RESEARCH

MAY 2013

# MELBOURNE SUBURBAN

Office Market Brief

## HIGHLIGHTS

- While the development pipeline in 2013 is expected to be higher than the previous two years, new supply remains below the long term average. New supply scheduled for completion this year is forecast to total 32,646m$^2$. With pre-commitment levels within the new stock healthy, options for tenants seeking new accommodation will remain limited.

- Despite uncertain economic conditions, tenant demand remains solid in the suburban office market with net absorption positive in the six months to April 2013. Melbourne's Suburban office vacancy rate decreased over the six months to April, falling to 5.4% from 6.2%. Melbourne's Suburban office market remains one of the tightest office markets, not just in Victoria, but nationally.

- The Melbourne suburban market continues to present an attractive investment opportunity. Despite fears of continued economic weakness, a constrained development pipeline coupled with the spread between borrowing costs and yields has fuelled investor interest.  In the 12 months to May 2013, investment activity in the Melbourne Suburban office market totalled $295.0 million.

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Table 1
Melbourne Suburban Office Market Indicators as at April 2013

| Market | Total Stock ($m^2$) | Vacancy Rate (%) | Six Month New Supply ($m^2$) | Six Month Net Absorption ($m^2$) | Average Prime Net Face Rent ($/ $m^2$) | Average Secondary Net Face Rent ($/ $m^2$) | Average Prime Core Market Yield (%) | Average Secondary Core Market Yield (%) |
|---|---|---|---|---|---|---|---|---|
| City Fringe | 1,022,314 | 4.4 | 5,000 | 10,420 | 320 – 350 | 260 – 290 | 8.00 – 8.75 | 8.75 – 9.25 |
| Inner East | 548,198 | 3.7 | 3,595 | 3,609 | 310 – 360 | 260 – 300 | 8.00 – 8.75 | 8.75 – 9.25 |
| Outer East | 755,162 | 7.2 | 11,300 | 1,876 | 270 – 310 | 200 – 250 | 8.25 – 8.75 | 9.00 – 10.00 |
| South East | 263,221 | 7.5 | 2,328 | -516 | 220 – 250 | 185 – 220 | 8.50 – 9.00 | 9.50 – 10.50 |
| **Total Market / Average** | **2,588,895** | **5.4** | **22,223** | **15,389** | **280 – 315** | **225 – 265** | **8.25 – 8.80** | **9.00 – 9.75** |

Source: Knight Frank
Definition: Grade: Prime includes office assets of Premium and A quality whilst Secondary includes office assets of B, C & D quality

## Supply & Development Activity

New supply within the Melbourne Suburban office market remains constrained, following the economic slowdown in 2009. Between 2010 and 2013, 50,082$m^2$ was added to the Melbourne Suburban office market in contrast to the 95,348$m^2$ that was added to the market in 2009 alone. While new construction is forecast to pick up in 2013, annual new supply will remain below the historical average in the medium term with 32,646$m^2$ scheduled for completion in 2013 and 28,882$m^2$ forecast in 2014.

Reflecting the cautious tenant environment and tighter funding conditions, new supply remains pre-commitment driven with 81% of the supply currently under construction pre-leased. In fact, the lean new supply pipeline has been underpinned by various government entity backed projects with the Australian Taxation Office, South East Water, and City West Water all pre-committing to new developments. By precinct, of the new stock delivered to the suburban office market in 2012, 58% was located in the Outer Eastern region. The current development pipeline reveals that the Outer East region will continue to dominate new supply accounting for 51% of suburban office space currently under construction.

## Tenant Demand & Rents

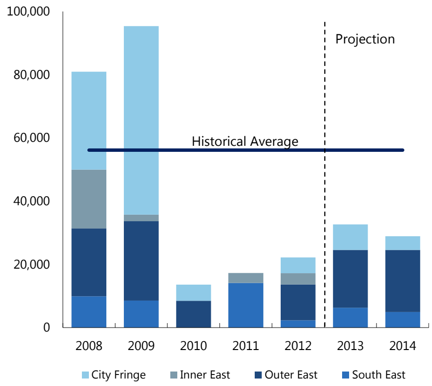
As at April 2013, total vacancy within the Melbourne Suburban office market fell from 6.2% to 5.4%, below the long term average of 5.8%. Increasingly tenant demand is being driven by cost sensitive occupiers and staff attraction (and retention) which has led to a gradual disconnect between regions and office grades.

Over the past six months, office vacancies have fallen in the City Fringe and Inner Eastern regions, to 4.4% (from 5.4%) and 3.7% (from 6.2%) respectively – their lowest levels since July 2008. Conversely, vacancies rose in both the Outer East and South Eastern precincts over the six months to April 2013.

Tenants have also recently capitalised on the competitive leasing conditions on offer to upgrade their office accommodation. Tenants have regularly consolidated multiple locations into better quality offices, utilising more flexible and efficient fitouts. Overall suburban A-grade office vacancy fell to 5.5% in the six months to April, with all precincts recording a decline in prime vacancies with the exception of the South East.

White collar employment growth within the suburban market has lifted in the past 12 months, increasing to an annual growth of 2.4% improving from 1.3% and 1.4% in the preceding two years. Professional Services, Health Care and the resurging Education sector are forecast to drive white collar employment growth over the next three years. Whilst tenant demand levels have not yet returned to long term averages, occupier demand significantly increased in the six months to April in comparison to the previous six month period. The Suburban office market recorded positive net absorption with the City Fringe and Inner Eastern precincts accounting for 91% of total absorption across the suburban market.

Figure 1
Suburban New Office Supply
($m^2$) 2008-2014




Source: Knight Frank

Although a number of tenants including BUPA, Salta Properties and Federation Centres (formerly Centro) will relocate into the CBD, the improving tenant demand (albeit slight), limited vacant A-grade opportunities and muted development pipeline is likely to ensure that vacancy will remain below the 10-year average in the short term. Net face office rents have remained relatively stable over the past six months in the Suburban office market, as a result of tenants remaining cautious. While incentive levels have largely remained contained, levels have increased in select buildings to offset upcoming vacancies.

## Investment Activity

Boosted by Cromwell Property Group's purchase of the new Australian Taxation Office development in Box Hill, investment activity in 2012 reached their highest levels since 2009. Investment sales activity (above $10 million) in 2012 within the Melbourne suburban office market totalled $318.5 million across 11 properties. In the year to date, while only three transactions above $10 million have been completed; similar levels were transacted in 2012 over the same period.

Attracted by the high yields on offer and balanced outlook for the suburban office market, unlisted funds, syndicates and private investors have been the leading purchasers of stock over the past 18 months. In contrast to Melbourne's other office markets, offshore investment in the suburban office market has been limited recently with only one asset acquired over the past two years by offshore interests.

Over the past 18 months, the City Fringe has been the focal point of investment activity with 42% of all suburban office transactions occurring in the precinct. While the Outer East accounted for 32% of office transactions (by value) this resulted solely from the sale of the ATO development in Box Hill. Investor appetite continues to gather momentum in the Suburban office market, buoyed by the compelling spread between debt costs and suburban office yields and underlying fundamentals. Given the fall in interest rates to record lows coupled with the resilience of the suburban market, core market yields are likely to begin to compress late 2013.

## Outlook

Melbourne's Suburban office market remains resilient; benefiting from its limited supply risks. New supply scheduled for completion this year in the Suburban office market is forecast to total 32,646m$^2$ – 41% below the long term annual average. Of the new supply entering the suburban market currently under construction, more than 81% is pre-committed. Vacancy is expected to remain at or below the long-term average and will support increasing competition for quality stock. As a result, the outlook for rental growth is relatively positive over the medium term. Given that suburban office yields remain extremely attractive relative to fixed income returns, there is increasing pressure on yields to compress through 2013 as the weight of funds for suburban assets continues to grow.

Table 2
### Recent Sales Activity Melbourne Suburbs

| Address | Price ($ mil) | Core Market Yield (%) | NLA (m$^2$) | $/m$^2$ of NLA | WALE (yrs) | Vendor | Purchaser | Sale Date |
|---|---|---|---|---|---|---|---|---|
| 17-27 Cotham Rd, Kew | 10.25 | 8.14 | 2,721 | 3,767 | 3.2 | Private Investor | Private Investor | Apr-13 |
| 15 Compark Circuit, Mulgrave | 7.70 | 9.70 | 2,955 | 2,605 | 3.9 | Trinity Group | Private Investor | Mar-13 |
| 973 Nepean Hwy, Bentleigh | undis | n/a | 11,825 | undis | 5.0 | Deloitte | Private Investor | Feb-13 |
| 436 Johnston St, Abbotsford | 32.0 | 10.10 | 10,116 | 3,163 | 2.2 | Opus Capital Group | Private Investor | Dec-12 |
| 101 Cremorne St, Richmond | 15.55 | 7.91* | 3,076 | 5,055 | n/a | Undisclosed | Private Investor | Dec-12 |
| 180-188 Burnley St, Richmond | 20.2 | 9.00* | 5,665 | 3,566 | n/a | Charter Hall | Private Investor | Dec-12 |
| 913 Whitehorse Rd, Box Hill | 119.23 | 8.00* | 19,680 | 6,059 | n/a | Grocon | Cromwell | Dec-12 |
| 71 Moreland Rd, Footscray | 14.43 | 11.20 | 6,195 | 2,238 | 3.6 | Centuria Property Funds | Private Investor | Dec-12 |
| Bld 3, 658 Church St, Richmond | 29.1 | 8.80 | 8,205 | 3,547 | 1.2 | APGF | Private Investor | Sep-12 |

Table 3
### Recent Leasing Activity Melbourne Suburbs

| Address | Precinct | Area (m$^2$) | Estimated Net Face Rent ($/m$^2$) | Term | Tenant | Start Date |
|---|---|---|---|---|---|---|
| 511 Church Street, Richmond | City Fringe | 4,300 | 415 | n/a | REA Group | Q4-14 |
| 6 Nexus Court, Mulgrave | Outer East | 2,600 | 315 | 9 | United Energy & Multinet Gas | Q3-13 |
| 122 Thomas Street, Dandenong | South East | 3,680 | 225 | 15 | Southern Health | Q3-13 |
| 369 Royal Parade, Parkville | City Fringe | 826 | 295 | 6 | Compass Group | Q2-13 |
| 615 Dandenong Road, Malvern | Inner East | 714 | 310 | 6 | LZR Accounting | Q2-13 |
| 245 Springvale Road, Glen Waverley | Outer East | 5,032 | 245 | 10 | MYOB | Q2-13 |
| 4 Nexus Court, Mulgrave | Outer East | 725 | 295 | 5 | Renault | Q1-13 |
| 677 High Street, Kew | Inner East | 1,400 | 330 | 5 | Greencap | Q1-13 |
| 600 Victoria Street, Richmond | City Fringe | 1,400 | 400 | 3 | Emerald Group | Q4-12 |
| Bld 10, 658 Church Street, Richmond | City Fringe | 2,700 | 315 | 5 | Smart Group | Q4-12 |

Source: Knight Frank * Passing Yield

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Abu Dhabi, UAE

Knight Frank Newmark Global


**Knight Frank Research**

**Richard Jenkins**
Director – Research VIC
+61 3 9604 4713
Richard.Jenkins@au.knightfrank.com

**Matt Whitby**
National Director – Head of Research & Consulting
+61 2 9036 6616
Matt.Whitby@au.knightfrank.com

**Valuation Contacts**

**Joe Perillo**
Joint Managing Director – Victoria
+61 3 9604 4617
Joe.Perillo@vic.knightfrankval.com.au

**Michael Schuh**
Director
+61 3 9604 4726
Michael.Schuh@vic.knightfrankval.com.au

**Commercial Agency Contacts**

**Paul Henley**
Managing Director – Commercial Sales & Leasing
+61 3 9604 4760
Paul.Henley@au.knightfrank.com

**Ken Smirk**
Director – Commercial Sales & Leasing
+61 3 8545 8622
Ken.Smirk@au.knightfrank.com

**Tim Grant**
Director – Commercial Sales & Leasing
+61 3 8545 8611
Tim.Grant@au.knightfrank.com

**Marcus Quinn**
Director – Commercial Sales
+61 3 9604 4638
Marcus.Quinn@au.knightfrank.com

**Simon D'Arcy**
Associate Director – Commercial Sales & Leasing
+61 3 9604 4668
Simon.D'Arcy@au.knightfrank.com

**Elise Betts**
Associate Director – Commercial Sales & Leasing
+61 3 8545 8619
Elise.Betts@au.knightfrank.com

**James Templeton**
Managing Director – Victoria
+61 3 9604 4724
James.Templeton@au.knightfrank.com


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