RESEARCH

Knight Frank

BRISBANE CBD

OFFICE MARKET OVERVIEW SEPTEMBER 2016

HIGHLIGHTS

Tenant activity is continuing to build with upgrading and migration into the CBD dominant factors for private sector tenants. The State Government relocations are also driving the market.

Average effective rents have hit their low point with prime effective rental growth of 0.8% over the past year, the first positive move since mid-2012. Effective rental growth will only be gradual over the next two years.

Investment demand continues to build, and the gap between Brisbane and Sydney prime average yields has begun to narrow. Improving leasing metrics will continue to support this trend but margin to remain 120bps+.

KEY FINDINGS

Total vacancy was 16.9% as at July 2016, up from 14.9% at the start of the year. This is expected to be the **peak of the vacancy for this cycle.**

Prime and secondary effective rents grew by a modest **0.8% p.a and 0.7% p.a** respectively as the rental cyclical low point is in the past.

Greater **leasing activity** has emerged, and while many tenants are not growing, **net absorption was boosted** by migration to the CBD and State Government take-up.

Yields remain under **downward pressure for core properties** as offshore investor interest continues to build.

JENNELLE WILSON
Senior Director — Research QLD

SUPPLY & DEVELOPMENT

As expected the additional supply took the vacancy rate to peak levels, although cushioned by higher net absorption. Continued improvement in leasing activity will boost the already strong investment demand.

After a three year hiatus of new supply, the long awaited projects of 180 Ann St and 480 Queen St have completed, adding a little over 113,000m² to the Brisbane CBD stock base. 180 Ann St was the first to reach practical completion with Commonwealth Bank and Tatts Group the major tenants committed to the building. The 57,465m² A grade building is 53% committed with interest in the finished product growing.

At the other end of the CBD, 480 Queen St has added 56,252m² to the premium stock. While the building is fully leased the vendor and developer, Grocon, has taken a head-lease over 8,400m² on three low-rise podium floors. A smaller development located on the Queen Street Mall, 155 Queen St, has also added 2,108m² of new stock to the CBD. The mixed use building, which is leased to retailer Zara over lower ground, ground and level one, is occupied by Brisbane Marketing over the three office levels.

The remaining new supply for 2016 is 1 William St, due to be completed late in the year. The 74,853m² building is fully committed to the State Government with relocation of State Government staff into the new tower to be the trigger for older obsolete space to be withdrawn. The three buildings of 80 George St, 100 George St and 75 William St form the Queens Wharf site. The Health & Forestry Buildings (26,651m²) and 62 Ann St (14,429m²) are also expected to be vacated although timing is not confirmed.

Despite the emerging green shoots in the leasing market the environment for future development remains difficult with few tenants having the ability to anchor a pre-commitment in the short term (Telstra, Suncorp, Origin, etc). Potential projects include Shayher Group's 300 George St, currently slated as a 35,000m² building (despite having a greater approved area) and ISPT's Regent development of a similar size. While ISPT is not expected to commence construction without a significant pre-commitment there is the possibility that Shayher Group may proceed with construction of the office tower in tandem with delivering the W Hotel building and residential tower.

Stock Withdrawal

Stock withdrawals during the first half of 2016 totalled 10,596m² with 3,940m² (82 Ann St) withdrawn for refurbishment and the remainder permanently withdrawn. 443 Queen St (5,560m²) has been withdrawn for redevelopment as a 40 level residential building. Part of 316 Adelaide St (1,096m²) has been withdrawn for conversion into student accommodation with a further 4,384m² to be withdrawn in H2 2016. Permanent withdrawals will accelerate over the remainder of 2016, underpinned by the Queens Wharf site (57,656m²). While CY2016 will be the peak for permanent CBD withdrawals (72,014m²+) the longer term will see further withdrawals with up to another 75,000m² of expected or potential withdrawals identified.

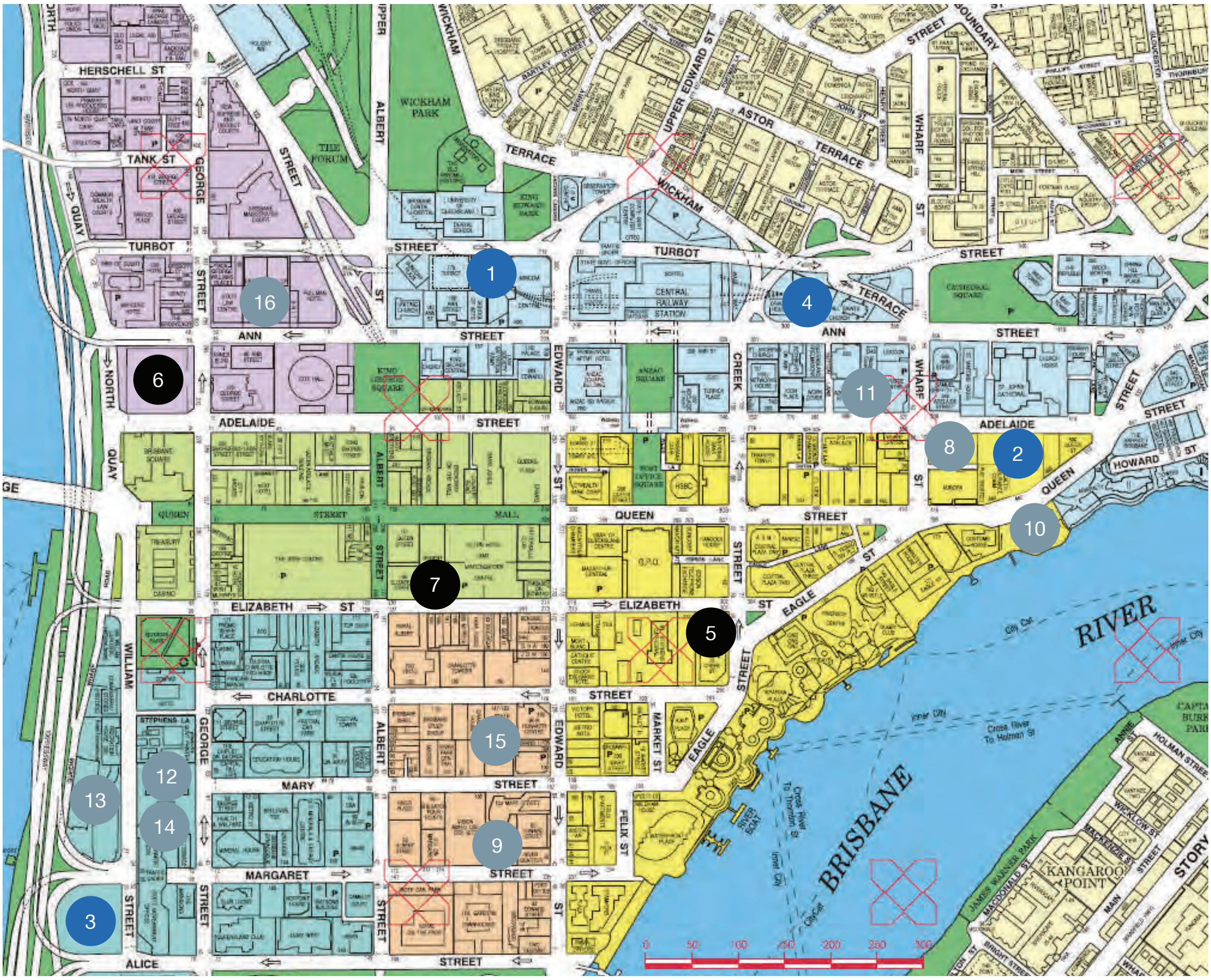
TABLE 1

Brisbane CBD Office Market Indicators as at July 2016

Grade	Total Stock (m²)	Vacancy Rate (%)	Annual Net Absorption (m²)	Annual Net Additions (m²)	Average Gross Face Rent ($/m²)	Average Incentive (%)	Average Core Market Yield (%)
Prime	1,177,947	15.7	49,996	112,374	708	37	6.00—7.10
Secondary	1,083,931	18.2	-8,577	-8,786	555	40	7.55—9.55
Total	**2,261,878**	**16.9**	**41,419**	**103,588**			

Source: Knight Frank Research/PCA

MAJOR OFFICE SUPPLY



1. 180 Ann St—57,465m² [CBA/Tatts Gp] Daisho — Q2 2016—53% committed
2. 480 Queen St—54,985m² office NLA [BHP/ PwC/Freehills] 100% committed (16% Grocon headlease) DEXUS/DWPF — Q2 2016
3. 1 William St—74,853m² [State Govt] Cbus Property/ISPT—Q4 2016 100% committed
4. #310 Ann St—18,400m² Pidgeon Family—Q1 2017
5. 12 Creek St Annex—6,297m² of GFA DEXUS Property Group/DWPF—tba
6. 300 George St—c35,000m² NLA Shayher Group—tba
7. 150 Elizabeth St—c35,000m² ISPT—subject to pre-commitment
8. 363 Adelaide St—14,700m² Valparaiso Capital —withdrawn Q1 2015 Student Accommodation Conversion
9. 240 Margaret St—3,750m² Aspial Corporation—withdrawn Q4 2015 Residential Development
10. 443 Queen St—5,560m² Cbus— withdrawn H1 2016 Residential Development
11. 316 Adelaide St—5,480m² MRL Capital—H1 & H2 2016 staged Student Accommodation Conversion
12. 100 George St & annex —22,906m² Queensland Government— H2 2016 Queens Wharf Integrated Resort Dev.
13. 75 William St—18,600m² Queensland Government— H2 2016 Queens Wharf Integrated Resort Dev.
14. 80 George St—16,150m² Queensland Government— H2 2016 Queens Wharf Integrated Resort Dev.
15. Health & Forestry House—26,651m² Cromwell Property—Potential 2016 State Govt Lease expires 2017
16. 62 Ann St—14,429m² Wee Hur Holdings—Potential 2016 State Govt Lease expires 2017

- Under Construction / Complete
- DA Approved / Confirmed / Site Works
- Mooted / Early Feasibility
- Former office buildings permanently withdrawn for change of use 2015 & forecast 2016

Source of Map: Knight Frank
As at September 2016, excluding strata
#major refurbishment
Avail office NLA quoted.
Major Pre-commit in [brackets] next to the NLA.

TENANT DEMAND & RENTS

Leasing activity has continued to show signs of improvement, but only within limited sectors of the market rather than widespread. As a result of the significant supply additions in the CBD the total vacancy has increased to 16.9%, up from 14.9% at the start of the year. While this represents a significant increase in the vacancy rate, due to better than anticipated net absorption in the first half of the year, it has not reached the heights of 18%+ that were previoulsy anticipated.

TABLE 2
Brisbane CBD—Vacancy Rates

Precinct	Jul 15	Jul 16
Premium	8.0%	22.1%
A Grade	12.3%	13.9%
Prime	**11.5%**	**15.7%**
B Grade	19.2%	18.6%
C Grade	15.0%	17.5%
D Grade	16.5%	16.8%
Secondary	**18.2%**	**18.2%**
Totals	**14.9%**	**16.9%**

Source: Knight Frank Research/PCA

The prime market vacancy rate has jumped to 15.7% under the influence of this prime supply as backfill space has largely remained available. Over the prior three years the average prime vacancy was just under 11% and this bubble in the prime vacancy is expected to work through relatively quickly given the current tenant trend towards upgrading their accommodation.

Secondary vacancy was 18.2% as at July 2016 and while this was a slight reduction from the start of the year, this represents no improvement from 12 months earlier. The secondary market remains difficult with tenants now expecting both high incentive deals and for the building to be refurbished.

Net Absorption

The Brisbane CBD total net absorption was 42,742m² for the first six months of 2016, the highest result since January 2012. Aligned with the new supply and current tenant trend towards upgrading, the majority of this was within the prime market (42,094m²) with a marginal increase in occupancy within secondary space of 648m².

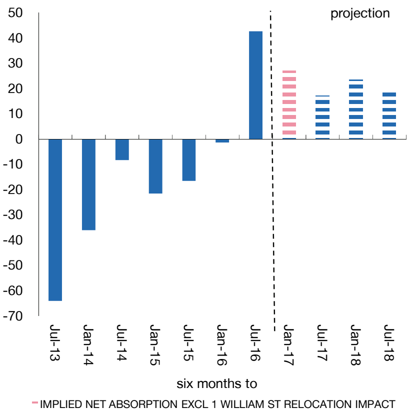
While a return to positive net absorption in the Brisbane CBD was widely expected by the market, the quantum of the recovery has surprised on the upside. One of the major contributions to this figure is the inclusion of the Tatts Group's 18,000m² commitment to 180 Ann Street. As the tenant is relocating from the fringe this provides a major boost to net absorption. Outside of Tatts Group the tenants relocating to the two newly constructed buildings have contributed little to the net absorption (circa 600-700m²) as most have relocated from within the CBD and taken a similar quantum of space.

Instead the net absorption growth has arisen from a number of disparate factors but can largely be attributed to fringe tenants relocating into the CBD, growth from specific industries (childcare, education, healthcare and IT) and space leased by the State Government.

These factors, particularly the State Government relocations, will continue to be in play over the second half of 2016. As outlined above the State Government will move from a number of buildings (Queens Wharf Site, Health & Forestry House and 62 Ann Street) into 1 William St. At this stage all of these backfill buildings are expected to be withdrawn from office stock, although the actual timing varies with the Queens Wharf Site buildings to be emptied first and the other buildings to follow. For the purposes of forecasting Knight Frank has assumed all impacts associated with the 1 William St move are accounted for at once, rather than over an assumed 6-12 month period. Therefore the addition of 74,853m² is more than balanced by the withdrawal of 98,736m² of these older buildings. This has an impact on the net absorption calculation as shown in Figure 1, with the nominal market derived net absorption of 25,450m² impacted by the reduction in total space occupied in relation to the 1 William St move.

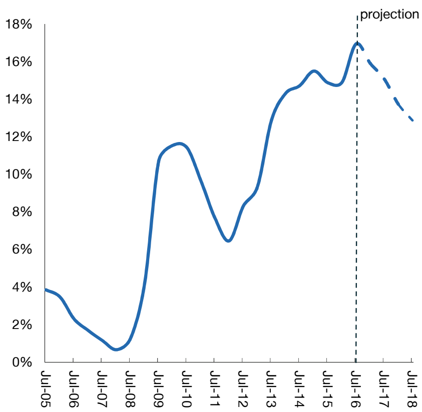
However the State Government remains active across the wider general leasing market with a further 8,200m² leased in 60 Albert St, three additional floors taken in 140 Creek St (3,300m²) as part of a wider eight floor re-commitment to the building, and three sub-lease floors taken -up in 400 George St (4,370m²). Without further one-off factors the net absorption is forecast to stabilise between 17,000m² - 23,500m² per six month period in the short term. Initially this will be reliant on inflows from Fringe and suburban tenants rather than growth in existing CBD users.

FIGURE 1
Brisbane CBD Net Absorption
('000m²) per 6 month period



Source: Knight Frank Research/PCA

FIGURE 2
Brisbane CBD Vacancy
% total vacancy



Source: Knight Frank Research/PCA

Vacancy

It is forecast that the current vacancy rate of 16.9% will form the peak for this cycle, with total vacancy of 15.7% forecast at the end of the year (based on Knight Frank's withdrawal timing assumptions). In a climate of little to no new supply, the removal of obsolete backfill space and with net absorption returning to above-average levels, the total vacancy rate has the potential to fall quite quickly.

Prime vacancy has been impacted by the addition of 180 Ann St and 480 Queen St, and some 37,000m² of backfill space in premium and A grade buildings still for lease. As a result the premium (22.1%) and A grade (13.9%) total vacancies increased over the past six months. The premium vacancy will work through quite quickly with good interest in backfill space already in evidence, particularly the discounted short term, sub-lease space taken up by opportunistic tenants.

Tenant Demand

The trend towards greater tenant activity and mobility has continued and, if anything, strengthened since first observed late 2015/early 2016. While the stock additions have taken the vacancy to new heights, there have been positive signs in the market and activity has begun to increase. In part this is due to tenants recognising that market conditions are favourable for negotiation but not likely to improve much further.

As expected, the number of tenants relocating from the Fringe or suburban market into the CBD has increased over the course of 2016. Aside from Tatts Group, which at 18,000m² is the largest relocation in recent times, Origin Energy is also at shortlist stage in their accommodation search, with relocation into the CBD one option. Tenants of all sizes have also been taking advantage of the low cost deals on offer in backfill sub-lease space with Fringe tenants Over the Wire and National Storage taking up some of the BHP backfill space in Riparian Plaza.

While demand from smaller tenants has continued to be a major driver of activity, demand is gradually broadening to encompass larger tenants. Given the disconnect between passing rents at the end of a five or seven year lease term and current market rents, the ability to relocate and upgrade with little to no additional financial burden, drives activity.

Rental Levels

Brisbane CBD office rents have remained largely static over the course of 2016, however it is now clearer that there will be no further falls in effective rents across the prime market. Prime gross face rents have continued to gradually increase, up by 1.6% over the past year to average $708/m² as improved demand has engendered a response from landlords. However due to the high vacancy rate still in evidence there has been no reduction in incentives.

Prime incentives average 37.0%, up slightly from 36.5% a year ago, but stable from the start of 2016. Average prime gross effective rents are now $446/m², a slight increase on the $443/m² one year ago, growth of 0.8% p.a. Although modest, this is the first increase in effective rents since Q2 2012. Despite emerging evidence that the low point in prime effective rentals is in the past, the pace of any turn-around is forecast to be relatively slow with 2.5% and 3.1% effective prime rental growth forecast over the next two years.

Secondary market rents have remained sluggish with modest increases to the face rent still being off-set by higher incentive levels. Average gross face secondary rents are $555/m² which represents growth of 1.8% over the past year. However the secondary average incentive of 40.0% is marginally higher than the 39.3% of a year ago, resulting in growth to gross effective rents of 0.7% p.a. The growth profile is expected to remain flat in the short term with 0.9% p.a and 2.4% p.a effective rental growth forecast over the next two years. Although conditions in the secondary market remain tough, the withdrawal of older stock and the works being undertaken by landlords to improve their buildings, have put a floor under average effective rents. The lingering high vacancy is expected to continue to weigh on the secondary market with gross effective annual rental growth to remain below 3.0% p.a in the 3-5 year horizon.

TABLE 3

Recent Leasing Activity Brisbane CBD

Address	NLA m²	Face Rent $/m²	Term yrs	Incentive (%)`	Tenant	Start Date
295 Queen St	8,064	undis	10	undis	NAB	Feb 17
333 Ann St	1,300	585 g	5	30-35	Mastercard	Aug 16
400 George St	4,370	undis	-	undis	Queensland Govt#	Aug 16
340 Adelaide St	1,220	525 g	5	undis	CPL	Jun 16
295 Ann St	2,423	undis	10	undis	Administrative Appeals Tribunal	Jun 16
140 Creek St	3,300	625 g	7	35+	Queensland Govt	Jul 16
60 Albert St	8,200	685 g	8	undis	Queensland Govt	Jan 16
180 Ann St	18,000	undis	15	undis	Tatts Group	undis

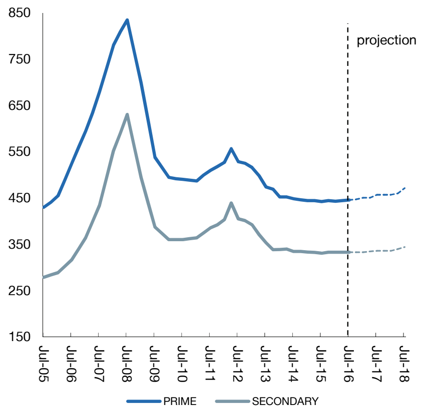
`estimated incentive calculated on a straight line basis g gross # sub-lease

Source: Knight Frank Research

FIGURE 3

Brisbane CBD Rents

$/m² p.a average gross effective rent



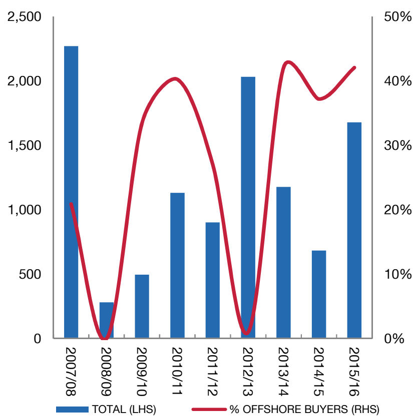
Source: Knight Frank Research

INVESTMENT ACTIVITY & YIELDS

Purchasing demand has remained strong within the Brisbane market, however limited opportunities have resulted in only five major commercial office sales in 2016 to date. When combined with an active finish to 2015, the total turnover for the past financial year (2015/16) is $1.68 billion, well above the $683 million recorded in the prior financial year.

As shown in Figure 4, the level of purchasing from offshore entities has been high over the past three years—ranging from 37% - 42% of total turnover in the CBD. However as shown in 2012/13, the market is not dependent on a high offshore presence to record strong turnover levels.

FIGURE 4
Office Market Investment ($10m+)
$ million Brisbane & % turnover offshore buyers

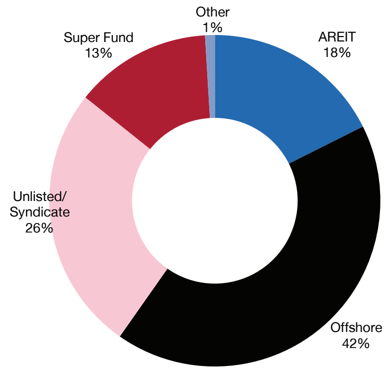


Source: Knight Frank Research

Over the majority of the past six financial years, and particularly in the last three financial years offshore investment has accounted for significant levels of Brisbane CBD turnover. Offshore investors have become more comfortable with Brisbane as an investment destination with re-sale risk now seen as very low given the market's ability to sell the vast majority of stock formally offered to the market in a reasonable time-frame.

Following the purchase of 313 Adelaide St ($125.40 million) and 50% of 201 Charlotte St ($81.57 million) by offshore entities in late 2015, three of the five 2016 sales have also been to offshore groups. At the start of the year 41 George St ($159.80 million) was purchased by AEP Management on behalf of the Basil Investment Trust with the property sold fully leased to the State Government on a 5.2 year WALE. Wee Hur Holdings have purchased a short/ medium term development site at 62 Ann St and 89 Turbot St for $62.50 million from QIC. The property features an office building to the Ann Street frontage which is leased to the State Government with a short tail and a heritage listed former market/warehouse to the Turbot St side.

FIGURE 5
Brisbane CBD Purchaser Profile
2015/16



Source: Knight Frank Research

The largest sale in the Brisbane CBD for the year to date was 300 Queen Street, also purchased by an offshore buyer, ARA Asset Management. The centrally located A grade asset was sold by private investor Kevin Seymour for $188 million, which reflected a core market yield of 6.73% on the building which has a WALE of 4.6 years. The other two major sales for 2016 have been APPF Commercial Fund acquiring the remaining 50% of the Transit Centre for $62.60 million from GPT Wholesale Office Fund and Unity Pacific's disposal of the trust's last major commercial asset. The twin buildings at 308 Queen Street and 88 Creek Street have been purchased by Primewest for $37.31 million on a core yield of 7.98%.

TABLE 4
Recent Sales Activity Brisbane CBD

Address	Grade	Price $ mil	Core Market Yield %	NLA m²	$/m² NLA	WALE yrs	Vendor	Purchaser	Sale Date
308 Queen St & 88 Creek St	B	37.31	7.98	4,579	8,148	2.0	Unity Pacific	Primewest	Jul 16
300 Queen St	A/B	188.00	6.73	19,364	9,709	4.6	Private Investor	ARA Asset Management	Jun 16
Roma Street Transit Centre	B	62.60 (50%)	n/a	29,521	4,242	n/a	GPT Wholesale Office Fund	APPF Commercial Fund	Mar 16
62 Ann St & 89 Turbot St	B/Site	62.50	n/a	14,429	4,332	1.1	QIC	Wee Hur Holdings	Mar 16
41 George St	B	159.80	8.58	29,960	5,334	5.2	QIC	Basil Property Trust (AEP Investment Mgt)	Jan 16

Source: Knight Frank Research

Both prime and secondary yields have continued to firm over the course of 2016. The Brisbane CBD prime yields have fallen to a median range of 6.0% - 7.10% as demand continues to grow and the breadth and depth of potential purchasers expands. The average prime yield of 6.55% represents a fall of 20 basis points over the past year and 145 basis points since the cyclical high in mid -2009. Secondary yields have also firmed however, held back by continued perceptions of leasing risk, the contraction has not been as sharp.

Secondary yields currently range between 7.55% - 9.55%, reflecting an average of 8.55%, an 18 basis point decrease over the past year and 64 bps since the prior peak. The yield range for secondary assets has continued to widen, as well-leased secondary assets have experienced yield firming on a par with the prime market. The lower median yield range for secondary assets (7.55%) has firmed by 30 basis points over the past year, and 120 basis points since the market peak. In contrast, weighed by the high secondary vacancy, the upper yield range (9.55%) has shown only marginal firming.

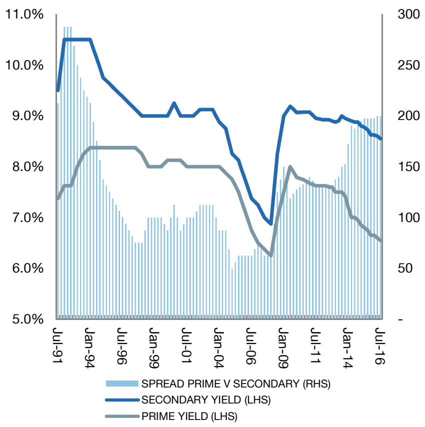
One of the reasons that the Brisbane CBD investment market has been receiving greater attention from investors has been the spread in yields against the Sydney and also Melbourne markets. As indicated in Figure 7, the current spread between prime yields in the Brisbane and Sydney CBDs has begun to contract, sitting at 127 basis points just below the cyclical high of 132 basis points at the start of 2016. However the current level remains well above the long term average of 99 basis points and it is expected that this gap will continue to narrow as the leasing market improves and greater investor competition emerges within the Brisbane market.

While few assets are formally on the market, 324 Queen St is being sold by joint owners Dexus Wholesale Property Fund and Brookfield Property Partners and is understood to be in due diligence. Aside from the traditional upswing in activity towards the end of the year, the Brisbane CBD is likely to see greater buyer acceptance and turnover of assets with manageable leasing risk.

FIGURE 6

Brisbane CBD Core Market Yields

% Yield LHS & Basis Point Spread RHS

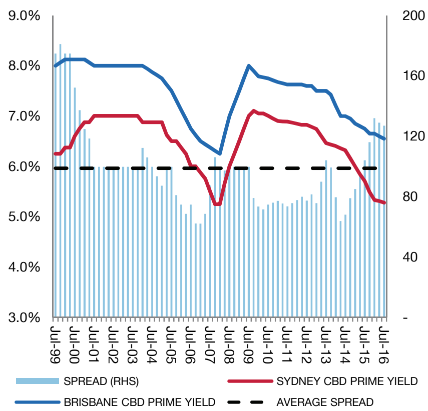


Source: Knight Frank Research

FIGURE 7

Brisbane CBD & Sydney CBD Yields

% Yield LHS & Basis Point Spread RHS



Source: Knight Frank Research

Outlook

- Tenant demand and activity have continued to improve over the course of 2016. While many tenants are still not growing markedly on relocation the net absorption has been boosted by State Government activity and migration into the CBD to take advantage of the strong negotiating position of tenants.
- Total vacancy is expected to have peaked at 16.9% in mid-2016 following the addition of 180 Ann St and 480 Queen St. Stronger than expected net absorption cushioned vacancy with a lack of new supply to support vacancy falls in 2017.
- Effective rents have begun to show some positive movement, albeit only very modestly with prime gross effective growth of 0.8% over the past year. While the cyclical low for average prime effective rents is in the past the medium term growth expectations remain low with significant effective rental growth (above 5% p.a) not expected to emerge before mid-2019.
- While a number of prime assets are achieving good occupancy levels, others have large tranches of space available. As a result there is the opportunity for selected owners to push for higher rents, while others will be forced to maintain high incentive levels. It is expected that tenants will continue to pragmatically chase the best deals so any pre-emptive increase to effective rents may stall deals in a building. Additionally there will emerge a greater range in achieved rentals between assets of similar building fabric due to the level of available space.
- Yields remain under downward pressure and although many purchasers remain wary of leasing exposure, the tolerance to this risk appears to be increasing. After extending to a cyclical high of 132 basis points the spread between prime Brisbane and Sydney yields is beginning to narrow slightly. While demand for Brisbane assets remains strong, continued good news from the leasing market will be required to increase competition and push yields even lower.

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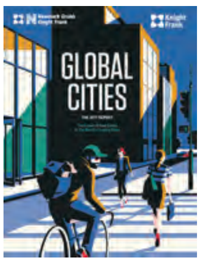

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