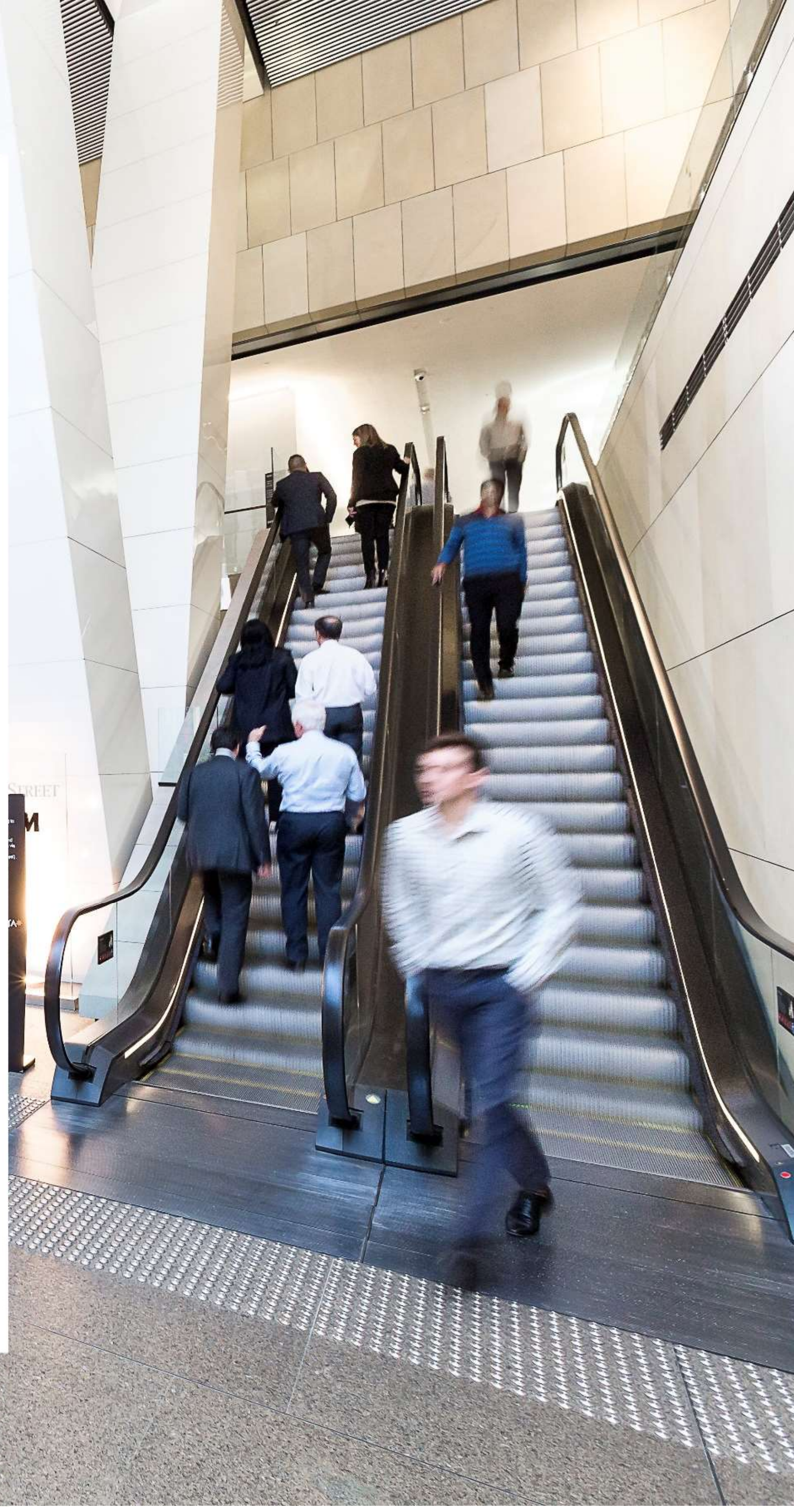
Investa *Inside*

Office Market Outlook

April 2021



Overview

Australia's economic recovery and white-collar employment growth are expected to support office market net absorption over the coming year. However, office vacancy rates in Australia's major CBD markets will remain elevated as the office development pipeline will continue to provide a steady stream of new office completions across Australia's major CBD markets in 2021 and 2022.

The disruption of COVID-19 has accelerated a number of existing trends to the way office work is conducted. These include the availability of workplace flexibility and the office workplace playing a greater role in driving collaboration and team-based office work.

These trends, and other shifts in tenant preferences from COVID-19, are expected to strengthen a 'flight to quality' in tenant leasing activity and drive outperformance in Australia's higher quality office buildings.

Key messages

- A solid rebound in business conditions and business confidence in recent months bodes well for the outlook for white-collar employment and cyclical demand for office space across Australia's major capital city markets.
- We explain how an acceleration in structural office work trends are expected to soften future net absorption by ~5-10% in comparison to pre-COVID net absorption assumptions.
- COVID-19 has not significantly impacted office construction activity across Australia's capital city markets. Despite some easing in office development approvals, the current supply pipeline will a produce a steady stream of new office completions across Australia's major CBD markets in the coming years.
- Reflecting weak growth in business operating costs, including office rent relief, white collar business profits increased sharply through 2020, creating an office rental affordability boost. We think this will strengthen the capacity for businesses to 'upgrade' their office.
- Broader financial market activity and investor sentiment indicates positive underlying capital demand and liquidity for Australian office assets. We expect a return to more open capital market activity will maintain downward pressure on Australian prime office cap rates.

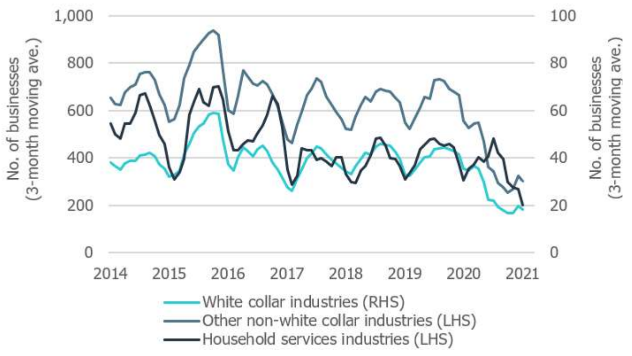
Economic Outlook

Sound base for economic recovery

Australia's economic conditions were severely impacted by COVID-19 through 2020. However, despite being hampered by restrictions on business and social activity, the Australian economy expanded by a solid 6.6% through the second half of 2020. This growth effectively accounted for the COVID-related decline in GDP through the first half of 2020, with GDP running at 99% of pre-COVID levels by the end of 2020.

In recent months, a positive read on business activity indicators reflects an Australian economy that is recovering soundly in 2021. In particular, the Australian business sector has been comparatively resilient through COVID-19 and is well placed as it faces a further wind back of the highly effective furlough measures and continues to 'open up' towards a post COVID-normal setting.

Chart 1: Australian Business Insolvencies



Sources: ASIC & Investa Research

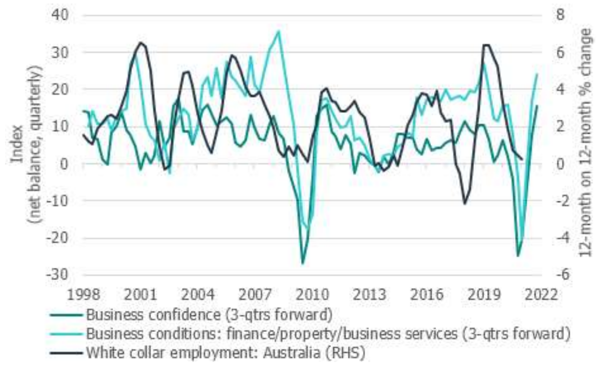
Conditions to support office demand

As the Australian economy, and its major capital cities, have increasingly implemented COVID-normal business operations, both business conditions and business confidence have rebounded strongly. A solid recovery in leading business indicators bodes well for the outlook for white-collar employment and cyclical demand for office space across Australia's major capital city markets.

However, Australia's growth potential, and the pace of economic recovery, is being held back by the headwind of restricted international cross-border movement. A successful rollout of the COVID-19 vaccination program is expected to moderate the strength of this headwind over the coming 12-24 months.

We expect a cautious reopening to international travel and migration will provide a measured return to pre-COVID rates of net overseas migration, and a gradual support to Australia's future economic growth.

Chart 2: Business Conditions & Office Employment



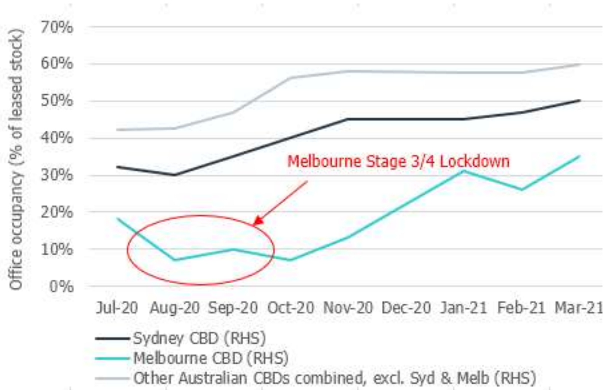
Sources: ABS, NAB & Investa Research

Market & industry variation

State-based policy responses have driven varied operating conditions across Australia's office markets, with Melbourne's recovery and office occupancy in particular lagging Australia's other markets due to the extended COVID-19 lockdown from July to September 2020. More recently, measures and government policy designed to support a 'return to the CBD' have driven convergence in Australian CBD market office occupancy rates.

In addition, the range of Australia's office-occupying businesses are also experiencing varied operating conditions. Across Australia's white-collar industries, specialist business services and public administration have together added more than 80,000 jobs in the year to February 2021. In contrast, business administration services (ie. office administration and employment services) have cut around 50,000 jobs in the past year.

Chart 3: Office Occupancy, Australian CBD Markets



Sources: Property Council of Australia & Investa Research

Office Leasing Market Outlook: Demand

Office-based employment and net absorption

While Australian labour market conditions, and the outlook for the white-collar business economy is positive, the lagged flow-through to Australian CBD office net absorption foreshadows some continued challenges to underlying leasing demand for another 6 to 12 months.

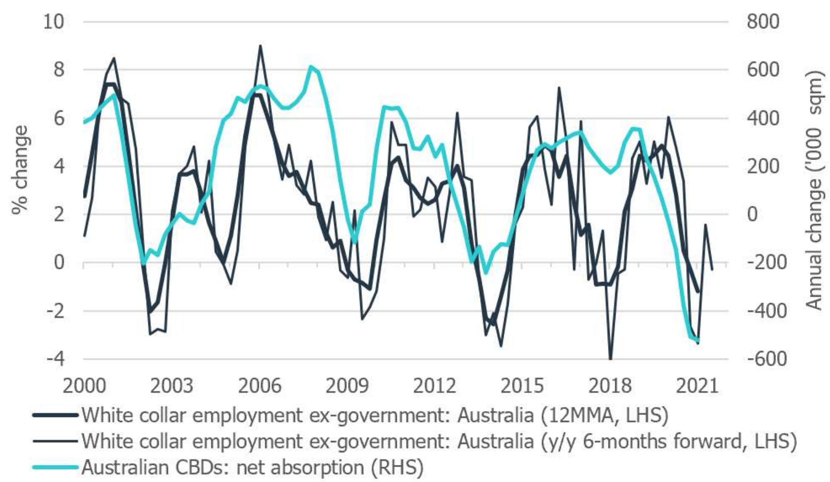
However, allowing for this lag, demand for Australian CBD office space is strongly correlated with economic conditions and white-collar employment. Historically, annual growth in private sector (ie. excluding government) white-collar employment greater than 2% has been sufficient to drive positive net absorption across Australia's major CBD office markets.

In addition to the impact of economic conditions and employment, the disruptive influence of COVID-19 on the operation of the white-collar economy has fuelled debate about the future role of the office market and the impact of new ways of working on future office demand and net absorption.

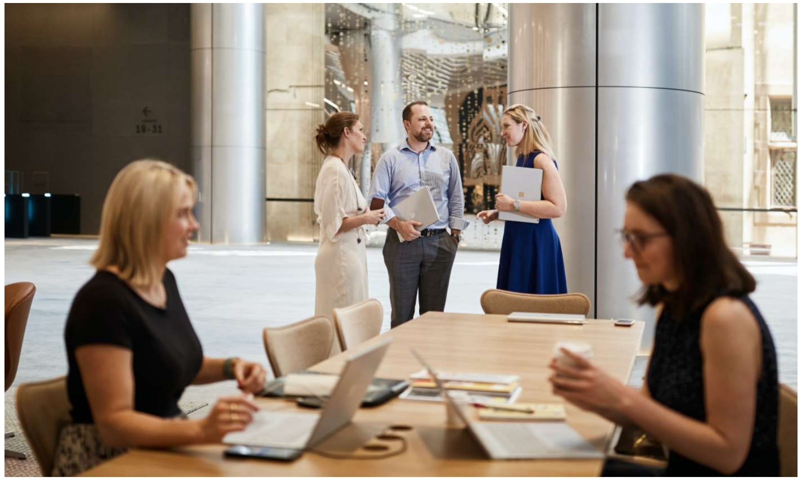
Two common workplace trends that were prevalent before COVID-19, and are being prioritised as businesses take the disruption of COVID to reassess their operations and business policies, are flexible working (including 'working from home') and the role of the office workplace. More specifically, increased workplace flexibility and remote work is expected to soften underlying demand for office space, while a shift towards greater utilisation of the office workplace for collaboration, team-based work, meetings and innovation is expected to increase office demand through upward pressure on workspace ratios (ie. office space required per employee).

While there is still some uncertainty about the likely scale impact of these factors on future demand for office space and net absorption (in fact a significant share of businesses are still unsure how, or if their workplace and operations will change), we estimate that the net impact of these two trends alone will create a moderate long-term reduction in future net absorption of ~5-10% in comparison to pre-COVID net absorption assumptions (for more detail see page 7: *New Ways of Working and Office Demand*).

Chart 4: White-Collar Employment & CBD Office Net Absorption



Sources: ABS, JLL Research & Investa Research



Office Leasing Market Outlook: Supply

Development activity supports office supply outlook

Australia's office supply outlook has not been significantly impacted by COVID-19. Office construction activity and supply chains have been largely maintained and 12 major office development projects were completed across Australia's CBD markets in 2020.

While office development approvals eased in 2020, and expected completion dates of some longer-term uncommitted office development projects have been delayed, the near-term pipeline will continue to provide a steady stream of new office completions across Australia's major CBD markets in 2021 and 2022.

A steady supply pipeline in the coming years will somewhat counter a cyclical rebound in demand and draw out the recovery in market conditions compared to previous cyclical recoveries. However, solid pre-commitment to new office development projects (~60% for the current under construction pipeline across Australia's CBD markets) reflects the strength of demand for high quality office space.

Consequently, we anticipate Australia's major capital city markets will experience variable conditions across precincts and grades, with higher vacancy and weaker market conditions concentrated in the lower grade and backfill assets. Partly offsetting the solid office development outlook, we expect a steady pipeline of office withdrawals in Sydney and Melbourne will constrain the availability of office stock, as backfill assets are either repurposed or refurbished and repositioned to compete with the new supply.

Chart 5: Approved Office Development

Sources: ABS & Investa Research

Office Leasing Market Outlook: Rent

Office rent relief & affordability

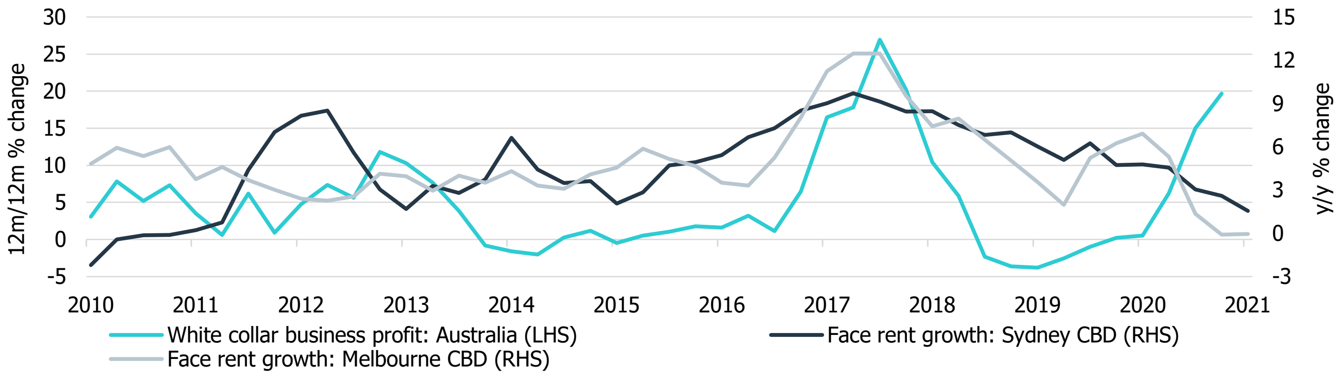
A range of COVID-19 furlough measures and policies, including the national code of conduct for commercial leases, dampened office occupying business operating costs. This drove an unexpected increase in white-collar business profit growth and supported office rental affordability.

In response to government-regulated rent relief policy and softer market conditions, rent growth across Australia's major office markets effectively stalled in 2020. In comparison, white-collar business income remained somewhat resilient, resulting in a surprisingly sharply increase in business profit growth.

In contrast to the tight CBD office market conditions in recent years, and corresponding solid rental growth, current market conditions present a unique rental affordability window. In addition, elevated incentives further support the easing in rental affordability on an effective basis.

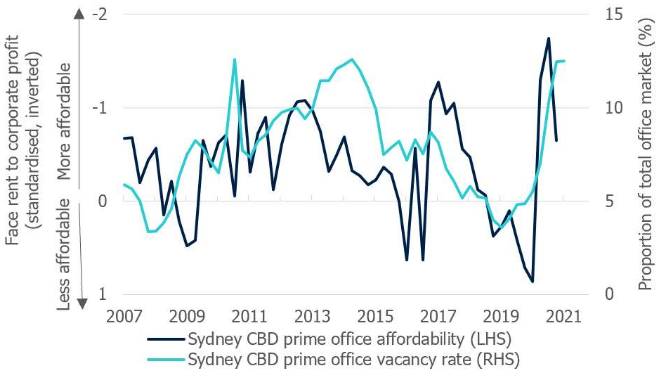
We expect favourable rental affordability conditions, combined with both elevated market vacancy and a strong tenant preference for centrally located, high quality and flexible office space will support a 'flight to quality' trend and drive future rental growth outperformance in Australia's CBD prime office markets through the cyclical recovery.

Chart 6: Prime Office Rent Growth vs White-collar Business Profit Growth



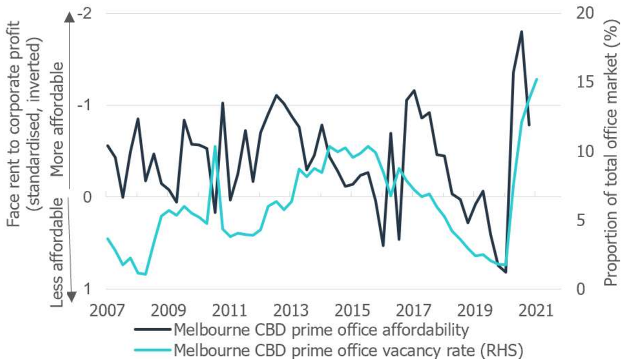
Sources: ABS, JLL Research & Investa Research

Chart 6.1: Sydney CBD Office Rental Affordability



Sources: ABS, JLL Research & Investa Research

Chart 6.2: Melbourne CBD Office Rental Affordability



Sources: ABS, JLL Research & Investa Research

Office Capital Markets

Pent up capital demand

Office capital market activity has slowed sharply during COVID-19. This provides a smaller base of transaction evidence to influence future capital market expectations. However, when combined with broader financial market activity and investor sentiment, this supports a positive underlying outlook for capital demand and liquidity for Australian office assets.

Global central banks, including the Reserve Bank of Australia, have committed to maintaining accommodative policy settings until economic and financial market conditions return to normal. This includes sustained economic growth and underlying inflation, which the RBA "does not expect to be met until 2024 at the earliest"[1].

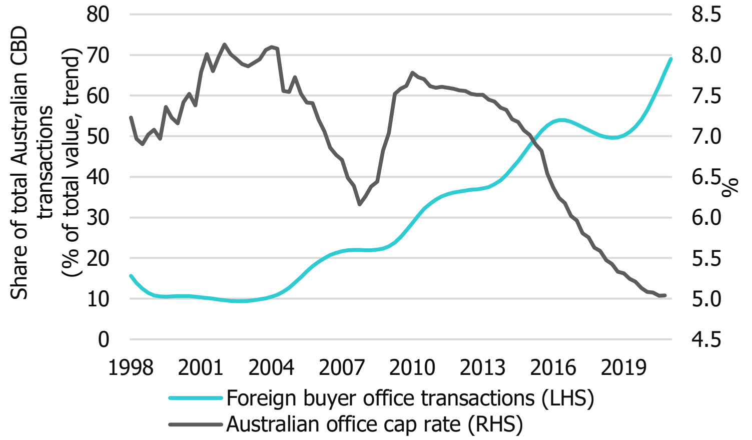
Consequently, we expect low policy rates to maintain downward pressure on interest rates and global liquidity to support the depth of capital.

Evidenced by the experience of 2020, where capital values have effectively held firm with modest easing in some assets, Australian office markets are expected to continue to provide stable and attractive returns. In particular, prime assets in Australia's major CBD markets are expected to attract strong capital demand and outperform.

However, a return to more open capital market activity, and a resumption of firm downward pressure on Australian prime office cap rates, is dependent on international business travel and cross-border movement of capital.

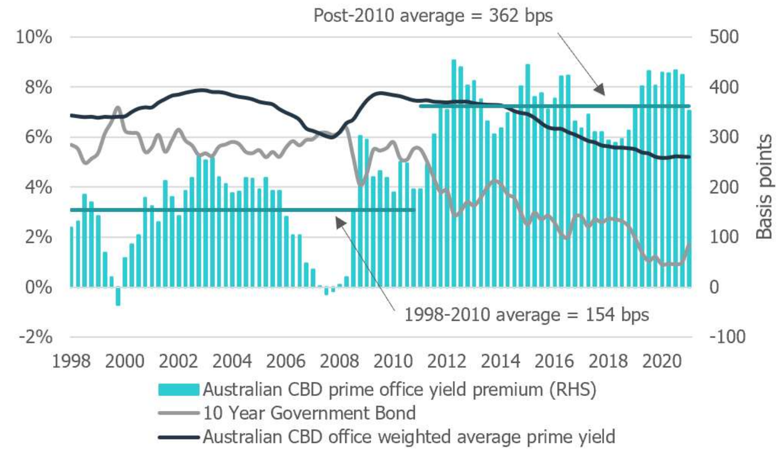
Since the mid-2000's foreign buyer activity has been critical in driving office capital market transactions and office market capital growth. We expect the COVID-19 pause in international travel, and the ability to conduct in-person due diligence, will unwind with the application of the COVID-19 vaccination program.

Chart 7.1: Foreign Capital Transactions & Australian Cap Rates



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

Chart 7.2: Bond Rates & Australian CBD Prime Office Yields



Source: JLL Research, RBA & Investa Research

[1] *Statement by Philip Lowe, Governor: Monetary Policy Decision*, RBA, 6 April 2021.

New Ways of Working & Office Demand

The disruption of COVID-19 has accelerated existing trends to the way office work is conducted. Applying basic assumptions related to the shift towards increased flexible work and greater use of the office for collaboration-style work, we estimate the net long-term impact on net absorption will create a modest 5-10% drag.

Flexible Work & Office Utilisation

Workplace flexibility relates to offering a suitable range of workplace options, including, but not limited to the office and home-based work. Assuming the net impact of greater workplace flexibility decreases forecast absorption by 20% (equivalent to a net increase on average of 1 day per week working from home) – this would decrease potential annual absorption in Sydney CBD by ~15-20,000sqm.

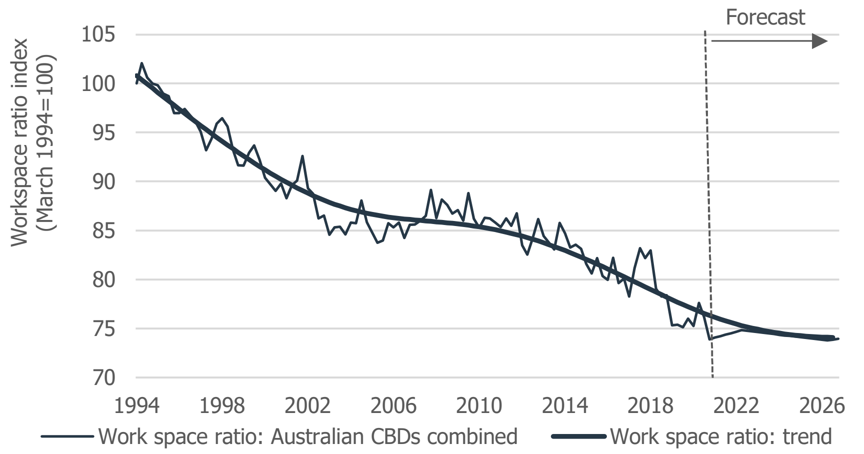
On the other side of the ledger, we assume workplace utilisation trends, and a greater emphasis on collaboration and team-based office work, will drive some moderate near-term upward pressure on workspace ratios, reversing the long-term downward trend, and adding ~10-12,000sqm to Sydney CBD annual absorption. In the longer-term, we expect this will revert to more stable declines in market workspace ratios.

Office Net Absorption Contributors

In addition to the net impact of accelerated adoption of flexible work practices and a shift in workplace utilisation trends, office net absorption is also impacted by tenant-specific factors, such as changes to location or building preferences. Assuming a stronger post-COVID tenant preference for centrally located offices, we expect that annual Sydney CBD office absorption from this factor will increase by a modest ~2-3,000sqm.

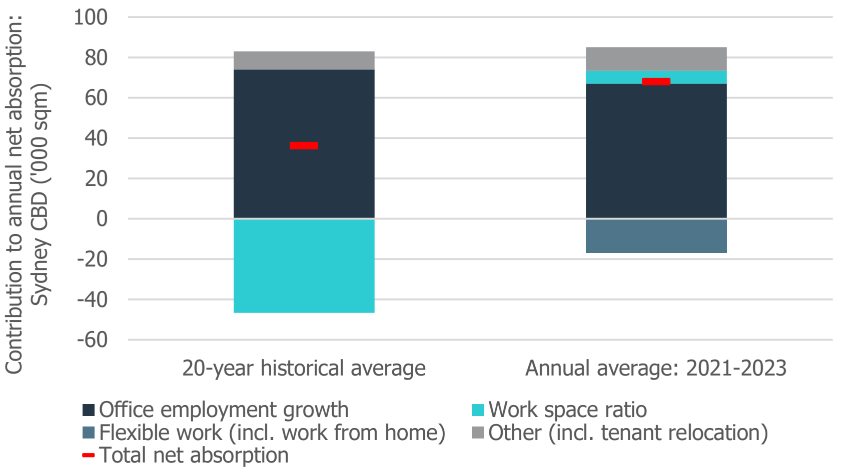
However, the economic cycle and white-collar employment remains the most significant factor impacting Australian capital city office absorption. Job creation and business expansion is expected to continue to account for approximately 60-65% of Australian CBD gross absorption.

Chart B1.1: Australian CBD Office Workspace Ratios



Sources: Property Council of Australia & Investa Research

Chart B1.2: Contributors to Sydney CBD Office Net Absorption



Sources: ABS, Property Council of Australia & Investa Research

Further Information

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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$12 billion of quality office real estate. As a specialist office manager of commercial office buildings Investa manages 21 assets in the key Australian CBD markets on behalf of ICPF, Oxford Investa Property Partners (OIPP) 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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