RESEARCH

CANBERRA

OFFICE MARKET BRIEF OCTOBER 2014

Key Facts

Over the past 5 years, A-grade vacancy rate in major precincts averaged **5.1% compared with 13.3% in secondary**

Dept. of Finance administering budgetary approval, with **very sound business cases required for relocation**

Commonwealth Government departments being directed to relocate to **sub-lease space, which continues to rise**

The differential between average prime and secondary yields is at a **cyclical high of 209 basis points**

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Leasing sentiment and activity remains constrained by fiscal consolidation, however, in contrast, competition amongst buyer groups remains strong, albeit investors are seeking long lease profiles and selective by asset grades.

Development Activity

Over the past five years, construction levels have been strong with Canberra (Civic & non-Civic) being the standout nationally growing its stock base by 18%. Over the next five years however, our forecasts indicate that Canberra will have the least amount of stock added across all major markets nationally, with only 1.5% expected to be added to its stock base, which will assist in cushioning the contractionary forces currently present.

Additions to the Canberra market during the first half of 2014 only totalled 28,318m², according to the PCA, which was around half the 10 year historical average. This was dominated by the refurbishment of various buildings on Moore and Mort Street, Civic, with the major completion being Investa's 16-18 Mort Street (14,500m²) refurbishment.

Apart from the One Canberra Avenue development, where completion of a five level, 24,500m² office building is imminent (flexible floor plates ranging from 2,200m² up to 5,000m²), there is expected to be a hiatus in construction. KDN Group's Gungahlin Business Park Stage 2 (9,000m²; H1 2015), which is 100% committed by the ACT Government, and ISPT's refurbishment of 2 Constitution Avenue (10,000m² vacant and being fully refurbished; H2 2015), are the only additions likely in 2015.

Beyond this, the market has a number of potential sources of supply however will progress dependent upon pre-commitment and are unlikely to be completed prior to 2017/18. DA approved projects include QIC's Section 96 (37,500m²), Walker Group's Northbourne Square (52,000m²) and Buildings 2 and 4 at the Leighton/Mirvac joint venture development at Section 63, which is a city block located in Civic. Section 63 will integrate commercial, public and retail space, and will incorporate four office buildings, ranging in size from 16,000m² to 50,000 m². There are numerous other projects that are in the early planning stages or are mooted. Federal government agencies will absorb the increasing amount of sub-lease space prior to locking in accommodation in new premises, which will also restrict the rate at which mooted development can proceed.

Occupier Demand & Vacancy

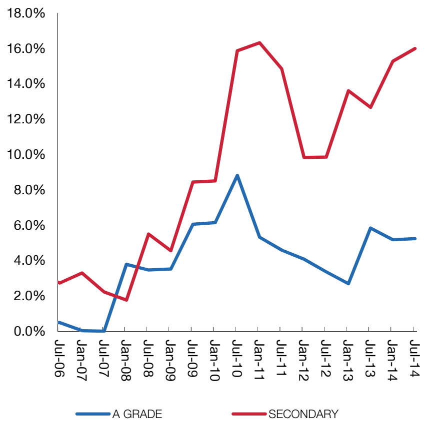
The Canberra vacancy rate has been steadily rising over the past two years and currently measures 13.6% as at July 2014, well above the 9.8% recorded in July 2012. While partly a function of below trend demand growth, the predominant driver has been new supply with stock levels increasing by 7.5% during the past 24 months (occupied stock has increased 2.9% during the same period). Although the Canberra total A-grade vacancy rate measures 12.6%, around two thirds of this vacancy is located within the Airport precinct. A-grade vacancy in other precincts such as Civic, Parliamentary and Town Centres is significantly tighter and sub 6.0%. Figure 1 highlights the diverging fortunes of A-grade and secondary vacancies in the major precincts mentioned above. The A-grade vacancy rate has averaged 5.1% over the past five years compared with 13.3% in secondary (currently 5.2% vs 16%). However amongst the Parliamentary and Town Centres precincts, demand is relatively soft given the lack of expansionary requirements from Commonwealth tenants (although this softness is yet to filter through to official absorption data given the presence of some pre-committed supply being completed).

Anecdotal feedback indicates a degree of improved sentiment amongst private sector tenants who appear to be preparing for an uplift in economic conditions . Although this presents an opportunity in a weakened market, there remains, however, a reluctance to commit to new space given Government uncertainty flowing through to the private sector. At present , private demand remains mostly limited to suites and sub-500m² lease sizes.

Downsizing of the Commonwealth employment base and the subsequent reshaping of government departments has resulted in surplus sub-lease space currently available in the market. Sub-lease vacancy has risen to 1.5% or 35,565m², although around half of this space is located in the Civic precinct, where the sub-lease vacancy rate measures 2.8%. The impact of the available sublease space, ranging from 1,000m²–10,000m², is that it will have first priority as departments source accommodation options. Until the rebalancing of the public service workforce is completed and the sublease space washes through the market, take-up of direct vacancies will stall.

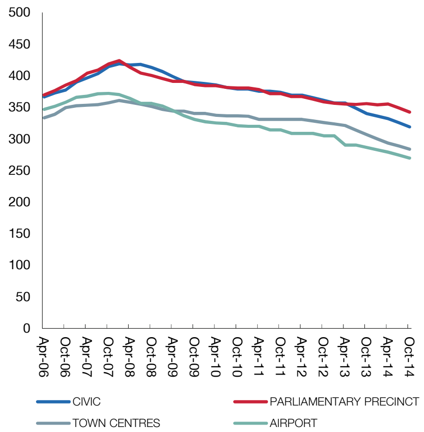
It is anticipated that further increases in sub-lease space will occur given ongoing fiscal constraint, with the Civic precinct likely to rise to circa 5.0% over the next six months with another 15,000m² becoming available. Government protocol to backfill sublease space within the Commonwealth portfolio may result in some tenant inflow to the Civic precinct with the DVA (Dept of Veterans Affairs) relocation a recent example.

FIGURE 1
Canberra Vacancy Major Precincts*
Per six month period (%) - by grade



Source: Knight Frank/PCA
* incorporates Civic, Parliamentary Precinct & Town Centres

FIGURE 2
Average Gross Effective Rent
Canberra ($/m²) - by precinct



Source: Knight Frank

TABLE 1
Canberra Office Market Indicators - October 2014

Grade	Total Stock (m²)^	Vacancy Rate (%)^	Annual Net Absorption (m²)^	Annual Net Additions (m²)^	Average Gross Face Rent ($/m²)	Outgoings ($/m²)	Average Incentive (%)	Average Core Market Yield (%)
A Grade								
Civic (City)	279,874	5.7	-5,077	0	405	74	21.0	7.50-8.50
Parliamentary	237,863	5.9	27,826	40,000	428	69	20.0	7.50-8.50
Town Centres	220,633	4.0	38,483	33,920	376	64	24.5	8.00-9.00
Airport	198,297	40.7	8,051	1,996	372	48	27.5	n/a
Secondary								
Civic (City)	393,210	15.6	6,014	16,628	358	84	27.5	9.50-10.25
Parliamentary	204,227	13.3	15,851	0	380	67	22.5	9.25-10.00
Town Centres	281,078	18.5	-28,511	-2,354	310	65	31.0	10.50-11.50
Total Market#	**2,369,200**	**13.6**	**42,077**	**90,177**				

Source: Knight Frank/PCA ^ as at July 2014 # includes sub-markets in addition to above listed major markets
Parliamentary comprises Barton, Parkes and Forrest office precincts Town Centres comprise Phillip, Tuggeranong and Belconnen office precincts

Rents & Incentives

Prime grade face rents have stabilised over the past six months, albeit still down a modest 0.2% over the past year, with gross face rents (Civic & Parliamentary precinct average) $417/m² as at October 2014. However, incentives have continued to grow, moving from 16.5% to 20.5%. Therefore on an annual basis the average gross effective rent has fallen by 5.0% to currently average $331/m². Some rental growth, led by the modern A grade properties, is expected to begin to emerge during 2015 as the prime vacancy remains relatively tight and with limited further space to come on line.

Secondary rents have also continued to soften over the past 12 months, falling a further 3.5% to average $277/m² on an effective basis ($369/m² gross face at 25% incentive). As vacancy is expected to remain elevated over the next 12-18 months, the secondary market is unlikely to show material improvement until 2016.

Incentives across all precincts have increased significantly over the past 12-18 months and on average seem to be moving towards a baseline of 25% for prime and 30%+ for secondary.

TABLE 2

Recent Leasing Activity Canberra

Address	NLA (m²)	Face Rental ($/m²)	Term yrs	Tenant	Date
28 Sydney Ave, Forrest	2,451	450	5	IBM	Sep-14
4 National Cct, Barton	2,148	Undisc	6	Fujitsu	Aug-14
64 Northbourne Ave, City	1,792	385	3	UGL	Aug-14
2 Phillip Law St, City	1,184	535	15	Servcorp	Aug-14
1 Thynne St, Bruce	6,000	420	15	AIHW	Jul-14
44 Sydney Ave, Forrest	3,463	390	3	DFAT	Jun-14
10 Moore St, City	2,278	375	5	Optus	Apr-14

Source: Knight Frank Undisc refers undisclosed rental

Investment Activity & Yields

In contrast to the general leasing market and local economic sentiment , the investment market is continuing to attract heightened amounts of capital, albeit with investors displaying a degree of selectiveness between asset grades and leasing profiles. Although weight of capital is underpinning prime asset demand with increased competition from AREITs and offshores investors emerging over the past 12 months, purchasers continue to conduct thorough due diligence prior to acquisition.

The majority of buying demand is focussed on prime assets with relatively long WALEs of circa 7 to 8 years as a minimum. Assets without such income security are being materially discounted with increasing evidence of a disparity in yields. For instance a new building with a 15 year Commonwealth lease would likely trade in a core market yield range of circa 6.75%-7.25%, although a semi modern building with an 5 or 6 year lease would be closer to 7.5%-8.5%.

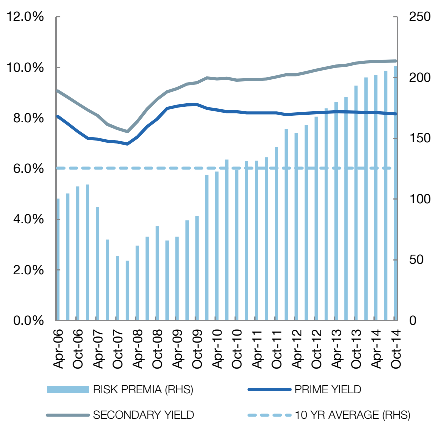
With leasing demand for secondary stock remaining soft, a considerable risk premium continues to be required by investors for assets to trade with average core market yields ranging between 9.5% and 11.5%, although trading above 12% in select circumstances. A number of assets with imminent vacancies or VP have been priced at a 'shell rate' (~$1,000/m²) plus the present value of the current income until expiry.

Opportunistic purchasers are in the market for such assets but there is no urgency. The differential between average prime and secondary yields is at a cyclical high of 209 basis points, 84 basis points above the 10 year average of 125 basis points, highlighting the discounting currently being priced into the market.

FIGURE 3

Core Market Yields & Spreads

Canberra blended average—Prime & Secondary



Source: Knight Frank

TABLE 3

Recent Sales Activity Canberra

Address	Price ($ mil)	Core Mkt Yield (%)	NLA (m²)	$/m² NLA	WALE (yrs)	Vendor	Purchaser	Sale Date
NewActon East, Civic	45.01	7.53	7,498~	6,003	10.1	Acton Developments	Placer Property*	Aug-14
1212 Kirkpatrick St, WC	30.50	10.08	9,286	3,285	8.9	Centuria*	Private Investor	Jul-14
186 Reed St, Greenway	25.81	7.75	5,403	4,776	8.9	Long Service Leave Authority (ACT Gov't)	Investec (IAPF)	May-14
10 Moore St, Civic	18.00	9.76	6,703	2,685	2.9	AMP Capital Investors	Quintessential Equities	May-14
14 Childers St, Civic	38.05#	8.08	15,034	5,062	5.4	Amalgamated Property Group	Morris Property Group	Mar-14
38 Sydney Ave, Forrest	35.50	n/a	9,099	3,902	3.9	Mirvac	Blackstone Group	Apr-14
14 Moore St, Civic	23.00	10.61	11,122	2,068	1.5	DEXUS	Quintessential Equities	Feb-14
26 Brisbane Ave, Barton	13.50	7.63	2,797	4,826	8.1	Private Investor	Hadley Green	Feb-14

Source: Knight Frank * single asset unlisted fund # 50% share WC Weston Creek ~includes 674m² of retail space

Outlook

Budgetary constraints and soft demand are broadening the parameters of tenant requirements, with occupiers increasingly prepared to consider options outside the traditional core to satisfy their needs in line with financial metrics.

Vacancy rates are expected to continue to increase over the next 12 months, with the overhang and potential for further increases in sub-lease space keeping upward pressure on vacancy. Face rents are showing signs of stabilising, however incentives continue to creep up.

The proposed ACT Government office of 40,000m² is again being mooted for Civic and is likely to see other government assets, particularly in the Northbourne Avenue corridor, freed up for redevelopment and will support the proposed light rail project.

Although government departments (and private sector tenants) are showing caution, there are still some relatively large enquiries in the market. After withdrawing an initial RFT for 24,000m² while they reviewed their integration with the Dept. of Immigration, the Australian Customs & Border Protection Service subsequently issued a co-location requirement RFT for 80,000m² in one precinct. Other major enquiries include Dept. of Employment (25,000m²; March 2017), ACT Government (40,000m²; 2018), CSC (3,000-3,750m²; mid 2015), Aust. Crime Commission (4,000m² plus; June 2015) and Deloittes (2,500m²; August 2015).

Prime yields, with bullet proof income streams, will continue to show modest firming over the next 12 months as demand from domestic and offshore investors has grown. Discounting will continue in the secondary market.

Adaptive re-use opportunities may emerge over the coming 12-24 months, albeit this avenue is in somewhat of a holding pattern until the full extent of Government cuts and restructures are determined along with further supporting policies. The current weakness in the secondary market may provide opportunities for developers to convert some of this stock to either mixed-use, hotel or residential uses however the underlying fundamentals are not comparable to Sydney and Melbourne, hence developer interest in this trend has been minimal thus far.

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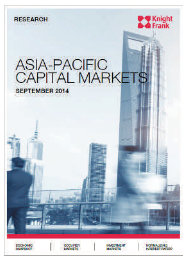

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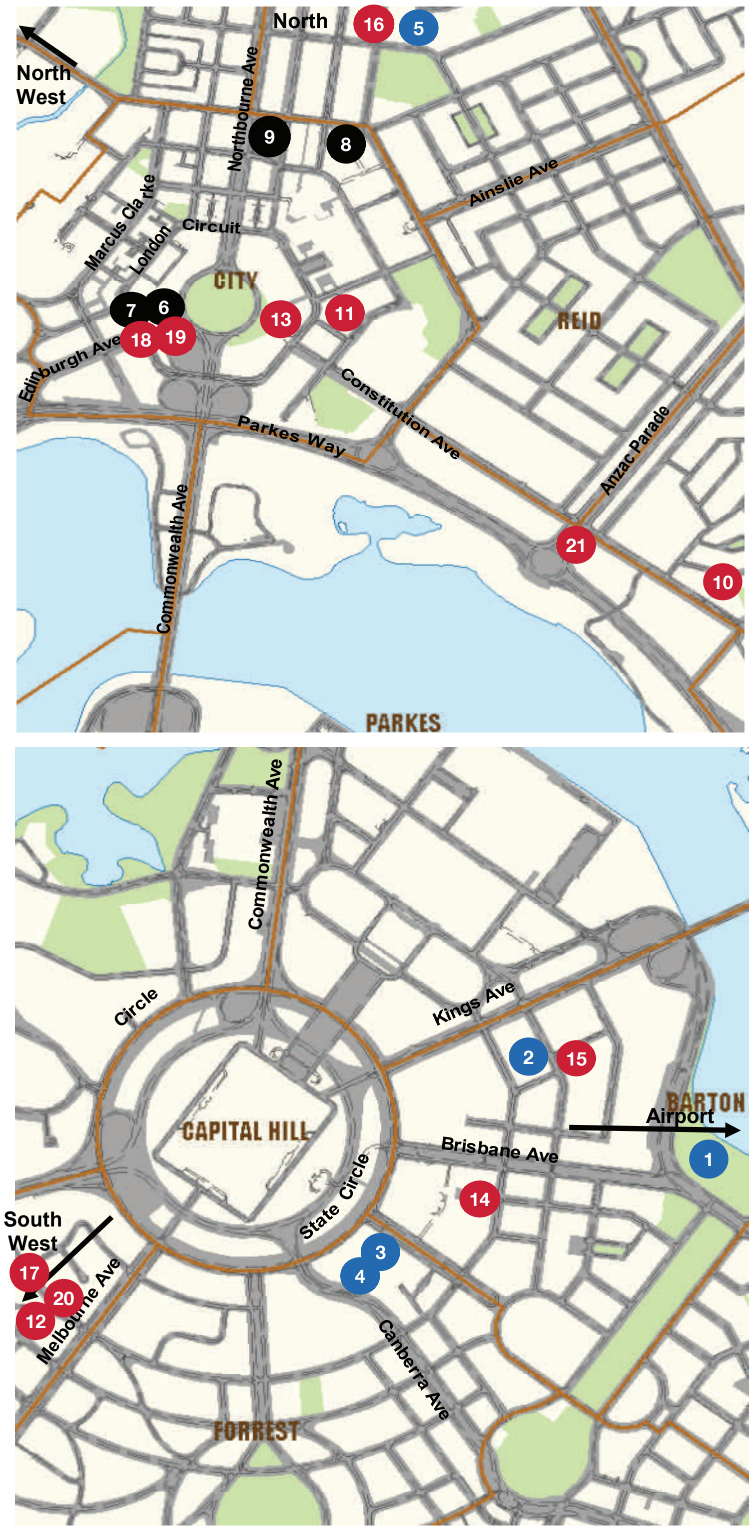
MAJOR OFFICE SUPPLY

1. 3-7 Molonglo Drive, Airport - 36,000m²
   Capital Airport Group - awaiting commitment
2. 4 National Circuit East, Barton - 9,434m²
   ISPT - Complete - 60% committed
3. 28 Sydney Ave, Forrest - 12,500m² [PwC & IBM]
   BDC ACT - Complete - 60% committed
4. 1 Canberra Ave, Forrest - 24,500m²
   Willemsen Group - Q3 2014
5. The Valley Ave & Gungahlin Pl - 9,000m² [ACT Govt]
   KDN Group, Q1 2015 - 100% committed
6. Vernon North - Building 4, London Circuit^ - 25,000m²
   Leighton/Mirvac JV - 2018+ seeking pre-commit
7. Signature Building 2, London Circuit^ - 16,000m²
   Leighton/Mirvac JV - 2018+ seeking pre-commit
8. Section 96^ - 37,500m²
   QIC - 2017+ seeking pre-commit
9. Northbourne Square, Northbourne Ave^ - 52,000m²
   Walker Group - 2018+ seeking pre-commit
10. 71 Constitution Ave, Campbell - 10,000m²
    Hindmarsh Group - 2017+
11. Nangari Street ^ - 6,500m²
    Molonglo Group - 2017+
12. 45 Furzer St, Phillip - 40,600m²
    Doma Group - 2018+ seeking pre-commit
13. Section 4^ - 40,000m²
    ACT Government - 2018+
14. 2 Darling Street, Barton - 11,500m²
    Doma Group - 2018+
15. 44 Macquarie St, Barton - 10,000m² mixed use
    Doma/Morris Group - 2018+
16. 26-28 Antill St, Dickson (ex ACT Tab bldg) - 8,000m²
    Amalgamated Group - 2020+ seeking pre-commit
17. Block 15 Section 3, Phillip - 12,500m² mixed use
    Woden Tradesman Club - DA Lodged
18. Landmark Building, London Circuit^ - 50,000m²
    Leighton/Mirvac JV - mooted
19. Vernon South - Building 3, London Circuit^ - 25,000m²
    Leighton/Mirvac JV - mooted
20. 45 Callam Street, Phillip - 17,500m²
    Hindmarsh Group - Mooted, seeking pre-commit
21. Anzac Park East, Parkes # - 12,534m²
    Federal Govt - mooted

Under Construction/Complete

DA Approved / Confirmed / Site Works

Mooted / Early Feasibility



Map source: ACT Planning and Land Authority (ACTMAPi)

NB. Dates are Knight Frank Research estimates
Major tenant precommitment in [brackets]
Major refurbishment
^ Civic precinct
Office NLA quoted