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The largest migration to premium assets in Sydney CBD

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Introduction

Throughout this year, we've heard a lot about the unprecedented level of withdrawals in the Sydney CBD spanning the next five years. As a result of the Sydney Metro project together with residential and hotel conversions, the Sydney CBD will permanently lose 206,565sqm of mostly secondary grade stock. This has placed downward pressure on incentives, resulting in significant increases in effective rents across all grades.

While rents increase and competition for space intensifies, tenants have seen an opportunity to upgrade their office accommodation as secondary rents surpass those of higher grades. Never before has such an aggressive flight to quality by tenants been witnessed.

Available space in Sydney CBD

Sydney CBD's annual average gross supply pipeline over the next five years appears strong in isolation, however taking into account withdrawals, net absorption and employment data forecasts, the market is expected to remain tight, driving vacancy and incentives lower.

While Sydney CBD will receive an average of 21,256sqm of available space per year for the next 5 years (accounting for precommitted space), the office market is projected to remain tight as Colliers Edge data forecasts net absorption of 29,727sqm per annum over the same period. Colliers Edge projects that total vacancy will increase only gradually (but remain under the 10-year historical average of 6.4 per cent) from 2.8 per cent in H2 2018 to 5.1 per cent in H1 2021, where the market achieves sizeable positive net supply.

	5 YEAR PERIOD: 2H 2016 to 2H 2021	ANNUAL
Supply	745,792m²	
Withdrawals	447,000m²	
Net Supply	298,792m²	59,758m²
Less precommitted space	192,511m²	
Available space	106,280m²	21,256m²
10 YEAR HISTORICAL AVERAGES		
Net Absorption	220,110m²	44,022m²
White collar office demand	131,675m²	26,355m²
10 YEAR FORECAST AVERAGES		
Net Absorption	148,635m²	29,727m²
White collar office demand	325,535m²	65,107m²

Source: Colliers Edge / Deloitte Access Economics

Rents spur migration

The rental gap between premium, A and B grade rents have diminished greatly in the last six months. B grade assets have experienced the largest net effective rental growth increasing 33.7 per cent in the twelve months to September 2016, and more recently, have been reported to surpass A grade and in some cases premium net effective rents.

Our forecasts indicate that due to the high level of secondary withdrawals, B grade net effective rental growth will continue, gaining 27 per cent over the next twelve months on the back of constrained supply.

Net effective rental growth rates in other grades aren't quite matching that of B grade, however they are still significant. Over the next twelve months, Colliers Edge forecasts indicate that A and premium grade net effective rents are expected to gain 24 per cent and 20 per cent respectively.

This has allowed tenants to strike while the iron's hot and act on opportunities to upgrade their office accommodation. New tenants entering the CBD office market have cast the net wider to allow for premium and A grade assets, despite originally seeking secondary space. Now, a presence within a desirable precinct or particular prime grade building appears more feasible considering the lack of available and affordable secondary space.

Turnkey Suites

Rents aren't the only variable triggering this tenant migration. Landlords such as DEXUS, Carlyle Group and GPT with buildings such as Grosvenor Place, Aurora Place and Chifley Tower have experienced successful take up of their turnkey suites i.e. carving up whole floors and speculatively fitting out spaces is 150sqm-300sqm which incoming tenants can effortlessly move into.

This tactic turns what has primarily been a long process to enter into the premium grade market into a seamless one with a quick turnaround of just a few months. By comparison, tenants seeking whole floor spaces of between 1,500sqm and 2,500sqm in these same premium buildings would enquire 12 months prior to lease execution. With a turnkey suite strategy, the landlord's downtime (time without income flow) reduces and the impact on the building's expiry profile decreases.

This dynamic, combined with the aforementioned withdrawals fuelling secondary grade rents, of attributing to the speedy take up of premium space.

Premium grade's popularity

Many small tenants taking sub-1,000sqm spaces within premium buildings have been especially targeted through these turnkey suites, however, of particular interest are some of the larger tenant moves together with the assets they have moved from:

TENANT: (MOVEMENTS OVER 1,000SQM)	MOVED FROM:	MOVED TO: (ALL PREMIUM BUILDINGS)
Avant	580 George Street (A)	Darling Park 3
Jardine Lloyd Thompson	66 Clarence Street (B)	Grosvenor Place
Aussie Home Loans	363 George Street (A)	Grosvenor Place
Korn Ferry	60 Castlereagh Street (A)	Aurora Place
Savills	50 Bridge Street (A)	Governor Phillip Tower
CHUBB/ACE	28 O'Connell Street (B)	Grosvenor Place
Rubik	321 Kent Street (A)	85 Castlereagh Street
BNY Millen	35 Clarence Street (A)	1 Bligh Street
PTW	9 Castlereagh Street (A)	Aurora Place
Ausbrokers	North Shore (B)	Aurora Place
Aleasing	255 George Street (A)	Aurora Place
Pernod Ricard Winemakers	Macquarie Park (B)	Barangaroo Tower 1
Unispace	1 Alfred Street (A)	Grosvenor Place
CLSA	20 Hunter Street (A)	Grosvenor Place
HFW	201 Elizabeth (A)	1 Bligh Street

*The tenants highlighted in grey are movements which skipped a grade i.e. from B-grade to premium.

Premium vacancy declines in Core and Midtown

In the six months to January 2017, premium vacancy in the Sydney CBD's core precinct is expected to fall to 4.6 per cent, from 9.7 per cent in July 2016. For the last four years, vacancy for the precinct has hovered between 8 and 11 per cent, its prior low being 3.1 per cent in July 2011.

Midtown is projected to experience a 450 basis points reduction in vacancy to 7.4 per cent from a previous vacancy rate of 11.9 per cent. Vacancy peaked last period (increasing by 10 per cent) as Ernst & Young relocated from 680 George Street to 200 George Street, leaving behind 25,500sqm of vacant space, however it's expected that approximately 10,000sqm is due to be absorbed by January 2017.

Notwithstanding the absorption in core and midtown premium grade assets, total Sydney CBD premium vacancy is forecast to remain elevated at 11.3 per cent, largely as a result of Barangaroo Tower 1 supplied to market without full occupancy.

Outlook

Permanent withdrawals driving an uplift in secondary grade effective rents have allowed tenants to contemplate premium office accommodation where they have otherwise been unable to. This, assisted with speculatively fitted out suites, has certainly underpinned the ease with which tenants have moved into premium assets.

While office markets have always experienced an element of tenant upgrading, it has never occurred this quickly. The motives for this tenant shift has largely been brought about by a knock-on effect from permanent withdrawals of secondary stock having triggered a 'value for money' concept, rather than organisational strategy.

Needless to say this dynamic is not sustainable. Effective rents are likely to remain elevated but will correct to their usual rank where premium attracts a higher rate than the lower grades, especially where premium space in certain precincts are likely to continue to be absorbed moving forward.