Australian Office – May 2023

SPOTLIGHT
Savills Research

Office Briefing

Demand for premium assets • Inflation drives rents higher • Rising yields, lower capital values

Near peak interest rates?

RBA appears close to the end of policy tightening cycle as consumer spending and inflation moderate

Consumption headwinds
Consumer spending is slowing as the impact of higher interest rates begins to bite. Nominal retail sales rose by 0.4% in March, with annual growth falling to 5.4%, the slowest growth rate in 18 months and below the headline inflation rate.

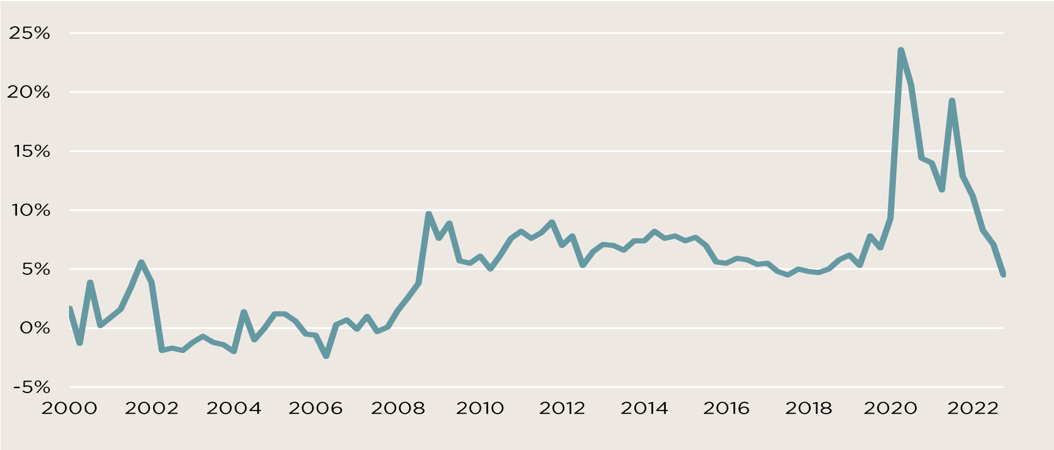
Driving the slowdown is the ongoing decline in the household savings rate, which has fallen back to pre-pandemic levels. Households have largely spent the income boost from pandemic stimulus, while higher inflation and interest payments have eroded household disposable income.

Inflation is also slowing signs of moderating. Growth in headline inflation slowed to 7.0% over the year to March, down from 7.8% in 2022, although rents, utilities, and the prices of many services continue to rise strongly.

RBA raises rates but end to tightening cycle in sight
After a pause in April, the RBA surprised financial markets by lifting the cash rate by a further 25 basis points in May to 3.85%, taking the cumulative increase to 375 basis points since May 2022. Despite the May increase, financial market pricing suggests the RBA is close to the end of the tightening cycle.

Globally, expectations for further monetary policy tightening have also been pared back following UBS' arranged takeover of Credit Suisse and several US bank failures. While the Federal Reserve raised interest rates by 25 basis points in early May to 5.0%-5.25%, the central bank appears to be at or near the end of its tightening cycle, with financial markets currently pricing in several interest rate cuts later this year. Yields on 2-year government bonds, which are highly sensitive to the outlook for central bank policy, have also fallen sharply in recent months. Two-year US Treasury yields have declined by around 100 basis points since early March while the German equivalent is around 55 basis points lower.

Lower household savings point to slowdown in consumer spending
Household savings, per cent of household disposable income



Source Savills Research / Macrobond

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Key economic indicators

Year-ended per cent change, 10-year average in brackets

Key State Indicators (%)	Latest	AUS	NSW	VIC	QLD	WA	SA	ACT
SFD / GDP Growth	Dec-22	2.7 (2.4)	3.4 (2.7)	4.1 (3.4)	2.4 (1.6)	3.2 (-0.2)	3.2 (2.4)	3.9 (2.8)
Population Growth	Sep-22	1.6 (1.3)	1.3 (1.1)	1.7 (1.6)	2.2 (1.5)	1.8 (1.3)	1.4 (0.9)	1.4 (2.0)
Employment Growth	Mar-23	3.1 (1.9)	3.6 (1.9)	3.5 (2.2)	2.1 (2.0)	0.8 (1.5)	3.8 (1.4)	5.0 (2.1)
Unemployment Rate	Mar-23	3.5 (5.4)	3.2 (5.0)	3.7 (5.4)	3.8 (5.8)	3.6 (5.4)	3.9 (6.1)	2.9 (3.9)
Inflation	Mar-22	7.0 (2.6)	7.3 (2.6)	6.8 (2.6)	7.4 (2.8)	5.8 (2.4)	7.9 (2.6)	6.2 (2.6)
Retail Trade Growth	Mar-23	5.4 (4.9)	5.7 (5.2)	5.6 (5.4)	2.7 (4.6)	6.9 (3.9)	8.2 (4.7)	7.9 (5.0)
Job Ad Growth Total	Feb-23	18.1 (5.6)	15.6 (5.7)	17.9 (7.3)	24.4 (5.1)	16.0 (2.7)	16.9 (5.9)	13.8 (6.9)
Job Ad Growth Office	Feb-23	14.1 (5.6)	5.3 (5.5)	16.0 (8.2)	23.4 (4.7)	19.4 (1.1)	18.9 (7.9)	9.5 (6.5)

Note: SFD measure excludes net exports; employment data are quoted n trend terms
Source Savills Research / ABS

Strong employment and population growth support occupier market
Labour market conditions continue to point to ongoing demand for office space. Total employment and grew strongly in February and March, while the national unemployment rate is 3.5%, around the lowest level since the 1970s.

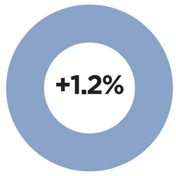
Australia's population growth has rebounded to be above pre-pandemic levels. Australia's estimated resident population rose by 1.6% over the year to September 2022, compared with 0.3% a year earlier, and the decade average of 1.3%. Net overseas migration drove the increase following the reopening of Australia's border in early 2022. Strong population growth will boost demand for office space over the long-term.

Demand for prime space and inflation drive rents higher
Tight labour conditions, strong demand for prime office space, and high inflation have driven a pick-up in rental growth in some markets over the past year. Rental growth is significantly stronger at the prime end of the market reflecting the ongoing flight to quality.

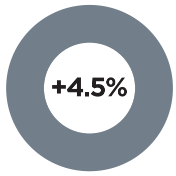
Investment activity remains largely on hold
The sharp rise in interest rates since mid-2022, higher debt costs, and ongoing uncertainty about the interest rate outlook continue to weigh on investment activity. Quarterly office transaction volume (+$10m) was c$1.29b in Q1, down by over 70% compared to Q1 2022, while year-on-year volumes were 18% lower. Pricing continues to adjust to higher interest rates, with average prime CBD office yields softening by a further 20bps in Q1.

Key economic forecasts

RBA Statement on Monetary Policy, May 2023

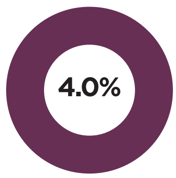


GDP growth
2023 year-end forecast



Headline CPI
2023 year-end forecast

Trimmed mean inflation
2023 year-end forecast



Unemployment rate
December 2023 forecast

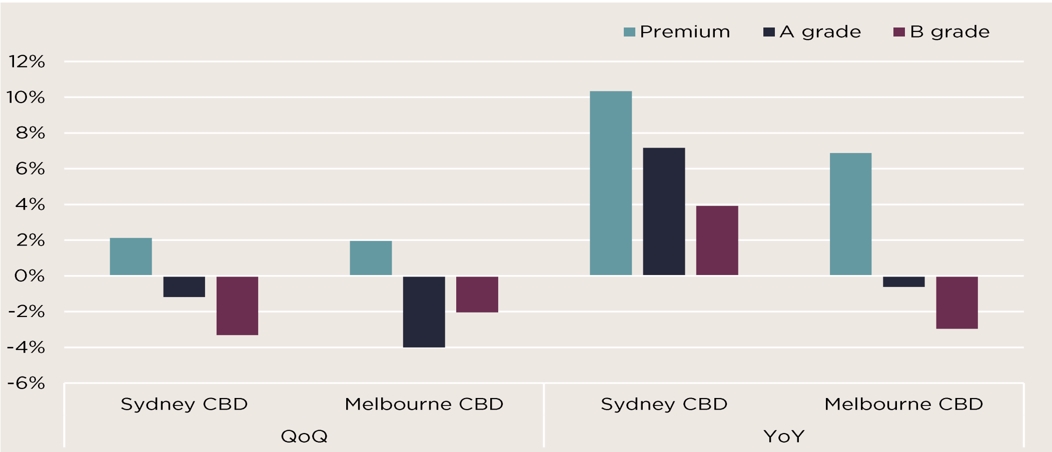
Source Savills Research / RBA

Flight to quality

Multi-speed office market amid uncertain economic outlook and changing occupier preferences

Net effective rental growth by grade

Per cent change q/q and y/y



Source Savills Research

Demand for premium space and inflation driving rents higher

Flight to quality driving divergence in rental growth across property grades

Australia's major office markets are seeing an ongoing flight to quality as employers look to attract and retain talent, coupled with an ever-increasing emphasis on ESG mandates and credentials.

Rental growth momentum

The flight to quality is driving a material divergence in rental growth across property grades in some major markets. In the Sydney CBD, for example, net effective rents for the premium segment grew by 2.1% in Q1 to be around 10% higher over the year. By contrast, net effective rents declined by 1.2% and 3.3% for the A grade and B grade segments respectively, with growth in face rents offset by rising incentives.

A similar trend is evident in the Melbourne CBD, where average incentives in the premium market declined over the quarter, driving a small increase in effective rental growth. Conversely, average incentives continued to increase in the A and B grade segments, leading to declines in effective rents over the quarter. In other major markets such as Brisbane and Perth, rental growth is more broad-based, with strong growth across the property grades.

Prime rental growth boosted by strong leasing market

Underpinning stronger rental growth has been the relatively buoyant occupier market conditions at the prime end of market. In the premium market, the cumulative increase in net absorption since H1 2020 across the Australian markets totalled around nearly 400,000 sqm, equivalent to 12.3% of premium office stock, while net absorption in the A grade segment was 266,100 sqm, equivalent to 2.3% of A grade office stock.

By contrast, demand for secondary market office space declined over the same period, with net absorption falling by around 537,300 sqm, equivalent to 4.7% of secondary office stock.

By market, Brisbane has seen a particularly strong increase in demand for office space, supported by robust employment growth and net interstate migration. In Sydney and Melbourne, overall net absorption fell, driven by a decline in demand for secondary office space, while take-up of prime space has been much stronger.

New supply puts upward pressure on vacancy

Higher supply drove the national vacancy rate higher from 12.9% in July 2022 to 13.3% in January 2023, with sizable supply additions in the Sydney, Melbourne, and Adelaide CBDs. Vacancy rose in all major CBD markets except for Brisbane and Perth. Less supply this year in major CBD markets such as Sydney and Melbourne will limit further upward pressure on vacancy.

Leasing markets

Stronger prime rental growth driven by robust demand for high-quality and prime location assets

+9.1% vs +3.9%
Sydney CBD prime vs secondary net effective rental growth, year to Q1 2023

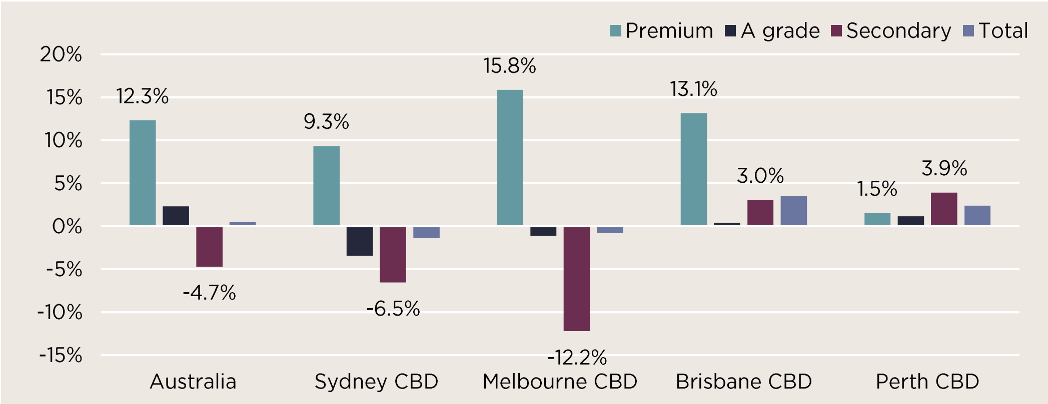
+3.6% vs -3.0%
Melbourne CBD prime vs secondary net effective rental growth, year to Q1 2023

+143,103 sqm
Increase in prime market net absorption nationally over the six months to January 2023

-112,199 sqm
Decrease in secondary market net absorption over the six months to January 2023

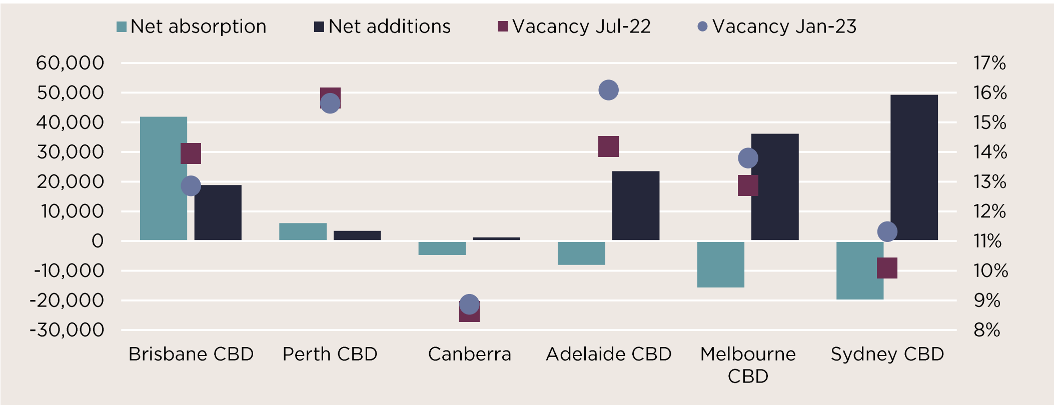
8.7% vs 13.3%
Premium CBD vacancy rate is 4.6 percentage points lower than the overall CBD vacancy rate

Net absorption by grade since H1 2020
Per cent of total segment office stock



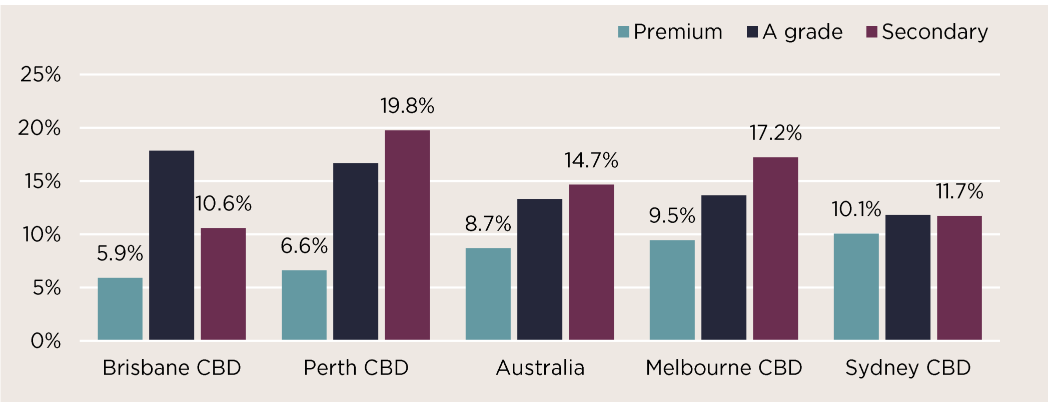
Source Savills Research / Property Council of Australia

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



Source Savills Research / Property Council of Australia

Vacancy rate by grade
Per cent, as at January 2023



Source Savills Research / Property Council of Australia

HIGHLIGHTS

Prime demand
Nationally demand for office space was subdued over the six months to January, with net absorption rising by c.30,900 sqm, well below the long-run average of around 145,000 sqm.

The overall total masks pockets of genuine strength in office demand and highlights the ongoing divergence across market segments. For example, net absorption in the prime (premium and A grade) office market rose by c.143,100 sqm, with take-up in the premium segment well above average. By contrast, net take-up in the secondary market declined by 112,200 sqm.

Rental growth accelerates
Inflation, demand for prime office space, and the completion of several premium office developments have driven an acceleration in premium market rental growth. In the Sydney CBD, premium net effective rents rose by 10.3% over the year Q1, following 25.5% peak to trough fall since the onset of the pandemic.

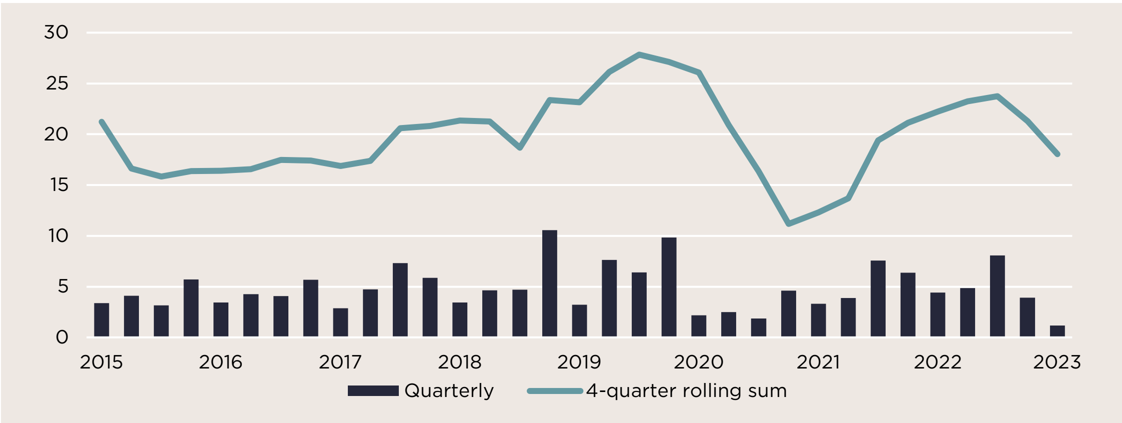
Sunshine state
Brisbane recorded the strongest demand for office space nationally over the six months to January, with net absorption in the CBD and fringe rising by c.41,900 sqm and c.38,700 sqm respectively. Coupled with limited supply, the Brisbane CBD vacancy rate declined from 13.9% to 12.9%, with the premium vacancy rate falling to 5.9%, the lowest premium vacancy rate of any Australian CBD market.

Reflecting buoyant occupier market fundamentals, Brisbane has seen the strongest rental growth of any major CBD market.

Investment activity slows

Sharp rise in interest rates and debt costs weigh on investment activity and capital values

Office investment volume down c.70% in Q1 2023 vs Q1 2022
Deals $10m+, quarterly and 4-quarter rolling sum, $bn



Source Savills Research / MSCI Real Capital Analytics

Further slowdown in investment activity in Q1

Volume and number of assets traded in Q1 2023 down on Q1 2022

Office sector investment activity slowed further in Q1, continuing the sharp slowdown seen in late 2022 reflecting uncertainty over the outlook for inflation and interest rates, higher debt costs, and the consequent gap between buyer and seller price expectations.

Investment activity down c.70% in Q1 2023

Office investment volume declined by over 70% in Q1 2023 compared with Q1 2022. Over the year to Q1 2023, investment activity fell by 18%. The number of assets traded also declined sharply, down by 68% in Q1 compared with Q1 2022, and 30% over the year.

Activity was strong prior to rising interest rates

Compared with the average over the five years prior to the pandemic (2015-19), investment volume was down by 8% over the year to Q1 2023, with volume boosted by several large deals completed in mid-2022 including Dexus's acquisition of Atlassian Tower in Sydney for an estimated $840m, NPS' and Allianz's purchase of a 50% stake in Commonwealth Bank Place from the Abu Dhabi Investment Authority for $610m, Charter Hall's 50% stake acquisition of the Southern Cross Towers Portfolio in Melbourne from Blackstone and Brookfield for $2.1 billion, and GIC's purchase of a 50% share in 555 Collins Street.

Yields continue to soften

Higher interest rates and debt costs have put pressure on office property yields, although the widening in yields continues to vary considerably at the individual asset level in line with investor and occupier preferences. In the Sydney CBD, average prime yields rose by a further 20bps in Q1 to range between 4.625%-5.25%, while in the Melbourne CBD, average prime yields increased by 22bps to average 5.10%.

Capital values under pressure

Softening yields are beginning to translate into lower capital values. According to MSCI Real Assets, capital growth in the office sector declined by 1.7% in Q4 (+0.2% y/y), the first quarterly fall since the pandemic impacted Q2 2020. By grade, prime assets are outperforming secondary ones, with capital values for premium and A grade assets declining by 1.7% and 1.4% respectively in Q4, while capital growth for B grade assets fell by 3.7% over the quarter (-5.4% y/y).

The falls in office capital values in Australia to date have been relatively modest compared to many other major markets, particularly in Europe and the US. While further declines in capital values are likely this year, Australia is expected to fare relatively well.

Capital markets
Higher interest rates lead to slowdown in investment activity and drive office yields higher

+20bps
increase in average CBD prime grade office yield in Q1 2023

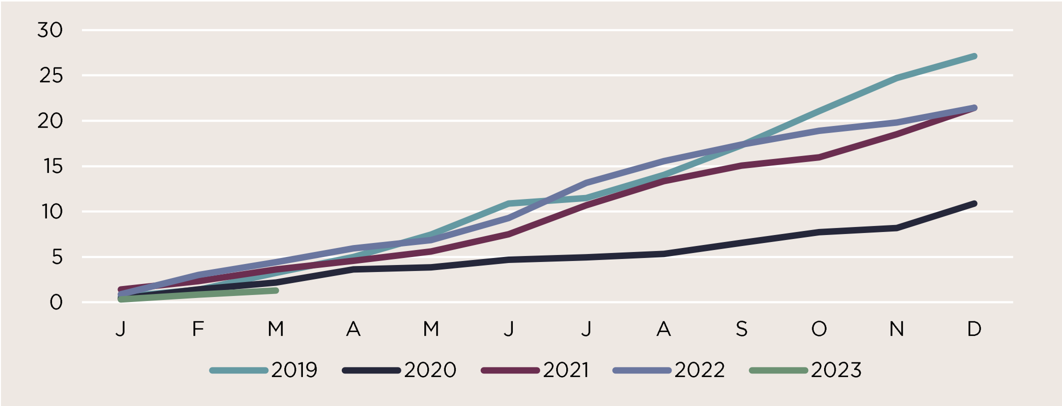
-71%
Investment volume in Q1 2023 vs Q1 2022

-68%
Number of assets traded in Q1 2023 vs Q1 2022

-7.6%
Investment volume year to Q1 2023 vs 2015-19 average

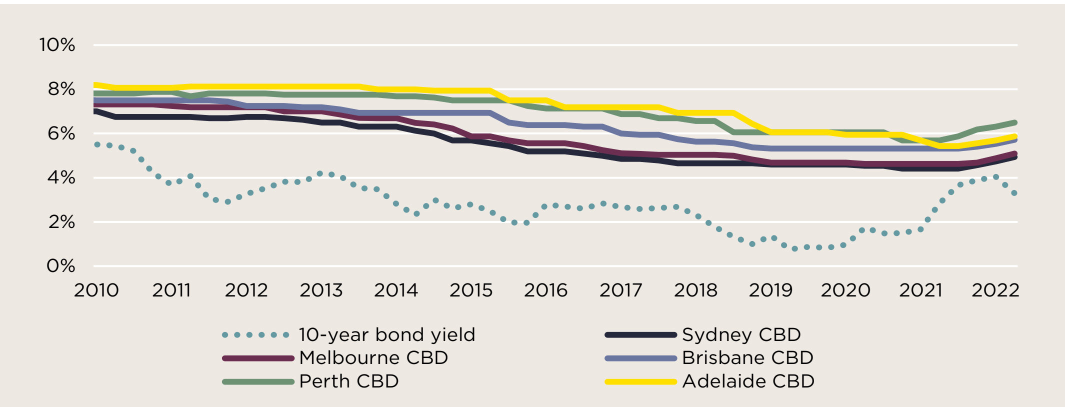
-1.7%
Office sector capital growth in Q4 2022

Investment volume
Cumulative monthly total, $bn



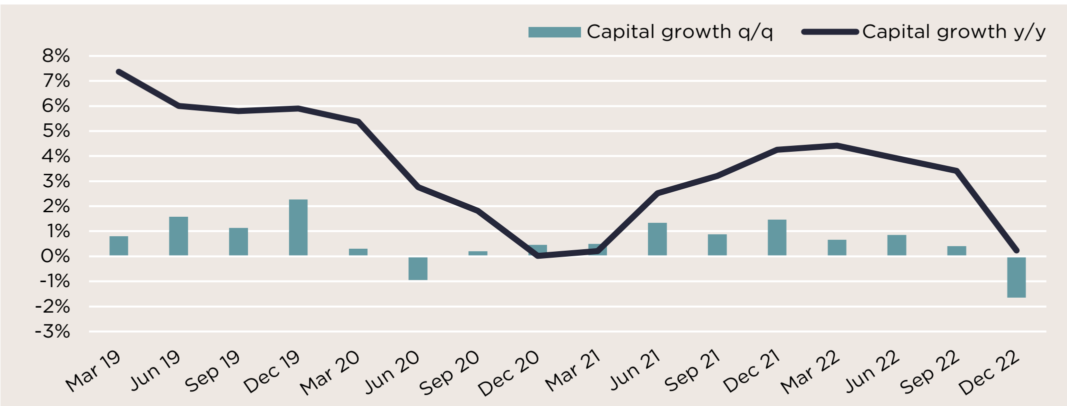
Source Savills Research / MSCI Real Capital Analytics

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



Source Savills Research

Capital gowth
Per cent change



Source Savills Research / MSCI Real Assets

HIGHLIGHTS

Investment slows further
Investment activity in the office market slowed further in Q1 as uncertainty about the interest outlook largely kept investors on the sidelines.

Investor shift
Domestic institutional investors have become more active over the past year. Net acquisitions of office assets among institutional investors totalled c.$3.7 billion over the year to Q1 2023 compared with c.$2.3 billion the year before. By contrast, net acquisitions by cross-border investors fell by c.$487 million after several years of very strong activity. High profile acquisitions from investors like GIC, NPS, and Allianz were offset by disposals from US, Canadian, and Middle Eastern investors.

Yields soften further
Higher interest rates and rising debt costs are driving office yields higher. Yields on premium assets across the major CBD markets rose by an average of 19 basis points in Q1, after having generally remained stable in Q4, while average A grade CBD yields increased by a further 21 basis points. Among the major CBD markets, Perth has seen the largest yield widening over the past year, followed by Sydney and Melbourne.

CBD market overview

Strength in demand for prime assets and high inflation drive stronger rental growth

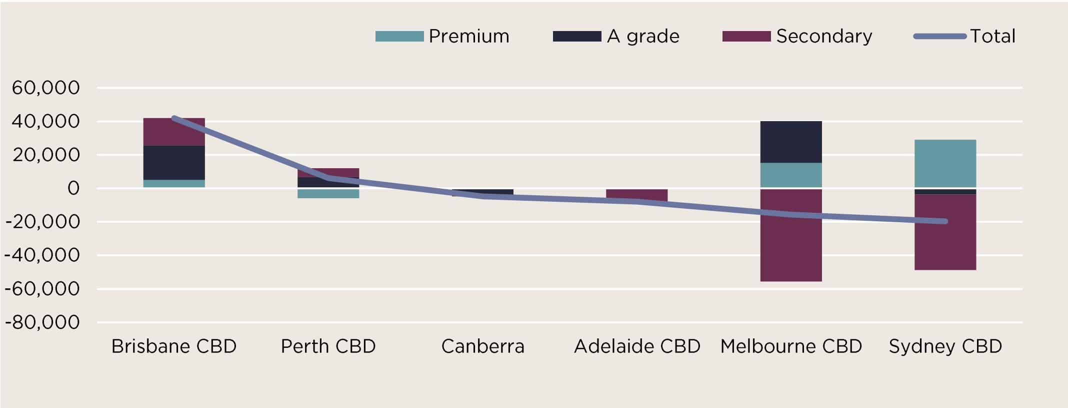
Major CBD market summary

Q1 2023

Market	Key trends
Sydney CBD	Net absorption fell by c.19,700 sqm over the six months to January 2023, with positive demand in the premium segment offset by falls in the A and secondary grades. Supply increased by c.71,700 sqm over the same period with the completion 180 George Street (Salesforce Tower) and 210 George Street. The CBD vacancy rate increased to 11.3% in January 2023, up from 10.1% in July 2022, and 9.3% at the same time last year. No major development completions in 2023 will limit further upward pressure on vacancy this year, while the three Sydney Metro over-station developments will add more than 150,000 sqm of office space in 2024. Reflecting robust leasing conditions at the prime end of the market as well as high inflation, average prime net face rents rose by 1.7% in Q1 2023 to be 7.0% higher over the year, while prime net effective rents increased by 9.1% y/y. Premium grade yields rose by 12.5 bps in Q1 to range between 4.25% and 4.75%, while average A grade yields softened by a further 27.5 bps to 5.0%-5.75%.
Melbourne CBD	Positive take-up in the premium and A grade segments was more than offset by falling demand in the secondary market leading to a c.15,700 sqm decline in net absorption over the six months to January. Over the same period, c.48,700 sqm of new and refurbished supply was added to the market including 140 Lonsdale Street and 637 Flinders Street. The vacancy rate increased to 13.8% in January 2023, up from 12.8% in July 2022. The development pipeline is limited over the next few years, with 555 Collins Street (48,000 sqm) due in 2023, and Melbourne Quarter Tower (68,000 sqm) reaching completion in 2024. The full refurbishment of 500 Bourke Street will also come online this year, adding 43,000 sqm of space to market. Average prime face rents were flat over Q1, but are still 3.1% higher over year. Declining incentives in the premium market were offset by rising incentives in the A grade segment, leaving average prime net effective rents 0.6% lower in Q1 (+3.5% y/y). Premium grade market yields rose by 18.8 bps in Q1, while average A grade yields softened by 25 bps.
Brisbane CBD	Brisbane recorded the strongest net absorption of any Australian market over the six months to January (+c.41,900 sqm) with positive net take-up across the prime and secondary markets. Coupled with limited net supply, the vacancy declined to 12.9% in January 2023, down from 13.9% in July 2022, and 15.4% at the same time last year. No new supply is expected this year, while the construction of 205 North Quay (43,700 sqm) is expected to be completed in late 2024. The premium market is particularly tightly held, with vacancy at 5.9%, the lowest level since January 2012 and lowest of any CBD market nationally. Reflecting the buoyant occupier market conditions at the prime end of the market, rents continued to grow strongly in Q1, with average prime net face rents rising by 1.6% (+9.1% y/y), while prime net effective rents were 1.9% higher. Average prime CBD office yields rose by 18.8 bps in Q1 to range between 5.45% and 6.0%.
Perth CBD	In the Perth CBD, a sustained period of positive net take-up continued, with net absorption increasing by c.6,100 sqm in the six months to January. Over the past two years, net absorption in the CBD has totalled c.86,900 sqm, equivalent to 4.8% of office stock, the highest of any major CBD market. The CBD vacancy rate declined by 0.2 percentage points to 15.6%, making Perth and Brisbane the only two CBD markets to record a decrease in vacancy over the period. Chevron's new headquarters at One The Esplanade reached completion in Q1, delivering 52,000 sqm of office space. Average prime net face rents accelerated sharply in Q1, rising by 3.1%, while declining incentives contributed to a 4.2% rise in net effective rents. Prime CBD office yields rose by a further 18.8 bps in Q1 to average 6.5%.
Adelaide CBD	Demand for office space was subdued in the six months to January, with net absorption declining by c.8,000 sqm. The fall was mainly driven by lower demand in the secondary market, although net absorption in the prime segment also fell. The completion of 83 Pirie Street added 30,000 sqm of office space to the market, which was the main driver of the CBD vacancy rate rising by 1.9 percentage points over the half-year to 16.1%. Development completions will be relatively high this year, with several projects due to come online, including 60 King William Street (c.42,500 sqm). Average prime net face rents rose marginally in Q1, but higher average incentives led to a 0.4% decline in net effective rents. Premium grade market yields rose by 12.5 bps in Q1, while average A grade yields softened by 25 bps.
Canberra	Take up of office space was subdued in the six months to January following the strong demand seen in 2020 and 2021. Net absorption fell by c.4,700 sqm driven by the A grade segment. Supply additions totalled c.48,700 sqm, including Civic Quarter (33,000 sqm) and several refurbishments, although these were largely offset by c.47,400 sqm of withdrawals. The vacancy rate increased marginally to 8.9%, although in terms of total vacacny, Canberra remains the most tightly held major office market in the country. Average prime net face rents were flat in Q1 (+7.0% y/y), while rising incentives drove average prime net effective rents 2.3% lower (+7.4% y/y).

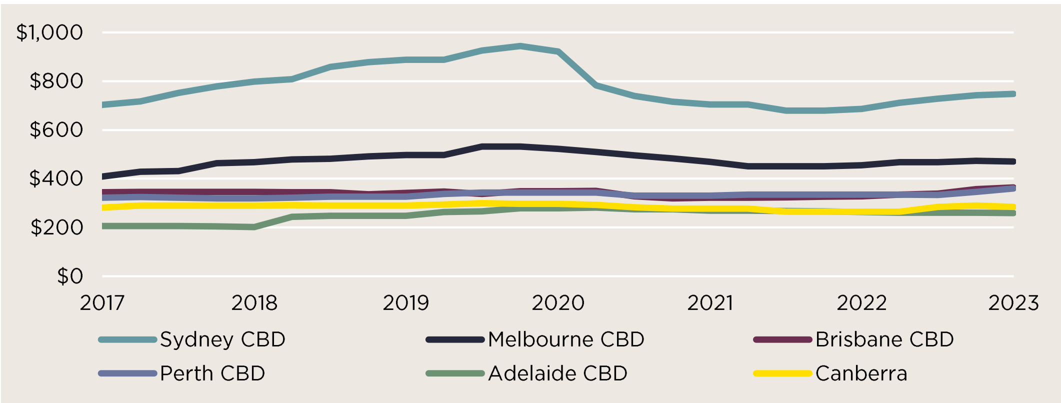
Source Savills Research / Property Council of Australia

Net absorption by city and grade
Major CBD markets, sqm



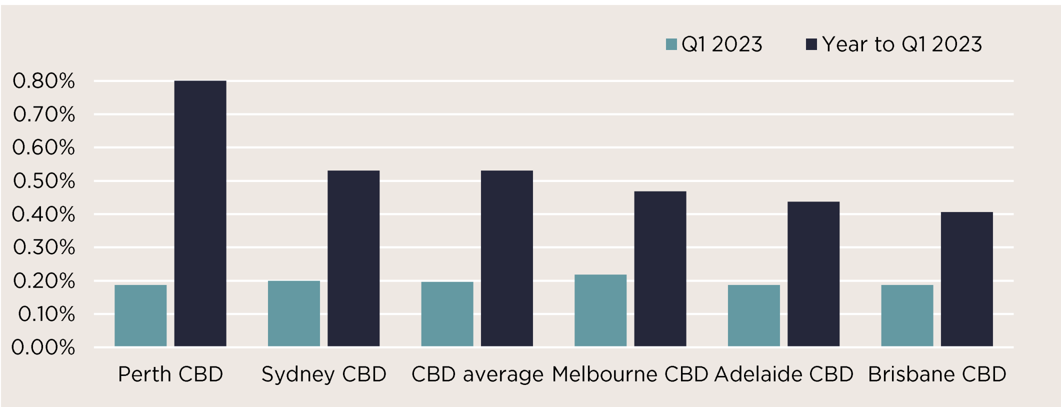
Source Savills Research / Property Council of Australia

Net effective rents
Prime CBD average, $/sqm



Source Savills Research

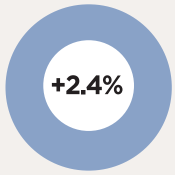
Change in prime CBD office yields
Percentage point change q/q and y/y



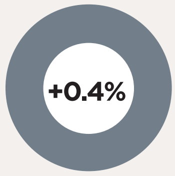
Source Savills Research

HIGHLIGHTS

Sustained demand for prime office space offset by falling take-up in secondary. New supply pushes vacancy higher as rents rise reflecting robust leasing market conditions and high inflation.



Net absorption
Increase in prime market net absorption (% of office stock), six months to January



Prime vacancy
Increase in prime market vacancy, six months to January

Prime rents
Average increase in prime net effective rents, Q1 2023

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

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