RESEARCH

Knight Frank

SYDNEY CBD

OFFICE MARKET OVERVIEW SEPTEMBER 2015

HIGHLIGHTS

Assets remain keenly contested amongst a broad depth of buyers, underpinning further yield firming, albeit more pronounced amongst secondary assets in response to greater risk appetite.

The recovery in tenant demand has continued with annual net absorption reaching its highest level since 2007. This has resulted in the early stages of moderating incentives and improving rental growth.

The onset of the new supply during the next 18 months will see a short term rise in vacancy that is expected to unwind in 2017 and 2018 when net supply is forecast to turn negative.

KEY FINDINGS

CBD vacancy rate fell from 8.4% to 6.3% in the 12 months to July 2015 following annual net absorption tracking at twice the long run average.

Some modest falls in incentives have boosted effective rental growth with annual prime gross effective rents increasing to 4.9% as at July (7.1% for secondary).

2015 YTD commercial sales amount to a record $4.93bn, however the number of transactions is down on last year with offerings more limited.

The IPG portfolio sale confirmed further compression amongst prime assets, however 65bps of secondary firming in H1 2015 has seen some narrowing in the prime to secondary yield spread.

NICK HOSKINS
Director—NSW Research

SUPPLY & DEVELOPMENT

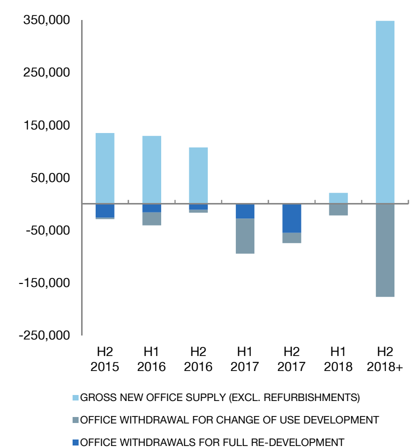
Supply volumes to the Sydney CBD have been extremely soft since the beginning of 2014, with the past 18 months recording total net supply of only 5,485m². This benign trend was evident in the first half of 2015 with gross supply of only 23,633m², equivalent to 30% of the historical average for gross supply. This consisted of 15,500m² of refurbished tenant backfill and the final 8,133m² of A-grade refurbished space at Deco, 155 Clarence St, the St Hilliers redevelopment of the old Red Cross HQ (note total office NLA is 11,925m², however 3,792m² was counted as completed in H2 2014).

However, the supply cycle is set to increase materially over the next 18 months with net supply of 244,711m² anticipated. During this period, completions of new buildings (ie. excluding refurbs) is forecast to measure 371,406m². Major projects during this period include 5 Martin Place (31,280m² office NLA), 20 Martin Place (15,920m²), 333 George St (12,500m²), 200 George St (38,676m²) and the three Barangaroo Towers (266,550m²). While these new developments have a combined pre-commitment level of 64.5%, the resulting backfill is anticipated to see the vacancy rate increase to between 8.5% and 9.0% by the end of 2016. It is noted that some divergence between grades is expected given the bulk of new supply comprises prime stock, with the prime vacancy rate forecast to approach 10% during this period.

However, this is expected to be a cyclical peak in the vacancy rate with the total vacancy rate forecast to reduce to around 6.0% by the end of 2017/early 2018. This outlook is underpinned by an absent period for new office development completions, above average stock withdrawals and a continuation of positive demand, albeit in line with historical trend levels. The withdrawals outlook is partly driven by withdrawals for full office re-developments, but also for some change of use re-developments, predominantly as residential or hotel conversions. To quantify, it is forecast that in the next three years, 136,498m² of office stock will be withdrawn for full office redevelopments, equivalent to 2.75% of stock, while 141,441m² will be withdrawn for change of use developments, equivalent to 2.85% of stock. From mid-2018 a further 175,403m² of office stock is earmarked for potential change of use conversion, equivalent to 3.50% of stock

Looking further ahead to when the next wave of supply starts reaching completion, there is approximately 348,000m² of projects either mooted or in the early planning stages that could potentially complete from the around 2019 onwards. While the timing for these projects remains uncertain, it is unlikely that all these projects will complete concurrently. Nevertheless it indicates that an uptick in the vacancy rate is likely in 2019 and 2020.

FIGURE 1
Permanent Withdrawals vs Supply
Sydney CBD (m² office NLA)



Source: Knight Frank Research/PCA

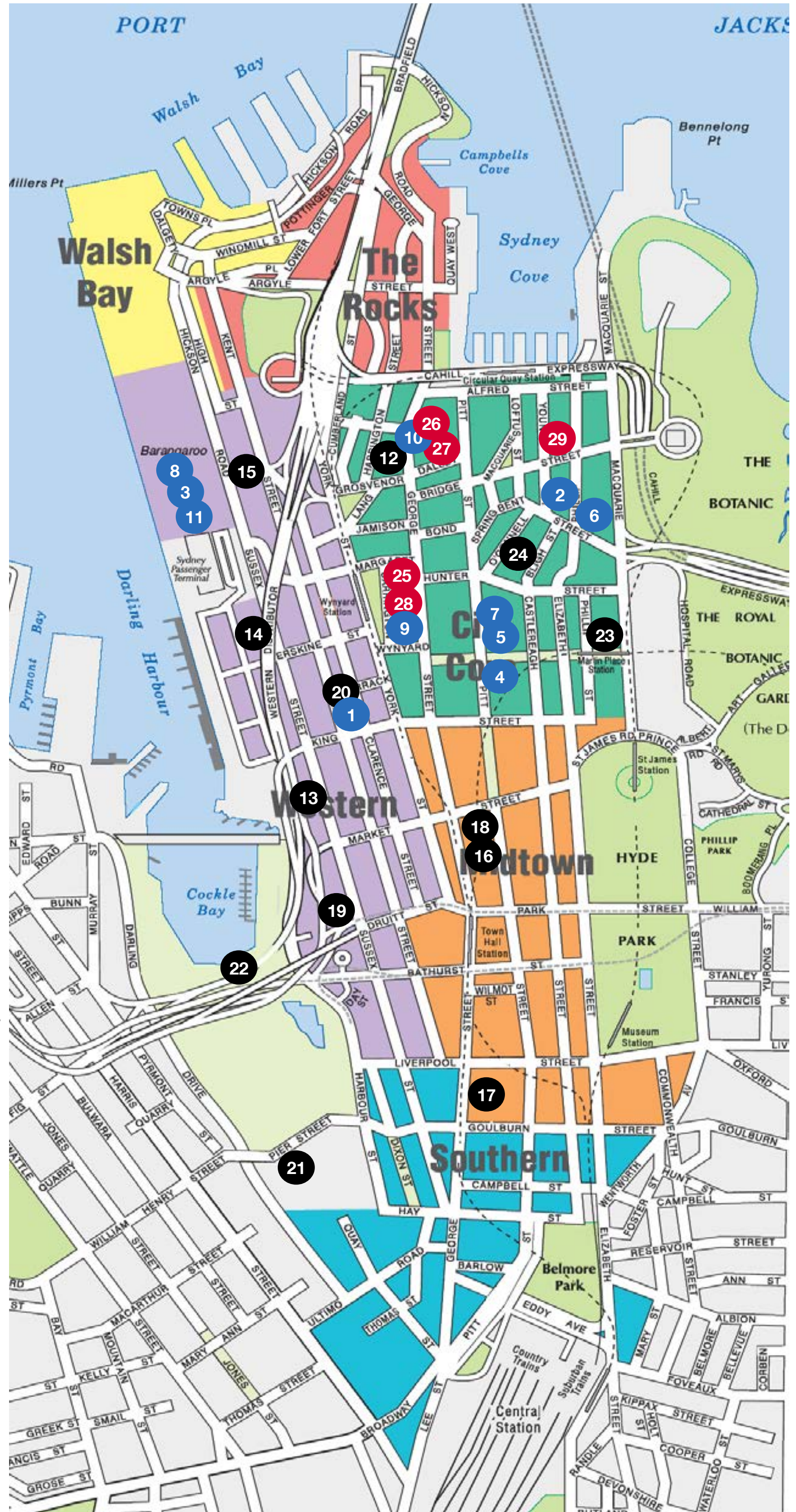
TABLE 1
Sydney CBD Office Market Indicators as at July 2015

Grade	Total Stock (m²)	Vacancy Rate (%)	Annual Net Absorption (m²)	Annual Net Additions (m²)	Average Gross Face Rent ($/m²)	Average Incentive (%)	Average Core Market Yield (%)
Prime	2,640,053	6.26	104,062	31,227	775 -1,100	29.0 - 30.0	5.25 - 6.50
Secondary	2,324,138	6.30	10,622	-19,224	590 - 725	28.0 - 29.0	6.50 - 7.50
Total	**4,964,191**	**6.28**	**114,684**	**12,003**			

Source: Knight Frank Research/PCA

MAJOR OFFICE SUPPLY

1. Deco, 155 Clarence St# - 11,925m² [Tyro Payments/Havas]
St Hilliers* - Q4 2014 & Q1 2015 - 86% committed
2. GMT, 1 Farrer Pl# (ex GPNSW) - 26,500m² [Minter Ellison]
DEXUS/GPT/APPF - Q2 & Q4 2015 - 58% committed
3. Barangaroo T2 - 88,200m² [Westpac/Gilbert + Tobin]
LLITST - Q3 2015 - 79% committed
4. 5 Martin Place - 31,280m² [Ashurst/Challenger/PIMCO]
DEXUS/Cbus - Q3 2015 - 82% committed
5. 20 Martin Pl# - 15,920m² [Apple/Regus]
Pembroke Real Estate - Q3 2015 - ~55% committed
6. Aurora Pl, 88 Phillip St# (ex Minter Ellison) - 12,896m²
NPS (Korea) - Q3 2015
7. 80 Pitt St# - 11,400m²
Yorkban P/L - Q4 2015
8. Barangaroo T3 - 77,800m² [KPMG/Lend Lease]
LLITST - Q1 2016 - 76% committed
9. 333 George St - 12,500m²
Charter Hall Core Plus Office Fund - Q2 2016
10. 200 George St - 38,676m² [EY]
Mirvac/AMP - Q3 2016 - 81% committed
11. Barangaroo T1 - 101,500m² [PWC/HSBC]
LLOneITST - Q4 2016 - 48% committed
12. Grosvenor Place, 225 George St# (ex Ashurst) - 10,000m²
DEXUS/CIC/CSC - H1 2016
13. One Wharf Lane, 161 Sussex St - 6,500m²
M&L Hospitality - Aug 2016
14. 10 Shelley St# (ex KPMG) - 27,500m²
DEXUS/Brookfield - H2 2016 - 100% committed
15. 30 The Bond, 30 Hickson Rd# (ex Lend Lease) - 16,000m²
DEXUS - H2 2016
16. 255 Pitt St# (ex Challenger, Apple) - 15,247m²
ISPT Core Fund - H1 2017
17. 680 George St# (ex EY) - 28,800m²
Brookfield/Arcadia - 2017
18. 55 Market St# (ex WBC) - 15,776m²
CIC - 2017
19. 201 Sussex St, DPII# (ex PWC) - 33,000m² [IAG]
GPT (GWOF)/AMP (ACPF)/Brookfield - 2018 - 100% comm.
20. 151 Clarence St - 21,000m² [Arup]
Investa - 2018 - 28% committed
21. SICEEP The Haymarket - 22,000m²
Lend Lease - 2018+
22. The Ribbon, 1 Wheat Rd - 38,000m²
Markham/Grocon/SHFA - 2018+
23. 60 Martin Place - 40,000m²
Investa/Gwynvill Properties - 2019
24. 33 Bligh St - 26,000m²
Energy Aust./Investa - 2019+
25. 275 George St - ~7,000m²
LaSalle Investment Management - 2019+
26. CQ Tower, 182 George & 33 Pitt Sts - 60,000m²
Cbus - 2020+
27. 55 Pitt St - 30,000m²+
Mirvac - 2020+
28. Wynyard Place - 65,000m²
Brookfield - 2020+
29. Quay Quarter Sydney - 89,000m²
AMP - 2020+ - Concept Plan Approval



Source of Map: Knight Frank

- Under Construction/Complete
- DA Approved / Confirmed / Site Works
- Mooted / Early Feasibility

NB. Dates are Knight Frank Research estimates

Includes select CBD major office supply (NLA quoted)

Major tenant precommitment in [brackets] next to NLA

Major refurbishment/backfill

* sale contract exchanged for purchase by Eureka Funds Management obo Union Investment

LLITST refers Lend Lease International Towers Sydney Trust (50% CPPIB, 25% APPF Commercial, 15% Lend Lease, 10% APG)

LLOneITST refers Lend Lease One International Towers Sydney Trust (37.5% Lend Lease, 37.5% QIA, 25% APPF Commercial)

TENANT DEMAND & RENTS

The transition of Australia's economic growth drivers away from mining investment towards the more interest rate sensitive parts of the economy such as housing and consumption has been a strong positive for labour growth in NSW. In the 12 months to July, 117,900 new jobs were created in NSW, representing 3.3% annual growth, the strongest rate since 2008. The service sectors have been the predominant source of growth with 61% of the new jobs created over the past year stemming from either the Professional Services, Administration or Technology sectors (ABS).

As a result of these dynamics, tenant demand for CBD office space has picked up substantially over the past year. In the 12 months to July 2015, CBD net absorption measured 114,684m², equivalent to 2.5% of total stock. This was the largest annual gain since 2007 and resulted in the vacancy rate falling to a six-year low of 6.3%. Over the past two years, the prime vacancy rate has, on average, been 137bps higher than the secondary rate. However this differential has now closed, with the vacancy rate for both prime and secondary converging at 6.3%. Nevertheless, both supply and withdrawal factors are expected to see the prime rate again move above the secondary rate over the next two years (refer 'Supply' section page 3).

Since the beginning of 2014, sub-lease vacancy has approximately halved to 0.4%, equivalent to 18,052m². This is substantially less than the historical average of 1.1% and results in Sydney being the only CBD market with a sub-lease vacancy rate below its historic rate. However, it is noted that Knight Frank data shows approximately 15,000m² of additional sub-lease space being actively marketed, but not yet physically vacant. The sub-lease data also indicates that despite the strong headline absorption figures, demand has not been broad based across all sectors. Of the sub-lease space tracked by Knight Frank, 55% extends from legal firms with six such firms sub-leasing in excess of 1,000m². The Finance and Insurance sector accounts for only 14% of the total, although it is noted that this does not include some recent sub-lease deals of space amounting to approximately 10,000m² including Rabobank, State Street and QBE, albeit with the latter stemming from a relocation as opposed to a vanilla contraction per se.

One of the key sources of occupancy growth has been the technology sector. The majority of new deals have either entailed a large proportion of expansionary space or new space for tenants who have not previously been CBD tenants. Examples included in the H1 2015 absorption data include new space for Intuit (2,100m²) and expansion space for both Twitter (1,800m²) and LinkedIn (1,747m²). Further technology leasing deals have been executed that will progressively crystallise into office absorption data in the forthcoming 12 months including Amazon, Apple and Stone and Chalk (refer Table 2 for lease details). Active briefs in the market from users including Atlassian, Dropbox and Google indicate further net absorption will stem from this sector.

There continues to be a steady flow of non-CBD tenants relocating to the CBD, which has directly added to net absorption. A number of these moves have partly been motivated by large floor plates being more readily available in the CBD, which is largely a result of higher supply levels over the past few years as shown by CBD stock levels increasing by 5.0% since the beginning of 2010 compared to only 2.0% for non-CBD markets. Incentive levels at historical highs have also been an attraction. Moves in excess of 1,000m² in H1 2015 included BAE Systems, UXC, Havas and Employsure. A number of briefs in the market imply this trend will continue to supplement demand over the next year, particularly following several instances of owner occupier sales in suburban locations in order to facilitate consolidation into the CBD.

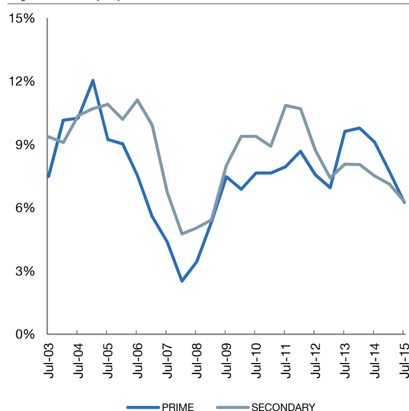
With demand conditions becoming more conducive to occupancy growth, the momentum in net absorption is expected to be sustained in the next two years in the form of above average tenancy growth. The depreciation of the Australian dollar is also expected to assist demand with the benefit to be most acute in sectors such as international education, professional services and wealth management. The general improvement in the US economy is also proving a positive indicator for CBD demand, an indicator that has shown a strong historical relationship to absorption rates (refer Figure 3).

As a result, annual net absorption in FY16

FIGURE 2

Sydney CBD Vacancy Rate

By Grade (%)

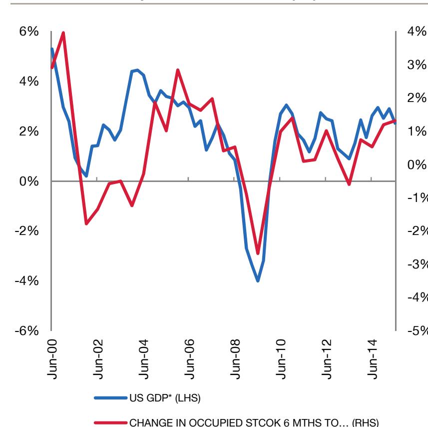


Source: Knight Frank Research/PCA

FIGURE 3

Sydney Demand & the US Economy

CBD Net absorption vs US GDP (%)

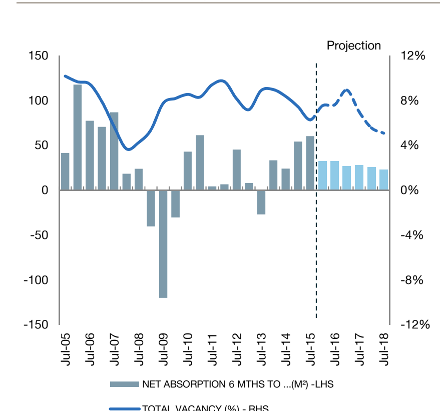


Source: Knight Frank Research/PCA/US BEA
*12 month rolling average of quarterly annual rates

FIGURE 4

CBD Net Absorption & Vacancy

per six month period (000's m², %)



Source: Knight Frank Research/PCA

and FY17 is forecast to average 1.3% of stock, before reverting to the long run average of 0.9% in the forecast years thereafter. While it is noted that these rates of growth are moderately below headline employment figures, this is representative of the impact of improved floor plate efficiency that is being derived from new developments.

Rental Levels

The fall in the vacancy rate in conjunction with the pick up in office demand has resulted in a relatively strong 12 months for rental growth. As at July, Prime face rents had increased to $961/m² gross ($801/m² net), equating to annual growth of 2.8%. The majority of this growth has extended from A-grade assets with Premium growth being more limited. After gradually increasing since 2011, prime incentives during the first half of 2015 have shown the first signs of a cyclical reduction, having moderated to an average of 29% to 30% compared to 30% to 32% as at January 2015. While this underpinned an increase in annual growth of prime gross effective rents to 4.9% as at July, it is noted that incentives remain asset specific depending upon asset vacancy issues.

Rental increases in the secondary market have been tracking above the prime rate with annual gross face growth of 4.3% as at July and effective growth measuring 7.1%. Average secondary gross face rents as at July measure $661/m² ($531/m² net) with gross incentives moderating to 28%. This secondary outperformance has resulted in a narrowing in the rental differential across the various grades from Premium to B-grade, a trend that has been present for the past two years.

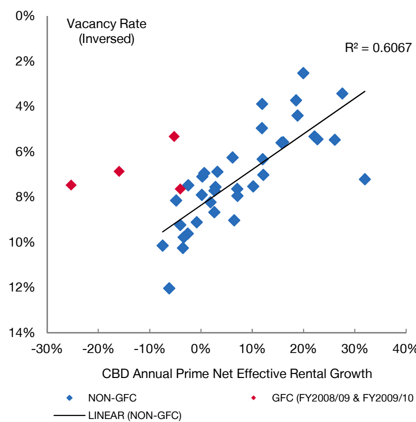
It is anticipated that a relatively positive period for CBD rental growth will be maintained over the next two years. With net absorption in the CBD expected to continue outperforming other capital city markets in the medium term, prime face rental growth is forecast to measure 4.0% in FY16. In FY17, the rate of face rental growth is expected to moderate to 2.0% as the market digests short term supply. However, with the vacancy rate to start reducing in FY18 to almost 6%, there is scope for a period of growth above CPI thereafter.

Traditionally, effective rental growth has been positive when the CBD vacancy rate is below 8% (refer Figure 5). As a result, and in view of the market progressing through the early stages of a recovery in demand, a gradual fall in prime incentives over the next 12 months to an average of 28% is anticipated. However, the supply induced, transient spike in the vacancy rate is likely to constrain the rate of incentive reduction in FY17 before an average level of 25% is reached by the end of FY18.

FIGURE 5

Rents and Vacancy - 1995 to 2015

Net Effective Growth vs Prime Vacancy Rate (%)

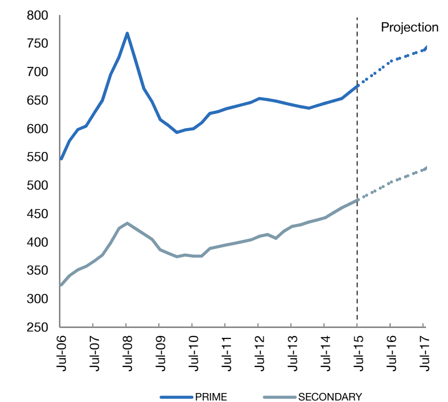


Source: Knight Frank Research/PCA

FIGURE 6

Average Gross Effective Rents

Sydney CBD ($/m²)



Source: Knight Frank Research

TABLE 2

Recent Leasing Activity Sydney CBD

Address	Precinct	NLA (m²)	Term (yrs)	Lease Type	Tenant	Sector	Start Date
T1 Barangaroo	Western	10,400	U/D	Precomm	Marsh & McLennan	Finance & Insurance	H2 2016
T1 Barangaroo	Western	2,300	U/D	Precomm	Servcorp	Business Services	H2 2016
200 George St	Core	5,680	10	Precomm	Mirvac	Real Estate	Mid-16
2 Park St	Midtown	c.10,000	U/D	New	Amazon	TMT	H1 2016
60 Margaret St	Core	c.9,000	U/D	New	ING	Finance & Insurance	2016
20 Martin Pl	Core	5,600*	U/D	Precomm	Apple	TMT	H2 2015
20 Martin Pl	Core	1,600	U/D	Precomm	Regus	Business Services	H2 2015
60 Margaret St	Core	1,306	5	New	Injury Treatment	Healthcare	Aug-15
345 George St	Core	6,727	8	New	Employers Mutual	Business Services	Jul-15
201 Kent St	Western	1,741	5	New	AussieCommerce	TMT	Jul-15
201 Elizabeth St	Core	1,740	5	New	Study Group	Education	Jul-15
201 Kent St	Western	3,023	5	New	Credit Corp	Finance & Insurance	Jun-15
50 Bridge St	Core	2,360	3	New	Stone & Chalk	TMT	Jun-15
201 Kent St	Western	1,741	5	New	Deals.com.au	TMT	Jun-15
123 Pitt St	Core	1,682	10	New	Knight Frank	Real Estate	Jun-15

Source: Knight Frank Research TMT refers Technology Media & Telecommunications U/D refers undisclosed *excludes option over one floor of expansion space

INVESTMENT ACTIVITY & YIELDS

The heightened amount of capital seeking opportunities in the Sydney CBD office market has continued in 2015, albeit with the number of offerings relatively limited at present. So far in 2015, deal volumes in value terms have amounted to $4.93 billion, which already exceeds the previous high of $4.64 billion that was recorded in 2014. However, this amount is materially boosted by two significantly large transactions, namely the purchase by China Investment Corporation (CIC) of the Investa Property Group (IPG) portfolio and the sale of Tower 1 at Barangaroo into a new wholesale fund for circa $2 billion. However, deal volumes as measured by the number of transactions recorded indicates a contrasting story. Year to date transactions ($10m+) measure 14, of which 10 occurred during the first half of the year. These figures are tracking well below the 39 transactions recorded in 2014 and are indicative of the lack of opportunities in the market despite the presence of a deep pool of unsatisfied capital.

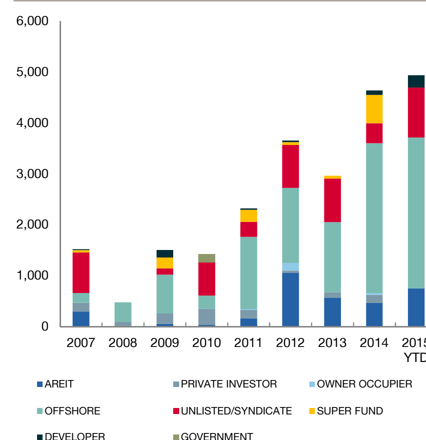
The result of capital inflow and limited buying opportunities has been continued downward pressure on yields with both prime and secondary assets steadily compressing further below the 10 year average, a trend that has been evident for the past 18 and 12 months respectively (refer Figure 6). As at July 2015, average prime core market yields ranged from 5.25% to 6.50%, which represents 30bps of firming in 2015 and results in average yields being 70bps firmer than the 10 year average.

The offering of the IPG assets by Morgan Stanley attracted interest from a number of investors including offshore groups, as well as a number of local institutions, predominantly with offshore capital partners. The portfolio sale reflected a

FIGURE 5

Sydney CBD Sales $10 million+

By Purchaser Type ($m)



Source: Knight Frank Research

weighted average core market yield of 5.60%, however it is estimated that the premium assets within the portfolio reflected a tighter yield in the range of

TABLE 3

Recent Sales Activity Sydney CBD

Address	Price ($ mil)	Core Mkt Yield (%)	NLA (m²)	$/m² NLA	WALE (yrs)	Vendor	Purchaser	Sale Date
155 Clarence St»	~140.00	6.07»	12,500	~11,200	~5.0	St Hilliers	Eureka Funds Mgt obo Union Investment	Aug-15
Portfolio Sale›	2,450.0	5.60	N/A	N/A	N/A	Investa Property Trust (Morgan Stanley)	China Investment Corporation (CIC)	Jul-15
T1 Barangaroo	~2,000#	c.5.75	~107,000	18,692	TBC	Lend Lease	LLOneITST	Jun-15
210 & 220 George St	97.27	6.90	13,639	7,132	1.7	Mirvac	Anton Capital obo Goldman Sachs	Jun-15
4-6 Bligh Street	68.00	6.80	9,964	6,825	3.0	Cromwell Property	RECAP IV*	Jul-15
36 Carrington St	~20.00	5.11^	2,297	8,707	1.8	Private	Brookfield	Apr-15
320 Pitt St	200.00	7.70	29,159	6,859	5.0	Equity Commonwealth Trust	Propertylink	Mar-15
309 George St	112.30	6.23	9,044	12,417	4.0	AM Alpha/Abacus (75%/25% JV)	HK Realway	Mar-15
130 Elizabeth St‡	~121.00	N/A	10,308	~11,641	0.9	Cbus Property	Ecove/Aoyuan	Feb-15
175 Phillip St‡	~45.00	N/A	8,630	~5,214	U/D	Sydney University	Galileo/ISPT	Feb-15
35 Clarence St	137.10	6.85	13,970	9,015	4.0	AMP (obo SunSuper)	Challenger Life	Jan-15
19-31 Pitt St‡	73.00	N/A	5,518	13,229	Conf.	AXF Group & Ever Bright Group	Dalian Wanda Group	Jan-15
92 Pitt St	30.65	7.40	4,621	6,633	2.2	LaSalle Invest. Mgmt	EG Funds Mgmt†	Jan-15

Source: Knight Frank Research

› Nine asset portfolio including six Sydney CBD assets, namely 225 George St (85,511m², 25% share), 400 George St (50,108m², 50% share), 126 Phillip St (42,256m², 25% share), 255 Elizabeth St (28,450m², 100% share), 31 Market St (25,079m², 100% share) and 55 Market St (22,908m², 100% share). Other assets comprised 120 Collins St, Melbourne (64,831m², 50% share), 80 Pacific Highway North Sydney (13,701m², 100% share) and 410 Ann St, Brisbane (20,470m², 100% share).

LLOneITST refers Lend Lease One International Towers Sydney Trust (37.5% Lend Lease, 37.5% QIA, 25% APPF Commercial)

Sale price assumes 100% occupancy with the price to be adjusted for any residual vacancies at completion

* RECAP IV refers Real Estate Capital Asia Partners IV L.P., managed by SC Capital Partners » as reported. Yield is a fully leased initial yield

‡ bought for potential residential redevelopment † on behalf of local private ^ passing initial yield Conf. refers confidential U/D refers undisclosed

5.0% to 5.25%, albeit with precise asset splits confidential to the purchaser. This range is close to the level that premium yields reached at the peak of the previous cycle in 2007. It is worth noting that the IPG portfolio sale represented compression of 90bps since December 2014, however some major leasing transactions in the interim, in addition to a likely portfolio premium, are likely contributors to the apparent firming over and above the organic firming existing in the market.

With regards to the investment in Tower 1 at Barangaroo, Lend Lease have sold 100% of the asset into a new wholesale fund to be known as Lend Lease One International Towers Sydney Trust (refer Table 3 for ownership splits). Tower 1 comprises approximately 101,000m² of commercial NLA and 6,000m² of retail, which implies a capital value of $18,692/m². While the sale reflected an estimated yield of approximately 5.75%, it is understood the sale price assumes 100% occupancy with the price to be adjusted for any residual vacancies at completion.

The average prime range is also supported by the August sale of 155 Clarence St, with the completely redeveloped A-grade office building trading on a reported fully leased initial yield of circa 6.07% with WALE of approximately 5.0 years. The transaction of the older, A-grade 320 Pitt St, however, sold with a core yield of 7.70%, which is above the average prime range, but reflective of some market speculation about the future accommodation requirements of the sole office tenant, Telstra.

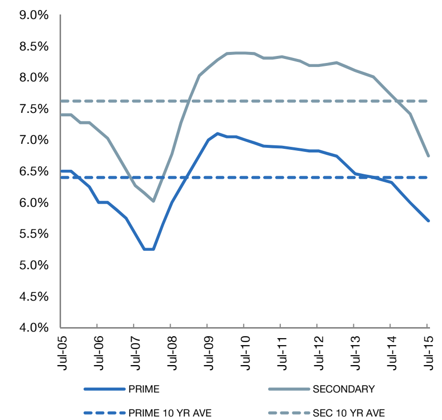
In the secondary market, average core market yields as at July 2015 are estimated to range from 6.50% to 7.50%. With core plus and value add style investments being keenly contested, secondary yield compression has accelerated in 2015, with firming in the first half of 2015 measuring 65bps. Until the end of 2014, prime yields had progressed further through the cycle compared to the secondary market. While this is usual in a compression cycle, it had also been assisted by banks permitting higher leverage on prime assets allowing investors to take advantage of low borrowing rates, as well as the generally longer lease tails on prime assets increasing the time period until rental renewals and, therefore, the funding of incentives.

However the firming recorded in the last six months now sees the secondary market trading at an average yield that is 85bps below the 10 year average as opposed to the 70bps in the prime market. Based on the Knight Frank historic index, the resultant narrowing of the prime to secondary yield spread to 104bps is the tightest spread since 2008. Although this suggests the extent of further compression is becoming more limited, secondary yields still remain 60bps softer compared to the 2007 peak, while the prime to secondary yield spread still remains 25bps wider than the 2007 peak. These comparisons indicate that forthcoming firming is likely to be more pronounced in lower A-grade and secondary stock.

FIGURE 6

Sydney CBD Yields

Core Market Yields - Prime vs Secondary



Source: Knight Frank Research

Outlook

- The steady improvement in CBD tenant demand is anticipated to continue over the next two years. At a macro level, Australia's shifting growth drivers away from mining investment is benefitting NSW, while lower interest rates and an improving US economy have traditionally supported CBD occupancy.
- While this demand is forecast to help digest the short term supply spike, an increase to the vacancy rate is nevertheless forecast. However the subsequent period of negative net supply in 2017 and 2018 will result in this increase unwinding relatively quickly.
- The two year outlook for prime rental growth is relatively positive with 4.0% face growth expected in FY16 before a supply induced moderation to 2.0% in FY17. Effective rental growth should exceed these rates, particularly in FY16 given the early signs of moderating incentives are expected to continue.
- While it is anticipated that transactions over the balance of 2015 will continue to exhibit some yield firming, the progression of cap rates moving further below long run average levels suggests that the bulk of medium term value appreciation will be reliant on the continuation of the rental recovery and subsequent improvement in average rents, particularly if long term interest rates start to rise.
- However, with limited buying opportunities in the prime market, the majority of transaction activity will likely stem from investors targeting non-core or value-add assets. This strategy is expected to be supported by the relative outperformance of secondary rents and an anticipated lower vacancy rate compared to prime during the next two years. This will continue to support secondary pricing, with the prime to secondary yield spread likely to continue narrowing through 2015.

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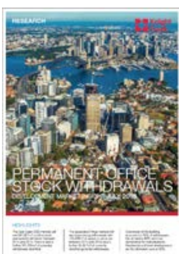
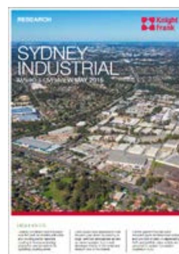

Australian Office Stock Withdrawals - July 2015

Sydney CBD Retail Brief August 2015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RESEARCH

Nick Hoskins
Director – NSW Research
+61 2 9036 6766
Nick.hoskins@au.knightfrank.com

Matt Whitby
Head of Research and Consultancy
+61 2 9036 6616
Matt.whitby@au.knightfrank.com

NSW

Richard Horne
Managing Director, NSW
+61 2 9036 6622
Richard.horne@au.knightfrank.com

CAPITAL MARKETS

James Parry
Head of Institutional Sales, Australia
+61 2 9036 6758
James.parry@au.knightfrank.com

John Bowie Wilson
Head of Commercial Sales
+61 2 9036 6743
John.bowiewilson@au.knightfrank.com

Dominic Ong
Head of Asian Markets
+61 2 9036 6747
Dominic.ong@au.knightfrank.com

OFFICE LEASING

John Preece
Head of Office Agency, Australia
+61 2 9036 6705
John.preece@au.knightfrank.com

Scott Berriman
Director, Office Leasing
+61 2 9036 6745
Scott.berriman@au.knightfrank.com

Jonathan Laverty
Director, Office Leasing
+61 2 9036 6799
Jonathan.laverty@au.knightfrank.com

Kymbal Dunne
Director - Major Projects
+61 2 9036 6801
Kymbal.dunne@au.knightfrank.com

VALUATIONS

David Castles
National Director
+61 2 9036 6648
David.castles@au.knightfrank.com