

- *Strong leasing demand for top class assets*
- *Rental growth hits 4.9% over the year*
- *Yield softening playing out*



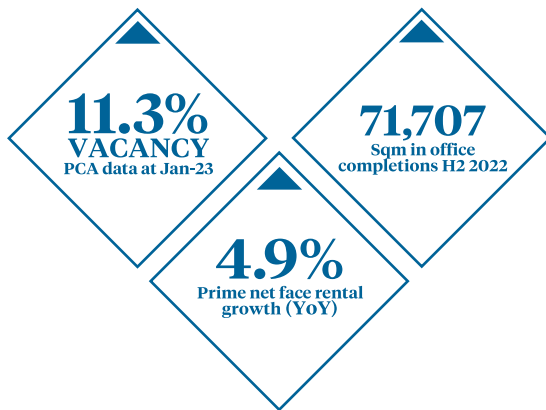
# Sydney CBD Office

**Market Report, February 2023**

[knightfrank.com/research](https://knightfrank.com/research)



# BEST IN CLASS ASSETS OUTPERFORMING



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**“Shifting tenant preferences and solid demand for best-in-class stock have underpinned a return to rental growth”**

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## Key Insights

The labour market remains strong, with historically low unemployment nationally and in Sydney there are high job vacancies across most white-collar industries.

Office space enquiry has been positive and translated into c236,000sqm of lease deals for 2022; driven by professional services and financial services.

With incentives holding firm and a 4.9% increase in face rental growth to average \$1,254/sqm; there has been positive movement in net effective rents with an increase of 2.8% y/y to measure \$753/sqm.

Following 120,000sqm of net supply added to the market in 2022, this year will see development activity limited to boutique size developments and minor refurbishments totalling c40,000sqm.

Increasing funding costs resulted in \$2.4 billion in transaction volumes for 2022, the lowest in a decade.

Prime yields are judged to have softened by 37.5bps since mid last year and will continue to be tested over the first half of 2023.

## Sydney CBD Office Market Indicators – January 2023

| GRADE        | TOTAL STOCK SQM  | VACANCY RATE % | ANNUAL NET ABSORPTION SQM | ANNUAL NET ADDITIONS SQM | AVERAGE NET FACE RENT \$/SQM | AVERAGE INCENTIVE % | EFFECTIVE RENTAL GROWTH %Y-Y (net) | CORE MARKET YIELD %* |
|--------------|------------------|----------------|---------------------------|--------------------------|------------------------------|---------------------|------------------------------------|----------------------|
| Prime        | 3,340,491        | 11.1           | 53,912                    | 155,753                  | 1,254                        | 34                  | 2.8                                | 4.40-5.10            |
| Secondary    | 1,942,705        | 11.7           | -50,210                   | -35,183                  | 903                          | 34                  | -0.4                               | 5.25-5.75            |
| <b>Total</b> | <b>5,283,196</b> | <b>11.3</b>    | <b>3,702</b>              | <b>120,570</b>           |                              |                     |                                    |                      |

Source: Knight Frank Research/PCA \*Core precinct and assuming WALE 5.0 years

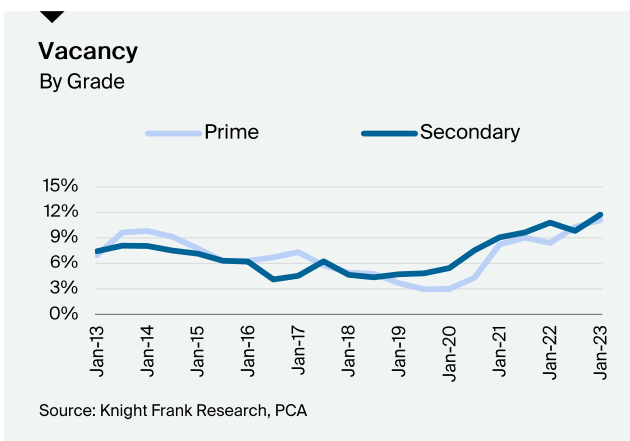
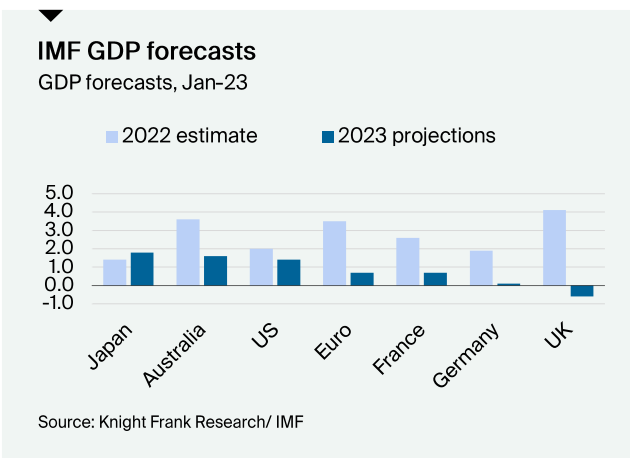
# POSITIVE OCCUPIER DEMAND FOR PRIME SPACE

## Australia remains resilient despite economic conditions playing out globally

Multiple economic indicators point to the strength and resilience of the Australian economy. The labour market remains strong, with historically low unemployment nationally and in Sydney there are high job vacancies across most white-collar industries.

However, the flipside of sustained economic growth and the ongoing legacy of substantial stimulus and supply chain disruption during the pandemic has resulted in persistent inflation, with the headline CPI reading jumping to 7.8% in Q4, the highest level since 1990. This is now weighing on consumer and business sentiment and giving rise to the ongoing cycle of interest rate hikes.

The path of interest rates will be a key influence on market sentiment, and signals that inflation is easing and the hiking cycle is largely complete, will help to restore confidence and liquidity.



## Positive sentiment in leasing market for best in class assets

Last year saw a strong finish to the year in terms of deal volumes with c236,000sqm of deals signed, in line with the five year average. Direct leasing transactions accounted for over 90% of the deal volumes, illustrating a healthy level of occupier activity, but the overall level of take-up was lower than 2021 due to fewer large-scale pre-commitments.

Occupier demand trends over 2022 were driven by financial services and professional services accounting for 25% and 19% respectively of total deal volumes. Tech sector demand slowed down in 2022 accounting for 16% of deal volumes, significantly down on the 37% in 2021. Demand from tech occupiers in 2023 will likely be subdued given the reduction in workforce sizes playing out globally by the major tech giants such as Google and Facebook.

Whilst vacancy edged slightly higher to 11.3% over the year this was brought about by the large influx of new supply, stemming predominately from Quay Quarter Tower and Salesforce Tower. By grade, prime vacancy has increased slightly to 11.1% as at January-23, despite recording positive absorption of 25,476 over the period, the increase in vacancy was supply driven rather than a lack of demand. In the secondary market, vacancy increased to 11.7% up from 9.8%, this was a result of 45,214 sqm of negative net absorption, stemming from the flight to quality trend in the market.

Forecasts suggest that vacancy has likely peaked for the next 12 months and will hold at current levels and whilst there will still be some challenges in the near term, the optimism in the market and active tenant enquiry bodes well for the long term recovery of the Sydney office market.





# NEW DEVELOPMENT STOCK SHINES

## New development resetting the benchmark of premium grade stock in the CBD

There has been a significant influx of new and refurbished stock, with over 120,000sqm of net additions added to the market over the last 12 months.

The flight to quality trend and focus on safety and wellbeing for occupiers has been one of the driving forces behind the new developments and refurbishments in the Sydney CBD office market.

In the six months to January 2023, office completions totalled 71,707 sqm, taking the total office stock base to 5,283,196 sqm. New supply was led by the practical completion of Salesforce Tower (55,207 sqm), which has achieved 85% occupancy; including major tenants Salesforce, Wellington Management, Tourism Australia, Greenhouse and the Executive Centre. Additionally, Poly Group has completed its development at 210 George Street (16,500sqm), Transurban secured c2,250sqm and will relocate from Chifley Square this year along with British American Tobacco company securing 2,500sqm.

In terms of refurbished stock, there were two refurbishments completed over 2022, they include 143 Macquarie Street (3,600sqm) and part of 477 Pitt Street (6,700sqm). A further 19,000 sqm of refurbished stock will likely come to back to market over the next six months from 255 George Street owned by Mirvac (MWOFF). The building was vacated by NAB relocating to Brookfield Place, leaving large backfill space which has since predominately been secured by BOQ, ATO and Eftpos.

## Development activity to ease in 2023

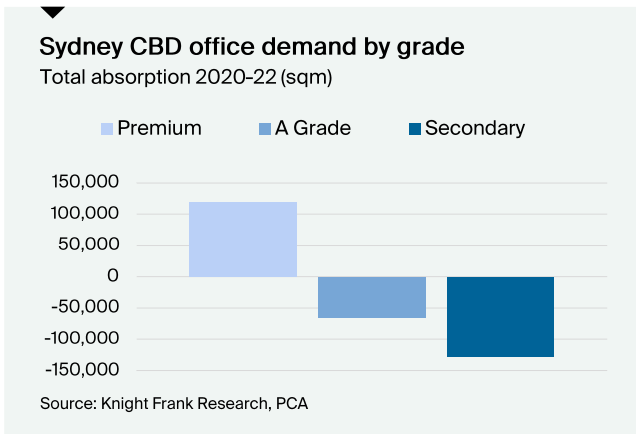
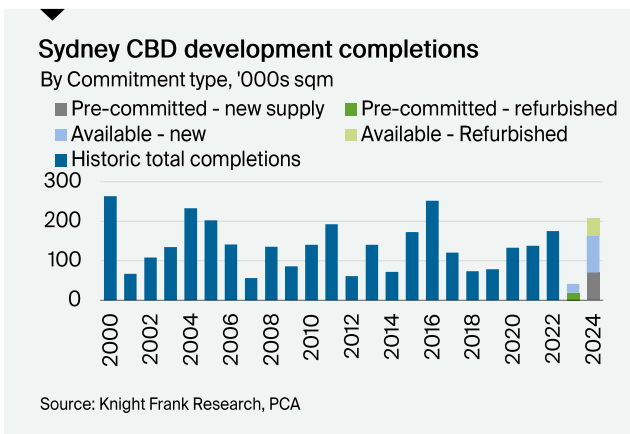
Whilst the delivery of new stock in 2022 was substantially pre-committed, it has resulted in some large backfill vacancies which will arise in the market. Major tenant movements that will cause the rise in backfill include Deloitte vacating Grosvenor Place (27,800 sqm) moving into QQT along with Corrs Chambers from 8 Chifley and Salesforce vacating Darling Park Tower 3 into Salesforce Tower.

Additionally, a number of buildings are set to be withdrawn in 2023 to make way for the Hunter Street Metro station, c42,000 sqm is forecast to be permanently withdrawn which may aid vacancy levels as tenants will be displaced and need to seek new office space.

The delivery of new development stock in 2023 will be limited to the boutique size developments at 121 Castlereagh Street (11,500sqm) and 32-36 York Street (8,366sqm). The subdued level of development activity this year will allow for current supply levels to be absorbed by the market.

Looking further ahead the next wave of new premium supply is expected to come to market from 2024 onwards and will predominantly come from the Over Station Developments (OSD) at Metro Martin North Tower (75,000sqm), Metro Martin South Tower (30,000sqm) and Parkline Place OSD (49,120sqm) all due by the end of 2024.

Beyond the OSD developments is the Tech Central precinct, in particular Atlassian Tower, who will anchor a 75,000sqm tower which will drive the much needed organic expansion of the CBD to its Southern boundaries.



# MAJOR OFFICE SUPPLY

## MAJOR REFURBISHMENTS

- 1 255 GEORGE STREET—19,000 SQM  
MIRVAC – H1 2023
- 2 33 ALFRED STREET—32,615 SQM  
MIRVAC— H2 2024
- 3 333 KENT STREET—14,200 SQM  
I Prosperity Group/Bridge Capital—  
2024

## UNDER CONSTRUCTION/ MAJOR PRE-COMMITMENT

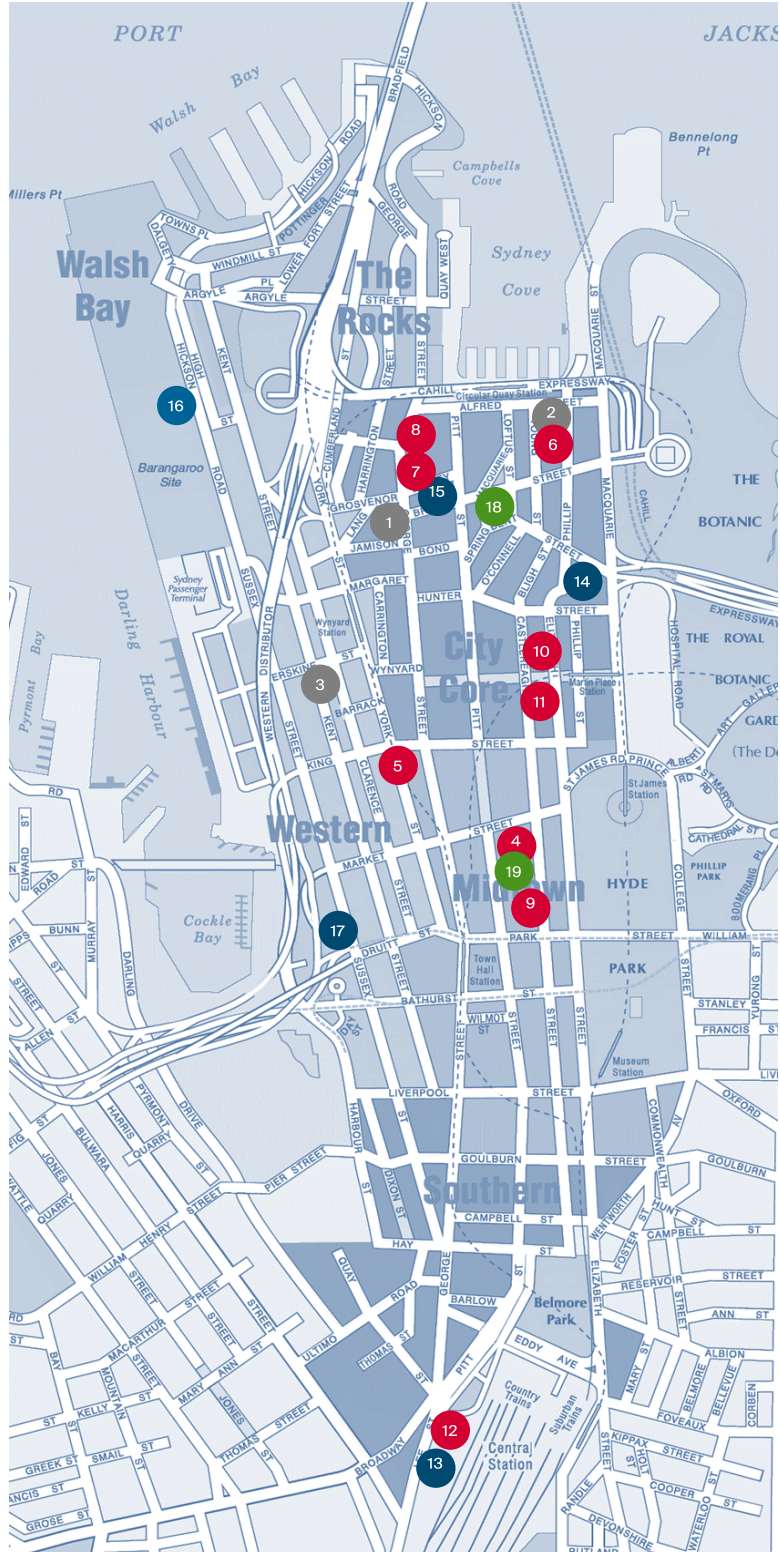
- 4 121 CASTLEREAGH STREET—12,068 SQM  
CBUS - H2 2023
- 5 36-36 YORK STREET—8,366 SQM  
H2 2023
- 6 QUAY QUARTER TOWER—88,274 SQM  
[AMP/DELOITTE/CORRS CHAMBERS]  
MIRVAC/DEXUS/REST— 95% COMMITTED—  
COMPLETE
- 7 210 GEORGE STREET—16,500 SQM  
POLY GROUP - 33% COMMITTED,  
COMPLETE
- 8 SALES FORCE TOWER—55,000 SQM  
LENDLEASE, PING AN, MITSUBISHI – 85%  
COMMITTED. COMPLETE
- 9 PARKLINE PLACE—49,120 SQM OXFORD/  
INVESTA—H1 2024
- 10 METRO MARTIN NORTH TOWER—75,000  
SQM  
MACQUARIE GROUP— H2 2024
- 11 METRO MARTIN SOUTH TOWER—30,000  
SQM—[ASHURST] 30% COMMITTED  
INVESTA/MANULIFE— H2 2024
- 12 TECH CENTRAL ATLISSIAN TOWER—  
75,000 SQM [ATLISSIAN]  
ATLISSIAN— 100% COMMITTED, H1 2026

## DEVELOPMENT APPROVED

- 13 CENTRAL PLACE—138,000 SQM  
DEXUS/FRASERS— 2028
- 14 2 CHIFLEY SOUTH —42,000 SQM  
CHARTER HALL/GIC— 2027
- 15 55 PITT STREET—70,000 SQM  
MIRVAC 2027
- 16 CENTRAL BARANGAROO—48,350 SQM  
GROCON/AQUALAND/SCENTRE. 2028
- 17 DARLING PARK TOWER 4—75,000 SQM  
GPT/MIRVAC – 2030

## DEVELOPMENT APPLICATION/MOOTED/ EARLY FEASIBILITY

- 18 56 PITT STREET—50,000 SQM  
DEXUS. 2029
- 19 133 CASTLEREAGH STREET—90,000SQM  
STOCKLAND 2029



NB Dates are Knight Frank Research estimates  
Major tenant commitment in [brackets]

# SOLID RENTAL GROWTH

## Face rental growth rates bounced back in 2022

The second half of 2022 witnessed a return to rental growth for both prime and secondary stock in the Sydney office market. In y/y terms, the average net face rent rose by 4.9% to \$1,254/sqm (\$1,477/sqm gross face) for the prime market and 3.2% to \$903/sqm (\$1,083/sqm gross face) for the secondary market. Amid the inflationary pressure and premium buildings delivered on the market, CBD prime face rents growth rate bounced back first time since 2020.

The current rental discount between prime and secondary rent is 28%, which is the widest gap in over five years. With the 'flight to quality' trend, tenants moved to more prime quality office space over secondary buildings, driving the rental growth.

## Incentives remain elevated

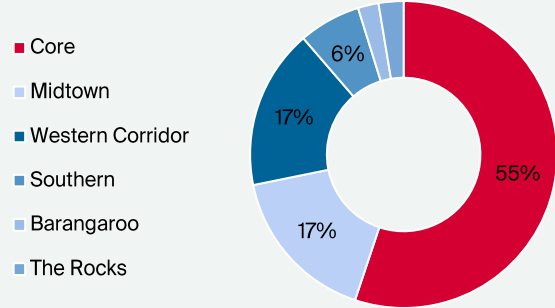
Incentives remain elevated in 2022, with the end-of-year average figure standing at 34% for both the prime and secondary markets. While many businesses are now pushing employees back to the office, the flexible working pattern is still here, landlords thus have been offering high incentives to retain and attract tenants to their buildings.

The increased face rents and steady incentives resulted in positive movement towards prime net effective rent over the year. The prime net effective rents climbed 2.8% in 2022 and were reported at \$753/sqm. Although they are still 18% down on pre pandemic levels.

The above-average vacancy and backfill space will likely see incentives remain above average in the near term as landlords continue to offer additional inducements to prospective tenants such as early access and contribution to fitouts.

### Lease deal activity by precinct

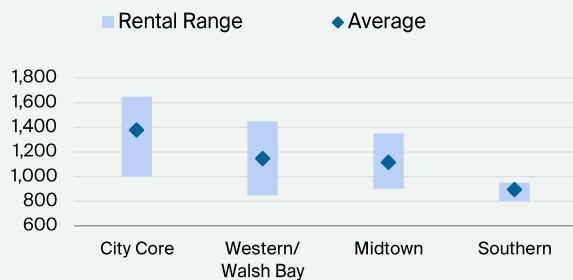
2022, % share of total market (sqm)



Source: Knight Frank Research

### Net rental range

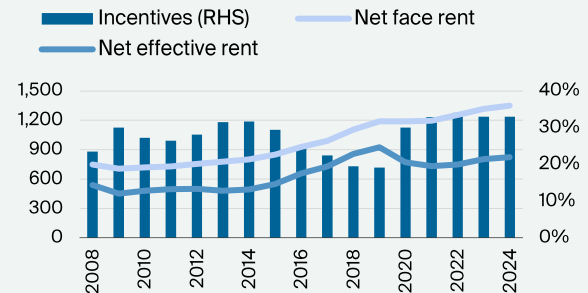
By precinct, \$/sqm



Source: Knight Frank Research

### Rent and incentives

\$/sqm, %



Source: Knight Frank Research

## Recent tenant commitments

| OCCUPIER           | PROPERTY          | PRECINCT | SIZE SQM | NET FACE RENT \$/SQM | INCENTIVE | TERM YRS | REPORT DATE |
|--------------------|-------------------|----------|----------|----------------------|-----------|----------|-------------|
| The Work Project~  | 50 Bridge Street  | Core     | 4,534    | 1,855                | 28%       | 8        | Q4-22       |
| Tik Tok Australia# | 180 George Street | Core     | 4,424    | 1,330                | U/D       | 10       | Q4-22       |
| Bell Potter~       | 88 Phillip Street | Core     | 3,118    | 1,655                | 35%       | 10       | Q4-22       |
| Kantar~            | 201 Sussex Street | Western  | 1,477    | 1,075                | 39%       | 5        | Q4-22       |
| Swire Shipping~    | 580 George Street | Midtown  | 1,103    | 1,225 (g)            | 36%       | 4        | Q4-22       |

# Pre-commitment ^ Sublease ~Direct (g) gross face

# HIGHER FUNDING COSTS IMPACTS ACTIVITY

## Monetary policy tightening driving cost of debt in property markets, impacting sentiment

Rising inflation locally and globally has resulted in significant monetary policy tightening by central banks, which has seen interest rates rise at the fastest pace in a generation.

The RBA has now raised rates by 325 bps since May last year with the cash rate now 3.35%, with further hikes expected pending new economic data.

For property markets, the cash rate has merely played catch-up with the sharp uplift in bond yields and swap rates since early 2022. Australian bond yields across all maturities moved swiftly upward in the first half of last year, but have stabilised somewhat in recent months, with the benchmark ten-year yield recently ranging from 3.3-3.8%.

This increase in bond yields across all maturities has had a commensurate impact on the cost of debt in property markets, with funding costs rising by 200-300 basis points for most borrowers. This has also had the impact of raising the cost of hedging currency exposures for foreign investors.

Whilst interest rates are still tipped to edge higher in the near term, it is widely expected that the end of the hiking cycle is near, and as inflation starts to ease this should gradually restore confidence and liquidity.

## Lowest annual deal volumes in a decade

The impact of higher funding costs on pricing has been clearly apparent, with reduced deal activity across all office markets nationally, with a number of investors opting to sit on the side lines and wait for conditions to stabilise.

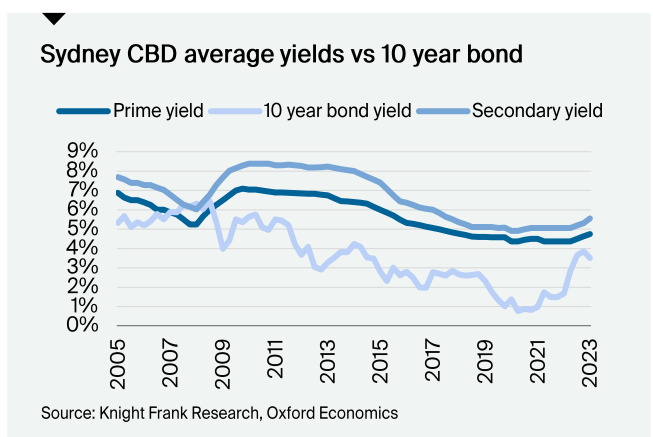
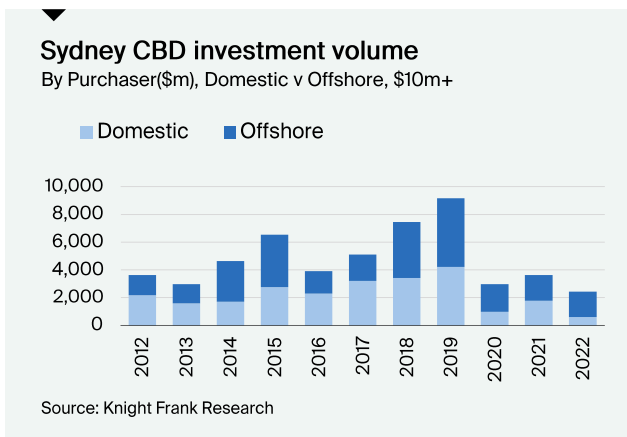
Transaction volumes in the Sydney CBD totalled \$2.4 billion in 2022. Offshore buyers continued to play a large role, representing 75% of transactional activity, highlighting Sydney's status as a safe haven market for global investors.

The largest deals of the year were negotiated before the rapid uplift in rates, with Allianz and Korea's NPS acquiring a 50% stake of Darling Quarter for \$625 million, reflecting a c.4.1% market yield. Brookfield divested two adjoining office towers at 32&36 Carrington St of its Brookfield Place Sydney precinct in Q3, with a combined value of \$109 million.

## Yield softening playing out

While there has been limited transactional evidence average prime and secondary Sydney CBD yields are judged to have increased by 37.5 and 50 basis points respectively since Q1 2022 to average to 4.7% and 5.6%. Yields will continue to be tested as transactional evidence emerges over the first half of the year.

This trend is echoed nationally and in other global markets given the universality of inflationary pressures and rate rises, but Sydney will remain a preferred destination aided by the nascent return of rental growth.





**Recent significant sales**

| PROPERTY                     | PRICE \$M        | CORE MARKET YIELD % | NLA SQM | \$/SQM NLA | WALE | PURCHASER                    | VENDOR                         | SALE DATE |
|------------------------------|------------------|---------------------|---------|------------|------|------------------------------|--------------------------------|-----------|
| <b>36 Carrington Street</b>  | 70.5             | 4.3                 | 2,874   | 24,530     | 4.1  | AFIAA                        | Brookfield                     | Sep-22    |
| <b>32 Carrington Street</b>  | 38.5             | 4.5                 | 2,127   | 18,101     | 2.6  | April Group                  | Brookfield                     | Sep-22    |
| <b>74 Castlereagh Street</b> | 160              | 4.2                 | 5,640   | 28,369     | 1.8  | Charter Hall                 | Country State Development      | Sep-22    |
| <b>4-6 Bligh Street</b>      | 210              | 4.4                 | 10,027  | 20,943     | 3.0  | Local Private                | RECAP IV Fund <sup>^</sup>     | Jul-22    |
| <b>Darling Quarter (50%)</b> | 625 <sup>*</sup> | 4.1                 | 61,000  | 20,492     | 12.5 | AREAP 1 <sup>&lt;</sup> Fund | Abu Dhabi Investment Authority | Jan-22    |

<sup>\*</sup>Gross sale price    <sup>^</sup> Real Estate Capital Asia Partners IV Fund



We like questions, if you've got one about our research, or would like some property advice, we would love to hear from you.



**Research**

Marco Mascitelli  
+61 2 9036 6656  
Marco.Mascitelli@au.knightfrank.com



**Occupier Services**

James Johnston  
+61 2 9036 6873  
James.Johnston@au.knightfrank.com



**Capital Markets**

Ben Schubert  
+61 2 9036 6870  
Ben.Schubert@au.knightfrank.com



**Research**

Ben Burston  
+61 2 9036 6756  
Ben.Burston@au.knightfrank.com



**Office Leasing**

Al Dunlop  
+61 2 9036 6765  
Al.Dunlop@au.knightfrank.com



**Office Leasing**

Andrea Roberts  
+61 2 9036 6703  
Andrea.Roberts@au.knightfrank.com

**Research**

Naki Dai  
+61 2 9036 6673  
Naki.Dai@au.knightfrank.com



**Asset Management**

Lisa Atkins  
+61 2 9604 4710  
Lisa.Atkins@au.knightfrank.com



**Valuations & Advisory**

James Marks  
+61 2 9036 6684  
James.Marks@au.knightfrank.com

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