INVESTA OFFICE

Inside

Q2 2014
Office Market Update
July 2014

> - Sydney CBD, North Sydney and smaller NSW markets are now beginning to recover. Demand is improving and vacancy broadly appears to have peaked while rental growth has emerged.
> - Demand has also recovered in Melbourne CBD and the smaller VIC markets; however the cycle is not yet as advanced as Sydney. Rental growth is likely to improve from here.
> - Brisbane and Perth saw further vacancy rate increases; however there is further evidence that demand is stabilising and economic data is supportive of improvements over the remainder of the year.
> - Capital markets continue to firm with further yield compression recorded during the quarter – led by the upper end of the prime grade Sydney CBD market.

We are pleased to bring you an overview of the current state of the major Australian office markets. This report relies on historical property data sourced from JLL Research (unless otherwise stated) current as at Q2 2014. All analysis and views of future market conditions are solely those of Investa.

Economic Overview

Economic fundamentals aligning

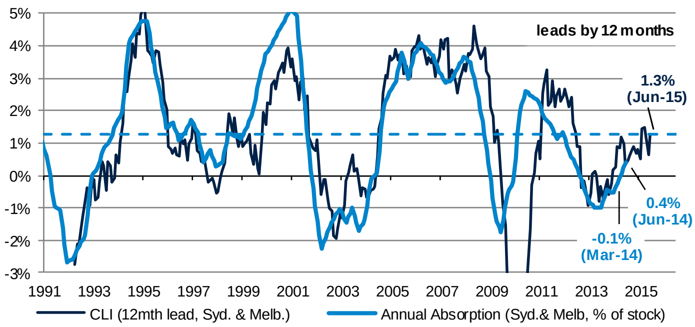
Since the start of the year we have seen a sustained turnaround in several of the key shorter leading indicators of office demand. In particular, a trend of job advertisement growth is now established (up 6% since the beginning of the year), after falling over the prior 18 months, and business conditions are also in the early stages of expansion. In addition, growth in full-time employment now appears to have passed its cyclical trough, growing 1.2% over the past 6 months. This is in line with the natural progression of the business cycle, given that the longer leading indicators (global and financial markets), which typically move around 12 months before office demand, have been positive for some time now. For further analysis please refer to "Leading Indicator Update – July 2014".

Share prices overall remain buoyant. The majority of equities markets are up on both a quarterly and 6 monthly basis. Asia-Pacific regional share prices are up over the June quarter (+5.6%) and domestic share prices, while slowing in growth, also improved (+1.9%). Encouragingly, the P/E multiples expansion seen last year is increasingly being supported by earnings momentum, while low interest rates and pre-GFC levels of volatility are promoting stability throughout financial markets. Likewise, the global economic recovery - led by the developed nations - has continued to improve, and GDP growth of Australia's major trading partners has lifted to around 4.5%. More timely global PMIs are consistent with these trends with the US, Eurozone, China and Japan indicators all in expansionary territory – notwithstanding some consolidation in recent months.

On the other hand, resource sector indicators on balance were more subdued. Commodity prices have slid back moderately over the past 6 months (-8.5% on average); however other indicators, like Chinese output and mining business conditions have been more positive. Resource share prices have been able to hold ground bouncing between 4,100-4,200 points over the same period.

In the residential sector, dwelling loans and building approvals have levelled somewhat (albeit at high levels), while prices continue to grow - particularly in Sydney. While we may be at or near the cyclical peak in house price growth, we are certainly not at the peak in house prices and going forward this trend will continue to support CBD office conversions.

CHART 1: SYDNEY & MELBOURNE CLI



Source: JLL Research (Q2 2014) and Investa Research

Office Market Overview

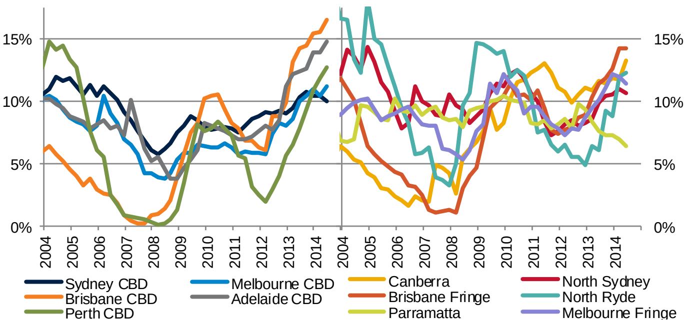
Sydney and Melbourne office markets step forward; other locations lagging the cycle

The long anticipated demand recovery appears to be materialising in the Sydney and Melbourne office markets in line with the balance of leading indicators - see Chart 1. Sydney CBD in particular surprised on the upside with 22,000 sqm of net absorption recorded during the quarter, while Melbourne CBD and North Sydney posted

11,000sqm and 3,000sqm respectively - mostly attributable to B grade market demand. As a result, vacancy rates fell moderately in these locations with the exception of Melbourne CBD, which rose due to the completion of 720 Bourke Street in Docklands (47,000sqm). The Sydney CBD vacancy rate now sits in single digit territory (9.9%).

The near-city office markets surrounding the improving Sydney and Melbourne CBDs are also showing initial signs of a turnaround. Vacancy rates in Chatswood, St Leonards and Melbourne Fringe have stabilised and are starting to trend down. Encouragingly, this has also been demand-led, suggesting that the broader economic fundamentals supporting office markets are well entrenched. Given the very low supply outlook in near-city markets, vacancy rates will most likely improve from here.

CHART 2: VACANCY RATES

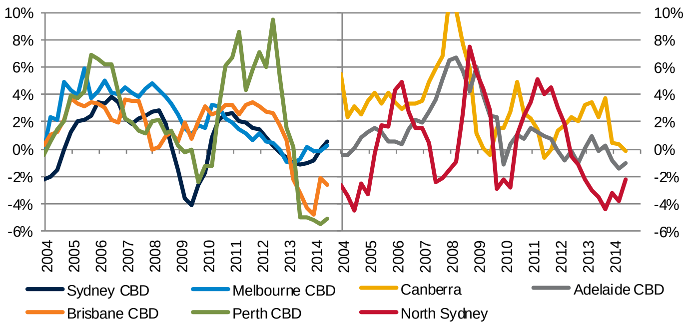


Source: JLL Research (Q2 2014) and Investa Research

At the same time, resource sector contraction continues to impact the Brisbane and Perth CBD office markets; with negative net absorption lifting the vacancy rates by 1 percentage point each over the quarter. Vacancy now sits at 16.5% in Brisbane (predominantly in secondary space) and 12.7% in Perth. While we expect rates of net absorption in these markets to approach neutral levels by the end of the year, given the stabilisation in key resource-related indicators, we also expect some residual contraction to linger in the interim due to the usual transmission lags.

Similarly Canberra and Adelaide CBD vacancy rates also rose by around 1 percentage point, driven by both negative demand and supply additions. Overall, average CBD vacancy rates rose moderately by 0.5 percentage points to 12.2%.

CHART 3: ANNUAL NET ABSORPTION (% OF STOCK)



Source: JLL Research (Q2 2014) and Investa Research

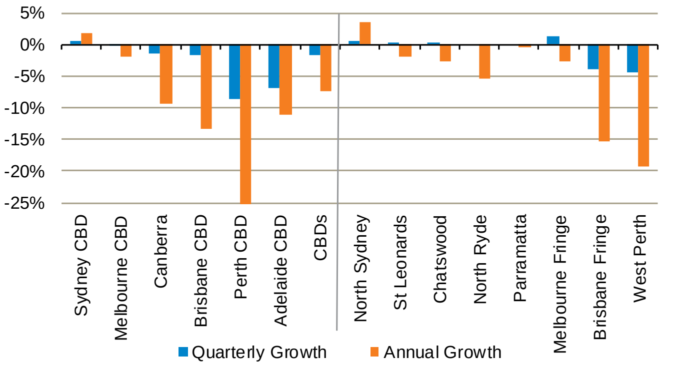
East coast office markets passing through the rental cycle low

Effective rental growth patterns are mirroring vacancy trends as expected. Prime rents grew marginally (around half a percent) over the quarter in Sydney and North Sydney – and are now up 2% and 3.5% respectively on an annual basis. Likewise, there were some early signs of growth in the North Shore markets of St Leonards and Chatswood suggesting that they too have passed the trough in their rental cycles.

Melbourne CBD effective rents appear to be passing through the bottom as well – though lagging Sydney slightly – having turned slightly positive over the past 6 months (+0.8%). The Melbourne Fringe is currently at a similar stage in the cycle; however it may enter the growth phase more quickly than the CBD given the substantially lower supply conditions in the near-term.

Overall, this quarter's vacancy and rental data suggest that the tide is starting to turn in the core East Coast cities. Incentives have broadly stabilised in these locations at what appears to be their peak, allowing face rental growth to flow fully into effective rent figures. Going forward we expect improving fundamentals to drive a more material uplift in the coming quarters.

CHART 4: PRIME NET EFFECTIVE RENTAL GROWTH

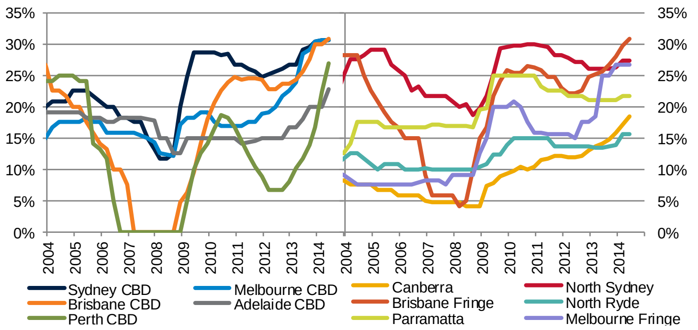


Source: JLL Research (Q2 2014) and Investa Research

Effective rents in other office locations still finding a floor

On the other hand, other major centres are still under pressure mainly due to rising incentives. Perth CBD in particular continues to see effective rents correct (-8.6% q-q) through rising incentives, which are now close to national averages at 27%. Brisbane, Adelaide and Canberra CBDs also recorded effective declines. However, in the case of Brisbane, rental decreases have slowed markedly, aided by stabilising incentives.

CHART 5: TENANT INCENTIVES (%)



Source: JLL Research (Q2 2014) and Investa Research

Medium–term supply under construction near long run averages in Sydney, Brisbane and Perth; the pipeline remains constrained elsewhere

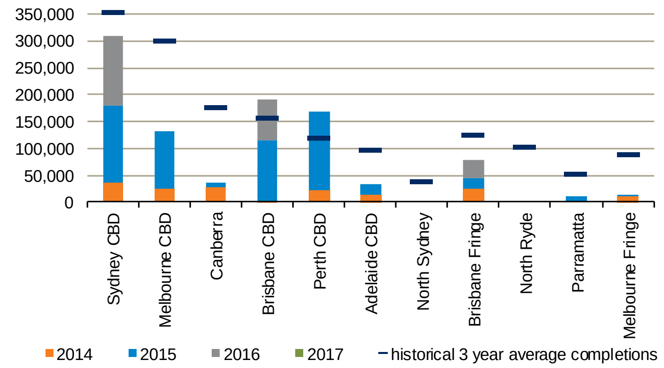
The supply cycle will start to ramp up late next year in several CBD markets, but the impact will be minimal in most locations over the next 12 months – see Chart 6.

In Sydney CBD the supply cycle is likely to lag demand. The market has been experiencing close to zero net supply in recent years, suppressed by withdrawals for residential/hotel conversion. We expect this supply-side dynamic will continue over the next 12 months before the delivery of several major projects including International Towers T2 & T3. There was significant pre-commitment activity during the quarter, including confirmation that both PwC (26,500 sqm) and HSBC (8,000) will move to International Towers T1. Investa Office Fund (IOF) also announced the re-development of 151 Clarence Street with Arup as the anchor tenant (5,900 sqm).

While the vacancy rate and effective rents in Sydney have responded more visibly to the turnaround in demand due to the tight supply environment, Melbourne CBD has not had the same experience to date, due to the more immediate delivery of supply. However, now that many of these projects have been completed, the pipeline in Melbourne is diminishing, with supply under construction now representing only 45% of the long-run average. As the remaining projects come to completion (including 150 Collins Street, 313 Spencer Street and 567 Collins Street), we expect demand to broadly balance supply, after which a low supply environment beyond FY15 should be more conducive to material levels of rental growth. Significant pre-commitments were announced during the quarter including Jemena, who will occupy 12,000 sqm in Investa's[1] 567 Collins Street (now circa 70% committed) and also announcement of the pre-commitment of PwC (17,200 sqm) to Mirvac's Riverside Quay at Southbank.

The resources-dominated markets will experience minimal net supply over the next 12 months with several large projects due for completion from the second half of 2015. These include 180 Ann Street, 480 Queen Street and 1 William Street in Brisbane CBD and the Old Treasury Building, Kings Square and Brookfield Place 2 in Perth CBD. Conversely, Adelaide's supply outlook is more similar to that of Melbourne, with a rising vacancy rate pushed up by immediate supply delivery but a rapidly diminishing future pipeline – with only 13,000sqm of refurbishments and 50 Flinders Street under construction. North Sydney is also supply constrained. While 177 Pacific Highway will commence shortly, this represents only 4.7% of stock and is due to complete in 2016.

CHART 6: SUPPLY UNDER CONSTRUCTION (SQM)



Source: JLL Research (Q2 2014) and Investa Research

Supply is very much contained in the smaller markets across the country. Only the Brisbane Fringe has meaningful levels of new supply under construction (close to 10% of stock). The NSW markets of North Sydney, North Ryde, Chatswood, St Leonards and Parramatta have minimal supply under construction. In the medium-term, tight supply conditions in the suburban markets combined with the historically narrow rental gap between the CBD and satellite locations should be supportive of rental growth in the core.

Prime office yields trending down; Sydney assets leading the charge amid improving fundamentals

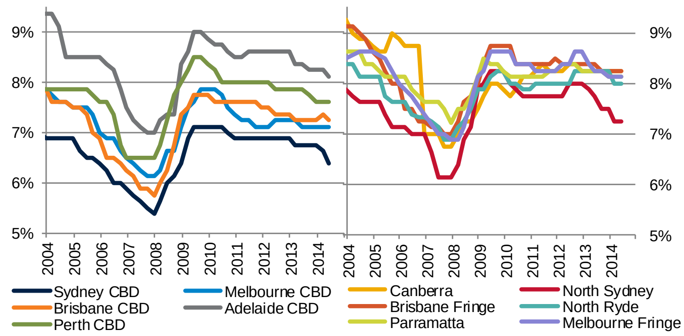
Prime yields in Sydney CBD recorded 25 bps of firming over the quarter (now 5.75%-7.00%) and Adelaide CBD also compressed by 12.5bps, driven by the higher quality end (at 7.25%-9.00%). Yields have also been

[1] Jointly owned by Investa Commercial Property Fund (50%) and Investa Office Fund (50%)

compressing in the Sydney and Melbourne suburban markets across prime but particularly secondary assets - ranging from 12.5 to 62.5bps of firming over the past 3-6 months.

In general, higher quality assets with long WALEs and strong covenants continue to experience the highest level of investor demand across all locations; and in many cases, the premium usually required to enter non-core markets is being eroded in order to acquire secure income streams.

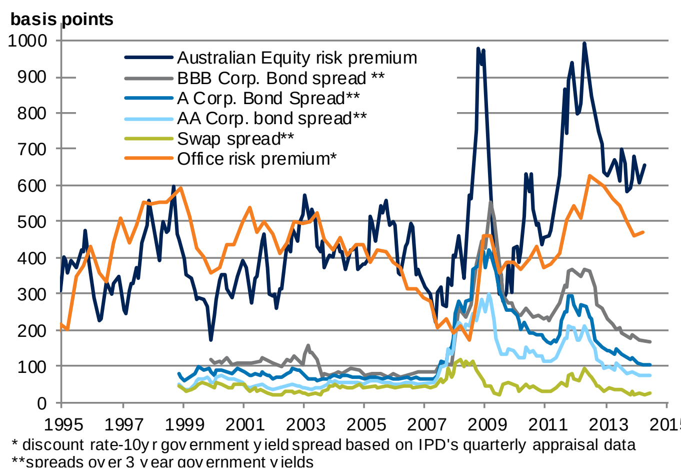
CHART 7: PRIME OFFICE YIELDS



Source: JLL Research (Q2 2014) and Investa Research

The overall theme in office capital markets remains unchanged. Yields are continuing to be driven by growing investor appetite and reducing risk spreads rather than significant growth upgrades. Importantly, the fall in risk premium for property (and for other asset classes) in our view reflects a step towards normalisation, particularly viewed in context of history and fixed income and equity markets – see Chart 8. While the rental growth outlook is only moderate at this stage, downside risk overall is now less of a concern. Yield compression is also being aided to a certain extent by stabilising government bond yields, which have fallen by circa 50 bps over the past 6 months.

CHART 8: RISK PREMIA (OVER GOVERNMENT YIELDS)



Source: Macquarie, IPD, RBA and Investa Research

While reported earnings growth for the office REITs and unlisted funds for FY14 will likely be weighed down by soft tenant demand, for many this will likely be significantly outweighed by accretive acquisitions and low debt costs. At the same time asset values and NTA will be supported by cap rate compression.

Major office transactions over the June quarter included:

> TIAA-CREF's purchase of 50% of the AGL Building, 699 Bourke Street development ($73M) in Melbourne CBD from Mirvac. This was a strong result for a Docklands asset, trading on a 6.5% cap rate. It is fully pre-committed with a 10 year WALE on completion.

> Growthpoint Properties' acquisition of the NSW Police HQ at 1 Charles Street Parramatta ($241.1M) from Australian Super on a 7.0% cap rate. The asset is fully let to the NSW State government with a 10 year remaining term and fixed 3.5%pa rental increases.

> Investa Office Fund's acquisition 6 O'Connell Street, Sydney CBD ($134.95M) from Blackrock. This asset is a multi-tenanted office building in the CBD core. The sale price equates to a 7.5% cap rate.

> 50% of Westpac Place in Sydney CBD ($435M) from Mirvac to Blackstone.

There were also several acquisitions in Sydney for potential hotel or residential conversion:

> 234 Sussex Street (11,000sqm) for $61M by Meriton

> 59 Goulburn Street (19,700sqm) for $90.2M by Singaporean group Roxy-Pacific Holdings Limited

Outlook

Sydney CBD leads the way - effective rental growth emerging

Absorption in Sydney CBD surprised on the upside this quarter (22,000 sqm) driving the annualised trend into expansionary territory and the vacancy rate down. This is in line with the balance of leading indicators and is being driven by smaller tenants in the market seeking space of less than 1,000 sqm. The secondary vacancy rate in Sydney remains lower than prime, unlike most other national CBD markets.

While near-term dynamics are favouring B grade fundamentals, in the medium-term it is likely that we will see an escalation in prime grade demand (particularly well-located A grade stock) through organic tenant expansion and trade-up activity.

Other factors are also boosting the market including the number of office assets being marketed as residential conversions thanks to the strength of the housing market. Around 117,000 sqm of B grade stock is expected to be permanently withdrawn from the office stock over the next 3 years.

Overall we expect Sydney to continue to lead the other markets into recovery as we enter a demand upswing over the course of the next 12 months.

Incentives stabilise while signs of rental growth emerge in Melbourne

There were further positive signs for the Melbourne occupancy market this data release. Demand was robust over the quarter (11,100 sqm), but importantly, like Sydney, the annualised trend rebounded into positive territory, indicating that we are nearing an upswing. We are starting to see the impact of structural factors on the market. In our paper Key Office Market Themes for 2014 we identified that tenant relocations from fringe locations would boost CBD office demand. Jemena's 12,000 sqm commitment to 567 Collins Street is a good example of this trend, and we expect more of these announcements over the next few years.

The cycle in Melbourne is not yet as advanced in Sydney, due to a stronger immediate supply pipeline which will mean that vacancy will stay higher for longer. Nevertheless, incentives now appear to have stabilised. We expect demand to gradually escalate from here, and the declining supply outlook from next year will mean that vacancy should start to trend down in the coming years.

On a relative basis Melbourne now has low anticipated supply compared to other CBD locations, and for this reason we are increasingly positive on the outlook for rental growth over the medium-term.

Signs of stabilisation in Brisbane – although supply headwinds remain on the horizon

Absorption was negative this quarter after a moderation of demand in Q1. This result was purely a function of an increase in sub-lease space, which in our view is at or near the peak. While the demand environment has been challenging, the forward-looking indicators point to stabilisation ahead. We expect absorption to moderate to neutral levels before returning to positive territory in FY15. With a confirmed supply pipeline it is likely that the vacancy rate will stay high over the medium-term, concentrated in the secondary sector of the market.

There are some encouraging signs developing however. On one hand the rate of effective rental declines has eased and we expect we are near the trough. On the other hand, capital markets remain very strong, with demand for good quality assets; particularly those with long leases, remaining unabated. This continued interest has driven yield compression even in market with deteriorating occupancy fundamentals.

Occupancy market deteriorates further in Perth – but the worst of the demand correction is likely over

Like Brisbane, Perth occupancy markets deteriorated further during the quarter and incentives rose accordingly. However unlike Brisbane, the weakness was concentrated in the direct leasing market, rather than in sub-lease space, which actually reduced over the quarter.

Looking ahead we expect that conditions will stabilise. Recent data from China, commodities prices and the longer-term outlook for the LNG sector in particular should soon place a floor on any further tenant contraction.

The WA economy will remain buoyant given the huge increases in export volumes that are starting to ramp up, and this will fund a number Government-led infrastructure projects that are in the planning stage. While these are unlikely to benefit office markets in the same way that the surge in mining investment did during 2010-2012, Government spending, combined with WA's continued above average population growth, will underpin longer-term demand.

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 Office

Investa Office is Australia's leading owner and manager of commercial office buildings, controlling assets worth close to $8 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 Office 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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