

Market Overview

The economic recession, over 2008 / 2009, the softening of the labour market and consequent fall in consumer confidence has had a dramatic impact on the retail sector. Demand for space has fallen and vacancies increased as retailers' turnover and profitability has declined. Recent data, however, suggests that some of these negative trends may be starting to reverse.

Rents in prime retail locations have been relatively stable over the past year. The rate of retail sales growth, both in Auckland and nationally, has improved over the last twelve months, and consumer confidence across the Auckland region is again exhibiting a positive trend.

From an investor perspective, the key issues that will have an impact on their investment decisions are the uncertainty over the strength of the economic recovery, coupled with the strength of specific tenant covenants, and the investors ability to access funding.

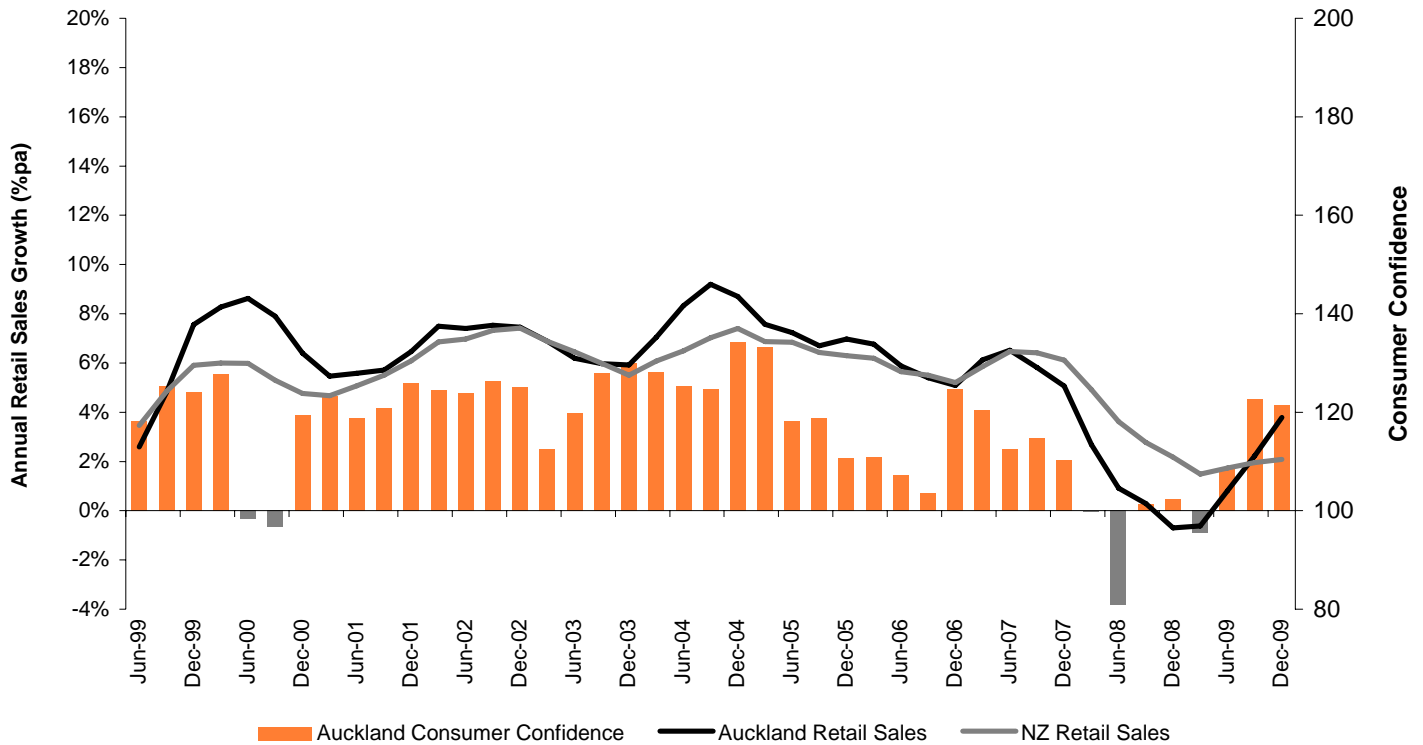
Retail Property Market Drivers

The performance of a region's retail property market is influenced by trends in its economic and demographic drivers in conjunction with supply trends. The combination of these factors had resulted in strong nominal growth in retail sales across the Auckland region over the decade to mid 2007; however, the rate of growth then experienced dramatic decline before the recent recovery seen over the past twelve months.

It is important to note that whilst improved consumer confidence and policy stimulus to lower interest rates has seen a recent increase in household spending, market expectations about future interest rate increases over the next two years remain strong and the rate of private sector credit growth is very low, indicating households are less willing to take on debt.

Figure 1 presents the trend in Auckland consumer confidence together with the trend in Auckland and New Zealand retail sales since 1999.

Figure 1: Auckland Consumer Confidence and Quarterly Retail Sales (excluding Motor Vehicles)



Source: Westpac and Statistics New Zealand

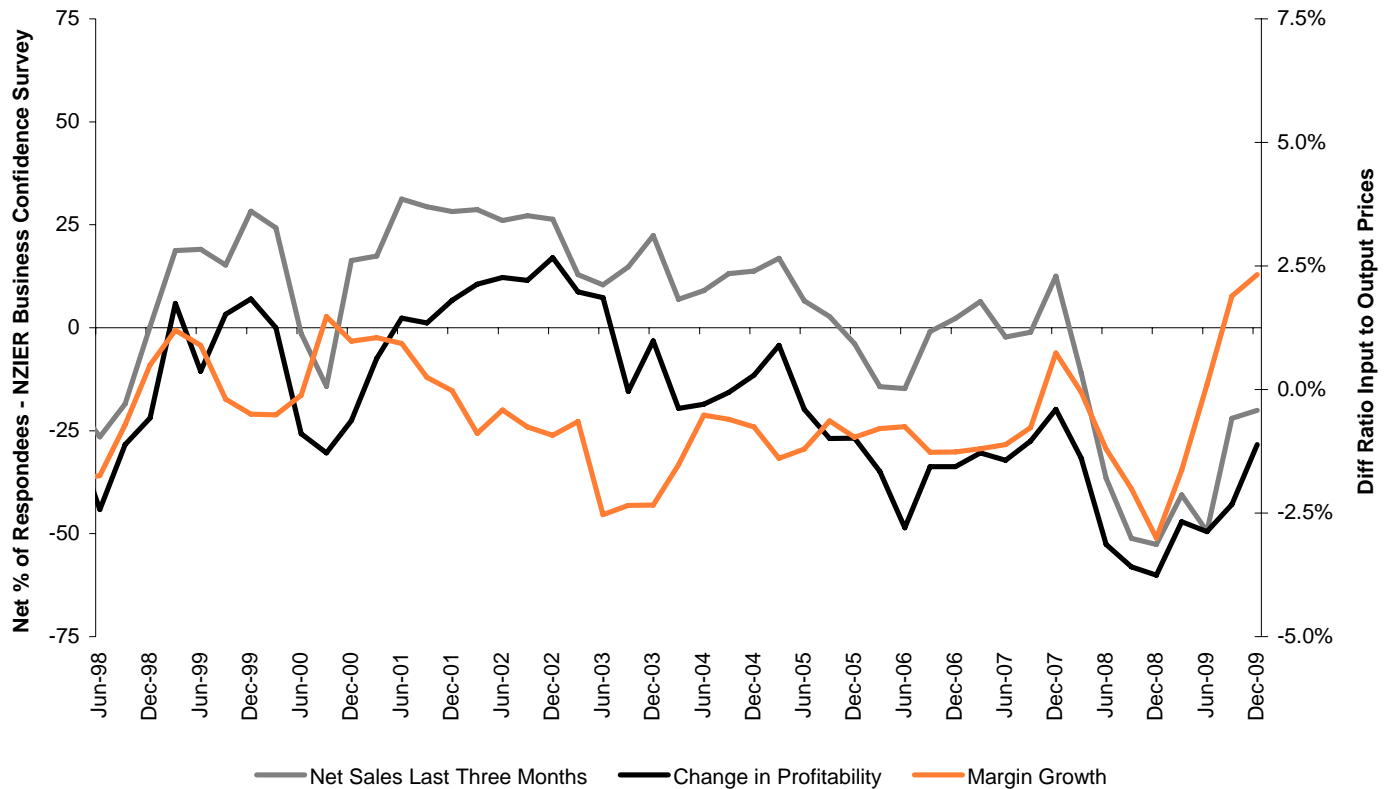
The rate of retail sales growth in Auckland increased from -0.7% in the year to December 2008, to 3.8% in the year to December 2009; up from 2.2% in the year to September 2009. The significant slowdown in retail sales growth in the region over the eighteen months up until March 2009 was due to a range of factors including; rising unemployment and employment concerns, general price inflation, weak or negative household wealth growth and a weak residential building sector.

Nationally, the rate of retail sales growth fell very marginally from 2.2% in the year to December 2008, to 2.1% in the year to December 2009. National sales, however, have increased over the last two quarters by 0.4 and 0.1 percentage points respectively.

Consumer confidence in the Auckland region in the December 2009 quarter was down very slightly (1.2 points) over the September 2009 quarter value, however, consumer confidence was up 19.2 points over the December 2008 quarter value. Over the last three years, since December 2006, consumer confidence in the Auckland region has fallen significantly, reaching its lowest level in 10 years in June 2008, but has since rebounded strongly. The December 2009 positive consumer confidence measure means, that for the third consecutive quarter, the number of optimists outweighed the number of pessimists. However, this does not necessarily indicate that we are at or near the bottom of the current cycle as unemployment still remains high.

Figure 2 illustrates the trend in retailer’s net sales and profitability expectations over the past 3 months, together with margin growth achieved within the retail sector since 1998.

Figure 2: Retailer Expectations for Sales and Profitability, and Margin Growth Trends



Source: NZIER

Retailers have been more positive about net sales and profitability over the last two quarters than they have been for a year and a half. Retailer’s margin growth, measured as the difference between the growth in input and output costs, has continued its recent positive trend and delivered the third consecutive positive result in the December 2009 quarter, the best result recorded in over ten years, indicating a significant focus by retailers on costs over this recent period. Figure 2, however, shows that for a number of years retailer’s costs have been rising faster than their prices, which is consistent with them experiencing a decline in profitability. This would suggest that their ability to pay higher rents is likely to continue to be constrained in the short term.

Table 1 presents the New Zealand wide trend in annual sales growth by store type.

Table 1: National Retail Sales Growth by Store Type

Store Type	Annual Sales Growth (\$M Dec 2009 Year)	Annual Retail Sales Growth (Year End)			
		Dec-06	Dec-07	Dec-08	Dec-09
Food Retailing	1,730.70	5.7%	-4.5%	-1.2%	2.2%
Supermarkets	15,259.00	6.3%	7.4%	6.6%	6.0%
Footwear	462.40	12.7%	10.8%	4.9%	2.4%
Clothing & Softgoods	2,615.30	3.1%	6.3%	-0.5%	1.4%
Furniture & Floor Coverings	1,267.80	3.8%	6.9%	-12.1%	-11.1%
Appliance Retailing	2,565.70	3.5%	5.1%	-2.1%	3.4%
Hardware	1,441.40	5.6%	14.0%	-3.5%	-3.1%
Chemist	1,872.10	6.3%	4.3%	2.9%	1.8%
Department	3,722.90	3.6%	5.2%	2.0%	-3.0%
Recreational Goods	2,382.60	2.9%	7.1%	-2.9%	4.3%
Accommodation, Hotels & Liquor	3,781.00	3.4%	6.2%	2.7%	-1.8%
Cafes, Restaurants & Takeaways	5,272.50	8.2%	6.5%	1.8%	3.2%
Other	1,788.40	9.0%	4.4%	3.8%	0.5%
Personal & Household Services	235.10	11.5%	4.2%	-8.1%	3.6%
Sub Total (Ex Motor Vehicles)	48,906.50	5.2%	6.1%	2.2%	2.1%
Motor Vehicle Retailing	12,748.60	1.3%	6.9%	-0.4%	-12.8%
Motor Vehicle Services	3,473.30	3.7%	3.9%	-1.0%	0.9%
Total	65,128.40	4.2%	6.2%	1.4%	-1.3%

Source: Statistics New Zealand

In the year to December 2009 the majority of all store type categories experienced positive growth with 'Supermarkets' and 'Recreational Goods' experiencing the strongest growth rates, up 6.0% and 4.3% respectively. Sectors to show the most significant declines in growth included motor vehicle retailing (-12.8%) and furniture and floor coverings (-11.1%).

Development Activity

Strong growth in retail sales over recent years is reflected in the large quantity of new retail space recently completed and still being developed. Development activity continues to be dominated by institutional investors looking to secure market share within key suburban catchments. In the CBD few opportunities exist to develop further retail space. As a result of this constraint owners are adopting a range of strategies to intensify the use of existing retail space and incorporate retail activity into traditionally non-retail properties. More recently we perceive that retail development activity has slowed significantly.

Retail developments recently completed, underway or proposed for the future include:

- Westfield has completed stages one and two of its new 70,000 square metre shopping mall in Albany, securing a number of key anchor tenants including Farmers, K-Mart and New World, as well as a 10 cinema SkyCity multiplex. The development included 142 shops and cost approximately \$210 million. Construction commenced in late 2006 with the retail component opening in November 2007, and the cinema complex completed and opened mid 2008. Albany is the largest Westfield shopping mall in New Zealand. The Westfield Group are currently in the process of trying to obtain approval to double the size of the Albany shopping centre including an extension of the centre over two levels and to add another 2,253 parking spaces;
- Symphony Projects Management has almost completed 'E2', which forms part of its 'Gateway Albany City' development. E2 comprises a \$61.5 million home and DIY shopping precinct on Oteha Valley Road which upon completion will house 10 large format retail stores. Construction began in late 2007 on a 12,500 square metre Mitre 10 Mega store, which opened just prior to Christmas 2008. Other key tenants include Retravisation, Freedom Furniture, Supa Deal Furniture and Beds R Us. Symphony's E1 and E3 precincts will also comprise up to 11,000 square metres of retail space – these are yet to commence construction;
- The new Deloitte Centre, developed by Multiplex, at 80 Queen Street was completed in October 2009. The retail component of the office tower provides over 1,500 square metres of ground floor, high end retail space. The main tenant that occupies this retail space is BNZ;
- Marlin Group's Soho Square development, a large mixed use development consisting of office, retail and residential space located in Ponsonby, is expected to include approximately 12,500 square metres of retail space. This development is currently on hold with receivers trying to sell the site;
- Redwood Group has gained resource consent to develop a \$75 million, 14 store, bulk retail centre opposite Sylvia Park on the Mt Wellington Highway. The retail centre will comprise 13,777 square metres of gross floor area;
- AMP Capital Investors has obtained resource consent to expand Botany Town Centre to provide an additional 5,500 square metres of retail space (approximately 30 new retailers), to be called the 'Orchard Building'. Resource consent for a further 400 car parks is pending. Originally expected to be completed by mid 2009, this development has been delayed for at least 18 months;
- Pelago Limited has applied for resource consent to redevelop the old Cook Street Council Depot into a 147,876 square metre mixed use development, including approximately 3,793 square metres of retail space;
- Westfield have proposed to redevelop and expand its 277 Broadway shopping mall in Newmarket, as well as linking it to a new mall development proposed for the adjacent Farmer's Extreme site on Mortimer Pass. Like most new retail developments, however, this proposal has been put on hold; and
- AMP Capital Investors have recently entered into an agreement to purchase the Lion Brewery site on Khyber Pass Road in Newmarket. It is expected that once the site has been re-zoned the proposal will comprise a significant mixed use development including a substantial portion of retail space.

Leasing Activity

Whilst most prime retail areas are continuing to experience low vacancy, tenant demand is softening. Conversely the secondary retail market has been hit hard by the recession, with many stores forced to close. Table 2 presents the typical rent ranges achieved in the key Auckland prime retail precincts.

Table 2: Retail Rents

Location	Typical Rental Range (\$Net psm)	
	March 2009	March 2010
Prime Queen Street	\$1,750 - \$2,750	\$1,750 - \$2,750
High Street	\$900 - \$1,300	\$900 - \$1,300
Prime Newmarket	\$1,200 - \$2,250	\$1,000 - \$1,950

Source: Darroch Research

Over the past twelve months retail rents in the Prime Queen Street and High Street retail areas have remained relatively stable. The Newmarket retail area, however, has been more adversely affected by the downturn in the economy, softening at both the bottom and top ends with a notable increase in vacancy.

Recent retail leases and reviews are presented in Table 3.

Table 3: Retail Leases and Reviews in Prime Locations

Address	Tenant	Date	Total Area (sqm)	Rental Range (\$Net psm)
Queen Street				
112 Queens Street	Partridge Jewellers (NL)	Nov-09	56	\$2,600 - \$2,700
94 Queen Street	City Star Convenience (RR)	Oct-09	45	\$2,550 - \$2,650
44-56 Queen Street	Michael Hill Jeweller (NL)	Sep-09	120	\$2,000 - \$2,100
75 Queen Street	N to Z Souvenirs (RR)	Jul-09	95	\$2,350 - \$2,450
110 Queen Street	Overland (NL)	Jan-09	67	\$1,950 - \$2,050
High Street				
18-20 High Street	Untouched World (RR)	Jun-09	102	\$1,100 - \$1,200
Newmarket				
255 Broadway	Telecom (RR)	Mar-10	108	\$1,800 - \$1,900
255 Broadway	Body Shop (RR)	Dec-09	98	\$1,875 - \$1,975
255 Broadway	Strand Bags (RR)	Jun-09	178	\$1,700 - \$1,800

Source: Darroch Research

RR = Rent Review NL = New Lease

Incentives are becoming a prominent feature in new retail leases and there has been limited new lease activity over the past twelve months. In some circumstances landlords are waiving rent reviews within existing leases and in some more extreme cases rents are being reduced in order to retain tenants.

Investment Market

Following a period of notably low investment demand for high value retail property, over the last six months we have seen some recovery in demand particularly for well leased properties under \$30 million. Recent sales include:

- The former Farmers store at 9-11 Link Drive, Wairau Valley, was sold in March 2010 by a Private Investor to KCL, for \$5,700,000 at a yield of 8.4%. Good Guys have recently taken an assignment of lease from Farmers;
- The Harvey Norman bulk retail premises at 10 Croftfield Lane, Wairau Valley, were sold in February 2010 by DNZ to Harvey Norman for \$19,200,000 at a yield of 9.2%. Harvey Norman will remain in the ground floor retail space with Colmar Brunton remaining in the first floor office space;
- The former North Shore Mail Centre at 3-5 Croftfield Lane, Wairau Valley, was sold in November 2009 by ING to Croftfield Properties Ltd at a yield of 8.1%. Existing tenants include; Briscoes, Bond and Bond and Noel Leeming;
- A convenience retail development overlooking the Stonefield’s residential development at 65 Lunn Avenue, Mt Wellington was sold in November 2009 by St Laurence for \$12,000,000 at a yield of 8.1%. Existing tenants; include Dunkin Donuts, St Pierres, Coffee Club and Michels Patisserie;
- The Kean’s Building at 152 Queen Street was sold in October 2009 by The NZ Guardian Trust Company for \$8,300,000. Tenants on the ground floor of the building are Max and Karaoke Bar;
- The Rialto Centre and adjoining Carlton DKF Tower in Newmarket were purchased by Ladstone Holdings Limited in August 2009 for \$49,000,000. Ladstone Holdings proposes to market the space following a strata and unit titling; and
- Eden Quarter Retail Complex, 284 Dominion Road, Mt Eden sold in August 2009 for \$2,500,000 at a yield of 4.8%. The building is leased to ANZ National.

Investors generally are taking a much more cautious approach, with the ability to access funding constraining those wanting to buy. Yields for secondary properties have increased and we are likely to see yield margins between prime and secondary widen further.

Table 4 presents the total return delivered by retail, industrial and CBD office property over the last year, two years, five years and ten years.

Table 4: Retail, Office and Industrial Annual Compound Returns

To December 2009	NZ CBD Office	NZ Industrial	NZ Retail
1 Year	-9.8%	2.4%	-1.3%
2 Years	-1.9%	3.6%	-1.2%
5 Years	11.8%	11.8%	10.7%
10 Years	10.0%	11.5%	11.5%

Source: Darroch Research and New Zealand Property Council

N.B. Returns series based on the New Zealand Property Council’s index up to March 2006, and since then Darroch’s return series.

With the exception of the past 24 months, retail returns had achieved in excess of 10% over the last five years. The CBD office market has under performed both the retail and industrial sectors in terms of annual returns, whilst the industrial market is the only property category to maintain positive returns over the last 2 years. Typical yields for retail property have remained relatively stable over the past year, ranging between 7% and 9.5%.

Market Outlook

The outlook for the retail sector is for the total volume of sales to continue to grow, but at a much slower rate than in the past. The positive factors which have underpinned sales growth over the last five or so years have weakened substantially with households, particularly those with high debt levels and / or employment uncertainty reducing discretionary spending. This has resulted in ongoing weakness in retail sales growth, especially for 'large ticket' items. The impact of this much weaker sales growth is already evident with an increase in vacancies in many secondary retail locations and more recently prime retail locations.

Over the short term, lower interest rates, lower inflation and stronger migration will provide some support for the retail sector as will a forecast increase in new residential building. However, offsetting this will be ongoing labour market weakness and a fragile economic recovery.

Demand for lower value well leased retail properties continues to out strip supply. This trend is likely to support the current level of yields in the short term even though it appears this sector of the market appears over sold. Yields may come under some upward pressure in the medium terms if interest rates increase in line with market expectations over the next two years.

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