- *Leasing market quietens as net absorption and enquiries down*
- *Prime face rents hold value, though pressure rising in the West and Docklands*
- *Investment market reprices, yields move out further and capital values fall*

Melbourne CBD Office with Southbank update

Market Report, September 2023

knightfrank.com/research

MARKET REPRICES AS LEASING MARKET WEAKENS

Market activity falls back as players pause in uncertain times.

15.0% VACANCY

$699 PRIME FACE RENT

42% PRIME INCENTIVES

"Vacancy rates move higher, incentives move out and yields rise as activity in both the capital markets and leasing sectors is becalmed."

The Key Insights

The vacancy rate has risen to 15%, the highest level in 26 years as extra space meets a quiet leasing market.

Net face rents remain stable, but incentives rise again to over 40% meaning net effective rents fall, with prime rents down 3.1% q/q.

Net absorption negative again, at −66,152 sqm, with prime property affected this time as well.

Yields move out further as re-pricing nears completion. Stability is appearing in the capital markets, and interest rates may of peaked, bringing hope that yields have found their level.

Melbourne CBD Office Market Indicators — July 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	3,670,532	14.2	-48,724	19,850	699	41.8	-1.0	5.7-6.0
Secondary	1,436,706	17.0	-17,428	-40,843	547	39.1	-2.6	6.1-6.6
Total	**5,107,238**	**15.0**	**-66,152**	**-20,993**				

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

INTEREST RATES PEAK AS ECONOMY SLOWS

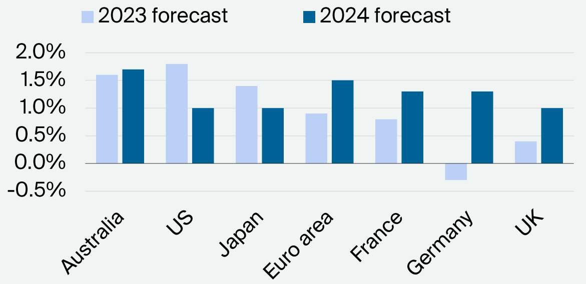
The economy is slowing markedly, in line with expectations

The latest GDP figures showed that though the Australian economy continues to slow it remains resilient, with Q2 growth of 0.4% (2.1% y/y down from 2.4%). This is in line with expectations and latest forecasts from the IMF which show that Australia is expected to grow by 1.6% in 2023 and 1.7% in 2024. Though this is below long term trends it remains a robust performance in a difficult global environment.

The weakening Australian and global economy continues to impact sentiment in the market with consumer sentiment near record lows and weakening retail sales. However signals remain mixed, with unemployment rising, but still low and business conditions remaining positive, even as business confidence remains flat. The latter is of course all important when firms are deciding space requirements for the future. The confidence indicator has remained low since Q3 2022, with firms uncertain as to how international events and inflationary pressures will impact future growth.

IMF GDP forecasts

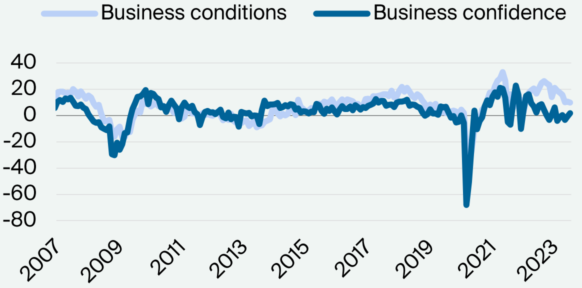
GDP forecasts, July-23



Source: Knight Frank Research, IMF

Business confidence and conditions

Net balance of positive and negative responses



Source: Knight Frank Research, Macrobond

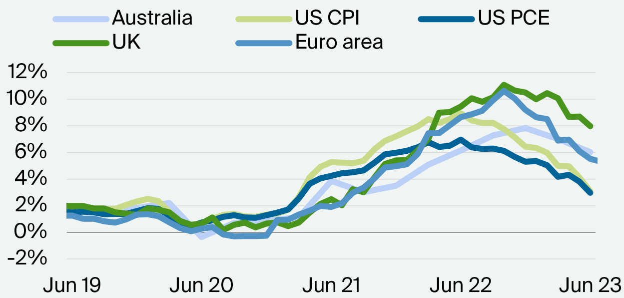
Inflation has peaked as attention now turns in the direction of interest rates

Headline inflation in Australia and across the major industrial countries seems to have peaked, as the surge in prices last year feeds through the figures. Interest now is on ensuring core inflation does not become embedded. Central banks are therefore concentrating on other indicators of activity and demand to see whether pressures are weakening.

Interest rates have now been kept on hold at 4.1% since they last rose in June, as the RBA pauses to see the full impact of the year of near continuous rate rises on core inflation. Indications are that whilst still well above the RBA's target of 2 -3%, the trimmed inflation rate is falling slowly but steadily from a peak of 6.9% to 5.9% now. Three of the four big banks think interest rates have peaked, whilst NAB thinks there is only one more rise to go. A feeling that we are there or there abouts is showing in the bond market with yields hovering just below 4%. This hopefully implies some stability and certainty to the cost of debt and thus pricing in the office market.

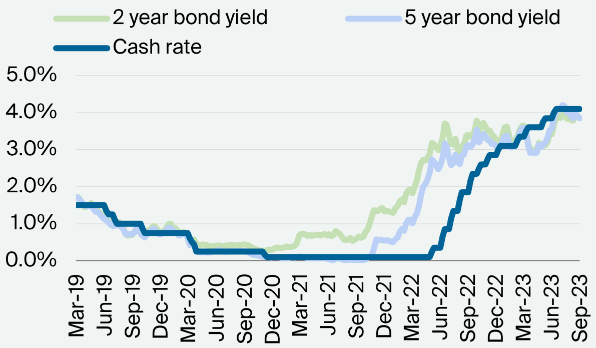
Headline inflation

Per cent change year on year



Source: Knight Frank Research, Macrobond

Australian interest rates



Source: Knight Frank Research, Macrobond

NET ABSORPTION WEAKENS FURTHER

Premium property sole bright spot as leasing market weakens further

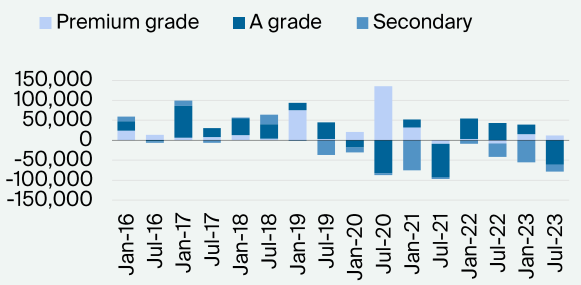
Premium grade property in Melbourne maintained its appeal to tenants as overall leasing activity continued to fall, with total net absorption down −66,152 sqm in H1 2023 compared to −16,854 sqm in H2 2022 and +1,991 sqm in H1 last year. Premium grade net absorption however remained positive with +12,093 sqm for H1 which adds up to over 27,000 sqm in the last 12 months. Unlike last period, Grade A stock saw negative net absorption of −60,817sqm, a major part of the overall negative numbers this time.

This is in line with the general trend in Australia overall, as the economy slowed and the outlook became more uncertain, net absorption turned negative for both CBDs (-21,740 sqm) and non-CBDs (-95,846 sqm). For Australian CBDs overall this is the first negative figure since H1 2021. This was clearly a story of the downturn being concentrated in the major markets as Sydney CBD saw net absorption of -40,173 sqm. This and Melbourne's result more than outweighed positive net absorption figures in the other capitals.

Enquiries fallback to pre-Covid levels, whilst size requirements remains low

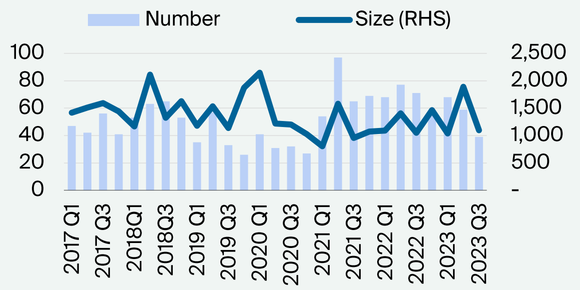
New tenant enquiries coming in to Knight Frank in Q3 have fallen back. As the pandemic receded and lockdowns ended there was a sharp increase in enquiries even as the average size of the requirements fell. The rolling average quarterly number of enquiries rose to 75 post–Covid, compared to 33 during the lockdowns (and the mid 40's before then) as the market caught up on delayed requirements. However, the average size requirement fell from around 2,000 sqm to 1,100-1,200 sqm. This was seen as the market trading up while shrinking footprint. New enquiries have fallen back to 53 in Q3, but size requirements still average 1,300 sqm, as the market calms but the larger space requirements have not returned.

Net absorption
By grade, sqm



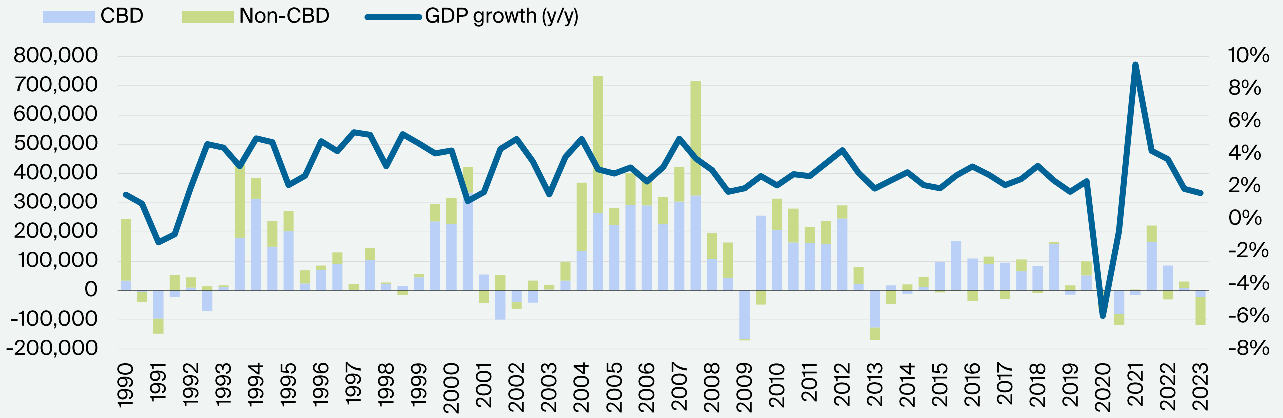
Source: Knight Frank Research, PCA

Tenant enquiries excl.20,000 sqm+ (qtly)
Number (LHS), avg. size (sqm, RHS)



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 CONTINUE TO RISE

Grade B buildings benefit from withdrawals as vacancy rate hits 15%

Vacancy rates rose to 15.0% in Melbourne CBD as only Grade B buildings saw a decline (from 22.0% to 20.4%). This was as the withdrawal of three buildings for refurbishment or, in the case of 60 Collins Street, the start of a total rebuild, meant withdrawals outweighed the negative net absorption. Premium grade buildings had the opposite issue, with the arrival of 555 Collins Street more than outweighing positive net absorption of 12,093 sqm to see vacancy rates rise to 12.2%. Meanwhile the withdrawal of the Old Myer building at 800 Collins Street was not enough to counter the negative demand in Grade A buildings, which saw vacancy rise to 15.2%, just above the market average. The weakness in the market is moving further up the grade chain, as availability of quality space remains.

Sub-lease vacancy rose back to 2% reflecting 103,445 sqm of space. Whilst subleasing remains high, it has not become the major issue many people feared. However, word on the ground is that there may be more unused space that has not been formally put up for sub-leasing as it is known it will not move, thus this number may under-represent the problem to some extent. This issue may unravel of its own accord as demand for space returns with confidence in the economy.

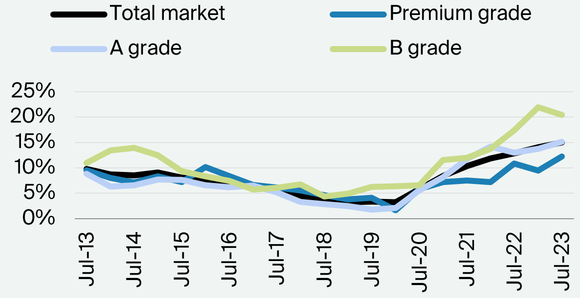
Pipeline low for next 2 years but demand expectations mean vacancy remains high

Going forward the development pipeline remains modest with no major change to expectations. Only 500 Bourke Street (44,000 sqm of refurbished space, 70% pre-committed) is due this year, whilst next year is dominated by Melbourne Quarter Tower with 68,000 sqm of new space (20% pre-committed). As we move out, every year has one or two significant builds coming on which will maintain a steady, though not dramatic, flow of quality stock.

We expect demand to remain positive but moderate in the next five years as the economy slowly recovers. Vacancy rates will thus edge down undramatically, but we expect vacancy rates in unloved secondary buildings to remain high and thus for prime rates to fall slightly more quickly.

Vacancy rate

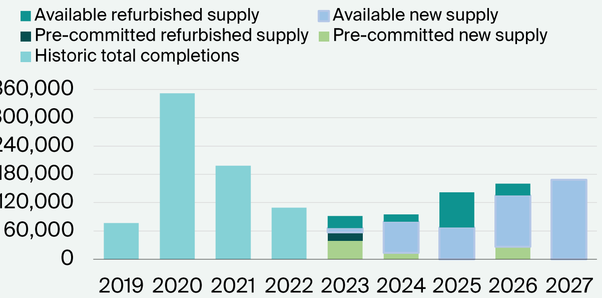
By grade, per cent



Source: Knight Frank Research, PCA

Melbourne CBD development pipeline

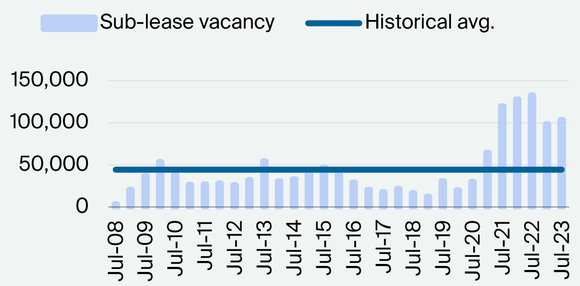
Sqm



Source: Knight Frank Research, PCA

Sub-lease vacancy

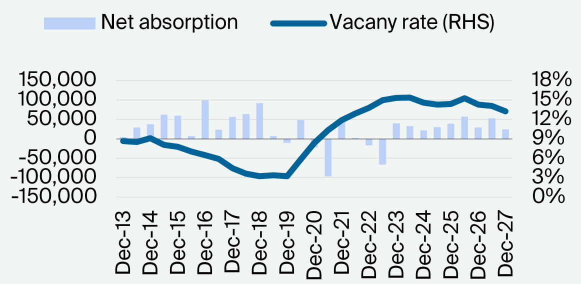
Sqm



Source: Knight Frank Research, PCA

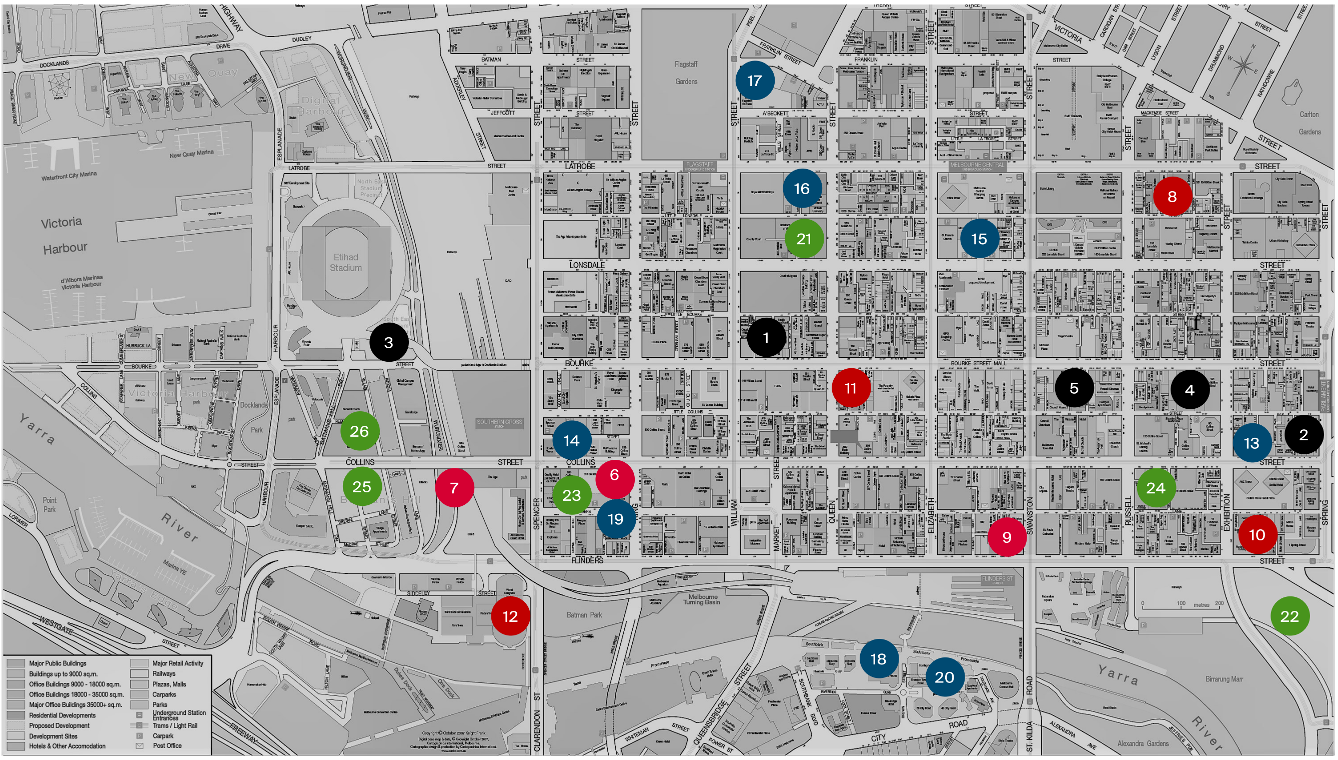
Net absorption and vacancy rate

Sqm (LHS), percent (RHS)



Source: Knight Frank Research, PCA

MAJOR OFFICE SUPPLY



NB Dates are Knight Frank Research estimates

MAJOR REFURBISHMENTS

1 500 BOURKE STREET – 44,000 SQM
ISPT – 70% COMMITTED, H2 2023

2 85 SPRING STREET – 15,000 SQM
PELLIGRA – H1 2024

3 720 BOURKE STREET – 30,000 SQM
CBUS PROPERTY – H2 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
CHARTER HALL – 82% COMMITTED,
COMPLETED

7 MELB QTR TOWER , 693 COLLINS STREET - 68,000 SQM
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 – 35% COMMITTED, H1 2026

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

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

CBA–25% COMMITTED

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

DEVELOPMENT APPROVED

13 60 & 52 COLLINS STREET– 40,000 SQM
DEXUS – H2 2027

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

15 300 LONSDALE STREET – 22,500 SQM
THE GPT GROUP – 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– 2027+

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

23 522 FLINDERS LANE – 30,000 SQM
INVESTA – 2027+

24 123 COLLINS STREET – 80,000 SQM
GRAND HYATT GROUP – 2028+

25 COLLINS SQUARE - GOODS SHED SOUTH – 70,000 SQM
WALKER – 2027+

26 710 COLLINS STREET– GOODS SHED NORTH – 70,000 SQM
ABAUS/WALKER – 2027+

INCENTIVES RISE AS EFFECTIVE RENTS COME UNDER PRESSURE

Face rents remain flat in quieter market

Prime net face rents in the CBD were flat in Q2 following on from incremental rises in previous quarters (y/y rise is 2.6%) remaining at $699/sqm. However, net face values are clearly under pressure in the Western Core and Docklands precincts. The completion of 555 Collins Street saw the building continue to lease out with Ericsson signing 3,350 sqm of space in it. There has also been some major public sector leasing with VCAT signing up to move to 300 La Trobe Street (14,000sqm). Commonwealth Bank has signed for 15,000sqm, in a pre-commit to the development on 435 Bourke Street due for completion in 2026 incorporating a 'solar-skin'. So deals are coming through, and as the market sees the interest rate cycle coming to an end and clarity appearing for the economy, more delayed decisions are expected to be finalised.

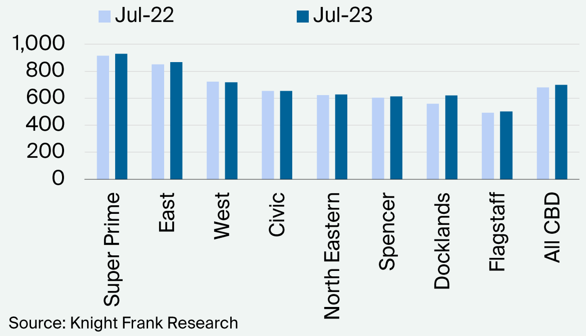
Incentives edge up further

Incentives continued to rise as higher vacancy rates and limited demand means the tenant is in the stronger position at present. Incentives rose from 39.9% last quarter to 41.8% in Q2, which combined with flat face rents saw effective rents fall 3.1% to $410/sqm (but only –1.0% y/y). The Eastern Core is the only area with incentives below 40%, with some areas of the Docklands struggling to keep incentives below 50%. The Civic, Flagstaff and North Eastern precincts managed to hold their net effective rents stable. The largest fall, in actual and percentage terms, came in the Docklands, where effective rents went from $372/sqm to $322/sqm, as incentives caught up with the market even as the face rents held firm for prime property. Secondary rents also saw incentives move out and average net effective rents are now standing at $333/sqm (down 2.3% on the quarter and down 2.6% y/y).

Going forward we are expecting to see 2023 remain flat, with incentives peaking. The combination of a more moderate pipeline, combined with some strengthening in the leasing market as confidence returns to the market, means that growth will return. However, the large amount of available stock and slower economic growth into the future means that incentives will drop slowly, and there will be only moderate face rent rises, concentrated in prime space.

Prime rents

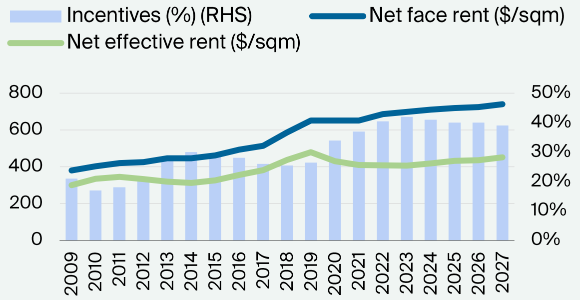
$/sqm, net face by precinct



Source: Knight Frank Research

Prime rents and incentives

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



Source: Knight Frank Research, PCA

Recent significant tenant commitments

OCCUPIER	PROPERTY	PRECINCT	SIZE SQM	Term YRS	START DATE
Ericsson	555 Collins Street	Western Core	3,350	10.0	Q3-2023
VCAT	300 La Trobe Street	Flagstaff	14,000	20.0	TBC
Commonwealth Bank of Australia	435 Bourke Street	Western Core	15,000	10.0	Q1-2026
Holding Redlich	500 Bourke Street	Western Core	3,945	11.0	Q3-2023
Wesfarmers Health	637 Flinders Street	Docklands	3,500	10.0	Q1-2023

SOUTHBANK UPDATE

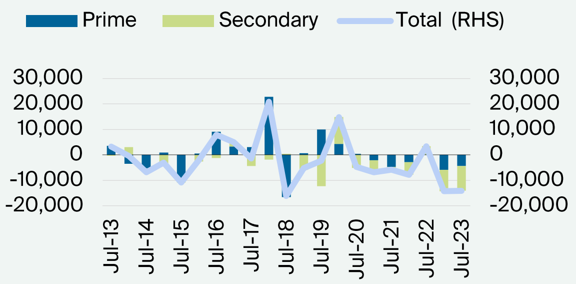
Net absorption remains negative as Southbank feels the office market pain

Unsurprising given the overall fragility of the Melbourne CBD market, Southbank is struggling somewhat as the natural overflow area for the City. Net absorption was again negative in H1 2023 and at –14,095 sqm was just 237 sqm better than H2 2022. Prime space continued to show more resilience, as net absorption fell by only 4,451 sqm. With the quieter market there has been little leasing activity to report.

Vacancy rates have again mirrored the main CBD showing a rise to 18.3%, well above the CBD, and up from 14.6% at the end of 2022. The withdrawal of the Foster's Brewery building at 77 Southbank Boulevard (13,906 sqm), was more than offset by the arrival of Eleven Eastern on Eastern Road (16,044 sqm). This combined with the negative absorption pushed the vacancy higher. The new space coming on also helped Grade A vacancy jump above that of secondary defying the wider trend within the market.

Southbank net absorption

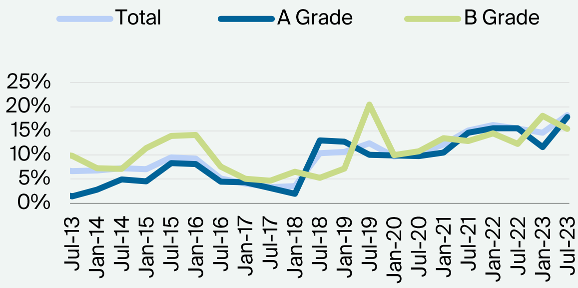
By grade, sqm



Source: Knight Frank Research, PCA

Southbank vacancy

By grade, per cent



Source: Knight Frank Research, PCA

Rental market subdued as effective rents fall

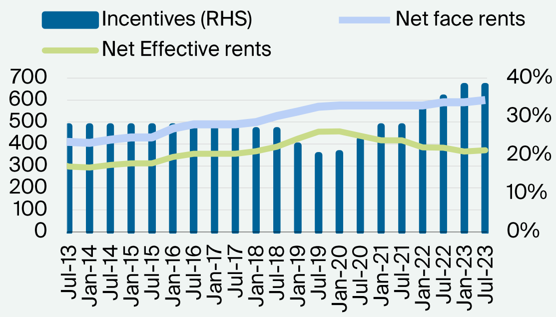
Face rents have been only edging up slightly in the last few years. Net face rents have risen from $570/sqm at H1 2019 to $600/sqm now. Unfortunately incentives in Southbank have been going the same way as elsewhere, meaning that effective rents have been falling fairly consistently from a high of $476/sqm to $372/sqm now. Given our overall outlook for the Melbourne economy and with little new development we are expecting rents to stabilise at their present level before showing a slight improvement going forward, shadowing the CBD.

Yields move out in tough capital market conditions

The real estate investment market has been quiet across Australia, and this includes Southbank. There have been no major deals in the last 6 months and our indicative view is that prime and secondary yields have moved out 50bps to 5.75% and 6.50% respectively.

Southbank prime rents and incentives

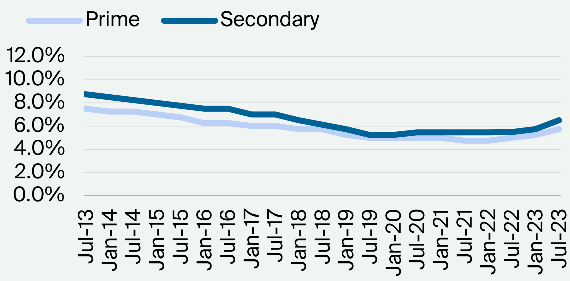
Net, $/sqm (LHS), per cent (RHS)



Source: Knight Frank Research, PCA

Southbank yields

By grade, per cent



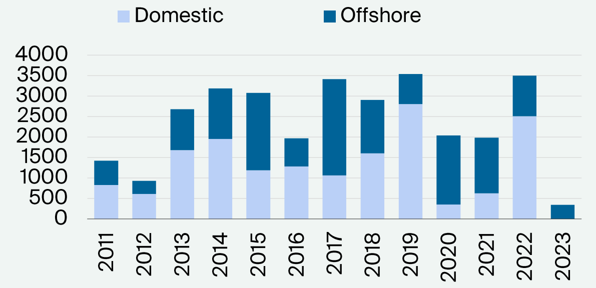
Source: Knight Frank Research

INVESTMENT MARKET QUIET ACROSS AUSTRALIA

Investment market remains particularly quiet in H1 2023

Following the very busy, frontloaded, 2022 where investment volumes were $3.503bn, the impact of continuous interest rate rises and global uncertainty has led to markets coming down to earth with a bang. Questions concerning pricing levels and the future of traditional offices have led to a sharp pause in the market. In H1 2023 only two office deals above $50m were transacted throughout all of Australia (both featuring Knight Frank). These were 44 Market Street in Sydney, and here in Melbourne at 7 Spencer Street, where Daibiru, a Japanese real estate company has bought a 50% share in the Mirvac development.

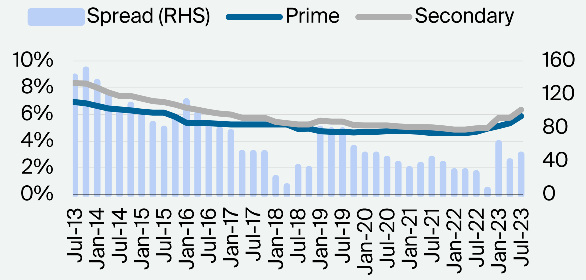
Outside of that deal, the only other deal of note was a $30m sale of the Grade B building 99 Queen Street to a Chinese Investor. This highlights that some private investors remain active, and possibly taking advantage of a lull in the market as institutional players are considering new strategies and pricing. Word on the ground is that, as with previous market pauses, investments are getting ready to be placed as the market restarts.



Yields continue to move out as markets reprice

Repricing has continued. With the bond market stabilising to a degree, a feel for the revised cost of debt is becoming clearer. This combined with the acknowledged weaker global economic outlook and its impact on tenant demand has brought some clarity to both buyers and sellers as to where pricing now stands in the market. This is the first phase in getting the market started again.

There has been limited activity but our indicative feel of where yields are is that they have moved a further 52bps (to 5.9%)for average prime and 60 bps (to 6.4%) for secondary in the last quarter. Yields have moved out around 130 bps for prime and 150bps for secondary since their lows last year. Given the very low levels they have come off, this has meant a sharp correction in capital values which is still playing out. Our yield forecasts see yields stabilising and, in particular prime yields, coming back in over the next two years as certainty returns to the market. Secondary yields may struggle to recapture their value given the uncertainty in tenant requirements for lower quality space.



Recent significant sales

BUILDING	Price $M	Core Market Yield %	NLA SQM	Purchaser	Vendor	Sale Date
7 Spencer Street	Conf.	Conf.	46,000	Daibiru	Mirvac	May-23
99 Queen Street	30.0	TBC	4,710	TBC	E. Scaunich Nominees	Apr-23

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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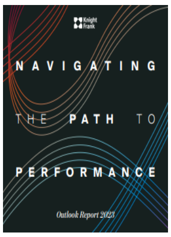
Sydney CBD Office Market Report August 2023

National Industrial report Q2 2023



Outlook Report 2023

Wealth Report 2023

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