RESEARCH

Knight Frank

PERTH CBD

OFFICE MARKET OVERVIEW SEPTEMBER 2017

HIGHLIGHTS

The first decline in the Perth CBD Office Vacancy Rate since January 2012 has provided an indication that the market has reached the bottom of the cycle.

Whilst the vacancy rate is forecast to remain at similar levels into 2018, the Prime market is expected to experience some effective rental growth due to easing incentives.

A recent spike in transactional activity from local, national and offshore purchasers indicates counter-cyclical purchasing has commenced.

KEY FINDINGS

The Perth CBD vacancy rate decreased to 21.1% as at July 2017, the first fall recorded since January 2012 at the peak of the resource sector boom.

Prime buildings remain better performed than Secondary, best represented by **a Premium vacancy rate of only 11.7%**, along with stabilised face rents and incentives.

Falling face rents and rising incentives has contributed to an increasing number of **Secondary buildings being leased on effective terms**.

Counter-cyclical purchasing has commenced with **three confirmed transactions** to date from local, national and international purchasers, with further activity anticipated.

Recent transactions suggest **a tightening of yields in the Perth market**, narrowing the gap with east coast capital cites.

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MARKET OVERVIEW

The Perth CBD has experienced a decline in office vacancy for the first 6 monthly period since the peak of the resource sector boom in January 2012, primarily due to a reduction in sublease availability.

In statistics published by the Property Council of Australia, the vacancy rate of 21.1% equates to a 1.4 percentage point decrease on the previous January 2017 figures, reflecting total vacant stock of 372,997m^2 and apportioned as 182,492m^2 to Prime, and 190,505m^2 to Secondary grade buildings.

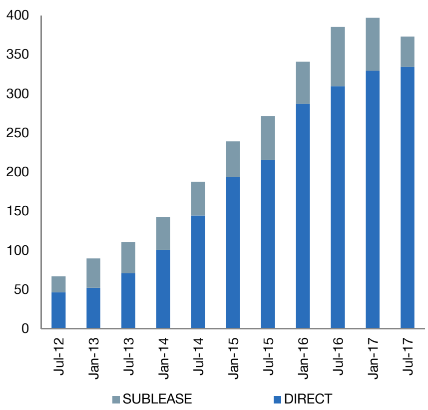
For the second successive biannual period, sublease availability has declined; having now reduced from 75,500m^2 reported in July 2016 to 38,743m^2 today. This fall is attributable to a combination of factors, including companies (namely within the resource sector) withdrawing space, as well as head leases expiring and converting to direct vacancy, or approaching expiry and no longer viable for subleasing. A moderate increase in direct vacancy of 4,912m^2 indicates a degree of these factors at play, however on the whole the result is considered to represent maturity in the market and a small step towards a return to equilibrium within Premium and upper A-grades.

The gap in performance between Prime and Secondary grade assets remains considerable, with tenants continuing to seize the opportunity to relocate into better quality space. Prime net absorption is recorded at 24,984m^2, compared to Secondary at 146m^2. Over a two year period, this trend is even more pronounced with total net absorption of 78,781m^2 and –47,449m^2, and current vacancy rates of 16.9% and 27.8% attributable to Prime and Secondary stock respectively.

New additions to the market of 2,452m^2 (netting to 1,188m^2 after stock withdrawals) are at their lowest level since January 2007; a period which has yielded 493,672m^2 of additional floor space across all grades within the CBD.

Confirmed new supply within the market is limited to the 48,484m^2 Premium-grade Capital Square development, anticipated to be ready for occupation mid 2018 and 100% pre-committed to Woodside. As a consequence, the Dexus-owned 47,300m^2 A-grade Woodside Plaza, located at 240 St Georges Terrace, will fall largely vacant. A significant refurbishment of floors and building amenities will occur and is expected to be available for occupation Q1 2019.

FIGURE 1
Direct and Sublease Vacancy
'000m^2 per six month period



Source: Knight Frank Research/ PCA

TABLE 1
Perth CBD Office Market Indicators as at July 2017

Grade	Total Stock (m^2)	Vacancy Rate (%)	Annual Net Absorption (m^2)	Annual Net Additions (m^2)	Average Net Face Rent ($/$m^2$)	Average Incentive (%)	Average Core Market Yield (%)
Prime	1,082,588	16.9	21,624	102	500—700	45-50 net	6.50—7.50
Secondary	686,369	27.8	-8,498	718	300—450	45-55 net	7.50—8.50
Total	**1,768,957**	**21.1**	**13,126**	**820**			

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. Woodside Plaza, 240 St Georges Tce - 47,300m²
Dexus - Refurbishment Est. Q1 2019

3. Westpac, 109 St Georges Tce - 13,890m²
Far East Organization - Significant Vacancy Q4 2017

4. 480 Hay St - 34,450m² - Seeking Commitment
FES Ministerial Body - DA Approved

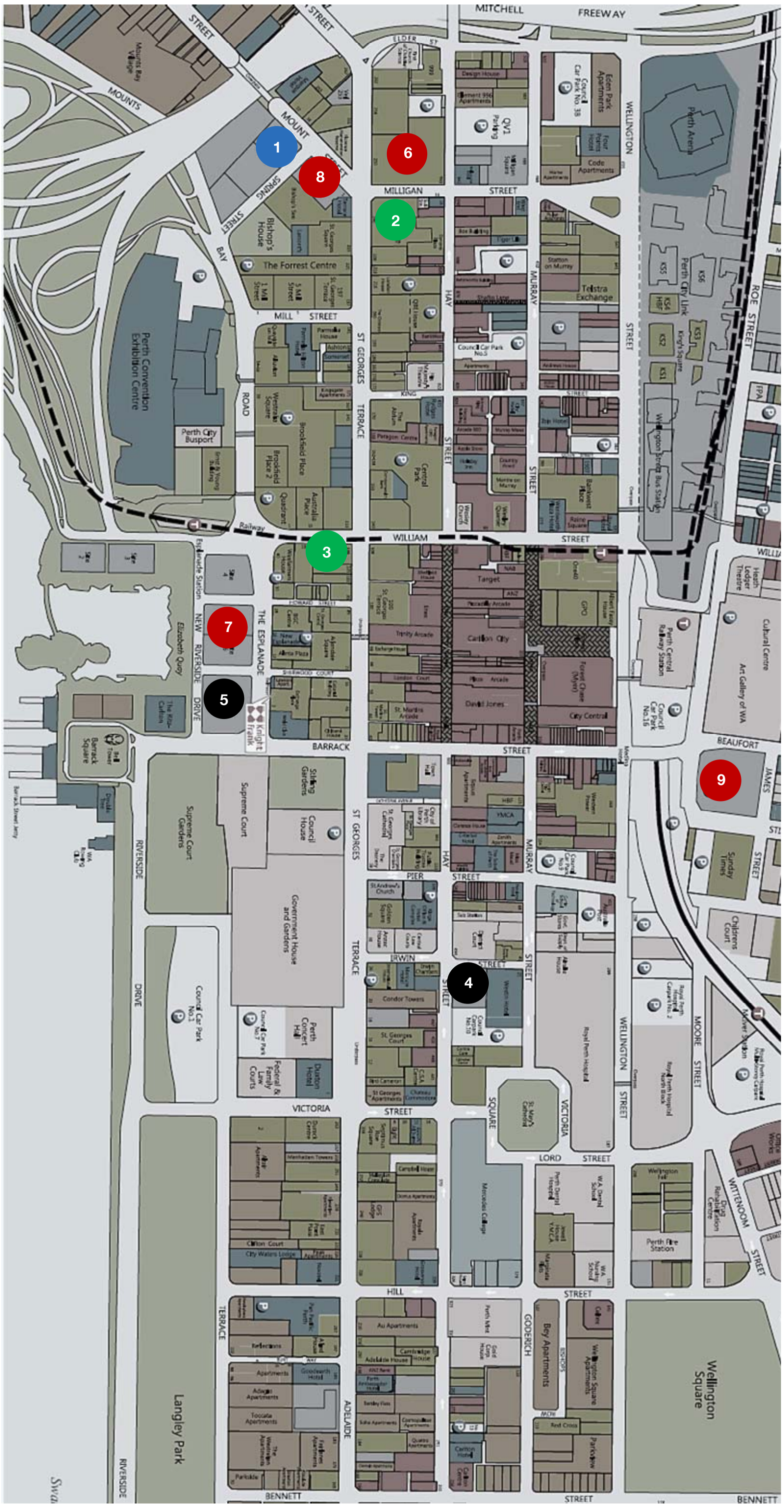
5. Crn Barrack St & The Esplanade - 70,000m² [Chevron]
Chevron - DA Pending

6. QV2 & QV3, Hay St - 10,916m² & 19,167m²
Investa/Commonwealth Super/City of Perth - DA Approved

7. Perth+, Lots 5 & 6 Elizabeth Quay - 15,000m²
Brookfield - Application for DA with MRA & in-principle support from City

8. 239 St Georges Tce (Bishops See Stage 2) - 46,000m²+
Brookfield/Hawaiian - Mooted

9. 30 Beaufort St & surrounds (World Trade Centre proposal) - 75,000m²
Nest Investment Holdings - Mooted



- 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

The Perth CBD office market continues to be defined by considerably stronger levels of demand from occupiers for Premium and upper A-grade buildings in comparison to B-grade buildings and below. This is best reflected by the Premium vacancy rate of 11.7%, A-grade vacancy rate of 19.4%, and B-grade vacancy rate of 30.8%, outlined below. We expect this trend to continue in the short to medium term.

TABLE 2

Perth CBD—Vacancy Rates

Grade	Jan 17	Jul 17
Premium	16.0%	11.7%
A Grade	20.6%	19.4%
Prime	**19.1%**	**16.9%**
B Grade	30.3%	30.8%
C Grade	21.3%	20.3%
D Grade^	37.5%	31.6%
Secondary	**27.8%**	**27.8%**
Totals	**22.5%**	**21.1%**

^ D Grade total stock only 7,722m²

Source: Knight Frank Research/ PCA

Net absorption recorded 25,130m² for the first six months, representing the second positive recording within a two year period, following the 35,447m² result in January 2016. Although negative net absorption was recorded in July 2016 and January 2017, the cumulative result over a two year period now equates to positive 31,332m². Whilst modest, this is a stark contrast to the cumulative negative net absorption of 152,602m² recorded from January 2013 to July 2015 inclusive.

Tenant Demand

As existing leases expire within Secondary buildings, tenants seeking to upgrade will continue to be a major source of demand for Prime buildings. The current vacancy rate for Premium stock at 11.7% is approaching a healthy level allowing for a potential easing of incentives into the future, which in-turn may price some prospective tenants out of that market. This is beginning to transpire with demand trickling down to lower A-grade properties.

For tenants locked in to existing leases, numerous examples exist of early vacation with incentives on the new lease structured to enable them to cover their outstanding obligations, whilst benefiting from the occupation of higher grade or refurbished premises. The prevalence of tenants seeking to enter into these deals is indicative of the sentiment that opportunities provided in the current market may not exist upon expiry.

An increasing source of further structural shift in vacancy from Prime to Secondary grade properties has arisen from mergers and acquisitions occurring as a symptom of Perth's broader economic weakness. Larger companies seeking to consolidate their operations as a result of acquiring smaller distressed entities are typically in the market for Prime space, with the space vacated more likely to be Secondary or non-core.

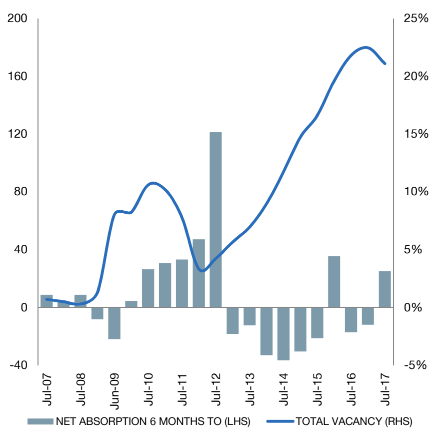
Other major sources of demand have come from tenants in fringe CBD office precincts such as West Perth, and further beyond including Subiaco and Osborne Park. Owners of higher capital value Prime-grade assets within the CBD typically have a greater capacity to fund upfront incentives through capital contributions to position their properties as more attractive, as well as reducing the effective rent for the occupier to a level competitive with suburban precincts.

Owners within these fringe precincts are less able to fund the same upfront benefits, and therefore cannot offer the same level of staff amenities (plus other locational benefits of a core CBD-located building). These suburban precincts are expected to struggle until equilibrium is met in the A-grade market and competition for tenants is predominantly with B-grade assets.

FIGURE 2

Net Absorption and Vacancy

('000m² and %) per six month period

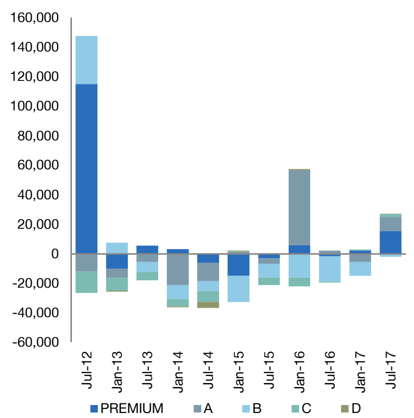


Source: Knight Frank Research/ PCA

FIGURE 3

Net Absorption by Grade

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

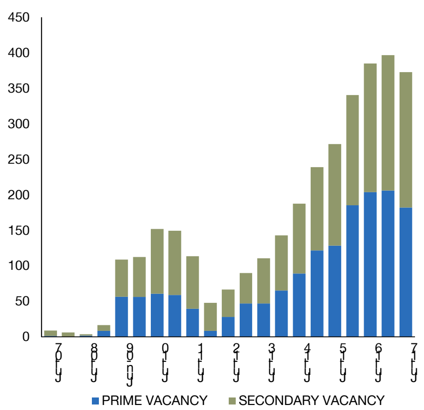


Source: Knight Frank Research/ PCA

FIGURE 4

Perth CBD Historical Vacancy

Prime and Secondary grade ('000m²)



Source: Knight Frank Research/ PCA

Rental Levels

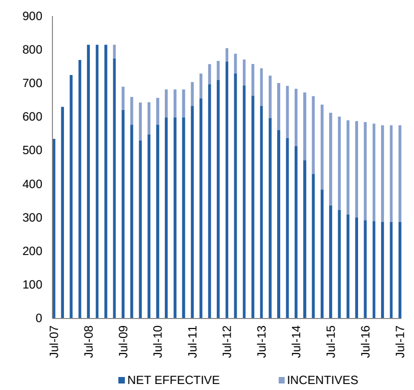
The precipitous fall in face rents for Prime grade buildings has stopped, having stabilised at an average of $600/m² for a period now approaching 12 months, with higher rates still obtainable within the upper levels of Premium grade properties. Incentives also appear to have stabilised, sitting broadly in the range of 40% to 50% (net) for the majority of deals struck. With the Premium vacancy rate now at only 11.7%, owners have less motivation to provide incentives above 50%. Accordingly, for the first time since mid-2012 there is potential for growth in effective rents for Premium-grade properties, and as a consequence greater competition can be anticipated as tenant demand shifts to A-grade space.

The rental market for Secondary grade stock paints a different picture entirely, with net face rents continuing to fall to approximately $350/m² as a result of a reduced demand. At this level, incentives (often seen at over 60%) are still not considered sufficient to fund fitout costs to better position the premises to compete. With their assets also producing less cash flow, many owners have become less willing to fund these upfront contributions, resulting in fitouts being recycled and more deals negotiated at effective rents.

Whilst on an effective basis these rents may appear competitive in comparison to suburban locations, the lack of upfront capital contributions may inhibit the ability to attract potential tenants as relocation and establishment becomes cost prohibitive.

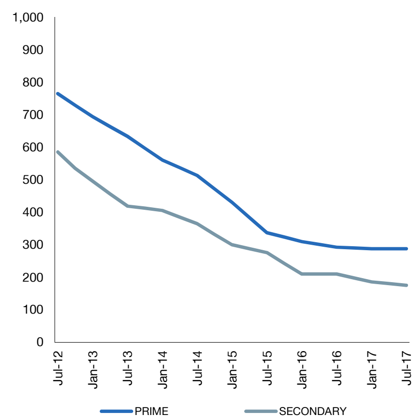
The creep of these effective rents is moving upwards towards B-grade stock. The impact of this can be negative for the values of these assets which may lead to distressed sales and stock withdrawals. The City of Perth have released six concept designs for the conversion of such buildings in an attempt to bring more education, student accommodation, multi-residential, mixed-use and health and well-being uses to the CBD.

FIGURE 5
Perth CBD Prime Office Rents
Average Net Rents and Incentives Rents ($/m^2)



Source: Knight Frank Research

FIGURE 6
Perth CBD Office Rents
Prime and Secondary Average Net Effective Rents ($/m^2)



Source: Knight Frank Research

TABLE 3
Recent Leasing Activity—Perth CBD

Address	NLA	Tenant	Lease Type	Sector	Date
251 St Georges Terrace	802	ASIC	New	Government	August 2018
160 St Georges Terrace	597	Cooper Energy	New	Oil & Gas	June 2017
2 The Esplanade	1,115	Allen & Overy	New	Law	June 2017
	298	Kansai	Renew	Utilities	June 2017
	786	AGS	Renew	Government	March 2017
18 Mount Street	697	Worley Parsons	New	Engineering	June 2017
40 St Georges Terrace	78	Fourth Floor Chambers	New	Law	May 2017
44 St Georges Terrace	128	Silk Hospitality	New	Service	May 2017
1060 Hay Street	604	Medtronic	New	Medical	May 2017
58 Mounts Bay Road	1,569	Kufpec Australia	New	Oil & Gas	May 2017
15-17 William Street	1,235	Resolute Mining	New	Mining	February 2017

Source: Knight Frank Research

INVESTMENT ACTIVITY & YIELDS

Transaction Activity

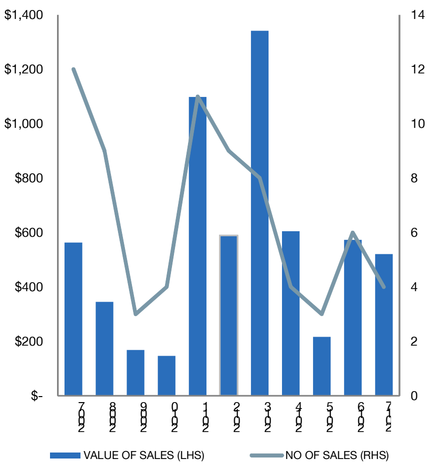
Following a subdued end to 2016 and start to 2017, transactional activity within the Perth CBD has rapidly picked up with four confirmed sales to a value of approximately $521 million, indicating counter-cyclical purchasing has commenced and the appetite for assets with the right leasing profile is strong.

144 Stirling Street, commonly known as the 'Hatch Building', is a four level A-grade building, situated to the north of the core office precinct and in proximity to the City's cultural district of Northbridge. The property sold fully leased with a WALE of 4.0 years to the listed 'Centuria Metropolitan REIT', representing the Sydney-based fund manager's first direct Perth acquisition.

FIGURE 7

Perth CBD Sales Activity 2007—2017

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



Source: Knight Frank Research

The property was acquired for $58.22 million on a 9% initial passing yield, with 100% of the building's NLA expiring in December 2020 and August 2021, dissuading many local purchasers.

109 St Georges Terrace is a 21-storey B -grade office tower, well-located at the prominent intersection of William Street and St Georges Terrace. The property was purchased by Far East Organization for $71.77 million showing a 5% initial passing yield, however upon lease expiry to vacating tenant Westpac, the property will be 75% vacant. Despite the building's older improvements and the imminent expiry, the property was well received by local, interstate, and offshore purchasers alike due to the limited opportunity to acquire landmark sites. The intent of the purchaser is understood to be letting up the property in the short term.

'The Quadrant' at 1 William Street is a 21 level A-grade office building, located at the corner of William Street and The Esplanade adjacent to Elizabeth Quay. A reported off-market transaction has occurred, with Primewest (backed by Singaporean sovereign wealth fund, GIC) being the purchaser. Full details of this transaction cannot yet be disclosed, however the property had a WALE of 3.3 years and vacancy rate of 38% at the time of the transaction being reported.

'Westralia Square' at 141 St Georges Terrace is a 19-storey A-grade office building that was initially offered for sale during 2015 and 2016 as part the Insurance Commission of Western Australia's (ICWA) divestment of their direct property portfolio. Marketing recommenced mid-2017 with GDI purchasing the property in August for a reported $216.25 million. A majority of the building's NLA expires April 2020, with GDI committing to a major capex program and anticipating high appeal for the space come expiry.

East of the core precinct, 226 Adelaide Terrace was acquired by Blackstone as part of the South Australia's Motor Accident Commission (MAC) portfolio. It is our understanding that the property was not apportioned a direct sale price.

In addition to confirmed sales, there are ongoing negotiations for 45 St Georges Terrace, a refurbished 11 storey B-grade building marketed with a 3.2 year WALE and 26% vacancy; and 8 St Georges Terrace, an 8 storey B-grade building situated to the eastern end of the core precinct that failed to find a purchaser from an on-market campaign late 2016.

> "Four confirmed sales to a value of approximately $521 million indicate the appetite for counter-cyclical purchasing is strong"

TABLE 4

Recent Sales Activity—Perth CBD

Address	Price $ mil	Core Market Yield (%)	NLA m²	$/m² of NLA	WALE yrs	Vendor	Purchaser	Sale Date
141 St Georges Terrace	216.25	TBC	32,635	6,626	2.5	ICWA	GDI	Aug 17
1 William Street	175.00#	TBC	23,450	7,463#	3.3	CBA Officers' Super Fund	Primewest / GIC	Jul-17
109 St Georges Terrace	71.77	6.80^	13,890	5,167	0.5	Charter Hall Prime Office Fund	Far East Org.	Jul 17
144 Stirling Street	58.22	7.67	11,042	5,271	4.0	Charter Hall Direct Trust	Centuria	Jul 17

Source: Knight Frank Research

^ based upon letting up of the building with no significant capital expenditure

\# approximate, to be confirmed

Yields

After seven $50+ million transactions between August 2015 and July 2016, sales activity within the Perth CBD stalled, providing a lack of evidence from which to substantiate market yields at a time of significant compression being experienced across east coast capital cities. This shortage of transactions was attributed to owners of prime assets being unwilling to divest with a lack of good quality alternative acquisition options, whilst the market was perceived to be too risky for counter -cyclical purchasing with vacancy rates still increasing and effective rents falling.

Sales which have recently occurred in 2017 now provide strong indication of the latter, with purchasers willing to acquire properties with higher levels of current or imminent vacancy.

Although core market yields can be broadly categorised into Prime (6.5% to 7.5%) and Secondary (7.5% to 8.5%), the split is more specifically aligned to leasing risk, which is generally a product of the vacancy profile of the asset, as well as the locational and asset-specific characteristics. A good example is the December 2016 sale of WorkZone East, situated in a non-core office precinct at 1 Nash Street, but achieving a 7.3% core market yield due to the long WALE of 9.3 years and the quality of the improvements. The sale of 'The Quadrant' will provide the best indication of Prime yields, and a sale of 45 St Georges Terrace will do the same for Secondary yields.

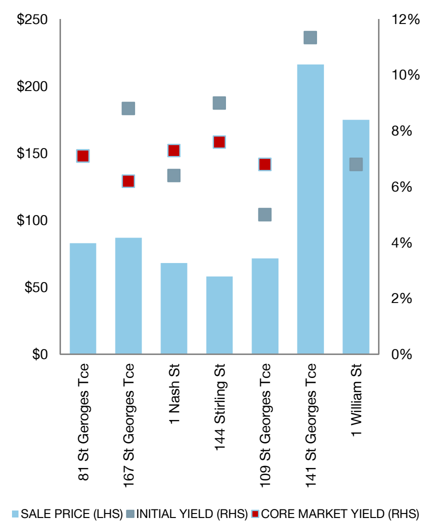
The current yield premium for Perth-based properties compared to an average across east coast capitals is approximately 150 basis points, having tightened from early 2016 when further rental market decline was factored in. The 10 year average differential sits at 115 basis points, suggesting further tightening may occur, particularly with rents for Premium and upper A-grade buildings widely considered to have stabilised.

An alternative scenario is that as the leasing market improves and incentives reduce, vacancy risk allowances incorporated into transactions will be reduced. In this instance, asset values still grow, however the core capitalisation rate is maintained.

FIGURE 8

Perth CBD Transaction Yields

July 2016—August 2017, All Grades, $ millions

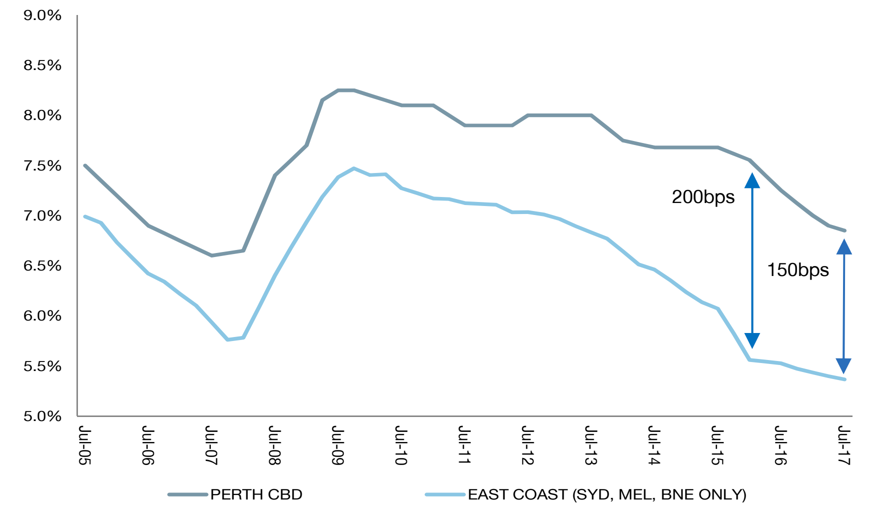


Source: Knight Frank Valuations

FIGURE 9

Perth CBD versus East Coast Prime Yields

2005 to 2017, East Coast average weighted by PCA Prime stock levels



Source: Knight Frank Research

Outlook

- With a decreasing Prime vacancy rate and evidence of face rents having stabilised over the past 6-12 months, incentives appear set to ease at the top end of the market, leading to an increase in effective rents. Anecdotally, Knight Frank has already experienced owner reluctance to offer the same level of incentives as was necessary to secure tenants 12 months ago.
- Effective rents have become increasingly prevalent at the lower end of the market, and are anticipated to rise into B-grade as owners cease funding large upfront incentives. The rise of effective rents has the capacity to impact on asset values, increasing the likelihood of redevelopments, conversions, and withdrawals.
- After a quiet period, sales activity has increased with four confirmed transactions, of which all have demonstrated a tightening in yields that was previously not substantiated. Further transactions anticipated in 2017 will assist in demonstrating where the Perth market sits in relation to the rest of Australia.

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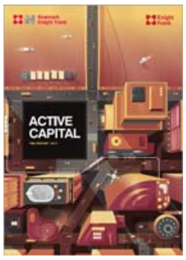

Active Capital 2017

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