RESEARCH

MARCH 2010

ADELAIDE OFFICE

Market Overview

Knight Frank

HIGHLIGHTS

- The total office vacancy for Adelaide rose from 4.8% to 7.0% in the six months to January 2010. The vacancy rate in the Core precinct remained relatively stable at 6.1% and remains one of the tightest in the nation.
- Vacancy levels in Adelaide’s Frame are the highest since January 1998, increasing from 2.3% in July 2009 to 12.7% as at January 2010. This was largely a result of the completion of two significant new developments at the southern end of King William Street.
- Since their peak in Q4 2007, core market yields have softened by 200 -300 basis points across all grades of stock. Average prime core market yields are now trading in a range of 8.75% – 9.75% in Adelaide’s Core precinct.
- Market rents have increased slightly in the six months to January 2010 and as vacancies decrease over the next couple of years, there will be upward pressure on rentals. Demand has shifted towards space with existing fit outs in place.

ADELAIDE OFFICE OVERVIEW

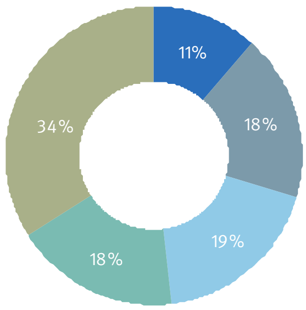
Economic Snapshot

Despite the sharp global economic downturn in 2008/09, the Australian economy has remained resilient and exceeded expectations. This can be largely attributed to strong growth in China, which continues to demand high volumes of Australian exports.

Australia's economic performance can also be attributed to the government's monetary and fiscal stimulus which has encouraged spending throughout Australia and protected jobs. This has prevented the Australian economy reaching the lows experienced by the majority of the advanced economies. The Australian economy is now in recovery mode with GDP growing by 2.7% in the year to the December 2009 quarter.

The next twelve months could still be a testing time for the South Australian economy. Manufacturing, which is still one of the major contributors to South Australia's GSP, was hit hard in 2009, while commercial construction approvals almost halved and retail growth slowed to below national rates. Despite this South Australia's fundamentals remain strong and the unemployment rate of 4.7% is the lowest in the nation.

Figure 1
White Collar Employment by Sector
Adelaide – December 2009



Source: Access Economics

The year ahead will test the durability of the economy with rising interest rates and the withdrawal of government stimulus likely to have the greatest impact.

Leasing Market & Rents

In the first quarter of 2010, tenant enquiry has been significantly stronger than in 2009. This can be attributed to renewed confidence in the private business sector.

Tenants are now demonstrating that their main focus is to seek out value. Consequently demand for some secondary space and existing fitted out space has increased. Incentives are still prevalent with the shortage of capital to build new fitouts.

Although there have been disparities between what tenants and landlords perceive as the current market rents, average gross face rentals have remained relatively stable across all grades of property over the last six months (to January 2010).

Table 1
Adelaide Office Market Indicators January 2010

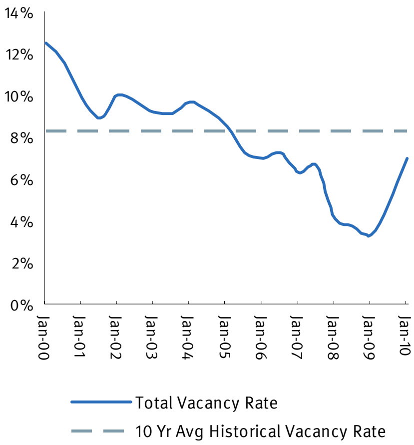
Grade	Market	Total Stock (m²)	Vacancy Rate (%)	Annual Net Absorption (m²)	Avg. Gross Face Rent ($/m²)	Average Incentive (%)	Average Capital Value ($/m²)	Avg. Prime Core Market Yield (%)
Prime	Core	395,418	6.1	-1,979	410	17.5	3,000 - 3,300	8.75 – 9.75
	Frame	67,632	38.5	1,317	360	15.0	2,700 – 3,000	9.00 – 10.00
	Fringe	20,966	6.7	-409	330	5.0	3,250 – 3,750	8.50 – 9.50
Secondary	Core	602,549	6.2	-4,492	310	15.0	2,500 – 2,750	9.50 – 10.50
	Frame	216,189	4.7	310	15.0	15.0	2,000 – 2,750	9.75 – 10.50
	Fringe	178,494	3.0	221	280	7.5	2,500 – 3,250	9.25 – 10.25
Total Market	Core	997,967	6.1	-6,471	350	16.0	2,750 – 3,000	8.75 – 10.50
	Frame	283,821	12.7	-2,845	322	15.0	2,250 – 2,750	9.00 – 10.50
	Fringe	199,460	3.4	-188	285	7.5	2,700 – 3,200	8.50 – 10.25
	Adelaide	**1,481,248**	**7.0**	**-9,504**	**336**	**14.7**	**2,550 – 3,050**	**8.50 – 10.50**

Source: Knight Frank Research/PCA
Definition: ^Core Market yield: - Abbreviation for analysed equated market yield - Calculated using the assessed Market Rental divided by Purchase Price adjusted for short term risk issues (vacancies, capital expenditure, etc).
Grade: Prime includes Premium & A grade stock whilst secondary includes B, C & D quality grade

The volume of total vacant space increased from 4.8% in July 2009 to 7.0% in January 2010. The highest vacancy level was felt in the Adelaide Frame market, where the vacancy rate rose from 2.3% in July 2009 (the tightest market nationally), to 12.7%. In a national context, Adelaide has the second tightest CBD office market in the country.

Adelaide's annual net absorption rate of -9,504m² was the first negative figure recorded since July 2004. Much of this can be attributed to the slowdown in demand and business contraction that occurred in the first half of 2009.

Figure 2
Vacancy Rates v 10 Year Average
Adelaide total market %



Source: PCA

Sub lease vacancy rates in the Core reached 1.3% with vacant sub-lease space jumping from 711m² in July 2009 up to 13,447m² in January 2010. We expect that sub-lease space has now peaked which bodes well for the future recovery in the leasing market.

Development Activity

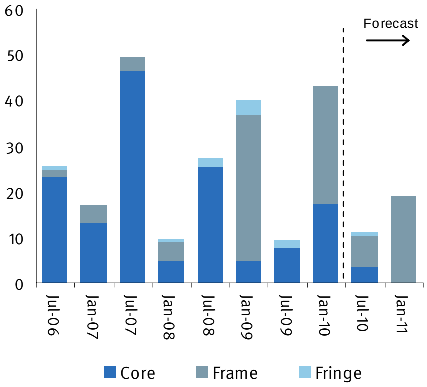
Development activity has slowed over the past year as lenders demand higher levels of precommitment (circa 80% plus) and more conservative maximum loan to valuation ratios of circa 50-60%. This is all part of lenders seeking higher levels of interest cover and protecting capital repayment. This has been further exacerbated by reluctance from tenants to pay new A-grade rental rates in the current economic environment. Businesses took a cautious approach following the Global Financial Crisis (GFC), but the economy is starting to gain momentum. Construction costs have remained elevated throughout the GFC, however building activity is expected to pick up in 2011/12.

The two most recent additions to Adelaide Core office stock have been "Aurora on Pirie – Eastern Tower" located at 147 Pirie Street and "The Conservatory on Hindmarsh" located at 131-139 Grenfell Street. These two developments comprise approximately 13,000m² and 4,000 m² respectively.

In the Frame precinct of the city, recent developments which have been completed include 400 King William Street and The Edge, at 420 King William Street. These developments are located opposite the Optus building in an area labelled the "Southern Gateway precinct".

Commercial development is likely to be subdued for the remainder of 2010. The only major projects confirmed going forward are the new SA Police headquarters at 100 Angas Street, which has been fully pre-committed, and Aspen Group's $200 million, Tower 8 building on Franklin Street, which will house the Australian Tax Office (ATO).

Figure 3
Development Activity
Adelaide Office ('000m²)

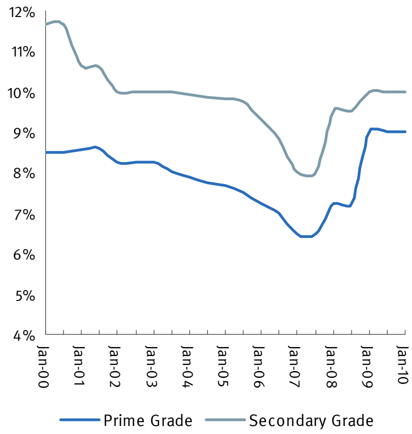


Source: Knight Frank/PCA

Sales & Investment

Over the past 12-18 months, the typical buyer profile for office assets has become almost exclusively private, comprising high net worth individuals, families and syndicates. These investors have capitalised on the economic downturn to purchase quality CBD assets at attractive yields, especially relative to the cost of debt and the return on cash investments.

Figure 4
Average Core Market Yields
Adelaide Office



Source: Knight Frank

The major REIT's, funds and institutions have now undergone balance sheet repair and are not far away from re-entering acquisition mode and although the AUD is relatively high, Asian investors have been hovering.

ACTIVITY IS BEGINNING TO PICK UP AGAIN

Over the past six months transactional activity has been most prevalent in the Core and Frame precincts of the CBD, however there is more stock currently being offered for sale on the City Fringe and in suburban areas. This will provide small investors with more choice and is anticipated to result in a higher level of sales activity in this area.

CORE

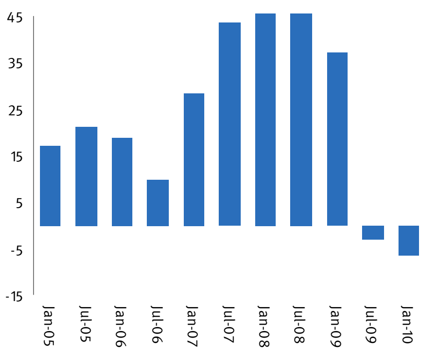
Leasing Market & Rents

The Adelaide Core office market almost surpassed one million square metres of net lettable office space this year. As at January 2010, this figure was 997,967m², of which 61,122m² was vacant.

Despite a tough year for South Australia's commercial property market, office vacancy in Adelaide's Core remains low. Total vacancy in the Core has increased slightly from 5.5% in July 2009 up to 6.1% in January 2010, with sub-lease vacancy accounting for 1.3% of this total vacancy. In a historical context the Adelaide Core office market vacancy rate remains at very low levels.

Annual net absorption to January 2010 in the Core market was -6,471m², which was the first negative annual figure recorded by the Core since July 2004. This was mainly driven by the negative net absorption recorded in H1 2009 of -13,307m², due to business contraction and an increase in sub-lease space.

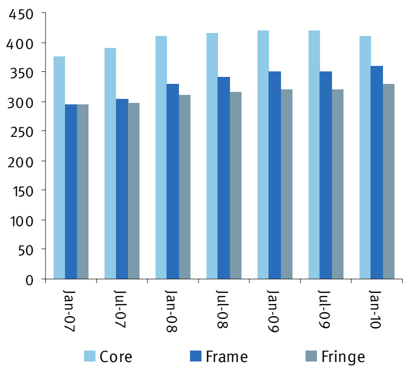
Figure 5
Net Absorption – Core precinct
12 month rolling ('000 m²)



Source: PCA

The majority of tenants facing lease expiry are renewing leases in existing locations due to the significant costs involved with relocating. In the six months to January 2010, net face rents have remained static throughout the Core market. Prime gross face rents are achieving on average $410/m², while secondary gross face rents are averaging $310/m².

Figure 6
Prime Gross Face Rents
Adelaide Office ($/m²)



Source: Knight Frank

The largest lease deal over the last six months was negotiated in November 2009, with the Public Trustee relocating into levels 13-15 of 211 Victoria Square. The 3,745m² of office space has been leased for a gross rent of circa $415/m² for a 10 year term.

The other major tenant move came as the College of Polytechnic expanded into its first location in the Adelaide CBD at 101-107 Pirie Street. The 1,100m² of office space has been leased for a gross rent of circa $300/m² and the lease will run for a 5 year term.

Development Activity

The Core office market currently has no further projects under construction or nearing completion. Subdued development is likely to continue throughout 2010 and commercial developments will not eventuate until significant pre-commitments can be secured.

The most recent developments completed were Urban Construct's 'Aurora on Pirie' and the Hines Group's 'Conservatory on Hindmarsh'. Located at 147 Pirie Street, Aurora on Pirie is an A-grade strata development comprising 192 individual office units. The 'Conservatory on Hindmarsh' is a mixed use building, where the State Government pre-committed to all of the office space that was on offer.

Sales and Investment

The sale of 115 Grenfell Street was the most significant CBD office sale in 2009, with the settlement occurring during August. The property was purchased by a local investor for $41.0 million from Investa Funds Management. The sale price reflects an initial yield of 9.39% and an improved rate of $2,949/m². Anchor tenants to this 15 level A-grade building include the University of Adelaide and the Commonwealth Government.

THE CORE OFFICE MARKET CURRENTLY HAS NO PROJECTS UNDER CONSTRUCTION OR NEARING COMPLETION

November 2009 also saw the sale of levels 5-9 of The Conservatory, 131-139 Grenfell Street. The 19 level mixed use development comprises ground retail floor, 4 levels of car parking, 5 floors of commercial accommodation and 10 floors of residential apartments. The commercial component was purchased for circa $16.4 million reflecting an improved rate of $4,050/m². The initial yield of 9.33% reflects the uncertainties associated with final outgoing charges and the community title holding.

Average prime yields in the Core currently range between 9.00 – 9.75%, with average secondary yields trading in a range of 9.50 – 10.50%.

FRAME

Leasing Market & Rents

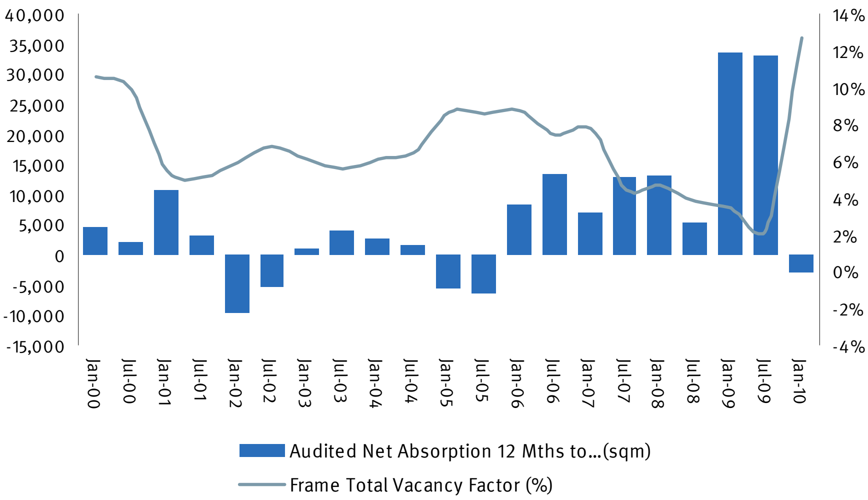
In January 2010, the vacancy rate of 12.7% in the Adelaide Frame office market represented the highest level in over a decade. This market was the tightest of the three Adelaide office markets and the tightest nationally in July 2009 at 2.3%. As it is a relatively small market, new supply can result in large swings in vacancy. Further stock additions in this market over the next two years have the potential to put further upward pressure on vacancies.

The net absorption rate for this market fell considerably in 2009 from 33,119m² as at January 2009 to -2,845m² as at January 2010. The two King William Street South developments also added an extra 25,900m² to the Adelaide Frame market, which was exacerbated by the slowdown in demand.

Recent leasing deals may suggest that average rents in the Frame have substantially increased, however this is not necessarily the case. Rental figures have been distorted due to a number of new projects coming on stream, which has appeared to push the average rents upwards. Leases are being negotiated for newly developed space upwards of $400/m² p.a gross, however, average prime gross face rents are circa $360/m² p.a gross. Secondary rents in the Frame have increased slightly in the past six months to January 2010 and are averaging $310/m² gross.

148 Frome Street – purchased for $17.6 million at an improved rate of $3,777/m²

Figure 7
Vacancy Rate vs Net Absorption
Frame Office market - 12 months rolling



Source: PCA

Development Activity

Building of the brand new state of the art Police Headquarters at 100 Angas Street has commenced with site works and construction of the $100 million project now well underway. The project is on schedule for completion by the end of 2011. The pre-committed tenant is the State Government, whom is spending $38 million dollars on a state of the art fit-out.

The building is the biggest police-building project in South Australia's history. This proposed 5-star rated office building will be 40 metres high and will provide 18,000m² of office accommodation for more than 1,000 staff over 9 floors.

Construction of the Aspen Group's Tower 8 building on Franklin Street will commence in September 2010. The plan is to consolidate all 3,000 Adelaide-based ATO employees into the one location. The building will cost $200 million and is scheduled to be completed by the end of 2012.

The major developments recently completed include 400 King William Street and "The Edge", both located in the "Southern Gateway Precinct."

The largest of these developments is 400 King William Street. The 11 storey building provides an additional 21,619m² of office space and 1,639m² for retail purposes.

Sales & Investment

Over the past six months yields have stabilised in the Adelaide Frame market. Current average prime yields in the Frame now range from between 9.00% and 10.00%.

VACANCY LEVELS IN THE FRAME ARE NOW PEAKING

The sale of the former HP House building at 148 Frome Street in November 2009 was the most significant Frame sale over the past six months. The property was purchased for $17.6 million by the Local Government Association for part owner occupation. The sale price reflected a low initial yield of circa 5% (due to vacancies) albeit a core market yield of 8.6% and an improved rate of $3,777/m².

FRINGE

Leasing Market & Rents

Unlike the Core and Frame markets, the Fringe office market allows tenants the opportunity to occupy smaller buildings. This suits tenants who desire a larger presence in their building. Other benefits include accessibility, ease of parking and parkland views.

The total vacancy rate in the Fringe office market fell from 4.5% in July 2009 to 3.4% in January 2010, totalling 6,842m² of vacant space. The Adelaide Fringe office market is the tightest office market in Australia, ultimately the result of limited development opportunities.

The Fringe precinct recorded a 12 month net absorption of -188m², remaining relatively stable. This is mainly due to the smaller tenants in this market and subsequently less large tenancy hand-back's or major tenant contractions.

THE FRINGE OFFICE MARKET IS THE TIGHEST MARKET IN AUSTRALIA

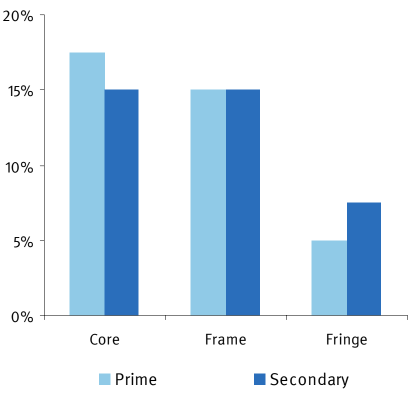
66 Rundle Street, Kent Town - expected to sell for circa $10 million (currently on the market)

In recent months there has been an increase in the number of tenants seeking larger accommodation options in the fringe market, particularly a number of accounting practices. However, due to the tight nature of the precinct and lack of any substantial recent development, many of these tenants have to consider a move to the CBD, as the typical low rise buildings are being outgrown.

Development Activity

The most significant development in Adelaide's Fringe market is the World Park at Richmond Road, Keswick. The construction of this 10,000m² project is underway with completion scheduled for November 2010. The building is fully pre-committed with 4,000m² being leased by the SA Government and 6,000m² to Coffey International.

Figure 8
Adelaide Office Incentives
% of Net Lease Value



Source: Knight Frank

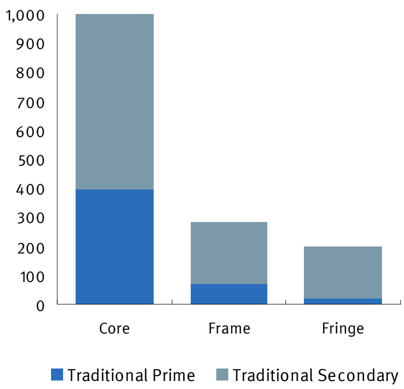
Sales & Investment

The Fringe office market comprises the smallest amount of stock, consisting of 199,460m² or 13.4% of Adelaide's total office supply. Of this figure, 89.5% of Fringe office space is secondary quality.

The most significant Fringe sale over the past six months was the sale of 84 North Terrace, Kent Town. The property was purchased in February 2010 for $4.0 million by a local investor. The sale price reflects an initial yield of 8.75% and an improved rate of $3,795/m².

The market will be eagerly anticipating the outcome of the sale of 66 Rundle Street, Kent Town, expected to sell for circa $10 million. This property is currently on the market and its sale will likely give an indication of the depth of the Adelaide Fringe market.

Figure 9
Adelaide Office Markets
Markets by grade ('000 m²)



Source: PCA

Fringe property owners have generally chosen to ride out a softer market, however as stock continues to age this may stimulate more transactional activity, alternatively redevelopment will be the only other option to rejuvenate the stock base.

Based upon a limited number of sales, anecdotal evidence suggests average prime yields now range between 8.50% - 9.50%, while secondary yields are likely to trade in the range of 9.25% - 10.25%.

84 North Terrace, Kent Town – purchased for $4.0 million at an improved rate of $3,795/m²

OUTLOOK

The economy remains relatively strong in Australia despite the continued global economic uncertainty. Although there has been a welcome initial rebound, the economy will likely continue a tentative recovery over the next twelve months, with growth expected to return to trend in 2011. Current forecasts by various economists are projecting GDP to reach 3% by the end of 2010 and circa 3.5% by 2011.

With stronger growth prospects and the economy returning to 'normal' conditions the RBA had raised the cash rate by 100 basis points to 4.00% since October 2009. Further rate rises are on the cards over the next twelve months, with a cash rate of circa 5% likely by early 2011.

The next twelve months will be a testing time for the economy with the withdrawal of government stimulus and rate rises likely to impact on consumer spending. Housing construction will lift to accommodate strong population growth and the share market should continue to gradually recover.

ADELAIDE'S COMMERCIAL PROPERTY MARKET IS WELL POSITIONED TO PERFORM STRONGLY

South Australia's commercial property market is well positioned to perform strongly on the back of increased activity in the mining and defence sectors, although the State's short term strength will largely depend on the strength of its manufacturing industry.

Table 2
Major Leasing Activity Adelaide Office market

Address	Area (sq m)	Estimated Rental ($/m²)	Term (yrs)	Tenant	Date
Levels13-15, 211 Victoria Square	571	$415 g	10	Public Trustee of South Australia	Nov-09
19 Grenfell Street	1,363	$355 g	6	Wipro Technologies	Dec-09
101 Pirie Street	1,100	$300 g	5	College of Polytechnic	Nov-09
182 Victoria Square	1,015	$350 g	10	Flinders University	Nov-09
Level 3, 190 Flinders St	981	$340 g	5	Dare Sutton Clarke P/L	Jan-10

Source: Knight Frank g gross

Table 3
Major Investment Sales Activity Adelaide Office market

Address	Grade	Price ($ mil)	Core Market Yield (%)	NLA (m²)	$/m² NLA	Purchaser	Sale Date
84 North Terrace, Kent Town	A	4.0	8.75	1,054	3,795	Private Local	Feb-10
148 Frome Street	A	17.6	8.60	4,661	3,777	The Local Gov't Association	Nov-09
Lot 3 (levels 5-9) Grenfell Street	A	16.4	9.33*	4,050	4,050	Century Funds Management	Nov-09
80 King William St	B	21.75	9.51	8,472	2,567	Private Local	Aug-09
115 Grenfell Street	A	41.0	9.39*	13,903	2,949	Private Local	Aug-09
199 Grenfell Street	B	13.75	9.95	5,061	2,717	Private Local	Aug-09

Source: Knight Frank * Initial Yield

The buyer profile in the Adelaide commercial property market changed significantly in the past 12-18 months with private investors and syndicates becoming dominant. With major REITs, funds and institutions likely to become more active in the market over the next 6-12 months, the private investors will begin to face more competition, especially with regards to potential acquisitions of A-grade assets.

Although there has been minimal evidence, a number of transactions indicate a stabilisation in yields as at January 2010. It is likely that prime yields have peaked, albeit secondary yields may continue to soften in the short term.

Given the limited availability of debt and higher hurdle rates, development activity is likely to remain subdued over the next 12-18 months. The notable exceptions will be the pre-committed SA Police Station at 100 Angas Street and the ATO building on Franklin Street, both in the Frame precinct.

The expected economic growth rates in 2010 will lead to increasing net absorption in the Adelaide office market. Subdued development activity will result in space gradually being soaked up and vacancy rates will tighten over the coming years.

In 2010 we can expect tenants to continue to place a strong emphasis on value and fitted out options. Competition between owners to attract new tenants will continue in the short term, however as vacancies tighten, we anticipate that incentives will diminish in the latter half of 2010 and into 2011.

With relatively low vacancy rates and historically high yields, the Adelaide commercial property market is expected to present attractive buying opportunities for potential investors in 2010.

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