NORTH SYDNEY COMPRESSING YIELD:

HOW LOW IS IT GOING TO GO?

CI AUSTRALIA | MARKET RESEARCH

INTRODUCTION

In the financial year 2017, North Sydney office market has continued to experience a boom. With the further withdrawal and conversion of office buildings to residential apartments , mixed use developments and infrastructure including the new metro station complex, there are limited opportunities to satisfy increasingly strong demand from both domestic and offshore investors. Transactions seen in last year and this confirm increasing prices and diminishing yields. We will outline the reasons for the compressions in yield and forecast future trends.

ADDRESS	PRICE ($M)	CORE MARKET YIELD (%)	PRICE $/PSM	SALE DATE
100 Arthur St	313.25	6.3	11,435	Jan-16
90 Arthur St	73.5	7.5	7,940	Aug-16
54 Miller St	52.3	6.6	7,520	Oct-16
2 Elizabeth Plaza	81	6.6	10,368	Mar-17
146 Arthur St	78	6	9,518	May-17
116 Miller St	134	5.25	11,779	Jul-17
165 Walker St	55.9	6	10,659	Jul-17
1 Pacific Hwy	114.5	5	14,983	Sep-17
56 Berry St	62	5.48	11,981	Oct-17
75 Miller St	51.8	5.71	10,507	Nov-17

WHAT JUSTIFIES TIGHTER YIELD?

The most basic and common driver for lower yields is the increase in demand. When the demand rises, price increase cuasing lower yields. Further factors that impact property yields include following:

- Falling Bond Yield
- Low Cost Of Debt
- Limited Stock
- Increase demand from institutional investors

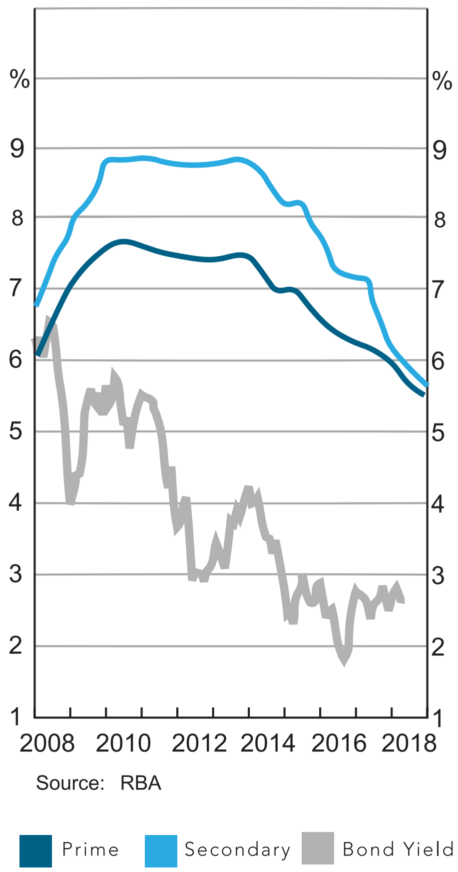
CRITERIA	RELATIONSHIP	EXPLANATION
Bond yield	+	Higher the bond yield, higher property yield
Supply in the market	+	More supply, higher property yield
Cost of debt	+	Higher cost of debt, higher property yield
Demands in the market	-	Higher demand, lower property yield

BOND YIELD

Currently Australia's 10-year bond yield has inscreased by over 20 basis points since it touched 2.6% in late March 2018. Current North Sydney office yields are at history low 5% for prime grade and 5.75% for secondary grade. If we assume 2.5% capital growth rate/ inflation, the total return of North Sydney office will be 7.5% for prime grade assets and 8.25% for secondary grade assets. This means property premium over risk free debt is 4.7%-5.45% -- it is little wonder that investors find commercial properties more attractive option. There are some doubts that bond yields will increase sharply due to global economy growth rise and inflation, therefore we believe that the increase of Australia 10 year government bond yield will remain moderate. This implies that yields spread over risk free will remain continue to be wide. Investors will continue to prefer commercial properties over government bond due to the "search for yield". The combination of continued rental growth and low bond yield will maintain pressure on property yields.

AVERAGE MARKET & AUSTRALIAN GOVERNMENT BOND YIELDS

NORTH SYDNEY



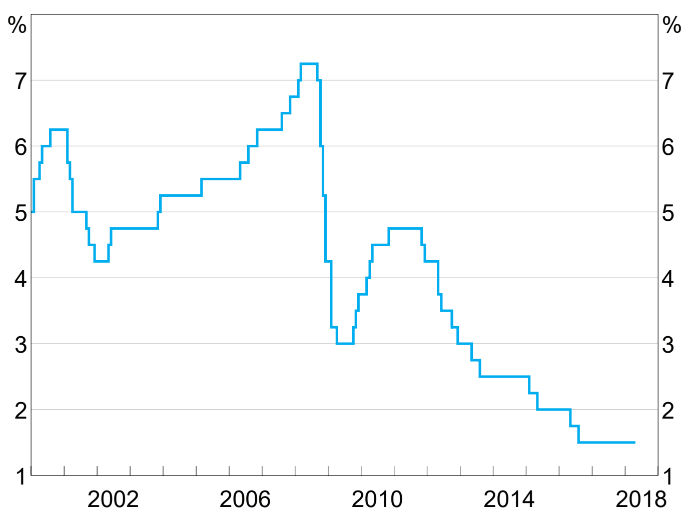
Source: RBA

COST OF DEBT

Fluctuation of interest rates and cash rate impact weighted average cost of capital "WACC" for investors. When interest rates decrease, investors search for a positive arbitrage which becomes more prevalent in the commercial market due to the low finance costs. This creates demand specifically for property against other investment options.

Figures from RBA has shown that the cost of debt (3 year fixed business interest loan) has been falling after reaching a peak in 2011. Whilst the cash rate has remained unchanged at 1.5%, it represents an Australian official low record which has continued for 20 months. We believe that both the interest rate and the cash rate will remain low in a soft economy, therefore the cost of debt for investors is low. Leveraged returns still look attractive to investors, we suggest yields will remain low until the RBA increases the cash rate.

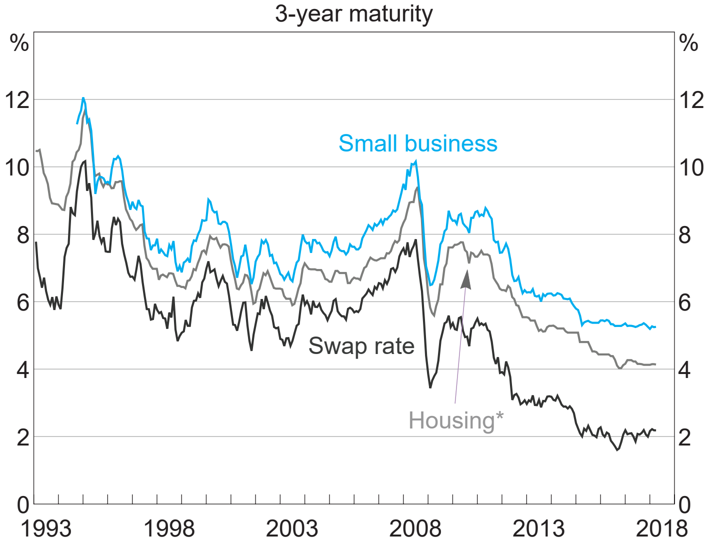
AUSTRALIAN CASH RATE



Source: RBA

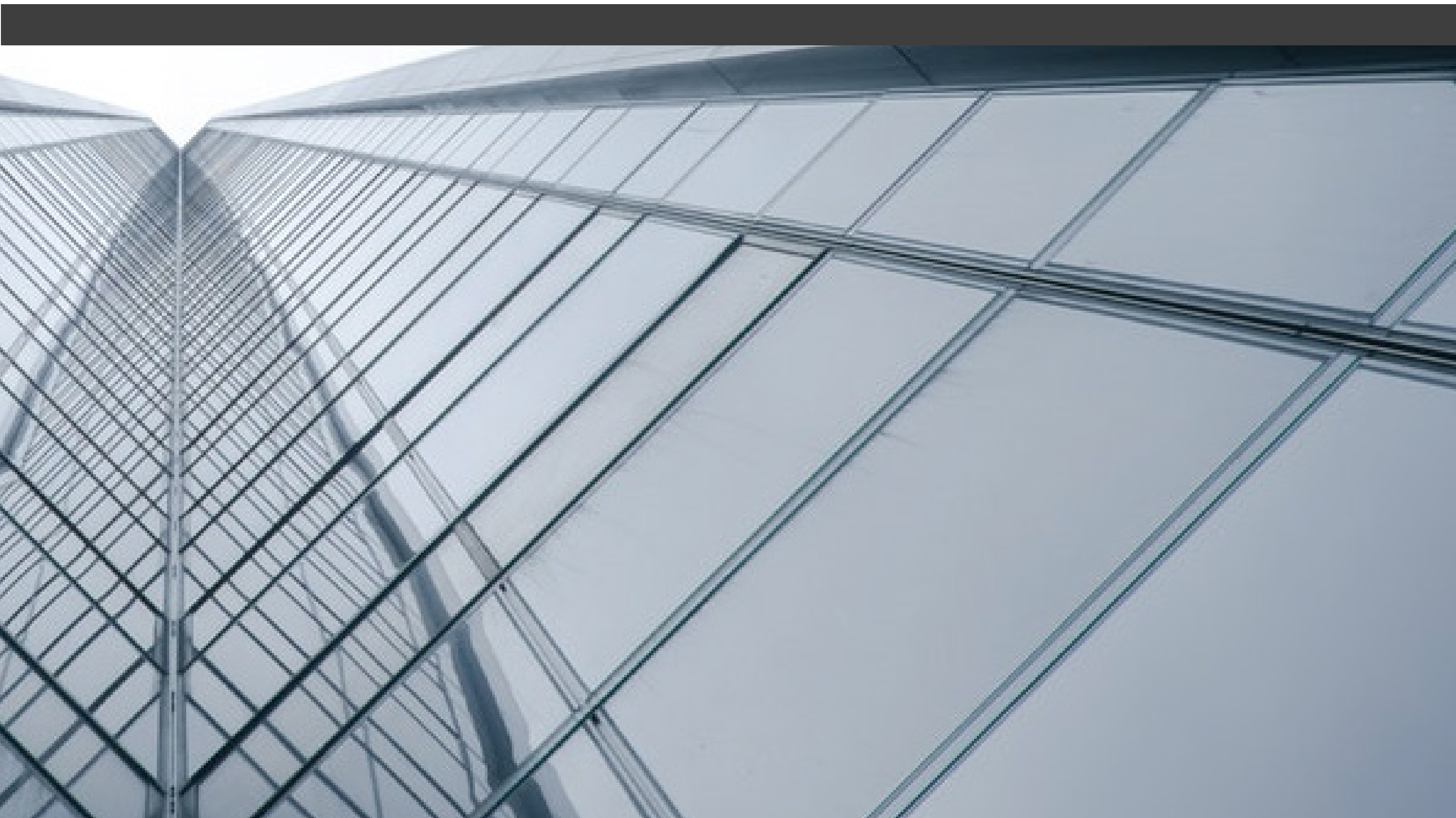
AUSTRALIAN FIXED INTEREST RATES

3-year maturity



* Availablet o owner-occupiers

Sources: Banks' websites; Bloomberg; Canstar Cannex; RBA

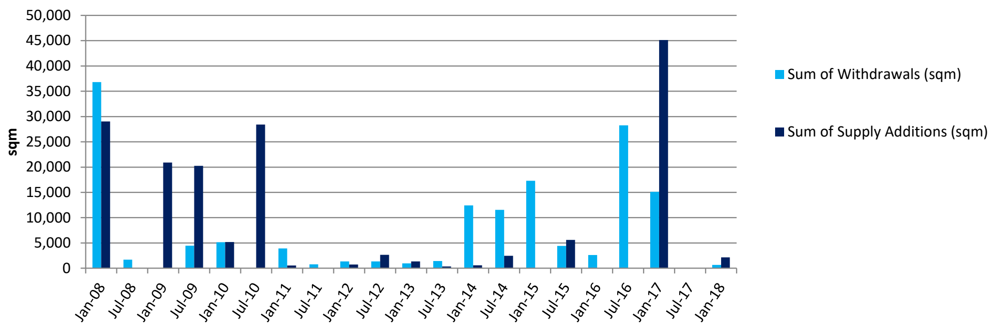


SUPPLY

With the forecast of 2 million population growth over 20 years in Australia , there is continued demand for high density residential development projects within North Sydney. Due to the scarcity of appropriately zoned sites, developers are buying secondary office towers and converting them into residential projects. In the second half of 2017, there was a total 23,000 sqm of office space withdrawls for residential and mixed use developments. Limited stock and increasing demand lead to aggressive competition driving prices up and property yields down. Currently we are experiencing a slow down in the residential market which in turn will subdue the heated development market and slow yield compression.

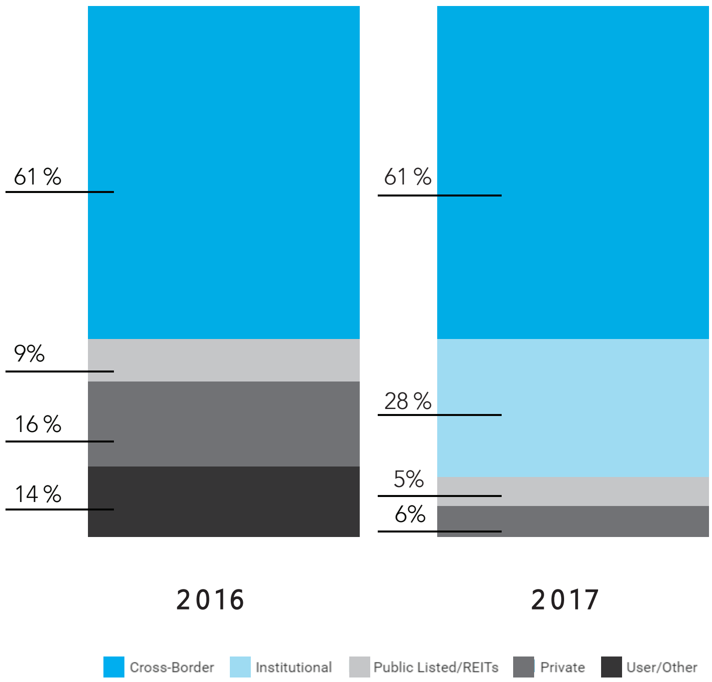
WITHDRAWAL V. ADDITIONS

Based on figures at Jan 2018 (Source PCA/CI Australia)



DEMAND

INVESTOR TYPE IN NORTH SYDNEY



Source RCA

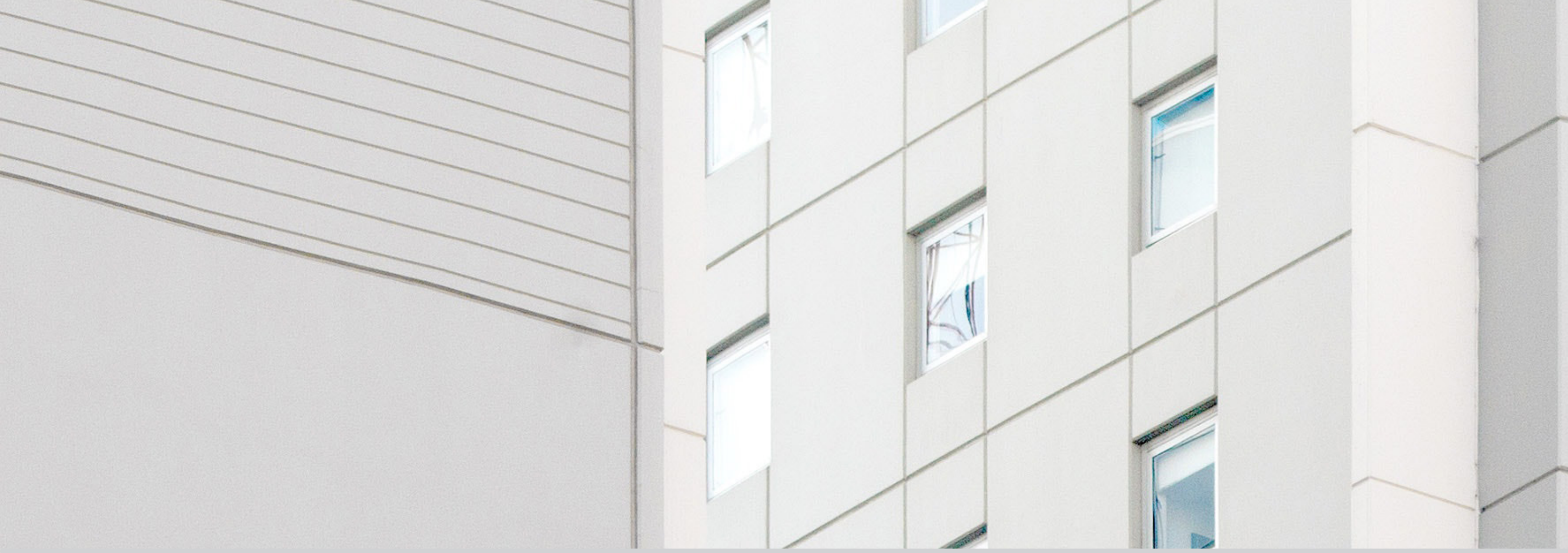
In 2017, institutional investors have become active in the North Sydney market where 28% of the buyers were institutional investors compared to none in 2016. We believe there are three reasons that account for this increase in demand.

Firstly, the significant stock withdrawal and rising rents in Sydney CBD making investors to seek opportunities in other areas. North Sydney which is a viable and sophisticated market offers an excellent alternative to the Sydney CBD.

Secondly, the upcoming new supply such as 1 Denison Street and 100 Mount Street confirm the North Sydney market enjoys demand from tenants seeking high quality premium space. 100 Mount Street has a 15% pre-committment to Laing O'Rourke and a further 45% to NBN—increasing the total pre-commitment to 60%, whilst 1 Denison Street has 15,500m² 12-year pre-commitment to Channel 9. Such pre-commitments can provide institutional investors long term, stable and predictable returns for which they are looking.

Thirdly, the improving public amenity in North Sydney includes the Victoria Cross Integrated Station Development which adds to North Sydney being an attractive location for investors. Once complete, the accessibility for tenants to North Sydney will be greatly improved and will encourgage a further surge in demand.

In summary, we expect the demand from investors for North Sydney to remain high and continue to place downward pressure on property yields.



FUTURE

The outlook for North Sydney property yields depend on general economic trends, interest rate movements, 10 year government bond yield, supply and demand of investment stock.

ECONOMY CONTINUES TO GROW

Australian economy is expected to continue with solid growth in short term. Employment has risen consecutively over last 18 months, and according to the Australian Bureau of Statistics, unemployment rate currently at 5.5% is expected to continue to drop to 5%. GDP wise, the International Monetary Fund (IMF) forecasts Australia to grow sharply from 2.3% in 2017 to 3% in 2018 and 3.1% in next year, well above recent estimates. Australia will still remain appealing to international investors due to its highly transparent market, stable economy and safe political environment.

RISING BOND YIELD IN MEDIUM TO LONG RUN

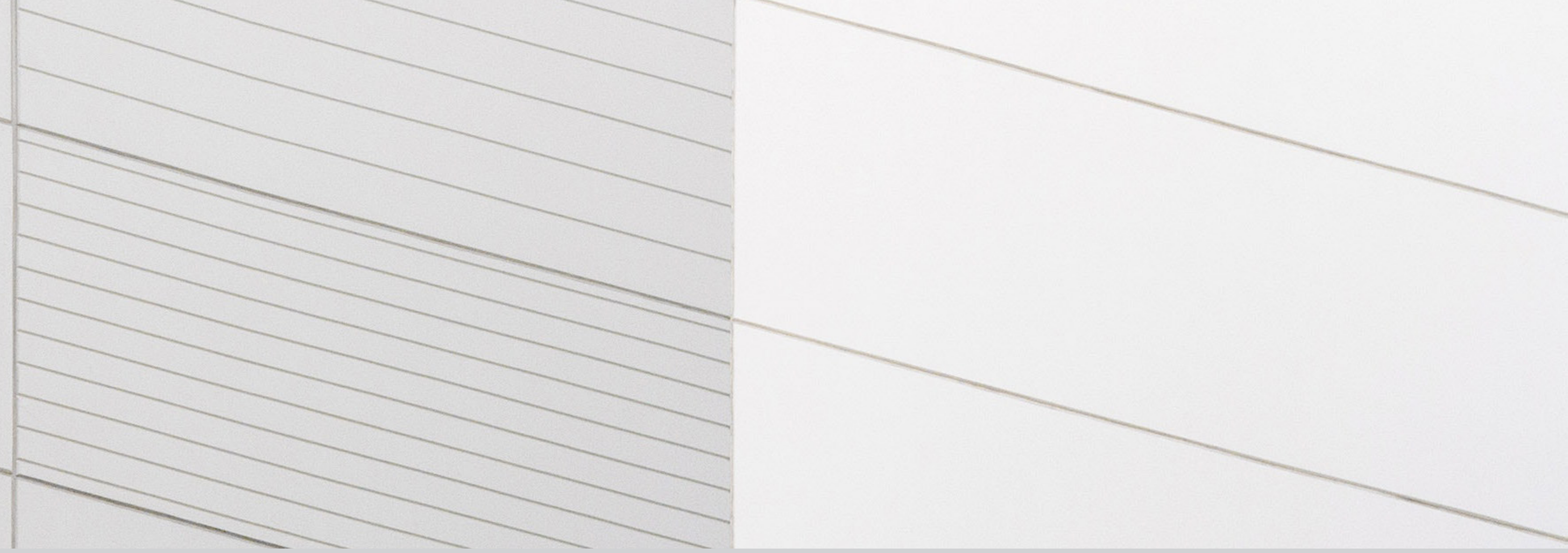
According to Morgan Stanley, RBA will keep interest rates at a record low at 1.5% for at least the next six to 12 months.

US 10 year Treasury note has increased to more than 3% been a first time since December 2013. It is the first time the US yield is higher than Australian bonds since the early 90s. The upswing reflects the enhancement of US economy, and economists predict that the Australian 10 year bond will increase in line with the US Treasury bond.

CONSTRAINED SUPPLY, STRONG DEMAND

Supply in short term is still expected to be constrained. Alongside with commercial conversion to residential, landlords are reluctant to offer their properties to the market whilst there is strong rental and capital growth, making capital market stock limited.

Demand from investors remains strong. Our belief is demand from offshore investors will continue albeit dependent on competing opportunities in other markets. Whilst we noticed a slowdown in activity from Chinese investors, they still represent a major component of the demand. There has also been strong interest from other Asian countries such as Singapore, Korea and Malaysia. Despite yields on commercial property assets being historically low, they still look attractive to foreign investors due to the comparatively high yields, the AAA-rated sovereign and a safe banking, financial and political system.



SUMMARY

In short term, we believe North Sydney property yields will continue to fall for next 6 to 12 months due to;

- Yield Spread over risk free and yield over debt remain high
- Rental growth will offset mid-long run increase in interest rate
- Supportive economic outlook, continue to attract offshore investors
- Improved infrastructure including New Sydney Metro and Norwest Metro railway will further boost office demand

We believe initially prime asset yields will drop to 4.5%-4.75% and secondary assets will drop to 5.25%-5.5%; and in the mid-term, when RBA increases interest rates, yields will stabilise.

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The CI Research department benefits from a vast network of industry connections and the inherent resource of property knowledge that accompanies. The teams at CI are dedicated in providing their personal knowledge and market opinions in the construction of this report, and work closely with our research teams to ensure an accurate market overview is achieved.

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