Acumentis Brisbane Fringe Office 2021 Report

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With over 25 years' experience within the valuation industry across all market sectors providing advice to all levels of government institutions, major Australian banks and private clients Paul Robbins is a specialist in the commercial market.

Together with Paul Day from the Acumentis research team they provide up-to-date analysis and projections for the Brisbane Fringe Office market.

Key Findings

- The Brisbane Fringe office market comprised of around 1.23 million square metres of stock in July 2021, it's Australia's largest non-CBD office market.
- This market makes up nearly one third of Brisbane's entire metropolitan office stock.
- Around 50% of the markets office stock is A grade, with 36% B grade space
- The Urban Renewal precinct development activity has increased stock to around 521,000 square metres or 43% of the Fringe's total. This growth is likely to continue with new development in the Fortitude Valley and Newstead area.
- Negative net absorption of around 23,000 square metres saw elevated vacancy rates of 16.1% in July 2021.
- Incentives and competition for tenants remains high, while tenant demand is weaker due to covid workplace uncertainty.
- A vacancy rate of 16.1%, as well as relatively stable rents, means there are no strong driving factors for CBD tenants to consider re-locating to the Fringe or Fringe tenants to (re-) centralise.
- New supply is under construction in both the CBD and Fringe. FY2022 will see the addition of 60,000 square metres of new office space to existing Fringe stock, equivalent to an increase of 4.9%.
- Major projects under construction - 152 Wharf Street, Spring Hill - 895 Ann Street, Fortitude Valley - 31 Duncan Street, Fortitude Valley.
- More than a dozen other projects either hold development approval or have recently applied.

Brisbane Fringe Office Indicators

Indicator	Jul-19	Jan-20	Jul-20	Jan-21	Jul-21
Total Stock (m^2)	1,227,994	1,224,099	1,234,183	1,223,314	1,232,309
Vacancy Rate	13.80%	13.70%	14.30%	16.60%	16.10%
Annual Net Absorption (m^2)	43,497	29,062	-826	-36,048	-22,839
Annual Net Supply (m^2)	26.229	5.605	6.189	-0.785	-1.874
Av. A Grade Gross Face Rent	$587	$590	$585	$591	$595
Average A Grade Incentive	37.50%	35%	40%	42%	43%
Average A Grade Initial Yield	6.60%	6.40%	6.25%	6.25%	6.10%

SOURCE: PROPERTY COUNCIL OF AUSTRALIA (PCA) & ACUMENTIS RESEARCH

Market Characteristics

In July 2021, the Brisbane Fringe office market comprised around 1.23 million square metres of stock based on the Property Council of Australia's (PCA) July 2021 Office Market Report. The five precincts that make up the Fringe are, collectively, Australia's largest non-CBD office market and make up nearly one third of Brisbane's entire metropolitan office stock.

Around 50% of the Fringe's office stock is classified as A grade, with the remainder largely made up of B grade space (36%). While the share of higher quality office stock increased significantly during the last major development phase (2008 to 2015), it is below the share of 'prime' space in the Brisbane CBD (56%).

The Urban Renewal precinct has been dominating development activity for over the past 10 years, with its stock increasing to around 521,000 square metres or 43% of the Fringe's total (see chart below). Its share is likely to increase further as most of the proposed new developments are located in the Fortitude Valley and Newstead area.

Supply & Development

A.

New office development activity in the Fringe continues despite headwinds from a weak leasing market, elevated vacancy rates and low occupancy rates due to Covid-19. Instead, development remains underpinned by the capital market's demand for investment product and high leasing incentives which encourage tenants to upgrade and/or consolidate.

The first six months of 2021 saw the completion of a 9,300 square metre building at 14 Stratton Street in Newstead, which was developed and is all but fully occupied by Mater Group. Since then, the speculatively built 17,800 square metre Mobo building at 134 Merivale Street in South Brisbane has reached practical completion. It has so far attracted tenants to around 5% of its total net lettable area (NLA). Also scheduled for completion late this year is the 18,200 square metre Jubilee Place at 470 St Pauls Terrace, Bowen Hills, which has secured pre-commitments to just under 50% of its space.

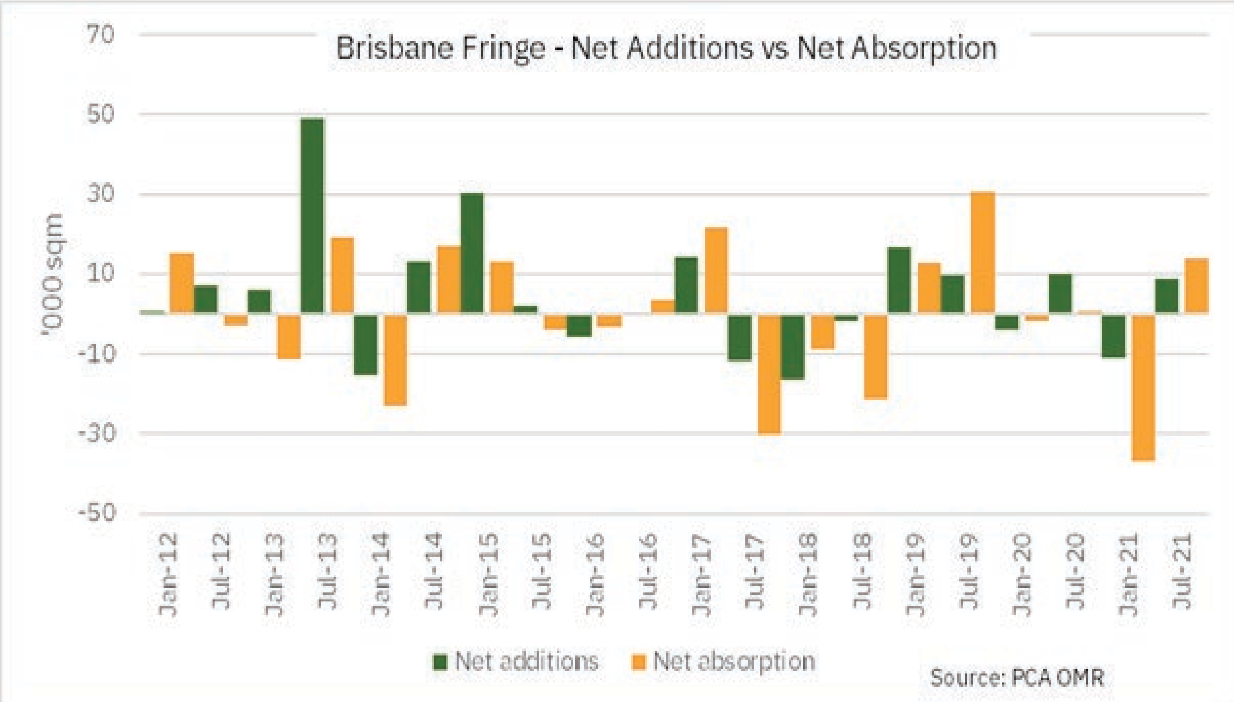
Construction is also under way at 152 Wharf Street, Spring Hill. Its 24,000 square metres of office space will be taken up by the Australia Taxation Office on completion in the June quarter of 2022. In total, FY2022 will see the addition of 60,000 square metres of new office space to existing Fringe stock, equivalent to an increase of 4.9%.

Meanwhile construction has commenced of a speculative 24,000 square metre building at 895 Ann Street, Fortitude Valley, after the developer pre-sold the project to Global real estate investment manager, DWS. Completion is expected in the first quarter of 2023. Another project is poised to commence at 31 Duncan Street, Fortitude Valley, after receiving a pre-commitment from Queensland Urban Utilities for just under a third or its floorspace. It features a 25,000 square metre office building atop a carparking station that is currently being re-developed.

There are more than a dozen other projects that either hold development approval or have recently applied. Most of these are in the Urban Renewal precinct and their prospects hinge on achieving at least a 50% tenant pre-commitment or fund-through arrangements with large investors prepared to take the risk.

Queensland's success in managing the Covid-19 pandemic has seen construction activity virtually unaffected by lockdowns. However, it has at least temporarily affected occupancy levels and has made tenants' decisions regarding their future office space requirements more complex.

The two following charts show the net new office supply joining the Brisbane Fringe Market. The first chart shows supply each half year over the past 10 years and the level of corresponding absorption of the new space with the second chart detailing new office developments under way and those awaiting pre-commitment.


Brisbane Fringe - Net Additions vs Net Absorption
70
50
30
10
-10
-30
-50
'000 sqm
Jan-12
Jul-12
Jan-13
Jul-13
Jan-14
Jul-14
Jan-15
Jul-15
Jan-16
Jul-16
Jan-17
Jul-17
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Jan-19
Jul-19
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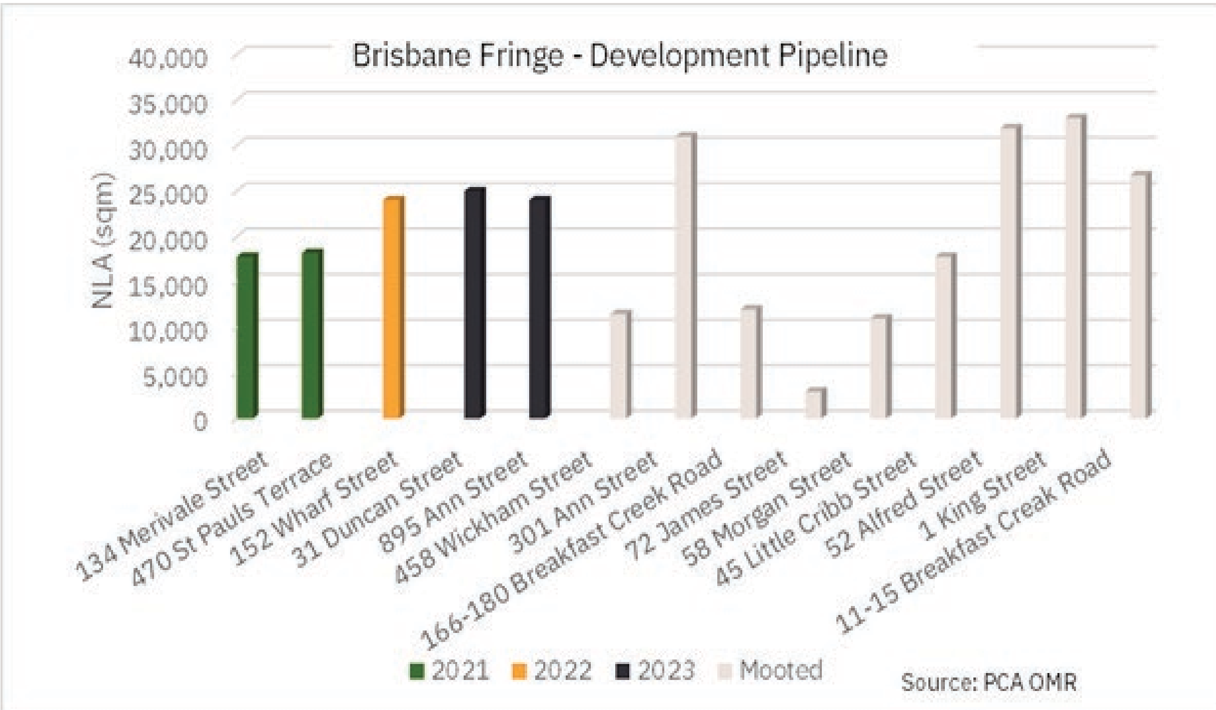
Jul-21
Net additions
Net absorption
Source: PCA OMR


Brisbane Fringe - Development Pipeline
40,000
35,000
30,000
25,000
20,000
15,000
10,000
5,000
0
NLA (sqm)
134 Merivale Street
470 St Pauls Terrace
152 Wharf Street
31 Duncan Street
895 Ann Street
458 Wickham Street
301 Ann Street
166-180 Breakfast Creek Road
72 James Street
58 Morgan Street
45 Little Cribb Street
52 Alfred Street
1 King Street
11-15 Breakfast Creak Road
2021
2022
2023
Mooted
Source: PCA OMR

A.

Demand

Backdrop

The Fringe office market developed during the late 1980s/early 1990s as a response to expensive CBD accommodation and generous car parking allowances. Its five submarkets also act as an overflow market during periods when supply cannot keep pace with demand in the CBD.

Office demand in the Fringe surged during and immediately after the first phase of Queensland's last mining investment boom (2006 to 2011). Many tenants were forced out of the CBD by virtually zero vacancies and a quadrupling of net effective rents. Those forced out included mining project managers and engineers, as well as banks and government agencies.

Once new supply in the CBD caught up with demand, effective rents halved and the overflow into the Fringe started to wane. Over the 10 years to June 2021, annual net absorption averaged just 430 square metres. The pattern of demand was similar to that of the CBD, though with less fluctuation from year to year. As the rental differential between Fringe A grade and CBD B grade space stabilised, tenant moves in both directions largely cancelled each other out.

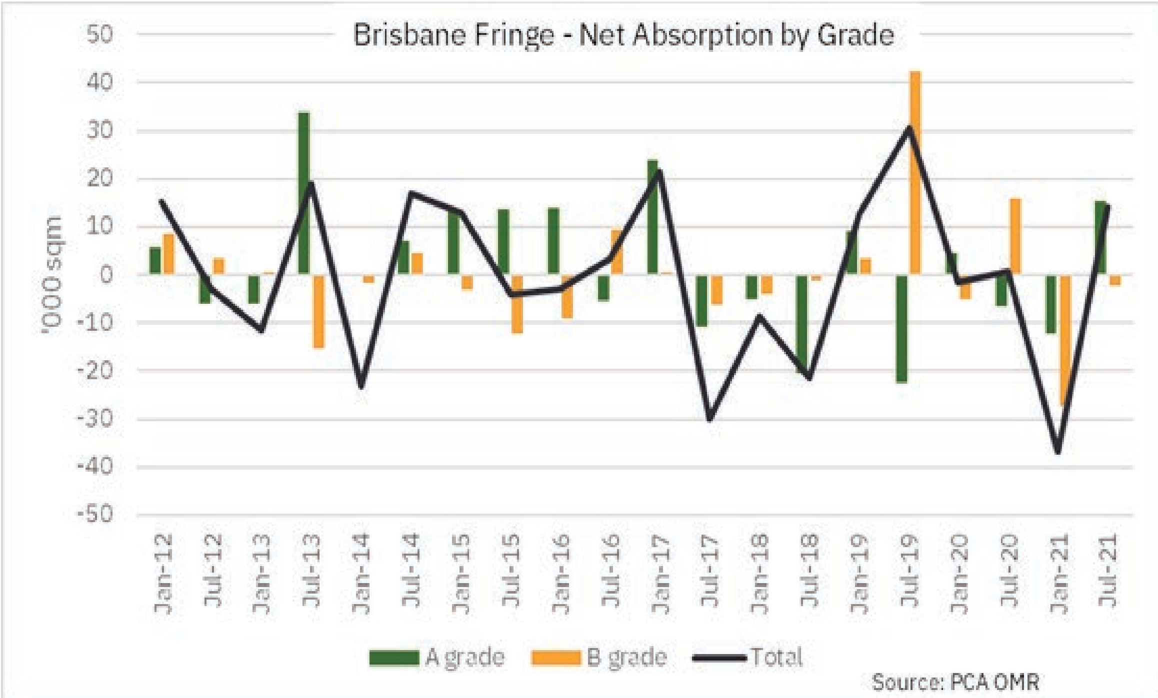
However, there have been distinct differences between the five submarkets. The Urban Renewal area has been outperforming the others in terms of both new supply and net absorption, primarily due to the availability of development sites. Over the past decade it has developed a critical mass and become the centre for resources engineering and project management.

Meanwhile, Milton has become a centre for Cross-River Rail. The Inner South and Spring Hill have been losing tenants over the past three to four years, with the Spring Hill office precinct suffering from ageing stock and facing strong competition from residential development. Toowong remains the smallest market and has also been losing stock to residential re-development.

Current state of play

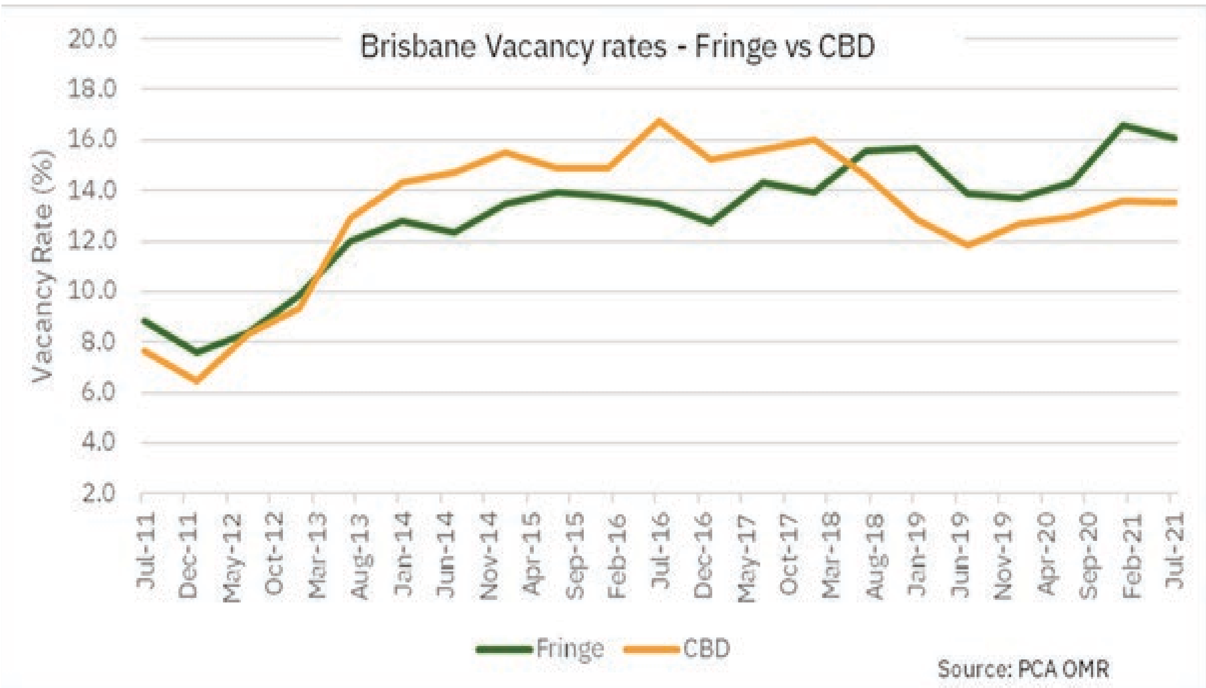
According to the PCA, the 12 months to July 2021 saw negative net absorption of around 23,000 square metres across the Fringe, a worsening compared with FY2020. However, all the negative net absorption occurred in the 6 months to December 2020, with most of the damage related to Virgin Australia and Flight Centre, both victims of Covid-19-related travel restrictions.

In contrast, the market recorded positive net absorption of 14,000 square metres recorded during the first half of 2021. The turnaround was mostly the result of Mater Group moving into their new headquarters in Newstead from premises that were not classified as office. Nonetheless, another increase in sub-lease space points to the ongoing challenge the pandemic poses for office demand, despite encouraging ABS figures for employment growth since September last year.



Outlook

Vacancy rates of 13.5% and 16.1% respectively in the CBD and the Fringe, as well as relatively stable rents, means there are no strong driving factors for CBD tenants to consider re-locating to the Fringe or Fringe tenants to (re-) centralise. Moreover, there are significant amounts of new space under construction in both markets to accommodate any given level of demand in the short term.



According to Deloitte Access Economics, the brakes will remain on in the Queensland economy for another 12 months, before growth accelerates in late 2022/early 2023. However, the exact timing depends on the re-opening of domestic and international borders, which should revive the tourism and hospitality industries - one of the Queensland economy's largest employment sectors. In the interim, non-residential and engineering construction will be one of the main drivers of (modest) growth, particularly in Southeast Queensland.

In the short term, modest overall employment growth will be reflected in moderate office employment and, hence, continued challenges for overall office demand. That leaves lease expiries and associated churn as the main source of leasing activity. With effective rents at their most affordable in 15 years and the leasing market highly competitive, tenant mobility is high: tenants can either take incentives as rent abatements or upgrade to newer premises with existing fitouts for no additional cost, including pre-commits to new projects. Accordingly, we will continue to see tenant movements in both directions between the CBD and the Fringe, as well as stronger net absorption amongst A grade buildings than the remainder of the market. The latter will be boosted by the ATO moving into 152 Wharf Street in mid-2022, with staff coming from suburban Chermside and 55 Elizabeth Street in the CBD.

Another key determinant of demand will be office users' medium-term response to Covid-19, i.e., how much space will they need in the future. While the increase in workplace flexibility could lead to tenants taking less space in the future, face-to-face contact will remain an important consideration for many industries. In order to attract and retain talent, employers will need to provide high levels of amenity, which could include more personal space in the office. Overall, the market will need to find a new balance point.

While more expensive than the Fringe, the CBD retains its advantage of being the most accessible by public transport, a feature that will only be cemented by Cross River Rail and the Brisbane Metro. For those wishing to drive, the Fringe still offers some advantages. Parking ratios are more generous compared with the CBD, but an accessibility suffers for those having to cross the river and/or pass the CBD on their commute.

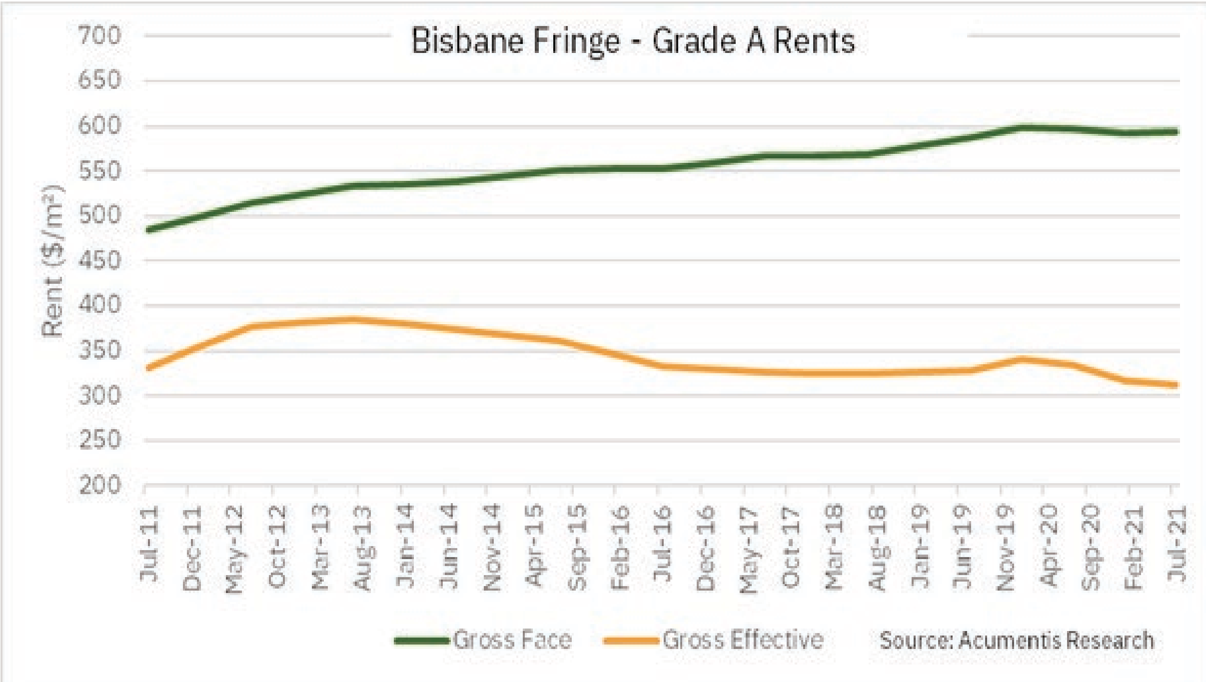
In the longer term, Deloitte Access Economics' forecasts are for employment growth to moderate in line with the ageing of the population. Nonetheless, over the entire 10-year forecasting period, annual employment growth is expected to average 1.7% per annum, which compares favourably with the last 10-year actual of 1.4%.

A.

Rents

Leasing conditions in the entire Brisbane market remain challenging: high vacancy rates in existing buildings, an increase in available sublease space, new supply under construction and projects seeking pre-commitment are all fanning competition for tenants. And tenant demand remains weak due to low growth in key sectors of the economy and the impact of Covid-19 workplace restrictions.

Consequently, face rents in the Fringe have been mostly flat since mid-2020. Average A grade gross face rents recorded growth of just 1% to $595 per square metre during the 12 months to June 2021. Over the same period, average A grade leasing incentives increased from 40% to over 43%, causing a 6.6% fall in gross effective rents to an average of $312 per square metre. Incentives for pre-commitment can be significantly higher.



The situation in the CBD is similar to the Fringe, with movements in rents and incentives following the same pattern. The gap has widened between face and effective rents in both the CBD and the Fringe markets as incentives escalated following global efforts to stimulate economies post-GFC via very low interest rates. Yield compression allowed developers to offer ever increasing incentives to attract pre-commitments, which filtered through to the market for existing space. Raising face rents underpinned the feasibility of new construction but were offset by incentives to keep effective rents flat (see Charts below).

Looking ahead, the forecast recovery in demand from 2022/23 is likely to take time to filter through to improvement in rents. Much will be absorbed into existing space or by new buildings, with vacancy rates slow to contract. Until such time as capital markets see a rise in interest rates, construction will continue to add new space and keep vacancies elevated. Under these circumstances, incentive levels are expected to remain elevated, although we could see the return of moderate growth in face rentals.

Like the Fringe, there are enough projects seeking pre-commitment in the CBD to contain rental growth in the city. As a consequence, a there is unlikely to develop a sufficient widening of the gap between CBD and Fringe rents to set in motion an increase in overflow demand and, hence, upwards pressure on rents.

The following table shows a list of recent leasing deals occurring in Brisbane's Fringe Market.

Brisbane Fringe Office - Recent Leasing Deals

Lease start	Address	Tenant	NLA (m^2)	Gross Face Rent $/$m^2$	Term (Yrs)
Jan-21	100 Brookes St, Fortitude Valley	Northrop Grumman	1,750	625	5
Mar-21	189 Grey St, Inner South	Ausenco Services	2,000	635	8
Mar-21	100 Brookes St, Fortitude Valley	KBR	1,750	625	5
Jul-21	14 Stratton St, Newstead	Mater Group	9,100	650	10
Jul-21	825 Ann St, Fortitude Valley	Clough	1,650	625	6
Jul-21	16 Marie St, Milton	Veris	585	485	UD
Jul-21	16 Marie St, Milton	Blue Apache	417	470	UD
Pre-com.	31 Duncan St, Fortitude Valley	Queensland Urban Utilities	6,000	UD	10

SOURCE: ACUMENTIS RESEARCH. UD – UNDISCLOSED

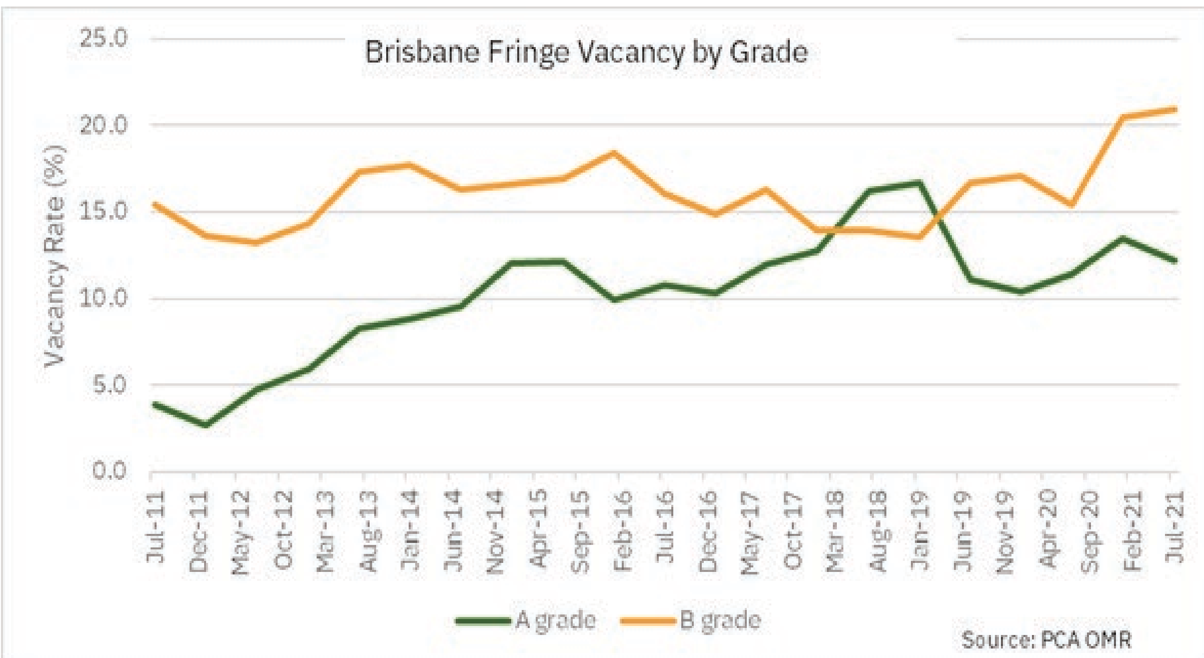
Vacancy

A.

According to the PCA, the Brisbane Fringe's vacancy rate sat at 16.1% on 30 June 2021, a 0.5% drop from the 31 December 2020 figure. This compares with a rate of 13.5% in the CBD, though both markets have been in double digit territory since 2013. In fact, the Fringe vacancy rate has been below 10% for only 8 out of the past 30 years when the market was caught short on supply during both phases of the last mining investment boom.

Much of the increase in vacancies over the past 12 months can be attributed to the release of sub-lease space in the wake of Covid-19. The official (PCA) sub-lease space figure nearly doubled from 1.3% at June 2020 to 2.5% at June 2021. However, there is likely to be substantially more hidden vacancy where tenants did not release vacant space to the market because they were pessimistic about the chances of finding someone to take the space of because they wanted to keep it for when Covid was no longer a problem.

A wide gap has opened between A and B grade vacancy rates since 2019. At 12.2%, the Fringe A grade vacancy rate sat below its CBD counterpart at June this year despite the release of sublease space and new supply additions. Solid net absorption helped the cause, particularly with new tenants coming out of non-office space and/or upgrading. In contrast, the B grade rate has blown out to 20.9% of mostly direct vacancy as shown in the chart below.



Looking ahead, there is little prospect of a significant drop in vacancy rates. While a new 'Covid-normal' is expected to see the return of many workers to the office and tenants pulling sublease space off the market, new supply scheduled for completion will act in the opposite direction – unless tenants can be found from outside the Fringe market. Only a lengthy pause in construction and sustained recovery in demand could bring the vacancy rate back below double digits, a situation unlike to eventuate until a sharp rise in global interest curtails demand from capital markets for new property.

Concerns over the Coronavirus (COVID-19) global pandemic has recently resulted in sharp falls on global and local stock markets. Travel bans, quarantine and supply chain interruptions are impacting global and local economies with many governments announcing economic stimulus measures. As at the date of valuation, whilst there appears to be a general softening of buyer and tenant demand for property in this locality, obvious negative impacts on the local property market are difficult to quantify at this stage, however, these may emerge over time. Any deterioration in the Australian economy may flow to the local economy and could have an impact on the subject property. This current global issue remains a fluid situation with updates being provided on a daily basis by governments.

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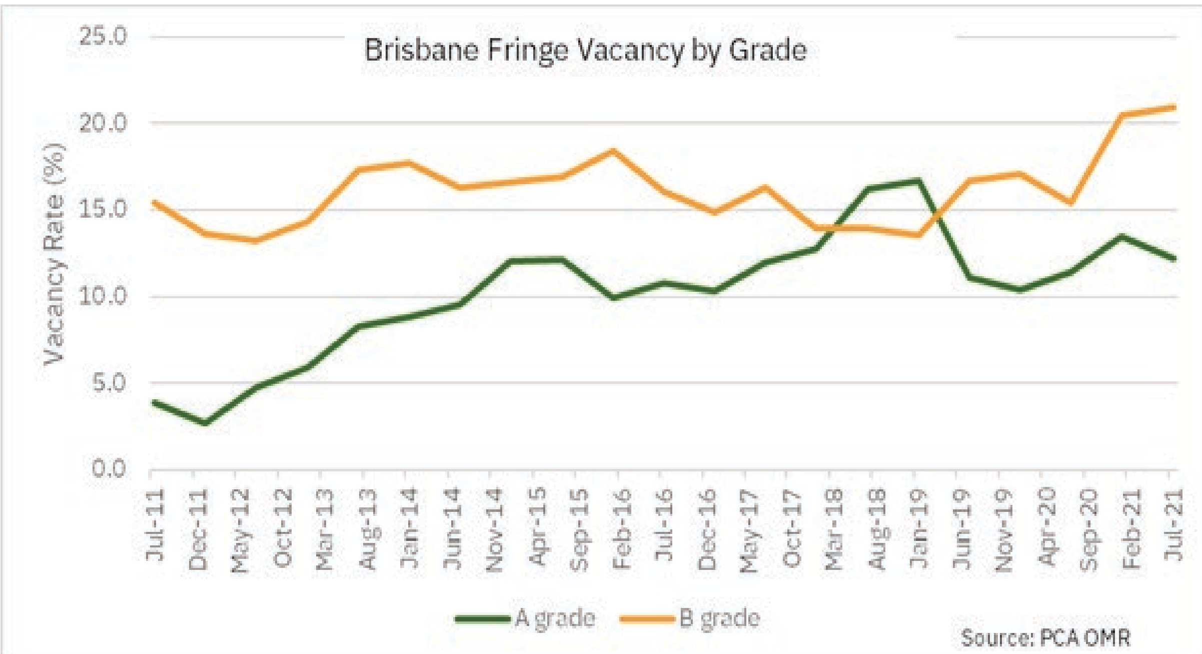

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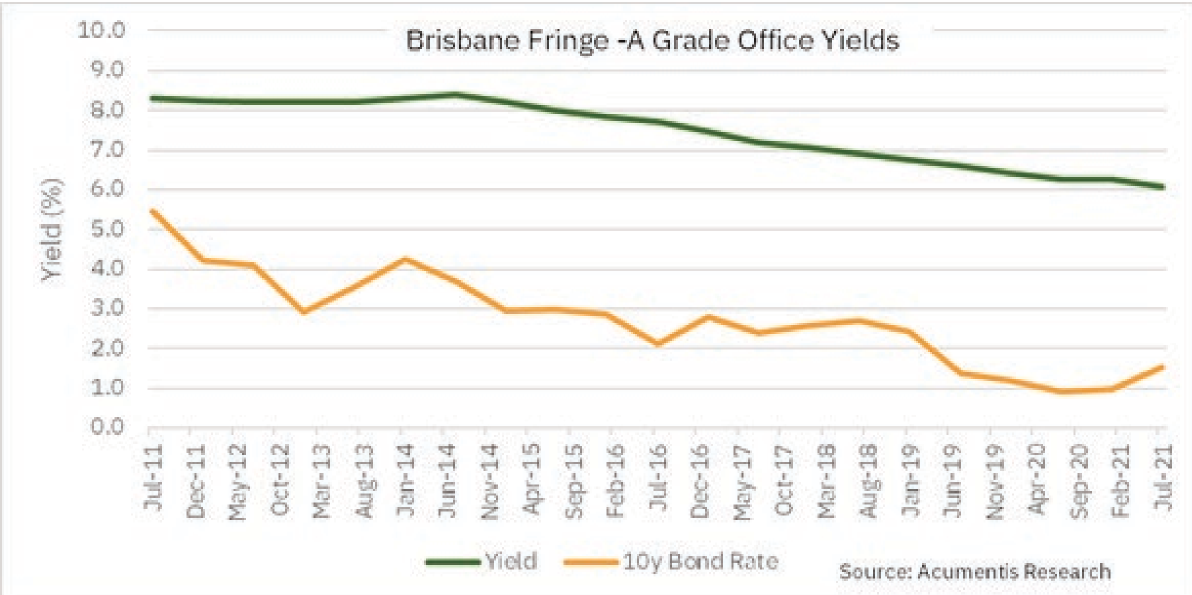
Investment & Yields

A.

After recording over $660 million in office transactions (>$5 million) during 2020, the Brisbane Fringe investment market has been quiet over the first 9 months of 2021. Less than $100 million worth of office property has changed hands thus far, lagging the recovery from an early Covid-induced hiatus in the CBD that has seen over $700 million worth of assets sold across just 3 transactions.

The paucity of sales in the Fringe is primarily due to a paucity of institutional-grade assets for sale. There is plenty of interest from both domestic and overseas investors, with the latter in particular looking for large prime assets, new or near new, with long WALE. The Fringe has been a prime target over the past few years, with institutional investors regarding the Fringe as a viable alternative to the CBD. With little for sale, investor have even turned their attention to the suburban market, which has recorded year-to-date sales in excess of $230 million.



After Covid caused a stalling of investment activity in early to mid-2020, yields recommenced their firming trajectory late last year. Average Fringe A grade investment yields were sitting at 6.1% at June this year, having firmed by 0.2% since September 2020. In the process, the discount to comparable CBD properties has narrowed to 0.3%, a level previously only observed during boom years with very low vacancy rates and strongly rising rents.

As usual, the average is disguising a wide band that stretches by nearly 1.5% between new A grade assets with longish WALE and older buildings with leasing risk. A new benchmark was set in October last year when 14 Stratton Street in Newstead sold on a yield of around 4.5%, representing a new building and underpinned by a 10-year lease.

The biggest sale over the past 18 months remains DWS's purchase of the site and an associated fund-through arrangement with Consolidated for the delivery of a 24,000 square metre building at 895 Ann Street, Fortitude Valley, for approximately $260 million.

Recent Brisbane Fringe Investment Office Sales

Lease start	Address	Price ($M)	NLA (m²)	$/m²	Initial Yeild
Sep-20	895 Ann Street,	Northrop Grumman	1,750	625	5
Fortitude Valley	260.0	24,000	10,833		8
Oct-20	14 Stratton Street, Newstead	122.5	9,088	13,479	4.45%
Nov-20	88 Jephson Street, Toowong	25.15	6,441	3,905	8.58%
Dec-20	2 Burke Street,	Clough	1,650	625	6
South Brisbane	80.2	8,637	9,286	5.46%	UD
Feb-21	37 Kennigo Street,	Queensland Urban Utilities	6,000	UD	10
Spring Hill	15.8	2,955	5,347	6.60%	10
Mar-21	33 Longland Street, Newstead	20.3	2,936	6,914	6.57%
Sep-21	49 Park Road, Milton	22.5	2,548	8,830	5.38%

SOURCE: ACUMENTIS RESEARCH. UD – UNDISCLOSED

B Grade office yields have also tightened over the past 12 months, with the average sitting at 7.0% at June.

After concerns about inflation earlier this year caused financial markets to factor in interest rate rises, sentiment has calmed and bond yields have stabilised.

Looking ahead, monetary policy setting remains largely expansionary around the globe. At home, the Reserve Bank has repeatedly indicated that it will not raise the cash rate, expecting APRA to use fiduciary instruments instead to regulate lending volumes. However, markets will closely watch the development of inflationary pressures and financial markets have already shown that they can act on their own, i.e., without central banks' involvement.

Despite the risk of inflation pushing up cash/bond rates, the spread between property yields and medium to long term bond rates remains wide. It provides investors with scope to absorb a possible narrowing, which means that investor demand will remain strong and the competition for scarce assets will continue to drive up prices and force down yields.

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