Desk talk

New Bayleys data points to some softening of fundamentals in the office leasing sector, with choice and opportunity emerging for occupiers as a result.

Quality office space with a high level of amenity is still characterising the sector as occupiers aim to position themselves in modern, well-located buildings to help draw staff back into the office, while also navigating a challenging economic and business environment.

Bayleys' latest *New Zealand Office Market* Update shows a definite two-step rental market across the country. The well-documented flight to quality has resulted in low vacancy rates and demonstrated rental growth for A-grade buildings, counterbalanced by dated or poorly located stock lagging, with landlords needing to offer occupier incentives to maintain face rents and occupancy levels.

On the investor side, the report says inflation and long-term interest rates appear to be peaking so yields are likely to stabilise after a period of softening – although lower sales volumes mean there is less evidence available to showcase this trend. Broker sentiment indicates the investment market remains relatively weak, despite having a significant correction since 2021.

Softer yields and persistently high construction costs mean higher rents are needed for new developments to be feasible, however there are some signs that material costs are stabilising which may help improve the viability of new developments.

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>
> **CHRIS FARHI**
> BAYLEYS NATIONAL HEAD OF INSIGHTS, DATA AND CONSULTING

Bayleys national head of insights, data and consulting, Chris Farhi says there's been a general rise in office vacancy rates in most markets, with the most notable trend being an uptick in sub-lease space, particularly in the Auckland CBD.

"Some of the larger sub-lease opportunities are for modern office spaces within good buildings, where corporate occupiers are downsizing their space footprint for operational efficiencies. This is giving the occupier market choice and for some tenants, the opportunity to secure quality space that may otherwise have been out of reach."

AUCKLAND'S INTRICACIES

Bayleys national director office leasing, Matt Lamb says the deceleration evident in the office leasing sector will be a "slow boat to turn around", but economic fundamentals are improving and the Bayleys leasing team is proactively on the tools.

"The brakes have come on in the medium-to-large office sector as corporates continue to review their space requirements through the lens of changed work models and a more subdued business environment.

"There's a cross-blended vacancy rate of around 11 percent across the Auckland market, and we've seen an influx of sub-lease space spring up in the CBD and on the fringes.

"We estimate there is around 73,000sqm of space available in the western frame of the CBD alone,

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> **MATT LAMB**
> BAYLEYS NATIONAL DIRECTOR OFFICE LEASING

with roughly half of that being sub-lease space as companies have been scrutinising their property commitments and often deciding to drop partial or whole floors.”

He says determining an optimal real estate footprint is no longer a decision made solely by a company’s chief financial officer or property team.

“The human resources side of the business is just as influential in ensuring that office space works effectively from a productivity and well-being standpoint, and as a staff attraction/retention tool.”

Lamb says such decision-making can be slow, with multi-national corporates reliant on offshore analysis and approvals, and others simply putting it in the too-hard basket, delaying major relocation decisions until closer to lease renewal or reviews.

“They’re using this time to assess what they really need and want from an office premises and, if change is required, what that will look like. For ease and efficiency, many are renewing leases to ensure business continuity and landlords are naturally keen for this to happen.

“Our team is working closely with landlord and occupier clients by prompting them to be forward-looking, to evaluate what their competition is doing, to be prudent and in the case of tenants, to weight up the costs and risks of moving versus staying put.”

For large corporates with sophisticated stakeholder interests and/or offshore decision-makers, a move to different premises can be years in the making.

“It’s an extremely considered process and there will always be competing priorities as companies balance operational costs with capacity to win and retain future business, and potentially grow once the global economic ship is righted.”

Lamb says there’s a genuine two-step office market playing out in Auckland with prime A-grade stock still in tight supply and propped up by a lack of new development, which means face rents have increased, while the secondary-grade market is facing ongoing headwinds.

“Realistically, owners of B-grade buildings in the city or on the fringe will need to have a game plan to remain competitive and keep cashflow going.

“Whether that’s through refurbishment and upgrades, accepting lower rates of return and providing greater incentives, repurposing to an alternative use – or exiting the market completely.

“That said, there has been something of a resurgence in demand for space by education providers and the private healthcare sector in pivotal locations, so the market is never truly static.”

GLOBAL CONTEXT

Farhi says overseas markets have generally been more heavily impacted by post-pandemic hybrid and remote-work models than New Zealand has.

“In many offshore markets, these off-site work practices became more ingrained and accepted given the typically extended work-from-home periods some places experienced during the pandemic, contrasted with New Zealand’s harder but faster lockdown.

“Many corporates we work with here are still fine-tuning their policies around prescribed in-office attendance, and while there are variations across business segments, the general consensus seems to be that an office-first strategy should prevail.”

Bayleys national head of occupier strategy & solutions, Steve Rendall says a report from Bayleys’ global real estate partner Knight Frank on the Asia-Pacific (APAC) office market, shows a challenging landscape for many key cities in the region, with evident downward pressure.

“However, Auckland, and, we can say to an extent, Wellington which wasn’t part of the report, have generally outperformed many other Asia-Pacific (APAC) office markets on some key metrics like prime office rents, vacancy rates and overall returns.

“Australia and many flagship Asian markets have significantly higher vacancy rates as large corporates have been offloading space.

“While we have seen some evidence of that happening in the Auckland market, it has not been as pronounced as in those cities where particular sectors – for example, the tech sector, have retrenched significantly.”

Rendall says because of New Zealand’s comparatively small size on a global basis, we don’t have a significant volume of large occupiers dominating the market with huge dedicated campus precincts which, when vacated, present landlords with considerable tracts of space to fill or repurpose.

“And, because new office developments here only proceed with long-term precommitments in place for at least 50 percent of the net lettable area, along with confidence that the balance can be filled, we haven’t had an oversupply of speculative space that has been seen elsewhere in the APAC region.”

With vacancy rates in Auckland CBD inching up due to available and projected sub-lease space, Rendall says he doesn’t expect to see speculative growth-based development happening any time soon.

“We simply do not have the population base or corporate demand for that right now. Auckland has a small number of high-quality new CBD projects planned, but these will only proceed with solid pre-commitments in place and the next couple of years will be quiet in terms of development.”

CAPITAL UPDATE

Bayleys Wellington office leasing specialist, Luke Frecklington says the leasing market in the capital is currently fairly muted but as with all real estate sectors, the market is cyclical and he’s an optimist.

“Everyone is in the trenches together, although the tenants have the upper hand at the moment with plenty of opportunity in the market and capacity to strike pretty favourable deals.

“The inventory of vacant office space is increasing so if occupiers are coming up to breakpoint or review, it’s a ripe market for scoping new premises.”

As the country’s seat of government, Wellington will be most impacted by the rigorous cuts to public sector roles across agencies, with the real impact on office inventory yet to be realised. Frecklington says there’s an element of “musical chairs” underway as the government’s property group backfills and consolidates space across its office portfolio before releasing redundant footprint to the open market.

“While there is some government-aligned space quickly available, I suspect that towards the end of this year and into early 2025, we could see significant amounts of sub-lease space come to the market and this will provide opportunity for other occupiers to secure well-located, good quality space with fitout.

“Just who will fill the sub-lease space coming onstream is a hard one to pick and while there will always be tenants looking for single floors, occupiers wanting to acquire whole buildings simply aren’t in the market right now.”

As further evidence of lower demand, there’s around 48,000sqm of current or projected vacant office stock on The Terrace which used to be a corporate stronghold, and significant vacancy in the Courtenay Place and Te Aro precincts.

“Landlords are taking advantage of emptying buildings to do seismic upgrades and refurbishments, but with rising insurances and rates hitting hard in the pocket, some of the smaller landlords may opt to exit the market,” says Frecklington.

In the A-grade market, most of the big moves have already taken place in the CBD, with a flurry of relocations to new builds in the northern frame, including in the Bowen Street precinct.

“Until fundamentals come back into line, we’d expect to see the development sector remain on hold in the immediate future,” says Frecklington.

In terms of lease structures and deal trends, most small-to-medium occupiers in the market want to utilise existing fitout where possible to avoid upfront capital outlay. In base-build properties where landlords haven’t got genuine capital to offer fitout contribution, and in other situations where owners are motivated to fill space, rent-free periods are common now in the capital.

“Typical lease lengths have also come back a bit showing that landlords are wanting to engage with tenants to find workable solutions.”

CHRISTCHURCH MARKET

Bayleys South Island director capital markets and corporate leasing, Jesse Paenga says the Christchurch office market is in a transitional phase at the moment as occupiers continue to work through their space requirements, but the city has compelling credentials.

“The CBD is looking great with its high level of amenity and supporting infrastructure including vibrant retail and hospitality offerings, and it’s busy.

“The return to the office happened quite quickly in Christchurch, as work-from-home dynamics didn’t seem to have the same traction here post-pandemic – perhaps because office workers hankered for normality having been through displacement some years earlier after the earthquakes.

“There’s also a sizeable inner city residential population now with The East Frame Residential Development, spanning six central blocks between Manchester Street and Madras Street, being well advanced which adds to the feeling that the city has been reinvented.”

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> **JESSE PAENGA**
> BAYLEYS SOUTH ISLAND DIRECTOR CAPITAL MARKETS AND CORPORATE LEASING

Paenga says there’s virtually nil vacancy in the A-grade office market, but there’s good opportunity and choice across B-grade space.

“There are large floor plates across multiple levels for lease in the former-IRD building in Cashel Street which has been strengthened and refurbished, and space coming onstream in the ex-New Zealand Refrigeration Company (NZR Co.) Building at 159 Hereford Street, which is undergoing a comprehensive upgrade.

“We also saw a number of occupiers moving from secondary-grade space into better quality premises vacated by several law firms who took up flagship new space in Carter Group’s recently-completed Regent Building at the corner of Cathedral Square and Worcester Street.”

There’s a new office building planned on the former Christchurch library site in Gloucester Street, but Paenga says other than this, there’s not a lot in the immediate pipeline.

“We do have half a dozen big occupiers actively scoping A-grade space with floors of 1,000-2,000sqm and waiting for the right opportunity to present itself.

“Corporate occupiers are generally looking to consolidate onto one floor, or a limited number of floors, for efficiency and to foster team collaboration and culture.”

Office rents have stabilised at a new high for the city says Paenga, with the leases struck at the Regent Building, for example, helping to push average rents up.

“I think it will take another high-spec A-grade development to reset rents again and nudge them upwards.”

For the full insights report on the office sector, go to:
bayleys.co.nz/insightsanddata/new-zealand-office-market-insights-2024