The Whillans Report

AUCKLAND MARKET UPDATE / 4TH QUARTER 2016

A Changing Market As We Move Into 2017

2016 proved to be another great year for Whillans Realty Group with both volume and total sales well up on last year's results.

Although land sales dominated our business this year, we are now experiencing a marked slowdown in the development sector.

Rising construction costs and the lack of available funding are beginning to take the heat out of this market.

On the flip side we are enjoying strong demand for investment property with both local and offshore high-net-worth privates, fund managers and sovereign wealth funds chasing income producing stock.

Notable transactions for Whillans Realty Group in 2016 included Ardmore Airport (Bruce Whillans), 92 Albert Street for $36 million, (Kathy Ying), 450 Queen Street for $39 million (Henry Thompson), Tamaki Estate for $30.3 million (Brice Clark) and Parkhill Road, Howick for $9.8 million (Blair Chandler).

In this edition of the Whillans Report our Senior Analyst Brendan Keenan looks at the key local and international factors that will have an impact on our market next year.

I trust you find value within this quarterly report and I look forward to doing business with you in 2017.

I wish you a Merry Christmas and all the very best for a happy and prosperous New Year.

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Ardmore Airport

450 Queen Street, CBD

92 Albert Street, CBD

Market 2016 Third Quarter Update

CBD Commercial (Q3)

The Auckland CBD office market continued to post strong capital gains in the six months to September 2016, supported by lower yields and sustained rental growth.

However, there was a noticeable deceleration in effective rental growth rates for both the prime and secondary CBD office markets. This is indicative of new office supply coming online, reversing a four and a half year trend of dwindling incentives.

Indicative prime and secondary office yields have reached all-time lows of 6.52% and 7.20% respectively.

Investment stock remains in short supply with syndicators, private investors and institutional funds going head to head for many of the same assets.

This demand combined with low interest rates compressed yields over the course of 2016.

However, the prospect of higher interest rates and weaker rental growth suggests we may see yields level off in 2017.

Auckland CBD Commercial Market Summary* (CBRE)

	PRIME	SECONDARY	PREV 6MTH TREND
Vacancy	1.4%	10.8%	Decreasing
Effective Rent	$405.00	$240.00	Increasing
Yield	6.52%	7.20%	Firming
Incentives*	7.6 mths	7.1 mths	Increasing

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

Auckland Industrial (Q3)

The industrial market was a standout performer in the six months to September 2016, with prime and secondary industrial yields both firming by 65 basis points.

Prime industrial yields have dipped below 6% for the first time in 20 years to 5.74%. Meanwhile secondary industrial yields have also followed suit dropping to 6.94%. Rental growth was respectable across the prime and secondary industrial market. However slower growth for industrial office rents weighed down the overall net effective rental growth for industrial premises.

In contrast, industrial land values increased 8.9% in the six months to September, up 17% in the last 12 months. Auckland continues to face a critical shortage of industrial land, and this is placing upward pressure on land values.

Traditional industrial precincts including Eden Terrace, Onehunga, Morningside, Tamaki and Ellerslie have been rezoned Mixed Use under the Unitary Plan. This gentrification and residential conversion together with the gradual exodus of industrial users from these locations is placing further pressure on those areas which are still zoned industrial.

Auckland CBD Industrial Market Summary* (CBRE)

	PRIME	SECONDARY	PREV 6MTH TREND
Vacancy	2.9%	4.3%	Flat
Effective Rent	$128.60	$95.20	Increasing
Yield	5.74%	6.94%	Firming
Land Value	$600	$225	Increasing

Market 2016 Third Quarter Update Continued

CBD Prime Retail (Q3)

The prime CBD retail market experienced exceptional rental growth in the six months to September 2016, with rents improving by 6.1% to $3,892/m2.

Prime retail yields continue to firm on the back of higher pedestrian foot traffic, low vacancy rates and the arrival of international retail brands seeking a presence on Queen Street. In the six months to September 2016, the indicative prime retail yield firmed 26 basis points to 4.95%. Interestingly, both the high and low range for retail yields remained unchanged. With higher interest rates on the cards, we believe rental growth rather than yield compression will drive capital growth across 2017.

Auckland CBD Prime Retail Market Summary* (CBRE)

	AVERAGE	HIGH	LOW	PREV 6MTH TREND
Rent	$3,892	$4,500	$2,800	Increasing
Yield	4.95%	4.75%	5.25%	Firming

What to Watch Out For in 2017

Will a Trump presidency lead to higher global interest rates?

Could the election of Donald Trump to the role of US President spell the end of the 35-year bull bond market? Consensus is growing among investors that Trump will push through significant public spending and tax cuts, boosting inflation and reversing a 35-year trend of declining bond yields. Add to this mix strong US wage growth and higher energy prices, and inflation becomes more of a possibility. For New Zealand, increasing US bond yields would lead to a weaker New Zealand dollar, feeding through to higher inflation and ultimately increased interest rates.

Some commentators, however, have warned that the market is downplaying the risks of Trump's victory. Globally, private and public debt levels are high. Combined with rising interest rates, this could outweigh the benefits of Trump's fiscal injection. Economists also warn that Trump's campaign promises would undermine globalisation and free trade — two pillars that have underpinned economic growth for decades. Should the market be more focused on growth, inflation, and rising interest rates? Or should the market be concerned with the risks of a recession triggered by protectionist trade policies in a world where low interest rates leave little room for monetary policy?

It's still too early to tell what policies Trump will implement when he officially takes up his role of President on 20 January. But, like a reality TV show, the next few weeks will be full of surprises.

Could increased interest rates affect commercial real estate?

How fast and how far interest rates rise will have a direct impact on commercial real estate markets globally.

In New Zealand, we expect the steady tightening of commercial yields to flatten over 2017. A healthy margin still exists between investment yields and funding costs. But any surge in interest rates could see yields begin to unwind. However, there's still room for capital growth, particularly in Auckland where demand and a lack of industrial, office, and retail space continue to put upward pressure on rents.

Even before Trump's victory, New Zealand's four major trading banks began tightening the screws on lending conditions, particularly for development funding. The reasons behind this tightening vary. A mixture of self-imposed lending caps and macro-prudential rules enforced by both New Zealand and Australia's Reserve Banks are partly to blame. Concerns of an apartment bubble and settlement risk within Brisbane, Melbourne, and Sydney are also contributing to tighter lending conditions. New Zealand's Australian parent banks are naturally aware of these concerns spreading.

Funding costs are already beginning to rise, with local banks relying on long-term offshore funding to bridge the current shortfall between local deposit and lending growth. In the aftermath of the GFC, central banks have also imposed new macro-prudential capital requirements so that commercial banks hold enough money on their balance sheets to cope with future downturns and absorb financial losses. In theory, having sufficient capital buffers reduces the likelihood of bank failure and taxpayer-funded bailouts. The requirement for more capital has meant that banks must charge more for every dollar they lend in order to maintain the same return as before.

However, there may be light at the end of the tunnel. If banks are willing to reinvest capital into the market, we could see lending conditions ease as developments reach practical completion and settlements begin flowing through. Additionally, a three or six month lending hiatus would see banks rebalance their loan books, enabling them to re-enter the market next year.

Kaikoura earthquake shifts commercial investment focus

The Kaikoura earthquake, which lead to widespread damage in the upper South Island and lower North, has focused investor attention back to Auckland. Our offshore clients who were attracted by the higher yields on offer in Wellington are now looking to invest only in Auckland.

Seismic strengthening and insurance premiums could once again become key purchase parameters next year. Ironically, many of the most affected buildings in Wellington had A-grade seismic ratings, calling into question IEP (Initial Evaluation Procedure) reports.

Auckland's land market gets the speed wobbles

Rising construction costs and a lack of development funding are quickly taking the heat out of Auckland's residential land market. Additionally, the Auckland Unitary Plan took effect on 15 November, opening up thousands of hectares of urban land for development. The plan also up-zoned large tracts of land around the CBD and the city's transit network. Consequently, purchasers are beginning to question whether residential land in Auckland is as finite as earlier thought.

With many land speculators looking to lock in capital gains, any rush for the exits could have a negative effect on residential land values in Auckland next year. Rising construction costs and delays have already tipped over several apartment schemes, with cautious bank credit controllers only willing to fund those projects with exceptionally robust development margins.

The land beneath many unsuccessful development projects is being quietly sold off-market, and land values will face a litmus test in 2017 as resale data flows through. Experienced developers with strong balance sheets and good banking relationships may find that the land market is far less competitive than it was in 2016.

What to Watch Out For in 2017

New Zealand seen as a safe haven

Net migration to New Zealand continues to underpin the country's property market. In the year to September, the country recorded a net gain of 70,000 people, with nearly 50% of these migrants settling in Auckland. More people results in more housing, more offices, more factories, and more retail.

Although many economists, including the government, have been calling the migration peak for months, a strong domestic economy, weaker offshore growth prospects, and the rising tide of global populism will continue to make New Zealand a very attractive place to live and do business. However, following the resignation of Prime Minister John Key, the upcoming election in 2017 will make interesting viewing given the current climate of global politics. Any anti-immigration or anti-foreign investment rhetoric in the lead-up to next year's election could well dampen confidence in the property sector.

Scale remains a barrier for offshore institutional investors who are looking to place a minimum of between $100 and $150 million into our market. A lack of stock, rather than investor mandate, remains the biggest impediment for these groups.

We believe this demand will inject liquidity into the property market in 2017 and act as a counterweight to any volatility.

Offshore investment becoming tougher for Chinese

Strict capital controls continue to be a major hurdle for Chinese investors and developers seeking to place funds outside their homeland. For smaller investors and developers, the lessening availability of bank funding in New Zealand, new IRD reporting rules, increased construction costs, and the stronger New Zealand dollar have all conspired to make it harder to invest here. For many potential investors, greener pastures exist elsewhere.

However, corporate investors, state-owned enterprises, and ultra-high-net-worth individuals with strong balance sheets still appear able to transfer funds outside of China. These groups are looking for large residential projects and are prepared to speculatively build in order to maximise their profit. With an eye on total return, many of these larger investors are cautiously entering our market and often seeking distressed development opportunities, where faltering development projects have been halted or are in the hands of lenders.

Adopting a wait-and-see approach

While some Chinese investors continue to be interested in New Zealand, most parties look to be adopting a wait-and-see approach. They're likely to re-enter the market after the Chinese New Year in January 2017.

This trend marks a notable change from the heady days of 2014 and 2015, when Chinese investors were more focused on parking cash in property rather than actual return on investments.

At the end of 2015, we forecast that the party couldn't last forever but the music would continue to play. As the Chinese Year of the Rooster approaches, will 2017 be a wake-up call for the market?

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Auckland Land Sales

CBD Land Sales

Address	Property	Proposal/Development	(m²)	Sale Price	$/psm	Date
155-167 Fanshawe Street	Ex-Caltex Site	No known consents.	3,879	$23,247,000	$5,993	Nov-16
38 Fort Street	Ex Brothel House	High-rise mixed use tower under construction.	282	$5,060,000	$17,943	Aug-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
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 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
201 Hobson Street	The Eve Apartments	Plans for residential apartments.	563	$4,700,000	$8,338	Apr-16
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
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 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
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
27 Rutland Street	Vacant	Plans for 12 level student accommodation development with 146 units.	309	$4,150,000	$13,430	Mar-15
70-74 Anzac Avenue	Abandoned Building	Plans and marketing underway for high-rise apartment development.	742	$6,000,000	$8,086	May-15

CBD Fringe Land Sales

Address	Property	Proposal/Development	(m²)	Sale Price	$/psm	Date
562-562A Richmond Road, Grey Lynn	Mixed Use	Retirement Village	4,501	$14,500,000	$3,222	Nov-16
57-59 France Street, Eden Terrace	Mixed Use	Kings Arms Tavern	2,112	$7,450,000	$3,527	Nov-16
103-104 Great South Road, Epsom	Mixed Use	1980's Office	2,076	$7,850,000	$3,781	Sep-16
10 Maidstone Street, Grey Lynn	Mixed Use	1980's Warehouse	634	$3,300,000	$5,205	Sep-16
7 Sarawia Street, Newmarket	THAB	1930's Flats	711	$3,100,000	$4,360	Aug-16
25 Exmouth Street , Eden Terrace	Mixed Use	1980s Warehouse / Office	2,053	$5,700,000	$2,776	Aug-16
3 Abbey Street, Newton	City Centre	1970s Office	607	$3,525,000	$5,807	Aug-16
15 Nugent Street, Grafton	Mixed Use	1980s Warehouse / Office	1,988	$6,700,000	$3,370	Aug-16
6 Akepiro Street, Mount Eden	Mixed Use	1980s Warehouse	1,681	$6,125,358	$3,644	Jul-16
159 Great North Road, Grey Lynn	Mixed Use	1970s Office	1,968	$8,000,000	$4,065	Jun-16
9 Madiera Lane, Grafton	Mixed Use	1980s Warehouse / Office	1,040	$3,550,000	$3,413	Mar-16
6 Nikau Street, Eden Terrace	Mixed Use	1980s Warehouse	903	$2,907,000	$3,219	Feb-16
22 Randolph Street, Eden Terrace	Mixed Use	Bare Site	1037	$3,100,000	$2,989	Feb-16

CBD Conversion Sales

Address	Property	Proposal/Development	(m²)	Sale Price	$/psm	Date
96 Albert Street	Media Design School	Plans to be converted into a hotel.	11,377	$36,000,000	$3,164	Oct-16
8-10 Whitaker Place	Whitaker Park Central	Plans to be converted into 80 units.	4,537	$16,500,000	$3,637	Mar-16
16-22 Anzac Avenue	Tasman House	Plans to be converted into student accommodation.	2,556	$6,400,000	$2,503	Dec-15
9 Princes Street	Ex Fonterra Building	Potential residential conversion.	12,389	$45,380,285	$3,663	Oct-15
10-12 Exmouth Street	The Citizen	Presales underway for conversion into 94 apartments.	3,530	$7,500,000	$2,125	May-15
8-10 Eden Crescent	Ex Cargen Hotel	Plans for conversion into heritage apartments.	2,991	$4,500,000	$1,505	Dec-14