- *Rents stable, demand/supply most balanced in the Metro*
- *Supply pipeline muted in the Metro areas / robust in the Fringe*
- *Yields have moved out markedly and investors remain cautious*

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Melbourne City Fringe & Metro Offices

Market Report, December 2022

MARKET ON PAUSE FOR INVESTORS AND TENANTS

14.5%
Vacancy rate in the City Fringe (7.2% in Metro precincts)

-47,313
Sqm change in net absorption in H1

$435
Million in transaction volumes in Metro 2022YTD

"...uncertainty in the economic and financial world leads to a pause in the investment and the landlord and tenant market as players evaluate requirements and pricing"

The Key Insights

Yields have moved out across the markets as investors pause in uncertain times, all markets are at least in the mid 5's for yields, whilst investment volumes, fine in H1 have slowed sharply.

Net absorption has turned slightly negative (-4-8000 sqm)in each precinct and sub-market in this report, as tenants pause as well, except for the Outer East metro (+10,763 sqm) and St Kilda Road (-36,276 sqm).

Supply remains muted in the metro areas, but over 100,000 sqm is expected in the City Fringe in 2023 and 2024.

Net face rents have remained stable across the markets, however incentives have risen in the last few years and continue to in St Kilda Road, leading effective rents lower.

Melbourne Metro Office Market Indicators— up to November 2022

MARKET	TOTAL STOCK SQM	VACANCY RATE %	SIX MONTH NET ABSORPTION SQM	PRIME NET FACE RENT $/ SQM	PRIME INCENTIVE %	CORE MARKET YIELD %
St Kilda Road	648,837	20.9	-36,276	525	40	5.00-5.50
City Fringe	1,196,554	11.0	-5961	538	33	5.10-5.35
Total City Fringe	**1,845,391**	**14.50**	**-42,243**	**531**	**36**	**5.05-5.42**
Metro Inner East	596,634	8.6	-8795	435	32	5.35-5.60
Metro Outer East	1,020,093	7.3	10,763	325	40	5.60-6.10
Metro South East	346,509	5.6	-4,430	320	33	5.60-6.10
Metro North & West	232,925	5.2	-2608	355	32	5.85-6.35
Total Metro	**2,196,160**	**7.2**	**-5,070**	**359**	**34**	**5.60-6.04**

Source: Knight Frank Research/PCA *assuming WALE 5.0 years

MELBOURNE ECONOMY REMAINS RESILIENT

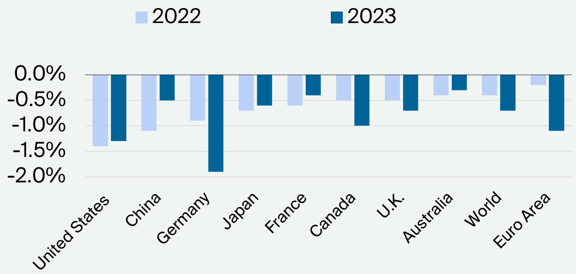
Despite increasing global headwinds, expectations remain positive for the economy

Expectations for growth in the Australian economy remain positive amid a myriad of economic and geopolitical events which have been occurring in recent times. Despite global inflationary pressures (and the marked increase in interest rates in response), energy crises and political instability Australian GDP is still expected to grow by 3.8% this year before slowing somewhat next year, according to the IMF. While this is a downgrade on previous forecasts, Australia is showing far more resilience than other countries.

Melbourne is a major recipient of this, with GRP growth of 5.9% expected this year. Going forward Melbourne continues to outperform and, despite a slowdown in 2023, is expected to average GRP growth of 3.4%p.a. between 2023-27, around 0.5% higher than Australia as a whole. Melbourne is expected to benefit from our global re-opening, with an increase in international workers and students many of which are attracted to Melbourne.

IMF GDP downgrades

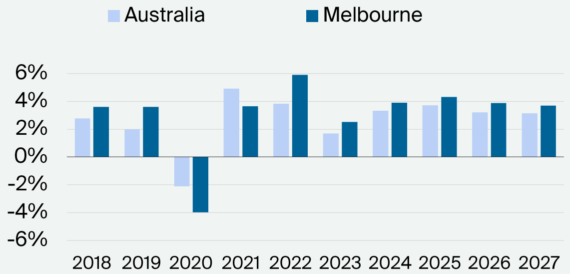
Deviation from April 2022 forecasts, percentage points



Source: Knight Frank Research, IMF

Australia GDP and Melbourne GRP

Per cent change



Source: Knight Frank Research, Oxford Economics

Inflationary pressures rise, particularly within the construction sector

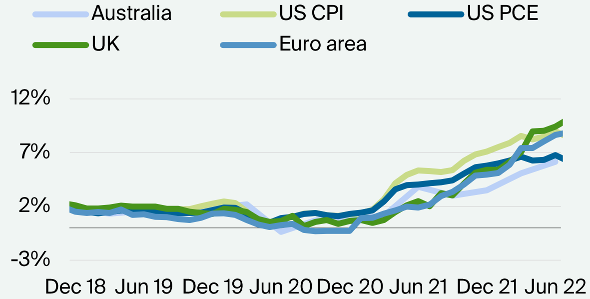
A major area of continued concern is the rise in inflation. Whilst Australia may not be facing the high rates (or forecasts) that other countries are facing, prices have still risen by 7.3% over the year to September, with the RBA forecasting 8.0% by year end, though recent indicators show it may be slightly less than this. The fear is that this may get locked in to the economy in a wage-price spiral, hence the Bank's rapid hiking of interest rates. The aim is to squeeze it out of the economy as quickly as possible.

The hope is that the price spike can be explained by supply side issues which should work their way through the economy. However, whilst the $10 iceberg lettuce has gone, major pricing issues remain, particularly for real estate. Inflation in the construction industry is running at 16% according to the latest ABS figures. Fundamental materials like steel beams and structural timber have seen much higher rises. This all plays through into costs for fit outs, refurbs and future developments.

The raising of interest rates is expected to be a major contributor to the slowdown in the economy next year as monetary policy tightens globally. To some extent this is just a reversion to normal after a decade of relatively loose monetary policy following the global financial crisis and then the pandemic. It will still take some getting used to and regardless, this is expected to impact all areas of commercial real estate as it feeds through to both weaker demand in the economy, and more costly and less freely available debt finance.

Headline inflation

Per cent change year on year



Source: Knight Frank Research, Macrobond

ST KILDA ROAD

Demand remains elusive, but little new supply means rents remain flat

Despite the post-pandemic bounce back in Melbourne, overall increases in net absorption throughout the CBD and Metro area Melbourne have been limited and with plenty of space available, tenants have been trading up. This has hit St Kilda Road, where the trend has continued for firms to move out, with John Holland construction group an example of the latest firm this year moving to the CBD. Consequently, H1 saw net absorption of –36,276 sqm, more than outweighing the positive number at the start of the year. As a result, vacancy rates have risen sharply to 20.9%. Only the fact that there has been little new supply has kept vacancy rates down in recent times. The pipeline remains tiny with just the odd building coming on line, like 5 Bowen Crescent (7,811 sqm) in 2023, and the refurbishment at 380, St Kilda Road adding 9,100 sqm.

Consequently, there has been little price pressure in the market and face rents have remained flat. Given the general trend through the Melbourne market for incentives to rise this has led to a fall in effective rents. So while face rents remain around $460 sqm, with some recent evidence of a slight rise, effective rents have fallen over 20% to $276 sqm as incentives have risen to 40%.

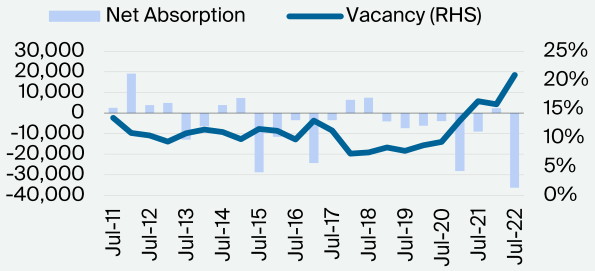
Investment remains muted as the impact of infrastructure work is awaited

Sales volumes have shown little improvement following the sharp drop during the pandemic. YTD investment volumes stand at $95.4m well below the $363m average pre-pandemic. Unsurprisingly, yields have remained flat in recent times. Prime yields having just moved under 5% at 4.9% in mid-2021, have followed the Melbourne office market generally and moved back out this year to 5.3%. This is on limited sales volumes, as the market looks for the new pricing level.

For a lot of investors, uncertainty about the St Kilda Road office market will probably remain until the full impact of the building of the ANZAC station in the Metro project is seen. Due for completion in 2025 there is currently major disruption to the areas infrastructure, but this should yield a quicker smoother link to the city in the future, with the first platform to platform transfer from trains to trams.

St Kilda Road vacancy and absorption

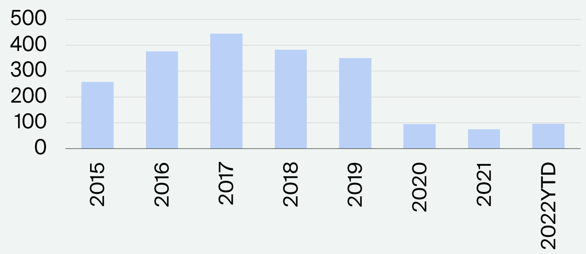
sqm,%



Source: Knight Frank Research, PCA

St Kilda Road sales volume

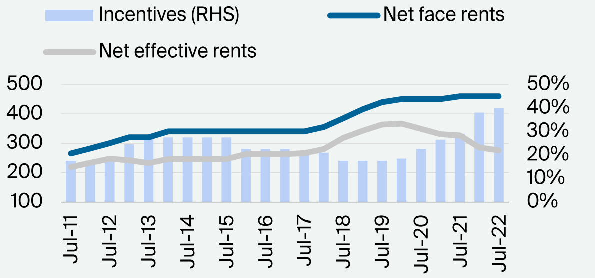
sales $10m+



Source: Knight Frank Research

St Kilda Road rents and incentives

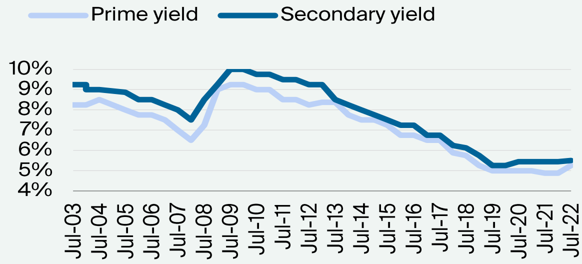
$/sqm, %



Source: Knight Frank Research

St Kilda Road yields

%



Source: Knight Frank Research

CITY FRINGE

Rents stable but marked increase in supply pipeline is on its way

Elsewhere in the City Fringe, the year has been marked by a rather flat market as Melbourne starts returning to normal. Consequently, there has been little change in rents reported in the main precincts in the Fringe locale. The Richmond / Cremorne precinct remains the most sought after with prime net face rents unchanged at $615/sqm, whilst the Northern Fringe is flat at $440/sqm. Elsewhere rents have touched up the odd $5. With incentives flat since April this implies there is virtually no change in net effective rents.

However after a few years where there has been little major new supply, there is now an increasing amount coming on board in the next few years. With little to be supplied by St Kilda Road, this implies that a major part is coming from the Fringe precincts with over 100,000 sqm in 2023 rising to 138,820 sqm in 2024. Given the usual moderate demand requirements this implies developers are hoping for a sea change in desire for space within Melbourne moving out of the CBD and into trendy areas, like Australia Post who are moving out to Charter Hall's Burnley development.

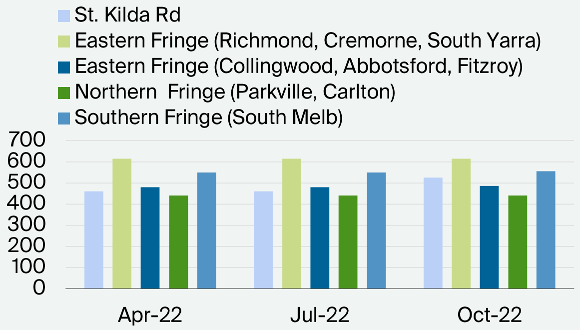
Yield spread rises, as nervous investors pause their purchases

Vacancy rates have risen across the Fringe as tenants leave St Kilda Road, and elsewhere new supply comes on-line. Vacancy rates are now at a decade high. Rates that had dropped to 2.8% in 2019 have risen sharply with City Fringe excl. St Kilda Road now at 11% and 14.5% inclusive. New supply has dropped just when the pandemic hit and things froze. With a considerable pipeline to come vacancy rates will rise further, despite a return of demand.

Yields have been moving out, unsurprising in the present financial environment. Uber low vacancy rates and high demand saw Fringe yields hit parity with the CBD in 2019/20. However, with increased uncertainty, investors have started repricing. Investment volumes have halved to under $350m, yields have moved out to around 5.25% (and still moving), and the spread to CBD has started to return, currently 0.29%.

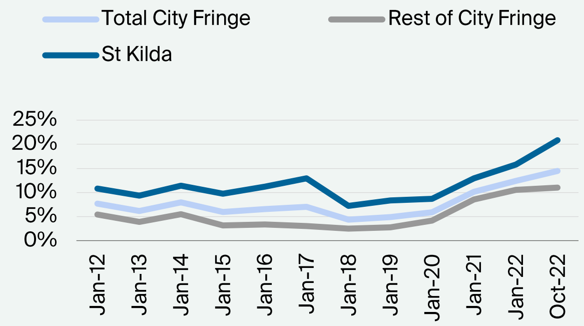
Prime net face rents

in per sqm rents, by precinct



Source: Knight Frank Research

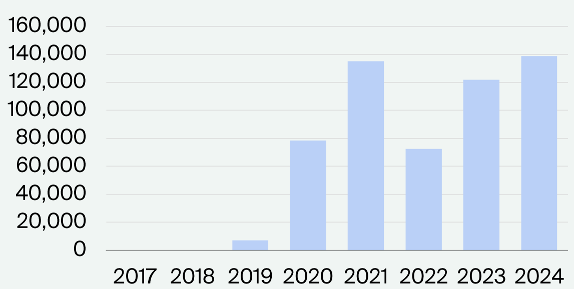
City Fringe vacancy



Source: Knight Frank Research

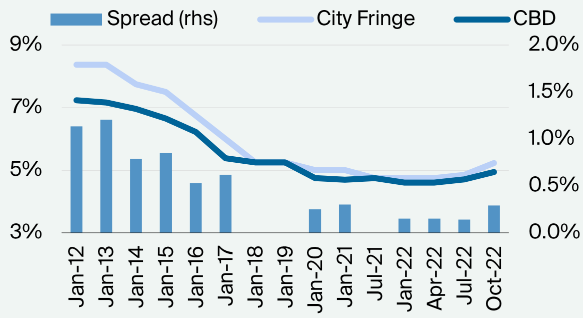
City Fringe office supply

in sqm



Source: Knight Frank Research

City Fringe v CBD prime yields



Source: Knight Frank Research

METRO DEMAND & SUPPLY

Demand softens but has not collapsed as tenants pause their leasing decisions

There has been a generally positive story about demand in the metro markets recently, even given a pause at the start of the pandemic. However, the overall leasing market has slowed through 2022 as tenants are still uncertain on what their post-pandemic demand will be. This has been compounded by the ongoing economic uncertainty. The vibrant metro market, despite many comments to the opposite, is not immune to this trend and net absorption has fallen, by 5,070 sqm in the YTD. Whilst it may turn positive with an end of year lease signing or two, at the moment it looks like the first decline in net demand this decade will be posted.

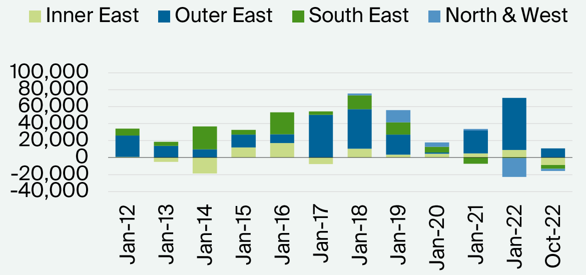
The Inner East (-8,975 sqm) as well as the South East(-4,430 sqm) are leading the fall. These numbers are small and are more indicative of a pause in activity in the last six months. Even the Outer East, which has shown strong demand in the past (with development around areas like Box Hill offering a clear non-CBD office market offering) has slowed.

A strength of the metro market is its greater mix of tenants. Whilst the tech slowdown will have hit some of the metro markets, there is a broad appeal beyond financial services and this diversity will help maintain demand for space.

Supply pipeline muted after delivering 2022 space

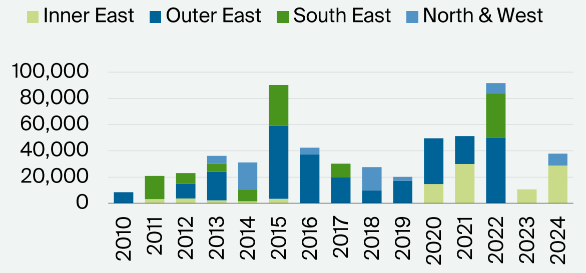
New supply in the metro regions is usually characterised by a number of smaller developments, with the occasional extra flurry as occurred in 2015. Then developments like those in Mulgrave by Australand/CIP and Strata led to an uptick in vacancy rates (in the Outer East and the East) despite there being a marked number of pre-committed developments to the public sector. 2022 is seeing over 50,000sqm coming on line, followed by limited new stock going forward. But this year's new supply includes 28,000 sqm pre-committed development by QIC at Ringwood (Outer East), so it is unlikely that we will see major oversupply. Indeed the Outer East has actually seen a fall in its vacancy rate to 7.3%. Overall there has been a tick-up in rates Metro-wide to 7.2% but within a fairly tight band; but this is not like in the CBD where high supply has hit the market as demand slows.

Metro office net absorption
in sqm by region



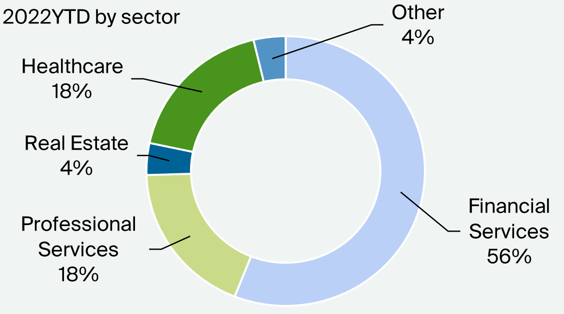
Source: Knight Frank Research

Metro office supply
in sqm



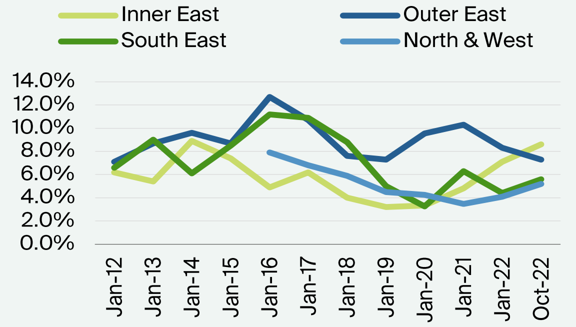
Source: Knight Frank Research

Metro office take-up
2022YTD by sector



Source: Knight Frank Research

Metro office vacancy



Source: Knight Frank Research

METRO RENTS & YIELDS

Net face rents remain stable, but incentives rise

There has been little upward pressure on net face rents since 2019, as new supply across Melbourne, followed by the pandemic, reversed the low trending vacancy rate. Space in metro precincts outside the Inner East has been on offer in a tight band between $295-350/sqm. A recent rise in the South East (playing a bit of catch up) has simply tightened the band to $320-350/sqm. The Inner East continues to trade on a premium of around $100 at $435/sqm.

Incentives have risen markedly from 20% in 2020 to 34% now. Much of that rise (to 31%) actually came before January 2021, so pre- pandemic. It was much more to do with the large amount of supply being delivered, particularly within the CBD (2020-2021). Whilst not providing extra space in the other precincts, it meant that one of their raison d'être, to provide reasonably priced overflow space for the CBD, was gone. Thus to compete and remain attractive incentives rose. As a result, net effective rents have fallen in the metro areas down 14% on their peak in January 2020 .

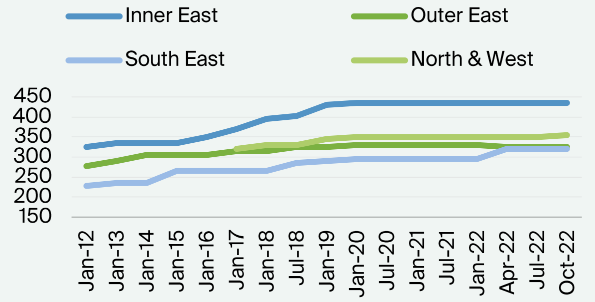
Yields rise as investors pause

Investment volumes in the Metro areas have mirrored the market generally, with investors reviewing and pausing on decisions in light of the changing outlook in the economy and wider capital markets. Investment volumes to October remain well below 2021 at $435m. However, $311.7m took place in H1, activity since then has dropped markedly.

In line with the wider market, yields moved out across the board over the last two quarters. The Inner East, which was trading at the same yield as the City Fringe in 2021, has moved out more aggressively and now sits at 5.48% with other areas in the East now at 5.85% and the North & West at around 6%. Given the continued attractiveness of some of these outer areas and the minimum supply, the yields are looking attractive. If interest rates, and thus the cost of finance begins to stabilise, market yields may not have much further to move.

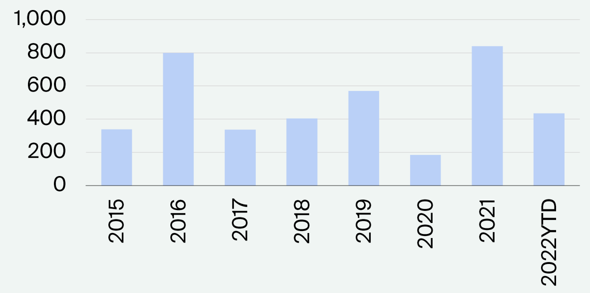
Metro office net face rents

$/sqm



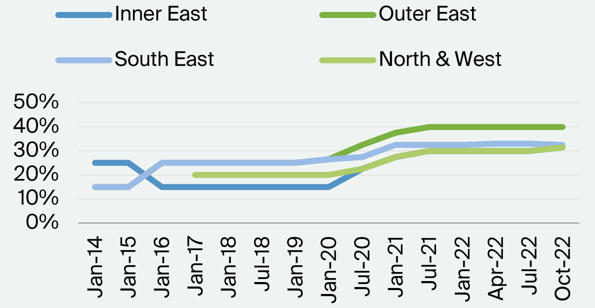
Source: Knight Frank Research

Metro sales volume $10m+



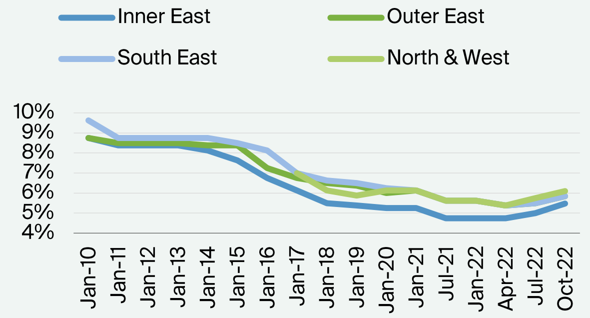
Source: Knight Frank Research

Metro incentives



Source: Knight Frank Research

Metro prime yields



Source: Knight Frank Research

RECENT MARKET ACTIVITY

Under Construction

ADDRESS	REGION	AREA (SQM)	DEVELOPER	MAJOR TENANT	EST. DATE OF COMPLETION
11-29 Eastern Road, South Melbourne	City Fringe	16,600	CDL Constructions	N/A	Q4 2022
222 Hoddle Street, Abbotsford	City Fringe	7,350	Hirsch & Faigen	The Hive	Q2-2023
65-81 Dover Street, Cremorne	City Fringe	10,000	Fortis	N/A	Q4 2023
36-52 Wellington Road, Collingwood	City Fringe	18,200	Hines	N/A	Q3 2023
5 Bowen Crescent, St Kilda Road	City Fringe	7,811	-	N/A	Q2 2023

Recent significant tenant commitments

OCCUPIER	PROPERTY	PRECINCT	SIZE SQM	TERM YRS	START DATE
The Hive*	222 Hoddle Street	Abbotsford	2,285	15	Q2-22
Swisse Wellness#	88 Langridge Street	Collingwood	900	U/D	Q3-22
Arrotex	459 Church Street	Cremorne	4016	5	Q2-22
Commonwealth Bank of Australia~	1 Dean Street	Moonee Ponds	7,104	12	Q3-22
360 Biolabs~	549 St Kilda Road	Melbourne	3,100	10	Q4-22
Dentsu	510 Church Street	Cremorne	4,665	7	Q3-22

Pre-commitment ^ Renewal ~Existing space *Spec

Recent significant sales

PROPERTY	BUYER	VENDOR	NLA SQM	PRICE $M	YIELD %	SALE DATE
611-633 Blackburn Road, Notting Hill	Monash University	Toyota Australia	3,926	66	VP	Aug-22
560 Church Street, South Yarra	Alfasi Property	Alan Hamilton	7,634	80	U/D	Aug-22
GSO Dandenong, 165-169 Thomas Street, Dandenong	Growthpoint Properties	Grollo Family	15,071	165	5.3	May-22
570 Elizabeth Street, Melbourne	U/D	Diabetes Australia	1,258	13.91	VP	Jul-22
33-41 Agnes Street, East Melbourne	CYL Investments	Krogold Constructions	1,828	22.54	4.6	May-22

We like questions, if you've got one about our research, or would like some property advice, we would love to hear from you.

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Brisbane City Fringe Report
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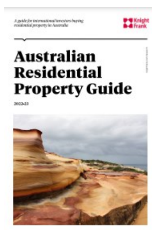
Wealth Report
2022



Australian Residential Report
2022-2023

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