RESEARCH

MELBOURNE METROPOLITAN

OFFICE MARKET OVERVIEW MAY 2020

METRO VACANCY STILL LOW HOWEVER MARKET COMES TO GRIPS WITH COVID-19

HIGHLIGHTS

Despite a minor uplift, office vacancy within the metropolitan office market remains low and below the long-term average.

2020 will see substantial supply added to the metropolitan office market with much of this expected to emanate from the increasingly popular city fringe.

2019 marked the sixth consecutive year of above average sales volume within the metropolitan office market.

KEY FINDINGS

The Melbourne metropolitan office vacancy rate increased marginally from 4.6% to 5.5% in the 12 months to January 2020, sitting below the historical average of 5.9%.

Prime net face rental growth (2.2% YOY) moderated as the market adjusted to recent large increases in rents.

Investment demand for metropolitan office assets remained strong, with 2019 transaction volumes totalling $857.6 million.

Yields continued to compress though at a slower rate. Prime yields compressed by 15 basis points in the 12 months to January 2020 to average 5.7%.

FINN TREMBATH
Associate Director

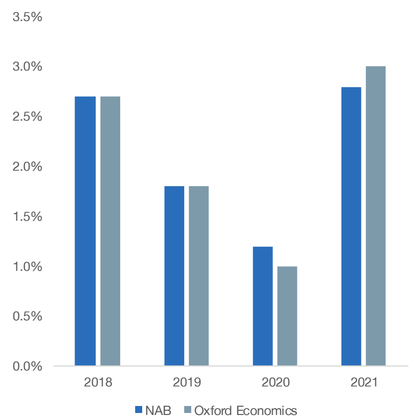
ECONOMIC OVERVIEW

Growth outlook downgraded

The evolving coronavirus outbreak clearly poses significant downside risks for the global and Australian economy. The spread of the virus globally is weighing on economic activity although the severity and duration of the impact remains uncertain. Consistent with the deterioration in the global outlook, growth in the Australian economy will slow this year with the Australian economy expected to see a large contraction in GDP growth in 2020, with the impact concentrated in the first half of the year.

While the impact on office-based employment is likely to be more limited, occupier demand may slow in the near term because of the spill-over effects from a weaker economic climate.

FIGURE 1
Real GDP Growth Forecasts
Year average



Source: Knight Frank Research / NAB / Oxford Economics

Strong policy response to drive recovery

Reflecting the significantly weaker outlook due to the COVID-19 pandemic, policymakers have announced unprecedented stimulus measures. The RBA cut interest rates by a cumulative 50 basis points in March to 0.25% and launched a quantitative easing program in the form of a commitment to maintain the three-year Australian Government bond yield at around 0.25%. In addition, the Federal Government has announced fiscal three stimulus packages to date, the largest of which is the $130 billion JobKeeper wage subsidy program. The stimulus measures announced so far (including the RBA lending facilities) total $320 billion or 16% of GDP.

As COVID-19 containment measures are progressively eased over the next couple of months, economic activity should begin to recover later this year. The RBA and private sector economists are forecasting a strong rebound in economic growth in 2021.

Melbourne still driving national economy

While growth will inevitably slow in 2020, Melbourne will remain a key driver of the national economy and continue to experience faster rates of growth underpinned by population growth, urbanisation and the clustering of key service industries. investors and developers remains resilient.

TABLE 1
Melbourne Metropolitan Office Market^ Indicators as at January 2020

Grade	Total Stock (sq m)*	Vacancy Rate (%)*	Annual Absorption (sq m)^	Average Prime Net Face Rent ($/ sq m)	Average Prime Incentive (%)	Average Secondary Net Face Rent ($/ sq m)	Average Prime Core Market Yield (%)	Average Secondary Core Market Yield (%)
City Fringe	1,050,519	4.1	-13,654	475—600	10—15	375—425	4.75—5.25	5.25—6.00
Inner East	558,348	3.3	4,722	385—485	12—18	325—375	5.00—5.50	5.50—6.25
Outer East	936,471	9.5	1,206	300—360	25—28	240—260	5.75—6.25	6.00—6.75
South East	350,583	3.3	6,893	270—320	25—28	220—250	6.00—6.50	6.25—6.75
North &	254,525	4.2	4,921	310—390	15—25	240—260	5.75—6.50	6.25—6.75
Total*	**3,150,445**	**5.5**	**4,088**	**390**	**20**	**297**	**5.73**	**6.18**

Source: Knight Frank Research * weighted by stock area *As at 1st Jan '20 ^12months to 1st Jan '20
^ refer to back cover for definition of Melbourne Metropolitan geographic boundaries

TENANT DEMAND & ABSORPTION

Low net absorption recorded in CY 2019

The metropolitan office market experienced low net absorption in CY 2019. The 4,088 sq m of net absorption was well below the 2018 figure of 53,410 sq m and was driven by negative absorption in the Fringes (-13,654 sq m). The sense is, in responding to the recent shortage of new supply between 2016-2019 many tenants chose to stay in their current accommodation (some signing short term leases), in effect electing to wait for the next wave of office supply which was due to land in 2020/21.

However, despite the promise of this new supply, the recent COVID-19 crisis has put the brakes on leasing activity in early 2020. And yet our view is demand should lift towards the middle of the year assuming government restrictions are eased.

Demand is expected to emanate from various sources, from opportunistic tenants who believe good deals can be struck in the current market, to tenants choosing to downsize (be it because of a forced reduction in staff sizes or due to a conscious decision to shift towards a work-from-home model which would result in a reduction in office space requirement).

Leasing activity is also likely to come from market relocations, be it businesses moving to reduce their rents (such as moving from the Fringe to more traditional suburban areas), or businesses moving to reduce their NLA (such as moving from outer areas closer to the CBD).

The need for organisations to cut costs and the growth in work-from-home models could also result in some businesses electing to decentralize their operations, and this would also pave the way for more leasing activity.

Additionally we believe some tenants will look to relocate to newer/recently completed developments given the deals that will be on offer for such buildings will likely be more appealing than those that have historically been offered.

2019 demand driven by Information Media & Telecommunications

Tenant demand within the metropolitan office market in 2019 came from a broad range of sectors, led by the information media & telecommunications sector (18%). While many of the information media & telecommunications leases can be traced to trendy Cremorne, the most notable deal was arguably Foxtel who late in the year signed a lease for 1 Dean Street in Moonee Ponds.

Net Absorption

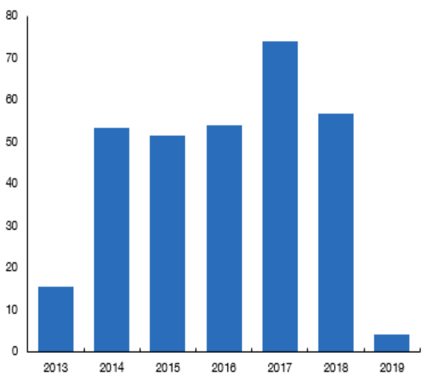
Overall	2019: 4,088 sq m

Coworking sector affected by COVID-19

With COVID-19 forcing many office workers to work from home, there have been reports of businesses re-negotiating their membership arrangements with coworking operators and there has also been reports of some coworking operators experiencing 100% vacancy during the crisis. Indeed, since lockdown measures have been implemented, Knight Frank Research have not recorded any new coworking operations opening in the Melbourne metropolitan market.

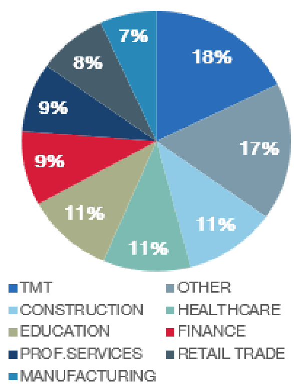
That said, while we expect post-COVID more and more white collar staff will likely work from home as businesses embrace leaner and more efficient operations, longer-term coworking will likely retain its relevance as new small businesses emerge from the aftermath of COVID-19 seeking affordable and flexible accommodation, and office share spaces provide a midpoint solution between working-from-home and traditional office space options.

FIGURE 2
Metropolitan Office Net Absorption
Per calendar year (000's sq m)



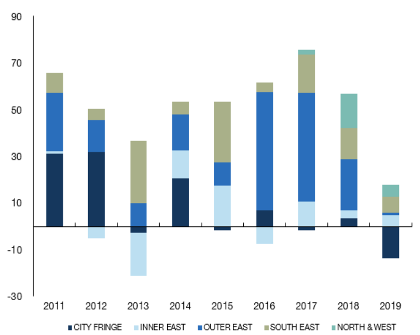
Source: Knight Frank Research

FIGURE 3
Metropolitan Office Sectoral Demand
CY 2019



Source: Knight Frank Research

FIGURE 4
Metropolitan Office Net Absorption
By Region (000's sq m)



Source: Knight Frank Research

SUPPLY & DEVELOPMENT

Vacancy Rate

Prime	6.5% +141 bps YoY
Secondary	4.4% +69 bps YoY

Supply drought set to be broken despite COVID-19

In 2019 CY, new supply added to the metropolitan office market totalled 27,207 sq m. The Outer East region accounted for most (62%) of the new supply in 2019, following the completion of Stage 3 at Caribbean Park (31 Dalmore Drive & 36 Lakeview Park in Scoresby).

The level of supply added to the market was similar to the amount of new stock added in 2018 CY (27,693 sq m), though was around 10% short of the supply added in 2017 and as signposted earlier supply levels in recent years have been below the long-term average (52,615 sq m).

However, the next wave of new supply is about to hit the metropolitan market, with 145,000 sq m of stock expected to land in 2020 with the majority of this new supply emanating from the Fringe. In spite of the situation with COVID-19, the majority of these new developments are currently under construction and expected to land.

While a substantial amount of new supply was also anticipated to be completed in 2021, due to the ongoing crisis surrounding COVID-19 the sense is beyond 2020 some of the mooted developments will not go ahead without a significant level of pre-commitment.

Melbourne's inner west/ north the next suburban frontier

Post-Covid, Melbourne's inner north/west corridor shapes as the next frontier for the city's metropolitan office supply. Coming off the back of the recent success of the inner east headlined by the small enclave of Cremorne becoming Melbourne's "Silicon Yarra", the residential growth and gentrification currently occurring in Melbourne's inner north/west suggests that suburbs such as North Melbourne, West Melbourne, Parkville, Kensington, Fitzroy and Footscray shape as the future of Melbourne's Fringe office supply.

At the time of writing in excess of 75,500 sq m of office development was either approved/under construction or awaiting permit approval in the city's inner west/ north. In North Melbourne, the office development pipeline including those developments awaiting permit approval currently sits at just under 42,000 sq m, while in West Melbourne the pipeline figure is close to 22,000 sq m.

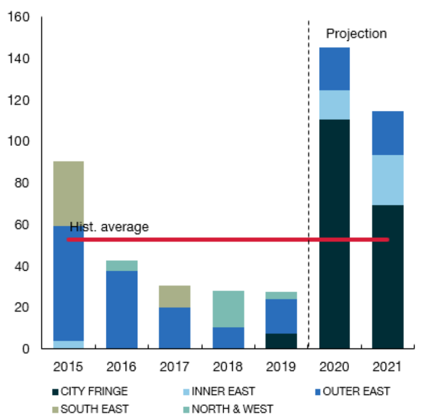
> "Approaching 145,000 sq m of new supply is expected to be delivered across the Metro office market in 2020"

Vacancy increased in 2019 but still sits below the long-term average

The metropolitan office vacancy rate increased marginally in 2019 CY, rising from 4.6% to 5.5%. The uplift in vacancy coincided with low annual net absorption being recorded during the period, with this low absorption reflecting the shortage of new supply that has been added to the market since 2015. Indeed, while vacancy has risen the current 5.5% vacancy figure is still below the long-term average of 5.9%.

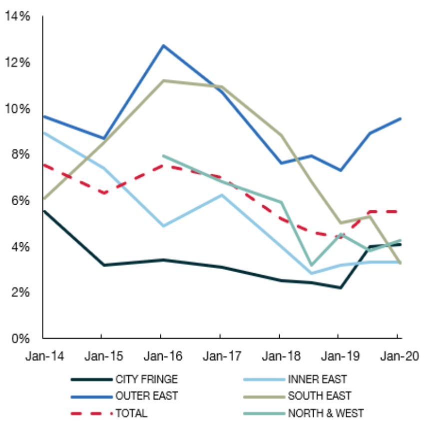
Looking ahead, at this point in time future vacancy levels remain unknown due to the continuing situation with COVID-19 not yet running its course.

FIGURE 5
Gross Supply Pipeline by Region
000's sq m excl. refurbishments



Source: Knight Frank Research

FIGURE 6
Vacancy Rate by Region
Total vacancy (%)



Source: Knight Frank Research

TABLE 2
Metropolitan Vacancy Rates by Grade (%)

Grade	Jan-18	Jan-19	Jan-20
Prime	**5.6**	**5.1**	**6.5**
B-Grade	5.7	4.1	5.5
C-Grade	3.3	3.0	2.4
Secondary	**4.8**	**3.7**	**4.4**
Total	**5.2**	**4.4**	**5.5**

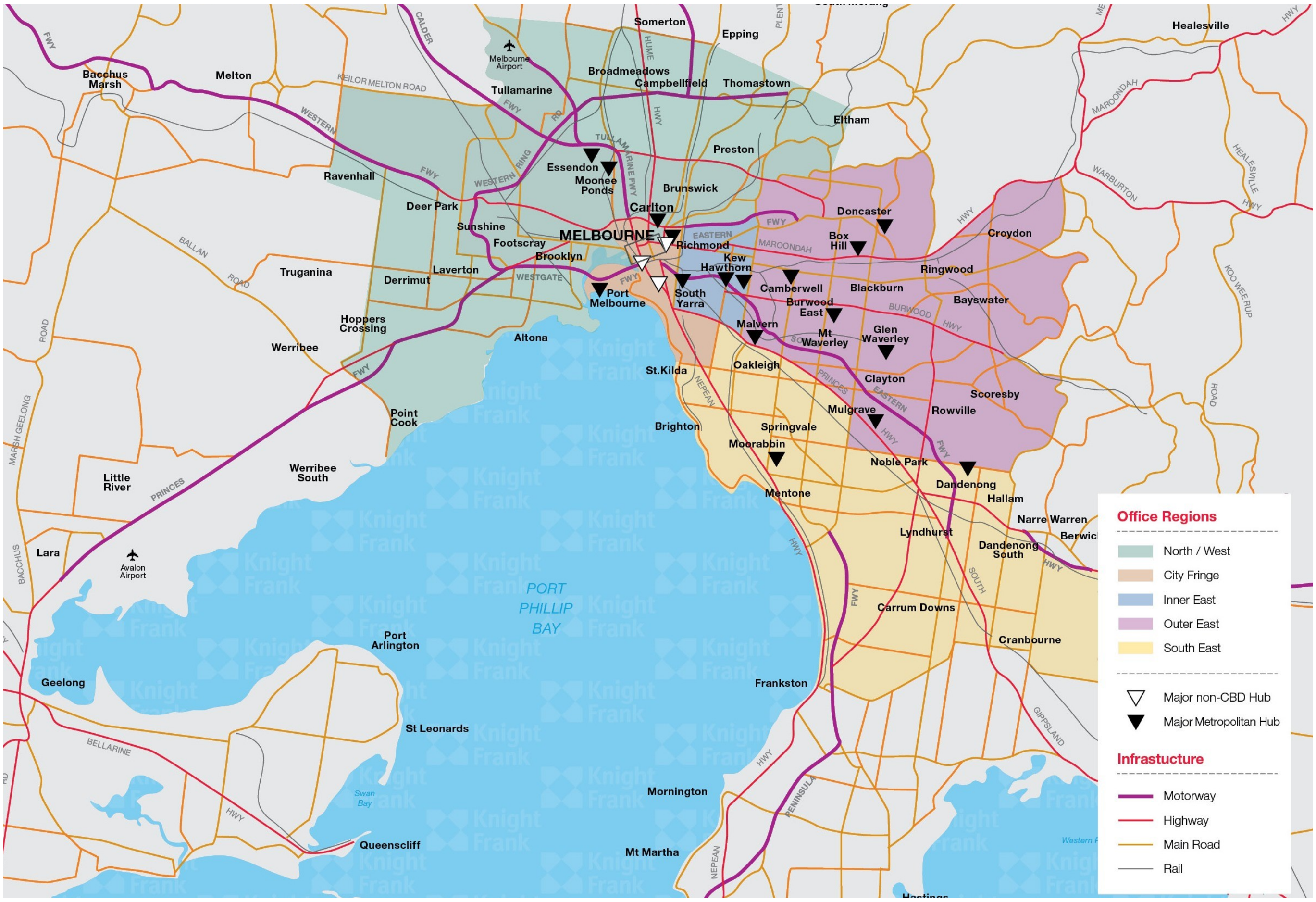
Source: Knight Frank Research

TABLE 3
Major Office Supply— Melbourne Metropolitan Office Market

Address	Suburb	Region	Area (sq m)	Developer/Owner	Stage	Est. Date of Compl.
Botanicca 9, 588 Swan St	Richmond	City Fringe	7,081	GARDA	Complete	- -
Stage 3, Caribbean Park	Scoresby	Outer East	17,000	Spooner Family	Complete	- -
107 Overton Rd	Williams Landing	North & West	3,126	Cedar Woods	Complete	- -
Botannica 3, 572 Swan St	Richmond	City Fringe	19,300	Growthpoint	Complete	- -
51 Langridge St	Collingwood	City Fringe	3,436	Private Investor	Complete	
17-21 Harcourt Pde	Cremorne	City Fringe	8,800	Caydon	U/C	Q2 2020
68 Clarke St	South Melbourne	City Fringe	9,845	Hickory Group	U/C	Q2 2020
600 Church St	Richmond	City Fringe	5,793	ICON	Complete	Q2 2020
60-62 Maroondah Hwy+	Ringwood	Outer East	3,325	Pellicano JV Camlen	U/C	Q2 2020
B1, 240 Wellington Rd~	Mulgrave	Outer East	17,393	CIP	U/C	Q3 2020
2-6 Gwynne St	Cremorne	City Fringe	3,175^	Roche	U/C	Q3 2020
2-16 Northumberland St	Collingwood	City Fringe	15,000	Impact Investment	U/C	Q3 2020
3 Newton St	Cremorne	City Fringe	5,000	Private investor	U/C	Q3 2020
11 Wilson St	South Yarra	Inner East	5,574	Vicland	U/C	Q3 2020
101 Moray St	South Melbourne	City Fringe	15,000	Deague Group	U/C	Q3 2020

Source: Knight Frank Research U/C under construction ^ office component ≠ Pre-committed by Reece + Pre-committed by State Govt.
~Forward funded transaction

Metropolitan Office Regions



Metropolitan Stock: Includes office stock in the Melbourne metropolitan area above 1,000 sq m in size. It excludes stock in the CBD and the major office markets of St Kilda Road and Southbank (see back page for details).

RENTS & INCENTIVES

Rental growth continued in 2019

The metropolitan office market continued to see prime rental growth over 2019 CY however growth was recorded at a slower rate when compared to previous years.

Prime net face rents increased by 2.2% in the 12 months to January 2020 to average $390/sq m. Prime incentives increased from 19% to 22% over the last CY, with most deals now being struck within the 18% to 24% incentives range. Prior to 2019 CY, in the preceding 5-year period prime rents grew at an average rate of 4.9% pa. The sense is in 2019 the market adjusted to the sustained period of strong rental growth witnessed between 2015 to 2019.

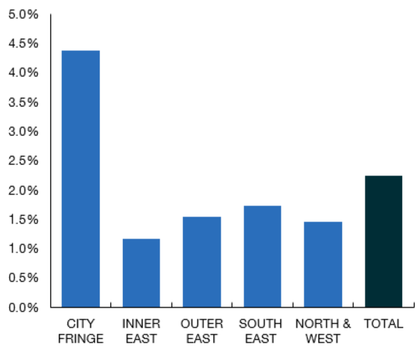
Moving forwards, rents are expected to hold in the short to medium term, however longer term the picture is clouded as any growth will be driven by future vacancy levels which at this point remain unknown. While a substantial amount of supply is expected to land in the metropolitan market in 2020, the COVID-19 crisis presents obvious challenges to the leasing market.

An adjustment is expected to incentives with an increase of circa 5% likely in 2020. The rise in incentives will be driven by the inability of tenants to fund fit outs and justify relocating offices. As the year progresses, tenants will increasingly want to see the financial upside linked to any relocation away from their current premises.

Rents & Incentives

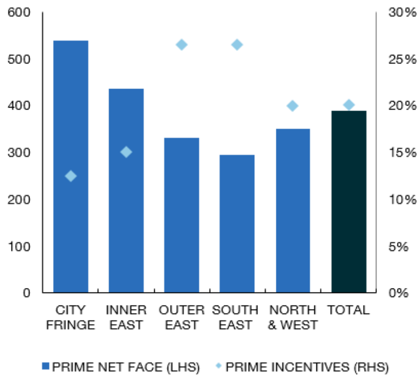
Prime Rents (n)	$390/sq m face +2.2% YoY $310/sq m effective +0.5% YoY
Secondary Rents (n)	$297/sq m face +4.6% YoY $240/sq m effective +4.3% YoY
Incentives	P: 20.0% S: 19.0%

FIGURE 7
Net Face Rental Growth
Year-on-year by region as at January 2020 (%)



Source: Knight Frank Research

FIGURE 7
Prime Net Rents and Incentives
By region as at January 2020 ($/sq m)



Source: Knight Frank Research

TABLE 4
Recent Leasing Activity Metropolitan Melbourne

Address	Precinct	NLA (sq m)	Term (yrs)	Lease Type	Tenant
501 Blackburn Road, Mount Waverley	South East	11,000	10	New	Metricon
611 Elizabeth Street, Carlton	City Fringe	9,500	10	New	Trinity College
595 Blackburn Road, Mount Waverley	South East	1,035	5	New	ECI Software Solutions
2 Luton Lane, Hawthorn	Inner East	5,660	5	Renewal	Swinburne Uni.
71 Gipps Street, Collingwood	Inner East	3,495	U/D	Pre-com	IWG-Spaces
353 Burwood Highway, Forest Hill	Outer East	3,210	10	New	Pronto Software
12 Wesley Court, Burwood East	Outer East	3,133	6	New	Ambulance Victoria
1 Cochranes Road, Moorabbin	South East	2,850	U/D	New	EFM Logistics
745 Springvale Road, Mulgrave	Outer East	2,821	10	New	Keysight Technologies
759 Springvale Road, Mulgrave	South East	2,450	8	New	Osteon Medical
101 Moray Street, South Melbourne	City Fringe	2,000	8	New	Ooh! Media
1 Technology Circuit, Hallam	South East	1,961	5	New	CHS Healthcare
58 Brindley Way, Dandenong South	South East	1,888	4	New	Orafol Australia
68-70 Rodeo Drive, Dandenong South	South East	1,768	6	New	Bates Concrete Construction

Source: Knight Frank Research

INVESTMENT ACTIVITY & YIELDS

2019 saw sustained strong investment activity

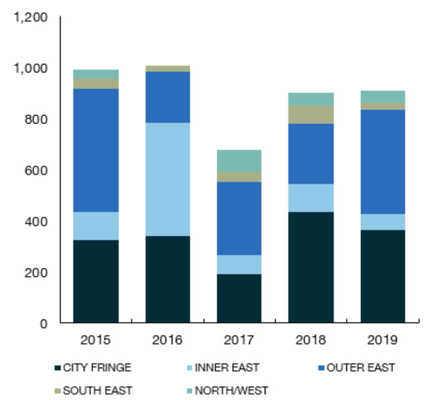
In 2019 CY, sales volume totalled $857.6 million across 29 transactions, with the vast majority of transactions stemming from the Fringe (36%) and the Outer East (47%). Office transaction volumes ($10 million+) have been above the long-term average for the last six years.

Notable transactions in 2019 CY include the sale of B1, 254-294 Wellington Road, Mulgrave which sold for $110.9 million at a core market yield of $5.92%, and B-10, 658 Church Street, Cremorne which transacted for $92 million.

FIGURE 9

Metropolitan Office Sales $10 Million+

By region ($m)



Source: Knight Frank Research

Offshore investment up

Offshore investors comprised 30% of all sales volume in 2019, which is up on the 22% recorded in 2018. With competition high for CBD office assets and a growing perception that the Australian office market offers a safe investment environment with strong market fundamentals, offshore investors continued to increase their presence in the metropolitan market in 2019. Moving forward however, offshore investment stands to be restricted somewhat due to new FIRB legislation. Local investment though is expected to remain strong for good quality assets.

Yield compression continued in 2019

In 2019, yields continued to compress off the back of strong competition for metropolitan office assets. Prime yields compressed by 15 basis points in the 12 months to January 2020 to currently range between 5.45% and 6.00%. The rate of compression of prime yields was less pronounced however when compared to secondary yields which compressed by 70 basis points over the same period, to now range between 5.85% and 6.50%. Looking ahead, whilst borrowing costs are likely to remain favorable we expect yields to flatten and remain stable on premium investments, while yields on secondary assets are likely to soften due to landlords investing in capital expenditure works, an emerging uncertainty surrounding tenant retention and the likelihood that better quality competing stock will hit the market. In assessing potential yields on investment opportunities it is anticipated that investors will place a greater risk on leasing, giving heightened consideration to facets such as tenant profile and guarantees. In the short to medium term it is envisioned that feasibility assessments will take the view that letting up periods will be longer and incentives will rise.

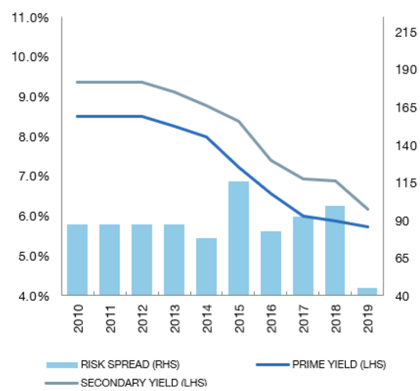
Current Yields

Prime	5.45% - 6.00% -15 bps YoY
Secondary	5.85% - 6.50% -70 bps YoY

FIGURE 10

Metropolitan Yields & Risk Spread

Core market yields & prime vs secondary spread (bps)



Source: Knight Frank Research

TABLE 5

Recent Sales Activity Metropolitan Melbourne

Address	Price ($ mil)	Core Mkt Yield (%)	NLA (sq m)	$/sq m NLA	Vendor	Purchaser	Sale Date
B1, 254 Wellington Rd, Mulgrave~≠	110.9	5.92	17,393	6,376	Frasers Property JV ESR Group	Ascendas REIT	Oct-19
2 Luton Ln, Hawthorn^	54.1	5.36*	5,660	9,590	Trumen Corp JV Bricktop Group	Zagame Corp.	Sep-19
4 Wesley Ct, Burwood East	51.0	6.37	11,221	4,545	Evergreen Nominee	Wing Tai Holding	Aug-19
1-11 Gordon St, Cremorne~	50.0	VP	5,464	9,151	Costa Fox	Bayley Stuart Capital	Oct-19
347-351 Burwood Hwy, Forest Hill^	45.9	7.42	10,692	4,288	Tallen Pty Ltd	Poly Real Estate Group	Apr-19
90-96 Maribyrnong St, Footscray	33.1	6.70*	6,470	5,117	IP Generation	Planum Partners	Jul-19

Source: Knight Frank Research U/D undisclosed VP vacant possession * initial yield ~ fund-through transaction ≠65% pre-committed to Nissan ^70% occ. with WALE of 3.4 years

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Metropolitan Stock Definition:
Includes office stock in the Melbourne metropolitan area above 1,000 sq m in size. It excludes stock in the CBD and the major office markets of St Kilda Road and Southbank.
Major suburbs for each region are as follows:
City Fringe: Carlton, Richmond, East Melbourne, Port Melbourne
Inner East: Hawthorn, Camberwell, Kew, Malvern, South Yarra
Outer East: Box Hill, Mount Waverley, Mulgrave, Burwood
South East: Cheltenham, Moorabbin, Dandenong
North & West: Footscray, Moonee Ponds, Essendon, Bundoora

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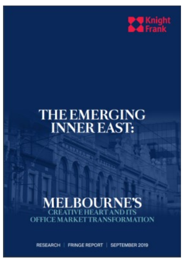
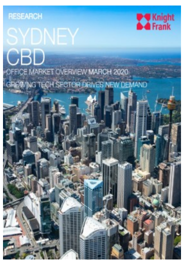


Melbourne's Fringe Office Market Report Sep 2019

Melbourne Industrial Market Overview Feb 2020



Sydney CBD Office Market Overview Mar 2020

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