INVESTA OFFICE

Inside

Q2 2016
Office Market Update
August 2016

> **Brexit drove in a spike in financial market volatility during June, however global market conditions have now stabilised.**
> **Volatility and concerns around European economic growth have resulted in an uncertainty over future interest rate rises, and accordingly bond yields have tightened further.**
> **We expect continued downward pressure on office yields in Australia due to the spread to bonds that remains very healthy compared to peer markets offshore.**
> **The domestic economy, and white-collar sectors in particular, remain in good shape. Business conditions in NSW and VIC are well above the long-term average.**
> **Due to this supportive environment, office space is in high demand and Q2 saw the strongest CBD net absorption since 2011.**

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 2016. All analysis and views of future market conditions are solely those of Investa Office.

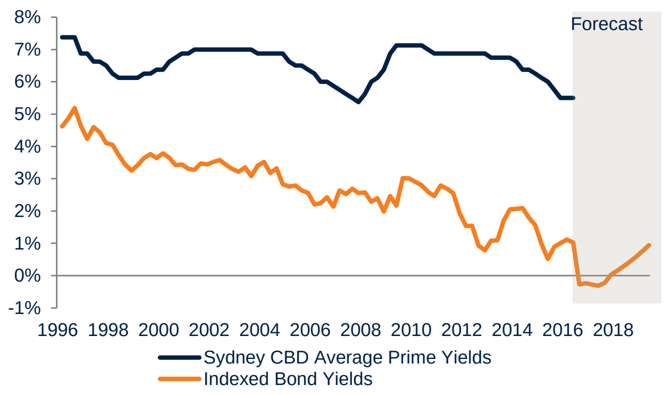
Economic Overview

Australia shrugs off Brexit concerns as business conditions and confidence hold firm

Political events captured the majority of global media attention during the quarter. The UK held a referendum, coined Brexit, to decide whether to remain in the European Union in late June. The decision was tight but won by the leave camp, a result that caught financial markets by surprise. Immediately after the vote, financial market volatility surged and economists looked to quantify the potential impact of the decision on the global economy. This uncertainty has resulted in global growth forecasts being revised down, with the majority of the impact likely to be restricted to the Eurozone. Towards the end of the quarter, and into early July, financial markets began to recover and market volatility has eased. The longer term issue is the continuing stability of the European Union, and the increased probability that other member nations may decide to trigger their own referendum to leave the Eurozone. This dynamic has had a direct impact on financial markets. Interest rate rises of any significance now seem unlikely over the medium-term. Accordingly bond yields have tightened further, with some government indexed (inflation adjusted) bond yields now negative. Property is a beneficiary of this trend, and despite office yields nearing historic lows across the globe, the office yield spread to bonds remains very attractive (see Chart 1).

In some respects the Brexit concerns and other geopolitical issues may be a net-positive driver for the Asia Pacific region from a capital allocation perspective. With limited direct economic exposure to Europe, it is likely that even more capital will be attracted to the region. Australia consistently rates highly as a destination for capital and these latest developments will further support this position.

CHART 1: BOND* YIELD AND SYDNEY PRIME YIELD

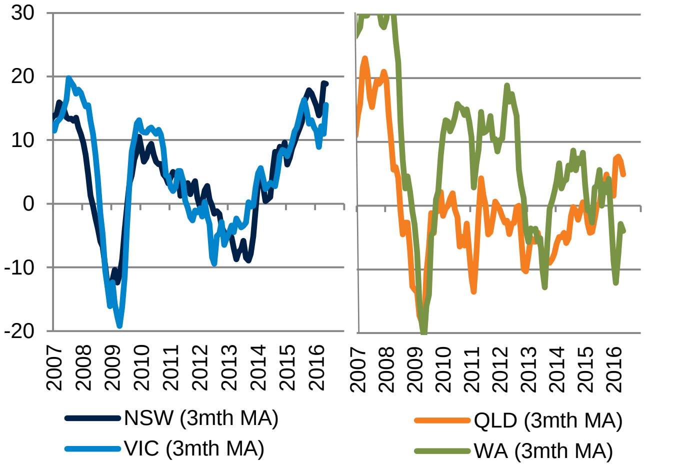


Source: Deloitte Access Economics (forecast & actual bond yields), JLL and Investa Research

*Bond yield refers to 10 year Australian indexed bond

In Australia the impact of Brexit is likely to be relatively contained, as the domestic economy continues to perform well. Business conditions are robust, but particularly strong in white-collar industries across the Eastern Seaboard. New South Wales and Victoria are enjoying business conditions well above average, as these states are being supported by a low cash rate and a relatively low Australian dollar. In addition, a healthy pipeline of infrastructure projects are boosting economic growth. Western Australia, on the other hand, is still working through the challenge of a mining industry slowdown. The massive pipeline of mining investment that peaked in 2012 is in decline, placing a drag on economic growth. Weak commodities prices suggest that the likelihood of new mining projects commencing in the short-term is low. Queensland sits somewhere in between. It has been impacted by the mining slow down, however as the State economy is more diversified than Western Australia, other sectors are gradually stepping up to fill the gap left by mining. As a result, business conditions in Queensland are showing improvement (see Chart 2).

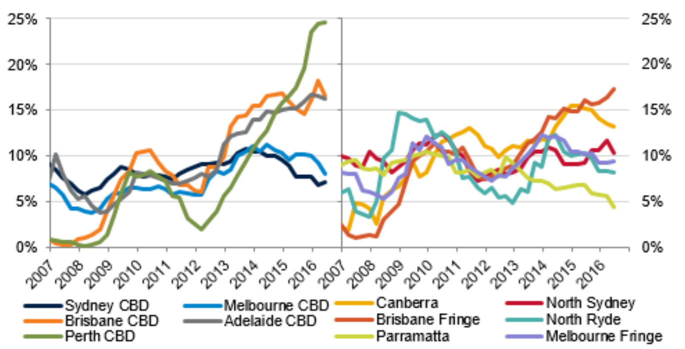
CHART 2: BUSINESS CONDITIONS BY STATE



Source: NAB and Investa Research

Office Market Overview

CHART 3: VACANCY RATES



Source: JLL Research and Investa Research

Premium grade vacancy hard to shift as affordable space outperform

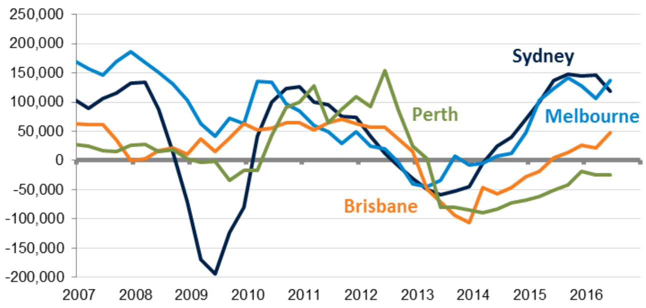
While occupancy market conditions are quite different across the country, there are some common themes that can be observed across many markets. Premium grade vacancy is relatively stubborn as this sector is partly impacted by new development recently completed, with an average vacancy rate of 14.9% across all markets compared to 9.2% for A grade. Generally it is the more affordable A grade market that is in highest demand.

The overall Sydney CBD vacancy rate rose slightly to 7.1% on the back of some new supply and associated back-fill spaces, but the market is well positioned. The secondary grade vacancy rate is very low at 5.5%, and A grade is also tight. Only the premium grade market has any meaningful space available.

North Sydney, Parramatta, and Macquarie Park also have low A grade vacancy (each below 7.5%). Melbourne is seeing a similar trend with the premium vacancy rate almost double that of A grade. Melbourne Fringe is also well positioned with A grade vacancy at just over 6%. As these figures suggest, good quality yet affordable space is becoming scarce in NSW and VIC markets across the board.

While overall market conditions are different in Brisbane, like other markets the A grade market is performing the best at the expense of premium. Perth is the major market that is bucking this trend to an extent. Vacancy is high across the board, but premium vacancy is slightly healthier at 19.5%, versus an overall market vacancy of almost 25.0%.

CHART 4: CBD ANNUAL NET ABSORPTION (SQM)



Source: JLL Research and Investa Research

Sydney and Melbourne demand continues at strength, Brisbane in recovery mode

The strong rate of recent absorption has continued in Sydney CBD. Demand momentum is running well above average with 33,000 sqm posted for the quarter, and 119,000 sqm over the last 12 months – almost three times the 10 year average. This trend is evident across NSW markets, with almost 75,000 sqm of space being absorbed across the smaller metropolitan markets over the year. One dynamic which is beginning to emerge is the pickup in demand for premium grade space in Sydney CBD. Due to a lack of options in the tight A and B grade markets, we have seen evidence of tenants upgrading to premium grade space. The premium vacancy rate will continue to face upward pressure due to new supply, but demand should improve from here.

Melbourne continues to outperform from a demand perspective with an exceptional 57,000 sqm of absorption recorded during the quarter (137,000 sqm year-on-year). A grade is driving the vast majority of this demand accounting for almost 90% of total absorption over the year.

This trend is also playing out in Brisbane. Demand has recovered and escalated to record 47,000 sqm over the last 12 months – well above the 10 year average. Like Melbourne the vast majority of annual absorption has been seen in the more affordable, yet good quality A grade market.

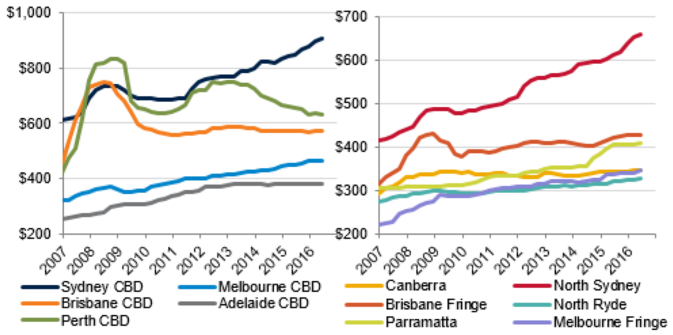
In contrast, the Perth market is still searching to find a floor. Overall demand is still negative, despite showing signs of abating late in 2015. Unfortunately tenants have handed back a further 20,000 sqm of space over the last 6 months and with mining investment still contracting, it may be a further 6 months to a year before the market recovers.

Rental growth escalates in Sydney thanks to strong occupancy markets

Sydney CBD and North Sydney continue to benefit from strong leasing fundamentals, leading other locations to record +7.0% and +7.7% Prime net face rental growth respectively on an annual basis. Escalation of face rental growth has been further supported by the prospect of significant stock withdrawals which is starting to impact on the number of options available for tenants who are forced to relocate.

Melbourne is also performing well, although at a lower rate, and recorded +3.1% Prime net face growth in the CBD over the year and +3.0% in the Fringe. Brisbane CBD Prime net face rents have held steady (+0.6% year-on-year); however, face rents in Perth have eased further (-3.6% year-on-year) as the vacancy rate continues to hit historic high levels.

CHART 5: PRIME NET FACE RENTS

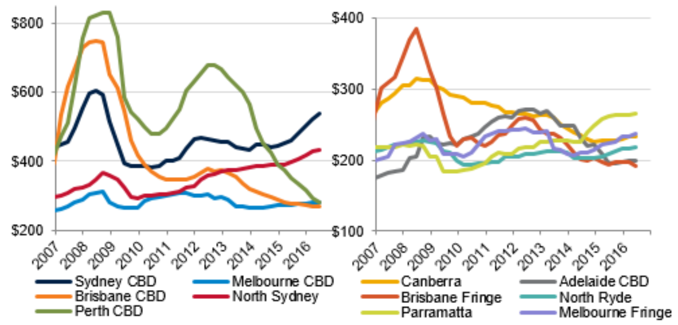


Source: JLL Research and Investa Research

Sydney effective rents boosted by tightening incentives, reflecting the improving market dynamics

As a result of strengthening office market in Sydney CBD, tenant incentives have been responding accordingly. Average Prime incentives have contracted by 2.9% over the course of the year. We are also seeing high levels of renewal activity, with the incentive spread between renewals and new leases re-emerging. There is evidence of renewal incentives below 20% in some cases, as options for office space in the A and B grade market are becoming scarce. Tightening incentives have boosted Prime net effective rental growth, recording +17.1% growth over 12 months. In our view, the majority of this rental growth has been driven by the A grade market where demand is highest and the effective rental growth has been relatively subdued in the Premium grade market.

CHART 6: PRIME NET EFFECTIVE RENTS



Source: JLL Research and Investa Research

Incentives appear to be approaching their cyclical peaks in most other major markets

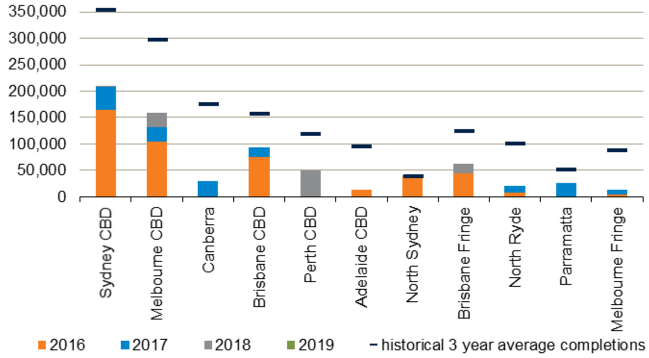
Melbourne continues to surprise from demand perspective, however the market is lagging the rental dynamics of Sydney. The level of incentives remained high at 33.0% despite strong leasing activity, and recorded +1.9% Prime net effective rental growth over the year. In our view, Melbourne CBD will follow the trend of Sydney CBD. This trend has already taken hold in Melbourne Fringe which has seen incentives wind back by 1.7% over the year to 25.0%, resulting in an annual net effective rental growth of 6.6%.

While the occupancy market in Brisbane CBD is gradually improving, the rental movement data suggests that the market is still challenged. Despite solid demand, incentives remain elevated at 35.9%, an increase of 1.9% from a year ago. Prime net effective rents fell by 3.5% over the year, driven by the upward incentive pressure from new supplies. Nonetheless, the rate of rental decline is slowing and we expect further stabilisation this year.

Perth has been adjusting to the challenging conditions and the market is still looking for a floor. Tenant incentives have continued to experience upward pressure, leading to an increase of 9.5% over the year, resulting in a 20.1% decline in net effective rental growth on an annual basis.

Canberra and Adelaide have been relatively stable, and net effective rents grew by 2.6% and 2.0% respectively over the year.

CHART 7: SUPPLY UNDER CONSTRUCTION (SQM)



Source: JLL Research and Investa Research

Supply cycle nears the peak, FY17-18 to be undersupplied

Q2 saw the delivery of 200 George Street (39,000 sqm) and the low rise component of International Tower 3 at Barangaroo (35,000 sqm) to Sydney CBD markets. While there were no other major completions during the quarter, over 74,000 sqm of office stock has been withdrawn across the country. These included 22,000 sqm in Sydney CBD, 17,600 sqm in Canberra, 14,500 sqm in Brisbane CBD and 13,600 sqm in North Sydney. More than two third of these withdrawals are to be converted to alternate uses.

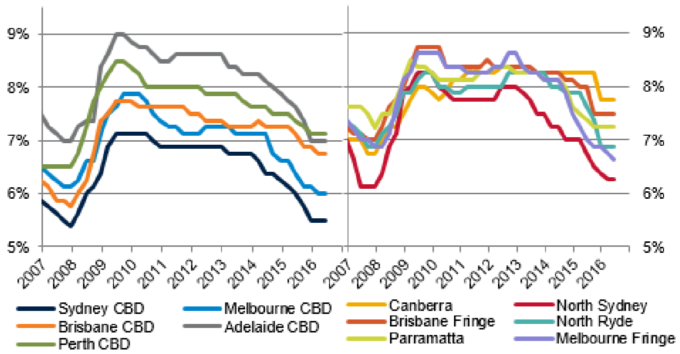
The supply cycle is nearing the peak. In Sydney CBD, International Towers – Tower 1 (101,000 sqm) and the high rise component of Tower 3 (44,000 sqm), and 333 George Street (12,000 sqm) are expected to reach completion this year. Melbourne CBD will see Collins Square Building 2 (65,000 sqm) and Building 4 (40,000 sqm) delivered shortly. In Brisbane CBD, 1 William Street (75,000 sqm) will be completed in 2017, a slight delay.

While this year will add a significant volume of supply to the markets across the country, there are factors that will mitigate much of the impact particularly in 2017, and beyond. Sydney and Brisbane in particular have a significant pipeline of permanent withdrawals alongside the normal redevelopment withdrawal cycle. This will likely result in negative net supply in the 2017-18 period. Sydney will see a wave of permanent withdrawals for residential/hotel conversions and the Metro Rail link project. At the same time, temporary withdrawals for office redevelopment will tighten the vacancy rate further. Brisbane will see a number of older assets withdrawn for conversion and as a result of the Queens Wharf project over the same time period.

Perth CBD's supply cycle came to a close with completions of projects totalling 150,000 sqm during 2015. The only significant building under construction is the Capital Square building (48,000 sqm) which is due to complete in late 2018. Furthermore the risk of new developments entering the pipeline in the immediate future is low due to challenging market conditions. This will likely result in the next supply cycle being pushed out, which may include the Elizabeth Quay and City Link sites.

Fringe markets across the country remain undersupplied. This is one of the major factors driving tenants to centralise, however at some point we expect some new developments to commence. Given the long lead time, and relatively low vacancy rate across the board, we do not see this negatively impacting the market over the medium-term.

CHART 8: PRIME OFFICE YIELDS



Source: JLL Research and Investa Research

Low interest rates likely to support further yield compression – particularly in Sydney

Australian office assets continue to generate strong interest from domestic and international investors. As a result of this competition and a lack of investment opportunities, capital values and cap rates are trending towards 2007 levels.

While the total number of transactions was lower this quarter, the total volume of transactions was similar to the previous quarter with around $3B of assets transacting across the country. Prime yields, however, remained unchanged across all CBD markets with no major sale recorded in Melbourne CBD and Perth CBD.

The major transactions in Sydney CBD included:

- 420 George Street, 75% interest purchased by ICPF from Fortius for $442.5M and 25% by Mercer from Australian Prime Property Fund, circa 5.2% equivalent yield.
- 1 Shelley Street, Brookfield sold the asset to Charter Hall Core Plus Office Fund and Morgan Stanley Real Estate Investing for $525M ($16,813/sqm).

In North Sydney, 181 Miller Street (11,000 sqm) was acquired by the NSW Government for $101M, for the Sydney Metro Rail project.

Brisbane CBD recorded a sale of 300 Queen Street, by Seymour Group to ARA Asset Management (Singapore) for $188M, circa 6.7% equivalent yield.

Going forward we expect occupancy market fundamentals to exert a greater influence on capital markets. Therefore we continue to see a case for further compression of Sydney and Melbourne yields as vacancy tightens and rental growth continues to escalate. Markets with higher vacancy are likely to see a stabilisation of yields, however recent history has demonstrated that assets with longer WALEs are highly sought after and investors may look through any short-term occupancy market weakness. As mentioned in the Economic Overview section, recent economic events have caused bond yields to fall yet again. In this uncertain environment, property yield spreads are very attractive and with this back drop further capitalisation rate tightening seems inevitable.

Outlook

Sydney set for a strong upswing as supply cycle nears completion

NSW economic conditions remain strong, with lower interest rates boosting the Finance & Insurance and Business Services industry sectors, which have been in expansion mode. We expect demand to moderate from recent strong levels to somewhere around the long-term average over the coming periods. However, so far demand has outperformed our expectations. A and B grade vacancy rates are already well below average, and the supply environment is looking increasingly positive once Barangaroo completes later this year. Beyond that there is little stock under construction and a significant pipeline of asset withdrawals (both permanent and temporary) that will place further downward pressure on the vacancy rate regardless of the demand environment.

Due to these dynamics, we are increasingly optimistic on the outlook for rental growth in Sydney. B grade net effective rents have increased almost 30% over the last two years, as affordable space has become in short supply. This has resulted in a surge in upgrade activity as tenants target A grade space, driving absorption that has been around four times the long-term average over the last 24 months.

The spectre of asset withdrawals means that further vacancy tightening is almost guaranteed over the next few years. Around 5% of stock – mostly A and B grade – will be removed permanently from the market, driving increasing competition for space that is well priced. While the Premium grade vacancy rate may remain higher for several years, we are now starting to see strong market dynamics in the A and B grade sectors, which will result in upgrade activity in the Premium market. With these supporting dynamics we expect the vacancy rate to tighten well below 5% driving strong rental growth. There is evidence emerging that incentives for tenant renewals are tightening sharply and we expect further reductions in incentives to boost effective rents from here.

The demand for Australian real estate shows no sign of abating, and the vast majority of capital, particularly from offshore, is looking for Sydney exposure. Given the positive outlook for vacancy and rental growth, combined with the low interest rate environment, we predict that office yields will fall below 2007 levels and remain there over the medium-term.

Melbourne incentives likely to contract boosting effective rents

After several years of hovering between 9-10%, strong demand and a pause in the supply pipeline has allowed for the vacancy rate to fall to just below 8%. Given the strong demand fundamentals and relatively low levels of supply under construction, we expect further downward pressure on the vacancy rate. This in turn should start to drive some downward pressure on tenant incentives, which have been stubbornly high.

Unlike Sydney there is no meaningful levels of stock withdrawal on the horizon, therefore the vacancy rate is unlikely to get to very low levels. Nonetheless, vacancy is still expected to reduce to just under 6% over the medium-term – a level that normally is conducive to solid rental growth in Melbourne. We remain cautious in our longer-term view, particularly compared to the outlook for Sydney, due to the availability of sites and the ease of development. There remains a number of tenants in the CBD and Fringe that are potential pre-commitments and we expect developers to continue to target them (a factor that is contributing to the stubborn levels of market incentive).

Investment markets remain strong in Melbourne, and we expect continued demand for quality assets and a tightening of yields. In recent years transaction evidence has suggested that there is very little spread between Sydney and Melbourne in terms of core cap rates. However, given the strong occupancy outlook for Sydney we predict that the historic spread of circa 50 bps will naturally re-establish, as the expansion of rental growth in Sydney encourages buyers to price assets more aggressively over the next few years.

Vacancy rate near the peak in Brisbane as supply pipeline nears completion

Brisbane supply cycle is nearing completion with 1 William Street (75,000 sqm – fully pre-committed) the last new build remaining to be delivered in the current supply cycle, along with the refurbished 310 Ann Street (18,400 sqm). The vacancy rate, however, is currently at record highs and it will take time to start contracting. Nonetheless demand momentum is moving in the right direction, and absorption has been positive for five consecutive quarters, running at around the long-term average rate. A flight to quality has also emerged with most activity seen in Prime grade assets, whereas Secondary market absorption has been negative over the same period. We are also seeing some tenants choosing to relocate back into the CBD from the

Fringe, a move that has become much more attractive as the rental gap between the two markets has eroded.

We expect demand dynamics to continue to improve in Brisbane, in line with gradually improving economic conditions in QLD. Like Sydney, there are a number of stock withdrawals in the pipeline, due to assets being demolished for the Queen's Wharf project, and a number of buildings also earmarked for conversion to alternate use, in total around 140,000 sqm. We expect rents and incentives to hold relatively stable over the medium-term, with growth beginning to emerge once downward pressure on the vacancy rate takes hold – in around 12-18 months' time.

The major risk to our view is the potential 300 George Street office tower development that may add around 46,000 sqm to stock. It is becoming more likely that the project will go ahead and as a result place upward pressure on the vacancy rate. In this case, it will take even longer for the vacancy rate to fall to levels that would drive rental growth.

Flight to quality underway in Perth as tenants capitalise on market conditions to upgrade

The vacancy rate is now significantly above 20% in Perth, however the most recent supply cycle is now complete, with no new major supply predicted until Capital Square building (48,000 sqm) is due for completion in late 2018. The question from this point is how long does it take for the tenant contraction cycle to stop, and then what does the "new normal" absorption profile look like in Perth. The signs are that it will take some time for tenant contraction to stop. The rate of tenant contraction, on an annualised basis, had been reducing for seven quarters in Perth, pointing to a shift in momentum. However more recent quarters of negative absorption indicate that we may not be through all of the correction yet.

Mining investment still has further to fall in WA and this poses a risk that mining tenants, and those that service them may give up more space yet.

Offsetting this will be an escalation of upgrade activity. The drivers are similar to those seen in Brisbane, as tenants make the most of high incentives to relocate from the Fringe market to the CBD, and in many cases also upgrade the quality of their accommodation. This trend is already well underway, with a number of relocations into the CBD observed over the last 12 months, and strong upgrade activity recorded. Prime grade absorption over the last 12 months was above the long-term average, whereas demand for Secondary space was strongly negative. This indicates that the majority of leasing activity is consolidated in Premium and A grade assets – a trend we expect to escalate.

Due to this, some Secondary grade assets are likely to be converted to alternate use, such as residential, hotel or student accommodation. Other older assets may face obsolescence without significant capital expenditure that some owners may be reluctant to invest at this point in the cycle. These assets may form a pool of structural vacancy that does not compete with the institutional market over the medium-term.

We expect Prime yields to remain stable from here – except for good quality assets with long WALEs. There is evidence nationally to suggest that buyers are willing to look through medium-term occupancy market weakness to secure stable cash flow. We do see risk in the Secondary market however, and there is a danger that Secondary grade yields expand in line with tenants choosing to upgrade to better quality stock.

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.

Further information

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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 $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 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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