- *WA economy outperforms the rest of Australia*
- *Leasing market activity slows significantly due to the pandemic*
- *Impact seen mainly through higher incentives as face rents remain stable*

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Perth CBD Office

Market Report, October 2020

ACTIVITY SLOWS AS MARKET ADJUSTS TO THE PANDEMIC

Leasing and investment activity have largely been put on hold as the full impact of the COVID-19 pandemic begins to emerge but Perth's economic fundamentals remain relatively strong.

18.4% VACANCY

44% PRIME INCENTIVES

6.4% PRIME YIELD

"Relatively strong economic fundamentals, demand for premium office space, and limited near-term supply leave the Perth CBD well placed to withstand the pandemic downturn."

The Key Insights

The overall vacancy rose from 17.5% in January to 18.4% in July 2020 driven by an increase in vacancy the secondary segment, while the premium vacancy rate declined from 7.4% to 6.8%.

Average prime incentives have increased to 42%-47%. Face rents have remained relatively stable, while growth in effective rents has slowed significantly from the elevated levels seen in recent times.

Demand for office space has been subdued over the past six months as tenants assess space requirements. While overall net absorption fell over the period, it remained positive for the prime segment.

The pandemic has largely put investment activity on hold in 2020 to date, following the strong levels of liquidity seen in the second half of 2019.

Average prime yields have declined by 12.5 basis points over the past six months to 6.40%, while secondary yields have widened marginally to 7.42%

City CBD Office Market Indicators — July 2020

GRADE	TOTAL STOCK SQM	VACANCY RATE %	NET ABSORPTION SQM	NET ADDITIONS SQM	AVERAGE NET FACE RENT $/SQM	AVERAGE INCENTIVE %	EFFECTIVE RENTAL GROWTH % YOY	AVERAGE CORE MARKET YIELD %*
Prime	1,045,584	12.2	2,810	0	620	42-47	5.6	6.25-6.55
Secondary	756,295	26.9	-14,917	4,674	394	50-55	-1.4	7.20–7.65
Total	**1,801,879**	**18.4**	**-12,107**	**26,043**				

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

WA ECONOMY OUTPERFORMS

Western Australia fairs relatively well amid large hit to the economy from the pandemic

The relatively strong performance of the Western Australian economy has been partly driven by stronger household consumption reflecting the more rapid easing of restrictions in the state. Retail sales rose by 17.9% over the year to August, significantly outpacing the 7.1% growth rate for Australia.

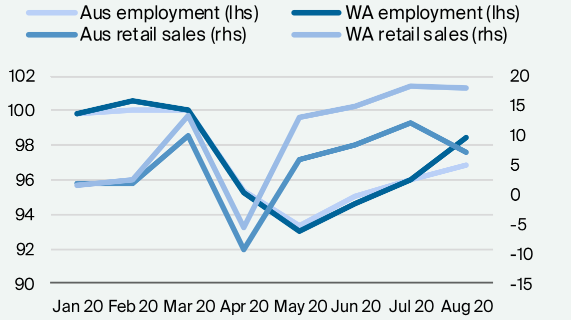
The mining sector has also been a relative bright spot for the economy, with an increase in mining investment in the June quarter partly offsetting weakness in private sector investment more broadly. Strong demand for iron ore from China has driven exports higher. Australia's exports of metal ores (most of which is iron ore) rose by 14% in rolling annual terms over the year to July, while exports to China rose by 7% over the same period. This reflects both higher export volumes and a 36% increase in iron ore prices over the year to September to US$123.50 a tonne.

The outperformance of the state's economy is driving a stronger rebound in the labour market. Employment increased by around 32,200 in Western Australia in August, accounting for 29% of the national increase, far outpacing the state's 10% share of the population. Employment growth in the state has largely recovered to be just 1.6% below pre-pandemic levels, compared to -3.2% for Australia overall.

Western Australia is set to continue to perform relatively strongly. Oxford Economics forecasts that GSP will grow by 1% in 2020, compared to a 4.3% contraction in GDP for Australia. Growth in the state is expected to pick up to 2.7% in 2021, 0.7 percentage points higher than the 2% growth rate predicted for Australia.

Employment and retail sales

Index, March 2020 = 100 (lhs), per cent change y/y (rhs)



Source: Knight Frank Research, Macrobond

Leasing activity slows as prospective deals placed on hold, although prime absorption still positive

Leasing activity in the Perth CBD market slowed significantly in the first half of the year due to the pandemic, as prospective deals were placed on hold while tenants review their requirements for office space. Total net absorption fell by 12,107sqm over the six months to July, with a 2,810sqm increase in net absorption in the prime segment (concentrated in premium grade stock), more than offset by a 14,917sqm decline in net absorption in secondary market (primarily B grade).

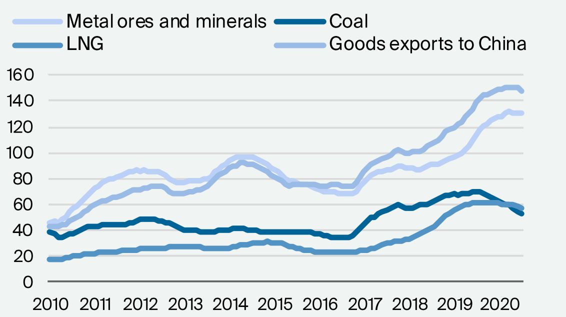
Chevron vacated 13,360sqm of project space at 905 Hay Street (Dynon's Plaza) following the conclusion of a 10-year lease, which partly drove the overall result, as did St George offering 3,000sqm of sub-lease space to the market.

Employment growth in the Perth CBD is expected to be relatively strong compared to most other major markets reflecting the better economic fundamentals for the state. The Perth office market has also been less impacted by the pandemic, with social distancing restrictions being eased more rapidly, allowing many businesses to return to the office relatively quickly.

Notwithstanding these positives, demand for office space is likely remain subdued in the near-term. In particular, the significant decline in oil prices due to lower global demand since the onset of the pandemic has led some mining and energy companies to significantly reduce estimates of capital expenditure in the near term, which could have potential flow on effects to engineering-related office employment in the Perth CBD.

Resource exports and goods exports to China

12 month rolling sum, $ billion



Source: Knight Frank Research, Macrobond

LIMITED SUPPLY PIPELINE REDUCES DOWNSIDE

Increase in vacancy concentrated in the secondary market, while premium vacancy continues to fall

The Perth CBD vacancy rate increased from 17.5% in January to 18.4% in July 2020, driven primarily by a 2.9 percentage point increase in B grade stock to 28.7%, mostly reflecting several buildings previously withdrawn for refurbishment being made available for lease. By contrast, the premium vacancy rate fell to 6.8% in July, down from 7.4% in January, while the A grade vacancy rate remained unchanged at 15.8%. The overall prime vacancy rate fell from 12.5% to 12.2%, while vacancy in the secondary market rose from 24.5% to 26.9%.

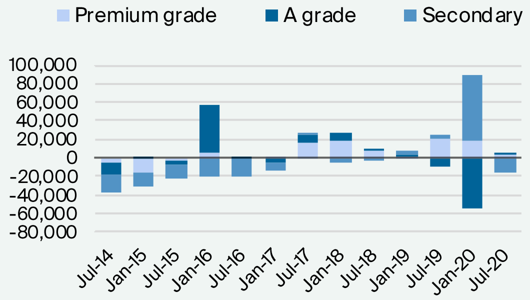
Sublease vacancy declined in the Perth CBD over the six months to July, the only capital market to record a fall. However, sub-lease space will likely rise in the near future as the full impact of pandemic emerges.

Vacancy likely to rise modestly but increase will be contained by limited new supply

The combination of subdued net absorption and limited supply will likely see the vacancy rate rise to around 20% by mid-2021. A pick up in office demand as employment growth strengthens is likely to drive a gradual but steady decline in the vacancy rate from there.

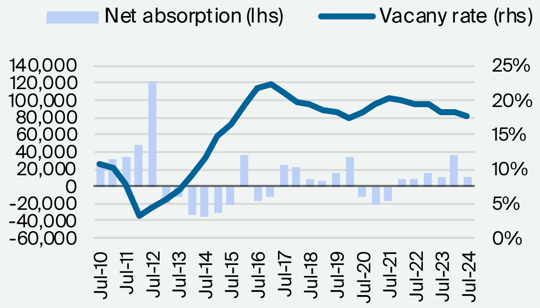
There are no major office developments coming online in the next 18 months. Beyond that, the Capital Square Tower 2 building is expected to deliver 25,200sqm of office space in 2022, while the Chevron headquarters (52,875sqm of office space) is due to be completed in 2023. Chevron is understood to have pre-committed around 41,000sqm of this space.

Net absorption
By grade, sqm



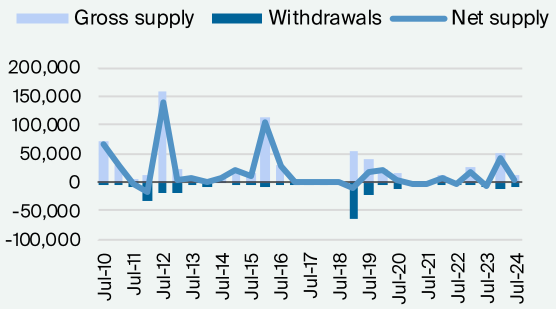
Source: Knight Frank Research, PCA

Net absorption and vacancy rate
Sqm (lhs), per cent (rhs)



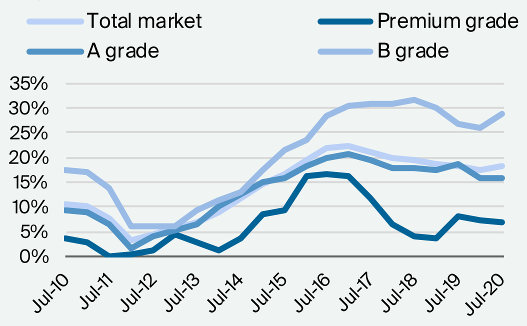
Source: Knight Frank Research, PCA

Supply and withdrawals
Sqm



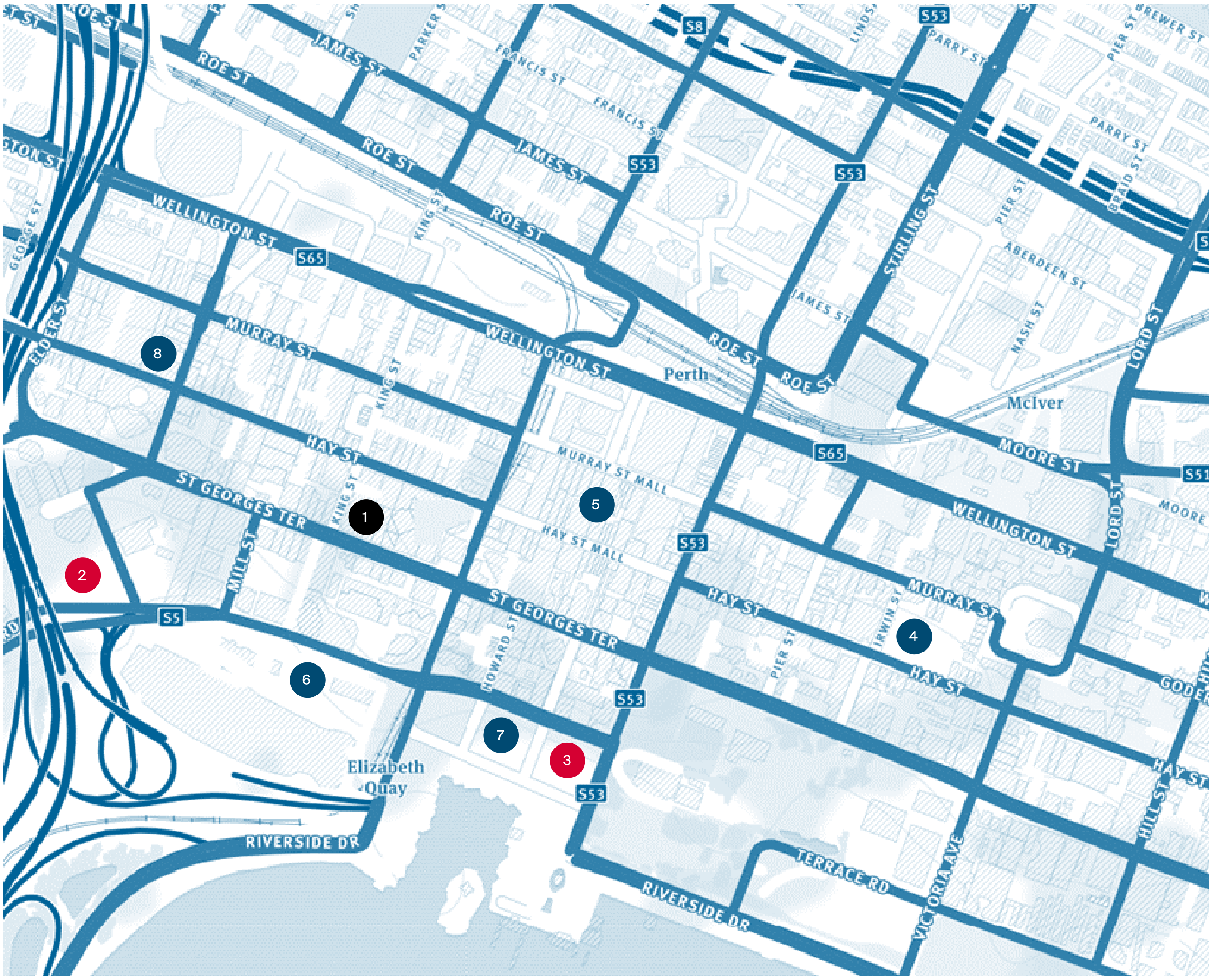
Source: Knight Frank Research, PCA

Vacancy rate
By grade, per cent



Source: Knight Frank Research, PCA

MAJOR OFFICE SUPPLY



MAJOR REFURBISHMENTS

1 168-170 ST GEORGE'S TERRACE – 12,500 SQM
DRADGIN PTY LTD. H2 2021

UNDER CONSTRUCTION/ MAJOR PRE-COMMITMENT

2 98 MOUNTS BAY ROAD – 25,200 SQM
AAIG MALAYSIA. H2 2022

3 LOTS 7 &8 ELIZABETH QUAY – 52,875 SQM [CHEVRON]
BROOKFIELD – 77% COMMITTED. H2 2023

DEVELOPMENT APPROVED

4 480 HAY STREET – 34,000 SQM
FES MINISTERIAL BODY. DATE TBC

5 674-692 HAY STREET MALL – 20,000 SQM
DEXUS. DATE TBC

6 21 MOUNTS BAY ROAD – 20,000 SQM
BROOKFIELD. DATE TBC

7 LOTS 5 & 6 ELIZABETH QUAY – 15,000 SQM TO 35,000 SQM
BROOKFIELD. DATE TBC

8 950 HAY STREET– 10,000 SQM
OAKESFIELD PTY LTD. DATE TBC

PANDEMIC HITS EFFECTIVE RENTAL GROWTH

Initial impact of the pandemic primarily seen through higher incentives

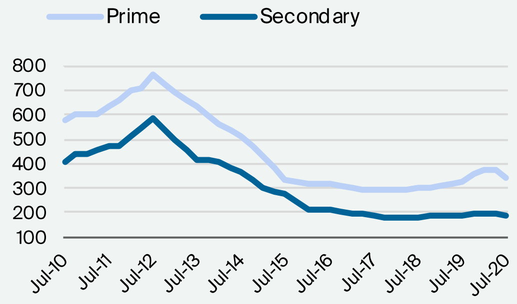
Rental growth has been adversely affected by the pandemic, with the adjustment seen mostly through higher incentives and falling effective rents. Average prime incentives rose by five percentage points in the three months to July to 44.2%, and are four percentage points higher than in January. Incentives currently range from around 42% to 47%. The increase in incentives has driven an 8.2% fall in prime net effective rents over the three months to July to $346/sqm. Effective rents are 6.8% below January levels. Over the year, effective rental growth slowed to 5.6%, down from a peak of 20.8% in January.

Prime net face rents have remained stable at $620/sqm over the past six months reflecting the limited activity in the leasing market. Over the year to July, face rents grew by 4.4%, slowing marginally from the 4.7% growth rate recorded in January.

In the secondary market, net effective rents fell by 3.6% over the three months to July, to be 1.4% lower over the year. Average incentives rose marginally to 52.3% and range from around 50% to 55%. Net face rents declined by 3.2% over the three months to July and are 0.8% lower over the year.

The average rental discount between the prime and secondary market is 36% in face terms and 46% in effective terms, above the historical averages of 30% and 31% respectively.

Net effective rent
By grade, $/sqm



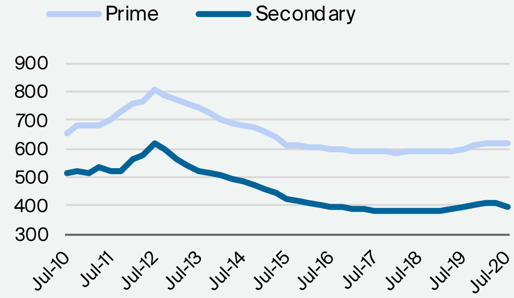
Source: Knight Frank Research

Incentives set to rise further as the office market adjusts to the new dynamic

While face rents are expected to remain fairly steady over the next 12 to 18 months, effective rents will likely decline materially as incentives increase further. Average prime incentives are expected to increase to around 50% by mid next year.

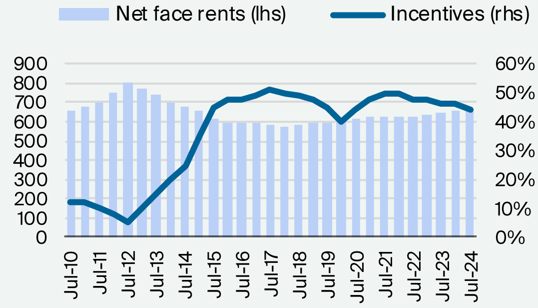
Incentives are then expected to begin to decline steadily from 2022, as momentum in the leasing market strengthens, leading to relatively rapid growth in effective rents compared to other capital city markets on average over the next five years, in part reflecting the relatively bright economic outlook for Perth.

Net face rent
By grade, $/sqm



Source: Knight Frank Research

Prime rents and incentives
Net, $/sqm (lhs), per cent (rhs)



Source: Knight Frank Research

INVESTMENT DOWN BUT PERTH RETAINS APPEAL

Pandemic puts investment on hold following strong activity in 2019

Like many markets in Australia and globally, the pandemic induced downturn has seen activity in capital markets largely pause. Uncertainty about the implications for occupancy levels, rental income growth, and capital value growth has led to investors sitting on the sidelines notwithstanding Perth's and Western Australia's relatively strong economic performance.

Investment volume has totalled $57.4 million in 2020 to date, reflecting a couple of transactions in the first quarter of the year, prior to the onset of the pandemic. Over the 2019-2020 financial year, transaction volume totalled $484.5 million, reflecting the strong level of activity in the second half of 2019, with notable acquisitions by Centuria, Charter Hall, and Redhill Partners. This compares with a 10-year average on a financial year basis of a little over $380 million.

Investment activity is showing signs of picking up, with two pending off-market sales at Kings Square in Fremantle and 190 St Georges Terrace in the Perth CBD, which have attracted strong interest from both east and west coast based investors, close to being contracted.

Despite the headwinds from the pandemic for capital markets, yields on prime office assets have continued to tighten. Prime yields declined by 12.5 basis points over the six months to July to 6.40%. Secondary yields widened marginally to 7.42% over the same period, leaving the spread to the prime yield 15.6 basis points higher to 102 basis points, compared with a 10-year average of 88.5 basis points.

Perth CBD office investment volume

$ million, transactions greater than $10 million

Source: Knight Frank Research

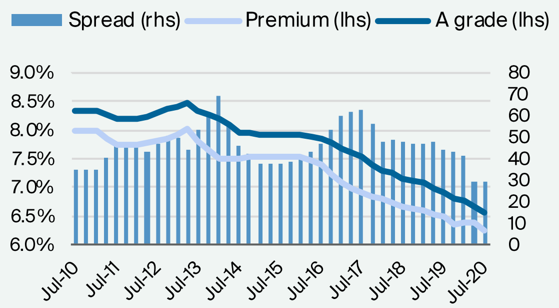
Pricing holds up reflecting long-term confidence in Perth

Within the prime segment, yields on A grade assets tightened more than premium yields, with A grade yields falling by 24 basis points over the six months to July to 6.54%, compared with an 11 basis point decline for premium yields to 6.25%. The A grade spread to the premium yield fell by 12.6 basis points to 29 basis points, well below the 10-year average of 46.7 basis points.

Perth remains an attractive market for long-term investment with relatively strong economic fundamentals and low interest rates likely to spur a revival in investment activity as the outlook for the leasing market becomes clearer. The significant decline in interest rates since 2019 has seen the spread to 10-year government bonds rise to 552.6 basis points in July, up from 446 basis points in January 2019, and a 10-year average of 440 basis points, despite the steady tightening in prime yields over the same period.

Yields

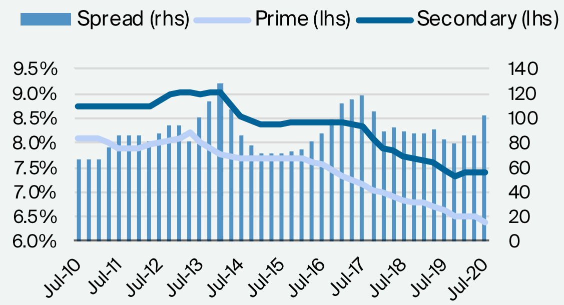
Per cent (lhs), basis points (rhs)



Source: Knight Frank Research

Yields

Per cent (lhs), basis points (rhs)



Source: Knight Frank Research

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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