- *Vacancy increases further as effects of pandemic hit home*
- *Office workers heading back to CBD a boon for CBD office market*
- *Prime yields hold*

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Melbourne CBD Office

Market Report, March 2021

IMPACT OF PANDEMIC BEING FELT IN CBD MARKET

While the COVID-19 pandemic has had a profound impact on the Melbourne CBD office market and vacancy is expected to rise further as the year unfolds, Victoria's economy is nonetheless tipped to recover strongly over the coming years.

8.2% VACANCY

26% of take-up was to Finance and Insurance Services

$1.8 BILLION TURNOVER

"While the impact of the COVID-19 pandemic will continue to be felt this year, the first steps to recovery will begin as the roll-out of the vaccine commences and office workers start returning to the city."

The Key Insights

CBD office vacancy has increased further since our last report, rising from 5.8% in July 2020 to 8.2% in January 2021. Prior to the pandemic hitting Australian shores, vacancy sat at 3.2% in January 2020.

Melbourne CBD's prime and secondary net face rents remained largely unchanged in CY 2020, however incentives increased and this has impacted on net effective rents.

In the range of 175,000 sq m of sub-lease vacancy has hit the Melbourne CBD office market in response to the COVID-19 pandemic impacting demand.

While sales activity was impacted by COVID, offshore investors still (84%) accounted for the lion's share of sales volume in the CBD in 2020.

Despite COVID-19, office yields remain low with core yields for prime assets in the CBD currently ranging between 4.50% and 5.00%.

Melbourne CBD Office Market Indicators—January 2021

GRADE	TOTAL STOCK SQM	VACANCY RATE %	ANNUAL NET ABSORPTION SQM	ANNUAL NET ADDITIONS SQM	AVERAGE NET FACE RENT $/SQM	AVERAGE INCENTIVE %	NET RENTAL GROWTH % YOY	AVERAGE CORE MARKET YIELD %*
Prime	3,429,187	7.9	101,987	134,016	710	30-38	0.0	4.50-5.00
Secondary	1,452,099	8.8	-79,590	-38,879	520	28-37	0.0	5.25–5.75
Total	**4,881,286**	**8.2**	**22,397**	**95,137**				

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

VICTORIA ECONOMY TO BOUNCE BACK

Victorian economy hit hardest by COVID-19 pandemic.

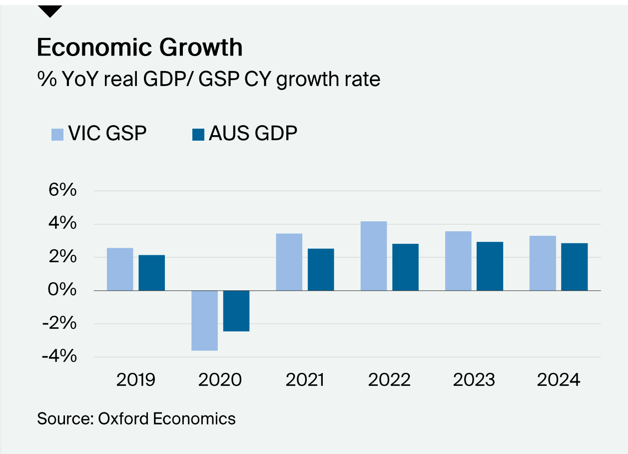
The COVID-19 pandemic sent the national economy into its first recession since 1990-1991 with the state of Victoria most affected due to the city's extended, hard 112-day lockdown period which effectively shut down many businesses and forced the closure of virtually all office workplaces in the second half of the year.

As a result of enduring a second wave of the pandemic, the Victorian economy contracted by -6.1% over 2020, compared to –2.8% for the national economy (Oxford Economics). The hit to employment growth was particularly noticeable, the state's –2.7% growth the lowest of all states and territories. While other states made a significant recovery in Q3 2020 following the easing of restrictions, activity fell sharply in Victoria as a result of the shutdown.

Victoria COVID-19 recovery commenced in Q4 2020.

With the state's strict lockdown proving successful at halting the spread of the virus, Victoria experienced a strong rebound in Q4 2020, the state's recovery essentially lagging behind the other states and territories.

The recovery has been partially driven by an improvement in retail sales. As at early 2021, Victoria's retail sales grew at a faster rate than other states and territories to the point retail sales had caught up to other regions, with a quarter lag.



Victoria tipped to rebound strongly in the long run.

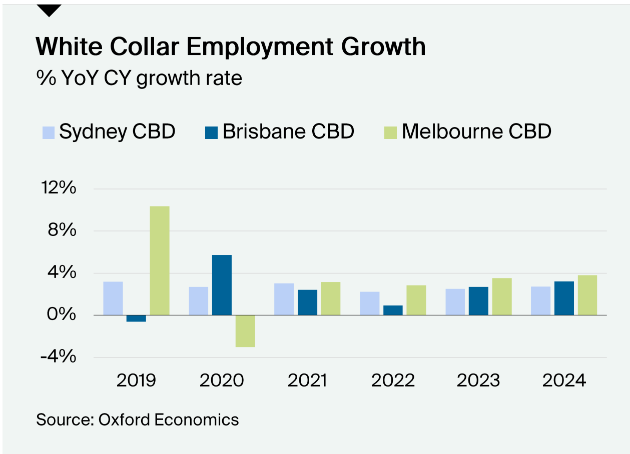
Despite being impacted the most by COVID, moving forwards Victoria's economy is expected to recover strongly. Between 2022-2025, the state's GSP is forecast to grow by over 3.0% each year, which is above the forecasts for other regions with the exception of Western Australia.

Victoria's longer term recovery will be driven in large part by white collar employment, which is tipped to grow by circa 3.0% per annum between 2022-2024, with the level of growth in white collar employment expected to outstrip other states and territories.

While employment growth is not expected to reach the record levels seen pre-COVID, the boost in employment is nonetheless expected to have a positive flow-on effect on office leasing demand and in turn will be the catalyst for broader economic recovery.

Economic recovery dependent on international travel restrictions.

Assuming the successful roll-out of the various COVID vaccines in 2021, the anticipated recovery of Victoria's economy post the COVID pandemic is contingent on Australia's borders reopening. Assuming borders are reopened promptly, this should pave the way for the resumption in overseas visitation and in particular overseas students who play a vital role in the local economy, especially within the Melbourne CBD.



AMAZON DEAL SHOWS APPEAL OF CBD MARKET

COVID causes a noticeable decline in leasing activity in 2020.

COVID-19 has had a profound impact on the Melbourne CBD office leasing market, with the level of leasing activity down considerably on what was recorded in 2019.

The number of new leasing deals recorded in 2020 (52) was 35% less than what was recorded in 2019 (81), while the amount of sq m leased into during 2020 (170,00 sq m) represented just 55% of what was recorded during 2019 (304,500 sq m). Consistent with this, the CBD recorded –25,419 sq m of negative absorption in H2 2020, the largest amount of negative absorption recorded since 2003.

While the amount of leasing enquiries has increased noticeably over the last couple of months in response to Melbourne recovering from the lockdown induced by the second wave of the COVID-19 virus outbreak, as yet this has not translated into considerable transactional activity.

However, as the year unfolds we anticipate leasing activity to pick up as businesses make decisions on how their operations will adjust to life post COVID.

Two sectors drive the Melbourne CBD office leasing market.

Two sectors — professional services and finance & insurance, — drove CBD office leasing volume over the course of 2020, together the two sectors accounting for half (49%) of all leasing activity during the 12-month period.

The finance & insurance sector led the way accounting for a quarter (26%) of all leasing volume, with Bank of China signing on for 1,353 sq m at 120 Collins Street, and consumer credit reporting agency Equifax agreeing to take up 2,040 sq m at 697 Collins Street, being two of the more notable new deals.

Amazon deal shows the underlying strength of Melbourne's CBD office market.

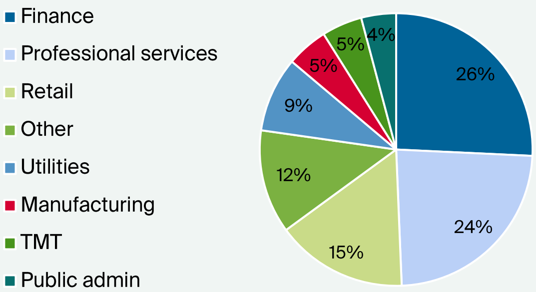
American tech behemoth Amazon has signed on as the anchor tenant in Charter Hall's 555 Collins Street development.

The $1.5 billion, 48,000 sq m premium development is currently under construction and due to reach completion in H2 2023. In pre-committing to 13,500 sq m, the Amazon deal has effectively fast tracked the first stage ($750 million) of construction, being built by Lendlease Constructions.

The 555 Collins Street development is a significant boost not just for the city's economy in the wake of the COVID-19 pandemic, but also for the Spencer office precinct, which has historically had among the highest levels of office vacancy in the CBD.

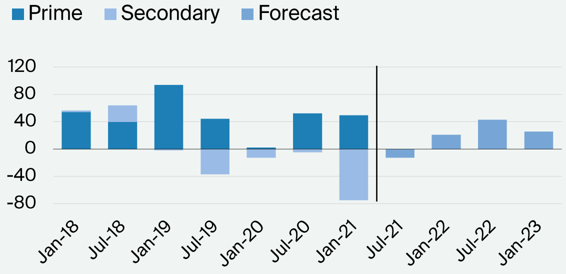
The development is also likely to be the first of a number of future developments that will prioritise PropTech as well as hygiene amenity and services in the post-COVID economy.

CBD Office Take-up by Sector
% share; CY20



Source: Knight Frank Research

CBD Office Net Absorption
'000 sqm by grade



Source: Knight Frank Research

SUB-LEASE VACANCY ON THE RISE

Office vacancy rises further as impact of COVID becomes more evident.

In the wake of the ongoing COVID-19 pandemic, Melbourne CBD office vacancy has increased further since our last report, rising from 5.8% in July 2020 to 8.2% in January 2021. Prior to the pandemic hitting Australian shores, vacancy sat at 3.2% in January 2020. Vacancy is now above the 10-year average of 6.3%.

Despite office workers starting to come back to the CBD and the promise of both a vaccine roll-out and borders reopening at some stage in 2021, we nonetheless anticipate vacancy to increase further during 2021 as some businesses inevitably scale back their office accommodation needs and new development completions hit the market.

Sub-lease vacancy increases notably in the wake of COVID-19 impacting on demand.

The COVID-19 pandemic has had a material affect on sub-lease vacancy in the CBD office market. Knight Frank Research estimate the amount of sub-lease vacancy in the CBD has risen from just under 20,000 sq m in January 2019 to circa 175,000 sq m in January 2021.

Sub-lease vacancy has risen dramatically in response to corporate tenants reconsidering their space needs with a subdued business outlook and a decision to cut staff numbers resulting in many tenants putting unneeded office space back into the market.

Sub-lease vacancy now accounts for 3.6% of all Melbourne CBD office stock. Not all of this is reflected in the official vacancy rate of 8.2% as yet, and while some may be eventually withdrawn Knight Frank still expect the official vacancy figure to rise further to 11.1% by the end of 2021.

Refurb supply adds to development completions expected in 2021.

While the amount of new development supply expected to hit the CBD market in 2021 will be less than what we saw last year, a significant amount of refurbished stock will ensure total completions in 2021 are substantial.

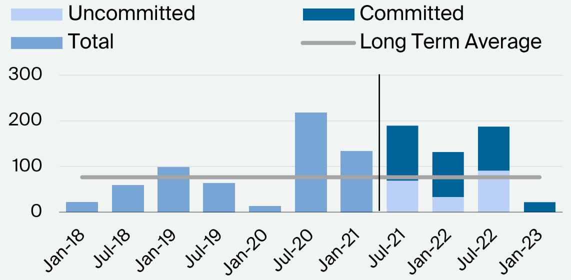
364-378 Little Lonsdale St (24,000 sq m) and 405 Bourke St (66,000 sq m) are the only new developments expected to reach completion this year, meaning the 90,000 sq m of new stock due to land in 2021 is below the 269,000 sq m of new supply that hit the market in 2020.

However, a considerable amount of refurbished stock (112,800 sq m) is due to hit the market this year, with two-thirds of this as yet uncommitted.

Beyond 2021, it is anticipated that any previously mooted developments could be reconsidered or have their development commencement dates pushed back due to uncertainty surrounding demand caused by COVID-19.

CBD Office Gross New Supply

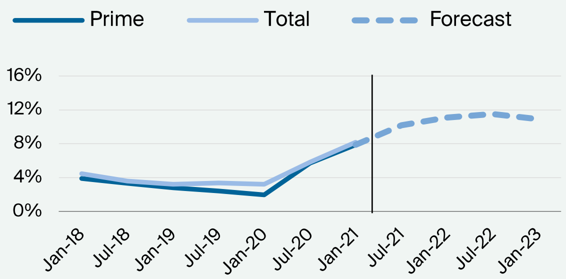
'000 sqm new supply



Source: Knight Frank Research/ PCA

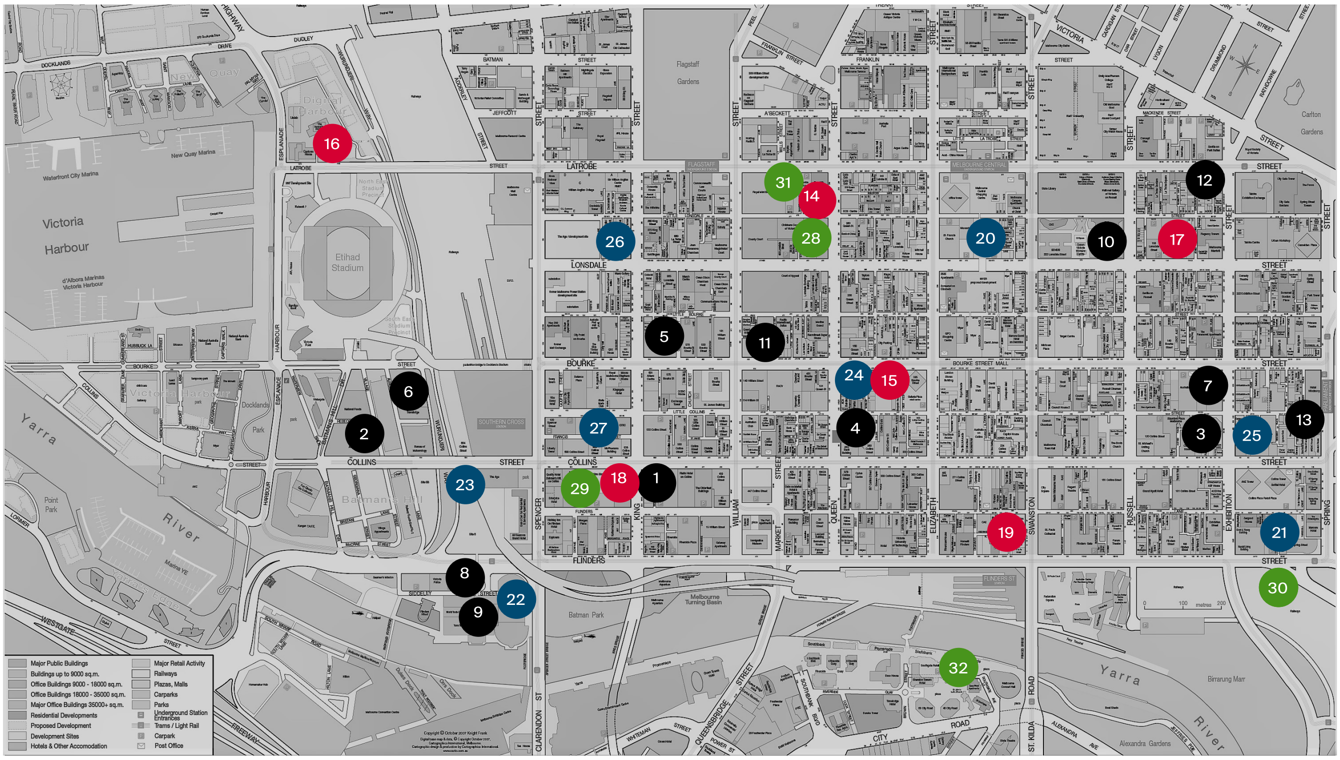
CBD Office Vacancy

% prime and total vacancy



Source: Knight Frank Research/PCA

MAJOR OFFICE SUPPLY



MAJOR REFURBISHMENTS

1 525 COLLINS STREET, 12,377 SQM
DEXUS/GROLLO – 0% COMMITTED. H1 2021

2 750 COLLINS STREET, 35,867 SQM [MONASH COLLEGE]
GPT – 100% COMMITTED. H1 2021

3 80 COLLINS STREET NTH, 8.034 SQM
DEXUS – 0% COMMITTED. H1 2021

4 QUEEN & COLLINS STREETS, 30,353 SQM
GPT – 0% COMMITTED. H1 2021

5 600 BOURKE STREET, 16,161 SQM
AMP – 0% COMMITTED. H2 2021

6 717 BOURKE STREET, 10,000 SQM
REST – 60% COMMITTED. H2 2021

7 121 EXHIBITION STREET, 24,000 SQM
BROOKFIELD/ 151 PROPERTY – 0% COMMITTED. H1 2022

8 637 FLINDERS STREET, 25,716 SQM
ZONE Q/ARTIFEX – 0% COMMITTED. H1 2022

9 18 SIDDELEY STREET (WTC), 14,029 SQM
JOIN GLORY MANAGED BY UDM – 0% COMMITTED. H1 2022

10 180 LONSDALE STREET, 16,000 SQM
DEXUS – 0% COMMITTED. H2 2021

11 500 BOURKE STREET, 46,000 SQM
ISPT – 0% COMMITTED H2 2022

12 321 EXHIBITION STREET,16,000 SQM
INVESCO – 0% COMMITTED H2 2021

13 85 SPRING STREET, 10,000 SQM
ANTON – 0% COMMITTED H2 2022

UNDER CONSTRUCTION/ MAJOR PRE-COMMITMENT

14 364-378 LTL LONDSALE STREET, 24,000 SQM [VICTORIA UNIVERSITY]
ISPT – 67% COMMITTED. H1 2021

15 405 BOURKE STREET, 65,000 SQM [NAB]
BROOKFIELD/ISPT – 100% COMMITTED. H2 2021

16 1,000 LA TROBE STREET, 33,000 SQM [MYER]
POLY GROUP – 27% COMMITTED. H1 2022

17 140 LONSDALE STREET, 22,000 SQM [AUSTRALIAN FEDERAL POLICE]
CHARTER HALL – 100% COMMITTED. H2 2022

18 555 COLLINS STREET, 48,000 SQM [AMAZON]
CHARTER HALL – 31% COMMITTED. H2 2023

19 OVER STATION DEVELOPMENT, SWANSTON STREET,20,000 SQM
LENDLEASE – 0% COMMITTED. H2 2024

DEVELOPMENT APPROVED

20 300 LONSDALE STREET, 20,000 SQM
THE GPT GROUP – 0% COMMITTED. H1 2023

21 32 FLINDERS STREET (NTH & STH TOWER)
THE GPT GROUP 0% COMMITTED. H1 2024

22 FLINDERS WEST, 7-23 SPENCER STREET, 45,000 SQM
MIRVAC – 0% COMMITTED. H1 2024

23 MELB QTR TOWER, 693 COLLINS STREET, 68,000 SQM
LENDLEASE – 0% COMMITTED. H1 2024

24 435 BOURKE STREET, 58,000 SQM
CBUS PROPERTY – 0% COMMITTED. H1 2024

25 60 & 52 COLLINS STREET, 28,000 SQM
DEXUS – 0% COMMITTED. H1 2025

26 600 LONSDALE STREET, 24,000 SQM
V LEADER – 0% COMMITTED. H1 2024+

27 600 COLLINS STREET, 55,000 SQM
HINES – 0% COMMITTED. H1 2025

DEVELOPMENT APPLICATION/MOOTED/ EARLY FEASIBILITY

28 283 QUEEN STREET,25,000 SQM
ISPT. H1 2023

29 522 FLINDERS LANE,30,000 SQM
INVESTA. H1 2024

30 SPRING & FLINDERS STREETS, TREASURY SQR,140,000 SQM
MIRVAC. H1 2025

31 383 LA TROBE STREET,44,000 SQM
MIRVAC. H1 2025

32 SOUTHGATE (TOWER 3),40,000 SQM
ARA. H1 2024

NB Dates are Knight Frank Research estimates
Major tenant commitment in [brackets] net to NLA

FACE RENTS HOLD BUT INCENTIVES INCREASE

Prime net face rents remain largely unchanged however effective rents decline as incentives rise.

While demand for CBD office accommodation has softened in response to the COVID pandemic forcing businesses to re-assess their space needs, landlords have not as yet adjusted their asking rents.

Prime net face rents in the CBD have risen marginally to now average $710/sq m — rents averaged $708/sq m at July 2020, the same as what was recorded in January 2020.

The impact of the pandemic, however, can be seen in incentives and in turn effective rents. While prime net face rents have remained largely unchanged in the 12 months to January 2021, incentives have risen notably in response to a rise in vacancy, with prime incentives now ranging between 30% to 38%.

The rise in incentives has resulted in net effective rents declining from $521/sq m in January 2020 to $462/sq m at January 2021.

Incentives, which can include rent free periods or free office fit-outs, increased substantially throughout 2020 as landlords attempted to lure tenants back to the CBD at the same time as a significant amount of new supply hit the market.

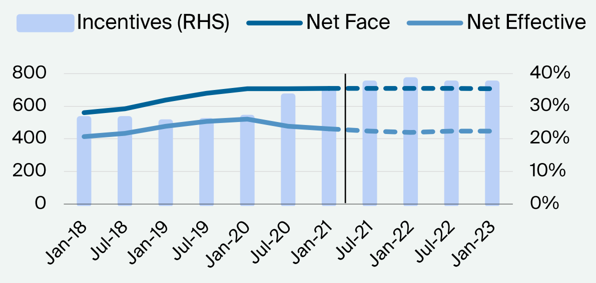
Prime incentives are higher in the Western Core precinct (average 35%) and Docklands precinct (36%) as compared to the Eastern Core precinct (average 30%).

Net face rents are forecast to hold steady while net effective rents are tipped to bottom out in 2021.

Due to the state experiencing an extended period of lockdown in 2020, Melbourne's recovery is expected to lag behind other capital cities. As a consequence, prime net face rents are expected to remain static over the course of 2021, as additional sub-lease availability weighs on the market and in turn on rental growth, and landlords and tenants re-negotiate existing leases.

Net effective rents are, however tipped to drop further. With incentives set to peak in the coming months, net effective rents are set to bottom out by the end of 2021.

CBD Office Rent and Incentive
$/sqm prime rent; % prime incentives; Indicative



Source: Knight Frank Research

Recent significant tenant commitments

OCCUPIER	PROPERTY	PRECINCT	SIZE SQM	TERM YRS	START DATE
Amazon#	555 Collins Street	Western Core	13,500	8	Q3 2023
Hesta~	2 Lonsdale Street	North Eastern	10,300	8	Q1 2022
BAE~	550 Bourke Street	Western Core	8,300	10	Q1 2021
NEC~	717 Bourke Street	Docklands	2,931	6	Q4 2020
Equifax~	697 Collins Street	Docklands	2,040	7	Q1 2021

Pre-commitment ^ Lease of speculatively developed space ~Existing space. Contact leasing team for further information on these deals.

SALES IN 2021 EXPECTED TO RISE

Sales volume down however investment activity expected to rise.

The amount of sales volume in 2020 was the lowest recorded for eight years. By dollar amount, total sales volume — for assets valued over $10 million — over 2020 totalled $1.86 billion, which is below the levels recorded every year since 2012 and almost half the level recorded in 2019 ($3.31 billion).

A lack of available assets for sale in 2020 brought upon by COVID related restrictions on inspections and travel affected sales activity in 2020, however this has acted to create pent up demand and we anticipate substantially higher levels of transaction volume in 2021 as the state emerges from COVID restrictions and business activity and in turn demand for office assets picks up.

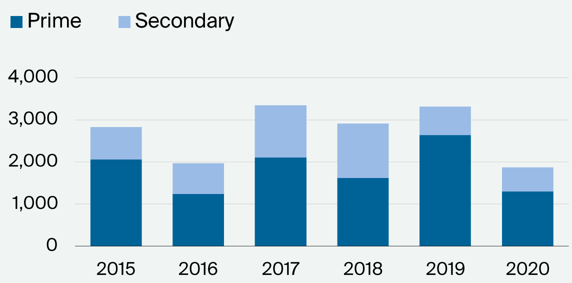
Moving forwards, as the city bounces back from the COVID pandemic we expect more development related transactions to take place, as well as more value-add deals. Long leased assets might also come to market in 2021 given the low cost of debt should drive lower yields and higher pricing for vendors.

CBD office sales volume driven by offshore transactions.

While sales volume in 2020 was down on recent years results, offshore investors accounted for the vast majority of sales volume (84%), and indeed over the last 3 years offshore investors have driven the lion's share of sales activity (37%).

CBD Office Sales Transactions

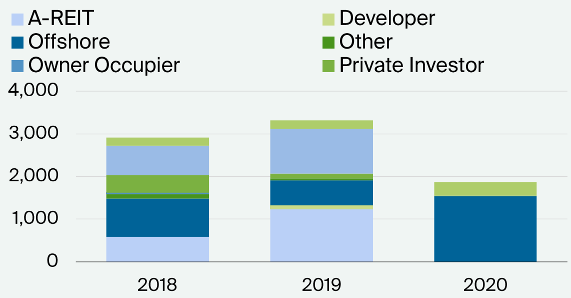
$ millions CY sales by grade; $10mln+ sales



Source: Knight Frank Research

CBD Office Sales Transactions

$ millions by purchaser type; $10mln+ CY sales



Source: Knight Frank Research

Moving forwards, Melbourne's strong underlying economic fundamentals, healthy returns and impressive recovery from COVID should result in the CBD office market continuing to appeal to overseas investors.

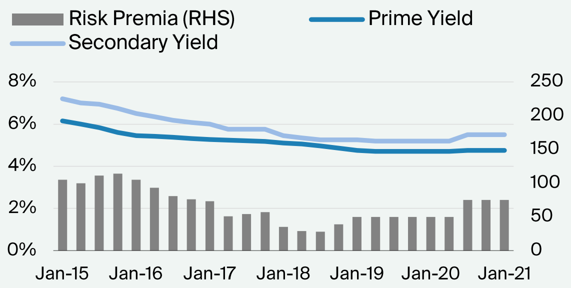
Despite the COVID pandemic, Melbourne CBD office yields remain low.

Despite the COVID-19 pandemic having an impact on the volume of CBD office assets being sold, Melbourne CBD office yields remain at low levels with the gap between property yields and cash such that yields continue to hold up well.

Prime yields currently range between 4.50% to 5.00%, while secondary yields range between 5.25% to 5.75%. The spread between prime and secondary yields currently remains at 80 basis points.

CBD Office Core Market Yields

% yields by grade; bps risk premia



Source: Knight Frank Research

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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