RESEARCH

SYDNEY CBD

OFFICE MARKET OVERVIEW SEPTEMBER 2014

HIGHLIGHTS

Strong capital inflow and record transaction volumes are continuing to underpin a firming in yields, however recent compression more pronounced amongst secondary grade assets.

The mild recovery in tenant demand over the past 12 months is forecast to continue with moderate organic growth in FY15 to be supplemented by non-CBD tenant inflow.

Approximately 98,673m² (2.0% of total stock) may be withdrawn between now until the end of 2016, however a further 134,762m² of projects have been identified as potential conversion opportunities.

KEY FINDINGS

CBD vacancy rate fell in H1 2014 from 9.0% to 8.4%. Net supply factors have resulted in a prime vacancy rate of 9.1% exceeding the secondary rate of 7.5%.

Vacancy expected to remain sub 9% over the next two years before increasing to almost 10% by the end of 2016 .

In the 12 months to July, prime face rental growth measured 3.1%, however growth was a more modest 0.5% on an effective basis.

YTD 2014 commercial sales amount to $2.78bn and are on track to imminently surpass the record high of $3.06bn recorded in 2013.

NICK HOSKINS
Director—NSW Research

SUPPLY & DEVELOPMENT

With 10 projects in excess of 10,000m² currently under construction, office completions are set to pick-up from mid-2015. However with pre-commitment levels measuring 55%, the impact on vacancy will be more pronounced when refurbished backfill re-enters the market from mid-2016.

The relatively soft period of supply within the Sydney CBD market over the past three years continued in the first half of 2014 with negative net supply of 6,518m². This was the third half yearly period of negative net supply in the last three years and has resulted in supply levels since the beginning of 2012 increasing at only 25% of the long term average rate. Nevertheless, one new development reached completion, being TransGrid's 14,000m² development at 180 Thomas Street in the Southern precinct. While part owner occupied, the building is now 61% leased.

The next 12 months is expected to see several larger developments reach completion with gross supply forecast to total 103,153m², equivalent to around two thirds the long term rate. This total predominantly comprises Deco at 155 Clarence St (developed by St Hilliers 12,000m², 56% committed) and Macquarie's development at 50 Martin Place (21,443m² for owner occupation) in 2014 followed by 20 Martin Place (Pembroke ~16,000m²) and 5 Martin Place (DEXUS/Cbus 31,280m², 44% committed) in the first half of 2015.

From mid-2015 to the end of 2016 the supply cycle is forecast to increase to above average levels with 361,050m² due to reach completion (excluding refurbs). The first Barangaroo tower to complete, T2, is due in the second half of 2015 (Lend Lease 88,200m²) with the second two towers completing in 2016 (77,800m² & 101,050m²). Other major projects include 200 George St (Mirvac/AMP, 39,000m²) and 333 George St (Charter Hall 14,000m²).

Although pre-commitment levels for new projects due to complete between mid-2014 and the end of 2016 amount to 54.8%, a number of large backfill options in excess of 15,000m² are expected to become available from 2016. The large pre-commitments at Barangaroo are the major source of such backfill, comprising KPMG (10 Shelley Street, 27,500m²), Lend Lease (30 The Bond, 17,000m²), Gilbert + Tobin (2 Park St, 9,280m²), Westpac (multiple tenancies, approximately 60,000m²), PWC (201 Sussex St, 33,382m²) and HSBC (580 George St, 13,130m²). The other significant backfill option is from EY (including some sub-lease space), amounting to 28,800m² at 680 George St.

Alleviating the impact of new supply on stock (and vacancy) levels has been substantially strong demand, particularly from offshore buyers, for residential conversion opportunities (refer sales commentary). The majority of these projects, however, are located south of Park St in either the Midtown or Southern precincts, as opposed to the bulk of new supply, which is located in the Core and Western Corridor precincts. It is estimated that approximately 98,673m² (2.0% of total stock) of office stock may be withdrawn between now until the end of 2016, however a further 134,762m² of projects have been identified as potential conversion opportunities, therefore underpinning an extended period of above average withdrawals.

TABLE 1

Sydney CBD Office Market Indicators as at July 2014

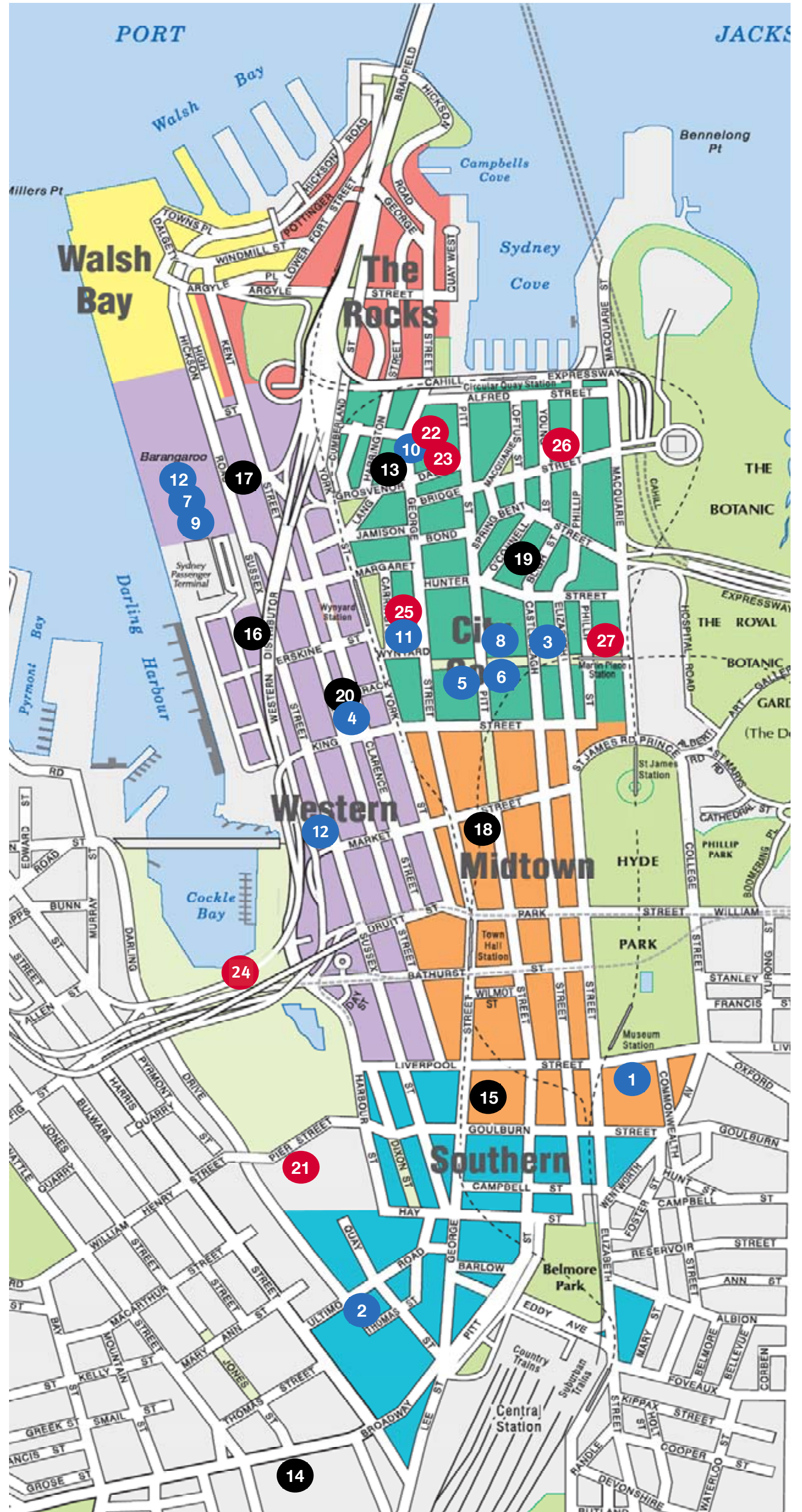
Grade	Total Stock (m²)	Vacancy Rate (%)	Annual Net Absorption (m²)	Annual Net Additions (m²)	Average Gross Face Rent ($/m²)	Average Incentive (%)	Average Core Market Yield (%)
Prime	2,608,826	9.1	30,033	78,272	725 -1,075	30.0 - 32.0	5.75 - 7.00
Secondary	2,343,362	7.5	27,239	-23,138	575 - 675	30.0	7.50 - 8.50
Total	**4,952,188**	**8.4**	**57,272**	**55,134**			

Source: Knight Frank/PCA NB. Average data is on a weighted basis

MAJOR OFFICE SUPPLY

1. 175 Liverpool Street# - 13,500m²
   GIC - H2 2013 & H1 2014 - 61% committed≈
2. 180 Thomas St - ~14,000m² [Transgrid/Amadeus]
   Transgrid - Q1 2014 - 61% committed
3. 50 Martin Place# - 21,443m² [Macquarie‡]
   Macquarie Group - Sept 2014 - 100% committed
4. Deco, 155 Clarence St - ~12,000m² [Tyro Payments]
   St Hilliers - Q4 2014 - 56% committed
5. 1 Martin Place# (ex Macquarie) - ~40,000m² [DLA Piper/APRA]
   Charter Hall Office Trust - 2014 & 2015 - 83% committed
6. 5 Martin Place - 31,280m² [Ashurst]
   DEXUS/Cbus - Q1 2015 - 44% committed
7. Barangaroo T2 - 88,200m² [Westpac/Gilbert + Tobin]
   Lend Lease* - Q4 2015 - 81% committed
8. 20 Martin Pl# - 15,920m²
   Pembroke Real Estate - Q4 2015
9. Barangaroo T3 - 77,800m² [KPMG/Lend Lease]
   Lend Lease* - 2015/16 - 75% committed
10. 200 George St - 38,000m² [EY]
    Mirvac/AMP - H1 2016 - 74% committed
11. 333 George St - ~14,000m²
    Charter Hall Core Plus Office Fund - Q2 2016
12. Barangaroo T1 - 101,500m² [PWC/HSBC]
    Lend Lease* - H2 2016 - 34% committed
13. Grosvenor Place, 225 George St# (ex Ashurst) - 10,000m²
    DEXUS/Investa/CSC - 2015
14. Central Park - up to 25,000m²
    Frasers - 2016+
15. 680 George St - 28,800m² # (ex EY)
    Brookfield/Arcadia - 2016+
16. 10 Shelley St# (ex KPMG) - 27,500m²
    DEXUS/Brookfield - 2017
17. 30 The Bond, 30 Hickson Rd# (ex Lend Lease) - 16,000m²
    DEXUS - 2017
18. 55 Market St# (ex WBC) - 15,776m²
    Investa - 2017
19. 33 Bligh St - 26,000m²
    Energy Aust./Investa - 2018
20. 151 Clarence St - 21,000m² [Arup]
    Investa - 2018 - 28% committed
21. SICEEP The Haymarket - 22,000m²
    Lend Lease - 2016+ - Concept Plan Approval
22. 182 George & 33 Pitt Sts - ~40,000m²
    Lend Lease - 2017+
23. George, Underwood & Pitt Sts - 40,000m²+
    Mirvac - 2017+
24. The Ribbon, 1 Wheat Rd - 38,000m²
    Markham/Grocon/SHFA - 2017+
25. 289-307 George St (City One) - 65,000m²
    Brookfield - 2018+
26. Quay Quarter Sydney» - ~40,000m²
    AMP - 2018+ - Concept Plan Approval
27. 60 Martin Place - ~38,000m²
    Investa/Gwynvill Properties - 2018+

- Blue: Under Construction/Complete
- Black: DA Approved / Confirmed / Site Works
- Red: Mooted / Early Feasibility



Source of Map: Knight Frank

NB. Dates are Knight Frank Research estimates
Includes select CBD major office supply (NLA quoted)
Major tenant precommitment in [brackets] next to NLA
Major refurbishment/backfill ‡ owner occupier
≈ precommitment % refers to NLA of partial refurbishment and not total building NLA

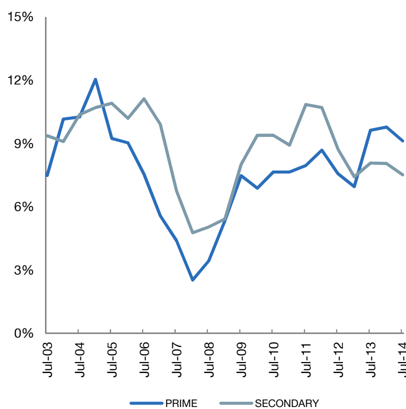
* in conjunction with co-capital partners CPPIB, APPF Commercial, First State Super, Telstra Super and APG

» Proposal involves amalgamation of 33 Alfred St, 50 Bridge St and various buildings in Young and Loftus Streets into one precinct. Permissable NLA to be transferred between sites with net NLA increasing circa 40,000m².

TENANT DEMAND & RENTS

The momentum generated in the Sydney CBD market in the second half of 2013 has continued into 2014 with the six months to July 2014 posting positive net absorption of 23,983m². This was the second highest absorption result in the country behind Melbourne CBD and the highest when measured over a 12 month period. On the back of this positive absorption, the CBD vacancy rate contracted from 9.0% in January to 8.4% as at July.

FIGURE 1
Sydney CBD Vacancy Rate
By Grade (%)



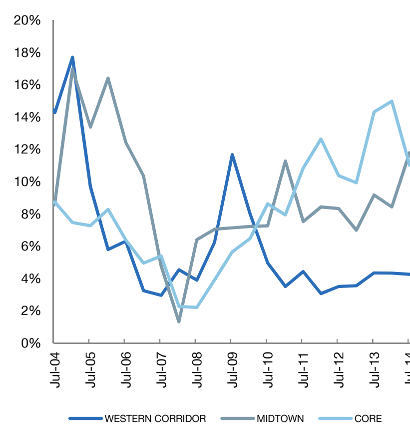
Source: Knight Frank/PCA

Unusually, the prime vacancy rate at 9.1% is higher than the secondary rate at 7.5%, a trend that has been present since the beginning of 2013, although not previously experienced since the beginning of 2005. This divergence, however, has been supply driven with the prime market experiencing positive net supply and the secondary market declining in size given a number of stock withdrawals (prime net supply of 109,914m² last two years vs –53,284m² for secondary). It is likely that withdrawals will continue to characterise the secondary market over the medium term given the high volume of change of use withdrawals currently in the pipeline (refer Supply page 2). Amongst the major precincts, the Western Corridor continues to exhibit the tightest prime vacancy rate at 4.3% with the Core and Midtown measuring 11.0% and 11.8% respectively.

As the market progresses through the early stage of a mild recovery, there appears to be several sectors supporting growth. This includes the Technology Media Telecommunications (TMT) sector, where a number of positive leasing outcomes have been achieved with tenants such as LinkedIn, iinet and Freelancer all signing recent deals. Although the sector only accounts for an estimated 6.0% of CBD white collar employment at present, there is scope for this to grow substantially given around 150,000m² of tenant enquiry from the sector is currently in the market. Education, the country's fifth largest export, has been another sector performing well with deal flow from groups such as Think Education and Open Colleges adding to net absorption.

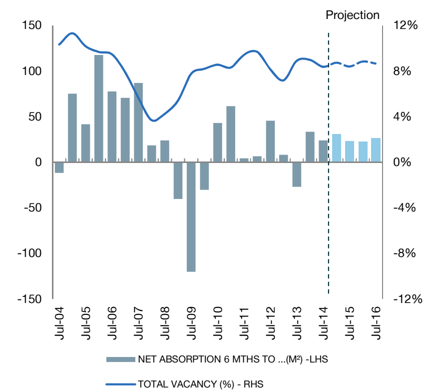
While previous research notes have referred to the need for sub-5,000m² tenants to drive growth into 2015 and 2016 (given the bulk of large users have already made space commitments), it is worth noting that many of the aforementioned deals have evidenced improved activity at the small and medium end of the market. This was reflected in the pick-up in tenant demand for B-grade assets, where positive net absorption of 22,431m² in the first half of the year marked the strongest result since the second half of 2010.

FIGURE 2
Sydney CBD Vacancy Rate
By Precinct (%)



Source: Knight Frank/PCA

FIGURE 3
CBD Net Absorption & Vacancy
per six month period (000's m², %)



Source: Knight Frank/PCA

Leasing conditions in the CBD's largest sector, Finance and Insurance (29.7% of CBD workforce), remain relatively subdued in terms of leasing enquiry with the sector accounting for the bulk of sub-lease options in the market. However, with credit growth moving to six year highs, a pick-up in M&A activity and positive signs from the US economy, a number of factors are providing the basis for some potential improvement.

Although organic demand growth in FY2015 is anticipated to remain modest, yet positive, total demand is expected to be supplemented by a number of non-CBD tenants relocating to the CBD. So far, new leasing deals with groups such as TAB, Havas Worldwide and Unilever amongst others amount to approximately 19,000m² of tenant inflow that will be reflected in net absorption data over the coming 12 months. Although historically high incentive levels in the CBD have worked to entice tenants, some tenants have also been attracted to the larger floor plate sizes available in the CBD, particularly given below average post-GFC supply levels have been more pronounced in non-CBD locations. The result of this boost is for CBD occupancy growth in FY2015 akin to trend.

Anticipated Vacancy Levels

A combination of stronger than anticipated absorption, above average

withdrawal projections and several supply projects not proceeding (eg. 430 Pitt St, reduced NLA at Central Park) has resulted in a lower medium term forecast vacancy rate compared to expectations at the beginning of the year. Although supply volumes will increase from mid-2015, the withdrawals of backfill space for refurbishment is expected to result in a lagged timing effect on net supply. As such, net supply is forecast to impact the vacancy rate most acutely in the second half of 2016. The resulting vacancy rate is therefore expected to remain sub 9% over the next two years before increasing to almost 10% by the end of 2016. It is noted that several tenant briefs considering partial decentralisation into non-CBD locations have been circulated in the market, however these have not been reflected in the forecasts given the absence of certainty or confirmation.

Rental Levels

As at July, annual growth in Prime face rents had increased 3.1% to $935/m² gross ($776/m² net). However on an effective basis growth was a more modest 0.5% as a result of average incentive levels increasing to 31% (gross basis). Nevertheless, this was an encouraging sign of improvement given it partly reversed the drop in effective rents experienced during 2013. Amongst the precincts, there has been some evidence of stronger rental growth in the Western Corridor compared to the Core and Midtown precincts, a likely reflection of the tighter prime vacancy rate as well as some uplift resulting from the improved amenity the precinct will enjoy from the Barangaroo development. Nonetheless, it is noted several large backfill options will potentially add to the precinct's vacancy rate in 2015 and 2016.

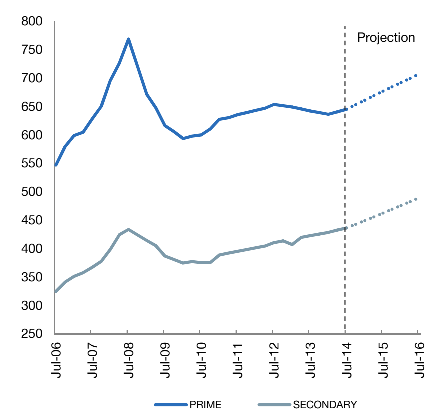
Underpinned by the turnaround in B-grade demand, rents in the secondary market have been tracking above the prime rate with annual gross face rental growth of 4.5% as at July, with effective growth measuring 3.3%. Average secondary gross face rents as at July measure $623/m² ($494/m² net) with gross incentives at 30.0%.

Despite near term demand being boosted by some tenant inflow, the medium term outlook is expected to remain commensurate with the moderate level of organic demand growth with prime face rental growth over the next two years forecast to average 2.5%. However, this growth is anticipated to be boosted somewhat by a gradual fall in average incentives from current levels of 31% to 28.5% by mid-2016, although still significantly above the 10 year average of 24.5%. Rental growth is likely to be slightly stronger in the secondary market given the improvement in demand from smaller tenants as well as the secondary market being less impacted by the uptick in the supply cycle.

FIGURE 4

Average Gross Effective Rents

Sydney CBD ($/m²)



Source: Knight Frank

TABLE 2

Recent Leasing Activity Sydney CBD

Address	Precinct	NLA (m²)	Term (yrs)	Lease Type	Tenant	Sector	Start Date
151 Clarence St	Western	5,900	10	Precomm	Arup	Business Services	H1 2018
Barangaroo T1	Western	c.26,500	10+	Precomm	PWC	Business Services	2016
Barangaroo T1	Western	c.8,000	10+	Precomm	HSBC	Finance & Insurance	2016
201 Kent St	Western	3,482	3	Renewal	Arup	Business Services	Oct-15
155 Clarence St	Western	1,600	8	Precomm	Havas Worldwide*	TMT	Q1-15
680 George St	Midtown	1,842	c. 4	New	Think Education*	Education	Feb-15
680 George St	Midtown	4,807	10	New	TAB*	Gaming	Jan-15
255 George St	Core	5,400	10	New	Bupa	Healthcare	Jan-15
2 Park St	Midtown	2,700	10	New	Unilever*	Consumer Goods	Dec-14
201 Kent St	Western	1,325	5	New	De Lage Landen	Finance & Insurance	Dec-14
155 Clarence St	Western	3,792	7	Precomm	Tyro Payments	TMT	Nov-14
180 Thomas St	Southern	c.4,600	U/D	Precomm	Amadeus IT Group	TMT	Oct-14
1 York St	Western	474	8	New	GRC Solutions	Education	Oct-14
1 Farrer Place	Core	1,481	10	New	The Executive Centre	Business Services	Jul-14
201 Kent St	Western	2,650	7	Renewal	Austrade	Government	May-14
201 Elizabeth St	Midtown	1,063	10	New	SGE Credit Union	Finance & Insurance	May-14
123 Pitt St	Core	1,500	5	Sub-lease	Credit Union Australia	Finance & Insurance	Feb-14

Source: Knight Frank TMT refers Technology Media & Telecommunications * Tenant re-locating to CBD

INVESTMENT ACTIVITY & YIELDS

The weight of capital moving into Australian property has maintained its momentum in 2014 with high levels of capital inflow continuing to result in heightened transaction volumes and firming yields. Year to date sales ($10m+) currently amount to $2.78 billion and are on track to imminently surpass the record high of $3.06 billion recorded in 2013. (Note. sales volume data excludes Sydney CBD assets included in $3.3bn DEXUS takeover of CPA).

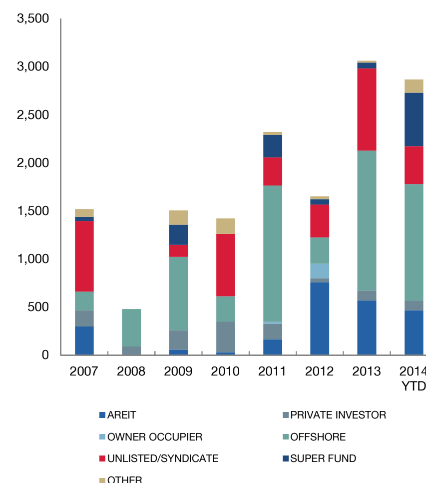
Strong demand from offshore buyer groups remains a key driver of demand on both a gross and net basis. Since the beginning of 2014, offshore buyers have accounted for 45% of purchases with capital chasing both prime core assets (where available given limited opportunities), but also secondary assets. Buildings with re-development/ change of use potential remain competitively sought, particularly those for residential development. Assets with such potential have traded at substantial premiums to metrics based on office usage on a going concern basis, with the average premium above book value equating to circa 35%, as measured from a sample of transactions recorded over the past 12 months. However, offshore secondary demand has not been limited to developers with some strong outcomes achieved on B-grade assets such as 299 Elizabeth St. The transaction reflected a relatively firm 6.3% core market yield, notably firmer than the average range, however indicative of the strong competition amongst offshore buyers for more 'digestible' sub $50 million assets.

Local Funds, both listed and unlisted, have been active traders of assets with portfolio re-balancing and capital management initiatives resulting in local buyer groups being net sellers over the past 18 months (refer Figure 6, page 7). In some cases, however, sales have been instigated via pre-emptive rights such as 201 Kent St and 10 Shelley St. While these two examples stemmed from the DEXUS takeover of CPA, it is noted that DEXUS have announced all other pre-emptive rights triggered as a consequence of the takeover have now been satisfied. Value add opportunities, either via re-leasing or repositioning, remain on the radar for local funds with examples including IOF's acquisition of

FIGURE 5

Sydney CBD Sales $10 million+

By Purchaser Type ($m)



Source: Knight Frank

TABLE 3

Recent Sales Activity Sydney CBD

Address	Price ($ mil)	Core Mkt Yield (%)	NLA (m²)	$/m² NLA	WALE (yrs)	Vendor	Purchaser	Sale Date
66 Goulburn St	136.00	7.70	23,298	5,838	1.9	Charter Hall*/Australand	GDI Property Group	Jul-14
50 Carrington St	88.00	7.30	11,277	7,804	3.7	DEXUS	Brookfield	Jul-14
1-3 Munn St	c.38.0†	N/A†	3,843	9,888	1.0	Woodben P/L	Owner Occupier	Jul-14
52 Martin Pl	555.00	5.65›	39,138	14,181	33.0›	QIC	REST Industry Super	Jun-14
201 Kent St≈	173.00#	7.00	39,930	8,665	4.5	DEXUS/CPPIB	Investa (ICPF)	Jun-14
6-10 O'Connell St	134.95	7.50	16,317	8,271	2.2	Blackrock Property	Investa (IOF)	Jun-14
59 Goulburn St	90.20	8.20	19,523	4,620	2.9	Charter Hall Office Trust	Roxy-Pacific Holding	Jun-14
151 Macquarie St	52.80	5.50	4,532	11,650	2.0	Lambardi Pty Ltd	CorVal~	Jun-14
280 George Street‡	50.00	6.75	5,123	9,761	2.3	Arena Invest. Mgmt.	Toga Far East Hotels	Jun-14
299 Elizabeth St	45.00	6.30	5,975	7,532	2.0	Burcher Property Group	Chinese Private	Jun-14
10 Shelley St≈	130.60#	6.30	28,697	9,102	1.7	DEXUS/CPPIB	Brookfield	May-14
88 Cumberland St	26.35	8.20	4,675	5,636	3.5	St Hilliers	Intrasia Oxley	May-14
275 Kent St	435.00#	5.96»	77,125	11,280	4.0	Mirvac	Blackstone	Apr-14
1 Castlereagh St	69.40	c.7.60	11,687	5,938	3.1	Mirvac	Blackstone	Apr-14
234 Sussex St[1]	61.00	U/D	11,067	5,512	2.6	AMM Property Holdings	Meriton	Apr-14

Source: Knight Frank *Charter Hall PFA Diversified Property Trust ‡ bought for potential hotel redevelopment ~ on behalf of offshore mandate
› Excluding the present value of abnormally long WALE reflects a normalised yield of 5.90% # 50% share ≈ acquired under pre-emptive rights
† circa 70% vacant possession and bought by owner occupier. Property located in Millers Point. ł bought for potential residential redevelopment
» Risk adjusted yield captures major tenant Westpac's partial exit option in 2016 and lease expiry in 2018. On a non-risk adjusted basis core yield measures 6.55%

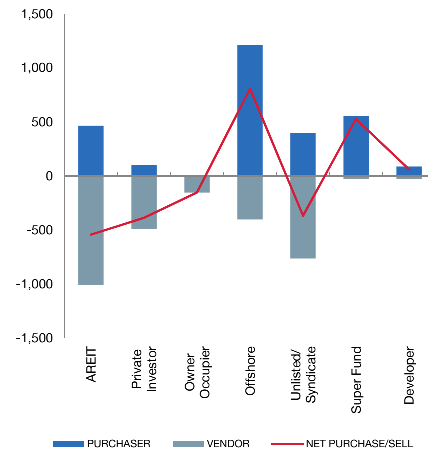
6-10 O'Connell St. The July sale of 50 Carrington St by DEXUS for $88 million after undertaking a capital expenditure program and leasing-up the buildings vacant space demonstrates the success local groups have achieved with this strategy.

In the year's largest two transactions, 52 Martin Place ($555million acquired by REST Industry Super) and 275 Kent St ($435 million, 50% share acquired by Blackstone), the market has confirmed buyer interest at sub 6% core market yields. This has evidenced some further firming in prime yields with the average prime range between 5.75% and 7.00%, reflecting approximately 75bps of tightening so far over the course of the tightening cycle that commenced around three years ago. It is understood that a number of competitive bids were submitted for 52 Martin Place, which, given the deal size, provides some indication of the magnitude of unsatisfied capital in the market seeking very limited prime opportunities.

However over the past six months, yield compression has been more pronounced in the secondary market with average secondary yields ranging between 7.50% and 8.50%. This takes cumulative firming for secondary assets to 65bps at this stage of the cycle. While partly a reflection of increased appetite for core plus and value add opportunities as well as competition from developers seeking alternative use sites, there appears a degree of catch-up with the spread between prime and secondary starting to revert to long run average levels. As per Figure 7, after moving out to 165bps, the spread now measures 139bps, however is yet to fully revert to the 10 year average of 124bps. Accordingly, favourable cyclical buying opportunities remain.

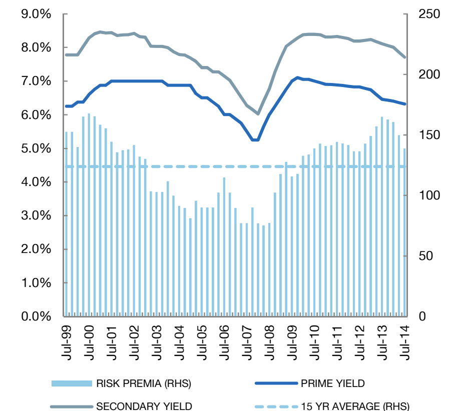
In relation to historical averages, prime yields are approximately 15bps tighter than the 10 year average after trending below the average at the end of 2013. In contrast, secondary yields have firmed to a level in line with the 10 year average, albeit with the anticipation of moving below the average over the balance of 2014 given the sales momentum in this part of the market.

FIGURE 6
Sydney CBD Purchaser/Vendor
$10 million+ sales - 2013 and YTD 2014



Source: Knight Frank

FIGURE 7
Sydney CBD Yields & Risk Spread
Core Market Yields & Prime vs Secondary Spread (bps)



Source: Knight Frank

Outlook

- In terms of tenant demand, the recent outperformance of non-mining capital cities is starting to evidence a broadening in economic drivers to the benefit of Sydney CBD office.
- Led by demand from the Technology Media and Telecommunications sector, net absorption is expected to track at trend levels over both FY15 and FY16, albeit the former boosted to a degree by tenant inflow.
- The relatively tighter secondary vacancy rate is likely to continue in the medium term given the improvement in deal flow amongst smaller tenants and the new supply entering the market over the coming 30 months.
- The two year outlook for prime rental growth is forecast to reflect the early stages of the recovery in tenant demand. Face rental growth inline with CPI (2.5% p.a.) to be enhanced by the early stages of reducing incentives.
- Firming demand amongst B-grade assets expected to sustain some rental outperformance from better quality secondary assets.
- Capital inflow and transaction activity expected to maintain the downward bias for yields. However the reversion in yield spreads between prime and secondary assets to long run levels that started in the first half of the year is likely to see secondary compression moderately exceed that of prime in the next 6 to 12 months.
- Prime yields are yet to compress to the same level as the two years preceding the market peak in 2007. While sales momentum and lower borrowing costs remain supportive for further tightening, it is noted that a comparatively lower outlook for rental growth is likely being reflected in IRRs. Notwithstanding the impact of offshore capital inflow, this may provide a degree of headwind to the extent of further yield compression, particularly until a more enduring improvement in rental growth takes hold.

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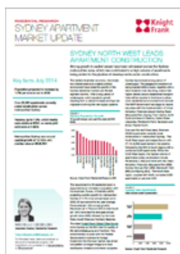

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