

Commercial Investment Returns

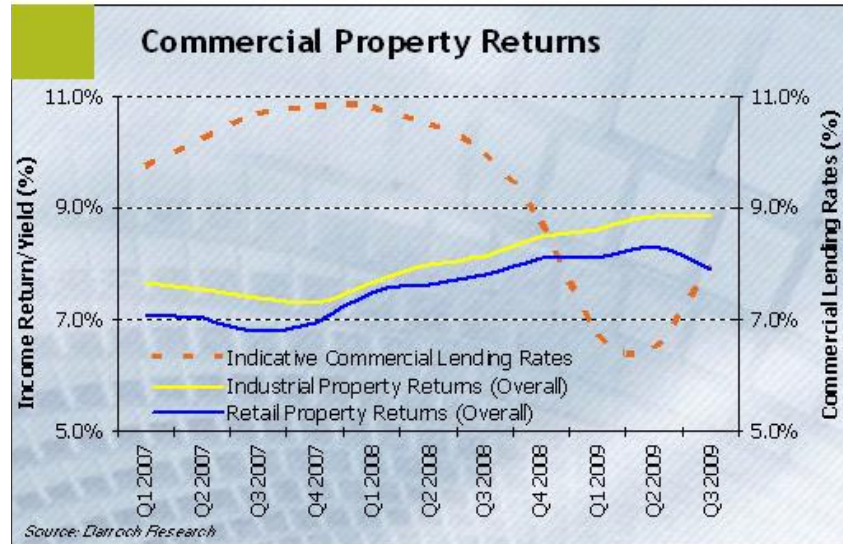
Quarter 3, 2009

Market Highlights

- ◆ Risk appetite returns to retail while industrial purchasing more cautious.
- ◆ Overseas interest drives retail yields down.
- ◆ Yield gap is positive but closing fast.
- ◆ Activity is forecast to quieten as 2010 approaches.

See details page 2

Key Market Results



Market Investment	Returns					Change			
	Sep-07	Sep-08	Mar-09	Jun-09	Sep-09	3 month	6 month	1 year	2 year
Industrial Property⁽¹⁾									
<\$1.5m	7.60%	8.12%	8.33%	8.19%	8.50%	0.31%	0.17%	0.38%	0.90%
>\$1.5m	7.35%	8.13%	9.23%	9.39%	9.21%	-0.17%	-0.02%	1.09%	1.86%
Overall	7.41%	8.13%	8.62%	8.74%	8.86%	0.11%	0.24%	0.73%	1.45%
Risk premium ⁽²⁾	0.86%	2.35%	4.60%	3.94%	4.02%	0.07%	-0.59%	1.66%	3.16%
Retail Property⁽¹⁾									
<\$1m	6.56%	7.71%	7.75%	7.77%	7.46%	-0.31%	-0.29%	-0.24%	0.90%
>\$1m	6.94%	7.82%	8.55%	8.54%	8.10%	-0.44%	-0.45%	0.27%	1.16%
Overall	6.81%	7.80%	8.11%	8.32%	7.91%	-0.41%	-0.20%	0.11%	1.10%
Risk premium ⁽²⁾	0.26%	2.03%	4.09%	3.52%	3.07%	-0.46%	-1.02%	1.04%	2.81%
Equity Returns									
Overnight Cash Rate	8.02%	7.52%	3.08%	2.45%	2.58%	0.13%	-0.50%	-4.93%	-5.43%
90 Day Bank Bills	8.81%	7.95%	3.24%	2.78%	2.77%	-0.01%	-0.47%	-5.18%	-6.04%
5 Year Govt. Bonds	6.55%	5.77%	4.02%	4.80%	4.84%	0.04%	0.82%	-0.93%	-1.71%
6 Month Deposit	7.99%	7.51%	3.62%	3.83%	4.24%	0.41%	0.62%	-3.27%	-3.75%
Base Lending Rate	12.11%	12.32%	10.01%	9.99%	10.03%	0.04%	0.02%	-2.29%	-2.08%

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).

Consent to reproduce Darroch Research's data is granted on the basis that any reproduced material is to be sourced wholly to Darroch Research.

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.

Risk appetite returns in retail while industrial purchasing is more cautious

Income returns for Auckland retail property declined in Q3 2009 for the first time in 21 months but returns for industrial property remain fairly static, according to the latest *Darroch CIR sales analysis*.

For the first time since Q4 2007 retail yields changed direction, falling a surprising 40 basis points and sending a signal that risk appetite is returning to retail property. News of the economy edging out of recession, improvement in retail spending and the influence of overseas investors have all played their part.

By contrast, income returns for industrial property increased marginally, with investors clearly more cautious about prospects within the sector. There are still a noticeable number of "For Lease" and "For Sale" signs across most Auckland industrial precincts (refer our report *Auckland Industrial Property Times 2H 2009*). Concerns over rental growth and uncertainty over the viability of some tenant businesses remain foremost in investor's minds. The industrial sector is displaying its classic 'lag' after property markets experience a downturn. New demand for goods and services is immediately evident in retail trade, but the flow-on effects to industrial markets are expected to take longer to filter through.

Investment demand remains very mixed. Well-leased, well located properties with strong tenant covenants (particularly in the \$2 million + price band) are keenly sought after. However the market still continues to witness a number of properties selling on a vacant possession basis, particularly in the industrial sector.

Overseas investors help to drive retail yields down

Overall income returns for *Auckland industrial property* increased 12 basis points (0.12%) from 8.74% (6 months ending June 2009) to 8.86% (6 months ending September 2009). But income returns for *Auckland retail property* fell 41 basis points (0.41%) from 8.32% in June 2009 to 7.91% in September 2009. The risk premium for property, measured against five year bonds, is currently 4.02% for the industrial sector and 3.07% for retail.

Our Q3 retail results exclude most transactions in the sell-down of the Lincoln Centre, Henderson (in July) where 16 commercial units were sold predominantly to Asian investors at 5% to 6% yields. If included in our analysis, our retail result would have to be revised down towards a 7.5% median yield.

Overseas investors from Asia have been quite active in the retail investment market this year. Many who purchased in early 2009 achieved a currency gain as the NZD tracked up in Q2 and Q3 and helped offset purchases at low yields. In hindsight, this made them more competitive than typical Kiwi buyers. Running a currency risk can be a double-edged sword; unless one sells at the peak and repatriates those funds, maximum gains are not achieved. Capital erosion occurs if the NZD drops and/or borrowing (mortgage) rates begin to rise.

Yield gap is positive but closing fast

For the first time in five years commercial property investments have been able to stack up on a true investment basis. Since January 2009 Auckland retail and industrial property has been operating in a positive yield gap environment; where typical income returns exceed typical borrowing costs. But this gap is now closing fast as commercial lending rates are rising sharply. For investors seeking attractive medium and long term rates, it is possible that the horse has already bolted. Commercial lending rates were at their trough in May/June (6.0% to 7.0%), but have risen sharply in the past three months. Banks are now factoring in higher risk margins with two year rates closer to 8.0% and 9.0% and we are aware that banks/lenders are very concerned about the impact of this on returns and value. We anticipate rising interest rates to generate caution amongst investors.

Activity is forecast to quieten as 2010 approaches

Overall, we anticipate a somewhat mixed investment market to continue in the short run. There are still a number of existing investors without tenants, looking to offload properties. The positive yield gap is closing which in turn is expected to dampen demand in due course. Overseas interest is expected to wane; given the NZD is near its trading peak. Domestic demand for property will depend on borrowing rates and opportunity cost of alternate investment returns.

If commercial lending rates continue to rise, market demand could remain unspectacular for some time – possibly even until major institutions like LPT's and superannuation trusts (especially from Australia) dominate the market again. For much of the last 18 months institutions have been preoccupied with protecting their lending covenants which were tested by declining capital values. However, superannuation funds in Australia continue to accumulate rapidly with Australians saving 9.0% p.a. These funds require investing and a refocus on property could see additional commercial and industrial properties across New Zealand added to portfolios.