- *Leasing market conditions improving*
- *Rise in face rents*
- *Slow down in investment activity*

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Sydney CBD Office

Market Report, September 2022

RENTAL GROWTH RETURNS

10.1%
VACANCY
PCA data at July 22

103,274
Sqm in office completions H1 2022

3.6%
Prime net face rental growth (YoY)

"Shifting tenant preferences and robust demand for best-in-class stock have underpinned a return to rental growth"

Key Insights

A buoyant labour market, with historically low unemployment nationally and in Sydney and record high job vacancies across most white-collar industries along with increased household will continue to support office demand in Sydney.

Office space enquiry has been positive and translated into c100,000sqm of direct lease deals; driven by the tech sector and financial services.

With incentives holding firm over and an increase in face rental growth; there has been positive movement in net effective rents with an increase of 1.7% YoY to measure $744/sqm.

The pipeline of new development stock due for completion over the next 12 months totals 71,500 sqm, with a commitment rate over 70%.

Increasing funding costs and changing financial conditions are now impacting market sentiment and have caused a slowing in transactional activity.

Yields have softened for first time since 2009, increasing by approximately 12.5bps, with more softening likely to occur.

Sydney CBD Office Market Indicators—July 2022

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)	AVERAGE CORE MARKET YIELD %*
Prime	3,282,362	10.3	45,948	97,624	1,232	34	0.5	4.25-4.75
Secondary	1,951,506	9.8	-16,444	-13,304	901	33	3.5	5.00–5.50
Total	**5,233,868**	**10.1**	**29,504**	**84,320**				

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

SUSTAINED OCCUPIER DEMAND

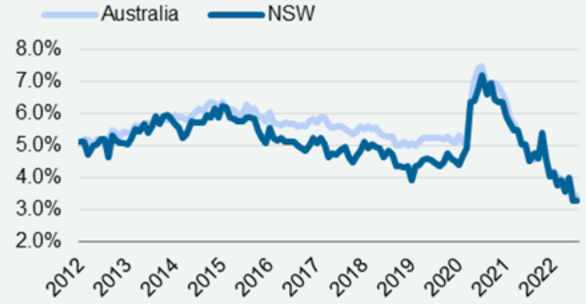
Robust economic growth but rising inflationary pressures

Multiple economic indicators point to the strength and resilience of the Australian economy. The labour market is buoyant, with historically low unemployment nationally and in Sydney and record high job vacancies across most white-collar industries. Meanwhile, household spending continues to grow rapidly, while high energy prices globally mean that Australia's commodity exports are generating large trade surpluses and underpinning corporate profits, all of which will continue to support office demand in Sydney.

However, multiple supply shocks in conjunction with elevated consumer demand continue to ratchet up inflationary pressures. This is particularly acute in the construction industry, where rapid increases in costs across multiple key inputs are resulting in the highest overall construction cost inflation for at least 40 years which will complicate the delivery of new schemes.

Unemployment rate

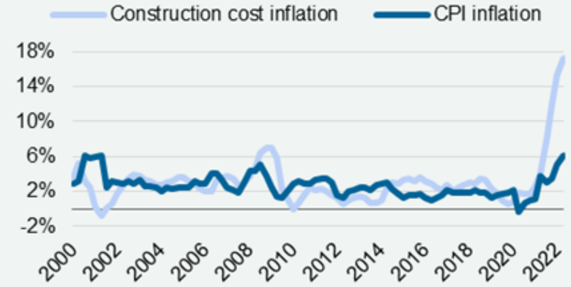
Australia and NSW



Source: Knight Frank Research, ABS

Rising inflation

Headline CPI and construction cost inflation, % yoy



Source: Knight Frank Research, ABS

Positive sentiment and demand in leasing market despite economic uncertainty

Despite the current economic conditions playing out globally which has had more of an impact on the investment market in conjunction with severe bad weather and a fresh covid wave; the leasing market conditions and sentiment have remained fairly positive.

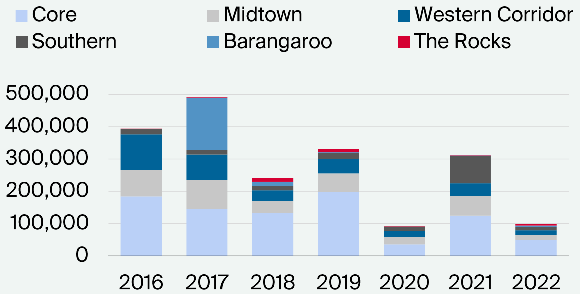
Last year saw a strong finish to the year in terms of deal volumes with c300,000sqm of deals signed, which were buoyed by several pre-commitments. So far for 2022, enquiry has been strong and translated into c100,000sqm of direct lease deals. Demand over the last 18 months has been driven by the tech sector accounting for 33% of all lease deals, followed by financial services (21%) and professional services (16%).

Reflecting the improvement in demand levels and activity during the first half of the year is the 21,692 sqm of positive net absorption that was recorded in H1 2022. Whilst vacancy edged slightly higher to 10.1% this was brought about the large increase in new supply, stemming predominately from Quay Quarter Tower. By grade, prime vacancy has increased slightly to 10.3% as at July-22, whilst secondary vacancy has tightened for the first time since the outbreak to measure 9.8%, down from 10.8%.

Forecasts suggest that vacancy has likely peaked for the next 12 months and will hold around 10% and whilst there will still be some challenges in the near term, the optimism in the market and active tenant enquiry bodes well for the long term recovery of the Sydney office market.

Lease deals by precinct

2016-2022YTD, sqm



Source: Knight Frank Research

NEW SUPPLY SUBSTANIALLY PRE-COMMITTED

Completions tip five year high

Following a period of supply deficits prior to 2021, there has been a significant influx of new and refurbished stock, with over 250,000sqm of net additions to the market. This is the largest period of completions since international towers entered the market.

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 playing out in the Sydney CBD office market.

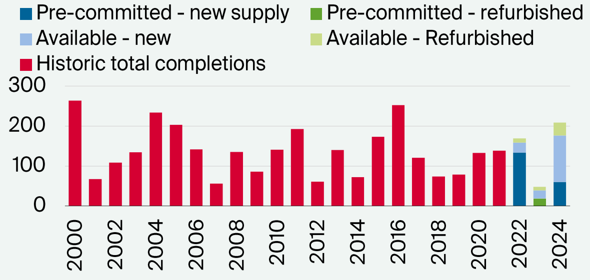
In the six months to July 2022, office completions totalled 103,274 sqm, taking the total office stock base to 5,233,868 sqm. New supply was led by the practical completion of Quay Quarter Tower (87,201 sqm), which has achieved near full occupancy; including major tenants Deloitte, AMP, IMC Trading, Johnson Winter & Slattery and Corrs Chambers Westgarth

In terms of refurbished stock, there were two refurbishments completed over the first half of the year, they include 143 Macquarie Street (3,600sqm) and part of 477 Pitt Street (6,700sqm). A further 19,000 sqm of refurbished stock will likely come to back to market over the next six months from 255 George Street owned by AMP Capital. The building was vacated by NAB relocating to Brookfield Place last year, leaving large backfill space which has since predominately been secured by BOQ, ATO and Eftpos.

Refurbishments, in conjunction with new development stock, are forecast to set another record of completions for 2022 with the Sydney office stock base forecast to hit c5.3 million sqm by year end.

Sydney CBD Development Completions

By Commitment type, '000s sqm



Source: Knight Frank Research, PCA

New development to reset the benchmark of premium grade stock in the CBD

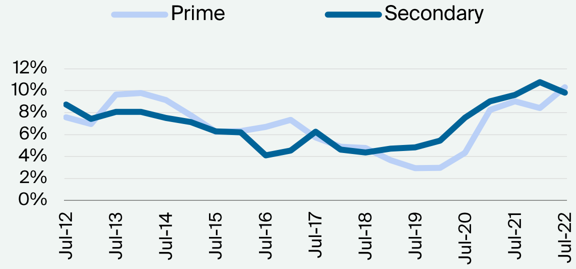
The pipeline of new development stock due for completion over the next 12 months totals 71,500 sqm, with a commitment rate over 70% across two schemes including Salesforce Tower (55,000 sqm) and 210 George Street (16,500 sqm). Salesforce is upsizing into CQT from Darling Park Towers, with JLL, Wellington Management, Tourism Australia, Greenhouse and the Executive Centre also relocating into CQT. At 210 George Street, Transurban has recently secured c2,250sqm and will relocate from Chifley Square next year.

Whilst these next developments are substantially pre-committed, there will be some large backfill vacancies which will arise in the market. Major tenant movements that will cause the rise in backfill include Deloitte vacating Grosvenor Place (27,800 sqm) moving into QQT along with Corrs Chambers from 8 Chifley and Salesforce vacating Darling Park Tower 3 into Salesforce Tower. Additionally, a number of buildings are set to be withdrawn in 2023 to make way for the Hunter Street Metro station, c42,000 sqm is forecast to be permanently withdrawn which may aid vacancy levels as tenants will be displaced and need to seek new office space.

Looking further ahead the next wave of new premium supply is expected to come to market from 2024 onwards and will predominantly come from the Over Station Developments (OSD) at Martin Place and Parkline Place OSD, in conjunction with the Tech Central precinct. The Tech Central precinct in particular, will be anchored by a 75,000 sqm commitment from Atlassian and will drive the much needed organic expansion of the CBD to its Southern boundaries.

Vacancy

By grade



Source: Knight Frank Research, PCA

MAJOR OFFICE SUPPLY

MAJOR REFURBISHMENTS

1 44 MARTIN PLACE–9,500 SQM
GWYNVILL GROUP – COMPLETE

2 570 GEORGE STREET–18,100 SQM
FAR EAST– COMPLETE

3 255 GEORGE STREET–19,000 SQM
AMP CAPITAL– H2 2022

4 33 ALFRED STREET–32,615 SQM
AMP CAPITAL– H1 2024

UNDER CONSTRUCTION/ MAJOR PRE-COMMITMENT

5 121 CASTLEREAGH STREET–12,068 SQM
CBUS - H2 2023

6 BROOKFIELD PLACE–59,000 SQM [NAB/ ALLIANZ/HUB/MOELIS]
AMP/BROOKFIELD– 100% COMMITTED. COMPLETE

7 QUAY QUARTER TOWER–88,274 SQM [AMP/DELOITTE/CORRS CHAMBERS]
AMP CAPITAL/DEXUS/REST– 95% COMMITTED–COMPLETE

8 210 GEORGE STREET–16,500 SQM
POLY GROUP - 33% COMMITTED, H2 2022

9 SALES FORCE TOWER–55,000 SQM
LENDLEASE, PING AN, MITSUBISHI – 80% COMMITTED. H2 2022

10 PARKLINE PLACE–49,120 SQM OXFORD/ INVESTA–H1 2024

DEVELOPMENT APPROVED

11 TECH CENTRAL ATLASSIAN TOWER– 75,000 SQM [ATLASSIAN]
ATLASSIAN– 100% COMMITTED, H1 2026

12 MARTIN PLACE METRO NORTH TOWER– 75,000 SQM
MACQUARIE GROUP– H2 2024

13 MARTIN PLACE METRO SOUTH TOWER– 30,000 SQM
INVESTA/MANULIFE– H2 2024

14 CENTRAL PLACE –138,000 SQM
DEXUS/FRASERS– 2027

15 2 CHIFLEY SOUTH –42,000 SQM
CHARTER HALL/GIC– 2027

16 DARLING PARK TOWER 4–75,000 SQM
GPT/AMP CAPITAL – 2028

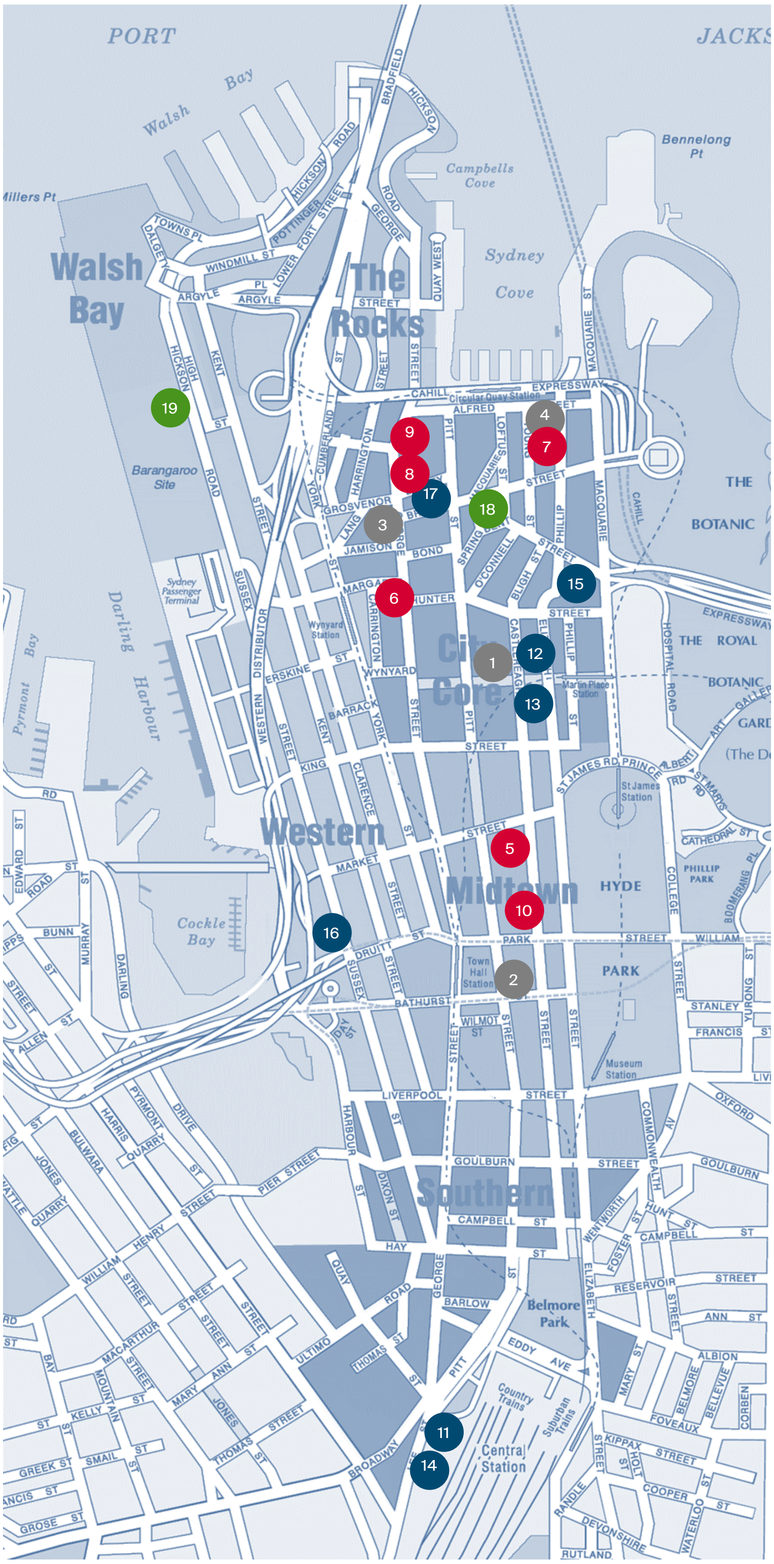
17 55 PITT STREET–70,000 SQM
MIRVAC 2026

DEVELOPMENT APPLICATION/MOOTED/ EARLY FEASIBILITY

18 56 PITT STREET–50,000 SQM
DEXUS. 2029

19 CENTRAL BARANGAROO–48,350 SQM
GROCON/AQUALAND/SCENTRE. 2027

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



RENTS RETURN TO GROWTH

Landlords push face rental growth

On a 12 month basis (to July 2022), average prime net face rents have increased by 3.6% to $1,232/sqm ($1,454/sqm gross face). In the secondary market rents now average $901/sqm ($1,075/sqm gross face) as at July 2022. This is the first significant shift in face rents since the beginning of 2020 on the back of inflationary pressures and higher quality office stock available on the market.

The current rental discount between prime and secondary rents is 27%. Demand has been weighted towards more prime quality office space through the 'flight to quality' adage, with a particular focus on amenity, safety and wellbeing, as occupiers look to remodel their workplace environment.

Incentives to remain high for the near term

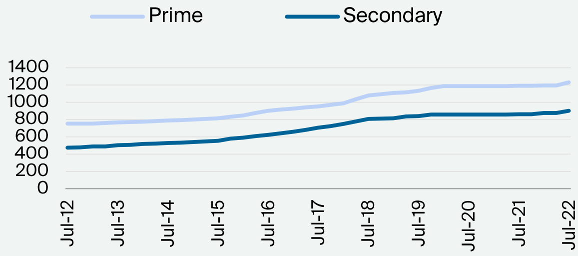
With landlords pushing face rents; they have held firm with offering high incentives in order to retain and attract tenants. Prime incentives average 34% as at July 2022 and are likely to remain at this level until at least the end of the year.

With incentives holding firm and an increase in face rental growth; there has been positive movement in net effective rents. Prime net effective rents now measure $744/sqm, up 1.7% since the start of the year. Whilst net effective rents are still down 19% since the start of the pandemic, with the worst appears to be behind us. Secondary incentives average 33%, with net effective rents now averaging $550/sqm.

Sublease vacancy and backfill space will likely see incentives remain above average in the near term and will see landlords continue to offer additional inducements to prospective tenants such as early access and contribution to fitouts.

Net face rents

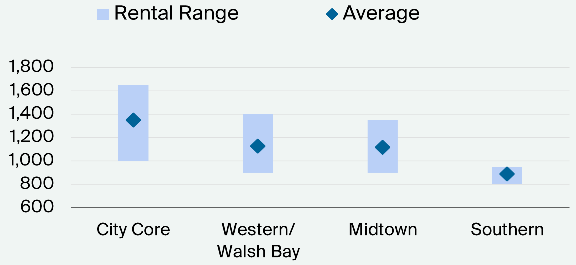
By grade $/sqm



Source: Knight Frank Research

Net rental range

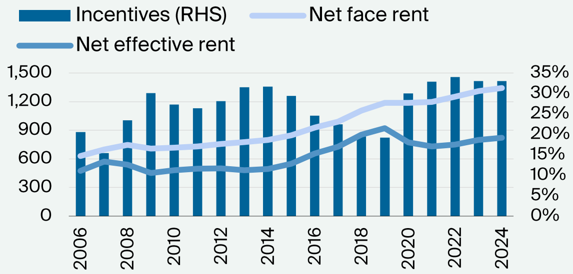
By Precinct, $/sqm



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
NSW Business chambers	8 Chifley Square	Core	2,600	1,175	35%	7	Q3-22
Transurban	210 George Street	Core	2,250	1,400g	36.5%	10	Q2-22
Australia Renewal Energy	20 Martin Place	Core	810	1,325	35%	5	Q3-22
Superloop	12 Shelley Street	Western	1,366	1,000	35%	5	Q3-22
Colgate Palmolive	420 George Street	Midtown	1,800	1,390	34%	5	Q3-22

\# Pre-commitment ^ Sublease ~Direct (g) gross face

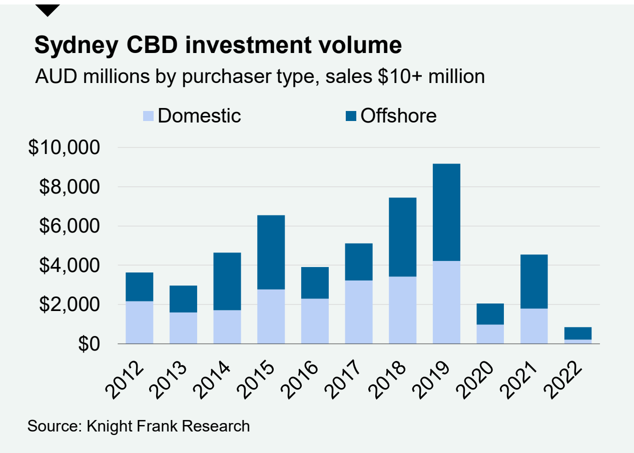
HIGHER FUNDING COSTS SLOW THE MARKET

Higher rates and uncertainty over the outlook impacting sentiment

While economic growth remains strong, rising inflation locally and globally has resulted in significant uncertainty over the outlook for interest rates and whether central banks will be able to act quickly enough to rein in these cost pressures while also engineering a soft landing. The RBA has now raised rates by 50 bps on several occasions with further hikes expected in coming months. However, for property markets, the cash rate is merely playing catch-up with the sharp uplift in bond yields and swap rates witnessed since January.

Global bond markets have been volatile in recent months as they react to conflicting signals on the outlook for inflation and hence changing interest rate expectations. From the start of the year, Australian bond yields across all maturities have moved swiftly upward, with the benchmark ten-year yield moving from 1.7% at the start of the year to 4.2% in mid June. Yields have partially retraced since then in response to concerns over the global economic outlook but remain far higher than the levels prevailing during 2019-21.

This increase in bond yields across all maturities has had a commensurate impact on the cost of debt in property markets, with funding costs rising by more than 200 basis points in most cases. This has also had the impact of raising the cost of hedging currency exposures for foreign investors.



Reduced deal flow so far in 2022

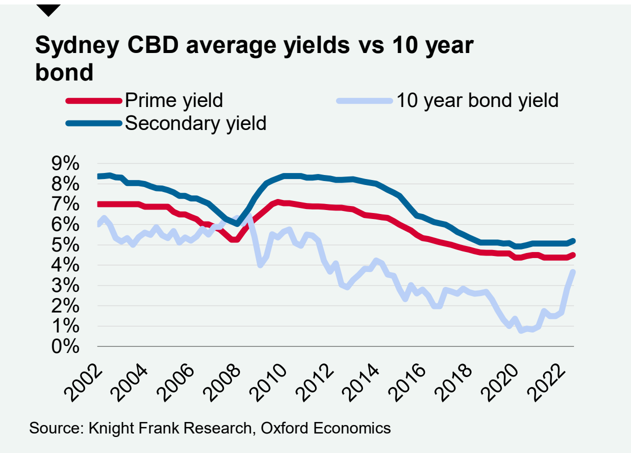
These changes in financial conditions are now impacting market sentiment and have caused a slowing in transactional activity as vendors and buyers reset expectations. Reflecting this shift, deal volumes stand at a relatively low $835 million so far this year, but this is expected to be boosted in coming months with several transactions in the pipeline, potentially including a 25% stake in 1 Farrer Place.

Demand for quality CBD office assets remains strong, but heightened uncertainty over the outlook is resulting in deals taking longer to transact. The largest deal of the year so far was the purchase by Allianz and Korea's NPS of Darling Quarter for $625 million, which was agreed before the change in market conditions.

Yields shift out for the first time since 2009

The impact of higher funding costs on pricing is starting to become apparent; however, it is too early to judge the full impact especially given that further rate rises are expected in the second half of the year. Average prime and secondary Sydney CBD yields are judged to have increased by 12.5 basis points to 4.5% and 5.2% respectively and will be tested more thoroughly during Q3 and Q4 as new transactions emerge.

This trend is echoed nationally and in other global markets given the universality of inflationary pressures and rate rises, but Sydney will remain a preferred destination aided by the nascent return of rental growth.



Recent significant sales

PROPERTY	PRICE $M	CORE MARKET YIELD %	NLA SQM	$/SQM NLA	WALE	PURCHASER	VENDOR	SALE DATE
4-6 Bligh Street	210	4.4	10,027	20,943	2.9	Local Private	RECAP IV Fund^	Jul-22
Darling Quarter (50%)	625*	4.2	61,000	20,492	12.5	AREAP 1< Fund	Abu Dhabi Investment Authority	Jan-22
10 Barrack Street	199	4.7	9,627	20,671	3.9	Shayher Group	AEW Capital	Dec-21
309-321 Kent Street (50%)	401	5.1	47,701	16,813	3.4	Ashe Morgan JV Liu Chong Hing Inv	Dexus	Dec-21
77 Castlereagh Street	250	4.6	13,161	18,996	4.2	Abacus Property	Blackstone	Dec-21

*Gross sale price ^ Real Estate Capital Asia Partners IV Fund < Allianz Real Estate Asia-Pacific Core I (AREAP I)

We like questions, if you've got one about our research, or would like some property advice, we would love to hear from you.

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

Capital Markets
Paul Roberts
+61 2 9036 6872
Paul.Roberts@au.knightfrank.com

Capital Markets
Ben Schubert
+61 2 9036 6870
Ben.Schubert@au.knightfrank.com

Research
Ben Burston
+61 2 9036 6756
Ben.Burston@au.knightfrank.com

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

Office Leasing
Andrea Roberts
+61 2 9036 6703
Andrea.Roberts@au.knightfrank.com

Occupier Services
James Johnston
+61 2 9036 6873
James.Johnston@au.knightfrank.com

Asset Management
Lisa Atkins
+61 2 9604 4710
Lisa.Atkins@au.knightfrank.com

Valuations & Advisory
James Marks
+61 2 9036 6684
James.Marks@au.knightfrank.com

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