KNIGHT FRANK VALUATIONS

April 2016

Institutional Commercial Market Update/ Analysis

Introduction

The beginning of 2016 brings some important changes in value metrics for the institutional market following some recent material transactions.

As important as some recent sales are for pricing in the "upper prime" market, it is also important to analyse the impact these sales may have on forward pricing across the A-grade and secondary markets.

Our analysis for this paper is focused on the Sydney CBD as an overall market proxy, but also references interstate benchmarks.

KEY POINTS

- ***Recent sales indicate material changes in value in the "upper prime" market.***
- ***"Valuation lag" will be evident versus many 2015 book values. This will involve "catch up" whilst the market potentially compresses further. This is likely to accelerate the rate of change in revaluations due to this "catch up", albeit the rate of compression for upper prime stock is expected to slow over the remainder of 2016.***
- ***A-grade trading within wide band, but below 6.0%.***
- ***Greater headroom for compression in secondary stock.***
- ***Whilst it may appear on cyclical trends alone that yields for "prime" assets are breaching previous peak levels (which they are and which appears to be leading to reluctance in the market by some participants), there is a greater case for a fundamental longer term shift in what market participants consider to be the "new norm", which makes comparison with previous cycles misleading. Therefore it would not be unreasonable to expect upper prime/premium yields be achieved in the high 4.0%'s assuming no major market disruption.***

Current Market Commentary

Over late 2015, pricing for "upper prime" assets (defined as upper A-Premium Grade assets with stabilised and/or long term lease profiles in "core" markets), was premised around some more dated sales (e.g. 161 Castlereagh St, Dec 14 @ 5.62%) with a degree of implied tightening based upon the analysed apportionment of the IPT sale (e.g. 5.0%-5.25% for the "trophy group" of assets – refer to IPT Market Update Paper in late 2015, which can be referenced within the KF ValSal App).

This "implied" tightening however was clouded by the portfolio nature of the transaction, and as such many "upper prime" assets were benchmarked within a range of 5.25% - 5.75% (i.e. softer than the parameters indicated by the IPT deal).

The analysis below of yields for key "prime" sales over the past 4 years provides some context to the yield trends for Prime assets (nb. Sydney assets are noted in blue and Melbourne assets green).

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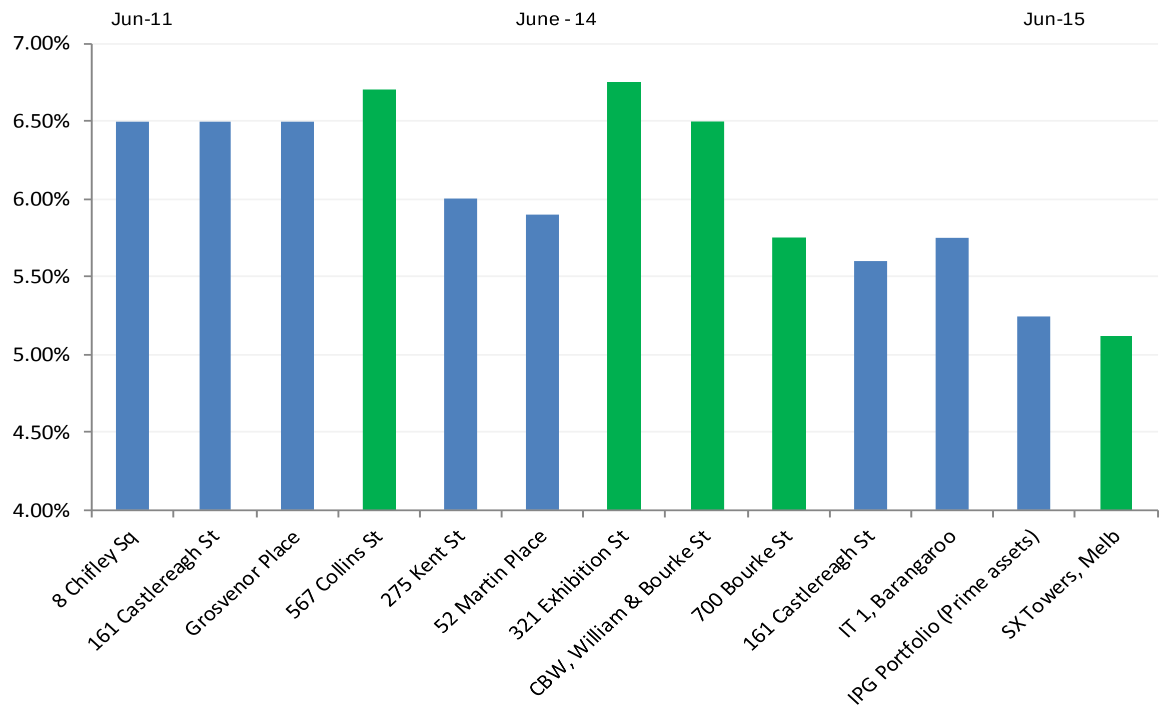
Prime Yields 2011 to 2016 - Knight Frank Valuations



Note: Analysis does not include 420 George St, Sydney which is currently pending.

The very recent sale of **Southern Cross Towers, Melbourne (5.1% @ December 2015 and IRR of 7.0%)** and the reported pending sale of 420 George Street (circa 5.25%), indicate that the range for "upper prime" assets is now considered to be more defined and established at 5.0%-5.25%, with IRRs between 7.0%-7.25% (although we understand some are reporting analysis on Southern Cross of sub-7.0%).

The parameters indicated (again highlighting the 'pending' nature of 420 George Street) support the IPT "trophy group" pricing parameters and therefore indicate that the "portfolio premium" uncertainties of the IPT deal are now historic – i.e. not relevant. In essence, the market has moved on and single asset sales are now supporting the earlier IPT parameters.

Furthermore, each of the assets are rated as upper A-grade assets, which may imply that a sub 5.0% yield is achievable for a "trophy/landmark" Premium grade asset However, it is also common in markets such as this for yields to converge between grades, which in the absence of any Premium grade sales, makes it difficult to determine the extent of any yield differential that a Premium grade asset may command versus say an upper A-grade asset. However, this is discussed further within this paper under **"Looking through the Cycle and Analysing 'Lower for Longer**'".

Overall, the "prime" market is now considered to be trading significantly below its 10 year average (up to 75-150 basis points) depending upon the particular qualities of the asset. This is demonstrated by the following chart.

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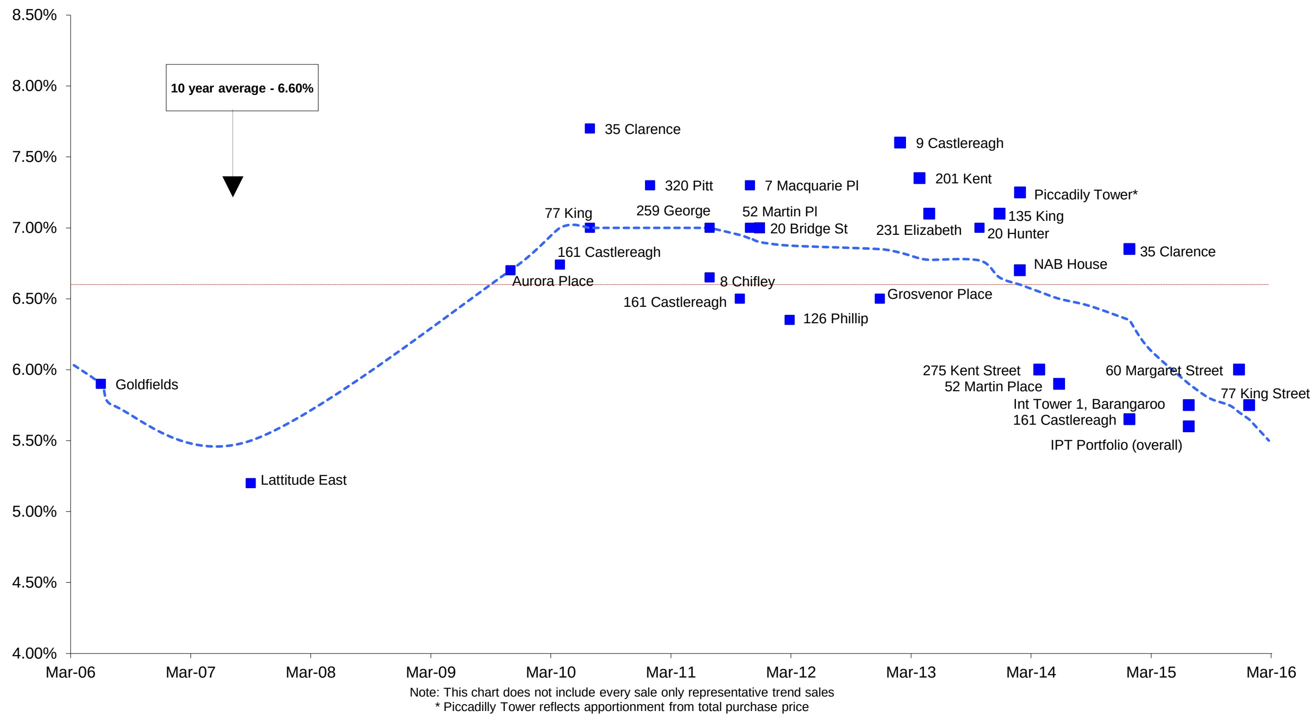
Prime Sydney CBD Office Yields - Knight Frank Valuations



What does this indicate?

It is clear that the metrics indicated suggest that material variations in value are now evident for many institutional assets. As such there is expected to be "valuation lag" across the market (i.e. the difference between current market indicators and 2015 book valuations).

However, it also indicates some push and pull factors relating to pricing in the A-grade and secondary markets, factors which may cloud pricing in the short term.

As we discuss further within, whilst the earlier chart shows peak to peak relativities, we do not consider that reference to the previous 2007 peak (a comparison made by many) is an appropriate relative measure of where we are at in the current cycle (refer within this paper to "Convergence" and "Looking Through the Cycle and Analysing 'Lower for Longer'").

The trading band for A-grade Assets

A-grade sales are considered to reflect a wider trading band in the current market. Parameters can be defined by the sales of 77 King Street (January 2016 @ 5.76%) and the MetCentre (January 2016 @ 5.72% - office component) and the sale of Southern Cross Towers, Melbourne (December 2015 @ 5.1%) and pending sale of 420 George Street (reported at circa 5.25%). In essence this represents a current trading band of between 5.1% and 5.75% - which is quite wide.

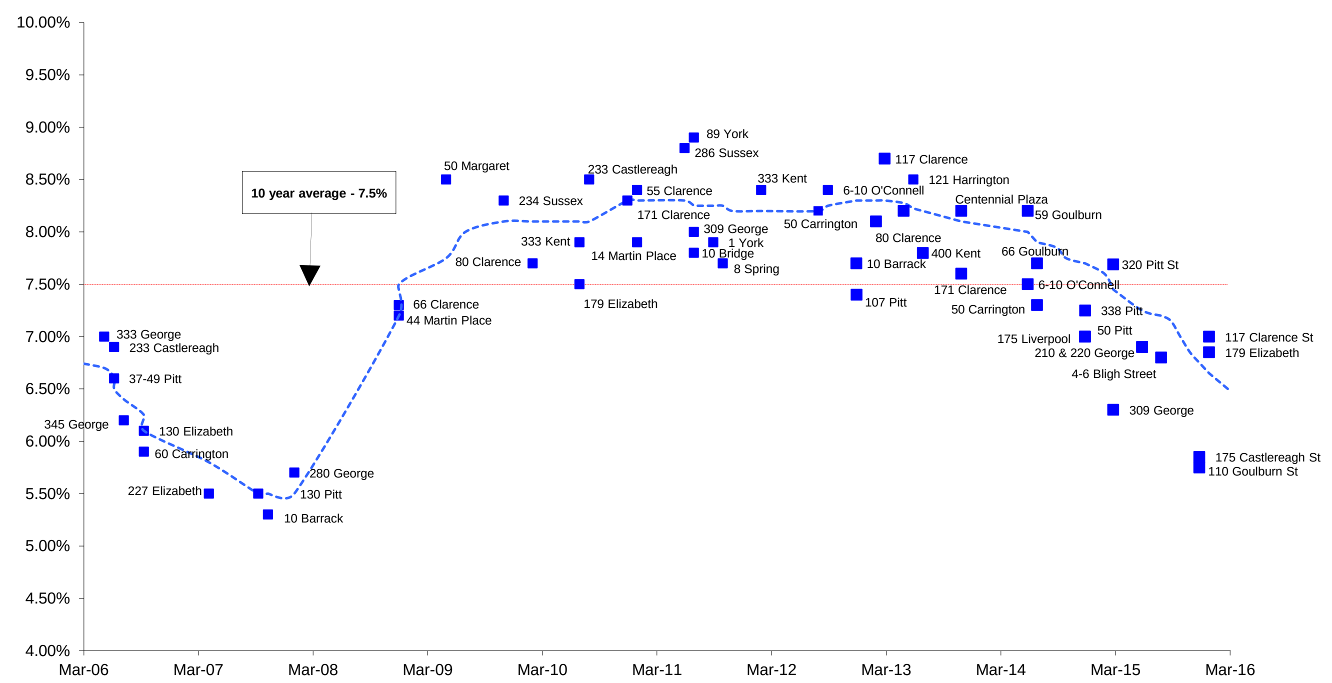
This wider trading band and yield compression for A-grade stock over 2015 and into 2016 is symptomatic of strong market conditions and a convergence of yields between upper A-grade and Premium stock. This convergence has been evidenced by sales such as 77 King Street and 60 Margaret Street and is being led by quality with stronger pressure evident for upper A-grade stock. We would expect this convergence and stronger compression to flow through to lower A-grade stock over 2016, however in the interim, pricing within the A-grade quality band is likely to remain less certain, subject to variability and open to greater interpretation by valuers until further sales occur.

It is interesting to note that yields for A-grade sales in early 2015, appeared misaligned (i.e. too soft) versus secondary sales such as 210-220 George Street (May 2015 @ 6.9%) and the later sale of 4-6 Bligh Street (August 2015 @ 6.8%). This misalignment is considered to have been re-balanced to a degree by the compression evidenced by sales such as 77 King Street (5.76%) and 60 Margaret Street/MetCentre (5.72% - apportioned office component only).

Secondary Assets

The withdrawal of space within the secondary market segment via residential conversions, commercial redevelopment (particularly within the core precinct) and compulsory acquisitions for the new Sydney Metro, is now emphasising the strong rental growth opportunities for secondary stock. Location however will remain a strong driver.

Secondary Sydney CBD Office Yields - Knight Frank Valuations



Note: This chart does not include every secondary sale only representative trend sales

Core market yields for secondary stock are more typically in the order of 6.25% - 7.25%.

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The secondary market has reverted below its 10 year average of 7.5%. Recent sales of B-grade assets are reflecting yields 75-100 basis points below the 10 year average level (less than the prime assets at 75-150 points below average). Accordingly, based upon this comparison alone, we would envisage further capacity/headroom for tightening in the secondary market relative to longer term averages, which will also be aided by withdrawals in this sector, particularly with the Core precinct.

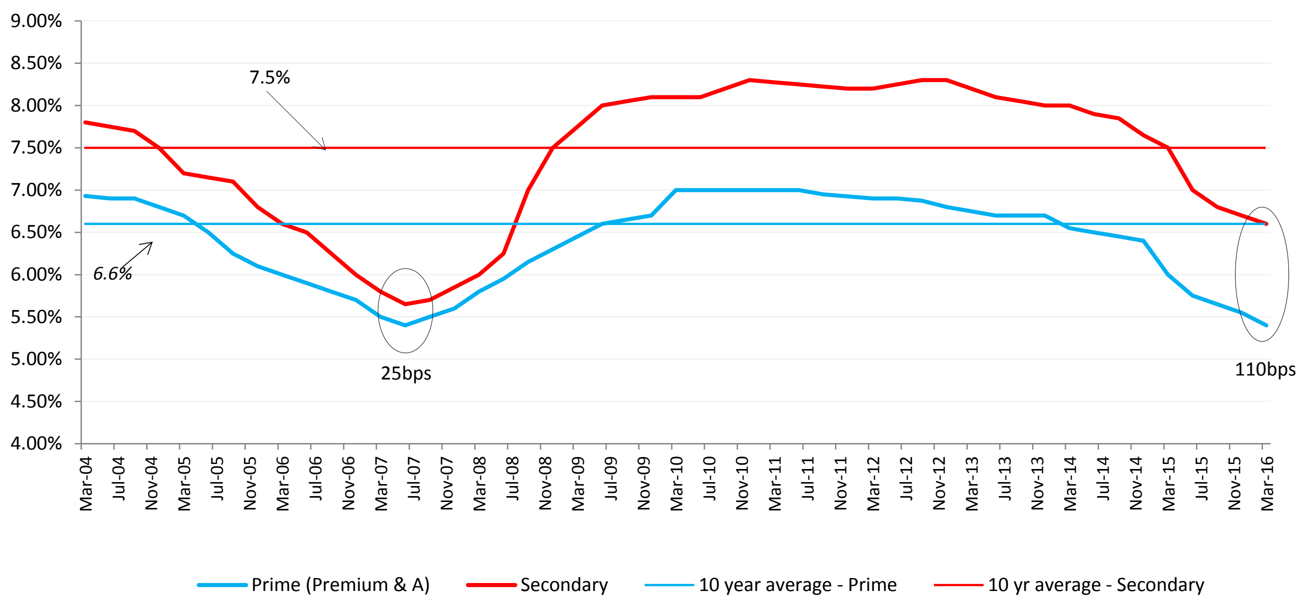
Furthermore, on current metrics, yields for secondary stock are between around 75-125 basis points higher/softer than A-grade stock, which also tends to imply that there will be some narrowing of this differential over 2016 – otherwise referred to as convergence.

Convergence

As noted within a previous paper (dated August 2015 and available for downloading, emailing and printing within the KF ValSal App), the convergence between prime and secondary markets can be a measure of the relative point we are at in the cycle and the "through the cycle" risks.

Interestingly, as noted in the graph below, the differential between prime and secondary has remained constant over the past 6-12 months, due largely to the re-rating demonstrated by recent and pending sales in the "prime" market. Using historic trends, it is expected that convergence between secondary and prime yields will occur over 2016, particularly if the rate of compression in 'Upper Prime' yields begins to slow. In other words, there is a strong case for compression in the secondary market, with this compression also supported by strong fundamentals for secondary stock (withdrawals, etc.).

Historical Yield Trends - Prime v Secondary (Sydney CBD) - Knight Frank Valuations



The above chart reflects general yield trends based upon representative benchmark transactions within the CBD as is not meant to represent exact yield levels

Looking through the Cycle and Analysing "Lower for Longer"

A common query in the current market is where is this cycle going? Can we look through and identify the risk issues? How is "lower for longer" reflected in yields? Should "upper prime" and Premium stock now trade at sub 5% and if so, by how much?

No one can clearly forecast to this degree, but relative measures can be a guide.

As noted previously, indicators such as convergence can provide some guidance as to "point in cycle" risk. At this time, there has been no material convergence which typically occurs as buyers move up the risk curve in order to satisfy the weight of funds. Prime and secondary are holding their relativities therefore indicating headroom for further compression. This measure alone (and we stress "alone" – it is only a single measure) would indicate no material cyclical risk is apparent.

We used standard deviation as a measure of risk in our paper dated August 2015, titled "Sydney Office Market Yield Trend Analysis in Historical Context". The "upper prime" market is currently trading well outside the standard deviation of +/-0.4% around its 10-15 year average of 6.5%. This alone generally implies increased risk as trading begins to occur within the higher end (pointy end) of the up-cycle.

However, this analysis is limited in that it does not reflect current and expected capital market conditions – i.e. the concept of "lower for longer". Hence the historical averages analysed are skewed by previous higher growth and higher interest rate environments. The new trend/paradigm therefore needs to be analysed, and point to point comparison with previous cycles may be of little relevance going forward.

Our analysis below reflects the 15 year trend for inflation indexed 10 year bond yields versus the prime office yield trend over the 15 years. Averages over the 15 years are also included.

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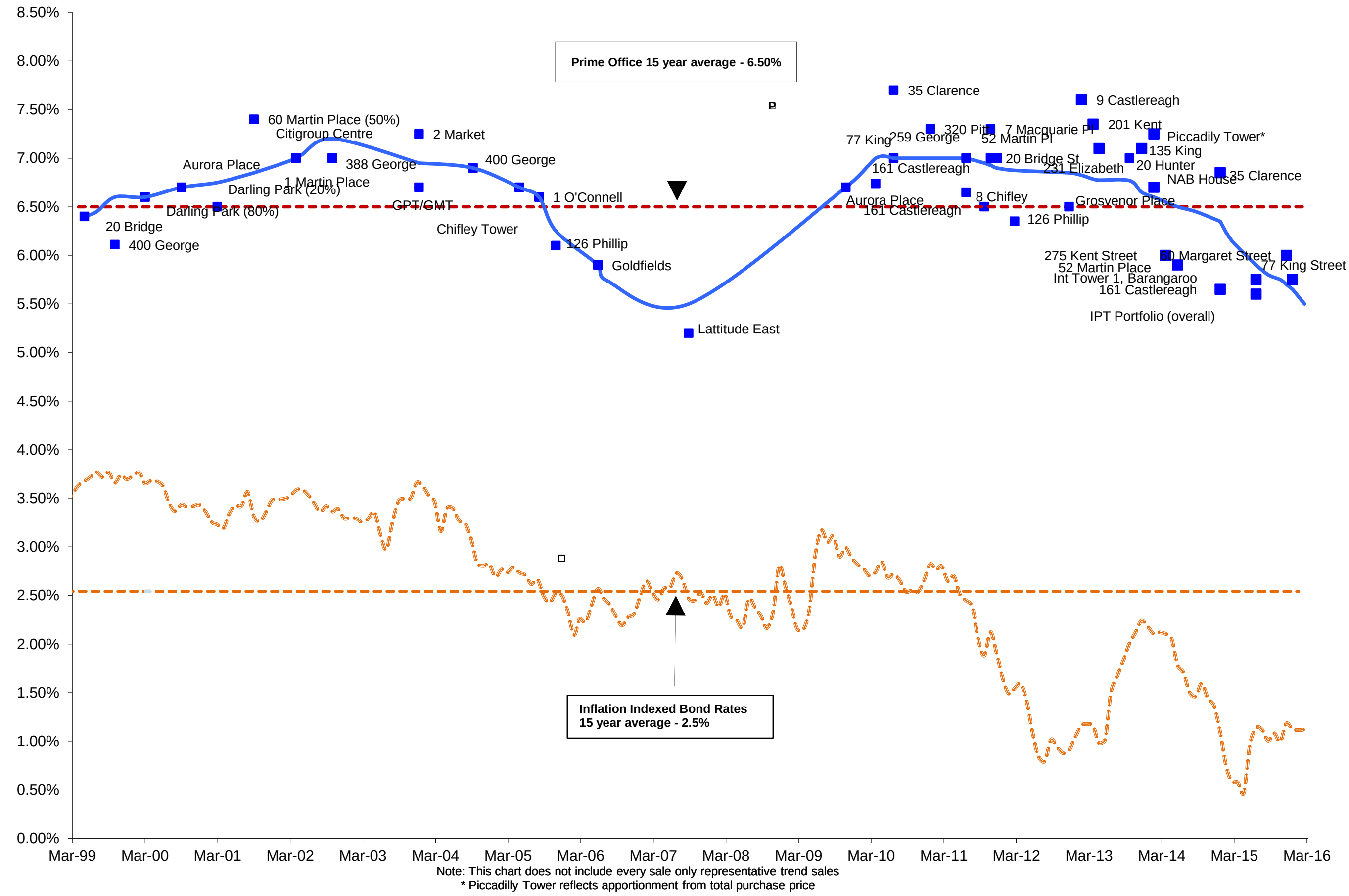
Prime Sydney CBD Office Yields - Knight Frank Valuations



Observations regarding the above include:

- There has been a clear parallel/correlation between the inflation indexed bond yield trend and prime Sydney CBD office yields over the last 15 years.
- The 15 year average indexed bond yield is approximately 2.5%, however, this reduces to approximately 2.0% over 10 years and to 1.5% for the last 5 years and 1.25% for the last 2 years. A clear long term downward trend.
- This trend is indicative of the low growth environment, and given current global growth trends, there is expected to be no material movements to this trend – which may indicate that it is reasonable to assume a longer term trend out a further 5 years averaging closer to 1.25%-1.5% **(caveated by no major capital market disruptions or spike in inflation expectations). This is well below the 15 year average of 2.5%.
- In simple terms, given historic yield margins over the indexed bond yield of around 4.0% for prime Sydney CBD assets (i.e. the difference between the averages of 6.5% for prime yields and 2.5% for inflation indexed bonds), the implied longer term sustainable average yield for prime Sydney CBD assets under a lower growth/interest rate regime, may be around 5.25%-5.5% (i.e. 4% above a new potential longer term average for inflation indexed bonds of 1.25% - 1.5%). An average of 5.25% - 5.5% (say 5.375%), is much lower than the average for the past 15 years of 6.5%.

- Applying our previously measured 15 year standard deviation range for prime CBD assets of +/-0.4% (refer to August 2015 paper), an appropriate longer term trading range through the cycle of 4.9%-5.8% may be implied (i.e. +/-0.4% under a re-based longer term average of say 5.375%).
- Using the standard deviation, the trading range noted may reflect a normalised longer term trading band, however, markets do run outside this standard deviation on the upside and downside. Therefore it would not be unreasonable to expect upper prime/premium yields be achieved in the high 4.0%s.
- The relativity of current yields versus terminal yields becomes a consideration as markets trade well below long term averages. Typically valuers may reflect a greater terminal yield margin under these circumstances. However, this should be reconsidered under a "lower for longer" scenario.

Conclusion

Whilst the analysis above is only one way of determining potential yield parameters under a "lower for longer" scenario, it would be reasonable to expect that a lower longer term yield band could be evidenced going forward and that sub 5.0% yields will be evidenced for upper prime/premium assets. Hence, whilst it may appear on historical data alone that "prime" yields are breaching previous peak levels (which they are and which is leading to reluctance in the market from some market participants), there is a greater case for a fundamental longer term shift in what market participants consider to be the new norm.

Whilst it is not the purpose of this paper to analyse IRRs, it may also be implied that sub 7.0% IRRs may also be reflected.

POINTS TO NOTE/CONSIDER

- ***Material impact to values evidenced by recent sales.***
- ***Book values are lagging in some instances and 2016 will involve catch up, potentially at the same time that the market is compressing further. This may accelerate the rate of revaluation compression, albeit the rate of compression for upper prime stock is expected to slow over the remainder of 2016. Developments in local and global credit markets will be monitored closely.***
- ***Extent of compression/re-rating of values will be open to interpretation. This may lead to inconsistency in reported values as the band between recent and previous sales and current book valuations is quite wide in some cases, more so in the A-grade market.***
- ***Quality of information will govern the interpretation of recent sales.***
- ***Does material tightening for upper A-grade assets rationalise a tightening to sub 5% for Premium assets. "Lower for longer" analysis would suggest it does.***
- ***Historic trends would imply further tightening potential for secondary stock, which will be further aided by high withdrawals in Sydney.***
- ***Whilst it may appear on cyclical trends alone that "prime" yields are breaching previous peak levels (which they are and which is leading to reluctance in the market from some participants), there is a strong case for a fundamental longer term shift in what market participants consider to be the new norm.***

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This report is available on the KF ValSal App. The App also contains analysis of individual commercial sales in the market in Australia which can provide further context on the metrics noted within.

It should be noted that this report and all major national commercial sales analysed by Knight Frank Valuations over the past 10 years, can be referenced and searched within the KF ValSal App. A free 2 week trial is now also available to test the App to see its benefits.

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