RESEARCH

PERTH CBD

OFFICE MARKET OVERVIEW APRIL 2017

HIGHLIGHTS

Limited office development in the pipeline for the Perth CBD will allow current vacant space to be absorbed over the medium to long term.

In the short to medium term, It is expected that the vacancy rate will remain in the order of 20%, due to modest net absorption expectations.

Both the leasing and capital markets are defined by two tier markets with strong demand for Prime and limited demand for Secondary assets.

KEY FINDINGS

The Perth CBD vacancy rate increased to 22.5% as at January 2017 from 19.6% a year ago, the highest level recorded in 22 years.

A **flight to quality** remains prevalent among tenants looking to take the opportunity of moving into higher quality space due to falling rents and attractive incentives.

Absorption for the Perth office CBD totalled a negative 14,928m^2, however **premium stock showed a positive absorption of 2,259m^2** in the six months to January 2017.

Incentive levels **currently range between 35-50%** of net rent and are anticipated to remain high. The lower end of the range generally relates to tenants already in situ.

Yield Compression continues with Prime yields **in the range of 6.50% to 7.50%.**

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SUPPLY & DEVELOPMENT

The office market has experienced increased supply in recent years, however further supply is limited with no new developments earmarked beyond the completion of Capital Square in Mid-2018.

Perth's total CBD stock of 1,767,769m^2 has declined marginally (by 368m^2) since July 2016 – the first decline in overall CBD stock in 3 years. Additionally, 3,390m^2 of new supply was added to the Perth CBD since July 2016, the lowest addition of new supply in 10 years. The low level of supply is as a result of no major new developments entering the marketplace since January 2016.

Pre-lease commitments are now a fundamental requirement of construction starts as developers and their financiers have adopted a more cautious frame of mind. The Perth CBD is not expected to see any new developments in the next several years without significant pre commitment.

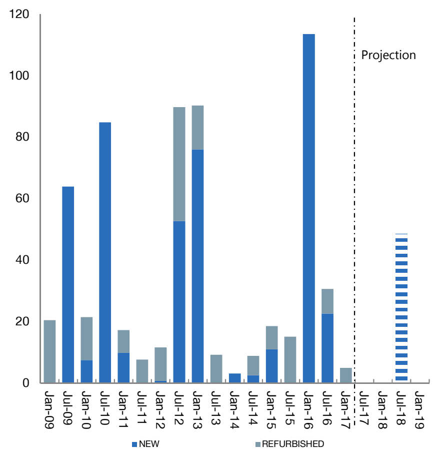
Within the next two years there is only one new major development that is 100% pre-committed – the Capital Square development. This is Woodside's new headquarters located at 98 – 124 Mounts Bay Road. This 48,484m^2 development commenced construction in late 2015 and is due for completion in mid-2018.

Ongoing refurbishment of CBD office buildings continues as owners seek to reposition their assets to be more attractive to tenants. This however does not add any additional stock to the existing supply and with continuation of positive tenant demand for good quality space in the CBD, aligned with little supply in the pipeline, a level of stability for the prime office market is expected over the next two years.

A Grade and B Grade stock make up the majority of total supply in the Perth office CBD accounting for 68% of total stock. A Grade stock has a current vacancy rate of 20.6% with B grade iat 30.3%, indicating the market weakness.

The increase in A Grade stock vacancy however, has been lower than the B Grade vacancy increase over the past 12 months as a result of the flight to quality that is occurring. This trend is expected to continue as tenants take the opportunity to move into better quality space, which has become more affordable due to falling rents and attractive incentives.

FIGURE 1
Perth CBD Office Supply
New and Refurbished Stock ('000m^2)



Source: Knight Frank Research/ PCA

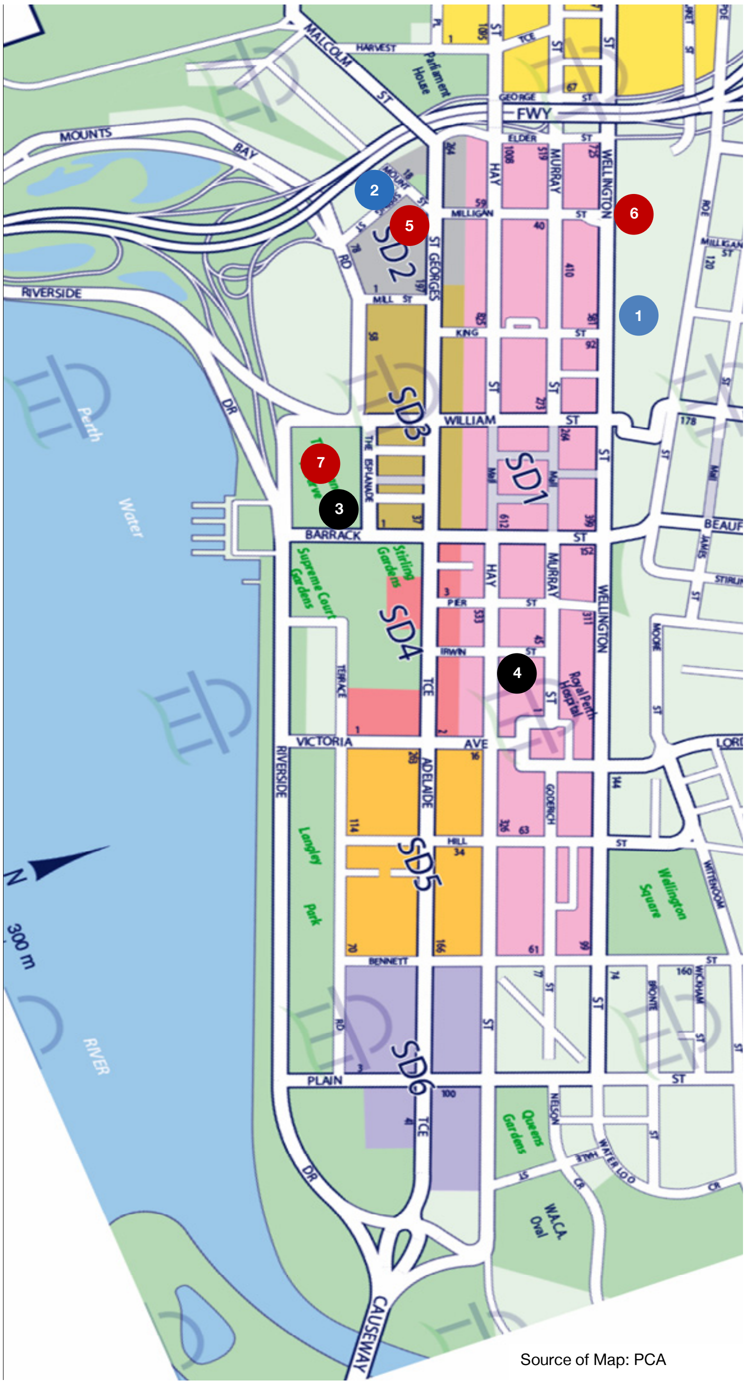
TABLE 1
Perth CBD Office Market Indicators as at 1 April 2017

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	1,081,386	19.1	53,147	19,159	528—629	35-50	6.50—7.50
Secondary	686,383	27.8	-29,704	11,360	381—417	45-50	8.00—9.00
Total	**1,767,769**	**22.5**	**23443**	**30,519**			

Source: Knight Frank Research/PCA ^ as at January 2017

MAJOR OFFICE SUPPLY

1. KS1 (Kings Square)*, 376 Wellington St - 22,612m²
   DEXUS & DWPF - Q1 2016 - 0% Commitment
2. Capital Square, 98-124 Mounts Bay Rd - 48,484m² [Woodside]
   AAIG - mid 2018 - 100% committed to Woodside
3. Crn Barrack St & The Esplanade - 70,000m² [Chevron]
   Chevron - DA Pending
4. 480 Hay St - 34,000m² - Seeking Commitment
   FES Ministerial Body - DA received
5. 239 St Georges Tce (Bishops See no.2) - 46,000m²+
   Brookfield/Hawaiian - Mooted
6. KS5 (Kings Square) * - 38,000m²
   Seven Entertainment - Mooted
7. Elizabeth Quay - 130,000m² excluding 70,000m² Chevron Site
   Leighton / Broad Construction Services



Source of Map: PCA

Under Construction/ Completed

Dev Approved / Confirmed / Site Works

Mooted / Early Feasibility

Major tenant precommitment in [brackets] next to NLA

TENANT DEMAND & RENTS

Net Absorption

Net absorption in the CBD office market is segmented across the office building grades of Premium, A, B, C and D grades (however there is nominal C and D grade office space). Net absorption for Premium assets has benefited from the flight to quality with tenants relocating from A grade and below to higher quality Premium space. This was shown in the six months to January 2017, when Premium assets recorded a positive 2,259m^2 of net absorption.

A Grade accommodation is by far the largest market segment with 725,064m^2 of stock; of this, vacant stock makes up 20.6%. In time we expect to see upper A Grade stock benefit from the movement to quality as Premium space continues to be absorbed. The Perth CBD office market is also seeing occupiers relocating from outside the market boundaries and expanding into the CBD market due to favorable rental conditions.

On the whole, however, A and B grade assets continue to suffer as the majority of negative net absorption for the six months to January 2017 came from A and B grade stock totaling 14,928m^2 combined. This is a result of the flight to quality, market drivers are showing that tenants are seeking to upgrade to better quality accommodation and in some cases, tenants are also seeking to down size, resulting in high levels of sublease space. It is expected that lower A and B grade stock will continue to struggle to attract tenants in the short to medium term.

Vacancy

The Perth CBD office vacancy lifted to 22.5% as at January 2017, an increase of 0.7 percentage points from the July 2016 figure of 21.8%. A total of 396,939m^2 of vacant office space is available across the Perth CBD. Vacant office space in the CBD has steadily increased year on year from a low of 47,863m^2 in January 2012. Premium grade vacancies fell slightly to 57,094m^2 from July 2016, whilst all other grades recorded an increase in vacancy with the exception of D grade which remained unchanged—although this space is nominal.

The largest volume of vacant space comes from A and B grade assets with 149,180m^2 (38% of total vacancy) and 145,003m^2 (37% of total vacancy) respectively. Both Prime (Premium and A grade) and Secondary (B grade and below) assets have seen consistent increases in vacancy since 2012 - with Prime grade vacancy lifting from a low of 1% to 19.1% in January 2017, whilst Secondary lifted from 5.9% in July 2012 to 27.8% in January 2017.

Prime vacant space increased by 20,000m^2 in the year ended January 2017, significantly lower than the year end January 2016 when vacancy grew by 63,700m^2. Secondary vacant space increased by 35,000m^2 over the past year to January 2017, a marginally lower increase from the year ended January 2016 of 38,000m^2.

Sublease space has continued to be a factor over the past six months, however the sublease vacancy has seen a reduction from July 2016, now sitting at 3.8%, a total of 67,597m^2, down from 4.3%. This reduction marks the first fall in sublease vacancy since January 2012 and is largely due to BHP withdrawing approximately 10,000m^2 of sublease space from the market.

The current Perth CBD office market is allowing tenants the opportunity to seek better quality space and obtain greater incentives and in turn reset their passing rentals. Tenants upgrading from secondary to prime grade properties are ideally looking for high quality office accommodation at competitive rents with longer lease terms and increased incentives.

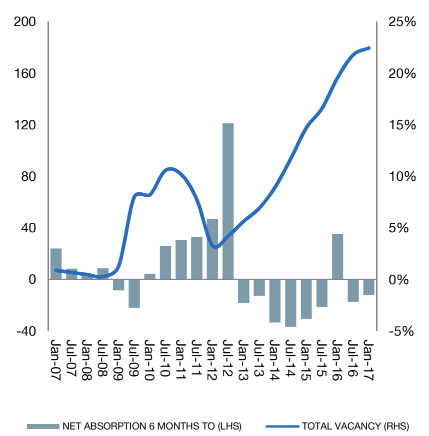
Tenants are seeking incentives that include both rent free periods/rebates as well as capital contributions for office fit-outs which in turn minimises the cost for the tenant to relocate.

Movement in the market includes Moray and Agnew signing a five year lease for 1,092m^2 at Level 30, 2 The Esplanade (Exchange Tower) after relocating from Level 5, 580 Hay Street, Perth.

FIGURE 2

Net Absorption and Vacancy

('000m^2 and %) per six month period

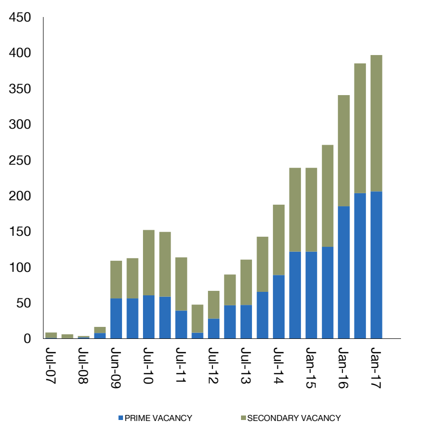


Source: Knight Frank Research/ PCA

FIGURE 3

Perth CBD Historical Vacancy

Prime and Secondary grade ('000m^2)

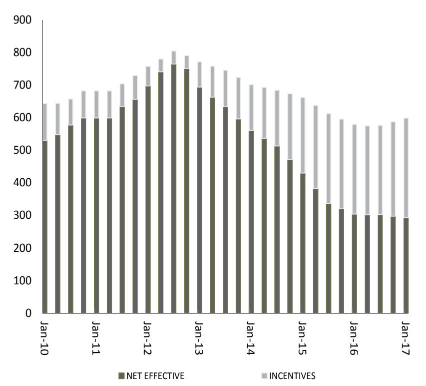


Source: Knight Frank Research/ PCA

FIGURE 4

Perth CBD Prime Office Rents

Avg Net Rents and Incentives ($/m^2)



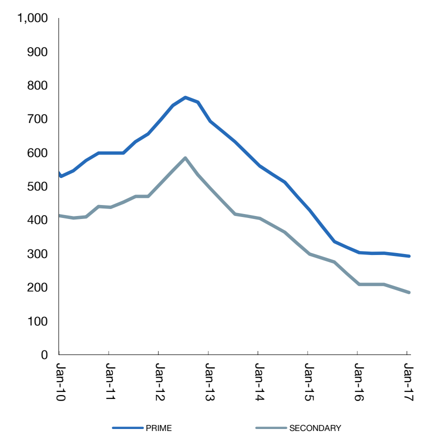
Source: Knight Frank Research

Also relocating to Exchange Tower is Quayside Chambers, taking 532m^2 of space with a 10 year lease. Additionally 10 William Street has been leased to the Central Queensland University for 10 years. The University has committed to 2,120m^2 of space over four levels with refurbishment of the building commencing soon.

FIGURE 5

Perth CBD Office Rents

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



Source: Knight Frank Research

Rental Levels

The Perth CBD Office market has continuously demonstrated a steady fall in both Prime and Secondary grade rents since mid-2012. Although Secondary grade face rents continue to soften, Prime face rents appear to be stabilising.

Net face rents in Prime grade assets, based upon a basket of average rents assessed increased from $578m^2 in July 2016 ($302/m^2 net effective) to an average of $599m^2($293/m^2 net effective) as at April 2017. Despite the slight rise in net face rents, the high levels of incentives have seen the net effective rents reduced by $9m^2.

Whilst incentives are expected to remain high in the prime market, they are considered to have stabilised. However there are still increases to incentives for secondary office space with secondary grade incentives expected to remain high for the foreseeable future.

“Incentives are expected to remain between 35% and 50% for the near future”

Secondary grade net face rents have fallen from $399 in July 2016 to $371 ($186 net effective) and continue to face downward pressure as vacancy increases in the sector, and tenants seek superior stock. With incentives at 50% plus, face rents are likely to continue to soften over the short to medium term.

TABLE 2

Recent Leasing Activity—Perth CBD

Address	NLA m²	Term yrs	Tenant	Lease Type	Date
2 The Esplanade	1,092	5	Moray & Agnew Solicitors	New Direct	Jun-17
	532	10	Quayside Chambers	New Direct	Apr-17
15-17 William Street	1,235	7	Resolute Mining	New Direct	Feb-17
	507	5	Sonic Health Plus	Renewal	Nov-16
10 William Street	2,120	10	Central Queen University	New Direct	Jan-17
41 St Georges Terrace	305	3	Jadestone Energy Australia	New Direct	Jan-17
220 St Georges Terrace	114	7	Travcom International Group	New Direct	Jan-17
	165	7	Consolidated Travel	New Direct	Jan-17
32 St Georges Terrace	305	5	China Construction Bank Australia	New Direct	Jan-17
	608	5	Taylor Burrell Barnett	New Direct	Jan-17
40 St Georges Terrace	324	5	Norwegian Geotechnical Institute	New Direct	Dec-16
	334	2	Fourth Floor Planning	New Direct	Nov-16
1 William Street	552	1.5	Alinta	New Direct	Nov-16
44 St Georges Terrace	297	5	Robert Half Australia	Renewal	Nov-16
	334	5	ACE Insurance Ltd	Renewal	Oct-16

Source: Knight Frank Research

INVESTMENT ACTIVITY & YIELDS

Transaction Activity

Sales activity in the Perth CBD saw sales transactions totaling $573.6 million for the calendar year 2016. This comes from six transactions, up from 2015's total of three with a value of approximately $216 million.

Both the leasing and capital markets are characterised by two tier markets, with strong demand for Prime assets but limited interest in the secondary sector. Sales volumes over recent years have dropped from a high of 11 in 2011, which amounted to over $1.1 billion. Interestingly 2013 had a lower number of sales changing hands, at eight, however amounted to a higher dollar value of over $1.34 billion combined, due to the high value sales of 300 Murray Street ($458 million) and King Square 1 ($434 million).

The first half of 2016 contained four of the six sales that occurred throughout the year of 2016 with a total combined value of $470 million. Notable sales included the Forrest Centre which sold for $190.4 million to a private Chinese investment company with a core market yield of 8.2% and vacancy of 23% at the time of sale. Primewest purchased a 50% share of Exchange Tower, located at 2 The Esplanade (equating to core market yield of 7.39%) for $110 million, with the balance share owned by AMP Capital (since December 2011). Recent improvements to the Exchange Tower include a full upgrade to the ground floor lobby as well as future plans to upgrade and refurbish the elevators.

The second half of 2016 saw a number of negotiations commence that resulted in the sale of 1 Nash Street, known as The WorkZone East Building, and 80 Stirling Street known as The Telstra Building. These two transactions combined totaled $103 million, ($68 million and $35 million respectively). The sale of 1 Nash Street was finalised in late December 2016, and was purchased by CorVal at a core market yield of 7.3%. The A Grade, 7 storey building is fully tenanted with a net lettable area of 12,362m^2 and a 5 star NABERS rating.

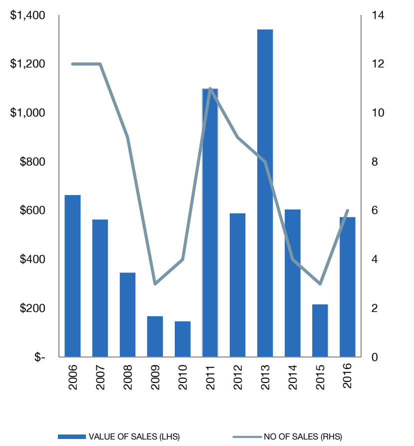
The Telstra Building, located at 80 Stirling Street, was sold to the Hong Kong-based firm Gaw Capital. The eight level office building has an NLA of 19,775m^2 and was bought with the intention of redeveloping the building into a 500 + bed student accommodation facility.

"The Perth CBD office market recorded six transactions in 2016 to the value of $573.6 million"

FIGURE 6

Perth CBD Sales Activity 2006—2016

($ million) Sales Value and Number

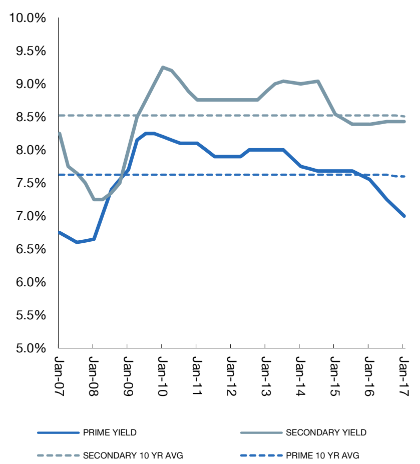


Source: Knight Frank Research

FIGURE 7

Perth CBD Office Yields

Prime and Secondary Core Market Yields



Source: Knight Frank Research

TABLE 3

Recent Sales Activity—Perth CBD

Address	Price $ mil	Core Market	NLA m²	$/m² of NLA	WALE yrs	Vendor	Purchaser	Sale Date
1 Nash Street - WorkZone	68.25	7.30	12,362	5,521	9.3	Charter Hall Opportunity Fund	CorVal	Dec-16
80 Stirling Street	35.00	-	19,775	1,770	-	CorVal	Gaw Capital	Dec-16
167 St Georges Tce	87.00	6.20	10,585	8,219	3.7	ICWA	Zone Q ~	Jul-16
2 The Esplanade *	110.00	7.39	34,432	6,389	3.3	Unlisted Syndicate	Primewest	Mar-16
81 St Georges Tce	82.95	7.10	12,225	6,785	9.3	Nick Tana	ARA Group	Mar-16

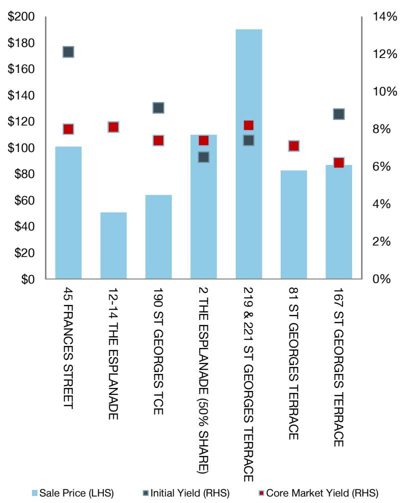
Source: Knight Frank Research *50% share of leasehold interest ~ Mainland Chinese develop ICWA—Insurance Commission of WA

There will be potential for large acquisitions in the Perth CBD office market in 2017 with a number of high profile CBD buildings on offer for purchase. One example is 109 St Georges Terrace, which is currently on the market. The B grade building has 19 levels with a NLA of 13,890m^2 and a 3.5 star NABERS rating. The Hatch Building at 144 Stirling Street, a 100% leased (with a WALE of 4.12 years) B grade office building, is also available for purchase.

As part of the Motor Accident Commission portfolio, 226 Adelaide Terrace known as ENI house is available for purchase. The portfolio comprises 100,000m^2 of office and 60,000m^2 of industrial spreading across five Australian states. 641 Wellington Street, Perth has also been put to market and will further provide grounds as a litmus test for Perth's CBD office market being one of the few B grade buildings available for purchase.

The recovery in Perth CBD office investment sales in 2016 saw double the amount of transactions that occurred in 2015. This indicates a growing confidence by investors that the market has reached the bottom of the cycle. A growing number of foreign investors have invested over the past year including ARA Group, Gaw Capital and Zone Q.

FIGURE 8
Selected Perth CBD Transactions
2015 & 2016—$ million LHS & Yield RHS



Source: Knight Frank Research

Yield compression continues as a result of high demand, ample available capital and a lack of core investment supply nationally, with prime yields now in the region of 6.50% to 7.50%. This compression is likely to continue in the short term for good quality assets with long term WALEs as Perth still has higher (softer) yields than the major East Coast capital cities.

Secondary yields have remained unchanged at a range of 8.00% - 9.00% with investors taking a more cautious approach to those assets which often have a higher vacancy, short term WALEs and are in need of capital works to maintain market position.

"Prime yield compression has firmed Perth CBD prime yields to 6.50% - 7.50% as a result of high investment demand, ample available capital and lack of available stock nationally"

Outlook

- The CBD office sector will continue to be defined by a two tier market with good demand for prime assets but only limited for secondary.
- Falling rents and higher incentives continue to provide tenants with favourable leasing conditions.
- More non-CBD tenants will continue to look to secure CBD office accommodation, taking advantage of competitive/attractive deals.
- Incentives have risen sharply to around 35-50% of the net rent and are expected to remain high for the near future
- Tenant enquiry levels indicate net absorption will remain soft throughout 2017.
- New developments are highly unlikely in the short term as the market will take time to absorb new 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 remain above 20% for the remainder of 2017.
- 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.
- Developers and financiers will seek a high level of pre-commitment before moving into the construction phase.
- Average prime core market yields are estimated to range between 6.50% and 7.50%, with only the long WALE, securely leased prime assets expected to show any material firming moving forward.

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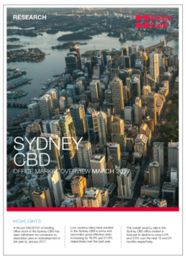

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