CIR Analysis

Commercial Investment Returns

Darroch Valuations
Valuers & Property Advisers

Quarter 2, 2009

Market Highlights

- Income returns for Auckland retail and industrial property continue to rise but at a slowing rate.
- Investors look for protection from market threats such as static rental growth and capital erosion.
- Risk Premium for commercial property drops under 4%.
- Yield Spread is widening - risk reflected in price banding.
- Commercial property performance worse than residential.

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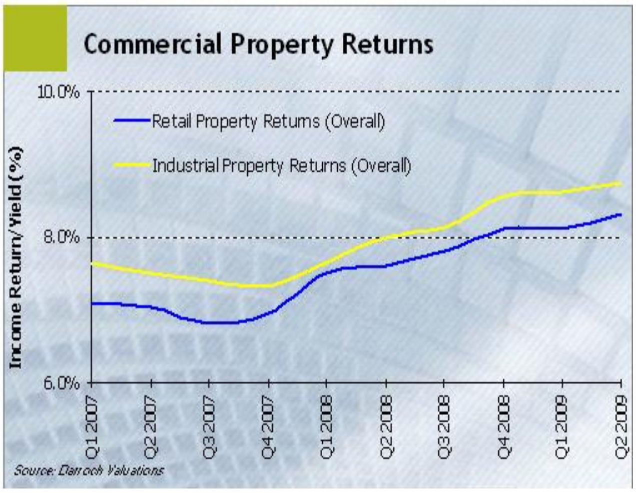

Key Market Results

Market Investment	Returns					Change			
	Jun-07	Jun-08	Dec-08	Mar-09	Jun-09	3 month	6 month	1 year	2 year
Industrial Property[1]									
<$1.5m	7.61%	8.00%	8.38%	8.33%	8.20%	-0.14%	-0.19%	0.19%	0.58%
>$1.5m	7.42%	8.09%	9.09%	9.23%	9.39%	0.16%	0.29%	1.29%	1.96%
Overall	7.51%	8.00%	8.51%	8.62%	8.74%	0.12%	0.23%	0.74%	1.23%
Risk premium[2]	*0.38%*	*1.55%*	*3.94%*	*4.60%*	*3.94%*	*-0.66%*	*0.00%*	*2.39%*	*3.56%*
Retail Property[1]									
<$1m	6.97%	7.60%	7.83%	7.75%	7.77%	0.02%	-0.06%	0.17%	0.80%
>$1m	7.75%	7.63%	8.31%	8.55%	8.54%	-0.01%	0.23%	0.91%	0.79%
Overall	7.03%	7.61%	8.10%	8.11%	8.32%	0.21%	0.22%	0.71%	1.29%
Risk premium[2]	*-0.11%*	*1.17%*	*3.52%*	*4.09%*	*3.52%*	*-0.57%*	*0.00%*	*2.35%*	*3.63%*
Equity Returns									
Overnight Cash Rate	8.10%	8.21%	5.05%	3.08%	2.45%	-0.63%	-2.60%	-5.76%	-5.65%
90 Day Bank Bills	8.32%	8.68%	5.23%	3.24%	2.78%	-0.46%	-2.45%	-5.90%	-5.54%
5 Year Govt. Bonds	7.13%	6.45%	4.58%	4.02%	4.80%	0.78%	0.22%	-1.65%	-2.33%
6 Month Deposit	7.98%	8.46%	4.81%	3.62%	3.83%	0.21%	-0.98%	-4.63%	-4.15%
Base Lending Rate	11.65%	12.25%	11.14%	9.85%	9.82%	-0.02%	-1.32%	-2.43%	-1.83%

Source: Darroch Valuations & 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.

Market Cautious Despite Renewed Interest

Income returns for Auckland commercial property rose again in Q2 2009, according to Darroch Valuations' latest CIR analysis. Investors remain cautious about the strength of the commercial property market and continue to factor in risk when purchasing. Major threats such as limited rental growth, uncertainty over tenants' business health and concerns over further capital erosion remain foremost in investors' minds.

There is some evidence that the wider investment community is dissatisfied with the low returns from equities currently on offer, with some market players revisiting commercial property as an investment option. For example there has been resurgence in syndicated properties although the prudent investor remains risk averse and is still adopting a defensive view. We expect confidence in the market to grow as economic news improves.

The market continues to witness a number of distressed sales, with some vendors having to sell on a vacant possession basis following the loss of cash-flow and an inability to secure replacement tenants.

Returns Reflect Real Risk

On average, income returns for Auckland industrial property increased 12 basis points (0.12%) from 8.62% (6 months ending March 2009) to 8.74% (6 months ending June 2009). Likewise, income returns for Auckland retail property increased 21 basis points (0.21%) from 8.11% in March 2009 to 8.32% in June 2009. The risk premium for property is currently 3.5% for the industrial sector and 3.95% for retail.

Darroch's Auckland Manager, John Darroch said "The current risk premium highlights just how low interest rates are at present. Short term commercial lending rates are currently as low as 6.0% to 6.5%, so income returns look attractive and conditions are there to rekindle interest in property. Having said this, many investors are conscious that medium and long term lending rates are forecast to rise and are trying to factor this into the purchasing equation".

"Investors are looking for protection from market threats such as poor rent growth prospects and further capital erosion if yields creep up further. Not only do they have to gauge where rising yields are likely to be in 12 to 18 months, but they are also mindful of potential cash-flow issues driven by possible business closures and rising unemployment. Investors are concerned with the current direction of rents and we are seeing a lot more leasing incentives appearing in the marketplace. In many cases, 'effective' market rents have fallen back to pre-2007 levels" said Mr Darroch.

Value Changes Hint at Slowing

There is evidence that the pace of rising yields is slowing. Both retail and industrial yields have risen 1.40% from the peak in Q4 2007 to Q2 2009. The bulk of this yield expansion occurred in the first 12 months of 2008 when onset of the recession saw the market immediately factor in a wholesale risk weighting for property. In 2009 yield expansion has slowed to around 0.2% but is still rising, albeit at an increasingly slower rate.

Mr Darroch said "Although yield expansion has slowed in the last 6 months, the overall yield trend has yet to plateau. Levelling yields would give the market a lot more confidence. In essence, the market is still trying to find its new perch. We are seeing a wider "yield spread" in the commercial property market than two years ago. Investors are more diligently ranking property according to perceived risk and discounting secondary stock a lot more".

Price Reflects Risk

The recession has impacted more on higher-priced commercial property. Institutional investors like LPT's are still preoccupied with reducing debt ratios as declining capital values impinge on borrowing covenants. Some institutions have offloaded a number of properties, which appear to have been welcomed by the market. However, issues over 'trust' are also still fresh in many investors' thoughts; particularly in the wake of finance company collapses and various moratoriums surrounding share trading activity. Many investors are considering more autonomous roles.

In the open market place, direct property performance is reflected in price banding. The investment market for small to medium sized properties is typically more competitive given this market is open to a wider potential pool of buyers. For industrial properties in the under $1.5 million price bracket, income returns are below 8.5%, whereas returns for industrial property above the $1.5 million threshold are in excess of 9.0%. For retail properties in excess of $1 million, returns are around 8.5%. For retail properties in under $1 million, the median yield is around 7.7%, hinting at some stabilisation in this lower price bracket.

Commercial Property Worse off than Residential

Capital erosion in the Auckland commercial property sector has easily outstripped its residential counterpart. QV's index shows the fall in Auckland residential house prices to have peaked at around -10% over the 12 months to March 2009, with recovery now underway. The REINZ median measure shows the fall in house prices to be less severe at around -7%. In the case of commercial property, the impact of rising yields has been far more severe and capital erosion continues.

Over the past 18 months retail yields have risen from 6.94% to 8.32% (138 basis points). A typical property with rent roll of $100,000 per annum has decreased from $1.44 m to $1.2 million; a fall of -16.6% or $250K. An investor would require a 20% rent increase to break even in this scenario. This is highly unlikely, given rents are flat or declining. For industrial property a change in yields from 7.30% to 8.74% over 18 months (on a property with a similar rent roll) equates to capital decline of -16.5% or a $225K loss in value. Again, a 19.7% rental increase would be required to recapture the underlying loss in value.

These results are not unexpected given that a similar scenario unfolded in the aftermath of the 1987 share market crash. Residential property values in Auckland fell around 5%, whereas some commercial values fell up to 50% as yields climbed and rents plummeted.