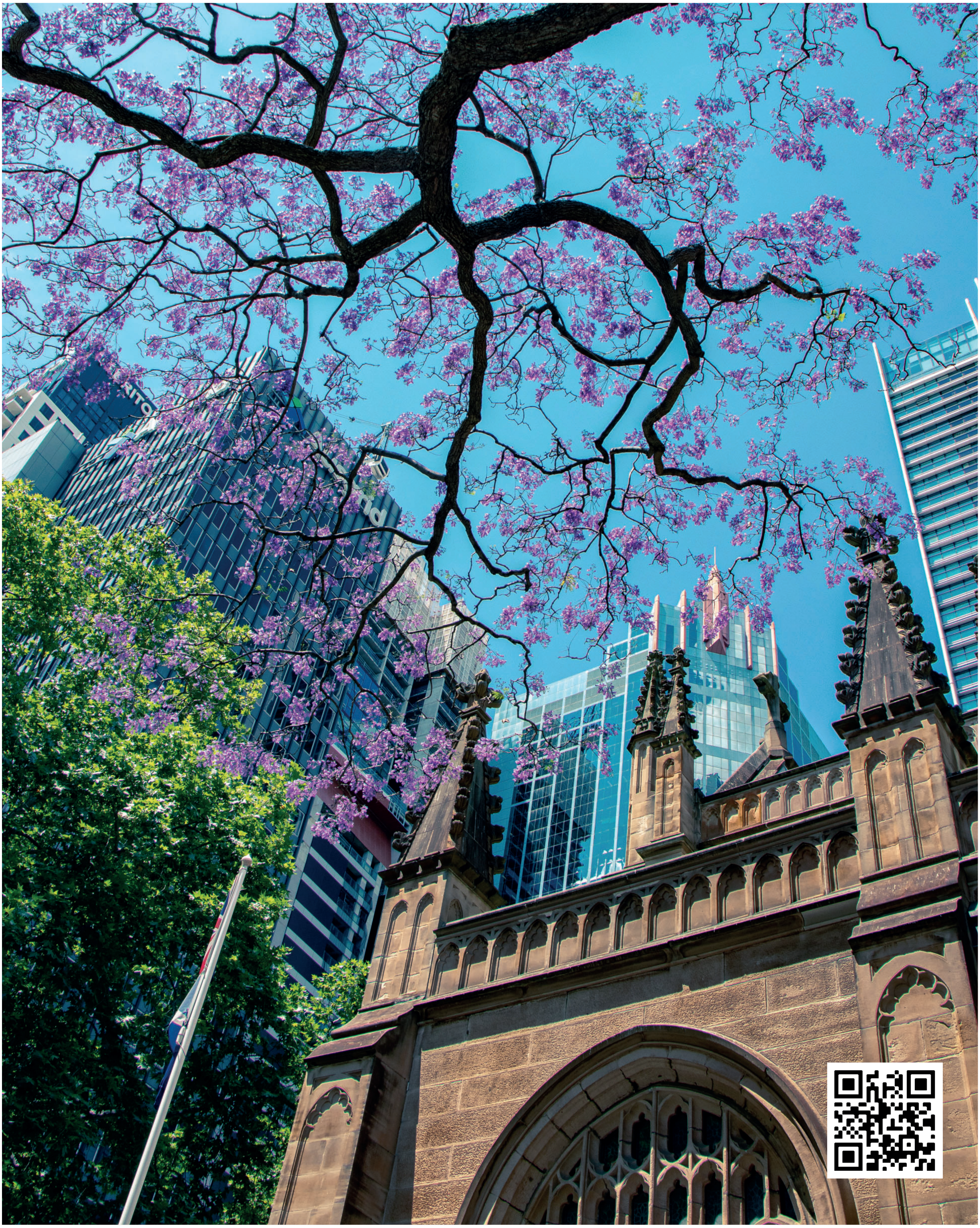
Asian Cities - 2H 2022

SPOTLIGHT
Savills Research

Australia Offices

savills



Prime assets outperform amid flight to quality

MULTI-SPEED OFFICE LEASING MARKET

Since the onset of the pandemic, Australia's major office markets have seen a flight to quality as employers look to attract and retain talent. The multi-speed nature of the office leasing market is highlighted by diverging trends in the demand for office space. In the premium market, the increase in net absorption since 1H/2020 across the Australian markets totalled around 324,500 sq m, equivalent to 10.8% of premium office stock, while net absorption in the A grade segment was equivalent to 1.4% of A grade office stock (Chart 1). By contrast, demand for secondary market office space declined over the same period, with net absorption falling by around 428,500 sq m, equivalent to 3.7% of secondary office stock.

While demand for office space at the prime end of the market has been relatively strong, a well above-average level of new development completions in 2021 and 2022, particularly in Sydney and Melbourne, has driven office vacancy rates higher (Chart 2). The premium vacancy rose from 3.5% at the beginning of 2020 to 8.9% in July 2022, while the A grade equivalent increased from 6.4% to 12.8% over the same period (Chart 3). Vacancy in the secondary market, which was significantly higher coming into the pandemic, has risen by 3.2 percentage points to 14.3%. While new development completions have led to a narrowing in the spread between the secondary and premium vacancy rates over the past two years, the spread remains high relative to history.

WEAKER GROWTH OUTLOOK IN 2023 REINFORCES THE FLIGHT TO QUALITY

The deterioration in global economic outlook amid high inflation and rising interest rates will reinforce the appeal of prime assets. While the Australian economy is expected to remain in expansionary territory in 2023 and avoid the worst of the global downturn, the slowdown in economic growth and deterioration in labour market conditions may increase leasing risk in some markets.

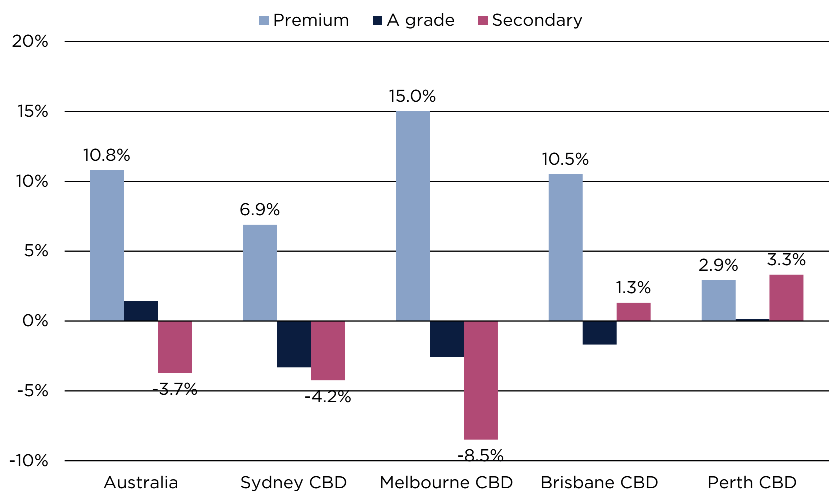
In this environment, the flight to quality seen in recent years is likely to continue, with ongoing relatively strong demand for well-located core assets, as well as premium and high-quality A grade buildings with highly rated green credentials.

STRUCTURAL TRENDS ALSO SUPPORTIVE OF DEMAND FOR PRIME OFFICE SPACE

In addition to cyclical factors, structural forces are also driving demand for prime and well-located assets. In the wake from the pandemic, more businesses are recalibrating their office environment to changes in work patterns with a goal of maximising workplace performance, against their ability to meet growing duty of care requirements and maintaining business continuity. In some cases, this may mean a reduction in floor space requirement and in others, an increase, but the commonality towards a newer, more efficient workplace in a central location is the same.

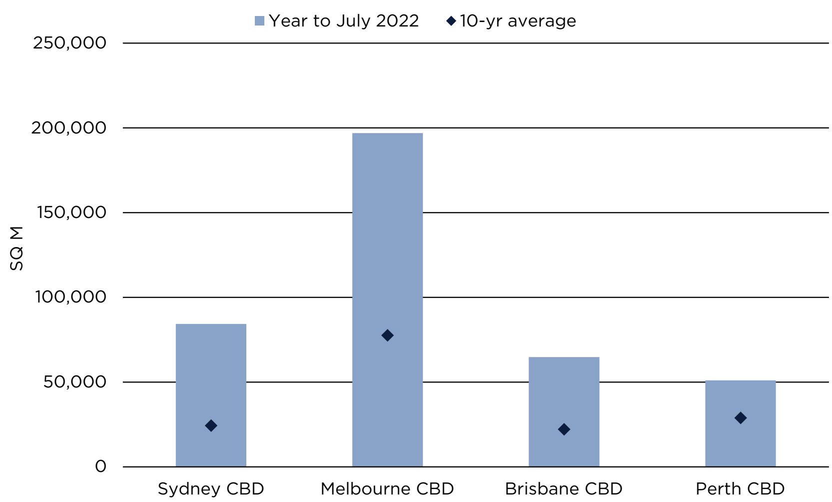
Assets in central locations with strong transport links will continue to outperform, alongside newer, higher quality office space that helps support business continuity,

GRAPH 1: Office Net Absorption by Grade since 1H/2020



Source Savills Research, Property Council of Australia

GRAPH 2: Net Additions by CBD Market, Year to July 2022 vs 10-year Average

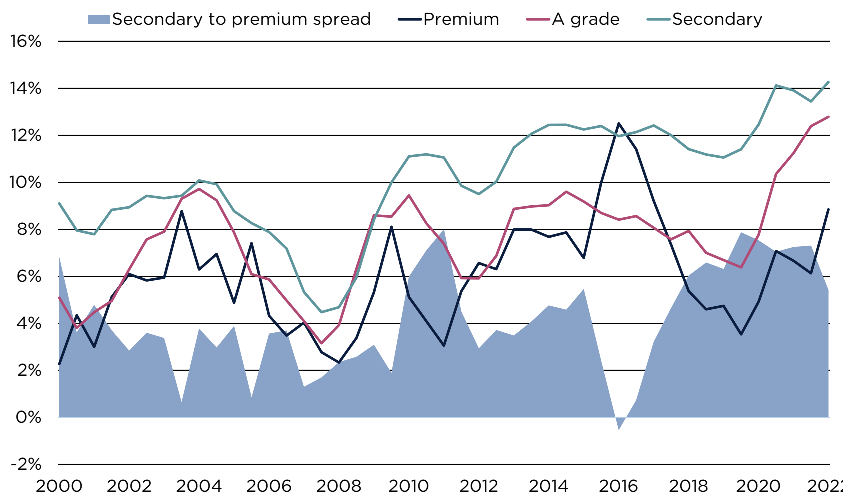


Source Savills Research, Property Council of Australia caters to the changes in work patterns, and allows employers to remain competitive in the battle for talent. While there are a number of factors at play here, the demographics of these central locations remain compelling, with access to a large number of people within a short commute time.

Supporting this, a large pipeline of infrastructure investment in major Australian capital cities will augment the appeal of central locations within these key markets by reducing commute times (Chart 4). For example, the Sydney metro project, which will reach overall completion by 2030, will establish a new network of four underground metro lines allowing for a train every four minutes during peak times and target travel time of about 20 minutes between Parramatta and Sydney CBD. The CBD and southwest section of the project will be complete by 2024, cutting travel time between the CBD and North Sydney to five minutes. In Melbourne, the North-East Link will dramatically cut travel times between Melbourne's north and southeast, while the Metro Tunnel rail tunnel running through Melbourne's CBD will connect South Kensington to South Yarra. Ramped up infrastructure investment in Brisbane, notably the Cross River Rail and Brisbane metro, alongside the investment associated with the 2032 Olympic Games, will transform the city, facilitating the development of multiple city precincts and increased urbanisation.

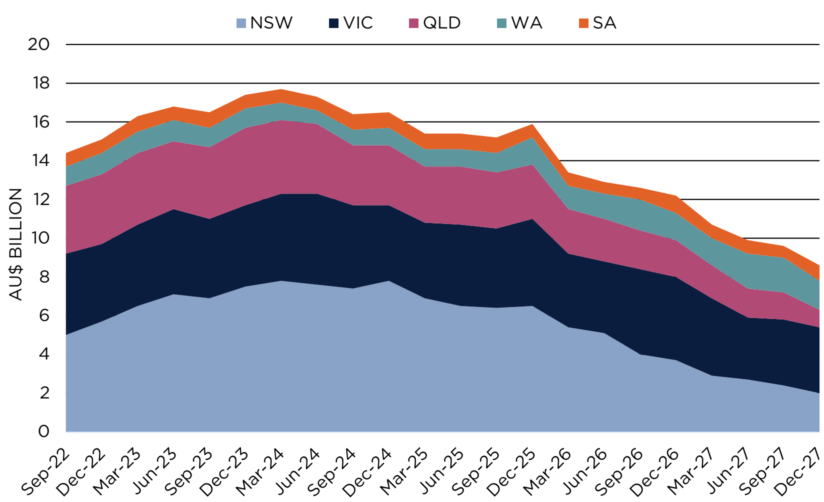
The deterioration in global economic outlook amid high inflation and rising interest rates will reinforce the appeal of prime assets.

GRAPH 3: Australia Office Vacancy Rate by Grade, 2000 to 2022



Source Savills Research, Property Council of Australia

GRAPH 4: Infrastructure Spending by State, September 2022 to December 2027

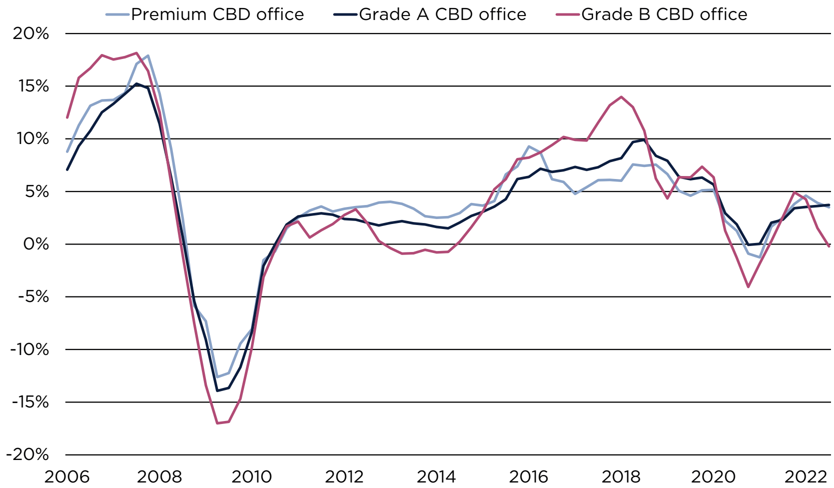


Source Savills Research, Infrastructure Partnerships Australia

INVESTOR ROTATION TOWARDS CORE ASSETS

The relative strength of the occupier market outlook for prime assets, both from a cyclical and structural perspective, will drive a rotation into core assets and out of non-core assets as major institutional investors reposition their portfolios towards assets that are less exposed to leasing risk. After a slowdown in investment activity this year reflecting the rapid rise in interest rates and funding costs, investor rotation into core assets and out of non-core assets is likely to gain momentum next year, as the interest rate outlook becomes clearer with major central banks expected to slow or end monetary policy tightening in the coming months.

GRAPH 5: Capital Growth by Grade, 2006 to 2022



Source Savills Research, MSCI

PRIME ASSETS SET TO OUTPERFORM

Reflecting stronger investor demand, prime assets are beginning to materially outperform the secondary market after the broad-based rebound in capital growth following the pandemic downturn. Capital values for premium and A grade assets both increased by around 3.5% over the year to September 2022 compared with a 0.2% fall for B grade assets over the same period (Chart 5). The relative strength in the occupier and investment market outlook for prime office property assets means this divergence in performance is likely to continue.

savills

For more information about this report, please contact us

Savills Australia

Paul Craig
CEO
+61 2 8215 8888
pcraig@savills.com.au

Savills Research

Katy Dean
Head of Research & Consultancy, Australia
+61 2 8215 6079
kadean@savills.com.au

Chris Naughtin
National Director, Capital Markets - Research, Australia
+61 2 8215 8832
chris.naughtin@savills.com.au

Simon Smith
Regional Head of Research & Consultancy, Asia Pacific
+852 2842 4573
ssmith@savills.com.hk