RESEARCH

ADELAIDE

OFFICE MARKET OVERVIEW MARCH 2017

HIGHLIGHTS

Adelaide's value proposition relative to the Eastern States and the low cost of finance have resulted in further yield firming. There is potential for this firming bias to continue in the short term.

The Adelaide CBD vacancy rate increased from 15.8% to 16.2% in the six months to January 2017. Contributing to this was the completion of 115 King William Street and 170 Frome Street.

Forecast supply over the short term is projected to be limited. No significant new buildings are expected to be completed in 2017 or 2018, with 2019 to have the next major supply.

KEY FINDINGS

In the six months to January 2017, average prime CBD incentives increased from 29% to 32.5%, resulting in a decrease in average effective rents of -5.3%.

The 2016 calendar year saw office sale transactions totalling $1.18 billion for assets greater than $10 million. It's expected that sales activity will remain strong in 2017.

In the six months to January 2017, CBD prime yields firmed by 16 basis points from an average of 7.39% to 7.23%, with the potential for a firming bias to continue in the short term.

Increased incentives have correlated with firming yields within the Prime market. Building owners have seen greater financial benefit from securing a long term tenant which allows for the potential of greater yield firming above the cost of incentives.

HENRY MATHEWS
Research SA

SUPPLY & DEVELOPMENT

Forecast supply is limited while current vacancy is absorbed. No significant new buildings will be completed in 2017 or 2018.

The Adelaide CBD recorded an increase in gross supply of 18,771m² in the six months to January 2017, approximately 35% above the 25 year average. Contributing to this was the completion of two buildings, 115 King William Street (6,775m²) in October 2016, and Emmett Property's 170 Frome Street (3,900m²) in December 2016. 170 Frome Street, which was built with a 38% tenant pre-commitment from accounting group Grant Thornton, is seeking tenants to fill remaining vacancies. It's understood 115 King William Street, a speculatively built 23 level building with no pre-commitment currently has less than 10% occupied.

After accounting for stock withdrawals, net supply stood at 15,157m² in the six months to January 2017. There were a number of minor partial refurbishments, however the only withdrawal of note was 2,743m² which was permanently withdrawn at 228-230 & 231 North Terrace for the construction of student accommodation by Urbanest.

Forecast supply over 2017 is expected to be limited, with no significant new buildings to be completed in either 2017 or 2018. This is largely the result of a surplus of quality vacant space currently available. The hiatus in construction will aid in stabilising the vacancy rate as the market absorbs the existing stock.

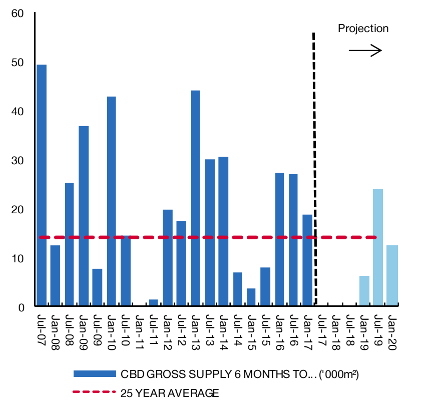
Construction of Charter Hall's 20 storey Precinct GPO development (24,000m²) is expected to commence in 2017 following a 51% pre-commitment by the Attorney General's Department, with an expected completion date in H1 2019. The second stage of the development, a smaller 15 level tower located above the heritage listed GPO building was to be office, however there is speculation it may now be developed into a luxury hotel.

Other developments of note in the pipeline include 322 King William Street, a mixed use development comprising two towers of 31 levels each, with residential, office (12,482m²), retail and hotel accommodation. Walker Corporation's Festival Plaza development (40,000m²) currently has no firm starting date and a number of smaller developments such as 185 Pirie Street (6,000m²) will be dependent on tenant pre-commitments to commence.

FIGURE 1

Adelaide Gross Supply Additions

CBD Office (000's m²)



Source: Knight Frank Research/PCA

TABLE 1

Grade	Market	Total Stock (m²)	Vacancy Rate (%)	Annual Net Absorption	Annual Net Additions	Average Gross Face Rent ($/	Average Incentive	Average Core Market Yield
Prime	CBD	594,887	14.9	4,302	21,178	503	32.5	6.75—7.50
	Fringe	37,297	4.7	340	0	442	20.0	7.25—8.00
Secondary	CBD	825,935	17.2	-5,409	13,106	381	33.3	8.00—9.00
	Fringe	177,653	12.6	-8,466	-376	345	20.0	8.00—8.50
Total Precinct	**CBD**	**1,420,822**	**16.2**	**-1,107**	**34,284**			
	Fringe	**214,950**	**11.3**	**-8,126**	**-376**			
Total Market	**Adelaide**	**1,635,772**	**15.6**	**-9,233**	**33,908**			

Source: Knight Frank Research/PCA NB. CBD includes the Core & the Frame precincts

MAJOR OFFICE SUPPLY

1. 50 Flinders St - 20,572m² [People's Choice C.U., Santos, BUPA]
Cbus - October 2015 - 91% committed

2. 81-95 Waymouth St # - 17,378m² [SA Govt]
KTS Properties - May 2016 - 70% committed

3. 115 King William St - 6,775m²
Local Private Developer - October 2016 - 10% committed

4. 170 Frome St - 3,900m² [Grant Thornton]
Emmett Properties - December 2016 - 38% committed

5. GPO Tower, 2-10 Franklin St - 24,000m² [SA Govt]
Charter Hall - 2019 - 51% committed

6. 185 Pirie Street - 6,000m²
Palumbo / Pruszinski - 2019+

7. 186-190 North Terrace - 5,000m²
Adelaide Development Company (ADC) - 2019+

8. 102-120 Wakefield St - 16,500m²
Kyren Group - 2019+

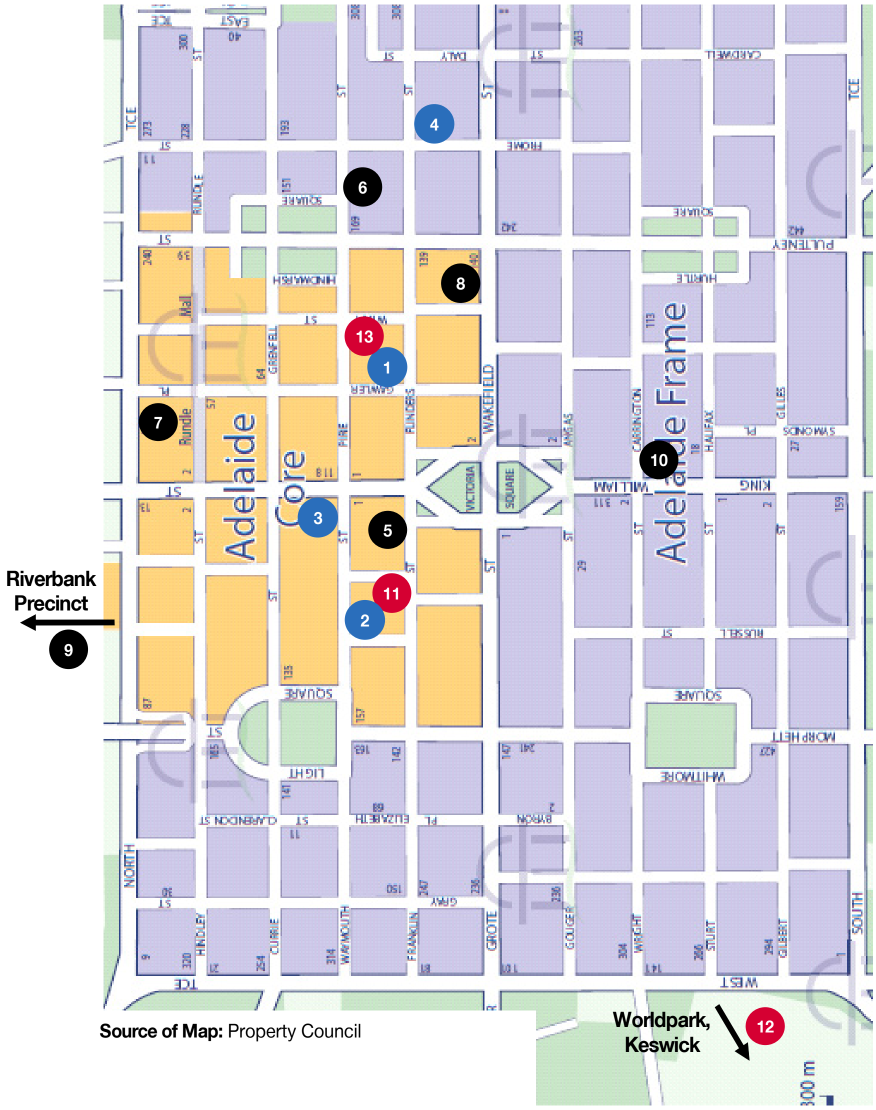
9. Festival Plaza / Riverbank Precinct - 40,000m²
Walker Corp/SA Government - 2019+

10. 322 King William Street* - 12,482m²
Karidis - 2019+

11. 42-56 Franklin St - 21,000m²
Kyren Group - 2019+

12. Worldpark - Richmond Rd, Keswick - 22,600m²
Axiom (Stage B & C) - 2019+

13. 57-61 Wyatt Street - 4,180m²
Private - 2019+



Source of Map: Property Council

Under Construction / Complete

DA Approved / Confirmed

Mooted / Early Feasibility

NB. Dates are Knight Frank Research estimates
Major tenant pre-commitment in [brackets] next to NLA

Major refurbishment
C.U Credit Union
Office NLA quoted (>3,000m²)
* Mixed use development comprising residential, retail, hotel and commercial

TENANT DEMAND & RENTS

Net Absorption

The Adelaide CBD recorded positive net absorption of 1,341m² in the six months to January 2017, and –1,107m² over the previous 12 month period. Since July 2009, there has been constant fluctuation in the take up of space and this result further continues the trend (see Figure 2).

The South Australian unemployment rate stands at 6.6% as at February 2017. Despite the unemployment rate remaining below the recent high of 6.9% in November 2016, it has continued to fluctuate between 6-7% since early 2016, indicative of a sluggish market and pointing to the state's broader economic drivers being stagnant.

The announcement that Australian naval construction group ASC and French based naval design company DCNS have secured a $50 billion Federal Government contract to build 12 submarines for the Australian Defence Force is a positive outcome for the state.

Tenants associated with the defence industry are anticipated to be active within the Adelaide leasing market, with three significant leases to Babcock International, Raytheon and DCNS occurring in the previous 12 months. Babcock International has leased 1,301m² at 70 Franklin Street for a 10 year term. In the Fringe, DCNS committed to 1,705m² at 1 Richmond Road, Keswick, while Raytheon has leased 1,300m² at 160 Greenhill Road for a five year term.

Vacancy

Vacancy in the Adelaide CBD increased from 15.8% to 16.2% in the six months to January 2017. This is the highest result since 1999 and remains significantly above the 10 year average of 9.5%.

Prime vacancy decreased from 15.4% to 14.9% in the six months to January 2017, with vacant prime stock now standing at 88,390m². Overall, the total amount of prime vacant space has continued to trend upward in the last 24 months despite this minor fall in the vacancy rate.

Over the same time period, vacancy in secondary space increased from 16.2% to 17.2%, with B, C and D grade space all contributing to the increase. C grade space saw a substantial increase from 16.8% to 18.1% (see Table 2).

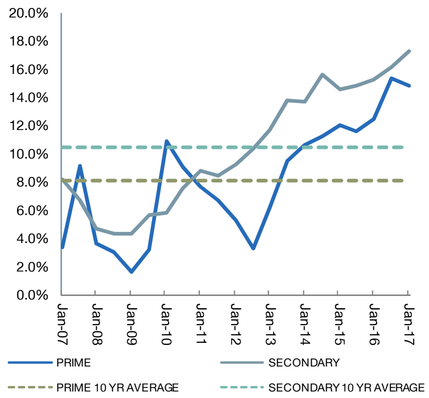
The Adelaide CBD contains a notable amount of ageing C and D grade office space, accounting for 31% of total stock. It is likely that this space will remain vacant for sometime unless refurbished, particularly given the availability of prime space with attractive incentives on offer.

The Fringe market also saw an overall upwards movement in vacancy rates, recording an increase from 10.2% to 11.3% (see Table 3). This increase was primarily driven by changes in A and B grade space.

In the six months to January 2017, A grade vacancy in the Fringe increased from 2.1% to 4.7% and B grade vacancy increased from 7.6% to 16.9%.

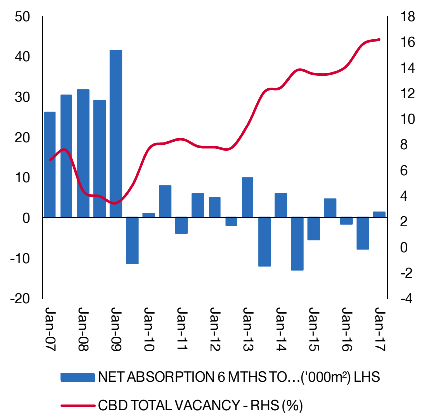
The Fringe represents a comparatively small market when compared to the CBD, and large fluctuations in the vacancy rate can result from only a few tenant movements, particularly evident by the B and D grade vacancy rates (see Table 3).

FIGURE 3
Adelaide CBD Vacancy Rates
Prime vs. Secondary Grade (%)



Source: Knight Frank Research/PCA

FIGURE 2
Adelaide CBD Net Absorption
('000m² LHS) vs Total Vacancy Rate (% RHS)



Source: Knight Frank Research/PCA

TABLE 2
Adelaide CBD Vacancy Rates (%)

Grade	Jan 2016	Jul 2016	Jan 2017
Premium	7.7%	8.3%	8.3%
A Grade	12.8%	15.9%	15.4%
Prime	**12.5%**	**15.4%**	**14.9%**
B Grade	11.1%	14.2%	15.6%
C Grade	17.9%	16.8%	18.1%
D Grade	20.6%	20.0%	20.2%
Secondary	**15.2%**	**16.2%**	**17.2%**
Total	**14.1%**	**15.8%**	**16.2%**

Source: Knight Frank Research/PCA

TABLE 3
Adelaide Fringe Vacancy Rates (%)

Grade	Jan 2016	Jul 2016	Jan 2017
Premium	-	-	-
A Grade	5.6%	2.1%	4.7%
Prime	**5.6%**	**2.1%**	**4.7%**
B Grade	5.6%	7.6%	16.9%
C Grade	7.9%	12.8%	11.4%
D Grade	9.6%	21.5%	7.4%
Secondary	**7.4%**	**11.9%**	**12.6%**
Total	**7.1%**	**10.2%**	**11.3%**

Source: Knight Frank Research/PCA

Tenant Demand

Despite some recent outlying successes, new leasing deals are predominately being led by existing tenants relocating or renewing rather than expansions or new tenants entering the market. This is affecting secondary grade buildings in particular, with existing tenants being incentivised to upgrade. Higher incentives have resulted in a reduction of the spread between A and B grade space in effective terms, and this, coupled with efficiency gains in A grade space means that rates on a cost per employee basis are increasingly more comparable between the two grades.

Over the previous six months, leases of note include the SA Attorney General's Department which extended for an additional 5 years at 45 Pirie Street, where they occupy circa 15,000m². During this term they will manage their relocation to the Adelaide GPO Development.

White collar employment in the Adelaide CBD has been sluggish over the 12 months to January, recording minimal overall change. By sector, increases of note include 18.5% by 'Administrative and Support Services' and 23.1% by 'Electricity, Gas, Water and Waste Services', however these were offset by decreases in 'Public Administrative Support Services' by –5.7% and 'Health Care and Social Assistance' by –7.4%. Following an extended period of stagnation, the expectation for white collar employment in the CBD over the next 12 months is for growth of approximately 2.3%. The forecast for the subsequent 2-3 years is modest annual increases ranging from 1.0%-2.0%.

Rental Levels

The Adelaide market has continued to experience a reduction in effective rents due to increases in incentives and modest or no growth in face rents. This has predominately been the result of the difficult current operating climate. However, increased incentives have also correlated with firming yields at the top end of the market. Building owners have seen greater financial benefit from securing a long term tenant which improves the asset's WALE and allows the potential for greater yield firming. This can provide an uplift above the cost of incentives, even if only on paper.

Average prime incentives in the CBD increased from 29% to 32.5% over the past six months to January 2017 and now range from 30%-35%. While the leasing market is likely to remain accommodative for prospective tenants, the expectation is that incentives have likely reached their peak. Average prime gross face rents have remained largely unchanged at $503/m², and as a consequence, there was a –5.3% decrease in average gross effective rents from $358/m² to $339/m² (see Figure 4).

Average secondary incentives in the CBD increased from 30% to 33%, while average secondary gross face rents saw a minor increase from $378/m² to $381/m². As at January 2017, average gross effective rents stood at $254/m², down from $264/m² in July 2016.

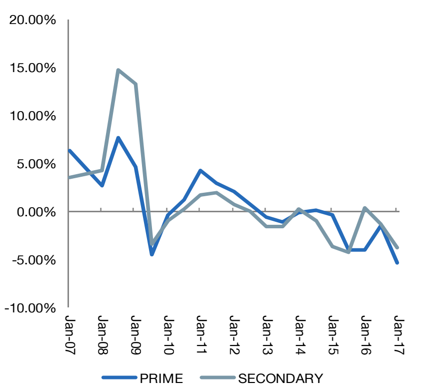
In the Fringe market, average incentives increased from 18% to 20% for prime space and from 19% to 20% for secondary space. Prime incentives increased in line with Secondary incentives due to upward pressure placed on Prime assets to refurbish and attract long term tenants.

Gross face rents were unchanged for both prime and secondary space at $442/m² and $345/m² respectively. As a result, average prime gross effective rents decreased from $362/m² to $353/m² and average secondary gross effective rents decreased from $279/m² to $276/m² over the previous 6 months.

FIGURE 4

Adelaide CBD Gross Effective Rent Growth

Prime vs. Secondary Grade (%)

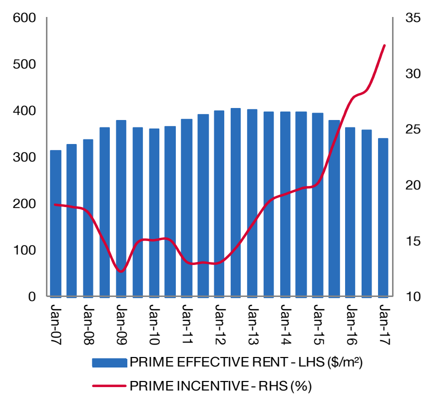


Source: Knight Frank Research

FIGURE 5

Adelaide CBD Prime Incentives vs. Gross Effective Rents

2007 - 2017 ($/m² LHS, % RHS)



Source: Knight Frank Research

TABLE 4

Recent Leasing Activity Adelaide CBD and Fringe

Address	NLA m²	Face Rent $/m²	Term yrs	Incentive (%)`	Tenant	Start Date
45 Pirie Street	15,071	535g	5	#	SA Government	Sep-17
108 North Terrace	2,786	480g	5	35	Optus	Jul-17
1 Richmond Road*	1,705	405g	#	#	DCNS	Feb-17
70 Franklin Street	1,301	445g	10	#	Babcock	Jan-17
1 King William Street	1,160	495g	7	30	Enzen Global	Sep-16
50 Flinders Street	1,775	430n	12	30	Bupa Australia	Aug-16
70 Hindmarsh Square	870	420g	7	30	AMP Services	Aug 16
160 Greenhill Road*	1,300	415g	5	15	Raytheon	Apr-16

`estimated incentive calculated on a straight line basis *Fringe g Gross n Net # Undisclosed

Source: Knight Frank Research

INVESTMENT ACTIVITY & YIELDS

The 2016 calendar year saw office sale transactions totalling $1.18 billion for assets greater than $10 million in the Adelaide CBD (Figure 6). This significant increase in transaction volumes shows the growing level of investor interest in Adelaide and the increased relevance of the state's office market on the national and international stage.

Highlighting the increased activity from overseas and institutional investors was Credit Suisse's purchase of 25 Grenfell Street from GDI Funds Management for $125.1 million. The deal reflected a core market yield of 7.48% and had a WALE of approximately 5.0 years. GDI Funds acquired the property in 2009 from AMP during the Global Financial Crisis for $76 million.

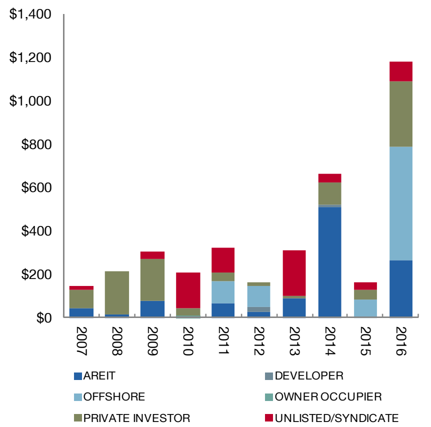
In October 2016, 12-26 Franklin street transacted for $266.135 million on a core market yield of 6.00%. This was an internal transaction between the Charter Hall Prime Office Fund (CPOF) and Telstra Super Fund (each having 50%), into the Charter Hall Long WALE REIT. The transaction included additional income support of approximately $17 million to account for the upcoming effective rent reviews for the major tenant, the Australian Taxation Office.

Another significant acquisition was the purchase of a 50% interest in Adelaide's tallest building, 91 King William Street, for $88.5 million. Local private syndicate Inheritance Capital Asset Management purchased the interest from Abacus Property Group reflecting a core market yield of 7.00% based on a WALE of 3.1 years. Abacus have retained the remaining 50% interest.

Other transactions that occurred in late 2016 were 97 King William Street and 233 North Terrace. In December, a private investor purchased 97 King William Street for $29.0 million reflecting a core market yield of 6.62%. The property sold fully leased to BankSA, who recently undertook a significant fitout, with a WALE of 4.8 years. The passing rent is considered below market, however is capped at a 10% increase at the next market review in 2021.

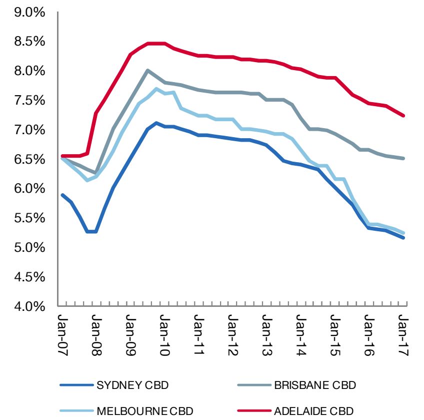
Also in December, a private investor with offshore ties purchased 233 North Terrace for $21.0 million reflecting a core market yield of 6.81%. The property sold with a 10 year lease back to the vendor, Australian Fashion Labels, following a comprehensive refurbishment program.

FIGURE 6
Adelaide CBD Sales $10 million+
By Purchaser Type ($m)



Source: Knight Frank Research

FIGURE 7
Adelaide CBD vs East Coast Yields
Prime Core Market Yields



Source: Knight Frank Research

TABLE 5
Recent Sales Activity Adelaide

Address	Price ($ mil)	Core Mkt Yield (%)	NLA (M²)	NLA ($/m²)	WALE (yrs)	Vendor	Purchaser	Sale Date
191 Fullarton Road*	9.43	7.61	2,326	4,053	2.8	Private	Private	Jan-17
25 Grenfell Street	125.10	7.48	25,544	4,929	5.0	GDI Funds Management	Credit Suisse	Dec-16
91 King William Street (50%)	88.50	7.00	31,399	5,638	3.1	Abacus Property Group	ICAM~	Dec-16
97 King William Street	29.00	6.62	15,115	1,919	4.8	Charter Hall CPOF	Private	Dec-16
233 North Terrace	21.00	6.81	4,102	5,119	9.5	Australian Fashion Labels	Private	Dec-16
195 North Terrace	16.65	7.37	4,249	3,542	2.3	Private	Private	Dec-16
12-26 Franklin Street	266.13	6.00	36,802	7,125	10.8	Charter Hall CPOF/Telstra SF	Charter Hall CLW	Oct-16
108 North Terrace	86.50	#	20,073	4,309	3.6	DEXUS	Private	Sep-16
132 Grenfell Street	13.85	6.80	3,147	4,401	3.7	Primewest	Private	Aug-16

*Fringe #Undisclosed ~Inheritance Capital Asset Management CPOF refers Charter Hall Prime Office Fund SF refers Telstra Super Fund
CLW refers Charter Hall Long WALE REIT
Source: Knight Frank Research

Yields for prime and secondary assets across the CBD and Fringe markets have continued to show firming. In the six months to January 2017, CBD prime yields firmed by 16 basis points from an average of 7.39% to 7.23% (see Figure 8).

In the CBD secondary market, average yields firmed 17 basis points from an average of 8.67% to 8.50%.

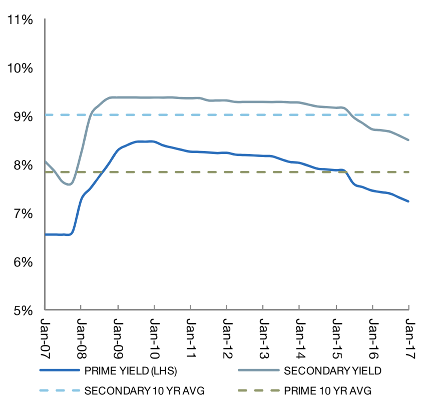
In addition to capital market trends such as the sustained relatively low cost of finance, which has been driving yield firming for some time, yield compression has increasingly resulted from the value proposition Adelaide offers when compared to Melbourne, Sydney and Brisbane (see Figure 7). Significant investment in the Adelaide Riverbank and North Terrace medical and entertainment precincts also present as a compelling point of difference.

Due to the increased interest in the Adelaide market from interstate, overseas and institutional investors, there is evidence to suggest that this firming bias of yields may continue in the short term, particularly for quality assets with strong income streams. At this time, it is considered that the weight of money is driving this increased demand rather than current improvements in office market fundamentals.

In 2017, the first significant transaction for the quarter occurred in the tightly held Fringe market. 191 Fullarton Road, Dulwich was purchased by a local private investor for $9.425 million on a core market yield of 7.61%. The property sold with a WALE of 2.8 years and vacancy of approximately 16.3%. The major tenant Hansen Yuncken occupy approximately 42% of the NLA.

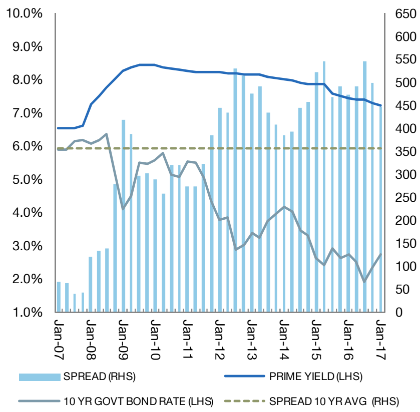
Investment yields in the Fringe office market have followed trend with the CBD investment market. In the six months to January 2017, average prime yields firmed 13 basis points to 7.60%, however, the Fringe has limited assets over the $10 million price point. The Fringe also saw secondary yields firming by 10 basis points to now average 8.40%.

FIGURE 8
Adelaide CBD Core Market Yields
Yields and Averages by Grade



Source: Knight Frank Research

FIGURE 9
Adelaide CBD Yields & Spreads
Core Market Yields vs 10 Yr Govt Bond Rate



Source: Knight Frank Research/RBA

Outlook

- Adelaide is entering a lull in the development supply cycle over the next 24 months, and it is expected no significant new office buildings will be completed. Smaller projects may progress depending on tenant pre-commitment. The lack of short term supply provides the market with the opportunity to absorb excess space.
- The next wave of supply is headlined by Charter Hall's Precinct GPO development following a 51% pre-commitment by the Attorney General's Department. The office tower component for Walker Corporation's proposed Festival Plaza / Riverbank Precinct redevelopment remains mooted.
- Demand for prime investments with secure and stable tenancy profiles remains strong and given Adelaide's value proposition, there is potential for the firming bias of yields to continue in the short term.
- Tenant demand is likely to remain inconsistent in the short term, led mostly by existing tenants relocating and upgrading, especially with attractive incentives on offer and projected modest growth in face rents.
- The leasing market is likely to remain accommodative for prospective tenants, however incentives have likely reached their peak. Tenants approaching lease expiry may take advantage of a surplus of quality vacant space and the limited growth in face rents.
- Building owners of secondary stock that can reposition their assets through refurbishment and upgrades have the potential to fill vacancies.
- Tenants associated with the defence industry are anticipated to play a more active role within the Adelaide leasing market.

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RESEARCH
Henry Mathews
Research Analyst—SA
+61 8 8233 5217
Henry.Mathews@sa.knightfrankval.com.au

Jennelle Wilson
Senior Director
+61 7 3246 8830
Jennelle.Wilson@au.knightfrank.com

SOUTH AUSTRALIA
Guy Bennett
Joint Managing Director - SA
+61 8 8233 5204
Guy.Bennett@au.knightfrank.com

Bobbette Scott
Joint Managing Director - SA
+61 8 8233 5211
Bobbette.Scott@au.knightfrank.com

CAPITAL MARKETS
Lukas Weeks
Director
+61 8 8233 5249
Peter.Mcvann@au.knightfrank.com

Tony Ricketts
Director
+61 8 8233 5259
Tony.Ricketts@au.knightfrank.com

OFFICE LEASING
Martin Potter
Senior Director
+61 8 8233 5208
Martin.Potter@au.knightfrank.com

Andrew Ingleton
Associate Director
+61 8 8233 5229
Andrew.Ingleton@au.knightfrank.com

VALUATIONS
James Pledge
Managing Director Valuations - SA
+61 8 8233 5212
James.Pledge@sa.knightfrankval.com.au

Nick Bell
Director Valuations - SA
+61 8 8233 5242
Nick.Bell@sa.knightfrankval.com.au

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