APRIL 2018

Situs RERC® UPA– URBAN PROPERTY AUSTRALIA —

AUSTRALIAN REAL ESTATE TRENDS

HOLDING FIRM IN ASIA PACIFIC

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SPECIAL RECOGNITION

The sponsoring firms would like to express their deep gratitude for Real Capital Analytics (RCA) for providing transaction volume and capital flow data during the completion of this report. All investment activity data comes from data provided by RCA. For more information about RCA's data services, visit www.rcanalytics.com.

We would also like to extend our appreciation to those who completed our 1Q 2018 Australian Market Expectations survey. Your willingness to share your expert opinions on the commercial real estate market has allowed us to share current trends with the industry as a whole. We thank you for your time and effort.

IN THIS VOLUME

CONTACT US

Please contact Situs RERC or Urban Property Australia with questions about the research in this report at **publications@rerc.com**

The *Australian Real Estate Trends* report is published by: Situs RERC, 6600 Westown Parkway, Suite 260, West Des Moines, Iowa 50266 and Urban Property Australia (UPA), Ground Floor, 312 St Kilda Road, Melbourne 3004, Victoria, Australia.

EXECUTIVE SUMMARY

APRIL 2018

For the third straight year, Australia is the third highest ranked country for commercial real estate investment in the Asia Pacific, according to data from Real Capital Analytics (RCA). Australia is ranked seventh in transaction volume globally, behind the US, Germany, the UK, France, China and Japan. Australia joins the US, UK and Germany as the only countries with multiple cities in the top 25 for global capital cross-border flow in 2017, and total commercial real estate investment into Australia surpasses many global economies, including Hong Kong, Singapore, Canada, Spain and the Netherlands.

The relatively high rankings for Australia are in spite of a 10% decline in total year-over-year (YoY) transaction volume. For context, only four of the top 14 nations in terms of transaction volume experienced negative YoY growth, according to RCA: the US, Mexico, China and Australia.

Australia also witnessed a 15% YoY decrease in cross-border capital in 2017; however, the percentage of total volume attributed to cross-border capital (46%) represented a smaller piece of the pie – down from 51% in 2016. Of the total capital flows into Australia, Singapore, China and the US led the pack for single countries, with each investing over US$2 billion[1]. Singapore, Malaysia, South Korea and Hong Kong all increased their investment into Australia in 2017 compared to 2016.

After six consecutive years of cross-border investment into Australia surpassing $10 billion annually, it appears that some offshore investors have started to recycle capital placed in Australian assets, realising strong capital growth. Chinese cross-border investment declined 53%, but it was still a net buyer of Australian commercial real estate. This decline occurred after the Chinese government tightened its rules on foreign investment. It's a fair assessment that the fall in investment volume probably more reflects the capital constraints from China rather than diminishing appetite. Regardless of the reason, Chinese investment accounted for 14% of total cross-border investment in Australian commercial real estate in 2017, its lowest share since 2013.

Reflecting Australia's strong economic and property investment performance, the bulk (44%) of respondents of the 1Q 2018 Situs RERC/UPA Australian Market Expectations survey indicated that it was a good time to hold Australian commercial real estate, up from 42% in the 1Q 2017 Australian Market Expectations survey. Fierce competition for assets in Sydney and Melbourne have led to exceptionally high prices and an increase in the recommendation to sell in these cities. In Sydney, 50% of respondents said that the next quarter would be a good time to sell commercial real estate and 41% of Melbourne respondents said that the next quarter would be a good time to sell. Yet, according to RCA data, only three countries are net sellers in the Australian real estate market – Malaysia, Canada and the US.

In this edition of the Situs RERC/UPA Australian Real Estate Trends report, we explore Australian and global economies and real estate investment activity. We also present the results of our Australian investor sentiment survey and provide a deep analysis of Australian capital cities. In a time of considerable turmoil and uncertainty around the world, the Australian economy – and its commercial real estate market – appear to be generally holding firm. As seen in this report, some property sectors and markets are faring better than others, but a generally rosy outlook for the Australian economy should buoy the real estate market in 2018.

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[1] Unless otherwise noted, currencies are listed in US dollars.

ECONOMY

GLOBAL ECONOMIC OUTLOOK

The global economic landscape found itself under sunnier skies during 2017. Just over a year ago, developed economies were gazing into the potential darkness of economic declines, with central banks resorting to negative interest rates. Since the third quarter of last year, however, world economies have rebounded and found a steady, upward path. The International Monetary Fund (IMF) estimates global output to have grown by 3.7% in 2017, and has revised 2018 and 2019 estimates upward to 3.9% **(see Exhibit 1)**. The acceleration reflects the broad-based nature of global growth, better-than-expected performance in Europe and Asia, and the expected impact of tax policy changes in the United States. According to the IMF, approximately 75% of the world economy is experiencing expansion, which is the greatest increase in global economic activity since 2010.

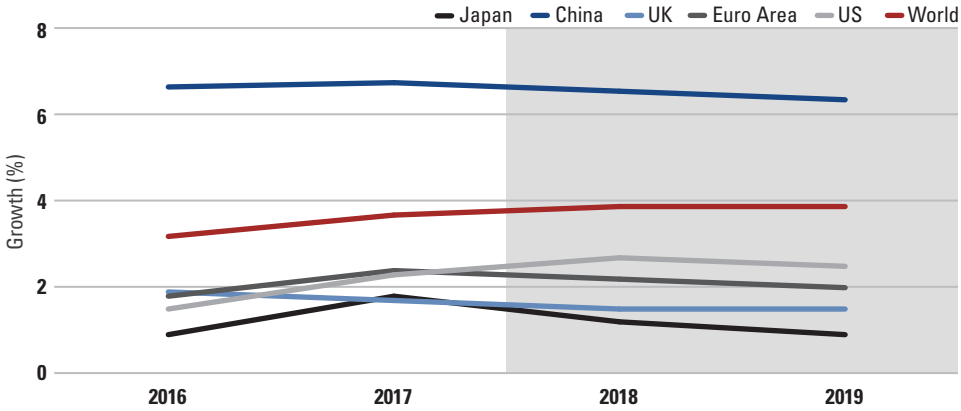
The gains were most noticeable across Europe, where the anxiety wrought by Brexit gave way to a more tempered outlook. Negotiations between European Union (EU) and UK leaders in March led to an approved deal for a 21-month transition period, which effectively maintains the relationship through 2020 and helps bring some certainty to the timing and process. While the UK's economy posted a moderate 1.7% gain in 2017, according to the IMF, it was nowhere near the recession expected a year ago. After years of anaemic growth following one debt crisis after another, the EU experienced its best growth since 2007. Ireland remained the fastest growing EU economy for the fourth year in a row. While economic growth in the EU was broad-based, the largest gains came mostly from peripheral countries during 2017 with Romania, Malta, Slovenia and Estonia all recording GDP gains of at least 4%, according to IMF data. The other developed eurozone economies — Germany, France, Italy and Switzerland — displayed more modest economic conditions, with GDP growth in the 1-2% range.

Asian economies continued moving with solid upward momentum during the year. China's GDP increased at a 6.8% annual rate in 2017, according to the IMF, but is expected to decelerate slightly to 6.4% in 2018 due to its deleveraging efforts to cut risk in its financial system, including government and corporate debt. The Bank of Japan has hinted that it might finally reduce its monetary stimulus program in 2020 as it expects inflation to reach its 2% goal sometime around fiscal year 2019. India's economy continued its growth pattern, despite the country's massive currency adjustment in 2016, with GDP growth poised to average 7.9% per year over the next four years, according to the IMF. Other Asian economies — Indonesia, Malaysia, Philippines, South Korea, Thailand and Vietnam among them — reflected the strength of neighbouring larger economies with 2017 GDP growth in the solid 3-6% range.

In the Americas, economic trends underscored a rising global tide. In Canada, the economy grew at over double the pace of 2016, with GDP growth registering 3% in 2017, led by consumer spending and investment in inventory and businesses. While economists expect moderation going forward, the outlook for 2018 remains positive in Canada. Mexico's economy took a more moderate path, with GDP projected to close 2017 with a 2.1% gain. In March 2018, Canada and Mexico's renegotiations of the North American Free Trade Agreement (NAFTA) with the US took an optimistic turn as the US softened its stance on importing goods for use in its auto industry – one of the most contentious issues in the talks. While several issues remain, there is optimism of a new NAFTA deal being announced within the next month. Canada and Mexico will also be exempt from the 25% tariffs on imported steel and 10% on aluminium during negotiations. Brazil's economy, recovering from its mild recession, grew 1% in 2017 – its first year of expansion since 2014. Argentina's economy found a more solid footing in 2017, with GDP gaining 2.5%. However, a prolonged drought affecting Argentina's soybean and corn crops is expected to weaken the country's performance in 2018. The economies of Colombia and Chile remained positive, with 1.7% and 1.4% GDP growth, respectively, while Venezuela's political crisis continues to deepen its economic woes and the humanitarian crisis in the country.

A major engine of global economic activity, the US is in its ninth consecutive year of expansion. The central bank continued to tighten its monetary policy, increasing the federal funds rate by 25 basis points in March 2018 amid low unemployment, growing GDP and expected stimulus from tax reform. Optimism about economic conditions continues to keep the unemployment rate low amid higher wages and increased business investment and consumer spending. The Fed indicated that there would likely be two more rate hikes this year, despite still-modest inflation. The few clouds hanging in the economic skies were additional federal spending and the rising national debt, slowing momentum in the housing market and continued declines in commercial real estate investment volume, which caused concern about the current real estate cycle's timing and duration.

EXHIBIT 1. WORLD ANNUAL GDP GROWTH



Note Shaded area represents projections.
Source IMF, December 2017.

AUSTRALIAN ECONOMIC OUTLOOK

Australia's economy is now in the 27th consecutive year of economic growth without a recession and is expected to grow at a solid pace over the next two years as the drag on growth from falling mining investment nears completion. Growth is expected from non-mining business investment, household consumption, public final demand and exports.

Over 2017, Australia's economy grew by 2.3% **(see Exhibit 2)**. Looking forward, infrastructure spending and non-mining business investment should help the Australian economy navigate the challenges of peaking liquefied natural gas (LNG) exports and dwelling construction. The Australian economy is forecast to grow by 2.9% in 2018 and 2.8% in 2019, boosted by the positive momentum in the global economy.

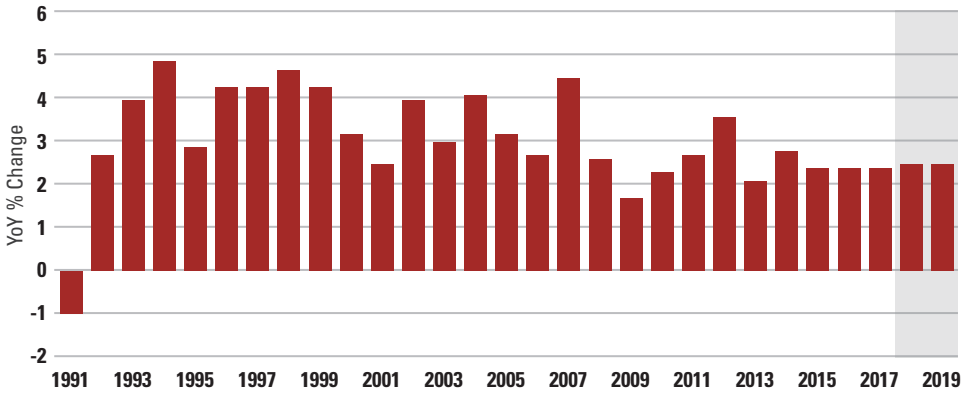
Over 2017, Australia's employment growth continued to impress, rising by 403,000, of which 302,000 were full-time jobs **(see Exhibit 3)**. Total Australian employment has now increased for 16 consecutive months, the longest uninterrupted stretch since the recovery from recession in the early 1990s. Victoria and New South Wales (NSW) are the standout states; however, all states saw an increase in the month of December **(see EXhibit 4)**. The strength in the economy suggests that the labour market is likely to continue to improve and the unemployment rate will gradually fall. Wage growth in Australia has been persistently low, but the improving labour market should eventually lift wages over time.

Population growth has picked up slightly over the past three years, due to higher levels of overseas migration, and is currently running at an annual increase of 1.6%. Although the relatively high levels of overseas migration are projected to persist over the medium to long term, the annual rate of population increase is forecast to marginally decline in the short term, averaging 1.5% over the next five years.

Over 2017, Australian employment increased by 403,000 – a 12-year high.

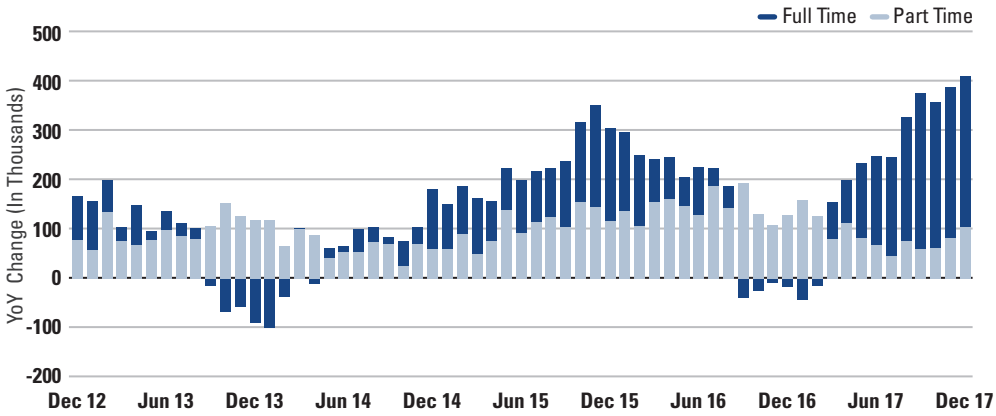
While household spending increased 2.7% in 2017, boosted by record-high employment growth, household income has not kept up.

EXHIBIT 2. AUSTRALIAN GDP GROWTH



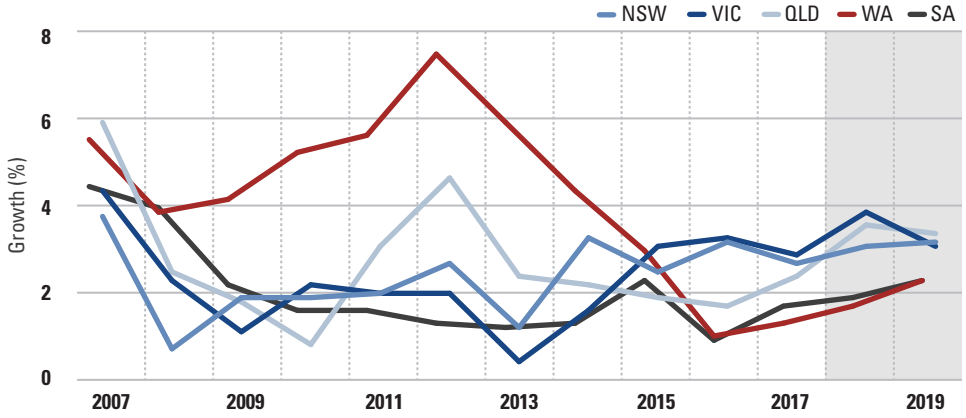
Note Shaded area represents projections
Source ABS / Urban Property Australia, December 2017.

EXHIBIT 3. AUSTRALIAN EMPLOYMENT GROWTH



Source ABS / Urban Property Australia, December 2017.

EXHIBIT 4. STATE ECONOMIC GROWTH



Note Shaded area represents projections
Source RBA / Urban Property Australia, December 2017.

EXHIBIT 5. AUSTRALIAN CASH RATE

Note Shaded area represents projections
Source RBA / Urban Property Australia, December 2017.

Held back by weakness in both wage and non-wage income growth, households had to reduce their savings rate to maintain consumption growth. Looking ahead, household spending is likely to be hampered by somewhat negative wealth effects, with the pace of house price rises slowing.

New business investment slipped in the December 2017 quarter, but this was due to a fallback in mining engineering construction. The latest capital expenditures estimates suggest that non-mining investment will continue to build momentum with new business investment increasing 5% in 2018 and 2019.

In addition, public infrastructure continues to ramp up. State governments on the East Coast are undertaking transport infrastructure construction (particularly roads and rail), and the federal government is continuing with the roll-out of the National Broadband Network (NBN). Overall, new government investment is forecast to rise 8.9% in 2018 and 3.2% in 2019.

Inflationary pressures remain subdued, with the underlying inflation rate remaining below the Reserve Bank of Australia (RBA)'s 2-3% band. Limited wage growth suggests that inflation is forecast to stay close to the bottom of the RBA's target band.

As expected, the RBA Board left the cash rate at 1.5% at its March 2018 meeting **(see Exhibit 5)**. The Board are continuing to look for evidence of improvement in household income growth, with wage growth still largely tracking inflation. With the expected coming downturn in residential construction (and its impact on business investment) and weak consumer spending, most expect that the RBA will keep the cash rate at 1.5% until late 2019.

Large movements in commodity prices and regional investment cycles have created significant differences in the recent economic performance of the states. But performances across the states have converged somewhat in recent months.

NSW is forecast to be the best performing state economy over the next two years, due to strength in private non-dwelling construction, public infrastructure investment, and positive momentum in business and financial services and tourism.

The Queensland economy is forecast to pick up over the next two years, benefitting from strong growth in resource-related exports and the tourism and education sectors.

The Victorian economy, which has outpaced the national economy over the past three years, is expected to slow as the housing market cools and consumer spending is held back by weak growth in household income.

NSW is forecast to be the best performing state economy over the next two years, due in part to increasing public infrastructure investment.

FEATURE ARTICLE
INFRASTRUCTURE KEY FACTOR IN ECONOMIC AND REAL ESTATE HEALTH

'Extensive and efficient infrastructure is critical for ensuring the effective functioning of the economy. Effective modes of transport — including high-quality roads, railroads, ports, and air transport — enable entrepreneurs to get their goods and services to market in a secure and timely manner and facilitate the movement of workers to the most suitable jobs. Economies also depend on electricity supplies that are free from interruptions and shortages so that businesses and factories can work unimpeded. Finally, a solid and extensive telecommunications network allows for a rapid and free flow of information, which increases overall economic efficiency by helping to ensure that businesses can communicate and decisions are made by economic actors taking into account all available relevant information'.
— World Economic Forum

The health of the commercial real estate market relies on high-quality, up-to-date infrastructure as much as any other part of the economy. Homeowners, retailers and industrial and office workers need access to roads, public transportation, utilities and the internet. Infrastructure projects also offer direct opportunities for investors as many of these are public-private partnerships (PPP). In countries where the population is growing fast or the infrastructure is crumbling – or both – public and private entities need to make hard choices about what projects to take on and how to pay for them.

ASIA

According to the Global Competiveness Report, released each year by the World Economic Forum (WEF), **Australia** ranks 28th in the world (out of 137 ranked countries) in infrastructure. Australia is facing demographic challenges that are putting strains on its current infrastructure approach. Its population is projected to grow from about 24.64 million in 2017 to about 36 million in 2050. This is the equivalent of adding a new city the size of Canberra each year for the next 30 years.

About 75% of the projected growth is expected to be concentrated in Australia's largest cities – Sydney, Melbourne, Brisbane and Perth. This will complicate efforts to manage traffic congestion, urban sprawl, pollution and rising home prices. In response to these dramatic changes, Australia, under the direction of Prime Minister Malcolm Turnbull, has created a 'smart cities' plan designed to reduce the average round-trip commute to an hour a day.

The first Australian Infrastructure Plan was released in February 2016, with 78 recommendations designed to improve productivity growth, maintain and enhance the nation's standard of living, and keep its cities vibrant. The plan is to be updated every five years. The government plan seeks to encourage high-quality medium- and high-density development, which would reduce the need for new infrastructure, rather than continue the past emphasis on expanding housing farther from urban centres.

In the last two years, more than $42 billion has been spent – much of it private investment – on infrastructure projects, including pipelines, light rail, hospitals and roads. By focusing on building up urban areas, the government expects to reduce the cost of infrastructure by nearly 40% per capita.

The government is also encouraging smaller cities, which aren't growing as fast, to provide infrastructure needed to encourage growth and, in the process, reduce some of the pressure faced by the largest cities. In addition, the federal government is encouraging the consolidation of local councils, which could lead to better coordination among the smallest cities to meet infrastructure needs.

The infrastructure report notes the extensive private involvement in projects that often are heavily subsidized by the public in other countries, including airports. The WEF believes that the current system of public subsidies for transport is unsustainable because it will require ever-increasing tax receipts to stay financially afloat, and recommends more in the way of toll roads and private investment in mass transport if necessary.

The report's specific recommendations include upgrading urban passenger transport systems, improving the national freight network and increasing broadband service. In addition, it recommends that states and territorial governments should deliver long-term regional infrastructure plans and that all communities ensure that drinking water meets minimum standards.

Australia is not doing as well in infrastructure as some other countries in the Asia Pacific region – especially **Hong Kong**, which is ranked No. 1 in the Global Competitiveness Report. Hong Kong budgeted about $12 billion to infrastructure projects for its 2017-2018 fiscal year

and plans to increase spending every fiscal year through 2021-22. The major projects are hospitals, a sports park, railway projects and new town developments. They are funded by revenue from land sales.

Japan is ranked No. 4 in infrastructure in the Global Competitiveness Report. In 2016, Japan approved a $61 billion infrastructure plan in hopes of doubling the number of tourists visiting the country by 2020, when Tokyo hosts the Summer Olympics. The money will help speed up development of a maglev rail line from Tokyo to Nagoya by 2027, with an extension to Osaka to start construction in 2035; neither of those projects will have any effect on the Olympics. Details still need to be worked out, but the government plans to offer low-interest loans to the privately owned Central Japan Railway Co.

Other Asia Pacific countries are much farther down the list. **China** is ranked No. 46, despite efforts to boost its infrastructure. China plans to move 250 million people over the next eight to 10 years into the country's megacities, and is investing highways spanning the continent, the world's largest wind power base, airports and new cities in the desert. Perhaps the most audacious (and certainly most expensive) project: By 2030, China plans to move 42 million people from a nine-city region into one giant megacity in the Pearl River Delta that will eventually have a population of 80 million. The project is slated to cost $322 billion.

EUROPE

UK (ranked No. 11 in infrastructure) unveiled a plan to spend more than £500 billion on over 700 infrastructure-related projects and programmes over the next few years. The projects include the Thames Tideway Tunnel, rolling smart metres and upgrading the A14 road, with a mixture of public and private spending.

France (ranked No. 7) prides itself on having a wide range of technologically advanced transportation options, mostly government operated. Along with its sophisticated mass transport in Paris, it has highly regarded railways, airports and ports.

Germany (ranked No. 10) has avoided much of the economic turmoil facing other countries since the Great Financial Crisis and has kept its budget in balance. But its cautious approach to spending has imperilled its traditional high standing as a world leader in infrastructure. Experts warn that Germany is in danger of falling behind unless it invests more in roads, broadband and public transport.

In **The Netherlands** (ranked No. 3), the government is committed to spending about €25 billion for constructing new roads, and road users will be encouraged to use existing motorways, waterways and railroads more efficiently. In addition, the EU is providing grants to the Netherlands for various railway, water and shipping projects. The Netherlands currently funds its highways through a national infrastructure fund with express lane fees, regular tolls and taxes.

UNITED STATES

The WEF ranked the **US** as No. 9 worldwide in infrastructure. This is despite the 'D+' grade the US received in the 2017 Infrastructure Report Card, which is issued every four years by the American Society of Civil Engineers. According to the report, the US faces a $2.0 trillion, 10-year investment gap in infrastructure, which will require substantial increases in the federal motor fuels tax and new fees to improve water, waste, transportation and energy services.

In February 2018, President Trump proposed turning $200 billion in federal money into $1.5 trillion for fixing America's infrastructure by leveraging local and state tax dollars and private investment. In March 2018, Congressional Democrats unveiled their own plan, involving $1 trillion in public spending paid for by rolling back the tax cuts passed last year. With the Democrats in the minority, the chance of their plan passing is nil, but it's unclear yet what if any plan will be passed.

GLOBAL COMPETITIVENESS RANKINGS – INFRASTRUCTURE

FLAG	COUNTRY	RANK
	Hong Kong	1
	The Netherlands	3
	Japan	4
	France	7
	US	9
	Germany	10
	UK	11
	China	27
	Australia	28

Source WEF, The Global Competitiveness Report 2017-2018.

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INVESTMENT ACTIVITY

GLOBAL INVESTMENT ACTIVITY[1]

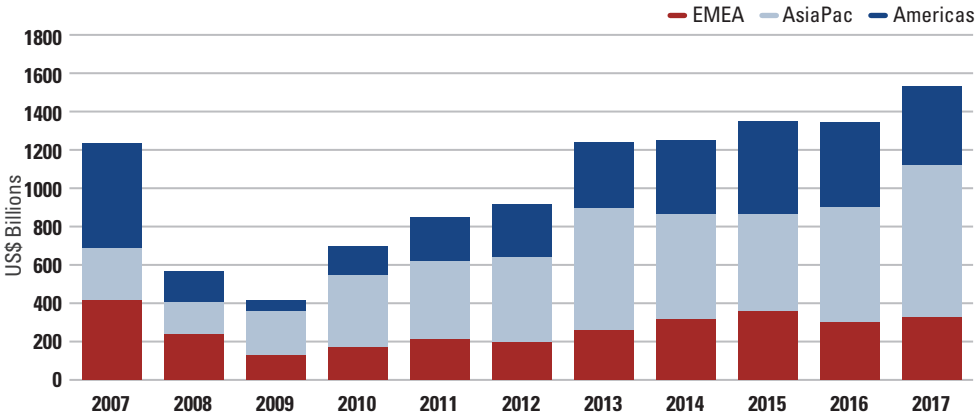
As shown in **Exhibit 6**, global commercial real estate investment (sales of $10 million or greater) totalled $1.5 trillion in 2017, up 14% from 2016, according to Real Capital Analytics (RCA). Most of the growth occurred in the Asia Pacific region **(see Exhibit 7)**, which grew by 32% last year, led primarily by strong investment in Beijing, Hong Kong and Singapore. The Europe, Middle East and Africa (EMEA) region came in second, growing approximately 9%, and was led by European portfolio deals and large single-asset transactions.

Slower transaction volume in the US weakened investment growth in the Americas, which fell nearly 7% in 2017. Transaction activity (on deals greater than $2.5 million) in the US slowed in 2017, with volume falling nearly 5% to $471 billion, according to RCA. Persistent concern over the age of the US economic expansion, which is in its ninth year, has created a pricing gap between sellers and buyers. This has hindered deal flow as buyers are hesitant to purchase at such low cap rates this late in the real estate cycle.

An area of growth across all of the regions was land sales. Developers were extremely active in Asia Pacific, especially China, and development site activity also grew in both the EMEA and Americas. Excluding development and land sites, total global real estate investment accounted for $873.25 billion, which was the second highest total for income-producing property investment since 2007, according to data from RCA **(see Exhibit 8)**.

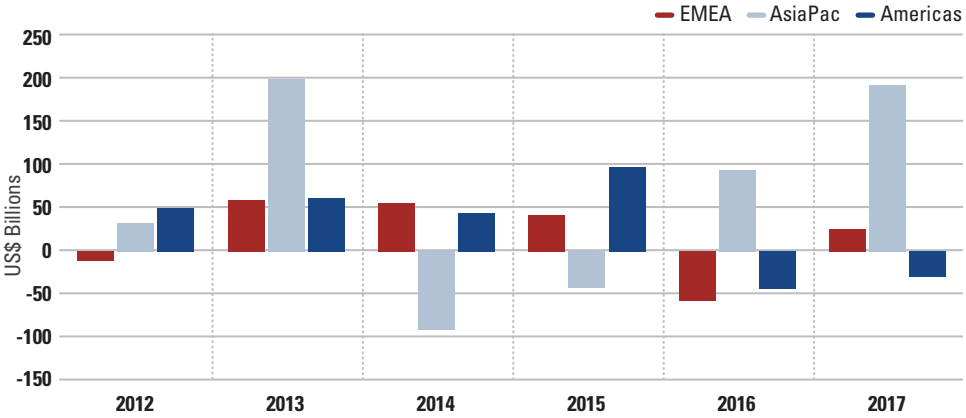
At almost 39%, the office sector continued to account for the largest percentage of global real estate investment in 2017 **(see Exhibit 9)**. While retail ranked third in share of global real estate investment in 2017, retail's percentage share of global investment has declined each of the last six years **(see Exhibit 10)**. The apartment sector surpassed retail's investment share in 2016, and industrial is expected to overtake retail in 2018 or 2019. Among the property types, industrial outperformed all

EXHIBIT 6. GLOBAL REAL ESTATE INVESTMENT VOLUME



Source RCA, February 2018.

EXHIBIT 7. CHANGE IN GLOBAL TRANSACTION VOLUME BY REGION



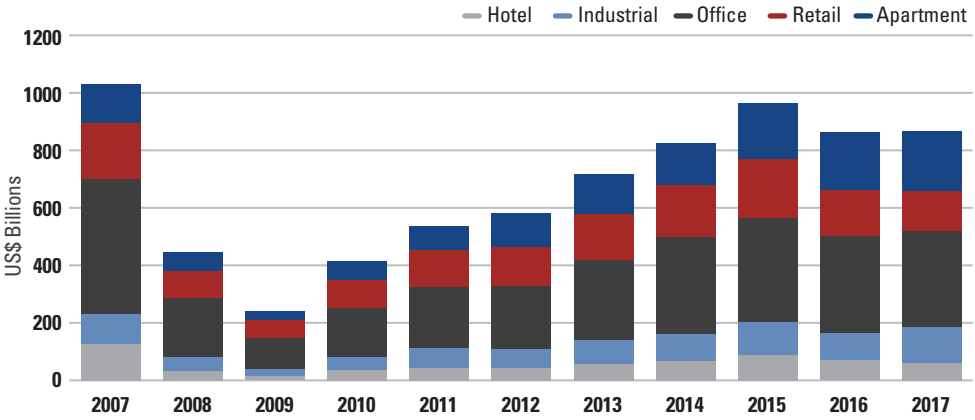
Source RCA, February 2018.

[1]The sponsoring firms of this report wish to thank Real Capital Analytics (RCA) for the investment activity data presented in this section. For more information about RCA, visit www.rcanalytics.com

sectors in the Americas and EMEA, and continues to be a strong asset class in global real estate investment. As more companies revise their global supply chain management strategies to fit online retailing, demand for logistics warehousing has continued to increase.

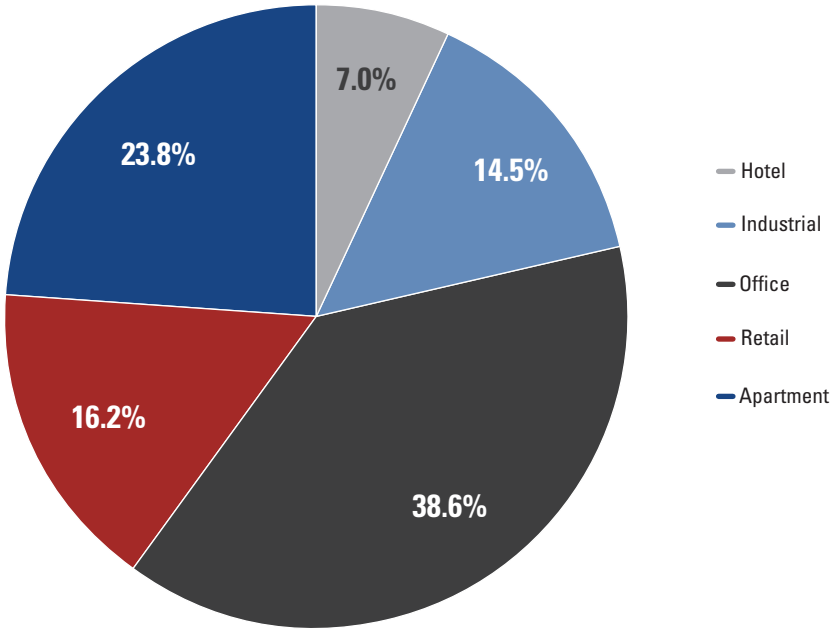
The Global RCA Commercial Property Price Index (CPPI) was up 8.4% in 2017. While this was an increase over the prior year, growth decelerated in 4Q 2017, increasing just 1.2%. Pricing triggered a drop in investment activity in the traditional global cities in 2017, as investors found it more challenging to find core assets in the primary global investment markets. Investors in search of yield instead sought to deploy capital in other cities, leading to an uptick in acquisitions in secondary markets.

EXHIBIT 8. GLOBAL REAL ESTATE INVESTMENT



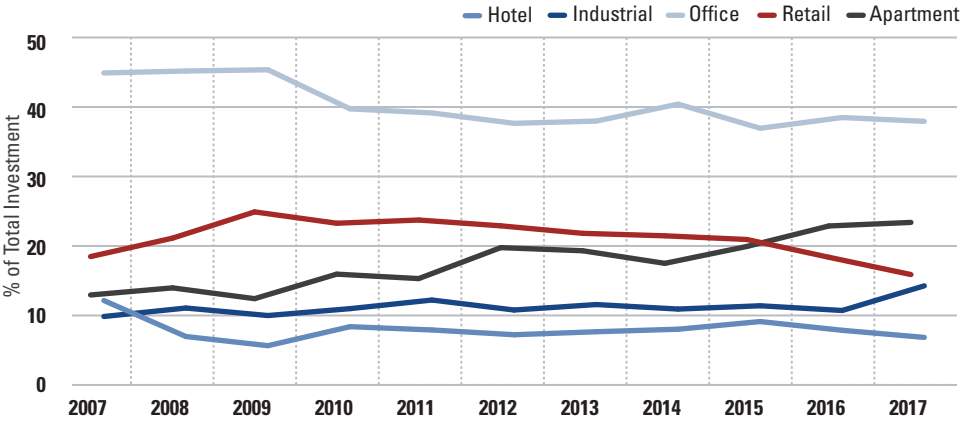
Source RCA, February 2018.

EXHIBIT 9. 2017 GLOBAL REAL ESTATE INVESTMENT BY ASSET TYPE



Source RCA, February 2018.

EXHIBIT 10. GLOBAL REAL ESTATE INVESTMENT SHARE BY ASSET TYPE



Source RCA, February 2018.

ASIA PACIFIC INVESTMENT ACTIVITY[1]

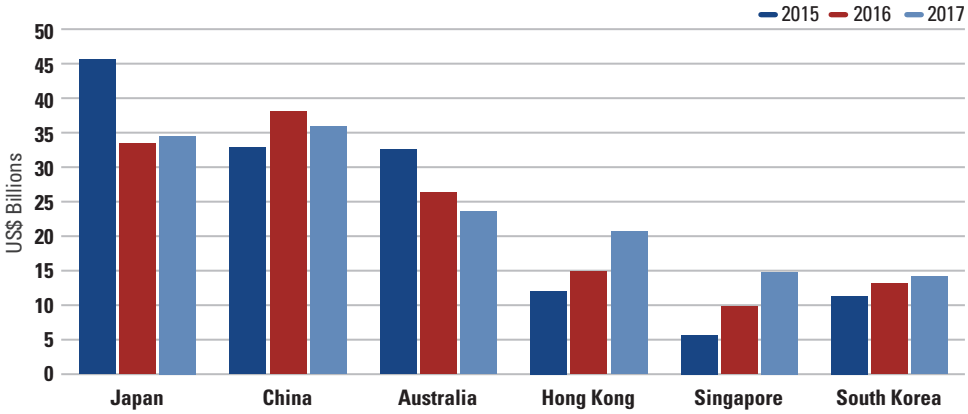
Commercial real estate investment in Asia Pacific totalled $157 billion in 2017, up 6% from 2016 levels, according to RCA. Asia Pacific property yields have hovered at historic lows in markets such as Japan, South Korea and Hong Kong, and compressed to new lows in Australia and Singapore.

The office and retail sectors, which have traditionally been a key target for investors, underperformed relative to other property types in 2017. The unwillingness of existing owners to sell and rapidly increasing prices spurred investors to move to other asset classes. Transactional activity in the office and retail sectors was stable compared to 2016.

Positive changes in the sector due to e-commerce, as well as robust growth in industrial fundamentals captured investors' attention in 2017 and acquisition volume grew by 20%. The industrial sector represented 73% of transactional activity across the Asia Pacific in 2017, up from only 10% in 2016. Sweeping trends such as the urbanisation of Asian cities and expanding e-commerce has reshaped the warehousing sector and supply chain throughout the region.

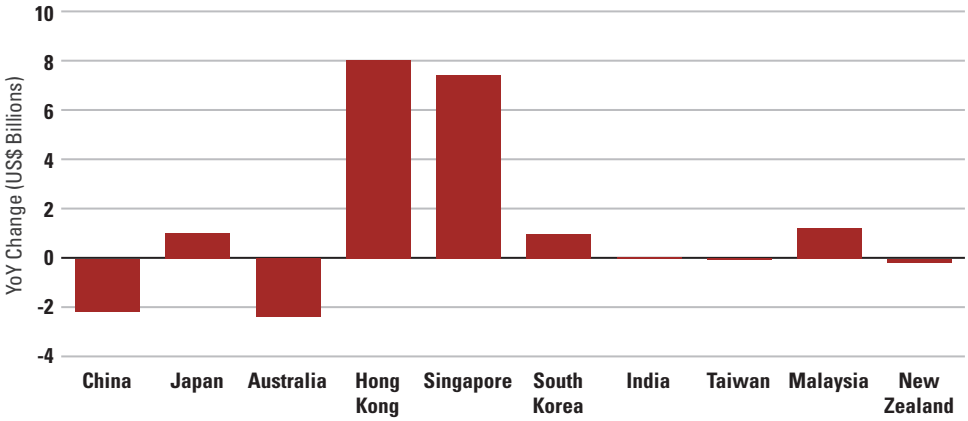
Investment activity for income-producing properties in Asia Pacific stayed focused on China and Japan; combined, they represented 45% of investment activity for standing assets in the region. China retained its crown as Asia Pacific's largest market for commercial real estate investment in 2017, even as transactional activity edged down 6% to $36.2 billion.

EXHIBIT 11. ASIA PACIFIC TRANSACTION VOLUME



Source RCA, February 2018.

EXHIBIT 12. ASIA PACIFIC TRANSACTION VOLUME CHANGE – 2017



Source RCA, February 2018.

[1]The sponsoring firms of this report wish to thank Real Capital Analytics (RCA) for the investment activity data presented in this section. For more information about RCA, visit www.rcanalytics.com

In Japan, Asia's second largest market, investment rose 3% to $34.9 billion (as seen in Exhibits 12 and 13).

Cross-border Asian investors in the region grew over 2017. Both Singaporean and Hong Kong investors increased their allocations across the region while Chinese capital declined marginally from record levels achieved in 2016. South Korea was another Asia Pacific market that reached a new peak in 2017, with a 7% increase in transactional activity to $14.3 billion.

Among the Asia Pacific metros, Beijing ranked number one in total transaction volume among all Asia Pacific metros ($48.5 billion), as well as number one in YoY growth (120%). Hong Kong and Singapore rounded out the top three in terms of total volume and YoY growth. Sydney, ranked 6th out of 11 Asia Pacific metros and is the only Australian metro to outrank a non-Australia Asia Pacific metro (Seoul).

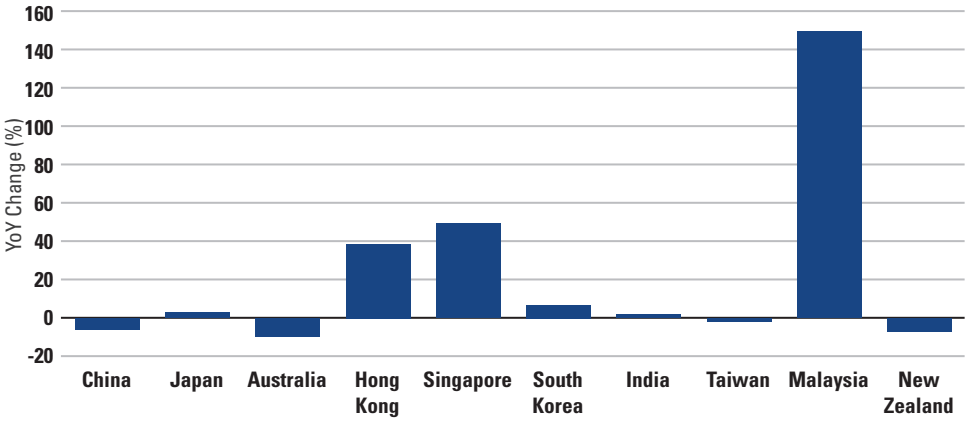
Investment activity in Hong Kong broke records in 2017. Acquisitions of income-producing assets grew 39%, underpinned by domestic purchasers. Scarcity of land and a flood of capital from mainland China were the main reasons for the surge in activity.

In China, capital shifted to the regional cities. Transactional volume increased in the majority of tier 2 and 3 cities such as Nanjing, Chengdu, Wuhan and Chongqing. In Guangzhou, transactional volume increased 157% over 2017.

Tokyo investments underperformed relative to acquisitions in other cities. Top pricing for office and retail assets in Tokyo persuaded investors to switch to higher-yielding assets in regional cities such as Yokohama and Osaka.

Many investors looked for opportunities in frontier markets because of favourable economic conditions and maturing real estate markets. Cambodia, Indonesia, Malaysia and Thailand all experienced triple-digit year-over-year growth, albeit starting at low levels. India – the largest of the frontier markets – recorded $3.5 billion of commercial real estate asset sales in 2017.

EXHIBIT 13. ASIA PACIFIC TRANSACTION VOLUME CHANGE – 2017



Source RCA, February 2018.

Commercial real estate investment reached an all-time high in Asia Pacific in 2017. Growth was led by activity in Singapore, South Korea and Hong Kong.

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AUSTRALIAN INVESTMENT ACTIVITY[1]

Australian transaction volume was ranked third in the Asia Pacific region, and seventh globally, behind the US, Germany, the UK, France, China and Japan. Of the top 14 nations in terms of transaction volume, only four experienced negative YoY growth: the US, Mexico, China and Australia. Total real estate investment (domestic and offshore) in Australia totalled $34.0 billion in 2017, 6% lower than 2016 levels, according to RCA; however, the volume is still 26% above the 10-year annual average.

The low transaction volumes were not a symptom of diminished investor interest because competition for real estate assets remains evident; however, high prices curtailed the activity. A lack of investable stock in key locations combined with property yields at historic lows crimped activity. Domestic real estate investment trusts (REITs), led by Charter Hall, DEXUS and GPT, became net buyers again in 2017.

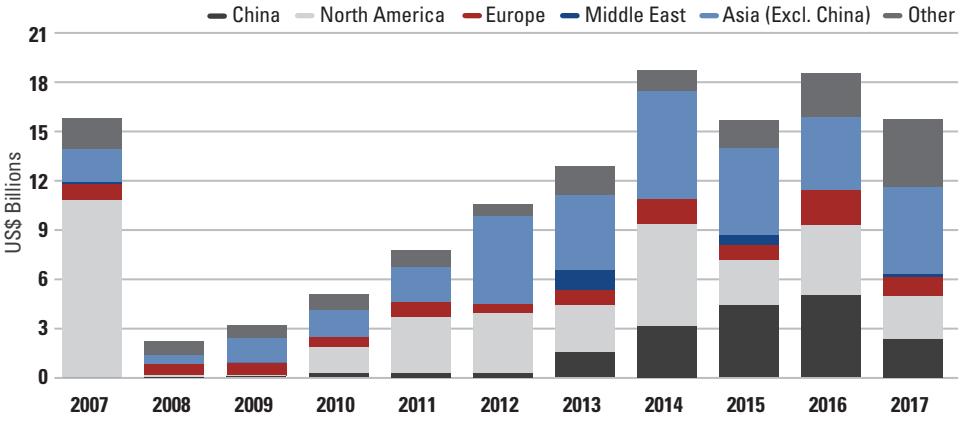
While overseas investors accounted for approximately 51% of transactions by value in 2016, surpassing domestic investors for the first time, cross-border flow real estate investment into Australia still accounted for 46% in 2017. Cross-border real estate investment into Australia in 2017 totalled $15.8 billion, down 15% from the $18.6 billion transacted in 2016. While cross-border investment in the Australian commercial real estate market fell over 2017, total volume transacted was still the fourth highest recorded in 10 years.

After six consecutive years of cross-border investment into Australia surpassing $10 billion annually, it appears that some offshore investors have started to recycle capital placed in Australian assets, realising strong capital growth. US, Canadian and Malaysian groups were all net sellers in the Australian commercial real estate market. However, US and China capital flows into Australia both decreased by approximately half, from 2016 to 2017. Even though Chinese cross-border investment declined 53%, the Chinese were still net buyers of Australian commercial real estate.

Impacted by the Chinese government's updated guidelines on outbound investment, Chinese investors accounted for 14% of total cross-border investment into the Australian commercial real estate market, its lowest share since 2013. In contrast, the proportion of Asian-based investment in Australia (excluding China) increased to 33%, or $5.3 billion. Singapore, Malaysia, South Korea and Hong Kong all increased their investment into Australia in 2017 compared to 2016.

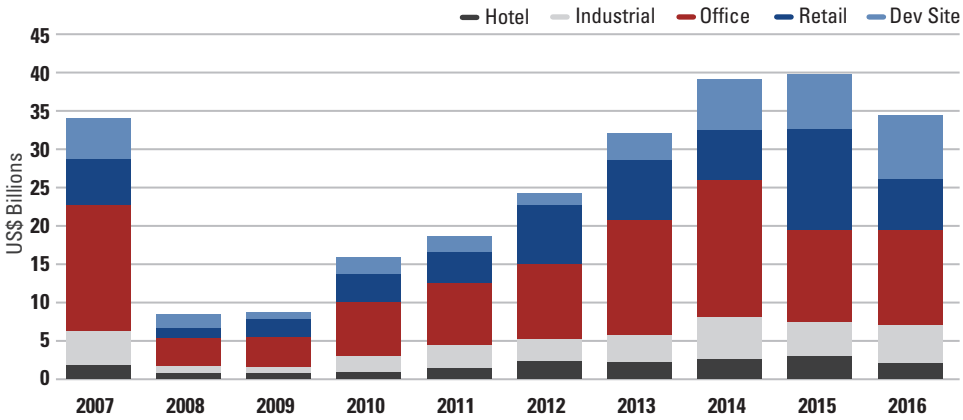
Even though Chinese cross-border investment declined 53%, the Chinese were still net buyers of Australian commercial real estate.

EXHIBIT 14. CROSS-BORDER COMMERCIAL REAL ESTATE INVESTMENT INTO AUSTRALIA BY ORIGIN



Source RCA, February 2018.

EXHIBIT 15. TOTAL COMMERCIAL REAL ESTATE INVESTMENT IN AUSTRALIA BY SECTOR



Source Urban Property Australia, 4Q 2017.

Of the total capital flows into Australia, Singapore, China and the United States led the pack for single countries, with each investing over $2 billion. Although cross-border investment into the Australian commercial real estate market from US investors fell in 2017, US-based capital still was the third largest source of total cross-border investment into Australia.

Canada's investment into Australia increased from just $26 million in 2016 to nearly $428

[1]The sponsoring firms of this report wish to thank Real Capital Analytics (RCA) for the investment activity data presented in this section. For more information about RCA, visit www.rcanalytics.com

million in 2017, easily making it number one in YoY change. This increase in investment was highlighted by Manulife Financial Corp.'s purchase of the office building at 800 Collins St in Melbourne for $295.2 million.

Australian cities dropped in the rankings for commercial real estate investment as record prices left buyers and sellers at an impasse. For transaction volume, not including development sites, Sydney suffered a 21% decline, while Melbourne recovered slightly in the second half of 2017 to record a 12% decline. Only Brisbane showed positive annual change in transactional activity (23%). While commercial real estate investment declined over the year in Sydney, it was the 6th highest destination for commercial real estate investment in the Asia Pacific region.

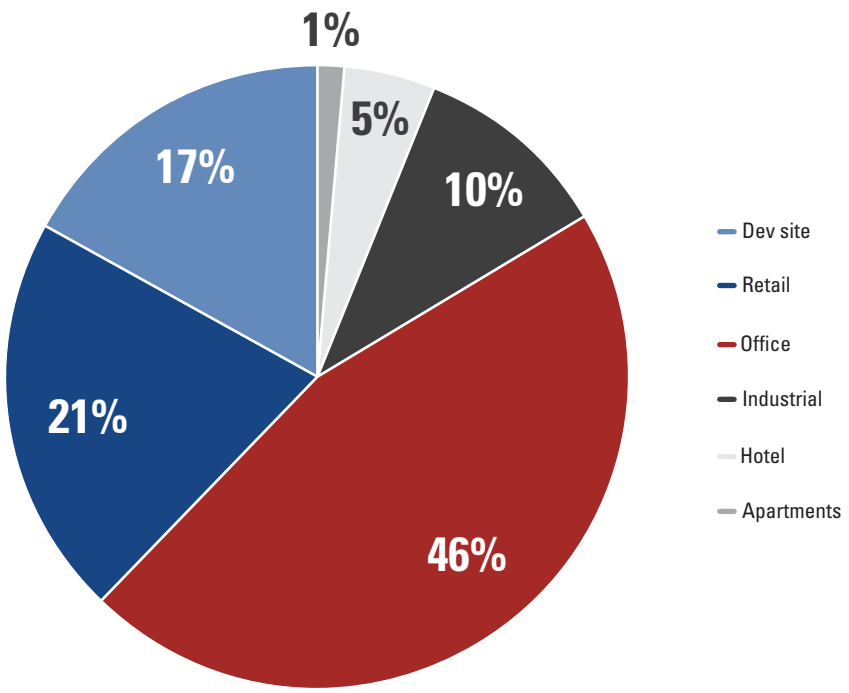
More broadly, offshore investors spent $6.9 billion on Australian office assets **(see Exhibit 15)**, primarily in Sydney and Melbourne, capitalising on the strong rental growth recorded in the CBDs over the past two years. Offshore investors spent $1.6 billion on Brisbane-based assets — the highest level for the city on record, as investors made countercyclical office acquisitions in the city.

As shown in **Exhibit 16**, boosted by a number of major shopping centres, retail assets accounted for 21% all cross-border purchases followed by development sites (17%) and industrial properties (10%). Cross-border investment into all other Australian property sectors, however, fell in 2017 compared to the preceding year.

Globally, investors faced a fully priced office environment in 2017, with yields either hovering at their historic lows or compressing further throughout the year. Although the Australian office market still offers value compared to other global cities, the spread is narrowing.

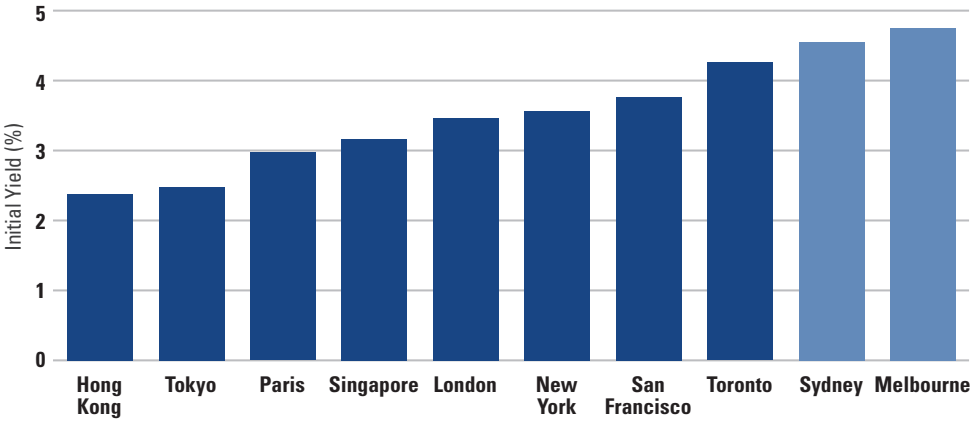
Reflecting the strong rental growth achieved in Sydney and Melbourne, both cities recorded some of the greatest compression of yields globally, as shown in **Exhibit 17**. Over 2017, CBD office yields for Sydney and Melbourne assets compressed by 140 basis points, compared to Hong Kong offices, which compressed by 50 basis points and New York (70 basis-point compression).

EXHIBIT 16. 2017 AUSTRALIAN REAL ESTATE INVESTMENT BY ASSET TYPE



Source RCA, February 2018.

EXHIBIT 17. GLOBAL PRIME OFFICE YIELDS



Source Urban Property Australia, January 2018.

Offshore investors spent US$1.6 billion on Brisbane-based commercial real estate assets – the highest level for the city on record, as investors made countercyclical office acquisitions in the city.

FEATURE ARTICLE
THE DIGITAL REVOLUTION IN COMMERCIAL REAL ESTATE

As the technology revolution marches forward and demographics shift, we will continue to see their profound effect on many areas of life, including commercial real estate. Worldwide, the commercial real estate industry has been slow to adapt to changing technologies. But the proliferation of automation, the Internet of Things and the emergence of machine learning and big data that are stemming from major advancements in technology are slowly, but surely, finding their way into the commercial real estate space.

Commercial real estate data have become much easier to access and disseminate throughout the industry. Many data providers can give real-time valuation metrics to users and allow investors access to view properties without having to travel there through programs such as Google Maps.

The digital revolution has made self-driving cars a reality, and while the technology still needs to be perfected, the potential for it to change the way in which people live, work and play is undeniable. Storage and service lots for autonomous vehicles can be located in inexpensive areas of the city. Real estate from parking garage and gas station structures can be reclaimed and redeveloped into more profitable ventures. While driverless cars will make urban life more attractive, they will also make having a long commute more feasible and urban sprawl may become more popular.

Commercial real estate financing is also moving into new territories as regulatory burdens shift lending from traditional banks to private funds, shadow banks and crowdsourcing platforms. Even commercial real estate lending practices are becoming non-traditional, with the advent of crowdsourcing platforms, which allow people to invest in commercial real estate (debt or equity) with as little as $1,000. It is a brave new world for the entire industry.

The digital revolution has led to an ever-expanding presence of e-commerce, which has both positive and negative implications for commercial real estate. It is forcing many retailers to rethink their strategies for competing in a digital world where 'bricks and sticks' are being replaced by 'point and clicks'. Many mall anchors are becoming obsolete and are being replaced by pop-up stores that have flexible leases. The malls that survive are those that repurpose their space, either by including entertainment or by adding living space and new types of stores that incorporate online shopping. Capitalising on e-commerce and finding creative shopping experiences will be increasingly important as well. For example, Nordstrom Local will have smaller-footprint stores with no merchandise, instead providing services such as manicures and on-site tailoring. And some traditional e-retailers have started opening 'showrooms' that allow consumers to try on products without large inventory.

Thanks to e-commerce, industrial distribution centres are thriving. Demand for space has overtaken supply, and competition in the market is fierce. E-commerce retailers typically require a greater amount of space than traditional retailers and supply chain constraints, such as last-mile delivery, pose challenges for owners and occupants in the sector. In addition to distribution centres, data centres are an emerging opportunity for investors. As more people consume digital content and make purchases online, landlords and owners of data centres are looking to expand faster.

Millennials are also affecting the way people live, work and play, now and in the future. Traditional office spaces, with private offices or cubicles, are giving way to open-office concepts that are fully technologically integrated. Mixed-used space, such as apartment buildings that also include offices, cafés, grocery stores, health and wellness centres, or dry cleaning services, are becoming popular. Industries in the sharing economy (such as Uber, Airbnb and WeWork), which did not even exist a decade ago, are changing the way that people use and lease space.

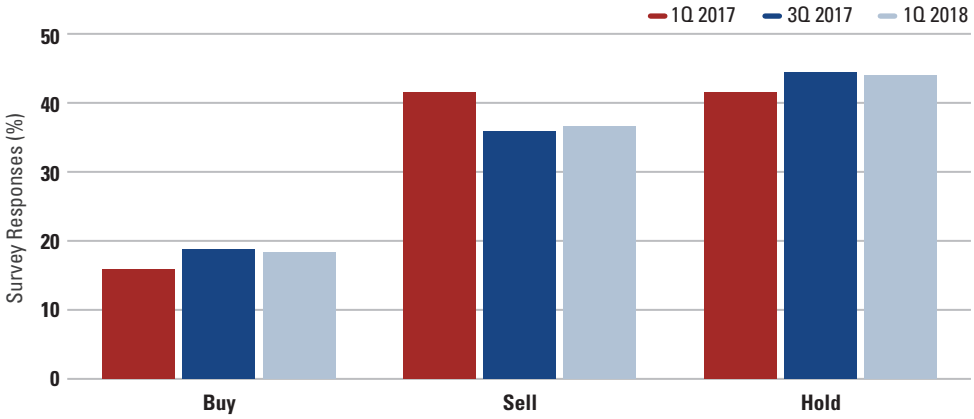
INVESTOR SENTIMENT

INVESTOR SENTIMENT

As part of the 1Q 2018 Situs RERC/UPA Australian Market Expectations survey, respondents were asked to provide insight for commercial real estate across five of the capital cities (Adelaide, Brisbane, Melbourne, Perth and Sydney) over the next year.

Respondents who contributed to the 1Q 2018 Situs RERC/UPA Australian Market Expectations Survey consisted of landlords, fund managers, investment bankers, REIT analysts, superannuation (pension) funds, valuers/appraisers, financiers, private investors and real estate agents. The variety of respondents ensured that the analysis of the survey offers insight into investor sentiment and provides a useful tool to evaluate investment trends for the commercial real estate market.

EXHIBIT 18. BUY-SELL-HOLD RECOMMENDATIONS



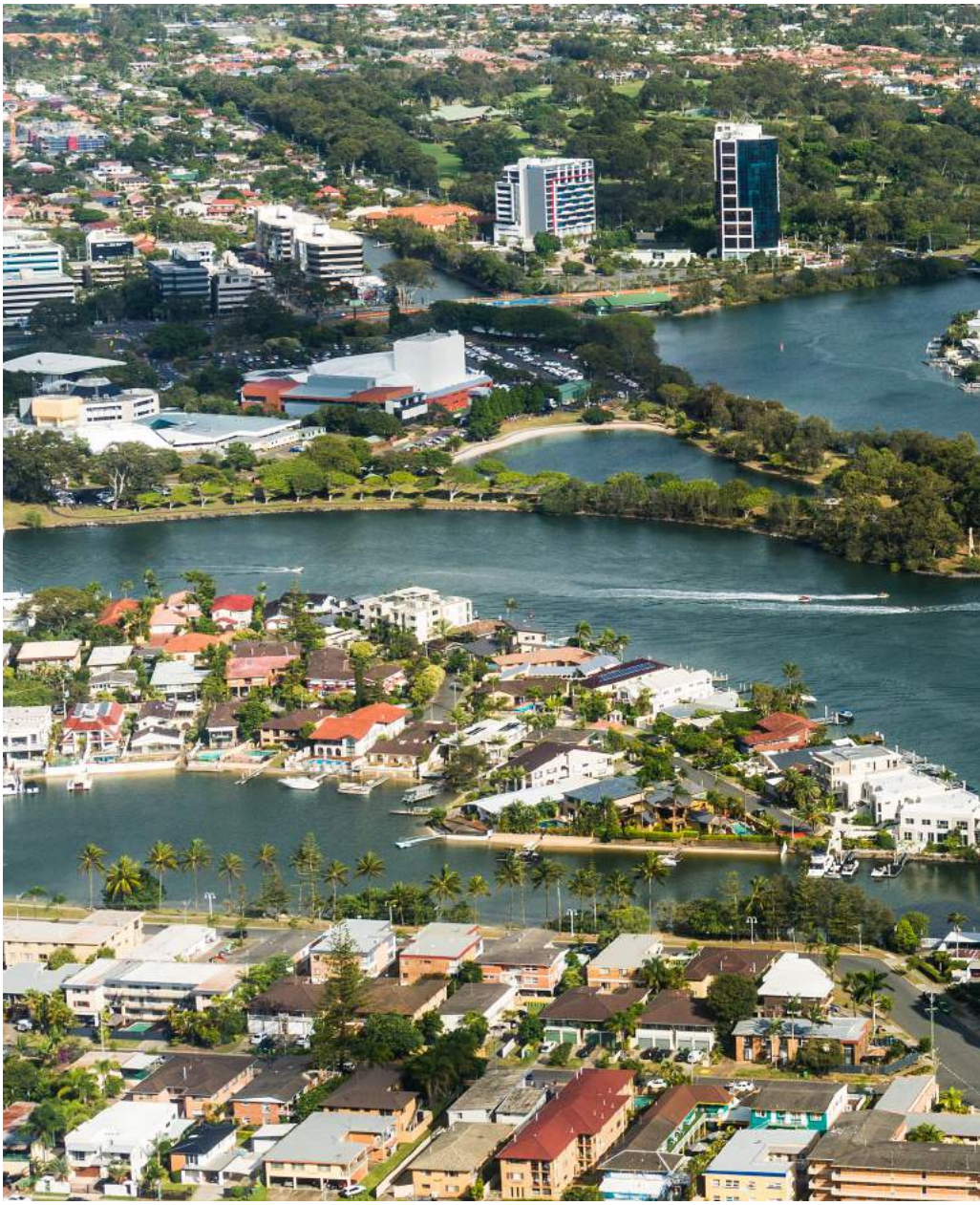
Source Situs RERC / Urban Property Australia, 1Q 2018.

BUY-SELL-HOLD RECOMMENDATIONS

Overall, the 1Q 2018 survey results revealed that respondents indicated that it was a good time to hold Australian commercial real estate, which accounted for 44% of respondents, followed by respondents who believed it was the best time to sell Australian commercial real estate (37%) **(see Exhibit 18)**. Reflecting the strong capital growth recorded across the Australian commercial real estate market, buying commercial real estate was the least appealing investment option to respondents. Buying Australian commercial real estate accounted for 19% of all responses.

Within Sydney and Melbourne, only 17% and 18% of all survey respondents, respectively, judged that it is a good time to buy commercial real estate. In contrast, 50% of respondents said that the next quarter would be a good time to sell commercial real estate in Sydney. Similarly, for Melbourne commercial real estate assets, 41% of respondents said that the next quarter would be a good time to sell commercial real estate.

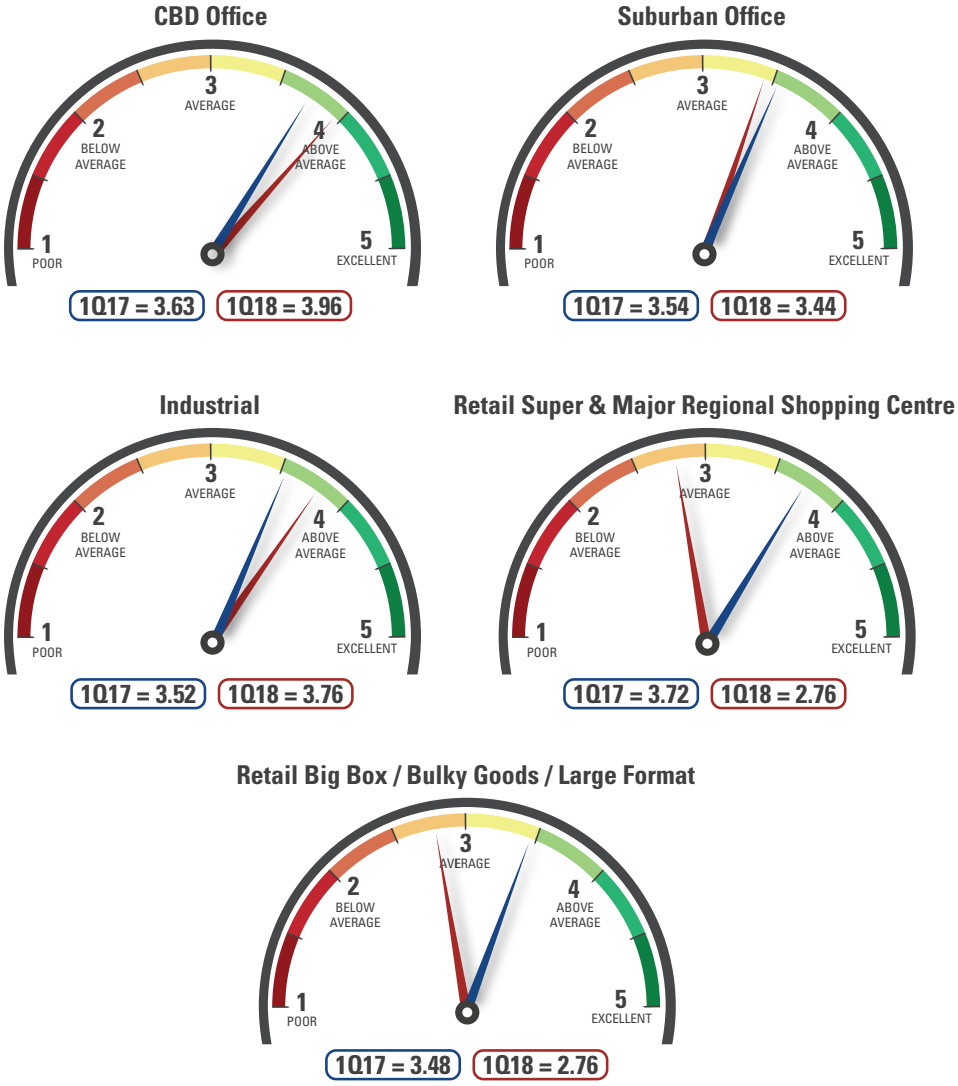
Most investors (44%) thought it was a good idea to hold Australian commercial real estate.



INVESTMENT CONDITIONS

For Australia overall, a clear divergence is emerging between the retail sector and the other sectors. Investment conditions for CBD office, suburban office and industrial were considered above average in 1Q 2018 **(see Exhibit 19)**. For the CBD office sector, the majority of respondents (72%) said that investment conditions were above average or excellent. The most prevalent response for the suburban office market was that investment conditions were above average or excellent (52%), up from 39% recorded in 3Q 2017. The structural changes of the retail sector adversely impacted investor sentiment with investment conditions for both retail shopping centres and retail big box/bulky goods/large format sectors appraised as below average overall. In contrast, the industrial sector increased to its highest rating of survey responses with 64% of respondents assessing investment conditions as above average or excellent.

EXHIBIT 19. INVESTMENT CONDITIONS BY ASSET TYPE



A clear divergence is emerging between the retail sector and the other sectors. Investment conditions for CBD office, suburban office and industrial were considered above average, while the retail sectors were considered below average.

Source Situs RERC / Urban Property Australia, 1Q 2018.

INVESTMENT OPPORTUNITIES

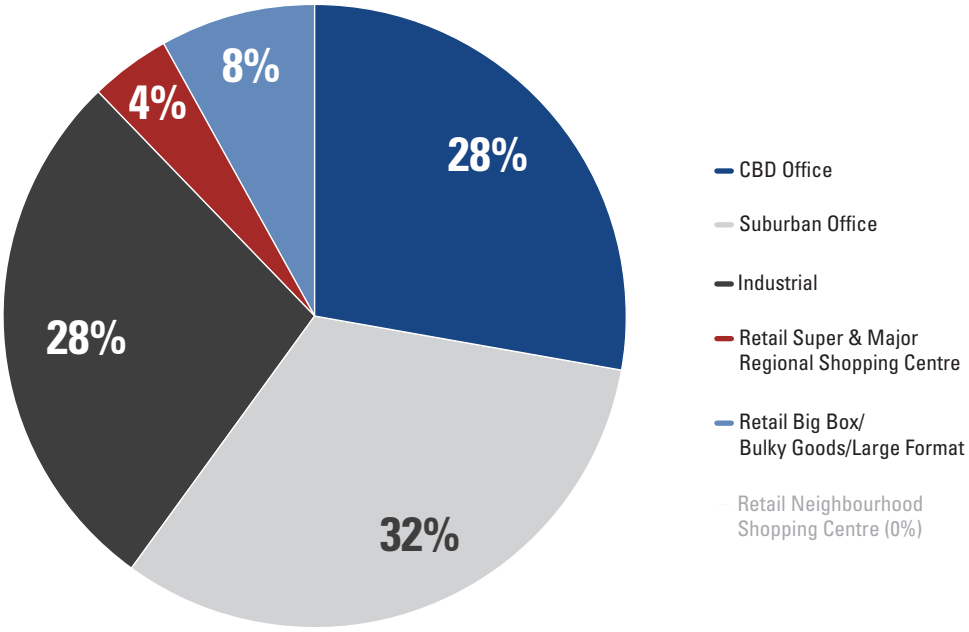
The suburban sector overtook the CBD office sector as the preferred asset class for investment over other property sectors in the next 12 months as of 1Q 2018, as shown in **Exhibit 20**. The record-low cap rates recorded in the CBD office sector have increased investor focus on non-CBD office markets. The fundamental shift created by the expansion of e-commerce has shifted investor sentiment regarding the retail and industrial sectors. The proportion of respondents who ranked industrial property as the best investment opportunity increased to 28%, from 16% in 1Q 2017. In contrast, the retail sector was considered the best investment opportunity by only 12% of respondents.

The record-low cap rates recorded in the CBD office sector have increased investor focus on non-CBD office with the sector ranked as the best investment opportunity in 2018.

AUSTRALIAN ECONOMY AND INTEREST RATE OUTLOOK

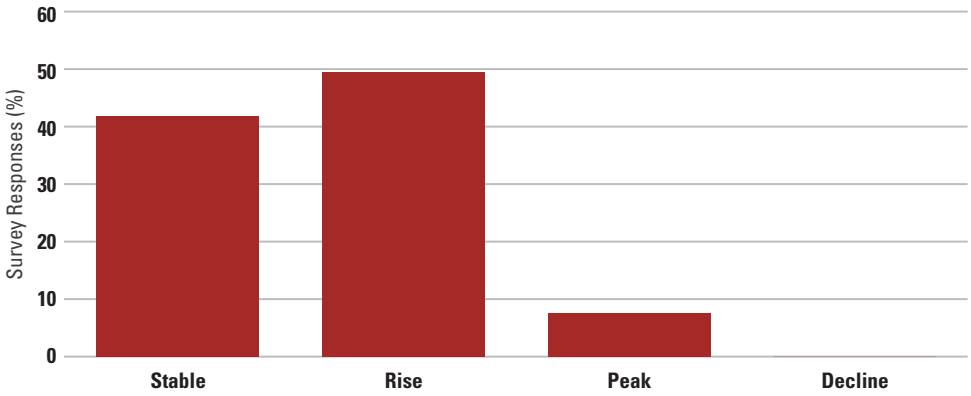
In terms of the performance of the Australian economy during the next 12 months, the largest number of survey respondents (50%) predicted that the Australian economy will grow, while 42% of respondents predicted that the Australian economy will remain stable **(see Exhibit 21)**. The remaining 8% of survey respondents predicted the Australian economy will peak in 2018, up from 2% recorded in 3Q 2017.

EXHIBIT 20. BEST INVESTMENT OPPORTUNITY (BY ASSET TYPE) 12 MONTHS TO JANUARY 2019



Source Situs RERC / Urban Property Australia, 1Q 2018.

EXHIBIT 21. PERFORMANCE OF AUSTRALIAN ECONOMY 12 MONTHS TO JANUARY 2019



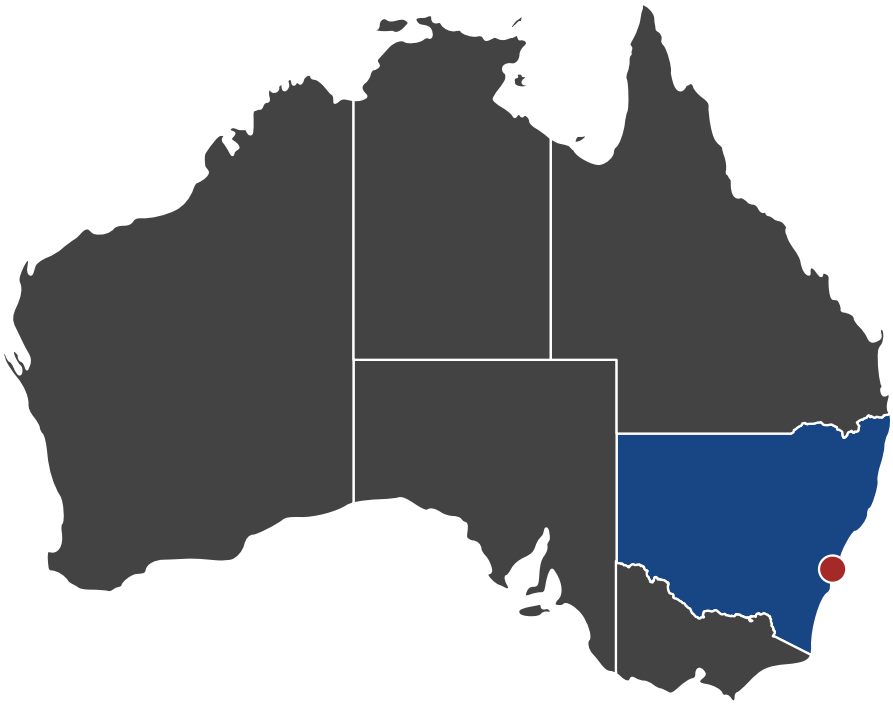
Source Situs RERC / Urban Property Australia, 1Q 2018.

92% of survey respondents predicted that the Australian economy will rise or remain stable over the next 12 months.

CAPITAL CITY UPDATES

SYDNEY

Sydney is the state capital of New South Wales (NSW) and, with more than 5 million residents, is the most populous city in Australia and Oceania, with more than 5 million residents. Sydney has an advanced market economy with strengths in finance, manufacturing and tourism. A significant number of foreign banks and multinational corporations are attracted to Sydney in part because its time zone spans the closing of business in North America and the opening of business in Europe. In addition to being a leading global financial hub, Sydney is amongst the top 15 most-visited cities in the world.



ECONOMY

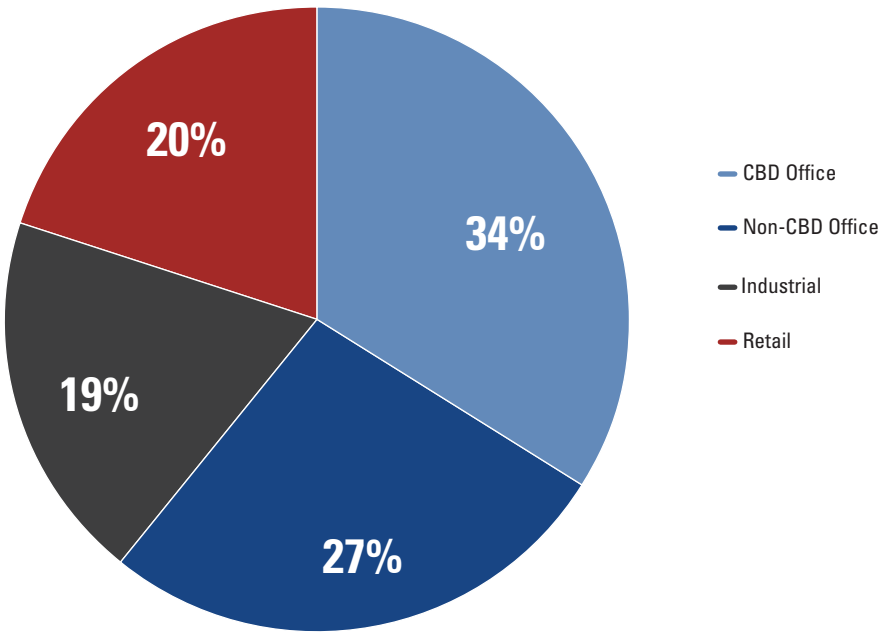
State final demand (a general indicator of momentum in the local economy) in NSW grew 3.0% in 2017. Looking ahead, NSW is forecast to be the best performing state economy over the next two years, due to strength in private non-dwelling construction, public infrastructure investment, and positive momentum in business and financial services and tourism. Labour market conditions in NSW remain strong, with employment growing 3.7% in 2017. The NSW unemployment rate fell to 4.8% during 2017, compared to 5.4% nationally. There are, however, some headwinds for NSW as the wealth effect of a rising housing market dissipates. With the housing market cooling, NSW's AU$73 billion[1] infrastructure pipeline is expected to support solid growth this year and through 2019.

New South Wales set to be the best performing Australian state over the next two years boosted by its AU$73 billion infrastructure pipeline.

OFFICE MARKET

The Sydney CBD office market is Australia's largest CBD office market, comprising 5.0 million square metres. Over 2017, vacancy in the Sydney CBD office market decreased from 5.8% to 4.6%, largely driven by office withdrawals for residential development and new infrastructure projects. While vacancy has tightened to its lowest level in almost 10 years, the pipeline of new supply remains relatively limited with 130,000 square metres scheduled to be completed over the next two years, compared to the two-year historical average of 325,000 square metres. With vacancy at its lowest level in a decade, Sydney CBD's prime and secondary gross effective rents have increased 20% and 15% respectively over 2017. Sales activity in the Sydney CBD office market over 2017 totalled $4.7 billion, the second highest level on record. Investment activity by asset type for Sydney can be found in **Exhibit 22**. The 1Q

EXHIBIT 22. SYDNEY PROPERTY INVESTMENT BY ASSET TYPE IN 2017



Source Urban Property Australia, January 2018.

[1]Unless otherwise noted, all currencies presented in the Capital Cities section are in Australian dollars.

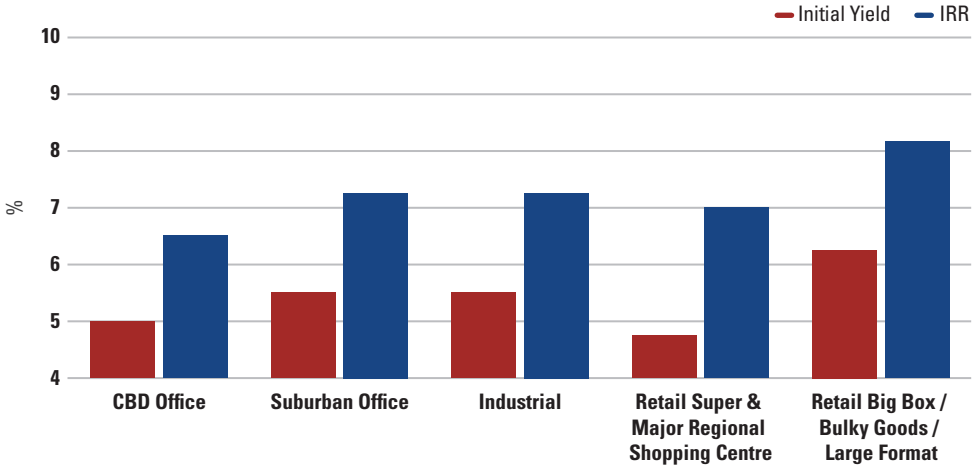
2018 Situs RERC/UPA survey results reveal that the average unlevered yield for prime Sydney CBD assets is 5.0% with an average Internal Rate of Return (IRR) of 6.5% (**see Exhibit 23** for initial yields and IRRs by property type).

With Sydney's falling CBD vacancy and strong employment growth recorded across NSW, the current vacancy rates of all of Sydney's non-CBD office markets are below their respective 10-year averages. Capitalising on the vision of Parramatta becoming 'Sydney's second CBD', the Parramatta office market vacancy rate fell to 3.0%, its lowest level since January 1990. The NSW government has driven leasing demand in Parramatta, accounting for 70% of total leasing activity over 2017, as government agencies decentralise from Sydney CBD to the West. Benefitting from a lack of contiguous vacant options in the CBD and the commitment of major infrastructure projects boosting connectivity, vacancy levels fell across the majority of Sydney's non-CBD office markets in 2017. Investable stock shortages and pressure to diversify have forced investors to look beyond CBD office markets. Over 2017, prime and secondary yields have compressed in Sydney's non-CBD office markets as the suburban office market appeals to a wide range of buyers, including residential developers and investors. Responses from the 1Q 2018 Situs RERC/UPA survey reveal that the average unlevered yield for prime Sydney suburban office assets is 5.5% with an average IRR of 7.25%.

INDUSTRIAL MARKET

On the back of strong population growth and a strengthening economy, tenant demand volume surpassed the 10-year average over 2017. Tenant demand for Sydney industrial property in 2017 was underpinned by the growth of e-commerce, which boosted activity from retailers, third-party logistics groups and wholesale traders. Following a prolonged period of subdued rental growth, the lack of quality stock and strong demand for prime industrial space resulted in above-average growth for prime rents over 2017, rising 4.5%. Reflecting the confidence in the Sydney industrial market, speculative new development surged in 2017, also lifting new supply levels above average; however, the vast majority of speculative developments were leased prior to completion. While investor demand remains strong, transaction volume dropped significantly in 2017. Although yield compression was relatively modest for prime assets, a lack of investable-grade stock has intensified competition for secondary properties. According to the January 2018 Situs RERC/UPA survey results, the average unlevered yield for prime Sydney industrial assets is 5.5% with an average IRR of 7.25%.

EXHIBIT 23. INITIAL YIELDS & IRRs – SYDNEY



Source Situs RERC / Urban Property Australia, 1Q 2018.

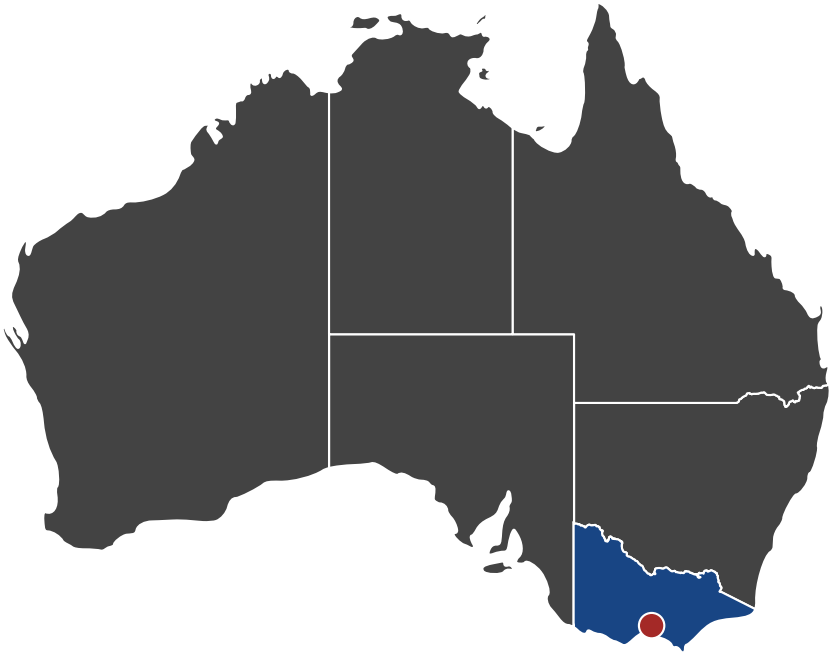
Sydney CBD office vacancy has fallen to its lowest level in 10 years.

RETAIL MARKET

Although retail spending growth in NSW continued to moderate over 2017, rising 2.6%, but down from 3.3% over 2016, the state continued to outperform the national average (2.5%). While consumer sentiment levels have increased, low wage growth, historically high household debt and easing house price growth are likely to constrain retail spending in coming years. The launch of Amazon to Australia in December 2017 has forced many retailers to refine their business lines and become more specialised. Additionally, landlords continue to face ongoing leasing challenges as retailers consolidate store networks and some retailers have falling into voluntary administration. Population growth will, however, support retail trade. Retail rents in Sydney are expected to remain flat in 2018 across all shopping centre classifications before gradually increasing in 2019 and 2020. NSW accounted for 31% of retail transactions across Australia in 2017 with $2.8 billion sales recorded, above the $1.8 billion transacted in 2016. The 1Q 2018 Situs RERC/UPA survey results reveal that the average unlevered yield for Sydney Super & Major Regional Shopping Centre assets is 4.75% with an average IRR of 7.0%. Sales of large-format retail centres in NSW totalled $600 million, accounting for 21% of all NSW retail transactions in 2017. Responses from the 1Q 2018 Situs RERC/UPA survey reveal that the average unlevered yield for prime Sydney large-format retail assets is 6.25% with an average IRR of 8.15%.

MELBOURNE

Melbourne is the second-most populous city in Australia, with about 4.7 million residents. According to the Economist Intelligence Unit, for seven consecutive years to 2017, Melbourne has been ranked as the world's most liveable city. Melbourne has a highly diversified economy with particular strengths in finance, manufacturing, research, IT, education, logistics, transportation and tourism. The city is home to Australia's largest and busiest seaport, which handles more than $75 billion in trade every year and 39% of the nation's container trade. Melbourne is Australia's leading centre for superannuation funds, with 40% of the total, including the $109 billion Federal Government Future Fund.



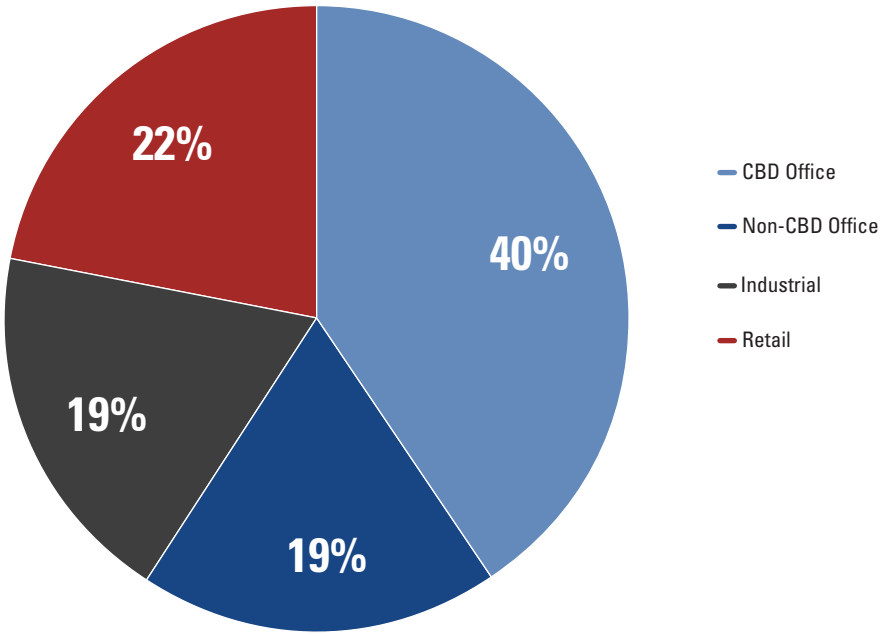
ECONOMY

Victoria's population growth is approaching record-high levels with the state's population growing by 147,400 in the year to September 2017, accounting for 37% of Australia's total population growth. Victoria's nation-leading population growth has underpinned economic growth for the state in recent years. Over 2017, Victoria's state final demand increased by 3.0%, second only to South Australia. Victoria's strong population growth has also supported retail trade, which grew 1.8% in the December quarter, the second highest growth rate among the states. Global economic conditions continue to improve, supporting the outlook for Victoria's economy, which remains strong given its diverse industry base. Victoria's record infrastructure program is also expected to generate further employment in the construction sector.

OFFICE MARKET

The Melbourne CBD office market experienced the largest decrease in vacancy over the second half of 2017 and now boasts the lowest vacancy rate across all Australian CBDs. The Melbourne CBD office market decreased to 4.6% as at January 2018, its lowest vacancy rate since July 2008. The CBD office market recorded 74,800 square metres of net absorption over 2017, more than any other Australian office market, and was the 15th consecutive calendar year of positive net tenant demand. As a result of vacancy falling to its lowest rate in nearly 10 years, prime CBD effective rents have reached unprecedented levels, growing 15% over 2017. Future supply is on par with historic averages over the next two years, with 240,500 square metres to be brought to market in 2018 and 2019. Boosted by several significant fund-through transactions, investment activity in 2017 within the Melbourne CBD office market surpassed $3.8 billion, its highest level on record. Investment activity by asset type for Melbourne can be found in

EXHIBIT 24. MELBOURNE PROPERTY INVESTMENT BY ASSET TYPE IN 2017



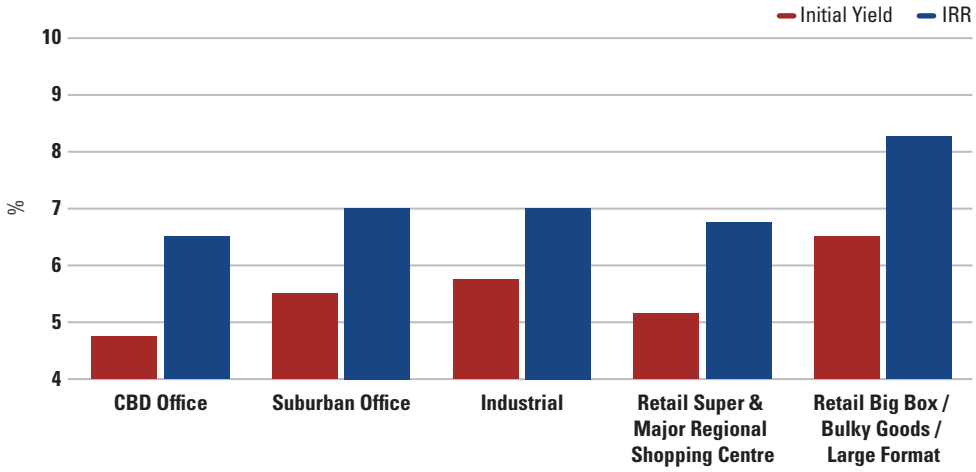
Source Urban Property Australia, January 2018.

Victoria continued to grow the fastest of all Australian states, with population increasing by almost 150,000 people over the year.

Exhibit 24. The 1Q 2018 Situs RERC/UPA survey results reveal that the average unlevered yield for prime Melbourne CBD assets is 4.75% with an average IRR of 6.5% (see **Exhibit 25** for initial yields and IRRs by property type).

Outside of the CBD, the Southbank office market recorded its highest level of tenant demand in seven years; however, high levels of supply pushed vacancy up. With further office properties withdrawn for residential development, vacancy in the St Kilda Road office market fell to its lowest level since July 2008. Looking forward, prime rents are forecast to grow solidly over 2018 underpinned by the current low vacancy, lack of new supply and additional stock withdrawn. With prime Melbourne CBD office assets transacting below 5% yields, investors – particularly smaller unlisted funds, private investors and offshore groups – are looking to more 'value add' opportunities with higher cap rates in non-CBD office markets. Intense competition for CBD office properties in Melbourne created a surge of activity in non-CBD office markets. Investment activity across Melbourne's non-CBD office markets totalled $1.7 billion in 2017, surpassing the $1.0 billion transacted in 2016. Responses from the 1Q 2018 Situs RERC/UPA survey reveal that the average unlevered yield for prime Melbourne non-CBD office assets is 5.5% (down from 5.98% as at January 2017 survey) with an average IRR of 7.0% (down from 9.0% as at the January 2017 survey).

EXHIBIT 25. INITIAL YIELDS & IRRs – MELBOURNE



Source Situs RERC / Urban Property Australia, 1Q 2018.

INDUSTRIAL MARKET

The Melbourne industrial market has been long profiting from the strength of the Port of Melbourne. Major transport infrastructure projects currently under development and in the pipeline are further expected to improve connectivity within the industrial precincts while expanding capacity in Melbourne's transport network. Melbourne's position as Australia's largest industrial city is expected to be augmented by these projects. While the recent closures of car manufactures will impact the Melbourne industrial market, the food export sector is expected to offset these closures over the coming years. Victoria accounted for 25% of Australian food exports over 2016/17. New supply levels for the Melbourne industrial market in 2017 were their lowest since 2013. New construction was led by tenant pre-commitments seeking bespoke facilities with speculative development limited. Lower stock levels are likely to provide a boost to rental growth through reduction of incentives over 2018. Over 2017, $1.75 billion was transacted across the Melbourne industrial market, lower than the $1.95 billion transacted in 2016. According to the 1Q 2018 Situs RERC/UPA survey results, the average unlevered yield for prime Melbourne industrial assets is 5.75% with an average IRR of 7.0%.

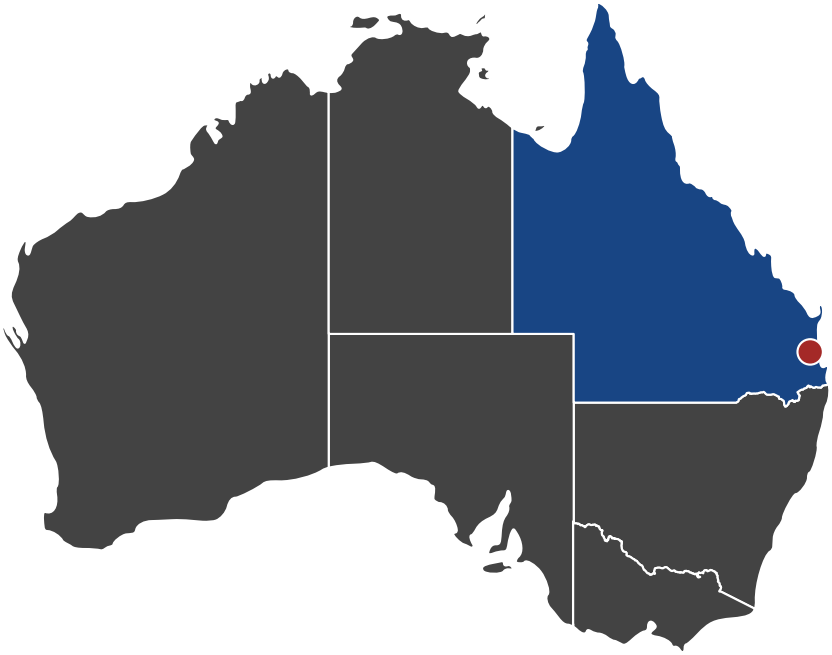
RETAIL MARKET

Victoria's favourable economic fundamentals continue to support the retail market. State final demand increased 4.4% over 2017, 200 basis points above the Australian GDP. Victoria's population grew 2.4% to 6.35 million people in the 12 months to September 2017. This strong population growth will continue to support retail spending. Victoria's retail sales turnover grew by 4.5% over 2017, the highest rate across Australia. According to the Australian Bureau of Statistics, retail trade growth in Victoria was led by sales of cosmetics, which grew by 15.7% over the year and cafés & restaurants (6.0%). Over 2017, retail transactions in Victoria totalled $2.0 billion, boosted by GPT's purchase of a 25% share of the Highpoint shopping centre. The transaction was struck on a record 4.2 % yield, the lowest ever paid in the history of Australia shopping centre transactions, indicating the high prices institutional investors are willing to pay for exposure in dominant shopping centres. The 1Q 2018 Situs RERC/UPA survey results reveal that the average unlevered yield for Melbourne Super & Major Regional Shopping Centre assets is 5.15% with an average IRR of 6.75%. Responses from the 1Q 2018 Situs RERC/UPA survey reveal that the average unlevered yield for prime Melbourne large-format retail assets is 6.5% with an average IRR of 8.25%.

The Highpoint shopping centre transaction was struck on a record 4.2% yield, the lowest ever paid in the history of Australia shopping centre transactions.

BRISBANE

Brisbane, with more than 2.3 million residents, is a popular tourist destination, serving as a gateway to the state of Queensland, particularly to the Gold Coast and the Sunshine Coast. Queensland has the largest area of agricultural land of any Australian state and the highest proportion of land area dedicated to agriculture. Some 30,500 businesses carry out agricultural activity in Queensland, and agricultural industries contribute more than $10 billion to the state's economy each year. Over the past two decades, Queensland's economic growth has generally exceeded the national average.



ECONOMY

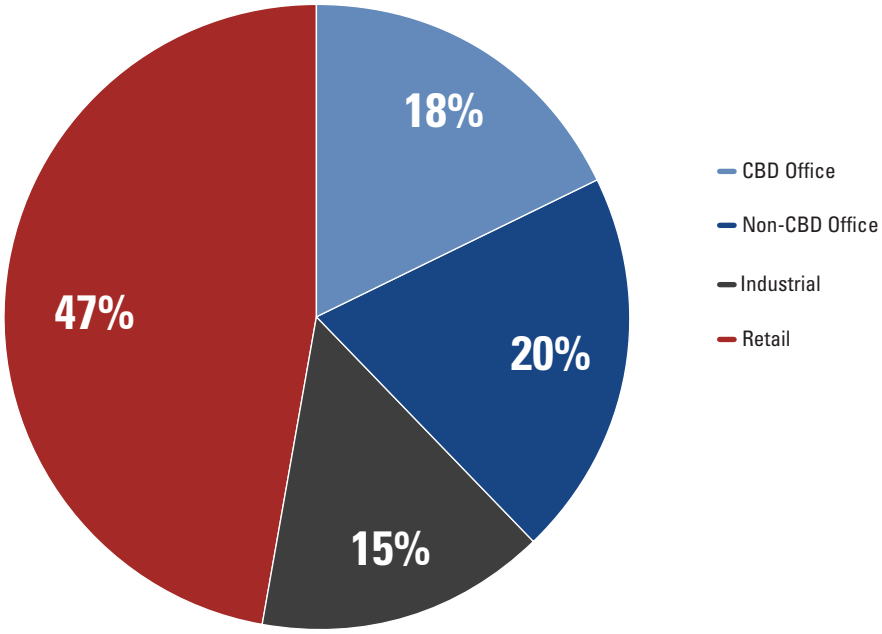
Queensland's economic conditions continued to improve over the second half of 2017. State final demand has now increased for five consecutive quarters, resulting in annual growth of 2.6% over 2017. In line with increasing economic activity, labour market conditions have also materially improved. Employment growth of 4.4% over 2017 was the strongest in the country. Queensland's population growth surpassed the national average at 1.7% in the year to September 2017, compared with the national growth of 1.6%. The improvement has come from both interstate and overseas migration. The outlook for the Queensland economy looks increasingly positive. With the incumbent government re-elected, work can begin on mooted infrastructure works, which will be a further boost to growth. Queensland's economy is forecast to grow 3.6% in 2018 and 3.4% in 2019.

With a notable yield spread still evident, Brisbane CBD is proving to be an attractive alternative for investors.

OFFICE MARKET

The state government continues to influence the Brisbane CBD office market. Following the consolidation of Queensland Health over 2017, total vacancy in the Brisbane CBD office market increased from 15.3% to 16.2%. Whilst the Brisbane CBD vacancy is currently high, vacancy rates appear to have reached a peak. Not only is stock under construction limited over the next three years but there has also been an increase in major tenant enquiries, which likely lead to lower vacancy rates. After five years of limited rental growth in the Brisbane CBD office market, prime office net face rents grew 10% over 2017. An environment of strengthening demand, coupled with a limited supply pipeline, is likely to result in further rental growth over the next three years. With a notable yield spread still evident between Brisbane CBD and Sydney and Melbourne CBDs, Brisbane CBD is proving to be an attractive alternative for investors. Investment

EXHIBIT 26. BRISBANE PROPERTY INVESTMENT BY ASSET TYPE IN 2017

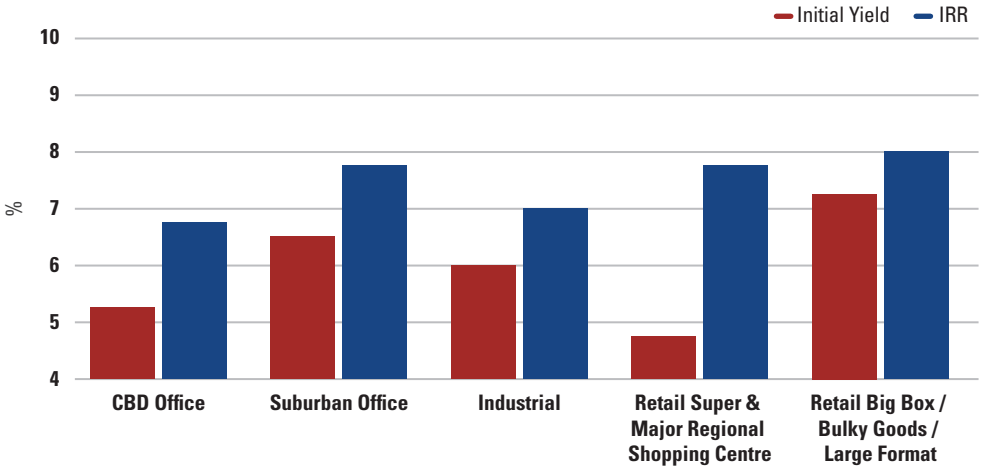


Source Urban Property Australia, January 2018.

activity by asset type for Brisbane can be found in **Exhibit 26**. The 1Q 2018 Situs RERC/UPA survey results reveal that the average unlevered yield for prime Brisbane CBD assets is 5.25% with an average IRR of 6.75% (see **Exhibit 27** for initial yields and IRRs by property type).

Whilst the Brisbane Fringe office market has grown significantly over the last decade, in the six months to December 2017, 15,000 square metres of stock was withdrawn from Brisbane's Fringe markets for conversion to retail, residential and student accommodation. Over 2017, total vacancy in the Brisbane Fringe office market increased to 14.1% from 13.0% a year prior. Looking forward with limited uncommitted new supply, vacancy is projected to trend down over the next two years. Over 2017, leasing activity was lower than the preceding 12-month period, largely as a result of tenants being attracted back to the CBD. With leasing conditions subdued, rental growth for the Brisbane Fringe office market has been constrained for the past three years. Despite soft tenant demand, Brisbane's Fringe market recorded its highest ever year of sales transactions in 2017. Yields continued to tighten as demand for core quality assets remained strong, with investors identifying more affordable options in Brisbane's Fringe market. Over 2017, Brisbane Fringe office transaction levels totalled $1.3 billion, more than double the $600 million transacted in 2016. Responses from the 1Q 2018 Situs RERC/UPA survey reveal that the average unlevered yield for prime Brisbane non-CBD office assets is 6.5% with an average IRR of 7.75%.

EXHIBIT 27. INITIAL YIELDS & IRRs – BRISBANE



Source Situs RERC / Urban Property Australia, 1Q 2018.

Investment activity over 2017 in the Brisbane industrial market reached its highest annual level since the record highs set in 2007.

INDUSTRIAL MARKET

Increasing population growth and the recovering state economy has also boosted the Brisbane industrial market. Industrial leasing activity in the Brisbane market reached its highest level in 2017 since 2012, led by the transport sector. State infrastructure developments such as the Cross River Rail and Queen's Wharf redevelopment, are expected to further support industrial works in the region over the coming years. The development of the second runway at the Brisbane airport is scheduled for completion in 2020; this will boost freight through the Trade Coast precinct. Despite increased occupier activity, a competitive pre-lease market has restricted rental growth over 2017; however, the strengthening state economy is expected to facilitate higher rents from 2019. Investment activity over 2017 in the Brisbane industrial market reached $970 million, its highest annual level since the record highs set in 2007. AREITs were the most prominent purchaser in the Brisbane industrial sector over 2017, highlighted by Charter Hall's sale and lease-back transaction of Coca-Cola's manufacturing plant in Richland for $156 million. With institutional investor appetite persisting for prime Brisbane industrial properties, further sale and lease-back transactions are likely to be brought to the market as owner-occupiers capitalise on investor demand. According to the 1Q 2018 Situs RERC/UPA survey results, the average unlevered yield for prime Brisbane industrial assets is 6.0% with an average IRR of 7.0%.

RETAIL MARKET

Although there is a degree of optimism, consumers remain wary of the Queensland economy's performance, particularly with the low wage growth, elevated household debt and relatively high unemployment. In the second half of 2017, Queensland retail turnover slowed, remaining below the national average. Over 2017, Queensland retail sales increased 1.1%, down from the 3.3% increase recorded in 2016. Queensland retail turnover growth outperformed only Western Australia (-0.4%) and the Northern Territory (-1.8%). Reflecting the subdued retail conditions, tenant demand remains mixed across Queensland with leasing agreements taking longer to finalise. Despite the soft retail conditions, international retailers continue to expand in Queensland with H&M, Mecca Maxima, Costco and Uniqlo all opening new stores in the state. Queensland accounted for 30% of retail transactions across Australia in 2017 with $3.1 billion sales recorded, boosted by the 50% stake in the Indooroopilly shopping centre sold for $802.5 million. Indooroopilly was the first super-regional shopping centre sale with management rights in more than a decade. The 1Q 2018 Situs RERC/UPA survey results reveal that the average unlevered yield for Brisbane Super & Major Regional Shopping Centre assets is 4.75% with an average IRR of 7.75%. Sales of large-format retail centres in Queensland totalled $140 million, accounting for 4.5% of all Queensland retail transactions in 2017. Responses from the 1Q 2018 Situs RERC/UPA survey reveal that the average unlevered yield for prime Brisbane large-format retail assets is 7.25% with an average IRR of 8.0%.

PERTH

Perth is the capital and largest city of the Australian state of Western Australia. It is the fourth-most populous city in Australia, with a population of around 1.94 million. Western Australia's economy is largely driven by extraction and processing of a diverse range of mineral and petroleum commodities. Western Australia's overseas exports accounted for 46% of Australia's total exports boosted by global demand for minerals and petroleum, especially in China (iron-ore) and Japan (for LNG). Six of the world's seven top international energy companies are headquartered in Perth – Australia's largest concentration of global oil and gas company headquarters.

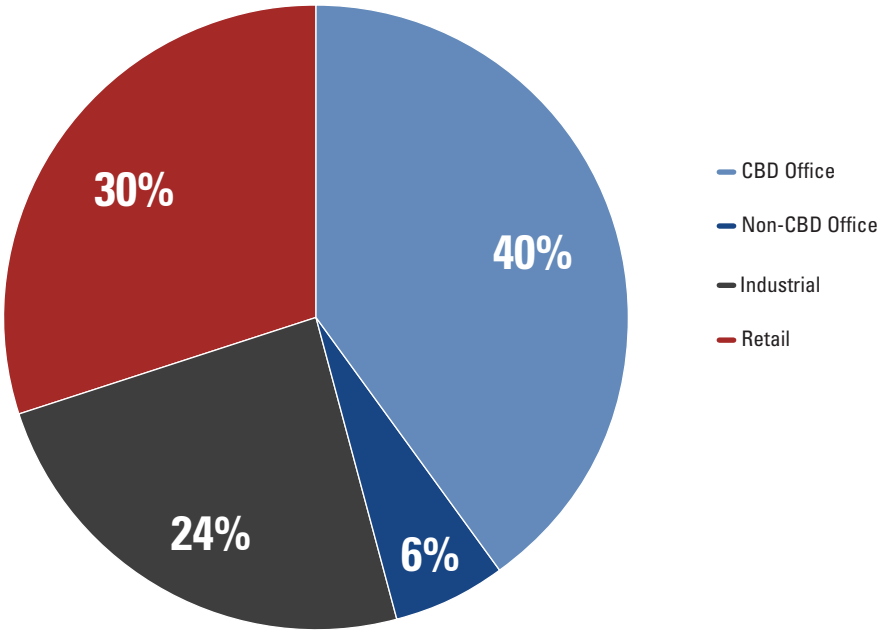
ECONOMY

The Western Australian economy's transition out of the mining investment boom is coming to an end, but growth remains weak. Western Australia recorded state final demand of 1.2% for 2017, substantially higher than when state final demand contracted by 7.6% over 2016. Labour conditions also appear to be improving with employment growing by 3.9% over 2017, outperforming the national average of 3.5%. The Metronet infrastructure project is likely to create further jobs and boost the state's economic recovery. The slowdown in mining continues to impact the state's population growth. Population growth in Western Australia has not surpassed 1% since late 2014. Western Australia's population increased by 0.9% in the year to September 2017. Western Australia's economy is projected to increase by 1.7% in 2018 with growth rising to 2.3% in 2019.

OFFICE MARKET

Although the Perth CBD office still has the highest vacancy rate of any Australian capital city, Perth continues to show promising signs of recovery. The Perth CBD office vacancy rate declined from 21.1% to 19.8% in the six months to January 2018. For the first time since 2012, the CBD has recorded positive demand for two consecutive six-month periods. Positively, the Perth CBD office market vacancy declined by 270 basis points over 2017, the greatest decline of any Australian office market. Sub-lease vacancy also decreased over 2017 to 1.5% of total stock – its lowest level since mid-2012. As a sign of improving conditions in the wider Perth market, sub-lease vacancy has been declining since 2016, as multiple occupiers either re-occupied or no longer marketed their premises for sub-lease. Mirroring the increasing tenant demand, transactional activity within the Perth CBD also increased over 2017 indicating that countercyclical purchasing has commenced and the appetite for assets with the right leasing profile is strong. Total sales

EXHIBIT 28. PERTH PROPERTY INVESTMENT BY ASSET TYPE IN 2017



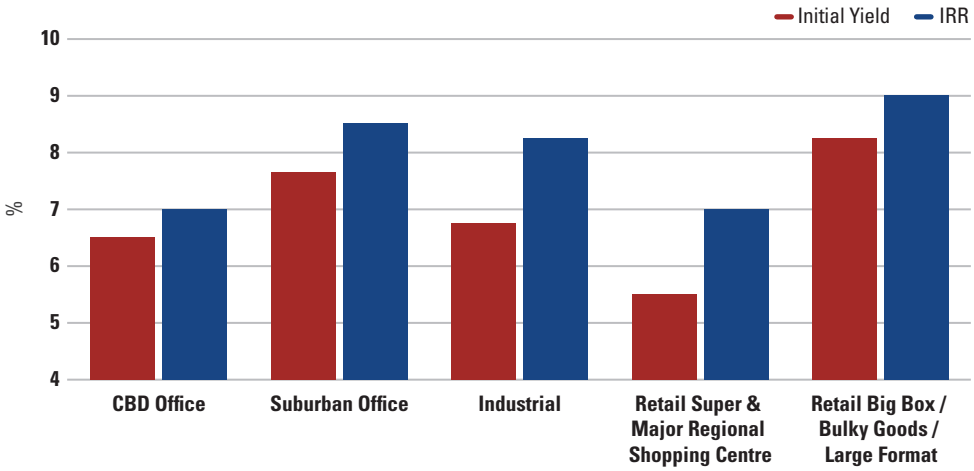
Source Urban Property Australia, January 2018.

Perth CBD office vacancy declined by 270 basis points over 2017, the greatest decline of any Australian office market.

volume reached $625 million in 2017, representing a 25% increase over 2016. Investment activity by asset type for Perth can be found in **Exhibit 28**. The 1Q 2018 Situs RERC/UPA survey results reveal that the average unlevered yield for prime Perth CBD assets is 6.5% with an average IRR of 7.0% (see **Exhibit 29** for initial yields and IRRs by property type).

Relocation to the CBD remains a feature of the West Perth office market, with a number of tenants relocating from West Perth to the CBD, contributing to the rise in the vacancy rate over the second half of 2017. The vacancy rate of the West Perth office market rose to 16.7% from 15.0% over the second half of 2017. Offsetting some relocations to the CBD has been a notable increase of suburban tenants moving into West Perth, upgrading their office accommodations. Traditionally, few major assets above $25 million transact in the West Perth office market, with just two assets being exchanged in this price bracket over the last five years. While the wide yield spread between West Perth and other Fringe markets remains very attractive for investors seeking counter-cyclical opportunities, recent investment has predominantly been led by opportunistic investors operating under a value-add or repositioning strategy. Over 2017, five offices in the West Perth market have sold, totalling $85 million. Responses from the 1Q 2018 Situs RERC/UPA survey reveal that the average unlevered yield for prime Perth suburban office assets is 7.65 % with an average IRR of 8.5%.

EXHIBIT 29. INITIAL YIELDS & IRRs – PERTH



Source Situs RERC / Urban Property Australia, 1Q 2018.

to pre-lease accommodation requirements. Since 2015, 90% of all new supply has been pre-committed with speculative development over the past three years negligible. As a result of soft occupier demand and increasing vacancy, Perth prime industrial rents have declined over the past four years. Perth prime industrial rents are not expected to grow until 2019 with incentives remaining elevated for the short term. Highlighting the lack of leased, large-scale investment-grade opportunities across the Perth industrial market, transactions over 2017 totalled $380 million, down from $600 million transacted in 2016. According to the 1Q 2018 Situs RERC/UPA survey results the average unlevered yield for prime Perth industrial assets is 7.75% with an average IRR of 8.25%. Both metrics tightened, illustrating the improving investor sentiment for Western Australia.

retail sector include subdued employment growth and house price movement (which declined 2.3% over 2017), diminishing household wealth and consumer confidence. The slowdown of population growth – from 3.2% in 2012 to 0.8% in 2017 – is also weighing on retail turnover. The state's population and employment are predicted to improve over the next five years, leading to above-average retail turnover. Over 2017, retail transactions in Western Australia totalled $475 million, down from the $625 million transacted in 2016. The 1Q 2018 Situs RERC/UPA survey results reveal that the average unlevered yield for Perth Super & Major Regional Shopping Centre assets is 5.5% with an average IRR of 8.25% and that the average unlevered yield for prime Perth large-format retail assets is 8.25% with an average IRR of 9.0%.

Retail turnover in Western Australia is forecast to grow above average over the next five years, driven by improving population and employment growth.

INDUSTRIAL MARKET

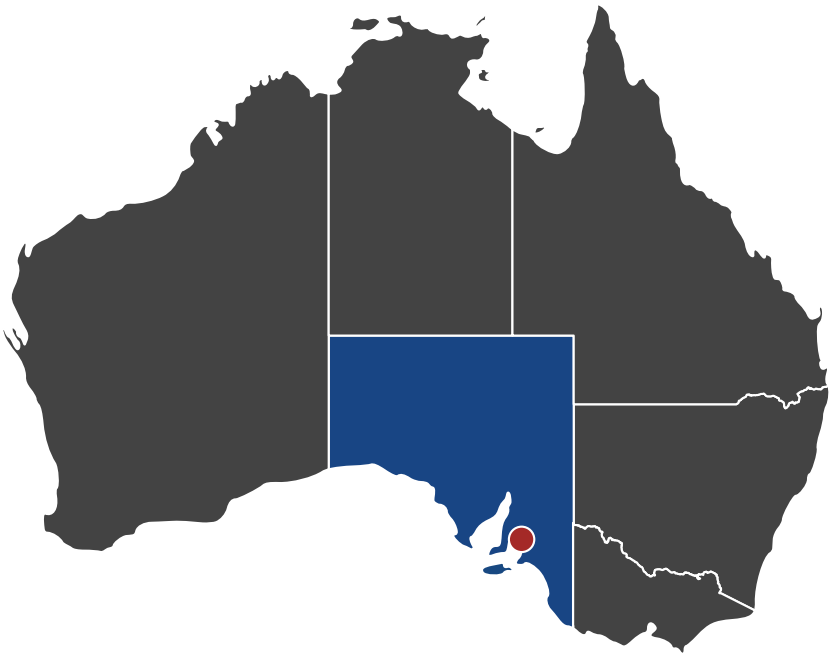
While tenant demand is improving, leasing activity in the Perth industrial market remains below average levels as has been the trend since 2015. Leasing activity has been largely driven by smaller-sized tenants with only three leasing commitments above 10,000 square metres signed during 2017. Over 2017, demand for Perth industrial property was led by the wholesale trade, transport and manufacturing sectors. With tenant demand relatively muted, new supply is minimal with just three projects currently under construction, totalling 40,000 square metres. With a lack of prime vacant stock, tenants have elected

RETAIL MARKET

The retail environment in Perth remains challenging. Retail turnover in Western Australia contracted by 0.4% over 2017. A slowdown in housing market construction and housing turnover have driven the slowdown in retail spending in the household goods sector. Other significant economic drivers weighing on the

ADELAIDE

Adelaide is the capital city of the state of South Australia, which has the most centralised population of any state in Australia, with more than 75% of its 1.3 million residents living in greater Adelaide. South Australia's largest employment sectors are health care, followed by retail trade. Adelaide is also home to a large proportion of Australia's defence industries, which contribute over $1 billion to the state's economy. Major defence technology organisations located in Adelaide include BAE Systems Australia, Lockheed Martin Australia, Saab Systems and Raytheon.

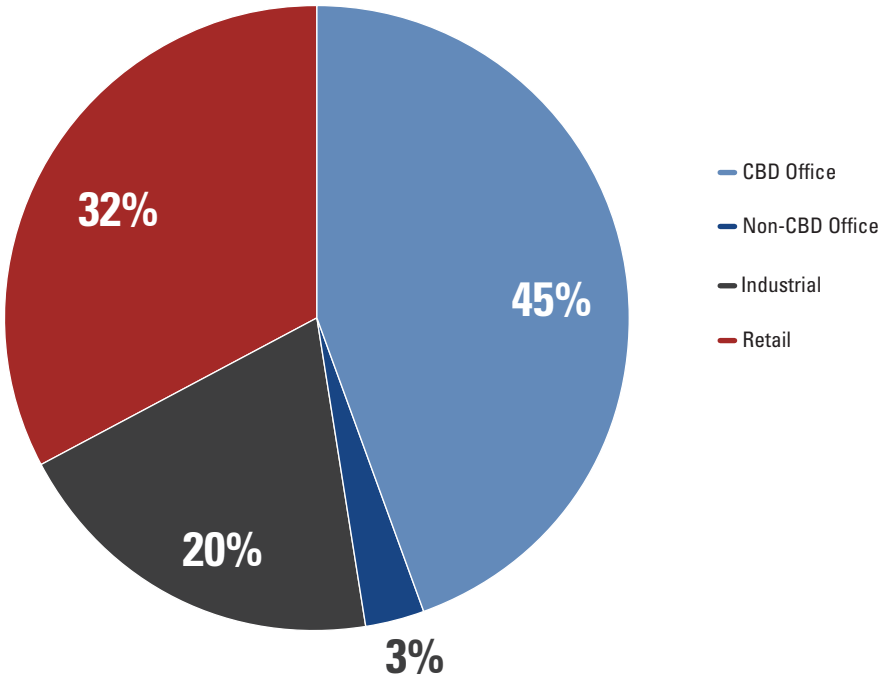


ECONOMY

South Australia has enjoyed a period of strong growth recently, driven by robust consumption. Strong household consumption has helped drive state final demand growth of 4.9% in 2017. South Australia's state final demand not only exceeds the national GDP growth but was also the highest of all Australian states in 2017. South Australia has remained quite resilient despite the loss of the its car manufacturing industry and weakened output from the mining and agriculture sectors. Labour conditions have remained robust. Looking forward, the South Australian economy is beginning to benefit from the new shipbuilding program centred at Techport near Port Adelaide with organic growth in office demand from defence-related industries being one by-product. Public investment in state infrastructure is also helping to buoy the jobs market with a significant rise in job advertisements noted recently that will support employment over the short to medium term. South Australia's economy is projected to increase by 1.9% in 2018 with growth rising to 2.3% in 2019.

The South Australian economy is beginning to benefit from the new shipbuilding program with a significant rise in job advertisements.

EXHIBIT 30. ADELAIDE PROPERTY INVESTMENT BY ASSET TYPE IN 2017



Source Urban Property Australia, January 2018.

OFFICE MARKET

Although the Adelaide CBD office market is one of the smallest markets nationally with 1.4 million square metres, it has traditionally had a diverse industry base that has made it a highly attractive place to live and do business. Being at the centre of Australia's road, rail and air logistics networks has provided time and cost advantages to many businesses, including those in the resources and most significantly defence industries. Over 2017, the Adelaide CBD office market vacancy rate decreased to 15.4%, down from 16.2%. Tenant demand for Adelaide CBD office space is also recovering with annual net absorption totalling 14,300 square metres, the highest annual level since 2008. In line with 2016 transaction volume, continued weight of capital has led to another

strong year of investment activity in the Adelaide CBD office market in 2017. In 2017, CBD sales totalled $480 million, above the long-term average, with Adelaide increasingly a destination for offshore capital. Investment activity by asset type for Adelaide can be found in **Exhibit 30**. The 1Q 2018 Situs RERC/UPA survey results reveal that the average unlevered yield for prime Adelaide CBD assets is 6.9% with an average IRR of 7.75% (see **Exhibit 31** for initial yields and IRRs by property type).

The Adelaide Fringe office market vacancy rate increased marginally over 2017, up to 11.4% from 11.3%. Vacancy increased as a result of refurbished space returning to market, the largest in a 12-month period since 2013. There continues to be some organic demand on the back of defence projects, with leasing activity in the Fringe office market on par with the long-term average. Investor demand for prime-grade assets in the Fringe remains high and opportunities remain limited. Over 2017, $30 million was transacted in the Adelaide Fringe area, across three transactions. Historically, few major assets are traded in the Fringe. Responses from the 1Q 2018 Situs RERC/UPA survey reveal that the average unlevered yield for prime Adelaide Fringe office assets is 7.75% with an average IRR of 8.75%.

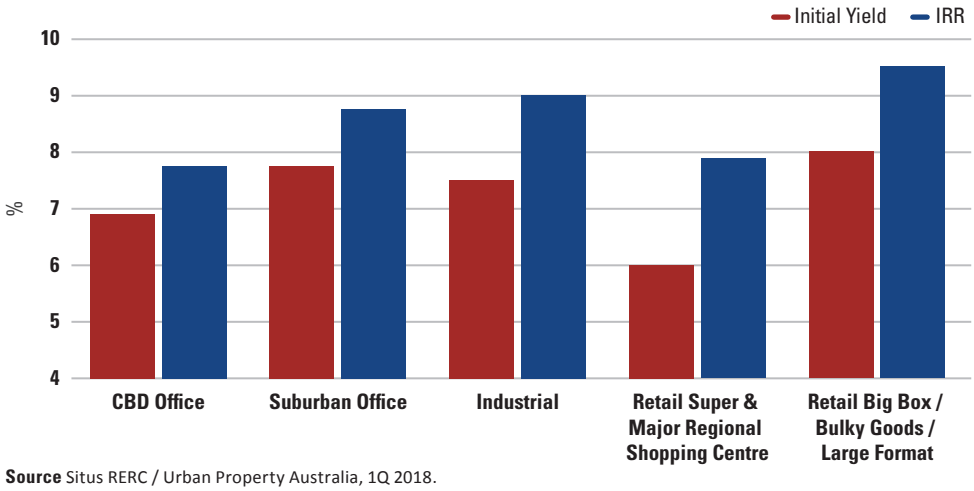
INDUSTRIAL MARKET

The government continues to boost its infrastructure program to create jobs during the transition period between naval shipbuilding projects and the closure of automotive manufacturing, with a record $9.5 billion being invested towards a series of infrastructure projects over the next four years. Although the closure of the Holden car manufacturing plant in October 2017 has adversely impacted the broader manufacturing sector, recently there has been a shift towards high-value, low-volume technology manufacturing. A combination of improving occupier demand and an undersupply of modern industrial accommodation has resulted in an increase in prime Adelaide industrial rents. Investment volumes have remained above trend, with the increase in major transactions noticeable in the last 12 months underpinned predominantly by institutional investors, including: Blackstone, Ascot Capital and Charter Hall. Investment activity over 2017 in the Adelaide industrial market reached $215 million, higher than the $110 million transacted in 2016. According to the 1Q 2018 Situs RERC/UPA survey results, the average unlevered yield for prime Adelaide industrial assets is 7.5% with an average IRR of 9.0%.

RETAIL MARKET

Retail spending in South Australia continues to outperform the national average, and most other states, having increased 4.2% over 2017.

EXHIBIT 31. INITIAL YIELDS & IRRs – ADELAIDE



Source Situs RERC / Urban Property Australia, 1Q 2018.

Improving occupier demand and an undersupply of modern industrial accommodation has resulted in an increase in prime Adelaide industrial rents.

South Australia's retail trade growth is the second strongest of all Australian states and well above the national growth rate of 2.5%. The positive trade growth is a result of ongoing strength in both take home and dining out food categories. Retail spending in South Australia has been supported recently by falling unemployment. Over 2017, the South Australian unemployment has fallen to 5.9%, down 70 basis points over the year. Although retail transactional activity levels increased 150% in 2017 over 2016 with $350 million sold, investment volumes remain below the long-term average. The 1Q 2018 Situs RERC/UPA survey results reveal that the average unlevered yield for Adelaide Super & Major Regional Shopping Centre assets is 6.0% with an average IRR of 7.88%. Sales of large-format retail centres in Adelaide totalled $75 million, accounting for 21% of all South Australian retail transactions in 2017. Responses from the 1Q 2018 Situs RERC/UPA survey reveal that the average unlevered yield for prime Adelaide large-format retail assets is 8.0% with an average IRR of 9.5%.

INVESTMENT TERMS AND METHODOLOGY

Using Situs' global valuation and loan advisory capabilities, Situs RERC's research and analytics capabilities and UPA's Australian market expertise, the Australia Real Estate Trends is intended to offer investors, lenders and agencies research-based insight into investor sentiment and to the investment environment for commercial real estate. Below are the definitions of terms used throughout the report.

Capital Cities/Metros: Adelaide, Brisbane, Melbourne, Perth, Sydney

Effective Rent: Rent received net of all applicable expenses.

Foreign Capital: Funds originated outside of Australia.

Initial Yield: Annualised rental income based on the cash rents passing at the balance sheet date, less non-recoverable property operating expenses, divided by the market value of the property, increased with (estimated) purchaser's costs.

Interest Rate: Also known as the official cash rate (OCR), it is the rate of interest that the Reserve Bank of Australia (RBA) charges on overnight loans to commercial banks.

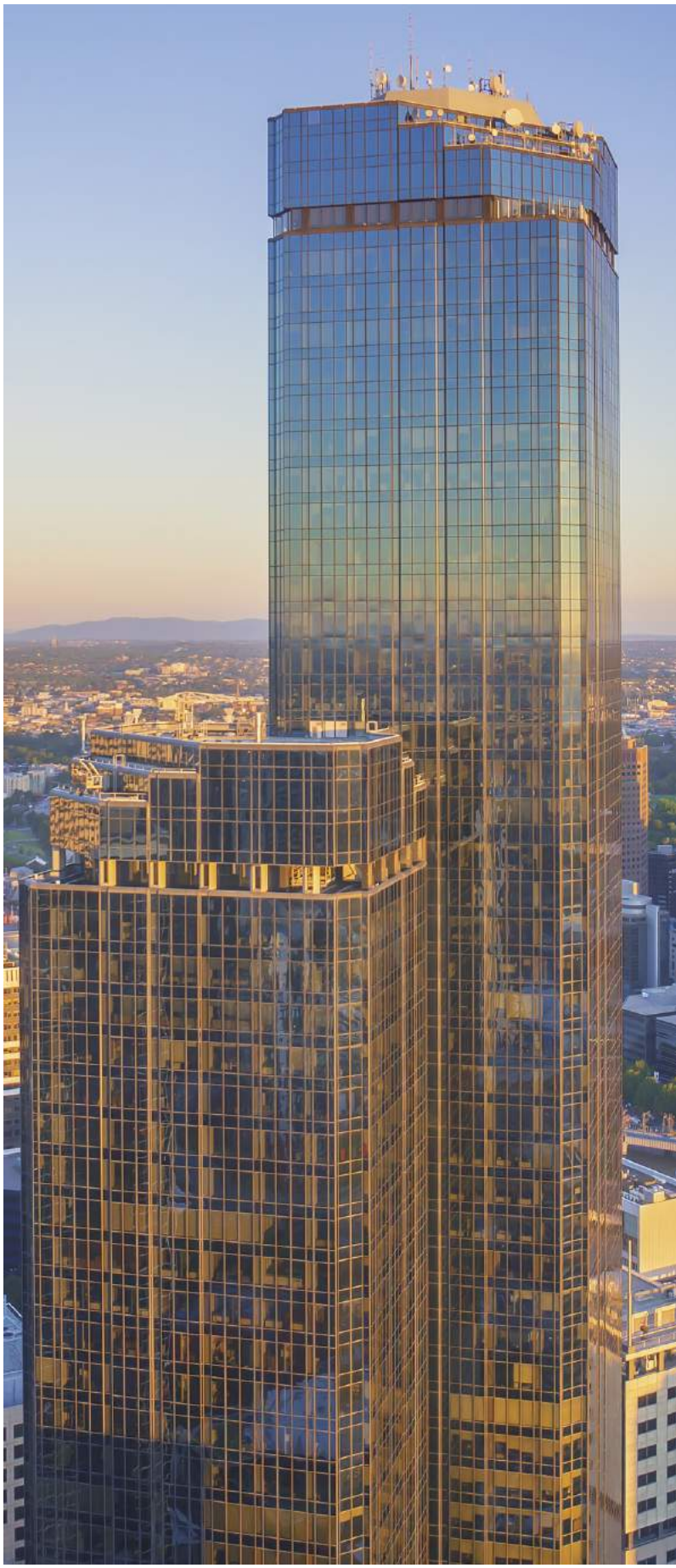
Internal Rate of Return (IRR): The IRR for unleveraged investments is the rate of interest that discounts the pre-income tax cash flows back to a present value that is exactly equal to the amount of the equity investment.

Investment Conditions Rating: A general survey-based rating classifying the general conditions for investing in commercial real estate as either poor, below average, average, above average or excellent. Rating considerations include economic factors, capital market factors, commercial real estate fundamentals and other miscellaneous factors.

Investment Surveys: Situs RERC and UPA conducts confidential surveys of investment trends with Situs RERC and UPA clients and contacts throughout Australia. We then collect results from the survey, analyse and interpret the information gathered, and report investor sentiment based on the results from the investment surveys. Because of sample size, results were not statistically significant, but the data are useful for trends analysis.

Property Sectors: CBD Office, Suburban Office, Industrial, Retail Super and Major Regional Shopping Centre, Retail Big Box/Bulky Goods/Large Format, and Retail Neighbourhood Shopping Centre.

Relative Ratings and Assessments: The ratings and opinions reflected in this report are relative to markets and metros included in our analyses. Interpretation of the ratings presented are intended to be viewed as explanations of trends within the particular market and not as definitive statistical evidence.



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