

OCCASIONAL PAPER

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investment strategy

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Comparing Melbourne and Sydney Central Office Markets



Key Points

- The central Melbourne and central Sydney office markets are the same markets in every respect except pricing.
- Both markets are approximately 5.8 million square metres in size, have much the same level of vacancy and enjoy the same levels of net absorption.
- There is a substantial pricing difference between the two markets; however Melbourne's investment returns have outperformed Sydney over the last decade.
- The reason for the pricing differential can be attributed to the capacity of each market to supply substantial amounts of office space.
- Over the period 1998 to 2007 Melbourne has exhibited stronger compound rental growth (10%) than Sydney (7%); Sydney has exhibited more capitalisation rate compression (63 bps) than Melbourne (zero); Melbourne has exhibited stronger compound capital growth (10.3%) than Sydney (9.6%); and Melbourne has delivered lower average incentive levels (11%) than Sydney (16%).
- Using a hypothetical IRR model which takes into account buying and selling costs, capital expenditure, leasing and other costs as well as market rents throughout the building and applying the market yields which were applicable at the time, Melbourne delivered an IRR over the 10 years from December 1997 to December 2007 of 17.38% whilst Sydney delivered an IRR of 14.26%.
- One potential reason for the stronger returns could be Victoria's strong economy including its population growth, Melbourne's role as a centre of education excellence, and as Australian headquarters of the country's biggest mining companies – among them: Rio Tinto, BHP, Shell, BP, Esso, ERA, Alumina, Bendigo Gold, Bluescope Steel, Newcrest Mining, Oxiana, St Barbara, Western Mining, North Broken Hill and Zinifex .

Introduction

The Melbourne central office market contains 5,796,436 square metres of lettable space. Of this approximately two-thirds (3,484,574 sqm) is located in the traditional CBD grid and 1,401,683 square metres is located in the St Kilda Rd, Southbank and Docklands precincts. The balance (910,179 sqm) is located in other city fringe suburbs.

The other city fringe suburbs are East Melbourne, Port Melbourne, South Melbourne, Albert Park, Middle Park, South Yarra, Abbotsford, Collingwood, Fitzroy, Carlton, North Melbourne, Richmond, Kensington and West Melbourne.

Demand for office space in the central Melbourne office market has been robust and has exceeded market expectations by a substantial amount. From the negative net absorption endured in 2001 and 2002, the Melbourne central office market experienced net absorption of almost 750,000 square metres over the last three years. In fact, since 2000, businesses have absorbed 1,000,000 square metres of office space. It is little wonder the central Melbourne office market has built 800,000 square metres of office space in that time.

Savills has identified over 150,000 square metres of tenant demand in the market currently. Whilst this may not lead to substantial net absorption it certainly accounts for a lot of activity with upgrades, both of fitouts and of buildings, and business consolidation factors driving relocation decisions.

Rents are expected to continue to grow as upgrade and consolidation activity continues to absorb the diminishing number of available and suitable tenant options. Rents can be expected to soften through 2009 and 2010 as a number of new buildings reach completion and a number of vacated buildings are refurbished.

Current Office Vacancy

The central Melbourne office market has weathered a substantial increase in supply and is currently enjoying lower vacancy rates than many predicted five years ago. It was not unusual to hear of 15% and 17% predictions in relation to impending vacancy rates. The reasons for those fears were three:

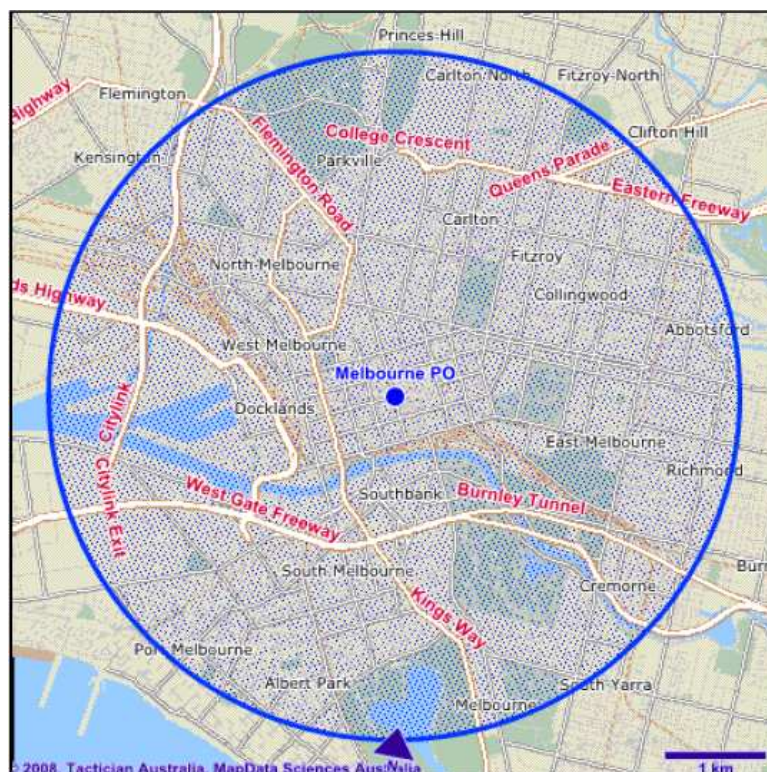
- 1) Melbourne had overbuilt office space in the past and suffered chronic oversupply;
- 2) Negative net absorption in 2001 and 2002 caused many in the industry to question levels of underlying demand; and
- 3) Everybody could see a wave of new supply coming.

Nevertheless, those fears were unfounded with the following vacancy rates now applying:

Central Melbourne's Office Vacancy Rates – January 2008

Grade	Stock	Vacancy	Vac. % Jan-08	Vac. % Jan-07
CBD	3,484,574	119,883	3.4%	7.1%
St Kilda Rd	757,100	46,389	6.1%	10.9%
S'bank/Docklands	644,583	24,722	3.8%	4.5%
Fringe	910,179	54,743	6.0%	5.8%
Total	5,796,436	245,737	4.2%	7.2%

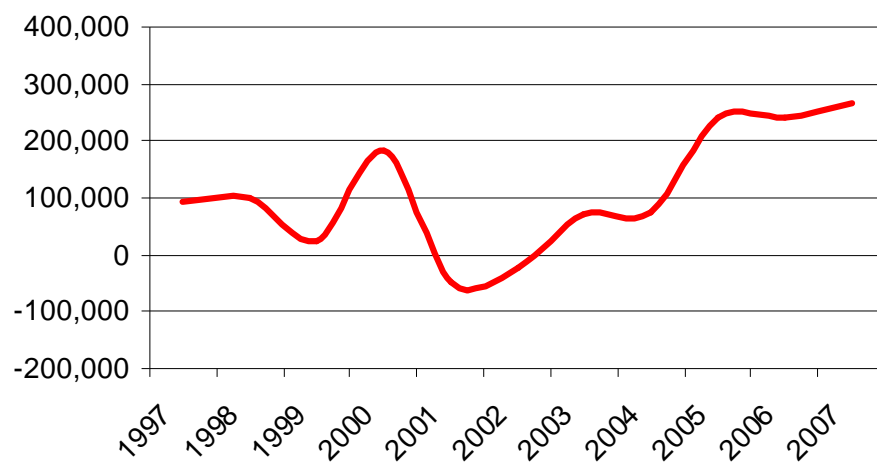
Source: Property Council of Australia/Savills Research



Office Leasing Demand

Net absorption in the year to January 2008 totalled positive 265,850 square metres. When we look more closely at the net absorption figures it is apparent the CBD accounted for positive net absorption of 143,018 square metres whilst Southbank, Docklands and St Kilda Rd totalled 101,185 square metres. The other fringe suburbs collectively enjoyed 21,647 square metres of net absorption.

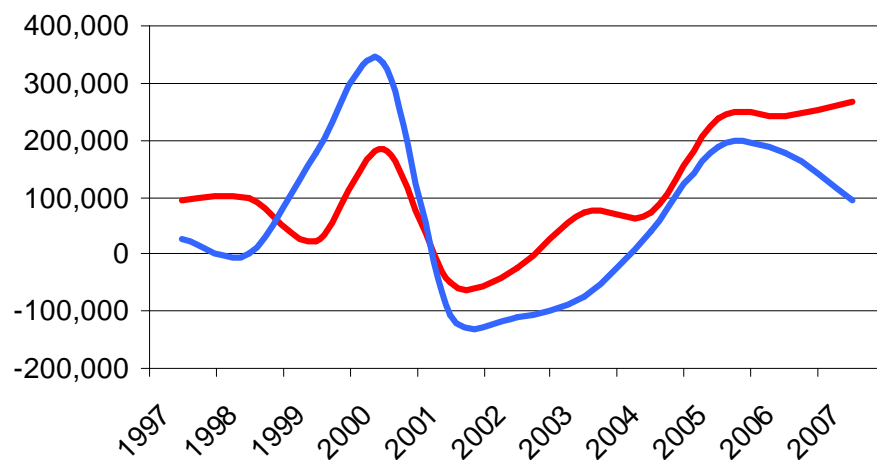
Central Melbourne Office Net Absorption 1997-2007



Source: Savills Research

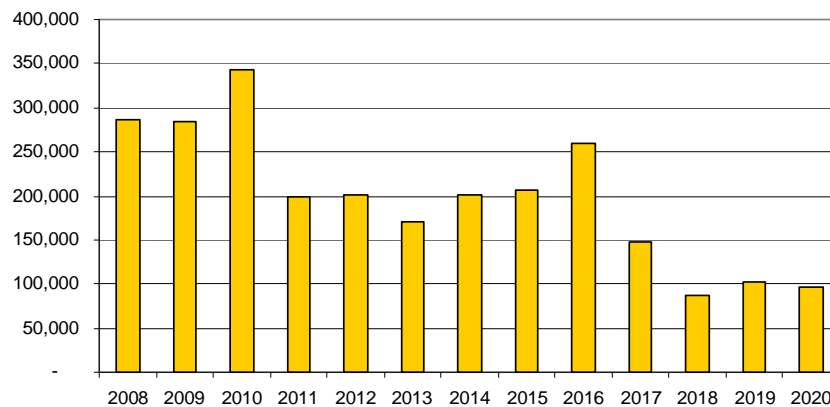
It is when we compare net absorption over a long period of time in the two markets that we see just how similar they really are and how robust demand is in both markets both in quantity and strength of growth.

Central Melbourne and Central Sydney Office Net Absorption 1997-2007



Source: Savills Research

Central Melbourne Office Lease Expiry Profile



Source: Savills Research

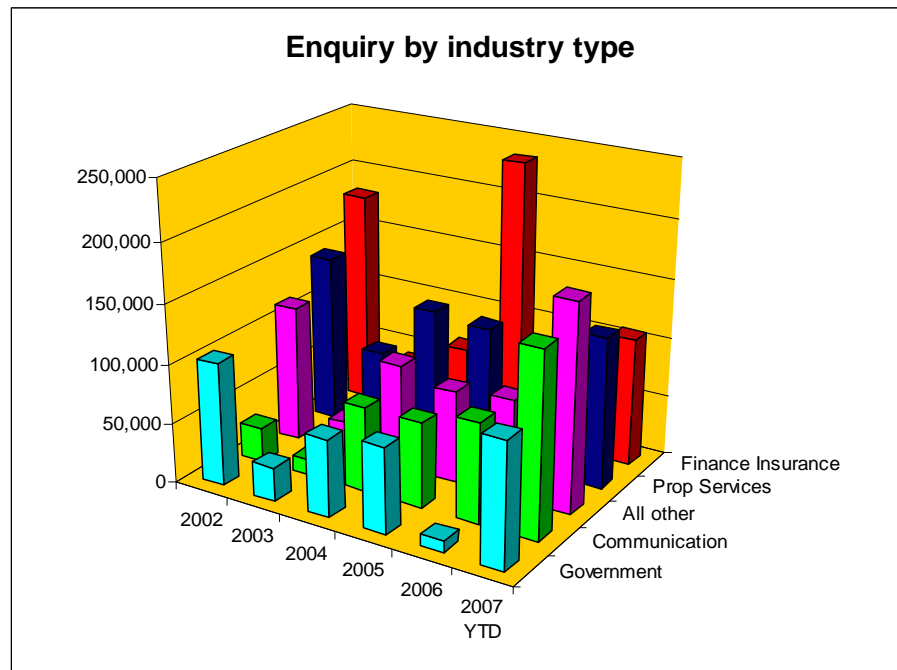
Further, the central Melbourne office lease expiry profile suggests ongoing tenant demand revolving around upgrade, expansion and consolidation from now through to 2011. Savills lease expiry database cover over 80% of lettable floorspace in the central Melbourne office markets. Analysis of the database shows up to 100,000 square metres of large, longer term leases (up to 10 years) fall due for renewal every year as can be seen in the graph above. On top of the 100,000 square metres there is up 200,000 square metres of smaller, shorter term leases (3 to 5 years) expiring every year. These shorter term leases “roll over” the top of the longer term leases as they are renewed or relocated every three to five years. For example, the three to five year leases falling due in 2008 either renew or sign new leases with expiries in the period 2011 to 2013. This means there is always in excess of 300,000 square metres of leases expiring in any given year. This makes the Melbourne office market a “deep” leasing market and a competitive leasing market.

Recent Central Melbourne Office Demand

The Savills Commercial Leasing department provides regular reports on the level and type of demand in the central Melbourne office market.

The central Melbourne office market had an above average number of enquiries through 2007. The number of enquiries was also for larger amounts of space reflecting some larger tenants in the market but also the requirement for expansion space by existing tenants in the market. This is reflective of good economic conditions generally. Melbourne is the corporate home of Australia's mining industry and expansion not only by that sector but by service providers to the mining sector such as engineers, lawyers and accountants also fuelled demand. The education sector is well represented in central Melbourne with many universities and technical colleges present. Many new educational institutions are arriving and many more language, vocational and academic institutions wish to establish a presence in and around the CBD. The amount of space currently required by office tenants in general is at record levels.

As we have indicated for some time, short-term vacancy continues to tighten. Contiguous amounts of space will not be available until later this year when some tenant moves create backfill space. In the meantime, the available space is expected to continue to tighten. At current enquiry levels our forward looking indicators pointed to a strong finish to the 2007 year and a strong first six months of 2008.



Source: Savills

The finance and insurance sectors have had the largest space requirements in the market over the past six years. Whilst smaller than previous years, current requirements from this sector are still significant. Interestingly, the communications sector has shown strong growth over the past four years and this shows no signs of abating in 2008. Many Government requirements have been met by the construction of new buildings in the CBD in recent years, however current requirements are at levels not seen in the past six years. Property and business services demand remains fairly consistent. The Other sector contains mining, manufacturing, utilities, retail and wholesale trade, health and education sectors. The large amount of space currently enquired for can be attributed in part to the education sector with over 40,000 square metres of office space enquiry currently active.

The Victorian economy is showing signs of strong economic growth fuelled by strong population growth, the resources sector (Melbourne is the corporate capital of the resources sector) and business and government investment; particularly in infrastructure.

Victoria generated \$247 billion Gross State Product in 2007. This is expected to grow by \$28 billion over the next three years. Victoria is enjoying substantial population growth with 65,000 people choosing Victoria as a home in 2007. Large amounts of housing construction underway in Melbourne and regional towns throughout Victoria to support this.

For historical reasons, Melbourne is the corporate headquarters of the Australian resource sector – Rio Tinto, BHP, Shell, BP, Esso, Western Mining, ERA, Alumina, Bendigo Gold, Bluescope Steel, Newcrest Mining, Oxiana, St Barbara, Western Mining, North Broken Hill and Zinifex to name a few – are headquartered in Melbourne. This means Melbourne also has mining industry lawyers, accountants and bankers as well as corporate advisors, geologists and engineers. When the resources sector booms so does Melbourne.

Melbourne is also a centre of education excellence with no less than six University campuses in or around the CBD. The Melbourne CBD attracts some 72,000 students every day attending not only University but also institutes, colleges and vocational and language training centres.

Victoria currently has an estimated resident population of some 5.2 million people. This is forecast to grow by just over 200,000 over the next three years. This level of net population growth will continue to underpin economic growth through demand for housing. This in turn will have positive effects on retail spending.

Victoria's unemployment rate has decreased in the past 12 months to register 4.4% at February 2008. Historically low levels of unemployment are resulting in strong wages growth for highly skilled labour.

Victoria is currently recording annual inflation of 3.3% in the year to December 2007, marginally higher than the national CPI of 2.9%. The Victoria and national inflation rates rose by 1.0% and 0.9% respectively in the December 2007 quarter. As a result of low unemployment and underlying inflation increasing faster than predicted, the Reserve Bank of Australia have increased interest rates twice in 2008 thus far. The official cash rate is currently registering 7.25% at March 2008.

The public, government and economic consensus is that the growth in Victoria should remain strong for the short term providing China's economic dominance continues, with Victoria's economic outlook remaining positive.

Melbourne's Central Office Market

Key Market Indicators – December 2007

Melbourne CBD

	Premium		Grade A		Grade B	
	Low	High	Low	High	Low	High
Rental- Net Face (\$/sqm)	400	600	320	350	240	320
Incentive Level (%)	8.0	12.0	8.0	12.0	8.0	15.0
Rental – Net Effective (\$/sqm)	360	540	290	315	215	285
Typical Lease Term	5.0	10.0	5.0	10.0	3.0	6.0
Yield – Market (% Net Face Rental)	5.75	6.00	6.00	6.50	6.50	7.00
IRR (%)	7.75	8.25	8.00	8.50	8.50	9.00
Outgoings – Operating (\$/sqm)	71	81	61	72	50	65
Outgoings – Statutory (\$/sqm)	34	39	29	33	20	25
Outgoings – Total (\$/sqm)	105	120	90	105	70	90
Cars Permanent Reserved (\$/pcm)	450	500	420	480	380	450
Cars Permanent (\$/pcm)	350	400	300	320	300	300
Capital Values (\$/sqm)	6,000	9,400	4,400	5,250	3,000	4,400

Source: Savills Research

Sydney CBD

	Premium		Grade A		Grade B	
	Low	High	Low	High	Low	High
Rental- Net Face (\$/sqm)	700	1,200	550	850	400	550
Incentive Level (%)	10.0	15.0	10.0	15.0	8.0	15.0
Rental – Net Effective (\$/sqm)	595	1,080	468	765	340	506
Typical Lease Term	8.0	10.0	7.0	9.0	4.0	6.0
Yield – Market (% Net Face Rental)	5.00	5.50	5.25	5.75	5.25	6.00
IRR (%)	7.50	7.75	7.75	8.25	7.75	8.00
Outgoings – Operating (\$/sqm)	100	110	65	80	55	75
Outgoings – Statutory (\$/sqm)	40	50	35	50	25	35
Outgoings – Total (\$/sqm)	140	160	100	130	80	110
Cars Permanent Reserved (\$/pcm)	750	1,000	650	850	550	650
Cars Permanent (\$/pcm)	700	800	600	700	500	600
Capital Values (\$/sqm)	11,000	16,000	9,000	12,000	7,000	9,500

Source: Savills Research

Melbourne's Central Office Market

St Kilda Road

	Grade A		Grade B	
	Low	High	Low	High
Rental - Net Face (\$/sqm)	240	275	215	240
Incentive Level (%)	8.0	15.0	8.0	15.0
Rental - Net Effective (\$/sqm)	210	245	190	215
Typical Lease Term	5.0	8.0	3.0	5.0
Yield - Market (% Net Face Rental)	6.50	7.50	7.50	8.50
IRR (%)	8.50	9.50	8.75	9.50
Outgoings - Operating (\$/sqm)	55	60	45	50
Outgoings - Statutory (\$/sqm)	30	35	30	35
Outgoings - Total (\$/sqm)	85	95	75	85
Cars Permanent Reserved (\$/pcm)	240	300	235	255
Capital Values (\$/sqm)	2,800	4,000	2,250	2,850

Source: Savills Research

Melbourne Suburbs

	Grade A		Grade B	
	Low	High	Low	High
Rental - Net Face (\$/sqm)	220	325	200	270
Incentive Level (%)	5.0	14.0	5.0	14.0
Rental - Net Effective (\$/sqm)	200	295	180	245
Typical Lease Term	5.0	10.0	3.0	5.0
Yield - Market (% Net Face Rental)	6.75	7.75	7.75	9.00
IRR (%)	8.25	8.75	8.75	9.75
Outgoings - Operating (\$/sqm)	40	40	33	35
Outgoings - Statutory (\$/sqm)	15	20	17	20
Outgoings - Total (\$/sqm)	55	60	50	55
Cars Permanent Reserved (\$/pcm)	90	150	70	140
Capital Values (\$/sqm)	2,700	4,400	2,000	3,200

Source: Savills Research

North Sydney

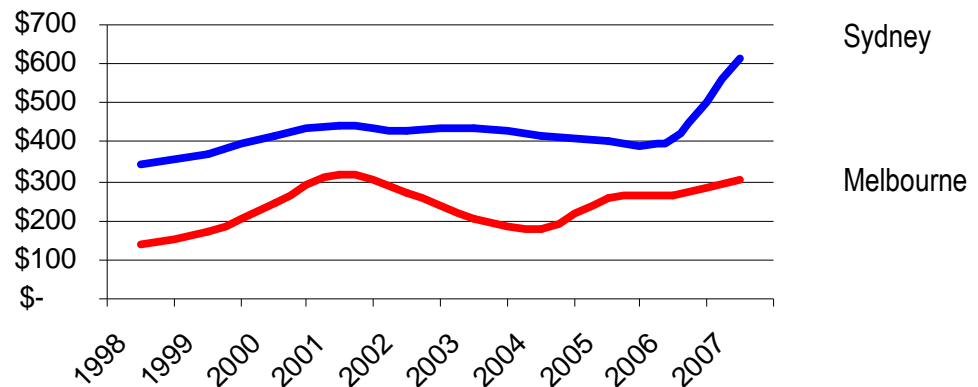
	Grade A		Grade B	
	Low	High	Low	High
Rental - Net Face (\$/sqm)	385	450	300	340
Incentive Level (%)	20.0	25.0	25.0	35.0
Rental - Net Effective (\$/sqm)	289	360	195	255
Typical Lease Term	5.0	8.0	3.0	6.0
Yield - Market (% Net Face Rental)	6.25	6.50	6.75	7.50
IRR (%)	8.25	8.75	8.25	8.75
Outgoings - Operating (\$/sqm)	65	70	50	55
Outgoings - Statutory (\$/sqm)	20	25	20	25
Outgoings - Total (\$/sqm)	85	95	70	80
Cars Permanent Reserved (\$/pcm)	400	500	350	450
Cars Permanent (\$/pcm)	400	500	375	450
Capital Values (\$/sqm)	5,500	7,200	4,000	5,000

Source: Savills Research

Pricing

If the central Melbourne and central Sydney office markets are approximately the same size with the same levels of net absorption at the same time then what are the pricing differences?

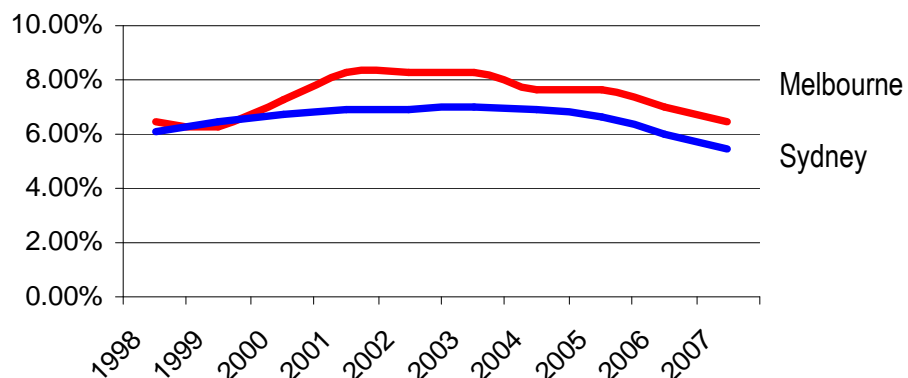
Sydney and Melbourne CBD Grade A Net Effective Rents 1998 to 2007



Source: Savills Research

Net effective office rents in the Sydney CBD have always maintained a premium over those in Melbourne. Certainly over the period considered in the graph above the premium has ranged from \$100 to \$300 per square metre and averaged approximately \$200. Over the period 1998 to 2007 Melbourne has exhibited stronger compound rental growth (10%) than Sydney (7%).

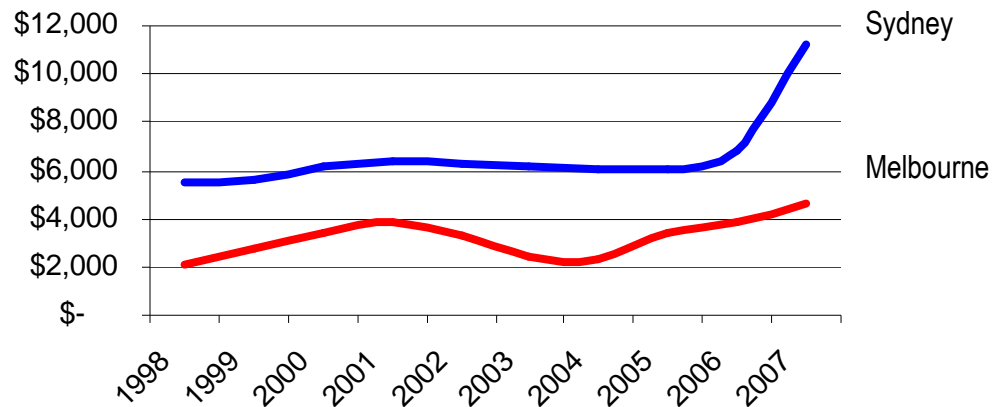
Sydney and Melbourne CBD Grade A Market Yields 1998 to 2007



Source: Savills Research

Like rents, market yields in the Sydney CBD have always maintained a premium over those in Melbourne. Certainly over the period considered in the graph above the premium has ranged from parity to 140 bps and averaged approximately 75 bps. Over the period 1998 to 2007 Sydney has exhibited more capitalisation rate compression (63 bps) than Melbourne (zero).

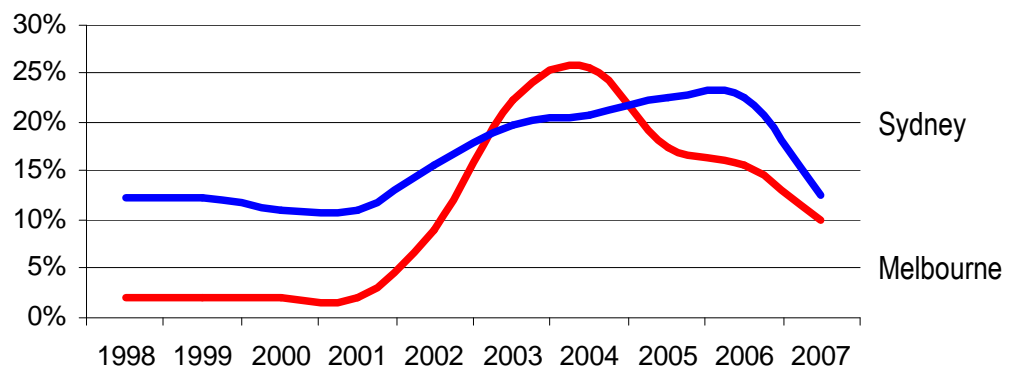
Sydney and Melbourne CBD Grade A Capitalised Values 1998 to 2007



Source: Savills Research

Given the difference in rents and market yields it is little surprise the Sydney CBD office market has a higher capitalised value. Certainly over the period considered in the graph above the premium has averaged approximately \$3,000 per square metre. Over the period 1998 to 2007 Melbourne has exhibited stronger compound capital growth (10.3%) than Sydney (9.6%).

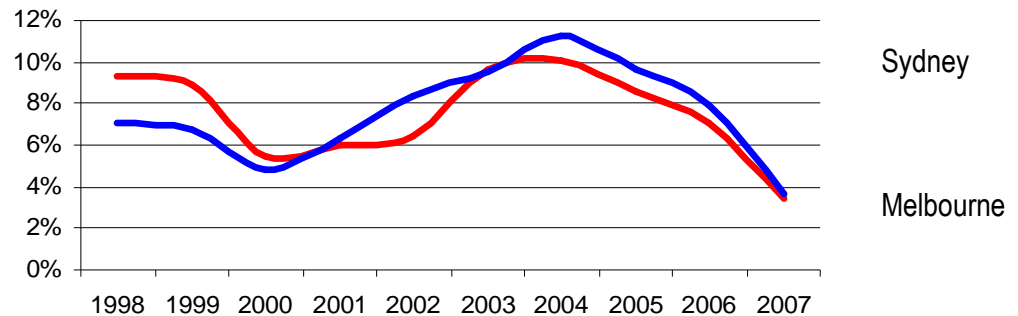
Sydney and Melbourne CBD Grade A Incentive Levels 1998 to 2007



Source: Savills Research

Incentive levels have moved much in line in both markets reflecting the nature of demand and vacancy in both markets. This outcome is not surprising considering net absorption has moved the same in both markets as has vacancy. Certainly over the period considered in the graph above the incentive levels have ranged from less than 5% to as high as 25%. Over the period 1998 to 2007 Melbourne has delivered lower average incentive levels (11%) than Sydney (16%).

Sydney and Melbourne CBD Office Vacancy Rate 1998 to 2007



Source: Savills Research

Whilst there has been a substantial premium to rents and yields in Sydney compared to Melbourne over the past decade, Melbourne has delivered superior investment performance. This seems counter-intuitive because in essence we seem to believe a premium should lead to superior performance. The IPD/PCA investment performance index shows a rolling annual return for Sydney of 20.3% and for Melbourne a return of 21.3%.

Using a hypothetical IRR model which takes into account buying and selling costs, capital expenditure, leasing and other costs as well as market rents throughout the building and applying the market yields which were applicable at the time, Melbourne delivered an IRR over the 10 years from December 1997 to December 2007 of 17.38% whilst Sydney delivered an IRR of 14.26%.

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