



#### MARKET DEFINITION

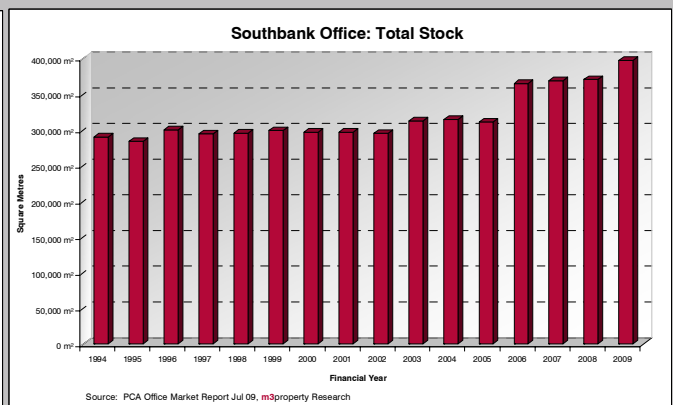
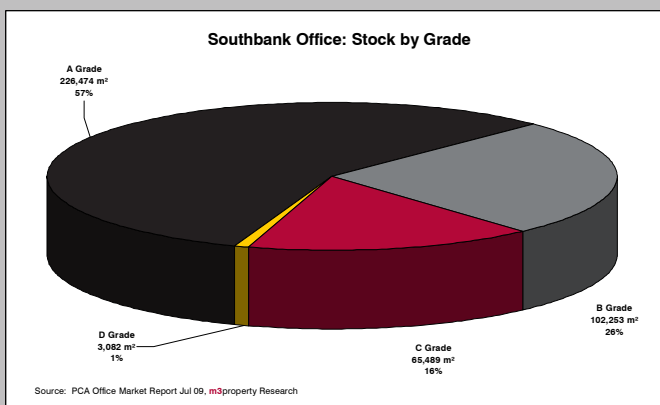
The Southbank office precinct comprises the seventh largest concentration of non-CBD office space nationally. Southbank was traditionally the preferred domicile of IT, media, finance and insurance organisations however, this trend has changed over time with a more diverse range of tenants moving into the precinct including health, mining, accounting, telecommunications and engineering firms.

The July 2009 Property Council of Australia Office Market Report shows total office stock of 397,298m<sup>2</sup>. As the Southbank office precinct is still relatively young compared to other non-core Australian office markets, the majority of supply comprises of A Grade stock at 57%, followed by B Grade (26%), C Grade (16%) and D Grade accounting for just a minor portion of the balance.

#### SUPPLY

As can be seen below, the long term net additions to supply have averaged 6,728m<sup>2</sup> p.a. since 1994. The largest increase recorded was in 2005 on the completion or the first stage of Freshwater Place (54,065m<sup>2</sup>), followed by a further 27,040m<sup>2</sup> in 2008 (a second stage of Freshwater Place known as 'Twenty8').

More than 100,000m<sup>2</sup> has been added to the market since 2000 whilst less than 30,000m<sup>2</sup> has come out of supply through market withdrawals. Most notably, the Freshwater Place developments have increased the proportion of prime grade office area above 50% in 2009 and this is set to continue in Southbank with a further 19,035m<sup>2</sup> currently under construction at South Wharf, located on the bank of the Yarra River adjoining Melbourne's Convention Centre.



#### DEMAND

Annual net absorption measures the uptake of available office space each period and can be used as a proxy for overall tenant demand. The chart below shows the annual net absorption of office supply in Southbank since 1994. Because of its relatively lower level of stock, Southbank is more prone to record greater volatility through tenant relocations or the addition or withdrawal of larger buildings. This is particularly evident in 2009.

Since 2005, the take up of office space has improved as tightening vacancy rates and rising rents throughout the CBD forced some tenants to consider space within the adjoining Southbank sub-market. Occupation of recently completed stock has underpinned a recent reversal in net absorption (January 2009, negative 7,980m<sup>2</sup>) with a large increase recorded over the six months to July 2009 (+20,011m<sup>2</sup>). This was primarily in A Grade office space and due to the occupation of new tenants into Twenty8 Freshwater Place.

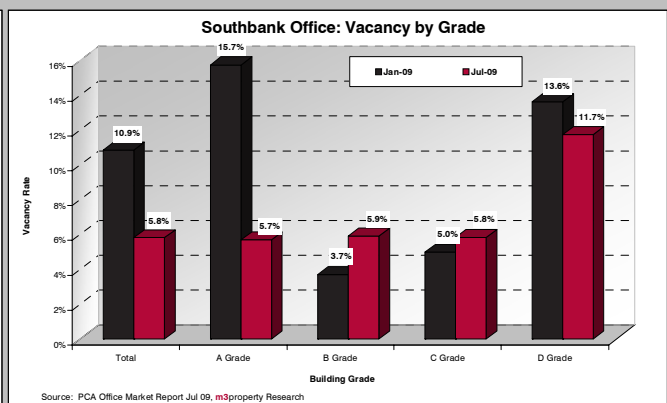
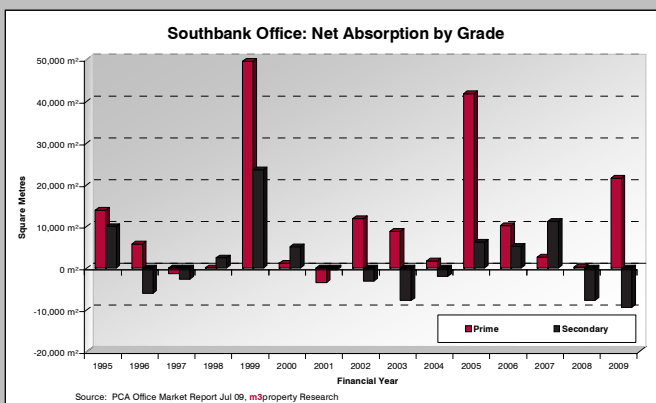
#### VACANCY

In July 2009 the overall Southbank office vacancy rate stood at 5.8%, a fall from 10.9% in January 2009 and primarily the result of the absorption of office space within Twenty8 Freshwater Place. The current vacancy level represents 23,104m<sup>2</sup> of available office space and comprises limited contiguous floor space in existing stock.

B and C Grade stock experienced an increase in vacancy while A Grade fell (down from 15.7% to 5.7% in July 2009). A Grade stock rose from almost nil vacancy in July 2008 (due to the addition of Twenty8 Freshwater Place which was partly vacant on completion) and will increase again in January 2010 on the back of new supply which is also expected to have some empty space.

With South Wharf and a further 7,293m<sup>2</sup> of refurbished space (58-82 Queensbridge Street) yet to enter the Southbank market, the outlook suggests an increase in total vacancy over 2010 to approximately 10% before trending back down to the decade average of around 7%.

Over the longer term, competition from the CBD (and increasingly more so Docklands) remain key risks in attracting tenants to the Southbank precinct while limited new stock remains in the pipeline for any prospective occupiers, particularly those seeking areas in excess of 5,000m<sup>2</sup>.



#### RENTS, YIELDS & SALES ACTIVITY

Effective rental levels in the Southbank precinct grew throughout 2008 because of reduced incentives and some moderate growth in face rental levels. This increase was generally supported by the lower vacancy rate and continued demand being driven by existing tenants seeking expansion space and new tenants entering the market. Prime grade face rents currently range between \$350 and \$400/m<sup>2</sup> net. Lease incentives on offer typically comprise rent free periods or lessor contributions to fit out and these vary depending on building, location and landlord.

Recent evidence indicates yields have stabilised with a softening of up to 150 basis points applied to valuations over 2008-09. This is reflective of the lack of institutional purchaser demand and the weight of money chasing commercial assets. Private investors and syndicates continue to fill the void left over by the larger funds.

There has been limited large-scale transactional activity recorded in Southbank over the last two years, the largest sale being 209 Kings Way purchased by Sachsenfonds for \$135m (\$5,475/m<sup>2</sup>) at a market yield of 6.41% in February 2008. In April 2009, 17-23 Queensbridge Street sold to a private investor for \$9.775m (\$3,446/m<sup>2</sup>) at a market yield of 8.54% and is the most notable sale in Southbank to date.

#### OUTLOOK

Southbank's current vacancy rate is high when compared to office markets of similar quality however, the lack of new development over the next few years will place Southbank in a good position to capitalise on stronger tenant demand once leasing markets improve.

The confirmation of ANL container lines as a new tenant to South Wharf has taken the pressure off prime grade vacancy in 2010 in Southbank as this project was a speculative development and had the potential to further blow out prime grade vacancy. ANL has agreed to a ten year lease of 6,150m<sup>2</sup> on the top three levels in South Wharf and building developer Austexx will also occupy 4,340m<sup>2</sup>.

Capital values showed strong growth in the 18 months prior to 2008, a phenomenon that has been reflected in most property investment classes over this period. Whilst in the past this has been primarily a consequence of yield compression, moving forward, we expect that capital values will remain under some pressure with forecast rental growth unlikely to fully offset any reduction in value caused by softer yields.

With the new development pipeline ending in early 2010 and a significant proportion of supply already pre-committed, it seems likely that total vacancy will rise in the short term before the potential exists for an undersupply of office area from 2011 and beyond. Consequently, net face rentals across all grades are likely to stabilise and incentive levels will adjust as landlords compete to secure sitting tenants, and of course attract new ones.

#### CONTACT DETAILS

**Richard Isaac**

**Valuer**

**Richard.Isaac@m3property.com.au**

**(03) 9605 1042**

**Frank Sorgiovanni**

**National Research Director**

**Frank.Sorgiovanni@m3property.com.au**

**(03) 9605 1075**

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