Australian Office – March 2023

SPOTLIGHT
*Savills Research*

# Flight to Quality

Demand for premium assets • Tenants gravitate towards CBD Core • Prime assets outperform

# Multi-speed office market

## Strong demand for prime assets amid uncertain economic and office market outlook

**Premium is king**
Australia's major office markets are seeing an ongoing flight to quality driven by employers looking to attract and retain talent as well as an ever-increasing emphasis on environmental and sustainability mandates and credentials.

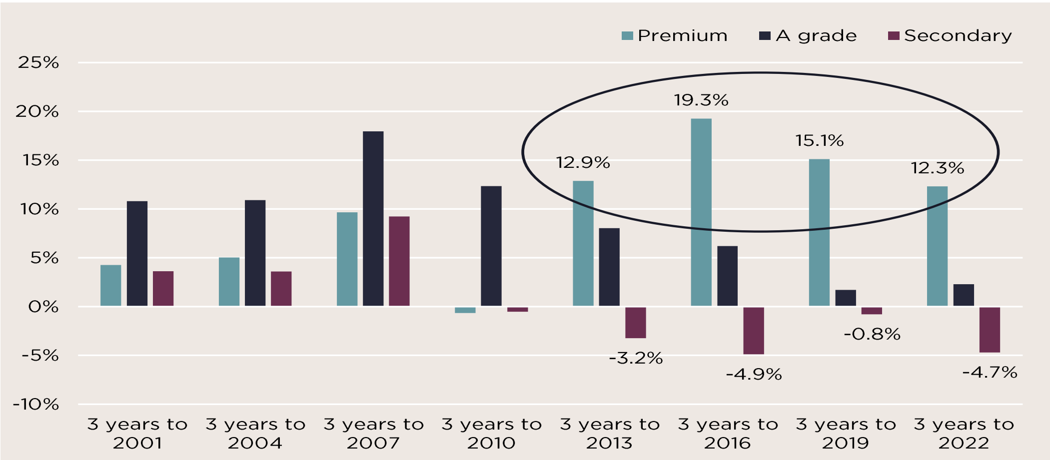
Tight labour market conditions are supporting demand for office space despite the structural changes in working patterns accelerated by the pandemic. However, this demand has been highly concentrated in the premium segment, with take-up diverging markedly across building grades.

In the premium market, the cumulative increase in net absorption since H1 2020 across the Australian markets totalled nearly 400,000 sqm, equivalent to 12.3% of premium office stock, while net absorption in the A grade segment was c.266,100 sqm, equivalent to 2.3% of A grade office stock.

By contrast, demand for secondary market office space declined over the same period, with net absorption falling by around c.537,300 sqm, equivalent to 4.7% of secondary office stock.

**Divergent trends in demand are nothing new**
The experience since the onset of the pandemic is not unique. Strength in demand for premium office space and declining take-up of secondary space has been a feature of the Australian office market for the past decade. From 2013-22, net absorption in the premium segment nationally averaged c.132,400 sqm (4.9% of premium office stock) per year, compared with c.41,900 sqm (2.5% of stock) a year over the decade prior. Over the same 2013-22 period, net absorption in the A grade segment has steadily slowed by remained positive, while net absorption in the secondary market has declined by c.159,300 sqm (1.4% of secondary stock) on average per year.

**Large divergence between prime and secondary take-up**
Cumulative net absorption by grade as a share of office stock, per cent




**Source** Savills Research / Property Council of Australia

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### Demand influenced by supply

The strength in demand for premium office space over the past decade is partly explained by the rising share of premium stock that became available during that period.

After being relatively constant at between 7%-8% since the late 1990s, the premium segment's share of total office stock increased by 5.5 percentage points from 7.4% in January 2012 to 12.9% in January 2023.

The share of A grade stock increased by 4.9 percentage points to 44.9% over the same period, while the secondary share declined by 10.4 percentage points to 42.3%.

### Economic outlook reinforces flight to quality

The slowdown in global growth amid high inflation and rising interest rates is reinforcing the appeal of prime assets.

While the Australian economy is expected to remain in expansionary territory in 2023, the slowdown in economic growth and labour market conditions both domestically and globally may increase leasing risk in some markets.

Premium markets are relatively tightly held and less exposed to leasing risk. Nationally, the premium vacancy rate is 8.7% compared to 13.3% for A grade and 14.7% for secondary.

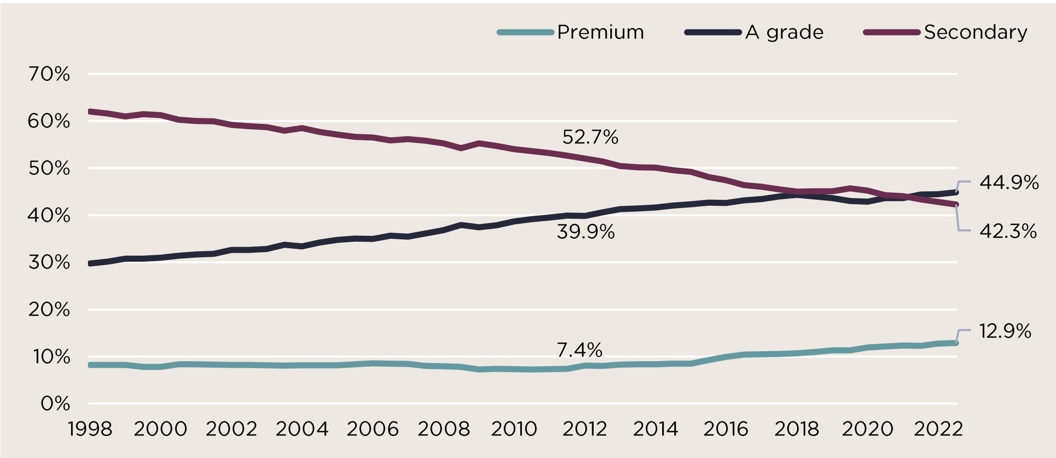
### Structural trends also support prime demand

In addition to cyclical outlook, structural forces are also driving demand for prime and well-located assets. In the wake from the pandemic, more businesses are recalibrating their office environment to changes in work patterns with a goal of maximising workplace performance, against their ability to meet growing duty of care requirements and maintaining business continuity.

In some cases, this may mean a reduction in floor space requirement and in others, an increase, but the commonality towards a newer, more efficient workplace in a central location is the same.

Assets in central locations with strong transport links will continue to outperform, alongside newer, higher quality office space that helps support business continuity, caters to the changes in work patterns, and allows employers to remain competitive in the battle for talent.

**Rising prime share of office stock**
Office stock by grade, per cent of total




**Source** Savills Research / Property Council of Australia

### Take-up concentrated in the prime market

**+399,600 sqm (+12.3% of stock)**
Increase in premium market net absorption nationally, 2020-22

**+266,100 sqm (+2.3% of stock)**
Increase in A grade market net absorption nationally, 2020-22

**-537,300 sqm (-4.7% of stock)**
Decrease in secondary market net absorption nationally, 2020-22

**12.9%**
Premium grade office stock, share of total, Jan 2023 (+5.5ppts since 2012)

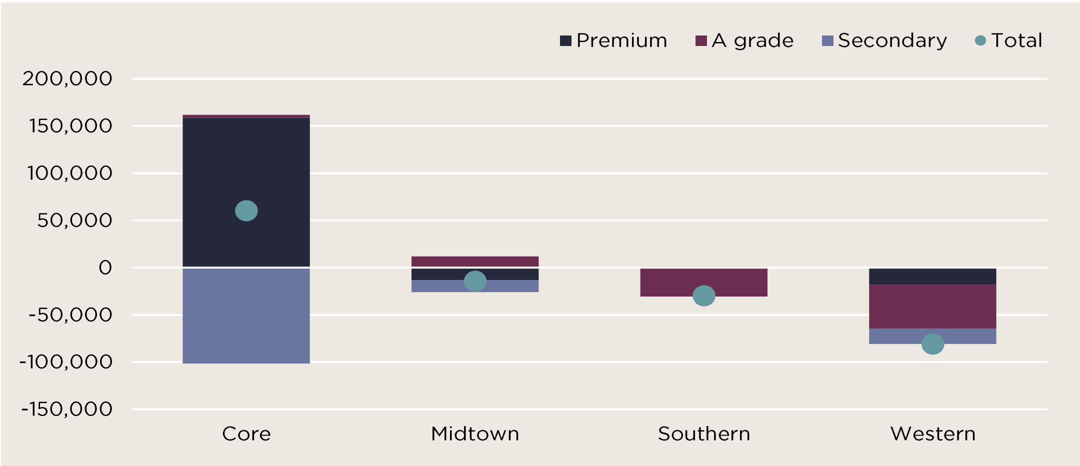
**44.9%**
A grade office stock, share of total, Jan 2023 (+4.9 ppts since 2012)

**42.3%**
Secondary office stock, share of total, Jan 2023 (-10.4ppts since 2012)

# Location, location, location

Occupiers gravitating towards Sydney's CBD Core

**Take-up in Sydney CBD concentrated in the Core**
Net absorption, 2020-22, by precinct and grade, sqm




**Source** Savills Research / Property Council of Australia

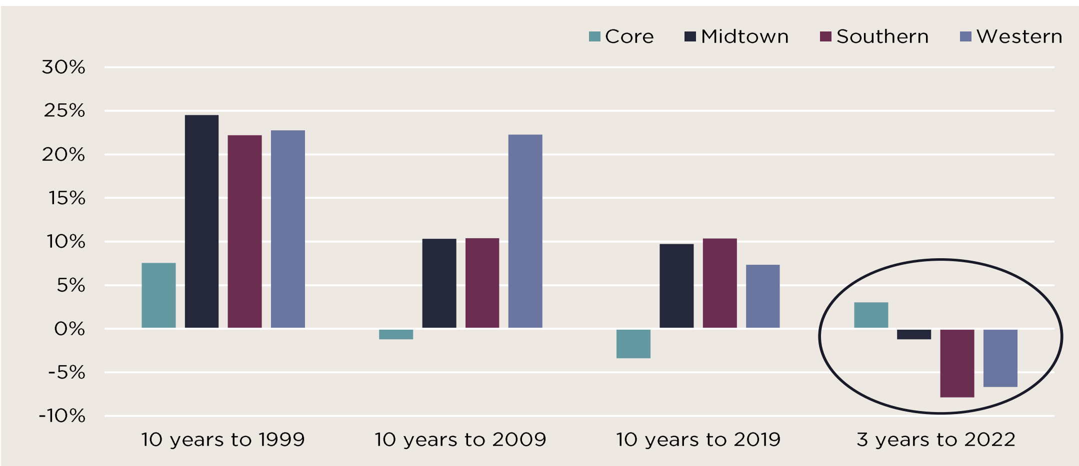
### Core revival

The importance of location can be seen in the relatively strong demand for centrally located office space over the past couple of years. In the Sydney CBD for example, net absorption over the past three years has been concentrated in the Core (c.60,300 sqm), while absorption in the Midtown, Southern, and Western precincts has declined.

While demand trends over this period have been heavily impacted by the COVID-19 pandemic (particularly during its onset in 2020 when leasing activity slowed dramatically), the rebound in demand for office space in 2021 and 2022 has been heavily skewed towards the Core where net absorption totalled c.101,100 sqm over these two years.

This trend of relatively strong demand in the Core represents a significant shift compared to the past several decades. Net absorption across all grades in the Core as a share precinct office stock was quite weak in the three decades to 2019, averaging just 1% over this period, with negative absorption in the 10 years to 2009 and the ten years to 2019. By contrast, take-up in the Midtown, Southern, and Western precincts grew strongly over this three-decade period, averaging between 14.3% and 17.5% of precinct office stock. This strong take-up reflects the relatively strong growth in office stock in these previously underdeveloped precincts and the relative affordability of leasing space in these areas.

**Net absorption by precinct**
Per cent of precinct office stock




**Source** Savills Research / Property Council of Australia

**Pandemic rebound concentrated in the Core**

**+101,100 sqm**
Increase in net absorption in CBD Core, 2021-2022

**+7,000 sqm**
Increase in net absorption in Midtown, 2021-2022

**-25,000 sqm**
Decrease in net absorption in Southern, 2021-2022

**-40,700 sqm**
Decrease in net absorption in Western, 2021-2022

# Capital markets implications

## Investor rotation towards core assets drives return outperformance

### Investor rotation towards core assets

The relative strength of the occupier market outlook for centrally located prime assets, both from a cyclical and structural perspective, will drive a rotation into core assets and out of non-core assets as major institutional investors reposition their portfolios towards assets that are less exposed to leasing risk. After a slowdown in investment activity in 2022 reflecting the rapid rise in interest rates and funding costs, investor rotation into core assets and out of non-core assets is likely to gain momentum in the second half of this year, as the interest rate outlook becomes clearer with major central banks expected to end monetary policy tightening in the coming months.

### Demand-supply imbalance driving green premium

A key driver of the flight to quality is the increasing emphasis investors and occupiers are placing on an office assets' green credentials. Office buildings with strong green certifications are increasing highly sought after and supply is limited. According to Savills World Research, on average, just 28% of total stock in the top 20 cities (by number of green certified offices) is green certified. Strong demand relative to limited supply is driving a material premium for highly rated green assets, both from a capital growth and income return perspective, which is beneficial to current owners and attractive to prospective investors.

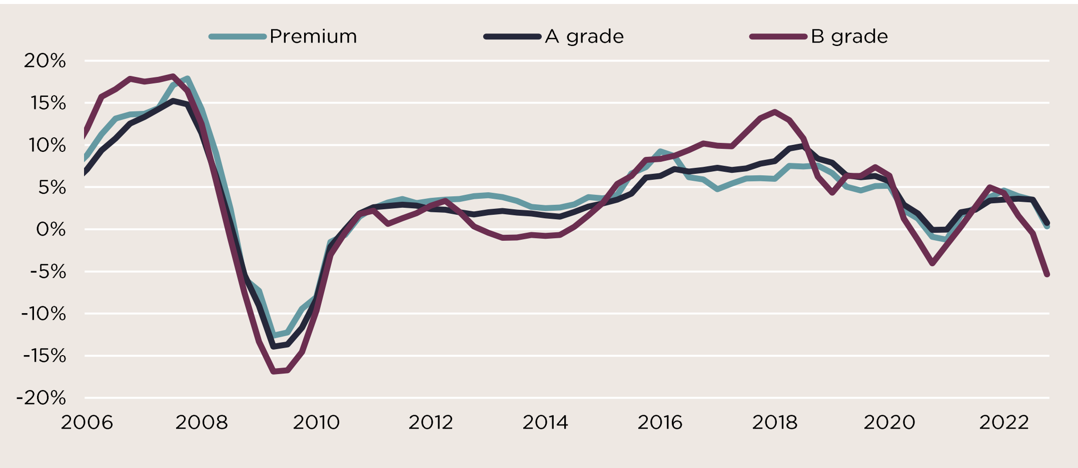
On the flip side, over 70% of existing office stock in these cities will need to be retrofitted or repurposed to meet higher environment standards. This represents a significant opportunity for value-add investors, although the current high rate of inflation and strong growth in material and labour costs may make many such projects cost-prohibitive in the short-term.

### Prime assets set to outperform

Reflecting stronger investor demand and occupier market fundamentals, prime assets are beginning to materially outperform the secondary market after the broad-based rebound in capital growth following the pandemic downturn.

Capital values for premium and A grade assets declined by 1.7% and 1.4% respectively in Q4 to record slightly positive growth over the year to December 2022. By contrast, capital growth for B grade assets fell by 3.7% over the quarter to be 5.4% lower over the year. The relative strength of the occupier and investment market outlook for prime office assets means this divergence in performance is likely to continue.

**Widening gap between prime and secondary office asset performance**
Capital growth by grade, per cent change y/y




**Source** Savills Research / Property Council of Australia

### Prime asset returns outperforming secondary

**+0.3%**
Premium asset capital growth, 2022

**+0.7%**
A grade asset capital growth, 2022

**-5.4%**
B grade asset capital growth, 2022

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For more information about this report, please contact us


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