RESEARCH

Knight Frank

CANBERRA

OFFICE MARKET OVERVIEW MARCH 2015

HIGHLIGHTS

Weak demand from the public sector has partly been offset by an uplift in private sector demand. This follows the continued outsourcing of some Government services.

The vacancy rate has deteriorated from 13.6% to 15.4% in the six months to January 2015. This is a reflection of new supply and weak demand within the secondary market.

Buyer activity remains focused on prime assets with relatively long WALEs of circa 7 to 8 years as a minimum. All transactions in 2014 were priced below $50 million.

KEY FINDINGS

Commonwealth Government departments continue to be directed to **sub-lease space** over direct space.

Gross face rents have remained unchanged, while an uplift in incentives has resulted in negative growth in gross effective rents.

Vacancy rate is expected to ease later in 2015 as improved sentiment from the private sector coincides with no new supply.

Commercial sales totalled $272.8 million in 2014, with a slow down in activity attributed to limited buying opportunities.

LUKE CRAWFORD
Analyst, Research and Consulting

SUPPLY & DEVELOPMENT

Following the recent completion of 1 Canberra Avenue and the refurbished 2 Constitution Avenue, a 2-3 year moderation in supply is expected with no imminent major projects expected.

Additions to the Canberra market during the second half of 2014 totalled 46,037m^2 and was dominated by the completion of 1 Canberra Avenue (24,500m^2) and the partially refurbished 2 Constitution Avenue (10,131m^2). At the same time, 21,563m^2 in withdrawals meant that the net addition to stock over the six month period was 24,474m^2.

Following the recent completions, supply is expected to ease with no major projects (15,000m^2+) expected to be developed over the next 2-3 years. However, this will come as welcome news to the local office market where the vacancy rate is at historical highs. The only addition to supply during 2015 is expected to stem from KDN Group's Gungahlin Business Park Stage 2 (9,000m^2) project which is expected to be completed in mid 2015. However, the site is fully pre-committed to the ACT Government.

Beyond 2015, future supply continues to include the London Circuit major DA approved projects of Vernon North—Building 4 (25,000m^2) and Signature Building 2 (16,000m^2), while just to the north, QIC's Section 96 (37,500m^2) and Walker Group's Northbourne Square (52,000m^2) remain in the longer term pipeline. Historically, office supply in Canberra was founded upon the notion of 'build it and they will come', however post GFC supply has been driven on pre-commitments. In this environment, timing on all projects remains uncertain.

There are numerous other projects that are in the early planning stages or are mooted, however given the recent increase in sub-lease space and the push for federal Government agencies to absorb it, it is likely that future supply will continue to be deferred. In this environment, no major projects are expected to be completed prior to 2018.

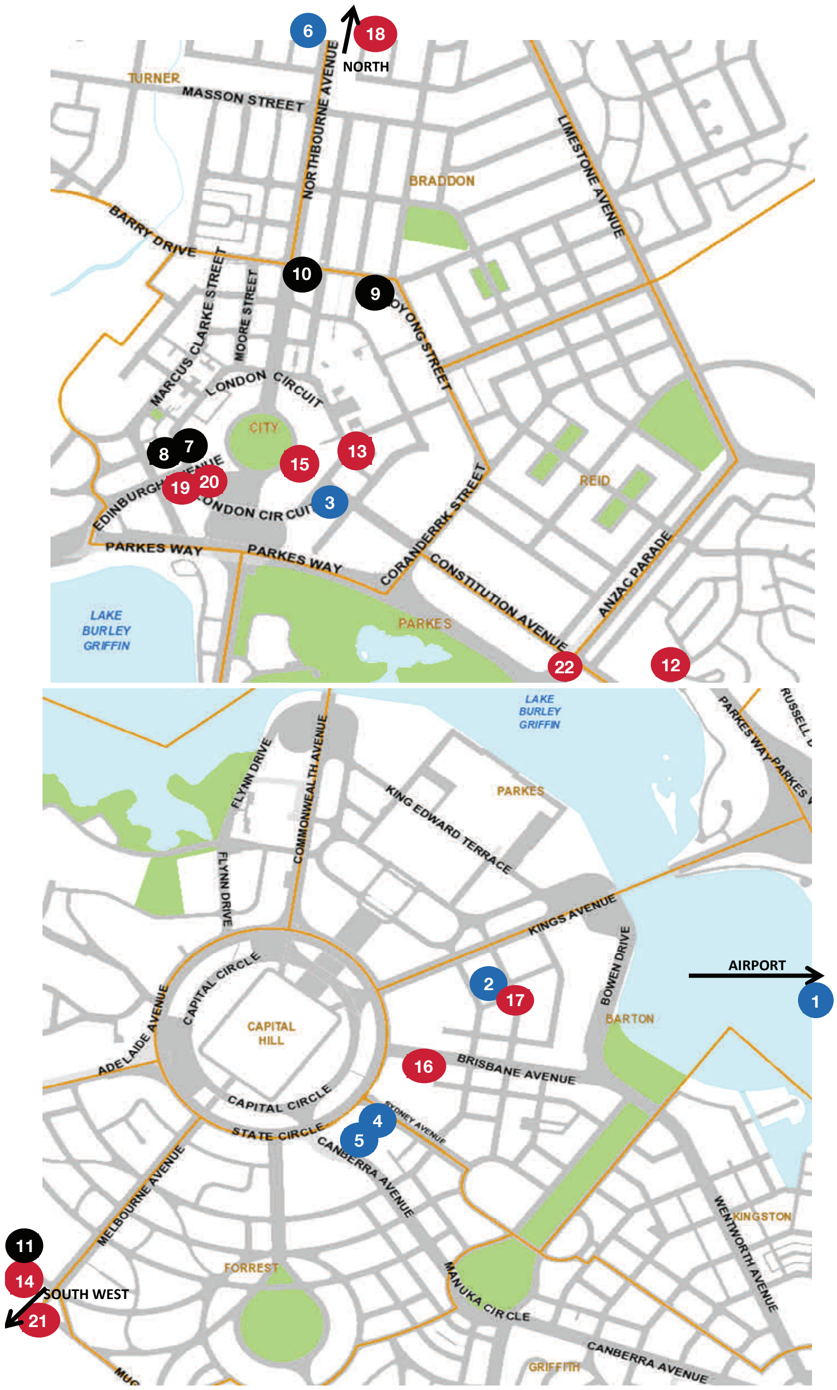
TABLE 1
Canberra Office Market Indicators as at March 2015

Grade	Total Stock (m^2)^	Vacancy Rate (%)^	Annual Net Absorption (m^2)^	Annual Net Additions (m^2)^	Avg Gross Face Rent ($/m^2)	Outgoings ($/m^2)	Average Incentive (%)	Average Core Market Yield (%)
A Grade								
Civic (City)	299,888	11.1	-2,505	20,014	405	74	21.0	7.50-8.50
Parliamentary	261,910	13.1	8,426	24,047	428	69	20.0	7.50-8.50
Town Centres	220,633	4.0	0	0	376	64	24.5	8.00-9.00
Airport	198,297	41.0	2,784	1,996	372	48	27.5	n/a
Other	94,508	12.1	702	0				
Secondary								
Civic (City)	388,062	17.4	6,342	15,326	358	84	27.5	9.50-10.25
Parliamentary	198,343	14.0	-7,648	-5,884	380	67	22.5	9.25-10.00
Town Centres	272,670	19.2	-16,455	-10,762	310	65	31.0	10.50-11.50
Other	459,363	11.3	-14,074	-160				
Total Market#	**2,393,674**	**15.4**	**-21,765**	**44,577**				

Source: Knight Frank Research/PCA ^ as at January 2015 #includes sub-markets in addition to above listed major precincts
Parliamentary comprises Barton, Parkes and Forrest office precincts Town Centres comprise Phillip, Tuggeranong and Belconnen office precincts
Other includes remaining PCA sub localities

MAJOR OFFICE SUPPLY

1. 3-7 Molonglo Drive, Airport - 36,000m²
   Capital Airport Group - awaiting commitment
2. 4 National Circuit East, Barton - 11,582m²
   ISPT - Complete - 60% committed
3. 2 Constitution Ave ^ # - 10,131m²
   ISPT - Complete (total NLA 20,014m²) >
4. 28 Sydney Ave, Forrest - 12,500m² [PwC, OPC & IBM]
   BDC ACT - Complete - 80% committed
5. 1 Canberra Ave, Forrest - 24,500m² [Dept of Finance *]
   Willemsen Group - Complete - 80% committed *
6. The Valley Ave & Gungahlin Pl - 9,500m² [ACT Govt]
   KDN Group, Mid 2015 - 100% committed
7. Vernon North - Building 4, London Circuit^ - 25,000m²
   Leighton/Mirvac JV - 2018+ seeking pre-commit
8. Signature Building 2, London Circuit^ - 16,000m²
   Leighton/Mirvac JV - 2018+ seeking pre-commit
9. Section 96^ - 37,500m²
   QIC - 2017+ seeking pre-commit
10. Northbourne Square, Northbourne Ave^ - 52,000m²
    Walker Group - 2018+ seeking pre-commit
11. Block 15 Section 3, Phillip - 12,500m² mixed use
    Woden Tradesman Club - DA Approved - 2019+
12. 81 Constitution Ave, Campbell - 10,000m²
    Hindmarsh Group - 2018+
13. Nangari Street ^ - 6,500m²
    Molonglo Group - seeking pre-commit - 2018+
14. 45 Furzer St, Phillip - 40,600m²
    Doma Group - 2019+ seeking pre-commit
15. Section 19 (Block 4)^ - 40,000m²
    ACT Government - 2018+
16. 2 Darling Street, Barton - 11,500m²
    Doma Group - 2018+
17. 44 Macquarie St, Barton - 10,000m² mixed use
    Doma/Morris Group - 2018+
18. 26-28 Antill St, Dickson (ex ACT Tab bldg) - 8,000m²
    Amalgamated Group - 2020+ seeking pre-commit
19. Landmark Building, London Circuit^ - 50,000m²
    Leighton/Mirvac JV - mooted
20. Vernon South - Building 3, London Circuit^ - 25,000m²
    Leighton/Mirvac JV - mooted
21. 45 Callam Street, Phillip - 17,500m²
    Hindmarsh Group - Mooted, seeking pre-commit
22. Anzac Park East, Parkes # - 12,534m²
    Federal Govt - mooted



Map source: ACT Planning and Land Authority (ACTMAPi)

NB. Dates are Knight Frank Research estimates
Major tenant precommitment in [brackets]
* Under Offer - recently tabled in parliament for new lease
^ Civic precinct
Office NLA quoted
Major refurbishment

> Underwent major refurbishment including the replacement of mechanical services, a new façade, lobby and toilets on all floors. The unoccupied space was fully refurbished while the remaining NLA which is occupied by Customs was left untouched

Blue: Under Construction/Complete
Black: DA Approved / Confirmed / Site Works
Red: Mooted / Early Feasibility

TENANT DEMAND & RENTS

Employment cuts and new supply has underpinned a large rise in the vacancy rate over the past six months. At present, the vacancy rate measures 15.4%, up from 12.9% a year ago. New supply has also come at the expense of the secondary market as the bulk of new stock is pre-committed, which has resulted in soft demand in lower quality buildings.

There remains a considerable separation between prime and secondary vacancy rates in Canberra's major office precincts. A-grade vacancies at Civic, Parliamentary Precinct and Town Centres currently stands at 9.8% which is substantially below the secondary market at 17.2% (see figure 1). This partly reflects the aspirational movement by smaller private tenants to higher quality buildings, which has left backfill space in secondary assets. The uptick in A-grade vacancies over the past six months is the result of new supply. (1 Canberra Avenue and the refurbished space 2 Constitution Avenue).

For some time now, it has been suggested that the Department of Finance will occupy 20,502m² at the newly built 1 Canberra Avenue, while the Australian Electoral Commission (AEC) would seek to co-locate and occupy the remaining office space. However, the Department of Finance's proposal has come under much scrutiny in recent weeks, particularly from the Parliamentary Public Works Committee, and the relocation remains unclear.

Unoccupied space at the Airport continues to remain a drag on the overall vacancy rate, accounting for over half (52%) of A-grade vacancies. As at January 2015, the vacancy rate at the Airport measured 41.0%, and is largely the result of new supply rather than a lack of demand.

Net Absorption

Tenant demand, as reflected by net absorption figures, has been weak over the past year. In the six months to January 2015, negative net absorption of 21,358m² (-21,765m² for the year) was recorded. However, it is very much a two tier market, with net absorption in the majority of prime markets remaining positive, particularly the Parliamentary precinct (3,564m² in the past six months). Alternatively, the secondary market has been subject to volatility, where on an annual basis negative net absorption has measured 31,835m² (see figure 2).

It appears that consumer sentiment amongst private sector tenants is improving as reflected by an increase in enquiries. A number of Government services have been outsourced which has provided scope for private consultancies to expand. A number of existing private sector tenants also appear to be taking advantage of favourable leasing conditions and consolidating their office space to one location. This is highlighted by the recent Deloitte deal at 8 Brindabella Circuit, where the professional services firm is leasing an additional 945m². Other notable lease deals include the law firm Meyer Vandenberg moving to 121 Marcus Clarke Street, Civic (see table 3).

Absorption levels from the public sector have been weak following the Federal Budget with the consolidation of some Government agencies. The reshaping and downsizing of Government departments has resulted in a rise of good quality sub-lease space. Given this rise, it is likely there will be less take-up of direct vacant space over the next 12 months as other departments are urged to relocate to sub-lease space.

TABLE 2

Canberra—Vacancy Rates

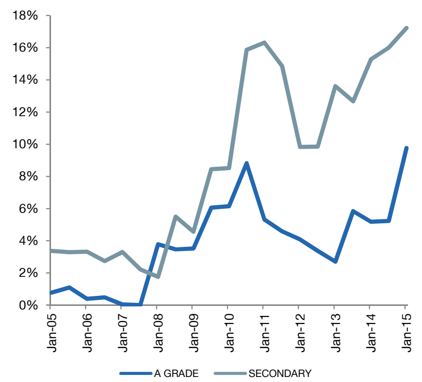
Grade	Jan 14	Jan 15
Prime	**12.9%**	**15.7%**
B Grade	12.7%	11.4%
C Grade	11.9%	17.3%
D Grade	20.3%	18.5%
Secondary	**12.9%**	**15.1%**
Total	**12.9%**	**15.4%**

Source: Knight Frank/PCA

FIGURE 1

Canberra Vacancy—Major Precincts*

Per six month period (%) - by grade

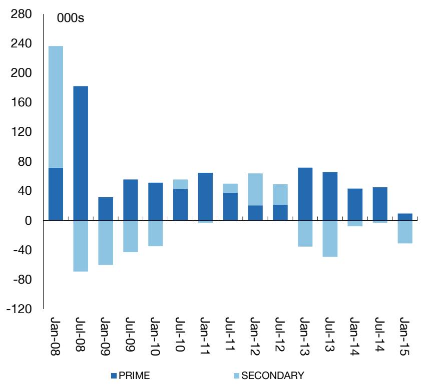


Source: Knight Frank/PCA

FIGURE 2

Annual Net Absorption by Grade

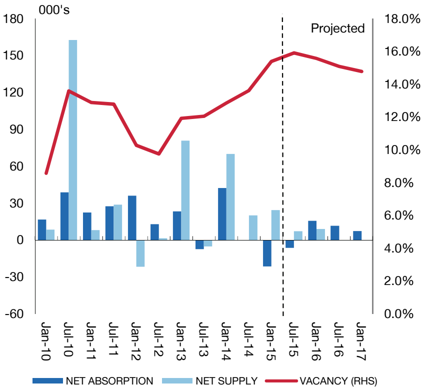
Canberra Total—Rolling Annual



Source: Knight Frank/PCA

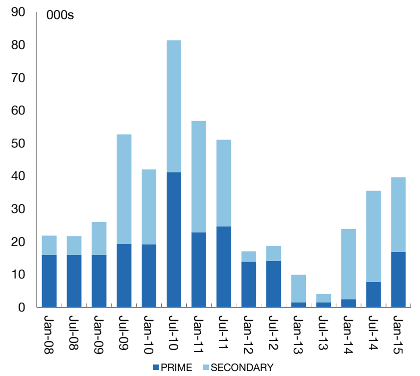
"Demand from private sector tenants continues to grow as Government services are outsourced"

FIGURE 3
Net Supply, Net Absorption & Vacancy
Canberra Total Forecast



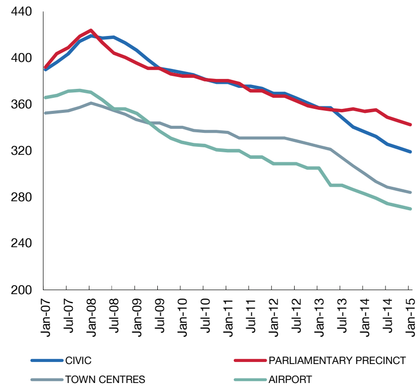
Source: Knight Frank/PCA

FIGURE 4
Canberra Sub-lease Vacancy
By Grade



Source: Knight Frank/PCA

FIGURE 5
Canberra A-grade Gross Effective Rents
By Precinct ($/m²)



Source: Knight Frank/PCA

Looking ahead, it is anticipated that negative net absorption will prevail over the next six months. Thereafter, net absorption is expected to improve with a number of lease deals due to commence. Demand within the secondary market is expected to remain soft as private businesses continue to relocate to higher quality office space. The vacancy rate is also expected to ease towards the end of 2015. An accelerated recovery in the vacancy rate could be assisted by stock withdrawals for residential and mixed-use conversion, with the proposed Capital Light Rail development likely to create demand for adaptive reuse opportunities.

Rents & Incentives

Rents for both prime and secondary markets have remained stagnant over the past 12 months. On the other hand, incentives continue to have a strong bearing on the market with a modest increase recorded over the past 12 months as landlords seek to secure tenants before more anticipated Government employment cuts.

The small increase in incentives has resulted in negative growth in gross effective rents. Currently, average A-grade gross face rents across the combined Civic and Parliamentary precincts is $417/m^2, which is unchanged from 12 months earlier. An increase in incentives to just under 21% has reduced gross effective rents to $319/m^2 and $342/m^2 for the Civic and Parliamentary precincts respectively. The secondary market continues to face strong competition as prime leasing options become comparably cheaper. No movement in gross face rents was recorded over the past 12 months, while an uptick in incentives meant that average gross effective rents reduced to $277/m^2 (down 3.5% for the year) across the combined precincts.

No material improvement in gross face rents is expected over the coming 12 months while the increase in sub-lease space and continued weak tenant demand from the public sector is likely to see incentives move towards 25% for prime and 30%+ for secondary assets.

TABLE 3
Recent Leasing Activity Canberra

Address	Locality	NLA (m²)	Face Rental ($/m²)	Term (yrs)	Lease Type	Tenant	Date
28 Sydney Avenue	Forrest	2,730	450g	10	New	OPC	Oct-15
8 Brindabella Circuit*	Airport	945	N/A	10	New	Deloitte	Aug-15
121 Marcus Clarke Street	Civic	2,900	390g	10	New	Meyer Vandenberg	May-15
Building 4, Equinox, 70 Kent Street	Deakin	1,040	395g	5	New	SAP	Apr-15
73 Northbourne Avenue	Civic	294	395g	5	New	Technology One	Apr-15
2-6 Bowes Street	Phillip	940	365g	5	New	DHS	Jan-15
73 Northbourne Avenue	Civic	379	410g	5	New	FEI Canberra Pty	Jan-15
221 London Circuit	Civic	1,499	380g	2	New	ACT—Asbestos Taskforce	Dec-14
14 Moore Street	Civic	2,609	380g	4	New	Lockheed Martin	Sep-14

Source: Knight Frank *currently occupies 1,665m² at 8 Brindabella Circuit g refers to gross

INVESTMENT ACTIVITY & YIELDS

Office transactions in Canberra have remained buoyed over the past year despite challenging market conditions. In the 12 months to December 2014, office sales have trended 66% above the 10 year average of $164.6 million. However similar to the leasing market, investment activity in Canberra is very much a two tier market. Prime grade assets with solid lease covenants and minimal CAPEX requirements are experiencing solid interest from institutional and overseas investors. Assets with shorter WALEs of circa 5 years and below are seeing considerable discounts applied.

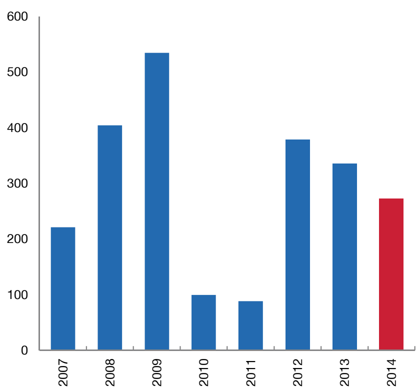
Despite remaining high by historical standards, investment activity in Canberra continues to ease with sale volumes trending downwards from the most recent peak in 2012. However, there remains considerable capital in the market, underpinned by offshore and unlisted funds. The modest slowdown largely reflects the ‘cherry picking’ nature of investors, coupled with the relatively limited offering of prime grade assets.

The bulk of sales activity remains concentrated around Civic and Barton, while investors continue to show a degree of selectiveness between asset grades and leasing profiles. Over CY 2014, sale volumes ($10m +) totalled $272.8 million, which is a 19% reduction from the $335.5 million recorded during 2013 (see figure 6). Market activity over the past year was dominated by sub $40 million sales, while the largest transaction was the August 2014 acquisition of NewActon East for $45.01 million, reflecting a core market yield of 7.53%.

Cheap debt brought about by historically low interest rates, coupled with mispriced assets relative to other CBD markets and a high risk premium in Canberra will ensure the market is now a focus for buyers.

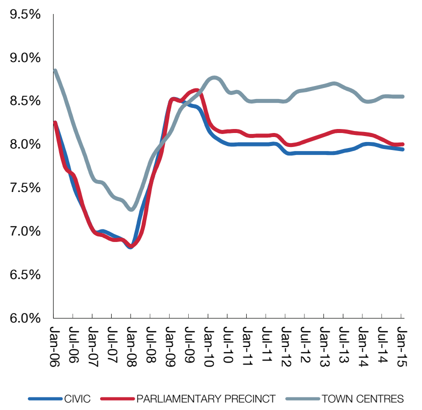
The majority of buying demand is focused on prime assets with relatively long WALEs of circa 7 to 8 years as a minimum. Assets without such income security are being materially discounted

FIGURE 6
Canberra Office Transactions
$10million +



Source: Knight Frank

FIGURE 7
Prime Core Market Yields
By Precinct



Source: Knight Frank/PCA

TABLE 4
Recent Sales Activity Canberra above $10 million

Address	Price ($ mil)	Core Mkt Yield (%)	NLA (m²)	$/m² NLA	WALE (yrs)	Vendor	Purchaser	Sale Date
44 Sydney Avenue, Forrest	32.00	11.80	9,977	3,207	n/a	360 Capital Canberra Trust	Quintessential Equities	Dec-14
217 Northbourne Avenue, Turner>	11.45	n/a	2,707	4,230	n/a	Magpie Prop. Developments	217 NBA Pty Ltd	Dec-14
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
38 Sydney Ave, Forrest	35.50	n/a	9,099	3,902	3.9	Mirvac	Blackstone Group	Apr-14
14 Childers St, Civic	38.05#	8.08	15,034	5,062	5.4	Amalgamated Property Group	Morris Property Group	Mar-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
> purchased with the intention for residential conversion with a DA already lodged.

with increasing evidence of a disparity in yields. With leasing demand for secondary stock remaining soft, a considerable risk premium continues to be required by investors for such assets.

The underlying market fundamentals have created an opportunity for buyers to reposition or redevelop secondary assets with residential or mixed-use conversions the likely outcome. A number of assets have already been identified as potential conversions, however a number of factors influencing the Canberra residential housing market are yet to play out, including the "Mr Fluffy" loose-fill asbestos buybacks and the planned Capital Light Rail development. Notwithstanding these factors, 20 Allara Street Civic (13,948m²) is currently on the market and will provide a benchmark for the conversion story.

Average core market yields have remained steady over the past six months, with core prime market yields ranging between 6.75% to 7.50% for assets with long WALEs and solid leasing covenants. In the case where prime assets have a weaker leasing profile, prime core market yields are materially higher at 7.50% to 8.50%. Alternatively, core market yields within the secondary market range between 9.25% and 11.50%. The differential between average prime and secondary yields remains at cyclical highs which accentuates the discounting currently being priced into the market (see figure 8).

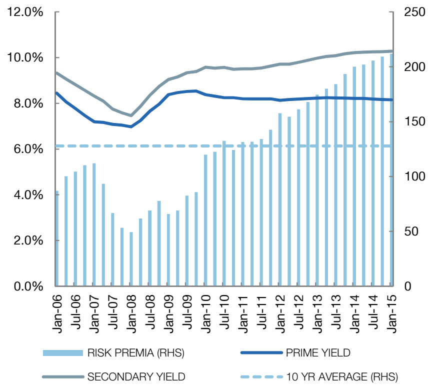
Looking ahead, there remains scope for some yield compression over the next 12 months, assisted by continued investor demand in a market characterised by limited buying opportunities and low cost of debt.

Buildings currently on the market for sale include the Mirvac owned 54 and 60 Marcus Clarke Street buildings which are being offered individually or part of a portfolio of 5 (2 in Sydney and 1 in Melbourne). Both assets are B-grade buildings located in Canberra's Civic precinct. Other sales on the market include the previously mentioned 20 Allara Street.

FIGURE 8

Core Market Yields & Spreads

Canberra blended average—Prime & Secondary



Source: Knight Frank

"There remains scope for some yield compression, assisted by strong investment demand in a market characterised by limited buying opportunities"

Outlook

- Financial constraints brought about by the 2014-15 Budget and with weak demand from public sector tenants is likely to constrain Canberra's office market during 2015.
- Positive signs are emerging from the private sector with a pick up in leasing demand. New lease deals from private tenants is expected to gradually gain some momentum in 2015.
- Private sector tenants are expected to take advantage of weak leasing market conditions and upgrade to higher quality buildings.
- Face rents are expected to remain flat over the next 12 months with an uplift in incentives continuing to play a role in lease negotiations.
- The increase in Government sub-lease space is likely to lead to less take-up of direct vacant space over the next 12 months.
- While there are a number of potential development sites in the pipeline, particularly within Civic, these developments will not proceed without a satisfactory level of pre-commitments. It is therefore likely that these projects will be deferred until demand from larger Government tenants improves.
- A weaker supply pipeline over the next 2-3 years will assist net absorption and place downward pressure on the vacancy rate.
- High risk premiums and mispriced assets relative to other CBD markets is likely to ensure the market becomes a focus of both domestic and global capital.
- Conversion opportunities are expected to emerge as buyers look to reposition or redevelop secondary assets. However, this is reliant on a number of influential factors including Government policy, potential light rail development and the "Mr Fluffy" loose-fill asbestos buybacks.

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Front Cover photo: 4 National Circuit, Barton. Owned by ISPT Core Fund

* Major Precincts incorporates Civic, Parliamentary Precinct & Town Centres

Definition:
Core Market Yield: The percentage return/yield analysed when the assessed fully leased net market income is divided by the adopted value/price which has been adjusted to account for property specific issues (i.e. rental reversions, rental downtime for imminent expiries, capital expenditure, current vacancies, incentives, etc.).

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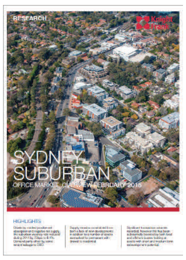

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