RESEARCH

CANBERRA

OFFICE MARKET BRIEF MARCH 2017

Key Facts

As at January 2017, Canberra's overall vacancy rate measured 12.6%, down from 13.0% in July 2016 and 14.6% a year prior.

Two speculative developments totalling circa 30,000m^2 are expected to be activated this year, indicative of a high level of confidence in future leasing conditions.

Prime and secondary effective rents have increased by 2.3% and 7.8% YoY respectively on average across Civic and Parliamentary precincts.

Yields continue to firm across the board on the back of strong investor demand amid limited available stock nationally.

ALEX PHAM

Senior Research Manager

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Leasing market fundamentals are improving across the Canberra office market, evidenced by two speculative developments of circa 30,000m^2 in the CBD, while the vacancy rate continues on a downward trajectory.

Development Activity

The Canberra office market is going through a period of solid demand and low levels of supply with just 3,304m^2 of gross office space added to the market over the past six months. Much of this modest supply was derived from refurbished space (2,700m^2) at 19-23 Moore Street, Turner. Annually, only 5,540m^2 of new NLA has been added to the market, the lowest level of supply in Canberra since the PCA began tracking the market in 1990.

The supply shortage has been further exacerbated by the increased withdrawal of office stock for residential or alternative uses. Over the six months to January 2017, 33,616m^2 was withdrawn from the market, resulting in a net contraction of 29,312m^2 in total stock over the year. Major permanent withdrawals over the past six months included 92-94 Northbourne Avenue, Braddon (3,450m^2) to be converted into residential and hotel uses, Eclipse House in Civic (5,864m^2) to be adapted into a hotel, and two buildings at 15 Mort Street (3,816m^2) and 17 Mort Street (1,699m^2) in Civic, being demolished to make way for the Civic Quarter development.

Looking forward, new additions are expected to increase in 2017, although uncommitted supply will be limited. The bulk of the new supply this year will be generated from the completion of a new 30,707m^2 building at Tuggeranong Office Park in Q3 2017, which will be fully occupied by the Department of Social Services. Additionally, two smaller refurbished assets in Civic will be available earlier in the year at 33 Allara Street (9,201m^2), which is 43% pre-committed to the Murray-Darling Basin Authority (MDBA), and 17 Moore Street (5,857m^2).

The ACT Government has recently agreed to a 20-year lease of a 20,000m^2 building at the Constitution Place development in the CBD with occupation expected in Q3 2020. This development will also comprise a speculative building of 12,000m^2 of office NLA. Another speculative project in the pipeline is the Civic Quarter development with a proposed office NLA of 18,000m^2, due for completion in Q3 2019. Across the ACT, there is potential for circa 210,000m^2 of DA approved office space development to be unlocked in the future. However, the timing of these projects remains elusive without tenant pre-commitments.

Tenant Demand & Vacancy

Leasing conditions in the Canberra office market continue on an uptrend on the back of a strong economy and a solid labour market. Over the year to February 2017, ACT's employment grew by 2.2% (4,600 jobs) which is almost triple the national average of 0.8%, according to the latest ABS figures. At 3.8% the Territory has the second lowest unemployment rate of all jurisdictions in the nation. The buoyant job market has translated to heightened space demand with net absorption measuring 8,080m² in the 12 months to January 2017. This comes as the Federal Government has begun to shelve any further cost cutting measures.

As a result of improved tenant demand, combined with negative net supply, Canberra's vacancy rate has been on a downward trend over the past two years to 12.6% as at January 2017, down from 13.0% in July 2016 and 14.6% a year prior. While partly a consequence of demand improvement, the significant withdrawal of secondary stock has been the primary reason behind the recent reduction in vacancy.

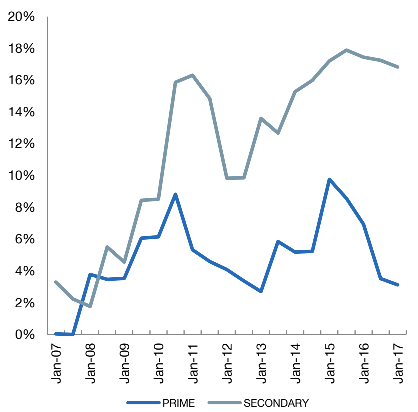
As at January 2017, A-Grade vacancy in the Canberra office market measured 9.5%, although the majority of this vacancy (75%) remained isolated within the Airport precinct. Looking forward however, we expect the Airport precinct vacancy rate to be substantially reduced with the Commonwealth Department of Immigration and Border Protection having committed to lease 3 Molonglo Drive (circa 36,000m²) with occupation expected from mid-2019. Excluding the Airport precinct, Canberra's A-Grade vacancy rate was extremely tight at 3.1% as at January 2017, down from 3.5% six months prior and substantially below the 10-year average of 5.0%. The significant reduction in prime vacancy is partly driven by the lack of new supply of prime office space over the past few years.

With demand being skewed towards prime space, many older buildings are being taken offline for redevelopment, resulting in the secondary vacancy rate within the major precincts of Canberra falling to 16.8% as at January 2017, from 17.2% six months prior. We expect these trends to be maintained over the next few years, which will see further reduction in the amount of vacant secondary space.

In the Civic precinct, the Department of Finance's 'Project Tetris' initiative continues to achieve the desired outcome with sub-lease vacancy further reduced to 7,018m², well below the peak of 33,700m² recorded just two years ago. As a result, the total vacancy rate in the Civic precinct declined to 9.4% as at January 2017, from 10.3% in the middle of last year and 14.7% a year ago.

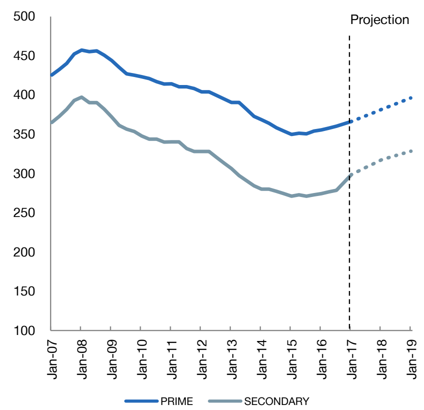
Importantly, vacancy in the prime market of Civic is significantly tighter at 4.2% as at January 2017, down from 5.3% six months ago and 11.1% at its peak in January 2015. With availability being diminished in the prime market, existing tenants with a requirement are becoming less demanding when it comes to lease renegotiation while potential tenants wishing to be in Civic will be encouraged to consider secondary options.

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

TABLE 1
Canberra Office Market Indicators - January 2017

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 (%)
A Grade								
Civic (City)	299,888	4.2	4,667	0	455	73	19.5	7.00-7.50
Parliamentary	261,910	1.3	24,967	0	448	70	17.8	6.75-7.25
Town Centres	220,633	3.9	223	0	390	65	24.5	7.75-8.75
Other	295,006	27.5	-325	-6,061				
Secondary								
Civic (City)	361,588	13.8	-18,186	-26,474	393	88	24.0	8.25-9.00
Parliamentary	195,698	14.7	6,375	0	393	72	20.0	8.25-8.50
Town Centres	273,270	22.3	-4,554	600	310	67	29.6	10.00-12.00
Other	434,155	11.4	-5,087	-14,223				
Total Market	**2,342,148**	**12.6**	**8,080**	**-46,158**				

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

A significant reduction in A-Grade vacancy has also been recorded in the Parliamentary precinct with the prime vacancy rate currently standing at 1.3%. This is substantially lower than the 10-year average of 7.7% and a rate of 10.8% just 12 months ago. While Government agencies continue to dominate larger tenancy requirements, demand from private corporations has also picked up over the past 12 months. This is evidenced by a major leasing deal of 3,200m² at 8 Brisbane Avenue, Barton by Lockheed Martin. Further afield, leasing conditions in the Town Centres remains steady, with the prime vacancy rate measuring 3.9% as at January 2017.

TABLE 2

Recent Leasing Activity Canberra

Address	NLA (m²)	Face Rental ($/m²)	Term (yrs)	Tenant	Date
33 Allara St, Civic	3,983	425g	10	MDBA	Apr-17
4 National Cct, Barton	865	U/D	9	ACIC	Dec-16
221 London Cct, Civic	1,025	395g	10	ACT Government	Jan -17
54 Marcus Clarke St, Civic	274	410g	3	IAS	Jan -17
20 Bradley St, Phillip	119	700g	5	Aussie	Jan -17

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

Rents & Incentives

The lowered vacancy rate, coupled with significant stock withdrawal is having a positive effect for rental growth across the Canberra market, particularly in the Civic and Parliamentary precincts. Gross face rents across the Civic and Parliamentary prime markets have increased by 1.2% YoY to $452/m² ($380/m² net) as at January 2017. This is higher than the 10-year average of 0.8%. In the secondary market, the reduction of available stock has led to secondary rental growth outperforming prime rental growth at 3.7% over the past 12 months ($393/m² gross face). Across the Town Centres, positive leasing sentiment is also apparent in the prime market, while the secondary market remains relatively benign. Town Centres' prime rents have grown by 1.3% over the past 12 months to $390/m² ($325/m² net) as at January 2017. Secondary gross face rents remain steady at around $310/m².

The overall incentive levels have begun to decline, although variations exist between different assets and locations. Prime incentives in Civic and Parliamentary precincts currently measure around 17.8% and 19.5% respectively while secondary incentives are around 20% and 24% respectively. The reduced incentives have resulted in gross effective rental growth of 2.3% p.a. for prime and 7.8% p.a. for secondary stock. Looking ahead, prime and secondary effective rents are expected to grow at 4.0% and 6.0% p.a. respectively over the next 12 months,

Investment Activity & Yields

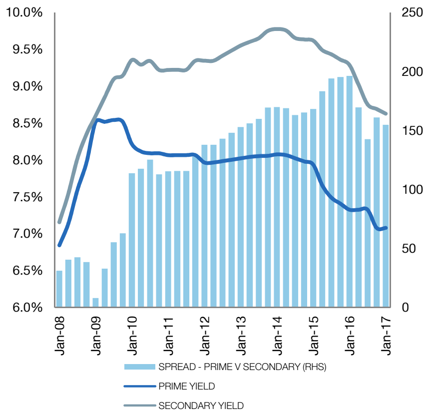
The Canberra office market continues to attract considerable capital interest from both offshore and local investors attracted by the relatively favourable pricing metrics compared to Sydney and Melbourne. The total office sales volume ($10 million+) measured $418.7 million in 2016. Although the total value was 20% lower than the record investment level in 2015, the number of transactions was higher since the figure in 2015 was artificially skewed by the sale of the Louisa Lawson building for $224.5 million. The Civic precinct continues to receive the majority of investor interest due to its superior location and strong leasing fundamentals. Major recent office transactions in the Civic precinct recently include Infrastructure House (111 Alinga Street, Civic) sold for $76.5 million and 62 Northbourne Avenue sold for $58.5 million. These transactions have confirmed further yield compression for prime assets in Civic, which are currently trading at 7.0% to 7.5% yields.

The Canberra investment market is set for another stellar year ahead with at least $549 million of transactions in due diligence in the first quarter of 2017. Significant assets expected to be settled in the year include 50 Marcus Clarke Street, Civic, 82 Northbourne Avenue, Braddon, Scarborough House, Phillip, 39 Brisbane Avenue, Barton, 2-6 Bowes Street, Phillip, Finlay Crisp Offices, Civic and 8-10 Hobart Place, Civic, amongst others. Knight Frank's preliminary analysis of these sale metrics indicate that yields will be tightened further across the board.

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	NLA (m²)	$/m² NLA	WALE (yrs)	Vendor	Purchaser	Sale Date
8 Atlantic St, Woden«	72.33	C/C	16,78	4,310	8.2	Indigenous REIT	Centuria	Nov-16
62 Northbourne Ave, Civic	58.50	6.49	10,21	4,747	9.8	Credit Suisse	Ascot Capital	Sep-16
111 Alinga St, Civic	76.50	6.97	16,41	4,661	9.9	Brookfield Australia	Prime Super	Aug-16
68-72 Northbourne Ave, Civic^	34.00	8.80	25,34	1,341	0.0	Walker Corporation	Amalgamated Property Group	Jul-16

Source: Knight Frank Research   C/C refers commercial in confidence   « exchanged in November 2016 with a delayed settlement   ^ purchased for redevelopment

Outlook

- The ACT economy is expected to remain in prime condition over the next twelve months, supported by improved retail trade and a solid labour market. Combined with the lifting of further cuts and hiring freezes by the Commonwealth Government, this will translate to improved office space demand by both government and private sectors.

- The new direct international flights to Canberra will have a positive flow on effect to the commercial market with Canberra now being directly connected to the most important trading routes between Australasia and Asia. This will boost significant growth in the service sector in the ACT, which is the primary driver of office demand.

- Another 45,700m² is expected to be added to the market this year, although uncommitted supply will be limited. The majority of the additional space in 2017 will stem from the completion of the new building (30,707m²) at Tuggeranong Office Park to be occupied by the DDS, who will move from an existing building of 33,500m² within the same precinct.

- The overall vacancy rate in Canberra is expected to tighten further over the next twelve months. Coupled with limited short term supply and high levels of withdrawals this will drive strong effective rental growth in both the prime and secondary markets.

- Effective gross face rents in the prime market are expected to grow at around 4.0% over the next twelve months while secondary effective gross face rents are forecast to increase by around 6.0% over the same period, although growth rates are expected to vary between individual assets and precincts.

- Investment activity is anticipated to remain solid over 2017, with investor demand being elevated by the attractive value proposition in Canberra compared to Sydney and Melbourne. Consequently, yields are expected experience further compression across the board due to the lack of opportunity nationally and an increase in the number of investors moving up the risk curve in search for value-added opportunities.

Front cover photo: Canberra International Airport – Canberra Airport Group
* Major Precincts incorporates Civic, Parliamentary Precinct & Town Centres

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RESEARCH
Alex Pham
Senior Research Manager
+61 2 9036 6631
Alex.Pham@au.knightfrank.com

ACT
Terry Daly
Managing Director, ACT
+61 2 6221 7869
Terry.Daly@au.knightfrank.com

OFFICE LEASING
Nicola Cooper
Senior Director, Head of Division, Canberra Office Leasing
+61 2 6221 7861
Nicola.Cooper@au.knightfrank.com

Daniel McGrath
Associate Director, Commercial Sales & Office Leasing, Canberra
+61 2 6221 7882
Daniel.McGrath@au.knightfrank.com

CAPITAL MARKETS
Nic Purdue
Associate Director, Institutional Sales
+61 2 6221 7858
Nic.Purdue@au.knightfrank.com

Paul Henley
Head of Commercial Sales
+61 3 9604 4760
Paul.Henley@au.knightfrank.com

VALUATIONS
Steven Flannery
Director Valuations, Canberra
+61 2 6221 7881
Steven.Flannery@au.knightfrank.com

Martin Elliott
Director Valuations, Canberra
+61 2 6221 7878
Martin.Elliott@au.knightfrank.com

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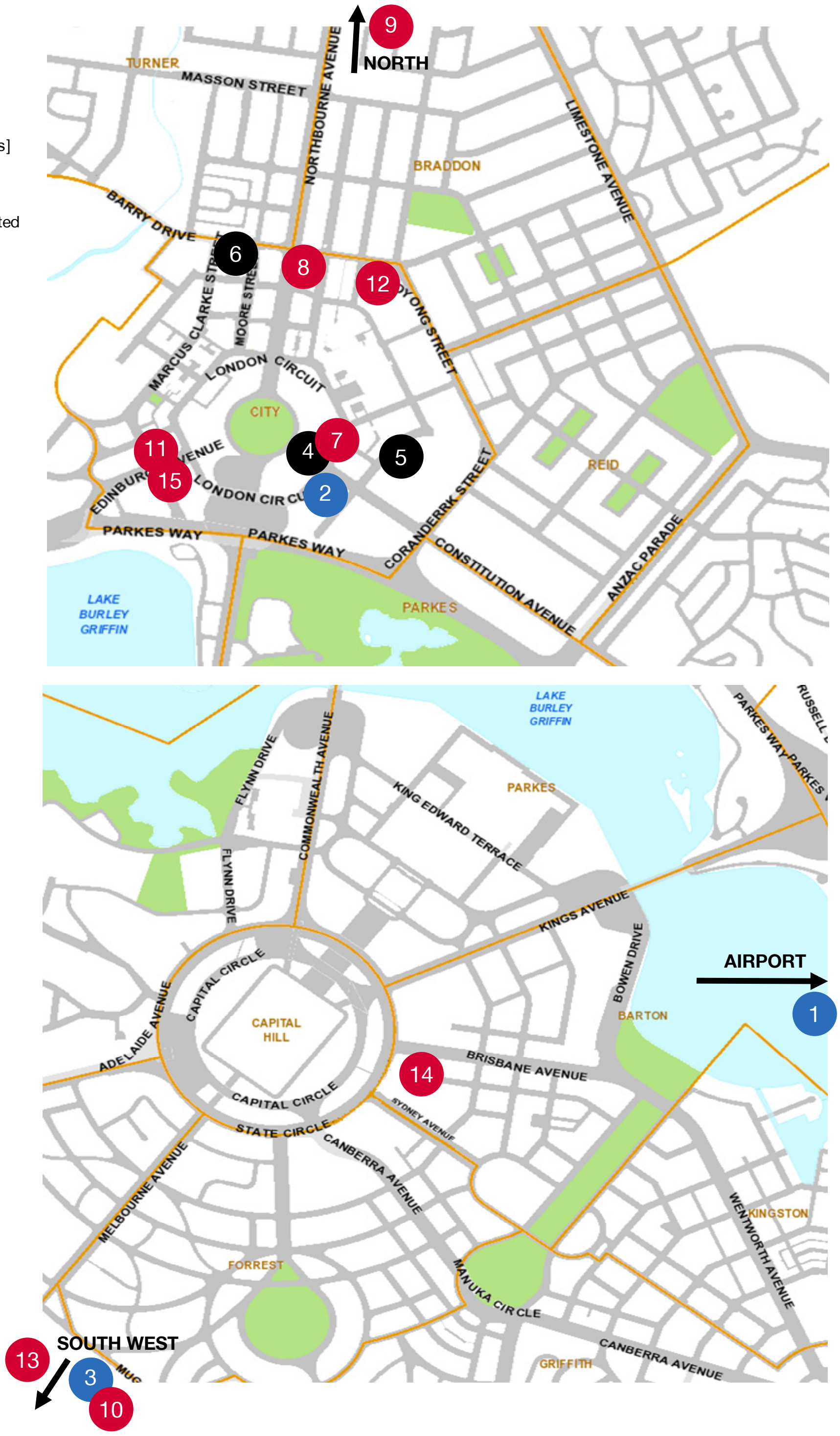
MAJOR OFFICE SUPPLY

1. 3 Molonglo Drive, Airport - 36,000m^2 [DoI&BP*]
   Capital Airport Group - Complete - 100% committed
2. 2 Constitution Ave^ # - 6,815m^2
   ISPT - Complete (total NLA 20,014m^2) - 66% committed
3. Tuggeranong Office Park - 30,707m^2 [Dept of Social Services]
   Cromwell Property Group – Q3 2017, 100% committed ~
4. Consitution Place (Bld. 1)^ - 20,000m^2 [ACT Govt]
   ACT Govt/Capital Property Group - Q3 2020, 100% committed
5. 33 Allara St^ # - 9,201m^2 [MDBA]
   Molonglo Group - Q2 2017, 43% committed
6. 17 Moore St^ # - 5,857m^2
   CorVal - Q2 2017
7. Constitution Place^ (Bld. 2) - 12,000m^2 ≈
   Capital Property Group - Q4 2019
8. Civic Quarter, Northbourne Ave^ - 18,000m^2 ≈
   Amalgamated Property Group - Q3 2019
9. 13-15 Challis St, Dickson - 13,000m^2 (MVR site ‡)
   ACT Govt - 2019+
10. Section 12 (Block 9 & 10) - 35,000m^2
    A&S Haridemos - 2020+
11. Signature Building 2, London Circuit^ - 16,000m^2
    Leighton/Mirvac JV - 2019+ subject to pre-commitment
12. Section 96^ - 37,500m^2
    QIC - 2019+ subject to pre-commitment
13. 45 Furzer St, Phillip - 40,600m^2
    Doma Group - 2020+ subject to pre-commitment
14. 2 Darling Street, Barton - 11,500m^2
    Doma Group - 2019+
15. Landmark Building, London Circuit^ - 54,000m^2
    Leighton/Mirvac JV - mooted

NB. Dates are Knight Frank Research estimates
Major tenant precommitment in [brackets]
* Dept of Immigration & Border Protection
≈ Speculative Development
^ Civic precinct
Office NLA quoted
Major refurbishment
~ Development is of the same size as what it's replacing
‡ Motor Vehicle Registry site

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



Source of Map: ACT Planning and Land Authority (ACTMAPi)