



OBSERVATIONS FROM PAST PROPERTY CYCLES AND THEIR IMPLICATIONS FOR THE FUTURE

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SUMMARY

- Negative net absorption has not been a major feature of past downturns.
- Supply has been the main vacancy driver with a double whammy effect during periods of absorption losses.
- There is no such thing as a fixed rental equilibrium vacancy point.
- Rents respond to the direction and speed of vacancy moves and strength of demand with varying lags.
- Market fundamentals show a clear influence on yields.
- Yields can rise even when interest rates are rapidly falling during periods of significant deterioration to fundamentals.

While the relationships of property and economic variables during past cycles are not foolproof indicators of the way future cycles may unfold, they do provide useful precedents to draw on. The recent dramatic changes in the property market and broader economy have resulted in a range of opinions being expressed on the way the property cycle will unfold in 2009 and beyond.

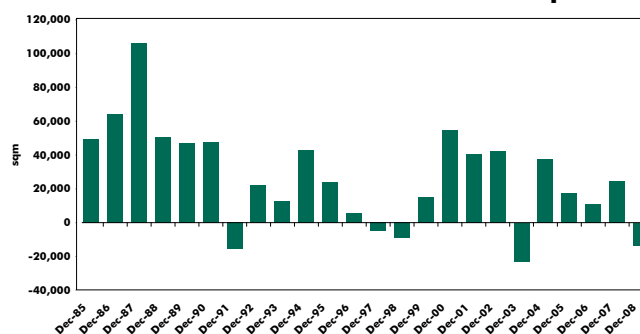
This publication examines the way various aspects of the property market have responded both to each other as well as to economic drivers through the two previous cycles of the mid 1980s to mid 1990s and the late 1990s to now. The analysis relies on the Auckland CBD office market for which CBRE has the most detailed and longest standing time series, although the experience of other sectors are not thought to be drastically different.

DEMAND AND SUPPLY vs VACANCY

Auckland CBD office net absorption was negative during 5 of the last 24 years. There has been a clear correlation between negative absorption and the economic recessions of 1991, 1998 and 2008. In addition, the private education sector downturn in 2003 also resulted in demand turning negative.

Any amount of negative absorption causes pain to those exposed to its effects. However, in the context of the 19 years when net absorption has been positive, the impact of negative absorption since the mid 1980s has been relatively minor on the property market. In total, 700,000 sqm of space was absorbed compared to 65,000 sqm of negative absorption¹.

Auckland CBD Office Net Absorption

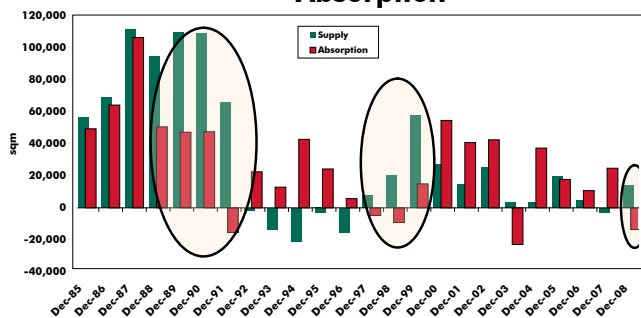


Source: CBRE Research & Consulting

While negative absorption has not been a major market feature, supply has been an important cyclical vacancy driver. During both previous downturns, the development cycle was in full swing with substantial amounts of new space being completed. Some 175,000 sqm came on the market during 1990-1991 and 78,000 sqm during 1998 and 1999.

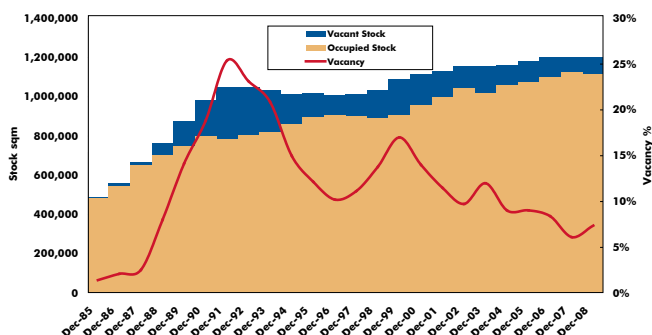
1) absorption calculations exclude sublease space put on the market by occupiers that is not physically vacant and therefore understate the true extent of demand contraction. However, the impacts of such sublease space are indirectly captured through their dampening effect on the net absorption of physically vacant space.

Auckland CBD Office Supply vs Absorption



Source: CBRE Research & Consulting

Auckland CBD Office Stock & Vacancy



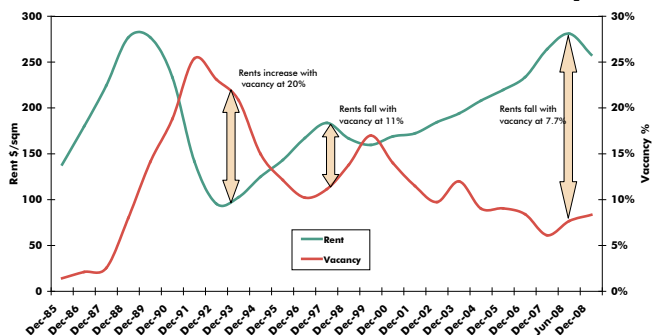
Source: CBRE Research & Consulting

The chart above illustrates the dramatic impact of new supply on vacant space with most of the large increases in the size of the vacant stock coming from increased supply as opposed to reductions in occupied stock.

VACANCY vs RENT

Equilibrium vacancy is sometimes alluded to as a fixed point. When vacancies rise above this point rents are supposed to fall, when vacancies fall below the equilibrium point rents should rise. In practice however there is no such thing as a fixed equilibrium vacancy.

Auckland CBD Office Rent vs Vacancy

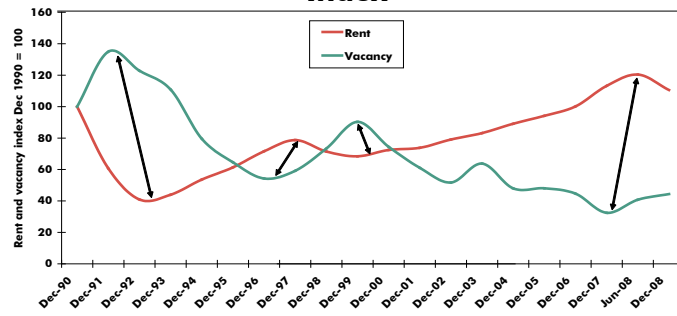


Source: CBRE Research & Consulting

To illustrate, vacancies were around 20% in 1993 when net effective rents bottomed out and started to increase. By contrast, during the late 1990s, rents started to fall when vacancies were at 11%.

While the ultimate size of the vacancy rate influenced the extent of rental falls and rises, rents responded to the direction and speed of vacancy moves and the strength of demand. There have been various lags between vacancies turning and rents following ranging from 18 months in the early 1990s to 6 months in the early 2000s.

Auckland CBD Office Rent vs Vacancy Index

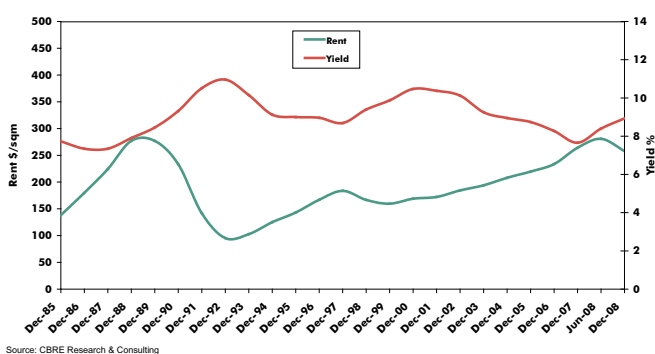


Source: CBRE Research & Consulting

RENT AND INTEREST RATE vs YIELD

Changing market fundamentals, as reflected in rental changes, have repeatedly shown up an inverse relationship to yields. The early 1990s rental contraction was accompanied by increasing yields and the subsequent rebound in rents was closely mirrored by falling yields. This pattern was also repeated in the 1998-2007 cycle.

Auckland CBD Office Rent & Yield

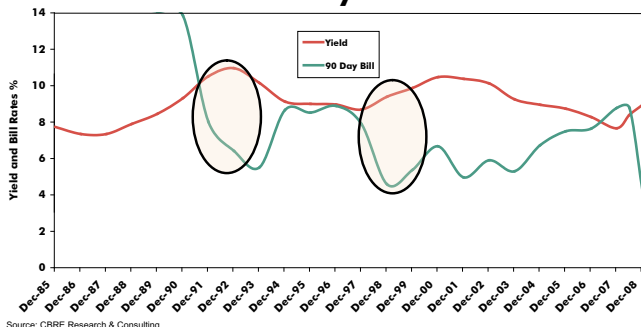


Source: CBRE Research & Consulting

The influence of market fundamentals on yields means that yields can rise even when interest rates are rapidly falling. During previous downturns, the Reserve Bank

significantly slashed interest rates in similar moves to that currently being experienced. Between December 1990 and December 1992, 90 day bill rates fell from 13.8% to 6.4%, while between December 1996 and December 1998 they fell from 8.9% to 4.6%. Yields have increased during both of these periods.

Auckland CBD Office Yield & 90 Day Bill



Conversely, during periods of improving or strong market fundamentals, principally during the 2004 to 2007 period but also in the mid 1990s, yields have decreased even with rising interest rates.

IMPLICATIONS FOR CURRENT CYCLE

Net absorption has already turned negative in 2008 and, given the economic outlook, will most likely remain negative in 2009. As a result, vacancy has increased in all sectors during the past year and will continue increasing this year. However, given the importance of supply as the major driver of vacancy increases, the ultimate cyclical vacancy peak will be heavily influenced by the size of the construction pipeline.

While the construction pipeline is more moderate than in the late 1980s/early 1990s cycle, it is sizeable in some sectors.

Confirmed Future Supply Pipeline

Sector	Increase on current stock	
CBD Office	9%	108,000 sqm
Non CBD Office	5%	60,000 sqm
Industrial	c2%	c175,000 sqm
Retail Centre	3%	30,000 sqm

The CBD office supply cycle has ramped up in 2008 and has the largest and most sustained pipeline, with confirmed additions increasing total stock by around 9% to the end of 2011. Supply in Non CBD offices has been high in 2007 and 2008 and the momentum will sustain through 2009. Confirmed supply will add 5% to stock, but beyond 2009 the pipeline drops significantly. The industrial and retail supply pipelines are on a downward trend following earlier peaks. We expect that around 2%-3% of the current stock will be added to these markets during 2009 and 2010.

The above implies that the vacancy threat is greatest in the CBD office market. However, in the absence of positive absorption, a 2% or 175,000 sqm increase in industrial stock could still have a sizeable proportionate negative vacancy impact given that the current stock of vacant space is 318,000 sqm.

Our observations from previous cycles indicate that rents don't respond to fixed vacancy equilibriums but the direction and velocity of vacancy changes coupled with the strength of demand. This implies that despite vacancies reaching cyclical lows over the past five years to levels well below long term averages in every sector, the rental impact of rising vacancies will be negative.

The supply profiles of the various market sectors, combined with their locational and precommitment attributes, will drive some variation in performance. However, effective market rents are forecast to fall during 2009 even if the extent of falls will be moderated by lower vacancy peaks.

To what extent will falling interest rates offset deteriorating fundamentals remains to be seen. Some economic commentators predict further aggressive interest rate cuts during 2009. The experience of the early and late 1990s downturns however suggests that if the fundamental supply/demand and rental drivers deteriorate sufficiently during 2009, yields will ease further.