- *Demand for office space rebounds*
- *New development completions lead to higher vacancy*
- *Lower supply and stronger demand to drive leasing market recovery*

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Melbourne CBD Office

Market Report, March 2022

MELBOURNE BOUNCES BACK

Demand for office space in Melbourne is rebounding amid strong economic and employment growth.

11.9% VACANCY

38% Prime incentives

$1.99 BILLION TURNOVER

"Momentum in the Melbourne office market is building with stronger net absorption and lower new development completions likely to drive vacancy lower from late 2022 onwards."

The Key Insights

CBD office vacancy increased further in H2 2021, rising from 10.4% to 11.9%, reflecting a 136,699 sqm increase in net supply.

Demand for office space has rebounded strongly, with net absorption rising by 45,560 sqm over the six months to January 2022.

Average net face rents continue to hold firm, however prime incentives rose from 37% to 38% over the three months to January, leading to a small decline in prime net effective rents.

Sales volume totalled around $2 billion in 2021, roughly in line with 2020 levels, with strong interest from offshore investors.

Prime office yields remain low and currently range between 4.35% and 4.85%.

Melbourne CBD Office Market Indicators—January 2022

GRADE	TOTAL STOCK SQM	VACANCY RATE %	NET ABSORPTION SQM	NET ADDITIONS SQM	AVERAGE NET FACE RENT $/SQM	INCENTIVE %	EFFECTIVE RENTAL GROWTH % YoY (NET)	CORE MARKET YIELD %*
Prime	3,553,178	12.1	54,304	128,707	708	30-40	-7.5	4.35-4.85
Secondary	1,478,605	11.3	-8,744	7,992	520	28-37	-3.7	4.75-5.25
Total	**5,031,783**	**11.9**	**45,560**	**136,699**				

Source: Knight Frank Research/PCA *assuming WALE 5.0 years

ECONOMIC ACTIVITY REBOUNDS

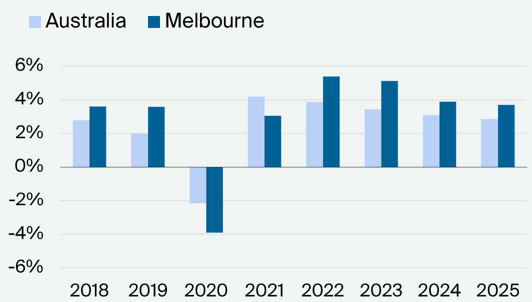
Strong recovery in economic growth and employment coming out of lockdown

Victoria is undergoing a strong recovery following the easing of lockdown restrictions late last year. Retail sales have risen by an exceptionally strong 16.0% since the easing of restrictions to be 7.1% higher than pre-Delta outbreak levels. Strong consumer spending is being supported by a rapid recovery in the labour market, with total employment in Victoria rising by 4.5% in the three months to January compared with 3.5% for Australia.

In terms of economic growth, Melbourne is set to outperform the national average over the next few years. Oxford Economics expects Melbourne's gross regional product to rise by 5.4% this year, compared with 3.8% GDP growth for Australia. Melbourne's economic performance is expected to be boosted by the gradual return of international students and tourists. Over the medium-term, Melbourne is also expected to benefit disproportionally from the return of overseas migrants as international border restrictions ease.

Despite the strong growth outlook for Melbourne, there is greater uncertainty around the global outlook. Inflation has risen significantly globally, prompting major central banks to bring forward their timetable for monetary policy tightening. Russia's invasion of Ukraine has led to further sharp rises in commodity and energy prices, which will flow through to higher inflation with the potential to adversely affect global growth. While Australia is experiencing less pronounced growth in inflation and wages than many major advanced economies, most economists expect the RBA to begin raising interest rates later this year.

Australia GDP and Melbourne GRP
Per cent change



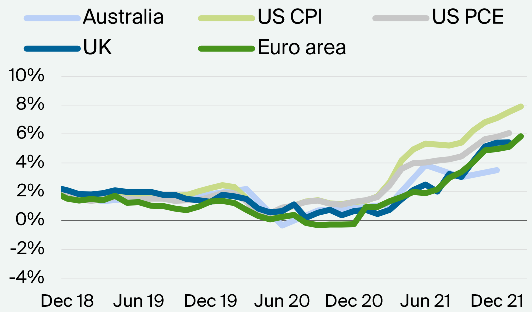
Source: Knight Frank Research, Oxford Economics

Economic recovery driving rebound in demand for office space

The rebound in economic and employment growth seen in recent months is translating into a turnaround in demand for office space. Total net absorption in the Melbourne CBD rose by 45,560 sqm in the second half of 2021, following the 96,635 sqm fall in net absorption in the first half of the year. Demand was concentrated in the prime market, with net absorption rising by 51,253 sqm and 3,501 sqm in the A grade and premium segments respectively. By contrast, net absorption in the secondary market fell by 8,744 sqm.

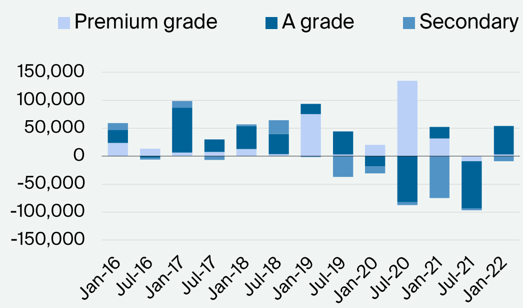
The precincts that experienced the largest falls in net absorption during the pandemic saw the strongest rebound in H2 2021. Net absorption in the Docklands and Western Core, which accounted for most of the development completions in the half-year, rose by 44,339 sqm and 32,2021 sqm respectively. By contrast, Flagstaff recorded a 22,296 sqm decline in net absorption.

Headline inflation
Per cent change year on year



Source: Knight Frank Research, Macrobond

Net absorption
By grade, sqm



Source: Knight Frank Research, PCA

STRONGER DEMAND BOOSTS OUTLOOK

Rebound in office demand points to less severe pandemic impact than many had anticipated

The sharp turnaround in demand for office space in H2 2021 bodes well for the longer-term office market outlook. Across the Australian markets, the decline in net absorption during the pandemic has been no worse than during historical economic downturns. Pent-up demand is driving an increase in market activity, with net absorption in H2 2021 at its highest level nationally since 2012, and we expect strong levels of take-up over the next few years.

Financial and professional services and public sector drive take-up

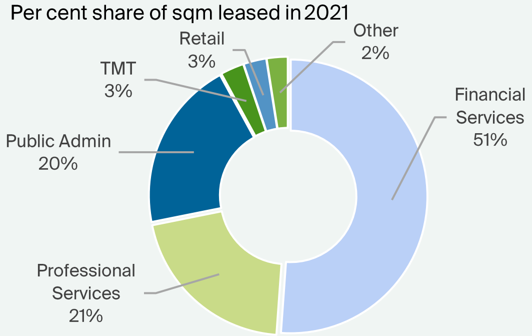
Demand for office space continues to be driven by financial services, professional services, and public administration. The finance and insurance industry accounted for just over half of office take-up in the CBD in 2021, boosted by 10,000 sqm+ lease deals by Medibank and Bupa, commencing in 2023 and 2024 respectively, while Aware Super has committed to 8,000 sqm of space starting in 2023. The top three sectors combined made-up 92% of take-up in 2021.

Smaller and medium-size leasing deals account for a higher share of take-up

Leasing deals involving less than 5,000 sqm of office space accounted for 52% of CBD office take-up by number of square metres leased in 2021 compared with around 30% in 2019 and 2020. Conversely, activity in larger deal bands remains subdued, with 5,000 sqm+ deals making up 48% of take-up in 2021, down from around 70% in 2019 and 2020. The share of deals between 5,000 sqm and 10,000 sqm fell particularly sharply, accounting for 8% of take-up last year, compared to 20% in 2020 and 36% in 2019.

CBD office take-up by sector

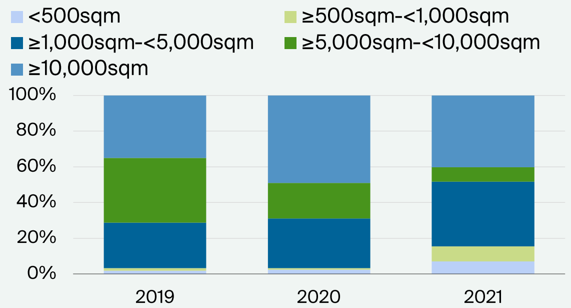
Per cent share of sqm leased in 2021



Source: Knight Frank Research
Other inclusive of Admin & Support Services, Real Estate, Wholesale Trade and Construction

CBD office take-up by deal size

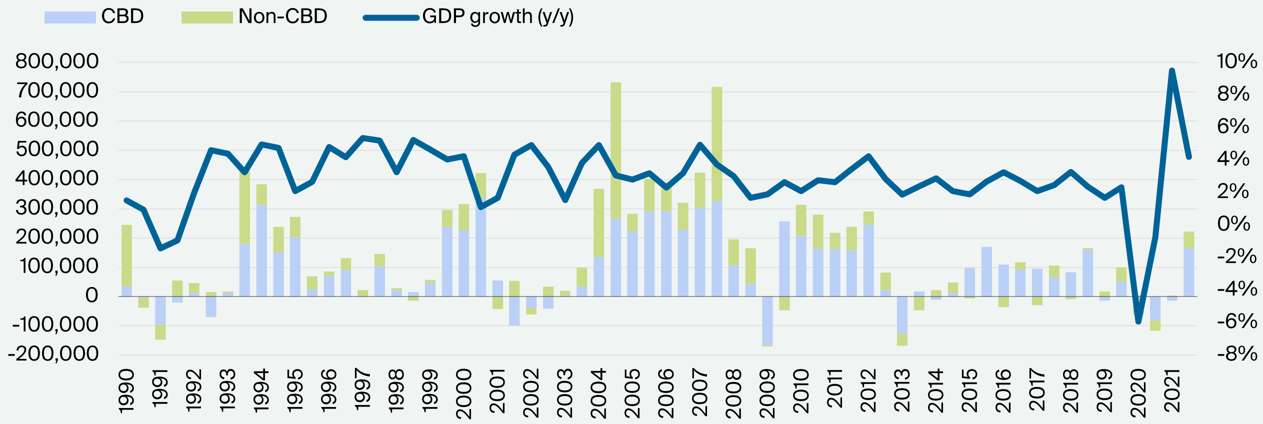
Per cent share of sqm leased



Source: Knight Frank Research

Office net absorption and GDP growth - all Australian markets

Absorption per six month period (sqm)



Source: Knight Frank Research, PCA

VACANCY RISES ON HIGHER SUPPLY

Higher supply drives vacancy rate higher despite stronger demand

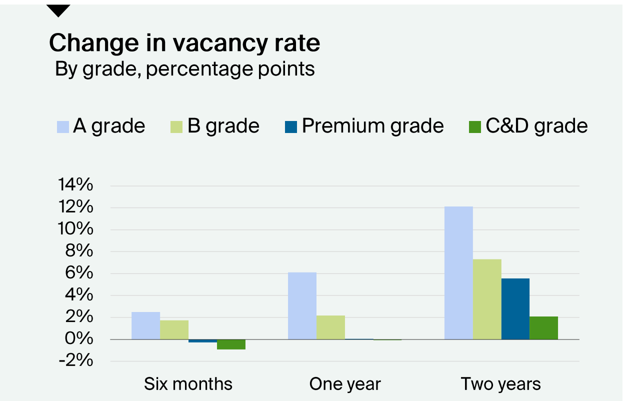
The Melbourne CBD office vacancy rose from 10.4% in July 2021 to 11.9% in January 2022. The prime office vacancy rate rose from 10.4% to 12.1%, driven by a 2.5 percentage point rise in vacancy in the A grade segment to 14.2%, while vacancy in the premium segment fell slightly from 7.5% to 7.2%. Vacancy in the secondary market increased from 10.2% to 11.3%, reflecting a 1.7 percentage point increase in B grade vacancy to 13.7%.

The increase in prime vacancy was driven by the high level of new supply, with 185,332 sqm of mostly A grade development completions in the six months to January, including Brookfield's and ISPT's 66,000 sqm new development at 405 Bourke Street, and GPT's 38,933 refurbishment at 750 Collins Street. The development completions bring the Melbourne CBD total office stock to just over 5 million square metres. The supply additions were concentrated in the Docklands and the Western Core, with these precincts accounting for a combined 57% of the increase in the CBD vacancy rate in H2 2021.

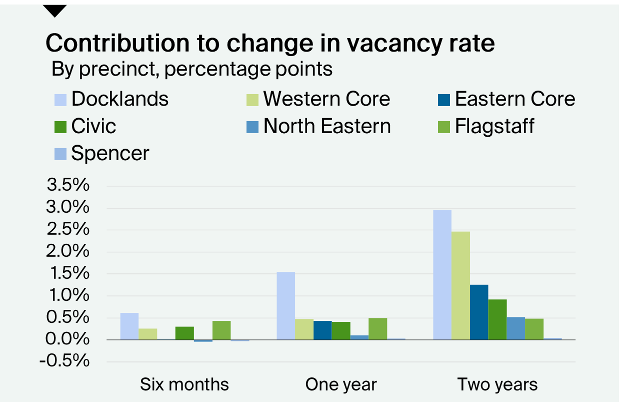
Lower supply pipeline and sustained net absorption to drive vacancy lower

Following a large influx in 2020 and 2021, new supply is expected to slow significantly over the next few years. A total of 109,795 sqm expected to land this year including 140 Lonsdale Street (22,000 sqm), while 117,000 sqm tipped for 2023 including 555 Collins Street. Looking further out, Melbourne Quarter Tower (693 Collins Street) is expected to add 68,000 sqm of office stock in 2024.

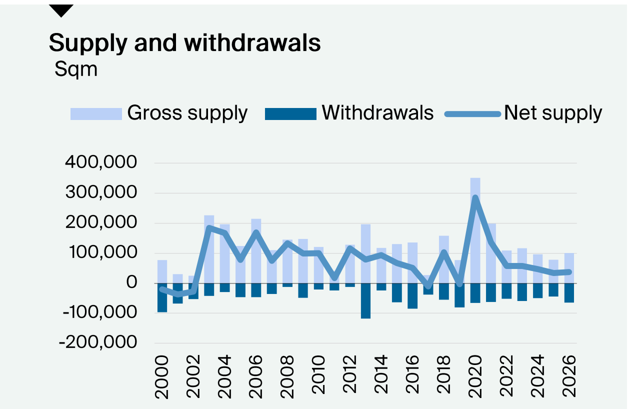
The lower level of new supply, coupled with stronger demand for office space will drive the recovery of the leasing market. The Melbourne CBD vacancy rate is expected to peak at 12.4% in the middle of the year, before falling back to 11.6% at the end of 2022, and then declining to around 9% over the next few years.



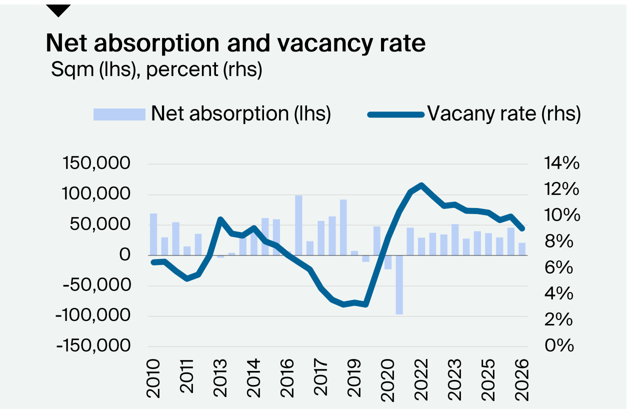
Source: Knight Frank Research, PCA



Source: Knight Frank Research, PCA

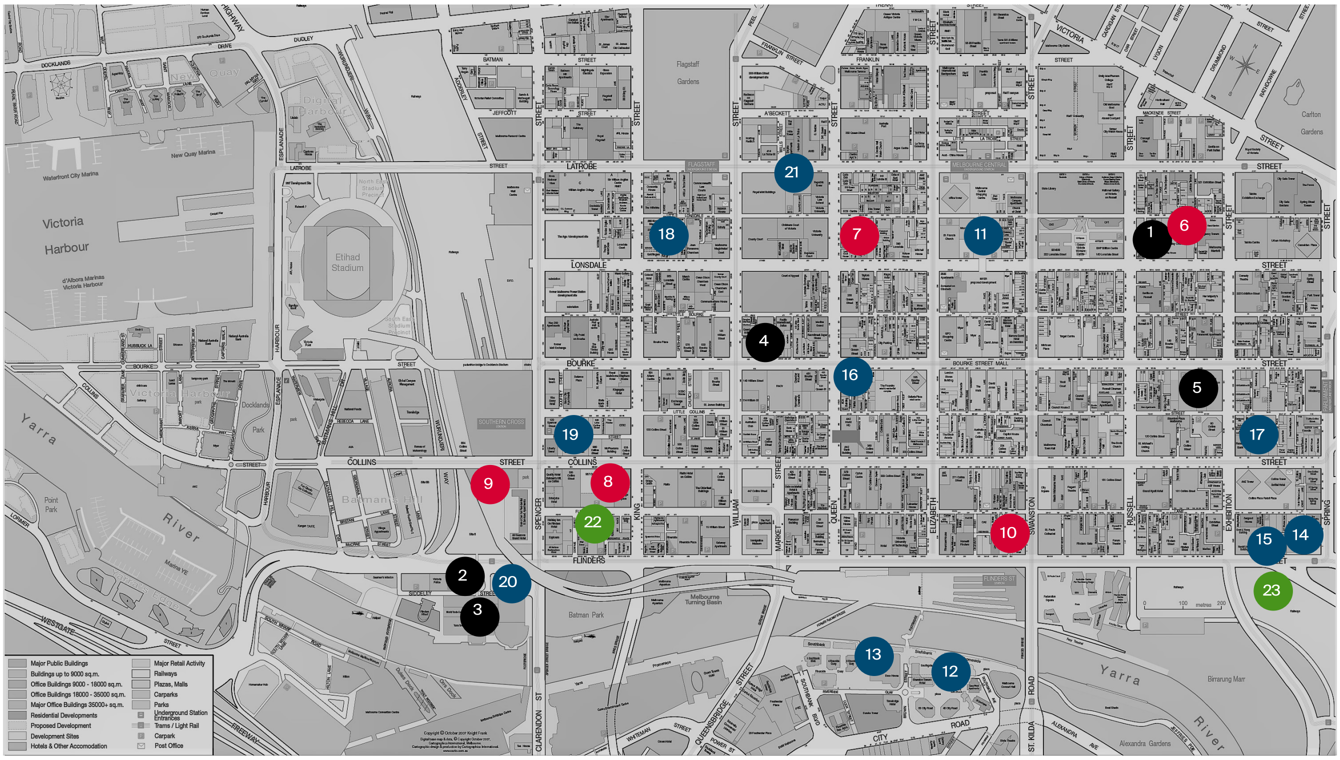


Source: Knight Frank Research, PCA



Source: Knight Frank Research, PCA

MAJOR OFFICE SUPPLY



NB Dates are Knight Frank Research estimates
Major tenant commitment in [brackets] net to NLA

MAJOR REFURBISHMENTS

1 150 LONSDALE STREET, 6,762 SQM
CHARTER HALL – 0% COMMITTED. H1 2022

2 637 FLINDERS STREET, 25,716 SQM
ZONE Q/ARTIFEX – 0% COMMITTED. H1 2022

3 18 SIDDELEY STREET (WTC), 14,029 SQM
JOIN GLORY MANAGED BY UDM – 0% COMMITTED. H1 2022

4 500 BOURKE STREET, 44,000 SQM
ISPT – 0% COMMITTED H2 2023

5 111 BOURKE STREET, 44,000 SQM
BROOKFIELD & 151 PROPERTY – 0% COMMITTED TBC

UNDER CONSTRUCTION/ MAJOR PRE-COMMITMENT

6 140 LONSDALE STREET, 22,000 SQM [AUSTRALIAN FEDERAL POLICE]
CHARTER HALL – 100% COMMITTED. H2 2022

7 283 QUEEN STREET, 25,000 SQM
ISPT. H1 2023

8 555 COLLINS STREET, 48,000 SQM
[AMAZON] CHARTER HALL – 44% COMMITTED. H2 2023

9 MELB QTR TOWER, 693 COLLINS STREET, 68,000 SQM
LENDLEASE – 22% COMMITTED. H1 2024

10 OVER STATION DEVELOPMENT, SWANSTON STREET,20,000 SQM
LENDLEASE – 0% COMMITTED. H1 2025

DEVELOPMENT APPROVED

11 300 LONSDALE STREET, 20,000 SQM
THE GPT GROUP – 0% COMMITTED. H1 2026

12 SOUTHGATE (TOWER 3), 40,000 SQM
ARA. TBC

13 12 RIVERSIDE QUAY, 57,000 SQM
NICE FUTURE INTERNATIONAL INVESTMENT PTY LTD – 0% COMMITTED.

14 1 SPRING STREET, 27,500 SQM
BESEN & ROTH FAMILIES – 0% COMMITTED. TBC

15 32 FLINDERS STREET (NTH & STH TOWER), 29,000 SQM
THE GPT GROUP 0% COMMITTED. H1 2024

16 435 BOURKE STREET, 68,000 SQM
CBUS PROPERTY – 0% COMMITTED. H1 2025

17 60 & 52 COLLINS STREET, 46,000 SQM
DEXUS – 0% COMMITTED. H1 2026

18 580 LONSDALE STREET, 25,000 SQM
HICKORY – 0% COMMITTED. TBC

19 600 COLLINS STREET, 55,000 SQM
HINES – 0% COMMITTED. H1 2026

20 FLINDERS WEST, 7-23 SPENCER STREET, 45,000 SQM
MIRVAC – 0% COMMITTED. TBC

21 383 LA TROBE STREET, 44,000 SQM
MIRVAC – 0% COMMITTED. TBC

DEVELOPMENT APPLICATION/MOOTED/ EARLY FEASIBILITY

22 522 FLINDERS LANE, 30,000 SQM
INVESTA. TBC

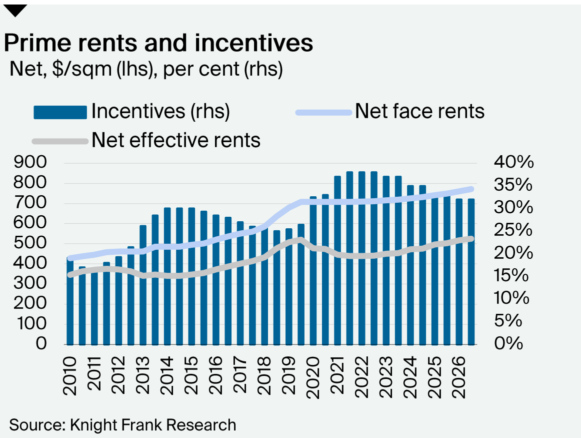
23 SPRING & FLINDERS STREETS, TREASURY SQR,140,000 SQM
MIRVAC. TBC [STAGE 1, 40,000 SQM H1 2026]

INCENTIVES RISE BUT ARE NEAR PEAK

Face rents remain stable but prime incentives rise leading to lower effective rents

Prime net face rents in the CBD averaged $708/sq m as at January 2022, which is unchanged over the past two years. However, average prime incentives continue to rise, averaging 38% in January, up from 37% three months before. As a result, prime net effective rents fell by 1.6% in the January quarter to average $439/sqm to be 7.5% lower over the year.

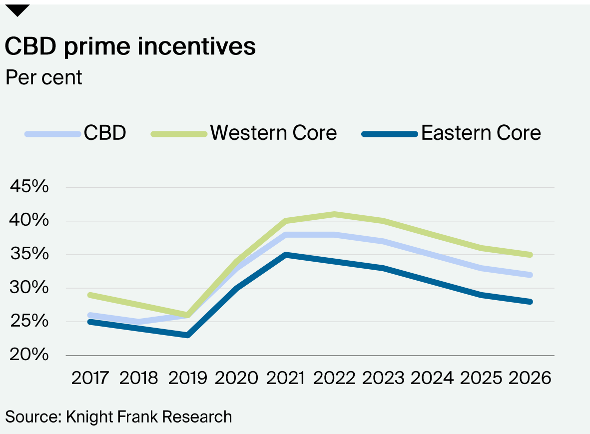
Face rents in the secondary market have also remain stable since the onset of the COVID-19 pandemic at $520/sq m. Average incentives remained unchanged over the past six months, although net effective rents are 3.7% lower over the year at $338/sqm.



Incentives to see steady decline from 2023 led by the Eastern Core

In line with improving leasing market conditions and tightening vacancy, we expect incentives to begin steadily declining from 2023. Lower incentives will drive a rebound in effective rental growth, with prime net effective rents expected to rise by 3.6% per annum on average from 2022 to 2026.

The recovery in effective rents will be led by the Eastern Core, where incentives are expected to begin a sustained decline from their current average of 35% from this year onwards. By contrast, we expect average incentives in the Western Core to rise a little further from 40% at the end of last year to 41% at the end of this year and remain around 40% in 2023. By the end of 2026, we expect prime incentives to average 28% and 35% in the Eastern Core and Western Core respectively. Prime net effective rental growth is forecast to be 4.9% p.a. in the Eastern Core compared to 2.8% p.a. for the Western Core.



Recent significant tenant commitments

OCCUPIER	PROPERTY	PRECINCT	SIZE SQM	START DATE
Medibank #	699 Collins Street	Docklands	15,400	Q4 2024
BUPA~	11 Exhibition Street	Civic	13,000	Q4 2023
Aware Super	555 Collins Street	Western Core	8,000	Q3 2023
Northern Trust~	120 Collins Street	Eastern Core	2,877	Q2 2021
Canaccord Genuity~	101 Collins Street	Eastern Core	1,572	Q1 2022

Pre-commitment ^Lease of speculatively developed space ~Existing space. Contact leasing team for further information on these deals.

OFFSHORE INVESTORS DRIVE INVESTMENT

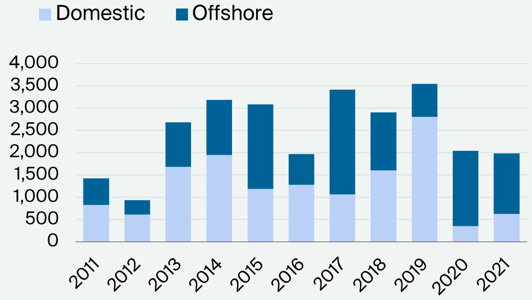
Investment activity picked up in the second half of 2021

Sales volume increased significantly in the second half of 2021 after a subdued first half of the year. Around $2 billion of CBD assets over $10 million transacted last year, roughly in line with 2020 levels. However, activity is still below pre-pandemic levels, with investment volume 33% below the average over the five years to 2019.

Lendlease's sale of Melbourne Quarter Tower to the National Pension Service of South Korea in July for $1.2 billion accounted for around 60% of investment volume in 2021 and underscores the appeal of Melbourne's CBD office market for offshore investors. Further supporting activity late last year was Forza Capital's purchase of 399 Lonsdale Street for $86.8 million, and the acquisition of 300 Flinders Street by Marprop and Futuro Capital for $80.8 million.

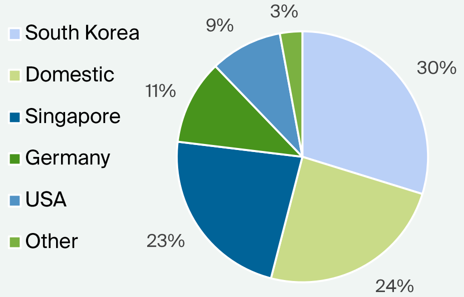
While domestic investor activity picked up in 2021, offshore investors continued to play a central role in driving activity. Overseas investors accounted for a well-above average 68% of investment volume in 2021 and 76% over 2020 and 2021. South Korea, Singapore, Germany, and the US have been the largest sources of capital inflow into the Melbourne CBD over this two-year period.

Melbourne CBD office investment volume
$ million, transactions greater than $10 million



Source: Knight Frank Research

CBD office investment by country
Per cent share, $10m+ sales, 2020 and 2021



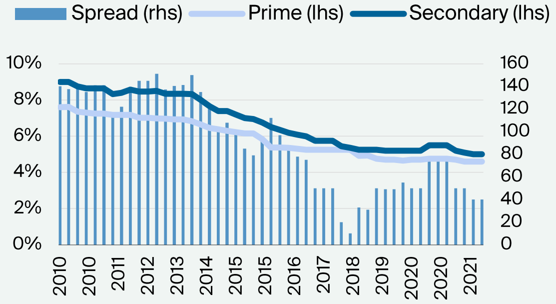
Source: Knight Frank Research

CBD prime office yields remain stable amid expectations of higher interest rates

Melbourne CBD average prime yields have remained stable over the past six months at 4.60% after tightening in the first half of the year. Prime yields currently range between 4.35% to 4.85%, while secondary yields range between 4.75% to 5.25%. The spread between prime and secondary yields is currently around 40 basis points.

While nominal interest rates are expected to begin to rise in the near future, prime office yields expected to remain at low levels as lower real interest rates (as a result of higher inflation) contribute to sustained demand for office property — particularly for well-located prime assets with long income streams that are less exposed to leasing risk.

CBD office yields
Percent (lhs), basis points (rhs)



Source: Knight Frank Research

We like questions, if you've got one about our research, or would like some property advice, we would love to hear from you.

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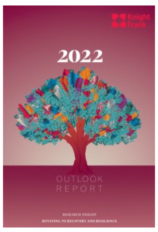

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