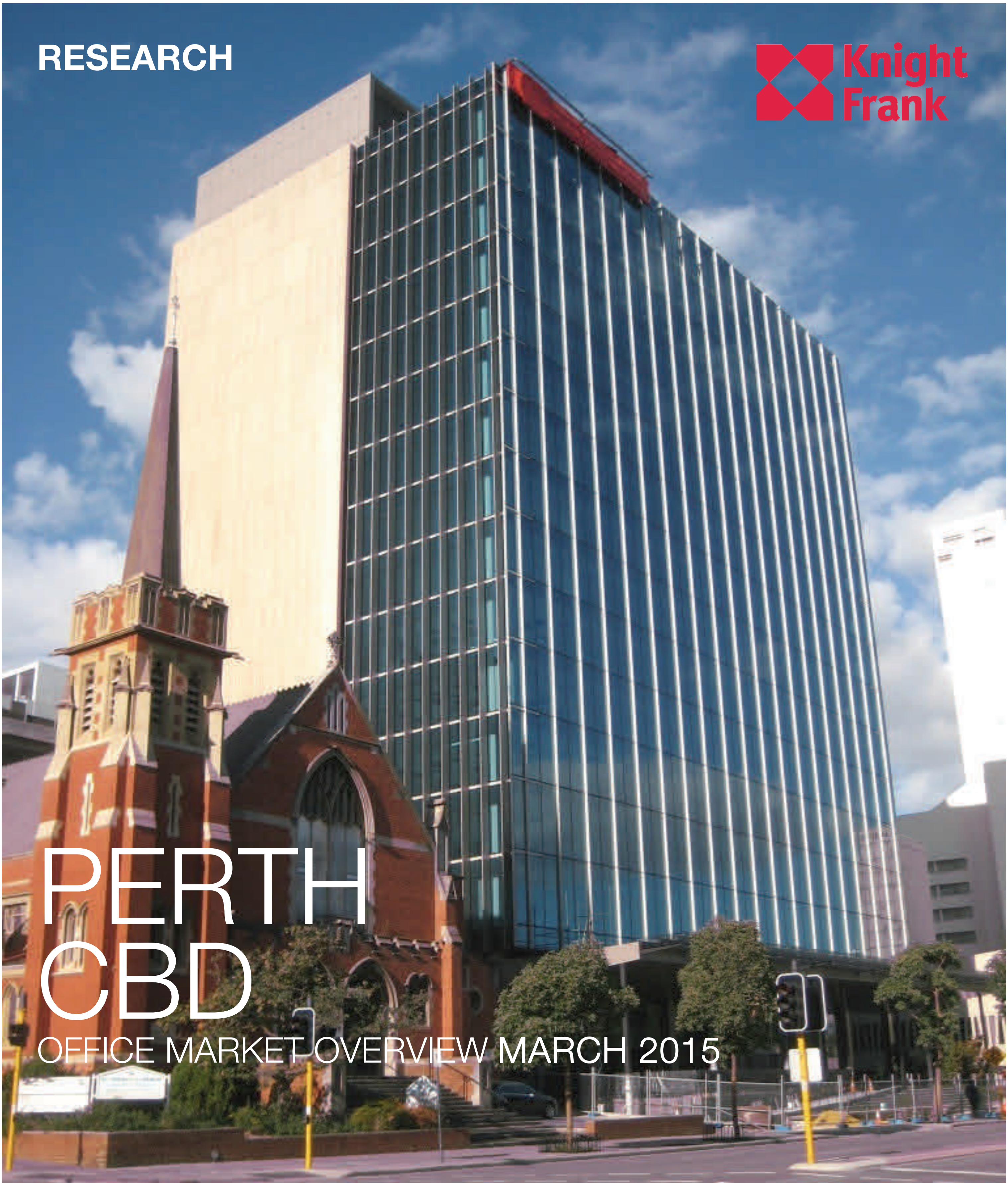
RESEARCH



# PERTH CBD

## OFFICE MARKET OVERVIEW MARCH 2015

## HIGHLIGHTS

A significant increase in backfill space will make an impact in 2015. New developments completing during the year will add 149,601m$^2$ of NLA to the market.

By the end of 2015, it is expected that the vacancy rate will be in excess of 20%, as new supply comes online against a backdrop of soft demand conditions.

A depreciating Australian dollar and lower interest rates should attract international investor interest into the Perth market.

# KEY FINDINGS

**Total CBD stock increased to 1,625,118m$^2$ as at January 2015,** following the completion of two office buildings.

**Approximately 149,600m$^2$ of office supply** is currently under construction and due for completion in 2015.

**The Perth CBD recorded negative net absorption in the six months to January 2015**, prime falling by -13,786m$^2$ and secondary recording -16,796m$^2$.

**It is expected that the vacancy rate will be in excess of 20%,** by the end 2015.

BALVEEN KAUR
**Research Analyst—WA**

# SUPPLY & DEVELOPMENT

By July 2015, 52,502m$^2$ of new supply is to be completed, followed by 97,099m$^2$ in the second half of the year. Overall, 62% of this new development has been pre-committed.

As of late 2014, Perth CBD saw the completion of refurbishment works at 565 Hay Street (Public Trustee Building) and the newly developed 861 Hay Street resulting in an increase to gross supply during the six months to January 2015 of 24,097m$^2$. There were also withdrawals of 3,283m$^2$ arising over the same period. 565 Hay Street is currently vacant with 7,700m$^2$ available, while 861 Hay Street was 47% pre-committed by Aurecon translating to 5,144m$^2$ still available to be leased.

In addition, a further 149,601m$^2$ of new supply is projected to be introduced to the market over 2015 from eight projects. Across the projects, 92,953m$^2$ or 62% has been pre-committed. There is a diversity of commitment levels across the developments with KS 2 (19,282m$^2$), KS 3 (5,675m$^2$) and Treasury Building (30,196m$^2$) fully committed to Shell, John Holland and the WA Government respectively.

At this stage space remains available in KS 4 (72% committed to HBF), 32 St Georges Terrace (40% committed to Legal Aid), 999 Hay St (59% committed by GHD), 123 St Georges Terrace (50% committed to a range of professional tenants) and KS 1 which is seeking commitment.

Beyond these projects under construction, further office development in the medium term is expected to be limited to those projects which have already achieved significant pre-commitments such as Woodside's Capital Square and the Chevron Building.

## Sub-lease/Backfill

Late 2014 saw Aurecon move to 861 Hay Street leaving 5,144m$^2$ of backfill space at 256 Adelaide Terrace. A significant increase in backfill space in Perth CBD is likely to make an impact in 2015 as new developments reach completion. In the first six months of 2015, backfill space of 16,000m$^2$ from tenant relocations including Shell, Legal Aid and HBF is expected to enter the market. This is followed by an even larger backfill impact of 35,432m$^2$ during the second half of 2015 from tenants such as Deloitte, Ashurst, Corrs, GHD and Crown Law relocating to the newly completed buildings.

The largest backfill space is attributed to consolidation of the WA State Government offices which will see Crown Law relocate from Westralia Square at 141 St Georges Terrace to the Treasury Building, leaving a backfill space of 20,000m$^2$. However, with a lease expiry in 2020 at 141 St Georges Terrace, the State Government is expected to reallocate the majority of backfill to other internal departments. There will however be some net inflow into the CBD also, with circa 8,000m$^2$ of new space to be absorbed by tenants currently occupying suburban office space, with Brookfield Multiplex and John Holland relocating to Brookfield Place 2 and KS3 respectively.

Sublease space continues to be a major factor within the Perth CBD office market. The sublease vacancy crept up marginally from 2.7% in July 2014 to 2.8% (up 2,305m$^2$) as at January 2015.

TABLE 1

**Perth CBD Office Market Indicators as at January 2015**

| Grade | Total Stock (m²) | Vacancy Rate (%) | Annual Net Absorption (m²) | Annual Net Additions (m²) | Average Net Face Rent ($/m²) | Average Incentive (%) | Average Core Market Yield (%) |
|---|---|---|---|---|---|---|---|
| Prime | 949,864 | 12.9 | -32,286 | 24,010 | 593—731 | 30—35 | 7.00—8.00 |
| Secondary | 675,254 | 17.4 | -34,984 | 4,999 | 439—482 | 30—35 | 8.00—9.00 |
| **Total** | **1,625,118** | **14.8** | **-67,270** | **29,009** | | | |

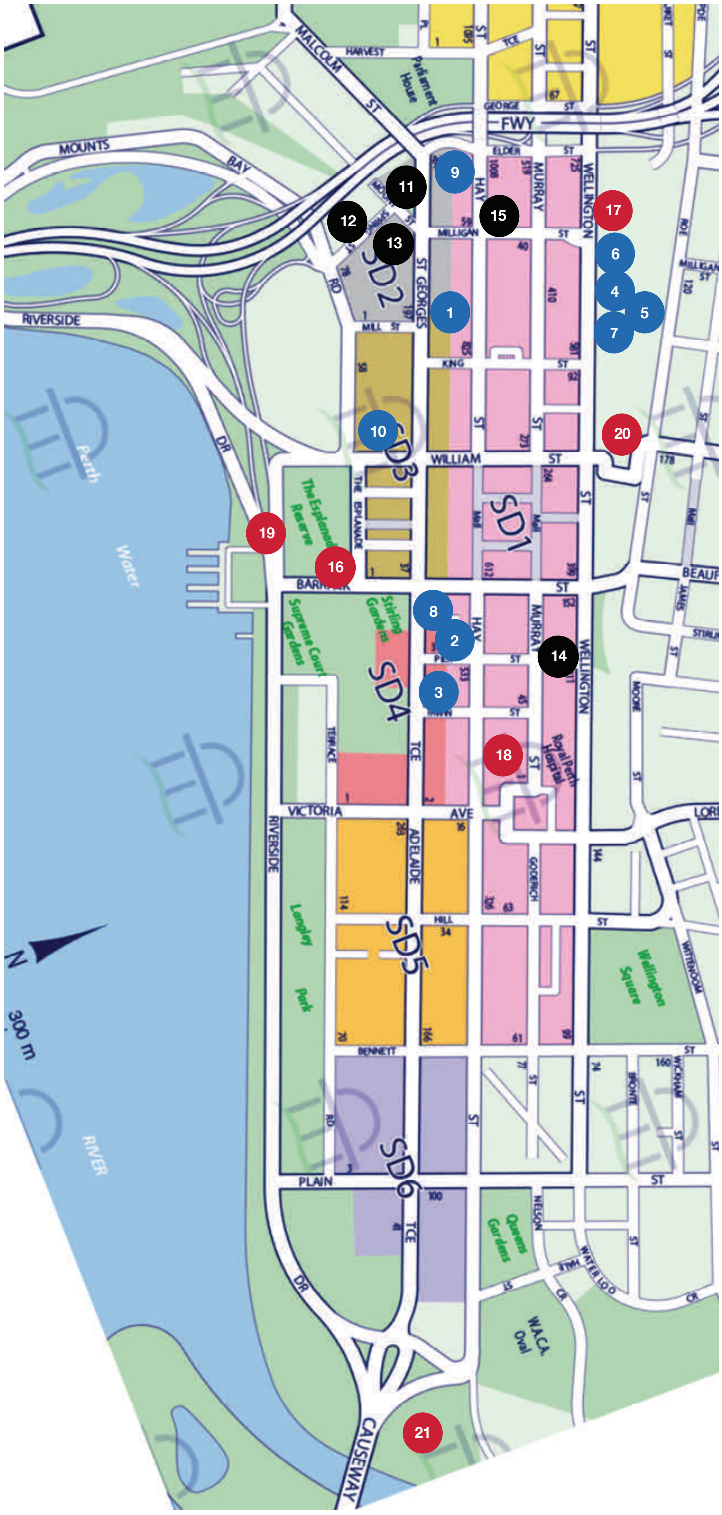
Source: Knight Frank/ PCA

# MAJOR OFFICE SUPPLY

1. 861 Hay St - 10,947m² [Aurecon]
Perth Diocese - Completed - 50% committed
2. 565 Hay St # - 7,560m²
Perth Diocese - Completed - seeking pre-commitment
3. 32 St Georges Tce # - 15,045m² [Legal Aid]
Private - Q2 2015 - 40% committed
4. KS2 (Kings Square)*, 376 Wellington St - 19,282m² [Shell]
DEXUS & DWPF - Q2 2015 - 100% committed
5. KS3 (Kings Square)*, 376 Wellington St - 5,675m² [John Holland]
DEXUS & DWPF - Q2 2015 - 100% pre-committed
6. KS4 (Kings Square)*, Wellington St - 12,500m² [HBF]
HBF - Q2 2015 - 72% committed
7. KS1 (Kings Square)*, 376 Wellington St - 22,543m²
DEXUS & DWPF - Q3 2015 - seeking pre-commitment
8. Treasury Building - 30,196m² [WA Gov't]
Mirvac / Keppel REIT consortium - Q3 2015 - 100% committed
9. 999 Hay St - 10,160m² [GHD]
QUBE - Q3 2015 - 59% committed
10. 123 St Georges Tce (Brookfield Place 2) - 33,600m² [Ashurst, Corrs, Deloitte, Brookfield] - Brookfield - Q4 2015 - 50% committed
11. Veil 253, 253 St Georges Tce - 3,577m²
Primewest - seeking pre-commitment
12. Capital Square, 98-124 Mounts Bay Rd - 50,500m² [Woodside] - H.O.A
AAIG - mid 2018 - 100% committed - Initial site-works
13. 239 St Georges Tce (Bishops See no.2) - 46,000m²+
Brookfield/Hawaiian - Q4 2015 - seeking pre-commitment
14. 100 Murray St # - 4,000m²
AWD Diversified - seeking pre-commitment
15. 950 Hay St (old Melbourne Hotel site) - 10,000m²
Oakesfield - seeking pre-commitment
16. Crn Barrack St & The Esplanade - 70,000m² [Chevron]
Chevron - DA Pending
17. KS5 (Kings Square) * - 38,000m²
Seven Entertainment - DA Pending
18. 480 Hay St - 34,000m²
BGC - DA Pending - seeking pre-commitment
19. Elizabeth Quay - 130,000m² excluding 70,000m² Chevron site
Leighton / Broad Construction Services
20. Perth City Link * - Circa 120,000m² exclusive of Kings Square
Mirvac/Leighton development consortium
21. Waterbank, near The Causeway - 17,000m²
Lend Lease / MRA - Initial site works

- Completed / Under Construction (blue)
- DA Approved / Confirmed / Site Works (black)
- Mooted / Early Feasibility (red)

NB. Dates are Knight Frank Research estimates
Office NLA quoted
Major tenant precommitment in [brackets] next to NLA
# Major refurbishment
* Mirvac/Leighton awarded the Perth City Link development contract excluding the Kings Square precinct.
KS1-5 are being developed by Leighton / Seven Group.



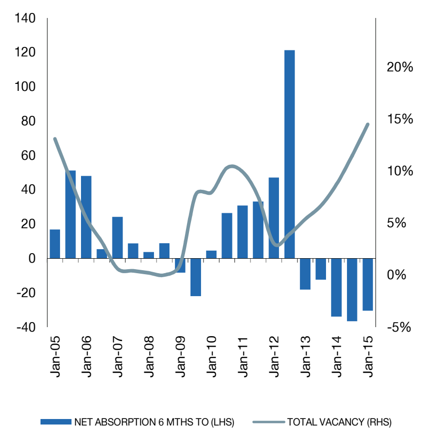
# TENANT DEMAND & RENTS

The total vacancy rate continues to increase according to PCA January 2015 data which recorded a total vacancy rate for the Perth CBD of 14.8%, up from 11.8% in July 2014. Over the past year, the prime vacant space increased by 85% compared to secondary vacant space which increased by 52%. The increasing prime vacancy in the Perth CBD is a direct result of the mining downturn, leading to business contractions and consolidation.

The prime vacancy has increased from 9.7% in July 2014 to 12.9%, recording a total vacancy of 122,591m$^2$. The premium building vacancy rate more than doubled from 3.9% in July 2014 to 8.5% in January 2015 while the vacancy rate within A-grade buildings increased for the sixth consecutive half year period, rising from 12.7% in July 2014 to 15.2%.

Similarly, the secondary market experienced increasing vacancy rate levels, at 17.4%, up from 14.6% in July 2014. While vacancy levels in C and D grade assets recorded a marginal improvement, B grade assets recorded the largest increase in vacant stock across all asset grades increasing from 60,820m$^2$ in July 2014 to 80,814m$^2$ in January 2015.

FIGURE 1
**Net Absorption and Vacancy**
('000m$^2$ and %) per six month period




**Source:** Knight Frank/ PCA

## Net Absorption

The Perth CBD market continued to experience negative net absorption over the six months to January 2015. Prime assets recorded -13,786m$^2$ and secondary assets recorded -16,796m$^2$. The negative net absorption is also attributed to the increase in sublease space available in the market as companies downsize. The Perth CBD recorded negative net absorption of 67,270m$^2$ over the calendar year to January 2015 as company contraction and tenant relocation made its impact.

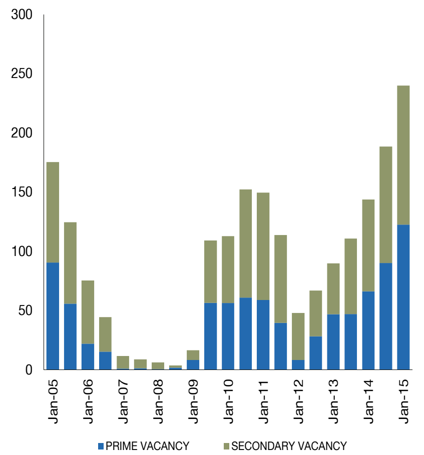
> "Negative net absorption levels will continue through 2015 due to low tenant demand."

Much of the prime negative net absorption has come from the premium market, contracting by 14,917m$^2$ over the past six months. In contrast, A-grade had an increase in absorption to 1,131m$^2$ over the past six months reflecting improvement from -12,360m$^2$ during the period before. This confirms the trend of tenants upgrading from secondary to prime buildings during soft market conditions. Further negative absorption was experienced in the secondary market (-16,796m$^2$). Negative net absorption levels will continue through 2015 due to low tenant demand.

## Vacancy

As outlined above, backfill space of 51,432m$^2$ is expected to enter the market in 2015 as tenants relocate to new buildings. Within the new developments, 56,648m$^2$ of office space will be vacant upon completion unless

FIGURE 2
**Perth CBD Historical Vacancy**
Prime and Secondary grade ('000m$^2$)




**Source:** Knight Frank/ PCA

further pre-commitments are secured thus adding further risk to Perth's expected vacancy rate.

Knight Frank projects the vacancy rate to reach its peak in late 2015 and the first half 2016 in excess of 20%. Vacancy rates should then gradually decline over the following two to three years due to a significant reduction in the level of new supply and improved tenant demand which are expected to positively impact the vacancy rate, albeit modestly through to 2018.

## Tenant Demand

Tenant demand remains soft due to uncertainty in current economic conditions as well as businesses looking to improve cost efficiencies and consolidate their office accommodation.

While some tenants prefer to adopt the 'wait-and-see' approach until the market stabilises before committing to a lease, the overall trend of tenants seeking a flight to quality is still evident. Tenants upgrading from secondary to prime grade properties are ideally seeking small to mid size space at a competitive rental rate coupled with an attractive incentive over a longer lease term.

Similarly, the Perth CBD could potentially experience the beginning of a new trend of tenant relocations from the city fringe or suburban offices, considering it is a good time for tenants to upgrade to a superior quality asset within a CBD location. Besides the pending relocations of Brookfield Multiplex and John Holland into the CBD, another prominent example includes the lease commitment by listed education provider Navitas. They relocated from its Applecross office to the entire eighth floor of 1,692m$^2$ at Brookfield Place, 125 St Georges Terrace as its global headquarters at a rental of approximately \$739/m$^2$ (\$1.25 million) a year.

On a positive note, in late 2014 BHP Billiton announced its new spin-off company South32's head office will be in Perth and also be listed on the Australian Securities Exchange (ASX). South32 has a conditional agreement to lease part of the office building at 108 St Georges Terrace, Perth. The A-grade office tower with 39,000m$^2$ of NLA, is jointly owned by Brookfield Property and its parent entity, Brookfield Asset Management. South32 is expected to take up naming rights after signing a 10.5 year lease and will lease around 8,300m$^2$ of the building which could be worth more than \$5.5 million in annual rent from May 2015 onwards, after shareholders vote to approve the demerger. Occupancy at the property will increase to 75%.

# Rental Levels

The increasing vacancy continues to add further pressure on landlords to accept rental levels in accordance with prevailing market conditions. As a result, tenants are benefitting from increasing incentives in the form of rent free periods and capital contributions for office fit-outs, which are minimising the costs associated with tenant relocation.

The Perth CBD office rental market has been challenging over the past three years with declining effective rents over that time. Rents are now below the trough of 2009-2010.

Net face rents in Prime-grade buildings have softened to an average of \$662/m$^2$ (vs. \$684/m$^2$ in July-14) representing a –3.3% fall during the six months to January 2015. Incentives have continued to rise sharply to average 30% -35% of the net rent over the term of the lease (vs. 25% in July-14). Net effective rents are being significantly impacted as rising incentives flow through. The net effective prime rents fell by 16% to an average of \$430/m$^2$ since July 2014.

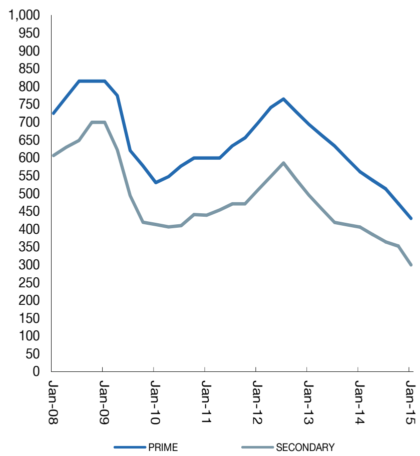
Similarly, net face rents in secondary-grade buildings have also declined due to strong competition as prime leasing options become comparably cheaper. Average secondary net face rents have decreased approximately –5.4% to \$461/m$^2$ compared to \$486/m$^2$ six months ago, with net incentives 30%-35% (vs. 25% in July-14).

Incentives levels are expected to remain high at around 30%-35% as vacancy levels rise further when new stock enters the market over 2015.

FIGURE 3

**Perth CBD Office Rents**

Prime and Secondary Average Net Effective Rents (\$ / m$^2$)




**Source:** Knight Frank

TABLE 2

**Recent Leasing Activity—Perth CBD**

| Address | NLA m² | Face Rent \$/m² | Term years | Incentive (%)` | Tenant | Start Date |
|---|---|---|---|---|---|---|
| 15-17 William Street | 292 | 450 n | 10 | 29 | Property Council of Australia (PCA) | Feb-15 |
| 54-58 Mounts Bay Road* | 2,319 | 745 n | 5 | 25 | Suncorp | Feb-15 |
| 250 St Georges Terrace# | 362 | 875 n | 3 | 12 | Ardross Estates | Feb-15 |
| 30 The Esplanade | 2,300 | 600 n | 7 | 24 | Kinetic IT | Dec-14 |
| 77 St Georges Terrace | 667 | 610 n | 7 | 25 | AICD | Dec-14 |
| 108 St Georges Terrace | 1,764 | 685 n | 5 | 15 | Pioneer Credit | Dec-14 |
| 125 St Georges Terrace | 1,658 | 760 n | 8 | 24+ | Allianz | Oct-14 |
| 2 The Esplanade^ | 620 | 850 n | 5 | 13+ | Mitsui Iron Ore | Oct-14 |
| 2 The Esplanade^ | 1,020 | 770 n | 5 | 16 | Mitsui & Co | Oct-14 |
| 50 William Street | 451<br>2,048 | 200 n<br>400 n | 15.25 | 12 | Anglican Schools Commission | Oct-14 |
| 863 Hay Street | 562<br>1,105 | 610 n<br>615 n | 6 | 25 | Hays Specialist Recruitment | Oct-14 |

`estimated incentive calculated on a straight line basis    n- net    + plus lessor's works    *sub-lease    #lease extension    ^lease renewal

**Source:** Knight Frank

# INVESTMENT ACTIVITY & YIELDS

The year 2014 saw sales activity moderate to $604.5 million in Perth CBD office transactions, following an active investment market in 2013 when more than $1.34 billion worth of Perth CBD office assets changed hands. Four office buildings sold in 2014 and three of these occurred within the first six months of the year, namely Septimus Roe Square, QV1 and 130 Stirling Street. The remainder of the year only saw 220 St Georges Terrace transacted in October 2014.

The most recent major sale, 220 St Georges Terrace, is a B grade office building located along the northern side of St Georges Terrace, between Milligan and King Streets and is within the core of the Perth CBD. The 10 level building with basement car parking has a net lettable area of 9,198m$^2$ and was sold in October 2014 for $35 million. The property required an immediate capital expenditure of approximately $5 million—$7 million for upgrades. The asset sold with a WALE by income of just under one year reflecting an improved rate of $3,805/m$^2$ and the passing and core market yields were 4.83% and 8.02% respectively.

The largest transaction of 2014 was the 50%, related party sale of QV1 at 250 St Georges Terrace. The half share in the premium grade landmark 42 level office tower, which includes a 5 1/2 level car parking station and retail plaza, sold for $388.5 million in June 2014 reflecting a core market yield of 7.20% (office tower, basement car park and retail only). Investa Commercial Property Fund (ICPF) purchased the property from Investa Property Trust in what is the largest CBD transaction since April 2013. QV1 is 100% leased and includes major tenants Chevron (40.3% of NLA), Worley Parsons, Clayton Utz, King and Wood Mallesons, Herbert Smith Freehills and Allens Linklaters. The asset sold with a WALE by income of 7.7 years reflecting a rate of $11,372/m$^2$ on NLA (office tower, basement car park and retail only).

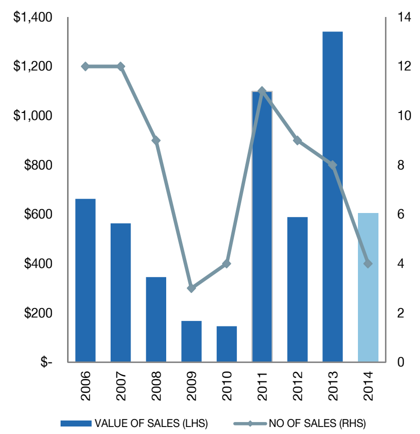
International investors continue to target Perth development sites. In December 2014, Georgiou Capital's Milligan Square was sold to Singapore-based Fragrance Group for $30 million. The vendor was in the midst of seeking office tenant pre-commitments after being granted a development approval for a 21,000m$^2$ office tower, restoration of the Pearl Villa and Milligan Hostel, and a 132-room hotel fronting Murray Street. The transaction of the 3,561m$^2$ site includes intellectual property rights and development approval. However, Fragrance Group will now redevelop Milligan Square into a residential project with a 132-room hotel on the site.

Several developers of CBD sites have reconsidered their development plans, shifting from office to residential and hotel towers to align with the current and weakening office market in the Perth CBD.

Developers are also adopting a cautious stance by deferring the construction of their projects with works to commence only when they have secured a good level of pre-lease commitment from potential tenants. However, with the high number of office buildings under construction and expected to be completed this year, new office developments are highly unlikely in the short to medium term as the market will take time to absorb new supply.

Currently, average prime core market yields are estimated to range between 7.00% and 8.00% while average secondary core market yields range between 8.00% and 9.00%. Both prime and secondary core market yields are at their lowest since 2008. Further yield compression for select prime assets is

FIGURE 4
**Perth CBD Sales Activity 2006—2014**
($ million) Sales Value >$10 million and Number




Source: Knight Frank

TABLE 3
**Recent Sales Activity—Perth CBD**

| Address | Grade | Price $ mil | Core Market Yield (%) | NLA m² | $/m² NLA | WALE | Vendor | Purchaser | Sale Date |
|---|---|---|---|---|---|---|---|---|---|
| 220 St Georges Terrace | B | 35.0 | 8.02 | 9,198 | 3,805 | 0.8 | Gucce Holdings | N. Giorgetta | Oct-14 |
| 250 St Georges Terrace# | P | 388.5 | 7.20^ | 61,217 | 11,372^ | 7.7 | Investa Property Trust | ICPF* | Jun-14 |
| 256 Adelaide Terrace | B | 91.0 | 8.56 | 17,247 | 5,133 | 1.8 | Aspen Group | Far East Organisation | Apr-14 |

Source: Knight Frank ^ Office, basement car park and retail only * Investa Commercial Property Fund # 50% share

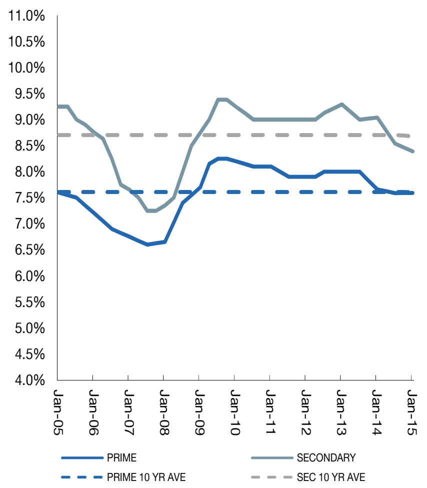
"Prime and secondary yields are at their lowest since 2008 recording between 7% and 9%"

imminent, assisted by strong overseas and national investment demand in a market characterised by limited buying opportunities.

Furthermore, the lowering cost of debt for most institutional players increases the attractiveness of making acquisitions under current market conditions. The buyer interest in the Perth CBD market remains high from offshore investors, institutions and syndicates, and is expected to continue. Most buyers favour modern, prime grade assets with long WALE's and minimal CAPEX requirements, however some offshore and institutional investors are seeking value add opportunities.

Besides WA being known as Australia's "gateway to Asia", the depreciating Australian dollar together with lower interest rates has attracted interest from international investors particularly from China, Singapore and Malaysia. Furthermore, Perth CBD office yields currently range between 7.00% and 9.00%, whereas in Asia they commonly fall below 4%. As a result, investment opportunities in Perth are perceived to be very attractive from an international buyer's perspective in the short to medium term, especially when investment opportunities in many parts of Asia are currently quite limited.

FIGURE 5
**Perth CBD Office Yields**
Prime and Secondary Core Market Yields




Source: Knight Frank

An artists impression of the Treasury Building which has been 100% pre-leased to the Crown Law—currently under construction and expected to be completed by third quarter 2015.

Source: www.cathedralandtreasury.com.au

## Outlook

- Growth in the West Australian economy is forecast to marginally decline to 2.25% during the year from 2.75% according to the Department of Treasury.
- Falling rents and higher incentives are providing tenants with some favourable leasing conditions which should continue for the next one to two years.
- Tenant enquiry levels indicate net absorption will remain soft during 2015.
- Developers continue to strive to secure tenants before commencement of construction works amidst the increasingly challenging office environment.
- Several developers have restructured development plans, shifting from office developments to building residential and hotel towers due to the current demand for residential and weakening office market in the Perth CBD.
- With the high number of office buildings under construction and expected to be completed this year, new developments are highly unlikely in the short term as the market will take time to absorb new the supply.
- Based on the pending vacancies as a result of tenant relocation, and assuming on-going soft demand in the short term, vacancy is expected to rise beyond 20% by the end of 2015.
- Incentives have risen sharply to around 30% - 35% of the net rent and are expected to remain high as vacancy levels rise.
- Average prime core market yields are estimated to range between 7.00% and 8.00%, with only the long WALE, prime assets expected to show any material firming in 2015.

**RESEARCH**
**Balveen Kaur**
Research Analyst—WA
+61 8 9225 2412
Balveen.Kaur@au.knightfrank.com

**Matt Whitby**
Group Director, Head of Research & Consulting
+61 2 9036 6616
Matt.Whitby@au.knightfrank.com

**CAPITAL MARKETS**
**John Corbett**
Managing Director—WA
+61 8 9225 2561
John.Corbett@au.knightfrank.com

**Tony Delich**
Director—Commercial Sales WA
+61 8 9225 2528
Tony.Delich@au.knightfrank.com

**Todd Schaffer**
Director—Commercial Sales WA
+61 8 9225 2402
Todd.Schaffer@au.knightfrank.com

**OFFICE LEASING**
**Greg McAlpine**
Senior Director, Head of Division– WA
+61 8 9225 2426
Greg.McAlpine@au.knightfrank.com

**Ian Edwards**
Senior Director — Asset Services WA
+61 8 9225 2420
Ian.Edwards@au.knightfrank.com

**Sallese Wilmot-Barr**
Associate Director — Office Leasing
+61 8 9225 2405
Sallese.Wilmot-Barr@au.knightfrank.com

**Kendall Forrest**
Associate Director — Office Leasing
+61 8 9225 2400
Kendall.Forrest@au.knightfrank.com

**GLOBAL CORPORATE SERVICES**
**Bret Madden**
Director
+61 8 9225 2407
Bret.Madden@au.knightfrank.com

**VALUATIONS**
**Marc Crowe**
Senior Director, Head of Division– WA
+61 8 9225 2521
Marc.Crowe@au.knightfrank.com

**ASSET MANAGEMENT SERVICES**
**Craig Dawson**
Senior Director, Head of Division– WA
+61 8 9225 2406
Craig.Dawson@au.knightfrank.com

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.

## RECENT MARKET-LEADING RESEARCH PUBLICATIONS

Sydney CBD Office Market Overview March 2015

Perth Industrial Vacancy Analysis - February 2015

Australian Retail Market Overview February 2015

Australian Apartments Market Overview Q1 2015

Knight Frank Research Reports are available at **KnightFrank.com.au/Research**



Knight Frank

Newmark Knight Frank Global