RESEARCH

BRISBANE FRINGE

OFFICE MARKET OVERVIEW DECEMBER 2017

HIGHLIGHTS

There was no new supply in 2017 and two buildings are to be completed in 2018. Refurbishment of fully vacant buildings will create quasi-new supply before further new towers come online 2019/20.

Effective rents have been stable in 2017 with incentives now on a par with the CBD. The competition from the CBD and tranches of prime available space will make it difficult to push rents in H1 2018.

Investment activity in the Fringe reached record levels during 2017 as offshore investors continued to embrace the market as an investment destination. Yields have continued to firm for core assets.

KEY FINDINGS

Total **vacancy has remained elevated at 14.4%**. Prime vacancy has increased to 12.4%, while secondary vacancy is also higher at 16.7%.

Prime effective rents remain stagnant. While face rents have increased slightly, **higher incentives, now on a par with the CBD,** have counteracted this impact.

Prime effective rent growth will be hampered in the short term by the level of available tranches of space. In the medium term the improving economy and tenant demand will translate to **average growth of 3.5% over the next two years.**

The value of transactions was at a **record high during 2017** as **offshore investors** fully embraced the market. This has seen yields remain on a **firming trend.**

JENNELLE WILSON
Senior Director — Research QLD

SUPPLY & DEVELOPMENT

Refurbished stock was the only supply for 2017, while only two completions in 2018 will keep stock additions low. Tenant requirements have spurred medium term options but only a select few will proceed.

After 23,800m² of new supply in 2016, the only addition to stock during 2017 has been the return of refurbished accommodation at 315 Brunswick St, Fortitude Valley. The building has 10,908m² of character office space, following extensive works, and is 60% leased to the State Government for an Innovation Hub (5,300m²) and Valti (1,260m²) with further commitments from the technology and business incubator sectors anticipated.

The delivery of new stock will return to the Fringe market in 2018 with two buildings to reach completion. The first is the 18,791m² 900 Ann St, Fortitude Valley, which was fully pre-committed by Aurizon. Recently Aurizon has announced some 7,100m² of this space is available for long term sub-lease. The other building to be completed during 2018 is K5 at Showground Hill which has an expected completion timeframe of mid-2018. The 14,429m² building is 43% committed to Aurecon. The building will be constructed using cross laminated timber and as a result will have high ecological credentials.

Beyond these two buildings there are no further projects which are under construction, however there is a reasonably extensive list of potential projects for medium term completion. Although Suncorp did not shortlist any Fringe projects, the release of its brief during 2017 awakened many office projects in the Fringe, largely across the Urban Renewal precinct. This was consolidated by the more recent ATO (up to 24,000m²) and Technology One (17,000m²) requirements. As a result there are presently a number of mooted developments which are being tracked by Knight Frank, offering a total of 266,400m² of office space. All but one of these are in the Urban Renewal precinct.

Only a limited number of these projects are expected to proceed in the medium term with 11 Breakfast Creek Rd, Newstead, the only project which currently has a formal commitment, 12% to joint-venture partner John Holland. The Technology One requirement, currently at short list stage, may trigger a further building commencement although re-committing to their current premises is understood to remain an option.

The inherent size of the sites available within the Urban Renewal precinct, combined with urban planning allowing for up to 30 levels has resulted in many proposed buildings being 30,000m² or greater. This will generally require more than one tenant to pre-commit to a project before the necessary commitment levels to commence are achieved, slowing the progression of new projects while competition remains high from CBD existing and new space.

Refurbishment and rebranding of a number of fully vacant buildings is likely to create quasi-supply over the next 12-24 months.

TABLE 1
Brisbane Fringe Office Market Indicators as at October 2017

Grade	Total Stock (m²)^	Vacancy Rate (%)^	Annual Net Absorption (m²)^	Annual Net Additions (m²)^	Average Gross Face Rent ($/m²)*	Average Incentive (%)	Average Core Market Yield (%)#
Prime	659,723	12.4	14,689	23,800	550	37.0	6.05—7.25~
Secondary	559,919	16.7	-19,197	-21,477	442	37.5	7.50—8.70
Total	**1,219,642**	**14.4**	**-4,508**	**2,323**			

Source: Knight Frank Research ^ PCA data as at July 2017 # data series based on assumed WALEs of 5-7 years
~ Upper prime assets with long WALEs are trading below this range

TABLE 2

Major Additions and Withdrawals— Brisbane Fringe

Additions

Address	Precinct	NLA (m^2)	% Leased	Major Tenant/s	Developer	Status	Date
315 Brunswick St, Fortitude Valley	Urban Renewal	10,908	60%	State Government	Ashe Morgan Investments	Refurbishment Complete	Oct 16
900 Ann St, Fortitude Valley	Urban Renewal	18,791	100%	Aurizon (sublease c7,100m^2)	Consolidated Properties onsold to Charter Hall	Construction	Mar 18
K5, Showground Hill, Bowen Hills	Urban Renewal	14,429	43%	Aurecon	Lend Lease	Construction	Jun 18
234 Wickham St, Fortitude Valley	Urban Renewal	8,924	-	-	LaSalle Asia Opportunity Fund IV	Refurbishment	TBA
339 Coronation Dr, Milton	Milton	13,172	-	-	Valad/Blackstone	Refurbishment	2019
11 Breakfast Creek Rd, Newstead	Urban Renewal	29,725 GFA	12%	John Holland	Charter Hall Office Trust/ John Holland#	Approved	STP
36-52 Alfred St, Fortitude Valley	Urban Renewal	32,693	-	-	LaSalle Asia Opportunity Fund IV	Approved	STP
301 Wickham St, Fortitude Valley	Urban Renewal	35,000	-	-	Cornerstone Properties	Approved	STP
801 Ann St, Fortitude Valley	Urban Renewal	44,300	-	-	Walker Corporation	Development Application	STP
358 Wickham St, Fortitude Valley	Urban Renewal	c30,000	-	-	Prime Space/Grocon	Mooted	STP
CDOP 7, Milton	Milton	19,600	-	-	AMP/Sunsuper	Mooted	STP
K3, Showground Hill Bowen Hills	Urban Renewal	c25,000	-	-	Lend Lease	Mooted	STP
895 Ann St, Fortitude Valley	Urban Renewal	c25,000	-	-	Consolidated Properties	Mooted	STP
Jubilee Hotel, 470 St Paul's Tce, Fortitude Valley	Urban Renewal	c25,000	-	-	JGL Properties	Development Application	STP

Major Withdrawals (1,500m^2+)

Address	Precinct	NLA (m^2)	Owner	Reason for Withdrawal	Date
611 Coronation Drive, Milton	Milton	1,756	Private Investors	Withdrawal for redevelopment (student accommodation)	Jun 17
25 Donkin St, West End	Inner South	8,074	R&F Properties	Withdrawal for redevelopment (residential)	Jun 17
895 Ann St, Fortitude Valley	Urban Renewal	2,824	Private Investor	Potential withdrawal for redevelopment (office)	tba
301 Wickham St, Fortitude Valley	Urban Renewal	2,512	Cornerstone Properties	Potential withdrawal for redevelopment (office)	tba
207 Wharf St, Spring Hill	Spring Hill	4,695	Land & Homes Group	Potential withdrawal for redevelopment (residential or hotel)	tba
Kings Row Building 1, Milton	Milton	3,907	Shayher Group	Potential withdrawal for redevelopment (residential)	long term
527 Gregory Tce, Bowen Hills	Urban Renewal	7,878	Kingsford Development	Expected withdrawal for redevelopment (residential)	long term

Source: Knight Frank Research   STP Subject to pre-commitment   # developer also an occupier in the building

TENANT DEMAND & RENTS

The total vacancy rate for the Brisbane Fringe market increased to 14.4% as at July 2017, from 12.9% at the start of 2017. This increase in the total vacancy rate was largely due to negative net absorption.

The prime market vacancy rate increased, up from 11.0% at the start of the year to 12.4% in July 2017. The direct prime vacancy rate has remained under double figures at 9.2% with the sub-lease vacancy rate showing some improvement, but remaining significant at 3.3%.

TABLE 3

Brisbane Fringe—Vacancy Rates

Precinct	Jan 17 (%)	Jul 17 (%)
A Grade	11.0	12.4
Prime	**11.0**	**12.4**
B Grade	14.2	15.6
C Grade	15.6	16.1
D Grade	25.5	60.9
Secondary	**15.0**	**16.7**
Milton	18.2	17.9
Urban Renewal	11.1	13.9
Spring Hill	15.0	18.4
Toowong	10.1	11.8
Inner South	11.4	11.1
Total	**12.9**	**14.4**

Source: Knight Frank Research/PCA

The Fringe secondary market vacancy rate also increased with some secondary properties being emptied prior to potential redevelopment. The total vacancy increased from 15.0% at the start of 2017, up to 16.7% in July 2017.

Spring Hill at 18.4% overtook Milton (17.9%) as the precinct with the highest vacancy rate due to the AFP relocating from 207 Wharf Street. Nevertheless with the upcoming relocation of Origin from Milton into the CBD in 2018, the precinct will see vacancy significantly increase again, triggering refurbishment and potential change of use for some assets. The Inner South remains the tightest market, with direct vacancy of just 6.8% and relatively high sub-lease vacancy of 4.3%.

Net Absorption

Net absorption has been lower during 2017 with a number of tenants relocating out of the Fringe market or downsizing. Traditionally, the Fringe market net absorption is boosted by new supply, frequently attracting new users to the region. This was the case in late 2016 when Flight Centre relocated from the CBD into 23,500m², however with no new additions during 2017, this factor has been absent from the market.

There was negative net absorption of 28,533m² in the first half of 2017 as the figures were impacted by a number of tenant relocations such as the Australian Federal Police (4,695m²), State Government (c10,000m²), Energex (3,000m²) and Careers Australia (4,000m²) vacating large tranches of space.

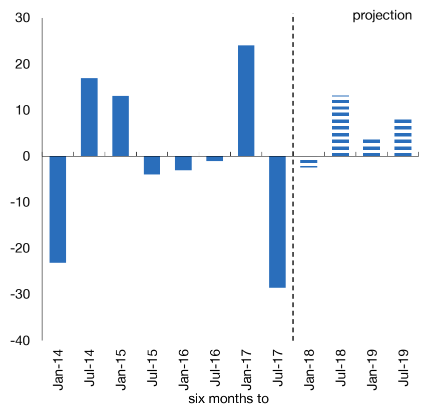
The second half of 2017 is expected to show slightly negative net absorption with leasing activity only modest and absorption impacted by the end of sub-leases at 100 Brookes St, Fortitude Valley plus buildings emptied and withdrawn for redevelopment.

The boost to net absorption by new building completions will return in early 2018 with Aurizon (leasing 18,891m² but only expected to occupy 11,791m²) and Aurecon (6,500m²) the major contributors.

FIGURE 1

Brisbane Fringe Net Absorption

('000m²) per 6 month period



Source: Knight Frank Research/PCA

Vacancy

The vacancy rate is expected to stagnate through the remainder of 2017 and into 2018 in the region of 14.0%. The Fringe is struggling to hold ground against the CBD and a number of major tenant moves from the fringe market into the CBD will have an impact on the vacancy rate going forward.

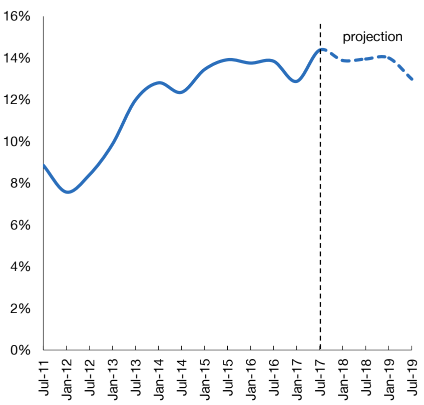
Origin Energy is the largest of these tenants, expected to leave c25,000m² of space in the Fringe, largely in Milton, when they relocate into 180 Ann St, CBD in 2018. Additionally Allianz is expected to vacate 6,000m² in Toowong to relocate to 310 Ann St, CBD. The creation of this backfill space in the Fringe will counteract the positives of tenant moves from the CBD into newly completed Fringe buildings in 2018—namely Aurizon and Aurecon.

Along with the vacancy rate, which is expected to remain stubbornly high in the near term, there are a number of buildings which are currently, or soon to be, fully vacant. Examples are 100 Brookes St, Fortitude Valley (10,165m²) and 207 Wharf St, Spring Hill (5,058m²) with 234 Wickham St, Fortitude Valley (9,508m²) currently off the market pending refurbishment. Also Origin will vacate the whole of 339 Coronation Drive, Milton (13,172m²) in H1 2018.

FIGURE 2

Brisbane Fringe Vacancy

% total vacancy



Source: Knight Frank Research/PCA

Tenant Demand

The competition for tenants between the CBD and Fringe markets has continued to escalate throughout 2017. The CBD has drawn a number of larger tenants into new or refurbished stock with Origin, Allianz and Tatts Group all key examples. However high availability of A grade and refurbished B grade space, particularly with speculative fitouts, are also proving attractive for smaller tenants to make the move into the CBD. The propensity for Brisbane tenants to move across market borders, chasing upgraded accommodation and new stock, is also in evidence with Aurizon and Aurecon’s commitment to buildings under construction in the Fringe.

The Queensland economy has continued to show positive signs with a major measure of business activity, State Final Demand, recording growth of 2.4% in the year to June 2017, reversing the fall of 1.1% in the year prior. Additionally Gross State Product indicated economic growth of 1.8% over the same period. More recently employment growth has shown strong annual uplift of 9% and 12% for the education and health care sectors in Queensland; important drivers for the office market.

Rental Levels

Average market rents have been largely stable within the Brisbane Fringe market over the course of 2017. Even though the direct prime vacancy rate has been consistently relatively low, there has not been enough competition in the market to engender any material increase to prime rents during 2017. The CBD has provided strong competition with many viable options for tenants. Additionally a number of large tranches of prime Fringe space have unexpectedly come available over the past six months.

Within the prime market average gross face rents have been stable, increasing by 0.5% over the past year from an average of $547/m² to $550/m². Average incentives have stabilised at 37%, up from 36% a year ago. The current level is expected to form the peak for incentives however the recent increase in the number of large, contiguous prime spaces available will see the current incentive levels persist well into 2018. Significant improvement in prime effective rents is not expected until early 2019 as the current level of direct, contiguous, prime space will take some time to be absorbed. As the economy continues to improve tenant demand is also expected to improve.

> “Though the direct prime vacancy rate has been low, there has not been enough competition to engender a material increase to prime effective rents.”

Newly built office space has maintained its rental premium to the existing prime market in the Fringe, with the economic rent for new construction $625—700/m² gross with incentives of 35%-40%+.

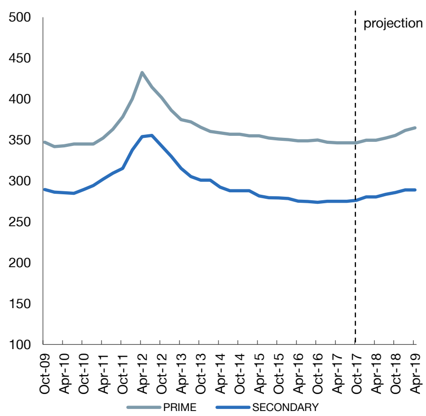
The secondary market has remained tough with little to no opportunity to grow effective rents. The average gross face rent increased slightly (up 0.9%) to $442/m² in the year to October 2017. With incentives stable at 37.5% on average, gross effective rents grew by 0.9% to $276/m². In the short term, face rent appreciation will be modest at best, however some erosion of incentives while the wider leasing market improves, is expected from mid-2018. As owners invest in their secondary assets through refurbishment these assets are likely to push to new face rent benchmarks to reflect this investment.

TABLE 4
Recent Leasing Activity Brisbane Fringe

Address	NLA m²	Face Rent	Term yrs	Incentive (%)`	Tenant	Start Date
5 King St, Bowen Hills	6,489	c590 n	10	undis	Aurecon^	Mid-18
900 Ann St, Fortitude Valley	18,791#	545 n	12	undis	Aurizon^	Apr 18
10 Browning St, South Brisbane	1,274	535 g	7	30-35	Shortcut Software	Sep 17
515 St Pauls Tce, Fortitude Valley	1,200	560 g	2	< 20	Urban Utilities	Aug 17
1 King St, Fortitude Valley	3,600	630 g	7	40+	SMEC	Apr 17
25 Montpelier Rd, Bowen Hills	1,245	520 g	3	30-35	Neds International	Apr 17
108 Wickham St, Fortitude Valley	4,570	590 g	7	35+	State Government	Apr 17
150 Leichhardt St, Spring Hill	1,308	460 g	7	30-35	Imagine Education	Mar 17

Source: Knight Frank Research ^ pre-commitment # have since offered approx 7,100m² for sub-lease
`est. incentive calculated on a straight line basis g gross n net

FIGURE 3
Brisbane Fringe Rents
$/m² p.a average gross effective rent



Source: Knight Frank Research

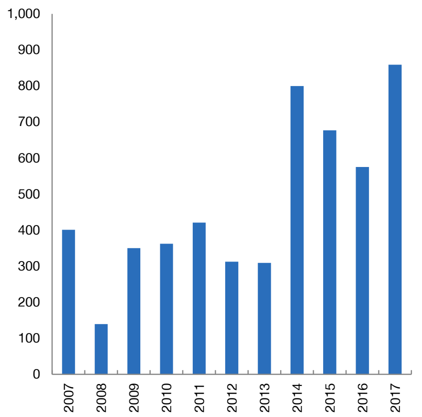
INVESTMENT ACTIVITY & YIELDS

The Brisbane Fringe office market is on track to achieve record high sales turnover, with preliminary total turnover for CY 2017 of $858.9 million. This is well ahead of the $575.4 million for CY 2016 and exceeds the previous record of $799.6 million during 2014. Three transactions in excess of $100 million were the foundations of the strong result.

FIGURE 4

Brisbane Fringe Transactions

$ million transactions $10m+



Source: Knight Frank Research

The penetration of offshore investors into the Fringe market has also continued strongly during 2017 with offshore capital purchasing two of the three largest sales in 505 St Paul's Terrace, Fortitude Valley ($205.5 million) and 520 Wickham St, Fortitude Valley ($119.15 million). As shown in Figure 5, offshore purchasers have been the greatest net purchasers of Fringe assets over the course of 2017. Offshore buyers acquired $408.5 million of Fringe assets over the year and disposed of $143.4 million.

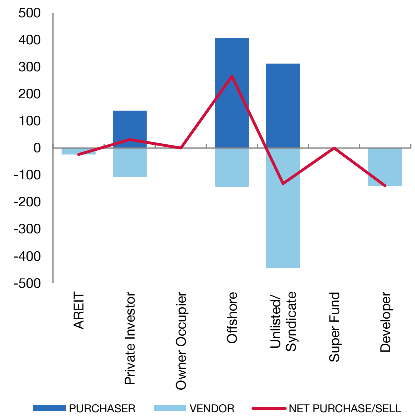
The only other investor type to be net purchasers of Fringe assets were the private investors with five assets transacted. The largest was Ralph Sarich's Cape Bouvard Properties purchase of 12 Commercial Rd, Newstead for $47.0 million.

Unlisted Funds and Syndicates also remained active in the market with acquisitions of $312.3 million across five transactions, the largest of which was Impact Investment Group's completion of the fund through purchase of 5 King St, Bowen Hills for c$140 million in early 2017.

FIGURE 5

Brisbane Fringe Purchaser/Vendor

$ million sales ($10m+) CY 2017 preliminary



Source: Knight Frank Research

Significant disposals of $468.5 million resulted in these unlisted funds being net sellers across the year. AREITs have remained largely out of the market during 2017 due to the superior purchasing power of offshore and wholesale funds at this time. This is not expected to change in the short term with offshore buyers having both the appetite and capacity to transact at current yield levels.

TABLE 5

Recent Sales Activity Brisbane Fringe

Address	Grade	Price $ mil	Core Market Yield %	NLA m²	$/m² NLA	WALE yrs	Vendor	Purchaser	Sale Date
199 Grey St, South Brisbane	A	92.60	6.81	11,845	7,818	4.6	Tribune Properties	AMP Capital Wholesale Australia Trust	Oct 17
100 Wickham St, Fortitude Valley	A	83.83	6.69	13,131	6,384	4.7	Keystone Private	Ascendas Business Park Trust	Sep 17
12 Commercial Rd, Newstead	A	47.00	6.06	6,558	7,167	5.6	Cambooya Pty Ltd	Cape Bouvard Properties	Sep 17
520 Wickham St, Fortitude Valley	A	119.15	6.18	14,672	8,123	5.9	AFIAA	M&G Real Estate	Aug 17
505 St Pauls Tce, Fortitude Valley	A	205.50	6.46^	17,618	11,664	10.5	ISPT Core Fund	AXA IM (Korean Teachers Fund)	Mar 17
200 Creek St, Spring Hill	B	38.70	8.38	7,603	5,090	3.5	Centuria 200 Creek St Fund	Sentinel Regional Office Trust	Jan 17
35 Boundary St, South Brisbane	A	48.55	7.01	8,082	6,007	3.0	Abacus Property Group/Heitman	Private Investor	Jan 17
164 Grey St, South Brisbane#	A	30.30	5.94	3,102	9,768	1.5	Private Investor	Moelis Aust Asset Mgt/ Marquette Properties	Dec 16

^passing yield # includes a significant retail component

Source: Knight Frank Research

The record-breaking turnover in the Fringe during 2017 underlines the investor acceptance this market now receives. The size and quality of recent developments has expanded the stock of institutional quality assets, further consolidating market activity. The availability of existing assets for sale is currently diminished, however continued purchaser focus on the region is likely to create further opportunities in 2018.

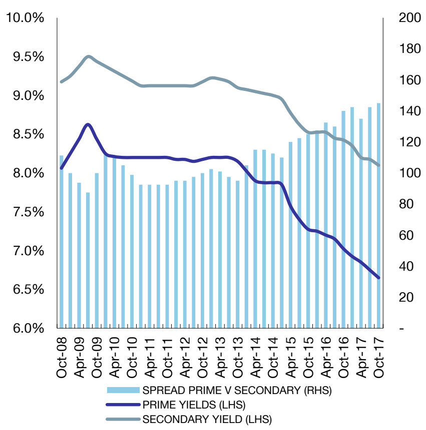
The weight of money seeking both core and value add investments has continued to push both prime and secondary yields lower. The average prime yield series, based on WALEs of 5-7 years, has contracted a further 38 basis points over the past 12 months to a median of 6.65%, with a range of 6.05% - 7.25%. At this time the contraction has been the greatest in the Fortitude Valley and South Brisbane markets.

In contrast, Milton and Toowong has received lesser institutional investment demand with pure investment yields not contracting to the same level as other precincts due to the tougher leasing market and uncertainly surrounding the backfill space to be created by Origin. However counter-cyclical purchasing has emerged in Milton with 12 Cribb St ($12.9 million), 189 Coronation Drive ($17.5 million) and 8 Gardner Close ($10.6 million) all having recently transacted. The precinct's location adjacent to the CBD, views over the Brisbane River and train station access means that the underlying land retains high value over and above current high office market vacancy.

Yields for secondary assets have contracted at a rate on a par with the prime stock, down by 33 basis points over the past 12 months across a range of 7.50% - 8.70%. Unless a secondary asset has the scale and scope for refurbishment and re-leasing to a tenant with strong covenant, demand is limited.

While the Fringe leasing market remains relatively softer in comparison to the CBD, the Fringe appears to be on a par with the CBD in terms of investor acceptance. At just 33 basis points the spread between the median prime yields for the CBD and Fringe is at lows not seen since 2005.

FIGURE 6
Brisbane Fringe Core Market Yields
% Yield (LHS)Prime v Secondary & BPS (RHS)



Source: Knight Frank Research

> "The record-breaking level of turnover in the Fringe market during 2017 underlines the investor acceptance this market now receives."

Outlook

- There has been no new supply during 2017 and the two projects for 2018 are 76% committed, although expected to only be 55% occupied. The pipeline of potential developments for the medium term has increased, drawn by a number of tenant briefs, with only a select few expected to reach fruition.
- Refurbished stock of 10,908m² was the only significant supply in 2017 and refurbished/backfill space will continue to shape the market during 2018 and beyond. Additionally over the past six months a number of tranches of prime space have come to the market, which somewhat de-railed the opportunity to push prime rents in the Fringe.
- Vacancy jumped due to a number of one-off factors in mid-2017 and is forecast to remain at similar levels over the course of 2018 as modest net absorption expectations will struggle to counteract backfill space even though new supply is limited.
- Effective rental growth in the prime market is expected to remain hampered by competition from the CBD through 2018. Nevertheless the improving economy and tenant demand will flow through to prime rents with effective rental growth averaging of 3.5%+ over the next two years.
- Yields have remained on a firming trend, and this will continue in the short term. Despite much discussion surrounding domestic and offshore increases to the cost of funds the Australian 10 year bond rates have remained in the vicinity of 2.4% - 2.8% during H2 2018, sitting at 2.55% in early December. Globally the weight of expectation remains towards tightening monetary policy, but for now these influences remain benign. While 2018 has the potential to bring greater volatility, and pricing of risk, for now the market is under the influence of strong investment inflows, particularly from offshore.

Image: 315 Brunswick St, Fortitude Valley

Definitions:
Core Market Yield: The percentage return/yield analysed when the assessed fully leased net market income is divided by the adopted value/price which has been adjusted to account for property specific issues (i.e. rental reversions, rental downtime for imminent expiries, capital expenditure, current vacancies, incentives, etc).
WALE: Weighted Average Lease Expiry
Precincts:
Milton—Includes the suburbs of Milton and Petrie Terrace
Urban Renewal—Includes the suburbs of Fortitude Valley, Newstead and Bowen Hills
Spring Hill—Spring Hill
Toowong—Toowong
Inner South—Includes the suburbs of South Brisbane, West End, Kangaroo Point, East Brisbane and Woolloongabba

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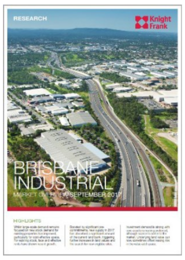

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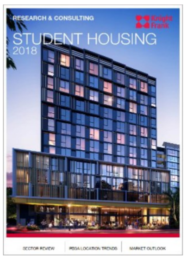

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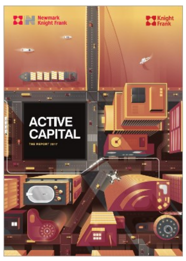

Active Capital 2017

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