

## Overview

The strong demand for Wellington office space over the last five years has been driven primarily by an expanding government sector. Business sector growth has not been as strong. Office building vacancy rates decreased slightly in the six months to December 2008 to 7.4%, down from 7.7% in June 2008. As at December 2008 the majority of Wellington's CBD vacant office space was in fair and average quality buildings, which often do not meet modern office user space requirements.

Whilst there are several new build proposals out in the market, which could potentially add a further 115,000 square metres to Wellington's CBD office stock over the next five years, the realignment of capital markets combined with increased borrowing costs and a tightening of lending conditions, and increased uncertainty around the future direction of the economy is, however, likely to constrain future development activity.

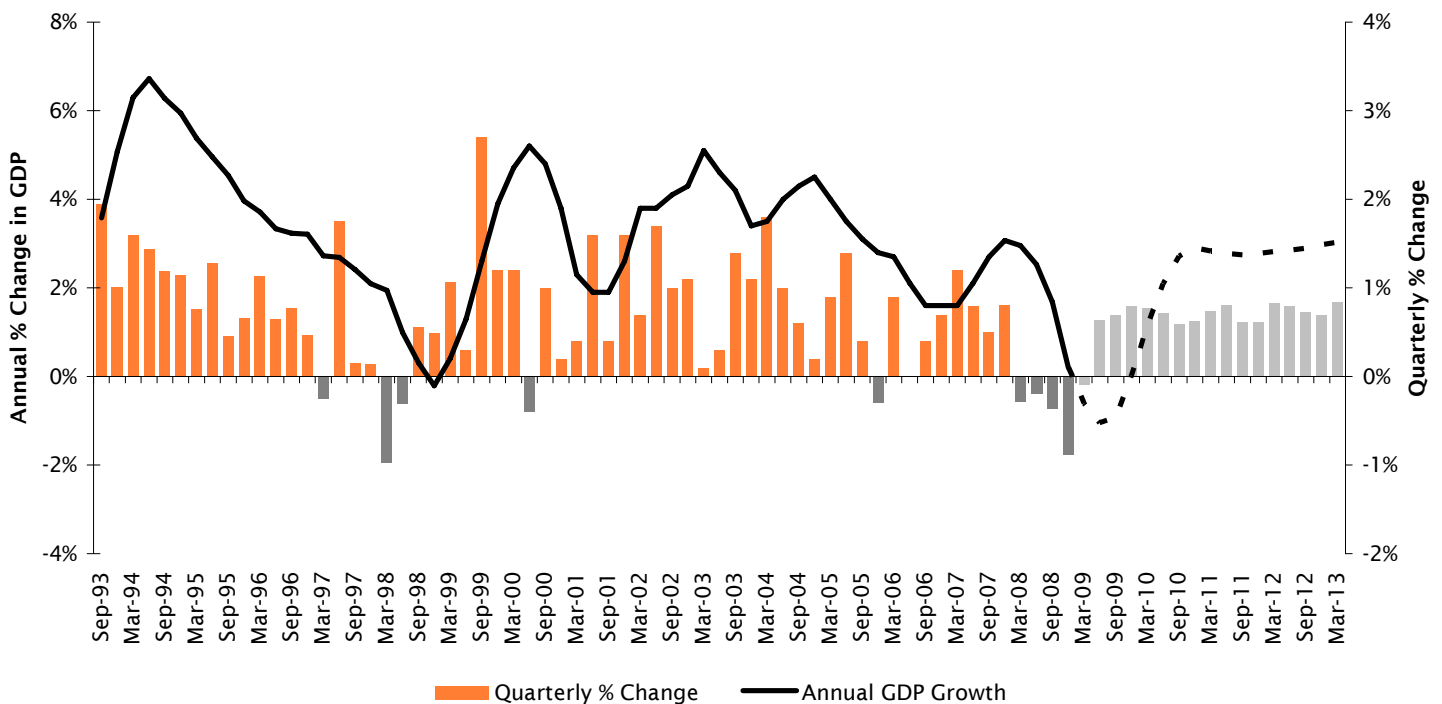
The impact of the current recession on the demand for office space is likely to continue though to the end of 2010 and combined with the completion of office buildings that are currently under construction, is likely to result in vacancy rates increasing to levels not experienced since the mid 1990s.

# The Economy and Office Market Drivers

New Zealand's economy experienced a consumer led slowdown over 2008. The economy contracted by 0.9% in the nine months to September 2008 and a further 0.9% in the December 2008 quarter. The outlook is for growth to start to recover late 2009, albeit at a slow rate, with GDP forecast to be flat in the December 2009 year.

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 2013.

**Figure 1: National Economic Growth**



Source: Statistics New Zealand and NZIER

The economy remains vulnerable to the downstream financial and economic impact of the ‘sub-prime’ mortgage crisis and the associated ‘credit crunch.’ Over the last six months bank lending criteria has tightened, there has been a sharp reduction in credit availability and money has become more expensive. Expectations of future economic growth remain soft, with most commentators expecting negative growth to continue over the first half of 2009.

The New Zealand economy is forecast to see positive growth later in 2009 as a result of:

- Increased government expenditure;
- The stimulus provided by the October 2008 and April 2009 tax cuts, although consumers may initially pay off debt rather than spend any increase in net income;
- The fall in the relative value of the New Zealand dollar will assist exporters profitability, offset the decline in some commodity prices and assist in reigning in our current account deficit;
- The fall in transport costs driven by lower petrol and diesel prices; and
- Lower interest rates may take some pressure off household budgets.

However, some of these benefits will be offset by:

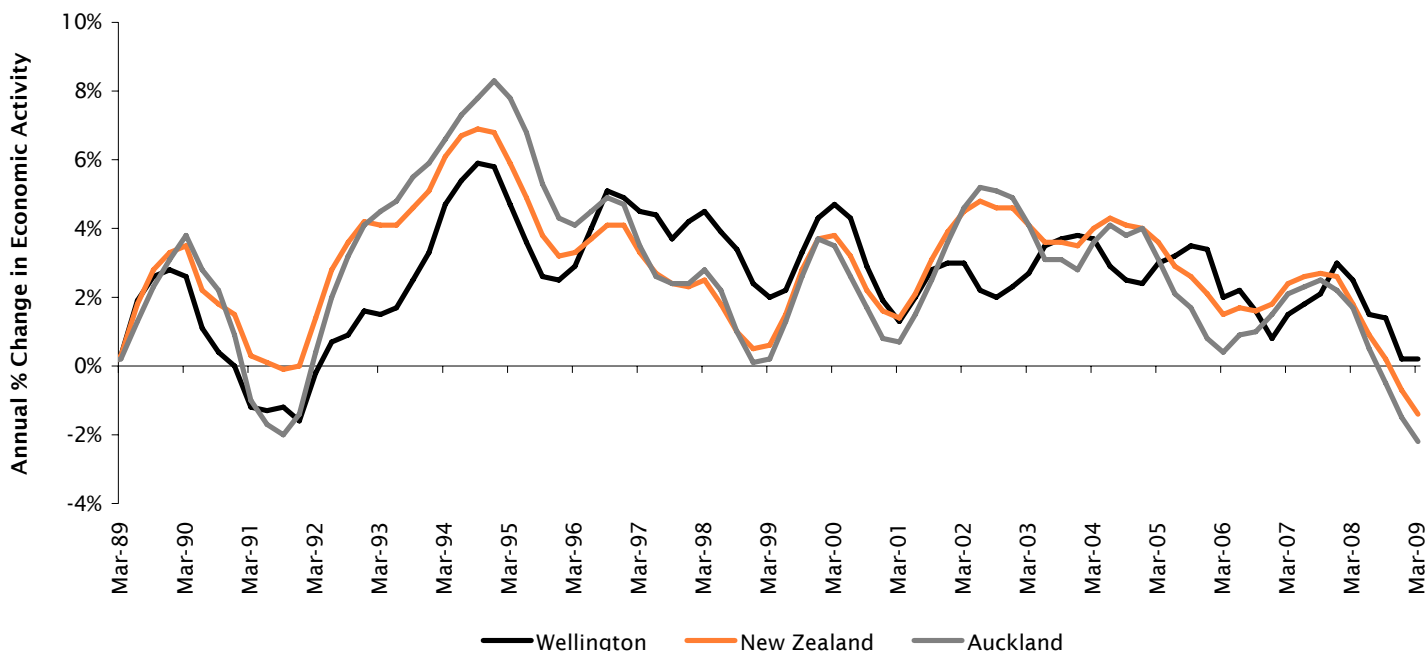
- A softening in labour market conditions and rising unemployment. The extent of the softening in the labour market will be a critical indicator of the depth and duration of this cycle;
- Interest rates for the non residential sector may remain high with tighter lending criteria and restrictions on the availability of credit;
- Net migration remains at below New Zealand’s long term average and tourist arrivals continue to decline;
- Further softening in housing market conditions and a subsequent fall in values; and
- Continued volatility in overseas and domestic capital markets.

There are significant downside risks associated with current economic forecasts and we suspect current growth expectations may overstate what is likely to occur.

The forecast recovery is expected to be export led. The growth that does occur is unlikely to be evenly distributed around the country. Regions with an export oriented economy are likely to do better than those with a domestic consumption focus, for example Wellington. The upside for Wellington will be driven to a large extent by changes within the public sector. It is important to note that although 40% of the Wellington market is public sector the 60% private business sector feeds off this public sector, and will be impacted by Government changes, for example potential outsourcing of public service contracts. This creates much more stable growth levels than would otherwise be expected.

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

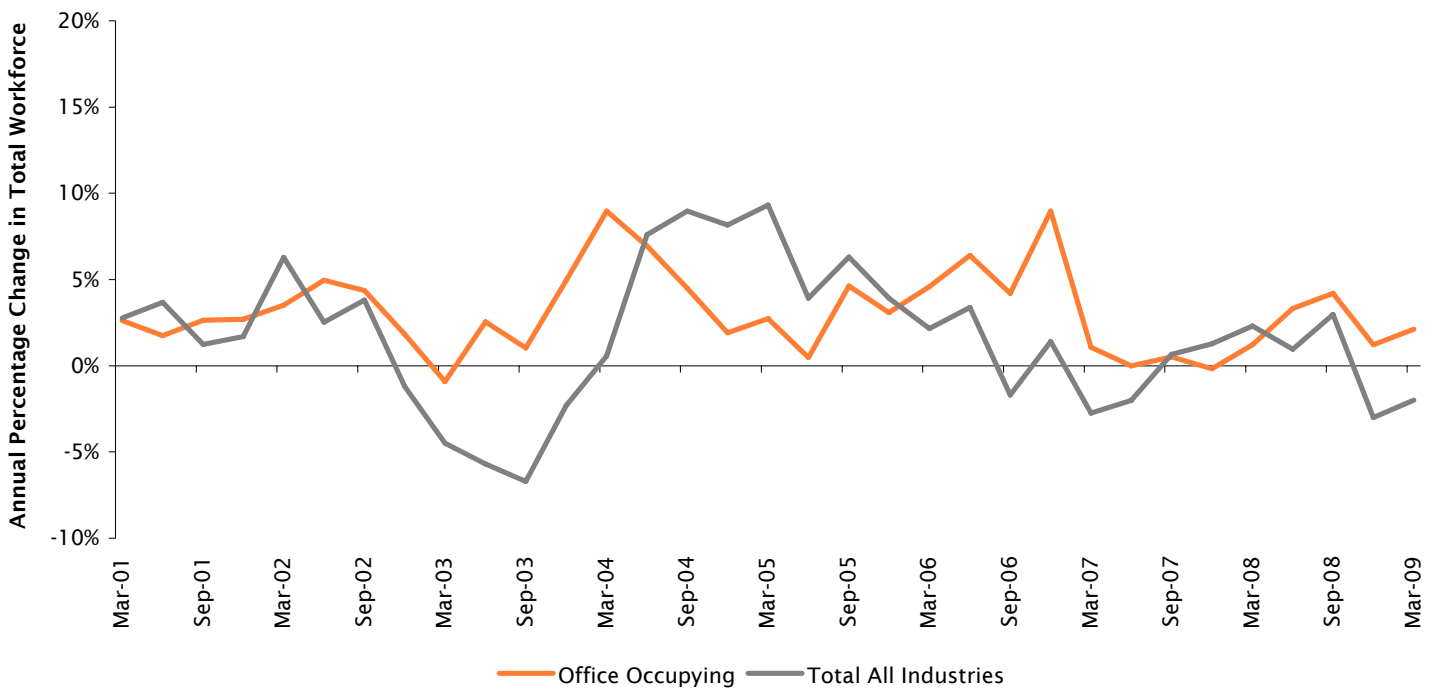
Growth in economic activity in the Wellington region remained stable for the year to March 2009 at 0.2%. This follows three consecutive decreases to the year to December 2008. On an annual basis growth was down from 2.5% in the year to March 2008, to 0.2% in the year to March 2009. The year to March 2009 figure, along with the year to December 2008 figure, are the lowest annual economic growth figures recorded since 1992. Key drivers include a decline in house sales, residential and commercial building consents and falling employment in the region.

The key issues for the Wellington CBD moving forward are:

- Will the government sector stay the same size or contract over the short to medium term given the change in government?; and
- Will demand growth continue to be sufficient to back fill space released by tenants moving to newly built space?

Figure 3 presents the annual percentage change in the office workforce compared to the total workforce in the Wellington Region.

**Figure 3: Wellington Regional Employment by Sector**



Source: Statistics New Zealand

The Wellington urban area has a central city focus. The main employment, entertainment, and transport nodes are all located either in or close to the CBD. The Wellington region employment market is dominated by Wellington City and in particular the CBD with approximately 60% of all people employed in the region working in Wellington City, and 40% in the CBD.

Prior to December 2008, total employment growth in Wellington City had remained positive for five consecutive quarters. However, over the year ending December 2008 total employment growth in Wellington turned negative, down 3.0%. This is the lowest recorded annual growth rate since December 2003. In the most recent year to March 2009 total employment growth in Wellington recovered slightly, but remained negative (-2.0%). Office sector employment growth in Wellington, unlike total employment growth, has remained positive over the last 18 months.

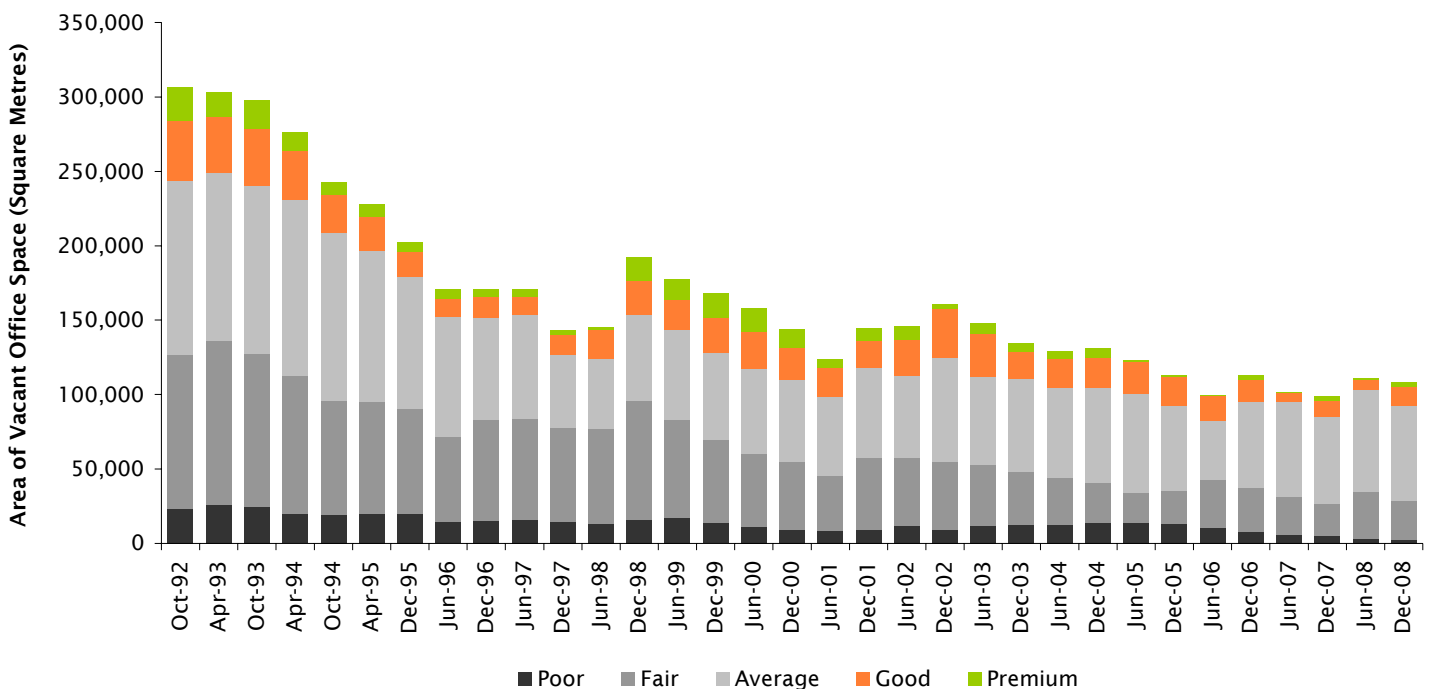
## Vacancy Rate Trends

The Wellington office market over the last five years has experienced a period of strong growth and out-performance. Growth has been largely driven by a strong demand for modern office space from the government sector. The growth in demand from the business services sector has, however, slowed over the same period, although the trend of moving into better quality space and consolidating operations onto one site continues.

Office building vacancy rates decreased over the last six months from 7.7% in June 2008 to 7.4% in December 2008, a reduction of 0.3 percentage points. As at December 2008 the majority of Wellington’s CBD vacant office space was in fair and average quality buildings, which often do not meet modern office space requirements.

Figure 4 presents the trend in the area of vacant office space within the CBD since late 1992.

**Figure 4: Wellington CBD – Vacant Office Space**



Source: Telfer Young

Over six months from June 2008 to December 2008:

- The prime space vacancy rate has increased from 1.0% to 2.7%;
- A grade vacancy rate has increased from 2.0% to 3.4%;
- B grade vacancy rate has fallen from 9.6% to 9.0%; and
- C grade vacancy rate has fallen from 13.4% to 11.3%.

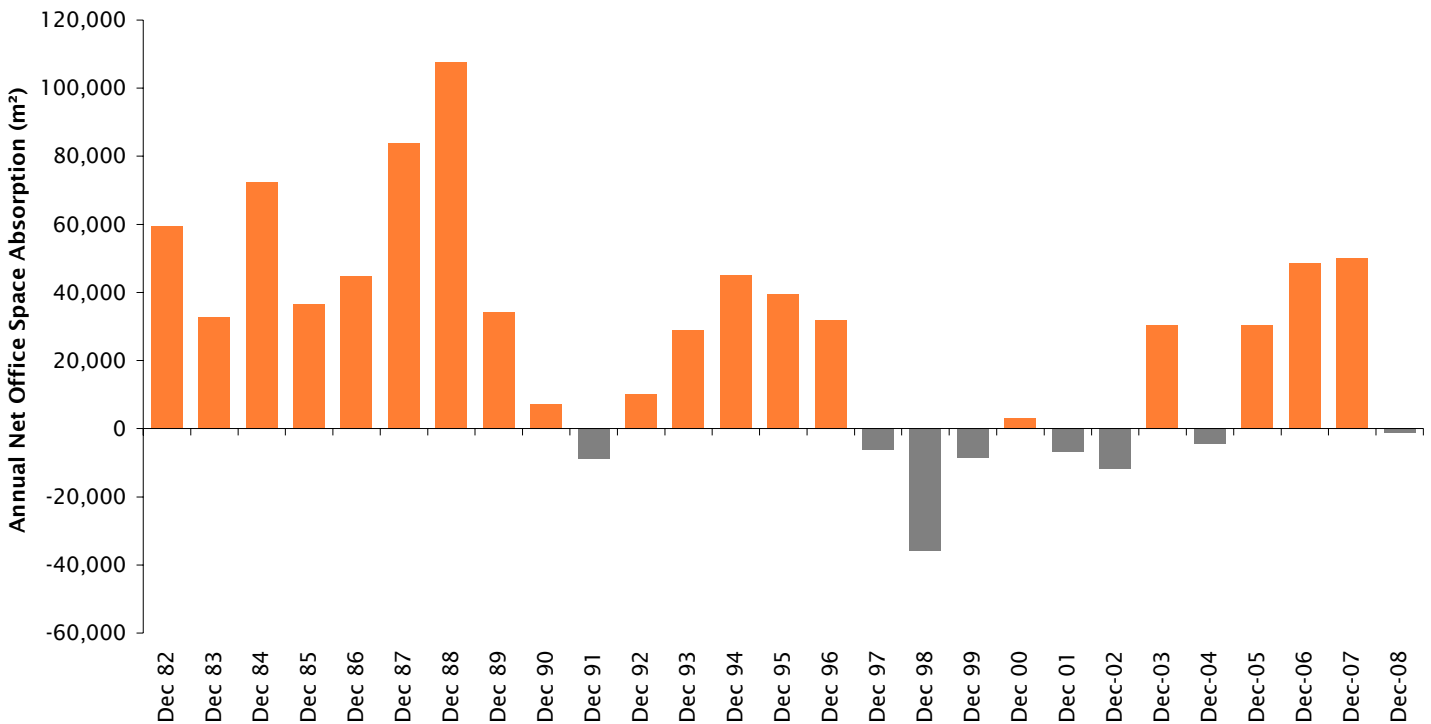
The trend in vacancy by precinct is:

- Core CBD vacancy rate has fallen slightly to 7.2% in December 2008 down from 7.8% in June 2008;
- CBD Fringe vacancy rate has fallen to 5.6% in December 2008 down from 10.8% in June 2008;
- Te Aro vacancy rate has increased very slightly to 8.2% in December 2008 up from 8.0% in June 2008; and
- Thorndon vacancy rate has increased to 9.1% in December 2008 down from 4.0% in June 2008.

# Current Demand

Figure 5 presents the trend in net annual office space absorption in Wellington’s CBD.

**Figure 5: Wellington CBD Net Office Space Absorption**



Source: Darroch Research

Net absorption in the year ended December 2008 was negative, albeit slightly, at -1,000 square metres, down from 50,000 square metres of positive net absorption in the December 2007 year. Net office space absorption in Wellington’s CBD was positive over the December 2005, 2006 and 2007 years, largely due to an expanding government sector. The negative uptake of office space during the late 1990s / early 2000s was a result of ongoing restructuring in the finance and insurance sectors in Wellington.

The affordability of office space may become an issue for some tenants, particularly those who leased space in prime and A grade office buildings two or three years ago. As their rents are reviewed to market they are likely to face significantly higher rentals. This could drive some businesses to reconsider their office space requirements. The key issue going forward for the Wellington office market will be the extent to which the demand for office space will either stay the same or contract given the stated intention of the new government to put a lid on the absolute size of the government sector.

Examples of leasing activity in the Wellington CBD over the last twelve months include:

- Gareth Morgan leased 700 square metres in the Gen-I Tower, 109 Featherston Street. Effective April 2009 at an effective rate of \$340 psm;
- Vector Limited leased 600 square metres in MV Marshall House, 146 Wakefield Street. Effective February 2009 at an effective rate of \$280 psm;
- Transpower leased just over 400 square metres in PricewaterhouseCoopers Tower, 113-119 The Terrace. Effective March 2009 at an effective rate of \$515 psm; and
- Telecom recently renewed a total of 7,100 square metres over seven levels in the north section of Telecom@Jervis, 68-86 Jervis Quay. Effective November 2008 for 6 years at a total rental of \$2.5 million per annum.

## Supply Side Issues

A number of office projects are currently underway which will add approximately 125,000 square metres of new and refurbished space to Wellington's existing office stock over the next three years. The repositioning of existing tenants is driving a significant proportion of the current development activity in the market. The government sector has been particularly active in terms of relocating into fewer, better quality buildings. These include:

- AMP Property Portfolio is developing a new 17,660 square metre annex building to be integrated with the adjacent Vogel Building on Aitken Street, which will also be refurbished and extended. Construction of the \$85 million annex is expected to be completed by September 2009, with the refurbishment and extension of the existing Vogel Building to begin in 2009;
- Cheops Limited is refurbishing the Tower Building on Customhouse Quay. The buildings existing five floors are being progressively upgraded;
- The new BNZ building at Centreport's Harbour Quays office park is due for completion in mid 2009. The 18,500 square metre, five story building will be occupied entirely by BNZ with associated ground floor retail;
- Mark Dunajtschik's new building for the Inland Revenue Department at 1 Featherston Street is currently under construction. The 33,500 square metre, \$150 million dollar building is expected to be completed towards the end of 2010. Inland Revenue have leased approximately 25,000 square metres of space in the building;
- The Redwood Group and Wellington Tenths Trust have recently commenced development of a 14,000 square metre office building in Pipitea Street for the GCSB, with completion scheduled for the end of 2010;
- Construction has commenced on Centreport's new Customs House development. This 6 storey building will provide 6,500 square metres of office space with a small amount of ground floor retail and has been designed to achieve a 5 star green rating. Completion is expected in late 2010; and
- In Willis Street The Wellington Company has commenced construction of two environmentally sustainable 5 green star rated buildings, linked by a central glass atrium, to create a campus style office development of approximately 26,000 square metres. Telecom has committed to the majority of the space, 19,000 square metres, which is scheduled for completion mid 2011.

The majority of the 125,000 square metres currently under construction / refurbishment has been leased with the government sector to occupy the majority of the space. The high level of construction activity and the expected slowdown in the rate of net absorption is likely to result in a significant increase in the amount of vacant space in buildings vacated by tenants shifting into new premises.

In addition, there are several new build proposals out in the market which could potentially add in excess of 100,000 square metres of space to the Wellington CBD office stock over the next five years. These include: Laptop House; an upgrade of the Bowen State and Charles Fergusson Buildings; Stratum Management's Thorndon Quay site; and possibly further construction on the Wellington waterfront.

The realignment of capital markets combined with increased borrowing costs and a tightening of lending conditions, and increased uncertainty around the future direction of the economy is, however, likely to constrain future development activity.

## Investment Performance

Demand for quality investment property in the Wellington 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 Wellington market, however, there is renewed market participation from syndicators and high net worth individuals generating sustained demand within the sub \$2 million bracket. Whilst there have been a number of large sales over \$10 million in the first quarter of 2009, this is not the market trend.

Recent CBD office sales of note have included:

- The Eagle Technology House at 135 Victoria Street sold in March 2009 for \$23 million at an initial yield of 9.7%. Oyster Group purchased the property from St Laurence. The building is leased to multiple tenants including Crown Forestry Rental Trust, Eagle Technology, Ministry of Justice and IRD;
- The Maritime Tower at 10 Customhouse Quay sold in March 2009 for \$62 million at an initial yield of 6.8%. A private investor purchased the building from Valad. The building is leased by KPMG and Chapman Tripp;
- The Public Trust building at 117-129 Lambton Quay was sold by DNZ Property Group to Robert Jones Holdings Limited in February 2009 for \$19 million at an initial yield of 8.1%. The building is leased to multiple tenants including Ministry of Education, Public Trust and the Families Commission;
- AMP Chambers at 195 Featherston Street sold in February 2009 for \$12.6 million on a yield of 9.0%. Green Newman Holdings purchased the building from AMP Capital Property Portfolio Limited; and
- Olympic House at 263-269 Wakefield Street sold in December 2008 for \$6.4 million by Museum Hotel Properties Limited.

The global credit crunch will continue to have an impact on investors' ability to transact and on yields achieved. Yields for secondary quality investments have already increased by at least 0.5% to 0.75%. 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 continue to increase across all property types and the yield gap between prime and secondary quality property investments will continue to widen.

Table 1 presents the total return delivered over specific periods of time up to December 2008 for CBD office in Auckland and Wellington as well as Auckland retail and industrial.

**Table 1: Annual Average Compound Returns – Auckland and Wellington**

To December 2008	Auckland			Wellington
	CBD Office	Retail	Industrial	Office
1 Year	-2.0%	-1.3%	2.6%	2.6%
2 Years	9.3%	10.6%	8.0%	14.8%
5 Years	13.8%	14.1%	13.2%	18.1%
10 Years	8.9%	13.1%	11.8%	13.0%

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

The underlying office market fundamentals have been strong in both Auckland and Wellington over the last five years 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 across all categories.

## Market Outlook

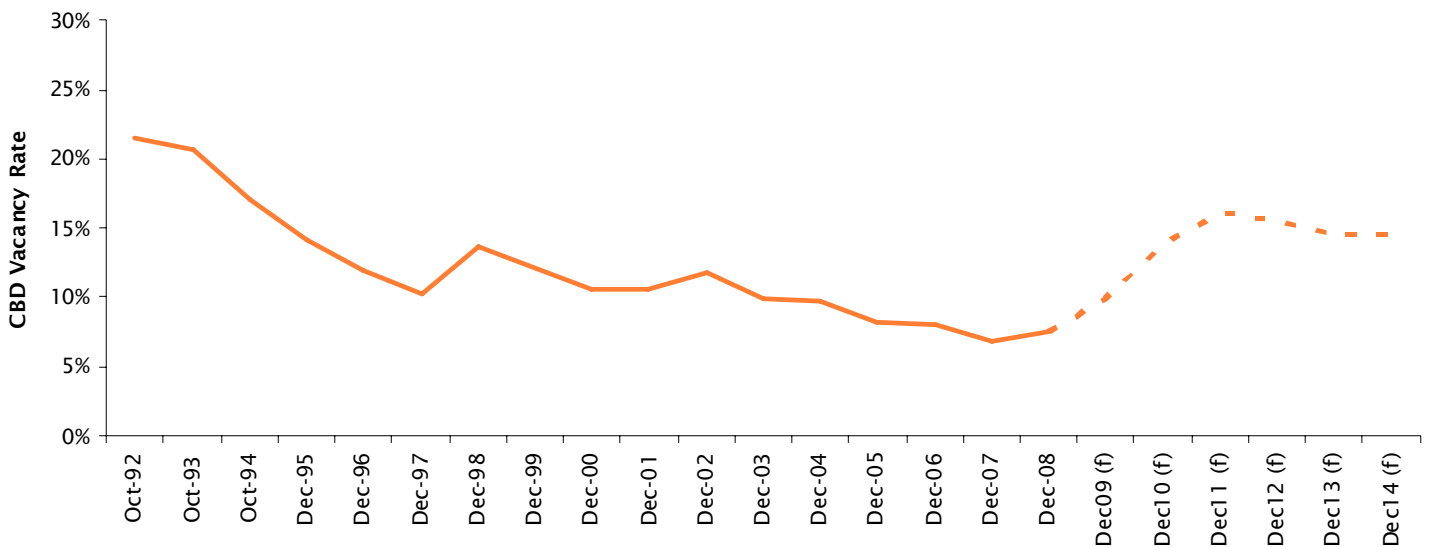
The outlook for Wellington’s CBD office market has deteriorated over the last year. Whilst vacancy rates have stabilised at their current level, they are expected to deteriorate over the next three years and rents are also expected to decline. The impact of the credit led recession is starting to have a significant impact on Wellington’s real economy. This along with the Government’s goal to limit public sector growth is likely to result in the regions overall economic growth turning negative. The length and total impact of this stage of the cycle will be driven by the economic cycle we are currently in. The underlying market fundamentals are unlikely to recover until economic growth starts to recover in the Wellington region. The outlook for vacancy rates and rents are discussed in the balance of this section of the report.

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:

- Falling tenant demand as a result of the current recession's impact on businesses demand for labour. The total area of occupied space is forecast to contract by between 25,000 and 30,000 square metres; and
- The market is also in the later stages of a mini construction boom. There is over 115,000 square metres of office space under construction which will be completed over the next three 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 6 presents Darroch’s forecast increase in CBD vacancy rates over the next three years.

**Figure 6: Vacancy Rate Forecasts**



Source: Darroch Research April 2009 Forecasts

Note that these forecasts are based on an economic outlook consistent with NZIER’s March 2009 quarter economic forecasts. If economic conditions deteriorate faster than this, vacancy rates experienced will be higher.

Darroch is forecasting CBD vacancy rates to increase to between 15% and 18% by March 2012. The rapid change in underlying market conditions is likely to have a significant impact on the CBD office market in the short to medium term and result 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% over the next two and a half years as a result of increased vacancies and falling tenant demand for office space.

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