The Whillans Report

AUCKLAND MARKET UPDATE / 2ND QUARTER 2016

Mixed Signals - A Changing Property Market?

My 30 years experience in the industry has shown me that to be successful in commercial real estate you have to follow the vagaries of the market and move with the cycle, effectively reinventing yourself to reflect a changing environment.

Although the land market has been overheated for some time, recent Chinese capital controls combined with prime lenders reducing their exposure to the development sector, are beginning to have a cooling effect on both sales volume and values.

Last week in Sydney we were encouraged by the focus Australian developers and fund managers have on New Zealand, and in particular Auckland.

The residential market in Sydney and Melbourne both appear to have reached their peak. Australian and the larger Australian based Chinese developers are actively seeking greener pastures. They recognise Auckland's housing shortage as an opportunity.

On the investment front, we met with several Australian fund managers who also have New Zealand clearly on their radar. These groups are currently chasing larger investment properties and portfolio opportunities.

Reflecting the changing property cycle, Senior Analyst Brendan Keenan has reviewed the Auckland CBD office market. We have examined the connection between interest rates and office yields.

We have also looked at the relationship between the prime and secondary office market.

Low vacancy rates, healthy funding margins, and increasing rents all point to further growth over the immediate term.

I trust you find value in the information contained in our quarterly report.

I look forward to doing business with you in the near future.

Bruce Whillans
Managing Director - Whillans Realty Group
bruce.whillans@whillans.co.nz
+64 (21) 985 619 I +64 (9) 304 1453

25 Parkhill Road, Howick

Ponsonby Post Office, Ponsonby

Springpark Stage 1, Mt Wellington

Market 2016 First Quarter Update

CBD Commercial (Q1)

A lack of new office supply combined with robust tenant demand saw secondary effective office rentals increase 10.5% to $233/psm and prime effective office rentals increase 5.1% to $398/psm in the 12 months to March 2016. Looking at the year ahead, most major research houses are pencilling in rental growth between 4% and 5% for prime office space, and between 5% and 6% for secondary office space. Despite this forecasted rental growth, there has been a minor uplift in prime rental incentives over the first quarter of 2016. This easing is indicative of the new prime office supply reaching the market. This new supply pipeline includes; 125 Queen Street, 151 Victoria Street West and the Fonterra Centre at 109 Fanshawe Street.

Lease incentives in the secondary market have flatlined and have not changed since September 2015.

Chinese, Southeast Asian, German and Australian investors are going head-to-head against cashed up local high-net-worth private investors and an exceptionally buoyant syndication market. Together, these market forces have driven office yields to a twenty year low.

Auckland CBD Commercial Market Summary* (CBRE)

	PRIME	SECONDARY	PREV 6MTH TREND
Vacancy	1.4%	10.8%	Decreasing
Effective Rent	$398.00	$233.00	Increasing
Yield	6.73%	7.46%	Firming
Incentives*	5.9 mths	6.4 mths	Flat

***Based on an indicative new 9 year prime and 6 year secondary lease**

Auckland Industrial (Q1)

The industrial market recorded strong growth in the 12 months to March 2016, with both prime and secondary effective rentals increasing by over 4%. Yields have continued to firm with indicative prime industrial yields improving to 6.39% and secondary industrial yields firming to 7.59%.

Supported by Auckland's growing economy and surging population, confidence in the sector remains high. The latest April Performance Manufacturing Index (PMI), a survey which measures manufacturing activity, remains elevated (currently 56 points).

A PMI reading above 50 points indicates manufacturing activity is expanding and below 50 indicates it is contracting.

Conversely, the ANZ Heavy Truckometre index, which provides a proxy for real time GDP growth by tracking heavy traffic movements, shows that we can expect moderate growth in GDP in the second quarter of 2016.

Auckland CBD Industrial Market Summary* (CBRE)

	PRIME	SECONDARY	PREV 6MTH TREND
Vacancy	2.9%	4.3%	Flat
Effective Rent	$125.30	$93.40	Increasing
Yield	6.39%	7.59%	Firming
Land Value	$600	$225	Increasing

Market 2016 First Quarter Update Continued

CBD Prime Retail (Q1)

The prime CBD retail market remains incredibly tight, with virtually no vacancy on the lower end of Queen Street. The closure of the Downtown Shopping Centre in May has had a noticable impact on vacancy rates, with tenants relocating to new premises in the CBD. Rising CBD employment and inner city resident numbers have boosted pedestrian foot traffic along the Golden Mile, with rental rates following suit. Indicative Queen Street retail rents have risen by 7.8% over the last six months. Meanwhile, the indicative prime CBD retail yield firmed eight basis points to 5.21% over the same period.

Auckland CBD Prime Retail Market Summary* (CBRE)

	AVERAGE	HIGH	LOW	PREV 6MTH TREND
Rent	$3,667	$4,000	$2,800	Increasing
Yield	5.21%	5.00%	5.50%	Firming

CBD Office Yields – Compression or Stabilisation?

The Auckland CBD office market is on fire. In this report, we look at the effect rising rents are having on office values. We explore the historical relationship between office yields, interest rates and the risk free rate of return. And, we question how much further yields will tighten.

After five years of continuous momentum, the Auckland CBD office market is showing no signs of stalling. Since June 2011, vacancy rates and lease incentives have been steadily trending downwards while office rentals and asset values have risen in parallel.

Office vacancy rates and in particular prime vacancy rates are now the lowest since 1990. Office yields have also firmed, surpassing their pre-GFC lows, with yields heading into new unchartered territory.

The current office cycle is being driven by some very unique market forces. The current migration boom, expansion in business credit, and Auckland's strong employment market have generated significant demand for office space. Meanwhile, a five year drought of new stock combined with rising construction and land costs, and the removal of secondary office space for residential conversions has restricted supply.

In the five years to March 2016, Auckland's total pool of CBD office stock increased by a mere 30,000m² from 1.386 million square metres to 1.416 million square metres. Globalisation and abnormally low interest rates have also made it easier for capital to shift across borders. This has created an international playing field for investors looking for returns.

Auckland CBD office values are being driven by a combination of robust market fundamentals and historically low funding costs. Together these forces have ignited investment activity in the CBD office market. Transaction volumes are now back to their pre-GFC levels.

With much of the world facing the prospect of deflation, and central banks dropping interest rates to encourage growth, asset prices have risen dramatically over the last six years. A pattern has emerged where high debt levels force interest rates to stay low, which in turn has encouraged borrowers to take on more debt. Against this backdrop, Auckland office yields have firmed substantially.

However, they have not dropped to the same extent that interest rates and 10-Year NZ Government Bond yields have fallen.

By using the 5-Year SWAP rate as a proxy for lending costs and adding a further risk margin of 2%, we have been able to illustrate the spread between market driven lending costs and commercial office yields. We acknowledge that this approach does not take into account cyclical market variances in the risk premium charged by banks, and that premiums will vary based on individual asset and debtor risk profiles.

However, after analysing this data, three clear trends emerge.

Trend 1: CBD office yields have reached new lows.

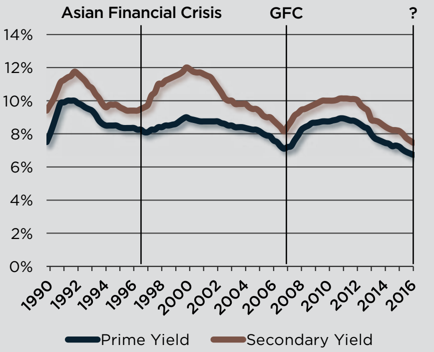
Prime and secondary office yields are the lowest they have been for 20 years. Combined with rising rent rolls and limited investment stock, office values have risen substantially over the last six years.

Trend 2: The gap between funding costs and yields has widened, amplifying leveraged returns.

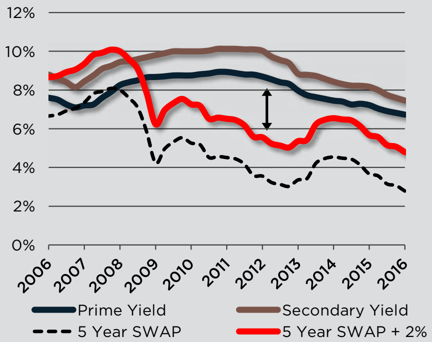
Despite record low CBD office yields, the margin between indicative funding costs and office yields is well above the long term average. By way of example the current margin between prime office yields and funding costs is a healthy 194 basis points. However, the average margin has only been 21 basis points over the last two decades.

By comparison, the margin between secondary office yields and interest rates is currently 267 basis points. This margin has averaged 178 basis points over the last 20 years. This has allowed investors to achieve attractive leveraged returns and has also fuelled an exceptionally buoyant syndication industry.

CBD Office Yields Set New Records
(CBRE)



Interest Rates vs Office Yields
(ASB, CBRE)



CBD Office Yields – Compression or Stabilisation? Continued

Trend 3: The margin between prime and secondary office yields has tightened.

The difference between prime and secondary office yields is the narrowest it has been in over 20 years. This tightening is often seen as a precursor to a market correction with investor euphoria leading to inadequate risk assessment and irrational pricing behaviour.

In the fourth quarter of 2006, prime and secondary CBD office yields hit a market low of 7.1% and 8.15%, respectively. In that same quarter, the spread between the two sectors also reached its narrowest point in a nearly a decade, symptomatic of an overheated market. By 2007, this was quickly replaced by failing finance companies, rising interest rates, and investors shifting to high quality income producing assets. Ten years prior, the market witnessed a similar merging of yields on the eve of the Asian Financial Crisis.

Are we on the brink of a similar correction? As we indicated at the beginning of this report, the office market is being driven by several unusual trends, but primarily it is being led by exceptionally low interest rates.

Unlike 1996 and 2006, when there was a negative and unsustainable margin between interest rates and office yields, there is now a very healthy margin. In addition, the margin between 10-Year NZ Government Bond rates and office yields is positive. In 1996 the relationship between government bonds and prime office yields was negative. In fact, the current margin between both prime and secondary office yields and interest rates and 10-Year NZ Government Bonds is well above the 20 year average.

Conventional logic would suggest that office yields will continue to fall in line with low interest rates and robust market fundamentals. The Reserve Bank of New Zealand together with most major trading banks have indicated a *lower-for-longer* approach to interest rates and the stars appear to be aligned for further capital growth. However, if interest rates do begin to climb, office yields may increase, but not at the same pace. The current margin provides a sound shock absorber for any unforeseen interest rate hikes.

New Zealand, as a small trading nation does not have immunity against global events. China's debt bubble, rising US interest rates, a reversal in migration flows, multiple geopolitical conflicts and pending elections all have the power to change the narrative overnight. These factors and other unknowns, positive and negative, could radically change the direction of our economy and Auckland's office market.

2016 is set to be a pivotal year for investors.

Brendan Keenan
***Senior Analyst* — WHILLANS REALTY GROUP**
brendan.keenan@whillans.co.nz

Auckland CBD Land Sales

CBD Land Sales

Address	Property	Proposal/Development	(m²)	Sale Price	$/psm	Date
520-536 Karangahape Road	Carpark	No known consents.	1,272	$5,010,000	$3,938	Mar-15
27 Rutland Street	Vacant	Plans for 12 level student accommodation development with 146 units.	309	$4,150,000	$13,430	Mar-15
36 Fort Street	Ex Brothel House	High-rise mised use tower under construction.	282	$3,000,000	$10,638	May-15
70-74 Anzac Avenue	Abandoned Building	Plans and marketing underway for high-rise apartment development.	742	$6,000,000	$8,086	May-15
38 Airedale Street	Two Level Building	Two level building. No known consents.	230	$1,475,000	$6,413	Jun-15
79-83 Beach Road	Car Rental	Two level building. No known consents.	814	$5,600,000	$6,879	Jun-15
35 Whitaker Place	Vacant Land	Resource Consent for 1,082 student beds in twin tower scheme.	3,071	$14,100,000	$4,591	Jun-15
38 Airedale Street	Two Level Building	Marketed as a development site.	230	$1,465,000	$6,414	Jun-15
151 Beach Road	Ideal Electrical	Sold to a developer. No known consents.	1,032	$6,800,000	$6,589	Sep-15
2 Anzac Avenue	Carpark	Corner of Anzac Avenue and Beach Road.	938	$9,500,000	$10,127	Sep-15
7-9 Halsey Street	Millar Paterson Metals	Reported in NBR that buyer is considering a mixed use development.	561	$3,085,000	$5,500	Oct-15
438 Queen Street	Real Groovy	Conrad Properties are building 236 apartments and 9 retail units.	1,965	$13,800,000	$7,022	Oct-15
26 Poynton Terrace	Carpark	Plans to develop boutique apartment building to be known as The Oasis.	334	$2,200,000	$6,586	Oct-15
6-8 Upper Queen Street	Vacant Buildings	Marketed as a development site.	1,176	$4,100,000	$3,486	Oct-15
10 Commerce Street	Tasman Building	Consented for 48 level apartment tower. Purchase included air rights.	1,388	$27,760,000	$20,000	Nov-15
163-165 Beach Road	Budget Rentals	Warehouse space. Under the PAUP the height will increase to 30m.	1,330	$6,700,000	$5,037	Dec-15
29 Beach Road	Liquor Centre	Marketed as a development site.	245	$2,550,000	$10,408	Dec-15
201 Hobson Street	The Eve Apartments	Plans for residential apartments.	563	$4,700,000	$8,338	Apr-16
121 Grafton Road	Vacant Land	Consented for student accommodation.	3,006	$15,200,000	$5,057	May-16
26 Airedale Street	Two Level Building	No known consents.	220	$2,920,000	$13,273	Apr-16
79 Airedale Street	On-Grade Carpark	Sale included 40 strata carparks. Consented for 17 level tower.	1,092	$7,600,000	$6,690	Jun-16

CBD Fringe Land Sales

Address	Property	Proposal/Development	(m²)	Sale Price	$/psm	Date
30-40 Enfield Street, Mt Eden	Mixed Use	Ex Orion Health Building and carpark.	3,750	$7,600,000	$2,027	Aug-14
99-115 St Georges Bay Road	Mixed Use	*Source Mondial and Attwoods* redevelopment site.	2,585	$7,750,000	$2,998	Aug-14
97-115 The Strand, Parnell	Business 5	Consent for 7,800m2 office building.	3,502	$7,820,000	$2,233	Aug-14
121 Grafton Road, Grafton	Mixed Use	Being developed into student accommodation *Grafton Crossing*.	3,006	$10,000,000	$2,326	Aug-14
17 Hargreaves Street, College Hill	Mixed Use	Currently leased to Xerox to 2016.	11,032	$32,500,000	$2,946	Dec-14
1 Exmouth Street, Eden Terrace	Mixed Use	Vacant carpark.	655	$1,920,000	$2,931	April-15
3-11 Rendall Place, Eden Terrace	Mixed Use	Development site.	2,279	$6,000,000	$2,632	May-15
11A Cheshire Street, Parnell	Mixed Use	Development site.	1,031	$3,400,000	$3,297	Jun-15
23 Cheshire Street, Parnell	Special Purpose 3	Plans for a retirement village. Site is subject to a MOU with AT.	23,368	$18,000,000	-	July-15
29 Altham Avenue, Sandringham	Mixed Use	Vacant caryard.	1,518	$3,000,000	$1,976	Sep-15
8 Roxburgh Street, Newmarket	Mixed Use	Mixed use development site with older style two-level building.	842	$3,750,000	$4,453	Oct-15
252-258 Great North Road	Mixed Use	Development site.	1,002	$3,300,000	$3,293	Nov-15
22-24 Randolph Street	Mixed Use	Concept plans for 40 unit residential development.	1,037	$3,100,000	$2,989	Feb-16

CBD Conversion Sales

Address	Property	Proposal/Development	(m²)	Sale Price	$/psm	Date
10-14 Lorne Street	Ex Crown Institute Building	Plans to refurbish and use for English language school.	5,121	$13,580,000	$2,652	Sep-14
44 Khyber Pass Road	Ex Newcall House	Currently being converted into SKHY Apartment development.	9,318	$23,000,000	$2,468	Sep-14
100 Mayoral Drive	Ex Chamber of Commerce	Purchased by owners of 85-89 Greys Avenue carpark.	2,770	$8,500,000	$3,069	Sep-14
8-10 Eden Crescent	Ex Cargen Hotel	Plans for conversion into heritage apartments.	2,991	$4,500,000	$1,505	Dec-14
9 Princes Street	Ex Fonterra Building	Potential residential conversion.	10,683	$45,000,000	$4,212	Oct-15
16-22 Anzac Avenue	Tasman House	Plans to be converted into student accommodation.	2,556	$6,400,000	$2,503	Dec-15