Investa *Inside*

Office Market Outlook

September 2022

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Introduction

"While Australia navigates the economic challenges of supply constraints, high inflation and increasing interest rates, Australian office leasing markets have established some positive momentum in the recovery to COVID-normality.

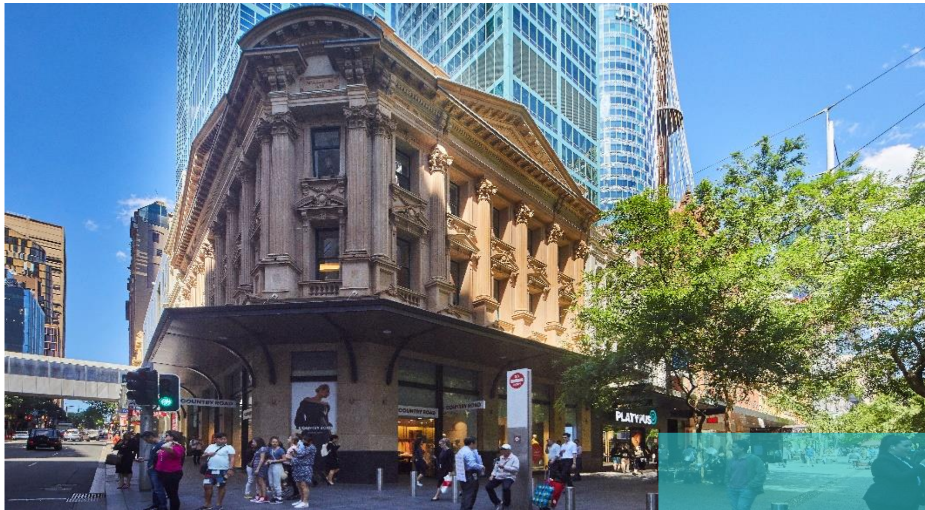
Strong growth in office-based employment has supported a clear 'flight to quality' trend in office leasing activity through the first half of 2022. Office leasing has revealed a drive for tenants to upgrade to higher grade office space to address a need for well located, technology enabled, sustainable office space with positive local amenity. This has been reflected with strong pre-commitment levels to new office development projects completed in 2021-22.

Looking ahead, Australian CBD office markets will continue to face some challenges. However, recent momentum reveals positive underlying demand for high quality office space, which is expected to support further recovery in Australian office market conditions in the coming year."

David Cannington
Head of Research & Strategy, Investa

Key Office Market Insights

1. ***Lower For No Longer***
   Tighter economic supply has drawn an end to the 'lower for longer' theme. However, office-based employment has surged over the past year, supporting increased office leasing demand.
2. ***New ways of working & leasing trends***
   As office-based businesses adapt to a hybrid workplace environment some common leasing trends have emerged, including a 'flight to quality', tighter workspace ratios and greater certainty in a 'return to the office'.
3. ***Market conditions, inflation & rent***
   While Australian CBD prime office rent growth has rebounded in 2022, higher inflation is expected to drive further upward pressure on office rents and maintain upward pressure on incentives.
4. ***Leasing demand & construction challenges***
   While the next wave of Australian office development faces the significant challenge of supply constraints and input price pressure, underlying tenant demand is expected to support the current wave of new and refurbished office supply.
5. ***Capital demand & financial market conditions***
   Financial market pressures are mainly challenging pricing for lower quality office assets carrying higher leasing risk. In comparison, capital values for well leased high quality prime office assets in Australia's major capital cities are showing more resilience.



1. Economic & Office Market Outlook

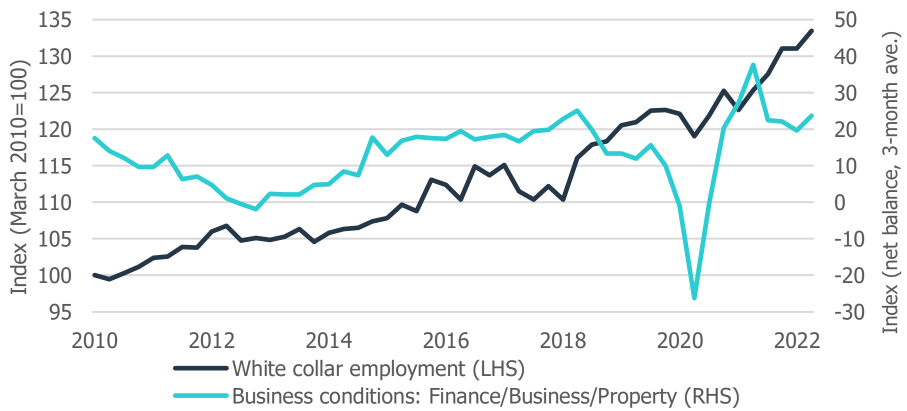
Economic Outlook: Lower for no longer

Tighter economic supply, from both domestic and global factors, has drawn an end to the 'lower for longer' theme, with inflation and interest rates unwinding from their long-term lows in recent months. Nonetheless, the shift in economic pressures has also reflected a post-COVID recovery in domestic demand conditions. Australian economic activity has rebounded strongly in 2022, with GDP 4.5% higher than its pre-COVID level.

Despite the cost and supply-chain pressures in play across the Australian economy, white-collar business sector conditions remain above the long-term average. Consequently, office-based employment growth has surged over the past year, with white collar jobs increasing by 220,000 in the 12 months to May 2022. In comparison, employment across all other sectors increased by 165,000 jobs over the same period.

Looking ahead, broadly positive underlying conditions for Australian office-occupying businesses combined with continued momentum for Australian businesses to 'return to the office' are expected to support leasing demand and office occupancy through the second half of 2022 (Chart 1.1).

Chart 1.1: Australian Office-Based Business Conditions & White-Collar Employment



Sources: Australian Bureau of Statistics, NAB & Investa Research

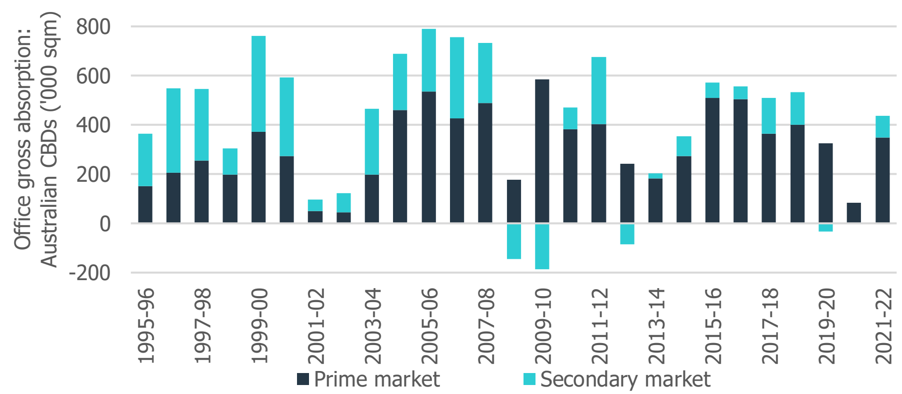
Office Market Outlook: Demand recovery gains momentum

Despite softening vacancy rates, office occupancy has gained steady upward momentum through the first half of 2022. In recent months the transition to hybrid work has challenged the 'return to the office', with employees adjusting to health and lifestyle impacts on flexible workplace arrangements.

However, a clear 'flight to quality' theme has been reflected in both occupancy and leasing market outperformance of higher quality office space. In particular, a post-lockdown release of pent-up leasing demand has flowed almost exclusively to the prime office market, with prime office space accounting for around 95% of Australian CBD leasing activity in the first half of 2022 (Chart 1.2).

Looking through the complexities of managing a hybrid workplace transition, we expect the 'flight to quality' theme to be maintained over the long-term. The capacity for prime grade workplaces to deliver on amenity, wellbeing, sustainability, technology, and connectivity for Australian office-based businesses will drive structural outperformance of higher quality office space across Australia's major capital cities.

Chart 1.2: Australian CBD Office Gross Absorption: Prime vs Secondary



Sources: Property Council & Investa Research

2. Office Demand Outlook

New ways of working emerging in leasing trends

As office-based businesses refine their office space design and utilisation in a hybrid workplace environment, leasing activity has highlighted some early-cycle trends.

As detailed in previous editions of Investa Inside, office tenant demand has primarily been driven by white-collar employment growth, with strong growth in office-based jobs supporting a solid increase in CBD office net absorption.

However, detailed leasing activity data has provided some evidence of how the 'new ways of office working' are impacting tenant demand. In particular:

- 'Flight to quality' in leasing activity
- Continued pressure on workspace ratios
- Greater certainty in 'return to the office'

Flight to quality

As highlighted previously in '*Office Market Outlook: Recovery Gains Momentum*' Australian CBD leasing activity has been led by demand for prime office space in the first half of 2022. Two factors in particular have reflected this trend; absorption and pre-commitment of new office development and relocation or upgrading to higher quality office space.

Net absorption multiplier & workspace ratios

In adopting a hybrid work model, office tenants have indicated a strong preference to increase utilisation of office space for collaboration and team-based work. This is expected to drive upward pressure on workspace ratios (leased office space per employee), and the office space multiplier.

However, counter to this expectation, leasing data is showing a continued downward trend in the office space multiplier, as businesses 'return to the office' and transition the office workspace to this business model (Chart 2.1).

Business confidence & leasing demand

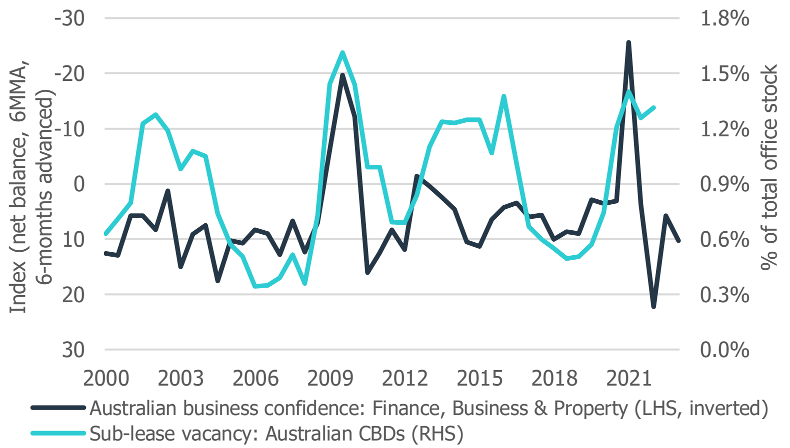
Despite a moderate correction in recent months due to higher inflation and interest rates, Australian business confidence has rebounded through 2022.

The recovery in office-occupying business confidence has been reflected in office leasing market activity (Chart 2.2). Sub-lease vacancy – an indicator of office tenant confidence – has tightened across Australia's CBD office markets. Combined with increased occupancy in Australia's major CBD office markets, this shows greater business confidence in Australia's 'return to the office'.

Chart 2.1: Australian CBD Office Space Multiplier

Sources: Australian Bureau of Statistics, Property Council & Investa Research

Chart 2.2: Australian Business Confidence vs CBD Office Sub-Lease Vacancy



Sources: Australian Bureau of Statistics, Property Council & Investa Research

3. Office Rent & Inflation

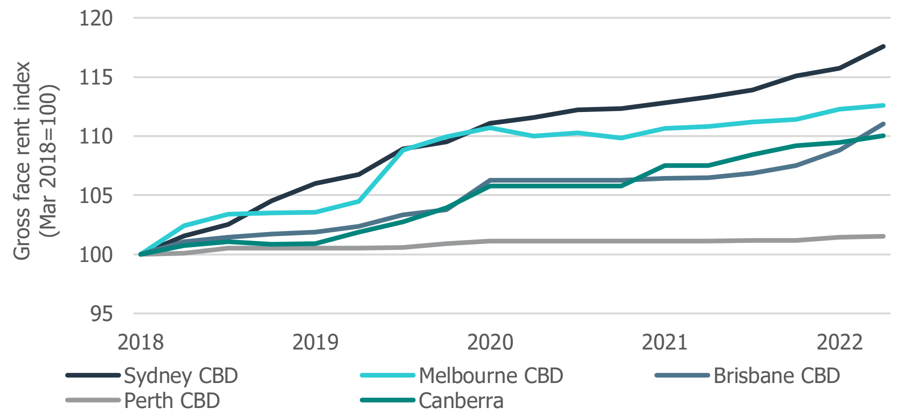
Market conditions driving upward momentum in rents

Following two years of Government-mandated rental growth restrictions through the pandemic, Australian CBD prime office rent increases have reactivated. While market conditions are in the early stages of a cyclical recovery, positive growth in Australian CBD prime office leasing demand has driven upward pressure on office rents (Chart 3.1).

Through the first half of 2022, Sydney CBD and Brisbane CBD prime office face rents have increased at annualised rate of 9% and 14% respectively. In comparison, the other Australian CBD markets have seen rents increase at more modest annualised growth rate of 5% or less.

Looking ahead, we expect tighter market conditions – reflecting an outpacing of leasing demand relative to new market supply – will continue to drive upward pressure on prime CBD office rents.

Chart 3.1: Australian CBD Prime Office Rent



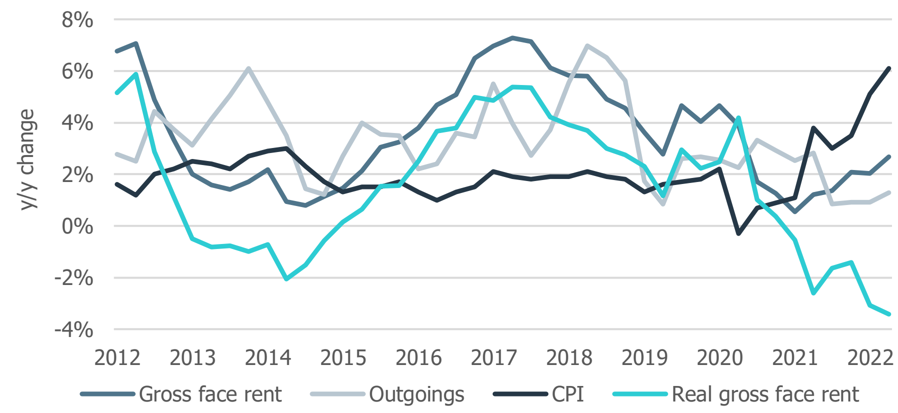
Sources: JLL Research & Investa Research

Higher inflation & economic rent

Another factor we expect will drive upward pressure on office rents is higher inflation. While rent growth in real terms (ie. adjusted for inflation) is running at the lowest rate since 2010, higher inflation will present upward pressure on nominal office rents over the coming year (Chart 3.2). In combination with positive underlying demand for Australian prime office space, this 'embedded' rent hedge will go some way to re-calibrating economic rents and partly offsetting the cost pressure on the pipeline of future office development.

Other factors are also creating headwinds to the pipeline of future office development. In addition to higher interest rates and inflationary pressure on the price of building materials, supply constraints are also adding delays to office construction timelines. Nonetheless, positive underlying demand for prime office space is driving pre-commitment levels to the office development pipeline and maintaining a supportive fundamental outlook for new office development and future office supply (see page 5: *Office Development Outlook*).

Chart 3.2: Australian CBD Prime Office Rent vs Inflation



Sources: Australian Bureau of Statistics, JLL Research & Investa Research

4. Office Development Outlook

Positive tenant demand butting heads with construction challenges

Australian office construction has faced some significant challenges through the first half of 2022, with the combined impact of supply constraints, higher interest rates and price pressure in construction materials (Chart 4.1) and labour impacting completion timelines and development feasibility.

Nonetheless, the continuation of construction activity through 2021 progressed a solid pipeline of new and refurbished office completions delivered in the first six months of 2022. In the 12 months to July 2022, 454,000sqm of additional office space was added to Australian CBD office market – the strongest financial year of net additions since 2009-10.

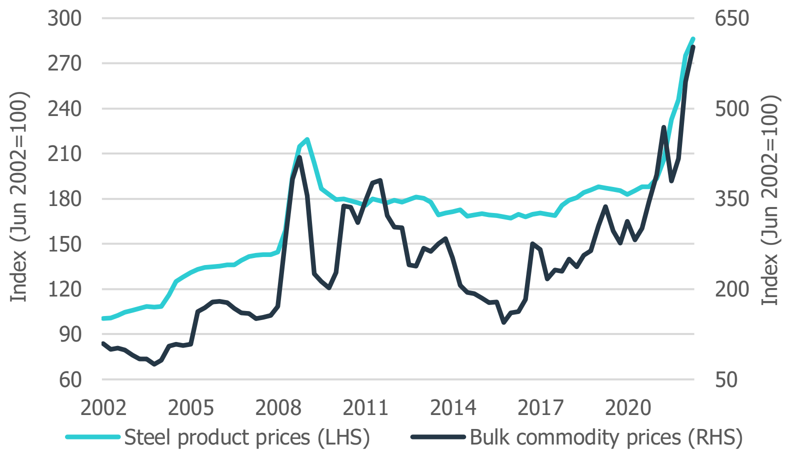
Australia's pipeline of future office development is expected to continue to shift on changes in input factors (ie. development costs, interest rates), with the planned completion timing of several projects being delayed in recent months. However, a strong underlying tenant preference for new and high-quality office space, or a 'flight to quality' leasing trend, continues to support a positive outlook for demand for high quality office development.

Over the first six month of 2022, approximately 42% of new office supply completed across Australia's CBD markets was refurbished space.

Looking ahead, we expect this trend to continue. In bearing the largest share of weakness in leasing demand conditions, capital value pressure in secondary markets and assets carrying leasing risk, is expected to maintain a solid pipeline of future office refurbishment and redevelopment activity.

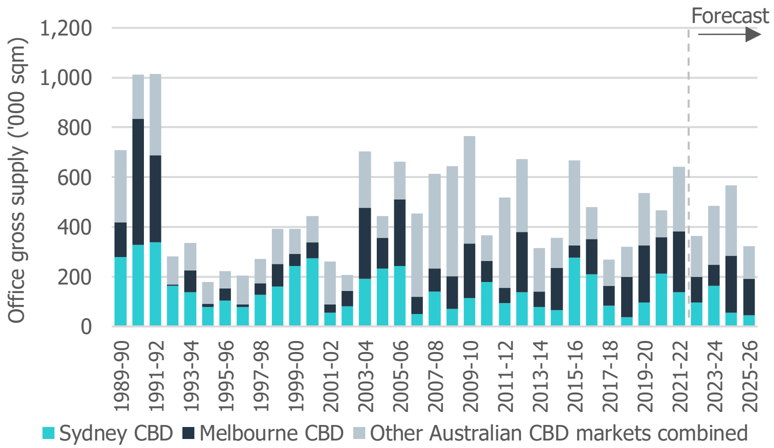
In the coming year however, office development completions and growth in Australian office supply will ease. Completed new office supply in the year to July 2023 is expected to be around half of the new supply completed in the year July 2022 (Chart 4.2).

Chart 4.1: Construction Materials Price Pressure



Sources: ABS, RBA & Investa Research

Chart 4.2: Australian CBD Office Development Activity & Forecast



Sources: Property Council & Investa Research

5. Office Capital Market Outlook

Pent up capital demand activates at a slower rate in 2022

Following the COVID-normal reactivation of cross border movement, and more free-flowing capital markets through the second half of 2021, Australian office capital market transactions eased in 2022.

Higher inflation, increased interest rates and economic uncertainty have created a 'cautious' tone across global capital markets. However, as capital sources assess the higher risk environment, high quality Australian CBD commercial office assets present as an attractive low-risk inflation hedge.

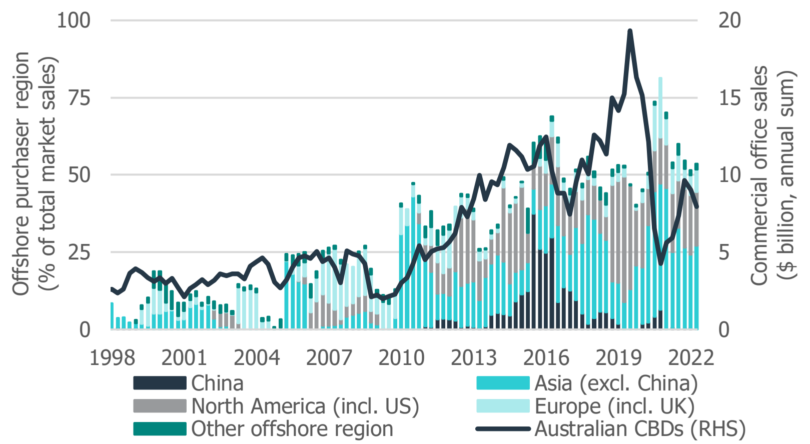
Australian office capital market transactions have eased in 2022, with approximately A$4.4bn in Australian CBD office assets transacted in the first half of 2022 (Chart 5.1). This compares to A$6.3bn and A9.7bn in the first and second half of 2021 respectively.

Looking ahead, higher returns for alternative fixed income assets are expected to impact capital values and pricing in some parts of the Australian office market. However, this is expected to mainly create downward pressure on lower quality office assets and fringe/suburban markets, carrying higher leasing risk. In contrast, higher quality assets in major CBD markets underpinned by solid leasing fundamentals will continue to offer positive inflation -hedged total returns.

Consequently, we expect to see a stronger discretionary investor appetite combined with globally competitive office market returns, to drive demand and capital market outperformance for well leased high quality prime office assets in Australia's major capital cities.

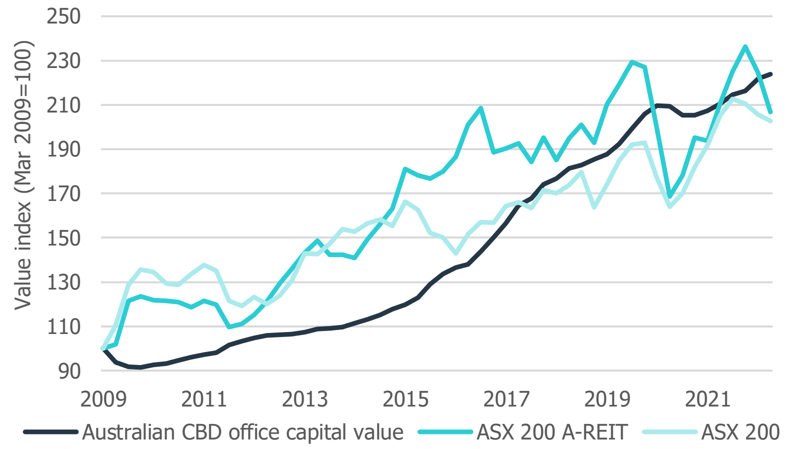
This enhanced appetite for safe-haven assets in an uncertain macro environment is expected to continue to support stable long-term capital growth of Australian CBD office assets. In comparison, returns in more cyclical asset markets, such as equity markets are likely to continue showing more volatility (Chart 5.2).

Chart 5.1: Australian CBD Office Sales & Offshore Buyers



Sources: JLL Research & Investa Research

Chart 5.2: Australian Equity Indices vs Australian CBD Capital Values



Sources: ASX, JLL Research & Investa Research investa

Further Information

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About Investa Research

Investa Research focuses on understanding the drivers and analysing the movements and trends within the Australian commercial office market. The research function is fundamental in guiding group investment strategy and decision making, as well as providing a competitive advantage through insightful analysis and forecasting.

The research team publishes regular updates on the performance of the major Australian office markets, as well as occasional papers and reports examining a broader scope of topics that may be of interest to investors, tenants and other Investa stakeholders.

About Investa

Investa is a real estate investment manager, developer and industry innovator that acquires, develops and optimises real estate assets on behalf of our partners. With more than $12.1 billion in assets under management, we create innovative and award-winning spaces and experiences for our customers, that set new standards in design, technology and environmental, social and governance (ESG) outcomes.

Regularly recognised as an employer of choice and for our market-leading diversity and inclusion practices, we strive to be at the leading edge of every real estate asset class we invest and operate in.