



# MELBOURNE CBD

OFFICE MARKET OVERVIEW APRIL 2015

## HIGHLIGHTS

Total vacancy is forecast to have peaked for the short term with a constrained pipeline of uncommitted new supply aided by the continued trend of migrating tenants into the CBD.

The flight to quality trend by tenants in recent years remains solid with Premium and A-grade net absorption accounting for 77% of all take up over the 12 months to January 2015.

Unprecedented investor demand for Melbourne CBD office assets has compressed both prime and secondary yields; with prime yields now roughly in line with the nadir set in 2007.

## KEY FINDINGS

**Beyond July 2015, there is only one CBD development scheduled** for completion prior to 2018 with limited additional backfill space

**While total vacancy in the CBD rose to 9.1%, of this, 36,600m<sup>2</sup>** resides in buildings mooted for alternative uses

**With incentives having stabilised, coupled with a lift in tenant enquiry,** rental growth is forecast in the next 12 months

**Investment sales activity reached record levels over 2014,** boosted by secondary office transactions



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## SUPPLY & DEVELOPMENT

Finally, after 12 years, a hiatus in the construction cycle for the Melbourne CBD office market is in sight with its culmination expected mid year. From the start of 2002, the Melbourne CBD office market has grown by 1.287 million square metres, increasing by 41% over that time. New supply has been dominated by A-grade stock with the Melbourne CBD office market now accounting for the highest amount of A-grade space across Australia's office markets.

In the six months to January 2015, gross CBD office supply totalled 87,795m<sup>2</sup>, the second highest level of new supply delivered to the CBD in a six month period over the past five years. New developments accounted for the majority of stock additions, led by Medibank's new office at 720 Bourke Street (47,000m<sup>2</sup>) and Westpac's new headquarters at 150 Collins Street (20,500m<sup>2</sup>).

Marking the end of this construction cycle, major projects nearing completion by July 2015 include: 313 Spencer St (Cbus Property/Invesco 29,400m<sup>2</sup>), 567 Collins St (Investa 55,000m<sup>2</sup>), 699 Bourke St (Mirvac 19,300m<sup>2</sup>) and 570 Bourke St (Charter Hall 27,000m<sup>2</sup>).

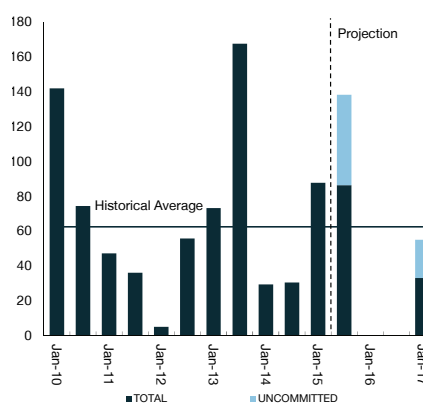
Beyond July 2015, there are no developments scheduled for completion until KPMG's new 55,000m<sup>2</sup> office at Walker Corporation's Collins Square precinct; which is scheduled for completion by 2017 with Maddocks also pre-leasing space in the development. For the first time since the 1993 financial year, new supply in the Melbourne CBD office market is forecast to fall below

3,000m<sup>2</sup> over a 12 month period with no new supply forecast to be delivered to the Melbourne CBD between July 2015 and July 2016.

Even though pre-commitment levels on the space under construction is substantial at 62%, subsequent backfill space is below previous years' levels. Backfill space from pre-committing tenants has been constrained by the continued migration of non-CBD tenants into the upcoming developments. Over the next two years, only 59,500m<sup>2</sup> within the CBD is projected to be vacated by tenants relocating into developments.

Telstra's decision to postpone its assessment to develop a 90,000m<sup>2</sup> development at 288 Exhibition Street, further reduces the amount of upcoming backfill space for the foreseeable future.

FIGURE 1  
**Gross Supply & Commitment**  
CBD Office (000's m<sup>2</sup>)



Source: Knight Frank/PCA

TABLE 1  
**Melbourne Office Market Indicators as at April 2015**

Grade	Total Stock (m <sup>2</sup> ) <sup>^</sup>	Vacancy Rate (%) <sup>^</sup>	Annual Net Absorption (m <sup>2</sup> ) <sup>^</sup>	Annual Net Additions (m <sup>2</sup> ) <sup>^</sup>	Average Net Face Rent (\$/m <sup>2</sup> )	Average Incentive (%)	Average Core Market Yield (%)
Prime	2,794,310	7.9	52,026	90,192	430—650	28.0—32.0	5.75—7.00
Secondary	1,602,682	11.3	15,187	3,932	295—390	30.0—33.0	7.00—7.50
<b>Total</b>	<b>4,396,992</b>	<b>9.1</b>	<b>67,213</b>	<b>94,124</b>			

Source: Knight Frank

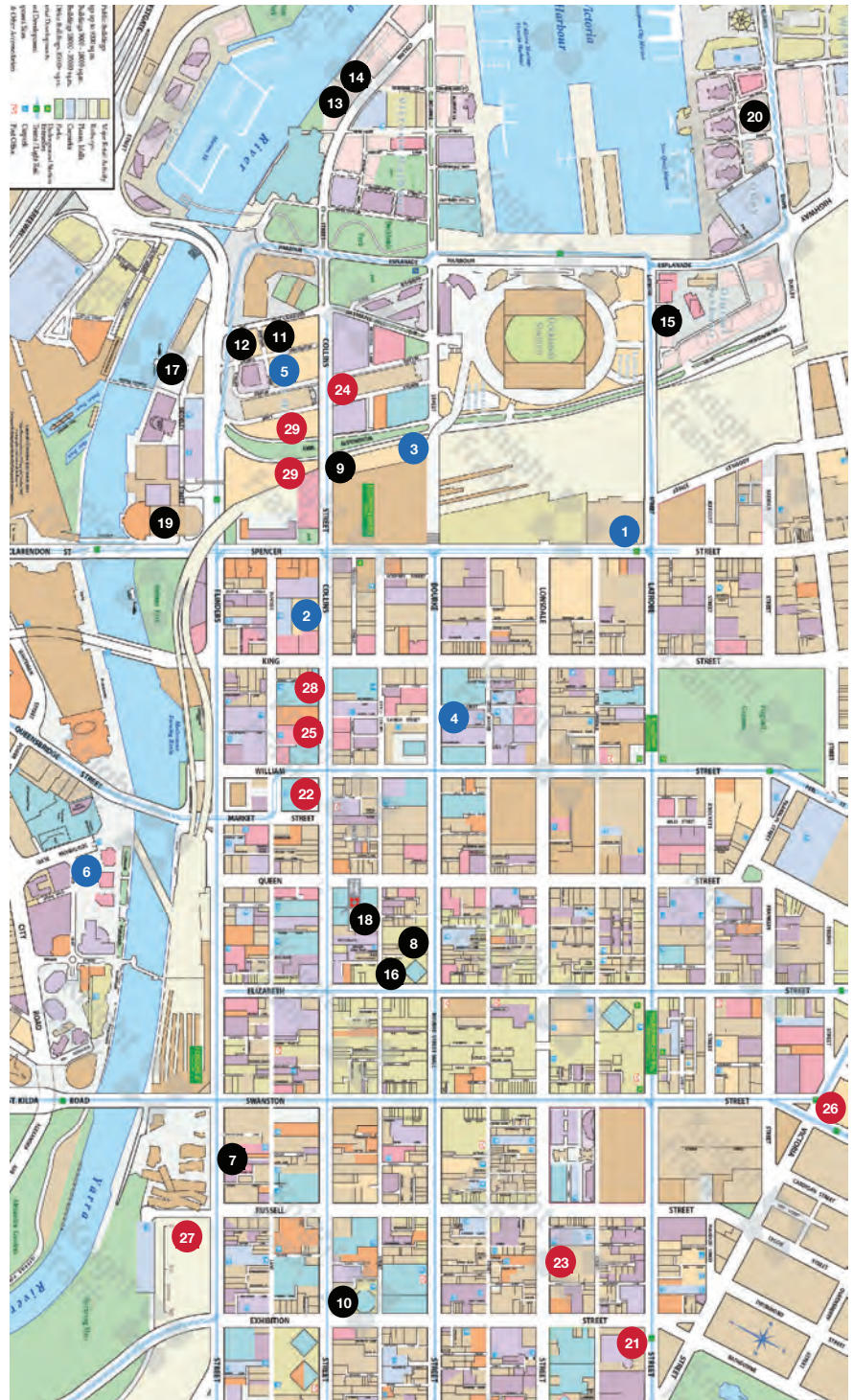
NB. Average data is on a weighted basis

<sup>^</sup> PCA data as at January 2015



# MAJOR OFFICE SUPPLY

- 1 313 Spencer St - 29,400m<sup>2</sup> [Victoria Police]  
Cbus Property/Invesco - Q2 2015 - 100% committed.
- 2 567 Collins St - 55,000m<sup>2</sup> [Corrs/Leighton Contractors/Jemena]  
Investa - Q2 2015 - 69% committed.
- 3 699 Bourke St - 19,300m<sup>2</sup> [AGL Energy]  
Mirvac/TIAA-CREF - Q2 2015 - 100% committed.
- 4 570 Bourke St - 27,000m<sup>2</sup>  
Charter Hall - Q2 2015.
- 5 2 Collins Sq - 55,000m<sup>2</sup> [KPMG/Maddocks]  
Walker - Q3 2016 - 60% committed.
- 6 2-4 Riverside Quay ^ - 20,100m<sup>2</sup> [PwC]  
Mirvac/SPT - Q4 2016 - 82% committed.
- 7 180 Flinders St - 20,000m<sup>2</sup>  
DEXUS - 2017+
- 8 405 Bourke St - 62,000m<sup>2</sup>  
Brookfield - 2018+
- 9 664 Collins St - 27,500m<sup>2</sup>  
Mirvac - 2017+
- 10 80 Collins St - 43,000m<sup>2</sup>  
Queensland Investment Corporation (QIC) - 2018+
- 11 4 Collins Sq - 30,000m<sup>2</sup>  
Walker - 2017+
- 12 5 Collins Sq - 35,100m<sup>2</sup>  
Walker - 2017+
- 13 Y3, 839 Collins St - 39,200m<sup>2</sup>  
Lend Lease - 2018+
- 14 Y4, 855 Collins St - 34,000m<sup>2</sup>  
Lend Lease - 2018+
- 15 1000 Latrobe St - 32,500m<sup>2</sup>  
Digital Harbour - 2017+
- 16 385 Bourke St - 27,000m<sup>2</sup>  
DEXUS - 2018+
- 17 North Wharf - 20,000m<sup>2</sup>  
WTC Asset Management - 2017+
- 18 360 Collins St - 18,000m<sup>2</sup>  
DEXUS - 2018+
- 19 601 Flinders St - 60,000m<sup>2</sup>  
Eureka/Asset 1 - 2018+
- 20 395 Docklands Dve - 22,000m<sup>2</sup>  
MAB - 2017+
- 21 288 Exhibition St - 90,000m<sup>2</sup>  
Telstra - 2018+
- 22 447 Collins St - 50,000m<sup>2</sup>  
Cbus Property - 2019+
- 23 124-148 Lonsdale St - 50,000m<sup>2</sup>  
Uniting Church/Leighton Properties - 2018+
- 24 710 Collins St - 47,500m<sup>2</sup>  
Equiset - 2018+
- 25 477 Collins St - 51,000m<sup>2</sup>  
Mirvac - 2018+
- 26 555 Swanson St (CUB Site) - 36,000m<sup>2</sup>  
Grocon - 2018+
- 27 Fed Square East - 60,000m<sup>2</sup>  
State Government - 2019+
- 28 525 Collins St - 5,000m<sup>2</sup>  
St Martins/Equiset - 2017+
- 29 Sites 5B & 6B - 100,000m<sup>2</sup>  
Lend Lease - 2018+



Source of Map: Knight Frank

- Under Construction / Complete
- DA Approved / Confirmed / Site Works
- Mooted / Early Feasibility

NB. Dates are Knight Frank Research estimates  
Major tenant precommitment in [brackets] next to NLA  
^ Southbank precinct  
Office NLA quoted

# TENANT DEMAND & RENTS

Australia's employment trends confirm that the domestic economy is currently rebalancing. After Victorian employment levels contracted over 2011, the labour force in the state continues to gather momentum. In the year to February 2015, Victorian employment rose by 121,500 equating to an employment growth of 4.3%. Victoria's employment growth over the year to February 2015 was the highest annual job gain in 20 years and strongest performing Australian state over the 12 months.

The growth of employment in Victoria was driven by the accommodation & food services industry, professional services and retail sectors. In terms of traditional white collar employment sectors, in addition to the strong gains of the professional services sector, public administration employment continued to expand while the finance sector contracted over the 12 months to February.

As a result of Victoria's employment gains, the state's unemployment rate has fallen to 6.0% as at February 2015, its lowest level since October 2013. Looking ahead, while job advertisements fell in March for the first time after nine months' of rises, job ads are now up 9.3% over the year. The likelihood of further interest rate cuts and a declining AUD, should bode well for additional employment growth in Victoria with consumer-related sectors spear-heading recent gains.

TABLE 2

## Melbourne CBD Vacancy Rates

Grade	Jan-14	Jul-14	Jan-15
Premium	8.0%	7.2%	5.7%
A Grade	6.3%	6.6%	8.5%
<b>Prime</b>	<b>6.7%</b>	<b>6.7%</b>	<b>7.9%</b>
B Grade	13.5%	13.9%	12.5%
C Grade	11.6%	9.7%	11.3%
D Grade	2.9%	2.9%	2.0%
<b>Secondary</b>	<b>12.0%</b>	<b>11.6%</b>	<b>11.3%</b>
<b>Total</b>	<b>8.7%</b>	<b>8.5%</b>	<b>9.1%</b>

Source: Knight Frank/PCA

Despite recording higher than average levels of net absorption in the six months to January 2015, vacancy rose in the Melbourne CBD impacted by new additions. In the final half of 2014, total vacancy in the CBD rose to 9.1%, up from 8.5% in July 2014. Notwithstanding the rise in vacancy, the Melbourne CBD office market has the second lowest vacancy amongst all of Australia's major CBD office markets only trailing behind Sydney at 7.4%.

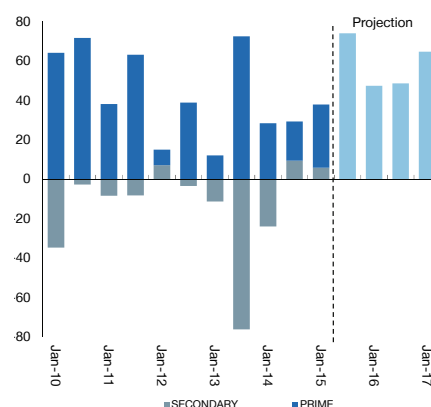
In the six months to January 2015, net absorption in the CBD office market totalled 37,922m<sup>2</sup>, the highest level achieved since July 2011, equating to 67,213m<sup>2</sup> absorbed over 2014. The flight to quality trend by tenants in recent years remains solid with the majority of space absorbed within prime quality space (Figure 2). Premium and A-grade net absorption totalled 52,026m<sup>2</sup>, accounting for 77% of all take up over 2014.

Whilst many of the tenants upgrading into prime CBD office space are relocating from similar sized tenancies, much of the net absorption in Premium and A-grade space stems from the migration of non-CBD tenants into the market. Recent incoming tenants to the CBD include: Whitbread Insurance from St Kilda Road and Viva Energy from Hawthorn.

After two consecutive years of declines in

FIGURE 2

## Melbourne CBD Net Absorption per six month period (000's m<sup>2</sup>)

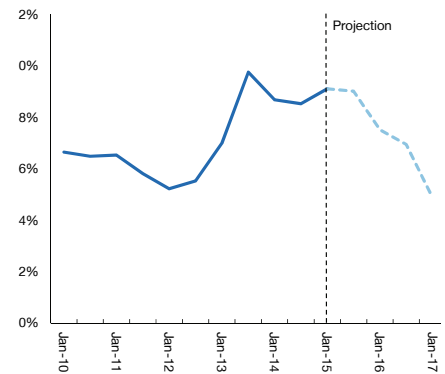


Source: Knight Frank/PCA

FIGURE 3

## Melbourne CBD Vacancy Rate

Total Vacancy (%)



Source: Knight Frank/PCA

occupied secondary CBD office space; take up within B-grade, C-grade and D-grade accommodation in 2014 totalled 15,187m<sup>2</sup>, driven by strong take up by educational tenants. Recent commitments made by educational tenants include: Study Group (505 Little Collins Street), Monash College (271 Collins Street) and Central Queensland University (120 Spencer Street).

Although B-grade office vacancy levels fell in the six months to January 2015, its level has been elevated with the inclusion of former office buildings mooted for alternative uses. Namely, 555 Collins Street (23,500m<sup>2</sup>) has been purchased by a residential developer and 383 King Street (12,900m<sup>2</sup>) has been purchased by Haileybury for educational purposes.

While sublease vacancy in the Melbourne CBD office market rose marginally from 0.8% in July 2014 to 0.9% as at January 2015; its current level remains below the historical average. Of interest, 42% of the sublease vacancy is located within the Docklands precinct with 16,300m<sup>2</sup> currently physically vacant being offered for sublease. Impacted by the increased levels of sublease vacancy, total office vacancy levels in the Docklands precinct has risen to 7.2% - its highest level since January 2008.

## Anticipated Vacancy Levels

Looking forward, Deloitte Access Economics is forecasting white collar employment growth in the Melbourne CBD office market of 2.7% in 2015, up from the growth of 1.7% achieved in 2014. Over the next three years, white collar employment growth in the Melbourne CBD office market is forecast to be driven by growth in the professional services, finance and government sectors.

Although tenant enquiry levels have risen substantially over the past six months, net absorption within the CBD is forecast to remain underpinned by migrating tenants. Incoming tenants that have committed to CBD space include: CrownBet, Jemena, and Victoria Police. The trend of incoming tenants has also insulated the CBD from the impact of backfill, capping significant rises in vacancy levels.

Total vacancy in the CBD office market is forecast to have reached its peak at 9.1% as at January 2015, after which a

steady decline in vacancy is forecast, aided by below average supply levels and migrating tenants over the next two years.

## Rental Levels

As at April 2015, the annual growth in prime face rents was flat, to average \$486/m<sup>2</sup> net. However over the year, net effective rentals decreased by 1.9%, albeit prime incentives appear to have peaked. Having plateaued since mid 2014, average incentive levels range between 28% and 32%. The higher enquiry levels may also reflect the realisation that incentives are expected to be lower in 12 months' time.

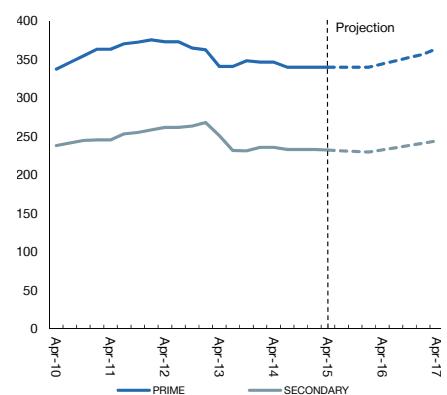
Prime net face rent levels are forecast to steadily increase over the next three years with an average prime net face rent growth of 2.5% per annum is forecast and an effective rental growth of 5.5% per annum over the same period. Given impending tightening vacancy levels in prime space in the Eastern and North Eastern precincts there is likely to be stronger rental growth for prime space

(particularly Premium stock) in those precincts than across the broader prime CBD office market.

While secondary office vacancy rates will be aided by the withdrawal of a number of secondary assets, net face and effective rental levels are forecast to remain steady through 2015 before gradually increasing from 2016 onwards.

FIGURE 4

### Average Net Effective Rents Melbourne CBD (\$/m<sup>2</sup>)



Source: Knight Frank

TABLE 3

### Recent Leasing Activity Melbourne CBD

Address	Precinct	NLA (m <sup>2</sup> )	Term (yrs)	Lease Type	Tenant	Start Date
171 Collins Street	Civic	1,975	11	New	The Myer Family	Q4-15
555 Bourke Street	Western	5,100	10	New	Yarra Trams	Q3-15
90 Collins Street	Eastern	1,139	5	New	Hendry Group	Q2-15
700 Collins Street	Docklands	7,577	10	New	Metro Trains	Q2-15
120 Collins Street	Eastern	3,378	8	New	CrownBet*	Q2-15
555 Lonsdale Street	Western	14,000	10	New	Barristers Chambers	Q2-15
180 Lonsdale Street	Civic	960	10	New	Regus	Q1-15
451 Little Bourke Street	Western	1,100	2	New	Maurice Blackburn	Q1-15
399 Lonsdale Street	Western	4,760	3	New	Australian Technical & Management College	Q4-14
114 William Street	Western	734	6	New	Worrells	Q4-14
271 Collins Street	Civic	3,100	10	New	Monash College	Q4-14
271 Collins Street	Civic	3,470	5	New	Monash College	Q4-14
505 Little Collins Street	Western	6,700	9.5	New	Study Group	Q4-14
303 Collins Street	Western	732	5	New	Western Union	Q4-14
525 Collins Street	Western	4,000	10	New	Hall & Wilcox	Q2-14

\*Tenant relocating to CBD

Source: Knight Frank



# INVESTMENT ACTIVITY & YIELDS

While domestic unlisted funds were the most prominent purchasers over 2014, offshore investment interest in the Melbourne CBD office market has been unprecedented. In a global context Melbourne attracted the seventh highest level of cross-border office investment in 2014, behind only London, Paris, Sydney, Manhattan, Tokyo and Boston.

In the 12 months to April 2015, investment sales activity (above \$10 million) within the CBD totalled \$3.10 billion across 35 properties, 43% higher than the \$2.16 billion that was transacted in the preceding 12 months.

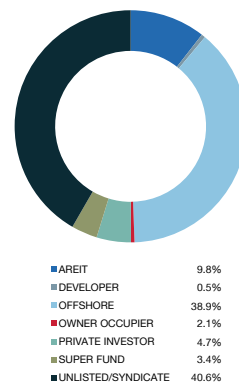
Having been usurped by offshore groups in 2013, unlisted funds and syndicates were once again the most prominent purchasers in the 12 months to April 2015, accounting for 41% of office sales by value. Significant acquisitions made by unlisted funds in 2014 included: AMP Capital Wholesale Office Fund's purchase of 700 Bourke Street for \$433.50 million and GPT Wholesale Office Fund's half share acquisition of the CBW office development for \$304.05

million, divested by Cbus Property. The CBW sale was Melbourne's largest office transaction on record (100% interest of \$608.1 million).

Offshore groups continued their recent interest within the CBD office market, accounting for 39% of sales by value. Total investment in the 12 months to April stood at \$1.21 billion compared to \$997 million acquired in the previous 12 months. Of interest, was the increased capital flows from North America and Europe into the Melbourne CBD office market. In the 12 months to April 2015, North American-based investors accounted for 46% of cross-border investment into the Melbourne CBD office market with European investors also active, accounting for 19% of cross-border investment. Offshore investment appetite into Australia remains attractive to most, with equity markets still volatile coupled with the arbitrage between funding costs.

With prime investment opportunities becoming increasingly scarce, the weight of capital seeking commercial property

FIGURE 5  
**Melbourne CBD sales by purchaser**  
\$10 million+ sales—2014 and YTD2015



Source: Knight Frank

resulted in investors converging on secondary assets. Over the 12 months to April 2015, secondary office sales in the Melbourne CBD totalled \$1.27 billion, surpassing \$1 billion spent in a year for the first time on record. The vast majority of transactions in the secondary market were made by offshore investors who accounted for 60% of all secondary asset acquisitions. Somewhat surprisingly,

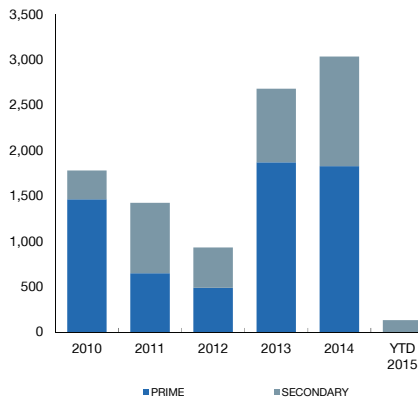
TABLE 4  
**Recent Sales Activity Melbourne CBD**

Address	Price (\$ mil)	Core Mkt Yield (%)	NLA (m <sup>2</sup> )	\$/m <sup>2</sup> NLA	WALE (yrs)	Vendor	Purchaser	Sale Date
446 Collins Street	34.00	4.47*	5,704	5,961	N/A	Cohen family	Offshore Private	Mar-15
410 Collins Street	28.25	4.59*	3,680	7,677	N/A	Vaughan family	Private Investor	Mar-15
383 King Street	52.00	VP	12,975	4,008	0.0	Aspial Group	Haileybury College	Feb-15
235 Queen Street	25.50	N/A	3,148	8,100	N/A	Private Investor	Private Investor	Dec-14
565 Bourke Street	81.75	7.20	15,926	5,097	3.0	Private Investor	Challenger Life	Dec-14
637 Flinders Street	86.40	N/A	23,050	3,748	6.9	Arena Office Fund	Anton Capital	Dec-14
464 Collins Street	25.00	VP	1,036	24,131	0.0	Grollo Equiset	Golden Age Group	Oct-14
818 Bourke Street	152.50	6.79	21,900	6,963	3.9	GPT	Hines Global REIT	Oct-14
350 Queen Street	~130.00	N/A	22,411	~5,801	N/A	KTS Holdings	3L Alliance	Oct-14
CBW, 181 William Street & 550 Bourke Street	608.10	6.50*	81,453	7,466	5.2	Cbus Property	GPT (50%) / GPT—GWO (50%)	Sep-14
700 Bourke Street	433.50	5.75	63,000	6,881	13.6	Cbus Property	AMP Capital (AWOF)	Sep-14
459 Little Collins Street	45.50	6.90	9,940	4,577	2.5	Uniting Church	Juilliard Group	Sep-14
40 Market Street	105.00	~6.25*	12,011	8,742	15.0	DEXUS (DXS)	MTAA Superannuation	Sep-14
600 Collins Street	~60.00	N/A	7,995	~7,505	N/A	Henkell Brothers	Offshore Private	Aug-14

Source: Knight Frank \* initial yield ≈ reported capitalisation rate

FIGURE 6

### Melbourne CBD Sales \$10 million+ By grade (\$m)



Source: Knight Frank

investor motivation/focus within the secondary market for the bulk of sales were for value add assets rather than immediate redevelopment opportunities.

Although the volume of offices transacted for the intention of residential redevelopment was lower than the preceding 12 months, developers remain keen for potential opportunities, encouraged by the high population growth within the Inner Melbourne region. Notable recent examples of assets purchased with the intention of conversion to alternative uses include: 555 Collins Street (\$78 million), 464 Collins Street (\$25 million) and 600 Collins Street (\$60 million). In addition to the offices already withdrawn, a further 60,000m<sup>2</sup> has been identified to be withdrawn for residential development in the near future.

The significant weight of capital seeking Melbourne CBD office investments from all buyer groups has resulted in continued compression of both prime and secondary yields. As demonstrated by the recent sales of 700 Bourke Street (core yield 5.75%) and CBW (core yield 6.5%), over the year to April 2015, average prime office yields have compressed a further 36 basis points to range between 5.75% and 7.00%. Average prime yields now stand 74 basis points lower than the 10-year average and now roughly in line with the nadir set in 2007 (see Figure 7).

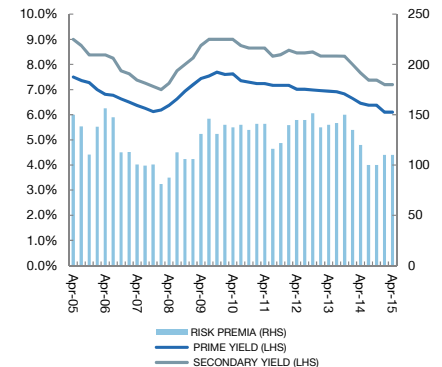
Core assets with long WALEs in place also remain competitively sought after as highlighted by the transactions of 40 Market Street (\$105 million with a 15 year lease in place, initial yield of 6.25%) with investors seeking long term secure income streams.

While yet to fall below the nadir benchmark of 2007 for secondary CBD yields, average secondary yields have tightened by 46 basis points in the year to April 2015 to range between 7.00% and 7.50%. Of interest, secondary Melbourne CBD office yields are now on average lower than Sydney CBD secondary assets (which trade in a broader range of 7.00% and 8.00%), reflecting the smaller price-point for Melbourne CBD-located assets and the strong demand for residential redevelopment in the Melbourne CBD.

Although yet to match the spread that existed between prime and secondary

FIGURE 7

### Melbourne CBD Yields & Risk Spread Core Market Yields & Prime vs Secondary Spread (bps)



Source: Knight Frank

CBD office yields in 2007, the current risk premium between prime and secondary assets is well below the 10-year average.

## Outlook

- While still challenging, Australia's economic drivers have moved into Victoria's favour. The falling AUD and interest rates should boost Victorian state economic activity. Deloitte Access Economics forecasts Victorian Gross State Product to grow by 2.10% in 2015 and on average by 2.30% per annum over the next five years.
- Lower interest rates are also likely to boost business services and education employment, in the CBD office market. Looking forward, Deloitte Access Economics forecasts white collar employment growth of 2.7% in 2015, up from 1.7% in 2014. Over the next three years, white collar employment in the CBD is forecast to grow by 22,800 jobs.
- Aided by the migration of non-CBD tenants, net absorption levels of the Melbourne CBD office market are forecast to be one of the healthiest in Australia over the next year.
- Beyond July 2015, only one CBD development is scheduled for completion in the next two years with backfill space sheltered by the continued migration of non-CBD tenants into new developments.
- Total vacancy is forecast to have peaked for the short term at 9.1% (as at January 2015) with a relatively constrained pipeline of uncommitted new supply and the withdrawal of secondary assets supporting the fall in the CBD office vacancy rate.
- Positive net absorption and falling vacancy rates are expected to lead to both net face and effective rental growth over the next three years, particularly for prime offices.
- Improving leasing conditions, and the current spread between funding costs and returns are anticipated to maintain investment demand for CBD office assets, with further scope for yield compression.



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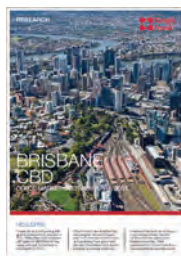
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