Sydney CBD Office Market

February 2024

Divergence across grades and precincts with premium grade assets in the core precinct out-performing

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Key Insights

Occupier and investor demand weighted towards best in class assets in core locations

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12.2%

Rise in overall vacancy

Overall vacancy edged higher to 12.2% from 11.3% over the year to January 2024.

-101K

Two year net absorption

Despite overall negative absorption across the CBD, premium grade stock within the core precinct has outperformed with positive absorption of 94,674sqm over the same period.

188k

Sqm of new supply in 2024

New development in 2024 will stem from the Over Station Developments. The market will then enter a period of limited supply in 2025-26 which will aid market recovery.

36%

Industry sector demand

Deal volumes were driven by the professional services and financial services industry accounting for 36% and 26% respectively.

4.5%

Rental growth

Prime net face rents average $1,311/sqm, an increase of 4.5% over the year. Incentives remain elevated at 35% and forecast to remain at this level over the medium term.

$1.6b

2023 transaction volumes

Transactional activity at its lowest level in over a decade for 2023, however activity likely to pick up as sentiment and outlook improves.

Sydney CBD Office Market Indicators – January 2024

Grade	Total Stock sqm	Vacancy Rate %	Annual Net Absorption sqm	Annual Net Additions sqm	Average Gross Face Rent $/sqm	Average Incentive %	Effective Rent Gth % y/y	Core Market Yield %*
Prime	3,346,904	12.5%	-41,806	6,413	1,543	34.9%	2.6%	5.78%
Secondary	1,872,389	11.8%	-62,995	-70,316	1,122	34.8%	0.6%	7.19%
Total	5,219,293	12.2%	-104,801	-63,903				

Source: Knight Frank Research/PCA * assuming WALE 5 years

Occupier demand strongest for premium assets

PROFESSIONAL AND FINANCIAL SERVICES DRIVING OCCUPIER DEMAND LEVELS

Weak absorption levels of negative 104,801 sqm were recorded over the CBD in 2023, despite this there has still been a healthy level of lease deal volumes and tenant enquiry. The weak absorption levels have partly been driven by some large occupiers downsizing.

Direct leasing transactions accounted for 60% of the deal volumes whilst the sub lease deals doubled its average with 42,000sqm in transactions. Furthermore; pre-commit activity was healthy with 50,000sqm signed mainly across the Over Station Developments and Chifley South.

Occupier demand trends over 2023 were driven by professional services and financial services accounting for 36% and 26% respectively of total deal volumes. Tech sector demand slowed to 10% of deal volumes. Demand in 2024 will likely stem from the professional and financial services occupiers as many revisit their workplace strategies and look to capitalise on an occupier favoured market.

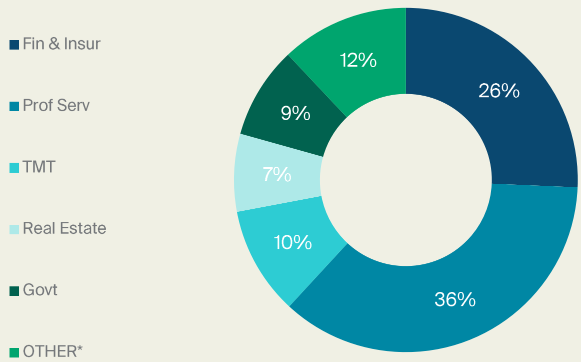
The structural shift of flight to quality and amenity continues to drive the demand for quality workspaces located close to multiple public transport options, food and retail operators, independent grocers, green spaces and wellness activities. Activating these amenities and offerings in the CBD provides an attractive reason for workers to come back to the workplace, socialise and collaborate.

DIVERGENCE ACROSS GRADES AND PRECINCTS WITH CORE PREMIUM STOCK OUTPERFORMING

Overall vacancy edged higher to 12.2% from 11.3% over the year to January 2024, which has stemmed from the negative absorption levels in the secondary market. By grade, prime vacancy has increased slightly to 12.5% as at Jan-24. In the secondary market, vacancy remained steady at 11.8%, the withdrawals over the period offset some of the negative demand. Over the last three years the flight to quality trend has become clear with absorption levels totalling negative 117,722sqm in the secondary market, whilst the premium market has experienced positive demand of 98,734 sqm over the same period. This is further highlighted by demand levels across the precincts, with prime assets in the core clearly outperforming the wider market as the only precinct to record positive absorption over the last three years.

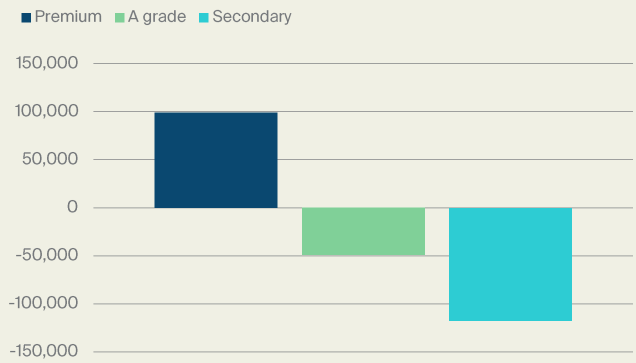
Looking ahead, assets in the market which have not had significant investment and upgrades that appeal to occupiers will continue to struggle, whilst the best in class assets in core locations will outperform and likely cause a greater divergence between assets in the market.

Lease deals by industry sector
2023, % share of total market (sqm)



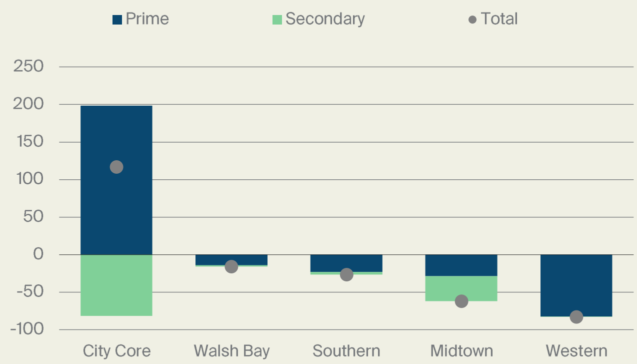
Source: Knight Frank Research

Sydney CBD office demand by grade
Total absorption 2021-23 (sqm)



Source: Knight Frank Research, PCA

Sydney CBD office demand by precinct
Net absorption 2021-2023, '000sqm



Source: Knight Frank Research, PCA

New development stock sought after

OVER STATION DEVELOPMENTS TO DRIVE NEW STOCK IN 2024

The clear divergence for demand between prime and secondary assets has been a driving force behind new developments and refurbishments as owners look to align building quality, design, environmental sustainability and wellbeing to occupier preferences in the CBD office market.

A number of buildings were withdrawn over the year, totalling 93,313sqm, the highest level of withdrawals since 2019. The majority of these were permanently withdrawn to make way for the Hunter Street Metro stations, along with some office refurbishments. This has resulted in a drop of the office stock base by 1.2% over the year to total 5,219,293sqm. By the end of 2024 the total stock base is forecast to near 5.4 million sqm. Following a strong year of development activity in 2022, new completions were at its lowest on record in 2023 with 29,410sqm. The subdued level of development activity in 2023 aided current supply levels to be absorbed by the market.

The next wave of new premium supply will be delivered this year 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 87% has already been achieved. Additionally, boutique developments at 333 Kent Street is scheduled for delivery in late 2024 which will encompass 14,200sqm of prime office space, along with CBUS property development at 121 Castlereagh Street (11,500sqm).

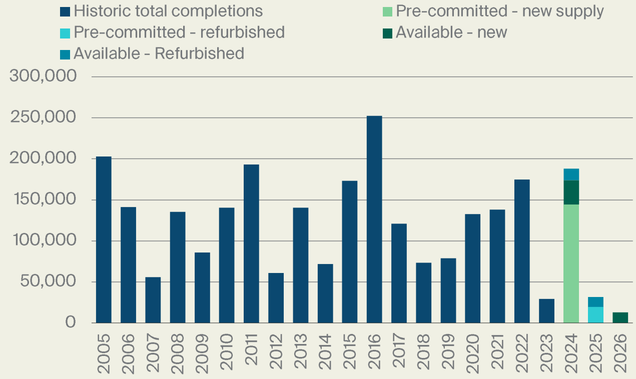
LIMITED DEVELOPMENT ACTIVITY IN 2025-26 WILL AID ABSORPTION FOR CURRENT STOCK LEVELS

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; Atlassian Tower, who will anchor a 75,000sqm tower which will drive the organic expansion of the CBD to its Southern boundaries. A further two developments are slated for delivery in 2027, which have already seen strong interest and commitments; these being Charter Hall's 2 Chifley South (42,000sqm) and Mirvac's 55 Pitt Street (70,000sqm).

New developments in the Sydney CBD have been in high demand historically, with an average pre-commitment rate of 86% across all new developments since 2018. Environmental design and ESG have been at the forefront of new developments and a contributing factor to strong commitment levels. With the next wave of supply already predominately leased this will bode well for other vacancies to be absorbed in addition to giving developers confidence for future developments.

Sydney CBD development completions

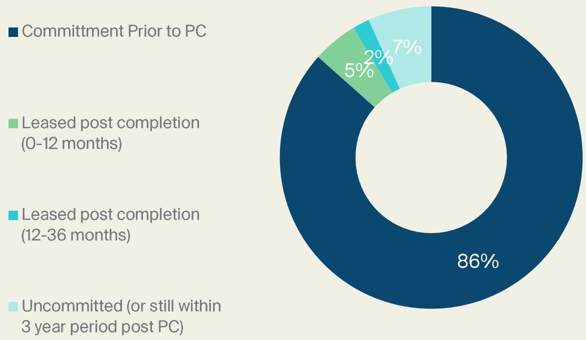
By Commitment type, sqm



Source: Knight Frank Research

Letting up times new developments

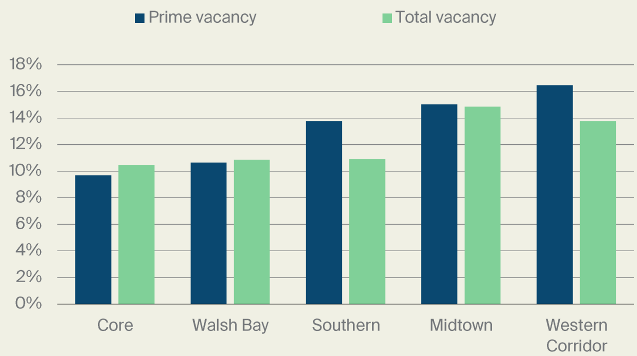
Since 2018



Source: Knight Frank Research

Vacancy rates by precinct

Prime vacancy vs total vacancy, as at Jan-24



Source: Knight Frank Research

Major office supply

Major Refurbishments

#	ADDRESS	SQM	COMPLETION
1	33 Alfred St	31,657	2025

Under Construction / Major Pre-commitment

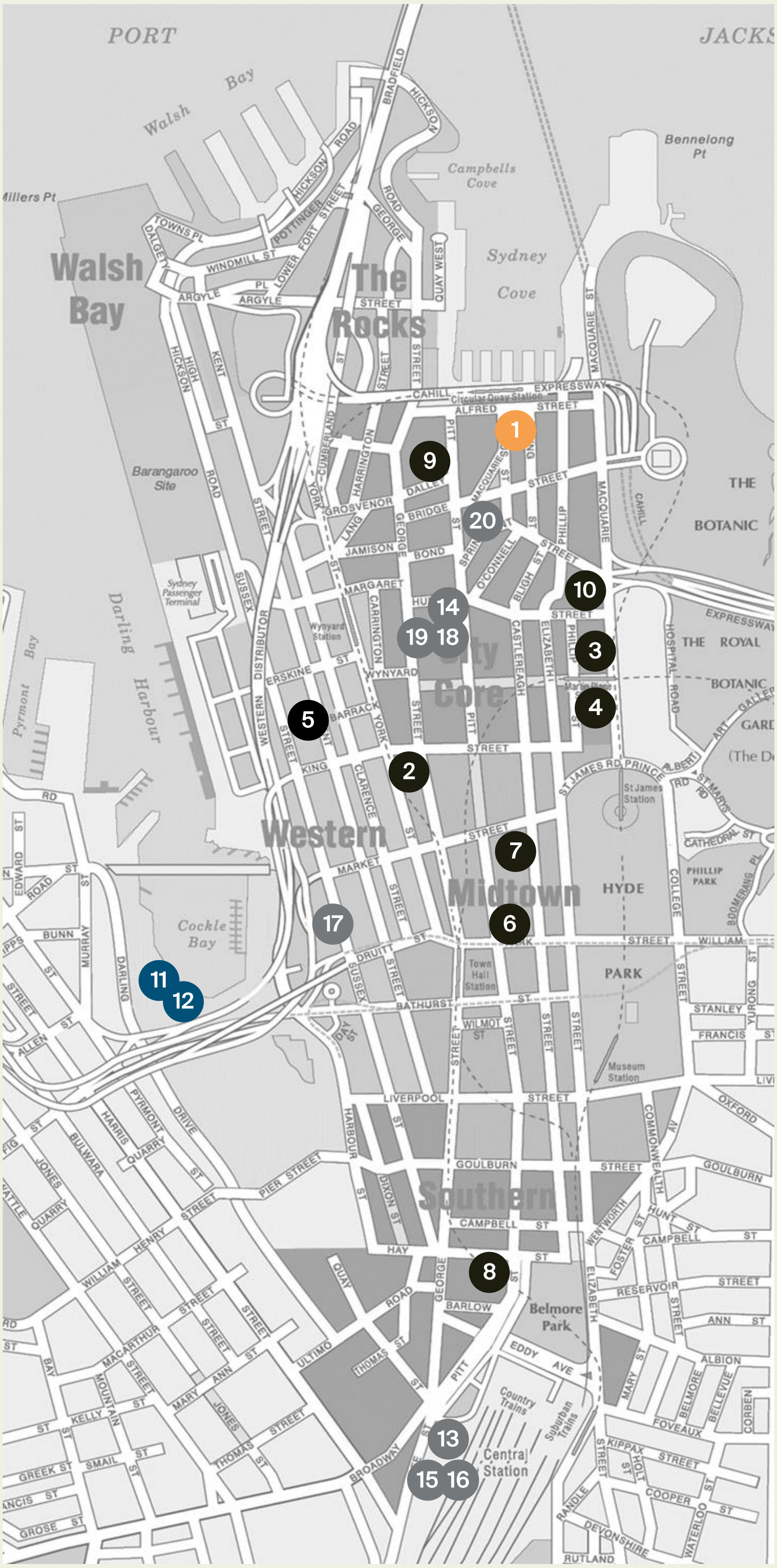
#	ADDRESS	SQM	COMPLETION
2	32-36 York Street	8,366	H1 2024
3	Metro Martin North Tower	75,000	H1 2024
4	Metro Martin South Tower	30,000	H1 2024
5	333 Kent St	14,200	H2 2024
6	Parkline Place	49,120	H2 2024
7	121 Castlereagh Street	11,500	H2 2024
8	Tech Central Atlassian Tower	75,000	H1 2027
9	55 Pitt Street	70,000	H1 2027
10	2 Chifley Square (South)	42,000	H2 2027

Development Approved

#	ADDRESS	SQM	COMPLETION
11	Harbourside (stage 1)	13,000	H2 2026
12	Habourside (stage 2)	14,000	H2 2027

Mooted

#	ADDRESS	SQM	COMPLETION
13	2 Lee Street / Toga Central	22,000	H2 2027
14	Milligan Development	50,000	2028
15	Central Place 1	47,209	2029
16	Central Place 2	69,000	2030
17	Darling Park Tower 4	75,000	2030
18	Hunter Connection East Tower	66,500	2032
19	Hunter Connection West Tower	53,523	2032
20	56 Pitt Street	58,000	2030+



Positive face rental growth as incentives remain high

PRIME AND SECONDARY RENTAL DISCOUNT CONTINUES TO WIDEN

Despite the rise in vacancy all CBD submarkets reported positive face rental growth over the year, resulting in the average CBD net face rent increasing 4.5% y/y to $1,311/sqm ($1,543/sqm gross face) in the prime market and 3.4% y/y to $934/sqm ($1,122/sqm gross face) for the secondary market. The core market, where occupier demand has been strongest, presented a 4.6% prime net face rental rise over the year, to average $1,442/sqm.

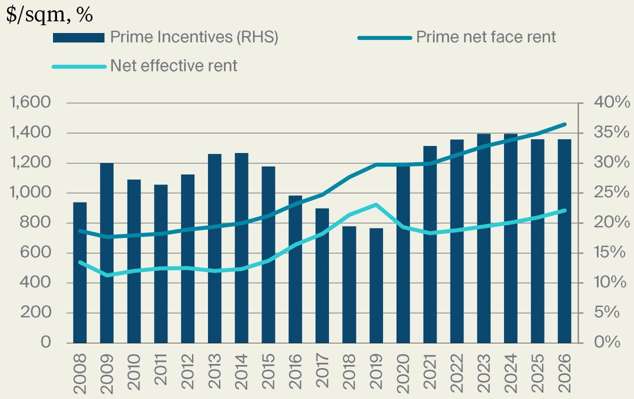
Rental discount between prime and secondary net face rents further expanded to 29% in Q4 2023, which is the widest gap since 2017. Driven by the demand weighting towards more prime office space and by new premium grade buildings resetting prime rents, the rental discount is likely to continue spreading.

INCENTIVES REMAIN ELEVATED

Incentives edged slightly higher over the year to average 35% for both prime and secondary markets. Positive movements in net effective rents were recorded over the year with the prime net effective rent average at $772/sqm as of the end of 2023, while secondary net effective rents measured $543/sqm. Despite the moderate growth in the net effective rents, they remain 12% down on pre-pandemic levels. Whilst face rents have grown across the board, there is a clear divergence in net effective growth across precincts as incentives have increased significantly more in the Western and Southern precincts impacting effective growth.

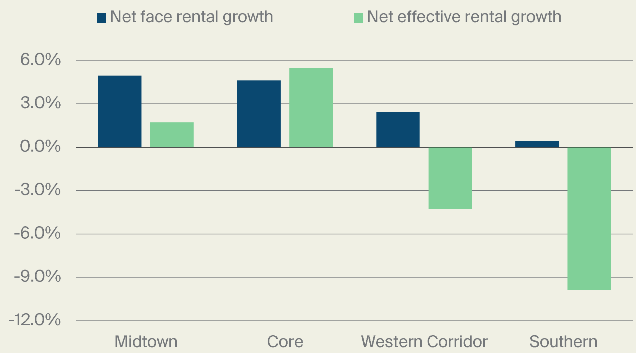
Looking ahead, incentives are anticipated to remain at current levels, with landlords continuing to offer additional inducements to fill their space such as early access and contribution to fitouts. With limited new supply in 2025-26 this will likely see further rental growth for prime assets across the CBD.

Rent and incentives
$/sqm, %



Source: Knight Frank Research

Sydney CBD office annual rental growth
By precinct, annual rental growth



Source: Knight Frank Research

Recent significant tenant commitments

Occupier	Property	Precinct	Size sqm	Face Rent $/sqm	Incentive %	Term yrs	Start Date
TPG (Vodafone) ^	200 Barangaroo Avenue	Barangaroo	9,248	1,260	38.0	7	Q3-23
BVN Architecture Services *	255 Pitt Street	Midtown	1,932	925	30.5	4	Q3-23
DIJGTAL ~	230 Clarence Street	Western	1,044	1,150 (g)	36.0	5	Q3-23
GPNSW *	66 Goulburn Street	Midtown	4,730	875	35.0	5	Q4-23
Bright HR ~	700 Harris Street	Southern	1,200	950 (g)	37.0	5	Q1-24
Wotton + Kearney ~	255 George Street	Core	2,800	1,550 (g)	35.5	10	Q4-24

Pre-commitment ^ Sublease ~ Direct * Renewal (g) gross face
Source: Knight Frank Research

Improving outlook for deal volumes

TRANSACTIONAL ACTIVITY TO PICK UP AS OUTLOOK AND SENTIMENT IMPROVING

Since mid 2022, uncertainty over the extent and duration of the interest rate hiking cycle 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 opted to wait until sentiment improves before bringing assets to market. As a result, deal flow was at its lowest level in over a decade in 2023, with only four major transactions totalling $1.6 billion in the Sydney CBD.

The major transaction last year was 60 Margaret Street trading on a core market yield of 6.1%, highlighting the clear shift in yield metrics. Furthermore, the sale of 255 George street is set to be finalised in the near term and will provide supportive evidence of where prime yield metrics sit.

The onset of the new year has seen a shift in tone and sentiment following consecutive quarterly declines in the inflation rate and a clearer economic outlook with markets factoring in the potential for rate cuts later this year.

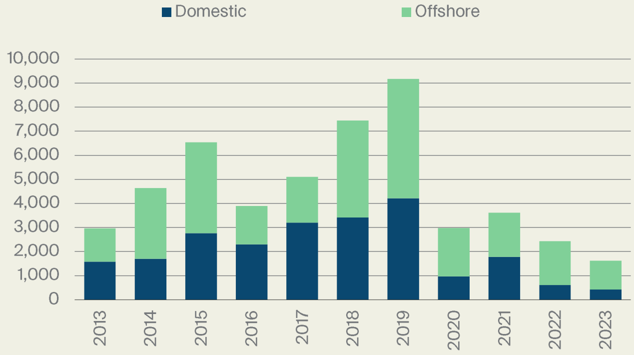
It remains to be seen whether these expectations will be met, but the debate provides a much more supportive backdrop for property than a year ago. With yields having substantially reset and the macro picture more encouraging, deal flow is likely to pick up as more investors return to acquisition mode and a number of assets are beginning on market campaigns along with many also shopped around off market. The disconnect between vendor and purchaser expectations and bid spread over the last 18 months is starting to close as fruition of declining book values come through which will further aid deal flow.

YIELD DISPARITY ACROSS PRECINCTS

Whilst sales evidence has still been limited, there has been a clear impact on pricing. Average prime and secondary Sydney CBD yields have expanded over the year to now average 5.8% and 7.2% respectively. The gap between prime and secondary is clear with capital values impacted harder in the secondary market given lower occupier demand for these assets and investors now having a stronger preference for assets with higher environmental sustainability. The yield spread is now at a decade high of 140bps between prime and secondary, with this divergence anticipated to expand further. Furthermore, there has become larger yield disparity between the precincts with prime assets in the core holding stronger valuations to other precincts, which is aligned to the occupier market performance.

Sydney CBD investment volume

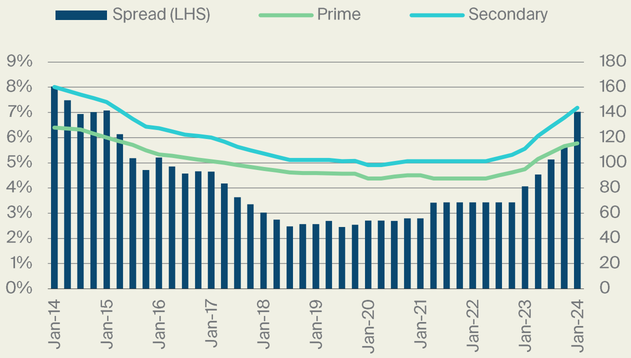
By purchaser ($m), domestic v offshore, $10m+



Source: Knight Frank Research

Sydney CBD office yield spread

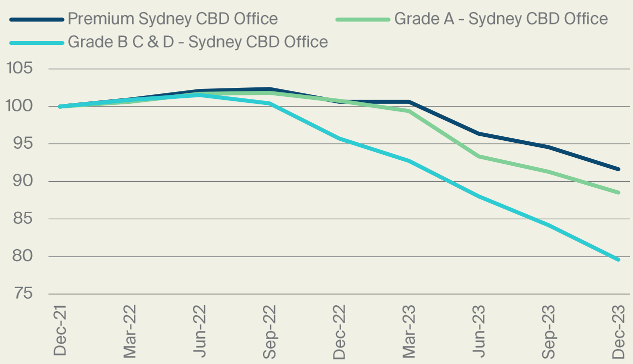
Prime vs secondary



Source: Knight Frank Research

MSCI valuation indices since end 2021

Capital value index by grade, December 2021 = 100



Source: Knight Frank Research, MSCI

Recent significant sales

Property	Price $ m	Core Market Yield %	NLA sqm	$/sqm NLA	WALE	Purchaser	Vendor	Sale Date
60 Margaret Street	779.2	6.1	47,167	16,520	3.3	AsheMorgan JV Mitsubishi Estate	Mirvac JV Blackstone	Oct-23
1 Margaret Street	293.1	5.9	20,754	14,123	1.6	Quintessential Equity	Dexus	Aug-23
44 Market Street	393.1*	6.5	30,699	13,356	2.7	PAG	Dexus	Jun-23
139-141 Macquarie Street	133.0	4.3	5,776	23,018	2.0	Shakespeare Property Group	Rigby Hall	Feb-23

*Net sale price
Source: Knight Frank Research

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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