RESEARCH

SYDNEY CBD

OFFICE MARKET OVERVIEW MARCH 2019

VACANCY HITS DECADE LOW

HIGHLIGHTS

Limited speculative supply continues to tighten vacancy levels across the Sydney CBD. The overall vacancy rate currently measures 4.1%, with the prime vacancy tighter at 3.7%.

Average prime gross face rents increased by 10.9% YoY to $1,293/sq m as at January 2019. In conjunction with declining incentives, prime gross effective rents surged upward by 15.1% YoY.

Investment volumes for the 2018 calendar year totalled $6.48 billion, surpassing 2017 levels with an impressive 27% jump YoY.

KEY FINDINGS

A total of 55,147 sq m has been withdrawn from the market over the past six months, taking net supply to –26,935 sq m.

Net absorption over the six months to January 2019 totalled 1,299 sq m.

The overall vacancy rate has declined to its lowest rate in almost a decade, reaching 4.1% in January 2019, down from 4.6% in July 2018.

Sydney CBD's prime and secondary gross effective rents have increased by 15.1% and 12.0% respectively over the past 12 months.

Sales for 2018 totalled $6.48 billion, up 27% YoY, with unlisted funds accounting for a third of all transaction volumes.

Core yields for prime assets in the CBD currently range between **4.25% and 5.00%**, while secondary yields are measuring between **5.00% and 5.50%**.

MARCO MASCITELLI
Senior Analyst

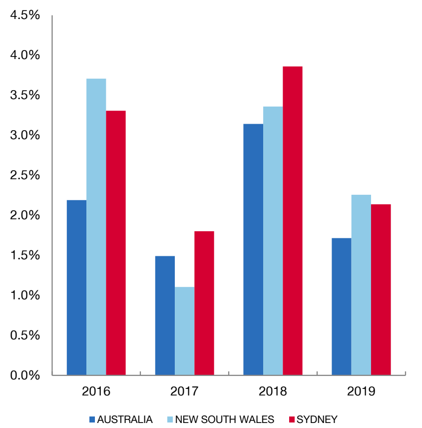
ECONOMIC OVERVIEW

Strong growth in 2018 lays solid foundation for 2019

A lower Australian dollar helped buoy jobs growth in 2018 and non-mining business investment increased. Despite Brexit, the US / China trade impasse and a slowing Chinese economy dampening global growth momentum, the Australian economy is forecast to grow at a solid pace during 2019.

Driven by above-trend population growth and labour force participation rates, the NSW economy grew by 2.6% in 2017-18. Although just below the rest of Australia at 2.8%, it is still outperforming its long-term average. In FY2019, the NSW growth rate is forecast to ease closer to 2.6% as the economy adjusts to house price falls. Solid jobs growth is expected to continue to support low unemployment, while the record infrastructure and non-residential construction pipeline is likely to help offset any further impacts to the growth outlook.

FIGURE 1
Annual Employment Growth
By Year



Source: Knight Frank Research, Oxford Economics

Record infrastructure buoys NSW employment growth

Government led infrastructure projects are at record levels, providing significant upside to NSW employment growth, which continues to outperform the national average.

The substantial pipeline of committed commercial building works is also playing an important role in Sydney's outlook. The strength of this investment over the last few years, together with pent-up office demand, above-average population growth and a historically low interest rate environment has helped Sydney remain an important focal point for both investors and developers.

Early signs of recovery in wage growth but interest rates still holding

CPI inflation at the national level remains subdued at 1.8% YoY but remains below the RBA target band. The RBA previously indicated that the next move in the cash rate was more likely to be an increase than a decrease; however there remains a strong case for holding the current rate to allow for further improvements to the unemployment rate and to encourage a rise in inflation and wage growth.

TABLE 1
Sydney CBD Office Market Indicators as at January 2019

Grade	Total Stock (sq m)^	Vacancy Rate (%)^	Annual Net Absorption (sq m)^	Annual Net Additions (sq m) ^	Average Gross Face Rent ($/sq m)	Average Incentive (%)	Average Core Market Yield (%)*
Prime	2,987,756	3.7	53,333	17,522	1,293	16-19	4.25—5.00
Secondary	2,021,477	4.7	-42,890	-44,328	962	18-21	5.00—5.50
Total	**5,009,233**	**4.1**	**10,443**	**-26,806**			

Source: Knight Frank Research/PCA ^as at January 2019 *Assuming WALE 5.0 years

TENANT DEMAND & ABSORPTION

Prime office maintains its stronghold on demand

The Sydney office vacancy rate has declined for the fourth consecutive six month period, dropping to its lowest rate in almost a decade at 4.1%. While current metrics suggest the overall market is being driven purely by pent-up demand, significant stock withdrawals for Government led infrastructure projects and alternative use continues to play a role. In the last two years, almost 390,000 sq m has been withdrawn from the market and critically this has coincided with a period of subdued development completions, adding downward pressure to vacancy.

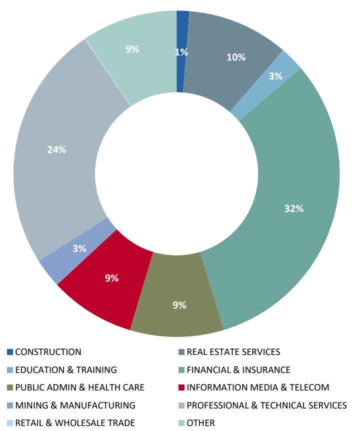
Demand continues to be focused on the prime market with a clear divergence emerging between prime and secondary vacancy in the six months to January 2019. Prime space recorded 16,328 sq m of positive net absorption in that period, whilst secondary space recorded negative net absorption of 15,029 sq m.

Positive absorption levels recorded in the Western Corridor and Walsh Bay precincts stemmed from the completion of 151 Clarence Street with the new space being occupied by Arup, Pfizer and Mills Oakley Lawyers.

The sector mix of lease deals in the market for 2018 was led by financial and insurance services, which had a 32% share of the total. This was followed by professional services with 24% and real estate services which had a 10% share. The average deal size in the market (excluding pre-commits) measured 783 sq m over 2018.

Co-working remains a feature, though activity has abated somewhat relative to the take-up trends seen early 2018. There are signs that owners are beginning to adopt a similar strategy by introducing their own co-working space options within their buildings – GPT introduced Space & Co last quarter at 580 George Street, while Dexus introduced SuiteX in two of their buildings last July.

FIGURE 2
Lease Deals by Industry
2018, Total market (sq m)



Source: Knight Frank Research

Secondary activity still constrained by withdrawals

More than 60% of the stock withdrawn from the market since 2012 has been secondary space, much of which has been permanent due to the Government led infrastructure projects or change of use. This has reduced the size of the secondary market by more than 16% over that time. This dynamic has resulted in a period of negative net absorption that has run for nearly three years. That said, in the last six months there were pockets of low level positive net absorption coming through in the Midtown, Western and Southern precincts, led predominantly by B grade space.

In the short-term, the secondary market is likely to remain somewhat constrained by withdrawal activity, with limited leasing options available to prospective tenants. The low vacancy rate is only compounding this dynamic and to a large extent, acting as a catalyst for declining incentives being offered by landlords and the strong rental growth rates seen recently.

Pre-commitment demand to fuel absorption outlook

Jobs growth has been robust and there are still strong indications of a continuation of this momentum on the back of record infrastructure investment and a forecast for above-average business investment. Office job advertisement numbers are at their highest, supporting the view that tenant demand will remain elevated in the short-term. There are also a number of active mandates in the market for expansion space, as well as tenants looking for short-term project space.

Net Absorption & Outlook

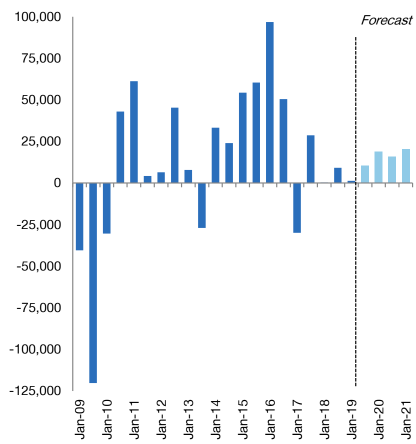
Prime	53,333 sq m YoY	↗
Secondary	-42,890 sq m YoY	↘

Source: Knight Frank Research/PCA

Limited large contiguous floor space options in prime space and the current low vacancy environment may temper select tenant movements in the immediate term. However, pre-commitment activity through the second half of 2019 and into 2020 is likely to counterbalance activity in the first half of 2019.

On the back of new completions and pre-commitment demand for the new stock, net absorption figures are expected to rise over 2019 and into 2020. Recent robust employment growth and an expected continuation of this trend in the short-term supports this outlook, however the market is unlikely to see any significant movement in the overall vacancy rate due to incoming new supply and potentially building refurbishment withdrawals.

FIGURE 3
Sydney CBD Net Absorption
(m²) per 6 month period



Source: Knight Frank Research/PCA

SUPPLY & DEVELOPMENT

Stock withdrawn for major refurbishments

The Sydney CBD has seen an end to the extensive permanent stock withdrawal cycle driven by residential conversions which was experienced in the 2016-2017 period. Withdrawals are now being driven by major refurbishments from owners upgrading assets to meet tenant demands. Stock withdrawals over the last six months totalled 55,147 sq m, outweighing completions of 28,212 sq m, resulting in negative net supply of 26,935 sq m. Whilst withdrawals over the last six months have been significant, the majority of withdrawals are temporary and will be coming back online as refurbished space is repositioned over the next two years.

The withdrawn stock has stemmed predominately from 388 George Street (38,5000 sq m), which has been taken offline for a full refurbishment and expected to come back to market in H1 2020 with the refurbished space already over 50% pre-committed. Additionally 210 & 220 George Street (17,732 sq m) has been permanently withdrawn to make way for a new prime commercial tower of c17,000 sq m developed by Poly Group, anticipated for completion in late 2021. Looking ahead, notable assets due to be withdrawn for major refurbishments over the next 18 months include 231 Elizabeth Street (22,964 sq m), 320 Pitt Street (28,866 sq m) and part of 1 Oxford Street (13,943 sq m).

Limited speculative stock on the horizon

Supply additions over the past six months have stemmed from the completion of 151 Clarence Street (20,925 sq m) which is now fully leased to major tenants including Mills Oakley and Arup. Additionally, the partial refurbishment at 222 Clarence Street (1,829 sq m) has come back to market.

Whilst new supply has been limited over the past 18 months, a number of major projects are currently under construction and set to make their way into the market over the next three years. By January 2022 the CBD office total stock level is anticipated to increase by approximately 3.8%, stemming from over 440,000 sq m of new developments and refurbished stock coming back to market.

Major developments set to be delivered to the market by 2022 include 60 Martin Place (38,600 sq m – 32% pre-committed to Norton Rose Fullbright and Banco Chambers), Wynyard Place (68,200 sq m – 80% pre-committed by NAB & Allianz – H2 2020) and Quay Quarter Tower (QQT) (circa 88,000 sq m – 75% pre-committed by AMP & Deloitte – 2021). Whilst the market will welcome incoming new supply, pressure on vacancy will remain in the short-term. More than half of this supply is already pre-committed and given current mandates for prime space in the CBD, this level of pre-commitment is expected to rise prior to developments reaching practical completion.

Vacancy Rate & Outlook

Prime	3.7% -120bps y-o-y
Secondary	4.7% +10bps y-o-y

Source: Knight Frank Research/PCA

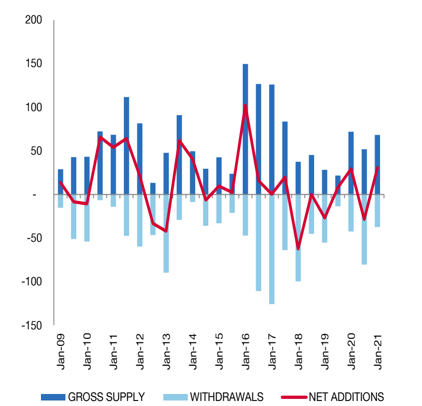
Vacancy hits decade low

Positive tenant demand in conjunction with negative net supply over the past 12 months has been the catalyst for overall vacancy reaching its lowest level in 10 years. Overall vacancy tightened by 50bps over the last six months to record 4.1% as at January 2019, this is well below the 10-year average of 7.3%. By grade, the prime vacancy rate declined from 4.8% to 3.7%, whilst secondary had a slight increase from 4.4% to 4.7%.

All precincts remain well below their 10-year average with the exception of the Southern precinct, which climbed from 0.6% to 6.9% in the last six months. This was driven by Sydney trains vacating c18,000sq m at 477 Pitt Street and relocating its headquarters in Clyde. With limited stock it's anticipated that the majority of this space will be backfilled within the next 12 months.

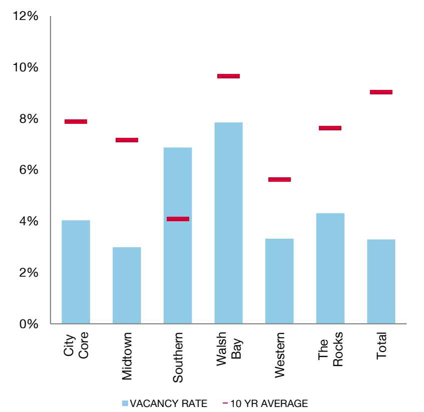
Looking forward, the overall vacancy rate in the CBD is expected to trend towards 3.5% by mid-2020. Vacancy is expected to remain low over the forecast period, with a substantial injection of new supply not expected until 2022.

FIGURE 4
Sydney CBD Office Supply
Per six month period (sq m)



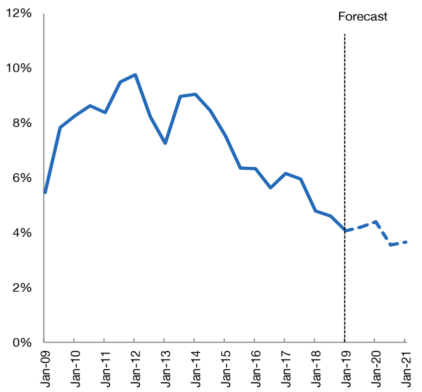
Source: Knight Frank Research/PCA

FIGURE 5
Sydney CBD Vacancy Rate
By Precinct (%) - January 2019



Source: Knight Frank Research/PCA

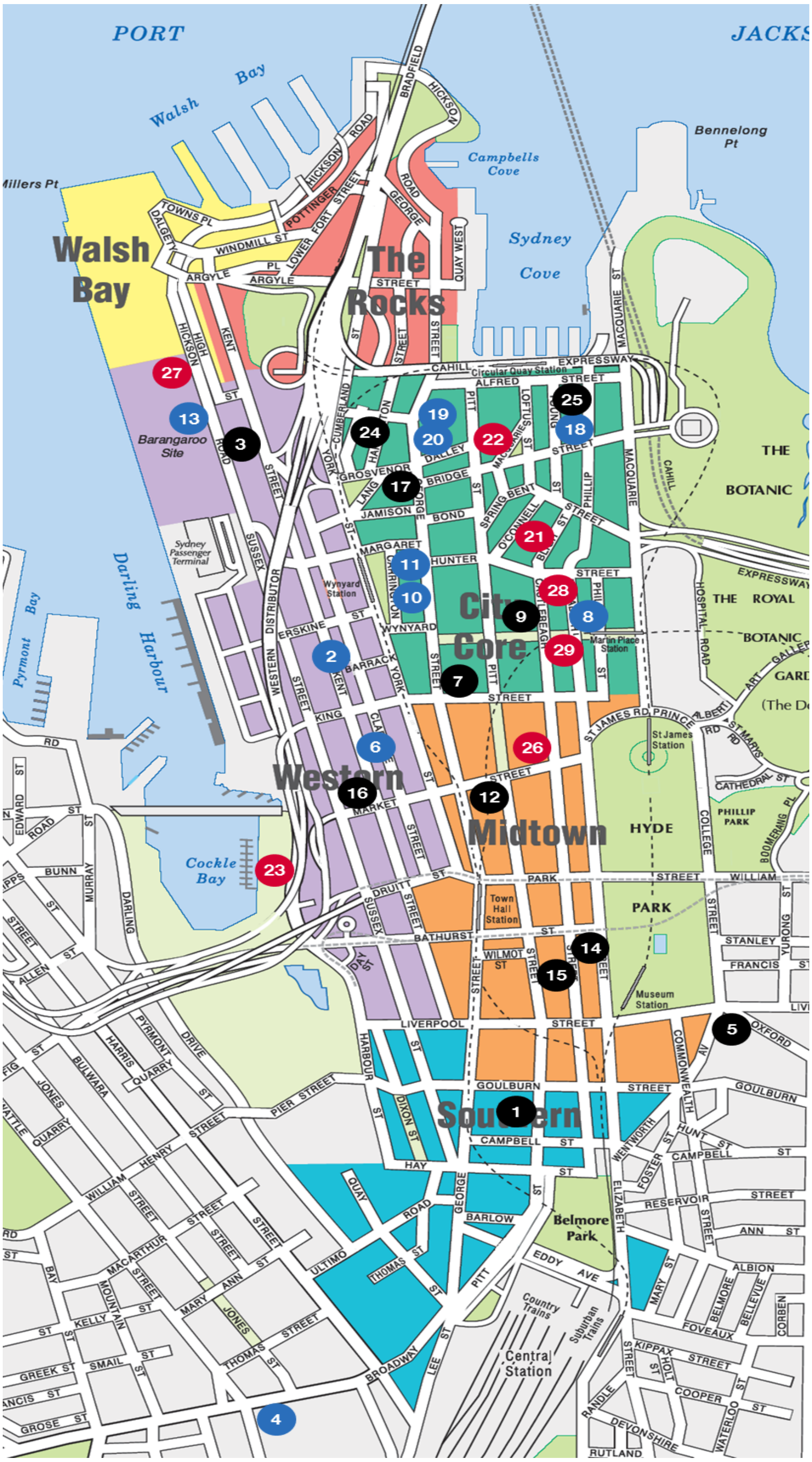
FIGURE 6
Sydney CBD Vacancy
% total vacancy



Source: Knight Frank Research/PCA

MAJOR OFFICE SUPPLY

1. 477 Pitt Street# - 18,000m2 (ex Rail Corp)
ISPT - H1 2019
2. 151 Clarence St - 20,925m² [ARUP, Pfizer]
Investa - Complete - 100% committed
3. 201 & 207 Kent St# - 5,536m² (ex ARUP)
Cromwell / Investa- H2 2019 - 20% committed
4. 100 Broadway - 5,447m² (UTS)
Frasers Property Group - H1 2019 -100% committed
5. 1 Oxford Street# (ex Dept of Education) - 11,208m²
Memocorp - H1 2021
6. 185 Clarence Street - 7,659m2
Built - H1 2020 - 40% committed
7. 388 George St# - 38,500m² (ex IAG)
Investa/Brookfield - H1 2020 - 60% committed
8. 60 Martin Place - 39,377m² [Banco Chambers]
Investa/Gwynvill Group - H1 2020 - 30% committed
9. 44 Martin Pl# - 9,500m² (ex Henry Davis York)
Gwynvill Group - H1 2021
10. Wynyard Pl - 68,200m² [NAB, Allianz]
Brookfield - H2 2020 - 80% committed
11. 275 George St - 6,363m²
John Holland - H1 2020
12. 55 Market St# - 20,552m² (ex Westpac)
Mirvac - H1 2021
13. Barangaroo C1 - 9,900m² (WeWork)
LLOneITST - H1 2020 -100% committed
14. 231 Elizabeth St# - 22,964m² (ex Telstra)
Charter Hall - H1 2021
15. 320 Pitt St# - 28,886m² (ex Telstra)
ARA - H1 2021
16. 2 Market# - 18,386m² (ex Allianz)
Allianz/Charter Hall - H1 2021
17. 255 George St# - 22,500m² (ex NAB)
AMP - H2 2021
18. Quay Quarter Tower (QQT) - 88,274m² (AMP/Deloitte)
AMP - H1 2021 - 75% committed
19. Circular Quay Tower (CQT) - 55,000m²
Lendlease - H2 2021
20. 210-220 George St - 17,000m²
Poly Real Estate - H2 2021
21. 33 Bligh St - 26,000m²
Energy Australia/Investa - Mooted
22. 55 Pitt St - 30,000m²+
Mirvac - 2023+
23. Darling Park Tower 4 - 70,000m²
GPT/Brookfield/AMP - 2023+
24. 121 Harrington Street# - 6,037m² (ex Dimension Data)
Harrington Street Investments - H1 2019
25. 33 Alfred Street# - 32,353m² (ex AMP Capital)
AMP Capital - H1 2023
26. 77 Market Street - c.12,000m²
CBUS/Scentre - H1 2022
27. Central Barangaroo - 45,000m²
Grocon/Aqualand/Scentre - 2023+
28. Martin Place Metro Station North Tower-75,000m²
2024+
29. Martin Place Metro Station South Tower -20,700m²
2024+



Refurbished Supply
New Addition (Under Construction/Pre-committed)
New Addition (Planned/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
Major refurbishment/backfill

RENTS & INCENTIVES

Rents, Incentives & Outlook

Prime Rents (g)	$1,293/sq m face 10.9% YoY $1,041/sq m eff 15.1% YoY
Secondary Rents (g)	$962/sq m face 8.6% y-o-y $793/sq m eff 12.1% YoY
Incentives	P: 19.5% S: 17.6%

Declining vacancy and low supply pipeline continues to fuel rental growth

Low vacancy environment continues to be reflected in leasing fundamentals, with average prime net face rents increasing almost 12% and prime net effective rents increasing 17.5% in the 12 months to January 2019. On a gross face basis, average prime rents have increased 10.9% over the same period, reaching $1,293/sq m ($1,110/sq m net face). Current rental growth metrics are trending well above their 10-year compound annual average growth rate of between 4.0% gross and 4.8% on a net basis.

In the secondary market, gross face rents grew by 8.6% over the 12 months to January 2019 to $962 sq m ($818 sq m net face). To some extent growth in gross effective rents (+12% YoY) has been driven by declining incentives, which fell from 20.1% to 17.6% over the same period.

Limited new supply in conjunction with the historically high level of withdrawal activity in recent times has been a major contributor to declining vacancy. Certainly in the short-term, supply-side factors will continue to play a critical role.

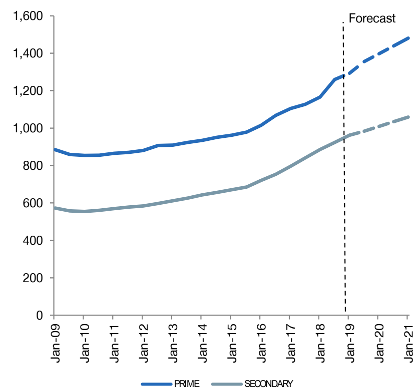
There is very little supply due to be added in 2019 and 2020 and with prime vacancy currently at 3.7% this could potentially amplify pent-up demand in the near-term, particularly in central CBD locations where the vacancy rate is already under 3.0%.

On that note, limited uncommitted new supply in the short-term is expected to continue to put downward pressure on the technical vacancy rate and sustain above-average gross face rental growth rates over the balance of this year (circa +6.0%), before the rate of growth tapers off just slightly in 2020 (circa +5.0%).

FIGURE 7
Sydney CBD Prime Rents
By Precinct ($/sq m)

Source: Knight Frank Research

FIGURE 8
Sydney CBD Rents
$/m² p.a average gross face rent



Source: Knight Frank Research

TABLE 2
Recent Leasing Activity Sydney CBD

Address	Precinct	NLA (sq m)	Term (yrs)	Lease Type	Tenant	Sector	Start Date
2 Chifley Square	Core	2,089	7.3	New	Shaw & Partners	Finance & Insurance	May-19
50 Goulburn Street	Midtown	1,380	7	New	MPA	Construction	Mar-19
77 King Street	Midtown	1,406	5	Renewal	Capgemini	Professional	Jan-19
60 Margaret Street	Core	1,458	10	New	Xenith IP	Professional	Dec-18
24 York Street	Core	851	5	New	Informa Australia	Professional	Dec-18
60 Margaret Street	Core	860	5	New	Hamber Services	Professional	Oct-18
126 Phillip Street	Core	8,664	8	Renewal	Deutsche Bank	Finance & Insurance	Oct-18
580 George Street	Midtown	943	8	New	Space & Co	Co-working	Sep-18
1 O'Connell Street	Core	751	4	Renewal	Clifford Chance	Professional	Sep-18
88 Phillip Street	Core	630	8	New	Credit Agricole CIB	Finance & Insurance	Sep-18
8 Chifley Square	Core	2,594	3	Assignment	Quantium	Information Media	Sep-18
680 George Street	Midtown	1,828	10	New	Regus	Co Working	Sep-18
260 Elizabeth Street	Southern	1,345	6.5	Renewal	Civil Aviation Safety Auth.	Public Administration	Aug-18

Source: Knight Frank Research

INVESTMENT ACTIVITY & YIELDS

Large core assets drive transaction volumes

Despite general business sentiment losing some of its momentum and a slowing residential market, the Sydney CBD office market recorded its strongest year of transaction volumes since 2015. Investment volumes for the 2018 calendar year totalled $6.48 billion and as anticipated surpassed 2017 levels with an impressive 27% jump YoY.

This strong surge in transactional activity can be attributed to the IOF portfolio deal and the increased number of core assets being put on the market in conjunction with solid investor demand led by offshore and local unlisted trusts.

The largest single transaction in the second half of 2018 was Charter Hall Prime Office Fund acquiring 10&12 Shelley Street from global REIT, Brookfield, for $804 million on a reported 4.50% core market yield. The property was purchased with a 9.6 year WALE and 100% leased to Macquarie Bank.

Diversified offshore capital

Cross-border capital flows accounted for 47% or $3.06 billion of total transaction volumes in 2018, up from $1.9 billion in 2017. Whilst 65% of cross border capital originated from Hong Kong and Singaporean investors in 2017, they only contributed to 9% of transaction volumes in 2018.

Current Yields & Outlook

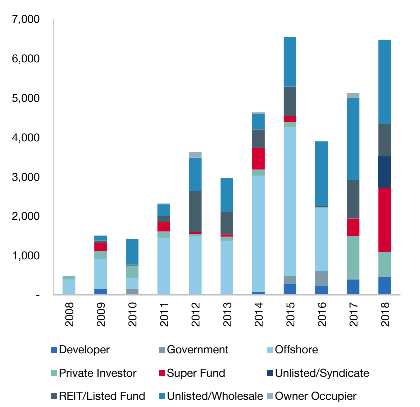
Prime	4.25% - 5.00% -41bps YoY	
Secondary	5.0% - 5.50% -25bps YoY	

The bulk of offshore capital (48%) came from Canada, which was solely attributed to the Oxford purchase of the Investa portfolio. The portfolio sale aside, offshore capital inflows stemmed from USA (7%), China (13%), Japan (8%) and Hong Kong (9%). The diversified offshore capital highlights the strength of the CBD with it being recognised across the globe as a sound investment option.

Yields sharpen to tightest level on record

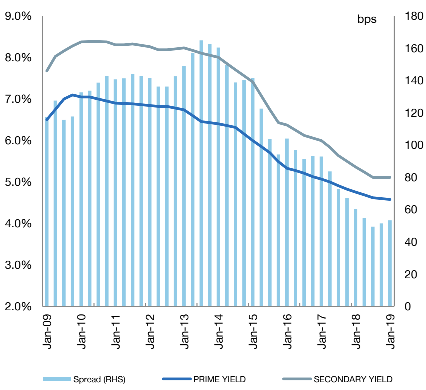
The strong demand from both domestic and offshore investors, in conjunction with limited available stock, has driven prime yields down by 41bps over the past 12 months to reach a new record low of 4.58%. The bulk of the yield compression occurred in the first half of 2018, with yields compressing a sharp 37bps. In the second half of 2018 yields remained relatively static, tightening by just 4bps. Secondary yields have followed, to reach 5.11% as at January 2019, albeit with no compression over the past six months. Knight Frank anticipates yields to remain steady over the next 12 months, with little room for investors to purchase on tighter yields given the risk spread between lending rates and bond yields.

FIGURE 9
Sydney CBD Sales $10m +
By Purchaser Type ($m)



Source: Knight Frank Research

FIGURE 10
Sydney CBD Yields & Spread
% Yield LHS & Spread RHS



Source: Knight Frank Research

TABLE 3
Recent Sales Activity Sydney CBD

Address	Price ($ mil)	Core Mkt Yield (%)	NLA (sq m)	$/sq m NLA	WALE (yrs)	Purchaser	Vendor	Sale Date
10 &12 Shelley Street	804.0	4.50^	42,000	19,143	9.6	Charter Hall	Brookfield	Dec-18
183 & 185 Clarence Street*	180.0	N/A	7,659	22,880	N/A	TH Real Estate	Built	Nov-18
275 George Street*	240.0	4.50*	8,000	30,000	10.0	Offshore	John Holland	Aug-18
23 Hickson Road#	90.5	6.36	8,553	10,582	5.3	Markham Corp	Sitex Properties	Jul-18
275 Kent Street (50%)	721.9	4.50	76,450	18,886	10.5	Mirvac JV ISPT	Blackstone	Jul-18
179 Elizabeth Street	265.0	5.20	15,686	16,894	3.9	Offshore	Markham Corp	May-18
117 Clarence Street	153.0	4.75	12,571	12,171	2.6	Investa	Roxy Pacific	May-18
55 Clarence Street	255.0	4.81	14,962	17,043	1.5	Zone Q	AEW Global	May-18

^Blended passing yield of both assets *Fund through deal #Strata leasehold

Source: Knight Frank Research

RESEARCH

Ben Burston
Partner, Head of Research & Consulting
+61 2 9036 6756
Ben.Burston@au.knightfrank.com

Katy Dean
Associate Director
+61 2 9036 6612
Katy.Dean@au.knightfrank.com

Marco Mascitelli
Senior Analyst
+61 2 9036 6656
Marco.Mascitelli@au.knightfrank.com

CAPITAL MARKETS

Ben Schubert
Partner, Joint Head of Institutional Sales, Australia
+61 2 9036 6870
Ben.Schubert@au.knightfrank.com

Paul Roberts
Partner, Joint Head of Institutional Sales, Australia
+61 2 9036 6872
Paul.Roberts@au.knightfrank.com

John Bowie Wilson
Partner, Head of Commercial Sales, NSW
+61 2 9036 6743
John.Bowiewilson@au.knightfrank.com

Dominic Ong
Partner, Head of Asian Markets
+61 2 9036 6747
Dominic.Ong@au.knightfrank.com

Jonathan Vaughn
Director, Commercial Sales, NSW
+61 2 9036 6729
Jonathan.Vaughn@au.knightfrank.com

OFFICE LEASING

Aaron Weir
Partner, Head of Office Leasing, NSW
+61 2 9036 6890
Aaron.Weir@au.knightfrank.com

Tina Raftopoulos
Director, Office Leasing
+61 2 9036 6639
Tina.Raftopoulos@au.knightfrank.com

Robin Brinkman
Director, Office Leasing
+61 2 9036 6682
Robin.Brinkman@au.knightfrank.com

Nick Lau
Director, Office Leasing
+61 2 9036 6764
Nick.Lau@au.knightfrank.com

Al Dunlop
Director, Office Leasing
+61 2 9036 6765
Al.Dunlop@au.knightfrank.com

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