

Office Market Link Sydney

Introduction

After a period of relative inactivity following the onset of the Global Financial Crisis, positivity is beginning to return to the Sydney office market, with both sales and leasing activity increasing over 2010. While the sprouting of these 'green shoots' has undoubtedly restored some faith in the Sydney market, both occupier and investor demand remains highly fragmented. Prime properties in the Sydney, North Sydney, Parramatta and North Ryde are in strong demand, while demand for secondary properties across Sydney remains low.

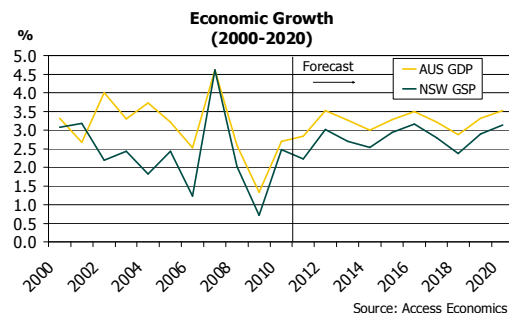
For the purpose of this report, we have reviewed the performance of office properties across all of the Sydney commercial office markets. To provide the reader with a greater understanding of the market dynamics concerning a current or upcoming investment, this report analyses the conditions of prime, secondary and strata offices in the major CBD and non CBD markets within Sydney.

Economic Conditions

Economic Growth

The Australian economy grew in the December quarter of 2010, with quarterly economic growth rising from 0.1% in the September quarter to 0.7% in the three months to December. Much of the rise in economic growth has come as a result of an increase in non-farm commodity exports. The release of the results in March did however, come with a warning from the Australian Treasury Department, with lower output over the Jan-March quarter expected as a result of the Queensland floods.

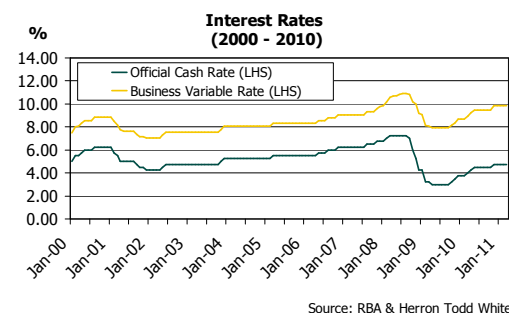
As opposed to other states, the New South Wales economy has a greater exposure to the finance and professional service sectors, than the mining and resource based states. As such, economic growth within the NSW economy has under performed the Australian economy since the onset of the Global Financial Crisis in early 2008.



In the 12 months to June 2010 the NSW economy grew at a rate of 1.71% compared to the Australian economy which grew by 3.0%, over the same period.

Interest Rates

With the RBA seemingly more confident on inflation following the increase in interest rates from 4.50% to 4.75% in November 2010, the RBA has left interest rates on hold in its last five meetings in December, February, March, April and May.

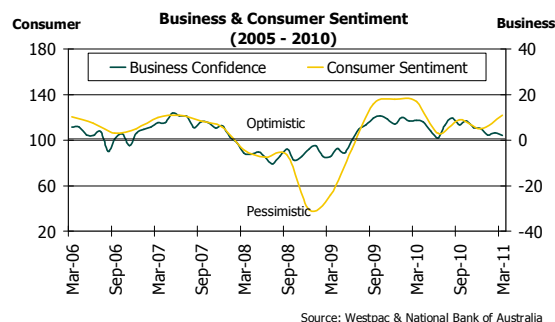


Despite the substantial increase in headline inflation recorded in the first quarter of 2011, the RBA has elected to focus on underlying inflation and leave interest rates on hold. The RBA has noted that the recent increase in CPI is reflective of the production losses associated with Cyclone Yasi and the summer floods. Furthermore, they believe that these price shocks will dissipate over the coming months, steering inflation close to the RBA target rate in the coming 12 months.

Business and Consumer Sentiment

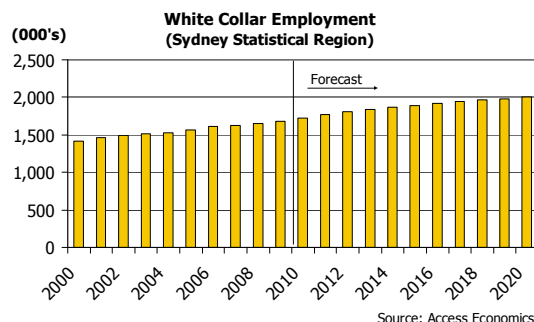
Business confidence levels are a key lead indicator of future spending and economic growth. After recording a notable fall in the December quarter, business confidence rebounded in the March quarter, rising by 6 points. Much of the improvement in confidence came as the worst of the flood impacts receded. On a monthly basis, business confidence has fallen sharply in the retail, construction and manufacturing sectors, but has risen in the finance/business/property sectors. Improving business confidence has the potential to drive demand for office accommodation, as businesses seek to take advantage of a perceived improvement in business conditions.

The most recent Consumer Sentiment Survey has indicated a slight rise in consumer sentiment following the fall in sentiment in March. As of April 2011, the consumer sentiment index stood at 105.3 points. According to the Westpac/Melbourne institute, this rise in sentiment has come as a result of a stronger economic outlook, interest rate stability and record high exchange rates. Confidence, however, has been constrained by the tragic events in Japan, unrest in the Middle East/North Africa and significant increases in petrol prices.



White Collar Employment

Changes in white collar employment are a key leading indicator as to the occupational demand for office space. As shown in the chart below, white collar employment within the Sydney Statistical Region has maintained an upwards trajectory since 2000. Over the 10 year period to June 2010, white collar employment grew by a total of 22.1%.



Looking forward, it is expected that the level of white collar employment within Sydney will continue to grow, as an expanding financial and professional services sector continues to drive employment. Over the 10 years to June 2020, white collar employment growth is expected to moderate slightly, with growth forecast to average 1.2% over this period.

With continued white collar employment growth forecast, it is expected that demand for office accommodation across Sydney will rise in the near to medium term.

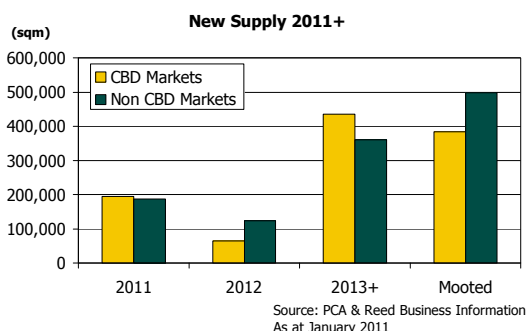
Market Conditions

Conditions within the Sydney office market improved during 2010, with investors returning to the market after a period of inactivity, following the onset of the Global Financial Crisis. These improved conditions have been witnessed in both the leasing and investment markets, with continued white collar employment growth driving demand for office space and an improved rental outlook, coupled with an easing of lending restrictions, driving demand for office investments.

Market conditions, however, remain weak in secondary and suburban locations, with aging stock coupled with weak occupier demand, limiting investor interest.

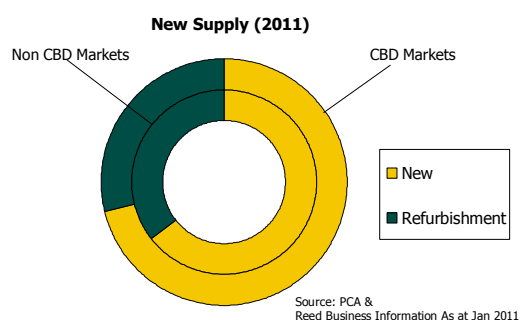
Supply

Over the 12 months to January 2012, some 380,174 sqm of commercial office floor space will be added to the Sydney office market. The increase in supply over 2011 signifies the end of the most recent development cycle, with a substantial amount of floorspace added to the Sydney office market in the last two years. Despite the increase in supply over 2011, vacancy is not expected to be adversely impacted, with the majority of the space featuring a high level of pre-commitment.



As shown in the chart above, 2012 will see a fall in new supply within the main CBD markets, with

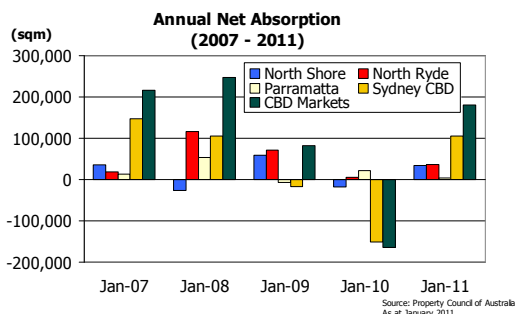
projects placed on hold at the onset of the Global Financial Crisis, but subsequently commencing construction in the last 12 months, expected to reach completion. Supply is expected to be slightly higher in the non CBD markets during 2012, with a number of buildings within in suburban locations expected to reach completion.



In the next 12 months, the majority of new supply delivered to the Sydney market will consist of a number of new buildings completed within the Sydney CBD. These include the One Bligh Street and Darling Walk developments. As shown in the chart above, refurbishments will account for only a minimal amount of new supply during 2011, with 114,780 sqm expected to be re-introduced to the Sydney market.

Occupier Demand

Demand for office space improved greatly over 2010, following a fall in demand during 2009.



While net absorption returned to positive territory in

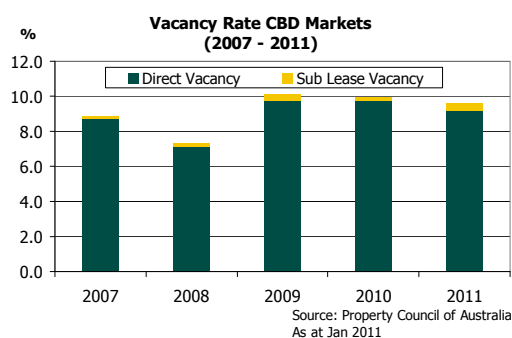
Selected Office Completions 2011-2012

Building Address	Suburb	Total Size (sqm)	Pre-commitment (%)	Comments
99 Alexander Street	Chatswood	1,200	100	Full refurbishment.
63A Archer Street	Crows Nest	2,661	100	Mixed use development featuring ground and first floor commercial space.
20 Bond Street	Sydney	29,579	20	Full refurbishment, following the relocation of Macquarie Bank.
1 Bligh Street	Sydney	42,000	55	A new premium building developed by Dexus.
Harbour Street	Haymarket	56,000	100	A campus style development, known as 'Darling Walk'.
85 Castlereagh Street	Sydney	33,000	95	A new premium building built as part of the Westfield Sydney City redevelopment.
7-9 Irvine Place	Baulkham Hills	12,760	100	A new A grade building located within the Norwest business park.
41-43 Bourke Road	Alexandria	17,000	0	A refurbished heritage industrial property.

Source: Reed Business Information, PCA & Herron Todd White

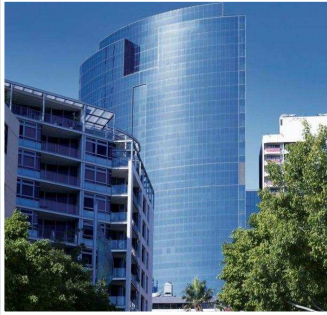
all of the major Sydney markets over 2010, demand was greatest in the Sydney CBD, with space being taken up in a number of new developments and refurbishments. During 2010, some 105,392 sqm was absorbed by the market.

Despite the strong net absorption results recorded over 2010, vacancy across the major CBD markets only decreased slightly, falling from 9.83% in Jan 2010 to 9.38% in Jan 2011. The weaker than expected vacancy results, come after a rise in the supply of A grade office space within the major CBD markets, with this sub-market growing by 59,733 sqm over the 12 months to Jan 2012.



Of the 741,843 sqm of vacant office space within the major CBD markets, the majority is contained within A grade buildings, with over 280,000 sqm of A grade space currently vacant within Sydney.

LEASING ANALYSIS



Address: 321 Kent Street Sydney

Property: A 21 story A grade building, built in 1990, refurbished in 2005.

Lease Details: Two high rise floors with a high quality of internal fitout. Lease includes exclusive use of the upper balcony.

Rental: \$1,135,200 (net)

Start Date: 01/01/2011

Floor Area: 2,200 sqm

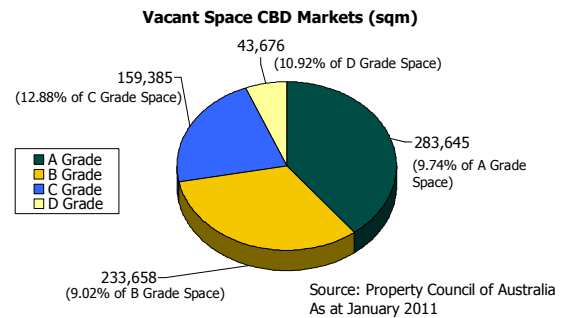
Lease Term: 2.5 Years

Reviews: 4.5% p,a

Incentives: 0%

\$/sqm: \$516

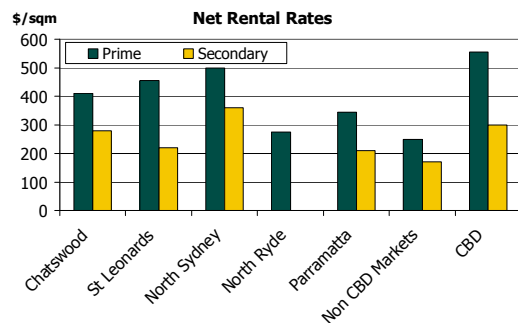
As shown in the chart adjacent, D grade properties have the lowest overall vacancy in Sydney with only 43,676 sqm, available within the major CBD markets.



Leasing Market Conditions

Reflecting the higher levels of vacancy, rental rates across all property grades recorded minimal growth over the 12 months of 2010. With the exception of A grade properties in Parramatta, landlords have been forced into competing against each other for a scarce number of firms looking to relocate or take up expansionary space. As such, incentives across the Sydney region remain high, ranging from 25%-30%, depending on the location and quality of the property.

As shown in the table below, prime Sydney and North Shore properties attract the highest rental rates, with an average gross rental rate of \$660/sqm and \$555/sqm respectively. Furthermore, rental rates within these markets can be significantly higher in premium buildings and newer A grade buildings with superior views.



LEASING ANALYSIS



Address:	25 Solent Circuit Baulkham Hills
Property:	A 36 unit B grade strata development completed in 1990.
Details:	A strata unit located in the second floor of the building.
Rental:	\$28,800 (net)
Start Date:	01/02/2011
Floor Area:	96 sqm
Lease Term:	3 Years
Reviews:	Greater of CPI or 4.0% p,a
\$/sam:	\$300 (net)

Outside of the major CBD's, rental performance has been highly dependent upon the location of the subject property. In the Sydney CBD fringe and South Sydney sub-markets, rental performance remains strong, as firms look outside of the Sydney CBD for discounted rental rates. Elsewhere in Sydney, rental performance remains weak, as a lack of demand coupled with ageing stock places downwards pressure on rental rates.

While rental conditions in prime and secondary office properties across Sydney have been weak for some time, the rental performance of smaller office suites (less than 100 sqm) has been somewhat stronger. Throughout Sydney, demand remains strong for these smaller suites, with the number of small businesses seeking space continually expanding. With incentives generally not playing a part in leasing negotiations of these smaller properties, net effective rents can be higher than similar quality larger properties. The rental performance of these smaller suites is, however, very location specific.

Investment Market Conditions

Demand for office investments improved during 2010, as investors moved to capitalise on lower capital values brought on by the Global Financial Crisis. Investor demand is, however, very property specific, with buyers wary of committing to investments with uncertain cash flow outlooks.

Prime office investments and secondary buildings with strong lease covenants remain in the highest demand, with sales of these properties achieving initial yields between 6.8% and 8.2%. Despite the higher demand for these properties, sales volumes have been relatively low, with owners of these properties generally having little need or desire to divest of these assets.

In broad terms, demand for secondary office investment remains subdued across the Sydney market. A review of transactions of secondary properties during 2010 however, revealed that demand, while remaining low, has improved for well located assets, with the Sydney CBD, North Sydney CBD and Sydney CBD fringe area featuring the greatest demand. A review of secondary office transactions revealed that yields for these assets range between 8.6% and 11.3%. Unlike the prime market, the number of secondary office assets

available for purchase remains high, as the hangover from the Global Financial Crisis continues to pressure owners of secondary properties.

SALES ANALYSIS



Address: 171 Clarence Street, Sydney

Details: A 15 storey C grade strata office building with all units currently held under single ownership.

Sale Price: \$29,500,000

Sale Date: 01/12/2010

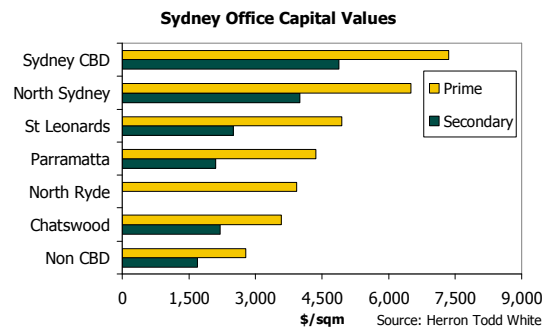
Building Size: 6,519 sqm

\$/sqm: \$4,525

Yield: 9.00%

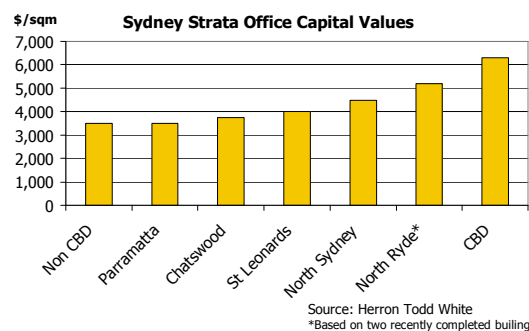
As shown in the adjacent chart, capital values for prime properties within the Sydney CBD remain the highest in the greater Sydney market (over \$7,000/sqm). At the other end of the scale, capital values of prime office properties within Chatswood have fallen to \$3,857/sqm, only slightly above the capital values achieved by prime office properties located outside of the major non CBD office markets.

Furthermore, it can be seen that secondary offices attract a significant discount to prime offices across the Sydney market, with secondary capital values attracting a 34%-52% discount to prime office properties.



Despite the fall in investor demand, consistent demand from owner occupiers has maintained capital values of strata office suites. Like the secondary market, demand for these properties has been very location specific, with strata office suites in the Sydney CBD fringe and Southern Sydney corridor attracting the greatest demand.

As shown in the chart below, capital values for strata office properties vary widely across the Sydney market, with strata offices in the Sydney CBD attracting the highest capital values.



While the chart above suggests a higher demand for strata offices within North Ryde, discussions with local marketing agents revealed that demand

remains low, with unsold office suites remaining in developments completed over two years ago. As these developments are the only representation of 'true' strata offices within the North Ryde market, their higher capital values are reflected in the chart above.

Selected Strata Office Sales

Address	Sale Price	Sale Date	Yield
102-11 Chandos St, St Leonards	\$245,000 (\$3,331/sqm)	March 2011	8.38%
201/25 Solent Cir, Baulkham Hills	\$235,000 (\$3,176/sqm)	February 2011	VP
7/235 Macquarie St, Sydney	\$675,000 (\$8,544/sqm)	November 2010	VP
31/88 Foveaux St, Surry Hills	\$390,000 (\$4,239/sqm)	October 2010	VP

Source: Herron Todd White

Market Outlook

Conditions within the Sydney office market are expected to continue to improve over 2011, as higher economic growth drives both occupier and investor demand. With a large proportion of upcoming supply featuring strong pre-commitment, it is expected that vacancy rates will begin to slide across the majority of Sydney markets. Higher levels of occupational demand, however, will likely be limited to prime properties, with vacancy rates for secondary offices in suburban locations expected to remain high.

Despite an improvement in investor demand during 2010 and early parts of 2011, sales transactions (as measured by total value of sales) will likely fall, with the number of higher value assets offered to the market expected to fall. In light of higher investor demand and a reduction in stock on the market, it is expected that yield compression will again become a factor in the Sydney office market.

At the bottom end of the market, investor interest for strata office suites is expected to remain low, with the yields offered by these properties below that deemed acceptable by an investor. With a reduction in demand from owner occupiers likely as a result of increasing interest rates, both sales liquidity and capital values of strata office suites are likely to fall during 2011.

Further Information

For a more in depth understanding of the current office market conditions and how they relate to your property, or for further information regarding any Herron Todd White service please contact either:

Peter Ainge

Research Analyst, Herron Todd White
(Sydney/ACT & SE NSW)

Telephone: +61 2 9221 8911

Mobile: +61 408 444 747

Email: peter.ainge@htw.com.au

Mark Skeed

Commercial Director, Herron Todd White
(Sydney/ACT & SE NSW)

Telephone: +61 2 9221 8911

Mobile: +61 488 998 717

Email: mark.skeed@htw.com.au

Or visit the website

www.htw.com.au