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.
**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 construction pipeline is likely to help offset any further impacts to the growth outlook.

**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.

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**TABLE 1**

Sydney CBD Office Market Indicators as at January 2019

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

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

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**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%.

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**FIGURE 1**

Annual Employment Growth by Year

Source: Knight Frank Research, Oxford Economics
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.

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

Source: Knight Frank Research

**Net Absorption & Outlook**

<table>
<thead>
<tr>
<th>Prime</th>
<th>53,333 sq m YoY</th>
</tr>
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<tbody>
<tr>
<td>Secondary</td>
<td>-42,890 sq m YoY</td>
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</tbody>
</table>

Source: Knight Frank Research/PCA

advertising 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.

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.

**Sydney CBD Net Absorption**

Source: Knight Frank Research/PCA

**FIGURE 2**

Lease Deals by Industry

2018, Total market (sq m)

**FIGURE 3**

Sydney CBD Net Absorption (m²) per 6 month period

Source: Knight Frank Research
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 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.
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
   Memoocap - H1 2021
6. 185 Clarence Street - 7,659m²
   Built - H1 2020 - 40% committed
7. 388 George St# - 38,500m² (AG)
   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)
    Minac - H1 2021
13. Barangaroo C1 - 9,800m² (WeWork)
    LLOneTST - H1 2020 - 100% committed
14. 231 Elizabeth St# - 22,964m² (ex Telstra)
    Charter Hall - H1 2021
15. 320 Pitt St# - 28,866m² (ex Telstra)
    ARA - H1 2021
16. 2 Market St# - 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
    Minac - 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
    GBS/Scenre - H1 2022
27. Central Barangaroo - 45,000m²
    Grocon/Aqualand/Scenre - 2023+
28. Martin Place Metro Station North Tower -75,000m²
    2024+
29. Martin Place Metro Station South Tower -20,700m²
    2024+

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/additl
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%).

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.
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 an 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 108.12 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.

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 (8%). 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 lending rates and bond yields.
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