free rate is proxied by using an indexed 10 year bond yield.

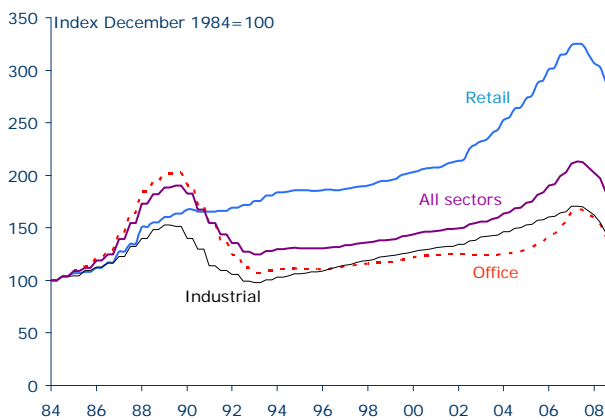
Retail property

The retail environment has proven more resilient in the first half of 2009 than many had expected. Very accommodating interest rate settings and substantial government stimulus have provided a timely and considerable boost to disposable incomes that has boosted private consumption. Furthermore, rising housing prices and solid gains in domestic equities have played a critical role in restoring consumer confidence. Regular positive 'surprises' in labour market outcomes in recent months have also allayed fears that employment prospects were dire. Retailers remain wary about trading conditions in the months ahead³ and while we do expect a renewed softening in retail conditions as household incomes slow, monetary stimulus already in the pipeline, minimal employment loss from here and a healthier trajectory for key asset markets should temper the expected to slowing in retail spending over 2009/10.

A healthy retail environment has been an important supporting influence on retail property market outcomes over the past decade, with direct retail property values having risen more substantially over the past decade than other sectors. Despite this, market adjustment since the global financial crisis has been a moderate 11% since peaking in early 2008 compared to office and industrial which have fallen 16% and 15% respectively.⁴ While there has been considerable market dislocation in the listed property sector, the fall-out upon the direct retail has been relatively mild.

Retail property: a clear out-performer

Capital values by sector

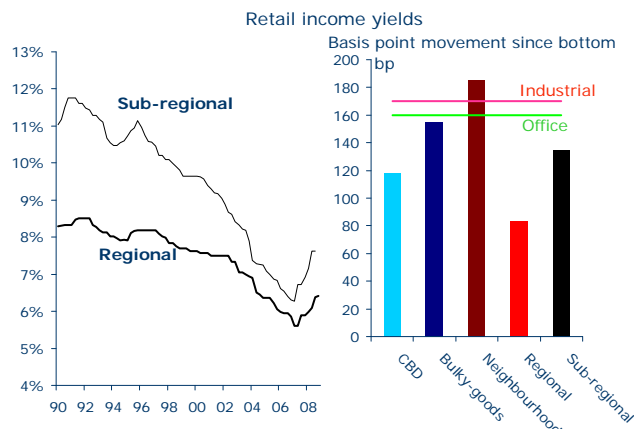


Source: Property Council/IPD Australia Annual Property Index

A softening in retail income yields over recent quarters has been significant but more moderate than for other property sectors with the exception of neighbourhood centres and bulky-goods stores whose yields have both softened in line with or around the same as for the industrial and office sectors. In the case of bulky-goods sector, evidence of oversupply and a subdued housing sector signal a rockier environment in the near-term.

Neighbourhood centres have performed more poorly (+185bp) as the market resets relative risk premia following the convergence in yields over the past decade.

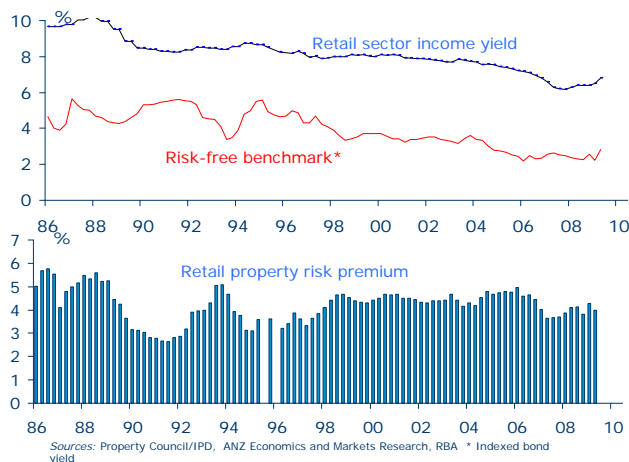
Softening in retail yields has been diverse



Source: Jones Lang LaSalle, ANZ Economics and Markets Research. Right hand panel retail yields are unweighted national averages of JLL data (calculated by ANZ). Industrial and office yields are calculated by JLL

A useful overriding benchmark for assessing the sustainability of property prices over the medium-term can be found in the property risk premium (PRP). The PRP in the June quarter was sitting around its long-term average, suggesting there is, using past guidance, valid historical support to June 2009 retail property values. However, in the new environment of tighter liquidity and greater risk aversion, it is conceivable equilibrium PRP is indeed higher than historical averages would suggest.

Retail risk premium around long-term average



Sources: Property Council/IPD, ANZ Economics and Markets Research, RBA * Indexed bond yield

Rentals are holding up well across most of the retail sectors with a flattening trend emerging in prime CBD, regional and sub-regional centres. Neighbourhood centres, on the other hand are showing greater vulnerability as are bulky-goods centres, particularly in Sydney (weak housing market and over-building of such centres in recent years) and Perth (adjustment to some rental overshoot). There are anecdotal reports of rising incentives as fears of higher vacancies threaten, although to date, the rise in vacancies has been patchy with conditions remaining tight in most CBD

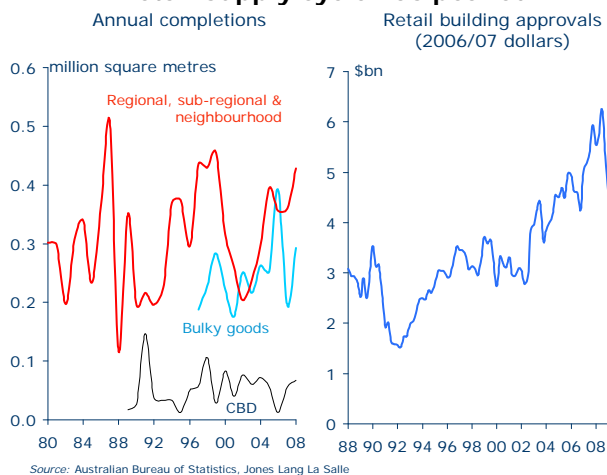
³ Jones Lang La Salle Retailer Sentiment Survey

⁴ IPD.

centres (except Perth and South East Queensland). While neighbourhood centres have higher structural vacancies than other retail centres, there does not appear to have been any deterioration in the demand/supply balance recently. Sub-regional centres, on the other hand, have experienced a notable rise in vacancies with the exception of Melbourne which remains tight and well positioned (1% vacancy rate).

The supply-side is likely to generate tighter conditions with the pipeline of projects under construction shrinking to around 865,000 square metres, the first time this figure has fallen below 1 million square metres since early 2007.⁵ Shop building approvals in real terms are also slowing sharply, suggesting there is little on the horizon to threaten this expected tightening in conditions from 2010. Provided retail spending does not decelerate further than expected, there is every prospect of a renewed upturn in rental growth once the current period of uncertainty washes through the market.

Retail supply cycle has peaked



Mr. Ange Montalti

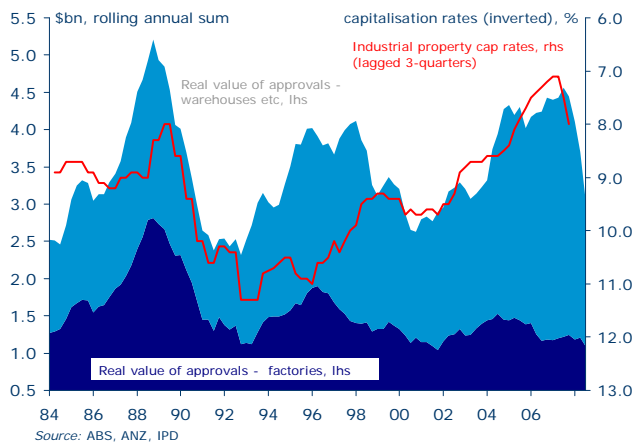
⁵ Jones Lang La Salle, Preliminary Market Overview, Second quarter 2009.

Industrial property

Despite what is turning out to be a much more moderate downturn in the Australian economy than was first thought, industrial property has been exposed to sectors that have been hit hardest. The manufacturing sector has contracted 9% over the past 9 months and the transport & storage sector has shrunk 5% over the same period, the latter driven by a run down in inventories over the period. Imports have contracted 15% in the last six months with the likelihood of more to come as domestic demand remains soft and the Australian dollar relatively high.

The reaction to this has been a sharp pull back in supply. The value of warehouse construction commenced has *fallen 61%* from peaks seen in 2008, with factory building down 34%. Despite this, projects already under construction, for the most part, are being completed due to a high level of pre-lease commitments. It is anticipated that additional industrial space in 2009 will be around half the levels seen in 2008. Supply will remain weak in 2010. Through the remainder of 2009 around 550,000sqm of additional space will be added. Much of this supply will be in the Sydney market with supply coming off more quickly in Melbourne and Brisbane. Of this total, around three-quarters are pre-committed. Fortunately, this high degree of pre-commitment and fairly limited speculative activity over the past year or so should limit what could have been a more significant over-supply problem. This should allow the market to respond more quickly to improving economic conditions in future.

Supply falls as cap rates ease
Real value of building approvals & cap rates



Over the medium term, a rebound in supply is unlikely to be forthcoming as current solid higher rates of pre-commitment are unlikely to be sustained. Sluggish economic performance in the sector has seen demand remain very weak with take up levels well down on 2008. A pullback in business' capital expenditure plans over the next 12-months (after being very strong in the previous two years) implies demand for industrial space will be softer for the remainder of the year (though not as soft a first thought).

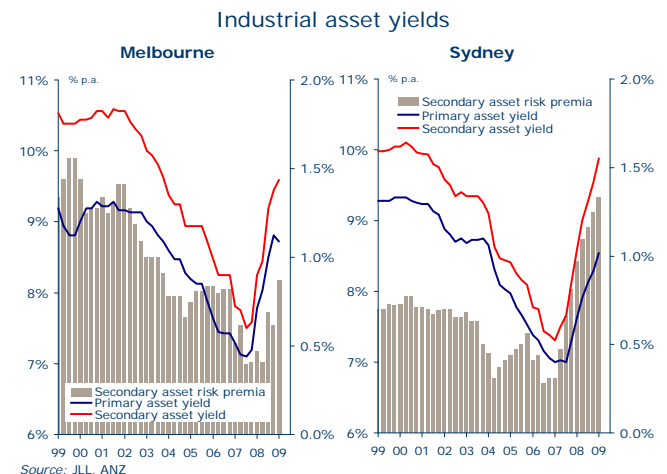
As a result, industrial land values have eased across all capital cities, *by as much as 30-40% in some areas*. Looking forward, the run down in business inventories is unlikely to continue which may see demand levels bottom out in the second half of 2009.

Weaker demand has arrested the relatively solid rental growth that has characterised recent years. Perth and Brisbane have seen rents come off significantly as these economies slow more sharply than the South-Eastern states. Yet in some areas of the Melbourne and Sydney, where rental growth was particularly strong in 2008, we are seeing a marked easing of rents. With no threat of oversupply, and demand solid enough to absorb the very limited additions to space, rents overall are expected to fall moderately this year, in contrast to the 20-30% falls in rents experienced through the 1990's recession. Rental growth in 2010 is likely to remain subdued before recovering in 2011.

Yields have decompressed around 170bps since peaking in late 2007. Much of this represents a correction of the undershoot experienced during the boom as *risk across sectors became too narrowly priced*. Values have fallen around 15% so far in this cycle, compared with a fall of around 36% in the 1990s recession⁶. Values are now beginning to stabilise, likely bottoming later this year. The rate of yield decompression decelerated in the June quarter and yields for prime assets are likely to continue to level out, especially in Sydney and Melbourne, with some adjustment still to take place in the mining states. Higher yields are attracting smaller investors back with most transaction activity taking place at values below \$5million.

However, yields on secondary assets continue to ease, *re-establishing a premium to primary assets that narrowed sharply over recent years*.

Risk premium across assets re-emerging



Dr. Alex Joiner

⁶ IPD

Tourist accommodation

The supply of tourist accommodation has continued to grow among larger providers (15+ rooms) but has dwindled at the smaller end (5 to 15 rooms). The number of establishments with 15+ rooms grew 1.2% in the year to March 2009, while their number of rooms grew 2.5%, about the same growth rates as seen in 2008. Among smaller operators however (5-15 rooms), the shrinkage accelerated to -3.3% for establishments and -3% for rooms in March 2009. This growth pattern is resulting in fewer, but larger, establishments across the industry.

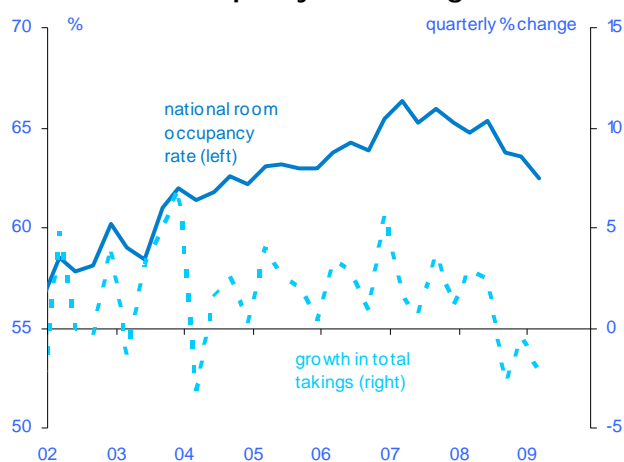
Tourist accommodation supply is still growing

	Mar 2005	Mar 2007	Mar 2009
Accommodation with 15+ rooms			
- establishments	4,137	4,205	4,301
- rooms	209,022	215,763	225,733
Accommodation with 5-15 rooms			
- establishments	2,130	1,919	1,866
- rooms	20,115	18,441	17,956
Total accommodation (5+ rooms)			
- establishments	6,267	6,124	6,167
- rooms	229,137	234,204	243,689

Source: ABS (original data to Mar Qtr 2009).

Demand for accommodation has been falling at an accelerating rate through 2008-09 on various measures, including occupancy rates, room nights occupied, guest arrivals and most importantly, total takings. Total takings fell 3.5% (YoY) in March 2009 for both larger (15+ rooms) and smaller (5-15 rooms) establishments. For larger establishments, this was the first fall in takings (YoY) since 2002. Employment has followed a similar path to occupancy and revenue, with 3.5% fewer people employed in larger establishments and 9.9% fewer employed in small establishments in March 2009.

...even as occupancy and takings tumble*

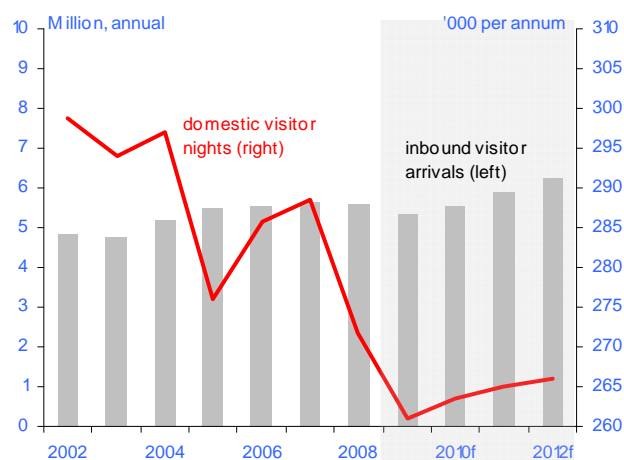


* Accommodation establishments with 15+ rooms.
Source: ABS (seas. adj. data to Mar Qtr 2009).

Growth prospects for the remainder of 2009 and into 2010 continue to look pessimistic. The Tourism Forecasting Committee (TFC) expects international visitor arrivals to fall by 4.0% (and the real value of their spending to decrease by 2.1%) in 2009, after already falling 1.0% in 2008, despite the boost to arrivals from World Youth Day in July. Reflecting the current state of their home economies, declines are greatest among tourists from Japan (-26%) and Korea (-25%), while growth is strongest from the much smaller tourist sources of China (+6.4%), India (+8.7%) and the Middle East (+9.7%). Rather optimistically, the TFC expects inbound visitor arrivals to commence positive growth again 2010.

The domestic travel market looks even more challenging, with domestic visitor nights expected to fall another 3.9% in 2009, after falling 5.8% in 2008. Only a weak recovery is expected from 2010 because, although Australian employment, incomes and spending are expected to begin to recover from this recession cycle by then, the stronger Australian dollar, expected rises in fuel prices and the continuing allure of cheap international travel will keep sucking our tourism spending offshore.

Inbound and especially local tourism plummet in 2009 and recover only slowly from 2010



Source: Tourism Forecasting Committee, Mar 2009.

Large geographic differences remain apparent. The **ACT** remains the most successful accommodation market in terms of both occupancy rates and takings, while **Queensland** and **NSW** appear to be falling the hardest, probably reflecting large differences between their key markets (business versus tourism). As of March 2009, occupancy rates had fallen in all states except Tasmania and the ACT, relative to a year earlier. Occupancy rates remain highest in the ACT (71%) and WA (67%) and lowest in Tasmania (59.8%), which focuses mainly on domestic tourism. Total takings fell by 7.2% in NSW, 3.8% in Qld and 2.7% in Victoria but grew by 7.2% in the ACT, 4% in SA, 3.5% in WA and 1.7% in Tasmania in the year to March 2009

Julie Toth

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