RESEARCH

MELBOURNE CBD

OFFICE MARKET OVERVIEW MARCH 2017

HIGHLIGHTS

The Melbourne CBD office market vacancy rate is projected to fall to 10-year lows over the course of 2017 with new supply constrained.

Prime net effective rents grew at their strongest rate in seven years, underpinned by face rental growth of 7.0% in 2016. Prime net effective rents are at their highest level on record at $387/m^2.

Although investor appetite remains strong for CBD assets, office investment sales activity in 2016 fell by 36% from the preceding 12 months, impacted by the scarcity of investment opportunities.

KEY FINDINGS

CBD total vacancy fell from 7.8% to 6.4% in the 12 months to January 2017, its lowest level in four years.

The CBD recorded positive net absorption of 109,612m^2 in the six months to January 2017, **the strongest figure nationally.**

The overall vacancy rate is expected to fall to 4.1% over the next 12 months with only one development scheduled to complete in 2017.

Reflecting the declining vacancy rate, **average prime effective rents grew at their strongest rate in seven years.**

The current spread between **prime and secondary yields is 71 basis points, the tightest on record.**

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SUPPLY & DEVELOPMENT

The Melbourne CBD is entering a relatively low period for new development, with total supply during 2017 expected to be at its lowest level in 15 years.

Gross CBD office supply totalled 136,368m^2 in the six months to January 2017, underpinned by the completion of Tower 2 & 4 at Collins Square, both of which completed in Q4 2016. This level of supply was more than double the long term average recorded over the past 10 years (62,151m^2 per six monthly period) and the largest six monthly increase since July 2013.

The withdrawal of office stock for redevelopment, alternative uses or refurbishment continues to impact stock levels in the Melbourne CBD. In the six months to January 2017, withdrawals totalled 48,130m^2, which included the refurbishment of KPMG's backfill space at 161 Collins Street (25,000m^2) and 477 Collins Street (12,181m^2) which will be redeveloped to accommodate 51,000m^2 of office accommodation. Looking forward, a number of buildings are expected to be withdrawn in 2017 for residential development led by 50 Franklin Street (11,000m^2) which was recently purchased by Lian Bang (Listed Singaporean developer).

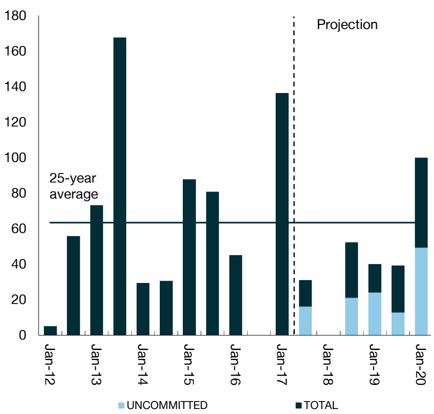
There are 10 new developments totalling 360,242m^2 currently under construction in the Melbourne CBD and anticipated to be completed by 2020. However, the supply pipeline is limited over the next two years, with five developments totalling 113,242m^2 currently under construction. As a result, gross supply added to the market in 2017 and 2018 will average 1.3% of stock per annum, well below the historical annual gross supply average of 3.6% of stock. Nevertheless, the supply cycle is set to increase materially from mid 2019 with five developments recently commencing construction totalling 247,200m^2.

Developments which recently commenced construction include ANZ's 839 Collins Street (39,000m^2), Walker Corporation's 5 Collins Square (40,000m^2) and Queensland Investment Corporation's 80 Collins Street (43,000m^2). Of the total space that is under construction, 59% is pre-committed, leaving 146,723m^2 uncommitted. A further 140,444m^2 of backfill refurbished space is also forecast to be returned to the market between 2017-2020.

FIGURE 1

Gross Supply & Commitment

CBD Office (000's m^2) per six month period



Source: Knight Frank Research/PCA

TABLE 1

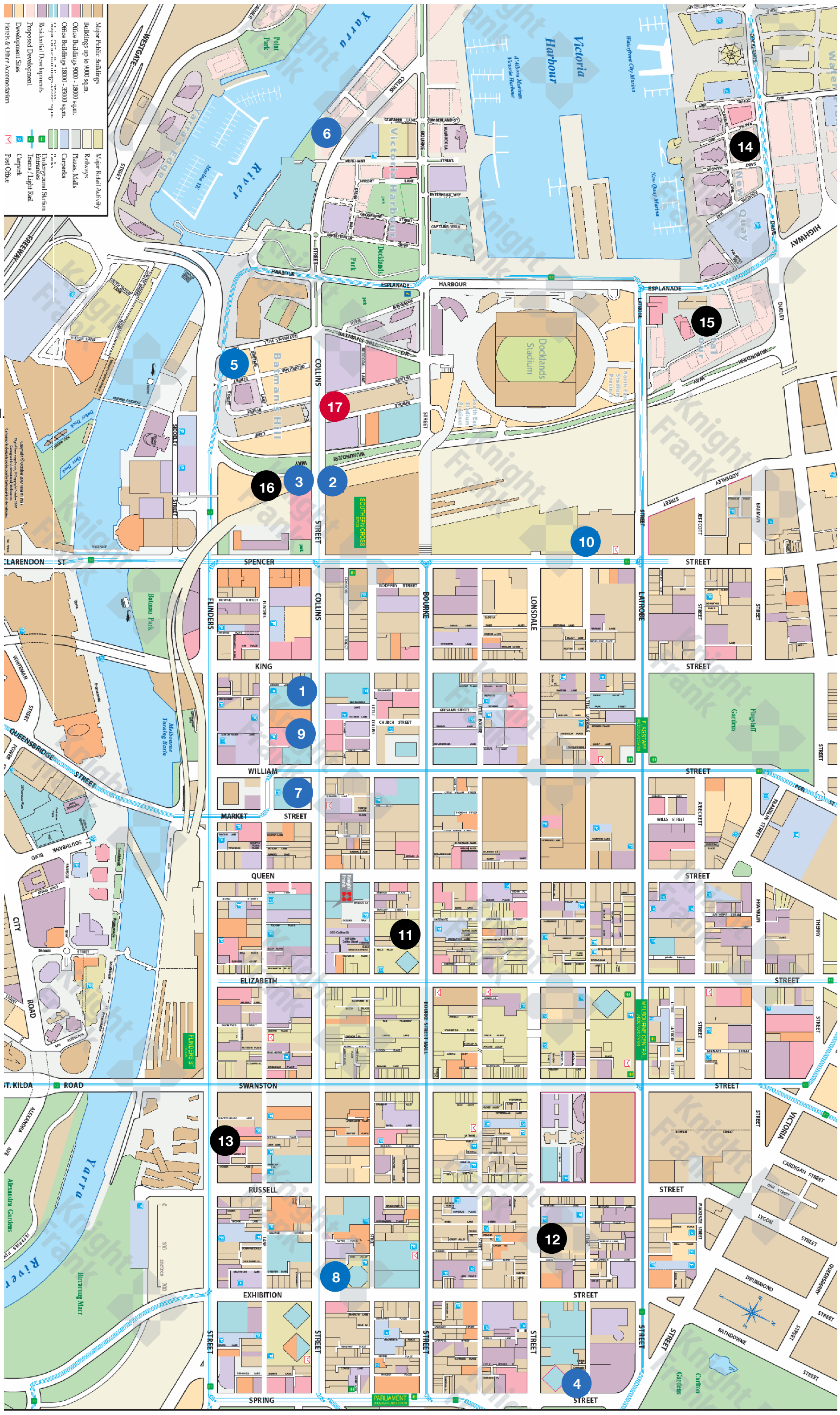
Melbourne CBD Office Market Indicators as at January 2017

Grade	Total Stock (m²)	Vacancy Rate (%)	Annual Net Absorption (m²)	Annual Net Additions (m²)	Average Net Face Rent ($/m²)	Average Incentive (%)	Average Core Market Yield (%)
Prime	2,986,349	6.5	101,080	76,268	490—580	25.0—30.0	4.75—6.00
Secondary	1,539,713	6.4	16,173	-14,373	310—440	25.0—30.0	5.75—6.50
Total	**4,526,062**	**6.4**	**117,253**	**61,895**			

Source: Knight Frank Research/PCA   NB. Average data is on a weighted basis

MAJOR OFFICE SUPPLY

1. 525 Collins St - 6,000m² [Bank of Melbourne]
St Martins/Equiset - Q2 2017 - 70% committed.
2. 664 Collins St - 25,800m² [Pitcher Partners, Exxon]
Mirvac - Q2 2018 - 67% committed.
3. One Melbourne Quarter - 26,400m² [Arup/Lend Lease]
Lend Lease - Q2 2018 - 53% committed.
4. 271 Spring St - 15,000m² [Australian Unity]
ISPT - Q4 2018 - 100% committed.
5. 5 Collins Sq - 40,000m² [Transurban]
Walker - Q3 2018 - 40% committed.
6. Y3, 839 Collins St - 39,200m² [ANZ]
Lend Lease - Q2 2019 - 68% committed.
7. 447 Collins St - 49,000m² [King & Wood Mallesons]
Cbus Property - Q4 2019 - 59% committed.
8. 80 Collins St - 43,000m² [Macquarie]
(QIC) - Q1 2020 - 14% committed.
9. 477 Collins St - 51,000m² [Deloitte]
Mirvac - Q2 2020 - 43% committed.
10. 311 Spencer St - 65,000m² [Victoria Police]
Australia Post/Cbus Property - Q3 2020 - 100% committed.
11. 405 Bourke St - 65,000m²
Brookfield - 2020+
12. 124-148 Lonsdale St - 55,000m²
Uniting Church/Charter Hall - 2020+
13. 180 Flinders St - 20,000m²
DEXUS - 2020+
14. 395 Docklands Dve - 22,000m²
MAB - 2019+
15. 25 Digital Dve - 10,000m²
Digital Harbour - 2019+
16. 2 & 3 Melbourne Quarter - 100,000m²
Lend Lease - 2020+
17. 710 Collins St - 47,500m²
Abacus Property Group - 2020+



Source of Map: Knight Frank Research

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
Office NLA quoted

TENANT DEMAND & RENTS

According to the Australian Bureau of Statistics (ABS), over 2016, 119,900 jobs were created in Victoria, towering over the nearest state - South Australia where 7,200 jobs were created with only 2,000 jobs created in New South Wales.

Much of the Victorian employment growth related to the increase in Victoria's population which continues to be Australia's fastest growing state. Major employment growth was recorded in the Healthcare, Education, Construction and Accommodation & Food services sectors. However, while the traditional white collar employment sectors of Finance, Professional services and Government all grew, this growth was modest over 2016.

In addition to the traditional white collar employment sectors, demand for office space in the CBD from educational based tenants continued to gather momentum in 2016. Examples over the past 12 months include Acknowledge Education relocating from 252 Lygon Street, Carlton to 3,772m^2 at 168 Exhibition Street and Melbourne University taking 6,458m^2 at 333 Exhibition Street.

Reflecting the employment growth across Victoria, net absorption in the Melbourne CBD office market in the six months to January 2017 totalled 109,612m^2. With total net absorption of 117,253m^2 for 2016, the absorption recorded in the second half of 2016 accounted for 93% of the annual total. This result was the strongest figure nationally and the largest six monthly result in the Melbourne CBD in 10 years.

The above-average levels of positive net absorption recorded in the Melbourne CBD office market were largely underpinned by CBD tenants expanding. Recent examples of tenants who expanded include Hub Melbourne, Amazon, IOOF, DeakinPrime and Pacific Hydro. Non-CBD tenants migrating into the CBD office market only accounted for 19% of the net absorption in 2016, well below the 79.4% recorded in 2015.

Tenants continue to upgrade their office accommodation with Premium and A-grade net absorption totalling 87,777m^2 in the second half of 2016, accounting for 75% of total net absorption. Much of this was in the A-grade market which recorded its strongest net absorption level since July 2009.

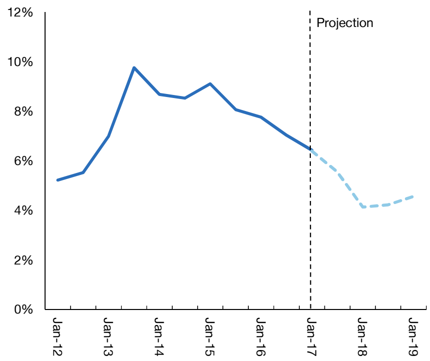
Despite the flight to quality trend underway in the Melbourne CBD office market, secondary office space recorded net absorption of 19,531m^2 in the six months to January 2017, the highest level in eight years.

As a result of above-average levels of positive net absorption, the overall vacancy rate fell from 7.0% to 6.4% in the six months to January 2017. Melbourne continues to host the second lowest vacancy rate amongst all of Australia's CBDs. Prime vacancy fell to 6.5%, the lowest level in three years, while secondary vacancy fell below prime for the first time since January 2004, sitting at 6.4% as at January 2017. Sublease vacancy in the Melbourne CBD office market fell marginally from 0.7% in July 2016 to 0.5% as at January 2017.

Occupancy growth over the last 12 months has stemmed from a combination of demand in the larger (3,000m^2+ tenancies) and the smaller (sub 500m^2) size cohort, with market acceptance for fitted out suites proving favourable. The growth of small businesses continues to rise with approximately 87% of employing businesses in the Melbourne CBD having four or less workers (ABS). This growth of small businesses has been supported by increased demand from the coworking sector, with Melbourne recording 35% growth in the number of sites over 2016.

We expect this trend to continue over the next 12-18 months with several large coworking tenant briefs in the market, combined with the arrival of WeWork into the Melbourne CBD, recently taking 6,000m^2 at 401 Collins Street. As at January 2017, coworking spaces accounted for only 0.4% of total CBD office stock.

FIGURE 3
Melbourne CBD Vacancy Rate
Total Vacancy (%)



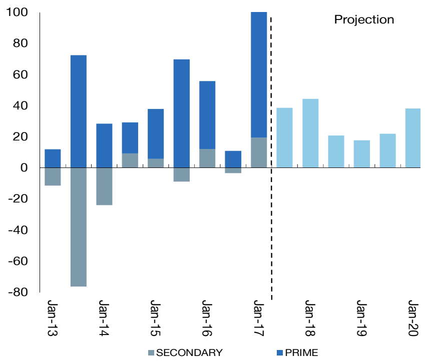
Source: Knight Frank Research/PCA

TABLE 2
Melbourne CBD Vacancy Rates

Grade	Jan-16 (%)	Jul-16 (%)	Jan-17 (%)
Premium	10.3	8.4	6.7
A Grade	6.5	6.1	6.4
Prime	**7.4**	**6.7**	**6.5**
B Grade	8.3	7.5	5.8
C Grade	9.4	9.1	8.3
D Grade	2.4	2.2	1.7
Secondary	**8.3**	**7.5**	**6.4**
Total	**7.7**	**7.0**	**6.4**

Source: Knight Frank Research/PCA

FIGURE 2
Melbourne CBD Net Absorption
per six month period (000's m^2)



Source: Knight Frank Research/PCA

Anticipated Vacancy Levels

The ANZ job advertisement series indicates job advertisements in Australia were 6.1% higher as at January 2017 compared with 12 months prior, with business and consumer confidence continuing to gain momentum.

White collar employment growth in the Melbourne CBD office market is forecast to increase by 2.1% per annum or 10,698 employees between 2017—2019. 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 & Insurance and Accommodation & Food sectors.

With white collar employment predicted to continue to increase, coupled with the absence of any major developments scheduled for completion until mid-2018, the overall vacancy rate is expected to continue to decrease over the next two years, falling to 4.1% by the end of 2018. With the supply cycle set to increase materially from mid 2019, vacancy is expected to gradually rise.

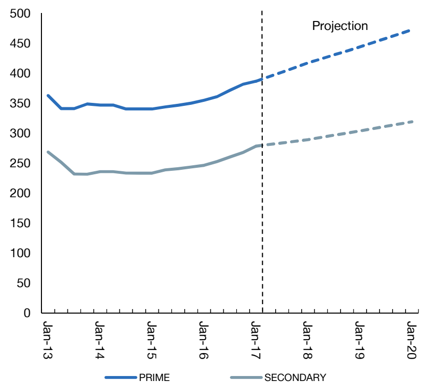
Rental Levels

On the back of positive tenant demand and vacancy falling to its lowest level in four years, average prime effective rents grew at their strongest rate in seven years. In the 12 months to January 2017, average prime effective rents increased by 8.9% to $387/m^2 net, an all time high. The growth of prime effective rents was underpinned by a face rental increase of 7.0% over the year. With average incentive levels ranging between 25% and 30%, average prime incentive levels declined for a second consecutive year, albeit marginally.

Following the trend in the prime market, secondary net effective rents grew by 12.9% in 2016, the strongest level since 2010. Effective growth was underpinned by average incentive levels declining for the first time in two years, combined with face rental growth of 8.2%. As at January 2017, average secondary effective rents sit at $278/m^2 while incentive levels range between 25% to 30%.

With vacancy anticipated to trend down over the next two years, prime net face rental levels are forecast to record average growth of 5.0% per annum with secondary net face rents to record average annual growth of 4.2% over the next three years. According to Knight Frank Research, on a global basis the Melbourne CBD is ranked in the top five cities for forecast rental growth performance over the next three years.

FIGURE 4
Average Net Effective Rents
Melbourne CBD ($/m^2)



Source: Knight Frank Research

TABLE 3
Recent Leasing Activity Melbourne CBD

Address	Precinct	NLA (m^2)	Term (yrs)	Lease Type	Tenant	Sector	Start Date
311 Spencer Street	Docklands	65,000	30	Precom	Victoria Police	Government	Q3-20
447 Collins Street	Western	6,500	10	Precom	HWL Ebsworth	Business Services	Q2-20
447 Collins Street	Western	5,000	10	Precom	Gadens	Business Services	Q2-20
Y3, 839 Collins Street	Docklands	26,500	12	Precom	ANZ	Finance & Insurance	Q2-19
664 Collins Street	Docklands	7,100	10	Precom	Exxon Mobil	Mining/Energy	Q2-18
Tower 2, Collins Square	Docklands	9,213	10	New Lease	Tabcorp	Arts & Recreation	Q4-17
700 Collins Street	Docklands	2,423	10	New Lease	Pacific Hydro	Utilities	Q1-17
168 Exhibition Street	Northern	3,772	5	New Lease	Acknowledge Education	Education	Q1-17
414 La Trobe Street	Flagstaff	4,000	U/D	Renewal	Financial Ombudsman	Government	Q1-17
414 La Trobe Street	Flagstaff	2,400	7	New Lease	BlueRock	TMT	Q1-17
567 Collins Street	Western	2,060	7	New Lease	Nous Group	Business Services	Q1-17
35 Collins Street	Eastern	1,680	3	Sub Lease	McKinsey Group	Business Services	Q1-17
Tower 2, Collins Square	Docklands	4,500	10	New Lease	DeakinPrime	Education	Q4-16

TMT refers Technology Media & Telecommunications   U/D refers undisclosed

Source: Knight Frank Research

INVESTMENT ACTIVITY & YIELDS

Although investor appetite remains strong for CBD assets, office investment sales volumes fell by 36% from the preceding 12 months, impacted by a scarcity of investment opportunities. In 2016 $1.97 billion was transacted across 23 properties within the Melbourne CBD office market, down from the $3.08 billion recorded in 2015.

The largest office transaction recorded in 2016 was the acquisition of 839 Collins Street for $430 million. Both Challenger and Invesco purchased a 50% share in the fund-through transaction, reflecting a core cap rate of 5.00%. The 20 level office tower (38,000m^2) is currently under construction with ANZ recently committing to 26,500m^2.

Domestic unlisted funds and syndicates were the most active buyers, with sales totalling $889.5 million accounting for 45% of all sales by value. Domestic private investors spent $333.3 million across six assets, their highest level of spending in the Melbourne CBD office market over the past 10 years. The largest private investor purchase was 1 Collins Street for $125 million.

Cross-border investment into the Melbourne CBD totalled $687 million, well down from the $2.26 billion invested in 2015. During 2016, offshore groups accounted for 35% of sales activity, or $687.05 million.

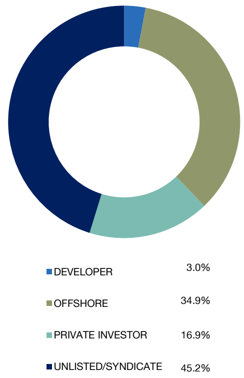
While Singaporean and Chinese-based investors acquired the majority of CBD assets purchased by foreign investors, Swiss based investors were also active, accounting for 28% of cross-border investment into the Melbourne CBD office market in 2016, with the acquisitions of 533 Little Lonsdale Street ($32.25 million) by Fidinam and 114 William Street ($161.50 million) by AFIAA.

Investors remained focused on Prime grade stock with Premium and A-grade assets accounting for 63% of sales volume or $1.24 billion. Prime grade asset sales have surpassed secondary asset sales every year for the past five years.

FIGURE 5

Melbourne CBD sales by purchaser

$10 million+ sales — 2016



Source: Knight Frank Research

While prime assets accounted for the majority of investment volume, secondary CBD offices transacted over the year totalled $729.7million, 24% above the long term average. Within the secondary market, offshore groups were the most active buyers, acquiring $368.5 million in 2016.

TABLE 4

Recent Sales Activity Melbourne CBD

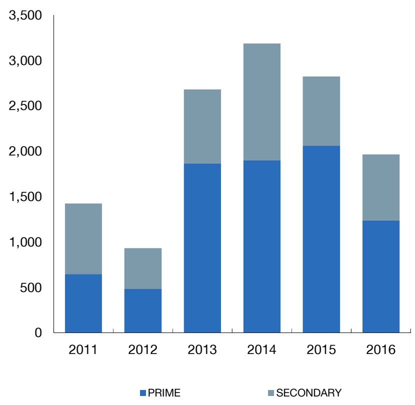
Address	Price ($ mil)	Core Mkt	NLA (m^2)	$/m² NLA	WALE (yrs)	Vendor	Purchaser	Sale Date
World Trade Centre 18-38 Sidley Street	267.50	6.78*	49,935	5,357	4.94	Abacus	Local Chinese Investor	Jan-17
839 Collins Street+	430.0	5.00^	38,000	11,316	N/A	Lendlease	Invesco & Challenger	Dec-16
100 Queen Street	274.50	5.20	36,630	7,494	2.5	ANZ Bank	GPT Wholesale Office Fund	Dec-16
85 Spring Street ⏏	75.00	VP	10,700	7,009	VP	Grocon	Golden Age	Dec-16
825 Bourke Street	72.70	6.10*	10,164	7,084	2.0	Lendlease	Juilliard Group	Dec-16
595 & 597 Little Collins Street ⏏	30.6	U/D	3,786	7,924	U/D	Anyran P/L Antonio and Annunziata Arduca	Pro-Invest	Dec-16
301 Flinders Lane ⏏	34.2	3.97	5,690	6,011	3.7	KLW Holdings	Poulakis family	Dec-16
440 Elizabeth Street ⏏	75.60	5.95*	13,812	5,430	U/D	Selected Growth Property	Chinese Investor	Nov-16
114 William Street	161.50	5.69	21,025	7,681	4.5	Straits Trading Company	AFIAA	Oct-16
95-111 Franklin Street ⏏	56.00	U/D	4,106	13,639	U/D	Holder East	Scape Student Living	Oct-16
380 La Trobe St	157.00	5.50	21,558	7,283	9.0	Invesco	Offshore Investor	Jul-16

Source: Knight Frank Research * initial yield U/D—undisclosed +Fund through transaction ^Core Cap Rate ⏏Change of use

FIGURE 6

Melbourne CBD Sales $10 million+

By grade ($m)



Source: Knight Frank Research

The volume of CBD offices purchased for redevelopment reached an all-time high total of $594.0 million in 2016 compared with $162.3 million in 2015. Hoteliers, developers and student accommodation providers were all active buyers with the largest transaction the sale of 95-111 Franklin Street for $56 million to Scape Student Living with plans to deliver a 50,000m^2 mixed use scheme.

While offshore investors remained a net buyer of CBD office in 2016, offshore groups were the largest sellers of CBD office property with Invesco and Straits Trading Company examples of two foreign investors who divested major CBD assets in 2016.

This calendar year has also begun strongly with $267.5 million already having transacted in the first quarter, from the acquisition of the World Trade Centre, 18-38 Sidley Street. A private Melbourne-based investor, backed by Asian funding purchased the asset for $267.5million, reflecting an initial fully leased yield of approximately 6.8%.

Fewer buying opportunities, combined with Melbourne's rental outlook, resulted in further yield compression of both prime and secondary yields in 2016, albeit the rate of compression has moderated.

As at January 2017, average prime office yields have compressed by 13 basis points over the past 12 months to 5.25%. In light of recent transactions, average prime yields range between 4.75% and 6.00% and stand 138 basis points lower than the 10-year average.

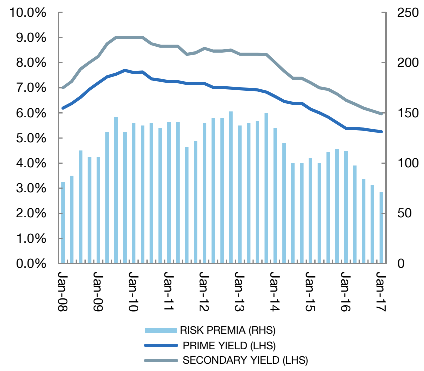
The recent sale of 100 Queen Street, having transacted on a core market yield of 5.20%, is evidence of this strong yield compression. The GPT Wholesale Fund (GWOF) purchased the asset for $274.5 million from the ANZ Bank

In the secondary market, average core market yields compressed by 54 basis points in the past 12 months to January 2017 to range between 5.75% to 6.50%. The current spread of 71 basis points between prime and secondary yields is their tightest level on record.

FIGURE 7

Melbourne CBD Yields & Risk Spread

Core Market Yields & Prime vs Secondary Spread (bps)



Source: Knight Frank Research

Outlook

- Over the next three years, white collar employment within the Melbourne CBD is forecast to grow by 10,698 employees. Tenant demand in the CBD is expected to remain strong over the next three years, underpinned by growth in the Professional Services, Finance & Insurance and Accommodation & Food sectors.
- Between 2017 and 2018 gross supply added to the market will average 1.3% of total stock per annum, well below the historical average of 3.6%. Of the space that is currently under construction, 59% is pre-committed.
- The overall vacancy rate in the CBD is anticipated to continue trend down over the next two years, falling to 4.1% by the end of 2018, before rising moderately in 2019 when the next development cycle commences.
- With positive net absorption combined with the vacancy forecast to remain below the historical average over the next three years, further gains in rents are projected. Prime and secondary net face rents are forecast to grow by 5.0% and 4.5% per annum over the next two years respectively.
- In the investment market, supported by Melbourne's rental outlook, marginal yield compression is anticipated, albeit at a slower pace than previously recorded.
- Looking ahead, investment volumes are anticipated to remain above the five year average in 2017 but unlikely to match volumes recorded in 2014 and 2015, impacted by the scarcity of investment opportunities rather than diminishing investor appetite.

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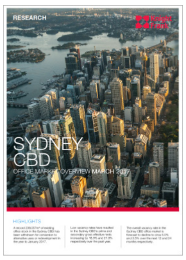

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