RESEARCH

MELBOURNE OFFICE STOCK WITHDRAWALS

DEVELOPMENT MARKET INSIGHT OCTOBER 2016

HIGHLIGHTS

Across Melbourne's office markets 208,066m² of office stock is forecast to be permanently withdrawn between 2016 and 2019, equating to 2.5% of all Melbourne's office stock.

Predominantly, office stock across Melbourne markets will be withdrawn for residential development, accounting for 69% of the office area to be withdrawn between 2016-2019.

Between 2016—2019 St Kilda Road office space withdrawals are forecast to account for 37% of total withdrawals followed by the CBD office market (26%) and the suburbs (19%).

KEY FINDINGS

Permanent withdrawals of office stock increased **by 93% in 2015** to 94,101m^2, **the highest level in 15 years.**

There has been **increasing interest from student accommodation** providers for redevelopment of offices.

Beyond 2019, the Suburban office market accounts for the bulk of potential future office redevelopment.

Permanent **withdrawals are expected to result in office vacancy rates falling** below 10-year averages.

RICHARD JENKINS
Director—VIC Research

Follow Richard at @RJenkinsR

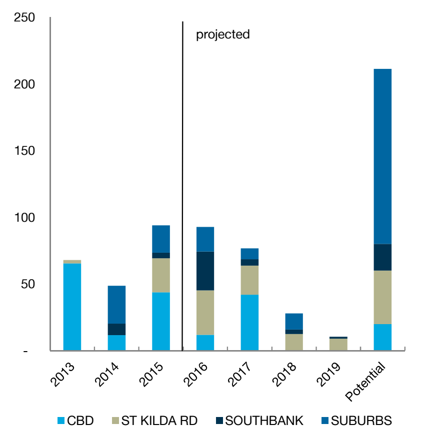
"Across Melbourne's office markets 208,066m² of office stock is forecast to be permanently withdrawn between 2016–2019 with 14,894 apartments proposed."

INTRODUCTION

While the CBD office market accounted for the bulk of withdrawals prior to 2016, over the next three years, St Kilda Road office space is forecast to lead all other markets for office withdrawals.

Permanent withdrawals of office stock across Melbourne's office markets reached their highest level in 15 years in 2015, having increased 93% on 2014 levels. Withdrawals for 2016 are expected to surpass 90,000m^2 again, led by withdrawals in the St Kilda Road and Southbank office markets.

FIGURE 1
Permanent Office Stock Withdrawals
'000m² by market



Source: Knight Frank Research

Having previously witnessed the redevelopment of largely secondary offices in the late 1990s through the implementation of "Postcode 3000", the CBD is once again the epicentre of apartment supply in the Inner Melbourne region. Between 2013 and 2015, the bulk of withdrawals across Melbourne's office markets were located in the CBD which accounted for 57.5% of total withdrawals.

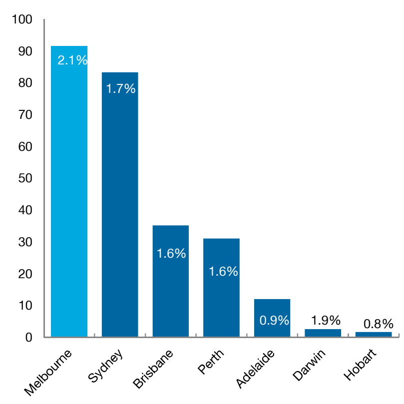
Despite new supply of Inner City apartment development running double the long term average, somewhat surprisingly, the residential vacancy level of the Inner Melbourne precinct fell over the last year. The City of Melbourne's population is expected to experience an increase of over 77,600 people to 181,325 by 2031 which is likely to support the elevated level of apartment development activity.

Victoria's population growth leads the nation. In the year to July 2015, Greater Melbourne attracted around 91,000 people, or 1,750 people a week. Looking forward, according to the ABS, the population of Melbourne is expected to grow to 6.0 million people in 2031.

In order to guide Melbourne's growth to 2050, the Victorian State Government released a new Metropolitan Planning Strategy "Plan Melbourne". As part of the Melbourne Metropolitan Strategy, Plan Melbourne has identified priority and potential urban renewal sites to harness opportunities from significant parcels of government held land and under-utilised industrial land in proximity to the existing infrastructure, especially public transport links.

Outside of the CBD office market, over the next four years, there is 154,118m^2 of office space to be withdrawn with at least 8,587 apartments currently proposed for St Kilda Road, Southbank and Suburban offices.

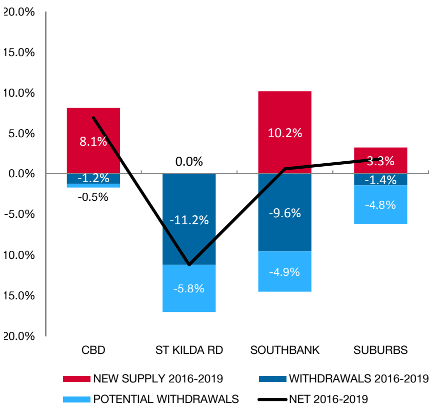
FIGURE 2
Population Growth 2014-2015
'000 annual change—by capital city



Source: ABS/Knight Frank Research

WITHDRAWAL ANALYSIS

FIGURE 3
Permanent Withdrawal v New Supply
% of current stock base—by market



Source: Knight Frank Research

Withdrawal of largely secondary office stock has also aided the fall in office vacancy rates across Melbourne's office markets. Within the CBD, permanent withdrawals in the next three years is forecast to account for 1.2% of stock against new construction of 8.1%. With no new office developments currently under construction in the St Kilda Road office market, office stock levels are forecast to continue to decline in the precinct. The level of permanent withdrawals between 2016 and 2019 in the St Kilda Road represents 11.2% of the current stock base. Elsewhere net office stock levels in Southbank and the Suburban office markets are forecast to increase marginally between 2016-2019.

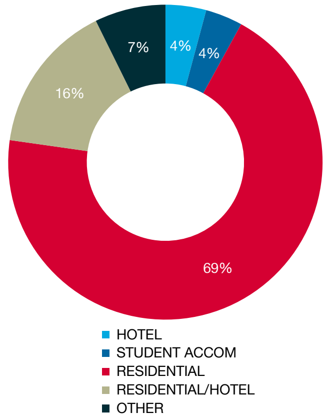
The vast majority of offices being withdrawn between 2016 and 2019 will be redeveloped (97%) compared to conversion (3%). All of those offices identified for conversion are located within the CBD office market.

The predominant driver for the withdrawal of office stock in the Melbourne market has been demand for residential accommodation supported by the nation-leading population growth of Victoria. As seen in Figure 4, residential development clearly dominates the reasons for the withdrawal of office space, accounting for 69% of the office area to be withdrawn between 2016-2019.

Outside of residential development uses there has been increasing interest from student accommodation providers. Given the falling Australian dollar, increasing number of overseas student enrolments and chronic shortage of suitable purpose built supply; a number of offices have been purchased for student accommodation redevelopment. UK-based Scape Student Living has purchased 393 Swanson St, Melbourne and 212–222 La Trobe Street, Melbourne while local provider Blue Sky has recently gained development approval for a 793-student bed development at 42-50 La Trobe Street, Melbourne.

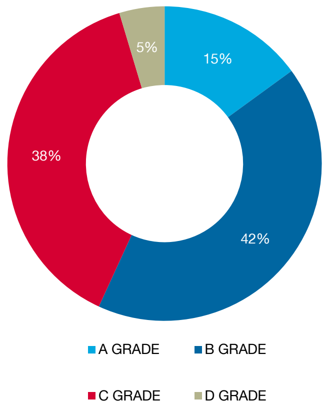
Similar to the growth of student accommodation development, the falling Australian dollar has also led to increased demand for hotel rooms. According to the Australian Bureau of Statistics, 693,200 short-term visitors arrived in June 2016, the largest one-month total on record. Acquisitions for hotel and residential/hotel redevelopment have largely been focused within the CBD, however with Asian Pacific Group's inclusion of 100 hotel suites within their Whitehorse Towers mixed use redevelopment, 836-850 Whitehorse Road, Box Hill shows hotel development broadening beyond the CBD.

FIGURE 4
Melbourne—Reason for Withdrawal
CBD, Southbank, St Kilda Rd and Suburban Office Withdrawals 2016—2019



Source: Knight Frank Research

FIGURE 5
Melbourne Office Withdrawals
By grade 2016-2019 & potential



Source: Knight Frank Research

The recent trend of tenants relocating into the CBD coupled with the acceptance of the medium density in prime urban locations has also led to the redevelopment of a number of former offices, particularly in the suburban office market. Having previously been occupied by SKM who relocated into the CBD, 590 Orrong Road, Armadale is currently being redeveloped into a 250-dwelling residential project, while Engineers Australia's former offices in North Melbourne is earmarked for future residential development.

Unsurprisingly the vast majority of permanent withdrawals of office stock forecast across Melbourne's office markets beyond 2016 are of secondary quality. While identified permanent withdrawals within A-grade office buildings account for 15% of total withdrawals, at present, all A-grade space is considered as potential withdrawals, with no formal date for withdrawal.

Within the CBD specifically, collectively the Flagstaff and Spencer precincts account for 60.9% of permanent withdrawals beyond 2016. With the exception of the Docklands precinct, Knight Frank Research has identified permanent office withdrawals across all CBD office precincts beyond 2016.

MELBOURNE CBD WITHDRAWALS

1. 35 Spring St, CBD—11,698m²
Cbus Property—H2 2013
Residential Redevelopment

2. 464-466 Collins St, CBD—1,044m²
Golden Age—H1 2014
Residential Redevelopment

3. 85 Spring St, CBD—10,700m²
Grocon—H2 2015
Residential Redevelopment

4. 383 King St, CBD—12,975m²
Haileybury College—H1 2015
Educational Use Conversion

5. 380 Lonsdale St, CBD—4,890m²
Brady Group—H1 2015
Residential Redevelopment

6. 393 Swanston St, CBD—4,738m²
Scape Student Living—H1 2016
Student Accommodation Redevelopment

7. 560 Lonsdale St, CBD—2,573m²
Central Equity—H2 2016
Residential Redevelopment

8. 48-50 La Trobe St, CBD—2,144m²
Blue Sky—H2 2016
Student Accommodation Redevelopment

9. 212-222 La Trobe St, CBD—1,073m²
Scape Student Living—H2 2016
Student Accommodation Redevelopment

10. 227-279 Flinders Ln, CBD—3,826m²
Wake Up Hostels—H1 2017
Hotel Conversion

11. 280 Queen St, CBD—3,130m²
Austhome/Brady Group—H1 2017
Residential Redevelopment

12. 33-35 King St, CBD—850m²
BPM—H1 2017
Residential Redevelopment

13. 600 Collins St, CBD—7,995m²
Landream—H2 2017
Residential Redevelopment

14. 383 La Trobe St, CBD—10,211m²
Sterling Global—H2 2017
Residential/Hotel Redevelopment

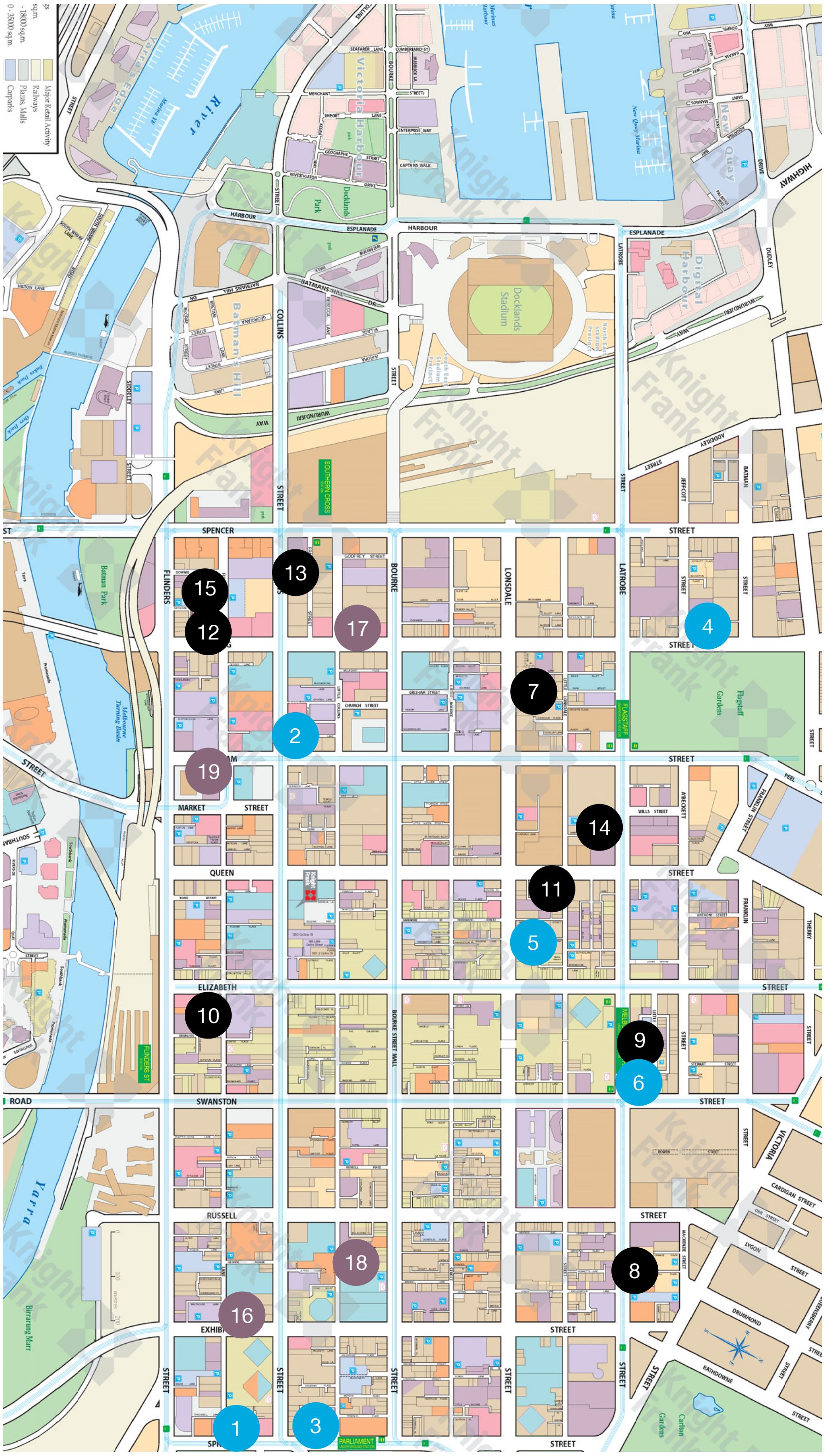
15. 539-545 Flinders Ln, CBD—3,300m²
Tune Hotels—H2 2017
Hotel Redevelopment

16. 63 Exhibition St, CBD—6,048m²
Asia One/Salta Property
Potential Residential Redevelopment

17. 121 King St, CBD—2,900m²
Capital Alliance King
Potential Residential/Hotel Redevelopment

18. 130 Little Collins St, CBD—2,508m²
Uniting Church Australia
Potential Residential/Hotel Redevelopment

19. 22 William St, CBD—5,700m²
Orion Homes Australia
Potential Residential Redevelopment



Office Stock Withdrawn

Expected Withdrawals

Potential Withdrawal Targets

Source of Map: Knight Frank
As at October 2016
Office NLA quoted.

ST KILDA ROAD WITHDRAWALS

1 — 14 Queens Rd, St Kilda Rd—9,600m²
Hallmarc Developments—H1 2015
Residential Redevelopment

2 — 601 St Kilda Rd, St Kilda Rd—10,241m²
Summerhill Property—H1 2015
Residential Redevelopment

3 — 450 St Kilda Rd, St Kilda Rd—4,585m²
Golden Age—H2 2015
Residential Redevelopment

4 — 20 Queens Rd, St Kilda Rd—4,276m²
JD Group—H1 2016
Residential Redevelopment

5 — 499 St Kilda Rd, St Kilda Rd—11,099m²
LAS Group/Qualitas—H1 2016
Residential Redevelopment

6 — 75 Palmerston Cres, St Kilda Rd—400m²
Enshine—H1 2016
Residential Redevelopment

7 — 74 Eastern Rd, St Kilda Rd—1,252m²
GURNER—H2 2016
Residential Redevelopment

8 — 412 St Kilda Rd, St Kilda Rd—16,285m²
UEM Sunrise—H2 2016
Residential Redevelopment

9 — 7 Bowen Cres, St Kilda Rd—4,244m²
GURNER—H1 2017
Residential Redevelopment

10 — 424-426 St Kilda Rd, St Kilda Rd—12,357m²
CLL@AU—H1 2017
Residential/Hotel Redevelopment

11 — 10 Queens Rd, St Kilda Rd—8,960m²
LK Property Group
Potential Residential Redevelopment

12 — 420 St Kilda Rd, St Kilda Rd—10,562m²
Chip Eng Seng
Potential Residential Redevelopment

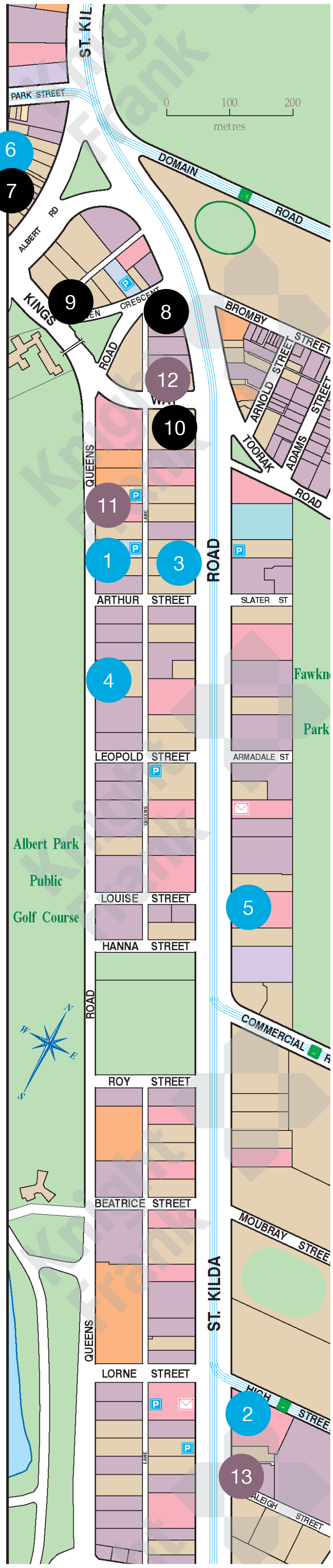
13 — 613 St Kilda Rd, St Kilda Rd—1,314m²
Golden Asset Group
Potential Residential Redevelopment

Office Stock Withdrawn

Expected Withdrawals

Potential Withdrawal Targets

Source of Map: Knight Frank
As at October 2016
Office NLA quoted



The last major office development in the St Kilda Road office market was the strata re-development at 1 Queens Road completed in 2003. Prior to this, the last major commercial development built on St Kilda Road was 417 St Kilda Road in 1991.

With 31,460m^2 withdrawn from the St Kilda Road office market in the 12 months to July 2016, office stock in the precinct has now shrunk by 20% from its peak of 871,030m^2 in 1992.

Recent withdrawals for residential development from the St Kilda Road office market include 450 St Kilda Road (4,585m^2), 601 St Kilda Road (10,241m^2) and 499 St Kilda Road (11,099m^2).

Of the office space to be withdrawn and identified to be redeveloped, 100% is within secondary offices, led by B-grade office buildings. Predominantly, St Kilda Road offices will be withdrawn for residential redevelopment which accounts for 67% of total withdrawals between 2016 and 2019. The level of office stock withdrawn in the St Kilda Road precinct expected over the next three years is double that achieved over the preceding three years to 2016.

Outside of residential development uses, the area is emerging as a health precinct with Australian Unity proposing to redevelop their head office at 114-124 Albert Road, South Melbourne into an integrated aged care and retirement living facility. Previously Singapore-based International Healthway Corporation purchased two St Kilda Road offices seeking to diversify into Australia. IHC were attracted into the St Kilda Road precinct given its proximity to the Alfred hospital and Australia's ageing population profile.

With the new Domain station currently being developed, access will be significantly improved to St Kilda Road, further encouraging residential development. Beyond 2019, office stock in St Kilda Road is forecast to continue to decline with a further 40,025m^2 earmarked for potential redevelopment.

SOUTHBANK & SUBURBAN MARKETS

Permanent withdrawals of office stock within the Southbank office market will accelerate through 2016, more than six-fold above 2015 levels. In fact, Southbank permanent withdrawals over 2016 will reach record high levels with 29,168m^2 forecast to be withdrawn. Between 2016 and 2019, 38,636m^2 of office stock has been identified as expected withdrawals, with a further 20,000m^2 of potential withdrawals.

Southbank offices which are expected to be withdrawn in the near future include: 43-47 City Road (1,096m^2), 147-155 City Road (2,143m^2) and 158 City Road (4,014m^2). Overwhelmingly the leading change of use of Southbank office stock is residential, which accounts for 80% of Southbank stock to be withdrawn between 2016 and 2019. In addition to residential there are a number of residential/hotel developments and hotel projects proposed for the precinct.

Complementing the population growth, the gentrification of Melbourne's activity centres and the acceptance of the medium density in prime urban locations has also led to increased apartment development in the suburbs.

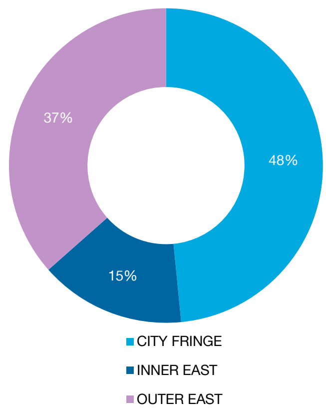
Despite the increasing number of suburban office buildings being redeveloped, the level of permanent withdrawals over the next three years represents 1.4% of the current Suburban office stock base.

The bulk of the suburban office space identified for potential redevelopment is located in the City Fringe precinct which accounts for 48% of total suburban withdrawals. Outside the City Fringe, reflecting the Government's encouragement of the gentrification of Melbourne's activity centres is the increasing level of apartment development in suburban hubs. Box Hill, one of Melbourne's recognized activity centres has almost 30,000m^2 of office space to be permanently withdrawn over the medium term.

FIGURE 6

Suburban Office Withdrawals

By region 2016-2019 & potential

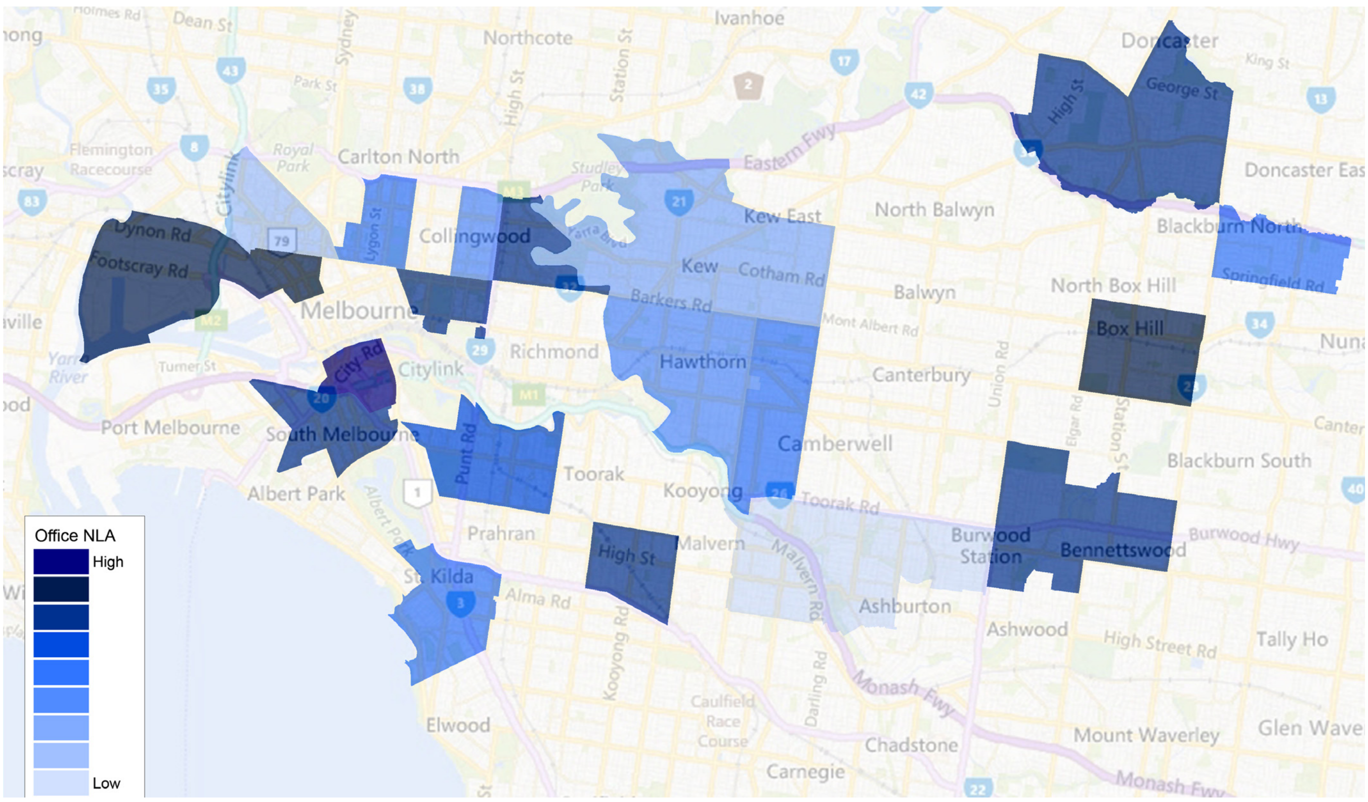


Source: Knight Frank Research

FIGURE 7

Distribution of Southbank & Suburban Office Withdrawals 2013-2019 & potential

'000m² by suburb



Source: Knight Frank Research

INVESTMENT ACTIVITY

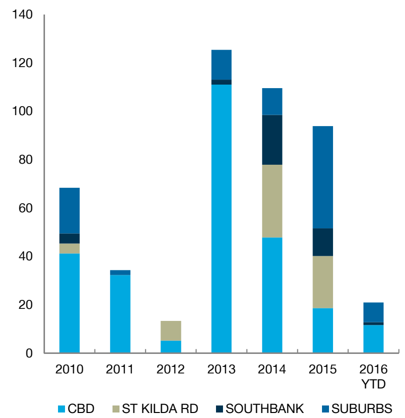
Investor demand for redevelopment opportunities also remains intense. Since 2013, offices purchased for a change of use across Melbourne's office markets have surpassed $500 million each year. In 2016 to date, $213.96 million of Melbourne offices were purchased for redevelopment purposes.

Since 2013, in total, 349,577m^2 of space across Melbourne's office markets was purchased for a likely change of use in the short to medium term.

FIGURE 8

Withdrawal Office Stock Sales

'000m² by market



Source: Knight Frank Research

Unsurprisingly, investors focused on secondary grade assets which offered higher and better uses, typically residential. Since 2013, B-grade assets accounted for 44.5% of sales volume of offices purchased for a likely change of use. In contrast, A-grade assets only accounted for 0.6% of offices sold for redevelopment purposes.

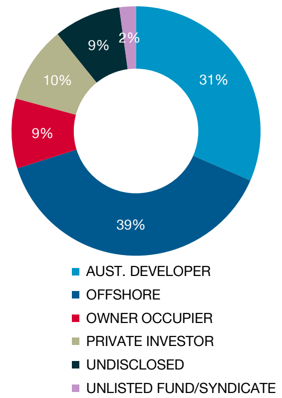
While the CBD office market accounted for 88% of office redevelopment sales (by NLA), by 2015, this proportion fell to 20%. Alternatively, developers turned their attention to the suburban market. In 2015, suburban offices which are earmarked for redevelopment accounted for 45% of office redevelopment transactions.

Of the offices identified for permanent withdrawals from 2016 onwards across the Melbourne's office markets, local developers and offshore groups collectively account for 70% of office space to be withdrawn. Offshore-owned assets earmarked fpr permanent withdrawals are dominated by Asian-based groups, led by Chinese, Malaysian and Singaporean investors, however

FIGURE 9

Melbourne Office Withdrawals

By owner type, 2016-2019 & Potential



Source: Knight Frank Research

Middle Eastern and European groups also own identified redevelopment opportunities.

Future

With Melbourne projected to be Australia's largest city by 2030 and the growing momentum of people preferring to live closer to places of work, well located office buildings offering potential for residential development are likely to remain of interest to developers in the medium term across all office markets.

TABLE 1

Recent Major Sales Activity Melbourne - Conversion or Demolition Assets

Address	Precinct	Price $ mil	Bld NLA m²	$/m² NLA	Site m²	$/m² Site	WALE yrs	Vendor	Purchaser	Sale Date
826-830 Whitehorse Rd, Box Hill	Suburban	30.80#	2,837	10,857	2,650	11,623	n/a	Navy Health & Scope	Offshore developer	Jul-16
539-545 Flinders Ln	CBD	18.50#	3,300	5,606	1,728	10,706	VP	NM Computer Services	Tune Hotels	Jun-16
33-35 King St	CBD	12.35#	850	14,529	353	34,986	VP	Asia One	BPM	May-16
216-222 City Rd	Southbank	32.33#	1,200	26,942	1,856	17,419	n/a	Private Investor	Aohua Sheng Le Property	Apr-16
83-113 Batman St	Suburban	35.00#	10,143	3,451	3,839	9,117	n/a	Hume Partners	Asian Pacific Group	Dec-15
7 Bowen Cres	St Kilda Rd	20.00#	3,728	5,365	1,234	16,207	n/a	Impressive Enterprises	GURNER	Nov-15
35-47 City Rd	Southbank	22.80#	2,752	8,285	1,704	13,380	n/a	Opera Australia/ Private Investor	Pro-Invest	Oct-15
383 La Trobe St	CBD	70.70#	10,211	6,924	2,845	24,851	2.0	Investa Office Fund (IOF)	Sterling Global	Jul-15

Source: Knight Frank Research # likely demolition

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RESEARCH
Richard Jenkins
Director—Research Vic
+61 3 9604 4713
Richard.Jenkins@au.knightfrank.com

Kimberley Paterson
Senior Analyst, Victoria
+61 3 9604 4608
Kimberley.Paterson@au.knightfrank.com

Michelle Ciesielski
Director—Residential Research
+61 2 9036 6659
Michelle.Ciesielski@au.knightfrank.com

Matt Whitby
Group Director
Head of Research & Consulting
+61 2 9036 6616
Matt.Whitby@au.knightfrank.com

CAPITAL MARKETS
Danny Clark
Head of Commercial Sales, Victoria
+61 3 9604 4686
Danny.Clark@au.knightfrank.com

Tim Grant
Director In Charge
Eastern Office, Capital Markets
+61 3 8545 8611
Tim.Grant@au.knightfrank.com

Paul Henley
Head of Commercial Sales Australia
+61 3 9604 4760
Paul.Henley@au.knightfrank.com

RESIDENTIAL PROJECT MARKETING
Daniel Cashen
Director
+61 3 9604 4749
Daniel.Cashen@au.knightfrank.com

Michael Robinson
Head of Project Marketing, Australia
+61 3 9604 4775
Michael.Robinson@au.knightfrank.com

OFFICE LEASING
Hamish Sutherland
Senior Director, Head of Division
+61 3 9604 4734
Hamish.Sutherland@au.knightfrank.com

VALUATIONS & CONSULTANCY
Michael Schuh
Joint Managing Director—Victoria
+61 3 9604 4617
mschuh@vic.knightfrankval.com.au

VICTORIA
James Templeton
Managing Director—Vic
+61 3 9604 4724
James.Templeton@au.knightfrank.com

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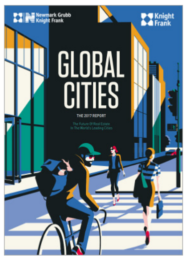

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