CIR Analysis

darroch

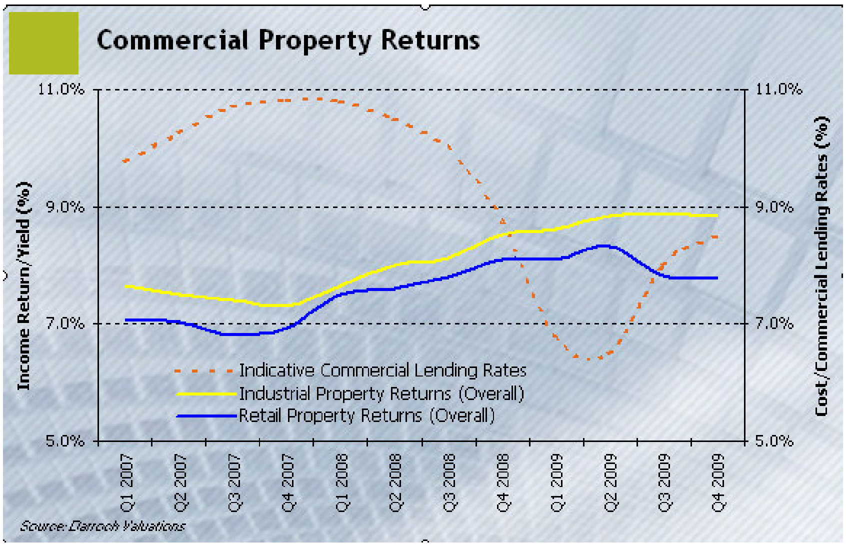
Commercial Investment Returns

Quarter 4, 2009

Market Highlights

- **Industrial yields show signs of levelling**
- **Risk premium heads south again**
- **Closing yield gap may stifle investment demand**
- **Flatter market activity forecast for 2010**

See details page 2



Key Market Results

	Returns					Change			
Market Investment	**Dec-07**	**Dec-08**	**Jun-09**	**Sep-09**	**Dec-09**	**3 month**	**6 month**	**1 year**	**2 year**
Industrial Returns(1)									
<$1.5m	7.23%	8.38%	8.19%	8.50%	9.00%	0.50%	0.80%	0.62%	1.77%
>$1.5m	7.30%	9.09%	9.39%	9.21%	8.66%	-0.55%	-0.73%	-0.44%	1.36%
Overall	7.30%	8.57%	8.74%	8.86%	8.85%	-0.01%	0.11%	0.29%	1.55%
Implied risk prem.(2)	*0.14%*	*3.99%*	*3.94%*	*4.02%*	*3.44%*	*-0.58%*	*-0.51%*	*-0.55%*	*3.30%*
Retail Returns(1)									
<$1m	6.29%	7.83%	7.77%	7.42%	7.71%	0.29%	-0.06%	-0.12%	1.42%
>$1m	7.15%	8.31%	8.54%	8.10%	8.23%	0.13%	-0.31%	-0.07%	1.09%
Overall	6.94%	8.10%	8.32%	7.83%	7.78%	-0.05%	-0.54%	-0.32%	0.84%
Implied risk prem.(2)	*-0.22%*	*3.52%*	*3.52%*	*2.99%*	*2.37%*	*-0.62%*	*-1.16%*	*-1.15%*	*2.59%*
Equity Returns									
Overnight Cash Rate	8.18%	5.05%	2.45%	2.58%	2.43%	-0.16%	-0.02%	-2.62%	-5.75%
90 Day Bank Bills	8.90%	5.23%	2.78%	2.77%	2.78%	0.01%	0.00%	-2.46%	-6.12%
5 Year Govt. Bonds	7.16%	4.58%	4.80%	4.84%	5.41%	0.57%	0.61%	0.83%	-1.75%
6 Month Deposit	8.36%	4.81%	3.83%	4.24%	4.24%	0.00%	0.41%	-0.57%	-4.12%
Base Lending Rate	12.15%	11.23%	9.99%	10.03%	10.05%	0.02%	0.06%	-1.18%	-2.10%

Source: Darroch Research & Reserve Bank New Zealand. (1) Returns are for 6 months ending Qtr, Auckland only. (2) Implied Risk Premium (Returns less 5 year Government Bond).

The Darroch CIR Analysis tracks investment returns for retail and industrial property in Auckland on a 6 monthly basis and is reported quarterly. It is based on an index which measures commercial sales performance since 1999-2000 and has proven an accurate reflection of investor sentiment and behaviour. The Auckland index change is significant in that it usually acts as a barometer for what is happening in commercial property circles around the country.

The index is unique in that it is entirely sales-based. It therefore provides an up-to-date check of investment activity and captures investor responsiveness to existing market conditions. Property sales used in the index are open market sales (or bonafide) only. Forced sales, fractional sales, trades or inter-company sales are not included in the analysis.

Retail Yields Remain Competitive, Industrial Returns Hint at Levelling

Income returns for Auckland retail property firmed slightly during Q4 2009 while Auckland industrial returns stabilised, according to Darroch's latest CIR Analysis. This can in part be attributed to more confidence in the economy which emerged during the final quarter of 2009, despite rising commercial lending rates and speculation surrounding property tax/depreciation reforms.

Overall returns for Auckland Retail Property edged down by 5 basis points (0.05%) from 7.83% to 7.78%, confirming the clear market turnaround noted in our Q3 report. From late 2007 and up to mid 2009 retail yields had increased by 1.4% before the beginnings of a recovery in retail spending.

Income returns for Auckland industrial property in Q4 2009 recorded 8.85% - nearly identical to Q3. Investment interest in industrial property had weakened substantially in the past 18 to 24 months but the Q4 2009 result is really the first sign that this market is perhaps starting to stabilise.

There is now a 1% yield differential between industrial and retail property. At the peak of the market (2007) the differential was just 0.35% in favour of retail. Sales analysis over the past decade has the average differential sitting at 0.5% in favour of retail. Given this, history would suggest that industrial yields would need to decline or retail yields would need to rise in order to get back towards "normal" market parameters.

The risk premium for property in Q4 09 – measured against five year bonds - is currently 3.5% for the industrial sector and 2.5% for retail sector. Just 9 to 12 months ago the risk premium was 4% and 3.5% respectively. Five year government bills are up nearly 1% on 12 months ago. The historic 10 year risk premium for industrial property is 3% and 2.4% for retail.

Closing Yield Gap Makes Property Less Attractive for Kiwi Investors

Commercial lending rates continued to track up over the latter part of 2009 and into 2010. The positive yield gap which emerged around mid 2009 has closed for retail and this also appears imminent for industrial. With borrowing costs in excess of rental return, investor demand is expected to slow, given these financial constraints. Rising interest rates also quell owner-occupier demand which had hitherto been very strong over mid 2009.

Asian investors have played a significant role in reviving demand for retail investment in Auckland. In many respects they have shown a preference for Auckland property over alternative property options. To a degree, vacancy risk is mitigated given there appears a ready supply of willing tenant businesses drawn from their community. Some Asian investors fund their purchase off shore and/or pay cash, meaning they are not as vulnerable to rising domestic (commercial) lending rates.

Flatter Activity Forecast for 2010

Overall, the market is interestingly poised. A number of negative indicators still remain influential including easing rent levels, rising lending rates and a weakening New Zealand Dollar. However, the economy is forecast to continue to improve over 2010 with growth for the year end March 2011 forecasted to be 2.6%, against 1.1% for the March 2010 year end.

In terms of investment property, we believe our next quarter results (Mar 09) will set the tone of the market for the remainder of the year. Our initial intelligence in the early months of 2010 suggests that in general, market players continue to adopt a cautionary stance. Vendors and purchasers are still holding their cards close to their chest.

While the market breathed a sigh of relief with news that land tax/comprehensive capital gains tax would not be on this year's budget agenda, the issue of depreciation rebates remain on the table.

From an investor viewpoint, the positive yield gap is closing which in turn is expected to dampen demand. Overseas interest is expected to wane; given the NZD is easing again. Larger institutions – particularly form Australia - appear unlikely to add to their portfolios given commercial yields in New Zealand are still competitive. In the short term at least, the commercial property market will have to principally rely on domestic market players. With these factors in mind a quieter/flatter 2010 market appears to be on the cards.