- *WA economy continues to outperform*
- *Premium market vacancy declines as demand strengthens*
- *Rental growth gains momentum*

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Perth CBD Office

Market Report, September 2022

FLIGHT TO QUALITY AS DEMAND FOR PREMIUM SPACE STRENGTHENS

The Perth CBD continues to see above-average demand for office space, particularly in the premium segment, reflecting the ongoing strong performance of Perth's economy and labour market.

15.8% VACANCY

4.8% PREMIUM VACANCY

6.55% PRIME YIELD

"The Perth office market is seeing a flight to quality with the premium vacancy rate declining to a low 4.8%."

The Key Insights

The overall CBD vacancy rate rose in H1 2022, increasing from 15.0% to 15.8% reflecting a 32,533 sqm increase in net supply. By contrast, the premium vacancy rate fell to 4.8%.

Net absorption rose by 13,302 sqm in H1 2022, boosted by an increase in net absorption in the premium segment to a well above-average 6,150 sqm.

Reflecting the ongoing momentum in the leasing market, rental growth is picking up. Prime net face rents rose by 2.3% over the year to July. Average prime incentives remained unchanged at 49.6%.

Higher interest rates have begun to feed through into a widening in prime office property yields. Average prime office yields in the Perth CBD widened by 25 basis points in the three months to July.

The outlook for the Perth market remains positive. We expect above average net absorption to drive vacancy lower over the next few years. Face rental growth is expected to remain strong over the next five years, increasing by over 4% per annum.

City CBD Office Market Indicators — July 2022

GRADE	TOTAL STOCK SQM	VACANCY RATE %	NET ABSORPTION SQM	NET ADDITIONS SQM	AVERAGE NET FACE RENT $/SQM	INCENTIVE %	EFFECTIVE RENTAL GROWTH % YoY (NET)	CORE MARKET YIELD %*
Prime	1,052,583	12.0	11,814	19,068	637	47-52	2.3	6.40-6.70
Secondary	750,746	21.2	1,488	13,465	404	50-56	4.2	7.55-8.05
Total	**1,803,329**	**15.8**	**13,302**	**32,533**				

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

SUSTAINED OCCUPIER DEMAND

Strong economic backdrop as inflation rises

The Australian economy continues to perform strongly, underpinned by robust consumer spending and very tight labour market conditions. Retail sales rose 1.3% in July, the strongest monthly growth rate since March, to be 16.5% higher over the year and 25% above pre-pandemic levels. Buoyant labour market conditions continue to support consumer spending , with the unemployment rate currently at a multi-decade low of 3.4%.

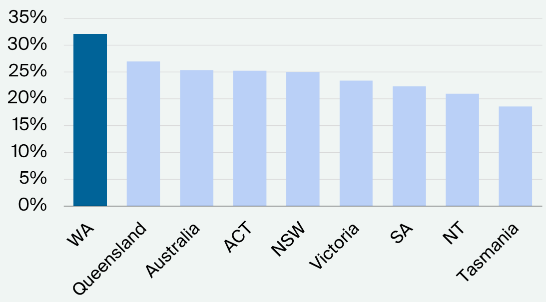
Economic activity in WA continues to be particularly strong. Retail sales in July were 32% above pre-pandemic levels, while employment grew by 7.2% over the same period compared to 4.4% for Australia. The WA economy is also benefitting from high energy and commodity prices, which are underpinning corporate profits and will continue to support demand for office space.

However, the global economic outlook has deteriorated amid higher inflation and rising interest rates. In Australia, headline CPI rose by 6.1% over the year to June, the highest growth rate since June 2001 following the introduction of the GST, while growth in underlying inflation is at its highest level since June 1991.

While Australia's inflation rate compares favourably with major advanced economies, higher inflation and the associated increase in interest rates are expected to drive a slowdown in consumer spending and economic growth in the second half of this year and into 2023. Inflation pressures are particularly acute in the construction industry, with growth construction cost inflation at its highest level in at least 40 years, which will complicate the delivery of new schemes in the years ahead.

Retail sales by state

Percent change since January 2020



Source: Knight Frank Research, Macrobond

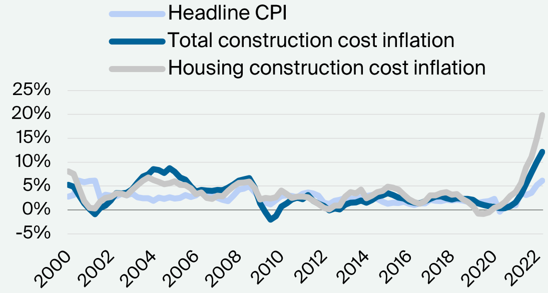
Demand for premium office space grows

The Perth office market has weathered the pandemic impact relatively well. After a slowdown in market activity in 2020 at the onset of the pandemic, demand for office space rebounded strongly in 2021. Since the beginning of last year, net absorption in the Perth CBD has totalled around 80,000 sqm (equivalent to 4.5% of office stock), the highest level of any major Australian CBD market.

Demand for office space in the Perth CBD slowed in the first half of 2022 but remains above average. Total net absorption increased by 13,302 sqm in H1 2022 following a 47,853 sqm increase in H2 2021. A flight to quality is evident with net absorption in the premium market picking up noticeably to 6,150 sqm, accounting for 46% of the CBD total. By contrast, net absorption in the A grade and secondary market segments slowed significantly, to 5,664 sqm and 1,488 sqm respectively.

Rising inflation

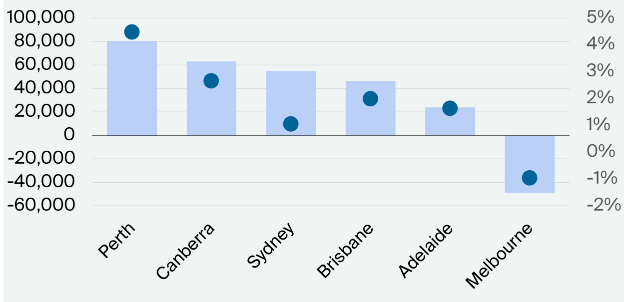
Headline CPI and construction cost inflation, % yoy



Source: Knight Frank Research, Macrobond

Net absorption since 2021 by CBD

Sqm (lhs), percent of total CBD office stock (rhs)



Source: Knight Frank Research, PCA

VACANCY RISES ON HIGHER SUPPLY

Premium market vacancy declines despite higher vacancy overall

Reflecting the strong demand for premium office space, the premium vacancy rate fell from 6.7% in January 2022 to 4.8% in July, the lowest level in eight years. By contrast, higher supply (with the completion of Capital Square Tower 2 and several refurbishments) drove A grade vacancy higher to 16.6% in July, up from 14.7% in January. The prime vacancy rate rose by 0.5 percentage points to 12.0% over the same period.

In the secondary market, vacancy increased from 20.0% in January to 21.2%. The increase was driven by a 2 percentage point rise in the B grade segment reflecting higher supply and a small decline in the net absorption.

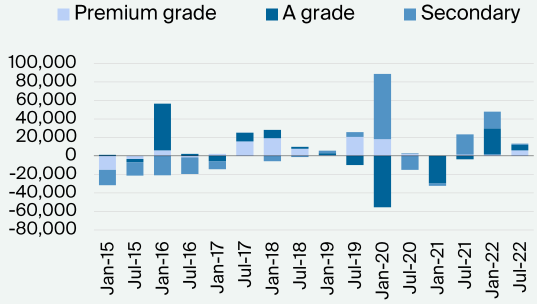
The overall Perth CBD vacancy rate rose by 0.8 percentage points to 15.8%.

Limited supply beyond 2023 to push vacancy lower

The relatively limited development pipeline beyond 2023 will facilitate the ongoing strong recovery in the CBD. Westralia Square 2 is expected to reach completion late this year, delivering 9,300 sqm of office space. Chevron's new premium grade 52,000 sqm HQ and Capital Square Tower 3 (16,000 sqm) are both expected to reach completion next year. Further out, Brookfield's 32,000 sqm development at 9 The Esplanade (Lot 6 Elizabeth Quay) is expected in 2025.

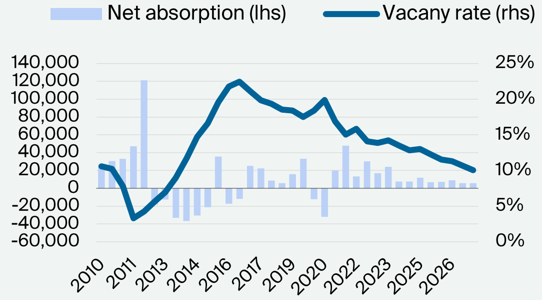
Reflecting the combination of well above-average demand and modest levels of new supply, we expect the vacancy rate to decline steadily over the next few years to around 10% by the end of 2025. However, the potential development of a further 70,000 sqm at Lot 4 Elizabeth Quay could significantly impact the forecast market recovery and push vacancy back up.

Net absorption
By grade, sqm



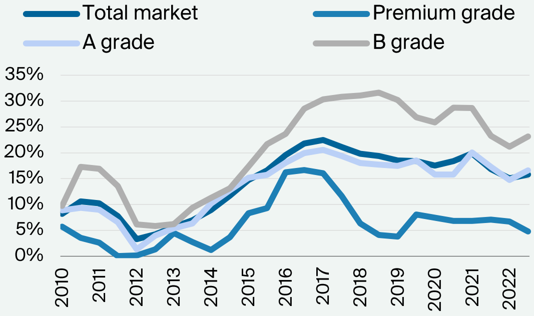
Source: Knight Frank Research, PCA

Net absorption and vacancy rate
Sqm (lhs), percent (rhs)



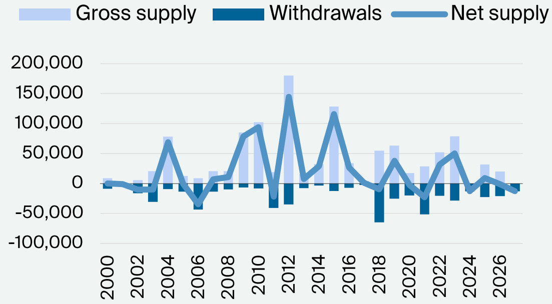
Source: Knight Frank Research, PCA

Vacancy rate
By grade, percent



Source: Knight Frank Research, PCA

Supply and withdrawals
Sqm



Source: Knight Frank Research, PCA

MAJOR OFFICE SUPPLY

MAJOR REFURBISHMENTS

1 DYNONS PLAZA (905 HAY STREET) - 13,200 SQM
REDHILL PARTNERS. H1 2022

UNDER CONSTRUCTION/ MAJOR PRE-COMMITMENT

2 WESTRALIA SQUARE 2 (141 ST GEORGES TERRACE) – 9,300 SQM
GDI. H2 2022

3 CAPITAL SQUARE TOWER 3 (21 MOUNTS BAY ROAD) – 16,000 SQM
AAIG. H1 2023

4 LOTS 7 & 8 ELIZABETH QUAY (ONE THE ESPLANADE) – 52,000 SQM [CHEVRON]
BROOKFIELD. H2 2023

5 LOT 6 ELIZABETH QUAY (9 THE ESPLANADE) – 32,000 SQM
BROOKFIELD. H1 2025

DEVELOPMENT APPROVED

6 LOT 4 ELIZABETH QUAY – 70,000 SQM
CA & ASSOCIATES. TBC

7 PERTH CONVENTION CENTRE PRECINCT (21 MOUNTS BAY ROAD) – 20,000 SQM
BROOKFIELD. H2 2026

8 1 MILL STREET– 45,000 SQM
GDI/LENDLEASE. DATE TBC

RENTAL GROWTH PICKS UP

Face rental growth gains momentum but incentives remain high

Prime net face rents rose by 1.7% over the six months to July 2022 to $637/sqm to be 2.3% higher over the year. For the premium segment, face rents increased by 1.5% over the same period to $686/sqm, 2.2% higher over the year. For the A grade segment, face rents rose by 1.8% over the six months to January to $588/sqm to be 2.5% higher over the year.

Average prime incentives remained unchanged over the six months to July at 49.6%, and have been stable since April 2021. Average incentives in the prime market are around mid-2018 levels, and 162 basis points lower than the peak in April 2017.

Reflecting stable incentives, prime net effective rents grew at the same pace as face rents over the year to July to $321/sqm. In the secondary market, net face rents rose by 3.7% over the six months to January to be 4.2% higher over the year.

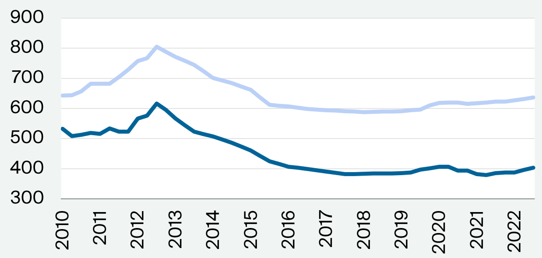
The average rental discount between the prime and secondary market remains relatively high at 37% in face terms and 42% in effective terms compared to the historical averages of 31% and 32% respectively.

Lower vacancy to drive strong face rent growth over the next five years

Reflecting ongoing above-average demand, modest supply, and higher inflation, growth in prime net face rents in the Perth CBD (currently $637/sqm) is expected to accelerate to 3.5% over the year to January 2023 and then pick up further to average 4% per annum over the next five years.

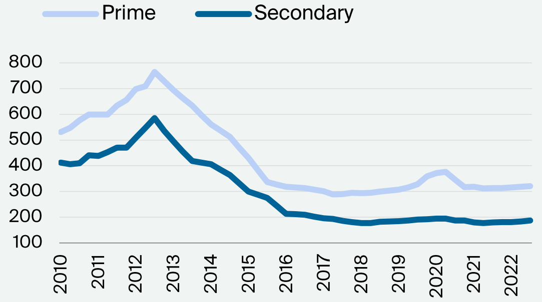
Incentives, which currently average just under 50% of net face rents, are expected to decline gradually over the next five years, leading to a pick in effective rental growth. Net effective rents are expected to grow by over 5% per annum over the next five years, the strongest growth rate of any major Australian CBD market.

Net face rent
By grade, $/sqm



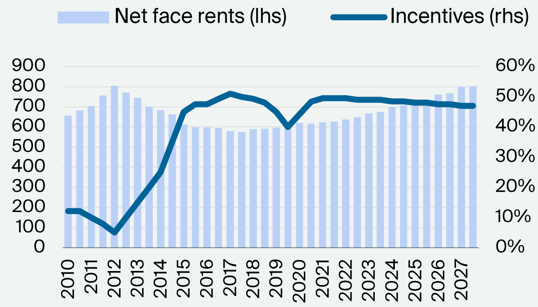
Source: Knight Frank Research

Net effective rent
By grade, $/sqm



Source: Knight Frank Research

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



Source: Knight Frank Research

INVESTMENT SLOWS AS FUNDING COSTS RISE

Rising interest rates drive CBD office yields higher

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.

Reflecting the shift up in interest rates, office yields have begun to rise nationally. In Perth, the average prime CBD office yield is estimated to have risen by 25 basis points over the three months to July to 6.55%. However, the scarcity of deal activity and the significant degree of variation in yields on individual deals makes the movement in average yields harder to assess than usual. The shift up in bond yields has led to a significant narrowing in the CBD prime office yield spread to government bonds to 288 basis points as at July 2022, down from 462 basis points at the end of 2021, and 543 basis points at the end of 2020.

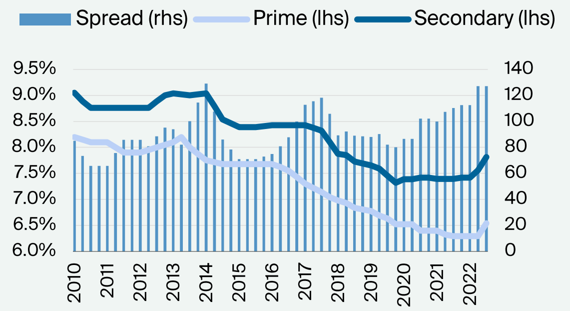
Investment subdued in H1 2022 but activity set to pick up

Investment in the Perth CBD slowed markedly in H1 2022 after a strong rebound in 2021. This is consistent with investment trends nationally, with other cities also seeing a slowing in deal momentum during the first half of the year, particularly for smaller deals which are being more impacted by the rise in borrowing costs. Investment volume has totalled only $16.1 million over the year to date.

However, there are several deals in the pipeline which should lead to pick up in deal volume later in the year. These potential deals include London House (216 St Georges Terrace), 108 St Georges Terrace, and Allendale Square (77 St Georges Terrace), Durack Centre (259-263 Adelaide Terrace & 2 Victoria Avenue), 81 St Georges Terrace, and St Martins Centre (44 St Georges Terrace).

Yields

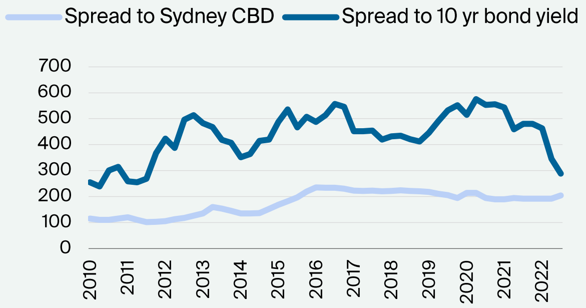
Percent (lhs), basis points (rhs)



Source: Knight Frank Research

Prime yield spread

Basis points



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.

Research
Chris Naughtin
+61 2 9036 6794
Chris.Naughtin@au.knightfrank.com

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

Managing Director, WA
Craig Dawson
+61 8 9225 2406
Craig.Dawson@au.knightfrank.com

Office Leasing
Rick McKenzie
+61 8 9225 2409
Rick.McKenzie@au.knightfrank.com

Office Leasing
Jeremy Robotham
+61 8 9225 2535
Jeremy.Robotham@au.knightfrank.com

Office Leasing
Greg McAlpine
+61 8 9225 2426
Greg.McAlpine@au.knightfrank.com

Occupier Services
Theo Smyrniotis
+61 8 9225 2521
Theo.Smyrniotis@au.knightfrank.com

Valuations & Advisory
Cameron Thomson
+61 8 9225 2452
Cameron.Thomson@au.knightfrank.com

Office Leasing
Ian Edwards
+61 8 9225 2420
Ian.Edwards@au.knightfrank.com

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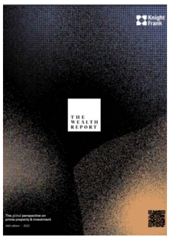
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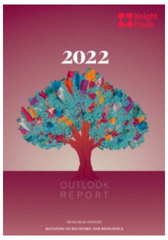

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