- *Premium assets continue to perform well*
- *Yields show outward movements with weaker investor sentiment*
- *Limited development pipeline to positively impact demand for A grade space*

Knight Frank

Perth CBD Office

knightfrank.com/research

Market Report, September 2023

PRIME STOCK DEMAND SEES PERTH WEATHER HEADWINDS

Net absorption continues to strengthen as resource sector positivity underpins market activity

15.9% VACANCY

6.3% PREMIUM VACANCY

6.8% AVERAGE PRIME YIELD

"Rents have increased, absorption is positive, future supply in the short term is limited and demand for premium stock is strong.

This should aid demand for existing A grade space in the short term."

The Key Insights

Strong net absorption of 23,950 sqm in H1 2023, and nearly 100,000 sqm in the past two years.

Vacancy has increased marginally over the last year to move to 15.9%. Premium grade vacancy has reduced to 6.3%, second only to Brisbane nationally.

High level of development completions in H1 2023 totalling 67,579 sqm, led by One The Esplanade (52,000 sqm). New supply in 2024 and 2026 is limited.

Prime and secondary rents both increased in H1 2023, with incentives remaining stable.

Demand for premium quality stock in Perth strengthens as the national flight to quality continues. The limited development pipeline and increased number of project requirements is expected to aid short term demand for existing A grade space.

Perth Office Market Indicators — July 2023

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	1,086, 925	12.8	19,974	24,007	678	48.8	6.9	6.83
Secondary	753,026	20.3	3,976	9,152	430	53.5	6.6	8.25
Total	**1,839,951**	**15.9**	**23,950**	**33,159**				

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

PERTH OFFICE STANDS OUT

Amid economic headwinds nationally, WA is outperforming

Following an extended period of strong growth, the Australian economy is slowing in response to sustained high inflation, elevated construction costs and the dramatic shift in interest rates. Australia's Q2 GDP growth increased to 0.4% q/q, reflecting a continuation of the subdued growth of Q1. Consumer sentiment continues to decline, with consumer spending moderating in response to a 400bps increase in interest rates since May 2022.

Despite the national headwinds, Western Australia continues to perform strongly, benefiting from commodity exports, particularly the increasingly sought after rare earths and critical minerals which are vital to renewable energy technologies.

Broadly in line with the national unemployment figure of 3.7%, the unemployment rate in WA was sat at 3.8% in August. The state's tight labour market and 0.7% increase in the participation rate (to 69.3%) both auger well for continued office demand in Perth.

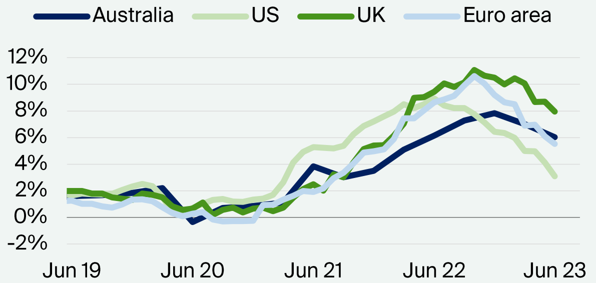
Sustained positive absorption in Perth CBD

Reflecting the sustained strength of economic and employment growth, Perth CBD has recorded a high level of net absorption over the past two years and this continued in H1 2023, with 23,950 sqm recorded, bringing the total over the past two years to 90,534 sqm. This reflects 4.9% of total stock, the second highest of any major CBD over the past two years, trailing Brisbane by only 0.1%.

Over this two year period, net absorption of B grade (26,181 sqm) has remained positive and net absorption of A grade (36,539 sqm) has been particularly strong. This contrasts with other major cities which have seen a more pronounced concentration of absorption in premium grade assets.

Headline inflation

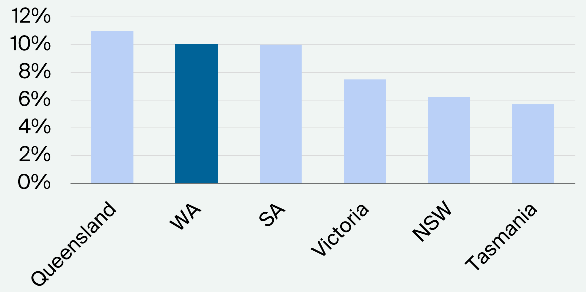
Per cent change year on year



Source: Knight Frank Research, Macrobond

Employment by state

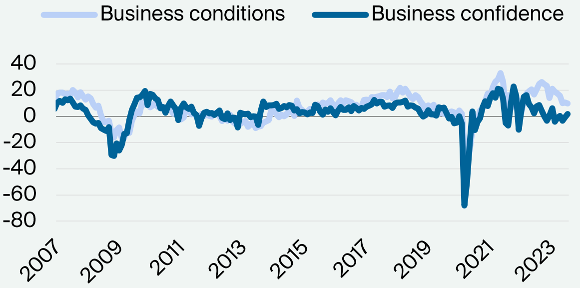
Per cent change since Jan 2020



Source: Knight Frank Research, Macrobond

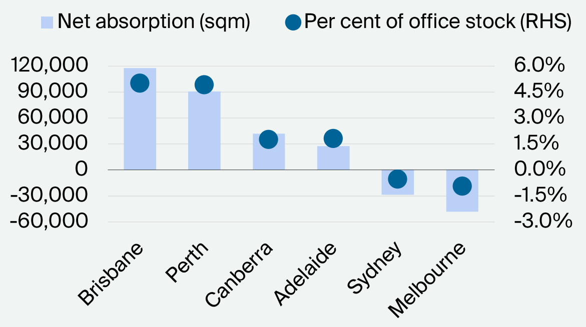
Business confidence and conditions

Net balance of positive and negative responses



Source: Knight Frank Research, Macrobond

Net absorption July 21 - July 23 by CBD



Source: Knight Frank Research, PCA

PREMIUM LEADS THE WAY ON VACANCY

Flight to quality reduces premium vacancy further

The overall vacancy rate moved out slightly in H1, increasing by 0.2% to stand at 15.9%. This period was notable for the highest supply additions in more than five years adding 67,579 sqm of gross supply, underpinned by Brookfield delivering 52,000 sqm at One The Esplanade. Despite supply additions, vacancy in premium tightened from 6.6% to 6.3%, however this was distorted by the withdrawal of 27,993 sqm in QV1 for refurbishment.

Whilst the premium vacancy rate will increase as a consequence of backfill and further completions, demand here remains the strongest of all grades. This is driven by the growing importance placed on quality of accommodation, precinct amenity and ESG from larger occupiers. The vacancy rate in A and B grades increased over H1 to 17.3% and 21.5% respectively. Absorption remained positive in B grade while A grade saw slightly negative net absorption, although it remains positive over 12 months. Perth continues to go against the national trends; while many markets are battling higher sub-lease vacancy, such as North Sydney (2.4%) and Melbourne (2.0%), led by major tenants seeking to downsize, this is not occurring in Perth, where sub-lease vacancy has declined again, sitting at only 0.5%, reflective of high occupancy rates and the performance of the local economy.

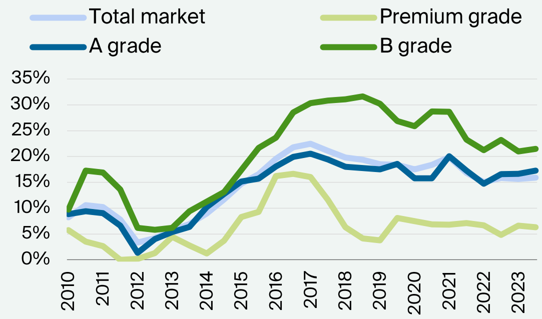
Limited supply pipeline to impact positively

The completion of Capital Square Tower 3 (13,681 sqm) and the 9,529 sqm at Westralia Square 2 ends the 2023 pipeline. There is a further 32,000 sqm at 9 The Esplanade due for completion in H1 2025. Further out, site works have commenced at Lot 4 The Esplanade, which is anticipated to deliver 60,000 sqm in 2027.

There are no completions due in 2024, and it is unlikely there will be substantial supply additions in 2025 or 2026 without a significant pre-commitment due to elevated construction and funding costs impacting project viability. With such limited supply, it is very likely that there will be a reduction in vacant space in 2024 through to 2026.

Vacancy rate by grade

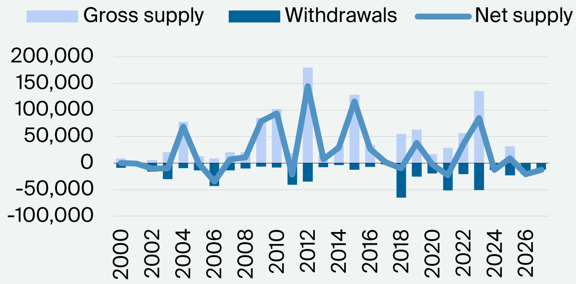
By grade, percent



Source: Knight Frank Research, PCA

Supply and withdrawals outlook

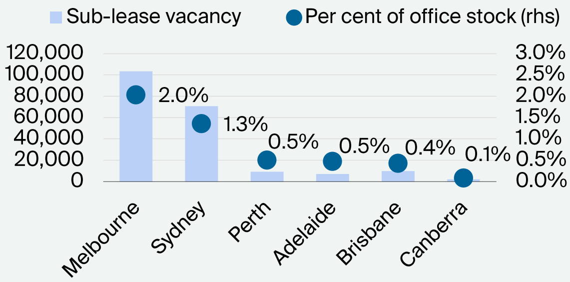
Sqm



Source: Knight Frank Research, PCA

Sub-lease vacancy by CBD

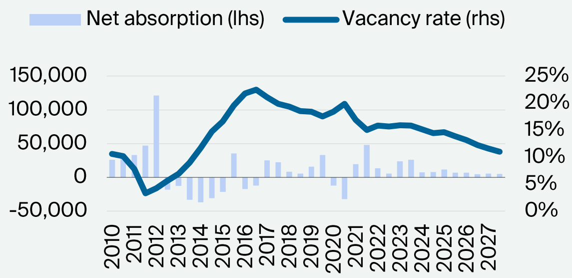
Sqm (lhs), per cent of toal CBD office stock (rhs)



Source: Knight Frank Research, PCA

Net absorption and vacancy rate outlook

Sqm (lhs), percent (rhs)



Source: Knight Frank Research, PCA

WEST PERTH PERFORMING STRONGLY

West Perth defies national trends with significant vacancy decline

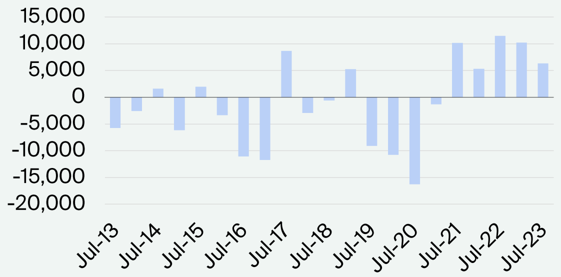
West Perth continues to perform strongly with it's fifth consecutive period of positive net absorption, experiencing a further 6,368 sqm in H1 2023, taking the overall vacancy rate down to 11.1%.

Vacancy declined across all grades. A grade vacancy has more than halved and is at a 10-year low of just 5.3%. Overall vacancy in West Perth as a whole has also effectively halved since the July 2020 peak of 22.1%. The latest rate of 11.1% is the lowest rate since July 2015 when it recorded 10.8%.

The improvement in the West Perth vacancy rate is more pronounced than the CBD due to significant stock withdrawals following purchases made by high-net-worth individuals; together with purchases by owner occupiers who thus remove stock they buy from the leasing market. This has been exacerbated by limited new supply additions over the past five years.

West Perth net absorption

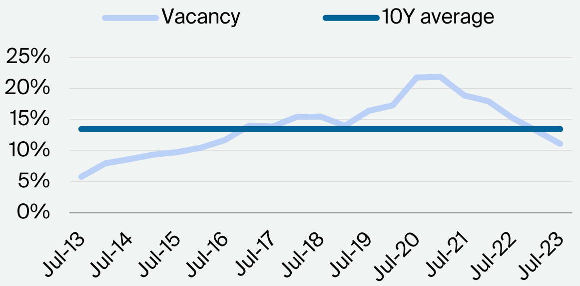
Sqm per six month period ending



Source: Knight Frank Research, PCA

West Perth vacancy rate

%



Source: Knight Frank Research

Continued resource sector strength underpins demand

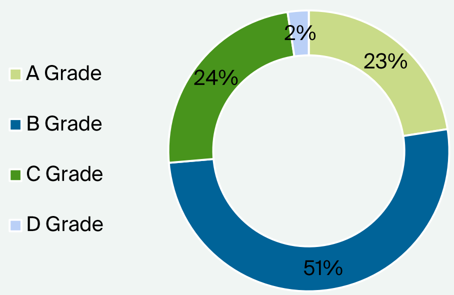
The strength of the mining and minerals sector in Western Australia has sustained the demand for office space from associated companies. Whilst the iron ore spot price has declined 80% from its 2021 peak the growth in critical metals and rare-earths has sustained the market.

The positive net absorption in West Perth has cemented the areas position as a viable non-CBD location, not only for miners but for a range of smaller space users who are taking up lesser quality stock, and in doing so underpinning the market's strength.

New space additions in the back end of 2022 were limited, and no new space has come online in H1 of 2023 further improving occupancy levels and causing existing space to be taken up. Furthermore, there is currently no committed new supply underway or planned.

West Perth stock

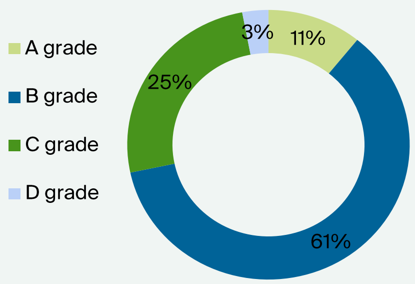
By grade, per cent



Source: Knight Frank Research, PCA

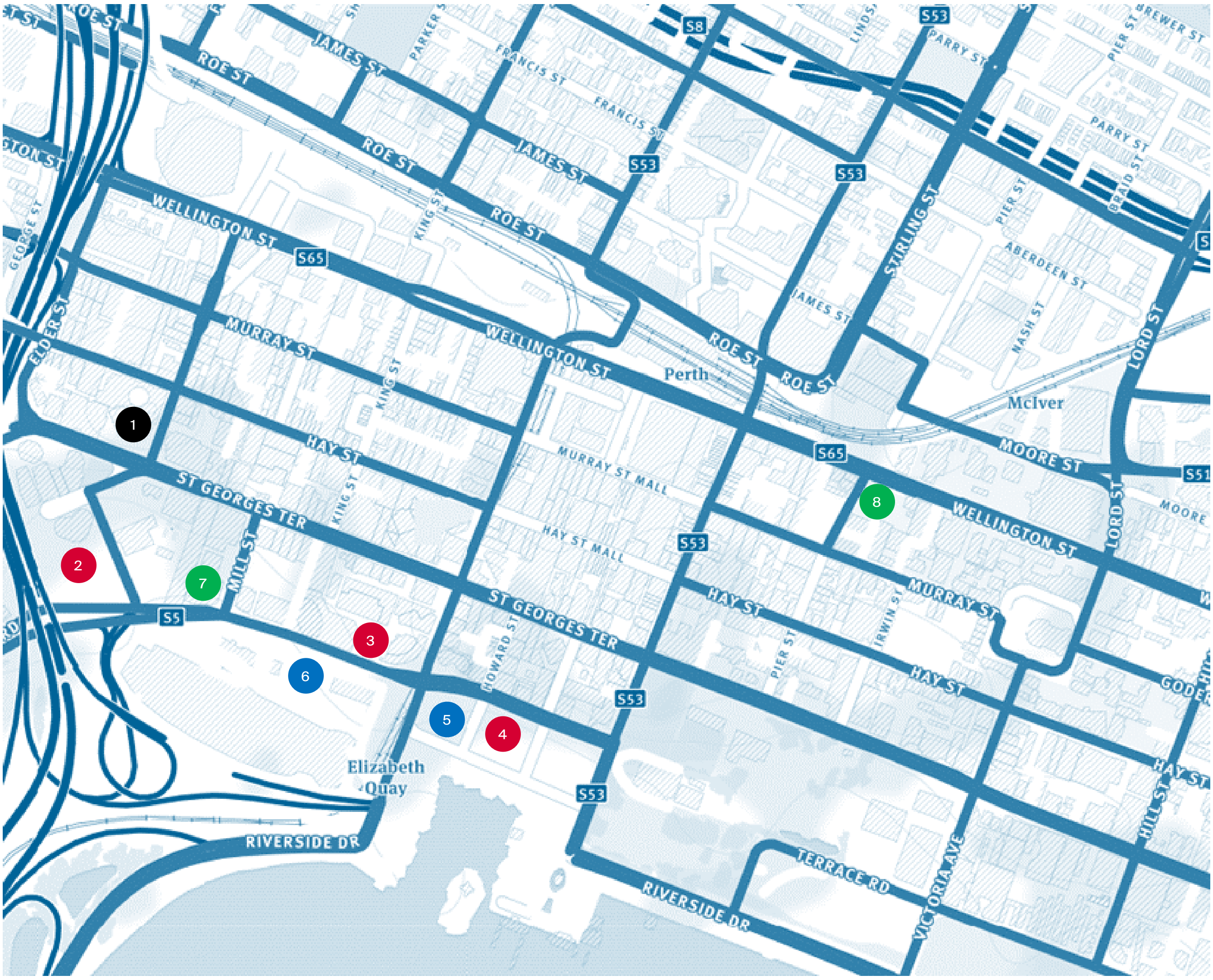
West Perth vacancy

Proportion by grade (%)



Source: Knight Frank Research, PCA

MAJOR CBD OFFICE SUPPLY



MAJOR REFURBISHMENTS

1 QV1 (250 ST GEORGES TERRACE) - 27,993 SQM
H1 2024

UNDER CONSTRUCTION/ MAJOR PRE-COMMITMENT

2 CAPITAL SQUARE TOWER 3 – 13,681 SQM
AAIG. H2 2023 – COMPLETED

3 WESTRALIA SQUARE 2 – 9,529 SQM
GDI PROPERTY GROUP H2 2023 - COMPLETED

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

DEVELOPMENT APPROVED

5 LOT 4 ELIZABETH QUAY – 60,000 SQM
CA & ASSOCIATES. 2027

6 PERTH CONVENTION CENTRE PRECINCT (21 MOUNTS BAY ROAD) – 20,000 SQM
BROOKFIELD. TBC

DEVELOPMENT APPLICATION/MOOTED/ EARLY FEASIBILITY

7 1 MILL STREET– 45,000 SQM
GDI/LENDLEASE. TBC

8 CORNER PIER STREET AND WELLINGTON STREET – 27,000 SQM
GDI PROPERTY GROUP. TBC

RENTAL GROWTH CONTINUES

Strong prime and overflow rent growth

Prime net face rents in Perth CBD rose by 1.5% over the six months to July 2023 to average $678/sqm, 5.3% higher over the last 12 months and among the fastest growing markets nationally.

In addition to face rental growth maintaining its positive momentum in H1 2023, Perth also saw stability in incentives in the first half of the year, unlike many other capitals. After escalating with the onset of the pandemic, average prime incentives reduced slightly in Q3 2022 to 48.8% from 49.6%, and have remained unchanged. Average incentives in the prime market are now back to around mid-2018 levels, and 240 basis points lower than the peak in April 2017.

Consequently, net effective rents also grew by a healthy 1.5% over the six months to July 2023, reaching $347/sqm. This reflected annual growth of 6.9% when last years incentive drop is taken into account, and further reinforces Perth as a particularly well performing office market over a challenging period.

Potential to out-perform in the recovery phase

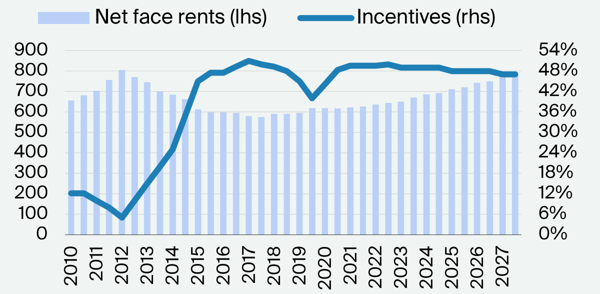
Given sustained tenant demand and a modest supply outlook beyond 2023, prime rents are expected to continue to rise.

Perth's history and ongoing demand suggest that it has the potential to out-perform other markets. The strength of the premium market in particular positions Perth well relative to other cities, with tight supply driving stronger rental growth, and the recent experience of rapid growth in 2019 illustrates the potential to surprise on the upside. Moving forward, the market will be aided by the limited supply pipeline to help reduce vacancy rates.

Reflecting the national experience, effective rental growth is likely to come primarily in the form of face rental growth, although incentives are also expected to edge down over the forecast period.

Prime rents and incentives outlook

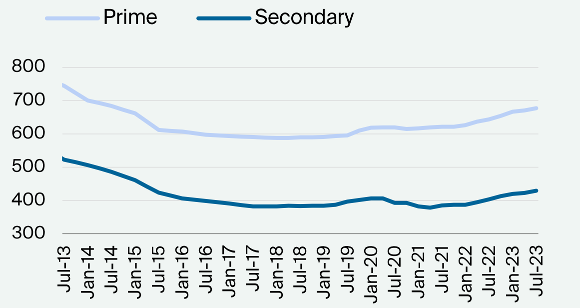
Net, $/sqm (lhs), percent (rhs)



Source: Knight Frank Research

Net face rent

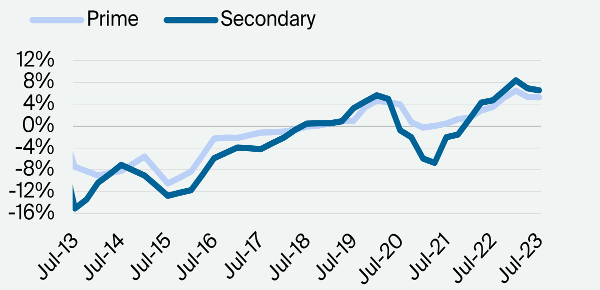
By grade, $/sqm



Source: Knight Frank Research

Net face rental growth

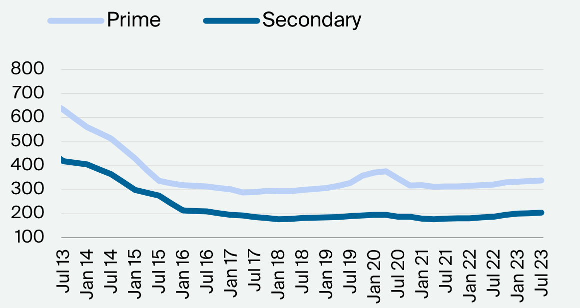
y/y %



Source: Knight Frank Research

Net effective rent

By grade, $/sqm



Source: Knight Frank Research

HIGHER FUNDING COSTS WEIGH ON MARKET

Transactions remain low, yields edge out nationally

High funding costs and uncertainty over the economic outlook are resulting in deals taking longer to transact. Low sales volumes nationally in H1 continued the trend from 2022, with many investors biding their time and potential vendors generally preferring to wait for sentiment to improve before bringing assets to market. Reflecting these trends, the two assets brought to market in Perth in H1 2023, Alluvion and Djookanup House both failed to transact.

While Perth's leasing market has continued to perform very well in 2023, office yields continued to rise in line with the national trend. Reflecting the sharp rise in funding costs since early 2022, prime yields have continued to edge upwards across all markets. In Perth the average prime yield now stands at 6.83%, up by 25 bps from January and an increase of 54 bps from 6.29% in July 2022.

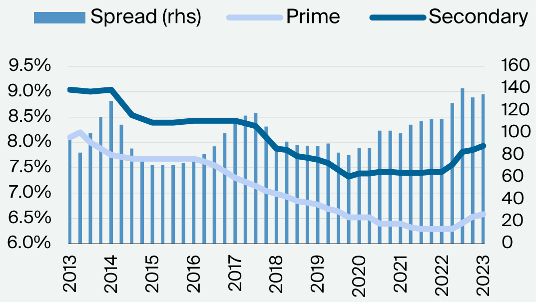
However, there is notable divergence between premium and A grade assets, with the premium market showing greater resilience to current market pressures. Premium yields stand at 6.33% on average, markedly lower than A grade, which has moved to an average of 7.24%. The divergence partly reflects perceptions of income security and long term growth potential. Investors are prepared to factor in greater future rental uplift for premium assets as opposed to A grade.

Interest rate outlook suggests a positive trajectory for investment markets

Both two-year and five-year bond yields increased during H1 to the range of 3.5 – 4%, although they have now stabilised around this level and this in turn will act to stabilise funding costs. Recent RBA Board statements reflect growing confidence that the actions taken to date in raising the cash rate to 4.1% will prove sufficient to enable inflation to return to the target range of 2-3%. This lowers the probability of further rate rises, with most forecasters now expecting an extended pause from the RBA. Over time, this will provide a more reassuring backdrop for the property market and create the conditions for deal flow to gradually return.

Perth office yields

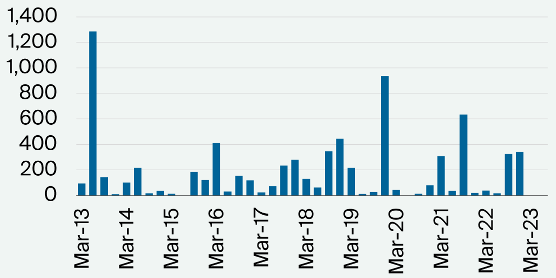
Percent (lhs), basis points (rhs)



Source: Knight Frank Research

Perth CBD sales volume

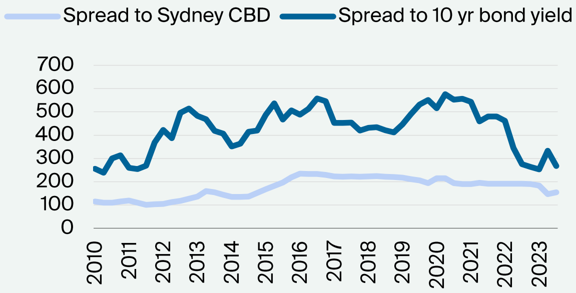
$m



Source: Knight Frank Research, RCA

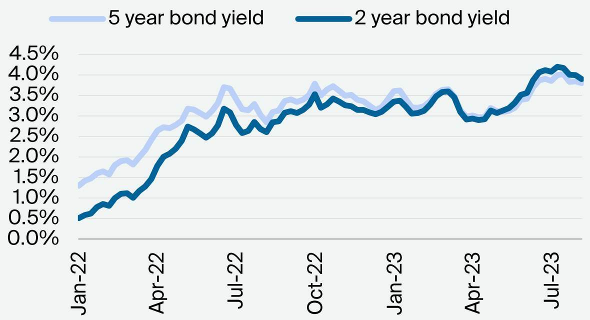
Prime yield spread

Basis points



Source: Knight Frank Research

Government bond yields



Source: Knight Frank Research, Macrobond

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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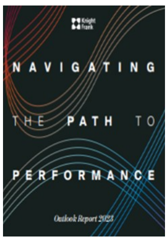

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