

## Melbourne Suburban Office Market Update

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April 2010

### MARKET DEFINITION

Melbourne's suburban office market comprises an estimated 2.7 million square metres of office space representing approximately 35% of total metropolitan office stock.

The suburban office market is made up of five separate sub-regions including the City Fringe (largest by square metre area) that includes around 850,000 square metres in the key suburbs of Port Melbourne, East Melbourne and Richmond.

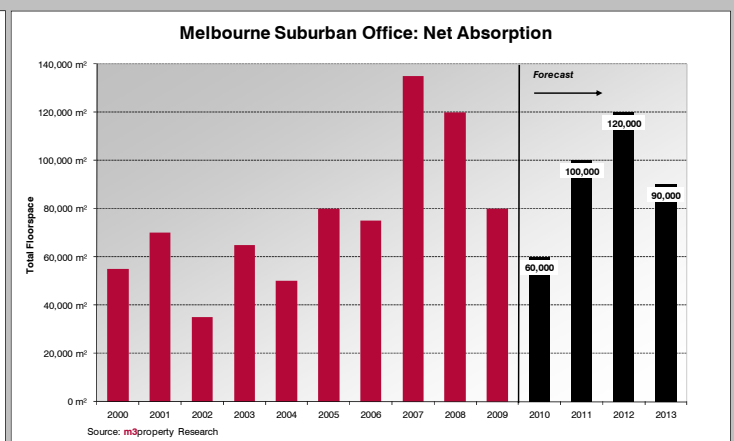
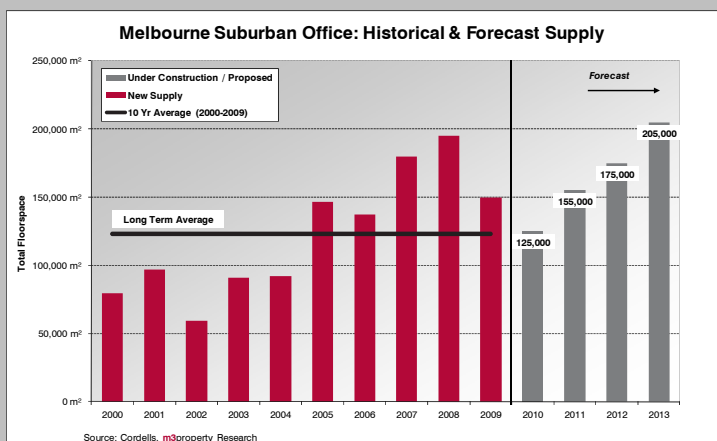
The Inner East totals 500,000 square metres with more than 200,000 square metres in Hawthorn and Camberwell alone. The Outer East, (750,000 square metres) is the second-largest sub-region with around two-thirds of stock existing in office / business park style developments (Mulgrave and Glen Waverley).

The South East sub-region provides around 350,000 square metres with its core suburban centre located in Dandenong with more than 100,000 square metres and smaller concentrations existing in Cheltenham and Moorabbin. Finally, the North & West jointly totals approximately 250,000 square metres in the main commercial suburbs of Moonee Ponds, Footscray, Preston and Heidelberg.

### SUPPLY

As a result of the financial credit crisis, the underlying fundamentals of demand and supply within Melbourne's suburban office markets have softened since the beginning of 2008. Notwithstanding this factor, development activity having gathered strong momentum since 2005 to meet solid levels of tenant demand recorded a large fall in new building starts during the final quarter of 2008.

Historically, the 10-year period to 2009 recorded some 365,000 square metres of new construction delivered in the City Fringe alone with a further 795,000 square metres added to the balance of suburban Melbourne. Supply analysis shows new construction over the last decade has averaged 123,000 square metres per annum. Approximately 150,000 square metres of new space was developed in 2009 while approximately 125,000 square metres remains either proposed or under construction in 2010.



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### DEMAND

Demand for prime grade inner office space had been relatively strong in the suburbs up until mid 2008. Solid tenant pre-commitments for new office accommodation underpinned several new developments within the inner Eastern suburbs of Hawthorn and Camberwell as well as several business park locations in the outer Eastern suburbs.

While leasing activity has slowed, tenants are nevertheless still attracted to non-CBD markets that provide larger floor plates and lower-rise accommodation consistent with the objectives relating to some firms' organisational culture. This includes greater levels of interactivity between staff. Amenity for staff is also an important aspect of this culture as well as ease of daily access to work via good public transport linkages and ample parking for private commuters.

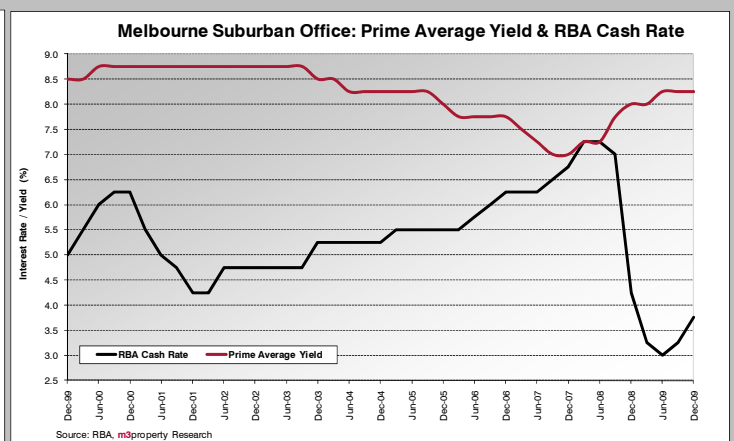
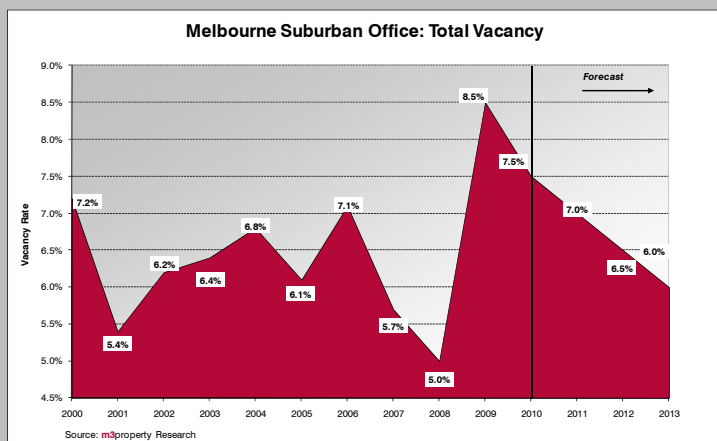
Net absorption peaked in 2007 at 135,000 square metres with 80,000 square metres recorded for 2009. Net absorption is forecast to decline further over 2010 as the suburban office market has not recovered as quickly as the CBD however, shall rebound on a stronger leasing market post-2010. Positive net absorption is underpinned by solid underlying employment growth and the expansion in workspace ratios.

### VACANCY, RENTS & INVESTMENT DEMAND

The overall vacancy rate as at January 2010 is estimated to be around 7.5% after falling from a peak of 8.5% in January 2009. Demand for suburban office stock peaked in late 2007 / early 2008 with vacancy falling to a 30-year low of just 5.0%. m3property Research forecast suburban vacancy to fall over 2010, albeit moderately, as the supply pipeline dissipates and leasing fundamentals improve.

The suburban office market has been characterised by lower rents when compared to the Near City markets together with lower rental incentives, outgoings and car parking. As tenant demand reduces, landlords have increased incentives in order to attract new and existing tenants.

The last 12 months has witnessed the extent of change in rental levels less pronounced for prime grade stock with some minor softening recorded over the course of 2008. Variance in rent levels is attributable to floor plate design and relative efficiencies, size and building age together with the intrinsic factor of location.



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As shown in the previous yield chart, yields in the early part of the decade were relatively stable averaging 8.75% before firming to a low of 7.00% in December 2007. When compared against the long term average, these yields were not sustainable and have since softened 125 basis points to 8.25% as at December 2009.

The increase in yields is reflective of the lack of institutional purchaser demand. The higher cost of capital has significantly reduced the number of potential buyers in the market for investment grade property with the bulk of sales limited to cashed-up private investors.

Funds have consolidated their portfolios to reduce debt levels and improve performance by liquidating non-core assets over 2009. In addition, declining flows of funds into managed investments combined with lower equity values result in falling target property holdings for a given weighting in diversified investment portfolios.

### OUTLOOK

Strong leasing activity was witnessed throughout 2008 in the suburban office market and most notably in the Outer East, underpinned by solid pre-commitments for new office space within business park environments. After the onset of the global financial crisis and economic downturn, 2009 witnessed the return of larger incentives and softening rents as leasing activity began to slow with falling business confidence.

A feature of the suburban office market has been the emergence of two distinct sub-markets; the City Fringe and the balance. Rents in the City Fringe traditionally are higher and yields lower, reflecting the higher land values and specification of buildings.

So far in 2010, rents have stabilised as vacancy rates across all grades have increased, while in order to attract and retain tenants, landlords have increased incentives. Over the next six months, vacancy is forecast to fall, albeit slightly, due to limited new supply and improving tenant enquiry levels resulting from stronger economic fundamentals. m3property Research forecasts that total suburban office vacancy has peaked and shall continue falling over the medium term. The problem of securing debt to allow for more development remains a challenge for small developers.

Similarly, incentives are now under pressure to fall back to longer term averages as the reduction in supply levels will pressure stronger rental growth over 2011-12 as the recovering economy meets with an under-supplied office market.

Sales transactions in 2009 were lower on previous years with buyer activity existing almost exclusively with cashed-up private investors for sub-\$10 million properties. Generally, purchasers have demonstrated a cautious approach as the marketplace contemplates further capital value adjustment but assets with significant discount to book values are transacting.

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