RESEARCH

WEST PERTH

OFFICE MARKET BRIEF SEPTEMBER 2014

Key Facts

The West Perth vacancy rate remained unchanged at 9.2% as at July 2014, when compared to six months prior.

Forthcoming supply is limited with 2,265m^2 currently under construction and due to complete in late 2014.

Tenant demand improved which has flowed through to absorption levels.

Tightly held stock has constrained the level of investment activity in West Perth.

MATT WHITBY

National Director,
Head of Research & Consulting
Follow at @KnightFrankAu

Contrary to the relatively benign conditions in the leasing market, investment demand for modern prime assets remains strong, although a lack of sellers is constraining the level of sales activity in West Perth during 2014.

Development Activity

The Property Council of Australia (PCA) recorded net supply additions to the West Perth area of 2,544m^2 in the six months to July 2014. This level of supply represents 0.6% of stock, which is directly in line with the 20 year average. The entirety of supply stemmed from 1101 Hay Street which was completed in the second quarter of 2014. No stock was withdrawn from the market during the equivalent period and as a result, net additions during the 12 months to July 2014 reached 7,901m^2.

It is anticipated that 2,265m^2 of new supply will enter the West Perth market during the remainder of 2014. The majority of new supply will come from 1160 Hay Street which is due for completion in quarter three and will deliver 1,500m^2 to the market. An additional 765m^2 of fully refurbished NLA at 11-13 Lucknow Place will come online during the same period. Lastly, 1,414m^2 is DA pending at 957-959 Wellington Street. Currently, there is no supply under construction or being refurbished that is due for completion in 2015 and beyond.

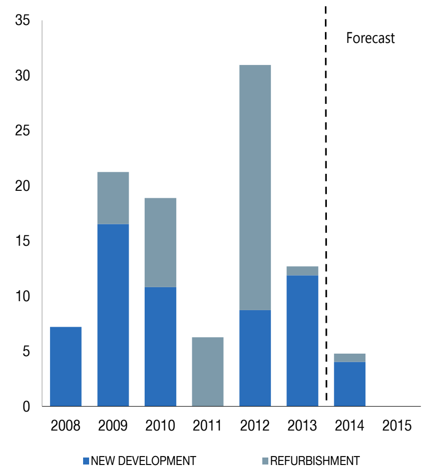
Net Absorption & Vacancy

Total net absorption for the 12 months to July 2014 was barely positive at 183m^2. However, on a six monthly basis, net absorption has gradually been improving over the past 18 months, with negative 5,720m^2 recorded in H1 2013, followed by negative 1,866m^2 in H2 2013 and turning positive in the first half of 2014 with 2,049m^2 of net absorption recorded in the six months to July 2014. The recent positive result was assisted by two large lease deals totalling 3,245m^2 at the newly constructed 1 Ord Street which was completed in late 2013. Absorption in prime grade buildings totalled negative 397m^2 over the past six months, while secondary grade buildings experienced improved demand resulting in 2,446m^2 of net absorption. Conditions are expected to continue to steadily improve, assisted by limited new supply.

With mildly positive net absorption during the first half of 2014, the total vacancy rate of 9.2% was unchanged compared to six months prior. The prime grade vacancy totalled 7,970m^2 representing 5.8% of total prime stock with the direct vacancy accounting for the majority (318m^2 of sublease). The secondary grade vacancy totalled 31,038m^2 representing 10.9% of total secondary stock which was also dominated by direct vacancy (27,791m^2).

The level of sub-lease vacancy, which significantly increased during the 12 months to July 2013, is slowly being taken up, indicating that most of the contractionary influences are now in the past. Nevertheless, the completion of 1160 Hay Street and 11-13 Lucknow Place during the second half of 2014 is expected to see upward pressure exerted on the vacancy rate leading into 2015.

FIGURE 1
West Perth Office Supply
New and Refurbished Stock ('000m^2)



Source: Knight Frank/PCA

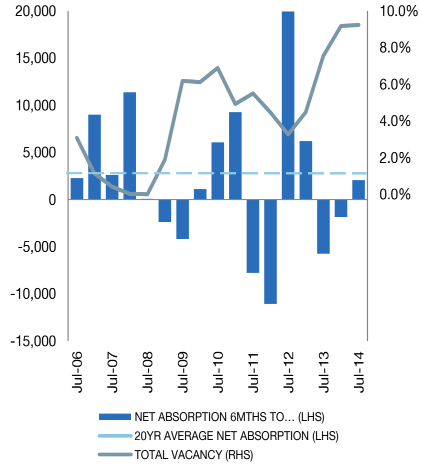
Tenant Demand & Rents

Similar to conditions in the Perth CBD market, tenant demand remains soft with businesses looking to improve cost efficiencies and consolidate their office accommodation. Some landlords are reacting to the softer conditions by stimulating demand through lower rental rates and offering favourable incentives. Not only does this appeal to existing West Perth occupants, but also tenants from fringe locations who can now consider the cost benefit of relocating. Generally, the main detractor of relocation for tenants is forfeiting a fit-out and bearing the cost of a new one. However, landlords are offering incentives by way of cash contributions or rent free periods to attract tenants and secure income streams.

Tenant demand has been weakest in West Perth's B-grade market with 22,650m^2 of vacant space recorded as at July 2014. Despite the soft leasing conditions, certain tenants have continued to make decisions for their longer term accommodation needs. This is demonstrated by the Bureau of Meteorology who leased 1,040m^2 at 1 Ord Street.

Mild absorption and elevated vacancy levels have resulted in further downward pressure on West Perth office rents in both prime and secondary assets. Prime net face rents have softened to an average of \$483/m^2 (vs. \$518/m^2 in Jan-14) representing a 6.8% fall during the six months to July 2014. Prime incentives have remained stable and average 20% of the net rent over the term of the lease. There were a number of deals over the past six months that exceeded the prime average rent, including CGG Services

FIGURE 2
West Perth Vacancy & Net Absorption
Per six month period (m^2)



Source: Knight Frank/PCA

who recently leased 2,205m^2 of NLA at 1 Ord Street for a rate of \$570/m^2 net.

The same contractionary influences saw net face rents in the secondary market fall to an average of \$419/m^2 (vs. \$444/m^2 in Jan-14) representing 5.6% of negative growth over the six month period. This is the lowest average secondary-grade net face rent recorded since October 2007, which was during a significant rental growth cycle in Perth's office markets as a result of Western Australia's booming resources industry. Notwithstanding this recent decline, secondary net face rents remain 7.7% above the ten year average of \$386/m^2. Going forward, West Perth rents are expected to stabilise with little to no improvement expected before 2017 as the market absorbs the significant levels of supply forecast to come online in the CBD.

TABLE 1
West Perth Office Market Indicators as at July 2014

Grade	Total Stock (m²)	Vacancy Rate (%)	Annual Net Absorption (m²)	Annual Net Additions (m²)	Average Net Face Rent (\$/m²)	Average Incentive (%)	Average Core Market Yield (%)
Prime	137,055	5.8	-861	3,448	483	20	8.00—8.50
Secondary	285,035	10.9	1,044	4,453	419	20	8.75—9.25
Total	**422,090**	**9.2**	**183**	**7,901**			

Source: Knight Frank/PCA

Investment Activity & Yields

The strong flow of capital currently being allocated to real estate within the broader Perth area has continued through the first half of 2014, however, tightly held stock has constrained the level of transactional activity in West Perth over the past six months. Sales volumes in West Perth during the 2014 year to date currently total only $20.05 million across two transactions.

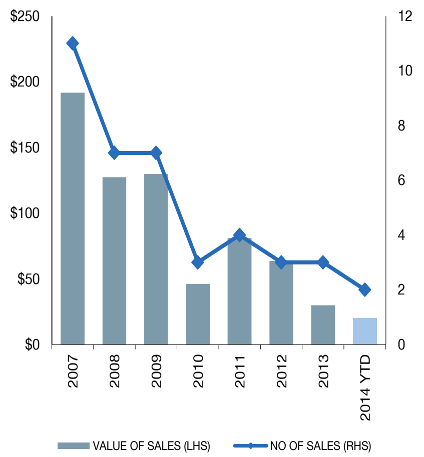
In May 2014, a syndicate of wholesale investors formed by Perth-based developer Ascot Capital purchased the Marketforce office building at 1314 Hay Street, West Perth for $9.05 million reflecting an initial passing yield of 7.22% (core market yield 8.36%). The 1,892m^2 building is fully leased to Marketforce Ltd for a term of 8 years, due to expire in March 2019. The property is zoned "Office/Residential" and has a plot ratio of 2:1 for office and 3:1 for residential with 20% bonus for short term accommodation development. The property sold with a WALE by income of 4.8 years, reflecting a land rate of $7,240/m^2 and a building rate of $4,783/m^2.

In June 2014, MercyCare, a not-for-profit provider of aged care, community health and children's services, purchased 38-40 Ord Street in West Perth reflecting an initial passing yield of 8.10% (core market 7.38%). The 1,580m^2 building is fully leased to Veritas DGC generating a net passing income of $887,700 per annum. Veritas' lease expires in October 2014 with no further option periods, at which time MercyCare will take full occupancy of the building. Accordingly, the building was purchased for owner occupation rather than investment purposes. The initial passing yield is based on the current passing income which is considered to be in–line with market.

Strong Investor appetite for prime West Perth assets resulted in further prime yield compression during the first six months of 2014. This has been evident since January 2013 with 22bps of firming recorded over the past 18 months. Average prime core market yields are currently estimated to range between 8.00% and 8.50% with a median of 8.28%. Secondary market yields were stable over the past six months as leasing conditions remain soft. Average secondary core market yields are estimated to range between 8.75% to 9.25% with a median of 9.00%.

With the majority of assets in West Perth of a smaller nature, the market receives strong interest from private investors, syndicators and offshore buyers. Most buyer types favour modern, prime-grade assets with low capex requirements, especially those with limited exposure to the current tenant market weakness.

FIGURE 3
West Perth Sales Activity
($ million) Sales Value > $5 million



Source: Knight Frank

TABLE 2
Recent Leasing Activity West Perth

Project	NLA m²	Face Rent $/m²	Term yrs	Incentive (%)	Tenant	Date
1160 Hay Street	261	545 n	6	12-17	Global Transport	Sep 14
1 Ord Street	1,040	570 n	10	10-15	Bureau of Met.	undis
41-43 Ord Street	420	400 n	4	0-5	undis	Aug 14
41-43 Ord Street	151	335 n	3	5-10	undis	Aug 14
1 Ord Street	2,205	570 n	10	15-20	CGG Services	Jul 14
610 Murray Street	355	300 n	undis	0-5	Vodafone	Jul 14
22 Delhi Street	548	450 n	5	12-17	DCH Legal	Jun 14
680 Murray Street	240	350 n	3	0-5	ADCO	Apr 14
22 Delhi Street	323	425 n	7	12-17	PSM Admin	Apr 14
22 Delhi Street	394	425 n	5	12-17	Capital Partners	Mar 14

Source: Knight Frank undis: undisclosed n: net

TABLE 3
Recent Sales Activity West Perth

Address	Grade	Price $ mil	Core Market Yield (%)	NLA m²	$/m² NLA	WALE	Vendor	Purchaser	Sale Date
38-40 Ord Street	B	11.00	7.38 #	1,580	6,962	0.3	Greenplace	MercyCare	Jun 14
1314 Hay Street	B	9.05	8.36	1,892	4,783	4.8	Private	Ascot Capital	May 14

Source: Knight Frank #: purchased for owner occupation

Outlook

A reduction in the level of available sub-lease space available in the market is a promising sign. Absorption levels are expected to improve as demand conditions improve. Furthermore, falling rents and elevated incentives are providing tenants with some favourable leasing options which is expected to stimulate tenant migration to higher quality premises.

The level of available space in West Perth is forecast to increase with 2,265m^2 of new supply due for completion over the coming months. Consequently, the vacancy rate is expected to rise, albeit marginally given improving absorption levels. Knight Frank expects the vacancy to remain elevated through to 2015, although a reduction thereafter is expected to come from improving demand conditions and a lack of new supply. However, with an abundance of competitive leasing options available within the Perth CBD, the potential exists for an increasing number of West Perth tenants to relocate to the main business centre, although not all tenants fit this profile. Despite the assumption that conditions will improve, it will take some time for an increase in leasing activity to flow through to an improvement in rental rates. Prime and secondary net face rental growth is expected to remain flat for the next 12 to 24 months while the market adjusts to prevailing demand conditions.

It is anticipated that investment demand will remain strong with the majority of buyer attention continuing to focus on prime assets. However, given the current high level of residential apartment and hotel development within Perth , it is unlikely that many West Perth office assets will be purchased for conversion purposes.

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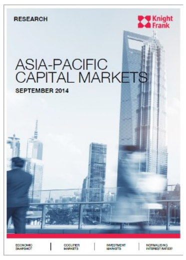

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RESEARCH
Matt Whitby
National Director—Head of Research & Consulting
+61 2 9036 6616
Matt.Whitby@au.knightfrank.com

COMMERCIAL SALES
John Corbett
Managing Director—WA
+61 8 9225 2561
John.Corbett@au.knightfrank.com

Tony Delich
Director—Commercial Sales WA
+61 8 9225 2528
Tony.Delich@au.knightfrank.com

Todd Schaffer
Director—Commercial Sales WA
+61 8 9225 2402
Todd.Schaffer@au.knightfrank.com

COMMERCIAL LEASING
Greg McAlpine
National Director
+61 8 9225 2426
Greg.McAlpine@au.knightfrank.com

Ian Edwards
State Director — Asset Services WA
+61 8 9225 2420
Ian.Edwards@au.knightfrank.com

Sallese Wilmot-Barr
Associate Director — Office Leasing
+61 8 9225 2405
Sallese.Wilmot-Barr@au.knightfrank.com

Kendall Forrest
Associate Director — Office Leasing
+61 8 9225 2400
Kendall.Forrest@au.knightfrank.com

GLOBAL CORPORATE SERVICES
Bret Madden
Director
+61 8 9225 2407
Bret.Madden@au.knightfrank.com

VALUATIONS
Marc Crowe
State Director—Valuations WA
+61 8 9225 2521
Marc.Crowe@au.knightfrank.com

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