RESEARCH

ST KILDA ROAD & SOUTHBANK

OFFICE MARKET BRIEF OCTOBER 2014

Key Findings

While office stock levels will continue to shrink in St Kilda Road, two new developments are underway in Southbank

Prime and secondary vacancy rates diverge as tenants relocate into better quality accommodation

With decreasing available contiguous prime options, solid effective rental growth is forecast in St Kilda Road

A record high level of investment sales is anticipated in 2014 boosted by a number of major sales

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After four years of no new supply in the Southbank office market, there is currently 40,000m² under construction in the precinct, of which 92% is already pre-committed.

Development Activity

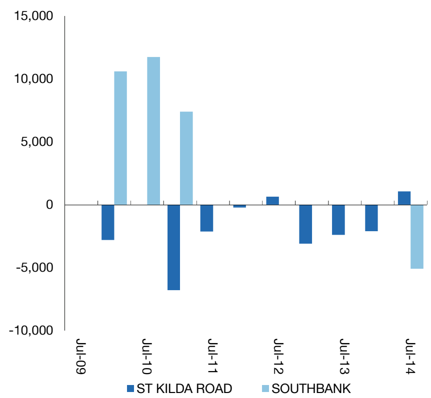
While office space in the St Kilda Road precinct increased in the first half of 2014, the 1,058m² increase in stock was due to a partial refurbishment re-entering the market. Having peaked in 1992 at 871,030m², office stock in the St Kilda Road precinct has fallen by 15% over the past 22 years. Increasingly, offices have been withdrawn for residential development; however 553 St Kilda Road (10,953m²) and 541 St Kilda Road (8,229m²) were purchased by Singapore-listed healthcare company International Healthway Corporation on an "as is" basis and for part owner occupation purposes, given the existing medical services in the surrounding vicinity.

In contrast, whilst office space in the Southbank office market decreased in the first half of 2014 (largely through withdrawals for residential development), two new office developments are currently under construction in the precinct. PricewaterhouseCoopers (PwC) has pre-committed to 17,200m² of a 21,000m² Mirvac development at 2 Riverside Quay. The A-grade 12-level office building above an existing 8-storey car park is scheduled for completion in late 2016, with the rejuvenation of the public realm in the Riverside Quay precinct also part of the development. In addition, construction has commenced on the Australian Broadcasting Corporation's new 20,210m² headquarters, which will include office space in addition to specialised studio space and is scheduled to be completed in early 2017.

FIGURE 1

St Kilda Rd & Southbank Net Supply

Per six month period (m²)

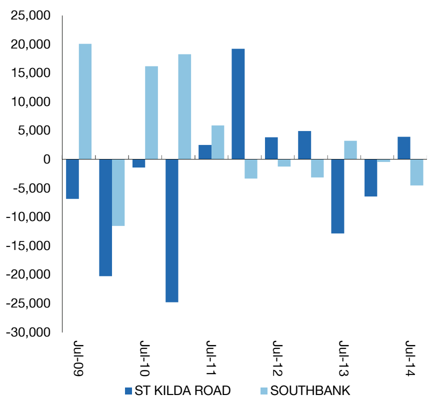


Source: Knight Frank/PCA

FIGURE 2

Net Absorption

Per six month period (m^2)



Source: Knight Frank/PCA

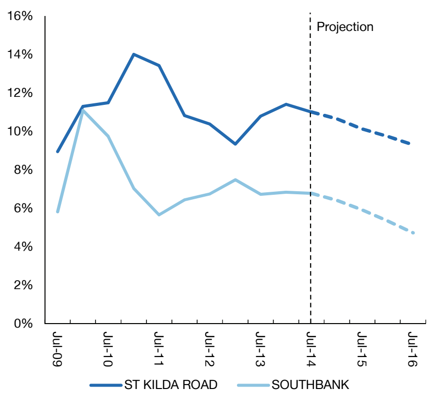
Net Absorption & Vacancy

Having recorded consecutive rises in vacancy through 2013, the total office vacancy rate in the St Kilda Road office market fell from 11.4% in January to 11.0% as at July 2014. The decline in total vacancy was driven by a rebound in absorption of A-grade stock. The St Kilda Road A-grade vacancy rate fell to 8.5%; its lowest level since January 2013. Prime and secondary office vacancy in St Kilda Road continue to diverge, with their spread as at July 2014, double the long term average. While leasing activity in the St Kilda Road precinct has increased over the past 12 months, the majority involved existing St Kilda Road tenants such as Hitachi, SAP and Simonds Homes and as such did not significantly reduce the total vacancy rate. Looking forward, the trend of tenants upgrading their office accommodation is projected to continue with recent leasing commitments involving tenants relocating from secondary space. Aided by steady white collar employment growth and boosted by incoming suburban tenants, total vacancy in the St Kilda Road office market is forecast to continue its decline over the next two years. Within the Southbank office market, the vacancy rate remained steady in the six months to July 2014 at 6.8%. A-Grade vacancies in the precinct increased to 4.9%, their highest level since July 2010. The rise in A-grade vacancy resulted largely from an increase in sublease space which as at July 2014 reached its second highest level on record, and the highest since July 1994. In the absence of any new supply until late 2016, the vacancy rate in the Southbank office market is forecast to remain below its long term average over the next two years.

FIGURE 3

St Kilda Rd & Southbank Vacancy

2009-2016 (%)

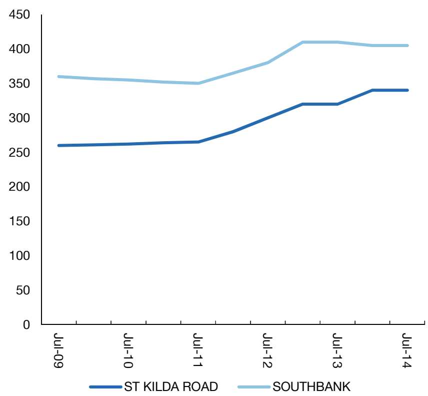


Source: Knight Frank/PCA

FIGURE 4

Average Prime Net Face Rents

St Kilda Rd & Southbank ($\$/m^2$)



Source: Knight Frank

Rents

Whilst average net face rental levels in the St Kilda Road office market have steadily increased over the past two years, incentives have also increased, reducing net effective rents. As at July 2014, prime net face rents average $\$340/m^2$, increasing by 6.3% over the last 12 months. Looking forward, as a result of the decreasing available contiguous prime vacant options in the St Kilda Road office market, solid effective rental growth is forecast as incentive levels begin to reduce.

Within the Southbank office market, whilst the relatively tight A-grade vacancy has insulated net face rental levels, averaging $\$405/m^2$, the impending backfill resulting from PwC's relocation and current level of sublease vacancy will maintain the elevated incentive levels for the short to medium term.

TABLE 1

St Kilda Road & Southbank Office Market Indicators as at July 2014

Grade	Market	Total Stock (m²)	Total Vacancy Rate (%)	Annual Net Absorption (m²)	Annual Net Additions (m²)	Average Net Face Rent ($/m²)	Average Incentive (%)	Average Core Market Yield (%)
Prime	St Kilda Road	245,325	8.5	7,475	0	330—350	25—30	7.25—7.75
	Southbank	248,819	4.9	-8,746	0	380—430	25—30	7.00—7.50
Secondary	St Kilda Road	492,151	12.2	-10,021	-1,056	260—290	25—35	7.75—8.25
	Southbank	173,534	9.5	3,771	-5,103	260—300	25—35	8.00—8.50
Total Market	**St Kilda Road**	**737,476**	**11.0**	**-2,546**	**-1,056**			
	Southbank	**422,353**	**6.8**	**-4,975**	**-5,103**			

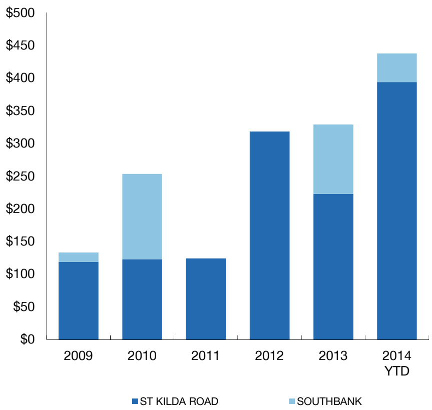
Source: Knight Frank/PCA

Investment Activity & Yields

Investment sales activity (above $10 million) in 2014 to date within the Southbank and St Kilda Road office markets currently totals $433.2 million from 10 properties. Sales in 2014 to date have exceeded all previous annual totals recorded with the exception of 2007 at $499 million. However current campaigns suggest that transactions to finalise in 2014 will set a new record high annual level for the Southbank and St Kilda Road office markets. (Note. Sales volume data excludes assets included in the $3.3bn DEXUS takeover of CPA).

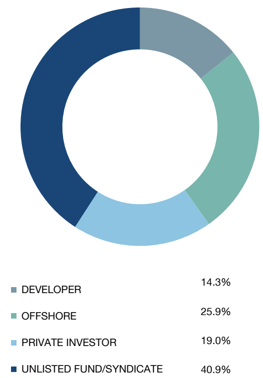
After tripling their spending levels of 2013, unlisted funds and syndicates accounted for 41% of sales by value, spending more than $177 million, up from the $50 million spent in the entire year of 2013. Major acquisitions made by unlisted funds this year include: Australian Property Opportunities Fund's purchase of 390 St Kilda Road for $56.0 million and UBS Grocon Real Estate's purchase of 484 St Kilda Road for $94.0 million. Transactional activity in 2014 has been boosted by a number of major sales. The sale of 484 St Kilda Road was the precinct's highest transaction on record while Dymocks Group's purchase of 441 St Kilda Road for $82.10 million was St Kilda Road's second highest office transaction on record. Investment opportunities in the Southbank office market remain scarce with transactions in the precinct accounting for 10% of the sales by value across the two markets from two transactions. While interest in office buildings that can be repositioned for residential development remains intense, the majority of assets sold in the Southbank and St Kilda Road office markets in 2014 were value add opportunities. The majority of these value add opportunities were secondary offices which accounted for 70% (by number) of the St Kilda Road and Southbank sales recorded.

FIGURE 5
St Kilda Rd & Southbank Sales
By office market $10 million+



Source: Knight Frank

FIGURE 6
St Kilda Rd & Southbank Sales
By purchaser by type $10 million+ 2014YTD



Source: Knight Frank

TABLE 2
Recent Leasing Activity St Kilda Road & Southbank

Address	NLA (m²)	Net Face Rental ($/m²)	Term (yrs)	Lease Type	Tenant	Date
2 Riverside Quay, Southbank	17,200	U/D	12	Pre-com	PwC	Q4-16
441 St Kilda Road	2,219	330	10	New	Australian Industry Group	Q4-14
580 St Kilda Road	914	275	7	New	Royal Freemasons	Q3-14
441 St Kilda Road	1,519	330	7	New	Transpacific	Q3-14
40 City Road, Southbank	570	430	3	New	Laing O'Rourke	Q3-14
417 St Kilda Road	5,500	U/D	7	Renewal	Oracle	Q2-14

TABLE 3
Recent Sales Activity St Kilda Road & Southbank

Address	Price ($ mil)	Core Mkt Yield (%)	NLA (m²)	$/m² NLA	WALE (yrs)	Vendor	Purchaser	Sale Date
441 St Kilda Rd	82.10	7.52	16,061	5,111	4.4	Centuria Property	Dymocks Group	Oct-14
11 Queens Rd	27.00	8.50*	8,806	3,066	2.0	Denison Funds	Vantage Property	Jul-14
484 St Kilda Rd	94.00	7.40	20,376	4,613	3.6	Abacus Funds	UBS Grocon Real Estate	Jul-14
54-68 Kavanagh St^	27.00	n/a	3,137	8,607	VP	Offshore Investor	Central Equity	Apr-14
68-70 Dorcas St^	17.00	n/a	2,462	6,905	n/a	Private Investor	Offshore Developer	Apr-14

Source: Knight Frank * initial yield U/D refers undisclosed
^ bought for potential residential redevelopment

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With investment appetite seeking Melbourne office assets continuing to gather momentum as the Australian economy shifts away from the resources led growth, yield compression in the St Kilda Road and Southbank office markets remains ongoing.

Over the past 12 months, average prime St Kilda Road office core market yields have compressed by 63 basis points to range between 7.25% and 7.75%, while prime Southbank office core market yields have compressed by 25 basis points to range between 7.00% and 7.50%. Although average prime St Kilda Road and Southbank yields now stand lower than the 10-year average, the spread to prime CBD office assets remains higher than the long term average, implying that further yield compression is possible.

Yield compression was also evident in the secondary market, with average secondary yields compressing by 50 basis points over the past year in both the St Kilda Road and Southbank office markets, albeit largely a result of premiums paid for potential residential conversions.

Outlook

Looking forward, white collar employment growth within the St Kilda Road office market is forecast to continue to recover. Deloitte Access Economics is forecasting white collar employment (WCE) growth of 1.7% in 2015, up from 0.5% in 2014. Within the Southbank precinct, WCE is also forecast to grow, boosted by the pre-committed developments currently under construction.

Aided by the increased level of conversion to alternative uses, predominately high density residential, coupled with the improving WCE outlook, vacancy rates are forecast to steadily fall in both the St Kilda Road and Southbank office markets over the next three years.

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

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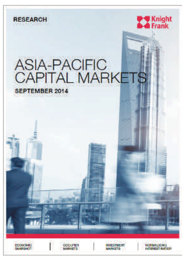

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