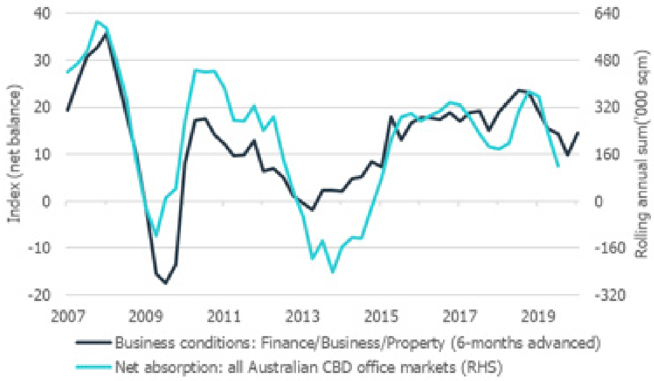
Investa Inside

Office Market Outlook

November 2019

Australian Office Market Outlook In Three Charts

Chart A1: Business Conditions & Office Demand

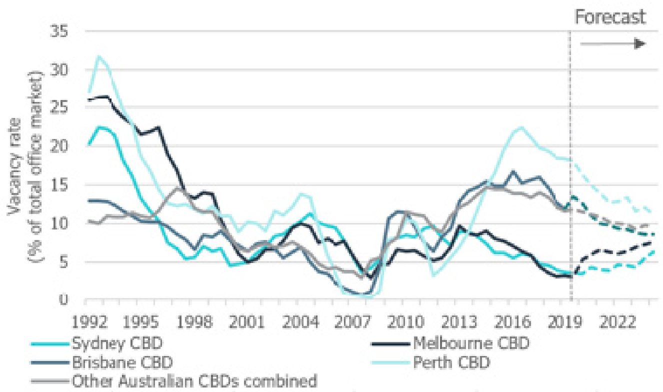


Source: JL Research & Investa Research

Business conditions, net absorption and supply

Despite the softness in Australian macroeconomic conditions, the business services economy has continued to outperform. Benefitting from a combination of subdued input prices (weak wages growth, lower interest rates), a low Australian dollar and solid growth in government spending, positive operating conditions have driven continued white-collar employment growth and outperformance in business services economic activity. Nonetheless, Australian CBD office net absorption slowed in 2019. While cyclical changes in business conditions have a close historical correlation with office net absorption, more recently net absorption has also been constrained by limited office supply.

Chart A2: Office Market Vacancy Rate Forecasts

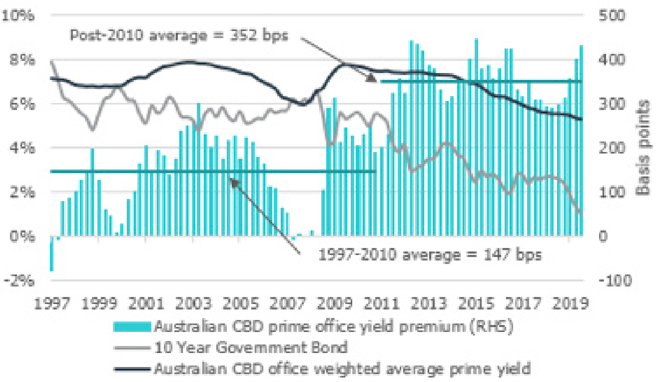


Source: JLL Research & Investa Research

Leasing market conditions to converge

Australia's major office leasing markets have remained tight throughout 2019, particularly in Sydney and Melbourne which are both breaking new long-term lows in vacancy. Despite softer net absorption across most markets, vacancy continued to drive lower under weak supply conditions. While new office supply has been scarce in recent years, and Australia's major capital city office markets of Sydney and Melbourne have been severely undersupplied, the tide of new supply is turning. We expect demand for office space in Australia's major capital city markets will remain positive and net absorption levels will also increase on the completion of the approaching office development pipeline.

Chart A3: Australian Office Yield Premium



Sources: JLL Research, RBA & Investa Research

Cap rates to remain lower for even longer

Capital transaction volumes in Australian CBD office markets broke through a new all-time high at $16.0 billion in the 12 months to September 2019. We expect that the factors which have driven this strong capital market activity, and further downward pressure and compression in Australian office cap rates over the past year, will remain in play for some time yet. In particular, a positive 'through the cycle' outlook for Australia's major capital city office leasing markets will support solid long-term total returns. Consequently, we expect demand for Australian office capital market transactions to remain robust, with cap rates compressing further over the next 12-18 months and looking further ahead will remain lower for even longer.

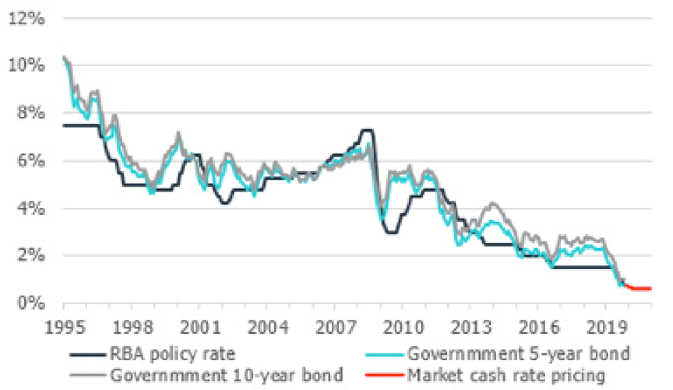
Economic Outlook

Interest rates decline on dovish policy bias

Australian economic growth slowed to 1.4% in the year to June 2019, the lowest annual growth since 2009. In response to softening Australian economic activity, combined with a moderate increase in unemployment and downside risks to the global economic outlook, the RBA has shifted to an easing monetary policy bias in 2019.

Since May, the RBA has cut the cash rate target by 75 basis points (bps) to a new all-time low of 0.75%. Futures markets are pricing in further downward bias in monetary policy, with the RBA putting the prospect of Quantitative Easing on the table if monetary policy warrants the cash rate being cut to 0-0.25% (Chart 1).

Chart 1: RBA Cash Rate & Government Bond Yields



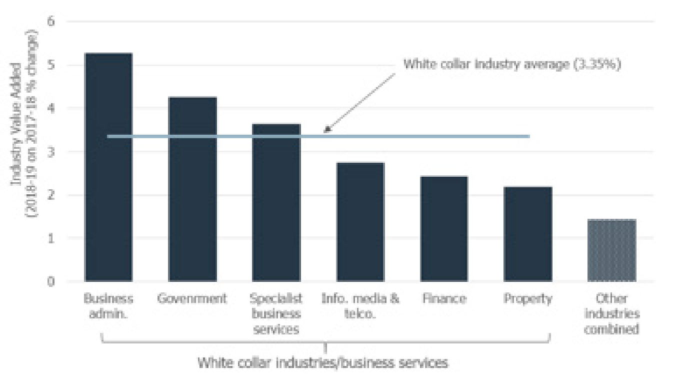
Source: RBA & Investa Research

Business services benefitting from lower rates

Despite the softness in Australian macroeconomic conditions, the business services economy has continued to outperform. Benefitting from a combination of subdued input prices (weak wages growth, lower interest rates), a low Australian dollar and solid growth in government spending, positive operating conditions have driven continued white-collar employment growth and outperformance in business services economic activity.

In the 2018-19 financial year, output from the office-based business economy increased by 3.35% on financial year 2017-18. In comparison, the remainder of the Australian economy increased by a more modest 1.45% (Chart 2).

Chart 2: Industry Economic Growth



Source: ABS & Investa Research

Employment growth supporting office demand

While Australia's unemployment rate has increased moderately in 2019, the Australian economy has added a solid 230,000 jobs in the nine months to September – a touch below the increase in the active workforce population. Of this increase, around 100,000 jobs have been added to the business services sector, or white-collar industries (Chart 3).

Almost all of the growth in white collar employment was generated in specialist business services and business administration in the major capital cities. In comparison, employment in government administration, property and technology have decreased moderately since 2018.

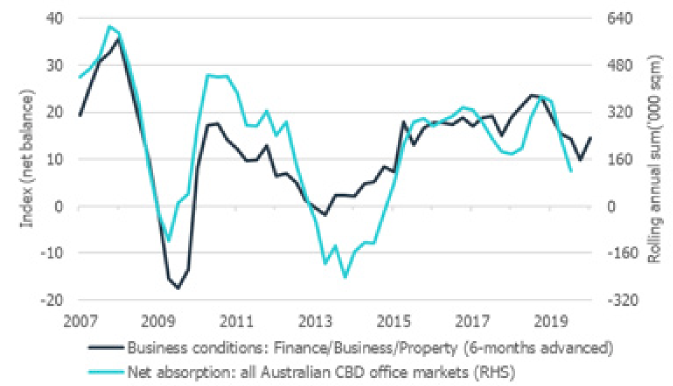
Chart 3: White Collar vs Other Employment

Source: ABS & Investa Research

Office absorption constrained by limited supply

Office-based employment continued to expand across Australia's major capital cities in 2019, however net absorption slowed. While cyclical changes in business conditions have a close historical correlation with office net absorption, more recently net absorption has also been constrained by limited office supply (Chart 4). That is, tight office vacancy in both Sydney and Melbourne – currently the lowest level of vacant office space in these markets in 30 years – and subdued new office supply, has capped the level of growth in occupied office space well below the solid absorption levels of recent years.

Chart 4: Australian Business Conditions & Office Demand



Source: JLL Research, NAB & Investa Research

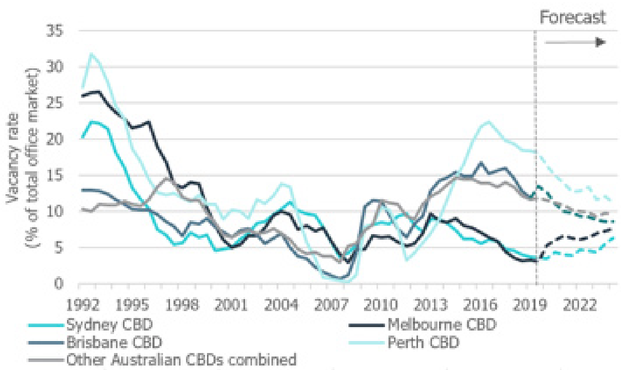
Office Leasing Market Outlook

Leasing market conditions to converge

Office leasing markets have remained tight throughout 2019, particularly in Sydney and Melbourne, which are both breaking new long-term lows in vacancy. Despite softer net absorption across most markets, vacancy continued to drive lower under weak supply conditions. Limited office vacancy in both Sydney and Melbourne have remained under pressure with continued positive demand (Chart 5).

However, Brisbane CBD has presented the sharpest reduction in vacancy in 2019, with positive net absorption contributing to a 56,000sqm reduction in office vacancy (equivalent to 2.3ppts) since the end of 2018. We expect positive business conditions (low interest rates, low Australian dollar and elevated commodity prices) combined with a solid $15 billion pipeline of major infrastructure projects will support office demand and further tightening in Brisbane CBD office market conditions over the next five years.

Chart 5: Office Market Vacancy Rate Forecasts



Source: Property Council & Investa Research (forecasts)

Pre-commitment and office net absorption

While new office supply has been scarce in recent years, and Australia's major capital city office markets of Sydney and Melbourne have been severely undersupplied, the tide of new supply is turning. In contrast to previous supply cycles, pre-commitment is much more of a factor in activating office development.

New developments currently under construction will be close to full on completion and will appear to provide little relief for already tight markets. Of the current office development pipelines in Sydney and Melbourne, a strong demand preference for new prime office space has driven strong pre-commitment rates of around 70-75%.

However, these tenants are largely upgrading from existing office space within the same market. Approximately 15% of the pre-commitment to new CBD office supply under construction in both Sydney and Melbourne will actually make a negative net contribution to the amount of occupied office space.

In total, Sydney and Melbourne's supply pipelines will leave a 120,000sqm and 275,000sqm wave of backfill vacancy respectively in lower grade and older office stock that will need to be occupied or absorbed by new and expanding office-based businesses, or unconfirmed net absorption (Chart 6).

Nonetheless, due to a lack of available high-quality office space, many tenants in Sydney and Melbourne are re-signing at existing space rather than moving, with some holding out until new uncommitted supply options become available in the coming cycle. In addition, we expect to see net absorption levels normalise once the supply cycle strengthens and vacancy approaches equilibrium.

Demand to remain positive on diverse drivers

For Melbourne CBD, strong population gains combined with a diverse tenant base and white-collar employment growth, will support absorption of the backfill space. While the Melbourne market will be faced with an unprecedented surge in supply, we expect the structural drivers of elevated demand in Melbourne will continue to support solid net absorption (~85,000sqm pa), albeit at more moderate levels than historical norms (~95,000 sqm pa) (Charts 6a & 6b).

Chart 6a: Sydney CBD Office Market Balance Forecasts

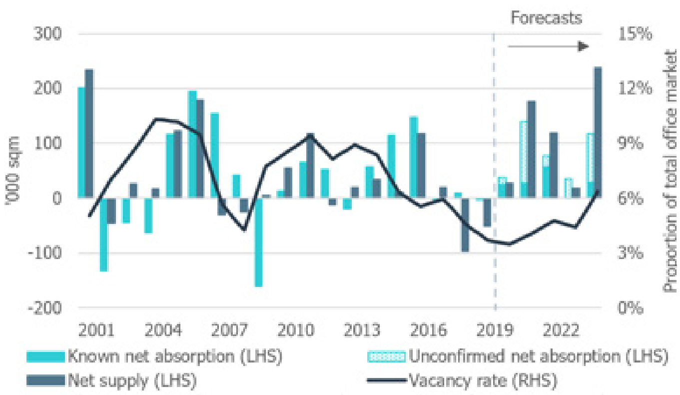
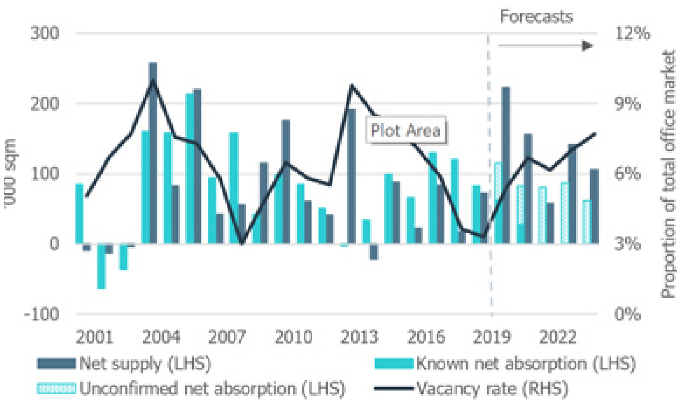


Chart 6b: Melbourne CBD Office Market Balance Forecasts



Source: Property Council & Investa Research (forecasts)

We expect demand for office space in Sydney will remain positive and net absorption levels will also increase on the completion of its office development pipeline. Sydney CBD new tenant demand is likely to continue to be dominated by multinational corporates operating in finance and specialist business services. Consequently, political volatility and economic uncertainty globally will heighten demand for office space in the relatively stable global gateway Sydney CBD market from offshore businesses looking to expand or relocate in the Asia Pacific region.

Further to the diverse cyclical and structural supports to demand for office space mentioned above, the development of major rail transport infrastructure in both Sydney and Melbourne is expected to enhance absorption of CBD office space from suburban market occupiers. Both the Metro Rail (Sydney, Stage 2 to be completed in 2024) and Metro Tunnel (Melbourne, to be completed in 2025/26) projects are expected to significantly improve accessibility to the CBD markets on completion, attracting new tenants from suburban markets into CBD office space.

Supply cycle to refresh prime office markets

The upcoming supply cycle across Australia's office markets will be dominated by Sydney and Melbourne, providing some relief to the tight prevailing office leasing conditions in these markets. More recently, stronger conditions in Australia's other major office markets, led by Brisbane, have also activated a positive outlook for planned office development (Chart 7).

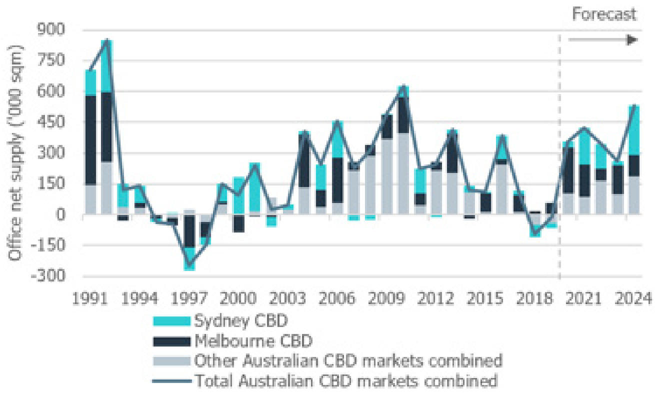
Chart 7: Australian Office Building Approvals

Source: ABS & Investa Research

In contrast to the weak supply conditions across Australia's major office markets over the past few years, completion of new office developments in Melbourne's CBD in the coming year will lead off a strong pipeline of much needed new prime office supply. By mid-2020, Melbourne will welcome five new CBD office developments, adding approximately 265,000sqm of new prime office space to Melbourne's CBD market. In contrast, Sydney's CBD market will see only one new office project complete (adding a modest 6,000sqm) in that time |before Sydney's CBD office supply cycle gathers stronger momentum in 2020-21.

Offsetting the boost to Australia's major capital city office supply from the surge in new office completions, we expect a steady pipeline of temporary withdrawals as backfill assets are refurbished and repositioned to compete with the new supply. This trend is expected to reflect a continued strong demand preference from tenants for high quality office space as evidenced by the elevated pre-commitment levels to the pipeline of new office developments. Consequently, we expect the pipeline of supply will continue to stagger the timing of large project completions through the upcoming supply cycle (Chart 8).

Chart 8: Australian CBD New Office Supply Forecasts



Source: Property Council & Investa Research (forecasts)

Rental growth to continue normalising[1]

Strengthening leasing market conditions and limited office vacancy, combined with strong demand for new office developments, have driven strong office rental growth in both Sydney and Melbourne over recent years. In particular, prime market rents in the tight CBD office markets of Sydney and Melbourne have increased by a solid 24% and 26% respectively over the past three years, largely reflecting a sharp tightening in leasing market conditions.

However, rental growth has started to 'normalise' in both Sydney and Melbourne, more recently in response to a pick-up in office development activity and a positive outlook for new office supply. Since the recent cyclical peak in 2017, prime office rental growth has reduced by more than a third in Sydney's CBD and has more than halved in Melbourne's CBD. Looking ahead, we expect tight, albeit more stable, office leasing conditions will ease rent growth further to 2021 (Charts 9a & 9b).

Easing supply conditions will maintain a softer upward bias on office rental growth compared to recent years. However, low vacancy and positive demand, particularly for high-quality prime CBD office space will sustain positive rental growth through the cycle. That is, new supply and strong pre-commitment deals are expected to carry face rental growth in the medium term, as strong demand for good quality space sets the benchmark for market rents.

[1] All rent and incentives data are reported on a gross basis (ie. including outgoings) for consistency and comparison across markets. Rents and incentives are usually reported on a net basis in Melbourne and Perth.

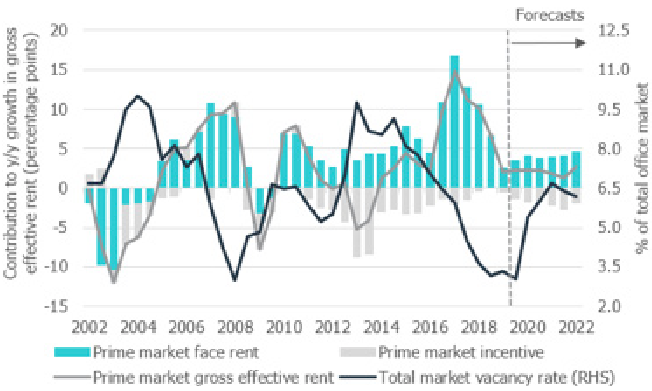
Incentives to remain prominent

In addition to the solid increases in face rents, incentives have boosted rents on an effective basis in Sydney and provided less of a headwind to Melbourne's effective rental growth on weak supply cycles across these two markets.

We believe that incentives have hit both a structural and cyclical trough in Sydney and Melbourne and will start to ease higher in the coming leasing market cycle. As the development pipeline comes to market in both Sydney and Melbourne, incentives are expected to progressively increase, particularly as vacancy in backfill space will also be competing for tenants. This moderate upward pressure on incentives will create a slightly negative drag on effective rental growth, while face rents continue to increase (Charts 9a & 9b).

Chart 9a: Sydney CBD Prime Effective Rent Forecasts

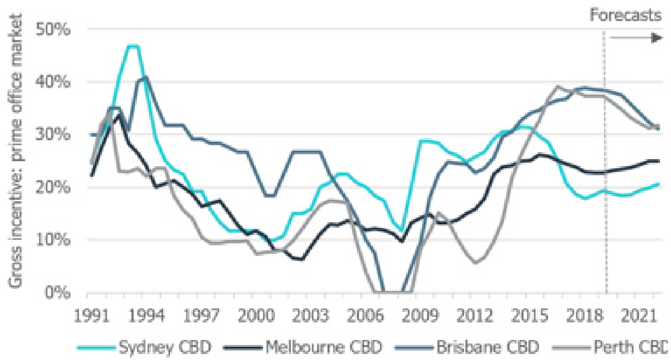
Chart 9b: Melbourne CBD Prime Effective Rent Forecasts



Source: JLL Research & Investa Research (forecasts)

In contrast to Sydney and Melbourne, the outlook for incentives in Brisbane and Perth are expected to drive lower on stronger leasing market conditions. In particular, a weaker pipeline of new office development activity in both of these markets will facilitate continued tightening in incentives, particularly in the respective CBD prime office markets in the coming year (Chart 10).

Chart 10: Australian Prime Office Incentive Forecasts



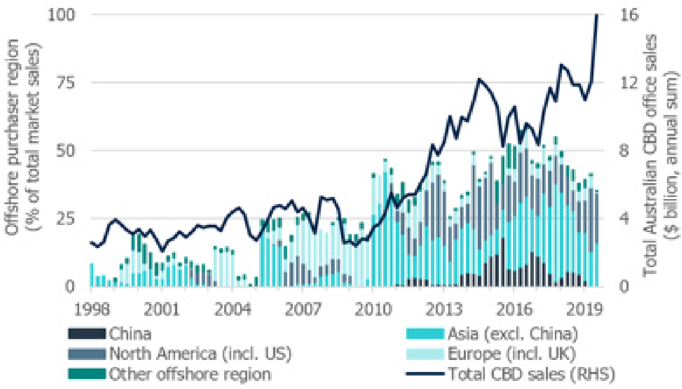
Source: JLL Research & Investa Research (forecasts)

Office Capital Market Outlook

Office capital market activity resurges

Capital transaction volumes in Australian CBD office markets broke through a new all-time high at $16.0 billion in the 12 months to September 2019, despite some softening in Australian economic activity combined with ongoing geopolitical uncertainty and further volatility in global capital markets (Chart 11). The major source of capital has been institutional investors with unlisted wholesale funds, contributing almost 50% of total Australian CBD office capital purchases in the year. In particular, CBD office asset sales to Australian wholesale funds contributed $5.4 billion (~34%) to the total capital transacted in the year.

Chart 11: Australian Office Capital Transactions

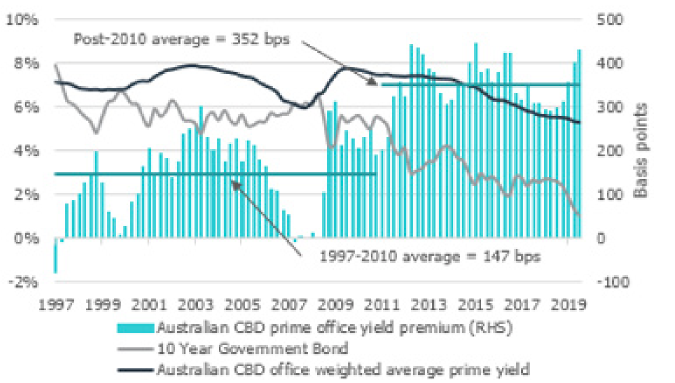


Source: JLL Research & Investa Research

Strong capital market activity has reflected a solid appetite from both domestic and offshore investors for the stable and elevated returns provided by Australia's major capital city office markets. In comparison to other asset classes, which are seeing lower returns and increased volatility, Australian office markets have maintained strong capital growth and income returns.

Prime office cap rates have compressed further in 2019 while the 'yield premium', or excess return on Australian CBD prime office property compared to Australian 10-year government bonds, has increased to a touch over 430 basis points (Chart 12).

Chart 12: Australian Office Yield Research



Source: JLL Research & Investa Research

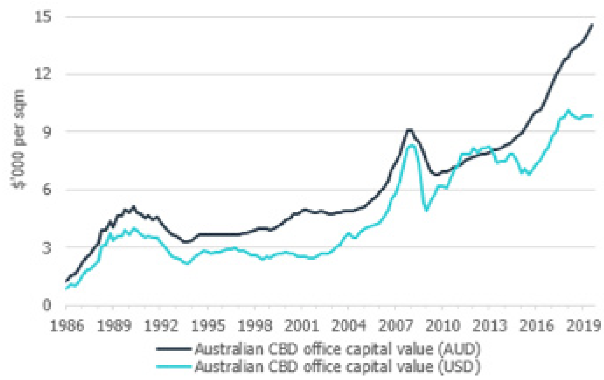
Australian office capital markets remain cyclical and will continue to reflect broader economic and financial market conditions. However, in contrast to the relatively volatile historical Australian office returns and yield premium (ie. before 2011), Australian office capital markets have provided more stable and elevated returns over the past decade. In fact, since 2010, benchmark 'risk-free' rates, such as the 10-year Australian Government bond rate have been more volatile (decreasing by ~450 basis points) in comparison to a more modest 210 basis points in Australian CBD prime office yields.

Cap rates to remain lower for even longer

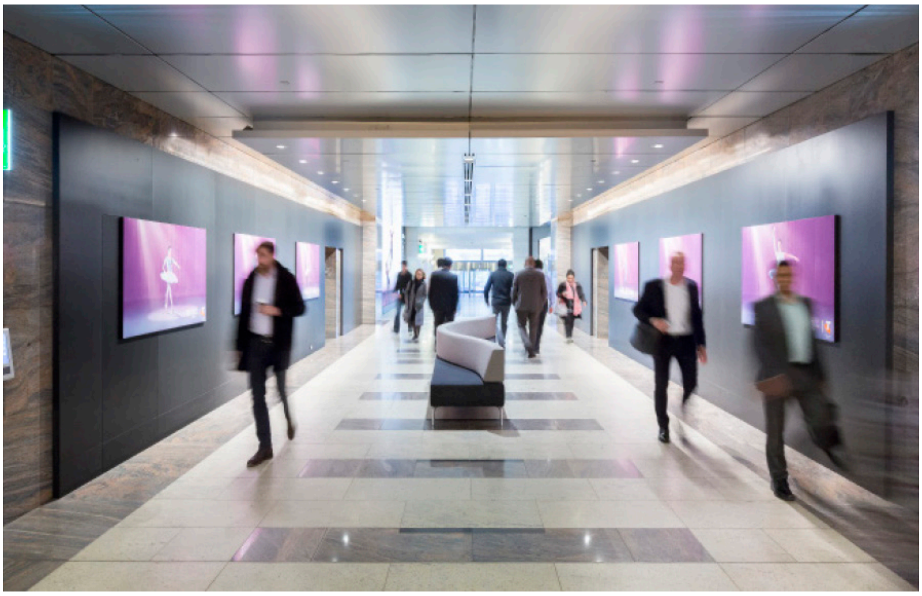
In addition, lower Australian interest rates have added downward pressure to the Australian dollar, maintaining Australian office capital value affordability to yield seeking investors. While Australian CBD office capital values have increased a solid 8.6% over the past year to an average of $AUD 14,500, a lower Australian dollar (AUD) against the US dollar (USD) has maintained Australian office capital values at a relatively stable $USD9,700-9,900 over the past 12 months. Consequently, Australian office markets continue to offer favourable affordability as well as high yield to offshore global investors (Chart 13).

We expect that the factors which have driven further downward pressure, and 20-25 basis points of compression in Australian office cap rates over the past year, will remain in play for some time yet. In particular, a positive through-the-cycle leasing outlook for Australia's major capital city markets will support solid long-term total returns. Consequently, we expect demand for Australian capital city office capital market transactions will remain robust, with cap rates compressing further over the next 12-18 months and looking further ahead, will remain lower for even longer.

Chart 13: Australian CBD Office Capital Values



Source: JLL Research, RBA & Investa Research



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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

Investa is a leading Australian real estate company managing close to A$13 billion of quality office real estate. As a specialist office manager of commercial office buildings Investa manages manages 32 assets in the key Australian CBD markets on behalf of ICPF, Oxford Investa Property Partners (OIPP) and private mandates. Its end-to-end real estate platform incorporates funds, asset, property and facilities management, development, sustainability, capital transactions and research.

Investa strives to create Australia's most valued working places be the first choice in Australian office, by delivering consistent outperformance for its investors and exceeding the expectations of its tenants and staff, while remaining an industry leader in sustainable building management and responsible property investment.