- *Net absorption remains positive*
- *Supply pipeline delivery slows, as vacancy and incentives peak*
- *Face rents rise for the first time in 30 months*

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Melbourne CBD Office

Market Report, September 2022

SELECTIVE DEMAND SEES RENTS RISE

Demand remains positive, but increased supply means increased vacancy rates.

12.9% VACANCY

$681 PRIME FACE RENT

40% PRIME INCENTIVES

"Net demand was low in H1 2022, but selective demand for better quality locations and buildings raised net rents within the CBD."

The Key Insights

Average net face rents rose for the first time since the start of the pandemic, though this was concentrated at the premium end of the CBD as tenants went for quality.

Demand for office space remained positive, just, with net absorption at 1,991 sqm. This is the first time there has been two positive periods in a row since the pandemic started, in a sign of some stability in the market.

Vacancy rates rose to 12.9% as supply increased and sub-leasing remained high.

Sales volume already totals $2.85bn in the year to date, greater than the whole of 2021.

Prime office yields edged out by 11bps as the market reacted to the increased cost of capital, prime yields are now averaging 4.71%.

Melbourne CBD Office Market Indicators — July 2022

GRADE	TOTAL STOCK SQM	VACANCY RATE %	NET ABSORPTION SQM	NET ADDITIONS SQM	AVERAGE NET FACE RENT $/SQM	INCENTIVE %	EFFECTIVE RENTAL GROWTH % YoY (NET)	CORE MARKET YIELD %*
Prime	3,601,966	12.3	35,395	48,788	681	40	-3.4	4.00-5.00
Secondary	1,490,090	14.2	-33,404	11,485	551	38	-3.8	4.75-5.25
Total	**5,092,056**	**12.9**	**1,991**	**60,273**				

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

ECONOMY REMAINS RESILIENT

Despite increasing global headwinds, expectations remain positive for the economy

Expectations for growth in the Australian economy remain positive amid myriad of economic and geopolitical events. Despite global inflationary pressures (and the marked increase in interest rates in response), energy crises and political instability , Australian GDP is still expected to grow by 3.8% this year before slowing somewhat next, according to the IMF. While this is a downgrade on previous forecasts, Australia is showing far more resilience than other countries.

Victoria is a major recipient of this, with GRP growth of 4.9% expected this year as it continues its strong rebound from the pandemic. Going forward Victoria continues to outperform with average GRP growth of 3.7%p.a. between 2023-27, around 0.5% higher than Australia as a whole (Source: Oxford Economics). Victoria is expected to benefit from our global re-opening, with an increase in international workers and students, many of which are attracted to Melbourne.

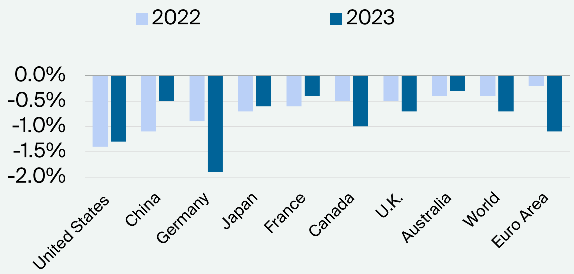
Inflationary pressures rise, particularly within the construction sector

A major area of continued concern is the rise in inflation. Whilst Australia may not be facing the high rates (or forecasts) that other countries are facing, prices have still risen by 6.1% over the year to June, with the RBA forecasting 7.75% by year end. The fear is that this may get locked in to the economy in a wage-price spiral, hence the Bank's rapid hiking of interest rates. The aim is to squeeze it out of the economy as quickly as possible.

The hope is that the price spike can be explained by supply side issues which should work their way through the economy. However, whilst the $10 iceberg lettuce has gone, major pricing issues remain, particularly for real estate. Inflation in the construction industry is running at 17% according to the latest ABS figures. Fundamental materials like steel beams and structural timber have seen rises closer to 40%. This all plays through into costs for fit outs, refurbs and future developments and so putting pressure on rents.

IMF GDP downgrades

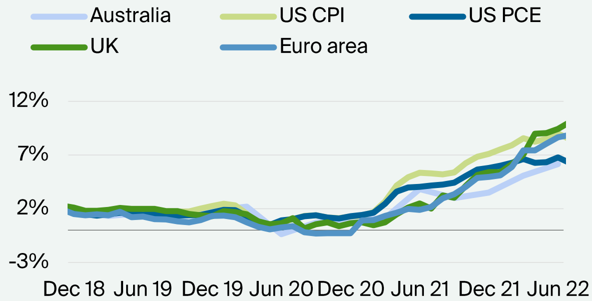
Deviation from April 2022 forecasts, percentage points



Source: Knight Frank Research, IMF

Headline inflation

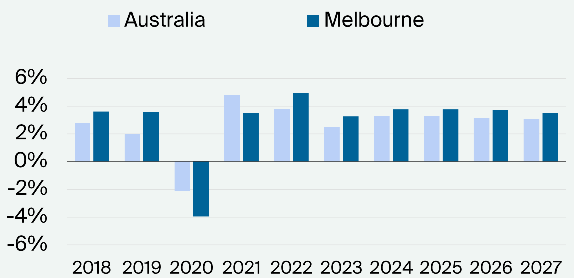
Per cent change year on year



Source: Knight Frank Research, Macrobond

Australia GDP and Melbourne GSP

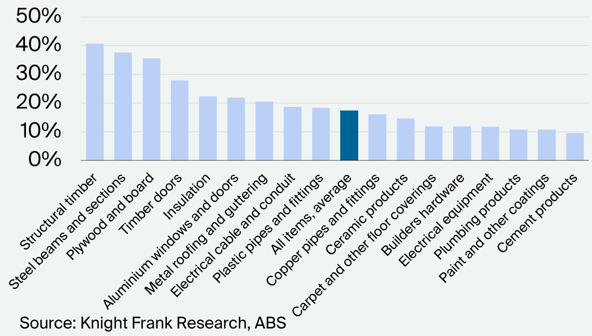
Per cent change



Source: Knight Frank Research, Oxford Economics

Annual change in construction costs

ABS producer price index, Q2 2022, % yoy



Source: Knight Frank Research, ABS

SENTIMENT IMPROVES AS TAKE-UP PIVOTS

Sharp slowdown in H1 2022 net absorption, following the strong rebound last period

On the plus side net absorption remained positive in H1, showing the first two-period positive growth figures since 2019. However, net absorption was only 1,991 sqm a sharp drop from the 45,560 sqm figure previously. This was not a Melbourne effect, with a national slowdown, following the rebound in the immediate post-pandemic lockdown euphoria as the economy opened up again.

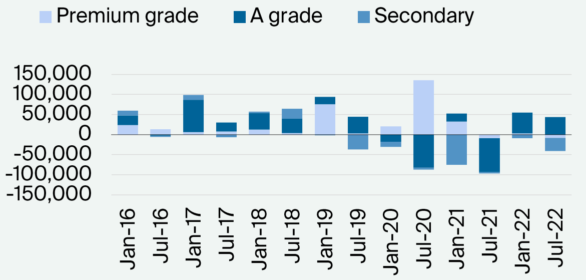
Evidence of trading up requirements as tenant demand and make-up pivots

The positive demand was made up of demand for A grade space which was 43,394 sqm. This was offset by -33,094sqm of secondary, and 8,000 sqm of unlet new premium stock coming on the market.

There was a marked shift in sector activity. Whilst financial services remained the most active, their share of the market dropped from 51% in 2021 to 40% in the first half of 2022. This was predominantly taken up by a large increase in professional services from 20 to 29% of the market. This sector has already taken-up over 75% of their take-up for the total of 2021. Public administration also increased its share (from 20%) as these two sectors accounted for over half of all space leased last period.

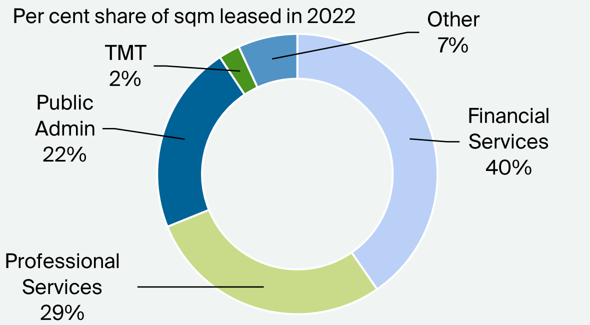
So, for example Pinsent Masons (law firm) has signed to move from 360 Collins to 101 Collins Street taking the opportunity to move from the West to the East Core. A professional services firm taking advantage of the market to trade-up its offices.

Net absorption
By grade, sqm



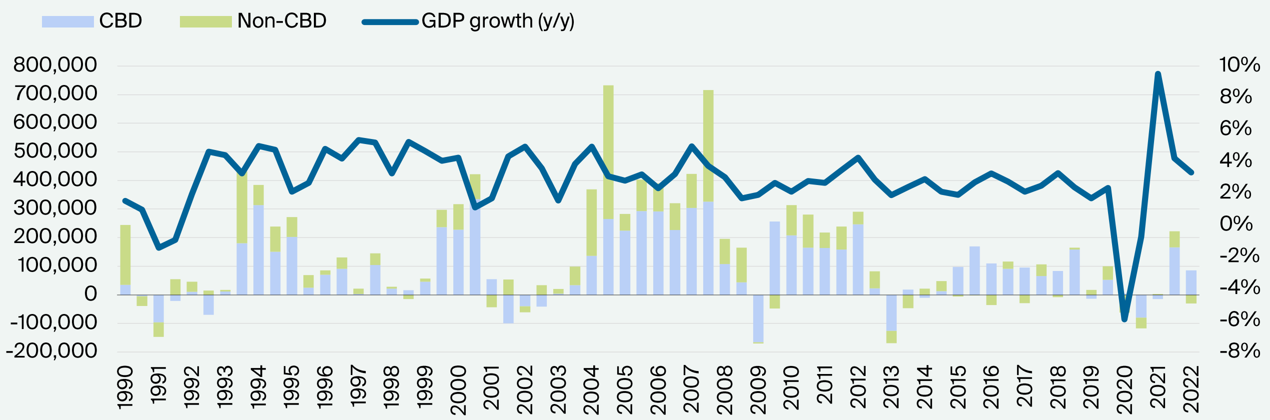
Source: Knight Frank Research, PCA

CBD office take-up by sector
Per cent share of sqm leased in 2022



Source: Knight Frank Research

Office net absorption and GDP growth - all Australian markets
Absorption per six month period (sqm)



Source: Knight Frank Research, PCA

END OF SUPPLY SURGE AS VACANCY RATE PEAKS

Grade A vacancy falls as supply surge ends

The vacancy rate in Melbourne rose a full 1% to 12.9% in July 2022. This was driven by increases in lower grades of vacant space as tenants traded up, combined with an arrival of premium grade stock from the supply pipeline. Vacant grade A stock availability fell. From a low of 1.8% in July 2019 the Grade A rate inexorably rose to a high of 14.2% by Jan 2022. However, as the surge of new supply, much of which was Grade A, has slowed, the bounce back in demand has seen Grade A vacancy drop to 13.0%.

Adding to the supply surge is the continued presence of sub-leasing space. This usually accounts for between 0.5-1.0% of vacancies. However, with the uncertainty around space requirements post pandemic, sub-leasing has jumped to 2.6%. How much pressure sub-leasing puts on the market is a particular issue. Not all will be competing with prime stock, whilst other space may not lease before lease expiry or may even be taken back by the tenant as conditions change.

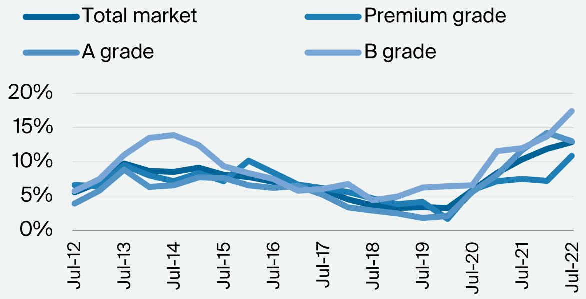
Supply pipeline dropping markedly into the future

Going forward the amount of new supply coming onto the market is expected to be much lower. 2023 is expected to see only 92,000 sqm arriving of which 36,000 sqm is already pre-committed. In 2024 this falls further to only 79,800 sqm with pre-commitments already eating into this.

The increase in construction costs combined with higher finance costs mentioned earlier means that developers may be more cautious about developments being mooted further out in the timeline, raising the bar on rent and lease terms that make a project viable. This combined with the present high vacancy rate will keep a cap on the pipeline going forward. Consequently, with an expectation of continued growth in the economy, and thus demand for space, we are forecasting a slow but steady decline in the vacancy rate going forward. We expect net absorption to remain around its long term average, whilst new supply remains restricted. Vacancy rates are expected to be sub-10% by the end of the forecasting period.

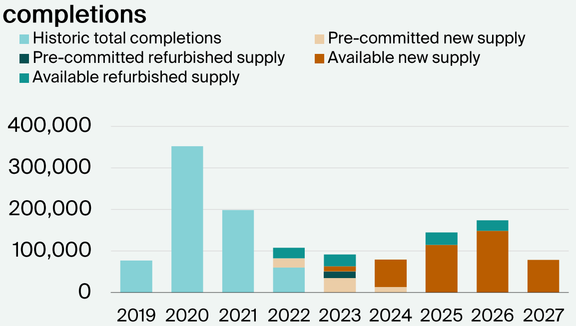
Vacancy rate

By grade, percent



Source: Knight Frank Research, PCA

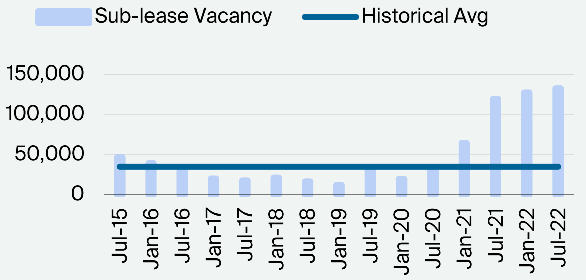
Melbourne CBD development completions



Source: Knight Frank Research, PCA

CBD Sub-leasing space

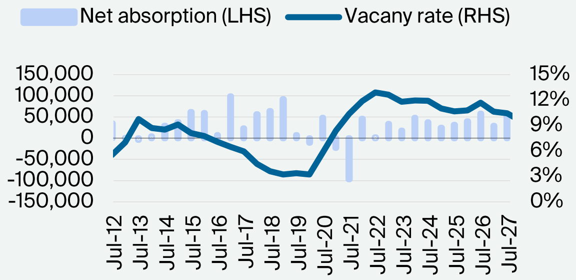
sqm



Source: Knight Frank Research, PCA

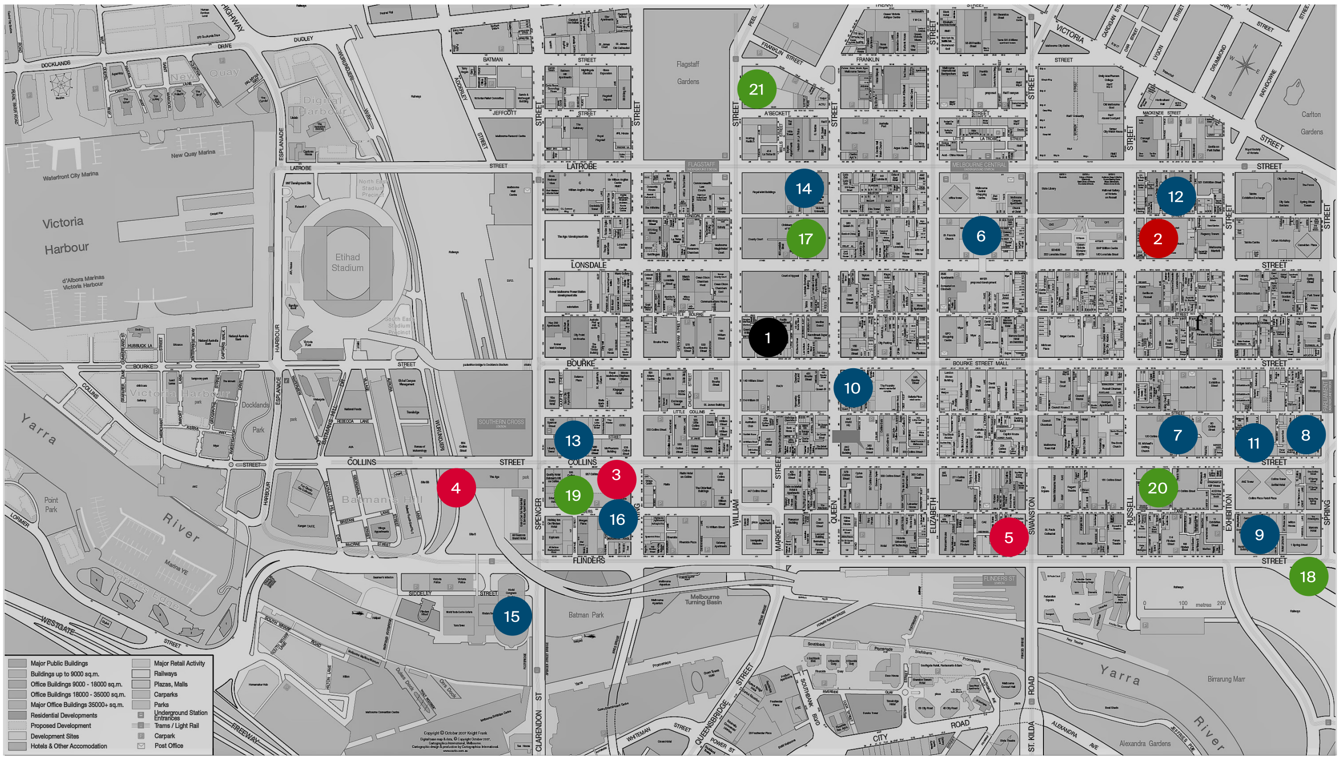
Net absorption and vacancy rate

Sqm (LHS), percent (RHS)



Source: Knight Frank Research, PCA

MAJOR OFFICE SUPPLY



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

MAJOR REFURBISHMENTS

1 500 BOURKE STREET, 44,000 SQM
[TAL]
ISPT – 35% COMMITTED. H2 2023

UNDER CONSTRUCTION/ MAJOR PRE-COMMITMENT

2 140 LONSDALE STREET, 22,000 SQM
[AUSTRALIAN FEDERAL POLICE]
CHARTER HALL – 100% COMMITTED. H2 2022

3 555 COLLINS STREET, 48,000 SQM
[AMAZON/AWARE]
CHARTER HALL – 75% COMMITTED. H2 2023

4 MELB QTR TOWER, 693 COLLINS STREET, 68,000 SQM
LENDLEASE – 20% COMMITTED. H1 2024

5 OVER STATION DEVELOPMENT, SWANSTON ST, 17,000 SQM
LENDLEASE – 0% COMMITTED. H1 2025

DEVELOPMENT APPROVED

6 300 LONSDALE STREET, 22,500 SQM
THE GPT GROUP – 0% COMMITTED.
H2 2024

7 90 COLLINS STREET STAGE-1, 15,000 SQM
MIRVAC – 0% COMMITTED. H2 2024

8 85 SPRING STREET, 30,000 SQM
PELLIGRA – 0% COMMITTED. H1 2024

9 51 FLINDERS STREET, 28,000 SQM
THE GPT GROUP 0% COMMITTED.
H2 2025

10 435 BOURKE STREET, 58,000 SQM
CBUS PROPERTY – 0% COMMITTED.
H1 2026

11 60 & 52 COLLINS STREET, 36,000 SQM
DEXUS – 0% COMMITTED. H1 2026

12 17 BENNETTS LANE, 11,800 SQM
PERRI PROJECTS– 0% COMMITTED.
H1 2024

13 600 COLLINS STREET, 55,000 SQM
HINES – 0% COMMITTED. H1 2026

14 383 LA TROBE STREET, 44,000 SQM
MIRVAC – 0% COMMITTED. H1 2027

15 7 SPENCER STREET, 42,000 SQM
MIRVAC – 0% COMMITTED. H2 2025

16 55 KING STREET, 35,000 SQM
CHARTER HALL
0% COMMITTED. H1 2027

DEVELOPMENT APPLICATION/MOOTED/ EARLY FEASIBILITY

17 283 QUEEN STREET, 30,000 SQM
ISPT. TBC

18 SPRING & FLINDERS STREETS, TREASURY SQR, 140,000 SQM
MIRVAC. TBC [STAGE 1, 40,000 SQM H1 2026]

19 522 FLINDERS LANE, 30,000 SQM
INVESTA. TBC

20 123 COLLINS STREET, 80,000 SQM
GRAND HYATT GROUP. TBC.

21 388 WILLIAM STREET, 25,000 SQM
SHEESH GALE. TBC.

FACE RENTS RISE AS INCENTIVES PEAK

Selective precincts within the CBD see strong face rent growth

Prime net face rents in the CBD rose 4.6% last quarter, their first rise in over 2 years. Average rents in the CBD now stand at $651/sqm. However the rise was not across the whole of the CBD. In a further sign of tenants trading up their space, it was the quality buildings and locations where rents rose the most. Consequently, the Eastern Core saw face rents rise 10.1% (from $774/sqm to $852/sqm). At the other end of the scale Flagstaff saw face rents continue to stagnate, remaining at an average net face rent of $493/sqm.

At the same time as top quality space is in demand, incentives have continued to rise, though the pace of change has slowed markedly. Average prime incentives rose slightly to 40%, a figure we are forecasting the market to top out at. Consequently, net effective rents rose by only 1.7% in the quarter and in Flagstaff actually fell slightly.

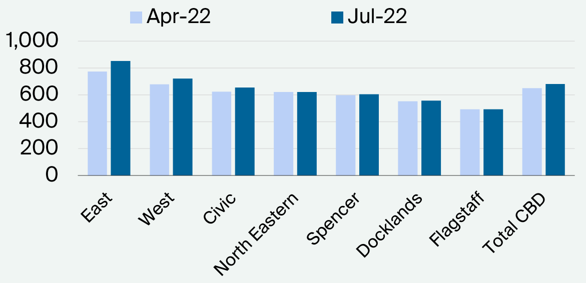
Steady rise in rents and decline in incentives expected through to 2027

Given the present forecasts for the economy as a whole discussed earlier we are expecting continued positive if unspectacular net absorption going forward. Combined with this there are likely to be few surprises on the supply pipeline horizon with costs (both construction and financial) rising sharply.

As a result our forecasts for the rental market are for face rents to continue to steadily rise. This will be concentrated in the premium end of the market, both in terms of location and build quality. With vacancy rates, and thus choice falling, we expect incentives to drop steadily as well.

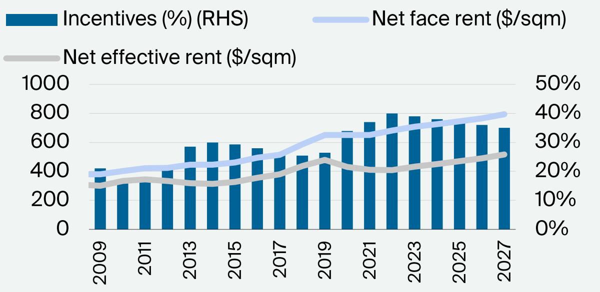
Our latest forecasts see average net facing rents rising to $793/sqm. Incentives are expected to drop to 35% and as a result net effective rents will rise from their present level of $409/sqm to $516/sqm by 2027.

Prime rents
$/sqm, Net face by precinct



Source: Knight Frank Research

Prime rents and incentives
$/sqm(LHS), per cent (RHS)



Source: Knight Frank Research

Recent significant tenant commitments

OCCUPIER	PROPERTY	PRECINCT	SIZE SQM	TERM YRS	START DATE
Services Australia ~	180 Lonsdale Street	Civic	9,000	3	Q2 2022
TAL #	500 Bourke Street	Western Core	6,330	10	Q2 2024
Aware Super #	555 Collins Street	Western Core	8,000	10	Q4 2023
Blue Rock ^	525 Collins Street	Western Core	3,900	5	Q1 2023
I-Select ^	727 Collins Street - Tower 2	Docklands	2,337	5	Q4 2022

Pre-commitment ^ Sublease ~Existing space.

YIELDS RISE AS THE COST OF CAPITAL INCREASES

Investment activity strong but influenced by a single deal.

Sales volumes to the end of August are already sharply up on last year standing at $2.848bn so far compared to $1.985bn for the whole of 2021. However, these numbers are dominated by the sale of the Southern Cross Towers. Charter Hall bought a 50% share in the towers, both of which were previously jointly owned by Brookfield and Blackstone.

Outside of these sales the market has been moderately active, and certainly busier than in 2021 when the first half saw only $465m of activity. However, international investors have been particularly quiet relative to the last couple of years. This is as the global geopolitical events cause international investors to reappraise their investment decisions. This indeed happened in the Southern Cross Towers deal which was going to be a joint bid between Charter Hall and GIC, before the later withdrew, leaving Charter Hall to continue alone.

CBD office yields tick up as bond rates move up on interest rate rises

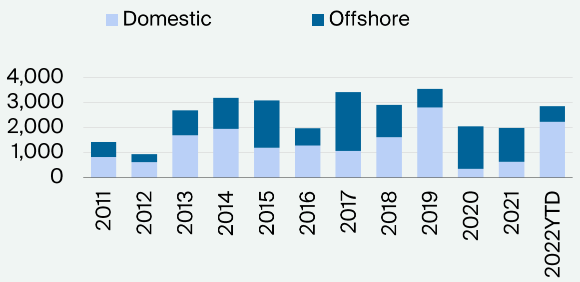
Prime interest rates rose slightly in H1 as investors began reappraising the financial environment as the era of near zero interest rates comes to an end and bond rates move upwards. Australian 10 year government bonds briefly went above 4% before stabilising around 3.4-3.6% in the last few months.

Yields rose in response, with our basket of offices showing an average yield of 4.71% up from 4.60% at the beginning of the year. Once again, as with rents, the rise was concentrated, but not limited to the weaker precincts within the CBD. Secondary yields also moved upwards to 5.0%.

With further interest rate rises ahead, and bond rates expected to remain elevated, our forecasts are for continued rises in yields in the short to medium term. This is in response to the increased cost of capital which we see peaking within the next 18 months. Once again the quality end of the market, which is always in high demand, is slightly less susceptible, but not immune, to these medium term pressures.

Melbourne CBD office investment volume

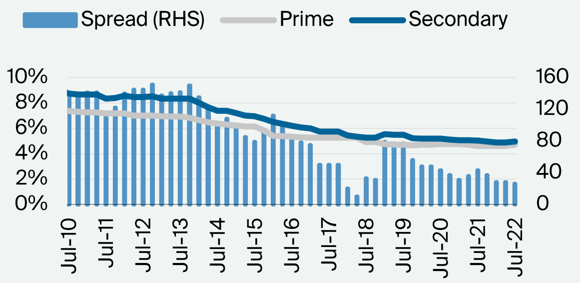
$ million, transactions greater than $10 million



Source: Knight Frank Research

CBD office yields

Percent (LHS), basis points (RHS)



Source: Knight Frank Research

Recent significant sales

BUILDING	BUYER	VENDOR	SIZE sqm	PRICE $M	YIELD %
Southern Cross Towers	Charter Hall Group	Brookfield/ Blackstone	126,000	2,000	4.25
555 Collins Street	GIC	Charter Hall	84,000	U/D	4.25
120 Spencer Street	CapitalLand Open End Real Estate Fund (COREF)	CBRE Investment Management	32,079	322	5.35
330 Collins Street	HThree City	AMP Capital/Sunsuper	16,036	236	4.30
85 Spring Street	Pelligra	Proprium Capital Partners	29,629	130	VP
225 King Street	SLB Development	Victoria University	6,286	40	VP

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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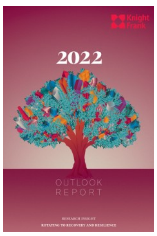

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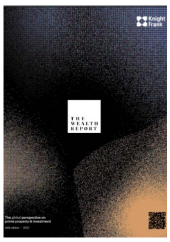

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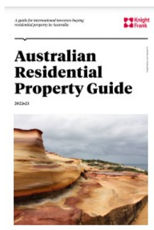

Australian Residential Report
2022-2023

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