RESEARCH

APRIL 2011

MELBOURNE CBD

Office Market Overview

Knight Frank

HIGHLIGHTS

- The Melbourne CBD office market absorbed 107,274m^2 of space to January 2011. This result is greater than the ten year average (90,714m^2) and was the strongest recorded nationally, just in front of Sydney CBD (105,392m^2).
- The second half of 2010 added just 47,605m^2 of space to the market. With limited new supply coming online over the next two years, vacancies are expected to decline sub 5% by the end of 2012. This is likely to sustain an escalation in net effective rents with strong face rent growth and a marginal reduction in incentives occurring.
- Sentiment for the Victorian office market remains overwhelmingly positive. The second half of 2010 recorded twenty two sales, with a value of $1.63 billion. A balanced buyer profile was evident, highlighting depth in the market. Enquiry remained strong from offshore groups, super funds and institutional investors, particularly for passive prime assets located in the Docklands precinct.

MELBOURNE CBD OVERVIEW

Table 1
Melbourne CBD Commercial Market Indicators January 2011

Market	Total Stock (m²) ^	Vacancy Rate (%) ^	Annual Net Absorption (m²) ^	Annual Net Additions (m²) ^	Average Prime Face rent ($/m²)	Incentives (%)	Average Prime Core Market Yields (%)
Prime	2,437,095	5.4	116,609	106,764	415 - 490	14 - 20	7.00 - 7.75
Secondary	1,650,519	7.7	-9,335	-5,808	280 - 350	18 - 22	7.50 - 9.25
Total	**4,087,614**	**6.3**	**107,274**	**100,956**			

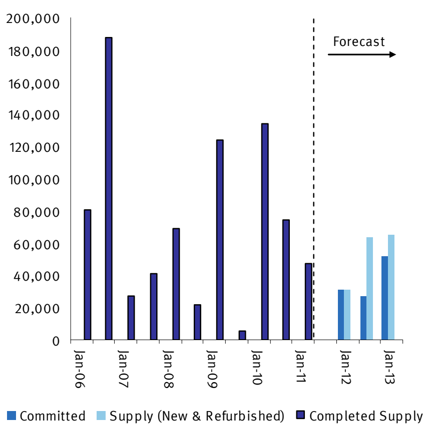
Source: Knight Frank/PCA ^ as at Jan 2011

SUPPLY & DEVELOPMENT ACTIVITY

With the exception of smaller markets such as Canberra, new supply growth in the Melbourne CBD office market has outpaced all other major Australian CBD office markets over the past decade. Developer's willingness to construct new buildings to meet demand has meant the Victorian capital expanded its office area by 30% from January 2001 and now holds 26% of the nation's total stock. This trend in growth has slowed since January 2010 as a result of the legacy left by the global financial crisis. As is the case across the nation, new additions to CBD markets have been relatively modest over the past year. The second half of 2010 did little to address the supply imbalance emerging in the Melbourne CBD office market. In the six months to January 2011 just 47,605m² was added to the market, well below the long-term half yearly average of 65,793m²

Excluding the completion of Cromwell's refurbishment at 321 Exhibition Street which is now 100% pre-committed to Origin Energy, there is no new uncommitted supply forecast to enter the market in 2011. Looking past 2011, the next construction phase isn't likely to deliver new stock to the market until 2012 when 127,069m² of new and refurbished space is slated for completion. As much as 63% of this space has already received pre-commitments. The first delivery of this office area will occur when Juilliard Group conclude their refurbishment at 555 Bourke Street. Holding Redlich has pre-committed to 28% of the 20,172 m² redevelopment.

Figure 1
Melbourne CBD Supply Scenario
New & Refurbished office space (m²)



Source: PCA / Knight Frank Research

As has consistently been the case in recent times, Docklands will contribute the greatest proportion of new stock in 2012; with 78,340m² added to the precinct following the completion of 735 Collins Street, The Goods Shed South, 990 Latrobe Street and 850 Collins Street. In what is now proving to be a well founded vote of confidence in the fundamentals of the Melbourne CBD office market, Australand's speculative development at 357 Collins Street will also reinstate 30,407m² of prime office space to the market by early 2012 and is likely to be a well timed addition.

Backfill Space

In the absence of any significant new CBD office stock, backfill space will provide prospective tenants with the only options for new accommodation during 2011. Approximately 34,140m² of new backfill space will be added to vacancy, of which 54% is A-grade stock. Additional space will come online in 2011 after Allianz and DeakinPrime confirmed a move from 601 Bourke Street, whilst Ansvar and IOOF will relocate out of 303 Collins Street. Telstra have downsized, moving out of 90 Collins Street, 360 Elizabeth and 469 Latrobe Street. They were rumoured to be leaving 525 Collins Street, however we understand they have renewed their lease. This will remove 16,000m² of Premium space that was expected to re-enter the market in 2011. The National Broadband Network who is now headquartered in Melbourne is likely to absorb the backfill left by Telstra.

MAJOR OFFICE SUPPLY

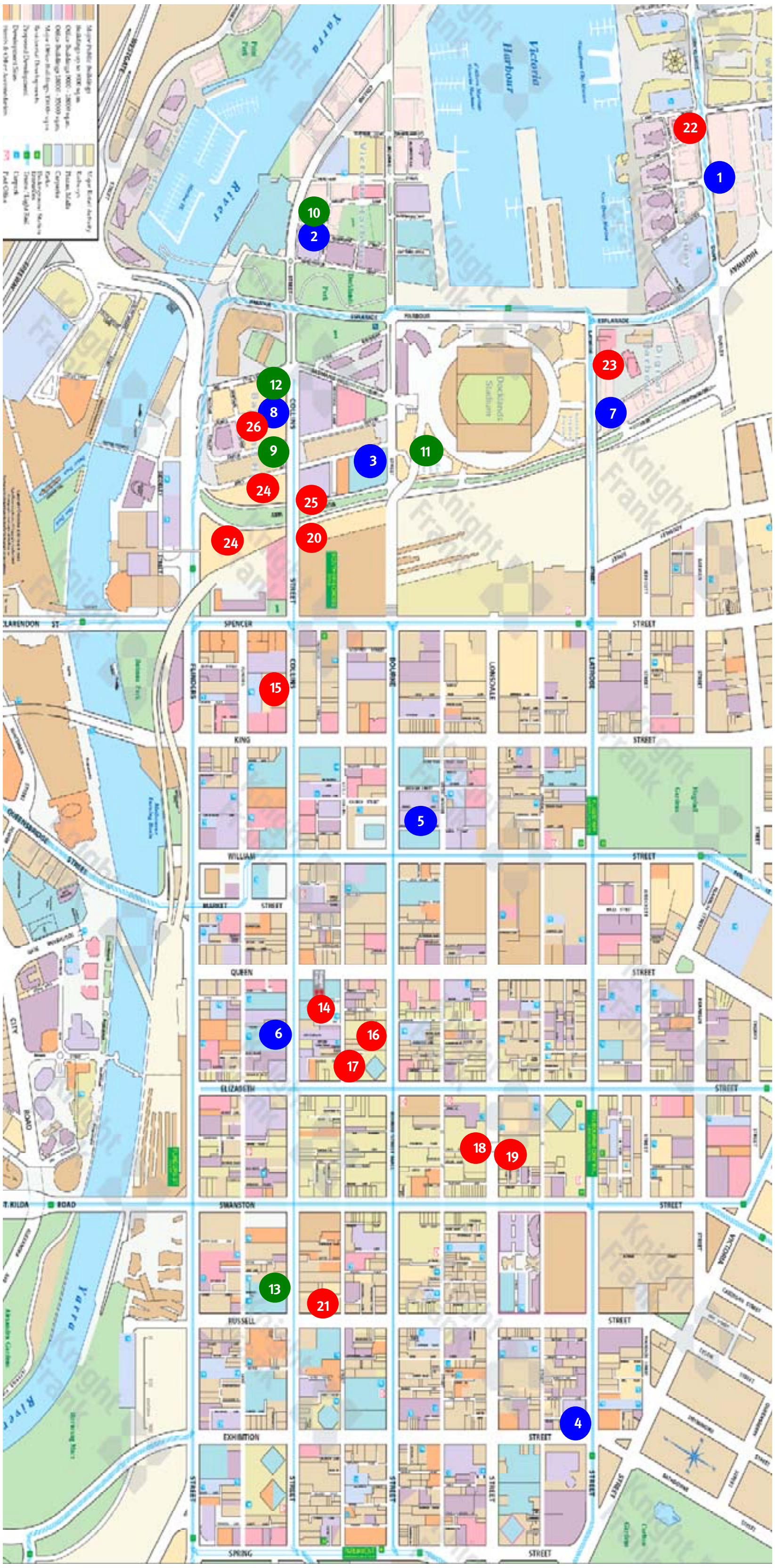
1. 380-400 Docklands Drive - 14,200 m² (CSC)
   MAB - completed in Q1 2010 - 100% committed.
2. 800 Collins St - 28,650 m² (Myer) - 100% committed.
   SEB/Lend Lease - completed in Q1 2010
3. 717 Bourke St - 39,872 m² (9 Network)
   REST - completed in Q3 2010 - 100% committed.
4. 321 Exhibition St # - 30,824 m² (Origin Energy)
   Cromwell - Q4 2011 - 100% committed.
5. 555 Bourke St # - 20,172 m² (Holding Redlich)
   Juilliard - Q1 2012 - 28% committed.
6. 357 Collins St - 30,407 m²
   Australand - Q2 2012 - 28% committed
7. 990 Latrobe St - 12,650 m² (Melbourne Water)
   MAC - Q2 2012 - 100% committed.
8. 745 Collins St - 38,000 m² (ATO)
   Walker - Q4 2012 - 90% committed.
9. The Goods Shed - 11,000 m² (Pearson)
   Walker - mid/late 2012 - 73% committed.
10. 850 Collins St - 15,840 m² (Aurecon)
    Lend Lease - Oct 2012 - 60% committed.
11. Bourke Junction, Nth Tower - 62,000 m² (NAB)
    ISPT/Cbus Property - Q2 2013 - 100% committed.
12. 735 Collins St - 39,500 m² (Marsh Mercer)
    Walker - Q2 2013 - 65% committed.
13. 171 Collins St - 27,700 m² (BHP)
    Charter Hall/Cbus - Q2 2013 - 41% committed.
14. 360 Collins St - 20,000 m²
    Dexus - Q4 2013 - Q1 2014
15. 567 Collins St - 52,000 m²
    APN / Leighton Properties - 2014+
16. 399 Bourke St - 63,000 m²
    Brookfield - 2014+
17. 385 Bourke St - 27,000 m²
    Colonial First State - 2014+
18. 275 Lonsdale St - 22,000 m²
    Colonial First State - 2014+
19. 300 Lonsdale St - 25,000 m²
    GPT Group - 2014+
20. 664 Collins St - 45,000 m²
    Mirvac - 2014+
21. 150 Collins St - 15,000 m²
    APN - 2014+
22. 395 Docklands Drive - 22,000 m²
    MAB - 2014+
23. 1000 Latrobe St - 32,500 m²
    Digital Harbour - 2014+
24. Sites 5 & 6B - 100,000 m²
    Vicurban - 2014+
25. 680 Collins St - 80,000 m²
    Vicurban - 2014+
26. 735 Collins St (Bldg C) - 40,000 m²
    Walker - 2014+

Under Construction/Complete (blue)

DA Approved / Confirmed / Site Works (green)

Mooted / Early Feasibility (red)

NB. Dates are Knight Frank Research estimates
* Major tenant precommitment in brackets
# Major refurbishment
Office NLA quoted



TENANT DEMAND & RENTS

Solid tenant demand in the Melbourne CBD has been underpinned by strong net absorption and a shortfall in supply. Consequently, total vacancy has dipped from its peak of 6.7% in January 2010 to now be the lowest of the major CBD markets at just 6.3%. Within this result, direct vacancy rose 20,597m² on the previous year's figure, but was offset by a reduction of 26,915m² in sublease space. Generally, a strong performing office market will be underscored by low amounts of sub- lease space and greater demand for higher grade stock as businesses move to upgrade their accommodation.

Examining the precincts, all but two experienced a reduction in vacancies. Spencer and the North Eastern precinct had a rise in total vacancy due to tenants moving out of secondary accommodation. Highlighting the size of the market, vacancy in the Spencer precinct jumped from 5.4% in January 2010 to 10.7% in January 2011, when just 11,839m² was vacated. Several tenant relocations meant vacancy in the North Eastern Precinct increased from 3.0% to 4.5%.

Further analysis of vacancies by grade and precinct reveal that there is a specific demand for prime stock located in the eastern precincts of the CBD. It is anticipated that as much as half of all current vacant stock in the Civic and Eastern precinct will have been absorbed by mid 2011. Developments at 357 Collins Street and 555 Bourke Street will be well placed to take advantage of the lack of options available to large tenants with requirements in these Eastern precincts. The alternative might be large pre-commitment to a new build which wouldn't deliver space until 2013 - 2014.

Table 2
Melbourne CBD Vacancy Rates
July 2010 – January 2011

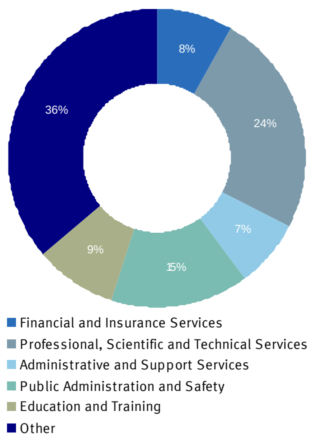
Grade	Jul-10 %	Jan-11 %
Premium	5.9	5.8
A Grade	5.5	5.2
B Grade	8.4	7.5
C & D Grade	7.0	8.0
Total	**6.5**	**6.3**

Source: PCA /Knight Frank

Net Absorption

Signalling a strong performing market, the net absorption figure (107,274m²) for the year to January 2011 eclipsed the average annual amount (90,714m²) of space absorbed over the last decade. Confirming the trend of a flight to quality in the corporate world, both the Premium and A-grade market recorded positive annual net absorption of 51,440m² and 65,169m² respectively. Secondary stock delivered a negative net absorption result of 9,335m² as tenants sought to secure better quality accommodation prior to expected rental increases.

Figure 2
Melbourne CBD Employment Growth
Break-up of employment growth 2011 - 2015

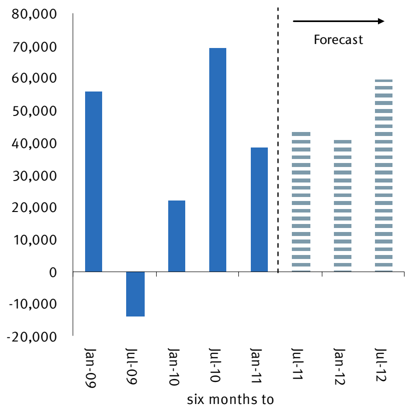


Source: Access Economics / Knight Frank Research

Going forward, forecast growth in white collar employment is expected to support levels of absorption in line with the long term trend.

Despite a lack of new supply coming online over 2011, the take up of backfill space should aid in meeting some of the forecast demand.

Figure 3
Melbourne CBD Net Absorption
(m²) 2009-2012

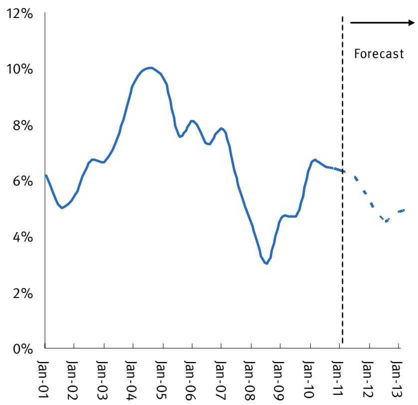


Source: PCA / Knight Frank Research

Anticipated Vacancy Levels

With the PCA's office market survey now providing several periods of declining vacancies, positive net absorption and dwindling supply, vacancy is expected to continue on a downward trajectory. With demand forecast to outstrip supply consistently through to 2013, vacancy is expected to fall to 4.5% by mid 2012.

Figure 4
Melbourne CBD Vacancy Rates
2001-2013



Source: PCA / Knight Frank Research

Tenant Demand

A continued push for expansion from the professional services, public administration and financial services sectors is establishing a competitive leasing environment in the CBD market. Increased levels of tenant enquiry is exacerbating the lack of options of contiguous prime grade space and pushing large corporates to explore pre-commitments in new developments. Established tenants considering a move have found increasing competition from prospective tenants situated outside the CBD. Mid size organisations located in fringe suburbs have embraced a phase of growth and are now more receptive to options presented in CBD locations. This option is proving more attractive in light of tightening vacancies and a subsequent trend of rising rents in the Metropolitan market. Recently, this has been evidenced by pre lease deals confirming the migration of firms such as Aurecon, Pearson and Melbourne Water to the Docklands and CPG and Halcrow to the “traditional CBD”.

Demand is being driven by a broad range of tenants. The current mix with active requirements within the CBD highlights the diverse nature of business in Melbourne. Interest from the financial services sector supports employment growth forecasts, with Westpac (20,000m²), Commonwealth Bank (25,000m²) and KPMG (30,000m²) all seeking new accommodation. Despite the Government adopting a decentralisation strategy, several state and federal backed Government tenants such as the Victorian Police (30,000m²), Department of Treasury and Finance (15,000m²), DIISR (2,000m²) have been actively seeking space within the CBD.

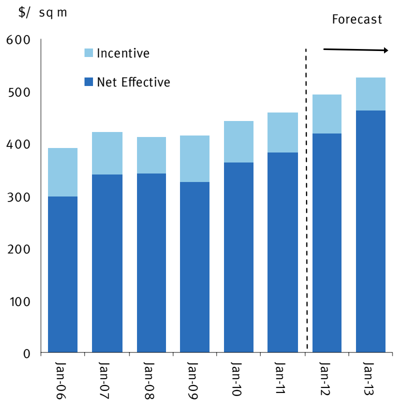
Rental Levels

As vacancy levels continued on a steady decline over the past twelve months, effective rents experienced an uplift driven by face rental growth and a marginal reduction in incentives. Prime grade rents recorded the most pronounced rise over the year to January 2011 with net effective rents increasing 12% to average $364/m². Growth in secondary rents was more subdued with just a 2% lift due to incentives remaining static. Despite little movement in incentives, there is scope for a reduction of incentives. Current average prime incentive levels range between 14%-20%, whilst secondary incentives range from 18%-22% of the net value of the lease.

Figure 5

Melbourne CBD Rents & Incentives

January 2006 to January 2013 – Net Rents



Source: Knight Frank Research

Table 3

Recent Leasing Activity (New Leases & Significant Renewals) Melbourne CBD

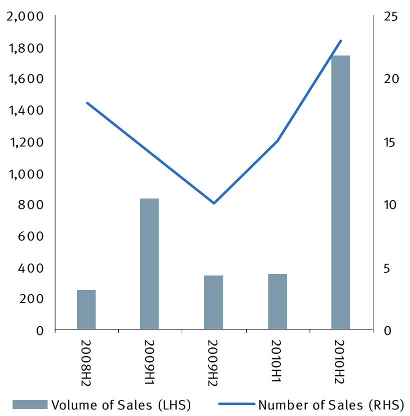
Address	Region	Estimated Net Face Rent ($/sq m)	Area (sq m)	Term (yrs)	Tenant	Start Date
720 Bourke Street *	Docklands	375	62,000	10	NAB	Q3 - 13
745 Collins Street *	Docklands	430	25,000	10	Marsh Mercer	Q2 - 13
735 Collins Street *	Docklands	400	35,000	12	ATO	Q2 - 12
321 Exhibition Street	North East	390	30,824	10	Origin Energy	Q4 - 11
300 Latrobe Street ^	Flagstaff	320	23,400	12	Telstra ^	Q1 - 11
990 Latrobe Street *	Docklands	385	12,650	15	Melbourne Water	Q2 - 12
171 Collins Street *	Civic	580	12,000	10	BHP	Q3 - 13
850 Collins Street *	Docklands	492	9,200	10	Aurecon	Q4 - 12
743 Bourke Street *	Docklands	400	7,200	10	Pearson	Q2 - 12
Lvl 4-6, 469 Latrobe Street	Flagstaff	320	4,000	10	CPG Australia Pty Ltd	Q4 - 11
161 Collins Street	Civic	385	4,000	5	Employees Mutual	Q3 - 11
Lvl 17, 530 Collins Street	Western	360	3,500	10	Productivity Commission	Q3 - 11
120 Collins Street ^	Eastern	Undis	3,000	5	BlueScope ^	Q4 - 10
555 Lonsdale Street	Western	315	2,700	12	Monash University	Q2 - 11
Lvl 2 & 3, 500 Collins Street	Western	340	2,670	Undis	Hospira	Q3 - 11
Lvl 27, 35 Collins Street	Eastern	540	1,680	10	Hastings Funds Mgmt	Q3 - 11
Lvl 40, 385 Bourke Street	Civic	425	1,390	7	Halcrow	Q1 - 11
Lvl 38, 140 William Street	Western	360	1,280	Undis	Barristers Chambers Ltd	Q2 - 11
Lvl 34, 140 William Street	Western	440	1,263	7	Lloyds Bank	Q1 - 11
Lvl 37, 120 Collins Street	Eastern	575	1,182	6	Bain Securities	Q1 - 11
31 Queen Street	Western	368	961	8	People Bank	Q1 - 11

Source: Knight Frank * Pre-Lease deal ^ Lease Renewal

INVESTMENT ACTIVITY & YIELDS

It appears that many investors identified the second half of 2010 as the buying "sweet spot", with twenty two major sales transacting for approximately $1.63 billion. Both sales and enquiry were particularly high for Prime grade assets throughout H2 2010, recording the strongest result since the onset of the GFC. Anecdotal evidence suggests that volumes could have been higher with greater availability of Prime grade assets. Investor demand remains strong into 2011 with over $200 million in property being transacted.

Figure 6
Melbourne CBD Major Sales
($m) Sales Volume › $5mill & number



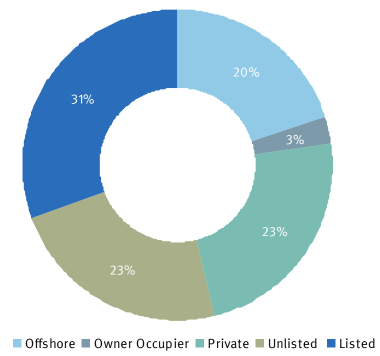
Source: Knight Frank Research

Strengthening equity markets and a positive outlook for Melbourne's office market has attracted heightened interest from the REITs sector in the second half of 2010. Many REITs recapitalised over the past year and created new vehicles for investment. With a buy mandate in place, some are closely examining the Melbourne CBD market. In the largest single REIT transaction in the state since the GFC, Colonial acquired a portfolio of solid performing prime assets from Grocon for $581.4 million in November 2010.

The appetite from offshore buyers remained strong throughout 2010 with a significant number of transactions completed along the entire eastern seaboard. Most International investors have actively sought prime grade passive investments such as RREEF's acquisition of 737 Bourke Street for $113 million; however there has been strong interest from other offshore buyers, mainly private, for development stock.

Private investors continued to have a notable presence in the Melbourne market with 23% of the sales volume attributed to this cohort. Private buyers have had a healthy appetite for secondary CBD assets. Recently PGA Properties bought 136 Exhibition Street for $27 million at a rate of $3,673/m².

Figure 7
Melbourne CBD Purchaser Profile
Office Sales › $5mil - Year to January 2011



Source: Knight Frank Research

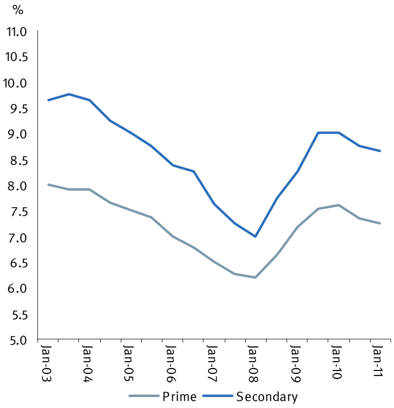
As shown in Figure 7, broad investor demand for CBD stock created a relatively even profile. In dollar terms, the Colonial acquisition of Grocon's office portfolio dwarfed other transactions in the market and skewed the purchaser profile towards the listed trusts. This however doesn't necessarily reflect the active investor profile. Enquiry into 2011 suggests we should expect a similar buyer profile, with offshore groups competing with REITs for passive prime assets, particularly in the Docklands, whilst privates seek to acquire strong performing secondary assets.

Table 4
Major Sales Transactions – Melbourne CBD

Address	Price ($ mil)	Core Market Yield (%)	NLA (m²)	$/m² NLA	WALE (Years)	Purchaser	Sale Date
31 Queen Street	81.00	8.32	19,212	4,216	2.7	Challenger Financial	Feb-11
990 La Trobe Street*	76.50	Undisc *	12,650	6,047	15.0	MAC	Feb-11
199 William Street#	45.00	VP	32,600	1,380	VP	Hengyi Australia	Jan-11
330 Collins Street	107.00	7.84	18,443	5,804	3.6	Sunsuper	Dec-10
136 Exhibition Street	27.00	8.46	7,351	3,673	2.6	PGA Properties	Dec-10
45 William Street	25.85	9.01	8,976	2,880	2.1	Henkell Brothers	Dec-10
Grocon Office Portfolio	581.40	7.60^^	165,132	Circa 5,150	8.4	Colonial (CPA)	Nov-10
717 Bourke Street	246.50	7.22	43,972	5,594	9.0	REST	Nov-10
737 Bourke Street	113.00	7.14	18,829	5,969	9.7	RREEF	Nov-10
422 Little Collins Street	16.25	10.13^	5,272	3,117	Undisc	Dilato Investments	Oct-10
174-184 Flinders Lane**	15.50	Undisc	Na	Na	Na	Cbus Property	Oct-10

Source: Knight Frank ^ Passing yield ^^ Weighted avg cap rate * Under Contract ** Joint Venture with Charter Hall VP Vacant Possession # Potential development site

Figure 8
Melbourne CBD Average Yields
Prime & Secondary core market yields



Source: Knight Frank Research

The flurry of transactions experienced in the second half of 2010 provided a better gauge of where yields are placed in the Melbourne market. Continued downward pressure on yields over the course of 2010, meant the historic investment gap between Melbourne and Sydney has narrowed post GFC. A combination of rental growth and rising capital values is fuelling debate as to whether Melbourne prime yields can bridge the gap between Australia's two major commercial property investment markets. Currently average Prime yields in Melbourne are in a range of 7.00% - 7.75%, while Sydney's average is 6.90%, above its long term historic average of 6.58%. Secondary yields in the Melbourne market range from 7.50% - 9.25%.

330 Collins Street, Melbourne.
Purchased by Sunsuper for $107.0 million

OUTLOOK

Despite a series of disruptions to economic activity brought about primarily by natural disasters, the Australian economy continued its unparalleled expansion for its twentieth consecutive year. Income derived from the commodity "pot", a committed capital spending program and a booming trade surplus look set to ensure momentum to produce healthy economic growth will continue in the short to medium term.

In response to a strong economic outlook, business confidence is gaining some buoyancy. This is translating to growth expectations in employment with results from two leading employment indices, pointing towards a notable increase in job additions. ANZ's job advertisement series recorded a 19.3% annual increase in job ads to February 2011. Similarly, Dun and Bradstreet's Business Expectations survey in February 2011, recorded the most positive employment outlook in seven years.

With such solid employment growth prospects in the Melbourne CBD, tenant demand looks set to continue its upswing well into 2013. A recovery in the financial services sector and expected growth from both public administration and professional/technical services will ensure Melbourne maintains a diverse tenant profile.

Despite underlying demand forming in the market, supply constraints will ensure this isn't entirely expressed in net absorption until at least 2012. Nevertheless, absorption should remain stable and at levels consistent with the ten year average (90,714m²). Looking ahead to 2012, absorption is expected to increase to levels seen prior to the GFC as new supply is delivered to market.

Anecdotally, developers appear to be responding to the supply imbalance by progressing plans to commence new buildings in both the "traditional" CBD and Docklands. Over the past year new development has been confined to the Docklands precinct. We anticipate projects located outside of Docklands to be activated as the lure of rising rents and low vacancies reduces risk, making projects more viable within the traditional CBD grid. This has already been evidenced by Charter Halls planned construction of a new Premium grade asset at 171 Collins Street, due for completion in 2013. A significant pre – commitment remains a requirement to any new build. There are a number of large tenant requirements such as Westpac, KPMG and Commonwealth Bank that could potentially anchor a number of the proposed city developments.

Prime net effective rents are forecast to rise 14.8% by the end of 2012 as a staggered growth pattern between Premium and A-grade rents becomes apparent. With diminishing options available to tenants seeking Premium space, Premium net effective rental growth is expected to outpace A-Grade over the next twelve months. Growth in secondary rents will be hampered by an influx of backfill over the next two years; hence growth will lag the prime segment.

Rental growth across prime assets will have a positive impact on book values. Recent transactions in the Docklands precinct, such as 990 Latrobe Street (under contract), 717 and 737 Bourke Street have been at the lower end of the current prime yield range, albeit these assets all had long secure leases. Despite a bias for prime yield compression, whether Melbourne's prime yields move close to parity with Sydney is debatable. Conversely, there is a case to argue that prime assets in Melbourne are "too hot" and with a rebounding market in Sydney, parity is unlikely.

A strong outlook for owners of commercial property, suggests the year ahead should continue to attract a diverse buyer. We anticipate continued interest from domestic and international Super/Pension funds as the Melbourne market shifts from a consolidation phase to a clear growth phase. Though a strong AUD may dissuade a handful of offshore investors, most are likely to see more upside from the outlook in the market.

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