RESEARCH INSIGHT

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BRISBANE OFFICE DEMAND

RESOURCE SECTOR IMPACTS

Commercial Property Insight

The Brisbane office markets have experienced both high and low points over the past five years. Along with riding the roller coaster of the GFC, the markets have also felt the impacts of resource sector activity. Many owners and analysts have sought to capture the relationship between the resource sector activity and office market demand, in order to better forecast market direction. In this document Knight Frank has examined a number of resource sector market indicators in order to see whether quantification of a direct relationship to office demand can be achieved.

Background 2008- 2012

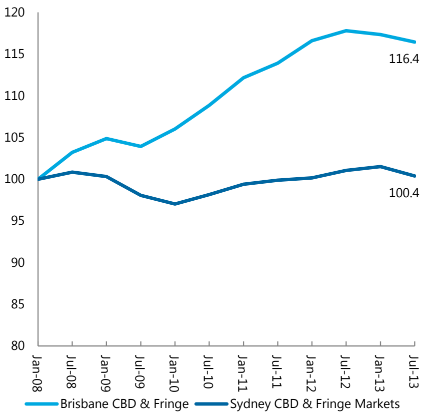
The Brisbane CBD and Fringe leasing markets were noticeably less affected by the GFC than more financial service oriented markets, such as Sydney. As shown in Figure 1, the Sydney markets have shown only marginal growth in the level of occupied office stock between January 2008 and July 2013, with gains seen during 2012 now having largely been eroded. The Sydney markets recovered from a period of contraction through 2009/10 as financial markets bounced back from their GFC lows.

In contrast, the Brisbane markets, while sharing a downswing in 2009, saw acceleration in occupied stock from mid-2009 through to early/mid 2012. In fact not only did the Brisbane CBD not suffer from contraction and subdued demand, it flourished. Over the three year period from mid 2009 through to mid-2012 the average annual net absorption was 73,425m²,

Figure 1

Brisbane versus Sydney

Change in Occupied Stock. Jan 2008 = 100



Source: Knight Frank/PCA

Sydney Fringe Markets = North Sydney, Crows Nest/St Leonards & Chatswood

almost double the 15 year average of 37,144m². Therefore the Brisbane market not only avoided the impacts of the economic downturn, it recorded some of the strongest results ever seen.

Anecdotally much of this growth occurring at a time when most businesses were remaining conservative, was due to activity within the mining, energy and engineering sectors with project offices abounding for both coal and LNG projects. The LNG sector in particular was showing particularly strong growth as companies such as Origin, Arrow Energy, Santos and British Gas/Qld Gas were all progressing major infrastructure projects to bring emerging fields to the market. In addition, after several years of strong and fragmented growth, miners, energy firms and engineers were embarking on consolidation of their office facilities.

Significant resource sector relocations:

- Bechtel – 17,500m² - 2007 & 2011
- SKM – 9,436m² - 2008
- Hatch – 9,055m² - 2008
- Santos – 10,105m² - 2009
- Origin – 12,800m² - 2009
- Ausenco – 13,000m² - 2009
- Aurecon – 11,000m² - 2009
- QGC – 10,344m² - 2009
- Worley Parsons – 8,183m² - 2009
- Energex – 28,600m² - 2010
- AECOM – 13,600m² - 2010
- Rio Tinto – 31,000m² - 2011
- Worley Parsons – 8,234m² - 2011
- Anglo American – 7,077m² - 2011
- GHD – 9,860m² - 2012
- Ergon – 6,668m² - 2012
- Arrow Energy – 14,800m² - 2013
- BHP – 14,000m² - 2016

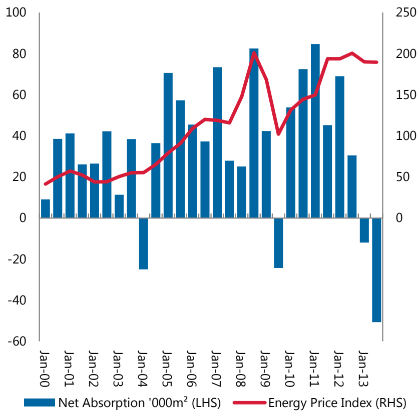
To identify the impact of the resource and energy sector, the CBD and Fringe markets need to be examined as one, as users were active in both markets. In general it has been said that mining companies are largely CBD dwellers while engineers are active within both the CBD and Fringe markets. Energy providers are also mixed with Origin having long standing ties to the Fringe market, while Santos, Arrow Energy and British Gas are all within the CBD.

To best analyse the resource sector impacts on office demand for Brisbane, the relevant indicators and drivers must cover both coal and LNG drivers. Queensland also has significant metals production, however these have not shown the same level of growth.

Energy Prices

Figure 2, below, shows the combined net absorption for the Brisbane CBD and Fringe against an index of Energy Prices (which encompasses coal, oil and also gas prices). Using a basic linear correlation the correlation co-efficient (r) and the co-efficient of determination (R^2) are measured. R^2 is generally referred to as a percentage and indicates the percentage of the variation in the response variable (ie office demand) which can be explained by the explanatory variable (ie energy prices).

Figure 2
Brisbane CBD & Fringe Combined Net Absorption v Energy Price Index
'000m² (LHS) vs Energy Index (RHS)



Source: Knight Frank/PCA/IMF

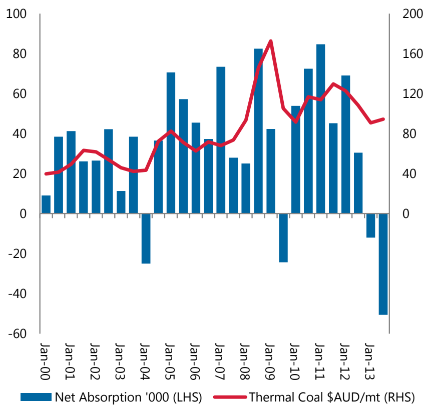
While there was some correlation between the two indicators from mid-2007 to late-2011 of 0.61 (R^2=37%), longer term the correlation is modest at 0.12 (R^2=1.4%). This indicates that prior to mid-07 and after early 2012 the market has responded to different drivers. It can be seen that although overall energy prices have stabilised over the past two years, office take-up has fallen away in the past 12 months.

ALTHOUGH ENERGY PRICES STABILISED, OFFICE DEMAND FELL

Coal Prices

Interestingly when comparing the same office market data to just coal prices, the recent relationship is weaker. The Australian Thermal Coal ($AUD/mt) is shown in Figure 3, below. Compared to the energy price index, the thermal coal price has a greater correlation over the life of the graph, at 0.28 (R^2=8%) but lower correlation from mid-2007 through to the current time of 0.47 (R^2=22%), only a minor relationship. Unlike the overall global energy index from the IMF, the thermal coal price series shows the decline in pricing levels which occurred from mid-2011 and which were attributed as the trigger for much of the reduction in demand.

Figure 3
Brisbane CBD & Fringe Combined Net Absorption v Thermal Coal Prices
'000m² (LHS) vs Thermal Coal $AUD/mt (RHS)



Source: Knight Frank/PCA/Index Mundi

Feedback from industry participants is that the dramatic cost cutting has not so much been triggered by falls in pricing, but the profitability levels of current and proposed projects. Therefore profitability weakness through a combination of lower prices, higher AUD and a cost bubble, is the driver behind resource and energy sector tenant weakness over the past 12 months, rather than pricing on its own. While the coal/LNG sector has been driving most of the expansion across Brisbane, base metals such as silver, copper and nickel are also important elements of the QLD resources sector. However mapping office demand against base metal pricing produced similar or lower relationships than coal prices.

Resource Sector Profitability

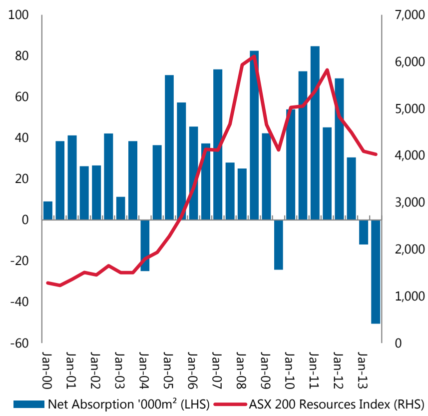
Measuring resource sector profitability is an inexact science with a number of major players in the Queensland market (ie GVK, Hancock Coal) private companies with no requirement to publish profitability results.

In a period of economic stability we would use the ASX Resources index as a proxy for profitability (and expected future pricing/profitability) within the sector without hesitation, however given the widespread share market volatility since the GFC, resource sector equity prices may well have been influenced by far wider factors than just simple profitability in the sector.

Nevertheless averaging the ASX 200 Resources index to six monthly rests to compare with net absorption reduces much of this volatility. Initial indications reveal a relatively higher correlation between the ASX 200 Resources index and net demand across the Brisbane markets than was found for energy or coal prices. This is particularly the case between July 08 and July 2013 with a correlation of 0.80 (R^2=64%).

However the overall impact at 0.26 (R^2=7%) for the period from January 2000 to current, remains somewhat tenuous and indicates that resources sector profitability has not been a decisive influence on the market over the whole of the past 13 years.

Figure 4
Brisbane CBD & Fringe Combined Net Absorption vs ASX 200 Resources Index
'000m² (LHS) vs ASX 200 Resources Index (RHS)



Source: Knight Frank/PCA/ABS/S&P

In addition, in all of the three above graphs, while there has been stabilisation or improvement over the past six months in the resource indicators, the demand across the office market has fallen dramatically. This indicates that there are other factors at work and this can clearly be shown through an analysis of some of the major vacancies and new vacancies which have emerged over the past 18 months.

THE RESOURCES SECTOR HAS NOT BEEN A DECISIVE INFLUENCE ON THE MARKET OVER THE WHOLE OF THE PAST 13 YEARS.

Table 1

Brisbane CBD & Fringe Recent major additions to Vacancy

Building	Former Tenant	Area (sq m)	Status	Reason
111 Eagle St, CBD	Nil	c10,000m^2	Completed Apr 2012	Remaining space. Arrow has first rights over part.
140 Creek St, CBD	ATO	10,949m^2	Make good/refurb	Relocation to 55 Elizabeth St
Transit Centre, CBD	Urban Utilities	8,350m^2	Vacant July 2013	Relocated to Fringe, lease runs to Aug 2014.
71 Alfred St, Fortitude Valley	Nil	7,482m^2	Completed Apr 2013	Building recently completed without pre-commitment
295 Ann St, CBD	QR	7,370m^2	Vacant Nov 2012	Sub-lease, contraction space.
420 George St, CBD	Translink	6,129m^2	Vacant Mar 2013	Contraction on lease expiry.
143 Turbot St. CBD	Suncorp	6,075m^2	Vacant Jan 2012	Contraction on lease expiry.
167 Eagle St, CBD	ATO	6,066m^2	Vacant July 2013	Relocation to 55 Elizabeth St
126 Margaret St, CBD	QUT	5,718m^2	Vacant Jan 2013	Contraction at lease expiry
133 Mary St, CBD	State Govt	4,905m^2	Vacant Oct 2013	Contraction at lease expiry
300 Queen St, CBD	BDO	4,723m^2	Vacant July 2013	Relocation to 12 Creek St

Source: Knight Frank

Recent Impacts on Vacancy

The largest contiguous vacancies within the Brisbane CBD are shown in Table 1 and none can be directly attributed to the slowdown in the resources sector. The major vacant blocks are instead largely due to new construction and the associated backfill space created by tenant relocation or by State Government, or Government entity downsizing.

The Brisbane CBD market, in particular, has been hit over the past 12 months by downsizing across a variety of users, with the State Government contraction of the first half of 2013 the most dramatic individual impact.

However the resources sector has played a part, initially the major impact was the withdrawal of demand from the market, as the resources sector had been the dominant force, expanding during a time when most other sectors of the market were highly conservative and tenant relocation and growth activity was low.

Figure 5

Brisbane CBD & Fringe Vacancy

% Total Vacancy

Source: PCA

The withdrawal of this demand put into stark relief the underlying weakness of the market. The second, and more recent, impact was as companies involved in the resources sector have begun to downsize and offer space back to the market. At this stage this is predominantly through sub-leasing, which does provide the potential for these companies to re-grow into the space as and when the market improves.

Analysis within the CBD indicates resource sector related tenants (including engineers) accounted for 30,215m^2 of space that Knight Frank has classified as contraction in 2012 and 2013, with more than 90% of this space being offered as sub-leases. Examples include Rio Tinto, XStrata, Newcrest, Santos, Anglo Coal, Stanwell, QER and Worley Parsons for areas between 1,800m^2 - 4,500m^2.

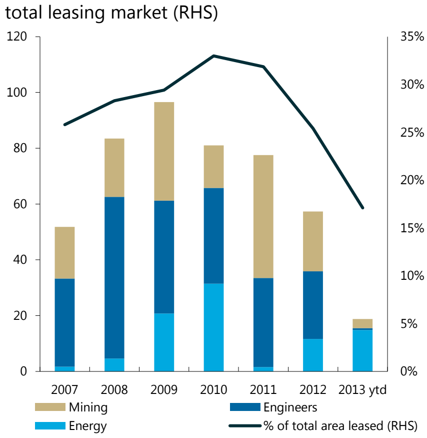
In contrast, the State Government contraction of space has accounted for 49,701m^2 of space being returned to the market, with only 47% of this space sub-lease. The financial sector has accounted for 11,080m^2 of contraction space with remaining industries covering a further 20,087m^2.

Therefore while the resources sector has definitely been an impact within the CBD, it has not been the dominant issue, accounting for 27% of the contraction space available to the market at this time. In the Fringe market the situation is similar with resources sector tenants such as Bechtel, KBR and Geodynamics only one element of the wider corporate downsizing.

Proportion of Resource Sector Tenants

While the Brisbane CBD and Fringe markets have seen a high level of activity from resource sector tenants, as shown in Figure 6, this has only exceeded 30% of total market activity twice, in 2010 and 2011. In terms of total leasing activity tracked by Knight Frank, based on the start date of the lease, the resources sector has accounted for between 25% - 33% over the seven years to 2012. The result for 2013 to date however, shows the degree to which activity within this sector has fallen, accounting for only 17% of lease starts in 2013.

Figure 6
Brisbane Commercial Markets
'000m² leasing activity (LHS) and Proportion of total leasing market (RHS)



Source: Knight Frank

Summary

As shown above, the resources sector is an important demand generator for the major Brisbane office markets. However in terms of total transaction activity, over the past seven years, it has only breached 30% on two occasions, generally accounting for approx. a quarter of market activity. As such its influence is often over-reported.

There is no doubt that through 2010 and 2011 the resources and energy sector gave the Brisbane markets a welcome boost while the rest of the economy was conservative, and the reduction in resource sector activity while the wider economy is still weak, has been deeply felt by the market.

There is a clear relationship between the performance of the ASX 200 Resources Index (as a proxy for profitability and also future pricing) and office market demand from mid-2008 through to today. This was the only driver studied that maintained a causal relationship through the demand downturn into 2013. Unfortunately the lack of any longer term correlation means that there is limited use as a forecasting tool, even if a reliable forward indicator was available. However it will be an indicator to watch closely over the coming year. Positive indications would be the continued reduction in the cost bases for major mining companies, a stable and softer AUD and improved prices and stability of current and forecast pricing for coal and LNG.

Many of the major companies have already made serious inroads into their overheads with Peabody reporting a 20% decline in their Australian costs in their second quarter 2013 results and Rio Tinto reported global cost reductions of 9% for H1 2013 (US$977 million operating cost improvements and $US483 million in lower exploration and evaluation spend). The AUD has depreciated by 10% against the USD since the recent April 2013 highs of $1.04. In addition, the ASX 200 Resources index for August is showing a 4.2% increase over the July figure, off the back of a general market rally. Therefore perhaps there are green shoots emerging within the sector, however it will take a significant improvement before this translates to additional office demand, with cost control remaining a priority.

The recent dramatic increases in vacancy levels across both the CBD and Fringe markets are as, if not more, attributable to the impact of new supply, downsizing by the State Government and general corporate conservatism and contraction, rather than the resource sector slowdown.

Analysis of office demand and the resource sector has shown that there is a relationship between the two, however this has only been significant over the past six years. Whether this has been due to a once in a generation expansion (particularly for LNG), the slower general market conditions highlighting resource sector activity or a combination of these factors, the jury is out as to whether the resource sector will be such a significant factor in the market again in the short term.

There is certainly a great deal of further capacity expansion and infrastructure which has been proposed, but currently deferred. In addition the Queensland state budget 2013/14 outlined an increase of 99% in mining/energy royalties over the next four years as the focus moves from development to commissioning and ongoing operations of the current crop of major projects.

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