PROPERTY INSIGHTS.

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SUMMER EDITION 4, 2016

2016: a year for change and opportunity in commercial property

Top themes for 2016

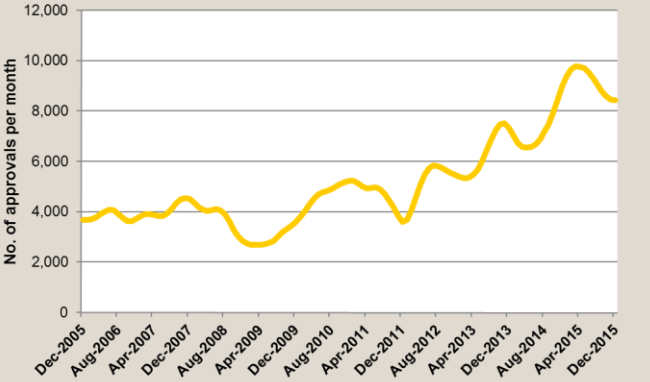
- **Interest and activity in commercial property investment set to further intensify**
- **Global financial markets uncertainty will continue to drive investors into other assets like commercial property, drawn by low inflation and low interest rates**
- **States heavily impacted by the downturn in mining investment set to move into an early positive recovery phase**
- **Slowing apartment development approvals nationally likely to see some sites return to the market, offering potential for non-residential development and use**
- **Residential property cycle to ease while commercial property fundamentals will continue to improve, with each market and sector at a different point of recovery.**

A year of change ahead

2016 will be the year the residential property cycle starts to ease, with growth in both pricing and development set to trend lower. As the residential property cycle recedes, the focus will shift to commercial property. Although investment activity is already running at a high level, interest in commercial property is set to intensify further in the year ahead.

With pricing likely to be pushed one notch higher to reach record levels, emphasis will turn to increasing returns through improvements in rental levels or a property's net operating income. Each commercial property sector and market offers very different growth potential.

Chart 1. 2015 apartment approvals



Source: Australian Bureau of Statistics, Building Approvals, 8731.0, Table 6, November 2015

Residential development set to ease

Recent years have seen an unprecedented rise in residential development, driven by high rise and high density apartments. The extraordinary growth across the industry reflects a surge in investor activity and a significant shift to apartment living in all of Australia's major cities.

However, apartment development is likely to slow this year — following a trend that emerged in the middle of 2015, when approvals started to drop. A decline in approvals as shown in **Chart 1,** is typically a signal the commencement of new construction activity will ease within six to 12 months.

With fewer approvals, commencements have indeed tapered, although they've plateaued at a high level. This is likely to see buoyant construction activity continue into 2017.

During the next phase of this unwinding process, as projects are completed, fewer will commence to take their place. The overall effect will be an eventual reduction in development activity which is likely to then continue at a more sustainable level.

Ultimately, this means some of the developments approved over the last few years will not proceed in this cycle. Owners may choose to sell those sites, providing an opportunity for others to develop uses more aligned to the changing demand-side conditions of 2016.

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Brisbane and Melbourne to lead site sales

The markets which have pushed hardest in apartment approval and development over the last few years are most likely to witness site sales in 2016. Brisbane and Melbourne stand out as the cities where developers are most likely to sell sites, as markets with sufficient demand for alternative uses in both the short and long term.

Although the Australian economy is forecast to grow below trend in 2016, underlying demand conditions in some sectors are sufficient to support alternative inner-city uses provided for in new development outlined in C**hart 2**.

Tourism-related activity is growing on the back of the lower value of the Australian dollar and high growth in tourist arrivals from Asia, particularly China. This is leading to demand for more tourist accommodation to cater for various consumer markets.

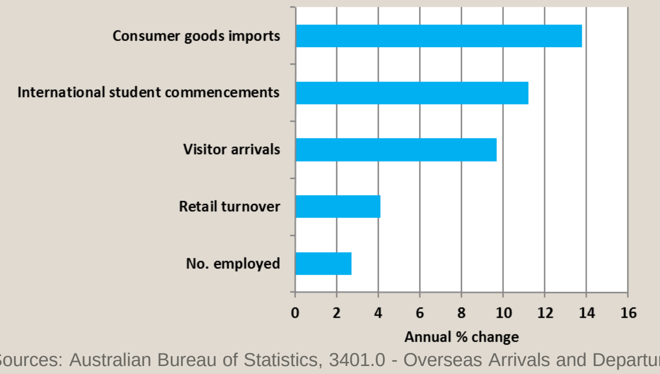
Similarly, demand for education is enjoying steady growth, particularly for higher education from international students. Purpose-built student accommodation is considered a pre-cursor to provide for this demand.

The easing back of the apartment development sector could be the opportunity student accommodation providers need — enabling them to secure their desired sites in strong locations at more reasonable prices.

Other uses may underpin development or refurbishment of existing buildings on sites previously earmarked for residential. These include boutique retail, office, medical, child care, service industrial, car parking or mixed use.

Local or State Governments may also see an opportunity in 2016 to buy sites to provide for public uses, such as schools, medical or transport-related, to better serve the large and fast-growing high density residential communities of these inner-city locations.

Chart 2. In property demand drivers



Sources: Australian Bureau of Statistics, 3401.0 - Overseas Arrivals and Departures, Nov 2015, 8501.0 – Retail Trade, Nov 2015, 5439.0 International Merchandise Imports, Table 7. Balance of Payments Broad Economic Categories Customs Value, Department of Education and Training,, 6202.0 – Labour Force Australia. Dec 2015

Alternatively, existing developer-owners in these areas may look to purchase sites to consolidate properties and plan for projects in the next residential development cycle.

Turning to investment

Beyond the likely shake-out in the residential development sector, interest in commercial property as an investment is expected to continue at a high level in 2016.

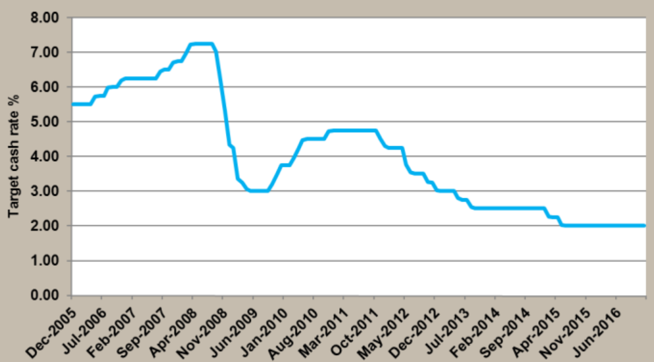
As uncertainty grows in global financial markets, more investors are driven to purchase quality commercial property. The start of 2016 has already been marked by volatility in markets around the world, including Australia.

With increased investment activity over the last few years, pricing has been pushed to an all-time high, across all price points. However, although prices are high, interest rates remain low making it attractive to buy quality real estate at current prices.

However, its also important at this point of the cycle to take into consideration factors which create a high quality commercial property asset, in both the short and long-term. These include:

- Strength of location for the use(s);
- Prospect of re-letting in the case of a vacancy;
- Strength of the tenant as a leasing covenant;
- Length and terms of the lease;
- Level of the rent relative to the prevailing market;
- Prospects for rent or other property income increases;
- Physical condition of the property and the need for any capital expenditure;
- Redevelopment potential;
- Land use zoning; and
- Any building operating costs which cannot be passed onto the tenant

Chart 3. Cash rate target 2005 - 2015



Source: Reserve Bank of Australia/Commonwealth Bank Proprietary Data, January 2016

Leasing demand holds strong

Purchasing commercial investment property at a high price places greater emphasis on the ability to increase income from the property and improve future returns.

The prospect for property income growth is driven by the strength of both leasing demand for a property and its location, as well as the number of available suitable properties competing for tenant.

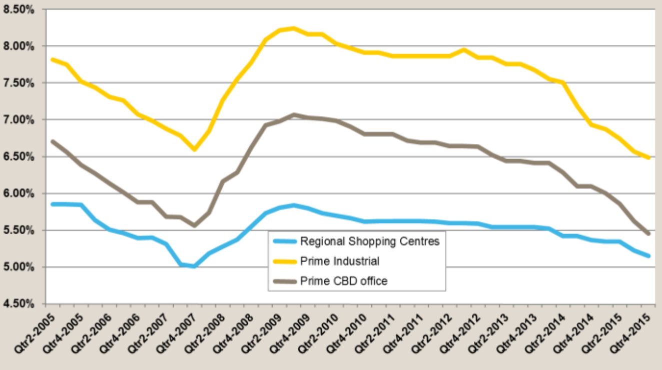
In 2016, the strength of leasing demand for commercial property is likely to be highest in Sydney and Melbourne. In these two cities, growth in population, employment and the economy generally is leading the country and providing the best short-term conditions to reduce market vacancy and increase rents or other property income.

New opportunities in the mining capitals

A significant trend in 2016 will be investors turning back to consider commercial property in Perth and Brisbane. Although these two markets have been adversely impacted by the restructure of their economies as the mining sector winds back, it seems the downturn phase of this restructure is largely over.

Looking ahead, recovery is the next phase for the Western Australian and Queensland economies and their commercial property markets. This may take some years, but it looks like the worst is over – and both Perth and Brisbane are likely to enjoy an increase in investment interest and activity over the next few years.

Chart 4. Australian commercial property yields, 2005-2015



Source: Real Estate Intelligence Service, JLL Research, Q4 2015

Expansion into growing markets

Higher investment yields can be found in Adelaide and Canberra commercial property and this started to stimulate investment activity in both markets in 2015. We expect this activity to increase in 2016 as relatively higher yields will continue to be found in these markets, compared to those in larger cities.

This is also in the context of downward pressure on yields being maintained across Australian commercial property, particularly for quality assets.

There will also be opportunities to invest in commercial property in regional Australia in 2016. However the outlook in these locations varies considerably and is tied to local economic and property drivers as well as being very sensitive to tenant competition.

Those factors which contribute to a quality asset, as outlined on page 2, need to be very carefully considered and applied in smaller markets, as the level of underlying tenant demand is lower and the economies of these cities continue to be heavily impacted by industry restructure.

What does it mean for investors?

While 2016 is expected to be a volatile year and one underpinned by an acceleration of change to property drivers, there is still plenty of opportunity to engage with the market.

The easing in high density apartment development is likely to see an increase in the sale of sites once earmarked for residential projects. These sites may provide the opportunity to offer uses to service the market created by a fast increasing population in these new high density suburbs. Ideally, shorter-term uses in existing buildings may provide the option for more intensive development in the future, when the residential development cycle strengthens once again.

In the meantime, the popularity of commercial property as an investment is set to increase further in 2016, amidst volatility of global and local financial markets.

The challenge will be buying the right property at the right price and working to improve income returns into the short to medium-term. While the larger cities offer greater short-term possibilities in this regard, buyers need to be selective elsewhere, as the timing around improvement in the fundamentals is less clear.

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Focus on: Commercial property in an agile economy

As the Australian economy continues to restructure away from the influence of a boom in mining investment, the focus is turning to what the “next big thing” may be and how this might impact on the occupational demand and pricing of property — be it residential or commercial. The strong upswing in apartment development nationwide has helped take up the construction industry capacity and expertise which has come out of the mining sector, and has stimulated land and property prices, particularly in inner-city areas. But like the resources sector, residential development is also cyclical and with approvals now peaked in this cycle, its likely this development activity will ease over the next 12-18 months.

The influences on the shape of future property demand are coming from many directions and won’t always result in a “next big thing”, but rather may come from and manifest in a number of medium-sized, smaller or emerging industries and companies. The highest employment growth in Australia, for example, is now in industries which just a few years ago were low on any ranking; Information, Media and Telecommunications; Professional, Scientific and Technical Services and Healthcare and Social Assistance are currently the top three growing categories of employment. These three industries are expressed in real estate demand in many different forms, scales and locations.

Information, Media and Telecommunications include activities that primarily create, enhance and disseminate information products. Social media companies such as LinkedIn and Twitter are a good example — and are now large office space users in Australia, creating quality leasing covenants which underpin the value of prime grade CBD office investments.

At the other end of the scale, Information, Media and Telecommunication start-ups are finding locations in small secondary and new strata offices on the edge of CBDs, in suburbs such as Surry Hills in Sydney and South Yarra and Richmond in Melbourne. Some are also supporting a new style of casual, collaborative work spaces on entire floors of CBD office buildings. Institutional and private landlords are responding to and benefitting from this trend by capturing this demand in a leasing arrangement.

Professional, Scientific and Technical Services companies are also heavily information and knowledge-based and include services such as scientific research, architecture, engineering, computer systems design, market research and advertising. Transfer of knowledge through collaboration is seen as a critical step in developing new ideas, services and products. This need for interaction is influencing business location and workspace design, but not removing the need for a real estate base altogether. Those property and business owners who understand the changing nature of this demand will be best placed to invest in and adapt their properties — particularly office properties — to benefit from it.

Healthcare and Social Assistance is a very broad industry and its real estate needs manifest in many ways. Its growth is influencing the development of specialised retirement and aged care facilities in suburban and regional areas of Australia — some valued at hundreds of millions of dollars. But at the same time, in an effort to improve client service, specialist healthcare providers are occupying suburban offices and shopping centre/strip centre shops and benefitting landlords, large and small at the same time.

So while headline economic growth may be forecast to below trend in 2016, there are still many opportunities for developers and landlords who can identify emerging and agile industries and their real estate needs.

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