m3commentary

MELBOURNE CBD OFFICE

Autumn | 2018

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MELBOURNE CBD OFFICE VACANCY HITS NEARLY RECORD LOW

- Melbourne CBD recorded the largest fall in vacancy rate across Australian CBDs in the 12 months to January 2018 , driven by a combination of stock withdrawals, limited new supply and improved leasing conditions
- Limited new supply was added over the last 12 months with a significant amount of withdrawals recorded over the same time period;
- Leasing conditions remained strong over the last 12 months and is expected to strengthen with limited supply coming online;
- Melbourne CBD sales activity was strongest of the office markets on record over the last ten years;
- Prime yields continued to compress while secondary yields stabilised over the year to January 2018;
- Prime net effective rental growth of 12.4% was recorded in the twelve months to January 2018.

DEFINITIONS

A-REIT: ASX listed Australian Real Estate Investment Trust

Completion date: determined by issue of a "Certificate of Occupancy"

Grade: is determined using the PCA report "A Guide to Office Building Quality".

Net absorption: is the change in occupied stock within a market over a specified period of time.

Net lettable area (NLA): defined in accordance with the PCA "Method of Measurement"

Pre-commitment: contract signed to occupy space in new or refurbished space prior to construction commencing.

Prime: Combination of premium and grade A.

Secondary: Combination of grades B, C and D.

WALE: Weighted average lease expiry.

MARKET OVERVIEW

Market fundamentals remains positive for the Melbourne CBD office market leading into 2018. with both state economic growth and business confidence above the national average. The office sector experienced strong levels of tenant demand over the year to January 2018. This, combined with limited new supply and considerable stock withdrawals, contributed to the Melbourne CBD office vacancy rate declining in January 2018. In turn, strong double digit net effective rental growth was recorded over the year to January 2018 as incentives start to trend down from historical highs. Yields continued to compress over the past year for core assets, with the spread between government bonds and prime yields considered wide compared to the long-term average.

The Melbourne CBD office market experienced limited new supply, considerable withdrawals, positive tenant demand and strong investment demand over the 2017 calendar year.

The CBD vacancy rate declined from 6.5% to 4.6% over the period from January 2017 to January 201. This was the largest drop in vacancy across all Australian CBD markets. This was primarily driven by a combination of stock withdrawals and improved leasing conditions.

Strong tenant demand contributed to the Melbourne CBD recording positive annual net absorption of 74,829 square metres during 2017. Sound Victorian economic fundamentals, employment growth and a low interest rate environment should support tenant demand during 2018.

Demand from firms including engineering and construction, education and training, business services and finance and insurance firms are likely to continue driving Melbourne CBD office demand in the short term.

The Melbourne CBD office market experienced negative net supply of -10,399 square metres over the last 12 months as a result of gross supply of 27,748 square metres and withdrawals of 38,147 square metres.

Melbourne CBD market experienced record level investment activity over 2017 and yield compression driven by high demand and a lack of stock available to the market.

818 Bourke Street, Docklands

KEY INFULENCES

ECONOMIC GROWTH

Victoria Gross State Product (GSP) (seasonally adjusted) grew by 3.3% during 12 months June 2017. Economic growth in Victoria is forecast to outperform national economic growth over the long-term.

EMPLOYMENT

In the year to January 2018 Victoria added over 101,000 jobs, compared to the year prior, with most of the growth occurring during first half of 2017. Although Victoria's seasonally adjusted unemployment rate declined in the month of January to 5.6%, the unemployment rate declined by 0.2 percentage points. The IT, Finance and Insurance sectors remain the main drivers of white collar employment in the State.

CASH RATE AND GOVERNMENT BOND RATES

The RBA has kept the official cash rate stable since lowering it to 1.50% in August 2016. The low cost of debt remains a key driver of investor demand for commercial property. Low returns on government bonds have also encouraged stronger demand for acquiring property as an investment during recent years.

BUSINESS CONFIDENCE

National Australia Bank's index of business confidence was 9 index points (nationally) in February 2018 (0 = neutral). This is above the long-term average for business confidence and is favourable for future economic growth. Business confidence is a key influence behind tenant decisions to relocate, expand or contract.

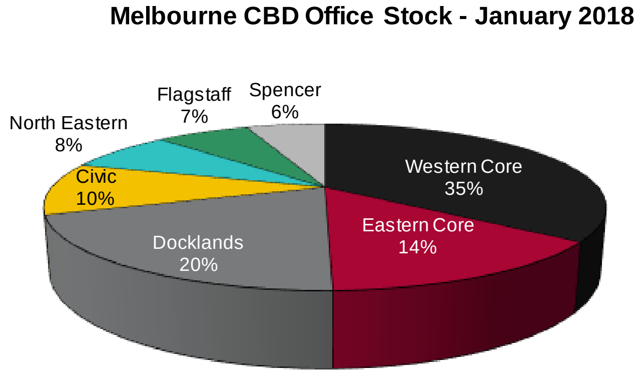
EXCHANGE RATE

While the value of the Australian Dollar has increased over the past year, it remains considerably lower than it was between mid-2009 and mid-2015, when it did not fall below US 80 cents. The lower value continues to be one of the driving forces behind strong demand from foreign investors.

575 Bourke Street, Melbourne

628 Bourke Street, Melbourne

KEY INDICATORS

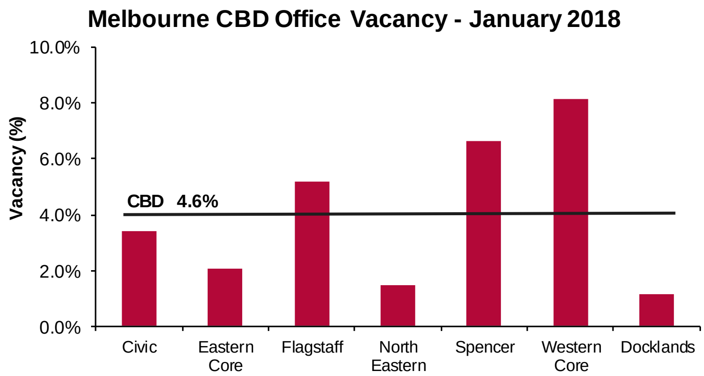


Source: Property Council of Australia OMR, m3property Research

STOCK AND SUPPLY

Total stock in the Melbourne CBD office market declined over the second half of 2017 to 4,515,776 square metres. The partial refurbishment of 161 Collins Street completed during the first half of 2017, with 25,000 square metres added back into the market as well as the partial refurbishment of 525 Collins Street completed in 2017.

Approximately 92,000 square metres is expected to complete during 2018 with 75% of this space pre-leased. Approximately 518,895 square metres is currently under construction to be completed between 2018 – 2021, of which 63% is already precommitted.



Source: Property Council of Australia OMR, m3property Research

VACANCY

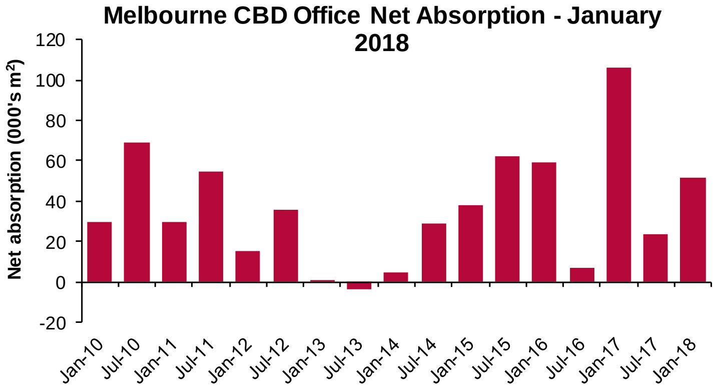
The total vacancy rate for Melbourne's CBD office market fell to 4.6% in January 2018 with prime grade vacancy at 6.5% in January 2017 falling to 3.9% over the 12 month period. Secondary grade vacancy was recorded at 6.4% in January 2017 dropping to 5.8% over the same period. The vacancy rate as at January 2018 remained well below the long term (since 1990) average of 11.2%. Net absorption was 51,376 square metres over the six months to January 2018.

Looking forward the vacancy rate is forecast to remain stable until the end of 2018.

Melbourne CBD Supply Under Construction

Property	Expected Completion	NLA	% Precommitted	Developer
737 Collins Street	4Q-2018	40,000	98%	Walker Corporation
664 Collins Street	2Q-2018	26,395	57%	Mirvac Group
699 Collins Street	3Q-2018	26,400	57%	Lend Lease
447 Collins Street	4Q-2019	49,000	60%	Cbus
271 Spring Street	2019	15,600	100%	ISPT
80 Collins Street	1 Q-2019	43,000	11%	QIC
311 Spencer Street	1Q - 2020	65,000	100%	Cbus
477 Collins Street	1Q - 2020	55,000	40%	Mirvac Group
839 Collins Street	2020+	39,000	70%	Invesco / Challenger
140 Lonsdale Street	2020+	16,500	NA	Charter Hall
130 Lonsdale Street	2020+	55,000	55%	Charter Hall
405 Bourke Street	2020+	66,000	100%	Brookfield / ISPT

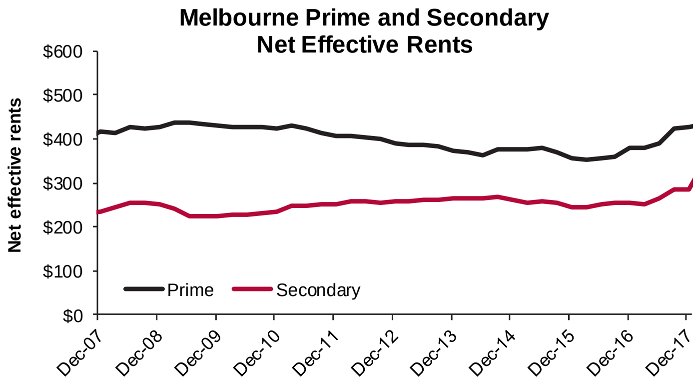
KEY INDICATORS



TENANT DEMAND

The Melbourne CBD office market recorded average net absorption (74,829 square metres) and net supply additions (-10,399 square metres) over the year to January 2018. Prime stock accounted for over 93% of positive net absorption in the year to July 2017. This is consistent with the market experiencing a rise in tenant enquiry for Prime CBD office space. Although tenant demand is expected to remain strong over the short-term, net absorption is anticipated to soften in the first half of 2018 as tenants pre-commit to new builds forecast to complete in 2018 and 2019.

According to the Victorian State Government, finance and professional services are the fastest growing employment sectors in the State, with the respective industries a significant driver of tenant demand in the Melbourne CBD.



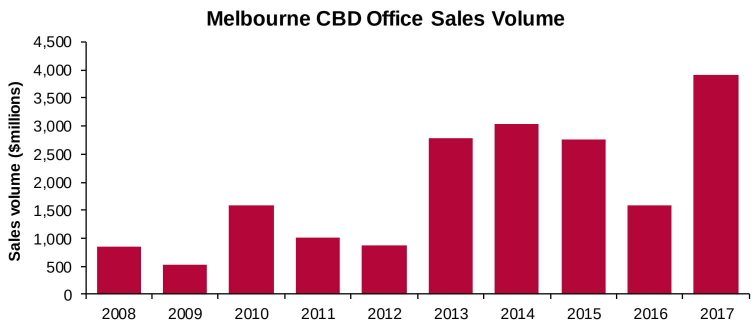
Source: m3property Research.

RENTAL GROWTH AND INCENTIVES

Average prime net effective rents witnessed growth of approximately 12.4% in the twelve months to January 2018, with prime net face rents ranging from $430 to $730 per square metre.

Incentives for prime grade office property declined to circa 22% - 28% during the second half of 2017. It is anticipated incentives will remain stable due to improved tenant leasing conditions and new supply entering the market during 2018.

Strong prime effective rental growth is anticipated over 2018, before slowing in 2019.



Source: m3property Research, Office Sales over $5.

INVESTMENT MARKET AND YIELDS

Investor activity in the Melbourne CBD remained strong in the twelve months to December 2017 with approximately $3.91 billion worth of office stock traded. Transactional activity was above the previous year's total of $1,578,800,000.

Significant transactions to occur the past twelve months include the sale of 477 Collins Street (50%) to Suntec REIT (Suntec) for $414 million, 839 Collins Street having sold to Invesco and Challenger for $425 million and 405 Bourke Street (50% share) which was purchased by ISPT for $400 million.

Prime yields continued to compress over 2017; prime yields compressed 38 basis points with yields ranging from 4.50% to 5.75%. Over the same period, secondary yields compressed 50 basis points with yields ranging from 5.50% to 6.50%.

Yields within the Melbourne CBD office market have reached historically low levels, the current spread between Melbourne's CBD prime office yields and long term government bonds is approximately 2.6 percentage points, which is considered wide when compared to the 20-year average of around 1.8 percentage points.

SIGNIFICANT SALES

Property	Date	Price	Equated Market Yield	Vendor	Purchaser
405 Bourke Street, Melbourne (50% share)	Dec 17	$400,000,000	NA	Brookfield Australia	ISPT
800 Collins Street, Melbourne	Nov 17	$295,200,000	5.15%	Lendlease	Manulife Real Estate
850 Collins Street, Melbourne	Nov 17	$156,100,000	5.80%	CIMB Trust Capital Advisors	MEC and CLSA Real Estate
575 Bourke Street, Melbourne	Nov 17	$140,200,000	5.36%	CIMP Trust Capital Advisors	MEC and CLSA Real Estate
469 LaTrobe Street, Melbourne	Nov 17	$160,500,000	5.29%	CIMP Trust Capital Advisors	AMP Capital Wholesale Office Fund
628 Bourke Street, Melbourne	Jul *17*	$184,650,000	5.74%	M&G Investments	Swiss Foundation
477 Collins Street (50% Share)	Jul 17	$414,000,000	4.80%	Mirvac Group	Suntec REIT
664 Collins Street, Melbourne (50% Share)	Jun 17	$138,000,000	4.98%	Mirvac Group	Morgan Stanley Real Estate Investing (MSREI)
990 Latrobe Street, Melbourne	Jun 17	$114,500,000	5.62%	SA Motor Accident Commission	Charter Hall
313 Spencer Street, Melbourne (50% Share)	Jun 17	$347,800,000	NA	Cbus Property	Keppel REIT
50 Franklin Street, Melbourne	Jan 17	$51,500,000	7.44%	Selected Growth Properties	LBR P/L
839 Collins Street, Melbourne	Jan 17	$425,000,000	5.24%	LendLease	Invesco and Challenger

Please contact one of our Commercial Valuers for a detailed sales analysis.

800 Collins Street, Docklands

850 Collins Street, Docklands

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OUTLOOK
MELBOURNE CBD OFFICE

The outlook for the Melbourne CBD office market remains positive. The sector will continue to benefit from strong annual population growth, increased productivity, and an expanding Victorian economy.

Tenant demand is expected to strengthen over the short term, driven by a lack of available quality stock and considerable withdrawals, with incentive levels likely to reduce over the year.

Vacancy is expected to remain stable over 2018 and 2019 before peaking in 2020 on the back of new supply and backfill space entering the market.

Limited new supply and improved tenant demand will result in prime effective rental growth in 2018, while secondary effective rents are expected to grow marginally.

Looking forward, limited investment opportunities, particularly for premium CBD assets, coupled with strengthening market fundamentals will result in a continued low yielding environment in 2018. Secondary grade yields are expected to remain stable over 2018

Offshore purchasers are expected to remain active in the Melbourne CBD office market, attracted to Victoria's positive fundamentals. Solid economic growth, strong annual population growth, and increasing white collar employment are expected to drive appetite from both local and offshore investors in 2018.

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