RESEARCH

SYDNEY CBD

OFFICE MARKET OVERVIEW MARCH 2017

HIGHLIGHTS

A record 239,057m² of existing office stock in the Sydney CBD has been withdrawn for conversion to alternative uses or redevelopment in the year to January 2017.

Low vacancy rates have resulted in the Sydney CBD's prime and secondary gross effective rents increasing by 16.3% and 21.0% respectively over the past year.

The overall vacancy rate in the Sydney CBD office market is forecast to decline to circa 5.0% and 3.5% over the next 12 and 24 months respectively.

KEY FINDINGS

A record 239,057m² of existing office stock in the CBD market, largely secondary grade, has been removed in the year to January 2017.

Absorption of prime office space measured 100,166m² over the 2016 calendar year, almost double the 10-year annual average of 59,490m².

Sydney CBD's prime and secondary gross effective rents have increased by 16.3% and 21.0% respectively over the past 12 months.

Investment volumes totalled $3.5 billion in the 2016 calendar year, down 47% from a year ago due to a distinct lack of available opportunities on the market.

Equivalent yields for prime assets in the CBD are currently ranging between 5.0% and 5.5% while secondary market yields measure from 6.0% to 6.25%.

ALEX PHAM
Senior Research Manager

SUPPLY & DEVELOPMENT

Gross office supply in the Sydney CBD office market will be significantly constrained over the next two years, exacerbated by an increase in stock withdrawal.

Withdrawal of office space for conversion to alternative uses or redevelopment continues to be a major theme in the Sydney CBD with 128,326m² of existing stock taken offline over the six months to January 2017. Of this amount, 61,609m² was withdrawn permanently. On an annual basis, a record 239,057m² of CBD's office NLA has been removed from the market in the year to January 2017. This is the highest withdrawal amount since the PCA began tracking the market in 1990 and equivalent to 4.8% of the total stock at the beginning of 2016.

Permanent withdrawals over the past six months included Gold Fields House at 1 Alfred Street (24,200m²) and Fairfax House at 19 Pitt Street (4,800m²) to be redeveloped into residential and hotel towers by Dalian Wanda. Other office buildings withdrawn for hotel conversion also included the Department of Lands building at 23-33 Bridge Street (6,257m²) and 280 George Street (5,140m²). In addition, demolition works have commenced on Thakral House at 301 George Street (11,500m²) making way for the Wynyard Place development while 275 George Street (c.9,000m²) has been vacated for redevelopment into a new office building. A further 66,650m² was temporarily removed from the market for refurbishment at 680 George Street (ex-EY), Wynyard Green at 11-17 York Street (ex-Navitas) and Darling Park Towers 2 (ex-PwC) and 3 (ex-Marsh & McLennan).

Counterbalancing the reduction in office stock was an equally strong level of gross supply, with 126,000m² of new stock being added to the market over H2 2016. This has taken the gross supply figure over the year to January 2017 to 252,484m², with the bulk of this supply stemming from the completion of the final two Barangaroo towers, T3 and T1 adding a combined NLA of 181,000m² (circa 70% occupied). New additions over the past six months also included 333 George Street (12,500m²—fully leased) and One Wharf Lane at 161 Sussex Street (6,700m²—56% committed). On a net supply basis, 13,427m² of office space has been added to the market in the twelve months to January 2017. This is less than half of the 10-year average of circa 30,000m² per annum.

Looking ahead, the gross addition of office space in the Sydney CBD is expected to be significantly constrained over the next two years. The supply shortfall will be exacerbated by rising levels of withdrawal (102,289m² in 2017) due to the construction of Sydney Metro and residential redevelopments. The confluence of these factors is expected to lead to a supply shortage and upward pressure on rents over the medium term. The modest gross supply over the next two years will include International House Sydney (7,440m²—100% committed), 151 Clarence Street (19,910m²—28% pre-committed to ARUP) and Darling Square (22,000m²—fully pre-leased to CBA).

Beyond 2019, we anticipate new additions to expand gradually from late 2019 through to 2022. Major office completions beyond 2019 will include 60 Martin Place (40,000m²—18% pre-committed by Henry Davis York from H2 2019), Wynyard Place (68,250m²—45% pre-committed by NAB from H2 2020), Quay Quarter Tower (QQT) (circa 90,000m²—41% pre-committed to AMP from H2 2021) and Circular Quay Tower (CQT) (55,000m²—H1 2021), amongst others (See development map on p.3).

TABLE 1

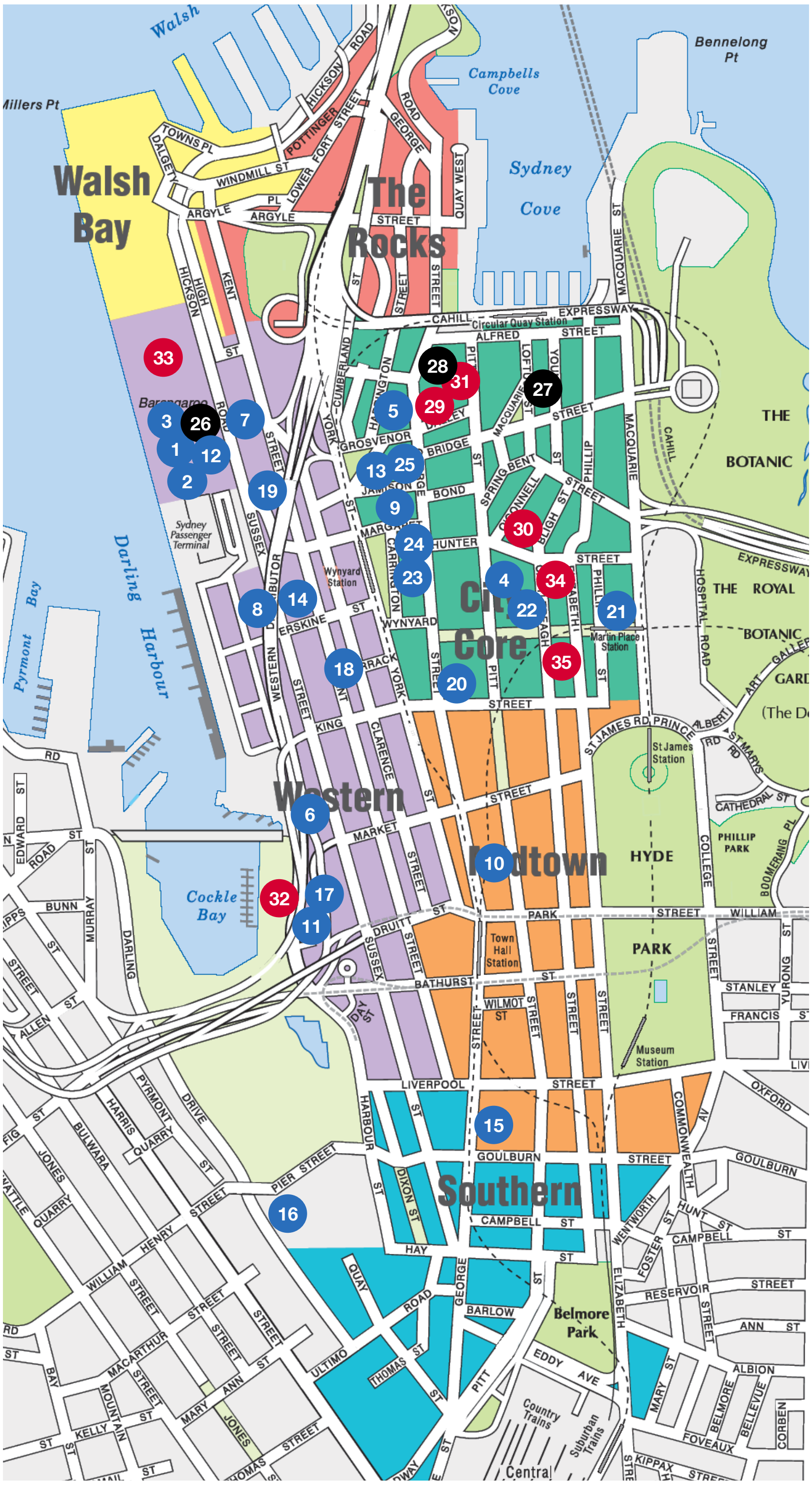
Sydney CBD Office Market Indicators as at January 2017

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	2,928,594	7.3	100,166	139,043	1,000 - 1,300	20.0 - 29.0	5.00 - 5.50
Secondary	2,151,305	4.6	-82,202	-125,616	700 - 900	17.0 - 21.0	6.00 - 6.25
Total	5,079,899	6.2	17,964	13,427			

Source: Knight Frank Research/PCA *Assuming full floor, mid rise, clear space and a 5 year lease

MAJOR OFFICE SUPPLY

1. Barangaroo T2 - 88,200m^2 [Westpac/Gilbert + Tobin/St George/BT]
LLITST - Q3 2015 - 81% committed
2. Barangaroo T3 - 79,221m^2 [KPMG/Lendlease]
LLITST - Q2 2016 - 78% committed
3. Barangaroo T1 - 101,571m^2 [PWC/HSBC/Marsh & McLennan]
LLOneITST - Q4 2016 - 64% committed
4. 80 Pitt St# (ex QBE) - 10,527m^2
Yorkban P/L - Q1 2017
5. 225 George St# (ex Ashurst) - 15,789m^2 [JLT]
DEXUS/CIC/CSC - H1 2016 - 90% committed
6. One Wharf Lane, 161 Sussex St - 6,700m^2
M&L Hospitality - Q3 2016 - 56% committed
7. 30 The Bond, 30 Hickson Rd# (ex Lendlease) - 16,228m^2 [Roche]
DEXUS - H1 2017 - 100% committed
8. 10 Shelley St# (ex KPMG) - 27,778m^2 [Suncorp]
Brookfield - H1 2017 - 100% committed
9. 60 Margaret St# (ex Mirvac, Suncorp) - 14,174m^2 [ING]
Mirvac - H1/H2 2017 - 71% committed
10. 255 Pitt St# (ex Challenger, Apple) - 15,427m^2
ISPT Core Fund - H1 2017 - 75% committed
11. 201 Sussex St, DPIII# (ex Marsh & McLennan) - 10,343m^2 [Advant]
GPT (GWOF)/AMP (ACPF)/Brookfield - H1 2017 - 48% committed
12. International House Sydney (Barangaroo C2) - 7,440m^2
LLOneITST - H1 2017
13. 259 George St# (ex Suncorp) - 20,352m^2
Memocorp Australia - H2 2017
14. 275 Kent St# (ex Westpac) - 17,976m^2
Blackstone/Mirvac - H2 2018
15. 680 George St# (ex EY) - 28,033m^2 [GPNSW]
Brookfield/Arcadia - 2017 - 79% committed
16. Darling Square, Haymarket - 22,000m^2> [CBA]
Lendlease - H1 2018 - 100% committed
17. 201 Sussex St, DPII# (ex PWC) - 33,000m^2 [IAG]
GPT (GWOF)/AMP (ACPF)/Brookfield - 2018 - 100% committed
18. 151 Clarence St - 19,910m^2 [ARUP]
Investa - Q3 2018 - 29% committed
19. 201 & 207 Kent St# - 5,536m^2 (ex ARUP)
Cromwell - Q3 2018
20. 388 George St# - 36,151m^2 (ex IAG)
Investa/Brookfield - Q4 2018
21. 60 Martin Place - 40,000m^2 [Henry Davis York]
Investa/Gwynvill Group - H2 2019 - 16% committed
22. 44 Martin Pl# - 9,500m^2 (ex Henry Davis York)
Gwynvill Group - H2 2019
23. Wynyard Pl - 68,250m^2 [NAB]
Brookfield - H2 2020 - 44% committed
24. 275 George St - c. 7,000m^2
LaSalle Investment Management - H2 2019
25. 255 George St# - 22,500m^2 (ex NAB)
AMP - H2 2020
26. Barangaroo C1 - c. 11,000m^2
LLOneITST - 2019+
27. Quay Quarter Tower (QQT) - 90,000m^2
AMP - H1 2021
28. Circular Quay Tower (CQT), 182 George & 33 Pitt St - 55,000m^2
Lendlease - H1 2021
29. 210 & 220 George St - 17,000m^2
Poly Real Estate - 2021+
30. 33 Bligh St - 26,000m^2
Energy Australia/Investa - Mooted
31. 55 Pitt St - 30,000m^2+
Mirvac - 2022+
32. Darling Park Tower 4 - 70,000m^2
GPT/Brookfield/AMP - 2022+
33. Central Barangaroo - TBC#
TBC* - 2024+
34. Martin Place Metro Station north tower - ex-55 Hunter Street
TBC± - 2024+
35. Martin Place Metro Station south tower - ex-39 Martin Place
TBC± - 2024+



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

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

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

Major refurbishment/backfill

« 2 floors of 1,491.4m^2 are under offer as at September 2016.

§ Westpac extended lease for 3 years.

> Office NLA only. Total NLA is 27,900m^2.

≠ Under the current plans, a maximum above-ground GFA of 150,000 m^2 and an unlimited amount underground are allowed. It is uncertain how much of this will be office space as at March 2017.

* A consortium consisting of Grocon, Scentre and Aqualand is reportedly the lead contender for development rights.

± Macquarie Group has submitted an unsolicited proposal for development, which is being considered by the State Government.

TENANT DEMAND & RENTS

Tenant demand was particularly buoyant in Sydney CBD's prime market over the past six months, evidenced by a strong absorption reading of 47,004m². On an annual basis, 100,166m² of prime space in the Sydney CBD has been taken up over the year to Jan. This is almost double the 10-year annual average of 59,490m². Strong demand for prime space in the CBD has been underpinned by a diverse range of sectors, including; Education, Banking & Finance, Insurance, Accounting and Information Technology, amongst others. Major tenant moves over the past six months included education provider Navitas taking 24,000m² at 225 Elizabeth Street, Employers Mutual leasing 6,700m² at 345 George Street and GrainCorp moving into 4,950m² at 175 Liverpool Street.

Looking forward, while overall absorption is expected to moderate due to secondary stock withdrawal, prime absorption is expected to remain solid over the next twelve months with a number of significant prime tenant moves on the horizon including Suncorp and IRESS Market migrating into 24,200m² and 3,400m² respectively at the newly refurbished 10 Shelley Street, following KPMG's departure last year. Additionally, the backfill space at 680 George Street, created when EY moved to 200 George Street, is expected to welcome a cohort of new tenants this year including Government Property of NSW taking up 11,000m² and Reckitt Benckiser occupying circa 3,000m², relocating from a suburban location. The Barangaroo towers have also achieved strong leasing results over the first few months of 2017 with new and imminent commitments including Baker McKenzie and Pernod Ricard Winemakers, which will relocate from 50 Bridge Street in the CBD and 16 Byfield Street in Macquarie Park respectively, with both buildings to be pulled down for redevelopment. As a large amount of prime space in the CBD market will be absorbed by tenants from non-CBD markets or buildings being taken offline, backfill vacancy in the CBD is expected to be relatively constrained.

While the prime market has gained solid traction over the past 12 months, absorption of lower grade space was influenced by the lack of available options coupled with rising effective rents. With limited secondary stock for lease, B-Grade tenants with space requirement and wish to be in the CBD are being presented with opportunities in the prime market or have to be more space efficient. This saw secondary absorption decline by 82,202m² over the 12 months to January 2017, which is correlated to the 125,616m² reduction in secondary stock over the same period. These trends are expected to be maintained over the next 12 months with the withdrawal of up to 62,000m² for the Sydney Metro project scheduled to take place gradually over this year. They include 175 Castlereagh Street (11,800m²), 55 Hunter Street (13,600m²), 39 Martin Place (14,500m²), 285 George Street (2,500m²), 5 Elizabeth Street (6,300m²), 12 Castlereagh Street (7,300m²), 302 Pitt Street (1,771m²) and 296 Pitt Street (3,600m²). In addition, a further 40,000m², mainly lower grade stock, is expected to be removed for residential and hotel conversion during this year.

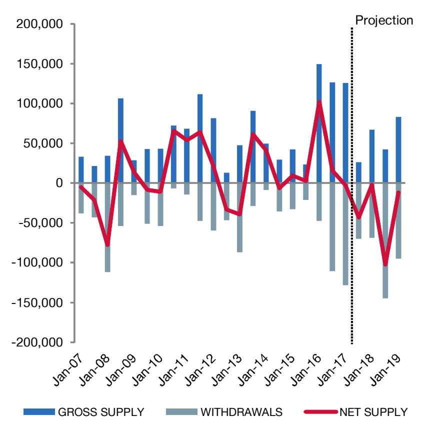
The overall vacancy rate in the Sydney CBD increased from 5.6% in July 2016 to 6.2% in January 2017, 100bps below the 10 year average of 7.2%. As expected, the slight increase was attributed largely to the delivery of the final two Barangaroo towers in late 2016. However, with the Barangaroo towers excluded the overall vacancy rate in the CBD was only 5.0% as at January 2017. The 'Barangaroo's effect' has pushed prime vacancy to 7.3% as at January 2017, up from 6.8% six months ago. In the secondary market, the lowered net absorption resulted in a small uptick in the secondary vacancy rate, which edged up from 4.1% in July 2016 to 4.6% in January 2017, however it remains well below the 10-year average of 7.4%.

With the exception of the Walsh Bay precinct, where the Barangaroo towers are located, vacancy are relatively tight across all precincts in the CBD as indicated by a vacancy rate well below the long-term trend (Figure 3). The Southern precinct was the tightest office market in the CBD with a current vacancy rate of 1.5% followed by the Core precinct with only 4.1% of stock available for lease. On the other hand, 35.3% of the total stock in the Walsh Bay precinct was physically vacant as at January 2017. However, we believe this figure was overstated to some degree as it did not take into account the amount of pre-committed space at International Tower 1 with tenants to move in the new year period. Over the first few months of 2017, the owners of Tower 1 are reportedly close to finalising up to 15,000m² of leases with prospective tenants and have started to subdivide a floor to small suites (as small as 250m²).

FIGURE 1

Sydney CBD Office Supply

Per six month period (m²)

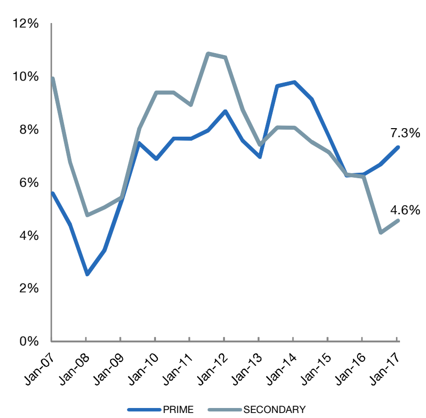


Source: Knight Frank Research/PCA

FIGURE 2

Sydney CBD Vacancy Rate

Prime vs secondary (%) - Past decade

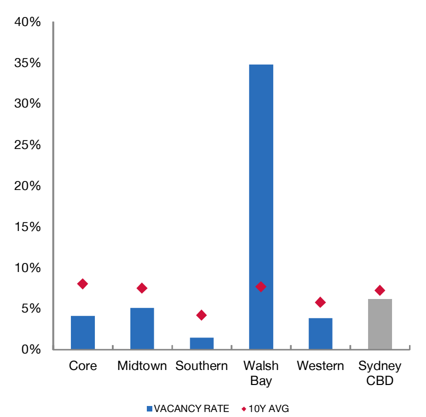


Source: Knight Frank Research/PCA

FIGURE 3

Sydney CBD Vacancy Rate

By Precinct (%) - January 2017



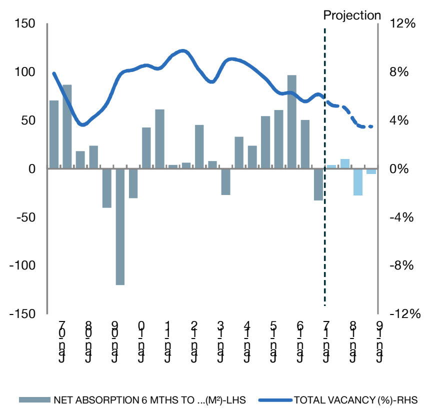
Source: Knight Frank Research/PCA

Looking ahead, the Sydney CBD's overall vacancy rate is expected to decline to circa 5.0% and 3.5% over the next 12 and 24 months respectively. Prime vacancy is expected to fall on the back of strong demand and a flight to quality by tenants. In the secondary market, while the vacancy rate is expected to remain below the long term trend, the reduction in secondary stock will be of greater influence. Beyond 2019, it is anticipated that the overall vacancy rate will gradually revert back to the long-term trend of between 7.0% and 8.0%, underpinned by the completion of the next generation of new office buildings in the CBD including 60 Martin Place, Wynyard Place, QQT (AMP) and CQT (Lendlease).

FIGURE 4

Net Absorption & Vacancy

Sydney CBD, per six month period (000's m², %)



Source: Knight Frank Research/PCA

Rental Levels

Sydney CBD office rents continued to grow across the board over the second half of last year, following the positive growth momentum over the first half of the year. In addition to increased net rents and lowered incentives, gross rents were further expanded by an increase in outgoings brought about by elevated land taxes across the CBD, in excess of 30% in some buildings. As a result, prime and secondary outgoings increased by 6.4% and 5.2% respectively in the past year.

Over the past 12 months, average gross face rents (assuming mid-rise, full floor and a 5-year lease) in the Sydney CBD's prime market increased by 8.8% YoY to $1,104/m² ($928/m² net) as at January 2017. Underpinned by demand from high-end legal firms, investment banks and Technology start-ups, gross face rents of prime office buildings in the Core precinct are currently between $1,100/m² to $1,300/m² on average with top rents eclipsing $1,700/m². Prime incentives decreased from 30% or above a year ago to between 20% and 29% as at January 2017. This has resulted in effective gross face rental growth of 16.3% in the prime market over the past year ($833/m²).

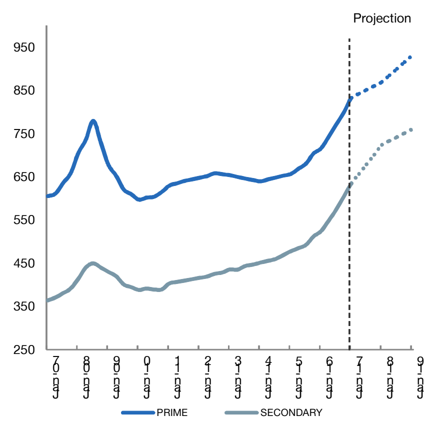
In the secondary market, the lack of available options led to an increase in gross face rents of 10.6% over the past year to $796/m² ($660/m² net) as at January 2017 with incentives falling to 17%—21%. On an effective basis, impressive secondary rental growth of 21.0% was recorded over the 12 months to January 2017, taking secondary gross effective rents to an average of $635/m².

Rental growth is expected to remain solid over the next two years, albeit not as strong as the recent levels. Accordingly, prime gross face rents are forecast to rise by 5%—6% p.a. on average over the next 24 months while prime incentives are expected to dip below 20%. In the secondary market, gross face rents are forecast to grow by an average of 6%—8% p.a. over the same period. Secondary incentives are expected to fall to between 15% and 16% by early 2019, although there will be variation amongst assets.

FIGURE 5

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
151 Clarence St	Western	5,969	10	Direct	ARUP	E&C	Oct-18
680 George St	Midtown	7,108	7	Direct	WSP Parsons	E&C	Nov-17
10 Shelley St	Western	24,203	11	Direct	Suncorp	Finance	Oct-17
10 Shelley St	Western	3,433	5	Direct	IRESS Market	TMT	Sep-17
30-34 Hickson Rd	Western	6,463	6	Direct	WPP AUNZ	TMT	Aug-17
680 George St	Midtown	5,530	10	Direct	Link Market	Finance	Jul-17
580 George St	Midtown	2,466	10	Direct	Mission Australia	Community	Jul-17
45 Clarence St	Western	1,858	5	Direct	Kaplan Education	Education	Jul-17
680 George St	Midtown	2,974	10	Direct	Reckitt Benckiser	Consumer Goods	Jun-17
30-34 Hickson Rd	Western	4,165	8	Direct	Roche	Health Care	May-17
321 Kent St	Western	1,586	11	Direct	REST Super	Finance	May-17
724 George St	Core	724	3	Direct	Alternative Media	Media	Mar-17
363 George St	Core	726	5	Direct	Atlassian	TMT	Mar-17
680 George St	Midtown	3,750	7	Direct	ServiceNow	TMT	Jan-17

Source: Knight Frank Research   TMT refers Technology Media & Telecommunications   E&C refers Engineering and Construction

INVESTMENT ACTIVITY & YIELDS

Investment activity in the Sydney CBD office market has been characterised by a distinct lack of stock, despite the sustained interest from both local and offshore investors. The calendar year of 2016 saw a total of $3.5 billion of office buildings transacted in the Sydney CBD. As anticipated, this was about half of the $6.6 billion recorded a year earlier. Early indicators over the first few months of 2017 are pointing towards a strong year of investment into the Sydney CBD office market with a number of sizable assets already on the market. They include 66 Goulburn Street (circa $240 million), 310-320 Pitt Street ($192 million+), 59 Goulburn Street (circa $150 million), 20 Bridge Street ($300 million+), a 50% stake in the MLC Centre (circa $700 million) and a 25% interest in the Wynyard Place developments (circa $500 million), amongst others.

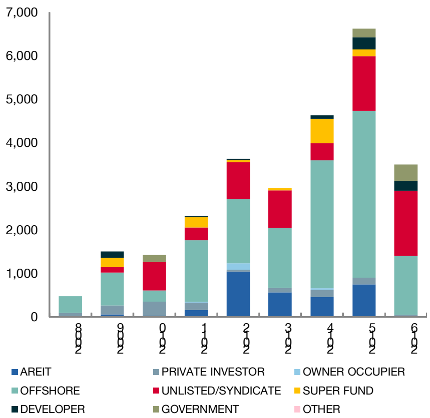
The most recent prime office transaction in the Sydney CBD was the off-market sale of AMP "Sydney Cove" building at 33 Alfred Street, which was transacted between related parties within the AMP Group and not open to the market. The 14,900m² A-Grade property was transferred from AMP Life Ltd to AMP Capital Diversified Property Fund (ADPF) and AMP Capital Wholesale Office Fund (AWOF) for $445 million at a core market yield of 5.30%. This strategic move will see the two AMP unlisted funds gaining full control over the Quay Quarter Sydney precinct. Last year also saw the acquisition of 420 George Street by Investa and Mercer in two separate tranches for $442.5 and $150 million from Fortius and Lendlease respectively. In combined value, this was the largest prime building transacted last year. The transactions were concluded on core market yields of 5.23% and 5.21% respectively. With these deals completed almost a year ago, indications are that a prime property with similar calibre in the CBD Core would expect to be traded at a sub-5% yield in the current market.

While transactions in the prime market were scarce over the past 12 months, investment activity in the secondary market remained relatively robust. The largest secondary building transaction in the CBD last year was the compulsory acquisition of 39 Martin Place by Transport for NSW for the construction of Sydney Metro. The property was acquired from DEXUS Group for $332 million, representing a significant premium to its book value of $226.4 million as at June 2016 and a rate per NLA of $19,307/m². Nevertheless, pricing metrics of this transaction are not considered market-based. Instead, the largest open-market transaction of a secondary building was at 55 Clarence Street which was bought by US-based AEW Capital Management from Eureka Funds Management for $169.33 million.

FIGURE 6

Sydney CBD Sales $10 million+

By Purchaser Type ($m)



Source: Knight Frank Research

TABLE 3

Recent Sales Activity Sydney CBD

Address	Price ($ mil)	Core Mkt Yield (%)	NLA (m²)	$/m² NLA	WALE (yrs)	Vendor	Purchaser	Sale Date
98-104 Goulburn St	20.30	N/A	1,658	12,244	0.4	Private	Private	Mar-17
55 Clarence St	169.33	6.08	14,896	11,368	2.2	Eureka FM	AEW Capital (US)	Dec-16
33 Alfred St~	445.00	5.30	31,759	14,012	4.1	AMP Life Ltd	ADPF / AWOF	Dec-16
39 Martin Pl#	332.00	N/A	17,196«	19,307	U/D	DEXUS / DWPF	Transport for NSW	Nov-16
92 Pitt St	52.17	5.80	4,642	11,239	2.7	EG FM (CPF1)	City Freeholds	Nov-16
303 Pitt St	43.00	N/A	3,410	12,610	U/D	Private	City of Sydney	Oct-16
28 O'Connell St»	91.00	4.60	6,116	14,879	1.2	ACE Insurance	Coombes Property	Oct-16
426 Kent St	13.50	N/A	2,880	4,688	U/D	Citilease Prop Group	Private	Oct-16
333 Kent St	88.89	N/A	8,938	9,945	U/D	Maville Group	Bridge/iProsperity	Sep-16
287 Elizabeth St	55.00	N/A	5,566	9,881	3.0	Citadin	Private (HK)	Jul-16
10-14 Quay St	42.00	N/A	4,381	9,587	U/D	Citadin	Private (HK)	Jul-16
420 George St (25%)^	150.00	5.23	37,688	15,920	4.9	Lendlease (APPFC)	Investa/Mercer	Aug-16
420 George St (75%)^	442.50	5.21	37,688	15,655	5.2	Fortius (FAPT1)	Investa (ICPF)	Apr-16

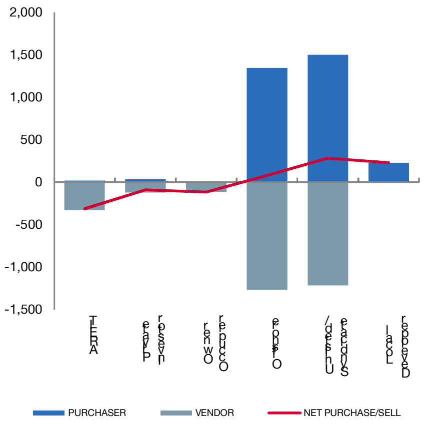
Source: Knight Frank Research ADPF refers AMP Capital Diversified Property Fund AWOF refers AMP Capital Wholesale Office Fund
DWPF refers DEXUS Wholesale Property Fund CPF1 refers Core Plus Property Fund No. 1 FAPT1 refers Fortius Active Property Trust No.1
ICPF refers Investa Commercial Property Fund ~ internal transaction between entities within the AMP group # acquired for the Sydney Metro project
» purchased by the adjoining owner « comprises 14,525m² office and 2,621m² retail components ^acquired by Investa and Mercer in two tranches

$169.33 million, representing a core market yield of 6.08%. Another secondary deal of interest last year was 28 O'Connell Street purchased for $91 million on a core market yield of 4.3% with the tight yield reflective of the amalgamation value with the adjoining property, 48 Hunter Street also owned by the same buyer.

During 2016, unlisted and property syndicates were the largest buyers with a total purchase value of $1.5 billion, representing an increase of 20% from a year earlier. They were followed by offshore investors, who bought a total of $1.3 billion in the Sydney CBD. Constrained by the lack of opportunities, offshore purchasing volume fell 65% below of the their strong investment value of $3.8 billion in 2015. Amongst offshore groups, investors from Mainland China and Hong Kong were in the lead with a total purchase value of $565.7 million (43% of total offshore purchases). On a net basis, unlisted funds and syndicates were the largest net buyers with a net purchase volume of $285 million, followed by local developers acquiring $228 million by value. The tightness of stock and confidence in future leasing conditions have compelled many local developers to activate development projects in the Sydney CBD.

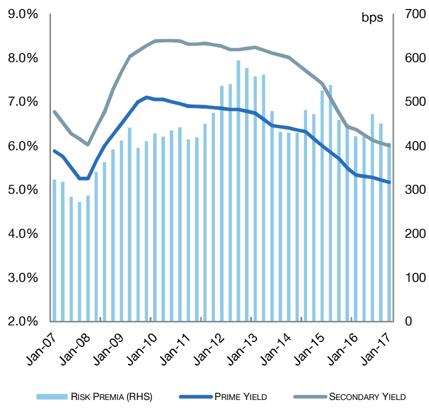
On the back of limited stock on the market and improving leasing activity, prime and secondary markets have experienced further tightening of yields over the past twelve months, with the rate of compression more profound in the secondary market. Core market yields for secondary grade properties with 5 year WALEs in the Sydney CBD currently measure between 6.0% and 6.25%, 30 to 50bp lower than a year ago. In the prime market, despite little trading activity, core market yields for prime grade properties with 5 year WALEs are expected to trade at around 5.0% to 5.5% or lower for assets with longer WALEs. There are expectations for further yield compression across the board this year, although further transaction evidence will be required for validation. An important influence on yields is a recent hike on government bond rates, which have increased by circa 40 to 50bps over the last six months on the back of increased borrowing costs globally. As a consequence, the average spreads between prime yields and government indexed-bond rates have decreased from 451bp six months ago to 407bp now.

FIGURE 7
Sydney CBD Purchaser/Vendor
$10 million+ sales—2016



Source: Knight Frank Research

FIGURE 8
Sydney CBD Yields & Spread
Core Market Yields - Prime vs Secondary



Source: Knight Frank Research

Outlook

- New supply of office space in the Sydney CBD will be significantly constrained over the next two years and exacerbated by increased withdrawals due to the Sydney Metro project and residential conversions. The confluence of these factors will lead to declining net supply and upward pressure on rents.
- The limited supply pipeline over the next two years will include International House Sydney (6,719m²–100% pre-committed), 151 Clarence Street (21,000m²–28% pre-committed to ARUP) and Darling Square (22,000m²–fully pre-leased to CBA). Beyond 2018, we anticipate the supply cycle to expand gradually from mid-2019 through to 2022.
- Tenant demand is expected to remain robust over the next 24 months, particularly in the prime market. However, the continued decline in secondary stock and rising effective rents will drive some B-Grade tenants to either upgrade to prime premises, be more space-efficient or relocate to non-CBD markets.
- On the back of positive demand amid limited supply, the overall vacancy rate in the CBD is expected to trend down towards 5.0% and 3.5% over the next 12 and 24 months respectively. Beyond 2018, we expect the overall vacancy rate to begin to revert to its natural levels of between 7.0%—8.0% in the long term as new supply is delivered.
- Over the next two years, secondary gross face rents are forecast to rise by 6.0% p.a. on average and secondary incentives are expected to trend down towards 15% or lower. In the prime market, expectations are for circa 5.0% p.a. gross face rental growth with incentives declining to circa 23%—24%.
- Investment volumes and liquidity are projected to improve over the next 12 months, judging by a high number of properties already in the transaction pipeline, including; 66 Goulburn Street, 59 Goulburn Street, 310-320 Pitt Street, 20 Bridge Street, the MLC Centre (50%) and Wynyard Place (25%).

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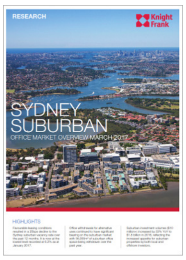

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