

MELBOURNE SUBURBAN

OFFICE MARKET OVERVIEW MARCH 2015

HIGHLIGHTS

After three years of consecutive rises, the vacancy rate in the Melbourne suburban office market fell to 6.3% as at January 2015, declining by 120 basis points over the 12 month period.

New supply is projected to record its second highest annual level ever in 2015. Supply has been boosted by increased levels of speculative development with more than 40,000m² under construction.

Boosted by a record number of sales in excess of \$30 million, office investment activity in the Melbourne suburban office market reached an all time high in 2014.

KEY FINDINGS

New construction levels are forecast to double in 2015, with speculative development at five-year high levels

Melbourne suburban office vacancy fell to 6.3% as at January 2015, with vacancy declining in all precincts

The City Fringe accounts for 38% of total suburban office net absorption, as tenants migrate closer to CBD

Investment sales activity reached record levels over 2014 with AREITs re-emerging after a seven year absence



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SUPPLY & DEVELOPMENT

Over 2014, new suburban office supply remained relatively passive with 37,200m² of gross office space added to the market. The level of completions during 2014 remained significantly below the 10-year historical average with only three buildings with NLA more than 3,000m² completed. By precinct, 50% of the new stock added to the Melbourne suburban office market in 2014 was located in the North/West precinct boosted by the completion of 1 McNabb, Footscray.

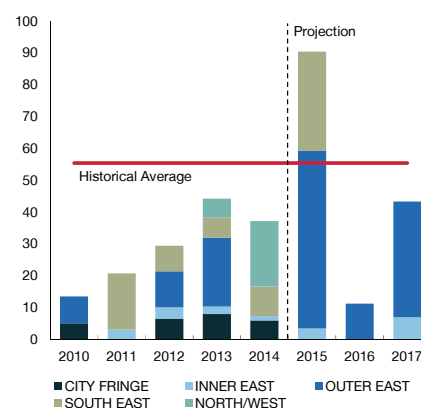
Looking forward, new construction levels are forecast to more than double in 2015, with 90,444m² expected to be delivered this year – the second highest annual level on record. As has been the trend of new suburban office supply in recent years, development remains underpinned by government entities with new offices for the Australian Taxation Office (two buildings), South East Water and the Cardinia Shire Council all scheduled for completion in 2015.

Given the suburban office development pipeline has been particularly constrained since 2010, a number of developers have recently launched speculative projects to capitalise on the improving tenant enquiry levels. Scheduled for completion in late 2015, 16,000m² of speculative developed office space is currently under construction at Caribbean Park in Scoresby by the Spooner family, a private developer/investor. Despite the increase in speculative development, pre-commitment levels on the space under construction remains relatively healthy with 57% of the 117,512m² that is due for completion over the next three years

currently pre-committed.

Despite recording the lowest level of vacancy and the strongest absorption, there are currently no major suburban office developments under construction within the City Fringe region. The bulk of the suburban office pipeline currently under construction is located in the Outer Eastern region which accounts for 71% of all new supply. Beyond 2017, while there are a number of potential sites which have DA approval for suburban office developments, increasingly these sites are being repositioned for residential development. Additional new supply is largely expected to be pre-commitment driven and based in established office and/or mixed use precincts offering quality amenity to office tenants.

FIGURE 1
Gross Supply Pipeline by Region
Suburban Office (000's m² excl. refurbishments)



Source: Knight Frank

TABLE 1

Melbourne Suburban Office Market[^] Indicators as at January 2015

Grade	Total Stock (m ²)	Vacancy Rate (%)	12 Month Net Absorption (m ²)	Average Prime Net Face Rent (\$/m ²)	Average Prime Incentive (%)	Average Secondary Net Face Rent (\$/m ²)	Average Prime Core Market Yield (%)	Average Secondary Core Market Yield (%)
City Fringe	1,029,326	3.2	20,510	320–350	20–30	270–300	7.00–8.00	8.00–8.75
Inner East	552,249	7.4	11,921	320–350	20–30	250–280	7.25–8.00	8.00–8.75
Outer East	783,227	8.7	15,390	290–320	10–20	200–240	8.00–8.75	8.50–9.25
South East	297,093	8.5	5,471	220–250	10–20	185–220	8.00–9.00	9.00–10.00
Total*	2,661,896	6.3	53,292	315	21	252	7.90	8.65

Source: Knight Frank

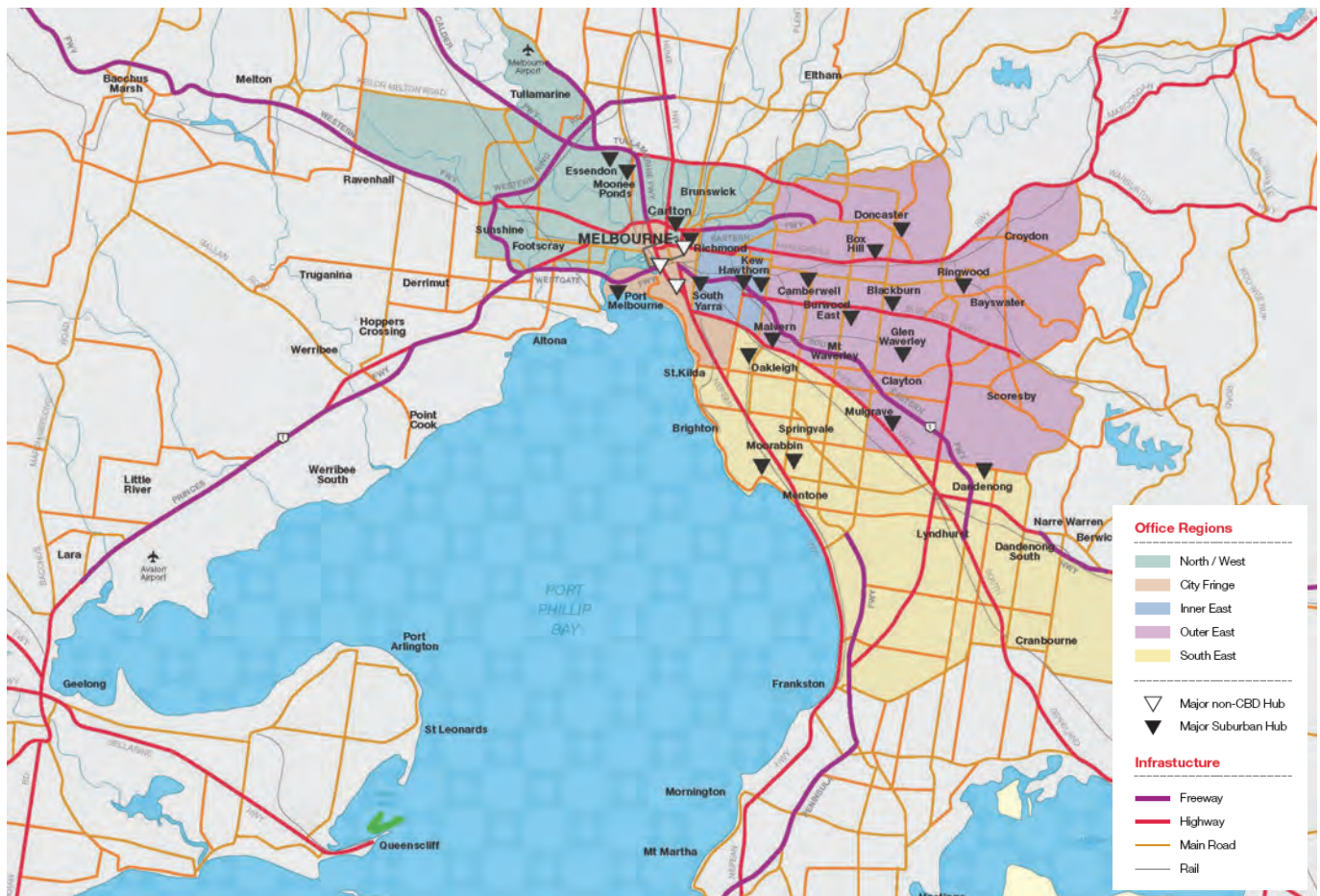
* weighted by stock area ^ refer back cover for definition of Melbourne Suburban geographic boundaries

TABLE 2

Major Office Supply – Melbourne Suburban Office

Address	Suburb	Region	Area (m ²)	Developer/Owner	Stage	Est. Date of Compl.
3 Nexus Crt	Mulgrave	Outer East	1,762	Salta	Complete	Q1 2015
1 Main St	Officer	South East	4,902	Cardinia Shire	U/C	Q1 2015
248 Burwood Rd	Hawthorn	Inner East	3,500	Hacer	U/C	Q2 2015
7R Playne Ave	Frankston	South East	12,500	South East Water	U/C	Q2 2015
913 Whitehorse Rd	Box Hill	Outer East	19,680	Grocon [^]	U/C	Q3 2015
35 Dalmore Drv	Scoresby	Outer East	16,000	Spooner Family	U/C	Q3 2015
8 Nexus Crt	Mulgrave	Outer East	5,800	Salta	U/C	Q4 2015
Bld B, 211 Wellington Rd	Mulgrave	Outer East	12,659	Australand/CIP [*]	U/C	Q4 2015
11-13 Robinson St	Dandenong	South East	13,803	EPC Pacific [‡]	U/C	Q4 2015
Bld A, 211 Wellington Rd	Mulgrave	Outer East	3,880 [#]	Australand/CIP	U/C	Q1 2016
545 Blackburn Rd	Mt Waverley	Outer East	7,400	Fortune Family	U/C	Q3 2016
1367 Dandenong Rd	Chadstone	Outer East	15,788	Novion/Gandel	U/C	Q2 2017
139 Camberwell Rd	Hawthorn	Inner East	7,000	Paul Tuddenham	DA Approved	2017+
171-175 Maroondah Hwy	Ringwood	Outer East	12,600	QIC	DA Approved	2017+
Nexus Business Park	Mulgrave	Outer East	10,000	Salta	DA Applied	2017+

Source: Knight Frank

[^] sold to Cromwell Property Group Dec 2012. ^{*} sold to Growthpoint Properties Dec 2014. [‡] sold to Cromwell Properties Aug 2013.
[#] office component
Suburban Office Regions

Suburban Stock: Includes office stock in the Melbourne metropolitan area above 1,000m² in size. It excludes stock in the CBD and the major office markets of St Kilda Road and Southbank.

TENANT DEMAND & RENTS

After three years of consecutive rises in the vacancy rate, the Melbourne suburban office vacancy rate fell to 6.3% as at January 2015, down from 7.5% in January 2014. While the total suburban office vacancy rate remains above the historical average of 5.9%, the 120 basis point fall in vacancy rate recorded over the 12 months was the largest annual decline since 2010. The suburban office market as at January 2015 is the tightest of all Melbourne's major office markets.

Reflecting the tenants' preference for better grade office space, A-grade and B-grade office vacancy rates fell in the 12 months to January 2015. Having risen to its highest level since 2009, A-grade grade office space vacancy declined from 8.5% to 7.5%. While the level of secondary grade office vacancy also fell, driven by the decline of B-grade vacant stock, C-grade office vacancies rose over 2014. The level of C-grade vacancy now sits at its second highest level in 10 years.

Over 2014, vacancy fell in all precincts with the exception of the South Eastern region. Vacancy within the City Fringe fell to 3.2%, its lowest level since 2002. While vacancy in the South Eastern region rose to 8.5%, given the size of the region, it is susceptible to major leasing transactions and its vacancy can be volatile as the region recorded the second lowest precinct vacancy level a year ago.

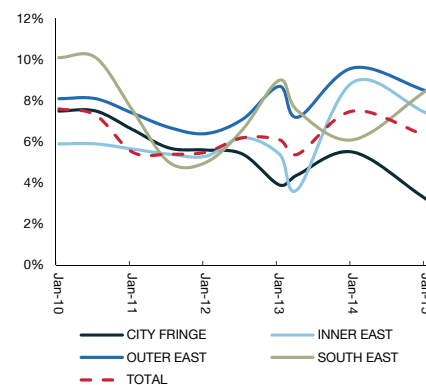
Starved by the scarce level of new supply over the past five years, in addition to the flight to quality trend, tenants have also migrated closer to the CBD. Over 2014, the vacancy rate of the City Fringe fell by 230 basis points, followed by the Inner East in which the vacancy fell by 150 basis points and the Outer Eastern precinct which fell by 80 basis points.

Tenants that have recently moved closer to the CBD include: Forever New from Kew to Burnley, Office Max from Mulgrave to Richmond and Warranty Group from Doncaster to Hawthorn East.

Net absorption in the Melbourne suburban office market rebounded over 2014 to total 53,392m², up from 15,600m² absorbed in the previous year. Reflecting the general incoming movement of tenants, the City Fringe precinct accounted for 38% of the total suburban office net absorption. Notably, all suburban office precincts recorded positive net absorption, for the first time in five years.

Despite the general level of positive absorption across suburban office precincts, excluding stock currently under construction, buildings with more than 3,000m² vacant increased slightly over 2014, up to 15 options, compared to 14 choices, a year prior.

FIGURE 3
Suburban Vacancy Rate by Region
Total Vacancy (%)



Source: Knight Frank

Anticipated Vacancy Levels

Although employment growth across the state over the past three years has been relatively modest, total employment in Victoria is at record high levels. In the year to November 2014, employment rose by 36,700 at a growth rate of 1.3%. In terms of traditional white collar employment sectors, growth over the year was only recorded in the government and retail sectors. Whereas, employment contracted over the past 12 months in the professional services, finance and health care sectors.

Looking forward, job advertisements across Australia have risen for eight consecutive months suggesting that labour demand is strengthening. Despite the improvement in the level of job ads, the unemployment rate has remained relatively stable reflecting the Australian economy is still rebalancing back to the traditional states of New South Wales and Victoria.

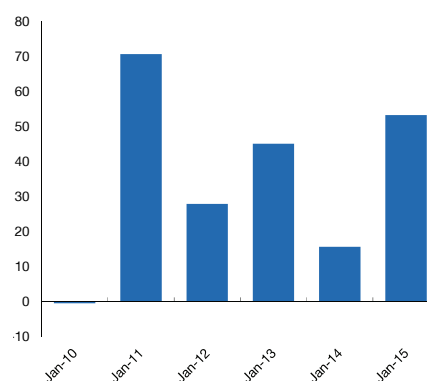
Although vacancy levels have been sheltered by a number of buildings which have changed in use; 181 Victoria Parade, Collingwood (retail—Bunnings), 836 Whitehorse Road, Box Hill (residential and hotel), the trend of suburban office tenants migrating into the CBD will continue to impact the suburbs. Tenants

TABLE 3
Suburban Vacancy Rates by Grade

Grade	Jan-13	Jan-14	Jan-15
A Grade	6.4	8.5	7.5
Prime	6.4	8.5	7.5
B Grade	5.3	7.1	4.7
C Grade	6.8	5.6	6.0
Secondary	5.8	6.1	5.2
Total	6.1	7.5	6.3

Source: Knight Frank

FIGURE 2
Suburban Office Net Absorption
per 12 month period (000's m²)



Source: Knight Frank

who are investigating relocations into other markets include: Porter Davis (from Narre Warren), Philip Morris (from Moorabbin) and CEVA Logistics (from Brooklyn).

Looking forward, Jemena's relocation from Mt Waverley into the CBD along with the ATO's former office in Box Hill and an increased level of speculative development in the precinct are anticipated to lead to a rise in vacancy within the Outer East. In contrast, the lack of new supply within the City Fringe coupled with the continuing trend of incoming tenants, such as Ford moving into Richmond from Broadmeadows, are expected to maintain the vacancy in the precinct below 5% for the medium term.

According to Deloitte Access Economics over the next three years, white collar employment in Melbourne's suburban office market is forecast to increase on average by 2.2% per annum, up from average growth of 1.4% recorded over the past three years. Over the next three years, employment growth in the

suburban office market is expected to be driven by growth in the health care, professional services and retail trade sectors.

Rental Levels

Since 2012, net face rents across the suburban office market have largely remained stable. In the 12 months to January 2015, average suburban A-grade net face rental levels increased by a mere 0.5% which was the weakest annual A-grade rental growth rate over the past three years.

Whereas average suburban secondary net face rental levels decreased by 2.3% over 2014, impacted by the tenants' preferences for prime quality accommodation.

While incentive levels in City Fringe and Inner Eastern precincts remain elevated to compete with the CBD office market, solid tenant demand and a lack of large available options should result in effective rental growth over the next 12 months,

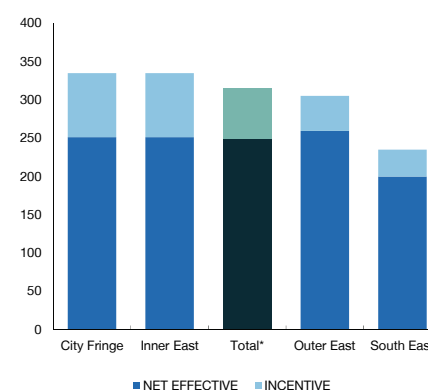
particularly for the City Fringe precinct.

In contrast, the impending level of backfill space is likely to lead to further softening in the Outer Eastern precinct, particularly for secondary grade offices with incentive levels anticipated to increase.

FIGURE 4

A-grade Net Rents and Incentives

By region as at January 2015 (\$/m²)



Source: Knight Frank
* weighted by area

TABLE 4

Recent Leasing Activity Melbourne Suburbs

Address	Precinct	NLA (m ²)	Term (yrs)	Lease Type	Tenant	Start Date
Bld B, 211 Wellington Rd, Mulgrave	Outer East	7,630	5	Precomm	Monash University	Q1-16
Bld A, 211 Wellington Rd, Mulgrave	Outer East	6,710	N/A	Precomm	Mazda [†]	Q1-16
8 Nexus Crt, Mulgrave	Outer East	3,600	10	Precomm	GS1 Australia	Q4-15
248 Burwood Rd, Hawthorn	Inner East	1,375	10	Precomm	Jellis Craig	Q3-15
248 Burwood Rd, Hawthorn	Inner East	924	6	Precomm	Xero	Q3-15
600 Victoria St, Richmond	City Fringe	2,500	10	New	Ford	Q3-15
290 Burwood Rd, Camberwell	Inner East	800	N/A	New	Beyond Blue	Q3-15
801 Glenferrie Rd, Hawthorn	Inner East	936	7	New	Marshall White	Q2-15
442 North Rd, Ormond	South East	1,651	5	New	Beis Efraim College	Q2-15
5 Lakeside Dr, Burwood East	Outer East	600	5	New	Huawei	Q1-15
650 Lorimer St, Port Melbourne	City Fringe	1,000	5	New	Porter Industries	Q1-15
1 Lakeside Dr, Burwood East	Outer East	6,400	3	New	Ambulance Victoria	Q1-15
99/45 Gilby Rd, Mt Waverley	Outer East	2,167	5	New	Cabrini Health*	Q1-15
Bld 8, 576 Swan St, Burnley	City Fringe	3,512	8	New	Forever New	Q4-14
Bld 3, 658 Church St, Richmond	City Fringe	1,423	6	New	Office Max	Q4-14
551 Blackburn Rd, Mt Waverley	Outer East	1,800	5	New	Calvary Health	Q4-14
600 Glenferrie Rd, Hawthorn	Inner East	1,770	2	Sublease	Acquire Learning	Q3-14

* Area leased incorporates 1,394m² office and lab space and 773m² warehouse space.

[†] Area leased incorporates 2,830m² of workshop space.

Source: Knight Frank

INVESTMENT ACTIVITY & YIELDS

Boosted by a record number of sales in excess of \$30 million, office investment activity in the Melbourne suburban office market reached an all time high in 2014.

Investment sales activity (above \$10 million) in 2014 within the suburban office market totalled \$711.67 million from 22 properties. The volume of sales achieved in 2014 was 118% higher than the long term average, and in fact, 37% higher than the previous record high set last year.

Following a subdued first quarter, investment activity surged in the final quarter with transactions totalling \$487 million, higher than the historical average yearly suburban sales total.

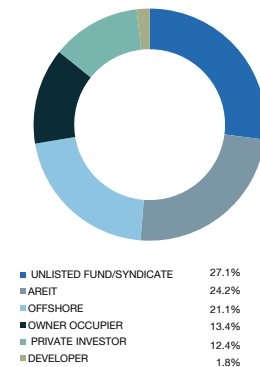
Over the course of 2014, there were nine sales in excess of \$30 million, accounting for 71% of total sales volume. Indeed, two of the transactions recorded in 2014 were the 3rd (60 Brougham St, Geelong—\$95.8 million) and 4th (6-22 Gladstone St, Moonee Ponds—\$83 million) highest suburban office sales ever.

All-time high sales volumes were recorded in the Inner East (\$193.9 million) and North/West precincts (\$83.0 million), albeit in one transaction. Suburban office investment over 2014 was led by those located in the City Fringe precinct which accounted for 34% of all suburban transactions (by value).

Unlisted funds and syndicates continued to be prominent buyers in the suburbs accounting for 27% of sales by value, spending \$192 million. Significant purchases made by unlisted funds in 2014 included: Impact Investment Group's purchase of 60 Brougham St, Geelong for \$95.8 million and Australian Unity Diversified Property Fund's purchase of 200 Victoria St, Carlton for \$42.3 million.

Of interest was the re-emergence of AREITs in the Melbourne suburban office market after limited activity for seven years. With prime investment opportunities becoming increasingly scarce in the CBD, AREITs accounted for 24% of all suburban office sales in 2014. AREIT investors spent more in the

FIGURE 5
Suburban office sales by purchaser
\$10 million+ sales 2014



Source: Knight Frank

Melbourne suburbs in 2014 than the previous nine years combined. Major acquisitions made by AREITs in 2014 included: GPT Metro Office Fund's purchase of 109-133 Burwood Rd, Hawthorn for \$63.0 million and Growthpoint Properties' purchase of 211 Wellington Rd, Mulgrave for \$62.6 million.

TABLE 5

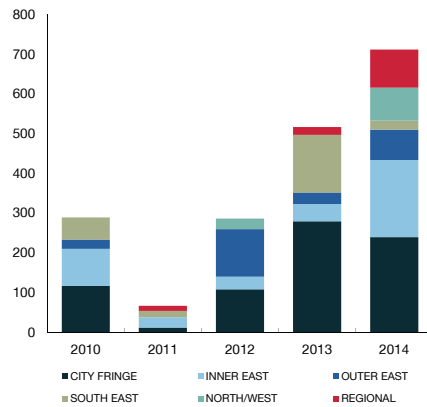
Recent Sales Activity Melbourne Suburbs

Address	Price (\$ mil)	Core Mkt Yield (%)	NLA (m ²)	\$/m ² NLA	WALE (yrs)	Vendor	Purchaser	Sale Date
295 Springvale Rd, Glen Waverley	22.00	7.25*	4,620	4,762	N/A	Philip Lim	IOOF Holdings	Feb-15
2-6 Railway Pde, Camberwell	23.00	N/A	3,838	5,993	N/A	Private Investor	Private Investor	Feb-15
Greenwood Business Park, Burwood	~72.00	N/A	19,910	~3,616	N/A	Burwood Highway JV	Ouson Group	Feb-15
211 Wellington Rd, Mulgrave	62.60	7.75*	12,718	4,922	6.7	Australand/CIP	Growthpoint Properties	Dec-14
B8, 572-576 Swan St, Burnley	46.50	7.70	8,338	5,577	7.2	Botanicca 8 P/L	360 Capital Office Fund	Dec-14
407-417 Royal Pde, Parkville	10.90	VP	1,859	5,863	N/A	Private Investor	Monash University	Dec-14
486 Albert St, East Melbourne	36.00	N/A	7,028	5,122	N/A	VECCI	Catholic Church	Nov-14
2 Luton Ln, Hawthorn	34.05	6.81	5,661	6,015	7.5	Bennelong Group	Kankuro Investments	Oct-14
293 Camberwell Rd, Camberwell	39.35	7.20	7,147	5,506	4.1	Bennelong Group	Private Investor	Oct-14
290 Burwood Rd, Hawthorn	23.35	7.50	4,400	5,307	2.7	Bennelong Group	Zagame Group	Oct-14
200 Victoria St, Carlton	42.30	8.70*	7,925	5,338	8.6	Impact Investment	Australian Unity^	Oct-14
60 Brougham St, Geelong	95.80	7.50*	15,386	6,226	15.0	Laidlaw family	Impact Investment	Oct-14
6-22 Gladstone St, Moonee Ponds	83.00	8.00	21,034	3,946	5.3	Charter Hall	Cyberra Investments	Oct-14

Source: Knight Frank * initial yield ^ Diversified Property Fund

FIGURE 6

Suburban Office Sales \$10 million+ By Region (\$m)



Source: Knight Frank

Offshore investors continued their interest in Melbourne's suburban office market spending \$150.4 million in 2014, up from \$102.1 million in 2013. Somewhat surprisingly, motivation/focus by foreign investors for the bulk of the sales were for value add assets rather than immediate redevelopment opportunities.

Encouraged by the historically low interest rate levels, owner occupiers were also active investors in Melbourne's suburban office market over 2014. Over the year, owner occupiers spent \$92.2 million on suburban offices in excess of \$10 million—a record high level.

The depth of capital seeking suburban office investment opportunities restricted domestic private investors to 12% of the 2014 transactions; despite spending \$88.4 million—the 5th highest annual level of spending by privates on record.

The significant weight of capital seeking Melbourne suburban office investments from all buyer groups continued the trend of yield compression of both prime and secondary yields.

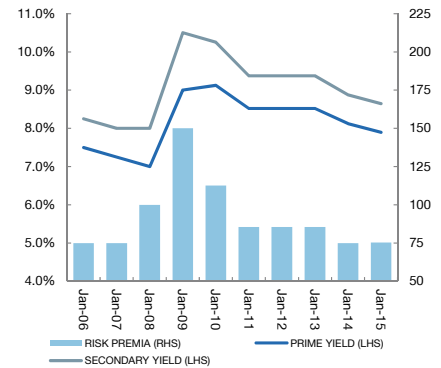
Over 2014, average prime office yields compressed by 23 basis points to 7.90% and range between 7.00% and 9.00%. Average prime yields now stand 42 basis points lower than the historical 15-year average of the 8.31%. While still some way off the nadir of benchmark suburban yields of 2008, as demonstrated with the

recent sales of 2 Luton Lane, Hawthorn and 293 Camberwell Road, Camberwell, transactional yields for quality stock sit below the historical average for the broader suburban market.

With prime investments relatively scarce coupled with increasing investor appetite seeking value add opportunities, greater yield compression has occurred in the secondary market over the past two years. Average secondary yields also tightened by 23 basis points over the course of 2014 to 8.65% and range between 8.00% and 10.00%. Given that the spread between prime and secondary suburban office yields is narrower than the long term average, prime suburban office assets may compress further over the course of 2015 in comparison to secondary assets.

FIGURE 7

Suburban Yields & Risk Spread Core Market Yields & Prime vs Secondary Spread (bps)



Source: Knight Frank

Outlook

- Looking forward, white collar employment growth within the Melbourne suburban office market is forecast to continue to recover. Deloitte Access Economics is forecasting white collar employment growth of 1.6% in 2015, up from 1.0% in 2014. Over the next three years, white collar employment is forecast to grow by 88,300 jobs.
- After five years of below average suburban office completions, new supply in 2015 is forecast to be the second highest annual level on record. Beyond the projects under construction, new supply is expected to be pre-commitment driven and based in established office precincts with sites mooted for commercial development being increasingly repositioned for residential and mixed-use development.
- The flight to quality and location trend by tenants observed over 2014 is likely to continue in the short term. With business confidence gaining momentum and an increased number of A-grade options, leasing activity is expected to continue to pick up.
- Despite the strengthening labour market, total vacancy is forecast to rise with the Outer East and South East to be particularly impacted by speculative development and tenant relocations closer to the CBD.
- Rents are likely to continue to diverge between the Inner and Outer suburban office precincts. In addition, the decreasing number of available prime vacant options in the City Fringe and Inner East is likely to lead to a reduction in incentives in those precincts.
- With prime investment opportunities becoming increasingly scarce in the CBD, the depth of appetite for suburban office assets is likely to further broaden as evidenced by the re-emergence of the AREIT activity in the market last year.
- Although yields have compressed for suburban assets, the existing yield spread between prime CBD and A-grade suburban offices suggests that prime suburban office yields are likely to continue to compress in the short term.



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Suburban Stock Definition:

Includes office stock in the Melbourne metropolitan area above 1,000 m² in size. It excludes stock in the CBD and the major office markets of St Kilda Road and Southbank.

Major suburbs for each region are as follows:

City Fringe: Carlton, Richmond, East Melbourne, Port Melbourne

Inner East: Hawthorn, Camberwell, Kew, Malvern, South Yarra

Outer East: Box Hill, Mt Waverley, Mulgrave, Burwood

South East: Cheltenham, Moorabbin, Dandenong

North/West: Footscray, Moonee Ponds, Essendon

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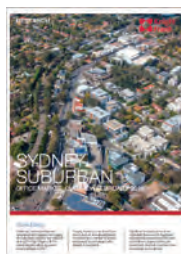
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