- **The transition of the economy away from mining investment is well underway and key white collar industries are enjoying above average business conditions**
- **As a result office space demand continues to surge in Sydney and Melbourne, and absorption was recorded at three times the annual long-term average**
- **This take up of space is driving escalating effective rental growth - particularly in Sydney**
- **High profile transactions have re-rated the investment landscape driving yields down to near 2007 levels**

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 Q3 2015. All analysis and views of future market conditions are solely those of Investa Office.

Economic Overview

Global growth remains below trend, with improvements in the US offset by China weakness

Overall the global economy remains patchy, with economic growth running at a below trend pace. The major developed economies now seem to be on relatively robust footing, with the US leading the way, along with the UK and Eurozone all recording moderate economic expansion. These locations have seen unemployment rates gradually fall over the last few years, with the US now nearing full employment. Despite improving labour market data however, private consumption and business profit growth generally remain fairly subdued.

Therefore while the US recovery seems on track, the long predicted FOMC meeting in September did not result in an interest rate rise, most likely due to increased financial market volatility on the back of a weakening outlook for China.

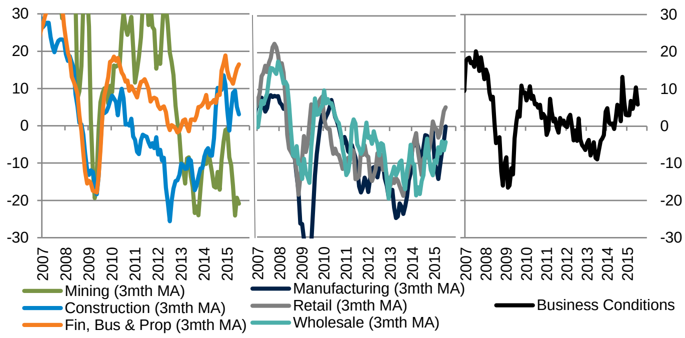
Economic growth has deteriorated most in the developing world in recent months. China's GDP is now tracking well below targets, and looking ahead, manufacturing PMI data highlights that the majority of Asian manufacturing industries are decelerating. This is having a major impact on global commodity prices, which are falling due to a combination of increased supply and tightening demand.

This environment is impacting Australia, and GDP expanded only marginally in the June quarter (0.2% seasonally adjusted) – impacted by weather disrupted exports and falling mining investment. Leading indicators suggest that the September quarter will be stronger, but growth on an annual basis will likely to remain below trend.

However there are positive signs that continue to develop as the lower Australian dollar continues to boost non-mining sectors of the economy, and evidence of this can be seen from labour market data. Employment growth overall has been relatively strong (around 2%), despite a weakening mining industry. This is due to the fact that the Business Services sectors are much larger drivers of employment growth, and the industries comprising this sector have been experiencing elevated business conditions for an extended period of time. If hiring momentum is maintained in these industries, then the unemployment rate may have already peaked.

With wage and consumer price inflation expanding at less than 2%, it is hard to see the RBA raising interest rates any time soon – indeed there is a possibility that the next move may be down. If the RBA holds firm for an extended period of time, or cuts, the interest rate differential between the US and Australia is likely to subside, as it is likely the Fed will begin to normalise rates during 2016. This should see further downward pressure on the Australian dollar – which will boost all trade exposed industries.

CHART 1: BUSINESS CONDITIONS BY INDUSTRY



Source: NAB and Investa Research

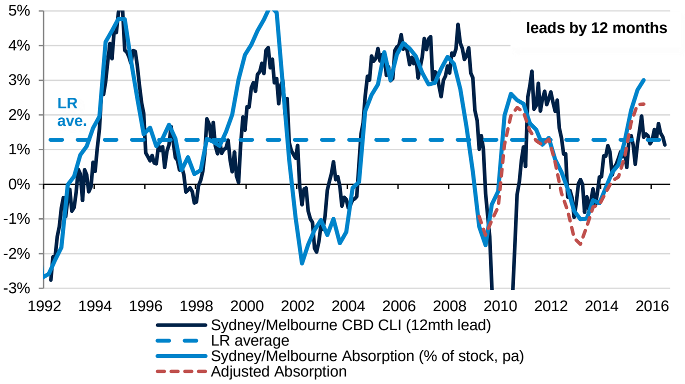
This economic transition can be observed in the latest office market data. The Sydney and Melbourne markets, thanks to a higher weighting to Finance and Insurance and Business Services, are strengthening on the back of increased demand for space. At the same time Brisbane and Perth, due to a higher weighting to Mining and associated industries, have a much weaker demand environment. In fact absorption in Sydney and Melbourne has been much stronger than most predictions, and has been running ahead of our leading indicator.

We expect that tenant demand in Sydney and Melbourne will remain stronger than average over the medium-term, supported by the continuing economic transition away from mining to broad-based growth and boosted by tenant relocations; however absorption may moderate somewhat from the levels recorded over the last 12 months.

Brisbane is now through the worst from a demand perspective, and we predict that absorption will gradually improve from here, as non-mining industries are increasingly being supported by a lower dollar.

Perth is still adjusting to the slowdown of the mining industry. As mining investment has wound back, demand conditions have weakened and are likely to remain below average for several years.

CHART 2: INVESTA SYDNEY AND MELBOURNE CLI



Source: JLL Research and Investa Research

Office Market Overview

Tenant demand escalates across key markets

Another strong quarter of tenant demand has resulted in stable or declining vacancy rates across all major markets except Perth. Sydney and Melbourne (both markets nearl recording 150,000sqm of demand) are leading the way with absorption of space running at around 3 times the long-term average on an annual basis – stronger than most forecasters predicted and higher than our leading indicator projections.

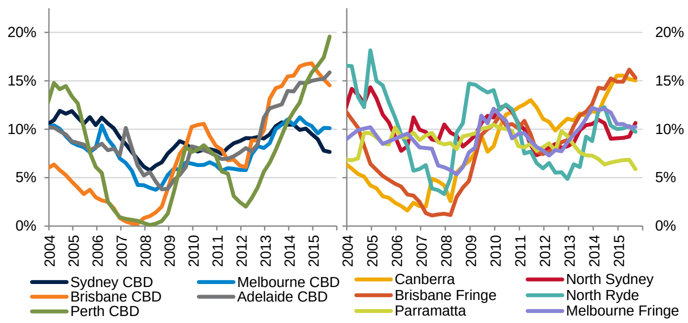
We have long expected this would be a possibility, due the positive impact on absorption resulting from tenants relocating into CBD markets from metropolitan areas - a now well established trend which has boosted Sydney and Melbourne absorption by around 30% over the last 12 months. Accordingly we have adjusted annual absorption to highlight this impact – see Chart 2 - in order to illustrate that true underlying demand across the broader market is running closer to the levels predicted by our model.

Another factor that explains much of the difference are industry level business conditions. Due to a lack of long-dated time series data broken up by industry type, we are forced to use Australia wide business conditions in our predictive model. This however understates the strength of business conditions being experienced by the major office occupying industries.

Despite strong demand, vacancy remained relatively stable in Sydney and Melbourne (7.7% and 10.1% respectively), due to new developments being delivered in the quarter. Brisbane led the way with a 0.5% fall in vacancy to 14.5%, thanks to an improvement in demand and stock withdrawals. Perth saw the largest increase (+2.1% to 19.6%) due to supply additions and a further deterioration of demand.

The metropolitan markets continue to perform strongly, with all market vacancy rates improving thanks to robust demand conditions and a lack of supply. The exception was North Sydney[1] which was impacted by the State Government (Roads and Maritime Services) relocating 15,000sqm from 101 Miller Street to another market which saw vacancy increase by 1.4%.

CHART 3: VACANCY RATES



Source: JLL Research and Investa Research

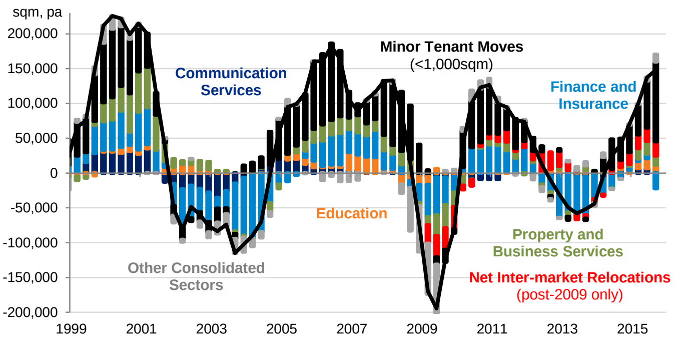
From a demand perspective there are a number of trends that are now well established. The Eastern Seaboard markets are in the midst of a demand upswing, led by Sydney and Melbourne. However encouragingly it now appears that Brisbane (+13,000sqm), Canberra (+15,000sqm) and Adelaide (+11,000sqm) have turned the corner. While lagging the strength of Sydney and Melbourne, all three markets have posted robust annual absorption figures which provide strong evidence the economic transition away from mining is now well advanced. Perth however has taken the brunt of this adjustment, and tenants have given up 42,000sqm over the last year.

At this stage of the cycle, across most locations, the key driver of demand has been from smaller sub-1,000sqm

[1] Regarded for investment purposes by Investa as a sub-market of Sydney CBD.

tenants. This segment of the market has been the strongest for some time and momentum continues to build. Chart 4 shows a breakdown of Sydney absorption by sector, which highlights the importance of the smaller tenant market.

CHART 4: SYDNEY CBD ANNUAL NET ABSORPTION BY SECTOR (SQM)

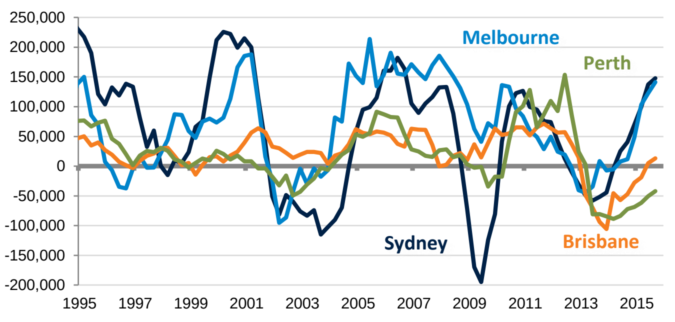


Source: JLL Research and Investa Research

Another trend gaining traction is the upgrade cycle. In CBD markets over 400,000sqm of prime grade space has been absorbed over the last year, yet over that same time period 114,000sqm of secondary space has been handed back. We expect this to continue as more secondary grade buildings are withdrawn for conversion to other use in the coming periods.

Likewise tenants are also upgrading location, with an increasing amount of centralisation now noticeable across all major office markets.

CHART 5: CBD ANNUAL NET ABSORPTION (SQM)



Source: JLL Research and Investa Research

Affordability remains a key criteria for tenants

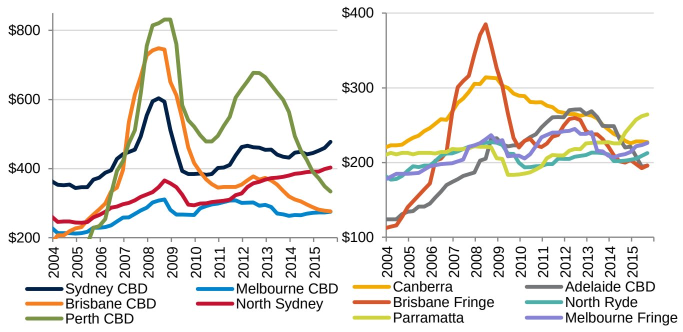
While there is no doubt that tenants are looking to upgrade to better quality assets, and the A grade market seems to be the sweet spot, as at this stage of the cycle affordability remains a key criteria for tenants. This has resulted in the bulk of absorption occurring in A grade assets. In Sydney, Melbourne and Brisbane combined, over the last year 274,000sqm of A grade space has been taken up compared to only 77,000sqm in premium grade assets.

This demand dynamic, and elevated premium grade vacancy across much of the country, has resulted in the A grade market delivering most of the rental growth attributed to the prime market over the last year[2].

Majority of growth taking place in face rents

Face rental growth on average is escalating as demand conditions improve. Sydney markets are leading the way on an annual basis with the CBD (5.5%), North Sydney (3.8%), Parramatta (8.6%) and North Ryde (2.7%) all performing strongly. Melbourne is not too far behind with the CBD (4.6%) and Fringe (5.5%) also performing well. Other markets are relatively stable, except for Perth which has seen face rents wind back 4.6% over the year.

CHART 6: PRIME NET FACE RENTS



Source: JLL Research and Investa Research

Incentives begin to wind back in Sydney

Finally there are real signs that the tide of tenant incentives has turned. Buoyed by improving fundamentals the Sydney CBD market incentive reduced by nearly 1% over the quarter, supported by a 0.4% reduction in North Ryde. As a result Sydney CBD effective rental growth recorded a strong 8.2% over the year.

We expect all Sydney markets to follow suit in the coming periods and predict gradually tightening incentives will boost already solid effective rental growth. In most other markets around the nation incentives have held relatively stable. We forecast that incentives will tighten in Melbourne over the next 6 months, followed by the other Eastern Seaboard states over the next year.

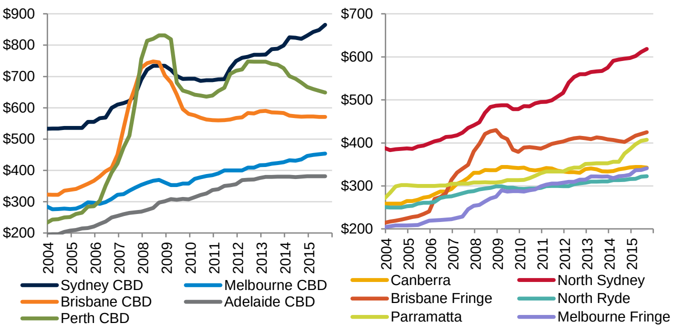
Perth will remain the exception. Incentives have hit 40% are likely to remain elevated for the immediate future. As a result effective rents have adjusted downwards sharply (-22% year-on-year).

[2] JLL classifies prime as an average of premium and A grade assets. In our view most of the rental growth achieved over the last year has been attributed to A grade assets with premium grade rents relatively stable.

Good quality B grade assets outperform in Sydney and Melbourne

The B grade market is in the midst of a rental upswing in Sydney and to a lesser extent Melbourne. Although B grade absorption has been negative over the last year, this figure is somewhat misleading[3], as occupied stock is being impacted by permanent withdrawals of space, and accordingly good quality B grade space is in short supply. As a result secondary (B, C and D grade) effective rents have outperformed over the last 12 months, up by 14.6% in Sydney and 5.4% in Melbourne. While the data is aggregated, in our view most of this growth is being driven by the B grade sector. We expect that the B grade market will continue to outperform, particularly in Sydney, due to the massive pipeline of likely and potential conversions that will reduce the number of available options for B grade tenants.

CHART 7: PRIME NET EFFECTIVE RENTS



Source: JLL Research and Investa Research

2016 will see the supply cycle peak

The peak of the supply pipeline this cycle is nearing. Q3 saw the delivery of some landmark developments in Sydney CBD markets including the 1st stage of Barangaroo Tower 2 (59,000sqm), and both 5 (33,860sqm) and 20 Martin Place (16,000sqm).

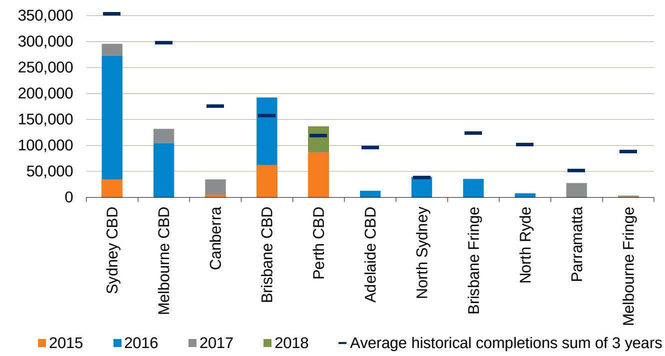
In Melbourne Investa completed 567 Collins Street, a new premium grade tower (50,500sqm). In Perth the 1st stage of Kings Square was finalised (building 2, 3 and 4 total of 37,500sqm) and 999 Hay Street (10,500sqm). Finally in Adelaide 50 Flinders Street (20,000sqm) was completed.

Withdrawals to mitigate supply post-2016

While a significant volume of construction will reach completion across the country over the next year, including the majority of the Barangaroo project, 735 Collins Street in Melbourne Docklands and 1 William Street, 480 Queen Street and 180 Ann Street in Brisbane, there are factors that will mitigate much of the impact on the market.

Sydney and Brisbane in particular have a significant pipeline of conversions that, alongside the normal redevelopment withdrawal cycle, will offset new supply coming online, resulting in negative supply during 2017-18. This withdrawal dynamic is also a factor in Melbourne (to a lesser extent), and may play an increasing role in Perth, where some older secondary grade assets are nearing obsolescence.

CHART 8: SUPPLY UNDER CONSTRUCTION (SQM)



Source: JLL Research and Investa Research

Yields re-rate as high profile portfolios are secured by offshore investors

The sale of major portfolios provided evidence that re-rated prime office yields during the quarter. The sale of Investa Property Trust (IPT) (predominately a Sydney CBD portfolio), while not technically completing during Q3, certainly provided evidence to the depth of market appetite and price making ability of major offshore investors. Similarly the sale of -GIC's $1bn industrial portfolio to Ascendas (also not yet settled) on a reported yield of around 6% highlighted the attractiveness of property as an asset class and can be seen as a vote of confidence for the Australian economy. As a result of these and other transactions, yields tightened 25bps at the upper and lower end of the prime yield spectrum in Sydney, Melbourne and Brisbane.

Sydney CBD prime yields now range between 5.25% - 6.25% with secondary yields 6.25% - 7.00%. Major office transactions other than the IPT sale included:

> 233 Castlereagh St (18,746sqm) $156m ($8,322/sqm) GDI Property to Visionary Investment,

> 155 Clarence St (11,181sqm) $120m[4] ($10,732/sqm) First State Super & St Hiliers to Eureka Funds.

Melbourne CBD prime yields range 5.25% - 7.00% and secondary yield 6.00% - 8.00%. Transactions incuded:

[3] Absorption is defined as the change in occupied stock between time periods. Due to this definition the emerging pipeline of B grade conversions is a drag on B grade absorption, however demand for good quality B grade space remains robust.

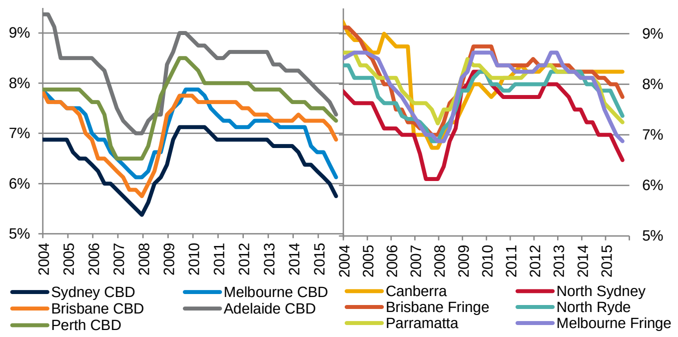
[4] This represents a net price – including payout of incentives the price would be $136m.

> 222 Exhibition St (28,081sqm) $231m ($8,226/sqm) AMP to LaSalle,
> 460 Lonsdale St (22,700sqm) $98m ($8,634/sqm) REST Industry Super to a private investor,
> 575 Bourke St (16,443sqm) $89m ($5,473/sqm) RREEF to CIMB.

JLL tightened the Brisbane prime yield range to 5.75% - 8.00%.

In our view there is still room for further compression of yields particularly in Sydney and Melbourne, the key gateway markets. We expect that yields in these locations will tighten to below 2007 levels by the end of this year – a further 25-50bps. From this point much will depend on the direction of interest rates, which we expect to remain at current levels, or lower, for quite some time. If evidence from offshore is repeated here, a further wave of compression could occur if effective rental growth predictions crystalise in the coming periods – a scenario that is looking increasingly likely for Sydney.

CHART 9: PRIME OFFICE YIELDS



Source: JLL Research and Investa Research

Outlook

Sydney in the midst of a cyclical demand upswing driving effective rental growth

The medium-term prospects for Sydney are increasingly positive. While the overall vacancy rate is likely to shift higher short-term, due to the completion of Barangaroo, A and B grade assets are well placed to capitalise on strong demand and the large pipeline of permanent and temporary withdrawals of stock that will result in tenants having to find alternate accommodation. If demand is maintained at even half current levels, the total vacancy rate could fall to below 5% in 2018 – aided by significant withdrawals such as 50 Bridge Street for the Quay Quarter redevelopment. We expect A and B grade to outperform from a rental growth perspective over the next 3 years, after which vacancy rates will likely converge, driven by the tenant upgrade cycle.

We expect that yields will tighten beyond 2007 levels, if as expected other landmark assets are brought to market. We have long held the view (you can read our 2013 paper here) that if the Australian interest rate cycle aligned with global conditions – which has now occurred – our office yields would likely follow those in other developed economies down to 2007 levels and beyond. Further ahead we expect a period of stability, however evidence from offshore suggests that if rental growth begins to escalate in the coming years, as we predict it will, yields could tighten further on the back of growth expectations.

Effective rental growth momentum to build in Melbourne

Centralisation continues to be a major force driving absorption in Melbourne and due to the lack of space in fringe markets, and this trend is likely to support further demand over the medium-term. This should result in downward pressure on the vacancy rate as the level of supply under construction is constrained compared to recent history.

Effective rental growth has been relatively subdued, despite strong demand fundamentals over the last 12 months. However tighter occupancy markets will support stronger face rental growth over the next 2 years, and this will be boosted by a gradual wind back of incentives. While there has been little evidence of shifting incentives yet in Melbourne, our view is supported by market dynamics in Sydney, which have been leading movements in Melbourne by around 6 months.

The investment market remains robust in Melbourne with strong demand for assets continuing, particularly from offshore. We expect the trajectory for Melbourne yields to follow Sydney, however Melbourne may be closer to the peak due to slightly lower medium-term growth prospects.

Brisbane demand fundamentals now improving, however new supply is imminent

The Brisbane market has now emerged from a period where the market was hit by a 'triple whammy'; State Government restructure, mining industry contraction and tenants relocating out of the CBD, which caused the vacancy rate to spike. However the market has stabilised thanks to 3 quarters of relatively robust absorption. This suggests that things will improve gradually from here, as Brisbane's non-mining industries will be boosted by the lower dollar and interest rates over the coming periods. Already the Business Services tenants have begun to respond by taking more space and we are now seeing occupiers located in fringe markets looking to upgrade location and move into the CBD.

However there are 3 major office towers due to be completed during the next 12 months, which combined will add almost 9% of stock to the market. As a result vacancy will peak next year, although in our view the market has already priced in the impact of new supply into current incentive levels. The major mitigating factor will be stock withdrawals, which will remove at least 6% of stock permanently over the next few years as major projects like

Queens Wharf ramp up. However the figure could end up much higher, as we expect the total to be boosted by older office towers being converted to student accommodation, a trend that has already commenced with the acquisition of 363 Adelaide Street for this purpose.

Upgrade cycle underway in Perth as supply comes online

The Perth market is still adjusting to the slowdown of mining investment, however the rate of tenant contraction is gradually slowing. Delving into the detail highlights that tenants are actively looking to upgrade the quality of their accommodation. Prime grade absorption totalled 18,000sqm over the last year, however tenants gave up 28,000sqm of space in secondary grade assets over the same time period. Like Brisbane there is increasing evidence of tenants looking to upgrade location by moving into the CBD from metropolitan markets – a trend that should escalate.

However supply remains the main challenge in this market with a number of assets still to complete in the coming periods. We expect effective rents to contract further due to competition for tenants, and there may be a risk of cap rate expansion in secondary grade assets. Better quality buildings, particularly those with longer WALEs, should remain somewhat protected.

The Perth market still has some positive aspects despite current weakness. The vast reserves of natural resources in Western Australia will result in another demand upswing at some point when commodity prices recover. In the meantime however we expect some upside from Business Services and Education tenants who will benefit from the lower dollar and interest rates, however growth in these sectors is unlikely to outweigh the contraction caused by declining mining investment over the short-term.

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
Pete Carstairs
General Manager, Research
Phone: +61 2 8226 9431
Mobile: +61 410 564 508
Email: pcarstairs@investa.com.au

Maya Iwamura
Research Analyst
Phone: +61 2 8226 9358
Email: miwamura@investa.com.au

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.

Investa Office
Level 6, Deutsche Bank Place
126 Phillip Street
Sydney NSW 2000 Australia
Phone: +61 2 8226 9300
Fax: +61 2 9844 9300

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