Australian Office – August 2023

SPOTLIGHT
Savills Research

Office Briefing

Ongoing flight to quality ● Mixed conditions across major markets ● $1.6bn deals pending

Multi-speed office market

Central bank policy rates nearing peak but resilient global economy points to interest rates staying higher for longer

Global economy slowing but risk of sharp downturn diminishing
The global economy is losing momentum, but the slowdown in economic activity has been milder than previously expected, reflecting stronger services sector output and robust labour market conditions in many advanced economies.

Global growth is expected to slow further this year and into 2024 but at a more gradual pace than previously anticipated, while the risk of a sharp downturn in the global economy is receding.

In Australia, employment growth supports spending
In Australia, economic growth has slowed in recent months reflecting the impact of higher interest rates and inflation. However, tight labour market conditions and robust employment growth continue to lend some support to consumer spending.

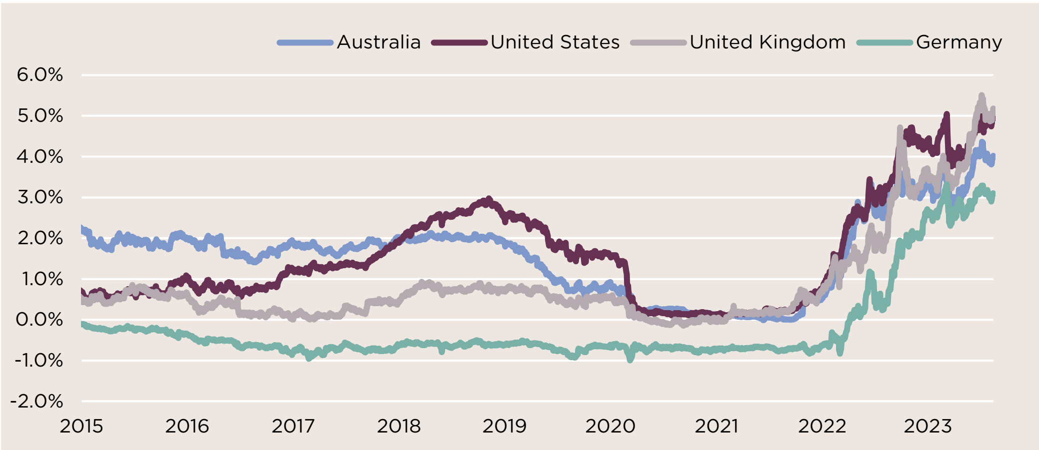
The RBA expects GDP growth to slow to 0.9% in 2023, before picking up 1.6% in 2024, well below the 2.4% average annual growth rate in the decade to 2022.

Interest rates expected to remain higher for longer
In line with the slowdown in activity, growth in inflation has generally moderated in recent months across advanced economies, although central banks remain concerned by elevated services price inflation.

Stronger than expected economic activity and the potential for this to lead to a more gradual slowdown in inflation has pushed out expectations of future interest rate cuts and led 2-year government bond yields to drift higher in recent months.

The US Federal Reserve increased the federal funds rate to 5.25%-5.5% in July, which financial markets expect will be the last increase in the cycle. However, the Fed is not expected to reduce interest rates until well into 2024, compared with expectations of multiple cuts in H2 2023 several months ago. In Australia, the RBA is expected to increase the cash rate one more time by 25 basis points to 4.35%.

2-year bond yields rise as expectations of near-term rate cuts receed
Per cent, daily



Source Savills Research / Macrobond

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Tale of the cities

Varying occupier demand in the major CBD markets points to a mixed outlook across the country

National office vacancy rate rises to highest level in over two decades
Declining demand for office space in Sydney and Melbourne and higher supply drove the national CBD office vacancy rate to 12.8% in July 2023, up from 12.6% in January and the highest level since 1996.

Sydney and Melbourne drive fall in demand
The decline in net absorption was concentrated in Sydney and Melbourne as several tenants reduced their office footprint. Net absorption fell by c.40,200 sqm and c.66,200 sqm over the six months to July in the Sydney and Melbourne CBDs respectively. Despite the sizable declines in the level of absorption, negative net supply limited the rise in vacancy in both cities, with Sydney CBD's vacancy rate rising by 20bps to 11.5%, while Melbourne's vacancy rate rose to 15.0%, up from 14.1%.

Conditions stronger in other major markets
Brisbane, Perth, Adelaide, and Canberra all saw positive net take-up of space over the same period.

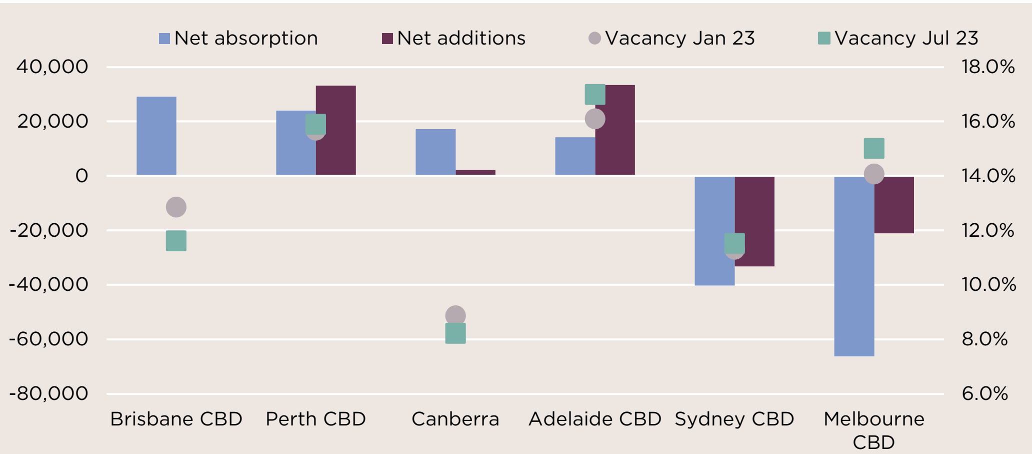
Brisbane again recorded the strongest rise in take-up among the CBD markets, with net absorption increasing by c.29,100 sqm over the six months to July. Sustained demand coupled with no new supply drove the Brisbane CBD vacancy rate to 11.6% in July, down from 12.9% in January.

Vacancy in Perth and Adelaide rose despite solid demand, reflecting completion of One The Esplanade (52,000 sqm) in Perth and 60 King William Street (c.40,000 sqm) in Adelaide.

Premium space in demand
Demand for office space continues to be concentrated in the prime market. Across CBD markets nationally, net absorption in the premium market rose by c.71,900 sqm over the year to July 2023, while net take-up in the A grade segment increased by c.60,300 sqm over the same period. By contrast, net absorption in the B grade and C grade segments declined by c.85,700 sqm and c.51,000 sqm respectively.

Demand and supply

Net absorption (sqm), net additions (sqm), and vacancy rate (per cent, RHS)



Source Savills Research / Property Council of Australia

Key economic forecasts

GDP growth

2023	2024
0.9%	1.6%

Headline CPI

2023	2024
4.1%	3.3%

Underlying CPI

2023	2024
3.9%	3.1%

Unemployment rate

2023	2024
3.9%	4.4%

Population growth

2023	2024
1.9%	1.7%

Source Savills Research / Deloitte Access Economics / RBA

Downsizing and upgrading

Tenants gravitate towards centrally located prime space, assisting rental growth in some markets

Leasing markets
Lower demand overall but take-up of premium space drives rental growth in most markets

+132,200 sqm
increase in CBD prime net absorption, year to July 2023

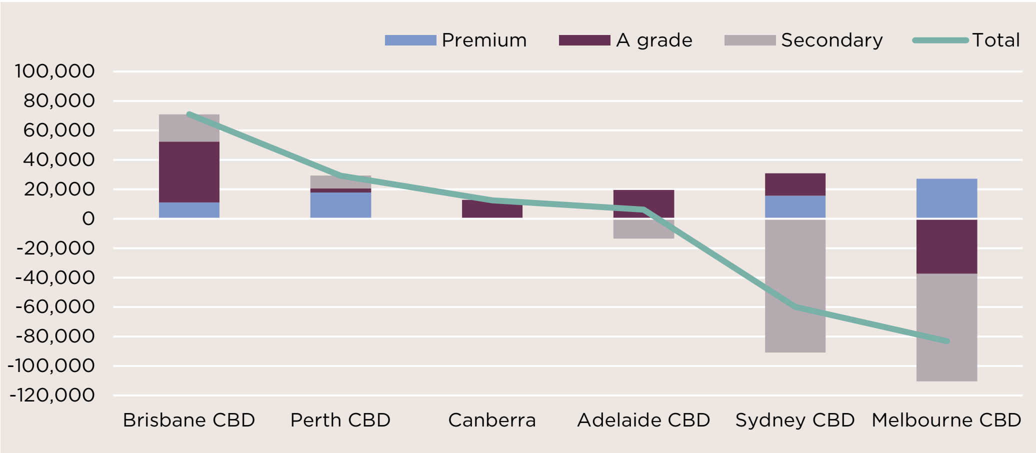
-148,000 sqm
Decrease in CBD secondary net absorption, year to July 2023

12.8%
National CBD vacancy rate, July 2023

4.4%
Brisbane CBD premium vacancy rate, July 2023

+12.9%
Brisbane CBD prime net effective rental growth y/y

Net absorption by grade
Year to July 2023, sqm



Source Savills Research / Property Council of Australia

Take-up of premium space bucks overall trend
Strong competition for prime space in core locations amid limited supply

Sydney and Melbourne drive divergence in demand
The bifurcation in demand across property grades and precincts is most evident in Sydney and Melbourne where demand in the premium market remains solid.

In the Sydney CBD, net absorption of premium and A grade space rose by c.15,600 sqm and c.15,200 sqm respectively over the year to July 2023, while take-up in the secondary market declined by c.90,800 sqm over the same period. In the Melbourne CBD, the premium segment was the only grade to record positive net take-up over the year.

Positive net absorption in Brisbane and Perth
Other markets such as Brisbane and Perth have seen a broader base of demand, with positive net absorption across the property grades over the past 12 months.

Mixed conditions across the country leading to large variation in rental growth
Demand for premium and well-located office space have driven a pick-up in rental growth across most of the major CBD markets, although incentives generally remain high.

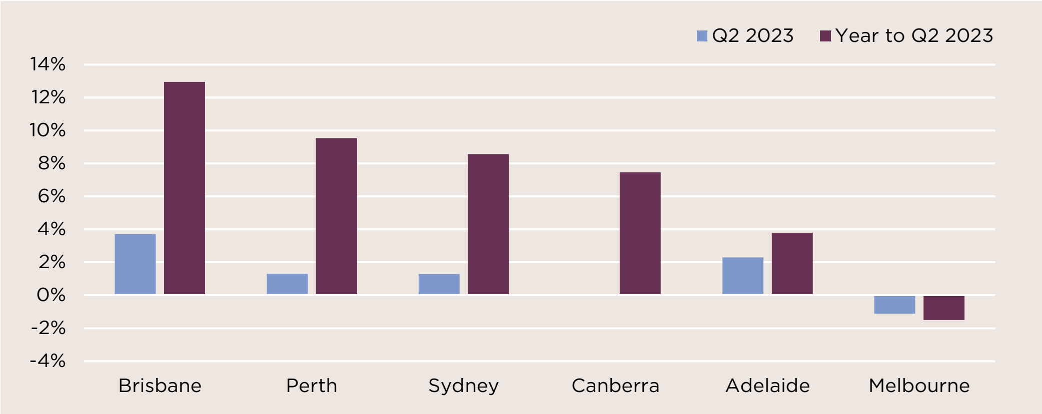
Brisbane continues to see the strongest rental growth across the major CBD markets, with prime average net effective rents increasing by 3.7% in Q2 to be 12.9% higher over the year.

In Sydney, competition for premium space and demand for speculative fit outs, particularly in the CBD Core continues to drive rents higher, with average prime net effective rents growing by 1.3% in Q2 to be 8.6% higher over the year.

Rental growth is relatively subdued in Melbourne, where the return to office has generally been slower and the market is still working through the large increase in supply that came online in 2020 and 2021. Average prime net face rents remained stable in Q2, while average net effective rents declined by 1.1% in Q2 (-1.5% y/y) driven by higher incentives.

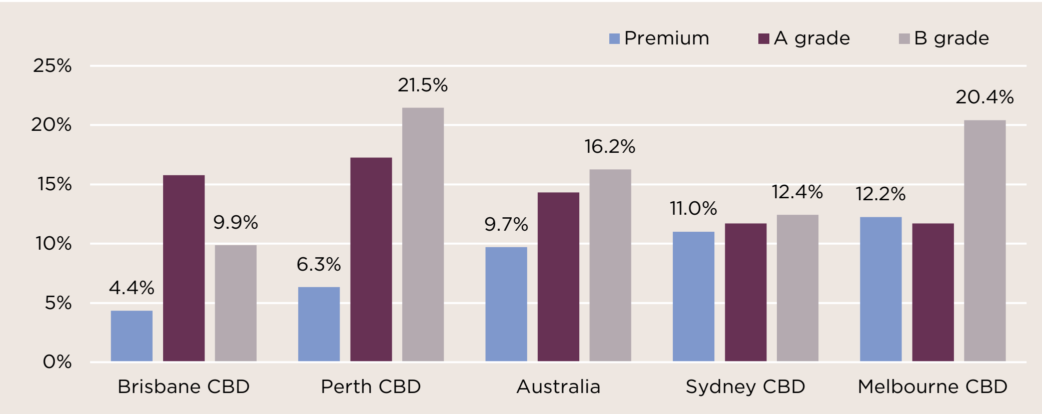
In Perth, average prime net face rents increased by 1.3% in Q2 (+4.4% y/y) and average prime incentives remained stable. In Adelaide, average prime net face rents rose by 3.1% in Q2 (+4.2% y/y), while average prime incentives remained stable over the quarter.

Prime net effective rents
Per cent change q/q and y/y



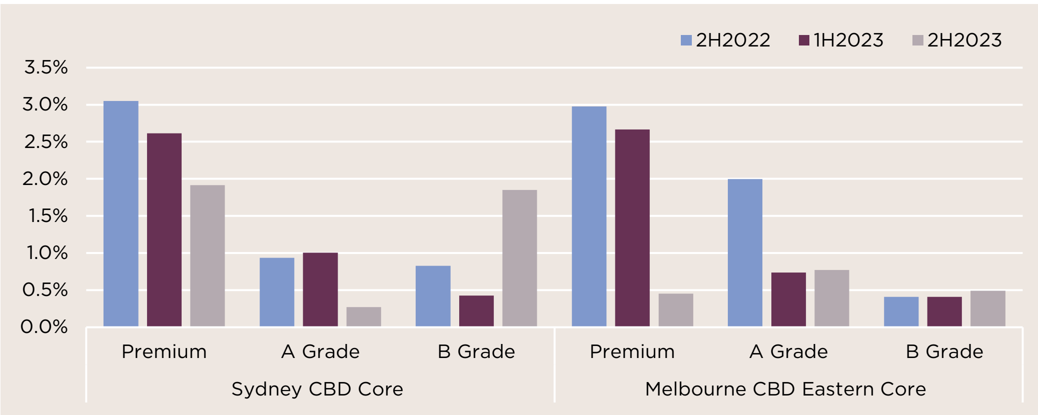
Source Savills Research

Vacancy rate by grade
July 2023, per cent



Source Savills Research / Property Council of Australia

Sydney and Melbourne CBD sub-lease space by grade
Per cent of total office stock



Source Savills Research / Property Council of Australia

HIGHLIGHTS

Brisbane premium market has lowest vacancy in the country
Sustained positive net absorption and no new development completions have driven the Brisbane CBD's premium vacancy rate to 4.4%, the lowest level of any major CBD market in the country, and the lowest rate since January 2020.

Core concentration
Demand for office space continues to be stronger in core locations. In Sydney, net absorption rose by 61,800 sqm in the CBD Core over the year to July 2023, compared with -37,800 sqm in Midtown and -65,400 sqm in Western and Walsh Bay. In Melbourne, demand has held up relatively well in the Eastern Core and North Eastern precincts, while take-up has been comparatively weak in the Western Core.

Prime sub-lease space declines in core locations
The amount of available prime sub-lease space in core CBD locations has declined significantly over the past year.

In the Sydney CBD Core, premium sublease vacancy declined to 1.9% in July 2023, down from 2.6% in January and 3.1% in July 2022. A grade sublease vacancy has also declined over the past six months while B grade sublease vacancy increased to 1.8% in July, up from 0.4% in January.

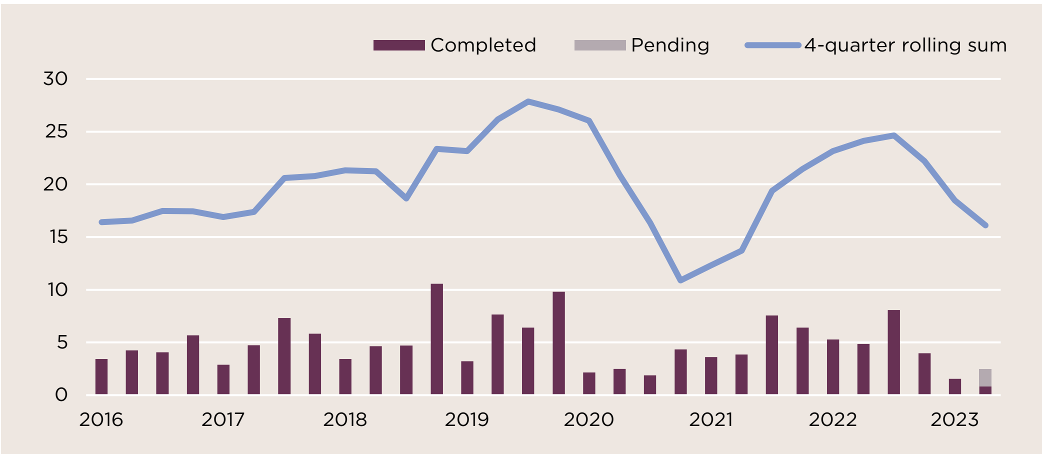
In the Melbourne CBD Eastern Core, premium sublease vacancy declined to 0.5% in July, down from 2.7% in January.

Investment activity subdued

Higher interest rates and debt costs continue to keep investors on the sidelines

Office investment volume down c.82% in Q2 2023 vs Q2 2022

Deals $10m+, quarterly and 4-quarter rolling sum, $bn



Source Savills Research / MSCI Real Capital Analytics

Completed deal volume slowed further in Q2

Several deals are in due diligence or pending

Investment activity down c.82% y/y in Q2

Office sector investment activity weakened further in Q2, continuing the sharp slowdown seen since H2 2022 reflecting uncertainty over the outlook for inflation and interest rates, higher debt costs, and the ongoing gap between buyer and seller price expectations.

According to MSCI Real Capital Analytics, office investment volume (completed deals, $10m+) totalled c.AU$857 million in Q2, down 45.1% from the c.AU$1.56 billion in Q1, and 82.4% from Q2 2022. Several deals have transacted in Q3 to date, including PAG's purchase of 44 Market Street from Dexus for $393.1 million, reflecting a 17.2% discount to the December 2022 valuation, while Dexus has exchanged contracts to sell 1 Margaret Street for $293.1 million. Around $1.6 billion of deals remain in due diligence or are pending.

Yields soften further in Q2

Higher interest rates continue to put upward pressure on office property yields. In the Sydney CBD, the average premium yield rose by 25bps in Q2 to 4.80%, while the average A grade yield also increased by 25bps to 5.50%.

In Melbourne, the average CBD premium yield softened by 12.5bps to average 4.875%, while the average A grade yield was 12.5bps higher at 5.625%.

Capital values fall led by secondary assets

Softening yields are beginning to translate into lower capital values in major office markets. Office assets in the Property Council/MSCI Australia Core Wholesale Property Index recorded a 4.3% decline in capital growth in Q2 to be 6.4% lower over the year (compared -3.5% y/y for retail and +2.4% for y/y for industrial).

Reflecting the flight to quality, premium office assets have held up relatively well, with an average capital value decline of 3.4% in Q2 (-5.3% y/y), while A grade assets fell by 5.2% (-6.8% y/y). In contrast, secondary capital values fell by an average of 7.6% in Q2 (-16.1% y/y).

Several major REITs and super funds have also revalued office assets lower over the past six months. Charter Hall and Dexus recorded declines in capital values of 3.7% and 8.8% respectively in June 2023 compared to December 2022. Super funds have generally recognised larger falls in capital values, with AustralianSuper revaluing their office assets between 5% and 10% lower over the same period, while Australian Retirement Trust recorded declines of between 10% and 15%.

Capital markets
Higher interest rates weigh on investment activity and capital values

+17.5bps
increase in average CBD prime grade office yield in Q2 2023

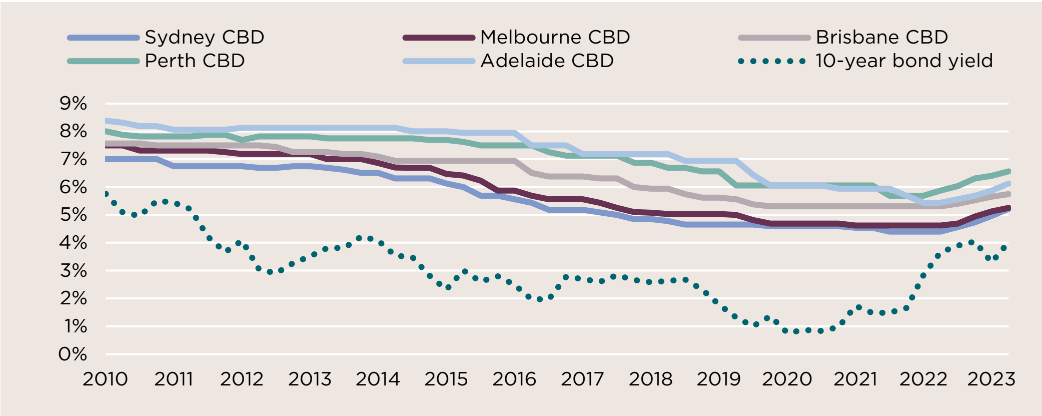
-82%
Investment volume in Q2 2023 vs Q2 2022

c.$1.6bn
Deals in due diligence or pending

-7.9%
Office fund capital value growth over the year to Q2 2023

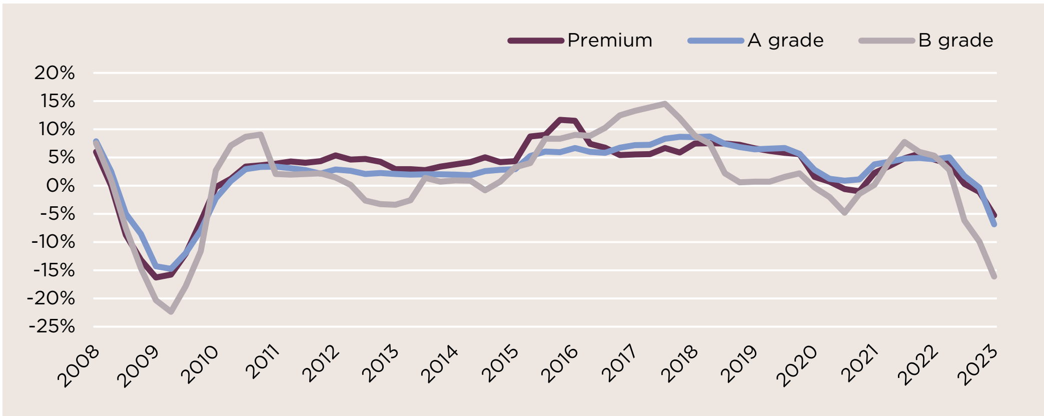
-5% to -15%
Major super fund office portfolio revaluations

Prime CBD office yields
Average prime yield vs 10-year government bond yield, per cent



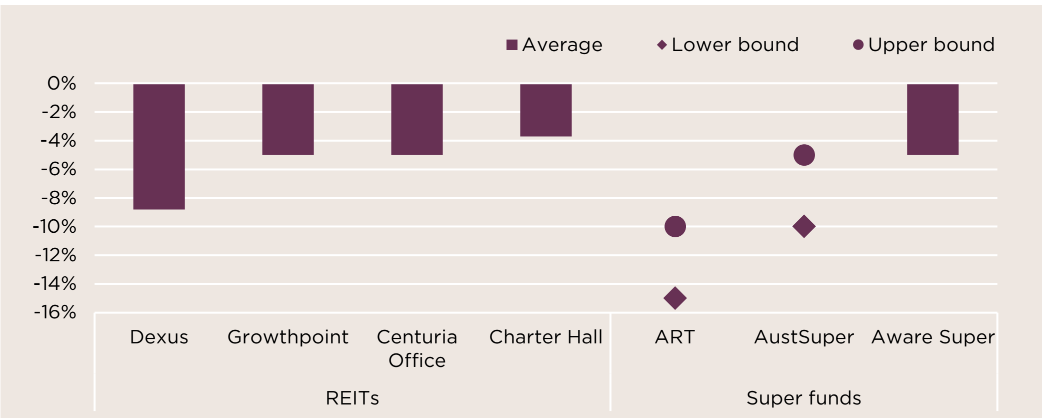
Source Savills Research / RBA

Property Council/MSCI Australia Core Wholesale Property Index
Capital growth by grade, year to Q2 2023



Source Savills Research / MSCI Real Assets

Office valuation downgrades among selected REITs and super funds
Per cent change, June 2023 vs December 2022



Source Savills Research / ASX / company, fund reports

HIGHLIGHTS

Investor shift among slowdown in activity

Higher interest rates and ongoing uncertainty over the interest rate outlook have impacted cross-border and domestic institutional investor activity to a greater degree than private investors. According to MSCI Real Capital Analytics, private investors have accounted for just over half of office investment volume in Australia in 2023 to date compared with one-sixth in 2022.

Conversely, cross-border and domestic institutional investors have been less active this year, each accounting for a little over one-fifth of office investment volume this year, compared with 35% and 42% respectively in 2022. However, Australia remains a key destination for cross-border capital, with Sydney and Melbourne the top two preferred markets among investors in the APAC region, according to the ANREV Investment Intentions Survey.

Capital value falls as office funds impose redemption limits

Office funds in the MSCI/ Mercer Australia Core Wholesale Property Fund Index recorded a 7.9% decline in capital growth over the year to Q2 2023, while major REITs and super funds have revalued their office portfolios between 4% and 15% lower over the past six months. Several major institutional investors have limited redemptions in flagship office funds, citing the gap between buyer and seller expectations are a barrier to asset disposals.

CBD market overview

Strong demand for prime and well-located assets drive rental growth but conditions vary across the CBD markets

Major CBD market summary
Q2 2023

Market	Key trends
Sydney CBD	Tenant appetite for premium space in prime locations as well as demand for spec fit-out space continues to drive leasing activity in the Sydney CBD. Several major leasing transactions occurred over Q2, including Ashurst pre-committing to 10,000sqm at 39 Martin Place, and pre-commitments from the NSW DPP (9,385sqm) and BDO Australia (6,100sqm) to Parkline Place. Average prime net face rents increased by 1.9% in Q2 to $1,338/sqm (+9.1% y/y). Average prime incentives remain high and drifted a little higher in Q2, leading to slightly slower growth in effective rents. Rental growth is expected to moderate over the next few years reflecting the anticipated economic slowdown, backfill vacancy arising from the Sydney Metro OSD completions, as well as some tenants reducing space in response to structural shifts in working patterns. Investment activity remained weak in Q2, however PAG's purchase of 44 Market Street from Dexus for $393.1 million was completed in August. The average premium grade yield rose by 25 bps in Q2 to 4.80%, while average A grade yields also softened by 25 bps to 5.65%.
Melbourne CBD	Occupier market conditions remain subdued in Melbourne reflecting the overall slower return to the office compared to the other major CBD markets and the large increase in office supply in 2020 and 2021, which has pushed CBD vacancy to relatively high levels. While overall demand is expected to remain tepid, take-up of prime stock is expected to remain significantly stronger than secondary as tenants seek to attract and retain talent. The development pipeline is limited over the next few years - 555 Collins Street (48,000sqm) is due this year, and Melbourne Quarter Tower (68,000sqm) reaching completion in 2024 - allowing the market some time to work through the current supply overhang. Prime net face rents remained stable in Q2, averaging $748/sqm (+1.4% y/y). Soft tenant demand is leading to upward pressure on incentives - average prime incentives rose by 0.6 percentage points in Q2 to 38.1%, resulting in a 1.1% fall in prime net effective rents (-1.5% y/y). Average premium and A grade yields both softened by 12.5 bps in Q2 to average 4.875% and 5.625% respectively.
Brisbane CBD	Leasing market conditions remain buoyant in Brisbane, with broad-based demand for space across industries, underpinned by strong interstate and overseas migration, and the large pipeline of infrastructure associated with city's rapid population growth and the Brisbane 2032 Olympics. There were two significant pre-commitments at 360 Queen Street in Q2, with QIC agreeing to take 10,000sqm and Herbert Smith Freehills committing to 4,700sqm. Reflecting the strength in occupier market conditions, rents continue to grow rapidly, with average prime net face rents growing by 3.0% in Q2 to $728/sqm (+10.9% y/y), while average prime net effective rents were 3.7% higher (+12.9% y/y). New supply is limited in the near-term, with the next major development (205 North Quay Tower, fully pre-committed) not reaching completion until late 2024. Low supply will continue to put downward pressure on vacancy and support rental growth in the near-term. Average premium grade yields softened by 10bps over the quarter to range between 5.25% and 5.50%, while A grade yields rose by 5bps to range between 5.75% and 6.50%.
Perth CBD	Sustained tenant demand from the mining, energy, and construction industries continue to support leasing market conditions. Nearly 100,000sqm of new and refurbished supply is expected to be added to Perth's CBD office market in 2023, including Chevron's new headquarters at One The Esplanade (52,000sqm, completed in Q1), Westralia Square 2 (9,500sqm, completed in Q2), and Capital Square Tower 3 in the second half of the year. These new developments will place some upward pressure on vacancy in the near-term. Average prime net face rents increased by 1.3% in Q2 (+4.4% y/y), while average prime incentives remained stable over the quarter at 46.25%. Face rental growth is expected to continue to be solid in the near to medium term, although incentives will remain relatively high. Prime CBD office yields rose by a further 15bps in Q1 to average 6.55%.
Adelaide CBD	Net absorption rose by a total c.14,300sqm in H1 2023, nearly three times the long-run average, with demand concentrated in the prime market. In 2023, c.90,000sqm of new development and refurbished office space will be added to the Adelaide CBD, including 60 King William Street (c.40,000 sqm, completed in H1 and near fully leased to Services Australia, Telstra, and NAB) and Festival Plaza (c.40,00sqm, due in H2 with precommitments from Flinders University and Deloitte). Development completions outpaced positive net absorption in H1 2023, leading the overall CBD vacancy rate to increase to 17.1%. Average prime net face rents rose by 3.1% in Q2 (+4.2% y/y), while average prime incentives remained stable over the quarter. Average premium grade market yields rose by 25bps in Q2 to 5.625%, while average A grade yields softened by 25 bps to 6.625%.

Source Savills Research / Property Council of Australia

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