

1<sup>st</sup> Quarter 2010

## 10 Year Rent Growth Review - Suburban Office

### ➤ Using North Shore Office Performance as a Barometer

The slow recovery from recession continues to have a dampening impact on the commercial property market, with tougher leasing conditions and sluggish sales levels still evident. The office market has been hit hardest and the effects of changing market forces on office asset performance can be quantified.

Through research and market monitoring, general changes can be measured and reported. In a nut shell, the office market is facing a number of challenges including rising vacancy rates, sliding rental levels, increased incentives and shorter lease terms.

Each of these components is intrinsically linked and represents a weakening of market forces affecting both landlord and tenant. During buoyant times, risk to both parties is minimised. The tenants business typically performs well and in turn landlords are often able to attain rental increases. Risk of vacancy to the landlord is minimised, given replacement tenants are usually in the wings. But during recession/post-recession periods, the opposite occurs and both parties are affected by uncertainty. Risk increases dramatically if the tenants business suffers and asset value is threatened if vacancy is imminent.

To a degree, the relationship is symbiotic and requires cooperation to counter softening market forces. In the case of the office sector, market conditions are expected to remain tough over the next 12 to 24 months. In a previous Property Pulse article, Darroch forecast Auckland CBD vacancy rates to increase to between 16% and 18% by 2012, with a projected 15% to 20% fall in 'effective' market rents from peak levels seen in 2007.

'Effective' market rent is a term used by valuers to calculate the 'net effective' rental being paid in a new lease after discounting for any incentives. It differs from the 'face' rental which is the 'nominal' rent specified in the lease (inclusive of incentives). Incentives can take many forms but the most common examples are rent holiday periods and fit-out contributions from landlords. These incentives have a time/money value associated with them, which must be deducted from the face rental. In difficult economic times, the level of incentives offered by landlords increase as they look to secure tenants and minimise vacancy risk. We have seen several new leases being negotiated with 2 months holiday for every one year of lease term. Previously ratios had been closer to one month per year; and during the economic peak incentives were rare. The true level of market rent has therefore dropped as the economy has dipped, and this is having an impact on asset value.

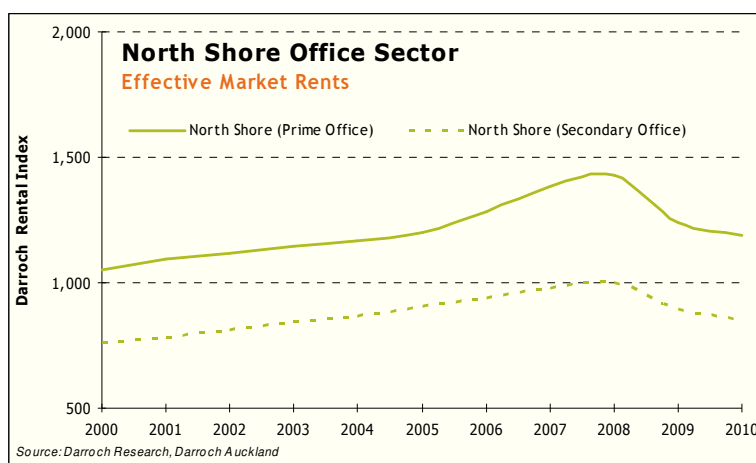
Here we look at the Auckland suburban office market and profile the performance of market rentals across the **North Shore office sector**. We feel that this is a good representation of what has been happening in the wider suburban office market across Auckland. Our analysis on North Shore offices dates back to the late 1990's and allows us a comprehensive 10 year review on rental levels and land value changes in the City.



*Effective market rents have been declining across the North Shore suburban office market*

For North Shore office markets, the last decade can be characterised in two halves. Steady growth occurred from 2001 until the market peak of mid 2007 - with the period 2004 to 2006 - reporting extremely buoyant (if not unsustainable) growth in rents levels and land values. Understandably, a reversal in market forces in the three years post 2007 has had a spiralling impact these levels. In fact, the readjustment in market rents has been so severe that 'effective' market rates for office accommodation are now around the same levels as they were five years ago (2005). Darroch's latest market survey has the office vacancy rate on the North Shore at 15% - up from 7% in 2007. A combination of weak leasing demand, fewer prospective tenants and excess supply of accommodation has had a dramatic impact.

Below we illustrate and table the performance of North Shore office rents between 2000 and 2010. The results show 'effective' market rents have fallen to levels previously attained in 2005/2006. Our valuers note that 'effective' market rents for prime offices in Takapuna have fallen from close to \$320 psm to \$260-\$270 psm net of opex. Similarly in Albany, market rents for prime offices hit \$275 to \$280 psm but now are delivering \$240 to \$250 psm. Although many landlords have ratcheted leases or CPI clauses providing above market rents, the real market (new lettings) is operating at a lower level, meaning a 'two tier' market is now in operation. The value of an asset must always be assessed in relation to the current market. Risk to a landlord is realised if a tenant defaults or vacates the premises.



The one bright piece of news for landlords has been the performance of car parking, which has been able to hold its rental values over the past 3 years. Over the 10 year period, car parking has been able to achieve compound growth rates of close to 7% pa, compared to office accommodation which achieved modest growth of 1.2% pa.

Nth Shore Office (Effective Rents)		Compound Growth Rates p.a.		
Component	Location/Quality	3 Yr Avg	5 Yr Avg	10 Yr Avg
<b>Land Values</b>	Albany Basin	-15%	0%	9%
	Takapuna	-13%	-3%	10%
<b>Office Rentals</b>	Albany - Prime	-4%	0%	1%
	Albany - Secondary	-3%	-1%	1%
	Takapuna - Prime	-5%	0%	1%
	Takapuna - Secondary	-5%	-1%	2%
<b>Carparking Rentals</b>	Albany - Covered	3%	4%	7%
	Albany - Uncovered	0%	0%	7%
	Takapuna - Covered	4%	7%	6%
	Takapuna - Uncovered	0%	4%	7%
<b>Overall Average</b>	<b>Offices</b>	<b>-4.5%</b>	<b>-0.6%</b>	<b>1.2%</b>
	<b>Carparking</b>	<b>1.8%</b>	<b>3.9%</b>	<b>6.8%</b>

Source: Darroch Research

Commercial land values too have fallen dramatically since the global downturn, but over the decade values have still increased close to 10% per annum. Back in 1999/2000 land values were around \$150-\$170 psm in Albany and \$900-\$1,000 in Takapuna. Despite sharp increases in values over most of the decade, commercial land values have fallen back again. As in past downturns, confidence in the market can take a number of years to reappear. There had been some improved leasing interest late last year but this has slowed down. The key driver in assisting the office market is improved business confidence and growth in the economy, but for now these factors remain somewhat deflated.