RESEARCH

MELBOURNE CBD

OFFICE MARKET OVERVIEW SEPTEMBER 2019

SUSTAINED LOW VACANCY CAUSES RENTS TO SKYROCKET

HIGHLIGHTS

Recent record low vacancy, the by-product of high levels of net absorption caused by strong tenant demand and limited supply, has resulted in rental growth rates not seen for almost 20 years.

Investment activity in 2019 is on record pace, with 2019 sales volume totalling $2.8 billion which is above the CY 2018 total of $2.5 billion, and only $528 million short of the record $3.3 billion recorded in CY 2017.

Yield compression has slowed and yet recent interest rate cuts and the likelihood of further cuts could boost demand for commercial property and in turn prolong the yield compression cycle.

KEY FINDINGS

CBD total vacancy remained **largely unchanged**, increasing only marginally from 3.2% to 3.3% in the 6 months to July 2019.

Prime and secondary net face rents grew by **16.2% YoY and 12.6% YoY** respectively in the year to July 2019; with continued growth anticipated over the short term.

A surge of office **development activity** is occurring within the CBD's **Docklands** and **Western Core** precincts.

In the first six months of 2019, **Super Funds** have emerged as the **main purchasers** of office property assets in Melbourne's CBD.

FINN TREMBATH
Associate Director

ECONOMIC OVERVIEW

Despite the headwinds presented by the slowdown in local and global economies, Melbourne's unprecedented employment growth continues to drive demand for office space.

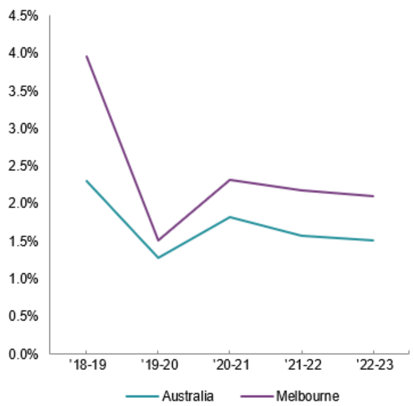
Victoria the engine room of the national economy

A slowdown in discretionary spending, caused in part by the softness in the housing market and slow income growth, has put the brakes on the local economy with Victoria's economic growth trending downwards since June 2018. And yet despite this, and the uncertainty over the broader global economy, Melbourne's population and employment growth has exceeded national averages, the state's infrastructure spend is at record levels, Victoria's small business growth is the highest of any state/territory, and over the last two years Victoria's GSP has grown at a higher rate than national GDP growth.

Employment growth to continue to fuel demand for office space

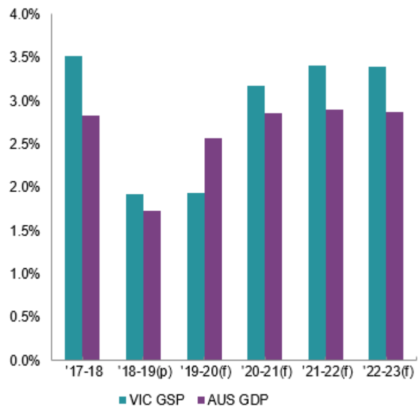
While employment growth is tipped to slow post 2020, office employment in Melbourne is nonetheless forecast to grow by a healthy 12% over the next 5 years (2019-2023). This translates to more than 25,000 new white-collar jobs which will need to be housed in office accommodation, ensuring robust tenant demand and office development over the medium term. Office employment growth is expected to be driven by the professional and public administration sectors.

FIGURE 1
Employment Growth
YoY forecasted growth on a FY basis



Source: Oxford Economics, ABS

FIGURE 2
Economic Growth
YoY forecasted growth on a FY basis



Source: Oxford Economics, ABS

TABLE 1
Melbourne CBD Office Market Indicators as at July 2019

Grade	Total Stock (sq m)*	Vacancy Rate (%)*	Annual Net Absorption (sq m)^	Annual Net Additions (sq m)^	Average Net Face Rent ($/sq m)	Average Incentive (%)	Core Market Yield (%)
Prime	3,091,343	2.2	108,422	75,676	$680	25.0%	4.65—4.90
Secondary	1,523,006	5.6	-25,110	-3,182	$501	26.0%	5.30—5.80
Total	**4,614,349**	**3.3**	**83,312**	**72,494**			

Source: Knight Frank Research/PCA *As at 1st July 19 ^12months to 1st July 19.

TENANT DEMAND & ABSORPTION

Net Absorption & Outlook

Prime YoYΔ:	31,573 sq m -20.3%	↗
Secondary YoYΔ:	-23,329 sq m -194.9%	↗

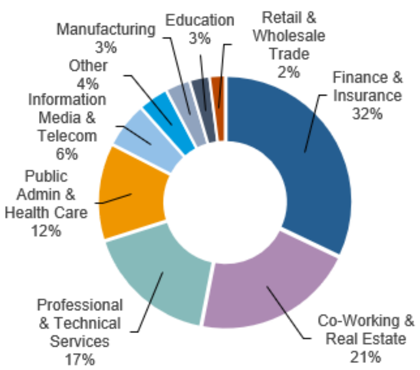
Source: Knight Frank Research/PCA
Note: Absorption for 6mths to 1st July 19.

Shortage of options results in low levels of absorption

Melbourne CBD's recent run of strong net absorption has come to an end with just 8,244 sq m of net absorption recorded between January and June. However, the low level of net absorption needs to be viewed within the context that sustained strong demand over recent years has starved the market of options.

This is reflected in the continued high level of pre-commitment activity, with developments expected to land in 2020 and beyond, such as 405 Bourke Street, Two Melbourne Quarter and 180 Flinders Street all virtually 100% pre-committed. Looking ahead, despite the headwinds presented by economic uncertainty, Melbourne's continued population growth and in turn employment growth should ensure the next wave of supply is met with strong levels of demand.

FIGURE 3
CBD Office Take-up by Sector
Indicative—YTD Jul'19



Other inclusive of Construction, Utilities, Charity and Recreational services sectors
Source: Knight Frank Research

Legal and Finance tenants active in CBD

A flight to quality is driving tenancy activity among the legal sector. In recent times Leo Cussen and Frenkel Partners Lawyers moved to William Street, and Jones Day and K&L Gates moved to 525 Collins Street. This comes off the back of DLA Piper and Ashurst pre-committing to 80 Collins Street and King & Wood Mallesons, HWL Ebsworth, Minter Ellison, Gadens and Norton Rose Fulbright all pre-committing to new developments along the west end of Collins Street.

Strong demand has also come from the finance sector. In the last 6 months ANZ and QBE took occupation at 839 Collins Street, and before this AMP secured 9,720 sq m across five levels at One Melbourne Quarter. In terms of pre-commitments, Macquarie Bank have committed to 80 Collins Street; Australian Super, CBUS and Vanguard have committed to 130 Lonsdale Street; and NAB have committed to all 65,000 sq m at 405 Bourke Street.

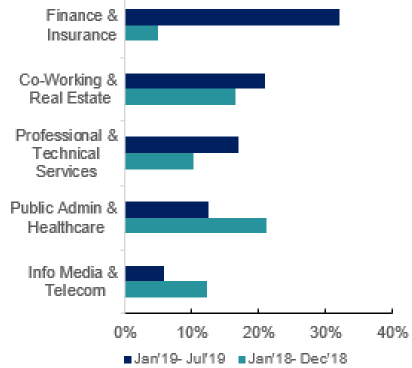
Coworking makes hay while the sun shines

The coworking sector has taken advantage of Melbourne's recent low vacancy levels and strong employment growth which has created demand for office space, taking up 34,436 sq m of NLA in the first half of 2019 which is double what the sector absorbed in the whole of 2018 (17,828 sq m). Seizing on the appetite for flexible working that is being driven by Millennials and Gen Z workers, and catering to growing demand from the corporate sector, the coworking movement has expanded rapidly in Melbourne's CBD.

Much of the recent growth of coworking in Melbourne's CBD has been driven by overseas majors, namely American juggernaut WeWork which is due to go public in the US in September, and recent Singaporean arrival JustCo which has signed up three Melbourne CBD locations in the first half of 2019 (276 Flinders Street, 15 William Street, and 447 Collins Street). In total, 90% of all coworking leases signed since January have been by WeWork and JustCo, the latter accounting for approaching 50% of all new coworking leases by sq m.

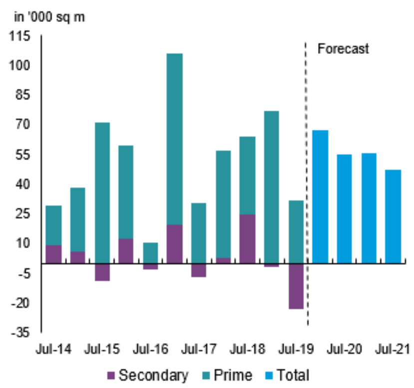
Moving forward, we expect the coworking sector to go through a period of consolidation as it adjusts to the potential challenges associated with rising vacancy and declining demand created by new supply. Already we have seen WeWork buy out Gravity at 114 William Street, and YBF acquire Teamsquare at 520 Bourke Street.

FIGURE 4
Sectoral Take-up over Periods
Indicative- Jan'19- Jul'19 vs Jan'18- Dec'18



Source: Knight Frank Research

FIGURE 5
CBD Office Net Absorption by Grade
Net Absorption on a semi-annual basis



Source: Knight Frank Research/PCA

SUPPLY & DEVELOPMENT

Vacancy Rate & Outlook

Prime YoYΔ:	2.2% -114bps	
Secondary YoYΔ:	5.6% +145bps	

Source: Knight Frank Research/PCA
Note: Vacancy as at 1st July 19.

Above average withdrawals keep pressure on vacancy

Melbourne CBD's office vacancy remains largely unchanged since January, increasing only marginally from 3.2% to 3.3%. For two years Melbourne has had the lowest CBD vacancy rate of all capital cities. Vacancy has remained low since January more so on account of above average withdrawals than net absorption levels. A shortage of quality, contiguous space has limited options for tenants looking to take up space. Indeed, the pursuit of quality assets is creating a divergence in vacancy by grade. Since January, prime vacancy has declined (2.2%, was 3.0%) while secondary vacancy has risen (5.6%, was 3.7%).

At a precinct level, vacancy in Spencer has increased (8.3%, was 5.0%) off the back of two consecutive periods of negative net absorption. Conversely, vacancy in Docklands continues to drop (0.6%, was 0.7%). Docklands has the lowest vacancy rate of all CBD precincts and vacancy has sat below 2% for two years running. Over the last FY more sq m of office space was absorbed in Docklands than all other CBD precincts combined. Elsewhere, vacancy in the much sought after Eastern Core continues to tighten. It has been more than ten years since we have seen such low levels of vacancy in this precinct.

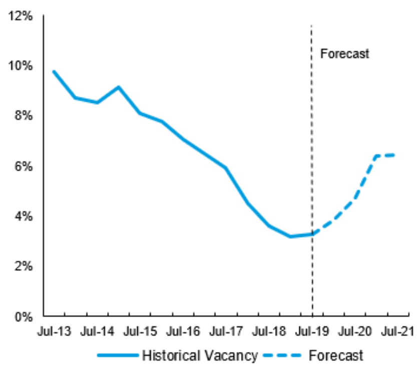
Gross CBD office completions totalled 64,054 sq m in the six months to July. The vast majority of this new supply (90%) stemmed from new development completions, with much of this driven by the 839 Collins Street (38,100 sq m) development. While the completions added to the market over the last six months are on par with the ten-year average of 63,314 sq m, virtually all new supply was pre-committed ensuring total vacancy remained low.

TABLE 2
CBD Office Vacancy By Grade

Grade	Jul-18 (%)	Jan-19 (%)	Jul-19 (%)
Premium	4.6	3.8	4.1
A Grade	2.9	2.3	1.5
Prime	**3.3%**	**2.7%**	**2.2%**
B Grade	4.4	4.9	7.2
C Grade	4.2	3.2	3.6
D Grade	2.9	1.5	2.8
Secondary	**4.2%**	**4.1%**	**5.6%**
Total	**3.6**	**3.2**	**3.3**

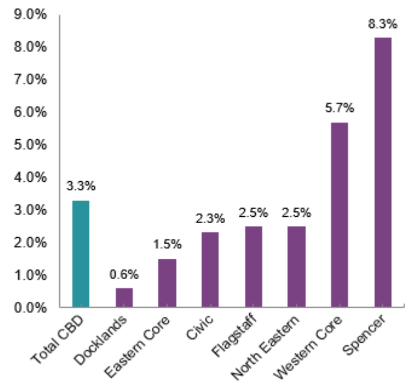
Source: Knight Frank Research/ PCA

FIGURE 6
CBD Office Vacancy
Vacancy (%) on a semi-annual basis



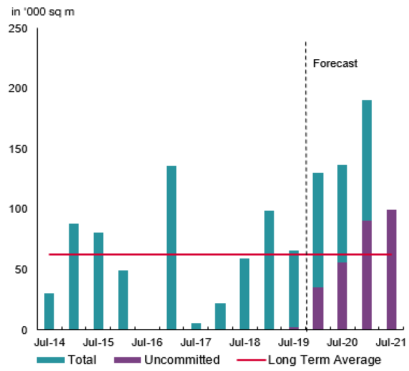
Source: Knight Frank Research/ PCA

FIGURE 7
CBD Office Vacancy by Precincts
Vacancy (%) as at 1st July 19



Source: Knight Frank Research/ PCA

FIGURE 8
CBD Office Gross New Supply
New Supply on a semi-annual basis



Source: Knight Frank Research/ PCA

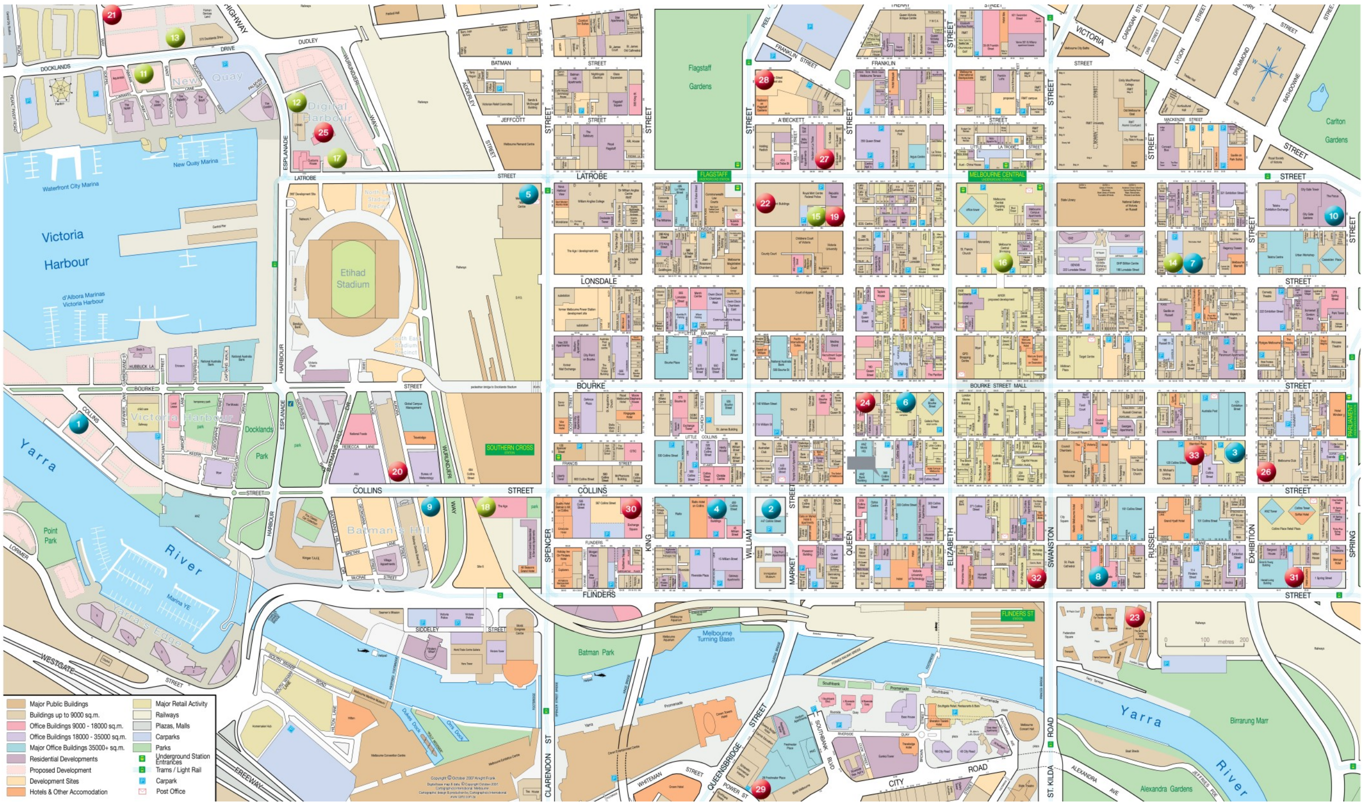
Wave of development along CBD's west end

A surge of office development activity is occurring along the west end of the CBD, specifically within the Docklands and Western Core precincts. In Docklands, Lendlease's Two Melbourne Quarter development (48,000 sq m) is currently under construction, and this will be followed by Melbourne Quarter Tower (68,000 sq m). In the Western Core, Cbus Property's 447 Collins Street development (49,000 sq m) and the Mirvac/Suntec REIT 477 Collins Street development (51,000 sq m) are under construction, and Charter Hall has lodged a development application for a proposed new office tower at 555 Collins Street in the Spencer precinct.

Vacancy to remain low before uplift in 2020

Vacancy is expected to remain tight in the second half of 2019. However, Melbourne is on the cusp of a new wave of development completions, with the city expected to account for the bulk of all new supply nationally over the coming years with the first wave of new stock due to hit the market in 2020. It is anticipated as tenants move into new towers the resulting backfill space will cause an uplift in vacancy to more traditional levels.

MAJOR OFFICE SUPPLY



Under Construction/Completed

1	Y3, 839 Collins Street - 39,200 sqm (ANZ) Lend Lease - Q2 2019 - 95% committed
2	447 Collins Street - 49,000 sqm+ (King & Wood Mallesons, HWL Ebsworth, Minter Ellison & Gadens) Cbus Property - Q4 2019 - 95% committed
3	80 Collins Street (South) - 43,000 sqm (Savills, Macquarie Bank, Centtex) QIC - Q1 2020 - 75% committed
4	477 Collins Street - 51,000 sqm (Deloittes, Norton Rose) Mirvac / Suntec REIT - Q2 2020 - 96% committed
5	311 Spencer Street, Melbourne - 65,000 sqm (Victoria Police) Keppel REIT / Cbus Property - Q3 2020 - 100% committed
6	405 Bourke Street, Melbourne 65,000 sqm (NAB) Brookfield - H2 2021 - 100% committed
7	Wesley Place, 130 Lonsdale Street - 55,000 sqm (Cbus, Aust Super, Vanguard, Telstra Super) Charter Hall - Q1 2020 - 100% committed
8	180 Flinders Street - 16,000 sqm (John Holland) DEXUS - 2020+ - 95% committed
9	Two Melbourne Quarter, 697 Collins Street, Melbourne - 48,000 sqm (Energy Australia - Regus Space) Lendlease - 2020+ - 80% committed
10	267 - 271 Spring Street - 15,000 sqm (Australian Unity) ISPT - Q4 2018 - 100% committed

Approved Developments

11	396 Docklands Drive, Docklands - 10,500 sqm MAB - 2020+
12	25 Digital Drive - 10,000 sqm Digital Harbour Holdings - 2020+
13	395 Docklands Drive, Docklands - 22,000 sqm MAB - 2020
14	140 Lonsdale Street - 15,000 sqm Charter Hall - H1 2021
15	364-378 Lt Lonsdale Street, Melbourne - 24,000 sqm Victoria University - 2020+
16	300 Lonsdale Street, Melbourne - 20,000 sqm The GPT Group - Q3 2021
17	1,000 La Trobe Street, Docklands - 38,500 sqm Poly Group - Q3 2021
18	Melbourne Quarter Tower (3 Melb Quarter) - 68,000 sqm Lend Lease - 2022+

Mooted Developments

19	283 Queen Street, Melbourne - 25,000 sqm Victoria University - 2021
20	710 Collins Street - 32,000 sqm Abacus Property Group - 2023+
21	440 Docklands Drive, Docklands - 100,000 sqm Ashe Morgan - 2020+
22	280-318 William Street, Melbourne - 40,000 sqm Country Court of Victoria - 2021+
23	Federation Square East, Cnr Flinders & Russell Sts - 60,000 sqm State Government - 2024+
24	Cnr Queen & Bourke Street, Melbourne - 64,500 sqm plus Cbus Property - Q3 2023
25	26-34 Digital Drive, Docklands - 47,000 sqm Cbus Property - 2022+
26	60 Collins & 52 Collins Street, Melbourne - 36,000 sqm Dexus - 2024+
27	383 LaTrobe Street, Melbourne - 44,000 sqm Mirvac - 2024+
28	412 William Street, Melbourne- 20,000 sqm Shesh Ghale - 2023+
29	25-35 Power Street, Southbank- 36,000 sqm M&L Investments - 2024+
30	555 Collins Street, Melbourne - 45,000 sqm Charter Hall - 2022+
31	32 Flinders Street, Melbourne - 40,000 sqm GPT - 2023+
32	Over Station Development, Swanston Street, Melbourne 20,000 sqm Lendlease - 2024+
33	7-9 Alfred Place, Melbourne - 8,000 sqm Seafirst Australia - H1 2023

NB. Dates are Knight Frank Research estimates. Major tenant pre-commitment in brackets. Major Refurbishment/Office NLA quoted.

RENTS & INCENTIVES

Rents, Incentives & Outlook

Prime Rents (g) (per sq m)	Face: $680 +16.2% YoY Eff: $507 +17.6% YoY	
Secondary Rents (g) (per sq m)	Face: $501 +12.6% YoY Eff: $368 +10.8% YoY	
Incentives	P:25.4% S:26.4%	

Source: Knight Frank Research/PCA
Note: Data as at 1st July 19.

Strongest growth since 2001

Melbourne CBD's recent low vacancy, the by-product of tight supply and high levels of net absorption, has resulted in rental growth rates not seen for almost 20 years. Over the 2018-19 FY, prime net effective rents grew by 17.6% (the highest rate since 2001) to reach $507/ sq m. The growth in effective rents was underpinned by a net face rental increase of 16.2% (again, the highest rate since 2001), with incentive levels ranging between 22%-28%. Secondary net effective rents increased by 10.8% to reach $368/ sq m, this growth supported by a net face rental increase of 12.6% with incentive levels ranging between 22%-28%. The record increase in rents continues to place upward pressure on fringe rents, especially within the trendy inner east.

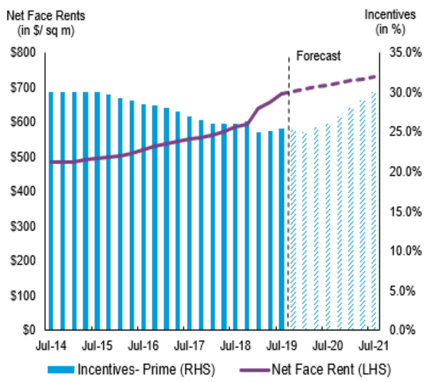
With all upcoming new stock in 2019 pre-committed and continued employment growth set to sustain tenant demand, rental growth is expected to remain strong in the short term with prime net face rents expected to rise by a further 4% over the next 12 months. As we move into the next supply cycle commencing in 2020, the market will naturally see a slowing of rental growth with a subsequent increase in incentives. That said, rental growth will remain robust as more than half of 2020 new supply is already pre-committed and developers will be expected to chase returns on new developments.

TABLE 3
Recent Leasing Activity Melbourne CBD

Address	Precinct	NLA (sq m)	Term (yrs)	Lease Type	Tenant	Sector	Start Date
525 Collins St	Western	10,000	10	New	Public Transport Victoria	Govt.	Q4-19
15 William St	Western	8,251	10	New	JustCo	Co-working	Q3-19
530 Collin St	Western	3,500	7	New	Momentum Energy	Utilities	Q1-20
140 William St	Western	1,830	7	New	Oracle Corp	Tech	Q4-19
607 Bourke St	Spencer	1,700	10	New	Workspace 365	Co-working	Q1-20

Source: Knight Frank Research

FIGURE 9
Prime Incentives & Net Face Rents
CBD Office: Indicative



Source: Knight Frank Research

TABLE 4
Recent Sales Activity Melbourne CBD

Address	Grade	Price ($ mil)	Core Mkt Yield (%)	NLA (sq m)	$/sq m NLA	WALE (yrs)	Vendor	Purchaser	Sale Date
80 Collins St	A	947*	5.3^	105,000	14,057	8.4/ 2.7*	QIC Global	Dexus	May-19
242 Exhibition St	A	830	4.5	65,913	12,592	11.9	Oxford / Investa	Charter Hall	May-19
595 Collins St	B	314	5.6	32,075	9,789	3.3	Pramerica REI	Foo Hang Jewelry	Feb-19
31 Queen St	B	200	5.0	19,236	10,423	2.6	Challenger	AEW Capital	Apr-19
737 Bourke St	A	192	4.9	18,216	10,540	6.7	KWAP	Charter Hall	May-19

*Relating to South & North office transaction cost and tenancy ^Equivalent yield U/D = Undisclosed VP = Vacant Possession
Source: Knight Frank Research, RCA

INVESTMENT ACTIVITY & YIELDS

CBD sales on record pace

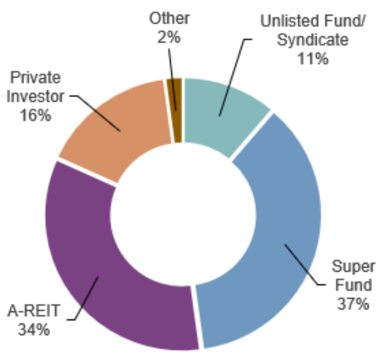
2019 is on course to see record investment levels in Melbourne's CBD office property market. Over the first half of 2019, sales volume totalled $2.8 billion which is above the CY 2018 total of $2.5 billion, and only $528 million short of the record $3.3 billion recorded in CY 2017. Plummeting interest rates, coupled with a strong occupational market which has boosted tenant demand and in turn rents, has been the basis for the strong investor activity.

While sales volume is high for this time of year, results have been driven considerably by two sales, namely QIC's $946.8 million (office component) sale of 80 Collins Street to Dexus/DWPF, and Investa Commercial Property Fund/ Oxford Investa Property Partners $830 million sale of 242 Exhibition Street to Charter Hall. Outside of these two deals, sales volume has been quite low which reflects a lack of opportunities on the market. Notably, both 80 Collins Street and 242 Exhibition Street are situated at the top-end of Melbourne's CBD.

Super Funds emerge as CBD's main buyers

In the first six months of 2019, Super Funds have emerged the main investors within the CBD office market. Between January and June, Super Funds accounted for over a third of all sales volume. Unease towards the retail sector has seen major institutional investors turn their attention to industrial and office assets. While both sectors are currently plagued by a shortage of options being presented to the market, strong market fundamentals have made industrial and office property appealing destinations for the weight of capital looking to invest in a low yield environment.

FIGURE 10
CBD Office Purchaser Profile
$10mln+ Sales—YTD Jul'19



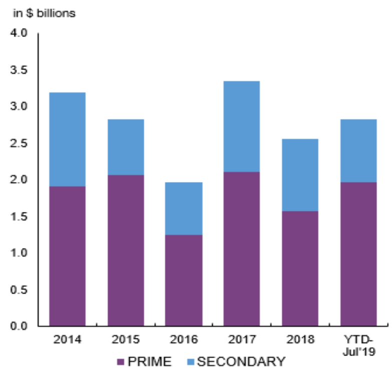
Total value of transactions: $2.82bn
Other inclusive Owner-occupiers and Undisclosed buyers
Source: Knight Frank Research, RCA

Current Yields & Outlook

Prime YoYΔ:	4.65% - 4.90% -30bps	↘
Secondary YoYΔ:	5.30% - 5.80% -5bps	↘

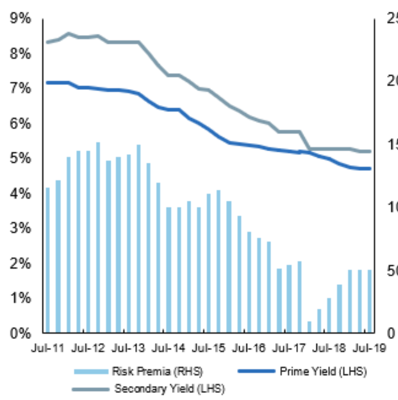
Source: Knight Frank Research/ PCA
Note: Data as at 1st July 19.

FIGURE 11
CBD Office Transactions By Grade
$10mln+ Sales—YTD Jul'19



Source: Knight Frank Research, RCA

FIGURE 12
CBD Office Core Market Yields
Yield (%) & Spread (bps)



Source: Knight Frank Research

> "2019 is on course to see record investment levels in Melbourne's CBD office property market"

Yield compression slows

Melbourne CBD office yields have in recent years fallen to record lows, however the falling trend of yields steadied in 2019. Since the start of the calendar year, both prime and secondary yields have compressed by just 5 basis points, with no movement recorded in the April-June quarter. Prime yields range from 4.25% to 5.00%. As was the case at the end of 2018, the current spread between prime and secondary yields stands at 50 basis points. Indicative of the low yields being recorded in the prime market, in the first half of 2019 A-Grade buildings 242 Exhibition Street (4.5%) and 737 Bourke Street (4.9%) each sold at sub-5.00% core market yields, while 80 Collins Street sold at an initial passing yield of 5.3%.

Potential impact of interest rate cuts

The recent cut to interest rates and the related sharp drop in bond yields are likely to increase demand for commercial property and in turn prolong the yield compression cycle. While declining bond yields are partly a reaction to heightened downside risks to economic growth, lower rates will result in lower funding costs, lower hedging costs and lower required returns and these combined impacts on the investment landscape are likely to trump concerns over risks to growth, and hence further prime yield compression is expected.

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