Charter Insight
Melbourne CBD Office Market

August 2019
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RESEARCH

Research conducted by Charter and the Property Council of Australia into Melbourne's CBD office markets shows that vacancy rates remain well below the historical average, that there is strong demand for new office space and an appetite among developers to switch from approved residential developments to office developments.

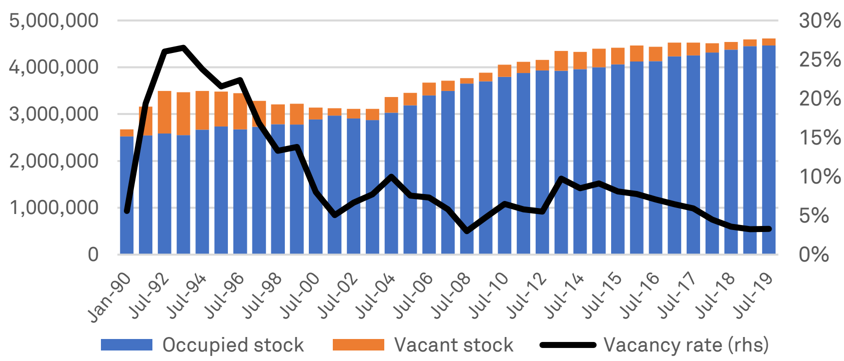
- Vacancy rates have increased slightly in the six months to July 2019 (3.3% compared with 3.2%) but remain well below the historical average of 11%.
- More than 382,800 sqm of new office space is due to be completed by 2021, but this is unlikely to be sufficient to meet expected demand given the level of pre-commitment to this space (86%).
- Low vacancy rates, reduced demand for residential inner-city apartments and high rates of return per sqm for office space are driving developers to convert previously proposed residential developments into office developments.

Supply & Demand

There is currently a total of approximately 4,614,000 sqm of office space within the Melbourne CBD. Since the Global Financial Crisis, the Melbourne CBD has managed to increase its office stock by 22.8%, with an additional 850,000 sqm net being added to the market. During a time of generally sustained global weakness in the office accommodation market, Melbourne has been able to absorb all of the supply thus avoiding any increase in vacancies, a result which is credited to its broad-based economy. The current vacancy rate of 3.3% is one of the lowest levels recorded in over a decade by the biannual Property Council's Office Market Report for Melbourne CBD and sits well below the historical average of 11% vacancy.

When looking at the vacancy rates for the different building grades, it is notable that the demand for space in A-Grade office buildings is extremely strong, with vacancy rates of 1.5%, while Premium Grade stock is sitting at vacancy rates of 4.1%. These rates are the tightest vacancy rates in over 10 years and reflect strong demand for quality office space by tenants.

Figure 1: Total Melbourne CBD Office Stock (SQM)



SOURCE - Charter Keck Cramer & Property Council of Australia (OMR)

Brendon Wood
CONSULTANT - RESEARCH & STRATEGY
E brendon.wood@charterkc.com.au
T +61 (03) 8102 8814

Glenn Lampard
DIRECTOR – VALUATIONS
E glenn.lampard@charterkc.com.au
T +61 (03) 8102 8928

Melbourne
Level 19/8 Exhibition Street
Melbourne VIC 3000
T +61 (0) 3 8102 8888

Sydney
Brisbane
Gold Coast
Singapore

admin@charterkc.com.au
charterkc.com.au

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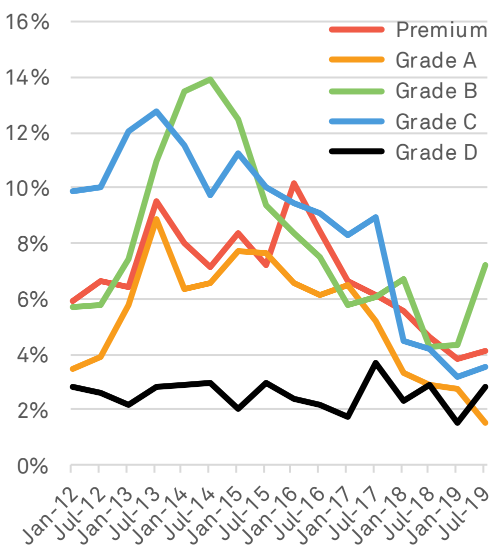
Figure 2: CBD Vacancy by Grade



SOURCE - Charter Keck Cramer & Property Council of Australia (OMR)

Premium and A-Grade stock has retained low vacancy rates over the past decade despite the addition of new stock which has been quickly absorbed. Most of this new stock has been in the Docklands precinct, where over 90% is classified as either Premium or A-Grade. Secondary grade stock has seen greater spikes in vacancy over the past decade, excluding B-Grade stock, which is currently at about 7% vacancy. All other grades are at historically low rates.

With tight vacancy rates and continued demand from tenants for quality space, there are some impending relocations in the next 18 months which will release some existing CBD office space into the market.

The Victoria Police will relocate to a new 65,000 sqm tower at 263-283 Spencer Street, Docklands and Australia Unity has just moved into its new 15,612 sqm tower at 271 Spring Street.

However, space freed by these relocations is minimal and the main focus is on the current and future pipeline of new office supply that has yet to be completed.

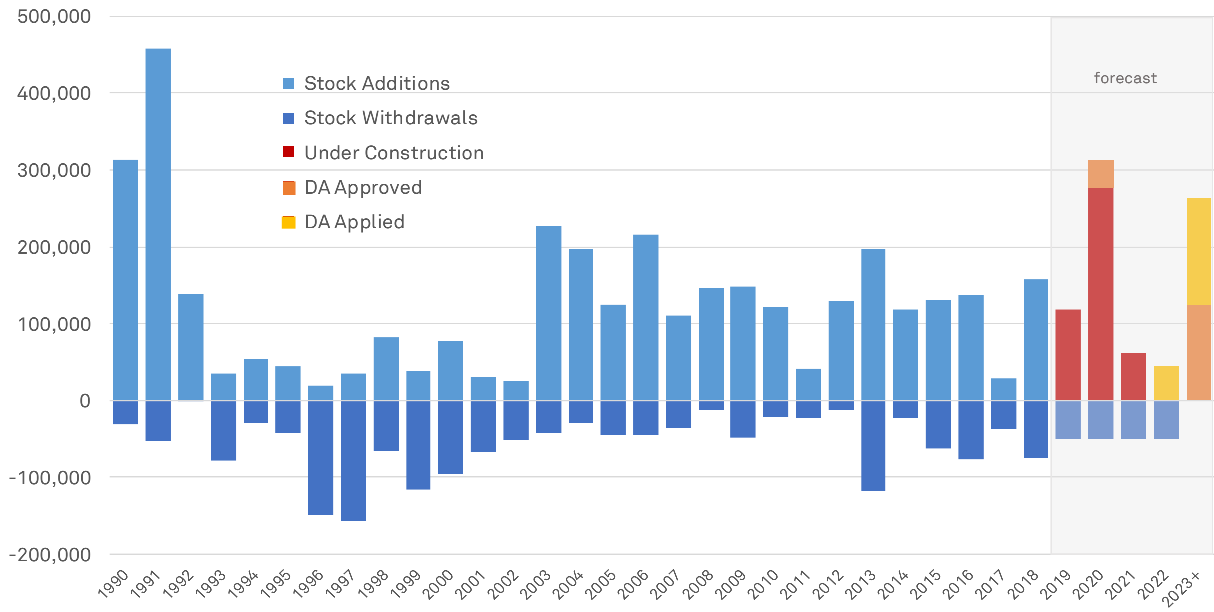
Supply levels are expected to improve slightly in the next few years with several significant projects due to be completed. There is a total of 382,900 sqm of office space currently under construction in the Melbourne CBD but more than 86% of this space has already been pre-committed. A further 263,695 sqm of office space has development approval and just under 80,000 sqm is currently in the planning phase. Given the high levels of pre-commitment the development pipeline and pending relocations leave a relatively limited supply of available new space and this combined with the low vacancy rates in established buildings, will be inadequate to meet the demands of tenants.

Table 1: Office Supply Pipeline

Office Space – Melbourne CBD	
Under Construction	382,894sq.m
Development Approval	263,695sq.m
Being Planned	80,000sq.m
Total	**726,589sq.m**

There are currently no developments in the pipeline beyond 2023, yet the demand for net absorption of office stock is expected to increase by an average of 90,000 sqm per annum to meet demand from tenants. The only tower under construction without any significant pre-commitments is 1000 La Trobe Street.

Figure 3: Melbourne CBD Office Supply (SQM)



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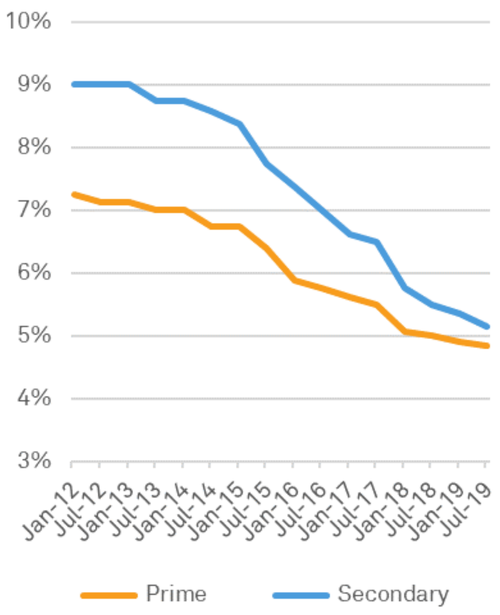
Rents & Yields

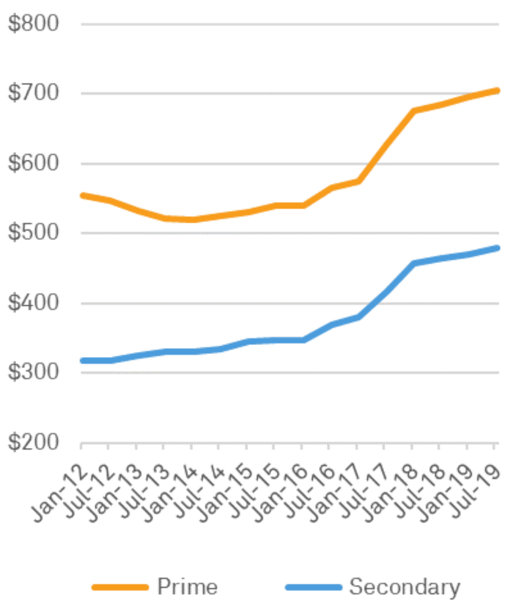
The very tight vacancy rates particularly for good quality stock, are resulting in upward pressure on rents which in turn is prolonging the downward pressure on market yields following an already sustained period of yield compression. The Melbourne office market has recorded extensive purchaser interest from both domestic and international investors. The weight of capital seeking to invest in a limited supply of core office assets is placing continued downward pressure on yields and returns.

This yield compression has been evident across all commercial property markets but particularly in the office market. Improved tenancy covenants associated with lower vacancy rates has helped provide a lower risk profile, attracting investors in a low-return environment. Continued income growth on the back of reduced vacancy levels is also supporting acquisitions, as an improved total returns scenario plays out with both an increase in face rents and a perceived further reduction in incentive levels expected.

Indicative Market Yield



Indicative Market Net Face Rents ($/SQM)



SOURCE - Charter Keck Cramer

Residential to Office Conversion

Low vacancy rates, reduced demand for residential inner-city apartments, strong demand for office space and high rates of return per sqm are driving developers to convert previously proposed residential developments into office projects. Given that office space is currently returning high rates per sqm and provide greater floorplate efficiency, and that there has been a downturn in residential markets, there is a trend for developers to look to convert previously approved residential apartment sites into office space.

Charter has observed that this trend is not limited to the CBD, with several sites in fringe areas such as Cremorne, Richmond and South Yarra also being converted from previously approved residential developments into office developments on the back of a lack of suitable CBD sites and strong rental rates. The following table shows four CBD developments which were previously approved for residential development and will instead now be developed as office space.

Table 2: Residential to Office Conversion Projects

Address	Suburb	No of levels	Net lettable Area
85 Spring Street	Melbourne	16	10,000sq.m
383 La Trobe Street	Melbourne	35	40,000sq.m
150 Queen Street/435 Bourke Street	Melbourne	55	64,500sq.m

Outlook

The Melbourne CBD is expected to continue experiencing tight vacancy rates and increasing rentals in the short term as new office supply continues to be heavily pre-committed. With just over 340,000 sqm of office space either at application stage or in early planning stages, the rate of absorption of these proposed new towers in the coming years will determine the softening, if any, of upward rental pressure beyond the year 2020. With significant levels of pre-commitment in new projects currently, it will be the backfill office space left by vacating tenants plus the few speculative developments without any pre-commitments such as 1000 La Trobe Street that will have the most impact.