RESEARCH

MELBOURNE CBD
STRATA MARKET INSIGHT NOVEMBER 2017

MELBOURNE CBD STRATA VALUES AT RECORD LEVELS

Strata office values has increased significantly over the past 12 months. This has been fuelled by favourable economic conditions coupled with muted short term new supply, strong secondary rental growth and positive tenant demand for small and medium sized office.

Highlights

Strata sale rates have increased 21% over the past 12 months to July 2017 with values at the upper end of the market ranging from $10,000 to $11,500/m².

Secondary gross effective rents have increased by 11.3% in the Melbourne CBD over the 12 months to July 2017.

Melbourne CBD office market supply will be **significantly constrained over the next 12 months**, with no new developments completing until mid-2018.

Vacancy rates for strata units in the Melbourne CBD measured 2.6% as at July 2017, the lowest since the PCA began tracking the market in 2004.

According to Knight Frank Research, **the volume of enquiry levels for 100-500m^2 size bracket has increased by 45%** over the past 12 months.

Strata price growth is expected to be maintained at circa 11.5% p.a over 2018 and 2019.

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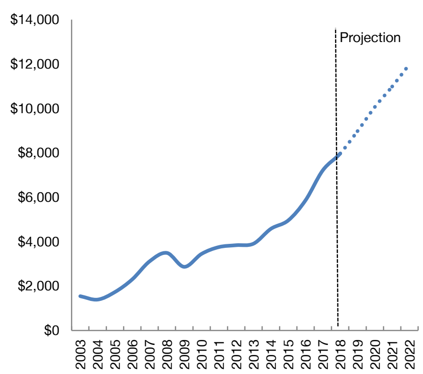
Favourable conditions in both the capital and leasing markets are driving strata office prices in the Melbourne CBD to record levels. The average strata sale rate (excluding car parking) currently measures $8,359/m² with the upper end of the market ranging from $10,000 to $11,500/m². This represents an increase of approximately 21% over the 12 months to July 2017. Knight Frank Research projects the strong capital value growth is likely to be sustained over the next four years due to a number of favourable drivers (figure 1).

FIGURE 1
Melbourne CBD Strata Office Values
Average Rate per m²



Source: Knight Frank Research

Market Drivers

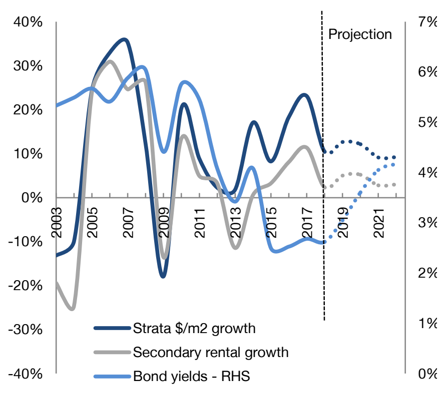
According to the Australian Bureau of Statistics (ABS) in the year to August 2017, 95,200 jobs were created in Victoria, well above all of the remaining states. Much of the Victorian employment growth continues to be supported by the rapidly growing population. Victoria continues to be Australia's fastest growing state, with an additional 2,000 residents entering the state per week.

The Melbourne CBD strata office market is well established, with total stock increasing by 10.3% over the last 10 years to measure 267,697m^2 as at July 2017. Nevertheless, since the addition of 517 Flinders Lane, 140 Bourke Street and 41 Exhibition Street in 2014, new strata supply in the Melbourne CBD has been subdued. With the absence of any major strata developments, total vacancy rates fell from 3.7% to 2.6% in the 12 months to July 2017, the lowest level since the PCA began tracking the market in 1994.

Commercial strata buildings continue to attract investors with many paying a premium to acquire a controlling stake. This has been supported by a lack of availability for investors seeking sites between the $5-$10 million cohort.

The expected capital appreciation for strata office space will be underpinned by strong rental growth, limited supply and positive tenant demand in the sub-500m² office category. Secondary net effective rents in the Melbourne CBD have increased by 11.3% over the 12 months to July 2017. This was due to a lack of prime grade options available which resulted in face rental growth of 9.3% in the secondary market. With no major office developments scheduled for completion until mid-2018, combined with limited space available across the Melbourne CBD market for sub-500m^2 space, will

FIGURE 2
Strata Capital Growth Drivers
Value v. Rental Growth v. Bond Yields (RHS)



Source: Knight Frank Research

continue to put tremendous pressure on effective rents. Its likely to entice many tenants to opt for purchasing their offices, rather than renting, as a more cost effective solution.

Future Demand

With supply in the Melbourne CBD office market significantly constrained over the next 12 months, combined with vacancy rates anticipated to fall to a historical low by mid-2018, this is expected to result in a substantial number of displaced tenants. Tenant enquiry levels over the past 12 months has stemmed from demand in the smaller (100-500m^2) cohort.

Knight Frank Research has found the number of enquiries has increased by 45% in the 12 months to July 2017. In addition, 86% of CBD-based businesses are SMEs with less than 20 employees. This will ensure a strong level of demand for strata office suites in the Melbourne CBD going forward.

Outlook

The outlook for the Melbourne CBD strata office market remains positive for 2018 and 2019 with price growth expected to be maintained at approximately 11.5% per annum. With constrained new supply over the next 12 months, this will continue to support strong rental growth, particularly in the secondary market with face rents anticipated to increase at an average of 4.5% per annum over the next two years.

The low interest rate environment remains a major influence on property values. Monetary policy remains largely accommodative with the cash rate being unchanged at the record low of 1.50% for the fourteenth consecutive month in November 2017. As interest rates remain low and demand for renting office space in the CBD remains high, the attractiveness for tenants to purchase office space rather than lease is expected to increase demand for strata suites over the next 12 months.

From 2021 some moderation on price growth will be anticipated on the back of increased overall supply levels and higher interest rates. Whilst the majority of this new supply will be in the prime grade market, a flow-on effect to the strata and secondary markets will be expected. In addition, increased borrowing costs over the long-term will start to become an important consideration for many investors over the next few years.

Looking ahead, there are a number of important implications for market participants. Existing strata owners with higher opportunity costs of capital will be encouraged to take advantage of the current strong market while the depth of the demand remains.

For potential owner occupiers and some existing tenants who don't have access to a broad base of alternative investment options, purchasing their own offices will become a more cost efficient solution than leasing. This strategy is particularly favourable in the currently low interest rate environment amid rising effective rents.

TABLE 1
Melbourne CBD Recent Strata Sales

Parent Address	Price ($)	Area	$/m^2
41 Exhibition St	4,444,000	275	16,160
100 Collins St	3,300,000	233	14,163
224 La Trobe St	1,927,800	189	10,200
2 Queen St	720,000	72	10,000
546-566 Collins St	1,000,000	104	9,615
415 Bourke St	2,200,000	233	9,442
552 Lonsdale St	2,400,000	267	8,989
134-140 Bourke	2,680,000	310	8,645
412 Queen St	2,500,000	305	8,197

Source: Knight Frank Research

"The outlook for the Melbourne CBD Strata office market remains positive over the next two years with capital growth expected to be maintained at circa 11.5% per annum."

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