MaxCap Group

NEW ZEALAND ECONOMIC AND COMMERCIAL REAL ESTATE UPDATE

DECEMBER 2021

NEW ZEALAND ECONOMIC AND COMMERCIAL REAL ESTATE UPDATE

OVERVIEW

- The New Zealand economy has exceeded expectations.
- The unemployment rate has fallen to 3.4%.
- $800 billion of additional household wealth is estimated to have been created in just two years, more than two times annual gross domestic product (GDP).
- Inflation is rising, driven by supply challenges and an economy hitting capacity constraints.
- Interest rates are on the ascent. Market expectations are the Official Cash Rate (OCR) could rise a further 185 basis points.
- Low unemployment and economic strength are supporting the property market, but market fundamentals have moved. Interest rates are rising, and residential building consents are surpassing population growth by a considerable margin.
- Supply challenges are nonetheless restraining the speed by which consents can turn into a finished product and a fundamental shortage of housing remains.
- Uncertainty surrounds the enduring impact of COVID-19, though New Zealand entered this era in a strong position.
- Over the near to medium term, we see the best value in selective investments into larger-scale subdivision and high-density residential, which remain structurally under-supplied against prevailing and forecast market demand; andopportunistic acquisition/value-add commercial and accommodation assets positioned to benefit from upside risks to migration and tourism (following border re-openings).

Unless otherwise stated, all amounts are in New Zealand dollars

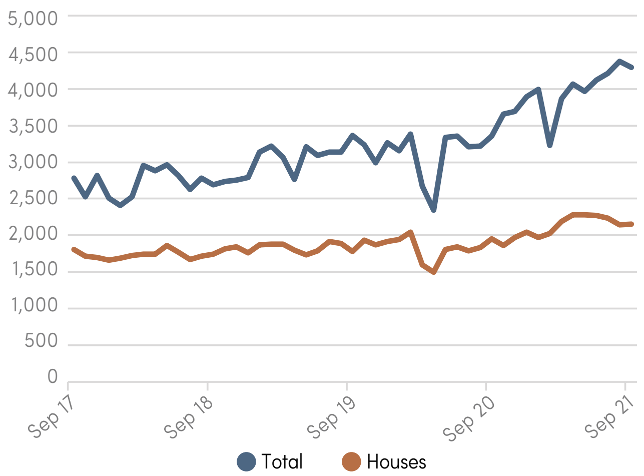
MARKET COMPOSITION

TABLE 1: KEY MEASURES

KEY MEASURES	NUMBER
Estimated resident population	5,126,300
Population growth (last 12 months)	27,500
Number of private dwellings	1,973,500
Households estimate (number)	1,883,900
Residential building consents issued (total): • Houses • Apartments • Townhouses /units	47,331 25,445 4,149 21,886
Residential building consents issued (total) Auckland	19,886
New homes consented per 1000 residents (national)	9.2

Source: Statistics NZ

GRAPH 1: NEW DWELLINGS CONSENTED MONTHLY



Source: Statistics NZ

THE ECONOMY – GOOD NEWS

The New Zealand economy exceeded expectations in the past year. Elimination of COVID-19 in 2020 was matched by a V-shaped recovery, boosted by expansionary fiscal and monetary policy, and strong rural incomes.

Money previously spent on offshore travel has been directed into the economy, mitigating the impact of a collapse in tourism visitors.

Construction activity is very strong, restrained only by worker and material availability. Indicators point to an economy operating above its operating potential and capacity.

The housing market remains strong. Property prices continue to move up, with house prices rising 3.3% in the month of October and 7.1% over three months. The net wealth of households rose $300 billion in 2020 and in the order of $500 billion in 2021. Those gains are delivering huge impetus to consumption via the wealth effect.

Signs of financial stress are limited. Bank non-performing loans are low, and people are paying off credit card debt.

Commodity prices are strong. Dairy farmers are looking forward to a strong dairy pay-out with a pay-out potentially $8-9 per kilogram of milk solid produced. The break even on a dairy farm is a bit below $6.

The labour market is particularly strong. The Reserve Bank of New Zealand (RBNZ) estimates that New Zealand is above maximum sustainable employment. Firms are struggling to source skilled and unskilled staff, putting pressure on wages to rise sharply.

GRAPH 2: UNEMPLOYMENT RATE

Source: Statistics NZ

THE ECONOMY – CHALLENGES

The return of COVID-19 is a reminder that 2020's elimination simply bought time to prepare for the inevitable. Uncertainty surrounds the enduing impact of COVID-19 and likely shifts in behaviour. The rising vaccination rates are allowing the economy to progressively open.

Unless otherwise stated, all amounts are in New Zealand dollars

The December quarter is historically the most important trading period for many firms, contributing the largest share of annual cash flows and supporting softer periods of the year.

Alert level restrictions are suppressing this activity and productivity which will invariably hit profitably and available cash flow in early 2022.

Alert level restrictions are suppressing activity and productivity which will invariably hit profitability and available cash flow in early 2022.

Population growth has slowed from a pre COVID19 trend of 90,000 per year to less than 30,000. While there are expectations many New Zealanders' offshore will return, there is also the risk many will depart. Migration flows to Australia are key to watch.

Some nervousness is being expressed towards China. China is a key trading partner for New Zealand, with some sectors (such as Forestry and Dairy) having significant concentration risk.

Cost pressures are becoming more persistent. Inflation is rising and unless matched by equivalent pay rise, it will leave households worse off.

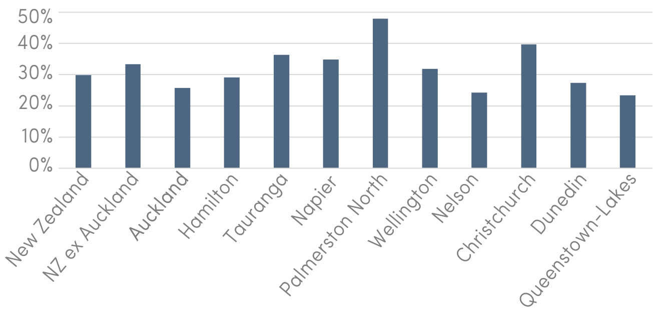
Capacity pressures are rife across the country, ranging from skill shortages to material availability.

Uncertainty surrounds how household spending and business investment will respond to ongoing health uncertainties with COVID-19 set to become more widespread geographically. High vaccination rates are mitigating the impact on the health system.

RESIDENTIAL HOUSING

House prices across New Zealand have increased rapidly, rising 29.9% in the past year, and 10.4% on average over the past five years. A key feature that has been a consistent strength across all geographical areas.

GRAPH 3: ANNUAL HOUSE PRICE GROWTH



Source: REINZ

The median days to sell October 2021 was 34, five days higher than October 2020. This mostly reflects Auckland where days to sell rose from 30 to 45. Excluding Auckland days to sell was 30, one day higher than a year ago.

Rapidly rising house prices reflects six key factors

1. The low international interest rate environment.
2. Incredibly stimulatory monetary conditions including the RBNZ's Large Scale Asset Program (now ceased). Interest rates have risen of late but remain low.
3. Favourable domestic economic conditions.
4. A fundamental shortage of housing reflecting years of under-build, and low consent issuance relative to population growth.
5. Structural impediments constraining the ability of supply to respond to demand signals including land availability and council delays.
6. Credit availability and requirements from the RBNZ banks hold more capital favouring mortgage lending over business lending.

Surging house prices has resulted in four responses

1. **Loan-to-value ratio restrictions.** The RBNZ reinstated loan-to-value (LVR) restrictions in early 2021 and tightened them further in September 2021. The restrictions are tighter for both owner occupier and investors than pre COVID-19.
2. **Consultation on debt serviceability restrictions.** The Minister of Finance agreed in July 2021 to add debt serviceability restrictions (DSRs) to the Memorandum of Understanding on macroprudential policy. DSRs build borrowers' buffers against serviceability shocks, such as a rise in interest rates. RBNZ removed LVR restrictions on 30 April 2020. Consulting on DSRs begins in late November. The consultation cover debt to-income (DTI) limits and floors on the test interest rates that banks use in their debt serviceability assessments.
3. **A joint Labour and National party initiative to boost housing supply.** This includes new intensification, allowing buildings of up to three storeys on most city sites without any need for resource consent from August 2022. This is in addition to numerous other initiatives aimed at both demand and supply.
4. **Widespread initiatives by the government.** Initiatives include a $3.8 billion Housing Acceleration Fund to speed up infrastructure funding for new housing, building more public and transitional housing, and support to first home buyers by raising income and price caps on First Home Loans and Grants.

Unless otherwise stated, all amounts are in New Zealand dollars

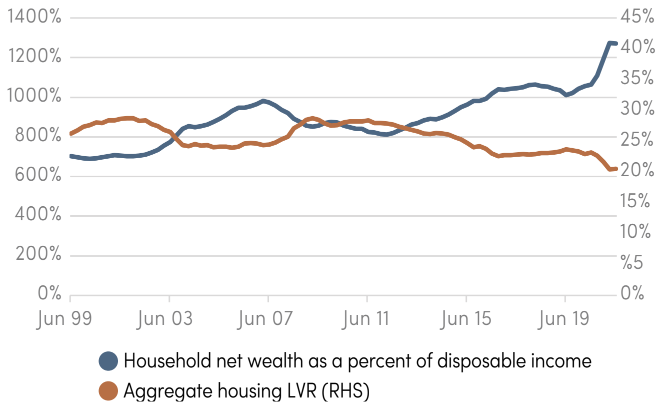
Rising risks

The RBNZ views house prices as unsustainable, citing rising interest rates, accelerating supply, tax changes on housing and tighter credit conditions. The RBNZ is projecting a slight easing in house prices of 5.3% over 2023 and 2024.

They also note that household balance sheets and debt serviceability have strengthened over the past six months. Net wealth has risen sharply, and leverage has fallen. Most households appear to have a substantial equity or net wealth buffer, should house prices ease.

However, first home buyers who have entered the market late, and have less wealth to absorb a fall in house prices could be vulnerable.

GRAPH 4: AGGREGRATE HOUSING SECTOR NET WEALTH AND HOUSING LEVERAGE



Source: RBNZ

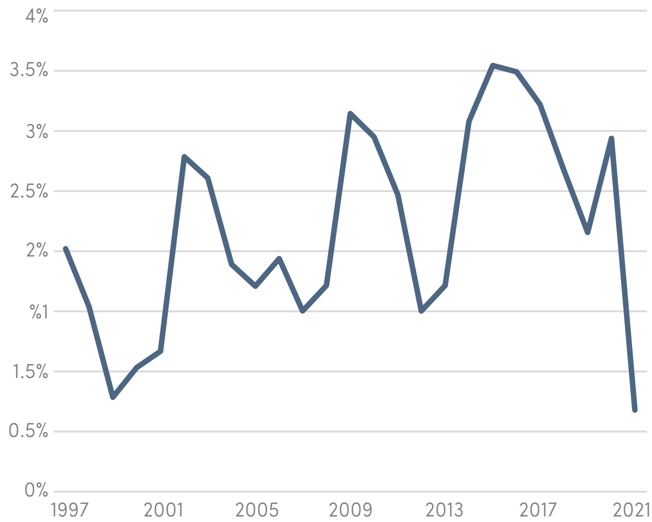
Housing balance

Economist estimates continue to point to a shortage of housing across New Zealand reflecting years of under-build and population growth materially exceeding supply. The shortfall is circa 25,000 in Auckland, and 70,000 across the entire country.

Changing intra-regional migration patterns are shifting housing demand with growing signs in rental data and social housing waiting lists of deepening housing challenges in regions.

Over the past three years, Auckland has seen an internal migration loss of 36,000, equivalent to the population of Upper Hutt or Gisborne (city) deciding to live elsewhere. Beneficiaries have been Northland, Waikato, and the Bay of Plenty. There are some signs this is broadening beyond these areas.

GRAPH 5: POPULATION GROWTH / BUILDING CONSENTS



Source: Statistics NZ, Bagrie Economics

Shifting housing fundamentals

While the housing market continues to be supported by constrained supply, pre-existing shortages, still historically low interest rates and low unemployment, the fundamentals for housing are shifting on four levels.

Rising interest rates

Rental yields continue to ease at a time the interest rate cycle has turned and proxies for the risk-free rate, such as the 10-year government bond, have lifted. This is compressing investors compensation for risk.

Slower population growth

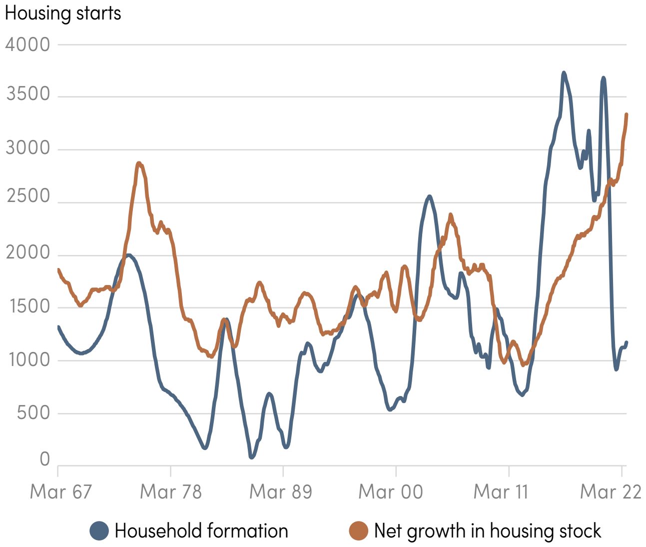
Population growth has eased from trending at 90,000 (and surging to more than 100,000 pre-COVID-19) to around 30,000. At the same time, building consent issuance has surged. The RBNZ estimates that growth in the housing stock is now exceeding household formation, thereby reducing housing shortages. Subject to availability of materials (which is pushing out residential delivery time), building consents data suggest a significant pipeline of new houses will become available by the middle of next year. New building activity is at record high levels.

Changes to tax settings

Housing investment returns have declined for existing houses following the removal of the tax deductibility of interest expenses from rental income. The extension of the bright-line test for tax on capital gain could also change some investors' expected returns.

Unless otherwise stated, all amounts are in New Zealand dollars

GRAPH 6: HOUSING DEMAND VS SUPPLY (MONTHLY, 12 MONTH MOVING AVERAGE)



Source: RBNZ

Tighter bank lending rules

The RBNZ has tightened LVR's a second time this year and is consulting on debt serviceability restrictions. Banks are reporting tighter anticipated credit conditions.

Intensification

Building consent issuance has risen rapidly in the past few years.

A major contributor has been accelerating consents for townhouses, flats and units which have almost doubled since 2019 and risen 269% since 2016.

The number of building consents in Auckland has risen from 14,634 to 19,886 in two years. Over the same period consents for townhouses/units has risen from 7,924 to over 13,000.

TABLE 2: RESIDENTIAL BUILDING CONSENTS ISSUED (NUMBER)

	2019	2020	2021
Houses	21,957	22,128	25,445
Apartments	4,505	3,368	4,419
Retirement village units	2,310	1,959	2,612
Townhouses, flats, units	7,678	10,279	15,125

Source: Statistics NZ

Over the past four years there has been a strong focus in the residential sector on delivery of higher density / infill development, mainly in the form of small to medium scale townhouse / terrace house / walk-up apartment type product.

While welcome, addressing housing shortages ultimately requires land freed up, and Greenfields's development, particularly larger scale, in association with Brownfield development.

COMMERCIAL PROPERTY

Overall

New Zealand commercial property performed well in the past year generating a total return (income and capital growth) of 14.9% to June 2021.

Commercial activity continues to be underpinned by low interest rates, buoyant economic activity (outside of alert level restrictions) and investors seeking solid investment yields with deposit yields still below the annual rate of inflation, thereby generating a negative real return.

Measures lessening the attractiveness of residential investment including limitations on interest deductibility, restrictions on rent review frequencies, and an extension of the bright-line test from five years to 10 years has resulted in an uptick in interest in commercial property from residential investors.

Divergence is a key theme and investors appear to be basing investment decisions on assessments of individual property prospects as opposed to wider trends. This is expected to intensify with interest rates rising and more attention on adding and extracting value.

Bank non-performing loans for commercial property are low at 0.2% of commercial loans according to the RBNZ's Financial Stability Report. Bank lending on commercial property development is also low at around 0.4% ($2 billion) of total bank lending, though bank lending on commercial property is far higher at around 8% of total bank lending.

A key uncertainty is how consumers businesses adjust to COVID-19 being entrenched in New Zealand; what this means for tenant demand is lower quality office and retail sites. Redevelopment opportunities are likely to present themselves with signs of rising vacancy rates in aspects of retail and office commercial property.

Unless otherwise stated, all amounts are in New Zealand dollars

Retail

Retail is facing mixed conditions. On one hand, retailing has been stellar with sales bouncing back incredibly well post the first lockdown in 2020 and exceeding expectations in the first half of 2021. There is hope a similar bounce-back will be seen heading into the Christmas period. Strong gains in house prices supporting the wealth effect on spending, low unemployment and rising wage gains provide a good backdrop for retailing.

However, ongoing border and movement restrictions are challenging with the December quarter the most important quarter of the year for retailers. Retail properties continue to face competition from online e-commerce platforms, and this trend has been reinforced by the pandemic.

Retail vacancy rates have risen to around 9% with Auckland absorbing three large mall developments.

Demand is holding up better in suburban areas. As consumers adjust to dealing with COVID-19 on an enduring basis, there is the risk demand for less attractive retail sites could ease further. Central business districts are seeing less foot traffic.

Building consents for shops, restaurants and bars has been easing over the past three years.

Industrial

Industrial remains the outperformer, supported by growth in demand for distribution centres reflecting increased online shopping and data centres.

Consumer shifts to e-commerce have accelerated during Covid. Industrial vacancy rates are low. Supply is responding to demand with building consents for storage buildings of $863 million in the past year, and $897 million for factories and industrial buildings.

Large developable sites well connected to transport infrastructure (logistics) are in demand.

Office

Quality counts when it comes to office space. With working from home the new normal, workers and employers desire quality workplaces when they are in the office, with greater distancing options.

The past decade has seen limited high-grade office space come to the Auckland market. Capacity in Wellington continues to recover from a loss of stock after the Kaikoura earthquake in 2016.

Lower-quality office buildings are at risk of increasing vacancies.

Office vacancy rates have risen to around 9%.

Tourism

Critically dependent on borders reopening, which is set to occur from Q2 2022. Some opportunistic buying / value-add and refinancing opportunities appearing and seem to be driven by the expectations that the sector will see a reversal of fortunes over coming months as borders open. Banks remain wary towards the sector which is driving enquiry towards non-banks.

TABLE3: BUILDING CONSENTS ISSUED ($ MILLION)

	2019	2020	2021
Factories and industrial buildings	640	566	897
Storage buildings	832	976	863
Shops, restaurants, and bars	668	545	489
Office, administration, public transport	543	506	609

Source: Statistics NZ

INTEREST RATES

Expectations for interest rates have changed materially in the past six months. The RBNZ has gone from projecting an unchanged Official Cash Rate (OCR) until the second half of 2022 in May 2021, to lifting the OCR in October and November 2021.

The reason has been an economy that has exceeded expectations despite the impact of recent lockdowns and an aura of uncertainty over COVID-19.

The headline inflation rate has risen to 4.9%. Some of this increase reflects higher oil prices, rising transport costs and the impact of supply shortfalls. However, capacity pressures are apparent in the economy, particularly in the labour market, and this is putting pressure on prices to rise. There is a risk that recent price rises will become imbedded in pricing expectations going forward.

The household debt servicing burden is currently low, reflecting low interest rates. The household debt servicing ratio (interest payments relative to income) is below 6%. It's average since 1999 is 9.4%.

Unless otherwise stated, all amounts are in New Zealand dollars

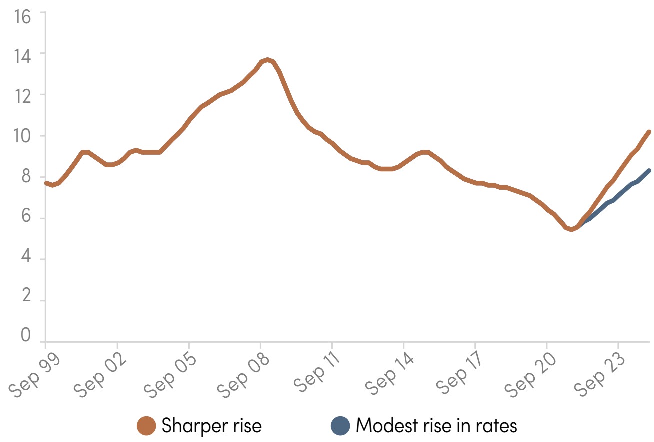
The RBNZ's November 2021 Financial Stability Report noted that household balance sheets and debt serviceability have strengthened in the past six months. Household debt is around 20% of the estimated market value of housing.

Market expectations are for the Official Cash Rate (OCR) rise towards 2.6% in early 2023. This is broadly in line with the RBNZ's own projections. Fixed mortgage rates have already moved up, and a 2.5% OCR would see the one-year fixed mortgage rate for home loans with an 80%-or-less loan-to-value head towards 5%.

The impact of these rate rises is likely to have a significant impact on the cost of house debt, with $194 billion of mortgage debt to refinance in the coming year: 68% of all fixed mortgages and 60% of all mortgages.

Higher interest rates will quickly hit some borrowers and take the household debt servicing ratio back towards 8-10%, depending on whether rates rise modestly (a further 150 basis points rise in the OCR) or sharper (250 basis points).

GRAPH 7: HOUSEHOLD DEBT SERVICING PERCENTAGE OF DISPOSABLE INCOME



Source: RBNZ, Bagrie Economics

CREDIT

The RBNZ Credit Conditions Survey reported strong credit demand for the past six months. Loan demand is expected to ease over the coming months, due to a combination of tighter lending regulations, economic challenges and higher interest rates.

Credit availability is also expected to decrease in coming months. Reasons include regulatory changes such as tightening LVR restrictions, changes to the Credit Contracts and Consumer Finance Act (CCCFA) from 1 December 2021, and the potential flow-on of the Delta outbreak on cash flow. Some banks have also started to implement debt-to-income restrictions.

Other factors constraining the availability of credit include banks' perception of risk and risk tolerance.

Tightening credit conditions by banks is unlocking opportunities for other financiers in key segments, particularly those with capital.

TABLE 4: CREDIT CONDITIONS – RBNZ CREDIT CONDITIONS SURVEY (NET PERCENTAGE CHANGE*)

	LOAN DEMAND OBSERVED CHANGE OVER PAST 6 MONTHS	LOAN DEMAND EXPECTED CHANGE COMING 6 MONTHS	CREDIT AVAILABILITY EXPECTED CHANGE NEXT 6 MONTHS
Residential mortgage	20.6	-11.8	-23.1
Commercial property	11.0	0.6	0.0
SME business loans	-0.1	0.0	0.0

Source: RBNZ

*Indicators vary from -100 to +100. A positive score indicates an increase in demand or availability.

WHAT TO WATCH

- **Inflation and inflation expectations, and the implications for interest rates.** Expectations for inflation are a critical part of inflation targeting by central banks. Near-term measures of inflation expectations have risen in line with an increase in actual inflation. Looking further out, the RBNZ's five-year measure of inflation expectations sit at 2.2% and 10-year 2%. This will provide some comfort to the RBNZ as inflation is not being assessed as permanently sticky.
- **Supply side challenges.** The economy does not have insufficient demand. It has problems meeting demand through material and worker availability and the productivity of resources. Measures to contain COVID19 are not productivity friendly.
- **Reconnecting with the rest of the world.** A path ahead has been plotted for opening Auckland up with the rest of the country. The next step is NZ with the rest of the world.

Unless otherwise stated, all amounts are in New Zealand dollars

- **Hospitalisation and intensive care utilisation as Auckland's border restrictions are removed.**
- **Wages and the labour market.** An acceleration in wages is expected as living cost adjustments are demanded. The continued two-horse race between inflation and wages would be unwelcome.

FORECASTS

Any set projections are subject to considerable caveats as New Zealand navigates the enduring impact of COVID-19. The bounce-back in activity and strength of the economy in late 2020 and the first half of 2021 has put the economy on good footing.

Monetary policy continues to provide strong support to the economy, though dampening in magnitude as the OCR returns to less stimulatory levels. Commodity prices are elevated, supporting the primary sector and rural communities. Record high consent issuance is supporting the construction sector, though material availability is a major problem.

Growth volatility is expected in the near-term reflecting the impact of alert levels shifts.

With the economy battling capacity constraints the outlook over the coming years is defined by supply, not demand. Potential or trend (supply) growth is estimated to be around 2%.

The government continues to spend large. Net government debt is low at around 30% of GDP though headed towards 50% of GDP. Unemployment is low, at 3.4%. Skill shortages and worker availability are key challenges for businesses. Job ad numbers are strong.

The NZD/USD is expected to remain elevated around 0.70 over the coming years, supported by NZ's economic position relative to the United States and strength in commodity prices. An emerging risk is the trajectory for of China's economy, with potential negative implications for the NZD. A rise in risk aversion, if, say, the US Federal Reserve responded to rising inflation by aggressively lifting interest rates, could be negative for the outlook of the NZD/USD.

The outlook for the NZD against the AUD is lower. The NZD/AUD sits well above estimates of fair value. Australia appears more advanced in dealing with the enduring impact of COVID-19 and reconnecting internationally.

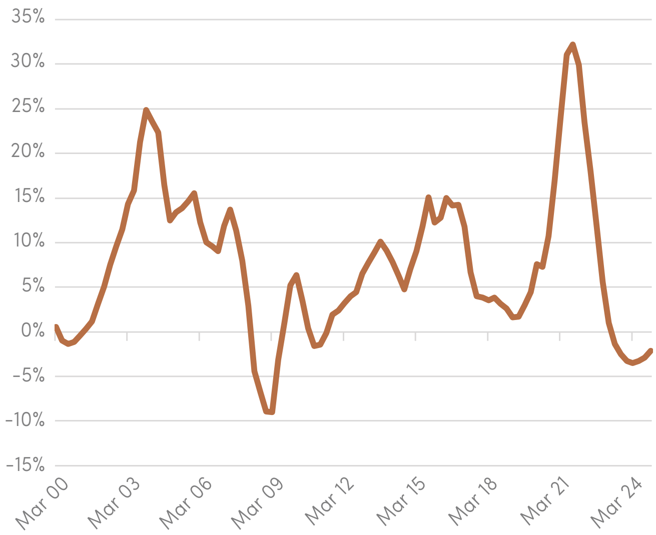
The RBNZ is projecting house prices to slumber over 2023 and 2024. Many fundamentals are pointing towards a turn. Inflation is also pushing the other way. Real house prices might fall, whereas nominal house prices might not.

Information and data in this report have been sources from the RBNZ, REINZ, Bayleys, Statistics NZ, NZ Treasury, Bagrie Economics and ANZ. The content does not represent financial advice.

The main areas of lending opportunity we are seeing at present are in Residential, Hotel, Value-Add Commercial and Retail Shopping Centre / Large Format construction.

Locations are well spread across the main population centres of Auckland, Hamilton, Bay of Plenty, Wellington in the North Island, and Christchurch / Queenstown in the South Island.

GRAPH 8: HOUSE PRICE PROJECTIONS (ANNUAL PERCENTAGE CHANGE)



Source: RBNZ,

OUR LENDING OUTLOOK

As noted within the economic commentary above, New Zealand's borders have effectively been closed since early 2020, causing a drop off in net migration gain. While building consents are now surpassing population growth, NZ remains an undersupplied market, following years of under building, and as also noted, consents are not translating into delivered product as easily as one would hope – due to supply chain restrictions, lack of labour, council delays etc.

We expect the current strong volume of lending enquiry to remain high for the foreseeable future. Presently, we are receiving additional enquiries due to many small local finance companies that have stopped accepting new applications as we lead into Christmas.

Unless otherwise stated, all amounts are in New Zealand dollars

There is still strong demand evident in the Residential market and developers are achieving sales off plan with steady enquiry.

Over the past four years, there has been a strong focus in the residential sector on delivery of higher density / infill development, mainly in the form of small to medium scale townhouse / terrace house / walk-up apartment type product. Large-scale high-rise developments have been limited in number, partly due to the lack of builders experienced in successful delivery of these projects, the longer duration of build time, greater compliance requirements representing higher market and cost risk, and general feasibility issues.

These smaller projects are not a target for MaxCap and we have been selectively targeting larger scale subdivision and apartment development opportunities.

Anecdotally, the Commercial market is showing signs of peaking, and with the increase in interest rates gaining momentum, yields are projected to rise. Vacancy is now occurring in certain sectors (e.g. CBD office below premium and A Grade) and we expect to see more investment opportunity in this area driven by banks turning away transactions that can no longer meet bank criteria. Over time we expect that our recent partnership with Apollo Global Funds will enable us to take advantage of the structural shift we expect to see in Commercial investment lending. The banks have already been reducing their market share of the development funding market but have not yet greatly decreased their lending to investment clients.

As border restrictions ease internationally and domestically, we expect the tourism industry to begin a recovery, and hotel occupancies to improve. We are currently seeing opportunistic buying / Value-Add and refinancing opportunities which appear to be driven by the expectations that the sector will see a reversal of fortunes over coming months as borders open. Most banks are still wary of lending into the sector which is driving the enquiry towards the non-banks.

Unless otherwise stated, all amounts are in New Zealand dollars

HEAD OFFICE

Level 33, 360 Collins Street
Melbourne VIC 3000
Australia
Tel +613 9620 2220

MAXCAP LOCATIONS

Melbourne
Perth
Sydney
Auckland
Brisbane

MANAGER

MaxCap Investment
Management Pty Ltd
ABN 68 169 902 005
AFSL 462086

Level 33, 360 Collins Street
Melbourne VIC 3000
Tel +613 9620 2220
Fax +613 9620 2221
legal@maxcapgroup.com.au

LinkedIn | Twitter | YouTube

MAXCAPGROUP.COM.AU