Australian Office – November 2023

SPOTLIGHT
Savills Research

Office Briefing

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Interest rate cuts pushed out ● Rental growth moderates ● Capital values adjusting slowly

Higher for longer

Central bank policy rates nearing peak but rising bond yields point to less scope for monetary policy easing in 2024

Sell-off in bond markets
Bond yields have risen sharply in recent months as market participants push out the timing of interest rate cuts in 2024. The Australian and US 10-year bond yields have both risen by around 50 basis points over the past three months.

Resilient economy and sticky inflation drive shift in interest rate expectations
The shifting outlook for interest rates is being underpinned by stronger than expected economic activity, particularly in the US, and inflation moderating more slowly than previously anticipated.

In Australia, strong population growth, driven by the rebound in overseas migration following the end of pandemic-era border restrictions, is supporting services sector activity despite a slowdown in consumer spending, while tight labour market conditions are also supporting growth. Highlighting the stronger than expected economic conditions, the IMF upgraded its 2023 GDP growth forecast for Australia to 1.8% in October, up from 1.6% in April.

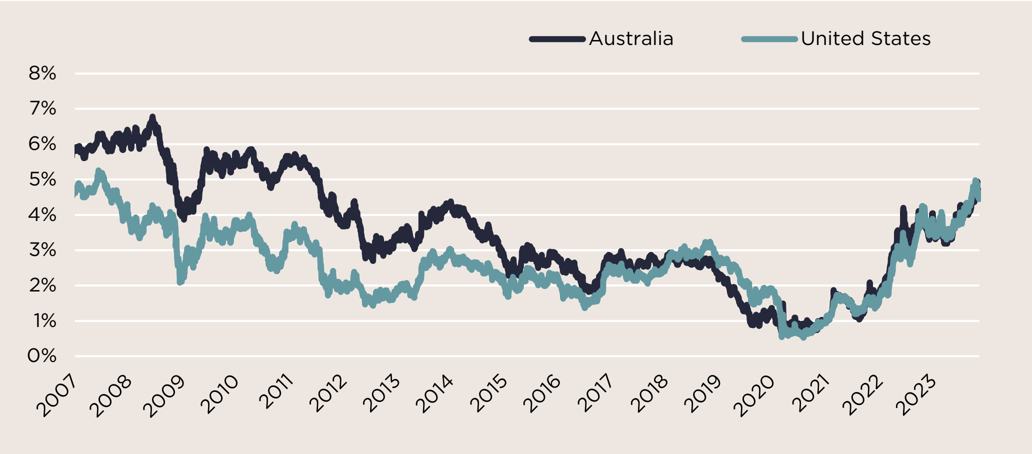
Geopolitical events add to inflation risks
Services price inflation continues to grow at a brisk pace while higher oil prices have contributed to rising fuel prices in recent months.

Geopolitical risks have increased recently, with the breakout of the Israel-Gaza war. An escalation of the conflict could potentially drive oil prices higher and presents an upside risk to inflation, although higher oil prices will also weigh on global activity.

Central banks near peak but timing of cuts pushed out
The US Federal Reserve left the federal funds rate at 5.25%-5.5% at its November meeting. FOMC members have scaled back their projections of interest rate cuts in 2024, with the median official expecting the federal funds rate will be 5.1% by end 2024, up from 4.6% in June 2023.

The RBA raised the official cash rate by 25 basis points to 4.35% at its 7 November 2023 meeting. Although there are very early indications that another hike is being partially priced in for February 2024, the RBA statement signalled hopes this would not be the case. This is echoed in the market pricing, which suggests the official cash rate will remain on hold for most 2024, with most economists still expecting a pivot to cut rates in late 2024.

Bond yields rise as financial markets adjust interest rate outlook
Australia and US 10-year bond yields, daily, %



Source Savills Research / Macrobond (bond yield as at 14 November 2023)

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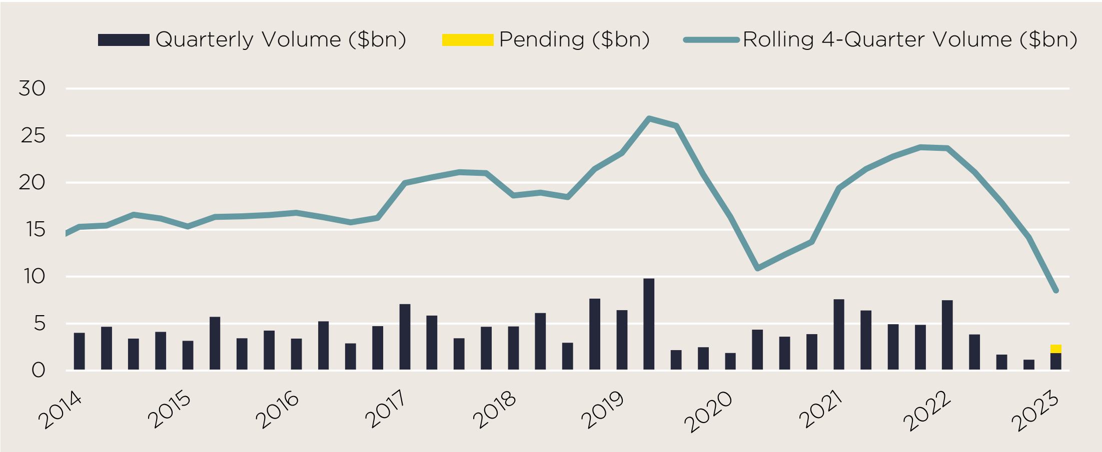
Capital markets adjusting

The higher interest rate environment continues to dampen investor confidence

Office investment volumes down c.75% in Q3 2023 vs Q3 2022
Quarterly and rolling 4-quarter investment volumes ($10m+), $bn



Source Savills Research / MSCI Real Capital Analytics

Q3 was the strongest quarter for deal volume so far in 2023

Roughly $898 million worth of deals pending

Deal volumes increase in Q3 but remain well down over the year
According to MSCI Real Capital Analytics, the total settled investment volume ($10m+) reached c.AU$1.85 billion in Q3, a 62% increase from the c.AU$1.15 billion recorded in Q2 2023 (this includes the $200 million sale of 189 Kent Street, which will eventually be repurposed into luxury apartments – excluding this transaction, quarterly investment volume rose by 44%). The settlement of several significant transactions, including 44 Market and 1 Margaret Street in Sydney, boosted sales volume in Q3.

Despite the quarterly increase, investment activity continues to be subdued. Transaction volumes were down 75% from the c.AU$7.49 billion recorded in Q3 2022. Investment activity has been concentrated in smaller deal sizes this year, with only seven transactions greater than AU$200 million occurring over the year to date, compared to 32 over the same period last year, and 25 in 2019. There are c.AU$898 million of assets currently pending at the time of writing (November 2023). Many of the deals entering due diligence have been subject to capital raise, which is leading to prolonged deal periods.

Private investors deploy capital as smaller deals drive activity
Private investors have become notably more active, with their share of deal volumes increasing to 36.6% in 2023 YTD, up from 17.3% in 2022, and well above their pre-COVID average (2015-2019) of 14.5%. This shift reflects low-leveraged and less constrained private investors seizing the opportunity to secure assets in a period characterised by reduced liquidity and competition for assets from institutional capital.

By contrast, cross-border investors' share of total deal volumes has declined to 28.7% in 2023 YTD, down from 34.8% recorded in 2022. Similarly, REITs' investment share has followed a similar trend declining from 23.5% in 2022 to 8.2% in 2023 YTD. Many institutional investors are choosing a 'wait and see' approach as the market adjusts to the higher interest rate environment.

Capital values are falling more slowly than they are in major overseas markets
Office capital values in Australia have begun to adjust to the higher interest rate environment but with a significant lag compared to major overseas markets.

According to MSCI Real Assets, office capital values in Sydney, Melbourne, Brisbane, and Perth declined by between 6% and 10% over the year to Q2 2023, well above the -14.2% average across 20 major office markets.

The performance of the Australian markets partly reflects stronger leasing market conditions, especially when compared to most US markets. However, it also reflects a lack of transactional evidence and a longer lag in valuations in Australia as they adjust to the impact of higher interest rates.

c.AU$1.85 billion
transacted in Q3

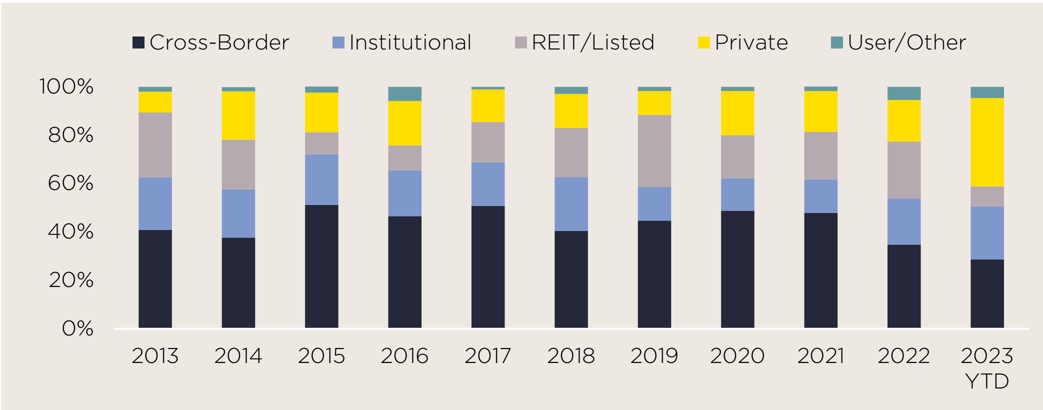
c.$898 million
deals pending at November 2023

36.6%
Private capital's share of the total investment volume in 2023 (YTD)

8.2%
REITs' share of total transaction volume in 2023 YTD

Private capital more active

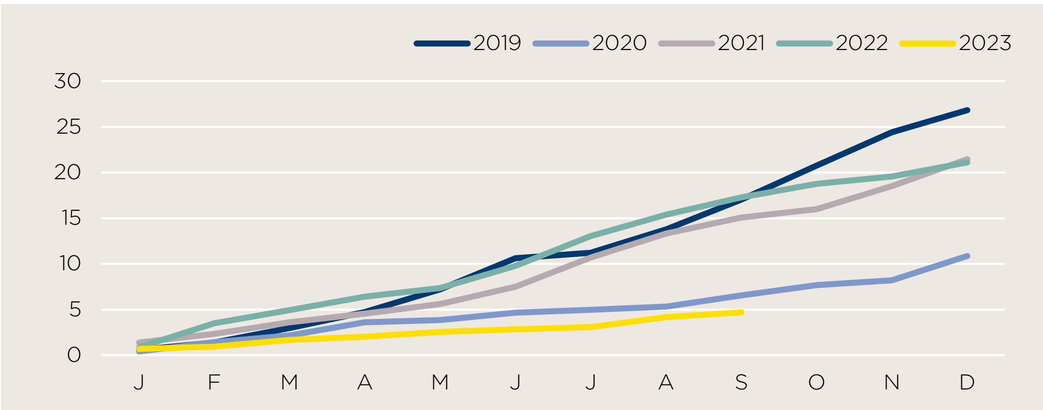
Buyer composition (deals $10m+) %



Source Savills Research / MSCI Real Capital Analytics

YTD sales volumes well down on recent years

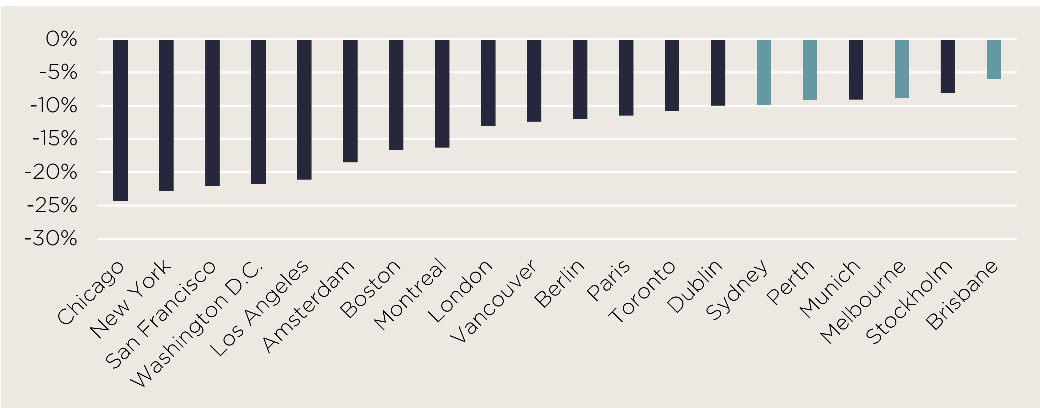
Monthly cumulative volume (deals $10m+) $bn



Source Savills Research / MSCI Real Capital Analytics

Capital growth by city

Per cent change y/y to Q2 2023



Source Savills Research / MSCI Real Capital Analytics

AUSTRALIAN CBD QUARTER HIGHLIGHTS

Yields continue to move out

Higher interest rates and debt cost continue to put upward pressure on yields, although transactional evidence remains limited.

In the major CBD markets, Sydney and Melbourne recorded the least softening in premium market yields, with Sydney yields moving out by 7.5bps to average 4.875%, and Melbourne yields widening by 12.5bps to 5.00%. A Grade market yields in both Sydney and Melbourne rose by 12.5bps over Q3 to reach 5.75%.

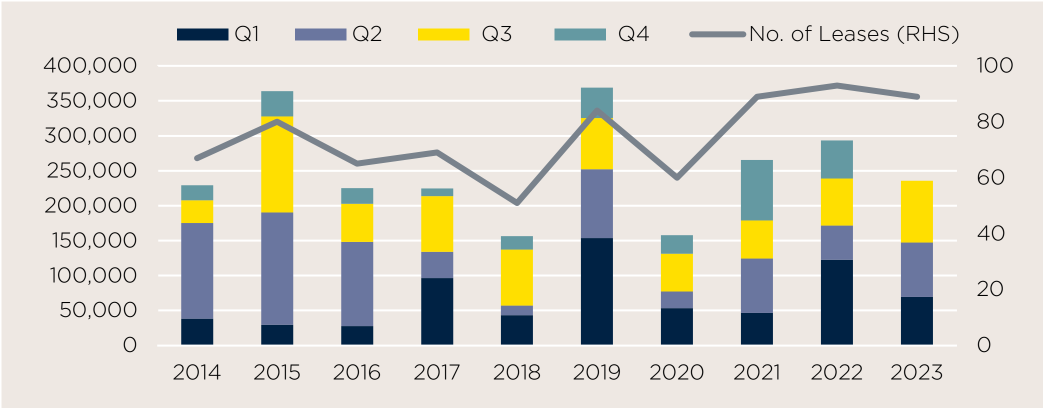
Smaller markets recorded slightly larger increases, with premium yields in the Brisbane CBD rising by 12.5bps to 5.625% and A Grade yields softening by 17.5bps to 6.30%, while premium and A Grade yields in the Perth CBD both increased by 25bps to 6.25% and 7.375%, respectively.

Rental growth supports premium capital values in Sydney and Brisbane

Despite softening yields, average capital values for premium CBD assets in Sydney and Brisbane remained stable in Q3. Ongoing demand for premium space continues to drive rental growth, which is offsetting widening yields.

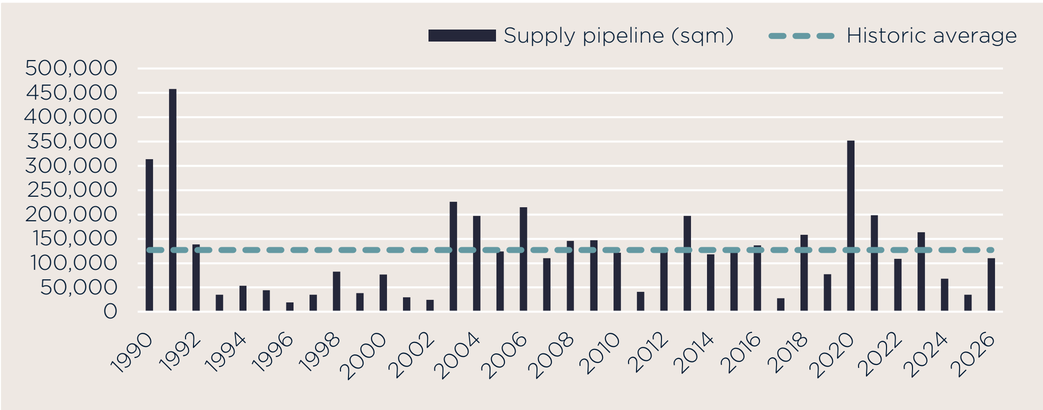
By contrast, A Grade capital values have fallen 3.3% q/q in Sydney and 2.1% q/q in Melbourne, with more pronounced declines seen across secondary assets.

Sydney CBD leasing volumes
Total leasing volumes (1,000sqm+) by quarter (sqm) v number of leases



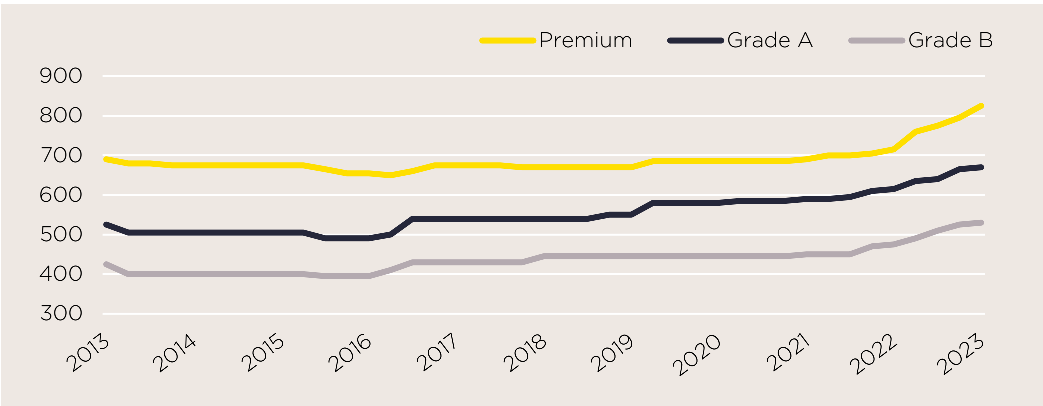
Source Savills Research

Melbourne's below average future supply will help absorp supply overhang
Historical and projected CBD supply, sqm



Source Savills Research / PCA

Brisbane rental growth is still running well above average
CBD prime net face rents by grade, $/sqm



Source Savills Research

EAST COAST HIGHLIGHTS

Sydney leasing volumes increase but average deal size falls
Leasing volumes increased by 10% q/q and 34% compared to the previous corresponding period. Leasing volumes reached c.91,700sqm in Q3, above the 10-year Q3 average of c.72,350sqm.

The average deal size has declined as tenants revaluate space requirements, with some opting for less space or subleasing. The proportion of deals exceeding 10,000sqm declined by 21ppts over the year to September to 14%, while deals between 5,000 – 10,000sqm increased by 14ppts to 28%.

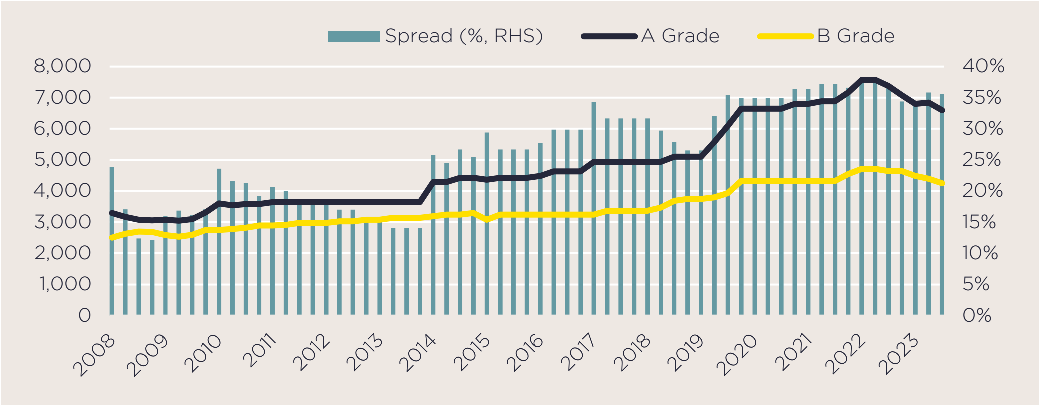
Pre-commitment deals support leasing activity in Melbourne as city grapples with supply overhang
Pre-commitments drove leasing demand in Q3, with three significant deals including The Victorian Civil and Administrative Tribunal pre-leasing 14,000sqm of A Grade at 300 La Trobe Street.

Despite the pick up in leasing activity, vacancy remains elevated on the back of an influx in new office supply over 2020-21. Development completions are set to moderate in the coming years, which will allow the market to adjust and absorb the supply overhang.

Lower vacancy driving strong rental growth in Brisbane
Tightening vacancy continues to propel rental growth, with average premium net face rent increasing 3.8% q/q to average $823/sqm, while A grade net face rents grew by 0.8% q/q to average $668/sqm.

Adelaide CBD average capital values

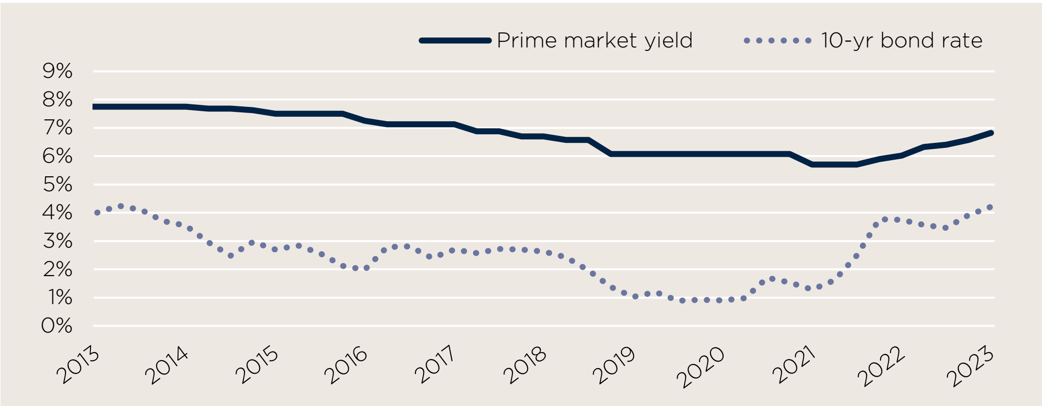
Average A and B grade capital values ($/sqm), spread (%, RHS)



Source Savills Research

Perth CBD prime market yields

Average prime market yield and 10-yr bond rate (%)



Source Savills Research / Macrobond (bond yield as at Q3)

ADELAIDE AND PERTH HIGHLIGHTS

Government tenants boost leasing activity in Adelaide

Demand for office space has been driven mainly by government tenants who accounted for two-thirds of leasing volumes over the year to date. Recently, engineering firm KBR signed a 7-year deal for 2,000sqm at 30 Pirie Street.

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 26%. With tenant demand for A grade running at more than double its long-run average, it is expected that value-add and opportunistic capital (particularly privates and syndicates), and lower leveraged mandates, will take advantage of market conditions to reposition secondary assets.

Occupiers gravitate to the CBD in Perth

Leasing activity in the Perth CBD remained healthy driven in part by a recentralisation to the CBD. Mining & Energy sector tenants accounted for 51% of leasing activity in Q3. Synergy Energy took 6,120 sqm at levels 22, 23 and 24 at 152 St Georges Terrace on a 10-year lease, while Alinta Energy leased a 3,495sqm Premium space at 300 Murray Street on a 7-year initial term.

Perth and Adelaide yields soften further in Q3

Perth CBD yields softened 25bps across all building grades with prime market yields averaging 6.80% in Q3. In Adelaide, with premium market yields softened by 17.5bps to average 5.8%, while the average A grade yield rose 25bps to 6.90%.

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