- *Leasing demand resilient across City Fringe and Metro markets*
- *Investment activity falls back further in uncertain times*
- *Face rents stable, whilst incentives continue to rise in many markets*

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Melbourne City Fringe & Metro Offices

Market Report, October 2023

DEMAND FOR PREMIUM SPACE KEEPS LEASING MARKET POSITIVE

9.7%
Vacancy rate in the City Fringe (7.9% in Metro precincts)

46,102
Sqm change in net absorption in H1 for Fringe and Metro

$45
Million in transaction volumes City Fringe 2023

"...a weakening of tenant demand in the CBD is feeding through in to St Kilda Road, however the City Fringe and metro areas are remaining more resilient"

The Key Insights

Net absorption strengthened particularly across City Fringe (42,000 sqm), while metro office market demand (4,000 sqm) also improved as tenants chase higher quality stock.

City Fringe will see record new developments in 2023 with over 130,000 sqm expected to be delivered, whilst the metro office market will see limited new developments this year.

Net face rents have remained stable across the markets, however incentives have risen again, leading effective rents lower.

Investment volumes remain subdued as investors adopt a wait-and-see approach, but with interest rates likely nearing their peak, improved investor confidence is hopefully on the horizon.

Melbourne Metro Office Market Indicators– up to July 2023

MARKET	TOTAL STOCK SQM	VACANCY RATE %	SIX MONTH NET ABSORPTION SQM	PRIME NET FACE RENT $/SQM	PRIME INCENTIVE %	CORE MARKET YIELD %
St Kilda Road	645,300	25.5	-24,911	525	45%	6.50-7.00
City Fringe	1,225,320	9.7	42,239	538	35%	5.94-6.56
City Metro	2,217,682	7.9	3,863	369	35%	6.19-6.75

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

FALLING INFLATION LEADS TO EARLY RATE PEAK

The economy has slowed but remains on track to outperform competitors

The latest GDP figures showed that the Australian economy remains on track to perform above trend, compared to other industrialised countries, even as it continues to slow. Q2 2023 saw growth of 0.4% (2.1% y/y down from 2.4%). This is in line with expectations and latest forecasts from the IMF which show that Australia is expected to grow by 1.6% in 2023 and 1.7% in 2024. Though weaker than the Australian historical average, it remains comfortably above many leading economies in a tough global environment.

Continued interest rate rises have started to impact the economy, with consumer sentiment near record lows and weakening retail sales. However signals remain mixed, with unemployment still low and business conditions remaining positive, even as confidence remains flat. The latter is all important when firms are deciding space requirements for the future. The confidence indicator has remained low since Q3 2022, with uncertainty about future growth.

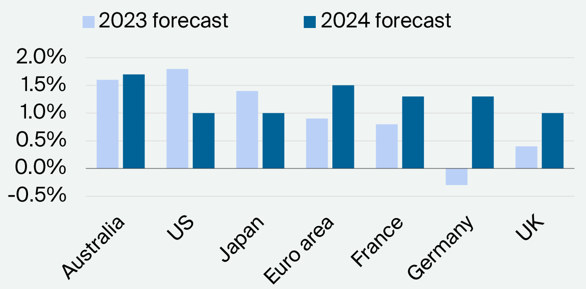
Inflation falls as interest rates peak

The inflation rate (both monthly and quarterly) peaked in 2022, and has been coming down steadily through 2023. This mimics, with a slight lag, international trends as global supply shocks and fuel price rises feed through economies. Inflation has peaked a bit earlier and fallen a bit faster than was initially expected.

The RBA last raised rates in June (to 4.1%) and since then all indicators (apart from employment) show a slowing economy. Government bond rates have also stabilised with 10 year rates steady at around 4%. This early peak in rates is well below what was anticipated last year. With inflation still above the RBA's target of 2-3%, it is expected that rates will not be cut for a while as the RBA confirms inflation has been beaten. It is expected that rates may fall, but slowly over the next couple of years, with bond rates also drifting down. This hopefully implies some certainty and stability to the cost of debt and a return of liquidity to the investment market.

IMF GDP forecasts

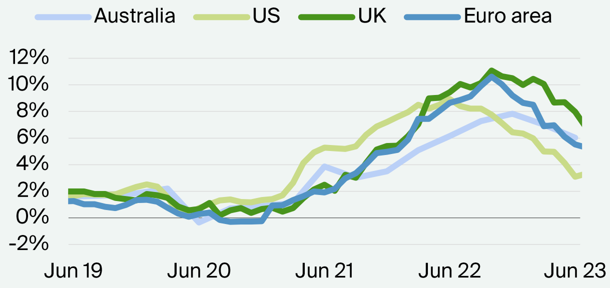
GDP forecasts, July-23



Source: Knight Frank Research, IMF

Headline inflation

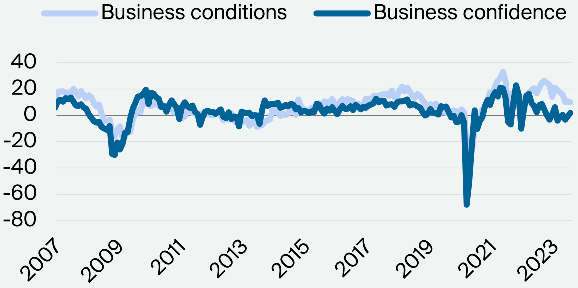
Per cent change year on year



Source: Knight Frank Research, Macrobond

Business confidence and conditions

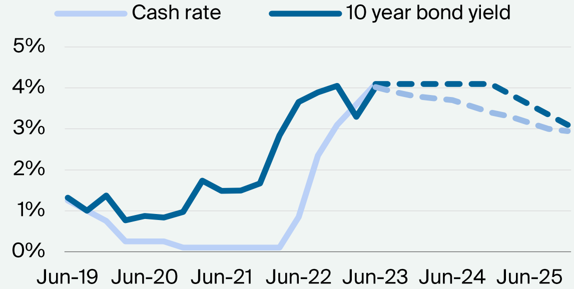
Net balance of positive and negative responses



Source: Knight Frank Research, Macrobond

Interest rate outlook

Cash rate and 10 year bond outlook



Source: Knight Frank Research, Oxford Economics

ST KILDA ROAD

Net Absorption weakens further

The accelerating flight to quality trend has put additional pressure on the already struggling St Kilda Road office market. With tenants either downsizing or moving into CBD and fringe markets, available space has increased dramatically in the precinct. Recently, Hertz and Cancer Council quit their long time St Kilda Road headquarters to move into South Melbourne and East Melbourne respectively. Additionally, newly refurbished building 5 Bowen Crescent also hit the market in Q2, adding nearly 7,811 sqm of space. Consequently, over the six months to July 2023, net absorption fell by –24,911 sqm, although still remaining below the all time high figure recorded in H1 2022. As a result, vacancy rates have gone up, standing at 25.5% as at July 2023.

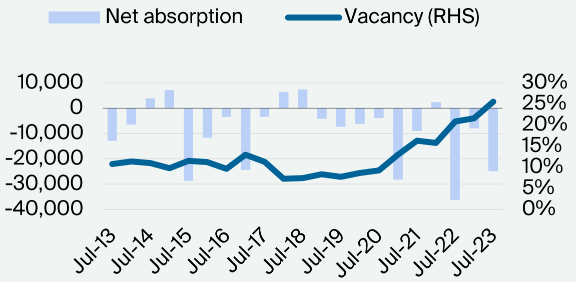
The supply pipeline remains tiny with just one building, 18-22 Thomson Street (2000 sqm) to arrive in H2 2023. 2024 supply also remains limited to a sub 3000 sqm building. With very little supply delivered, there has been little price pressure in the market and face rents have remained flat. Given the 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 $525/sqm, effective rents have fallen over 8% during H1 2023 to $289/sqm as incentives have risen to 45%. However, the major refurbishment of Mirvac's 380 St Kilda Road, providing high quality space positioned just opposite the new ANZAC train station, should provide evidence as to the strength of the location in attracting new tenants.

Investment activity dries up in an uncertain market

Transaction activity in the St Kilda Road area has remained low in recent years since the start of the pandemic. Over 2022 transaction volumes totalled just under $50m in in a single asset transaction, VACC House at 464 St Kilda Road (Wing Tai acquired Abacus's 50% share). This is well below the $363m average pre-pandemic. Similarly, there hasn't been any transaction recorded in 2023 so far. With limited deal evidence it is difficult to be certain of yields but our indicative view is prime yields sit between 6.5% and 7.0%. For a lot of investors, uncertainty about the St Kilda Road office market will remain until the full impact of the building of the ANZAC station in the Metro project is seen.

St Kilda Road vacancy and absorption

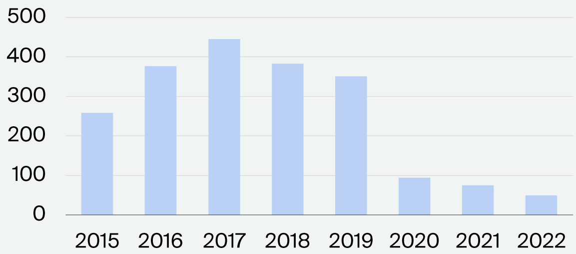
Sqm, %



Source: Knight Frank Research, PCA

St Kilda Road investment volume

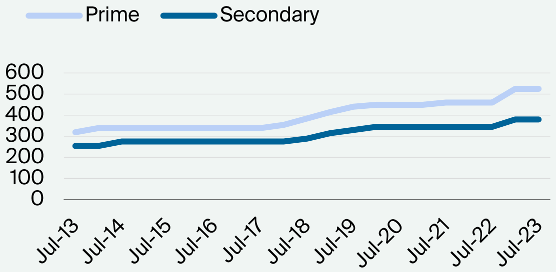
$10m+



Source: Knight Frank Research

St Kilda Road rents

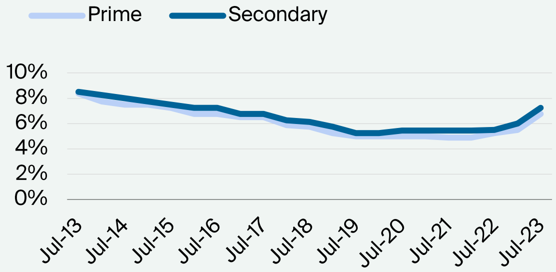
Net, $/sqm by grade



Source: Knight Frank Research

St Kilda Road yields

by grade, %



Source: Knight Frank Research

CITY FRINGE

Flight to amenity and quality driving continued demand for space

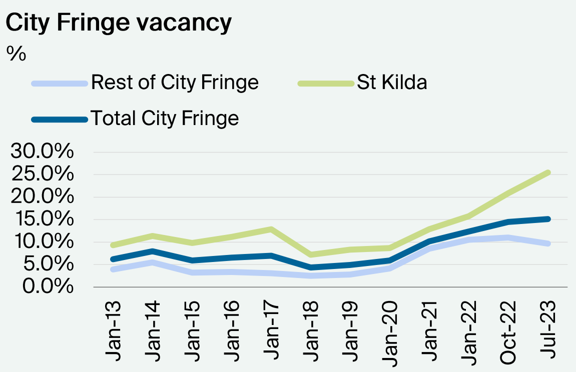
The City Fringe office market has witnessed robust demand in the past few years and it has further strengthened in 2023 with a healthy net absorption of 42,000 sqm recorded between Oct-22 and July-23. The bulk of the leasing activity was carried out in Collingwood and South Melbourne which continues to attract tenants due to the abundant retail amenities surrounding office buildings and easy transport access. Strong demand was shown for new stock as tenants continue to upgrade their space and location. 200 Victoria Place achieved full commitment within three months of practical completion, highlighting confidence in the City Fringe office market. 11 Eastern Road, South Melbourne is now complete, with Levi's committed to 1,000 sqm and a further 3,000 sqm under offer.

As a result, the overall vacancy rate improved from 11% recorded in October last year to 9.7% in July this year. Vacancy rates in lower grade buildings continue to rise. City Fringe rents remain unchanged, standing at $538/sqm. There has been very little upward pressure on incentives in the last 6 months which has also kept effective rents flat, but rises at the end of 2022 mean effective rents are down 4.6% y/y.

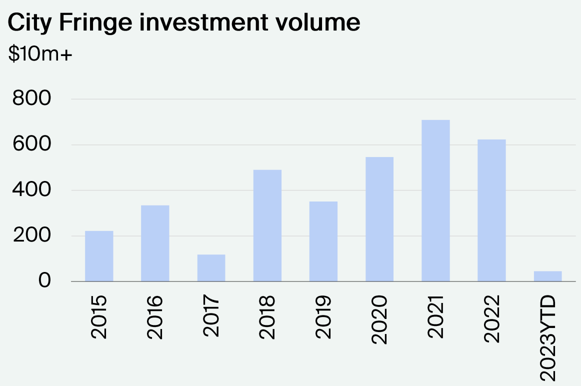
2023 is forecast for a record year for new developments with over 130,670 sqm (for buildings 3000+ sqm) expected to be delivered, of which nearly 50,000 sqm remains to arrive later this year. The supply pipeline is expected to slow down somewhat in 2024. Tenant demand has quietened in recent months, in line with the economy generally, but with a reduced new supply arriving next year, vacancy rates are expected to be fairly stable in the near future.

Limited transaction activity means sharp fall in investment volumes

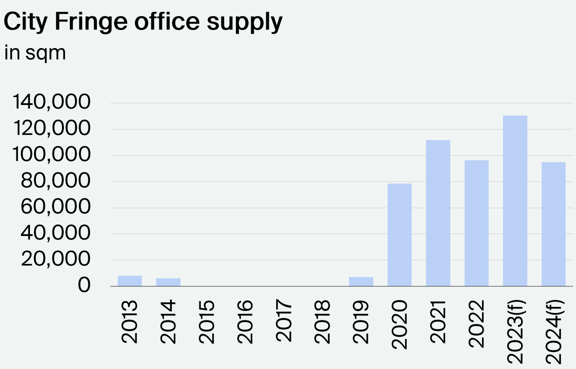
Transaction volumes in the City Fringe totalled $622 million in 2022, down 12% from the record seen in 2021. However, there has been a marked slowdown in volumes in H1 2023, unsurprising in the higher funding cost environment. Only two transactions have been recorded so far totalling $45m. Following the overall market trends, yields have continued to drift out, with prime yields now averaging 6.25%.



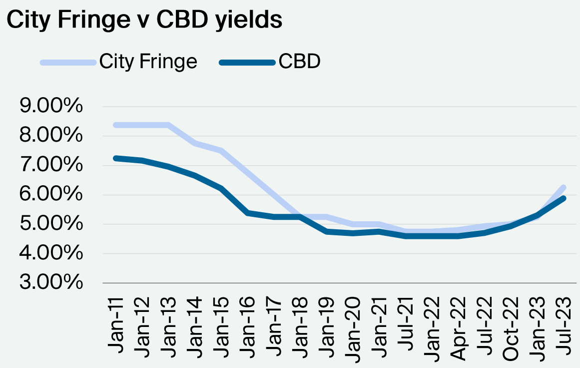
Source: Knight Frank Research



Source: Knight Frank Research



Source: Knight Frank Research



Source: Knight Frank Research

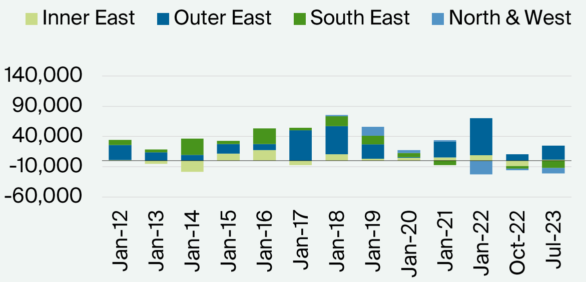
METRO DEMAND & SUPPLY

Diverse tenant demand returns metro area to positive net absorption

Following a slowdown in 2022, demand across metro Melbourne rebounded in the start of the year. H1 2023 recorded a small positive net absorption of 3,863 sqm. The Outer East emerged as the strongest market, with nearly 23,000 sqm of net absorption recorded. Notably, the majority of the demand was for new and existing A grade stock. Inner East demand also improved with around 2,100 sqm net take-up. Elsewhere, the South East and North West markets slowed further, with negative net absorption. The metro areas net position thus sums to near neutral as we moved into H2 2023.

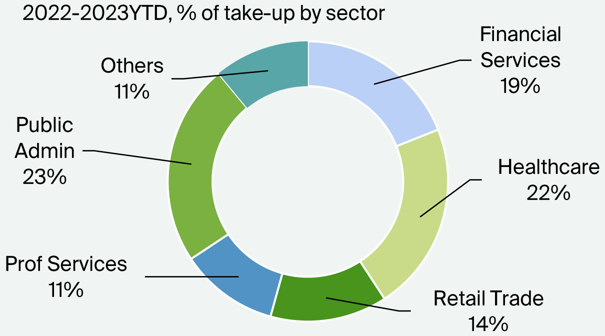
Compared to the CBD, the metro continues to benefit from its tenant client mix. Whilst 2022 started off strong for financial services (56% of overall take-up), space requirements fell back in this sector in 2023. However, public administration has filled the gap this year. With health care, professional services and real estate all increasing their share of take-up (the latter rising from 4% to 14%) the diversified base provides a small but steady amount of demand in the wider metro area.

Metro office net absorption
in sqm by region



Source: Knight Frank Research

Metro office take-up
2022-2023YTD, % of take-up by sector



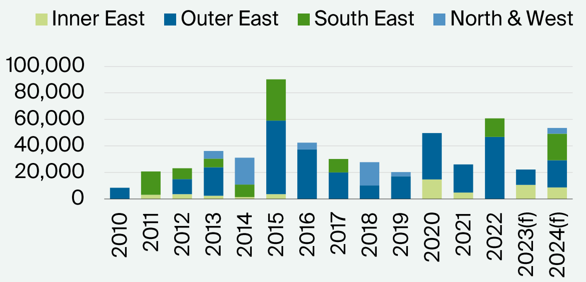
Source: Knight Frank Research

Limited new developments for 2023 as supply pipeline remains intermittent

The metro region has historically seen lower levels of new developments, with intermittent larger developments. In 2022, nearly 60,000 sqm of space was delivered, higher than in recent years. However, supply pipeline for 2023 remains limited to 20,000 sqm, the bulk of which has been delivered. Inner East accounts for majority of the new supply in 2023 and added nearly 13,500 sqm of space in Q2. Consequently, Inner East saw vacancy rates rising further to 9.6%. Outer East which has had a strong pipeline historically delivered just one sub 3000 sqm building this year. Consequently, with limited new supply, the vacancy rate in the Outer East fell to 7.0% between October 2022 and July 2023. Overall, there has been a tick-up in rates metro-wide to 7.9 % but within a fairly tight band.

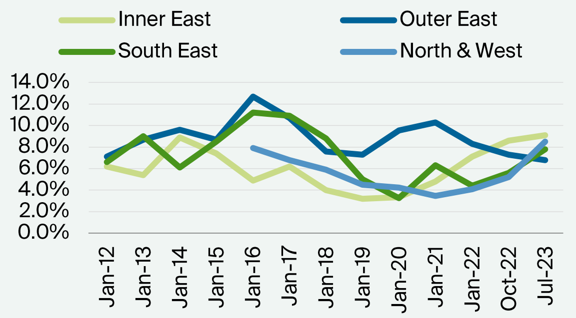
Going forward, there are major projects lined up for early 2024 including One Middle Road (20,000 sqm) and 633 Springvale Road (8,600 sqm) which will put some pressure on the vacancy rates outlook in the metro area in the short term.

Metro office supply
in sqm



Source: Knight Frank Research

Metro office vacancy
%



Source: Knight Frank Research

METRO RENTS & YIELDS

Net face rents edge up, as do incentives

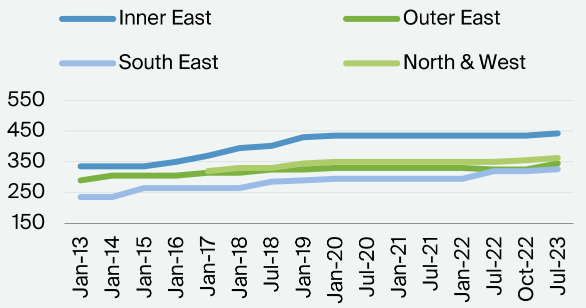
Face rents have recorded little upward movement since 2019. The moderate demand and supply within the metro area has kept the market balanced, whilst elsewhere new supply across Melbourne CBD has reversed the low trending vacancy rate.

Average net face rents for the prime market are judged to be standing at $369/sqm as at July 2023 up 3.2% on July 2022. The Inner East area rents continue to stand out at $443/sqm (up 1.8% y/y) but it is the Outer East that has seen the fastest growth in the last year, up 6.2% to $345/sqm. The South East remains the cheapest precinct at $326/sqm (up 1.9% y/y).

Incentives have continued to edge out, with the Inner East having incentives averaging 35% and elsewhere in the metro regions it is closer to 40%. Pressure on incentives is expected to continue as landlords closer to and within the CBD continue to offer higher incentives.

Metro office net face rents

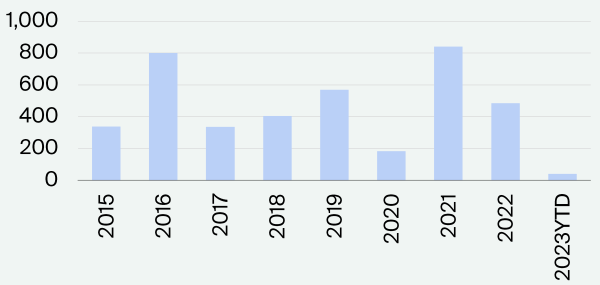
$/sqm



Source: Knight Frank Research

Metro investment volume

$10m+



Source: Knight Frank Research

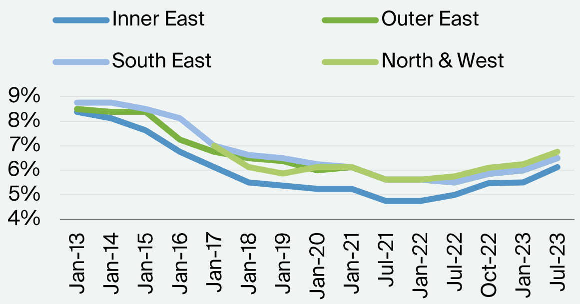
Quiet investment market as yields continue to drift out

The economic uncertainty and rise in interest rates has led to a sharp fall in investment activity across Melbourne, including in the metro area. The transaction volumes in 2022 were down 42% following a strong 2021 but were still near the average pre-pandemic. However, H1 2023 has seen just one transaction across the metro areas, 436 Elgar Road, Box Hill at $40m.

Metro yields have continued to move out in 2023 in response to the difficulties in the capital markets. Yields across the metro regions moved out by 50bps, with the exception of the Inner East which moved out 63bps to 6.1%, though it remains the lowest yielding region. Average yields are now 6.5%. Metro yields have now moved out 106bps since their low in July 2021. However, in line with the market resilience and the already high yields, this is lower than the movement in the CBD (128 bps), the Fringe (150bps) or St Kilda Road (187bps). Yields for prime property are now nearing their peak.

Metro prime yields

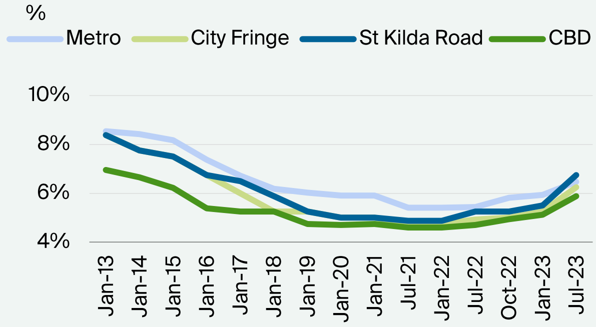
%



Source: Knight Frank Research

Melbourne yields

%



Source: Knight Frank Research

RECENT MARKET ACTIVITY

Under construction

ADDRESS	REGION	AREA (SQM)	DEVELOPER	MAJOR TENANT	EST. DATE OF COMPLETION
36 Wellington Road, Collingwood	City Fringe	18,200	Hines	N/A	Q3-2023
65 Dover Street, Cremorne	City Fringe	9,100	Fortis	Adidas	Q4-2023
88 Laurens Street, North Melbourne	City Fringe	17,830	Accord	N/A	Q4-2023
One Middle Road, Chadstone	City Fringe	20,000	Vicinity Centres	Adairs	Q2-2024

Recent significant tenant commitments

OCCUPIER	PROPERTY	PRECINCT	SIZE SQM	TERM YRS	START DATE
Analog Devices	818 Whitehorse Road, Box Hill	Outer East	2,002	3.0	Q1-23
Calvary Care	352 Wellington Road, Mulgrave	South East	1,317	6.0	Q1-23
Adidas	61-65 Dover Street, Cremorne	City Fringe	2,826	10.0	Q4-23
ACCIONA Australia	71 Gipps Street, Collingwood	City Fringe	3,655	U/D	Q2-23
Centre for Eye Research	200 Victoria Parade, East Melbourne	City Fringe	2,163	tbc	Q2-23
Cancer Council	200 Victoria Parade, East Melbourne	City Fringe	4,423	10.0	Q3-23

Recent significant sales

PROPERTY	BUYER	VENDOR	NLA SQM	PRICE $M	YIELD %	SALE DATE
112 Trenerry Crescent, Abbotsford	Rick Jamieson	Zagame Family	4,252	29.7	-	May-23
436 Elgar Road, Box Hill	U/D	Garda Property Group	5,725	40.3	5.9	Mar-23
289 Wellington Parade	Bayley Stuart	Harmony Property Investments	5,526	51.7	4.5	Dec-22
88 Langridge Street	DWS International GmbH	Peregrine Projects	6,000	77.5	5.2	Nov-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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