Intelligent Investment

JUNE 2024

Why Melbourne
Office

REPORT

CBRE RESEARCH

Executive Summary & Outlook

Conditions in Melbourne's office market indicate an investment cycle beginning to turn favourable, driven by elevated demand and a subdued supply environment that will aid office fundamentals for years to come.

Melbourne is primed to see elevated demand levels driven by two key areas; migration and expansionary occupier activity.

Australia's migration levels have reached historic highs. This trend is forecast to continue, with elevated migration expected for the remainder of the decade. We expect Melbourne's relative affordability and liveability to drive growth from net overseas and interstate migration into Victoria, supporting the outlook for Melbourne office.

Large occupier activity across Melbourne's CBD has been mostly contractionary post-pandemic. We expect a reversion of this trend. As economic conditions improve, occupiers are likely to be looking to expand to capitalise on potential growth. Current prime office availabilities drive our perspective that existing assets across the CBD will command strong rental premiums for assets with in demand building features and fundamentals.

Investment into Melbourne's office market in 2024 comes at an opportune time driven by a range of key fundamentals. Our analysis shows Melbourne is set to repeat multiple former cycles. At the forefront of this is Melbourne's office supply outlook. Local conditions highlight office supply is set be subdued in the short term. From 2027 onwards, given current feasibility and lending conditions, expectations are that limited to no supply will enter the market.

These conditions drive our perspective that vacancy is peaking, incentives are set to decline and current capital values represent a once in a cycle buying opportunity.

All signs are pointing towards significant improvements in Melbourne's office fundamentals, answering the question "Why Melbourne?".

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The Affordability Puzzle

The Now, The Why, The Future

The Now

Australia, like most of the globe, is facing rising cost of living pressures that are expected to linger in the coming years.

As a result, housing affordability is an increasingly important factor for local and foreign white-collar workers. Melbourne's position as a global city across key metrics aids this perspective.

The Why

CBRE Research data shows a clear trend. Australian office workers value affordability and commute time as two of the highest priority items when choosing where to live.

Melbourne's residential housing market offers white-collar workers significantly more affordable living when factoring in both wages and housing affordability for comparable assets.

The Future

CBRE Research expects two trends to impact Melbourne's office market for the rest of the decade:

Increased proportion of overseas migrants

We expect white-collar, overseas migrants to find a greater appeal in Melbourne's relative affordability and strong economic opportunity. This has the potential to drive increased inflows above the historic average of 25%.

Increased net interstate migration

We expect white-collar Australian workers living in other major capital cities to move to Melbourne at increasing rates. This will be driven by the allure of it's affordability and comparable earning ability relative to other cities.

What matters to Australia's white-collar population

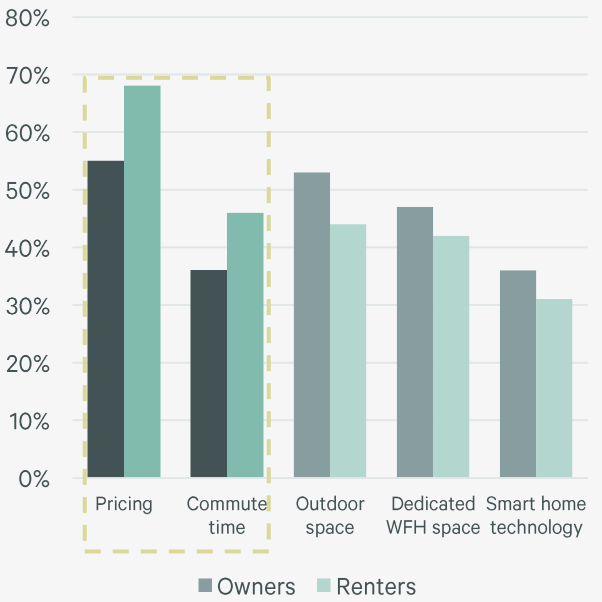
Australian white-collar workers have a clearly demonstrated preference for three key areas when assessing where to live; housing affordability, economic opportunities and commute time.

Affordability was ranked the most important amongst both owners and renters.

Economic opportunity ('pay and benefits') was the most prominent answer (65%) amongst Australian workers when considering new job opportunities. Commute time ranked second with more than half noting it as a key consideration.

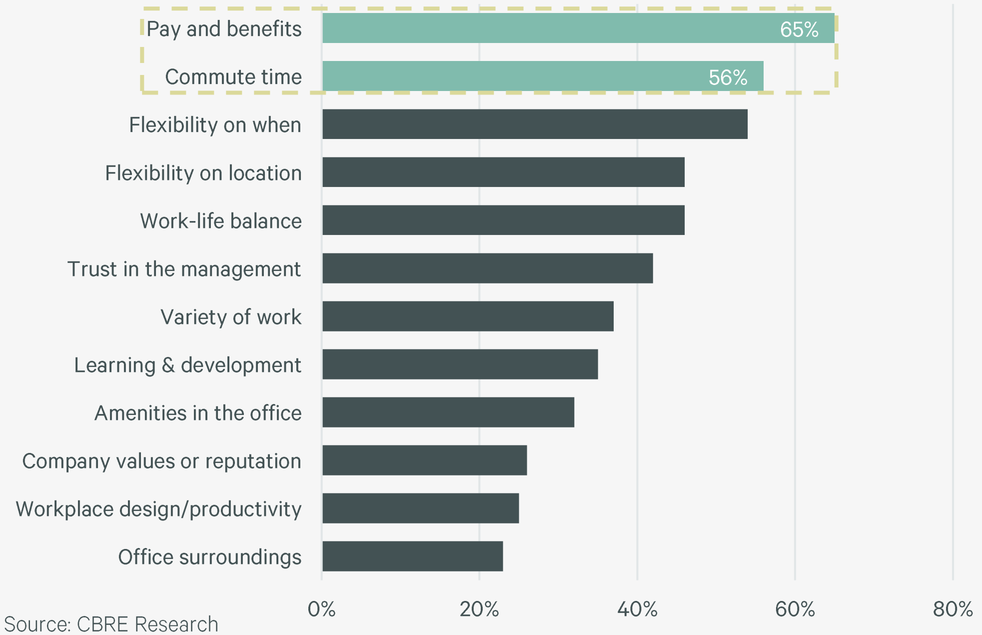
When considering commute time, more than two thirds of Australian workers prefer to live within 30 minutes of their office when considering where to work.

Figure 1: Factor importance when choosing a property.



Source: CBRE Research

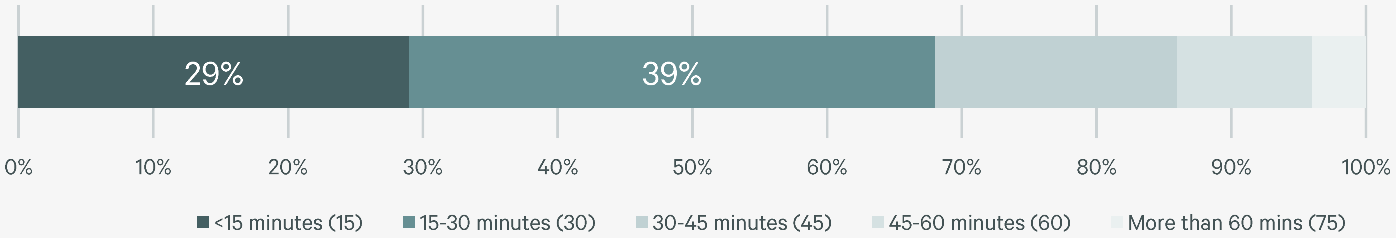
Figure 2: Parameters for assessing job opportunities



Source: CBRE Research

Figure 3: Office posture preference by commute time

68%
of Australian office workers prefer <30min commute times



Source: CBRE Research

Affordability differentials between states

When assessing comparable suburbs within a 30-minute radius of the CBD, Melbourne's affordability is in stark contrast to that of Sydney.

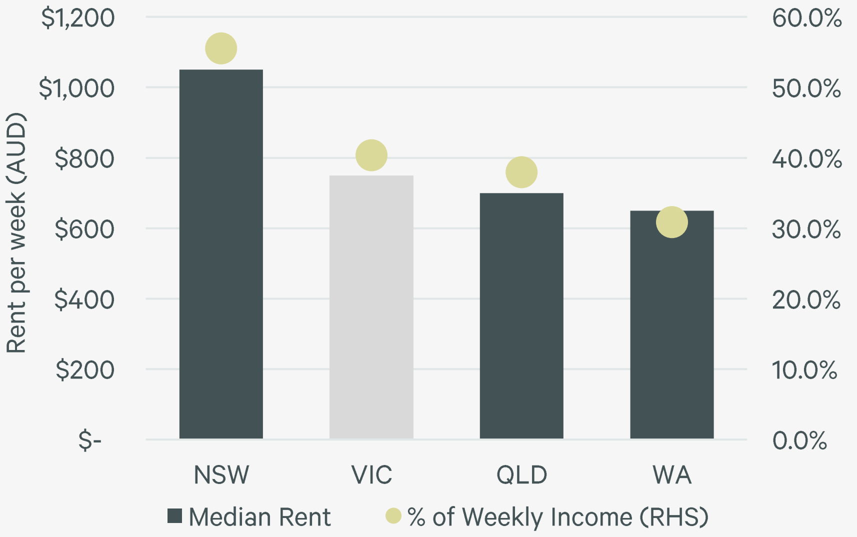
On a nominal basis, median rents in Sydney are c.40% higher than that in Melbourne. With respect to house prices, this difference equates to c.80%.

When adjusting for wage differentials, this equates to a c.15% difference in weekly income expenditure.

Whilst other major Australian states present higher levels of affordability, Victoria is a key hub for Australian employment, accounting for more than a quarter of employment nationally.

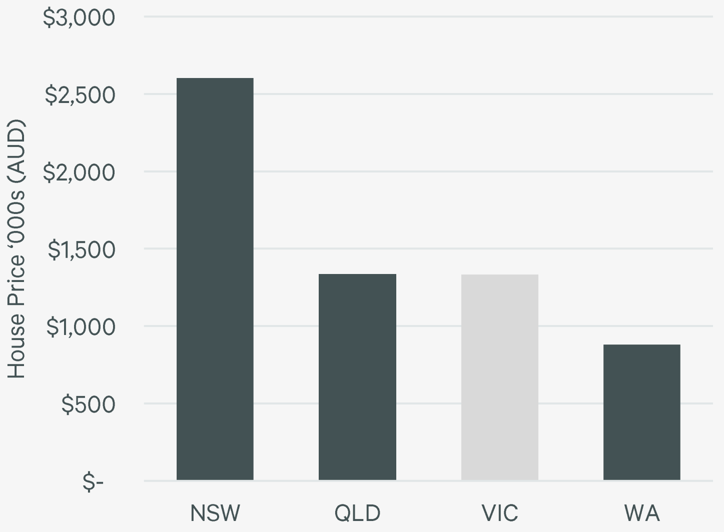
This relationship between employment and affordability is a key reason for our expectations elevated interstate migration inflows to occur over the remainder of the decade.

Figure 4: Rental affordability of comparable suburbs by state



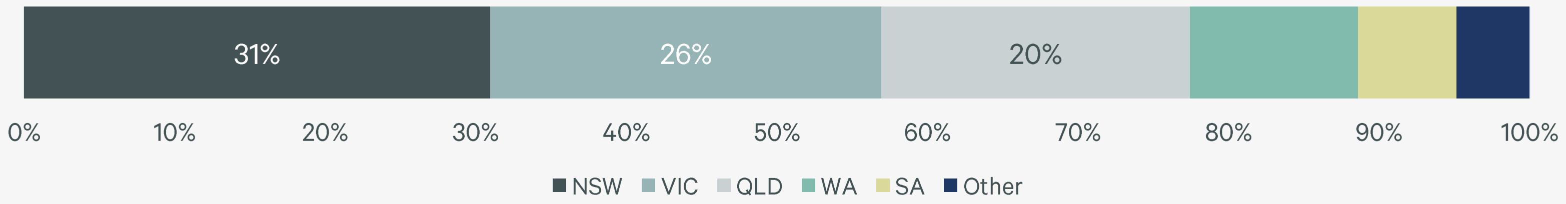
Source: CBRE Research, CoreLogic, ABS
Note: Comparable suburbs are defined as suburbs within a 30minute radius of a central CBD location.

Figure 5: House affordability of comparable suburbs by state



Source: CBRE Research, CoreLogic,
Note: Comparable suburbs are defined as suburbs within a 30minute radius of a central CBD location.

Figure 6: Share of total Australian employment



Source: CBRE Research, ABS

Melbourne is a global city

Despite being less well-known relative to its global counterparts, Melbourne ranks in the top 10 global cities across three key metrics; quality of living, crime and cost of living.

This puts Melbourne as one of the most liveable cities in the world.

Melbourne's liveability is a key factor as to why we expect elevated levels of overseas migration into the state over the remainder of the decade.

Figure 7: Relative positioning amongst global cities

Quality of living	Crime	Cost of Living	Economic opportunities	Wealthiest
Auckland	Tokyo	Johannesburg	Dubai	New York
Vancouver	Singapore	Jakarta	London	Tokyo
Sydney	Sydney	Mumbai	New York	London
Toronto	Toronto	Vancouver	Paris	Singapore
Berlin	Melbourne	Auckland	Singapore	Los Angeles
Melbourne	London	Toronto	Shanghai	Hong Kong
Singapore	New York	Melbourne	Los Angeles	Shanghai
Paris	Frankfurt	Sydney	Hong Kong	Sydney
New York	Los Angeles	Dallas	Madrid	Toronto
Milan	Auckland	Milan	Sydney	Houston
London	Hong Kong	Berlin	Toronto	Melbourne
Madrid	Dallas	Paris	Mumbai	Paris
Tokyo	Paris	Tokyo	Vancouver	Dubai
Los Angeles	Madrid	Dubai	Melbourne	Mumbai
Dallas	Dubai	London	New Delhi	Rome
Hong Kong	Milan	Shanghai	Berlin	Vancouver
Dubai	Shanghai	Los Angeles	Tokyo	New Delhi
Johannesburg	Johannesburg	New York	Milan	Madrid
Jakarta	Mumbai	Singapore	Auckland	Auckland
Mumbai	Jakarta	Hong Kong	Johannesburg	Manchester

Source: BCG, Henley & Partners, Mercer, World Population Reviews, CBRE Research

How migration will impact Melbourne’s office market

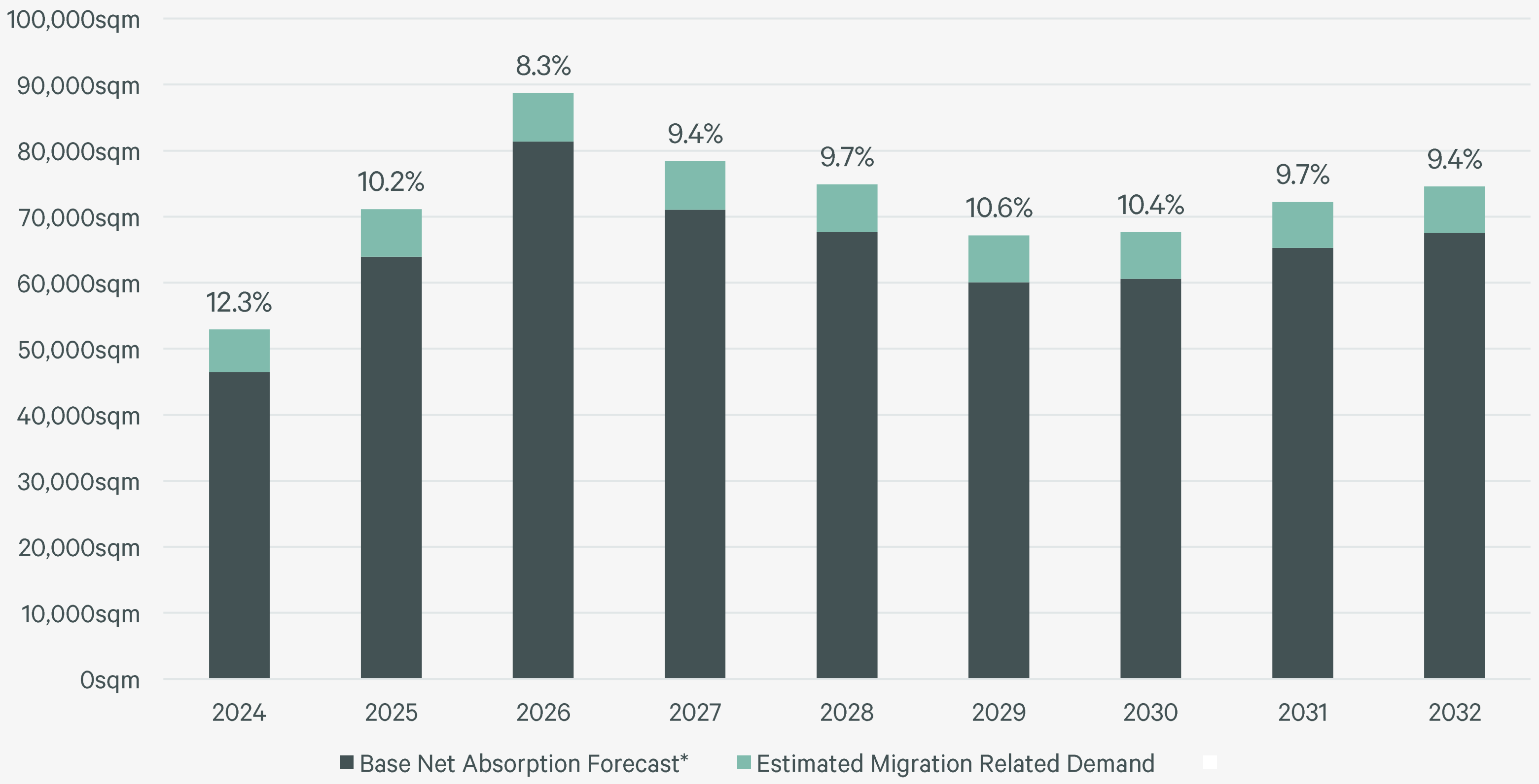
Melbourne currently offers strong affordability and liveability relative to not just the rest of Australia, but major global cities.

This forms our belief that Melbourne is primed to receive a significantly higher amount of migrants over the coming years.

As Victoria’s population increases, office space requirements will grow and expand. As such, we expect elevated levels of net absorption across Melbourne’s office market.

Our current estimates put the associated migration-related demand at a 10% average increase year-on-year above current absorption forecasts.

Figure 8: Melbourne CBD total net absorption forecast by year and estimated additional migration demand impact.



Source: CBRE Research
Note: Base net absorption forecast refers to a *ceteris paribus* value that excludes the impact of any known tenant moves. Percentage figures correspond to the estimated increased net absorption associated with increased net overseas migration and net interstate migration flows.

The Occupier Evolution

Amenity Matters, Why & Where, Evolving Preferences, Behind Vacancy

Amenity Matters

In the current office environment, space requirements have shifted with a higher focus on amenity and worker satisfaction to drive higher worker attendance rates. Our data indicates Melbourne occupiers are considering these features of the highest importance when making leasing decisions, a factor unlikely to change.

Why & Where

Following significant space reductions seen post-covid, we foresee a reversion in tenant space requirements.

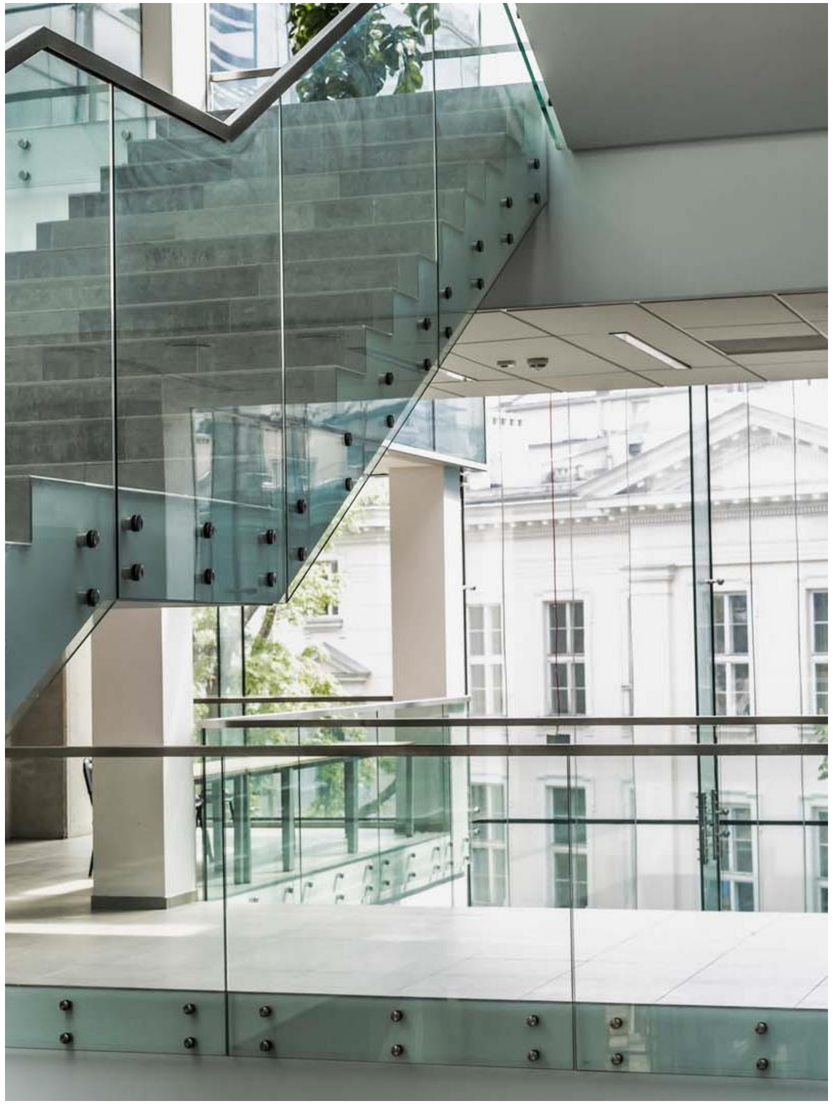
With Melbourne currently positioned as the most affordable major CBD in the eastern seaboard. This will help drive tenant expansionary and relocation activity over the next few years.

Evolving Preferences

Evolving tenant preferences across Melbourne's CBD has resulted in highly bifurcated market. Beyond the traditional prime / secondary classification, we define two sub-sets of the prime market – outperformers and underperformers. We expect this bifurcation to remain due to the unique and quality offerings of the outperformers.

Behind Vacancy

Vacancy across Melbourne is better than it seems. Underneath the surface, tenants looking for specific features in existing assets have limited options in the current market. This is combined with our expectation of a continuing expansionary activity among small occupiers which will aid improvements in office fundamentals across Melbourne.



The importance of amenity in the evolved workspace

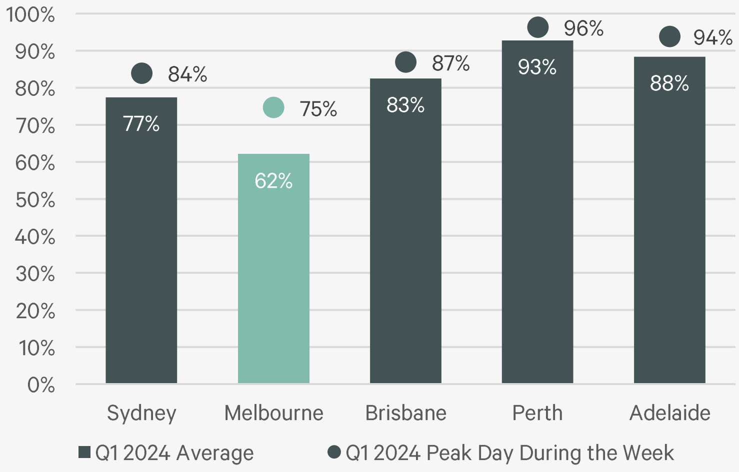
Following the pandemic, a material shift has occurred amongst occupiers. Namely, as occupancy levels remained muted, a stronger focus on office amenity and employee satisfaction has emerged.

When surveyed in 2023, Melbourne occupiers identified both amenity (64%) and an ‘attractive location for talent’ (49%) as two of the most important features when considering leasing decisions.

This came at a time where occupancy levels were c.50% and the domestic labour market remained historically tight. Both variables have improved but continue to favour employee bargaining conditions.

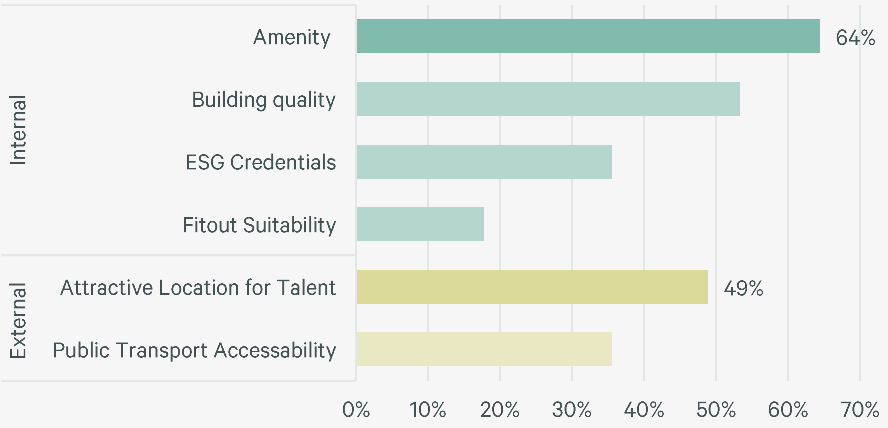
In light of this, preferences continue to evolve and adjust domestically as occupiers seek out competitive and innovative workspaces to attract talent.

Figure 9: Office occupancy levels by Australian CBD



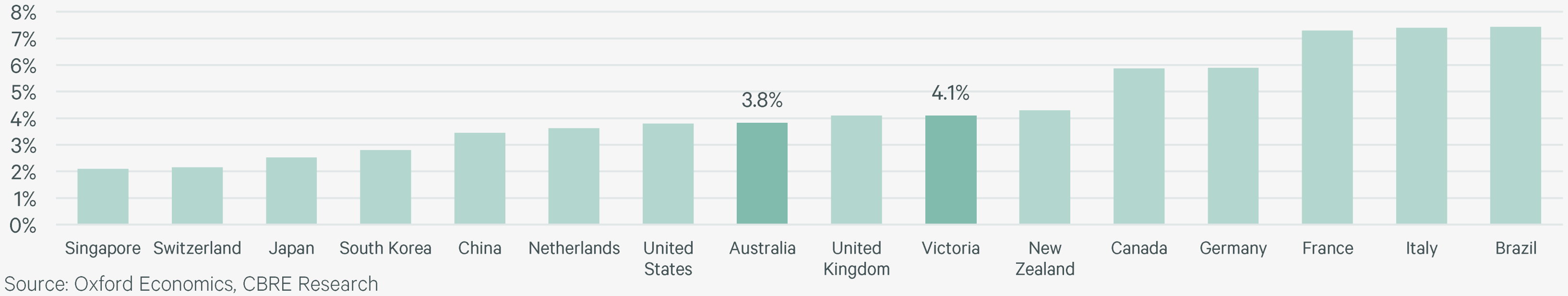
Source: CBRE Research

Figure 10: Melbourne occupier feature importance when considering a relocation or lease regear (top 3 most important).



Source: CBRE Research

Figure 11: Global unemployment Levels (Q1 2024*)



Source: Oxford Economics, CBRE Research

Note: Data is the most recently available at the time of publication. Some European Union countries data corresponds to Q4 2023 levels. Victoria’s unemployment rate corresponds to the March 2024 seasonally adjusted rate.

Occupier affordability & expansionary activity

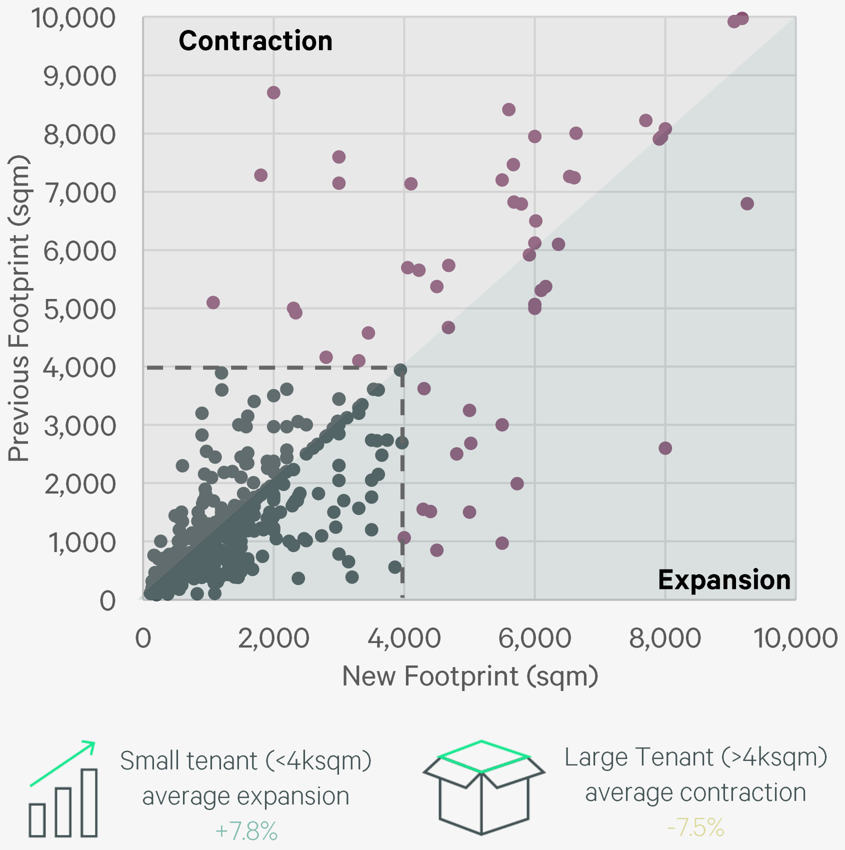
Nationally post-pandemic, smaller tenants have continued to expand, contrasted by larger tenants who've seen significant contractions. In Melbourne, this has had a significant impact on local sublease conditions.

Despite the right-sizing that has occurred, expectations are that Melbourne has seen the bulk of its contractions, and are set to see mostly expansionary activity from this point onward, driven by strong economic growth.

This perspective is not only driven by migration expectations, but also by office affordability. As of Q1 2024, Melbourne currently offers the lowest average face and effective rent on the eastern seaboard.

In a period of cost pressures and budget constraints, occupier's looking to expand, capitalising off strong prospective economic conditions, will see Melbourne as a prime candidate.

Figure 12: Office occupier relocation analysis



Source: CBRE Research
Note: Analysis examines the growth in footprint (%) by size of tenant. N = 495.

Figure 13: Prime office affordability by major Australian CBD

Source: CBRE Research

The industries primed to expand across Melbourne

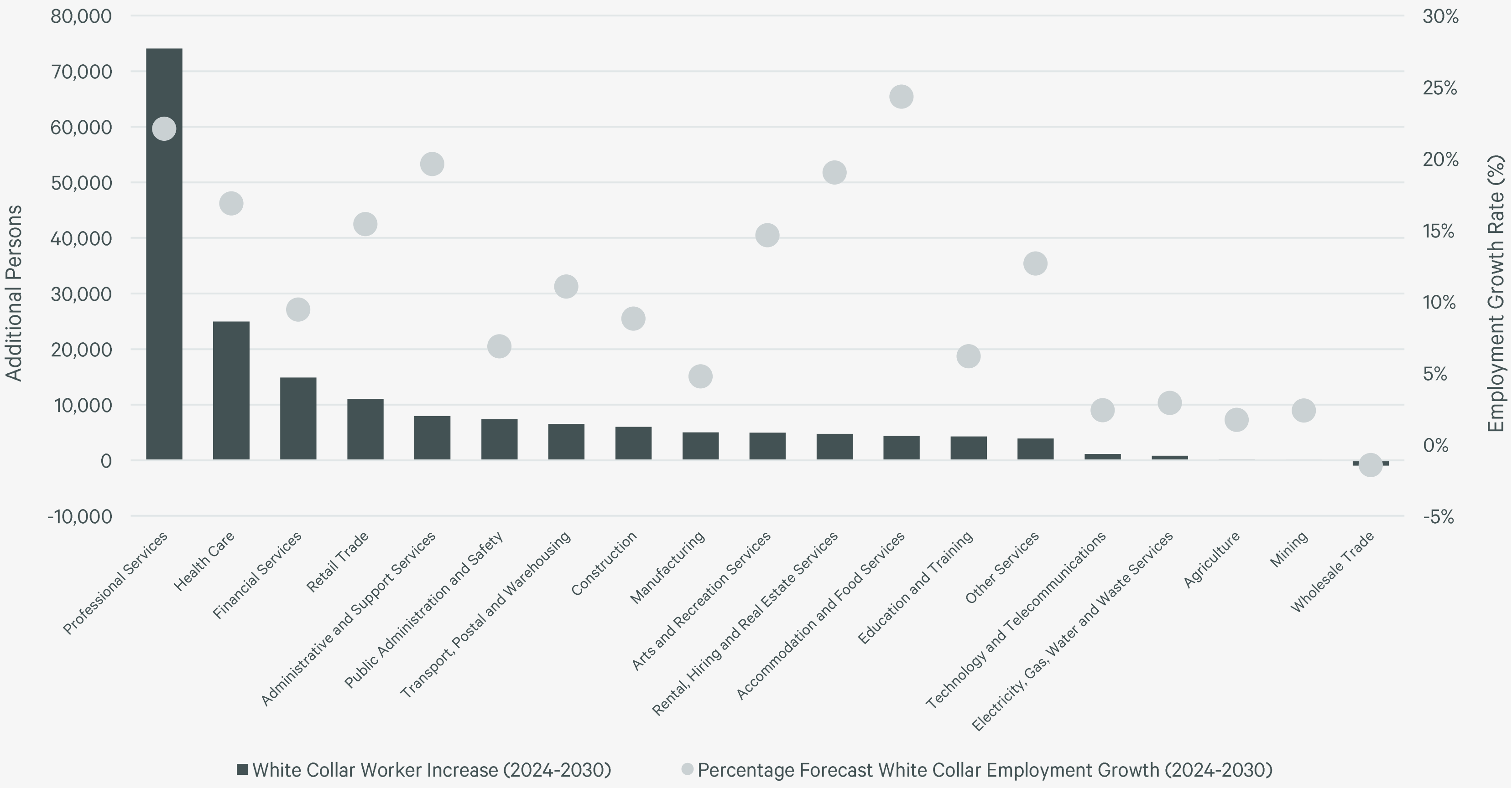
Current CBRE Research data indicates three key industries which will lead occupier expansionary activity until 2030; Professional Services, Health Care and Financial Services firms.

Melbourne's professional services sector is set to see more than 20% in employment growth over the next six-years. This equates to more than 70,000 additional in this industry.

With more than 115,000 workers expected to enter the state across three key sectors, office space requirements will need to expand.

If Melbourne captures elevated overseas and interstate migration flows, these estimates will increase, driving further heightened levels of demand across the state.

Figure 14: Melbourne CBD white collar employment growth forecast by industry type (2024-2030).



Source: CBRE Research, Deloitte Access Economics

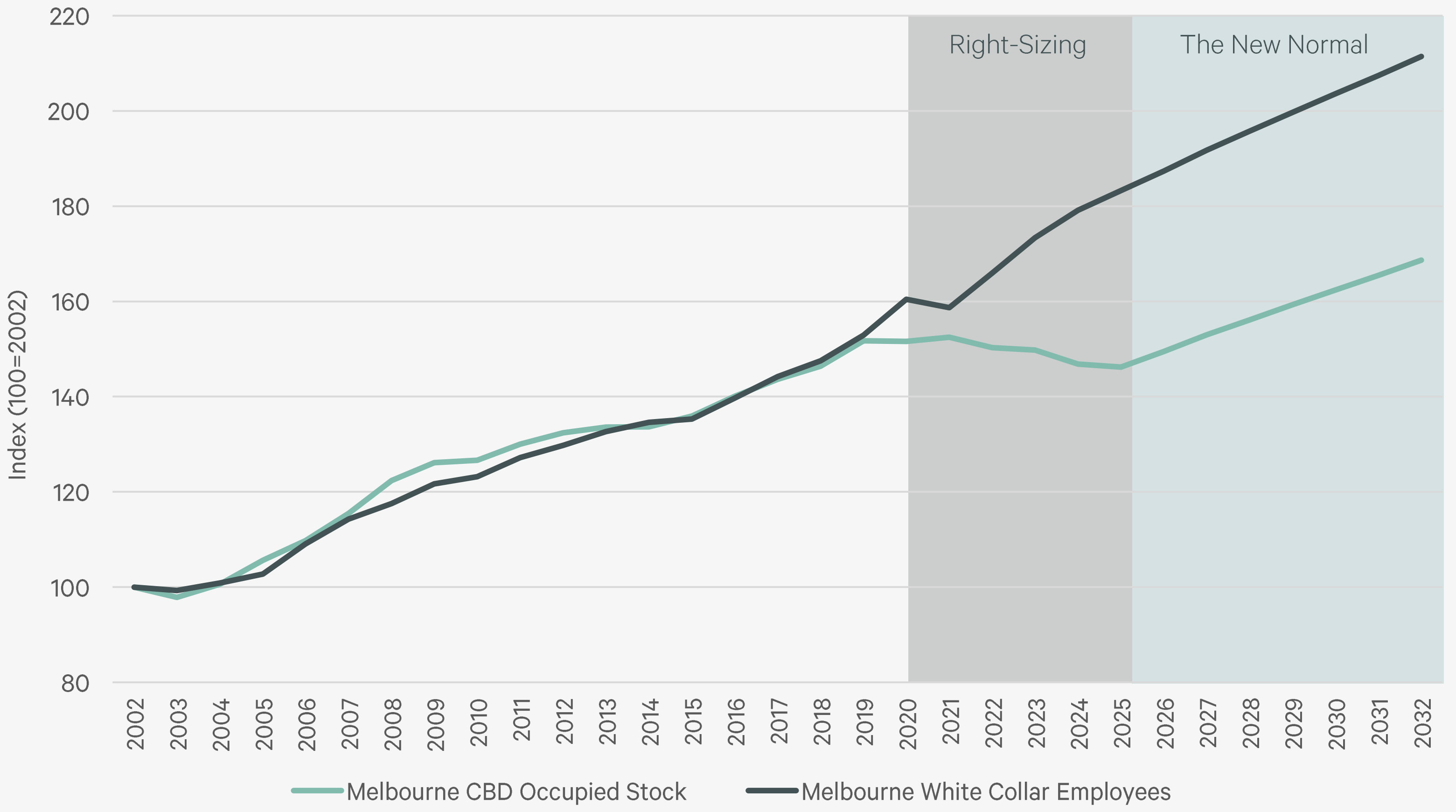
Right-sizing complete as work arrangements normalise

Historically, occupied stock and white-collar employment levels showed a strong correlation, as occupier workspace requirements remained mostly constant.

Right-sizing and the adoption of hybrid work arrangements brought with it a clear break from the historical trend.

We believe the divergence to mostly be over, with occupier right-sizing and adjustments to workspace needs to stabilise by the end of 2024. With it, the reintroduction of elevated absorption levels, attributed to strong growth in Melbourne's white collar employment levels.

Figure 15: Melbourne CBD historical and projected occupied stock and white-collar employment trend



Source: Deloitte Access Economics, PCA, CBRE Research

Evolving tenant preferences

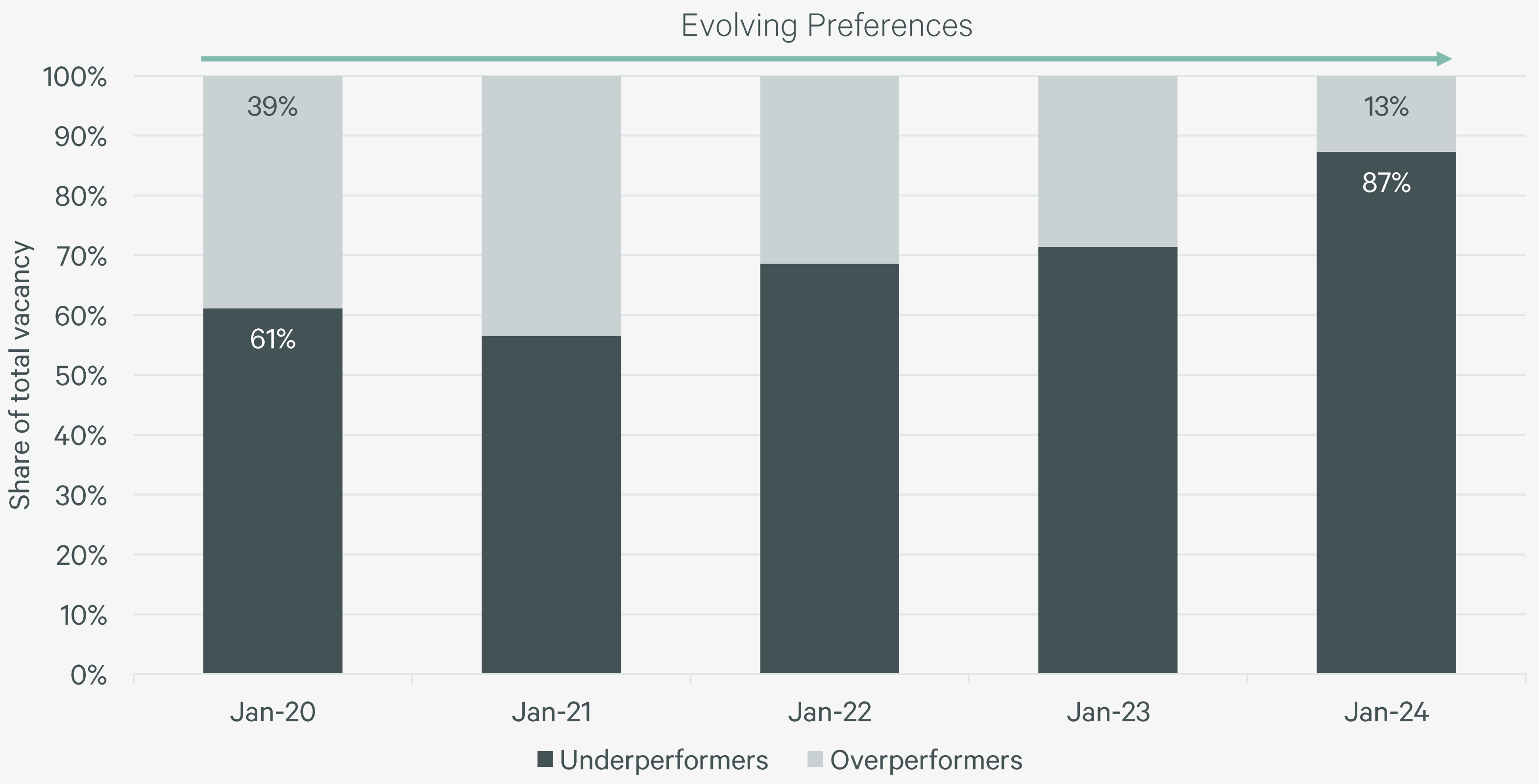
Tenant preferences across Melbourne have seen a significant evolution post-pandemic. Analysis conducted on vacancy over the last five-years has demonstrated a clear trend; occupier interest in existing 'overperformers' has grown steadily to meet the changing nature of office requirements.

With a stronger focus on amenity & wellbeing, prime vacancy levels in a select basket of assets has steadily decreased. In contrast, assets that don't meet these preferences have struggled, accounting for 87% of total prime vacancy, up from 61% just five-years prior.

Office space utilisation and requirements have shifted and are unlikely to revert to pre-pandemic norms, driving occupier decision making for the remainder of the decade.

This is likely to increase the bifurcation already seen between overperformers and underperformers.

Figure 16: Melbourne CBD prime vacancy analysis by performance classification



Source: CBRE Research, PCA
Note: Vacancy analysis was conducted on the same basket of buildings over time. Performance classifications for individual assets are based on current vacancy levels of assets relative to their respective PCA defined precinct.

Limited availability in Melbourne CBD office for specific requirements

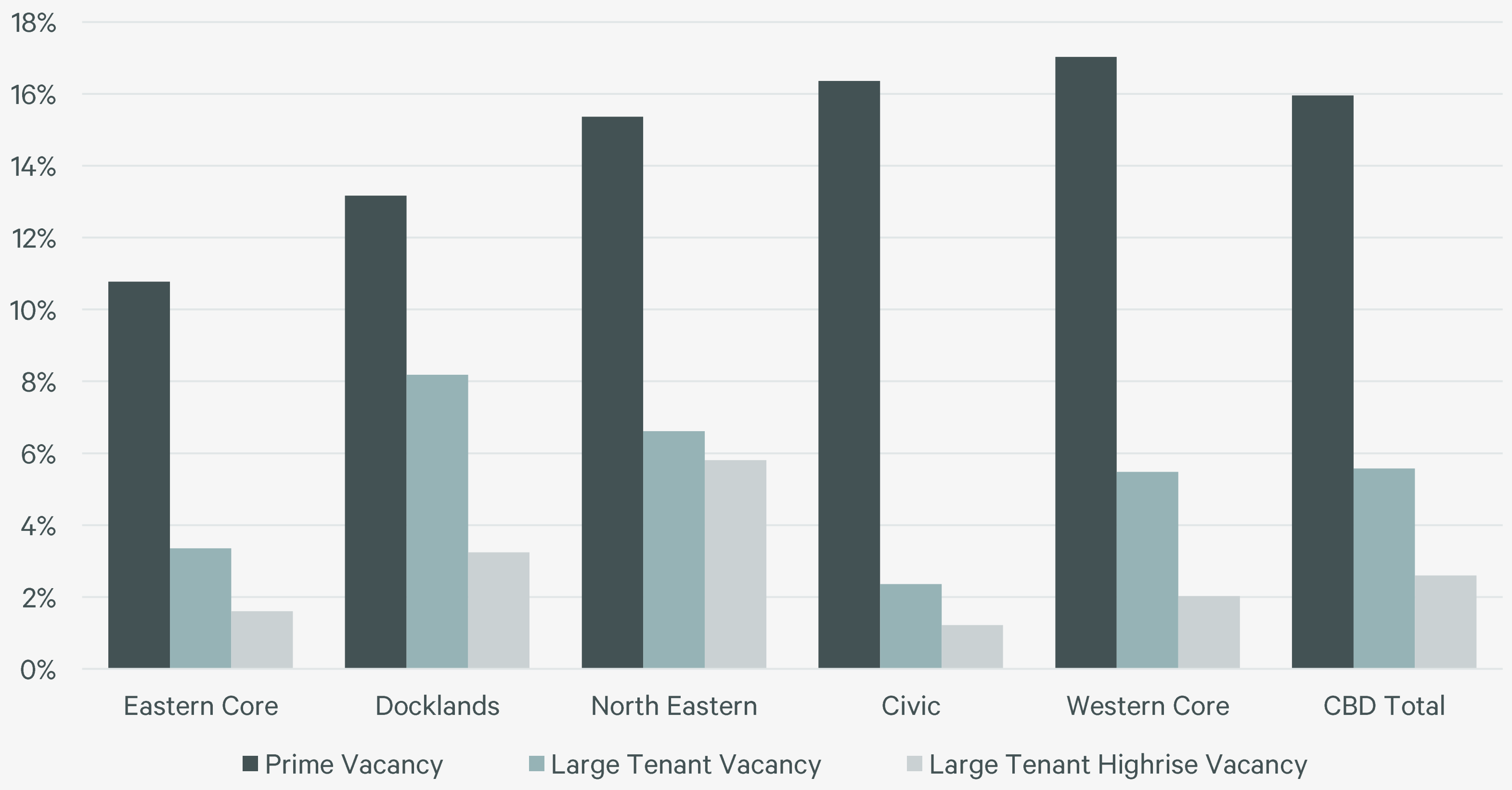
Headline vacancy figures across Melbourne paint a bleak, yet unrealistic picture of the current availability in the market.

Current conditions in Melbourne's office market show that there is limited availability in some precincts for tenants with large space requirements. Vacancy for spaces that meet these requirements are on average 10% lower than headline figures suggest. For larger tenants looking for availability in high rise buildings and floors, this equates to a further 13% differential.

These figures highlight the hidden strength in Melbourne's office market.

With limited true availability, we expect strong rental growth to continue and smaller occupiers to maintain their expansionary activity, slowly driving lower vacancy levels across the CBD.

Figure 17: Melbourne CBD prime vacancy analysis by availability classification



Source: CBRE Research, PCA
Note: Large tenant vacancy is defined as 3000sqm or more in contiguous whole or part floors. Highrise vacancy is measured by building height and position of the vacant floors.

Opportune Timing

Why all of Melbourne's office fundamentals are saying "Now"

Cash Rates & Capital Values

Why we believe cash rates have peaked and how buying into Melbourne office today is equivalent to a multi-year capital discount.

Construction Costs

We share our views on the current construction environment and how feasibility requirements have risen in recent years.

Supply Environment

We highlight Melbourne's current supply pipeline, lending environment conditions and how asset fundamentals are set to improve in a subdued supply environment.

Office Incentives

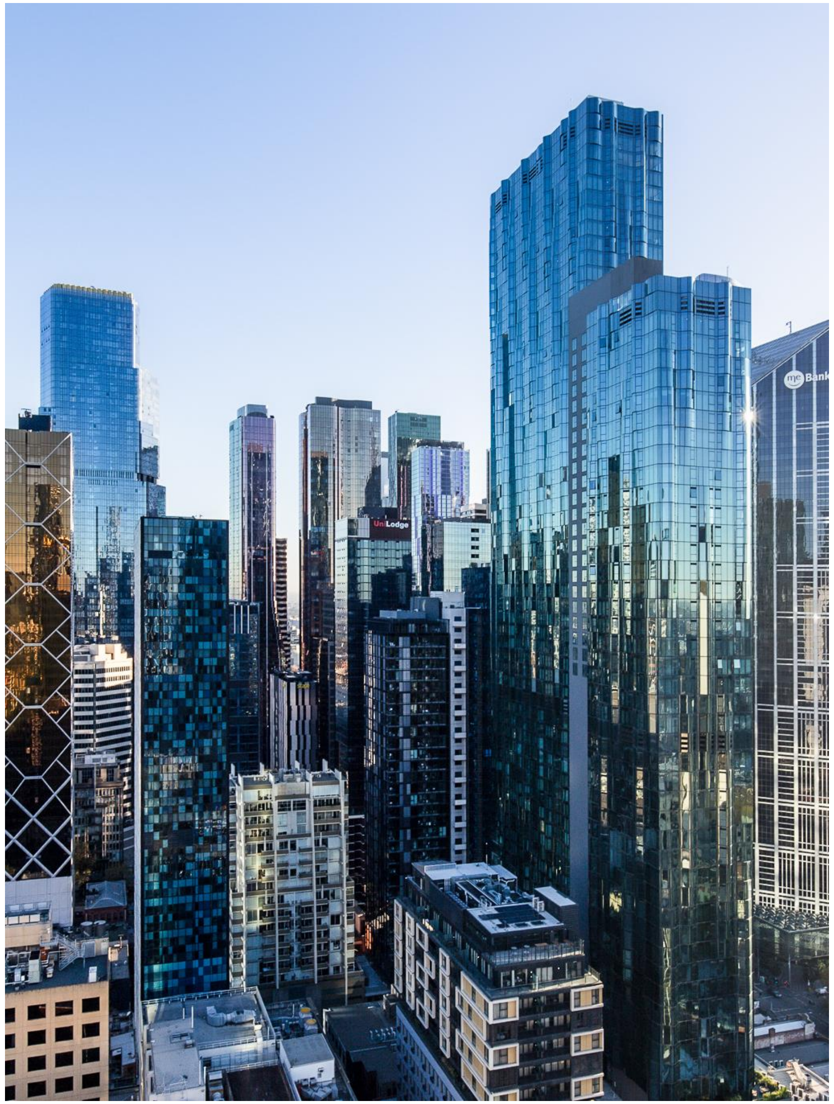
Why Melbourne's office market is set to repeat a former cycle, bringing with it declining levels of incentives across the CBD.

Vacancy Conditions

We highlight how shifting preferences have altered vacancy fundamentals across Melbourne and our expectations over the coming years.

Melbourne Occupancy

We outline our views on equilibrium occupancy and share how Melbourne's office market seeks to gain as it returns to pre-pandemic levels.



Monetary policy doesn't stay restrictive for long

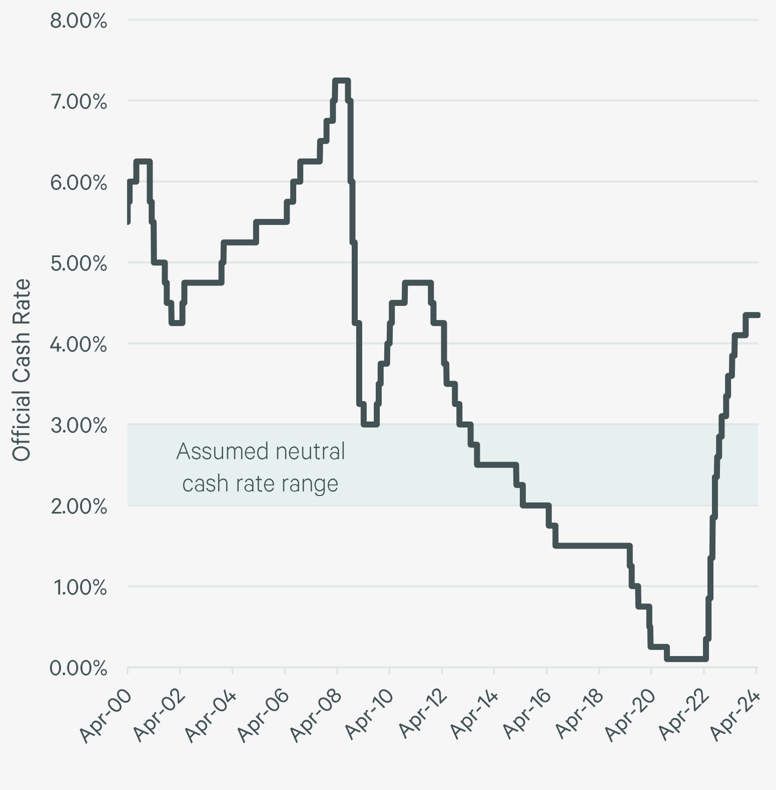
Historically, cash rates have spent little time at their respective peaks. Over the past three cycles, the longest they've remained at their peak value was 12-months. Australia is at seven-months of its current peak of 4.35%.

Monetary policy generally doesn't stay restrictive for long given the strain it puts on the domestic economy. With current cost of living and economic pressures present across the country, consensus expectations amongst Australia's major banks is that cash rates have reached their peak and will begin declining over H2 2024.

Given the historical relationship observed, and existing major bank forecasts, we expect these rate cuts to begin prior to the end of 2024.

With that in mind, we expect that office asset yields will see similar declines over the coming years, driven by adjustments in bond yields.

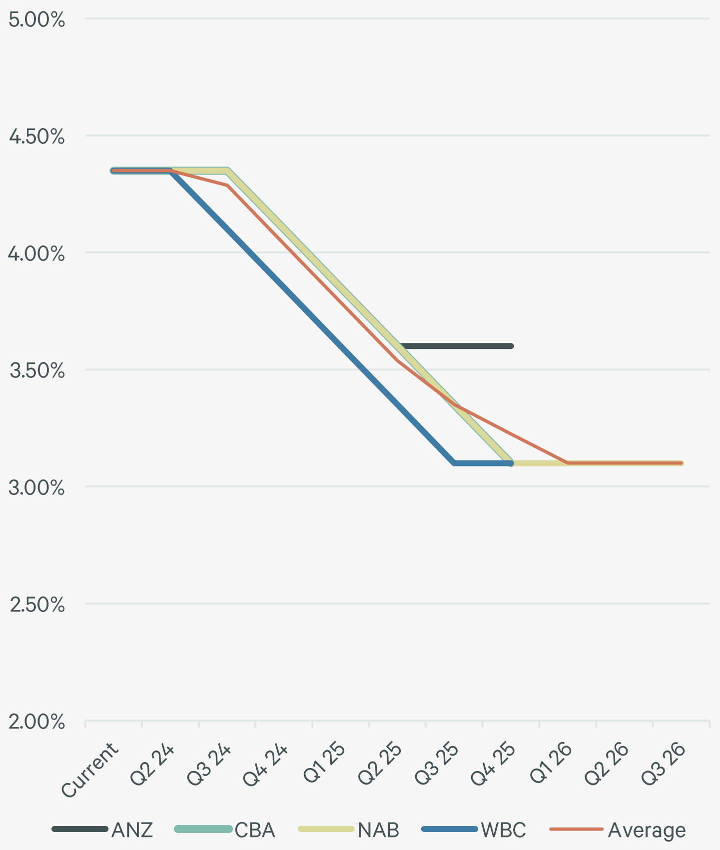
Figure 18: Historical cash rate and cycle peak length



2000/01 Peak	2008 Peak	2009/10 Peak	Current Peak
7 months	6 months	12 months	7 months and counting...

Source: CBRE Research, RBA

Figure 19: Big four cash rate forecast as at April 2024



Source: CBRE Research

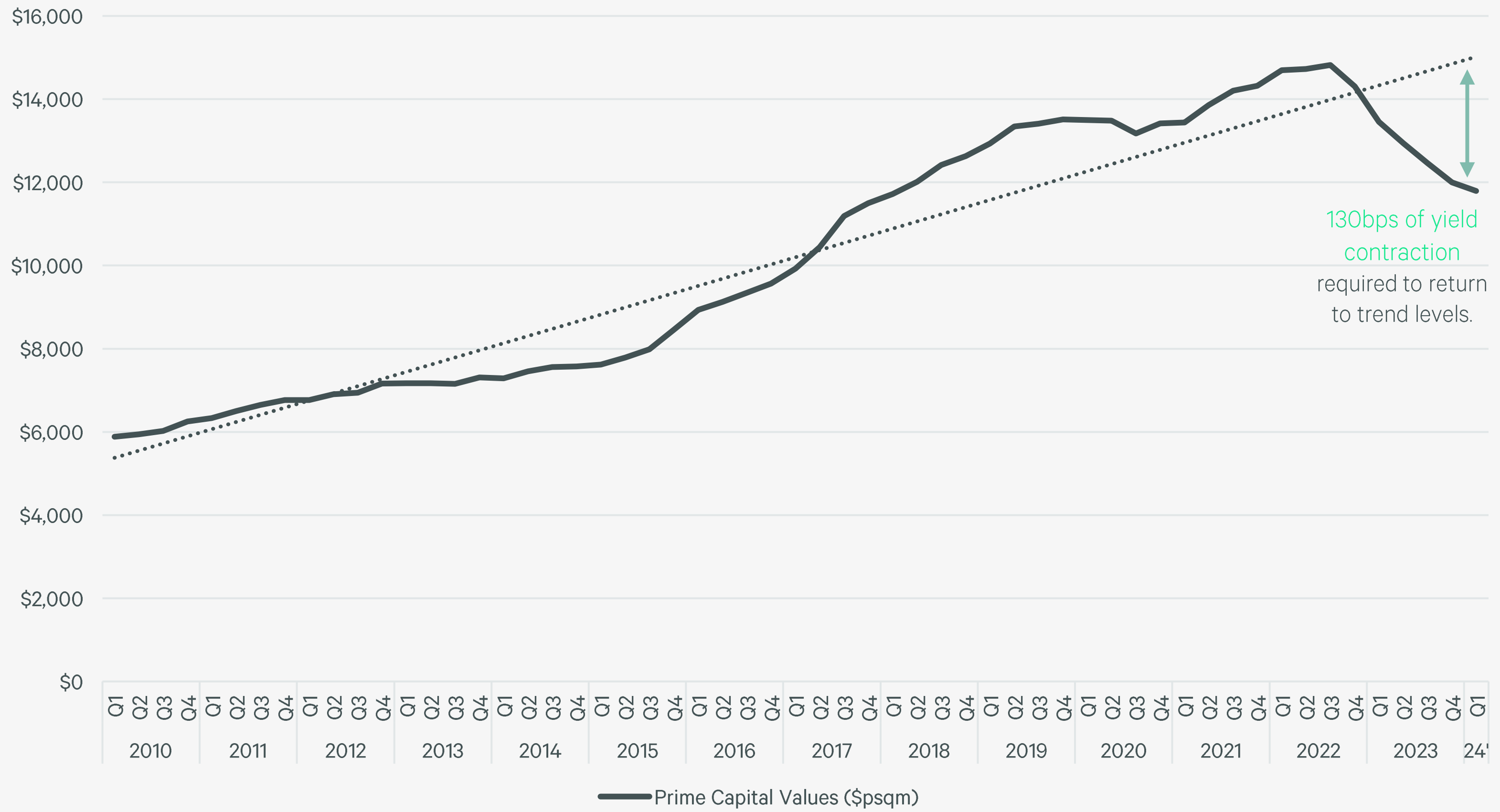
A once in a cycle buying opportunity

Prime capital values have seen a sharp decline in the last 24 months following significant yield expansion. At Q1 2024 levels, capital values have effectively regressed 5-years of natural capital appreciation, putting it below trend growth.

We see investment into Melbourne office assets today as buying at a five-year discount, equivalent to a period where Melbourne was on track to become the strongest office market in Australia.

At Q1 2024 rents, we note a 130bps yield contraction is required to return to trend levels of capital values. Given our outlook, we view this as an inevitability, similar to prior capital value cycles.

Figure 20: Historical prime Melbourne CBD office capital values and linear trend



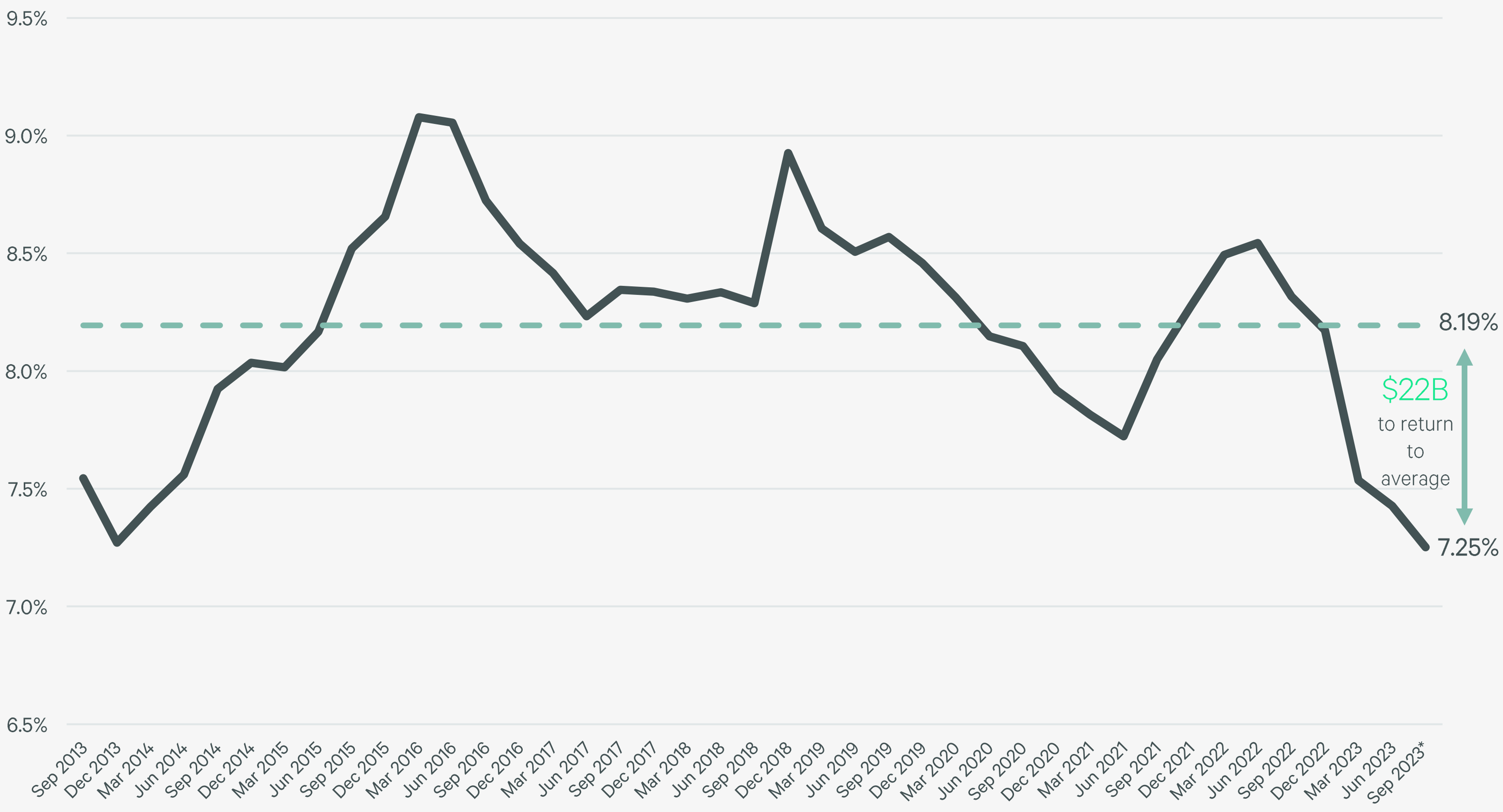
Source: CBRE Research

Buying pressures set to increase as super funds return to target allocations

Historically, Australian superfunds have averaged an 8.19% allocation to property. Given declining asset property values across the country, there is now a 94bps spread between current and target allocations. This equates to $22 billion dollars in investment required.

Target investment allocations are generally sticky and difficult to change. As such, we expect heightened buying pressures to occur in the coming years, as Australian superfunds seek to return to their respective target allocations for property.

Figure 21: Historical Australian superfund property allocation



Source: CBRE Research

Construction costs elevated, increasing pressure on development pipeline

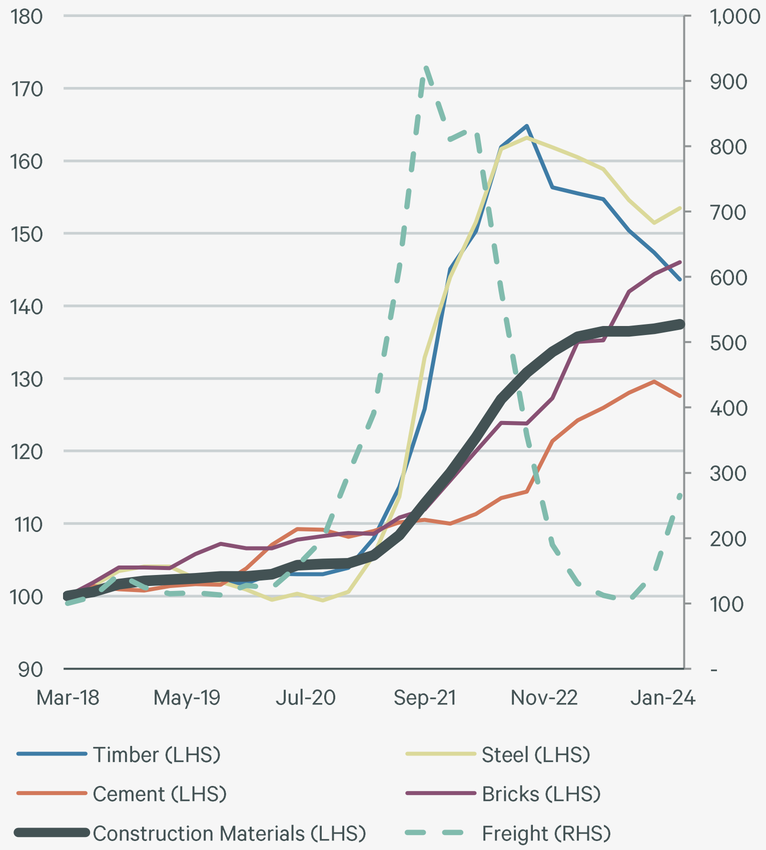
Melbourne's office market is being impacted by elevated construction cost pressures and a high cost of debt. At current levels, it is now 35-40% more expensive to build than in 2019.

This has a natural impact on economic rents across the state. With economic rents now >30% higher than levels seen in 2020, feasibility for new projects is under significant strain.

Whilst most construction inputs have seen pressures ease, major construction projects remain in the domestic pipeline that will likely dampen office construction over the remainder of the decade.

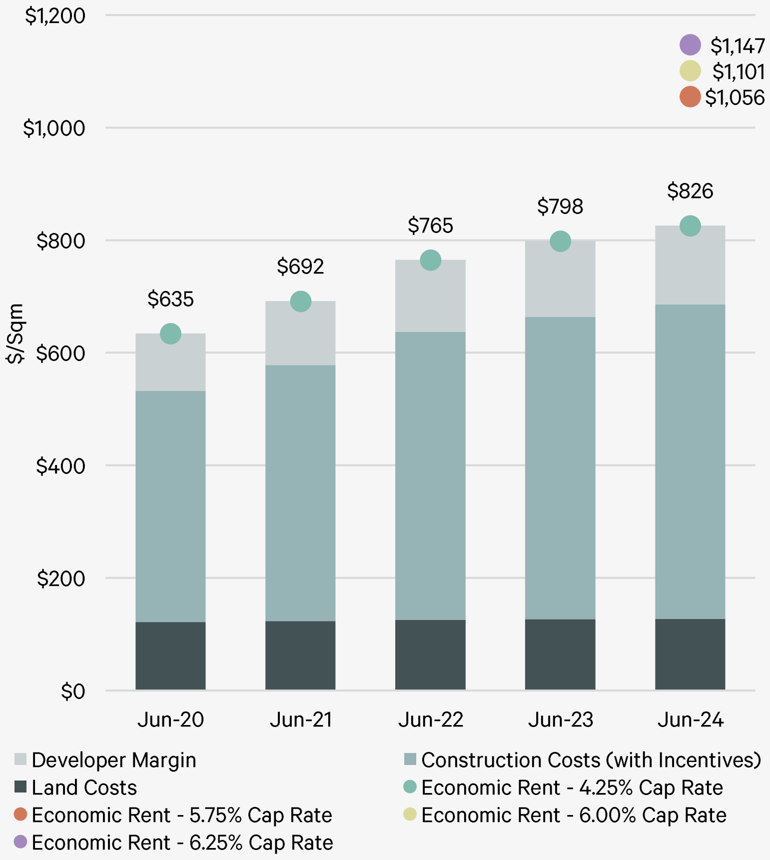
Most notably, this includes Queensland's Olympic Games development, Victoria's suburban rail loop and Sydney's metro rail project. These projects account for billions in developments taking place over the next 10 years that are expected to keep construction costs elevated in the coming years.

Figure 22: Historical and current construction costs



Source: CBRE Research

Figure 23: Melbourne CBD economic net face rents over time



Source: CBRE Research

High feasibility requirements set to result in undersupplied market

Melbourne's existing supply environment represents a relatively large wave expected to be delivered over 2026 (c.155,000sqm), followed by a significant number of mooted projects with no completion timelines set.

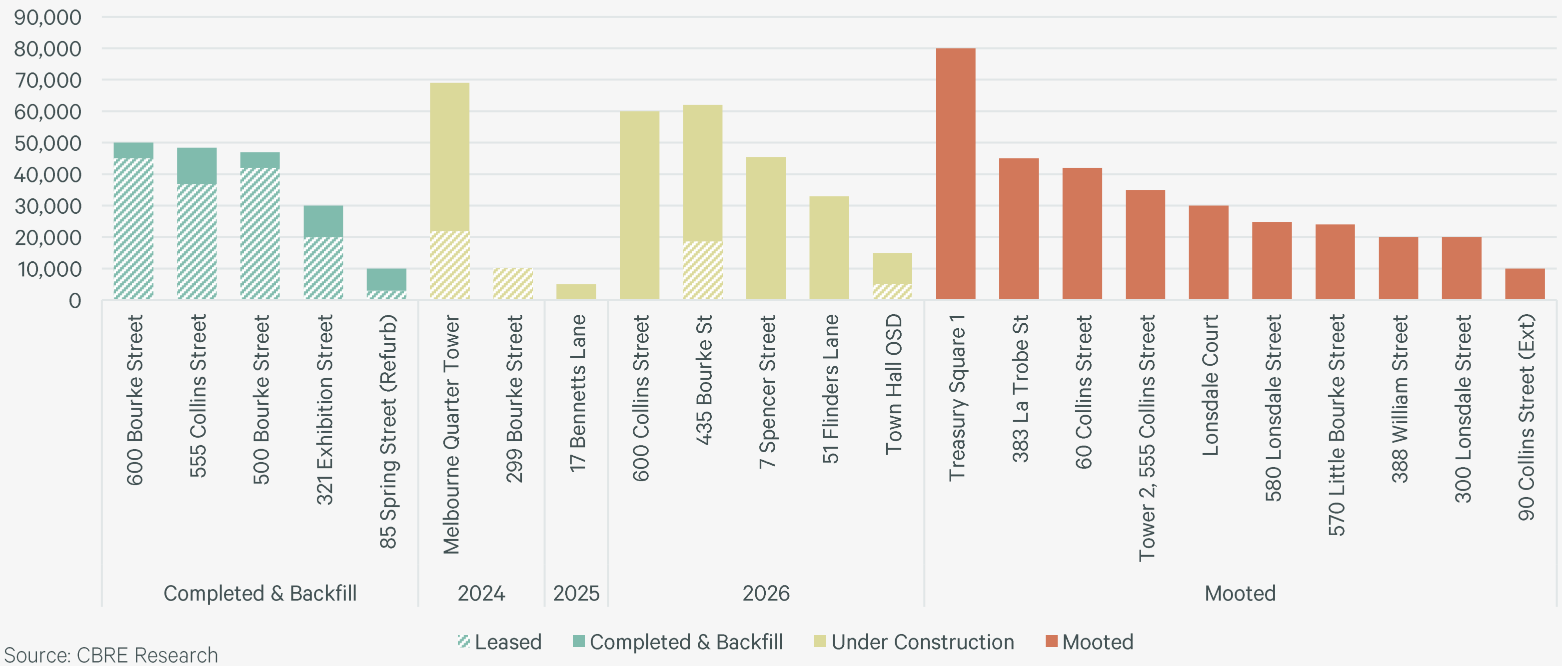
Two factors currently drive our expectations of an undersupplied market; lending conditions and feasibility concerns.

Lending for office construction requires a significant barrier to entry, with 79% of surveyed lenders requiring a >50% pre-lease requirement[1]. This is in conjunction with current elevated economic rents raising the threshold new developments need to pass.

Existing assets across Melbourne are set to benefit from the subdued supply environment that may remain until the end of the decade.

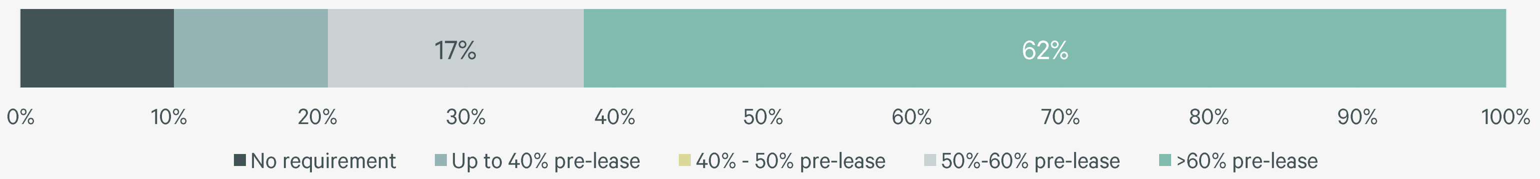
[1] Survey results were collected for CBRE Research's 'H1 2024 Lender Sentiment Survey' conducted over May 2024.

Figure 24: Melbourne CBD office completed and future supply pipeline



Source: CBRE Research

Figure 25: Surveyed Australian lender office construction pre-lease requirements as at H1 2024



Source: CBRE Research

Incentives set to decrease as future conditions mirror the past

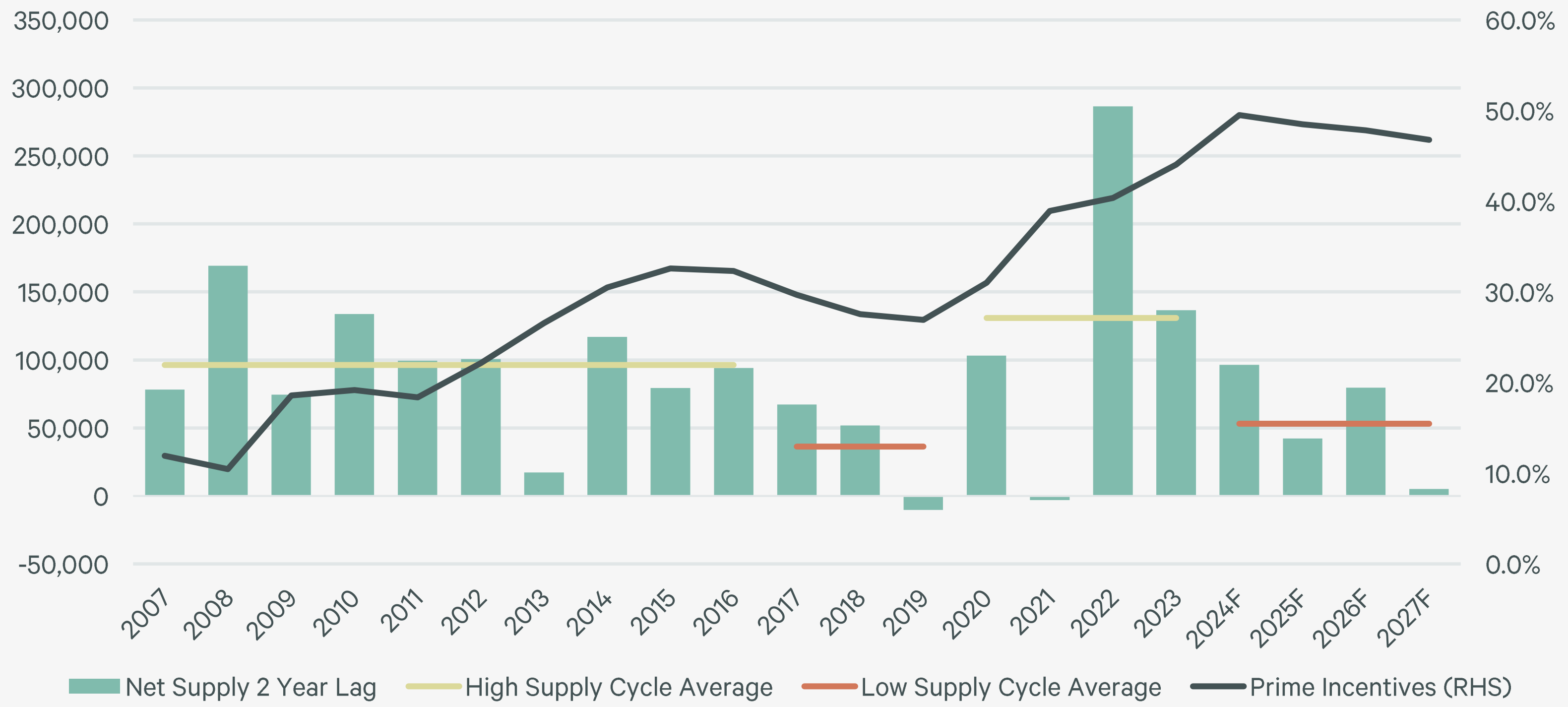
Melbourne's office market has experienced three distinct supply cycles since 2007. We view these as periods of elevated supply, followed by subdued supply.

In periods of subdued supply, prime incentives have seen gradual declines from their respective peaks.

We view current market conditions expected over 2024-2027 to be a repeat of this trend. Supply over this period is expected to be relatively muted when compared to the highs seen over 2020-2023[1].

As such, we expect incentives to begin contracting across the Melbourne market in the coming years. Given expectations around current supply conditions and project timelines, we anticipate the declining incentive cycle to potentially last until the end of the decade.

Figure 26: Melbourne CBD office lagged net supply and prime incentive cycle.



Cycle	2007-2016	2017-2019	2020-2023	2024-2027
Average Supply	96,000	36,000	131,000	53,000
Change in Supply (%)	-62%		-59%	

Source: CBRE Research, PCA

[1]These correspond to lagged years.

Vacancy bifurcation forecast to grow

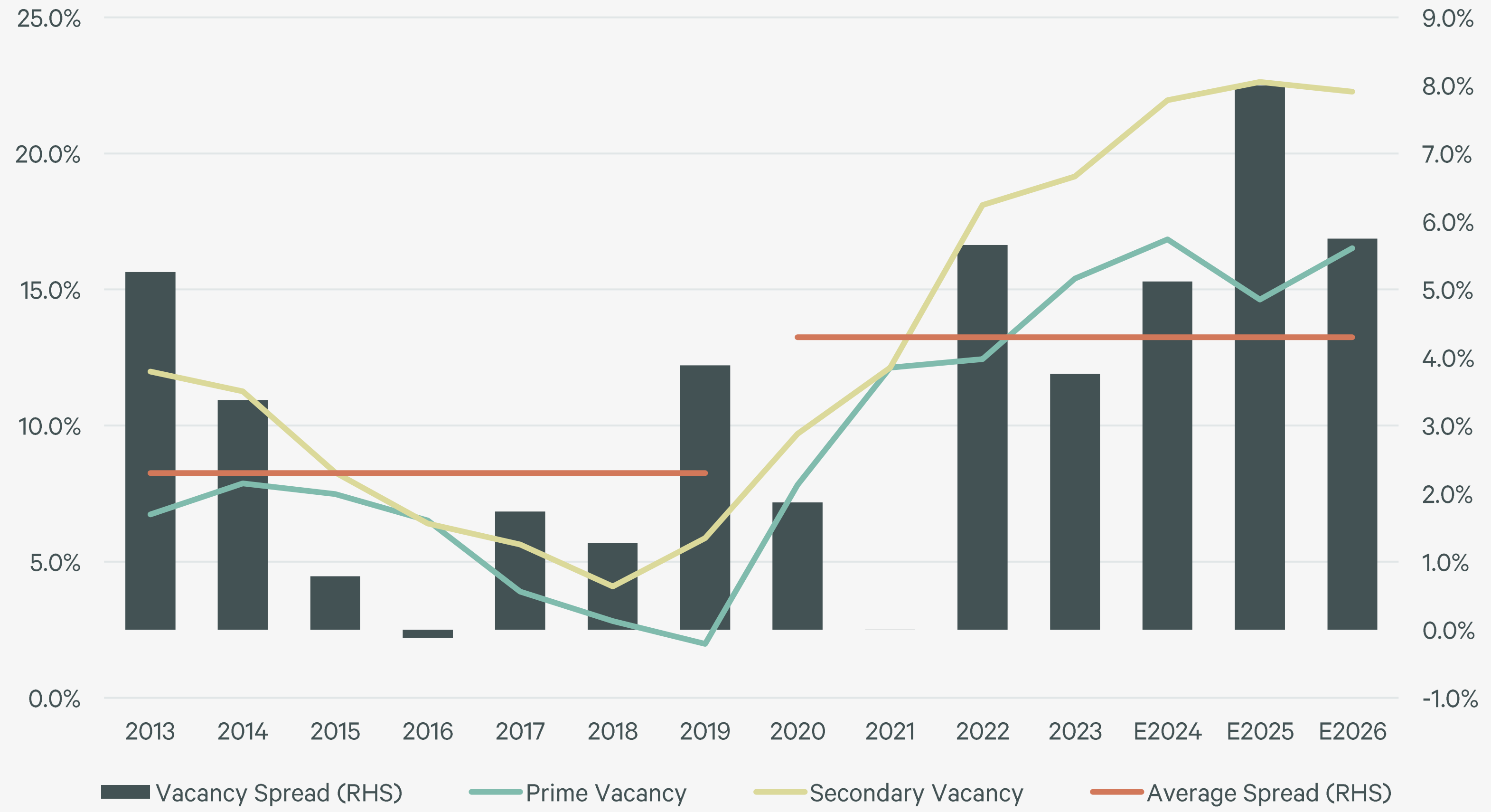
Pre-pandemic conditions in Melbourne's office market saw limited bifurcation between prime and secondary vacancy.

As tenant preferences have evolved, Melbourne CBD's vacancy spread has increased modestly and is forecasted to remain elevated. Current forecasts indicate a 200bps increase in vacancy spread from 2.3% in the cycle 2013-2019, to 4.3% from 2020-E2026.

We attribute this increase to the changing nature of tenant preferences and requirements.

Vacancy across the CBD is forecast to peak in 2024, with a moderate increase forecasted in 2026 driven by the large supply mooted that year (should it be delivered). Demand fundamentals remain in place, and trend vacancy is forecast to decline gradually over the remainder of the decade.

Figure 27: Melbourne CBD office historical and forecast vacancy



Source: CBRE Research

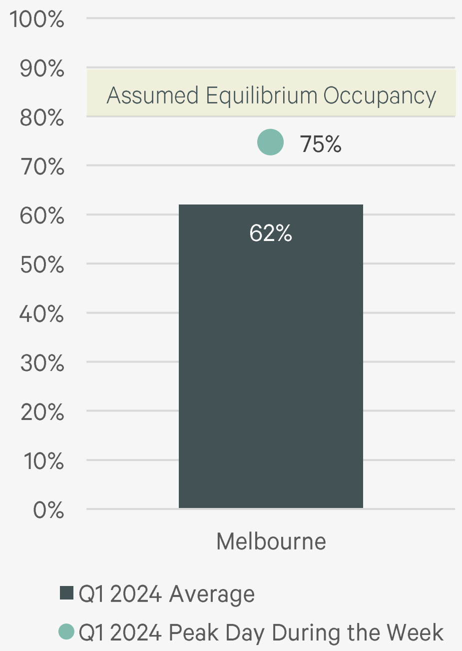
Current occupancy levels presents significant upside demand

The assumed equilibrium occupancy across Australia is estimated between 80-90%[1]. Compared to Q1 2024 levels in Melbourne, this equates to a potential 18%-28% in occupancy upside.

Based on our estimates, the net absorption impact from an increase in occupancy across the state could equate to anywhere from c.85,000sqm to c.170,000sqm. This represents a decline in vacancy of 1.6% to 3.3%[2].

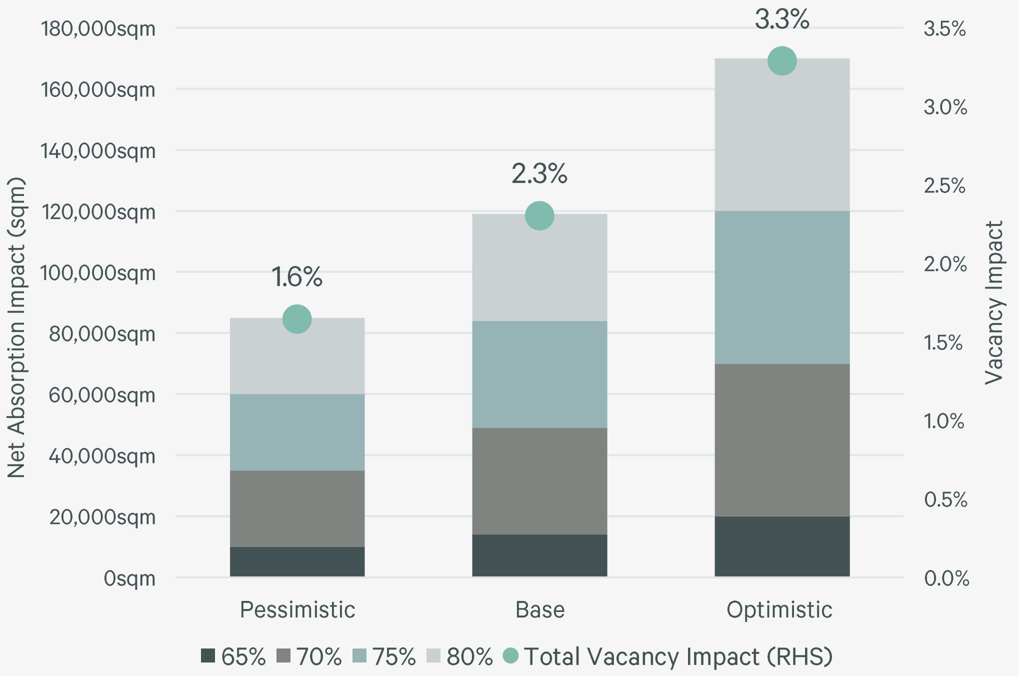
As occupancy levels improve across the state, namely on Mondays (53%) & Fridays (43%), existing occupiers may need to reconsider existing space requirements to facilitate the potential surge in demand. This is the primary factor driving our current upside estimates.

Figure 28: Melbourne office occupancy[1]



Source: CBRE Research

Figure 29: Melbourne CBD office estimated occupancy improvement impact[1]



Source: CBRE Research

Figure 30: Melbourne CBD office occupancy levels by weekday[1]

Day of the week	Monday	Tuesday	Wednesday	Thursday	Friday
Average Occupancy	53%	75%	69%	70%	43%

Source: CBRE Research

[1]Occupancy corresponds to the % of occupancy relative to pre-covid levels.

[2]Based on total Melbourne CBD stock levels as at January 2024.

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