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Property Times

Wellington Office
1H 2010

Market Overview

Key Wellington office market indicators, including vacancy rates and rental rates, have deteriorated over the last two years. Vacancy rates are expected to continue to increase as new developments are completed, tenant demand is likely to remain soft, and rental levels are forecast to continue to fall.

The global credit crunch and associated recession of 2008 / 2009 has seen tenant demand ease since late 2008. Another key driver of weaker tenant demand growth over the same period has been the change in government in late 2008. Office building vacancy rates increased in the six months to December 2009 (8.8% to 10.2%), with an additional 19,800 square metres of space becoming vacant, mostly within Good and Average quality building. As at December 2009 the majority of Wellington's CBD vacant office space was in 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 100,000 square metres to Wellington's CBD office stock over the next five years, increased borrowing costs, a tightening of lending conditions, and uncertainty around the future demand growth is, however, likely to constrain future development activity.

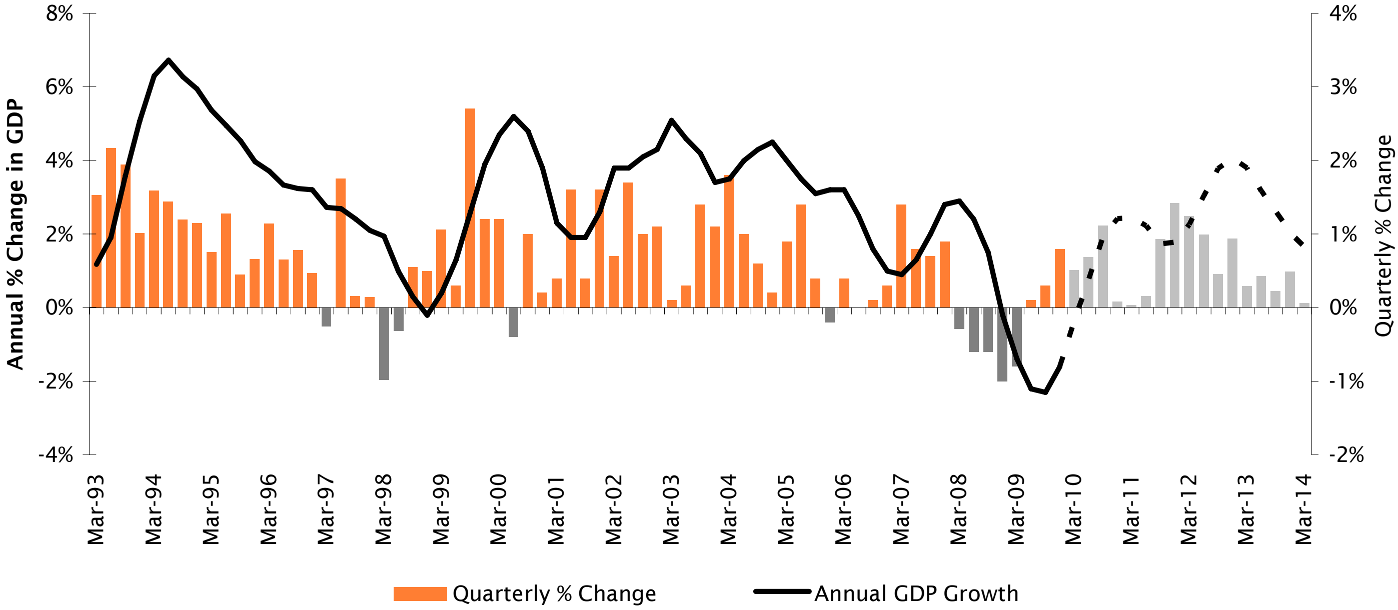
The impact of the 2008 / 2009 recession on the demand for office space is likely to continue to be felt through to the end of 2010 and combined with the completion of office buildings currently under construction, is likely to result in vacancy rates increasing to levels not experienced since the mid 1990s.

The Economy and Office Market Drivers

New Zealand's economy experienced a consumer led slowdown over the early and middle part of 2008 which was then compounded by the global credit crisis and subsequent global economic recession. The economy contracted for five consecutive quarters, up to, and including, the first quarter of 2009, however, this negative trend has since reversed and the last three quarters have seen positive growth of 0.1%, 0.3% and 0.8%.

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 2014.

Figure 1: National Economic Growth



Source: Statistics New Zealand and NZIER

The outlook is for growth to continue to recover, albeit at a slow rate, with GDP, on an annual basis, forecast to be positive by the first quarter of 2010.

The economic recovery, however, remains vulnerable to a range of global and domestic influences.

In terms of positives a number of factors can be cited:

- Stronger global economic growth;
- Continued strength in the Australian economy, New Zealand's key trading partner, combined with a relatively low NZD / AUD cross rate;
- A strong rebound in commodity prices during 2009 which has consolidated over the first half of 2010;
- A significant increase in late 2009, in Fonterra's payout for the 2009 / 2010 season;
- A stronger manufacturing sector;
- A recovery in residential building, albeit off a low base;
- Above trend, albeit weakening, overseas migration gains;
- Increased government infrastructure expenditure; and
- Strong business and consumer confidence.

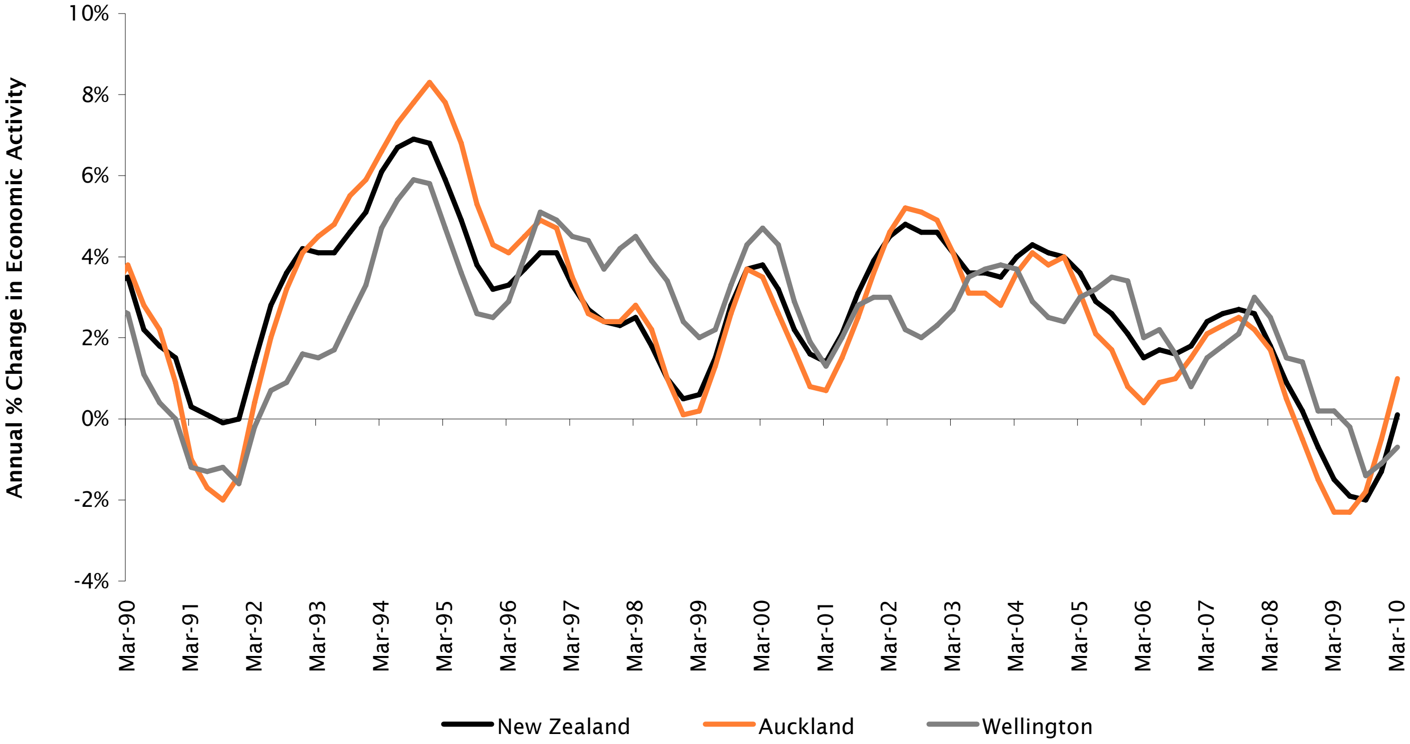
However, some of these benefits will be offset by:

- Interest rate increases. The bottom of the current interest rate cycle has now passed with the Reserve Bank increasing the OCR for the first time in three year at its June review, with the market expecting ongoing rate rises towards 6% by early 2012;
- Still fragile labour market notwithstanding recent increases in employment and fall in unemployment;
- A forecast easing in net overseas migration gains;
- Tighter lending criteria and restrictions on the availability of credit for the non-residential sector;
- Continued volatility in overseas and domestic capital markets; and
- Pressures on household budgets from increased energy, food and transport costs also in October GST will increase by 2.5 percentage points to 15%.

There are downside risks associated with current economic forecasts, both global and New Zealand growth remains fragile, and current growth expectations may overstate what is likely to occur. Change in the size of the public sector is likely to have an impact on Wellington's economy over the short to medium term and hence the demand for office space.

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

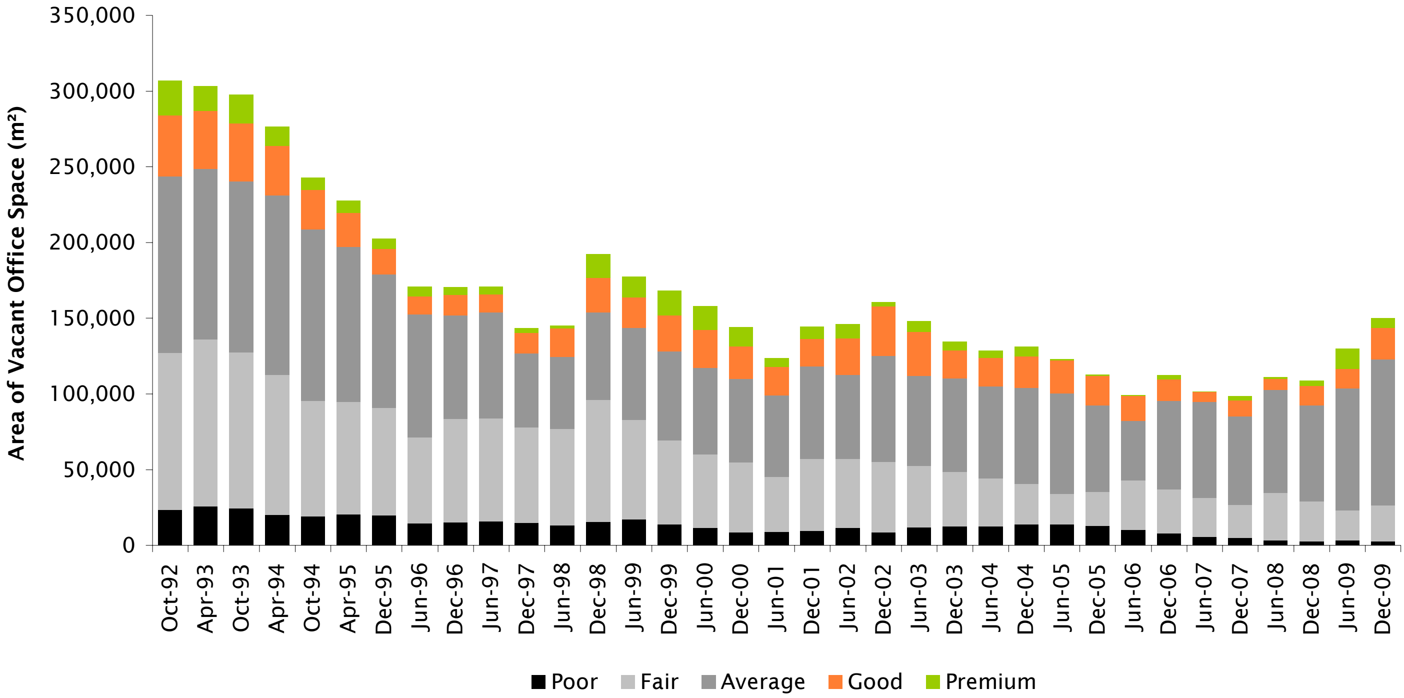
Economic activity in the Wellington region over the March 2010 quarter increased by 0.4 percentage points following a 0.3 percentage point increase in the December 2009 quarter. Annual growth is, however, still negative at -0.7% in the year to March 2010. New Zealand wide, economic activity in the year to March 2010 was up just 0.1%. This is the first time since the September 2007 quarter that national economic activity, on an annual basis, has been stronger than the Wellington region economic activity.

Vacancy Rate Trends

Office building vacancy rates increased from 8.8% in June 2009 to 10.2% in December 2009, an increase of 1.4 percentage points. As at December 2009 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 3 presents the trend in the area of vacant office space within the CBD since late 1992.

Figure 3: Wellington CBD – Vacant Office Space



Source: Telfer Young

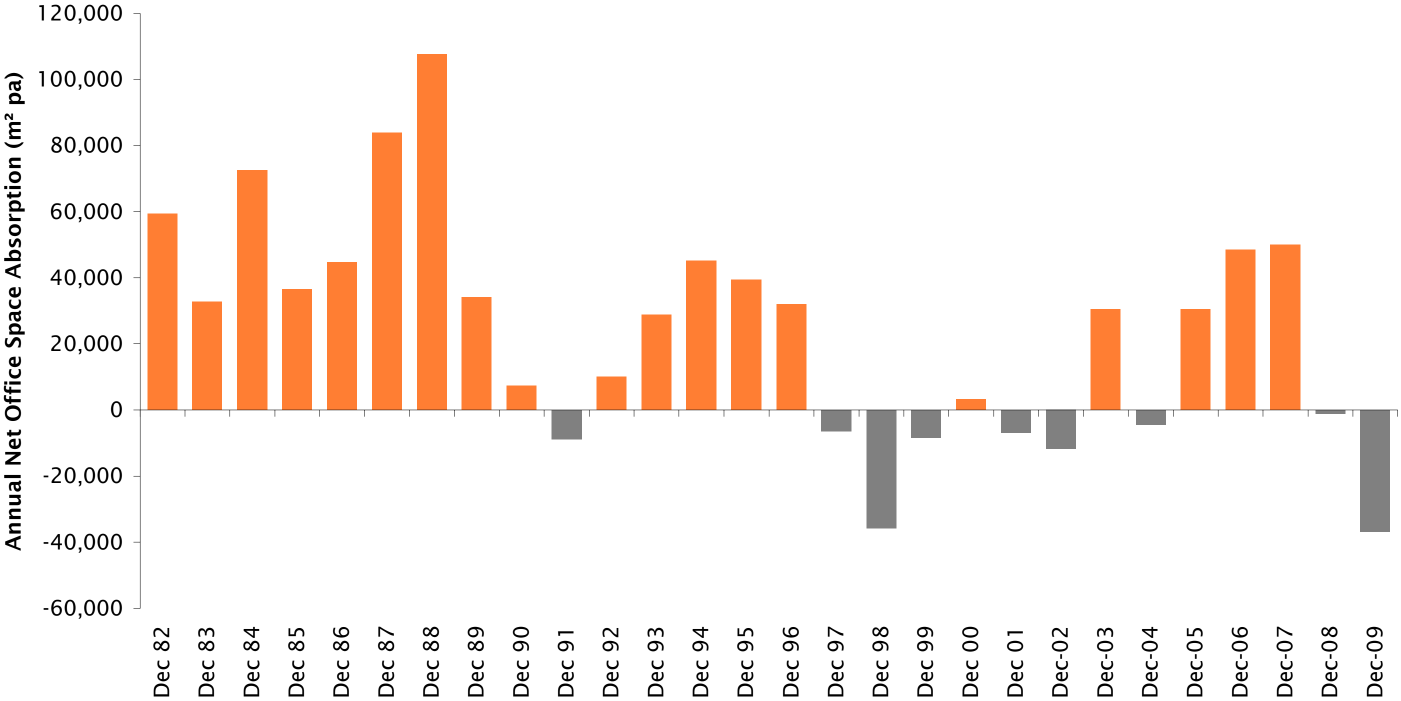
Over the six months to December 2009:
- The premium space vacancy fell from 9.6% to 4.7%;
- A grade vacancy increased from 3.6% to 5.6%;
- B grade vacancy increased from 10.9% to 13.3%;
- C grade vacancy increased from 9.3% to 11.0%; and
- D grade vacancy fell from 14.1% to 12.5%.

The Wellington office market, up until about mid 2008, experienced several years of strong growth and out-performance. This growth was driven largely by a strong demand for modern office space from the government sector. Over that same period, however, the growth in demand from the business services sector was weaker, although the trend of moving into better quality space and consolidating operations onto one site continued, and is still evident today.

Current Demand

Figure 4 presents the trend in net annual office space absorption in Wellington's CBD.

Figure 4: Wellington CBD Net Office Space Absorption



Source: Telfer Young

Net absorption in the year to December 2009 was negative for the second consecutive annual period at 36,884 square metres. Over the six months to December 2009 net absorption was -31,030 square metres. The economic downturn of the last two years has seen many businesses reassess their current and anticipated future office space requirements. In addition the new National led coalition Government, since late 2008, has reined in the previously rapid growth of government space requirements in the CBD.

Going forward the key issue 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 National led coalition government to put a cap on the absolute size of the government sector.

Examples of recent leasing activity in the Wellington CBD include:

- Housing New Zealand Corporation has leased slightly less than 6,000 square metres over four levels at 80 Boulcott Street, formerly the CSC House. Occupation is planned for late 2010 after completion of a major refurbishment;
- Sinclair Knight Merz has subleased approximately 1,160 square metres of space from the Department of Building and Housing in AMP House, 88-96 Customhouse Quay from March 2010 at an effective rental rate of $305 to $315 psm;
- Techtonics Group has leased 550 square metres of space in Lumley House, 3-11 Hunter Street from April 2010 at a rental rate of $345 to $355 psm; and
- Hudson Global Resource (NZ) Limited has leased (renewal) 1,050 square metres of space in the State Insurance Tower, 1 Willis Street from June 2010 at an effective rental rate of $405 to $415 psm.

Supply Side Issues

A number of office projects are currently underway which will add approximately 90,000 square metres of new and refurbished space to Wellington's existing office stock over the next two years. These include:

- AMP Property Portfolio is refurbishing and extending the existing Vogel Building to be completed in two stages. The first stage of the refurbishment, consisting of the lower six floors totalling approximately 6,000 square metres, has been completed and the second stage, consisting of the upper ten levels of about 10,500 square metres, is due to be completed in April 2011. The project also included the construction of a new 17,660 square metre adjoining annex building which was completed in December 2008;
- Mark Dunajtschik's new building for the Inland Revenue Department at 1 Featherston Street is currently under construction. The 33,500 square metre 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 are developing a 14,000 square metre office building in Pipitea Street for the GCSB, with completion scheduled for the end of 2010;
- Construction is underway 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 is building 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 90,000 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 current weak tenant demand 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 to the buildings currently under construction, 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.

Increased borrowing costs, a tightening of lending conditions, and uncertainty around future demand growth 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 and the majority of sales that have occurred in Wellington over the last six months have been forced sales.

Recent CBD office sales of note have included:

- Morrison Kent House at 105-109 The Terrace was purchased by Farmers Trading Company in March 2010 for $32.8 million, at an initial yield of 7.1%. The building was sold by Petherick Properties, in receivership. Farmers occupy all the retail levels on the lower floors of this building;
- Guardian Trust House at 15 Willeston Street was sold in January 2010 for $13.9 million, at an initial yield of 11.3%. The building was sold by Petherick Properties, in receivership;
- Petherick Tower at 38-42 Waring Taylor Street was purchased in December 2009 by an unknown purchaser for $9.0 million, at an initial yield of 5.2%. The building was also sold under the instructions of the Petherick Properties receivers;
- Telegroup House at 330 Lambton Quay sold in November 2009 for $7.0 million to an unknown purchaser, at an initial yield of 8.4%; and
- The State Services Building at 100 Molesworth Street, Thorndon was purchased by local investor Paul Benjamin for $25.5 million, at an initial yield of 9.2%. The office space is fully leased to State Services Commission.

The global credit crunch of 2008 / 2009 has had a significant impact on investors' ability to transact and on yields achieved. 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 consolidate across all property types and the yield gap between prime and secondary quality property investments will stabilise.

Table 1 presents the total return delivered over specific periods of time up to March 2010 for CBD office in Auckland, Wellington and Nationally.

Table 1: Annual Average Compound Returns – Auckland, Wellington and Nationally

To March 2010	Auckland CBD Office	Wellington CBD Office	New Zealand CBD Office
1 Year	-1.6%	-0.9%	-1.4%
2 Years	-5.7%	-1.9%	-0.7%
5 Years	9.3%	11.8%	12.1%
10 Years	8.3%	12.2%	10.7%
15 Years	8.0%	10.0%	9.3%

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.

Up until early 2008 the underlying office market fundamentals has been strong in both Auckland and Wellington 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.

Market Outlook

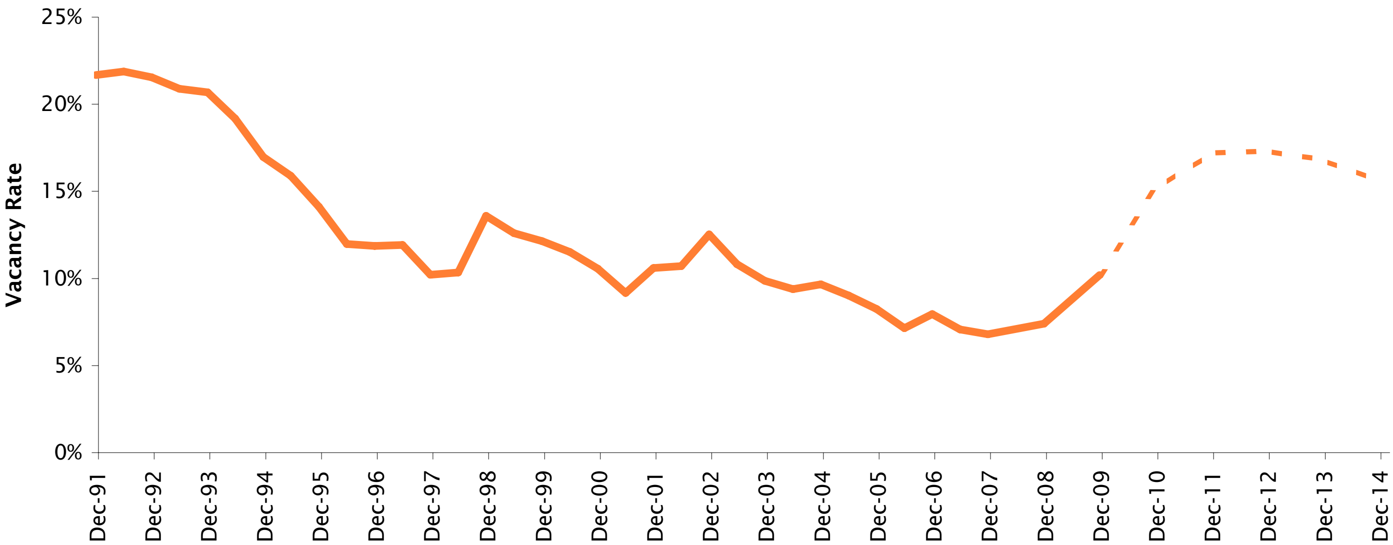
The recession of 2008 / 2009 has had a significant impact on Wellington's real economy. This along with the Government's goal to limit public sector growth is likely to result in the region's overall economic growth remaining below trend over the short to medium term. The underlying market fundamentals are unlikely to recover until the economy experiences a number of quarters of strong economic growth.

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:

- Weak / negative tenant demand as a result of the 2008 / 2009 recession's impact on businesses demand for labour combined with the National led administration's drive to limit the size of the public service. With the economic recovery not yet significantly strong to generate renewed demand growth. The total area of occupied space is forecast to contract by between 25,000 and 30,000 square metres in the period to late 2011; and
- The market is also in the later stages of a mini construction boom. There is over 90,000 square metres of office space under construction which will be completed over the next two years. The majority of this space is pre-let. However the tenants shifting into new premises will leave significant vacancies behind in their existing premises.

Figure 5 presents Darroch's forecast increase in CBD vacancy rates over the next three years.

Figure 5: Vacancy Rate Forecasts



Source: Darroch Research – March 2010 Forecasts

Note that these forecasts are based on an economic outlook consistent with NZIER's September 2009 quarter economic forecasts. If economic conditions deviate significantly from the NZIER's forecast a different vacancy outturn is likely.

Darroch is forecasting CBD vacancy rates to increase to between 16% and 18% by March 2012. The change in market conditions over the last couple of years has had a significant impact on the CBD office market and resulted in a shift in the balance of bargaining power from the landlord to the tenant. In addition, prime CBD gross rents are likely to ease by between 15% and 20% from the peak of the current rental cycle by mid 2012, as a result of increased vacancies and falling tenant demand for office space.

For more information, please contact:

Darroch Limited
Level 10
State Insurance Tower
1 Willis Street
PO Box 1545
Wellington NZ
Tel: +64 (0)4 472 3529

www.darroch.co.nz

Contacts

Key Wellington Contacts

Consulting and Research
Ian Mitchell
+64 (0)4 460 3857
ian.mitchell@darroch.co.nz

Property Services
Murray Stevens
+64 (0)4 472 3529
+64 (0)21 349 920
murray.stevens@darroch.co.nz

Sales and Investments
DTZ New Zealand Limited MREINZ
Licensed Real Estate Agent (REAA 2008)
Kevin Richards
+64 (0)9 374 6621
kevin.richards@dtz.co.nz

Valuation
Wayne Nyberg
+64 (0)4 460 3810
wayne.nyberg@darroch.co.nz

Plant and Machinery Valuation
Tony Pratt
+64 (0)4 460 3820
tony.pratt@darroch.co.nz

New Zealand Office Contacts

Auckland		
John Darroch	+64 (0)9 374 6613	john.darroch@darroch.co.nz
Wellington		
Milton Bevin	+64 (0)4 460 3853	milton.bevin@darroch.co.nz
Christchurch		
Lance Collings	+64 (0)3 363 5044	lance.collings@darroch.co.nz

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