Savills Research

Briefing
Canberra Office

August 2017

Highlights

- Sentiment continues to improve in the wake of the favourable May Budget, as reflected in an increase in enquiry from Commonwealth tenants;
- We expect the leasing market is at or near a cyclical low;
- The vacancy rate has continued to trend downwards (11.4%), which is particularly evident in Civic (3.5%) and Barton (0.0%);
- Development planning activity has increased with a surge in supply expected in 2019/20.

A Grade Averages	Latest	Yr Change	Outlook
Rental – N.F. ($/sq m)	360	n/c	↔
Incentives	17.5	-600bps	↘
Rental – N.E ($/sq m)	280	+1.8%	↗
Yield – Market (%)	6.40	-50bps	↘
IRR (%)	8.15	-10bps	↘
Capital Values	6,800	+21.4%	↗

Demand & Supply	Latest	PCP*
Vacancy	11.4	13.0
Net Absorb. ('000 sq m)	7.1	29.7
Stock U/C ('000 sq m)	15.0	-
- % of market	0.64	-
- % committed	-	-

*PCP = Previous Corresponding Period

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Executive Summary

The Canberra office market consists of just over 2.33 million square metres of net lettable space, split into 26 sub-localities. The largest locality is Civic with 659,034 square metres. By grade quality, A Grade buildings account for the largest proportion of stock in Canberra, representing 46.1% of the market.

The performance of the Canberra office market is often counter-cyclical to the other major office markets in Australia, and has historically been driven by elections and subsequent fluctuations in the size of the public sector.

Traditionally, the Canberra office market is characterised by high net additions, with a 15 year average of 58,990 square metres; however, more recently, we have seen a moderation in new supply with a continuation of this trend expected until 2019. This has been largely as a result of persistent budget deficits prompting the Federal government to implement cost cutting measures since 2014, which has made developers more risk averse as they are reluctant to start construction on any new buildings till pre-commitments are met. With the Government and Community sector the most dominant tenant type in the Canberra office market (making up over 90% of total tenants as at June 2017), easing of the government's purse strings has had a direct influence on the level of new supply with Commonwealth tenants the most likely to pre-commit to new prime stock.

This has had an effect of falling vacancy rates, particularly in A Grade stock. Most notably, the vacancy rate in the Barton precinct was recorded at 0.0% in June 2017. The lack of available space in the Barton precinct will consequently help to drive secondary vacancy rates downwards over the medium term as tenants opt for high quality B grade as an alternative.

PCA Summary Table – Canberra (as at Jun-17)

	Prime	Secondary	Total	AUS CBD
Total Stock ('000)	1,077.4	1,260.6	2,338.1	**18,018.7**
Total Vacancy ('000)	101.4	165.9	267.3	**1,898.0**
Vacancy (%)	9.4 (11.1)	13.2 (11.4)	11.4 (11.2)	**10.5 (8.6)**
Net Absorption ('000)	5.2 (52.6)	1.9 (-16.3)	7.1 (36.3)	**188.1 (199.0)**
Net Absorption (%)*	0.5 (8.0)	0.2 (-1.4)	0.3 (1.9)	**1.2 (1.3)**
Net Additions ('000)	0.0 (62.7)	-33.4 (-2.0)	-33.4 (60.7)	**125.5 (325.6)**
– Stock Additions ('000)	-	14.3	14.3	**495.7**
– Stock Withdrawals ('000)	0.0	47.7	47.7	**376.4**
Net Additions (%)	0.0 (9.1)	-2.6 (-0.2)	-1.4 (3.1)	**0.7 (2.0)**

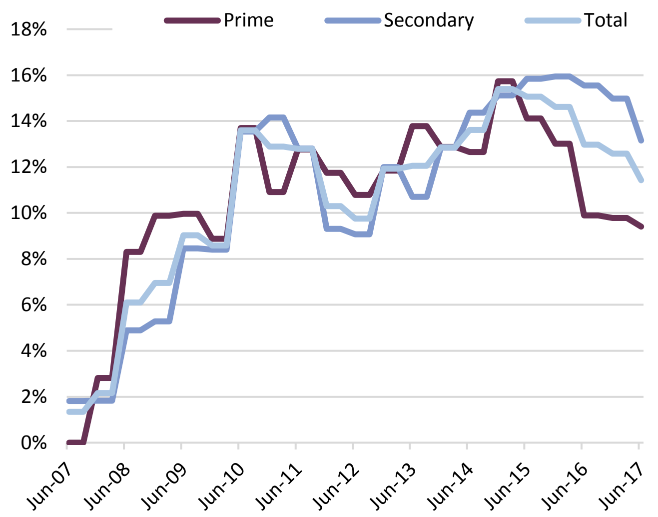
Source: PCA / Savills Research (10yr Averages shown in brackets); *As a percentage of occupied stock

Vacancy

The total vacancy rate in Canberra fell to 11.4% in June 2017, down from 13.0% a year earlier, on the back of continued improvements to underlying demand coupled with limited new supply. Limited new supply was a driving force behind falling vacancies in the Barton and Civic precincts, where A Grade vacancy rates fell to 0.0% and 3.2% respectively, with no new additions in Barton since July 2013. The lack of available space in the Barton precinct will consequently help to drive secondary vacancy rates downwards over the medium term as tenants opt for high quality B grade as an alternative. Whilst historically high secondary vacancy have been a feature in the Canberra office market as a result of Commonwealth preference for new prime accommodation, recent take-up activity of secondary space by second tier groups drove the secondary vacancy rate down to 13.3% in June 2017 from 15.5% a year earlier.

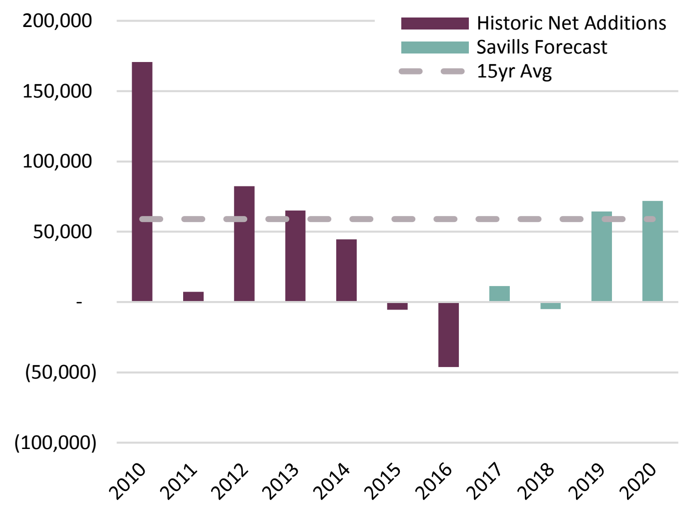
In light of a limited supply profile over the next 2 years, Savills Research anticipates a gradual tightening in vacancy to continue until a surge of new supply hits the market in 2019/20 helping to alleviate pressure, particularly in the prime market.

Historic Vacancy (Canberra)



Source: Savills Research

Net Supply by Year



Source: Savills Research

Supply

Historically, new additions have been a key feature of the Canberra office market with a 15 year average of 58,990 square metres. However, this has not been the case since 2015 as a result of cost cutting measures by Commonwealth tenants, the effects of which are expected to be felt at least until 2019. Canberra's supply pipeline is expected to return to historical norms in the 2019/20 period, when projects such as 'Civic Quarter' (27,600 square metres) enters the market.

Mixed use schemes are also proving popular with two commercial / hotel developments proposed. QIC has lodged plans for a mixed use development of the vacant Cooyong Street site adjoining their Canberra Centre shopping centre. Similarly, local developer / owner Capital Property Group has plans for a whole block development in the Civic precinct to be known as 'Constitution Place'. The stage 1 office component comprises 20,000 square metres with a subsequent stage including additional office accommodation and a hotel.

Leasing Activity & Demand

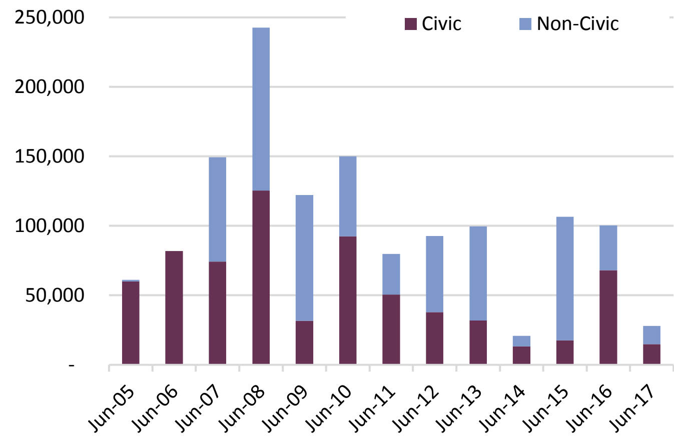
In the 12 months to Jun-17 Savills identified 35,429 square metres of leasing activity. This is down 67.1% on the 12 months prior and down 68.2% on the 10 year average (111,378 square metres). With tenant demand in Canberra historically correlated with the state of the Federal budget and the prevailing political climate, this fall in demand was to be expected with budget cuts initiated by the current Liberal government.

Of the 35,429 square metres leased in ACT in the last 12 months, tenants from the Government & Community sector were the most dominant, leasing 92.1% of total stock (26,257 square metres). Both local government and Defence contractors have contributed to take-up this year. For example, Lockheed Martin have leased 3,215 square metres of B Grade space (two leases) at 8 Brisbane Avenue, Barton. Additionally, the ACT Government took 10,900 square metres of renovated space at 2-6 Bowes Street, Phillip in one of the larger deals struck earlier in the year.

Looking at leasing volume by grade, B grade leases were the most numerous with 17,583 square metres leased over the year to June 2017, with a lack of available prime quality space, particularly in the Barton and Civic precincts.

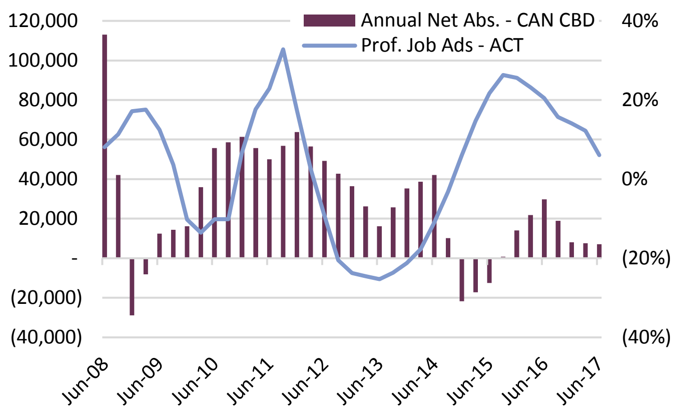
Looking ahead, with the May Federal budget not including any new major cost-cutting measures, aggregate demand should increase moving forward. This is further reinforced by positive growth in professional job advertisements, which has been shown to be a lead indicator for leasing demand. Over the year to June 2017, annual growth in professional job advertisements was recorded at 6.1%, the third strongest result in the country.

Leasing Activity by Precinct (> 1,000 square metres)



Source: Savills Research

Net Absorption vs. Growth in Professional Job Ads



Source: Savills Research

Top Leases (by Area Leased)

Tenant	Property	Date | NLA	Type | Rent | Term
ACT Government	2-6 Bowes Street, Phillip	Dec-16 | 10,931	Direct | 355 (G) | 15
Department of Infrastructure and Regional Dev.	62 Northbourne Ave, City	Nov-16 | 10,218	Renewal | 410 (G) | 10
Commonwealth Super	7 London Cct, City	Jun-17 | 6,915	Direct | 470 (G) | 6
ACT Government	2 Constitution Ave, City	Dec-16 | 2,799	Direct | 404 (G) | 12
Lockheed Martin	8 Brisbane Av, Barton	Jun-17 | 2,257	Direct | 385 (G) | 6
ANU	7-11 Barry Dr, Turner	Jun-17 | 1,805	Direct | 380 (G) | 3
ACT Government	2-6 Bowes Street, Phillip	Dec-16 | 10,931	Direct | 355 (G) | 15

Source: Savills Research

Sales

In the 12 months to June 2017, Savills identified approximately $653 million worth of office transactions (greater than $5 million) in the Canberra office market.

This level of activity is well beyond the ten year average of $420 million and can be traced to a single transaction; the sale of 50 Marcus Clarke Street, City. The asset was sold for $321 million to South Korean asset management firm, Mirae Asset Global Investments at an equated yield of 5.75% by Malaysian vendor CIMB Trust & Malaysian Employees Provident Fund. It is important to note that traditionally, these larger assets are tightly held with only four traded in the past five years.

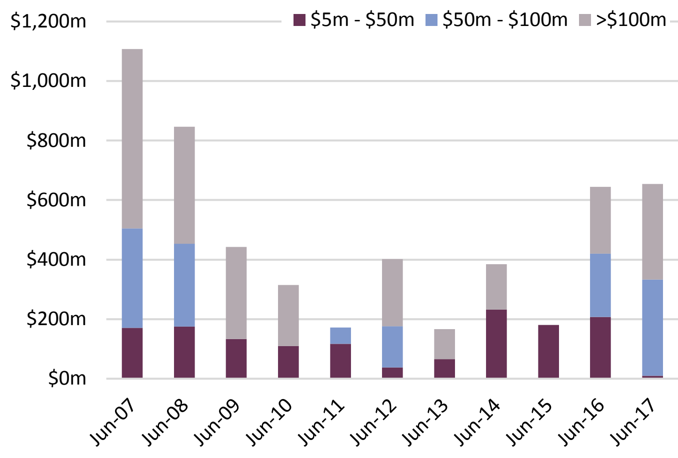
Another noteworthy transaction was the sale of 82 Northbourne Avenue, Braddon in June 2017 for $57.3 million on an equivalent yield of 5.85%. The asset was sold with a 7.1 year WALE by another Malaysian vendor to Australian based fund manager Challenger.

These two deals typify sales activity in the year to June 2017 with an active foreign investor presence. Foreign investors were responsible for the purchase of 58% of all sales transactions over FY-17. Foreign vendors from Malaysia and Germany have divested a combined total of $436.8 million over this period. Local funds with two acquisitions recorded, in both cases taking advantage of long WALE's to implement buy and hold strategies.

Market yields in Canberra Civic, as at June 2017, are estimated to range between 5.50% and 7.25% for A grade, and between 7.50% and 10.50% for B grade buildings. The average yield for A grade office buildings in the quarter to June 2017 is 6.38%, representing a 38 basis point firming over the year.

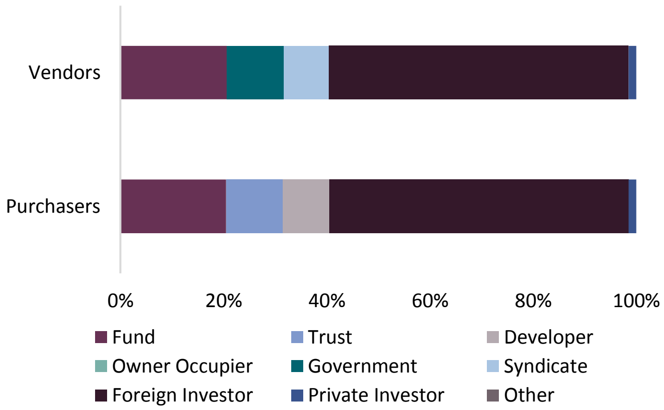
Capital values in the Civic precinct in Canberra, as at June 2017, are estimated to range from $5,265 per square metre to $8,350 per square metre for A grade buildings, and between $3,500 per square metre and $5,400 per square metre for B grade buildings.

Sales Activity by Size



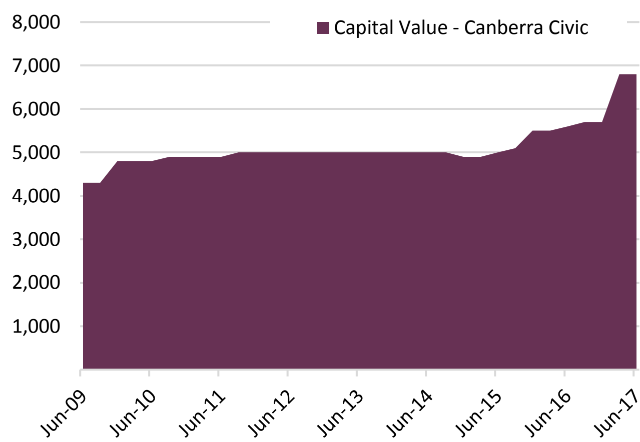
Source: Savills Research

Vendor & Purchaser Type



Source: Savills Research

Capital Values ($/sq m)



Source: Savills Research

Top Sales (over the year to Jun-17)

Property	Price ($m) | Date | NLA	Yield | Type | $/sq m
50 Marcus Clarke St, City	321.00 | Mar-17 | 40,201	5.75 | e | 7,985
Infrastructure House	76.50 | Aug-16 | 16,413	6.90 | e | 4,661
Scarborough House	72.33 | Nov-16 | 16,782	7.24 | i | 4,310
62 Northbourne Ave, City	58.50 | Nov-16 | 10,218	6.50 | e | 5,725
2-6 Bowes St, Phillip	58.38 | Feb-17 | 12,377	6.45 | e | 4,717
82 Northbourne Av, Braddon	57.33 | Jun-17 | 6,979	5.85 | e | 8,214
50 Bunda St, City	9.80 | May-17 | 2,071	6.92 | e | 4,732

Source: Savills Research ; Yield Types: i = Initial, r = Reported, e = Equated, v = Vacant, dev = development

Rents

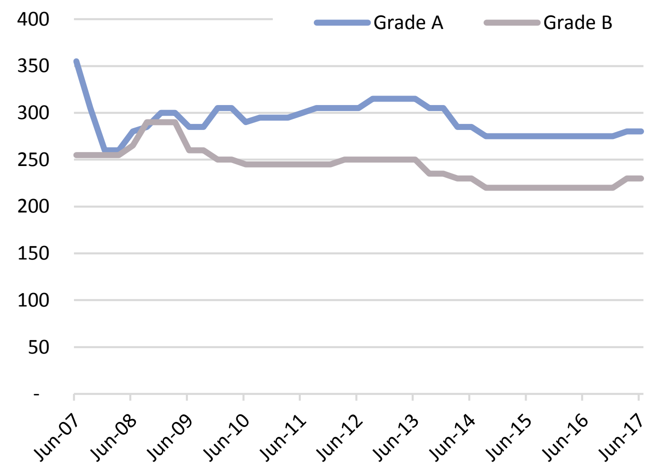
Rents in Canberra traditionally exhibit lower volatility compared to other Australian CBDs. This can be traced to the typically long-term lease structures of the most dominant lessee, the Commonwealth Government, with terms ranging from 10 to 15 years and fixed annual rental increases.

Net face rents in the Canberra Civic precinct range from $340 to $400 per square metre per annum for A Grade and from $290 to $325 per square metre per annum for B Grade, as of June 2017.

Incentive levels have gradually eased during the year, resulting in modest effective rental growth. A Grade net effective rents now average $280 per square metre, up 1.8% from a year prior, whilst average B Grade net effective rents were recorded at $230 per square metre in June 2017, up 4.6% from a year prior.

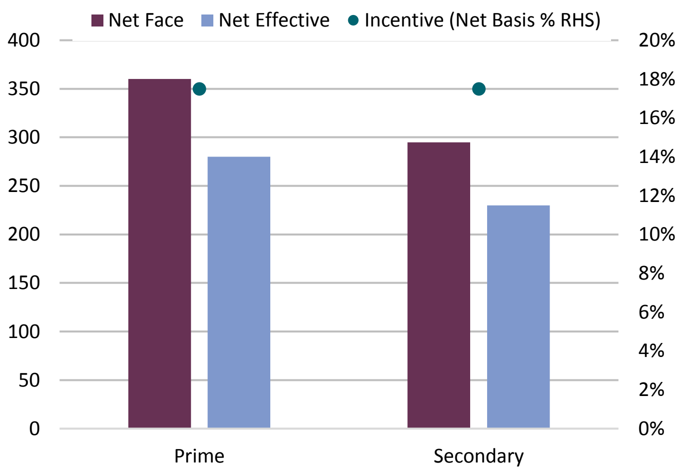
Savills Research anticipates this trend to continue, albeit largely confined to the Civic and Barton precincts. The tight conditions being experienced in these areas is a function of scarce new supply combined with strong demand for both A grade and B grade accommodation. However, new supply expected from 2019 onwards is expected to shift the balance of power back in tenants' favour.

Net Effective Rents by Grade ($/sq m)



Source: Savills Research

Net Face & Net Effective Rents (as at June 2017)



Source: Savills Research

Development

The table below details the major upcomingand planned development projects in the Canberra office Market.

Building Address	Dev Stage	NLA	Exp. Comp	Precinct	Tenant
10 Brindabella Circuit	UC	4,932	2017	Airport	
12 Brindabella Circuit	UC	1,361	2017	Airport	
CWA House, 17 Moore Street	UC	5,895	2017	Civic	
2 Faulding Street	UC	1,600	2017	Symonston	
44 Thesiger Court	UC	1,235	2018	Deakin	
125 Bunda	DA	41,689	2019	Civic	
Civic Quarter Stg 1, 70 Northbourne Av	DA	15,900	2019	Civic	
Civic Quarter Stg 2, 70 Northbourne Av	DA	11,700	2019	Civic	
London Cct, cnr Ediburgh Av	EP	47,520	2020	Civic	
London Cct, cnr Cooyong St	EP	24,450	2021	Civic	
London Cct, cnr Ediburgh Av	EP	18,870	2021	Civic	
West Block, Queen Victoria Terrace	Mooted	7,677	2022	Barton	
Constitution Place Stg 1	DA	20,000	2020	Civic	ACT Government
Constitution Place Stg 2	DA	9,500	2020	Civic	

Outlook

The prospect of a more active Commonwealth Government sector has lifted sentiment in Canberra. Nascent signs of recovery are already emerging, as indicated by the declining vacancy rate, modest effective rental growth and solid jobs advertisements growth of 6.1% (over the year to June 2017). This follows a two year period of flat rental growth as market activity waned due to savings measures implemented by the Commonwealth Government, which took a toll on market activity and sentiment.

Savills Research anticipate the gradual tightening in vacancy to continue until a surge in new supply in 2019 / 2020 helps to alleviate pressure, particularly in the prime market. Modest growth in effective rents is a likely consequence, although confined to Civic and Barton, where acute vacancy rates and strong demand maintain downward pressure on incentives.

The steady risk-adjusted returns available in Canberra are expected to continue to attract both local and offshore investors, particularly pension funds. Looking further up the risk / return curve, we expect value-add strategies will remain popular with private investors.

An interesting test for the market will be the success of pre-leasing campaigns for new stock in Civic, which are currently asking circa $550 per square metre gross per annum. This represents a premium of approximately 10% relative to existing prime stock in that precinct.

Canberra Key Indicators (as at June 2017)

	Civic				Non-Civic			
	A Grade		B Grade		A Grade		B Grade	
	Low	High	Low	High	Low	High	Low	High
Rental – Gross Face ($/sq m)	425	485	385	420	410	480	350	390
Rental – Net Face ($/sq m)	330	390	285	305	330	400	260	300
Incentive Level Net	15%	20%	15%	25%	15%	20%	15%	25%
Rental – Net Effective ($/sq m)	255	305	210	220	270	330	210	240
Outgoings – Operating ($/sq m)	55	60	60	70	55	60	60	70
Outgoings – Statutory ($/sq m)	25	30	25	30	20	25	20	25
Outgoings – Total ($/sq m)	80	90	85	100	75	85	80	95
Typical Lease Term	5	15	3	10	5	15	3	10
Yield – Market (% Net Face Rental)	5.50	7.25	7.50	10.50	5.50	8.50	8.00	11.00
IRR (%)	7.25	9.00	9.25	12.00	7.50	9.50	9.25	12.00
Cars Permanent Reserved ($/pcm)	310	375	310	375	165	230	165	230
Cars Permanent ($/pcm)	-	-	-	-	-	-	-	-
Office Capital Values ($/sq m)	5,265	8,350	3,500	5,400	4,775	7,725	3,100	5,000

Source: Savills Research NB: All rents equivalent to whole floor mid-rise

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