INVESTA OFFICE Inside

Q1 2014 Office Market Update

April 2014

> **Leading indicators of office demand begin to align; signs of an early labour market recovery emerge**
>
> **CBD office demand improves to neutral levels and sub-lease vacancy contracts further**
>
> **Withdrawal of office stock for conversion escalates due to strengthening residential markets**
>
> **Vacancy rates stabilise - CBD vacancy rate holds firm at 11.7%**
>
> **Effective rental growth emerges in Sydney (3.3% q-q) and Melbourne (1.0% q-q) as incentives stabilise**
>
> **Yields contract further in Sydney and North Sydney – pricing levels for assets currently on the market imply further compression is likely this year**

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 Jones Lang LaSalle Research (JLL) (unless otherwise stated) current as at Q1 2014. All analysis and views of future market conditions are solely those of Investa Office.

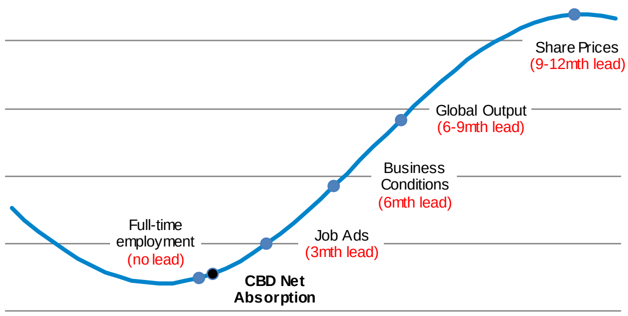
Economic Overview

Leading indicators falling into line; labour markets now showing improvements

The global cyclical upswing, led by a synchronised recovery in the advanced economies, remains on track. Global PMIs and GDP growth of Australia's major trading partners continued to signal expansion, despite softer momentum at the start of the year - caused by severe weather in the US and distorting effects of the Asian New Year celebrations. The US and UK continue to grow solidly, while at the same time the Eurozone and the major developed Asian economies[1] are at the start of an early upturn. Growth in China remained relatively stable, as were local and regional financial markets which held firm over the quarter following the strong rally of the previous year. Domestically, the NAB business conditions index continues to hold its upward trend – notwithstanding the February consolidation – and importantly the finance/business/property services sub-index has remained in positive territory. Overall, there were few notable changes in the general economy over the previous period, with many of the pre-existing trends consolidating over Q1.

The exception to this however, was the notable uplift in several labour market-related indicators. Job advertisements grew by 6.4% over the quarter while latest official ABS figures showed early signs of a turnaround employment growth.

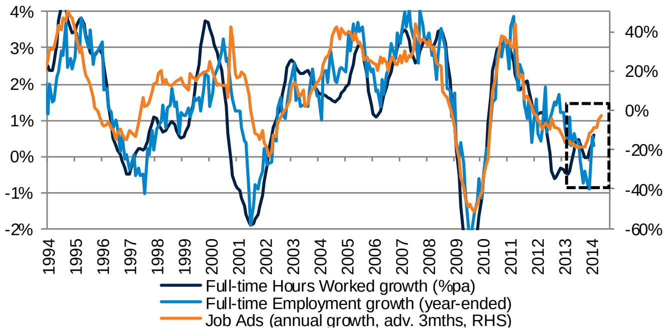
CHART 1: LEADING INDICATOR CYCLE MAP



Source: Investa Research (illustrative)

In previous reports we have noted the strong improvements in several key office demand leading indicators including share prices (from early-2013), economic conditions overseas (from mid-2013) and most recently domestic business conditions (from late-2013); these indicators continue to hold up. In the context of office markets, and the typical chronology of the demand leading indicators, a labour market recovery is the final signal before an actual uplift in net absorption is likely to occur - typically having the shortest lead time over office space demand. Now that we have started to see growth starting to emerge in the key labour market indicators, we are increasingly confident that we are now at an inflection point. Our view is that full-time employment growth will gain more traction from mid-2014, increasing momentum in underlying occupier demand and a stronger uplift in office net absorption.

CHART 2: SELECTED LABOUR MARKET INDICATORS



Source: ABS, ANZ and Investa Research

[1] South Korea, Taiwan, Hong Kong, Japan and Singapore

Dwelling prices continue to post solid gains

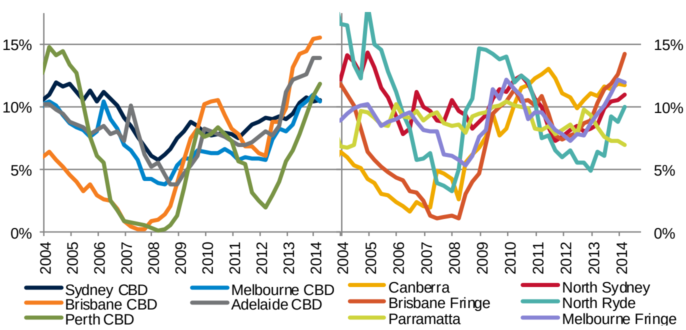
Residential property prices continue to grow with dwelling prices up 15.6% in Sydney, 11.6% in Melbourne, 4.8% in Brisbane and 4.7% in Perth over the year. Driven by historically low borrowing rates, the surge in house prices, alongside a weak secondary office market and an aging office stock, will see an increase in B-Grade office withdrawals for residential conversion – particularly in Sydney, North Sydney and Brisbane. We expect prices to continue to increase while interest rates remain low.

Office Market Overview

Occupancy conditions moderating

A key takeaway from the Q1 data is that there are further signs that office market momentum is starting to shift. Vacancy appears to be stabilising in Sydney, Melbourne, Adelaide, Canberra and even Brisbane, with rates broadly unchanged over the quarter (See Chart 3). Behind this trend was a moderating demand profile – shifting from negative to more neutral levels - with quarterly net absorption effectively zero for these markets. The exception to this however was Perth CBD which experienced another quarter of negative net absorption which drove vacancy up a full percentage point. Despite this, the area-weighted average CBD vacancy managed to hold firm over the quarter remaining at 11.7%.

CHART 3: VACANCY RATES

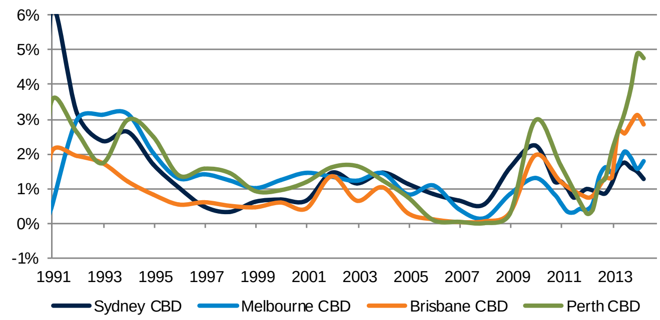


Source: Jones Lang LaSalle Research and Investa Research

Likewise, sub-lease availability appears to be broadly levelling off in all the major markets (see Chart 4) and in many cases has started to contract. While Sydney, Melbourne and North Sydney sub-lease vacancies have already been trending down over the past few quarters, the emergence of this trend in some of the weaker markets like Brisbane and Perth is indeed an encouraging sign.

While we usually don't emphasise short-term quarterly movements, due to the impact of period to period volatility, the combination of moderating demand, stabilising vacancy and a turnaround in sub-lease availability, synchronised over the majority of the major office markets, suggests a true change in underlying fundamentals rather than quarterly statistical noise. Indeed the macroeconomic signs are supportive of improving occupancy fundamentals, and looking forward we expect these demand-side trends to gain more momentum – initially starting from the largest markets of Sydney and Melbourne.

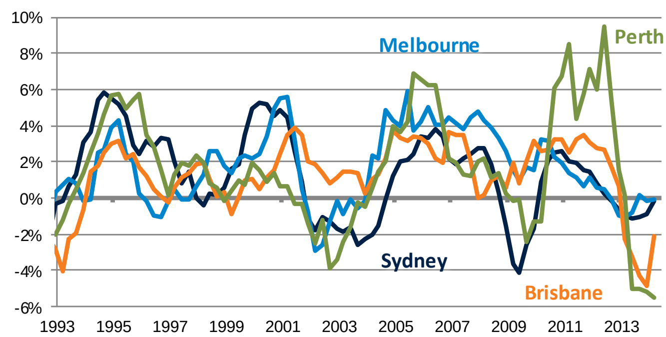
CHART 4: SUB-LEASE SPACE (% OF STOCK)



Source: Jones Lang LaSalle Research and Investa Research

In contrast to the CBDs, performance in the non-CBD office markets was mixed, reflecting the more local dynamics in play, volatility related to the smaller market sizes and being comparatively less synchronised to the global economy. Vacancy rates continued to rise in Brisbane Fringe, Macquarie Park, St Leonards and West Perth while they fell in Parramatta, Chatswood and Melbourne Fringe. Nonetheless overall the smaller markets are well placed with relatively low vacancy rates.

CHART 5: ANNUAL NET ABSORPTION (% OF STOCK)

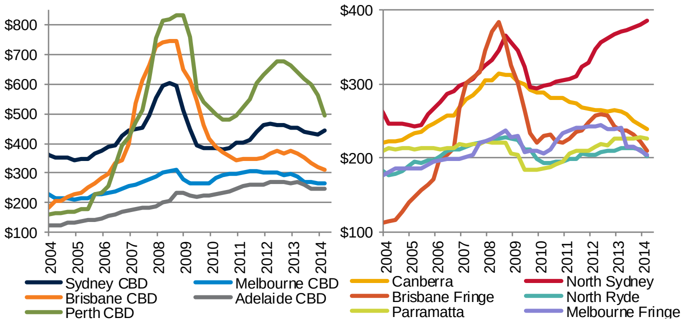


Source: Jones Lang LaSalle Research and Investa Research

Effective rents improving in Sydney and Melbourne; while down in Brisbane and Perth

In addition to the vacancy statistics there were also early positive signs in the rental data. Prime net effective rents expanded during Q1 in Sydney (+3.3%) and Melbourne CBDs (+1.0%) while remaining stable in Adelaide (see Chart 6); however rents in these markets remain down on a year-ended basis. The overall trend for rents in these markets appears to be one of stabilisation, potentially signalling a mid-cycle low-point. Similarly, North Sydney rents also increased in Q1, continuing the strong results this market has delivered over the past few years. Overall, incentives appear to be peaking in these core markets (see Chart 7) – a key driver for an improvement in effective rents.

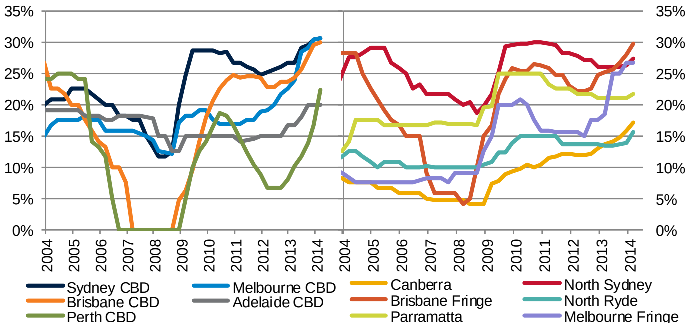
CHART 6: PRIME NET EFFECTIVE RENTS



Source: Jones Lang LaSalle Research and Investa Research

At the same time market rents continued to contract in the “resource markets” of Brisbane and Perth. Behind this was a decline in face rents exacerbated by an upward shift in market incentives in Perth (now at 22.5%). Rents in these markets should begin to stabilise over the coming periods as they approach closer to long-run equilibrium levels and vacancy rates begin to level-off. Indeed it appears that the pace of the deterioration in Brisbane has already started to slow.

CHART 7: TENANT INCENTIVES (%)



Source: Jones Lang LaSalle Research and Investa Research

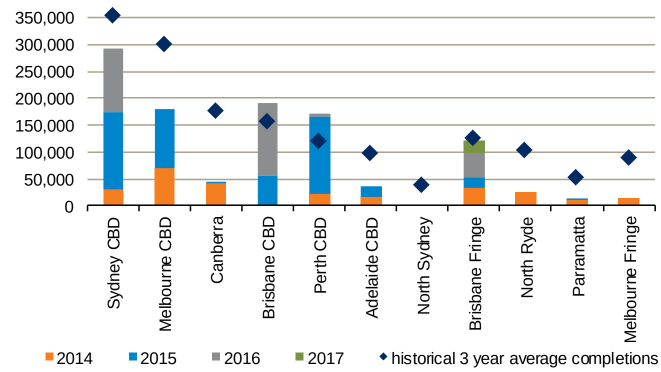
Supply withdrawals to offset completions in the near-term…

Withdrawals in various locations assisted in keeping net supply down over the quarter, including 333 George Street in Sydney CBD for redevelopment (-10,850 sqm) which offset the completion of the Transgrid Haymarket Tower (13,950 sqm) and the 175 Liverpool Street extension (3,190 sqm). There were also several withdrawals for residential conversion including 85 Spring Street in Melbourne CBD (-10,400 sqm) and a range properties in North Sydney (-12,000 sqm). In aggregate the level of Australian CBD office stock contracted by 20,000 sqm. Looking forward, we expect this withdrawal factor to become more prominent; and we have already identified a further 110,000 sqm of stock in Sydney that is likely to be permanently withdrawn for conversion over the next 2 years.

…While the medium-term pipeline in line with the historical average

Looking further ahead, new office supply remains in check. CBD supply currently under construction, for completion over the next 3 years, is around 33% lower than the average completion rate over the same time period. In addition the vast bulk of the supply pipeline represents projects to be delivered in 2015 or later – with the exception of Melbourne (see Chart 8). This includes Barangaroo in Sydney; 1 William Street, 180 Ann Street and 480 Queen Street in Brisbane; and the Old treasury Building, Kings Square and Brookfield Place Tower 2 in Perth. With completions to be minimal in 2014, this will give demand time to recover, and it is likely that most of the new supply will be completed in a stronger leasing market.

CHART 8: SUPPLY UNDER CONSTRUCTION (SQM)



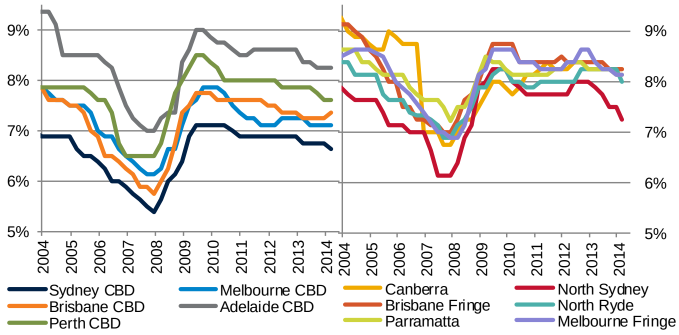
Source: Jones Lang LaSalle Research and Investa Research

Supply is also contained in the smaller markets. Only the Brisbane Fringe has any meaningful levels of new supply under construction (close to 10% of stock). The NSW markets of North Sydney, North Ryde, Chatswood, St Leonards and Parramatta continue to be very supply constrained. 177 Pacific Highway in North Sydney will start construction soon; however this represents only 4.7% of stock and is due to complete in 2016. In our view, these tight supply conditions will lead to additional demand in Sydney CBD as tenants are forced to relocate to find appropriate accommodation.

Prime office yields edge down in Sydney and North Sydney amid the improving fundamentals

Prime yields in Sydney recorded 12.5 bps of compression in Sydney driven by a fall in the lower end of the range (6.00%-7.25%), and North Sydney compressed by 25 bps (6.75%-7.75%). Meanwhile prime yields in the Brisbane CBD posted a 12.5 bps expansion (6.50%-8.25%) likely due to investor sentiment around supply and vacancy rate prospects.

CHART 9: PRIME OFFICE YIELDS



Source: Jones Lang LaSalle Research and Investa Research

Major office transactions included:

> Investa Office Fund's acquisition of 50% of Piccadilly Tower in Sydney ($194.25M) from Stockland

> GPT Wholesale Office Fund's conditional portfolio acquisition of the former CPA assets from DEXUS: 50% of 10 Shelley Street ($130.6M) in Sydney; 750 Collins Street ($249.5M), 50% of Freshwater Place 2, Southbank Boulevard ($130.6M) and Media House, 655 Collins Street ($102.2M)

> Dexus Wholesale Property Fund's acquisition of AM60, Corner Albert Street & Margaret Street in Brisbane ($161.3M) from LaSalle Australia Core Plus Fund

There were also several acquisitions for residential conversion opportunities. These include the Energy Australia Building 570 George Street Sydney ($151.8M, 22,000 sqm) by Singaporean company Far East Consortium, and 168 Walker Street, North Sydney ($84M, 17,800 sqm).

On the 16th April Mirvac announced the sale of 50% of 699 Bourke Street in Docklands to TIAA-CREF for $73.0M. This represents a capitalisation rate of 6.5% - a strong price for a Docklands asset.

Several transactions are currently in due diligence which we are monitoring closely for any indicative shift in pricing - including Westpac Place in Sydney and Central Plaza III in Brisbane. In our view it is likely that final pricing of these assets will provide evidence of further yield compression.

Outlook

Labour market improvements suggest that office market demand will escalate in the coming quarters – however the pace is likely to be slow and steady rather than a sharp rebound

Global growth and financial markets remain supportive of office demand and now domestic business conditions and labour markets have also turned. This provides us with increasing confidence that we are through the worst and close to a market turning point.

Adding to the supportive macro-economic environment there are structural factors that will impact office markets over the medium-term. We have identified some of these in a recent paper - see Key Office Market Themes for 2014 – and encouragingly some of these trends are starting to gain traction.

In particular the rate of permanent office stock withdrawals is escalating due to the strength of the residential market. The growth of this trend in Sydney, Melbourne and North Sydney is already apparent in the data; however in our view it is increasingly likely to begin to impact the other CBD office locations in the coming quarters.

Sydney CBD leads the way - effective rental growth starts to emerge

Absorption moderated in Sydney this quarter (1,504 sqm), however with labour markets improving in NSW we are increasingly confident we are at a turning point, even though this is not coming through in the demand statistics as yet. Vacancy rates declined in 3 of the 4 CBD precincts (Core, Midtown, and the Western Corridor) while the Southern Precinct saw vacancy rise due to new supply additions (180 Thomas Street and 175 Liverpool Street).

It appears that the market is beginning to price in these improvements, as net face rents increased by 3.3%, while incentives held firm, driving a solid quarter of rental growth. Structural factors are increasingly favouring the Sydney market. Business conditions reported by the Finance and Insurance sector are the best of all industries, and NSW is leading the way for employment growth over the last 12 months.

Other factors are also boosting the market including the number of office asset being marketed as residential conversions thanks to the strength of the housing market. We expect Sydney to continue to lead the other markets into recovery as we enter a demand upswing over the next 12 months.

Incentives stabilise while signs of rental growth emerge in Melbourne

Like Sydney there were positive signs in the data this quarter. Although demand was neutral (-2,322 sqm) incentives stabilised and signs of rental growth have emerged. Conversions to residential saw 22,935 sqm withdrawn permanently from stock (0.5% of the market). This is a trend we expect to see continue across all CBDs to varying degrees. As a result vacancy fell by around half a point to 10.4%.

Due to confirmed supply we expect the vacancy rate to increase marginally next year, before declining on the back of improving demand. There are signs that the market is beginning to price in these improving conditions. Incentives remained stable this quarter while face rents improved by 1.5%. We expect the pace of rental growth to gradually pick up from here and escalate from 2016 by which time the majority of supply currently under construction will be complete.

Signs of stabilisation in Brisbane – although supply headwinds remain on the horizon

The Q1 data provided a welcome reprieve after 5 very negative quarters of data. Absorption moderated to neutral levels (-1,615 sqm), with prime grade demand positive (906 sqm) offset by continued secondary weakness (-2,521 sqm). Importantly tenant incentives were stable over the quarter, although face rentals saw a modest decline. We expect to see continued divergence between different grades of assets over the next few years due to the high level of older buildings with small floor plates in this market. Better assets with efficient floor plates in good locations will outperform.

Despite the moderating market conditions this quarter, the supply pipeline remains a challenge. 1 William Street (75,000 sqm), 480 Queen Street (55,000 sqm) and 180 Ann Street (58,000 sqm) are all now under construction and scheduled for delivery between 2015 and 2016, and this supply on the horizon is likely to keep vacancy rates and incentives elevated until later in the decade.

Occupancy market deteriorates further in Perth – but the worst of the demand correction is likely over

2014 has started the way 2013 ended – with a further contraction of tenant demand. Since the most recent vacancy low point of 2.0% in Q1 2012, vacancy has risen nearly 10.0% thanks to almost 2 years of negative absorption.

From a demand perspective we expect that the worst is over. Commodities prices, WA business conditions and hours worked (a component of the labour force data) all suggest that the demand environment should improve to a neutral level in the coming quarters. The remaining risk in Perth is the confirmed supply pipeline for delivery during 2015. In our view this risk is lower than other markets, such as Brisbane, as a result of lesser backfill implications. Nonetheless the vacancy rate will rise and is likely to peak at around 12.0% which represents a large increase from several years ago, but is only around the long-term average level in this market.

We expect that improving demand fundamentals will start to push down vacancy to below average levels mid-to-late decade driving a recovery in effective rents.

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 8226 9431
Mobile: +61 410 564 508
Email: pcarstairs@investa.com.au

Nick Chui
Research Analyst
Phone: +61 8226 9916
Mobile: +61 405 811 176
Email: nchui@investa.com.au

About Investa Office

Investa Office is Australia's leading owner and manager of commercial office buildings, controlling assets worth more than $7 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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