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Challenges and opportunities for NZ commercial property sector

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After seven years of sustained growth, the NZ commercial property sector is facing challenging times in light of concerns about short terms adjustments to pricing and valuations.

However, opportunities remain for savvy investors according to CB Richard Ellis forecasts at the firm's annual Market Outlook breakfast presentation in Auckland.

Breakfast presenter Bruce Whillans, National Director of Institutional Investments for CBRE, believes the NZ market has been hit by what he calls the "perfect storm".

"Markets do this now and again, but the shakeout this time around is particularly severe," says Whillans.

"At the top end of the commercial property market, sales have fallen to their lowest level in 15 years with sales over \$5m down 60% for the first half of 2008 compared with the first half of 2007. However, though confidence is understandably at a low ebb, the commercial sector, in particular, still enjoys historically low vacancy levels and lease terms, whilst declining, are still good and under renting is prevalent."

So what does this mean for the future?

In Whillans view, institutional investment levels will remain lackluster for the next 12-18 months as the market settles and the effects of sales and re-valuations establish new benchmarks. However he says new buyers are already emerging to fill the void.

"We are already seeing a noticeable increase in enquiry from the private sector. A similar trend can be seen in Australia," says Whillans.

"We are also experiencing a resurgence of interest from the cashed up South East Asia region from investors who are comfortable with New Zealand as an investment destination."

Whillans says enquiry from Europe, particularly Germany and the UK, is also healthy. This is mainly represented by high net worth private investors and closed end funds chasing income returns.

Of all the sectors, however, it is the development arena which is likely to see the greatest change.

"Private developers have become an endangered species," says Whillans.

"With a total reliance on debenture generated funds, their return in the near future is unlikely. As a result the development land grab is over, with vacant land often considered more of a liability than an asset. "

Development in New Zealand has traditionally been the domain of privates supported by the finance industry. Now, Whillans says much of the enquiry on the development front is coming from Australian corporates interested in stepping into some of the better projects to take advantage of existing consents and record low land values.

"Very rapidly we are going to see a changing of the guard with corporates dominating the development market," says Whillans.

The Auckland office leasing market will be another focus of next week's CBRE Market Outlook breakfast.

CBRE Office Services negotiator and breakfast presenter Campbell Pritchard says he will be urging "forward looking" landlords not to be distracted by the current low office vacancy rates.

"In my opinion, they are an artificial indicator of the way market power is currently evolving," says Pritchard.

"With many businesses feeling the pinch financially, we're noticing an increasing number of tenants looking to sublease and assign space to cut costs. I believe that this increase in sublease and assignment space is a more accurate, real time indicator of the state of the market."

Pritchard warns that the sublease market is just the peak of what he describes as the approaching "vacancy iceberg".

"Additionally, many major Auckland tenants will move into new CBD premises over the coming 12 months - moves that will free up a lot of space within the CBD," says Pritchard.

"So landlords, don't be misled by the current low head-lease vacancy rates. Instead, in a market of increasing options for tenants you should be thinking about steps you can take to minimise your vacancy rates and maximise your profits going forward."

He recommends various strategies for office landlords - one being to have a master building plan for all the assets in their portfolios.

"Being well informed and prepared is essential," says Pritchard.

"Landlords should know their tenancy makeup intimately. They should also have a similar knowledge of their competitors' buildings and be aware of any points of difference. For the landlords that know they are going to lose large tenants to new developments, they should be reviewing that space now and planning how to fill it."

Landlords who have multiple floor plates becoming available should start marketing as early as possible, pushing the message that they will be investing the necessary capital into the space.

"The objective may well be to secure a single large tenant, but landlords should have a set date when they shift emphasis to subdividing and marketing the space to more numerous smaller tenants," says Pritchard.

"The real up-side of having smaller tenants is that a premium can be charged for smaller spaces, allowing the buildings overall rental income to buck the trend of softening rental rates over the next two years."

His final word of advice for landlords whose buildings are fully tenanted is that "The Tenant is King".

"Court existing tenants approaching lease expiries with more vigour - they should be approached with similar incentives offers as potential new tenants," says Pritchard.

"Moving is expensive but that will not guarantee that your current tenants stay put. Remember there will be landlords around who are offering large incentives to shift into what may be considered more desirable space at cheaper or similar rental rates."

The Auckland industrial sector will be another focus of next week's CBRE Market Outlook breakfast.

CBRE Industrial Associate Director and breakfast presenter David Arlidge says the softening of yields for industrial investment property remains the most topical issue confronting the industrial sector.

Arlidge says industrial yields have shifted out by between 100 - 200 basis points which is "changing the whole game and bringing with it a raft of new opportunity.

"To say that all industrial property has been drastically devalued as a result of the recent events in the debt markets is generalist and misleading," says Arlidge.

"The yields for secondary industrial property over the past three years had become out of control - primarily driven by the owner occupier market and significant funds being available coupled with a lack of prime investment opportunities. Consequently, yields for secondary stock moved within 20-40 basis points of prime investment stock. "

As a result, Arlidge says it is logical that the secondary market will adjust and this will create challenges for the owners of non-core assets wanting to reduce debt or re-capitalise.

Says Arlidge: "Our advice is to focus on repositioning secondary assets for when the market bounces back. Refurbish, renegotiate long term leases and look to hold. In this market the best way to maximise realisation outcome is through the disposal of prime passive properties or value-add opportunities in markets with strong fundamentals and growth prospects."

On the opportunity side, he recommends buyers look at secondary properties of between 1000 square metres and 3,000 square metres which can be repositioned to capitalise on the lack of quality buildings in traditional, industrial-zoned locations.

"Tenants want quality and will pay for the right product," Arlidge concludes.

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