Briefing
Melbourne Fringe Office

August 2018

Highlights

- Withdrawal of stock for conversion has previously contributed to the tightening vacancy rate, however there are signs that this is beginning abate with St Kilda Road and Southbank recently recording a rise in the headline vacancy rate in the six months to June 2018;
- Tenant demand amidst moderating supply fundamentals continues to drive to significant rental growth - Average A grade net effective rents are showing an increase of 19.1% in the 12 months to June 2018;
- Offshore investment continues to drive transaction volumes in the St Kilda Road and Southbank precincts, accounting for more than 60% of acquisitions in the last 12 months;
- Average Grade A yields are pass their 10-year lows, indicative of low vacancy rates and tenant demand.

A Grade Averages	Latest	Yr Change	Outlook
Rental – N.F. ($/sq m)	450	+15.4%	↗
Incentives	19.0	-225bps	↙
Rental – N.E ($/sq m)	365	+19.7%	↗
Yield – Market (%)	5.90	-35bps	↙
IRR (%)	6.90	-35bps	↙
Capital Values ($/sq m)	6,750	+15.3%	↗

Demand & Supply (St Kilda Rd)	Latest	PCP*
Vacancy (%)	7.4	11.3
Net Absorb. ('000 sq m)	13.9	-27.8
Stock U/C ('000 sq m)	-	-
- % of market	-	-
- % committed	-	-

*PCP = Previous Corresponding Period

Report Contents

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Executive Summary

Strong economic indicators and forward drivers such as job advertisements continue to underpin solid gains in the Fringe markets, with buoyant tenant demand amidst moderating supply fundamentals leading to significant rental growth.

A limited supply profile in the St Kilda Road and Southbank precincts has been a feature of the market over the last five years as developers permanently withdraw stock for hotel and residential conversions. Tenant demand and limited Prime options has led to a decline in the headline vacancy rate and contributed to significant rental growth over the same period. In addition to stock being withdrawn for residential conversion, there has been some repositioning of existing stock through refurbishment, however this supply is only just returning to the market resulting in a rise in the vacancy rates recently.

These supply improvements combined with obsolescence in Secondary stock has increased the gap between Prime and Secondary grade vacancy in the St Kilda Road precinct, while in Southbank the vacancy gap has narrowed. In addition to a pull-back in incentives over the last two years, rental growth has generally been aligned with limited availability in both precincts. On average basis, net face rents have increased 18% over the 12 months to June 2018, outperforming rental growth in the CBD.

Similarly, growth in capital values has been more pronounced in the Fringe relative to the Grade A in the CBD. Following two landmark asset sales in 2016-17, overall capital inflows now appear to be closely aligned with the trend over the last 10 years, albeit slightly elevated in the $50 million to $100 million price point. There are still signs of yield compression through the last 12 months, although the rate of compression does appear to be slowing and investor appetite remains elevated.

PCA Summary Table – St Kilda Road & Southbank (as at Jun-18)

	St Kilda Road			Southbank			Aus Non-CBD
	Prime	Secondary	Total	Prime	Secondary	Total	
Total Stock ('000)	245.3	409.3	654.6	267.7	154.2	421.9	**7,256.4**
Total Vacancy ('000)	11.9	36.8	48.7	17.5	8.4	25.9	**650.2**
Vacancy (%)	4.9 (8.6)	9.0 (11.7)	7.4 (10.6)	6.5 (5.0)	5.5 (9.7)	6.1 (6.9)	**9.0 (9.2)**
Net Absorption ('000)	3.0 (.8)	10.9 (-10.7)	13.9 (-10.0)	6.2 (5.8)	-1.6 (-2.9)	4.7 (2.9)	**29.9 (48.1)**
Net Absorption (%)	1.3 (0.3)	3.0 (-2.5)	2.3 (-1.5)	2.6 (2.7)	-1.1 (-1.8)	1.2 (0.8)	**0.5 (0.8)**
Net Additions ('000)	0.0 (-0.6)	-12.6 (-9.6)	-12.6 (-10.1)	15.8 (7.5)	1.3 (-2.8)	17.2 (4.7)	**-10.6 (73.5)**
- Stock Additions ('000)	-	-	9.3	39.6	3.1	42.7	**154.1**
- Stock Withdrawals ('000)	0.0	0.0	22.0	23.8	1.0	25.5	**164.7**
Net Additions (%)	0.0 (-0.2)	-3.0 (-2.1)	-1.9 (-1.4)	6.3 (3.4)	0.9 (-1.7)	4.2 (1.2)	**-0.1 (1.1)**

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

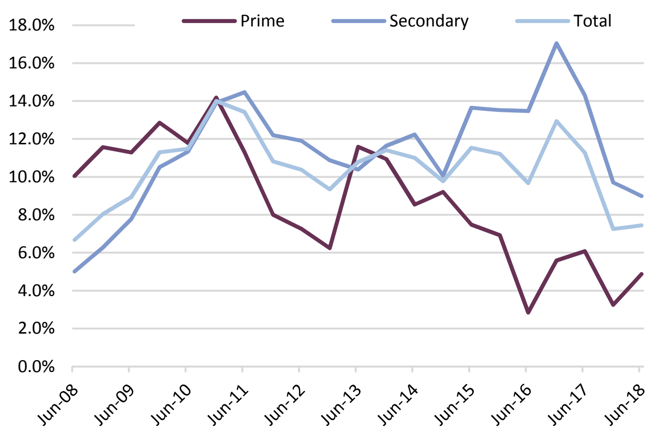
Vacancy

In addition to strong tenant demand, withdrawal of Secondary grade office stock for conversion has been a contributing driver to the St Kilda Road and Southbank precincts tightening vacancy rate over the last few years. However there are signs that this is beginning abate, with both precincts recording a rise in headline vacancy rates in the six months to June 2018.

The headline vacancy in the St Kilda Road precinct rose slightly through the first half of the year from 7.2% in January to 7.4% in June 2018 due to the addition of B grade space recently, yet still well-below the long-run average and below the previous 12 months (11.3%). 9,346 square metres of B grade space has returned to precinct. This is the first time significant additional supply has been added to the precinct since the early 2000s.

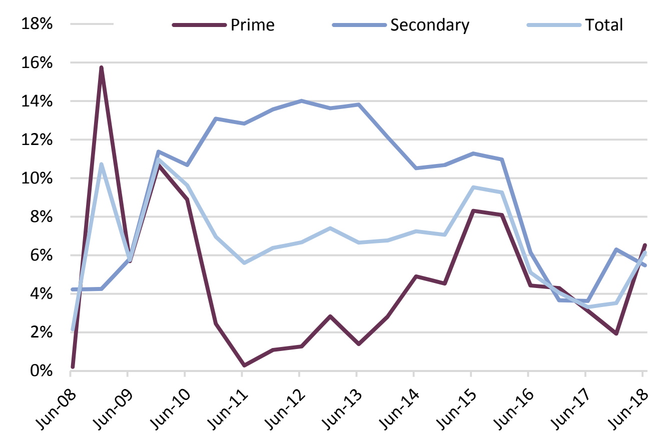
After dropping to a vacancy rate of 1.9% in January 2018, the headline vacancy rate in the Southbank precinct increased to 6.5% in June 2018. The addition of new supply in Southbank precinct has contributed to a large rise in the headline vacancy rate over the six months to June. In addition to 19,400 square metres of stock being added to the precinct, Southbank recorded negative absorption over the same period.

Historic Vacancy (St Kilda Road)



Source: PCA / Savills Research

Historic Vacancy (Southbank)



Source: Savills Research

Supply

Office stock in the St Kilda Road precinct has reduced in size by more than 100,000 square metres over the last decade, while Southbank stock has increased by circa 46,000 square metres over the same period. Both markets have been characterised by a large withdrawals of late, however Southbank's stock additions, either through new development or repositioning of buildings through refurbishment, has been higher than the St Kilda Road precinct over the past five years.

Early last year, Mirvac's 2 Riverside Quay was completed, adding 21,003 square metres of Grade A space to the market for the first time since 2009. The Australian Broadcasting Corporation redevelopment at 120 Southbank Boulevard (102 Sturt St) was completed late last year, adding a further 20,210 square metres to the market.

In addition to the stock withdrawals for conversion to residential, there are examples of office space being withdrawn for refurbishment, although the trend has been more prominent in Southbank. The partial refurbishment of 2 Southbank Boulevard recently reached practical completion, returning to stock levels as at June. 12 Riverside Quay has development approval for a full refurbishment of approximately 21,500 square metres that could be completed by the end of 2018.

The circa 6,000 square metre BMW Southbank site sold in December for more than $100 million to Beulah International, with proposed plans for the site being unveiled recently. The proposed redevelopment will comprise two towers with a mixed use design to include a hotel and residential component, along with approximately 10,000 square metres in commercial office space. If approved, timing has been proposed for 2022/23.

The State Government recently announced plans to redevelop the Southbank art and cultural precinct on the site of the existing Carlton and United Breweries (CUB) building at 77 Southbank Boulevard that they acquired recently. The redevelopment of this site will likely see the office component currently on leaseback to CUB, withdrawn for conversion.

Leasing Activity & Demand

In the 12 months to June 2018, Savills identified approximately 35,113 square metres of leasing activity (>500 square metres) in the Melbourne Fringe office market. Leasing volumes are above the previous 12 months, however not dissimilar to average annual volumes over the last five years.

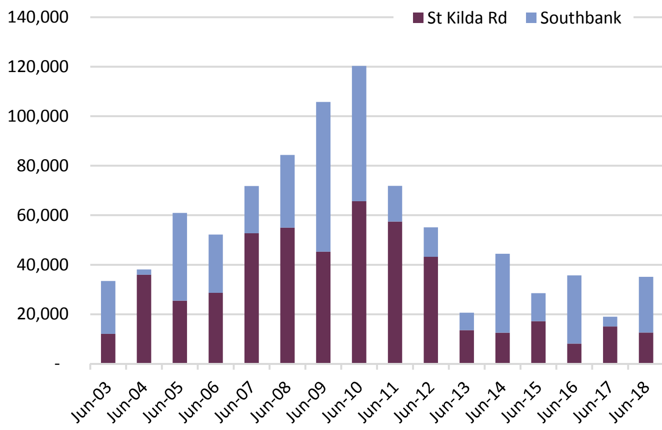
Of the 35,113 square metres (>500 square metres in size) reported leased in the 12 months to June 2018, 'Property & Business Services' remains the most dominant of industries, accounting for 34% of transactions by volume. 'Wholesale & Retail' take-up was the second highest of all sectors, led by two transactions, including Carlton & United Breweries (CUB) lease in Freshwater Place and Deluxe Australia at 476 St Kilda Road.

Following PricewaterhouseCoopers (PWC) relocation to Southgate Centre early last year, Freshwater Place at 2 Riverside Quay, a number of new tenants have leased space in the building, including WPP, Cliftons and CUB, amongst others. WPP has leased two floors in the building, circa 3,500 square metres, and is expected to relocate from 162 Collins Street, while Cliftons has secured 1,806 square metres on a seven year lease.

After occupying 77 Southbank Boulevard for more than two decades, CUB has rationalised about 8,000 square metres after signing a 10-year lease for 6,388 square metres at Freshwater Place. CUB's Southbank tower has recently been sold to the State Government for $95.38 million. CUB will leaseback the current space while the government firms up plans for the site.

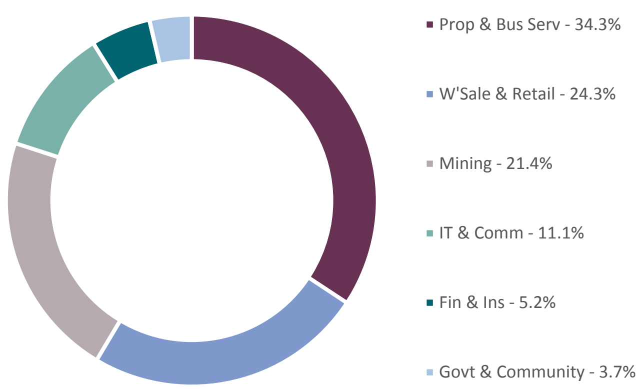
Deluxe Australia has relocated from South Melbourne to 476 St Kilda Road, leasing circa 2,100 square metres on a 10 year lease. More recently, the Commonwealth Government has leased 1,290 square metres at 40 City Road, Southbank.

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 Blvd, Southbank	Feb-18 | 6,388	d | n.a | 10
WPP	2 Southbank Blvd, Southbank	Feb-18 | 3,600	d | n.a | 7
Toll Holdings	464 St Kilda Rd, Melbourne	Sep-17 | 2,843	d | 270 (N) | n.a.
Deluxe Australia	476 St Kilda Rd, St Kilda	Sep-17 | 2,140	d | n.a | 10
Crawford & Company	324 St Kilda Rd, Melbourne	Jul-17 | 1,836	d | 450 (G) | n.a.
The SMART Group	324 St Kilda Rd, Melbourne	Jul-17 | 1,836	d | 423 (G) | 5
Cliftons	2 Southbank Blvd, Southbank	Feb-18 | 1,806	d | n.a | 7
Adecco Group	28 Freshwater Pl, Southbank	Sep-17 | 1,780	r | 520 (N) | 8
Macquarie Leasing	464 St Kilda Rd, Melbourne	Jul-17 | 1,720	d| n.a | n.a.
Sodexho	607 St Kilda Rd, Melbourne	Nov-17 | 1,300	r | 350 (N) | 7

Source: Savills Research Leasing Types: p = Pre-commitment, d = Direct, s = Sub-Lease, r = Renewal

Sales

In the 12 months to June 2018, Savills has identified approximately $682.8 million worth of office transactions (greater than $5 million) in Melbourne's Fringe precinct. While the rolling year-on-year volumes to June 2018 are below last year, they are closely aligned with investment trend over the last 10-years.

Volumes in the previous reporting period (2016/17) were well-above historical trends following two landmark transactions, including Southgate Complex to ARA Asset Management for $578 million and 28 Freshwater Place to JP Morgan for $286 million in August 2016.

Offshore investors continued to dominate overall transactional activity, accounting for 61% of acquisitions ($5m+) in the Southbank and St Kilda Road precinct throughout the last 12 months.

Syndicators were generally more active with divestments over the same period, with Lester Group selling 324 St Kilda Road for $42 million to Glorious Sun Group (Hong Kong) and Bayley Stuart Capital selling 606 St Kilda Road to Gingko Investments (China) for $57.5 million.

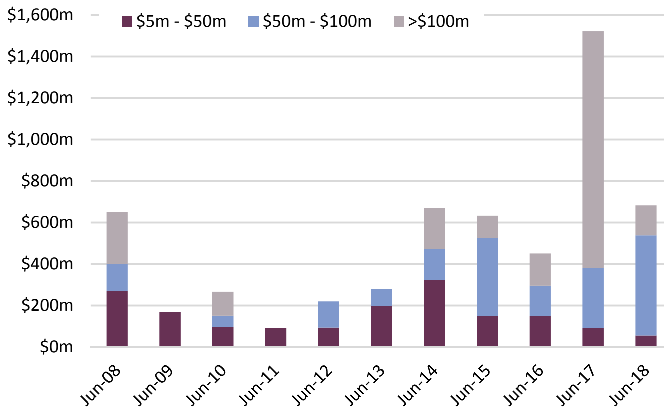
Fort Street Real Estate Capital (APOF) sold 390 St Kilda Road to Rockworth Capital Partners (Singapore) for $97.85 million. Fort Street originally acquired the asset in 2014 for $56 million.

Abacus Property Group, in partnership with Wing Tai Holdings, a Singaporean listed property, acquired 464 St Kilda Road for $95.38 million in April 2018. The eight level office building, which comprises circa 13,800 square metres has been owned and occupied by the Victorian Automobile Chamber of Commerce (VACC) for six decades. The property is fully leased, and has been sold on a leaseback arrangement, with VACC leasing back circa 30% of the floor space. Abacus has reported a WALE of 2.4 years at the time of sale.

While the yield compression cycle has been running for some time, there are signs that the rate of compression is beginning to slow, with no change in average A grade yields since December 2017. However, on a rolling year-on-year basis, as at June 2018, average A grade yields are showing a compression of 30 basis points, down from 5.50% in June 2017.

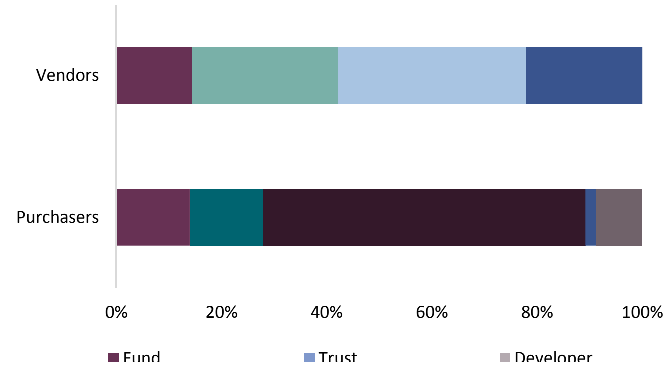
Capital values in the St Kilda precinct, as at June 2018, are estimated to range from $5,500 per square metre to $8,000 per square metre for A grade buildings and between $5,000 per square metre and $6,000 per square metre for B grade buildings. Average capital values for Grade A properties have increased 15.3% over the year.

Sales Activity by Size (> $5 million)



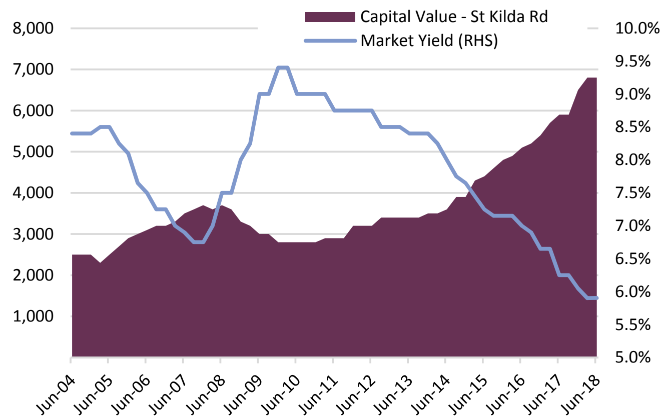
Source: Savills Research

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
464 St Kilda Rd, Melbourne	95.00 | Apr-18 | 13,827	5.16 | r | 6,871
312 St Kilda Rd, Melbourne	77.00 | Nov-17 | 10,000	4.66 | i | 7,700
10 Queens Rd, Melbourne	60.00 | Jun-18 | 9,004	5.00 | r | 6,664
606 St Kilda Rd, Melbourne	57.50 | Feb-18 | 8,647	n.a | n.a | 6,650
324 St Kilda Rd, Southbank	42.00 | Nov-17 | 7,102	5.98 | e | 5,914
1 Bowen Cres, South Melbourne	14.00 | Oct-17 | 2,695	4.00 | r | 5,195

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

Rents

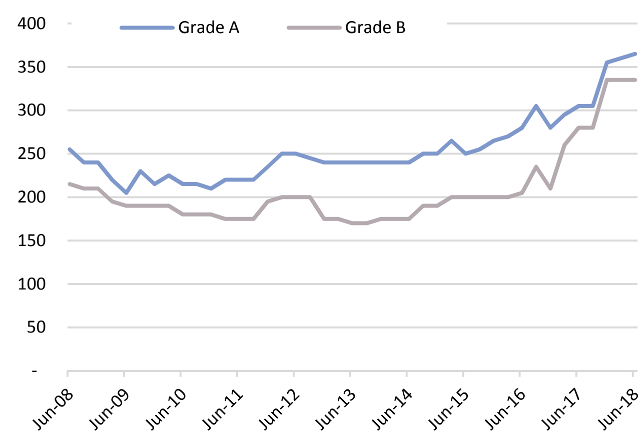
Strong tenant demand together with large withdrawals of office stock for residential conversion since 2014 have contributed to the St Kilda Road and Southbank precincts tightening vacancy rates and underpinned significant rental growth over the same period.

Similar to CBD trends, rental growth has generally been aligned with limited Prime options, as well as a pull-back in incentives over the same period.

As at June 2018, net face rents in the St Kilda Road precinct typically range from $425 and $475 per square metre per annum for A grade and $385 to $420 per square metre per annum for B grade. On average net face rents have increased 18% over the 12 months to June 2018.

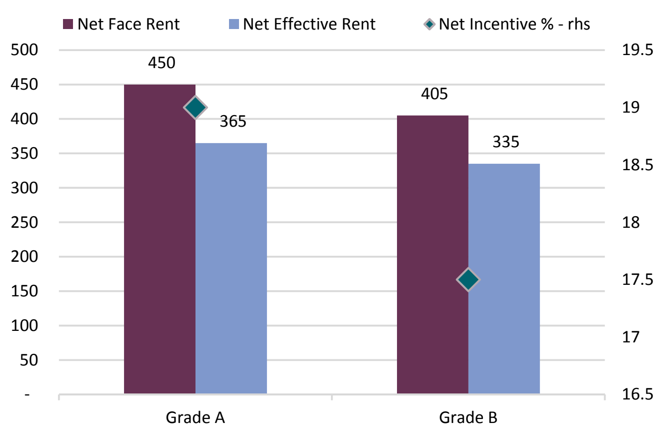
On a net effective basis, Average A grade rents are showing a 19.1% increase over the 12 months to June 2018, while average B grade net effective rents are up 19.6%.

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



Source: Savills Research

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



Source: Savills Research

Outlook

Recentralisation to the CBD, underpinned by limited available Prime options in the Fringe precinct had been a trend through 2016 and 2017, however tightening vacancy in both markets has constrained this to some extent recently. Still, there are a number of active mandates from tenants within Southbank and St Kilda Road precincts on the back of upcoming lease expiries.

Tenant demand and limited new incoming supply over the next two years may lead to a further decline vacancy rates within the St Kilda Road and Southbank precincts. Limited available Prime office space within both precincts, combined with any further withdrawals is likely to underpin short-term rental growth. The market has already witnessed strong rental growth throughout the past 12 to 18 months, accompanied by a reduction in incentives, with Prime, in particular, experiencing significant increases to face rental levels.

Investor interest for quality grade assets in St Kilda Road and Southbank remains strong, however a shortage of assets available for sale could potentially constrain investment activity levels in the short-term. Yields are at record lows and while there are still signs of compression through the last 12 months this now appears to be slowing. That said, there still remains scope for further yield compression as investment capital prices in expectations of future net operating income growth.

St Kilda Road Key Indicators (as at Jun-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	16	21	15	20
Rental - Net Effective ($/sq m)	345	385	320	345
Outgoings - Operating ($/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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