RESEARCH


# PERTH CBD

## OFFICE MARKET OVERVIEW **SEPTEMBER 2019**

## RECOVERY BUILDS FURTHER MOMENTUM

## HIGHLIGHTS

The Perth CBD office leasing market has rebounded solidly, with prime effective rents growing 9.5% YoY on tight availability, and net absorption beginning to shift towards secondary buildings.

With leasing activity focused on the subprime market, larger top-tier occupiers are exploring pre-commitment opportunities which may add to the currently limited new supply horizon.

Buildings marketed throughout 2019 (to date) have offered a wide range of investment fundamentals, and the anticipated transactional volume in excess of $1 billion will highlight further yield compression.

# KEY FINDINGS

Refurbished floors returned to the market for lease and delayed commencements for incoming tenants meant the Perth CBD office **vacancy rate only reduced 10 bps to 18.4%** in the 6 months to July 2019.

However **6 months net absorption of 15,923 square metres** indicates demand for space is continuing.

High quality Premium and upper A-grade space has attracted most of this demand, allowing **prime effective rents to grow 9.5%** over the past 12 months.

**No new supply** is confirmed until 2023 when Chevron will occupy a new 30 storey tower at Elizabeth Quay to be constructed by Brookfield. Other mooted proposals will likely have a similar horizon should they secure pre-commitment.

**Yields have firmed 19 bps YoY**, and the calendar year could record the highest transaction volume since 2013.

NICHOLAS LOCKE
**Senior Analyst — Research WA**

# ECONOMIC OVERVIEW

Improvement in the Perth CBD office market continues to gain traction with genuine inroads being made on vacancy and incentives, and yields tightening further.

## Commodity price growth moderating, but still sitting at healthy levels

The sustained run of steep price improvement in WA's major commodities appears to be slowing, with short-term iron ore supply shortages in Brazil resolving quicker than first expected, and the collapse in LNG spot prices putting pressure on export contracts in place (where prices are typically determined based on the price of oil.)

Prices falling back to more sustainable levels are unlikely to be the catalyst for any economic or property market regression, as the more recent rapid increases were viewed as temporary, and not the sole basis behind the expanding pipeline of major projects.

The short-term boost is still providing welcome benefits, with above-forecast royalty revenue being a major contributor to the State budget returning to fiscal surplus in 2018-2019 for the first time in 5 years and improving the State's credit rating.

Increased revenue is also allowing the Government to begin chipping away at approximately $36 billion of net debt, and fund the first round of investment into major new metropolitan rail projects.

This relationship between commodity prices and private and public sector investment drives employment in professional services, and is the rationale behind office occupancy levels having historically moved in step with commodity prices (see Figure 1). The main misalignment occurred due to periods of <1% vacancy and the inability to bring supply to the market in time.

A further indicator to future economic prospects is the continued growth in mineral exploration dollars spent.

The June 2019 quarterly recording of $413.1 million reflects the highest level value since March 2013, continuing unabated growth since the trough of March 2015 ($183.2 million, +125%) and highlighting confidence within the sector.

FIGURE 1
**Commodity Prices & Occupied Space**
**LHS: Indexed to Jul-99, RHS: '0,000sqm**


Source: RBA, PCA, Knight Frank Research

TABLE 1
**Perth CBD Office Market Indicators as at July 2019**

| Grade | Total Stock (m²) | Vacancy Rate (%) | Annual Net Absorption (m²) | Average Net Face Rent ($/m²) | Average Incentive (%) | Average Core Market Yield (%) |
|---|---|---|---|---|---|---|
| Prime | 1,118,177 | 14.8 | 14,279 | 550—650 | 40—45 | 6.25—7.00 |
| Secondary | 657,658 | 24.4 | 8,396 | 370—450 | 45—55 | 7.00—7.75 |
| **Total** | **1,775,836** | **18.4** | **22,675** | | | |

Source: Knight Frank Research/PCA

# TENANT DEMAND & ABSORPTION

**Net Absorption & Outlook**

| | |
|---|---|
| Prime | 14,279 sqm YoY<br>10,484 sqm 6 mo |
| Secondary | 8,396 sqm YoY<br>5,439 sqm 6 mo |

Source: Knight Frank Research/PCA

## The 'flight-to-quality' is complete, and shaping the market as a result

Movement of tenants into prime space from secondary buildings and non-CBD locations has slowed as the range of available options diminish, and those able to capitalise on softer market conditions have locked in long terms.

This has had a two-fold impact on tenant demand:

- larger top tier occupiers in the market are forced to explore the possibility of pre-committing to a new building; and
- leasing activity has shifted towards smaller tenants, to the benefit of well -located and refurbished secondary buildings.

This trend is represented in Figure 4, where the contribution of sub-1,500 sqm enquiries has been trending upwards on a quarterly basis.

## CBD occupancy creeping closer to peak levels

The latest PCA recording marks 2½ years of positive absorption into the Perth CBD office market (see Figure 2), and 84,766 square metres more occupied NLA compared with the trough of July 2015.

Today's 1,450,000 sqm of occupied space sits higher than January 2012, but lower than July 2012 when approximately 157,000 sqm of mostly pre-committed stock was added to the market, instigating the beginning of negative absorption as occupiers consolidated accommodation and requirements lessened.

The significance of approaching this milestone is that the positive net absorption has occurred without the same volume of project-specific office space (essentially short-term demand).

## An element of uncertainty still remains

Whilst the economy appears to have turned the corner and commodity prices are contributing to resource-sector led demand, the primary reason for net absorption over the past two years has been tenants returning to the city that were previously priced out during the peak of the boom.

"Larger top tier occupiers in the market are forced to explore the possibility of pre-committing to a new building, and leasing activity for smaller tenants has moved subprime, to the benefit of well-located and refurbished secondary buildings."

This demand—thus far to the detriment of suburban and fringe markets—will lose momentum as higher quality CBD offerings push back on asking rents and incentives, and remaining price-competitive offerings present as less compelling reasons to relocate.

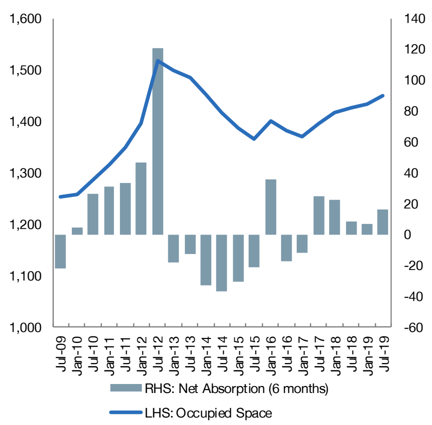
Increased white collar employment will be required in order to sustain positive net absorption, and this will only occur with improvements to the broader economy.

As always, the most likely driver to economic improvement? Resource sector-led private investment.

FIGURE 2

**Perth CBD Occupied Floorspace**

'0,000 sqm

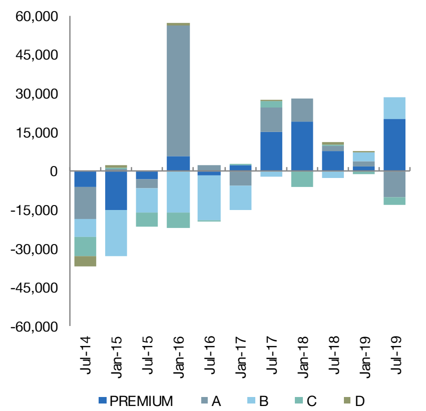



Source: Knight Frank Research/PCA

FIGURE 3

**Perth CBD Net Absorption**

sqm net absorption per 6 month period by grade

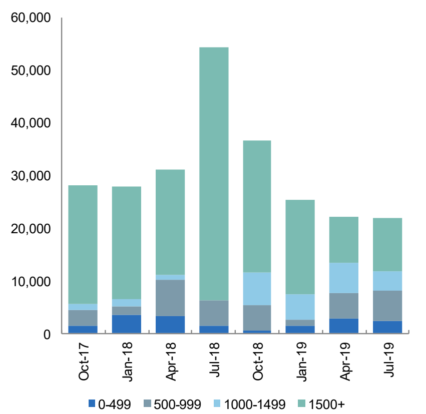



Source: Knight Frank Research/PCA

FIGURE 4

**Perth CBD Tenant Rep Enquiry**

sqm, sum of requests per quarter, CBD only




Source: Knight Frank Research

# SUPPLY & DEVELOPMENT

**Vacancy Rate & Outlook**

| | | |
|---|---|---|
| **Prime** | 14.8% +160bps YoY | |
| **Secondary** | 24.4% -450bps YoY | |

Source: Knight Frank Research/PCA

## Today's vacancy rates don't paint the full picture

A divergence between space currently deemed vacant (unoccupied) by the Property Council versus space actually available for lease (advertised today) has widened over the past 18 months, and in particular the past 6 months.

Strong letting up activity has occurred across numerous buildings that is *still* yet to be incorporated within Property Council figures, providing a distorted view of the market at the present time.

Knight Frank's analysis of the market has found that 15.4% of the core CBD (as far east as Victoria Avenue) is currently advertised for lease (see Figure 5, and refer to the rear page of this report).

Comparatively, fringe areas are struggling, with advertised vacancy in the 'East End' (Victoria Avenue to Hill Street) elevated at 31%, and Northbridge & Stirling Precincts at 17%.

## A-grade expiries will test the depth of the market

GDI Property Group's announcement of having re-secured WA Police at Westralia Square for an additional 5 year term has removed a major source of uncertainty in the market, with several other known suitors in the market now set to formally commence leasing campaigns.

The varied agreements with the State Government to retain the Police, secure the Department of Births, Deaths, and Marriages, and lose the Department of Justice results in a net reduction in leased space of 11,142 square metres (in addition to other lease expiries). With little like-for-like 'upper' A-grade accommodation available by way of competition, the building appears strongly positioned to attract tenants.

Other buildings vying for the WA Police are thought to have included 905 Hay Street (leased to Chevron until April 2020), and 168-170 St Georges Terrace (leased to the State Government until early-mid 2020).

The former provides modern accommodation at the west end of the CBD, whilst the latter will likely require larger scale refurbishment, but provides functional large floorplates in a central CBD position.

The three buildings anticipated to be available will provide large tranches of space to the market following a period whereby contiguous areas have been letting up well (Figure 6).

Each building also provides a slightly different style of accommodation that will be demarcated by asking rents.

## New development proposals fighting for the same tenants

The battle for pre-commitments has intensified, with a major tenant that could underpin the development of a new tower currently considering proposals, in addition to the outstanding decision from WA Police to consolidate sections of their workforce into a new building.

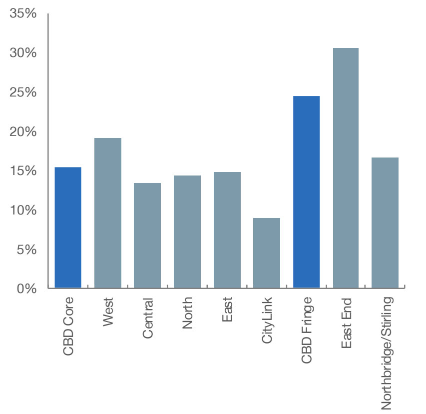
According to the AFR, ConocoPhillips have reportedly committed to a new A-grade building to be constructed at Capital Square, however confirmation may hinge on a potential sale of its north-west gas interests.

Development proposals prepared for both of the above, FMG (delayed—no decision made), ABN Group (committed to the suburbs), and other confidential requirements have flushed out a range of development sites, indicating where the CBD's future supply is likely to come from.

FIGURE 5

**Perth CBD Vacancy By Precinct**

% of market advertised

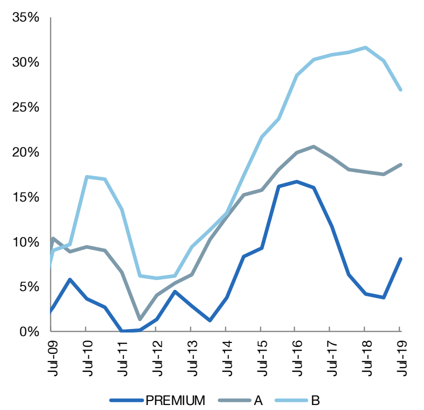



Source: Knight Frank Research

FIGURE 6

**Perth CBD Vacancy By Grade (PCA)**

% by grade

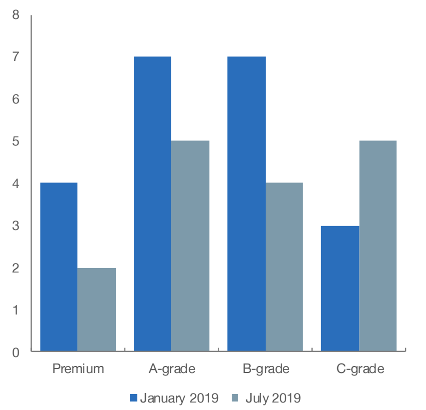



Source: Knight Frank Research/PCA

FIGURE 7

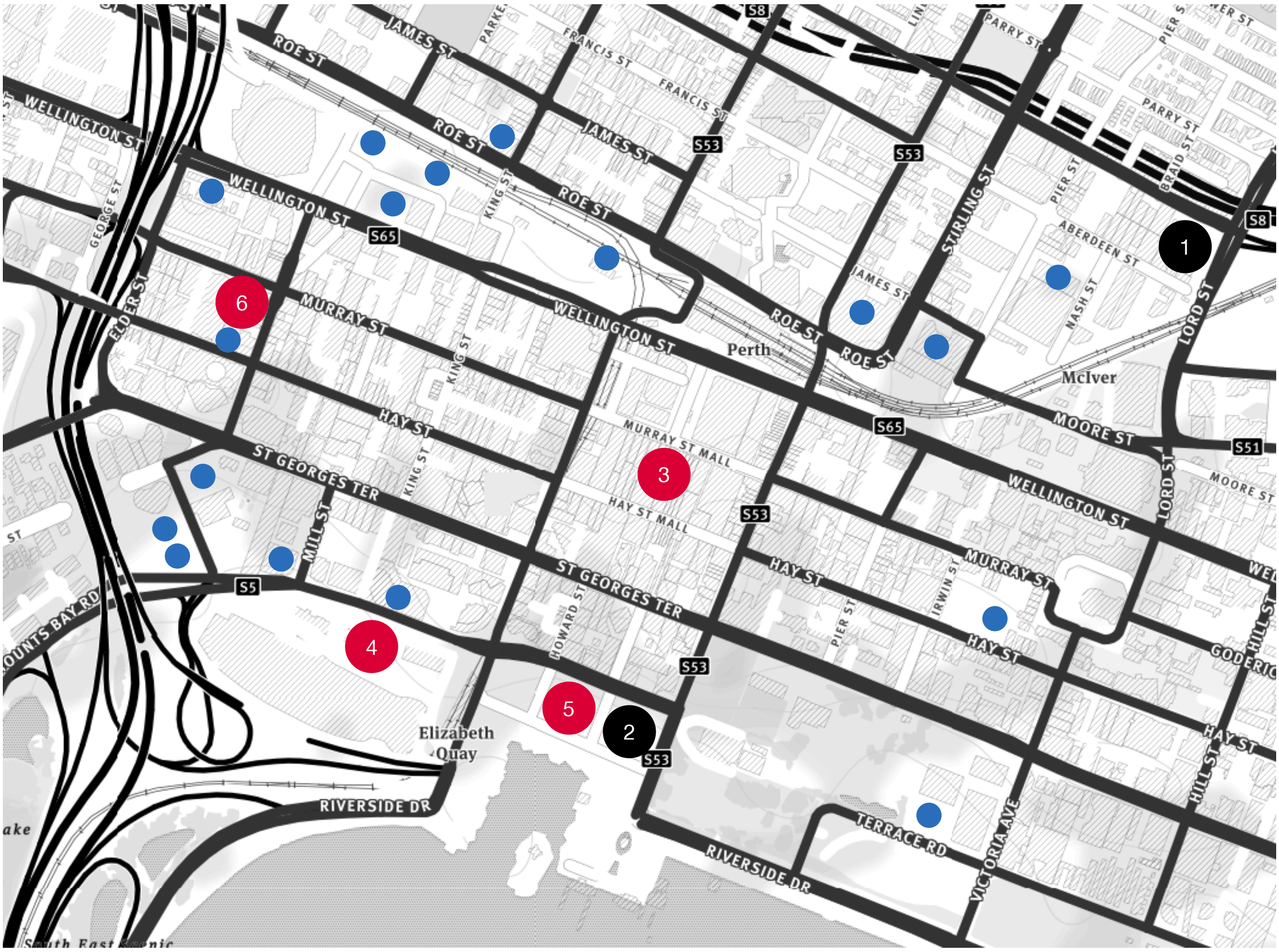
**Contiguous Spaces Advertised**

# by PCA grade over 3,000 sqm (inc sublease)




Source: Knight Frank Research

# MAJOR OFFICE SUPPLY




1 — 105 Lord Street— 6,930m²
NextDC
Under Construction
Completion H1 2020

2 — Lot 7 & 8 EQ—52,785m² [Chevron]
Chevron/Brookfield
DA Approved#
Completion 2023

3 — 674-692 Hay Street Mall— 20,000m²
Dexus
DA Approved
Seeking pre-commitment (office/education)

4 — 1 & 21 Mounts Bay Road—18,197m²
Brookfield
DA Approved
Seeking pre-commitment

5 — Lots 5 & 6 EQ—15,000 & 35,000m²
Brookfield
In-principle planning approval#
Seeking pre-commitment

6 — Cnr Milligan St & Murray St—10,000m²
Fragrance Group
DA Approved
Seeking pre-commitment

- Black: Confirmed / Under construction / Site works
- Red: DA submitted / DA approved (past 24 months)
- Blue: Development sites (Mooted / Known to be actively seeking pre-commitment / Expired DA)

Office NLA component quoted (approx.)

Major Pre-commit in [brackets] next to the NLA

# denotes planning under the auspices of the Metropolitan Redevelopment Authority

# RENTS & RECENT TRANSACTIONS

**Rents, Incentives & Outlook**

| | | |
|---|---|---|
| **Prime Rents (n)** | $596/sqm face +1.0% YoY $328/sqm eff +9.5% YoY | |
| **Secondary Rents (n)** | $388/sqm face +1.0% YoY $187/sqm eff +2.7% YoY | |
| **Incentives** | P: 45.0% S: 51.8% | |

## Effective rents climbing as incentives drop

Deal evidence observed during late 2018 / early 2019 indicated incremental improvements to incentives were taking place, generally in line with the fairly modest declines to overall vacancy.

The improvements have continued —and escalated—to the extent that A-grade buildings previously offering generous deals at well over 50% are now securing tenants at levels closer to 40%.

The principle reason for the more sudden decline can be attributed to particularly aggressive landlords having mostly leased their buildings, removing a key element of competitive tension which has arguably kept incentives significantly elevated for longer than necessary.

## Face rental growth on the horizon for prime buildings

Prime net face rents remain generally static at an average of $596/sqm; a level that has increased slightly (+1% YoY), but only for buildings reduced to nominal vacancy.

Effective rental growth transitioning into face growth will likely occur as incentives decline to a level in line with the cost of a fit-out; typically around 30-35% (net) depending on the level of specification and the length of lease term. At this stage—with no residual incentive to claim as abatement—we speculate upwards pressure on face rents will increase.

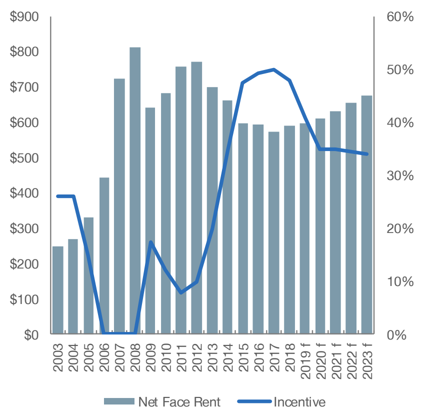
Six months ago, the prospect of incentives declining to these levels (30-35%) within the short term appeared distant, however should recent momentum be maintained, we anticipate these levels will be reached in 2020.

Knight Frank's forecasting model projects prime net effective rental growth of 36% to the end of 2023 on top of the 9.5% growth achieved over the past 12 months.

Of note, these projections are based on economic forecasts that will change rapidly should major resource-sector projects receive final confirmation.

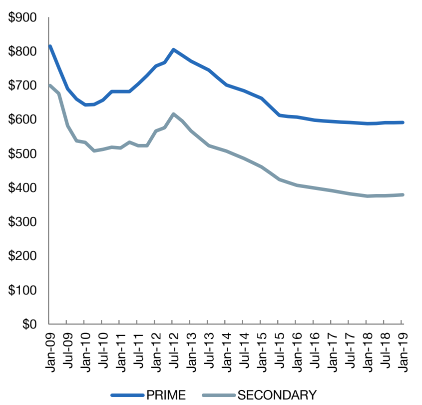
"Aggressive landlords having mostly leased their buildings has removed a key element of competitive tension which has arguably kept incentives significantly elevated for longer than necessary."

FIGURE 9
**Prime Face Rent & Incentive**
**LHS: $/m² p.a average face net**
**RHS: % incentive**




Source: Knight Frank Research

FIGURE 8
**Perth CBD Face Rents**
**$/sqm p.a average prime v secondary**




Source: Knight Frank Research

TABLE 3
**Recent Leasing Activity Perth CBD**

| Address | NLA m² | Term yrs | Tenant | New / Renewal |
|---|---|---|---|---|
| 256 St Georges Terrace | 14,699 | Various | Chevron | R* |
| 240 St Georges Terrace | 10,706 | 10 | Worley | N |
| 95 William Street | 6,784 | 7 | Rio Tinto | R* |
| 556 Wellington Street | 5,232 | 10 | St John of God | N |
| 45 Francis Street | 3,414 | 15 | WeWork | N |
| 55 St Georges Terrace | 3,222 | 10 | Minister for Works | N |
| 32 St Georges Terrace | 3,077 | 10 | Minister for Works | N |
| 15-17 William Street | 1,867 | ND | McDermott International | N |

Source: Knight Frank Research * varied

# INVESTMENT ACTIVITY & YIELDS

## Varying investment traits will provide a strong snapshot of the market

Based on confirmed transactions, properties understood to be under contract, and those currently marketed, Knight Frank anticipates approximately $1.15 billion of CBD office sales could occur during 2019; a figure that would be the strongest annual result since 2013.

Whilst this outcome is underpinned by a 50% stake in the new Chevron building to be constructed at Elizabeth Quay (thought to be under contract to Invesco for approximately $400 million), another three $100+ million buildings are understood to be under contract, including the recently announced sale of William Square to Centuria for $189.5 million.

The Chevron building, William Square and HBF House (developed within the Kings Square precinct between the CBD & Northbridge) have each been marketed based on their modern accommodation, strong tenant covenants, and long WALE, and will each command tight yields.

66 St Georges Terrace (confirmed transaction), 28 The Esplanade, 2 Mill Street, and 263 Adelaide Terrace (including 2 Victoria Avenue) are all considered core plus / value add propositions sitting within the secondary leasing market, however their letting up prospects are amongst the brightest within the category that are poised to benefit as the prime end of the market continues to fill up.

**Current Yields & Outlook**

| | | |
|---|---|---|
| **Prime** | 6.43% - 6.88%<br>-19bps YoY | |
| **Secondary** | 7.39% - 7.77%<br>-15bps YoY | |

## Prime yields sharpening with rental growth prospects

Perth's elevated prime yield spread to Sydney has seen some narrowing over the past 6 months (Figure 11), coinciding with a reduction in Perth's face/effective rent dichotomy.

As incentives erode further, returns will improve, and eventual face rental growth will drive capital appreciation.

These improving growth prospects—along with cheaper borrowing costs—should ensure that the tightening has not finished, or at very least will prevent a softening in comparison to other late-cycle domestic markets.

## Value-add purchases looking strong in hindsight

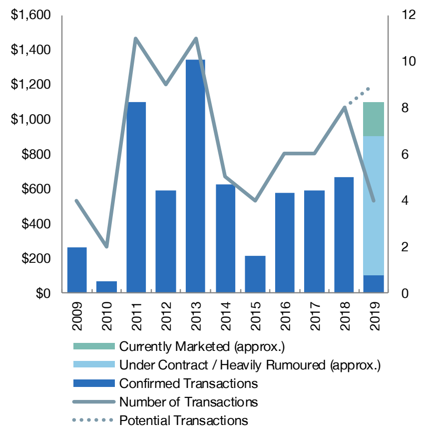
For sales transactions greater than $10 million to have occurred across 2017 and 2018, buildings were on average 32% vacant as at the date of transaction.

As at 1 September, the same group are 16% vacant, with further areas understood to be at heads of agreement. With greater occupancy and yields tightening further, the value of counter-cyclical investing is already evident.

FIGURE 10

**Perth CBD Office Transaction Volume**

$ millions, transactions $10 million+
Perth (inc. Stirling Prec.), East Perth, Northbridge

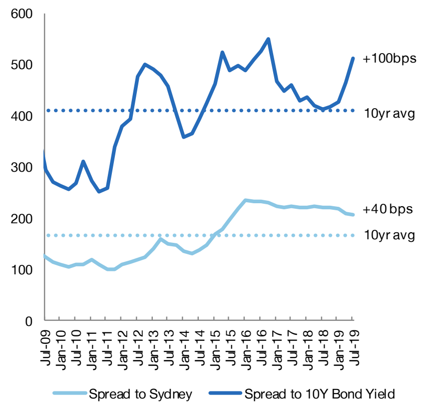



Source: Knight Frank Research

FIGURE 11

**Prime Office Yield Spreads**

bps




Source: Knight Frank Research

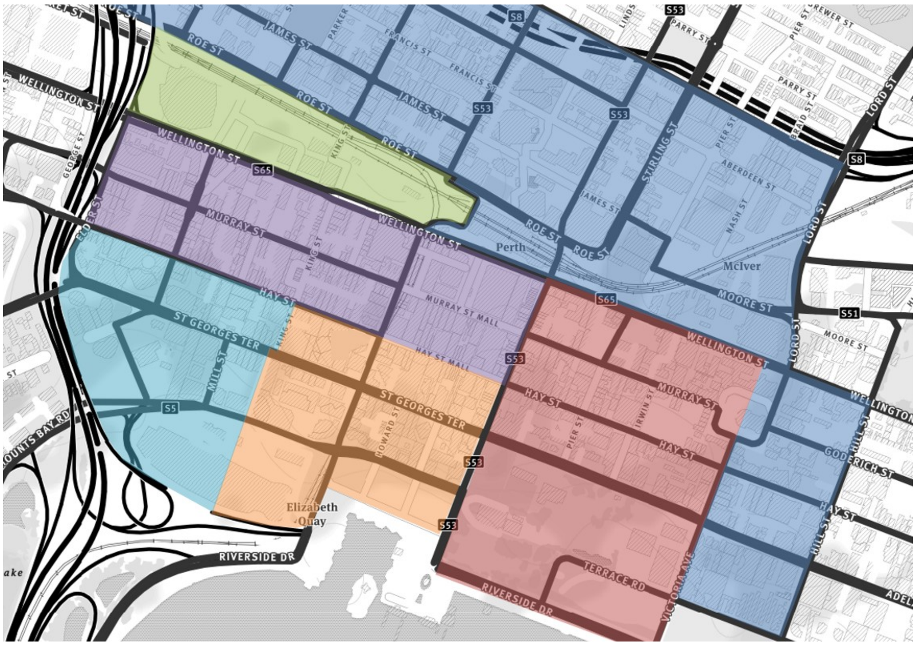
TABLE 4

**Recent Sales Activity Perth CBD**

| Address | Grade | Price $ mil | Core Mkt Yield % | NLA m² | $/m² NLA | WALE yrs | Vendor | Purchaser | Sale Date |
|---|---|---|---|---|---|---|---|---|---|
| 45 Francis Street# | - | 189.5 | 6.4 | 21,765 | 8,706 | 7.7 | Warrington/Goldman | Centuria | Sep 19 |
| 180 Hay Street# | A | 12.6 | - | 4,925 | 2,558 | VP | Owner Occupier | GDI | Jul-19 |
| 179 St Georges Terrace | C | 18.3 | - | 4,164 | 4,383 | - | Private Syndicate | Warrington C.P. | Feb 19 |
| 66 St Georges Terrace | B | 72.0 | 7.1 | 11,407 | 6,312 | 1.9 | Oxford | CorVal | Feb 19 |
| 34-50 Stirling Street | - | 24.0 | 7.3 | 6,447 | 3,723 | 2.2^ | Owner Occupier | Elanor Investors | Dec 18 |
| 226 Adelaide Terrace | A | 86.0^ | 7.0 | 14,391 | 5,976 | 2.4 | Blackstone | Primewest | Dec 18 |

Source: Knight Frank Research ^ partial rental guarantee # under contract

**Advertised Vacancy Areas Covered:**




| | |
|---|---|
| CBD Core—Central | CBD Fringe—East End, Stirling, Northbridge |
| CBD Core—West | |
| CBD Core—North | |
| CBD Core—CityLink | |
| CBD Core—East | |

**Method:** Advertised vacancy analysis summarised herein is produced on the basis of online listings being up to date as at the time of collection. Best endeavours are made to verify the accuracy of this information, however any findings presented within this report should be treated as a guide only. We do not attempt to forecast impending vacancy prior to the space being advertised for lease.

July 2019 analysis incorporates 1,623 floors across 128 buildings greater than 2,500 square metres.

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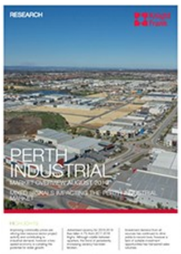


Perth Industrial Overview August 2019


Melbourne CBD Office Market Overview September 2019


Australian Capital View Outlook 2019


The Wealth Report 2019

Knight Frank Research Reports are available at KnightFrank.com.au/Research






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