RESEARCH

MAY 2012

MELBOURNE CBD

Office Market Overview

Knight Frank

HIGHLIGHTS

- In the absence of any major developments completed, total vacancy fell despite subdued tenant demand. However total vacancy is now anticipated to steadily increase over the next two years, peaking at 8.2% in January 2014 after which total vacancy is forecast to trend down.
- Uncertainty in the financial markets in the wake of the global economy has dampened business confidence, impacting demand for CBD office space. After an initial recovery period of rental growth, the subdued labour market conditions have stalled face rents with upward pressure now on incentives.
- Despite limited transactional activity, increased demand has resulted in a marginal tightening of core market yields. Increased offshore demand and renewed interest from private investors, coupled with the increasingly attractiveness of real estate yields should lead to further transactions.

MELBOURNE CBD OVERVIEW

Table 1
Melbourne CBD Office Market Indicators as at April 2012

Market	Total Stock (m²) ^	Vacancy Rate (%)^	Annual Net Absorption (m²)^	Annual Net Additions (m²) ^	Average Net Face Rent ($/m²)	Average Incentive (%)	Average Core Market Yield (%)
Prime	2,471,386	4.1	71,068	34,291	380 – 700	15 – 25	6.75 – 7.50
Secondary	1,627,739	7.0	-1,942	-16,975	260 – 400	18 – 20	7.50 – 8.75
Total	**4,099,125**	**5.3**	**69,126**	**17,316**			

Source: Knight Frank ^ Property Council of Australia OMR

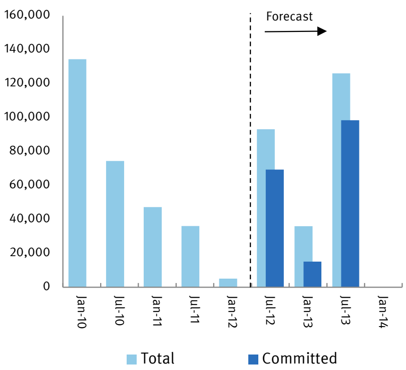
SUPPLY & DEVELOPMENT ACTIVITY

A mere 5,065 m² of office space was added to the Melbourne CBD office market in the six months to January 2012, the lowest half year total since July 2002, prior to the start of the last construction cycle. All of the space added to the CBD was through minor refurbishment of existing stock.

The confirmed pipeline of new developments will ensure that this new construction cycle will extend through to at least 2014 as 349,194m² of new office space is slated for completion. With strong levels of pre-leases anchoring new developments over the next two years, just 72,288m² (or 28%) of space is yet to be committed. Historically, the Melbourne CBD office market has added approximately 3.7% of gross supply to the stock base each year. Over 2012 and 2013 the market will add an average of 3.0% of gross supply per annum.

In 2012, 129,137m² of new and refurbished office space is anticipated to be delivered to the market. Approximately 60% of this space will be constructed in the Docklands precinct. Improved amenity and access to large floor plates have contributed to attracting new tenants to pre-commit to new developments in the precinct. Of the 78,558m² of space expected to be delivered in Docklands this year, 80% has been taken by pre-lease tenants. More than a third of the pre-committed space has been leased by tenants migrating into the CBD from other office markets.

Figure 1
Melbourne CBD Supply
(m²) Supply (new & refurb) & commitment



Source: Knight Frank/PCA

The remaining 50,579m² of office space to be constructed in 2012 will be located in the CBD Core. Australand is expected to complete works on their speculative redevelopment at 357 Collins Street by mid-year. A Core Collins Street location has assisted the developer in securing several tenants to this building, leaving just 30% of space available. Juilliard Group's redevelopment at 555 Bourke Street will result in an additional 20,172m² being added to the CBD legal precinct. Holding Redlich have pre-leased 28% of this space and will re-locate from their temporary accommodation upon completion.

Docklands will continue to deliver the majority of new supply in the short term. In 2013, Marsh Mercer and NAB are scheduled to move into their new offices at Walker's Collins Square project and the Cbus development at 700 Bourke Street respectively. Charter Hall and Cbus will jointly develop the Eastern precinct's first Premium graded tower in twenty years at 171 Collins Street, supplying an additional 29,057m² of office space which is due to be completed by mid 2013. The last office development delivered to the Eastern Core was SX2 at 111 Bourke Street, completed in late 2009.

Despite the high levels of pre-commitment, in addition to the new supply currently under construction over the next three years, more than 179,000m² of office backfill space within the CBD will be vacated by tenants including NAB, Telstra and BHP. There are also emerging signs that large contiguous spaces are now being offered for sub-lease as a result of the continued uncertain economic conditions and soft labour market in Victoria.

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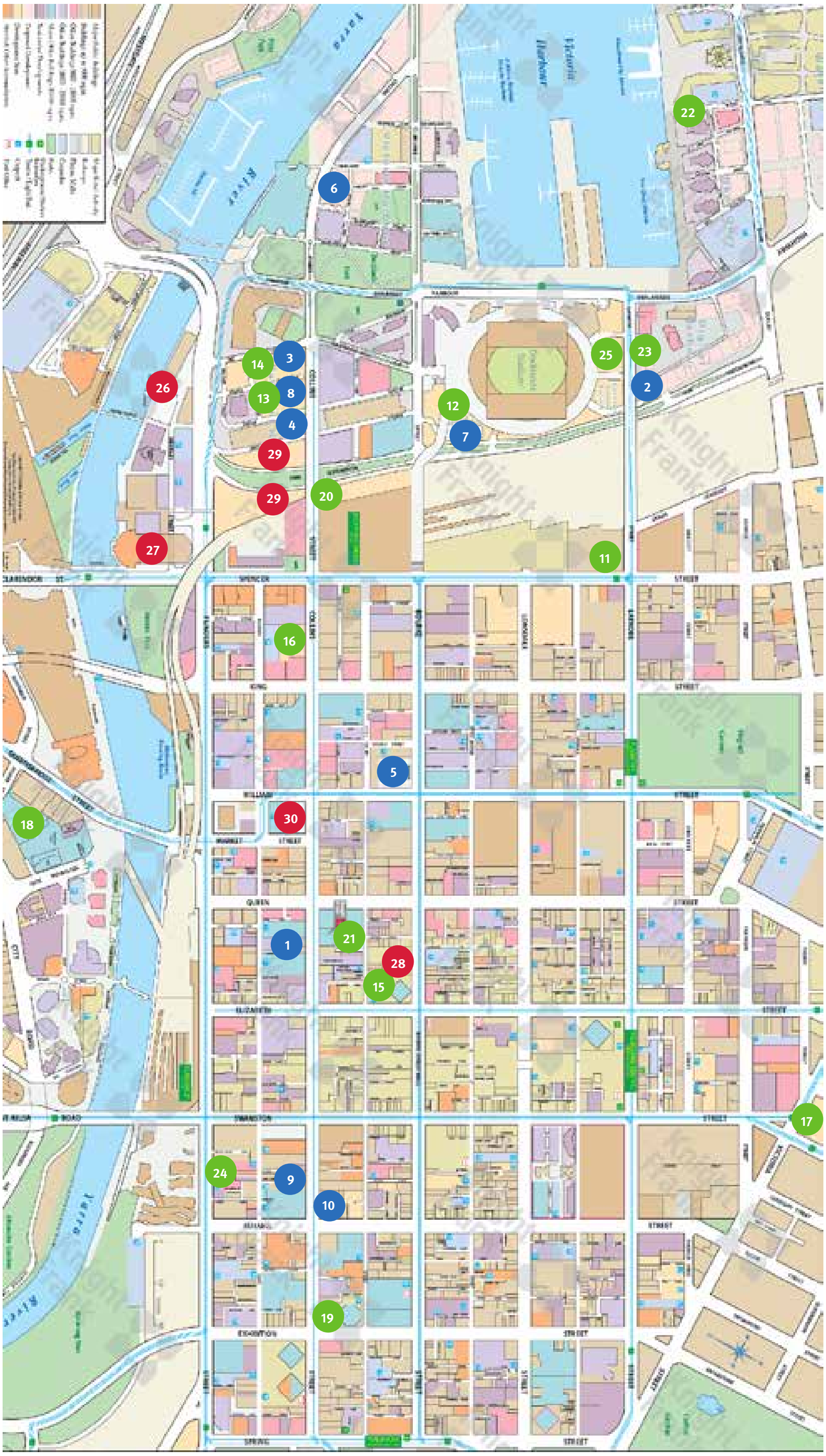
1. 357 Collins St # - 30,407 m² (Commonwealth Bank) Australand - Q2 2012 - 70% committed.
2. 990 Latrobe St - 12,200 m² (Melbourne Water) MAC (SA) - Q2 2012 - 100% committed.
3. 3 Collins Square - 38,000 m² (ATO) Walker - Q2 2012 - 90% committed.
4. The Goods Shed - 12,518 m² (Pearson) Walker - Q2 2012 - 57% committed.
5. 555 Bourke St # - 20,172 m² (Holding Redlich) Juilliard - Q3 2012 - 28% committed.
6. 850 Collins St * - 15,840 m² (Aurecon) Lend Lease - Q4 2012 - 60% committed.
7. 720 Bourke St - 62,000 m² (NAB) Cbus Property - Q2 2013 - 100% committed.
8. 1 Collins Square - 35,000 m² (Marsh Mercer) Walker - Q2 2013 - 65% committed.
9. 171 Collins St - 29,057 m² (BHP) Charter Hall/Cbus - Q2 2013 - 50% committed.
10. 150 Collins St - 20,000 m² (Westpac) APN/Grocon - Q3 2014 - 72% committed.
11. 313 Spencer St - 27,000 m² (Victoria Police) Cbus/Aust Post - Q4 2014 - 100% committed.
12. 740 Bourke St - 47,000 m² (Medibank) Cbus Property - Q3 2014 - 63% committed.
13. 2 Collins Square - 50,000 m² Walker - 2014+
14. 4 Collins Square - 20,000 m² Walker - 2014+
15. b|e South - 27,000 m² Colonial First State - 2014+
16. 567 Collins St - 52,000 m² APN/Leighton Properties - 2014+
17. 555 Swanson St (CUB Site) - 36,000 m² Grocon - 2015+
18. Freshwater Place Stage 3 - 42,500 m² Australand - 2015+
19. 82 Collins St - 38,000 m² Queensland Investment Corporation (QIC) - 2015+
20. 664 Collins St - 45,000 m² Mirvac / Grocon - 2015+
21. 360 Collins St - 20,000m² DEXUS - 2015+
22. 395 Docklands Dve - 22,000 m² MAB - 2015+
23. 1000 Latrobe St - 32,500 m² Digital Harbour - 2015+
24. 180 Flinders St - 20,000m² DEXUS - 2015+
25. 685 Latrobe St - 33,000 m² Charter Hall & Flagship - 2015+
26. North Wharf - 20,000m² WTC Asset Management - 2015+
27. 601 Flinders St - 60,000 m² Eureka/Asset 1 - 2015+
28. 399 Bourke St - 63,000 m² Brookfield - 2016+
29. Sites 5B & 6B - 100,000 m² Lend Lease - 2016+
30. 447 Collins St - 80,000 m² ISPT - 2017+

Under Construction

DA Approved / Confirmed / Site Works

Mooted / Early Feasibility

NB. Dates are Knight Frank Research estimates
Major tenant precommitment in brackets next to NLA
Major refurbishment
Office NLA quoted
* Sold to CIMB Trust (Nov-11)



TENANT DEMAND & RENTS

Adversely impacted by Victoria's contracting labour market, declining business confidence and the financial market turmoil, tenant demand was soft over the second half of 2011. Weak tenant demand saw the Melbourne CBD record net absorption of 14,127m² over the six months to January 2012, around a third of the average over the past 10 years.

Despite the recent softness in activity, minimal new supply delivered to the market in the second half of 2011 actually resulted in the vacancy rate falling from 5.8% in July 2011 to 5.3% in January 2012.

Table 2
Melbourne CBD Vacancy Rates
Vacancy by building grade

Grade	Jul-11	Jan-12
Premium	4.7	5.9
A Grade	4.3	3.5
Prime	**4.4**	**4.1**
B Grade	7.6	5.7
C Grade	9.8	10.0
D Grade	2.9	2.8
Secondary	**8.0**	**7.0**
Total	**5.8**	**5.3**

Source: PCA

In terms of quality grades, for the majority, vacancies fell in the six months to January 2012. Prime grade office space continues to be the most sought after grade with the vacancy rate declining from 4.4% to 4.1%. Although vacancy within Premium grade accommodation increased from 4.7% to 5.9% in the past six months, A-grade vacancy fell to 3.5% - its lowest rate since July 2008. Secondary office stock also recorded a fall in vacancy overall, driven by solid absorption in B-grade space.

The 5.3% total vacancy is made up of 4.6% on a direct basis with sub-lease vacancy steady at 0.7%; however anecdotal reports indicate that it has increased significantly in the first quarter of 2012 with an additional 80,000m² available for sub-lease, potentially increasing the sub-lease vacancy rate to 3.1%.

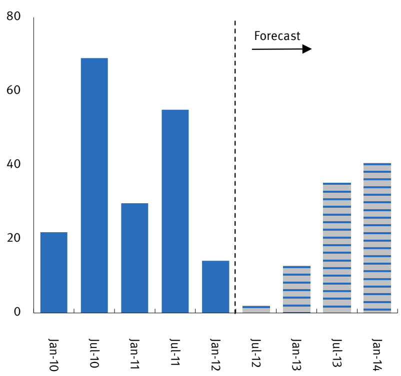
As at January 2012, the office vacancy rate in the Docklands precinct sits at 0.8%; its lowest rate in six years. Strong tenant demand for office space within the Western Core also resulted in vacancy falling in the precinct to 6.7%, its lowest rate since July 2009.

Net Absorption

Over the past year, tenants seized the opportunity to upgrade their office accommodation in the CBD, continuing the flight to quality trend witnessed in recent years.

Total net absorption for prime stock over the past year was 71,068m²; whilst tenants vacated 1,942m² of secondary space over the same period. During the twelve months to January 2012, the North Eastern and Western Core precincts experienced the greatest demand for office accommodation recording a combined net absorption amount of 62,025m² or 89% of the CBD total.

Figure 2
Melbourne CBD Net Absorption
(000's m²) per six month period



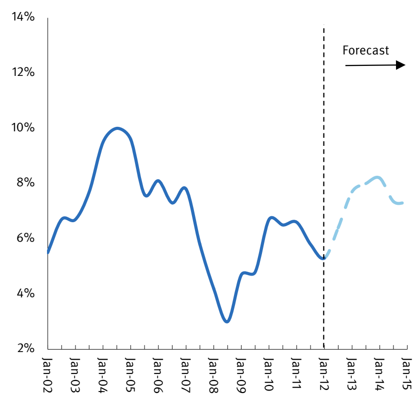
Source: PCA/Knight Frank

While sub-lease vacancy is likely to increase as tenants contract in the short term, annual net absorption should be supported by tenants such as Aurecon, Melbourne Water and Pearson migrating into the CBD. Whilst annual net absorption is not expected to match the levels recorded in the past four years, it is anticipated to remain positive in the next two years as the absorption stemming from the new supply will outweigh the sublease and backfill.

Anticipated Vacancy Levels

Although the amount of un-committed new supply currently under construction is not significant, easing business investment has led to tenant demand declining in the past six months and is forecast to remain subdued for the next 12 months. A likely rise in sub-lease vacancy and an increase in backfill accommodation will lead to a rise in vacancy over the next 12 months. Total vacancy is forecast to peak at 8.2% by January 2014 before trending down to 7.3% in 2015. While white collar employment in the Melbourne CBD is anticipated to only modestly expand in 2012, employment growth should increase in 2013 by a substantial rate of 3.0%.

Figure 3
Melbourne CBD Vacancy
% total vacancy



Source: PCA/Knight Frank

Tenant Demand

Victoria's appeal as a hub for peripheral support services to both the domestic mining industry and Asia's growing infrastructure industry has seen local engineering and other service provider firms expand in the State. With significant investment being made on the State's energy infrastructure, utility companies have also been a source of office demand.

Similarly, other industries such as health and to a lesser degree communications have shown a level of resilience to the impacts of broader market turmoil that has dampened business sentiment.

Over the past decade, white collar employment growth in Melbourne's CBD has been very robust, averaging 3.7% per annum, five times the annual growth in Sydney CBD and even outpacing the resource boom cities of Brisbane and Perth.

However, recent years have seen subdued growth as on-going global instability weighs on business spending leading to more modest employment growth in the CBD.

Yet, Deloitte Access Economics projects an early turnaround. Looking forward, healthy growth is expected to return to Melbourne's property and business sectors (which accounts for 30% of the employment base) as the global economic horizon clears.

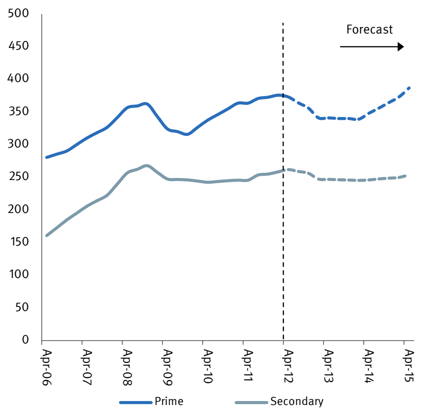
So the coming years look better than the previous few but not as good as pre-GFC times. Employment growth in the Melbourne CBD is projected to average about 6,000 new jobs per year over the medium term. However, for the year ahead, employment growth will be weak, impacted by recent cuts in the finance sector and public administration employment as outlined in the 2012/13 Victorian State Budget.

Rental Levels

After an initial recovery period of growth following the GFC, rents eased over the final half of 2011, as business sentiment faded in the wake of the global economic conditions. Prime net effective rents now average $373/m², representing annual growth of 2.6% with incentives averaging 19%. Although net face and effective rental levels have been stable over the past six months, there is increasing evidence that upward pressure on incentives levels are building. Average incentive levels are forecast to increase in line with the rising vacancy to 25%. In the secondary market, average net effective rents now average $262/m² with incentives also increasing to an average level of 19%.

However, it is important to note that incentive levels vary considerably, dependent on the tenant's circumstances, with incentive levels for renewed leases or accommodation with quality existing fit-out only requiring modest incentive levels.

Figure 4
Melbourne CBD Rents
$/m² average net effective rent



Source: Knight Frank

Table 3
Recent Leasing Activity (New Leases & Significant Renewals over 500m²) Melbourne CBD

Address	Region	Estimated Net Face Rental ($/m²)	Area (sqm)	Term (yrs)	Tenant	Start Date
313 Spencer Street *	Docklands	n/a	27,000	15	Victoria Police	Q4-14
740 Bourke Street *	Docklands	n/a	30,000	10	Medibank	Q3-14
150 Collins Street *	Civic	n/a	13,875	12	Westpac	Q3-14
11 Exhibition Street	Eastern	540	11,500	10	BUPA	Q1-14
700 Bourke Street*	Docklands	375	62,000	10	NAB	Q3-13
171 Collins Street*	Civic	580	11,913	10	BHP	Q2-13
101 Collins Street	Eastern	720g	1,700	10	Gilbert Tobin	Q3-12
171 Collins Street	Civic	585	700	7	Egon Zehnder	Q2-13
120 Collins Street^	Eastern	493	2,850	10	Urbis	Q3-12
357 Collins Street	Western	385	13,500	10	Commonwealth Bank of Australia	Q3-12
150 Lonsdale Street	North East	370	3,300	5	Super Partners	Q2-12
520 Bourke Street^	Western	400	1,122	3	Draft FCB	Q1-12
333 Collins Street	Western	275	3,000	5	AMEX	Q1-12
161 Collins Street	Civic	385	2,931	7	VMIA	Q1-12
300 La Trobe Street	Flagstaff	330	1,300	8	Amec Zetkin	Q1-12
161 Collins Street	Civic	365	3,191	11	Griffith Hack	Q1-12
525 Flinders Street	Spencer	340	4,447	6	TRU Energy	Q4-11

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

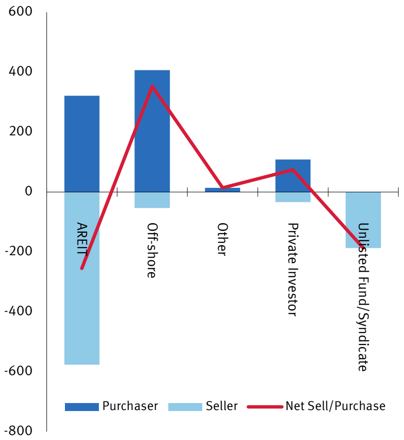
INVESTMENT ACTIVITY & YIELDS

Despite increasing interest to invest into the Melbourne CBD office market, transactional activity over the 12 months to April 2012 remains limited. Investment sales activity (above $5 million) within the Melbourne CBD in the 12 months to April 2012 was substantially below the sales volumes recorded in 2011 and 2010. A total of $850.75 million was transacted across 12 properties, down from the $2 billion that was transacted in the preceding 12 months.

Investors were particularly focussed on trophy assets with four buildings transacting above $100 million. The Melbourne CBD office market continues to attract overseas buyers, a trend that began to emerge in the latter half of 2010. Offshore investors accounted for 47% of all stock transacted, increasing from 26% a year earlier. In contrast, private investors who typically provide much of the transactional activity became relatively less acquisitive in the second half of 2011.

So far in 2012, only three CBD offices have sold (to external parties) with 525 Flinders Street ($55 million in May), 565 Bourke Street ($53.5 million in February) and 477 Collins Street ($67 million in January) transacting.

Figure 5
Melbourne CBD Office Purchaser/Vendor
$ million sales over $5 million yr to April 2012



Source: Knight Frank

As capital remains scarce, A-REITs have had to continue to divest assets in order to recycle funds and restructure their balance sheets. A-REITs have been the largest net seller in the 12 months to the end of April with a net purchase/sell of $-254 million.

Although investment activity has lulled in the wake of increased global economic uncertainty, increasing offshore interest has resulted in a marginal tightening of prime core market yields. Currently, average prime yields in the Melbourne CBD range from 6.75% - 7.50%.

The recent related party sale of 242 Exhibition Street demonstrates a benchmark for passive, prime assets in Melbourne, with a 50% interest selling for a core market yield of 7.00%.

While most investors continue to focus on core assets, secondary properties have also recorded a slight tightening in core market yields over the past six months.

Secondary asset transactions have indicated core market yields range between 7.50% - 8.75%, albeit with some inconsistency depending upon the asset's qualities and tenancy configuration. However, increasing difficulty to source finance for properties with short term lease profiles has resulted in purchasers re-pricing assets with leasing risk.

Table 4
Major Sales Transactions Melbourne CBD

Address	Price ($ mil)	Core Market Yield (%)	NLA (m^2)	$/m² NLA	WALE (Years)	Vendor	Purchaser	Sale Date
525 Flinders Street	~55.00	7.30^	10,000	5,500	N/A	Uniting Church	AFIAA (Switzerland)	May-12
120 Collins Street^^	255.22	6.50^	64,831	7,873	3.0	Investa Property Group	Investa Commercial Property Fund	Mar-12
242 Exhibition Street^^	217.5	7.00	65,914	6,600	8.2	Investa Property Group	Investa Office Fund	Mar-12
565 Bourke Street	53.50	8.47^	15,966	3,570	2.8	Eastern Holdings (Subsidiary of OCBC)	Prime Value Asset Management	Feb-12
477 Collins Street	67.00	7.75	11,987	5,590	3.7	Australian Unity	Aviva	Jan-12
538 Collins Street	14.00	VP	3,510	3,989	VP	Private Investor	Owner Occupier	Jun-11
661 Bourke Street	100.00	7.53	18,256	5,478	9.5	Brookfield Prime Property Fund	Real I.S. (Germany)	Nov-11*
850 Collins Street	114.20#	7.25	17,215	6,622	10.0	Lend Lease	CIMB Trust (Malaysia)	Nov-11
452 Flinders Street	201.50	7.54	38,349	5,254	4.6	Stockland	DEXUS	Nov-11
150 Queen Street	25.50	8.16	8,153	3,128	1.6	Charter Hall	Chip Eng Seng	Sep-11

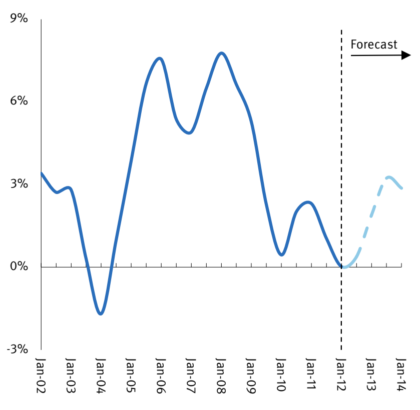
Source: Knight Frank # net sale price ^ initial passing yield * Settlement in March 2012 ^^ 50% interest

OUTLOOK

The Victorian Government expects the State to continue to grow economically in the medium term. While remaining positive, Victorian economic growth is expected to be relatively weak in the near-term: growing by 1.75% in 2012-13 impacted by a high Australian dollar and weaker global and national economic conditions. Beyond 2013-14, the Victorian economy is forecast to return back to growth rates closer to trend.

Over the past decade, white collar employment growth in the Melbourne CBD has outpaced Sydney, Brisbane and Perth. More recently however, volatility in the global economy and recent cuts to employment in Melbourne's finance and public service sectors has dampened business confidence. Despite the recent weakness, Deloitte Access Economics projects an early turnaround with white collar employment forecast to grow by an average 2.2% per annum over the next three years.

Figure 6
Annual White Collar Employment Growth
Melbourne CBD



Source: Deloitte Access Economics

After a modest year of new supply for the CBD office market – its lowest annual total in 10 years; the development pipeline is set to rebound in 2012. While 129,137m² is scheduled for completion this year and a further 126,057 m² due for completion in 2013, supply levels remain below the 10 year historical average of 134,634m².

Beyond 2013, it is likely that new supply will remain below the 20-year average for at least the short term. The recent economic uncertainty has impacted business confidence, leading to many tenants now being more tentative when entering the long term commitments required to support new developments.

Of the 302,694 m² that is due for completion over the next three years, much is pre-committed with only 89,788 m² available for lease. While 70% of the development pipeline has been pre-leased, a further 179,000m² of backfill space has also been identified to come online over this period. Surprisingly, 61% of this identified backfill space is of A-grade and Premium grade accommodation.

Although tenant demand has been subdued in these challenging times, the CBD's comparable rental levels across Melbourne's fringe office markets, continues to result in tenants being attracted into the CBD. In the short term, annual net absorption is forecast to remain positive on the back of these incoming tenants. Tenants who have leased space in the CBD after vacating non-CBD office space include: Aurecon, Melbourne Water and Pearson. Looking forward, net absorption for the next three years is forecast to average 59,600m².

Over the next 12 months, vacancy rates are forecast to steadily rise as a result of soft tenant demand coupled with an increase in backfill and sub-lease accommodation. Total vacancy is expected to rise to 6.4% in July 2012, and peak at 8.2% in July 2014 before trending down in 2015. Premium and A-grade vacancy rates are also expected to rise through tenants contracting and/or relocating into recently completed developments. Beyond this, total vacancy is anticipated to trend down with new supply constrained by the tighter funding conditions and sporadic major tenant requirements needed to support new construction.

There is likely to be a pause in rental growth over 2012 and may actually lead to effective rental level falls dependent on economic developments. Face rents are expected to remain steady over 2012 for Premium and A-grade office stock. While there is some downward risk for net face rentals in secondary grade assets impacted by the increasing backfill and sub-lease accommodation. Incentives however have begun to increase and may rise further as a result of the increasing options for tenants. As the vacancy peak of 2014 nears, incentives are expected to steadily decrease with significant effective rental increases in the second half of 2014 forecast.

With the likely increasing divergence of bond yields and real estate yields, transactional activity is expected to increase over the remainder of 2012. Given that many A-REITs are now in a position to acquire stock having restructured their balance sheets, competition for institutional grade assets should also increase.

The positive expectations for rental growth over the medium term for the Melbourne CBD and continuing take up of development sites for both residential and commercial uses is likely to result in yields remaining stable with a firming bias for "trophy" assets.

Despite the Federal government's decision to increase withholding tax rates for foreign investors; Australia and particularly Sydney and Melbourne's CBD office markets are likely to continue to be of interest to offshore parties in the short term. Australia's growing economy, high levels of transparency and relatively high CBD office yields are all major drivers to invest for offshore investors.

Furthermore, despite the relative strength of the AUD against the USD, much of the incoming offshore capital has been sourced from countries with similarly high performing currencies such as Canada, Switzerland and other selected Asian countries and has thus not dampened offshore interest.

RESEARCH

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