investa

Investa *Inside*

Office Market Outlook

May 2023

Introduction

"Office activity across Australia's major CBD markets reveals a clear multi-paced post-pandemic recovery.

Leasing activity, office development and capital markets are all reflecting a flight to quality trend through outperformance in higher quality assets.

However, more detailed analysis shows that market outperformance is based on a much broader range of factors beyond building quality grade. Tenants are undergoing the 'Great Office Upgrade', relocating and actively upgrading their office workplace to meet their requirements.

Australian CBD office markets are adjusting to the combined impact of both a reset in tenant requirements and the challenge of macroeconomic headwinds. Nonetheless, conditions will continue to favour office buildings and workplaces that provide market-relevant facilities and high-quality tenant experiences."

David Cannington

Head of Research & Strategy, Investa

Key Office Market Insights

1. ***Economic & Market Outlook***

   Inflationary pressures and higher interest rates will continue to present a challenge to office-based business conditions through 2023. This has presented multi-speed office demand as businesses look to upgrade their office space.

2. ***Leasing Demand Outlook***

   While net growth in leased office space remains subdued, leasing activity reveals Australian office-based businesses are undergoing the Great Office Upgrade. Tenants are actively upgrading along the office grade scale & moving within Australia's CBD office markets.

3. ***Office Occupancy***

   Office occupancy and utilisation trends show Australian office-based businesses are entering a new phase in the post-pandemic hybrid workplace transition. While there is still room for improvement, a focus on business performance is driving office utilisation higher and an emphasis on workplace design.

4. ***Office Development Outlook***

   Development cost pressures continue to present a significant challenge to office development activity. However, positive demand for higher grade and new office stock is supporting the pipeline for best-in-class office design and development.

5. ***Office Capital Market Outlook***

   Global capital inflows remain a critical element in determining capital values and cap rates across Australia's CBD office capital markets. Easing capital values and a lower Australian dollar have provided an affordability boost to offshore capital sources.

1. Economic & Office Market Outlook

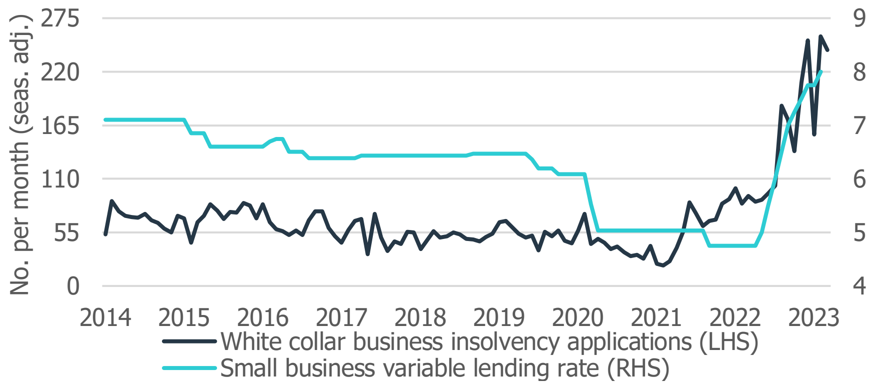
Economic Outlook: Office-based business challenges

While inflation pressures appear to be easing, sharp increases in interest rates over the past year have presented a challenge to Australian business conditions. In particular, office-based (white collar) businesses have been faced with the dual post-COVID headwinds of higher debt servicing costs and global financial market stability concerns.

Pre-dating the recent stresses on US and European banks, declining business conditions have triggered a sharp post-COVID increase in Australian white-collar business insolvency applications over the past year (Chart 1.1). While Australia's labour market remains tight with the unemployment rate at a very low 3.5%, white-collar employment has softened since mid-2022 reflecting the economic challenge faced by Australia's office-based businesses. In contrast to the strong gains through 2021-22, white-collar employment has slowed, to be 80,500 jobs lower in the 9 months to March 2023.

Global conditions and domestic policy settings will continue to present challenges for the Australian economy as it navigates the path to lower inflation. However, counterbalancing these cyclical challenges, further recovery in Australia's immigration flow will go some way to resetting a solid foundation for Australia's long-term economic growth.

Chart 1.1: Interest Rates vs White-collar Business Insolvencies



Sources: Australian Securities & Investments Commission, RBA & Investa Research

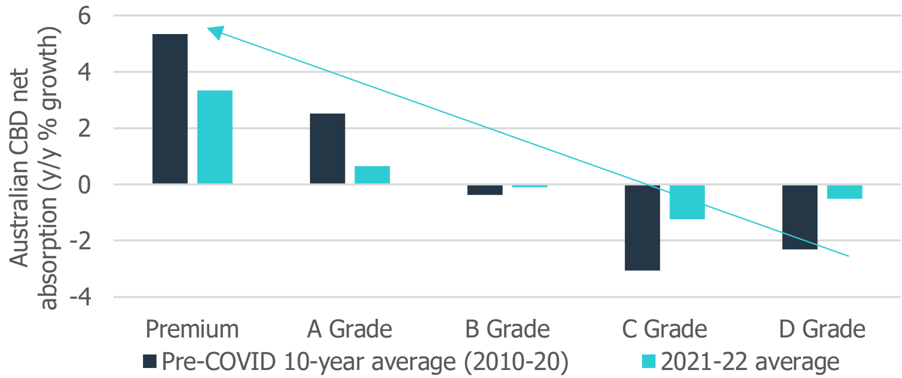
Office Market Outlook: Multi-speed office demand

Following a solid initial post-COVID rebound, total market demand for Australian office stock softened through the second half of 2022. However, detailed leasing data has revealed a reversion to pre-COVID demand trends (Chart 1.2). Notably, positive take-up of higher-quality office stock has reflected market conditions that have facilitated a flight to quality, or the Great Office Upgrade (detailed in *Section 2. Office Demand Outlook*).

Softer market demand has reflected the combined impact of increased economic challenges facing Australian office-based-businesses and a conservative business approach to office space requirements. While these conditions have moderated the recovery in total market demand, leasing activity data reveals clear outperformance in post-COVID demand for higher grade office stock.

Office take-up in 2022 has been driven by prime assets in Australia's CBD office markets. While secondary office demand in Australia's CBD markets declined in 2022, demand for prime (Premium and A Grade) stock increased at moderately less than pre-COVID levels. In calendar year 2022 take-up of Premium grade Australian CBD office stock was around 75% of pre-COVID levels, while A Grade stock attracted around 80% of pre-COVID levels.

Chart 1.2: Australian CBD Office Occupied Stock by Grade



Sources: Property Council & Investa Research

2.Office Demand Outlook

The Great Office Upgrade

As higher office occupancy rates continue to reinforce the central role of the office in the hybrid work model, Australian CBD office leasing activity has highlighted some clear office-based business workplace trends.

Investa's analysis of market leasing data reveals Australian office markets are experiencing the Great Office Upgrade, a clear trend of tenants upgrading across and within office market grades.

The main beneficiary of this trend is the premium grade market, showing the strongest growth in leasing demand through 2022 (+3.9% y/y). The largest Australian office market, the A Grade market (45% of the total office market) is seeing softer growth (+1.3% y/y), being weighed down by a significant amount of within-grade 'tenant churn'. In contrast, leasing demand for secondary market buildings (B-D Grade) continued to decline (-1.8% y/y, Chart 2.1).

The Great Office Upgrade reinforces a post-pandemic tenant preference for buildings and office space that provide a combination of high performance, enhanced experience and greater flexibility. In addition, it also reflects the current favourable office rental affordability conditions. A post-pandemic recovery in prime market rent growth (3.3% y/y) has only increased at around half the rate of white-collar business income growth (+6.2% y/y) through 2022.

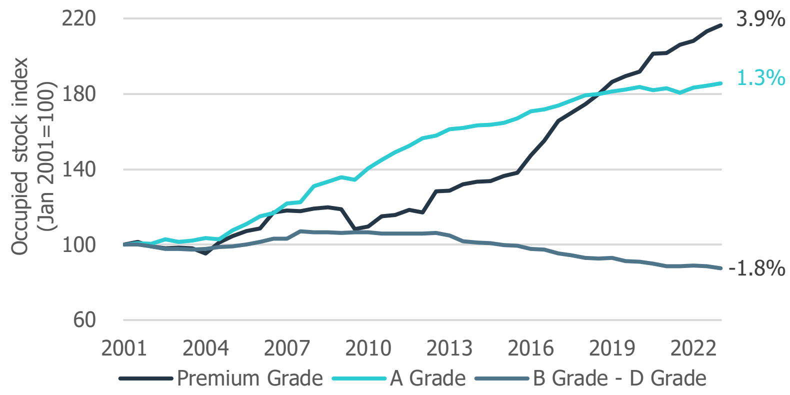
Market demand & tenant churn

Lease take-up of Australian CBD office space (gross absorption) has continued its post-pandemic recovery. Gross absorption through 2022 increased by around 290,000sqm across Australia's CBD office markets – approximately 60% of the pre-pandemic 3-year average level – while prime market take-up was a stronger 305,000sqm (~80% of pre-pandemic levels) (Chart 2.2).

In comparison, net growth in total office leasing demand (net absorption) was more subdued with economic uncertainty and cautious business sector sentiment impacting office leasing decisions, particularly through the second half of 2022 and into Q1 2023.

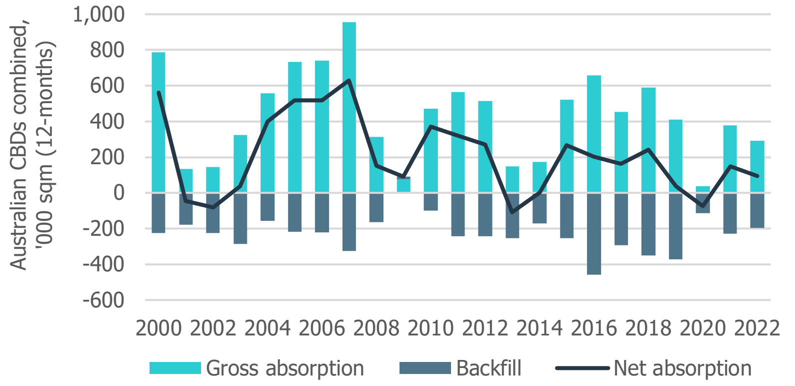
While global and macro headwinds have weighed on growth in Australian CBD market demand, tenant market 'churn' (ie. tenants actively 'upgrading' within their existing market) has also dampened the net growth impact of leasing activity and take-up across Australia's major CBD office markets. In fact, upgrading activity and relocating tenants have created a 200,000sqm wave of backfill vacancy through 2022. Consequently, vacancy remained elevated across Australia's major CBD markets as net growth in office demand was outpaced by the weight of both new office completions and lower grade backfill space.

Chart 2.1: Australian CBD Leased Office Stock



Sources: Property Council & Investa Research

Chart 2.2: Australian Leasing Activity vs Net Growth in Leased Stock



Sources: Property Council & Investa Research

3.Office Occupancy

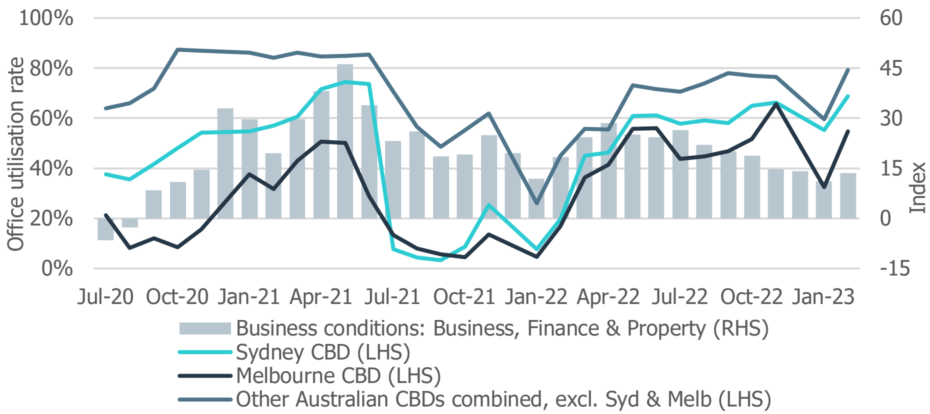
Office occupancy and early-cycle hybrid work utilisation

Office occupancy rates have stabilised through 2023 following a seasonal dip through the new year holiday period. Reflecting the impact of a broad-based adoption of hybrid work by office-based businesses, Australia's CBD office markets have posted occupancy rates of 50-70% of pre-COVID or maximum occupancy. Accounting for unleased office floorspace, Australian CBD leased office occupancy or office utilisation rates are at a higher 55-90% (Chart 3.1).

Across Australia's major CBD markets, Melbourne CBD office occupancy and utilisation has been most significantly impacted by the adoption of hybrid work. Despite some positive momentum in recent months, the long-term impact of Melbourne's extended COVID lock down policy has weighed on the post pandemic recovery in Melbourne's CBD office occupancy.

Office occupancy and utilisation rates correlated closely with business conditions (and business confidence through the pandemic. However, more recently office utilisation rates have been more stable, reflecting a structural, albeit experimental adjustment to long-term hybrid work practices.

Chart 3.1: Australian CBD Office Utilisation vs Business Conditions



Sources: Property Council of Australia & Investa Research

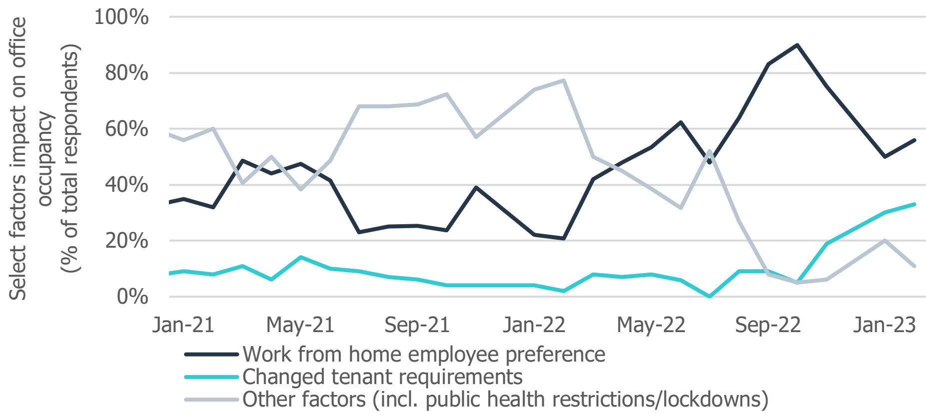
Hybrid work: business drivers and trends

The major Australian CBD office markets are entering a new phase in the post-pandemic hybrid work transition. In the initial phase of the transition, office occupancy and utilisation rates were significantly driven by the workplace preferences of office employees. Through the second half of 2022 office occupancy remained broadly unchanged, with up to 90% of this rate being attributed to employee's 'work from home' preference (Chart 3.2).

However, more recently office tenant business requirements and workplace policy have had a greater impact on office occupancy and utilisation rates. This reflects the next phase of the hybrid work transition, as white-collar or office-based businesses turn their focus to the impact of hybrid workplace choices on both employee wellbeing and business performance.

This transition reflects Investa's future of work research findings of tenant preferences. Primarily, a significant element in this phase of hybrid work transition is for Australia's office tenant businesses to drive improved business performance through optimising office utilisation and workplace design.

Chart 3.2: Factors Impacting Australian CBD Office Occupancy



Sources: Property Council of Australia & Investa Research

4.Office Development Outlook

High quality office demand offsetting construction challenges

Despite some tentative signs of easing, supply constraints and elevated input prices (ie. building materials, labour costs and interest rates) continue to apply pressure on construction activity and development business margins. In particular, steel prices increased 16% in 2022, with bulk commodity prices 24% higher over the 12 months and further 6.5% in the first three months of 2023. Nonetheless, positive demand for new and high-quality office stock have supported an uptick in building approvals for Australian office construction and the pipeline for new office supply (Chart 4.1).

Demand for new office space across Australia's major CBD markets is being buoyed by the flight to quality and the Great Office Upgrade (see: *Section 2. Office Demand Outlook*). 8 out of the 10 major office development projects under construction across Australia's three largest CBD office markets, have lease pre-commitment (~35% of the combined new office space to be completed in Sydney, Melbourne and Brisbane CBDs over the next two years).

However, pressure on office development margins is expected to drive a greater focus on lease pre-commitment, covenants and development feasibility through 2023.

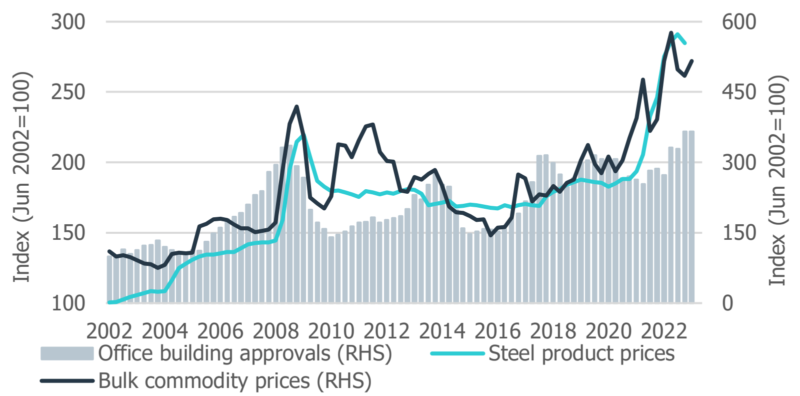
Office development pipeline narrowing

Following a three-year period of absorbing a solid stream of new and refurbished office completions, Australia's CBD office markets are experiencing a hiatus in the office supply cycle. Australian CBD office completions in 2022-23 are expected to be at the lowest level since 2018-19.

While the current office development pipeline will expand the available stock of high-quality office space in 2024 and 2025, the pipeline for longer-term uncommitted projects is being challenged. In particular, projects with cash flow risk and thin development margins are pushing completion timeframes out, or in some cases being terminated. Consequently, Investa's office market forecasts point to a slowing in office supply growth over the coming years, with trend growth expected to slow to the lowest rate in the past 25 years by 2028 (Chart 4.2).

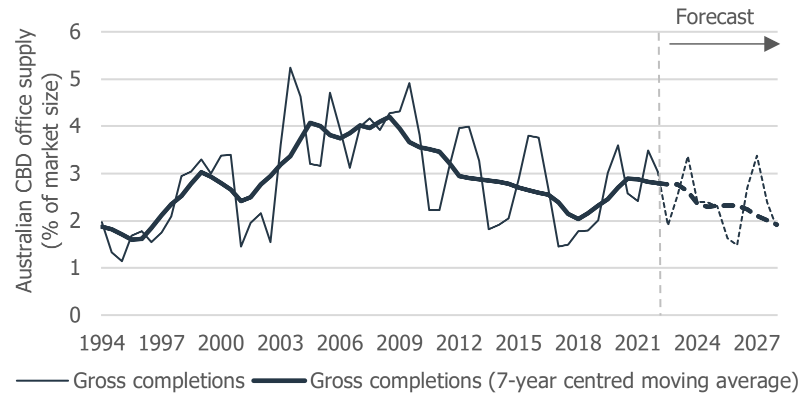
In the coming year however, slower office development completions and growth in Australian office supply compared to recent years will drive absorption and leasing pressure on the existing market vacancy, particularly in the Premium and high-quality A Grade CBD markets.

Chart 4.1: Construction Materials Prices vs Office Building Approvals



Sources: ABS, RBA & Investa Research

Chart 4.2: Australian CBD Office Development & Forecast



Sources: Property Council & Investa Research

5. Office Capital Market Outlook

Global capital to drive growth outlook

A slowing in global capital inflows combined with a slowdown in asset sales listings has driven a 7.5% decline in Australian prime office capital values from June 2022 to March 2023.

High inflation, economic uncertainty and increased interest rates have created a ‘cautious’ tone across global capital markets, with offshore-sourced Australian office capital sales slowing to the lowest level in over a decade. In contrast, Australian buyer transactions have remained within a solid 12-month range of $7.5-10 billion through 2022 and Q1 2023, reflecting more stable domestic demand and greater local confidence in the underlying value of Australian commercial office assets.

Nonetheless, the depth of global capital remains a critical element to the outlook for Australian commercial office capital markets and capital values. Investa’s analysis of the past 25+ years of Australian office capital market transactions shows a strong relationship between the contribution of offshore-sourced capital in the Australian commercial office transactions market and capital growth (or cap rate compression) (Chart 5.1). In particular, since 2011 offshore-sourced capital has contributed 30% or more to the total amount of capital transacted across Australian CBD markets while cap rates have compressed. This has approached annual compression rates of ~30-70bps when offshore-sourced capital contributes 50% or more.

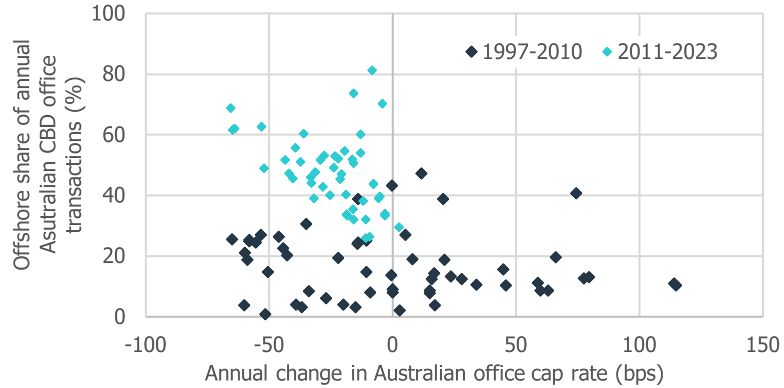
Investor sentiment and financial conditions

While cautious sentiment has weighed significantly on offshore-based capital transactions over the past year, the underlying appetite for Australian office market assets from offshore capital investors has remained steady. In addition, capital liquidity depth has held up relatively well despite some isolated corporate stress events in recent months.

Despite compression in the yield, or cap rate spread to risk-free benchmark rates (ie. bond yields) over the past year, favourable financial market conditions have set Australian commercial office capital markets for a strong recovery when financial market conditions stabilise and global capital markets strengthen.

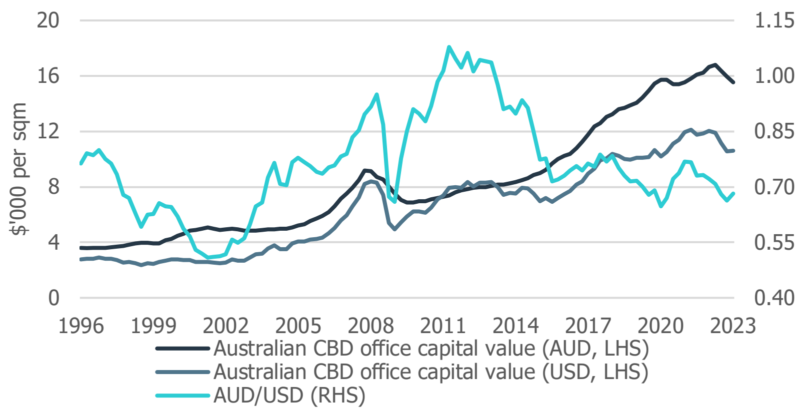
In particular, a combined decline in the Australian dollar and easing in Australian office capital values has decreased the USD-value of Australian CBD commercial office assets to 2017 levels. In comparison, domestic buyers (transacting without the benefit of a currency gain) are paying almost 20% more for prime Australian CBD commercial office assets over the past 5 years (Chart 5.2).

Chart 5.1: Offshore Buyer Sales vs Cap Rate Movement



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

Chart 5.2: Australian CBD Office Capital Values & Australian Dollar



Sources: JLL Research, RBA & Investa Research

Further Information

Investa Research

David Cannington
Head of Research & Strategy

P +61 418 655 200
E dcannington@investa.com.au

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 $16 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.