Savills Research

Briefing
Melbourne Fringe Office

August 2017

Highlights

- The Southbank office market recorded the nation's lowest vacancy rate at 3.3%, which was also the lowest it has been since July 2008;
- Ongoing permanent withdrawals of office stock in the St Kilda Road precinct has led to total stock contracting 15% over the last 13 years;
- Strong rental growth was evident in the St Kilda Road office market with net effective rents growing 8.9% over the year to June 2017;
- Investment activity was the strongest on record with $1.42 billion transacted over FY-17;
- A Grade market yields fell 75 basis points from a year ago with an outlook of further compression.

A Grade Averages	Latest	Yr Change	Outlook
Rental – N.F. ($/sq m)	390	+5.4%	↗
Incentives	21.5	-250bps	↙
Rental – N.E ($/sq m)	305	+8.9%	↗
Yield – Market (%)	6.25	-75bps	↙
IRR (%)	7.25	-50bps	↙
Capital Values ($/sq m)	5,900	+15.7%	↗

Demand & Supply (St Kilda Rd)	Latest	PCP*
Vacancy	11.3	9.7
Net Absorb. ('000 sq m)	-27.8	-15.0
Stock U/C ('000 sq m)	0	0
- % of market	n/a	n/a
- % committed	n/a	n/a

*PCP = Previous Corresponding Period

Report Contents

For our latest national reports, visit
savills.com.au/research

To join the Savills Research mailing list, please email
research@savills.com.au

Executive Summary

Melbourne CBD's fringe markets have performed well on the back of strong 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 5 years as developers permanently withdraw stock for hotel and residential conversions. Tellingly, 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 Southbank are currently at their lowest levels since 2008, whilst total stock levels in the St Kilda Road office market contracted 15% over the last 13 years.

Whilst the St Kilda Road and Southbank office markets provide an affordable alternative to the neighbouring CBD, limited options, particularly in Southbank means that tenant activity has been largely muted over the last 12 months to June 2017. Growth in rents and capital values was even more pronounced in Melbourne CBD's fringe markets, compared to the CBD across both prime and secondary grade stock.

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

	St Kilda Road			Southbank			Aus Non-CBD
	Prime	Secondary	Total	Prime	Secondary	Total	
Total Stock ('000)	245.3	422.0	667.3	248.3	152.9	401.1	**7,263.4**
Total Vacancy ('000)	14.9	60.3	75.2	7.9	5.5	13.4	**690.9**
Vacancy (%)	6.1 (9.0)	14.3 (11.3)	11.3 (10.5)	3.2 (4.6)	3.6 (9.5)	3.3 (6.7)	**9.5 (8.6)**
Net Absorption ('000)	-7.9 (0.3)	-19.8 (-10.7)	-27.8 (-10.4)	2.6 (5.1)	-2.6 (-2.1)	0.0 (3.0)	**-1.9 (92.7)**
Net Absorption (%)*	-3.3 (0.1)	-5.2 (-2.6)	-4.5 (-1.6)	1.1 (2.4)	-1.7 (-1.3)	0.0 (0.8)	**0.0 (1.5)**
Net Additions ('000)	0.0 (-0.6)	-18.9 (-8.9)	-18.9 (-9.4)	-0.6 (5.6)	-6.9 (-2.8)	-7.5 (2.7)	**2.3 (125.7)**
– Stock Additions ('000)	-	-	-	22.4	-	22.4	**168.8**
– Stock Withdrawals ('000)	0.0	18.9	18.9	23.0	6.9	29.9	**166.5**
Net Additions (%)	0.0 (-0.2)	-4.3 (-1.9)	-2.8 (-1.3)	-0.2 (2.6)	-4.3 (-1.7)	-1.8 (0.7)	**0.0 (1.9)**

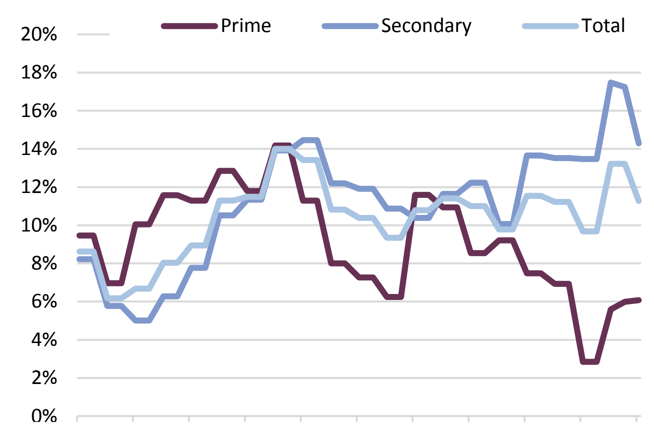
Source: PCA / Savills Research (10yr Averages shown in brackets); *As a percentage of occupied stock

Vacancy

Vacancy rates remained highly divergent in Melbourne's fringe markets. Although falling from a historic high of 12.9% in December 2016, vacancy rates in the St Kilda Road precinct remained high at 11.3% in June 2017. On the other hand, vacancy rates in the Southbank precinct continued their downward trend recording the lowest vacancy rate nationally at 3.3% in June 2017. Falling stock levels as a result of permanent stock withdrawals have become a feature of Melbourne's fringe markets, leading to rising rents and falling incentives. This has led to sitting tenants with limited available relocation options within the market.

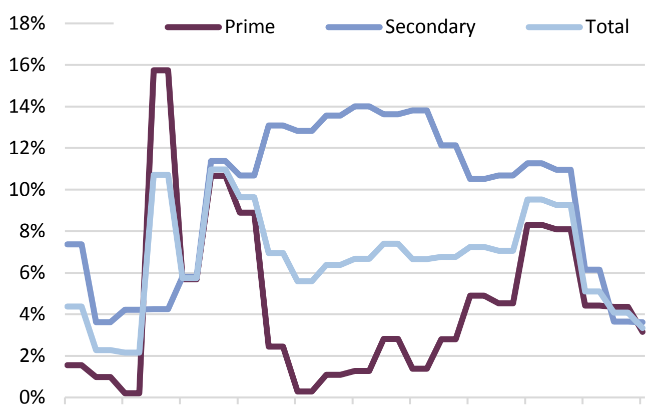
With no new developments in the pipeline for St Kilda Road and Southbank, Savills Research expects further falls in the vacancy rates across Melbourne's fringe markets over the short to medium term.

Historic Vacancy (St Kilda Road)



Source: PCA / Savills Research

Historic Vacancy (Southbank)



Source: Savills Research

Supply

Falling stock levels have become a feature of Melbourne's fringe markets as a result of permanent withdrawals associated with hotel and residential conversions. Office stock levels in St Kilda Road are now at their lowest levels on PCA records whilst in the Southbank precinct, they are at their lowest levels since 2008. Over the 12 months to June 2017 alone, 18,900 square metres of office space was permanently withdrawn in St Kilda Road and 6,900 square metres in Southbank for either residential or hotel conversions offering higher use.

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 leading to office stock levels in the precinct to contract by nearly 15% (103,000 square metres) over the last 13 years.

Whilst development activity has been muted in the Southbank office market, in the 12 months to June 2017, two new buildings were added for the first time since the completion of Twenty8 Freshwater Place in January 2009. Mirvac's completion of 2 Riverside Quay added 21,003 square metres of A Grade office space to the market earlier this year. More recently, Australian Broadcasting Corporation completed 102 Sturt Street, adding 30,000 square metres to the market.

Looking ahead, there are no new upcoming developments Melbourne's fringe markets over the next 2-3 years. At the same time, continued withdrawals for non-office developments are likely to further constrain stock levels in the St Kilda Road and Southbank precincts.

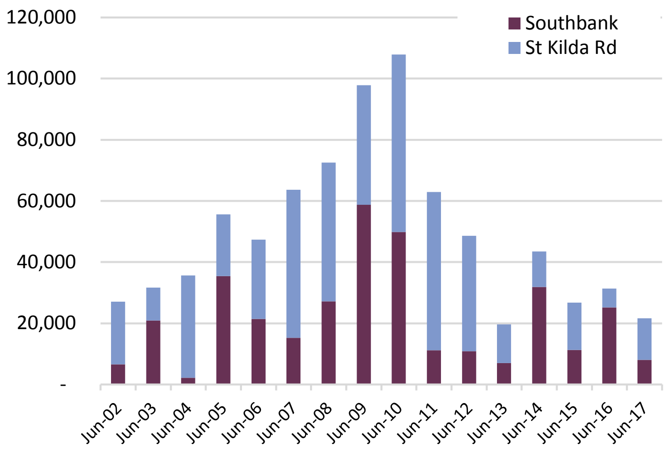
Leasing Activity & Demand

In the 12 months to June 2017, Savills recorded 21,619 square metres of leasing activity in Melbourne's fringe markets (across St Kilda Road and Southbank). This is down 31% on the 12 months prior and down 60.1% on the 10 year average (54,225 square metres). A flight to quality was evident, as limited availability of options within the fringe markets, particularly in the St Kilda Road precinct, led some tenants to relocate to the CBD. Most notably, Tabcorp moved its headquarters from 5 Bowen Crescent in St Kilda Road to take-up 9,213 square metres of prime office space in Walker Corporation's Collins Square building in Docklands. Looking at leasing volume by grade, A Grade leases were the most numerous with 11,845 square metres leased over the 12 months to June 2017. Contrary to tenants moving away from older stock in St Kilda Road, the Southbank market successfully retained a major tenancy within the precinct, PriceWaterhouse Coopers relocated to its pre-committed office space at 2 Riverside Quay from Twenty8 Freshwater Place within Southbank.

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, leasing 56.4% of total stock (12,192 square metres). Notable leases from the sector include Parsons Brinckerhoff's lease at Twenty8 Freshwater Place (5,310 square metres) and Tract Consultants' lease at 6 Riverside Quay (1,360 square metres), both in the Southbank precinct.

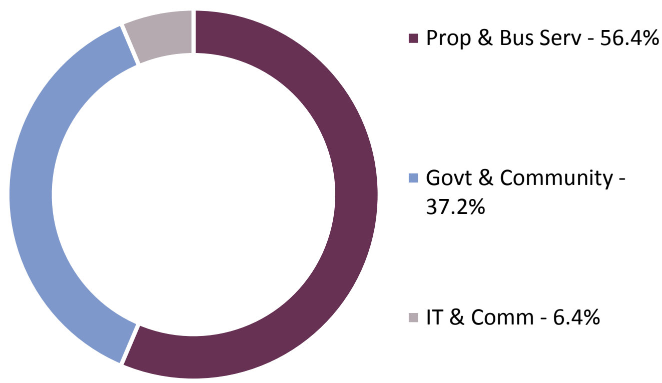
The largest leasing transaction recorded for the St Kilda Road precinct was Monash University's 8,052 square metres lease at 553 St Kilda Road. The education provider occupied six lower levels at the building to accommodate Health Science focused academic research and administration staff.

Leasing Activity by Precinct (Melbourne Fringe)



Source: Savills Research

Leasing Activity by Tenant Type (Melbourne Fringe)



Source: Savills Research

Top Recent Leases (by Area Leased)

Tenant	Property	Date | NLA	Type | Rent | Term
Monash University	553 St Kilda Rd, Melbourne	Jul-16 | 8,052	Direct | 255-290 (N) | 10
Parsons Brinckerhoff (WSP)	28 Freshwater Pl, Southbank	Nov-16 | 5,310	Direct | 485 (N) | 6
WPP	380 St Kilda Rd, Melbourne	Feb-17 | 3,800	Renewal | n.a | 5
Big Red Communications Group	464 St Kilda Rd, Melbourne,	Dec-16 | 1,722	Direct | n.a | n.a.
VM Ware	2 Southbank Bvd, Southbank	Dec-16 | 1,375	Direct | n.a | 7
Tract Consultants	6 Riverside Quay, Southbank	May-17 | 1,360	Direct | n.a | 9

Source: Savills Research

Sales

Savills recorded $1.42 billion across 10 sales over the 12 months to June 2017 setting a new record in Melbourne CBD's fringe markets as investors look for affordable options away from the CBD. Reported sales over FY-17 were 212% above the 10-year average ($456 million).

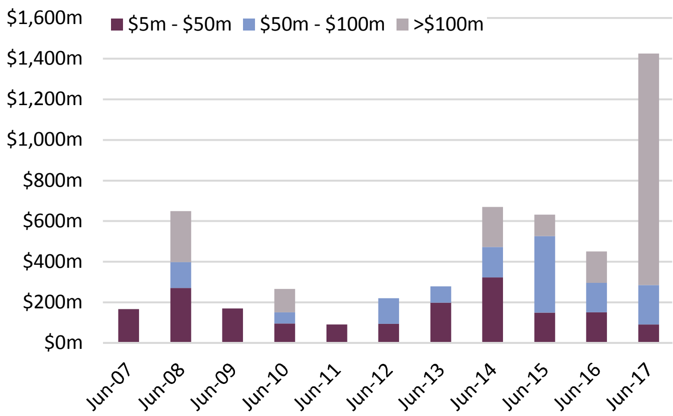
Foreign investors remained the most dominant purchaser type, accounting for 85% of all sales in the year to June 2017, with a relatively low Australian Dollar (compared to its peak in March 2013), coupled with relative affordability underpinning demand in Melbourne CBD's fringe markets. Notable transactions by foreign investor include ARA Asset Management's purchase of Southgate Complex for $578 million in August 2016, making it the largest commercial property transaction for Melbourne office markets over the past year as well as, JP Morgan's acquisition of Twenty8 Freshwater Place, Southbank for $286 million and Frasers Property Group's purchase of 12 Riverside Quay. While setting new benchmarks for both yields and capital values, all three sales were A-grade assets located along the promenade in the Southbank precinct, and all offered premium water-views combined with proximity to the CBD, the art precinct, and the Crown casino complex.

In recent years, the rising scale of inner city apartment developments has led to developers purchasing office buildings for future residential development. Singaporean developer Tong Eng Group's recent purchase of 5 Queens Road for $116.3 million for a likely medium term residential conversion, is indicative of renewed interest in the market for residential developments.

Yield compression over the last 12 months to June 2017 in the St Kilda Road precinct saw A Grade yields tightening by 75 basis points, whilst secondary yields compressed by 35 basis points on average over the same period. Whilst 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.

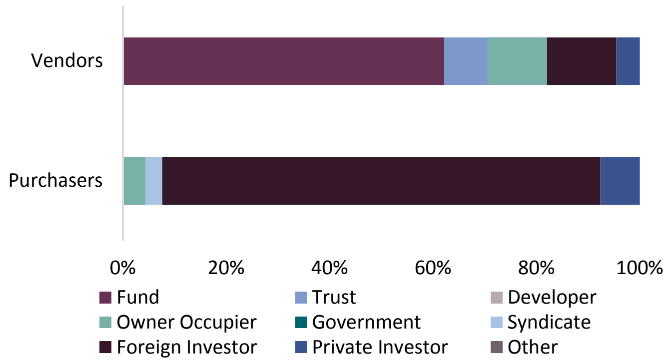
Capital values in the St Kilda Road market as at June 2017 are estimated to range from $5,000 to $6,750 per square metre for A Grade buildings and between $4,500 and $5,500 per square metre for secondary grade buildings. Average capital values for A Grade properties grew by 15.7% over the year.

Sales Activity by Price (Melbourne Fringe)



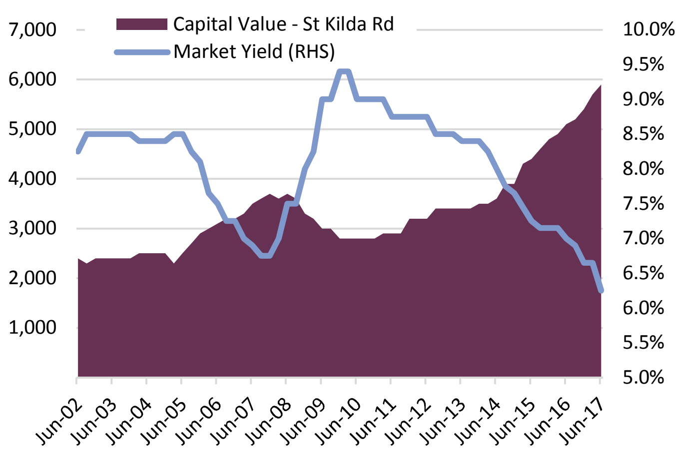
Source: Savills Research

Vendor & Purchaser Type (Melbourne Fringe)



Source: Savills Research

Cap Values ($sq m) vs. Market Yield



Source: Savills Research

Top 10 Sales (Melbourne Fringe)

Property	Price ($m) | Date | NLA	Yield | Type | $/sq m
Southgate Complex	578.00 | Aug-16 | 76,266	6.10 | e | 7,579
28 Freshwater Pl, Southbank	286.00 | Aug-16 | 33,520	5.96| e | 8,532
12 Riverside Quay, Southbank	160.00 | Dec-16 | 21,000	n.a | n.a | 7,619
5 Queens Road	116.30 | Oct-16 | 17,499	6.50 | e | 6,646
533 St Kilda Rd, Melbourne	70.00 | Nov-16 | 10,316	6.00| e | 6,786
420 St Kilda Rd, Melbourne	68.84 | Jun-17 | 10,459	n.a | n.a | 6,582
457 St Kilda Rd, Melbourne	55.00 | Oct-16 | 9,518	n.a | n.a | 5,779
541 St Kilda Rd, Melbourne	47.75 | Nov-16 | 8,246	6.61 | e | 5,791
Hertz Building	37.00 | Jun-16 | 7,567	6.5 | r | 4,890
19-25 Raglan St, South Melbourne	7.00 | Aug-16 | 1,689	n.a | n.a | 4,144

Source: Savills Research

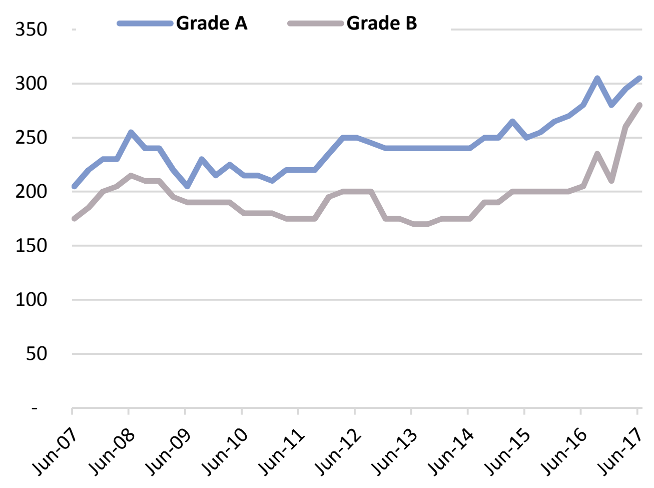
Rents

A lack of significant new stock additions since January 2004 in conjunction with permanent office stock withdrawals have led to falling vacancy rates in Melbourne CBD's fringe markets. Falling stock levels have meant that tenants have fewer options for moving, giving landlord's the upper hand, leading to positive net face rental growth for both prime and secondary grade assets.

Net effective rents in the St Kilda Road precinct are now at historically high levels ranging from $275 to $335 per square metre per annum for A Grade stock and between $250 and $310 per square metre for B Grade buildings. Average A Grade net effective rents grew 9% over the 12 months to June 2017 with growth for B Grade net effective rents even more pronounced at 27%.

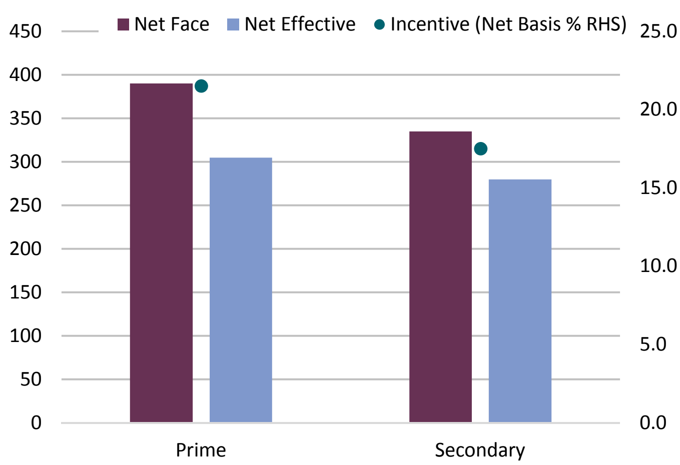
Rising rents and falling incentives in the Southbank precinct have meant that current tenants now have limited relocation options available within the already tight market and are thus likely to opt for lease renewals on favourable terms, rather than looking for alternative space in the more expensive CBD.

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



Source: Savills Research

Net Effective Rents by Grade - St Kilda Rd (as at June-17)



Source: Savills Research

Outlook

Over the 12 months to June 2017 approximately 25,000 square metres of office stock was permanently withdrawn from Melbourne CBD's fringe markets for either residential or hotel conversions offering higher use. Looking forward, Savills Research expects this trend to continue within the CBD Fringe markets, albeit at a lower rate. Recent planning control changes around the St Kilda Road market, including a mix of height limits and building setbacks impacting the plot area ratios, will likely curtail potential residential conversion over the short to medium term.

Improving tenant demand and a lack of new upcoming supply over the next 12-24 months will lead to further falls in vacancy rates across the St Kilda Road and Southbank precincts. Limited available office space within both precincts, combined with continued contractions in total office stock is expected to encourage rental growth, especially for prime office stock.

Looking further ahead, Melbourne's strong population growth forecast (underpinning white collar employment growth) combined with continued improvements to infrastructure (for example, an enhanced public transport network) is likely to renew interest from developers for office developments in the CBD Fringe precincts over the medium to longer term.

Whilst investor interest for quality grade assets in St Kilda Road and Southbank is anticipated to remain strong, a shortage of assets available for sale are likely to constrain investment activity levels. Although investment yields are now below their previous lows from the pre-GFC era, the current low-interest rate environment still offers a considerable risk premium. Savills Research expects the current yield compression cycle to continue in the short to medium term as CBD fringe assets remain attractive to many investors seeking a greater risk premium spread over both CBD yields and 10-year government bond rates.

St Kilda Road Key Indicators (as at Jun-17)

St Kilda Road	A Grade		B Grade	
	Low	High	Low	High
Rental – Gross Face ($/sq m)	460	535	405	475
Rental – Net Face ($/sq m)	350	425	300	370
Incentive Level Gross	19%	24%	15%	20%
Rental – Net Effective ($/sq m)	275	355	250	310
Outgoings – Operating ($/sq m)	55	70	50	65
Outgoings – Statutory ($/sq m)	45	50	45	50
Outgoings – Total ($/sq m)	100	120	95	115
Typical Lease Term	3	6	3	5
Yield – Market (% Net Face Rental)	6.00	6.50	6.75	7.50
IRR (%)	7.00	7.50	7.25	7.75
Cars Permanent Reserved ($/pcm)	300	330	280	320
Cars Permanent ($/pcm)	5,000	6,750	4,500	5,500
Office Capital Values ($/sq m)	460	535	405	475

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

Key State Contacts

Research
Monica Mondkar
+61 (0) 3 8686 8086
mmondkar@savills.com.au

Project Management
David Hayden
+61 (0) 3 9445 6806
dhayden@savills.com.au

Valuations
Trent Preece
+61 (0) 3 8686 8097
tpreece@savills.com.au

CBD & Metro Sales
Clinton Baxter
+61 (0) 3 8686 8021
cbaxter@savills.com.au

Office Leasing
Mark Rasmussen
+61 (0) 3 8686 8010
mrasmussen@savills.com.au

Asset Management
Phillip McLoughlin
+61 (0) 3 8686 8094
pmcloughlin@savills.com.au

The Savills Research & Consultancy team has years of experience, and is supported by our extensive agency, property management and valuation professionals. For national-level consultancy or subscription requirements please contact:

Capital Strategy & Research
Chris Freeman
+61 (0) 2 8215 6093
cfreeman@savills.com.au

Savills is a leading global property service provider listed on the London Stock Exchange. Trusted since 1855, we have extensive experience across the Asia Pacific, with over 50 offices, and in Australia, we have over 800 staff focused on meeting all your property needs.

savills