Australian Office – February 2024

SPOTLIGHT

Savills Research

Office Briefing

Interest rate cuts coming into view ● Capital values falling ● Premium assets holding up

Rate cuts come into view

Moderating inflation raises expectations of central bank pivot to lower interest rates

Financial markets price in more central bank easing
Easing inflation pressures have seen major economy government bond yields decline in recent months from the highs reached late last year as financial markets price in more interest cuts this year. Australian and US 10-year bond yields have both declined by around 65 basis points since the end of October, while the UK and German equivalents have fallen by 45 basis points.

Lower bond yields reflect increasing confidence that central banks will begin to ease monetary policy later this year. Financial markets are pricing in around 70bps of cuts in 2024 by the US Federal Reserve starting around mid-year, while the ECB is expected to lower its policy rate by 100bps. In Australia, the RBA is expected to deliver at least one rate cut in 2024, with one 25-basis point move fully priced in by November.

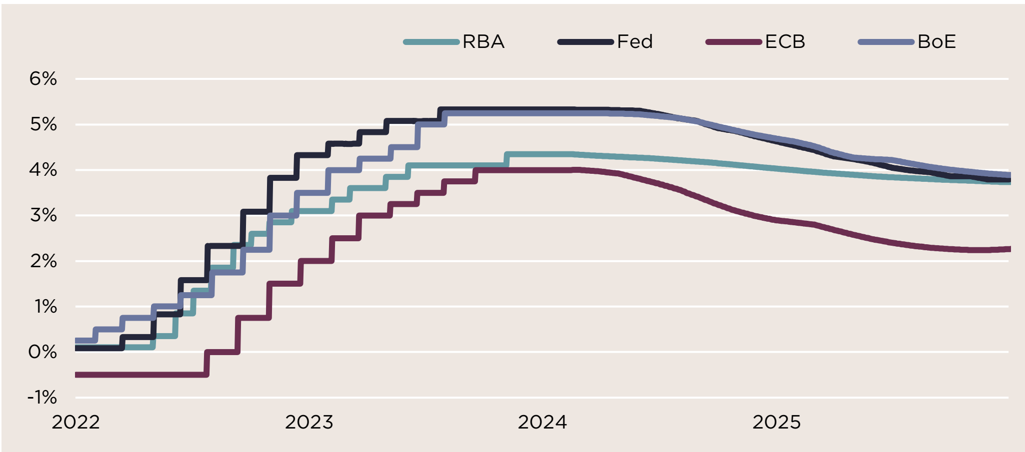
Softening consumer spending and inflation driving rate expectations
The shifting outlook for interest rates is being underpinned by recent weaker than expected economic activity and inflation.

GDP growth slowed to 0.2% in Q3 (2.1% y/y), with household consumption, the largest component of GDP, making no contribution to growth. More timely data suggest consumer spending has slowed further in recent months, with retail sales falling by 2.7% in December to be just 0.8% higher over the year, well below the rate of inflation and population growth.

In line with slowing activity, inflation is moderating at a faster than expected pace. Annual headline inflation slowed from 5.4% in Q3 to 4.1% in Q4, and down from the recent peak of 7.8% in Q4 2022. Underlying inflation is also softening, with annual growth in trimmed mean inflation slowing to 4.2% in Q4, down from 5.1% in Q3, and materially below the RBA's forecast of 4.5%

Positive outlook for inflation but geopolitical uncertainties pose risks
While inflation pressures are easing, the outlook remains uncertain. Services price inflation could remain sticky, while disruptions to Red Sea trade, which have impacted supply chains and increased shipping costs, could potentially pose upside risks to inflation.

Major central bank policy rate outlook
Futures pricing, daily, per cent



Source Savills Research / Macrobond (futures pricing as at 14 February 2024)

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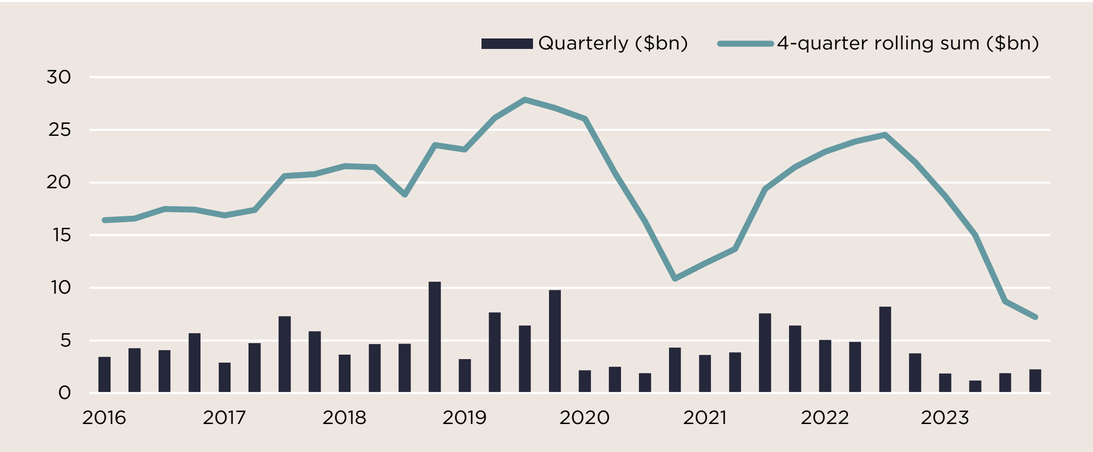
Tide turning

Investment activity remained subdued in Q4 but interest rate stability should drive a recovery in investment volume

Office investment up c.20% in Q4 but still well down over the year
Quarterly and rolling 4-quarter investment volumes ($10m+), $bn



Source Savills Research / MSCI Real Assets

c.AU$2.27 billion
transacted in Q4

+21%
Q4 23 vs Q3 23
-40%
Q4 23 vs Q4 22

33.0%
Private capital's share of the total investment volume in 2023

-10.5%
National office capital value growth, year to Q4 2023

Q4 was the strongest quarter for deal volume in 2023

Sales volume boosted by the settlement of 60 Margaret Street

Deal volumes increase in Q4 but are still down 67% over the year

According to MSCI Real Assets, total investment volume ($10m+) reached c.AU$2.27 billion in Q4 2023, a 21% increase from the c.AU$1.88 billion recorded in Q3 2023. The settlement of several significant transactions, including 60 Margaret Street in Sydney ($796 million) and 175 Eagle Street in Brisbane ($240 million), boosted sales volume in Q4.

Despite the quarterly increase, investment activity continues to be subdued. Transaction volumes in Q4 2023 were down 40% from Q4 2022 and 67% lower in 2023 compared with the previous year.

Private investors were active buyers in 2023 while REITs were large net sellers

Private investors became more active buyers in 2023, with their share of deal volumes increasing to 33%, up from 17% in 2022, and well above their pre-COVID average (2015-2019) of 14%.

Among institutional investors, unlisted entities accounted for 25% of investment volume last year, up from 20% in 2022. By contrast, listed institutional investors accounted for just 5% of acquisitions in 2023, down from 23% in 2022 and 18% in the five years to 2019. REITs were large net sellers of office property in last year, with many seeking to offload secondary or older office assets to reposition their portfolios and fund future development pipelines.

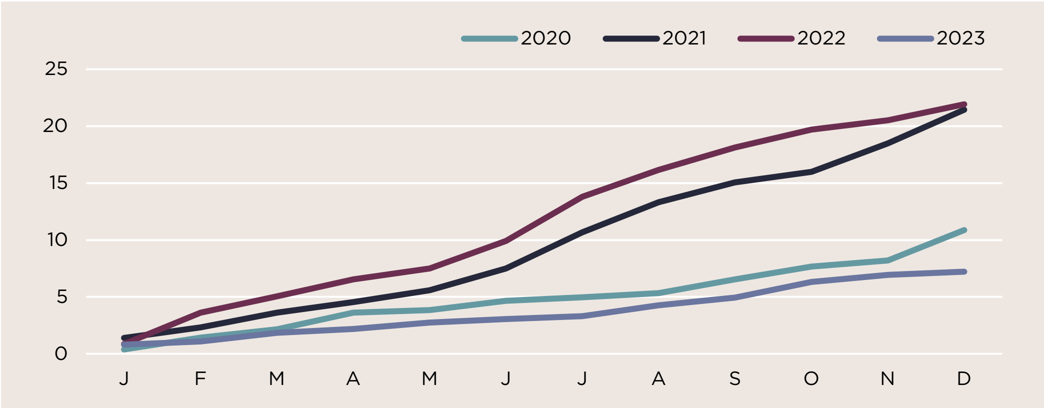
Capital values falling but premium assets performing better

Capital values continue to decline as the impact of higher interest rates washes through commercial property markets, but the magnitude of value declines vary significantly by grade and city.

According to MSCI Real Assets, office capital values declined by 10.5% nationally over the year to Q4 2023. Premium grade assets fell by less, down by 8.1% over 2023, while capital growth for A grade assets was -12.1%. Secondary assets recorded steeper declines, falling by 15.4% over the year.

2023 sales volumes well down on recent years

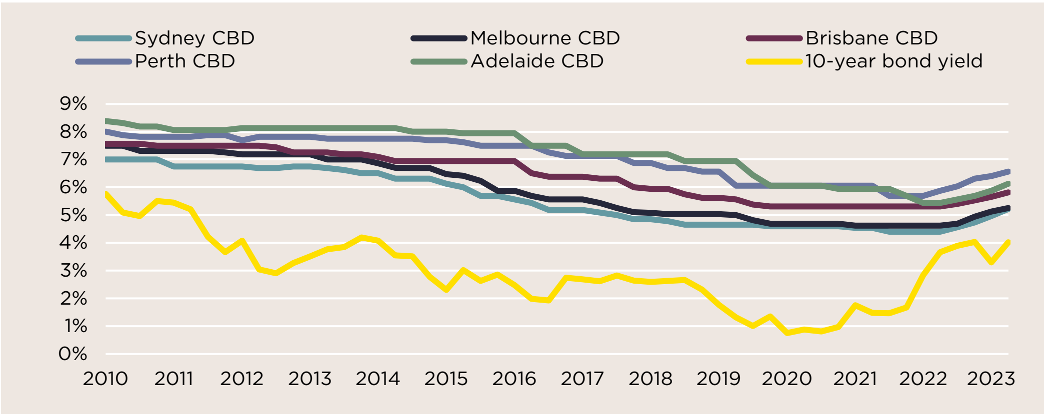
Monthly cumulative investment volume (deals $10m+) $bn



Source Savills Research / MSCI Real Assets

Average prime CBD office yields

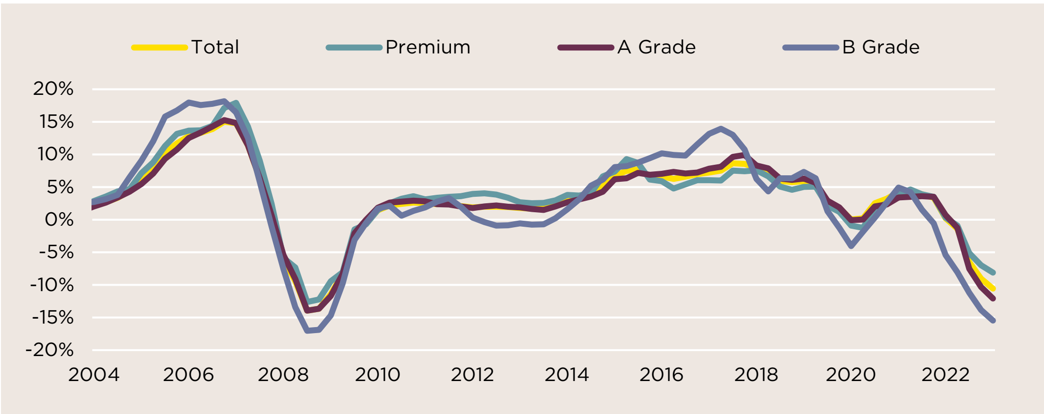
Per cent



Source Savills Research / Macrobond

Capital growth by grade

Per cent change y/y to Q4 2023



Source Savills Research / MSCI Real Assets

HIGHLIGHTS

Yields move out in Sydney and Melbourne

Average prime CBD yields in Sydney and Melbourne continued to widen in Q4, both rising by 12.5bps to 5.45% and 5.50% respectively.

In Sydney, average premium and A grade yields increased by 12.5bps over the quarter to 5.00% and 5.88%.

Average prime yields remained stable in the other major CBD markets at 6.00% in Brisbane CBD, 6.80% in Perth, and 6.35% in Adelaide.

Sydney and Melbourne lead capital value falls

According to MSCI Real Assets, Sydney and Melbourne recorded relatively large declines in CBD office capital values in 2023 compared to other Australian markets (although not compared with major markets globally), with capital growth of -10.9% and -11.1% respectively over the year to Q4 2023.

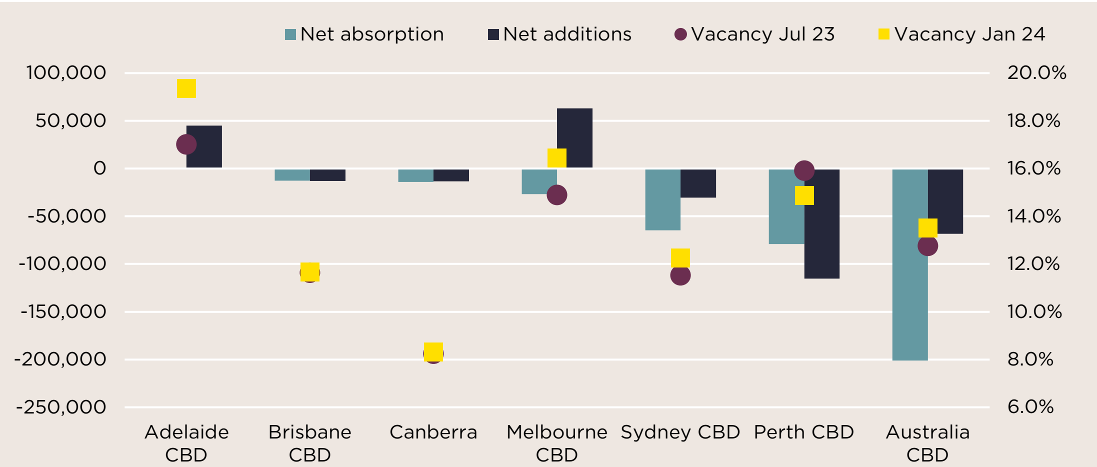
Brisbane CBD and Perth CBD capital values fell by a more modest 7.8% and 5.5% respectively over the same period, supported by stronger rental growth.

Since the beginning of the interest rate tightening cycle in mid-2022, office capital values have declined by 12.2% in Sydney and 12.5% in Melbourne. Brisbane (-8.3%) and Perth (-9.4%) have recorded smaller declines over the same period. The lack of transaction activity complicates the interpretation of changes in capital values and we will need to see more investment activity for price discovery.

Vacancy rising

Premium grade market remains relatively tightly held

Net demand, net supply and change in vacancy
Six-months to January 2024, sqm (LHS), per cent (RHS)



Source Savills Research / PCA

Net take up of office space declines amid large number of stock withdrawals

Decline in net absorption concentrated in secondary stock

Vacancy continues to rise

The vacancy rate across Australia's CBD office markets rose from 12.8% to 13.5% over the six-months to January 2024, driven by a significant decline in net absorption (c.201,300 sqm), which was partly offset by negative net supply as a large amount of space was withdrawn from the market.

Secondary market the key driver of weaker demand

Negative net take-up continues to be concentrated in secondary stock, with net absorption across the secondary grades declining by c.179,400 sqm over the six-months to January 2024, while net take-up of prime space fell by c.21,800 sqm.

Brisbane and Adelaide were the only major CBD markets to record positive net absorption in the prime market over the six-month period at c.31,900 sqm and c.3,900 sqm, respectively.

Perth bucks national trend of rising vacancy

Perth was the only CBD market to record a fall in vacancy in the six months to January 2024, with the vacancy rate declining by one percentage point to 14.9%. A large amount of withdrawn space offset a decline in net absorption.

Brisbane and Canberra recorded marginal increases in vacancy to 11.7% and 8.3%, respectively. Higher incoming supply was the predominant driver of higher vacancy in Adelaide following the completion of Festival Plaza. At the same time, development completions (500 Bourke Street and 300 Flinders Street) and negative net take-up drove Melbourne CBD vacancy to 16.4%.

Premium relatively tightly held

Although vacancy is rising, premium market vacancy remains relatively low. Across Australia's CBD markets, the premium vacancy rate was 10.9% as at January 2024 compared to 13.7% for A grade and 14.5% for the secondary market.

Brisbane and Perth have particularly large disparities between premium and secondary vacancy, with the secondary market vacancy rate more than double the premium equivalent.

-21,800 sqm
Decrease in prime net absorption across Australian CBD markets, six months to January 2024

-179,400 sqm
Decrease in secondary net absorption across Australian CBD markets, six months to January 2024

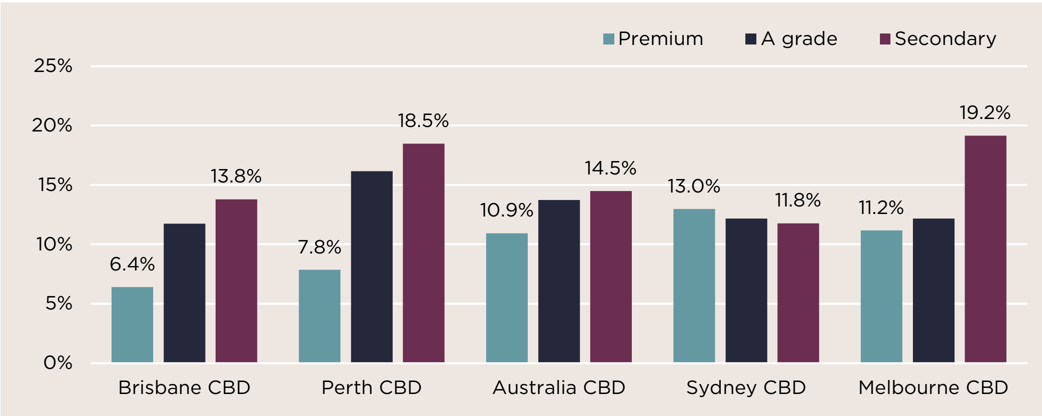
13.5%
Australian CBD vacancy rate, January 2024

6.4%
Brisbane CBD premium vacancy rate, January 2024

+11.1%
Brisbane CBD prime net effective rental growth y/y

Vacancy rate by grade

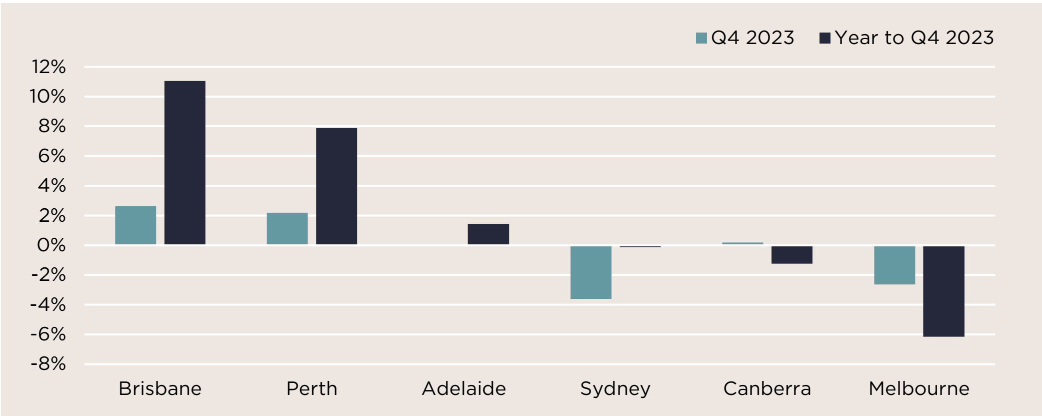
Per cent of total office stock



Source Savills Research / PCA

Prime net effective rents

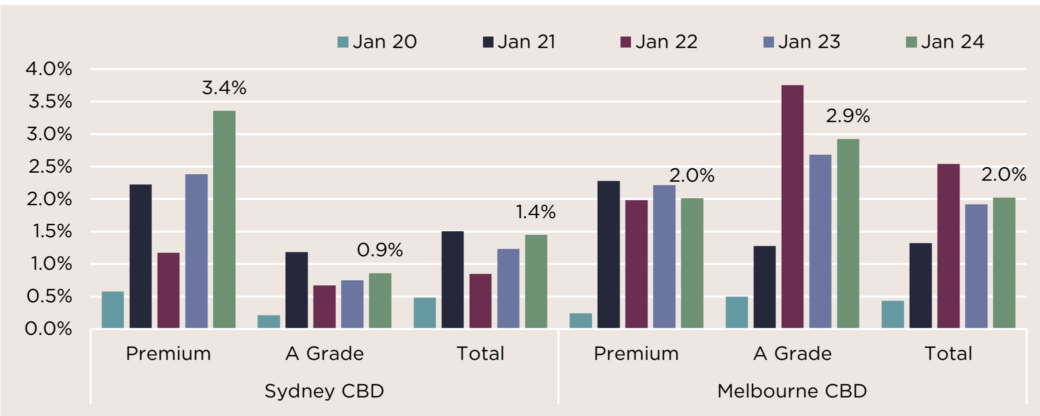
Per cent change q/q and y/y



Source Savills Research

Sydney and Melbourne CBD sub-lease vacancy

Per cent of total office stock



Source Savills Research / PCA

HIGHLIGHTS

Effective rental growth slowing as incentives move higher

Reflecting mixed leasing market conditions across the country, there continues to be a large variation in rental growth between major markets.

Brisbane continues to see the strongest growth among the CBD markets, with prime net effective rents growing by 2.6% in Q4 (+11.1% y/y) driven by face rental growth while average incentives remained stable. Perth recorded 2.2% growth in net effective rents to be 7.9% higher over the year.

By contrast, Sydney and Melbourne both recorded declines in prime effective rents, reflecting rising average incentives, as occupiers attempt to attract tenants, and stable face rents. Prime net effective rents declined by 3.6% in the Sydney CBD in Q4 to be broadly flat over the year, while Melbourne recorded a 2.6% fall in the quarter to be 6.1% lower over the year.

Prime sub-lease vacancy creeping higher

Sub-lease vacancy is rising, particularly at the premium end of the Sydney market. Premium grade sub-lease vacancy in the Sydney CBD was 3.4% in January 2024, up from 3.0% in July 2023 and 2.4% a year earlier. The CBD Core and Western precincts accounted for the vast majority of the increase in sub-lease space over the year. In Melbourne, sub-lease also edged higher, driven by a rise in the A grade segment, but sub-lease vacancy remains significantly below January 2022 levels.

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