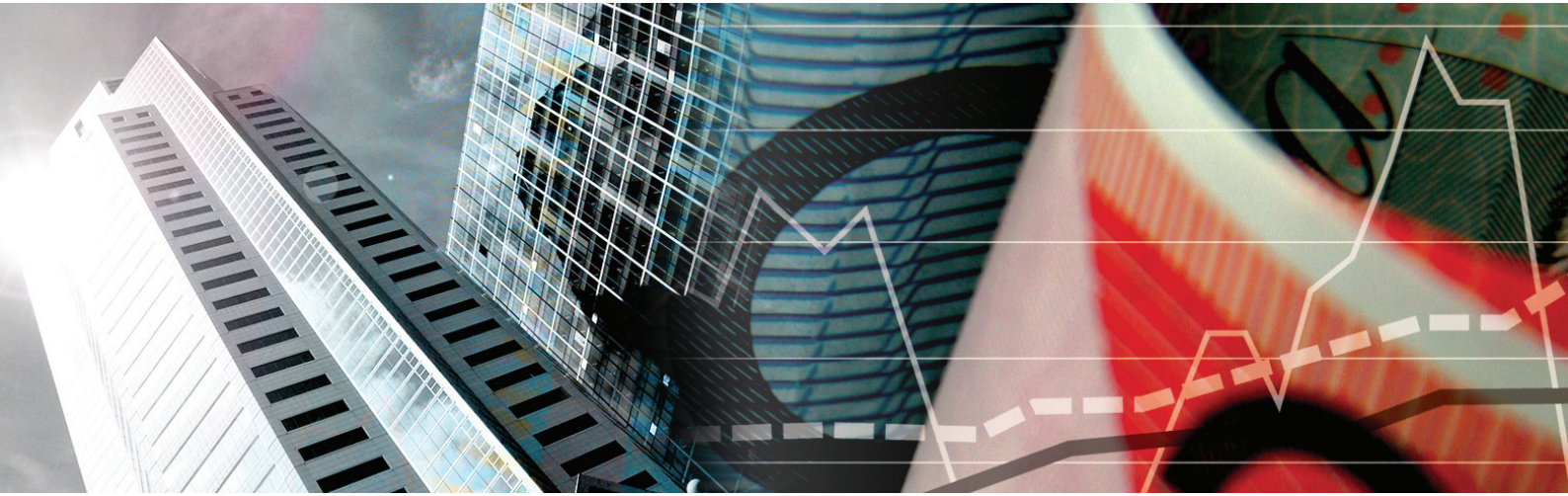


Melbourne CBD Office

MARKET OUTLOOK

MARCH 2009



The global financial crisis weighed heavily on commercial property in 2008. Liquidity concerns and significant asset write-downs further eroded the S&P/ASX 200 A-REIT index to approximately 75% below its February 2007 peak at the time of writing.

While assets have been repriced, the value debate now centres around two primary issues. Firstly, what impact rising unemployment and future supply will have on occupancy and rental levels, and secondly, whether or not yields will increase further.

As at January 2009 vacancy rates increased around the country from record lows and are expected to move higher as the economy slows and new supply is delivered. The Melbourne CBD continued to achieve strong net absorption in the 6 months to January but recorded an increase in vacancy to 4.8%.

Yields softened considerably during 2008. Total returns are now approaching levels more representative of longer term hurdles rates and some private investors have begun making opportunistic acquisitions. However wider economic and financial issues continue to restrict investment from institutions with most seeking divestment for now.

Figure 1
Melbourne CBD Market Indicators - February 2009

	Premium	A Grade	B Grade	Outlook (12 mths)	Net Face Rental Growth Forecast	
Yield	6.50 - 7.00%	7.00 - 7.50%	8.00 - 9.00%	▲	A Grade	
IRR	8.50 - 9.00%	9.00 - 9.50%	10.00 - 11.00%	↔	Year Ending Dec	
Capital Value (per sqm)	\$5,000 - \$7,000	\$4,500 - \$5,000	\$2,500 - \$3,500	▼	2009	0.0%
Rental (per sqm)					2010	0.0%
- Net Face	\$400 - \$500	\$300 - \$400	\$225 - \$275	↔	2011	0.0%
- Net Effective	\$350 - \$425	\$300 - \$350	\$200 - \$250	▼	2012	5.0%
Outgoings (per sqm)	\$105	\$85	\$80	▲	2013	5.0%
Incentive	5 - 10%	15 - 25%	10 - 20%	▲	2014	4.5%
Vacancy (Jan 09) *	0.8%	6.0%	5.5%	▲	2015	4.0%
Total Stock (sqm, Jan 09) *	605,050	1,597,030	947,065	▲	2016	4.0%
Supply Additions (sqm, 12 mths to Jan 09) *	0	121,606	11,758	▲	2017	3.0%
Net Absorption (sqm, 12 mths to Jan 09) *	6,138	86,152	21,829	▼	2018	3.0%
					Average	2.83%

Source : PCA*, Urbis

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Investment

There were relatively few significant investment transactions during 2008. While institutions seeking to re-capitalise offered a large volume of stock, both publicly and off market, few were ready to meet the market. Uncertainty about whether values had bottomed also made buyers cautious.

As anticipated institutions made few acquisitions. This allowed private groups with adequate borrowing capacity to bid with less competition.

Scarcity and cost of finance continued to be a problem, motivating vendors are restraining investors. Despite the Reserve Bank's interest rate cuts, the retail cost of commercial property finance remains high. Banks have also tightened lending criteria and loan to value ratios as well as becoming reluctant to accept large exposures to any single party.

Lower gearing levels for many investors has meant that a higher return is now required from investments in order achieve similar leveraged returns to those achieved in 2007.

New development has now become difficult to justify due to diminished assessments of end value resulting from recent market softening. Scarcity of development funding and increasing tenant pre-commitment requirements, now in the order of 70 – 80%, have also made it very difficult to drive development.

Several developments with pre-commitments in the order of 50% have been abandoned within the CBD and Docklands for these reasons. Despite this there are certain Melbourne CBD projects still being pursued.

Foreign banks, which carry approximately 28% of lending to the Australian commercial property sector, are also tipped to be withdrawing as a result of the global financial crisis. This is giving investors fewer finance options. The Australian Business Investment Partnership (ABIP) has been established to help fill this finance gap.

The share market collapse has also put many diversified investment and superannuation portfolios into a position of being overweight in property, thereby reducing their appetite for further investment until such time as their portfolios are re-balanced.

As a result of these conditions values fell in 2008 with capitalisation rates and rental growth expectations softening. We are aware of only five major Melbourne CBD office building sales since June 2008. Refer Figure 2.

The above transactions showed initial yields from 6.59% to 9.37%, analysed market yields from 6.59% to 9.49% and internal rates of return from 8.68% to 10.89%. These sales indicate a widening yield spread between prime and secondary yields assets.

The sale of 570 Bourke Street was an internal transfer while 473 Bourke Street sold to adjoining owner RACV. Therefore these are not considered to be true indications of market value.

Figure 2
Key Transactions - Sales

Property	Building Grade	Vendor	Purchaser	Area (sqm)	Sale Date	Sale Price	Sale Price (\$ per sqm)	Initial Yield *	Analysed Market Yield	Analysed IRR **
570 Bourke Street	B+	Charter Hall (50% Share)	Charter Hall Core Plus Office Fund	35,097	Jul-08	\$72,500,000	\$4,132	Related party transfer at book value.		
55 King Street	B	NAB Superannuation Fund Pty Ltd	Lend Lease Core Plus Fund	12,399	Jul-08	\$44,000,000	\$3,549	7.06%	7.69%	8.68%
111 Bourke Street	A	Babcock & Brown/Baron Group (50% Share)	MTAA Superannuation Fund	46,200	Sep-08	\$121,000,000	\$5,238	6.59%	6.59%	9.22%
461 Bourke Street	B-	Macquarie Direct Property Fund	Alan Finkel	15,653	Dec-08	\$34,000,000	\$2,172	9.37%	9.49%	10.89%
473 Bourke Street	B	473 Bourke Street Pty Ltd	RACV	8,962	Dec-08	\$42,000,000	\$5,500	Adjoining owner sale		

* Passing Yield on Fully Let Basis
Source : Urbis

** Assumes Compound Net Market Face Rental Growth Average of 2.83%

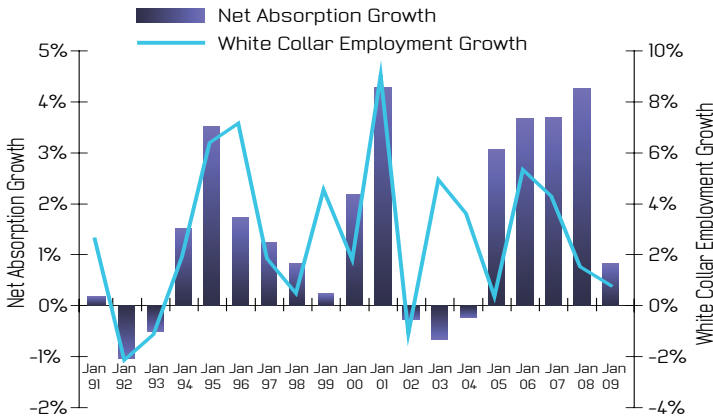
Leasing

The Melbourne CBD continued to outshine other markets registering net absorption of 115,723 sqm in the 12 months to January 2009. Despite this the vacancy rate increased to 4.8% from 3.1% in July 2008.

Approximately 225,550 sqm is now under construction and due for completion by mid 2010 in the Melbourne CBD. Assuming no new projects are commenced an average annual net absorption of some 112,500 sqm would be required in order to maintain the current vacancy rate over the next 2 years.

Figure 3 shows Annual Net Absorption and White Collar Employment Growth nationally from 1990 to 2008. A strong correlation between white collar employment growth and net absorption is evident and periods of negative white collar employment growth in 1992 to 1993 (economic recession) and 2002 (dot-com bubble) coincide with periods of negative net absorption.

Figure 3
Australian Annual Net Absorption v's White Collar Employment Growth (1990 - 2008)

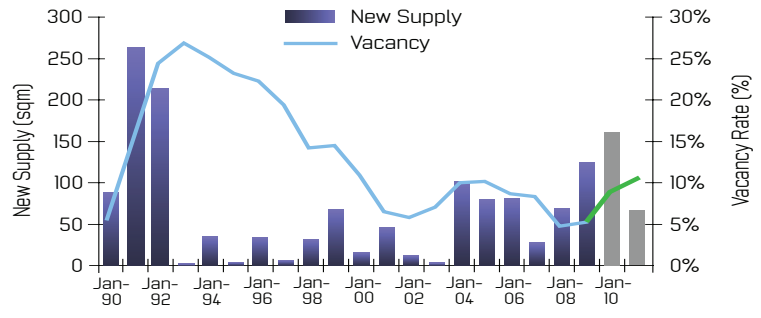


Source : Urbis, ABS, PCA

Current economic conditions are most likely to result in a slowing in the rate of white collar employment. Economists widely expect the unemployment rate to increase significantly over the next 2 to 3 years and that Australia will experience, or only narrowly avoid recession. Based on this outlook it is reasonable to conclude that net absorption will decrease dramatically from current rates, and could potentially head into negative territory during 2009 to 2010.

In light of this the Melbourne CBD vacancy rate is tipped to rise. Figure 4 shows historic new supply and vacancy for the Melbourne CBD and potential future vacancy rates assuming no new projects are commenced and zero net absorption for 2009 and 2010. Note that in this scenario the vacancy rate would rise to approximately 10.0% by the end of 2010.

Figure 4
Melbourne CBD - Historic & Future Annual Net Absorption v's Vacancy - (1990 - 2014) Assumes Zero sqm Net Absorption 2009 - 2010



Source : Urbis

Despite increasing vacancies we expect face rents to hold firm supported by leasing incentives increasing to as high as 25% to 30%. Recent Premium and A grade lettings summarised in Figure 6 show net face rents broadly in the range of \$350 to \$420 sqm. Leasing incentives have increased particularly within new developments facing competitive conditions and are now generally in the range of 15% to 25%.

Figure 5 demonstrates the strong inverse relationship between net effective rents and vacancy rates, and provides an indication of the potential magnitude of effective rental movements in periods of over and under supply. While the Perth and Brisbane markets are expected to experience substantial oversupply and vacancy rate escalation, we do not expect the Melbourne CBD to face vacancies of the magnitude shown here.

Figure 5
Vacancies & Rents - A Grade Office

	Vacancy Rate		Change In Net Effective Rent	Vacancy Rate		Change In Net Effective Rent
	1988*	1993*		2003*	2008*	
Sydney	2.5%	24.8%	-70%	7.9%	3.1%	16%
Melbourne	2.5%	19.3%	-64%	8.2%	3.0%	9%
Brisbane	8.0%	6.8%	0%	3.6%	0.5%	202%
Perth	8.0%	30.5%	-63%	9.1%	0.3%	175%
Adelaide	5.0%	18.0%	-45%	7.5%	1.5%	2%

* July to July

Source : Urbis; PCA

Figure 6
Key Transactions - Leasing

Property	Rise	Comm. Date	(\$ per sqm) (net)	Initial Term (years)
CBD				
Existing Buildings				
525 Collins Street	Mid	Dec-11	\$390	6
485 Latrobe Street	Low	Oct-09	\$350	10
360 Collins Street	Mid	Jan-09	\$420	6
80 Collins Street	High	Nov-08	\$440	9
485 LaTrobe Street	Low	Sep-08	\$330	1.2
385 Bourke Street	High	Sep-08	\$350	8
New Developments				
181 William Street	Mid	Mar-09	\$450	10.25
181 William Street	Mid	Dec-08	\$385	8
181 William Street	Low	Sep-08	\$385	12
Docklands, South Wharf & Southbank				
New Developments				
28 Freshwater Place	Low-Mid	Jun-09	\$375-\$395	8-12

Source : Urbis

About

Melbourne CBD Office Market Outlook is a twice-yearly publication of Urbis.

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