RESEARCH

SYDNEY CBD
STRATA MARKET INSIGHT JUNE 2017

Highlights

Strata sale rates per square metre have increased by 12.6% over the past 12 months with values at the upper end of the market pushing through $10,000-12,000/m².

Secondary gross effective rents have increased by 21.0% in the Sydney CBD over the 12 months to January 2017.

A total of 239,057m² has been withdrawn from the Sydney CBD market over the year to January 2017. Of which, **86,833m² across 13 secondary buildings has been demolished.**

A further 540,000m² is projected to be withdrawn across the entire Sydney CBD market over the next five years, due to the Sydney Metro construction, residential conversions and redevelopments.

78% of tenant expiries in the Sydney CBD over the next two years will be in the sub-500m² bracket.

Strata price growth is expected to be maintained at circa 10% per annum over 2017 and 2018.

Beyond 2020, expectations are for some moderation in price growth on the back of increased overall supply levels and higher interest rates.

ALEX PHAM
Senior Research Manager

"Rising effective rents are enticing many existing tenants to become owner occupiers and take advantage of the historically low interest rate environment."

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WHERE ARE STRATA VALUES HEADING TO?

Strata office values have increased significantly over the past 12 months. This was driven by strong secondary rental growth, significant stock withdrawals, muted new short term supply and positive tenant demand for small and medium sized office premises.

Favourable conditions in both the capital and leasing markets are driving Strata office prices in the Sydney CBD to unprecedented levels. The average Strata sale rates (excluding car parking) currently measure $7,574/m² with the upper end of the market pushing through $10,000-12,000/m². This represents an increase of circa 12.6% YoY. Knight Frank Research's projection models indicate the strong value growth rates would be maintained over the next two years (Figure 1) due to a number of favourable drivers.

Market Drivers

The expected capital appreciation will be underpinned by strong rental growth, limited supply and positive tenant demand in the sub-500m² office category. Secondary gross effective rents in the Sydney CBD have increased by 21.0% on average over the 12 months to January 2017. This was due to a record level of stock withdrawals last year, which totaled 239,057m². This was the highest withdrawal level since the PCA began tracking the market in 1990. Of this amount, 86,833m² across 17 secondary buildings was demolished last year. Looking ahead, a further 540,000m² is projected to be withdrawn from the Sydney CBD market over the next five years, due to the Sydney Metro construction, residential conversions and redevelopments. This will continue to put tremendous pressure on effective rents and entice many tenants to opt for purchasing their offices, rather than renting, as a more cost effective solution.

Since the subdivision of 350 George Street in 2013, new strata supply in the Sydney CBD has been negligible over the past four years. With the introduction of 'Collective Sale and Renewal Reform' to strata properties last year, there have been expectations for new strata redevelopments. Nevertheless, no projects have been initiated, while residential conversion continues to be the primary focus for many existing owners.

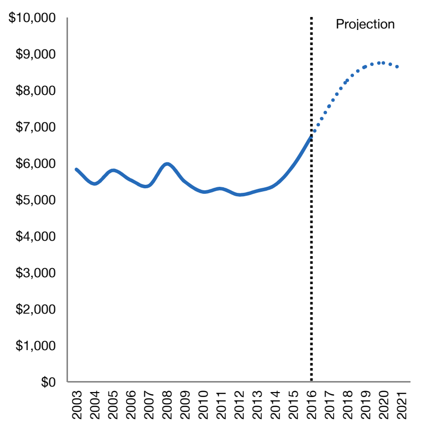
Future Demand

The significant withdrawal of secondary stock over the next few years is expected to result in a substantial number of displaced tenants. Knight Frank's analysis reveals that the average floor size required by these tenants is 457m². In addition, 78% of tenant expiries in the Sydney CBD over the next two years will be in the sub-500m² bracket. This is in line with our research that shows 89% of CBD-based businesses are SMEs with less than 20 employees. This will ensure a strong level of demand for Strata office suites in the CBD going forward.

Interest Rate Outlook

The low interest rate environment remains a major influence on property values. Monetary policy remains largely accommodative with the cash rate being maintained at the record low of 1.5% for the tenth consecutive month in June 2017. Looking forward, interest rates are showing some increases as banks tighten lending criteria, and expected to rise in the medium term. This will gradually slow down the rate of growth in capital values.

FIGURE 1
Sydney CBD Strata Office Values
Rate per sq.m



Source: Knight Frank Research

Strata Office Market Outlook

The outlook for the Sydney CBD Strata office market remains positive over 2017 and 2018 with price growth expected to be maintained at approximately 10% per annum. With already constrained new supply, the significant stock withdrawal in the secondary market will translate to strong rental growth. This will lead to increased demand by owner occupiers and tenants displaced by buildings being demolished over next 24 months.

From 2019, some moderation on price growth will be anticipated on the back of increased overall supply levels and higher interest rates. Whilst the majority of this new supply will be in the prime grade market, a flow-on effect to the Strata and secondary markets will be expected. In addition, increased borrowing costs over the long-term will start to become an important consideration for many investors over the next few years.

Looking ahead, there are a number of important implications for market participants. Existing Strata owners with higher opportunity costs of capital will be encouraged to take advantage of the currently strong market while the depth of the demand remains. For potential owner occupiers and some existing tenants who don't have access to a broad base of alternative investment options, purchasing their own offices will be a more cost efficient solution than leasing. This strategy is particularly favourable in the currently low interest rate environment amid rising effective rents.

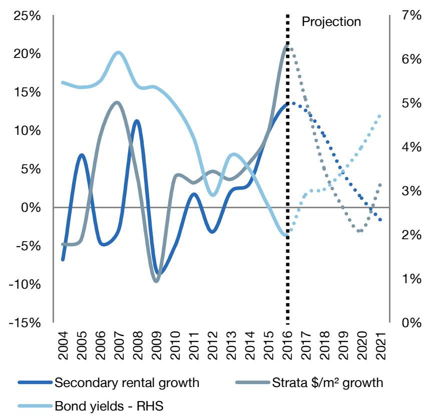
Whilst pockets of value remain across the Sydney CBD Strata market, purchasers are increasingly investigating alternative markets as CBD prices continue to rise. This will see investor demand cascading to non-CBD locations such as the City Fringe, North Sydney and Parramatta.

> "The outlook for the Sydney CBD Strata office market remains positive over the next 18 months with price growth expected to be maintained at circa 10% per annum."

FIGURE 2

Strata Capital Growth Drivers

Value v. rental growth v. bond yields



Source: Knight Frank Research

TABLE 1

Recent Strata Sales

H1 2017

Address	Price ($)	Area	$/m²
447 Kent St	5,500,000	604	$9,106
263 Clarence St	3,750,000	402	$9,328
70 Castlereagh St	4,900,000	389	$12,596
370 Pitt St	2,410,000	241	$10,000
109 Pitt St	1,300,000	112	$11,607
105 Pitt St	1,692,000	141	$12,000
33 York St	5,000,000	556	$9,000
131 Macquarie St	7,860,000	523	$15,000
67 Castlereagh St	385,000	36	$10,694

Source: Knight Frank Research

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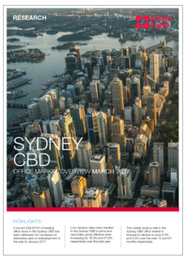

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Inner Brisbane & CBD Hotel Market Insight March 2017

Build-To-Rent Insight April 2017

The Wealth Report 2017

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