Melbourne CBD Office Market
with Southbank & Docklands update

March 2024 | Quality holds out, as the CBD starts to awaken | knightfrank.com.au/research

Key Insights

Premium grade remains popular as low demand sees vacancy rates rise further

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16.4%
Latest vacancy - CBD

Vacancy rates rose 1.5% in the last 6 months. However, premium grade vacancy actual fell 1.0% across the CBD.

-86K
Annual net absorption

Net absorption was -26,879sqm in the last 6 months, an improvement on H1 2023's figures. Again, premium net absorption was actually positive +12,304sqm for H2 and +24,397sqm for 2023 as a whole.

68k
Sqm of new supply in 2024

One new development will be complete in 2024

2025 = 166,500sqm (6% is pre-committed)

2026 = 100,000sqm (31% pre-committed)

6.25%
Yield Q4'23 – prime basket

Prime yields continued to rise, up 25bps on the quarter and 112 bps on the year. The average yield in the basket ranged from 5.25% to 6.75%.

2.0%
Face Rental Growth

2023 y/y - Basket

Prime net face growth y/y = +2.0%

Secondary growth y/y = -5.6%

Prime net effective growth y/y = -7.0%

Secondary growth y/y = -17.0%

46.0%
Prime Incentives

Prime incentives have continued to rise, up 0.8% from 45.2% on the quarter and up 5.5% on the year.

Melbourne CBD Office Market Indicators – January 2024

Grade	Total Stock sqm	Vacancy Rate %	Annual Net Absorption sqm	6-monthly Net Additions sqm	Average Net Face Rent $/sqm	Average Incentive %	Net Effective Rent Growth % q/q	Core Market Yield %*
Prime	3,724,643	15.4%	-2,910	54,111	700	46.0	-1.2	6.11-6.39%
Secondary	1,445,706	19.2%	-23,969	9,000	537	45.8	0.0	6.73-7.23%
Total	5,170,349	16.4%	-26,879	63,111				

Source: Knight Frank Research/PCA * assuming WALE 5 years

Signs of CBD awakening following a weak 2023

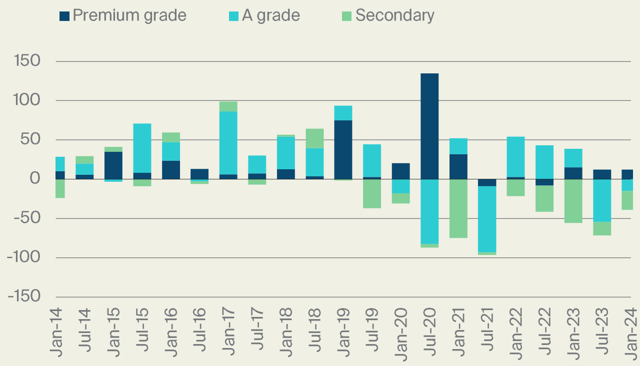
NET ABSORPTION REMAINS NEGATIVE IN MELBOURNE AND AUSTRALIA WIDE

The wider Australian office market saw demand continue to weaken in H2 2023. Over Australia as a whole net absorption within the major CBDs showed the largest negative drop on record of -201,264sqm. Melbourne continued to show negative net absorption, though at -26,879sqm it more than halved the H1 2023 number of -59,652sqm. Demand for premium space remained robust at +12,304sqm, and +24,397sqm for 2023 as a whole. A Grade net absorption was better than the poor figures at the start of the year but still remained negative (at -15,214sqm).

ENQUIRIES WEAKEN, BUT 2024 HAS STARTED WELL

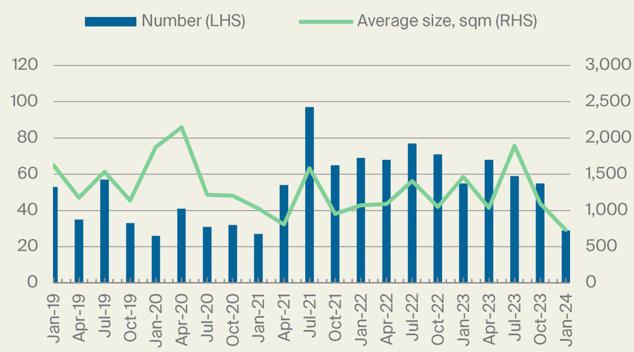
Enquiry levels returned to their pre-pandemic levels as we ended 2023 (29 for Q4), with the average size remaining low. However, in a sign that the corner may be turning, and the tenant market bottomed out, enquiries in the first 2 months of 2024 are already nearing 60. Tenants that were pausing in their decision making in uncertain 2023, are having to move ahead with enquiries in the new year and leasing activity is thus picking up. We are seeing significant enquiries, with the CBD awakening. Tenants are re-affirming their belief in the CBD, sometimes at the expense of old buildings in the Fringe and metro areas. For example, a government department with a long history in the eastern suburbs took 2,000sqm in a high amenity CBD tower on a 7-year term. Zurich have taken 1,400sqm at Bourke Place on a 7-year term. Though they are moving from larger premises at 385 Bourke Street, they are committing to another 7 years in the CBD, just with a smaller plate. We are also seeing a growing list of tenant enquiries coming from the likes of St Kilda Rd. Large space enquiries are also returning to the market; the decision has been made to keep in the CBD.

Net absorption
by grade, 000's sqm



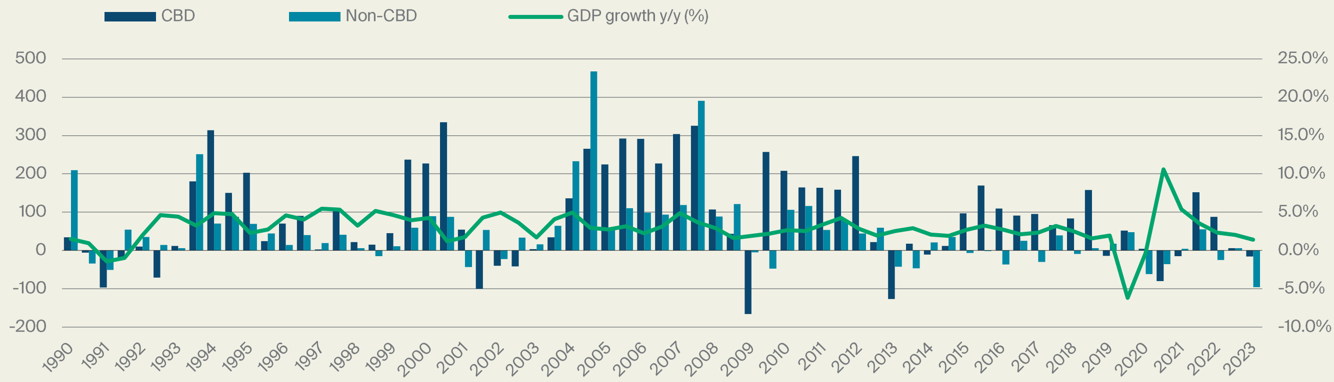
Source: Knight Frank Research, PCA

Number of Melbourne CBD lease enquiries excluding 20,000 sqm+



Source: Knight Frank Research

Office net absorption and GDP growth (Australia)
absorption per six month period, 000's sqm, %



Source: Knight Frank Research, PCA, Oxford Economics

Vacancy rates continue to rise, but respite is in sight

VACANCY RATES TO PEAK IN 2024

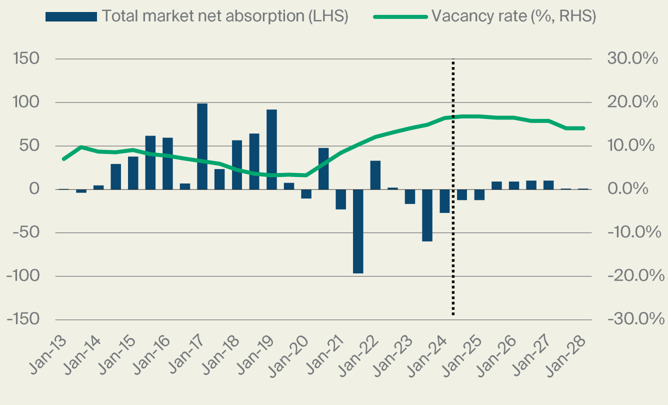
At 16.4%, vacancy rates in Melbourne have risen to a level not seen since 1997, as the supply surge of the last few years met the demand pause post–covid. This has seen vacancy rates rise from a near record low of 3.2% in just four years. However, premium grade vacancy rates fell 1% to 11.2%, even as B grade rates rose 1.9% to 22.3% as the flight to quality continues.

However, hope is in sight. Our expectations for the supply pipeline have changed rapidly with projects getting delayed, pushed back or mothballed. A couple of smaller projects (17 Bennetts Lane and 85 Spring Street) set for 2024 completion have not started and have been moved back to 2025. Elsewhere, 600 Collins Street (60,000sqm) which was expected to be delivered in 2026 has been pushed out to 2028+ as a pre-commit is needed to get this underway. 60 & 52 Collins Street (42,000sqm) and Stage 2 of 555 Collins Street (35,000sqm) scheduled for 2027 have been pushed out to 2028 on a lack of pre-commits, whilst several later projects have moved to possible/mooted. This has led to a marked reduction in the near-term pipeline and a gap appearing (2027) where nothing may land, for the first time on record - however something will probably drop there, e.g. a delayed/overrun 2026 project.

VACANCY RATES TO FALL

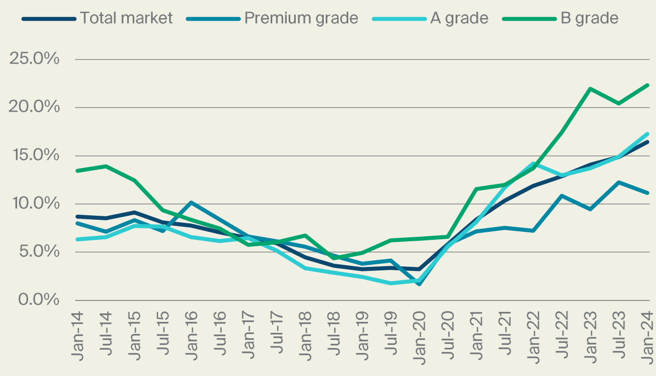
All this means we expect vacancy rates to slowly fall from a peak later this year. Net supply (i.e. minus withdrawals) is expected to be negligible over the next five years. Despite expectations for below average growth in demand for space, this means vacancy rates will drop back as new supply is reduced. Secondary offerings will remain more vulnerable.

Net absorption and vacancy rate
by 000's sqm, %



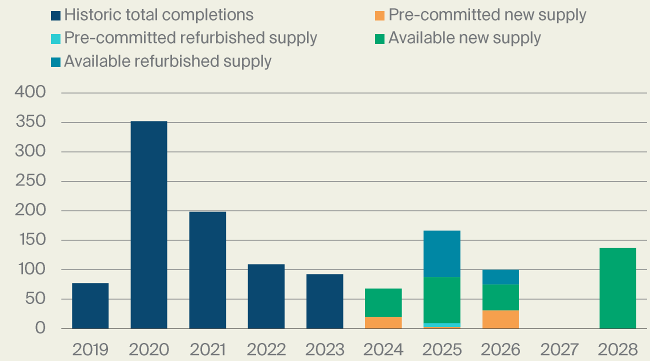
Source: Knight Frank Research, PCA

Vacancy rate
by grade, %



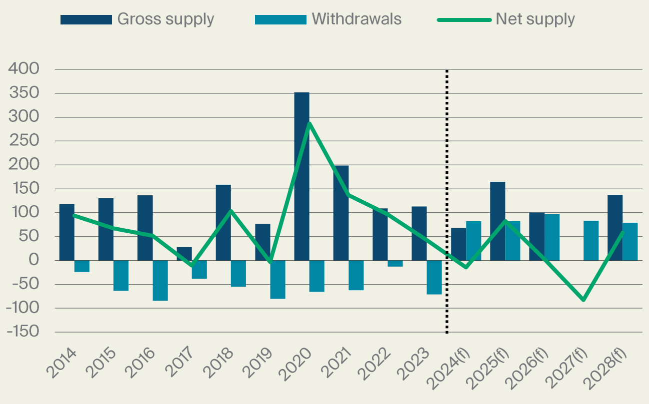
Source: Knight Frank Research, PCA

Melbourne CBD development pipeline
by 000's sqm



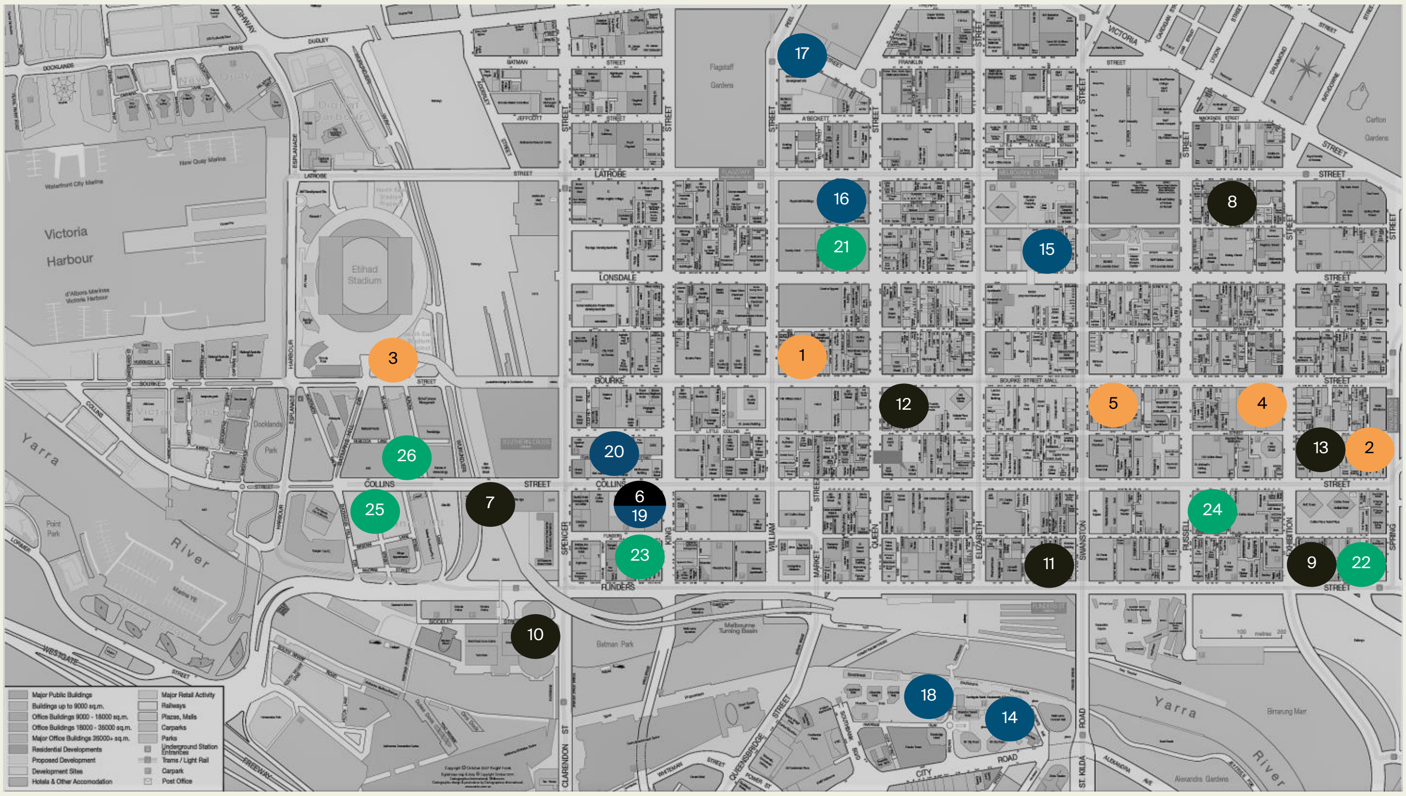
Source: Knight Frank Research, PCA

Supply and withdrawals
by 000's sqm



Source: Knight Frank Research, PCA

Major office supply



Major Refurbishments

#	ADDRESS	SQM	COMPLETION
1	500 Bourke Street	44,000	Completed
2	85 Spring Street	10,000	H1 2025
3	720 Bourke Street	30,000	H2 2025
4	111 Bourke Street	45,000	H2 2025
5	235 Bourke Street	25,000	H1 2026

Under Construction / Major Pre-commitment

#	ADDRESS	SQM	COMPLETION
6	555 Collins Street	48,000 (82% committed)	Completed
7	693 Collins Street (Melbourne quarter tower)	68,000 (29% committed)	H1 2024
8	17 Bennetts Lane	10,500	H1 2025
9	51 Flinders Lane	29,000	H2 2025
10	7 Spencer Street	42,000	H2 2025
11	OSD Swanston Street	17,000 (35% committed)	H1 2026
12	435 Bourke Street	58,000 (43% committed)	H2 2026
13	60 & 52 Collins Street	42,000	H1 2028

Development Approved

#	ADDRESS	SQM	COMPLETION
14	Southgate (Tower 3)	40,000	H1 2028
15	300 Lonsdale Street	22,500	H1 2028+
16	383 La Trobe Street	44,000	H1 2028+
17	388 William Street	25,000	H1 2028+
18	12 Riverside Quay	60,000	H1 2028+
19	555 Collins Street – Stage 2	35,000	H1 2028
20	600 Collins Street	60,000	H2 2028+

Development Application / Mooted / Early Feasibility

#	ADDRESS	SQM	COMPLETION
21	283 Queen Street	30,000	H2 2028+
22	Spring & Flinders Street	140,000	H2 2028+
23	522 Flinders Lane	30,000	H2 2028+
24	123 Collins Street	80,000	H2 2028+
25	Collins Square	70,000	H2 2028+
26	710 Collins Street	70,000	H2 2028+

Quality holds out as incentives rise further

FACE RENTS FLAT FOR THE QUARTER BUT EFFECTIVE RENTS FALL

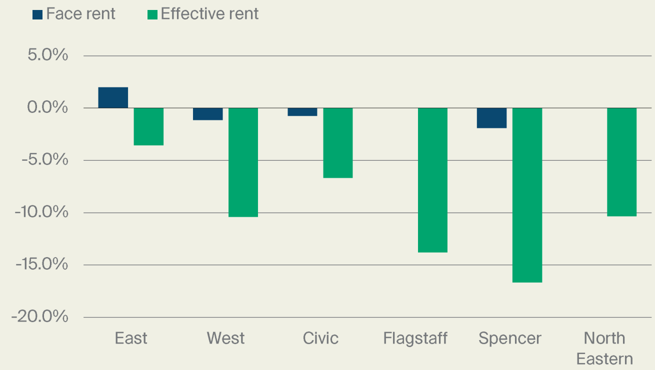
The prime face rents basket remained flat at $700/sqm at the end of 2023 (+2.0% y/y). However, growth only remained in the Eastern Core and a Docklands catch-up. Overall, the CBD has been struggling to hold face rents at there present levels throughout 2023 with growth becoming very selective even within precincts.

Whilst face rents have held steady, this has been achieved by increasing incentives to tenants. Average incentives across the CBD are now 46.0%, with only (again) the Eastern Core below 40%. Several precincts now have prime incentives at 50%. Given average incentives started 2023 at 40.5%, this has meant a sharp decline in prime net effective rents (-7.0%), with secondary net effective rents hit further (-17.0%). Prime effective rents in the precincts of Spencer (-16.7%) and Flagstaff (-13.8%) have been hit hardest. Even the Eastern Core has seen a slight slip back in effective rents (-3.8%).

EXPECTATIONS STABILISE GOING FORWARD

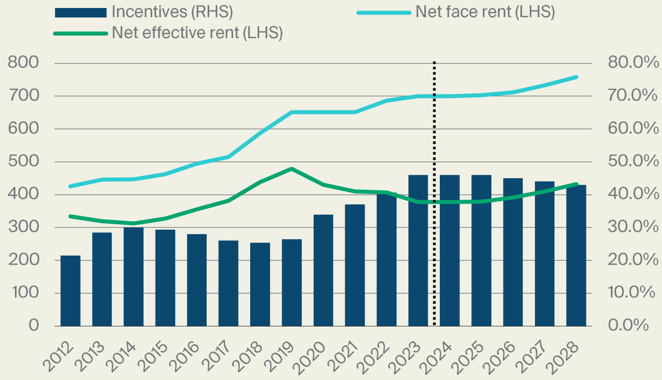
Looking forward, our expectations are that, again, we are near the peak of the incentives rise, as vacancy rates peak. It is expected that in the short-term face rents will remain flat. Moving in to 2025, however, as supply starts to tighten, incentives will come in and consequently effective rents will start rising. Incentives are then expected to fall back from their present highs throughout the rest of the forecast. However, given the vacancy rate overhang, net face rental increases will be very selective throughout the forecasting period and weighted towards the end of the forecast period, when supply tightens.

Melbourne CBD rental growth 2023
by % change y/y



Source: Knight Frank Research

Prime rents and incentives
by $/sqm and %



Source: Knight Frank Research

Recent significant tenant commitments

Occupier	Property	Precinct	Size sqm	Face Rent $/sqm	Incentive %	Term yrs	Start Date
Allens	101 Collins Street	Eastern Core	8,500	1,140	37	10	Jul-25
AGL	699 Bourke Street	Docklands	16,000	600	51	12	Jul-25
Flight Centre	720 Bourke Street	Docklands	2,700	585	55	8	Jul-24
Gallagher Bassett	360 Elizabeth Street	Civic	3,100	595	60	7	Jul-25
AEMO	171 Collins Street	Civic	4,900	850	38	5	Feb-24

\# Pre-commitment ^Sublease ~ Direct * Renewal (g) gross face
Source: Knight Frank Research

Southbank & Docklands share the CBD's pain

VACANCY RATES AND YIELDS RISE IN LINE WITH CBD

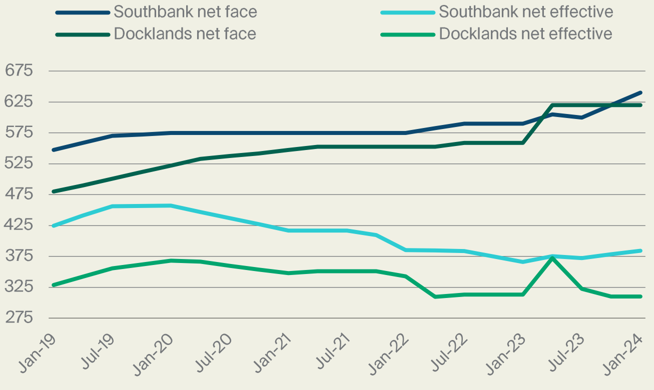
Major statistics for Southbank and the Docklands have been trending in a similar vein to the central CBD. Vacancy rates have risen sharply, in Docklands from a historic low of 0.5% in January 2020 to 14.6% now. Whilst this is below the CBD it is a rapid rise in the last few years. The Southbank, which has generally seen higher vacancy rates sits at 17.0% now. We expect Docklands vacancy rates to rise further in the short-term as Melbourne Quarter Tower (MQT) (68,000sqm – but filling and around 31% let already) drops in H1 2024 and 7 Spencer Street (42,000sqm and 0% pre-commit) drops in 2025, two of the major builds in the pipeline.

Yields have risen in step with the market and are standing at 6.25% (matching the CBD).

PRIME RENTS FLAT AS NET ABSORPTION REMAINS POSITIVE

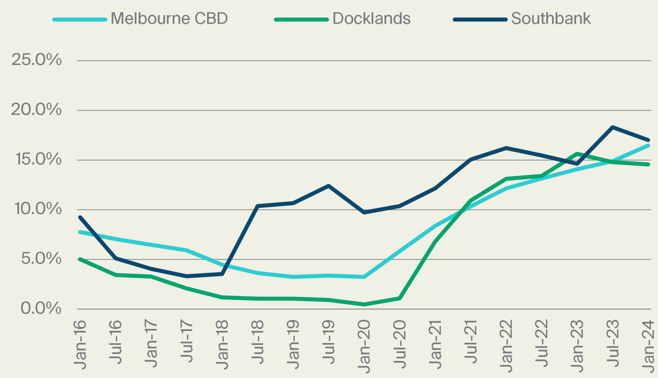
Net absorption in both precincts was positive in H2 2023. Over the last 24 months Docklands has been the more attractive offer to tenants, having net absorption of +24,450sqm compared to -30,003sqm for Southbank. AGL's renewal at 699 Bourke St (16,000sqm) following Medibank, 7 Corporation and Beca moving into the MQT shows that Docklands space near the CBD has continued attraction. Dockland's rents have held firm at $620/sqm this year, but while incentives in prime Docklands have moved out to 50% (above the CBD average), further west away from the CBD they are now touching 60%+. Southbank has retained a slight premium (at $640/sqm) and has seen less pressure on incentives, below the CBD average at 40%.

Southbank and Docklands rents
by precinct, $/sqm



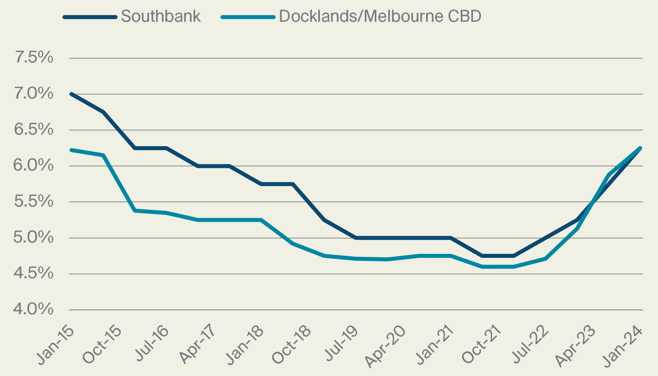
Source: Knight Frank Research

Southbank & Docklands vacancy rate
by precinct, %



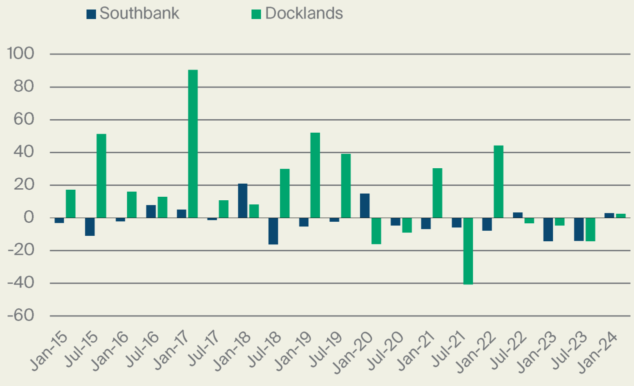
Source: Knight Frank Research, PCA

Southbank & Docklands yields
by precinct, %



Source: Knight Frank Research

Southbank & Docklands net absorption
by precinct, 000's sqm



Source: Knight Frank Research, PCA

Investment market quiet, but pricing reset nears its end

A VERY QUIET YEAR AS MARKETS REPRICED

Since mid 2022, uncertainty over the extent and duration of the re-pricing within the office market has borne heavily on the investment market within Melbourne. Investment volumes in 2023 totalled just $541.1m compared to $3,503m in 2022 and a 10-year average of $2,832m. 2023 was dominated by the sale of 50% of 7 Spencer St in H1 for $315m to Japanese buyer Daibiru, which helped offshore investments makeup a record 80% of activity.

Yields have been moving out since the start of 2022 and having hit a low of 4.60% prime yields are now standing at 6.25%. Secondary rents have fared worse moving out 210bps to 6.98%. As the market has become more uncertain and bifurcation has become more apparent, the spread between prime and secondary has started to expand and from a low of 6bps now stands at 73bps.

CAPITAL VALUES HIT AS YIELDS RISE AND RENTS STRUGGLE

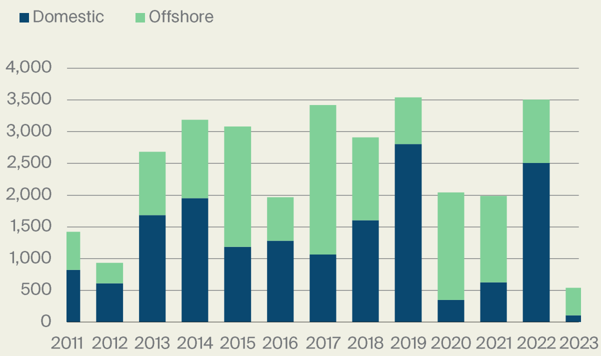
As the cost of debt and the stalling of global growth feeds through to capital markets generally, much, but not all of the yield movement has been impacting all sectors of commercial real estate. However, the weak net absorption has also hit rental growth in the office market with prime face rents just holding their value and fallen in secondary markets. Consequently, unlike the industrial sector which continued to get rental growth shoring up its capital values, there has been no mitigation of the yield hit in the office sector, and for secondary markets it has been compounded. Capital values for Melbourne CBD on our market sentiment indices have fallen 22.5% for prime offices from their peak in Q2 2022. This again is a basket of values with ranges from -15-30%. Secondary have again faired worse.

CAPITAL VALUES - THERE OR THEREABOUTS

Our models on pricing show that, at least for prime yields, we are at or near the peak of the correction. This implies that by the end of 2024 yields may be falling, dependent on the profile of the cash rate and longer-term government bonds. Prime face rents should stabilise through 2024 and thus the fall in capital values should come to an end. The market will turn going forward with capital value growth in selective locales. The weaker outlook for secondary markets means this recovery may take longer to materialize there.

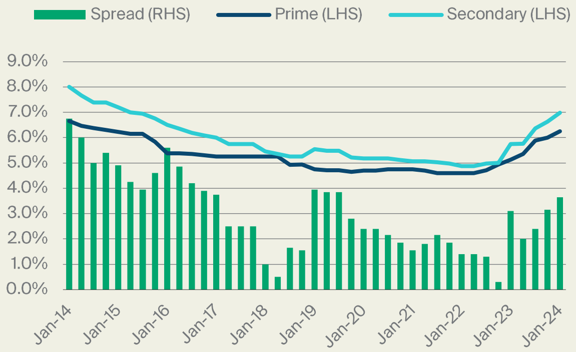
With pricing becoming clearer, we would thus expect activity to resume in the investment market in the second half of 2024.

Melbourne CBD office sales $10m+
by investor type and domicile, $m



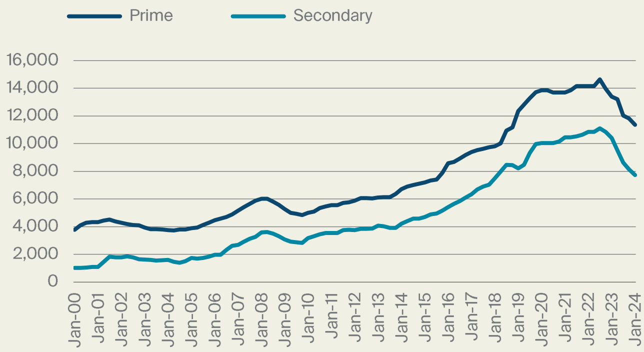
Source: Knight Frank Research

Melbourne CBD office yields
by grade, %, bps



Source: Knight Frank Research

Melbourne CBD capital values
by grade, $/sqm



Source: Knight Frank Research

Recent significant sales

Property	Price $ m	Core Market Yield %	NLA sqm	$/sqm NLA	WALE	Purchaser	Vendor	Sale Date
7 Spencer Street	315	Conf.	46,000	-	n/a	Dailbriu (50% share)	Mirvac	May-23
99 Queen Street	30	-	4,710	-	-	Conf.	E. Scaunich Nominees	Apr-23
406 Collins Street	25	5.8	3,742	5,474	1.5	Conf.	Adrian Abrahams	Oct-23

*Net sale price
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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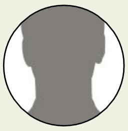

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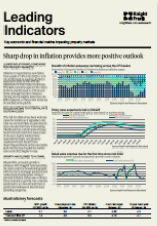
Recent Research



Economic Indicators Report

Build to rent report

Australia Industrial Report

Brisbane's Accelerated Development


Active Capital Report 2023

The Wealth Report 2023

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