RESEARCH

ST KILDA ROAD & SOUTHBANK

OFFICE MARKET BRIEF MAY 2016

Key Findings

St Kilda Road office market **stock has now shrunk by almost 20%** from its peak in 1992

Vacancy in St Kilda Road forecast to fall to 15-year lows over the next 18 months with further withdrawals

Southbank office market recorded solid prime rental growth with limited prime contiguous options available

34,152m² of secondary office stock sold in 2015 which is now **mooted for residential redevelopment**

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With 130,300m² and 47,600m² identified to be permanently withdrawn from the St Kilda Road and Southbank office markets respectively, office vacancies in both precincts are forecast to fall.

Development Activity

With 15,685m² withdrawn from the St Kilda Road office market in the six months to January 2016, office stock in the precinct has now shrunk by almost 20% from its peak of 871,030m² in 1992. Withdrawals in the St Kilda Road office market over the past 12 months for residential development include; 450 St Kilda Road (4,585m²), 601 St Kilda Road (10,241m²) and 14 Queens Road (9,600m²). Similarly, office stock in the Southbank office market declined in the six months to January 2016, diminishing by 3,587m² with 68-70 Dorcas Street (2,432m²) amongst a number of offices withdrawn for residential development.

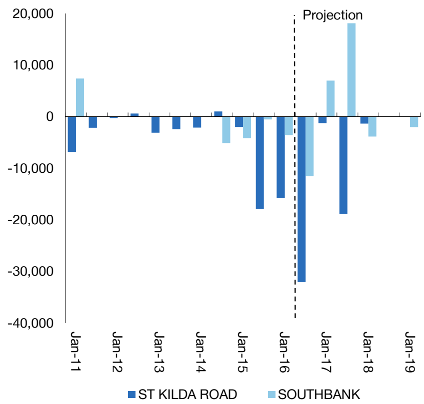
Looking forward, the persistent residential developer demand for Inner City sites will result in further St Kilda Road and Southbank office withdrawals. Over the medium term a further 130,300m² and 47,600m² is forecast to be permanently withdrawn from the St Kilda Road and Southbank office markets respectively. The majority of mooted withdrawals are within B -grade stock with currently no prime office space projected to be withdrawn.

In terms of new office supply, Mirvac/ISPT's 21,000m² development at 2 Riverside Quay, Southbank is scheduled for completion in late 2016 having been pre-committed by PricewaterhouseCoopers (PwC). In addition, the Australian Broadcasting Corporation has committed to a new 20,210m² office at 102 Sturt Street, Southbank which is scheduled to be completed in early 2017.

FIGURE 1

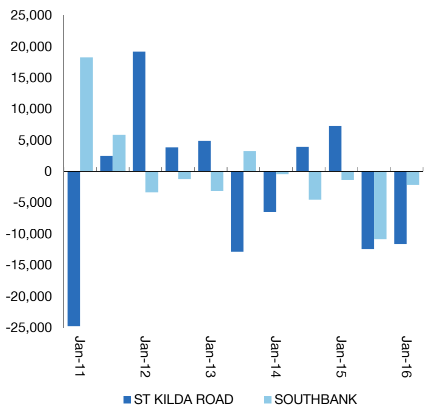
St Kilda Rd & Southbank Net Supply

Per six month period (m²)



Source: Knight Frank Research/PCA

FIGURE 2
Net Absorption
Per six month period (m^2)



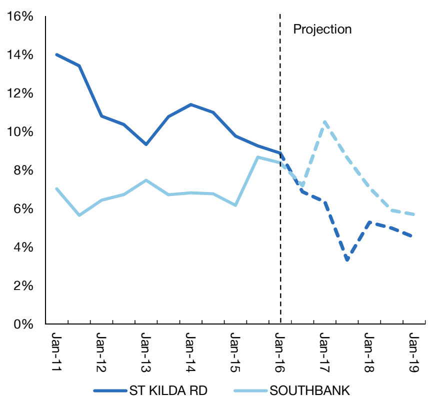
Source: Knight Frank Research/PCA

Net Absorption & Vacancy

Although the St Kilda Road office market recorded negative net absorption in the six months to January 2016, for a second consecutive half-year, vacancy declined. The total office vacancy rate in the St Kilda Road office market fell from 9.3% in July 2015 to 8.9% as at January 2016. The level of occupied space declined in the St Kilda Road office market as a result of the withdrawal of stock which was previously largely occupied. Several tenants who were displaced as a result of stock redevelopments relocated into nearby office buildings, with A-grade and B-grade St Kilda Road office vacancy rates falling. The St Kilda Road A-grade office vacancy rate has now fallen to its lowest level since January 2013. Looking ahead, the total vacancy rate of the St Kilda Road office precinct is anticipated to continue its decline, falling to 15-year lows over the next 18 months.

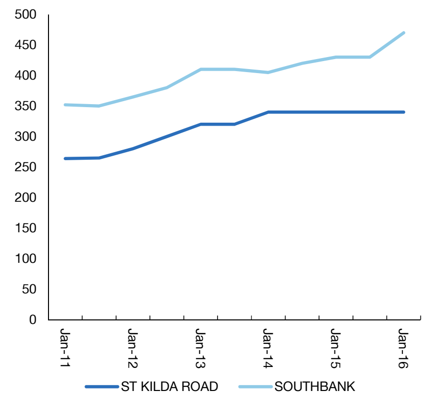
Total vacancy in Southbank fell to 8.4% as at January 2016, down from a five-year high of 8.7% in July 2015, having been adversely impacted by a number of tenant vacations. Previously constrained by an average A-grade vacancy rate of 1.7% between 2011 and 2014; the availability of A-grade accommodation has now attracted some new tenants into the precinct. While Mondelez International relocated within Southbank offices; Philip Morris (from Moorabbin), ADCO Constructions (Hawthorn) and CEVA (Brooklyn) are amongst a number of new tenants who will be relocating into the precinct over 2016. Total vacancy in Southbank is expected to rise and peak in January 2017 with the completion of 2 Riverside Quay before steadily falling through to 2019.

FIGURE 3
St Kilda Rd & Southbank Vacancy
2011-2019 (%)



Source: Knight Frank Research/PCA

FIGURE 4
Average Prime Net Face Rents
St Kilda Rd & Southbank ($/$m^2$)



Source: Knight Frank Research

Rents

With vacancy sitting above the 10-year average, prime and secondary net face rental levels in the St Kilda Road office market have remained steady over the past two years. As at April 2016, prime net face rents average $340/$m^2$. However, the decreasing available contiguous prime vacant options in the St Kilda Road office market along with the reduction of total office stock in the precinct (even though it is of secondary grade quality) has led to a slight reduction of prime incentives which now range between 20% and 25%. Despite the A-grade vacancy rate currently double the 10-year average, the Southbank office market has recorded solid rental growth over the past 12 months. As at April 2016, prime net face rents average $470/$m^2$, with only one prime option currently available offering contiguous space in excess of 2,000m^2.

TABLE 1
St Kilda Road & Southbank Office Market Indicators as at April 2016

Grade	Market	Total Stock (m^2)^	Total Vacancy Rate (%)^	Annual Net Absorption (m^2)^	Annual Net Additions (m^2)^	Average Net Face Rent ($/$m^2$)	Average Incentive (%)	Average Core Market Yield (%)
Prime	St Kilda Road	245,325	6.9	5,590	0	330—350	20—25	6.50—7.00
	Southbank	248,819	8.1	-8,860	0	420—520	25—30	6.00—6.50
Secondary	St Kilda Road	456,625	10.0	-29,667	-33,526	260—290	20—30	7.00—7.50
	Southbank	165,264	8.9	-4,156	-4,100	260—300	20—30	7.25—7.75
Total Market	**St Kilda Road**	**701,950**	**8.9**	**-24,077**	**-33,526**			
	Southbank	**414,083**	**8.4**	**-13,016**	**-4,100**			

Source: Knight Frank Research/PCA ^ PCA data as at January 2016

Investment Activity & Yields

After a record year set in 2014, office sales (above $10 million) totalled $471.72 million from 11 transactions in the 2015 calendar year. The volume of sales achieved in 2015 was 20% higher than the 10-year term average, led by sales within the St Kilda Road office market which recorded its second highest annual level in 10 years.

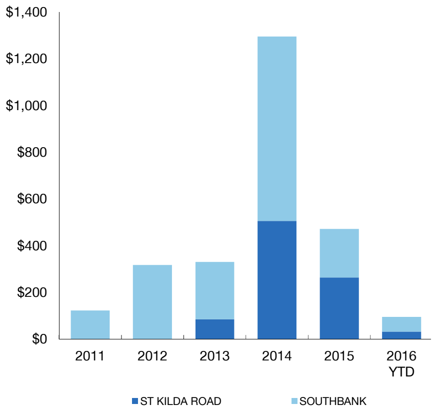
Similar to trends witnessed in Melbourne's other office markets, offshore investors led all purchaser types accounting for 63.6% of sales by value, spending $299.8 million, a 10-year high in the St Kilda Road and Southbank office markets.

The vast majority of sales of Southbank and St Kilda Road offices recorded over the past 12 months were purchased for residential conversion purposes. In total $230.08 million of St Kilda Road and Southbank assets were purchased for a change of use; 412 St Kilda Road ($58.0 million) and 7 Bowen Crescent ($20.0 million) were amongst a number of offices purchased by local and offshore developers in 2015 which are now earmarked for residential development. In total, 34,152m^2 of St Kilda Road and Southbank office space was purchased for a likely change of use in the short to medium term.

FIGURE 5

St Kilda Rd & Southbank Sales

By office market $10 million+



Source: Knight Frank Research

Over the past 12 months, average prime St Kilda Road office core market yields have compressed by 75 basis points to range between 6.50% and 7.00%. Prime Southbank office core market yields also compressed by 75 basis points over the year to range between 6.00% and 6.50%.

The steady decline of yields within the St Kilda Road and Southbank office markets over the past three years has now led to average prime and secondary yields sitting 143 bps and 138 bps below their 10-year averages respectively.

TABLE 2

Recent Leasing Activity St Kilda Road & Southbank

Address	NLA (m^2)	Term (yrs)	Lease Type	Tenant	Sector	Date
40 City Rd, Southbank	10,191	5	Renewal	HWT	TMT[∞]	Q3-18
2 Southbank Bvd, Southbank	872	8	New	Only About Children	Health Care	Q2-16
30 Convention Centre Pl, South Wharf	7,794	10	New	Philip Morris	Manufacturing	Q2-16
60 City Rd, Southbank	1,363	7	New	Celgene	Health Care	Q1-16
75 Dorcas St, South Melbourne	1,525	10	New	ADCO Constructions	Construction & Infrastructure	Q1-16
5 Queens Rd, Melbourne	818	6	New	LivePerson	TMT[∞]	Q1-16
1 Southbank Bvd, Southbank	1,530	6	Sublease	UGL Rail	Construction & Infrastructure	Q1-16
606 St Kilda Rd, Melbourne	870	2	New	Choosewell	Finance & Insurance	Q1-16

TABLE 3

Recent Sales Activity St Kilda Road & Southbank

Address	Price ($ mil)	Initial Yield (%)	NLA (m^2)	$/m^2 NLA	Vendor	Purchaser	Sale Date
216-222 City Rd, Southbank^[†]	32.33	N/A	1,200	26,944	Various	Offshore Developer	Apr-16
11 Dorcas St, South Melbourne	23.28	N/A	3,622	6,427	Offshore Investor	Offshore Investor	Mar-16
606 St Kilda Rd, Melbourne	40.00	7.00	8,647	4,626	Offshore Investor	Bayley Stuart Capital	Feb-16
30 Convention Centre Pl, Sth Wharf	155.00	6.85	20,756	7,475	DEKA	CBRE GI	Dec-15
636 St Kilda Rd, Melbourne	87.50	7.00	17,432	5,020	Blackstone	AMP[‡]	Dec-15
41-49 Bank St, South Melbourne^	15.07	VP	2,600	5,796	Private Investor	Guangdong Carrington	Dec-15
613 St Kilda Rd, Melbourne^	12.10	2.41	1,436	8,426	Private Investor	Golden Asset	Nov-15
256-260 City Rd, Southbank^	27.00	1.41	1,586	17,024	Apex Vic	Undisclosed	Oct-15
35-47 City Rd, Southbank*	22.80	N/A	2,752	8,285	Various	Pro-Invest	Oct-15

Source: Knight Frank Research U/D undisclosed ‡ Wholesale Australian Property Fund † Also includes 107-117 Queensbridge Street, Southbank
* bought for potential hotel redevelopment ^ bought for potential residential redevelopment ∞ TMT refers Technology Media & Telecommunications

Outlook

The recently released 2016/17 State Budget provides full funding for the Metro Rail Project which includes a new station under St Kilda Road. Construction on the new Domain station is expected to commence in 2018 and due to be operational by 2026.

While the new Domain station will significantly improve access to St Kilda Road, residential development will continue, resulting in St Kilda Road and Southbank office stock levels falling further. In the short term an additional 130,300m^2 of St Kilda Road and 47,600m^2 of Southbank office space has been identified to be withdrawn. 55% of the mooted withdrawals is within B-grade stock with the remainder of stock in C-grade and D-grade accommodation. Currently no A-grade office space is projected to be withdrawn. Despite two major developments currently under construction, total office stock in Southbank is forecast to peak in July 2017, only marginally above current stock levels before falling as further stock is withdrawn.

While both office markets recorded negative net absorption over the first half of 2015, total vacancy in both precincts is forecast to fall over the next three years. Whilst the office vacancy level in the Southbank office market will be briefly elevated by PwC's relocation in late 2016; by January 2018, the total vacancy rate in the precinct is projected to be 7.1%. St Kilda Road is expected to continue to record largely negative net absorption in the short term but reflects the withdrawal of office space which is mostly currently occupied. By mid-2017, St Kilda Road vacancy levels are forecast to fall to 15-year lows.

The lack of contiguous prime space for lease within both the St Kilda Road and Southbank office markets coupled with the continued reduction of office stock is expected to encourage rental growth, particularly in the prime market.

With Melbourne projected to be Australia's largest city by 2030 and the growing momentum of people preferring to live closer to places of work, former fringe office buildings offering potential for residential development are likely to maintain investor appetite in both the St Kilda Road and Southbank office markets.

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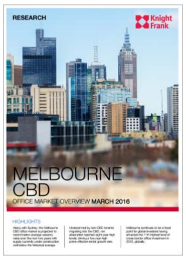

Melbourne CBD Office Market Overview March 2016

Melbourne Suburban Office Overview March 2016

Australian Residential Review April 2016

The Wealth Report 2016

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