

CANBERRA

OFFICE MARKET BRIEF SEPTEMBER 2016

Key Facts

As at July 2016, the Canberra vacancy rate measured 13.0%, down from 15.1% a year earlier.

Tenant demand remains focussed on the prime market, while stock withdrawals in the secondary market has aided the vacancy rate.

Underpinned by a reduction in incentive levels, prime and secondary effective rents increased by 2.1% and 2.8% respectively over the past 12 months.

Yields remain under downward pressure, while the spread between prime and secondary yields has narrowed to its lowest level since 2012.



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Leasing sentiment continues to improve in Canberra, albeit varying by precinct. In combination with further secondary stock withdrawals and a period of weak office supply, the vacancy rate is expected to trend downwards.

Development Activity

Office supply in Canberra has been minimal over the past 12 months where a period of below trend tenant demand and tranches of government sublease space led to the deferral of new projects. In gross terms, just 8,452m² of office NLA was added to the Canberra market over the past 12 months which was the lowest level since the PCA series begun in January 1990. Excluding Hobart, this was the lowest of any CBD market nationally over the past year.

On a net basis, office stock withdrawals are beginning to gain momentum where in combination with a pick-up in tenant demand is placing downward pressure on the vacancy rate. Over the past six months, 19,046m² was withdrawn from the market, resulting in a net reduction of 16,846m² during the period. Notably, 12,985m² of this was for residential conversion including the CSIRO building in Campbell (6,163m²), 217 Northbourne Avenue (3,100m²) and 214 Northbourne Avenue (3,089m²), while the remainder (6,061m²) was withdrawn for refurbishment (10 Brindabella Circuit - 4,700m² and 12 Brindabella Circuit - 1,361m²).

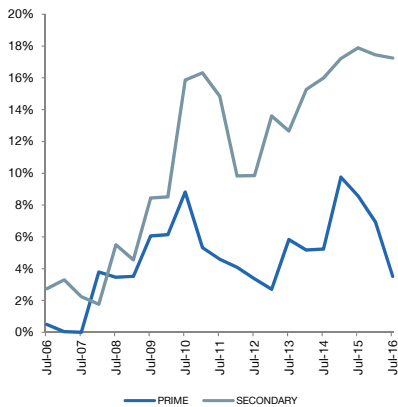
Over the next two years, the supply pipeline across Canberra is limited with the only addition expected to stem from the redevelopment of the Tuggeranong Office Park (30,707m²). The new development is earmarked for completion in Q3 2017 and is 100% committed to the Department of Social Services. Following a lengthy tender process, it was recently announced that Capital Property Group has won the contract to develop an office complex in Civic, adjacent to the Legislative Assembly on London Circuit. The development will include approximately 20,000m² of office NLA (there is potential for further office NLA to be added as part of a speculative build) and will be leased to the ACT government on a 20 year term on completion in mid 2020.

There is potential for a further 290,000m² to be added to the market over the next decade including the development of the existing Motor Vehicle Registry site in Dickson (13,000m²) and numerous sites in Civic (see supply map for details). However, the timing of these sites remains relatively unknown and they are now unlikely they will be delivered prior to 2019 following the progression of the ACT Government office building site in Civic.

Tenant Demand & Vacancy

Notwithstanding the recent Federal election and the forthcoming ACT election in October, the Canberra leasing market has continued to show signs of improvement. A return to more favourable economic conditions and a more buoyant labour market have been the catalysts, while stock withdrawals for alternative uses has placed downward pressure on the vacancy rate. As a result, tenant demand in Canberra has picked up over the past year, with net absorption measuring 29,704m² in the 12 months to July 2016. Although fragility remains in the public sector, it appears the worst of the employment cuts are behind us which should create flow on effects to tenant demand going forward.

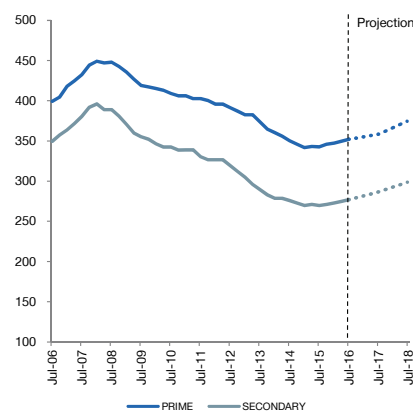
FIGURE 1
Canberra Vacancy Major Precincts*
Per six month period (%) - by grade



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

The Canberra vacancy rate has been steadily decreasing over the past 18 months and currently measures 13.0% as at July 2016, down from 15.1% a year prior. While partly a function of a pick-up in demand, the predominant driver has been a net reduction in stock levels as older underutilised buildings are withdrawn from the market. Currently, the Canberra total A-grade vacancy rate measures 9.9%, however almost 75% of this is located within the Airport precinct. A-grade vacancy in the major precincts such as Civic, Parliamentary and Town Centres is significantly tighter at 3.5% (see Figure 1). The Department of Finance moving into the newly built One Canberra Avenue, Forrest building underpinned the material reduction in the prime vacancy rate in the past six months.

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



Source: Knight Frank Research

Broadly, the aspirational movement of tenants upgrading to higher quality premises has continued, supported by the favourable rental and incentive metrics on offer. As a result, tenant demand in the secondary market remains fragile with the vacancy rate in the major precincts elevated at 17.2%, despite being down from the 17.4% recorded six months prior.

For Civic, the Department of Finance's 'Project Tetris' initiative which was aimed to reduce the amount of vacant space leased by government tenants has reduced sub-lease vacancies within the precinct to measure 1.1%, well below the 4.9% recorded just 18 months earlier. While the total vacancy rate in Civic measures 10.3%, the prime market is significantly tighter at 5.3% where there are limited leasing options available. As a result, existing tenants seeking to remain in the area have been forced to become less selective upon their lease expiry, while potential tenants have been forced to look at secondary leasing options.

Elsewhere, the vacancy rate has reduced significantly in the Parliamentary precinct to 7.4% in July 2016 (from 13.9% in January) following the Department of Finance's occupation of One Canberra Avenue, Forrest. With demand being directed towards Civic and the Parliamentary Precincts, a lack of tenant depth in the Town Centres continues to place little downward pressure on the vacancy rate, where it currently stands at 14.2%. However, with further buildings earmarked for withdrawal through adaptive reuse, the vacancy rate is expected to trend downward over the coming 12 months.

TABLE 1
Canberra Office Market Indicators - July 2016

Grade	Total Stock (m ²)	Vacancy Rate (%)	Annual Net Absorption (m ²)	Annual Net Additions (m ²)	Average Gross Face Rent (\$/m ²)	Outgoings (\$/m ²)	Average Incentive (%)	Average Core Market Yield (%)
A Grade								
Civic (City)	299,888	5.3	8,085	0	444	74	20.6	7.00-7.50*
Parliamentary	261,910	1.6	30,192	0	448	70	17.8	7.00-7.50*
Town Centres	220,633	3.4	1,251	0	385	65	24.5	8.00-8.50
Other	295,006	26.8	769	-6,061				
Secondary								
Civic (City)	388,062	14.3	17,039	0	378	89	26.8	8.00-9.00
Parliamentary	195,698	15.3	3,089	-5,032	388	72	22.0	8.00-9.00
Town Centres	272,670	22.9	-9,980	600	310	67	29.6	8.50-10.50
Other	437,593	12.2	-20,741	-12,748				
Total Market	2,371,460	13.0	29,704	-23,241				

Source: Knight Frank Research/PCA Parliamentary comprises Barton, Parkes and Forrest office precincts Other includes remaining PCA sub localities
* Modern upper prime assets with long WALEs trading below this range (sub 6.00%) Town Centres comprise Phillip, Tuggeranong and Belconnen office precincts

Rents & Incentives

The recent decline in the Canberra vacancy rate is flowing through to the rental market, albeit concentrated in the Civic and Parliamentary precincts. Across the combined Civic and Parliamentary prime markets, gross face rents currently average \$446/m² (\$373/m² net), up 1.4% from 12 months prior. Alternatively, minimal rental growth was recorded in Canberra's Town Centres, increasing 0.3% over the past 12 months (\$385/m² gross).

With a lack of prime leasing options in the Civic and Parliamentary precincts, tenants are being directed towards the secondary market which has led to the outperformance of secondary rents, increasing 1.9% over the past year to July 2016 to measure \$383/m² gross (\$302/m² net). Similar to the prime market, secondary rents in the Town Centres have been stagnate, currently averaging \$310/m² gross (\$243/m² net).

Although very asset specific, incentive levels have begun to decline, currently averaging 19% for prime and 24% for secondary across the Civic and Parliamentary precincts. As a result, gross effective rents increased 2.1% for prime and 2.8% for secondary where a number of private sector tenants have been actively seeking secondary space. A moderate reduction in incentive metrics has also been recorded for prime space at Canberra's Town Centres, however remain elevated in the secondary market.

Investment Activity & Yields

Investment demand in Canberra has picked up considerably throughout 2016, as both local and offshore investors are drawn to the elevated yield metrics on offer when compared to Sydney and Melbourne. So far in 2016, sales volumes (\$10m+) have totalled \$241.6 million across six

TABLE 2

Recent Leasing Activity Canberra

Address	NLA (m ²)	Face Rental (\$/m ²)	Term (yrs)	Tenant	Date
221 London Cct, Civic	394	415g	5	Capgemini Australia	Mar-17
2 Constitution Ave, Civic	2,799	U/D	12	ACT Corrective Services	Dec-16
55 Blackall St, Barton	380	380g	2	Boeing	Nov-16
60 Marcus Clarke St, Civic	1,342	405g	3	AECOM	Sep-16
2 King St, Deakin	437	380g	4	Konekt Australia	Jul-16

Source: Knight Frank Research g refers to gross U/D: Undisclosed

transactions. This result was up 83% from the same time last year and was largely the result of the recent sales of 111 Alinga Street (sale price held commercial in confidence) and Aviation House (16 Furzer Street, Phillip) for \$68.07 million. With Aviation House representing a core market yield of 8.09%, the sale provided clarity towards the firming of yield metrics in Canberra's Town Centres. With the pending Civic sales 62 Northbourne Ave and the Finlay Crisp Centre, investment volumes during 2016 are anticipated to be above 2015 levels.

With fewer buying opportunities in the prime market, investors are increasingly becoming more willing to move up the risk curve and purchase secondary assets with more leasing and vacancy risk. Opportunistic purchasers seeking value add/change of use opportunities have also been active in recent months, demonstrated by the April 2016 sale of 217 Northbourne Avenue, Turner for \$12.99 million. At the same time, the recent sale of Dickson on Northbourne for \$40 million highlights the strong demand for development sites across Canberra.

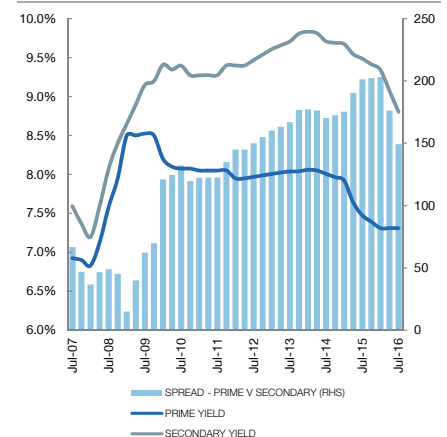
Yield metrics continue to tighten, however the rate of firming over the past six months has been strongest in the secondary market. Over the past 12 months, firming in the prime market has moderated,

reducing 16 bps over the period in the Civic and Parliamentary precincts, well below the 68 bps recorded in the secondary market. For a new prime building backed by a 10-15 year Commonwealth lease, a core market yield in the order of 5.50% to 6.00% would be achievable, however without the same income security (i.e. a five year WALE), a core market yield of 7.00% to 7.50% would be more likely. Depending on location and based on a five year WALE, yield metrics in the secondary market are estimated to range between 8.00% and 10.50%.

FIGURE 3

Core Market Yields & Spread

Canberra Blended Average—Prime & Secondary



Source: Knight Frank Research

TABLE 3

Recent Sales Activity Canberra

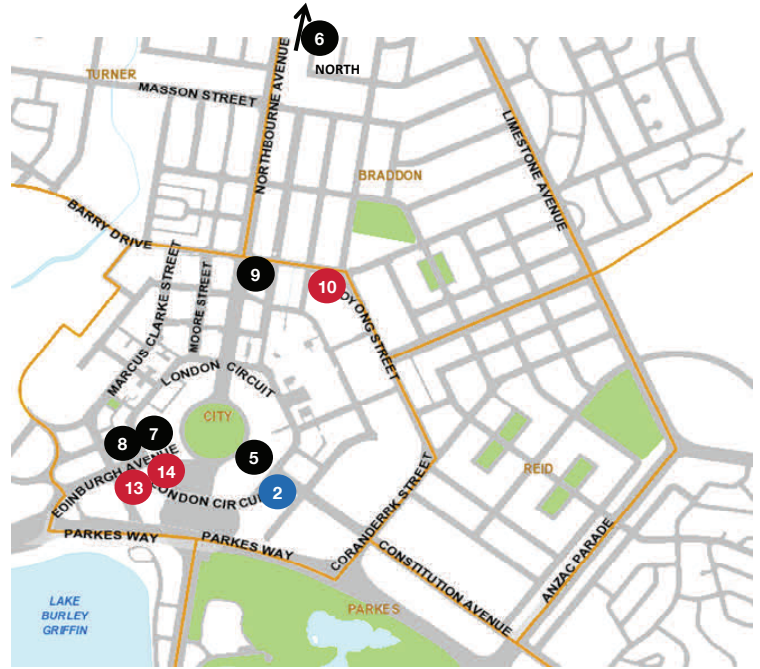
Address	Price (\$ mil)	Core Mkt Yield (%)	NLA (m ²)	\$/m ² NLA	WALE (yrs)	Vendor	Purchaser	Sale Date
111 Alinga St, Civic	Conf.	Conf.	16,413	4,661	Conf.	Brookfield Australia	Prime Super	Aug-16
16 Furzer St, Phillip>	68.07	8.09	14,812	4,596	4.9	Mirvac	Patella Properties	May-16
73 Northbourne Ave, Civic	29.20	7.85	6,112	4,777	2.9	Hume Partners Property	South Haven Group	Apr-16
217 Northbourne Ave, Turner~	12.99	VP	3,204	4,057	VP	217 NBA Pty Ltd	Arc Constructions ACT	Apr-16
197 London Cct, Civic^	13.53	9.82	5,883	2,299	0.9	Private Investor	Zapari Group	Jan-16

Source: Knight Frank Research ~ Bought for residential development > Also known as Aviation House ^ Also known as Eclipse House
VP Vacant possession Conf.: Confidential

MAJOR OFFICE SUPPLY

- 1** 3-7 Molonglo Drive, Airport - 36,000m² [DoI&BP*]
Capital Airport Group - Complete - 100% committed
- 2** 2 Constitution Ave ^ # - 10,131m² [ACT Govt]
ISPT - Complete (total NLA 20,014m²) - 28% committed
- 3** One Canberra Ave, Forrest - 24,500m² [Dept of Finance]
Willemssen Group - 100% committed
- 4** Tuggeranong Office Park - 30,707m² [Dept of Social Services]
Cromwell Property Group - Q3 2017, 100% committed -
- 5** Section 19 (Block 4)^ - 20,000m² + >
ACT Government/Capital Property Group - 2020
- 6** 13-15 Challis St, Dickson - 13,000m² (Motor Vehicle Registry site)
ACT Government - 2019
- 7** Vernon North - Building 4, London Circuit^ - 25,000m²
Leighton/Mirvac JV - 2019+ subject to pre-commitment
- 8** Signature Building 2, London Circuit^ - 16,000m²
Leighton/Mirvac JV - 2019+ subject to pre-commitment
- 9** Northbourne Square, Northbourne Ave^ - 52,000m²
Amalgamated Property Group - 2020+ subject to pre-commitment
- 10** Section 96^ - 37,500m²
QIC - 2019+ subject to pre-commitment
- 11** 45 Furzer St, Phillip - 40,600m²
Doma Group - 2020+ subject to pre-commitment
- 12** 2 Darling Street, Barton - 11,500m²
Doma Group - 2019+
- 13** Landmark Building, London Circuit^ - 50,000m²
Leighton/Mirvac JV - mooted
- 14** Vernon South - Building 3, London Circuit^ - 25,000m²
Leighton/Mirvac JV - mooted
- 15** 45 Callam Street, Phillip - 17,500m²
Hindmarsh Group - Mooted, subject to pre-commitment

NB. Dates are Knight Frank Research estimates
 Major tenant precommitment in [brackets]
 * Dept of Immigration & Border Protection
 > Potential for additional office NLA as part of a speculative build
 + Government commitment on completion
 ^ Civic precinct
 Office NLA quoted
 # Major refurbishment
 ~ Development is of the same size as what it's replacing



- Under Construction/Complete
- DA Approved / Confirmed / Site Works
- Mooted / Early Feasibility

Outlook

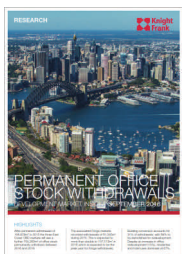
- With the Federal election now over and the worst of the public sector employment cuts behind us, it is expected that leasing activity will pick-up over the coming 12 months, particularly from Government departments who over the past six months have held back on space commitments.
- In combination with further stock withdrawals in the secondary market and persistent demand from privates expanding through a pick-up in employment growth, the vacancy rate is expected to trend downwards.
- The supply pipeline is limited at present with just 30,707m² expected to be added to the market over the next 18 months, stemming from the completion of the Tuggeranong Office Park. While there are a large number of projects in the pipeline including the recently awarded contract to Capital Property Group to construct a 20,000m² office building in Civic, these projects will not be delivered prior to 2019 and are reliant on significant tenant pre-commitments.
- After reaching the bottom of their cycle in late 2015, a period of modest effective rental growth is expected, stemming from both a modest increase in face rents and a fall in incentives. Effective rental growth of between 2.0% and 2.5% is expected for both prime and secondary markets in the Civic and Parliamentary precincts over the next 12 months.
- Sales activity is expected to remain strong throughout the remaining months of 2016. The yield disparity between the Sydney and Melbourne CBD markets will also support further buying demand where prime assets in Canberra are priced circa 200 basis points higher.
- Further yield compression is expected, particularly in the secondary market where pricing parameters are expected to reflect alternative use potential. In this case, the convergence experienced over the past six months between prime and secondary yields is expected to become more pronounced throughout 2016 and into 2017. However, volatility in the secondary market is expected to continue.

Front cover photo: One Canberra Avenue – Willemsen Group

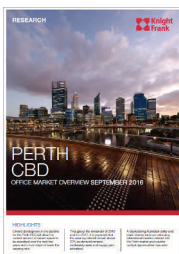
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