RESEARCH

# MELBOURNE CBD

## OFFICE MARKET OVERVIEW SEPTEMBER 2017

## HIGHLIGHTS

New supply in the Melbourne CBD office market will be significantly constrained over the next 12 months, with vacancy projected to fall to 10-year lows by mid 2018.

Strong employment growth across Victoria has supported above average levels of net absorption, with the Melbourne CBD recording the highest volume nationally in the 12 months to July 2017.

Strong investment volumes have been recorded in the year to date with $2.2 billion transacted, 12% above the 2016 total. Offshore purchasers have accounted for 56% of total sales.

# KEY FINDINGS

**CBD total vacancy fell from 7.1% to 6.5%** in the 12 months to July 2017, the lowest level in four years.

**The CBD recorded the strongest net absorption figure nationally,** totalling 128,389m$^2$ in the 12 months to July 2017.

**The overall vacancy rate is expected to fall to 4.1%** over the next 12 months with no developments scheduled to be completed until Q2 2018.

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 75 basis points, the tightest on record.**


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# SUPPLY & DEVELOPMENT

## Supply in the Melbourne CBD office market will be significantly constrained over the next 12 months, with no developments completing until mid 2018.

Gross CBD office supply totalled just 30,606m$^2$ in the six months to July 2017. Of this amount, only 3,900m$^2$ was new completions coming from the Rialto extension at 525 Collins Street, while the remainder was backfill space from KPMG at 161 Collins Street (25,000m$^2$). This supply added to the market over the past six months was the lowest level since January 2012 and well below the long term average of 62,302m$^2$.

The withdrawal of office stock for redevelopment, alternative uses or refurbishment continues to impact stock levels in the Melbourne CBD. In the 12 months to July 2017, 57,334m$^2$ was withdrawn from the CBD office market. Nevertheless, net new supply totalled 109,640m$^2$, underpinned by strong completions in the second half of 2016.

In the next 12 months, the addition of gross office space will be significantly constrained with no office projects anticipated to be completed until Q2 2018. This is expected to lead to a supply shortage, notably for larger tenants and place upward pressure on rents in the medium term. New supply additions in 2018 are expected to total 107,242m$^2$, averaging 2.3% of total stock, well below the historical average of 3.6%. The majority of new office supply is pre-committed and will include 664 Collins Street (25,800m$^2$—100% pre-committed), One Melbourne Quarter (26,400m$^2$—53% pre-committed), 5 Collins Square (40,000m$^2$ -100% pre-committed) and 271 Spring Street (15,000m$^2$ -100% pre-committed).

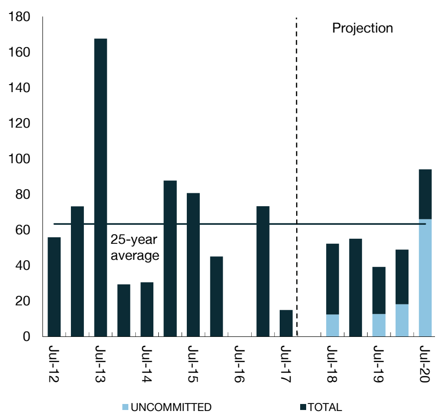
Beyond 2019 we anticipate gross supply additions to increase gradually from late 2019, through to 2021, with new supply during this period averaging 5.4% of total stock. Major office completions beyond 2019 will include 447 Collins Street (49,000m$^2$), 80 Collins Street (43,000m$^2$) and 311 Spencer Street (65,000m$^2$).

In total, 354,442m$^2$ is currently under construction across nine developments, of which 62% is pre-committed leaving 133,300m$^2$ uncommitted.

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 July 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 | 3,009,179 | 6.1 | 120,614 | 109,985 | 510—600 | 25.0—27.0 | 4.75—5.25 |
| Secondary | 1,541,419 | 7.2 | 7,775 | 1,676 | 340—460 | 25.0—30.0 | 5.50—6.00 |
| **Total** | **4,550,598** | **6.5** | **128,389** | **111,661** | | | |

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

# MAJOR OFFICE SUPPLY

1 664 Collins St - 25,800m² [Pitcher Partners, Exxon]
Mirvac/Morgan Stanley Real Estate - Q2 2018 - 100% committed.

2 One Melbourne Quarter - 26,400m² [Arup/Lend Lease]
Lend Lease - Q2 2018 - 53% committed.

3 5 Collins Sq - 40,000m² [Transurban, NBN]
Walker - Q3 2018 - 100% committed.

4 271 Spring St - 15,000m² [Australian Unity]
ISPT - Q4 2018 - 100% committed.

5 Y3, 839 Collins St - 39,200m² [ANZ]
Lend Lease - Q2 2019 - 68% committed.

6 447 Collins St - 49,000m² [King & Wood/HWL/Gadens]
Cbus Property/ISPT - Q4 2019 - 63% committed.

7 80 Collins St - 43,000m²
QIC - Q1 2020 - 14% committed.

8 477 Collins St - 51,000m² [Deloitte]
Mirvac/Suntec REIT - Q2 2020 - 43% committed.

9 311 Spencer St - 65,000m² [Victoria Police]
Keppel REIT/Cbus Property - Q3 2020 - 100% committed.

10 395 Docklands Dve - 22,000m²
MAB - 2019+

11 396 Docklands Dve - 10,500m²
MAB - 2019+

12 25 Digital Dve - 10,000m²
Digital Harbour - 2019+

13 130 Lonsdale St - 55,000m²
Uniting Church/Charter Hall - Q2 2020

14 140 Lonsdale St - 15,000m²
Charter Hall - 2020

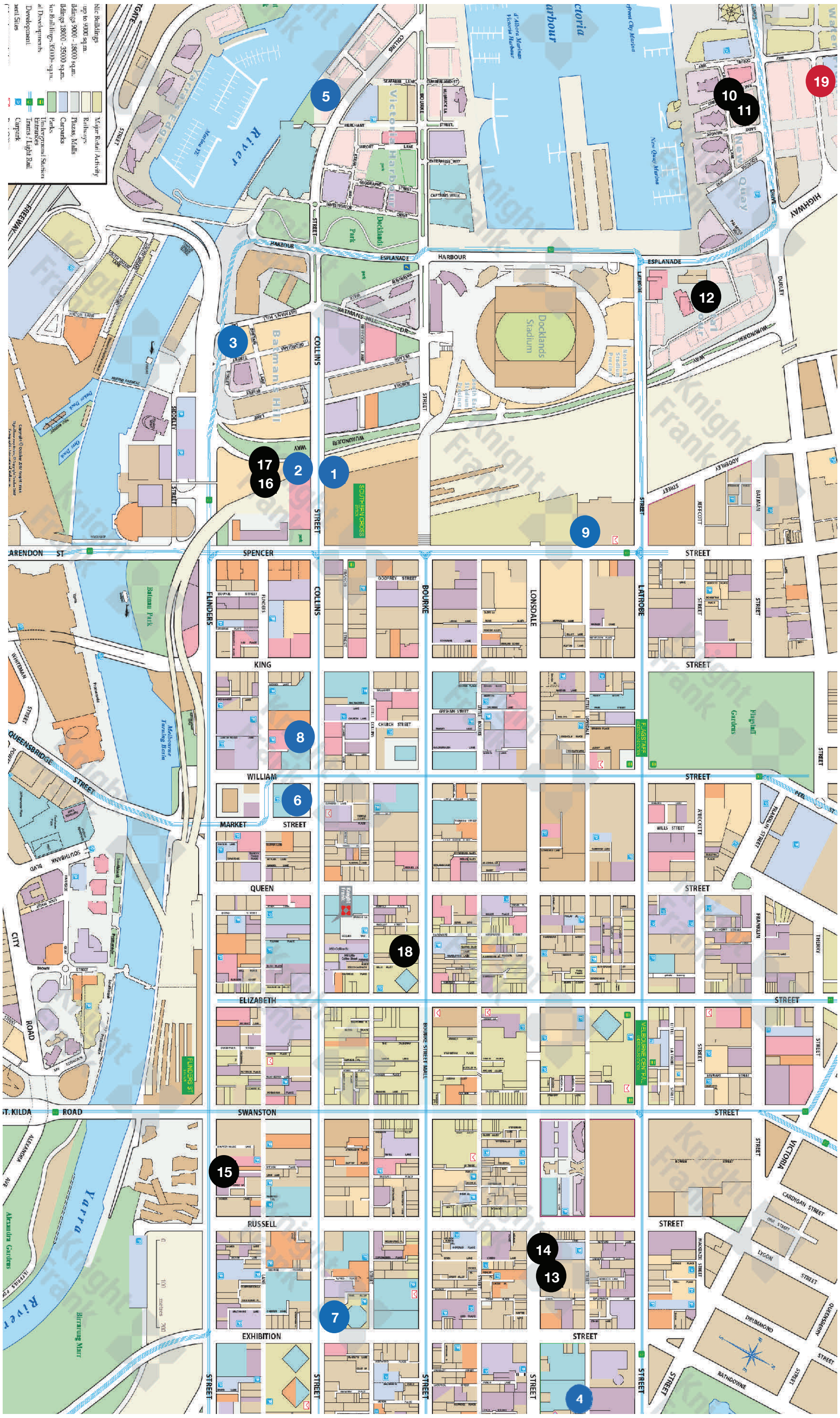
15 180 Flinders St - 20,000m²
DEXUS - 2020+

16 2 Melbourne Quarter - 55,000m²
Lendlease - 2020+

17 3 Melbourne Quarter - 45,000m²
Lendlease - 2020+

18 405 Bourke St - 65,000m²
Brookfield - 2021

19 Harbour Town - 12,000m²
Ashe Morgan - 2020+




**Source of Map:** Knight Frank Research

Under Construction / Complete
DA Approved / Confirmed / Site Wo
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), in the 12 months to June 2017, 119,900 jobs were created in Victoria, close to all the remaining states combined. 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 each week. Major employment growth was recorded in the Education, Government, Retail Trade, Healthcare and Professional services sectors.

Demand for office space in the CBD from education-based tenants has continued to gain momentum in 2017. Those over the past 12 months include Monash University committing to 37,500m$^2$ at 750 Collins Street, 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. Looking ahead, there are several tenant requirements from the education sector looking for space in the CBD, the most notable being RMIT (10,000m$^2$).

Reflecting the employment growth across Victoria, net absorption in the Melbourne CBD office market in the 12 months to July 2017 totalled 128,389m$^2$. This was the strongest figure nationally and the largest annual result for the Melbourne CBD n nine years. With the unemployment rate in Victoria falling to 6.0% as at July 2017, businesses are increasingly focused on the attraction and retention of staff. The flight to quality trend continues with occupiers upgrading their office space. Premium and A-Grade net absorption totalling 120,614m$^2$ in the 12 months to July 2017, accounting for 83% of total net absorption.

Tenant enquiry levels over the past 12 months has stemmed from demand in the smaller (100-500m$^2$) cohort. Knight Frank research shows the number of enquiries has increased by 45% in the 12 months to July 2017. Furthermore, the number of tenant enquires within the 500-1,000m$^2$ cohort have also increased, up by 39% over the same period. This has been supported by landlords becoming more flexible through subdividing floors, with market acceptance for fitted out suites proving favourable. This has seen some assets achieve rental premiums of 10% including 360 Collins Street and 222 Exhibition Street.

Generational shifts continue to shape our working environments with flexibility becoming a key tenant requirement. The office is becoming a platform for connection and collaboration and we are increasingly seeing landlords recognise the benefit of flexible workspace and coworking. Growth in the coworking industry has gathered significant momentum over the past 12 months. Knight Frank Research shows that the volume of coworking spaces in Melbourne has increased by 63% since the start of 2016, to total 95,400m$^2$. In 2017 Wework, Spaces, Rocketspace and Guild cowork have all leased space in the CBD totalling 22,300m$^2$. While the growth of small businesses continues to rise with 86% of employing businesses in Melbourne CBD having less than four employees (ABS), coworking is no longer confined to small scale start-ups. In the Melbourne CBD, Space&Co and Hub Southern Cross are home to large corporates such as Sensis, Suncorp, NAB and Australia Post all occupying between 20 to 60 desk spaces.

As a result of above-average levels of positive net absorption, the overall vacancy rate fell from 7.1% to 6.5% in the 12 months to July 2017. Prime vacancy fell to 6.1%, the lowest level in four years, while secondary vacancy increased for the first time in two years to 7.2%. Increases were the result of several large backfill options coming online, the most notable at 565 Bourke Street (Lumo Energy 5,000m$^2$).

In the 12 months to July 2017, vacancy fell in the Eastern, Docklands and Western core precincts, all recorded vacancy rates below their respective 10-year average levels. The Docklands and Eastern Core precincts hold the tightest vacancy rates of 2.1% and 2.5% respectively.

TABLE 2

**Melbourne CBD Vacancy Rates**

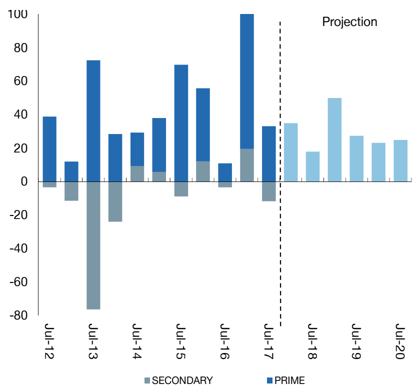
| Grade | Jul-16 (%) | Jan-17 (%) | Jul-17 (%) |
|---|---|---|---|
| Premium | 8.4 | 6.6 | 6.1 |
| A Grade | 6.2 | 6.5 | 6.1 |
| **Prime** | **6.7** | **6.5** | **6.1** |
| B Grade | 7.5 | 5.8 | 6.6 |
| C Grade | 9.1 | 8.3 | 9.0 |
| D Grade | 2.2 | 1.7 | 3.7 |
| **Secondary** | **7.5** | **6.4** | **7.2** |
| **Total** | **7.1** | **6.5** | **6.5** |

**Source:** Knight Frank Research/PCA

FIGURE 2

**Melbourne CBD Net Absorption**

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

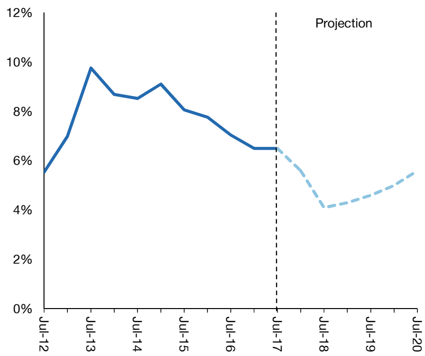



**Source:** Knight Frank Research/PCA

FIGURE 3

**Melbourne CBD Vacancy Rate**

Total Vacancy (%)




**Source:** Knight Frank Research/PCA

## Anticipated Vacancy Levels

The ANZ job advertisement series indicates job advertisements in Australia were 13.3% higher as at September 2017 compared with 12 months prior, with business confidence at similar levels to those recorded pre-GFC.

White collar employment growth in the Melbourne CBD office market is forecast to increase by 2.1% per annum or 13,255 employees between 2018—2020. Over the next three years, white collar employment growth in the Melbourne CBD office market is forecast to be driven by growth in the Accommodation & Food Sectors (8.6%) Public Administration (6.9%) and Professional Services (3.9%).

With the absence of any major developments scheduled for completion until mid-2018, combined with above average levels of tenant demand, the overall vacancy rate is expected to fall to 4.1% by mid 2018. With the supply cycle set to increase materially from mid 2019, vacancy is expected to gradually rise towards 7.8% by mid 2021.

## 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 since 2011. In the 12 months to July 2017, average prime net effective rents increased by 8.0% to $402/m^2$, a historic high. The growth of prime effective rents was underpinned by a face rental increase of 5.7% over the year, with average incentive levels ranging between 25% and 27%. Nevertheless, incentive levels continue to be higher for pre-committing tenants.

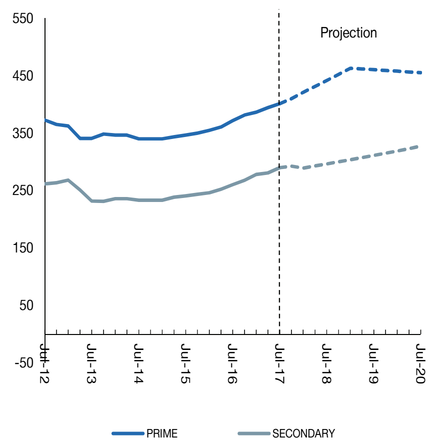
Following the trend in the prime market, secondary net effective rents grew by 11.3% in the 12 months to July 2017. Effective growth was underpinned by face rental growth of 9.3%. As at July 2017, average secondary effective rents sit at $290/m^2$ while incentive levels range between 25% to 30%.

Looking ahead, with a shortage of supply available, prime and secondary net face rents are forecast to increase by 13% and 9% respectively, by the end of 2018. Prime incentive levels are forecast to trend down towards 24% over the next 12 months, while secondary incentive levels are forecast to remain stable, ranging between 25% to 30%.

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 |
|---|---|---|---|---|---|---|---|
| 839 Collins Street | Docklands | 26,500 | 12 | Precom | ANZ Bank | Finance & Insurance | Q3-19 |
| 271 Spring Street | Northern | 15,612 | 15 | Precom | Australian Unity | Finance & Insurance | Q2-19 |
| 664 Collins Street | Docklands | 3,168 | 10 | Precom | Fujitsu | TMT | Q2-18 |
| 664 Collins Street | Docklands | 6,366 | 10 | Precom | AGL Energy | Utilities | Q2-18 |
| Tower 5, Collins Square | Docklands | 16,000 | 12 | Precom | Transurban | Construction | Q2-18 |
| 800 Collins Street | Docklands | 9,000 | 10 | Sublease | Latitude Financial | Finance & Insurance | Q4-17 |
| 401 Collins Street | Western | 6,000 | 10 | New Lease | WeWork | Coworking | Q4-17 |
| 161 Collins Street | Civic | 8,100 | 10 | Precom | Accenture | Business Services | Q4-17 |
| 750 Collins Street | Docklands | 37,500 | U/D | New Lease | Monash University | Education | Q3-17 |
| 333 Collins Street | Western | 2,063 | 10 | New Lease | Thompson Reuters | Business Services | Q3-17 |
| 2 Lonsdale Street | Northern | 9,270 | 10 | New Lease | Minister for Finance | Government | Q3-17 |
| 525 Collins Street | Docklands | 1,000 | 7 | New Lease | Australia Jinding | Real Estate | Q2-17 |
| 850 Collins Street | Docklands | 2,154 | 7 | New Lease | National Heart Foundation | Healthcare | Q2-17 |

TMT refers Technology, Media & Telecommunications    U/D—undisclosed

**Source:** Knight Frank Research

# INVESTMENT ACTIVITY & YIELDS

Investment volumes (above $10 million) within the Melbourne CBD office market in the year to date, currently total $2.2 billion across 12 properties. The volume of sales achieved in the year to date is 12% above the 2016 total ($1.97 billion) and 29% higher than the long term average.

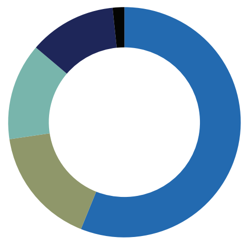
Volumes were supported by three sales in excess of $300 million, all of which were fund through transactions. The largest office transaction recorded so far in 2017 was the acquisition of a 50% stake in 477 Collins Street for $415 million. ARA Asset Management purchased the partial interest from Mirvac, reflecting a reported yield of 4.80%. The 38-level office tower (51,000m$^2$) is currently under construction with Deloitte committing to 22,500m$^2$. This transaction followed another divestment by Mirvac, with Morgan Stanley Real Estate acquiring a 50% stake in 664 Collins Street. The building is currently under construction, scheduled for completion in Q2 2018 and is fully pre-committed to Pitcher Partners, AGL, Exxon and Fujitsu.

Another notable transaction was 311 Spencer Street where Keppel REIT acquired a 50% share totalling $347.8 million. The transaction reflected an initial yield of 5.00%. The 40-storey tower is currently under construction and is anticipated to complete in Q3 2020. Victoria Police will vacate their current premises at 637 Flinders Street to occupy the entire 65,000m$^2$ building.

FIGURE 5

**Melbourne CBD sales by purchaser**

$10 million+ sales — 2017




**Source:** Knight Frank Research

TABLE 4

**Recent Sales Activity Melbourne CBD**

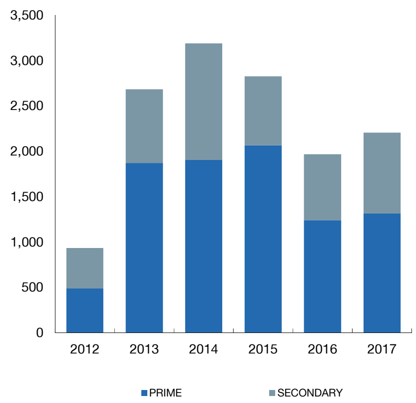
| Address | Price ($ mil) | Core Mkt Yield (%) | NLA (m$^2$) | $/m² NLA | WALE (yrs) | Vendor | Purchaser | Sale Date |
|---|---|---|---|---|---|---|---|---|
| 120 Spencer Street | 252.0 | 5.75* | 33,258 | 7,366 | U/D | Anton Capital | CBRE Global Investors | Aug-17 |
| 990 La Trobe Street | 114.5 | U/D | 12,942 | 8,846 | U/D | Blackstone | Charter Hall | Aug-17 |
| 628 Bourke Street | 180.0 | 6.00* | 24,731 | 7,278 | 5 | M&G Real Estate | AFIAA | Jul-17 |
| 664 Collins Street^# | 138.0 | 4.97* | 25,800 | 10,697 | 10 | Mirvac | Morgan Stanley Real Estate | Jul-17 |
| 447 Collins Street ^# | 300.0 | U/D | 49,800 | 12,048 | 10 | Cbus Property | ISPT | Jul-17 |
| 477 Collins Street^# | 415.0 | 4.80* | 58,048 | 14,928 | 12 | Mirvac | ARA Asset Management | Jul-17 |
| 311 Spencer Street^# | 347.8 | 5.00* | 65,000 | 10,701 | 30 | Australia Post | Keppel REIT | Jul-17 |
| 247 Collins Street | 35.0 | 4.20* | 2,014 | 17,387 | 7.5 | Lian Beng Group | Oriential Holdings | Apr-17 |
| 825 Bourke Street | 72.7 | 5.41 | 10,456 | 7,084 | 2.1 | Lendlease | Julliard Group | Dec-16 |
| World Trade Centre | 267.5 | 6.78* | 49,935 | 5,357 | 4.94 | Abacus | Local Chinese Investor | Jan-17 |
| 839 Collins Street# | 430.0 | c.5.00 | 38,000 | 11,316 | N/A | Lendlease | Invesco & Challenger | Dec-16 |
| 100 Queen Street | 274.5 | 5.20 | 36,630 | 7,494 | 2.5 | ANZ Bank | GPT Wholesale Office Fund | Dec-16 |

**Source:** Knight Frank Research    *initial yield    U/D—undisclosed    ^50% share    #Under Construction

FIGURE 6

**Melbourne CBD Sales $10 million+**

By grade ($m)




**Source:** Knight Frank Research

Offshore purchasers were the most active buyers in the year to date, acquiring $1.23 billion, accounting for 56% of total sales activity. This is the second highest total on record, with volumes in 2015 totalling $1.36 billion.

While Singaporean and Chinese-based investors acquired the majority of CBD assets purchased by foreign investors, American and Swiss based investors were also active, accounting for 26% of cross-border investment into the Melbourne CBD office market in the year to date. The most notable acquisition included 628 Bourke Street ($180 million) by AFIAA reflecting an initial yield of 6.00%.

Investors remained focused on Prime grade stock with Premium and A-grade assets accounting for 60% of sales volume or $1.31 billion. Prime grade asset sales have surpassed secondary asset sales every year for the past six years.

While prime assets accounted for the majority of investment volume, secondary CBD offices transacted over the year totalled $888 million, 51% above the long term average. Within the secondary market, offshore groups were the most active buyers, acquiring $335 million in the year to date.

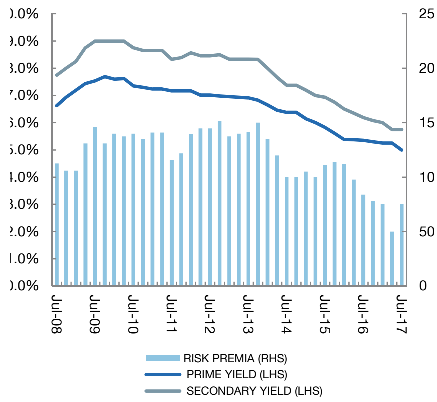
Fewer buying opportunities, combined with strong investor demand, particularly offshore investors, has resulted in further yield compression of both prime and secondary yields. As at July 2017, average prime office yields have compressed by 35 basis points in the past 12 months to 5.00%. In light of recent transactions, average prime yields ranged between 4.75% and 5.25% and stand 154 basis points lower than the 10-year average.

In the secondary market, average core market yields compressed by 44 basis points in the 12 months to July 2017 to range between 5.50% to 6.00%. The sale of 120 Spencer Street reflecting an initial yield of 5.75% is evidence of this strong yield compression in the secondary market. The current spread of 75 basis points between prime and secondary yields is the 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 13,255 employees. Tenant demand in the CBD is expected to remain strong over the next three years, underpinned by growth in the Accommodation & Food sectors, Public Administration and Professional Services.
- Net supply of office space in Melbourne will be significantly constrained over the next 12 months with no new office projects anticipated to complete until Q2 2018.
- The new supply pipeline is expected to expand from 2019 onwards with new supply during this period averaging 5.4% of total stock. Major office completions beyond 2019 will include 447 Collins Street (49,000m2), 80 Collins Street (43,000m2) and 311 Spencer Street (65,000m2).
- The overall vacancy rate in the CBD is anticipated to continue trending down over the next 12 months, falling to 4.1% by mid-2018, Beyond 2019, we expect the overall vacancy rate to revert closer to its historical average of 7.5% when the next development cycle commences.
- While tenant demand in the Melbourne CBD remains strong, net absorption is expected to be well below the long term average over the next 12 months due to the lack of available space.
- 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 6.5% and 4.5% per annum over the next two years respectively.
- Looking ahead, investment volumes are anticipated to remain above the five year average in 2017. This is unlikely to match volumes recorded in 2014 as impacted by the scarcity of investment opportunities rather than diminishing investor appetite.

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