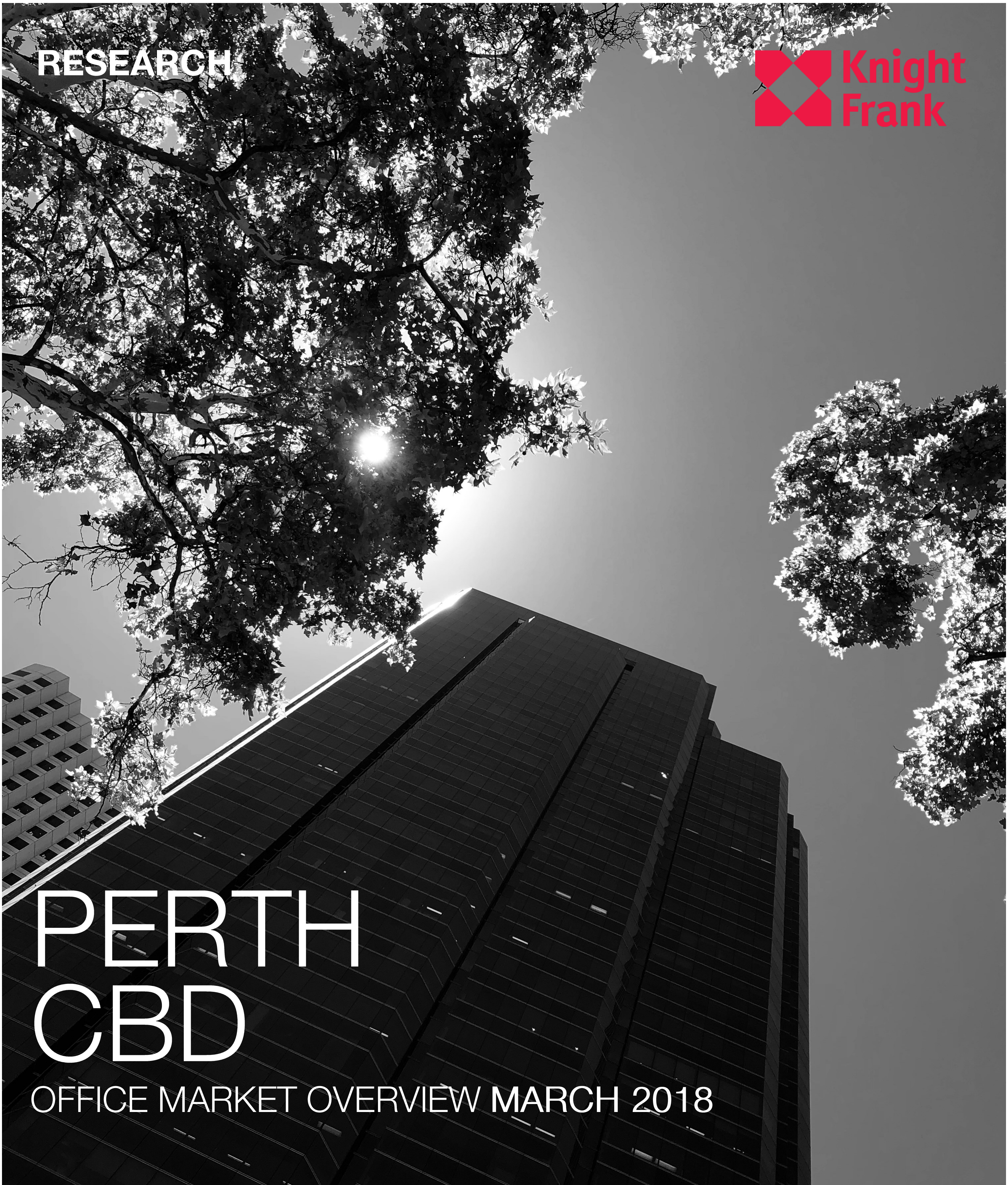


RESEARCH

PERTH CBD

OFFICE MARKET OVERVIEW **MARCH 2018**

HIGHLIGHTS

The Perth office market vacancy rate has fallen from 21.1% to 19.8%, attributed to a reduction in both direct and sublease availability.

Positive absorption was composed of +28,060 square metres into prime stock, and –5,882 square metres away from secondary stock, continuing the divergent trend evident since July 2014.

Strong buying activity for secondary buildings occurred Q4 2017 and Q1 2018, providing evidence of counter-cyclical purchasing and an indicative yield range.

KEY FINDINGS

The Perth CBD vacancy rate decreased to 19.8% as at January 2018, the second successive fall since the peak of 22.5% recorded in January of 2017.

Demand for space is still primarily driven by **tenants relocating from fringe or suburban areas**, as well as **upgrading their space within the CBD**.

With a lack of new supply, **leasing absorption should continue to reduce the vacancy rate for prime buildings** in particular.

The relative weakness of the secondary market has lead to **landlords installing speculative fitouts in order to attract smaller tenants.**

Despite the weak leasing market, **strong transactional activity for secondary buildings** suggests purchasers may have called the bottom of the market.

NICHOLAS LOCKE
Valuer—WA

Follow at @KnightFrankAu

MARKET OVERVIEW

Improving sentiment surrounding the Perth CBD office market has now been reinforced with the release of the Property Council of Australia's latest vacancy figures; indicating a decline in direct and sublease vacancy, particularly at the Premium end of the market.

The January 2018 vacancy rate has fallen 1.2 percentage points from the previous July 2017 headline vacancy rate of 21.2% to 19.8%. Perhaps most pertinently, this was a product of decline in both direct and sublease vacancy rates, whereas the previous positive recording in July 2017 was driven solely by a reduction in sublease availability which is not necessarily a strong indicator of tenant demand. The reported sublease vacancy rate of 1.5% is below the 20 year average of 1.8%, suggesting that demand should be directly absorbed to the benefit of property owners in the short-term.

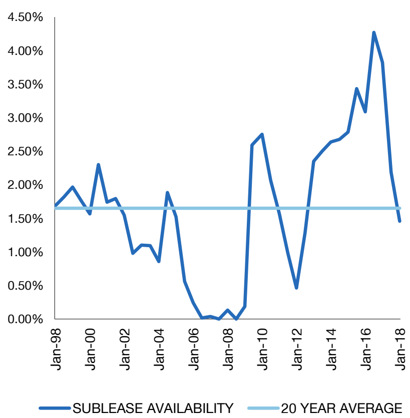
Net absorption across the total market of 22,178m² has been predominantly to Premium (+19,075m²) and A-grade (+8,985m²) buildings, with the total secondary market recording a flat result (-5,882m²), albeit from lower overall stock. secondary properties are now likely to have twice the vacancy of their prime counterparts with a reported vacancy rate of 28.8% in comparison to 14.2%.

Whilst prime stock is outperforming secondary, the true performance line is currently drawn within A-grade buildings, which account for 41% of total stock and vary markedly with their offerings. An example of success is the Premium-grade 240 St Georges Terrace, owned by DEXUS, which has achieved significant commitment for space that will be vacated by Woodside.

In contrast, we are aware of A-grade buildings in less preferred locations that may also lack the same range of building facilities and amenities. These buildings have struggled with longer term vacancies and have been reliant on floor subdivision and speculative fitouts in an attempt to attract smaller tenants.

Despite the difficulties leasing secondary buildings, three B-grade buildings have been placed under contract in 2018 in addition to the settled sale of 45 St Georges Terrace. Should these sales be confirmed at their reported prices, a rough 100bps secondary yield spread will be disclosed after adjusting for specific financial factors (such as vacancy). In comparison, a lack of recent prime transactions provides less of an indication of current market sentiment.

FIGURE 1
Sublease Availability
% of all stock per six month period



Source: Knight Frank Research/ PCA

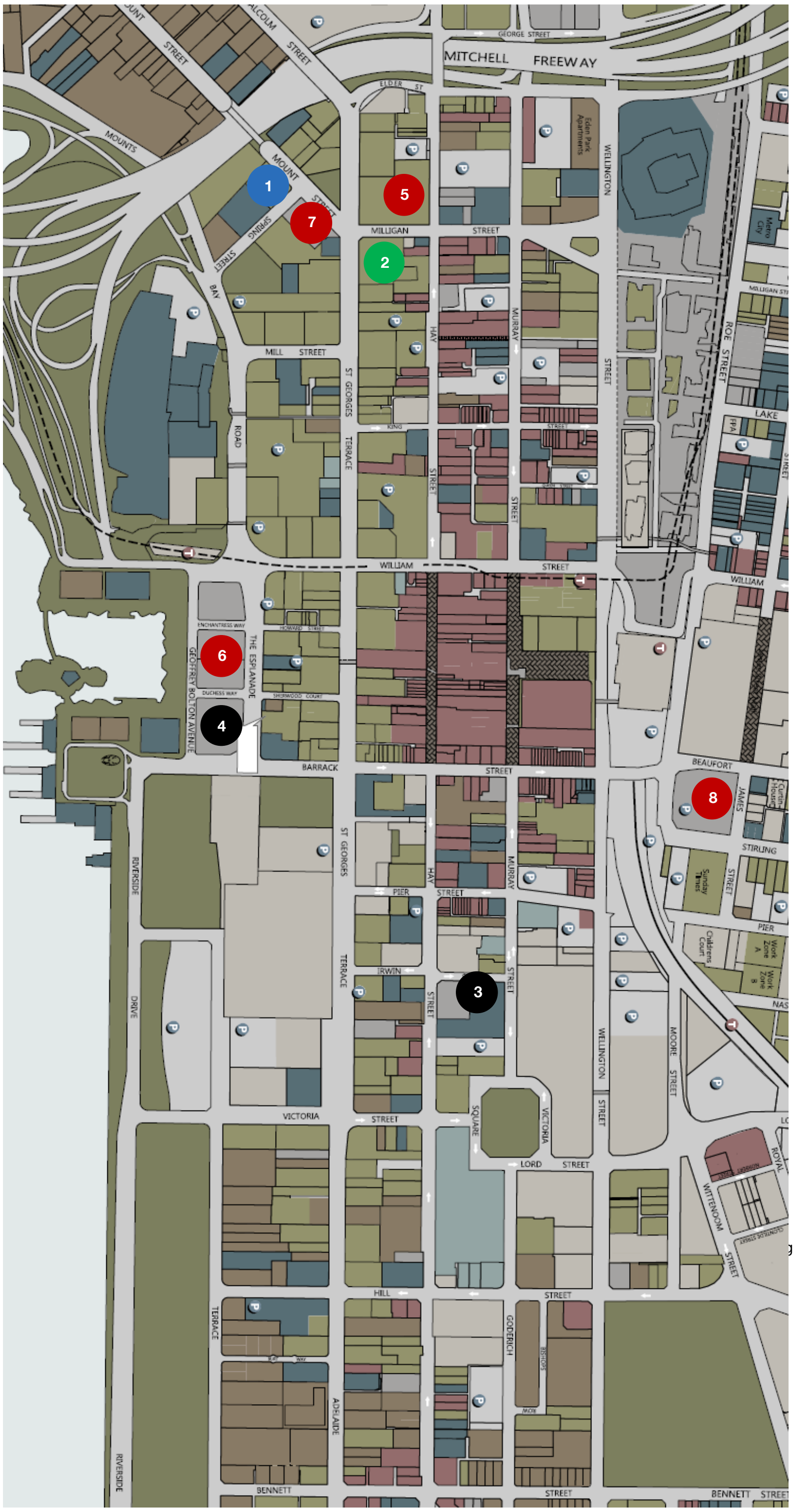
TABLE 1
Perth CBD Office Market Indicators as at February 2018

Grade	Total Stock (m²)	Vacancy Rate (%)	Annual Net Absorption (m²)	Average Net Face Rent ($/m²)	Average Incentive (%)	Average Core Market Yield (%)
Prime	1,081,288	14.2	28,060	500—700	45-50 net	6.50—7.50
Secondary	687,777	28.8	-5,882	300—450	45-55 net	7.50—8.50
Total	**1,769,065**	**19.8**	**22,176**			

Source: Knight Frank Research/PCA

MAJOR OFFICE SUPPLY

1. Capital Square, 98-124 Mounts Bay Rd - 48,484m² [Woodside]
   AAIG - mid 2018 - 100% committed to Woodside
2. 240 St Georges Tce - 47,300m²
   Dexus - $165 million refurbishment - Q1 2019
3. 480 Hay St - 34,450m² - Seeking Commitment
   FES Ministerial Body - DA Approved
4. Crn Barrack St & The Esplanade - 70,000m² [Chevron]
   Chevron & undisclosed development partner - DA Pending
5. QV2 & QV3, Hay St - 10,916m² & 19,167m²
   Investa - DA Approved
6. Perth+, Lots 5 & 6 Elizabeth Quay - 15,000m² & 40,000m²
   Brookfield - Application for DA with MRA & in-principle support from City
7. 239 St Georges Tce (Bishops See Stage 2) - 46,000m²+
   Brookfield/Hawaiian - Mooted
8. 30 Beaufort St & surrounds (World Trade Centre proposal) - 75,000m²
   Nest Investment Holdings - Mooted, subject to an unsolicited bid for adjoining State-owned land



Under Construction / Completed

Significant Vacancy / Refurbishment

Dev Approved / Confirmed / Site Works

Mooted / Early Feasibility

Major tenant precommitment in [brackets] alongside NLA

Map Source: Knight Frank Office Leasing

TENANT DEMAND & RENTS

Diversification away from resource sector occupiers?

Demand for space is being driven mainly by Government and service-based industries, with approximately 60,000m² of large format demand recorded by Knight Frank on top of significant deals that have been struck for future commencements within currently tenanted space.

Employment statistics released by Deloitte Access Economics as at Q4 2017 suggest the white collar force for Perth and West Perth bottomed out in June 2017, following the peak recorded in June 2014. Industries leading with growth over the past 3 years include: Electricity, Gas, Water & Waste Services, Accommodation & Food Services, Information Media & Telecommunications, Education & Training, and Health Care & Social Assistance; all industries that have long been suggested as critical to the diversification of the WA economy. Whilst their growth is positive, their proportion of the CBD white collar force has only increased from 14.4% to 17.7% since December 2014, versus an increase from 41% to 47% across greater Perth over the same period, indicating the City has not attracted as much employment in these areas as may have been hoped.

TABLE 2

Perth CBD—Vacancy Rates

Grade	Jul 17	Jan 18
Premium	11.7%	6.3%
A Grade	19.4%	18.0%
Prime	**16.9%**	**14.2%**
B Grade	30.8%	31.1%
C Grade	20.3%	23.1%
D Grade^	31.6%	31.6%
Secondary	**27.8%**	**28.8%**
Totals	**21.1%**	**19.8%**

^ D Grade total stock only 7,722m²
Source: Knight Frank Research/ PCA

Both confirmed and prospective tenants are typically relocating from their existing lower grade premises, or from fringe and suburban locations such as West Perth (which is particularly apparent) as their existing leases expire.

Divergence within grades

The vacancy rate for Premium stock is now just 6.3%, down from 11.7% recorded in July 2017, and 16.0% in January 2017. This has reduced the pressure on landlords of the highest regarded buildings to offer the same 50%+ incentives experienced previously, which is bringing a greater range of A-grade buildings into the reckoning for tenants seeking high quality space. As this demand trickles down, the 18.0% vacancy rate of A-grade buildings is anticipated to decline throughout 2018, but this will be somewhat constrained by mixed performance within the grade. For those tenants with larger requirements and the desire for contiguous space, options are limited to just a handful of buildings despite the total availability of 153,132m² in prime buildings recorded by the PCA. This may prevent further decline in effective rents in buildings that can offer such characteristics, in comparison to those that offer subdivided or discontiguous space.

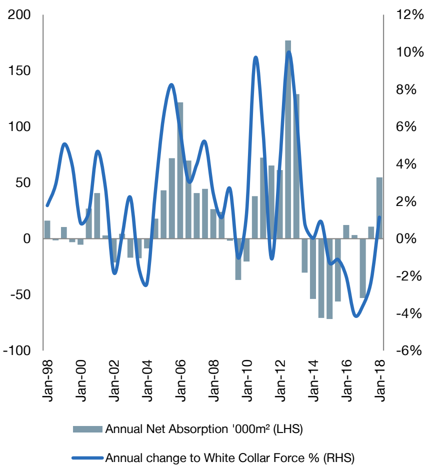
Supply implications should Chevron vacate QV1

One major implication for demand trickling down the grades will be Chevron's decision upon their current lease expiry at QV1 in December 2023 for some 32,000m² of space. Chevron own a development site at Elizabeth Quay, however Knight Frank understands a proposal has been presented at an alternative site, whilst the owners of QV1 will also present a compelling case to stay which may incorporate the mooted development of QV2 and QV3. Should Chevron commit to any newly constructed space, future vacancy in QV1 will eventually be to the detriment of the lower grade buildings as tenants relocate.

FIGURE 2

Net Absorption and White Collar Employment

('000m² and %) per twelve month period

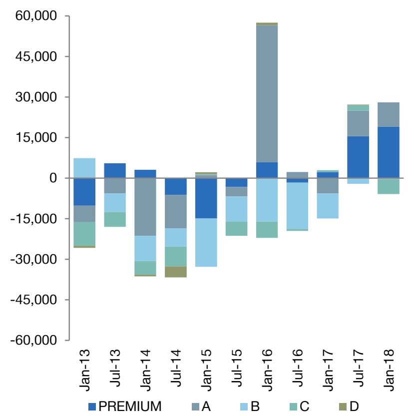


Source: Knight Frank Research/ Deloitte Access Economics/PCA

FIGURE 3

Net Absorption by Grade

Premium, A, B, C & D Grade stock ('000m²)

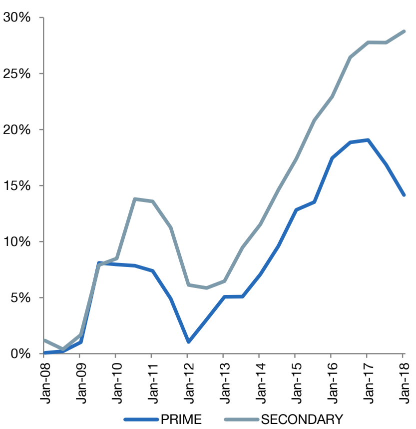


Source: Knight Frank Research/ PCA

FIGURE 4

Vacancy by Grade

Prime and Secondary grade (%)



Source: Knight Frank Research/ PCA

Face rent stagnant

Improved vacancy recordings have not yet transpired to a material change in face rents, however for Premium and upper-A-grade buildings, the need to provide the same level of incentives has reduced. This signals potential growth in effective rents, albeit modest. Rents have stabilised at approximately $600/m² on average, however rates of $700/m² and above are still being achieved within the upper levels of Premium-grade properties that benefit from good views. The spread of A-grade buildings is such that the lower end of the range is now disclosed as regular asking rates of $500/m² plus 45% to 50% incentives.

Secondary properties continue to struggle with downward pressure on face rents as tenants shift to higher grade buildings. A majority of deals struck are in the range of $350-$450/m² plus incentives of around 50%, however we are aware of face rents as low as $300/m² in C-grade space, creeping closer towards effective levels.

Speculative fitouts to attract new tenants

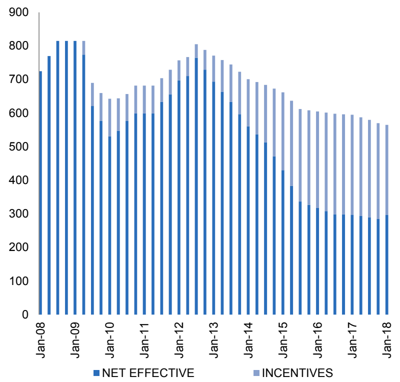
Other strategies to appeal to prospective tenants include speculative fitouts and show suites for partial floors, which has had enough success to now be a regular consideration for property owners that may not have the ability to attract larger tenants. Speculative fitouts offer the tenant the ability to see exactly what they're getting, and appeal to those that are seeking to relocate in the short term.

Despite the capital expenditure outlaid to construct such space, incentives in the form of rent-free periods or rebates are still expected. For some owners, this is not a feasible option; particularly within the less institutionalised secondary market.

Further risks (in time) may be the opportunity cost of securing a larger occupier with part floors occupied, or incoming tenants only committing to short lease terms, whereby upon expiry a new incoming tenant with a larger space requirement may have no regard using recycled fitout over a portion of the space.

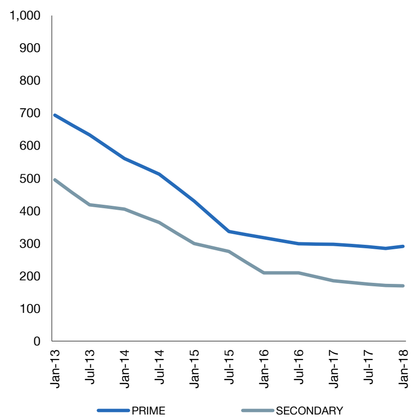
Conversely, a 3 year old fitout should still be attractive to future smaller tenants which highlights that these considerations are largely dependent on where a building is positioned relative to the rest of the market. The strategy has been successful for letting up some well -located smaller floorplate buildings.

FIGURE 5
Perth CBD Prime Office Rents
Average Net Rents and Incentives Rents ($/m²)



Source: Knight Frank Research

FIGURE 6
Perth CBD Office Rents
Prime and Secondary Average Net Effective Rents ($/m²)



Source: Knight Frank Research

TABLE 3
Recent Leasing Activity—Perth CBD

Address	NLA	Level	Tenant	Sector	Date
140 St Georges Terrace	1,102	19	WA Super	Superannuation	March 2017
15-17 William Street	2,130	11 & 12	Virtual Gaming Worlds	Online Casino	February 2017
34-50 Stirling Street	1,983	G	Fortix	Education	February 2018
2 The Esplanade	1,041	17	Victory Corporate	Serviced Offices	February 2018
503 Murray Street	400	1	Lloyd's Register	Assurance	January 2018
2 Mill Street	467	5	HCL Services Australia	I.T.	December 2017
256 Adelaide Terrace	2,030	8 & 11	Minnovo	Engineering	December 2017
15-17 William Street	1,228	7	Subsea7	Engineering	November 2017
68 Milligan Street	898	Gnd	Ausnet Real Estate	Property	September 2017

Source: Knight Frank Research

INVESTMENT ACTIVITY & YIELDS

Strong sales activity

The second half of 2017 saw a marked increase in sales activity. Adding to the sales of 109 St Georges Terrace, Westralia Square, and The Quadrant, 45 St Georges Terrace was sold to a Singaporean-based group by private treaty after a formal sales campaign closed.

45 St Georges Terrace is an 11 storey B-grade building that has undergone some refurbishment since it was previously acquired by Credit Suisse in September 2012. The property sold 80.1% occupied with a WALE by income of 4.5 years, and deferred commencement to a future tenant. The sale has been analysed to reflect a core market yield of 7.80%, incorporating the significant correction in secondary rents that has occurred. The property is located towards the eastern end of the core office precinct, however the long WALE over the leased portion was considered attractive to the Singaporean-based purchaser with a mandate to acquire higher yielding assets, particularly given the initial yield of approximately 7.60%.

A further three properties offered during 2017 are reported to be under contract, including 55 and 182 St Georges Terrace, offered collectively, and 6-8 Bennett Street in East Perth.

55 St Georges Terrace is an 11-storey B-grade building situated at the corner of Sherwood Court. The property has recently undergone significant capital expenditure to include new end-of-trip facilities, plus speculative fitouts on several floors. Whilst the property was offered 77.5% vacant, it is understood to have generated some leasing interest in recent times, and a number of deals were pending throughout the selling campaign. Whilst a majority of tenant demand is likely to be for A-grade properties throughout 2018, 55 St Georges Terrace will be well placed to capitalise as the higher grade space is absorbed.

182 St Georges Terrace is an 11-storey B-grade office building, well-located on the northern side of St Georges Terrace to the west of King Street, and opposite the highly regarded Brookfield Place precinct. The property was initially constructed in 1956 and has since been refurbished, however is situated on a small 808m² allotment which is built up to either side, reducing the infiltration of natural light to tenancies.

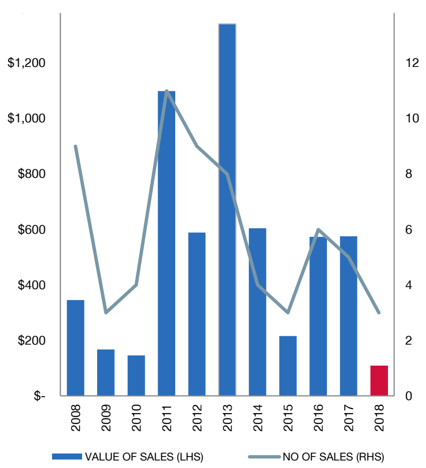
6-8 Bennett Street in East Perth is an 8-storey complex incorporating two refurbished adjoining buildings located east of the core office precinct, and to the south of Adelaide Terrace. The building is leased to two tenants with a favourable 6 year WALE (by income) on the 68.5% occupied portion, plus a lease to Wilson Parking Australia for 204 bays.

These confirmed sales have continued the strong recent trend of transactions to offshore purchasers, particularly for secondary properties since 2016.

FIGURE 7

Perth CBD Sales Activity 2008—2018

($ million) Sales Value and Number (to February)

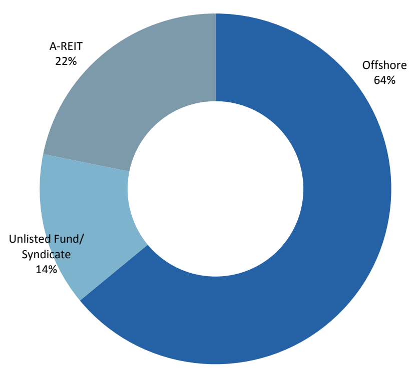


Source: Knight Frank Research

FIGURE 8

Perth CBD Purchaser Profile

% Sales Value 2016-2018



Source: Knight Frank Research

TABLE 4

Recent Sales Activity—Perth CBD

Address	Price $ mil	Core Market Yield (%)	NLA m²	$/m² of NLA	WALE yrs	Vendor	Purchaser	Sale Date
6-8 Bennett Street	43.50	8.32	10,219	4,257	6.0	BGC	OKP Holdings / HSB Holdings	Feb-18
55 St Georges Terrace	44.20	7.37#	8.629	5,122	1.0	Standard Life	Zone Q	Feb-18
182 St Georges Terrace	21.10	8.03	5,414	3,897	0.9	Standard Life	Zone Q	Feb-18
45 St Georges Terrace	54.20	7.80	10,011	5,414	4.5	Credit Suisse	Straits Trading Co.	Dec-17
105 St Georges Terrace^	11.0	8.36	3,826	2,875	0.9	WA Super	Private syndicate	Nov-17

Source: Knight Frank Research

\# approximate, to be confirmed

^ denotes 35 individual strata-titled lots, sold in one line

Strong evidence of a secondary yield range

Analysis of the three properties under contract in 2018 as well as other confirmed sales indicates a secondary core market yield range of approximately 7.50% to 8.50%, when adjusted for property-specific financial risk factors. Where each individual transaction falls within this range appears to be in line with other property characteristics, particularly pertaining to location and the age and configuration of the buildings.

Interpretation of a prime yield range

It is now the interpretation of a prime yield range that has become somewhat subjective, with the closest benchmark transaction being the sale of The Quadrant in August 2017. This sale was analysed to reflect a core market yield of 6.90%, however this included risk allowances for a 38.2% vacant component as well as significant budgeted capital expenditure. As such, an upper end prime building with less associated risk may be anticipated to attract a tighter yield towards 6.50% on average, and tighter again for Premium buildings. A 25% stake in QV1 was marketed through the second half of 2017 which may have provided an indication, but did not proceed to a sale.

The historical risk premium for Perth—where are we now?

The average prime yield differential between Perth and Sydney has widened to around 200bps; 50bps above the 10 year average of closer to 150bps. East coast based purchasers have already recognised the relative value in Perth properties with long WALEs, but as the prime leasing market improves and effective rents grow by virtue of decreasing incentives, this interest may broaden.

Similarly, over a 10 year period the Perth prime office yield has attracted a 375bps average premium above Australian Government 10-Year Bond yields. At present, and incorporating a recent softening in the 10-Year Bond yield, Perth prime buildings reflect a 420bps premium which again suggests a similar 47bps softer position than the 10 year average of 373bps.

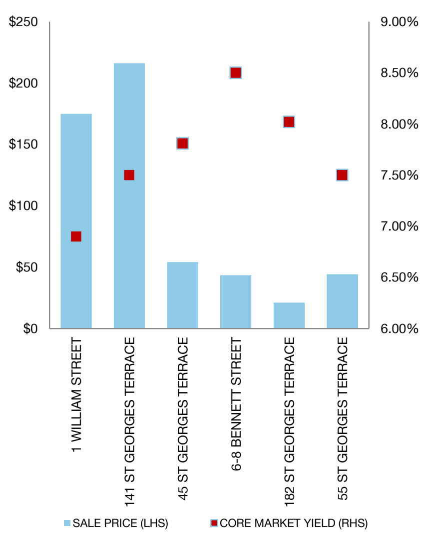
And where are we heading?

The issue of softening bond yields may have some ramifications for property yields, should the current trend translate to interest rate rises in late-2018 or early-2019 that may alter required rates of return. However with an extra 50bps of risk built in to prime yields above 10 year averages, Perth appears reasonably well-placed should further softening occur.

The trend forward for Perth is open to a variety of factors. Any further compression of prime yields will likely come as a result of investor perception of improving prospects in the local market, particularly if incentives are anticipated to fall and the strong divergence between face and effective rents reduces. Furthermore, any confirmed supply additions will impact upon the standing of individual buildings and their performance in coming years.

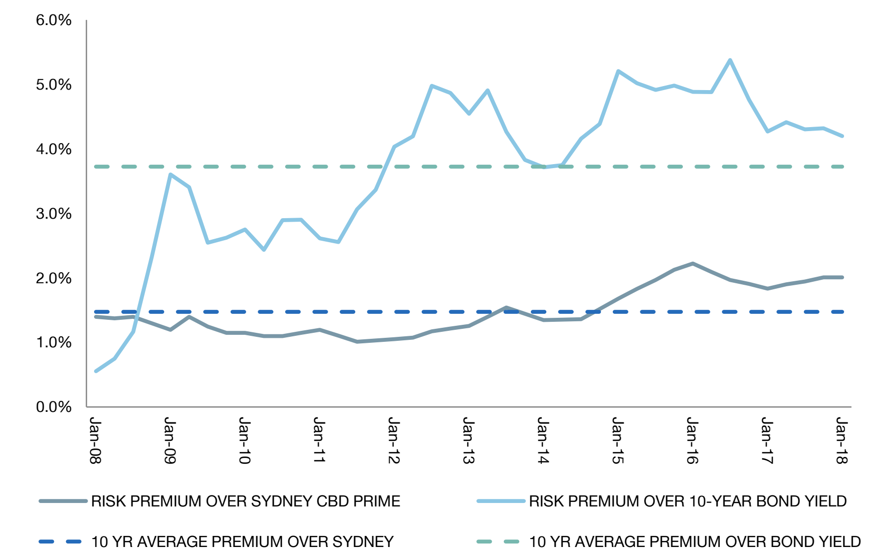
> "The average prime yield differential between Perth and Sydney has widened to around 200bps; 50bps above the 10 year average of closer to 150bps"

FIGURE 9
Perth CBD Transaction Yields
Aug 2017—Feb 2018, All Grades, $ millions



Source: Knight Frank Valuations

FIGURE 10
Perth CBD Risk Premium
2008 to 2018, Prime Grades, Core Market Yields



Source: Knight Frank Research

Outlook

- Since the end of the mining construction boom, the Perth CBD office market has suffered with a steadily increasing vacancy rate. The sublease vacancy rate peaked at 4.3% in July 2016, but has now fallen to 1.5% (0.3% below the 20 year average). This indicates a maturity to the market whereby occupiers present requirements now match their contracted space, and the end to some lease terms committed to during the peak of the boom. Any expansionary activity by firms will now likely be paired with increase demand for office space.
- Whilst market sentiment is improving, the effect of Woodside relocating to 98 Mounts Bay Road and the backfilling of their current space at 240 St Georges Terrace may lead to a future increase in the vacancy rate, highlighting the future risks in the market for owners with secondary buildings in particular.
- New supply mooted (see Page 3) is primarily targets a Chevron relocation, and would not be anticipated to all transpire. Chevron's decision in this regard will have significant future ramifications on the prime leasing market should they vacate their current space of some 32,000m² at QV1.
- As the prime leasing market continues to improve, growth in effective rents is anticipated for Premium-grade buildings in particular where tenant demand has been the strongest, and the impetus for landlords to provide 50%+ incentives has reduced.
- Recent transactions have all been for secondary buildings and have shown a slight firming in yields. In the absence of any evidence, but with improved leasing prospects, we consider the conditions may also be right for a firming in prime yields.

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Photo credit: Chris Whincop, General Manager, Exchange Tower.

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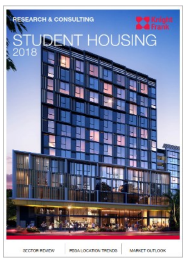
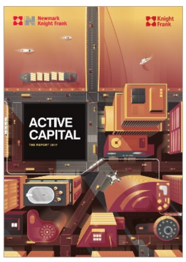
Australian Office Top Sales Transactions CY 2017

Perth CBD Office Market Overview September 2017



Student Housing 2018



Asia Pacific Capital Markets 2017

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