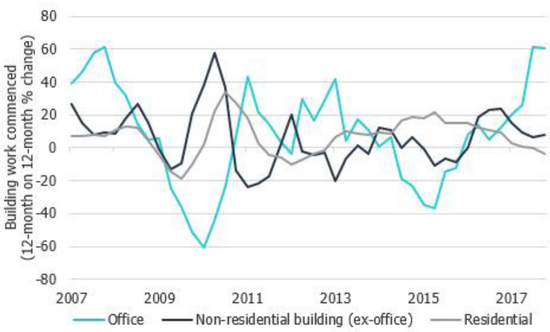
Investa Inside

Q2 Office Market Outlook

May 2018

Australian Office Market Outlook In Three Charts

Chart A1: Australian Property Construction

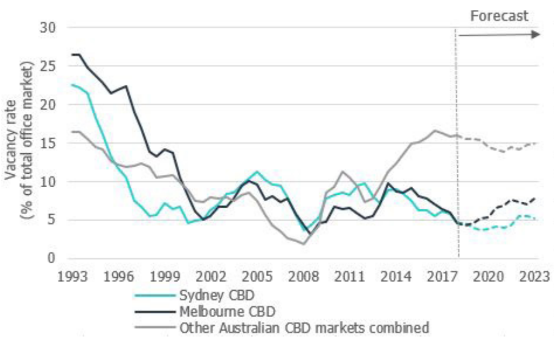


Source: ABS & Investa Research

Commercial office construction to the fore

Following the lull in commercial property construction in recent years, strong leasing market fundamentals in Sydney and Melbourne's office markets have driven a solid rebound in office development. A surge in new office projects is filling the void left by the slowdown in residential property construction, with annual office commencements 60% (or $3.16 billion) higher in 2017. This growth is creating supply-chain bottleneck issues and driving the cost of building materials and development higher. See Box 1 of Investa Inside for more detail.

Chart A2: Australian Office Leasing Market Conditions

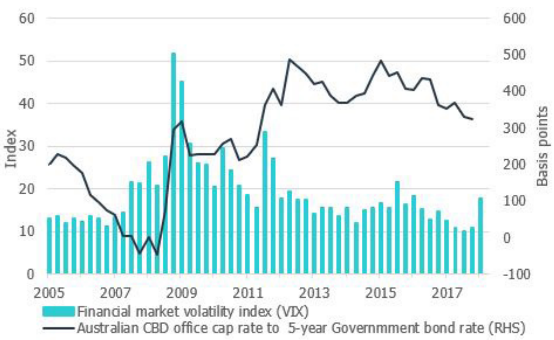


Source: Property Council & Investa Research

CBD office market conditions wedge

Australian CBD office conditions continue to reflect two-speed markets. Office leasing markets in Sydney and Melbourne are the clear outperformers with vacancy rates driving below 5%, towards new decade-lows. While leasing conditions across the other Australian CBD markets remain soft, recent indicators point to an improved outlook in the coming years. Looking ahead, we expect the relative outperformance of Sydney and Melbourne's CBD office markets, or the wedge in office market conditions, will ease in the coming years.

Chart A3: Australian CBD Cap Rates & Financial Markets



Source: Property Council-IPD, RBA & Investa Research

Capital markets weather financial jitters

Australian office capital markets have remained steady in the face of both increasing bond market yields and the recent spike in financial market volatility. We expect investor demand and capital flows will continue to be attracted to Australian CBD office markets for some time yet. Despite office market cap rates compressing a further 40 basis points across Australian CBD markets in 2017, strong total returns and favourable underlying market conditions are likely to maintain downward pressure on Australian CBD office cap rates in the coming year.

Economic Outlook

Business conditions support positive outlook

Australia's 27th consecutive year of economic growth looks set to continue for some time yet, supported by a positive outlook for the business economy and the office-based services sector. Business conditions for the finance, business services and property sectors are the strongest they've been in over a decade and profit growth across white-collar businesses remains strong (Chart 1).

Chart 1: White Collar Business Conditions & Profit

Source: ABS, NAB & Investa Research

Nonetheless, white-collar employment stumbled somewhat in 2017 on lower government employment. Looking ahead, solid growth in government investment and a healthy pipeline of major public infrastructure projects is expected to support public sector employment growth in 2018. Further details of this will be provided in the 2018-19 Commonwealth and State Budget releases.

Fuelled by both solid public sector investment and increasing private sector business investment, NSW and Victoria are expected to continue to generate solid economic growth and a positive business sector outlook in the coming year. In addition, the economic outlook for Queensland, WA, SA and the ACT have all improved over the course of 2017, with state final demand in all these jurisdictions stronger than the previous five-year average.

Reflecting the broad-based momentum of the business services economy across all states and territories, property market confidence and the outlook for the property sector has converged at cyclical highs recently (Chart 2).

Chart 2: Property Sector Confidence

Source: ANZ-Property Council & Investa Research

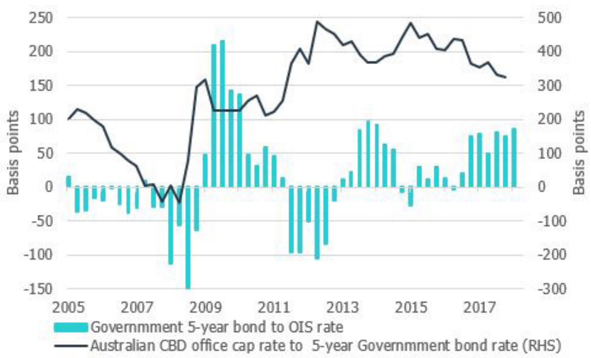
While labour costs remain largely benign and markets view interest rates will stay anchored at historical lows for at least another year, solid growth in both public sector and business investment is driving prices higher in building materials markets and is starting to fuel wage growth in the construction industry. In Box 1: CBD Office Development we analyse the Australian CBD office development pipeline and the impact of stronger office construction activity on development input prices.

Rates to remain lower for longer

Higher global interest rates have maintained moderate upward pressure on Australian Government bond yields, while accommodative RBA policy has kept the overnight cash rate at an all-time low of 1.50% since August 2016. Looking ahead, rates markets have this trend continuing for some time yet, with the overnight cash rate not expected to increase until at least mid-2019. Consequently, the spread between longer-dated bonds and the Overnight Cash Rate has widened to a 3-year high, reflected in a steepening of the yield curve.

At the same time, yields or cap rates on Australian CBD office property have compressed. Historically, a steepening of the yield curve has coincided with a tightening cycle in office cap rates followed by some cap rate softening as the yield curve flattens (Chart 3). While we expect this cyclical trend to continue, we forecast that the softening cap rates will be more moderate in the current cycle compared to previous cycles. The strength of investor demand for Australian CBD prime office assets is likely to maintain cap rates at, or moderately below current levels through 2018 and into 2019 (see Capital transactions… are we at the bottom section for more detail).

Chart 3: CBD Office Risk Premium & 5-year Bond Spread



Source: ABS, NAB & Investa Research

Office Market Outlook

Leasing markets tighten on weak supply

While the office development cycles of Sydney and Melbourne are gaining momentum, the lagged impact of weak office development across most major Australian markets in recent years past are driving tighter leasing conditions. In fact, with the exception of Perth's CBD (increasing by a meagre 560 sqm), the size of all Australian CBD office markets decreased in the March quarter 2018 with net supply lower. Consequently, office vacancy rates tightened across all Australian CBD markets, except Sydney and Adelaide where negative net absorption slightly outweighed the reduction in office space.

In contrast to recent weak supply conditions, the Australian CBD office supply outlook is buoyant. Almost 720,000 sqm of space is currently under construction, with the size of the Australian CBD office market to increase by more than 4% as this development cycle is delivered (see New office supply approaching section and Box 1: CBD Office Development for more detail).

Looking ahead, we expect that underlying momentum in economic activity, and more specifically the business services economy will support net absorption of office space. Melbourne and Brisbane in particular are expected to receive a boost to net absorption with tenants likely to centralise from neighbouring suburban markets. However, leasing market conditions across all major CBD office markets will largely reflect the relative strength of supply, to converge in the coming years. Vacancy in Melbourne's CBD is likely to ease from a low of 4.4% at the end of 2018 to 6.5-7.0% in 2020 and further to 7.5-8.0% by 2022. In contrast, Sydney's later development cycle will not soften leasing markets until 2021. Until then Sydney's CBD is expected to maintain tight conditions, with the vacancy rate to reach a cyclical low of 3.5-3.75% in 2019. The outlook for subdued office development in Brisbane and Perth, combined with positive net absorption, will drive downward pressure on elevated vacancy rates in these CBD office markets in the coming years (Chart 4).

Chart 4: Office Market Balance Forecasts

Source: PCA & Investa Research

New office supply approaching

Coming off a slow start to the year, with no new additions to Australian CBD office markets in the first quarter of 2018, the current pipeline of development activity will start to come online in the second half of 2018. The largest share of new supply will be added in Sydney and Melbourne's CBD office markets, with the development pipeline in other markets showing a subdued supply outlook.

In Sydney's CBD the early-stage supply cycle looks to be measured, with new stock additions arriving in smaller projects in the earlier years of the cycle, followed by larger new office projects and refurbishments in greater number, from 2020 onwards.

Investa Office Fund's (IOF) Barrack Place, at 151 Clarence Street will be the only significant office project to be delivered to Sydney's CBD in 2018 with a total of 20,400 sqm leading off Sydney's CBD office supply cycle. However, withdrawal activity in Sydney's CBD is expected to continue to provide a supply headwind and drive negative net supply in the second half of 2018 and through 2019. The only major new office project countering the negative tide of withdrawals in 2019 will be Investa Commercial Property Fund's (ICPF) 60 Martin Place, adding 40,300 sqm to Sydney's CBD office market in H2 2019. Following on from these projects, the belly of the supply cycle will provide a further 210,000 sqm across projects including Wynyard Place (~68,000 sqm, H2 2021), Quay Quarter (~90,000 sqm, H2 2021) and Circular Quay Tower (~55,000 sqm, H2 2021).

In comparison, Melbourne's CBD office development cycle is expected to provide a steady stream of new office supply over the next five years. In particular, Docklands is expected to receive an injection of around 365,000 sqm over this period (~40% increase in the Docklands office market). In comparison to Sydney's supply pipeline (albeit to be delivered with a time lag to Melbourne) the current pipeline of new office projects under construction in Melbourne's CBD has less speculative space (75% pre-committed). However, within this total Docklands has less than 50% of space pre-committed. 2020 is shaping up to be the year of peak office completions in Melbourne, with a projected 239,000 sqm of new office supply to be delivered in the year (including Collins Arch ~51,000 sqm, Olderfleet Place ~54,000 sqm, 80 Collins South Tower ~43,000 sqm and Wesley Place ~55,000 sqm).

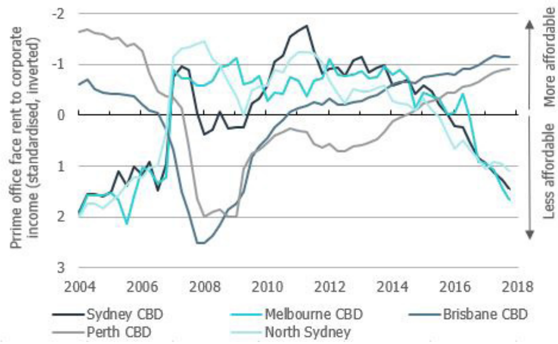
Challenging leasing conditions in both Perth and Brisbane's CBD markets in recent years have left a subdued pipeline in their wake. However, a positive outlook and a cyclical recovery in Brisbane's CBD prime office leasing market has seen an improvement in new office project feasibilities in the pipeline. A positive outlook for prime office absorption and potential leasing commitments, including the significant Suncorp brief, have buoyed the delivery of future office projects in Brisbane's CBD pipeline. While Shayer Group's speculative office project at 300 George Street (~48,000 sqm) is the only project currently under construction (expected to be delivered in mid-2019) a number of new office development projects are firming up. These include ICPF's 360 Queen Street (~50,000 sqm), 80 Ann Street (~75,000 sqm), The Regent Building (~55,000 sqm) and 62 Mary Street (~38,000 sqm).

Rent growth to converge across markets

Strong leasing market conditions have supported solid growth in Sydney and Melbourne face rents, while lower incentives have provided a further boost to effective rents (allowing for rent-free incentives). At the same time, white collar business income and profit growth has accelerated.

Nonetheless, reflecting the strong cyclical leasing market conditions, office rental affordability has deteriorated in both Sydney and Melbourne's CBD with prime face rents outpacing growth in white collar income. North Sydney rental affordability has also declined to a lesser degree. In contrast, Brisbane and Perth CBD rents have only recently posted some moderate growth and remain affordable compared to the elevated levels through 2007-08 and 2012-13 (Chart 5).

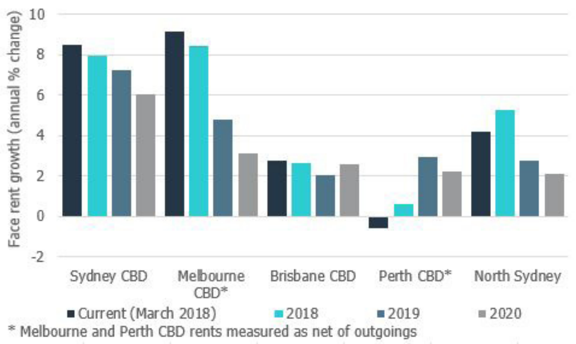
Chart 5: Office rental affordability



Source: ABS, JLL Research & Investa Research

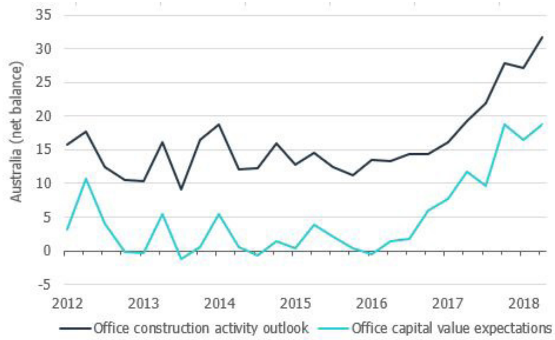
Looking ahead, we expect that leasing market conditions will continue to determine the relative strength of rental growth, particularly in effective terms, while a degree of reversion will soften face rent growth in Sydney and Melbourne CBD prime office markets over the next 2 years. In contrast, we expect rents to gather some moderate positive momentum in Brisbane and Perth over the same period (Chart 6).

Chart 6: Office Market Rent Forecasts



Source: JLL Research & Investa Research (forecasts)

Chart 7: Office Outlook: Construction & Capital Values



Source: ANZ-Property Council & Investa Research

Cyclical improvement in CBD leasing markets are also expected to generate continued downward pressure on incentive levels. There is still ample capacity for incentives to decline over the next five-plus years in Brisbane and Perth. However, Sydney and Melbourne incentives are likely to trough in the next 1½-2 years before easing moderately as new supply from the current development cycles creates price competition for new leases commitments.

Capital transactions… are we at the bottom?

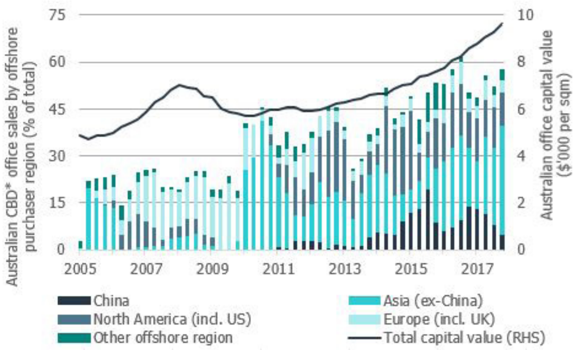
Office capital market analysts have been asking this question for at least the past two years. We expect that cap rates have troughed in many Australian office markets. However, solid demand for a limited pool of CBD prime office assets is likely to maintain cap rates at, or around current levels for at least another 6-12 months. Three factors underpinning this view are:

- Despite tightening sharply in recent years, relative yields on Australian CBD office assets remain attractive compared to alternative asset classes and global property markets.
- Global investors continue to indicate intentions to increase direct exposure to Australia's office markets with global (Asia Pacific in particular) capital portfolio allocations remaining underweight in Australian office property, particularly in Sydney and Melbourne.
- Despite volatility in financial markets through 2018, the depth of capital markets remain strong. Equity markets are buoyant, business profits are surging, pull-back in quantitative easing is gradual and the global economic backdrop is positive.

The main source of global capital buying Australian CBD office property continued to be derived from Asia Pacific investors, with the drop off in China-sourced capital offset by a stronger presence of capital from Singapore, Hong Kong and Japan (Chart 8). Consequently, transaction volumes remained strong and cap rates tightened across all CBD office markets through 2017.

Looking ahead, we expect the weight of global capital seeking Australian property exposure will remain steady. In addition, solid income growth off the back of improving leasing market conditions, will provide attractive total returns for high yield-seeking investors. Consequently, we expect CBD office cap rates will reach the bottom of the cycle in 2018. However, we are looking for capital markets to maintain CBD office cap rates at the current cyclical lows until mid to late-2019.

Chart 8: Office Capital Transactions & Capital Values



Source: JLL Research, Property Council-IPD & Investa Research

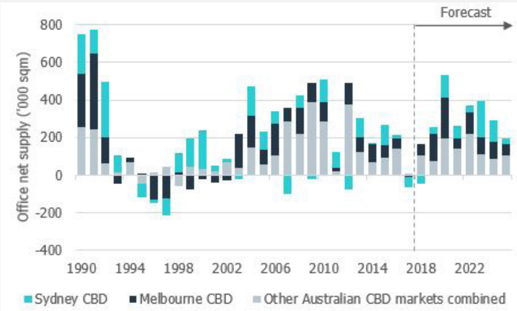
Box 1: CBD Office Development

- Investa's forecasts point to new office supply across Australia's CBD markets hitting a 30-year high as soon as 2020.
- Strong office development is facing a headwind of supply-chain bottlenecks and increased building materials prices.

Office construction: regeneration & growth

Following a five-year lull in office construction, Australian CBD office development is activating. In response to strong market fundamentals and solid total returns, both Sydney and Melbourne's CBD office markets are leading the charge, in the early stages of a strong supply cycle. This will provide the largest annual injection of Australian CBD new office supply in almost 30 years in 2020, and a much-needed generational refresh of office stock in Australia's two largest markets (Chart 1.1).

Chart 1.1: Australian CBD Office Supply



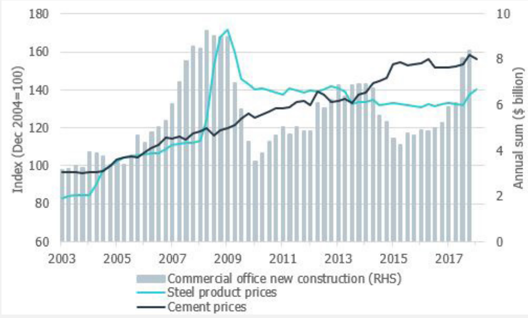
Source: ABS, JLL Research & Investa Research

Aided by the combined supply surge and the withdrawal of 50,000 sqm of lower grade office stock for the development of rail infrastructure in in 2017, the prime office market share in Sydney's CBD is expected to increase from 54% only three years ago to 68% by 2024.

Development dynamics: input price pressure

Led by the combined surge in office construction and public infrastructure development, construction work completed in the year to March 2018 posted the largest annual increase (~$19 billion) since the mining boom. While the level of current office development pales in comparison to mining investment in 2012-13, it is creating similar supply-chain bottlenecks and input price pressures. Combined with strong demand for building materials for public infrastructure development and the tail-end of a residential construction boom, the surge in Australian CBD office construction is adding pressure to undersupplied building material markets. Consequently, the price of steel and cement have increased by a strong 6½% and 3% respectively in the past year and a half (Chart 1.2).

Chart 1.2: Construction & Building Material Prices



Source: ABS, RBA & Investa Research

In addition, jobs growth in construction outpaced other sectors in 2017 to contribute its highest share of total employment (9.6%) in February 2018. Despite recorded wage growth in construction remaining subdued at 1.9% y/y at the end of 2017, more recently we have started to see early signs that tight construction labour market conditions are driving stronger wage growth. We expect both surging office construction combined with record levels of infrastructure development will continue to drive stronger growth in construction labour costs through the second half of 2018, and further into the current development cycle.

The new supply cycle… or the last of its kind

As has been the case through every previous office cycle, market conditions will ebb and flow and development cycles will lag prevailing conditions.

There's no doubt that new office development sites are becoming increasingly rare within the the existing CBD footprints, recently reflected in the pipeline of withdrawals for redevelopment in Sydney's CBD. However, as sure as the current supply cycle will come and go, natural growth in occupier demand for office space will spur office development, one way or another.

Faced with the headwinds of congestion and political conservatism, development innovation is rapidly advancing with respect to site amalgamation, tighter footprints, and more efficient workspace and building design. Consequently, we expect that office development in Australia's major CBD markets will continue to prevail and the current supply cycle is more likely to be the 'new norm' rather than the last of its kind.

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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 more than A$11 billion of quality office real estate. As a specialist office manager of commercial office buildings Investa manages more than 37 assets in the key Australian CBD markets on behalf of ICPF, the ASX-listed Investa Office Fund (IOF) 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.

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