- *CBD net absorption remains positive (+40,054 sqm) for prime property*
- *Prime face rents cement H1 2022 rises*
- *Yields continue to edge out as cost of capital impacts pricing*

Melbourne CBD Office with Southbank update

Market Report, March 2023

knightfrank.com/research

MARKET SLOWS AS TENANTS AND INVESTORS TAKE STOCK

Bifurcation leads to a split in net absorption signals, flight to quality becomes more apparent

13.8% VACANCY

$686 PRIME FACE RENT

41% PRIME INCENTIVES

"Vacancy rates move higher but demand for prime space remains, whilst second tier offerings struggle"

The Key Insights

Average net face rents grew moderately in the December quarter, with this concentrated at the premium end of the CBD as tenants went for quality.

Demand for office space went negative (-15,654 sqm) after two continued periods of positive demand. However, demand for Premium and Grade A space rose as flight to quality continues.

Vacancy rate rose to 13.8% as supply of space surpassed demand; though this was concentrated in the secondary market.

Prime yields moved out further to 5.13% as events in global capital markets keep pressure on finance; the gap between prime and secondary yields continue to rise.

Melbourne CBD Office Market Indicators — February 2023

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	3,650,682	12.4	40,054	48,716	686	41	-0.5	4.75-5.50
Secondary	1,477,549	17.2	-55,708	-12,541	569	38	-1.3	5.50-6.00
Total	**5,128,231**	**13.8**	**-15,654**	**36,175**				

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

ECONOMY SLOWS BUT GROWTH CONTINUES

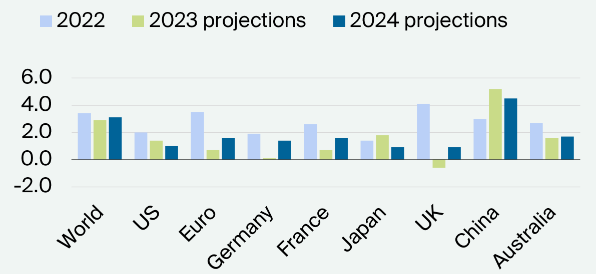
Continued evidence of the market slowing as interest rate rises begin to bite.

The Q4 GDP figure (0.5%) showed the Australian economy continued to slow down through the second half of 2022 finishing the year with annual growth of 2.7%. Forecasts from the IMF are for the economy to continue to slow into 2023, but avoid recession with growth of 1.6% forecast for 2023. There is upside to this, as it based off growth of only 5.2% for China which may well post stronger growth as it recovers from 2022's lockdowns.

Melbourne's economy recovered strongly in 2022, with growth of 6% having previously been particularly hard hit by the global shutdown and lockdowns within Melbourne itself. This strong performance is expected to continue, even as the economy itself slows down. Growth of 2.5% in GSP is forecast for 2023, and overall Melbourne is expected to outperform the Australian average by over 0.4%p.a. between 2023-2027. This should provide impetus to office market demand in the next few years.

IMF GDP forecasts

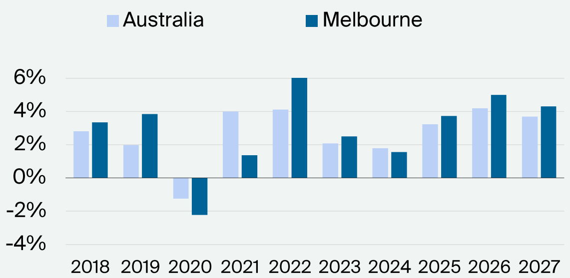
GDP forecasts, Jan-23



Source: Knight Frank Research, IMF

Australia GDP and Melbourne GSP

Per cent change



Source: Knight Frank Research, Oxford Economics

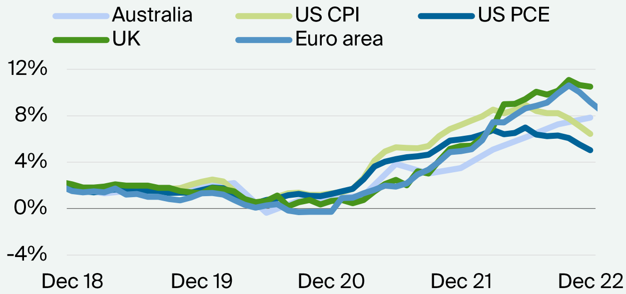
Inflationary pressures show signs of peaking in the first half of 2023.

Inflation rose markedly around the world, including Australia, in 2022. The RBA has responded to this by applying monetary pressure via raising rates. However, at least internationally, there are signs that the peak has been reached. Inflation has stabilised in Europe, whilst in the U.S. it is on a clear downward trajectory, though still at stubbornly high rates.

Australia lagged the trend on the upside and appears to be replicating this on the downside, with inflation still rising (to 7.8% in Q4), though at a clearly slowing rate. It is thought that inflation may have peaked here as well. Within the construction sector cost increases are on a downward trajectory with the latest rate now 14% compared to 17% in mid -2022. Steel beams at one point were showing price rises of 41%, but are now at 'only' 18% as price costs flow through. Consequently, it is hoped we can expect stabilisation in interest rates in the next few months and thus some stability within the financial markets.

Headline inflation

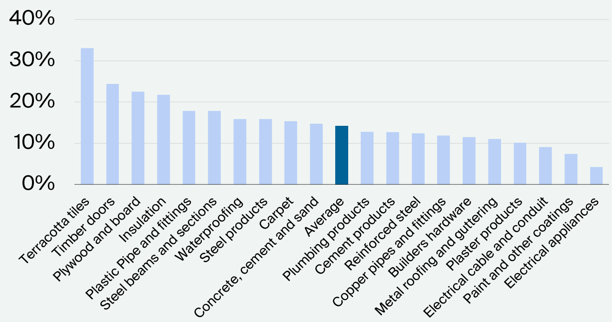
Per cent change year on year



Source: Knight Frank Research, Macrobond

Annual change in construction costs

ABS producer price index, Q42022, % y/y



Source: Knight Frank Research, ABS

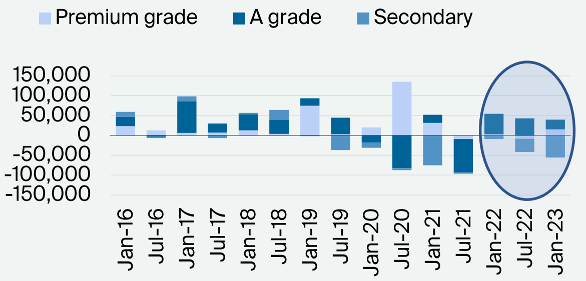
NET ABSORPTION TURNS NEGATIVE

Weak secondary demand overwhelms good demand for quality space

Australian net absorption slowed markedly in the second half of 2022, with negative figures in Melbourne and Sydney just being offset by a strong Brisbane market. Within Melbourne Premium and Grade A markets remained resilient as the overall leasing market weakened with the uncertainty in global markets and the slowing economy. Total net absorption of -15,644 sqm was down to –55,708 sqm for Grade B-D. Meanwhile, Premium Grade buildings had a net absorption of 15,243sqm with Grade A even stronger at 24,811 sqm. This is following a trend which has seen secondary property not having positive net absorption since H1 2018, falling 232,443 sqm in that time. However it has sped up with the last year seeing net absorption of -89,112 sqm. Conversely, demand for Grade A stock has been positive since lockdowns finished in clear evidence of people trading up.

Net absorption

By grade, sqm



Source: Knight Frank Research, PCA

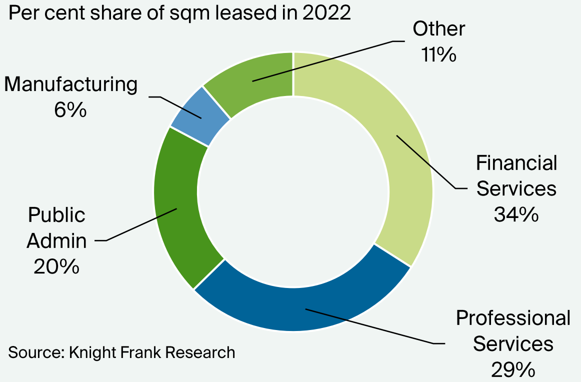
Financial services sector quieter in an uncertain year for tenants

There has been a marked change in the take-up through the CBD, as uncertainty about returning to the office has quietened some of the usual banking and financial services demand and tenants pause on requirements. Financial services which made up 51% of take-up in a bumper 2021 remained the main sector, just, in 2022 with 34% of a smaller total, meaning their activity halved. Professional services increased their share by 8% remaining roughly as active in 2022 as in 2021, whilst the overall market quietened. Public administration's share remained unchanged, meaning the big 3 made up only 83% of total take-up down from 92% previously.

Big market deals were much more scarce as uncertainty ruled. This situation is expected to continue, at least for H1 2023, until a bit more clarity returns to the global economy.

CBD office take-up by sector

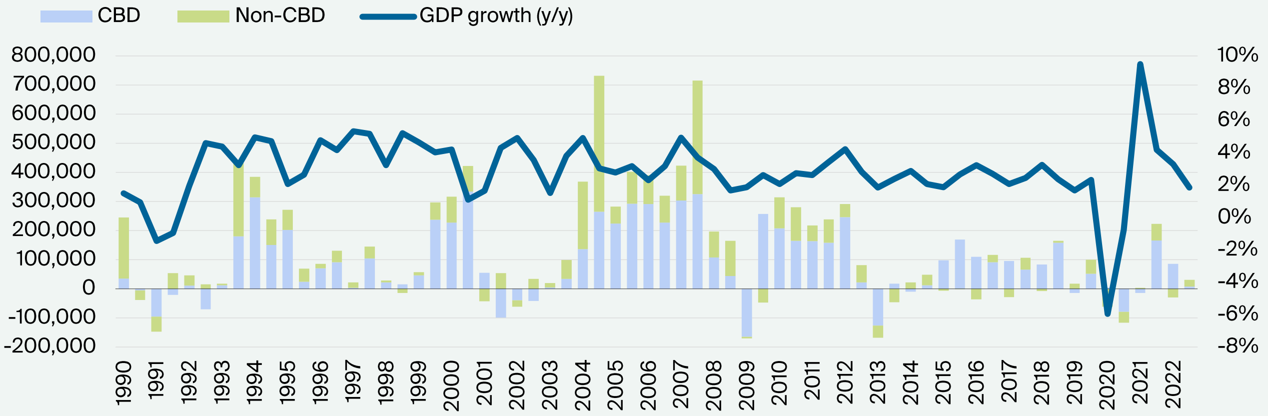
Per cent share of sqm leased in 2022



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 RATES EXPECTED TO PEAK

Evidence of bifurcation as vacancy rate rises in Grade B buildings

Melbourne's vacancy rate continued to rise (up 0.9%) to 13.8% in H2 2022. A final addition of new Grade A supply combined with negative net absorption pushed vacant space 51,829 sqm higher to a rate last seen in 1999. However, continuing the thread of this report, it was driven by a jump in Grade B vacancy of 3.4% to 20.8%. Grade A rates edged up to 13.7% whilst Premium Grade fell from 10.9% to 9.5%. This provides a clear illustration of the bifurcation of the market; as tenants trade up due to the availability of good quality space. Consequently, the weaker part of the secondary market is struggling to get traction in the leasing market.

Sub-leasing also fell back below 2% and 100,000 sqm of space. This is less to do with space being leased and more to do with tenants changing their mind. Improving figures for occupancy in the later part of 2022 probably helped concentrate the mind of tenants on their requirements; though this remains a fairly fluid part of the market until occupancy rates firm up further.

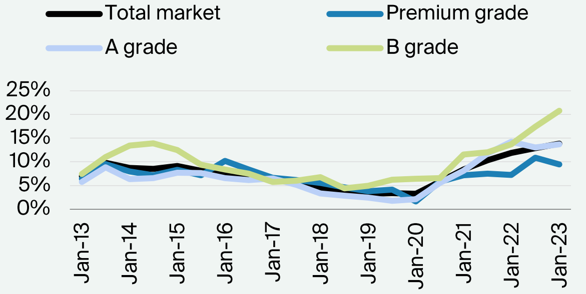
Tighter supply pipeline going forward will put pressure on vacancy rates

Going forward the development pipeline is modest in the next couple of years. 2023 has only got 555 Collins Street (48,000 sqm, 75% pre-committed) of new space, and 500 Bourke Street (44,000 sqm, 35% pre-committed) of refurbished space, whilst next year is dominated by Melbourne Quarter Tower with 68,000sqm of new space (20% pre-committed). As you head into 2026/27, developments which may have been marginal calls are becoming increasingly uncertain in the current economic and financial environment. Developers are rightly looking for those increasingly hard to come by pre-commits to push ahead with schemes.

We expect demand to remain positive if moderate in the next five years as the economy initially slows before returning to average growth. However, limited supply means we expect to see consistent downward pressure on the vacancy rate (outside 2026 if all planned buildings come through that year). At the same time we expect vacancy rates in secondary buildings to remain high and for prime rates to fall more quickly.

Vacancy rate

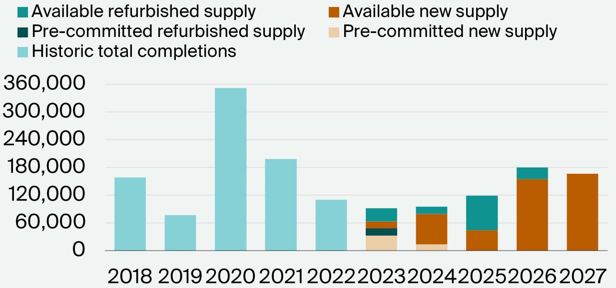
By grade, percent



Source: Knight Frank Research, PCA

Melbourne CBD development pipeline

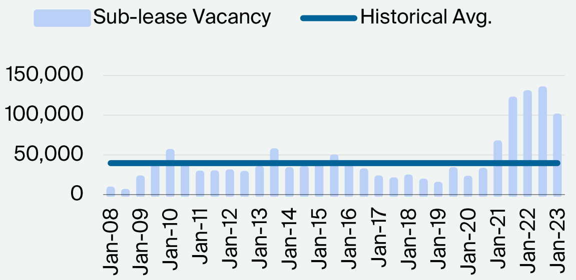
Sqm



Source: Knight Frank Research, PCA

Sub-lease vacancy

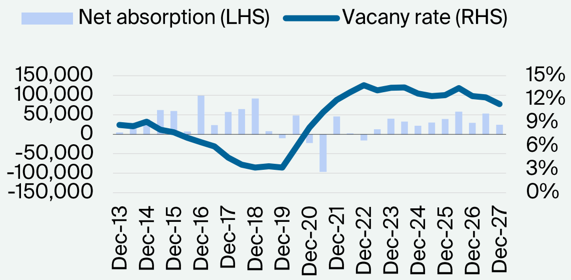
sqm



Source: Knight Frank Research, PCA

Net absorption and vacancy rate

Sqm (LHS), percent (RHS)



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

1 500 BOURKE STREET – 44,000 SQM [TAL]
ISPT – 35% COMMITTED, H2 2023

2 85 SPRING STREET – 5,000 SQM
PELLIGRA – H1 2024

3 720 BOURKE STREET – 30,000 SQM
CBUS PROPERTY – H1 2025

4 111 BOURKE STREET – 45,000 SQM
CHARTER HALL & BROOKFIELD – H2 2025

5 235 BOURKE STREET – 25,000 SQM
FUTURO CAPITAL – H1 2026

UNDER CONSTRUCTION/MAJOR PRE-COMMITMENT

6 555 COLLINS STREET – 48,000 SQM [AMAZON/AWARE]
CHARTER HALL – 75% COMMITTED, H2 2023

7 MELB QTR TOWER – 693 COLLINS STREET, 68,000 SQM [MEDIBANK]
LENDLEASE – 20% COMMITTED, H1 2024

8 17 BENNETTS LANE – 11,800 SQM
PERRI PROJECTS – H1 2024

9 OVER STATION DEVELOPMENT, SWANSTON ST – 17,000 SQM
LENDLEASE – H1 2025

10 51 FLINDERS STREET – 28,000 SQM
GPT – H2 2025

11 435 BOURKE STREET – 58,000 SQM
CBUS PROPERTY– H1 2026

DEVELOPMENT APPROVED

12 7 SPENCER STREET – 42,000 SQM
MIRVAC – H2 2025

13 60 & 52 COLLINS STREET, 36,000 SQM
DEXUS – H1 2026

14 600 COLLINS STREET – 55,000 SQM
HINES – H2 2026

15 300 LONSDALE STREET – 22,500 SQM
THE GPT GROUP – 0% COMMITTED, H1 2027

16 383 LA TROBE STREET – 44,000 SQM
MIRVAC – H1 2027

17 388 WILLIAM STREET – 25,000 SQM
SHEESH GALE – H1 2027

18 12 RIVERSIDE QUAY, SOUTHBANK – 60,000 SQM
LOI KEONG KUONG – 2026+

19 555 COLLINS STREET STAGE-2, 35,000 SQM
CHARTER HALL – H2 2027

20 SOUTHGATE (TOWER 3), SOUTHBANK– 40,000 SQM
ESR – 2026+

DEVELOPMENT APPLICATION/MOOTED/ EARLY FEASIBILITY

21 283 QUEEN STREET, 30,000 SQM
ISPT– 2026+

22 SPRING & FLINDERS STREETS, TREASURY SQR – 140,000 SQM
MIRVAC – 2028+

23 522 FLINDERS LANE – 30,000 SQM
INVESTA – 2026+

24 123 COLLINS STREET – 80,000 SQM
GRAND HYATT GROUP – 2027+

25 COLLINS SQUARE - GOODS SHED SOUTH – 70,000 SQM
WALKER – 2026+

26 710 COLLINS STREET– GOODS SHED NORTH – 70,000 SQM
ABAUS/WALKER – 2026+

FACE RENTS HOLD ON TO H1 GAINS

Face rents rise 0.7% as levels hold up in a quieter market

Prime net face rents in the CBD rose just 0.7% in the last quarter of 2022, but ended the year up 5.4% overall to hold on to the gains made in H1 even as the market calmed. Average rents in the CBD now stand at $686/sqm up from $681/sqm in Q3. Rents edged up in most precincts, but again the East outperformed with 1.9% growth to $868/sqm. The year has seen rental growth concentrated around the best precincts with the Paris quarter seeing growth of 12.1% in the year whilst Flagstaff saw 2.0%. Not only are tenants preferring prime over secondary, there is a clear preference for the better locations and better buildings within that category.

Incentives edge up further

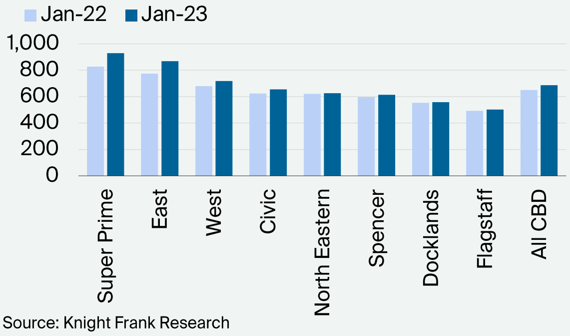
Continuing the trend of 2022, incentives edged up again to 40.5%, as more areas in the CBD standardised at around 40% incentive, with Civic, Spencer and North Eastern precincts now around 42%. The Docklands remains split with space nearer the CBD having incentives around 40%, whilst as you move further out incentives head nearer to 50%. The Eastern Core remains the only precinct with prime space consistently having incentives below 40% .

Consequently, effective rents have remained flat at $408/sqm and given the rise in incentives through 2022 (from 38.5% in Q4 2021) actually have fallen 0.5% in the year, from $410/sqm at the start. Again this has been concentrated in the markets where face rent growth has been harder to find. Secondary rents have fallen further as incentives moved out, with effective rents down 1.3% on the year.

Going forward we are expecting to see very modest growth in 2023 for face rents with effective rents virtually flat (up 1%) as incentives remain high on the back of high vacancy rates. We expect moderate rental growth and incentive declines going forward , concentrated in prime space, as the impact of limited supply kicks in. Incentives are expected to move in slowly going forward as landlords look to prioritise face rent growth.

Prime rents

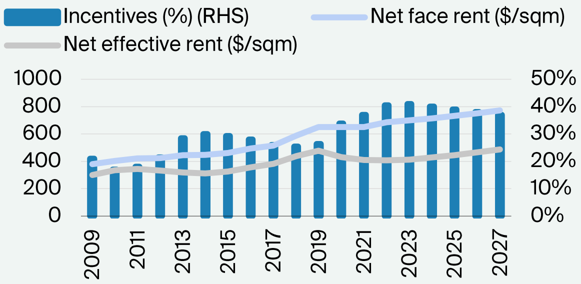
$/sqm, Net face by precinct



Source: Knight Frank Research

Prime rents and incentives

$/sqm (LHS). per cent (RHS)



Source: Knight Frank Research

Recent significant tenant commitments

OCCUPIER	PROPERTY	PRECINCT	SIZE SQM	Term YRS	START DATE
Allianz	555 Collins Street	Spencer	6,500	10	Q4-2023
BlueScope	181 William Street	Western Core	1,900	10	Q4-2023
Figari	727 Collins Street	Docklands	2,700	10	Q1-2024
PKF	500 Bourke Street	Western Core	2,200	10	Q1-2024
AEMO	171 Collins Street	Civic	4,900	5	Q1-2024

SOUTHBANK UPDATE

Market remains quiet as overflow activity from CBD remains muted

With a quieter market in the CBD, unsurprisingly Southbank is also showing less activity. Vacancy rates actually fell in H2 2022, though this was caused by withdrawals of space (mainly 20,000 sqm of 12 Riverside Quay) being greater than the negative net absorption (-14,332 sqm). Vacancy rates consequently fell, from 15.5% to 14.6%, but there are 2 main stories behind this. First, as with the CBD, they are dominated by Grade B (up from 12.3% to 18.1%). The withdrawal has led Grade A direct vacancy to drop from 11.0% to only 3.6%.

However, Southbank also has a particular problem with sub-leasing which has jumped to 8.1% (22,785 sqm) from 4.6% in H1 and 0.6% just a few years ago. This is much higher than any other precinct and partly highlights the type of tenant that has occupied the space in the past and is now seeking to lessen their floorspace.

Rental market subdued as incentives respond to the CBD lead

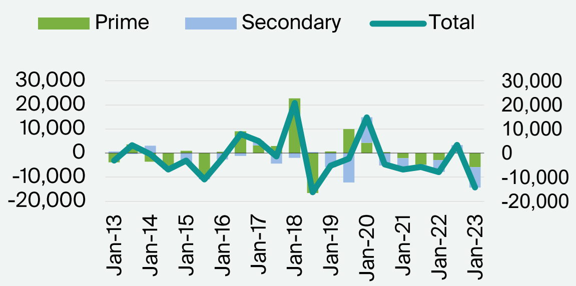
Prime face rents edged up 2.6% at the start of 2022, partly mirroring demand trends elsewhere in the city, and now sit at $575/sqm, whilst secondary rents have remained flat since the pandemic started at $355/sqm. However, prime incentives have jumped to 38%, from below 30% in 2021, as incentives across the CBD have faced upward pressure.

Future market closely linked to CBD

There is no new supply in the pipeline for 2023 or 2024. 12 Riverside Quay (mentioned previously) is pencilled in for 2026+ delivery of 60,000 sqm of space as is Southgate Tower (40,000 sqm) . These developments will depend on the overall market environment. So with little new significant supply anticipated it is expected that, as the Melbourne CBD recovers, some overflow benefit will occur in the Southbank.

Southbank net absorption

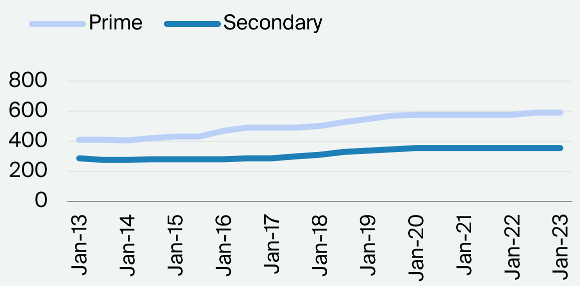
By grade, sqm



Source: Knight Frank Research, PCA

Southbank rents

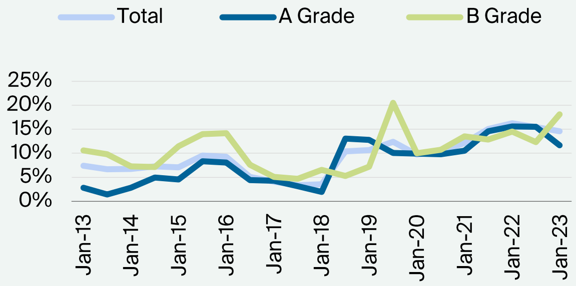
$/sqm, net face by grade



Source: Knight Frank Research

Southbank vacancy

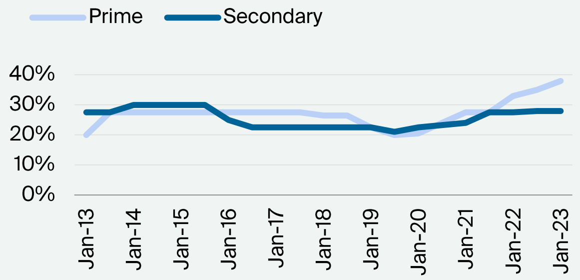
By grade, percent



Source: Knight Frank Research, PCA

Southbank incentives

By grade, percent



Source: Knight Frank Research

INVESTMENT QUIET AS PLAYERS TAKE STOCK

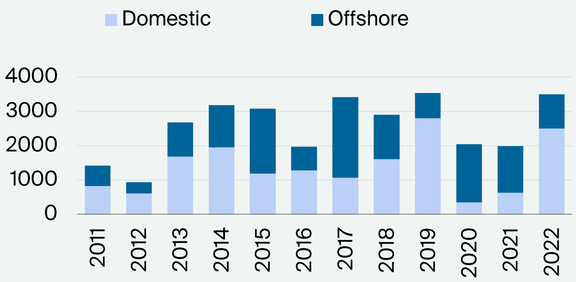
Year end volumes held up by H1, as H2 shows little activity

Investment volumes in 2022 far exceeded 2021's $2bn, standing at $3.503bn dollars. However, this has been dominated by the $2bn deal for the Southern Cross Towers in H1. Activity fell markedly in the second half of the year as costs of debt and investor sentiment led to uncertainty for investors, while sellers had to reprice to the new market metrics.

The final quarter of the year was particularly quiet in terms of deals in the market, following the lively start to 2022. The most noticeable deal was for 440 Collins Street and 459 Little Collins Street. This combined deal came in at $277m with an initial yield of 5.1%, sold by Julliard Group to Lendlease. Though the details came out in Q3 the transaction was formalized in October (RCA). Other than that deal, the market has been fairly quiet — for assets valued over $10 million — ending the year on a low, with RCA stating that year-on-year deals across Australia were down 64% (again concentrated in H1 2022).

Melbourne CBD office investment volume

$ million, transactions greater than $10 million



Source: Knight Frank Research

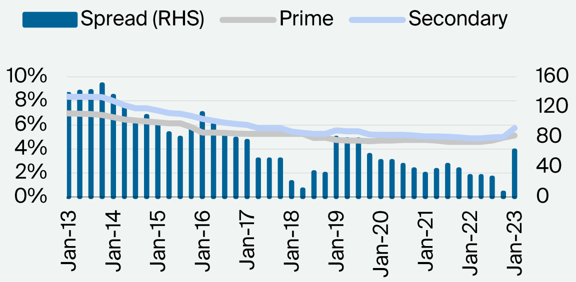
Yields continue to move out as markets reprice

Yields have continued their steady movement out as markets come to terms with the higher price of debt and a slowing global economy and the implications therein. Prime yields moved out another 19bps to 5.13% with rises across the board driven by the general repricing. Secondary markets pushed out further to 5.75% increasing the spread over the prime markedly. As further evidence of bifurcation appeared, it showed up the relatively weaker position secondary are in, in relation to tenant demand and future rental growth expectations. Southbank prime yields moved out to 5.25% on sentiment given minimum deal evidence.

We are seeing the end in sight to yield rises within the market, and expect stability to arrive by mid-2023. Our expectation is for this to be at around 5.4% for prime, before some recovery in end 2023/2024 as markets correct an inevitable overshoot, amidst more certainty on government bond rates and the economic outlook both locally and globally. Secondary investments will re-establish their traditional discount to prime, which has been generally missing in the last few years.

Melbourne CBD office yields

By grade, % (LHS), basis points (RHS)



Source: Knight Frank Research

Recent significant sales

BUILDING	BUYER	VENDOR	SIZE SQM	PRICE $M	YIELD %
440 Collins St & 459 Little Collins St	Lendlease	Julliard Group	30,000	277	5.10
Southern Cross Towers	Charter Hall Group–50%	Brookfield/ Blackstone	126,000	2,000	4.25
330 Collins Street	HThree Capital	AMP/Sunsuper	18,000	236	4.30
555 Collins St	GIC	Charter Hall Group	84,000	u/d	4.25
85 Spring St	Pelligra	Proprium Capital Partners	10,700	130	VP

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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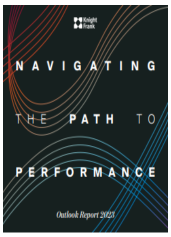

Outlook Report 2023

Wealth Report 2023

Active Capital 2023

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