

Briefing Melbourne Fringe Office

April 2018



Highlights

- Ongoing permanent withdrawals for higher-use has led to contraction of total office stock in the St Kilda Road precinct (16%) over the last 14 years;
- Vacancy rate in the St Kilda Road precinct is at its lowest level since June 2008 led by permanent stock withdrawals and positive net absorption (for the first-time in three years);
- Prime and Secondary grade net effective rents are at historic high levels within the St Kilda Road precinct driven by rise in net face rents and fall in incentives,
- Capital values are now at record high levels driven by yield compression with A Grade market yields falling by 75 basis points from a year ago;
- Southbank had standout net absorption levels of all non-CBD markets across Australia.

A Grade Averages	Latest	Yr Change	Outlook
Rental – N.F. (\$/sq m)	450	+15.4%	↗
Incentives	19.5	-450bps	↘
Rental – N.E. (\$/sq m)	360	+22.0%	↗
Yield – Market (%)	5.90	-75bps	↘
IRR (%)	6.90	-35bps	↘
Capital Values (\$/sq m)	6,800	+19.3%	↗

Demand & Supply (St Kilda Rd)	Latest	PCP*
Vacancy (%)	7.2	-5.7
Net Absorb. ('000 sq m)	3.1	-24.7
Stock U/C ('000 sq m)	-	-
- % of market	-	-
- % committed	-	-

*PCP = Previous Corresponding Period

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Executive Summary

Melbourne CBD's fringe markets have performed well on the back of robust economic indicators in Victoria underpinning strong tenant demand. A limited supply profile in the St Kilda Road and Southbank precincts have been a feature of the market over the last five years as developers permanently withdraw stock for hotel and residential conversions. All major development projects currently under-way in both the St Kilda Road and Southbank markets are for residential use with no commercial developments earmarked for the area. Total stock levels in the St Kilda Road office market contracted 16% over the last 14 years to their record low levels, while Southbank saw highest levels of net additions (25,100 square metres) since January 2009.

Limited options, particularly in Prime grade stock, have tempered tenant activity over the year to December 2017. Melbourne's Fringe markets saw a higher rental and capital value growth compared to the CBD due to a shortage of stock.

PCA Summary Table – St Kilda Road & Southbank (as at Dec-17)

	St Kilda Road			Southbank			Aus Non-CBD
	Prime	Secondary	Total	Prime	Secondary	Total	
Total Stock ('000)	245.3	400.0	645.3	279.3	155.2	434.5	7,273.3
Total Vacancy ('000)	8.0	38.8	46.8	12.5	9.8	22.2	660.7
Vacancy (%)	3.2 (8.8)	9.7 (11.5)	7.2 (10.6)	4.5 (4.8)	6.3 (9.6)	5.1 (6.8)	9.1 (8.9)
Net Absorption ('000)	5.7 (.4)	-2.7 (-11.5)	3.1 (-11.1)	25.8 (7.6)	-6.3 (-3.1)	19.5 (4.6)	11.5 (57.6)
Net Absorption (%)	2.5 (0.2)	-0.7 (-2.7)	0.5 (-1.7)	10.7 (3.4)	-4.2 (-1.9)	5.0 (1.2)	0.2 (0.9)
Net Additions ('000)	0.0 (-0.6)	-38.6 (-10.5)	-38.6 (-11.1)	27.4 (8.7)	-2.3 (-2.7)	25.1 (5.9)	-36.5 (86.3)
- Stock Additions ('000)	-	-	-	27.4	3.1	30.5	102.5
- Stock Withdrawals ('000)	0.0	16.7	38.6	0.0	4.6	5.4	139.0
Net Additions (%)	0.0 (-0.2)	-8.8 (-2.3)	-5.6 (-1.6)	10.9 (3.8)	-1.5 (-1.6)	6.1 (1.5)	-0.5 (1.3)

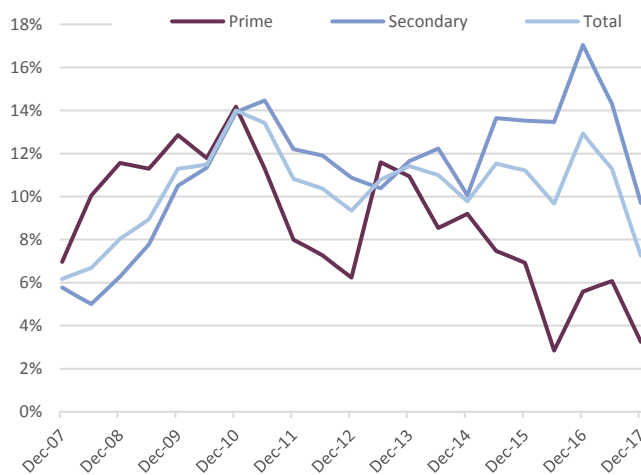
Source: Savills Research (10yr Averages shown in brackets; NB: Secondary Rents shown are for B grade; All rents equivalent to whole floor mid-rise)

Vacancy

Melbourne CBD's fringe markets (St Kilda Road and Southbank) recorded divergent performance in their vacancy trends. Vacancy levels in the St Kilda Road precinct were down from a historic high of 12.9% a year ago to 7.2% in December 2017, its lowest levels since June 2008. On the other hand, the vacancy rate in the Southbank precinct climbed up to 5.1% after recording the lowest vacancy rate nationally just six months ago. Falling stock levels resulting from permanent stock withdrawals have become a feature of Melbourne's Fringe markets, particularly in St Kilda Road, leading to a fall in incentives and record rise in rents. Sitting tenants have limited available relocation options within the St Kilda Road market, particularly for Prime grade category having the lowest vacancy rate of 3.2% on record.

With no new developments in the pipeline for St Kilda Road and Southbank, Savills Research expects further falls in the vacancy rates across Melbourne's Fringe markets over the short to medium term.

Historic Vacancy (St Kilda Road)



Source: PCA / Savills Research

Historic Vacancy (Southbank)



Source: Savills Research

Supply

Permanent withdrawals for other uses, resulting in falling stock levels, have become an ongoing trend of Melbourne's Fringe markets. While office stock levels in St Kilda Road are now at record low levels, Southbank precinct saw a rise in stock for the first time since 2011. Over the year to December 2017, St Kilda Road saw 14,872 square metres of office space permanently withdrawn from the precinct, while Southbank withdrawals totalled 2,300 square metres. Withdrawals from both precincts were all for residential conversions offering higher use.

Having peaked in 2004, office stock levels in the St Kilda Road precinct have fallen by 16% (125,086 square metres) over the past 14 years. In addition to this trend of permanent withdrawals in the St Kilda Road office market, development activity has been practically non-existent since the redevelopment of 1 Queens Road in January 2004.

In contrast, the Southbank office market saw net additions of 27,400 square metres in 12 months to December 2017, led by the completion of Australian Broadcasting Corporation's head office at 102 Sturt Street. There are no new imminent developments in Melbourne's Fringe markets over the next two years. At the same time, stock levels in the St Kilda Road and Southbank precincts will continue to constrain further with withdrawals for non-office developments.

Leasing Activity & Demand

Over the year to March 2018, Savills Research recorded 30,508 square metres of leasing activity in Melbourne’s Fringe markets (across St Kilda Road and Southbank). Leasing volume is up 67% from the 12 months prior but below the 10-year average (56,208 square metres). Leasing activity increased over the previous 12 months driven by the take-up in Southbank precinct.

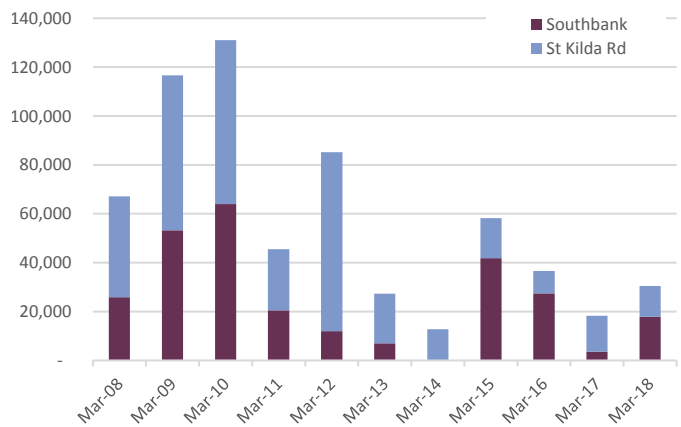
Looking at leasing volume by grade, Grade A leases were the most numerous with 19,973 square metres leased over the 12 months to March 2018. All of the prime grade leases were within the Southbank precinct.

Of the total space leased in Melbourne’s CBD Fringe markets in the last 12 months, tenants from the Property & Business Services industry were the most dominant tenant category leasing 40.9% of the total stock. Most notable Grade A lease from the sector included Tract Consultants’ direct lease at 6 Riverside Quay (1,360 square metres) in the Southbank precinct. In addition, the largest lease in the CBD fringe market was Carlton & United Breweries (6,500 square metres) Grade A lease at 2 Southbank Boulevard in Southbank.

Property and Business Services tenants were also active in the Secondary grade office space through 2017. Recent leasing transactions in the Secondary grade space include Macquarie Leasing’s 1,720 square metres lease at 464 St Kilda Road, The Smart Group, and Crawford and Company both leasing 1,836 square metres of office space respectively at 324 St Kilda Road.

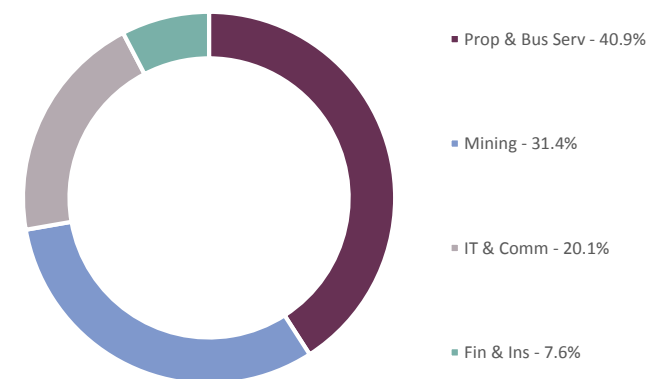
‘Direct’ leases accounted for 69% of total leasing activity with the balance coming from lease renewals. ‘Direct’ leases were up 45% from the previous year accounting for 20,002 square metres of leasing activity recorded over 12 months to March 2018.

Leasing Activity by Precinct (> 500 square metres)



Source: Savills Research

Leasing Activity by Tenant Type (> 500 square metres)



Source: Savills Research

Recent Notable Leases (by Area Leased)

Tenant	Property	Date NLA	Type Rent Term
Carlton & United Breweries	2 Southbank Bvd, Southbank	Feb-18 6,500	Direct 800 (G) 10
Toll Holdings	464 St Kilda Rd, Melbourne	Sep-17 2,843	Direct 270 (N) n.a.
Crawford & Company	324 St Kilda Rd, Melbourne	Jul-17 1,836	Direct 450 (G) n.a.
The SMART Group	324 St Kilda Rd, Melbourne	Jul-17 1,836	Direct 423 (G) 5
Adecco Group	28 Freshwater Pl, Southbank	Sep-17 1,780	Renewal 520 (N) 8
Macquarie Leasing	464 St Kilda Rd, Melbourne	Jul-17 1,720	Direct n.a n.a.
Tract Consultants	6 Riverside Quay, Southbank	May-17 1,360	Direct n.a 9
Sodexo	607 St Kilda Rd, Melbourne	Nov-17 1,300	Renewal 300 (N) 6
Sterling Group	70 City Rd, Southbank	Aug-17 600	Direct 400 (N) 3

Source: Savills Research

Sales

Savills Research recorded \$633 million in sales volume across nine properties in the 12 months to March 2018. Falling by 53% from the record sales 12 months prior, relatively muted sales activity in 2017 was a result of lack of investment properties offered for sale in the Fringe markets, while the competing CBD market presented numerous lucrative options for investment. Also, majority of the transactions were recorded for St Kilda Road precinct, while Southbank market offered only three properties for sale over the year to March 2018 period. Reported sales over the past year were 32% above the 10-year average.

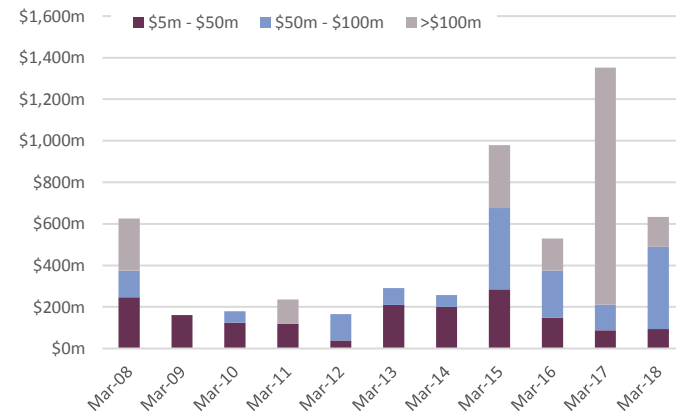
Foreign Investors remained the most dominant purchaser type, accounting for 77% of all sales in the year to March 2018, purchasing six of the nine properties sold in the past 12 months. Notable transactions by Foreign Investors include Mapletree's purchase of 417 St Kilda Road for \$144.4 million in August 2017 from Newmark Capital, Rockworth Capital Partners' acquisition of 390 St Kilda Road for \$97.85 million and Tong Eng Group's purchase of 312 St Kilda Road.

In a latest sale and lease-back deal Development Victoria, purchased Carlton United Breweries head quarter for \$95 million in the Southbank. The owner has a three year lease lease-back arrangement, allowing the state government body to formulate plans for the site.

In recent years, the rising levels of inner city apartment developments have led to developers purchasing office buildings for higher use. Vantage Property Group on behalf of KKR acquired 420 St Kilda Road for \$68.8 million with future redevelopment potential. Also, Rockworth Capital Partners' purchase of 390 St Kilda Road is for a likely medium-term residential/hotel conversion. The yield compression cycle has continued for the past seven years (since December 2010) with yields for Grade A assets tightening by 75 basis points on average over the year, while Secondary yields tightening was more pronounced at 125 basis points on average, mainly due to lack of stock offered for sale.

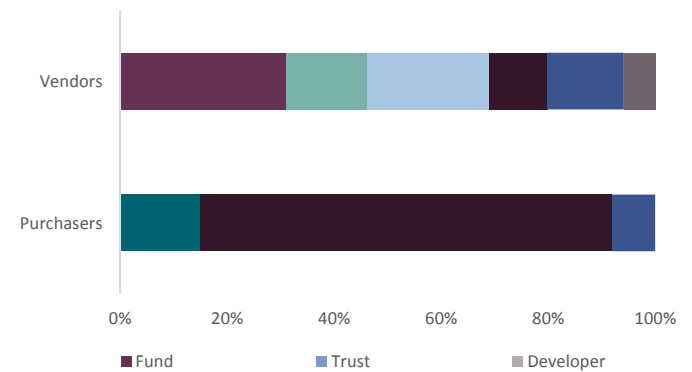
While current market yields remain at record low levels, this coincides with historically low-interest rates and 10-year bond yields, incentivising purchasers to seek a healthy return on property investment. Capital values estimated in the St Kilda Road range from \$5,500 to \$8,000 per square metre for Grade A buildings and between \$5,000 and \$6,000 per square metre for Grade B buildings in March 2018. Average capital values for Grade A properties grew by 19% over the year, while Grade B properties rose by 15% in the same period.

Sales Activity by Size (> \$5 million)



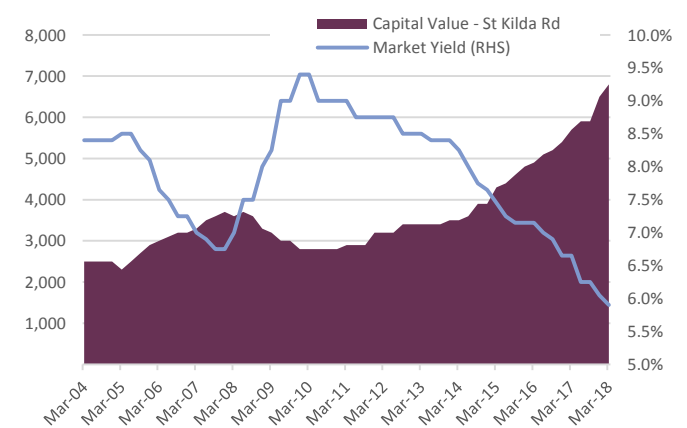
Source: Savills Research

Vendor & Purchaser Type (> \$5 million)



Source: Savills Research

Capital Values (\$/sq m) vs. Market Yield



Source: Savills Research

Recent Notable Sales (by Sale Price)

Property	Price (\$m) Date NLA	Yield Type \$/sq m
417 St Kilda Rd, Melbourne	144.40 Aug-17 20,135	6.11 e 7,172
390 St Kilda Rd, Melbourne	97.85 Aug-17 16,307	6.18 e 6,000
Carlton United Breweries HQ, Southbank	95.00 Feb-18 11,679	n.a n.a. 8,134
312 St Kilda Rd, Melbourne	77.00 Nov-17 10,000	4.66 r 7,700
606 St Kilda Rd, Melbourne	57.50 Feb-18 8,647	n.a n.a. 6,650
420 St Kilda Rd, Melbourne	68.84 Jun-17 10,459	6.02 e 6,582
324 St Kilda Rd, Melbourne	42.00 Oct-17 7,102	5.98 e 5,914
10-16 Dorcas St, Southbank	37.00 Jun-17 7,567	6.50 r 4,890
1 Bowen Cst, South Melbourne	14.00 Oct-17 2,695	4.00 r 5,195

Source: Savills Research

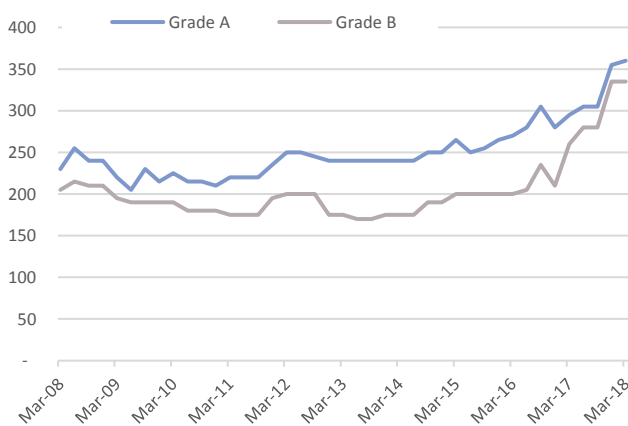
Rents

Permanent office stock withdrawals combined with a lack of substantial new supply additions since January 2004 have led to declining vacancy rates in Melbourne's Fringe markets. Falling stock levels have limited tenant migration within the Fringe precincts, leading to positive net face rental growth in both Prime and Secondary grade buildings.

Net effective rents in the St Kilda Road precinct are now at historically high levels ranging from \$340 to \$380 per square metre per annum for Grade A stock and between \$320 to \$345 per square metre for Grade B buildings. Average Grade A Net effective rents grew 22% over the 12 months to March 2018.

Incentives are likely to fall further, in turn, boosting rental rates resulting from limited availability of office space, particularly for Prime accommodation. Higher rents within the already tight market are likely to constrain tenant migration, with tenants preferring lease renewal compared to relocation.

Net Effective Rents by Grade - St Kilda Rd (\$/sq m)



Source: Savills Research

Net Face & Net Effective Rents – St Kilda Rd (as at Mar-18)



Source: Savills Research

Outlook

Over the 12 months to December 2017, Melbourne's Fringe markets saw a permanent withdrawal of approximately 13,500 square metres of office stock for residential conversions offering higher use. In near term, Savills Research expects this ongoing withdrawal trend to slow down, impeded by the decelerating apartment developments. Additionally, planning control changes around the St Kilda Road precinct, combining height restrictions and building setbacks influencing the plot area ratios, will likely curb potential residential conversion over the medium term.

Strong tenant demand is likely to extend across the St Kilda Road and Southbank precincts from Melbourne CBD as its vacancy rate further falls from its current lowest rate nationally. Additionally, the outlook of constrained supply over 2018-19 is expected to drop vacancy rates in the Fringe markets. Incentive levels are likely to fall further, in turn, boosting rents resulting from the limited availability of office space. Rental growth is expected to be distinct in the Prime office accommodation. Tight vacancy levels and rising rents are likely to limit tenant migration, with tenants favouring lease renewal compared to relocation.

Victoria leads Australia in population growth and economic growth rates. Forward-looking drivers point to sustained office demand resulting from all of the macroeconomic metrics, particularly strong full-time jobs growth, and professional job advertisements. Besides, favourable business conditions (above the series average) are likely to translate into positive leasing activity over the next 12 months. Continued improvement to the public transport network (Metro Tunnel project) may renew interest from developers for office developments in the CBD Fringe precincts over the medium to longer term.

Melbourne Fringe markets, which still offer a notable spread compared to the CBD market will continue to remain attractive investment destination for purchasers. Although the investment yields are now at historically low levels corresponding to the low-interest rates on record, this still offers to cushion against the long-term bond yields. RBA's recent meeting suggested a continuance of the current monetary policy, upholding interest rates for most of 2018 period. Due to the lower interest rates and long-term bond yields outlook, Savills Research anticipates the yield compression cycle to continue with purchasers pursuing future rental growth as an alternative to substantial capital gain rises.

The US Federal Reserve System raised its benchmark interest rates in March 2018, and has a forecast for further two rate hikes over the course of 2018. As interest rates rise in the competing global markets such as the US and lift yields, Australian markets - especially Melbourne Fringe precincts offering lower yields will remain an attractive investment destination for foreign buyers.

St Kilda Road Key Indicators (as at Mar-18)

St Kilda Road	A Grade		B Grade	
	Low	High	Low	High
Rental - Gross Face (\$/sq m)	545	595	500	535
Rental - Net Face (\$/sq m)	425	475	385	420
Incentive Level Net	17%	22%	15%	20%
Rental - Net Effective (\$/sq m)	340	380	320	345
Outgoings - Operating (\$/sq m)	65	75	60	70
Outgoings - Statutory (\$/sq m)	50	50	45	50
Outgoings - Total (\$/sq m)	115	125	105	120
Typical Lease Term	3	6	3	5
Yield - Market (% Net Face Rental)	5.75	6.10	6.00	6.25
IRR (%)	6.75	7.00	7.00	7.25
Cars Permanent Reserved (\$/pcm)	300	330	280	320
Office Capital Values (\$/sq m)	5,500	8,000	5,000	6,000

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

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