PROPERTIES & PATHWAYS

BEYOND THE HEADLINES

The true state of the

Perth CBD Office Market

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INTRODUCTION

Most of us read the news. But some never question the ideas, points of view and so-called "facts" that the journalists of our established media platforms offer.

But what if we did? What if we dove deeper into the stories? What if we peeled the curtain of the headlines and accessed the truth?

That's exactly what we've done for the Perth CBD Office Market. And that's exactly what we'll present to you in this white paper.

If the words of today's publications in Australia were taken as gospel, it'd be incredibly hard to believe that it's worth investing in almost any office premises in the country. Terms like 'national office crisis' are flippantly thrown around, and anecdotal evidence is given as cold hard facts. The east coast, these publications present, is watching a crisis unfold in its office markets. And despite firm evidence of strong performance, the west's office market is either hidden in the shadows or included in these dire forecasts.

We think these publications could do better.

We've done our homework on the Perth CBD Office Market, and we can tell you there's lots to be excited about from an investor's perspective. Limited supply, burgeoning demand, a vibrant economy and rising rents all point to an exciting future for this commercial real estate sector.

It all boils down to the one thing that newspapers won't tell you: **Perth runs a race of its own**.

Who are we?

Properties & Pathways is a dynamic commercial property investment firm in Australia.
We handpick our properties to ensure growth and high yielding returns for our investors. We invest alongside our investors and this commitment to each commercial property breads absolute transparency at every turn.

Cal Doggett
Managing Director
Properties & Pathways

Reading Between the Lines

Why east coast fund activity doesn't signal a "national office crisis".

Amid a flurry of dramatic headlines, it's easy to develop a gloomy outlook on Australia's office property market, especially when heavyweight property funds like Dexus and Charter Hall divest their office assets at substantial discounts.

But that's what independent, purposeful research is for. It's like the broad brushstroke versus the precise, surrealist painting technique.

So, time for us to get the brushes out and paint for you an accurate picture of the current Australian office landscape.

Why are Dexus & Charter Hall in the news?

Back in June, **Dexus**, a major real estate company in Australia, sold a premium office building in Sydney (44 Market Street) for much less than its book value – namely selling for $393.1 million, recording a 17.2% drop in its December 2022 valuation.

This created a buzz with national publications, who began presenting the doomsday scenario that we might see a lot more of this happening in the commercial property sector (specifically in office).

Fast forward to mid-July, and **Charter Hall**, the biggest Australian property investment manager in the game, said they'd limit redemptions (or distributions) in their office-focused Direct DPF Fund to just 25%.

The ASX-listed company only gave back 25% of what was asked for in February, but said they'd return more to investors soon and pay back the rest by the end of the year once they sold enough assets to do so.

We've since seen Centuria Capital suspend their distributions as well; a major blow for investors.

These, plus other pieces of world property news, helped the creative minds behind news desks come up with a term that would make advertising genius David Ogilvy proud: "The global office property crisis."

We think that's very misleading for investors.

Why?

There're two sides to every country.

First and foremost, it's essential to note that Australia's property market is not monolithic. The markets in heavyweight cities like Sydney and Melbourne don't dictate the trends in, say, Perth.

The bigger the fund, the more rigid the strategy.

The divestment decisions by funds like Dexus and Charter Hall stem from their unique financial strategies and policies, including maintaining certain leverage ratios and catering to investor redemptions.

We understand large funds like these often have financial covenants that are central to their investment strategy. For example, serious consideration is often given to a fund or property's LVR (Loan-to-Value Ratio). When LVRs increase above a certain threshold (triggered by a decrease in property value), funds can find themselves having to sell assets. **They can do this to keep their leverage ratios in check or to meet the demands of investors who want to withdraw their investment funds.**

Therefore, Dexus' and Charter Hall's divestments shouldn't be viewed as a blanket indictment of the Australian office property market but rather a strategy born out of internal financial considerations and impacted by differences in property markets across the nation.

Put simply, **their actions don't necessarily reflect the overall health of the Australian office property market.**

Where are they invested?

Take Charter Hall's case, for instance. The ASX-listed fund manager has been grappling with making redemptions to investors exiting their Direct PDF Fund. But interestingly, **only 9% of the office properties in that fund are based in Western Australia** (only two assets out of over 20), the majority being east coast assets.

One might look to see which assets they are divesting, and yes, they are looking to sell one of these WA assets. But take a look at a recent statement on Charter Hall's website (captured by *The AFR* on July 16)[1]:

"We have since marketed a number of properties for sale, in order to satisfy the remaining 75% of redemption requests received. However, we will only sell assets for prices that reflect fair value."

But, I guess, "office crisis" has a nicer ring to it than "cross-sector and location-specific investment fund redemption crisis".

It's all relative.

Recent sales such as Dexus's Sydney property, which fetched a significant discount, have indeed raised eyebrows. But consider this... Dexus's stock is trading at a whopping 31% discount to the value of its net tangible assets as of December 31. Compare this to the 17.2% discount to Dexus's December book value when they sold 44 Market Street, and the sale actually marks twice as better outcome than the market has priced Dexus shares.

This perspective turns the steep discount on the Sydney property sale into a relative win compared to the market's pricing of Dexus's shares.

The fund is only willing to sell assets that will fetch reasonable prices. One would figure they would currently take too much of a hit on their east coast assets, where signs of market weakness is evident.

Taking a step further, we see that **office isn't even entirely to blame for their portfolio losses.** From *The AFR* on June 15, the article titled "Charter Hall takes $1.9b hit on portfolio as rates bite":

It was Charter Hall's long-leased retail assets – including pubs and petrol stations – that took the biggest revaluation hit, down 7.8%.

The actions of individual firms should not cloud the overall robustness of Australia's office property market. **We must avoid letting isolated incidents shape our perception of the overall market's health.**

Because despite the potential for optimistic interpretations, the market's sentiment remains largely negative, thanks to prevailing headlines and a lack of depth in their reporting. There's more to the story. And there's more than one property market. Perth's, for example, is running its own race in the face of this so-called "global office crisis".

1 afr.com/property/commercial/charter-hall-office-fund-limits-redemptions-to-25pc-in-falling-market-20230715-p5doi8

Perth's Limited Supply

Why it **bodes well** for investors.

Everything in business, including buying property, works based on supply and demand. The levers of supply and demand shift prices, they fluctuate rental rates, they impact landlords and tenants, and they certainly influence investment decisions.

Perth's CBD office market is no different.

The story unfolding in Perth is unique and separate from the rest of Australia, which is why special attention needs to be paid to it, rather than taking national headlines' blanket reporting on Australia's office market as gospel.

That's because Perth, unlike other major Australian cities, experienced a unique story amidst the global pandemic. While COVID-19 sent nationwide ripples through property markets, West Australia – which shut its borders in the attempt to maintain a somewhat normal way of life – managed to rebound.

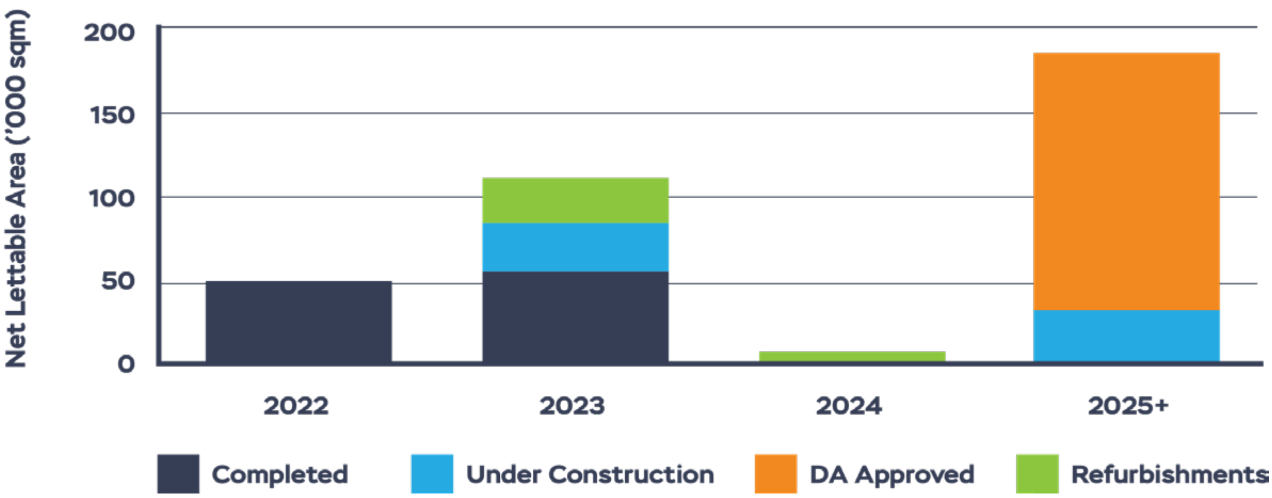
And it's the city's resilience and unique recovery that provides the backdrop for our focus today: **the future supply of office space in Perth's CBD and what it means for investors.**

The current scenario.

The Perth office market has undergone a huge shift in 2023. And it's the below graph of the Perth CBD supply volumes (by net lettable area) that presents this shift well.

A solid 79,000 sqm of new pre-committed supply will hit the market this year, the highest annual addition since 2015. Most of it is completed, with the remaining 32,000 sqm currently under construction (9 The Esplanade, Perth).

Supply pipeline: new developments & major refurbishments



And, sure, if these 2023 figures were given on their own, then anyone doubting the Perth office market's resurgence would be honking their horns in victory: too many buildings for lease, without the occupants to fill them, doesn't bode well for property values.

But a careful look at the data will put the truth in headlights...

Tony Robbins' level of persuasion to convince an educated investor audience of their opinion.

Because even though there are development applications planned for 2025 and beyond, potential delays loom. Inflation, rising interest rates and escalating construction and labour costs – these all

There is **no scheduled** supply in the Perth CBD office market in 2024.

Nothing. Only refurbishments.

And while the substantial supply hitting the market in 2023 may seem concerning, a deeper look reveals that **80% of that supply is already pre-committed, limiting its impact on the market.**

So, anyone thinking the vacancy rate has the potential to rise anytime soon due to new supply is going to need mean that new projects will need hefty pre-commitments to proceed.

Given this very limited supply pipeline, **the vacancy rate in Perth's office market is projected to drop to around 12% by 2026** (currently at approx. 15.6%), according to Knight Frank research.

Why is limited supply a good thing for investors?

Limited supply in the Perth CBD office market presents a range of opportunities for investors:

1. **Price Dynamics:** A market with low supply and high demand typically pushes prices up, offering excellent **capital appreciation** potential.
2. **Rental Yields:** Limited supply coupled with high demand could allow landlords to charge higher rents, **boosting yields**.
3. **Vacancy Rates:** Lower supply could reduce vacancy rates (as already forecasted for Perth by Knight Frank Research), leading to **higher rental income** and easing cost coverage for investors.

This promising landscape is already drawing in-the-know investors to the A-grade Perth CBD office market. But it's important to consider the other side of the coin—**demand**.

Is there demand for A-grade office assets in Perth CBD, both for tenants and prospective landlords?

Perth Office Demand

Why Perth's office is **running a race of its own.**

Perth is setting its own pace in the post-pandemic office property market.

Amid work-from-home culture discussions – and unlike Sydney, Melbourne and Adelaide – the demand for Perth office space is growing, aligning with the west's hugely positive economic dynamics.

Research shows tenant enquiry increasing too, and investors are readying to ride the wave of burgeoning office market demand. And all of this is mirroring the period we observed between 2010 and 2012 – a time of phenomenal growth.

This could be the most important chapter in our Perth Office story.

Tenant enquiry on the up.

While Melbourne, Sydney and Adelaide's office markets grapple with rising vacancy rates, there seems to be no stopping enquiries for Perth office space.

Check out the below graph from CBRE, which supports the continued increase in enquiry levels on Perth CBD assets in the three years to December 2022:

In just two years, from December 2020 to December 2022, there was a 50% increase in enquiries for office space in the city.

But what about 2023?

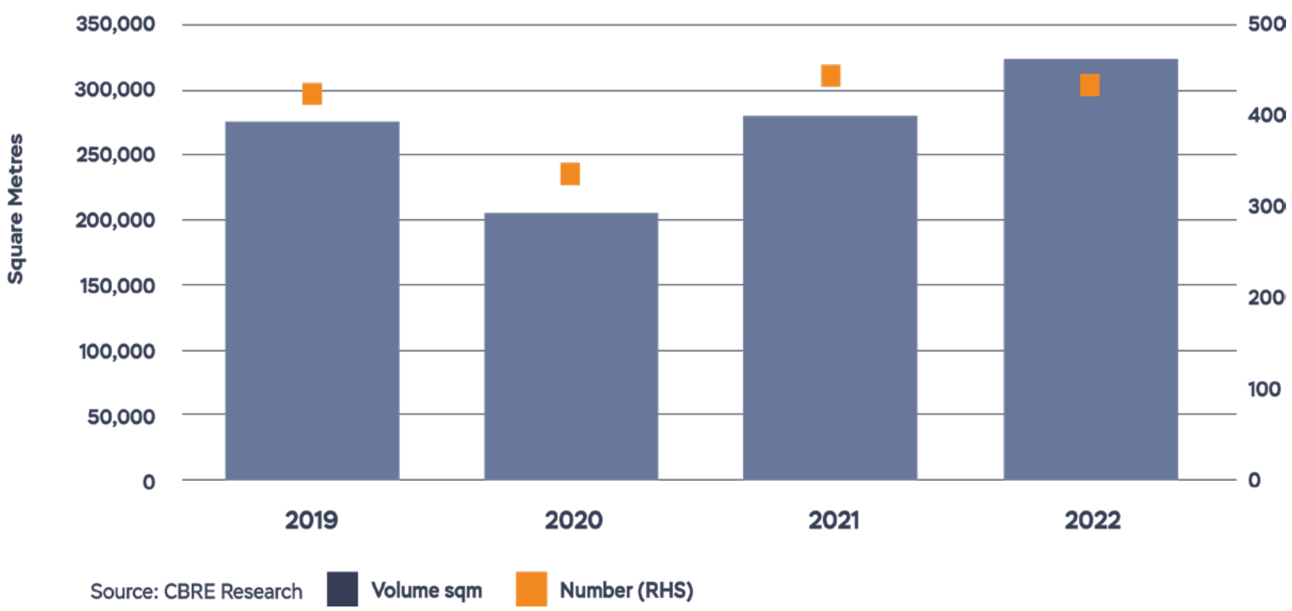
In The West Australian on August 2, 2023, CBRE's Nicholas Volk said Perth's leasing market is buzzing with activity. According to the senior research analyst, physical office occupancy in Perth leads the country, while nearly 39,000sqm of gross leasing volume was recorded in the first half of the year.

This is after Perth's office market saw a record 226,000sqm in enquiry in just the first six months of 2023 – nearly as much as the entire 2022 calendar year.

Incentives are dropping in the face of rising tenant demand and – as we'll see in our next and final email – net effective rents are headed north across all building grades.

None of this is an accident. It's the result of outstanding economic conditions for WA – something, once again, that sets the state apart from its east coast neighbours.

Perth CBD enquiry volumes



Perth's thriving economy.

Strong mining, oil and gas sectors are helping fuel a robust WA economy. The rest of the country is playing catchup – and so is most of the developed world.

"WA's economy is expected to outperform the nation and advanced global economies in 2023 with the re-opening of China lifting commodity prices and powering WA."

– CBRE Research

Perth CBD Office Report Q4, 2022

That's right, not only is WA's economy eclipsing the rest of Australia, but it's also outshining many of the world's advanced economies.

WA's annual economic growth forecast of 3.2% for 2023 sits well above the 1.2% forecasted growth for Advanced Global Economies, stated by the International Monetary Fund's January 2023 economic growth projections.

That means WA is expected to see nearly triple the growth of other advanced economies. And sure, challenges exist in WA, like they do nationwide. Inflation is one of them, but rising inflation isn't necessarily a *hurdle* for businesses – it's an *indicator*, of a healthy, bustling business environment.

Want proof?

WA's Chamber of Commerce (CCIWA) chief economist Aaron Morey says three in five businesses indicated in 2023's Q1 survey that they had boosted employee base wages at an average rate of 11%. **Almost 60% of WA businesses are continuing to upskill existing employees**, and over half said they are taking on more apprentices and trainees.

Workforce and skills gaps remain in the Perth employment market, but the CCIWA has stressed those shortages appear to have peaked.

After all, WA added 28,000 jobs to its employment market in 2022 – the majority of those advertised in the back half of the year.

We've seen this before.

The thing is, these are the types of signs that we saw back in 2009 – right before Perth prices started to go through the roof.

During the initial stages of the 2007-2008 Global Financial Crisis, Perth's economy actually thrived, thanks to strong resources activity and demand from China.

Then, fast forward to FY11/12, Perth's property market, particularly its office segment, witnessed unprecedented rental growth amid decreasing vacancy rates. **Prime gross rents in the Perth CBD rocketed to approximately $800 per sqm in 2012, illustrating the significant influence of supply and demand dynamics on the office market.** Meanwhile, rental growth in Sydney and Melbourne stalled or even declined during 2011 and 2012.

2009 set the stage for a phenomenal period for office property in WA. Robust economic growth was fuelled by high commodity prices and the re-emergence of China.

This mirrors conditions today. Sure, past performance doesn't predict the future. But the old saying that history never repeats doesn't often apply to real estate markets.

Capital investment into WA is on the rise.

To be honest, 'on the rise' is an understatement.

In the 12 months to September 2022, investment into the state amounted to $34.7 billion. That's a whopping figure. But the bigger number here, as we round the bend to September 2023, is that capital investment is up 13.5% year-on-year.

And this trend continues even when the mining sector is taken out of the equation. Putting mining, oil and gas aside, there's been an 18.2% increase in non-mining capital investment into WA.

Here come the investors.

Brookfield is one of the world's largest asset managers, investing in long-life, high-quality commercial properties around the globe. Which is why we weren't surprised to hear of their unapologetic excitement about the Perth office market:

"The office sector around the country and, frankly, around the world is the tale of two cities. There's the very best assets and then there's all the rest. The very best assets are continuing to perform extremely well and Perth is no exception to that."

– **Sophie Fallman**, Brookfield's head of Australian real estate

The Australian Financial Review, Monday 31 July 2023

Brookfield has already poured big bucks into the Premium office market, including the $800-million ***One The Esplanade*** project and its upcoming ***Nine The Esplanade*** development. And despite all the talk of a global shift to hybrid work, Brookfield's Australian real estate head, Sophie Fallman, is incredibly optimistic about Perth's office market.

Speaking to the AFR earlier in the week, Ms Fallman says Brookfield is witnessing the same demand as we are for both **Premium and A-grade offices**, giving exceptional praise to Western Australia's bustling, resource-driven economy.

Brookfield expects office demand to keep rolling thanks to a long-term boom in critical minerals. Empty space in Perth's top-of-the-line buildings is getting tougher to find for tenants, and that's expected to continue.

Brookfield is clear: Their main focus during this current cycle of the market is Perth.

And this is just one asset manager. How many more are out there making Perth CBD office a huge part of their investment strategy?

What's our take on all of this?

As we make our investment decisions, we draw a lot of comfort from these promising statistics. And our belief is that Perth's thriving office market is undeniably an investment opportunity not to be missed.

The story so far says it all.

- With soaring demand for office space and a booming economy, the city offers **robust potential for capital growth**.
- The economic indicators are strong, **mirroring the precursors to the previous boom**.
- **Institutional investor demand** is seeing an uptick, along with a huge increase in capital investment into the state.

And it writes a very straightforward plot that leads to our protagonists – Perth's office occupants – to find long-term accommodation in high-quality Perth CBD buildings. While in the process, perhaps reducing the vacancy rate to 12% by 2026 (down from today's 15.6%), as predicted by Knight Frank Research.

This is why we don't fear the headlines coming from Melbourne and Sydney-centric newspapers.

And this is why we believe Perth's office rents are set to go through the roof, once again.

How are we so sure rents will surge? Well, who says it hasn't already begun?

The Rising Tide of Rents

What makes **commercial rents rise**?

There are dozens of factors we could throw at you, but in our opinion it often boils down to these three:

Supply constraints (See Page 4)

If there's limited development in a specific area, supply may not keep up with growing demand, leading to higher rents.

Demand (See Page 6)

Prime locations with excellent accessibility and amenities tend to have higher tenant demand. The limited availability of such spaces can drive up rental prices.

Economic growth (See Page 6)

When the economy is thriving and businesses are expanding, there is a higher demand for space to accommodate the growing workforce. Landlords can then charge higher rents because of increased demand.

If you've followed our story of the Perth CBD's office market so far, you'll be thinking ***check, check, check***. Because indeed, on paper Perth ticks all boxes for rising office rents.

So, now, we're simply going to answer two questions:

Are rents rising in Perth's CBD?

Are they going to keep rising?

Let's find out.

Are Perth CBD office rents on the rise?

They are, and they have been for a while.

Demand for office space in Perth is strong, and hands-on publications are starting to advertise it. Earlier in August, WA's ***Business News*** reported on the Perth office's resilience post-COVID and its leasing market's increased activity across all grades.

Business News revealed that despite the headline figures across the country, there is strong demand for office space in Perth, citing the Property Council of Australia WA Division's executive director Sandra Brewer:

> **"Demand has soared beyond the historical average by more than double, showcasing the strength of Perth's strong post COVID-19 return to work and the enduring significance of the CBD as a premier destination for businesses."**
>
> – **Sandra Brewer**, Executive Director of the Property Council of Australia (WA)
>
> **WA Business News, 3 August 2023**

But does this translate to rental growth?

Prime-grade rents reaching new heights.

Well, that same article boasted significant news for landlords who've held Prime-grade Perth office space in the last year, with Cygnet West research showing that net effective rents have increased by 19.4% in the last 12 months for Premium and A-grade office space, reaching an average of $433 per sqm for Premium grade stock.

Incentives are also dropping, seen in the below table by CBRE, which is a clear indicator of heightened demand (something we highlighted in our last email very much exists). Sure, according to Cygnet West, incentives remain above 40%. But rents are a fraction of what they were in 2012 – it's the downward trend of incentives, and the complementing upward trend of rents, that tells the true story.

Perth CBD records the highest effective rent growth of all CBD markets in Q4

Perth CDB	Q4 2022	Q3 2022	Q4 2021	Q-o-Q Change	Y-o-Y Change
Prime NFR	$650/sqm	$638/sqm	$612/sqm	+1.9%	+6.3%
Incentives	48.7%	48.7%	50.8%	Stable	-217bps
Prime NER	$334/sqm	$328/sqm	$301/sqm	+1.9%	+11.0%
Prime Yields	6.63%	6.42%	6.26%	+21bps	+37bps

Source: CBRE Research

Table: CBRE revealed in their Q4 2022 office market report that Prime rents were on a firm trajectory north, while incentives were headed south. This trend has continued.

Will Perth CBD office rents continue rising?

We know property markets are cyclical, and because current rental rates are still well below previous peaks (i.e. Net effective rents in December 2012 reached $700 per sqm), all indicators suggest Perth office rents have plenty of room to grow. They won't reach previous highs overnight, but the market sentiment confirms rents are undoubtedly moving in the right direction.

The fuel for rising rents will run out when either there's too much supply or not enough demand. And indeed, all data and commentary from leading property experts suggest the opposite.

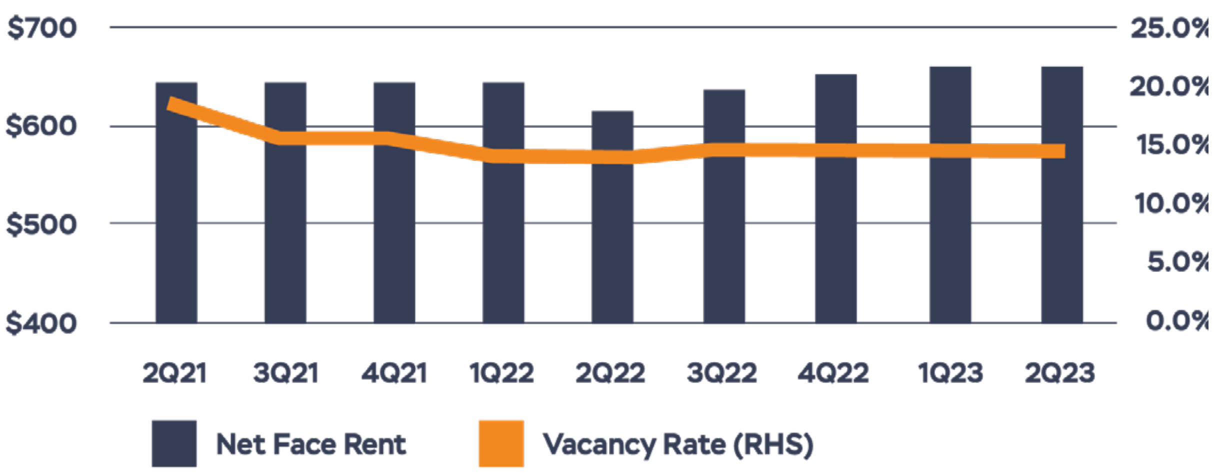
"The Perth CBD office net absorption reading was the second strongest of all major CBD markets over the quarter. Market sentiment remains positive, with JLL inspection numbers also elevated, suggesting future office demand is expected to stay strong."

JLL head of office leasing, Nick Van Helden, told Business News WA that despite global uncertainties from inflation and rising interest rates, Perth's office market is expected to continue setting the pace for both domestic and foreign economies.

"Demand continues to be led by the professional services and mining sectors, as the commodities sector remains buoyant."

An essential factor contributing to the promising outlook for the Perth office market is the limited supply pipeline beyond 2023, which is expected to continue putting downward pressure on the vacancy rate and maintain the sector's growth momentum. Moreover, the combination of high inflation and above-average demand is the extra bit of muscle powering continued rental growth in the Perth CBD.

Prime net face rent, overall vacancy (6 monthly)



Graph: Vacancy rates are steadily declining in the face of increasing rental rates. This is a trend that experts expect will continue.
Source: PCA; Cushman & Wakefield Research

Let’s Recap

1. **Read beyond the headlines**: The recently publicised challenges of office funds like Dexus, Centuria and Charter Hall have little or no bearing on the office market in Perth’s CBD – nor does the performance of east coast office markets in general.

2. **Supply shortages on the horizon**: While the development market is active and as new projects come online in 2023, the supply pipeline falls off a cliff come 2024. This bodes very well for landlords looking to benefit from higher rents.

3. **Demand on the up**: Tenant demand is upward bound, thanks to a bustling WA economy and an active mining and resources sector. And even investor demand is becoming buoyant for Prime-grade office space, with some institutional investors already getting in on the action.

4. **Rents headed north. Incentives headed south**: And finally, as we’ve seen today, the numbers are all very positive for owners of office space in the Perth market.

We didn’t write this script. We’re only reading it – something we’re finding few east coast publications are doing.

So, the message for us is clear. Don’t take every headline as gospel. Because the truth lies in the minutia, the micro data, the intimate details that truly reveal what’s happening in a property market. Perth is sometimes overlooked or lumped in with the rest of the country’s activity.

But as we see it, the Perth CBD office market presents such robust indicators that it’s running a race of its own.