- *Tenant engagement has been low as occupancy decisions are deferred*
- *Restrictions on movement and economic uncertainty slowing investment*
- *Brisbane is well placed to recover once restrictions are lifted*

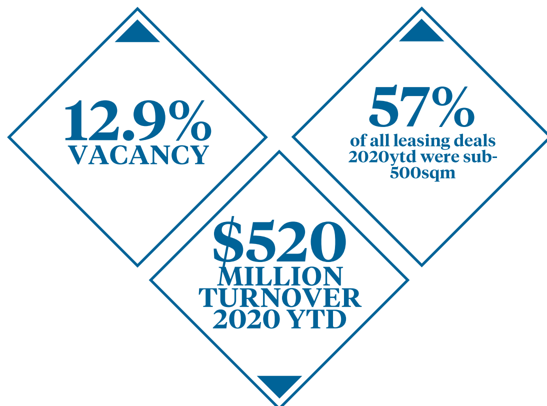
Brisbane CBD Office

Market Report, September 2020

knightfrank.com/research

BRISBANE CBD ACTIVITY HAS BEEN LIMITED IN 2020

The onset of a health-crisis induced recession has impacted on activity within the Brisbane CBD market with both leasing and sales transaction volumes at low levels, blurring values



"Where possible large tenants are deferring decisions on their future workplaces, seeking greater clarity and a sense of what employees will favour. These decisions can't be deferred indefinitely and we expect that tenant engagement will increase in the New Year."

MARK MCCANN

HEAD OF OFFICE LEASING QUEENSLAND

The Key Insights

Despite positive net absorption in H1 2020 vacancy increased to 12.9% due to supply additions. Vacancy will stay in the region of 13% to the end of 2020 before increasing past 15% during 2021.

Prime and secondary gross effective rents have fallen by 1.8% and 0.9% respectively over the past 12 months. In the main, face rents are being maintained with incentives softening.

Real Estate services, largely co-working/flex space, accounted for 24% of leasing activity in 2020 ytd with most activity in the first months of the year. Professional services activity has been steady, accounting for 23% of leased space.

Following record breaking levels of investment in 2019, 2020 is expected to be far lower with only $520 million transacted to date. There have been few assets formally offered to the market.

The yield band is widening with core assets maintaining a tightening bias given the low cost of funds and demand for low-risk. Risk exposed assets will be priced more harshly.

City CBD Office Market Indicators—July 2020

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	AVERAGE CORE MARKET YIELD %*
Prime	1,278,759	11.0	33,645	53,325	775	35-40	-1.8	4.90-6.15
Secondary	991,861	15.4	-6,340	5,695	622	38-42	-0.9	6.10-7.40
Total	**2,275,620**	**12.9**	**27,305**	**59,020**				

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

PANDEMIC MITIGATION TRIGGERS RECESSION

Globally the lockdowns and restrictions on travel have had a material impact on economic activity; Australia has performed relatively well.

The measures taken by Governments across the globe to control personal movement to mitigate and slow the spread of the COVID-19 virus has triggered many economies into recession.

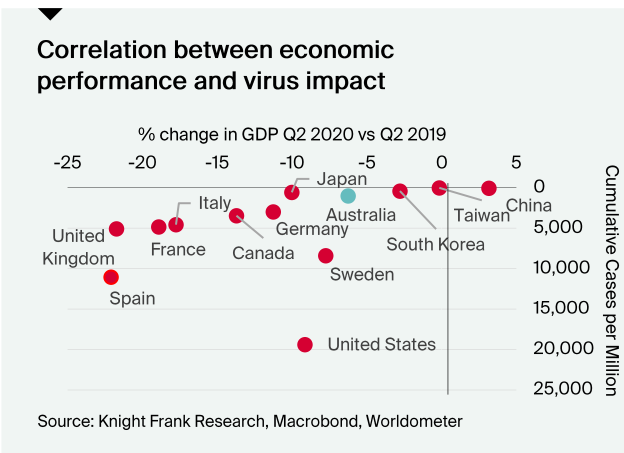
Although entering a recession for the first time since 1991 the Australian economy and health system have proven to be robust on the global stage. This will enhance Australia's reputation as one of the safe havens of the APAC market—attractive for both headquarter locations and investment.

The fall in Australian GDP in the second quarter was nevertheless the highest recorded at 7% and reflected the significant curtailment of activity between March and June. As expected the majority of the impact was through household expenditure, down 12.1% with accommodation and food the hardest hit sector (-56.1%).

Oxford Economics has forecast flat conditions through Q3 2020, although the return to a hard lockdown in Victoria in July gives potential downside risks to that figure. Overall for Australia economic growth during 2020 will be –5.8%.

As shown below, there appears to be economic benefits to controlling the virus with a lower case rate somewhat aligned with more modest falls to GDP.

Correlation between economic performance and virus impact



Source: Knight Frank Research, Macrobond, Worldometer

Queensland is well positioned among the states to begin the recovery faster.

Queensland is currently in the fortunate position where many elements of household life have been relatively normal since July. This is expected to see a return to positive growth in Q3 of 2.1% for the quarter.

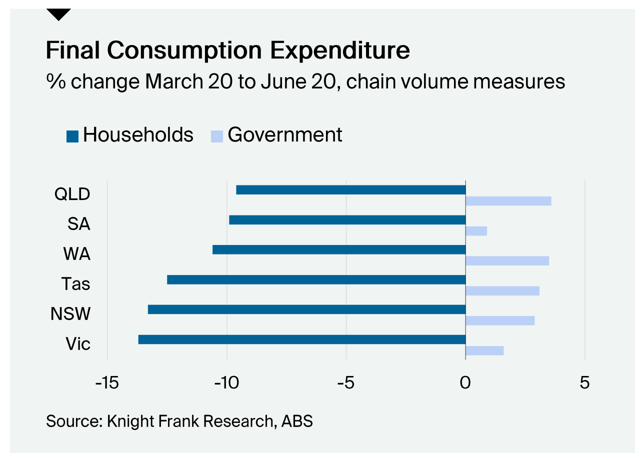
The overall GSP change for Queensland during 2020 is forecast at –3.7%. In broad terms it is expected to take until Q1 2022 for GSP (at level prices) to bypass the activity recorded in Q4 2019 for Queensland. Australia is expected to take a further quarter to recover the lost ground. Therefore the recovery in the demand side for property markets needs to be considered on a similar timeframe.

Queensland is also benefitting from having both a physically and sectorally diverse economy. Queensland's economy is originated 50% from Brisbane itself, while Sydney (70%) and Melbourne (80%) are of far greater importance to their state's economic health, making those economies more exposed to a shut down in metropolitan activities.

There is already a high infrastructure spend locked in for the Brisbane region, including the $5.4 billion Cross River Rail project. Additionally household spending held up relatively well compared with other states during Q2 and there were fewer restrictions on activity in Q3 than were the case in NSW or Victoria, meaning the Queensland economy is ahead of the other states in locally generated activity. However from a practical point of view the reintroduction of border closures in early August placed additional barriers to deals being completed.

Final Consumption Expenditure

% change March 20 to June 20, chain volume measures



Source: Knight Frank Research, ABS

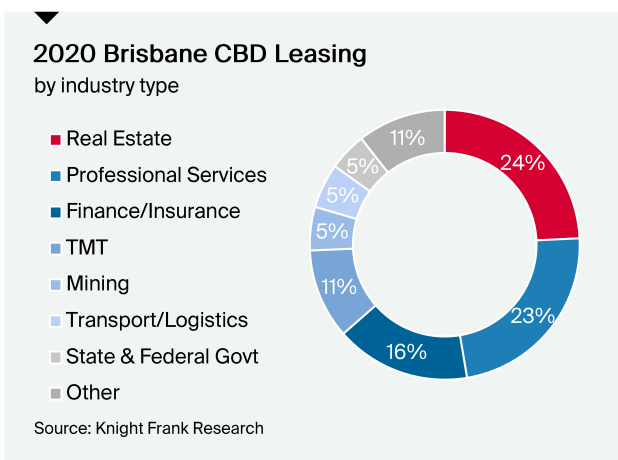
TENANTS STILL TO DETERMINE LONG TERM NEEDS

Leasing activity has been low in 2020 with a reluctance from tenants to make long term plans.

The widespread working from home phenomenon which emerged from March this year was an accelerant to a workplace practice which had been slowly building, but lacking management acceptance for many years. It is only within the last five years that internet speeds and cloud connectivity have made working from home a seamless experience, allowing for similar productivity away from the office and un-tethering the workforce from a single, central office location.

While the past nine months in no way could be considered as business as usual, the trend towards working from home now has greater manager and corporate acceptance with productivity levels during the enforced work from home period generally positive. However the translation of extensive working from home when back to a normal working environment is the factor many companies are grappling with. For most industries it is expected that a blend of office time and working from home will become the common path. Informal collaboration, on-boarding and being visible for promotion are all factors likely to draw a working population back into an office environment.

Major corporates are also grappling with determining headcount numbers, given the current economic climate. Headcount, desk configurations, desk booking rather that hot desking and what proportion of workers will be in the office at any stage all need to be determined. Unsurprisingly the larger companies have deferred decision making this year with 80% of leases signed in Brisbane 2020 ytd being under 1,000sqm.

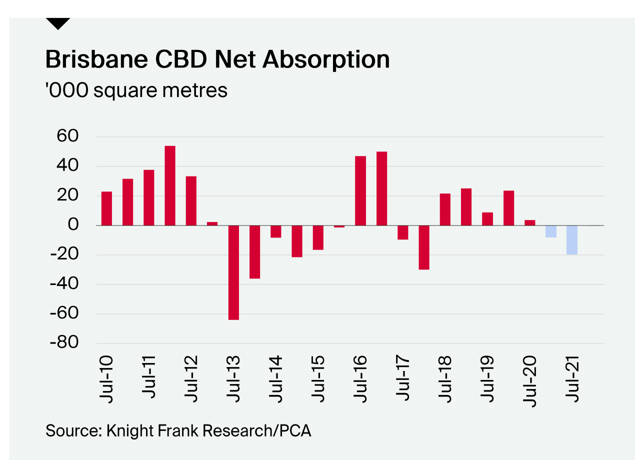


Contractionary impact on net absorption will be greatest during 2021 as falling headcounts take time to flow through to total space occupied.

Even though the momentum building in the Brisbane market through the latter half of 2019 was curtailed in early 2020 by the pandemic fallout there was still positive net absorption in H1 2020, albeit far more modest than the leasing activity over the first months of 2020 would have indicated.

Net absorption will turn negative during H2 2020 as corporate rationalisations begin to emerge, however with many of the largest companies remaining on full or substantial WFH policies until the end of the year the full impact will not flow through until 2021. In the short term, while head counts for many companies are falling, the social distancing and associated safe workplace rules mean that for many fitouts only a proportion of desks can be used at any one time, artificially boosting the amount of space required until such measures can be eased. For this reason many companies continue to defer or delay decisions on major moves.

Current forecasts from Oxford Economics indicates that total employment numbers across the industries which make up base office demand will not return to Jan 2020 levels until H1 2022. Therefore net absorption is likely remain negative until that time, with the contraction to be most dramatic in early 2021 as companies can no longer defer decisions and need to make a call on their office footprint. The expected availability of flex space will assist companies to downsize while retaining short term options for expansion.



SUPPLY IN 2021 & 2022 TO IMPACT VACANCY

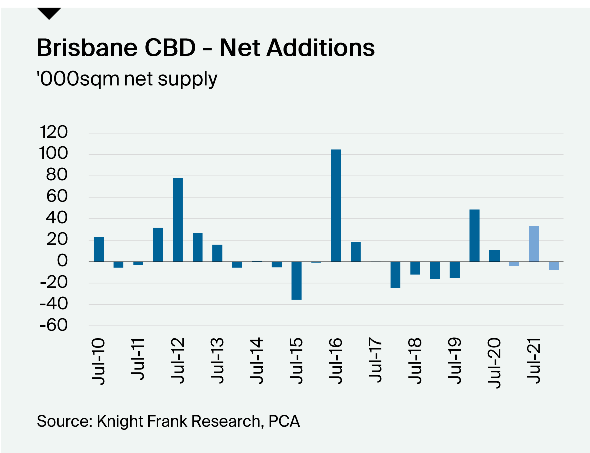
Supply cycle unlikely to be impacted for near term delivery, however proposals for 2023+ will face higher hurdles and potential deferment.

The near term supply cycle is not expected to change in the CBD market with the two projects under construction to continue without changes to timing or size. The Midtown Centre remains on track for completion mid-2021 and is continuing to field interest from a number of tenants. However at this stage the only formally committed tenant remains Rio Tinto, accounting for 45% of the building.

The other major project at 80 Ann St is also well into construction for completion H2 2022 with the anchor tenant Suncorp. It is understood that Suncorp is seeking to reduce its pre-committed space within the building, however the size has not been finalised. Of the remaining projects 360 Queen St has works underway to demolish the existing buildings, however this project may be increasingly vulnerable to delays given the current private sector reluctance to act.

Beyond 2024 the supply cycle remains fluid with the Federal Government, through DHS, having released a brief for c40,000sqm which could anchor, if not fully occupy a new building in the CBD. The next stage of the process has yet to be advised, however many developers are working on proposals to meet this brief.

Apart from Midtown Centre, the next two years will be characterised by stock refurbishment and in some cases complete obsolescence as older building struggle to adapt to the ever increasing service and amenity requirements from tenants.



Source: Knight Frank Research, PCA

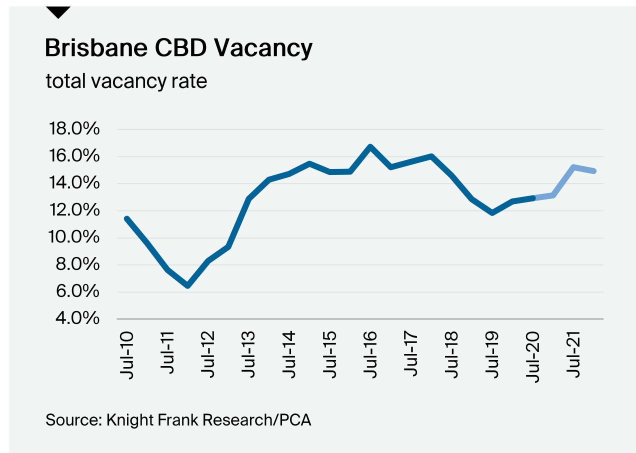
Vacancy to climb above 15% during 2021.

The vacancy rate will drift higher to the end of 2020, but remain in the order of 13% with low activity levels and benign supply. During 2021 the completion of Midtown Centre, coinciding with the expected downsizing tenants handing back space, will see the vacancy increase to 15.2% in mid-2021. Vacancy is expected to remain elevated during 2022 before beginning to see material decreases during 2023.

Sub-lease vacancy remained relatively low at 0.6% in the July PCA survey but is expected to increase over the coming 12-18 months. If the space marketed for sub-lease, but still currently occupied, is also considered then there is currently just over 25,000sqm of stock available for sub-lease representing 1.1%.

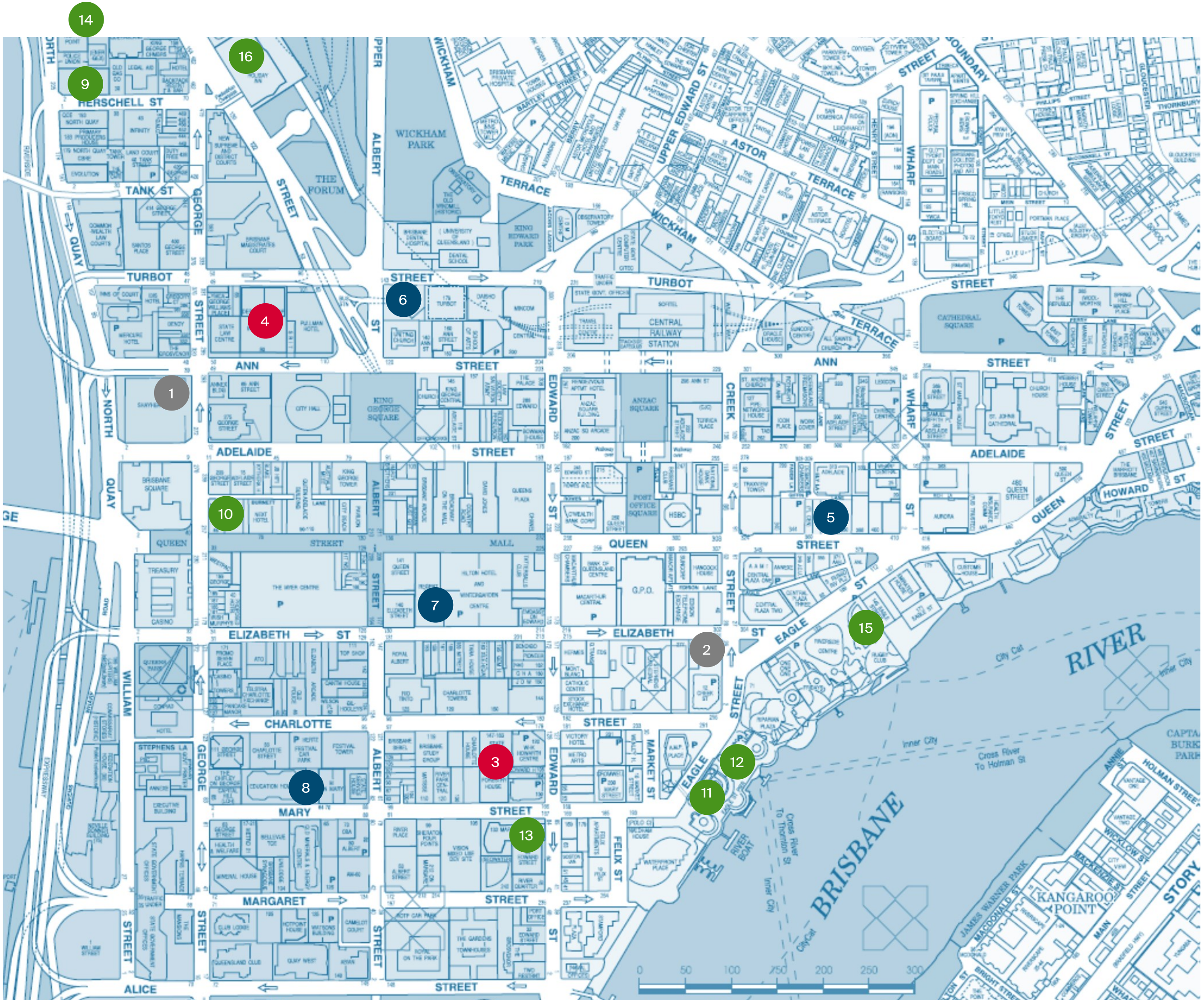
Of the larger contiguous sub-lease availabilities, to date none of these are attributable to COVID-19 headcount reductions—St George Bank, Allianz and Telstra were in the process of restructuring and downsizing prior to the pandemic outbreak. The space offered by Allianz at 310 Ann St was relatively quickly absorbed.

In the medium term, vacancy is expected to remain above 10% through to 2024/25 which in itself will limit supply additions without substantial pre-commitment.



Source: Knight Frank Research/PCA

MAJOR OFFICE SUPPLY



RECENTLY COMPLETED

1. 300 GEORGE ST—47,700 SQM [URBIS/ TRANSURBAN}
   SHAYHER GP – 20% COMMITTED. H2 2019
2. 12 CREEK ST ANNEX—7,200 SQM [HUDSON RECRUITMENT]
   DEXUS PROP GP– 20% COMMITTED. H1 2020

UNDER CONSTRUCTION/ MAJOR PRE-COMMITMENT

3. MIDTOWN CENTRE 155 CHARLOTTE ST & 150 MARY ST—45,000 SQM [RIO TINTO]
   DMC PROJECTS/ASHE MORGAN– 45% COMMITTED. H1 2021
4. 80 ANN ST—60,243 SQM [SUNCORP]
   MIRVAC/M&G– C60% COMMITTED. H2 2022

DEVELOPMENT APPROVED

5. 360 QUEEN ST—38,000 SQM
   CHARTER HALL POF/ICPF– SITE WORKS TIMING STC
6. 343 ALBERT ST—50,160 SQM
   CHC 5%/GIC95% TIMING STC
7. 150 ELIZABETH ST—C42,000SQM
   ISPT– TIMING STC. MAY REFRESH DA
8. 62 MARY ST- 38,000SQM
   QIC—TIMING STC

DEVELOPMENT APPLICATION/MOOTED/ EARLY FEASIBILITY

9. 205 NORTH QUAY—61,983 GFA SQM
   CBUS/NIELSON PROP. DEV APPLICATION
10. 60 QUEEN ST—26,592 SQM
    CHARTER HALL. DEV APPLICATION
11. WATERFRONT PRECINCT NORTH TOWER—75,331 GFA SQM
    DEXUS . DEV APPLICATION
12. WATERFRONT PRECINCT SOUTH TOWER—60,000 GFA SQM
    DEXUS. DEV APPLICATION
13. 133 MARY ST ANNEX—12,226 SQM
    ARA. DEV APPLICATION
14. 309 NORTH QUAY—C55,000 SQM
    CHARTER HALL. MOOTED
15. 141 EAGLE ST—27,000 SQM
    GPT. MOOTED
16. GRIFFITH UNI CAMPUS—ROMA STREET CROSS RIVER RAIL STATION MOOTED

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

INCENTIVES INCREASING QUICKLY

Face rents have come under some pressure with low tenant activity, however to date most of the movement has been from increased incentives

Prime face rents have fallen by only 0.8% since the start of 2020 and remain 0.6% above the levels of a year ago. Landlords have been reluctant to give up the ground made in face rents since late 2018, hoping for the storm to pass relatively quickly. Therefore tenant enticement has largely been through increases to incentives and other inducements such as delayed lease start and removal of make-good clauses.

Prime incentives were 35% on average at the start of 2020 and have increased by 200bps to 37% as at mid-year with the trajectory to continue through into 2021 with a peak of 38.5%, on average. With tenants ready to act still scarce and landlords wanting to see some post COVID-19 activity, there will be deals done out of line with the currently accepted range of 35-40% for prime assets.

Prime effective rents have fallen by 1.8% in the year to Jul 20 and are forecast to fall a further –4.3% to mid-2021 before stabilising and starting to see some improvement into early 2022. This is dependent on the economy recovering to pre-COVID-19 levels in approximately two years from onset.

The lack of deals negotiated in the past six months, particularly any of scale, continues to hamper an accurate measurement of market conditions. Many tenants are combining rental relief negotiations with lease extensions or rolling month to month deals.

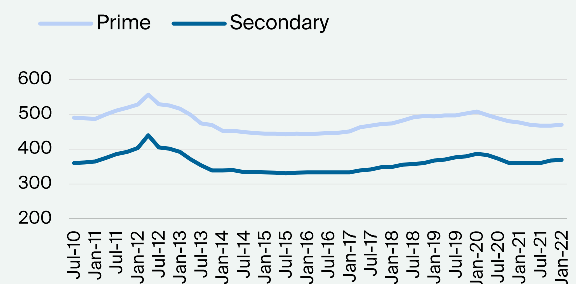
A lack of activity means that clarity for market rental levels is lacking

While many of these negotiations are ongoing, there are relatively few which are finalised. Additionally confidentiality arrangements hamper market clarity. The lack of new long term leases and/or blended relief/extensions is likely to continue during the remainder of 2020.

The secondary market has also seen effective rental falls of 0.9% yoy to July 2020 with a further fall of 3.6% to mid-2021 expected. Incentives have increased to 40% on average and are forecast to increase further into 2021 to 42%. Unlike Sydney and Melbourne the Brisbane CBD had seen only relatively modest increases to effective rents over the past three years and therefore the rental market is likely to be more stable.

Brisbane CBD Rents

$/sqm gross effective prime v secondary



Source: Knight Frank Research

Recent significant tenant commitments

OCCUPIER	PROPERTY	PRECINCT	SIZE SQM	FACE RENT $/SQM	INCENTIVE	TERM YRS	START DATE
IWG/Regus	71 Eagle St	Financial	3,729	880	35-40	10	Feb 20
Over the Wire	100 Creek St	Financial	1,754	710	35-40	6	Oct 20
Bornhorst & Ward	133 Mary St	Midtown	807	630	40+	7	Jul 20
Tanda	545 Queen St	Uptown	750	640	-	7	Jul 20
Hudson Recruitment	12 Creek St Annex	Financial	625	850	30-35	7	Jul 20
McMahon Clarke	100 Creek St	Financial	563	697	35-40	7	Apr 20
Taishin Bank	111 Eagle St	Financial	464	945	25-30	5	Oct 20

Pre-commitment ^ Lease of speculatively developed space ~Existing space

LIMITED ACTIVITY IN 2020 TO DATE

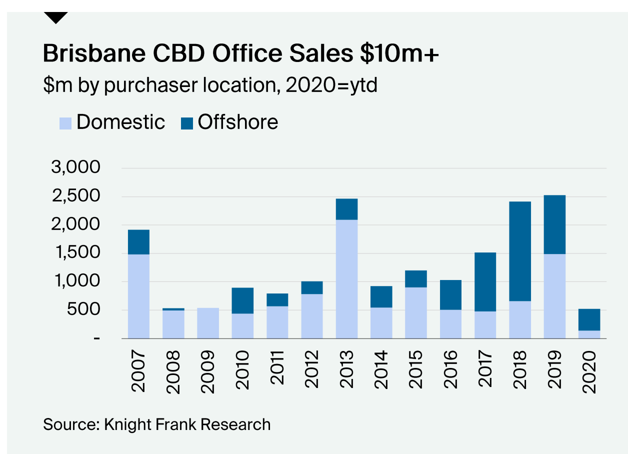
Whether due to travel restrictions preventing due diligence or a lack of market clarity/confidence, there have been no major CBD office building transactions negotiated since early 2020.

Transaction activity in the Brisbane CBD has stalled with only a few sales, largely negotiated in late 2019, reaching completion during 2020. With turnover to date standing at $520 million, there is the potential that the low levels of transactions seen during 2008 and 2009 (c$540 million) may be repeated.

Testing the market during this period has been 50 Ann St, which was being formally marketed just as the pandemic impact on travel restrictions emerged in March. After an initial contract did not proceed the property was informally offered again in July, but also failed to progress past due diligence. The asset, fully leased to the State Government with a c4 year WALE, has just been re-launched to the market with an EOI close in November.

There are also at least two off market assets in negotiation or due diligence which may provide more definitive market direction on the risk acceptance of purchasers. It is expected that letting up assumptions and exposure to vacancy will be priced more harshly than in 2019.

Despite this caution, the long term interest in Brisbane as a key investment destination remains with medium to longer term development sites still being contested. In August DEXUS settled their acquisition of 155 Edward St for $87 million. The future site has a key corner position next to extensive holdings by the Catholic Church.



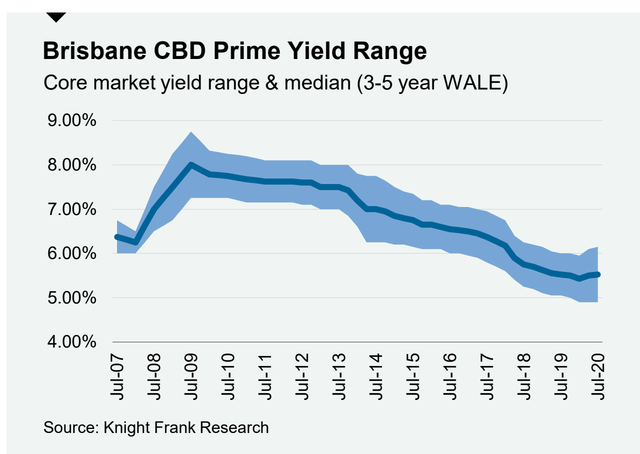
Source: Knight Frank Research

Additionally, a large land parcel in the maturing North Quarter precinct is being acquired by Charter Hall with the purchase of 309 North Quay becoming unconditional in March. The precinct will benefit from the extensive infrastructure works in that portion of the CBD with the Roma Street Rail Station to become the only CBD station which has all lines running through the station.

Demonstration of economic resilience and continued infrastructure spend will be essential to keep Brisbane front of mind with investors.

Brisbane has been considered a secondary market behind Sydney and Melbourne at roughly half the physical size. However the recent sustained improvements in the leasing market, and investor appetite for Australia has seen Brisbane offerings now considered by a far wider tranche of international buyers than was the case just 5 years ago.

As investors deal with both the physical barriers to inspecting and purchasing assets and the natural human response of risk aversion during un-precedented times it is to be expected that other key gateway cities are being considered ahead of Brisbane in the short term. For this reason, aside from 50 Ann St, there have been no on-market campaigns of significant office assets, leaving the market untested. In recent weeks the Sydney investment market has seen renewed activity after a quiet year to date and Brisbane is now following suit. As transactions complete again in the gateway cities it is expected that non-gateway markets will also regain traction. Overall Australia is expected to consolidate its reputation amongst the APAC region for good governance and stable markets.



Source: Knight Frank Research

Yield range is broadening as core assets hold value; but risk-exposed assets soften.

Money market fundamentals remain highly supportive of stable low yields with both the RBA and Fed continuing a dovish stance. The RBA has expanded the low interest rate target from only the cash rate to 0.25% on 3 year bonds as well. Longer term, the cost of money also remains at low levels with the Aust (0.85%) and UST (0.69%) 10 year bonds.

For true core assets, Government or corporate tenants not exposed to economic fragility with long term leases, yields are expected to continue to show a slight firming trend. The scarcity of such assets and the shift in investor sentiment to safe havens will only intensify competition and take yields to potential further new lows for these assets. In the main, prime Brisbane assets are expected to see yields remain relatively stable, however assets with potential exposure to vacancy in the next 2-3 years may face some discounting if offered to the market, broadening the yield band.

In contrast, secondary yields are more vulnerable to sentiment and potentially higher vacancy across the sector as a whole. The weight of funds seeking value-add assets is anticipated to be lower in the short term. While distressed vendors are not yet on the horizon, this may emerge should the lockdowns continue into 2021. With no transactions negotiated in recent months it is difficult to point to any definitive movement in yields, however the longer it is with no transactions, the greater the chance that there is a dislocation between buyer and vendor expectations.

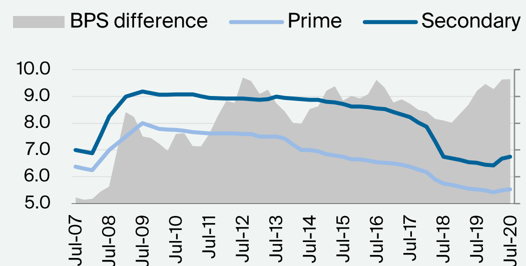
“Price impacts have been highly divergent. True core property pricing has remained firm, however exposed assets have been hit harder with a difference in price expectations still in place between purchasers and vendors of these assets.”

JUSTIN BOND

HEAD OF CAPITAL MARKETS QUEENSLAND

Brisbane CBD yields

% median core market yield (LHS), bps premium prime yields to 10 year bonds (RHS)



Source: Knight Frank Research, RBA

Recent significant sales

PROPERTY	PRICE $M	CORE MARKET YIELD %	NLA SQM	$/SQM NLA	WALE	PURCHASER	VENDOR	SALE DATE
155 Edward St#	87.00	-	1,528 site	-	6.5	Dexus Property Group	Private Investor	Aug 20
66 Eagle St	380.0^	5.04	31,896	11,914	3.5	Deka-Immobilien Global	APPF Commercial & ADIA	Mar 20
410 Queen St	53.50	5.01	5,704	9,379	2.4	PGA Queen St	Rifici Family	Feb 20
313 Adelaide St	137.60	5.70	14,592	9,430	5.5	Prime Super	Deutsche Asset & Wealth Mgt	Dec 19
308 Queen St & 88 Creek St	47.40	6.08	4,506	10,519	1.5	Primewest (unlisted fund)	University of Queensland	Dec 19
247 Adelaide St	18.59	6.28	3,019	6,158	2.5	Charter Hall REIT/ Abacus Funds Mgt	Private Investor	Dec 19

NLA of 2,044sqm the income is from high end retail tenants but purchased as a medium term redevelopment option, yield undisclosed ^gross price

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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