SYDNEY CBD
OFFICE MARKET UPDATE

JUNE 2021

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EXECUTIVE SUMMARY

Welcome to our latest Sydney CBD Office Market Update, where we analyse and explore how the sector is recovering from the impacts of COVID-19, macroeconomic factors exerting influence such as bond rates and emerging trends.

The CBD market is demonstrating a particular sense of resilience. Despite capital transaction volumes for office investments unsurprisingly tracking below previous years, activity is building as sellers and buyers regain confidence and capitalise on new opportunities as a result of changed market conditions.

With Sydney remaining a transparent and stable destination for capital, foreign investment also remains prevalent accounting for 71.40% of all office transactions in 2020.

While occupancy rates remain subdued on the leasing front, tenant demand is returning, albeit with heightened expectations and demands for what a physical office space should provide. The recent NSW Government announcement regarding the acquisition of CBD buildings to make way for the new Hunter Street Metro Station will contribute to increased future demand, removing approximately 44,000 sqm of commercial space from the market.

If you would like to discuss this report further or enquire about bespoke market or actuarial analysis, we'd be delighted to speak with you.

ANDREW HUNTER

CHIEF EXECUTIVE
OFFICER CI AUSTRALIA
+61 418 222 522

The data quoted is from sources including CI Australia Research, Real Capital Analytics (RCA) and Property Council of Australia (Jan-21 Release)

OFFICE LEASING

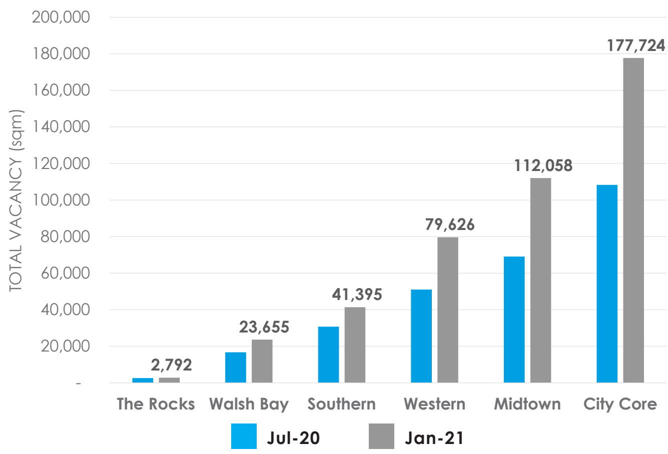
Tenants regain confidence and clarity, bringing back employees and acting on physical space requirements

TOTAL VACANCY

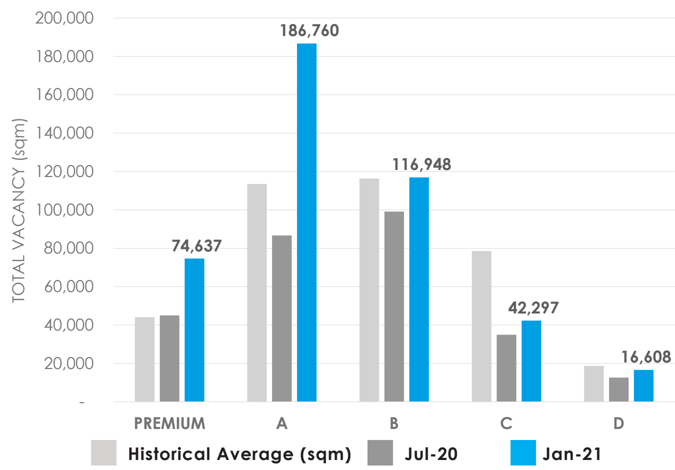
Total vacancy in the Sydney CBD has risen to 8.60%, just 10 basis points below the 30-year historical average of 8.70%. This represents a total of 437,250 square metres (sqm) of vacant stock available for lease across the CBD. This result is highly attributable to the impacts of COVID-19, such as tenants temporarily sub-leasing, or permanently exiting and reconsidering their physical space commitments following mandatory work from home (WFH) orders.

- A majority (66.72%) of this vacant stock is located in the City Core and Midtown precincts. It's no surprise these precincts experienced high levels of vacancy (with the exception of Barangaroo) with the highest average rents across the CBD and large corporate occupiers.
- A large portion (42.70%) of the total vacant stock in the CBD is A-grade (186,760 sqm). Whilst it should be noted that this is proportional to the total amount of A-grade stock to total stock in the CBD (38.10%), A-grade stock is the only sector to have witnessed its vacancy rate rise above the historical average of 7.80% in the six-monthly reporting period. This is also attributable to the large differentials between A and B-grade rents in the CBD.
- Premium Grade stock however is at 6.20% vacancy, sitting well below the historical average of 13.63%. Tenants of Premium Grade assets generally have higher quality covenants, large workforces and longer lease commitments which may have afforded less flexibility to permanently contract their requirements during the pandemic.

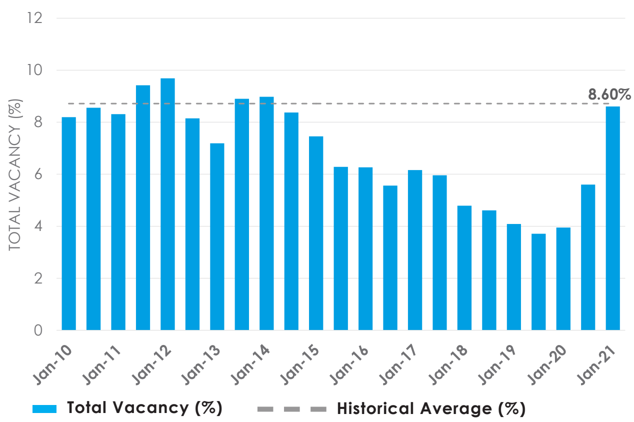
TOTAL VACANCY BY PRECINCT



TOTAL VACANCY BY GRADE



TOTAL VACANCY VS HISTORICAL AVERAGE

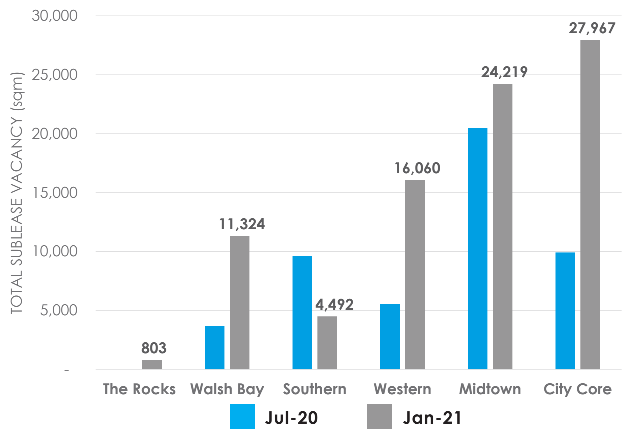


THE SUBLEASE STORY

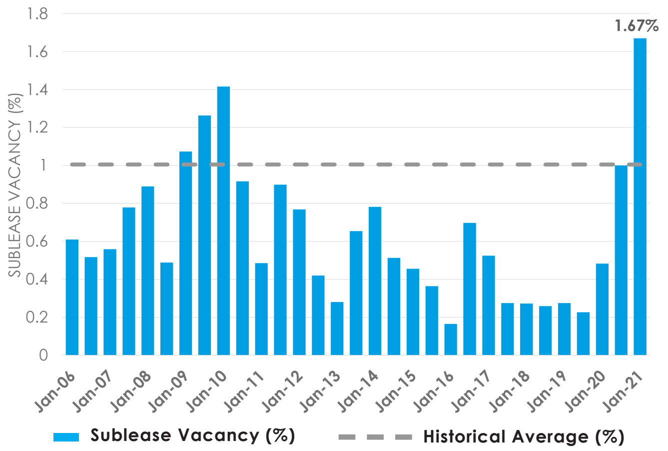
Sublease vacancy has risen 67 basis points above the 30-year historical average, reaching 1.67% this reporting period, as occupiers look to recoup the costs of unused physical space. This represents a total of 84,865 sqm of vacant sublease stock available for lease across the CBD.

- 61.50% of this is located within the City Core and Midtown precincts, with prime grade stock taking the largest hit due to the average rents sitting well above $1,000 per sqm.
- Overall, higher quality stock in the Premium, A and B-grade range represents 92.00% (78,045 sqm) of total vacant sublease stock on the market.

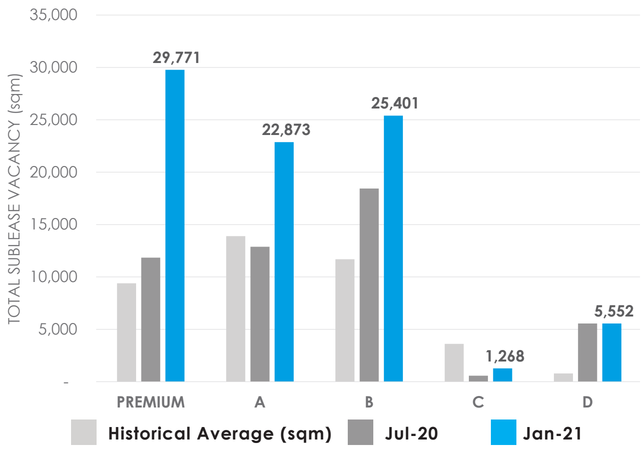
SUBLEASE VACANCY BY PRECINCT



SUBLEASE VACANCY VS HISTORICAL AVERAGE



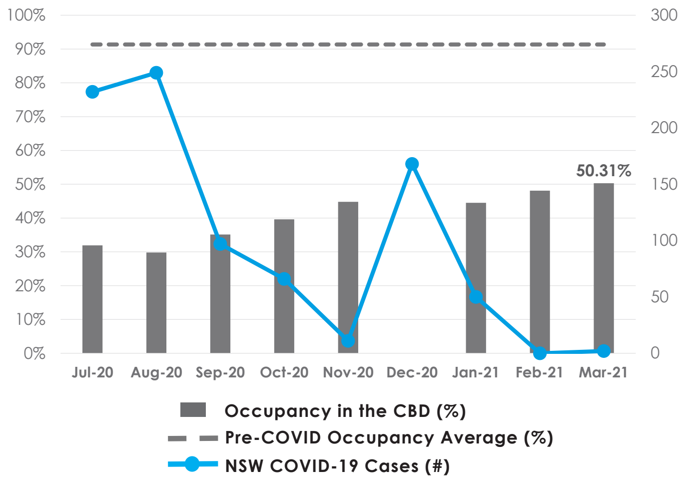
SUBLEASE VACANCY BY GRADE



OCCUPANCY AND DEMAND

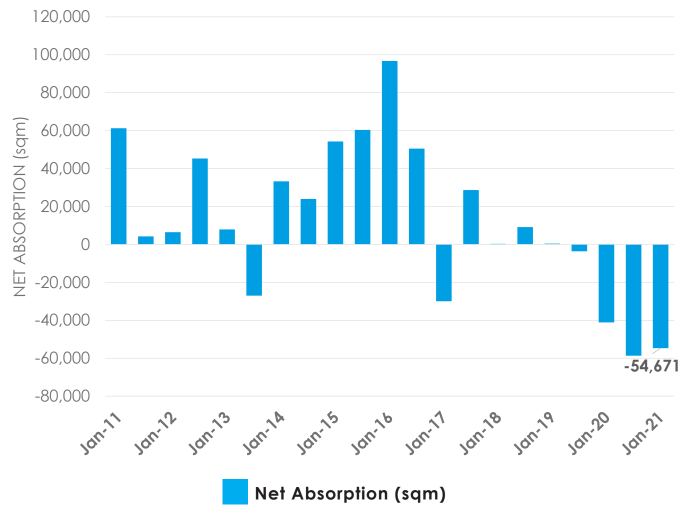
Businesses are encouraging their workforces to return to the office on a full or part-time basis, evidenced by a survey conducted by the Property Council of Australia (PCA) which showed occupancy at 59% as of April 2021, compared to the 29% recorded in August 2020.

SYDNEY CBD OCCUPANCY VS NSW COVID-19 CASES



> *"Current occupancy rates remain significantly lower than the pre-COVID average of 91.35%, and the reduction in tenant demand is evident in the more than 54,000 sqm of negative net absorption recorded. While this is a slight improvement on the negative net absorption of 58,675 sqm recorded from the first half of 2020, the market recovery is gaining pace and tenant confidence is returning."*
>
> **BEN KARDACHI,**
> DIRECTOR, LEASING

SYDNEY CBD OFFICE NET ABSORPTION



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SUPPLY AND DEVELOPMENTS

A total of 279,258 sqm of prime office space is set to be added to the market by 2022, of which 119,227 sqm is expected for completion by the end of this year.

With only 46.69% of this year's new stock pre-committed, this will result in total vacancy rising to 9.48% by the end of 2021, with tenant demand ceteris paribus. New developments underway are as follows:

- **Brookfield Place** – The largest development completed in Q2 2021. Located over Wynyard Station, the 29-storey development will add 60,821 sqm of premium office space to the CBD market. With 91% pre-committed, the anchor tenant is NAB occupying over 31,000 sqm across nine floors.
- **180 George Street** – Known as Lendlease's 'Salesforce Tower' after the 53-storey building's anchor tenant, this Circular Quay development is due for completion mid-2022 and set to be the city's new tallest office building. Upon completion, it will inject 55,207 sqm of premium office space to the CBD with 52% already pre-committed.
- **Quay Quarter Tower** – Also due for completion in 2022, QQT will deliver 88,274 sqm of premium office space to the CBD, of which 76% is pre-committed. Deloitte will be the anchor tenant of the building, occupying over 35,000 sqm on a 10-year lease.

OUTLOOK

Total vacancy is expected to increase by more than 2% by the end of 2021, given the encouraging but moderate tenant demand and the continued addition of new supply.

> *"Studies of the last three major economic downturns show an average lag of two years before vacancy rates reach their peak in major CBDs around Australia. Based on this, we forecast that rising vacancy rates will peak by mid-2022, as current vacancy figures do not reflect the full impact of the COVID-19 pandemic."*
>
> **VIVIENNE CHEN**
> HEAD OF RESEARCH

It is likely that permanent changes to office use as a result of the pandemic will continue to emerge as businesses are now able to make more informed decisions about efficiency and productivity based on performance while working from home and employee surveys and feedback.

Despite subleasing vacancy rates increasing significantly, we expect the take-up of current sublease space to outweigh the new sublease space being placed on the market. As these offerings are fitted and available at lower rates than direct office vacancies, this is an attractive opportunity for growing businesses that were previously unable to source space in the CBD. 2021 has seen large firms such as Telstra, EY and Ashurst reclaim their subleasing offers from the market as they solidify their decisions on final spatial requirements relating to working from home and the office, leading to a reduction in subleasing space in the office market.

In line with rising vacancy forecasts, we anticipate a further 8 – 10% decline in effective rents, with the majority of this witnessed through a rise in incentive levels. It should be noted that average net effective rents have already dropped 18.10% from peak to trough (Macquarie Research, April 2021). 100% of this was attributable to average gross incentives reaching circa 35%, whilst face rents continued to show "growth" over 2020.

TREND WATCH

Fit-out is king: Quality existing or speculative fitouts are now expected by tenants in the current market. With vacancy rates rising, low occupancy levels and modest demand, overall gross incentives have been on the rise, with a larger portion attributed to rental abatements provided by existing fitouts.

Anything but ordinary: With a large pipeline of new office developments boasting superior quality due for completion over the next two years, the impressive form, function and innovation expected of CBD buildings will shift noticeably. As such, secondary-grade buildings may struggle to satisfy the appetite for prestigious designer lobbies, workspaces, amenities and luxury end-of-trip facilities.

SYDNEY CBD CURRENT DEVELOPMENTS

1. **55 Market Street**
   NLA 20,000 sqm
2. **44 Martin Place**
   NLA 10,000 sqm
3. **570 George Street**
   NLA 18,100 sqm
4. **75 Pitt Street**
   NLA 2,200 sqm
5. **4-6 Bligh Street**
   NLA 10,000 sqm
6. **143 Macquarie Street**
   NLA 3,700 sqm
7. **185 Clarence Street**
   NLA 7,500 sqm
8. **210 George Street**
   NLA 16,500 sqm
9. **187 Thomas Street**
   NLA 33,000 sqm
10. **37-55 Pitt Street**
    NLA 60,000 sqm
11. **6 York Street**
    NLA 6,000 sqm
12. **Darling Park Tower 4**
    NLA 60,000 sqm
13. **33 Blight Street**
    NLA 24,000 sqm
14. **275 George Street**
    NLA 7,300 sqm
15. **180 George Street**
    NLA 55,200 sqm
16. **388 George Street**
    NLA 37,500 sqm
17. **Quay Quarter**
    NLA 88,250 sqm
18. **Brookfield Place**
    NLA 67,800 sqm
19. **231 Elizabeth Street**
    NLA 23,000 sqm
20. **56-68 King Street**
    NLA 6,300 sqm
21. **133 Liverpool Street**
    NLA 4,650 sqm

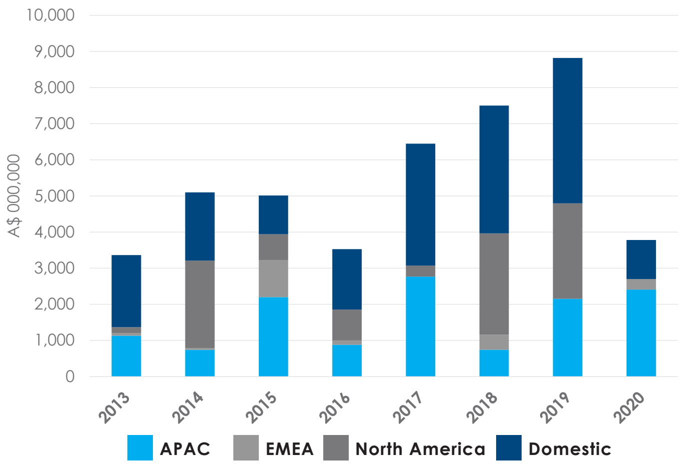
CAPITAL TRANSACTIONS

Activity and demand pick up substantially as prime well-let office assets demonstrate their resilience

HOW IS THE MARKET TRACKING?

Capital transaction volumes are tracking below the impressive results of previous years. Total sales volumes recorded by Real Capital Analytics (RCA) as of December 2020 was A$3.78 billion for the Sydney CBD, representing a year-on-year (YoY) reduction of 50.50% against total 2019 volumes. However, activity has continued to gain pace thus far in 2021, after picking up significantly in Q4 2020. In fact, transaction volumes in Q4 2020 alone represented 70% of the total sales volume recorded for the full year of 2020.

CAPITAL TRANSACTIONS VOLUMES



"Australia's response and handling of the pandemic has been largely successful in bolstering confidence among commercial real estate investors. Pricing models and assumptions are currently being tested and reset. We expect buyers to continue assessing viable income-generating opportunities and actively investing in the CBD market."

JOHN BOWIE WILSON,
DIRECTOR, INVESTMENT SALES

NOTABLE TRANSACTIONS REFLECT MARKET RESILIENCE

Investment from foreign buyers led the way in large transactions over the second half of 2020, including:

- The off-market acquisition of a 50% stake in **Grosvenor Place at 225 George Street**, marking the largest office transaction of 2020. China Investment Corporation (CIC) secured this investment from Dexus for A$925 million, a 5% discount from its book value in June 2020 and on par with its book value as of December 2020. However, the investment comes with some leasing risk, with only 89% of the building occupied and the anchor-tenant Deloitte's imminent move to Quay Quarter Tower upon completion in 2022.
- The off-market divestment of **45 Clarence Street, Sydney** from Dexus to Peakstone, a Singapore-based capital manager, totalled A$530 million. The A-grade tower spanning 32,000 sqm over 28 storeys was reported to have a 3.3 year WALE as of 31 December 2019, with leases to major tenants such as Westpac, Bankwest and Qube Holdings.
- A 25% stake of **400 George Street, Sydney**, was sold by Investa Commercial Property Fund to UK-based M&G Real Estate for A$290 million. With Telstra as the anchor tenant until 2025, the sale of this A-grade building represents an initial passing yield of 4.60% and a capital value of $23,150 per sqm.
- A 25% stake in **1 Farrer Place, Sydney**, was sold by GPT Group to Lendlease-managed Australian Prime Property Fund (APPF) Commercial for A$584.6 million. The deal for this 85,700 sqm, premium-grade building was struck at an initial passing yield of 4.90%, representing a capital value of $27,287 per sqm.

YIELDS AND PRICING

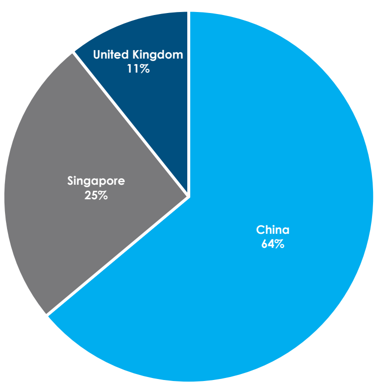
As of Q4 2020, average capitalisation rates (cap rates) tightened further within the 4.00% - 4.25% range, whilst average capital values dropped by 6.80% to $17,173 per sqm over the year of 2020. Focusing on prime assets only, the top quartile price per sqm continues to rise, showing a growth of 18.30% YoY despite cap rates remaining flat at 4.00%. Overall, RCA's hedonic series for the Sydney CBD office market shows that underlying cap rates are softening.

The hedonic cap rate for the Sydney CBD office market sits at 5.01%, whilst prime asset cap rates continue to average at lows of 4.25%. The hedonic price for an office asset sits at $12,000 per sqm, whilst prime office assets are competitively priced at average highs of $24,000 per sqm.

CROSS-BORDER INVESTORS KEEP SYDNEY IN SIGHTS

Despite the Sydney CBD office market having experienced a reduction in total investment volumes over 2020, cross-border investments accounted for 71.40% of all office transactions, a 17% increase from 2019. Of this, a majority (89.25%) originates from investors within the APAC region such as China, Hong Kong (SAR), and the remainder (10.75%) from capital in the UK. This has highly positive implications on Sydney's overall market liquidity with less than a 5% drop in Sydney CBD's Capital Liquidity Score as at Q4 2020, sitting well above the historical lows observed during the GFC (RCA).

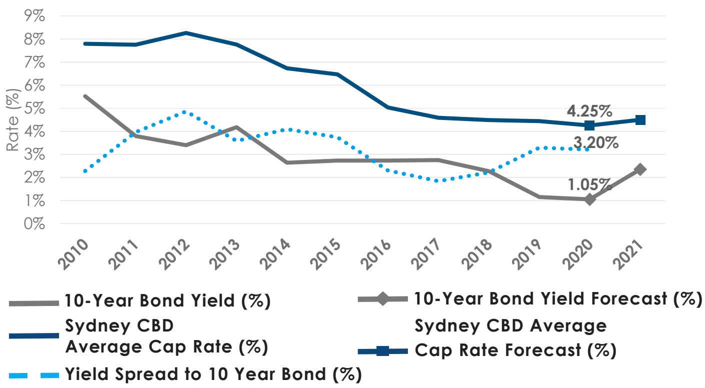
BREAKDOWN OF CROSS BORDER BUYER COMPOSITION 2020



As of Q4 2020, Sydney CBD office assets offered an average return of 3.27% above the Australian 10-year bond rate, significantly higher than comparable markets in the APAC region such as Hong Kong and Seoul at 2.08% and 2.53% respectively.

Globally, Sydney yields above the long bond are lower than larger cities like London and New York who offer risk-based returns of 4.42% and 5.12% above their local risk-free rates. Sydney, however, is arguably the more politically stable destination for investors looking to diversify.

10-YEAR BOND YIELD COMPARISON FOR SYDNEY CBD



We expect transaction volumes will return to the levels observed in 2018 – 2019 over the remainder of 2021, as investor demand remains strong and price discovery emerges post-pandemic. The transactional volume recorded in Q1 2021 Sydney CBD is already higher than the seasonal lows experienced in the first quarters of the last four years. To put this into perspective, Q1 2021 transaction volumes, Australia-wide, are still tracking 19% below volumes recorded in Q1 2020. With business confidence as measured by NAB's Business Confidence Index as of April 2021 at its 10-year high and the lift in Foreign Investment Review Board (FIRB) thresholds as of January 2021, we see foreign investor confidence rising further over the course of 2021.

However, the Australian 10-year bond rate observed its first significant uptick in February this year and again in May since bottoming out in August 2019, leading to the cap rate spread to bond dropping down to 2.50% in Q1 2021. With NAB as of April 2021 forecasting the 10-year bond to continue its trajectory to rates well above 2% over 2021, we expect to see prime yields softening by circa 15 – 25 basis points over the next year.

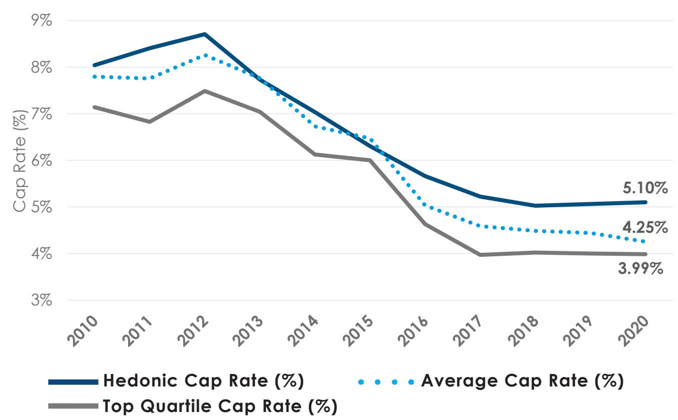
In turn, the average cap rate will be rising back up to the 4.25% - 4.50% range and assuming average built-in rental increases of 3.75%, indicative average capital values will drop by at least 2.50% in line with a 25-basis point increase in cap rates.

A CASE STUDY OF A-REIT PERFORMANCE

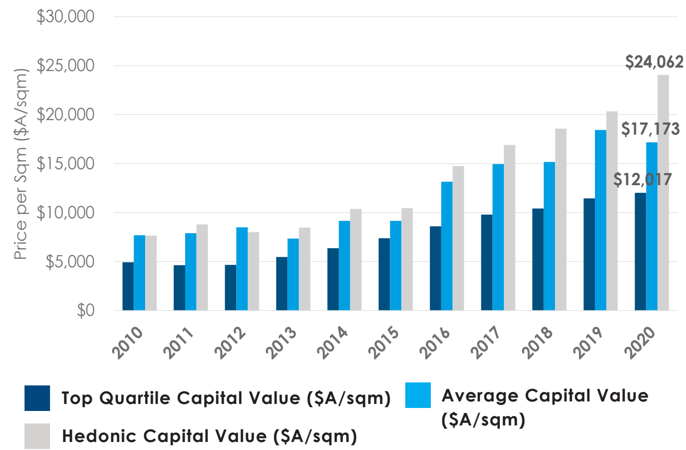
The demand side of the CBD market remains stronger than ever, with the long bond rate at global lows. In Australia, The Reserve Bank (RBA) persisted in maintaining the cash rate at an all-time low throughout 2020, dropping 65 basis points since the beginning of 2020 to the current 0.10%. This has resulted in a continued search for alternative yield from investors, as the 10-year government bond dipped to a historical low of 0.86% over the two months following the announcement. Globally, long bond rates parallel this phenomenon with the US and Japanese government bond rates dipping to 0.62% and -0.40% respectively within the same period, and many world economies falling into recession as a result of low interest rates.

In addition, with limited stock for sale on the open market, all reported transactions in the CBD over 2020 remain competitively priced despite obvious COVID-associated risks such as the rising vacancy rate, subdued tenant demand and a substantial amount of supply due to enter the markets over the next two years. It is unsurprising that the sales of well-let assets such as 400 George Street ($290m)and 1 Farrer Place ($584.6m) were able to achieve results at book valuation and on par with pre-COVID, 2019 pricing.

SYDNEY CBD OFFICE MARKET - CAP RATES Q4 2020



SYDNEY CBD OFFICE MARKET - CAP VALUES Q4 2020



Whilst the subdued leasing market continues to place downward pressure on pricing, office valuations have shifted only marginally over the past year due to the continued tightening of discount rates and cap rates in line with globally low long bond rates.

In a case study of Dexus, Australia's largest office landlord, its portfolio grew by 20 basis points in its latest half year results as of 31st December 2020, but declined by 1.30% since its pre-COVID valuations as of 31 December 2019. Dexus reported that 75% of its growth this half was driven by scheduled rental growth built into office leases, which usually brings about circa 4.50% of portfolio valuation uplift (Dexus' results, FY2019). 25% of this growth was attributable to the 20-basis point compression in portfolio cap rates to 4.95% this half.

Focusing on assets located in the Sydney CBD in the Dexus portfolio, the average cap rate adopted in its book valuations has compressed by a total of 3 basis points over the course of 2020, sitting at 4.85%. Initial yields calculated on its new book values have tightened from 4.52% to only 4.36% this reporting period. With the aforementioned predicted growth in the long bond, this low yield appears especially unsustainable for assets with high vacancies and/or short weighted average lease expiries (WALE). We anticipate more of this risk priced in A-REIT valuations over the next year.

As a result of reduced pricing overall, we expect to see a large portion of transactional activity picking up in the form of mergers and acquisitions (M&A) as more A-REITs continue to trade at a significant discount to Net Tangible Assets (NTA). A key example as of April 2021 is the merger between Centuria Capital (CNI) and Primewest (PWG), wherein the groups merged to form a total market capitalisation of $2.2 billion. CNI and PWG shares are reported to have gained 1.81% and 5.80% respectively since the announcement.

2021 SALES TRANSACTION

DATE	ADDRESS	NLA (SQM)	PRICE (A$)	A$/ sqm	Yield	Grade	% Share	Purchaser	Vendor
Feb-21	CPSU House, 191 Thomas Street	4,797	80,080,000	16,694	3.4%	B	100%	Confidential	CPSU Community & Public Sector Union
Jan-21	Cassa Commercial House, 73 York Street	1,553	30,200,000	19,447	4.4%	C	100%	Confidential	Pacvale
Jan-21	Interpro House, 447 Kent Street	604	7,100,000	11,756		B	100%	Transport Workers Union of NSW	Agamon Pty Ltd
Jan-21	Martin Place Station Development, 39 Martin Place	31,999	800,000,000	25,001		Premium	100%	Investa Property Group, Manulife Financial	Macquarie Group
Dec-20	Pitt Telephone Exchange 76-78 Pitt Street	23,472	281,500,000	11,993		A	100%	Charter Long WALE	Telstra
Dec-20	45 Clarence Street	32,099	530,000,000	16,511	5.1%	A	100%	Zone Q (Peakstone)	Dexus
Dec-20	262 Castlereagh Street	925	23,612,639	25,528		C	100%	Central Element	RSL Lifecare
Dec-20	400 George Street	50,108	290,000,000	23,150	4.6%	A	25%	M&G Real Estate	Investa Property Group
Nov-20	Grosvenor Place, 225 George Street	42,000	925,000,000	22,024	4.8%	Premium	50%	China Investment Corporation	Dexus
Oct-20	Ground Floor, 71 York Street	335	9,900,000	29,553		B	100%	Confidential	Pacvale
Aug-20	Hudson House 127-131 Macquarie Street	633	11,660,000	18,421		B	100%	Cambooya Properties	Epsom Enterprises Pty Ltd
Jul-20	Castlereagh Chambers, 64-68 Castlereagh Street	275	6,400,000	23,273		B	100%	Confidential	Gemtec Pty Ltd
Jul-20	139 Elizabeth Street	2,818	46,000,000	16,324	4.1%	C	100%	Fife Capital	Dencal Pty Ltd
Jul-20	432-434 Kent Street	1,400	23,500,000	16,786	4.3%	B	100%	ATMC Property	Various
Apr-20	Level 1 and 2, 71 York Street	1887	18,500,000	9,804		B	100%	Confidential	Walker Douglas Investments Pty Ltd
Apr-20	Transport House, 388-390 Sussex Street	1,115	29,037,500	26,043	3.0%	C	100%	Taurus Aurum Lin Pty Ltd	Transport Workers Union
Apr-20	Westfield Sydney, 100 Market Street	28,385	683,000,000	24,062	3.9%	A	100%	Link REIT	Blackstone

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OUR TEAM

MIKE STOKES
Director,
Capital Transactions
+61 418 251 579

JOHN BOWIE WILSON
Director,
Capital Transactions
+61 423 000 882

BEN KARDACHI
Director,
Commercial Leasing
+61 419 230 278

BEAU STEWART
Director,
Tenant Representation
+61 400 505 545

RESEARCH

SHIRLEY FAN
Head of Asia Desk
+61 452 531 797

VIVIENNE CHEN
Head of Research/
Investment Analytics
+61 466 303 100

LILY WANG
Investment Analyst
+61 414 281 029

CI AUSTRALIA PTY LIMITED

Level 4, 35 Clarence Street

Sydney, 2000

www.ciaustralia.com.au