- *Leasing activity has been significantly impacted by Covid-19*
- *Face rents are holding but incentives have increased*
- *Influx of large assets for sale will boost H2 investment volumes*

Knight Frank

knightfrank.com/research

Sydney CBD Office

Market Report, September 2020

ACTIVITY DOWN AS BUSINESS ADAPTS TO COVID-19

Leasing and investment activity has been impacted as the full economic impacts of downturn unfold, but there are signs confidence is emerging for Sydney's long-term performance.

5.9%
VACANCY
PCA data at Jul-20

32%
of take-up were to Govt entities in H1 2020

$992
MILLION TURNOVER
H1 2020

"...investment demand for core assets in Sydney remains compelling amidst global uncertainty and geopolitical instability."

The Key Insights

Economic uncertainty during the pandemic and lower white collar employment has led to an increase in the Sydney CBD office vacancy rate from 3.9% in January to 5.9% in July 2020.

Average incentives have increased to 25-30%. Face rents are holding but with incentives up, gross effective rents have declined by 7.9% in prime and 8.5% in secondary in the six months to July 2020.

Private sector leasing demand has been subdued as tenants assess workplace utilisation rates. Government demand is helping to partially offset the decline in private sector demand, accounting for 32% of total leasing volumes in the year to August.

Investment volumes in H1 2020 reached $991.6 million. A rebound is likely in the coming months with several large core CBD assets being offered for sale.

Following significant compression during 2019, the core yield range for prime assets is holding between 4.25% and 4.75%.

Sydney 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 (net)	AVERAGE CORE MARKET YIELD %*
Prime	3,036,801	4.3	29,958	74,303	1,385	25-30	-6.3	4.25-4.75
Secondary	1,941,137	7.6	-128,248	-79,184	1,017	25-30	-10.7	4.75–5.25
Total	**4,977,938**	**5.6**	**-98,290**	**-4,881**				

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

STRONG FOUNDATION WILL HELP RECOVERY

Australia enters recession for the first time in three decades, but strong policy response to drive recovery

The virus outbreak continues to pose downside risks for the global economy. The containment of the virus, mostly through enforced government restrictions, has weighed on economic activity and led Australia into its first recession in almost three decades.

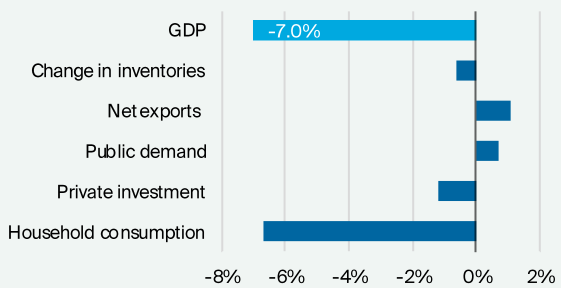
Although some parts of the economy are starting to see a rebound due to the easing of restrictions over the last few months, GDP declined 7% in the June quarter.

The combined effect of the pandemic and government responses to contain the spread of the virus has led to the largest quarterly fall on record. The decline in services spending due to travel and retail trading restrictions was a large contributor to the decline, as was the drop in business and housing investment. State and Federal Government fiscal stimulus to help support households and businesses has been significant and may have offset the decline a little.

With the Melbourne lockdown creating some headwinds for the rest of the country, Oxford Economics predicts growth will be largely unchanged in September 2020 quarter, with GDP forecast to fall to 4.3% in 2020 before recovering to grow by 2.0% in 2021.

Contributions to GDP growth

June quarter, %



Source: Knight Frank Research, Macrobond

Sydney's previous strong performance helps cement its foundation amidst global uncertainty and geopolitical instability

Employment and hours worked increased in July 2020, although unemployment and underemployment remain high. The misalignment reflects a rise in part-time employment and people currently out of the workforce but looking for work.

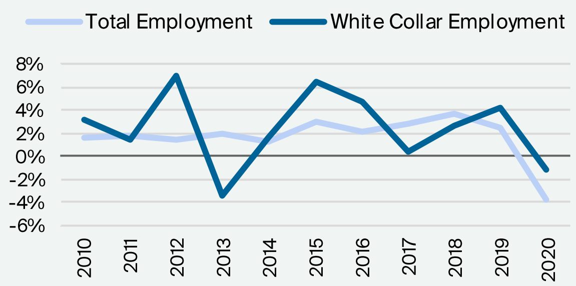
Although the underemployment and underutilisation of office space due to changing remote working policies is impacting the outlook, the support for recovery is positive. The Sydney CBD office market had a near record low vacancy rate when the pandemic began and a strength in its white-collar employment growth rate, important factors to the market's eventual recovery.

Tenant demand through the last six months has been restrained, and while there is likely to be a further rationalisation of space by some businesses in the short-term, investment demand for core assets in Sydney remains compelling amidst global uncertainty and geopolitical instability.

The high level of interest coming from select domestic and offshore groups targeting the influx of large core assets being offered to the market does suggest that there is confidence in the tenant base in Sydney and that transaction activity will begin to recover.

Sydney Employment Growth Rate

Total Employment v White Collar Growth Rate %, 2010 - 2020



Source: Knight Frank Research, Oxford Economics

DEMAND DECLINES BUT GREEN SHOOTS EMERGE

Tech sector lease activity declines after large growth in market share prior to the pandemic

Although the tech sector has dominated new enquiry since the start of the pandemic, the rapid growth in the sector's market share that was witnessed in 2019 has begun to evaporate. Venture capital funding has been declining since the onset of the virus and this has potentially constrained the ability of start-ups to scale in the short-term.

The government's recent approval of the rezoning of the area at Central, which also includes the planned Atlassian anchored tower, has the potential to reignite interest from start-ups and scale-up businesses looking for commercial floorspace in Sydney now, helping to offset the decline in demand from other industry sectors directly impacted by the pandemic.

The amount of available sublease space in the CBD has risen significantly due to a shift in workplace requirements and this has increased the amount of prime space available in core locations, which could appeal to those tech occupiers looking to scale now.

Private sector demand has been scaled back but government demand is helping to offset decline

Remote working policies continue to be rolled out and although not yet to full size, businesses are gradually transitioning back to the workplace. However, the changes are creating some uncertainty in regard to leasing demand and some businesses are postponing expansion or relocation plans as they consider their space requirements. Private sector active requirements seem to have been scaled back considerably due to short-term remote working policies.

Reflecting the decline in activity from the private sector, government lease deals in 2020 (to August) account for around 32% share of total leasing volumes by square metres, well above its five year average of around 10%.

DFAT, AFCA, IPCA, NSW Treasury and Australian Council for the Arts have secured new leases since March, with start dates in September and October. Additionally, ASIC is understood to have renewed terms for its floors in 100 Market Street prior to the pandemic and has plans for a new fitout.

There are several active mandates from both state and federal government agencies which could partially offset the short-term decline in demand from the private sector, including ACCC, Department of Defence, Health, The ATO and ABS.

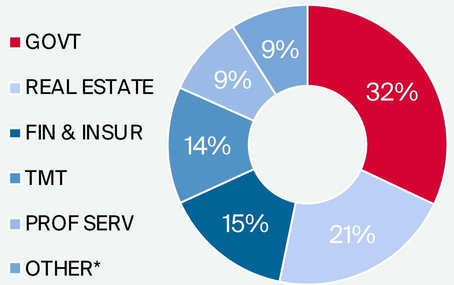
Absorption rates decline and office vacancy rises

Vacancy has increased in the six months to July 2020 to 5.6%, up from 3.9% in January 2020. All grades recorded an increase in vacancy over the period, with total net absorption declining by 58,675sqm in the six months to July 2020. Premium grade did record positive demand, but this was offset by a decline in absorption across the balance of the market.

The decline in leasing decision making during the last few months, in conjunction with rise in sub-lease options, is expected to drive a further increase in vacancy in the second half of 2020.

Lease Deals by Industry Sector

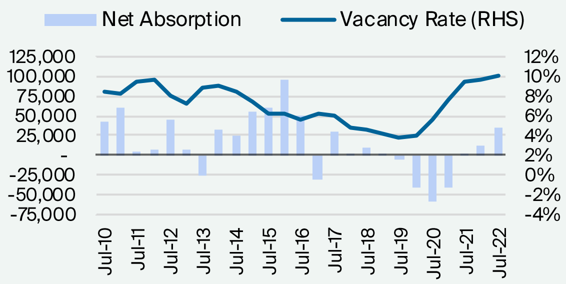
2020 (to August), Total market (sqm)



Source: Knight Frank Research TMT= Technology, Media, Telecoms *Other: Health, Admin, Education, Accommodation, Mining, Transport, Consruction.

Vacancy and Absorption

Sqm, %



Source: Knight Frank Research, PCA

BACKFILL LOOMS AMIDST LONG TERM SUPPLY

Stock withdrawals ease as new and refurbished stock near completion

The supply deficit experienced over the last three years is coming to an end as stock withdrawals begin to ease and developments of both new and refurbished stock progress for completion over the next two years, leading to a significant influx of premium supply. Stock withdrawals over the last six months totalled 1,000sqm, its lowest on record, whilst completions totalled 25,162sqm, stemming predominately from the refurbishment of 320 Pitt Street (20,310sqm).

Across the wider market there is over 150,000 sqm of stock currently undergoing refurbishment works, of which 40% has been committed. Major refurbishments with completion imminent include the Brookfield/Oxford owned 388 George Street (38,500sqm) and the Charter Hall owned 231 Elizabeth Street (22,964sqm). Additionally, Amazon has committed to the majority of Allianz's backfill space at 2 Market Street (18,000sqm), currently under refurbishment. Whilst strong commitments prior to Covid-19 were achieved at these assets, other refurbishments such as 55 Market Street (22,500sqm) and 44 Martin Place (9,500sqm) have achieved minimal commitments in comparison.

New development stock remains substantially pre-let, however backfill space to be impacted

The pipeline of new development stock currently under construction totals over 240,000sqm, with a commitment rate nearing 70% across major schemes including Brookfield Place (59,000sqm), CQT (55,000sqm) and QQT (88,000sqm). This pipeline will be delivered over the next two years and will be less impacted by the limited demand being experienced across the market now.

The stricter lending conditions imposed by financial institutions post-GFC enforced certain commitment levels be met before construction can commence in order to protect against an oversupply in the market and any sudden shocks to the economy.

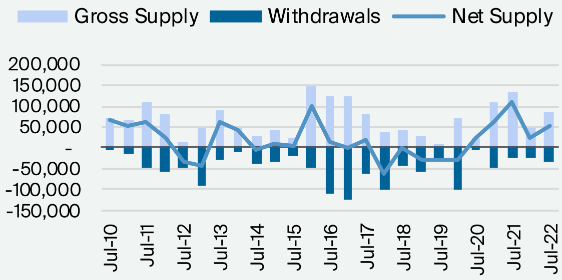
Upon completion of the new developments, the market will be dealing with significant backfill space, which pre-Covid the market would have been more likely to absorb. However, given the current state of the market occupiers seem to be downsizing their office space as they utilise technology and evolve remote working policies. Significant backfill space will arise from Deloitte vacating Grosvenor Place (27,800sqm) moving into QQT and NAB vacating 255 George Street (23,000sqm) Brookfield Place.

Tech Central precinct approvals fast tracked

The NSW Government recently announced it would fast track its assessment of 24 major projects in order to boost the economy and generate jobs. Among these is Sydney's new tech precinct near Central Station.

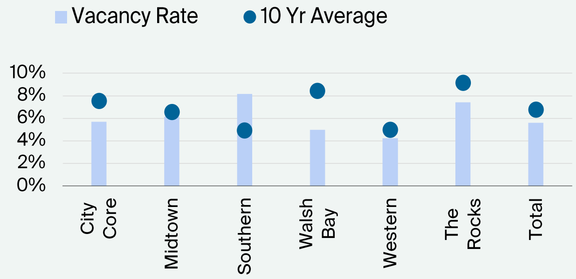
The Western Gateway sub-precinct has been rezoned and will enable Atlassian to build its new Headquarters across a 70,000sqm hybrid timber tower, of which it will occupy c60,000sqm. Adjacent to the Atlassian Tower, Dexus and Frasers will deliver a twin tower development across c150,000sqm of commercial floor space. The fast tracked developments bode well for the expansion of the Southern CBD, which encompasses a strong education base and an array of amenity.

Supply and Withdrawals
Sqm



Source: Knight Frank Research, PCA

Vacancy
By Precinct, %



Source: Knight Frank Research, PCA

MAJOR OFFICE SUPPLY

MAJOR REFURBISHMENTS

1 320 PITT STREET—20,310 SQM [WEWORK]
ARA— 40% COMMITTED. H1 2020

2 231 ELIZABETH STREET—22,964 SQM [PROPERTY NSW]
CHARTER HALL— 100% COMMITTED. H2 2020

3 388 GEORGE STREET—38,500 SQM [QBE,FIRST STATE]
BROOKFIELD/OXFORD— 55% COMMITTED. H2 2020

4 55 MARKET STREET—20,552 SQM
MIRVAC— H2 2020

5 477 PITT STREET—18,000 SQM
ISPT— H2 2020

6 570 GEORGE STREET—18,100 SQM
FAR EAST— H1 2021

7 44 MARTIN PLACE—9,500 SQM GWYNVILL GROUP – H1 2021

8 2 MARKET STREET—18,000 SQM [AMAZON] CHARTER HALL— H1 2021

9 33 ALFRED STREET—32,615 SQM AMP— H1 2024

UNDER CONSTRUCTION/ MAJOR PRE-COMMITMENT

10 275 GEORGE STREET—6,363 SQM [VICTORY SERVICED OFFICES]
DAIBIRU— 40% COMMITTED. H2 2020

11 BROOKFIELD PLACE—59,000 SQM [NAB/ ALLIANZ/HUB]
BROOKFIELD— 90% COMMITTED. H1 2021

12 QUAY QUARTER TOWER—88,274 SQM [AMP/DELOITTE]
AMP/REST— 80% COMMITTED. H1 2022

13 CIRCULAR QUAY TOWER—55,000 SQM [SALESFORCE]
LENDLEASE, PING AN, MITSUBISHI – 55% COMMITTED. H2 2022

DEVELOPMENT APPROVED

14 MARTIN PLACE METRO NORTH TOWER—75,000 SQM
MACQUARIE GROUP— H2 2024

15 MARTIN PLACE METRO SOUTH TOWER—30,000 SQM
MACQUARIE GROUP— H2 2024

16 PITT STREET METRO TOWER—49,120 SQM
H2 2024

17 TECH CENTRAL ATLASSIAN TOWER—70,000 SQM [ATLASSIAN]
ATLASSIAN— 85% COMMITTED, H1 2025

18 TECH CENTRAL –150,000 SQM
DEXUS/FRASERS— H1 2025

19 DARLING PARK TOWER 4—60,000 SQM
GPT/AMP— H1 2026

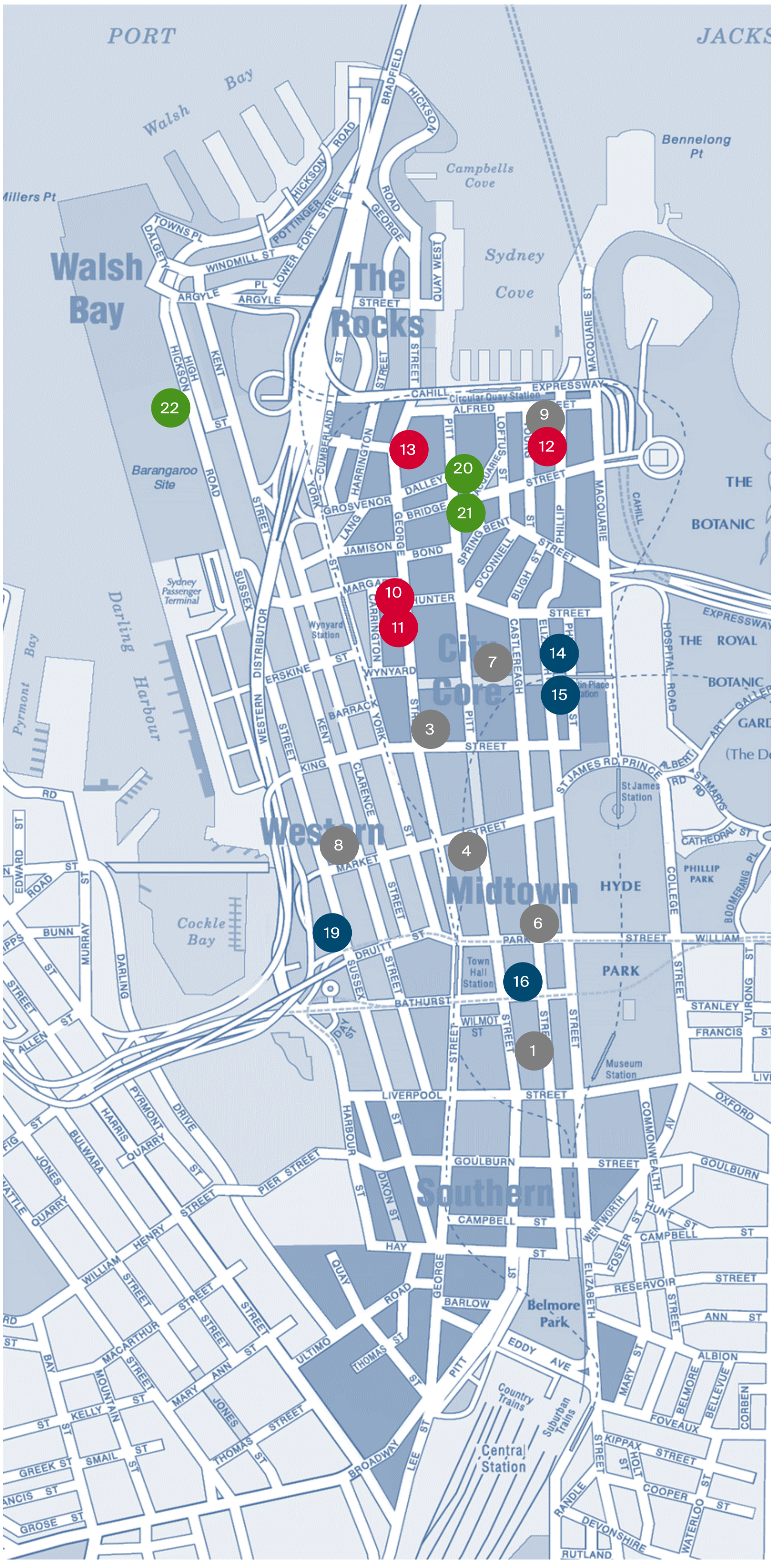
DEVELOPMENT APPLICATION/MOOTED/

20 55 PITT STREET—60,000 SQM
MIRVAC. 2025+

21 56 PITT STREET—50,000 SQM
DEXUS. 2025+

22 CENTRAL BARANGAROO—48,350 SQM
GRCON/AQUALAND/SCENTRE. 2026+

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



RISING INCENTIVES MAY STIMULATE ACTIVITY

Rental growth cycle halts

The above trend rental growth cycle experienced over the last couple of years has halted as a result of the economic and market uncertainty due to Covid-19. Tenant demand has dropped significantly over the last six months as business decisions around office space have been put on hold and remote working policies are in place for the foreseeable future. The rise of sub-lease vacancy and lower white-collar employment growth also reflects limited tenant demand in the market as a result of Covid-19.

On a 12 month basis (to July 2020), average prime gross face rents have increased by 4.8% to $1,385/sqm ($1,189/sqm net face), however are unchanged since January as a direct result of Covid-19. In the secondary market rents rose slightly by 2.2% in the 12 months to July 2020 to $1,017/sqm ($857/sqm net face), similarly to the prime market, secondary rents have not moved over the last six months.

The current rental discount between prime and secondary rents is 27%, below its historical average of 31%. There seems to be greater demand for higher quality office space through the 'flight to quality' adage, with a particular focus on health, safety and wellbeing, as well as increased amenity to help bring employees back to the workforce. This could see the rental gap widen as secondary stock may struggle to fulfill these occupier demands.

As the occupier demand pool remains limited, landlords have had to increase their incentive offerings in order to retain and attract tenants.

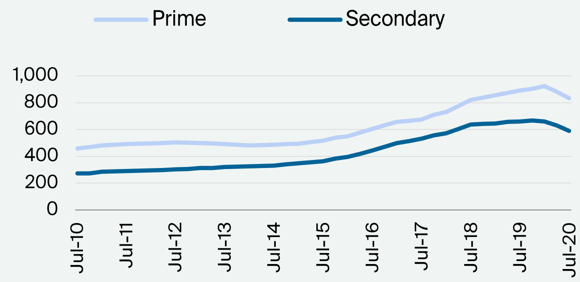
Sharp increase in incentives to retain and attract new tenants

Late 2019, incentives dipped to decade low levels of sub 20%, however this has changed substantially with average prime incentives climbing to 25.6% as at July 2020.

The rise in incentives has resulted in net effective rents dropping to $835/sqm, down 9.6% in the six months to July 2020. Average secondary incentives have risen to 26.2%, declining net effective rents by 10.6% to $590/sqm.

While there is limited deal evidence, increased sublease vacancy and slower white collar employment growth suggests that incentives have continued to move, with a consensus that they are above 30% as at September. Face rents are still holding, but a further rise in incentives will reflect a fall in effective rental rates over the next quarter.

Net Effective Rent
By Grade $/sqm



Source: Knight Frank Research

Recent significant tenant commitments

OCCUPIER	PROPERTY	PRECINCT	SIZE SQM	FACE RENT $/ SQM (g)	INCENTIVE	TERM YRS	START DATE
Metro Finance ~	35 Clarence Street	Western	702	1,055	21%	4	Feb-20
Mason Stevens~	420 George Street	Midtown	1,191	1,378	18%	5	Jun-20
Adecco Australia~	123 Pitt Street	Core	880	1,127	-	8	Apr-20
NSW Treasury Dept~	201 Kent Street	Western	1,325	1,124	17%	10	Q4-19
Intuit~	1 O'Connell Street	Core	2,400	1,744	17%	5	Apr-20
BNY Mellon~	1 Bligh Street	Core	1,607	1,311	28%	5	Jun-20

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

INVESTMENT DOWN BUT INVESTORS ARE READY

Short-term fall in leasing demand may be producing some headwinds to investment activity but pricing has been resilient

In line with an overall slowdown in activity globally due to the Covid-19 pandemic, investment deal volumes in Sydney have declined through the first half of 2020.

Investment volumes for H1 2020 reached $991.6 million, down from $3.55 billion in H1 2019.

While the pandemic is delaying investor decision making, deal volumes are still trending above the low levels seen during the GFC indicating that the market is dealing with a very different dynamic.

The low volume of deals and supply of assets for sale during the first half of 2020 also suggest that the short-term easing of leasing demand may have been producing some headwinds to overall investment activity.

However, the market is not seeing any distressed asset sales and pricing up to this point in the cycle appears to be mostly unaffected.

Additionally, the Sydney CBD office market is coming off a record 2019 where $9.17 billion in transactions were recorded. This is the highest deal volume recorded in Sydney in the last decade and follows a ramp up in off-market and mega-deal activity.

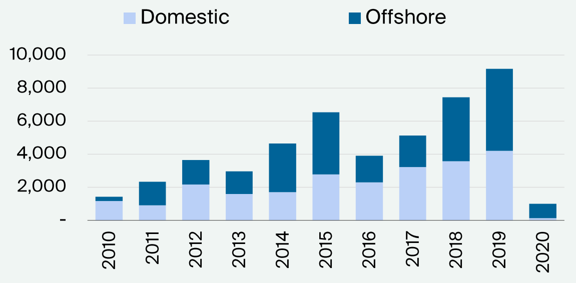
Pricing on the assets being exchanged reflects long-term confidence in Sydney

In the first significant CBD transaction since the start of the pandemic, Dexus announced in June 2020 it had exchanged contracts to sell 45 Clarence Street to Peakstone, a Singaporean headquartered capital manager, for $530 million, subject to FIRB approval. The sale price is consistent with the Dexus December 2019 book value and reflects a core market yield of 4.97%. Dexus received the off-market unsolicited offer from Peakstone, who is understood to be working with Zone Q, the owner of 55 Clarence Street. Zone Q previously acquired 55 Clarence Street in 2018 for $255 million.

Given the pricing and economic uncertainty being faced globally, the deal is noteworthy at this stage of the cycle as it reflects relatively limited pricing movement and the long-term confidence in the CBD market.

Sydney CBD Office Sales $10m+

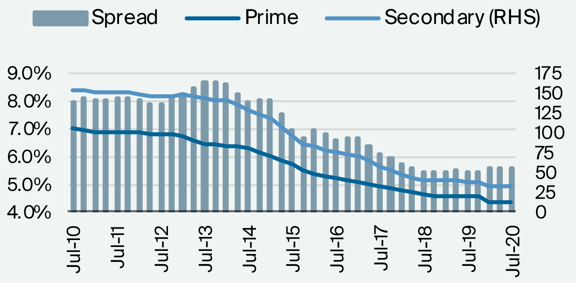
By Purchaser ($m), Domestic v Offshore



Source: Knight Frank Research

Yield Spread

Prime vs Secondary, %, bps



Source: Knight Frank Research

Prime yields holding firm after sustained compression

Despite the number of assets being exchanged dropping significantly on last year, there are no signs that yields on the deals tracked in the early period of the pandemic have been impacted.

Average prime yields are holding at 4.38% as at July. This is unchanged since January 2020 but reflects a compression of 20bps on July 2019.

Similarly, secondary yields remain have held at 4.92% since January, but show a compression of 15bps on July 2019.

Investment volumes have declined but appetite for core assets with long income streams may drive a rebound in asset sales

Although the deal count in the first half of 2020 is down substantially on the same time last year, offshore investors have been the largest source of capital in 2020, accounting for nearly 90% of deals by value. This is in significant contrast to 2019, where there was a relatively even split between domestic and offshore capital inflows into Sydney.

There was also a surge in mega-deal activity ($500m+ in value) during 2019 that was driven by institutional appetite. While this is yet to occur in 2020, a rebound in investment volumes is likely in the coming months with several large core CBD assets being offered for sale.

Leasing conditions have been challenging but the income security of some of these assets amidst greater instability in global markets will make Sydney a compelling proposition for the select group of buyers looking to increase their exposure in Australia.

Recent significant sales

PROPERTY	PRICE $M	CORE MARKET YIELD %	NLA SQM	$/SQM NLA	WALE	PURCHASER	VENDOR	SALE DATE
45 Clarence Street	530.0	4.97	31,992	16,567	2.7	Peakstone	Dexus	Jun-20
59 Goulburn Street	270.0	5.50	19,721	12,691	3.6	Poly Real Estate Group	Fortius Funds / SC Capital	Feb-20
100 Market Street	683.0	4.10	28,385	24,062	9.0	Link REIT	Blackstone Group	Dec-19
323 Castlereagh Street	325.0	5.10	26763	12,144	1.4	Lasalle Investment Management	MKH Properties	Nov-19
6-10 O'Connell Street	315.0	4.90	16,317	19,580	2.9	Hong Kong Private	Oxford Properties	Oct-19
161 Castlereagh Street (25%)	405.0	4.30	60,213	26,825	9.3	ISPT	Blackstone JV^	Oct-19

^ Blackstone Group Joint Venture with Ivanhoe Cambridge

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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