- *Positive demand for best in class assets*
- *Continued rental growth*
- *Yield softening playing out*

Knight Frank

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Sydney CBD Office

Market Report, August 2023

BEST IN CLASS ASSETS OUTPERFORMING

11.5%
VACANCY
PCA data at July-23

186,186
Sqm new supply in 2024

3.4%
Prime net face rental growth (YoY)

"Flight to amenity and quality driving demand for best in class assets in core location."

Key Insights

With inflation now past its peak and interest rates nearing the end of its tightening cycle, the path forward will become clearer for occupiers and investors.

Office space enquiry, specifically for prime space has been positive, with lease deals over the last 18 months driven by professional services and financial services.

With incentives holding firm and a 3.4% increase in face rental growth y/y to average $1,274/sqm; there has been positive movement in net effective rents with an increase of 2.1% y/y to measure $759/sqm.

This year will see development activity limited to boutique size developments and minor refurbishments totalling c33,000sqm before an influx of new supply in 2024 stemming from the OSD.

Increasing funding costs and cautious investors sitting on the sidelines has resulted in only one major transaction in the CBD so far this year.

Prime yields are judged to have softened by 100bps since mid last year and will continue to be tested throughout the year.

Sydney CBD Office Market Indicators — July 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	3,359,491	11.4	30,873	77,129	1,274	34	2.1	5.00-5.75
Secondary	1,890,470	11.7	-90,784	-61,036	912	34	-2.1	6.25-6.75
Total	**5,249,961**	**11.5**	**-59,911**	**16,093**				

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

POSITIVE DEMAND FOR PRIME SPACE

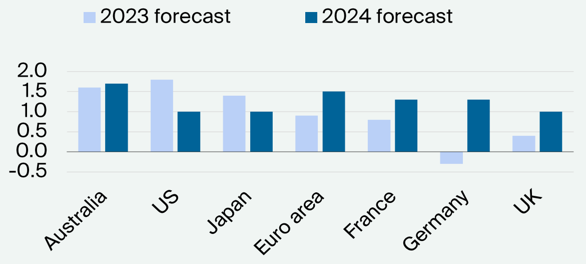
Economic slowdown provides clearer path forward

Like all economies, Australia has been impacted by higher interest rates and surging inflation, however, the labour market and wider business sentiment have been resilient. The pace of economic growth has begun to slow due to declining consumer spending, but Australia is still expected to out-perform peer economies with forecast growth of 1.6% in 2023 and 2024, with Sydney retaining its place as a leading investment hub within the Asia Pacific region.

Flight to amenity and quality driving demand for best in class assets in core location

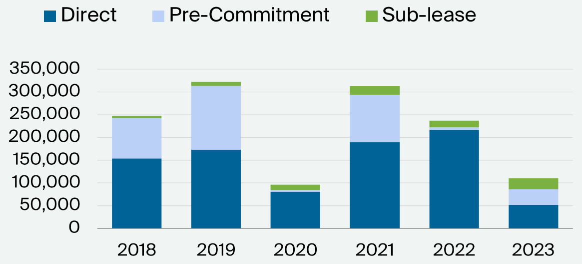
Last year saw a strong finish to the year in terms of lease deal volumes with c236,000sqm of deals signed, in line with the five year average and driven by direct lease deals. So far for 2023, enquiry has been moderate and translated into over 110,000sqm of lease deals across not only direct leasing transactions but pre-commits and above trend sub-lease deals.

IMF GDP forecasts
GDP forecasts, July-23



Source: Knight Frank Research/IMF

Activity by deal type
2018-2023YTD, by total sqm



Source: Knight Frank Research

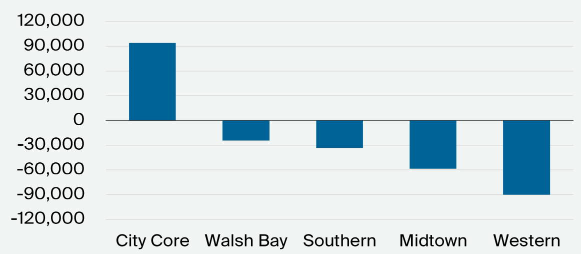
Demand since the beginning of 2022 has been driven by financial services 27% and professional services 24%. Notably, tech sector demand has slowed from its peak in 2021-22 given the downsizing in workforces playing out globally across major tech giants such as Google, Facebook, Atlassian and Microsoft.

The flight to amenity story continues to drive the demand for quality workspaces located close to multiple public transport options, food and retail operators, independent grocers, green spaces and wellness activities. Activating these amenities and offerings in the CBD provides an attractive reason for workers to come back to the workplace, socialise and collaborate. Furthermore, there has become clearer divergence in demand between precincts with the core precinct far outperforming the other sub-markets across the CBD.

Overall vacancy edged slightly higher to 11.5% from 11.3% over the six months to July 2023, which has stemmed from the negative absorption levels in the secondary market. By grade, prime vacancy has increased slightly to 11.4% as at July-23, despite recording positive absorption of 5,397sqm over the period, the increase in vacancy was supply driven rather than a lack of demand. In the secondary market, vacancy stabilised at 11.7%, the withdrawals over the period offset the negative demand. Over the last five years the flight to quality trend has become clear with absorption levels averaging negative 51,288sqm per annum in the secondary market, whilst the prime market has averaged positive demand of 27,632 sqm over the same period.

Looking ahead, assets in the market which have not had significant investment and upgrades that appeal to occupiers will continue to struggle, whilst the best in class assets in core locations will outperform and likely cause a great divergence between assets in the market.

Sydney CBD office demand by precinct
Total absorption 2020-2023 (sqm)



Source: Knight Frank Research, PCA

NEW DEVELOPMENT STOCK SOUGHT AFTER

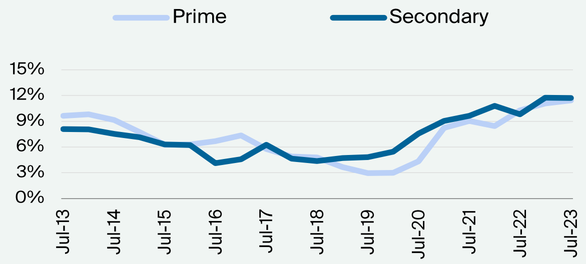
Limited new supply in 2023

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.

Following the two major completions of Quay Quarter Tower and Sydney Place last year, new supply over the first half of this year has been limited to the refurbishment of 255 George Street (19,000sqm). 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.

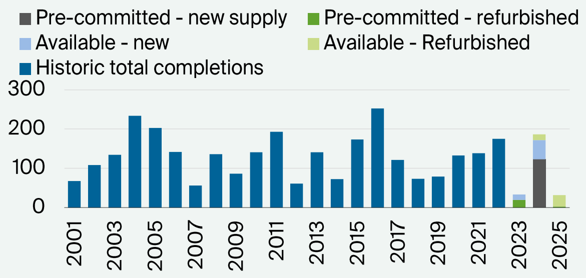
There were a number of buildings permanently withdrawn over the first half of the year, totalling 52,235sqm. The majority of these were withdrawn to make way for the Hunter Street Metro stations. This has resulted in a drop of the office stock base by 0.6% to now total 5,249,961sqm. By the end of 2024 the total stock base is forecast to eclipse 5.4 million sqm.

Vacancy
By grade



Source: Knight Frank Research, PCA

Sydney CBD Development Completions
By Commitment type, '000s sqm



Source: Knight Frank Research, PCA

Next wave of premium supply in 2024 already substantially pre-committed

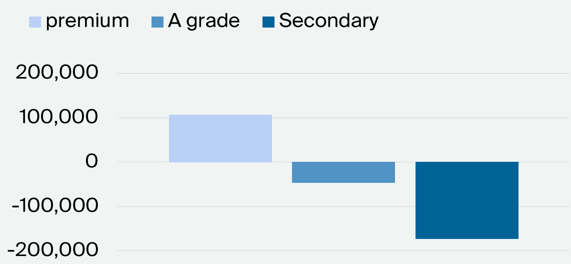
Whilst the delivery of new stock over the last 18 months has been substantially pre –committed, it has resulted in some large backfill vacancies in addition to some occupiers subleasing or reducing office footprint. Major tenant movements resulting in large backfill space include Deloitte vacating Grosvenor Place (27,800 sqm) moving into QQT along with Salesforce vacating Darling Park Tower 3 into Sydney Place. At Barangaroo, Lendlease and Westpac are sub-leasing some of their space whilst PWC and KPMG have handed back several floors.

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 aid current supply levels to be absorbed by the market in the medium term.

The next wave of new premium supply will be delivered in 2024 stemming from the Over Station Developments at Metro Martin North Tower (75,000sqm), Metro Martin South Tower (30,000sqm) and Parkline Place OSD (49,120sqm). Across these three schemes a commitment rate of over 80% has already been achieved. Additionally, boutique development at 333 Kent Street is scheduled for delivery in late 2024 which will encompass 14,200sqm of prime office space.

Beyond the OSD developments there are no major schemes forecast for delivery until at least 2027. The only major development which has broken ground is at 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.

Sydney CBD office demand by grade
Total absorption 2020-23 (sqm)



Source: Knight Frank Research, PCA

MAJOR OFFICE SUPPLY

MAJOR REFURBISHMENTS

1 255 GEORGE STREET–19,000 SQM
MIRVAC – COMPLETE

2 33 ALFRED STREET–32,615 SQM
MIRVAC/DEXUS– 15% COMMITTED-
H1 2025

3 MERCHANT HOUSE, 333 KENT STREET–14,200 SQM
ADDENBROOKE– H2 2024

UNDER CONSTRUCTION/ MAJOR PRE-COMMITMENT

4 121 CASTLEREAGH STREET–12,068 SQM
CBUS–50% COMMITTED - H2 2023

5 32-36 YORK STREET–8,366 SQM –45% COMMITTED–H2 2023

6 PARKLINE PLACE–49,120 SQM OXFORD/ INVESTA–77% COMMITTED [BDO,PNSW] - H1 2024

7 METRO MARTIN NORTH TOWER–75,000 SQM [MACQUARIE BANK] 100% COMMITTED
MACQUARIE GROUP– H1 2024

8 METRO MARTIN SOUTH TOWER–30,000 SQM–[ASHURST] 30% COMMITTED
INVESTA/MANULIFE– H1 2024

9 TECH CENTRAL ATLASSIAN TOWER– 75,000 SQM [ATLASSIAN]
ATLASSIAN– 100% COMMITTED, H1 2027

10 2 CHIFLEY SOUTH –42,000 SQM
CHARTER HALL/GIC– 38% COMMITTED [UBS,CHARTER HALL] - 2027

11 55 PITT STREET–70,000 SQM
MIRVAC 2027

12 HARBOURSIDE–27,000SQM MIRVAC
STAGE 1 (H1 2026) STAGE 2 (H1 2027)

DEVELOPMENT APPROVED

13 CENTRAL PLACE 1 –69,000 SQM
DEXUS/FRASERS– H1 2028

14 CENTRAL PLACE 2 –69,000 SQM
DEXUS/FRASERS– 2030+

15 2 LEE STREET–26,300 SQM
TOGA–H2 2027

MOOTED DEVELOPMENTS

16 56 PITT STREET–58,000 SQM
DEXUS 2030+

17 133 CASTLEREAGH STREET–90,000SQM
STOCKLAND H1 2029

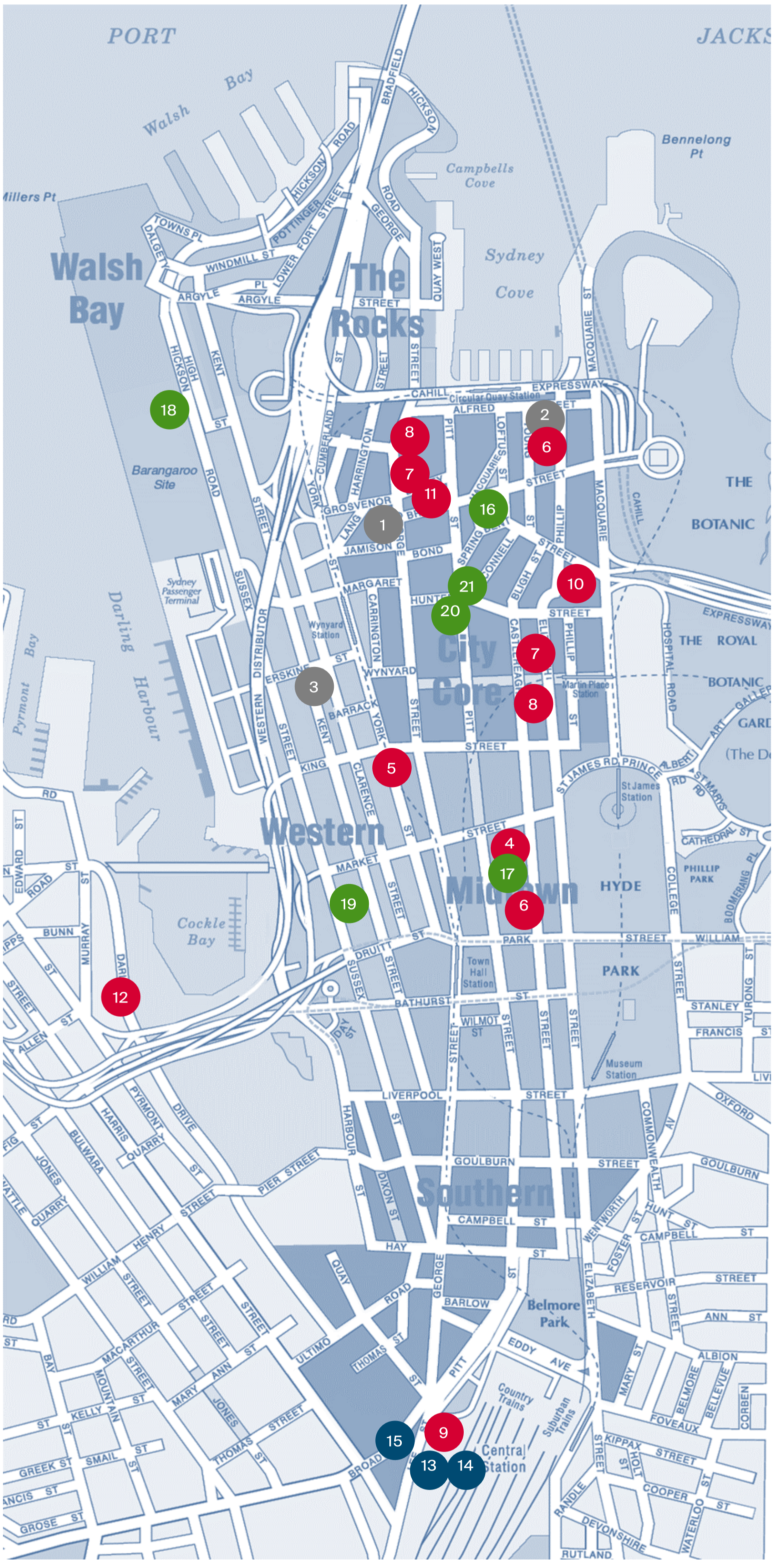
18 CENTRAL BARANGAROO–48,350 SQM
AQUALAND TBC

19 DARLING PARK TOWER 4–75,000 SQM
GPT/MIRVAC – H1 2030

20 HUNTER CONNECTION EAST TOWER 66,500 SQM H1 2030

21 HUNTER CONNECTION WEST TOWER 53,523 SQM H1 2030

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



STEADY RENTAL GROWTH WITH FIRM INCENTIVES

Continued growth for net face rents

The rental growth momentum continues in the first half of 2023. On an annual basis (to July 2023), average net face rents have increased by 3.4% to $1,274/sqm ($1,500/sqm gross face) for the prime market. The secondary market has reported a moderate annual growth rate of 1.3% on net face rent over 12 months to average $912/sqm ($1,093/sqm gross face). It is worth noting that prime rents in the core saw the strongest growth over the year of 4.1% to average $1,407/sqm. With new developments and generally best in class assets located in the core precinct it is likely we will continue to see stronger growth in this sub-market.

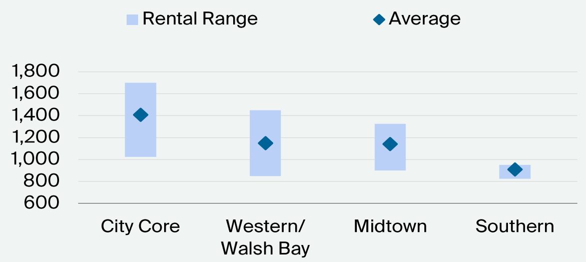
The current rental discount between prime and secondary net face rents remains the widest gap in over five years at 28%. This is driven by the demand weighting towards more prime office space, and new premium grade buildings resetting the top-end prime rents.

Incentives remain elevated

Average incentives remain elevated at 34%, with some deals struck in the high 30's. Landlords have been offering high incentives to secure and entice tenants into their buildings and the high incentives are forecast to continue for the foreseeable future.

Net rental range

By precinct, $/sqm



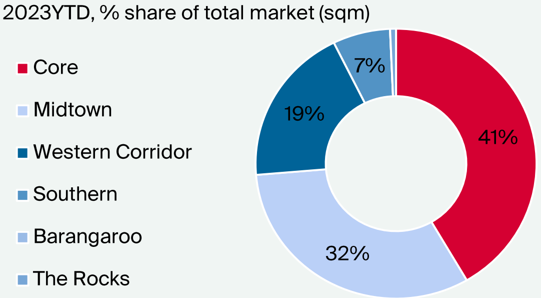
Source: Knight Frank Research

The average prime net effective rents increased mildly by 2.1% over the year to measure $759/sqm, these levels are still 18% below the pre-pandemic levels. In the secondary market net effective rents are averaging $538/sqm as at July 2023.

Looking ahead, incentives are to remain at their current levels, with landlords continuing to offer additional inducements to prospective tenants to fill their space such as early access and contribution to fitouts.

Lease deal activity by precinct

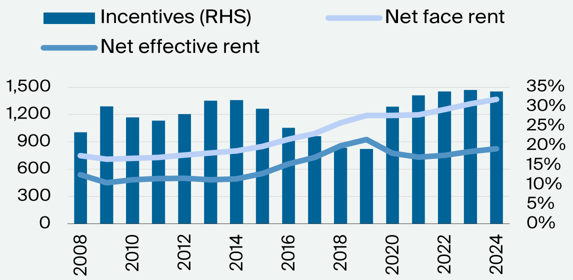
2023YTD, % share of total market (sqm)



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
Velocity frequent flyer~	420 George Street	Midtown	1,220	1,330	34%	5	Q2-23
Adobe ~	201 Sussex Street	Western	5,844	1,190	38.5%	5	Q2-23
QIC ~	1 Bligh Street	Core	1,637	1,590	34.0%	7	Q2-23
Maurice Blackburn ~	161 Castlereagh Street	Midtown	1,547	1,350	38.0%	6	Q2-23
Kardos Scanlan ~	44 Martin Place	Core	850	1,230	35%	5	Q2-23

Pre-commitment ^ Sublease ~Direct

SIGNIFICANT DROP IN INVESTMENT ACTIVITY

Shift in tone from the RBA will help to restore confidence

For more than a year, uncertainty over the extent and duration of the interest rate hiking cycle has cast a shadow over the global office market and Sydney has been no exception. Rising funding costs and pervasive uncertainty have encouraged many investors to sit on the sidelines, while vendors have opted to wait until sentiment improves before bringing assets to market. As a result, deal flow has stalled with only one transaction confirmed in the first half of 2023.

However, after an extended period of interest rate increases, recent RBA Board statements reflect growing confidence that the actions taken to date in raising the cash rate to 4.1% will prove sufficient to enable inflation to return to the target range of 2-3%. This shift in tone has come after consecutive quarterly declines in the inflation rate and consecutive quarterly contractions in retail sales volumes, which clearly indicate that the cumulative weigh of rate rises is now taking a toll on households and the pace of economic growth more broadly.

While slower growth would not typically be welcomed by the market, the silver lining is that it reduces the likelihood of further rate rises. Most forecasters are now expecting an extended pause from the RBA, which will provide a more reassuring backdrop for the property market and create the conditions for deal flow to gradually return.

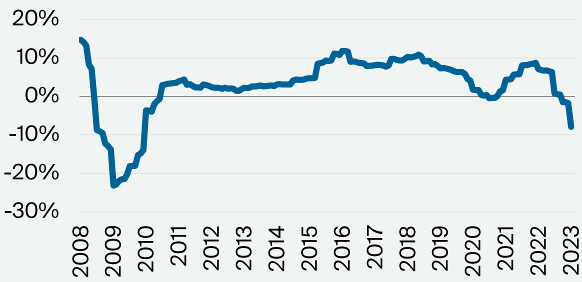
In the only deal so far this year, Hong Kong-based private equity group Pacific Alliance Group acquired the A-grade 44 Market Street from Dexus, for a net sale price of $393.1 million in June, reflecting a 17% discount to its December 2022 book valuation on a passing yield of 5.5%. Looking ahead, several assets are currently on the market that could boost transaction volumes in the second half of the year.

Widening yield spread between prime and secondary buildings

Despite the lack of deal flow, it is clear that pricing has been impacted, with average prime and secondary Sydney CBD yields judged to have expanded by 100 and 125 basis points respectively over the year to 5.4% for prime and 6.4% for secondary. Formal valuations have begun to adjust, with specialist office funds reporting an average annual decline of 7.9% over the year to June. The current yield spread between prime and secondary assets reflects a 7-year high of 100 basis points and is expected to rise further as the divergence in occupier market performance between prime and secondary assets feeds through to valuations. Yields will be tested more thoroughly in the second half of this year as more transactional evidence emerges.

Net capital return - office funds

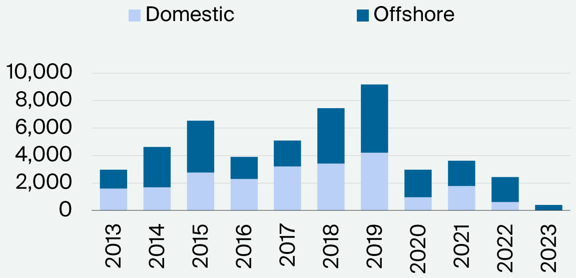
Average capital growth (y/y)



Source: Knight Frank Research, MSCI/Mercer Core Wholsale Monthly PFI

Sydney CBD investment volume

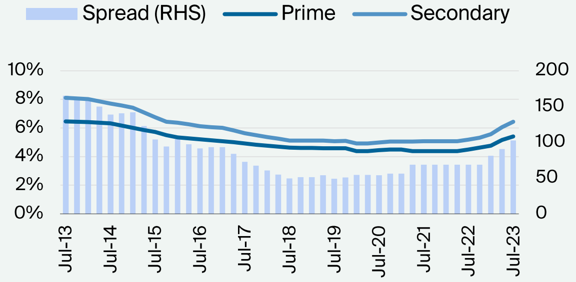
By purchaser ($m), domestic v offshore, $10m+



Source: Knight Frank Research

Sydney CBD office yield spread

Prime vs secondary



Source: Knight Frank Research

Recent significant sales

PROPERTY	PRICE $M	CORE MARKET YIELD %	NLA SQM	$/SQM NLA	WALE	PURCHASER	VENDOR	SALE DATE
44 Market Street	393.1 *	5.5#	30,699	13,356	2.7	PAG	Dexus	Jun-23
36 Carrington Street	70.5	4.3	2,874	24,530	4.1	AFIAA	Brookfield	Sep-22
32 Carrington Street	38.5	4.5	2,127	18,101	2.6	April Group	Brookfield	Sep-22
74 Castlereagh Street	160	4.2	5,640	28,369	1.8	Charter Hall	Country State Development	Sep-22
4-6 Bligh Street	210	4.4	10,027	20,943	3.0	Local Private	RECAP IV Fund^	Jul-22

*Net sale price ^ Real Estate Capital Asia Partners IV Fund
passing yield

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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