Briefing
Melbourne CBD Office

August 2017

Highlights

- Tenant demand in the Melbourne CBD was a national standout, with net absorption at its highest level since 2008 and leasing activity the strongest since 2010;
- As a result vacancy rates continued to fall in both prime and secondary grades and remain well below the national CBD average;
- Investment demand remained strong, with sales activity just below the FY-16 record and driving further gains in capital values;
- Rental growth remained positive with a fall in incentives driving further upward moves in net effective rates;
- Investment yields fell a further 50 basis points from the same time last year, while current market conditions point to further tightening

A Grade Averages	Latest	Yr Change	Outlook
Rental – N.F ($/sq m)	545	+3.8%	↗
Incentives	27.5	-50bps	↗
Rental – N.E ($/sq m)	395	+3.9%	↗
Yield – Market (%)	5.50	-50bps	↔
IRR (%)	6.90	-35bps	↙
Capital Values ($/sq m)	9,500	+5.6%	↗

Demand & Supply	Latest	PCP*
Vacancy	6.5	7.1
Net Absorb. ('000 sq m)	128.4	66.4
Stock U/C ('000 sq m)	348.4	–
- % of market	7.7	
- % committed	65.1	

*PCP = Previous Corresponding Period

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Executive Summary

The Melbourne CBD office market has been going from strength to strength on the back of the strongest economic indicators in the country, while forward indicators point to continued outperformance and have provided impetus for business expansions accommodation upgrades.

In both total quantum and relative terms the Melbourne CBD showed the strongest net demand of any CBD over FY-17, with absorption at 3.1% of occupied stock almost three times the national average, and represents Melbourne's 15th consecutive quarter of positive take-up. This led to a decline in vacancy levels across both prime and secondary grades. Demand from the Education sector grew, as Melbourne's status as the most liveable city in Australia, and relative affordability compared to Sydney, continued to be a drawing card for international students. Educational institutes competing with professional services and government sector tenants looking to expand or upgrade their existing floor space became a clear feature of the market in FY-17.

In the past 12 months 167,000 square metres of total space was added in the CBD, the majority of which was prime stock (88.4% of total stock additions). With 57,300 square metres of stock withdrawn for refurbishment or redevelopment over the same period, displaced tenants competing for limited options, particularly in the prime market, drove incentive levels down marginally by 50 basis points over the year to June 2017.

Savills Research anticipates a further decline in available office stock over the next six months resulting from strong demand coupled with the shortage of upcoming supply, which will put downward pressure on the vacancy rate. Whilst the supply pipeline remains below that of the 15 year average for the next 2 years, nearly 300,000 square metres is forecast to hit the market in 2020, which will help meet tenant requirements.

PCA Summary Table – Melbourne CBD (year to Jun-17)

	Premium	A Grade	Prime	Secondary	Total	AUS CBD
Total Stock ('000)	751.4	2,257.8	3,009.2	1,541.4	4,550.6	18,018.7
Total Vacancy ('000)	46.0	137.1	183.1	111.5	294.6	1,772.9
Vacancy (%)	6.1 (6.2)	6.1 (5.6)	6.1 (5.8)	7.2 (7.9)	6.5 (6.6)	10.5 (8.6)
Net Absorption ('000)	13.8 (11.2)	106.8 (80.2)	120.6 (91.5)	7.8 (-15.5)	128.4 (75.9)	188.1 (199.0)
Net Absorption (%)	2.0 (1.8)	5.3 (4.9)	4.5 (4.0)	0.5 (-1.0)	3.1 (2.0)	1.2 (1.3)
Net Additions ('000)	-3.6 (14.3)	111.6 (83.9)	108.0 (98.2)	1.7 (-14.4)	109.6 (83.8)	125.5 (325.6)
– Stock Additions ('000)	3.9	143.8	147.7	19.3	167.0	495.7
– Stock Withdrawals ('000)	7.5	32.2	39.7	17.6	57.3	376.4
Net Additions (%)	-0.5 (2.1)	5.2 (4.8)	3.7 (4.0)	0.1 (-0.9)	2.5 (2.1)	0.7 (2.0)

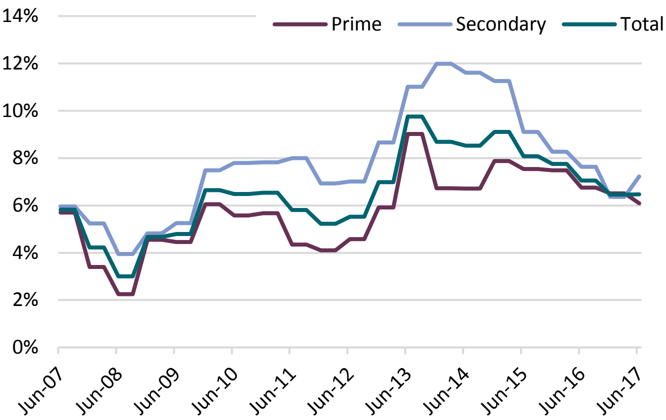
Source: PCA / Savills Research (10yr Averages shown in brackets); *As a percentage of occupied stock

Vacancy

Strong tenant demand, underpinning a robust take-up in the 12 months to June 2017, led to a decline in vacancy levels across prime and secondary markets. The total vacancy rate of 6.5% recorded in June 2017, was down from 7.1% a year ago. Tenant migration in pursuit of 'flight to quality', either for building quality or location remains the key driver for tightening of the prime office space in the CBD market. A fall in secondary vacancy rates was due to a considerable amount of secondary accommodation being withdrawn for refurbishment or redevelopment.

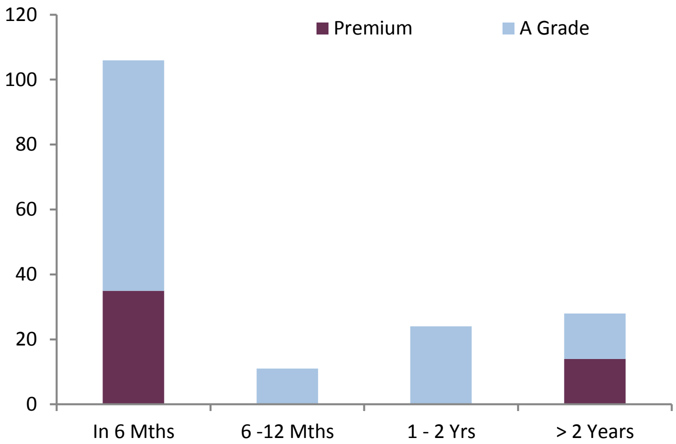
Savills Research anticipates a further decline in available office stock over the next six months resulting from strong demand coupled with the shortage of upcoming supply, which will put downward pressure on the vacancy rate.

Historic Vacancy Rate



Source: PCA / Savills Research

Full Floor Availability by Period



Source: Savills Research

Full Floor Availability

The Savills Prime Full Floor Availability Report assesses the state of the leasing market in a different manner to standard vacancy surveys. The report shows each Premium and A Grade building in the city on a floor-by-floor basis highlighting which floors are available for lease, now and in the near future, including those under construction and refurbishment.

The total number of prime full floor leasing options (current and future) sit at 237 prime grade floors in June 2017, up from 170 full floors 12 months ago. Availability in full floors is highest on record due to factoring in upcoming developments. In recent months, there has been upward trend of available options due to future tenant relocations to pre-committed developments within the market. However, impending prime full floor availability between June and December 2017 sits tight with only 106 full floors available to lease, declining from 115 full floors available in the corresponding period last year.

	By Grade			By Precinct			
	Total	Premium	A Grade	North West	North East	South West	South East
Total Prime Floors (No)	1,527	407	1,120	217	190	700	413
Total Prime NLA (sq m)	2,118,238	572,080	1,546,158	275,291	306,210	896,764	616,887
Prime Floors Available (No)	237	53	184	33	18	142	44
Prime Full Floor Avail. (sq m)	319,911	77,292	242,619	42,390	23,803	184,740	68,978
Prime Full Floor Avail. (%)	15.1	13.5	15.7	15.4	7.8	20.6	11.2
Max Contiguous Floors (No)	34	9	34	9	15	34	22
Max Contiguous Area (sq m)	35,095	11,964	35,095	11,964	14,772	20,496	35,095

Source: Savills Research

Leasing Activity & Demand

In the 12 months to June 2017, 426,914 square metres of space was leased in the Melbourne CBD. This is up 53% from 12 months ago and up 26% on the 10 year average (315,367 square metres). Almost a quarter of total space was leased in the Docklands precinct.

Of total office stock leased in the last 12 months, 52% of leases were large tenant requirements sized above 10,000 square metres, amounting to 221,236 square metres of office take-up. Grade A stock accounted for the majority of the absorption measuring 310,458 square metres of office space leased over the past year.

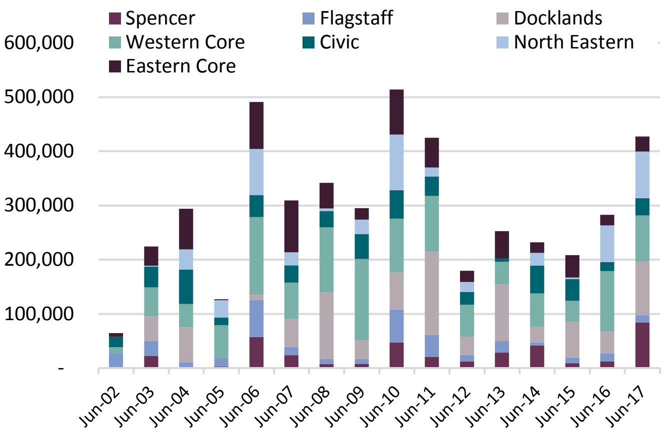
The Government and Community sector was the dominant cohort, responsible for 40% of total office leasing activity, while Property and Business services was second accounting for almost 25%. Demand from the Education sub-sector (a sub-sector of the Government & Community sector) grew, as Melbourne's status as the most liveable city in Australia and relative affordability compared to Sydney, continued to be a drawing card for international students. This drove educational institutes to compete with professional services and government sector tenants looking to expand or upgrade their existing floor space.

Tenant demand from the Education & Training sub-sector grew 226% from the previous year, with recorded leasing activity of 53,577 square metres. Educational institutes were particularly active in the first 6 months of 2017, accounting for nearly three-quarters of total Government & Community sector leases in this period. The largest recorded transaction from the Education & Training sub-sector was Cambridge International's lease of the Lonsdale Building (7,837 square metres).

Whilst 'Direct' leases accounted for the majority of recorded leases at 39%, pre-commitment activity was at the highest level since June 2011 with 'Pre-Commitment' leases more than doubling from the previous year with 164,942 square metres pre-commitments recorded over the twelve months to June 2017. Notable pre-commitments include Deloitte agreeing to take up 22,000 square metres at Mirvac's 477 Collins Street as well as ANZ's 26,500 square metre pre-commitment of 839 Collins Street.

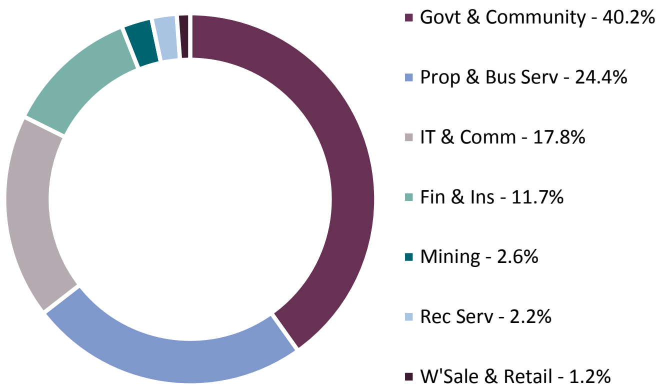
The adjoining chart illustrates growth in professional job advertisements as a strong lead indicator for net absorption. Growth in professional job advertisements has been consistently positive in Victoria over the last 3 years with job advertisements in June 2017 at their highest level since February 2012. This is clearly reflected in positive net absorption numbers in Melbourne CBD. With growth in professional job ads still strong in the current quarter, it would be prudent to expect this to translate to continued net absorption performance over the remainder of 2017.

Leasing Activity by Precinct



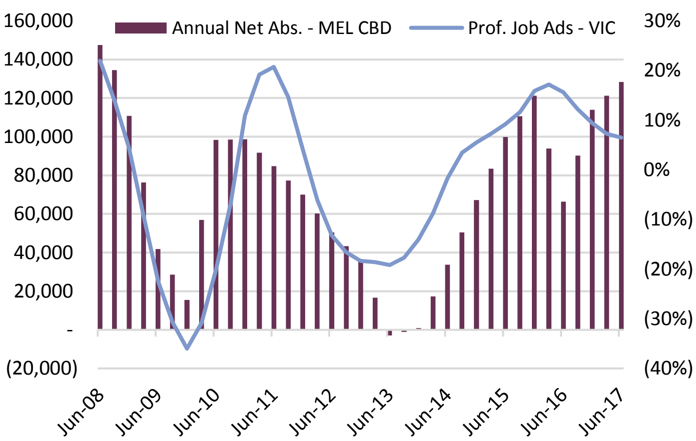
Source: Savills Research

Leasing Activity by Tenant Type



Source: Savills Research

Net Absorption vs. Job Ads Annual Growth

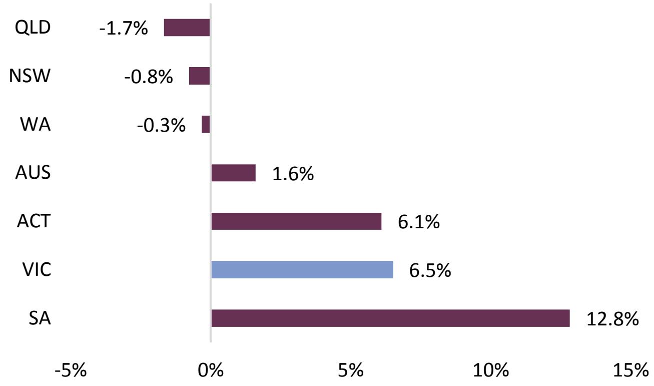


Source: PCA / DOE / Savills Research

Although moderating recently, growth in professional job ads in VIC remained the second highest amongst all the states and also considerably higher than the 1.6% national average. What is notable about the Victorian economy is that growth in full-time jobs has been material over the last year, where there has been a trend towards more part-time employment in all other Australian states. This points to stronger employment metrics for Victoria, which are likely to translate to continued strength in tenant demand for Melbourne CBD.

Improving business conditions were evident from the NAB Index, which rose to the highest level since before the Global Financial Crisis, with this improvement driven by professional services. As a result, Savills Research expect a positive outlook for Melbourne demand to persist in the short to medium term at least.

Office Job Ad Growth by State (Jun-17)



Source: DOE / Savills Research

Top 20 Leases (by Area Leased)

Tenant	Property	Date | NLA (sqm)	Type | Rent | Term
VIC Police, Fed Police & ACIC	311 Spencer St, Melbourne	Dec-16 | 65,000	Precom | n.a | 30
ANZ	839 Collins St, Docklands	Jan-17 | 26,500	Precom | n.a | n.a.
Minter Ellison	447 Collins St, Melbourne	Dec-16 | 10,500	Precom | n.a | 12
Accenture	161 Collins St, Melbourne	Feb-17 | 8,000	Direct | 500 (N) | 10
Cambridge International	108 Lonsdale St, Melbourne	Feb-17 | 7,837	Direct | 400 (N) | 10
Allianz Australia Services	360 Elizabeth St, Melbourne	Apr-17 | 7,260	Renewal | n.a | 5
Exxon Mobil	664 Collins St, Docklands	Jan-17 | 7,100	Precom | n.a | n.a.
MLC Limited	727 Collins St, Docklands	Dec-16 | 6,725	Direct | n.a | n.a.
Melbourne University	333 Exhibition St, Melbourne	Feb-17 | 6,528	Direct | 380 (N) | 6
Gadens Lawyers	447 Collins St, Melbourne	Jan-17 | 5,329	Precom | n.a | 10
Development Victoria	8 Exhibition St, Melbourne	Dec-16 | 4,836	Direct | 530 (N) | 10
Programmed Group	333 Collins St, Melbourne	Feb-17 | 2,800	Direct | n.a | 5
Symbion	737 Bourke St, Docklands	Jan-17 | 2,800	Direct | 425 (N) | 10
Host Plus	114 William St, Melbourne	Nov-16 | 2,778	Direct | 420 (N) | 8
Downer EDI	567 Collins St, Melbourne	Jan-17 | 2,500	Direct | 470 (N) | 3
Pacific Hydro	700 Collins St, Docklands	Feb-17 | 2,423	Direct | 450 (N) | 10
Blue Rock Law	414 La Trobe St, Melbourne	Feb-17 | 2,400	Direct | 360 (N) | 7
National Heart Foundation	171 La Trobe St, Melbourne	Jun-17 | 2,154	Direct | 420 (N) | 7
Mckinsey	35 Collins St, Melbourne	Jan-17 | 1,691	Sublease | 620 (N) | 3
RMIT University	171 La Trobe St, Melbourne	Jun-17 | 1,300	Renewal | n.a | 3

Source: Savills Research

Sales Activity

Investment activity remained near record, with Savills Research recording approximately $2.94 billion of Melbourne CBD office transactions over 18 sales in the 12 months to June 2017, at similar levels to the preceding 12 months. Reported sales over the current annual period were 75% above the 10 year average ($1.67 billion).

Depreciation of the Australian dollar from its peak in March 2013, have boosted investment in Australian commercial property from foreign investors over the recent years, with this trend still evident. Foreign investors remained the most dominant purchaser type, accounting for 69% of all buyers in the year to June 2017.

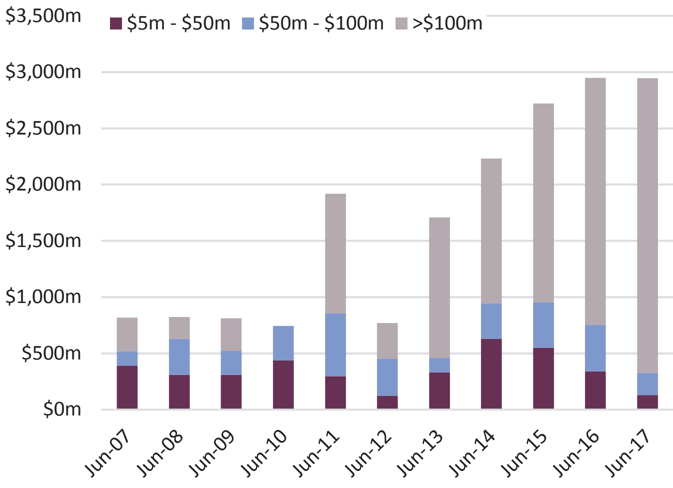
A shortage of prime assets offered for sale in a strong investment environment has translated to solid demand for assets currently under development. Four fund through transactions, amounting to $1.32 billion, have been recorded in the Melbourne CBD over the past year. Notable fund through transactions include ARA Asset Management's acquisition of a 50% stake in 477 Collins Street for $414 million (a development currently under construction by Mirvac) and Morgan Stanley's acquisition of a 50% share in 664 Collins Street for $138 million, which is to be held in Morgan Stanley's Prime Property Asia Fund.

In addition, Australia Post has divested its 50% holding of Cbus' 311 Spencer Street development to Keppel REIT for $347.8 million. The 42 level A-grade building, comprising 65,500 square metres of leasable area has been pre-committed by Victoria Police, Australian Crime Commission and Federal Police.

The steady rate of investment levels represent the lack of prime assets offered for sale, rather than plateaued investment appetite and a few transactions which were still under due diligence for the reporting period are yet to be added to total sales.

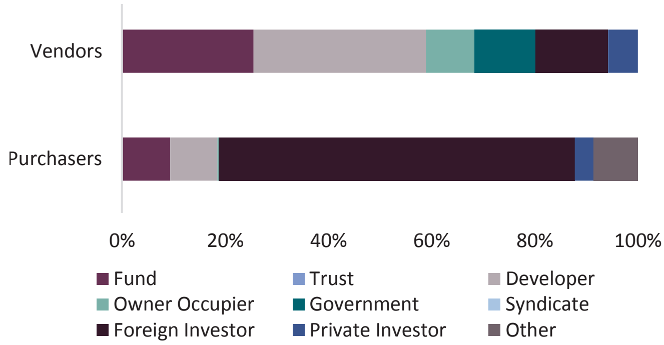
Yield compression has been evident over the last 12 months, with yields for Grade A assets tightening by 50 basis points on average, whilst secondary yields tightened by 35 basis points on average.

Sales Activity by Price (Melbourne CBD)



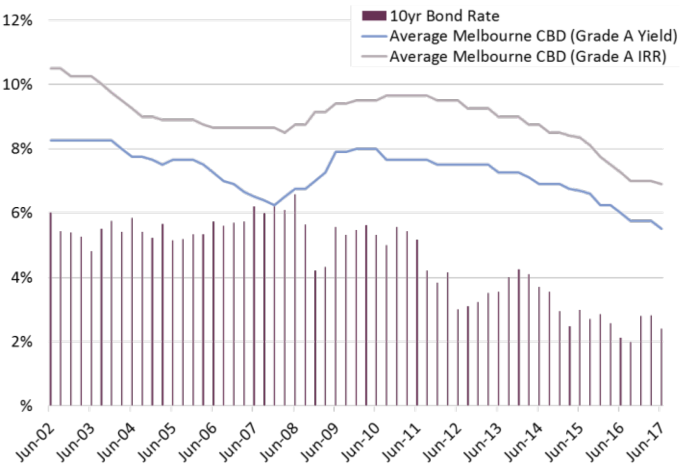
Source: Savills Research

Vendor & Purchaser Type



Source: Savills Research

Yield Spread to Bond & IRR – Melbourne CBD

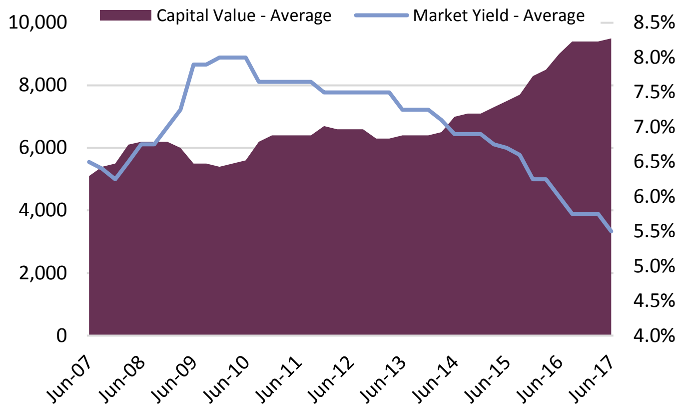


Source: Savills Research

Capital values in the Melbourne CBD as at June 2017 are estimated to range from $7,000 to $12,000 per square metre for Grade A buildings, and between $6,000 and $8,000 per square metre for secondary grade buildings. Average capital values for Grade A properties grew by 5.6% over the year.

Although the current market yields remain at record low levels, this coincides with historically low interest and 10-year bond rates, incentivising investors to seek a healthy return through property investment. Record low interest rates coupled with volatile global financial markets, led investors to select core office property as a solid investment asset class, further augmenting the capital values over the past year.

Cap Value vs. Market Yield



Source: Savills Research

Top 20 Sales

Property	Price ($m) | Date | NLA	Yield | Type | $/sq m
839 Collins St, Docklands	$425.00m | Jan-17 | 39,000	5.25 | i | $10,897
477 Collins St, Melbourne (50%)	$414.00m | Jun-17 | 55,000	4.75 | r | $15,055
311 Spencer St, Melbourne (50%)	$347.80m | Jun-17 | 65,500	n.a | n.a | $10,620
ANZ World Headquarters	$274.50m | Dec-16 | 36,605	5.06 | e | $7,499
World Trade Centre, Docklands	$267.50m | Feb-17 | 53,301	7.00 | i | $5,019
120 Spencer St	$165.20m | Mar-16 | 32,217	6.92 | e | $5,128
114 William St, Melbourne	$161.50m | Sep-16 | 21,022	5.75 | e | $7,682
Esso House, Melbourne	$160.00m | Dec-16 | 21,000	n.a | n.a | $7,619
380 La Trobe St, Melbourne	$157.00m | Jul-16 | 21,661	5.55 | e | $7,248
664 Collins St, Docklands (50%)	$138.00m | Jun-17 | 26,000	4.97 | r | $10,615
1 Collins St, Melbourne	$125.00m | Feb-16 | 9,450	5.25 | r | $13,228
RMIT Building, Melbourne	$75.60m | Nov-16 | 13,778	6.20 | e | $5,487
The Gauge, Docklands	$72.70m | Dec-16 | 10,384	6.13 | e | $7,001
50 Franklin St, Melbourne	$51.50m | Nov-16 | 11,447	n.a | n.a | $4,499
The Dominion, Melbourne	$35.25m | Mar-16 | 1,500	6.00 | r | $5,342
395 Collins St, Melbourne	$35.00m | Jul-16 | 5,781	5.79 | r | $6,054
247 - 249 Collins St, Melbourne	$35.00m | Apr-17 | 2,084	4.20 | r | $16,795
179 Bourke St, Melbourne	$33.00m | Mar-17 | 1,500	4.00 | r | $22,000
10-12 Collins St, Melbourne	$18.70m | Jun-16 | 705	n.a | n.a | $6,739
539-545 Flinders Ln, Melbourne	$18.50m | Jul-16 | 1,500	7.31 | r | $8,352

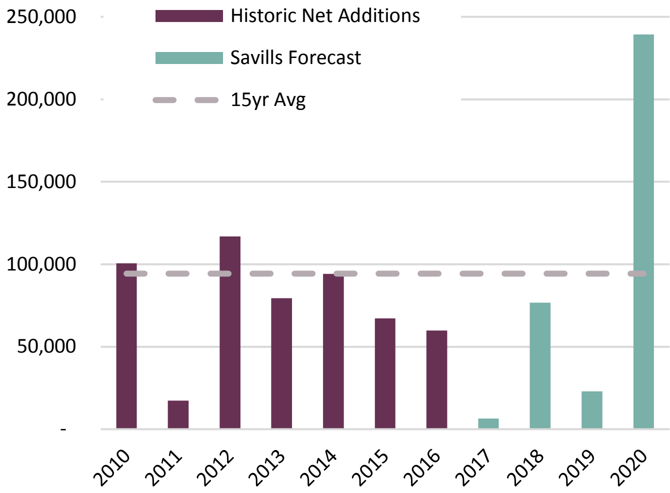
Yield Types: i = Initial, r = Reported, e = Equated, v = Vacant, dev = development
Source: Savills Research

Supply

Declining vacancy levels amidst a low interest rate environment has led to a spur of office development activity in Melbourne CBD. In recent years, the majority of the new office supply has been focused in the Docklands precinct with net additions of 92,000 square metres in the precinct over 2016 in Walker Corporation's – Tower 2 and Tower 4. At the same time, 76,494 square metres of office accommodation was withdrawn, of which 40,429 square metres was for refurbishment purposes.

The forecast supply for 2017 in the CBD includes the new development and partial refurbishment of Rialto Towers, refurbishments at 15 William Street, 161 Collins Street, 109 Flinders Lane and 95 Queen Street, all totalling 47,839 square metres of office accommodation. Future supply levels remain low until the new supply comes online in 2020-21.

Net Supply by Year



Source: Savills Research / PCA

Development

The table below details the major upcoming and planned development projects in the Melbourne CBD.

Building Address	Dev Stage	NLA	Exp. Comp	Tenants
Tower 5, 737 Collins Street, Collins Square	UC	40,000	2018	Transurban, Grant Thornton
One Melbourne Quarter	UC	26,400	2018	Arup, Lendlease
664 Collins Street	UC	23,200	2018	Pitcher Partners, Exxon
839 Collins Street	UC	38,000	2019	ANZ
271 Spring Street	UC	15,600	2019	Australian Unity
405 Bourke Street	UC	61,500	2020	NAB
80 Collins Street South Tower	UC	43,000	2020	Macquarie Group, Savills
477 Collins Street	UC	51,661	2020	Deloitte
447 Collins Street	UC	49,000	2020	King & Wood Mallesons, Gadens, HWL Ebsworth
311 Spencer Street	PS	65,000	2020	Vic Police, Fed Police, ACIC
130 Lonsdale Street	PA	55,000	2020	
Melbourne Quarter Tower	PA	55,000	2021+	
Two Melbourne Quarter	PS	49,000	2021+	

Source: Savills Research; UC = Under Construction, DA = Development Approved, EP = Early Planning, PS = Plans Submitted, PA = Plans Approved

Rents

Net effective rents in Melbourne CBD typically range from $360 to $560 per square metre per annum for premium assets, $355 to $455 per square metre for Grade A stock, and between $265 and $320 per square metre for B grade buildings.

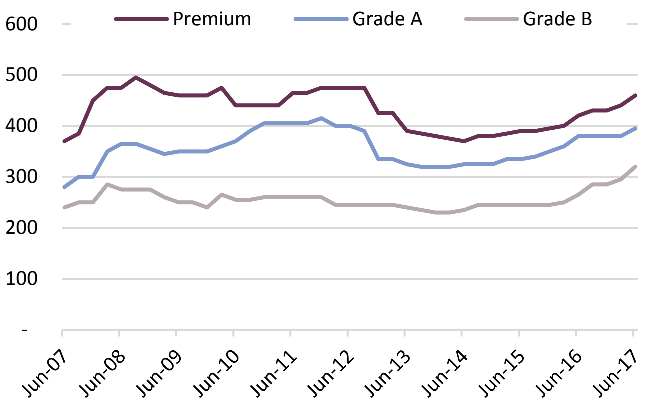
Average net effective rents in Melbourne CBD grew 3.9% over the year to June 2017, marginally more than net face rents, as a result of a fall in incentives. Average net effective rents for premium grade assets grew by 10%, whilst net effective rents for Grade A recorded a 4% increase over the current twelve month period. The highest growth over the past year was recorded for Grade B net effective, which rose by 21%.

Net effective rents in the Melbourne CBD are now witnessing cyclical upturn, recording the highest average rents for premium and Grade A assets since June 2012. This rental growth corresponds with tightening prime vacancy rates since June 2012. Interestingly, Grade B net effective rents are now at historical high levels.

Growth in net effective rents over the 4 years was as a result of a combination of growth in net face rents and falling incentive levels. Net incentive levels have fallen from the highest level of 31% (in June 2014) and now sit at about 27% for prime grade property.

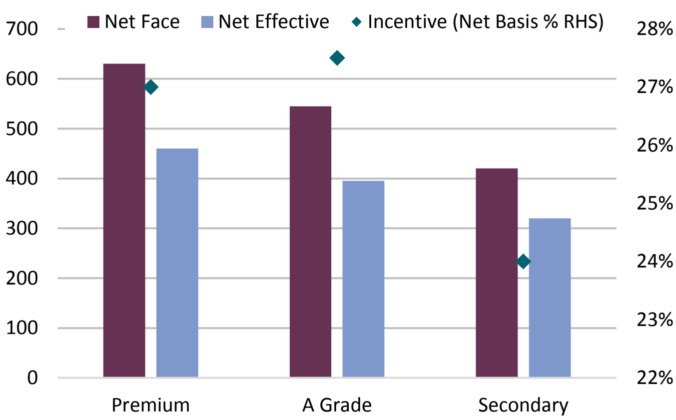
Looking forward, Savills Research expects marginal growth in rents over the next two years, with a stabilising effect thereafter, as nearly 250,000 square metres of supply comes online in the 2020-21 period.

Net Effective Rents by Grade ($/sq m)



Source: Savills Research

Net Face & Net Effective Rents (as at Jun-17)



Source: Savills Research

Outlook

Melbourne's standout demand performance is largely as a result of strong economic fundamentals in the Victorian economy. The Victorian economy leads the nation across a variety of economic indicators such as population growth, employment growth and economic growth. Forward looking drivers point to sustained strength on the demand side on the back of above average growth in employment metrics, particularly, strong full-time jobs growth and professional job advertisements. In addition, positive business and consumer sentiments (at their highest levels since the Global Financial Crisis) are likely to aid leasing activity over the next 12 months.

As overall tenant demand continues to remain strong, Savills Research expects pre-commitment led construction to drive new development activity over the next two years. Tenant migration to pre-committed stock is likely to affect backfill vacancy in the medium term. As a result, rental growth is expected to remain marginal, with incentives still at play, albeit at lower levels. Although the investment yields are now below their previous lows from pre GFC era, the current low interest rate environment still offers a considerable risk premium. With a 'lower for longer' outlook for interest and long term bond rates still at play, Savills Research expects this yield compression cycle to continue, though not at the levels seen over the last 2 years, with investment capital chasing expectations of future income growth.

As Melbourne CBD enters a new phase of development activity, Savills Research expect net supply to be muted over the next 2 years after which close to 250,000 square metres of developments will come online in 2020-21, which will have a stabilising impact on rents and currently falling incentive levels.

Melbourne CBD Key Indicators (Q2-17)

Melbourne CBD	Premium		A Grade		B Grade	
	Low	High	Low	High	Low	High
Rental – Gross Face ($/sq m)	680	955	655	765	530	585
Rental – Net Face ($/sq m)	490	765	490	600	390	445
Incentive Level Net	26%	28%	25%	30%	22%	26%
Rental – Net Effective ($/sq m)	360	560	355	435	300	340
Outgoings – Operating ($/sq m)	115	135	100	110	85	109
Outgoings – Statutory ($/sq m)	60	70	55	60	37	47
Outgoings – Total ($/sq m)	175	205	155	170	122	156
Typical Lease Term	6	10	5	8	3	7
Yield – Market (% Net Face Rental)	5.00	5.75	5.00	6.00	6.00	7.00
IRR (%)	6.75	7.00	6.75	7.00	7.00	7.50
Cars Permanent Reserved ($/pcm)	550	800	500	700	450	600
Cars Permanent ($/pcm)	450	600	450	600	420	500
Office Capital Values ($/sq m)	8,500	12,000	7,000	12,000	6,000	8,000

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

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