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WHEN WILL THE SYDNEY CBD OFFICE MARKET ACHIEVE EQUILIBRIUM?

A cycle of strong net supply and increasing vacancy is yet to come

Kristina Mastrullo
Associate Director | Research
kristina.mastrullo@colliers.com

Summary

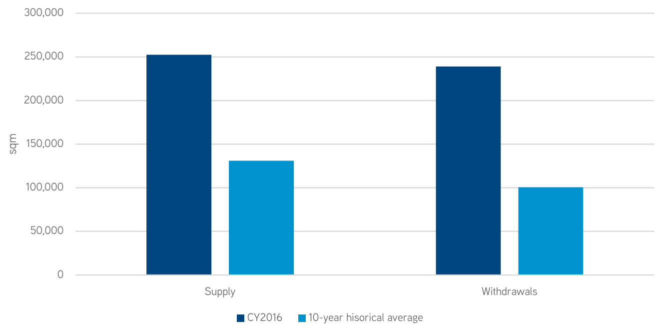
Over the last year, the Sydney CBD office market has experienced unprecedented rental growth on the back of tightening supply and steady demand, and while in the immediate term it appears that rents will continue to grow, the rate of growth is expected to moderate.

Within the next five years, we've identified a cycle of strong net supply and increased vacancy resulting in a more balanced office market.

Where are we now?

Since January 2012, the Sydney CBD office market has experienced a period of sustained low net supply combined with stable demand resulting in declining vacancy from 9.0% to 6.2% in January 2017, according to the Property Council of Australia (PCA). CY2016 saw a record year of withdrawals (approx. 240,000sqm) caused by the Sydney Metro acquisitions along with hotel and residential conversions further assisting the fall in vacancy.

Supply & withdrawal volumes



Source: Colliers Research

On the demand side, the Sydney CBD office market has been supported by sustained white collar employment growth, increasing demand for professional services, the expansion of flexible work space organisations, and record levels of investment in infrastructure and amenity. Combined, these factors have created a supply/demand imbalance leading to unprecedented positive rental growth. In CY2016 net effective rents grew 26% for premium, 24% for A grade and 31% for B grade.

However, looking forward we have identified a period within our forecasts where positive net supply increases, initiating the shift toward a more balanced leasing market.

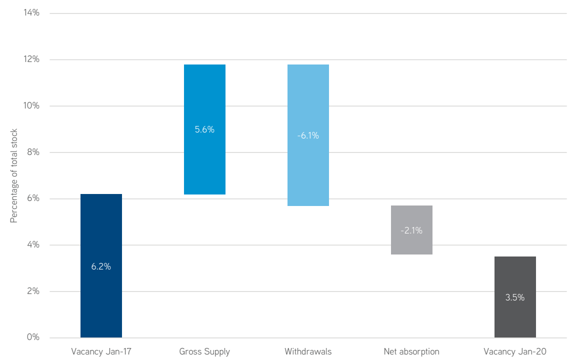
The market tightens

January 2017-January 2020

By January 2020, vacancy is expected to fall to 3.5% as withdrawals continue to outweigh supply. In addition, demand is expected to remain positive despite accounting for possible tenant relocations to metro markets.

In addition to the Sydney Metro acquisitions, a further 34,000sqm of permanent withdrawals will occur for hotel and residential conversion, while temporary withdrawals for refurbishments and new developments account for a larger portion (236,000sqm). The most notable withdrawal is the 76,000sqm of 50 Bridge Street and surrounds for the development of Quay Quarter Tower.

Vacancy Attribution Chart Jan17 to Jan20



Source: Colliers Research

So, while supply levels over the period are just shy of 280,000sqm (e.g. Darling Square, 151 Clarence Street and 60 Martin Place) withdrawals total 312,000sqm, leaving us with -32,000sqm of net supply by January 2020.

We expect this constrained market to bring about more positive growth with forecast net effective rents to increase at an average of 9.0%YoY for all grades. However looking further, we're anticipating a correction in effective rental growth as vacancy returns to long-term averages.

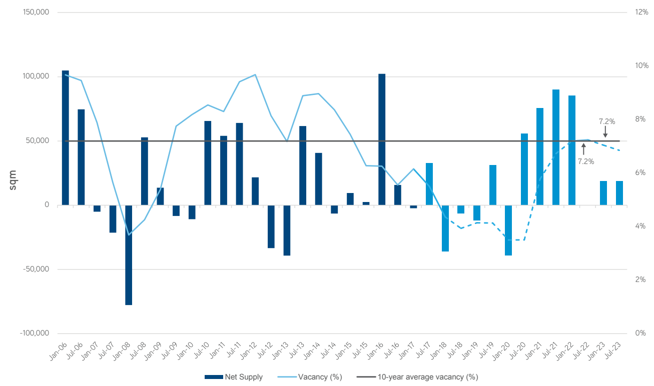
Positive net supply phase

July 2020-July 2022

60 Martin Place's redevelopment will initiate Sydney CBD's next supply cycle, along with Wynyard Place, Quay Quarter Tower and Circular Quay Tower. As withdrawals subside in this period (estimated at 62,000sqm) and a possible 113,000sqm of backfill space is added, our model is predicting a rise in vacancy to 7.2% by July 2022, reverting to the current ten-year historical average.

Between July 2020 and January 2022, the Sydney CBD office market is projected to enter four consecutive six-month periods of +76,000sqm of average net supply, well above the ten-year historical average (+15,000sqm), totalling +307,000sqm. Accounting for positive net absorption, we foresee 209,000sqm of vacant space being added between July 2020 and July 2022 in addition to the forecasted 179,000sqm in July 2020, thus projecting a total market vacancy of 388,000sqm (7.2%).

Net supply vs Vacancy rate



Source: Colliers Research

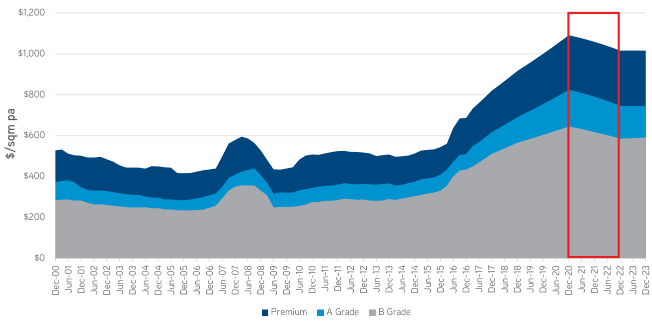
Clawback in effective rents

2021 and 2022

As positive net supply elevates vacancy, net effective rental growth rates are forecast to slip into negative territory over 2021 and 2022. During this period we anticipate net face rental growth to remain positive, albeit marginal, at an average of sub 1%QoQ for all grades. Incentives, however, will increase from an average forecast of 18% at the end of 2019 to 27% by the end of 2022. With weak net face rental growth, net effective growth is forecast to average -0.9%QoQ for premium and -1.2%QoQ for A and B grades (a combined growth rate of -8.4% for the period).

As vacancy increases and new and refurbished stock becomes available, owners will need to compete for tenants by offering increased incentives, as the largest volume of vacant space since 2014 hits the Sydney CDB office market.

Average Net Effective Rents



Source: Colliers Research

What does this mean?

A doubling in vacancy (from 3.5% to 7.2%) by 2022 looks likely to move us away from a landlord-favourable office market as this next supply cycle is set to alleviate upward pressure on face rents by creating a more competitive environment for securing tenants, leading to increasing incentives. This will ultimately translate into a period of relief for tenants seeking to secure office accommodation in the Sydney CBD.

While *Deloitte Access Economics* forecasts strong Sydney CBD base office demand growth of over 60,000sqm annually for the next 5 years, the vacancy level projected by July 2022 will shift the Sydney CBD toward equilibrium, enabling occupiers to enjoy a wider choice of accommodation options as we revert to softer market conditions after 2020.