- *CBD office vacancy continues to climb*
- *Prime face rents resilient*
- *Prime yields compress*

knightfrank.com/research

Melbourne CBD Office

Market Report, September 2021

MARKET RESILIENT DESPITE CONTINUED LOCKDOWNS

COVID-19 has impacted on demand within the CBD's office market, however Victoria's economy is tipped to start recovering in 2022 and the office market recovery is expected to follow suit now that the rollout of the vaccination program is being accelerated.

10.4% VACANCY

37% Prime incentives

$464 MILLION TURNOVER

"Despite repeated lockdowns and a continued rise in vacancy, rents have held and yields have compressed and the sense is the momentum that commenced in late 2020 will continue in 2022."

The Key Insights

CBD office vacancy continues to increase, rising from 8.4% in January 2021 to 10.4% in July 2021. Prior to the pandemic hitting Australian shores, vacancy sat at 3.2% in January 2020.

Net face rents continue to hold firm, however incentives have continued to increase which has placed further downward pressure on net effective rents.

Sub-lease vacancy almost doubled over the last 6 months, the 119,717 sqm of sub-lease space the highest recorded for the CBD office market since 1994.

Sales volume is down in H1 2021 however offshore demand remains strong and pent up demand signposts a bounce back in transaction volumes in the months ahead.

Office yields remain low with core yields for prime assets currently ranging between 4.35% and 4.85%.

Melbourne CBD Office Market Indicators—July 2021

GRADE	TOTAL STOCK SQM	VACANCY RATE %	ANNUAL NET ABSORPTION SQM	ANNUAL NET ADDITIONS SQM	AVERAGE NET FACE RENT $/ SQM	AVERAGE INCENTIVE %	NET RENTAL GROWTH % YOY	AVERAGE CORE MARKET YIELD %*
Prime	3,424,471	10.4	-41,098	129,300	708	30-38	0.0	4.35-4.85
Secondary	1,470,613	10.2	-78,366	-20,365	520	28-37	0.0	4.85-5.35
Total	**4,895,084**	**10.4**	**-119,464**	**108,935**				

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

RECOVERY HALTED

Most recent lockdowns put the brakes on the state's economic recovery.

Victoria's economy started to recover from the impacts of the COVID-19 pandemic in late 2020 and the recovery continued into the new year. Signs of the state's economic recovery were evident in the NAB Business Confidence survey results, with Victoria experiencing net positive levels of business confidence since late 2020. The state recorded double digit positive net business confidence in all but one month in the period between October 2020 to June 2021.

The recent repeated lockdowns have, however arrested some of the momentum behind the state's economic recovery, with confidence levels deteriorating in July though still remaining in positive territory.

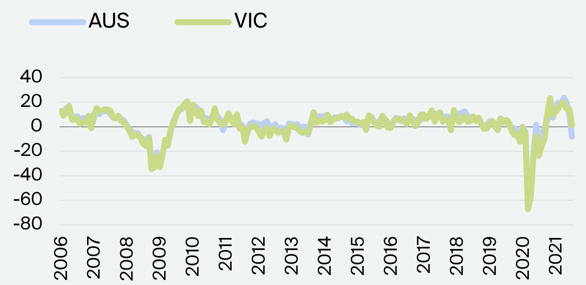
Reason for positivity as the state's vaccination program picks up steam.

Despite the continued uncertainty caused by the ongoing Delta outbreaks, the state is due to reach a high level of vaccination in the coming months, and this should pave the way for an easing of restrictions which should have the effect of reinvigorating business and in turn the economy.

Indeed the sense is the economy could bounce back swiftly, for the state's brief history with lockdowns has shown that if outbreaks are quickly contained and restrictions promptly eased, the economy tends to recover quickly. Furthermore, the state's economic recovery in late 2020/early 2021 was stronger than initially expected, and this also bodes well for the state's economic outlook moving forwards.

Business Confidence

Net balance of positive and negative responses



Source: Knight Frank Research, Macrobond

Pandemic continues to impact the office leasing market.

The impact of the COVID-19 pandemic on demand for office space continues to be felt with subdued leasing activity being reflected in absorption levels.

Negative absorption levels were recorded for the second consecutive PCA reporting period. The –96,635 sqm of net absorption recorded over the first half of 2021 is the highest level of negative absorption ever recorded for Melbourne's CBD over a six month period and comes off the back of -22,829 sqm of absorption being recorded in H2 2020.

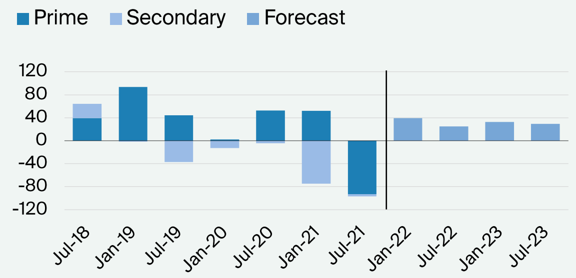
Smaller end of office leasing market started to recover prior to recent lockdowns.

There is evidence though that the smaller end of the leasing market started to recover in late 2020/early 2021. Knight Frank research reports that the number of sub 500 sqm deals in H1 2021 (15) was already approaching the average number of sub 500 sqm deals recorded between 2018-2020 (23), and the average size of new leases in H1 2021 was 1,978 sqm, which is noticeably below the levels recorded between 2018-2020 (3,102 sqm). Recent examples of sub 500 sqm deals transacting in 2021 include Lawson Delaney signing up for 298 sqm at 500 Collins Street, and Ainslie Bullion leasing 345 sqm at 357 Collins Street.

Anecdotally, we can report that many large corporates are still weighing up their office accommodation decisions, while many smaller businesses are taking advantage of a marked rise in incentives and greater flexibility in leasing arrangements.

CBD Office Net Absorption

'000 sqm by grade



Source: Knight Frank Research

SUBLEASE VACANCY DOUBLES

Three sectors drive the Melbourne CBD office leasing market.

In recent years, much of the CBD's recent office take-up has emanated from the CBD's largest precinct, the Western Core. Between 2019 to 2020 more than a third of all take-up stemmed from this precinct.

While demand for office space in the CBD comes from a broad range of sectors, recently three sectors — finance and insurance services, public administration and professional services — drove CBD office leasing volume. Combined these three sectors accounted for 87% of all leasing activity over the first six months of the year.

As was the case in 2020, the finance & insurance sector led the way accounting for approaching half (45%) of all leasing volume, with BUPA signing on for 13,000 sqm at 11 Exhibition Street one of the most notable deals recorded over the period.

Sublease vacancy in the CBD doubles in six months.

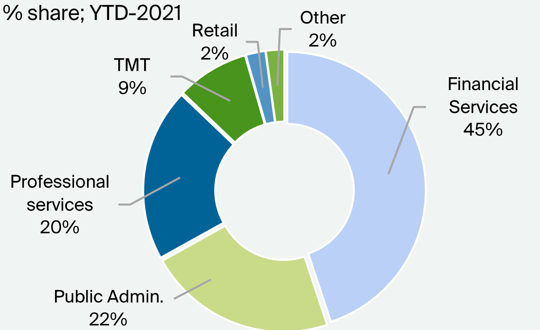
The effects of the COVID pandemic have been borne out in a surge in the amount of sublease vacant space being placed back into the market. The amount of sublease vacant space almost doubled over the past six months, rising from 64,583 sqm in January to 119,717 sqm in July. The current level of sublease vacancy is the highest seen since July 1994.

At a precinct level, sublease vacancy has increased noticeably in the Docklands, where NAB is looking to sublease its space at 800 Bourke Street. Sublease vacancy in the Docklands has risen from 0.9% in January to 5.1% in July, in turn contributing to the uplift in total vacancy.

Encouragingly, the sense is sublease vacancy has in fact now peaked with examples of quality sublease stock being removed from the market.

CBD Office Take-up by Sector

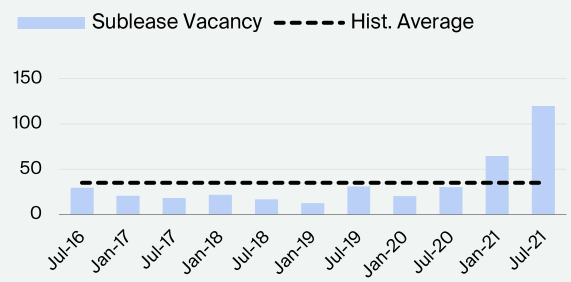
% share; YTD-2021



Source: Knight Frank Research
Other inclusive of Admin., Real Estate, Wholesale Trade and Construction services

CBD Office Sublease Vacancy

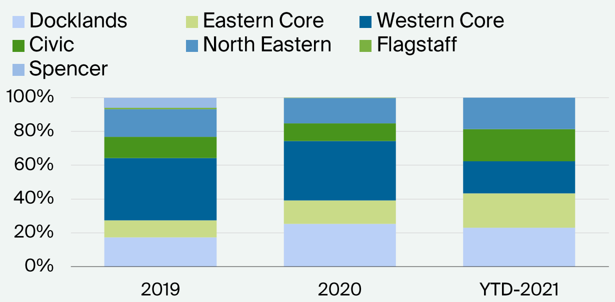
'000 sqm



Source: Knight Frank Research, PCA

CBD Office Take-up by Precinct

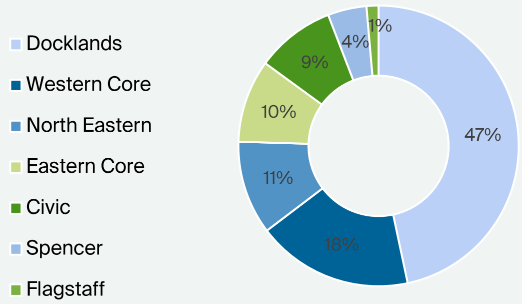
% share



Source: Knight Frank Research

CBD Office Sublease Vacancy by Precinct

%; Jul-21



Source: Knight Frank Research, PCA

VACANCY CONTUINUES TO RISE

Subdued leasing demand causes office vacancy to continue to rise.

As the COVID-19 pandemic enters its second year, Melbourne CBD office vacancy has increased further, rising from 8.4% in January to 10.4% in July. The current vacancy level is above the 10-year average of 6.6% and is the highest level of vacancy recorded since January 2000.

While an uptick in the enquiry-transaction conversion rate was noticeable early in the year, the recent spate of lockdowns has put the brakes on demand for office space and the current outbreak in Sydney has further dampened business confidence.

Substantial pipeline to keep pressure on vacancy levels.

The CBD's immediate office development pipeline is substantial. In H2 2021, 254,074 sqm of new supply is expected to land in the CBD, highlighted by Brookfield and ISPT's 66,000 sqm new development at 405 Bourke Street, and GPT's 38,933 refurbishment at 750 Collins Street. The above average level of new supply will ensure vacancy levels in the CBD remain elevated over the short to medium term.

However, new supply is expected to slow post 2021, with just 68,507 sqm expected to land in 2022 and 137,000 sqm tipped for 2023, and this reduction in new supply should aid the recovery of the leasing market.

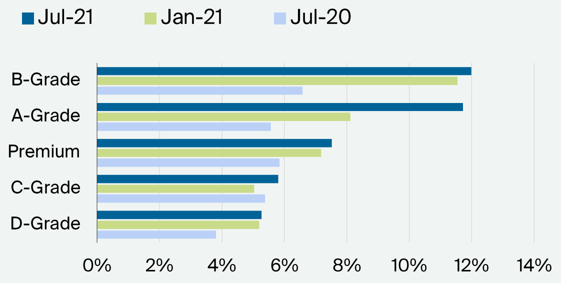
Victoria's COVID experience to shape future office developments.

In the aftermath of the COVID era, we expect to see landlords and developers look to COVID-proof new office developments with an emphasis on health and hygiene.

While social distancing requirements may result in some firms adopting higher density ratios, offsetting this will be an accelerated shift towards quality in a bid to mitigate the spread of COVID and in turn boost the appeal of office buildings. New and refurbished office buildings that employ design elements such as touchless technology, thermal imaging, outdoor break-out/meeting spaces, improved wellness amenity, green spaces and fresh air/filtered air con, will command a greater premium moving forwards.

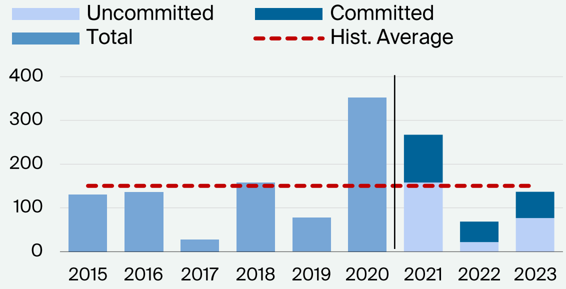
Already landlords and developers are engaging in conversations with tenants to gain a better understanding of their future accommodation needs in the post-COVID era.

CBD Office Vacancy by Grade
%



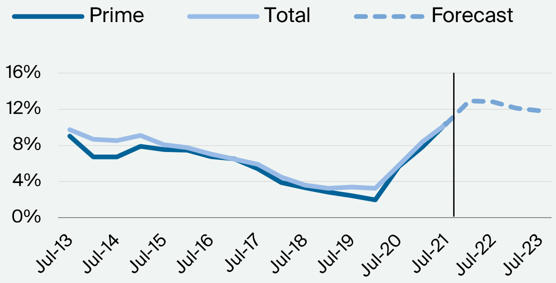
Source: Knight Frank Research, PCA

CBD Office Gross New Supply
'000 sqm new supply



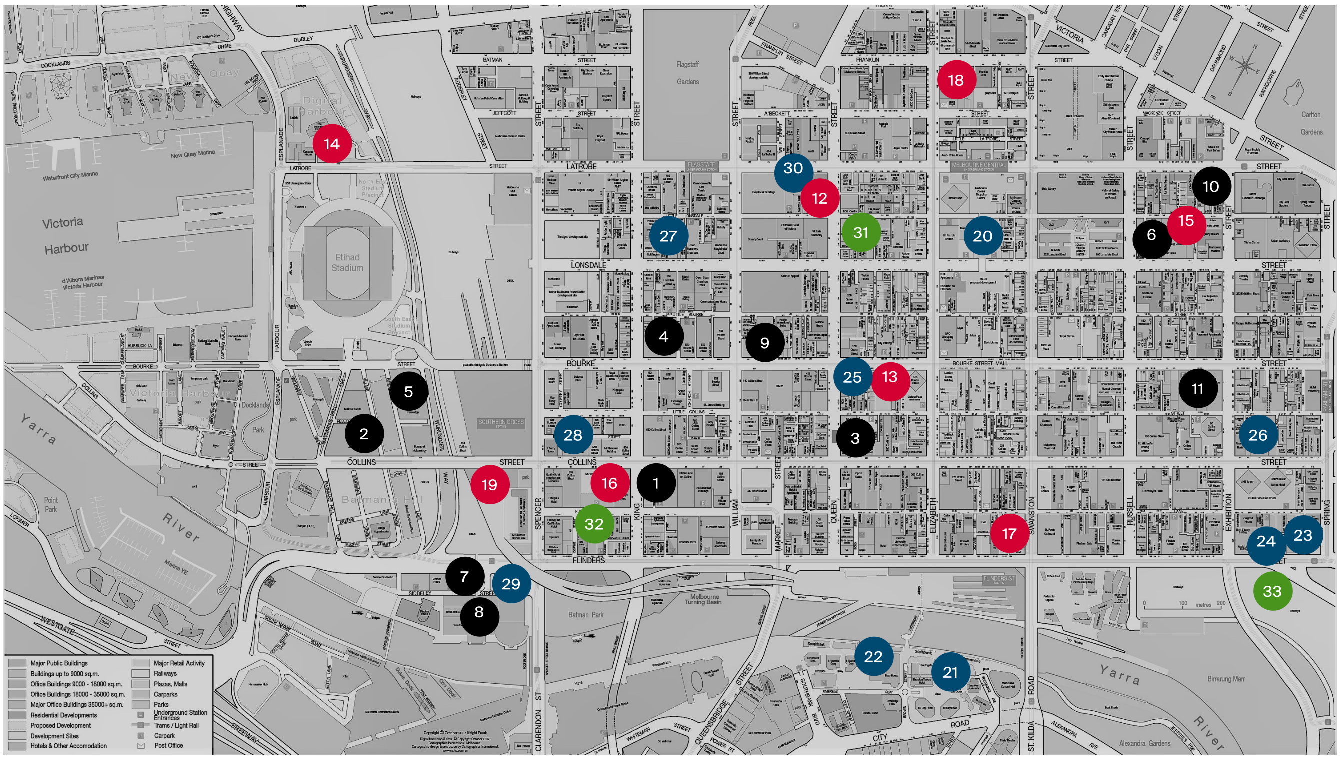
Source: Knight Frank Research/ PCA

CBD Office Vacancy
% prime and total vacancy



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

1 525 COLLINS STREET, 12,377 SQM
DEXUS/GROLLO – 0% COMMITTED. H2 2021

2 750 COLLINS STREET, 38,933 SQM [MONASH COLLEGE]
GPT – 100% COMMITTED. H2 2021

3 QUEEN & COLLINS STREETS, 30,353 SQM
GPT –31% COMMITTED. H2 2021

4 600 BOURKE STREET, 21,161 SQM
AMP – 0% COMMITTED. H2 2021

5 717 BOURKE STREET, 10,000 SQM
REST – 0% COMMITTED. H2 2021

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

7 637 FLINDERS STREET, 25,716 SQM
ZONE Q/ARTIFEX – 0% COMMITTED. H1 2022

8 18 SIDDELEY STREET (WTC), 14,029 SQM
JOIN GLORY MANAGED BY UDM – 0% COMMITTED. H1 2022

9 500 BOURKE STREET, 44,000 SQM
ISPT – 0% COMMITTED H2 2023

10 321 EXHIBITION STREET,15,000 SQM
INVESCO – 0% COMMITTED H1 2022

11 111 BOURKE STREET,44,000 SQM
BROOKFIELD & 151 PROPERTY – 0% COMMITTED H1 2026

UNDER CONSTRUCTION/ MAJOR PRE-COMMITMENT

12 364-378 LTL LONDSALE STREET, 24,000 SQM [VICTORIA UNIVERSITY]
ISPT – 100% COMMITTED. H2 2021

13 405 BOURKE STREET, 66,000 SQM [NAB]
BROOKFIELD/ISPT – 100% COMMITTED. H2 2021

UNDER CONSTRUCTION/ MAJOR PRE-COMMITMENT

14 1,000 LA TROBE STREET, 33,000 SQM [MYER]
POLY GROUP – 18% COMMITTED. H2 2021

15 140 LONSDALE STREET, 22,000 SQM [AUSTRALIAN FEDERAL POLICE]
CHARTER HALL – 100% COMMITTED. H2 2022

16 555 COLLINS STREET, 48,000 SQM
[AMAZON] CHARTER HALL – 31% COMMITTED. H2 2023

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

18 99 FRANKLIN STREET, 10,500 SQM
BUILT – 0% COMMITTED. H2 2021

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

DEVELOPMENT APPROVED

20 300 LONSDALE STREET, 20,000 SQM
THE GPT GROUP – 0% COMMITTED. H1 2024

21 SOUTHGATE (TOWER 3),40,000 SQM
ARA. H2 2024

22 12 RIVERSIDE QUAY, 57,000 SQM
NICE FURNITURE – 0% COMMITTED. H1 2025

23 1 SPRING STREET, 27,500 SQM
BESEN & ROTH FAMILIES – 0% COMMITTED. H1 2025

24 32 FLINDERS STREET (NTH & STH TOWER), 29,000 SQM
THE GPT GROUP 0% COMMITTED. H1 2024

25 435 BOURKE STREET, 64,000 SQM
CBUS PROPERTY – 0% COMMITTED. H1 2025

26 60 & 52 COLLINS STREET, 28,000 SQM
DEXUS – 0% COMMITTED. H1 2025

27 580 LONSDALE STREET, 25,000 SQM
HICKORY – 0% COMMITTED. H1 2025

28 600 COLLINS STREET, 55,000 SQM
HINES – 0% COMMITTED. H1 2025

29 FLINDERS WEST, 7-23 SPENCER STREET, 45,000 SQM
MIRVAC – 0% COMMITTED. H1 2025

30 383 LA TROBE STREET, 44,000 SQM
MIRVAC – 0% COMMITTED. H1 2025

DEVELOPMENT APPLICATION/MOOTED/ EARLY FEASIBILITY

31 283 QUEEN STREET,25,000 SQM
ISPT. H1 2023

32 522 FLINDERS LANE,30,000 SQM
INVESTA. H1 2025

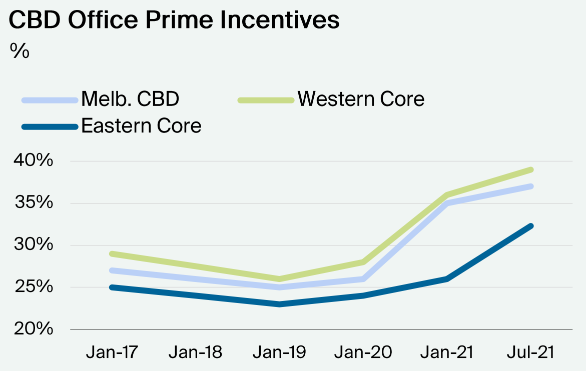
33 SPRING & FLINDERS STREETS, TREASURY SQR,140,000 SQM
MIRVAC. H1 2026

INCENTIVES TO PEAK

Face rents hold however effective rents continue to decline in the face of rising incentives.

Since the onset of the COVID pandemic, CBD net face rents have remained resilient. While the recent COVID-19 enforced lockdowns have put a dent in the office led market recovery that commenced in late 2020, landlords have continued to hold firm on their asking rents. Consequently, prime net face rents in the CBD average $708/sq m as at July 2021, which is unchanged over the past 18 months.

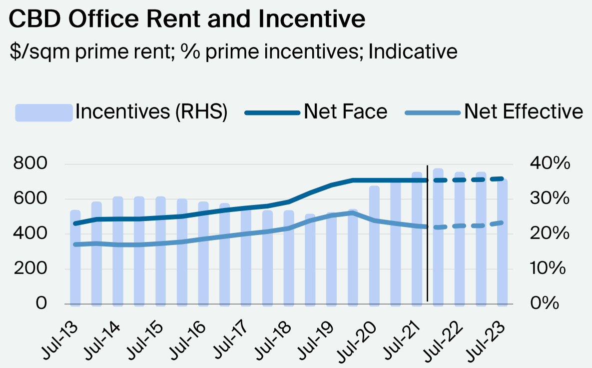
Despite face rents continuing to remain stable, the substantial rise in sub-lease vacancy over the last six months has forced incentives to continue to rise, with prime incentives now averaging 37% in the CBD. And this persistent escalation in incentives has resulted in net effective rents continuing to decline. Prime net effective rents in the CBD currently average $448/sqm, which is down on the $462/sq m average recorded at January 2021.



Net effective rents are forecast to bottom out by the end of the year.

Despite Victoria continuing to experience lockdowns in 2021, the state has shown it can exit lockdowns swiftly, and in light of this we expect the recovery of the office market to gradually resume late in the year off the back of an expected lift in vaccination rates that should see more white collar workers return to the office.

In line with this, prime net face rents are tipped to continue to hold steady in the second half of 2021 and incentives, while likely to edge up slightly more in the second half of the year, should hit their ceiling by the end of the year which in turn will result in net effective rents bottoming out. We expect incentives to start to gradually come down throughout 2022, with the decline led by the eastern core with the western core and the Docklands likely following suit in 2023.



Recent significant tenant commitments

OCCUPIER	PROPERTY	PRECINCT	SIZE SQM	TERM YRS	START DATE
Medibank #	699 Collins Street	Docklands	15,400	10	Q4 2024
BUPA~	11 Exhibition Street	Civic	13,000	7	Q4 2023
Afterpay~	Queen & Collins Streets	Western Core	4,900	5	2021
Northern Trust~	120 Collins Street	Eastern Core	2,877	6	Q2 2021
Canaccord Genuity~	101 Collins Street	Eastern Core	1,572	10	Q1 2022

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

SALES VOLUME TO PICK UP

Sales activity down however volumes set to rise in late 2021 and early 2022.

Sales activity in the first half of 2021 has been noticeably muted, with just $464.7 million of assets transacting over the period (for assets valued over $10 million). A shortage of quality office assets has been brought to market in the past 12 months and this can be directly attributed to the lockdown restrictions.

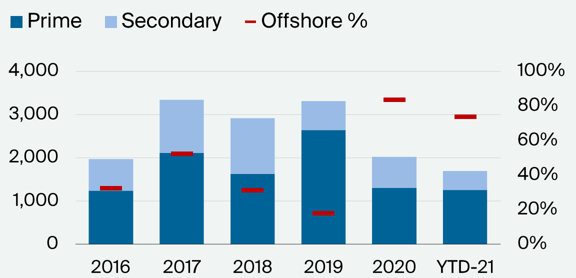
However, Lendlease's July sale of Melbourne Quarter Tower to the National Pension Service of South Korean for $1.2 billion reaffirms the underlying strength of Melbourne's CBD office market and ensures sales volumes will bounce back strongly in the second half of the year. The largest and final commercial office building in Lendlease's Melbourne Quarter precinct, Melbourne Quarter Tower transacted at a rate of $17,143/sqm and provides further evidence of the appeal Melbourne CBD office assets have among offshore investors.

Global investment leads the way in capital investment in Melbourne's CBD office market.

Foreign investors continue to play an active role in Melbourne's CBD office market. Since 2018, approaching $5 billion of CBD office transactions have been through offshore buyers, led by interests in Singapore, South Korea and USA. Melbourne's high-growth economy sustained by record population growth, coupled with strong rental performance relative to other major global markets are key drivers behind the increase in overseas demand for the city's commercial real estate. And the strength of Australia's COVID-19 response, again relative to many other countries also gives investor's confidence in the market.

CBD Office Sales Transactions

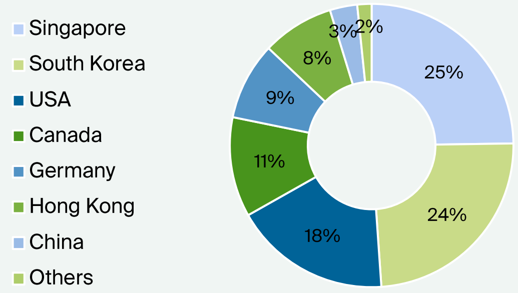
$ millions CY sales by grade; $10mln+ sales



Source: Knight Frank Research

CBD Office Offshore Purchaser Profile

% share 2018 to YTD-21;$10mln+ sales



Source: Knight Frank Research
Others inclusive of Switzerland and Macau

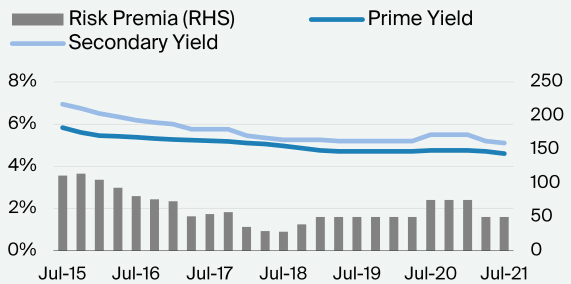
Lasting appeal of CBD office market assets sees yield compression return.

While COVID-19 has limited the volume of CBD office sales, CBD office yield compression has returned in H1 2021. The impact of the pandemic saw average prime yields rise throughout 2020 to reach 4.75% in January 2021, however yields have since come back down to now average 4.6%. Prime yields currently range between 4.35% to 4.85%, while secondary yields range between 4.85% to 5.35%. The spread between prime and secondary yields stands at 50 basis points. Lendlease APPF's purchase of 469 La Trobe Street is indicative of the low yields being recorded in H1 2021. Acquired for $203 million, the asset transacted at a passing yield of 4.78%.

Moving forwards, we expect to see further yield compression when leasing market sentiment improves for buildings that have longer WALEs and strong rental income returns.

CBD Office Core Market Yields

% yields by grade; bps risk premia



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.

Research
Finn Trembath
+61 3 9604 4608
Finn.Trembath@au.knightfrank.com

Office Leasing
Hamish Sutherland
+61 3 9604 4734
Hamish.Sutherland@au.knightfrank.com

Asset Management Services
Ben Veale
+61 3 9604 4756
Ben.Veale@au.knightfrank.com

Research
Kanwal Singh
+61 3 9604 4627
Kanwal.Singh@au.knightfrank.com

Capital Markets
Paul Kempton
+61 3 9604 4774
Paul.Kempton@au.knightfrank.com

Valuations
Michael Schuh
+61 3 8548 6820
Mschuh@vic.knightfrankval.com.au

Research
Ben Burston
+61 2 9036 6756
Ben.Burston@au.knightfrank.com

Occupier Services
Gordon Wyllie
+61 3 9604 4666
Gordon.Wyllie@au.knightfrank.com

Recent Publications.

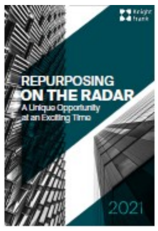
St Kilda Rd & Southbank Offices Report April 2021

Sydney CBD Office Report September 2021

National Industrial Report Q2 2021

Urban Logistics report July 2021

Outlook Report 2021



APAC Repurposing Report 2021

Knight Frank Research Reports are available at knightfrank.com/research

Knight Frank Research provides strategic advice, consultancy services and forecasting to a wide range of clients worldwide including developers, investors, funding organisations, corporate institutions and the public sector. All our clients recognise the need for expert independent advice customised to their specific needs.

Knight Frank