RESEARCH

HIGHLIGHTS

- Given the availability of development finance remains mostly limited to schemes with a pre-lease in place; the pipeline of new supply in the Melbourne suburban office market is muted. New supply scheduled for completion this year is forecast to total 31,228m² – 50% below the long term annual average.
- Uncertainty in the financial markets in the wake of the global economic downturn has dampened business confidence, impacting tenant demand. Total vacancy rose increasing to 5.8% in September, from 5.1% in March. The Outer East region recorded the highest vacancy at 7.1%; however all regions experienced increases in vacancy.
- Investment activity above $5 million in Melbourne's suburban office market remains well below that of recent years, with only nine offices transacting in 2012 to date. With limited institutional exposure, suburban office yields have remained relatively stable in the last six months with investor appetite still strong for quality investment opportunities.

SEPTEMBER 2012

MELBOURNE SUBURBAN

Office Market Overview

Table 1

Melbourne Suburban Office Market Indicators September 2012

Market	Total Stock (m^2)	Vacancy Rate (%)	Six Month Net Absorption (m^2)	Average Prime Net Face Rent ($/$m^2$)	Average Secondary Net Face Rent ($/$m^2$)	Average Prime Core Market Yield (%)	Average Secondary Core Market Yield (%)
City Fringe	1,024,108	5.4	-2,547	320 – 340	260 – 290	8.00 – 8.75	8.75 – 9.25
Inner East	555,066	6.2	-6,025	310 – 350	270 – 300	8.00 – 8.75	8.75 – 9.25
Outer East	739,477	7.1	-8,009	270 – 310*	200 – 250	8.25 – 8.75	9.00 – 10.00
South East	259,893	6.6	-3,064	220 – 250	185 – 220	8.50 – 9.00	9.50 – 10.50
Total Market / Average	**2,578,544**	**5.8**	**-19,645**	**280 – 310**	**225 – 265**	**8.25 – 8.80**	**9.00 – 9.75**

Source: Knight Frank Research * Upper range reflects achieved pre-lease rents.

Definition: Grade: Prime includes office assets of A-grade quality whilst Secondary includes office assets of B, C & D quality grade
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)
Net Absorption: The change in the volume of occupied stock.

MELBOURNE SUBURBAN OFFICE REGIONS

Source: Knight Frank

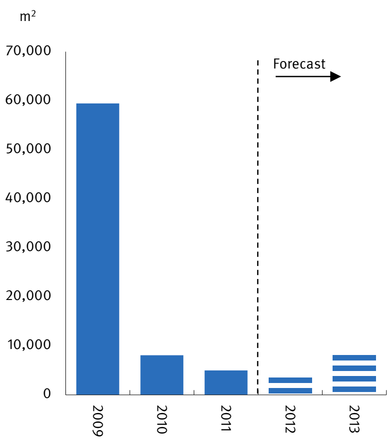
CITY FRINGE

The City Fringe region accounts for 40% of the total Melbourne suburban office space. This region covers suburbs surrounding the CBD and includes Port Melbourne, Richmond, Collingwood and East Melbourne.

Development Activity

As a result of the tighter funding conditions, new development in the City Fringe has been constrained since 2009. New supply in the region is anticipated to total a mere 3,500m^2 in 2012 – its lowest annual increase since 2001. Although new development is forecast to increase in 2013; there is only one project currently under construction scheduled for completion. The 8,032m^2 joint venture development between The Pacific Group and Icon Developments at Botanicca 8 within the Botanicca Corporate Park, Richmond is already 50% pre-leased by GE Australia. New development within the City Fringe is likely to be pre-commitment driven with limited speculative development and remain below the 10-year average in the medium term.

Figure 1
City Fringe Major New Office Supply
2009-2013



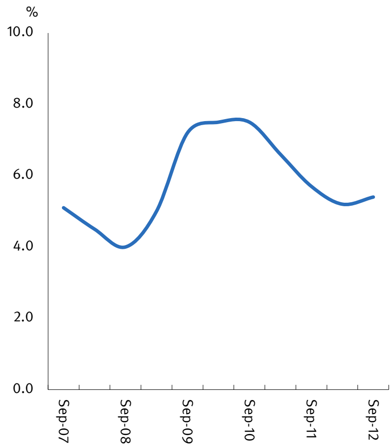
Source: Knight Frank

Vacancy & Tenant Demand

As at September 2012, total office vacancy in the City Fringe office precinct had increased to 5.4% from 5.2% in March. Vacancy is now hovering around the 10-year average. Despite a number of tenant relocations from the region including Melbourne Water to their newly completed Docklands headquarters (having vacated East Melbourne); tenant demand for quality office space in the precinct remains steady. As a result of the increasing vacancies arising within the CBD, the vacancy rate in the City Fringe is expected to come under further pressure.

After steady growth over the past two years, as a result of the softening demand, prime net face rents in the City Fringe have stabilised. In contrast, with secondary vacancies falling, secondary net face rents have risen in the six months to September. However, looking ahead traditional City Fringe tenants are likely to at least consider taking advantage of the competitive leasing terms on offer within CBD options which will limit additional rental growth in the short term.

City Fringe Office Vacancy
2007-2012



Source: Knight Frank

Investment & Yields

Whilst transactional activity in the City Fringe office market has been limited over the past 12 months, more recently three buildings in excess of $20 million have sold since March. City Fringe office investments are likely to remain sought after buoyed by the fundamental strength of the precinct and constrained development pipeline.

Figure 2

Table 2
Major Office Leasing Activity City Fringe

Address	Area (m^2)	Face Rental ($/$m^2$)	Term (yrs)	Tenant	Date
Botanicca Corporate Park, Building 8, 576 Swan Street, Richmond	4,540	380n	8	GE Australia	Q2-13
101 Cremorne Street, Richmond	980	340n	3	Enterprise Support	Q4-12
21-31 Goodwood Street, Richmond	1,400	TBC	6	Madman Entertainment	Q3-12
658 Church Street, Richmond	5,124	295n	5	IPSOS Australia	Q2-12

Table 3
Major Office Sales › $5mill City Fringe

Address	Sale Date	Price ($ mill.)	Core Market Yield (%)	NLA (m^2)	Rate ($/$m^2$)
Building 3, 658 Church Street, Richmond	Sep-12	~28.00	9.68*	8,205	3,413
15-31 Pelham Street, Carlton	Jul-12	20.60	8.38	5,905	3,489
100 Wellington Parade, East Melbourne	Mar-12	22.55	VP	6,500	3,462

* Initial yield n net face
Source: Knight Frank

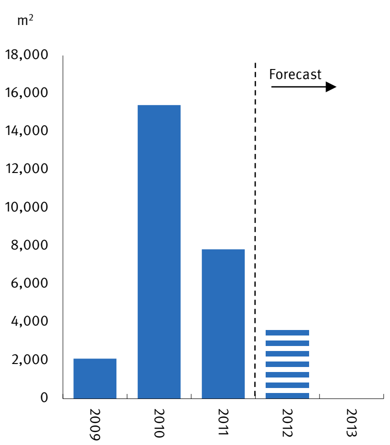
INNER EAST

The Inner Eastern region includes suburbs such as Camberwell, Hawthorn, Kew, Malvern and South Yarra. The Inner East forms 21% of the total suburban market.

Development Activity

Over the past 10 years, new office supply in the Inner East has averaged 9,000m² per annum. Yet in 2012, a mere 3,600m² is forecast to be completed with 6-8 & 10-12 Elizabeth Street, Hawthorn (1,600m²) and 917 Riversdale Road, Surrey Hills (2,000m²) the only developments currently under construction in the region. In the wake of the deterioration in the lending environment, several mooted developments have been shelved. With white collar employment forecast to remain patchy in the near term, sites with commercial developments planned will continue to be under pressure to have plans amended for alternate uses. With market rents still below economic rents, new developments will only commence once sufficiently pre-committed.

Figure 3
Inner East Major New Office Supply
2009-2013



Source: Knight Frank

Vacancy & Tenant Demand

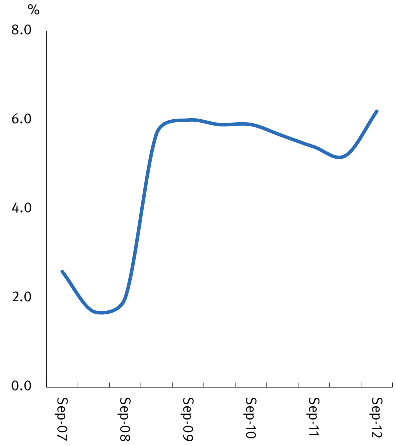
As at September 2012, total office vacancy within the Inner Eastern precinct was 6.2% up from 5.2% in March 2012, its highest level since 2004. Over the past 10 years, vacancies in the Inner East have averaged 4.7%, and historically are below the total vacancy for the metropolitan office market.

Vacancy within the Inner East has increased this year as a result of several tenant relocations and general easing of business conditions. By quality grade, A-grade office vacancy rose to 3.2%, B-grade office vacancy to 7.6% and C-grade office vacancy was 10.2%. Within the Inner East, Camberwell's vacancy is 6.0% - it's highest since 2007, while Hawthorn's vacancy remains low at 2.2%.

Although vacancy within the Inner East has increased this year, it remains a much sought after location for tenants due to its strong public transport links. Vacancy should trend down over the next 18 months as tenants occupy upcoming vacancies, as demonstrated by API's decision to backfill Pearson's former tenancy in Camberwell. API is relocating from Bayswater.

Despite the relatively high vacancy level in the Inner East; subdued tenant demand and limited available vacant contiguous space have resulted in a slight uplift of both prime and secondary net face rentals in the six months to September 2012.

Figure 4
Inner East Office Vacancy
2007-2012



Source: Knight Frank

Investment & Yields

Sales activity to date in the Inner East was consistent with the broader suburban market in 2012, recording just two major sales totalling $32 million. The most recent transaction was Little Projects' disposal of their recently developed office building at 863 High Street, Armadale to Vantage Property Investments for $14.50 million. Recent sales indicate that prime core market yields range between 8.00% and 8.75% with secondary properties ranging between 8.75% and 9.25%.

Table 4
Major Office Leasing Activity Inner East

Address	Area (m²)	Face Rental ($/m²)	Term (yrs)	Tenant	Date
500 Chapel Street, South Yarra	6,700	TBC	12	Village Roadshow	Q4-12#
81-89 Cotham Road, Kew	1,000	285g	5	Planet Innovation	Q2-12
108 Power Street, Hawthorn	1,471	330n	8	Roche Pharmaceuticals	Q1-12

Table 5
Major Office Sales › $5mill Inner East

Address	Sale Date	Price ($ mill.)	Core Market Yield (%)	NLA (m²)	Rate ($/m²)
863 High Street, Armadale	May-12	14.50	8.32	3,182	4,557
108 Power Street, Hawthorn	May-12	17.50	8.57	3,036	4,680

g Gross Face n Net Face # Renewal & Expansion Space
Source: Knight Frank

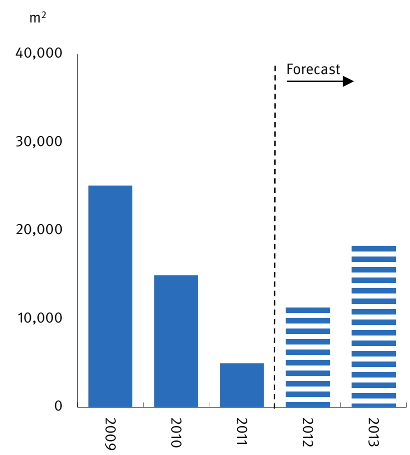
OUTER EAST

The Outer Eastern region comprises 739,477m² of office stock and is the second largest suburban office region, representing 29% of Melbourne's metropolitan office stock. The Outer Eastern region includes suburbs such as Box Hill, Mt Waverley, Mulgrave and Burwood.

Development Activity

Only 5,000m² of office space was completed in the Outer East in 2011 – the lowest annual total since 1999. Constrained by a lack of vacant options offering contiguous space, six new developments have now commenced construction following tenant pre-commitments. Currently there is 48,600m² under construction in the region – of which 86% has already been pre-committed. In late 2012, Bristol-Myers Squibb and Carlisle are scheduled to move into their new offices at Nexus Corporate Park. Nearby Schneider Electric and Olympus have pre committed to new buildings at Goodman's Ferntree Business Park, Notting Hill which are both scheduled to be completed in 2013.

Figure 5
Outer East Major New Office Supply
2009-2013



Source: Knight Frank

Looking ahead, the Australian Taxation Office has recently pre-committed to a new 19,000m² development located at 913 Whitehorse Road, Box Hill. Scheduled for completion in mid-2014, the new five-star Green Star ATO office will be one of the largest suburban office buildings in the Melbourne market.

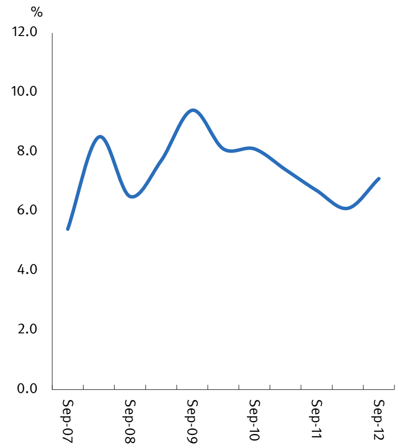
Vacancy & Tenant Demand

Although vacancy within the Outer East increased 100 basis points to 7.1% in the six months to September 2012, it remains below its long term average. Total vacancy in the Outer East has hovered around 7% over the past five years, but as a result of a surge in leasing transactions completed last year, vacancies are likely to trend down over the next 12 months. Tenant demand within the Outer East has been boosted over the past 18 months with tenants keen to lower occupancy costs by consolidating offices in the region and capitalising on the more affordable rental levels.

Within the Outer East, vacancy in Box Hill rose to 5.7% with the departure of Skilled Group amongst others, while the Mt Waverley /Mulgrave/Notting Hill precinct recorded a vacancy rate of 7.0% impacted by some long-standing secondary vacancies.

Office rentals in the Outer Eastern have stabilised in 2012 after steady growth over the past two years. Average net face rents for prime Outer Eastern offices range between $270/m² and $310/m² with the upper range reflecting the pre-lease rental levels achieved. While incentives have remained stable to date in 2012, upward pressure is building as a result of the patchy tenant demand impacted by the uncertain economic environment.

Figure 6
Outer East Office Vacancy
2007-2012



Source: Knight Frank

Investment & Yields

Investment activity in the Outer Eastern office market continued to be at a low level last year with only one property transacting over $5 million. In April 2012, a private investor purchased 362 Wellington Road, Mulgrave for $8.8 million, on a core market yield of 9.97%.

Table 6
Major Office Leasing Activity Outer East

Address	Area (m²)	Face Rental ($/m²)	Term (yrs)	Tenant	Date
913 Whitehorse Road, Box Hill	19,100	420n	15	ATO#	Q3-14
347 Burwood Highway, Burwood East	5,200	260n	10	MYOB	Q2-13
35 & 37 Dunlop Road, Mulgrave	3,613	332n	10	Adidas	Q3-12
352 Wellington Road, Mulgrave	2,700	245n	7	Toll Holdings	Q2-12
6 Lakeside Drive, Burwood East	1,530	245n	5	Eastern Health	Q1-12

Table 7
Major Office Sales › $5mill Outer East

Address	Sale Date	Price ($ mill.)	Core Market Yield (%)	NLA (m²)	Rate ($/m²)
362 Wellington Road, Mulgrave	Apr-12	8.80	9.97	3,611	2,437

n Net Face # Pre-lease
Source: Knight Frank

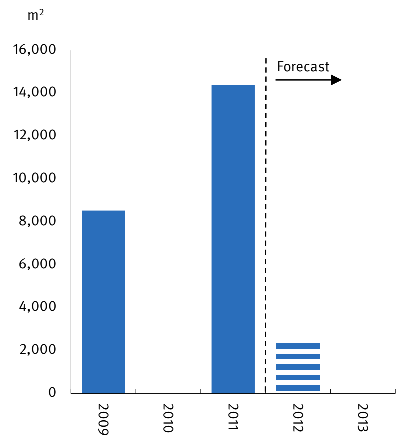
SOUTH EAST

The South Eastern region comprises 259,893m² of office stock and accounts for approximately 10% of Melbourne's Suburban office stock. The South East includes the suburbs of Cheltenham, Moorabbin and Dandenong amongst others.

Development Activity

In recent years, new office development in the South East has been concentrated in the Dandenong precinct as part of the "Revitalisation of Dandenong" project. Places Victoria is working in partnership with the City of Greater Dandenong to deliver the Revitalising Central Dandenong initiative. As part of the initiative Places Victoria has acquired a significant amount of land for development opportunities. New supply levels in the South East reached record levels in 2011 through the completion of Grocon's new 14,399 m² Government Services building in Dandenong.

Figure 7
South East Major New Office Supply
2009-2013



Source: Knight Frank

While development remains patchy, largely driven by pre-commitments, the limited A-grade stock in the region (only 6% of South East office space) has led to solid demand for quality new accommodation.

Beyond 2012, the Melbourne Racing Club has proposed a $1 billion redevelopment of the Caulfield Racecourse – one of Melbourne's largest ever urban renewal projects. The mooted mixed use development – Caulfield Village; is proposed to include 10,000m² of office space along with residential and retail components. In addition, South East Water has committed to a new 12,500m² development at 7R Playne Street, Frankston. South East Water plan to occupy their new headquarters in late 2015, relocating from Heatherton.

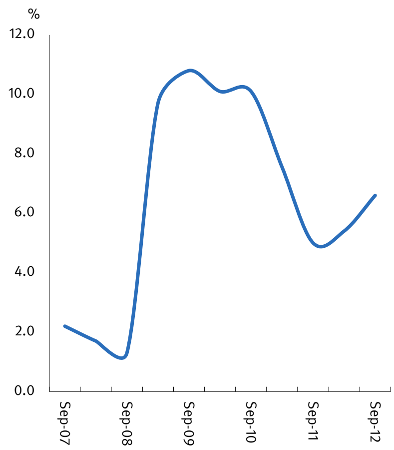
Vacancy & Tenant Demand

As at September 2012, total office vacancy in the South East office precinct increased to 6.6% from 5.4% in March. Although the current vacancy is above the 10-year average of 5.4%, given the size of the South East market, it is susceptible to major leasing transactions and its vacancy can be volatile as a result.

By quality grade, A-grade office vacancy remains very tight at 1.4%, B-grade office vacancy increased to 8.0% and C-grade office vacancy is still high at 13.2% rising from 11.0% in March 2012. Within the South East, Moorabbin's vacancy is 6.1%, Cheltenham's vacancy is 1.3% and Dandenong's vacancy is 10.4%.

Constrained by the lack of contiguous vacant A-grade options, leasing commitments have been limited in 2012 to date. In the six months to September 2012, the South East region recorded net absorption of -3,064m². As at September 2012, prime net face rents within the South East range from $220/m² to $250/m² and secondary stock from $185/m² to $220/m².

Figure 8
South East Office Vacancy
2007-2012



Source: Knight Frank

Investment & Yields

Investment sales activity in the South East office market continued at minimal levels. In 2012 to date, office sales (above $5 million) totalled $14.2 million from two sales. 53-55 Robinson Street, Dandenong was sold to a syndicate, while 1068-1074 Dandenong Road, Carnegie was sold to an owner occupier.

Table 8
Major Office Leasing Activity South East

Address	Area (m²)	Face Rental ($/m²)	Term (yrs)	Tenant	Date
11 Corporate Drive, Heatherton	729	210n	6	Bayside Medical	Q2-12
311 Lonsdale Street, Dandenong	980	240n	5	Red Cross	Q2-12

Table 9
Major Office Sales › $5mill South East

Address	Sale Date	Price ($ mill.)	Core Market Yield (%)	NLA (m²)	Rate ($/m²)
53-55 Robinson Street, Dandenong	May-12	6.60	9.22*	2,729	2,418
1068-1074 Dandenong Road, Carnegie	Apr-12	5.60	VP	3,480	1,609

* Initial Yield n Net Face VP Vacant Possession
Source: Knight Frank

OUTLOOK

A contraction in the mining industry, prompted by lower commodity prices and tighter household spending is impacting on Australia's economic growth. The Australian economy expanded by 0.6% in the June 2012 quarter, led by the resources states of Queensland and Western Australia. In contrast, Victoria's economy contracted by 0.3% in the June 2012 quarter – reflecting the slowdown in manufacturing, housing and retail sectors.

Given Victoria's industry mix, it is more adversely exposed to a high $AUD than most other states in Australia. However, Victoria has been relatively resilient over the past 18 months with the bulk of evidence suggesting that Victoria's slowdown will be modest. Over the next three years, the Victorian economy is expected to grow by an average 2.6% per annum – in line with long term averages.

Employment growth remains divided by sector and state. Despite Australia's unemployment rate falling in August, job ads trending lower suggests that the employment growth will be soft for the remainder of 2012. Victoria's labour market has been subdued in 2012, with employment actually contracting in the year to August. Looking forward, Melbourne metropolitan white collar employment is anticipated to record modest growth over the next three years. Professional Services and Health Care are anticipated to grow strongly in the suburban market over the next three years, whilst employment in Retail Trade and Finance & Insurance are forecast to shrink.

Melbourne's suburban office market contains more than 2.5 million square metres accounting for more than 30% of Melbourne's office space. The availability of capital remains restrictive to development and as a result has impacted the pipeline of new supply in the Melbourne suburban office market. It is likely that new supply for the short term will remain below the 10-year average which will ensure that any rises in vacancy rates will be limited.

New supply scheduled for completion this year in the suburban office market is forecast to total 31,228m^2 – 50% below the long term annual average. Of the new supply entering the suburban market currently under construction, more than 69% is pre-committed, leaving limited options for tenants seeking new accommodation. With tighter lending conditions, it is anticipated new supply will continue to be driven by pre-committed projects.

Melbourne's suburban office vacancy rate increased over the six months to September, rising to 5.8% from 5.1% in March. Despite the rise in vacancy, Melbourne's suburban office market remains one of the tightest, not just in Victoria, but nationally. Melbourne's suburban office vacancy has increased back to its 10-year average, but remains a relatively stable market having risen above 7.5% (in 2004) only once over the past 10 years. All sub-regions recorded increases in vacancy over the past 12 months; however, total vacancy is forecast to trend down over the next two years as a result of the limited un-committed pipeline of new supply.

MELBOURNE'S SUBURBAN OFFICE VACANCY RATE IS LOW AGAINST AUSTRALIA'S MAIN OFFICE MARKETS

As a result of softening tenant demand stemming from the uncertain global economic conditions, typically tenants either consolidated offices or renewed at their current locations. Despite the limited leasing transactions occurring in 2012 to date, the lack of contiguous options has resulted in rental levels rising across most sub-regions, albeit marginally. However, with most corporates remaining cautious, incentive levels have risen to fund fit-out and relocation costs. Presently, there remains solid demand for good quality accommodation, particularly with good fit-outs in place. Should business investment levels remain subdued, face rental levels may begin to soften from their recent highs. Increasing CBD office vacancy rates (and incentive levels) may further encourage tenants seeking better quality office accommodation to migrate into the CBD. At present there are a number of active requirements investigating options within the suburban office market. The Warranty Group (1,200m^2), Coffey (3,500m^2), Experion (4,000m^2) and Michelin (2,000m^2) are amongst some who are likely to continue to drive a moderate level of demand across the suburban market in the short term.

With limited institutional exposure, the Melbourne suburban office market has been somewhat insulated from the significant swings in value which occurred as a result of the GFC and consequently assets have been tightly held in recent years. Investment sales activity (above $5 million) within the Melbourne suburban office market in 2012 remains below the sales volumes recorded in the last few years. A total of $139.5 million was transacted across only nine properties, down from the $174 million that was transacted in the same period last year. Institutions continue to predominately dispose non-core assets, with private investors and owner occupiers dominating the investment activity in the past 12 months. Private investors accounted for 46% of all stock transacted, with syndicates and unlisted funds acquiring a further 32% of suburban offices sold. Investor appetite is still strong for good quality assets in Melbourne's suburban office market, driven by the growing tenant base and consistently low vacancies. As a result of the limited investment opportunities available, yields are anticipated to remain stable with a firming basis for the next 12 months.

RESEARCH

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