Investa Inside

Office Market Outlook: What to expect in 2024

December 2023

Introduction

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Australia’s major CBD office markets faced a number of headwinds through 2023.

While we expect these factors to largely remain in play into 2024, forward-looking indicators point to some potential easing in these headwinds, presenting some green shoots to the outlook for Australia’s office markets through the second half of 2024.

In particular, leasing market activity has been dominated by tenant relocation and upgrading, reflecting the strength of demand for higher grade and well-located office space.

Greater stability in economic and market conditions through 2024 is likely to support a shift in both leasing and capital market activity, setting up a more positive outlook for Australia’s office market performance through the second half of 2024 and beyond.

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David Cannington
Head of Research
& Strategy, Investa

Key office market insights: what to expect in 2024

Economic and office market outlook

Following a year of challenging conditions through 2023, Australia’s major capital city office markets are expected to face a year of two halves in 2024. While economic and office market headwinds will continue into 2024, the outlook for the second half of 2024 is likely to improve.

Office development outlook

Development and construction market pressures are likely to remain a factor for some time yet. Pre-commitment to office development projects will remain a significant feature in shaping Australia’s new office supply outlook through 2024.

Office leasing demand outlook

Australia’s major capital city office markets are expected to continue to experience The Great Office Upgrade through 2024, with tenant relocation and upgrading prominent leasing market themes. While remaining historically favourable for tenants, Australian CBD office rental affordability conditions are likely to decline in 2024.

Office capital market outlook

Multiple headwinds impacting Australian office capital market activity are expected to remain in play through 2024. However, several factors are expected to re-ignite cross-border capital flow and capital growth across Australia’s prime CBD office markets through the second half of 2024 and into 2025.

Office occupancy and hybrid work

Australia’s major capital city office markets have reported increased physical occupancy rates in 2023. Office occupancy is expected to continue to approach equilibrium in 2024, strengthening tenant workspace requirements and leasing demand growth in 2024 and beyond.

Economic and office market outlook

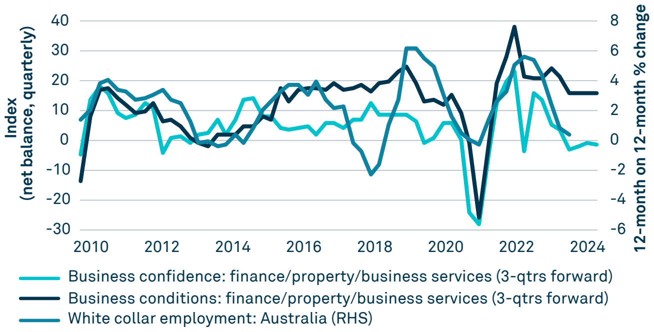
Economic outlook: inflation, interest rates and employment

Inflation and interest rates have dominated Australian and global macroeconomic conditions in 2023. With inflation slowing and the Australian rate cycle appearing to be at, or near the peak, the focus in 2024 is likely to shift to how the Australian economy responds to the prevailing fiscal and monetary policy settings.

A significant challenge to be faced by the Australian economy and business sector is addressing the underlying softness of office-based business confidence while business conditions have remained somewhat resilient (Chart 1.1). Like the divergence in business confidence and conditions in 2017 and assuming business conditions remain broadly stable, a pick-up in business confidence could trigger a rebound in office-based employment.

The outlook for global risks remains uncertain reflecting geopolitical tensions and economic uncertainty in Australia's major trading partners. However, restrictive monetary policy combined with a strong rebound in net overseas migration is expected to steer the Australian economy to achieve a 'soft landing' in 2024. Consequently, the Reserve Bank's forecasts indicate Australia is expected to add around 55-65,000 white-collar jobs in 2024, compared to 35,000 (annualised) in the first three quarters of 2023[1].

Chart 1.1: Australian business conditions/confidence vs white-collar employment



Sources: ABS, NAB & Investa Research

1. Statement of Monetary Policy, RBA November 2023.

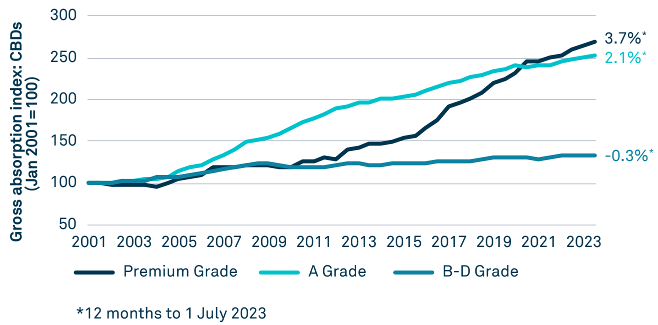
Office market outlook: a year of two halves in 2024

Following a year of challenging conditions through 2023, Australia's major capital city office markets are expected to face a year of two halves in 2024. Australia's office markets are likely to continue to face some headwinds through the first half of 2024. However, the outlook for the second half of 2024 is likely to improve. A combination of more stable economic conditions and improved leasing market activity are expected to emerge through the second half of 2024, supporting an early phase of a cyclical market recovery.

Throughout 2024, the 'flight to quality, amenity and sustainability' will likely remain a strong theme across Australia's office leasing markets (Chart 1.2). This is expected to drive a moderate prime market-led recovery through the second half of 2024, with high quality and well-located CBD office buildings seeing the strongest leasing activity. Improved leasing market performance is also expected to support prime office capital market sentiment and capital transactions activity from the second half of 2024 onwards.

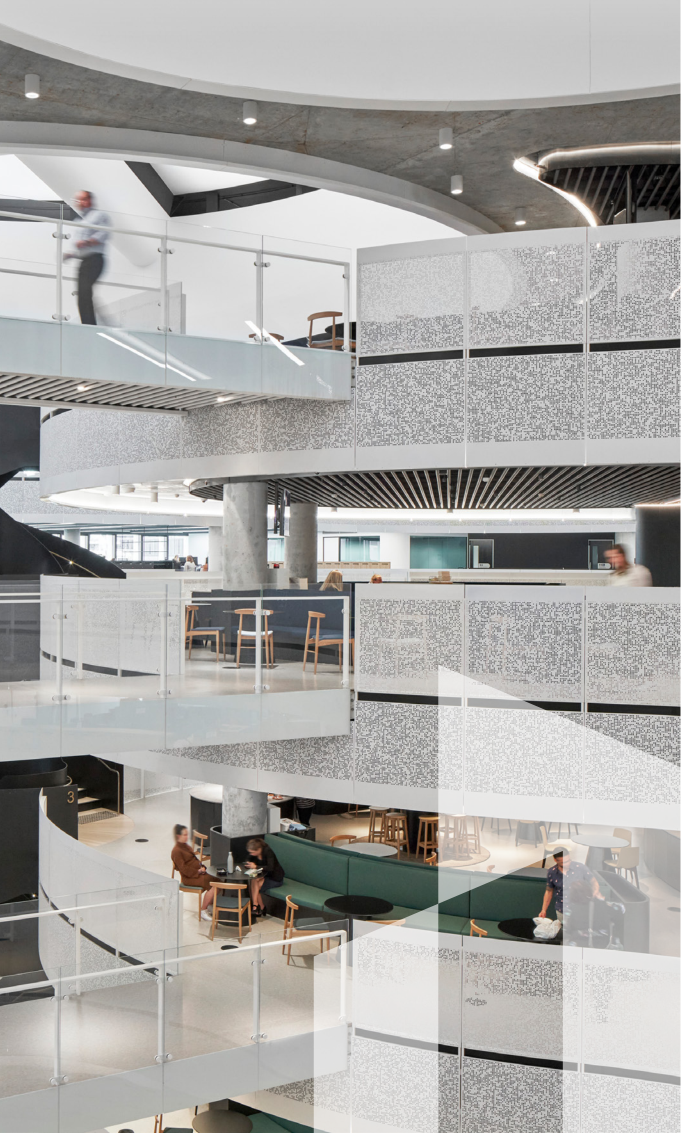
In contrast, secondary market conditions are expected to remain soft for some time yet. Lower grade buildings are expected to continue to find meeting tenant workplace requirements for amenity, efficiency and sustainability challenging in a post-pandemic hybrid work environment.

Chart 1.2: Australian CBD lease take-up (gross absorption)



Sources: Property Council of Australia & Investa Research

Office demand outlook



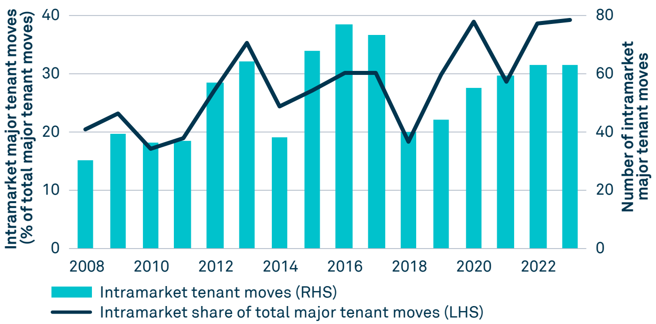
The Great Office Upgrade: tenant relocation

Supported by an ongoing tenant preference for high quality, better credentialed office space, Australian office markets have continued to experience The Great Office Upgrade through 2023. While growth in office leasing demand, or net absorption has been largely weak in 2023, tenant upgrading activity or a 'flight to quality, amenity and sustainability' has remained a strong trend across Australia's office leasing markets. Australia's CBD office leasing has shown this trend with further growth in prime office absorption (+203,600sqm or +1.8% in 12-months to September 2023), in contrast to continued weak secondary office absorption (-113,200sqm or -1.7%).

While hybrid work has broadly been established as the default office workplace model, office-based businesses have continued to find an optimal balance between home and office-based work. With an aim to deliver on priority office workplace objectives, including productivity, sustainability, amenity and experience, tenants in Australia's major CBD office markets have been relocating to higher quality office buildings more than ever.

In fact, 2023 office leasing data reported the strongest rate of intramarket (within the same market) tenant relocation and upgrading activity since the GFC for major tenant moves across Australia's CBD office markets (Chart 2.1).

Chart 2.1: Intramarket tenant relocation activity: Australian CBDs



Sources: JLL Research & Investa Research

Australian office rental affordability

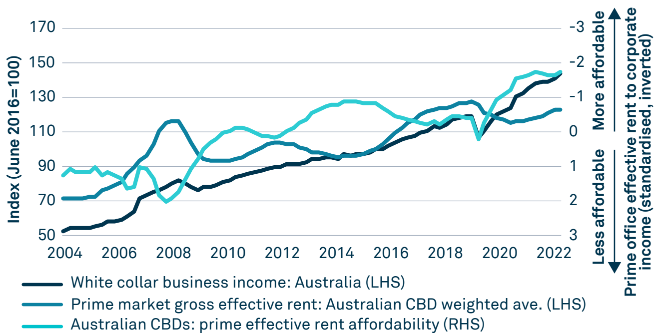
While tenant preferences have reinforced the strength of underlying market demand for prime office buildings and high-quality office space, favourable rental affordability conditions have supported a strong relocation trend across tenant office leasing activity.

Reflecting the resilience in white-collar business conditions through 2023 compared to modest growth in office rents and elevated incentives, Investa's Office Rental Affordability Index shows Australian CBD prime office rent is at the most affordable level in the past 20 years for office-based businesses (Chart 2.2).

The Rental Affordability Index reflects the recent outpacing in white-collar business income growth (20% higher than pre-pandemic levels) compared to Australian CBD prime office rent growth. Despite recently returning to a growth phase, Australian CBD prime office effective rents (accounting for incentives) remain around 4% below pre-pandemic levels.

While remaining historically elevated, Australian CBD office rental affordability conditions are likely to decline in 2024. With incentives stabilising and rents increasing, effective rents are expected to continue to increase across Australia's major CBD prime office markets in the back half of 2024. In comparison, Australian white-collar business income growth is likely to be challenged by high interest rates and soft economic growth.

Chart 2.2: Australian CBD prime office rental affordability index



Sources: ABS, JLL Research & Investa Research

Office occupancy and hybrid work

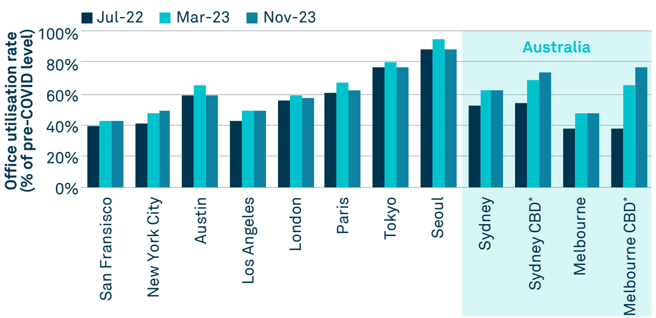
Australian office occupancy trends

Despite tapering in recent months, Australia's major capital city office markets have reported increased physical occupancy (office utilisation) rates in 2023. Coming off somewhat tentative occupancy rates in the first half of 2022 in the initial post-lock down phase, 'return to the office' momentum has seen physical office occupancy rates in both Sydney and Melbourne increase by a solid 10 percentage points since mid-2022 (Chart 3.1).

While broader market data, including secondary and fringe market buildings, does not show the same strength in momentum, Investa's office portfolio data shows a stronger 'return to the office' rebound in 2023 across well-located and high-quality Australian CBD office buildings.

Upward momentum in office occupancy rates across Australia's major CBD office markets reflects a positive outlook for Australian CBD office occupancy in comparison to other major global city office markets. In particular, office occupancy across major US capital city markets with some exception to increased office occupancy in New York City, appears to have stalled at around 40-60% of pre-pandemic occupancy.

Chart 3.1: Australian CBD office utilisation vs other global gateway cities



*Investa portfolio. November 2023 data represents latest available data at 31 October 2023.

Sources: Kastle & Investa

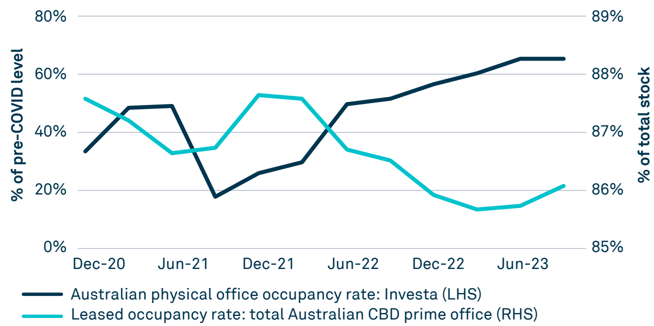
Hybrid work and office occupancy outlook

Predicting the hybrid office workplace of the future is fraught with uncertainty, as office-based businesses continue to navigate the significant transition to post-pandemic hybrid work. However, occupancy and utilisation trends can reveal some interesting insights into common trends and challenges.

Office tenants are seeing significant variation in office occupancy rates across the workweek. Commonly, peak office attendance is clustered in the middle of the workweek with office occupancy rates highest from Tuesday to Thursday – in the range of 80-90% of pre-pandemic capacity. While office occupancy is lower on Mondays, occupancy rates on Fridays are generally the lowest at around 40-50% of pre-pandemic capacity.

While physical office occupancy (office utilisation) is not directly correlated with leased office occupancy (leased office space), the post-pandemic gap between the two measures appears to be in the early stage of narrowing (Chart 3.2). Physical office occupancy seems to be approaching an equilibrium, with prime market occupancy rates converging across markets, grades and locations. While Brisbane and Perth have led the recovery in leasing market conditions in 2023, more stable physical office occupancy in both Sydney and Melbourne is likely to support leasing demand growth in 2024 and beyond.

Chart 3.2: Australian CBD prime office occupancy: leasing market vs physical market



Sources: JLL Research, Investa & Investa Research

Office development outlook

Office development challenges

Despite tentative signs of easing in commodity and steel prices in 2023, supply constraints and elevated input prices (ie. building materials, labour costs and interest rates) continue to apply pressure on construction activity and office development margins.

Having eased by 13% since their 2022 peak, steel prices in particular remain around 35% higher than pre-pandemic levels. Additionally, cement prices have gained 17% since 2020 and construction sector wages are increasing at 4.25% annually (Chart 4.1).

Upward pressure on construction input prices has reflected the significance of construction supply chains constraints, creating delays and uncertainty with construction timelines. Building materials and labour have been stretched on strong demand for construction, with Australia's major project pipeline running at an all-time high of $60-70 billion in 2023-24[2].

Looking to 2024, development and construction market pressures are likely to remain a factor for some time yet. Easing in commodity prices through 2023 presents some optimism. However, global macroeconomic challenges and ongoing geopolitical tensions indicate supply chain challenges will persist well into 2024, while labour market tightness and interest rate pressure will also maintain upward pressure on construction input prices, debt pricing and yields.

New office supply and 'flight to quality'

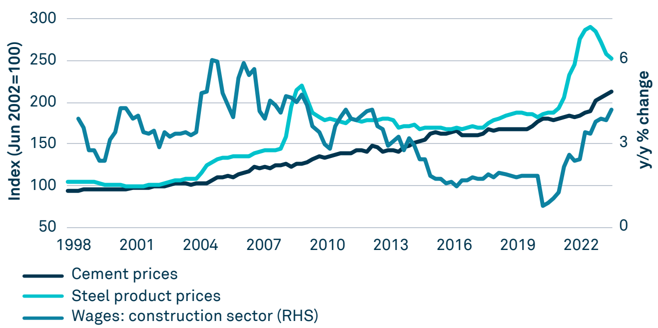
As highlighted in the Office Demand Outlook section, while leasing market conditions have been challenging in 2023, a 'flight to quality, amenity and sustainability' has remained a strong theme across leasing activity. This theme has driven solid lease demand for future new office projects across Australia's CBD office markets, with ~155,000sqm of pre-commitment in 2023 to date.

While Sydney CBD faces the most significant near-term new office supply outlook, with ~170,000sqm of new and fully refurbished stock to be completed in 2024, it also shares the highest development pipeline pre-commitment with Brisbane CBD (both 55%, Chart 4.2).

In comparison, the outlook for Melbourne CBD new office supply presents a more challenging situation. Of the ~110,000sqm of new and refurbished office supply to be completed in 2024, a modest 25,000sqm is currently accounted for (20%).

While investors and developers are expected to maintain a conservative risk appetite, pre-commitment to office development projects will remain a significant factor. In particular, elevated incentives and delayed timelines are likely to remain a feature of the outlook for markets that are faced with an acute new office supply challenge.

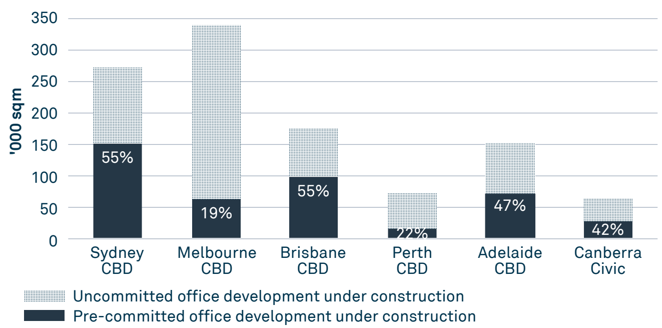
Chart 4.1: Construction input prices: Australia



Sources: ABS & Investa Research

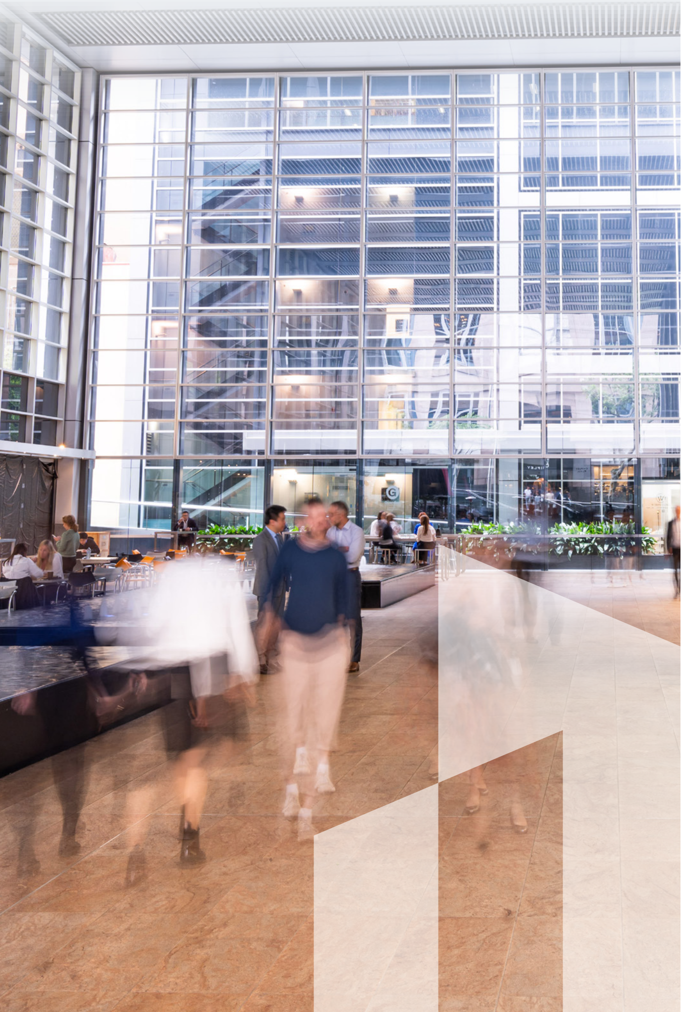
2. Australian Major Projects, ANZ Research October 2023.

Chart 4.2: Australian CBD office development pipeline and pre-commitment



Sources: Various & Investa Research

Office capital market outlook



Capital market headwinds

Facing the multiple headwinds of high interest rates, global investor caution and soft leasing market conditions, Australian office capital market activity has slowed to the lowest level in more than a decade.

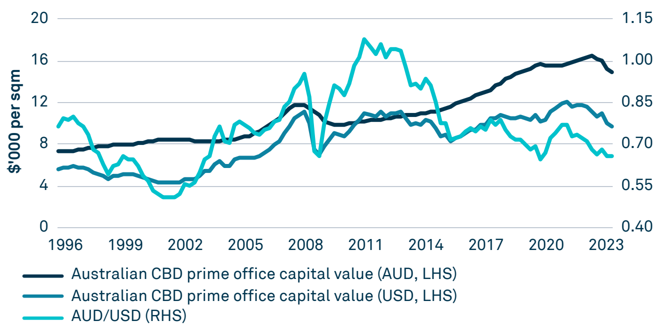
While the slowdown in transactions activity has reflected softer buyer demand, vendors have also held assets as the capital transactions market tests fair market value, or a market clearing price for Australian office property.

The capital transactions market stalemate and buyer-vendor pricing gap is likely to continue as long as buyers and vendors face the prevailing headwinds. While these conditions are expected to remain in play through early 2024, we expect that the strength of these headwinds will start to ease through the second half of 2024.

In particular, Australian interest rates are expected to remain elevated for some time yet. However, the outlook for Australian interest rates is more stable through 2024 in comparison to 125bps of RBA policy rate hikes in 2023.

In contrast to the stable outlook for Australian interest rates, market expectations indicate 2024 could see cuts to the US Fed Funds rate. While this would likely ease the upward pressure on bond yields, it would also create upward pressure on the Australian dollar, which is running near 20-year lows at ~0.65USD. This would go some way to unwinding the foreign currency pricing benefit provided since mid-2021 (Chart 5.1).

Chart 5.1: Australian prime CBD office capital values and Australian dollar



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

Short-term cycle and long-term trend

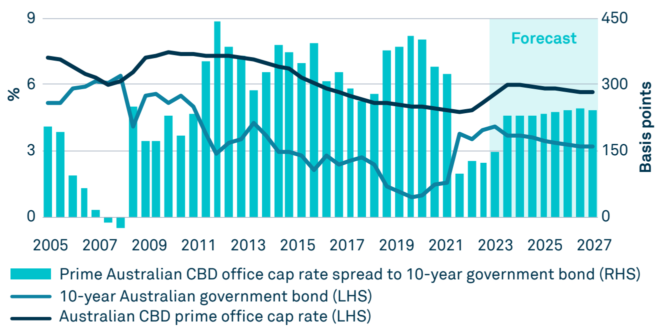
The capital market headwinds impacting Australian office capital markets reflect a combination of cyclical factors and investor sentiment. While these factors are expected to maintain pressure on capital transactions and capital values into 2024, we do not consider these to be permanent or structural.

We expect the Australian office market is approximately halfway through the current capital value easing cycle, with prime capital values to ease a further 5-10% through 2024. However, several factors are expected to drive a reversion to stronger cross-border capital flow and capital growth across Australia's prime CBD office markets through the second half of 2024 and into 2025:

- More stable global economy and inflation outlook.
- Improved Australian CBD prime leasing market conditions.
- More stable to lower interest rates and bond yields.
- Stronger investor sentiment and confidence in the outlook for Australian office markets.

Consequently, we expect Australian office capital markets to experience a year of two halves in 2024. Existing pressure on capital values is likely to be short-term, or transitory through the first half of 2024, with capital market transactions gradually driving a return to capital value growth and downward pressure on cap rates in the latter part of 2024 and beyond (Chart 5.2).

Chart 5.2: Australian CBD prime office cap rate vs 10-year Government bond



Sources: Property Council-MSCI, RBA & Investa Research

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 approximately $14 .2billion[3] 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.

3. As at 30 September 2023.