PERTH CBD OFFICE MARKET: THE WINDS THEY ARE A CHANGIN'

OVERVIEW

The Perth CBD office market is emerging from the most severe cyclical downturn since the early 1990's. However, in contrast to the strong rebound of previous recoveries, a modest outlook for WA economic growth and underlying business demand for office space points to a gradual improvement in Perth office leasing market conditions over the coming years.

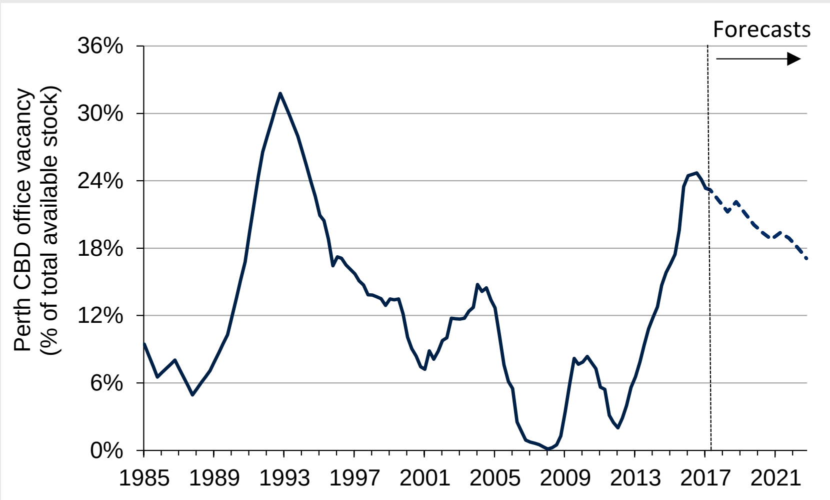
KEY POINTS

> Headwinds & tailwinds: Economic headwinds for the WA economy are easing, while tailwinds are providing only moderate support to economic growth.

> Cyclical moderation: The office cycle in Perth has historically been quite volatile, riding the highs and lows of the mining cycle. Looking ahead, the Perth CBD office market will likely experience a subdued cyclical upturn, with conditions less dependent on the mining sector outlook than in recent years.

> Two-speed market: the early-cycle improvement in Perth's CBD office market has been concentrated in the prime office market, partly reflecting tenants upgrading to higher quality office space. In contrast, the lower-grade market is continuing to weaken.

CHART 1: WORST OF THE DOWNTURN HAS PASSED FOR PERTH CBD OFFICE MARKET



Source: Jones Lang LaSalle Research and Investa Research (forecast)

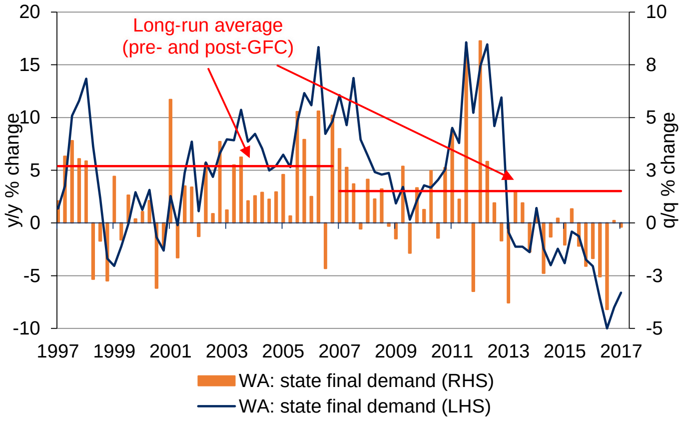
Economic Outlook

Headwinds to WA economic growth are passing

While the bulk of economic headwinds from the post-mining investment boom have passed, the WA economy still has some baggage to filter through in the coming years. In particular, business investment has some further to fall with more than $100 billion of capital expenditure in the energy sector across the Gorgon, Prelude and Wheatstone projects being completed by the end of 2018.

Nonetheless, a number of tailwinds are gaining momentum and driving some more stable economic activity in WA. Resource and energy export volumes are increasing and improvement in resource prices have made some ground in adding to economic production and income growth respectively.

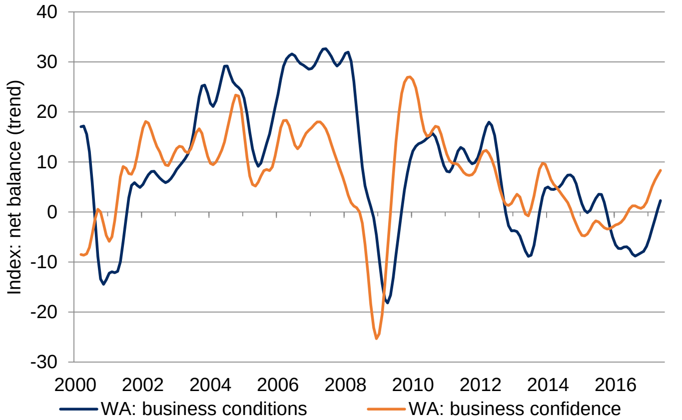
CHART 2: WA ECONOMY STILL HAS SOME WORK TO DO



Source: ABS and Investa Research

These tailwinds have supported both some optimism in WA's business sector and improvement in business operating conditions, which are now positive for the first time since late-2015. Nonetheless, while these WA business indicators are running at multi-year highs they are still below the levels posted across the rest of Australia.

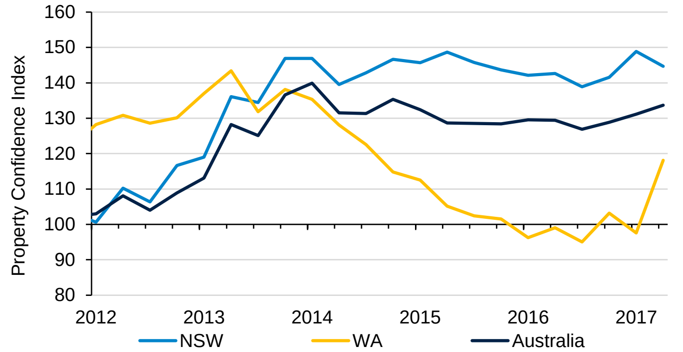
CHART 3: WA BUSINESS OUTLOOK IMPROVING



Source: NAB and Investa Research

Improved WA business confidence has taken some time to flow through to the property sector. However, more recently the property sector outlook has increased sharply driven by a more optimistic outlook for capital growth and WA economic conditions.

CHART 4: WA PROPERTY CONFIDENCE CLOSING THE GAP



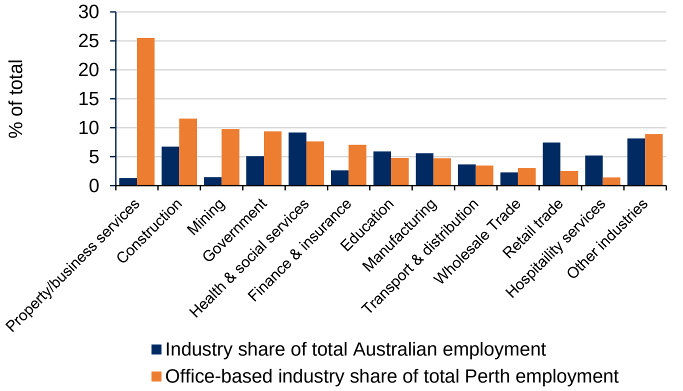
Source: ANZ-Property Council and Investa Research

Modest employment gains, lower mining dependence

While WA's mining sector has borne the brunt of the economic cycle over the past decade, office-based employment in the Perth CBD market is driven by a number of different industries. Outside of direct office-based mining employment, the combination of property and business services, construction and government contribute approximately 45% of all office-based employment in Perth. Consequently, the outlook for underlying demand of Perth office space is dependent on a broader range of leading indicators than just commodity prices and mining exports.

Granted, integration with mining sector activity drives employment in downstream and support industries (incl. property and business services, construction and finance and insurance) in both an upturn and downturn. However, this correlation has weakened through the recent mining cycle downturn, partly reflecting the weaker employment multiplier from transitioning to the production phase of the mining cycle.

CHART 5: PERTH OFFICE MARKET IS MORE THAN MINING



Source: ABS, BIS Oxford Economics and Investa Research

Investment, public spending and population are vital

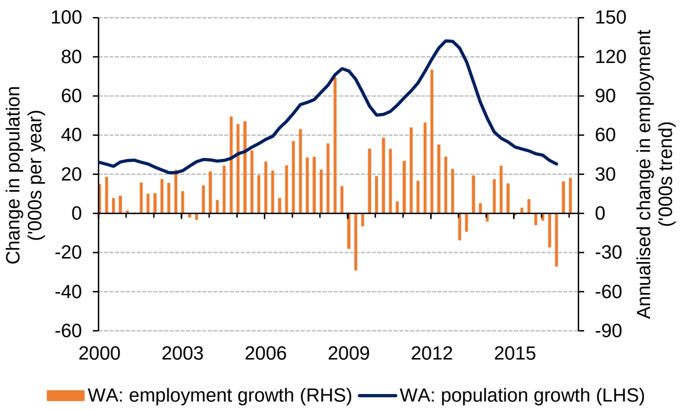
Beyond resource and energy markets, some of the key leading indicators for Perth office demand include non-mining business investment, public infrastructure expenditure and population growth. While we see some more positive signs for Perth office employment compared to recent years, the outlook for these indicators points to only a modest improvement in underlying office demand and net absorption through the remainder of 2017 and into 2018.

Non-mining business investment has declined sharply through the second half of 2016, with the amount of non-residential building activity 40% lower in the year to the end of 2016. This has included a dearth in office construction through 2016 following the completions of Tower Two at Brookfield Place, Old Treasury and Kings Square precinct. Looking ahead, the only significant office development project in Perth over the next three years is around 48,500 sqm of office space currently under construction at Capital Square, which is due for completion in 2018.

The outlook for public infrastructure projects is also rather sparse, with the $1.86 billion Forrestfield-Airport Rail Link the only public infrastructure project currently under construction. Under consideration for commencement in 2018 is the $2.5 billion Metronet rail project. Nonetheless, the tax and royalties windfall from stronger WA resources and energy revenues could potentially further support WA state government expenditure and public sector employment going forward.

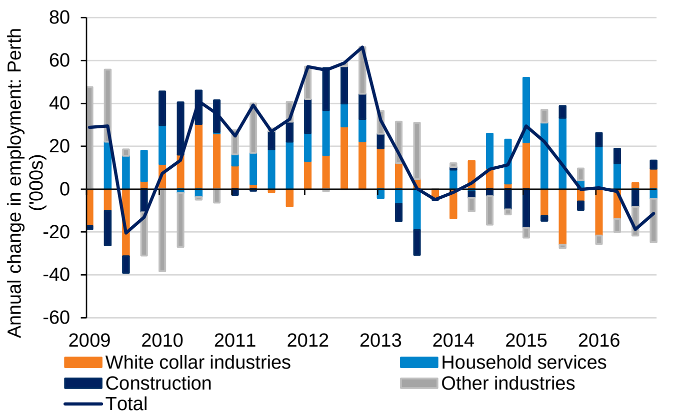
While remaining historically weak towards the end of 2016, WA population growth appears to be stabilising. In particular, the leakage of migration to the eastern states appears to be stemming, with Perth offering improved employment prospects. Flowing on from expectations of more stable employment and population growth, the outlook for household spending and demand for housing are likely to improve, reversing some of the weakness in recent years.

CHART 6: POPULATION GROWTH CONTINUING TO SLOW



Source: ABS and Investa Research

CHART 7: PERTH WHITE COLLAR EMPLOYMENT GROWING



Source: ABS and Investa Research

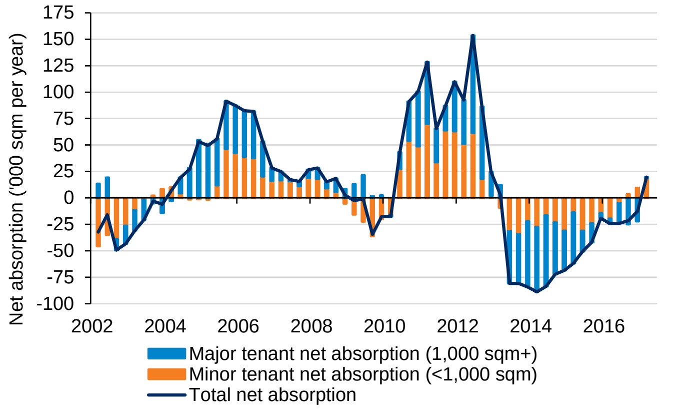
Office Market Outlook

Increased demand for Perth CBD office space

As is a common theme in the early stages of a cyclical office market recovery, the leading sectors of market demand can capitalise on favourable rental affordability to upgrade their office space, or undertake a 'flight to quality'. This theme is driving a prime office lead recovery in Perth's CBD.

Following almost four years of contraction since the mining boom, underlying demand for Perth CBD office space is once again increasing. Net absorption, in particular demand for smaller (sub-1,000 sqm) tenancy space, has driven an early-cycle turnaround in the outlook for Perth CBD leasing market conditions.

CHART 8: PERTH CBD OFFICE DEMAND INCREASING



Source: Jones Lang LaSalle Research and Investa Research

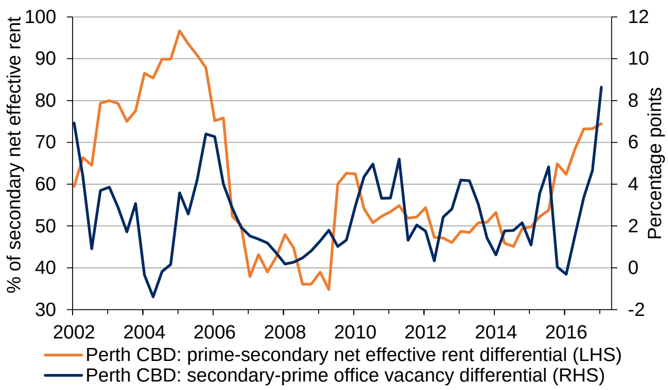
In addition to increased demand for office space from tenants looking for smaller floor plates, net absorption has been positive for both the government sector and finance and insurance. The combination of these sources of positive demand for office space have more than offset the continued negative (albeit softer) impact of lower mining sector demand.

Perth CBD: prime market leading office recovery

As a legacy of the market weakness of recent years, Perth's CBD is experiencing two-speed market conditions. Demand for prime office space is leading the upturn, with net absorption increasing at the strongest level since 2012, while net absorption of secondary office space remains weak and has now been falling for 19 consecutive quarters.

Stronger absorption of prime office space in Perth CBD has reflected a combination of both increased office-based employment and a 'flight to quality'. Tenants are benefitting from improved business conditions and favourable rental affordability across property grades to upgrade from secondary space to higher quality office alternatives. This trend has seen the differential in the prime and secondary market vacancy rates (20.0% and 28.6% respectively) blow out to a multi-decade high. Consequently, rental affordability across Perth CBD office grades are also widening. Prime market effective rents are increasing on lower incentives and more stable face rents, while the secondary market continues to offer rent discounts and higher incentives to attract tenants. The dispersion between these markets most recently suggests this 'flight to quality' theme has some further to run.

CHART 9: UPGRADING TO DRIVE RENT DIFFERENTIAL



Source: Jones Lang LaSalle Research and Investa Research

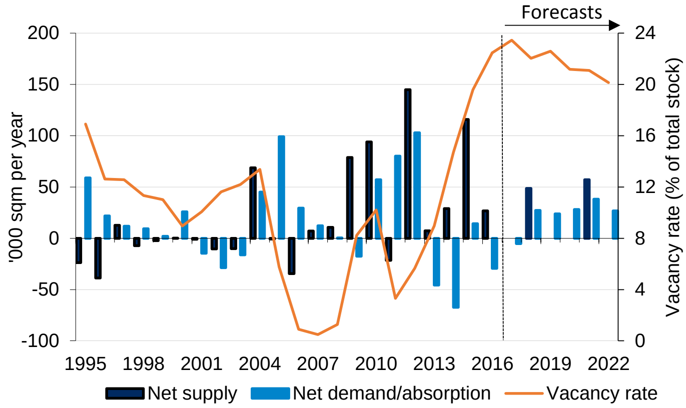
Commodities remain key to development outlook

As many highly cyclical markets such as the Perth office market experience, timing is critical. Demand conditions in the Perth office market have historically been strongly correlated to cyclical changes in commodities markets. Development is typically activated with pre-commitment strongly skewed towards the resources sector (41% of pre-commitments in completed projects since 2007 have been concentrated in the mining sector). However, the long lags in office development from project development to completion has made Perth prone to both undershooting and overshooting the sharp cyclical changes in prevailing market demand.

Following this trend, the Perth CBD office market has expanded strongly by around 324,500 sqm (or 22% of total stock) over the past five years while net absorption has been falling for much of that period. In stark contrast, the existing development pipeline indicates a subdued outlook for new office supply.

Currently, there is just one project under construction, Capital Square at 98 Mounts Bay Road (approx. 48,500 sqm), which is fully pre-committed to Woodside Petroleum. Beyond the Capital Square development there are two other mooted office development projects (Chevron at Elizabeth Quay and Waterbank) that look most likely to proceed in Perth's CBD over the next five years. In total, net supply over the coming five years is expected to increase by a meagre 105,500 sqm (or a 6% increase in the size of the Perth office market). That is, around one third of the total net supply added over the past five years.

CHART 10: PERTH MARKET FUNDAMENTALS TO IMPROVE



Source: Property Council and Investa Research (forecasts)

Potential upside to Perth office development

While the sparse existing development pipeline will go some way to supporting a near-term cyclical improvement in Perth CBD office market conditions, an ageing office stock profile in Perth CBD presents potential upside to future development. In 2022 the total amount of office stock more than 10 years old will be 85% (currently 70%).

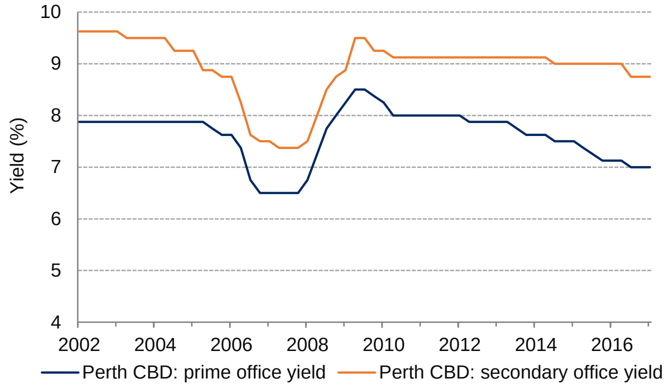
Under this scenario, demand for new office space could surprise on the upside in the longer-term, potentially driven by either unexpected cyclical strength or an acceleration in structural demand for new or high-spec office space. Consequently, there is the potential that the lack of 'shovel ready' projects could leave the Perth CBD office market undershooting potentially stronger demand, particularly in the prime office segment.

Limited capital transactions but yields remain tight

The capital transactions pool in the Perth CBD office market has been shallow in the past year, with only six sales transacting in 2016 for a total of approximately $590 million. Nonetheless, similar to trends experienced across most other CBD markets in Australia in recent years, foreign investors are looking to increase their exposure to Perth CBD office property.

Of the total value of Perth CBD office market capital transactions in 2016, 72% was sold to offshore investors. Reflecting solid demand for the limited number of assets transacted, Perth CBD office yields tightened, led by steady yield compression, particularly in prime office assets.

CHART 11: PRIME YIELDS DRIVING COMPRESSION

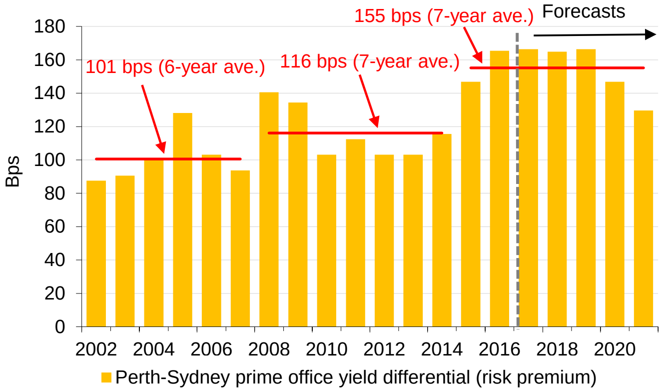


Source: Jones Lang LaSalle Research and Investa Research

However, in comparison to the major CBD markets of Sydney and Melbourne yield compression in the Perth CBD office market has been softer. Consequently, the Perth office yield premium on the Sydney market has widened sharply, from an average of around 116 basis points through the mining boom to around 165 basis points in 2016. We expect the Perth market premium on the major CBD markets of the eastern states will remain around these elevated levels for some years to come.

Based on expectations of moderate improvement in the underlying market fundamentals in the coming years, this premium is likely to continue to attract solid investor capital and further downward pressure on yields (albeit not significantly different to expected compression in Sydney and Melbourne), particularly for high quality office assets.

CHART 12: PERTH-SYDNEY YIELD SPREAD HAS WIDENED



Source: Jones Lang LaSalle Research and Investa Research

About Investa Research

Investa Research provides thought leadership and innovation through market research and strategic insights. Through market leading research and analysis of office markets, Investa Research provides a strategic advantage to both operational and investment business decisions. Our analytical strength identifies emerging market opportunities and potential risks within the Australian commercial office market to guide group investment strategy and decision making.

The research team publishes regular updates on the outlook for 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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