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Investa Inside

Office Market Outlook

October 2017

Synchronisation: Recent market data has reflected cyclical synchronisation across Australia's major office markets. However, our forecasts indicate this trend is likely to be short-lived.

Ebb and flow: Limited new office additions in the coming year continue to support tighter leasing market conditions. However, solid development pipelines in both Melbourne and Sydney present a healthy outlook for new office supply.

Affordability: Tight office market conditions are driving solid rent increases in Sydney and Melbourne, while economic conditions are supporting white-collar business income growth. We analyse market trends in office rental affordability.

Economic Outlook

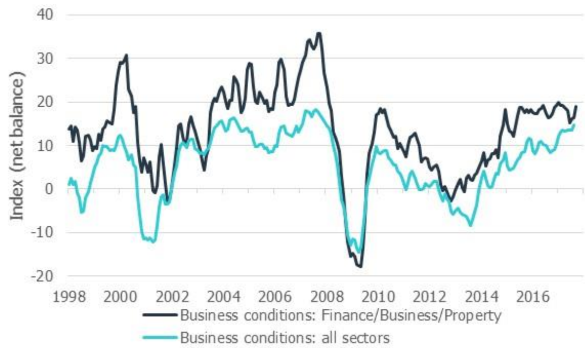
Australian economy: positive business outlook

Australian economic conditions continue to provide a positive outlook for Australia's major office markets. Business conditions for the finance, business services and property sectors have been buoyant for the past two years, supporting office-based employment growth (Chart 1).

In particular, specialist business services and government administration have driven strong white-collar employment growth and office absorption in both the Sydney and Melbourne markets. However, recent declines in finance and business administration employment indicates that the strong gains of recent years are unlikely to be sustained in the coming year.

While economic activity remains subdued outside NSW and Victoria, forward-looking indicators point to some moderately positive momentum. The outlook for Queensland has improved with both business conditions and investment picking up through 2017. WA continues to be impacted by the mining investment downturn, however WA's business outlook has also improved with the pick-up in commodity prices in 2017 compared to recent years.

Chart 1: Australian Business Conditions



Source: NAB & Investa Research

While Australia's business sector outlook is likely to remain positive for some time yet, we expect that the largest gains have passed. The tailwinds of solid business conditions appear to be 'topping out', and while there is still some existing private investment and public infrastructure work in the pipeline, expansion of office-based businesses is likely to be curtailed by increased operating costs. Despite labour costs remaining benign, increased government taxes and surcharges and higher energy costs are adding to the costs of operation. In *Box 1: Office affordability* we compare and analyse rental affordability across Australia's major office markets.

Rates outlook: moderately higher

The unwinding of accommodative global policy settings, particularly in the US, has continued to gradually push bond rates higher. However, the cautious moves of the Federal Reserve have been reasonably conservative to date, and point to an outlook for further modest increases in US Treasury rates with some risk of a faster pace of rate rises if the Fed find themselves falling 'behind the curve'.

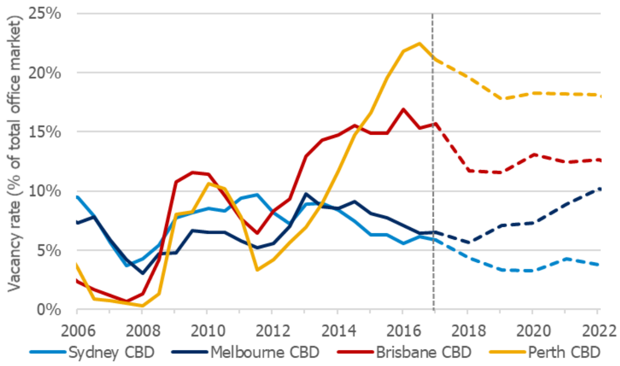
In Australia, the RBA have carefully shifted the bias of rate expectations mildly into the positive. Markets are pricing the next move in Australian policy rates to be a rate hike in Q4 2018. Despite this important shift, RBA commentary has tempered expectations of the shift in policy bias. In particular, the RBA have continued to emphasize their awareness of the financial vulnerability of Australian household debt to higher interest rates. Consequently, we see any increase in interest rates from policy moves to be gradual.

Office Market Outlook

Synchronised cyclical improvement… for now

2017 has seen leasing market momentum synchronise across Australia's big four CBD office markets for the first time since the mining investment downturn of 2012. Largely reflecting benign supply of new office space, vacancy rates are trending lower in Sydney, Melbourne, Brisbane and Perth (Chart 2).

Chart 2: Office Vacancy Rates



Source: PCA & Investa Research

Leasing market conditions in the CBD office markets of Sydney and Melbourne have historically tracked closely in line, particularly through the cyclical improvement of the past five years. Both markets have benefitted from solid white collar employment growth, experiencing strong underlying demand for office space. In addition, leasing markets in Sydney and Melbourne have also tightened on subdued development activity and weak new office supply, with Australia's largest CBD office markets increasing a meagre 1.6% and 3.9% over the past five years.

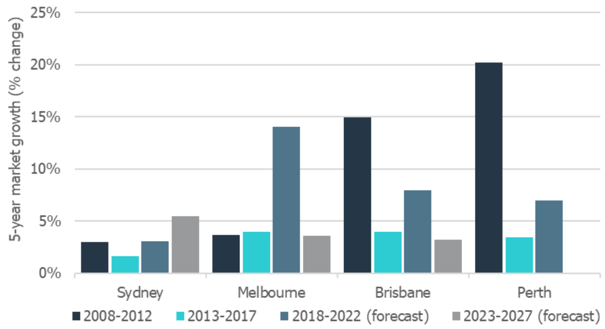
Office development… ebb and flow

However, a strong development cycle in Melbourne will drive counter-cyclical easing in market conditions in 2-5 years, as the Melbourne CBD office market is faced with the challenge of absorbing over 650,000 sqm of additional office space - equivalent to almost 2½ times the size of Sydney's International Towers at Barangaroo. We expect that Melbourne CBD office absorption, while remaining slightly stronger than 100,000 sqm per year over this period, won't be sufficient to stop the vacancy rate easing towards 10% by 2021. Solid pre-commitment to current office development projects (~70% of space to be added in the next three years) indicate that the bulk of future vacancy will be concentrated in the backfill space associated with upcoming completions.

In comparison, the office development cycle of Sydney's CBD is more moderate and later than Melbourne's. The soft development and supply outlook in Sydney's CBD is expected to be amplified by further withdrawals of existing office space for redevelopment or infrastructure construction in the coming years. Consequently, Sydney's CBD market is expected to be undersupplied for much of the next five years, maintaining tight leasing market conditions (ie. 3.0-4.5% vacancy rate) for some time yet (Chart 3).

While early-cycle office development activity is being activated in Brisbane, office leasing markets in both Brisbane and Perth are expected to improve on a weak near-term supply outlook. In the wake of the mining investment downturn, office tenant expansion and relocation is seeing a 'flight to quality' in Brisbane and Perth. We expect this trend to continue for some time yet, with the prime office market to outperform in the current cycle.

Chart 3: Office Supply



Source: PCA & Investa Research

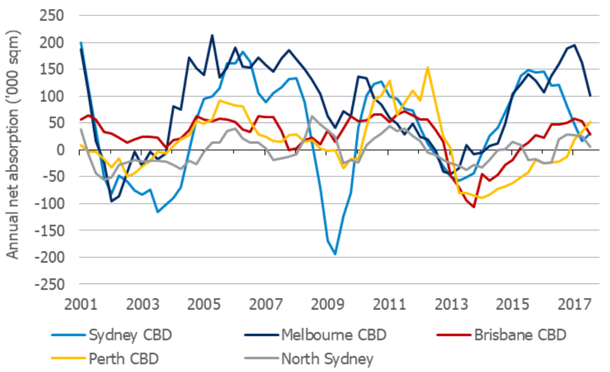
Absorption… soft is not the new normal

Despite solid growth in white collar employment and strong underlying demand for available office space, net absorption across some markets has been softer compared to recent history. The notable exception has been Melbourne's CBD, where office absorption has increased strongly (160,000 sqm in 2016-17), reflecting the combined impact of tenant expansion, new office-based business creation and centralisation of non-CBD businesses.

In contrast to the strong annual net absorption in Melbourne's CBD, Sydney CBD net absorption edged only slightly higher with a more modest 16,500 sqm. While weak absorption in Sydney has reflected some softening in white collar employment growth, the headline number also incorporates several temporary dampening factors, including (Chart 4):

- Weak additions to new office supply are limiting the availability of excess space to absorb.
- Unprecedented withdrawal of office space for redevelopment, refurbishment or public infrastructure construction is reducing the space options for office tenant moves.
- Current tight market conditions are constraining available space options and limiting the opportunity for deal flow.
- Underlying trends combined with the cost pressures, including difficult rental affordability (see *Box 1: Office market affordability*) are incentivising the drive to create floorspace efficiencies.

Chart 4: Office Net Absorption



Source: JLL Research & Investa Research

However, as the negative pressure on supply of office withdrawals in the Sydney CBD market eventually eases and office development activity creates new supply, the bulk of these absorption headwinds will dissipate. Consequently, we expect that Sydney CBD office absorption will remain subdued for another two 2 years, before accelerating to 75-80,000 sqm in 2019-20 and further to a strong 125-130,000 sqm in 2020-21.

Brisbane and Perth office absorption on the other hand is mainly reflecting moderate cyclical improvement. Somewhat stronger underlying demand for office space in these markets is largely occupying prime market vacancy (or a 'flight to quality') at the expense of the secondary market.

Capital transactions… still going strong

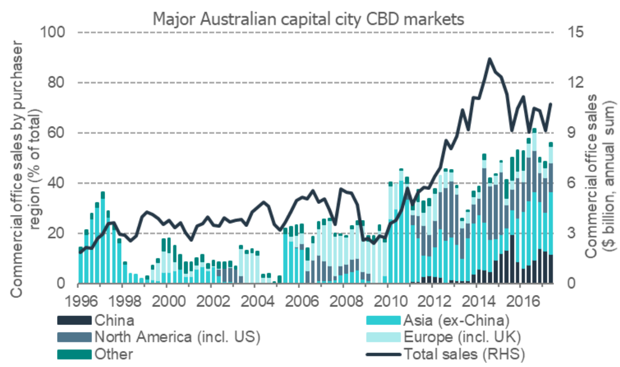
Despite ongoing market concerns about a potential trigger for the next global liquidity event, financial market conditions remain supportive of strong capital flow in office transaction markets:

- The Australian dollar continues to trade in the 0.75-0.80 range against the US dollar, supporting Australian asset affordability for foreign investors.
- Interest rates remain low, while bond rates have only increased marginally higher than the recent all-time lows.

Consequently, global liquidity remains strong and the search for yield is maintaining tight cap rates in Australian capital city office markets. However, capital flow has stabilised in 2017 and office market yield compression has similarly eased (Chart 5).

Looking ahead, in the absence of a major financial market shock, we expect office cap rates in Australia's major capital cities will tighten up to 25 basis points further in 2018. In addition to solid income growth off the back of improving leasing market conditions, Australia's major capital city office markets will continue to present attractive total return for yield-seeking investors.

Chart 5: Office Capital Transactions



*Includes Sydney CBD, North Sydney, Melbourne CBD, Southbank/St Kilda Rd, Brisbane CBD, Perth CBD, Adelaide CBD and Canberra/Civic
Source: JLL Research & Investa Research

Box 1: Office market affordability

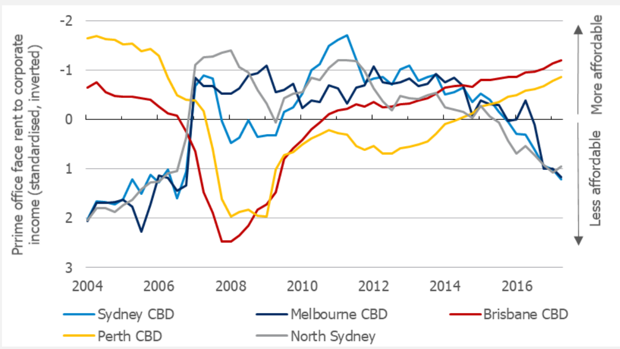
Sydney and Melbourne office rents have increased sharply to be almost 20% higher in the past two years. We find that while this rate of growth has only recently breached historical affordability benchmarks, rental affordability may have an impact on business leasing decisions as market conditions diverge in the coming years.

Office rents have surged in Sydney and Melbourne in the past year, reflecting the combined impact of strong office market conditions and a degree of 'catch up', following five years of modest rental growth.

Accounting for the cost of outgoings, 'net' face rents in Sydney and Melbourne prime office are increasing annually at double-digit growth rates (13% and 15% respectively). In Sydney, tenant leasing incentives are falling, adding to 'effective' rent growth and easing the upward pressure on face rents. However, in Melbourne, incentives have remained sticky at around 30% (~3 years rent free on a 10-year lease).

In comparison, positive trading conditions have driven white collar business income growth to five-year highs of 4.5%. In a relative sense, this has reflected more difficult rental affordability for office tenants in these markets. However, when compared to prime office rental affordability over the past 13 years, Sydney and Melbourne CBD prime office rents have only recently breached historical norms. This is not unusual in strong office market conditions (Charts 1.1 & 1.2).

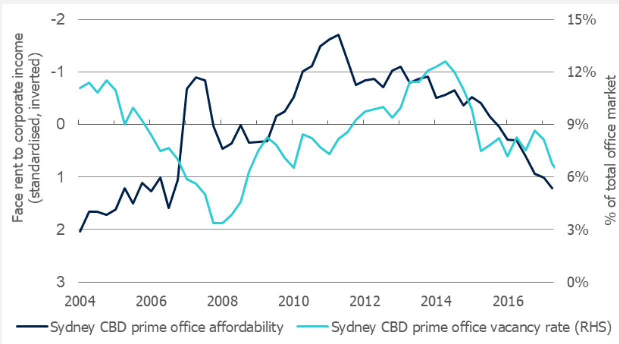
Chart 1.1: Relative affordability, major office markets



Source: ABS, JLL Research & Investa Research

While we expect office rents will continue to reflect strong market conditions in 2018, growth is likely to soften from the strong gains in 2017. We expect prime office face rent growth in 2018 to ease to 9-10% in Sydney CBD and 5-6% in Melbourne CBD. In the longer term, the supply response to strong rental growth and low vacancy will further ease pressure on rent growth. Consequently, prime office rental growth in Sydney and Melbourne is unlikely to continue at the current multiple of almost 3-to-1 for much longer, when compared to business revenue growth, softening the affordability pressures in Sydney and Melbourne.

Chart 1.2: Sydney Office Vacancy and Rental Affordability



Source: ABS, JLL Research & Investa Research

Nonetheless, other critical elements should not be ignored when considering the potential impact of rental affordability on office market absorption, including the quality and availability of appropriate office space. Like any individual economic decision model, price or affordability is only one element in a range of factors, including consumer preferences (i.e. office space and location requirements) and capacity (i.e. availability).

With office amenity (ie. technology, fit out/facilities, lifestyle offering) increasingly important to businesses ability to attract and retain talented workers, 'more affordable' prime space options may provide a viable alternative for tenants unable to make a core CBD move 'stack up'.

As mentioned in Office Market Outlook, the supply response to strong market conditions is coming at different times across Australia's major office markets. This will not only impact the relative availability of high quality office space, but will also create variable pressures on rental growth and affordability.

Time will tell if this has a significant impact on business leasing decisions. However, when paired with a combination of strong underlying demand, a multi-year shortage of space and upward pressure on business operating costs and outgoings, variation in rental affordability is expected to have some impact in the coming years.

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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.

About Investa

Investa is a leading Australian real estate company managing more than A$11 billion of quality office real estate. As a specialist office manager of commercial office buildings Investa manages more than 37 assets in the key Australian CBD markets on behalf of ICPF, the ASX-listed Investa Office Fund (IOF) and private mandates. Its end-to-end real estate platform incorporates funds, asset, property and facilities management, development, sustainability, capital transactions and research.

Investa strives to create Australia's most valued working places be the first choice in Australian office, by delivering consistent outperformance for its investors and exceeding the expectations of its tenants and staff, while remaining an industry leader in sustainable building management and responsible property investment.