RESEARCH

ST KILDA ROAD & SOUTHBANK

OFFICE MARKET BRIEF SEPTEMBER 2018

Key Findings

Tenant demand is being driven by strong white collar employment growth and businesses partaking in staff attraction and retention strategies.

Leasing activity in the 12 months to July 2018 was dominated by the Professional Services and Financial Services sectors.

Prime rental growth was higher than prime rental growth in the CBD office market.

Prime yields in the St Kilda Road office market compressed by 75 points in the 12 months to July 2018.

JANE WONG
Research Analyst

Follow at @KnightFrankAu

Demand is strong in the St Kilda Road and Southbank office markets, and set against a backdrop of declining stock, this has paved the way for strong rental growth.

Tenants eye location, amenity and accessibility

In a tight Victorian labour market and the war for talent that follows suit, attracting and retaining staff is becoming increasingly important to businesses. Tenants nowadays look for office space with good workplace design and amenity as a means of attracting and retaining top talent and boosting staff happiness.

Landlords are responding to this generational shift in workplace culture, undertaking lobby refurbishments and providing shared lifestyle facilities/services such as end-of-trip facilities, bicycle storage and concierge services. This strategy is particularly important in the St Kilda Road office market, where secondary grade buildings account for the majority of stock.

This shift in tenant demand has provided the St Kilda Road and Southbank office markets with a competitive edge over other city fringe markets, given their close proximity to the CBD, unique local amenity and multiple tram routes. Access to both markets will be further enhanced when the Anzac station (part of the Metro Tunnel project) opens in 2026.

Falling CBD office vacancy sees tenant demand spill over

Vacancy in the CBD office market fell to its lowest level in 10 years (3.6% as at July 2018), underpinned by strong tenant demand and limited new supply. As a result, CBD office rents have grown considerably, prompting more and more tenants to expand their search for office space into the city fringe.

Beyond their close vicinity to the CBD and their rich local amenity, St Kilda Road and Southbank also offer lower rents in comparison to other fringe suburbs, such as Richmond and Cremorne, and this has been a major drawcard for tenants.

In a recent leasing transaction negotiated by Knight Frank, JB Hi-Fi Group committed to 9,500 sq m of office space at 60 City Road, Southbank, following its desire to centrally locate its operations. Other recent notable tenant movements into the two markets include WPP (from CBD to Southbank) and

Tract Consultants (from Richmond to Southbank).

Despite elevated refurbishment activity, the two markets are shrinking

Strong tenant demand in the St Kilda Road office market brought net absorption levels to a six-year high in the six months to July 2018. However, vacancy rose slightly, up from 7.2% to 7.4%, as 9,346 sq m of refurbished secondary grade stock was added back into the market over the same period.

Refurbishment activity in the Southbank office market was robust. 19,400 sq m of refurbished prime grade stock was added back into the market in the six months to July 2018, causing vacancy to rise from 3.5% to 6.1%. Vacancy in Southbank is anticipated to fall back below 4% over the next six months, following several leasing transactions which have taken place since the start of the new financial year. Net absorption levels in Southbank were negative in the six months to July 2018, anchored by ExxonMobil wholly vacating 12 Riverside Quay (20,049 sq m) to relocate to Docklands.

Despite elevated refurbishment activity, both markets will continue to experience permanent stock withdrawals as developers take advantage of an increase in demand for residential buildings. The permanent withdrawal rate is anticipated to be higher along St Kilda Road, due to the higher amount of older, convertible stock available and strong buyer appetite for high-end apartments along the leafy boulevard.

Growing popularity for speculative fitouts

Tenants seeking smaller office space (<500 sq m) in St Kilda Road and Southbank are displaying a growing preference for speculative fitouts. This is consistent with tenant demand trends taking shape in the CBD office market, where enquiries in the 100-500 sq m range have quadrupled over the past four years.

Landlords are accommodating this growing preference, knowing that turn-key solutions in smaller office space appeal to a wider range of tenants and in turn help reduce letting-up periods. For tenants, speculative fitouts allow them to transition smoothly into a new office space without worrying about project managing a fitout and the associated downtime involved.

Prime rental growth in the two markets outperforms the CBD

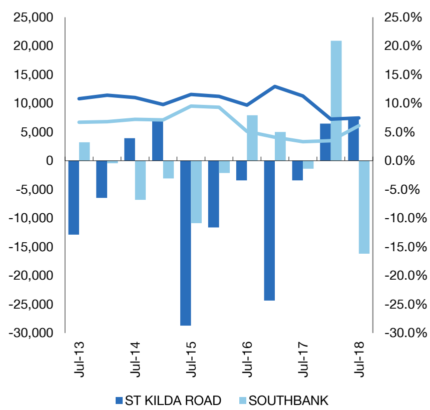
Despite vacancy rising, increased competition for high quality office space in two slowly shrinking markets placed upward pressure on rents. In the 12 months to July 2018, prime rental growth in both markets surpassed the 6.5% prime rental growth recorded in the CBD office market. Prime net face rents in St Kilda Road grew by 13.2% in the 12 months to July 2018 to now average $385/sq m. In Southbank, prime net face rents grew by 7.7% over the same period to average $528/sq m.

Prime rental growth is anticipated to continue as demand for office space in both markets shows no signs of slowing, supported by tenant migration and the flight to quality. Rental growth in the secondary market is also anticipated to continue as landlords inject capital into secondary stock.

FIGURE 1

Vacancy & Net Absorption

Vacancy (RHS) & net absorption (LHS) (sq m) per six month period - Office

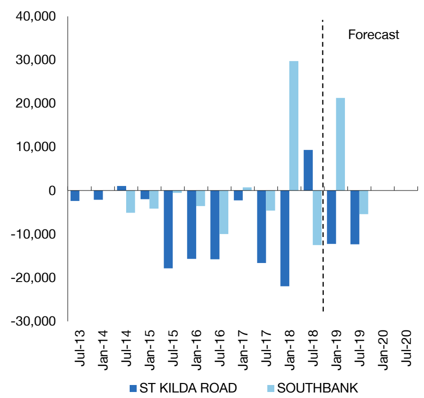


Source: Knight Frank Research/PCA

FIGURE 2

St Kilda Rd & Southbank Net Supply

Per six month period (sq m) - Office



Source: Knight Frank Research

TABLE 1

St Kilda Road & Southbank Office Market Indicators as at July 2018

Grade	Market	Total Stock (sq m)	Total Vacancy Rate (%)	Annual Net Absorption (sq m)	Annual Net Additions (sq m)	Net Face Rents ($/sq m)	Incentives (%)	Core Market Yield (%)
Prime	St Kilda Road	245,325	4.9	2,969	0	360—410	15—20	5.50—6.00
	Southbank	267,706	6.5	6,240	-4,367	475—580	25—28	5.50—6.00
Secondary	St Kilda Road	409,323	9.0	10,900	9,346	270—310	15—22	6.00—6.25
	Southbank	154,224	5.5	-1,553	-964	290—365	20—25	6.00—6.25
Total Market	**St Kilda Road**	**654,648**	**7.4**	**13,869**	**9,346**			
	Southbank	**421,930**	**6.1**	**4,687**	**-5,331**			

Source: Knight Frank Research/PCA

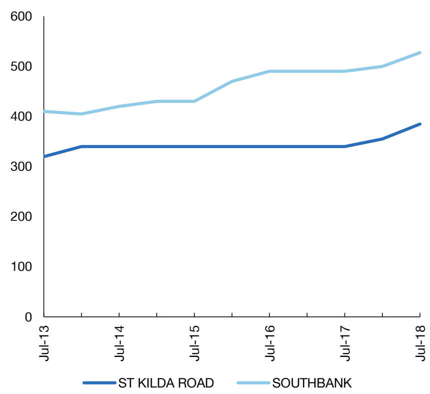
Lack of large office space a challenge

Strong tenant demand and ongoing stock withdrawals have created a vacuum for large contiguous office space across the two markets. This poses a challenge for tenants with larger requirements, which has resulted in many tenants expanding their search into neighbouring South Melbourne. Office vacancy in South Melbourne currently sits at 1.6%.

FIGURE 3

Average Prime Net Face Rents

St Kilda Rd & Southbank ($/sq m) - Office



Source: Knight Frank Research

South Melbourne developments have predominantly consisted of residential-use or mixed-use, however, demand from the office market is seeing developers renew their interest in commercial developments. There is currently as much as 45,000 sq m under construction or in planning in the South Melbourne office market.

Tightening yields due to lack of investment stock

Over 2018 to date, sales volumes in the St Kilda Road and Southbank office markets total $287.7 million across five transactions (refer to Table 3 for examples), three of which were identified as having strong redevelopment potential. Investment activity has been trending downwards since reaching peak levels in 2016, underpinned by large anomalous sales in 2016 and a shortage of investment stock in the years that have followed.

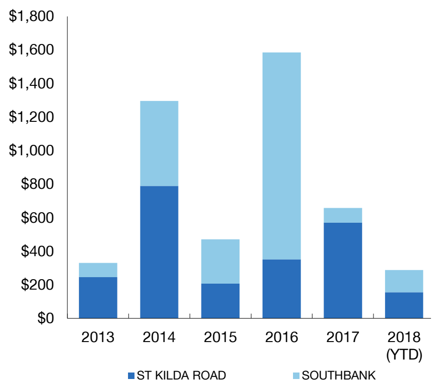
Competition for limited assets from offshore investors and AREITs in 2018 has compressed yields further. Prime yields in the St Kilda Road office market compressed by 75 basis points to average 5.75% in the 12 months to July 2018 and in the Southbank office market, by 25 basis points to average 5.75% over the same period.

The lack of investment stock has in part been brought upon by landlords choosing not to sell as they are unlikely able to recycle their capital into assets for the same rate of return as a few years ago. Instead, landlords are holding onto their assets to benefit from high rental income and capital growth.

FIGURE 4

St Kilda Rd & Southbank Sales

By office market ($10 mil+)



Source: Knight Frank Research

TABLE 2

Recent Leasing Activity St Kilda Road & Southbank

Address	NLA (sq m)	Term (yrs)	Lease Type	Tenant	Sector	Date
2 Southbank Boulevard, Southbank	6,400	10.0	New	CUB	Manufacturing	Jan-19
40 City Road, Southbank	698	7.0	New	Blockchain Global	IMT≠	Aug-18
549 St Kilda Road, Melbourne	1,100	5.0	New	Choosewell	Financial Services	Jul-18
417 St Kilda Road, Melbourne	1,626	5.0	New	Zenitas Healthcare	Healthcare	Jul-18
2 Southbank Boulevard, Southbank	1,360	7.0	New	WPP	Professional Services	Mar-18

Source: Knight Frank Research ≠Information Media and Telecommunications

TABLE 3

Recent Sales Activity St Kilda Road & Southbank

Address	Price ($ mil)	Core Market Yield (%)	NLA (sq m)	$/sq m NLA	Vendor	Purchaser	Sale Date
102 Dodds Street, Southbank~	20.50	5.40	2,404	8,527	Pacific International Lines	Singapore investor	Jun-18
10 Queens Road, Melbourne	60.00	5.00*	8,711	6,888	Amity Property Group	Chinese investor	May-18
464 St Kilda Road, Melbourne	95.38	5.25	13,827	6,898	Victorian Automobile Chamber of Commerce	Abacus Property Group & Wing Tai Holdings^	May-18
77 Southbank Blvd, Southbank~	99.00	U/D	14,144	6,999	SABMiller	Victorian Government	Jan-18

Source: Knight Frank Research U/D undisclosed *initial market yield - has development potential ^joint venture

Knight Frank Research provides strategic advice, consultancy services and forecasting to a wide range of clients worldwide including developers, investors, funding organisations, corporate institutions and the public sector. All our clients recognise the need for expert independent advice customised to their specific needs.

RECENT MARKET-LEADING RESEARCH PUBLICATIONS

Melbourne CBD Office Market Overview September 2018

Suite Spot 2018

Sydney CBD Office Market Overview September 2018

Active Capital 2018

Knight Frank Research Reports are available at **KnightFrank.com.au/Research**

RESEARCH & CONSULTING
Jane Wong
Research Analyst
+61 3 9604 4650
Jane.Wong@au.knightfrank.com

Ben Burston
Partner, Head of Research & Consulting
+61 2 9036 6756
Ben.Burston@au.knightfrank.com

CAPITAL MARKETS
Paul Henley
Partner, Head of Commercial Sales, Australia
+61 3 9604 4760
Paul.Henley@au.knightfrank.com

Danny Clark
Partner, Head of Commercial Sales, VIC
+61 3 9604 4686
Danny.Clark@au.knightfrank.com

OFFICE LEASING
Hamish Sutherland
Partner, Head of Office Leasing
+61 3 9604 4734
Hamish.Sutherland@au.knightfrank.com

Adam Jones
Director, Office Leasing
+61 3 9604 4647
Adam.Jones@au.knightfrank.com

OCCUPIER SOLUTIONS
Gordon Wyllie
Director, Occupier Solutions
+61 3 9604 4666
Gordon.Wyllie@au.knightfrank.com

VALUATIONS & ADVISORY
Michael Schuh
Partner, Joint Managing Director
+61 3 9604 4726
Mschuh@vic.knightfrankval.com.au

VICTORIA
James Templeton
Partner, Managing Director
+61 3 9604 4724
James.Templeton@au.knightfrank.com

Knight Frank

Newmark Knight Frank