RESEARCH

ST KILDA ROAD & SOUTHBANK

OFFICE MARKET BRIEF **MARCH 2019**

BENEFITTING FROM THE STRONG CBD OFFICE MARKET

Key Findings

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.

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Research Analyst

As tenants compete for city fringe office space in an environment of declining CBD availability, rents in the St Kilda Road and Southbank office markets have grown considerably.

CBD office squeeze draws more tenants to the fringe markets

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, Broadspectrum 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 58 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.

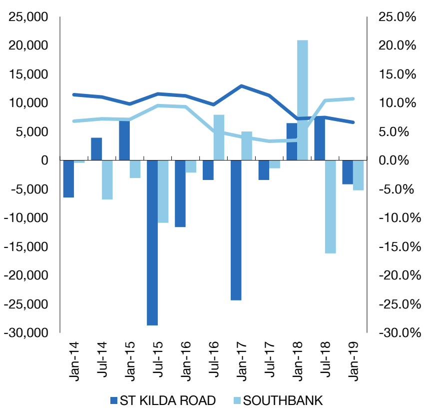
Rents climb but still more affordable than other fringe markets

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%).

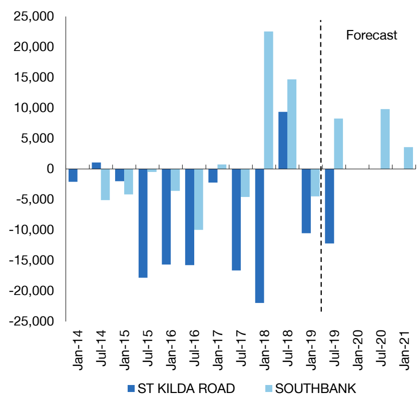
Following rising demand and ongoing office refurbishments in the Southbank office market, prime net face rents grew by 9.5% over the same period to average

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 January 2019

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	254,671	8.2	4,893	0	380—450	15—20	5.00—5.50
	Southbank	287,706	12.8	-15,915	0	475—620	20—25	5.00—5.50
Secondary	St Kilda Road	389,420	7.7	-1,735	-10,557	280—350	15—22	5.50—6.00
	Southbank	149,724	6.5	-5,253	-4,500	290—385	20—25	5.50—6.00
Total Market	**St Kilda Road**	**644,091**	**6.6**	**3,248**	**-10,557**			
	Southbank	**437,430**	**10.7**	**-21,938**	**-4,500**			

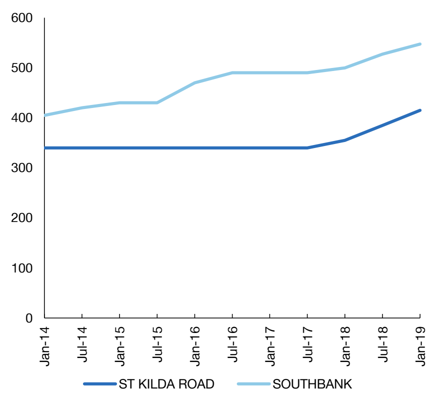
Source: Knight Frank Research/PCA

$548/sq m. Secondary net face rents grew by 8.9% to average $338/sq m. Whilst rental growth has been significant, the St Kilda Road and Southbank office markets still offer attractive rents compared to the CBD and other fringe markets (Richmond, Cremorne, etc.). Prime net face asking rents for new South Melbourne office developments are averaging $550/sq m.

FIGURE 3

Average Prime Net Face Rents

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



Source: Knight Frank Research

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.

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.

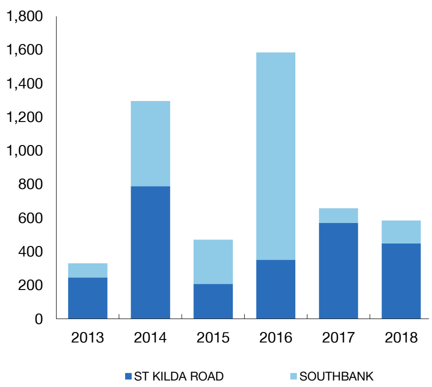
Increasing competition for quality assets caused prime yields in the St Kilda Road office market to compress by 63 basis points in the 12 months to January 2019 to average 5.25%. In the Southbank office market, prime yields compressed by 50 basis points to average 5.75%.

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.

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
58 Queensbridge Street, Melbourne	5,452	8.0	New	Schweppes/Asahi	Manufacturing	Mar-19
441 St Kilda Road, Melbourne	U/D	5.0	Renewal	KBR	Professional Services	Jul-19
509 St Kilda Road, Melbourne	3,377	2.0	Renewal	Broadspectrum	Construction	Jul-19
2 Southbank Boulevard, Southbank	1,714	10.0	New	Space&Co.	Rental Hiring & Real Estate	Oct-18
476 St Kilda Road, Melbourne	2,000	5.0	New	Evolution Health	Heath Care & Social Services	Nov-18

Source: Knight Frank Research U/D undisclosed

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
541 St Kilda Road, Melbourne	64.00	5.00*	8,246	7,761	Bayley Stuart	Marprop Development & GLL RE Partners^	Dec-18
509-515 St Kilda Road, Melbourne	163.00	4.90	19,644	8,298	Beville Group	Chinese investor	Nov-18
194-210 Kings Way, South Melbourne	32.00	4.80*	4,993	6,409	Clantot Pty Ltd	Private investor	Oct-18
9-17 Raglan Street, South Melbourne	14.00	3.40*	1,915	7,311	Beyo Group	Chinese investor	Jul-18

Source: Knight Frank Research * initial market yield ^ joint venture

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