Commercial Research

Between the Lines

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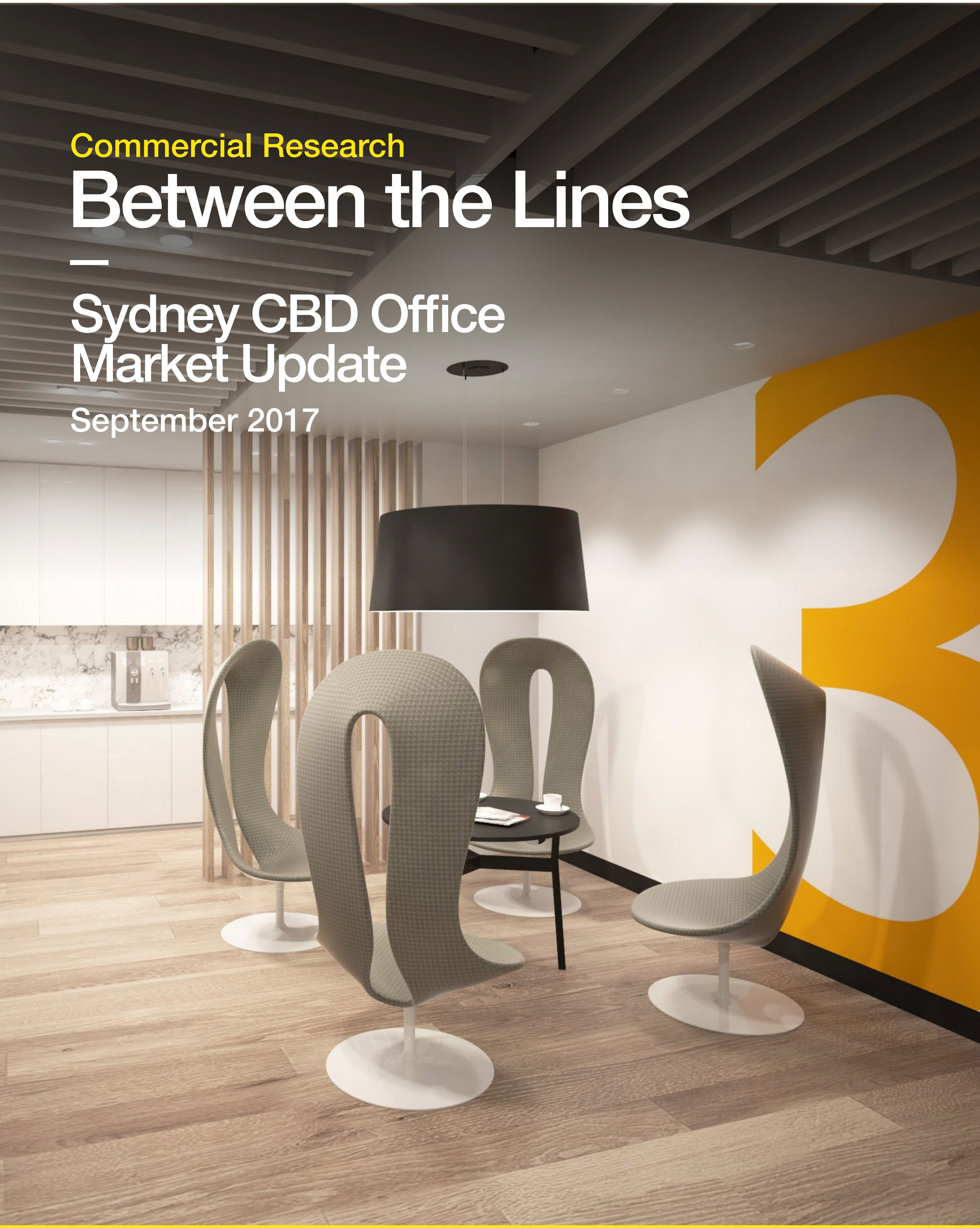
Sydney CBD Office Market Update

September 2017



Sydney CBD Office Market

Total Stock Level
5,086,316 sqm

Completions ↓ 83,534 sqm

Withdrawals ↓ 75,821 sqm

Net Supply ↑ 7,713 sqm

Premium ↓ **9.5%**

A Grade ↓ **3.6%**

B Grade ↑ **5.8%**

C Grade ↑ **6.9%**

D Grade ↓ **3.8%**

Direct Vacancy ↓ 5.5%

Sublease ↓ 0.3%

Total Vacancy ↓ 5.9%

Net Face Rents
PRIME ↑ $990/sqm

SECONDARY ↑ $795/sqm

Incentive
↘ 15%+

Investment Yields
PRIME ↘ 4.85%

SECONDARY ↘ 6.50%

Strata Capital Values by Precinct

Core+ ↑ 45.7% to $11,711/sqm

Midtown+ ↑ 10.9% to $8,955/sqm

Western Corridor+ ↑ 19.9% to $8,737/sqm

Southern+ ↑ 18.3% to $7,214/sqm

Strata Sales Volume

2017* $38.8 mill

Total Strata Capital Values

2017* ↑ 33.0%+ to $10,127/sqm

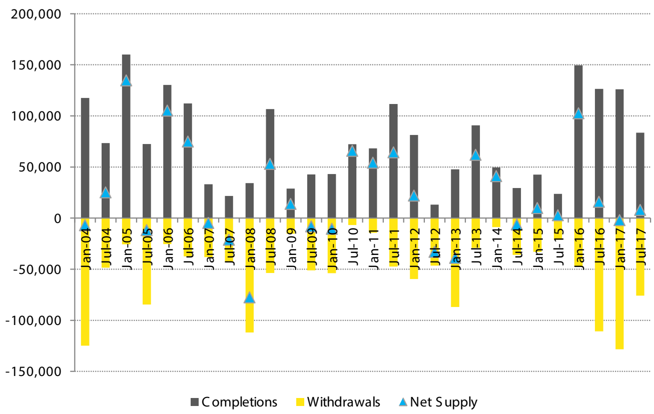
Sources: Property Council of Australia & Ray White   *to August +compared to 2016

The Sydney CBD office market continues to surprise. While the supply and withdrawal phenomenon continues keeping stock levels stable, the construction on the skyline and disruption to the city has been a greater than ever envisaged.

Demand has held keeping vacancies stable at their low rate of 5.9% and after remarkable rental increases the outlook for this continuing now looks a little more uncertain. Affordability is a big issue for many tenants in the CBD faced with huge rental hikes and limited incentive, many turning to co-working spaces or the quest to purchase strata stock which has now seen an unprecedented lift in value rendering this also unaffordable to many.

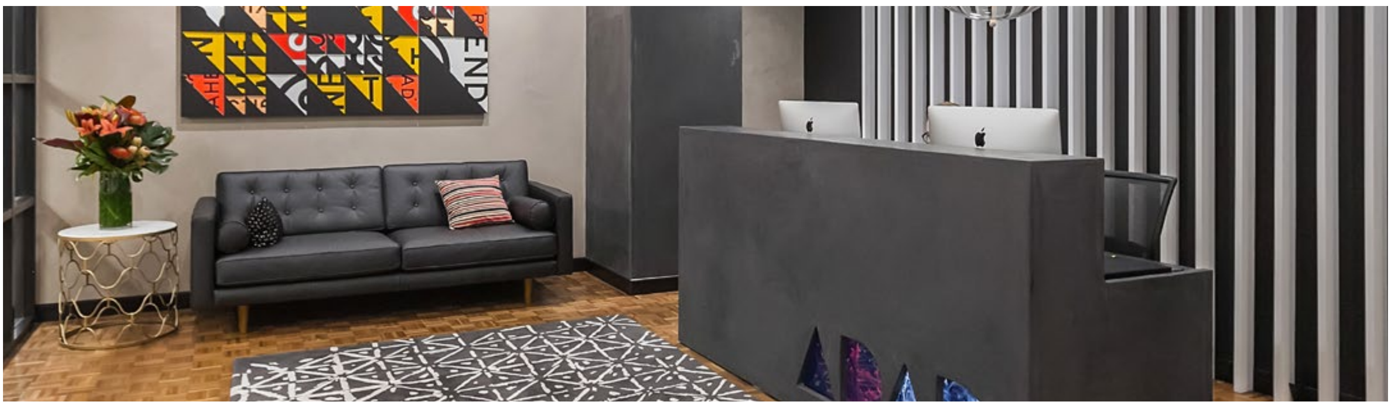
Sydney CBD Office

Net Supply (sqm)



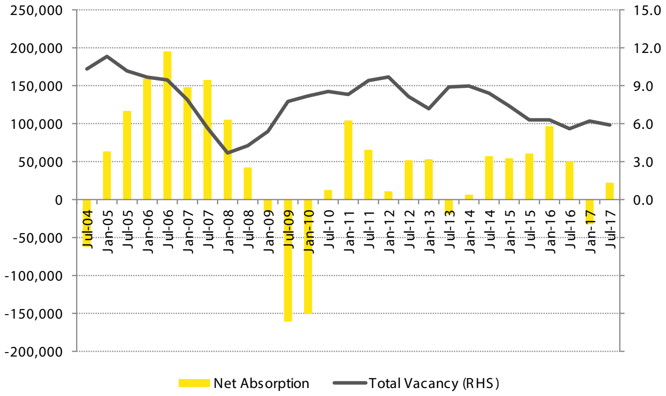
Source: Property Council of Australia

These last five years have been interesting times for the Sydney CBD with many massive projects having a sizeable impact. This market has seen a significant transformation with the completion of three office towers at Barangaroo opening up the western waterfront precinct. The city also has seen massive disruption with the closure of George Street in parts making way for the light rail, while the Sydney metro has also seen the withdrawal of office buildings, others removed for residential redevelopment and many substantial refurbishment projects dotted around the CBD. However, despite all this construction the size of the overall office market has shown limited fluctuations. High withdrawals have combatted high supply with net supply remaining close to nil most periods over this five year time frame. The total stock level for the Sydney CBD is 5,086,316sqm and despite the many completions since January 2012, there has only been a real change of 3.1% in the stock level. The six months to July 2017 highlights this trend with the completion of 83,534sqm mostly of refurbished stock such as 60 Margaret Street, Darling Park Tower 3 and 80–82 Pitt Street which was somewhat cancelled out by the withdrawal of 10 properties totalling 75,821sqm mostly for demolition including 55 Hunter Street, 2 Bligh Street and 175 Castlereagh Street.



Sydney CBD

Net Absorption (sqm) v Total Vacancy (%)

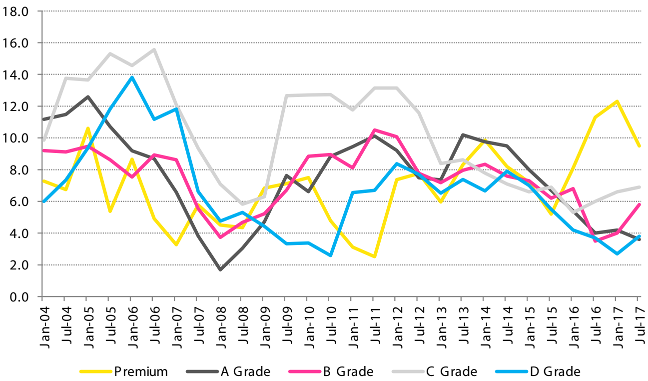


Source: Property Council of Australia

We saw the first negative take up in the last half of 2016 which resulted in vacancies increasing after three years of positive absorption. This was driven by high white collar employment growth in finance, property and professional services industries together with technology seeing vacancies fall from 9.0% to 5.6%. The six months to July 2017 saw some recovery in demand recording 22,216sqm absorbed resulting in vacancies reducing again to 5.9% or 298,248sqm. Looking ahead, supply will continue to be added dominated by refurbished stock, with the next six month expected to see close 50,000sqm completed with only a small withdrawal anticipated; as most of this stock is committed there is further scope for vacancies to reduce by the end of the year. While further ahead the completion of a number of new buildings currently under construction or in site works including 151 Clarence Street (22,000sqm), 10 Carrington Street (56,000sqm), 60 Martin Place (38,600sqm) all yet to secure commitment could result in a turnaround in this low vacancy rate with greater upward movement.

Sydney CBD Office

Vacancy by Precinct (%)



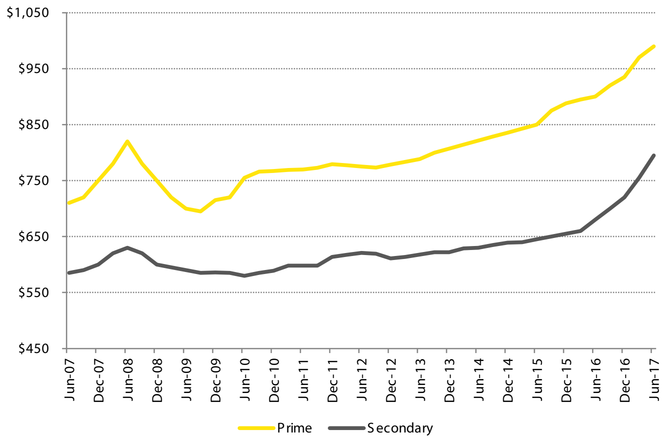
Source: Property Council of Australia

Vacancies across the Sydney CBD have been outstanding maintaining this location as the best performing CBD across Australia. Total vacancies improved to 5.9% this period off the back of substantial improvements in the Premium grade assets which grew over the prior year due to the completions at International Towers without full commitment. This premium quality grade now represents vacancy of 9.5% down from 12.5% last period, A grade also falling to 3.6% from 4.1%. While the smaller secondary markets all witnessed vacancies slide; B grade growing from 4.0% to 5.8% this period, C up to 6.9% from 6.6% while the small D market also increased to 3.8% from 2.9%. Encouraging however has been the limited sub lease space, across the total market, this now only accounting from 0.3% of the total vacant stock, down from 0.7% 12 months prior.

High demand and stable net stock levels have done much to keep vacancies low across the Sydney CBD office market, while many tenants have traded up to higher quality assets during this time of high supply completions however affordability continues hamper many occupiers.

Sydney CBD Office

Net Face Rents ($/sqm)



Source: Ray White

The Sydney CBD office market is in a unique rental position, with the supply and withdrawal environment aiding this prolonged low vacancy. With a need for tenants to be relocated due to withdrawals, coupled with high employment growth driving the increasing need for space; net face rents have respond favourably and incentives have moved down. Over the last year prime net face rents recorded a 10.0% increase, to average $990/sqm yet within a range of $850/sqm to $1,100/sqm or up to $1,400/sqm in Premium quality buildings. Incentives in this market have improved considerably given the strong demand for space and now represent around 15% or slightly higher for larger, new premium stock.

Secondary assets have however been the stand out performer, the rising issue of affordability has seen a high demand in secondary assets; this is confirmed by the tight vacancy situation across the B, C and D grade assets. Net face rents across secondary can range widely between $650/sqm and $1,000/sqm with the current average recorded at $795/sqm representing a strong 16.9% annual growth rate. While this market has been showing considerable growth over the last three years, this last year has seen a greater urgency by vacating tenants as well as new players into the market creating greater competition and this outstanding rate of growth.

Recent Office Leasing Transactions

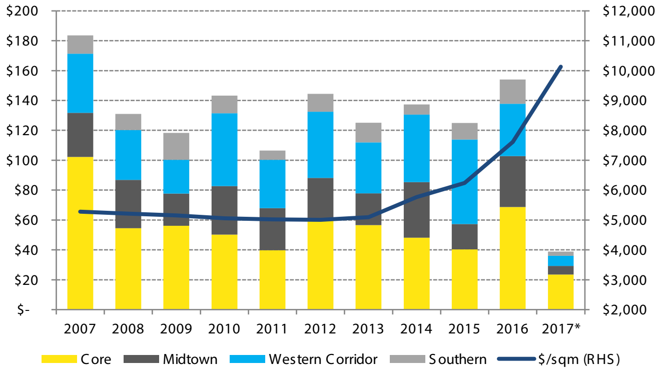
Address	Area (sqm)	Lease Start Date	Lease Term	Gross Face Rent ($/sqm)	Tenant Name
Part 26, Tower 1, 100 Barangaroo Ave	1,019	Oct-17	6	$1,303	Coverforce International Pty Ltd
Level 10 & 11, 66 Clarence Street	1,737	Sep-17	6	$795	United Office Services
Level 13 & Suite 601, 111 Elizabeth Street	1,118	Sep-17	10	$840	Clarence Professional Group
Suite 902, 66 Clarence Street	393	Aug-17	5	$825	JHK Legal
10/28 O'Connell Street	483	Aug-17	4	$970	Aquasia
1/63 York Street	208	Jul-17	3	$721	Assured Legal Solutions
11.01/46 Market Street	120	May-17	3	$795	The Hypothesis Consulting
Part 3/99 York Street	144	Feb-17	4	$675	Vision Property

Source: Ray White

Rising rents bring further concerns around affordability with many occupiers being priced out of the Sydney CBD market and having to consider other regions such as North Shore, City Fringe and Parramatta who have all benefitted with their own strong increases in face rents.

Sydney CBD Strata

Volumes by Precinct v Total Capital Values



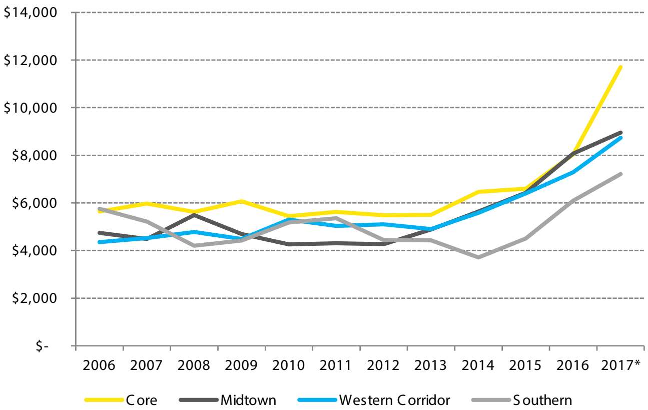
Source: Ray White, Cityscope *to August

The Sydney CBD Strata Office market continues its spectacular upward momentum in values into 2017. A large pool of eager investors continues to seek out the limited strata premises available to the market which has resulted in this value uptick. The first eight months of 2017 has resulted in $38.9million in transactions, dominated by the Core accounting for 60.3% of these sales followed by Western Corridor and Midtown attributing 17.6% and 14.9% respectively. While these volumes are down, historically there has been a busier end to the year, but based on current results these sales levels are unlikely to reach the $154.0million recorded last year. This limited pool of sales for 2017 has yielded a high capital value rate of $10,127/sqm, up 33.0% over the last year after the 22.1% growth on the prior year. While this rate is outstanding it represents an average of the varying quality grades across the CBD and market precincts, we have witnessed a wide range of results this year setting new high benchmarks.

While we have seen high demand for stock during 2017 by investors, owner occupiers are also actively pursue these investments, with the substantial rising rents the major catalyst. As such we have seen the average price paid per strata premises average over $1million for 2016 and 2017 compared to just $844,000 in 2015.

Sydney CBD Strata

Capital Value by Precinct ($/sqm)



Source: Ray White, Cityscope *to August

While the average growth rate across the total Sydney CBD has shown high value increases, looking at the individual CBD office precincts continues to yield outstanding results. The stand out performer during 2017 has been the Core, accounting for more than half of all transactions; these values have been consistently high resulting in an average of $11,711/sqm which is up 45.7% on last year. This market has seen sales with capital values ranging between $6,000/sqm to close to $15,000/sqm while a broad range the bulk of transactions has occurred in the upper price range keeping the average high. Midtown and Western Corridor values have now narrowed with Midtown recording 10.9% improvement in the last year to $8,955/sqm while Western Corridor has represented 19.9% growth to $8,737/sqm. While only a small sample size and historically volatile in nature, the Southern precinct has only recorded a couple of sales yet continue the upward momentum started last year increases 18.3% to $7,214/sqm. With limited available stock and a growing investment pool of buyers, values are likely to continue to grow throughout 2017 with the outlook beyond that dependant on the broader market conditions.

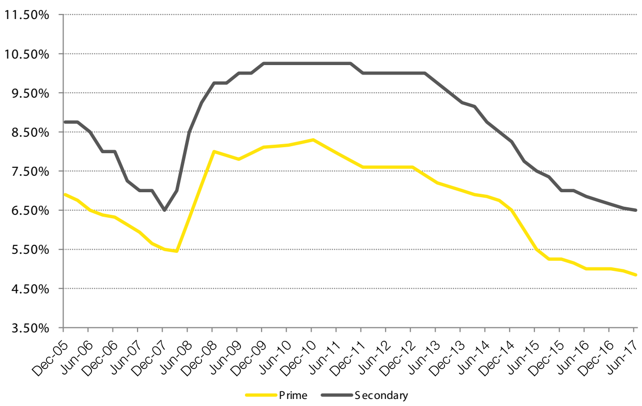
Recent Office Strata Transactions

Address	Region	Area (sqm)	Sale Price	Sale Date	$/sqm
37 Bligh Street	Core	43	$641,000	Aug-17	$14,907
105 Pitt Street	Core	141	$1,692,000	May-17	$12,000
229 Macquarie Street	Core	72	$864,000	May-17	$12,000
368 Sussex Street	Western Corridor	13	$138,000	May-17	$10,615
321 Pitt Street	Midtown	65	$660,000	Apr-17	$10,154
109 Pitt Street	Core	62	$750,000	Apr-17	$12,097
99 York Street	Western Corridor	204	$1,860,000	Apr-17	$9,118
22 Market Street	Western Corridor	76	$730,000	Mar-17	$9,605

Source: Ray White

Sydney CBD Office

Investment Yields



Source: Ray White

The Sydney CBD Office market continues to be firmly on the international radar as a location of interest. This spotlight has been on the market due to its size and profile as the economic capital of Australia together with the attractive locational attributes of the city. This has done much to move investment yields downwards over the past five years achieving new lows for both prime and secondary stock. While overseas investment levels may look to subside, the weight of domestic funds competing for quality stock has continued this reduction, with the recent example of the half stake in MLC Centre to DEXUS Property Group on a 4.50% reported yield highlighting this local trend. Current Prime yields now average 4.85% while Secondary assets now average 6.50% within a broader range, yet the gap between the prime and secondary continues to narrow.

Strata stock has also been highly sought after by both investors and owner occupiers looking to shelter from the ongoing rental increases. There have been few investor transactions for this market in 2017, attracting new highs in capital values with yields as low as 5.00%.

There is some uncertainty surrounding the next steps for the Sydney CBD office market, while results are robust today and high absorption is anticipated towards the end of the year which is likely to keep vacancies low.

Completions during 2018 and beyond and the somewhat unsustainable trajectory of rental growth and yield compression we have seen may result in a change in sentiment and confidence. This could result in a slowdown in activity and growth albeit still keeping Sydney CBD as one of the most sought after assets or business location across Australia.

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