INVESTA INSIDE 16

OFFICE MARKET OUTLOOK

December 2016

> Australian economic momentum has eased towards the end of 2016 and office employment growth is likely to soften in 2017.
> Markets continue to shift on speculation of the impact of a Trump presidency on both the US and global economy. Nonetheless, the 2017 outlook for Australian office leasing conditions will continue to be dominated by underlying domestic market fundamentals.
> Capital transaction flows point to further yield compression in Australian major CBD office markets. However, government bond rates, global economic uncertainty and central bank policy remain critical to the outlook for capital growth. The Australian dollar will also have a significant impact on capital flows in 2017.

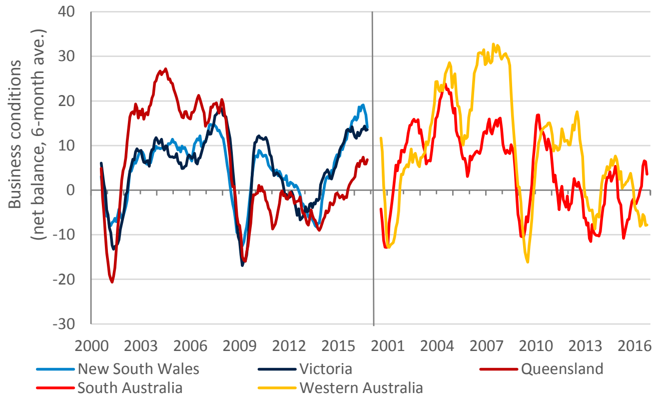
Economic Overview

Australian economic outlook positive, but momentum easing

The Australian economic outlook continues to be buffeted by the ebbing and flowing prospects of the global economy. Commodity prices, Trumponomics, foreign central bank policy, geopolitical risks and a China slowdown will all have an impact on Australia's economic growth in 2017. However, an important key to Australia's economic outlook, particularly for leasing demand and capital growth in the major CBD office markets, is a low – or lower – Australian dollar (AUD).

While the AUD increased moderately in 2016, it remains well below the elevated levels of recent years and continues to support business conditions and the recovery in non-mining economic growth. For Australia's business economy, a low AUD is necessary to support both price competitiveness of Australia's exports to foreign consumers (including services exports) and to contain domestic spending 'leakage' offshore. In addition, a lower AUD provides an affordability windfall to Australian property capital transactions, supporting capital growth (see *Market insight: Australian dollar and office capital flows* for further detail).

CHART 1: AUSTRALIAN STATE BUSINESS CONDITIONS



Source: NAB and Investa Research

Somewhat surprisingly, financial markets have been much more stable than many anticipated ahead of Trump's presidential win. Nonetheless, government bond yields have sustained solid gains in recent months, with the 10-year Australian Government Bond rate increasing 90bps since the end of September this year, to be at 2.8% in early-December. Combined with further office yield compression, this whittles away at the yield premium on Australian office property.

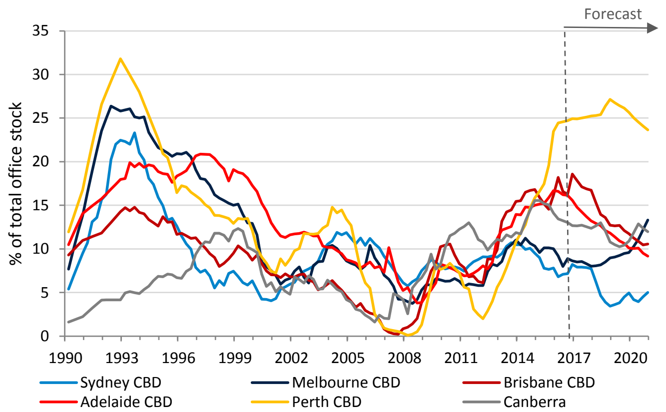
Looking ahead, despite tightening further, the Australian office property yield premium is expected to remain historically elevated. Australian government bond yields are likely to edge only moderately higher in 2017, with the recent bond yield adjustment having largely accounted for a Trump view of the US economy and prevailing global economic conditions. At the short end, tentative Australian economic indicators are likely to maintain a slight easing bias on short-term market rates. In addition, softening foreign capital flows are expected to moderate office capital growth and yield compression in the coming year (see *Market insight: Australian dollar and office capital flows* for further detail).

Office Market Overview

Development to drive divergent leasing conditions

2016 was a ‘bumper year’ for CBD office absorption and leasing markets in Sydney and Melbourne. Despite softening slightly in the year Sydney leasing market conditions remained tight, reflecting strong white collar employment growth. In comparison, Melbourne’s vacancy rate was largely capped by limited new supply. Outside of the two major capital cities, office leasing conditions remain soft, with Perth office vacancy rates in particular drifting out to new 20-year highs (see Chart 2).

CHART 2: OFFICE VACANCY RATES



Source: JLL Research and Investa Research

Looking towards 2017, softer employment growth will moderate office absorption compared to a strong 2016. Employment growth in Sydney is expected to continue to outperform other markets, supported by a solid state economic outlook and expenditure on key infrastructure projects (incl. WestConnex, Sydney Metro and CBD/South East Light Rail). However, beyond 2019 the Sydney and Melbourne office development outlook will diverge, breaking the recent tight correlation in leasing market conditions between the two major capitals.

Leasing market conditions will remain tight in both Sydney and Melbourne in 2017, supported by weak near-term development activity across the major capitals. In the face of ongoing economic uncertainty, soft commercial office development in the near-term mitigates the potential impact of any unexpected negative demand shocks. However, beyond 2019 the supply safety net in Melbourne will start to retract. A solid pipeline of office construction points to a an overhang of supply in new office additions in 2020-21, with net supply gains to hit the strongest level since the early 1990’s. Further, in part reflecting caution towards over development in the Melbourne CBD apartment market, there is little planned withdrawal of office backfill space for conversion or redevelopment.

Consequently, the Sydney and Melbourne office development outlook will diverge, breaking the recent tight correlation in leasing market conditions between the two major capitals. While Sydney vacancy rates are expected to drive further to new cyclical lows, Melbourne is likely to drift out and hit double digit vacancy rates by 2020.

Of the other markets, the outlook for leasing conditions in Brisbane, Adelaide and Canberra point to moderate improvement through 2017. In particular, demand for Brisbane CBD office space will continue to muddle through the backfill from Queensland state government’s relocation to 1 William Street. Perth remains the laggard, with weak economic momentum and further deterioration in labour market conditions expected to drive further weakness in leasing conditions for a number of years to come.

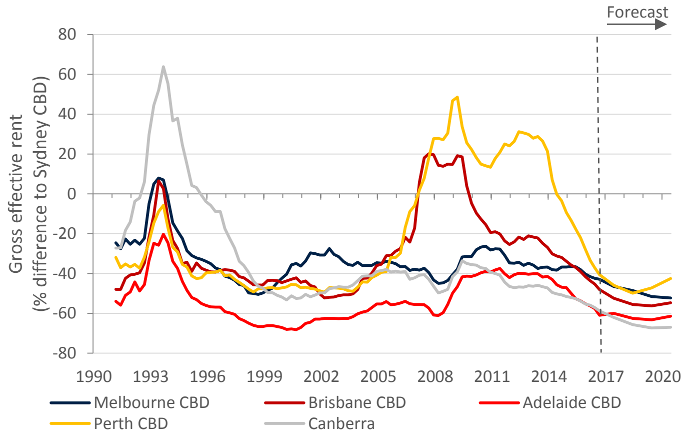
Leasing market to see divergence in incentives

Sydney’s outperformance will be felt in the leasing market with prime face rents increasing at a touch under 6.5% in compound annual growth terms to June 2019. In addition, the strong outlook is expected to cut incentives in half over the same period, with prime office effective rents increasing around 12.7% per annum.

In contrast, with a soft longer-term outlook for leasing market fundamentals, office incentives are unlikely to push much lower than current levels in the Melbourne CBD market. Consequently, prime office effective rents are likely to increase at around half the pace (6.4% per annum) of the Sydney CBD market over the next three years. Brisbane CBD, Adelaide CBDand Canberra rents are likely to reflect soft leasing market conditions, edging moderately higher in 2017, while Perth CBD is unlikely to see any notable growth in face rents until 2019.

On a comparative basis, the premium on Sydney CBD prime office effective rent to the Melbourne CBD market is likely to increase from currently around 100% to over 135% by mid-2019. With the depth of new development in the Melbourne pipeline, this affordability differential could impact on tenant location decisions - in effect assisting absorption of the surge in Melbourne CBD office supply. Similar affordability (and availability) differentials with Sydney CBD are also likely to create positive absorption spill over with businesses considering relocation to Sydney fringe markets such as North Sydney, Parramatta and Chatswood.

CHART 3: SYDNEY CBD OFFICE RENT DIFFERENTIALS

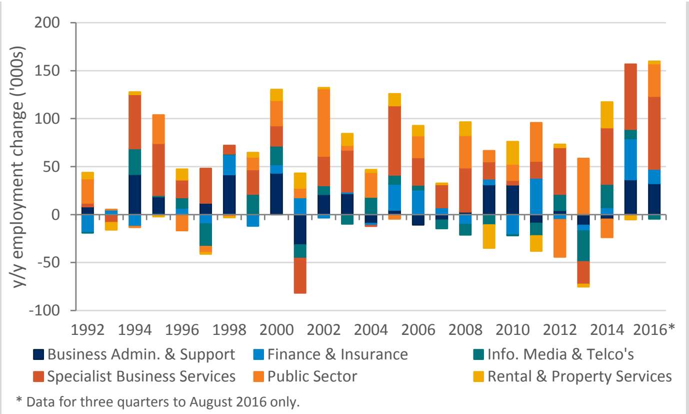


Source: JLL Research and Investa Research

Market insight: Changing occupier needs for office space

The Australian labour market has performed well in 2016, with the unemployment rate falling from 5.75% at the end of 2015 to 5.6%. White collar industries have provided the majority of employment growth, driven largely by specialist business services, the government sector and business administration.

CHART 4: WHITE COLLAR EMPLOYMENT GROWTH



Source: ABS and Investa Research

However, underneath the cyclical improvement in the headline indicators, recent labour market trends have revealed significant structural shifts in Australian employment. Two trends that are having an impact on office employment are:

> Increasing part-time/casualisation of employment.

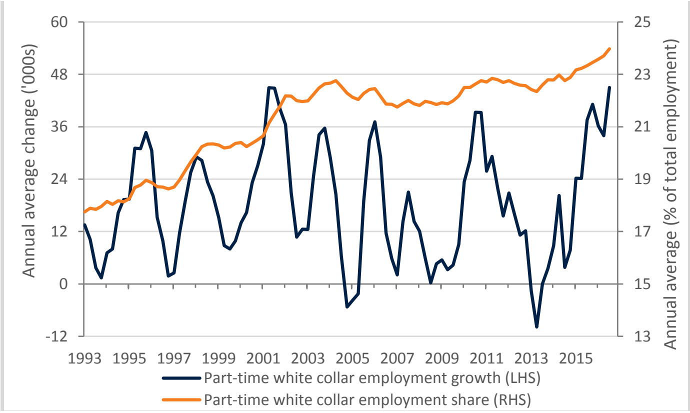
> Changing composition of office employment towards specialist business services.

Part-time/casualisation of office employment

Of the 360,000 new jobs that have been created in Australia since 2014, part-time/casual positions have increased at an unprecedented rate of 2.5-to-1 for every full-time position. The main factor influencing this structural change has been ongoing competitive demand conditions, which have driven businesses to trim labour costs where possible. In addition, an ageing population has contributed to the increase in part-time/casual employment.

While the most significant impact of labour 'casualisation' has occurred in the household services sector, business services and the office market have also been impacted by this trend. Across white collar employing sectors, the number of part-time employees has increased sharply in recent years to account for almost 1-in-4 of every office employee most recently (see Chart 5).

CHART 5: PART-TIME/CASUAL OFFICE EMPLOYMENT



Source: ABS and Investa Research

Employment growth driving a different office business mix

Another impact of both competitive demand pressures and the emergence of disruptive innovation is growth in the use of specialist business services. To compete on a global scale, Australian businesses are increasingly using freelancers and consultants to meet their intermittent project needs. This operational shift has driven strong growth in employment demand for technical specialists and creative business service providers, particularly in Sydney and Melbourne, which have greater market exposure to global business service competition.

Office sector impact

Both of these employment trends are in part a reflection of similar structural shifts driven by the disruptive innovation movement in other economic markets. Consequently, this creates an opportunity for office development, with space increasingly required to be more flexible and adaptable to accommodate 'on-demand' utilisation. For example, tenant requirements for office 'hot desks', 'on-demand' specialist office facilities (incl. meeting rooms, corporate function space) and 'co-working' space are likely to become more prominent in the coming years.

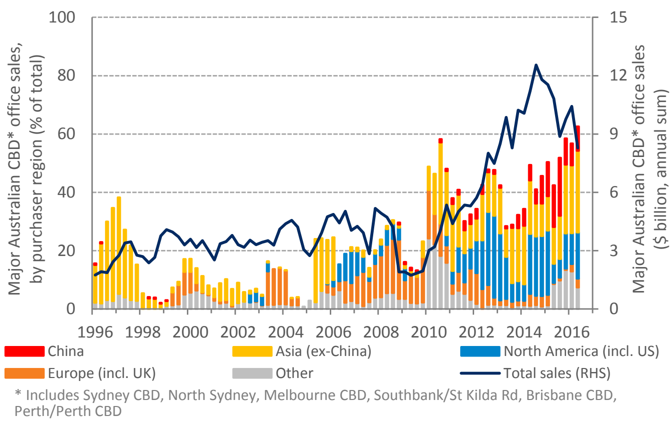
Market insight: Australian dollar and office capital flows

Foreign capital is critical to Australian office capital growth

Foreign capital flows have become a critical support to Australian commercial office sales transactions and capital growth in recent years. Despite capital flows easing recently, the attractiveness of Australian commercial office property to foreign investors remains historically elevated, with the share of total Australian major CBD office sales to foreign buyers at an all-time high of 62.6% (see Chart 6).

While the main drivers of this step-up are considered ‘sticky’, largely reflecting a structural shift in portfolio allocations towards Australian commercial office assets, foreign capital flows are fluid and will follow assets that offer ‘value’. In a market where alternative low-risk assets (i.e. government bonds) are expected to offer higher yield in the coming year and the cost of debt is increasing, investor capital allocations will increasingly search for value and yield.

CHART 6: CBD OFFICE CAPITAL TRANSACTIONS

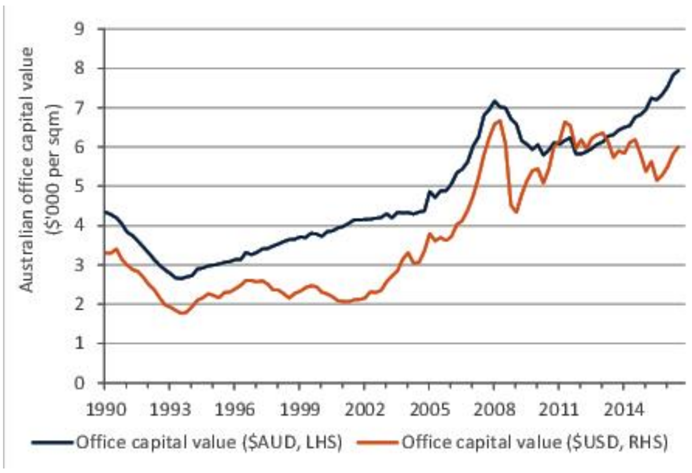


Source: JLL Research and Investa Research

AUD is a key dependency to office capital transactions

Similar to trends across the broader Australian economy, commercial office foreign buyer capital transaction decisions are a function of both value and expected return. As a result, commercial office capital transactions and returns generally benefit from a lower Australian dollar. In recent years, a significant depreciation in the Australian dollar, has created around a 30% capital value windfall for foreign investors. That is, despite CBD commercial office capital sales slowing over the past two years, a moderate depreciation in the Australian dollar (from around USD0.90 to USD0.75) has made Australian commercial office better value in USD/m^2 terms (-2.8%), while gaining 17% capital growth (see Chart 7).

CHART 7: AUD & OFFICE CAPITAL VALUES



Source: MSCI IPD and Investa Research

Office sector impact

Combined with improving leasing market fundamentals in the major capital city CBD markets, a low (or lower) Australian dollar is likely to provide an ‘affordability support’ for foreign capital flows to Australian commercial office markets in the face of lower commercial office returns and increased bond yields.

On the other hand, an appreciation in the Australian dollar could present a headwind to foreign capital flows and Australian office capital returns. As the recent Q3 Australian GDP release highlighted the outlook for Australia’s economy, of which Australian commercial property is a key element, is largely dependent on a lower Australian dollar.

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

David Cannington
Head of Research & Strategy

T. +61 3 8600 9209
E. dcannington@investa.com.au

About Investa

Investa is one of the largest owners and managers of institutional grade, CBD office buildings in Australia. Our $10.3 billion portfolio comprises 41 buildings accommodating more than 750 businesses. Funds under management in Investa's listed and unlisted office funds total over $8.4 billion, managed on behalf of over 15,000 investors.

Investa is a global leader in sustainability and is committed to responsible property investment and sustainable building ownership and management practices.

Our vision is to be the First Choice in Australian Office for our tenants, investors and employees. Our customer centric operating platform enables the delivery of a superior service experience, which contributes to higher tenant retention and better operational and fund performance.

Investa has over 200 staff and is headquartered at Investa's 126 Phillip Street development in Sydney.

Investa Property Group
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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