

Market Overview

The Auckland office market is currently displaying classic late cycle characteristics – an over supply of space and soft tenant demand, which has flown through to rental rate declines.

Auckland CBD vacancy rates have increased significantly over the last two years due to a combination of falling demand and the downstream vacancy impact of new supply. Darroch's March 2010 vacancy rate survey showed an increase of 1.6 percentage points in CBD vacancy rates in the six months since September 2009. At the same time, net effective rents are continuing to ease and whilst net absorption, over the six months to March 2010, was positive, albeit slight, tenant demand growth remains weak.

The overall CBD office vacancy rate as at March 2010 was 13.3%, up from 11.7% in September 2009 and 9.0% in March 2009. While the overall vacancy rate has increased significantly it is yet to wholly reflect the downstream impact of the recent recession; we would expect to see this occur 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, Westpac, Ernst and Young and Telecom 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 130,000 square metres to Auckland's CBD office stock over the next five years, increased borrowing costs, a tightening of lending conditions, and uncertainty over the future demand growth, is likely constrain to future development activity.

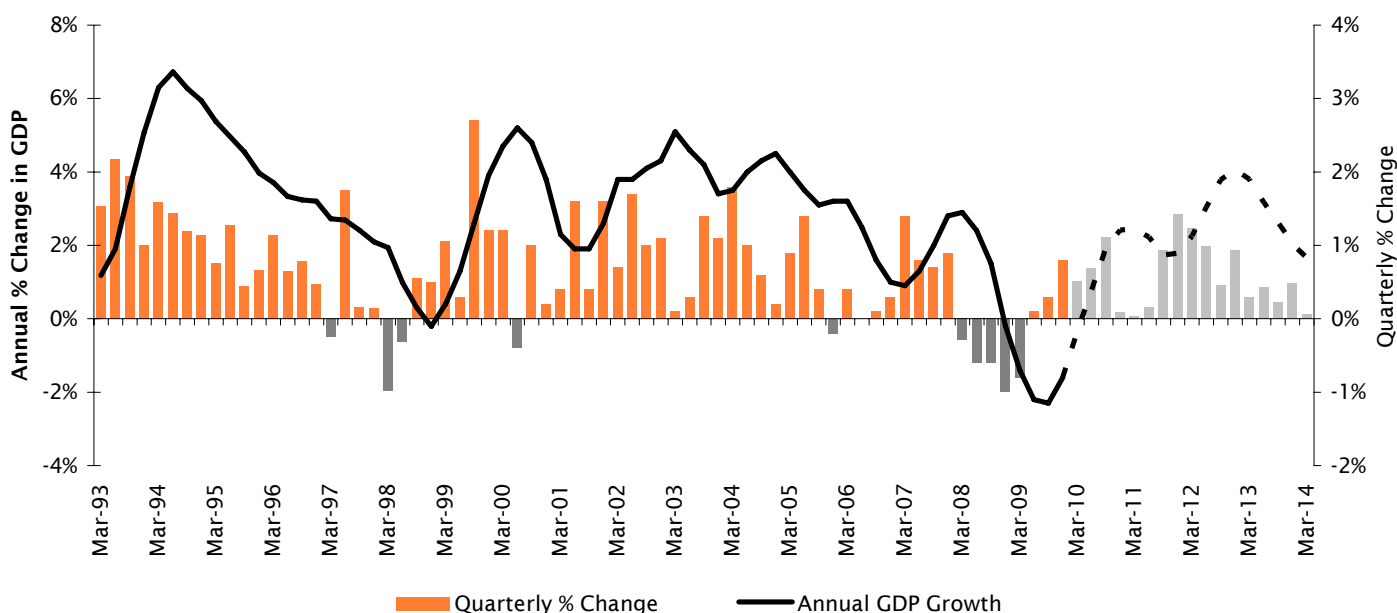
The impact of the 2008 / 2009 recession on the demand for office space is likely to continue to be felt through to the end of 2010 and combined with the completion of currently under construction office buildings, is likely to result in vacancy rates increasing to levels not experienced since the mid 1990s.

The Economy and Office Market Drivers

New Zealand's economy experienced a consumer led slowdown over the early and middle part of 2008 which was then compounded by the global credit crisis and subsequent global economic recession. The economy contracted for five consecutive quarters, up to, and including, the first quarter of 2009, however, this negative trend has since reversed and the last three quarters have seen positive growth of 0.1%, 0.3% and 0.8%.

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 2014.

Figure 1: National Economic Growth



Source: Statistics New Zealand and NZIER

The outlook is for growth to continue to recover, albeit at a slow rate, with GDP, on an annual basis, forecast to be positive by the first quarter of 2010.

The economic recovery, however, remains vulnerable to a range of global and domestic factors.

In terms of positives a number of factors can be cited:

- Stronger global economic growth;
- Continued strength in the Australian economy, New Zealand's key trading partner, combined with a relatively low NZD / AUD cross rate;
- A strong rebound in commodity prices during 2009 which has consolidated over the first half of 2010;
- A significant increase in late 2009, in Fonterra's payout for the 2009 / 2010 season;
- A stronger manufacturing sector;
- A recovery in residential building, albeit off a low base;
- Above trend, albeit weakening, overseas migration gains;
- Increased government infrastructure expenditure; and
- Strong business and consumer confidence.

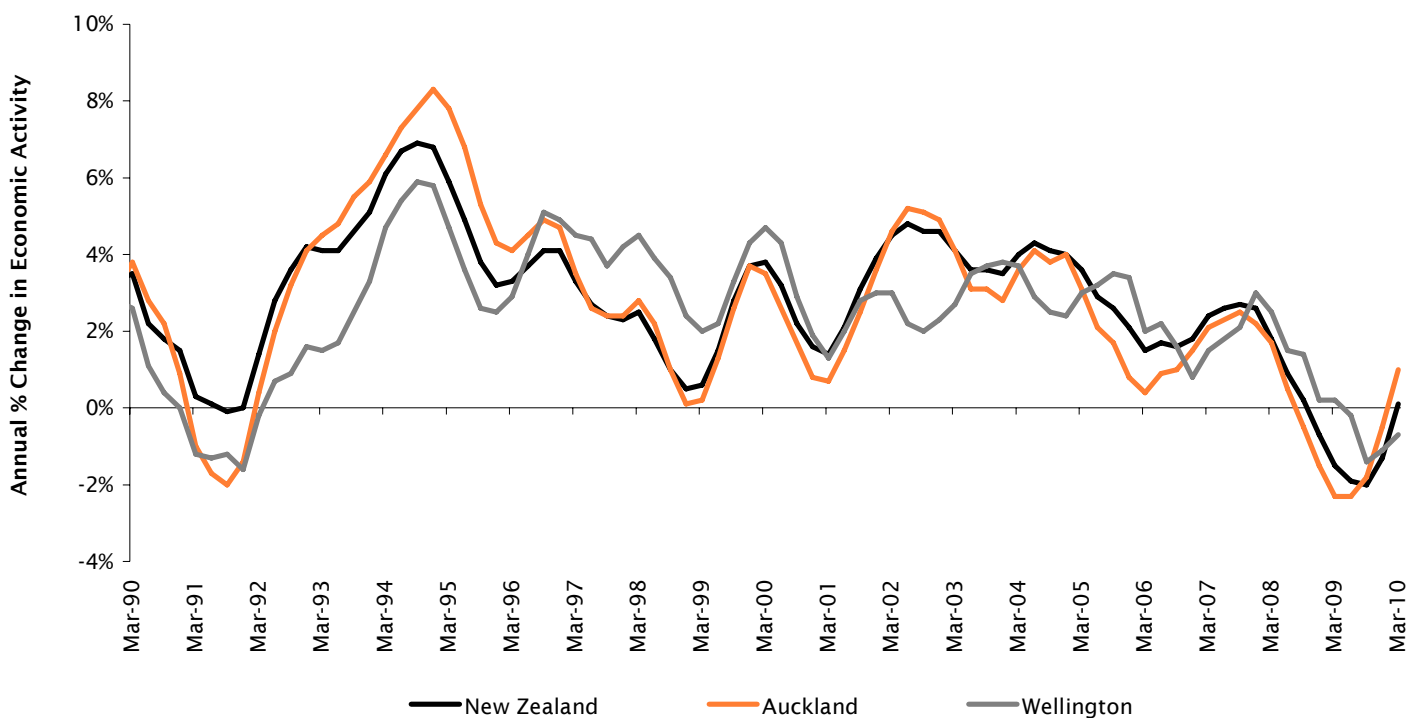
However, some of these benefits will be offset by:

- Interest rate increases. The bottom of the current interest rate cycle has now passed with the Reserve Bank increasing the OCR for the first time in three year at its June review, with the market expecting ongoing rate rises towards 6% by early 2012;
- Still fragile labour market notwithstanding recent increases in employment and fall in unemployment;
- A forecast easing in net overseas migration gains;
- Tighter lending criteria and restrictions on the availability of credit for the non-residential sector;
- Continued volatility in overseas and domestic capital markets; and
- Pressures on household budgets from increased energy, food and transport costs also in October GST will increase by 2.5 percentage points to 15%.

There are downside risks associated with current economic forecasts, both global and New Zealand growth remains fragile, and current growth expectations may overstate what is likely to occur.

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

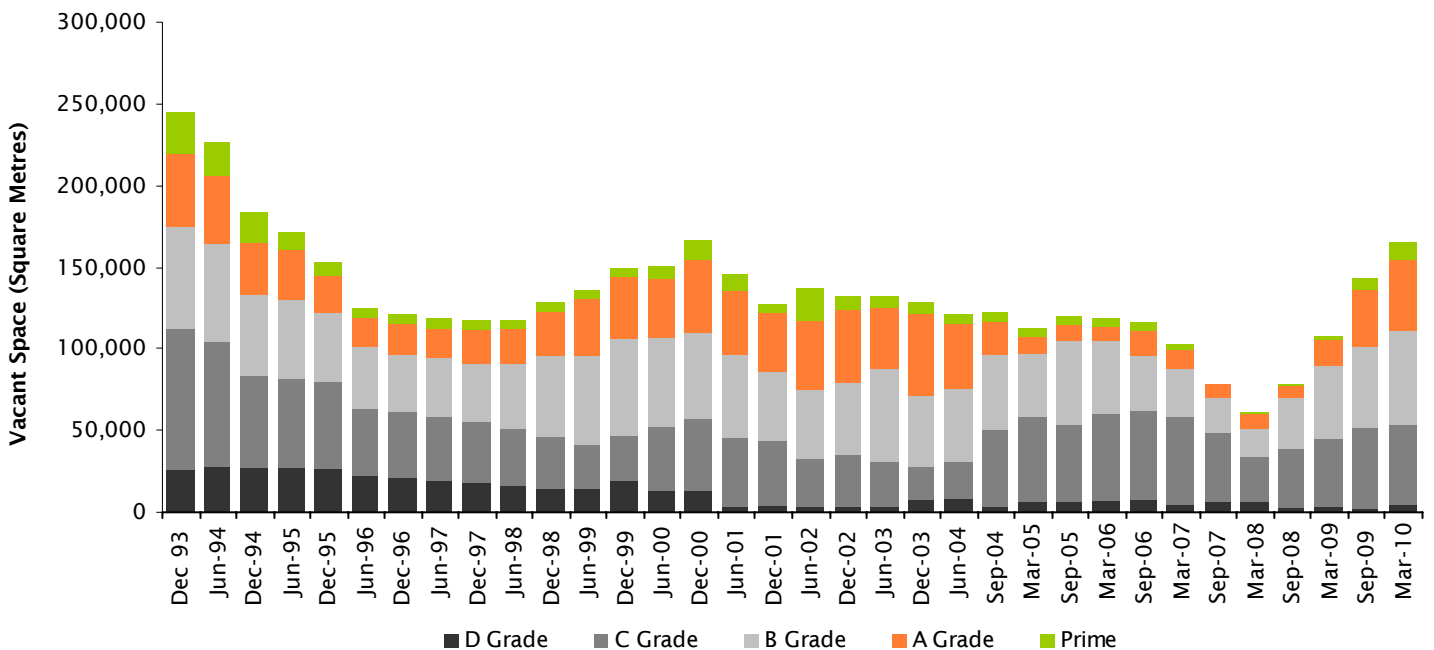
Economic activity in the Auckland region over March 2010 quarter increased by 1.5 percentage points following a 1.3 percentage point increase in the December 2009 quarter. Annual growth is now positive, 1.0% in the year to March 2010. Annual economic growth in the year to March 2010 has exceeded the national growth rate (0.1%) for the third consecutive quarter.

Vacancy Rate Trends

The overall CBD office vacancy rate as at March 2010 was 13.3%, up from 11.7% in September 2009 and 9.0% in March 2009.

Figure 3 presents the trend in the area of vacant office space within the CBD since late 1993.

Figure 3: Auckland CBD – Vacant Office Space



Source: Darroch Research

Over the last twelve months, since March 2009, the amount of vacant space in the CBD has increased by over 50% with the total area of vacant office space increasing by 15.8% over the six months to March 2010. The majority of the vacant office space is still located in B and C grade office buildings.

Whilst the vacancy rate has increased significantly it is yet to wholly reflect the downstream impact of the recent recession and current office supply pipeline. In addition to reduced tenant demand as a consequence of the downturn in the economy over the 2008 / 2009 period, 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, Westpac, Ernst and Young and Telecom 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.

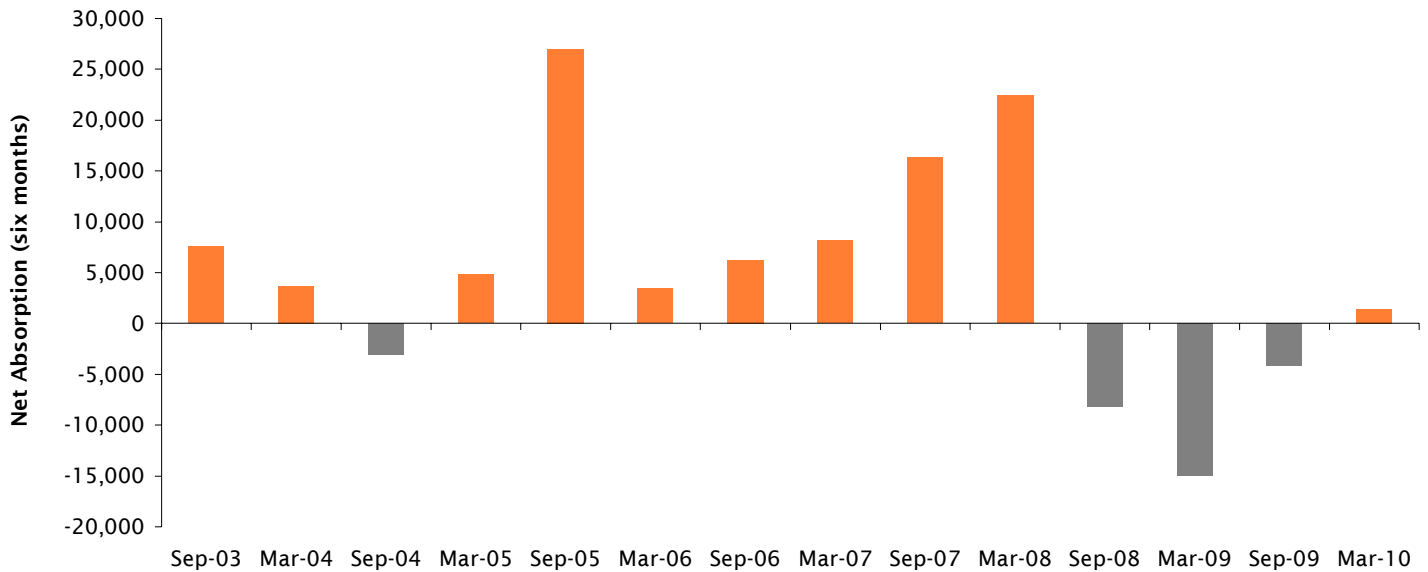
Increases in A and B grade vacancy were the most substantial over the six months to March 2010, up 4.7 and 2.1 percentage points respectively to 14.7% and 16.0%. Whilst, Prime, C and D grade also recorded an increases in vacancy, up 1.8 and 0.8 percentage points respectively, to 6.0% and 13.0%.

All CBD precincts experienced an increase in their vacancy rates over the September 2009 to March 2010 period ranging between 1.2 and 6.3 percentage points, with the exception of the Symonds Street and Quay Park precincts which recorded declines in vacancy of -0.9 and -4.8 percentage points respectively.

Current Demand

Figure 4 presents the net absorption of office space in the Auckland CBD from September 2003 to March 2010 at six monthly intervals.

Figure 4: Auckland CBD Net Office Space Absorption



Source: Darroch Research

The Auckland CBD office market, in the six months to March 2010, had positive net absorption growth, albeit very small (1,400 square metres). However, over each of the three previous six month periods net absorption was negative. The return to positive net absorption, albeit slight, over the last six months is evidence of still weak tenant demand growth. It does, however, suggest that in net absorption terms, if not vacancy and rent, the worst of the current cycle may be behind the market.

Recent examples of leasing activity in the Auckland CBD include:

- Morrison Kent has leased 640 square metres of space on level 11 of the Gosling Chapman Tower at 51-53 Shortland Street. The lease is effective August 2010;
- Grove Darlow and Partners have taken a lease over space on level 9 of Union House at 2 Commerce Street, effective early 2010 at an unknown rental rate;
- Cameron and Co. has leased 400 square metres in the Vero Centre at 48 Shortland Street. Effective February 2010 for six years at an effective net rate of \$500 to \$510 psm;
- NZ Institute of Studies has leased 700 square metres at 155 Queen Street. Effective February 2010 at an effective net rate of \$240 to \$250 psm; and
- Royal Business College has leased 500 square metres of space at 60 Federal Street. Effective October 2009 at an effective net rate of \$150 to \$160 psm.

Supply Side Issues

A number of significant office developments, including 23,000 square metres of Prime grade, five star green rated office space in the newly completed Deloitte Centre, 14,700 square metres of office space within the refurbished Downtown House and 9,000 square metres of office space in the NZI Centre, have been completed over the past twelve months, increasing Auckland's CBD office stock by over 56,000 square metres. In addition, a number of developments, currently under construction, will increase CBD office stock by a further 50,000 square metres over the next 12 to 18 months.

Key CBD office developments currently underway or proposed are as follows:

- Cooper and Company are well advanced with construction of the East Complex within their Britomart precinct redevelopment consisting of two new linked office blocks, together with the recently completed redevelopment of the historic 'Charter House'. These three buildings in total will provide approximately 40,000 square metres of new office space. Westpac have committed to 25,700 square metres of space and occupy all of Charter House, the southern office block of the East Building plus an additional 3 floors above the atrium level of the northern office block which together are to be renamed 'Westpac on Takutai'. Ernst and Young have committed to 9,500 square metres of space in the northern office block of the East Building, whilst Southern Cross will take up the remaining 6,300 square metres in April 2011. Stage One was completed at the start of 2009 and final completion is scheduled for early 2011;
- Mansons TCLM are well advanced with construction of the Telecom Building, a five star green rated office development on the former Auckland Mail Centre site in Victoria Street West. The development comprises 4 medium rise office buildings, offering 30,000 square metres of space, all of which has been leased to Telecom NZ. Completion is expected in 2011; and
- Kiwi Income Property Trust has entered into a development agreement with ASB Bank Limited to develop new head office premises for the bank on Jellicoe Street in Wynyard Quarter. Construction is expected to begin by mid 2011 and be completed by late 2013. ASB will occupy approximately 18,000 square metres of office space on an 18 year lease.

This significant level of development activity is likely to 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 130,000 square metres to Auckland's CBD office stock over the next five years. It is understood ANZ National Bank are negotiating a lease on a proposed new development with private developer Tim Edney on land he owns on Customs Street East, opposite the new Westpac development. Other proposed developments that are not currently linked to any particular key tenants include: several Mansons TCLM proposals for the Auckland CBD; and other office proposals associated with Britomart.

Increased borrowing cost, a tightening of lending conditions, and uncertainty around future demand growth, 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.

Recent CBD office sales of note have included:

- In December 2009 the Peace Building at 98-100 Symonds Street was sold for \$9.25 million by Axa Asia Pacific Holdings to a private investor on a yield of 10.5%. The building is tenanted by Peace Software and UUNZ Institute of Business;
- In November 2009 35 High Street was purchased for \$7 million by Kegg Investments Limited on a 7.1% yield;
- In November 2009 166 Queen Street was purchased by Hq Property Investments Limited for \$15.6 million; and
- In October 2009 the Kean's Building at 150-152 Queen Street was sold for \$8.3 million by The New Zealand Guardian Trust Company to the Standard Trustee Company Limited on a yield of 7.7%.

The global credit crunch of 2008 / 2009 has had a significant impact on investors' ability to transact and on yields achieved. 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 consolidate across all property types and the yield gap between prime and secondary quality property investments will stabilise.

Table 1 presents the total return delivered over specific periods of time up to March 2010 for CBD office in Auckland, Wellington and Nationally.

Table 1: Annual Average Compound Returns – Auckland, Wellington and Nationally

To March 2010	Auckland CBD Office	Wellington CBD Office	New Zealand CBD Office
1 Year	-1.6%	-0.9%	-1.4%
2 Years	-5.7%	-1.9%	-0.7%
5 Years	9.3%	11.8%	12.1%
10 Years	8.3%	12.2%	10.7%
15 Years	8.0%	10.0%	9.3%

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.

Up until early 2008 the underlying office market fundamentals has been strong in both Auckland and Wellington 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.

Market Outlook

The outlook for the Auckland CBD office market, despite positive net absorption over the last six months, has deteriorated over the last two years. Vacancy rates have increased, and are expected to continue to increase, and rents have eased. The recession of 2008 / 2009 has had a significant impact on Auckland's real economy.

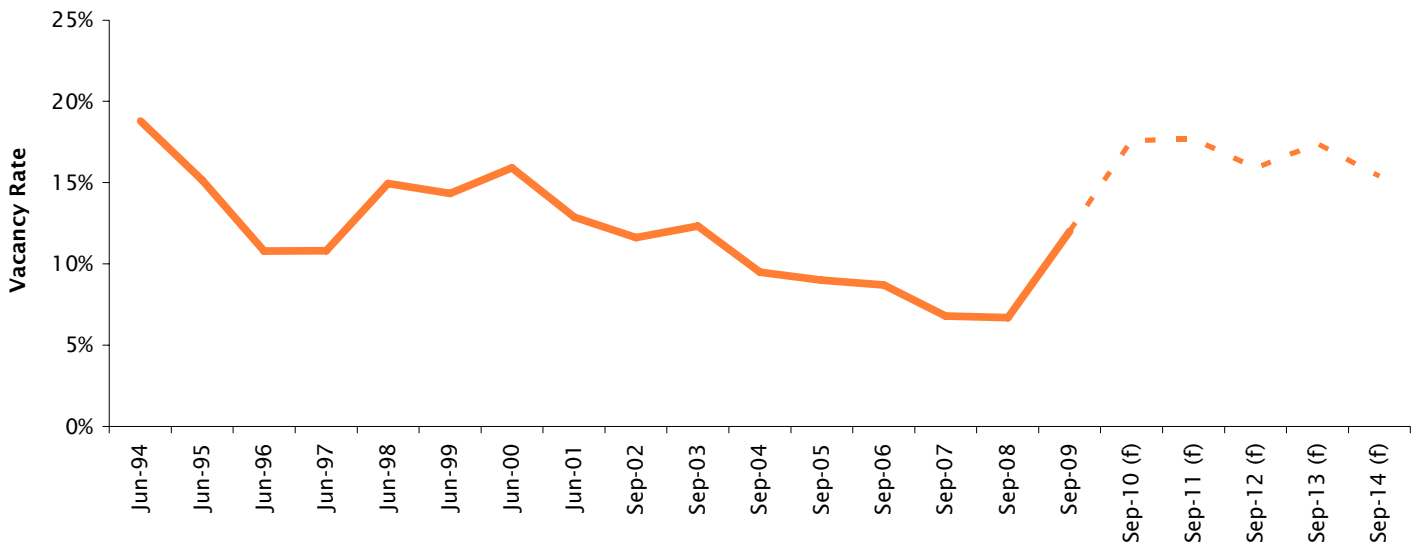
The underlying market fundamentals are unlikely to recover until the economy experiences a number of quarters of strong economic growth.

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:

- Weak / negative tenant demand as a result of the 2008 / 2009 recession's impact on businesses demand for labour. With the economic recovery not yet significantly strong to generate renewed demand growth. The total area of occupied space is forecast to contract by 30,000 and 35,000 square metres respectively over the next two years; and
- The market is also in the later stages of a mini construction boom. Over 50,000 square metres of office space will be completed over the next two years. The majority of this space is pre-let, however, the tenants shifting into their new premises will leave significant vacancies behind in their existing premises.

Figure 5 presents Darroch's forecast increase in CBD vacancy rates over the next three years.

Figure 5: Vacancy Rate Forecasts



Source: Darroch Research September 2009 Forecasts

Note that these forecasts are based on an economic outlook consistent with NZIER's September 2009 quarter economic forecasts. If economic conditions deviate significantly from the NZIER's forecast a different vacancy outturn is likely.

Darroch is forecasting CBD vacancy rates to increase to between 16% and 18% by March 2012. The change in market conditions over the last couple of years has had a significant impact on the CBD office market and resulted in a shift in the balance of bargaining power from the landlord to the tenant.

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

For more information,
please contact:

Darroch
Level 16
Auckland Club Tower
34 Shortland Street
Auckland NZ
Tel: +64 (0)9 309 3040

www.darroch.co.nz

Contacts

Key Auckland Contacts

Consulting and Research

Ian Mitchell
+64 (0)4 460 3857
ian.mitchell@darroch.co.nz

Property Services

Andrew Potter
+64 (0)9 374 6659
andrew.potter@darroch.co.nz

Sales and Investments

DTZ New Zealand Limited MREINZ
Licensed Real Estate Agent (REAA 2008)
Kevin Richards
+64 (0)9 374 6621
kevin.richards@dtz.co.nz

Valuation

John Darroch
+64 (0)9 374 6613
john.darroch@darroch.co.nz

Plant and Machinery Valuation

Peter Todd
+64 (0)9 374 6619
peter.todd@darroch.co.nz

New Zealand Office Contacts

Auckland

John Darroch	+64 (0)9 374 6613	john.darroch@darroch.co.nz
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Wellington

Milton Bevin	+64 (0)4 460 3853	milton.bevin@darroch.co.nz
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Christchurch

Lance Collings	+64 (0)3 363 5044	lance.collings@darroch.co.nz
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