

- *Early signs of improving leasing demand*
- *Face rents are holding but incentives have increased*
- *2020 investment volumes at lowest level since 2013, but Q4 above average*



# Sydney CBD Office

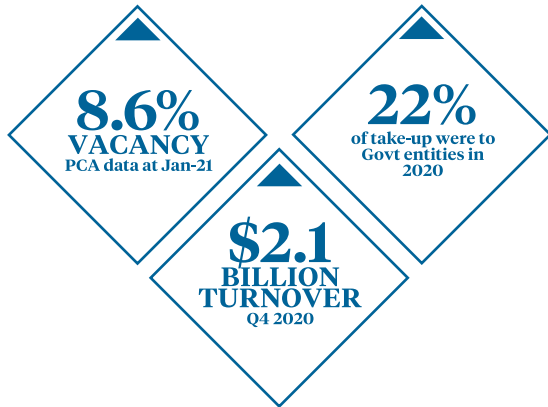
**Market Report, March 2021**

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# ACTIVITY DOWN BUT SIGNS OF CONFIDENCE

*Leasing and investment activity has been impacted, but there are early signs a recovery is underway.*



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**“...activity in Q4 reflects pent-up demand from investors for prime assets and an increased willingness by investors to look beyond the current cycle.”**

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## The Key Insights

Business investment has increased for the first time since Q3 2019. Given the government has begun to taper off its income support measures, the rise is an encouraging sign that the economy is continuing to rebound from the pandemic.

Average incentives have increased to 30%. Face rents are holding but with incentives up, gross effective rents have declined by 6.0% in prime and 7.5% in secondary in the six months to January 2021.

Reflecting the decline in leasing activity from the private sector, government in 2020 accounted for 22% of total leasing volumes by square metres, well-above its five-year average of around 9%.

Year end investment volumes are 67% below the record seen in 2019, but \$2.1 billion in transactions was recorded in Q4, well above its 10-year average of \$1.6 billion.

Prime yields are holding firm between 4.25% and 4.75% after sustained compression prior to the pandemic.

## Sydney CBD Office Market Indicators—January 2021

| GRADE        | TOTAL STOCK SQM  | VACANCY RATE % | ANNUAL NET ABSORPTION SQM | ANNUAL NET ADDITIONS SQM | AVERAGE GROSS FACE RENT \$/SQM | AVERAGE INCENTIVE % | EFFECTIVE RENTAL GROWTH % YOY (net) | AVERAGE CORE MARKET YIELD %* |
|--------------|------------------|----------------|---------------------------|--------------------------|--------------------------------|---------------------|-------------------------------------|------------------------------|
| Prime        | 3,137,209        | 8.3            | -39,911                   | 124,328                  | 1,385                          | 30-35               | -16.3                               | 4.25-4.75                    |
| Secondary    | 1,944,908        | 9.0            | -73,432                   | 4,013                    | 1,017                          | 30-35               | -19.2                               | 4.75-5.25                    |
| <b>Total</b> | <b>5,082,117</b> | <b>8.6</b>     | <b>-113,346</b>           | <b>128,341</b>           |                                |                     |                                     |                              |

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

# REBOUND CONTINUES ABOVE EXPECTATIONS

## In a sign that the economic recovery is underway, business investment and consumer spending increase beyond expectations

Recent data confirms that the economic recovery has been stronger than expected, with consumer spending and employment growth performing particularly well.

Following the 3.4% rise in the September quarter, Australian GDP grew by 3.1% the December quarter, which was well above the 2.5% expected by market commentators. This is the first time that GDP has grown by more than 3.0% in two consecutive quarters. The continued rebound was driven by household spending, which increased 4.3% in the quarter, reflecting pent-up demand in Victoria following the relaxation of restrictions at the end of October.

Both housing and business investment have increased reflecting further signs of confidence in the economy. However, the rises do coincide with government initiatives, such as HomeBuilder (both new construction and renovation activity) and the expanded instant asset write-off scheme to buy capital equipment. Notably, this is the first time business investment has increased since Q3 2019 and forecasts for future business spending have risen. Given the government has begun to taper off its income support measures such as JobKeeper, the rise in private sector investment is an encouraging sign that the economy is continuing to rebound from the pandemic.

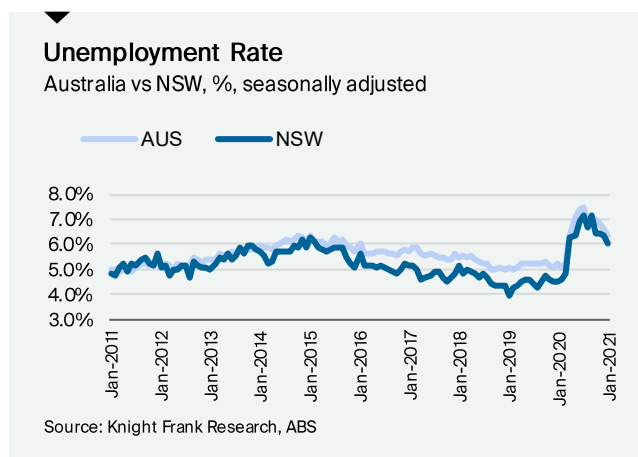
## Further positive signs the economy is rebounding emerge as employment and sentiment sees an uptrend

There has been a strong increase in employment, with recent figures showing that national employment numbers are just 0.4 percentage points below pre-pandemic levels in February 2020. January 2021 was the fourth consecutive monthly rise in employment, and again highlights signs that the economy is rebounding quickly into 2021.

The unemployment rate in NSW is 6.0% in January 2021, below the national rate of 6.4% and well below its pandemic peak rate of 7.2% in July 2020. The trend is further supported by recovery in other data including job ads, retail spending and consumer confidence.

The Westpac-Melbourne Institute consumer sentiment index rose in February 2020 and remains at the elevated levels last seen in 2013. While the NAB's sentiment survey has lifted to over a decade high in February. The sustained rise in confidence suggests that businesses remain optimistic about the outlook even as government support such as JobKeeper and JobSeeker are scheduled to end in March.

Despite strength in recent figures, the uncertainty around COVID-19 restrictions and the tapering of government support this quarter is still impacting some businesses with plans for relocation or expansion in the short-term. However, the easing of restrictions and growing confidence in the public health initiatives is providing some momentum for continued improvement in the business sector into 2021.



# DEMAND STILL DOWN BUT SENTIMENT IMPROVING

## Leasing volumes decline but early signs emerge tenants are on the move

Overall leasing volumes in Sydney remain impacted by pandemic conditions, but sentiment is improving as more office workers begin the transition back to the workplace.

There was a distinct halt in activity during Q2 2020 relative to the historical average due to the pandemic and subsequent containment measures. This resulted in the total vacancy rate rising to 8.6% in January 2021, up from 5.6% in July 2020 and total net absorption declining by 54,671sqm over the same period. However, as the year came to a close, transaction activity was beginning to improve and Q4 take up finished just 27% short of the same period in 2019 and 2018.

Preliminary figures for Q1 2021 show that almost 40,000sqm in lease transactions have been recorded, suggesting that tenants are once again reviewing and acting on leasing options in the market. Notably, Corrs Chambers Westgarth pre-committing to 10,000sqm at QQT for 15 years. Further analysis of the initial numbers for Q1 show that more than 62% of deals by volume of square metres have been for direct leasing deals, with 26% for pre-commitments and 12% on sublease space.

## Sublease availability rises but tenants starting to review options and activity is emerging

The amount of available sublease space has risen since the onset of the pandemic. The industry agreed figure reported by the PCA is around 85,000sqm (as at January 2021), however more recent Knight Frank estimates indicate it to be over 165,000sqm.

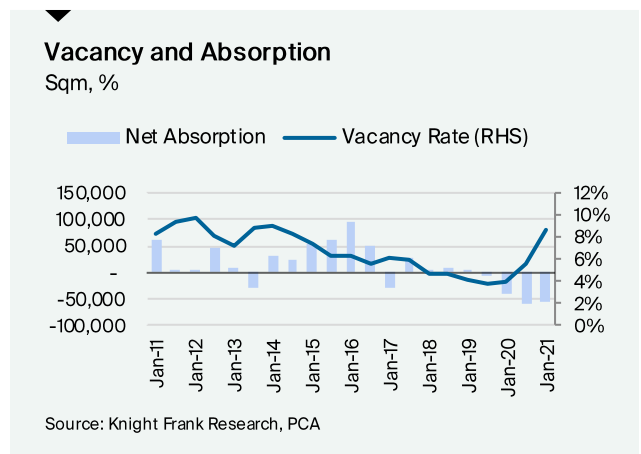
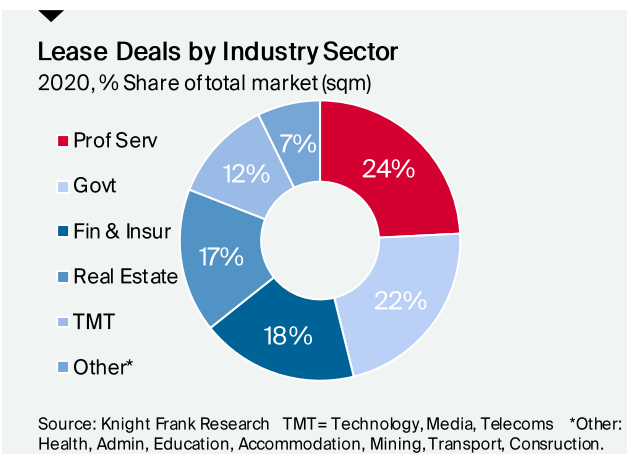
Businesses have been undergoing a review of strategies to support a return to workplace as well as remote working and this has resulted in the contraction of some office space requirements. While the state and federal governments have enacted numerous stimulus measures to help offset the effect of the downturn, there has still been short-term impacts to office demand. Sublease deals are averaging 12% of leasing volumes so far this year, compared to five-year average of a just under 2% of total volumes.

As sublease space is typically already fitted out and is of prime quality this appears to be creating some momentum for tenants considering relocation plans and helping to partially offset the recent rise in sublease availability. An existing fitout appears to be the bright spot for tenants, as it allows them to move quickly and reduce the time and cost allocated to designing a new fitout, potentially offering some occupiers a easier transition.

## Government demand helping to offset decline in private sector requirements

Reflecting the decline in activity from the private sector, government lease deals in 2020 account for a 22% share of total leasing volumes by square metres, well-above its five-year average of around 9%.

The previous ramp up in tech sector leasing activity has tempered and is now running around its historical average, accounting for 12% of leasing volumes last year. Finance and Insurance sector demand has declined from an average of 29% annually to about 18% of total volumes in 2020. However, this could shift in the coming months as more businesses return to the office and review workplace requirements.



# NEW SUPPLY LESS IMPACTED BY CONSTRAINED DEMAND

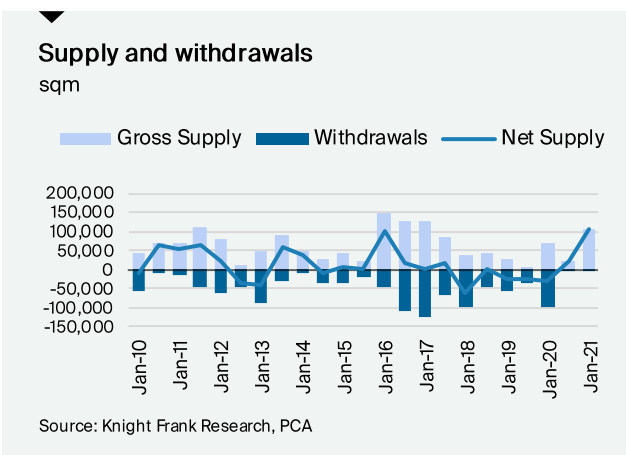
## Influx of refurbished stock

The supply deficit experienced over the last three years has come to an end, with net supply reaching its highest level in over 15 years, totalling 104,179sqm as at January 2021, taking the total office stock base to 5,082,117sqm. The completion of a number of major refurbishments over the second half of 2020 has been the catalyst for the influx of supply.

Major refurbishments completed included the Brookfield/Oxford owned 388 George Street (37,530qm), 55 Market Street (20,532sqm) and the Charter Hall owned 231 Elizabeth Street (22,964sqm). Additionally, new development stock stemmed solely from the completion of Daibiru Corporation's, 275 George Street (7,263sqm). Across the 107,729sqm of stock added over the period a commitment rate of approximately 55% was achieved, albeit the majority of commitments were secured prior to the Covid outbreak.

A further 50,000sqm of refurbished stock will likely come to market by year end, including 2 Market Street (18,386sqm) primarily committed to Amazon along with 44 Martin Place (9,059sqm) and 570 George Street (18,100sqm), although these are yet to see any strong commitments.

Upon completion of these refurbishments, will likely see the number of upgrade and refurbishment works scaled back by landlords as they focus to fill existing vacancies and upcoming backfill within their portfolios. Given the below average demand levels the risk to outlay capital expenditure on upgrading secondary stock is high in the short term unless there is a significant pre-commitment, this in turn will likely see a greater divergence between prime and secondary stock.



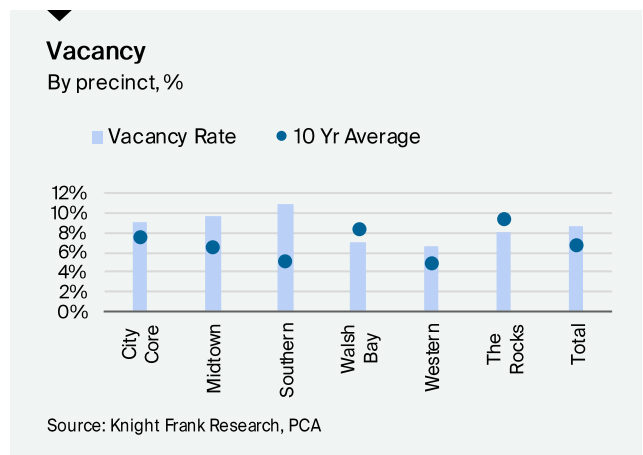
## New development under construction is substantially pre-let

The pipeline of new development stock currently under construction totals over 220,000sqm, with a commitment rate nearing 75% across all schemes including Brookfield Place (60,821sqm), CQT (55,000sqm) and QQT (88,274sqm). Practical completion at Brookfield Place is imminent, whilst the remaining pipeline will be delivered over the next two years and will be less impacted by the limited demand given pre-commitments were achieved prior to the Covid outbreak.

Whilst there are strong commitments on the new developments, backfill space will arise from occupiers vacating existing space to move into new stock. Significant backfill space will arise from Deloitte vacating Grosvenor Place (27,800sqm) moving into QQT and NAB vacating 255 George Street (23,000sqm) to Brookfield Place.

## Next wave of supply to come post economic recovery

Looking further ahead, the next wave of significant supply will come post 2024, which current forecasts suggest will see a full economic recovery at this time and see occupier demand levels restored to historical levels.



# MAJOR OFFICE SUPPLY

## MAJOR REFURBISHMENTS

- 1 320 PITT STREET—20,310 SQM [WEWORK]  
ARA— 40% COMMITTED. COMPLETE
- 2 231 ELIZABETH STREET—22,964 SQM [PROPERTY NSW]  
CHARTER HALL— 100% COMMITTED. COMPLETE
- 3 388 GEORGE STREET—38,500 SQM [QBE, AWARE SUPER, CORELOGIC]  
BROOKFIELD/OXFORD— APPROX. 60% COMMITTED. COMPLETE
- 4 55 MARKET STREET—20,552 SQM  
MIRVAC— COMPLETE
- 5 477 PITT STREET—18,000 SQM  
ISPT— COMPLETE
- 6 570 GEORGE STREET—18,100 SQM  
FAR EAST— H1 2021
- 7 44 MARTIN PLACE—9,500 SQM GWYNVILL GROUP — H1 2021
- 8 2 MARKET STREET—18,000 SQM [AMAZON]  
CHARTER HALL— H1 2021
- 9 33 ALFRED STREET—32,615 SQM  
AMPCAPITAL— H1 2024

## UNDER CONSTRUCTION/ MAJOR PRE-COMMITMENT

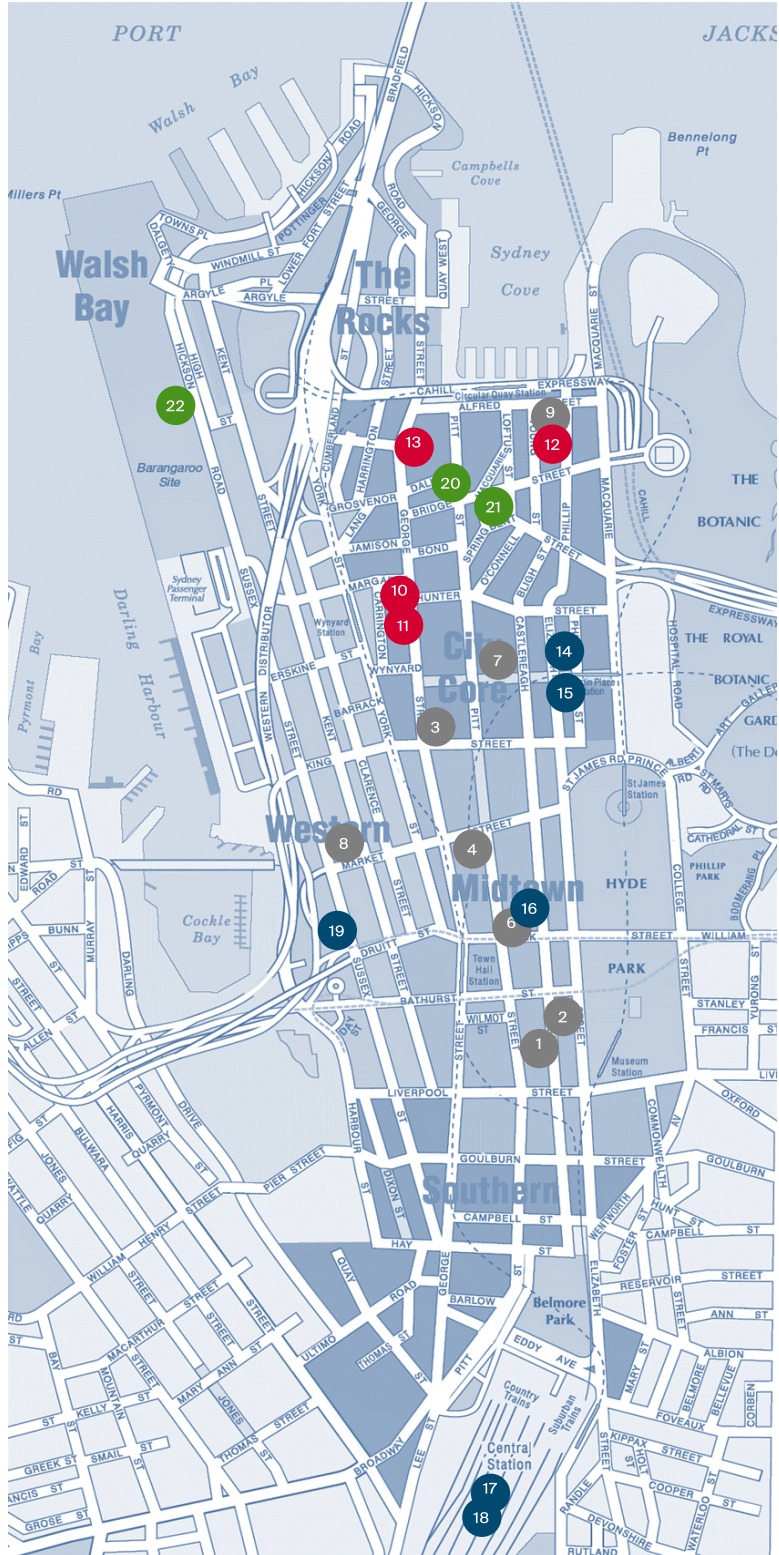
- 10 275 GEORGE STREET—6,363 SQM  
DAIBIRU— 40% COMMITTED. COMPLETE
- 11 BROOKFIELD PLACE—59,000 SQM [NAB/  
ALLIANZ/HUB/MOELIS/GOODMAN]  
AMP/BROOKFIELD— 95% COMMITTED. H1 2021
- 12 QUAY QUARTER TOWER—88,274 SQM [AMP/DELOITTE/CORRS CHAMBERS]  
AMP CAPITAL/REST— 85% COMMITTED. H1 2022
- 13 CIRCULAR QUAY TOWER—55,000 SQM [SALESFORCE]  
LENDLEASE, PING AN, MITSUBISHI — 55% COMMITTED. H2 2022

## DEVELOPMENT APPROVED

- 14 MARTIN PLACE METRO NORTH TOWER—  
75,000 SQM  
MACQUARIE GROUP— H2 2024
- 15 MARTIN PLACE METRO SOUTH TOWER—  
30,000 SQM  
INVESTA/MANULIFE— H2 2024
- 16 PITT STREET METRO TOWER—49,120 SQM  
OXFORD/INVESTA—H2 2024
- 17 TECH CENTRAL ATLISSIAN TOWER—  
70,000 SQM [ATLISSIAN]  
ATLISSIAN— 85% COMMITTED, H1 2025
- 18 TECH CENTRAL —150,000 SQM  
DEXUS/FRASERS— H2 2026
- 19 DARLING PARK TOWER 4—60,000 SQM  
GPT/AMP CAPITAL — 2027

## DEVELOPMENT APPLICATION/MOATED/ EARLY FEASIBILITY

- 20 55 PITT STREET—60,000 SQM  
MIRVAC. 2026
- 21 56 PITT STREET—50,000 SQM  
DEXUS. 2027
- 22 CENTRAL BARANGAROO—48,350 SQM  
GRCON/AQUALAND/SCENTRE. 2027



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

# INCENTIVES RISE AS FACE RENTS HOLD FIRM

## Landlords hold firm on face rents

For the most part of 2020 business decisions around office space had been put on hold and full time remote working policies were in place as a result of economic and market uncertainty due to COVID-19.

Whilst office occupancy rates continue to improve in line with the labour market recovery and a pick up in tenant enquiry albeit at more moderate levels, the above trend rental growth cycle experienced pre-COVID has halted.

On a 12 month basis (to January 2021), average prime gross face rents have remained unchanged at \$1,385/sqm (\$1,189/sqm net face). Similarly, in the secondary market rents are unchanged in the 12 months to January 2021 at \$1,017/sqm (\$857/sqm net face).

The current rental discount between prime and secondary rents is 27%, below its historical average of 31%. Demand has been weighted towards more prime quality office space through the 'flight to quality' adage, with a particular focus on amenity, safety and wellbeing, as occupiers look to remodel their workplace environment. As a result, this could see the rental gap widen as secondary stock may struggle to fulfil these occupier demands.

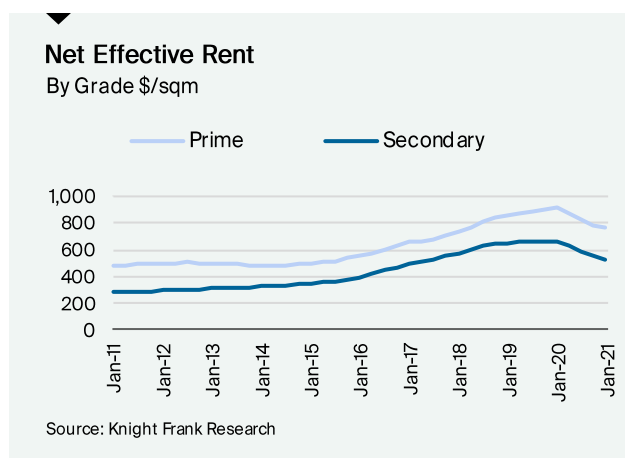
With the significant rise in sublease vacancy and a constrained occupier demand pool, landlords continue to increase their incentive offerings in order to retain and attract tenants.

## Sharp increase in incentives to retain and attract new tenants

Following incentives hitting decade low levels in late 2019, landlords swiftly increased incentive offerings throughout 2020 which have now climbed to average 30% as at January 2021.

The rise in incentives has resulted in net effective rents dropping to \$773/sqm, down 16.3% in the 12 months to January 2021. Average secondary incentives have risen above prime incentives to over 32%, resulting in 19.2% decline in net effective rents to \$534/sqm.

Sublease vacancy and constrained tenant demand will continue to place pressure on effective rents and incentives may rise further in the near term as landlords offer additional inducements to prospective tenants such as early access and contribution to fitouts.



## Recent tenant commitments

| OCCUPIER                             | PROPERTY               | PRECINCT | SIZE SQM | FACE RENT \$/SQM (g) | INCENTIVE | TERM YRS | START DATE |
|--------------------------------------|------------------------|----------|----------|----------------------|-----------|----------|------------|
| <b>FTI Consulting~</b>               | 1 Macquarie Place      | Core     | 1,205    | 1,610                | 28%       | 7        | Q1-21      |
| <b>Moorebank Intermodal Company~</b> | 1 O'Connell Street     | Core     | 307      | 1,830                | 40%       | 4        | Q1-21      |
| <b>Sedgwick~</b>                     | 35 Clarence Street     | Western  | 1,100    | 1,175                | 31%       | 5        | Q1-21      |
| <b>Barrenjoy Capital Partners^</b>   | 161 Castlereagh Street | Midtown  | 3,250    | 1,647                | 30%       | 3        | Q1-21      |
| <b>Ivory Group</b>                   | 171 Castlereagh Street | Western  | 303      | 1,000                | 35%       | 3        | Q1-21      |
| <b>Mayday Recruitment</b>            | 60 Carrington Street   | Core     | 430      | 1,110                | 31%       | 3        | Q4-20      |

# Pre-commitment ^Sublease ~Direct

# SIGNS OF RESILIENCE IN Q4 INVESTMENT ACTIVITY

## Investment volumes fall to lowest level since 2013

Investment activity during 2020 dropped to its lowest level since 2013, with most REITs taking decisive action to halt trading amid short-term volatility in property fundamentals.

Following record \$9.1 billion in transactions in 2019, the rapid deterioration of global economic conditions brought about by the pandemic and government containment measures saw transaction activity decline to just \$3.1 billion in 2020.

## But signs of confidence return in Q4, as quarter volumes rise above average

Although border restrictions and snap lockdowns in some states and territories slowed down the momentum for offshore and domestic investors for most of 2020, investors were still focused on shoring up balance sheets by selectively investing in high quality, well-leased assets with potential for capital growth.

This strategy began to play out in the last quarter of 2020, with \$2.08 billion in transactions recorded in Q4, which was well-above the 10-year Q4 average of \$1.6 billion.

While year end investment volumes are 67% below the record seen in 2019, the uptick in activity in Q4 reflects pent-up demand from investors for prime core grade assets in Sydney accounting for 85% of transaction volumes and potentially an increased willingness by investors to look beyond the current cycle.

## Offshore investors step up their exposure

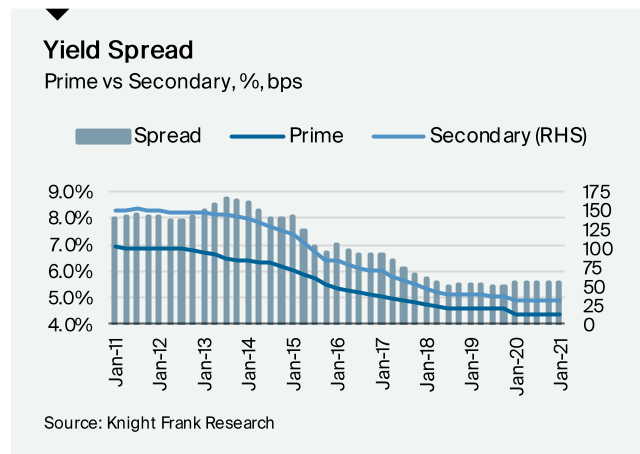
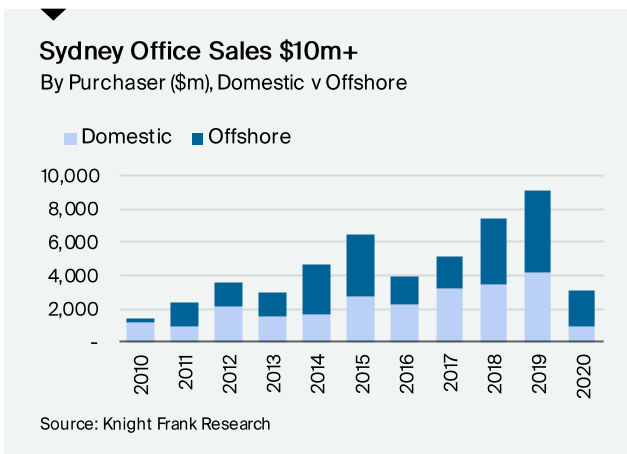
Offshore groups are showing the strong interest, with the share of deal volumes growing from a historical average of about 50% to 68% in 2020. Australia looks relatively attractive compared to other global markets in managing the pandemic and with the economic recovery well underway and exceeding expectations the outlook is promising.

## Offshore investors raise their stakes

Two offshore groups recently increasing their stakes in existing assets in Sydney illustrates the emerging confidence.

China's sovereign wealth fund, China Investment Corporation (CIC) has acquired an additional 50% stake in Grosvenor Place from Dexus (in partnership with CPPIB) for \$925 million. The sale was the largest transaction in Sydney since mid-2019 but represented a discount of about 5% to its June 2020 book value, reflecting the current vacancy and short-term leasing risk in the tower. Given significant backfill will arise when major anchor Deloitte relocates to QQT in 2022, the transaction is a strong sign of confidence for Sydney office market. CIC initially bought a 25% interest in the asset in 2015, as part of its purchase of an office portfolio from Investa.

M&G Real Estate acquired an additional stake in 400 George Street from Investa for approximately \$300 million, increasing their ownership to 50%. M&G is currently a co-owner with CIC, which has the other 50% after their initial purchase in 2015. Investa's divestment is part of its plan to recycle capital into its development pipeline.





In recent news to support this sentiment, Investa has partnered with Canadian group Manulife to acquire 39 Martin Place for \$800 million.

Although none of the tower has been committed, Manulife sighted that despite some headwinds resulting from pandemic, they were focused on expansion in the Asia Pacific region and on high quality assets, which are supported by strong long-term macro and demographic prospects.

The deal is quite a turnaround from almost a year ago. ISPT had originally agreed to buy the tower from Macquarie but the deal collapsed amid softening leasing metrics at the onset of the pandemic. It is the first JV for Manulife.

### Benchmark S&P/ASX 200 A-REIT Index recovery

Further evidence to support the uptick in investor demand for office during Q4 is in the recovery in the benchmark S&P/ASX 200 A-REIT Index, which finished the year 64% above the its lowest level in March 2020. This index tracks the performance of Australian real estate investment trusts (A-REITs) and mortgage REITs. Although the index is down by about 4.5% on December, possibly due to the COVID-19 outbreaks that led to border restrictions in most states and territories, it is still showing a strong recovery on the steep plunge it took at the onset of the pandemic.

### Prime yields holding firm after sustained compression

Average prime office yields have remained relatively stable since the onset of the pandemic. There is an increasing focus on covenant strength and security of income as noted by the recent run of deals in the last quarter.

In Sydney, average prime yields are 4.38% as at January 2021. This is unchanged since January 2020 but reflects a compression of 23bps on January 2019. Similarly, secondary yields are stable at 4.92%, but show a compression of 20bps on January 2019.

### Recent significant sales

| PROPERTY                        | PRICE \$M | CORE MARKET YIELD % | NLA SQM | \$/SQM NLA | WALE | PURCHASER                       | VENDOR                     | SALE DATE |
|---------------------------------|-----------|---------------------|---------|------------|------|---------------------------------|----------------------------|-----------|
| <b>39 Martin Place</b>          | 800.0     | U/D                 | 30,000  | 26,667     | U/D  | Investa / Manulife              | Macquarie Group            | Jan-21    |
| <b>400 George Street (25%)*</b> | 290.0     | 4.95                | 51,057  | 22,720     | 5.7  | M&G Real Estate                 | Investa                    | Dec-20    |
| <b>76-78 Pitt Street</b>        | 281.5     | 4.53                | 23,473  | 11,993     | 10   | Charter Hall Long WALE REIT     | Telstra                    | Dec-20    |
| <b>225 George Street (50%)</b>  | 925.0     | 4.80                | 83,747  | 22,090     | 3.1  | Chinese Investment Corporation  | Dexus/Canada Pension Board | Nov-20    |
| <b>1 Farrer Place (25%)</b>     | 584.6     | 4.7                 | 85,087  | 27,482     | 4.3  | Lendlease (APPCF <sup>^</sup> ) | GPT                        | Dec-20    |
| <b>45 Clarence Street</b>       | 530.0     | 4.97                | 31,992  | 16,567     | 2.7  | Peakstone                       | Dexus                      | Jun-20    |

<sup>^</sup> Australia Prime Property Commercial Fund) \*Due to settle June 2021

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



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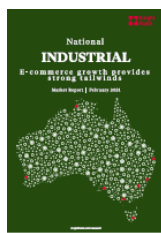
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