INVESTA OFFICE Inside

Q2 2015
Office Market Update
July 2015

> **Economic conditions are favouring white collar industries in Eastern Seaboard markets**
>
> **Flight to affordability in Sydney and Melbourne as tenants flock to A and B grade space**
>
> **Effective rental growth continues in NSW and VIC markets, while Brisbane stabilises and Perth contracts further**
>
> **Capital markets continue to be supported by strong investor demand and an attractive yield spread**

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

Economic Overview

Grexit fears capture headlines, but domestic economic conditions remain supportive of office space demand

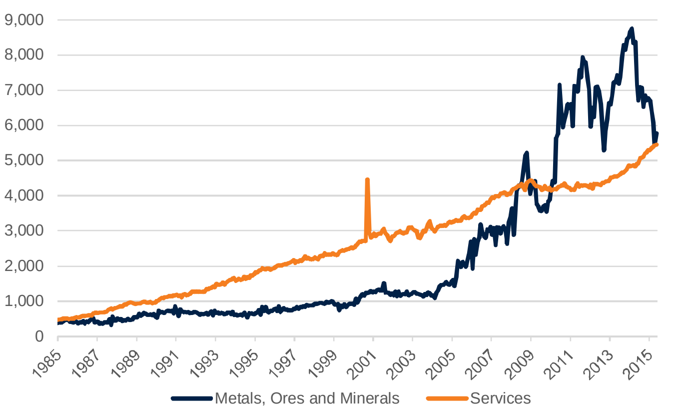
The Greek crisis has dominated news late in the quarter, and increased uncertainty around the future of Greece continues. As a result, global and Australian shares have undergone a modest correction and volatility has increased. The VIX index however remains fairly stable and is some distance from the levels seen during the European debt crisis a few years ago.

Weak commodity prices and a falling mining investment pipeline are weighing on the economy which is expanding at respectable, but sub-trend rate. The RBA is actively looking to support the non-mining sectors of the economy, and as a result the cash rate was lowered for the second time this year during May, hitting a record low of 2%. A further rate cut remains on the table as the Reserve Bank governor continues to emphasise the desire for the Australian dollar to depreciate further. However there are signs in the domestic economic data that suggest that further rate cuts may not be needed.

The recent Federal Budget measures delivered in May were well accepted by business, and this was reflected in the May NAB monthly business survey which showed that business confidence increased to the highest level in nine months. Business conditions continue to trend upwards driven by industries in the Services sector such as Finance, Business and Property Services and the Recreation and Personal Services. This has translated into improvement in the labour market.

In line with the ANZ's job advertisements series which have been trending higher for some time, employment growth has been solid and unemployment rate continues to surprise on the upside. Despite most projections that were pointing to an increase in unemployment rate, it remains little changed over a year. The quarterly detailed employment data from the Australian Bureau of Statistics (ABS) indicates that strong employment growth has been driven primarily by the Health Care and Social Assistance sector and the Professional, Scientific and Technical Services. Other industries in the Services sector including Education and Training, Accommodation and Food Services, and Arts and Recreation Services are also creating more employment and contributing to the growth in the labour market while Mining jobs have been falling (you can read our full analysis of the detailed labour force data here). The data highlights that historically low interest rates and the lower Australian dollar are now boosting non-mining industries.

CHART 1: EXPORTS ($ MILLIONS)[1]



Source: ABS and Investa Research

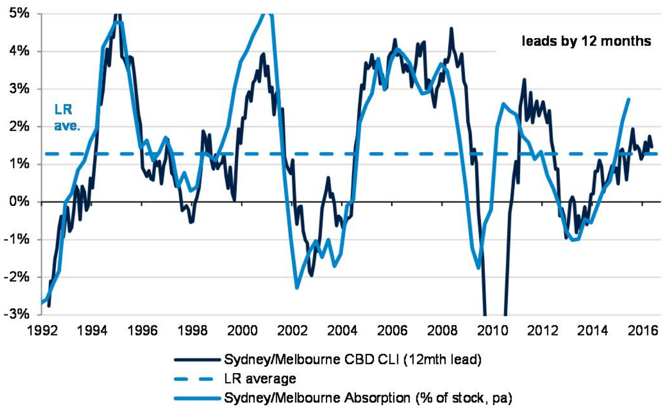
Real GDP for the Mar-15 quarter exceeded market expectations, rising by +0.9% (q-q) and +2.3% (y-y). Strong exports have contributed to this growth, whilst there has been a drop in resource prices this has been counteracted somewhat by an increase in volumes. In addition, the exports of the Services sector such as

[1] Current prices, seasonally adjusted

Education and Tourism have picked up strongly. Services exports were almost equal to iron ore exports in May, providing evidence that the transition of the Australian economy away from mining investment is well underway (see Chart 1).

The improvements in the Services sector which includes a large share of office occupying industries, have translated to a strong increase in demand for office space – particularly in the Sydney and Melbourne office markets which have the highest weighting to these industries. Absorption has been running well ahead of our leading indicator model (Chart 2). This is not a surprise. Most of the inputs into our model are broad national economic indicators such as NAB business conditions, and may understate the strength of economic fundamentals in the Sydney and Melbourne markets. For example business conditions in NSW and VIC are currently 50% stronger than the national average, which helps explain the current divergence.

CHART 2: INVESTA SYDNEY AND MELBOURNE CLI



Source: JLL Research and Investa Research

There are factors boosting demand in Sydney and Melbourne that are not captured in economic data, the most important being centralisation which has underpinned around 15% of absorption in Sydney and Melbourne over the last 12 months; a trend that we see impacting markets for some time yet.

Office Market Overview

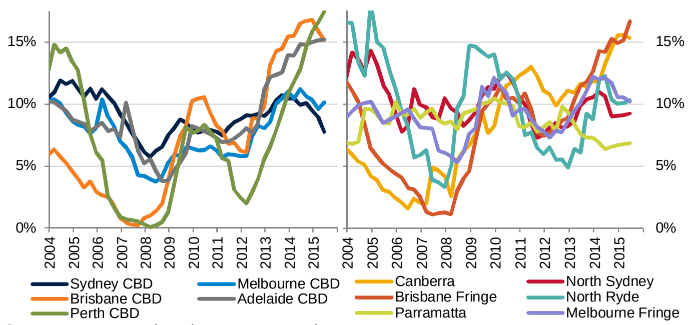
A grade vacancy tightens to below 6% in NSW markets…

Improved demand has led to a further contraction in vacancy rates, with CBD markets tightening slightly (0.25%) over the quarter to 11.9%. Sydney CBD led the way with a 1.2% improvement over the quarter, followed by Brisbane (0.75%).

Looking at annual movements highlights the changing fortunes of different markets around the country. Sydney markets are leading the charge with CBD vacancy falling by 2.2% over the year, followed by North Ryde (-1.9%) and North Sydney (-1.4%), with Parramatta seeing only a slight increase in an already very low vacancy rate of 6.9% (+.50%). Melbourne is also improving with the CBD vacancy rate falling by 1.1% over the year, and the fringe tightening by 1.9%. The Brisbane market overall was stable, with the CBD tightening by 1.4%, offset by further vacancy rises in the fringe of 2.5%. Perth CBD saw the largest movement with the vacancy rate expanding by 4.7% over 12 months.

The total vacancy rate clouds the picture somewhat, particularly in Sydney. A grade vacancy is now below 6% in all NSW markets above 500,000 sqm in size. The premium market is still facing some headwinds with Sydney CBD vacancy 12.5% - more than double the A grade vacancy rate. At this point in the cycle tenants are opting for more affordable accommodation and demand for premium assets has been relatively weak.

CHART 3: VACANCY RATES



Source: JLL Research and Investa Research

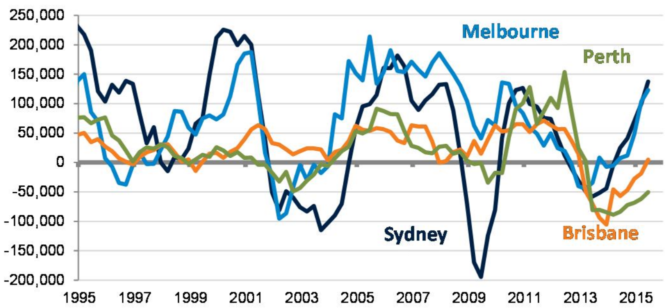
…thanks to "flight to affordability"

Tenant demand was again strong in Sydney and Melbourne CBD during the quarter, with Brisbane also in positive territory. Flight to affordability is behind much of this demand with annual A grade absorption totalling over 145,000 sqm in Sydney. Likewise Melbourne CBD absorbed 123,000 sqm of space (predominately A and B grade) during the year (the strongest since 2010). While the industry drivers are slightly different between the two markets, there are some similar trends. Demand is being driven by smaller (sub-1,000 sqm) tenants who are seeking good quality, affordable accommodation as they move into growth mode.

Demand conditions have also improved in Brisbane CBD, with the contraction cycle now complete, annual demand for prime space totalled nearly 16,000 sqm. The real weakness remains in the poor quality end of the secondary market. While the rate of contraction is slowing, Brisbane has an excess of lower quality options with inefficient floor plates which are likely to struggle to attract tenants in the short-term.

Similar dynamics are taking place in Perth, which is still adjusting to the slowdown of the mining industry. The rate of contraction in prime stock is lessening. Over the last year tenants in prime assets gave up 7,000 sqm of space compared to 54,000 sqm in FY14. So far there is no respite for the secondary market in Perth, as the annual rate of contraction (-43,000 sqm) has escalated over the past two years. This indicates that the upgrade cycle is well underway, and tenants are looking to take advantage of the current conditions to secure better quality space.

CHART 4: ANNUAL NET ABSORPTION (SQM)



Source: JLL Research and Investa Research

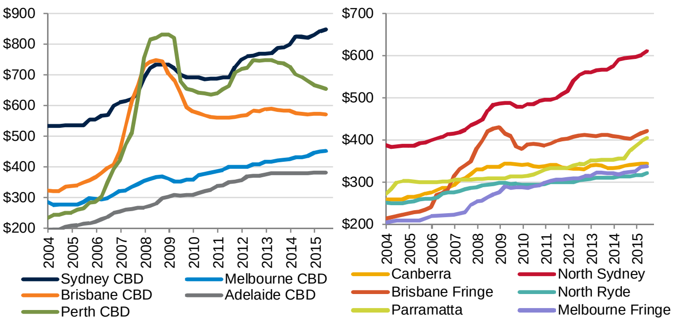
Signs of incentive contraction in Sydney…

On the whole incentives are stabilising in most markets, the exception being Perth (3.0%) and Adelaide (2.5%) – markets struggling with high vacancy rates. In NSW the next move in incentives is likely to be down, as the market has enjoyed stability for some time now, with Sydney CBD seeing some slight downward pressure during Q2. Our view is that A grade incentives are already in decline, but the prime incentive figure is being held up by premium grade incentives which remain stubbornly high.

…and continued upward pressure on face rents

CBD prime rents continue to expand – more than offsetting any increase in tenant incentives recorded for the quarter. NSW markets are leading the way, with Sydney (0.7%), North Sydney (1.6%), North Ryde (1.6%) and Parramatta (2.0%) expanding at a solid pace this quarter. Melbourne markets paused this quarter, but are up around 5% over the year. Perth is the only market to see a correction, with face rents contracting 5.6% over the last 12 months.

CHART 5: PRIME NET FACE RENTS



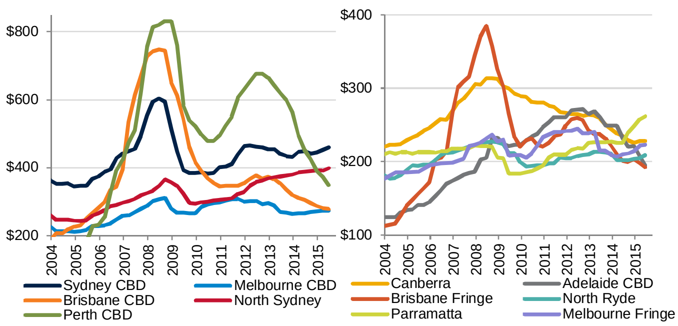
Source: JLL Research and Investa Research

Effective rents to escalate in Sydney and Melbourne

Now that incentives are stabilising within Eastern Seaboard markets we are starting to see sustained effective rental growth. All Sydney markets have seen prime net effective rents expand by around 3% over the year – with Parramatta the stand-out at 16% growth. Our view is that A grade Sydney CBD rents have grown more strongly than the prime number suggests, as the premium market remains a handbrake for now. This is supported by strong secondary effective rental growth in the CBD which totalled 6.9% over the year. A similar dynamic is occurring in Melbourne, although there is a lesser divergence between grades. Annual Melbourne CBD prime effective rent growth was 3% compared to around 4% in the secondary market.

In contrast Brisbane and Perth have endured a challenging year, with incentive pressure reducing rents. Brisbane prime effective rents are down 8.8% for the year, but the momentum has slowed with rents contracting just 1% during the quarter. Perth however remains in the midst of a correction cycle, with prime rents contracting 23% over 12 months. We expect some further falls before the market stabilises.

CHART 6: PRIME NET EFFECTIVE RENTS



Source: JLL Research and Investa Research

Construction to peak FY16 as landmark projects near completion

There were minimal completions for the quarter. The most significant included 699 Bourke Street (19,300 sqm) and the extension to 570 Bourke Street (15,550 sqm) in Melbourne. There were nearly 50,000 sqm of withdrawals this quarter however, including 25,000 of residential conversions in Melbourne Fringe and 3,400 sqm of conversions in North Sydney.

The majority of assets under construction will complete during the next financial year. These include International Towers (Barangaroo, circa 267,000 sqm), 200 George Street (38,700 sqm) and 5 Martin Place (34,000 sqm) in Sydney.

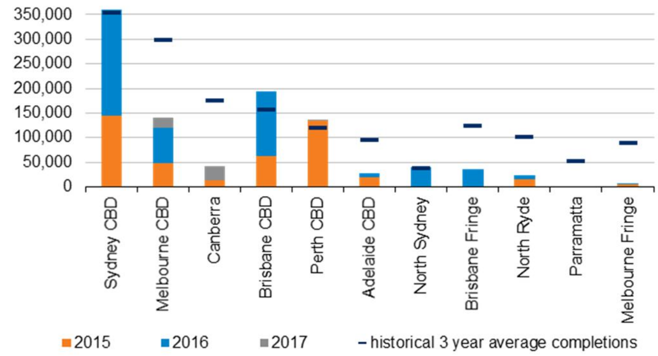
The new landmark premium 567 Collins Street (55,000 sqm) in Melbourne, 480 Queen Street (55,000 sqm) and 180 Ann Street (58,000 sqm) in Brisbane, and Kings

Square (60,000 sqm), 54-58 Barrack Street (Old Treasury Building, 30,000 sqm) and 123 St Georges Terrace (Brookfield Place 2, 34,000 sqm) in Perth.

Future supply pipeline to be constrained, impacted by conversions and withdrawals for redevelopment

While significant volume of construction will complete across the country in FY16, there are factors that will mitigate much of the impact on the market. Sydney and Brisbane in particular have a significant pipeline of slated conversions that, alongside the normal redevelopment withdrawal cycle, will offset new supply coming online. This will likely result in negative supply during 2016-17 in Brisbane and 2017 in Sydney. 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 7: SUPPLY UNDER CONSTRUCTION 3 YEAR HORIZON (SQM)



Source: JLL Research and Investa Research

Cap rates continue downward trend as Australian markets move towards global peers

Australian assets have continued to be hotly contested from both domestic and offshore parties. Total transactions for the financial year totalled almost $13B – only just behind FY14, which was a record year. This strong interest combined with several interest rate cuts has led to cap rate compression across the board over the last 12 months. Over the quarter, most markets saw further compression, led by some landmark sales including International Towers 1 in Sydney and Waterfront Place in Brisbane.

Melbourne CBD led the way this quarter (-25bps), and has seen the strongest compression of over the year - 75 bps.

Key transactions in Melbourne for the year include:

> The CBW complex ($608M, 6% initial yield),
> 700 Bourke Street ($433M, 5.7% initial yield), and
> 357 Collins Street ($223.5M, 6.6% initial yield).

Sydney CBD also saw a further 12.5 bps of compression in prime yields, (37.5 bps y-y) driven by the sale of trophy assets over the last 12 months including:

> International Towers 1 ($2B),
> 52 Martin Place ($555M, 5.2% initial yield), and
> 1 Alfred Street ($425M, residential conversion).

There was also strong interest in secondary grade assets, thanks to the supportive occupancy market fundamentals combined with acquisitions from developers seeking residential conversion opportunities, and this activity drove a 50 bps tightening of yields over the year in this segment of the market.

Volumes in Brisbane were down on the previous record year, however the good quality end of the prime market was well supported with the recent sales which include:

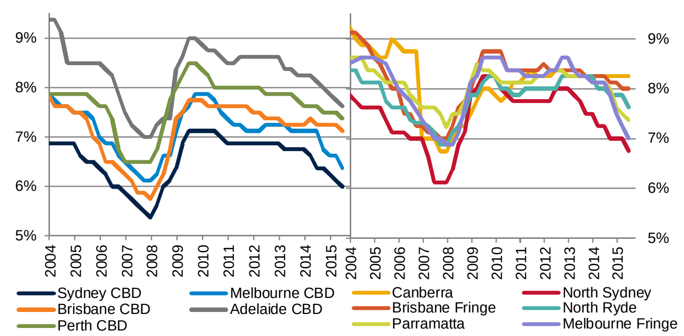
> Waterfront Place ($592M, 6.3% initial yield), and
> 215 Adelaide Street ($224M, 6.9% initial yield).

The occupancy market weakness of secondary grade stymied any compression in those assets over the year.

Perth saw limited transactions, with the 50% sale of QV1 to ICPF the only significant sale during the year. However based on this, and trophy asset sales in other markets, the upper prime yield tightened 50 bps during FY15, whereas the lower quality assets saw yields stay relatively stable weighed down by occupancy market concerns.

Overall the market trend is similar to last year, with most capital chasing quality assets in core locations. However there was a noticeable move up the risk curve with a greater number of investors prepared to transact on good quality assets in non-core fringe locations. Secondary yields are being supported by keen interest by developers for conversion to other use – particularly in Sydney CBD and North Sydney.

CHART 8: PRIME OFFICE YIELDS



Source: JLL Research and Investa Research

Outlook

Absorption surges in Sydney driving improved effective rents

The strongest annual absorption figure since 2006 signals that we are now in the midst of a demand upswing in Sydney. The pace of recovery so far has been well ahead of our estimates. Over the last year demand has been strongest for assets that offer good quality space at an affordable price. Evidence of this can be seen in the strength of the A grade market which has posted 145,000 sqm of absorption over 12 months. In contrast, demand has been weak for premium grade space, which has only absorbed around 14,000 sqm over the last year.

We expect this trend to continue. The global economy is still facing challenges and at this stage of the cycle there are fewer companies willing to pay premium grade rents. Vacancy is already low in the A grade (5.6%) and B grade (8.7%) markets; whereas premium grade remains challenged at 12.6%. With the bulk of supply under construction of premium grade it is likely vacancy will increase before it improves. However we are already seeing incentives contracting in the A and B grade markets as vacancy begins to tighten. Eventually as the rental gap closes the upgrade cycle will boost demand for premium space. A good example of how this could play out is 50 Bridge Street. If AMP proceed with the Quay Quarter redevelopment, current tenants of this A-grade building are potential candidates to upgrade to premium space. However this cycle will take time to unfold, and our view is that the A and B grade markets will out-perform the market overall for the next 3 years.

Melbourne outlook upgraded thanks to stronger demand and reduced supply pipeline

Melbourne CBD is also moving into a demand upswing, but the momentum continues to lag Sydney by around 3-6 months. Nonetheless we have upgraded our view of the Melbourne market this quarter. Like Sydney, demand momentum is running a little ahead of our estimates, driven mainly by A and B grade demand. Added to this, the announcement that Telstra will not proceed with the development of a new 90,000 sqm asset in Melbourne improves our vacancy forecast over the medium-term. For a market that has consistently delivered significant supply for over a decade, the current level of supply under construction (141,000 sqm) is very low.

We expect the performance between asset grades to be relatively uniform over the next few years - in contrast to Sydney. This is mainly due to the affordability equation in Melbourne; there is much less incentive for tenants (particularly those with a national footprint) to specifically seek affordable options at the expense of other factors, although of course the level of rent remains important.

Firming withdrawals to boost Brisbane as relocations to the CBD emerge

Demand conditions are gradually improving in Brisbane. We are now seeing a slow and steady pick up in absorption. Smaller tenants have been expanding for the last 12 months, and more recently this has been boosted by some absorption from larger Services tenants. There has also been some evidence of tenants relocating from fringe markets back into the CBD. We have speculated for some time that this was a likely occurrence now that the rental gap between the markets has closed. At the peak in 2008 fringe markets were $400 sqm more attractive on an effective basis than the CBD, but this has now contacted to only around $100 sqm.

The withdrawal picture is also firming in Brisbane as projects like Queens Wharf inch closer to commencement. We estimate that nearly 160,000 sqm is likely to be permanently removed from stock over the next few years – predominately B grade space. This could result in B grade vacancy falling by more than half, and this is likely to put a floor on rental levels.

While absorption is likely to be lower over the next few years than what was experienced during the mining boom, we expect that Brisbane will see continued expansion in the Education and Services sectors as the economy continues to transition back to traditional drivers of economic growth.

The upgrade cycle to commence in Perth as secondary grade vacancy nears 20%

Overall the Perth market still remains in contraction mode, however delving into the detail highlights that tenants are now starting to use the current conditions to their favour and upgrade to better quality accommodation. While absorption was again negative overall, the prime market saw some positive absorption during Q2.

While we expect leasing market weakness to persist for some time, there is a potential upside for the Services sector in Perth. Business Service tenants have given up over 50,000 sqm of space over the last 3 years – more than offsetting the expansion seen during FY09-12. This does suggest that perhaps the current weakness may be an over-correction. While we do not expect the Services sector in Perth to be as strong as what we are experiencing in Sydney and Melbourne, there should be some upside for these businesses as the economic cycle continues to develop.

However supply remains the main challenge in this market with over 11% of stock remaining under construction. We expect vacancy to remain elevated for some time, particularly in secondary grade assets.

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 $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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