RESEARCH

MELBOURNE CBD

OFFICE MARKET OVERVIEW SEPTEMBER 2018

HIGHLIGHTS

Sustained tenant demand coupled with a scarcity of new supply in 2017/18 has resulted in the Melbourne CBD vacancy rate falling to 3.6% in July 2018, the lowest level recorded for 10 years.

The Melbourne CBD recorded the highest volume of net absorption nationally in the 6 months to July 2018, supported by continued strong employment growth across Victoria.

Tenants seeking office space in Melbourne's CBD are increasingly seeking flexibility and convenience, as evidenced by the continued rise of the coworking sector and the recent popularity of spec suites.

KEY FINDINGS

CBD total vacancy fell from 5.9% to 3.6% in the 12 months to July 2018, the lowest level recorded in ten years.

Prime and secondary effective rents grew by **7.2% y.o.y and 14.5% y.o.y** respectively in the year to July 2018; with continued steady growth anticipated.

Demand for CBD office space is being **driven by an increasingly diverse pool of tenants, coupled with a proliferation of smaller occupiers** seeking space in the CBD.

Limited on-market asset availability along with **increasing investor interest** has resulted in further **yield compression** across both prime and secondary assets.

FINN TREMBATH
Associate Director

ECONOMIC OVERVIEW

With a record $13.7 billion invested in government infrastructure in 2018/19, and continued population and jobs growth forecast, demand for office space in Melbourne's CBD is expected to remain strong.

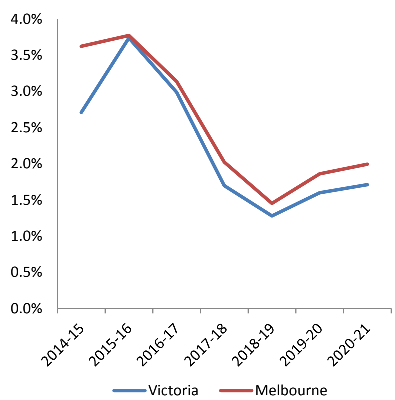
Buoyant Melbourne CBD office market underpinned by a healthy economy

Sustained economic growth has played a key role in Melbourne's thriving CBD office market over the course of 2017 and 2018.

The Victorian and National economies have experienced strong growth over the past 12 months. Victoria State Final Demand recorded 4.9% growth over the period, while GDP growth of 3.1% was recorded for the Australian economy as a whole. The ABS also reports a recent population growth rate for Melbourne of 2.5%. This population growth has had a positive flow-on effect on employment in Melbourne, with Oxford Economics reporting that employment grew by 3.1% during 2017.

This sustained population and employment growth has created a need for investment in infrastructure, and the Victorian Government has responded by committing to numerous projects including the CityLink Tulla Widening, West Gate Tunnel, Western roads Upgrade, and the Chandler Highway Bridge Project. Moreover the government has recently pledged funding for the Melbourne Airport Rail Link.

FIGURE 1
Employment Growth



Source: Oxford Economics

Continued employment growth to further fuel demand for Melbourne CBD office space

Moving forwards, Melbourne is expected to continue to grow rapidly, as it benefits from strong interstate and offshore migration. The ABS expects Melbourne's population to continue to grow by 2.0% per year between 2018 to 2020, and off the back of this Oxford Economics has forecast employment in Melbourne to grow by 1.7% per year over the same period. This continued expansion sets a solid platform for Melbourne's CBD office market, underpinning a solid outlook for absorption and growth in office stock.

TABLE 1
Melbourne CBD Office Market Indicators as at July 2018

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 (%)	Average Core Market Yield (%)
Prime	3,015,667	3.3	93,644	32,488	$586	26.0%	4.75—5.25
Secondary	1,526,188	4.1	28,500	15,231	$445	25.0%	5.25—5.75
Total	**4,541,855**	**3.6**	**122,144**	**47,719**			

Source: Knight Frank Research/PCA

TENANT DEMAND & ABSORPTION

Net Absorption & Outlook

Prime	FY18 91,268sqm 19.3% y-o-y
Secondary	FY18 25,500sqm

Source: Knight Frank Research/PCA

Strong demand creates positive net absorption

On the back of the strong demand for office space, the CBD experienced solid office leasing activity across both prime and secondary markets with 39,607 and 25,785 sq m absorbed respectively in the last 6 months—this equates to a total of 65,392 sq m which is above the long term average of 45,767 sq m. Melbourne CBD has experienced sustained strong net absorption since July 2017.

Moving forwards, employment growth will ensure sustained demand for office space, however new supply will be constrained up until 2020 with limited stock forecast to arrive in 2019 and most upcoming stock in late 2018/early 2019 already pre-committed. With supply expected to be tight, moderate net absorption is expected up until 2020 after which absorption levels are expected to rise with the arrival of new stock. Over the short term however, with much of the upcoming space pre-committed, tenants looking for space in the CBD will be faced with a lack of options which might squeeze prospective tenants to city fringe alternatives such as Cremorne/Richmond and Southbank/St Kilda Road.

Demand driven by a diverse pool of tenants

The coworking movement shows no sign of slowing down, and has quickly matured to no longer be the domain of just start-ups and freelancers. Established businesses and corporates are now seeing the cost-saving and talent acquisition benefits associated with shared spaces, and leading landlords such as Dexus, ISPT and GPT are responding by offering flexible workplace services. As a further sign of the sector's growth, major players HUB Australia and WeWork have either increased or are in the midst of increasing their footprint in Melbourne's CBD this year.

Following on from the flurry of leasing activity witnessed in the second half of 2017, the education sector continues to exhibit a hunger for the CBD with several lease commitments entered into since the start of the year, most notably RMIT signing on for 10,634 sq m at 222 Lonsdale Street. The recent influx of education tenants into the CBD can in part be attributed to the need to cater to city-based workers wanting to access industry related post-graduate courses.

Much of the recent demand for CBD office space can also be linked to the government sector. Headlining recent leasing transactions, the Department of Education signed at 35 Collins Street for 7,000 sq m, and moving forwards the Victorian Government will take up 15,000 sq m of space at 222 Exhibition Street in Q3 2018 with infrastructure groups the primary tenants.

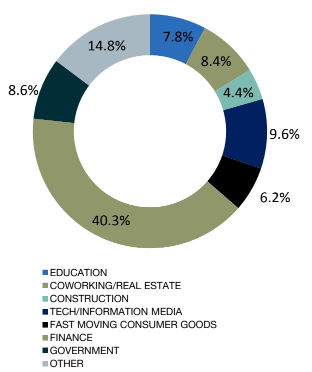
A new trend is the migration of FMCG brands to the CBD. Historically inhabitants of suburban or fringe areas, the centralisation of operations to the heart of the city might reflect a focus on talent acquisition and retention. Treasury Wine Estates are taking up 5,200 sq m of space at 161 Collins Street and MARS are taking up 1,000 sq m of temporary space at Collins Square Tower Two with a plan to take up 5,000 sq m longer-term in Tower One. Treasury Wines will move from Southbank while MARS recently moved to 15 William Street before which they were located at 380 St Kilda Road.

"Strong employment growth has driven above average levels of net absorption in the Melbourne CBD"

Proliferation of smaller occupiers continues

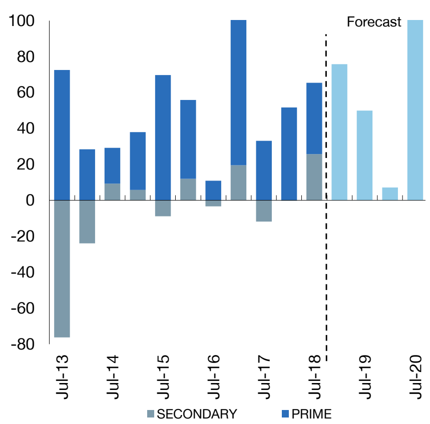
Smaller occupiers – in particular those in the tech, services and construction sectors - continue to be a source of demand for CBD office space, as evidenced by Knight Frank Research which shows that over the last four years enquiries for office space in the 100-500 sq m range has quadrupled, with a 107% increase in the last 12 months. The war for talent, a need to be closer to CBD-based clients, and the benefits presented by speculative suites are reasons underpinning the rise of smaller occupiers in the CBD.

FIGURE 2
2018 Take-up by Sector (Indicative)



Source: Knight Frank Research

FIGURE 3
Melbourne CBD Net Absorption
('000 sq m) per 6 month period



Source: Knight Frank Research/PCA

SUPPLY & DEVELOPMENT

Vacancy Rate & Outlook

Prime	3.3% -2.8% bps y-o-y
Secondary	4.1% -3.1% bps y-o-y

Source: Knight Frank Research/PCA

Low level of completions in 2017 results in vacancy falling to a ten-year low

A perfect storm of strong demand, above average net absorption and low levels of development completions has led to a sharp decline in stock availability which has further lowered the vacancy level. Vacancy now stands at a ten year low of 3.6%, in effect the lowest CBD level nationally.

At a precinct level, vacancy has declined noticeably in the North East (0.6% in July 2018 was 9.9% in July 2017), Flagstaff (4.2% was 9.7%) and Spencer (4.3% was 10.5%) precincts.

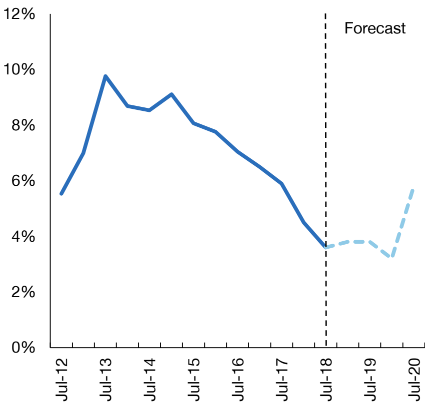
The East vs. West divide along Collins Street – where, along the sought after Paris-end of Collins Street vacancy has typically been lower compared to the Western Core - has become particularly pronounced in recent years. Today, vacancy in the Western Core (6.7%) is almost five times that recorded in the Eastern Core (1.4%). Proximity to the top end of town, superior amenities and a

TABLE 2
Melbourne CBD Vacancy Rates

Grade	Jul-17 (%)	Jan-18 (%)	Jul-18 (%)
Premium	6.1	5.6	4.6
A Grade	5.2	3.3	2.9
Prime	**6.1**	**4.0**	**3.3**
B Grade	6.0	6.7	4.2
C Grade	9.0	4.5	4.2
D Grade	3.7	2.3	2.9
Secondary	**7.2**	**5.8**	**4.1**
Total	**5.9**	**4.5**	**3.6**

Source: Knight Frank Research/PCA

FIGURE 4
Melbourne CBD Vacancy

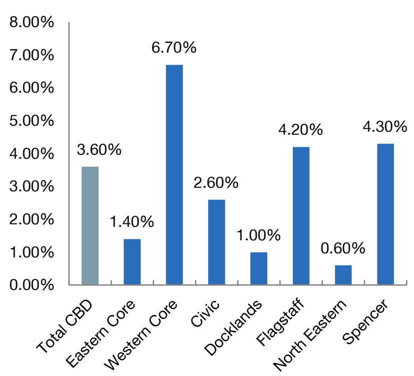


Source: Knight Frank Research

greater number of A Grade buildings are among the reasons for the East end's stronger performance. Major brands Google and Nike signing leases east along Collins Street reinforces the pulling power of the East end of Collins Street.

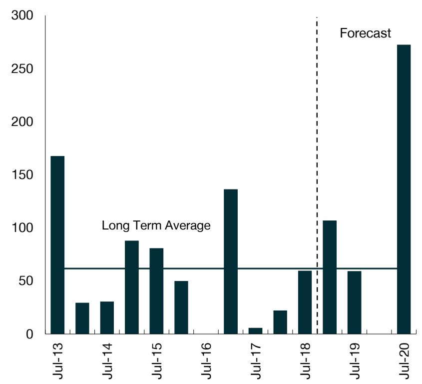
Gross CBD office completions totalled 59,613 sq m in the six months to July 2018. A little under half of this amount (44%) stemmed from new development completions—specifically 664 Collins Street—with the remainder emanating from refurbishments. The completions added to the market over the last six months is on a par with the long term average of 61,503 sq m however it comes after a 12 month period where completions were well below the long-term average, in effect creating pent-up

FIGURE 5
Vacancy by Precinct



Source: Knight Frank Research/PCA

FIGURE 6
Gross New Supply
CBD Office (000's sq m) per six month period



Source: Knight Frank Research

tenant demand and in turn low vacancy.

Vacancy set to remain low before picking up in 2020 as new supply hits the market

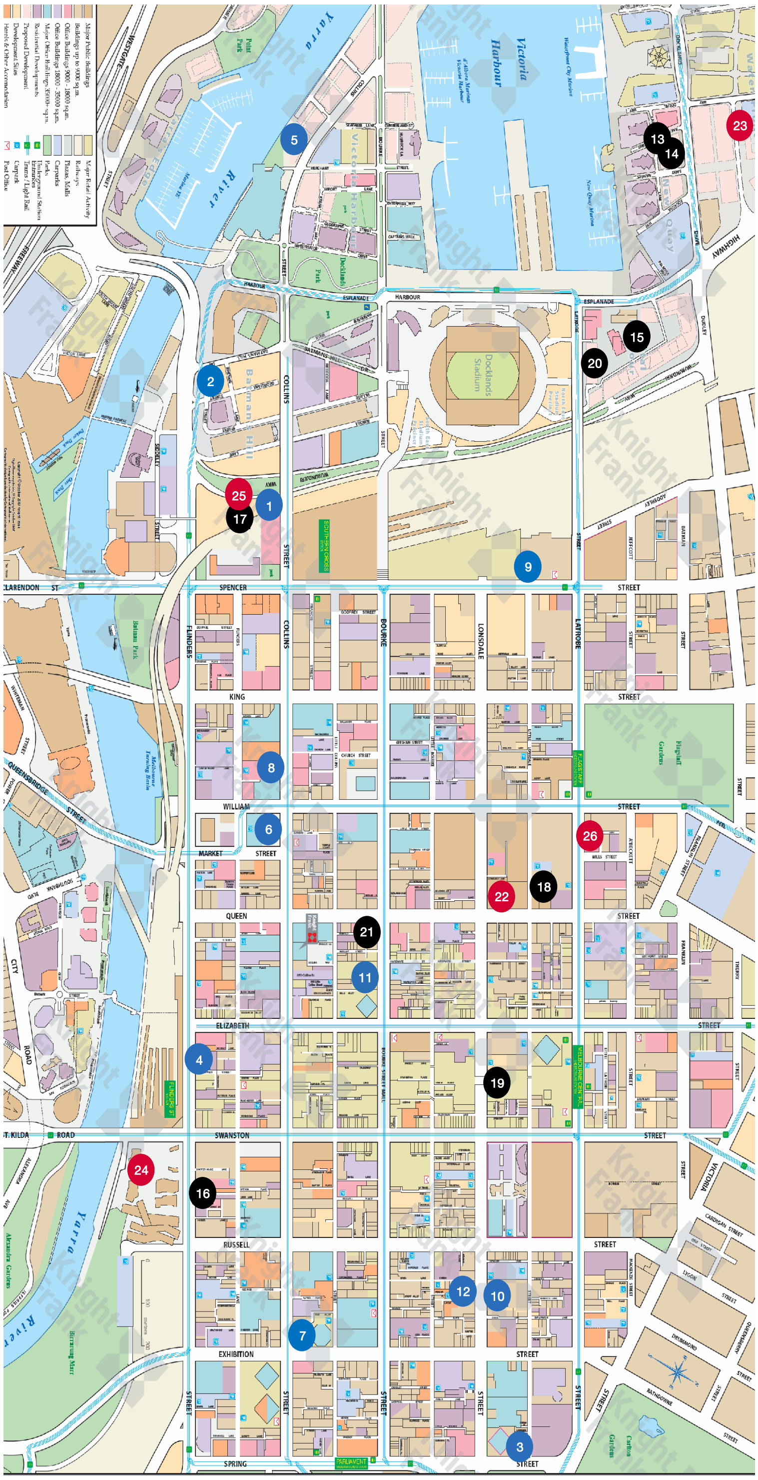
Immediate gross office supply additions in the second half of 2018, totalling 106,830 sq m, are expected to be above the long-term average and are headlined by the long-awaited arrival of One Melbourne Quarter (26,400 sq m) and 5 Collins Square (41,650 sq m) both of which are pre-committed.

However, the addition of gross office space will be constrained in 2019. Beyond this, the next major wave of development is not expected to come online until 2020. In total, 436,500 sq m of new supply is expected in 2020, with Two Melbourne Quarter (48,000 sq m) and the new Victoria Police Centre at 311 Spencer Street (65,000 sq m) the most notable additions.

With the growth in office stock set to remain relatively subdued until 2020, combined with the expectation of sustained tenant demand fuelled by continued white collar employment growth, the Melbourne CBD office vacancy rate is expected to remain low during 2019 before picking up by July 2020 to circa 6.0%.

MAJOR OFFICE SUPPLY

1. One Melbourne Quarter - 26,400 sq m [Lend Lease/Arup/AMP]
Lend Lease - Q3 2018 - 100% committed
2. 5 Collins Sq - 41,650 sq m [Transurban, NBN]
Walker - Q3 2018 - 100% committed
3. 271 Spring St - 15,000 sq m [Australian Unity]
ISPT - Q1 2019 - 100% committed
4. 276 Flinders St - 5,000 sq m
Fivex - Q1 2019
5. Y3, 839 Collins St - 39,200 sq m [ANZ]
Lendlease - Q2 2019 - 83% committed
6. 447 Collins St - 51,000 sq m [King & Wood/HWL/Minter/Gadens/Future Fund]
Cbus Property/ISPT - Q1 2020 - 87% committed
7. 80 Collins St South - 43,000 sq m [McKinsey/Macquarie/CenITex/DLA]
QIC - Q1 2020 - 44% commited
8. 477 Collins St - 51,000 sq m [Deloitte/Norton Rose]
Mirvac/Suntec REIT - Q2 2020 - 56% committed
9. 311 Spencer St - 65,000 sq m [Victoria Police]
Keppel REIT/Cbus Property - Q2 2020 - 100% committed
10. 130 Lonsdale St - 55,000 sq m [Vanguard/CBUS Super/Telstra Super]
Charter Hall - Q1 2020 - 55% committed
11. 405 Bourke St - 65,000 sq m [NAB]
Brookfield/ISPT - Q2 2021 - 68% committed
12. 140 Lonsdale St - 15,000 sq m
Charter Hall - Q1 2020
13. 395 Docklands Dve - 22,000 sq m
MAB - Q1 2020
14. 396 Docklands Dve - 10,500 sq m
MAB - Q1 2020
15. 25 Digital Dve - 10,000 sq m
Digital Harbour - Q3 2020
16. 180 Flinders St - 16,000 sq m [John Holland]
DEXUS - Q3 2020 - 60% committed
17. 2 Melbourne Quarter - 48,000 sq m [Energy Australia]
Lendlease - Q3 2020 - 45% committed
18. 364-378 Little Lonsdale St - 25,000 sq m
Victoria University - Q3 2020
19. 300 Lonsdale St - 20,000 sq m
GPT - Q3 2022
20. 1000 La Trobe St - 36,000 sq m
Poly Australia - Q3 2021
21. 140-150 Queen St - 70,000 sq m
Cbus Property - Q3 2021
22. 283 Queen St - 25,000 sq m
Victoria University - Q1 2020
23. Harbour Town - 100,000 sq m
Ashe Morgan - 2022+
24. Federation Square East - 60,000 sq m
State Government - 2022+
25. 3 Melbourne Quarter - 55,000 sq m
Lendlease - Q3 2021
26. 383 La Trobe St - 40,000 sq m
2022+



- Under Construction / Complete
- DA Approved / Confirmed / Site Works
- Mooted / Early Feasibility

NB. Dates are Knight Frank Research estimates
Major tenant precommitment in [brackets] next to NLA
Office NLA quoted

Source of Map: Knight Frank Research

RENTS & RECENT TRANSACTIONS

Rents, Incentives & Outlook

Prime Rents (g)	$585/sqm face 6.5% y-o-y $431/sqm eff 7.2% y-o-y	↗
Secondary Rents (g)	$445/sqm face 12.1% y-o-y $332/sqm eff 14.5% y-o-y	↗
Incentives	P:26.0% S:25.0%	↗

Rapid rental growth as vacancy hits record low

Strong tenant demand combined with record vacancy in the last 12 months has resulted in average prime net effective rents growing at a high rate of 7.2% to reach $431/ sq m. This growth was underpinned by a net face rental increase of 6.5% over the same period, with average incentive levels ranging between 25%-28%, a similar range to what was observed 12 months ago.

Average secondary net effective rents increased by a whopping 14.5% - the highest rate for 8 years - to reach $332/ sq m. This growth was backed by a net face rental increase of 12.1% over the same period - again the highest rate seen in 8 years - with average incentive levels ranging between 20%-28%, a lower range than what was observed 12 months ago. A scarcity of prime space coupled with a recent disproportionate disparity in prime vs. secondary rents is felt to be behind the double digit rise in secondary rents.

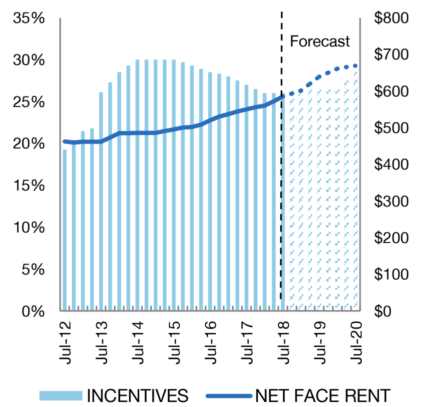
With a shortage of supply expected to keep vacancy levels down until 2020 when new stock arrives, prime net face rents are forecast to continue growing at 9.2% to the end of 2019. After this there will be a period of moderation and increasing incentives. If underlying tenant demand continues, vacancy is forecast to peak around 6% to 7% in 2020/21, which would still leave the market in equilibrium.

TABLE 3
Recent Leasing Activity Melbourne CBD

Address	Precinct	NLA	Term	Lease	Tenant	Sector	Start Date
222 Exhibition St	North East	5,250	12	New	WeWork	Coworking	Q1-19
222 Lonsdale St	Civic	10,634	15	New	RMIT	Education	Q3-19
162 Collins St	Civic	3,500	U/D	New	HUB Australia	Coworking	Q2-18
727 Collins St	Docklands	5,000	U/D	New	MARS	FMCG	Q1-18
161 Collins St	Civic	5,200	U/D	New	Treasury Wines	FMCG	Late 2018
35 Collins St	Eastern	7,000	U/D	New	Dept. of Education	Govt	Q2-18

Source: Knight Frank Research   U/D = Undisclosed

FIGURE 7
Prime Incentives & Net Face Rents
LHS: $/sq m average net face rent
RHS: % Indicative



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
697 Collins St	Premium	550.00	U/D	50,000	11,000	U/D	Lend Lease	First State Super/APPF	Mar-18
699 Bourke St	A	102.00	4.90*	U/D	U/D	U/D	TH Real Estate	Morgan Stanley's Prime Asia	Apr-18
601 Bourke St	B	72.00	4.95*	8,121	7,388	5.60	Pragmatic Education	Unlisted/Syndicate	Apr-18
277 William St	B	93.88	4.91	12,080	7,772	4.00	EG Funds	KHI Holdings Group	Jun-18
160 Harbour Esp	A	100.00	U/D	7,980	12,531	U/D	NRMA	Development Australia	Jun-18

Source: Knight Frank Research   *Initial Yield   U/D = Undisclosed

INVESTMENT ACTIVITY & YIELDS

Two Melbourne Quarter deal fuels investment activity

Melbourne CBD office market investment volumes (deals above $10 million) in the year to date currently total $1.12 billion across nine properties. At this rate, investment activity is on course to exceed the long term yearly average of $1.94 billion.

Approaching half of all sales volume (48%) was driven by the sale of Two Melbourne Quarter which sold for $550 million to First State Super (50%) and APPF (50%). The price paid for Two Melbourne Quarter is the highest recorded since a half share in Southern Cross Towers was sold in December 2015 for $675 million.

The Two Melbourne Quarter development, which will comprise 48,000 sq m of office space, is due to be completed in the second half of 2020 with Three Melbourne Quarter scheduled to complete a year later and One Melbourne Quarter due to complete later this year.

The amount of Chinese foreign investment in the Melbourne CBD office market is down on recent levels. New controls on exporting capital implemented by the Chinese government would likely explain the recent decline in Chinese investment. While Knight Frank Research (Active Capital 2018 report) reveals offshore inflows to Australia more broadly remain very strong, Chinese investment in Australian property halved in 2017 with a shift in focus away from office towards smaller scale residential developments. Between Jan-June 2018 Chinese investment made up 12% of all sales activity in Melbourne's CBD office market, compared to 66% at the corresponding period in 2017.

Once again, investors remained focussed on prime grade stock with premium and A grade assets accounting for two-thirds (66.7%) of sales volume or $752 million. Prime grade asset sales have surpassed secondary asset sales every year for the past seven years.

Current Yields & Outlook

Prime	4.75% - 5.25% -24bps y-o-y	↘
Secondary	5.25% - 5.75% -50bps y-o-y	↘

Healthy investment appetite puts downward pressure on yields

Prime and secondary yields continued to firm in the first half of 2018. Through a combination of limited stock and favourable leasing conditions, solid investor activity in Melbourne's CBD office market continues to place downward pressure on yields for both prime and secondary office stock.

> "The real story rests with secondary stock which saw yields compress by 50 basis points"

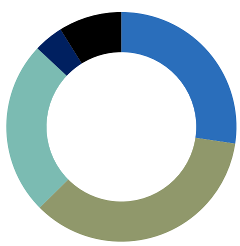
Prime yields compressed by 24 basis points in the last 12 months, however the real story rests with secondary stock which saw yields compress by 50 basis points. The current spread of 28 basis points between prime and secondary yields is the tightest level on record. The gap between prime and secondary yields will continue to close which is a normal part of a buoyant market cycle.

The 2018 to-date sales of 601 Bourke Street and 277 William Street, at respective yields of 4.95% (initial) and 4.91% (core) are evidence of the strong yield compression currently taking place in the secondary market. This secondary yield compression has been brought upon by investors' appetite for risk in light of recent strong rental growth and prolonged tight supply.

Yield compression cycle beginning to slow

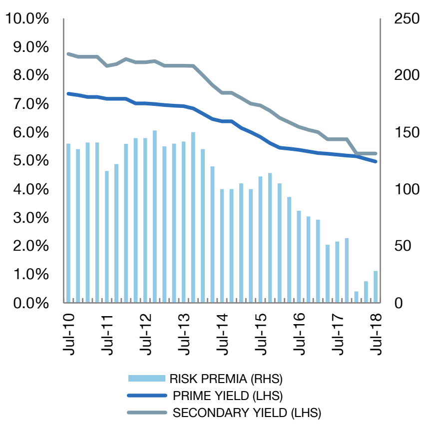
While the yield compression cycle has been running for almost 6 years now the pace of compression has started to slow down and capital growth is also expected to slow as we enter 2019.

FIGURE 8
Melbourne CBD Purchaser Profile
$10 million+ sales—2018



Source: Knight Frank Research

FIGURE 9
Melbourne CBD Core Market Yields
% Yield LHS & Basis Point Spread RHS



Source: Knight Frank Research

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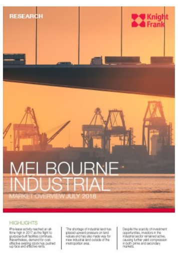

Melbourne Industrial Market Overview July 2018

Melbourne Metropolitan Office Market Overview April 2018

Active Capital 2018

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