RESEARCH

MARCH 2014

MELBOURNE SUBURBAN

Office Market Overview

HIGHLIGHTS

- Impacted by some tenant relocations to other office markets and tenant consolidations, Melbourne's suburban office market vacancy rate increased to 7.5% as at January 2014 – its highest level since January 2010, and up from 6.1% in January 2013. Despite tenants still being relatively cautious, occupied space in the suburbs continued to increase over 2013. Whilst net absorption over 2013 totalled 15,607m^2, this level was the lowest annual total recorded since 2004.

- Development activity in the suburban market continues to improve with 38,646m^2 of gross office space added to the suburbs, the largest annual level of supply since 2009. Although new supply levels have increased, 2013 completions were still 30% below the historical average.

- Despite the current soft leasing conditions, investment sales activity reached record levels over 2013 with transactions totalling $516 million; $100 million higher than the previous annual record of 2007.

MARCH 2014
MELBOURNE SUBURBAN
Office Market Overview

Table 1
Melbourne Suburban Office Market Indicators January 2014

Market	Total Stock (m^2)	Vacancy Rate (%)	12 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	1,032,826	5.5	-2,676	310 – 350	260 – 300	7.50 – 8.00	8.50 – 8.75
Inner East	548,198	8.9	-18,493	320 – 350	260 – 300	7.75 – 8.50	8.50 – 9.25
Outer East	773,446	9.6	9,831	290 – 320	200 – 270	8.00 – 8.75	8.50 – 9.50
South East	283,758	6.1	26,945	220 – 250	185 – 220	8.50 – 9.00	9.50 – 10.50
Total Market / Average‡	**2,638,228**	**7.5**	**15,607**	**295 – 335**	**255 – 285**	**7.75 – 8.50**	**8.50 – 9.25**

Source: Knight Frank ‡ Total averages are weighted based.

Definition: Grade: Prime includes office assets of A-grade quality whilst Secondary includes office assets of B, C & D quality grade
Core Market yield: The percentage return/yield analysed when the assessed fully leased net market income is divided by the adopted value/price which has been adjusted to account for property specific issues (i.e. rental reversions, rental downtime for imminent expiries, capital expenditure, current vacancies, incentives, etc.).
Net Absorption: The change in the volume of occupied stock.

MELBOURNE SUBURBAN OFFICE REGIONS

Source: Knight Frank

SUPPLY & DEVELOPMENT ACTIVITY

In 2013, 38,646m² of gross office space was added to the Melbourne suburban office market, the largest annual level of supply since 2009. While the development pipeline in the suburban market continues to pick up since its nadir of 2010, the level of completions remains 30% below the 10-year historical average of 55,000m² per annum.

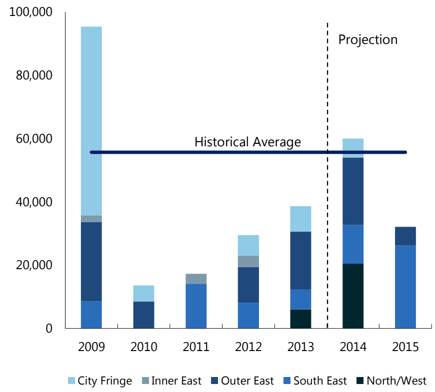
Boosted by the flurry of development activity in Goodman's Ferntree Business Park, Notting Hill and Salta's Nexus Business Park, Mulgrave, 47% of the gross stock added to the Melbourne suburbs was located in the Outer East. Following the completion of 6 Nexus Court, Mulgrave, pre-committed by ADP, Schneider's Victorian state office and Olympus' new office in Ferntree Business Park, new supply delivered in the Outer East in 2013 was above the region's annual long term average.

Looking forward, new construction is forecast to continue to pick up in 2014, with 59,982m² scheduled for completion this year, followed by 32,103m² forecast to be completed in 2015. While development activity is increasing; the vast majority of new supply has been underpinned by various government entities such as the Australian Taxation Office (two buildings), South East Water and the CFA. Following the urban renewal project of Dandenong, the State government has also committed to a $350 million development at McNab Avenue, Footscray. An office building is part of a planned mixed used precinct to regenerate the Footscray station precinct. The development is pre-committed by various government departments including; Justice, Planning & Community Development, City West Water and the State Trustees.

Of the 92,085m² that is due for completion over the next two years, 90% is currently pre-committed. Interestingly, of this scheduled new supply, 41% of the development is concentrated in the South East region, followed by the Outer East which will account for 29% of all new suburban office supply over the next two years.

Beyond the developments currently under construction, whilst still dependent on tenant pre-commitments, there is an increasing trend of approved office developments that are part of retail shopping centres expansions, as demonstrated by Chadstone (16,000m²) and Eastland (25,000m²).

Figure 1
Supply Pipeline by Region
Suburban office (m²)



Source: Knight Frank

Table 2
Office Supply Major suburban developments

Address	Suburb	Region	Area (m²)	Developer/Owner	Stage	Est. Date of Completion
Essendon Fields, 15 Vaughan St	Essendon Airport	North/West	6,000	Linfox / Beck Corp	Complete	Q1 2013
Nexus Business Park, 6 Nexus Crt	Mulgrave	Outer East	8,139	Salta	Complete	Q4 2013
Botanicca Corporate Park, 572-576 Swan St	Burnley	City Fringe	8,062	Pacific Group / Icon Developments	Complete	Q4 2013
Ferntree Business Park, 296-324 Ferntree Gully Rd	Notting Hill	Outer East	7,300#	Goodman	Complete	Q4 2013
Ferntree Business Park, 296-324 Ferntree Gully Rd	Notting Hill	Outer East	5,400#	Goodman	Complete	Q4 2013
1 McNab Ave	Footscray	North/West	20,500	Grocon	U/C	Q2 2014
913 Whitehorse Rd	Box Hill	Outer East	19,680	Grocon‡	U/C	Q2 2014
Estate One, 77-125 Princes Hwy	Dandenong South	South East	4,500	Cbus Property	U/C	Q2 2014
511-521 Church St	Richmond	City Fringe	6,000	Cremorne Properties	U/C	Q3 2014
1 Main St	Officer	South West	4,902	Places Victoria	U/C	Q3 2014
7R Playne Ave	Frankston	South East	12,500	South East Water	U/C	Q2 2015
Nexus Business Park, 8 Nexus Crt	Mulgrave	Outer East	5,800	Salta	U/C	Q4 2015
11-13 Robinson St	Dandenong	South East	13,800	EPC Pacific Group*	U/C	Q4 2015

Source: Knight Frank   U/C refers under construction   # Office component   * Sold to Cromwell Property Group (see Table 5)
‡ Sold to Cromwell Property Group in 2012

TENANT DEMAND & RENTS

The Melbourne suburban office vacancy rate rose to 7.5% as at January 2014 – its highest level since January 2010, and up from 6.1% in January 2013. Notwithstanding this, the level of occupied stock in the Melbourne suburbs continued to increase over 2013, although occupied stock declined slightly in the second half of 2013. Reflecting the subdued tenant environment, net absorption over 2013 totalled 15,607m^2, the lowest level achieved since 2004.

Similar to the other office markets in Australia, Melbourne's suburban office vacancy rate is now above its 10-year average of 5.8%. In terms of quality grades, with the exception of C-grade office space, vacancies rose in the 12 months to January 2014. Despite solid net absorption levels, A-grade vacancy rose from 6.4% to 8.5%, which was impacted by some tenant relocations to other office markets such as BUPA and Federation Centres to the CBD. Presently, the A-grade vacancy rate in the suburban office market is at its highest level since July 2009. Given the shortage of available space within the new developments currently under construction, tenants are likely to capitalise on the opportunity to upgrade their office accommodation which should offset a sustained period of high A-grade vacancy.

Table 3
Vacancy by Grade
Melbourne Suburbs

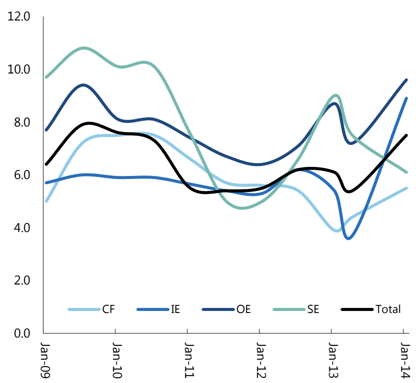
Grade	Jan-13	Jan-14
A Grade	6.4	8.5
Prime	**6.4**	**8.5**
B Grade	5.3	7.1
C Grade	6.8	5.6
Secondary	**5.8**	**6.1**
Total	**6.1**	**7.5**

Source: Knight Frank

By region, with the exception of the South East, all regions recorded vacancy rate rises over the course of 2013.

Contrary to expectations that City Fringe tenants would relocate into the CBD, the St Kilda Road precinct was the biggest beneficiary of migrating City Fringe tenants over 2013 as demonstrated by Cancer Council Victoria. While the City Fringe vacancy rate rose to 5.5%, which was above its 10-year average, the conversion of former office accommodation into residential development remains widespread. This persistent demand from residential developers for City Fringe sites is likely to result in a fall in vacancy in the precinct over the short term as stock is withdrawn.

Figure 2
Suburban Vacancy by Region
% total vacancy



Source: Knight Frank

Elsewhere, the vacancy in Inner East region rose to 8.9%, its highest level in 15 years, impacted by the relocations of BUPA and an increasing level of sublease vacancy. In contrast, the South East precinct fell to 6.1%; its lowest level since 2012, with declines in vacancy levels in Cheltenham, Moorabbin and Hampton. However given the size of the South East market, it is susceptible to vacancy fluctuations.

As a result of over 18,000m^2 of new space added in the Outer East region over 2013, and a round of tenant office consolidations, its vacancy rate increased, rising to 9.6%, up from 8.7% as at January 2013. The Outer East vacancy rate is now at its highest level since 2004. Despite the high level of pre-commitment levels in the recent completions, given that the majority of tenant relocations were from within the precinct, occupied space did not significantly increase in the region. Over 2013, net absorption in the Outer East equated to 9,831m^2 – its lowest calendar year total in the past 10 years. Despite the subdued leasing activity, occupied office stock in the Outer East as at January 2014, has now achieved record levels, having increased every year since 2010. The other region which was the driver of net absorption in the Melbourne suburban office market was the South East which recorded positive absorption of 26,945m^2 – its highest level achieved in the past 10 years.

MELBOURNE'S SUBURBAN ABSORPTION LEVELS WERE THE HIGHEST OF ALL VICTORIAN OFFICE MARKETS

While annual employment growth across Victoria has gradually risen since its nadir of 2011, employment growth rates remain well below pre-GFC rates, reflected in the modest leasing activity witnessed during the past year. In the year to November 2013, Victorian employment increased by 1.1%, slightly above the rate recorded in 2012. According to the Australian Bureau of Statistics, Victorian employment growth was largely driven by the health, agriculture and public service sectors. In terms of traditional white collar employment sectors, the professional services sector grew only modestly over the year while employment in the finance sector contracted in the 12 months to November 2013.

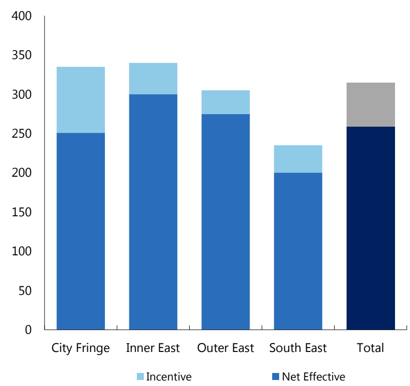
Anticipated Vacancy Levels

Looking forward, with Victoria's unemployment already at 12-year highs at 6.2%, as a result of the proposed closures of Ford, Toyota and Alcoa, further rises are likely. While there will be some broader employment losses other than those just restricted to the car manufacturing industry, manufacturing white collar employment in the suburban office market only accounts for 5% of the suburban office employment base. Over the next three years, white collar employment in Melbourne's suburban office market is forecast to increase on average by 1.7% per annum, driven by growth in the professional services, health care and education sectors. In contrast, manufacturing white collar employment is forecast to decline over the next three years. Total office vacancy levels in the suburban office market is forecast to have peaked as at January 2014 as white collar employment growth continues to gather momentum over the next three years. Whilst overall vacancy rates may trend down, the Outer East and South East are likely to experience further rises in vacancy over the next two years. Within the Outer East, while the ATO has fully pre-committed to a new 19,680m^2 development at 913 Whitehorse Road in Box Hill, the agency will vacate 20,155m^2 at 990 Whitehorse Road, also in Box Hill. Likewise, suburban office vacancies in the South Eastern precinct are anticipated to rise following the ATO's relocation in Dandenong in 2015.

Rental Levels

Since 2012, net face rents across the suburban office market have largely remained stable. In the 12 months to January 2014, average suburban A-grade net face rental levels increased 1.7%; however the majority of this growth came from the lift in prime rents in the Outer East region through the development of the new generation of projects built in the past two years. Similarly, secondary net face rental levels have also remained steady over 2013. Whilst incentive levels on average have risen in the suburban office market, of interest are differences in levels across the regions. In order to compete with the increasing leasing options in the CBD office market, incentives for City Fringe located offices typically range between 20% and 30%. In contrast, incentives across the other suburban office regions range between 10% and 20%. Despite vacancy reaching four-year highs and soft tenant demand, face rentals have been held up by a lack of options for larger suburban office tenants. With pre-commitment levels high on the limited new supply, there are currently only 14 buildings with vacancies in excess of 3,000m^2.

Figure 3
A Grade Net Rents and Incentives
By region as at January 2014 ($/m^2)



Source: Knight Frank

Table 4
Recent Leasing Activity Melbourne Suburbs

Address	Region	Area (m^2)	Net face Rent ($/m^2)	Term (years)	Tenant	Start Date
8 Nexus Court, Mulgrave	Outer East	3,600	315	10	GS1 Australia	Q4-15
192 Burwood Road, Hawthorn East	Inner East	1,100	340	5	Blueprint Group	Q2-14
1-9 Dandenong Street, Dandenong	South East	2,450	290	10	Victorian State Government	Q2-14
100 Drummond Street, Carlton	City Fringe	1,680	280	10	Drummond Street Services	Q2-14
693 Bourke Road, Camberwell	Inner East	1,100	330g	7	Warranty Group	Q1-14
678 Victoria Street, Richmond	City Fringe	555	345	5	Allity Aged Care	Q1-14
33 Lakeside Drive, Burwood East	Outer East	6,031	n/a	10	ESTA	Q1-14
31-41 Joseph Street, Blackburn	Outer East	2,557	170	n/a	Ambulance Victoria	Q1-14
15 Vaughan Street, Essendon Airport	North/West	6,000	n/a	9	Good Guys	Q1-14
Bld 10, 658 Church Street, Richmond	City Fringe	1,400	335	5	Witchery	Q1-14
2-6 Railway Parade, Camberwell	Inner East	1,000	330	2	ROI	Q4-13
650 Chapel Street, South Yarra	Inner East	2,890	350	6	Clemenger	Q4-13
436 Johnston Street, Abbotsford	City Fringe	1,640	316	1.8	Oneview	Q4-13
2-20 McDonalds Lane, Mulgrave	Outer East	3,000	150g	3	BMW	Q4-13
205-211 Foster Road, Mt Waverley	Outer East	900	195	5	General Cable	Q4-13
530-540 Springvale Road, Glen Waverley	Outer East	600	350g	5	IPSEN	Q2-13

Source: Knight Frank g gross face

INVESTMENT ACTIVITY & YIELDS

In stark contrast to the subdued leasing activity, investment activity reached record levels in the suburban office market. Investment sales activity (above $10 million) in 2013 within the suburban office market totalled $516.6 million across 21 properties, an 80% increase on 2012 transactional levels and almost $100 million higher than the previous annual record of 2007 when $426 million was transacted.

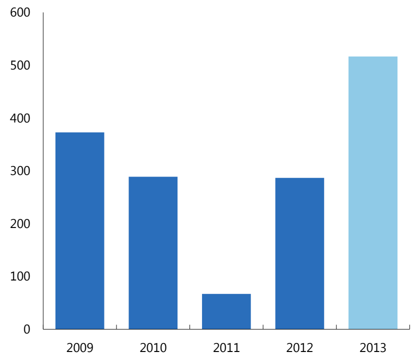
Transactional activity over 2013 was boosted by a number of portfolio sales which included Cromwell's acquisition of three assets from EPC Pacific which included 11-13 Robinson Street in Dandenong for $70.39 million and 10-16 Dorcas Street in South Melbourne for $25.54 million. Investec also acquired two Melbourne suburban office assets in preparation of an eight property REIT of Australian buildings to be listed on the Johannesburg Stock Exchange. Investment levels last year were also raised as a result of major asset transactions. Four buildings sold above $30 million during 2013, the most in any one calendar year since 2007.

As has been the trend over the past five years, unlisted funds and syndicates remained active purchasers of Melbourne suburban office property. In 2013, these groups accounted for 43% of total sales by value. Whilst private investors have always been willing buyers in the suburban office market, over 2013, privates acquired $121.9 million of all transactions – their highest spend levels since 2009. Of interest has been the emergence of offshore purchasers in the suburbs who are increasingly delving into markets beyond the CBD office market. Offshore groups purchased 19% of all stock during 2013, spending $102 million – their highest levels of spending since 2006.

Over 2013, the City Fringe precinct remains the focal point of investment activity with more than 50% of all suburban office transactions occurring in the region (by value and number).

Since the GFC, yields within the suburban office market have remained relatively elevated. Over 2013 however, strong investor demand placed downward pressure on yields with average prime office yields compressing by 40 basis points to now range between 7.75% and 8.5%.

Figure 4
Melbourne Suburban Sales $10million+
By Calendar Year ($ million)



Source: Knight Frank

Table 5
Recent Sales Activity Melbourne Suburbs

Address	Price ($ mil)	Core Market Yield (%)	NLA (m^2)	$/$m^2$ NLA	Vendor	Purchaser	Sale Date
109-133 Burwood Rd, Hawthorn	60.00#	8.00#	13,113	4,576	First State Developments	GPT	Feb-14
641 Mt Alexander Rd, Moonee Ponds	11.20	10.75*	5,151	2,174	Private Investor	Private Investor	Feb-14
311 Glenferrie Rd, Hawthorn	12.75	VP‡	2,004	6,362	Private Investor	City of Stonnington	Nov-13
449 Punt Rd, Richmond	28.70	8.80*	6,384	4,496	Belgrave Group	Investec	Oct-13
43 Elizabeth St, Richmond	54.47	8.50*	11,917	4,571	Belgrave Group	Investec	Oct-13
200 Victoria St, Carlton	33.55	8.70	7,925	4,233	Drapac Group	Impact Investment	Oct-13
10 Wesley Crt, Burwood East	13.02	9.60*	4,287	3,038	AMP Capital Investors	Private Investor	Oct-13
1 Main St, Officer	28.00~	VP‡	5,006	5,527	Places Victoria	Cardinia Shire Council	Oct-13
850 Lorimer St, Port Melbourne	11.25	n/a	5,583	2,015	Aust. Property Growth Fund	Undisclosed	Oct-13
543-549 Bridge Rd, Richmond	24.25	7.61	4,668	5,195	George Saade	City of Yarra	Sep-13
Bld 5, 658 Church St, Richmond	10.80	7.74	2,200	4,909	Private Investor	Vantage Property	Sep-13
250 Camberwell Rd, Camberwell	20.40	8.40*	5,420	3,764	Bennelong Group	Bricktop	Sep-13
11-13 Robinson St, Dandenong^	70.39~	7.75	13,803	5,100	EPC Pacific Group^	Cromwell Property	Aug-13
10-16 Dorcas St, Sth Melbourne^	25.54	8.00	7,567	3,375	EPC Pacific Group^	Cromwell Property	Aug-13
294 Bay Road, Cheltenham	24.00	8.36	4,921	4,877	Forza Capital	Trilogy Funds	Aug-13

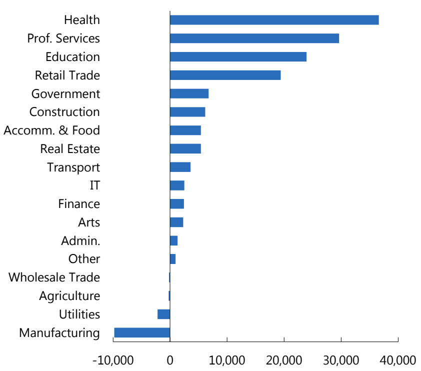
Source: Knight Frank U/D refers to undisclosed * passing initial yield ~ on completion basis ‡ bought for owner occupation
VP refers vacant possession # reported ^as part of a portfolio sale

OUTLOOK

Weighed down by a high exchange rate, Victoria's economy has weakened over the past two years. However, a falling Australian dollar, low exposure to slowing resource-related construction and a high population growth outlook indicates that Victoria's economy has already bottomed (despite the proposed manufacturing job losses). Over 2013, Victoria's economy grew by 0.9% - its lowest annual level since the recession of 1991. Conversely, the Victorian economy is forecast to grow by 2.3% in 2014 before increasing to 2.8% in 2015. Moreover, the lower Australian dollar is already boosting international tourist arrivals and is assisting foreign student numbers. In addition, the current level of interest rates is a substantial positive for the Victorian economic outlook. Housing finance is showing strong growth, which should lead to a strengthening of housing construction – one of Victoria's key drivers for economic growth.

Employment growth in Victoria continues to recover, with employment growth in the 12 months to November 2013 of 32,500 employees, or 1.1%, up from 0.8% recorded over the previous year.

Figure 5
White Collar Employment Growth
Melbourne Suburbs, 2014-2019



Source: Deloitte Access Economics

Although consumer confidence was dented by the recent announcements of Toyota and Qantas; emerging signs of a recovery in the number of job ads suggest the labour market should strengthen over 2014. Looking forward, white collar employment growth within the Melbourne suburban office market is expected to continue to steadily increase in the short term, in comparison to the modest growth of the last three years. Deloitte Access Economics is forecasting white collar employment growth in Melbourne's suburbs of 1.1% in 2014, increasing to 1.9% in 2015 and 2.0% in 2016.

An improving labour market should aid a recovery in confidence levels which is likely to flow through to increased business investment and increased leasing activity. Net absorption within the suburban office market is also likely to be boosted from an increased number of A-grade options for tenants after a number of years of limited uncommitted new supply entering the market.

Whilst still largely pre-commitment driven, new supply in Melbourne's suburban office market is forecast to increase by almost 60,000m^2 this year with a further 32,000m^2 currently under construction and scheduled to complete in 2015. Encouraged by the absorption of uncommitted space in the recently completed buildings, speculative development is likely to steadily increase, albeit in modest volumes.

Having risen to its highest level in four years, total vacancy in the Melbourne suburban office market is forecast to have peaked, aided by the moderate development pipeline and high pre-commitment levels. Whilst tenant demand is likely to remain patchy over 2014, given the high pre-commitment levels on new supply; the forecast growth of suburban white collar employment will easily absorb the remaining uncommitted space resulting in a likely decline in vacancy. In fact, total vacancy within Melbourne's suburban office has not exceeded 8% over the past 15 years.

As a result of the forecast modest fall in vacancy, rental levels are anticipated to remain relatively steady over the next 12 months. Looking ahead further as the economy continues to improve in 2015 combined with the lack of vacant options for large tenants, solid rental growth is anticipated for both renewals and new leases in prime quality assets. As business confidence improves, incentives will also diminish back to average levels.

The combination of the relatively subdued development pipeline, declining vacancy outlook and existing yield spread between prime CBD and suburban office assets, yields for suburban office assets are likely to continue to compress in the short term.

With investment competition remaining intense for prime, core assets, institutions are increasingly seeking to expand their exposure to the Victorian office market with more investment into the suburban market. Investor appetite for modern assets with long lease expiry profiles will continue to attract institutional interest as demonstrated in recent years by Cromwell's purchase of the ATO's office buildings in Box Hill and Dandenong, both while still under construction. More recently, GPT is reported to have purchased 109 Burwood Road, Hawthorn for its new unlisted metropolitan office fund.

Figure 6
Melbourne Suburban Average Yields
Prime and Secondary Core Market Yields

Source: Knight Frank

RESEARCH

Americas
USA
Bermuda
Brazil
Canada
Caribbean
Chile

Australasia
Australia
New Zealand

Europe
UK
Belgium
Czech Republic
France
Germany
Hungary
Ireland
Italy
Monaco
Poland
Portugal
Romania
Russia
Spain
The Netherlands
Ukraine

Africa
Botswana
Kenya
Malawi
Nigeria
South Africa
Tanzania
Uganda
Zambia
Zimbabwe

Asia
Cambodia
China
Hong Kong
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Indonesia
Macau
Malaysia
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