Australian Office – May 2024

SPOTLIGHT
Savills Research

Office Briefing

Interest rate cuts pushed out • Rental growth but higher incentives • New deals resetting pricing

Rate cuts pushed back

Sticky inflation prompts reassessment of the magnitude and timing of central bank policy rate cuts in 2024

Stronger than expected inflation drives shift in interest rate expectations
Financial markets have pared back the timing of interest rate cuts from central banks following a string of stronger than expected inflation data. Financial markets currently expect one 25bps cut from the Fed this late this year, compared with previous expectations for 75bps of cuts commencing mid-year.

RBA's next move less certain but ECB still expected to cut mid-year
The timing of monetary policy easing by the RBA has also been pushed back, with no cuts expected this year (compared with previous expectations of a 25bps cut in November), and financial markets even pricing in a small chance of a rate increase following stronger than expected Q1 CPI data.

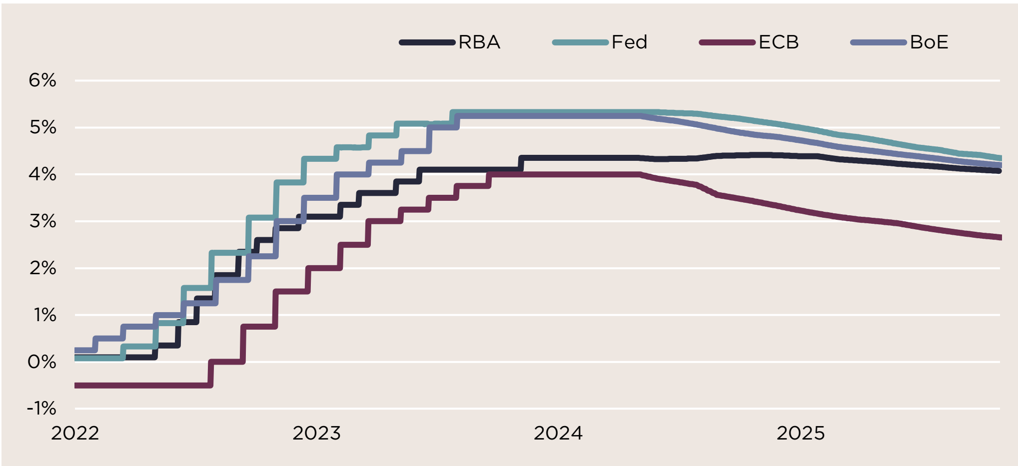
In the Euro area, where growth prospects are weaker and inflation is moderating more quickly, rate cut expectations have been less impacted. The ECB is still expected to commence cutting its policy rate mid-year and deliver several interest rate cuts by the end of 2024.

Rising bond yields
The reassessment of the near-term prospects for monetary policy easing has driven bond yields higher. Australian and US 10-year bond yields rose by between 45-50bps in April.

Signs of rebound in services activity
Economic activity slowed in Q4, with Australia's GDP growing by a below trend 1.5% year on year. However, more timely Purchasing Managers Index (PMI) data for March 2024 show the services sector expanded at its fastest pace since April 2022, pointing to the potential for a cyclical recovery in 2024.

Tight labour market a positive for demand for office space
While softening, labour market conditions remain solid, with 2.4% growth in employment over the year to March 2024. The unemployment rate has risen but remains at multi-decade lows at 3.8%.

Higher for longer
Central bank policy rate trajectory implied by financial market pricing, %



Source Savills Research / Macrobond (pricing as at 6 May 2024)

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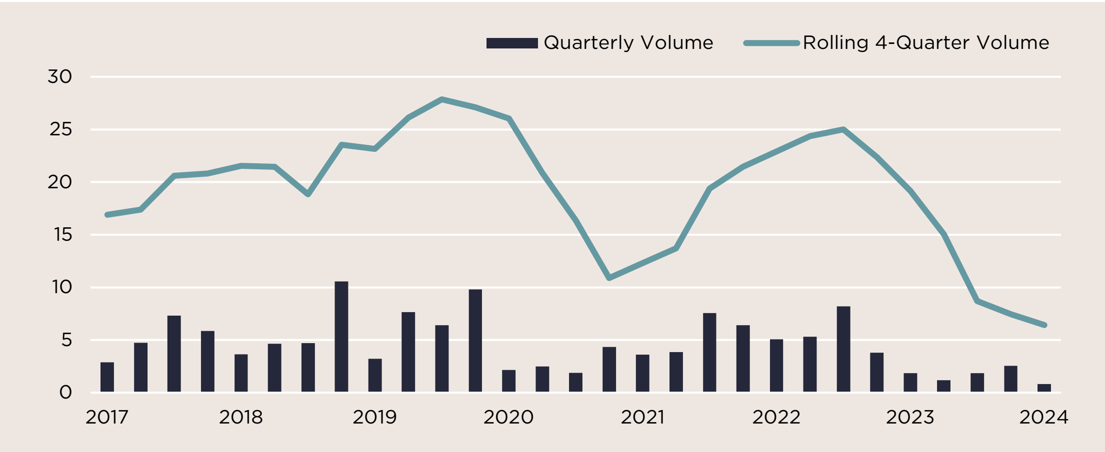
Pricing continues to adjust

Q1 activity subdued but ongoing repricing will help boost investor confidence this year

Office investment volumes down c.56% in Q1 2024 vs Q1 2023
Quarterly and rolling 4-quarter investment volumes (deals $10m+), $bn



Source Savills Research / MSCI Real Assets

Slow start to 2024

Pending 255 George Street sale will help repricing gain momentum

Deal activity remains subdued
According to MSCI Real Assets, total investment volume ($10m+) reached c.$815 million in the March quarter, down 68% on Q4 and 56% lower than Q1 2023.

Asset repositioning a major driver of deal activity, pointing to a gradual recovery in investor confidence
Acquisitions of secondary office assets for repurposing were a key driver of deal activity in Q1. In Sydney, 499-501 Kent Street was sold for $66 million to Icon Oceania, who intend to reposition the asset into a 229-room luxury hotel, while the 82 Sussex Street was sold for $29 million to a private investor, with plans for a mixed-use redevelopment, comprising residential and office space.

Meanwhile, in Brisbane, 41 George Street, a secondary grade asset, was sold to Marquette Properties for $120 million. The asset reportedly traded at a 25% discount to its last traded price of $159 million eight years ago. The buyer plans to transform the tower into student housing.

255 George Street sale to help reset the benchmark for pricing
Keppel's purchase of a 50% stake in 255 George Street from Mirvac for $363.8 million (subject to FIRB approval) announced early in Q2 is an encouraging sign that repricing in the office sector is gaining momentum. The asset sold at a 17% discount to its peak book value.

Major funds record further declines in capital values in Q1
Capital values continued to decline in March driven by the office sector. According to the MSCI/Mercer Australia Core Wholesale Monthly Property Fund Index, net capital growth for office specialist funds declined by 4.0% in March to be 16.4% lower over the year. This compares with year-on-year falls of 7.8% and 5.5% for retail specialist and industrial specialist funds respectively.

c.AU$815 million
transacted in Q1 2024

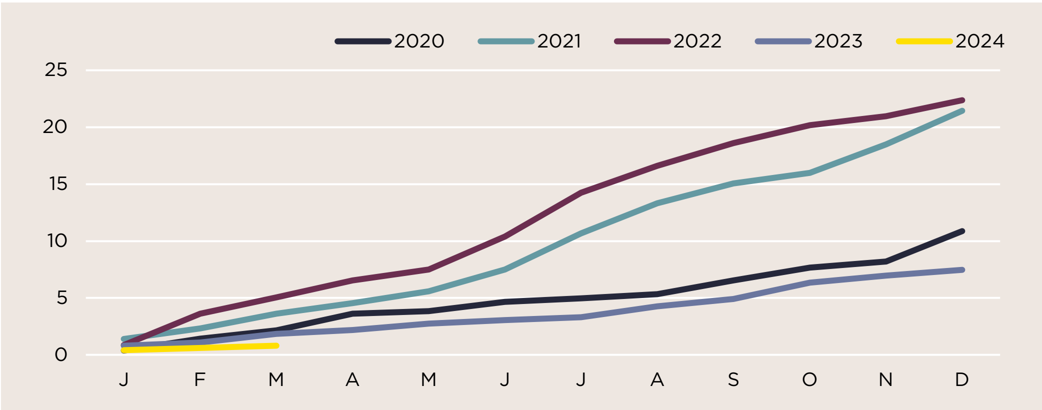
c.$993.5 million
deals pending as at April 2024

52.2%
Private investor share of the total investment volume in 2024 YTD

-16.4%
Net capital growth, office specialist funds, year to March 2024

Slow start to 2024

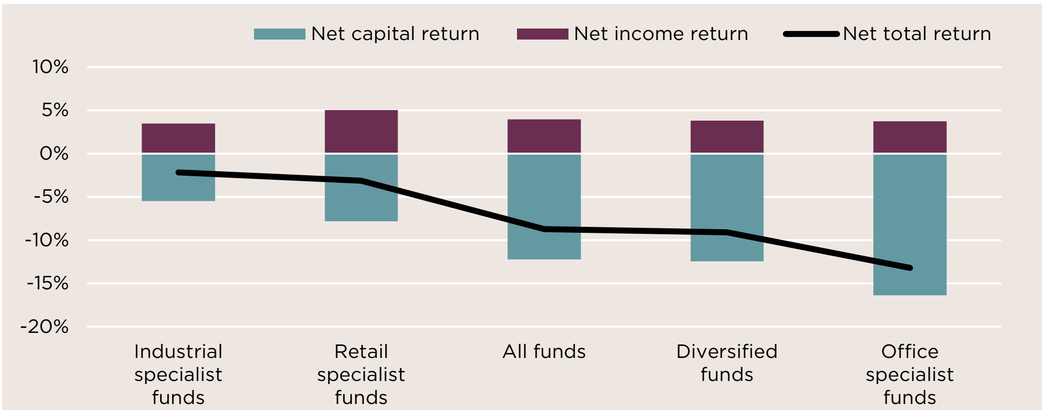
Monthly cumulative deal volume (deals $10m+) $bn



Source Savills Research / MSCI Real Assets

Office funds record further capital value declines

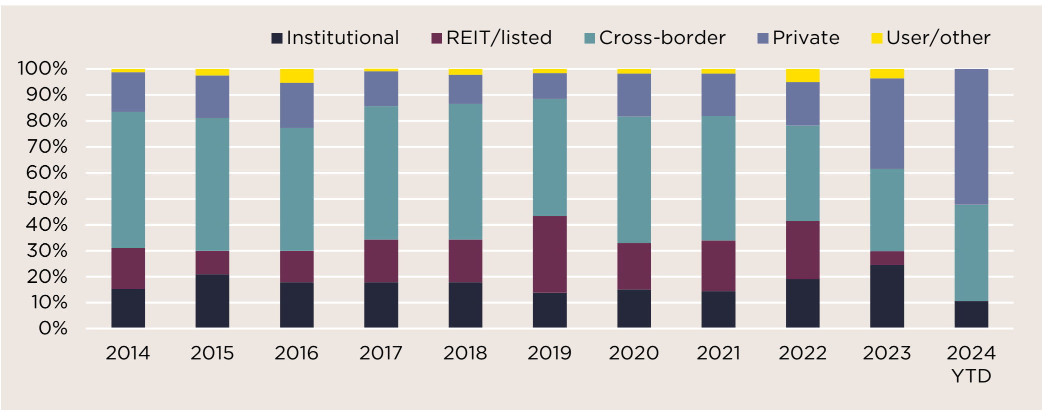
Capital growth, income return, and total return, year to March 2024, %



Source Savills Research / MSCI Real Assets

Cross-border and private investors drive investor activity in Q1

Share of total investment volume by investor type, %



Source Savills Research / MSCI Real Assets

HIGHLIGHTS

Counter-cyclical investment

Investors are increasingly taking a counter-cyclical approach to office property acquisitions, seeking out assets at pricing below replacement value to capitalise on potentially undervalued assets.

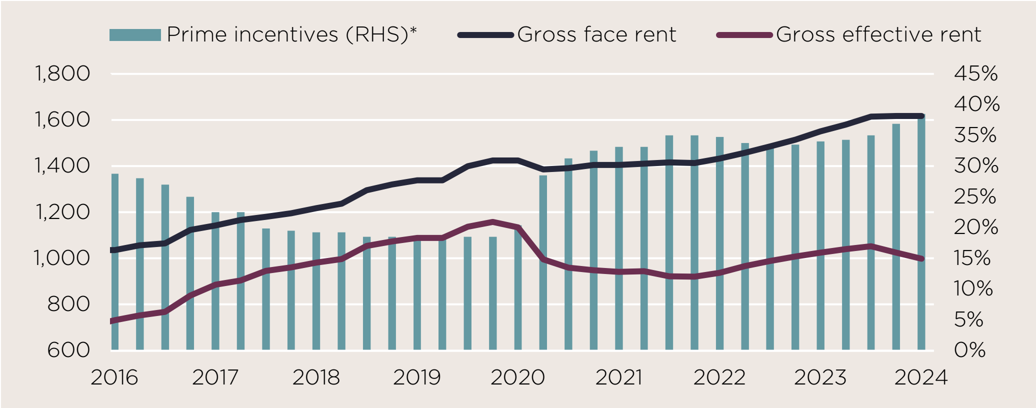
In a recent example, Realside acquired 45 Pirie Street in Adelaide for 27% below its previous sale price and well below replacement value, with the aim of achieving an IRR in the high teens by improving amenity, in order to capitalise on demand for limited prime space in Adelaide.

Meanwhile, Quintessential Equity acquired 1 Margaret Street in Sydney's CBD, with plans to invest $90 million to rejuvenate the 18-storey office tower, including a transition to an all-electric building, to attract tenants placing an increasing emphasis on amenity and sustainability.

Privates take advantage of institutional investor pullback

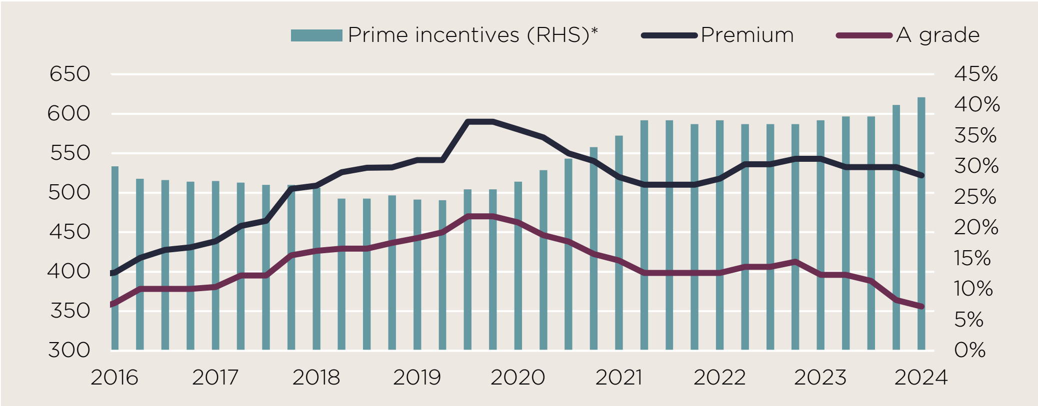
Private investors remained relatively active in Q1, accounting for around half of investment volume, around 2.5 times the historical average share. Smaller, and often cash-rich, private buyers are benefitting from reduced competition from institutional investors, in line with trends in capital markets globally. Notable private investor acquisitions in Q1 included 124 Walker Street in North Sydney for $95.5 million, and 309 North Quay Street in Brisbane for $46 million.

Sydney CBD prime face rents hold firm as incentives rise
Prime gross face and effective rents ($/sqm), prime incentives (%, RHS)



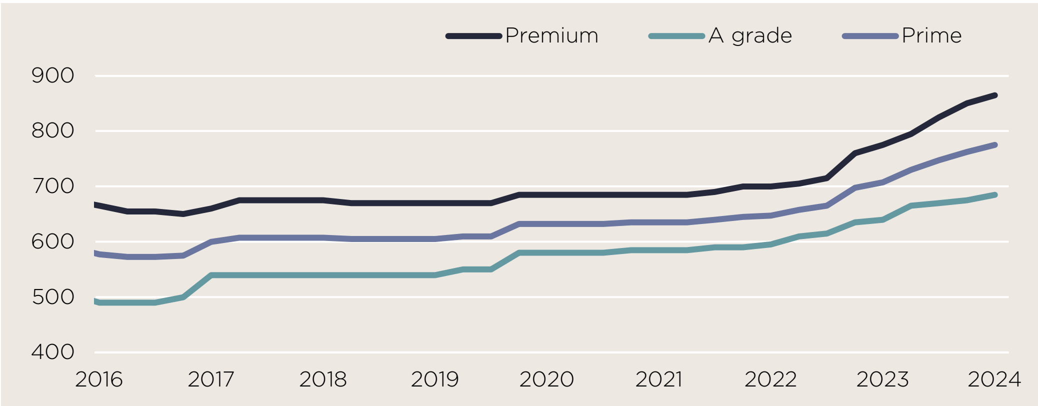
* Average gross incentive
Source Savills Research

Rising incentives driving Melbourne CBD prime effective rents lower
Premium and A grade net effective rents ($/sqm), prime incentives (%, RHS)



* Average net incentive
Source Savills Research

Brisbane CBD rental growth slowing but remains well above average
Prime net face rents by grade, $/sqm



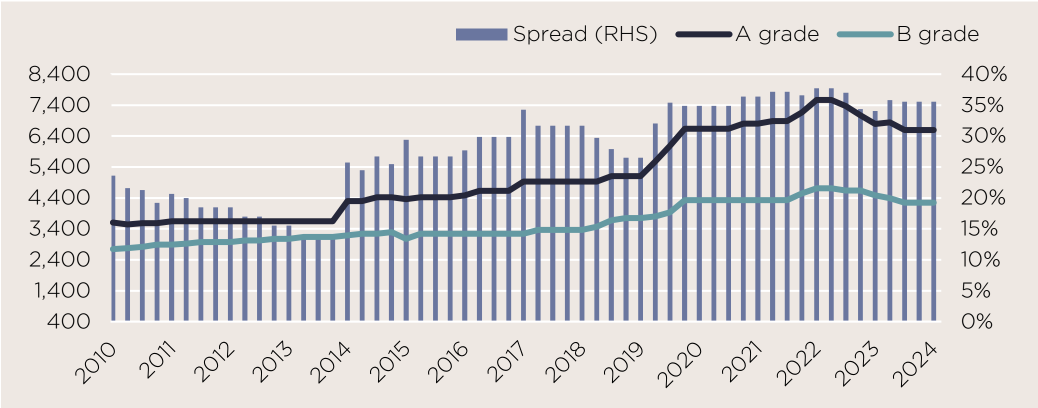
Source Savills Research

EAST COAST HIGHLIGHTS

Sydney and Melbourne incentives rising
Face rents in Sydney and Melbourne are holding firm but landlords are increasing incentives to secure lease deals. Higher average incentives drove a 3.6% fall in prime net effective rents in Sydney in Q1 (-5.5% y/y), while face rents remained stable. Melbourne recorded a 2.1% decline in prime net effective rents to be 6.5% lower over the year, reflecting an increase in average incentives.

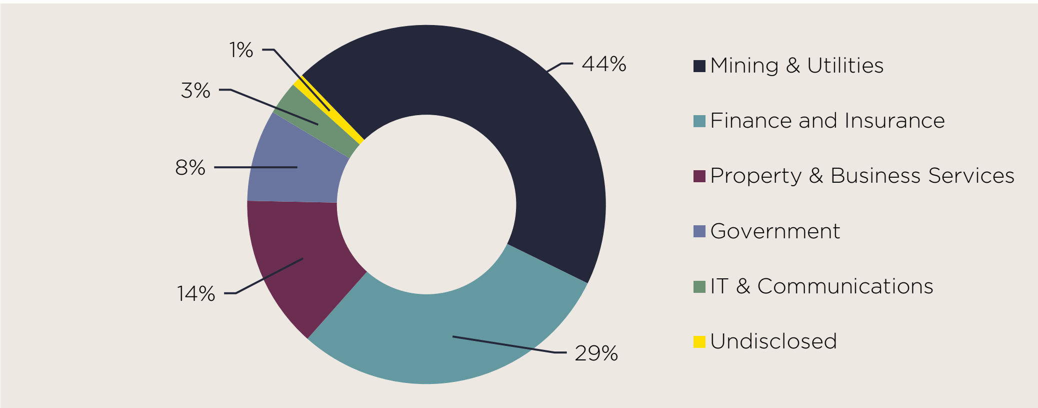
Brisbane rental growth slowing but still relatively strong
Brisbane continues to see the strongest rental growth among the major CBD office markets, although the pace of growth is moderating from elevated levels. Prime net face rents increased by 1.6% in Q1 to be 9.5% higher over the year. An increase in average incentives translated into a more modest 0.8% rise in prime net effective rents in Q1 (+9.8% y/y).

Adelaide CBD prime assets trading at a high premium
Average A and B grade capital values ($/sqm), spread (%, RHS)



Source Savills Research

Mining sector tenants boosting leasing activity in Perth
Perth CBD leasing volumes by industry (%), year to Q1 2024, deals 1,000sqm+



Source Savills Research

ADELAIDE AND PERTH HIGHLIGHTS

Prime asset premium
Adelaide A grade office assets are currently priced at a 36% premium to B grade assets, well above the long run average of 28%. The price premium for prime assets in Adelaide relative to its historical average is the highest of the major CBD markets.

Mining sector drives tenant activity in Perth as occupiers continue to gravitate to the CBD
Leasing activity in Q1 was boosted by Fortescue Metals relocating its headquarters from East Perth to take 22,852sqm at 256 St Georges Terrace. Mining & Utilities sector tenants have been a key driver of an increase in leasing activity over the past year, accounting for 44% of leasing volume in the Perth CBD over the year to March 2024.

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