RESEARCH

Knight Frank

CANBERRA

OFFICE MARKET BRIEF MARCH 2016

Key Facts

Stock withdrawals and a fall in sub-lease vacancies has resulted in a slight reduction in the vacancy rate to 14.9% over the six months to January 2016.

Tenant demand has been solid in select precincts, however broadly remains focused on the prime market.

Boosted by Civic, a moderate increase in both prime and secondary gross face rents has been recorded, up 0.7% and 0.6% respectively over the past year.

A number of recent sales have provided clarity to the firming in yield metrics, however there remains scope for further compression during 2016.

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With economic conditions in Canberra beginning to improve, supported by recent employment growth, underlying market fundaments for both leasing and sales markets will continue to improve throughout 2016.

Development Activity

Following strong construction and refurbishment activity between 2013 and 2015, albeit concentrated in just a few major projects, office supply in Canberra over the past 12 months has slowed to its lowest level since 2000 where in gross terms 18,197m² of stock was added during the period. The second half of 2015 saw office supply levels moderate further with completions totalling just 6,252m². Supply over this period largely resulted from a full refurbishment at 50 Blackall Street (5,032m²).

On a net basis, the withdrawal of office stock for both change of use and temporary refurbishment has resulted in a net decline in stock levels over the past six months. Net supply over the second half of 2015 measured –11,620m², reducing Canberra's overall stock base to 2,390,758m². Withdrawals over the period included 219 Northbourne Ave, Turner (6,852m²) and East Block, Parkes (5,225m²).

Looking ahead, office supply in Canberra is expected to remain benign over the next two years, with additions in the interim resulting from the redevelopment of Tuggeranong Office Park (30,707m²) and refurbishments from tenant relocations. Recently, a series of announcements by the ACT Government will signify the beginning of Canberra's next round of office projects from late 2018. In early 2016, the ACT Government announced the proposals for the development of a 20,000m² office complex on the car park adjacent to the Legislative Assembly building in Civic and the development of the existing Motor Vehicle Registry site in Dickson to accommodate 13,000m² of office NLA. Both proposals are subject to pre-commitment.

Beyond this, there are a large number of mooted projects across Canberra with the potential to add over 300,000m² to the market, the majority of which are located in or around Civic (see supply map for details) and have been in the pipeline for a number of years. The recent announcement of the proposed ACT Government office building in Civic is expected to impact the timing of these projects, and/or the development outcome for some sites. At the same time, given the Commonwealth's focus on contracting their accommodation requirements, it is now unlikely they will be delivered prior to 2020.

Tenant Demand & Vacancy

With signs of positive economic data emerging from the ACT, underpinned by a recovery in the labour market, business confidence is beginning to return, particularly in the private sector. Over the 12 months to February 2016, employment growth in the ACT measured 1.3% (trend data), well above the five year average of 0.3% per annum. However despite this, the labour market remains two tiered with the fragility within the public sector persisting with further employment cuts earmarked during 2016.

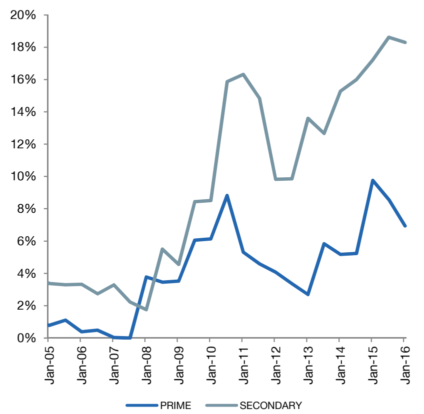
Following a return to more positive economic conditions, leasing enquiries have been solid in recent months, albeit remaining largely focussed on the Civic precinct. The withdrawal of office stock and a further reduction in sub-lease vacancies over the six months to January 2016 was the catalysts behind the vacancy rate declining to 14.9% (15.3% in July) as modest demand for prime space (11,877m²) was almost fully offset by negative net absorption of 11,820m² within the secondary market. As a result, net absorption totalled just 57m² in the six months to January 2016.

With tenant demand remaining focussed on the prime market as tenants take advantage of favourable rental and incentive metrics, the divergence in vacancies between prime and secondary markets within Canberra's major office precincts has widened to its highest level (see Figure 1). At present, the vacancy rate in the prime market measures 6.9% (major precincts), of which 60% is located at the Airport where the vacancy rate measures 42.6%. Broadly speaking, tenant demand within the secondary market remains weak with the vacancy rate in the major precincts currently standing at 18.3% as a result of reduced tenant depth and prohibitive policies around adaptive re-use opportunities.

By precinct, demand has been most pronounced within Civic where net absorption over the past six months totalled 20,906m² which was its largest six monthly increase since 2007. Civic appears to be out of sync with the broader market as net absorption in the secondary market has been over double that of prime over the past six months. This has been brought about by a lack of sizeable contiguous options in the prime market where tenants looking to remain in Civic have had to lease suitable secondary assets instead. This in turn has created some urgency amongst tenants looking for space in Civic otherwise they will miss out. Elsewhere, absorption levels in the Parliamentary precinct have been more moderate while Town Centres continue to struggle given a lack of tenant depth.

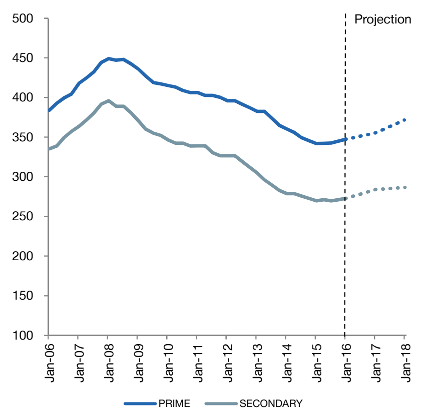
Looking ahead, both the ACT and Federal elections in 2016 are anticipated to result in a moderate slowing in enquires over the short term as private's wait to see the result of both. However thereafter and in combination with further reductions in sub-lease space as a result of the Government's 'Project Tetris' initiative, leasing activity is expected to gain further momentum, resulting in a moderate decline in the vacancy rate over the next 12 months.

FIGURE 1
Canberra Vacancy Major Precincts*
Per six month period (%) - by grade



Source: Knight Frank Research/PCA
* incorporates Civic, Parliamentary Precinct & Town Centres

FIGURE 2
Civic Gross Effective Rent
By Grade ($/m²)



Source: Knight Frank Research

TABLE 1
Canberra Office Market Indicators - January 2016

Grade	Total Stock (m²)	Vacancy Rate (%)	Annual Net Absorption (m²)	Annual Net Additions (m²)	Average Gross Face Rent ($/m²)	Outgoings ($/m²)	Average Incentive (%)	Average Core Market Yield (%)
A Grade								
Civic (City)	299,888	5.7	16,022	0	440	74	21.1	7.00-7.75*
Parliamentary	261,910	10.8	6,090	0	445	70	18.5	7.00-7.75*
Town Centres	220,633	4.0	0	0	385	65	24.5	8.00-8.50
Other	301,067	28.8	14,298	8,262				
Secondary								
Civic (City)	388,062	15.0	9,473	0	377	89	27.6	8.75-9.75
Parliamentary	198,150	21.6	-15,325	-193	380	72	22.5	8.75-9.75
Town Centres	272,670	20.5	-3,397	0	310	67	30.8	10.25-11.50
Other	448,378	13.1	-18,301	-10,985				
Total Market	**2,390,758**	**14.9**	**8,860**	**-2,916**				

Source: Knight Frank Research/PCA Parliamentary comprises Barton, Parkes and Forrest office precincts Other includes remaining PCA sub localities
* Modern upper prime assets with long WALEs trading below this range (sub 6.25%) Town Centres comprise Phillip, Tuggeranong and Belconnen office precincts

Rents & Incentives

The lack of available leasing options in the combined Civic and Parliamentary prime markets has resulted in modest rental growth over the past 12 months with prime gross face rents in these precincts averaging $443/$m^2$ (annual growth of 0.7%). With the Civic secondary market performing quite well in comparison to the broader secondary market, some moderate uplift in gross face rents has occurred in the Civic and Parliamentary precincts, increasing 0.6% over the past year to $378/$m^2$.

Incentive levels continue to differ somewhat by location and are largely dependant on the motivation of the landlord and their willingness to renew and lease vacant space. In the prime market, incentive metrics have stabilised over the past six months to currently average 20%, resulting in effective rents of $355/$m^2$ (up 0.8% over the past 12 months).

Alternatively, secondary incentive levels remain at 25%, taking effective rents to $284/$m^2$. With shallow tenant demand in Canberra's Town Centres, average incentives are higher at circa 25% for prime and 31% for secondary.

TABLE 2

Recent Leasing Activity Canberra

Address	NLA (m^2)	Face Rental (\$/m^2)	Term (yrs)	Tenant	Date
10-12 Mort St, Civic	15,398	425g	8	Dept. of Employment	Mar-17*
2 King St, Deakin	280	380g	6	AJ Gallagher	Apr-16
205 Anketell St, Greenway	1,665	450g	10	CIT>	Feb-16
1 Farrell Pl, Civic	310	340g	5	Concorde Legal	Jan-16
1 Farrell Pl, Civic	328	340g	5	Armstrong Legal	Nov-15
14 Moore St, Civic	471	385g	7	Aurecon	Nov-15

Source: Knight Frank Research g refers to gross * Renewal > Canberra Institute of Technology

Investment Activity & Yields

After a slow start to 2015 where sales volumes ($10m+) totalled $115 million for the first half of the year, investment activity in Canberra gained significant momentum towards the end of 2015, underpinned by the sale of several large government leased buildings. Canberra office sales ($10m+) in 2015 totalled $525.3 million across nine transactions, 82% above the $288 million recorded for 2014 and 39% above the most recent peak in 2012 ($378.7 million). The pick up is largely the result of three significant transactions recorded in the final months of 2015, accounting for 69% of sales by value.

With an increasing number of buyers becoming priced out of the Sydney and Melbourne markets, a growing number have turned their attention towards Canberra, attracted by the higher yields and secure long term government leases on offer. This is evident by recent offshore interest in Canberra, highlighted by the December 2015 sale of the Louisa Lawson building (25 Cowlishaw Street) at Greenway which was acquired by FG Asset Management (Korean) for $224.5 million. Although prime yields have firmed materially over the past 12 months, they remain approximately 200 basis points above Sydney and Melbourne CBD markets, making Canberra an attractive investment proposition.

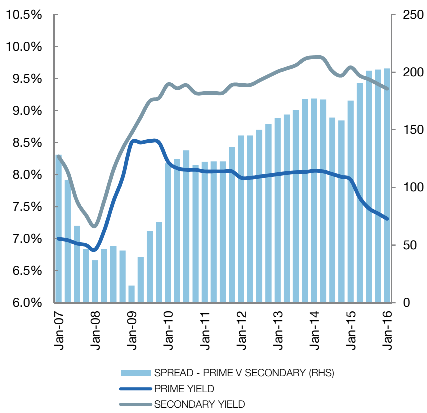
With few prime assets being brought to the market in recent years, particularly those with a solid leasing profile, the recent prime grade sales provided further clarity to the firming of yield metrics in Canberra. Over the past 12 months, prime core market yields have firmed by 61 bps on average, considerably above secondary yields where modest firming of 33 bps was recorded over the same period.

Demonstrated by the 5.38% core market yield recorded for the Louisa Lawson Building, "Upper" prime yields range from 5.25% to 6.25% for a prime new building backed by a 10-15 year Commonwealth lease. Alternatively, a prime asset with a five year lease would trade closer to 7.00%-7.75%. With leasing conditions in the secondary market remaining weak, investors continue to require an elevated risk premium where average core market yields currently range from 8.75% to 11.50% depending on location.

FIGURE 3

Core Market Yields & Spread

Canberra Blended Average—Prime & Secondary



Source: Knight Frank Research

TABLE 3

Recent Sales Activity Canberra

Address	Price (\$ mil)	Core Mkt Yield (%)	NLA (m^2)	\$/m^2 NLA	WALE (yrs)	Vendor	Purchaser	Sale Date
14 Mort St, Civic	41.50	7.42	9,384	4,423	9.1	Charter Hall	Ascot Capital*	Feb-16
25 Cowlishaw St, Greenway~	224.50	5.38	26,000	8,635	15.5	GDC (ACT) Pty Ltd	FG Asset Management	Dec-15
134 Reed St, Tuggeranong	70.025<	7.60	15,231	4,924	7.3	Record Funds Mgmt	Enwerd Pty Ltd	Nov-15
255 London Cct, Civic	70.025	6.05	8,972	7,805	11.8	Brompton Asset Mgmt	Growthpoint+	Nov-15
33 Allara St, Civic	29.00	10.41	9,900	2,929	1.4	360 Capital Office Fund	DCA No 1 Pty Ltd	Oct-15

Source: Knight Frank Research ~ Also known as the Louisa Lawson Building < Sale was conditional upon the purchaser fulfilling a number of obligations associated with the lease (circa $5 million deducted including other expenditure items) resulting in a net price of $70.025 million ($75 million gross).
* Ascot Capital 14 Mort St Property Trust + Growthpoint Properties Aust. Ltd

Outlook

- With both the ACT and Federal elections earmarked to occur in 2016, leasing activity is expected to moderately stall over the short term as tenants hold back on commitments until respective governments are confirmed. With more sustained levels of employment growth anticipated during 2016, underpinned by the private sector, it is anticipated that leasing activity will gain further momentum thereafter.

- With no new supply expected until late 2017 (Tuggeranong Office Park), coupled with an improving leasing market, it is anticipated that the vacancy rate will trend downwards over the next two years. If changes are made to the Lease variation Charge (LVC) which are more supportive of adaptive re-use opportunities, an accelerated fall in the vacancy rate will occur as stock is withdrawn.

- Following the recently announced government office project in Civic and the redevelopment of the Motor Vehicle Registry site in Dickson, it is likely that these developments will also lead to the disposal of a number of dated ACT Government assets across Canberra. These buildings represent development opportunities.

- Effective rents appear to have reached the bottom of their cycle and are expected to see modest growth of circa 2.5% and 1.0% over the next 12 months for prime and secondary markets respectively. This result is underpinned by an anticipated fall in incentives, albeit gradual.

- With the yield spread between Canberra and other CBD markets currently at historical highs for both prime and secondary, there remains scope for further yield compression over the coming 12 months, particularly given recent evidence of growing interest from offshore groups and a return to rental growth, albeit modest.

- With increased interest coupled with a number of assets currently for sale, investment volumes are expected to remain buoyed during 2016.

Front cover photo: 2 Constitution Avenue, Civic. Owned by ISPT
* Major Precincts incorporates Civic, Parliamentary Precinct & Town Centres

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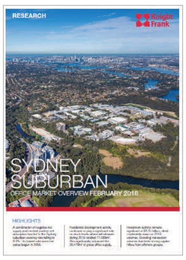

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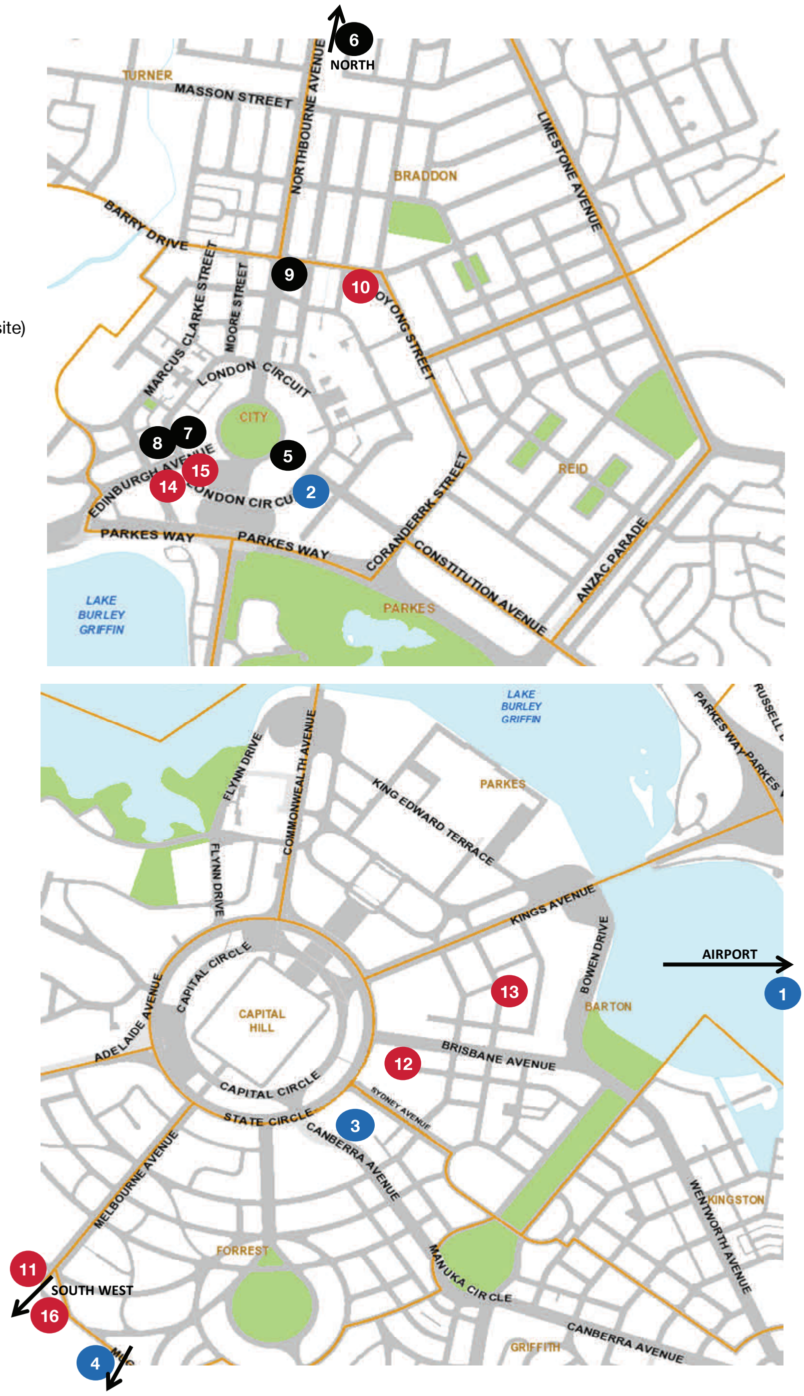
MAJOR OFFICE SUPPLY

1. 3-7 Molonglo Drive, Airport - 36,000m²
Capital Airport Group - Complete - awaiting commitment
2. 2 Constitution Ave ^ # - 10,131m²
ISPT - Complete (total NLA 20,014m²) - awaiting commitment
3. 1 Canberra Ave, Forrest - 24,500m² [Dept of Finance *]
Willemsen Group - Complete - 80% committed *
4. Tuggeranong Office Park - 30,707m² [Dept of Social Services]
Cromwell Property Group – Q3 2017, 100% committed ~
5. Section 19 (Block 4)^ - 20,000m²
ACT Government - 2018
6. 13-15 Challis St, Dickson - 13,000m² (Motor Vehicle Registry site)
ACT Government - 2018
7. Vernon North - Building 4, London Circuit^ - 25,000m²
Leighton/Mirvac JV - 2018+ subject to pre-committment
8. Signature Building 2, London Circuit^ - 16,000m²
Leighton/Mirvac JV - 2018+ subject to pre-commitment
9. Northbourne Square, Northbourne Ave^ - 52,000m²
Walker Group - 2019+ subject to pre-commitment
10. Section 96^ - 37,500m²
QIC - 2018+ subject to pre-commitment
11. 45 Furzer St, Phillip - 40,600m²
Doma Group - 2020+ subject to pre-commitment
12. 2 Darling Street, Barton - 11,500m²
Doma Group - 2018+
13. 44 Macquarie St, Barton - 10,000m² mixed use
Doma/Morris Group - 2018+
14. Landmark Building, London Circuit^ - 50,000m²
Leighton/Mirvac JV - mooted
15. Vernon South - Building 3, London Circuit^ - 25,000m²
Leighton/Mirvac JV - mooted
16. 45 Callam Street, Phillip - 17,500m²
Hindmarsh Group - Mooted, subject to pre-commitment



Map source: ACT Planning and Land Authority (ACTMAPi)

NB. Dates are Knight Frank Research estimates
Major tenant precommitment in [brackets]
* Under Offer - Contract not yet signed
^ Civic precinct
Office NLA quoted
Major refurbishment

- Under Construction/Complete (blue)
- DA Approved / Confirmed / Site Works (black)
- Mooted / Early Feasibility (red)