

Market Overview

The office market has entered a new stage of the current property cycle. Auckland CBD vacancy rates have started to increase due to a combination of falling demand and the downstream vacancy impact of new supply. The results of Darroch's March 2009 vacancy rate survey recorded a 2.3% increase in CBD vacancy rates. At the same time, net effective rents have started to ease and net absorption has turned negative.

The overall CBD office vacancy rate as at March 2009 was 9.0%, up from 6.7% in September 2008 and 5.3% in March 2008. Whilst the vacancy rate has increased significantly it is yet to wholly reflect the impact of the current economic environment; we would expect to see this over the next six to twelve months. Aside from reduced tenant demand as a consequence of the downturn in the economy, vacancy rates will also be impacted over the short to medium term by the volume of office space expected to come to the market as tenants, such as BNZ, Deloitte and Westpac, vacate existing office space within the CBD to take up space they have pre-committed to in new developments currently under construction. Much of this 'back fill' space will require refurbishment to attract new tenants. This is likely to lead to an excess supply of vacant lower grade office space that will take some time to absorb.

Whilst there are several new build proposals out in the market, which could potentially add a further 100,000 square metres to Auckland's CBD office stock over the next five years, the realignment of capital markets combined with increased borrowing cost and a tightening of lending conditions, and increased uncertainty of the future direction of the economy, is likely constrain to future development activity over the short term.

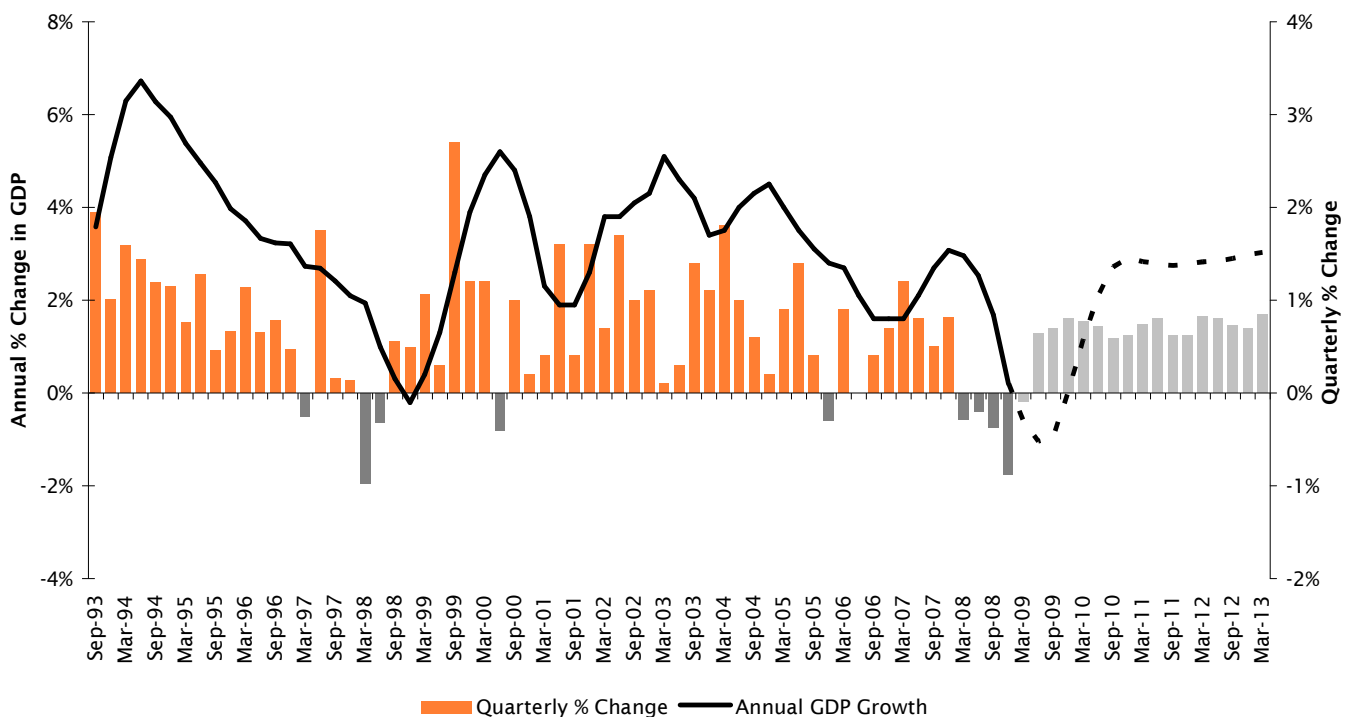
The impact of the current recession on the demand for office space is likely to continue though to the end of 2010 and combined with the completion of office buildings that are currently under construction, is likely to result in vacancy rates increasing to levels not experienced since the mid 1990s.

The Economy and Office Market Drivers

New Zealand's economy experienced a consumer led slowdown over 2008. The economy contracted by 0.9% in the nine months to September 2008 and a further 0.9% in the December 2008 quarter. The outlook is for growth to start to recover late 2009, albeit at a slow rate, with GDP forecast to be flat in the December 2009 year.

Figure 1 demonstrates the trend in annual and quarterly economic growth (GDP) since 1993 and in addition presents the growth forecast up to, and including, March 2013.

Figure 1: National Economic Growth



Source: Statistics New Zealand and NZIER

The economy remains vulnerable to the downstream financial and economic impact of the 'sub-prime' mortgage crisis and the associated 'credit crunch.' Over the last six months bank lending criteria has tightened, there has been a sharp reduction in credit availability and money has become more expensive. Expectations of future economic growth remain soft, with most commentators expecting negative growth to continue over the first half of 2009.

The New Zealand economy is forecast to see positive growth later in 2009 as a result of:

- Increased government expenditure;
- The stimulus provided by the October 2008 and April 2009 tax cuts, although consumers may initially pay off debt rather than spend any increase in net income;
- The fall in the relative value of the New Zealand dollar will assist exporters profitability, offset the decline in some commodity prices and assist in reigning in our current account deficit;
- The fall in transport costs driven by lower petrol and diesel prices; and
- Lower interest rates may take some pressure off household budgets.

However, some of these benefits will be offset by:

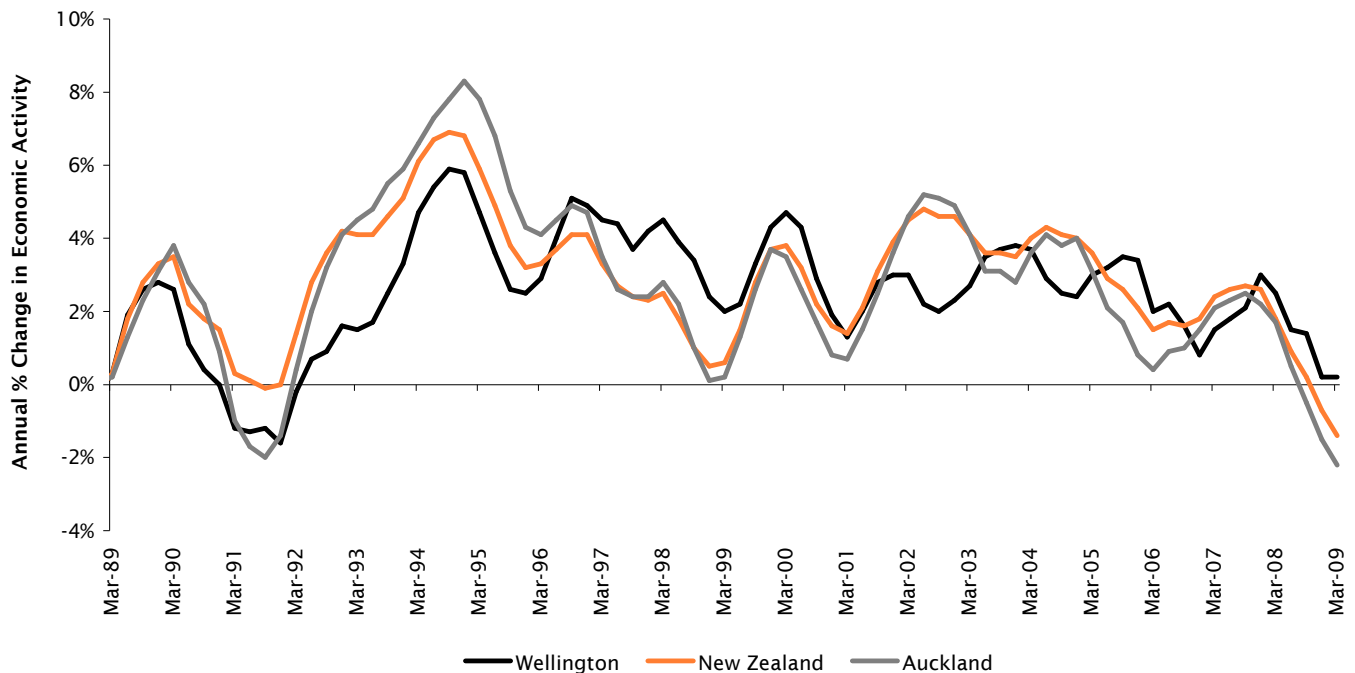
- A significant softening in labour market conditions and rising unemployment. The extent of the softening in the labour market will be a critical indicator of the depth and duration of this cycle;
- Interest rates for the non residential sector are likely to remain high with tighter lending criteria and restrictions on the availability of credit;
- Net migration remains below New Zealand’s long term average and tourist arrivals continue to decline;
- A still weak housing market conditions and a likelihood of future fall in values; and
- Continued volatility in overseas and domestic capital markets.

There are significant downside risks associated with current economic forecasts and we suspect current growth expectations may overstate what is likely to occur.

The forecast recovery is expected to be export led. The growth that does occur is unlikely to be evenly distributed around the country. Regions with an export oriented economy are likely to do better than those with a domestic consumption focus, for example Auckland. The upside for Auckland will be driven to a large extent by how quickly net migration numbers recover and the relative flow of tourists into the country. The 2011 Rugby World Cup may be the catalyst that assists to boost growth to levels at, or above, the long term average.

Figure 2 presents the trend in regional economic activity in Auckland and Wellington, and compares it against the national trend.

Figure 2: Regional Economic Activity



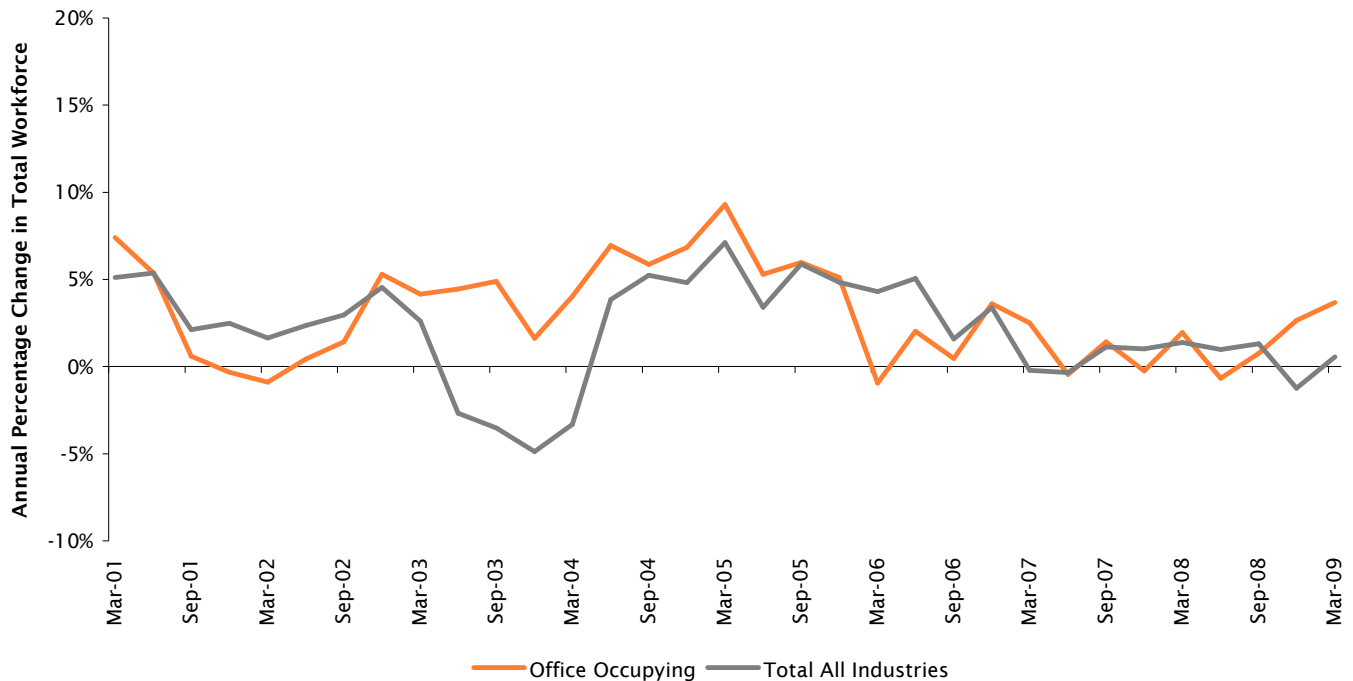
Source: ANZ National Bank

Growth in economic activity in the Auckland region fell for the sixth consecutive quarter in the March 2009 quarter. On an annual basis growth was down from 1.7% in the year to March 2008 to -2.2% in the year to March 2009. The year to March 2009 figure was down 0.7 percentage points over the December 2008 year result and was the third consecutive negative annual result recorded for the region, an outturn not

experienced since 1991. Key drivers include a continued decline in retail sales, a weak housing market and falling employment in the region.

Figure 3 presents the annual percentage change in the number of people employed in the Auckland region overall and in the key office occupying groups.

Figure 3: Auckland Region Employment Growth by Sector



Source: Statistics New Zealand

Total employment growth in Auckland during the mid 2004 to mid 2006 period was consistently around 5.0% per annum. From mid 2006 total employment growth weakened, and was negative over the March 2007 and June 2007 years. Over the latter half of 2007 and through to late 2008, Auckland’s total employment growth showed some recovery. In the year to December 2008, however, total employment growth in Auckland turned negative, down 1.2%. In the most recent year to March 2009 total employment growth in Auckland turned positive once again, up 0.6%. Growth in office sector employment in Auckland has generally followed a similar trend to total employment, albeit with more volatility. The most recent employment survey shows an increase in office sector employment growth from 2.7% in the December 2008 year, to 3.7% in the March 2009 year, which is somewhat surprising given the trend in vacancy rates presented in the next section.

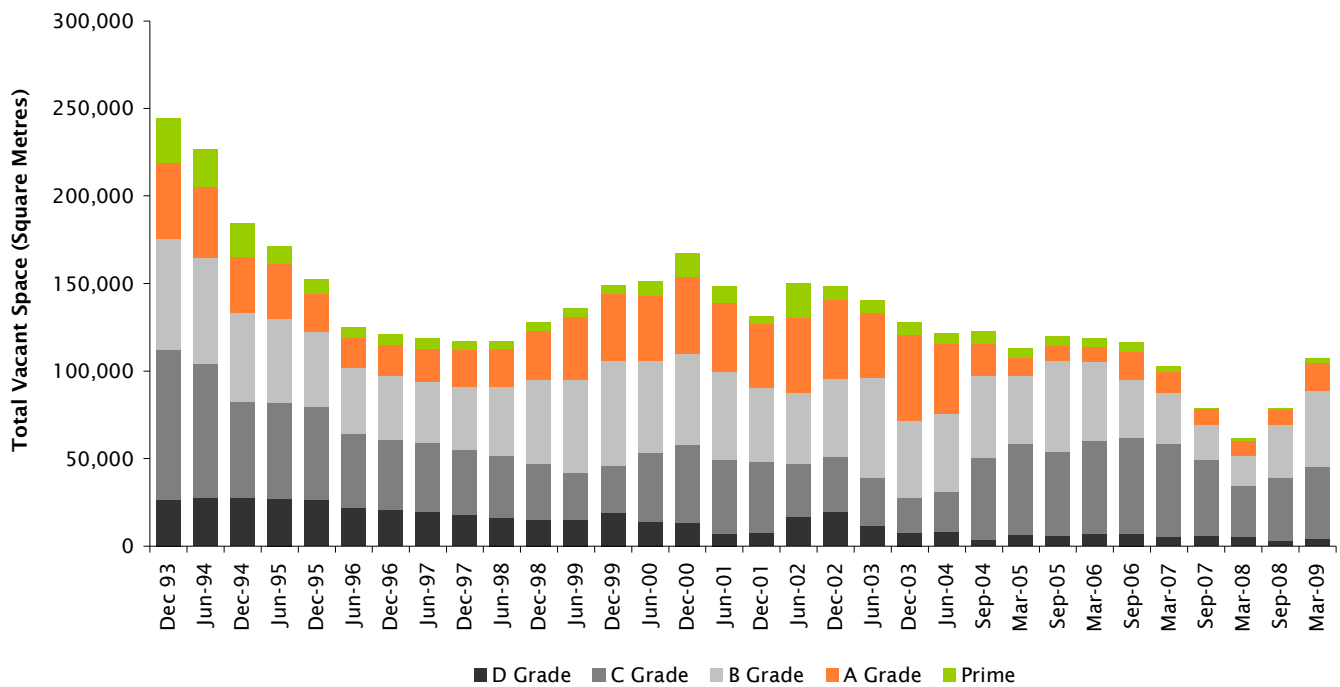
Most of the surveys undertaken recently around future employment intentions indicate that employer’s, particularly in the office occupying sector, will be reducing employment, rather than increasing it, which in turn will impact the demand for office space over the medium term.

Vacancy Rate Trends

The overall CBD office vacancy rate as at March 2009 was 9.0%, up from 6.7% in September 2008 and 5.3% in March 2008.

Figure 4 presents the trend in the area of vacant office space within the CBD since late 1993.

Figure 4: Auckland CBD - Vacant Office Space



Source: Darroch Research

Over the last twelve months, since March 2008, the amount of vacant space in the CBD has increased by 75%. The total area of vacant office space increased by 36.6% over the six months to March 2009, with the majority of the vacant office space still located in B and C grade office buildings. However, the increase in vacant space over the six months from September 2008 to March 2009 was driven largely by increased vacancy in A and B grade buildings.

Whilst the vacancy rate has increased significantly over the last twelve months, it is yet to wholly reflect the impact of the current economic environment.

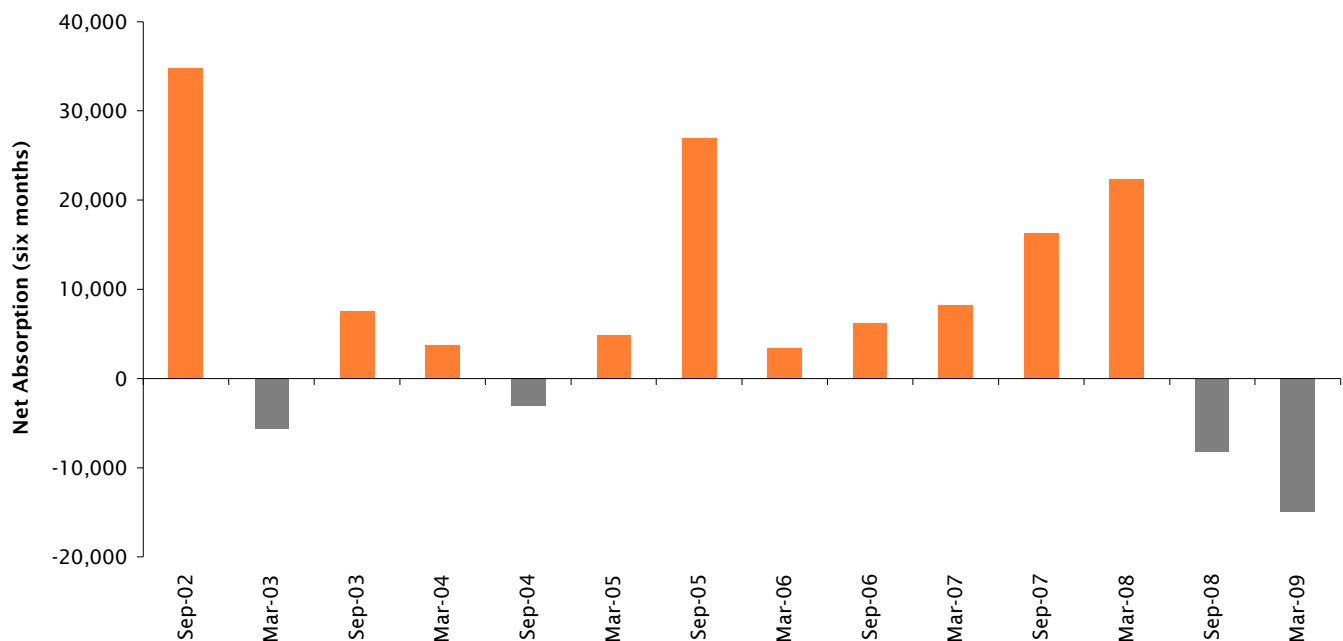
Increases in A and B grade vacancy were the most substantial over the six months to March 2009, up 3.8 and 2.7 percentage points respectively to 12.2% and 5.9%. Whilst, Prime and C and D grade also recorded an increase in vacancy, up 1.4 and 1.5 percentage points respectively, to 1.7% and 11.1%.

All CBD precincts experienced an increase in their vacancy rates over the September 2008 to March 2009 period, with the Quay Park precinct experiencing the most substantial growth, up 16 percentage points to 20.2%, brought about largely by the 4,200 square metres of space vacated by GE Money in the GE Plaza building at 8 Tangihua Street.

Current Demand

Figure 5 presents the net absorption of office space in the Auckland CBD from September 2002 to March 2009 at six monthly intervals.

Figure 5: Auckland CBD Net Office Space Absorption



Source: Darroch Research

The Auckland CBD office market enjoyed a period of constant positive tenant demand between March 2005 and March 2008. Over the twelve months to March 2009, however, net absorption turned negative, with just over 23,000 square metres of CBD office space vacated in net terms.

The negative trend in net absorption is evidence of weaker demand for CBD office space driven primarily by much weaker economic growth. Despite the economic environment, there is still development activity within the CBD office market, with a number of new developments due for completion over the next six to twelve months. However, almost all of this space has already been pre-committed meaning very little new, high quality space will be available to the market.

Examples of leasing activity in the Auckland CBD over the last six months include:

- Tourism Holdings has leased 930 square metres in total across two floors at 83 Beach Road. Effective February 2009 for 6 years at an effective net rate of \$170 to \$225 psm;
- Saudi Consulate has leased a part floor of 613 square metres at 1 Queen Street. Effective January 2009 at an effective net rate of \$325 psm;
- A confidential tenant has leased 1,400 square metres in total across two levels in the Datacom building at 101-103 Wellesley Street West. Effective January 2009 at an effective net rate of \$190 to \$250 psm; and
- ING leased 5,750 square metres in total across 5 levels in the former St Laurence House at 139 Quay Street. Effective early 2009 at an effective net rate of approximately \$350 psm. However, this space currently remains vacant and is available for sublease.

Supply Side Issues

A number of significant office developments, including 20,000 square metres of office space across two office buildings in Quay Park, by developer Mansons TCLM and 9,500 square metres in the refurbished Charter House, have been completed over the past twelve months, increasing Auckland's CBD office stock by almost 30,000 square metres. In addition, a number of new developments currently under construction will increase CBD office stock by in excess of 100,000 square metres over the next 12 months.

Key CBD office developments currently underway are as follows:

- Multiplex is developing a 19 level building at 80 Queen Street, providing 23,000 square metres of Prime grade, five star green rated office space. BNZ have committed to approximately 60% of the office space and accounting firm Deloitte have taken the remainder of the office space and naming rights. Construction is underway and completion is expected October 2009;
- AMP New Zealand Office Trust is undertaking a significant 13,600 square metre up-grade of, and addition to, Downtown House, 21 Queen Street. Completion is expected late 2009 and the developer is hoping to achieve a five star green rating;
- Newcrest secured the former 'Seamart' site on the corner of Fanshawe Street and Market Place and have almost completed development of a five star green rated office building offering approximately 9,000 square metres of space. IAG has committed to lease all of this space with completion expected in mid 2009;
- Cooper and Company have commenced construction of the East Building consisting of two new linked office blocks, together with redevelopment of the historic 'Charter House', to provide approximately 35,000 square metres of new office space. Westpac have committed to 22,000 square metres of space and will occupy all of Charter House and the southern office block of the East Building which together are to be renamed 'Westpac on Takutai'. EY have recently committed to 9,500 square metres of space in the northern office block of the East Building, with options for further space in the future. Stage one was completed at the start of 2009 and final completion is scheduled for 2011; and
- Mansons TCLM have commenced construction of a new five star green rated office development on the former Auckland Mail Centre site in Victoria Street West. The development will comprise 4 medium rise office buildings, offering 30,000 square metres of space, all of which has been leased to Telecom New Zealand. Completion is expected in 2011.

This significant level of development activity could have an effect on vacancy rates in the short to medium term, as space is vacated by tenants relocating to new premises with much of this vacated space likely to require substantial refurbishment before it will attract new tenants.

In addition, there are several new build proposals out in the market, which could potentially add a further 100,000 square metres to Auckland's CBD office stock over the next five years. These include several Mansons TCLM proposals for the Auckland CBD; Westfield's proposal for the Downtown Shopping Centre site; Pelago's Cook Street depot site proposal; Dae Ju's development on the former Auckland Star site; and proposals associated with Britomart.

The realignment of capital markets combined with increased borrowing cost and a tightening of lending conditions, and increased uncertainty around the future direction of the economy, is however, likely to constrain future development activity.

Investment Performance

Demand for quality investment property in the Auckland office market has reduced, institutional investors are essentially out of the current market as purchasers and many are now net sellers. There is limited demand for those ‘non-liquid’ assets i.e. \$15 million and over in the Auckland market, however, there is renewed market participation from syndicators and high net worth individuals generating sustained demand within the sub \$2 million bracket.

Recent CBD office sales of note have included:

- In December 2008 Wright Cy Limited purchased 401 Queen Street, comprising 2,338 square metres of office space. The property was purchased for \$5.1 million. The building was mainly vacant as at the date of sale;
- In December 2008 a private investor acquired the Victoria House at 23 Victoria Street East, comprising 1,609 square metres of office space. The property was purchased for \$7.2 million on a yield of 7.43%;
- 2 Lorne Street was purchased in December 2008 by Mirage Property Investments Limited for \$7.25 million. The property is 1,280 square metres; and
- In October 2008 a local Auckland investor purchased Hawkins House and the Ricoh Building on Stanley Street from Goodman Property Trust for \$22.95 million. The two properties have a net lettable floor area 5,051 and 4,887 square metres and were valued in March 2008 at \$12.5 million on a yield of 8.5% and \$12 million on a yield of 8.75% respectively. The sale price represents a decline of 6.3% on their March valuations.

The global credit crunch will continue to have an impact on investors’ ability to transact and on yields achieved. Yields for secondary quality investments have already increased by at least 0.5% to 0.75%. At this stage of the cycle it is difficult to precisely determine current market yields due to a lack of sales evidence. Our expectation over the next 12 months is that yields will continue to increase across all property types and the yield gap between prime and secondary quality property investments will continue to widen.

Table 1 presents the total return delivered over specific periods of time up to December 2008 for CBD office in Auckland and Wellington as well as Auckland retail and industrial.

Table 1: Annual Average Compound Returns – Auckland and Wellington

To December 2008	Auckland			Wellington
	CBD Office	Retail	Industrial	Office
1 Year	-2.0%	-1.3%	2.6%	2.6%
2 Years	9.3%	10.6%	8.0%	14.8%
5 Years	13.8%	14.1%	13.2%	18.1%
10 Years	8.9%	13.1%	11.8%	13.0%

Source: Darroch Research and New Zealand Property Council

NB: Return series based on the New Zealand Property Council’s index up to March 2006 and since then Darroch’s return series

The underlying office market fundamentals have been strong in both Auckland and Wellington over the last five years and the returns achieved over that period reflect this. However, the recent increase in yields, combined with slower rental growth, is beginning to have a negative impact on the returns achieved across all categories.

Market Outlook

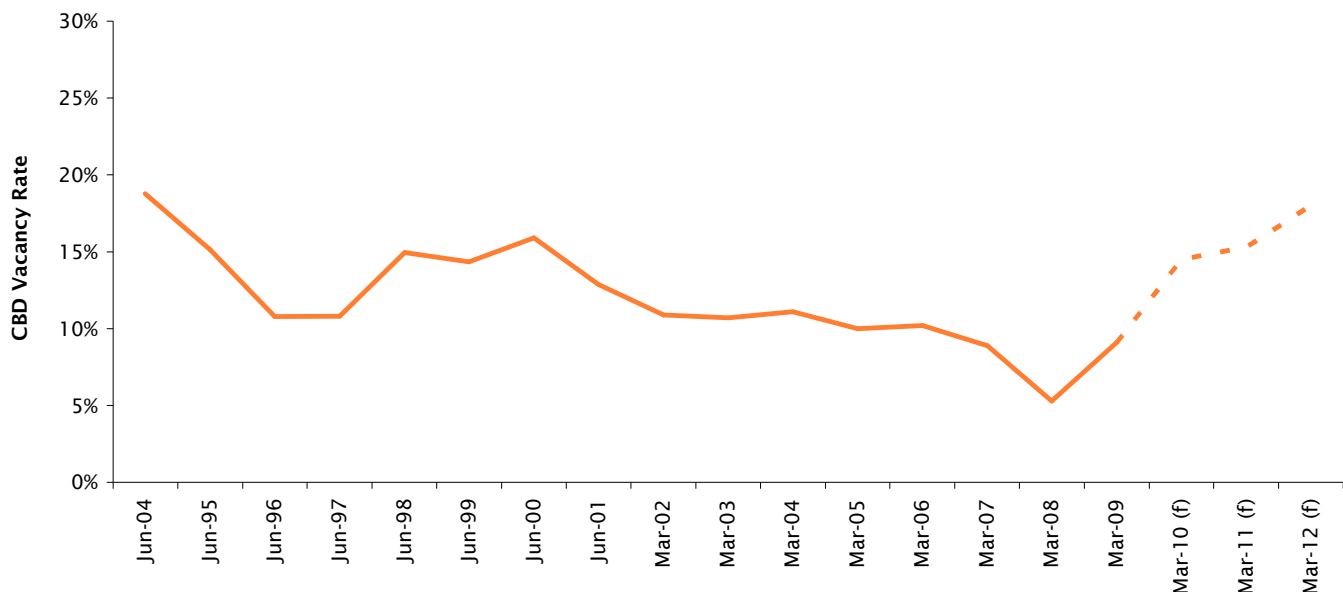
The outlook for the Auckland CBD office market has deteriorated over the last year. Vacancy rates have started to increase, and are expected to continue to deteriorate, and rents have started to ease. The impact of the credit led recession has started to have a significant impact on Auckland’s real economy. The length and total impact of this stage of the cycle will be driven by the economic cycle we are currently in. The underlying market fundamentals are unlikely to recover until economic growth starts to recover in the Auckland region. The outlook for vacancy rates and rents are discussed in the balance of this section of the report.

A number of factors are likely to drive CBD vacancy rates to levels not experienced since the mid 1990s. The market is currently experiencing classic late cycle characteristics. These include:

- Falling tenant demand as a result of the current recession's impact on businesses demand for labour. The total area of occupied space is forecast to contract by 30,000 and 35,000 square metres over the next two years; and
- The market is also in the later stages of a mini construction boom. Over 98,000 square metres of office space will be completed over the next three years. The majority of this space is pre-let, with the exception of AMP Office Trusts Downtown House refurbishment. However, the tenants shifting into their new premises will leave significant vacancies behind in their existing premises.

Figure 6 presents Darroch’s forecast increase in CBD vacancy rates over the next three years.

Figure 6: Vacancy Rate Forecasts



Source: Darroch Research April 2009 Forecasts

Note that these forecasts are based on an economic outlook consistent with NZIER’s March 2009 quarter economic forecasts. If economic conditions deteriorate faster than this, vacancy rates experienced will be higher.

Darroch is forecasting CBD vacancy rates to increase to between 17% and 18% by March 2012. The rapid change in underlying market conditions is likely to have a significant impact on the CBD office market in the short to medium term and result in a shift in the balance of bargaining power from the landlord to the tenant.

Darroch Consulting and Research's latest rental forecasts predict prime CBD net effective rents to ease by between 15% and 20% over the next two and a half years as a result of increased vacancies and falling tenant demand for office space.

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