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Investa Inside

Office Market Outlook

December 2024

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Recovery takes hold

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Australia's major CBD office markets are showing signs of early cycle recovery, with both leasing and capital markets expected to improve through 2025.

Headwinds from the post-COVID work transition appear to be easing, as hybrid work patterns settle. Lower inflation and anticipated interest rate cuts will ease pressure on Australian business conditions. We expect macro conditions will support positive leasing demand and capital growth in the coming year.

Sydney CBD is leading the pack of Australia's major office markets in terms of positive leasing demand and capital market activity. However, Australia's other major office markets are at varying stages of cyclical recovery.

David Cannington
Head of Research & Strategy, Investa

What to expect in 2025: office market insights

1

Market conditions to tighten

We believe office demand in 2025 will strengthen, to outpace supply across Australia's major CBD office markets – for the first time since early 2020. Three factors are expected to drive increased office leasing demand in 2025:

1. Lower inflation and likely interest rate cuts are expected to improve business conditions and increase office-based business headcount.
2. Evidence indicates office tenant businesses are largely at, or near a post-COVID hybrid workplace 'steady state'.
3. High quality office stock is leading the office leasing market recovery.

2

Tenant expansion to lift demand

Our analysis indicates that office-based businesses are in the early stages of an expansion phase. Increased office-based business headcount combined with weaker post-COVID work transition headwinds are expected to support tenant expansion and leasing demand in 2025.

3

Competition for quality to intensify

Following a solid few years of new office completions, new office supply is expected to slow sharply in 2025. Constrained by high construction costs and input supply constraints, we forecast new office supply will slow to a 7-year low in 2025.

Paired with stronger underlying office leasing demand and a continued 'flight to quality, amenity & sustainability' theme, we expect this will see a material shift in major CBD office market conditions, with increased competition for high quality and well-located office stock.

4

Recovery of office capital markets

Australia's office capital markets are showing early signs of a cyclical recovery, with increased transactions activity reflecting stronger investor sentiment and an outlook for near-term decreases in interest rates and Australian bond yields. However, we expect the cyclical recovery across Australia's major CBD office capital markets to vary, with Sydney CBD prime market assets leading the pack.

Economic & office market outlook

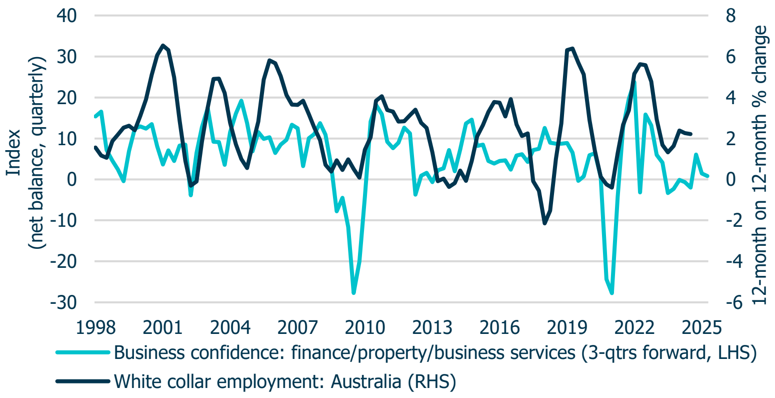
Economic outlook: Interest rate cuts approaching

Despite remaining stubbornly high, inflation finally edged within the 2-3% target range in the September quarter for the first time since Q1 2021. Combined with modest economic growth, we expect Australian policy rate cuts of around 50-75 basis points through 2025 and a further 25-50 basis points through 2026.

This is likely to ease some of the recent pressure on households, business conditions and confidence in Australia. Following subdued growth through the first half of 2024, Australia's white-collar business employment increased moderately through the second half of the year (Chart 1.1). This supported a positive rebound in office leasing demand in 2024, with Q3 Australian CBD office net absorption posting the strongest quarterly increase since 2018.

Looking towards 2025, we expect a consolidation of further gains in white-collar employment. We forecast an increase of 50-60,000 white-collar jobs across Australia in 2025 (in addition to the 73,600 jobs added in 2024 to date) will generate 180-200,000sqm additional net absorption across Australia's CBD office markets.

Chart 1.1: Australian business confidence vs white-collar employment



Sources: ABS, NAB & Investa Research

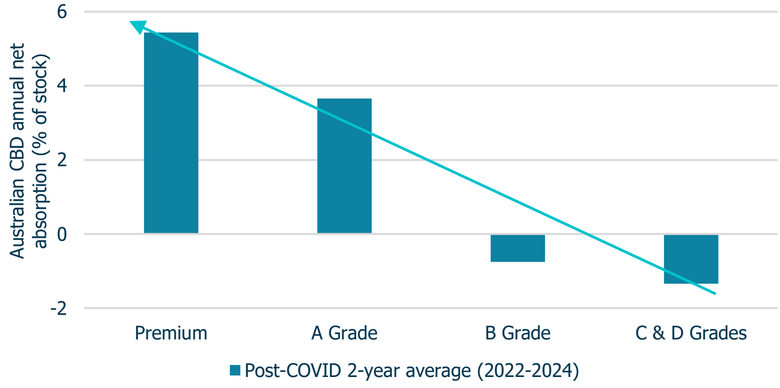
Office market outlook: Further leasing momentum gains in 2025

While leasing demand across Australia's major office markets recovered through 2024, office vacancy rates drifted higher as demand struggled to keep up with new office completions. However, the 'flight to quality, amenity and sustainability' theme has remained prominent in Australian, with tenant demand for high quality stock (including new supply) leading the recovery in Australian CBD office leasing activity (Chart 1.2). This theme reflects the Great Office Upgrade[1], with significant tenant relocation activity across Australia's major CBD office leasing markets. Notably, upgrading tenants are maintaining their existing footprint at a greater rate than in the past.

Office occupancy has also stabilised through 2024, with average occupancy rates across Australia's major CBD office markets reported at 70-75% (peak day occupancy rates of 85-90%) of pre-COVID occupancy.

We think these trends reflect the final phase of Australia's post-COVID tenant demand adjustment. As we approach 2025, we expect the headwinds to office leasing activity in recent years will continue to ease, supporting further gains in leasing demand across Australia's major CBD office markets.

Chart 1.2: Australian CBD lease demand (net absorption) by office grade



Sources: JLL Research & Investa Research

1. Intramarket tenant relocation activity. See Investa Australian Office Market Outlook, December 2023 https://www.investa.com.au/office-market-outlook-2024

Office leasing demand outlook

Office occupancy stabilises

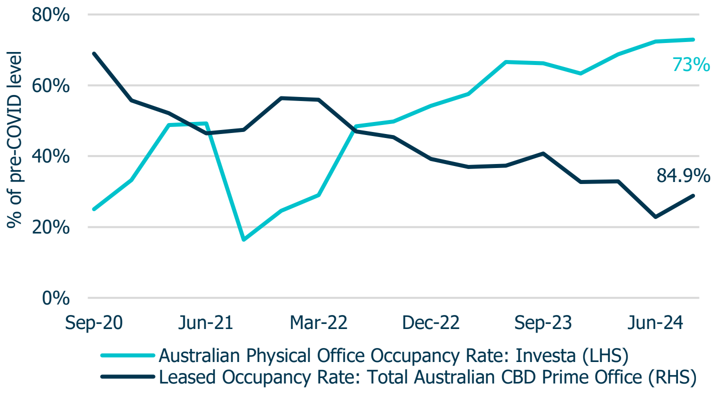
Investa's office occupancy stabilised at 70-75% of pre-COVID levels through 2024, including peak day occupancy rates of 85-90% - up from 60-70% through 2023[2]. This is the highest reading since the start of the pandemic and equates to approximately 3½-4 days per week in the office on average, across Australia's major CBD office markets.

Investa's office occupancy trends align with broader city-wide pedestrian activity and public transport usage data. These data also show outperformance in high quality office buildings with good amenity, direct accessibility and superior location.

Higher office occupancy in 2024 has reflected both a strong desire for office workers to work collaboratively in a physical office workspace and an increase in tenant businesses reporting office workplace attendance directives. More stable expectations of office attendance and reported occupancy rates have coincided with positive leasing demand (ie. net absorption) and an uptick in Australian CBD prime market leased occupancy (Chart 2.1).

While there is still further to go for some Australian office tenant businesses in finding their post pandemic 'steady state', stable and elevated office occupancy presents a positive underlying outlook for tenant leasing requirements and office leasing demand in 2025.

Chart 2.1: Physical vs leased occupancy: Australian CBDs



Sources: JLL Research & Investa Research

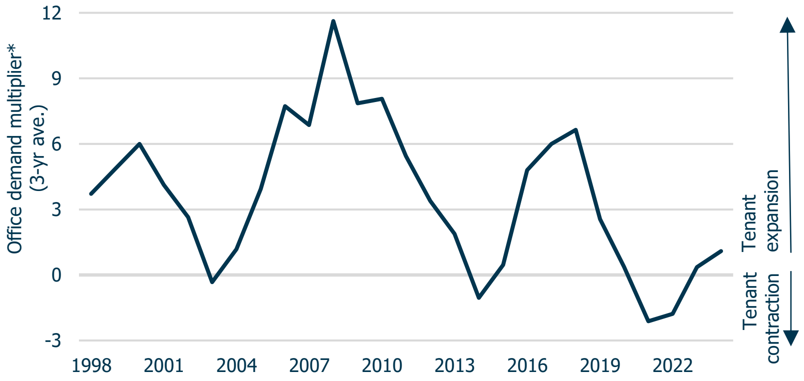
Australian office demand recovery

While white collar employment slowed through 2024, with challenging business conditions and tentative business confidence weighing on business hiring decisions. However, the outlook for office-based business expansion - and leasing demand - looks more upbeat in 2025.

Lower interest rates and improved business conditions are expected to support office-based employment, with specialist business services and finance likely to lead the office-based business hiring recovery. With a number of Australian businesses, including significant employers across both of these sectors and others announcing expectations for office attendance through 2024 we expect the tenant market is entering the final phase of post-COVID hybrid tenant workspace adjustments. As we enter the sixth year since the beginning of the pandemic, we expect the headwinds on tenant leasing demand from hybrid work transitions will ease in the coming years.

Australian CBD office market leasing activity data also supports an outlook for further gains in tenant demand, with indications Australia's office businesses are entering the early stages of a tenant expansion phase (Chart 2.2). This outlook foreshadows a positive multiplier effect on office market net absorption from white collar employment gains in 2025 and beyond.

Chart 2.2: Australian CBD office demand multiplier



*Annual office market net absorption divided by annual change in white collar employment
Sources: ABS, JLL Research & Investa Research

2. Investa's office portfolio contributing to reported office occupancy accounts for ~545,000sqm of prime grade Australian CBD office stock.

Office development outlook

Artist impression
360 Queen Street, Brisbane

Office development challenges continue

The outlook for new office supply is expected to slow sharply in 2025, with the construction sector and office development continuing to be challenged by high construction costs and input supply constraints.

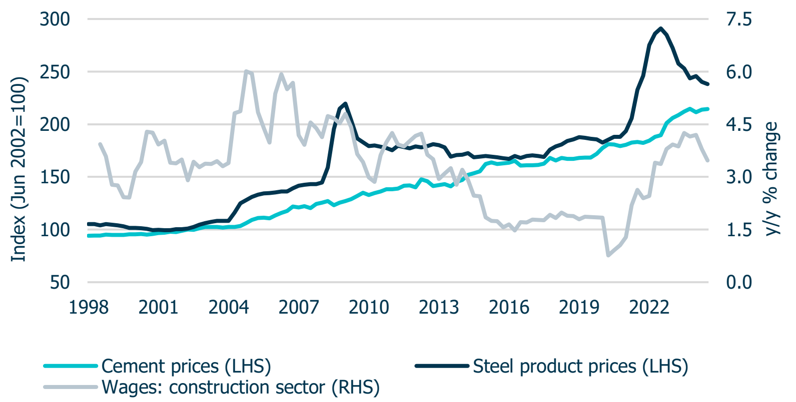
While the cost of construction materials has eased from recent peaks, development costs remain significantly higher than pre-pandemic levels. In particular, cement prices are ~25% higher and steel prices are ~28% higher compared to pre-pandemic levels. Additionally, construction sector wages have increased 15% over the past 5 years, including 3.5% growth in the past year (Chart 3.1).

With high interest rates and elevated cost of debt, the pipeline of future Australian office supply has continued to narrow through 2024.

Despite the prevailing office development challenges, almost 300,000sqm of new and refurbished office stock completed in 2024. Across Australia's CBD markets office tenants had an abundance of new and existing high-quality tenancy options to choose from.

However, as the pipeline of new stock is crimped, we expect this will change in 2025. While the availability of high-quality uncommitted office space options is expected to decline, Australian CBD prime office market vacancy will come under downward pressure in 2025, to be limited to a small number of uncommitted new office developments and existing stock.

Chart 3.1: Construction input prices: Australia



Sources: ABS & Investa Research

New office supply to slow sharply

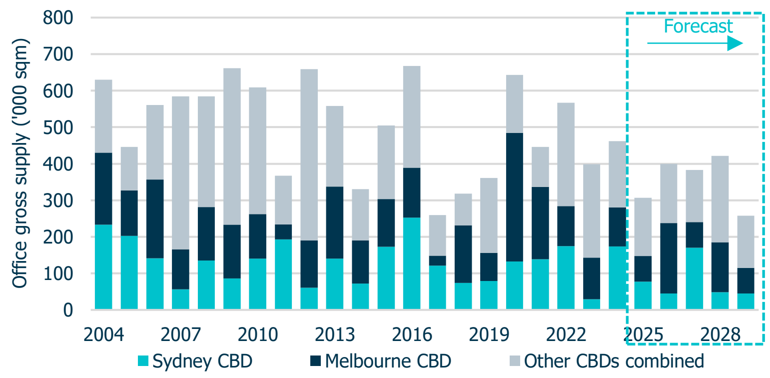
We expect Australia's major CBD office markets will face a noticeable slowing in new office stock in 2025, forecasting new Australian CBD office supply will post the lowest annual increase since 2018 (Chart 3.2). This is expected to continue into 2026.

Melbourne CBD being the sole exception with around 200,000sqm of new office supply expected in 2026 and a significant pipeline of uncommitted new office supply under construction (~170,000sqm or 80% of the pipeline). We forecast the scale of uncommitted new supply will create a delayed tightening in Melbourne CBD office market conditions for a few more years.

We expect the flight to quality, amenity and sustainability will remain a permanent office leasing market theme across Australia's major CBD office markets, adding another layer to the approaching supply imbalance. We believe this will drive two structural trends through the coming supply cycle:

1. Outperformance of higher quality, effectively-serviced and well-located office stock; and
2. Increased office withdrawals for refurbishment, repositioning and redevelopment.

Chart 3.2: Australian CBD office supply forecast



Sources: Various & Investa Research

Office capital market outlook

Capital market turning point

Following a challenging few years of subdued transactions activity and lower capital values, Australia's office capital markets are showing early signs of a cyclical recovery.

Increased transactions have reflected stronger investor sentiment and firmer expectations of near-term cuts to interest rates and Australian bond yields.

In particular, Sydney CBD has led the Australian office capital markets recovery. It recorded the strongest 12-month period of transactions since 2021, with $3.1 billion in Sydney CBD office capital transactions reported in the three quarters to September 2024 (Chart 4.1). This rebound has continued in Q4 2024, with transactions including BGO's purchase of 10-20 Bond St for ~$580 million.

In comparison, Australia's other office markets are still seeing somewhat tentative capital transactions with a limited number smaller assets transacting in markets other than Sydney CBD. Looking ahead, we expect both supportive macroeconomic conditions and stronger capital market sentiment to drive further momentum gains in Australia's CBD prime office market capital transactions through 2025, with a continued focus on prime market assets in Sydney CBD.

Divergent recovery across markets

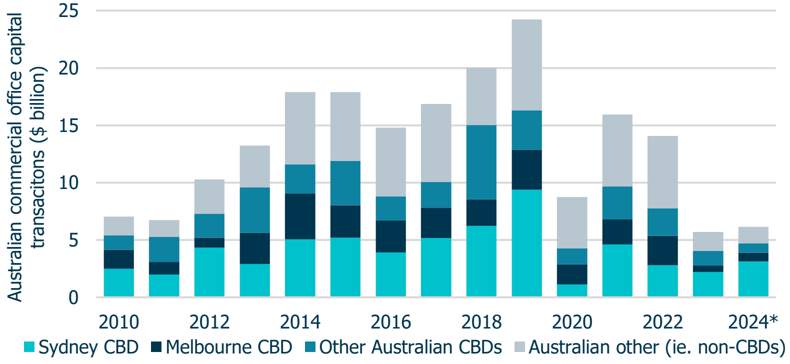
As the cyclical capital transactions market recovery experiences variable timing and strength across Australia's office markets and asset types, we expect capital growth rates to also vary. A stronger capital appetite and increased competition for high quality Sydney CBD assets is driving more stable capital values across this segment of the market.

We expect cap rates for Sydney CBD prime market assets have largely 'topped out' and will come under moderate downward pressure through 2025.

In contrast, tentative investor sentiment and capital market pricing uncertainty remain 'in play' in Melbourne CBD due to recent increases in commercial property taxes combined with a softer leasing market outlook. Accordingly, we forecast Melbourne CBD has at least another 12 months before prime office market cap rates start to compress (reflecting increasing capital values).

Consequently, we expect the cyclical recovery across Australia's major CBD office capital markets to run a range of paths (Chart 4.2). Sydney CBD prime office capital returns are forecast to outperform through the cyclical recovery. In contrast, Melbourne CBD prime market cap rates are expected to converge and more closely align with Australia's other CBD markets (ie. excluding Sydney CBD) through 2025 and beyond.

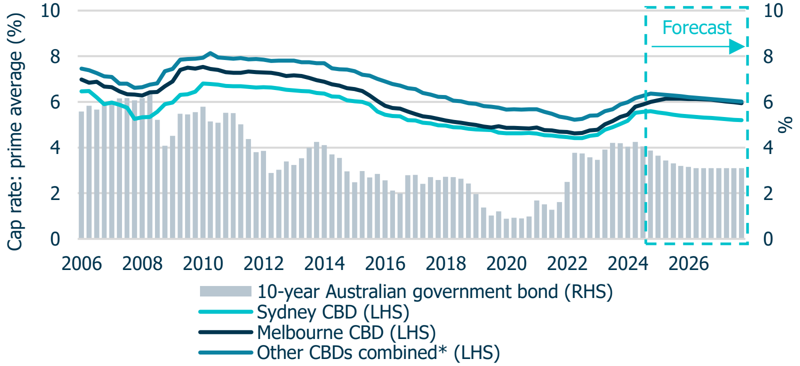
Chart 4.1: Australian office capital transactions



*Includes data from March quarter to September quarter only

Sources: JLL Research & Investa Research

Chart 4.2: Australian CBD prime office cap rate vs 10-year government bond



*Prime office stock weighted average

Sources: JLL Research, Property Council-MSCI, RBA & Investa Research

Australia’s office market outlook for 2025

Australia’s office market recovery takes hold

The past year has largely reflected challenging market conditions with continued post-COVID leasing market consolidation combined with the addition of a large volume of new and refurbished office stock. Furthermore, subdued capital transactions market activity has maintained downward pressure on office capital values.

Looking towards 2025, recent market data points to the early stages of a cyclical recovery. We expect Australia’s CBD office markets will consolidate this cyclical upturn in 2025 – although the strength of recovery is forecast to vary across CBD markets and asset types.

Summary

The year ahead

As inflation eases further, long-anticipated interest rate cuts are likely to support improved business conditions and tenant business expansion plans in 2025.

New Australian CBD office supply will slow to its lowest annual level since 2018, increasing leasing market competition for high-quality, well-located workplaces.

Macroeconomic conditions will also support further gains across Australia’s office capital market transactions.

Sydney CBD is expected to continue leading the recovery in Australia’s office capital markets, with prime market cap rates forecast to compress through 2025.

The future horizon

Office tenants are finding their post-COVID hybrid work ‘steady state’. As headwinds from the hybrid work transition ease, leasing demand will re-align with the business growth cycle.

The flight to quality, amenity and sustainability is here to stay. High quality, well-located office stock with good amenity will continue to outperform.

The development cycle will recover– although not at the strength of previous cycles. As construction market conditions eventually rebalance, underlying demand and outperformance of high-quality assets will drive an increase in new and refurbished office supply.

Australia’s office capital markets are forecast to re-establish a moderate long-term cap rate compression cycle. A positive investor appetite for Australian prime market office assets will drive a return to long-term capital value growth.

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.