RESEARCH

Knight Frank

PERTH CBD

OFFICE MARKET OVERVIEW **MARCH 2019**

RECOVERY PUSHES ON AS PROJECT CAPEX LOOMS

HIGHLIGHTS

Net absorption of 6,750 sqm drove the office vacancy rate down for the fourth successive half yearly period. Further reduction is expected as tenants relocate throughout 2019.

Major supply additions that have contributed to a weaker leasing market have now been delivered, giving the market the opportunity to settle around current stock levels until circa 2024.

Transactional volume in the CBD was underpinned by the sale of Exchange Tower which reportedly attracted widespread interest. Further prime asset transactions are expected during 2019.

KEY FINDINGS

With major occupier moves scheduled to occur mid 2019 onwards, a **subdued net absorption of 6,752 sqm** was recorded over the second half of 2018, to reduce the **overall vacancy rate** to **18.5%**.

Prime effective rents grew 4.5% compared with January 2018, and are forecast to continue to grow as incentives erode, whilst the **secondary market has stopped declining** with well-located stock now back in leasing contention.

No new supply is confirmed until 2023 when Chevron will occupy a new 30 storey tower at Elizabeth Quay to be constructed by Brookfield. Other mooted proposals will likely have a similar horizon should they secure pre-commitment.

The yearly CBD office transaction volume was underpinned by the sale of Exchange Tower. **Yield compression has continued**, and the tighter end of the range will be tested with sales expected to occur in 2019.

NICHOLAS LOCKE
Analyst — Research WA

ECONOMIC OVERVIEW

Improving sentiment in the economy will receive a further boost as new resource sector projects ramp up, and the short-term royalty benefit of price growth in iron ore fines flows through to State Government coffers.

Iron ore fines surging towards 5 year highs

The confluence of catastrophic tailings dam failures in Brazil and renewed Chinese appetite for lower grade product has led to significant price growth in iron ore in the early part of 2019.

Vale has announced it will decommission 10 tailings dams, impacting global supply of high-grade pellet product by 40 to 50 million tonnes per annum. At the same time, Chinese steel mills facing shrinking margins in the face of a slowing domestic economy and geopolitical factors have turned to cost effective lower grade fines supplied by some WA mines, despite their polluting effects during production.

The culmination of both supply and demand-side influences has seen an increase from around $US68 to $US86 per dry metric tonne (62% Fe), and a reduction in the spread to lower grades .

State budget poised to return to surplus

Surging iron ore prices will provide a welcome boost to the 2018-19 State budget to the tune of $1 billion, where iron ore royalty income was forecast based on a price of $US55.

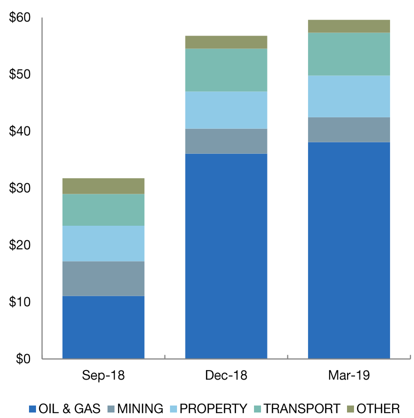
Combined with payments associated with the more equitable distribution of GST income, the pipeline of infrastructure currently in planning phase (including major rail projects) now looks far more deliverable than when first announced, and the budget will return to surplus for the first time in 6 years in 19/20.

LNG projects more closely linked to office demand

Significant investment from Woodside in Scarborough and Browse LNG projects will be hoped to progress to confirmation stage during 2019, and drive uptake in project office space.

The entry of WeWork to Perth has been timed to coincide with this demand, purporting that flex space is a more appropriate leasing outcome for projects.

FIGURE 1
Likely Future Projects Value
$ billions



Source: Business News IQ, Knight Frank Research

TABLE 1
Perth CBD Office Market Indicators as at January 2019

Grade	Total Stock (m²)	Vacancy Rate (%)	Annual Net Absorption (m²)	Average Net Face Rent ($/m²)	Average Incentive (%)	Average Core Market Yield (%)
Prime	1,082,124	13.0	13,673	540—640	40—50	6.50—7.25
Secondary	677,122	27.4	1,660	360—410	50—55	7.25—8.00
Total	**1,759,246**	**18.5**	**15,333**			

Source: Knight Frank Research/PCA

TENANT DEMAND & ABSORPTION

Net Absorption & Outlook

Prime	13,679 sqm YoY 3,795 sqm 6 mo
Secondary	1,660 sqm YoY 2,957 sqm 6 mo

Source: Knight Frank Research/PCA

Modest absorption in 2018, but deals struck suggest plenty more to come in 2019

Full year net absorption of 15,333 sqm recorded for 2018 suggests an office market recovering at a slow pace.

While the numbers can't be disputed, the impact of favourable market conditions and broader economic improvements have led to larger tenants securing space well in advance of occupying it, creating a scenario where vacancy recordings lag the changes in demand on a delay of sometimes over 12 months.

We are aware of multiple floor deals struck at Central Park, 240 St Georges Terrace, Kings Square 1, and The Quadrant that will mostly filter through to vacancy recordings over the next 6 and 12 months, in addition to other properties known to be at Heads of Agreement or under heavy consideration.

Sublease availability still tracking downwards

Sublease availability currently sits below 20 year averages as both a percentage of the market (1% versus 1.6%) and as a quantum of space (17,572 sqm versus 24,449 sqm).

As a read on the comfort of occupiers with their current space contracted, this is a positive sign.

Secondary absorption turns positive

Secondary absorption figures turned positive in January 2019 after a slowing rate of decline for the past two years. This is the first meaningfully positive recording since July 2012, and is hopefully an indication of wider spread improvement across the market.

As and when evidence of sustained improvement in secondary buildings emerges, the conversation will begin to turn towards which remaining buildings offer attributes suitable for re-leasing; which buildings are now no longer fit for purpose and may need to be withdrawn from the market for more significant refurbishment programmes; and which buildings should now effectively be treated as redevelopment sites.

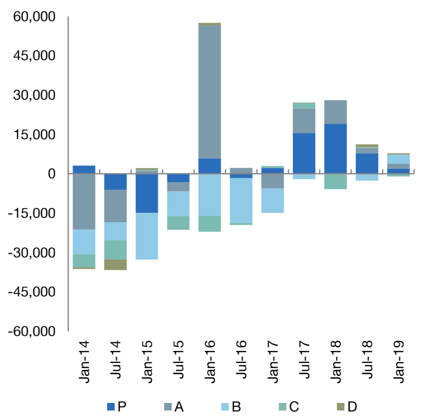
Full year net absorption figures suggest an office market recovering at a slow pace, however large tenants securing space well in advance of occupying it creates a scenario where vacancy recordings can lag changes in demand by sometimes over 12 months.

Enquiry rates remain solid

Knight Frank's database of represented tenant enquiries requesting CBD locations reveals consistent demand of around 34,000 sqm per quarter.

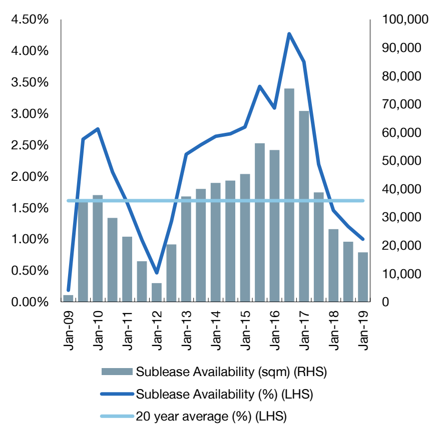
Given the lead times of larger tenants and our knowledge of deals done to date (as disclosed prior), we would expect to begin seeing the results of strong demand mid-2018 flow through to vacancy and absorption recordings later this year.

FIGURE 2
Perth CBD Net Absorption
('000m²) per 6 month period by grade



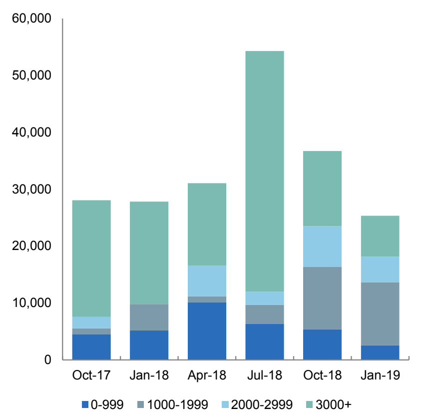
Source: Knight Frank Research/PCA

FIGURE 3
Perth CBD Sublease Availability
% & sqm of vacant stock per 6 month period



Source: Knight Frank Research/PCA

FIGURE 4
Perth CBD Tenant Rep Enquiry
Sum of requirements by area, per quarter



Source: Knight Frank Research

SUPPLY & DEVELOPMENT

Vacancy Rate & Outlook

Prime	13.0% -120bps YoY
Secondary	27.4% -141bps YoY

Source: Knight Frank Research/PCA

Premium spaces hard to come by

The narrative of tenants shifting from inferior buildings or fringe locations into high quality CBD buildings has been well told, with the spread between prime and secondary vacancy rates widening consistently since January 2013.

The resulting premium vacancy rate of 3.8%# recorded in January 2019 is historically low in the context of the wider market, where overall vacancy remains high at 18.5%.

From 1997 to 2005—prior to the large economic expansion that was to the benefit of all building grades, premium space was on average 5.2% vacant, compared with an overall average of 11.1%.

Since this period, an additional 150,000 square metres of premium stock has been added to the market, which sits predominantly occupied.

The spotlight is now firmly on A-grade buildings

The logical conclusion to draw from the lack of premium availability would be to assume that A-grade space is now poised to benefit.

Whilst we do believe this will transpire over time, its important to note that 41% of the market is graded A, and the current vacancy rate of 17.5%# reflects 127,000 square metres of vacant stock. Above trend absorption will be required to make significant inroads on this space.

Specific attributes will set certain buildings apart from the pack

The large chunk of A-grade space on the market shouldn't be treated as equal though, with large differences in age, floorplate size and external glazing impacting upon the desirability to potential tenants.

Knight Frank's analysis of space currently advertised for lease indicates that floorplates under 750 sqm are three times more likely to vacant than those over 1,500 sqm, and that floors in buildings with partially framed and/or inset external glazing are three times more likely to be vacant than those with floor-to-ceiling glazing.

Contiguous spaces quickly disappearing

Large contiguous spaces within all buildings (let alone those with desired features) is low, despite the elevated overall vacancy rate.

Following the recent announcement of WeWork taking space at Central Park, Knight Frank are aware of only 7 spaces larger than 5,000 sqm, and a further 13 larger than 3,000 sqm. Many of these buildings don't have the attributes multi-floor tenants require, and as such are not genuine options.

Contiguous full floor availability is forecast to increase come early-to-mid 2020 when State Government leases expire at Westralia Square and The Atrium, and Chevron expires at Dynons Plaza. The movements of the WA Police (currently at Westralia Square) will soon be known, and provide clarity to what competing space will be on offer for tenants bringing their requirements to the market over the next 12 to 18 months.

Landlords with contiguous space during this in-between period may find themselves in the position to push for effective rental growth, however this will depend largely on how imminently space is needed. Project space requirements may be the catalyst towards this.

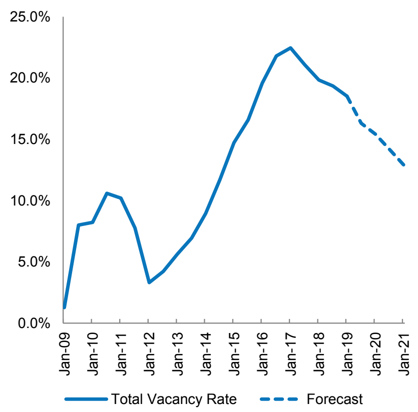
TABLE 2
Perth CBD—Vacancy Rates

Grade	Jan 18	Jan 19
Premium#	6.3%	3.8%
A Grade#	18.0%	17.5%
Prime	**14.2%**	**13.0%**
B Grade	31.1%	30.2%
C Grade	23.1%	21.1%
D Grade	31.6%	13.0%
Secondary	**28.8%**	**27.4%**
Totals	**19.8%**	**18.5%**

adapted from PCA (new addition of Mia Yellagonga substituted from A-grade to Premium-grade)

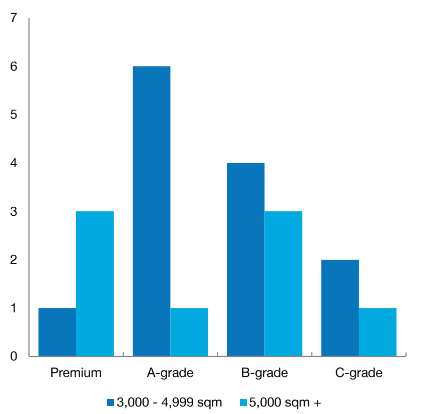
Source: Knight Frank Research/PCA

FIGURE 5
Perth CBD Vacancy
% total vacancy



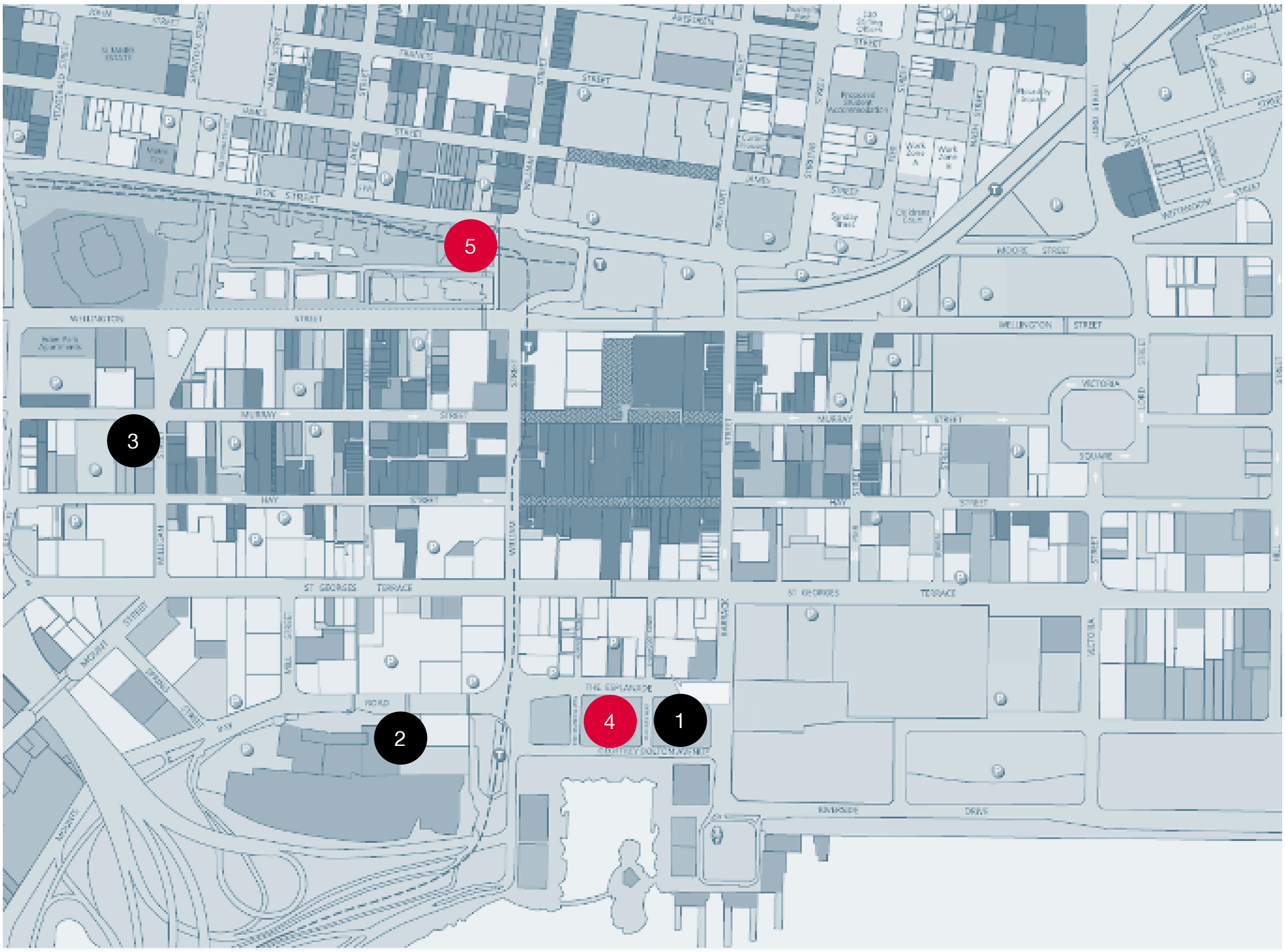
Source: Knight Frank Research/PCA

FIGURE 6
Contiguous Spaces Advertised
 # by size and grade (inc sublease)



Source: Knight Frank Research

MAJOR OFFICE SUPPLY



Supply pipeline reduced to a single confirmed addition

Following the completion of Capital Square—now branded Mia Yellagonga—for Woodside, the supply pipeline for the Perth CBD has dried up to a single proposal to accommodate Chevron at Elizabeth Quay, expected during 2023.

A range of other proposed developments are currently seeking pre-commitment; both within the CBD and on the fringe, with each developed with the specific intent to accommodate either the WA Police or FMG. The progression through the planning system of these proposals is not indicative of their likelihood to proceed.

A decision by the WA Police is likely in coming months.

1. Lot 7 & 8 EQ—52,785m² [Chevron]
   Chevron/Brookfield
   DA Approved#
   Completion 2023
2. 21 Mounts Bay Road—18,197m²
   Brookfield
   DA Approved
   Seeking pre-commitment
3. Cnr Milligan St & Murray St—10,000m²
   Fragrance Group
   New DA Approved July 2018
   Mixed use development
4. Lots 5 & 6 EQ—15,000 & 35,000m²
   Brookfield
   Mooted#
   Estimated 2023+
5. 1 Yagan Sq, PCL—35,000m² (approx.)
   Devwest
   Mooted#—preferred proponent of MRA

Under Construction / Complete

DA Approved / Confirmed / Substantial Commencement / Site Works

Development Application Submitted / Mooted / Early Feasibility

Source of Map: Knight Frank

Avail office NLA quoted.
Major Pre-commit in [brackets] next to the NLA.
EQ Elizabeth Quay
PCL Perth City Link
# denotes areas under the auspices of the Metropolitan Redevelopment Authority
^ denotes substantial commencement of DA

RENTS & RECENT TRANSACTIONS

Rents, Incentives & Outlook

Prime Rents (n)	$591/sqm face No change YoY $307/sqm eff +4.5% YoY	
Secondary Rents (n)	$376/sqm face -1.5% YoY $182/sqm eff +4.9% YoY	
Incentives	P: 48.0% S: 51.7%	

Signs of effective growth at the top end of the market

Prime net face rents remain generally unchanged at an average of $590/sqm; a level that has been mostly maintained since mid-2015.

We are aware of recent deals for premium grade space leasing in the range of $565/sqm to $785/sqm with incentives ranging from 35% to 53%; and A-grade space leasing in the range of $500/sqm to $615/sqm with incentives ranging from 46% to 53%.

In the past 12 months a minor, albeit noticeable, decline in incentives has emerged with deals for premium-grade space now more regularly struck in the range of 45% to 50%. Any significant variations from these metrics are generally attributable to sitting tenant renewals, or longer lease terms whereby the landlord is not willing to extend the discount any further due to long-term valuation and cash flow repercussions.

In effective terms, this has lead to year-on-year prime growth of approximately 4.5% (on average).

We are also aware of increases to asking rates for higher quality buildings that are now predominantly leased, however are yet to see any deal evidence to prove market acceptance.

Secondary properties harder to benchmark as spec suites become the norm

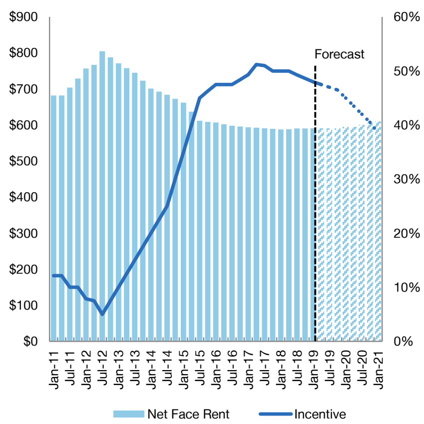
Once a tactic to set a building apart from its competition, speculative fitouts are now a necessity in order to attract tenants into smaller secondary spaces.

The resulting deal evidence is highly varied, with instances of a simple reduction in incentive, versus elevated face rents with in-between incentives.

Well-located B-grade buildings with contiguous space are now back in leasing contention, however we are yet to see any large deals.

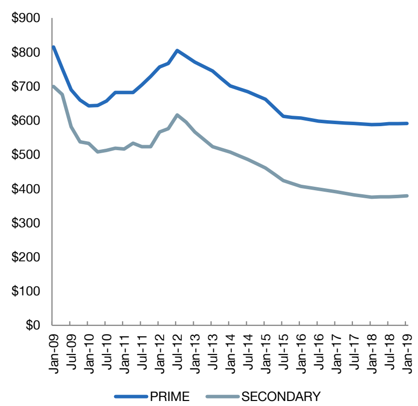
Once a tactic to set a building apart from its competition, speculative fitouts are now a necessity in order to attract tenants into smaller secondary spaces

FIGURE 7
Prime Face Rent & Incentive
LHS: $/m² p.a average face net
RHS: % incentive



Source: Knight Frank Research

FIGURE 8
Perth CBD Face Rents
$/m² p.a average prime v secondary



Source: Knight Frank Research

TABLE 3
Recent Leasing Activity Perth CBD

Address	NLA m²	Term yrs	Tenant	New / Renewal
152-158 St Georges Terrace	7,850	12	WeWork	N
1 William Street	6,000#	ND	Technip	N
250 St Georges Terrace	5,071	10	Clayton Utz	R
226 Adelaide Terrace	4,542	4 & 6	Commonwealth of Australia	N
1 William Street	4,000#	ND	Commonwealth of Australia	N
2 The Esplanade	3,681	5	Mitsui	R
250 St Georges Terrace	3,364	12	King & Wood Mallesons	R
256 St Georges Terrace	3,029	3	Chevron	R
140 St Georges Terrace	2,110	7	AngloGold Ashanti	N

Source: Knight Frank Research # as reported ND not disclosed

INVESTMENT ACTIVITY & YIELDS

Value-add sales coming to the fore as major funds depart and pricing appeals

The recent theme in transactional activity of Perth CBD office buildings is that of international vendors with billions of dollars of AUM divesting from buildings deemed non-core to their strategy.

These divestments do not insinuate a lack of opportunity; rather it is simply the case that Perth mandates are generally for high capital value prime buildings with more stable cash flow that don't require a specific value-add strategy.

Value-add purchasers can generally be characterised into two types:

1. Offshore-originating entities attracted to the yield, with access to cheaper capital and the ability to hold through void periods; and
2. Syndicators active across different price points, attracted to bargain pricing, or the genuine value-add proposition they believe to be offered.

The two most recent sales fit firmly into the latter. 66 St Georges Terrace and 226 Adelaide Terrace were each on-sold after being acquired by Oxford Properties and Blackstone indirectly via portfolio transactions.

66 St Georges Terrace was immediately on-sold, whilst new leases were secured at 226 Adelaide Terrace to improve the saleability prior to the December 2018 transaction date.

Current Yields & Outlook

Prime	6.55% - 7.00% -21bps YoY	
Secondary	7.45% - 7.88% -26bps YoY	

The sharper end of the yield range will be tested in 2019

The December 2018 sale of the premium -grade Exchange Tower to GIC for was notable as being the largest arms-length Perth CBD transaction since Raine Square in 2013.

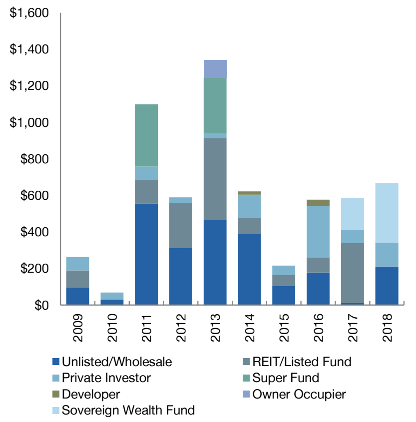
A successful refurbishment and leasing programme prior to the sale consolidated the building as one of Perth's finest, however its leasehold nature and lack of large multi-floor anchor tenant may have contributed to it not selling at a sharper yield than the 6.9% analysed.

The potential sale of HBF House, also known as Kings Square 4, will disclose a tighter yield due to modern building improvements, and a 10 year WALE over a portion of the building to be agreed via leaseback. Properties with these investment fundamentals rarely transact in Perth, and its expected the property will be met with strong interest.

In addition to HBF, rumours of other prime buildings to be put to the market suggest a strong potential sales volume in store for 2019.

2018 was notable in achieving over $1 billion in office sales (over $10 million), however abnormally large transactions occurred outside the CBD.

FIGURE 9
Perth CBD Transaction Volumes
$ millions, transactions $10 million+
Perth, East Perth, Northbridge



Source: Knight Frank Research

The prime yield differential to Sydney remains high

The spread between Perth and Sydney prime office yields remains elevated at 220 bps, well above 10 year (164 bps) and 20 year (133 bps) averages.

Forecast improvement in the Perth leasing market may be the impetus to further yield compression and a narrowing of the spread, however we believe this is will be gradual and require further evidence of a return to sustained economic growth.

TABLE 4
Recent Sales Activity Perth CBD

Address	Grade	Price $ mil	Core Mkt Yield %	NLA m²	$/m² NLA	WALE yrs	Vendor	Purchaser	Sale Date
66 St Georges Terrace	B	72.0^	Approx. 7.1%	11,407	6,312	1.9	Oxford	CorVal Partners	Feb 19
226 Adelaide Terrace	A	86.0^	Approx. 7%	14,391	5,976	2.4	Blackstone	Primewest	Dec 18
2 The Esplanade	Premium	326.0	6.9	34,270	9,513	5.2	AMP / Primewest	GIC	Dec 18
8 St Georges Terrace	C	9.2	7.3#	4,587	2,005	0.0#	Blackstone	Quintessential	Dec 18
125 Murray Street	C	8.1	7.7#	6,325	1,281	0.0#	HBF	Silverleaf	May 18
441 Murray Street	C	22.0	7.9#	5,849	3,761	0.0#	Centuria	Redhill Partners	Mar 18

Source: Knight Frank Research #denote vacant possession sales ^ as reported (unconfirmed)

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