INVESTA OFFICE

Inside

Q1 2016
Office Market Update
April 2016

> The global economic environment has steadied and financial market volatility has reduced significantly since the start of the year.
> The domestic economy remains solid, with the unemployment rate gradually trending down – led by white-collar sector employment growth.
> As a result tenant demand continues to be very strong in Sydney and Melbourne, and this is placing downward pressure on vacancy rates and driving rental growth.
> Capital markets continue to be well supported by volumes and further yield compression was evident during Q1.

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 Q1 2016. All analysis and views of future market conditions are solely those of Investa Office.

Economic Overview

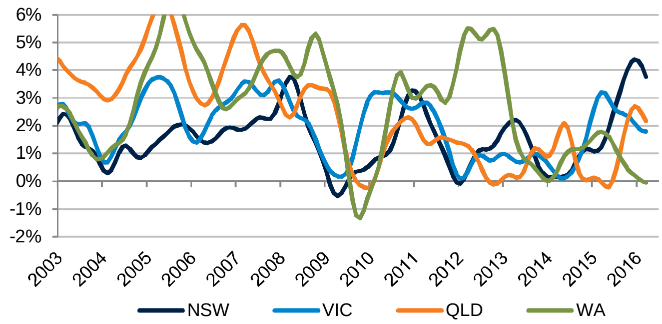
Global economic conditions stabilise as Australian labour markets strengthen

After a nervous end to the prior year, 2016 has started with a gradual stabilisation of global economic conditions. The S&P VIX index, a measure of share market volatility, has more than halved since the recent peak in early February, and is now comfortably below the long-term average. Likewise commodity prices have increased over the quarter, up 6.7%[1] since December.

Generally the major themes from last year are still exerting an influence on the global economy. Developed nations, on balance, are driving most of the world's economic growth, albeit at a below trend pace. The US continues to recover; however, while the labour market remains strong, with the unemployment rate now at just 5%, the manufacturing sector has weakened in recent periods, impacted by the rising $US. This development may slow the rate of any Federal Reserve interest rate increases over the remainder of the year. Nonetheless US PMI was recently recorded at 51.4, which indicates the economy is still in expansionary territory.

These global dynamics are impacting Australia. Commodity prices, although improved during Q1, remain well below recent peaks and this is placing pressure on the profitability of resources companies, and as a result the prospect of new mining projects commencing in the short-term are slim. However, the economic transition away from mining is becoming increasingly entrenched. This is demonstrated by the continued strength of the domestic labour market. Employment expanded by a healthy 2% over the year to March – a strong performance given that GDP has grown at a below trend pace over the same time period, impacted by reducing mining investment. The bulk of these new jobs have been created in the Eastern Seaboard states of NSW and VIC.

CHART 1: STATE ANNUAL EMPLOYMENT GROWTH



Source: ABS and Investa Research

NSW in particular is benefiting from a high weighting to Business Services and Finance & Insurance industries and also a significant pipeline of Government infrastructure projects. As a result the unemployment rate is falling, and now sits at 5.3%. For the first time since the 1980s the NSW share of the Australian population has increased, highlighting that some of those workers attracted to WA and QLD during the mining boom are now returning to NSW. This trend is also playing out in VIC, which is also benefitting from a strengthening economy. VIC has the fastest rate of population growth in the country, aided by more affordable housing than NSW.

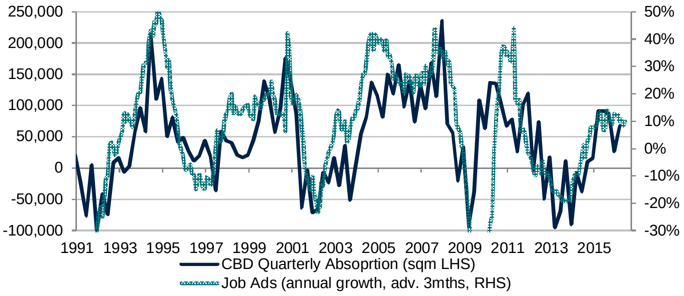
The flipside of this positive momentum is being experienced in WA and to a lesser extent QLD. Although the ramp up in resources production is supporting economic output, unemployment is increasing as large-scale mining investment projects either wind-up or are placed on hold (like the Browse floating LNG plant). QLD sits somewhere in the middle lane between the strong

[1] Source: RBA index of commodity prices 1/4/16 - $US based

performance of NSW/VIC and the mining related weakness being experienced in WA. Some industry sectors are being supported by a lower $AUD and interest rates - education and tourism for example - where at the same time mining and related industries are struggling.

These labour market trends can be observed in office market absorption data, with strong demand for office space recorded in Sydney and Melbourne, thanks to white-collar business expansion. Space is being absorbed in Brisbane at around the long-term average rate, supported by some tenant relocations into the CBD, whereas tenants continue to contract in Perth. Encouragingly lead indicators of employment remain positive and the current level of job advertisements implies that CBD absorption should hold at current levels over the short-term.

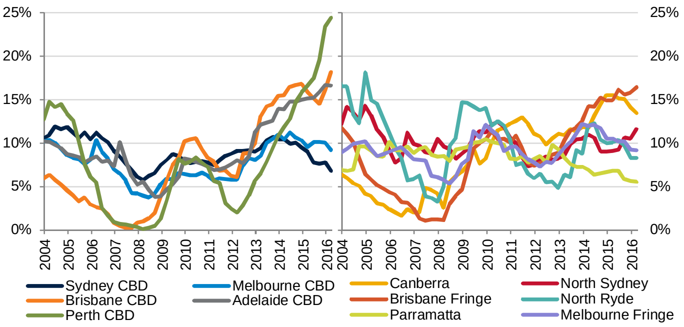
CHART 2: CBD ABSORPTION AND JOB ADS



Source: ANZ, JLL Research and Investa Research

Office Market Overview

CHART 3: VACANCY RATES



Source: JLL Research and Investa Research

Vacancy rates compress in Sydney and Melbourne…

Vacancy rates continue to wind back in Sydney and Melbourne due to continued strong demand for space. Sydney CBD has tightened to 6.8%, a fall of 1% over the quarter. Conditions are becoming very tight in the A grade (5.5%) and B grade (6.7%) segments of the market, which together make up around 70% of total stock. Premium grade vacancy remains elevated at 11.4% and we expect this to increase as the Barangaroo project reaches completion. Other Sydney metropolitan markets are also performing well, and overall the metropolitan vacancy rate is now 7.7%, a tightening of 1.6% on last year.

Melbourne is also improving and the CBD vacancy rate contracted to 9.2%, almost a percentage point over the quarter but only 0.4% over 12 months, as there has been supply delivered to the market over the course of the year. Melbourne Fringe is also tightening, down 1.3% to 9.2% over 12 months.

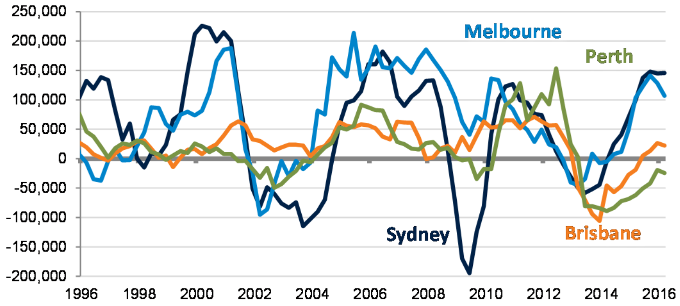
…however remain under upward pressure in Brisbane and Perth

New supply has driven the vacancy rate up further in Brisbane, and it now sits at 18.2%, a new record high, while Brisbane Fringe also saw vacancy rise to 16.4% (+1.5% year-on-year). Perth continues to face challenges. The supply cycle is now complete, with no new major supply predicted until Capital Square is due to be finalised in 2018. However, the demand remains weak and tenants are still in contraction mode, particularly those that service the mining industry, driving up the vacancy rate to 25.4% - an increase of 7.9% over 12 months.

Canberra improves while Adelaide turns the corner

Market conditions are improving in Canberra, thanks to a gradual pick-up in demand fundamentals and little new supply completions in recent times. Vacancy now sits at 13.4%, down 1.8% over the year. The market is more subdued in Adelaide where new supply additions have increased the vacancy rate to 16.6%. Demand overall is treading water, and there has been little take up of space over the last two years. However, there is upgrade activity underway, and the Prime vacancy rate is significantly lower than the overall market at 10.6%.

CHART 4: CBD ANNUAL NET ABSORPTION (SQM)



Source: JLL Research and Investa Research

Sydney and Melbourne tenants taking more space

Absorption continues to be recorded at a very strong rate in Sydney. The quarter saw 37,000 sqm absorbed, and the annual rate of 146,000 sqm is more than twice the 10 year average. Over 80% of net demand over the last 12 months has been driven by the A grade market, and much of this has been from tenants who occupy less than 1,000 sqm of space. Looking at metropolitan markets, on a net basis absorption has been mildly negative over the last year. Centralisation is a significant factor, and a lack of options is resulting in many tenants looking to move into the CBD. Similar trends are playing out in Melbourne, with the CBD recording strong growth similar to Sydney (+107,000 sqm year-on-year and +31,000 sqm quarter-on-quarter).

Brisbane CBD has posted positive demand for the fifth consecutive quarter (+2,600 sqm) and on an annual basis absorption has returned to the long-term average level (+22,000 sqm). We expect that we are through the worst from a demand perspective, and we expect momentum to improve from here; however, one caveat to that view is the potential for State Government tenants to hand back space on relocation to 1 William Street on completion, due to increased efficiencies. However, there are signs that State Government are increasing headcount now and this is likely to mitigate much of this risk.

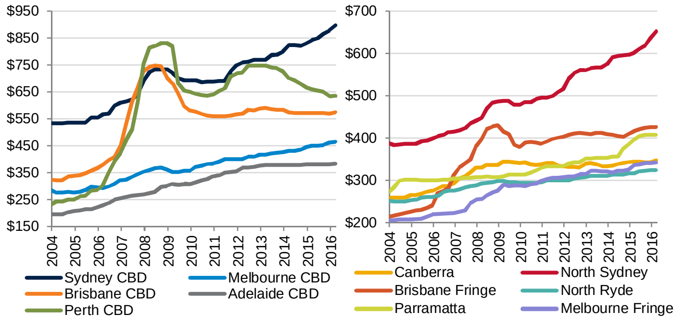
Perth continues to face major demand hurdles. The rate of tenant contraction had been reducing for seven quarters until the latest data, which saw a rebound of negative absorption (-17,000 sqm).

There are some common themes across all monitored markets in terms of demand dynamics. The strongest trend underway is centralisation which is impacting all the major markets (to varying degrees), as is the impact of conversion of assets to other use, which forces tenants into the market, and in many cases results in upgrade activity. Centralisation is having the greatest impact in Melbourne, accounting for around 50% of CBD absorption over the year, compared to only around 7% in Sydney. Brisbane Fringe is also being impacted, with 9,000 sqm of tenants moving into the CBD, which accounts for the majority of the 11,000 sqm of space that was handed back by tenants in that market over the year. Perth CBD is also benefitting from tenant relocations from smaller sub-markets (+13,000 sqm year-on-year), however this has been unable to offset the impact of tenants giving up space.

Occupancy fundamentals driving rents, benefitting Sydney

Due to strong leasing fundamentals, Sydney CBD and North Sydney are leading the way in terms of rental growth, recording +6.6% and +8.4% Prime net face growth respectively on an annual basis. The evidence suggests that the majority of the Prime face rental growth recorded over the year has been occurring in the A grade market where conditions have been very strong. Melbourne is also experiencing growth, but at a lower rate; +3.5% growth in the CBD over the last year and +1.6% in the Fringe. Brisbane CBD face rents have remained stable over the year, however Perth net rents continue to fall (-3.7% year-on-year) in line with increasing vacancy.

CHART 5: PRIME NET FACE RENTS



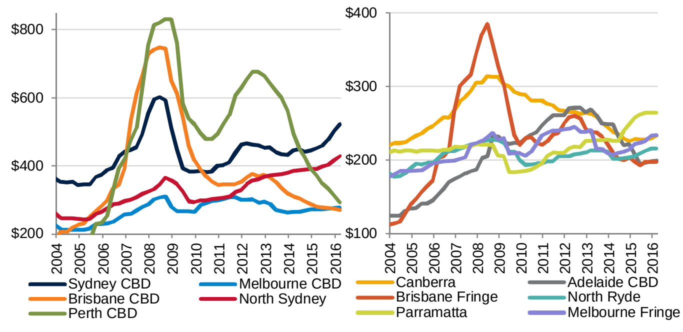
Source: JLL Research and Investa Research

Effective rents bolstered in Sydney by reducing incentives, but stable in other locations…for now

The tide is slowing turning for tenant incentives. Sydney is leading the way, with incentives for new leases falling by 2.6% to 29.0% over the course of the year. However, we are now seeing the discount for renewal incentive re-establish itself in the Sydney market. The incentive discount on renewal compared to new lease has historically been around 20%, however during the GFC this eroded as owners looked to secure cash flow. This spread is re-emerging as options become tight for tenants in certain market segments, a good example being the B grade market which is seeing available option reduce quickly, and as a result incentives are below 20% in some cases.

We expect that other markets will follow Sydney in time, with Melbourne CBD the next likely candidate. Evidence of this trend taking hold can be seen in Melbourne Fringe which has already seen incentives wind back, a solid reduction of 1.7% over the year. Canberra and Adelaide are relatively stable, whereas Brisbane (+2.0% year-on-year) and Perth (+10.3% year-on-year) continue to see upward incentive pressure, although we expect Brisbane incentives should stabilise in the coming periods.

CHART 6: PRIME NET EFFECTIVE RENTS



Source: JLL Research and Investa Research

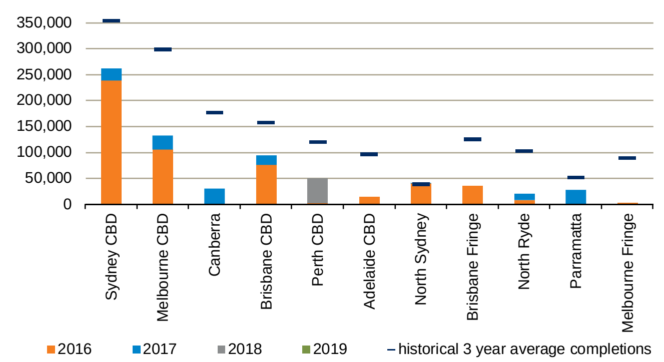
Sydney effective rents boosted by tightening incentives

Prime net effective rental growth has escalated in Sydney, recording 15.7% growth over 12 months – a strong result reflecting the improving market dynamics for owners. However, in our view these statistics have been dampened by the Premium grade market where rental growth has been relatively subdued, and the majority of this growth has been driven by the A grade market. B grade effective rents are also expanding rapidly (+20.4% year-on-year), as the prospect of significant withdrawals of stock start to impact on the number of options available for tenants who need to relocate. All other monitored Sydney markets are following suit, with North Sydney (+9.6%), Macquarie Park (+5.0%) and Parramatta (+2.6%) experiencing upward pressure on effective rents over the year.

Melbourne is lagging the rental dynamics of Sydney, but nonetheless rental returns are improving. CBD effective rents expanded by 2.1% over the year, with Melbourne Fringe slightly stronger at 5.4%. Canberra has also turned the corner thanks to improving demand, and effective rents grew by 2.2% over the year.

Brisbane remains challenged, although the rate of rental decline is slowing. CBD rents fell by 3.8% over the year, driven by upward incentive pressure. However, conditions in the Fringe have stabilised over the same period, which suggests the market overall is close to finding a rental floor. Perth is still searching for the bottom however. Effective rents have declined by 21.5% over the year, and a third of this adjustment occurred during this quarter.

CHART 7: SUPPLY UNDER CONSTRUCTION (SQM)



Source: JLL Research and Investa Research

Supply cycle nears the peak, FY17-18 to be undersupplied

The supply pipeline is heavily weighted to the near-term. In Sydney CBD, this includes International Towers – Tower 1 (101,000 sqm) & Tower 3 (78,000 sqm) and 190-200 George Street (40,000 sqm) while in Melbourne CBD this includes Collins Square Building 2 (64,000 sqm) and Building 4 (40,000 sqm). Brisbane CBD will see 1 William Street (75,000 sqm) delivered shortly.

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 and beyond. 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 the 2017-18 period. Sydney will see a wave of withdrawals (240,000 sqm) for conversion to other use and also the Metro rail line, and at the same time temporary withdrawals for new office projects will tighten the vacancy rate further. Brisbane will see a number of older assets withdrawn (circa 140,000 sqm) for conversion and as a result of the Queens Wharf project over the same time period.

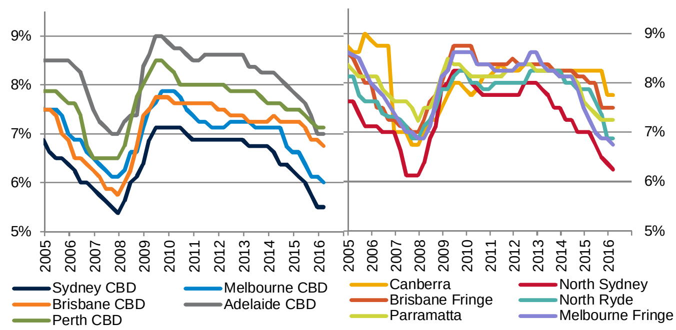
There is a risk in Brisbane that 300 George Street (circa 46,000 sqm) commences development, as this forms part of a mixed-use development. However, at this stage we are not forecasting this development as our base case assumption.

Perth CBD's supply cycle has come to a close for now. The only significant building under construction is the Capital Square building (48,000sqm) which is due to complete 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 Elizabeth Quay and City Link sites.

Fringe markets across the country remain undersupplied. This is one of the major factors driving tenants to centralise, however at some point we expect some new developments to commence (particularly in Sydney). Given the long lead time, and relatively low vacancy rate across the board, we do not see this negatively impacting the market over the medium-term.

Cap rates compress further as demand for assets shows no sign of abating

CHART 8: PRIME OFFICE YIELDS



Source: JLL Research and Investa Research

Capital continues to target Australian office assets with around $3B of assets transacting across the country during the quarter, with Sydney markets making up almost half of this figure.

Sydney CBD yields remained unchanged (Prime ranging from 5.00% - 6.00%), with the following assets transacting:

> 77 King Street, K-REIT sold the asset to Invesco for $160M ($13,352/sqm), circa 5.7% equivalent yield.
> 179 Elizabeth Street, LaSalle sold the asset to Markham Corp for $148M ($9,800/sqm) circa 6.9% equivalent yield.
> 71-79 Macquarie Street (Amatil Building), sold by AMP to China's Macrolink Real Estate for $126M for residential conversion.
> 151 Castlereagh Street, sold by Blackstone to Deutsche Asset Management for $120M ($10,000/sqm).

North Sydney Prime yields tightened slightly (25 bps) at the upper end to now range between 5.75% - 6.75%. The major transaction activity included:

> Innovation Place (100 Arthur Street) was sold the Salteri family to Ascendas for $315M ($11,300/sqm).

After a strong few years of transaction activity in Melbourne, there was only one major sale in Q1, and Prime yields remained unchanged ranging from 5.25% - 7.00%.

> 1 Collins Street (9,500sqm), the Goodridge family sold the asset for $125M to Harry Stamoulis.

Brisbane assets continue to be highly sought after, despite occupancy market concerns. Yields tightened slightly at the lower quality end of the Prime range and now sit between 5.75% - 7.75%. Major sales included:

> Minerals House, 41-59 George Street (28,548sqm) was sold by QIC to AEP Investment Management (Singapore) for $159M ($5,600/sqm) – most likely for conversion.
> 545 Queen Street was sold by GPT to Double Gold Stone Pty Ltd for $82M – this is also likely to be converted to residential.
> A 50% share of The Transit Centre, 151 Roma Street, was sold by GWOF (GPT) to APPF (Lend Lease) for $62.5M ($4,300/sqm).

After a long period of inactivity, a number of transactions crystallised in Perth, however yields remained unchanged between 6.00% - 8.25%. The following sales were confirmed:

> Exchange Tower (2 The Esplanade), a 50% share was sold by Vicinity Centres to Primewest for $110M ($6,400/sqm), on an equivalent yield of 7.7%.
> The Forrest Centre was sold by Insurance Commission of Western Australia (State Government) to YT International (a Hong Kong based developer) for $220M ($7,000/sqm).

Going forward we expect occupancy market fundamentals to exert a greater influence on capital markets. Therefore we continue to see a case for further compression of Sydney and Melbourne yields as vacancy tightens and rental growth continues to escalate. Markets with higher vacancy are likely to see a stabilisation of yields, however recent history has demonstrated that assets with longer WALEs are highly sought after and investors may look through any short-term occupancy market weakness.

Outlook

Sydney set for a strong upswing as supply cycle nears completion

NSW economic conditions remain strong, with lower interest rates boosting the Finance & Insurance and Business Services industry sectors, which have been in expansion mode. We expect demand to moderate from recent strong levels to somewhere around the long-term average. Nonetheless, A and B grade vacancy rates are already well below average, and the supply environment is increasingly looking positive once Barangaroo and 200 George Street complete later this year. Beyond that there is little stock under construction and a significant pipeline of asset withdrawals (both permanent and temporary) that will place further downward pressure on the vacancy rate regardless of the demand environment.

Due to these dynamics, we are increasingly optimistic on the outlook for rental growth in Sydney. B grade net effective rents have increased almost 30% over the last two years, as affordable space has become in short supply. This has resulted in a surge in upgrade activity as tenants target A grade space, driving absorption that has been around four times the long-term average over the last 24 months.

The spectre of asset withdrawals means that further vacancy tightening is almost guaranteed over the next few years. Around 5% of stock – mostly A and B grade – will be removed permanently from the market, driving increasing competition for space that is well priced. While the Premium grade vacancy rate is likely to remain elevated for several years, we expect that over time strong market dynamics in the A and B grade sectors will result in eventual upgrade activity in the Premium market.

The demand for Australian real estate shows no sign of abating, and the vast majority of capital, particularly from offshore, is looking for Sydney exposure. Given the positive outlook for vacancy and rental growth, we predict that office yields will fall below 2007 levels and remain there over the medium-term.

Melbourne incentives likely to contract boosting effective rents

The vacancy rate had remained stable in Melbourne at around 10% for over three years; however strong demand

and a pause of supply additions has allowed the vacancy rate to move down a percentage point over the last 12 months. As business conditions continue to be robust in Melbourne we expect that absorption will remain buoyant; although perhaps not as high as recent quarters. Nonetheless there is an upcoming period of low supply on the horizon. Supply currently under construction is less than half the long-term average. This is a major positive for the market, as due to the positive demand environment, there is a window of constrained supply that could result in a tightening vacancy rate if demand holds at anywhere near current levels.

Unlike Sydney we don't expect this dynamic to be boosted by significant levels of stock withdrawal. However, vacancy is still likely to reduce to just under 6% over the medium-term – a level that normally is conducive to solid rental growth in Melbourne. We do remain slightly cautious in our longer-term view, particularly compared to the outlook for Sydney, due to the availability of sites and the ease of development.

Investment markets remain strong in Melbourne, and we expect continued demand for quality assets and a tightening of yields. In recent years transaction evidence has suggested that there is very little spread between Sydney and Melbourne in terms of core cap rates. However, given the strong occupancy outlook for Sydney we predict that the historic spread of circa 50 bps will naturally re-establish, as the expansion of rental growth in Sydney encourages buyers to price assets more aggressively over the next few years.

Vacancy rate near the peak in Brisbane as supply pipeline nears completion

Brisbane supply cycle is nearing completion with only 1 William Street (75,000 sqm – fully pre-committed) remaining to be delivered later in the year. However, the vacancy rate is currently at record highs and it will take time for the vacancy rate to contract. Nonetheless demand momentum is moving in the right direction, and absorption has been positive for five consecutive quarters, running at around the long-term average rate. A flight to quality has also emerged with most activity seen in Prime grade assets, whereas in the Secondary market absorption has been negative over the same period. We are also seeing some tenants choosing to relocate back into the CBD from the Fringe, a move that has become much more attractive as the rental gap between the two markets has eroded.

We expect demand dynamics to continue to improve in Brisbane, in line with gradually improving economic conditions in QLD. Like Sydney, there are a number of stock withdrawals in the pipeline, due to assets being demolished for the Queen's Wharf project, and a number of buildings also earmarked for conversion to other use, in total around 140,000 sqm. We expect rents and incentives to hold relatively stable over the medium-term, with growth beginning to emerge once downward pressure on the vacancy rate takes hold – in around 12-18 months' time.

Flight to quality underway in Perth as tenants capitalise on market conditions to upgrade

The vacancy rate is now above 20% in Perth, however thankfully the most recent supply cycle is complete, with only Capital Square remaining and due for completion in 2018. The question from this point is how long does it take for the tenant contraction cycle to stop, and then what does the "new normal" absorption profile look like in Perth.

The rate of tenant contraction, on an annualised basis, had been reducing for seven quarters in Perth, pointing to a shift in momentum. However the latest data was strongly negative (-17,000 sqm), with a number of resources companies and support businesses giving up space. We believe that we are through the worst; however despite the recent recovery in resources prices, current mining business conditions remain very subdued. We expect that there is further spare office space capacity in the market that will continue to be released over the course of the year.

Offsetting this will be an escalation of upgrade activity. The drivers are similar to those seen in Brisbane, as tenants make the most of high incentives to relocate from the Fringe market to the CBD, and in many cases also upgrade the quality of their accommodation. This trend is already well underway, with a number of relocations into the CBD observed over the last 12 months, and strong upgrade activity recorded. Prime grade absorption over the last 12 months was above the long-term average, whereas demand for secondary space was strongly negative. This indicates that the majority of leasing activity is consolidated in Premium and A grade assets – a trend we expect to escalate.

Due to this, some Secondary grade assets are likely to 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.

We expect Prime yields to remain stable from here – except for good quality assets with long WALEs. There is evidence nationally to suggest that buyers are willing to look through medium-term occupancy market weakness to secure stable cash flow. We do see risk in the Secondary market however, and there is a danger that Secondary grade yields expand in line with tenants choosing to upgrade to better quality stock.

About Investa Research

Investa Research focuses on understanding the drivers and analysing the movements and trends within the Australian commercial office market. The research function is fundamental in guiding group investment strategy and decision making, as well as providing a competitive advantage through insightful analyses and forecasting.

The research team publishes regular updates on the performance of the major Australian office markets, as well as occasional papers and reports examining a broader scope of topics that may be of interest to investors and other Investa stakeholders.

Further information

Pete Carstairs
General Manager, Research
Phone: +61 2 8226 9431
Mobile: +61 410 564 508
Email: pcarstairs@investa.com.au

Maya Iwamura
Research Analyst
Phone: +61 2 8226 9358
Email: miwamura@investa.com.au

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.

Investa Office
Level 6, Deutsche Bank Place
126 Phillip Street
Sydney NSW 2000 Australia
Phone: +61 2 8226 9300
Fax: +61 2 9844 9300

The first choice in Australian office