- *Businesses delaying their leasing decisions due to COVID-19*
- *Face rents steady but incentives anticipated to go up*
- *Investor demand remained strong for core assets with strong lease covenants*

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Adelaide CBD Office

Market Report, October 2020

HIGH DEMAND FOR STRONG CORE ASSETS DESPITE COVID

Whilst COVID-19 has disrupted activity in the office market locally and nationally, core assets with strong lease covenants remain highly sought after in Adelaide.

14.2% TOTAL VACANCY

4.1% VACANCY new generation prime office located in core precinct

$351.1 MILLION TURNOVER

"In the middle of a global pandemic Knight Frank sold an office building off market for $174.65 million and set a new pricing record."

GUY BENNETT

PARTNER, HEAD OF INSTITUTIONAL SALES, VIC & SA

The Key Insights

The Adelaide CBD vacancy rate has increased by 0.2% to 14.2% in July 2020. The increase was mainly attributed to a supply increase resulting from refurbishments of B Grade buildings.

Leasing activity remained subdued with the majority of businesses deferring their relocation and expansion decisions given current economic uncertainty.

Average prime incentives currently stand at circa 31.4%, however the weaker demand in the leasing market is likely to place some upward pressure on incentives.

A forecast for a significant supply increase in 2023 will have a material impact on the Adelaide CBD vacancy rate at this time as large volumes of space in secondary buildings will be seeking new tenants.

Yields for prime assets in the Adelaide CBD continue to compress and currently range between 5.50% and 6.75%. Strongest demand remains for those properties offering strong lease covenants.

Adelaide CBD Office Market Indicators — July 2020

GRADE	TOTAL STOCK SQM	VACANCY RATE %	SIX MONTH NET ABSORPTION SQM	SIX MONTH NET ADDITIONS SQM	AVERAGE GROSS FACE RENT $/SQM	AVERAGE INCENTIVE %	EFFECTIVE RENTAL GROWTH % YOY	AVERAGE CORE MARKET YIELD %*
Prime	609,006	10.8	2,844	0	549	27.5-35.0	4.91	5.50-6.75
Secondary	838,473	16.7	1,692	9,748	389	30.0-37.5	2.72	6.75–8.50
Total	**1,447,479**	**14.2**	**4,536**	**9,748**				

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

LACK OF ACTIVE SPACE REQUIREMENTS

Tenant demand was concentrated in new generation prime office buildings

In the 12-18 months prior to COVID-19, the Adelaide office leasing market was on an upward demand trend. In the years preceding this, building owners were reliant more so on tenant relocations or renewals, whereas much of the demand during 2018/19 stemmed from new entrants to the market, particularly from tenants associated with the defence sector.

The majority of the tenant demand is concentrated in prime stock reflecting a continuing flight to quality by tenants. More specifically, tenant demand in the CBD has been focussed on new generation prime office buildings defined as those that were constructed post-2006.

New generation buildings generally provide improved accommodation and more efficient floor plates and as a result can pave the way for savings in rent and longer lease terms. As at July 2020, the total vacancy for new generation prime office buildings in the core precinct was approximately 4.1%, whilst older prime office buildings have a vacancy rate of approximately 25.1%.

The continuing trend of tenants trading up to better grade office space is likely to have an impact on the secondary market. Hence, secondary building owners face amplified requirements to reposition their assets through refurbishment and upgrades in order to retain appeal. A recent example of successfully achieving this is 74 Pirie Street, Adelaide. The property was fully refurbished and attracted many small and medium businesses such as Keystone Capital, Capital United, Dialog Group, EMM Consulting and Future Urban.

Large national businesses are adopting a “wait and see” approach regarding leasing decisions

In the six months to July 2020, leasing activity was subdued, and given the level of uncertainty in the current economic environment, large national businesses/corporates are tending to defer their leasing decisions where possible, and adopt a “wait and see” approach before they make any new long-term lease commitments. However, the level of enquiries and activity from small or private businesses remained steady, albeit fewer than pre COVID-19.

Those tenants with an upcoming lease expiry are leaning towards renewing or extending their existing lease. Business such as HWL Ebsworth, Super SA and Return to Work SA have recently exercised their lease renewals or extended their lease rather than relocating.

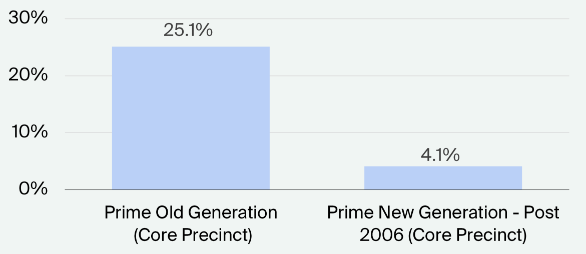
Net absorption declined

In the six months to July 2020, Adelaide CBD recorded positive net absorption of 4,536m², majority of which was driven by leasing of A-grade stock, which totalled 2,844m².

Net absorption was approximately 22.7% below the 25-year average six months net absorption of 5,873m², and at the time of writing, there were only a handful of tenants active in the Adelaide office market seeking office space greater than 1,000m².

Prime Office Vacancy in Core Precinct

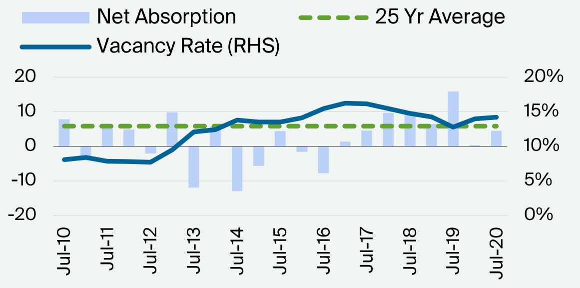
New vs Old generation



Source: Knight Frank Research

CBD Office Vacancy & Absorption

% total vacancy; '000 sqm net absorption



Source: Knight Frank Research, PCA

FUTURE SUPPLY WILL CREATE BACKFILL SPACE

New supply with no tenant pre-commitment

In the six months to July 2020, Adelaide CBD recorded positive net supply of 9,748m². This figure is approximately 68% above the 25-year average six months net supply of 5,802m². The positive net supply was mainly attributed to the full refurbishments of 74 Pirie Street and 89 Pirie Street.

The next major office supply is the development of 108 Wakefield Street by Kyren Group. The development will comprise a 14-level A-Grade office tower disposed as ground floor retail and 13 upper levels of office space. The property is currently under construction without tenant pre-commitment and is scheduled for completion in Q4 2020. On completion, the property will have an NLA of 15,586m².

Significant amount of backfill space is expected to enter the office market over the next 2-3 years

The Department of Human Services (DHS) put out a request for offer in 2018 for office space of up to 29,000m² seeking occupation in 2023. Development sites that may have been shortlisted to accommodate this requirement include Festival Plaza office tower (43,636m²) by Walker Corporation and a proposed 15 storey office tower (43,000m²) at 52-66 King William Street by Charter Hall. Other major developments mooted include 200 North Terrace (Commercial & General 26,000m), 42-56 Franklin Street (Kyren Group 21,000m²) and 120 Frome Street (Leyton Property Group 7,310m²).

The outcome of the DHS tender and the proposed developments will have a material impact on the Adelaide CBD vacancy rate over the next 2-3 years. Assuming new buildings are constructed significant volumes of backfill space in secondary buildings will likely be brought to the market.

Cbus Property to build a $300 million office building with SA Government as the major tenant

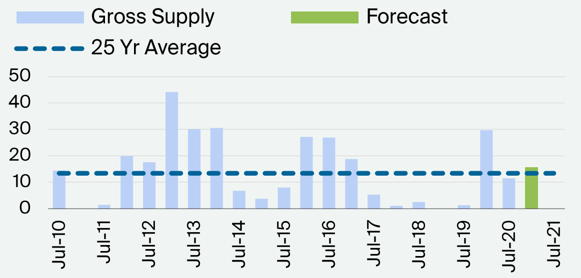
In April 2020, Cbus Property was announced as the successful proponent to build a $300 million, 20 storey building at 73-85 Pirie Street to accommodate the requirement of the State Government tender for the Department of Planning, Transport and Infrastructure (DPTI). DPTI will be the anchor tenant and occupy 10 floors (circa 17,500m²), consolidating the department's seven city locations into one. The deal was struck with an initial term of 10 years and the lease will commence from practical completion date (circa H2 2023).

New developments are likely to put pressure on vacancy rates over the short to medium term

The Adelaide CBD vacancy rate has remained steady despite COVID-19. In the six months to July 2020, the Adelaide CBD vacancy rate increased by 0.2% to 14.2%. The increase was mainly attributed to refurbishments of B Grade buildings, which added 9,730m² of net supply to the B grade stock.

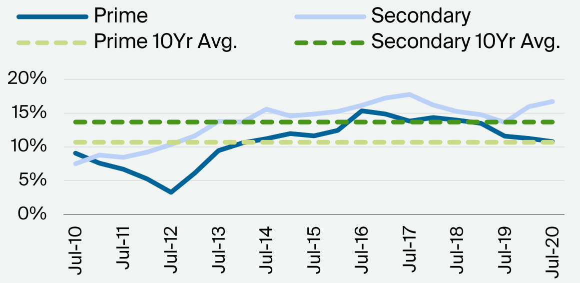
While many eastern states have experienced a spike in sublease vacancy, Adelaide CBD remained resilient with no material volume of sublease space brought to the market. However, vacancy in Adelaide CBD is likely to increase, given the number new major developments scheduled for completion over the short to medium term are not likely to be met with a significant pressure in leasing demand.

CBD Office Gross Supply
'000 sqm



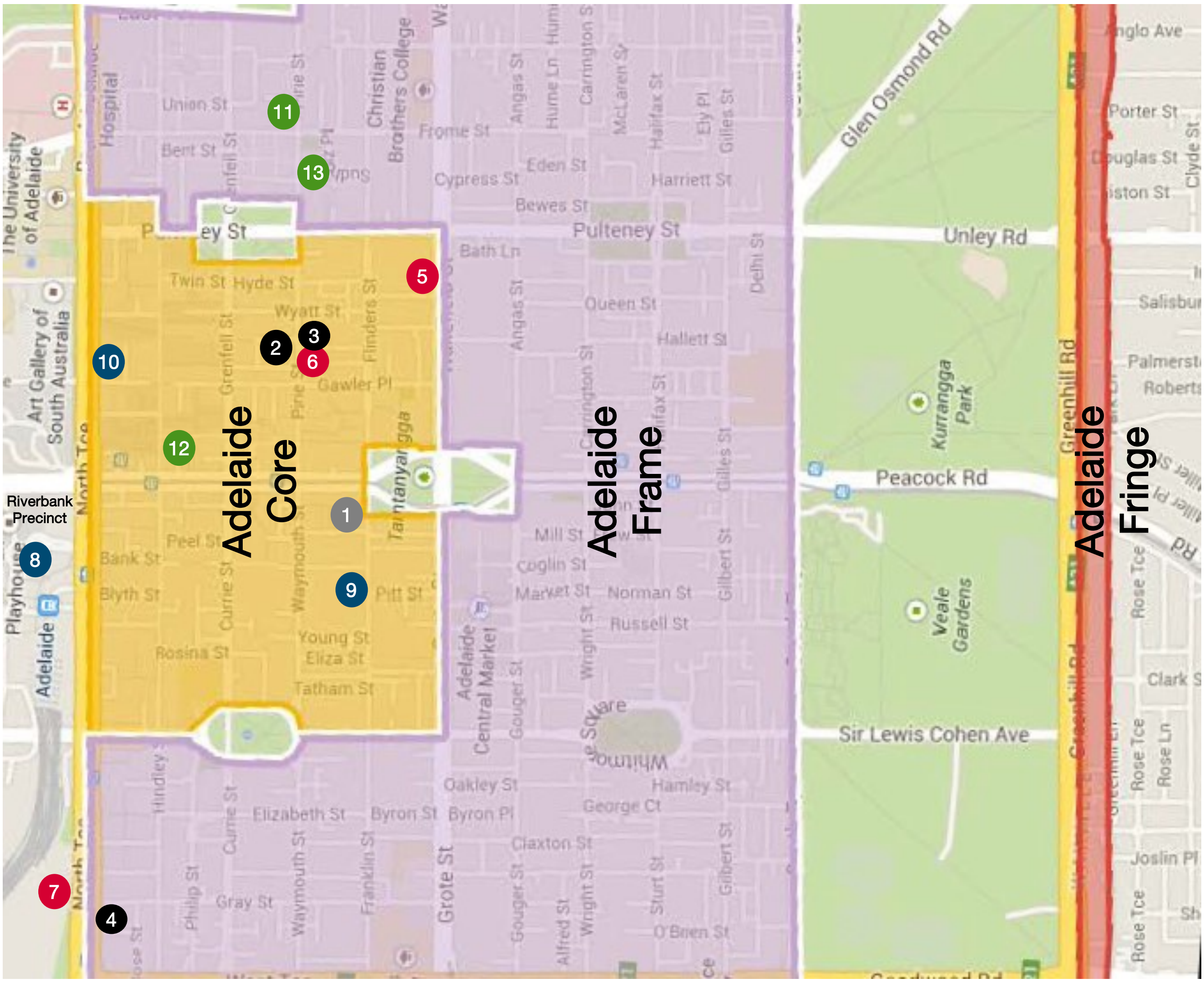
Source: Knight Frank Research, PCA

CBD Office Vacancy
% Prime vs Secondary



Source: Knight Frank Research

MAJOR OFFICE SUPPLY



RECENTLY COMPLETED

1. GPO EXCHANGE 2-10 FRANKLIN STREET–24,500 SQM [BHP/SA GOVERNMENT]
   CHARTER HALL – Q4 2019

MAJOR REFURBISHMENTS

2 74 PIRIE STREET–1,570 SQM
MARAS GROUP–Q2 2020

3 89 PIRIE STREET–7,345 SQM
PELLIGRA GROUP–Q2 2020

4 21 NORTH TERRACE–3,500* SQM (OFFICE/MEDICAL)
LUCA GROUP–0% COMMITTED Q2 2021

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

UNDER CONSTRUCTION/ MAJOR PRE-COMMITMENT

5 108 WAKEFIELD STREET–15,586 SQM (OFFICE) & 452 SQM (RETAIL)
KYREN–0% COMMITTED Q4 2020

6 73-85 PIRIE STREET–30,000 SQM [SA GOVERNMENT–DPTI]
CBUS–58% COMMITTED. 2022+

7 SAHMRI 2, NORTH TERRACE–20,000* SQM (OFFICE) [SA GOVERNMENT & SAHMRI]
COMMERCIAL & GENERAL–2023

DEVELOPMENT APPROVED

8 FESTIVAL PLAZA–43,636 SQM (OFFICE) & 4,500 SQM (RETAIL)
WALKER CORPORATION-2022+

9 42-56 FRANKLIN STREET–21,000 SQM
KYREN

10 200 NORTH TERRACE–26,000 SQM (OFFICE) & 3,000 SQM (RETAIL)
COMMERCIAL & GENERAL

DEVELOPMENT APPLICATION/MOOTED/ EARLY FEASIBILITY

11 120 FROME STREET–7,310 SQM
LEYTON–2022+

12 52-66 KING WILLIAM STREET–40,000 SQM (OFFICE) & 3,000 SQM (RETAIL)
CHARTER HALL–2023

13 185 PIRIE STREET – 6,300 SQM
PALUMBO-MOOTED

UPWARD PRESSURE ON INCENTIVES

Face rents remain steady

Adelaide's leasing market had enjoyed growth in prime face rents and a contraction in prime incentives in the 12-18 month period leading up to March 2020.

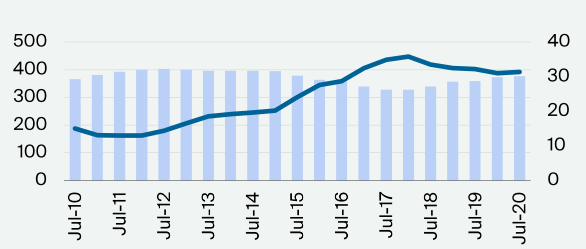
In the six months to July 2020, average prime gross face rents in Adelaide CBD increased slightly, from $540/m² to $549/m². Meanwhile, the average secondary face rental remained largely unchanged given demand has been predominantly focused on prime stock.

Moving forward, with the vacancy rate expected to rise and the leasing market tipped to remain subdued, face rental growth is likely to remain flat over the short term.

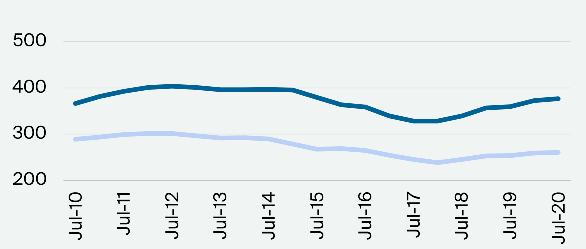
Incentives anticipated to increase

Over H1 2020, average prime and secondary incentives in Adelaide CBD have remained stable at 31.4% and 33.3% respectively.

There has not been any weight of evidence to show incentives have increased as a result of the COVID-19 pandemic. However, with leasing demand tipped to remain subdued and landlords expected to compete over limited requirements for office space, it is anticipated that incentives are likely to increase in the coming 12 months.



Source: Knight Frank Research



Source: Knight Frank Research

Recent significant tenant commitments

OCCUPIER	PROPERTY	PRECINCT	SIZE SQM	FACE RENT $/ SQM	INCENTIVE	TERM YRS	START DATE
DPTI#	73-85 Pirie Street	Core	17,500	N/A	-	10	Circa 2023
Mellor Olsson	89 Pirie Street	Core	1,572	-	-	8	-
Commonwealth Govt	80 Grenfell Street	Core	810	525g	-	10	August 2020
Finlaysons Lawyers	43 Franklin Street	Core	2,417	507g	-	10	July 2020
Victory Offices	11 Waymouth Street	Core	1,614	426n	-	10	March 2020
Aurecon	25 Grenfell Street	Core	2,500*	500g	-	10	March 2020
DVA	91 King William Street	Core	2,100*	535g	-	7	January 2020

Pre-commitment - undisclosed g Gross n Net *approximate (r) renewal

DEMAND REMAINED STRONG FOR CORE ASSETS

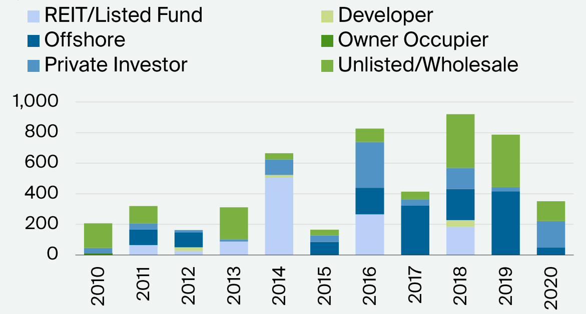
Pandemic slowed sales activity in H1 2020

Prior to COVID-19, Adelaide's office market enjoyed strong interest from a range of purchasers, particularly interstate and off-shore investors. However, sales activity has slowed down locally and nationally during the pandemic.

YTD 2020 total transactions currently stand at $351.05 million for properties above $10 million in Adelaide CBD. This figure is approximately 21% below compared to the same time last year. Despite a fall in total sale volume, pricing has been resilient and appears to be unaffected.

The outlook for the investment market remains positive, with investors continuing to seek long WALE assets with strong lease covenants. In addition, SA is seen as a safe haven for investment, reflecting the broader economic response towards the COVID-19 outbreak.

CBD Office Investment Turnover



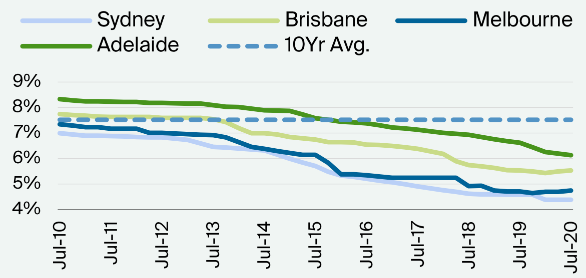
Source: Knight Frank Research

Prime yields continued to firm despite COVID-19

Despite the challenges brought by the pandemic, average yields for prime office buildings across the Adelaide CBD have continued to firm, and whilst strong demand for quality assets and the historically low cost of funds remains in force, there is not likely to be any softening bias in the short term. As at July 2020, Adelaide CBD prime yields range from 5.50% - 6.75%, while secondary yields ranged from 6.75% - 8.25%. On average, the prime yields edged in by 14 basis points, from 6.26% to 6.13% in the six months to July 2020. At the same time, the secondary yields firmed by 6 basis points, from 7.95% to 7.88%.

The value proposition and attractive yields in SA coupled with low interest rates and stamp duty abolition on commercial property continue to attract investors to South Australia. Currently, average prime yields across the eastern seaboard are generally in excess of 100-175 basis points firmer than in Adelaide.

CBD Office SA vs East Coast Yields



Source: Knight Frank Research

Recent significant sales

PROPERTY	PRICE $M	CORE MARKET YIELD %	NLA SQM	$/SQM NLA	WALE	PURCHASER	VENDOR	SALE DATE
75 Hindmarsh Square	40.50	c6.15	4,662	8,687	3.8	Harmony Property	Private Investor	Oct-20
22 King William Street	47.02	c6.93	9,604	4,896	2.7	Intergen Property Partners	Southern Cross Equity Group	Oct-20
50 Flinders Street	174.65	6.15	21,745	8,032	5.3	Nikos Property	Cbus Property	Aug-20
Realside Adelaide Portfolio#	200.00* (50% interest)	6.58-7.24	N/A	N/A	N/A	Realside Property	Australasian Property Developments	Mar-20

c Circa * 50% of $200.00 million # portfolio includes 141-149 Rundle Mall, 100 Pirie Street, 169 Pirie Street (all Adelaide) and 186 Greenhill Road, Parkside

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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