RESEARCH

CANBERRA

OFFICE MARKET BRIEF SEPTEMBER 2015

Key Facts

A slight fall in the vacancy rate to 15.3% was recorded over the six months to July 2015, the result of a moderate pick up in net absorption

While prime gross effective rents have remained flat over the past 12 months, a small uptick in secondary grade incentives has reduced effective rents by 1.6% over the past year

Leasing demand remains focussed on the prime market as tenants take advantage of current leasing and incentive metrics

With limited buying opportunities, investment volumes have slowed with YTD 2015 sales ($10m+) totalling $131.78 million

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Positive signs are emerging in Canberra's leasing market following an improvement in sentiment and activity over the past six months. Yield firming has been broadly limited to prime stock with volatility existing in the secondary market.

Development Activity

Following three years of strong construction activity, office supply in Canberra over the past six months has slowed to total 11,945m² for the period, 78% under the 10 year average. Partly offsetting this was 3,241m² in withdrawals, resulting in a net stock addition of 8,704m² over the six month period. Recent supply has stemmed from the completion of KDN Group's Gungahlin Business Park Stage 2 (9,000m²) project, 10-12 Lonsdale Street (1,745m²) as part of a mixed use format and a partial refurbishment at 216 Northbourne Avenue (1,200m²).

Looking forward, office supply in Canberra is expected to wane with no major projects expected to be delivered to the market until at least 2018. In this case, any supply over the next three years is expected to consist of refurbishments stemming from tenant turnover or small new additions as part of mixed use formats. This is the case at present where refurbishments are underway at 50 Blackall Street (4,727m²), while 1,200m² of new stock is expected at 63-67 Constitution Avenue in late 2016.

Beyond this, there is a considerable pipeline of office projects which have the potential to add just over 350,000m² to the Canberra market. However, with government departments being urged to relocate and absorb sub-lease space as opposed to pre-committing to new stock, it is likely that new office projects will be shelved until full commitment is sourced (at least 2018).

From 2018, potential supply includes the Civic DA approved projects of Vernon North—Building 4 (25,000m²) and Signature Building 2 (16,000m²), while Section 96 (37,500m²) and Walker Group's Northbourne Square (52,000m²) project remain in the pipeline. There are numerous other non Civic developments in the early planning stages, however given the current overhang of sub-lease space, it is unlikely they will be delivered prior to 2020. At the same time, with residential conditions expected to improve, particularly once the "Mr Fluffy" buy-back scheme plays out, a number of the mooted office projects may instead be developed for residential and mixed use purposes.

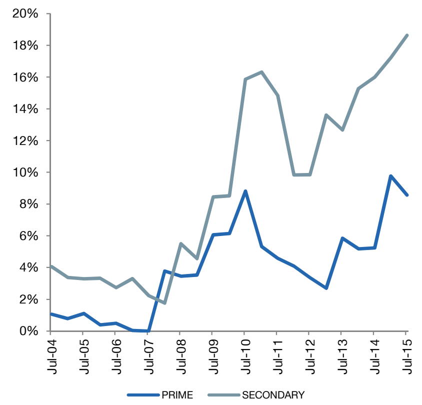
Tenant Demand & Vacancy

Following a pick-up in tenant demand, the Canberra vacancy rate has recorded a modest improvement over the first half of 2015 where it currently stands at 15.3%, down from 15.4% in January. 2014 marked a challenging period for the Canberra office market as the reshaping and downsizing of some government departments led to a rise in sub-lease space. However it appears the market is stabilising with the bulk of government sub-lease space being absorbed and leasing activity beginning to gain some pace.

With leasing demand remaining focussed on the prime market as tenants take advantage of favourable leasing conditions, the divergence in vacancies between prime and secondary markets within Canberra's major office precincts has widened. Prime vacancies at Civic, Parliamentary and Town Centres has reduced to 8.6%, while vacancies in the secondary market continue to trend upwards (see Figure 1), reaching a historical high of 18.2%.

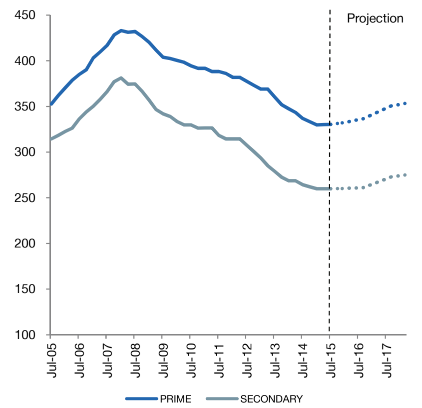
For the total prime market including PCA sub-localities outside of the major office precincts, the vacancy rate is currently 14.1% with unoccupied space at the Airport accounting for 52% of all prime vacancies. As at July 2015, the vacancy rate at the Airport measured 39.9%, however with tenant amenity improving greatly in recent years, it is likely the vacancy rate in the area has peaked.

FIGURE 1
Canberra Vacancy Major Precincts*
Per six month period (%) - by grade



Source: Knight Frank Research/PCA
* incorporates Civic, Parliamentary Precinct & Town Centres

FIGURE 2
Civic Gross Effective Rent
By Grade ($/m²)



Source: Knight Frank Research

In the six months to July 2015, net absorption in Canberra measured 8,803m², which was its first positive six monthly period since the second half of 2013. However by grade, it very much remains a two tier market with net absorption in the prime market totalling 24,533m² over the six months to July 2015. On the other hand, tenant demand within the secondary market remains weak with net absorption of –15,730m² recorded over the six months to July 2015. A lack of expansionary requirements from Commonwealth tenants has been the catalyst.

The relaxation of the public service hiring freeze announced in the 2015/16 Federal Budget is likely to improve sentiment in the leasing market going forward. However, its impact is expected to be initially felt in sub-lease space as a result of 'Project Tetris' (a government initiative to reduce vacant sub-lease space). For the private sector, leasing demand continues to gain momentum, particularly for sub 500m² tenancies as businesses opt to relocate to higher quality office space given current leasing and incentive metrics.

Looking ahead, the continued whole of government approach to take up sub-lease space when direct leases expire is likely to keep the vacancy rate at current levels over the next 12 months. However, improved labour market conditions coupled with no new supply will likely see the vacancy rate trend downwards from mid-2016. An accelerated recovery could occur if the residential market gains momentum and older stock is withdrawn for conversion, however this is reliant on government initiatives including changes to the Lease Variation Charge (LVC).

TABLE 1
Canberra Office Market Indicators - July 2015

Grade	Total Stock (m²)	Vacancy Rate (%)	Annual Net Absorption (m²)	Annual Net Additions (m²)	Average Gross Face Rent ($/m²)	Outgoings ($/m²)	Average Incentive (%)	Average Core Market Yield (%)
Prime								
Civic (City)	299,888	8.0	12,105	20,014	419	74	21.0	7.25-7.75
Parliamentary	261,910	13.1	3,564	24,047	445	70	18.5	7.25-7.75
Town Centres	220,633	4.0	0	0	376	65	24.5	8.00-9.00
Other	301,067	28.5	14,174	8,262				
Secondary								
Civic (City)	388,062	18.7	-16,373	-5,148	358	85	27.5	9.50-10.00
Parliamentary	198,343	17.9	-14,219	-5,884	380	72	22.5	9.25-9.75
Town Centres	272,670	19.1	-8,368	5,686	310	67	31.0	10.50-11.50
Other	459,805	12.1	-3,438	-13,799				
Total Market	**2,402,378**	**15.3**	**-12,555**	**33,178**				

Source: Knight Frank Research/PCA Parliamentary comprises Barton, Parkes and Forrest office precincts
Town Centres comprise Phillip, Tuggeranong and Belconnen office precincts Other includes remaining PCA sub localities

Rents & Incentives

Gross face rents have stagnated over the past 12 months with no change recorded for both prime and secondary markets. At present, prime gross face rents across the combined Civic and Parliamentary precincts average $432/m², while no movement in incentives has kept prime gross effective rents stable at $347/m². On the other hand, secondary rents (in the Civic and Parliamentary precincts) have softened, falling a further 1.6% over the past 12 months to average $277/m² on an effective basis ($369/m² gross face at 25% incentive).

Incentive levels continue to differ somewhat by location and are largely dependant on the motivation of the landlord and their willingness to renew and lease vacant space. Notwithstanding this, incentives currently average 20% for prime and 25% for secondary (Civic and Parliamentary precincts). With leasing conditions remaining subdued at Canberra's town centres, average incentives are higher at circa 25% for prime and 31% for secondary.

Modest effective rental growth of circa 2% for prime and 0.5% for secondary is expected over the next 12 months as a gradual fall in incentives coincides with a slight pick-up in gross face rents.

TABLE 2

Recent Leasing Activity Canberra

Address	NLA (m²)	Face Rental ($/m²)	Term (yrs)	Tenant	Date
1 Farrell Pl, Civic	620	330g	10	Nicholl & Co	Jan-16
4 National Cct, Barton	4,318	UD	10	ACC	Dec-15
14 Moore St, Civic	471	385g	7	Aurecon	Nov-15
EQ4, 70 Kent St, Deakin	2,275	395g	12	Capital Pathology	Sept-15
40 Allara St, Civic	3,062	385g	5	DFAT	Jul-15
14 Mort St, Civic	9,383	395g	10	Department of Employment	Jul-15

Source: Knight Frank Research g refers to gross UD: Undisclosed

Investment Activity & Yields

Following a slow start to the year, sales activity in Canberra has gained some momentum in recent months, albeit with investors continuing to display a degree of selectiveness between asset grades and leasing profiles.

So far in 2015, five assets ($10m+) have traded across Canberra, totalling $131.78 million and underpinned by Centuria Capital's purchase of 54 and 60 Marcus Clarke Street Civic (from Mirvac). Despite being offered as a portfolio (two in Sydney and one in Melbourne), Centuria bought the two Canberra assets for a combined total of $63.26 million. In spite of elevated buyer demand, investment volumes in Canberra are down 42% from the same time last year, with the reduction the result of assets remaining tightly held.

The underlying theme within the market over the past few years has been quality and WALE with the current spread between prime and secondary yields at all time highs (205bps—see Figure 3). With demand being focussed on quality assets with a minimum WALE of 7 to 8 years, recent yield firming has been confined to the prime market while significant volatility currently exists in the secondary market. Over the past 12 months, prime core market yields have firmed by circa 50bps to range from 6.25% to 7.00% for a new building backed by a 10-15 year Commonwealth lease. Alternatively, a prime asset with a five year lease would trade closer to 7.25%-7.75%.

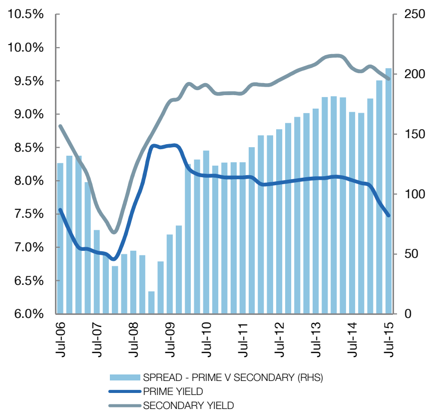
With leasing conditions in the secondary market remaining weak, investors continue to require an elevated risk premium with average core market yields ranging from 9.25% to 11.50%, indicating firming of 16bps over the past year.

Opportunistic purchasers seeking value add/change of use opportunities remain active in the market, demonstrated by the recent sale of 20 Allara Street, Civic for $20.50 million to a local developer. However the extent of this is dependent on government initiatives.

FIGURE 3

Core Market Yields & Spread

Canberra Blended Average—Prime & Secondary



Source: Knight Frank Research

TABLE 3

Recent Sales Activity Canberra

Address	Price ($ mil)	Core Mkt Yield (%)	NLA (m²)	$/m² NLA	WALE (yrs)	Vendor	Purchaser	Sale Date
64 Allara St, Civic	16.80	7.59	3,155	5,325	4.6	Australian Ethical Investment Limited	Cromwell Property Group^	Jul-15
54 Marcus Clarke St, Civic*	14.20	9.73	5,156	2,754	2.1	Mirvac Property Trust	Centuria Metro. REIT	Apr-15
60 Marcus Clarke St, Civic*	49.06	8.69	12,205	4,020	2.1	Mirvac Property Trust	Centuria Metro. REIT	Apr-15
20 Allara St, Civic#	20.50	12.74	13,948	1,470	0.3	Lend Lease Real Estate Investments	Morris Property Group	Apr-15
44 Sydney Ave, Barton	31.22	9.72	9,977	3,129	1.3	360 Capital Canberra Trust	Quintessential Equity	Mar-15~

Source: Knight Frank Research ^ Cromwell Direct Property Fund # Purchased with the intention for residential conversion
~ Exchange of contracts took place in December 2014 with settlement occurring in March 2015 *Select assets which were part of a portfolio divestment

Outlook

- Leasing activity is expected to gather some pace over the next 12 months, particularly in the prime market as private sector tenants continue to take advantage of favourable leasing conditions.
- Following the recent relaxation of the public service hiring freeze, the bulk of vacant government sub-lease space has now been absorbed. In this case, the vacancy rate is anticipated to remain at current levels over the next 12 months.
- While there are a large number of potential office projects in the pipeline, supply is expected to be limited over the next three years off the back of a lack of pre-commitments.
- With supply expected to be constrained, coupled with an improvement in labour market conditions, the vacancy rate is anticipated to trend downwards from mid-2016.
- Effective rents appear to have reached the bottom of their cycle and are expected to see modest growth of circa 2.0% and 0.5% over the next 12 months for prime and secondary markets respectively. This result is underpinned by an anticipated fall in incentives, albeit gradual.
- While investment volumes are slightly down on last year (YTD), buyer demand is expected to remain buoyed over the next 12 months for prime and to a lesser extent secondary stock.
- Demand is expected to remain most pronounced for quality prime assets with solid leasing covenants, however given the lack of prime grade stock brought to the market over the past two years, this segment of the market is relatively untested. The current offering of 255 London Circuit, Civic with a 12 year WALE will provide further clarity for assets with this tenure/covenant.
- Following firming of circa 50bps over the past 12 months, further yield compression in the prime market is anticipated off the back of growing interest from both domestic and overseas buyers. Some firming in the secondary market is expected however will likely remain volatile in the face of soft leasing conditions.

Front cover photo: 60 Marcus Clarke Street, Civic. Owned by Centuria Capital
* Major Precincts incorporates Civic, Parliamentary Precinct & Town Centres

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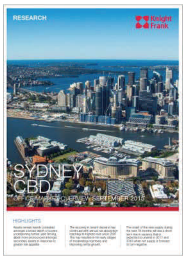
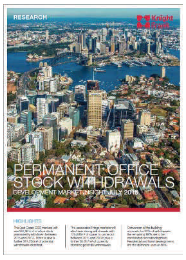


Sydney CBD Office Market Overview
September 2015



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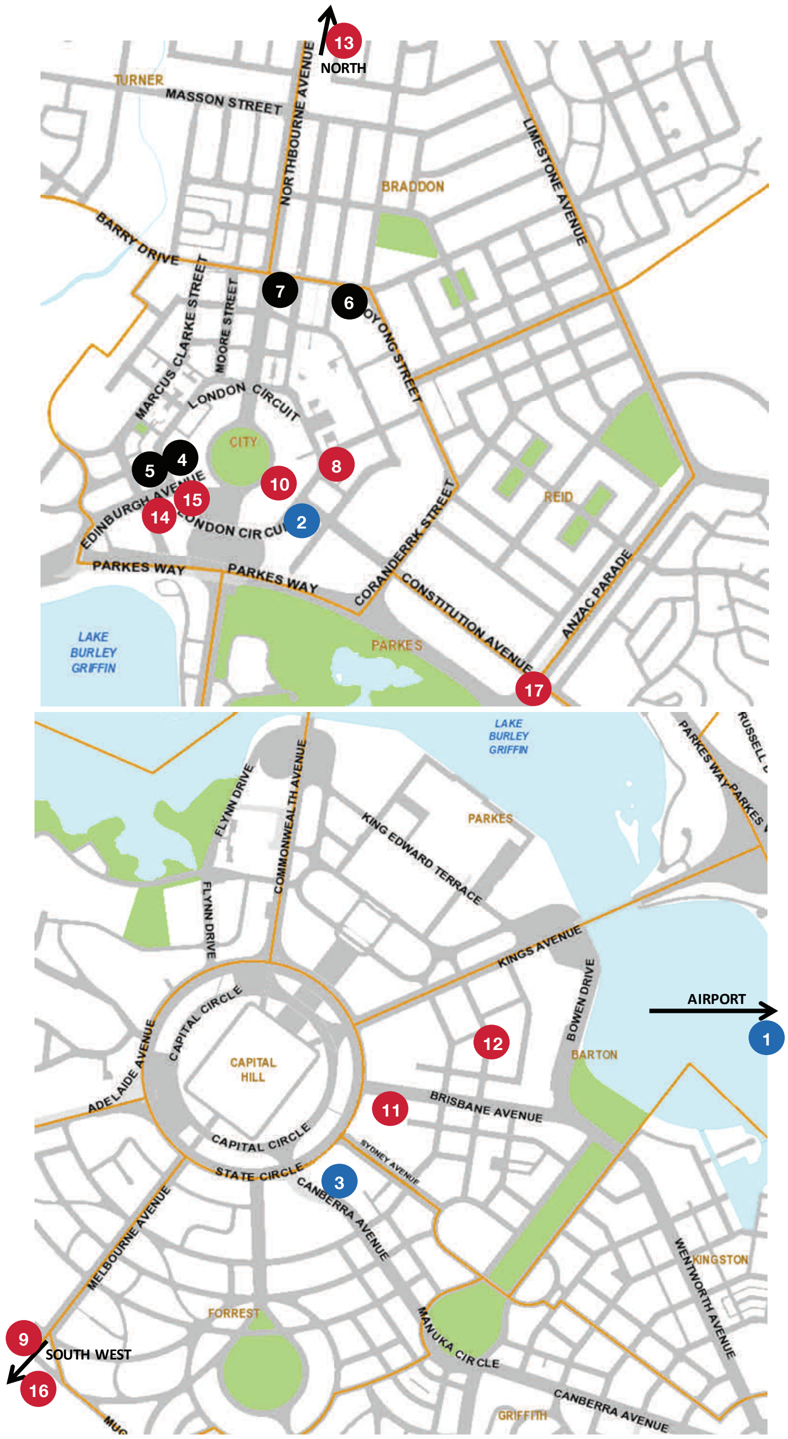
MAJOR OFFICE SUPPLY

1. 3-7 Molonglo Drive, Airport - 36,000m^2
   Capital Airport Group - Complete - awaiting commitment
2. 2 Constitution Ave ^ # - 10,131m^2
   ISPT - Complete (total NLA 20,014m^2) - awaiting commitment
3. 1 Canberra Ave, Forrest - 24,500m^2 [Dept of Finance *]
   Willemsen Group - Complete - 80% committed *
4. Vernon North - Building 4, London Circuit^ - 25,000m^2
   Leighton/Mirvac JV - 2018+ seeking pre-commit
5. Signature Building 2, London Circuit^ - 16,000m^2
   Leighton/Mirvac JV - 2018+ seeking pre-commit
6. Section 96^ - 37,500m^2
   QIC - 2018+ seeking pre-commit
7. Northbourne Square, Northbourne Ave^ - 52,000m^2
   Walker Group - 2019+ seeking pre-commit
8. Nangari Street ^ - 6,500m^2
   Molonglo Group - seeking pre-commit - 2018+
9. 45 Furzer St, Phillip - 40,600m^2
   Doma Group - 2020+ seeking pre-commit
10. Section 19 (Block 4)^ - 40,000m^2
    ACT Government - 2019+
11. 2 Darling Street, Barton - 11,500m^2
    Doma Group - 2018+
12. 44 Macquarie St, Barton - 10,000m^2 mixed use
    Doma/Morris Group - 2018+
13. 26-28 Antill St, Dickson (ex ACT Tab bldg) - 8,000m^2
    Amalgamated Group - 2021+ seeking pre-commit
14. Landmark Building, London Circuit^ - 50,000m^2
    Leighton/Mirvac JV - mooted
15. Vernon South - Building 3, London Circuit^ - 25,000m^2
    Leighton/Mirvac JV - mooted
16. 45 Callam Street, Phillip - 17,500m^2
    Hindmarsh Group - Mooted, seeking pre-commit
17. Anzac Park East, Parkes # - 12,534m^2
    Federal Govt - mooted



Map source: ACT Planning and Land Authority (ACTMAPi)

NB. Dates are Knight Frank Research estimates
Major tenant precommitment in [brackets]
* Under Offer - Contract not yet signed
^ Civic precinct
Office NLA quoted
Major refurbishment

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