Australian Office – May 2023

SPOTLIGHT
Savills Research

Perth Office Briefing

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Demand is broad based ● Inflation drives rents higher ● Rising yields, investment on hold

Western Australia outperforming Australia

Strong consumer spending and exports drive WA economy

Economic growth in WA outpaces most states
Since the onset of COVID-19, Western Australia's (WA) economy has outperformed Australia, with WA's gross state product (GSP) growing by 9.7% over the past three years (or 3.1% in average annual terms), the second strongest growth rate of any state.

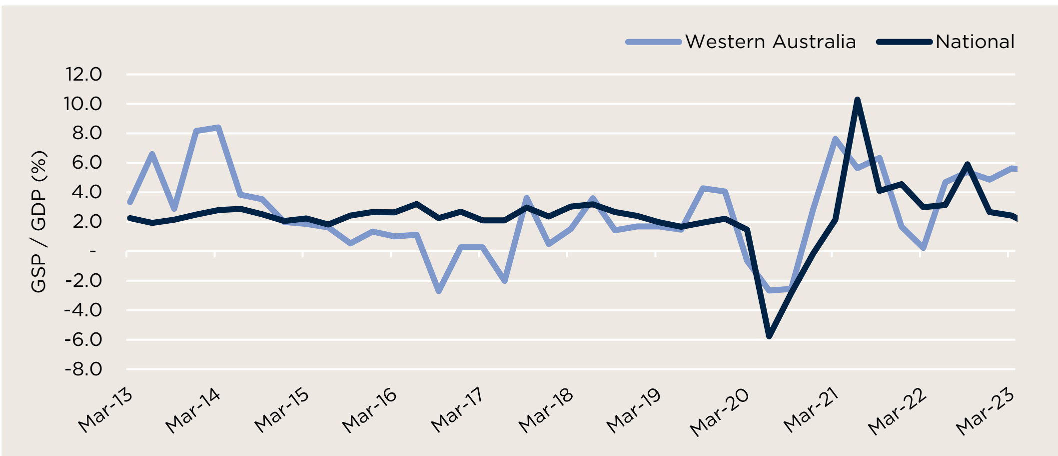
Driven by strong consumer spending
Robust consumer spending has underpinned the strength of WA's economy. Retail sales in WA have risen by one-third over the past three years (averaging over 10% growth per year), by far the strongest growth rate of any state.

Consumption supported by tight labour market
Consumer spending has supported the prolonged outperformance of the labour market in WA. The state's unemployment rate fell to 3.0% in mid-2022, its lowest level since 2008. Although the unemployment rate drifted up a little to 3.4% subsequently, WA's labour market remains relatively tight, with the state currently having the second lowest unemployment rate in Australia.

Exports also supporting growth
Resource exports have also made a strong contribution to growth in recent years, boosted by global demand for LNG and iron-ore, particularly from China. WA has benefited both from higher export volumes and commodity prices. In 2021-22, WA accounted for 59% of Australia's exports and 56% of Australia's LNG exports. China's reopening coupled with sustained demand for LNG and renewable energy will continue to drive demand for the state's exports.

Demographic trends also positive
Since the reopening of the state's borders in early 2022, WA's population growth has rebounded to above pre-pandemic levels. Estimated resident population rose by 1.8% over the year to September 2022, compared to 0.7% the previous year. Net overseas migration (+23,311 people) drove the increase, followed by natural increase (+15,395 people) and net interstate migration (+11,658 people). Strong population growth will boost demand for office space over the long-term.

Exports drive growth in gross state product to above average levels
WA gross state product vs national gross domestic product



Source Savills Research / Deloitte Access Economics

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Strong demand for space

Sustained net absorption drives vacancy lower

Strong economic activity supporting occupier markets
Robust economic growth and a tight labour market are driving sustained demand for office space in the CBD. Net absorption has totalled c.86,900 sqm over the past two years, equivalent to 4.8% of office stock, the highest of any major CBD market.

The recent strength in demand for space is due to industries like mining, energy, and construction – growth in these sectors has led tenants to renew or expand their office footprint. The demand from the resources sector has driven new development activity, particularly in Elizabeth Quay, including the recently completed Chevron HQ by Canadian investment management firm Brookfield. BHP also renewed their lease for an additional 15 years at Brookfield Place Perth for 41,000sqm in August last year.

Premium market relatively tightly held
Ongoing demand for premium grade space has seen the vacancy rate remain relatively tight at 6.6% as at January 2023. This is below the 10-year average of 7.6% and well-below the total CBD vacancy rate of 15.6%.

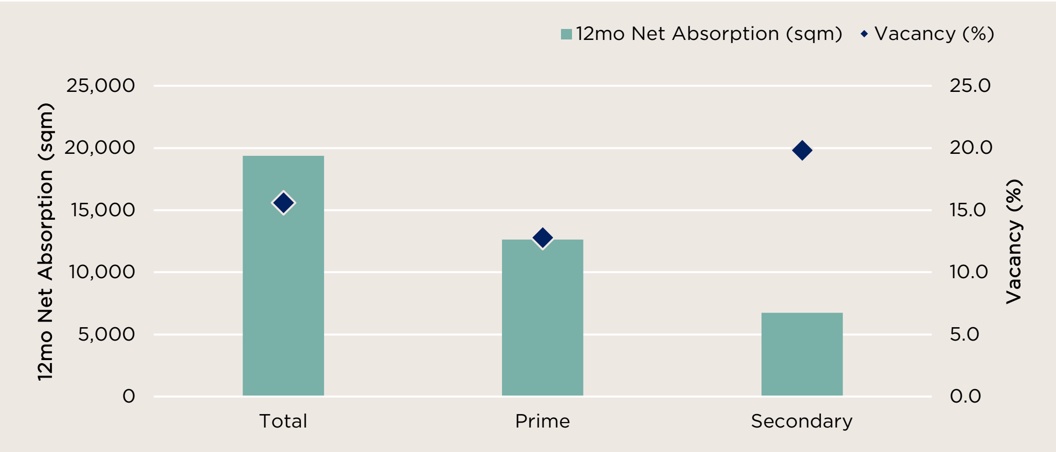
Demand is broad-based across the Perth CBD with A and B grade assets also seeing solid net absorption. Despite positive demand, A grade vacancy increased to 16.7% in January, up from 16.6% in July 2022, with c.8,600sqm of net supply more than offsetting c.6,700sqm of positive net absorption. B grade vacancy fell from 23.2% in July 2022 to 20.9% in January, with six-month net absorption reaching c.7,900sqm.

2023 supply to place upward pressure on vacancy
In 2023, c.97,800sqm of new and refurbished supply is expected to be added to Perth's CBD office market. Three new office developments are due to be completed in 2023, adding 77,500sqm of prime grade office space to supply. This includes the recently completed One The Esplanade in Perth's Elizabeth Quay, which reached practical completion in Q1 2023. The development will feature Chevron as the anchor tenant.

Westralia Square 2 is currently 55% pre-committed and will add 9,500sqm of office space in Q2 2023 when it reaches practical completion, while AAIG's Capital Square Tower 3 currently has no pre-commitments and will add 16,000sqm of space (including a small serviced apartments component) in the second half 2023.

Brookfield and Cbus Property have recently struck a JV to develop Nine The Esplanade in Perth's Elizabeth Quay into a 19-level office development, with service retail on the ground floor. The office tower is due to be completed in Q1 2025 and will feature over 33,000sqm of premium grade office space and large floor plates averaging 1,870sqm. The development is approximately 30% pre-committed with EY, Multiplex and Hub committing to the tower.

Positive net absorption across all grades
12 month net absorption (sqm) and vacancy rate by grade (%)



Source Savills Research / Property Council of Australia

Leasing market

Strong rental growth across prime and secondary assets, driven by sustained demand for office space, inflation, and declining incentives

+3.0% vs +4.8%
Prime vs secondary net face rental growth, year to Q1 2023

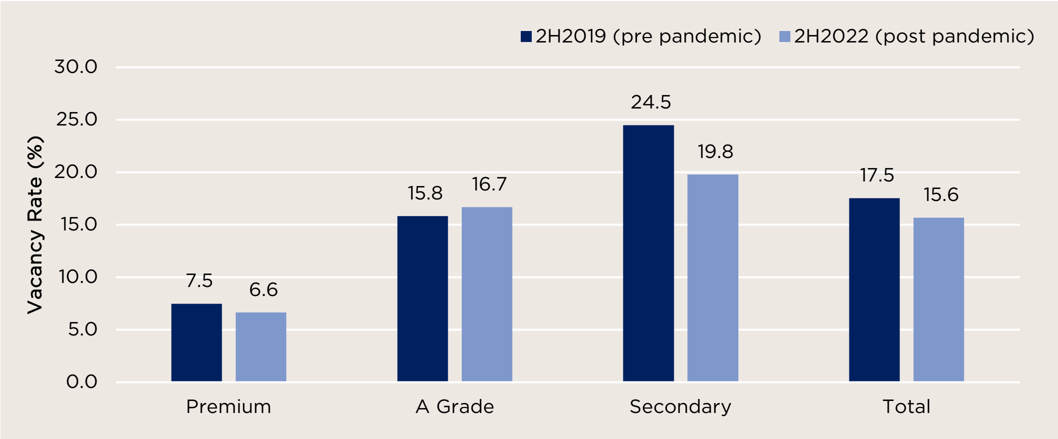
+8.1% vs +11.0%
Prime vs secondary net effective rental growth, year to Q1 2023

+86,938sqm
Increase in total market net absorption in two years to January 2023

15.6% vs 17.5%
Total CBD vacancy rate is 1.9 percentage points lower than the pre-pandemic (Jan 2020) vacancy

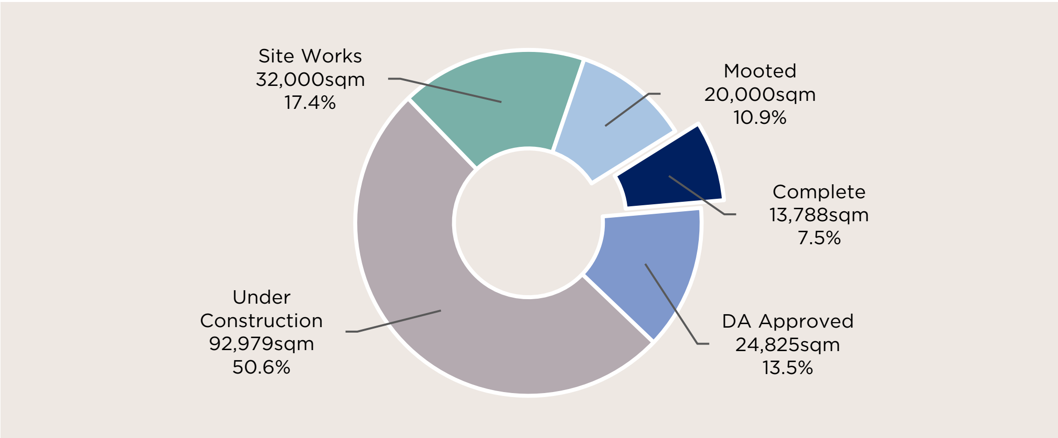
6.6% vs 15.6%
Premium CBD vacancy rate is 9.0 percentage points lower than the overall CBD vacancy rate

Vacancy remains below pre-pandemic levels
Pre and post pandemic vacancy rate by grade (%)



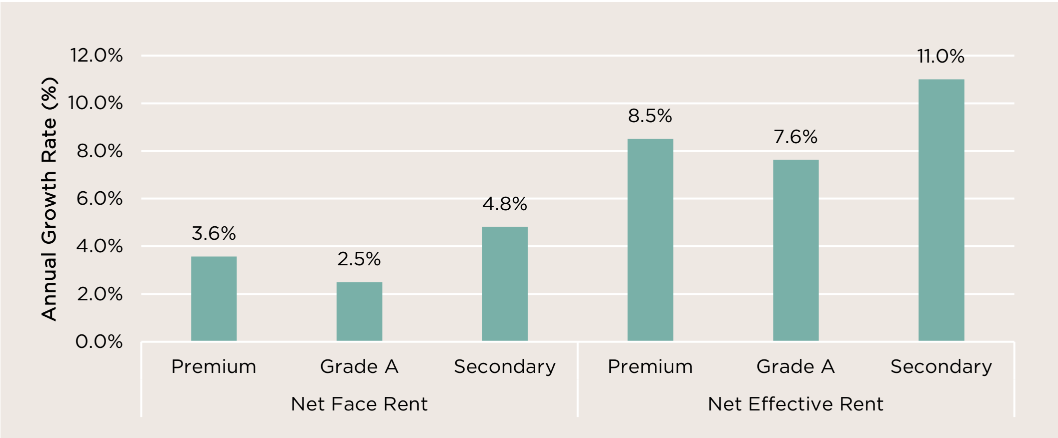
Source Savills Research / Property Council of Australia

By the end of 2023, 5% of CBD supply is scheduled for completion
Forecasted supply by development stage (sqm)



Source Savills Research / Property Council of Australia

Strength in secondary rental growth
Annual rental growth by grade (%)



Source Savills Research

HIGHLIGHTS

Sustained occupier demand and high inflation driving face rents higher

Strength in the state's labour market, demand for prime office space, and high inflation has driven premium grade face rents +3.6% y/y to average $725/sqm, while A grade rents have increased by +2.5% y/y to $615/sqm. B grade face rents increased +4.8% y/y to $435/sqm. The widening gap between premium and A grade face rents demonstrate the resilience of the premium grade asset class in the CBD office market.

Falling incentives boosting effective rental growth

Amid, the strength in the prime office leasing market in the CBD, incentives appear to have peaked with premium grade incentives holding at 45.0%, while A and B grade incentives have tightened to 47.5% and 50.0%. Declining incentives, paired with the face rental growth the market is seeing, has resulted in net effective rents increasing across all building grades.

Premium grade effective rents have increased +8.5% y/y to $399/sqm, while A grade effective rents have increased by +7.6% y/y to $323/sqm. B grade effective rents experienced the largest growth over the quarter and year increasing by +11.0% to $218/sqm.

Investment activity mostly on hold

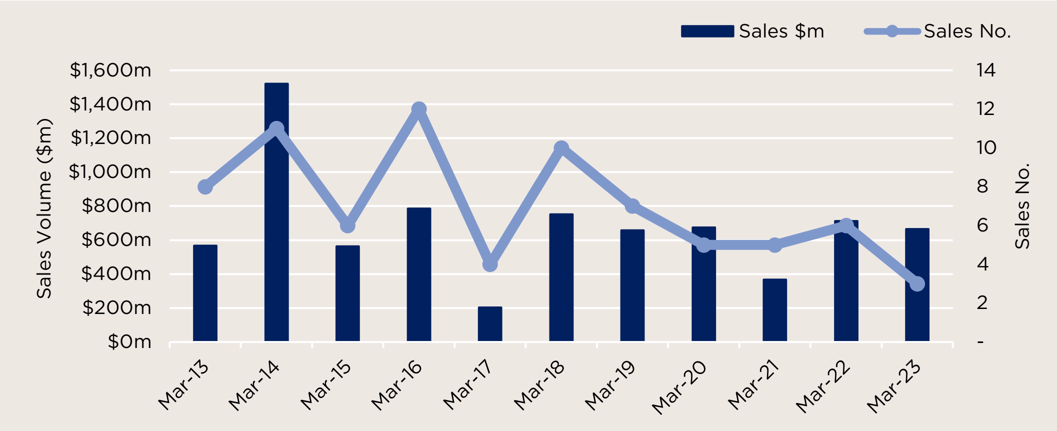
Uncertain interest rate outlook weighs on investment activity
Interest rates have increased sharply, with the RBA raising the cash rate by 375bps over 12 meetings, the fastest tightening of the monetary policy in a generation. This has seen investor confidence dampen due to the significant increase in all-in cost of debt and uncertainty around the interest rate outlook. This has weighed on investment activity and led to a 'wait and see' approach from investors.

There were no transactions in the Perth CBD in Q1. In annual terms (year to March 2023), c.$665 million in transaction volumes were recorded, representing a 7% fall in sales volumes and 50% fall in assets traded compared to the previous year. Although annual transaction volumes have declined year-on-year, volumes remain 8% above the pre-pandemic average of c.$615 million.

Domestic capital remains most active
Domestic capital remains the most active in the CBD market with acquisitions for domestic investors accounting for all of investment activity. The lack of offshore investment activity over the past year is unusual historically – offshore capital has accounted for 38% of investment volume on average over the past five years, and 33% on average over the past 10 years. Institutional investors were responsible for 85% (c.$563 million) of total volumes in 12-months to March 2023.

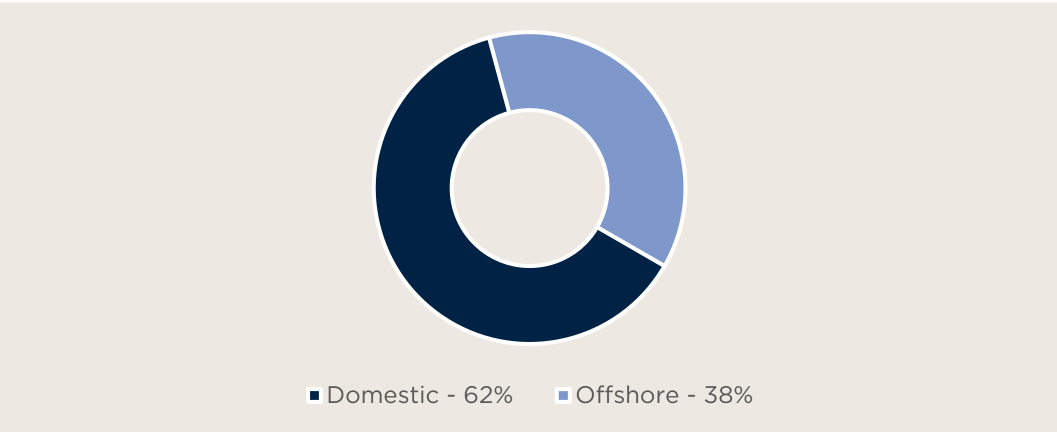
Yields softening on higher interest rates and weaker investor sentiment
Office yields are pushing out as buyer and seller expecations diverge, reflecting the rapid increase in interest rates and debt costs. However, the magnitude of yield softening is difficult to quantify given the lack of current lack of investment activity.

Transaction volumes remain above pre-pandemic average
Perth CBD office sales volumes v number of sales



Source Savills Research

Domestic capital remains the most active in the CBD
Five-year average buyer composition, domestic and offshore (%)



Source Savills Research

Investment market
Higher interest rates lead to slowdown in investment activity and drive office yields higher

-7%
Fall in transaction volumes, year to Q1 2023

-50%
Fall in assets traded, year to Q1 2023

c.$665 million
worth of assets were traded, year to Q1 2023

Outlook

WA's economy to continue to perform strongly

In the short term, the Australian economy is expected to slow to reflect the impact of higher interest rates. However, Savills expects WA's economy to continue to perform strongly, boosted by China's reopening and long-term tailwinds from renewable energy, LNG, and demographics.

Demand for office space should remain resilient, with the state having more exposure to the mining and engineering sectors, and less reliance on sectors that are reducing office space requirements. Leasing activity is expected to remain solid in the near-term, while the state continues to experience strong economic, employment, and population growth.

Savills expects there to be some upward pressure on vacancy in 2023, with an expected c.97,800sqm of new and refurbished office supply to come online. Perth's supply pipeline is limited following the completion of One the Esplanade, which will help vacancy recover from 2024 onwards. However, the potential development of Lot 4 Elizabeth Quay would add c.70,000sqm of office space that could place upward pressure on vacancy and dampen occupier market conditions if completed.

Face rental growth is expected to continue to be solid in the near to medium term. Incentives will remain high due to the amount of supply that is expected to be completed in 2023.

Transaction volumes are expected to recover in the second half of 2023 when the interest rate outlook becomes clearer. Office property yields have softened materially, and this is expected to translate into lower capital values in the coming months as buyer and vendor expectations begin to align.

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