LEADING INDICATOR UPDATE – JULY 2014

Sydney and Melbourne office demand on the road to recovery while Brisbane and Perth inch towards stabilisation

> **Recent leading indicator data, while not strong, continues to support the positive trends that began to emerge late last year.**
>
> **Importantly they are increasingly synchronised - with the turnaround in the shorter leading domestic indicators, now aligning with the longer leading global and financial market indicators**
>
> **The demand outlook for Sydney and Melbourne CBDs is increasingly positive while resource sector indicators signal that the Brisbane and Perth markets are inching towards stabilisation.**

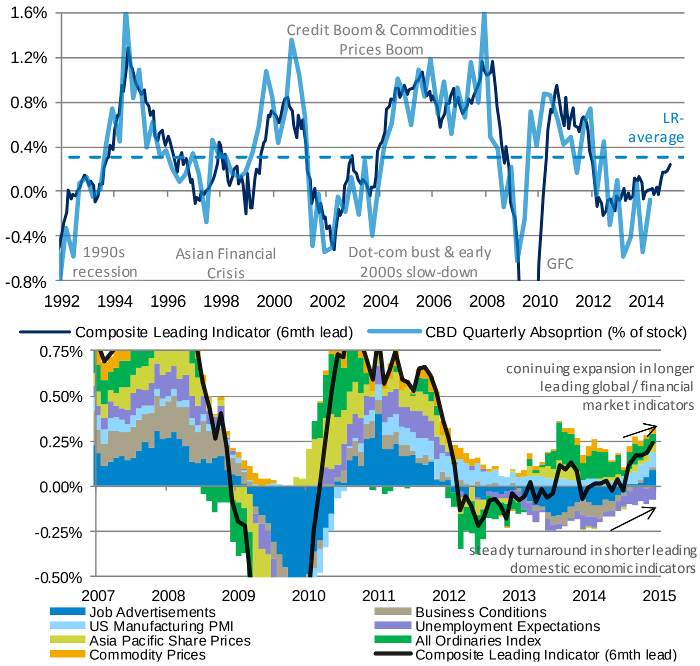
Since the beginning of the year we have seen a turnaround in several of the shorter-term leading domestic indicators of office demand. In particular, the improvements in job ads and business conditions, which lead net absorption by 3-6 months, have both entered the early expansion phase. As outlined in previous reports, this is in line with the natural progression of the business cycle, given that the longer leading indicators that typically move around 12 months before office demand, have been positive for some time now. This includes global output and share price growth - notwithstanding that this has been mainly multiples rather than earnings driven (see Box A). In addition, growth in full-time employment – a coincident indicator rather than leading – now appears to have passed the trough.

Given these developments, it is timely to revisit Investa's suite of forward-looking demand indicators in their entirety and to gauge the implications for office space absorption in the major markets over the next 12 months.

CBD composite leading indicator shows an uptick

Seven months ago (see "Leading Indicators and Office Demand – Dec 2013") we observed the emergence of a global economic upswing, namely in the major advanced economies (from mid-2013) as well as the strong rally in share prices (from early-2013). The All Ordinaries Index (+14.8% y-y), Asia-Pacific share prices (+9.3% y-y) and US manufacturing PMI (+12% y-y) were all positive contributors to our CBD composite leading indicator (CLI) which leads quarterly CBD absorption by 6 months (see Chart 1).

CHART 1: INVESTA CLI & DECOMPOSITION



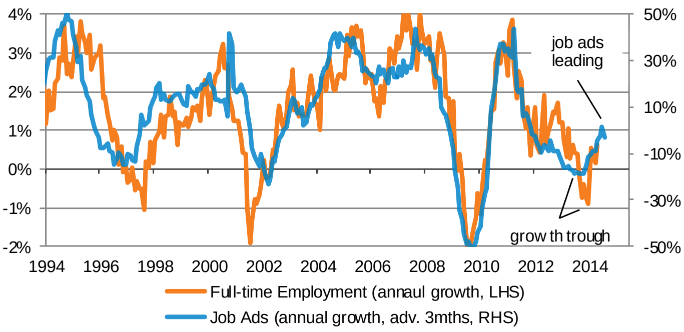
Source: JLL (Q1 2014) and Investa Research

However, given that at that point in time these gains had not yet translated into improvements in domestic fundamentals, we did not forecast any positive absorption over the 6 months to Jun-14. Instead we speculated that the recovery of domestic indicators would occur over those 6 months, and that a rebound in CBD office net absorption would materialise in the second half of 2014.

It appears that this trend is now underway with job ads and NAB business conditions switching from significant headwinds in our Composite Leading Indicator (CLI) to mild tailwinds. In conjunction with continuing expansion in equities markets and US PMI, the headline index has been driven into positive territory. With both global and domestic indicators becoming positive, we are increasingly confident in our previous forecast of a demand recovery commencing over the second half of 2014 and accelerating over 2015.

While consumer unemployment expectations remain a drag on the index (22% higher than its 10 year average), such sentiment based household data are particularly sensitive to the recently released Federal Budget. We believe this effect is temporary and will dissipate over the next few months, likely resulting in the unemployment outlook re-synchronising with the rest of the indicators. Indeed, when looking backwards, full-time employment, a coincident indicator of demand, now confirms that the demand trough has passed.

CHART 2: FULL-TIME EMPLOYMENT



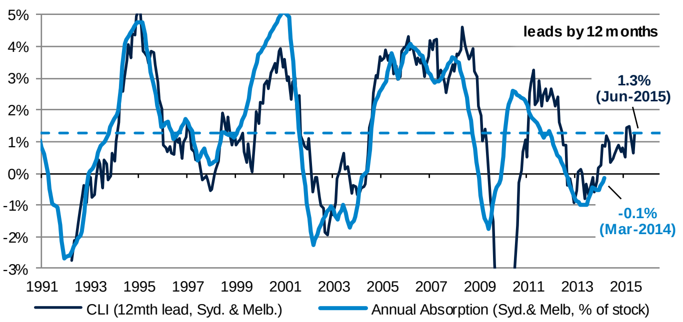
Source: ABS, ANZ and Investa Research

It is also worth noting that while aggregate CBD absorption has historically been highly weighted to Sydney and Melbourne due to their scale (with the weighting of the economic variables in the CLI reflecting this), recent volatility in the resources driven office markets has had an unusually high influence on total CBD demand. This has caused a deviation from Investa's CLI, which by design, is underweight resources variables. Going forward, as the economy rebalances from being mining centric to a more traditional mix of drivers, we expect the weightings of national CBD absorption to return to around historic norms.

Demand outlook for Sydney and Melbourne increasingly positive

Chart 3 shows our *Sydney-Melbourne CLI* which leads *annual net* absorption by 12 months. The economic variables that comprise this indicator are very similar to those of the CBD CLI, as the included data is applicable to the largest Australian markets. The rebound in the Sydney-Melbourne CLI has been primarily driven by buoyant domestic and regional equity prices and to a lesser extent, improvements in job ads growth at the short end. This indicates that most of the CBD absorption upside is expected to be skewed to Sydney and Melbourne.

CHART 3: SYDNEY & MELBOURNE CLI



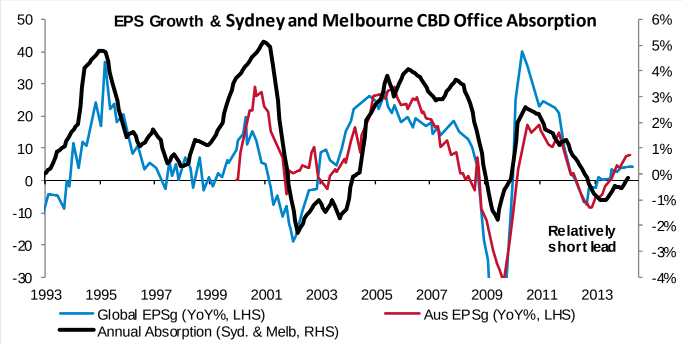
Source: JLL (Q1 2014) and Investa Research

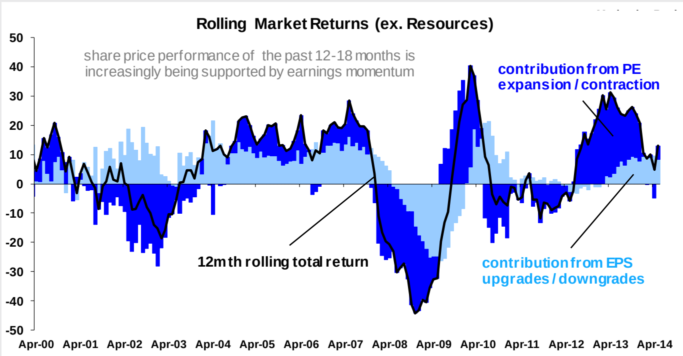
Our view remains that these markets will reach slightly below trend absorption levels by the end of 2014, with a stronger rebound likely by the end of FY15. This should improve vacancy rates in Sydney first (thanks to the low near-term supply outlook), followed by Melbourne (after FY15 supply is delivered).

Box A: Assessing EPS growth and ASX200 share price performance

Australian share price growth over the past 12-18 months has primarily been driven by multiples expansion rather than bottom-line earnings growth. While some may downplay the share market rally as a useful leading indicator due to this fact, we view this as a normal phase in the economic cycle, reflecting a change in market expectations for future growth and a reassessment of risk – both of which lead the actual change in profitability. In our view this is what makes share prices such a useful leading indicator. While PE multiples (and share prices) lead office demand by circa 12 months, EPS growth behaves more like jobs ads and employment growth, typically providing only a short lead over office demand (from 0 to 6 months at the most – see below). For this reason, the only modest level of company earnings growth to date is, in our view, consistent with what we have seen in share prices, as well as in the business cycle chronology of Investa's broader suite of leading indicators.

History suggests that even low EPS growth should hold current PE levels – see appendix B - and encouragingly, valuations appear to be increasingly supported by earnings momentum. If earnings continue to steadily rise, we should see sustainable growth in share prices going forward.





Source: MSCI, BoAML, JLL, Macquarie and Investa Research

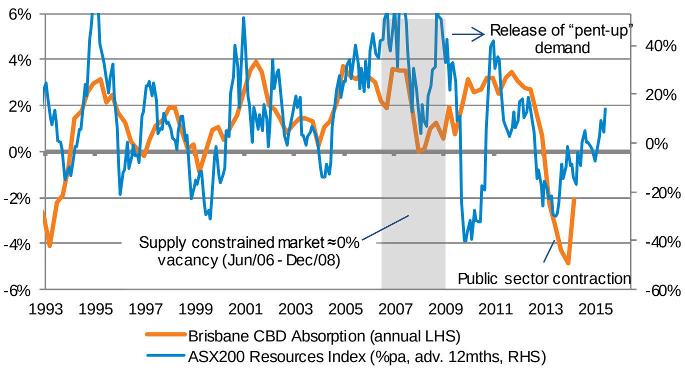
From a leasing market perspective we are encouraged by a pick-up in activity levels, particularly from smaller tenants in the market seeking space of less than 1,000 sqm. We expect demand from this market segment to be a significant driver of improving absorption over the remainder of the year.

Stabilisation in Brisbane and Perth demand just around the corner

Resource related indicators on balance continue to suggest a stabilisation in demand conditions in the Brisbane and Perth CBD office markets. While commodity prices are moderately down over the year, resource sector share prices have held ground, with the AXJR index bouncing between 4,100-4,200 points over the same period. Likewise, FY15 EPS estimates for the sector suggest some growth - notwithstanding that these results will largely be production led. Second-tier indicators like mining business conditions and China producer price inflation, also point to a stabilisation in demand. Given these factors, we maintain the view that we should broadly start to see net absorption across these two markets approach neutral levels over H2 2014, returning to mildly positive levels in H1 2015.

At the same time, we expect some residual contraction to occur in the very near-term (including in the upcoming Q2 data), given the sharp falls in commodity prices that occurred last year and the inherent transmission lag that these indicators have over the office sector (circa 12 months).

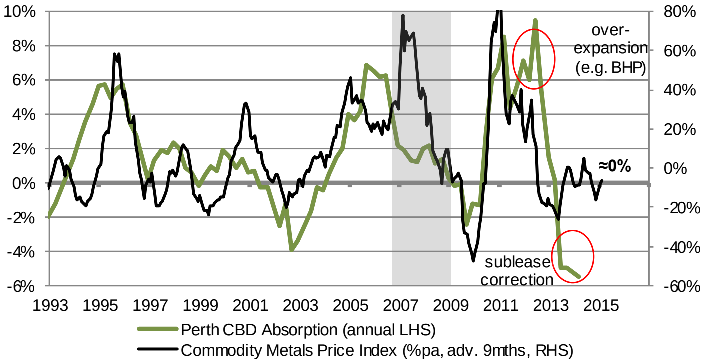
CHART 4: BRISBANE ABSORPTION & RESOURCE SHARES



Source: JLL (Q1 2014), ASX and Investa Research

For Brisbane, this demand profile will likely see the vacancy rate moderately rise before temporarily stabilising at the end of the year. The peak is expected to occur in 2016 after the delivery of several large projects. Given that lead times have tended to vary slightly over time (see Chart 4), a key risk to the near-term outlook is that the demand turnaround takes longer than expected and the vacancy could peak higher.

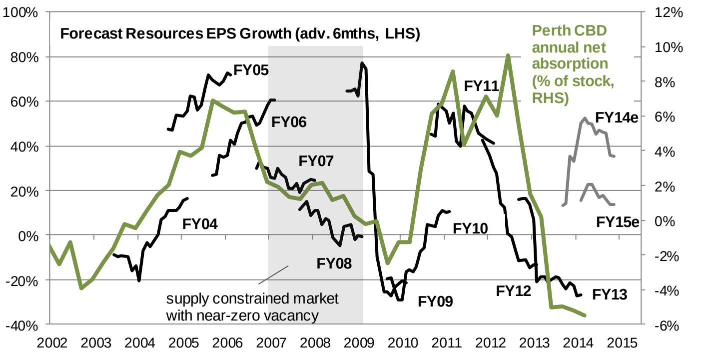
CHART 5: PERTH ABSORPTION & COMMODITY PRICES



Source: JLL (Q1 2014), IMF and Investa Research

For Perth, the transition in underlying demand may be slightly slower than Brisbane, given that this current downturn is partly a correction from over-expansion as well as cyclical. Higher than expected absorption levels in 2012[1] (arguably stronger than economic fundamentals justified), have been reversing, predominantly in the form of extra sub-lease availability. As a result, we believe the near-term contraction will linger a little longer – see Charts 5 and 6. On the other hand, known *net* absorption generated from pre-commitment activity will provide a sizeable boost over 2015; however this will be coupled with more immediate supply. All things considered, we are forecasting a steady rise in Perth CBD vacancy with a similarly timed but lower peak than Brisbane in 2016.

CHART 6: RESOURCE SECTOR EARNINGS FORECASTS



Source: Macquarie Research, JLL (Q1 2014) and Investa Research

Conclusion

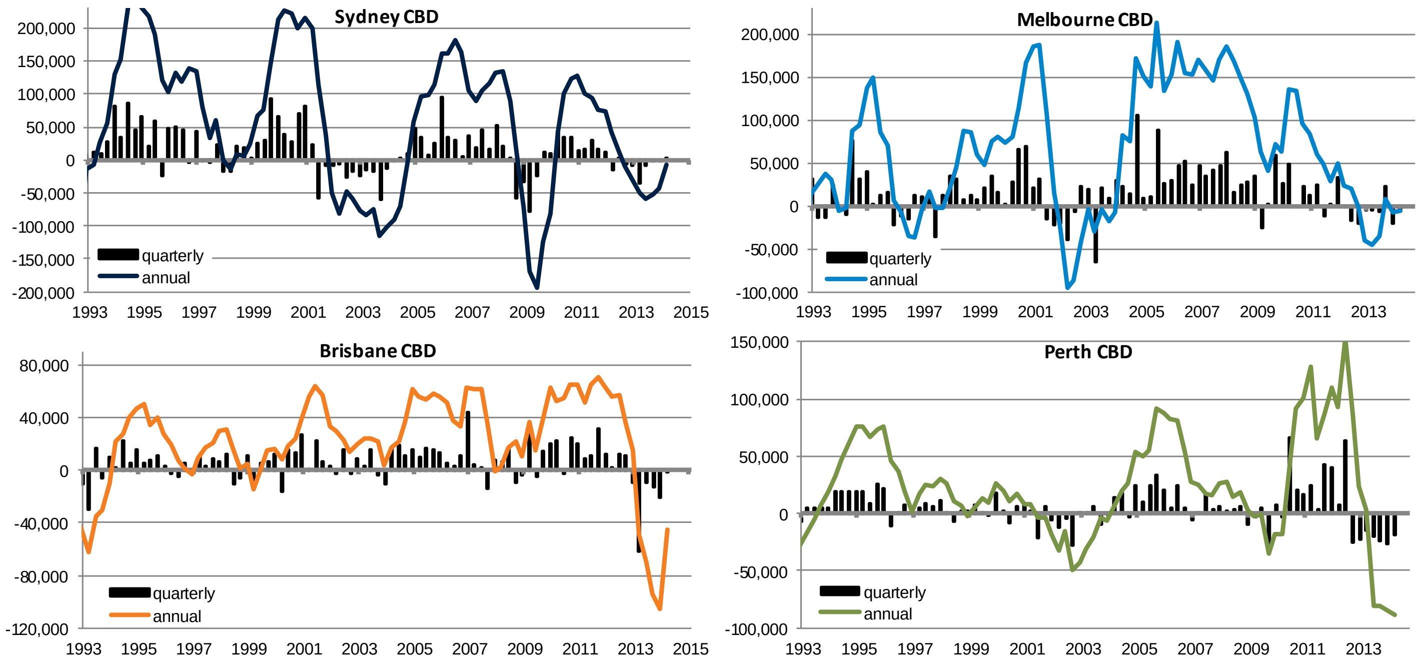
The past six months of leading indicator data continues to support a gradual recovery in office space demand; however market conditions will remain divergent in different locations. We are increasingly confident that Sydney CBD, North Sydney and Melbourne CBD are on the road to recovery and as a result we expect demand to reach near-trend levels by the end of this calendar year. These markets will be boosted by the re-weighting of the

[1] Companies hoarded underutilised space in 2012 (e.g. BHP keeping 30,000sqm of backfill space after moving to their new HQ).

economy away from mining investment led growth to more traditional growth drivers, which will benefit industry sectors such as finance and insurance, business services, real estate and construction.

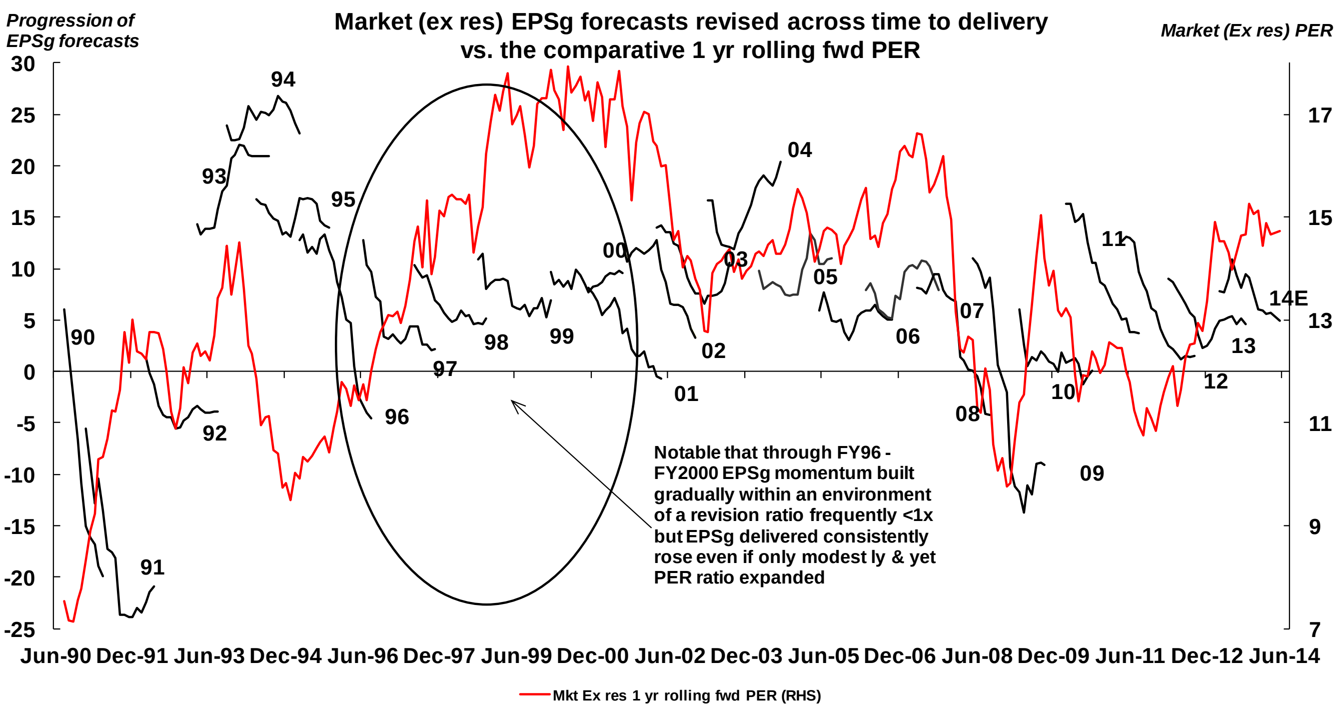
The flip-side to this is that there is likely to be further correction in the resources markets of Brisbane and Perth. However, key leading indicators such as commodities prices and share-market data imply that we are now through the worst of contraction. As a result, we expect that absorption will continue to stabilise, reaching neutral levels by the end of the year before becoming mildly positive in 2015.

APPENDIX A: CBD OFFICE NET ABSORPTION (1993-2014) – QUARTERLY AND ANNUAL



Source: JLL and Investa Research

APPENDIX B: AUSTRALIAN SHAREMARKET (EX. RESOURCES): EPS FORECASTS & FORWARD PE RATIOS



Source: Macquarie Research

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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