Effective Rent Growth Recorded as Melbourne Shows First Signs of Incentive Stabilisation.

▲707 AUD/sqm
Net Face Rent (+1.85% q-o-q)

▼46.9%
Prime Incentives (-3 bps q-o-q)

▲16.5%
CBD Office H2 2023 Vacancy (+237 bps y-o-y)

▲6.05%
Prime Yield (+16 bps q-o-q)

Note: Arrows indicate change from previous quarter / half / year.

Key Points

- Leasing demand in Melbourne's CBD declined moderately, with total negative 6-month net absorption of -26,879sqm recorded. Negative net absorption was partially offset by strong positive demand for Premium grade office space (+12,304sqm).
- Supply in Melbourne's CBD continues to show signs of normalisation amidst an elevated cost of debt and low pre-commitment levels. This could aid performance of existing assets.
- Melbourne CBD's overall vacancy rate ended H2 2023 at 16.5%. This figure represented an increase of 155bps from H1 2023. Vacancy continues to bifurcate across precincts as tenant preference becomes more pronounced.
- Prime net face rents continue to remain sticky despite rising vacancy. Incentives in Q1 2024 saw the first sign of stability in recent years, resulting in positive effective rent growth.
- Melbourne CBD office sales remained subdued in Q1 2024, with $64m in CBD assets transacting. Yields expanded across Melbourne however at a decelerated pace in some precincts.

FIGURE 1: Melbourne CBD Office | Summary of Prime Market Indicators

Melbourne CBD	1Q24	4Q23	1Q23	Q-o-Q Change	Y-o-Y Change
GFR	**AUD 914**	AUD 897	AUD 870	+1.85%	+4.96%
NFR	**AUD 707**	AUD 700	AUD 682	+0.98%	+3.67%
Incentives	**46.9%**	46.9%	41.4%	-3 bps	+548 bps
NER	**AUD 377**	AUD 372	AUD 401	1.08%	-5.91%
Yield	**6.05%**	5.88%	5.08%	+16 bps	+95 bps

Source: CBRE Research

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Economic Overview

Economic headwinds begin to emerge as GSP growth moderates.

Victoria experienced a year-on-year increase of 2.6% in Gross State Product (GSP) over the 2022-23 financial year (FY), a moderate decline from the post-covid highs of 6.3% growth recorded over the 21-22 FY. White-collar industries contributed minimally to this financial year's growth. Service based industries continued to show resilience in Victoria, albeit with subdued volatility. The subdued performance over FY 23-24 can be partly attributed to the impact of rising interest rates, lowering consumption in the state.

Labour market remains tight, may limit tenant growth over 2024.

Victoria's unemployment rate remains at very low levels relative to historical conditions. The current unemployment rate of 3.8% is at some of its lowest levels seen since 2000. Whilst a strong labour market generally aids consumer confidence, occupiers may face headwinds over 2024 as worker bargaining power remains elevated, putting upward pressure on wages for large corporations, limiting tenant growth.

Victorian Budget represents increased costs for Landlords, could limit foreign investment.

The 2023-24 Victorian Budget brought forward significant changes to the commercial real estate sector locally. This included the introduction of an annual property tax equal to 1% of the lands unimproved value, an increased land tax rate of 0.1%, the doubling of the Victorian Absentee Owner Surcharge from 2% to 4% and the reduction of the minimum threshold for non-trust absentee owners from $300,000 to $50,000. In short, this will equate to increased outgoings for assets. Given the increased absentee rates, it's possible foreign investment may see declines as well.

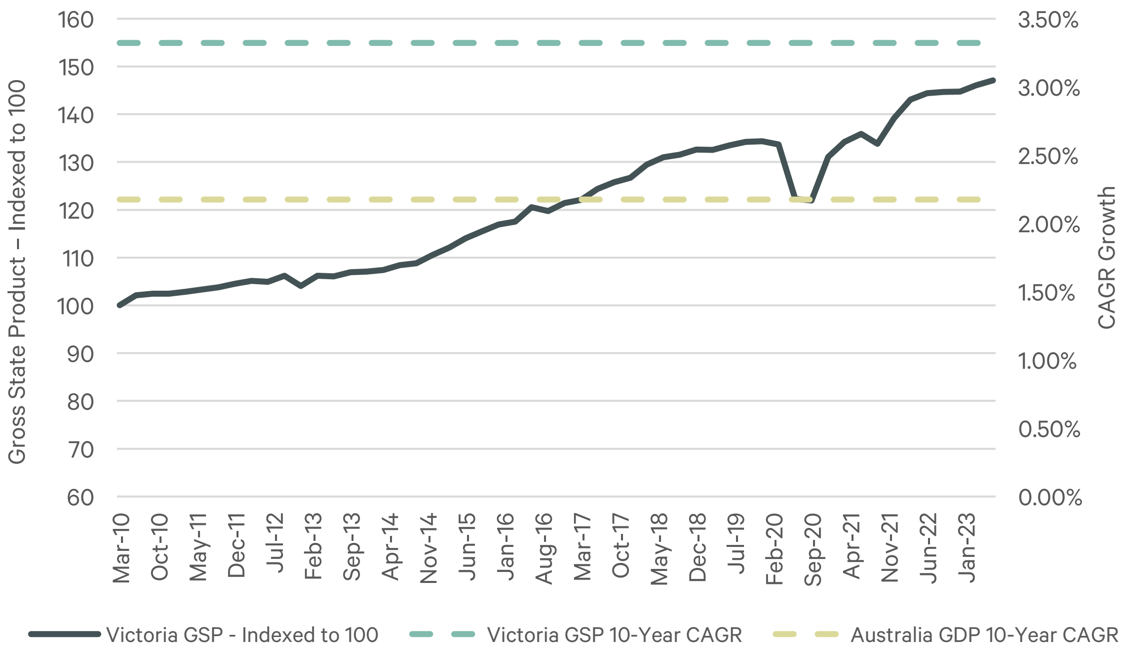
Inflation expected to normalise over 2024, potentially aiding office yield contraction.

CBRE Research expects inflation to ease over 2024 towards 3.5% from it's current level of 4.1%. This should give scope for the RBA to begin implementing rate cuts over 2024. Melbourne's office market could see a domino effect aiding office yields across the state. As interest rates begin to ease, long-term bond yields are likely to see similar declines, aiding in the contraction of office yields.

Record high migration expected to result in under-supplied office market in coming years.

Migration is expected to reach historic highs, contributing to strong economic growth nationally. With a forecasted 1,135,000 in net migration between the 2023-2025 financial years, Melbourne's office sector can expect some tailwinds over this period. Locally in Melbourne, based on historical migration trends, CBRE Research expects approximately 550,000sqm in demand for additional office space over this 3-year period. Based on current expectations and historical around supply, a significant supply-demand imbalance may emerge, driving reductions in vacancy over the coming years.

FIGURE 2: Victoria Gross State Product - Indexed to 100 & 10-Year CAGR Comparison



Source: Deloitte Access Economics, CBRE Research

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Office Demand

Flight-to-quality drives premium grade outperformance.

Melbourne CBD saw another period of overall negative absorption as office vacancy continues to adjust to changing occupancy conditions. As of January 2024, trailing 6-month net absorption totalled -26,879sqm compared to -86,325sqm on a trailing 12-month basis in Melbourne's CBD. These figures are further indication of occupier right-sizing.

Premium grade office space was the only grade that saw positive net absorption. CBRE research attributes this to tenant flight-to-quality, which is leading to further bifurcation between precincts across Melbourne.

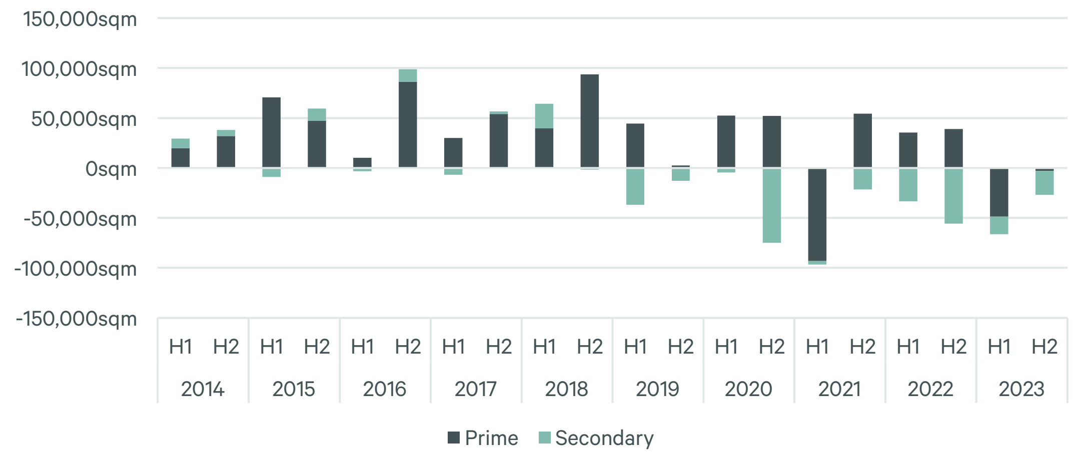
Precinct bifurcation widens as tenant preference becomes more pronounced.

On a precinct level, H2 2023 saw mixed results across precincts. This data reaffirms the bifurcation currently experienced in the market. CBRE Research notes that as the flight-to-quality trend continues, tenant requirements for quality space, strong amenity and good accessibility are key factors driving decision making. Tenants in Melbourne's CBD have begun showing clear preference for core precincts with lower enquiry volumes and leasing demand in non-core precincts.

Notably, higher levels of affordability driven by elevated incentives have begun to drive certain leasing preferences in the precinct. Precincts like Docklands, which as of Q1 2024 has the highest recorded incentive rate in Melbourne at 56.3%, recorded positive net absorption for the H2 2023 period. CBRE Research attributes this to healthy demand levels driven by affordability focused decision making amongst some local and international occupiers.

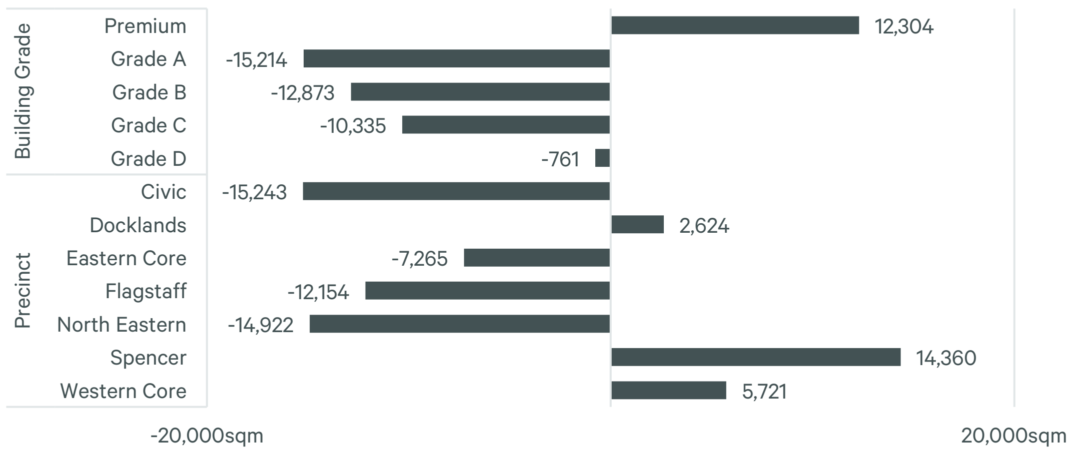
Regardless, as office occupancy levels continue to rise across the city and long-term tenant space requirements become more solidified, expectations are this precinct bifurcation to widen. The effects of this have already begun to show signs with respect to vacancy rates across Melbourne's CBD.

FIGURE 2: Melbourne CBD Office | 6-Month Net Absorption, by Building Grade



Source: PCA, CBRE Research

FIGURE 3: Melbourne CBD Office | 6-Month Net Absorption (sqm), by Building Grade & Precinct, H2 2023



Source: PCA, CBRE Research

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Supply

Melbourne CBD supply conditions continue to show signs of normalisation.

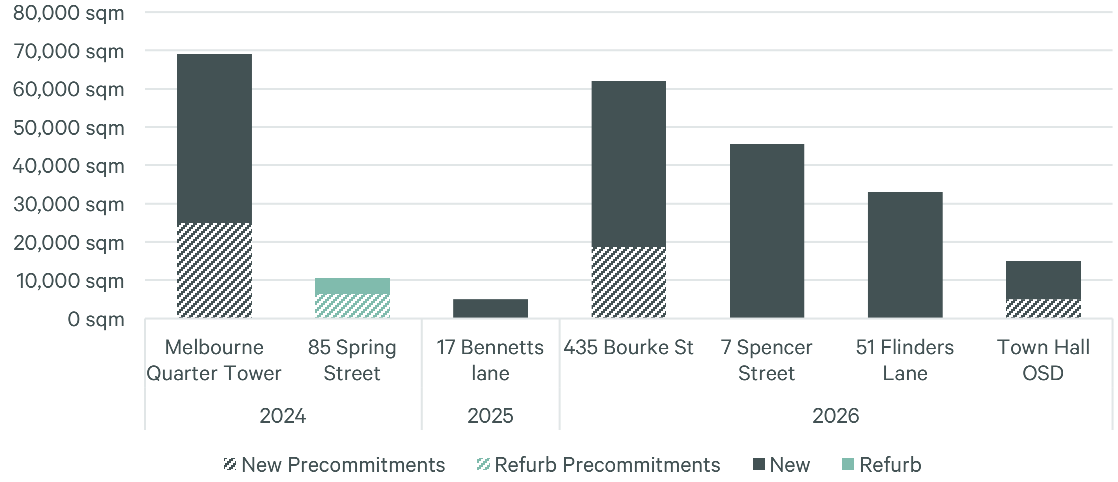
Melbourne's CBD saw the practical completion of the refurbishment in 500 Bourke Street (c.47,000sqm) in H2 2023. Total office supply brought to market in 2023 reached close to 100,000, following the completion of two major developments (500 Bourke Street and 555 Collins Street).

Supply between 2024-2026 is expected to reach c.240,000sqm. These levels are modest in comparison to the levels seen in 2020 and 2021. With supply normalising, vacancy is expected to subside. Expectations are the combination of rising demand, driven by occupancy levels normalising over coming years, coupled with historically high migration to support this reduction in vacancy in a subdued supply environment.

Supply pipeline sees continued delays amidst low pre-commitment levels.

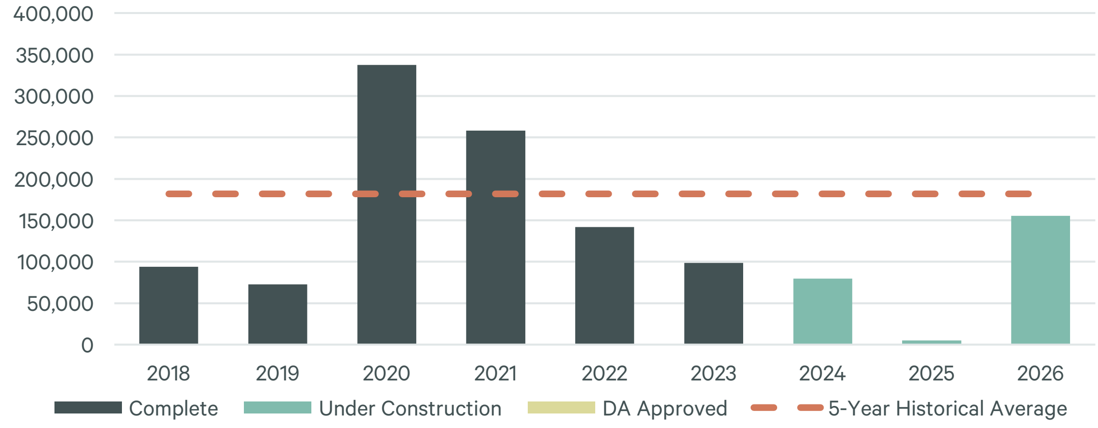
Melbourne's supply pipeline continues to evolve as developers of key projects fail to meet required pre-commitment levels. These concerns have become increasingly relevant amidst the current elevated interest rate environment, whereby lenders are engaging in a higher degree of scrutiny compared to prior cycles. CBRE Research expects continued changes in the supply pipeline over 2024, as existing projects may return from mooted status if demand levels across the CBD begin to show a resurgence.

FIGURE 4: Melbourne CBD Office | Upcoming Major Development Projects



Note: Mooted projects not shown
Source: CBRE Research

FIGURE 5: Melbourne CBD Office | Historical & Forecast Supply



Note: Mooted Projects not shown.
Source: CBRE Research

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Vacancy

Total vacancy continues to rise, with signs of life emerging amidst premium vacancy decline.

Melbourne's CBD overall vacancy increased 156 bps to 16.5% in H2 2023. Vacancy across the CBD has seen consecutive increases since H1 2020. Underperformance in H2 2023 can be partly attributed to 63,000sqm of net supply brought to market, which was unable to be fully absorbed by the market.

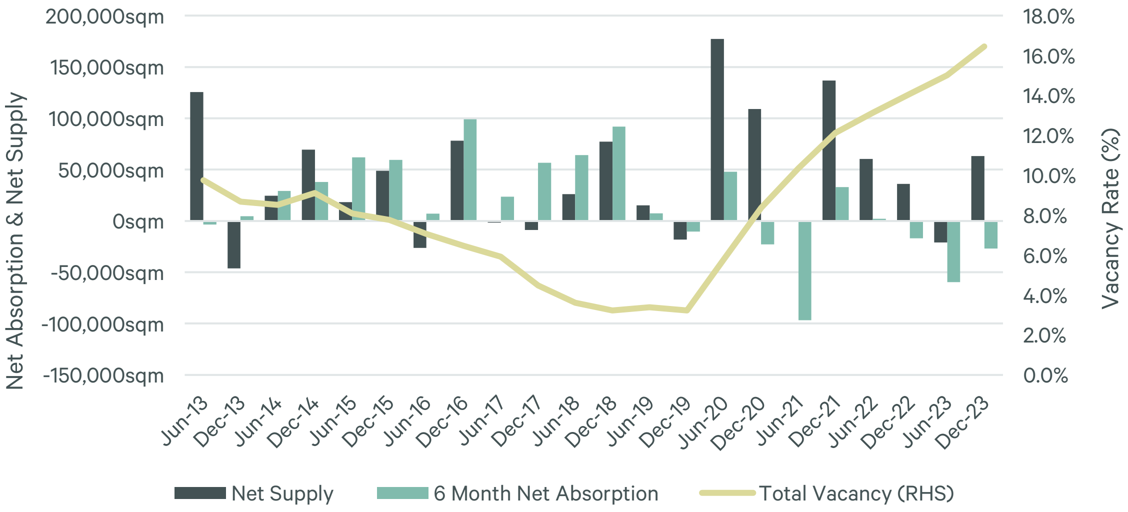
Total vacancy across all asset grades saw increases in H2 2023, except for Premium grade office space, which saw a 108 bps decline to 11.2%. Tenant demand continues to be strongest in this limited group of assets. Grade A assets saw overall increases over the last 6-months, however CBRE Research attributes this primarily to occupier right-sizing due to low occupancy levels and footprint reductions in favour of higher quality space.

With occupancy levels expected to see continued increases over 2024, vacancy across Melbourne's CBD may see reductions. Despite this, investments from tenants into higher quality office space is expected to be a pre-requisite for occupancy levels to rise. As a result, the combined result expected is further rises in secondary vacancy, offset by increased demand for prime space in key locations.

Outliers emerge in Melbourne's sublease vacancy market. Sublease volumes expected to decline over 2024 as no further major tenant moves are anticipated.

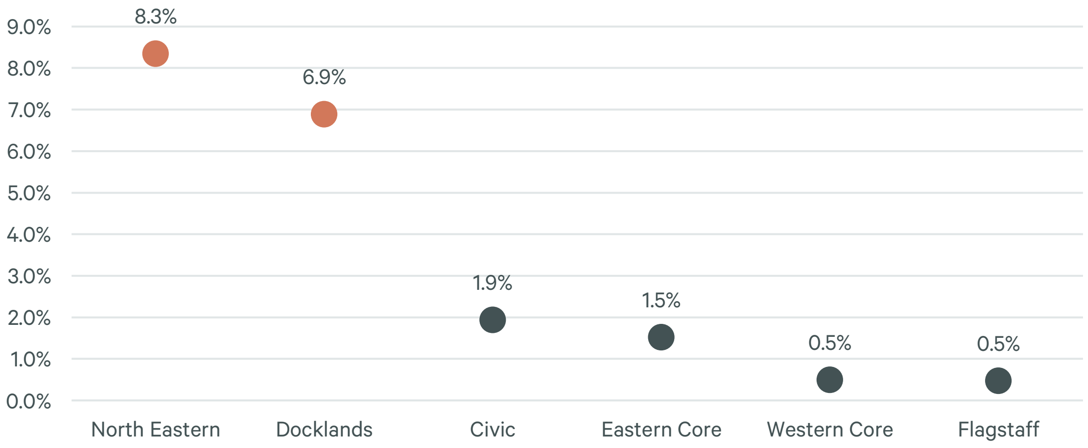
CBRE Research's sublease vacancy data suggests the emergence of two key outliers in the sublease market. Notably, close to 2/3rd of sublease space available in the market is across 4 assets. As of Q4 2023, no further large tenant moves are expected that will drive significant changes in sublease volumes. With strong leasing activity being seen in existing sublease spaces, overall volumes may see a gradual decline over 2024.

FIGURE 6: Melbourne CBD Office | Market Balance



Source: PCA, CBRE Research

FIGURE 7: Melbourne CBD Office | Sublease Vacancy Rate by Precinct



Source: CBRE Research Sublease Barometer

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Rental Performance

Face rents continue to rise with widening spread between Premium and Grade A growth rates.

Face rents across Melbourne's CBD saw modest quarterly growth or stability in all precincts over Q1 2024. A similar trend was observed on a year-on-year basis, with all precincts experiencing non-negative growth.

Melbourne's leasing market has proven its preference to keep face rents firm in the face of rising vacancy. Notably, face rental growth continues to be seen primarily in Melbourne's premium grade stock. Average CBD face rents experienced a 160bps spread between year-on-year growth of Premium (4.4%) and A Grade (2.8%) stock. This spread between premium and Grade A stock widened from the 90bps recorded in Q4 2023. With significant differences between assets in Melbourne's market, each precinct continues to see bifurcated performance with respect to this trend.

Bifurcation within the market continues to be evidenced as incentive stabilisation begins in some precincts.

On an effective rent basis, most precincts except for the Eastern Core continued to record year-on-year negative effective rental growth. Despite this, signs of effective rent stabilisation have begun to emerge. Prime Incentives have begun to stabilise in key assets and precincts which is aiding this stability.

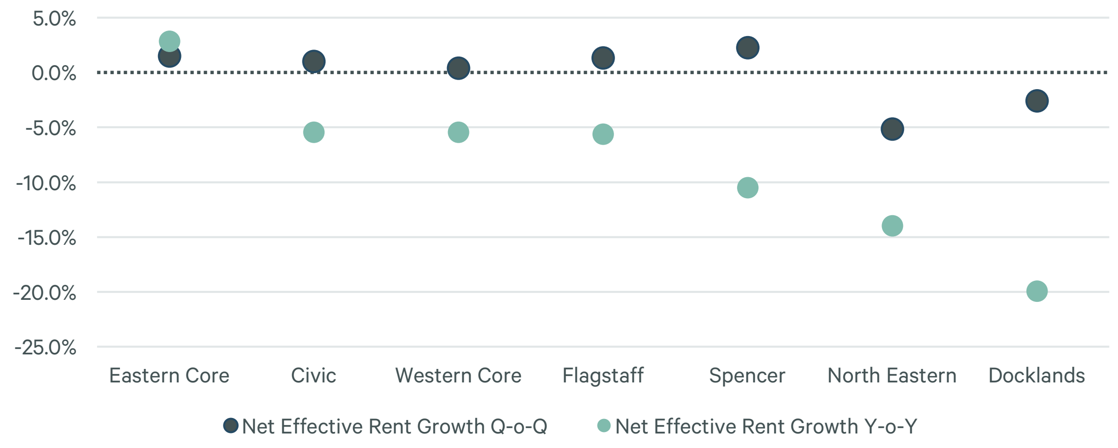
Stabilising incentives in Melbourne CBD's Prime office market is evidence of demand levels normalising in most precincts. Landlords in high performing assets are beginning to hold firm with respect to incentives as vacancy levels in these assets begins to decline. As conditions continue to normalise across the market throughout 2024, further mild fluctuations in incentives are expected, however to a lesser degree experienced throughout 2023.

FIGURE 8: Melbourne CBD Office | Prime Rental Indicators, by Precinct

Melbourne CBD Precinct	Prime NFR (AUD/sqm)			Prime NER (AUD/sqm)			Prime Incentives (%)		
	1Q24	Q-o-Q Change	Y-o-Y Change	**1Q24**	Q-o-Q Change	Y-o-Y Change	**1Q24**	Q-o-Q Change	Y-o-Y Change
Civic	**689**	1.0%	3.1%	**369**	1.0%	-5.4%	**46.4%**	Stable	483 bps
Docklands	**542**	0.2%	0.2%	**237**	-2.6%	-19.9%	**56.3%**	125 bps	1100 bps
Eastern Core	**837**	1.0%	6.0%	**507**	1.5%	2.9%	**39.8%**	-25 bps	200 bps
Flagstaff	**568**	1.3%	4.4%	**295**	1.3%	-5.6%	**48.0%**	Stable	550 bps
North Eastern	**612**	Stable	Stable	**302**	-5.1%	-14.0%	**50.7%**	267 bps	800 bps
Spencer	**673**	2.3%	3.9%	**336**	2.3%	-10.5%	**50.0%**	Stable	800 bps
Western Core	**748**	0.4%	3.4%	**393**	0.4%	-5.4%	**47.4%**	Stable	488 bps

Source: CBRE Research

FIGURE 9: Melbourne CBD Office | Prime Net Effective Rent Growth Rates by Precinct



Source: CBRE Research

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Investment Market

Subdued volumes in Q1 2024 with transaction levels expected to increase.

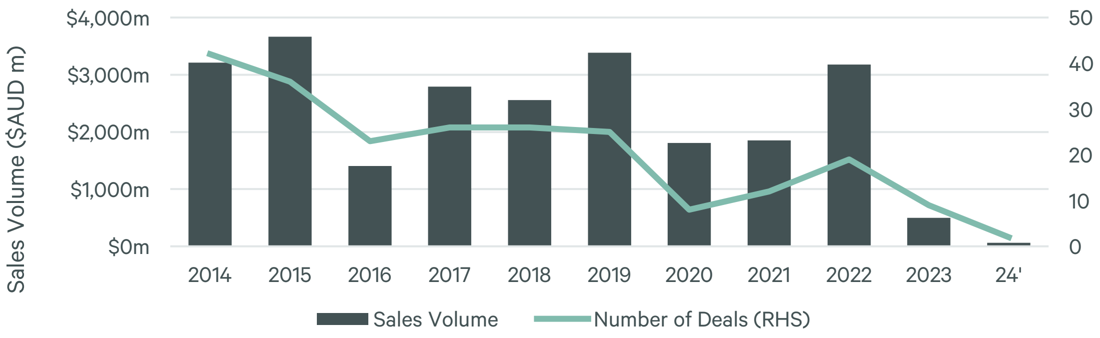
Sales volumes in Melbourne's CBD over Q1 2024 reached $64m, a minor increase from Q4 2023 (c.$60m). Subdued volumes continued following the lowest observed levels in 10 years in 2023. Beyond struggling fundamentals, mismatched buyer-vendor expectations and a climbing cost of debt are key factors that contributed to these subdued levels.

Investment activity in Q1 2024 has been impacted by heightened uncertainty around the impact of tax reforms, increased lead times for deals and rising levels of scrutiny from the current buyer pool in the market. Despite this, expectations remain positive that 2024 will see a rebound in investment volumes as pricing expectations become more aligned and certainty rises as to the trajectory of asset performance.

Yield expansion continues at bifurcated levels between assets and precincts.

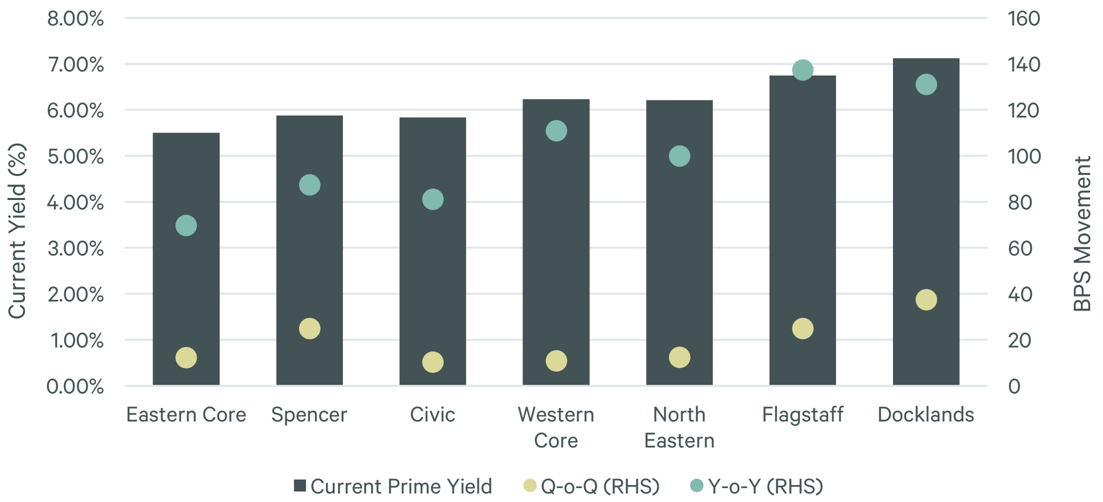
Average CBD prime yields expanded 16 bps to 6.05% in Q1 2024, a modest decline from the 32bps increase seen in Q4 2023. Yields expansion continues to bifurcate over the quarter and year. Despite limited deal evidence in the market, expectations are that yields in premium assets in prime locations are holding firm and increasing at a decelerating rate.

FIGURE 10: Melbourne CBD Office | Sales Activity



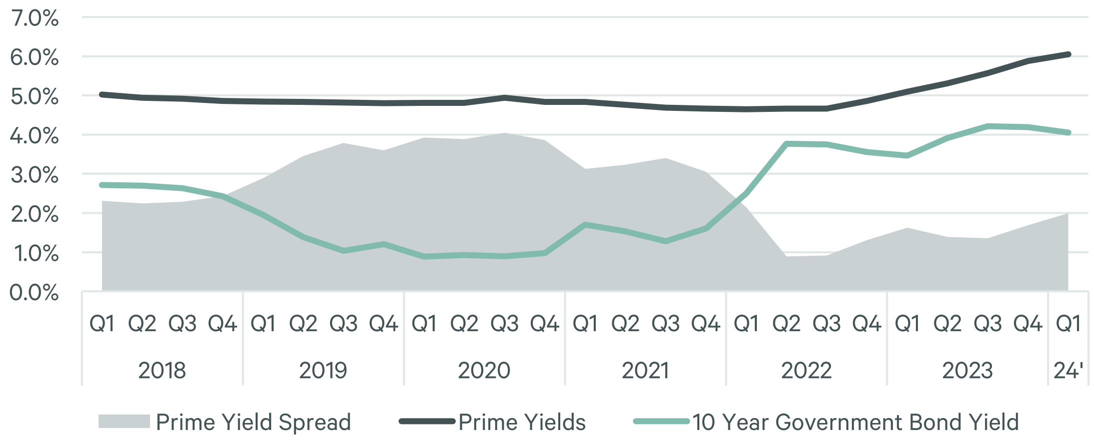
Source: CBRE Research

FIGURE 11: Melbourne CBD Office | Current Prime Yield and Prime Yield Change by Precinct



Source: CBRE Research

FIGURE 12: Melbourne CBD Prime Office Indicative Yields vs Commonwealth Government 10-yr Bond Yields



Source: RBA, CBRE Research

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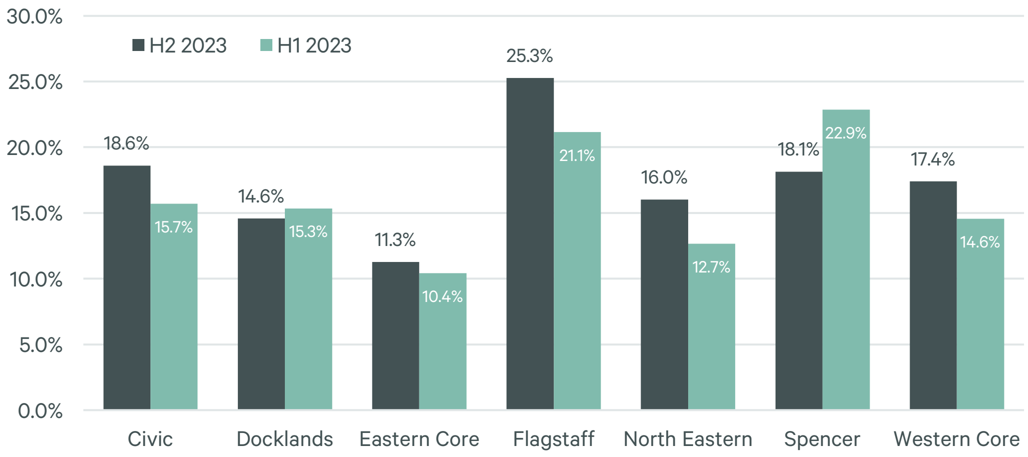
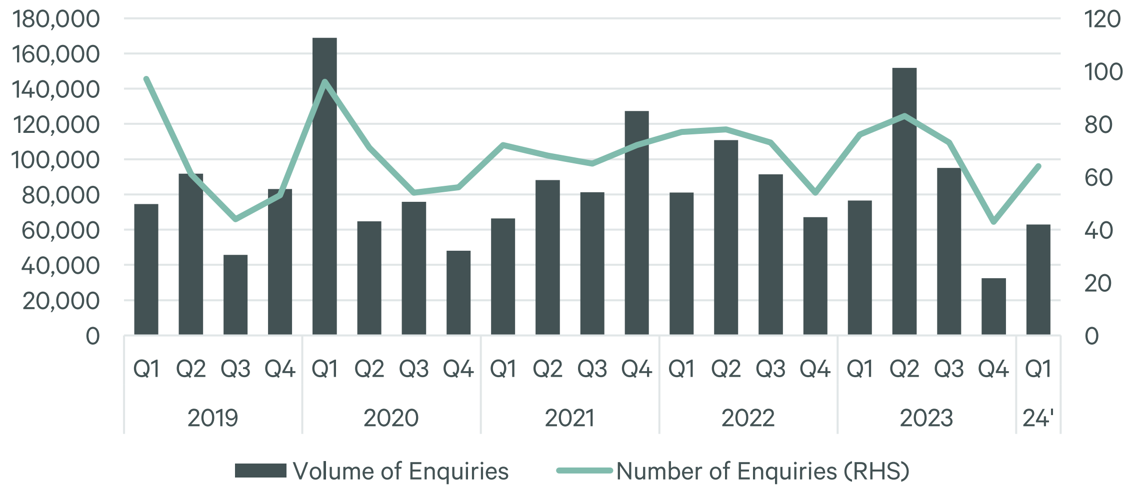
FIGURE 13: Melbourne CBD Office | Total Vacancy Rate by Precinct



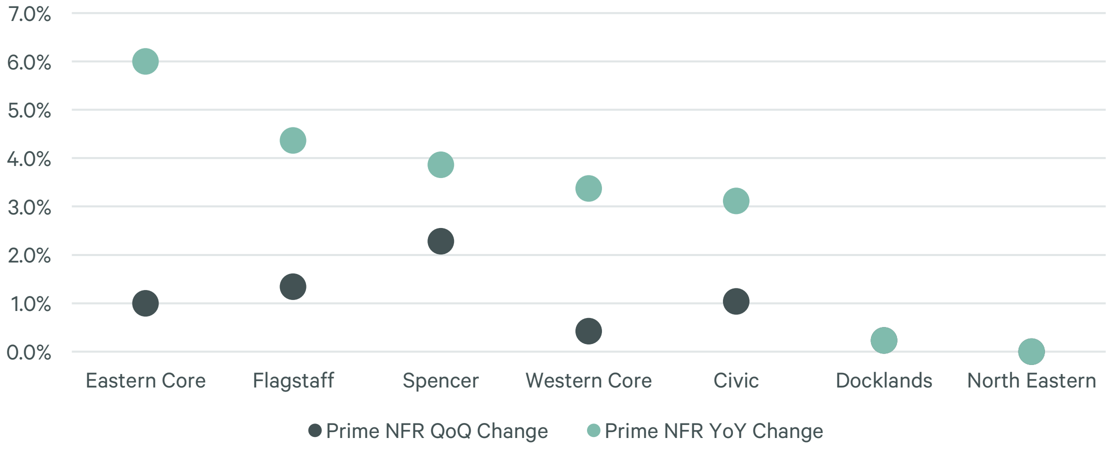
Source: PCA, CBRE Research

FIGURE 14: Melbourne CBD Office | Tenant Enquiry Levels



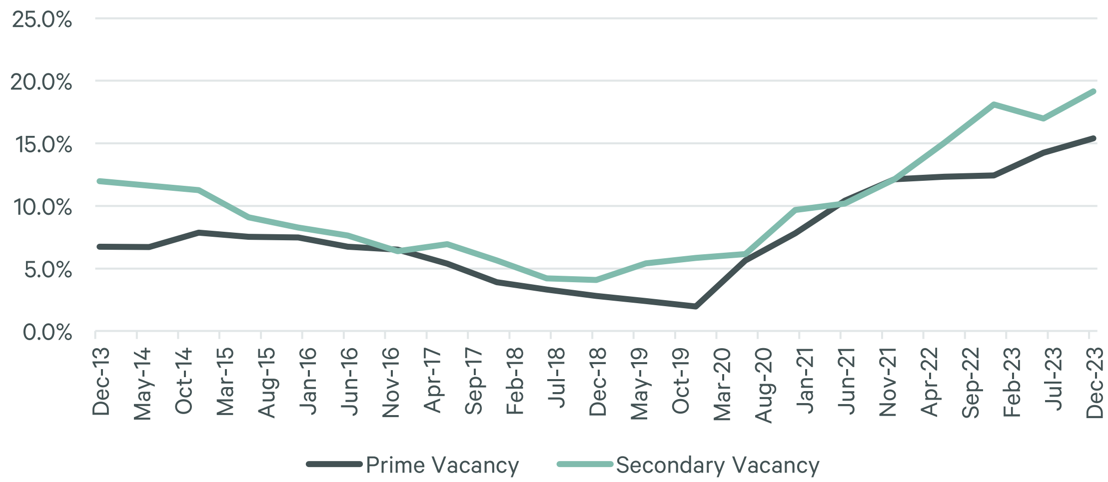
Source: CBRE Research

FIGURE 15: Melbourne CBD Office | Net Face Rental Rates Growth Rates by Grade



Source: CBRE Research

FIGURE 16: Melbourne CBD Office | Vacancy Rates, by Grade



Source: PCA, CBRE Research

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Contacts

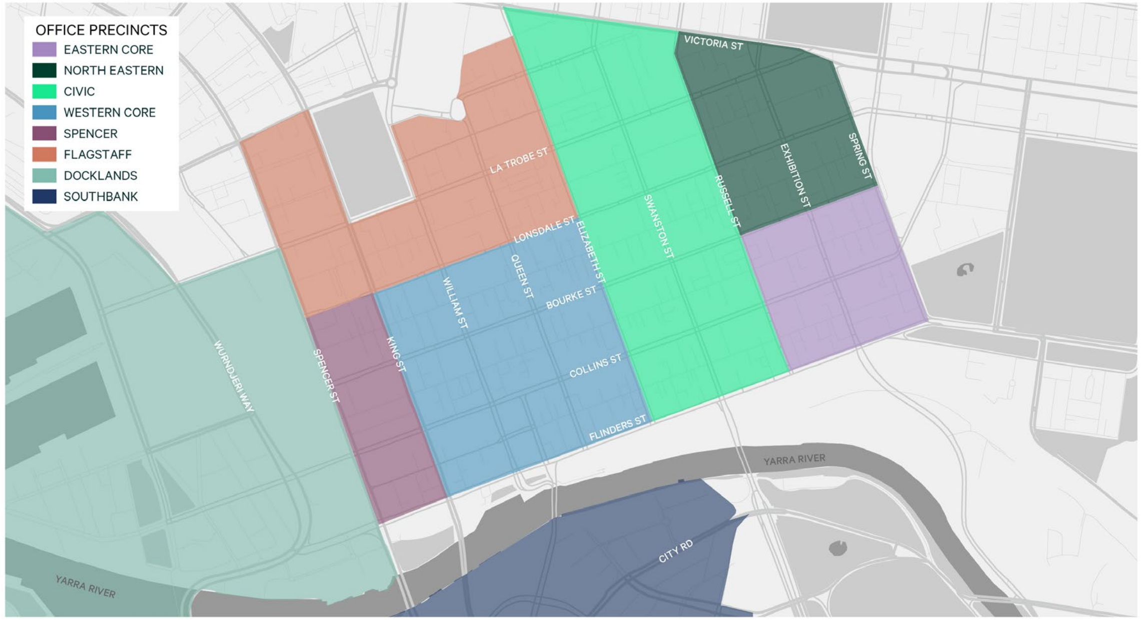
Research

Cameron Douglas-Perrine

Senior Analyst
Melbourne Office Research
+61 450 801 459
Cameron.DouglasPerrine@cbre.com

Office Submarket & Precinct Maps

Melbourne CBD



Contact

Melbourne

Level 34
8 Exhibition Street
Melbourne, VIC 3000

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