Savills Research
Victoria

Briefing
Melbourne Fringe Office

February 2018

Highlights

- The St Kilda Road office market recorded positive net absorption for the first-time in three years causing its vacancy rate to fall to the lowest level since June 2008;
- Total office stock in the St Kilda Road precinct has contracted by 16% over the last 14 years led by ongoing permanent withdrawals for mainly residential conversions;
- Rental growth for St Kilda Road was highest of all non-CBDs nationally with the net effective rents for both Prime and Secondary grade at record high levels within the precinct;
- Southbank recorded highest positive net absorption of all non-CBD markets nationally.

A Grade Averages	Latest	Yr Change	Outlook
Rental – N.F. ($/sq m)	450	+21.6%	↗
Incentives	21.5	-250bps	↙
Rental – N.E ($/sq m)	355	+26.8%	↗
Yield – Market (%)	6.05	-60bps	↙
IRR (%)	7.00	-25bps	↙

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

Report Contents

Associate Director — Research

Monica Mondkar
mmondkar@savills.com.au

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

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

Executive Summary

Melbourne'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)	-16.7 (-10.5)	-38.6 (-11.1)	27.4 (8.7)	-1.5 (-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)**

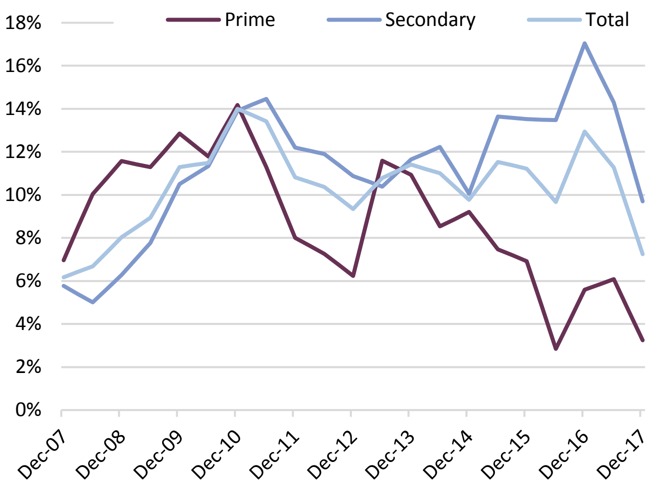
Source: Savills Research (10yr Averages shown in brackets; NB: Secondary Rents shown are for B grade; All rents equivalent to whole floor mid-rise

Vacancy

Melbourne'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.

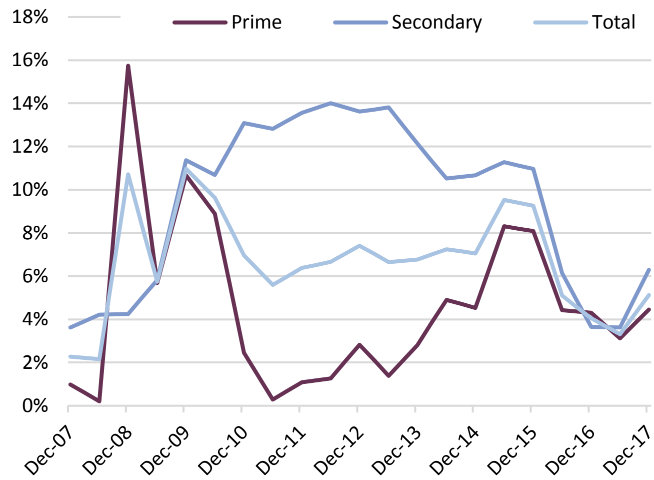
With no new developments in the pipeline for St Kilda Road and Southbank, Savills Research expects further falls in the vacancy rates across Melbourne's Fringe markets over the short to medium term.

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 December 2017, Savills Research recorded 28,328 square metres of leasing activity in Melbourne's Fringe markets (across St Kilda Road and Southbank). Leasing volume is down 14% from the 12 months prior and nearly half of the 10-year average (56,670 square metres). Leasing activity has been falling over the recent years due to the ongoing withdrawal of stock in the Melbourne Fringe markets, particularly in St Kilda Road.

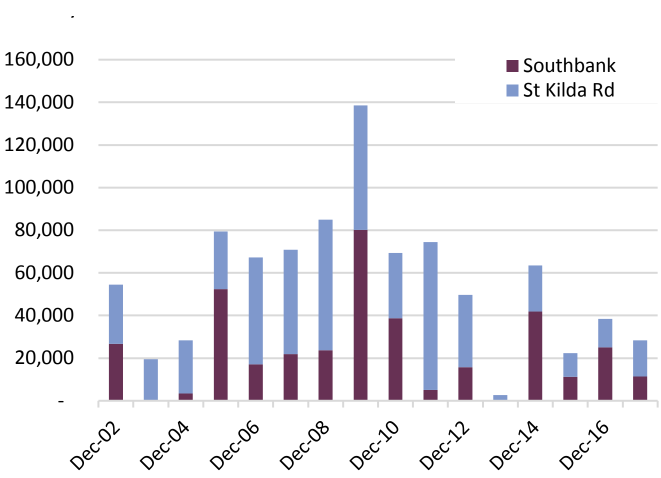
Looking at leasing volume by grade, Grade B leases were the most numerous with 15,043 square metres leased over the 12 months to December 2017. Majority of Secondary grade leases were in the older stock within the St Kilda Road precinct.

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 48.1% of the total stock. Notable Grade A leases from the sector include WPP's lease renewal at 380 St Kilda Road (3,800 square metres) and Tract Consultants' direct lease at 6 Riverside Quay (1,360 square metres) in the Southbank precinct.

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.

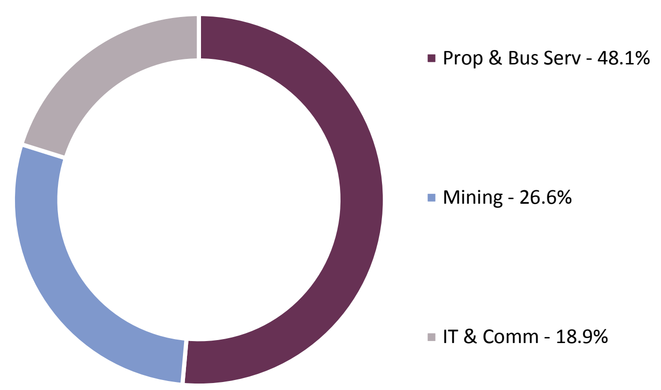
'Direct' leases accounted for 71% of total leasing activity with the balance coming from lease renewals. 'Direct' leases were up 20% from the previous year accounting for 20,148 square metres of leasing activity recorded over 12 months to December 2017.

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
WPP	380 St Kilda Rd, Melbourne	Feb-17 | 3,800	Renewal | n.a | 5
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

Source: Savills Research

Sales

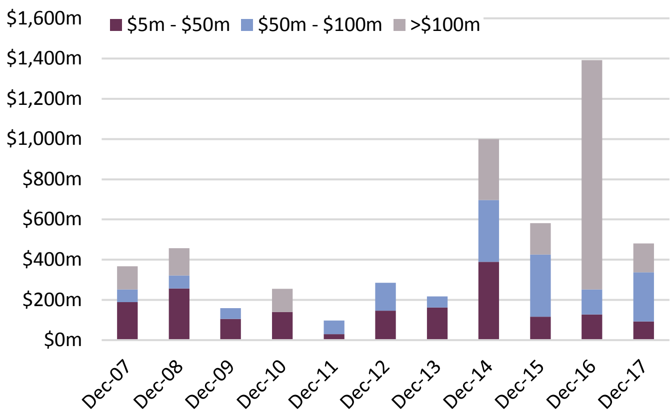
Savills Research recorded $481 million in sales volume across seven properties in the 12 months to December 2017. Falling by 65% from the record sales 12 months prior, relatively muted sales activity in 2017 was a result of lack of investment properties offered for sale in the Fringe markets, while the competing CBD market presented numerous lucrative options for investment. Also, all the seven sales transactions were recorded for St Kilda Road precinct, while Southbank market did not offer any properties for sale over the year to December 2017 period. Reported sales over the past year were also marginally below the 10-year average ($493 million).

Foreign Investors remained the most dominant purchaser type, accounting for 89% of all sales in the year to December 2017, purchasing six of the seven properties sold in 2017. 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. While setting new benchmarks for both yields and capital values, all three sales were located along the St Kilda Road Boulevard offering proximity to the CBD and the art precinct.

In recent years, the increasing levels of inner city apartment developments have led to developers purchasing office buildings for future residential or hotel development. 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 60 basis points on average over the year, while Secondary yields tightening was more pronounced at 115 basis points on average, mainly due to lack of stock offered for sale.

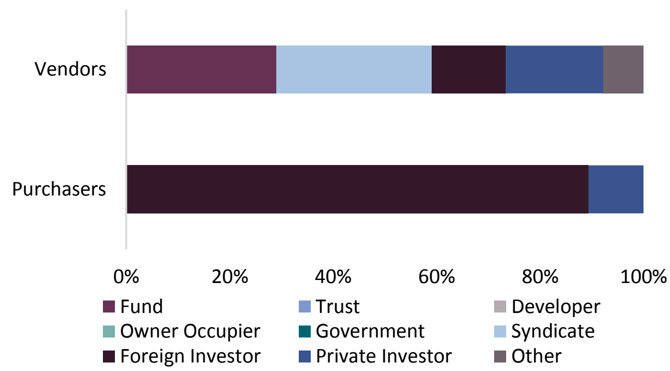
While current market yields remain at record low levels, this coincides with historically low-interest rates and 10-year bond yields, incentivising purchasers to seek a healthy return on property investment. Capital values estimated in the St Kilda Road range from $5,000 to $8,000 per square metre for Grade A buildings and between $5,000 and $6,000 per square metre for Grade B buildings in December 2017. Average capital values for Grade A properties grew by 20% over the year, while Grade B properties rose by 15% in the same period.

Sales Activity by Size (> $5 million)



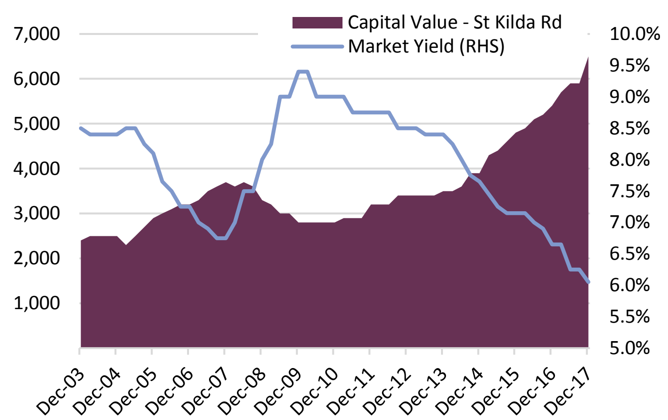
Source: Savills Research

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
312 St Kilda Rd, Melbourne	77.00 | Nov-17 | 10,000	4.66 | r | 7,700
420 St Kilda Rd, Melbourne	68.84 | Jun-17 | 10,459	6.02 | e | 6,582
324 St Kilda Rd, St Kilda Rd	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
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
312 St Kilda Rd, Melbourne	77.00 | Nov-17 | 10,000	4.66 | r | 7,700

Source: Savills Research

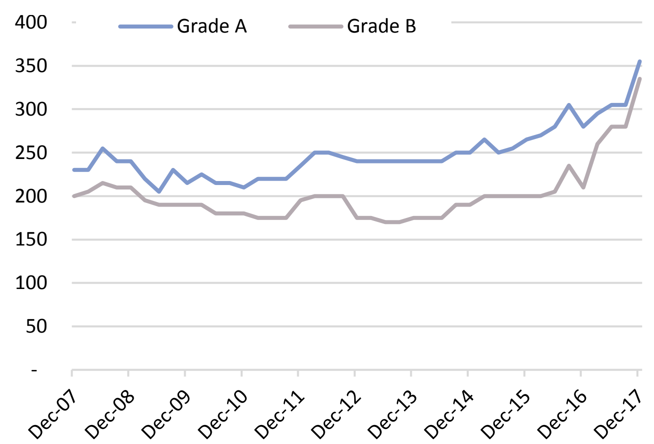
Rents

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 $335 to $375 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 27% over the 12 months to December 2017.

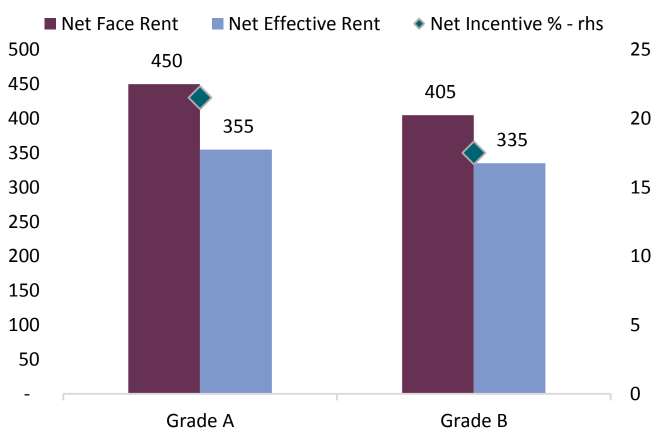
Incentives are likely to fall further, in turn, boosting rental rates resulting from limited availability of office space, particularly for Prime accommodation. Higher rents within the already tight market are likely to constrain tenant migration.

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



Source: Savills Research

Net Face & Net Effective Rents – St Kilda Rd (as at Dec-17)



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.

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 December 2017 and has a forecast for further three 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 Dec-17)

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 (%)	19	24	15	20
Rental - Net Effective ($/sq m)	335	375	320	345
Outgoings - Operating ($/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	6.30	6.00	6.50
IRR (%)	6.75	7.25	7.00	7.25
Cars Permanent Reserved ($/pcm)	300	330	280	320
Office Capital Values ($/sq m)	5,000	8,000	5,000	6,000

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

Valuations
Joe Phegan
+61 (0) 3 8686 8064
jphegan@savills.com.au

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

Capital Transactions
Ben Parkinson
+61 (0) 3 8686 8012
bparkinson@savills.com.au

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

Asset Management
Howard Chapman
+61 (0) 3 8686 8870
hchapman@savills.com.au

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