INDUSTRIAL

property Research

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AUCKLAND

AUCKLAND INDUSTRIAL VACANCY FALLS AS LEASING MARKET PICKS UP

A strong economic backdrop has seen business confidence surging over recent months. New Zealand's GDP grew by 2.6% in the year to September 2013 while the Auckland region registered growth of 2.8% over the same period according to Statistics New Zealand and Auckland Council.

Business confidence is sitting at its highest level since 1999 according to the latest ANZ survey while the manufacturing sector registered the highest confidence in 15 years.

The impact of the improved economic drivers on the industrial sector is well illustrated by the results of *Bayleys Research's* latest industrial vacancy survey which has seen the vacancy within Auckland's leading industrial precincts falling from 5.5% to 3.8%.

The survey covers The Airport Corridor, Wiri, Penrose, Mount Wellington, Rosebank Road, East Tamaki and the Albany Basin. Vacancy in the 2014 survey, compared to last year, fell in all precincts with the exception of Wiri, where the figure remained all but unchanged.

AUCKLAND INDUSTRIAL VACANCY RATES

	2013	2014	
Airport	6.0%	4.5%	↓
Wiri	4.9%	5.0%	→
Penrose	4.1%	2.6%	↓
Mt Wellington	5.9%	3.8%	↓
Rosebank Road	5.0%	1.5%	↓
East Tamaki	5.9%	3.7%	↓
Albany Basin	5.4%	4.4%	↓
Auckland	**5.5%**	**3.8%**	↓

Source: Bayleys Research

The greatest percentage fall was recorded in the Rosebank Road precinct, although volatility is common in this area. The relatively limited size of the precinct means that changing circumstances in a small number of building can have a significant impact.

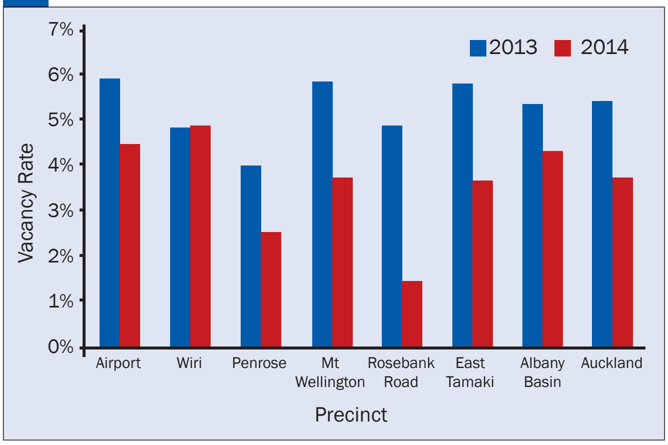
A more reliable trend can be drawn from longer term results across the larger precincts. At the time of the 2012 survey vacancy rates within the Airport Corridor, Wiri and Mount Wellington all stood at over 7% while in the 2014 survey all precincts sit below 5% vacancy. In the region's largest precinct, East Tamaki vacancy has fallen to below 4%. The tightening of supply is particularly acute in the 400m² to 800m² range in which less than 10 vacant units were recorded within the survey area, which covers approximately 1,000,000m², at the date of the vacancy survey.

The trends evident in precincts south of the Harbour Bridge are reflected in the North Shore's Albany Basin where the vacancy rate has fallen from a 2013 level of 5.4% to 4.4%. This result has been achieved despite the total inventory surveyed having increased by approximately 10,000m² as construction and refurbishment projects have ended.

The results reflect a strong year in the industrial leasing markets. Tenants have competed with owner occupiers to secure premises as businesses have moved into expansion mode at a time when the next development phase, hindered by a shortage of land, has yet to gather full momentum.

The limited supply of vacant space reflected by the latest survey results illustrates why rental levels have risen over the last year. Landlords have also been able to secure longer leasing terms as firms look to secure their position in the increasingly competitive environment.

VACANCY RATE BY PRECINCT - 2013 vs 2014



Source: Bayleys Research

The rise in rental values has been particularly pronounced at the higher end of the quality scale with high stud, clear span warehouses attracting the highest rents, due to their greater cubic capacity and lower cost per pallet position. The widening rental band has, as a result, forced companies to carefully assess their requirements before committing to leases. Many firms do not necessarily require high stud warehouses and can operate effectively from mid height premises. This has led some companies to opt for older style premises which may be larger than required but which can be obtained for a lower overall rental than a smaller high stud alternative.

The development sector has begun to react, however it is hindered by both a lack of available industrially zoned land and the values which such land now commands. Recent months has seen land values climbing sharply, reflecting the general lack of land supply within established precincts and the extremely limited amount of such land being brought to market.

Land values in leading precincts such as the Airport Corridor and East Tamaki have now exceeded their pre GFC peaks making speculative industrial development financially unviable. By way of example an 8,900m² development site in Pavillion Drive in the airport corridor precinct recently sold at a price equating to $345/m². A comparable land holding sold approximately 18 months ago at approximately $315/m² and agency opinion is that immediately pre GFC such land would have commanded a value of $250-$270m².

In East Tamaki land in Cryers Road recently sold at $400/m². Given these values, the cost to develop industrial premises built to current standards and specifications is in the region of $2,250/m². Given this background it is unsurprising that the sales value of existing premises has risen from, in the region of, $1,200/m² in 2011 to a current level of between $1,500/m² and $1,600/m² with further increases expected.

The increased costs act as a deterrent to development, particularly on a speculative basis. As a result, a majority of development activity, despite the tightening of the market, continues to be via the design build route. There are however developers who continue to be able to provide speculatively developed schemes. As a general rule these are individuals or companies which have landholdings which they have owned for an extended period of time, thereby negating the requirement to recover the costs based upon current land values to make schemes viable. Goodman Property Trust, for example, is currently developing a new 6,260m² warehouse premises at Highbrook Business Park. The property is due for completion in June. The building, at Business Parade North, will provide a high stud warehouse with a minimum 10 metre clearance, 400m² of offices and a 750m² canopy.

Auckland International Airport also continues to expand on its speculative development programme. The Airport Company recently developed "Flex", a warehouse and office development providing 10 small to medium sized units which were originally offered on flexible leasing terms.

Just one year since completion Flex is at 100% occupancy. The Airport plan to replicate this success with a further 7,280m2 of office and warehouse split into eight units. The Airport company is also developing a Duplex property located at The Landing with 6,810m² of office and warehouse split into two tenancies. The development has an expected completion date of early 2015.

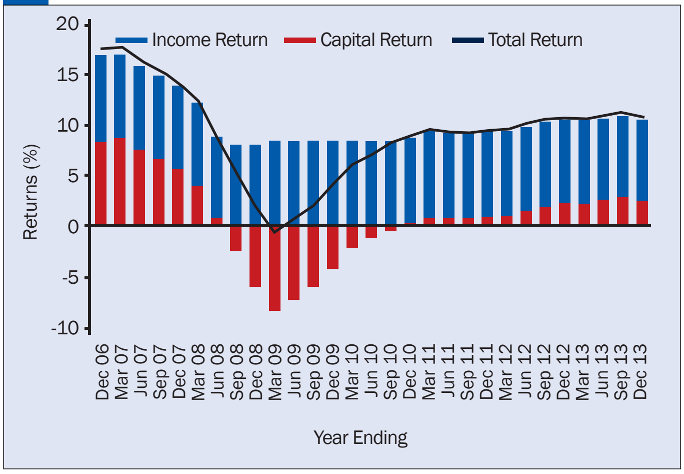
The warehouse is due to be completed in June 2014. The warehouse offers high stud industrial space with good operational areas, a large canopy and an office overlooking the yard area. The property also benefits from having proximity and ease of connectivity to New Zealand's largest transport hub.

The Airport Company also recently developed "Flex", a warehouse and office development providing 10 small to medium sized units which were originally offered on flexible leasing terms. The airport has reported a high level of success in the leasing of the project.

AUCKLAND RETURNS BEAT NATIONAL MARKET

The results of the latest Investment Property Databank (IPD) index show industrial property to have continued to provide consistent returns over the last year. In the 12 months to December 2013 industrial property generated a total return (return on income plus change in capital value) of 10.8%, the third highest figure recorded since March 2008.

TOTAL RETURNS INDUSTRIAL PROPERTY



Source: IPD, Bayleys Research

While returns from income tend to be consistent, generally sitting in a band between 8.0% and 8.5% the capital return element is rather more volatile. Following the Global Financial Crisis (GFC), capital values fell for nine consecutive quarters from September 2008. Capital appreciation returned to the sector in the final quarter of 2010 and in the year to December 2013 stood at 2.5%. The latest figure is the third highest recorded since the opening three months of 2008.

IPD runs a number of indices for industrial precincts within the Auckland Region, although given the smaller number of premises located within each one, returns are not calculated every quarter. In the year to December 2013 Mount Wellington located premises generated an annual return of just below the national average of 9.7% while the East Tamaki precinct generated returns of 11.4% over the same period. The figure for Penrose was last updated for the September 2013 quarter when it stood at 11.5%.

Over the longer term Auckland based property has tended to provide higher capital returns than over the country as a whole as illustrated in the table below. Whilst the average capital return from industrial property over the last 15 years has been 1.8% the return generated by Mount Wellington and East Tamaki located premises has been 2.0% and 3.2% respectively.

INDUSTRIAL PROPERTY CAPITAL RETURN

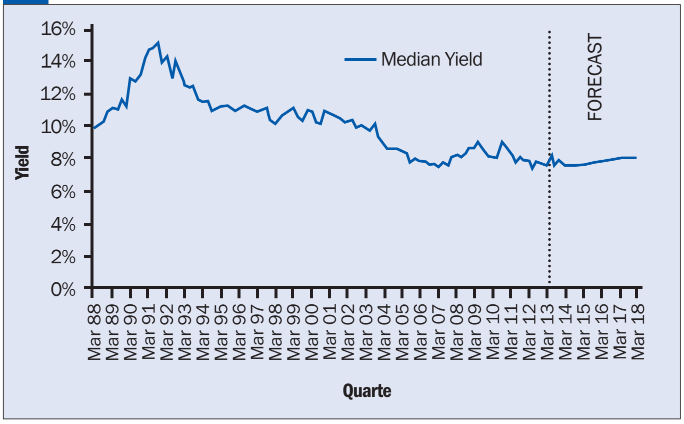
	NATIONAL	MOUNT WELLINGTON	EAST TAMAKI
1 Year	2.5%	1.4%	2.9%
3 Year	1.9%	2.2%	3.1%
5 Year	0.3%	0.0%	1.5%
10 Year	2.6%	2.8%	4.3%
15 Year	1.8%	2.0%	3.2%

Source: IPD, Bayleys Research

YIELDS FLATTEN AS RISK REDUCES

The median yield achieved from Auckland located industrial property investment sales in the final quarter of 2013 was 7.8% according to the latest *Bayleys Research* Auckland industrial yield index.

MEDIAN AUCKLAND INDUSTRIAL YIELD



Source: Bayleys Research

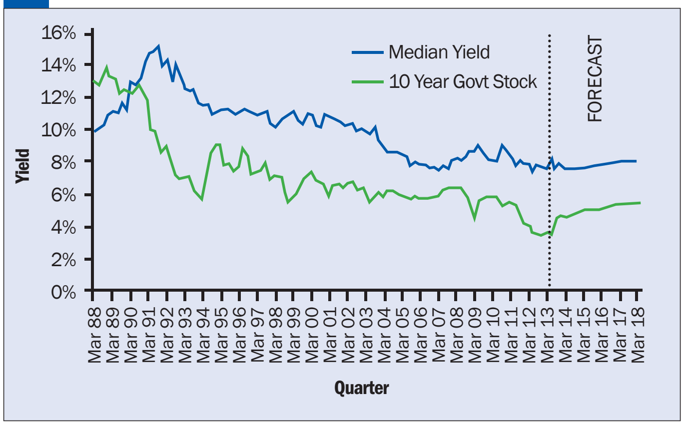
The median yield figure has sat in a tight band between 7.5% and 7.8% since the September quarter of 2012,.having fallen from over 8% in June of 2011.

Yields softened rapidly at the onset of the GFC and New Zealand's recession in late 2007 with the median yield increasing from 7.5% in the September quarter to a peak of 8.9% in the third quarter of 2010.

The increase in the median yield reflected the greater risk which characterised the industrial property market at the time as vacancy rates increased and rental levels fell.

The perception of risk in the market is illustrated in the graph below which shows the difference between industrial property yields and the return which can be achieved from a risk free alternative which is shown as New Zealand Government 10 year stock. The risk premium being the difference between the two figures. As the graph below illustrates, from the mid 1990's through to 2003 the risk premium generally sat at between 3.5% and 4%. Between 2003 and 2007 however the gap shrank significantly until in the September quarter 2007 it stood at just 1.1%.

MEDIAN YIELD v 10 YEAR GOVERNMENT STOCK



Consensus Forecasts *Source: Bayleys Research, NZIER*

As yields rose sharply over the course of 2008, the risk premium widened and it sat at over 4% from mid 2012 to mid 2013. It should be noted that this gap would have been wider still had it not been for the fact that very little high yielding secondary stock sold during the recession as investors dealt almost exclusively in prime property, thereby skewing the median yield figure.

Over recent months, however, as the economy has strengthened, the leasing market has tightened and rental growth has returned to the market. As a result the risk premium has again begun to shrink sitting at 3.1% at the end of 2013.

Given that the Reserve Bank of New Zealand has now begun to increase interest rates it is likely that yields will begin to soften, although, as the *Bayleys Research* Auckland industrial yield index has previously shown, yields only tend to react to long term changes in interest rates. Consensus forecasts compiled by the New Zealand Institute of Economic Research indicate that longer term interest rates, including Government stock, are also likely to rise. Therefore the current risk premium of approximately 3% seems set for a period of stability as both long term interest rates and yields rise over the next few months.

INFRASTRUCTURE UPDATE

Progress on Auckland's Western Ring Route has continued over the last year with the most significant aspect having been the commencement of tunnelling at Waterview which will, when finalised, complete the Western Ring Route project.

The $1.4b Waterview Connection is the largest roading project ever undertaken in New Zealand. It involves construction of 4.8km of six-lane motorway to link State Highways 16 and 20.

Half of this new motorway link will be underground in Australasia's largest road tunnel. It is anticipated that the project will be completed in early 2017 and will provide road users with an alternative to State Highway 1 when travelling between Auckland City's southern and northern suburbs.

In its latest update, the New Zealand Transport Agency reported that the tunnelling equipment had reached a distance of 537 metres.

Completing the Western Ring Route

Source: NZTA

The route will significantly improve connections between established business precincts in the South of the City with rapidly expanding precincts in the north west. Journey times between the Port of Auckland and Auckland International Airport will also be reduced while the alternative north south route will also reduce traffic dependence on State Highway 1 and the Harbour Bridge.

OUTLOOK

The economic backdrop for the balance of 2014 is very positive. GDP growth is projected to grow, in the region of 4% in the 2014 calendar year. The NZIER consensus forecasts are for the unemployment rate to fall to 5.4% by March 2015 and 5.1% by March 2016.

NATIONAL INDEXES

	Mar 2009	Mar 2010	Mar 2011	Mar 2012	Mar 2013	Mar 2014
BNZ - BusinessNZ PMI (s.a.)	41.8	56.3	49.3	53.9	53	58.4
Production (s.a.)	38.9	59.2	48.7	55.9	52.9	60.5
Employment (s.a.)	39.8	49.7	51.7	50.9	51	56.3
New Orders (s.a.)	42.6	57.6	48.9	56.3	54.6	60.5
Finished Stocks (s.a.)	46.9	53.7	48.8	49.7	50.7	51.1
Deliveries (s.a.)	40.9	56.3	46.5	51.5	52.7	57.1

(s.a.) Seasonally Adjusted

Source: BNZ, Bayleys Research

Business confidence sits at multi year highs according to the latest ANZ business confidence survey. Most encouragingly, companies' expectations for their own business continue to be far higher than at any time since the mid 1990's.

The manufacturing sector has now been in expansion mode for 18 consecutive months according to the BNZ Bank's latest PMI survey. The survey also found almost all manufacturing sub groups to be expanding. The results of the latest survey are shown in the table above. A PMI reading above 50 points indicates manufacturing activity is expanding; below 50 indicates it is contracting. The main PMI and sub-index results are seasonally adjusted.

While there will be economic headwinds, primarily higher interest rates as the year progresses these have, as yet, not impacted upon business confidence.

It is anticipated that business confidence will increasingly translate into greater investment and growth. In terms of the property market this equates to a greater requirement for space which, given the already low vacancy rates, will drive upward pressure on rentals. This will in turn make more development schemes financially viable spurring an increase in construction and competition for development land.

Hannigan Drive, St Johns

Sold by Tender for $4,876,500 at a yield of 6.6%

INDUSTRIAL TRENDS TABLE 2014

Precinct	Standard Lease Type	Rental Market ($\$/m^2$) Warehouse	Rental Market ($\$/m^2$) Office/Show	Rental Trend	Leasing Market Demand	Leasing Market Supply	Cap Rate (Yield) Yield	Cap Rate (Yield) Forecast	Investment Market Demand	Investment Market Supply	Land Value ($\$/m^2$)
Wairau Valley	Net	$90-$120	$120-$220	Steady	Strong	Scarce	6.0%-8.0%	Steady	Strong	Scarce	$500 - $1,000
Albany/North Harbour	Net	$100-$120	$160-$250	Steady	Sufficient	Scarce	6.25%-7.75%	Steady	Strong	Scarce	$400 - $550
Silverdale	Net	$90-$120	$140-$220	Steady	Strong	Scarce	7.0%-8.0%	Steady	Steady	Sufficient	$250 - $350
Auckland City Fringe	Net	$100-$120	$160-$220	Steady	Strong	Scarce	8.0%-9.0%	Steady	Strong	Scarce	$800-$1,400*
Penrose	Net	$90-$120	$140-$220	Steady	Strong	Scarce	7.0%-9.0%	Firming	Strong	Scarce	$350 - $500
Mt Wellington	Net	$90-$120	$140-$220	Steady	Strong	Scarce	7.0%-9.0%	Firming	Strong	Scarce	$350 - $000
West Auckland	Net	$90-$120	$150-$200	Steady	Strong	Sufficient	7.5%-10.0%	Steady	Strong	Scarce	$200 - $450
Rosebank Road	Net	$60-$120	$100-$200	Steady	Strong	Scarce	8.5%-9.5%	Steady	Strong	Scarce	$290 - $450
East Tamaki	Net	$90-$125	$130-$225	Steady	Strong	Scarce	7.0%-8.0%	Steady	Strong	Scarce	$350 - $450
Airport	Net	$85-$115	$120-$225	Steady	Strong	Scarce	7.5%-9.0%	Steady	Strong	Scarce	$325 - $375
Manukau/Wiri	Net	$85-$110	$110-$200	Steady	Strong	Scarce	8.0%-9.50%	Steady	Strong	Scarce	$260 - $325

*** Estimated due to scarcity of transactions*
** For alternative land use*

Source: Bayleys Research

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