MaxCap
Investment Management

MAXCAP AUSTRALIAN OFFICE MARKET UPDATE

OCTOBER 2021

OVERVIEW

- The COVID-19 pandemic disrupted the global office market in 2020, forcing a sudden and significant shift in the way people undertook their day-to-day work.
- Tenants were forced to review their operational strategies and space requirements. Net absorption reached historic lows while national vacancy rates surged to highs not experienced since the late 1990s. This led to an increase in sublease space and incentives, which have placed downward pressure on net effective rents across Australian cities.
- Federal and State Governments have provided a clear road map to phase out of lockdowns, to reopen the economy and international travel to stimulate economic growth by early to mid-December 2021, once the national target of 80% full vaccination has been achieved. In the meantime, the governments have also fast-tracked shovel ready commercial development projects with an end value of c. $2.5 billion in H1 2021 to stimulate the economy.
- The private sector has supported a return to the office, albeit with increased acceptance of flexible working arrangements. A hybrid working model has emerged, with the office now providing a place to connect, collaborate and build culture.
- Positive sentiment and confidence have returned to the market as a result of the faster-than-expected economic recovery. Growth in the labour market, particularly in the white-collar sector, will continue to support the recovery of office market demand.
- Prime spaces continue to benefit from the flight-to-quality trend that has emerged from the high vacancy, low rent environment. Recent leasing transactions shows that institutional tenants have been active in searching for premium grade spaces in CBD and CBD fringe areas.
- Post COVID-19, corporate and government tenants are seeking high-quality office environments to align with their culture and brand, sustainability commitments and to attract talent and retain their teams.[1]
- To remain competitive in the market, building owners must improve the overall quality of their buildings to attract corporate and government tenants. Refurbishment/improvement expenditure has increased over the past 5 years with average total spending for assets below 3 stars / unrated stock, which account for 48% of total office stock by NLA estimated at $450 million per annum nationally. There is potential to go over $1 billion per annum on refurbishment and upgrade work costs as demand for sustainable buildings increases in the coming years, noting that this has not taken into account the debt requirement for new developments and refurbishment of higher-grade stock.[2]
- Secondary commercial real estate stock is increasingly challenging to lease and asset owners are responding to heightened demand from tenants and the broader market for premium 'green buildings'. The repositioning and retrofitting of existing commercial office buildings are becoming critical in attracting premium tenants seeking to upgrade their existing premises.
- As the rebound for the Australian economy and labour markets continues to unfold, companies will continue to gain confidence and start to unwind their decision-making holding patterns. The focus will then shift to their office requirements and the space and environment needed to retain company culture, employee engagement and to attract and retain talent to drive the future growth of their businesses.
- Investors will remain attracted to Australian commercial real estate because of its transparency, long-term economic fundamentals, and stable returns.

1. Kylie Rampa, CEO, Lendlease, 'Commercial Office Design Going through a sea change, Australian Financial Review, 13 April 2021

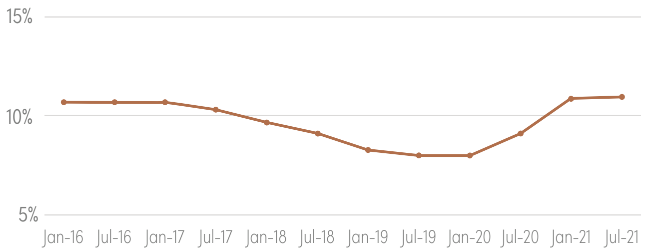
2. JLL

THE TURNING POINT FOR COMMERCIAL PROPERTY

Prior to March 2020, the Australian commercial office segment was booming.

- Approximately $9B transaction value completed in the 12 months up to March 2020.
- National commercial office vacancy at a historical low (~8.0%) for the past 5 years, with Melbourne (3.2%) and Sydney (3.8%) being the two strongest markets in Australia.
- Low vacancy pushed rental rates higher, with Sydney and Melbourne's markets reaching new heights, further compressing yield rates.
- National absorption rates were the highest for the past decade, with most of the new developments achieving at least 50% pre-commitments within the first 12 months of the construction period.

FIGURE 1. NATIONAL OFFICE VACANCY RATE



Source: Property Council of Australia, Office Market Report

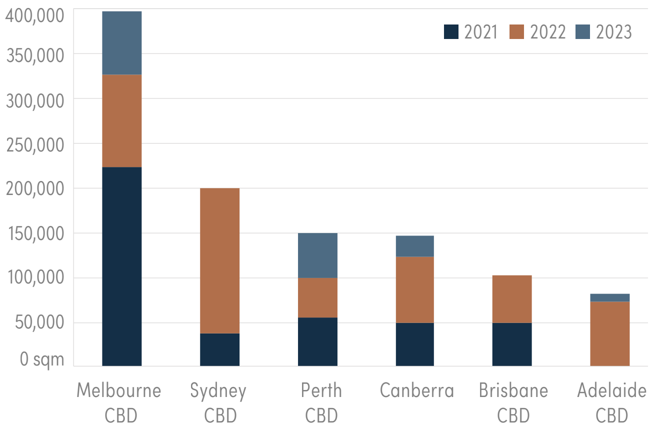
The COVID-19 pandemic hit Australia hard in early-2020, which forced the federal and state governments to take drastic measures to contain the virus, such as the closure of the international border and total lockdown of major cities – most employees were forced to work from home, leaving empty offices in Australia's CBDs.

The pandemic has changed the whole ecosystem of the commercial office market – corporate tenants are reconsidering their options, property owners are reconfiguring office spaces to attract tenants, governments and authorities are providing support to reset the segment.

SUPPLY

At a national level, the total projected supply entering the Australian CBDs is forecast to be 1.22m sqm for the next three years commencing Q3 2021 (source: PCA, JLL). The Melbourne CBD is leading the charge with more than 220,000 sqm to be completed in 2021, which continues to be the largest commercial office market in Australia.

FIGURE 2. FUTURE SUPPLY OF CBD MARKETS (2021-2023)



	Melbourne CBD	Sydney CBD	Perth CBD	Canberra	Brisbane CBD	Adelaide CBD
% of current stock	8.0%	3.9%	8.4%	6.1%	4.5%	5.5%
Pre-commitment	41.1%	49.1%	28.6%	38.4%	63.4%	22.9%

Source: PCA

The extended lockdowns currently impacting Victoria and New South Wales continue to put downward pressure on net absorption rates, pushing vacancy rates higher. However, pre-commitments for premium grade offices remain robust with some notable transactions announced lately.

TENANT MARKET

Moving to a hybrid model

As entire corporate workforces abruptly shifted from the office to a home-based work environment in 2020, tenants were forced to review their operational strategies and spatial requirements. While this sparked a global debate around the future of the office, the rising occupancy levels witnessed through Q4 2020 and Q1 2021 indicate that an exclusive working-from-home model will not eventuate. Instead, a hybrid working model has emerged, with employees splitting their time between remote work and office work. The office has now become an important space to drive company culture, productivity, and collaboration. As tenants pause and rethink their use of space, short-term leases and more flexible arrangements are preferred, coupled with a focus on wellness and quality as a means of attracting employees back to the office.

Increase in supply and vacancy

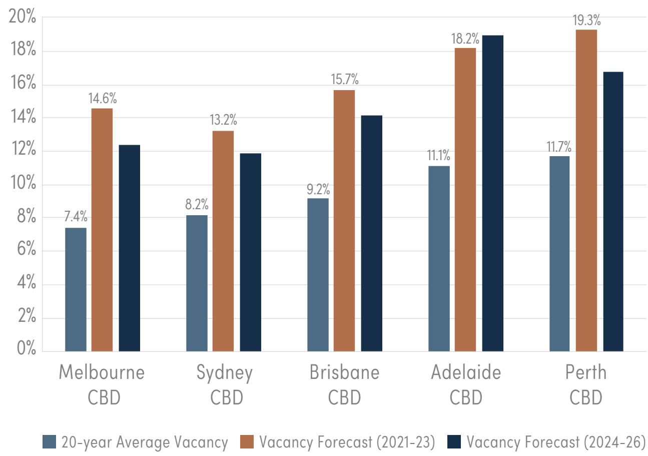
A push to a hybrid workforce has exerted upward pressure on office market vacancy across the country. Average Australian CBD office vacancy rates rose from 8.0% in June 2020 to 14.0% in June 2021. (Source: JLL Q2 2021 report) The increase was driven by the reduction in leasing activity and the subsequent rise of sublease availability, as tenants reduced their footprint while deferring decisions on longer-term plans.

While the rate at which sublease space is put the market is slowing and there were some positive signs in Q1 2021 with some tenants reabsorbing space previously marketed for sublease, on average, occupiers are looking for about 10% less workspace relative to pre-pandemic requirements. Mirvac, for example, is factoring in a 10% reduction in its space requirements and Westpac and ANZ have confirmed they will also be reducing their special requirements.

Rising vacancy levels and high levels of sublease space have resulted in landlords increasing incentives to attract tenants, which placed downward pressure on rents. While face rents remained stable in 2020 and unchanged in Q1 2021, with incentives currently averaging around 35%, effective rents have fallen from pre-pandemic levels. The country's largest landlord, Dexus, saw effective rents drop around 15% in Sydney over the past year and 10% in Melbourne. Higher incentive levels are expected to remain over the short to medium term to continue to drive the occupancy rebound, particularly as new office supply in Melbourne, Sydney and Brisbane comes to market. The supply pipeline remains concentrated in Melbourne, with the local market size increasing by 4% in 2021 compared with a 2% increase in Sydney, Brisbane, and Canberra.

These elevated vacancy levels will also likely push office building refurbishments to increase nationally over the short to medium term, given the pandemic has placed greater importance on health and wellbeing. Building features and amenities that support flexibility, improved staff wellbeing and reduced running costs are increasingly desirable. High vacancy across national markets will leave poorer quality, older stock obsolete, unless capital expenditure on refurbishment is undertaken to reposition these assets.

FIGURE 3. NATIONAL OFFICE VACANCY FORECAST



Source: JLL Research

Flight to quality

Organisations will gravitate towards assets with strong sustainability attributes. This creates a potential pool of pre-commitment tenants for developers and an opportunity for investors to refurbish existing assets.[3]

In an environment characterised by higher vacancy and the greater choice this implies for tenants, a flight-to-quality trend has emerged. Tenants are pushing for more favourable lease terms but also seeking to secure workplaces with sustainability features that deliver positive environmental outcomes and better-quality work environments for their employees.

With the rise of Environmental, Social, and Governance (ESG) strategies globally, the number of corporate statements announcing carbon neutral targets has accelerated since the Australian bushfires in early 2020.[4]

ESG targets will be a fundamental influence on leasing decisions for large occupiers moving forward. Wellness and sustainability certified buildings that optimise indoor air quality, provide acoustic and thermal comfort, maximise natural lighting, and improve energy efficiency are favoured. These buildings complement the efforts of companies to meet their ESG commitments and help them to deliver an improved work environment and experience for their staff as they return to the office.

The flight-to-quality trend will also assist in offsetting some of the lease contraction activity, as workspaces are repositioned and refurbished to incorporate more collaborative and break-out spaces, while also increasing the workspace ratios. With this reconfiguration of existing space, coupled with jobs growth in Australia's white-collar employment sectors, some space extension may even be required.

Prime space vs secondary space

This flight-to-quality has benefited the prime office space, and the divergence between prime and secondary vacancy is expected to become more pronounced. This will be exacerbated in Melbourne and Sydney, as new premium supply comes to the market over the next four years. The average vacancy rates between prime and secondary supply appear to have diverged over the past five years in both the Melbourne and Sydney market.

The spread between prime and secondary grade rents is expected to continue widening over the coming years, as quality-focused tenants are willing to pay a premium for prime spaces. Lower-grade space which cannot meet tenants' stringent requirements will increasingly become redundant if not refurbished.

3. JLL-research-australia-and-new-zealand-investment-market-themes-for-2021, December 2020

4. JLL

PROPERTY OWNERS

- Increased cost in the form of incentives and rebates
- Reposition existing assets
- Different strategy

The impacts of the pandemic have created a 'tenant's market' for the commercial office sector, with tenants enjoying a clear advantage in leasing negotiations, in most market segments.

With the surge in vacancies, property owners are competing to lease up office buildings, offering lower rental rates, higher incentives in the form of rental discounts, cash incentives, rent-free periods and fit-out/renovation contributions.

Incentives have increased from an average of 13% to c.20% across various office grades in the past 12 months. This has put downward pressure on profitability for property owners, which will, in turn, affect property values.

To alleviate the situation, some property owners have taken steps to reposition their assets, such as refurbishing and upgrading buildings. Whilst these are capital intensive activities, they are essential to attract or retain tenants in this challenging environment.

Major institutional property players have recognised the market opportunity with tenants' flight to quality and are leading the industry in the repositioning of existing assets and raising capital to reposition or enhance existing properties within their portfolios. Some of the major changes include:

- Renovation of office spaces to create a more sustainable environment and lower running costs.
- Larger and more flexible floorplates.
- Touchless entry into offices.
- Leveraging innovation and technology to allow employees to interact with each other, even in a hybrid working model environment

Most large corporations have embraced the new normal – flexible working arrangements for all employees, activity-based and open office environments. This has prompted many companies to reconsider their office space requirements and slash pre-committed spaces in office developments under construction.

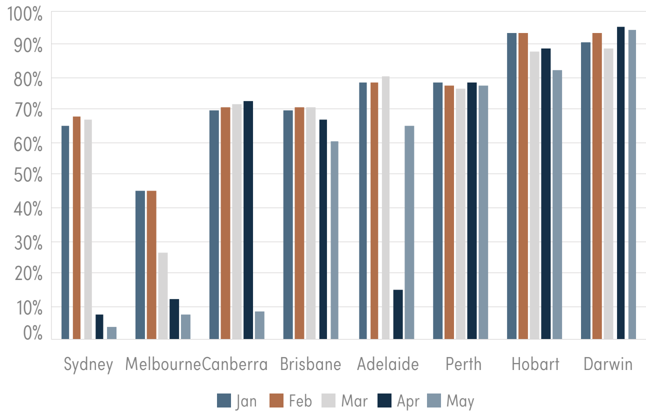
GOVERNMENT INITIATIVES

- Stimulus package announcements – jobseeker / jobkeeper payments, child-care subsidies
- Initiatives to attract workers to return to CBDs
- Fast-tracking of development projects

During the pandemic period, the federal and state governments have introduced various measures and packages to stimulate the economic activities in our major CBDs.

At the federal government level, major stimulus packages such as jobseeker payments and uncapped childcare subsidies were introduced in 2020. These measures were attempts to save jobs, and also to enable and encourage working parents to attend their workplaces by reducing some or all of the financial cost of childcare.

FIGURE 4. OFFICE OCCUPANCY BY CBD, 2021 (% OF PRE-COVID-19 LEVELS)



Source: Property Council of Australia

Outside of Sydney and Melbourne, the COVID-19 situation is currently under control in most major Australian cities, albeit small outbreaks continue to occur, placing cities into snap lockdowns for short periods. The outbreaks have hit Melbourne most severely, with several periods of lockdown across the past two quarters. The duration and frequency of lockdowns in Victoria have resulted in little improvement in the office occupancy rate over the past five months.

The Melbourne City Council and the Victorian Government have introduced various incentives to bring crowds back to the CBD, such as free parking, rebates on expenses in CBD, travel vouchers etc. These are intended not only to stimulate activity but also to support businesses in the CBD.

Local councils and state governments have fast-tracked shovel ready office development projects, issuing approvals to projects with a total end value of c. $2.5bil in 2021 to date. This is a strong vote of confidence for the office sector, both from the government and private sectors, that the commercial property segment remains a key component of the Australian economic recovery.

SECTOR OUTLOOK

- Positive health and economic indicators, as well as the increasing pace of the vaccine rollout, will continue to support the recovery of the economy and, in turn, the office market.
- As we approach the targets set out under the National Roadmap to reopening, the rebound of the Australian economy and labour markets will continue to gather momentum, and companies will increasingly gain confidence and start to unwind their decision-making holding patterns. It is likely that in Q1 2022 focus will begin to shift to office requirements and the optimal workspaces for retaining and attracting talent, maintaining company culture and encouraging collaboration and sustained productivity to drive business growth.
- Sustainability features are expected to remain a key requirement for future office building design and fit-out. This is being driven by investor and tenant demand and regulatory shifts. Consistent with the global trend, occupier demand for sustainable offices will gather pace in Australia. The tangible benefits that sustainable office buildings can deliver to investors through a combination of higher rents and stronger leasing velocity provide incentives to absorb the retrofitting costs to incorporate improved sustainability and best in class design standards.
- Going forward, building owners will need to provide flexibility (flex-space) to mitigate the risks of future economic uncertainty and to meet tenant requirements. Flex-space comprises a mix of core leased space with flex spaces that can be scaled up and down as needed and this offering has emerged as a key requirement for tenants as a future-proofing leasing strategy. This may result in a reduced footprint of occupiers on a direct lease basis, as they partner with landlords on flex-space.
- Relative to other geographies, Australia is in an enviable position 18 months into the pandemic from both a health and economic management perspective which should provide investors in Australia's property market with a degree of optimism.

The Australian economy performed well through COVID-19, and Q1 2021 economic indicators suggest the economic recovery is underway and will be a sharper recovery than previously expected. With GDP recording a quarter on quarter increase of 3.1% in December 2020 and 1.8% quarter on quarter to March 2021, GDP is projected to **grow by 5.1% in 2021** and **3.4% in 2022**.

The labour market indicators are especially encouraging with the unemployment rate improving to 4.5% as of August 2021 (Source: ABS). The recovery in the labour market is expected to further support the recovery in office demand, with most of the growth occurring in traditionally office-bound industries of professional and technical services and government.

With the current vaccine rollout gaining pace and a clear National Road map to reopening of the economy, domestic and international borders and ultimately immigration, the longer-term prospects for the commercial property market remain strong.

NATIONAL SNAPSHOT

Source: JLL Q2 2021 report

SYDNEY

The extensive lockdown in NSW continues to have a great impact on the Sydney CBD market, with investment activity dropping significantly – only two transactions totalling $113.1m occurred in Q2 2021. Leasing sentiment for Sydney continues to improve despite leasing volumes remaining relatively low. The CBD's prime vacancy rate increased to 13.6% while the secondary vacancy rate increased 1.2% to 12.5% over Q2 2021, pushing the headline vacancy rate up to 13.2%. Demand has seemingly shifted in favour of city fringes with net absorption of 14,800 sqm across Sydney fringe, South and Northwest Sydney, and headline vacancy largely remains unchanged over the past quarter. Driven by an increase in incentives of averaging 32.6%, CBD prime gross effective rents over the quarter decreased by 2.2% to $895 per sqm p.a. Yield for both prime and secondary spaces held firm between 4.38%-5.00%.

SYDNEY	VACANCY (%)	YIELD (%)	PRIME GER ($/SQM P.A.)
Q2 2021	13.2%	4.38-5.00%	$895
Q1 2021	12.1%	4.38-5.00%	$915
Change	▲	↔	▼

MELBOURNE

Investment activity picked up in Q2 2021 from last quarter albeit total volume remains below average. The CBD recorded four transactions (≥ AUD 5.0 million) totalling AUD 316.1 million, demonstrating a positive investor sentiment. CBD office vacancy dropped marginally by 0.2% this quarter to 14.1%, there were some positive signs in the sublease environment with net absorption of 6,575 sqm (Q1 2021 -56,195 sqm). As demand for non-city office spaces continues to trend upwards, Melbourne city fringe and south-eastern suburb markets continue to see strong growth in net absorption of 11,700 sqm and 7,870 sqm respectively. With leasing incentives continuing to rise in back filing vacancies, CBD prime gross effective rents dropped 1.9% to average $532 per sqm p.a. and similar trends were noted for city fringe and S.E.S stock at $431 (-1.1%) and $358 (-0.7%) per sqm p.a. respectively.

MELBOURNE	VACANCY (%)	YIELD (%)	PRIME GER ($/SQM P.A.)
Q2 2021	14.1%	4.38-5.13%	$532
Q1 2021	14.3%	4.38-5.38%	$542
Change	▼	↔	▼

BRISBANE

Building on a strong Q1, the Brisbane CBD has seen 5 key asset transactions totalling $682.3 million in Q2 2021 signalling confidence in the market. The headline vacancy rate increased to 15.9% on the back of -6,407 sqm absorption and is still tracking above the historical average of 13.3%. Gross effective rents for prime and secondary spaces fell marginally by 0.3% to $395 per sqm and 0.4% to $291 per sqm respectively, owing to an increase in incentives for both classes. Yield has held stable over the quarter, with prime median yield measured at 5.63% and secondary at 6.63%.

BRISBANE	VACANCY (%)	YIELD (%)	PRIME GER ($/SQM P.A.)
Q2 2021	15.9%	5.00-6.25%	$395
Q1 2021	14.0%	5.00-6.25%	$396
Change	▲	↔	▼

PERTH

Despite being the only 'COVID-19-free' Australian state, tenants in Perth's CBD continue to hold off on relocation decisions creating a challenging leasing environment. Only one major office transacted in the past quarter. The CBD's prime vacancy rate improved by 0.3% over the quarter to 15.4% and the gross effective rent for prime and secondary spaces remain stable circa $400 and $300 per sqm p.a. respectively. The average Perth CBD prime yields are compressed by 25 bps to range between 5.00%-7.5% while secondary yields are also compressed by 50 bps within the range of 6.5% to 9.5%.

SYDNEY	VACANCY (%)	YIELD (%)	PRIME GER ($/SQM P.A.)
Q2 2021	19.7%	5.25-7.50%	$450
Q1 2021	20.2%	5.25-7.50%	$450
Change	▼	↔	↔

FUTURE COMMERCIAL MARKET TRENDS – COMMERCIAL REAL ESTATE DEBT OPPORTUNITIES

With the COVID-19 environment gradually improving and stabilising, MaxCap has observed market sentiment recovering for commercial real estate debt opportunities within the office sector. Major banks and non-banks continue to support the development and acquisition of commercial office assets, albeit with more conservative metrics.

MaxCap has observed increased market activity in the segment within the past six months and will continue to selectively participate in transactions that demonstrate the following favourable risk-return characteristics:

1. Pre-commitments

Noting that leasing pre-commitments are scarce in the current environment, with many tenants taking a wait-and-see approach, a robust leasing strategy is key to attracting new tenants.

MaxCap views pre-commitments in any form as essential to securing development funding for commercial assets. Pre-commitments demonstrate market acceptance of the product and the borrower's (asset owner) capability in securing new tenants.

2. Tenancy profiles

Corporate strategy concerning office space in the medium term remains largely unknown, mainly due to the hybrid working model adopted by most large companies and the government sector to date. Whilst some institutional property owners have secured government agencies and large corporates as anchor tenants, the trend seems to suggest that companies, in particular SMEs, are moving to suburban and city-fringe office locations.

New leases will tend to be short-term with higher incentives and split among a greater number of tenancies within the office asset. This may present a challenge for borrowers concerning the primary exit / refinance strategy, as a shorter but higher volume of leases may not fall within the major banks' appetite for financing commercial offices.

Asset owners and managers continue to explore options, including offering various incentives to secure target tenants, hoping to achieve the optimal tenancy mix.

MaxCap will work continue to work with borrowers in developing comprehensive strategies to enhance the asset value and improve the strength of exit for MaxCap as the lender.

3. Quality enhancement

Capitalised property owners may use this opportunity to reposition their assets to improve amenities, floorplates, end of trip facilities and energy efficiency.

MaxCap continues to support property owners in repositioning existing assets.

With ESG being a key focus for major corporate players and investors, financial institutions will move quickly to establish green loans to support initiatives in asset repositioning work to improve building energy ratings.

Whilst opinions on the commercial property market remain divided, investors and asset managers are upbeat and confident that commercial offices will continue to play an important role in the economic recovery phase. Asset owners are continuing to monetise their prime assets at a premium, driven by a strong desire for yield from both local and international investors.

MaxCap expects to see strong risk-adjusted opportunities appear in the non-bank space, for well-structured debt investments in the opportunistic and value add space.

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