

Australian CBD office markets bottoming out

Property Market Review

1 December 2009

- **Positive office demand nationally.** The outlook for office demand continues to improve with a turnaround in demand witnessed in Q309. This followed a period of rapid decline in net absorption across all major CBD markets due to a slowdown in white-collar employment growth.
- **Moderate supply conditions ahead.** A modest amount of new supply entered CBD office markets in Q309, with no new development commencing. In the near term, supply is expected to remain relatively solid but a lack of pre-commitments beyond 2010 will likely result in a moderation of office supply nationally.
- **Rents to stabilise as the rise in vacancies slows.** The extended period of softening space markets and increasing vacancy rates appears to be coming to an end. The national CBD vacancy rate rose modestly in Q309. However, an improvement is not expected to begin until late 2010/early 2011. Rising vacancy rates are causing incentives to climb, leading to a fall in effective rents. Nevertheless, the period of subdued rental growth has almost ended in Sydney, Melbourne and Adelaide while Perth and Brisbane will experience further rent adjustments. We expect all markets to reach the trough of the cycle over the next 12 months.
- **The end of prime yield decompression.** As property markets begin to stabilise, so too will investment yields. In the near-term, we anticipate further moderation in average prime yields while secondary yields face greater downside uncertainty due to a higher vacancy risk.

1. Space market fundamentals

A more optimistic outlook for office markets nationally began emerging in September quarter 2009 (Q309), primarily due to resilient labour market conditions. Positive office demand (as measured by net absorption), due mainly to high pre-commitments, was recorded. However, vacancy rates increased across the nation, although only slightly, due to the backfill space issues as new supply entered markets. These conditions led to additional rental growth weakness during the quarter; however, the decline in rents appears to be either moderating or already bottoming out across the key CBD markets. Moreover, evidence emerged of a slowing in the softening of investment yields, and in some instances yield stabilisation, which was linked to a pickup in investment activity (although primarily in sub A\$50 million price bracket).¹

Demand and supply

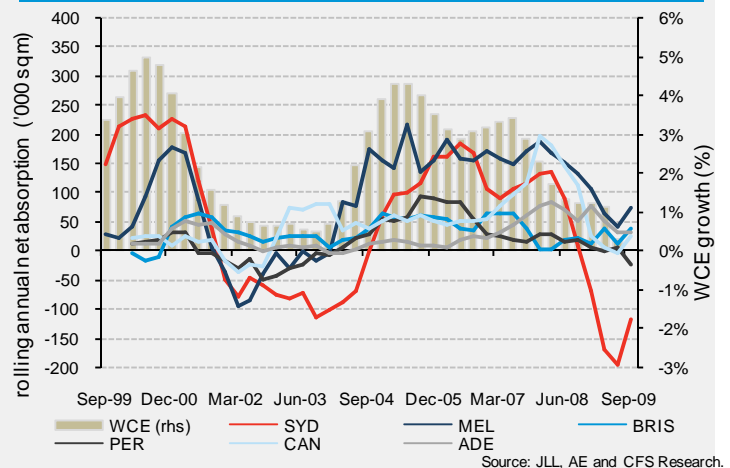
White collar employment is a key driver of demand for office space, and its rapid deterioration during the tail end of 2008 and early 2009 negatively impacted net absorption across all major Australian CBD markets. While white collar employment is still below peak levels reached in 2007, renewed employment activity in the finance and insurance and property and business services sectors has emerged. Positive net absorption (104,900 sqm) was recorded nationally in Q309, indicating that demand has reached a possible turnaround point.

Sydney, due to its high occupancy exposure to the finance and insurance sector (29.6%), was the worst performer recording negative net absorption of 90,000 sqm in the first three quarters of 2009 - of which 55% was in prime grade. However, Sydney rebounded with positive net absorption of 12,700 sqm in Q309 – the first positive quarter since 2008.

Demand in Perth and Brisbane has been fuelled by the expansion of resource-oriented companies and associated support services on the back of the resource boom. The abrupt decline in external demand for resources following the collapse of Lehman Brothers had a negative flow-on effect on these markets. However, the latter recorded positive net absorption on the back of new supply with a relatively high level of pre-commitments, and stronger leasing activity from the public sector. Prospects for Perth and Brisbane office demand have improved, with a sharp and apparent recovery underway in China and other resource hungry developing economies strengthening the outlook for the demand for office space in the medium to long term. In the near term; improving business confidence, increased tenant enquiry, and rising activity from companies such as BHP Billiton and Chevron in Q309, as a result of the approval of the Gorgan Gas project, is expected to result in a pickup in demand in Perth. Nevertheless, this has to be tempered against an influx of new supply which will place further upward pressure on vacancy rates in these markets during this time.

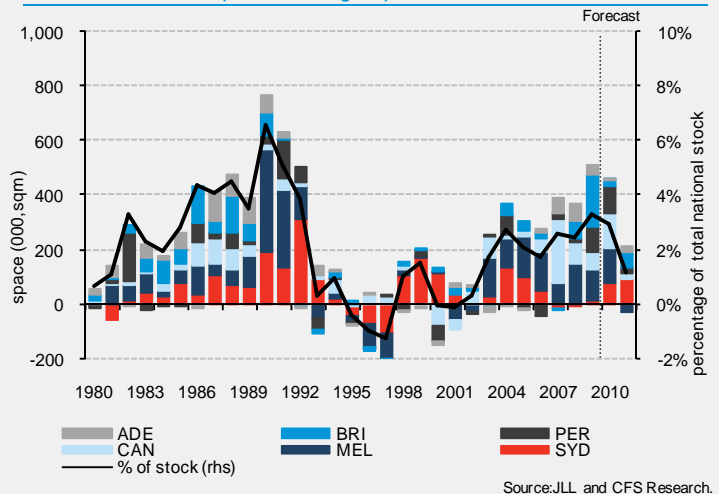
In contrast, Melbourne performed strongly in Q309, with net absorption of 59,000 sqm. The thin rental spread across grades in Melbourne continues to attract tenants into the CBD from Fringe and Suburban markets - dissimilar to Sydney. Adelaide recorded a quarter of positive net absorption of 7,900 sqm (in A grade mainly) after falling 18,700 sqm during the first half of 2009 (H109); although tough leasing conditions continue to prevail. The government sector provided support within the Canberra market, with an increase in hiring activity resulting in a rapid rise in office demand. Net absorption of 35,100 sqm was recorded during Q309 after falling 16,900 sqm in H109.

Figure 1: Trend in annual net absorption and total white collar employment (WCE) CBD office markets, period ending September 2009



The current construction pipeline across all major Australian CBD markets is relatively moderate compared with the supply boom in the late 1980s/early 1990s. During the 12 months to September 2009, a total of 614,000 sqm entered the market, of which 215,400 sqm (with 92% pre-commitment) occurred in Q309. Moreover, there is 985,000 sqm of new supply currently under construction with expected completions concentrated in Brisbane, Melbourne, Perth and Canberra.

Figure 2: Net additions across states CBD office markets, period ending September 2009



However, new supply beyond 2010 continues to moderate due to a variety of reasons including: i) finance difficulties; ii) lack of pre-commitments; iii) uncertainty regarding rental outlook; and iv) construction costs issues which resulted in no new development commencements in Q309 across major CBDs. Strengthening economic and financial conditions during 2010 should see an improvement in supply conditions.

Vacancies and rents

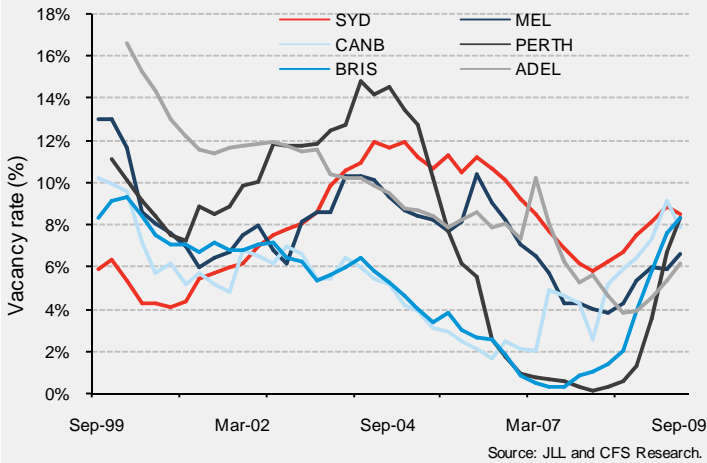
Since the onset of the Global Financial Crisis, vacancy rates have increased rapidly across all markets after an extended period of firming. However, in Q309 the rate of increase in vacancy rates has slowed (+0.2%) and national CBD vacancy rate is currently 7.7% (4.6% in Q308) - still well below historical peaks. In Q309, Melbourne, Brisbane and Adelaide CBD markets recorded a minor rise in vacancy rates, while Perth experienced a moderate increase in vacancy rate (+1.7%). The main contributors to this rise were an increase in backfill space

¹ However, activity has picked up in the price range above A\$100m in Q4 2009.

as new supply was completed. Sydney and Canberra recorded a firming in vacancy rates.

In the short term, most markets are set to experience additional minor rises in vacancy rates due to a strong expected new supply and associated backfill issues. A gradual firming in vacancy rates is anticipated in line with a rebound in economic activity and an expected pick-up in office demand in a relatively limited supply environment.

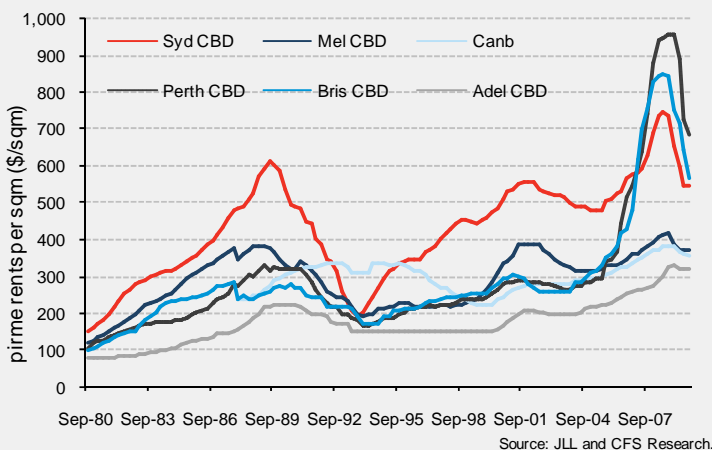
Figure 3: Trend in spot vacancy rates
CBD office markets, period ending September 2009



All major CBD markets have recorded falling effective rental growth during the year to September 2009, as seen in Figure 4. The biggest rental fall was in the resource-driven cities of Perth (-28.9%) and Brisbane (-33.2%), followed by Sydney (-26.1%), Melbourne (-10.5%) and Canberra (-7.6%), while ADE experienced only a modest decline of -2.5%.

In Q309, rents appear to have bottomed out in Sydney (+0.0%), Melbourne (+0.7%) and Adelaide (+0.4%), while the pace of decline slowed in Brisbane (-12.3%) and Perth (-6.1%) with the further rental decline expected in the next 12 months. Rental declines coincided with an increase in incentives as landlords were fighting to maintain existing occupancy levels. Incentives are expected to remain comparatively high in many CBD markets throughout 2010. However, declines in incentives are expected once owners are assured that markets have reached a trough, thereby mitigating any potential tenant retention risk.

Figure 4: Nominal gross effective rental levels
CBD office markets, period ending September 2009

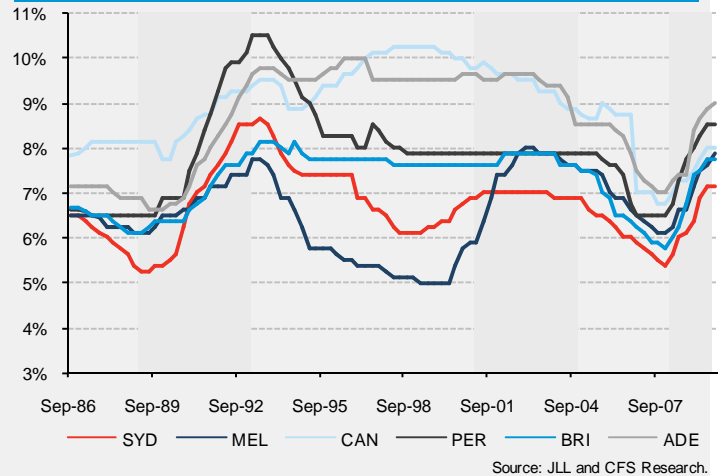


2. Investment markets

The investment market nationwide remained active over Q309, dominated by foreign and domestic private investors with approximately A\$1.1 billion of office property assets transacted. With 21 transactions recorded, the sub \$50 million price segment was particularly dynamic, while the price segment above A\$50 million was comparatively dormant.

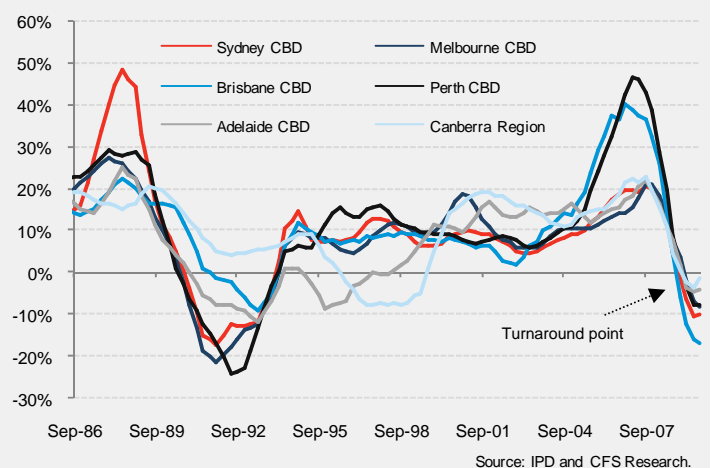
Average prime and secondary yields softened slightly in Q309 by 7bps and 5bps, to 7.8% and 9.2% respectively. We expect further (modest) softening in average investment yields across prime grade assets, while secondary assets will be exposed to greater softening due to a larger vacancy risk. However, while the contraction across markets continued in Q309 it is worthwhile mentioning that the pace of deterioration slowed, indicating that national office markets may be near the bottom of the cycle.

Figure 4: Average equivalent investment yields
Prime CBD office markets, period ending September 2009



Moreover, the observed change in investment performance in Sydney, Adelaide and Canberra office markets in Q309, as seen in Figure 5, gives a further support that a turning point in returns has emerged. While in the past 18 months the key office CBD markets experienced a deterioration in total returns solely due to declines in capital returns, a recent improvement in both capital growth and income return (across abovementioned markets) reflects the positive change in supply-demand dynamics. This highlights a more optimistic outlook for office markets nationally in the near term.

Figure 5: Total returns across prime CBD office markets
Annual percentage change, period ending September 2009



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