

RESEARCH



# MELBOURNE SUBURBAN

OFFICE MARKET OVERVIEW MARCH 2016

## HIGHLIGHTS

Impacted by increased levels of speculative development, the total suburban office vacancy rose to 7.5%, however it still remains the tightest of all Melbourne's major office markets.

Offsetting the record levels of speculative development is the increasing level of suburban office stock being permanently withdrawn with 62,316m<sup>2</sup> earmarked for likely conversion.

For a second consecutive year, office investment activity in the Melbourne suburban office market reached an all time high, led by offshore investors, which accounted for 33% of total sales.

## KEY FINDINGS

**New supply completed in 2015 was the second highest level** delivered to the suburban office market in the past 15 years

**Melbourne suburban office vacancy rate rose to 7.5%**, with A-grade office vacancy at a six-year high

Average prime suburban office **net face rents increased by 3.0%**, the fastest rate since 2010

Record levels of sales activity resulted in **prime yields continuing to tighten, firming by 83 basis points** in 2015



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## SUPPLY & DEVELOPMENT

Gross suburban office supply totalled 90,344m<sup>2</sup> in 2015, the second highest level of new supply delivered to the market in the past 15 years and the highest since 2009. The Outer Eastern precinct accounted for 87% of new suburban office supply, led by the Australian Taxation Office at 913 Whitehorse Road, Box Hill (19,680m<sup>2</sup>) and Building B, 211 Wellington Road, Mulgrave (12,659m<sup>2</sup>) having been pre-committed by Monash University.

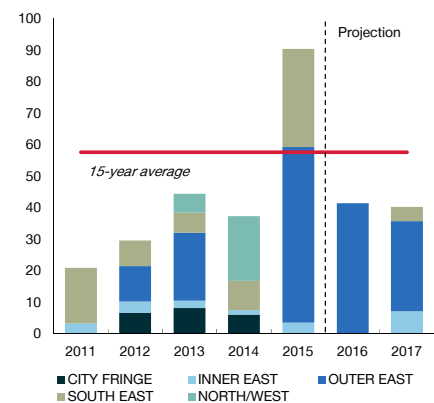
Looking ahead, new supply levels are forecast to once again fall below the historical average with 41,363m<sup>2</sup> expected to be delivered this year. Major projects that are expected to be completed in 2016 include: 1367 Dandenong Road, Chadstone (15,788m<sup>2</sup>); Building C, 211 Wellington Road (10,295m<sup>2</sup>) and Building A, 211 Wellington Road (3,880m<sup>2</sup>) both located in the Mulgrave Office Park. While the level of new supply to be built in the Outer East in 2016 is not expected to match levels recorded in the precinct in 2015; it will account for 100% of the suburban office pipeline of 2016.

Interestingly, despite the relatively constrained suburban office development pipeline, pre-commitment levels on the space currently under construction sit at the relatively low rate of 49%. Pre-commitment levels have been lowered with increased speculative development. 545 Blackburn Road, Mt Waverley (7,400m<sup>2</sup>) is one such project having commenced construction without a tenant.

Following the relatively healthy take up of recently completed speculative projects at Caribbean Park in Scoresby by the Spooner family and 3 Nexus Court, Mulgrave; further speculative development is forecast, buoyed by the improving tenant enquiry levels.

Offsetting the increased levels of speculative development is the increasing level of suburban office stock being permanently withdrawn for a change of use, particularly for residential development. The largest building withdrawn over the past year was 850 Whitehorse Road, Box Hill (7,345m<sup>2</sup>) by the Asian Pacific Group. Over the short to medium term, the level of suburban office withdrawals is anticipated to increase with Knight Frank tracking 62,316m<sup>2</sup> of stock earmarked for potential conversion.

FIGURE 1  
**Gross Supply Pipeline by Region**  
Suburban Office (000's m<sup>2</sup> excl. refurbishments)



Source: Knight Frank Research

TABLE 1  
**Melbourne Suburban Office Market<sup>^</sup> Indicators as at January 2016**

Grade	Total Stock (m <sup>2</sup> )	Vacancy Rate (%)	12 Month Net Absorption (m <sup>2</sup> )	Average Prime Net Face Rent (\$/m <sup>2</sup> )	Average Prime Incentive (%)	Average Secondary Net Face Rent (\$/m <sup>2</sup> )	Average Prime Core Market Yield (%)	Average Secondary Core Market Yield (%)
City Fringe	1,029,626	3.4	-1,555	350–375	10–20	300–325	6.50–7.00	7.75–8.50
Inner East	555,749	4.9	17,301	340–360	10–20	280–300	6.50–7.00	7.50–8.50
Outer East	830,683	12.7	10,074	290–320	20–30	200–240	7.00–7.50	8.00–9.00
South East	335,498	11.2	25,839	250–280	20–30	185–220	7.75–8.50	8.50–9.25
<b>Total*</b>	<b>2,751,256</b>	<b>7.5</b>	<b>51,359</b>	<b>327</b>	<b>19</b>	<b>274</b>	<b>7.07</b>	<b>8.30</b>

Source: Knight Frank Research

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

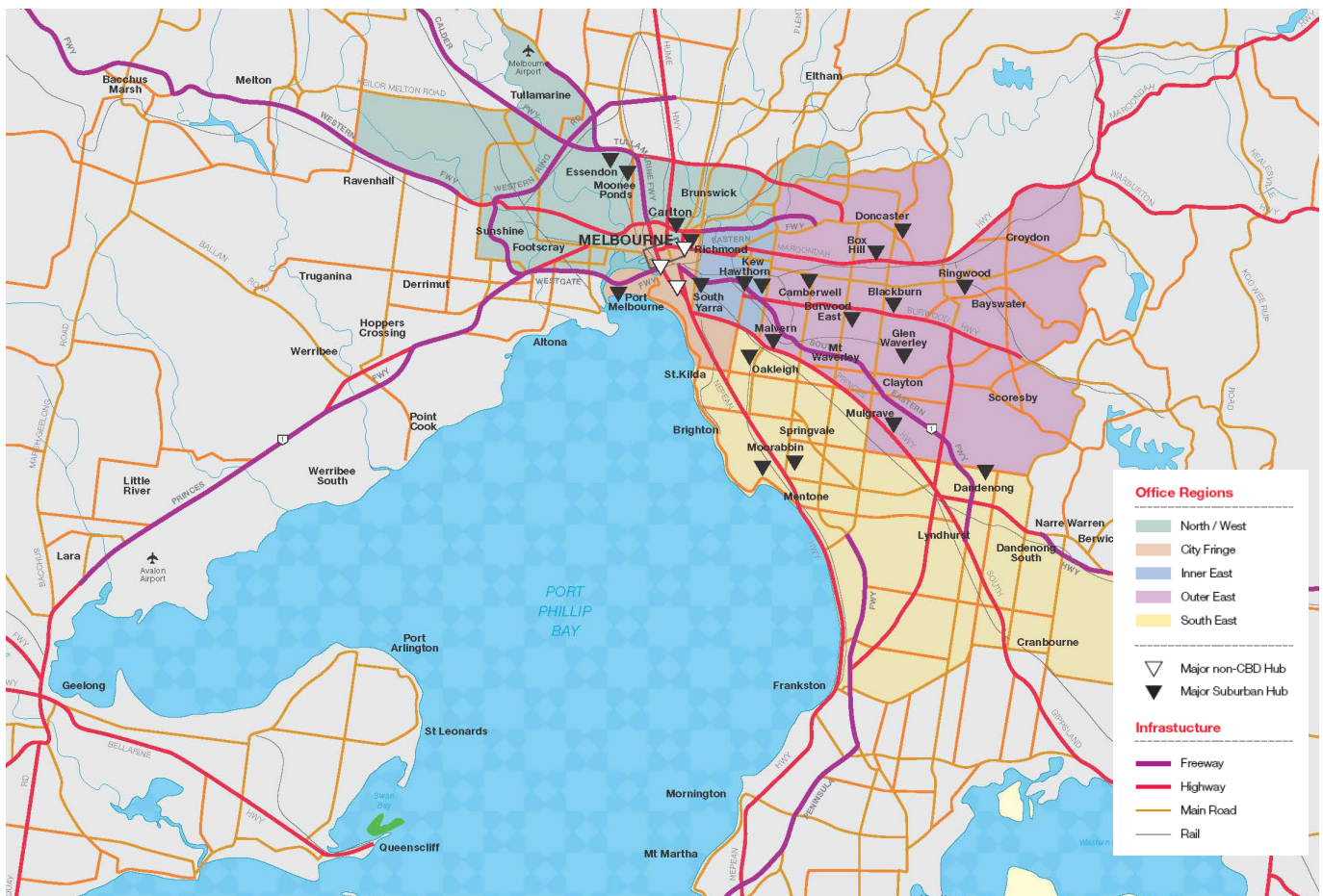
TABLE 2

Major Office Supply – Melbourne Suburban Office

Address	Suburb	Region	Area (m <sup>2</sup> )	Developer/Owner	Stage	Est. Date of Compl.
913 Whitehorse Rd	Box Hill	Outer East	19,680	Grocon <sup>^</sup>	Complete	Q3 2015
35 Dalmore Dr	Scoresby	Outer East	16,000	Spooner Family	Complete	Q3 2015
8 Nexus Crt	Mulgrave	Outer East	5,800	Salta	Complete	Q4 2015
Bld B, 211 Wellington Rd	Mulgrave	Outer East	12,659	Australand/CIP*	Complete	Q4 2015
11-13 Robinson St	Dandenong	South East	13,803	EPC Pacific <sup>‡</sup>	Complete	Q4 2015
Bld A, 211 Wellington Rd	Mulgrave	Outer East	3,880 <sup>#</sup>	Frasers/CIP	U/C	Q1 2016
545 Blackburn Rd	Mt Waverley	Outer East	7,400	Fortune Family	U/C	Q3 2016
Bld C, 211 Wellington Rd	Mulgrave	Outer East	10,295	Frasers/CIP <sup>†</sup>	U/C	Q4 2016
Stamford Business Estate	Rowville	Outer East	4,000	Frasers	U/C	Q4 2016
1367 Dandenong Rd	Chadstone	Outer East	15,788	Novion/Gandel	U/C	Q2 2017
Caribbean Park	Scoresby	Outer East	16,000	Spooner Family	DA Approved	2017+
139 Camberwell Rd	Hawthorn	Inner East	7,000	Paul Tuddenham	DA Approved	2017+
66 Victor Cr	Narre Warren	South East	5,498	Lettieri Group	DA Approved	2017+
1-3 Janefield Dr	Bundoora	North/West	4,000	Norddenne	DA Approved	2017+
171-175 Maroondah Hwy	Ringwood	Outer East	12,600	QIC	DA Approved	2017+
Parkview Estate	Moorabbin	South East	4,000	Pellicano	DA Approved	2017+
Nexus Business Park	Mulgrave	Outer East	10,000	Salta	DA Applied	2017+

Source: Knight Frank Research <sup>^</sup> sold to FG Asset Management Sep 2015. \* sold to Growthpoint Properties Dec 2014. <sup>‡</sup> sold to Cromwell Properties Aug 2013. <sup>#</sup> office component <sup>†</sup> sold to Growthpoint Properties Nov 2015.

## Suburban Office Regions



**Suburban Stock:** Includes office stock in the Melbourne metropolitan area above 1,000m<sup>2</sup> in size. It excludes stock in the CBD and the major office markets of St Kilda Road and Southbank.

# TENANT DEMAND & RENTS

Although a number of major tenants relocated out of the suburban office market, highlighted by Jemena's and Viva Energy's migration into the CBD from Mt Waverley and Hawthorn respectively, net absorption remained positive in the Melbourne suburban office market over the 12 months to January 2016.

For a sixth consecutive year, Melbourne's suburban office market recorded positive net absorption with 51,359m<sup>2</sup> absorbed. Net absorption levels were boosted largely through two means, white collar growth and increased owner occupier activity. LCI Education now own and occupy the former premises of Cardno at 150 Oxford Street, Collingwood who relocated into the CBD. Likewise, Kennards Self Storage now occupy 453 Auburn Road, Hawthorn having purchased the building of former owner occupier Cabrini Health in early 2015 who relocated into another office in Hawthorn East.

The improvement in the labour market has been the greatest in NSW where the unemployment rate has dipped to a national low of 5.2% and the state's pace of employment growth is a very robust 4.4% over the year which is consistent with a rebalancing of growth away from resources and towards services. This was also seen in Victoria, albeit to a lesser extent, where employment growth is running at a 2.6% pace.

TABLE 3  
Suburban Vacancy Rates by Grade

Grade	Jan-14	Jan-15	Jan-16
A Grade	8.5	7.5	9.4
<b>Prime</b>	<b>8.5</b>	<b>7.5</b>	<b>9.4</b>
B Grade	7.1	4.7	6.1
C Grade	5.6	6.0	4.4
<b>Secondary</b>	<b>6.1</b>	<b>5.2</b>	<b>5.1</b>
<b>Total</b>	<b>7.5</b>	<b>6.3</b>	<b>7.5</b>

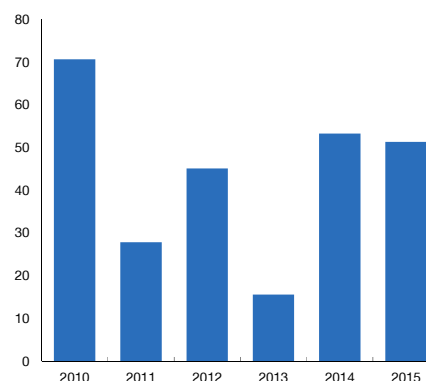
Source: Knight Frank Research

According to the Australian Bureau of Statistics, over 2015, Victorian employment growth was largely driven by the health care, construction and professional services sectors. In terms of traditional white collar employment sectors, these levels also appear to be improving with finance and professional services sectors both rebounding having contracted over 2014. Public services employment however was muted with total employment contracting by 10,000 employees over the 12 months to November 2015. In the year to November 2015, Victorian employment increased by 3.1%, its fastest growth rate since 2000.

Interestingly, the South Eastern precinct accounted for 50% of the total net absorption within the Melbourne suburban office market in 2015. The high level of net absorption within the South East was largely driven by owner occupation relocations, which included South East Water into Frankston and the Cardinia Shire into Officer. In contrast, the City Fringe precinct recorded negative net absorption over 2015 impacted by several tenant relocations into other office precincts; which included Engineers Australia (to the CBD) and National Association of Testing Authorities to the Inner East.

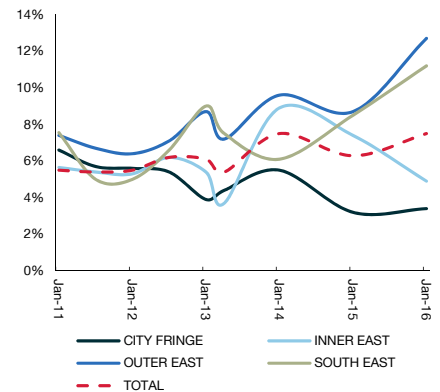
While the Melbourne suburban office market recorded positive net absorption,

FIGURE 2  
Suburban Office Net Absorption per calendar year (000's m<sup>2</sup>)



Source: Knight Frank Research

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



Source: Knight Frank Research

vacancy rates rose impacted by the higher than average levels of new supply delivered to the market over 2015. Total suburban office vacancy rose to 7.5%, up from 6.3% in January 2015. Having fallen by 120 basis points over 2014, vacancy rose by 120 basis points over 2015 and is currently 160 basis points above the historical average. Although the total suburban office vacancy increased, the market still remains the tightest of all Melbourne's major office markets with the CBD at 7.7%, St Kilda Road (8.9%) and Southbank (8.4%).

Impacted by the spate of major tenant relocations and high levels of speculative development, A-grade office vacancy rates increased to 9.4% as at January 2016, its highest level since 2010, up from 7.5%, 12 months earlier. B-grade suburban office vacancy levels also increased up to 6.1% from 4.7% over 2015. Surprisingly the C-grade office vacancy rate fell in the 12 months to January 2016 to 4.4%, its lowest level since 2009. The 170 basis point decline in C-grade office vacancy levels reflects a number of sizeable leasing commitments completed over 2015, possibly reflecting tenants preferences for flexible short term accommodation with economic conditions still uncertain albeit improving.

Over 2015, vacancy increased in all precincts with the exception of the Inner

Eastern region. Vacancy within the City Fringe marginally rose to 3.4%, but is still below its historical average. In contrast, vacancy in the Inner Eastern region fell to 4.9% down from 7.4% a year ago, its lowest level since 2008. Both the Outer East and South Eastern precincts were adversely impacted by the significant levels of new supply built (and associated backfill vacated) in 2015 with both regions' vacancy levels in excess of 10%. In fact, the level of vacancy in the South Eastern region rose to a historic high although given the size of the region, it is susceptible to major leasing transactions and its vacancy can be volatile. Similarly, the level of vacancy within the Outer East has reached its highest level in a decade.

In terms of leasing options by size, the past 12 months saw a slight reduction in options less than 1,000m<sup>2</sup>. Whereas, the number of available leasing options in excess of 2,000m<sup>2</sup> increased to 27 compared to 21 a year ago.

Looking ahead, job advertisements continue to rise in Australia registering a 1% monthly increase in January 2016 and are up 10.8% over the year to January 2016. Over the next three years, white collar employment in Melbourne's suburban office market is forecast to grow on average by 1.7% per annum, slightly down from the average growth of 2.0% 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, education and professional services sectors.

### Rental Levels

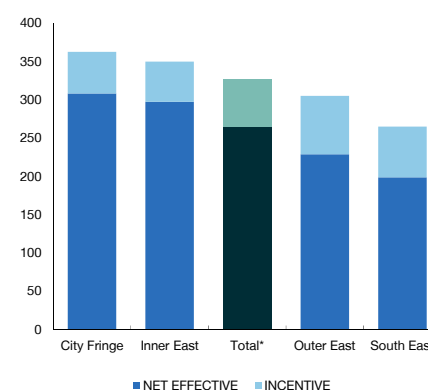
Despite total vacancy having risen, average prime suburban office net face rents increased at the fastest rate in six years. In the 12 months to January 2016, average suburban A-grade net face rental levels increased by 3.0% to \$327/m<sup>2</sup>. Average prime suburban rental growth was underpinned by five-year high rental growth in both the City Fringe and Inner Eastern precincts. In the 12 months to January 2016, prime net face rents grew

in all precincts. However on an effective basis, rental growth rates were more varied with declines in the Outer East and South East. Having declined in 2014, average secondary suburban office net face rents grew to \$274/m<sup>2</sup> driven by growth in the City Fringe and Inner Eastern regions.

FIGURE 4

### A-grade Net Rents and Incentives

By region as at January 2016 (\$/m<sup>2</sup>)



Source: Knight Frank Research  
\* weighted by area

TABLE 4

### Recent Leasing Activity Melbourne Suburbs

Address	Precinct	NLA (m <sup>2</sup> )	Term (yrs)	Lease Type	Tenant	Start Date
Stud Rd, Rowville	Outer East	4,000	12	Precomm	GPC Asia Pacific	Q1-17
570 Church St, Richmond	City Fringe	7,000	N/A	New	Red Energy	Q1-17
8 Redfern Rd, Hawthorn East	Inner East	2,500	N/A	New	Bayer	Q3-16
Bld C, 211 Wellington Rd, Mulgrave	Outer East	4,792	5	Precomm	BMW Finance	Q3-16
35 Dalmore Dr, Scoresby	Outer East	1,500	10	New	Austbrokers Countrywide	Q2-16
35 Dalmore Dr, Scoresby	Outer East	1,000	5	New	AVEA Insurance	Q2-16
167 Cremorne St, Richmond	City Fringe	2,755	7	New	MYOB	Q2-16
240-246 E. Boundary Rd, Bentleigh E.	South East	4,000	N/A	New	iSelect	Q2-16
718 High St, Kew	Inner East	500	3	New	Oak Financial Partners	Q1-16
20 Corporate Dr, Moorabbin	South East	7,600	7	New	Visionstream	Q1-16
Bld B, 211 Wellington Rd, Mulgrave	Outer East	1,839	5	New	BSN Medical	Q1-16
30-32 Compark Cct, Mulgrave	Outer East	2,600	10	New	Hydrix	Q1-16
15-17 Shierlaw Ave, Canterbury	Inner East	1,100	5	New	Direct Connect	Q1-16
6 Palmer Pde, Richmond	City Fringe	1,297	5	New	Vinomofo	Q4-15
18-20 Prospect St, Box Hill	Outer East	729	5	New	Eastern Medical Primary	Q4-15
347 Burwood Hwy, Burwood East	Outer East	1,963	5	New	NEC	Q4-15
8 Redfern Rd, Hawthorn East	Inner East	1,550	7	New	EBM Insurance	Q4-15
678 Victoria St, Richmond	City Fringe	807	N/A	New	Medtronic	Q4-15
Bld 10, 658 Church St, Richmond	City Fringe	755	5	New	Enirgi Metal Group	Q3-15

Source: Knight Frank Research

# INVESTMENT ACTIVITY & YIELDS

For a second consecutive year, office investment activity in the Melbourne suburban office market reached an all time high.

Investment sales activity (above \$10 million) in 2015 within the suburban office market totalled \$961.23 million from 32 properties. The volume of sales achieved in 2015 was in fact 245% higher than the long term average, and \$141 million higher than the previous record high set in 2014. Moreover, suburban office investment accounted for 24% of all office transactions (by value) across all Melbourne's office markets.

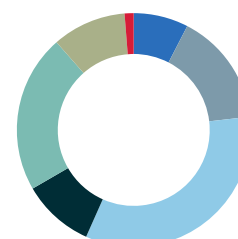
Suburban office sales activity was boosted by a higher than average number of transactions in excess of \$30 million. Over the course of 2015, there were 10 sales in excess of \$30 million, accounting for 62% of total sales volume. Indeed, Korean-based FG Asset Management's purchase of 913 Whitehorse Road, Box Hill for \$156 million was Melbourne's largest suburban office transaction on record.

Offshore investors led all purchaser types accounting for 33% of sales by value, spending \$321.7 million, an all-time high in the suburban office market, highlighted by FG Asset Management's acquisition. The offshore investment across Melbourne's suburban office markets in 2015 was dominated by Asian-based groups, led by Korean, Chinese and Malaysian investors, however European investors were also active.

Interestingly, along with offshore groups; developers, owner occupiers and private investors also recorded all-time high levels of spending in the suburban office market in 2015. In contrast, whilst still active, unlisted funds and syndicates only spent \$98.5 million in the suburban office market, with spending in the previous three years all in excess of \$150 million.

While investor appetite remains focused on Core Plus/Value Add opportunities, increasingly offshore groups and local developers are purchasing assets for residential conversion purposes. In total \$327.58 million of suburban offices were purchased for a change of use. 185

FIGURE 5  
Suburban office sales by purchaser  
\$10 million+ sales 2015



Source: Knight Frank Research

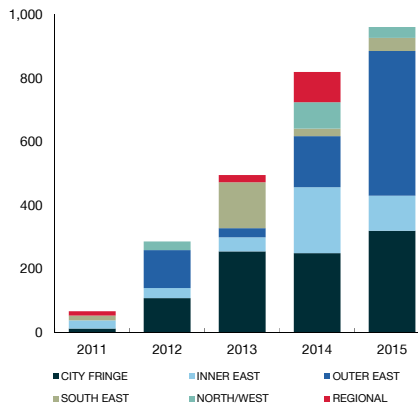
Rosslyn St, West Melbourne (\$40.3 million) and 820 Whitehorse Rd, Box Hill (\$18.18 million) were amongst a number of suburban offices purchased in 2015 which are earmarked for residential development. In total, 74,587m<sup>2</sup> of suburban office space was purchased for a likely change of use in the short to medium term.

TABLE 5  
Recent Sales Activity Melbourne Suburbs

Address	Price (\$ mil)	Core Mkt Yield (%)	NLA (m <sup>2</sup> )	\$/m <sup>2</sup> NLA	WALE (yrs)	Vendor	Purchaser	Sale Date
31 Vision Dr, Burwood East	24.23	7.41*	6,389	3,796	N/A	Offshore Investor	Private Investor	Dec-15
83-113 Batman St, West Melbourne	35.00	N/A <sup>‡</sup>	10,143	3,451	N/A	Hume Partners	Asian Pacific Group	Dec-15
Bld C, 211 Wellington Rd, Mulgrave	50.90	7.25*	10,295	4,944	N/A	Frasers Property/CIP	Growthpoint Properties	Dec-15
180-188 Burnley St, Richmond	31.20	6.42	5,655	5,517	6.6	Private Investor	Najee Imam	Nov-15
1320 Malvern Rd, Malvern	12.30	5.56*	1,752	7,021	N/A	Private Investor	Private Investor	Oct-15
90-94 Tram Rd, Doncaster	16.10	6.90* <sup>‡</sup>	3,495	4,607	N/A	Juilliard Group	HSA Capital	Oct-15
820 Whitehorse Rd, Box Hill	18.18	N/A <sup>‡</sup>	1,739	10,454	N/A	Private Investor	Longriver Group	Sep-15
913 Whitehorse Rd, Box Hill	156.00	6.01	19,941	7,823	13.8	Cromwell Property	FG Asset Management	Sep-15
31-47 Joseph St, Blackburn North	24.00	7.25*	8,839	2,713	N/A	Private Investor	Offshore Investor	Aug-15
973 Nepean Hwy, Moorabbin	41.50	8.20	11,956	3,471	3.8	JAK Investment Group	Henkell Brothers	Aug-15
172-186 Moreland Rd, Brunswick	21.00	6.45*	16,861	1,243	N/A	Private Investor	Private Investor	Jul-15
30-32 Prospect St, Box Hill	12.00	N/A	2,850	4,211	N/A	Private Investor	AMES	Jul-15
2-6 Railway Pde, Box Hill	20.30	N/A	4,100	4,951	N/A	Private Investor	National Assoc. Testing	Jul-15

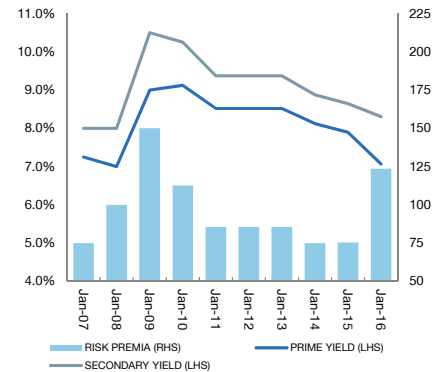
Source: Knight Frank Research \* initial yield ‡ bought for potential residential conversion

**FIGURE 6**  
**Suburban Office Sales \$10 million+**  
 By Region (\$m)



Source: Knight Frank Research

**FIGURE 7**  
**Suburban Yields & Risk Spread**  
 Core Market Yields & Prime vs Secondary Spread (bps)



Source: Knight Frank Research

year average of the 8.23%. Whilst still not at the benchmark suburban yields of 2008, as demonstrated with the recent sales of 913 Whitehorse Road, Box Hill and 180-188 Burnley Street, Richmond, transactional yields for quality stock sit below the average yield range for the broader suburban market.

Although not to the same degree, suburban secondary office yields also compressed over 2015 to now sit 78 basis points below the long term average of 9.08%. Average secondary yields tightened by 34 basis points over the course of 2015 to 8.30% and range between 7.50% and 9.25%.

By region, the City Fringe accounted for the bulk of 2015 sales by value (33%), with five properties transacting above \$30 million including Altis Property Partners' acquisition of 191-197 Salmon Street, Port Melbourne for \$85 million, the fifth largest suburban office transaction on record. While the property is located adjacent to the re-zoned Fishermans Bend Urban Renewal precinct, The property is likely to benefit from increasing withdrawal of nearby commercial stock.

All-time high sales volumes were recorded in the City Fringe (\$320.3 million) and Outer Eastern precincts (\$454.7 million) over 2015.

2016 has also begun strongly with around \$275 million having either transacted or currently in due diligence with expectations to settle in the first quarter. The level of sales activity projected in the first quarter of 2016 is expected to surpass those recorded in the first quarter of 2015.

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 2015, average prime office yields compressed by 83 basis points to 7.07% and range between 6.50% and 8.50%. Average prime yields now stand 116 basis points lower than the historical 15-

## Outlook

- Looking forward, white collar employment growth within the Melbourne suburban office market is forecast to continue to increase and gain momentum. White collar employment is forecast to grow by 0.4% in 2016, before increasing to an average growth of 1.6% per annum between 2017 and 2019. Over the next three years, white collar employment is forecast to grow by 68,300 jobs.
- Melbourne suburban gross office supply is projected to remain below average over the next three years with speculative development accounting for 45% of total new supply. Offsetting the record levels of speculative development is the increasing level of suburban office stock expected to be permanently withdrawn with 62,316m<sup>2</sup> earmarked for potential conversion.
- Although the Melbourne suburban office vacancy rate increased to a six-year high level; as a result of below average gross supply and increased levels of withdrawals, the suburban office vacancy rate is expected to trend down over the next three years.
- Coupled with business confidence gaining momentum and the strengthening labour market, net absorption levels within the suburban office market are projected to remain above average in the short term.
- With vacancy in the CBD office market forecast to decrease further, Melbourne suburban office rents are projected to continue to increase, with prime office properties anticipated to significantly outperform secondary suburban offices.
- As competition to invest in the CBD continues to increase and returns diminish, increasingly new investors are seeking opportunities in the suburban office market. As evidenced by the increasing offshore and AREIT activity, sale volume levels are expected to remain above average with focus on trophy investment opportunities. This increased investment appetite is likely to lead to further cap rate compression, albeit not at the same rate recorded over the past two years.



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### Suburban Stock Definition:

Includes office stock in the Melbourne metropolitan area above 1,000 m<sup>2</sup> 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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