- *Vacancy almost doubles though is still below long-term average*
- *Melbourne's strong economic fundamentals holds the CBD in good stead*
- *Prime yields hold*

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Melbourne CBD Office

Market Report, September 2020

CBD OFFICE MARKET IMPACTED BY COVID-19

The COVID-19 pandemic has impacted the Melbourne CBD office market. Despite the recent growth within the CBD office market and the city's strong economic fundamentals, there was a significant rise in office vacancy over the first half of 2020.

5.8% VACANCY

28% of take-up was to Professional Services

$1.37 BILLION TURNOVER

"While COVID has clearly impacted the CBD office leasing market, we believe activity will pick up in the next 6 months as the market adjusts to changes such as new ways of working."

The Key Insights

Vacancy in the CBD increased to 5.8% as at July 2020, almost double the 3.2% recorded at January 2020. Despite the increase, vacancy still sits below the long term average.

Melbourne CBD's prime and secondary net face rents remain unchanged in the first 6 months of 2020, though incentives have risen.

Leasing activity within the CBD office market was driven by professional services tenants who accounted for 28% of leasing volume by sq m over the last 12 months.

Offshore investors are driving investment within the Melbourne CBD office market accounting for 59% of all sales volume over the last FY.

Yields remain low with core yields for prime assets in the CBD currently range between 4.50% and 5.00%.

Melbourne CBD Office Market Indicators—July 2020

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	3,295,171	5.7	53,231	165,870	708	22-30	4.1	4.50-5.00
Secondary	1,490,978	6.2	-17,505	-6,826	520	22-28	3.8	5.25–5.75
Total	**4,786,149**	**5.8**	**35,726**	**159,044**				

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

COVID DRIVES ECONOMY INTO RECESSION

The COVID-19 pandemic plunges Australia into its worst economic contraction in 90 years.

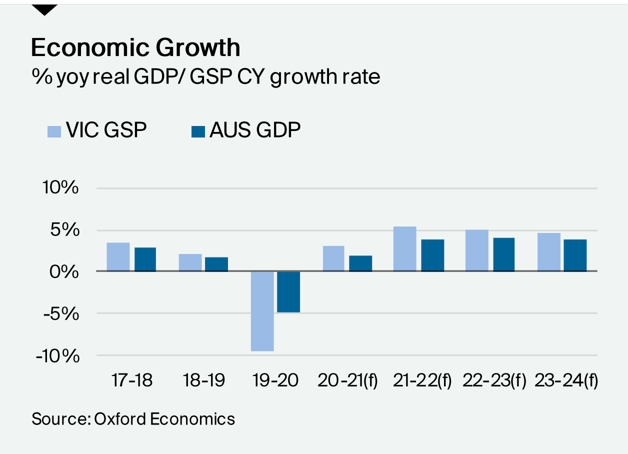
The COVID-19 pandemic has had a profound impact on world economies and Australia has not been immune with the nation suffering its worst economic recession since the Great Depression.

The Australian Bureau of Statistics recently announced that the nation was suffering its first recession since 1990-1991. The economy contracted by 6.3% over the last financial year off the back of GDP falling by 7% in the June quarter. A contraction in household spending was the primary factor driving the decline in GDP.

Victoria among the hardest hit as Stage 4 lockdown takes its toll.

NSW and Victoria have been the hardest hit by the fallout of the COVID-19 pandemic, with state final demand in Victoria declining by 8.5% over the June quarter and the state's GSP contracting by 9.5% over the last financial year.

While national GDP is expected to remain unchanged in Q3 2020, the recently extended Stage 4 lockdown in Melbourne will likely impact the broader national economy that saw signs of recovery in July off the back of rising employment figures. While the Victorian state government has announced a road map to begin reopening the economy through the gradual lifting of restrictions, retail trade restrictions are set to continue well into October.



Recent strong employment growth comes to a halt as companies go into enforced lockdown.

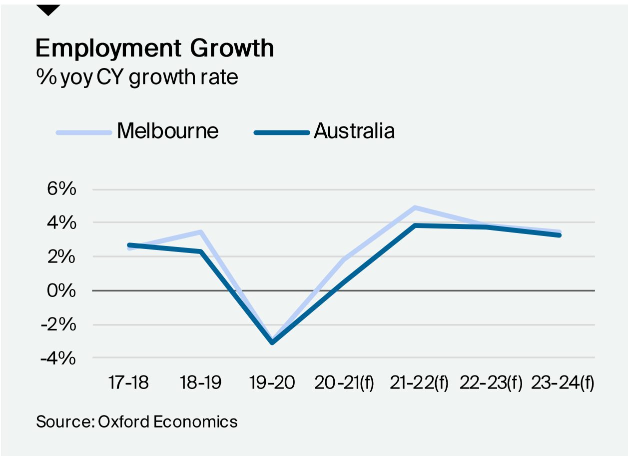
Melbourne's recent strong employment growth, the bi-product of the city's record population growth, has comes to a halt with –3.0% employment growth recorded over the 2019/2020 financial year — down on the 3.5% growth recorded the preceding financial year. Employment growth has been impacted by the COVID-19 pandemic with companies being forced into lockdown, and unprecedented numbers of staff working from home since March. Employment growth is, however tipped to pick up in 2021 to circa 2.0%-3.0% and this should have a positive flow-on effect on office leasing demand.

Signs of improvement in sentiment though businesses remain cautious.

According to NAB, at a national level business conditions began to improve in April and conditions have now recovered to be back in line with pre-COVID levels. The NAB survey was however, conducted prior to Melbourne being sent into Stage 4 lockdown, and Melbourne businesses are likely to remain cautious until such time as restrictions begin to ease.

True impact of COVID-19 pandemic yet to be felt on the commercial property sector.

While COVID-19 has had an impact on the Melbourne CBD office leasing market, with virtually all deals put on hold since March, due to the shortage of transactional activity the pandemic has not as yet had an appreciable impact on the development pipeline, rents or yields.



ACTIVITY UP BUT TRANSACTIONS YET TO FLOW ON

Leasing activity down in H1 2020 due to COVID-19 forcing changes to ways of working.

COVID-19 had an immediate impact on the Melbourne CBD office leasing market, with the level of leasing activity down noticeably since the city went into lockdown. The number of new leasing deals recorded in H1 2020 (23) is half of what was recorded in H2 2019 (48), while the amount of sq m leased into during H1 2020 (39,396 sq m) represented just 17% of what was recorded during H2 2019 (231,291 sq m).

While there has been a recent uptick in leasing enquiry levels, transactional activity as yet has not followed through. With virtually all white collar staff working from home since March, large tenants have been putting off major relocation decisions, and even tenants with expiries coming up have decided to let their leases expire, preferring to bank the outgoings and rental savings and wait for the new year to renegotiate new leasing arrangements.

Four sectors drive the CBD office leasing market.

Four sectors — professional services, coworking & real estate, finance & insurance, and public administration & healthcare — drove CBD office leasing volume over the 2019/20 FY, together the four sectors accounting for three-quarters (74%) of all leasing activity during the 12-month period.

Professional services led the way accounting for 28% of all leasing volume, with IT consulting firm Infosys committing to 9,000 sq m at Two Melbourne Quarter in Docklands a notable leasing deal recorded in H1 2020.

Net absorption masks a softening in leasing demand.

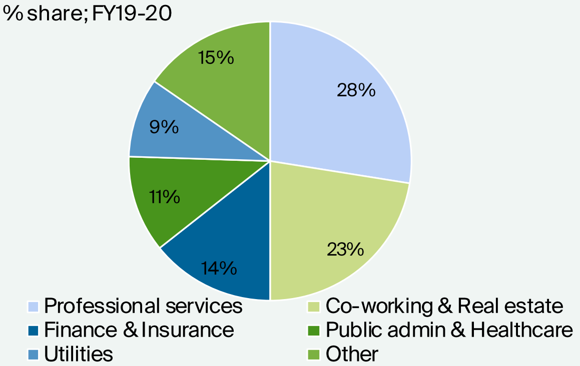
While the absorption of prime office space in H1 2020 (50,759 sq m) is up on the low level of net absorption observed in H2 2019 (2,472 sq m), the level of net absorption recorded in H1 2020 is at odds with broader leasing sentiment that suggests leasing activity has been impacted in H1 2020 due to the COVID-19 pandemic.

COVID-19 pandemic forces the office market into a state of flux.

The office market is undergoing a period of profound change. The COVID-19 pandemic has accelerated some recent changes within the market—such as the shift to remote working—while turning other recent trends—such as the densification of office sq m space—on their heads. With Melbourne still in the midst of its second wave, the aftermath of COVID-19 won't be played out until the earliest 2021 as the workforce seems set to continue to work from home for the remainder of 2020.

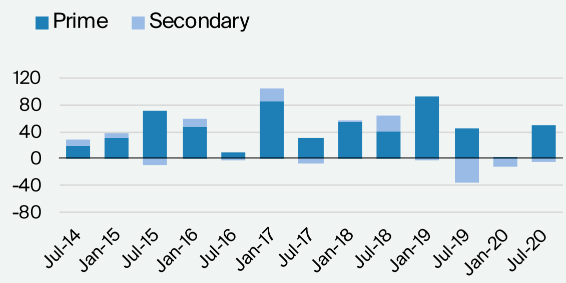
Moving forward, we expect it will take most companies 6 to 12 months to adjust to the new normal, with leasing demand likely to be impacted as the recession takes its toll on some businesses. The extent to which leasing demand is affected will depend on the timing of various lease expiries and on the amount of sub-leasing vacancy that hits the market.

CBD Office Take-up by Sector
% share; FY19-20



Source: Knight Frank Research

CBD Office Net Absorption
'000 sqm by grade



Source: Knight Frank Research

RECENT LOW VACANCY SOFTENS COVID BLOW

Office vacancy rises with a further increase expected to come.

Melbourne CBD office vacancy increased from 3.2% in January 2020 to 5.8% in July 2020, almost doubling as the market adjusted to the impact the COVID-19 pandemic had on broader tenant demand. Despite the increase, vacancy is still below the 10-year average of 6.3%.

Moving forward, we anticipate vacancy to increase further to over the coming 12 months as the real impact of COVID-19 takes hold and new development completions hit the market. Vacancy is likely to escalate higher for secondary stock given tenants will likely pursue a flight to quality during this period. While vacancy is tipped to rise, at this stage we are not forecasting vacancy to rise to the levels seen in the 1990s when the market was flooded with an oversupply of stock. Just how high vacancy increases will be driven in part by the amount of sub-leasing vacancy that gets presented to the market. That the CBD's vacancy is coming off a very low base (3.2% in January 2020) and much of the new supply that is due to land in the next 12 months is already pre-committed should work to offset the potential spike in vacancy. Furthermore, the return of backspace to the market will likely be staggered and this should also act to soften the future impact on vacancy levels.

Market expected to enter a period characterised by a slowdown in development.

The COVID-19 pandemic has not as yet had a noticeable impact on the CBD's development pipeline, with the immediate 2020/21 supply already under construction and in the range of 350,000 sq m new supply (including major refurbishments) still set to land over the coming financial year. Beyond the immediate 12 months, we expect any potential mooted developments to be reconsidered or pushed back as the broader market comes to grip with the longer term implications of COVID-19. Future developments will likely require substantial pre-commitments before they become green lit.

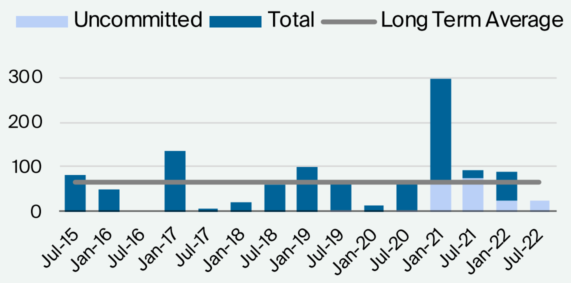
Melbourne CBD is now the largest office market in the country, with notable developments completed in 2020 including 80 Collins Street, 311 Spencer Street, 130 Lonsdale Street, 477 Collins Street and 447 Collins Street.

Treasury Square development shapes as the next big thing for the Melbourne CBD office market.

As we look beyond COVID-19, the wait for Melbourne CBD's next super site might finally be over with the pending development of vacant transport land at Treasury Square in the city's east end. Running along the southern side of Flinders Street, along the rail corridor between Exhibition and Spring streets, the old VicTrack site will be developed into a multi-billion dollar mixed use project that could potentially yield in the range of 130,000 sq m of lettable commercial space.

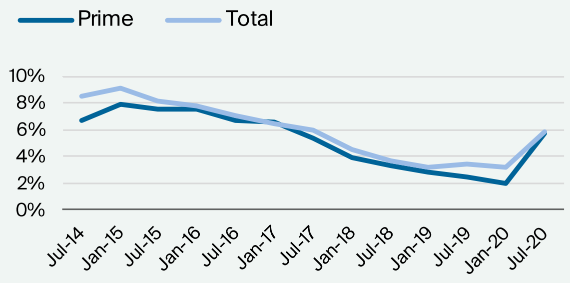
In what will be one of the largest ever commercial sites in Melbourne's CBD, the development looms as Melbourne's next major commercial development site and has the potential to change the face of the much sought after Eastern Core precinct which has historically been starved of new supply.

CBD Office Gross New Supply
'000 sqm new supply



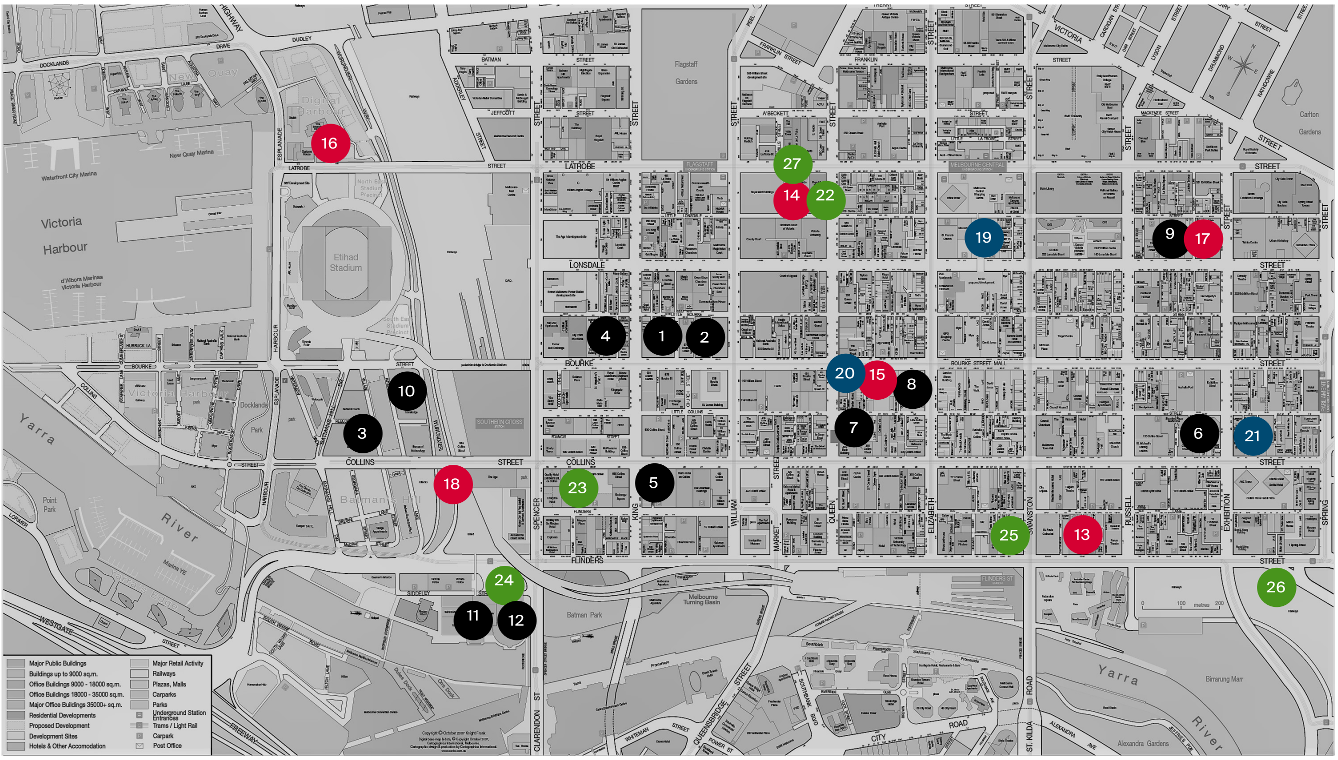
Source: Knight Frank Research

CBD Office Vacancy
% prime and total vacancy



Source: Knight Frank Research/PCA

MAJOR OFFICE SUPPLY



MAJOR REFURBISHMENTS

1 600 BOURKE STREET, 161,161 SQM
AMP – 0% COMMITTED. H2 2020

2 550 BOURKE STREET, 22,000 SQM
GPT – 40% COMMITTED. H2 2020

3 750 COLLINS STREET, 35,867 SQM [MONASH COLLEGE]
GPT – 100% COMMITTED. H2 2020

4 628 BOURKE STREET, 8,000 SQM
AFIAA – 0% COMMITTED. H2 2020

5 525 COLLINS STREET, 12,377 SQM
DEXUS/GROLLO– 0% COMMITTED. H1 2021

6 80 COLLINS STREET NTH, 8.034 SQM
DEXUS – 0% COMMITTED. H1 2021

7 QUEEN & COLLINS STREETS, 34,000 SQM
GPT– 0% COMMITTED. H1 2021

8 385 BOURKE STREET, 10,000 SQM
DEXUS – 0% COMMITTED. H1 2021

9 150 LONSDALE STREET, 13,000 SQM
CHARTER HALL – 0% COMMITTED. H2 2021

10 717 BOURKE STREET, 10,000 SQM
REST – 0% COMMITTED. H2 2021

11 637 FLINDERS STREET, 25,716 SQM
ZONE Q/ARTIFEX– 0% COMMITTED. H1 2022

12 WORLD TRADE CENTRE, 24,000 SQM
JOIN GLORY MANAGED BY UDM – 0% COMMITTED. H1 2022

UNDER CONSTRUCTION/ MAJOR PRE-COMMITMENT

13 180 FLINDERS STREET, 15,900 SQM [JOHN HOLLAND]
DEXUS– 63% COMMITTED. H2 2020

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. H2 2022

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

18 MELB QTR TOWER, 693 COLLINS STREET, 68,000 SQM
LENDLEASE– 0% COMMITTED. H2 2023

DEVELOPMENT APPROVED

19 300 LONSDALE STREET, 20,000 SQM
THE GPT GROUP– 0% COMMITTED. H1 2023

20 435 BOURKE STREET, 58,000 SQM
CBUS PROPERTY– 0% COMMITTED. H2 2023

21 60 & 52 COLLINS STREETS, 35,730 SQM
DEXUS – 0% COMMITTED. H1 2025

DEVELOPMENT APPLICATION/MOOTED/ EARLY FEASIBILITY

22 283 QUEEN STREET,25,000 SQM
ISPT/VICTORIA UNIVERSITY. 2023+

23 562 FLINDERS LANE,30,000 SQM
INVESTA. 2023+

24 FLINDERS BANK, 7-23 SPENCER STREET, 40,000 SQM
MIRVAC. 2023+

25 OVER STATION DEVELOPMENT, SWANSTON STREET,20,000 SQM
LENDLEASE. 2023+

26 SPRING & FLINDERS STREETS, TREASURY SQR,140,000 SQM
DEVELOPER TBC. 2025+

27 383 LA TROBE STREET,44,000 SQM
MIRVAC. 2025+

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

RENTS HOLD AS INCENTIVES RISE

Prime net face rents remain unchanged however incentives have risen in the face of the COVID-19 pandemic.

While the COVID-19 pandemic has weighed on leasing demand, with little transactional activity occurring since March, as yet there has been little evidence of net face rents being materially affected by the virus and its associated economic fallout.

Prime net face rents in the CBD remain unchanged at an average of $708/sq m as at July 2020, the same as was what recorded in January 2020. Previously the CBD had experienced a period of rapid rental increase, with prime net face rents increasing by 11% over the 2019 calendar year.

While there has been no movement in prime net face rents, incentives have risen with prime incentives now ranging between 22% to 30%, the rise in incentives causing net effective rents to decline from $521/sq m in January to $478/sq m at July.

Incentives have risen notably since the start of the year in response to the softening of demand caused by COVID-19 and a wave of new supply hitting the market.

Prime incentives are higher in the city's Western Core (average circa 35%) compared to the Eastern Core (circa 30%).

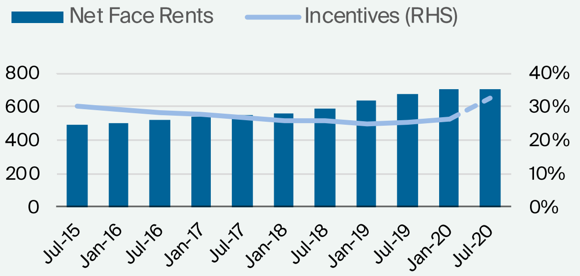
A modest decline in net face rents is tipped for 2021 CY before rents begin to stabilise post the COVID-19 pandemic.

Prime net face rents are expected to hold throughout the rest of 2020 CY, with the recent rise in incentives offsetting any change in net face rents over the immediate short term.

Prime net face rental growth is expected to decline modestly in 2021 however, as more sub-lease vacancy emerges and tenants and landlords renegotiate leases.

Net face rents should, however stabilise from 2022 onwards as employment growth picks up and the market more broadly comes to grips with the new normal.

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



Source: Knight Frank Research

Recent significant tenant commitments

OCCUPIER	PROPERTY	PRECINCT	SIZE SQM	TERM YRS	START DATE
HSF#	80 Collins Street	Eastern Core	10,000	10	2021
Origin Energy~	321 Exhibition Street	North Eastern	15,000	7-10	Q4 2021
Australian Super#	130 Lonsdale Street	North Eastern	16,500	10	Q4 2020
ME Bank~	360 Elizabeth Street	Civic	13,500	10	Q1 2021
Qantas~	333 Collins Street	Western Core	1,959	5	Q4 2019

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

SALES DOWN BUT OFFSHORE INTEREST REMAINS

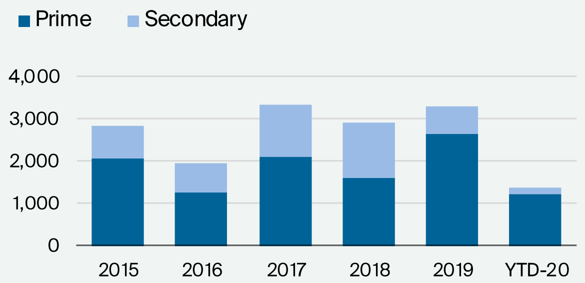
Sales volume down on recent years results.

Sales volume over the first half of 2020 is tracking below results recorded in recent years. By dollar amount, total sales volume — for assets valued over $10 million — over H1 2020 totalled $1.37 billion—on current pace sales volume in 2020 CY looks set to fall below the levels recorded over each of the last 3 years. However we expect CY 2021 to have much higher levels of transaction volume as Victoria comes out of COVID restrictions and business activity picks up.

The most significant sales over H1 2020 were the GIC and Dexus joint venture acquisition of a half stake in Rialto Towers at 525 Collins Street for $644 million, and the GIC acquisition of a half stake in 222 Exhibition Street for $205.6 million. While on the surface both sales are proof of the confidence investors have in the CBD market, the process behind both sales commenced pre-COVID, and so arguably weren't a true test of the state of the capital markets. More reflective of current market conditions is the recent sale of 452 Flinders Street, which sold for $455 million ($12,000/sq m) at yields of 4.83% (initial) and 4.80% (market). Despite transacting in the middle of the COVID pandemic, 452 Flinders Street attracted a number of offers from both local and overseas investors and accordingly its sale reflects the strength and depth of capital for the Melbourne CBD market, in particular for quality, well leased assets.

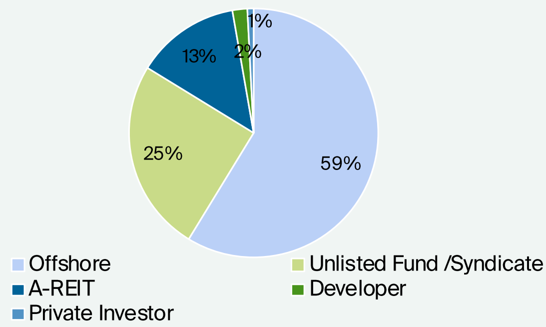
Indeed strong underlying economic fundamentals — such as population growth and record infrastructure spend — and returns that compare favourably with those recorded in many major international cities, all act to position the Australian and Melbourne CBD office markets well in the eyes of overseas investors.

CBD Office Sales Transactions
$ millions CY sales by grade; $10mln+ sales



Source: Knight Frank Research

CBD Office Purchaser Profile
% share FY19-20 sales; $10mln+ sales



Source: Knight Frank Research

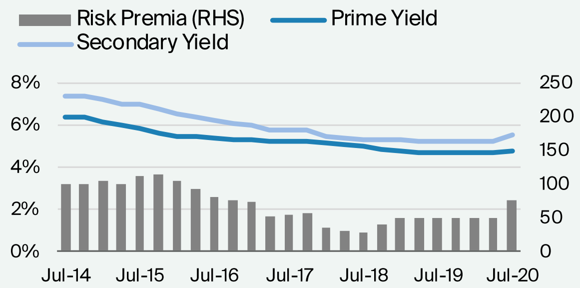
Offshore investor appetite remains strong for Melbourne CBD office assets.

Offshore investors continue to drive sales activity within the Melbourne CBD office market. Offshore investors accounted for more than half (59%) of all sales volume during the last 12 months, with a total of $1.32 billion in CBD office sales stemming from this cohort.

Melbourne CBD office yields remain at low levels despite a slight softening of secondary yields.

Despite the COVID-19 pandemic, Melbourne CBD office yields remain at low levels. 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 sits at 80 basis points — a softening of secondary yields over H1 2020 has resulted in a widening of the spread between prime and secondary yields.

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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