RESEARCH

MELBOURNE CBD

OFFICE MARKET OVERVIEW **MARCH 2020**

MELBOURNE CBD NOW THE TIGHTEST OFFICE MARKET NATIONALLY

HIGHLIGHTS

A recent shortage of new development supply and sustained demand driven by record population and employment growth sees vacancy decline even further.

For the second consecutive year, double digit net face rental growth has been recorded for both prime and secondary CBD office markets.

CBD office sales volume in CY 2019 exceeded the 10-year average as institutional investors increasingly gravitate to the Melbourne CBD office market.

KEY FINDINGS

CBD total vacancy continues to be low, decreasing marginally from 3.4% to 3.2% in the 6 months to January 2020.

Prime and secondary net face rents grew by **11.0% YoY and 14.3% YoY** respectively in the year to January 2020.

Melbourne CBD will receive an injection of **new supply** in 2020 (315,000 sq m) however virtually all of this is already **pre-committed** (97%).

2019 saw above average **sales volume** for Melbourne CBD office assets with **$3.16B** worth of sales recorded.

FINN TREMBATH
Associate Director

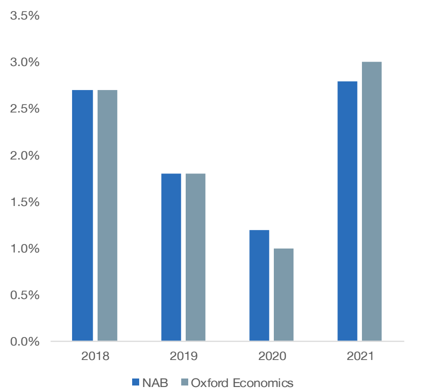
ECONOMIC OVERVIEW

Growth outlook downgraded due to COVID-19

The evolving coronavirus outbreak clearly poses significant downside risks for the global and Australian economy. The spread of the virus globally is weighing on economic activity although the severity and duration of the impact remains highly uncertain. Consistent with the deterioration in the global outlook, growth in the Australian economy will slow in this year. At the time of writing, NAB forecasts real GDP growth will slow from 1.8% in 2019 to 1.2% in 2020, while Oxford Economics predicts growth will be a little weaker at 1.0%. These forecasts represent downgrades of 0.8 and 1.2 percentage points respectively to annual GDP growth since December 2019.

In Australia, the initial growth impact is being felt primarily through services exports such as tourism and education. While the impact on office-based employment is likely to be more limited, occupier demand may slow in the near term because of the spill-over effects from a weaker economic climate.

FIGURE 1
Real GDP Growth Forecasts
Year average



Source: Oxford Economics, NAB, Oxford Economics

Strong policy response to drive recovery

In response to the weaker growth outlook, the RBA has cut interest rates by 25 basis points to 0.5% and is expected to ease policy further through an additional rate cut and targeted measures at reducing long term bond yields. In addition, the Federal Government has announced stimulus measures equivalent to around 1% of GDP aimed at boosting business investment and consumer spending. Assuming the virus outbreak peaks in the coming months, growth is expected to mount a strong recovery later in the year as lower interest rates, fiscal stimulus and a return to confidence all combine to boost activity. At this stage, NAB and Oxford Economics expect GDP growth to recover strongly in 2021 to an above-trend pace of 2.8% and 3% respectively.

Melbourne still the heartbeat of the national economy

While growth will inevitably slow in 2020, Melbourne will remain a key driver of the national economy and continue to experience faster rates of growth underpinned by population growth, urbanisation and the clustering of key service industries. Coupled with a tight occupier market, this long-term growth trajectory will ensure demand from investors and developers remains resilient.

TABLE 1
Melbourne CBD Office Market Indicators as at January 2020

Grade	Total Stock (sq m)*	Vacancy Rate (%)*	Annual Net Absorption (sq m)^	Annual Net Additions (sq m)^	Average Net Face Rent ($/sq m)	Average Incentive (%)	Core Market Yield (%)
Prime	3,117,946	2.0	46,931	3,930	$708	26.4%	4.65—4.90
Secondary	1,490,978	5.9	-49,839	-6,961	$520	26.4%	5.30—5.80
Total	**4,608,924**	**3.2**	**-2,908**	**-3,031**			

Source: Knight Frank Research/PCA *As at 1st Jan '20 ^12months to 1st Jan '20

TENANT DEMAND & ABSORPTION

Net Absorption

Prime YoYΔ:	2,472 sq m -97.4%
Secondary YoYΔ:	-12,904 sq m n.m.

Source: Knight Frank Research/PCA
Note: Absorption for 6mths to 1st Jan '20,
n.m.-not meaningful

Melbourne CBD office market witnesses a further decline in vacancy rate

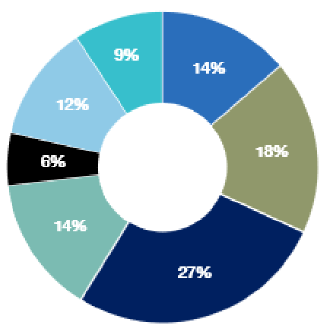
The Melbourne CBD office market has virtually run out of office space. In the second half of 2019 CY vacancy declined again to now reach 3.2%. This is the equal lowest level of vacancy recorded for over 10 years.

The decline in vacancy has been caused by sustained tight supply post-2014 coupled with a prolonged run of strong net absorption. Between 2015 to 2018 net absorption averaged 115,900 sq m annually, which is almost double the long -term average of 64,500 sq m.

The strong net absorption is the result of robust demand sparked by record population and employment growth.

Consequently, Melbourne is now the tightest CBD office market in the country, and yet a delayed development pipeline has meant a shortage of supply was presented to the market in 2019.

FIGURE 2
CBD Office Take-up by Sector
CY2019



Other inclusive of Manufacturing, Construction, Education, Retail, Charity and Recreational services sectors
Source: Knight Frank Research

CBD office market records lower absorption levels in 2019

The shortage of new supply, coupled with above average withdrawals, meant that in 2019 CY the Melbourne CBD office market recorded its lowest 12-month absorption level for over 6 years with negative absorption of -2,908 sq m recorded.

High pre-commitment levels recorded on 2020 supply pipeline

The low take-up activity should not, however be construed as a lack of tenant demand as virtually all of the 2020 new development pipeline is pre-committed which speaks to the pent-up nature of demand within the CBD market.

Much of the headline pre-commitment leasing activity in 2019 took place at the top end of town in the city's much sought after Eastern Core precinct.

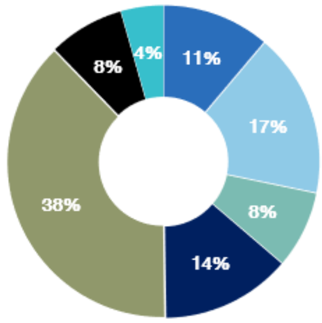
Legal firm Herbert Smith Freehills have signed on for 11,000 sq m at the landmark development at 80 Collins Street. Macquarie Bank (6,000 sq m) and investment firm TPG (834 sq m) have also signed on for the top two floors at the Dexus development.

Leasing activity concentrated on Western Core and Docklands

Indeed, while demand has been driven by a range of sectors, much of the take up has been driven by four particular sectors : the professional services, finance & insurance services, public administration & health care services, and coworking & real estate sectors.

The lion's share of the leasing activity has been concentrated around the Western Core and Docklands precincts.

FIGURE 3
Take-up by Precinct
CY2019



Source: Knight Frank Research

In 2019 CY, just over 104,000 sq m of office space was taken up in the Western Core (this represents 38% of all CBD office take up), while approaching 50,000 sq m was taken up in the Docklands (equates to 17% of all CBD take up).

Coworking increasingly playing a role in new developments

The coworking sector continues to evolve.

In recent times developers have started leveraging the growing appetite for coworking space to lift the level of pre-commitments required to green-light new office developments.

This new trend has been driven by the need to provide prospective incoming corporate tenants with an assurance that the upcoming development will house coworking operators who deliver flexible work solutions.

Changes to ways of working, such as ANZ in Docklands shifting to agile work practices in 2018, have changed the floor space and configuration needs of major corporates.

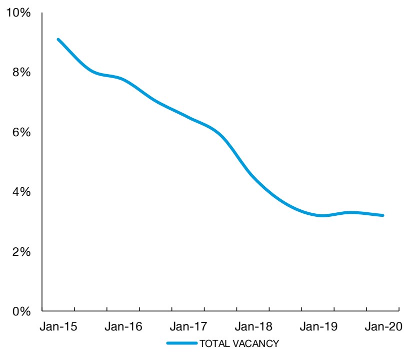
SUPPLY & DEVELOPMENT

Vacancy Rate

Prime	2.0%
YoYΔ:	-84bps
Secondary	5.9%
YoYΔ:	+177bps

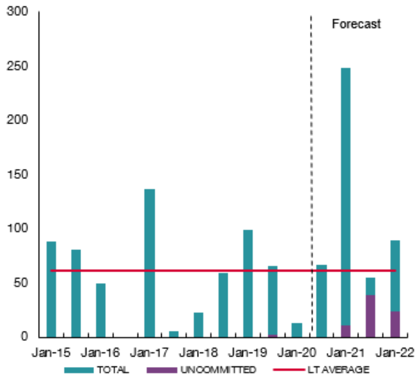
Source: Knight Frank Research/PCA
Note: Vacancy as at 1st Jan 20.

FIGURE 4
CBD Office Vacancy
Vacancy (%) on a semi-annual basis



Source: Knight Frank Research/ PCA

FIGURE 6
CBD Office Gross New Supply
New Supply on a semi-annual basis ('000 sq m)



Source: Knight Frank Research/ PCA

Melbourne CBD office market continues to record low vacancy

Melbourne CBD's extraordinary run of low office vacancy continues with vacancy dropping again from 3.4% in July 2019 down to 3.2% at January 2020. Vacancy has hovered between 3.2% to 3.6% for two years now, with the current run of low vacancy not matched in the last 30 years.

The amount of vacant office space in the Docklands precinct continues to dwindle, with vacancy dropping from 1.0% to 0.5% over the last CY. Originally intended as a new source of office supply for Melbourne, Docklands' office stock has more than doubled over the last decade and the precinct has now reached full capacity.

The divergence in vacancy by grade that we witnessed in our last report continues to widen, with prime vacancy further declining (2.0% in Jan 2020, was 2.4% in July 2019) while secondary vacancy has risen (5.9%, was 5.4%).

Emerging backfill anticipated to lift CBD vacancy levels

The pipeline of new office development that is expected to land in Melbourne's CBD over the next 2 years will result in backfill vacancy as CBD based tenants relocate to new office space within the CBD.

Between 2020-2021 in excess of 310,000 sqm of backfill space is expected to hit the CBD market. Approaching 190,000 sqm of backfill is due to arrive in 2020 and a further 120,000 sqm is likely to surface in 2021.

Western Core to provide much of the emerging backfill space

More than half (54%) of the upcoming backfill space will emanate from the Western Core precinct.

All of the 2020/21 backfill stock is set to be Premium or A grade quality, and with the recent flight-to-quality trend dictating demand rests with premium stock, much of the CBD's forthcoming backfill stock is tipped to be absorbed promptly, once any refurbishments are completed.

Landlords invest in refurbishments in response to looming backfill

Given the amount of backfill space due to hit the market in the coming 2 years, the CBD office leasing market is tipped to become competitive.

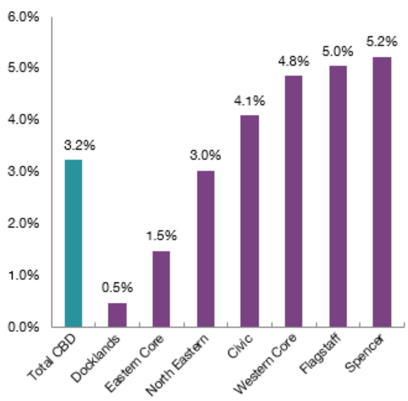
In response to this we are already seeing a number of landlords investing in refurbishments in a bid to reposition their assets to maximise their leasing potential. 628 Bourke Street, 360 Elizabeth Street, 530 Collins Street, 100 Queen Street and 600 Bourke Street are all currently undergoing refurbishments.

TABLE 2
CBD Office Vacancy By Grade

Grade	Jan-19 (%)	Jul-19 (%)	Jan-20 (%)
Premium	3.8	4.1	1.7
A Grade	2.4	1.8	2.1
Prime	**2.8**	**2.4**	**2.0**
B Grade	4.9	6.2	6.4
C Grade	3.2	3.4	4.7
D Grade	1.5	3.1	3.4
Secondary	**4.1**	**5.4**	**5.9**
Total	**3.2**	**3.4**	**3.2**

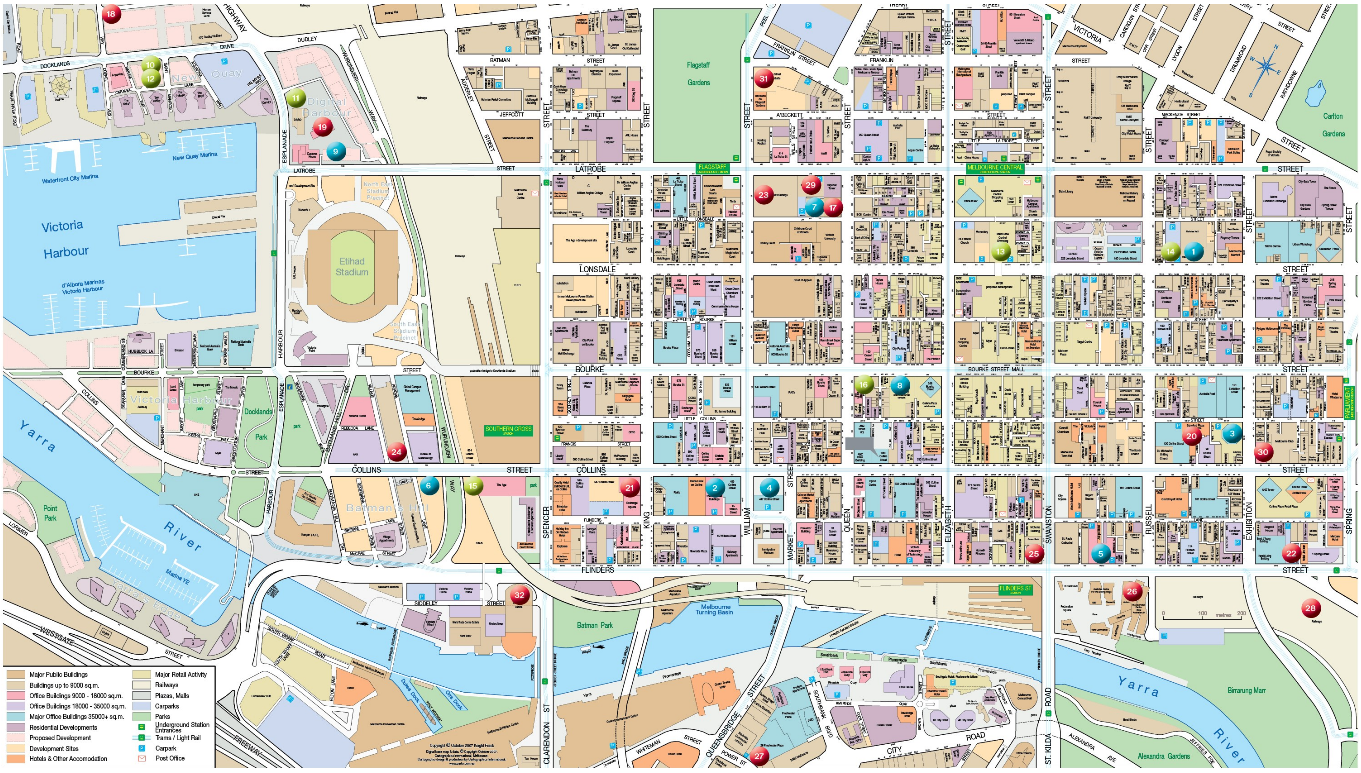
Source: Knight Frank Research/ PCA

FIGURE 5
CBD Office Vacancy by Precincts
Vacancy (%) as at 1st Jan '20



Source: Knight Frank Research/ PCA

MAJOR OFFICE SUPPLY



Under Construction/Completed

1	Wesley Place, 130 Lonsdale Street - 55,000 sqm (Cbus, Aust Super, Vanguard, Frontier Advisors) Charter Hall - Q2 2020 - 100% committed
2	477 Collins Street - 51,000 sqm (Deloittes, Norton Rose) Mirvac / Suntec REIT - Q2 2020 - 96% committed
3	80 Collins Street (South) - 43,000 sqm (DLA Piper, Ashurst, Herbert Smith Freehills) Dexus - Q3 2020 - 95% committed
4	447 Collins Street - 49,000 sqm (King & Wood Mallesons, HWL Ebsworth, Minter Ellison & Gadens) Cbus Property / ISPT - Q3 2020 - 95% committed
5	180 Flinders Street - 16,000 sqm (John Holland) DEXUS - Q3 2020 - 95% committed
6	Two Melbourne Quarter, 697 Collins Street, Melbourne - 48,000 sqm (Energy Australia, Regus Spaces) Lendlease - Q3 2020 - 96% committed
7	364-378 Little Lonsdale Street - 24,000 sqm Victoria University - H1 2021 - 67% committed
8	405 Bourke Street, Melbourne 65,000 sqm (NAB) Brookfield/ISPT - H2 2021 - 100% committed
9	1000 La Trobe Street - 38,500 sqm (Myer 11,000 sqm) Poly Group - Q4 2021 - 28% committed

Approved Developments

10	396 Docklands Drive, Docklands - 10,500 sqm MAB - 2022+
11	25 Digital Drive - 10,000 sqm Digital Harbour Holdings - 2022+
12	395 Docklands Drive, Docklands - 22,000 sqm MAB - 2022+
13	300 Lonsdale Street, Melbourne - 20,000 sqm The GPT Group - 2022+
14	140 Lonsdale Street - 22,000 sqm Charter Hall - 2022+
15	Melbourne Quarter Tower (691 Collins Street) - 68,000 sqm Lend Lease - 2023+
16	435 Bourke Street, Melbourne - 59,000 sqm Cbus Property - 2023+

NB. Dates are Knight Frank Research estimates.
Major tenant pre-commitment in brackets.

Mooted Developments

17	283 Queen Street, Melbourne - 25,000 sqm Victoria University - 2022+
18	440 Docklands Drive, Docklands - 100,000 sqm Ashe Morgan - 2022+
19	26-34 Digital Drive, Docklands - 47,000 sqm Digital Harbour - 2022+
20	7-9 Alfred Place, Melbourne - 8,000 sqm Seafirst Australia - H1 2023+
21	555 Collins Street, Melbourne - 45,000 sqm Charter Hall - 2023+
22	32 Flinders Street, Melbourne - 20,000 sqm GPT - 2023+
23	280-318 William Street, Melbourne - 40,000 sqm Court Services Victoria (CSV) - 2023+
24	710 Collins Street - 32,000 sqm Abacus Property Group - 2023+
25	Over Station Development, Swanston Street, Melbourne 20,000 sqm Lendlease - 2024+
26	Federation Square East, Cnr Flinders & Russell Sts - 60,000 sqm State Government - 2024+
27	25-35 Power Street, Southbank- 36,000 sqm M&L Investments - 2024+
28	Treasury Square, Spring Street & Flinders Street - 140,000 sqm TBD - 2025+
29	383 LaTrobe Street, Melbourne - 44,000 sqm Mirvac - 2025+
30	60 Collins & 52 Collins Street, Melbourne - 28,000 sqm Dexus - 2025+
31	412 William Street, Melbourne- 20,000 sqm Shesh Ghale - 2022+
32	Flinders West, 7-23 Spencer Street, Melbourne - 40,000 sqm Mirvac - 2023+

RENTS & INCENTIVES

Rents & Incentives	
Prime Rents (g) (per sq m)	Face: $708 +11% YoY Eff: $521 +9% YoY
Secondary Rents (g) (per sq m)	Face: $520 +14% YoY Eff: $383 +13% YoY
Incentives	P:26.4% S:26.4%

Source: Knight Frank Research/PCA
Note: Data as at 1st Jan 20.

CBD office market records sustained rental growth

Melbourne CBD office rents continue to grow at a rapid rate with double-digit growth evident for both prime and secondary rents over the last CY.

Sustained tenant demand and high occupancy of CBD office stock has accelerated rental growth for landlords.

Over the 2019 CY, prime net effective rents grew by 8.8% to reach $521/ sq m. The growth in effective rents was underpinned by a net face rental increase of 11.0%, with incentive levels ranging between 22%-30%.

Secondary net effective rents increased by 13.2% to reach $383/ sq m, this growth supported by a net face rental increase of 14.3% with incentive levels ranging between 22%-28%.

Fringe office market benefits from the CBD's rental growth

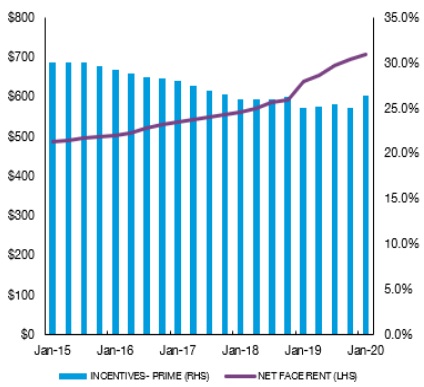
The strength of the increase in CBD rents over the past 3 years has been such that a flow-on effect has been felt in the office fringe market, especially within the inner east where net rents have risen by 88% in Cremorne and 81% in Richmond over the last 4 years to July 2019.

TABLE 3
Recent Leasing Activity Melbourne CBD

Address	Precinct	NLA (sq m)	Term (yrs)	Lease Type	Tenant	Sector	Start Date
140 Lonsdale St	Western	22,750	30	Pre-commit	Australian Federal Police	Govt.	Q4-22
360 Elizabeth St	Civic	13,689	10	Renewal	ME Bank	Finance	Q1-21
80 Collins St	Western	10,300	12	New	Herbert Smith Freehills	Legal	Q2-21
333 Collins St	Western	1,980	5	New	Qantas	Transport	Q4-19
360 Elizabeth St	Civic	1,453	8	New	Energy & Water Ombudsman (VIC)	Public Admin.	Q3-19

Source: Knight Frank Research

FIGURE 7
Prime Incentives & Net Face Rents
Net face rents ($/ sq m) and Incentives (%)



Source: Knight Frank Research

TABLE 4
Recent Sales Activity Melbourne CBD

Address	Grade	Price ($ mil)	Core Mkt Yield (%)	NLA (sq m)	$/sq m NLA	WALE (yrs)	Vendor	Purchaser	Sale Date
242 Exhibition St[1]	A	124.5[2]	4.5[4]	63,398[4]	13,092[4]	11.5[4]	CHC 5, CPOF, PSP	Charter Hall Long WALE REIT	Dec-19
120 Harbour Esplanade	A	81.3	4.5	8,341	9,747	6.25	Wharf Investments	Marprop Development	May-19
22 William St	B	52.0	2.6[3]	5,657	9,192	1.6	Orion International Group	Fidinam Group	Oct-19
45 Exhibition St	B	27.5	1.3[3]	1,567	17,562	n.a.	Normadel Investments/ Kranz Family	CSC	May-19
212 King St	B	22.1	2.9	1,279	17,279	n.a.	New World Property	Private Investor	Jun-19

Represents 1. Related party transaction, 2. Partial interest (15%), 3. Passing yield, 4. Reflects 100% interest.
Source: Knight Frank Research, RCA

INVESTMENT ACTIVITY & YIELDS

2019 a bumper year for sales driven by large deals

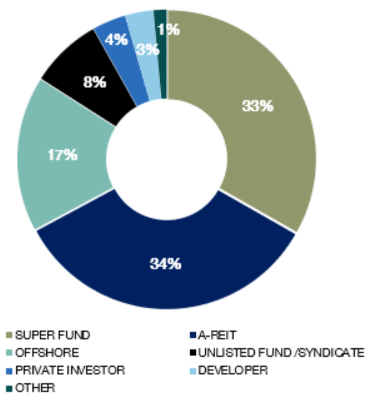
CY 2019 was a big year for CBD office investment with recorded sales volume well above the long-term average. Sales volume totalled $3.16 billion which is above the CY 2018 total of $2.92 billion, and above the 10-year average of $2.42 billion. The 2019 figure is only marginally short of the record $3.34 billion recorded in CY 2017.

Investors are increasingly attracted to the Melbourne CBD office market due to the city's strong underlying economic fundamentals and value for money proposition compared to many other global cities.

Sales results were driven by two notable transactions, namely QIC's $946.8 million (office component) sale of 80 Collins Street to Dexus/DWPF, and Investa Commercial Property Fund/Oxford Investa Property Partners $830 million sale of 242 Exhibition Street to Charter Hall.

In total, seventeen sales were recorded in 2019, which is the lowest number recorded since 2012 (N=16). This reflects a lack of opportunities brought to the market rather than a lack of investor appetite.

FIGURE 8
CBD Office Purchaser Profile
$10mln+ Sales—CY2019



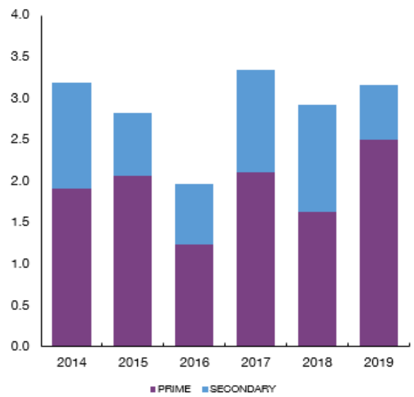
Total value of transactions: $3.16bn
Other inclusive Owner-occupiers and Undisclosed buyers
Source: Knight Frank Research, RCA

Current Yields

Prime YoYΔ:	4.65% - 4.90%	-5bps
Secondary YoYΔ:	5.30% - 5.80%	-5bps

Source: Knight Frank Research/ PCA
Note: Data as at 1st Jan 20.

FIGURE 9
CBD Office Transactions By Grade
$10mln+ Sales—CY2019 (in $ billions)

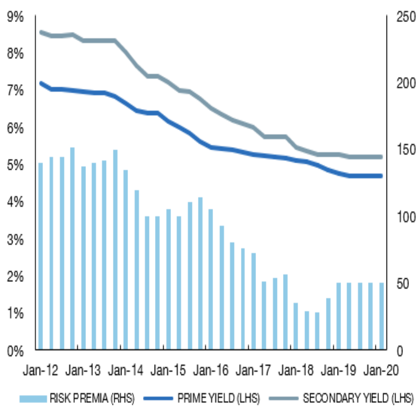


Source: Knight Frank Research, RCA

2019 CY produces an increase in institutional sales

Institutional investors are increasing their exposure to the CBD office investment market.

FIGURE 10
CBD Office Core Market Yields
Yield (%) & Spread (bps)



Source: Knight Frank Research

> "2019 saw above average sales volume for Melbourne CBD office assets with $3.16B worth of sales recorded"

Three-quarters (75%) of all sales volume recorded in CY 2019 stemmed from institutional investors which is an increase on the 57% recorded for CY 2018.

Institutional investors have responded to lower interest rates by increasing their concentration of investments in the Melbourne CBD office market, and in doing so have repositioned themselves to capitalise on the next phase of Melbourne's growth.

Melbourne CBD experiences a slowing in yield compression

Melbourne CBD office yields have maintained their record low levels throughout the course of 2019, though the rate of decline has slowed considerably.

Both prime and secondary yields compressed by just 5 basis points throughout the course of 2019 CY, with no movement recorded in the second half of the year.

Prime yields currently range from 4.65% to 4.90%, while secondary yields range from 5.30% to 5.80%. As was the case at the start of 2019, the current spread between prime and secondary yields stands at 50 basis points.

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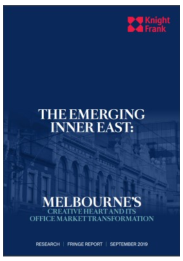

Melbourne's Fringe Office Market Report Sep 2019

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