The Whillans Report

AUCKLAND MARKET UPDATE / 3RD QUARTER 2016

Whillans Realty Group Completes $150 Million In 3rd Quarter

Whillans Realty Group has produced an exceptional result this quarter with the team completing eight sales totalling $150 million. This highlights the strength of our client relationships and the strong alliances we have within the Chinese market.

Notable sales included The Ardmore Airport, (Bruce Whillans), 450 Queen Street (Henry Thompson), 57-59 Wakefield Street (Brice Clark), 39 Corinthian Drive (Blair Chandler) and 92 Albert Street (Kathy Ying).

These sales are reflective of what is proving to be an international property boom. Globally the continuation of low interest rates is driving investors into commercial real estate, one of the only asset classes to still offer attractive returns.

Never before have I experienced the current level of offshore enquiry, with private investors, fund managers and sovereign funds all chasing investment property and effectively pushing yields down to all-time lows.

In light of this emerging trend, Senior Analyst Brendan Keenan looks at the rationale behind negative interest rates and the effect they could have on New Zealand's commercial real estate markets.

I trust you find value in the information contained in this quarterly report and 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

Ardmore Airport

450 Queen Street, CBD

92 Albert Street, CBD

Market Update Second Quarter 2016

CBD Commercial (Q2)

New office supply has finally tempered what has otherwise been one of the hottest office markets in decades. Reflective of this new supply reaching the market, vacancy levels have edged up from an all-time low of 6.7% in December 2015 to 7.7% in the second quarter of 2016. Despite this minor upturn in vacancy rates, most research houses believe the market is reaching a state of equilibrium where new supply will match tenant demand, allowing vacancy levels to remain stable over the next five years. However, for occupiers, the CBD office market remains tight. On an annual basis, prime face rents increased by 8.5%, and effective rents increased by 5.9%.

In the secondary office market, face rents increased by 8.3% and effective rents increased by 10.5%. With the RBNZ signalling further rate cuts and office fundamentals remaining strong, investment yields have continued to move lower. Prime office yields firmed 18 basis points over the first half of 2016, while secondary office yields firmed by 22 basis points over the same period. Indicative of this firming trend, three substantial secondary office buildings sold in the second quarter; 450 Queen Street at a 6% initial yield ($39 million), The Telco Building on Federal Street for 7% ($31.75million) and the AUT Building on the corner of Wakefield and Queen Street for 6.8% ($47.2million).

Auckland CBD Commercial Market Summary* (CBRE)

	PRIME	SECONDARY	PREV 6MTH TREND
Vacancy	3.3%	11.2%	Increasing
Effective Rent	$405.00	$238.00	Increasing
Yield	6.64%	7.38%	Firming
Incentives*	7.2 mths	6.4 mths	Increasing

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

Auckland Industrial (Q2)

The industrial market continued to record steady growth in the 12 months to June 2016, with prime and secondary effective rentals increasing by 5.4% and 4.7% respectively. Yields have continued to firm with indicative prime industrial yields on track to dip below 6% by the end of this year. Secondary industrial yields have followed suit, firming 67 basis points in the 12 months to June and currently tracking at 7.36%. Supported by Auckland's growing economy and surging population, confidence in the sector remains high.

The latest July Performance Manufacturing Index (PMI), a survey which measures manufacturing activity, remains elevated (currently at 55). A PMI reading above 50 points indicates manufacturing activity is expanding and below 50 indicates it is contracting. After stalling for most of 2014 and 2015, industrial land values have experienced a solid uplift over the first half of 2016. Indicative industrial land values have surged by 15.2% in the last six months, hitting an all-time high of $455/m^2$.

Auckland CBD Industrial Market Summary* (CBRE)

	PRIME	SECONDARY	PREV 6MTH TREND
Vacancy	1.0%	2.49%	Increasing
Effective Rent	$128.60	$95.20	Increasing
Yield	6.15%	7.36%	Firming
Land Value	$600	$225	Increasing

The Whillans Report

AUCKLAND MARKET UPDATE / 3RD QUARTER 2016

Market Update Second Quarter 2016 Continued

CBD Prime Retail (Q2)

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 noticeable impact on vacancy rates, with tenants relocating to new premises in the CBD. The 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 9% over the last six months. Meanwhile, the indicative prime CBD retail yield firmed 22 basis points to 5.03% over the same period.

Auckland CBD Prime Retail Market Summary* (CBRE)

	AVERAGE	HIGH	LOW	PREV 6MTH TREND
Rent	$3,833	$4,500	$2,800	Increasing
Yield	5.03%	5.25%	4.75%	Firming

Could negative interest rates affect NZ's commercial property market?

In this edition of the Whillans Report we look at the rationale behind negative interest rates and we explore the arguments for and against this radical approach to monetary policy. We also uncover some unusual consequences of negative interest rates. And finally, we look at the impact of negative interest rates on commercial real estate markets around the globe.

An attempt to raise our 'velocity of money'

Since the recent global financial crisis, many theories have been offered to explain the widespread slowdown in economic growth rates. These theories range from the automation of the workforce, rising wealth inequality, aging populations, and the ineffectiveness of credit growth to boost economic output.

In this world of slow growth rates, central banks want to encourage consumers and companies to spend their savings in order to increase the circulation of money in the system. In doing this, consumers and companies would lift what is known as the 'velocity of money'. In simple terms, the velocity of money is the number of times one unit of legal tender is used to buy goods and services over a fixed time period.

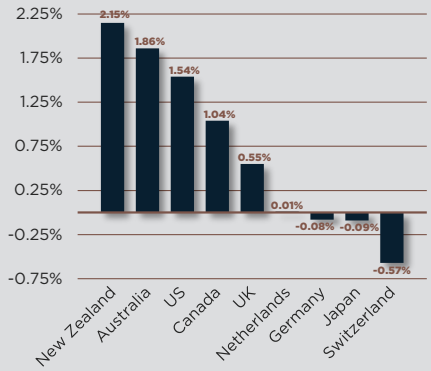
One way to lift the velocity of money is to introduce a negative interest rate policy (NIRP). The central aim of NIRP is to do exactly what central banks are after: to stimulate an economy by discouraging saving and encouraging borrowing.

The two sides of the story

The velocity of money plays a critical role in the debate around negative interest rates. Some experts (primarily central bankers) believe negative interest rates will increase the velocity of money.

In this scenario, commercial banks are penalised for holding cash, opting rather to lend it to consumers and companies, who in turn will buy more goods and services. In Japan, the eurozone, Switzerland, and other countries that have embraced NIRP, commercial banks are charged for parking their cash reserves at central banks.

(Fig 1) 10-Year Government Bond Yields
(Bloomberg 19/08/2016)



However, other experts warn that NIRP could slow down the velocity of money circulating through the economy as investors can — and will — literally hoard cash. These experts fear that NIRP could lead to a type of 'negative feedback loop', where investors' expectations around growth and inflation are lowered. This in turn discourages investment and spending, and ultimately leads to deflation — the very thing NIRP is intended to avoid.

Bill Gross, investment guru and founder of global investment management firm Pimco, likened negative interest rates to "a supernova that will explode one day". He also noted that "global yields are the lowest in 500 years of recorded history".

Could a cashless society become a reality?

Already, anecdotal stories are circulating about the safety deposit business taking off in Europe, where physically stockpiling cash provides a better return (at 0%) than leaving cash with a bank (at a cost).

The value of gold is rising, up 28% in $USD since December 2015. And in May, the European Central Bank announced that it would end production of the €500 note. Many market commentators cynically viewed this move as a way to discourage companies and ultra-high-net-worth privates from hoarding cash. But the European Central Bank cited that the note, which is often referred to as the 'Bin Laden of bank notes', is frequently used by terrorists and organised crime syndicates. They noted this as the key reason for its withdrawal.

In this world of negative interest rates, is a cashless society just around the corner?

The impact of NIRP on currency value

Another side effect of NIRP is competitive currency devaluation, where an abrupt national currency devaluation by one nation is matched by a currency devaluation of another.

For smaller market economies, like Switzerland, the aim of negative rates has been to stop 'hot money' from lifting the exchange rate. 'Hot money' is capital that is frequently transferred between financial institutions in an attempt to maximize interest or capital gain.

A higher exchange rate not only hurts exporters but also leads to deflation through lower prices for consumer goods (aptly called 'importing deflation'). Arguably, the latter now applies to New Zealand, with the Reserve Bank of New Zealand now forced to drop the Official Cash Rate (OCR) in order to keep our dollar down.

Whillans Realty Group Limited (REAA 2008)
+64 (09) 304 1453 / whillans.co.nz

The Whillans Report

AUCKLAND MARKET UPDATE / 3RD QUARTER 2016

Could negative interest rates affect NZ's commercial property market?

With one of the highest cash rates in the Western world (Fig1), the Reserve Bank's August rate cut did little to lower our exchange rate. Perversely, our dollar moved higher in the hours following the rate cut due to market participants factoring in a bigger-than-expected drop to the OCR.

Reserve Bank Governor Graeme Wheeler now seems to have found himself between a rock and a very hard place: keep interest rates on hold, and sit back and watch as a higher Kiwi dollar suffocates our export and tourism industry; or join the rest of the world in the race to the bottom and allow asset prices to balloon. It would appear the latter is his only option. And this leads us to the question, what effect are negative interest rates having on commercial real estate markets?

A recalibration of investment returns

In our June 2016 Whillans Report we noted that historically low funding costs have dragged Auckland commercial property yields to their lowest point in 25 years; that is, the lowest level since reliable record keeping began. Indicative prime Auckland office yields are currently around 6.5%.

Real estate markets globally are witnessing a similar recalibration of investment returns. In mature markets, like Hong Kong and Singapore, prime office yields are beginning to dip below 3%.

For institutional investors, including pension funds, insurers, and sovereign wealth funds (which rely heavily on fixed-income securities), negative interest rates are playing havoc with investment portfolios. These groups require certain return thresholds to meet their long-term funding obligations. A pension fund will need a set rate of return to fund retirement for its members, while an insurance company uses its returns to cover claims.

In order to meet their long-term obligations, these investors have to look at much riskier assets to offset the lower returns offered by fixed-income securities. In turn, fund managers are reassessing their asset allocation models and reweighting in favour of commercial real estate. With a wave of capital chasing commercial property, values are rising around the globe.

In New Zealand, we are seeing this wave of capital materialise in the form of a booming syndication industry, rising local real estate investment trust (REIT) values, and aggressive plays by high-net-worth privates. Offshore pension and sovereign wealth funds have also been quietly acquiring stakes in some of New Zealand's most prized and coveted commercial property assets.

People often forget that there is a compounding effect on value when yields firm. The further commercial property values move down the yield curve, the higher (and more exponentially) values rise.

By way of example, the difference in value (assuming rent remains constant) between an office building purchased at 8% and then re-sold at 6% is 33%. If the building is purchased at 6% and then sold for 4%, the value rises 50%.

While commercial property yields cannot turn negative, valuations will begin to get very interesting as they head lower and lower. In this low-interest-rate environment, is there a risk that property values become increasingly detached relative to market and individual asset fundamentals?

Should we worry about unknown consequences?

In the short to medium term, negative interest rates are creating the perfect conditions for a global commercial property boom. However, many economists worry about the unknown consequences of this policy and what the ultimate end game might look like. Is NIRP the financial equivalent to global warming, where the impacts are unknown and potentially even irreversible? Interesting times indeed.

In the long run, who will pay the price for this global property boom? In the words of economist Milton Friedman, 'There's no such thing as a free lunch'.

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

The Whillans Report

AUCKLAND MARKET UPDATE / 3RD QUARTER 2016

Auckland CBD Land Sales

CBD Land Sales

Address	Property	Proposal/Development	(m²)	Sale Price	$/psm	Date
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
57 - 59 Wakefield & 28 Airedale Street	1940's building	Apartment development site	768	$6,200,000	$8,073	May-16
121 Grafton Road	Vacant land	Consented for 300 student apartment units.	3,006	$15,200,000	$5,057	May-16
201 Hobson Street	The Eve Apartments	Presales underway for the 12 level Eve apartments.	563	$4,700,000	$8,338	Apr-16
26 Airedale Street	Two level building	No known consents.	220	$2,920,000	$13,273	Apr-16
163-165 Beach Road	Budget Rentals	Warehouse space. 30 metre height limit.	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
10 Commerce Street	Tasman Building	Consented for 48 level apartment tower. Purchase included air rights.	1,388	$27,760,000	$20,000	Nov-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 is building 236 apartments and nine retail units.	1,965	$13,800,000	$7,022	Oct-15
26 Poynton Terrace	Carpark	Construction underway on the 27 unit The Oasis apartments.	334	$2,200,000	$6,586	Oct-15
6-8 Upper Queen Street	Vacant buildings	A block of 62 units planned for the site.	1,176	$4,100,000	$3,486	Oct-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
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
36 Fort Street	Ex brothel house	High-rise mixed use tower under construction.	282	$3,000,000	$10,638	May-15
70-74 Anzac Avenue	Abandoned building	Construction underway on the 98 unit, 14 level Connect Apartments.	742	$6,000,000	$8,086	May-15
520-536 Karangahape Road	Carpark	No known consents.	1,272	$5,010,000	$3,938	Mar-15

CBD Fringe Land Sales

Address	Property	Proposal/Development	(m²)	Sale Price	$/psm	Date
10 Fleet Street, Eden Terrace	Mixed Use	North facing site overlooking Basque Park.	424	$1,650,000	$3,802	Sep-16
9 Prosford Street, Ponsonby	Mixed Use	Vacant warehouse, sold as a development site.	304	$2,350,000	$7,730	Sep-16
15 Nugent Street, Grafton	Mixed Use	Returning $162,000 with 12 month lease term.	1,988	$6,700,000	$3,370	Aug-16
9 Farnham Street, Parnell	Mixed Use	Presales underway for a 14 unit, six level apartment building.	406	$1,900,000	$4,680	Mar-16
4-8 Rose Road, Grey Lynn	Mixed Use	1890 villas, sold as a development site.	960	$5,300,000	$5,521	Mar-16
25 Nixon Street, Grey Lynn	Mixed Use	1970 workshop.	273	$1,150,000	$4,212	Feb-16
15 Vinegar Lane, Ponsonby	Mixed Use	Bare site.	172	$1,095,000	$6,366	Feb-16
22-24 Randolph Street, Eden Terrace	Mixed Use	Concept plans for 40 unit residential development.	1,037	$3,100,000	$2,989	Feb-16
252-258 Great North Road, Grey Lynn	Mixed Use	Marketed as a development site.	1,002	$3,300,000	$3,293	Nov-15
8 Roxburgh Street, Newmarket	Mixed Use	Marketed as a development site. Curently a two level building.	842	$3,750,000	$4,453	Oct-15
29 Altham Avenue, Sandringham	Mixed Use	Marketed as a development site. Curently a car yard.	1,518	$3,000,000	$1,976	Sep-15
23 Cheshire Street, Parnell	Special Purpose 3	Summerset retirement village. Site is subject to a MOU with AT.	23,368	$18,000,000	-	Jul-15
11A Cheshire Street, Parnell	Mixed Use	Presales underway for the four level, 36 unit Parnell Central apartments.	1,031	$3,400,000	$3,297	Jun-15
3-11 Rendall Place, Eden Terrace	Mixed Use	Development site.	2,279	$6,000,000	$2,632	May-15
35 Broadway, Newmarket	Mixed Use	Plans for new six level office building anchored by Mercury Energy.	3,090	$15,380,000	$4,977	Apr-15

Terrace Housing and Apartment Buildings (THAB) Land Sales

Address	Property	Proposal/Development	(m²)	Sale Price	$/psm	Date
74-80 Anzac Street, Takapuna	THAB	Presales underway for the 97 unit, six level Sargeson Apartments.	1,988	$7,434,657	$3,740	Oct-15
55-57 Anzac Street and 22 Lomond Street, Takapuna	THAB	Concept plans for the eight level Modulus Apartments underway.	1,771	$6,380,000	$3,602	May-15
70-72 Anzac Street, Takapuna	THAB	Marketed as a development site.	1,034	$2,935,000	$2,838	Apr-15
41-47 Killarney Street, Takapuna	THAB	Concept plans for the Killarney Apartments underway.	4,737	$14,300,000	$3,019	Apr-15
3 Campbell Road, Takapuna	THAB	Concept plans for the Campbell Road Apartments underway.	1,391	$3,838,888	$2,760	Sep-14

Whillans Realty Group Limited (REAA 2008)
+64 (09) 304 1453 / whillans.co.nz