Savills Research
Victoria

Briefing
Melbourne Fringe Office

June 2019

Highlights

- Australian Institutions and Trusts remained the most dominant purchaser type, accounting for 49.7% of sales volume;
- Net effective rents in the St Kilda Road precinct are now at historically high levels;
- Tenants from the Mining industry were the most dominant sector, leasing 32.2% of total stock;
- Investment activity was higher than the previous year on record with $688.0 million transacted over FY-19;
- Strong employment growth has enabled companies expand from suburban offices into the Melbourne CBD fringe.

A Grade Averages	Latest	Yr Change	Outlook
Rental – N.F. ($/sq m)	475	+5.6%	↗
Incentives	20.5	-470bps	↙
Rental – N.E ($/sq m)	380	+8.6%	↗
Yield – Market (%)	5.25	-65bps	↙
IRR (%)	6.65	-25bps	↙
Capital Values ($/sq m)	8,000	+17.6%	↗

Demand & Supply (St Kilda Rd)	Latest	PCP*
Vacancy (%)	6.6	7.2
Net Absorb. ('000 sq m)	3.2	3.1

*PCP = Previous Corresponding Period

Source: Savills Research

Report Contents

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Executive Summary

The Melbourne Central Business District office fringe markets continue to perform strongly on the back of reliable economic performance in Victoria and strong rental growth. Real estate developers have permanently withdrawn stock for hotel, and residential conversions with limited commercial developments earmarked for the area. Strong tenant demand combined with the low supply levels, has seen rents surge in the St Kilda Road and Southbank precincts over the 12 months leading to June 2019. Since 2008, total stock levels in Southbank are have declined to their lowest levels, while total stock levels in the St Kilda Road office market fell 14.7% over the last ten years.

In Southbank, Savills Research has identified a significant amount of leasing activity following the delivery of 34,000 square metres of backfill space to the market. Both the Southbank and St Kilda Road fringe precincts have engaged a similar trajectory in terms of rental growth, together, have also mirrored the Central Business District in tenant demand in the past 12 months, although have presented slightly higher levels of stock, providing a greater capacity for positive net absorption.

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

	St Kilda Road			Southbank			Aus Non-CBD
	Prime	Secondary	Total	Prime	Secondary	Total	
Total Stock ('000)	254.7	389.4	644.1	287.7	149.7	437.4	**7,284.3**
Total Vacancy ('000)	12.3	30.0	42.3	36.8	9.8	46.6	**662.1**
Vacancy (%)	4.8 (8.2)	7.7 (11.8)	6.6 (10.5)	12.8 (5.1)	6.5 (9.8)	10.7 (7.1)	**9.1 (9.4)**
Net Absorption ('000)	5.0 (2.1)	-1.7 (-11.3)	3.2 (-9.3)	-15.9 (6.0)	-5.5 (-2.8)	-21.4 (3.2)	**7.6 (37.6)**
Net Absorption (%)*	2.1 (0.9)	-0.5 (-2.7)	0.5 (-1.4)	-6.0 (2.8)	-3.8 (-1.8)	-5.2 (0.9)	**0.1 (0.6)**
Net Additions ('000)	9.3 (0.4)	-10.6 (-11.5)	-1.2 (-11.1)	15.6 (6.1)	-5.5 (-2.6)	10.2 (3.5)	**18.1 (45.4)**
- Stock Additions ('000)	9.3	1.8	11.1	19.4	-	19.4	**133.0**
- Stock Withdrawals ('000)	0.0	12.4	12.4	3.8	5.5	9.2	**114.8**
Net Additions (%)	3.8 (0.2)	-2.6 (-2.6)	-0.2 (-1.6)	5.7 (2.4)	-3.5 (-1.6)	2.4 (0.8)	**0.2 (0.6)**

Source: Savills Research (10yr Averages shown in brackets); NB: Secondary Rents shown are for B Grade; All rents equivalent to whole floor mid-rise
*As a percentage of occupied stock

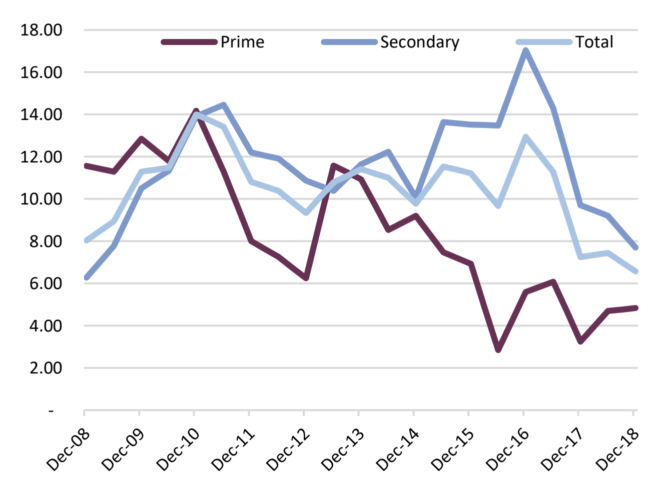
Vacancy

A combination of permanent office stock withdrawals in conjunction with a shortage of new stock additions has led to falling vacancy rates in Melbourne CBD’s fringe markets. The latest PCA vacancy rates in the St Kilda Road precinct have now dropped to 6.6% in December 2018, from 7.4% 12 months prior. Vacancy rates in the Southbank precinct rose above its 10-year average trend to 10.7%, the highest vacancy rate in the fringe precinct and a significant increase from 3.5% in December 2018. The Southbank vacancy increase was a result of PricewaterhouseCoopers's exit of 2 Southbank Boulevard in 2017.

Falling stock levels as a result of permanent stock withdrawals have become a feature of Melbourne's fringe markets, particularly in St Kilda Road, leading to rising rents and falling incentives. This has led to sitting tenants with limited available relocation options within the market.

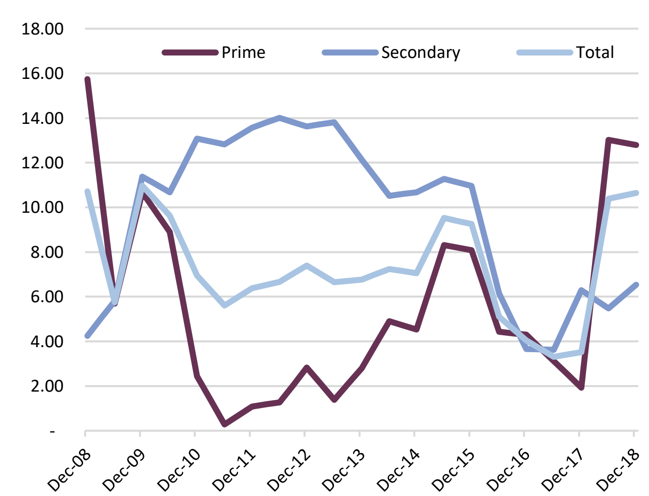
In the past 12 months to June 2019, there have been 11,780 square metres of new leases and renewals in the 55,000 square metre tower. Within that, 6,388 square metres were leased to new tenants such as Carlton & United Breweries, Select Solutions and Space&Co.

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 the hotel and residential conversions. Office stock levels in St Kilda Road are now at their lowest levels ever, while in the Southbank precinct they are at their lowest levels since 2008. Over the 12 months to January 2019 alone, 12,400 square metres of office space was permanently withdrawn in St Kilda Road and 4,500 square metres in Southbank for either residential or hotel conversions.

In addition to the stock withdrawals for conversion to residential, there are examples of office space being withdrawn for refurbishment, with this trend the most prominent in Southbank. Looking ahead, there are limited upcoming developments in Southbank and St Kilda Road markets over the next 1-2 years. Continued withdrawals for non-office developments are likely to further constrain stock levels in the St Kilda Road and Southbank precincts.

Leasing Activity & Demand

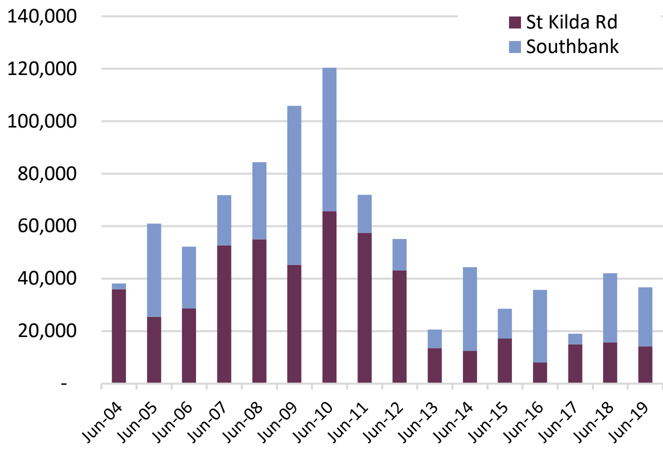
In the 12 months to Jun-19 Savills Research identified 36,695 square metres of leasing activity, down 15.3% from the 12 months prior and down 50.1% on the 10 year average (73,590 square metres). The majority of these leases (approximately 61.5% of total space) occurred in the Southbank precinct.

Of the 36,695 square metres leased in Melbourne CBD Fringe in the last 12 months, tenants from the mining industry were the most dominant, leasing 32.2% of total stock (7,850 square metres). Grade A leases were the most numerous with 28,868 square metres leased over the year to Jun-19.

A strong economy and employment growth has enabled companies expand from suburban offices into the Melbourne CBD fringe. The largest leasing transaction from the 'Wholesale and Retail' sector include JB Hi-Fi Group at 1-3 Southgate Avenue, Southbank (9,500 square metres) and CUB at Levels 20-23, 2 Southbank Boulevard, Southbank (6,388 square metres) both in the Southbank precinct.

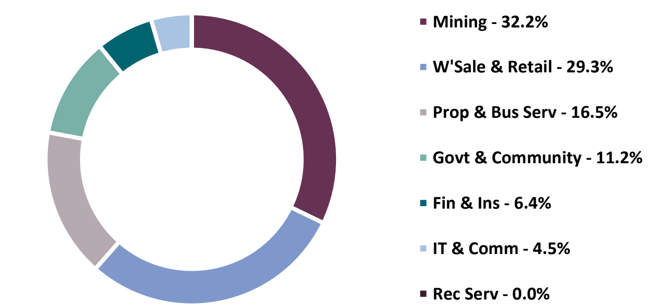
The largest leasing transaction recorded from the 'Mining' sector for the St Kilda Road precinct was the renewal of Newcrest Mining (5,405 square metres) lease at 600 St Kilda Road for a 5 year term in July 2018.

Leasing Activity by Precinct (Melbourne Fringe) (> 500 square metres)



Source: Savills Research

Leasing Activity by Tenant Type (Melbourne Fringe) (> 500 square metres)



Source: Savills Research

Recent Notable Leases (by Area Leased)

Property	Tenant	Date | NLA	Type | Rent | Term
1-3 Southgate Ave, Southbank	JB Hi-Fi Group	Sep-18 | 9,500	Direct | n.a | n.a.
Level 20 -23, 2 Southbank Blvd, Southbank	CUB	Nov-18 | 6,388	Direct | 563 (N) | 6
600 St Kilda Rd, Melbourne	Newcrest Mining	Jul-18 | 5,405	Renewal | 355 (N) | 5
509 St Kilda Rd, Melbourne	Broadspectrum	May-19 | 3,377	Renewal | 450 (N) | 2
2 Southbank Blvd, Southbank	Select Solutions	Mar-19 | 1,873	Direct | 545 (N) | 5
2 Southbank Blvd, Southbank	Cliftons	Aug-18 | 1,806	Direct | n.a | 7
2 Southbank Boulevard, Southbank	Space and Co	Mar-19 | 1,714	Direct | 540 (N) | 10
417 St Kilda Rd, Melbourne	Zenitas Healthcare	Jul-18 | 1,590	Direct | 400 (N) | 5
549 St Kilda Rd, Melbourne	Choosewell	Jul-18 | 1,549	Direct | 390 (N) | 5
60 City Rd, Southbank	Phantom Electrics	Nov-18 | 1,280	Direct | 510 (N) | 5

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

Sales

In the 12 months to June 2019, Savills Research recorded approximately $688.0 million worth of office transactions (greater than $5 million) in the St Kilda & Southbank precincts.

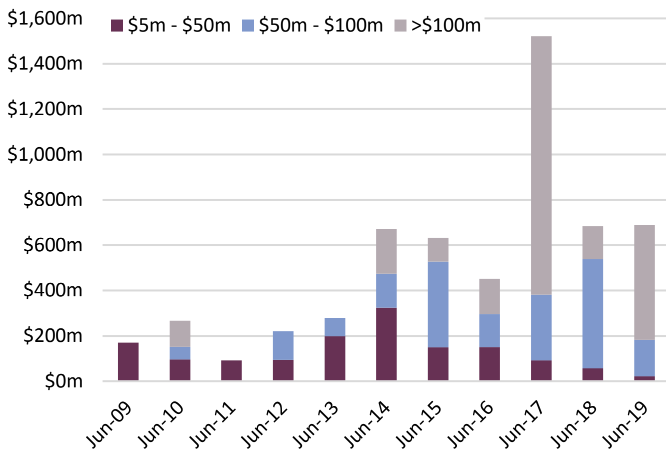
Australian Institutions and Trusts remained the most dominant purchaser type, accounting for almost half of all sales volume in the year to June 2019, with a relatively low Australian Dollar (compared to its peak in March 2013), coupled with relative affordability underpinning demand in Melbourne CBD's fringe markets. Notably, GPT Group exercised its pre-emptive right to purchase the remaining 50% share of the premium grade office building located at 2 Southbank Boulevard, Southbank for $342 million from co-owner Frasers Property.

Foreign Investors have remained prominent, an example being a buyer of 420 St Kilda Road for $98 million on a tight yield of circa 4.76%. The Grade A property was previously owned by local property group Vantage Property and US giant KKR.

Yield compression over the last 12 months to June 2019 in the St Kilda Road precinct saw A Grade yields tightening by 65 basis points to record lows.

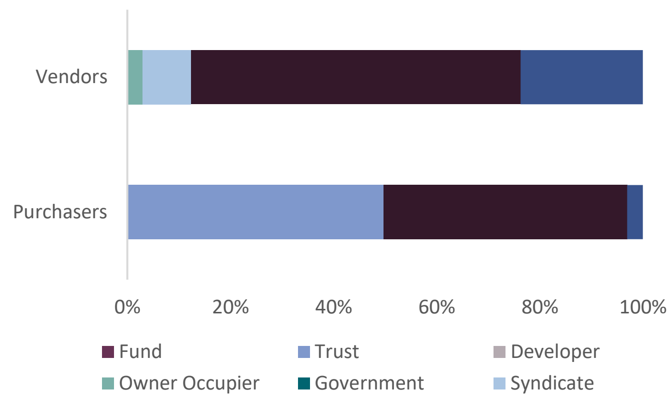
Capital values in the St Kilda Road market as at June 2019 are estimated to range from $7,000 to $10,000 per square metre for A Grade buildings and between $5,500 and $7,250 per square metre for secondary grade buildings. Average capital values for A Grade properties grew by 36.2% over the year.

Sales Activity by Size (St Kilda Rd) (> $5 million)



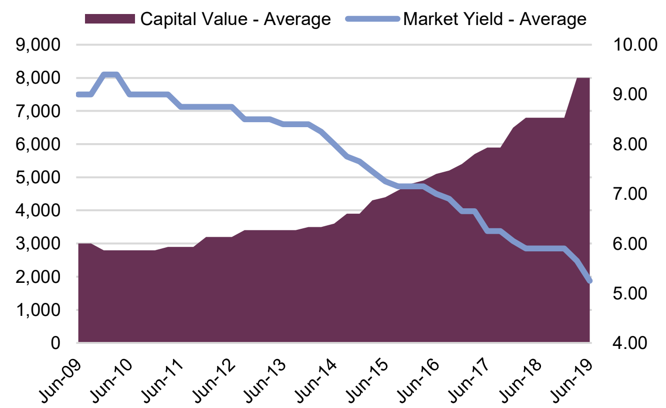
Source: Savills Research

Vendor & Purchaser Type (St Kilda Rd) (> $5 million)



Source: Savills Research

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



Source: Savills Research

Recent Notable Sales (Melbourne Fringe)

Property	Price ($m) | Date | NLA	Yield | Type | $/sq m
2 Southbank Blvd, Southbank (50.0%)	342.00 | Feb-19 | 55,000	4.73 | i | 12,436
509 St Kilda Rd, Melbourne	163.00 | Nov-18 | 19,645	4.96 | r | 8,297
420 St Kilda Rd, Melbourne	98.00 | Apr-19 | 10,452	4.76 | i | 9,376
541 St Kilda Rd, Melbourne	64.00 | Dec-18 | 8,250	5.12 | I | 7,761

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

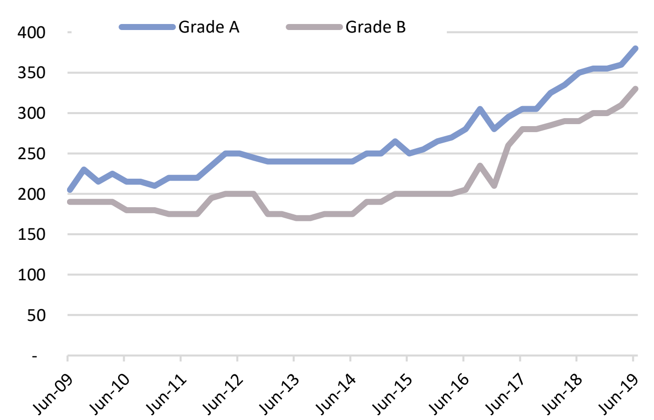
Rents

As at June 2019, A Grade net face rents in the St Kilda Road precinct increased 5.6%, averaging $475 per square metre. Average B Grade net face rents were recorded at $410 per square metre, witnessing an increase of 1.2% over the 12 months to June 2019.

Net effective rents in the St Kilda Road precinct are now at historically high levels ranging between $355 to $400 per square metre per annum for A Grade stock and between $300 and $345 per square metre for B Grade buildings.

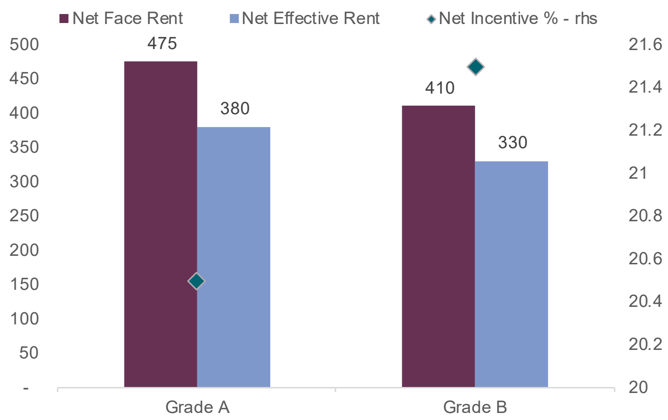
With incentives falling by 4.7% in A Grade stock and rising rents in the Southbank precinct means that current tenants have limited relocation options available within the already tight market. Thus are likely to opt for lease renewals on favourable terms, rather than looking for alternative space in the more expensive CBD.

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



Source: Savills Research

Net Face & Net Effective Rents – St Kilda Rd (as at Jun-19)



Source: Savills Research

Outlook

Over the mid 2018/2019 period, approximately 13,000 square metres of office stock was permanently withdrawn from Melbourne CBD's fringe markets for either residential or hotel conversions offering higher use. Savills Research anticipates this trend to continue within the CBD Fringe markets, albeit at a lower rate. The recent planning control changes around the Southbank 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.

Melbourne's strong population growth forecast (underpinning professional 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.

While investor interest in for quality grade assets in St Kilda Road and Southbank is expected to remain active, a shortage of assets available for sale is 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 short to medium term as CBD fringe assets remain attractive to many investors seeking a higher risk premium spread over both CBD yields and 10-year government bond rates.

St Kilda Road Key Indicators (Q2-19)

St Kilda Road	A Grade		B Grade	
	Low	High	Low	High
Rental - Gross Face ($/sq m)	580	640	505	565
Rental - Net Face ($/sq m)	445	505	380	440
Incentive Level Net (%)	16	25	15	28
Rental - Net Effective ($/sq m)	355	400	300	345
Outgoings - Operating ($/sq m)	65	75	60	70
Outgoings - Statutory ($/sq m)	60	65	55	60
Outgoings - Total ($/sq m)	125	140	115	130
Typical Lease Term	3	6	3	5
Yield - Market (% Net Face Rental)	5.00	5.50	5.50	6.25
IRR (%)	6.50	6.75	6.75	7.00
Cars Permanent Reserved ($/pcm)	300	330	280	320
Office Capital Values ($/sq m)	7,000	9,000	5,500	7,250

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

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