Australian Office – August 2024

SPOTLIGHT
Savills Research

Office Briefing

Interest rate cuts globally, RBA on hold ● Deal activity picks up ● Demand for prime space

Holding pattern for now

RBA remains on hold but moderating underlying inflation brings forward expectations of rate cuts in 2025

Headline CPI accelerates but underlying inflation slows

After slowing sharply over the course of 2023, headline inflation has picked up in recent months. Headline CPI rose by 1.0% in the June quarter to be 3.8% higher over the year.

However, the trimmed mean measure of inflation, which excludes volatile items, came in below expectations, growing by 0.8%, down from 1.0% growth in Q1, while the annual rate slowed slightly from 4.0% to 3.9%.

RBA on hold near-term but pricing of rate cuts in 2025 brought forward

The RBA kept the cash rate on hold at 4.35% at its August meeting, with the governor emphasising the need to "remain vigilant to the upside risks to inflation", adding that "near-term interest rate cuts are not on the agenda".

By component, the pace of moderation of domestically generated non-tradables inflation has slowed and remains high at 5.0% Y/Y. By contrast, annual growth in tradables inflation increased by just 1.5%. However, higher shipping costs and supply chain disruptions have the potential to put upward pressure on tradables inflation.

Despite these upside risks, financial market participants brought forward the timing of RBA policy easing in 2025 following the Q2 inflation data release and are currently fully pricing in one 25bps cut by Q1 2025.

Interest rate cuts globally amid slower growth and moderating inflation

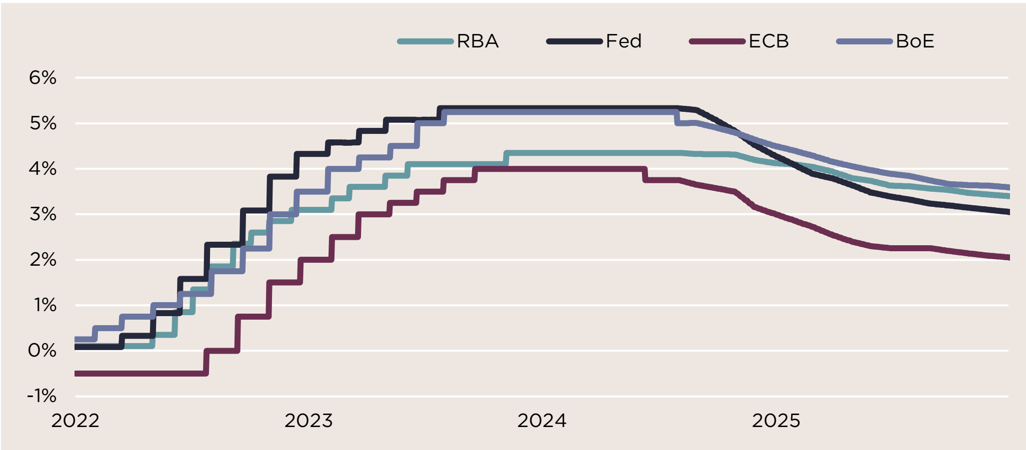
Major central banks have begun to ease policy rates in recent months. In June, the ECB cut its deposit rate by 25bps to 3.75%, while the Bank of Canada has reduced its policy rate by a cumulative 50bps since June to 4.50%. In August, the Bank of England cut its policy rate by 25bps to 5.0%.

The US Federal Reserve has strongly signalled it will cut the federal funds rate at its next meeting in September.

Financial markets are pricing in more aggressive easing from the Fed, with softer labour market data prompting concerns about a harder landing in the US.

Volatile pricing but financial markets are betting on more rate cuts

Futures pricing, daily, per cent



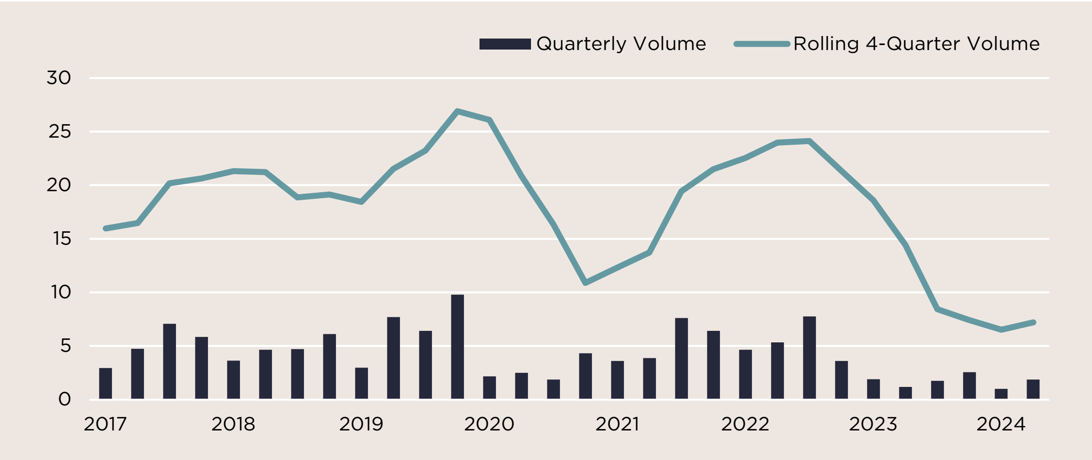
Source Savills Research / Macrobond (futures pricing as at 7 August 2024)

Chris Naughtin
National Director
Capital Markets Research
chris.naughtin@savills.com.au

Repricing driving major deals

Investment activity picked up Q2 driven by a few large deals, but activity still remains subdued by historical standards

Office investment up 86% in Q2 compared to Q1
Quarterly and rolling 4-quarter investment volumes ($10m+), $bn



Source Savills Research / MSCI Real Assets

Q2 was the strongest quarter for deal volume since Q4 2022

Sales volume boosted by the completion of several large deals

Deal volumes increase 58% vs Q2 2023 but still well down in four-quarter rolling terms
According to MSCI Real Assets, total investment volume ($10m+) reached c.AU$1.88 billion in Q2 2024, a 58% increase from the c.AU$1.19 billion recorded in Q2 2023. However, this total excludes Mitsui Fudosan's purchase of a 66% stake in the 55 Pitt Street development with an estimated end value c.$2.0 billion. Including the estimated value of Mitsui Fudosan's stake in 55 Pitt Street, transaction volume in Q2 would be three times higher than in Q1 at $3.2 billion.

Deal volume was boosted by several large transactions late in Q2 including Cbus Super's acquisition of a 50% stake in 5 Martin Place in Sydney for $296.2 million and Quintessential Equity's purchase of 240 Queen Street in Brisbane for $250 million.

Despite the large increase in quarterly volumes, investment activity continues to be subdued by historical standards. Deal volume over the year to Q2 2024 was 50% lower than the year to Q2 2023 (-41% including the 55 Pitt Street transaction), while Q2 volumes were 56% below the ten-year Q2 average.

Cross-border investment increases
The share of offshore investment has increased over 2024 to date, with cross-border investors accounting for 55% of investment volume this year, up from a historically low share of 32% in 2023.

Unlisted institutional investors have increased their share of acquisitions from 23% in 2023 to 28% over the year to date, while the share of private investment has declined from 36% in 2023 to 16% in 2024 YTD.

REITs remain net sellers
REITs continue to be active on the sell side, accounting for 56% of disposals YTD, with many funds seeking to offload secondary and older office assets to reposition their portfolios and fund future development pipelines.

Office funds recording significant capital value falls
Capital values continue to decline as the impact of higher interest rates washes through commercial property markets. According to the MSCI/Mercer Australia Core Wholesale Monthly Property Fund Index, capital growth declined by 13.8% over the year to June 2024 for all funds in the index, while total return fell by 10.4%. Office-specialist funds recorded the sharpest declines in asset performance, with -19.5% capital growth and -16.4% total return over the year.

c.AU$1.88 billion
transacted in Q2

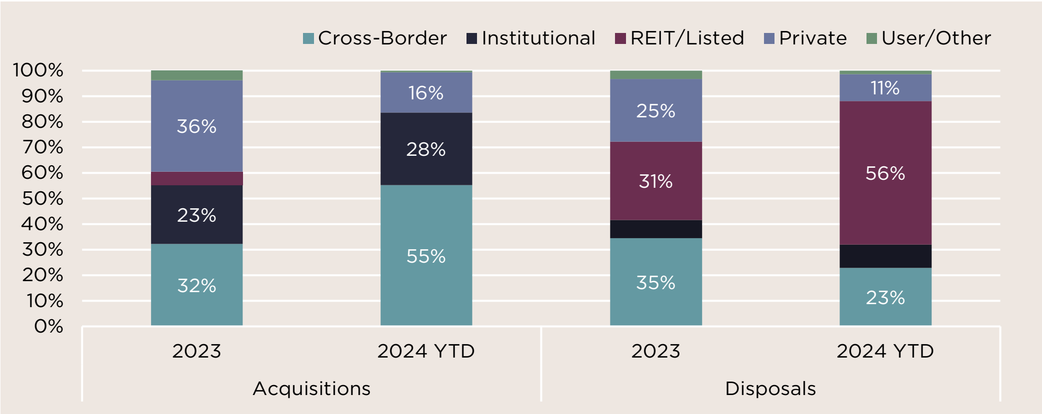
+86%
Q2 24 vs Q1 24
+58%
Q2 24 vs Q2 23

55%
Cross-border capital's share of total investment volume in 2024 YTD

-19.5%
Office specialist funds capital value growth, year to Q2 2024

Offshore investor activity rising as REITs remain active sellers

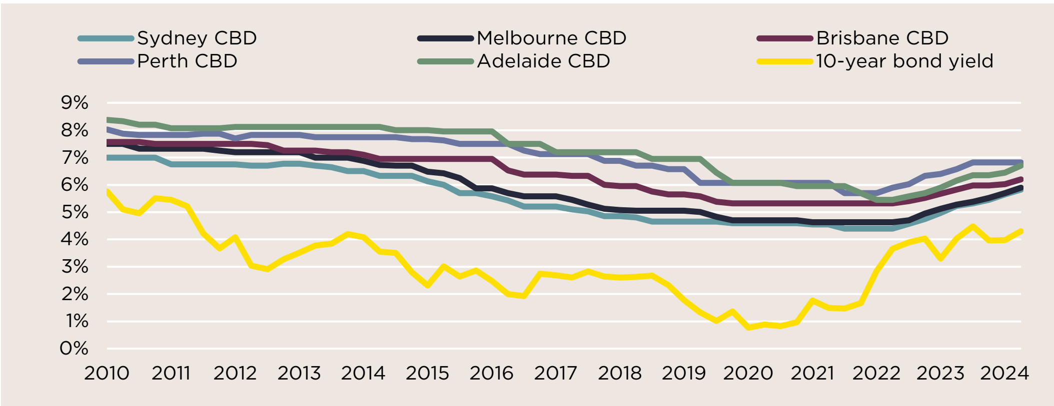
Share of office acquisitions and disposals (deals $10m+), per cent



Source Savills Research / MSCI Real Assets

Prime yields continue to expand but at a slower pace

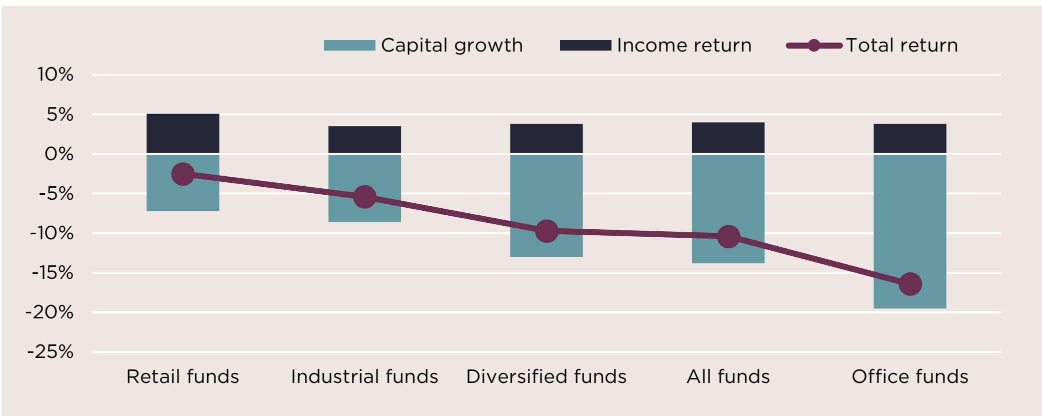
Average prime CBD office yields, per cent



Source Savills Research / Macrobond

Office funds record further capital value declines

Capital growth and total return, per cent change over the year to Q2 2024



Source Savills Research / MSCI/Mercer Australia Core Wholesale Monthly Property Fund Index

HIGHLIGHTS

Major deals transacting at large discounts to peak book value

The pricing adjustment to the higher interest rate environment is gaining momentum with recent transactions in Sydney and Melbourne occurring at discounts of between 20-25% to peak book value.

Dexus and Canada Pension Plan Investment Board sold their joint half stake in 5 Martin Place in Sydney at a 24% discount to peak value, while Mirvac sold 367 Collins Street for $340 million, a nearly 20% discount to peak book value.

Valuation declines and a narrowing bid-ask spread are likely to support the recovery in deal activity later this year and into 2025.

Yields continue to rise but at a slower pace

The pace of yield expansion has slowed in most CBD markets.

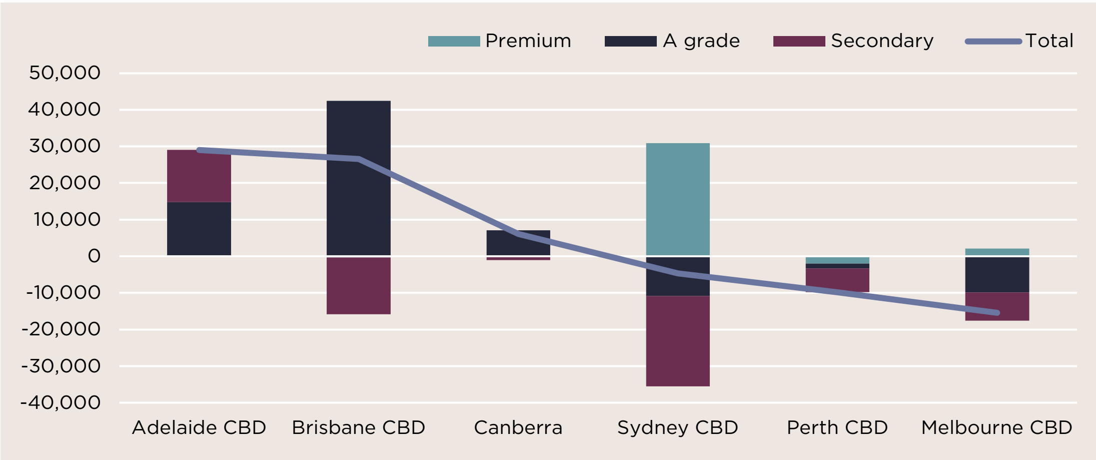
Average prime CBD yields in Sydney and Melbourne rose by 17.5bps and 20bps respectively in Q2 to 5.825% and 5.90%.

In the Brisbane CBD, average prime yields increased by 17.5bps to 6.20%, while the average prime CBD yield in Perth was stable at 6.825%. Adelaide recorded the largest widening in yields in Q2, with a 25bp expansion to 6.70%.

More of the same

High quality offices continue to be in demand, as tenants give up more secondary space

Take-up of prime space mostly postive
Net absorption, six-months to July 2024, sqm



Source Savills Research / PCA

+72,900 sqm
Increase in prime market net absorption across Australian CBD markets, six months to July 2024

-41,100 sqm
Decrease in secondary market net absorption across Australian CBD markets, six months to July 2024

13.6%
Australian CBD vacancy rate, July 2024

7.2%
Brisbane CBD prime vacancy rate, July 2024

+5.9%
Brisbane CBD prime net effective rental growth y/y

Stronger demand for office space

Increase in net absorption concentrated in prime stock

Flight to quality continues
Demand for office space increased across Australia's CBD markets in the first half of the year, with net absorption rising by c.31,800 sqm over the six months to July. Non-CBD markets also recorded positive net absorption at c.20,100 sqm over the same period, driven by the Brisbane Fringe, North Sydney, and Macquarie Park.

Demand continues to be concentrated in higher quality space, with net absorption across the prime CBD markets increasing by c.72,900 sqm over the six-months to July, while net take-up of secondary space fell by c.41,100 sqm.

The Brisbane CBD recorded another large increase in A grade net absorption at c.42,400 sqm (equivalent to 4.3% of office stock), while net take-up of premium space in the Sydney CBD rose by c.30,900 sqm. The Adelaide CBD stood out with positive net take up across the prime and secondary grades, while net absorption declined in Perth and Melbourne.

Vacancy rises marginally on higher supply
Despite positive net absorption, the vacancy rate across Australia's CBD office markets rose slightly from 13.5% to 13.6% over the six-months to July, driven by higher net supply (c.40,800 sqm), which was mostly offset by positive net absorption.

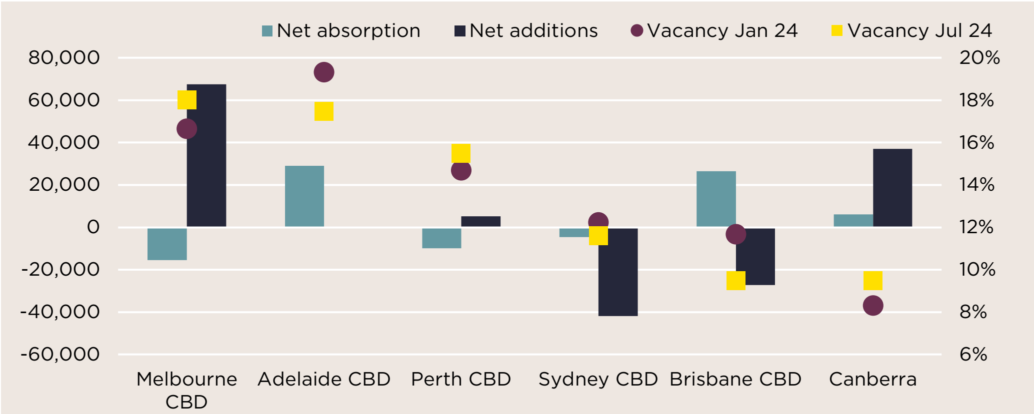
Brisbane closing in on Canberra as the tightest market nationally
Strong prime market take-up in Brisbane and negative net supply saw the overall CBD vacancy rate fall from 11.7% in January to 9.5%, around the same level as Canberra, while the prime vacancy rate declined to 7.2%, the lowest of the major CBD markets.

Soft demand and new supply drive Melbourne vacancy higher
The Melbourne CBD vacancy rate rose to 18.0% in July, the highest among the CBD markets and up from 16.6% in January. The result reflected the completion of Melbourne Quarter Tower (c.69,000 sqm), and negative net take-up of c.15,400.

Premium and well-located space more tightly held
Despite higher vacancy in Melbourne, vacancy in the city's Eastern Core declined by 0.5ppts to 10.8%, compared to 18.9% and 19.7% for the Western Core and Docklands respectively. In the Sydney CBD, vacancy in the premium market fell to 10.8%, down from 13.0% in January, while A grade vacancy rose 0.5ppts to 12.7%. Premium vacancy in the CBD Core remains relatively tight, declining to 8.1%, down from 10.3% in January.

Vacancy declines in Sydney, Brisbane, and Adelaide

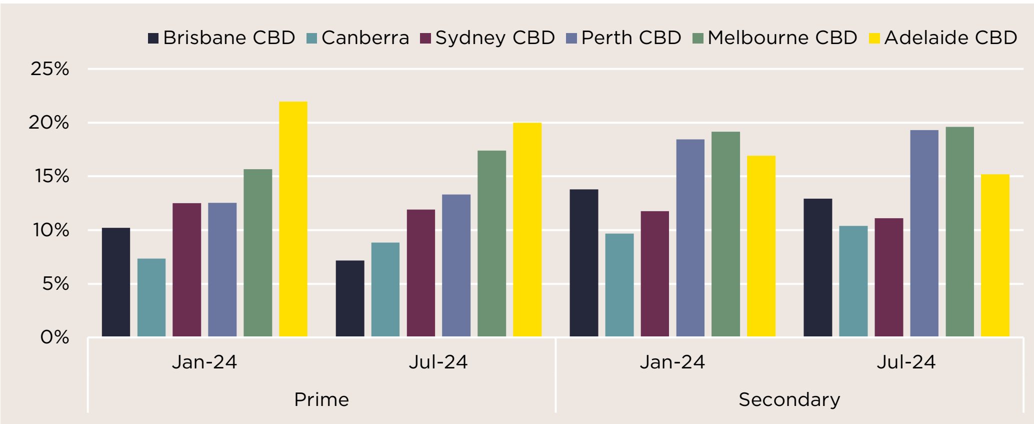
Net demand and supply, six-months to July 2024, sqm (LHS), vacancy, per cent (RHS)



Source Savills Research / PCA

Brisbane CBD becomes the tightest prime market nationally

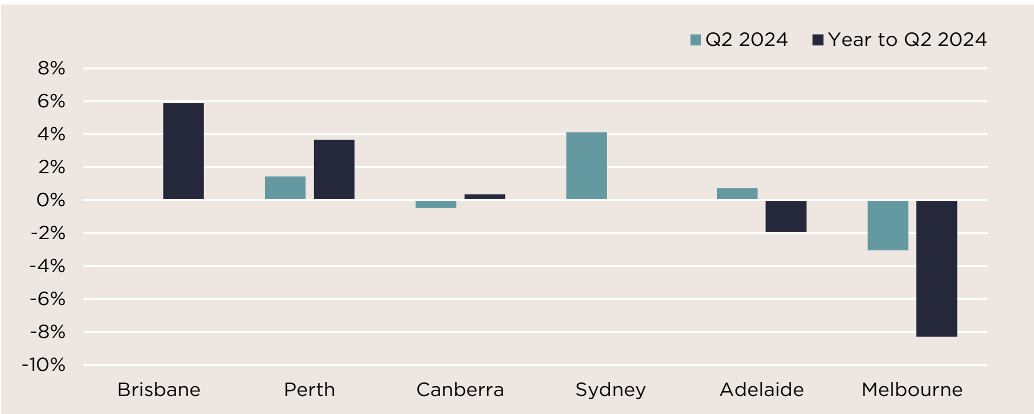
Prime and secondary vacancy, per cent of office stock



Source Savills Research / PCA

Solid Q2 rental growth in Sydney; strongest annual growth in Brisbane

Prime CBD net effective rents, per change q/q and y/y



Source Savills Research

HIGHLIGHTS

Face rental growth in Sydney as incentives rise in Melbourne

The Sydney CBD recorded strong growth in face rents in Q2, with net face rents up 4.1% to be 9.0% higher over the year (although net effective rents were flat over the year).

In Melbourne, net face rents remained stable over the quarter, but higher average incentives drove a 3.0% decline in prime net effective rents to be 8.3% lower over the year.

Brisbane saw no change in face or effective rents in Q2 but again recorded the strongest annual growth in net effective rents among the CBD markets (+5.9%). Perth saw 1.4% growth in net effective rents in the quarter to be 3.7% higher over the year.

Below average supply pipeline to help market absorb vacancy

Development completions will be below average over the next few years. From 2024-28, new supply across the major CBD markets is expected to be around 30% below its historical average.

The Sydney Metro over-station developments will drive supply in Sydney to a little above average this year but new developments are expected to be well below average in 2025 and 2026.

Melbourne, Brisbane, Perth, and Adelaide are also set to see lower levels of new supply on average over 2024-28, with development completions only expected to be above average in Canberra.

Savills Research
For more information about this report, please contact us

Research & Consultancy

Chris Naughtin
National Director
+61 2 8215 8832
chris.naughtin@savills.com.au

Katy Dean
National Head of Research
+61 2 8215 6079
kadean@savills.com.au

Barbara Cocca
Research Analyst
+61 2 8215 6078
barbara.cocca@savills.com.au

Cristina Siracusa
Research Analyst
+61 2 8215 813
cristina.siracusa@savills.com.au

Capital Transactions

Paul Craig
CEO, National Head
+61 2 8215 6000
pcraig@savills.com.au

Office Leasing

Tom Mott
National Head
+61 400 259 922
tmott@savills.com.au

Valuations & Advisory

Michael Pisano
National Director
+61 422 704 396
michael.pisano@savills.com.au