INVESTA OFFICE Inside

Q4 2015 Office Market Update
January 2016

> **Concerns around the global economy have weighed on global financial markets late in 2015. However white collar industries in Australia are performing well and expanding their workforce at a robust pace.**
>
> **Accordingly, office space demand continues to be strong particularly in Sydney, and there is evidence that competition for space is now winding back incentives.**
>
> **Above average tenant demand and the announcement of further stock withdrawals has resulted in the majority of market analysts upgrading their Sydney rental growth forecasts, broadly aligning with our view.**
>
> **Capital markets remain strong with further compression recorded during Q4, driving yields near historic lows.**

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 Q4 2015. All analysis and views of future market conditions are solely those of Investa Office.

Economic Overview

China concerns escalate financial market volatility but Australian economic fundamentals remain robust

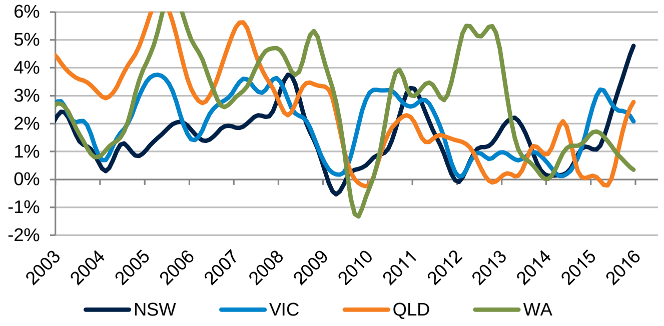
The end of 2015 saw the US Federal Reserve take the first long awaited step towards monetary policy normalisation by increasing the benchmark funds rate by 25bps – the first rise in nearly a decade. The move demonstrated the underlying confidence in the US economy and was widely expected by the vast majority of market participants due to consistently strong labour market figures. The unemployment rate has now halved since the 2010 high and is holding steady at 5% at the end of 2015.

Despite the interest rate increase, the Fed emphasised their desire to keep monetary policy accommodative, indicating that the pace of future rate hikes will likely be gradual. This position seems prudent given the increased financial market volatility that has emerged since late August 2015. Concerns around global economic growth, specifically China, have been the triggers for much of the recent share market correction. Commodities prices have fallen sharply due to increased supply and moderating demand. The oil price in particular corrected sharply late in 2015, nearing the post-GFC low point.

In Australia these issues are having an impact, with lower commodities prices dragging down the AUD which was in decline for most of 2015. This, combined with falling mining investment, is impacting locations that are highly exposed to the mining industry – Western Australia in particular. The flipside is that lower interest rates and the lower currency are boosting other industries. Non-mining business investment is gradually improving and business conditions, while weakening towards the end of the year, remain robust for the majority of industries. It is worth noting that while the mining industry, particularly mining investment, has had a significant impact on GDP over the last decade, the impact on the labour market has been much smaller, with mining directly employing around 2.4% of the labour force during the industry peak in 2013 (and less than 2% now). The services sector on the other hand is the engine room of the labour force, employing around 60% of the workforce.

Evidence of the strengthening labour market can be observed in the quarterly detailed labour force data from the Australian Bureau of Statistics. 346,000 jobs were created over the year to November equating to an annual growth of 3% - led by the services sector; in particular health care & social assistance and business services. The unemployment rate trended lower over the course of 2015 and generally outperformed the predictions of most economists, which suggests that the peak in unemployment may have passed. Encouragingly leading indicators point to further strength, highlighted by ANZ Job advertisements which increased by 10% over the year to December.

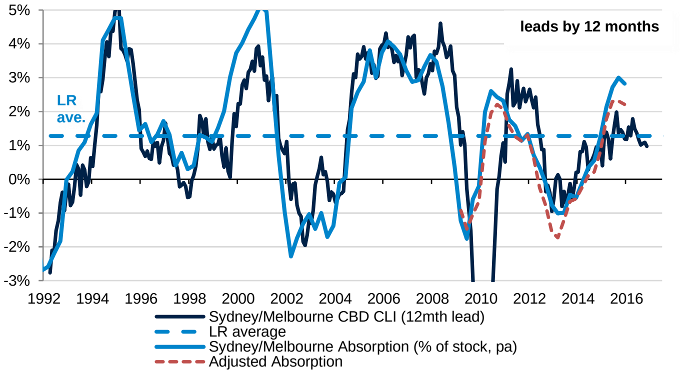
CHART 1: ANNUAL STATE EMPLOYMENT GROWTH



Source: ABS and Investa Research

Our leading indicator model, a composite of domestic and international macro-economic data, has moderated somewhat mainly due to weakened share markets. Domestic business conditions and labour market lead indicators remain supportive of office market demand at around the long-term average howeer We expect that actual absorption of space in Sydney and Melbourne CBDs will be higher than this, boosted by the ongoing trend of tenant centralisation.

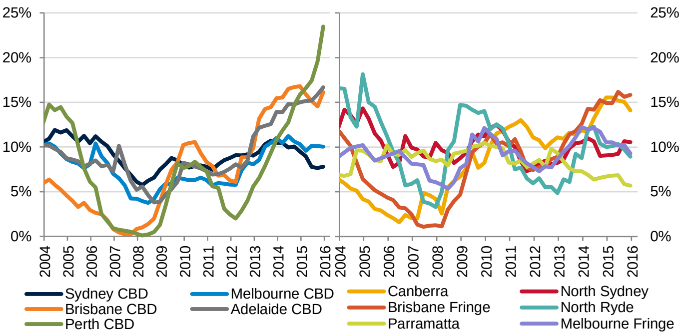
CHART 2: INVESTA SYDNEY AND MELBOURNE CLI



Source: JLL Research and Investa Research – adjusted absorption removes centralisation demand from the calculation

Office Market Overview

CHART 3: VACANCY RATES



Source: JLL Research and Investa Research

Tenant demand continues to expand in Sydney and Melbourne…

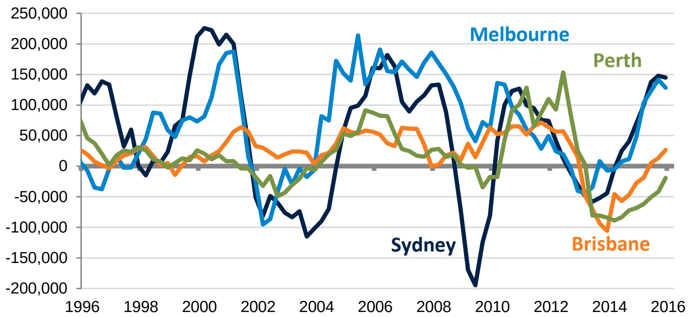
Positive net absorption was again recorded across the main gateway office markets of Sydney and Melbourne CBD in Q4. Sydney CBD was the standout performer recording a solid 24,000sqm of new demand, supported primarily by a strong take-up of prime space (22,000sqm). The impact on market vacancy was however offset by the delivery of 34,000sqm of long anticipated office supply, including the remaining tranche of International Towers (Baranagaroo) T2 and the State Theatre & Commercial Development 478-480 George Street. Melbourne CBD on the other hand recorded a relatively moderate level of net absorption (4,000sqm) though no new supply was delivered. This was the result of circa 21,000sqm of sub-lease space entering the market which offset around 18,000sqm of tenant expansion. These supply-demand dynamics meant that vacancy rates remained broadly stable in both markets over the quarter (7.8% for Sydney CBD and 10.0% Melbourne CBD)

Looking at the bigger picture, the quarter's results continue to highlight that the demand recovery cycle in these markets, which emerged over the course of 2015, remains on track.

Sydney CBD in particular has been strong with annual net absorption running at 2-3 times the historical average[1], and is being supported by high levels of organic demand through net tenant expansion (see Chart 4). This has been particularly conducive to tightening vacancy rates – and rental growth – with the market vacancy rate falling 1.7% percentage points over the past year. Furthermore it is encouraging to see occupiers continuing to upgrade to higher quality accommodation, and that the tightening B grade market is having positive flow-on effects to the broader market, particularly A grade stock.

Melbourne CBD, despite recording similar levels of net absorption year-on-year, is trailing Sydney's recovery due to new supply which has held the vacancy rate relatively stable. A significant level of demand is being driven by CBD centralisation into new developments from non-CBD locations rather than the level of expansion activity seen in Sydney. Nonetheless looking through the modest quarterly absorption figure, which can be volatile, Melbourne's demand recovery remains well underway and is driving a gradual decline in vacancy.

CHART 4: CBD ANNUAL NET ABSORPTION (SQM)



Source: JLL Research and Investa Research

…while demand is recovering in Brisbane and Perth, though not enough to offset new supply

Net absorption was also positive in Q4 for the Brisbane and Perth CBDs, both of which are gradually recovering from the global resources slowdown. Brisbane saw a healthy

[1] 10-year average annual net absorption

11,000sqm of demand, and recorded a fourth consecutive quarter of net tenant growth; while Perth recorded a low level of positive absorption (600sqm) the first positive quarterly figure since mid-2012.

Vacancy rates rose in both markets however, due to the completion of several developments. In Brisbane, vacancy increased to 16.1% from 14.5% due to net supply of 54,000sqm primarily driven by the completion of Daisho's 180 Ann Street project. Similarly, Perth's vacancy rate jumped to 23.5% over the quarter from 19.6% with the delivery of Brookfield Place Tower 2 (34,000sqm), Old Treasury Building at 54-58 Barrack Street (31,000sqm) and Kings Square 1 (20,000sqm).

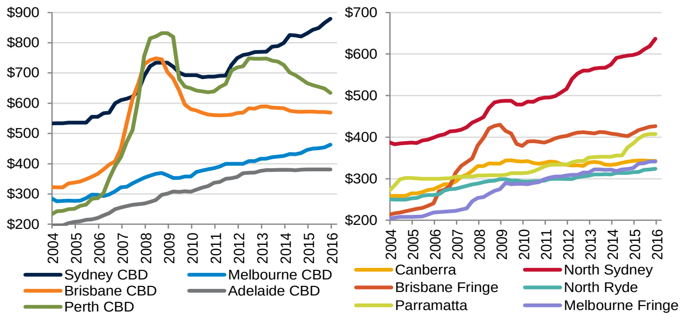
The main takeaway from the Brisbane Q4 results, was a reinforcement of our view that the demand cycle has firmly turned the corner. Take-up of space is being driven by the non-mining sector, a portion of which is occurring due to tenant movements and relocations from the Brisbane Fringe into the CBD. Despite solid demand, incentives remain under pressure due to the level of supply being delivered to the market. There is also a divergence between prime and secondary grade assets with vacancy rates of 13.2% and 18.8% respectively. With the majority of the remaining supply pipeline imminent in Brisbane we expect that we are through the worst of the correction.

For Perth the market remains challenged, however the results show tentative signs that demand is moving gradually closer to a stabilised state. While the mining and business services sectors are still negative contributors to demand, the rate of contraction has slowed markedly over the past year. On the other hand, positive contributors have been from non-traditional sources, namely from tenant relocations from non-CBD locations and the one-off expansion into the Old Treasury Building by the Department of the Attorney General (circa net +15,000sqm) and which have helped to produce the relatively neutral demand figures over the past few quarters. Nevertheless, we are focused on the level of underlying organic demand and a stabilisation to signal a true inflection point in the demand cycle. Over the near-term this will be weighed down by recent movements in iron ore and oil prices, and we expect conditions to remain relatively subdued for a while yet as the market absorbs the space that has recently been brought to market.

Rents mirroring occupancy trends, with growth mainly taking place in face rents

The direction and magnitude of the physical office market trends are being reflected in the rental movement data. Sydney CBD and North Sydney are leading the way, recording +5.8% and +6.6% prime net face growth respectively on an annual basis. In our view the majority of the prime face rental growth recorded over the year has been occurring in the A grade market where conditions are improving rapidly. Melbourne is trailing Sydney with the CBD (+3.8%) and Fringe (+4.6%) markets also performing well. Brisbane CBD face rents have been relatively stable over the year while Perth have fallen (-4.9%).

CHART 5: PRIME NET FACE RENTS

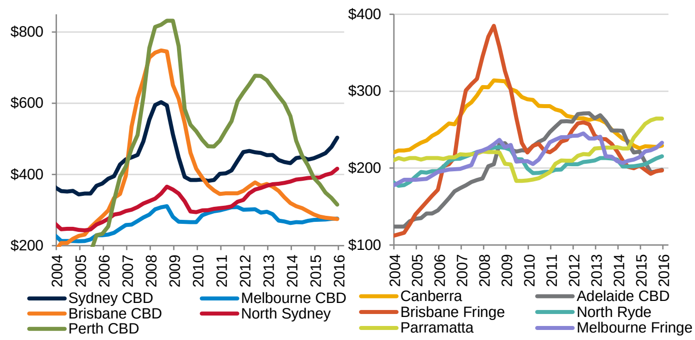


Source: JLL Research and Investa Research

Effective rents bolstered in Sydney by reducing incentives…

Due to tightening vacancy rates, and strong A grade demand we have started to see competition for space between tenants occurring in Sydney CBD. Consequently we have started to see incentives starting to fall; -1.1% over the quarter and -2.0% from the peak of 32% in June 2015. This has helped to drive strong prime net effective rental growth of +5.4% over the quarter and +13.0% on an annual basis. The spread between the incentive offered to new tenants and those that renew is beginning to widen again as the market balance begins to favour landlords. During the GFC this spread almost disappeared as asset owners looked to secure tenants to minimise risk, however we expect renewal incentives to be significantly lower than the new lease rate as a norm going forward.

CHART 6: PRIME NET EFFECTIVE RENTS



Source: JLL Research and Investa Research

North Sydney is also benefiting from an improving CBD market and has seen solid levels of effective growth (+6.3% year-on-year). We expect conditions to remain accommodative over the near-term and predict further gradual reductions in market incentives over the coming periods.

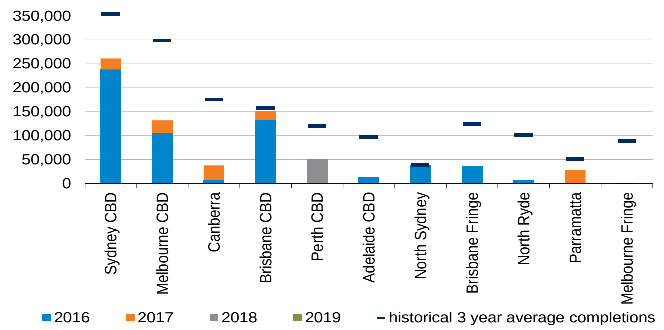
…while incentives appear to be approaching their cyclical peaks in most other major markets

Melbourne CBD has recorded only moderately positive effective growth to date (+1.4% year-on-year), weighed down by stubborn incentive levels. While the market has been slower to tighten up than Sydney, we expect as the fundamentals improve further we will likewise see aq gradual decline in incentives and more meaningful effective rental growth.

Brisbane CBD is a further step behind. Prime net effective rental growth was slightly negative over the quarter, however on an annual basis the rate of decline has been easing gradually since 2013, and we expect further stabilisation this year.

Perth CBD is the exception to the story and is still well amidst the rental correction cycle. Incentives continue to rise and are now at 42%, which have driven a sharp -19.4% decline in net effective rents over the year (-5.6% over the quarter).

CHART 7: SUPPLY UNDER CONSTRUCTION (SQM)



Source: JLL Research and Investa Research

Supply cycle peaking in 2016

The expected completion of supply under construction is heavily weighted to 2016. In Sydney CBD, the pipeline includes International Towers – Tower 1 (101,000sqm) & Tower 3 (78,000sqm) and 190-200 George Street (40,000sqm) while in Melbourne CBD this includes Collins Square Building 2 (64,000sqm) and Building 4 (40,000sqm). Brisbane CBD will likewise see the delivery of 480 Queen Street (55,000sqm) and 1 William Street (75,000sqm) in 2016 which will keep the vacancy rate elevated.

While the above developments show that a significant volume of supply will complete across the country this year, there are factors that will mitigate much of the impact particularly in 2017. Sydney and Brisbane in particular have a significant pipeline of permanent withdrawals for conversion alongside the normal redevelopment withdrawal cycle. This will likely result in negative net supply in 2017-18. In addition, the NSW Government announced in November 2015 that as part of the construction of the new Metro rail line, it will make compulsory acquisitions of circa 60,000sqm of office assets to be demolished and withdrawn from the office stock.

Perth CBD's supply cycle has largely come to a close with the completion of the Old Treasury Building this quarter. The only significant building under construction is the Capital Square building (48,000sqm) which is due 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 likes of Elizabeth Quay and City Link sites.

Cap rates reaching near pre-GFC lows

2015 was a record year for office transactions. Sales totalled $16.1B over the year – including portfolio sales - with over 50% occurring in the Sydney metropolitan area. Global capital continues to target Australian assets, and the majority of these transactions have been completed by funds domiciled offshore.

Q4 saw some significant assets trade on the market. In Sydney a 25% share of International Towers 1 was sold to an undisclosed purchaser (Asia domiciled) for $350M. 120 Goulburn Street also transacted, sold for $155M to Commerz Real. 175 Castlreagh Street was also acquired for $98M by the NSW State Government as part of the Metro rail project.

In Melbourne there were some very significant sales that provided evidence of further yield compression. Southern Cross 1 and 2 were acquired by Blackstone as part of the Brookfield portfolio sale for a total of $675M. This price represented an equivialent yield of around 5.3% - a very strong price for the A grade buildings. 161 Collins Street was also acquired by Pembroke Real Estate for $275M, and 120 Spencer Street (B grade) was purchased by Anton Capital for $165.5M, at an equivalent yield of 6.9%.

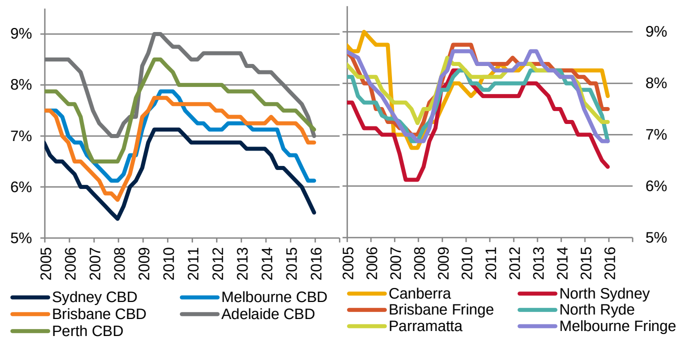
In Brisbane there were two significant sales, both again completed by offshore investors. 313 Adelaide Street was acquired by Deutsche Bank for $125M (7% equivalent yield) while 201 Charlotte Street was purchased by Blackrock for $90M - both strong sales given the occupancy market challenges that Brisbane has experienced over the last 12 months.

Canberra also saw interest from offshore capital with the Louisa Lawson Building in Greenway acquired by FG Asset Management (Korea) for $225M, whilst 255 London Circuit was sold to Growthpoint for $70M, which represented a market cap rate of around 6%.

We expect 2016 to be another strong year for transactions, and the general themes of 2015 to be maintained. Yields are now at or close to pre-GFC levels in most office markets, though the economic environment is very different. As opposed to being driven by high growth expectations and low risk premia, pricing is being supported by record low interest rates and subsequently return hurdles required by investors have been reducing.

We expect the strong levels of pricing will remain supported over the near-term (in the absence of a significant capital market event). The composition of pricing drivers may change however, and a potential re-rating of growth assumptions may provide an additional boost as improving fundamentals becoming increasingly entrenched. There is evidence of this beginning to emerge. The major real estate agencies have all upgraded their rental growth forecasts for Sydney recently, noting the strong demand dynamics and factors such as the Metro that will remove assets from stock. Increasingly the market view of Sydney is aligning and most analysts are forecasting around 25-35% effective rental growth over the next 5 years.

CHART 8: PRIME OFFICE YIELDS



Source: JLL Research and Investa Research

Outlook

Sydney effective rents to escalate as competition for space heats up

Strong state economic fundamentals are providing a platform for continued tenant demand in Sydney over the medium-term. We expect absorption will remain robust and that the withdrawal of office space for conversion to other use and re-development will tighten the B grade vacancy rate sharply over the next few years. This is likely to result in a surge of tenants upgrading to A grade space – boosting the already strong performance of this market segment. Premium grade vacancy is likely to remain elevated for a few years while supply is absorbed, but as A grade vacancy tightens, the rental gap will likely narrow, providing an opportunity for tenants to upgrade. The scale of the withdrawal pipeline was given a boost by the announcement by the NSW State Government that around 60,000 sqm of office assets will be compulsory acquired for the new Metro rail line. We now expect around 240,000 sqm of office assets to be permanently withdrawn over the next 5 years – around 5% of total stock. Temporary withdrawals of assets such as 60 Martin Place, 151 Clarence Street, and 50 Bridge Street for redevelopment will likely tighten vacancy rates sharply during a window where there is likely to be minimal supply under construction. This will potentially tighten the vacancy rate sharply placing upward pressure on rents.

The market is beginning to price in these factors, and although the vacancy rate is likely to rise slightly over the next 12 months as supply completes (mainly Barangaroo), effective rents are already expanding strongly. We expect further growth over the medium-term, led by the A and B grade market. Already there are signs of competition for space emerging as the market balance has shifted to favour asset owners, and as a result we expect incentives to begin to pull back further, boosting already solid face rental growth.

Sydney yields are now at levels comparable to the last market peak in 2007, however capital market drivers and the economic environment are very different today. We expect further downward pressure on yields driven mainly by the weight of capital targeting Australian real estate. On a global basis Australian yields remain attractive, and if the occupancy market improves as we expect, rental growth will support further capital appreciation.

Melbourne steady for now, but improving economic conditions and reducing supply will boost rents medium-term

At face value it would seem that demand conditions are similar in Sydney and Melbourne, as both markets have absorbed a similar level of space over the last 12 months. However centralisation of tenants has driven around 35% of this demand in Melbourne, and while this trend has been beneficial to the market and kept vacancy in check, organic demand, competition for space and rental growth has been much stronger in Sydney.

Supply additions have kept the vacancy rate stable in Melbourne during 2015 despite robust demand. Looking forward however, supply now under construction is well below average, boding well for future rental growth, particularly given that economic outlook is positive for Victoria over the next few years. We remain slightly cautious given the relative ease of development in Melbourne. Without the asset withdrawal pipeline that exists in Sydney, it is unlikely that the market vacancy rate will reduce as quickly or fall as low. We expect the vacancy rate to sit between 7-10% over the medium-term, delivering steady, stable rental growth.

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 rental growth prospects.

Demand is recovering in Brisbane, however the vacancy rate peak is imminent

Economic fundamentals have been steadily improving in Queensland, with business conditions picking up throughout most of 2015. Job advertisements have also improved driving employment growth and as a result office space absorption was above average during 2015.

However despite these improving demand dynamics, there are still two major assets under construction that will complete during 2016; 480 Queen Street and 1 William Street. These buildings will add around 130,000 sqm to the market (around 6% of stock), though much of this supply is pre-committed. Like the Sydney market we expect withdrawals of stock will mitigate the remaining supply risk. We forecast around 140,000 sqm will be removed from the market for development and conversion to other use. However unlike Sydney the vacancy rate in Brisbane is likely to peak at around 19%, with the majority of vacancy occurring in secondary grade assets. We expect to see significant upgrade activity as tenants make to most of favourable leasing conditions to improve the quality of their accommodation. Good quality but affordable space such as A grade and upper B assets are best placed to capitalise on this trend as it develops over the next few years.

Supply takes a breather in Perth while rents search for a floor

2015 was a record year for supply in Perth, combining with a weak demand environment to push vacancy up to well over 20%. Thankfully there will be a pause in the supply pipeline for the next two years until the completion of Capital Square in late 2018, and as a result rents should stabilise gradually over the course of this year.

We expect that absorption will remain subdued, however better quality assets will attract the majority of demand as tenants upgrade. There was a pick-up in centralisation activity in Perth during the second half of 2015 and we predict this trend will continue as some tenants may look to move into the CBD at an opportune time.

Some secondary grade assets may be converted to other 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.

Despite tough occupancy market conditions in Perth, valuers tightened yields during 2015. There were minimal transaction during the year, and some evidence of a gap in pricing expectations between vendors and potential purchasers due to challenging leasing conditions. As rents find a floor in the coming periods we expect a pick up in transaction activity as more assets come to market.

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.

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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