> **Convergence: A positive Australian economic outlook is expected to drive broader improvement in office leasing demand across capital city markets.**
>
> **Near and far: The next development cycle is underway in Melbourne – and is most likely not far away in Sydney and Brisbane.**
>
> **How low can you go?: Yield seeking investors continue to be attracted to high quality Australian commercial office assets, driving yields to new historical lows in the major CBD markets.**

Economic Overview

Australian economy: improving global back drop

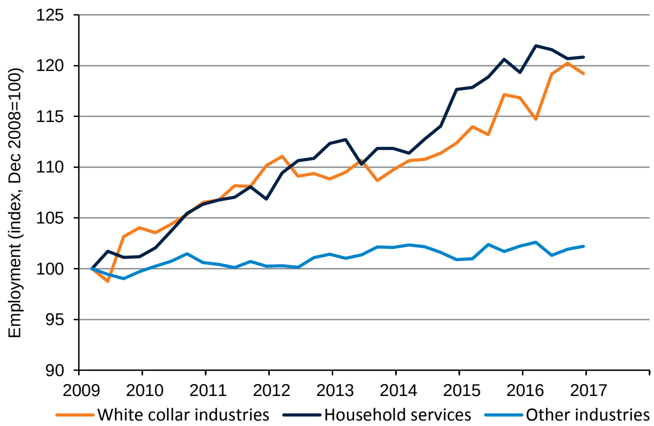
Forward looking indicators of economic activity point to a solid outlook for the Australian economy through the remainder of 2017. A pick-up in global industrial production, cross-border trade and commodity prices have improved the outlook for Australian commodity exports and income. In particular, this has buoyed business conditions in Queensland and Western Australia.

In contrast, economic momentum has eased in NSW and Victoria, reflecting the combined impact of a stubbornly elevated Australian dollar (AUD), higher interest rates and subdued domestic demand. Nonetheless, the NSW and Victorian economies remain the 'front-runners', with their economic outperformance driving strong leasing conditions and capital growth in the Sydney and Melbourne CBD office markets.

An inflated housing market remains at the forefront of domestic economic risks. In response to these concerns, mortgage lending has been squeezed, particularly for housing investors, and the pipeline of residential construction has weakened. In contrast, tight leasing market conditions and solid capital growth in the major capital city CBD office markets look prime for driving the next office development cycle. This is already in train in Melbourne, with the CBD market in the early stages of a cyclical boom in office development (see Box 1 for further detail).

Labour market conditions remain mixed, with leading indicators suggesting that employment growth will remain positive in the near term. However, office employment growth has eased since mid-2016. Conditions for office-based businesses remain challenging and will continue to weigh on the outlook for white collar employment growth and office absorption in the coming year.

CHART 1: AUSTRALIAN EMPLOYMENT GROWTH



Source: ABS and Investa Research

Rates outlook: steady as she goes

Rates markets have remained relatively stable in the first quarter of 2017, with Australian Government Bond rates remaining around the levels reached towards the end of 2016. On the back of a very cautious US Federal Reserve hiking cycle and an improving global growth outlook, bond rates should edge higher through 2017. The most likely risk to this outlook appears to be the potential for a dampening of rates markets in the unlikely event of socio-political unrest around the upcoming European elections.

Despite moderately higher bond rates and increased retail lending rates, there are no clear indications that RBA policy rates will budge from the current level of 1.50% for the remainder of 2017 (and most likely further into 2018). Weighing up the risk of further inflating household leverage and driving an increase in financial instability in the face of weak wage growth, the RBA are likely to 'sit on the sidelines' until they can see a sustained pick-up in wages and inflation. Consequently, yields for Australian commercial office property – and the premium on alternative low-risk assets – are likely to continue to edge lower with investors expected to continue to show a healthy appetite for Australian commercial office.

Office Market Overview

Leasing markets: CBD market convergence to come

Sydney and Melbourne remain the clear outperformers across Australia's CBD office markets with leasing market conditions remaining tight. Despite softening in recent months, (Sydney recorded negative net absorption absorption for the first time since 2013 in the second half of 2016) the outlook for absorption of available office space remains solid, reflecting expectations of further growth in white collar employment in 2017.

Supply-side factors in the two main office markets have played a significant role in maintaining tight leasing market conditions. In Sydney, withdrawals of CBD office space for conversion to alternate use and for the Metro Rail project have driven supply to a standstill. Likewise, a lull in the completion cycle has allowed excess vacant space to be absorbed the market. The sub-lease vacancy rate in Melbourne has compressed to 0.5%, the lowest level since 2009, reflecting a combination of both gains in white collar employment and centralisation of businesses from suburban markets to the CBD.

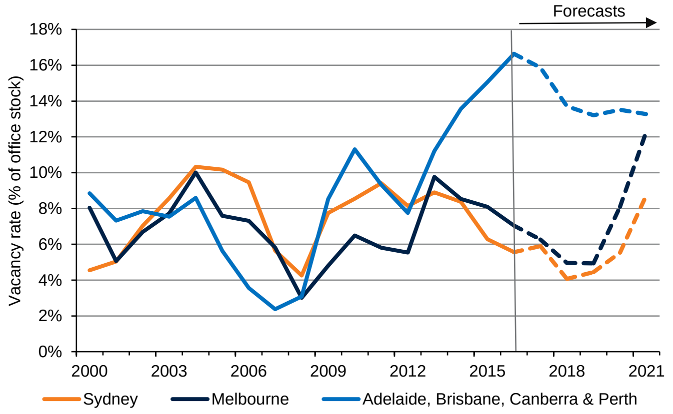
However, solid absorption of office space combined with strong capital growth has activated a strong office development cycle in Melbourne's CBD. The outlook for office leasing conditions in Melbourne is likely to soften rapidly from 2019 with the vacancy rate expected to increase to a 20-year high of over 10% by 2020 (see Box 1 for further detail). In contrast, the size of the Sydney CBD market is expected to contract by approximately 200,000 sqm to June 2019 driving the vacancy rate to 2.5-3.0%.

Outside the two major Australian office markets the picture is less favourable, with vacancy in the remaining capital cities all in double digits. Nonetheless, the outlook for the Brisbane and Perth office markets in particular have improved on the recent increases in commodity prices and export volumes. While a sustained recovery may be some years away in Perth, Brisbane office demand indicators are already solidifying. White collar employment growth has supported 95,000 sqm of positive net absorption over the past 12 months.

Rent outlook: two-speed market to remain in 2017-18

Sydney and Melbourne's outperformance will be reflected in the leasing market with prime face rents increasing at around 8.5% (in gross terms) and 5.6% (in net terms) respectively in the year to June 2018. However with a looming surge in Melbourne CBD new office supply, incentives are expected to remain elevated in Melbourne (~27-30% in the year to June 2018), while incentives in Sydney will tighten to around 18-20% over the same period.

CHART 2: OFFICE VACANCY RATES



Source: JLL Research and Investa Research (forecasts)

In contrast, soft leasing markets in Brisbane, Adelaide and Canberra will result in weak face rent growth in the year to June 2018 of 4% (gross), 2.5% (net) and 2.5% (gross respectively. Perth is expected to see little to no face rent growth in 2017-18, with only moderate improvement in leasing market conditions likely to see very attractive incentives (around 50%) unwind in the first instance.

Capital transactions: yield compression not done yet

Commercial office sales eased through 2016 with total CBD office sales of $9.5 billion, down from $10.5 billion in 2015. Nonetheless, this largely reflected lower sales volumes rather than a lack of demand from investors. In particular, foreign investors searching for high quality yielding assets remained prominent in the transactions market accounting for around one half of all transacted CBD office property. Despite tighter Chinese government controls of outbound capital flow, sales of Australian commercial office property to Chinese buyers remained strong.

Despite easing transaction activity, capital growth remained strong with yields continuing to compress to new historical lows across most CBD markets. In Sydney, prime yields pushed through the low water mark of 5.0% in the second half of 2016, while Melbourne prime yields are also pushing the 5.0% mark.

Looking ahead, strong investor demand and global capital flows are expected to continue to apply downward pressure to office yields in the coming year. However, the yield premium offered on Australian commercial office assets will continue to be moderately unwound with increased returns on alternative risk-free benchmark assets.

Commercial office property will continue to provide attractive yield value to investors with improving underlying fundamentals, increasing income returns and limited supply.

Box 1: Melbourne office development surging

Melbourne's CBD office market could be entering the largest development boom since the early 1990's. In stark contrast to a scarcity of office development across the other major CBD markets in Australia, office construction in Melbourne's CBD is in the midst of a strong cyclical upturn.

Looking through the severe shortfall of new office space in 2017, driving tighter leasing market conditions over the coming 12-18 months, a surge in new office supply is fast approaching. Along the Collins Street spine of the CBD alone, around 200,000 sqm of new office space is currently under construction and is due for completion from 2018-2020.

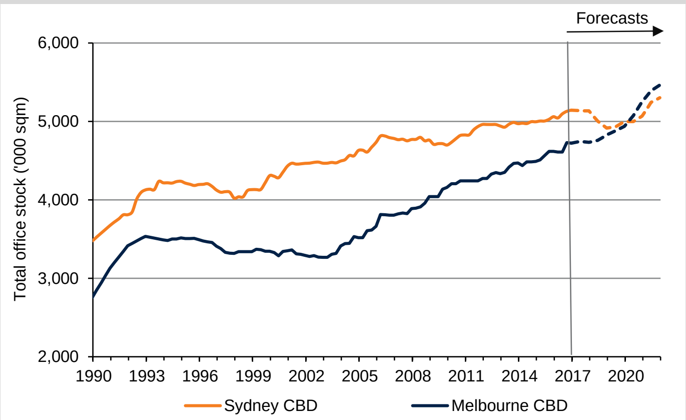
On the path to becoming Australia's largest CBD market

In contrast to the speculative development cycle in the early 1990's, more than 60% of current office space under construction in Melbourne's CBD has committed tenancies on completion. Consequently, the most significant softening in leasing conditions from the supply surge is likely to be experienced in the backfill space which in contrast to recent times has little demand for residential redevelopment in a market flooded with high-rise apartments.

In addition to current office construction activity, a further pipeline of around 370,000 sqm of approved new office space is likely to be added to the Melbourne CBD office market over the next five years.

In comparison to expectations of a shrinking Sydney CBD market, dominated by a large pipeline of office withdrawals for the construction of Metro Rail and residential redevelopment, this outlook would have Melbourne surging to become the largest CBD market in Australia by mid-2020.

CHART 1.1: SYDNEY & MELBOURNE OFFICE MARKET SIZE



Source: JLL Research and Investa Research (forecasts)

Is this the development cycle Melbourne needs?

The near-term outlook for construction activity in Melbourne's CBD market has been hit by a sharp weakening in the appetite for residential apartment development in recent years. However, a solid outlook for office development provides a welcome economic and employment offset to the slowdown in residential building.

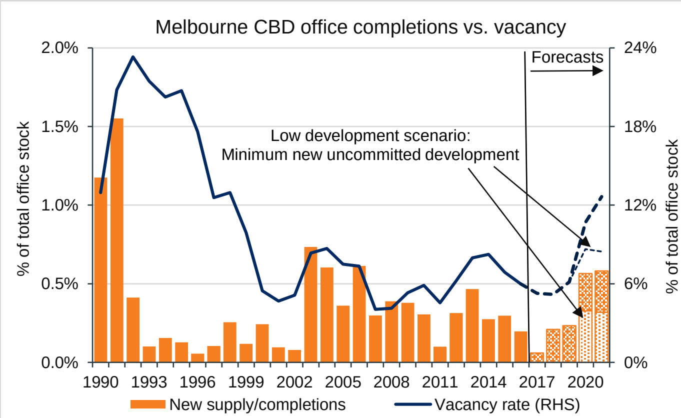
In recent years underlying demand for office space in Melbourne's CBD has been strong. Since 2014, average annualised net absorption has been around 160,000 sqm, reflecting the combination of employment growth in information technology, media, telecommunications and government with the centralisation of businesses from suburban markets to the CBD to take advantage of attractive effective rents.

To be, or not to be (absorbed)… that is the question

However, some uncertainty remains about the continued strength in Melbourne's CBD office-based employment and future office absorption levels in the face of this development cycle. Reflecting the combination of some moderation in office employment growth and tailing-off in centralisation activity we estimate that net absorption will ease to an annual average of around 75,000 sqm over the forecast period (to 2022).

Under the assumption that all approved development projects are completed, we are forecasting that the vacancy rate in Melbourne's CBD will reach a 20-year high of 10.7% by 2020, and further to 12.7% by 2021. In comparison, under a minimal development scenario[1], the vacancy rate also eases to a more moderate 8.6%.

CHART 1.2: MELBOURNE CBD OFFICE DEVELOPMENT



Source: Property Council and Investa Research (forecasts)

Nonetheless, the development cycle is here, and by 2020 Melbourne is likely to be home to the largest CBD office market in Australia, offering a selection of new prime space in a market that will remain attractive to tenants and investors alike.

[1] Assumes that DA approved projects with some leasing commitment are completed. Also includes Flinders Gate, 855 Collins Street and Wesley Church site.

About Investa Research

Investa Research focuses on understanding the drivers and analysing the movements and trends within the Australian commercial office market. The research function is fundamental in guiding group investment strategy and decision making, as well as providing a competitive advantage through insightful analyses and forecasting.

The research team publishes regular updates on the performance of the major Australian office markets, as well as occasional papers and reports examining a broader scope of topics that may be of interest to investors and other Investa stakeholders.

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About Investa

Investa is Australia's leading owner and manager of commercial office buildings, controlling assets worth close to $9 billion in key CBD markets across Australia.

Our end-to-end real estate platform incorporates funds, portfolio and asset management, property services, development, sustainability, capital transactions and research. We strive to be the first choice in Australian office, by delivering consistent outperformance for our investors and exceeding the expectations of our tenants and staff.

Investa is a global leader in sustainability and is committed to responsible property investment and the ongoing pursuit of sustainable building ownership and management. We are a signatory of the United Nations Principles for Responsible Investment.

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