



Folkestone

NAVIGATING THE ROAD AHEAD
REAL ESTATE OUTLOOK 2016



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NAVIGATING THE ROAD AHEAD

SUMMARY

- DIVERGENCE IN PERFORMANCE BETWEEN MINING AND NON-MINING STATES TO WIDEN
- 2016 WILL BE A CHALLENGING YEAR TO DEPLOY CAPITAL
- INVESTORS WILL CONTINUE TO FOCUS ON QUALITY NON-RESIDENTIAL ASSETS WITH SECURE INCOME
- RESIDENTIAL PROPERTY MARKETS TO COOL BUT NO MAJOR COLLAPSE ANTICIPATED
- REAL ESTATE SOCIAL INFRASTRUCTURE ASSETS WILL CONTINUE TO BE IN DEMAND
- A-REITs WILL CONTINUE TO PROVE POPULAR AS A SAFE HAVEN IN A VOLATILE EQUITIES MARKET

INTRODUCTION

As we enter 2016, investors are now asking the question **“which road should I take”** – real estate markets have, or are close to, peaking ... or is there more upside in this cycle?

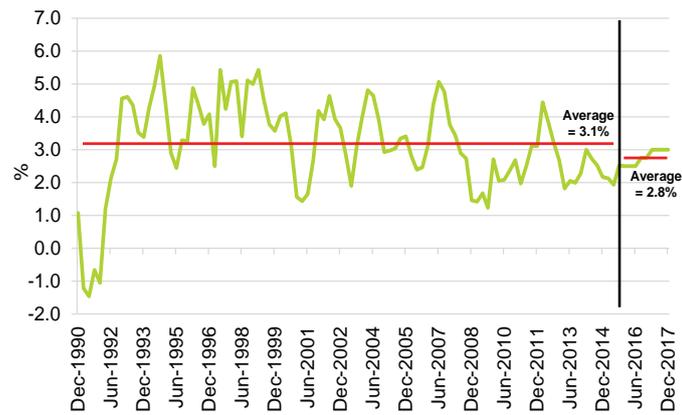
Since the lows of the GFC, all three real estate sectors – residential, non-residential and listed A-REITs – have delivered positive returns. After six years of an up cycle, it is not surprising that investors are increasingly questioning “is this as good as it gets?” There are signs emerging across all three real estate sectors suggesting investors should exercise caution in the year ahead.

At this point, we acknowledge the strong performance of all three sectors in 2015 won't be repeated to the same extent this year, but we also believe that a major downturn is unlikely in the year ahead. The one caveat on this is if the volatility and negative investor sentiment that has transcended global financial markets in the first two months of this year persists, leading to a major tightening of liquidity in financial markets, then real estate whether listed or unlisted won't be immune to the fallout.

ECONOMIC OUTLOOK

The Australian economy is now in its 26th year of continuous growth. Yet, in recent years Australia seems unable to break out of the disappointing pace of growth that has kept real GDP growth between 2.0 per cent and 2.5 per cent, below the long-term trend rate of 3.1 per cent (Figure 1).

Figure 1: Australian GDP Growth: 1990 – 2017



Source: ABS, Bloomberg

Although the housing market has performed well, and employment growth and consumer spending have been strong, economic growth has been dampened by the resource downturn, muted business spending and an array of global concerns – the China slowdown and the sharply lower commodity prices.

Business conditions in WA and QLD are weighing heavily on business confidence, while conditions are significantly better in NSW and VIC (these two states account for over 60 per cent of the economy) (Figure 2). This clearly reflects the divergence occurring between the mining and non-mining economies.

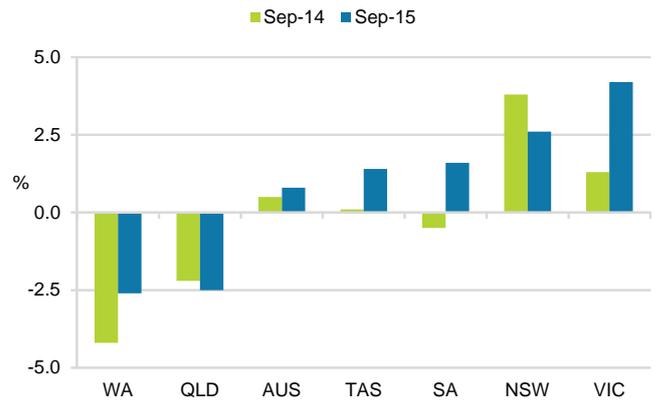
Mining investment has been declining sharply since peaking in 2012 reflecting the completion of a range of large scale mining projects. Mining investment is expected to weaken further as new projects wind up and resource companies cut back spending as a result of the collapse in commodity prices.

Non-mining investment has remained muted in the past year. Survey measures of non-mining business conditions and capacity utilisation have improved; while growth in business credit picked up in the second half of 2015.

However, non-mining business has yet to fully compensate for the decline in mining investment as the improvement in business conditions seem to be occurring in more labour intensive rather than capital intensive segments of the business community.

The rotation in economic activity from mining to non-mining sectors is underway, albeit not yet to the extent required to drive above trend economic growth.

Figure 2: Domestic Final Demand: 2014 and 2015



Source: ABS

NSW's growth is being driven by infrastructure spending and a strong housing market. The challenge for NSW will be to continue growing as momentum from the housing sector fades during 2016. NSW Treasury is forecasting \$67 billion of infrastructure spending to be funded between now and 2018/2019, with just under half to be spent in the next two years, funded in part from the proceeds of the sale of the State's poles and wires, ports and surplus buildings¹.

VIC is also performing well due to solid population growth, and a strong housing market while the mining downturn is impacting WA and to a lesser extent QLD.

EMPLOYMENT GROWTH STRONG

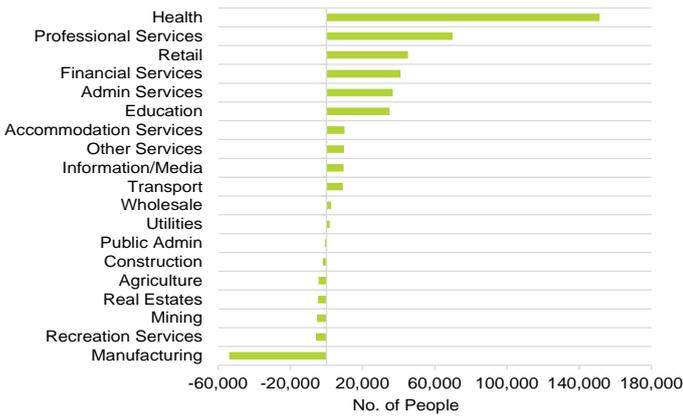
The labour market has surprised on the upside. Employment grew by 298,000 jobs or 2.6 per cent in the 12 months to January 2016, well above the average year-on-year growth over the last 20 years of 1.8 per cent.

Figure 3 shows that it is the labour intensive industries where most of the jobs have been created in the year to November 2015 (latest data) The growth is being driven by population growth (education and healthcare), aging population (healthcare), solid consumer spending (retail) an expansion in professional services and financial services and the decline in the Australian dollar (education and tourism).

¹ Infrastructure Statement 2015-2016 – Budget Paper No. 2 - NSW Government – June 2015

Despite the lower dollar, employment is contracting in the manufacturing and mining sectors.

Figure 3: Employment Growth by Sector: Year to November 2015

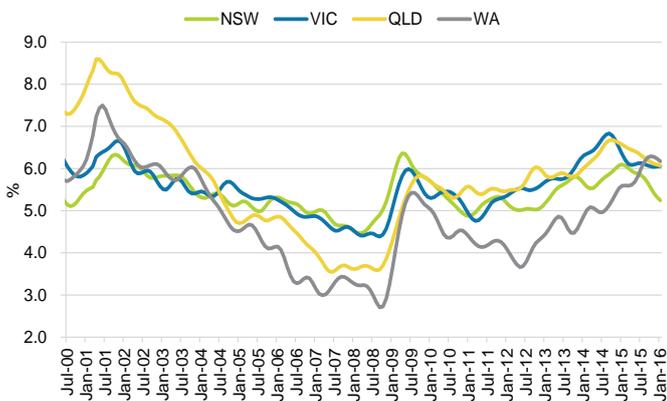


Source: ABS

The overall unemployment rate was 6.0 per cent in January 2016, up from 5.8 per cent in December 2015 but below the peak of 6.3 per cent in December 2014.

The NSW labour market continues to strengthen with trend employment growth running at 4.7 per cent year on year, and the unemployment rate falling from 6.1 per cent to 5.2 per cent over the year (Figure 4). VIC is growing at 1.5 per cent year on year, while employment in QLD is now growing at 3.1 per cent year on year. WA's employment growth is muted, and as a result the unemployment rate has increased from a cyclical low of 2.8 per cent in August 2008 to 6.2 per cent in January 2016, now above the national rate for the first time since 2003.

Figure 4: Unemployment Rate by State: 2000 – 2016



Source: ABS



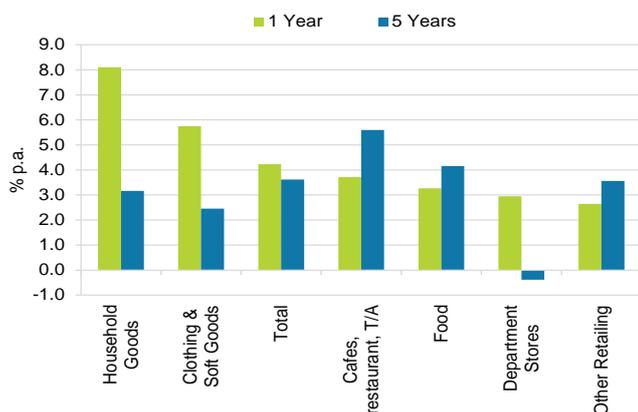
CONSUMER CONFIDENCE REMAINS RESILIENT

The Westpac Melbourne Institute Index of Consumer Sentiment rose by 4.2 per cent in February 2016 to move back above 100 to 101.3. There have only been five months in the past two years when optimists have outweighed pessimists (i.e the Index is above 100). While record low interest rates, low petrol prices, and an improving labour market are helping consumers stay positive, the resilience of consumer sentiment was surprisingly positive in February 2016 given global market volatility, the sharp falls in equities in the first six weeks of the year and constant media headlines about a slowing housing market.

Drilling down into the sentiment survey, we find that consumers believe 'family finances relative to a year ago' are better, up 3.4 per cent compared to February 2014 and 'family finances over the next 12 months' are up 0.6 per cent on the previous year. However, when it comes to the housing market, sentiment is clearly deteriorating. The 'time to buy a dwelling' index fell 12 per cent to 99.3 in February and is now 21 per cent below its level of a year ago.

Consumer spending remains buoyant up 4.2 per cent in 2015. Household goods was the stand out sector up 8.1 per cent in the year (Figure 5). The strong housing market has fueled a boom in the purchase of household goods. Department store sales improved and were above the five year average of -0.4 per cent per annum. Food retailing whilst posting 3.3 per cent growth, is below the five year average of 4.2 per cent per annum. Price competition between the supermarkets has intensified in recent years which is great for consumers, but is putting pressure on the earnings margins of Coles, Woolworths and Metcash. See page 17 for more detail on consumer spending trends and the impact on the retail sector.

Figure 5: Retail Spending By Sector: 1 and 5 Year Growth to December 2015



Source: ABS

MONETARY POLICY ACCOMMODATIVE

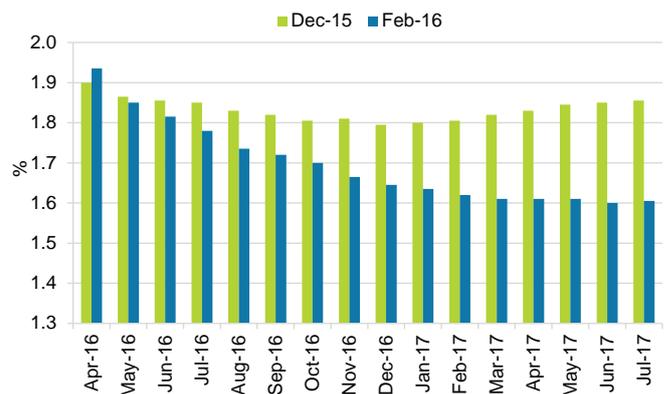
The RBA acknowledges that domestic inflationary pressures have eased and inflation should remain low in the near-term. The RBA cites "heightened competitive pressures, declines in the cost of business inputs such as fuel and some regulated utilities, and the fact that spare capacity in the labour market has been contributing to low growth in labour costs"² as key reasons for the subdued inflation outlook.

The RBA reduced the cash rate by 50 basis points in the first half of 2015 to an historic low of 2.0 per cent.

We believe monetary policy will remain accommodative. The RBA is clear they remain ready to cut interest rates if economic conditions deteriorate.

According to the RBA's latest minutes, "the outlook for continued low inflation may provide scope for easier monetary policy, should that be appropriate to lend further support to demand."³ At the time of writing, the financial markets are expecting the RBA to ease further in the year ahead (Figure 6).

Figure 6: Cash Rate Expectations: 12 Months to July 2017



Source: Yield Report

2 Statement on Monetary Policy – RBA – February 2016

3 Minutes of the Monetary Policy Meeting of the Reserve Bank Board – 2 February 2016

CAPITAL MARKETS

2016 has started with major dislocation in global markets. Share markets have been hit as concerns about China, European banks and the global economic outlook weigh on investors. This uncertainty has increased the risk premium that investors require and therefore reduced the price of what investors are prepared to pay for equities and high yield debt. At the same time, there has been a flight to safe haven assets such as government bonds in countries such as the US and Australia, pushing yields back down.

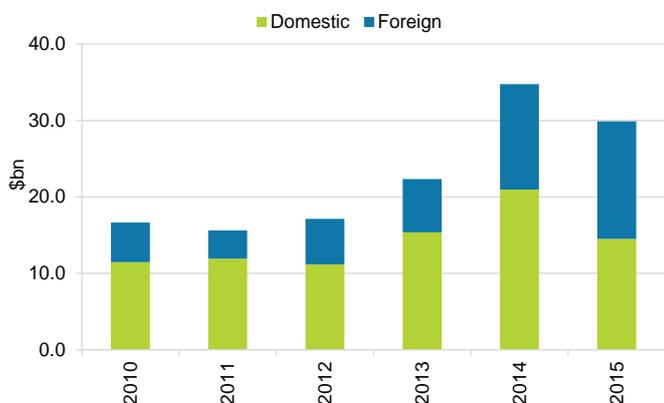
Volatility will remain a feature of the 2016 investment landscape. In such an environment, prime real estate with secure income will look attractive.

A-REITs which have outperformed equities in four of the past five years, will again be in demand from equity investors looking for a safe haven amongst the listed securities.

INVESTMENT FLOWS - AUSTRALIA CONTINUES TO BE A MAGNET FOR CAPITAL

International capital was a feature of the Australian market in 2015. According to Cushman & Wakefield, non-residential transactions topped \$29.9 billion, with foreign investors accounting for just over 50 per cent of total transactions by value (Figure 7). This was 14 per cent below the \$34.8 billion recorded in 2014 but still well ahead of levels recorded between 2010 and 2013.

Figure 7: Non-Residential Transaction Volumes: 2010 – 2015



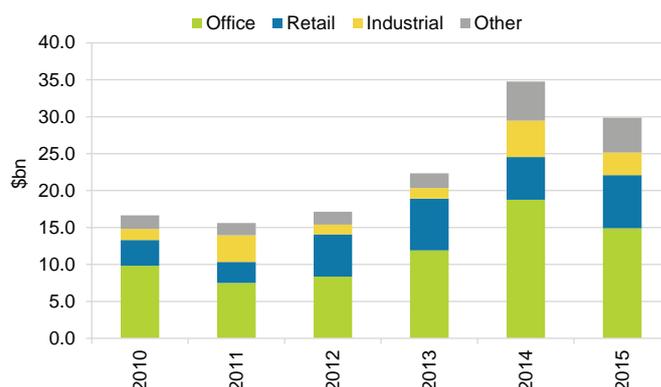
Source: Cushman & Wakefield

Foreign investment activity in non-residential real estate has been growing steadily over the past few years driven by a confluence of factors. These include global investors chasing Australia's relatively high yields, Australia's

transparent and relatively stable market, the growth in Asia-Pacific focused real estate funds which are allocating capital to Australia as part of their regional mandates, growth in China's insurance companies which are targeting real estate investments, together with a relaxation of restrictions on their international investing activities and the decline in the Australian dollar.

While office transactions accounted for almost 50 per cent of the total value of transactions in 2015, at \$14.9 billion (Figure 8), it was the retail sector that showed increased investor appetite. Retail transactions totalled \$7.2 billion – a 25 per cent increase on 2014 levels. Industrial transactions, despite the \$1.1 billion acquisition of the GIC/ Fraser's portfolio by the Singapore listed Ascendas REIT, totalled \$3.1 billion, considerably less than the \$4.9 billion transacted in 2014.

Figure 8: Non-Residential Transactions Sector: 2009 – 2015



Source: Cushman & Wakefield

Looking ahead, international investors will continue to be active buyers of Australian non-residential assets. According to the Colliers International survey of major investors⁴, the top three target markets in the Asia Pacific region in 2016 are Tokyo, Sydney and Melbourne. A similar result was found in the PwC/Urban Land Institute survey of global investors and fund managers⁵ – the three best prospects in 2016 were also Tokyo, Sydney and Melbourne. Back in 2009 at the depths of the GFC, according to the PwC/Urban Land Institute survey, Sydney ranked 14th and Melbourne 11th of the major Asia-Pacific cities to buy in.

CBD offices remain the most popular real estate assets for foreign investors to acquire, followed by industrial/logistics and hotels.

⁴ Global Investor Outlook – Colliers – January 2016

⁵ Emerging Trends in Real Estate – Asia Pacific 2016 – PwC & Urban Land Institute – December 2015

2016 is shaping up to be a challenging environment to deploy capital into real estate.

It has been a similar story in the residential market, with foreign investors actively buying in Australia. Foreign individuals have predominately acquired apartments sold off the plan while Asian developers, particularly those from China, have been aggressively acquiring residential development sites. We expect, given concerns about the Chinese economy and tighter restrictions on capital outflows, that Chinese investment activity in the residential sector will taper off from the record levels of 2015. However, China will continue to be active buyers of both commercial and residential property in Australia.

A CHALLENGING ENVIRONMENT TO DEPLOY CAPITAL

With yields across most sectors reaching cyclical lows, and the continued international capital entering the market, which typically has a lower cost of capital than most domestic players, the “weight of money” and “hunt for yield” will continue in earnest. For many domestic investors it will be difficult to compete.

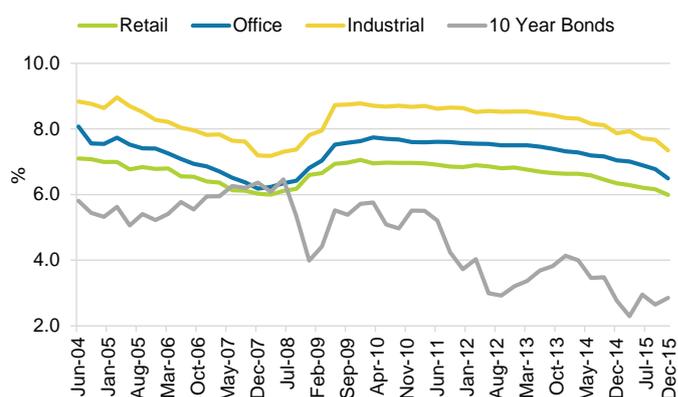
Australian super funds will be active but we expect they will increasingly look at offshore investments. A number of the major superannuation funds now have allocations to international real estate as part of their investment strategies. The A-REITs will focus on actively managing their existing portfolio and M&A to grow in the year ahead.

2015 saw two major portfolio acquisitions, the Ascendas REIT's \$1.1 billion acquisition of the GIC/Frasers industrial portfolio (see page 20) and China Investment Corporation's (CIC) \$2.5 billion acquisition of the Investa Property Group, making it the biggest direct real estate transaction in Australia's history. This transaction of nine CBD office buildings was purchased on a reported yield of circa 5.1 per cent.

For the large offshore pension funds and insurance companies these types of deals offer the advantage of scale and allow the buyer to deploy large sums of capital in one transaction. There are few portfolios that readily come to mind that could be sold this way in 2016 but no doubt the international investors will be working hard to identify potential opportunities. Of course, there is always the possibility of privatisation of one or more A-REITs but with most of the A-REITs trading at significant premiums to NTA, this is less likely. This situation is quite different to the US, where a number of the listed REITs have been trading at discounts to NTA, and are being actively looked at as potential privatisation targets.

Yield compression (when yields fall, values increase) in the non-residential sector has been driven by investors aggressively deploying capital rather than strong underlying real estate fundamentals. As we highlighted in our last report, the capital cycle has been running ahead of the real estate cycle. Real estate yields (cap rates) look attractive compared to bond yields – the spread between real estate and bond yields is still wide by historical standards - but the absolute levels are nearing record lows across most core sectors (Figure 9). The question is – can they go lower? Back in 2007, the premium virtually evaporated as yields contracted and interest rates were circa 360 percentage points higher than they are today.

Figure 9: Real Estate Cap Rates vs 10 Year Bond Yields: 2004 – 2015



Source: MSCI/IPD and IRESS

With yields firming to almost record levels, an increasing number of groups that acquired assets in the depths of the GFC or the early years of the recovery may look to take advantage of pent-up demand for core assets and crystallise the large profits they are sitting on.

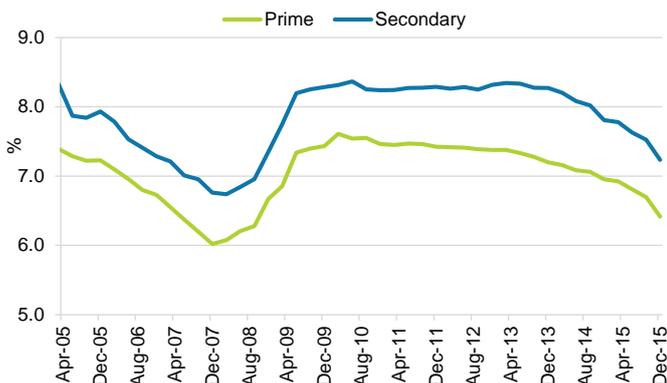
However, it is unlikely that transaction volumes will surpass 2015 levels, due in part to the issue of where do the sellers redeploy the capital if they transact now. Also, a significant number of assets have already traded in recent years to buyers who have long-term hold strategies (i.e. sovereign wealth funds, Chinese insurance companies) and are unlikely to sell. Finally, a growing number of investors are likely to be more cautious in deploying capital at this point in the cycle.

In previous cycles, the standard response to investors not being able to get set in core assets was to move up the risk curve to value-add and opportunistic investments, or move to less crowded markets like suburban office.



Typically, the cap rate spread between prime and secondary assets tend to converge as we move further through the cycle. This cycle is no different when we look at the gap between prime CBD (Premium and Grade A) and secondary CBD (Grade B, C and D) office assets. The gap is now sitting at 80 bps versus 60 bps at the peak of the last cycle (Figure 10). Also, the decline in secondary yields has been more pronounced since December 2013, as investors started to pursue secondary assets in the hunt for yield.

Figure 10: Prime and Secondary CBD Office Cap Rates: 2005 – 2015



Source: MSCI/IPD

BANK LENDING GROWING BUT MORE FOCUSED

Debt continues to be available, albeit the banks are revisiting their loan books at a time when more non-bank lenders are entering the market.

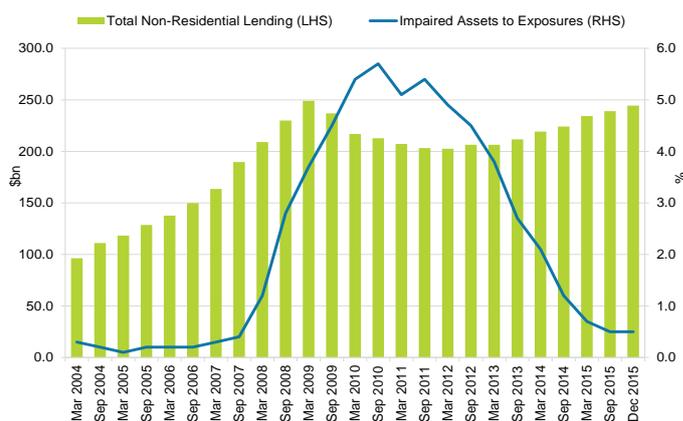
Non-residential property exposures for all authorised deposit-taking institutions (ADI's) (e.g. banks, building societies and credit unions) was \$244.4 billion at 31 December 2015, an increase of \$17.4 billion (7.7 per cent) on 31 December 2014 (Figure 11). Of this, 83.6 per cent or \$204.4 billion was lent on domestic assets. The largest sector exposures were office property (\$74.6 billion) at 30.5 per cent and retail property (\$57.5 billion) at 23.5 per cent.

The level of impaired non-residential property exposures was just \$1.3 billion at 31 December 2015 or 0.5 per cent of outstanding loans - a positive sign of the health of the non-residential market. Back in the GFC, impaired loans topped out at 5.7 per cent (Figure 11).



The regulatory intervention by APRA last year has worked with the banks tightening their rein on investor loans and higher risk mortgage lending to the residential sector.

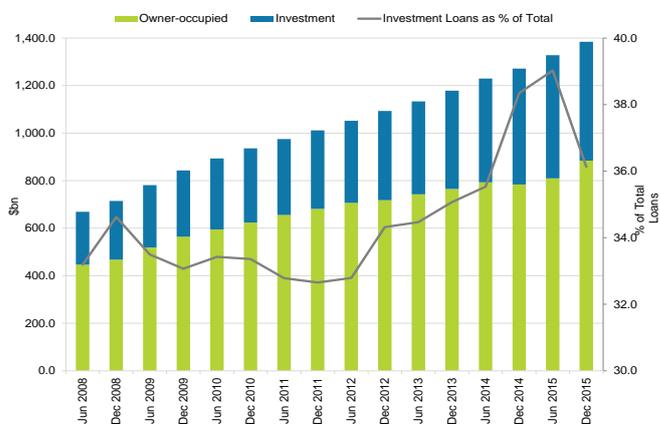
Figure 11: Non-Residential Lending Exposure: 2004 – 2015



Source: APRA

Residential loans to households by ADIs stood at \$1.38 trillion at 31 December 2015, an increase of \$112.6 billion (8.9 per cent) on 31 December 2014 levels (Figure 12). Of these, owner-occupied loans accounted for \$884.1 billion (63.9 per cent), an increase of \$100.1 billion (12.8 per cent) from a year earlier. Investor loans totalled \$500.0 billion (36.1 per cent), an increase of \$12.5 billion (2.6 per cent) from 31 December 2014.

Figure 12: Residential Lending Exposure: 2008 – 2015



Source: APRA

Digging down into the detail, it appears that the regulatory intervention by APRA last year has worked, with the banks tightening their rein on investor loans and higher risk mortgage lending to the residential sector. Investor approvals (32 per cent of the total book) have fallen significantly to their lowest levels since 2010, while loans with low deposits have also fallen. Just 9 per cent of approvals were for loans with an LVR greater than 90 per cent, down from 15 per cent two years ago, and are at their lowest levels since 2011. Loans with an LVR between 80 per cent and 90 per cent remained constant at 14 per cent of approvals, down from the 20 per cent average between 2008 and 2014.

Anecdotal evidence also points to the major banks increasing margins and introducing more stringent loan underwriting for both residential and non-residential development and winding back their lending footprints in some locations (mining towns in particular). However, at the same time, they are aggressively chasing lending opportunities in other areas, particularly income producing non-residential assets on the east coast.

NON-BANK LENDERS ENTERING THE MARKET

Competition is also increasing as foreign banks (especially from Asia) and non-bank lenders (superfunds, family offices) step up their real estate lending programs in Australia. We see these non-bank lenders as important sources of debt capital moving forward.

Given the souring credit markets of late, and the banks deploying tighter lending standards to certain sectors of the market, the opportunity for private lenders to provide real estate debt both at the senior (first ranking mortgage) and the more opportunistically sub-ordinated, mezzanine debt (second ranking mortgage) at attractive rates of return will definitely gain momentum in 2016. Folkestone recently met with one of the private banks attached to a big four bank who told us they were actively looking for real estate debt opportunities across the capital stack for their clients. Their rationale, and one we agree with, is that for the right assets and borrower profiles, the risk-adjusted returns on real estate debt are likely to be more attractive than the low yields on offer from investing in the equity of non-residential assets in the year ahead.

In a competitive environment, borrowers will value flexibility, speed and certainty of execution rather than pricing. The private lending market which is typically more expensive than the banks, will offer a competitive alternative to the traditional banks as borrowers base their decisions on more than just price.

For those A-REITs that use the corporate debt markets, the cost of finance has risen in the past year given the global financial market volatility and lenders tightening underwriting standards. Whilst the base rate (the reference rate in the market to which a bank margin is applied) has come down, margins have increased. By way of example, the ASX listed Charter Hall Retail Trust (rated by Moody's as Baa1) priced a 10-year USPP (a private debt placement to investors in the US) in February 2016. The coupon in USD was 3.76 per cent which included a margin of 210 basis points. Once swapped back into AUD it equated to BBSW (an Australian base rate) plus a margin of 255 basis points. The trust did a similar deal in April last year and the coupon was 3.55 per cent including a margin of 160 basis points or once swapped back into AUD, was BBSW plus 194 basis points.

AVOID HIGHER GEARING

With real estate yields falling and the overall cost of debt (base rate plus margin) still relatively low, it is tempting to increase leverage levels to super-charge the return from real estate.

Whilst interest rates are likely to stay low for longer, at some point they will rise, or worse still, we could have a major capital market shock. As a reminder of the impact of leverage, for an investor using 30 per cent leverage, an asset's value would need to decline by 70 per cent for the equity to be lost. An investor using 65 per cent leverage will see all of their equity wiped out if asset values declined by 35 per cent.

We believe now is not the time to adopt aggressive leverage levels or poorly designed, complicated capital structures.

Across the real estate funds, gearing remains at reasonable levels and well below levels recorded in the lead up to the GFC. Wholesale unlisted funds gearing levels stand at 12 per cent⁶, while retail unlisted funds average 38 per cent⁷ and the A-REIT's average gearing level is approximately 31 per cent⁸.

6 Mercer/IPD Australia Monthly Property Fund Index Core Wholesale - January 2016

7 Property Council/IPD Unlisted Core Retail Property Index - January 2016

8 A-REIT January Monthly - JP Morgan - 7 February 2016

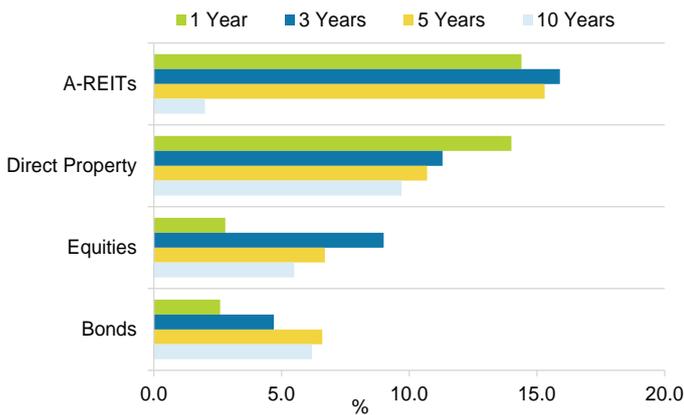
REAL ESTATE INVESTMENT RETURNS

A-REITs delivered a 14.4 per cent total return in 2015, outperforming non-residential property (14.0 per cent), equities (2.8 per cent) and bonds (2.6 per cent) (Figure 13).

A-REITs have been the standout performer over the past five years – taking the title as the best performer in 4 of the past 5 years.

Over the five years to 31 December 2015, A-REITs have delivered a total return of 15.3 per cent per annum, more than double the 6.7 per cent per annum from equities and 6.6 per cent per annum from bonds and higher than the 10.7 per cent for non-residential property (Figure 13).

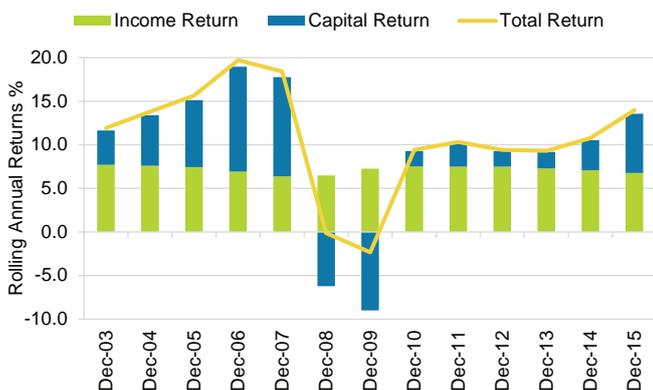
Figure 13: Asset Class Total Returns: to 31 December 2015



Source: ASX, MSCI/IPD, UBS

In 2015, non-residential property⁹ generated a total return of 14.0 per cent driven by a strong capital return of 6.8 per cent (Figure 14). This was the highest total return since December 2007 when non-residential property generated a total return of 18.4 per cent.

Figure 14: Non-Residential Total Returns: 2003 - 2015



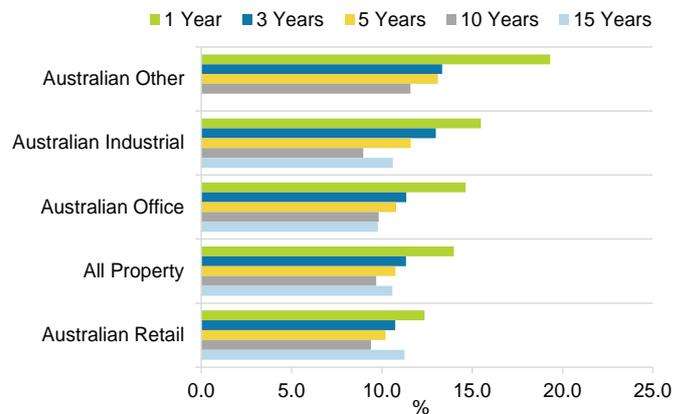
Source: MSCI/IPD

⁹ Measured by the PCA/IPD Direct Property Index

Of the non-residential sectors, 'Australian other' (primarily comprising hotels and healthcare assets) was the best performing sector with a total return of 19.3 per cent followed by industrial at 15.5 per cent (Figure 15). Other property has been the standout sector across all time periods to 31 December 2015. These alternate sectors have performed well due to the increased investor focus on social infrastructure – the demographic drivers are strong in relation to healthcare and solid tourism demand is driving hotel performance.

The office sector generated a total return of 14.6 per cent for the year. The strong result was driven by the non-CBD office markets which returned 16.1 per cent compared to 14.1 per cent for CBD office. The CBD office return was boosted by strong results from both the Sydney CBD (17.8 per cent) and Melbourne CBD (14.8 per cent), but held back by the lack lustre total return of just 2.0 per cent from the Perth CBD.

Figure 15: Non-Residential Sector Returns: to 31 December 2015



Source: MSCI/IPD

Residential property performance was mixed, with yields falling to record lows in some markets and capital growth diverging across the major markets.

As at December 2015, Sydney and Melbourne house yields were 3.2 per cent and 3.0 per cent respectively – close to historical lows. Combining the yield and capital returns show Sydney recorded an average total return of 15.4 per cent in 2015 compared to 14.8 per cent in Melbourne. At the other end of the scale, Perth generated a total return of just 0.2 per cent and Darwin 2.0 per cent.

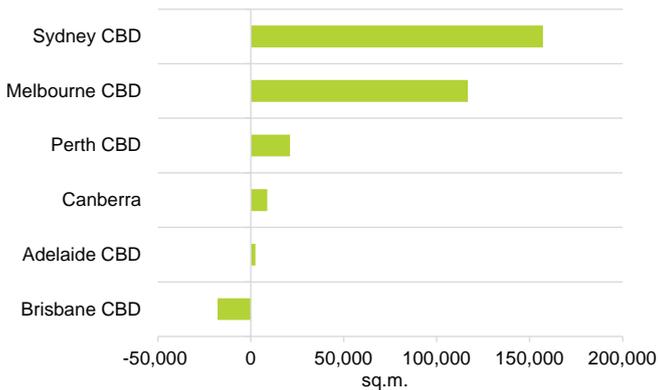
OFFICE

Tenant demand and rental growth continue to strengthen in Sydney and Melbourne while Brisbane, Perth, Adelaide and Canberra office markets continue to struggle.

Sydney and Melbourne CBD's continue to surprise on the upside. Strengthening economic growth in both markets is fuelling service sector employment growth – key occupiers of office space. This is driving above trend demand in both markets.

In the year to January 2016, occupied space in the Sydney CBD grew by 157,150 square metres – the strongest growth in a decade (Figure 16). In the Melbourne CBD, occupied space grew by 116,763 square metres, the best result in eight years.

Figure 16: Net Demand: Major Office Markets: 12 Months to January 2016



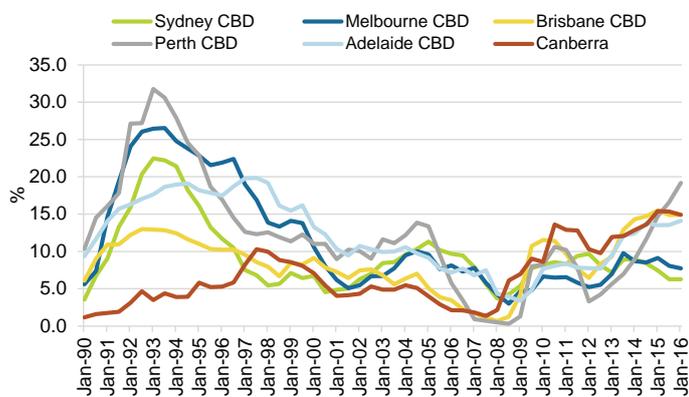
Source: Property Council of Australia

The Sydney CBD vacancy rate declined from 7.4 per cent to 6.3 per cent in the year to January 2016, although it was unchanged in the second half of the year (Figure 17). New supply of 149,498 square metres in the second half of 2015, offset new demand and withdrawals of space, hence the vacancy rate remained unchanged. A sign of a strong tenant market is the amount of sub-lease space - where existing tenants look to shed excess space. According to the latest PCA numbers, there is only 8,362 square metres or 0.2 per cent of space available for sub-lease in the Sydney CBD market.





Figure 17: CBD Vacancy Rate: 1990 – 2016



Source: Property Council of Australia

Sydney has definitely benefited from the booming IT sector. In the past six months, IT companies such as Apple, Dropbox and Expedia all took new space in the city. Martin Place, once the banking hub of Sydney, has reinvented itself into a technology hub with LinkedIn, Atlassian, Apple, Dropbox and Booking.com all occupying space in the precinct.

Leasing agents are reporting that enquiry levels for space is picking up, with IT, finance, insurance and professional services all recording significant increases in enquiry – a positive indicator for future demand and take-up.

The market will also benefit from withdrawal of stock – some of which is due to the state government’s compulsory acquisition of 53,200 square metres for the new metro rail.

We expect the Sydney CBD vacancy rate to push back towards 8 per cent in 2016, as more than 264,000 square metres of new supply comes online this year. Almost 70 per cent of this space, 181,000 square metres, comprises the two remaining towers being built by Lend Lease at Barangaroo. The vacancy rate should decline again given there are no new buildings slated to come on line in 2017 and 2018 – the first time since the early 1980’s that Sydney has had no new supply within a 12 month period.

Table 1: Key Office Statistics: December 2015

	Net Effective Rent (\$/sq.m.)	Annual Change (%)	Avg. yeild (%)	Annual Change (Bps)
Sydney CBD	624	6.5	5.39	-57
Melbourne CBD	337	0.0	5.90	-63
Brisbane CBD	402	-1.7	6.78	-36
Adelaide CBD	288	6.5	7.14	-82
Perth CBD	336	-28.4	7.71	-22
Canberra	280	1.8	6.95	-79

Source: CBRE

The Melbourne CBD vacancy rate fell from 9.1 per cent to 7.7 per cent in the 12 months to January 2016 (Figure 17). Supply was elevated, with 125,824 square metres of space coming online almost matching the net demand of 116,763 square metres. The saving grace for Melbourne was withdrawals of 65,000 square metres during the year.

Looking ahead, Melbourne CBD has only 72,000 square metres of space in the CBD coming on line this year, and we expect the market to absorb this space quite well.

Rental growth accelerated in Sydney during the second half of 2015 as supply tightened and demand strengthened. Sydney CBD's net effective rental growth was 6.5 per cent for the year (Table 1). Melbourne CBD's rental growth was flat during 2015. Incentive levels remain elevated (still above 30 per cent in both markets) but should moderate in the next year as demand continues to improve. Declining incentives in conjunction with reasonable face rental growth will result in effective rental growth in the Sydney and Melbourne CBD's over the next few years. Asset values should increase further (albeit the rate of growth will be lower than in 2015), underpinned by the weight of capital chasing assets and the improving market fundamentals.

The Sydney and Melbourne suburban markets are also showing improved activity. The two lowest vacancy rates in the country are in East Melbourne (0.8 per cent) and Parramatta (5.6 per cent).

Brisbane and Perth office markets have a completely different story. Both the CBD and suburban markets continue to be impacted by soft demand and elevated supply levels. The Perth CBD vacancy rate was 19.2 per cent in January, up from 14.7 per cent a year ago (Figure 17). Whilst there was positive leasing activity in the past year (Figure 16) – with two big space users Shell Australia and the WA government moving from the suburbs into the CBD – Perth was hit by a wave of new supply coming online at a time when the resource sector had collapsed. In 2015, 128,000 square metres of new space hit the market, and a further 31,171 square metres is forecast to come on line in 2016.

As a result, effective rents in Perth were down 28 per cent in 2015 (Table 1) and are now down 40 per cent from the cyclical peak in 2012. Incentives are tracking between 40 per cent and 50 per cent with no respite in sight for landlords. The Perth CBD market will take some time to work through the overhang of space. Despite the weight of capital chasing real estate, Perth is one market where cap rates should soften and values are expected to decline in the year ahead. It's a similar story in West Perth, where occupied space contracted by 2,000 square metres in the last year, pushing the vacancy rate to 12.2 per cent.

Although Brisbane's vacancy rate fell slightly from a record high of 15.5 per cent at the start of 2015 to 14.9 per cent at year end (Figure 17), there is more downside risk to the Brisbane market in 2016.

The Brisbane CBD and suburban markets are expected to weaken in 2016 as subdued demand, particularly from mining and mining services firms, is compounded by the next wave of supply hitting the market. As a result the vacancy rate will remain elevated through 2016 and into 2017. In Brisbane CBD, 192,281 square metres will hit the market in 2016 – almost 9.8 per cent of the current stock base. A further 18,450 square metres will come online in 2017. Only 62 per cent of this space has been pre-committed. By year end, the vacancy rate in Brisbane CBD is expected to be well above the record 15.5 per cent reported in January 2015. Net effective rents fell 1.7 per cent in 2015, and we expect rents to remain under pressure in 2016.

Turning to the Brisbane fringe office market, the vacancy rate sits at 12.5 per cent with occupied space contracting by 7,373 square metres in 2015. With 22,000 square metres of new space hitting the fringe market in 2016, the vacancy rate is expected to increase.

Adelaide and Canberra markets are struggling with weak demand – occupied space in Adelaide grew by a miniscule 2,493 square metres and Canberra by 8,860 square metres in 2015. Given the state of their local economies, demand will remain weak through 2016 and into 2017 keeping vacancy rates elevated. Adelaide and Canberra's vacancy rates should remain above 14.0 per cent in 2016 which will curtail rental growth in both markets.

Investor activity continues to be focused on Sydney and Melbourne, as noted by offshore investors. Gateway cities featuring dynamic environments, international airports and highly trained workforces remain the most coveted locations globally. Sydney predominates – its aura and power and financial services hub has captivated global investors' attention while Melbourne's rise up the rankings continues. Yields are close to cyclical lows in both markets and we'd expect the weight of money to push yields even lower in both markets in 2016.

Investors will continue to look for mispricing opportunities in Brisbane, Canberra and Adelaide, especially given the higher yields. It may be premature to look at the Perth market as values will continue to remain under pressure in 2016 although some counter cyclical buyers have started to look at Perth.

TECH HUBS - COLLABORATION LABORATORIES

Across cities, co-working spaces, or hubs as they are more commonly known as, are springing up to allow tech start ups to gravitate to a shared working environment that foster collaboration. Start-ups can establish connections, build networks and grow without the overheads that come with traditional office space.

The Sydney CBD and surrounding suburbs now have a number of tech hubs - Tank Stream Labs, Fishburner, VibeWire, HubSydney, the WorkBench and more recently, Stone & Chalk, a fintech hub.

Fintech is one of the fastest growing sectors in the financial services industry globally. Digital disruption is transforming the financial services industry by revolutionising payment systems and creating new forms of financial services delivery through peer-to-peer lending, crowd-funding, automated financial advice and crypto-currencies to name a few.

Stone & Chalk is an independent, not for profit fintech hub whose overarching objective is to incubate and nurture financial services-focused tech start ups. It is a physical "centre of gravity" that allows start ups to locate in one location (50 Bridge St in the heart of the financial core of the Sydney CBD) and collaborate with mentors from financial institutions, technology companies, leading academics and universities, government and regulators. The NSW government is backing the initiative, which is also being funded by Australia's biggest banks and financial institutions, including Westpac, ANZ Bank, Macquarie, Suncorp, AMP, HSBC and IAG. Leading corporations outside the financial services sector, including Woolworths, Amazon, Intel, Optus, Oracle, KPMG and Veda, have also come on board to lend their support and provide funding.

Since opening in mid 2015, Stone & Chalk has grown to 178 permanent residents and 58 companies who have access to dedicated labs, full and part time desks, offices and casual drop in spaces. Stone & Chalk epitomises that "place matters" in accelerating collaboration and innovation within cities and hubs such as these will be critical if cities are to attract and retain talent in the digital era.



Stone & Chalk



Fishburner

RETAIL

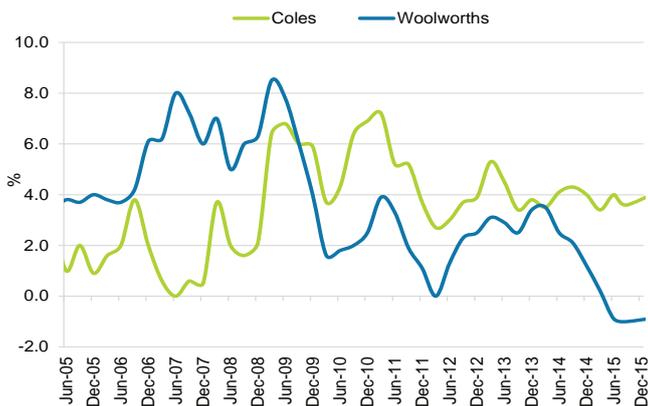
The retail sector is benefiting from a stronger employment environment, the recent housing boom and positive consumer confidence. As noted earlier, the consumer is in relatively good shape.

Consumption is running at its strongest pace in several years. Retail trade recorded annual growth of 4.2 per cent in the year to December 2015. Household goods and clothing and soft goods were the best performing retail categories with annual growth of 8.1 per cent and 5.8 per cent respectively. The weakest categories were other retailers and department stores with growth of 2.6 per cent and 2.9 per cent respectively. See Figure 5 on page 6.

However, supermarket sales growth remains under pressure. The competition between the two supermarket titans - Coles and Woolworths - and the up and coming global value chains - Aldi and Costco - is putting downward pressure on grocery prices and margins.

The gap between Coles and Woolworths sales has widened to the largest in a number of years. Coles has outperformed Woolworths in terms of like for like food and liquor sales for six consecutive years (Figure 18). Woolworths has acknowledged that it was perceived as having higher prices, vowing to lower their prices and invest in a scaleable store renewal program.

Figure 18: Coles and Woolworths Food and Liquor Sales: 2005 - 2015



Source: Company Reports/JP Morgan

The supermarkets appear to have learned from their octane induced expansions where it was all about getting sites in order to shut their competitor out, to returning to the traditional site selection methodology based around population benchmarks.

The retail landscape remains dynamic, evidenced by the recent demise of Dick Smith and the poor performance of the Master's hardware chain. Both offer classic textbook cases of retailers with poor operating models and retail

offerings, making it difficult to remain competitive. Both operate in retail categories that have been performing strongly as evidenced by the robust performance of JB Hi-Fi and Harvey Norman in the household goods category and Bunnings in the hardware category.

The recent February reporting season of both the listed retailers and the listed A-REITs with retail exposure highlighted a relatively upbeat retail environment. Sales growth was positive, especially for the speciality retailers, and there were signs that even the major tenants (department stores and mini majors) were recording improved sales.

The retail environment remains highly competitive, with changing trends, more savvy consumers, competition from online shopping, people wanting more entertainment and lifestyle choices, as well as an influx of international retailers (H&M, Zara, Uniqlo and Top Shop to name a few).

One trend we expect to continue is the move by retailers to adopt more flexible fitouts that can be updated along with the latest product lines. Retailers previously spent large sums on store fitouts that would remain unchanged for five plus years. Now the fitouts utilise more cost effective materials that can be readily changed to maintain consumer interest and engagement.

The evolution of retail centres to include more non-retail uses such as gyms, childcare, entertainment, community services and restaurants as well as the growth of mini-major stores (stores in excess of 400 square metres) will continue to be a theme played out in the next few years. The traditional anchor tenants (department stores and big discount department stores) are losing their appeal and are no longer key drivers of traffic to centres.

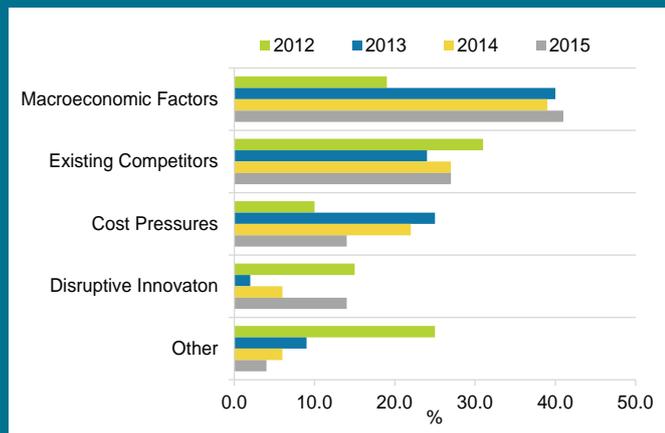
A great deal has been written about the demise of "bricks and mortar" retail centres due to internet retailing. It appears that both retailers and retail centres are adapting to the competition. Most retailers are now implementing creative omni-channel strategies whereby they use a variety of channels including physical stores, online stores and mobile apps to facilitate engagement with customers and generate sales. The retail centres, in turn, are working to create a more stimulating environment for both retailers and consumers to interact.

According to the NAB Online Retail Sales Index, the online retail market in Australia comprised \$19.1 billion of sales in the 12 months to December 2015. This was up 11.2 per cent over the year, outperforming the traditional retail sales growth of 4.2 per cent in 2015. Online retail sales now represent approximately 7 per cent of retail sales.

A COMPETITIVE RETAIL LANDSCAPE

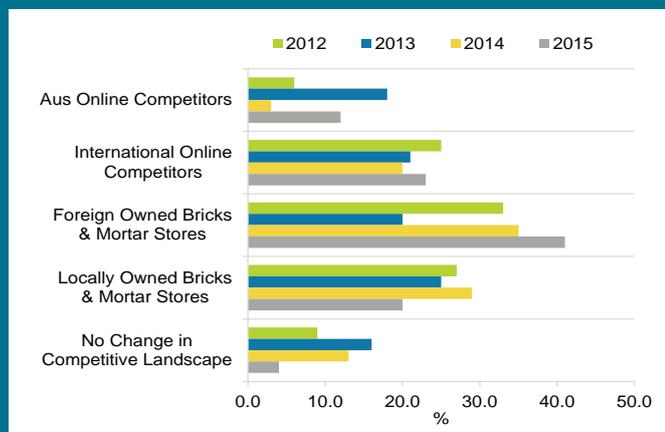
The outlook for discretionary retailers continues to improve, despite the structural changes besetting the retail landscape. According to a Deloitte survey¹, retailers operating in Australia remain optimistic about their fortunes for 2016 with 82 per cent expecting their earnings to grow in 2016, and 41 per cent expecting the growth to exceed 5 per cent. However, it is not without risk. Just over 40 per cent of respondents cited macroeconomic conditions as the greatest business risk in 2016 (Figure 19). Surprisingly, only 14 per cent considered digital disruption to be their greatest business risk in the year ahead.

Figure 19: Retailer Risk Perception



Source: Deloitte

Figure 20: Retailer Competition Expectations



Source: Deloitte

International retailers and bricks and mortar retailers are expected to generate more competition than online retailers (Figure 20). Just over 40 per cent of Australian retailers believe that foreign-owned retailers operating bricks and mortar stores are their greatest competition not digital disruption. Only 23 per cent of retailers are concerned about international online retailers and 12 per cent from Australian online competitors.

In recent years we have witnessed an influx of retailers into Australia. However, by global standards, the penetration is low. Of the top 250 global retailers, only 39 have a presence in Australia. Many of these operate under a range of brands such as Steinhoff which owns furniture brands Freedom, Snooze and Poco as well as discount department store chains Best and Less and Harris Scarfe. Looking ahead, we expect more international retailers to set up shop in Australia fuelled by a lower Australian dollar, the positive economic growth outlook and the rapidly growing Chinese tourism market in Australia.

Competition is driving retailers to lift their performance, in-store appearance, location, customer service, omni-channel delivery – merging virtual online with physical in-store shopping experience – and product range. It also means they have to drive cost efficiencies. In short, retail management needs to be sharp.

1 Deloitte Retailers' Christmas Survey – Wrapping Up the Festive Season – Deloitte – November 2015





Retail landlords will ramp up developments in the coming years. Scentre Group, Australia's largest retail landlord (owner of most of the Westfield centres in Australia) has been selling non-core retail assets and increasing its development activity. It's a development pipeline of more than \$3.0 billion is focusing on expanding the food, dining and entertainment precincts, as well as introducing new domestic and international retailers into their centres.

Investor appetite for retail remains strong with 2015 transaction volumes totalling \$7.2 billion, up 24 per cent on 2014 levels. Sales activity was across the retail spectrum with neighbourhood centres, regional centres, CBD centres and large format retail centres all in demand. Two recent transactions symbolise the strength of investor demand for retail assets; Blackstone, the world's largest real estate fund manager, acquired Rundle Plaza Mall in Adelaide CBD for \$400 million – highlighting that our centres are in demand from global institutional investors. ISPT, the industry super backed fund manager, acquired the World Square retail complex in the southern part of the Sydney CBD for more than \$280 million at an aggressive initial yield of 4.5 per cent. However, a shortage of stock is constraining transaction activity.

According to CBRE, retail yields compressed between 20 and 60bps in 2015, with large format retail/bulky goods centres (-58bps) and neighbourhood centres (-52bps) experiencing the largest compression. Regional centre yields compressed by 22bps and sub-regional by 39bps.

Regional centre yields have not firmed to the extent of the other retail sectors primarily due to the lack of transactional evidence – Australia's major "fortress" centres are tightly held and rarely trade. Investor appetite would be strong if these malls were put to market and would certainly trade

on yields below 5.65 per cent as indicated by CBRE – the question is will any of these centres hit the market in 2016?

Retail leasing spreads (the gap between the rent on expiring leases and the rate on new leases – a negative spread indicates the new lease is at a lower rate) remain negative, albeit they are improving, and we would expect this to be the case in the year ahead.

Retailer margins will continue to be under pressure across most retail segments, which limits the amount of rental growth that landlords can achieve in the coming year.

Landlords need to focus on how they can generate superior operating level performance, in other words, how can they drive their retail assets harder.

Retail centre selection will be critical. The bifurcation in performance between good and the not so good centres will be a feature of 2016.

Retailers will continue to focus on their national footprint, and gravitate to those centres located in strong catchment areas with the highest footfall potential. This will mean more store rationalisations by the big brands - the focus will be on store productivity rather than gross store numbers.

Poorly presented centres with weak tenancy mixes should be scrutinised more heavily because a clear divide is developing between those centres that can thrive in a competitive retail environment and those that cannot. Despite this, the weight of money chasing retail assets will see buyer activity across the board.

INDUSTRIAL

The Australian industrial market continues to evolve from older style manufacturing and warehousing to one focused on transport, logistics and e-commerce.

Investor appetite for prime industrial assets is strong, driven by the demand for large distribution facilities. The long leases, quality tenant covenants, larger lot sizes (20,000 square metres plus) and exposure to the buoyant logistics/e-commerce sector are key attractions for institutional investors.

Competition remains strong among developers to secure pre-lease tenants, limiting upward pressure on rents. Rental growth remains weak due to elevated supply levels in most markets except Sydney (where supply levels in 2015 were 30 per cent below the long-term average). Supply levels are anticipated to temper in 2016, which should lead to improved rental growth prospects across most markets.

The Sydney industrial sector is benefiting from much more discipline in bringing new developments to market – unlike the last cycle when speculative development ran well-ahead of demand.

According to CBRE, super prime industrial yields compressed by 70 bps in Melbourne and other key markets falling by circa 30 bps (Table 2). Secondary yields also firmed, to the point where the gap between prime and secondary yields in some markets have converged. This is systematic of the weight of money flowing into the sector, and investors moving up the risk curve in the search for higher yields. We expect investment activity to remain primarily focussed on high quality 'prime' industrial assets. However, like all assets, investors need to ensure they don't over pay for yield at this point in the cycle.

Table 2: Key Prime Industrial Statistics – December 2015

Market/Grade	Avg. Net Rent (\$/sqm)	Annual Change (%)	Avg. Yield (%)	Annual Change (Bps)
Sydney	123	2.4	6.4	-30
Melbourne	80	-3.3	6.3	-70
Brisbane	116	-1.5	6.5	-30
Perth	113	-6.1	7.5	-30
Canberra	109	0.0	8.1	0
Adelaide	83	-3.8	7.8	-10

Source: CBRE



The highlight of 2015 was the transaction of a portfolio comprising 26 industrial assets in July 2015 from GIC (Singapore based)/Fraser's to Ascendas REIT (Singapore based) for \$1.1 billion, on a passing initial yield of circa 5.91 per cent. The portfolio included assets across Australia's eastern seaboard with a weighed average lease expiry of 5.7 years. We understand that there were more than 15 bids received on the portfolio, five of which were short listed with each of those parties above \$1 billion and all representing offshore capital.

Whilst the outlook for demand is positive, both Sydney and Melbourne have a large supply of industrial land with more unzoned land also in reserve. This is expected to contain growth in pre-commitment rents despite improving tenant demand. Nevertheless, there are locations in Melbourne where land availability is tight, especially central and inner Melbourne.

Developers will continue to seek industrial properties in inner city locations for opportunities to convert to residential. This is a trend we believe will continue driven by changing demographics, and also, the changing nature of the industrial sector, with a decline in manufacturing, and the growth in logistics and e-commerce. The latter prefer large distribution centres located near major transport nodes. Hence areas such as Erskine Park in western Sydney, Campbelltown in south-west Sydney, Laverton North and Truganina in Melbourne's west and Yatalla in Brisbane's south are fast becoming major distribution hubs and are key targets for investors looking to acquire state of the art distribution sheds leased to quality tenants on long-term leases.

RESIDENTIAL

The housing sector has played a key role in the recent transition of the Australian economy away from the resource sector. Low interest rates and population growth have fuelled rising house prices and a dwelling construction boom.

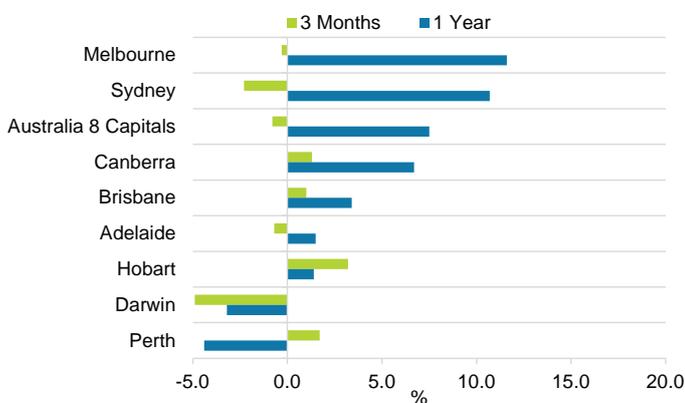
As we enter 2016, the macro prudential tightening cycle looks to be reigning in housing activity in the key markets of Sydney and Melbourne. Yet this has not been enough to quell the debate that Australian housing is expensive, affordability remains poor, and a crash is looming. We don't subscribe to the bust theory, rather we expect the housing market to moderate in 2016.

Despite media headlines making sweeping statements about the residential market, it is important to remember that the residential market is not homogenous. There are a range of factors that drive markets including location and dwelling type (house vs. apartment).

Four of Australia's eight capital cities recorded negative house value movements over the past three months, with Sydney house values falling 2.3 per cent (Figure 21). Values also fell in Darwin (-4.9 per cent), Adelaide (-0.7 per cent) and Melbourne (-0.3 per cent). Hobart recorded the strongest growth in home values over the quarter with a 3.2 per cent capital gain.

The recent slowdown in Sydney prices has pushed the Melbourne market into first place for annual growth in house values with an 11.0 per cent rise compared to Sydney where values are 10.5 per cent higher over the past twelve months.

Figure 21: Residential House Prices: January 2016

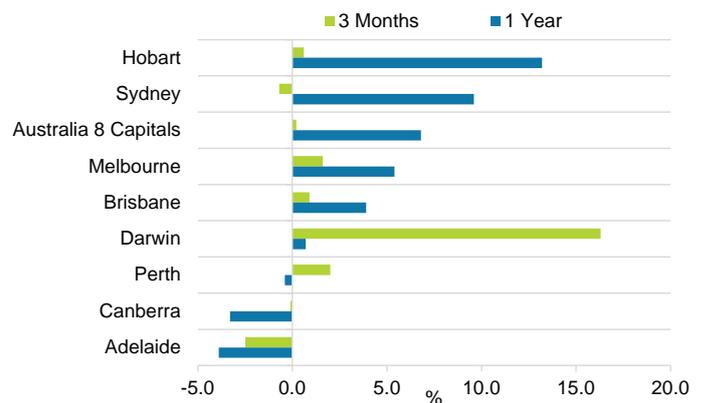


Source: CoreLogic RP Data

Across the apartment market, it was a similar story. Three markets recorded a decline in value in the three months to

January – Sydney (-0.7 per cent) (Figure 22), Adelaide (-2.5 per cent) and Canberra (-0.1 per cent). Across the year, the big winners were Hobart (+13.2 per cent), Sydney (+9.6 per cent) and Melbourne (+5.4 per cent). Adelaide (-3.9 per cent), Perth (-0.4 per cent) and Canberra (-3.3 per cent) were the weakest apartment markets.

Figure 22: Residential Apartment Prices: January 2016



Source: CoreLogic RP Data

Rental growth across the capital cities over the past twelve months has remained flat, although again there is a wide variation in performance across the markets.

Weekly rents in Darwin and Perth fell 13.4 per cent and 8.6 per cent in the past year respectively. The largest rental increases were in Sydney and Canberra of 1.4 per cent and 1.8 per cent, pushing gross rental yields to 3.4 per cent and 4.1 per cent respectively, now only marginally higher than the previous record low.

Given elevated supply in some markets, rental growth is expected to be subdued in 2016.

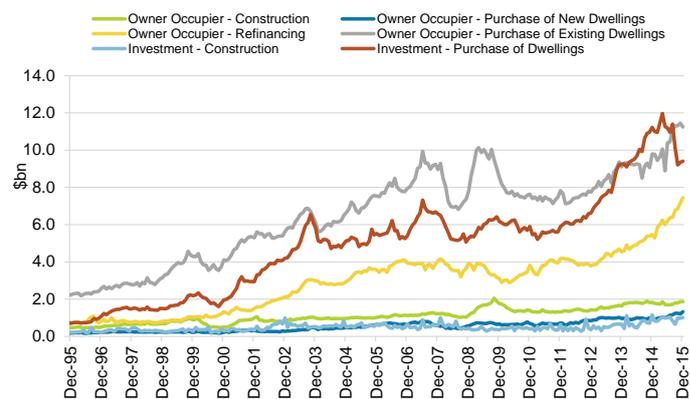
In December 2015, the total value of housing finance commitments was recorded at \$33.5 billion. Over the course of 2015, the composition of lending has changed from being driven by investors and owner occupier refinances to being driven by owner occupied new loans as investor loans fell away (Figure 23).

The macro prudential controls introduced by APRA in December 2014 to strengthen mortgage lending standards appears to be working. APRA insisted that banks should not be increasing their share of higher risk lending, growth in investor lending should not be materially above 10 per cent and appropriate interest rate floors and buffers should be applied in serviceability assessments. As a result, lending standards tightened significantly in 2015 with



annual housing credit growth for investment loans plunging below 10 per cent in the last quarter of 2015. Overall housing credit growth was 7.4 per cent with stronger owner occupied growth (+9.0 per cent) offset by weaker investor volumes (4.7 per cent). Investor lending is now at the lowest level since December 2009.

Figure 23: Housing Credit Growth: 1995 to 2015

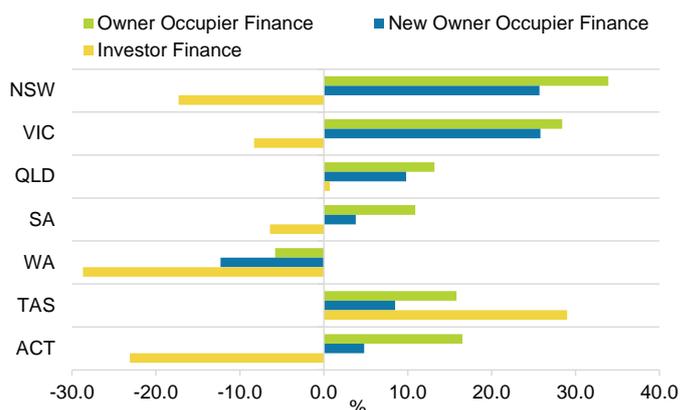


Source: ABS

The share of loans held by investors (value terms) has fallen from a peak of 43 per cent in May 2015 to 34.7 per cent in December 2015 in line with the longer run average of 35 per cent since 2000.

Across the states, there is a marked variation in housing credit trends which generally mirror the change in dwelling values over the year. NSW and VIC have lead the growth in owner occupier finance – up 33.9 per cent and 28.4 per cent respectively (Figure 24). In WA, housing credit fell, with investor finance plummeting by a massive 28.7 per cent.

Figure 24: Housing Finance by State: 12 Months to December 2015



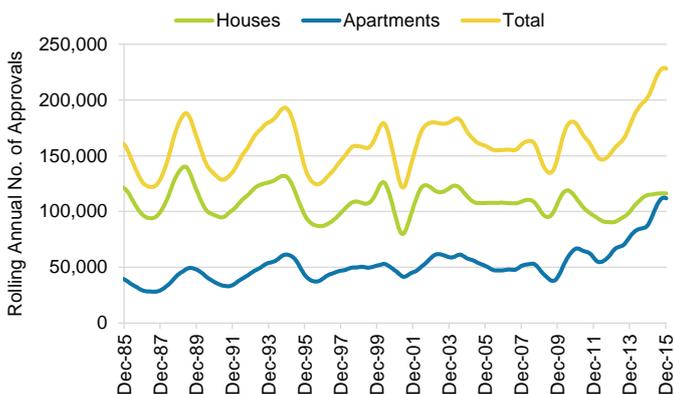
Source: ABS



Looking at 2015 as a whole, a record 228,171 dwellings were approved, 12.3 per cent higher than in 2014. This is almost 50 per cent above the long-term average of circa 155,000 per annum (Figure 25). Prior to 2014, the record high was 201,000 approvals way back in 1973. For the first time ever there was virtually a 50:50 split between detached houses and apartment approvals (Figure 25).

However, the growth during 2015 was not balanced across the market segments - apartment approvals were up a massive 26.6 per cent, while detached house approvals inched up by just 1.3 per cent. The extraordinary growth is a function of convergence of factors including a surge in investor activity driven by low interest rates, and until recently, aggressive lending policies, population growth, affordability (new apartments are typically cheaper than houses) and a significant shift in the acceptance of apartment living and the gentrification of inner city areas where the majority of new apartments are being built.

Figure 25: Housing Approvals by Type: 1985 - 2015

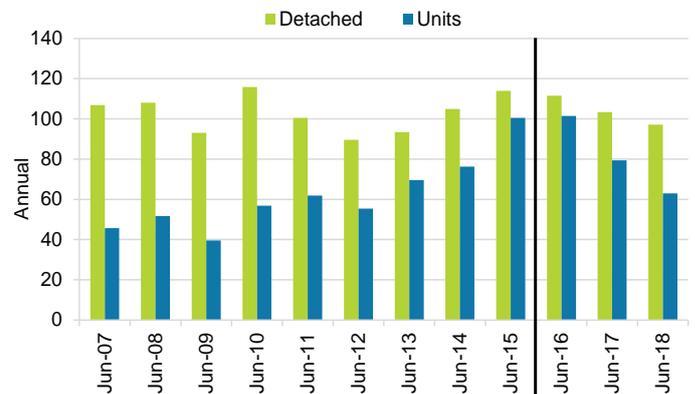


Source: ABS

Approvals have continued to trend lower in the second half of 2015, and at December 2015 were 8 per cent below their April 2015 peak. This is a trend we expect to continue in 2016. This together with the weakness in house prices at the end of 2015 supports our view that the housing market is cooling.

Construction activity should remain elevated in the first half of 2016 as the approvals move through to construction phase. Building approvals should taper off in the second half of the year, and then pull back significantly in 2017. The latest HIA residential building forecasts¹⁰ show dwelling starts falling from a peak of just over 220,000 in 2015 to a cyclical trough of 160,000 in June 2018. The HIA point out that the decline will be more pronounced in the apartment segment than the detached housing segment (Figure 26), with multi-unit commencements falling 37.9 per cent from the peak of 101,500 by June 2018.

Figure 26: Australian Housing Starts: 2007 – 2018



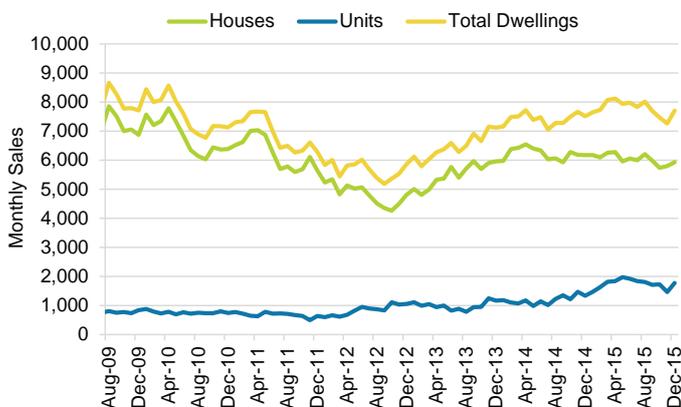
Source: HIA

¹⁰ HIA Housing Forecast – February 2016



We expect that some projects which have recently received development approval will not proceed in this cycle. A cooling market, tighter lending conditions, rising construction costs, and in some cases, inflated prices for sites, will mean the development economics won't stack-up. This could also lead to some sites coming back to market, providing opportunities for developers who had been priced out of the market in recent years. It could also see some sites being used for alternate uses such as hotels, student accommodation and childcare.

Figure 27: New Home Sales: 2009 - 2015



Source: HIA

New home sales were up 6.0 per cent in December 2015, following declines in each of the previous three months. Despite the strong December sales, the level of sales in the December quarter was down 12.3 per cent on the previous quarter and 8.9 per cent lower than in the December quarter 2014.

Consistent with the trends discussed earlier in terms of credit growth and approvals, apartment sales have started trending down, with 1,778 unit sales in December – 10 per cent lower than the peak sales period in May 2015 when 1,976 units were sold.

NSW has been a powerhouse, with detached new home sales in the December quarter 12.5 per cent higher than in the December quarter 2014, whereas in VIC, detached new home sales were up just 0.1 per cent in the December quarter compared to the same time in 2014.

QLD is showing signs of rebounding in the later part of the year (affordability is certainly helping), with detached new home sales 4.3 per cent higher in the December quarter than the previous quarter, and 7.1 per cent higher than the December quarter 2014.

The residential sector is not homogenous and therefore the prospects for residential will vary across markets and between houses and medium density apartments.

Tighter credit conditions, lower yields and affordability issues will temper price growth in the Sydney and Melbourne markets. However, we don't expect these markets to collapse. The Brisbane house and land market should hold-up due to its competitive affordability, while the Perth residential market will continue to struggle following the resource sector downturn. We remain concerned about the risk of oversupply in the South Sydney, inner Melbourne and inner Brisbane apartment markets, and the tighter lending controls on investors will exacerbate the risks in these markets. Our preference in the coming 12 months, is residential land in the growth corridors of Melbourne, Sydney and Brisbane, apartments in Sydney around major transport nodes and residential in well located mixed use developments.

SOCIAL INFRASTRUCTURE

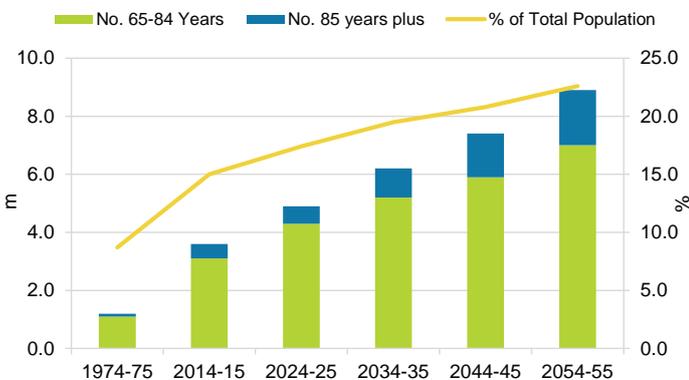
SENIORS LIVING

The seniors housing sector comprising manufactured housing estates, retirement villages and residential aged care, is undergoing significant transformation.

A confluence of factors is driving significant change in the sector – an aging population, the move from a boutique, cottage industry to one of sophistication and scale, a shortage of quality accommodation, increased government spending and finally, the recognition by investors that real estate related social infrastructure is in fact a legitimate investment opportunity. A flurry of ASX listings in the recent years by both specialist aged care operators – Japara, Regis and Estia, and listed A-REITs – Gateway Lifestyles, Ingenia, and Lifestyle Communities have shone the spotlight on the sector. AVEO (the former FKP) is transforming itself into a specialist retirement operator.

The over 65's make up around 15.0 per cent of the population and this is forecast to increase to around 17.4 per cent by 2025 – an increase of 1.3 million people (Figure 28). By 2044-45, 1 in 5 Australians will be aged over 65. The over 85's are growing at a faster rate than the over 65's. In 2015, there were 472,000 Australian's aged over 85, and this is projected to double in the next 20 years. As the number of elderly people increase, they will increasingly demand a seamless transition to different stages in the seniors living continuum from their own home, through to independent living units (retirement villages or a manufactured housing estates) and then into an aged care facility. As a result, we expect to see more integrated facilities where retirement and aged care are co-located.

Figure 28: Australian Population >65 years: 1975 - 2055



Source: ABS and Treasury Projections

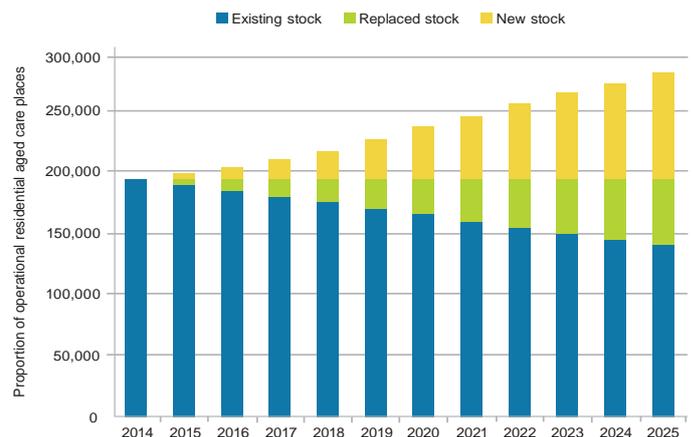
In line with the government's desire to see more people age in place, and a commitment to increase funding for home and community care packages, manufactured housing estates and retirement villages which are designed

to allow older residents a greater degree of independence, will increasingly look to offer additional services and tap into the government's home and community care packages.

Australian penetration rates for retirement villages remain well below some international averages at less than 5.0 per cent. We expect the penetration rates of manufactured housing estates and retirement villages will gradually increase, in line with the improved quality of accommodation that the industry is now delivering and their greater acceptance as a viable accommodation option for Australia's ageing baby boomers.

The Australian Government estimates that the residential care sector will need to build approximately 82,000 additional places over the next decade (Figure 29), compared with 36,778 new places that came on line over 10 years to 30 June 2014¹¹. At the same time, the sector will need to knockdown and rebuild a substantial proportion of its current stock. Assuming that the cost of construction continues to grow at about the current rate, and that a quarter of the current stock of buildings is rebuilt at an even rate over the next decade, the Government estimates that the investment requirement of the sector over the next decade to be in the order of \$33 billion.

Figure 29: Number of Operational Residential Aged Care Places Required Between 2014 – 2025



Source: Aged Care Financing Authority

We remain convinced that the seniors living sector in Australia will continue to professionalise, consolidate and become more attractive as an investment asset class. This will require a significant amount of capital, and we see great opportunity for investors taking a long term investment view and partnering or acquiring quality management teams to drive this structural change.

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SENIORS LIVING FACILITIES

The seniors living sector comprises three main types of accommodation:

Manufactured Housing Estates – also known as relocatable home parks, are a retirement style concept that provide an affordable 'lifestyle' product which is an alternate to traditional retirement villages. Manufactured housing estates operate under a ground lease agreement in which the resident owns the relocatable home and leases the right to occupy the site from the village owner/operator. Community facilities generally available include swimming pools, bbq's, bowling greens, tennis courts and a community centre. Residents pay a rental for the site (and sometimes an exit fee) which includes a fee for the use of the common area facilities and the maintenance of the roads and common areas.

Retirement Villages – established for over 55's but typically cater for people 70's plus. The villages usually comprise units (hence they are often termed independent living units). The residents don't own the unit but will live in the village subject to a lease or licence to occupy. Retirement villages typically operate under a deferred management fee (DMF) structure. Under a DMF the resident pays a sum coming into the village (typically below the value of a similar unit in the area that is not in the retirement village) and upon exit when they sell the unit, the operator retains a portion of the sale price based on a predetermined formula which is based on the length of stay in the village (capped at a certain number of years) and may also take into account the capital growth of the unit. The resident will also pay an on-going fee to cover the cost of operations and maintenance of the village.

Aged Care Centres – a special-purpose facility which provides accommodation and other types of support, including assistance with day-to-day living through to intensive forms of nursing care to frail and aged residents. Facilities are accredited by the Aged Care Quality Agency to receive funding from the Australian Government. Aged care facilities often provide different types of care including dementia, palliative and respite care - which provides short-term support for people whose carers are unable to meet usual care arrangements or if someone is ill and needs an extra level of temporary support. Residents can pay for their accommodation in either a lump sum or a daily payment or a combination of both. Residents care is funded by a combination of government funding and private pay services depending on their level of care requirements and hotel-style services they desire.



EARLY LEARNING

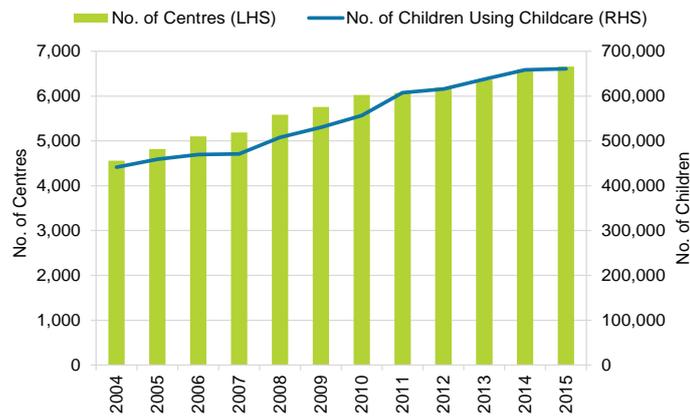
Demographic and socio-economic changes continue to drive the demand for early learning (childcare) accommodation.

Early learning is now seen as both a mechanism to support labour force participation (particularly driven by the increase in female participation in the workforce) and an important form of early learning and education.

The number of females working has increased substantially since the 1970's. The proportion of women working has increased from 43 per cent in the late 70's to just under 60 per cent.

Since 2004, the number of children using long day care child care has increased by 219,520 or approximately 50 per cent from 441,240 to 660,760 in March 2015 (Figure 30). As at March 2015, there were approximately 6,656 long day care centres in Australia, an increase of 2,099 centres or 46 per cent since 2004¹² (Figure 30). Despite the large increase in the number of centres, there continues to be unmet demand, as evidenced by lengthy waiting lists, in many areas across Australia.

Figure 30: Number of Long Day Childcare Centres and Children Using a Long Day Childcare Centre: 2004 - 2015

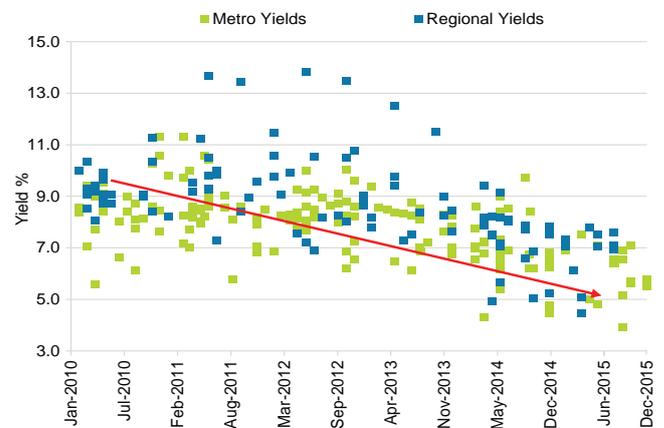


Source: Australian Government

We believe early learning centres will continue to offer an attractive real estate investment opportunity in 2016.

Over the past few years, childcare centre yields have declined as investors increasingly recognise the benefits of investing in childcare real estate (Figure 31).

Figure 31: Early Learning Centre Sale Yields: 2010 - 2015



Source: Folkestone

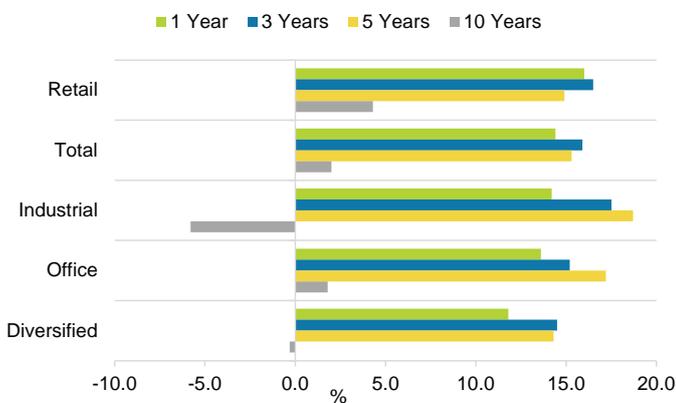
We believe early learning centres will continue to offer an attractive real estate investment opportunity in 2016 given:

- the lease structure – a combination of a long duration initial lease term of circa 15 years (the current Folkestone portfolio average is 7.9 years), positive rental growth given rental increases are typically linked to CPI changes and are triple-net in structure which means that all capital expenditure and refurbishments related to the centre are paid by the tenant;
- the quality of early learning centres is improving – newer centres are high quality purpose built centres rather than the 'converted residential premises';
- tenants are inherently linked to their premises due to the specialised nature of the centres;
- the on-going demand for early learning and child care places;
- government funding support of the sector; and
- significant long term alternate use prospects, particularly for medium density housing.

A-REIT's

The ASX listed Australian Real Estate Investment Trust (A-REIT) sector continues to be a popular investment option for investors looking to access quality real estate in a more liquid form than direct real estate. Notwithstanding the A-REIT sector's strong performance in 2015 of 14.4 per cent, there was a marked variation in the performance across the various A-REIT sectors (Figure 32) and individual A-REITs (Figure 33) during the year.

Figure 32: A-REIT Sector – Total Returns: Year Ending 31 December 2015



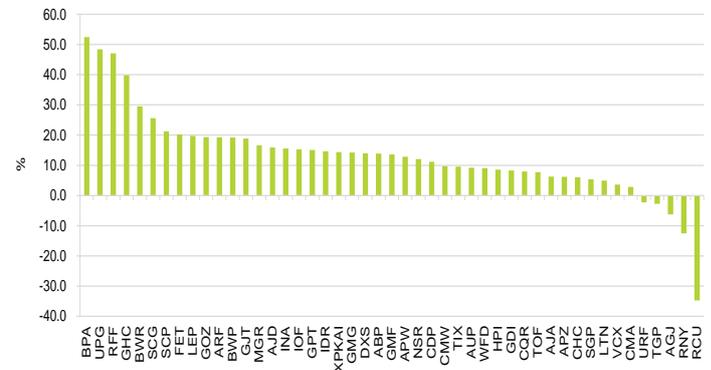
Source: UBS

The spread in returns between sectors was 240 basis points with retail the stand-out performer, driven by strong returns from Scentre Group (SCG) (26.2 per cent) and SCA Property Group (SCP) (21.2 per cent).

The spread between the best and worst performing A-REITs was a massive 87.3 percentage points. Brookfield Prime Property Fund (BPA) generated a total return of 52.5 per cent and at the other end of the spectrum, Real Estate Capital Partners USA Property Trust (RCU) generated a total return of -34.8 per cent.

The variation in performance is a stark reminder to advocates of Indexing this sector, that active stock-picking can add value. This is no more evident than in the Folkestone Maxim A-REIT Securities Fund which is a high conviction manager that invests in listed A-REITs and real estate securities based on their view of individual securities with no reference to their weightings in the Index. The Fund returned 16.8 per cent on an after fees, pre-tax basis outperforming the Index by 250 basis points and was the best performing A-REIT securities fund in the Mercer Institutional A-REIT Securities Fund Survey at 31 December 2015.

Figure 33: A-REITs Total Returns: Year Ending 31 December 2015

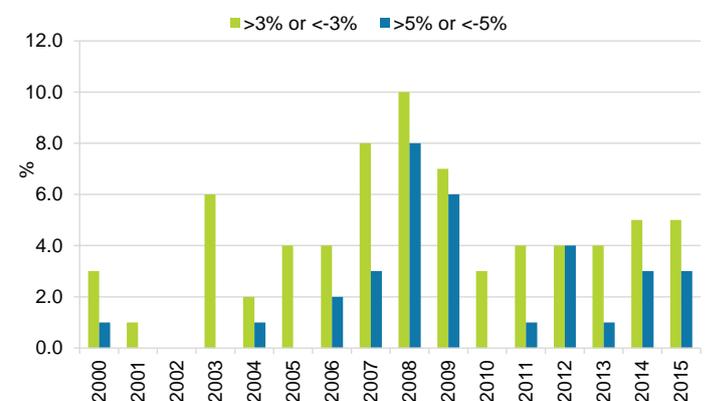


Source: IRESS

The volatility of A-REITs has increased significantly in recent years. In 2015, the S&P/ASX 300 A-REIT Index was up or down by more than 3 and 5 per cent in a month on five and three occasions respectively. Go back 10 years to 2005, and movements of this magnitude only occurred on four occasions of up or down by 3 per cent and there was not one month where the return was plus or minus 5 per cent in a month. We put the increased volatility down to three factors:

1. general equity investors turning to the A-REIT sector given its defensive characteristics and relatively attractive dividend yield;
2. increased hedge fund activity in the large cap A-REITs; and
3. the on-going uncertainty in global equity markets which is impacting all listed securities.

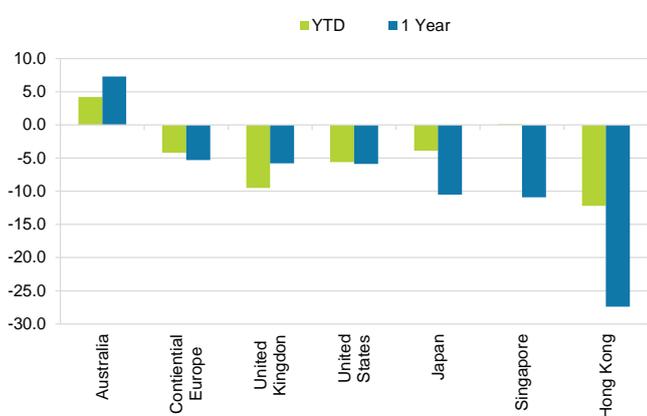
Figure 34: A-REIT Volatility: 2000 - 2015



Source: IRESS

Notwithstanding the heightened volatility, the A-REIT defensive qualities have demonstrated in a tough market. The A-REITs are the only major REITs market globally to post a positive total return in the year to 19 February 2016 (Figure 35) and have significantly outperformed Australian equities YTD by 10.4 percentage points (4.2 per cent versus -6.2 per cent).

Figure 35: A-REITs vs Global REITs: 12 Months to 19 February 2016



Source: Thomson Financial Datastream/UBS

Given the heightened concerns around global capital markets, the A-REIT sector appears better placed to weather major shocks in the capital markets than it was during the GFC. Gearing levels are lower (circa 30 per cent versus 37 per cent), payout ratios are more sustainable (circa 90 per cent versus 100 per cent plus), the off-shore exposure is significantly less (5 per cent versus 37 per cent) and pricing seems more reasonably (premium to NTA of 37 per cent versus 70 per cent).

In addition, since the GFC, the A-REITs have worked to improve the quality of their portfolios through new development, redevelopment of existing properties, and recycling older properties which are more susceptible to obsolescence. The lack of acquisitions and an increase in disposals should not be looked at in a negative light. Instead, investors should be applauding the A-REITs that have been disciplined in their capital allocation, focusing on maintaining low leverage and growing earnings through active asset management instead of attempting to increase earnings through higher leverage and short-term property plays.

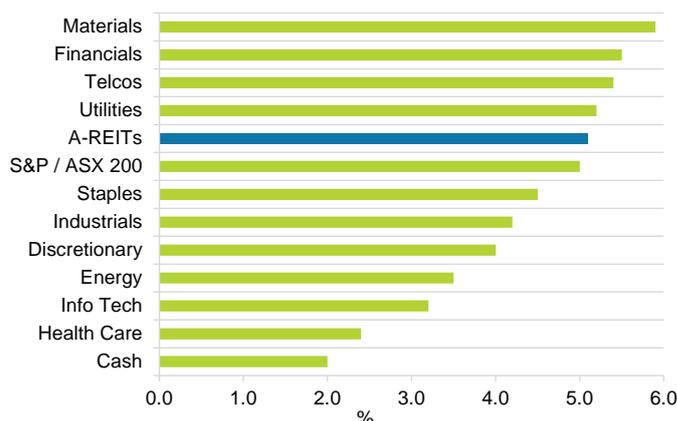
2016 is shaping up as another year where performance will vary across both sectors and individual A-REITs. Stock picking will be crucial.

We expect equity issuance in 2016 to remain at subdued levels. With pricing of assets getting close to historical highs, A-REITs will be less competitive than unlisted funds and foreign investors in acquiring new assets. We expect the A-REITs to take the opportunity to recycle capital and sell non-core assets into the market to improve asset quality and where possible, redeploy the proceeds to fund development and refurbishment activity across their portfolio

M&A activity was alive and well in 2015. Novion and Federation merged to create Australia's second largest retail landlord now called Vicinity Centres (VCX), 360 Industrial Trust (TIX) after a protracted hostile takeover finally secured Australian Industrial Trust (ANI), and at the end of the year, Dexus (DXS) and Investa Office Fund (IOF) agreed terms to merge (the unitholder meeting is scheduled for April 2016). We expect further M&A activity in 2016 driven by the push for scale and the lack of buying opportunities in the direct market.

We expect A-REITs to deliver a total return of circa 10 per cent in 2016, underpinned by dividend yield of 5 per cent. The A-REITs present well on yield relative to the cash rate and other ASX listed equity sectors (Figure 36). Despite the sector trading on 15.3x, a 10 per cent premium to the historic average of 13.9x, we believe the A-REITs will be well supported given their relatively visible earnings and distribution growth, which will be attractive for investors looking for defensive income streams in the current uncertain environment, and the potential for further NTA uplift coming into the August 2016 reporting season.

Figure 36: ASX Sector Yields and Cash Rate – February 2016



Source: IRESS

OUTLOOK



Despite an uncertain economic environment, we expect steady real estate demand across most non-residential sectors with the exception of Perth, which is being impacted by the resource sector downturn. Notwithstanding cap rates are nearing pre-GFC lows given the weight of money chasing real estate assets, capital values for quality assets (i.e. those with strong covenants, long leases and quality locations) will rise in the year ahead, albeit not to the extent recorded in 2015.

International investors will continue to be active buyers in Australia particularly for prime office, retail and industrial assets making it difficult for local investors who typically have a higher cost of capital to compete.

We are now seven years into the up-cycle, and we see less upside to many markets than we have in recent years. Valuations are not cheap enough in many instances to reflect the risk we see from the macroeconomic headwinds.

The availability of equity from domestic and international investors and debt from lenders will be critical. Should one or both of these sources of capital contract due to concerns about economic or capital market conditions, it could place pressure on values especially for secondary assets unless there is a clear strategy for value creation.

The challenge in this environment is to avoid broad “beta” plays on real estate (investing in the hope that the market uplift will drive asset performance) or simply taking greater risk in search of higher (yield) returns.

Easing capital market tailwinds and close to full valuations in some markets will mean that earnings growth rather than yield compression will be the key driver of value creation going forward.

Investors seeking higher returns by taking on more risk may not be rewarded. Instead investors should focus on value-creation through active management of assets via releasing, repositioning or refurbishing. Now is not the time to stretch on price or overcommit to acquisition-driven strategies – maintaining investment discipline will be key. Be disciplined, and be patient. Sometimes being defensive, including raising some extra cash, is actually an offensive move as it creates optionality when the future appears most uncertain. In our view, the next 12 to 24 months could be one of those times.

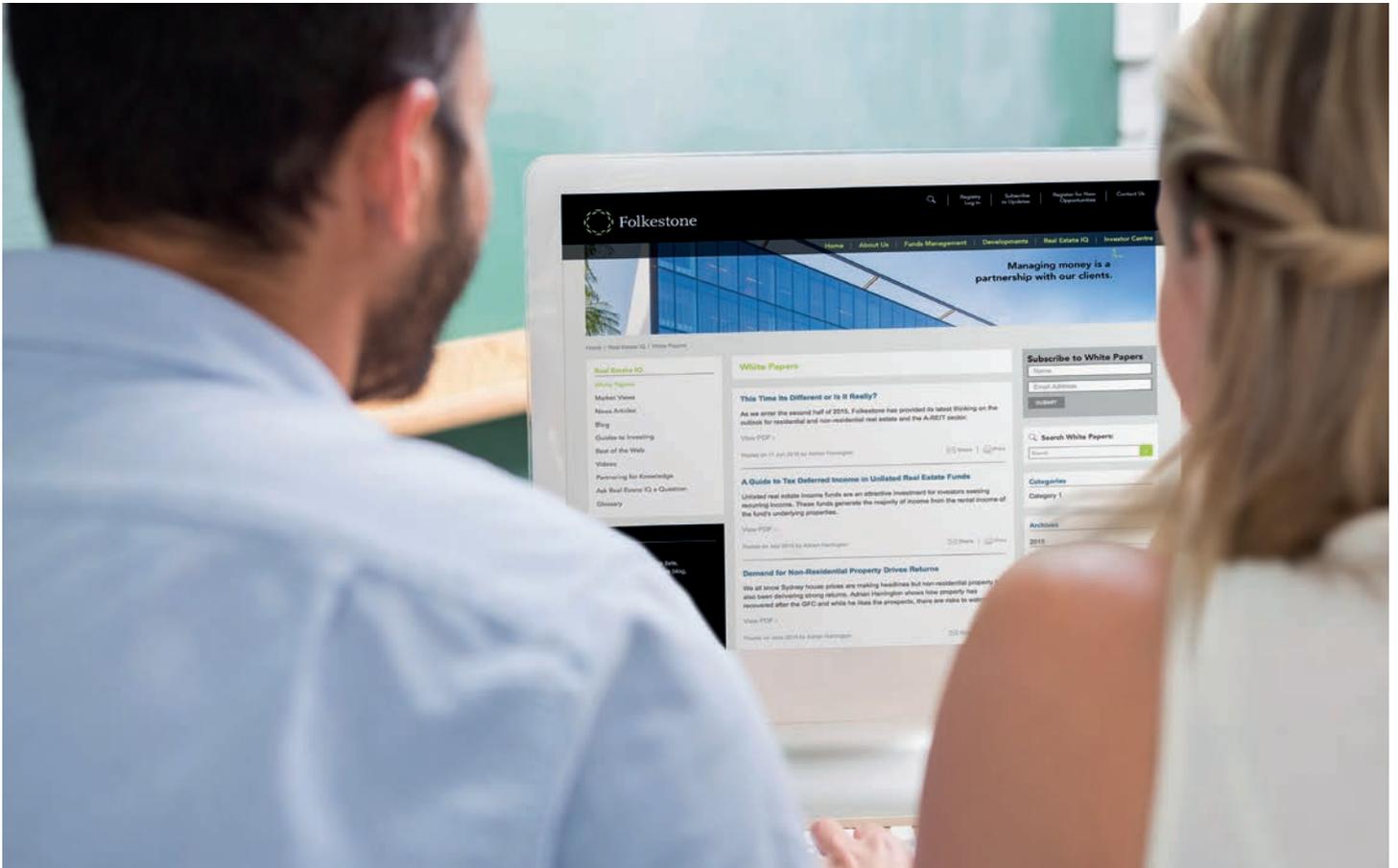
We continue to believe that real estate related social infrastructure (childcare, seniors living, healthcare and student housing) will offer attractive investment returns in the coming year. The demographic drivers and a shortage of quality accommodation in these sectors will see investors increasingly look at these investments as a legitimate part of a real estate portfolio.

The residential sector is not homogenous and therefore the prospects for residential will vary across markets and between detached housing and medium density housing. Tighter credit conditions, patches of over supply, lower yields and affordability issues will temper price growth in the Sydney and Melbourne markets - the double digit growth recorded in the past two years is not sustainable. However, we don't expect these markets to collapse.

We believe the residential market will moderate in 2016, with a slow down in the rate of price growth and construction activity from historical highs. The apartment markets in south Sydney, inner Melbourne and inner Brisbane will come under pressure due to an oversupply of apartments and a slowdown in investor activity.

Our preference in the coming 12 months, is well located, residential land offering affordable product in the growth corridors of Melbourne, Sydney and Brisbane, apartments in Sydney around major transport nodes and residential in mixed use developments.

We will also look for selected real estate investment and development opportunities in large regional towns which offer key services, strong catchment areas, diversified economies and medium to long-term growth prospects.



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Folkestone

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