A tightening CBD office market is creating a flow-on effect for demand in the fringe markets.

Office refurbishments and speculative fitouts are strategies being adopted by landlords to keep pace with the market.

St Kilda Road office market saw the strongest rental growth over the past year.

Prime yields in the St Kilda Road office market compressed by 63 points in the 12 months to January 2019.

Fuelled by Victoria’s strong population growth and in turn employment growth, Melbourne’s CBD has the tightest office market in the nation with vacancy dropping to a 10-year low of 3.2%. This decline in vacancy has led to a leap in rents for tenants seeking CBD office space, causing them to expand their search into fringe areas such as St Kilda Road and Southbank.

With CBD office vacancy forecast to remain low over the year, the spill over in tenant demand is expected to continue until the next wave of new supply reaches the CBD office market in 2020 and rental growth slows.

Demand driven by various growing industries

Demand for St Kilda Road and Southbank office space in the past year was driven by growth in the Professional Services (e.g. The Fuel Agency) and Manufacturing (e.g. Schweppes/Asahi) industries.

Tenants test the waters but elect to stay along St Kilda Road

In recent times, we have witnessed numerous businesses currently housed along St Kilda Road test the wider market only to renew their leases in the precinct. KBR, Broadspecturm and Newcrest are examples of tenants that have chosen to stay in the precinct after seeking alternative accommodation solutions elsewhere. The fact that these tenants have decided to stay along St Kilda Road reinforces the precinct’s attraction within the broader central Melbourne office market from an affordability and amenity viewpoint.

St Kilda Road lures tenants despite limited options

Despite a relative lack of large contiguous tracts of space, a number of new tenants found new accommodation along St Kilda Road in 2018.
Health supplements manufacturer Evolution Health committed to 2,000 sq m at 476 St Kilda Road; Toyota leased 1,165 sq m at 432 St Kilda Road; insurance broker Choosewell leased 1,154 sq m at 549 St Kilda Road; and clinical research organisation Nucleas Network signed on for 934 sq m at 484 St Kilda Road.

Buildings earmarked for residential now reverting back to office

In the six months to January 2019 one building at 424 St Kilda Road (12,357 sq m) was withdrawn from the St Kilda Road office market for residential conversion, underpinning the fall in office vacancy from 7.4% to 6.6% over the period.

For years, office buildings along the leafy boulevard have been subjected to residential conversions, given the willingness of buyers to pay a premium to live close to the CBD, trams and parkland, and the large availability of older convertible stock.

With the nation’s current housing slowdown, however, the environment has changed. Developers have begun revising their residential development intentions as demand falls and pre-sales fail to reach settlement.

On the flip side, this has created more opportunities for office developments. In the CBD, sites with permit approvals for residential/mixed-use towers are being replaced with commercial schemes (555 Collins Street and 383 La Trobe Street). This might set a precedent for 424 St Kilda Road and other sites earmarked for residential developments to be added back to the office market.

Southbank, which has a higher proportion of newer prime grade stock, is less susceptible to these impacts.

Following the push for office refurbishments, the six months to January 2019 saw 4,500 sq m at 56 Queensbridge Street temporarily withdrawn for partial refurbishment.

Speculative fitouts well-received

Growing demand for speculative fitouts in sub-500 sq m office space is prompting more and more landlords to adopt this strategy in their St Kilda Road and Southbank buildings. Not only do speculative fitouts appeal to a wider range of tenants, they help reduce letting -up periods as well. Speculative fitouts are beneficial for smaller tenants as they are financially attractive and allow for a relatively quick and easy move-in.

Rents climb but still more affordable than other fringe markets

Tenants’ desire to be located in fringe areas and falling stock have placed upward pressure on rents.

This was more apparent in the shrinking St Kilda Road office market as it recorded the strongest year-on-year rental growth on record. St Kilda Road prime net face rents grew by 16.9% in the 12 months to January 2019 to average $415/sq m, while secondary net face rents grew by 14.5% to average 315/sq m. Once again, prime rental growth in the St Kilda Road office market surpassed that of the CBD (+13.2%).

Following rising demand and ongoing office refurbishments in the Southbank office market, prime net face rents grew by 9.5% over the same period to average

<table>
<thead>
<tr>
<th>Grade</th>
<th>Market</th>
<th>Total Stock (sq m)</th>
<th>Total Vacancy Rate (%)</th>
<th>Annual Net Absorption (sq m)</th>
<th>Annual Net Additions (sq m)</th>
<th>Net Face Rents ($/sq m)</th>
<th>Incentives (%)</th>
<th>Core Market Yield (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Prime</td>
<td>St Kilda Road</td>
<td>254,671</td>
<td>8.2</td>
<td>4,893</td>
<td>0</td>
<td>380—450</td>
<td>15—20</td>
<td>5.00—5.50</td>
</tr>
<tr>
<td></td>
<td>Southbank</td>
<td>287,706</td>
<td>12.8</td>
<td>-15,915</td>
<td>0</td>
<td>475—620</td>
<td>20—25</td>
<td>5.00—5.50</td>
</tr>
<tr>
<td>Secondary</td>
<td>St Kilda Road</td>
<td>389,420</td>
<td>7.7</td>
<td>-1,735</td>
<td>-10,557</td>
<td>280—350</td>
<td>15—22</td>
<td>5.50—6.00</td>
</tr>
<tr>
<td></td>
<td>Southbank</td>
<td>149,724</td>
<td>6.5</td>
<td>-5,253</td>
<td>-4,500</td>
<td>290—385</td>
<td>20—25</td>
<td>5.50—6.00</td>
</tr>
<tr>
<td>Total</td>
<td>St Kilda Road</td>
<td>644,091</td>
<td>6.6</td>
<td>3,248</td>
<td>-10,557</td>
<td>290—385</td>
<td>20—25</td>
<td>5.50—6.00</td>
</tr>
<tr>
<td></td>
<td>Southbank</td>
<td>437,430</td>
<td>10.7</td>
<td>-21,938</td>
<td>-4,500</td>
<td>290—385</td>
<td>20—25</td>
<td>5.50—6.00</td>
</tr>
</tbody>
</table>

Source: Knight Frank Research/PCA
In 2018, sales volumes in the St Kilda Road and Southbank office markets totalled $584.9 million across 10 transactions. This figure is down from what was recorded in 2017, underpinned by a lack of assets on offer rather than a lack of investor appetite. Investors are choosing to hold onto their assets to benefit from strong rental returns and capital growth.

St Kilda Road’s prime city fringe location and declining stock has made it one of Melbourne’s most sought-after investment markets. Towards the end of 2018, 509 St Kilda Road sold for a record price of $163 million on a 4.90% core market yield. Tenants occupying the building include Fair Work Australia and AIA Insurance. The previous record sale was a $144.4 million deal at 417 St Kilda Road in 2017.

Increasing competition for quality assets caused prime yields in the St Kilda Road office market to compress by 63 basis points in the 12 months to January 2019 to average 5.25%. In the Southbank office market, prime yields compressed by 50 basis points to average 5.75%.

Given the strong fundamentals of the St Kilda Road and Southbank office markets, both markets will continue to receive high levels of interest from both domestic and offshore investors. Investors will continue to look for quality assets with strong tenancy profiles and positive rental reversions.

### Recent Leasing Activity St Kilda Road & Southbank

<table>
<thead>
<tr>
<th>Address</th>
<th>NLA (sq m)</th>
<th>Term (yrs)</th>
<th>Lease Type</th>
<th>Tenant</th>
<th>Sector</th>
<th>Date</th>
</tr>
</thead>
<tbody>
<tr>
<td>58 Queensbridge Street, Melbourne</td>
<td>5,452</td>
<td>8.0</td>
<td>New</td>
<td>Schweppes/Asahi</td>
<td>Manufacturing</td>
<td>Mar-19</td>
</tr>
<tr>
<td>441 St Kilda Road, Melbourne</td>
<td>U/D</td>
<td>5.0</td>
<td>Renewal</td>
<td>KBR</td>
<td>Professional Services</td>
<td>Jul-19</td>
</tr>
<tr>
<td>509 St Kilda Road, Melbourne</td>
<td>3,377</td>
<td>2.0</td>
<td>Renewal</td>
<td>Broadspctum</td>
<td>Construction</td>
<td>Jul-19</td>
</tr>
<tr>
<td>2 Southbank Boulevard, Southbank</td>
<td>1,714</td>
<td>10.0</td>
<td>New</td>
<td>Space&amp;Co.</td>
<td>Rental Hiring &amp; Real Estate</td>
<td>Oct-18</td>
</tr>
<tr>
<td>476 St Kilda Road, Melbourne</td>
<td>2,000</td>
<td>5.0</td>
<td>New</td>
<td>Evolution Health</td>
<td>Health Care &amp; Social Services</td>
<td>Nov-18</td>
</tr>
</tbody>
</table>

### Recent Sales Activity St Kilda Road & Southbank

<table>
<thead>
<tr>
<th>Address</th>
<th>Price ($ mil)</th>
<th>Core Market Yield (%)</th>
<th>NLA (sq m)</th>
<th>$/sq m NLA</th>
<th>Vendor</th>
<th>Purchaser</th>
<th>Sale Date</th>
</tr>
</thead>
<tbody>
<tr>
<td>541 St Kilda Road, Melbourne</td>
<td>64.00</td>
<td>5.00*</td>
<td>8,246</td>
<td>7,761</td>
<td>Bayley Stuart</td>
<td>Marprop Development &amp; GLL RE Partners^</td>
<td>Dec-18</td>
</tr>
<tr>
<td>509-515 St Kilda Road, Melbourne</td>
<td>163.00</td>
<td>4.90</td>
<td>19,644</td>
<td>8,298</td>
<td>Beville Group</td>
<td>Chinese investor</td>
<td>Nov-18</td>
</tr>
<tr>
<td>194-210 Kings Way, South Melbourne</td>
<td>32.00</td>
<td>4.80*</td>
<td>4,993</td>
<td>6,409</td>
<td>Clantot Pty Ltd</td>
<td>Private investor</td>
<td>Oct-18</td>
</tr>
<tr>
<td>9-17 Raglan Street, South Melbourne</td>
<td>14.00</td>
<td>3.40*</td>
<td>1,915</td>
<td>7,311</td>
<td>Beyo Group</td>
<td>Chinese investor</td>
<td>Jul-18</td>
</tr>
</tbody>
</table>

Source: Knight Frank Research

TABLE 2

TABLE 3

$548/sq m. Secondary net face rents grew by 8.9% to average $338/sq m.

Yield compression continues as competition for quality assets intensifies

In 2018, sales volumes in the St Kilda Road and Southbank office markets totalled $584.9 million across 10 transactions. This figure is down from what was recorded in 2017, underpinned by a lack of assets on offer rather than a lack of investor appetite. Investors are choosing to hold onto their assets to benefit from strong rental returns and capital growth.

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