RESEARCH

# MELBOURNE CBD

## OFFICE MARKET OVERVIEW **MARCH 2019**

## CBD CONTINUES RECORD GROWTH

### HIGHLIGHTS

New supply is being met with strong demand and this has resulted in the Melbourne CBD vacancy rate falling to 3.2% as at January 2019, the lowest level recorded for over 10 years.

Underpinned by sustained favourable leasing conditions, the coworking sector is flourishing with majors—WeWork, HUB and Spaces—tripling their CBD footprint.

Investor appetite remained strong for CBD office assets in CY 2018, despite a shortage of stock resulting in sales volume being down marginally on what was recorded in CY 2017.

# KEY FINDINGS

**CBD total vacancy fell from 4.5% to 3.2%** in the 12 months to January 2019, the lowest level recorded in over ten years.

**Prime and secondary net face rents grew** by **13.9% y.o.y and 11.2% y.o.y** respectively in the year to January 2019; with continued growth anticipated.

The last six months has seen a number of **residential development** schemes **sold back to commercial developers and owners.**

Weight of capital looking to invest in a **supply starved office landscape** has caused **prime yields to continue to sharpen**.


FINN TREMBATH

**Associate Director**


# ECONOMIC OVERVIEW

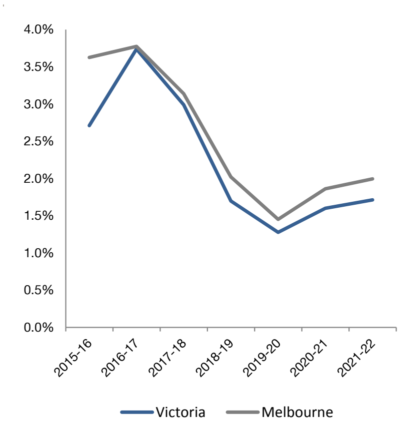
Underpinned by record economic growth, Melbourne continues to record the highest rate of absorption across all CBD markets nationally, with strong demand also leading to a high rate of pre-commitments on upcoming development.

## Sustained growth spurs unprecedented infrastructure investment

The recent strong growth in Melbourne's population and economy extends into 2019, bringing sustained benefits to the city's CBD office market landscape.

The Victorian and National economies continue to experience strong growth. Victoria GDP recorded 3.5% growth in 2018, while GDP growth of 2.8% was forecast for the Australian economy as a whole. According to the ABS, Melbourne's population grew by 2.7% between 2017 to 2018, and in line with this employment in Melbourne has risen, with Oxford Economics reporting that employment grew by 3.1% during 2017-18. Migration, both from overseas and interstate is fuelling this employment growth.

FIGURE 1
**Employment Growth**




Source: Oxford Economics

In response to Melbourne's extensive population and economic growth, the Victorian Government has announced an unprecedented $60 billion plus infrastructure package, at the centre of which are the proposed $50 billion suburban rail loop, $6.5 billion to remove railway level crossings, and the belated airport rail link. These projects are in addition to the North East Link and Melbourne Metro Railway projects.

## Demand for CBD office space tipped to remain strong as population and employment continue to grow

Melbourne's growth shows no sign of slowing with the city tipped to surpass Sydney as the most populous city in Australia within the next 10-15 years. The ABS expects Melbourne's population to continue to grow by 1.8% per year between 2020 to 2022, and off the back of this Oxford Economics forecast employment in Melbourne to also grow by 1.8% per year over the three year period. Moving forwards, Melbourne's expected continued growth should translate to favourable conditions for the city's CBD office market.

TABLE 1
**Melbourne CBD Office Market Indicators as at January 2019**

| Grade | Total Stock (sq m) | Vacancy Rate (%) | Annual Net Absorption (sq m) | Annual Net Additions (sq m) | Average Net Face Rent ($/sq m) | Average Incentive (%) | Average Core Market Yield (%) |
|---|---|---|---|---|---|---|---|
| Prime | 3,076,058 | 3.0 | 107,106 | 83,369 | $638 | 25.0% | 4.65—4.90 |
| Secondary | 1,522,421 | 3.7 | 28,184 | -666 | $455 | 26.0% | 5.30—5.80 |
| **Total** | **4,598,479** | **3.2** | **135,290** | **82,703** | | | |

Source: Knight Frank Research/PCA

# TENANT DEMAND & ABSORPTION

**Net Absorption & Outlook**

| | | |
|---|---|---|
| **Prime** | CY18 107,106 sqm<br>26.2% y-o-y | |
| **Secondary** | CY18 28,184 sqm | |

Source: Knight Frank Research/PCA

## Solid recent supply is being met with strong levels of demand

Melbourne's CBD experienced strong office leasing activity with 69,898 sq m absorbed in the last 6 months—this is above the long term average of 47,387 sq m. Almost all of this absorption was taken up by prime stock (67,499 sq m). Aside from the first half of 2016, Melbourne CBD has experienced sustained strong net absorption since mid way through 2014, and in the last 6 months, Melbourne accounted for approaching 50% of national CBD net absorption.

Strong economic growth and a profound cultural shift in ways of working (agile practices, mobile workforces, flexible hours) is creating a war for talent that is resulting in unprecedented demand for office space in Melbourne's CBD.

Demand has come for both existing stock (eg: State Government at 222 Exhibition Street—14,500 sq m) and pre-committed stock (eg: DLA Piper at 80 Collins Street—5,000 sq m).

From a sectoral perspective, demand is being driven by an increasingly diverse pool of tenants, spearheaded by the coworking, government, education and tech sectors.

Looking ahead, there will be no let up in demand for office space in 2019 as employment growth is tipped to continue at a healthy rate for the foreseeable future. In excess of 500,000 sq m of new stock is due to land in the next two years, and with much of the upcoming 2019 and 2020 stock already pre-committed (see 839 Collins St, 447 Collins St, 80 Collins St, 477 Collins St, 311 Spencer St, 405 Bourke St and 267-271 Spring St), the outlook for absorption levels in Melbourne's CBD is positive.

## Coworking sector continues to flourish as majors expand their footprint

The last 12 months has seen the coworking movement shift up a gear, with the sector's major providers racing to take up space in an already tight CBD market, and landlords of large office buildings undertaking sophisticated 'suite' strategies to ensure they don't get left behind in a rapidly changing office landscape. New accounting standards stipulating leases under 12 months can remain off the books has further boosted the appeal of coworking.

Between them, within the 2018/19 FY WeWork, HUB and Spaces will have opened up seven new outlets in Melbourne's CBD, and by the time Spaces' Two Melbourne Quarter office opens in 2020 the total NLA shared amongst the three coworking majors will total approximately 50,000 sq m (up from 15,000 sq m pre July 2018). With a penchant for prestige locations (see WeWork at 222 Exhibition Street; HUB at the iconic Georges building; and Spaces at Rialto and One & Two Melbourne Quarter) and with outlets often positioned near key transport hubs, coworking's heavy hitters are deploying astute game plans in a bid to attract tenants within an increasingly competitive sector.

> "Much of the new CBD office stock that is due to land in 2019 and 2020 is already pre-committed"

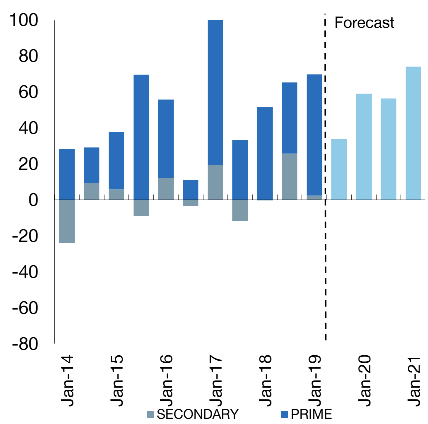
The acceleration of the coworking sector reflects broader growth in demand for flexible office space. Set against the backdrop of a diminishing sub-leasing market, recent times have seen a spike in demand for turnkey/spec suites and the emergence of flexible workspace brokers. Knight Frank anticipates further growth in flexible working in 2019, as more and more tenants seek out quality office accommodation not tied to long contracts.

Elsewhere, in Melbourne's tall towers landlords such as Dexus and GPT have adapted their marketing strategies, converting large vacated spaces into smaller, sub-1,000 sq m spaces in a bid to lure small/medium tenants and accommodate the changing needs of larger, more established tenants.

FIGURE 2
**2018 Take-up by Sector (Indicative)**


Source: Knight Frank Research

FIGURE 3
**Melbourne CBD Net Absorption**
('000 sq m) per 6 month period




Source: Knight Frank Research/PCA

# SUPPLY & DEVELOPMENT

**Vacancy Rate & Outlook**

| | | |
|---|---|---|
| **Prime** | 3.0% | -0.3% bps y-o-y |
| **Secondary** | 3.7% | -0.4% bps y-o-y |

Source: Knight Frank Research/PCA

## Melbourne CBD vacancy declines further

Melbourne CBD's recent low office vacancy level continues to drop, with vacancy now siting at a record low 3.2%. Since January 2018, vacancy has steadily declined across both prime and secondary assets. With a burgeoning economy fuelling tenant demand, available stock levels have remained low, which in turn has further reduced the vacancy level. These strong property fundamentals have made the Melbourne CBD the tightest office market nationally.

At a micro level, vacancy within the Docklands precinct remains low at 0.7%, coming off 1% vacancy recorded in the September 2018 Knight Frank report. From a commercial perspective, the Docklands precinct has displayed a degree of resilience many pundits didn't expect five to ten years ago. Low rents relative to some other CBD precincts, a dearth of available commercial development space and a spate of recent lease renewals (Bureau of Meteorology—15,500 sq m at 700 Collins St) and expansions/CBD core relocations (ANZ—26,500 sq m at 839 Collins St) are factors driving the Docklands' current low vacancy rate.

The last 6 months has seen vacancy drop in the CBD's Flagstaff precinct. A number of sub-500 sq m deals (such as Clarence Workplaces for Professionals at 456 Lonsdale Street, and Fair Work Ombudsman at 414 La Trobe Street) have driven this decline in the vacancy rate.

Gross CBD office completions totalled 98,758 sq m in the six months to January 2019. The majority of this new supply (69%) stemmed from new development completions, with much of this driven by the 5 Collins Square (41,650 sq m) and One Melbourne Quarter (26,400 sq m) developments. While the completions added to the market over the last six months exceed the long term average of 68,363 sq m, all of the new supply was pre-committed ensuring vacancy levels remained tight.

## Melbourne anticipated to dominate national supply

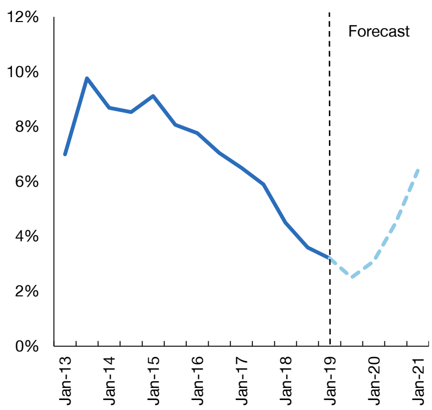
Melbourne's unrivalled population and economic growth is such that the city is tipped to account for as much as half of the 1 million sq m of new office space due for Australian CBD markets over the next three years. Already, in H2 2018 Melbourne's additional 98,758 sq m of new office stock was almost four times that recorded for Sydney (28,212 sq m).

## Vacancy expected to rise from 2020

While much of the new office stock due to land in 2019/20 is already pre-committed, the amount of new office stock to be added to Melbourne's CBD in 2020 and beyond is substantial, and as tenants vacate existing premises to move into new premises vacancy is likely to rise.

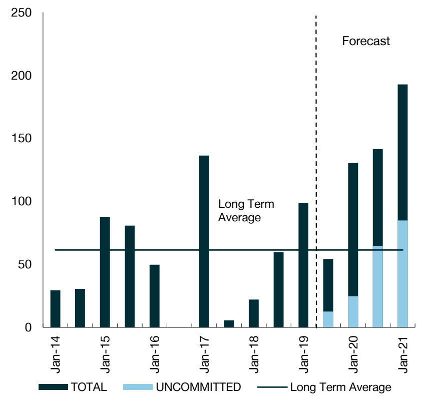
The vacancy rate is expected to remain near historic lows during 2019, but rise from 2020 as upcoming completions act to boost office stock and gradually raise supply levels, thereby acting to rebalance the market over time.

FIGURE 4
### Melbourne CBD Vacancy




Source: Knight Frank Research

FIGURE 6
### Gross New Supply
CBD Office (000's sq m) per six month period



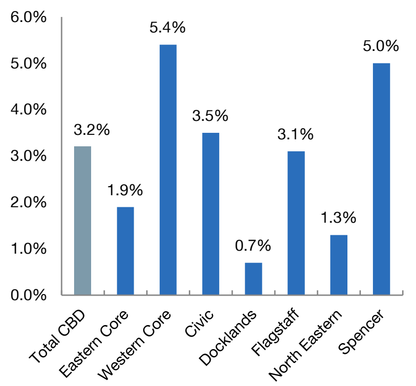

Source: Knight Frank Research

TABLE 2
### Melbourne CBD Vacancy Rates

| Grade | Jan-18 (%) | Jul-18 (%) | Jan-19 (%) |
|---|---|---|---|
| Premium | 5.6 | 4.6 | 3.8 |
| A Grade | 3.3 | 2.9 | 2.7 |
| **Prime** | **4.0** | **3.3** | **3.0** |
| B Grade | 6.7 | 4.2 | 4.3 |
| C Grade | 4.5 | 4.2 | 3.2 |
| D Grade | 2.3 | 2.9 | 1.5 |
| **Secondary** | **5.8** | **4.1** | **3.7** |
| **Total** | **4.5** | **3.6** | **3.2** |

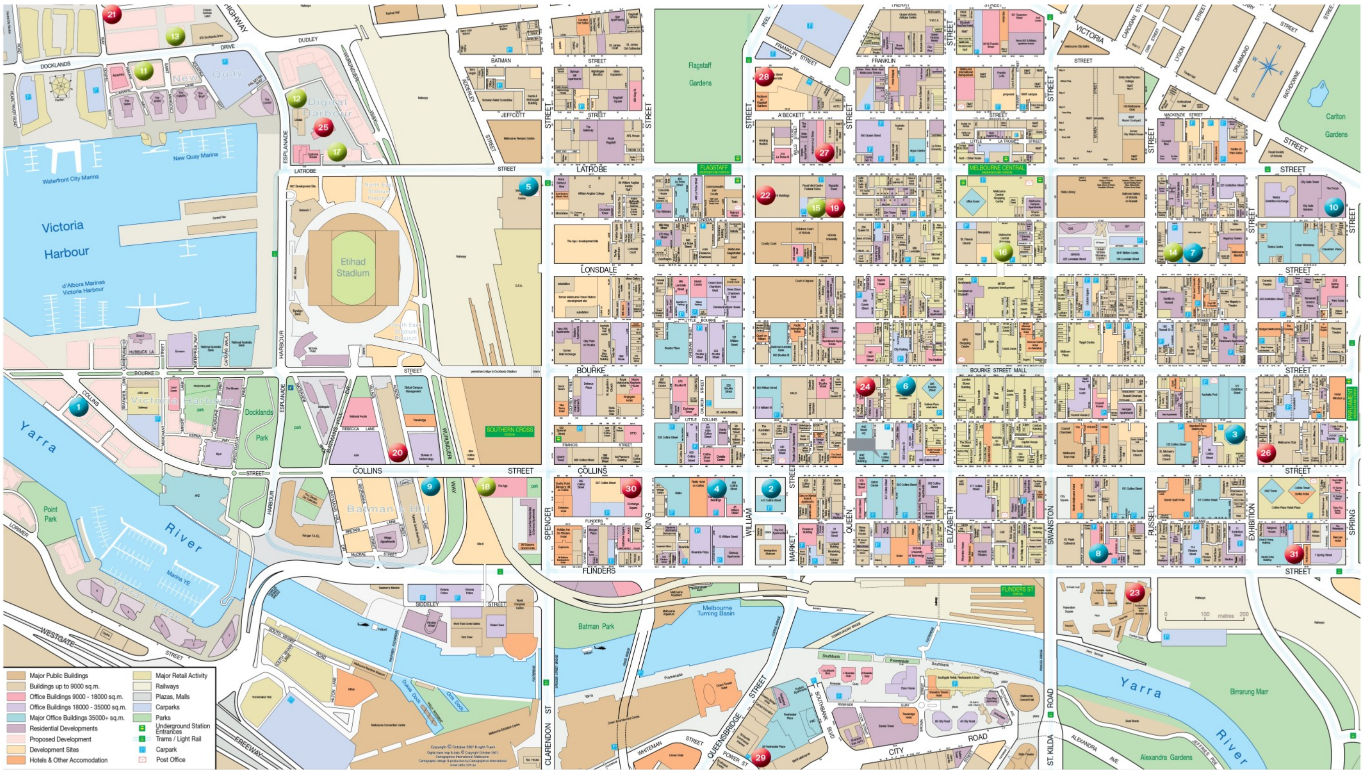
Source: Knight Frank Research/PCA

FIGURE 5
### Vacancy by Precinct




Source: Knight Frank Research/PCA

# MAJOR OFFICE SUPPLY




## Under Construction/Completed

**1** Y3, 839 Collins Street - 39,200 sqm (ANZ)
Lend Lease - Q2 2019 - 68% committed

**2** 447 Collins Street - 49,000 sqm+
(King & Wood Mallesons, HWL Ebsworth, Minter Allison & Gadens)
Cbus Property - Q4 2019 - 85% committed

**3** 80 Collins Street (South) - 43,000 sqm
(Savills, Macquarie Bank, Cenitex)
QIC - Q1 2020 - 65% available

**4** 477 Collins Street - 51,000 sqm (Deloittes, Norton Rose)
Mirvac / Suntec REIT - Q2 2020 - 96% committed

**5** 311 Spencer Street, Melbourne - 65,000 sqm (Victoria Police)
Keppel REIT / Cbus Property - Q3 2020- 100% committed

**6** 405 Bourke Street, Melbourne 65,000 sqm (NAB)
Brookfield - 2021 - 100% committed

**7** Wesley Place, 130 Lonsdale Street - 55,000 sqm
(Cbus, Vanguard, Telstra Super)
Charter Hall - Q1 2020 - 55% committed

**8** 180 Flinders Street - 16,000 sqm (John Holland)
DEXUS - 2020+ - 50% committed

**9** Two Melbourne Quarter, 697 Collins Street, Melbourne - 48,000 sqm
(Energy Australia - Regus Space)
Lendlease - 2020+ - 58% committed

**10** 267 - 271 Spring Street - 15,000 sqm (Australian Unity)
ISPT - Q4 2018 - 100% committed

## Approved Developments

**11** 396 Docklands Drive, Docklands - 10,500 sqm
MAB - 2020+

**12** 25 Digital Drive - 10,000 sqm
Digital Harbour Holdings - 2020+

**13** 395 Docklands Drive, Docklands - 22,000 sqm
MAB - 2020

**14** 140 Lonsdale Street - 15,000 sqm
Charter Hall - 2020

**15** 364-378 Lt Lonsdale Street, Melbourne - 24,000 sqm
Victoria University - 2020+

**16** 300 Lonsdale Street, Melbourne - 20,000 sqm
The GPT Group - 2021+

**17** 1,000 La Trobe Street, Docklands - 38,500 sqm
Poly Group - 2021+

**18** Melbourne Quarter Tower (3 Melb Quarter) - 65,000 sqm
Lend Lease - 2022+

## Mooted Developments

**19** 283 Queen Street, Melbourne - 25,000 sqm
Victoria University - 2021

**20** 710 Collins Street - 32,000 sqm
Abacus Property Group - 2020+

**21** 440 Docklands Drive, Docklands - 100,000 sqm
Ashe Morgan - 2020+

**22** 280-318 William Street, Melbourne - 40,000 sqm
Country Court of Victoria - 2021+

**23** Federation Square East, Cnr Flinders & Russell Sts - 60,000 sqm
State Government - 2022+

**24** Cnr Queen & Bourke Street, Melbourne - 62,000 sqm plus
Cbus Property - 2022+

**25** 26-34 Digital Drive, Docklands - 47,000 sqm
Cbus Property - 2021

**26** 60 Collins & 52 Collins Street, Melbourne - 36,000 sqm
Dexus- 2023

**27** 383 LaTrobe Street, Melbourne - 44,000 sqm
Mirvac- 2023

**28** 412 William Street, Melbourne- 20,000 sqm
Shesh Ghale - 2023

**29** 25-35 Power Street, Southbank- 36,000 sqm
M&L Investments

**30** 555 Collins Street, Melbourne - 45,000 sqm
Charter Hall - 2022+

**31** 32 Flinders Street, Melbourne - 40,000 sqm
GPT - 2023

NB. Dates are Knight Frank Research estimates / Major tenant pre-commitment in brackets /# Major refurbishment / Office NLA quoted

# RENTS & RECENT TRANSACTIONS

**Rents, Incentives & Outlook**

| | | |
|---|---|---|
| **Prime Rents (g)** | $638/sqm face<br>13.9% y-o-y<br>$476/sqm eff<br>15.0% y-o-y | |
| **Secondary Rents (g)** | $455/sqm face<br>11.2% y-o-y<br>$335/sqm eff<br>12.0% y-o-y | |
| **Incentives** | P:25.0%<br>S:26.0% | |

## Continued low vacancy sees rents skyrocket

Sustained tenant demand coupled with relatively low levels of development completions over recent years has created high levels of net absorption which in turn has led to record low vacancy and rental growth.

Over the last 12 months, prime net effective rents grew by 15.0% (the highest seen since 2008) to reach $476/ sq m. This growth was underpinned by a net face rental increase of 13.9% (the highest seen since 2001), with incentive levels ranging between 22%-28%. This rapid rise in prime rents has had a flow-on effect on the fringe, where prime net face rents have risen as much as 40% over the last 3 years.

Secondary net effective rents increased by a notable 12.0% to reach $335/ sq m. This growth was backed by a net face rental increase of 11.2% with incentive levels ranging between 20%-28%.

With much of the upcoming 2019 stock already pre-committed and demand for office space set to continue rents are tipped to rise further. Moreover, developments involving the amalgamation of sites such as 435 Bourke Street should only further fuel rent increases.

Moving forwards, Melbourne net face rents are expected to rise by 9.0% in 2019 CY, after which the rate of growth should decline as new stock hits the market in 2020.

TABLE 3

### Recent Leasing Activity Melbourne CBD

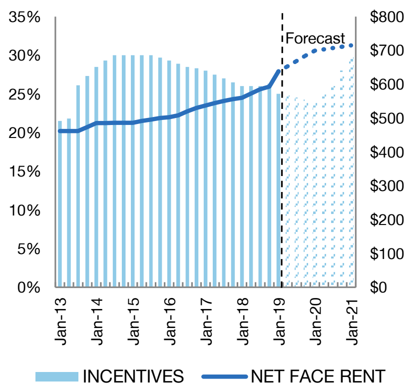
| Address | Precinct | NLA | Term | Lease | Tenant | Sector | Start |
|---|---|---|---|---|---|---|---|
| 695 Collins St | Docklands | 3,000 | U/D | New | Spaces | Coworking | H1-19 |
| 414 La Trobe St | Flagstaff | 4,304 | 5 | Renew | Fair Work Ombudsman | Government | Q2-18 |
| 120 Spencer St | Spencer | 8,600 | 10+ | New | WeWork | Coworking | H1-19 |
| 414 La Trobe St | Flagstaff | 2,145 | U/D | New | Spiire | Professional | H2-18 |
| 310 King St | Flagstaff | 560 | 3 | New | Melb Education Institute | Education | H2-18 |
| 222 Exhibition St | North East | 15,000 | U/D | New | State Govt | Govt | H1-19 |

Source: Knight Frank Research U/D = Undisclosed

FIGURE 7

### Prime Incentives & Net Face Rents

LHS: $/sq m average net face rent
RHS: % Indicative




Source: Knight Frank Research

TABLE 4

### Recent Sales Activity Melbourne CBD

| Address | Grade | Price ($ mil) | Core Mkt Yield (%) | NLA (sq m) | $/sq m NLA | WALE (yrs) | Vendor | Purchaser | Sale Date |
|---|---|---|---|---|---|---|---|---|---|
| 383 La Trobe St | B | 122.00 | 5.7 | 9,679 | 12,605 | 4.0 | Sterling Global | Mirvac | Sep-18 |
| 60 Collins St | B | 160.00 | 2.5 | 13,817 | 11,579 | 2.8 | Reserve Bank of Australia | Dexus | Sep-18 |
| 555 Collins St | C | 140.00 | VP | 22,999 | 6,087 | VP | Fragrance | Charter Hall | Oct-18 |
| 104 Exhibition St | C | 37.10 | 3.0% | 2,205 | 16,823 | 1.59 | Liberal Party | Harold Holt foundation | Nov-18 |
| 818 Bourke St | A | 223.29 | 5.18 | 23,271 | 9,593 | 3.48 | Hines Global REIT | Centuria Metropolitan REIT & P.Lederer | Sep-18 |

Source: Knight Frank Research *Initial Yield U/D = Undisclosed

# INVESTMENT ACTIVITY & YIELDS

## Offshore investment drops

Investor appetite remains strong for CBD assets, with office sales volumes in CY 2018 – $2.53 billion across 21 properties (deals above $10 million) – sitting above the 10 year average of $2.14 billion. Despite this, the 2018 figure is down on the CY 2017 figure, which is due to a shortage of stock being on the market. CY 2018 also saw a drop off in cross-border investments (down from 52% in 2017 to 34% in 2018). This decline in can be linked to reduced levels of Chinese foreign investment caused by a reduction in the level of capital from the Chinese government. The recent decline in office sales volume also reflects the scarcity of opportunity on offer for asset holders to sell and buy back into properties promising superior returns.

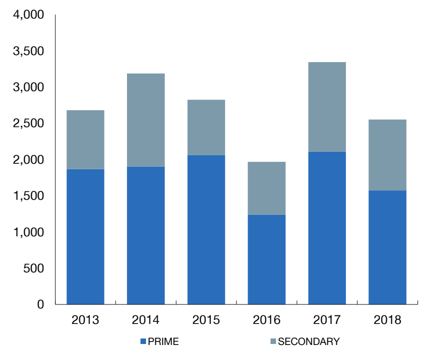
## Office benefits from residential misfires

The last six months has seen a number of residential development schemes sold back to commercial developers and owners. Charter Hall purchased 555 Collins Street for $140 million after owner Fragrance Group struggled to find enough buyers for its planned residential project. And Mirvac purchased the Royal Mint Centre at 383 La Trobe Street for $122 million. The seven storey building was previously earmarked for a $700 million luxury hotel and apartment project. Both sites are anticipated to be developed into new office towers. A challenging apartment landscape underpinned by tight bank lending is felt to be behind the recent spate of abandoned residential development projects.

**Current Yields & Outlook**

| | | |
|---|---|---|
| Prime | 4.65% - 4.90% -40bps y-o-y | ↘ |
| Secondary | 5.30% - 5.80% -0bps y-o-y | ↘ |

FIGURE 10
Melbourne CBD Sales $10 million+
By Grade (Millions)




> "Offshore investment levels have declined sharply, down from 52% in 2017 to 34% in 2018"

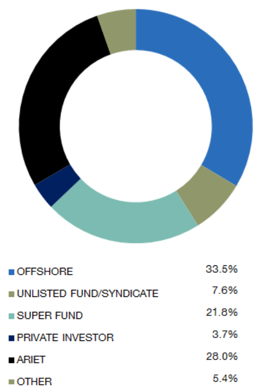
## Prime yields continue to compress

Record low vacancies and escalating rents have created favourable leasing conditions and this has caused robust demand for commercial real estate. And with this weight of capital looking to invest in a supply starved office landscape, prime yields continue to sharpen—prime yields compressed by 40 basis points in the last 12 months and continued to firm throughout the second half of 2018. The current range of prime yields ranges from 4.65% to 4.90%. To illustrate the strong yield compression currently taking place in the prime market, in 2018 CY 699 Bourke Street and 818 Bourke Street sold for respective yields of 4.9% (initial) and 5.18% (core).

Yields for secondary stock have remained static over the past year, and the current spread between prime and secondary yields now stands at 50 basis points.

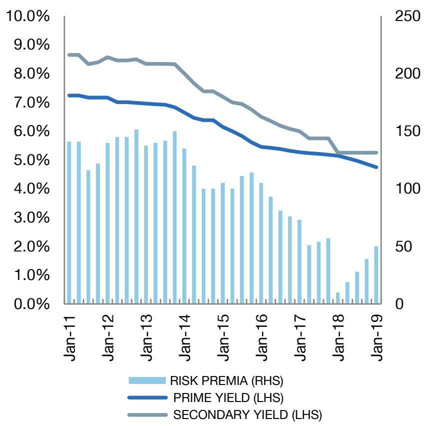
The yield compression cycle has been running since 2012, and prime yields are likely to be nearing the bottom of the compression cycle. Despite this, Melbourne's office market continues to prosper based off strong underlying economic drivers. As a result, yields may firm further still in 2019 as local and offshore investors continue to compete for quality assets, however the rate of compression will be minimal. Moving forwards capital growth will be driven to a greater extent by rental growth.

FIGURE 9
Melbourne CBD Purchaser Profile
$10 million+ sales—2018




Source: Knight Frank Research

FIGURE 11
Melbourne CBD Core Market Yields
% Yield LHS & Basis Point Spread RHS




Source: Knight Frank Research

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