MARKET

PULSE

THE INSIGHTS THAT WILL HELP YOU PLAN YOUR COMMERCIAL PROPERTY STRATEGY FOR THE COMING FINANCIAL YEAR.

It's now three years since HSBC famously described New Zealand as having a "rock star" economy. The commercial property sector is thriving, and the economic outlook points to further growth and prosperity. But there are concerns. *Total Property* asks the major players, the economic experts and the country's leading political and business figures how they see the market performing over the next 12 months.

What are the biggest challenges facing the commercial and industrial property sector? And what are the biggest opportunities?

Owen Batchelor, *vice president of equity research at First Capital New Zealand*

The economic environment is positive and that's supporting occupier demand for space in the office, industrial and retail sectors. We've had declining vacancy rates, falling yields, and rising asset values in most sectors for a number of years, but the commercial property sector is cyclical and the current cycle will eventually turn. Any turn in the market is likely to lead to a softening in yields and downward pressure on asset values. A number of the listed vehicles have de-levered their balance sheets over recent years, which is sensible as falling asset values will likely place pressure on gearing levels.

For developers and landlords, rising construction and funding costs are certainly an issue, as is availability of credit. However, a number of major developers anticipated this and as a result locked in funding throughout their development periods. Landlords in the industrial and retail space should continue to do well, whereas the outlook for landlords in the office sector is more uncertain, with a significant amount of supply set to come online over the next few years driving a very competitive

CHRISTINA LEUNG, SENIOR ECONOMIST AT NEW ZEALAND INSTITUTE OF ECONOMIC RESEARCH

leasing market, which may keep rents in check.

For buyers, the biggest challenge is finding attractively priced stock. At the smaller end of the market, properties are reaching very low yields.

Sellers are most likely to do well given that there remains a lack of assets available for sale, and will most likely see the benefits from rising asset values.

Nick Cobham, *PSP portfolio manager at AMP Capital*

With low vacancy rates and firming property yields, all sectors of the commercial property market have enjoyed a good level of capital growth in recent years. But there is likely to be more of a focus on income returns as the rate of yield compression gradually begins to slow.

New Zealand is still seen as an attractive market to invest in, and increasingly so by overseas institutional investors as they continue to seek out the comparatively high cap rates offered, not only relative to bond spreads but also to the balance of their international real estate investments.

Simon Bridges, *Minister for Economic Development*

Short-term prospects for the New Zealand economy look encouraging. Low interest rates and population growth are likely to support domestic economic activity.

The current outlook for the commercial and industrial construction sector is for the non-residential building forecast to increase to a peak in 2018, while other infrastructure construction is forecast to gradually increase over the next five years.

It is true that some developers have recently reported tightening credit conditions for construction projects. The available statistics to date do not yet indicate a general problem in terms of access to finance by the construction or property development industries.

Grant Robertson, *Labour Finance Spokesman*

New Zealand needs new hospitals, schools, roads, and transport just to keep pace with the increasing population. There is a lot of resistance by regulatory agencies to imported materials and that importers, whilst meeting international standards, tend to be seen as not meeting local standards.

Scott Pritchard, *chief executive of Precinct Properties*

There are some great opportunities, particularly around continued growth in the innovation and SME sectors. This will

SIMON BRIDGES, MINISTER FOR ECONOMIC DEVELOPMENT

lead to more flexible use of real estate and we have seen co-working offerings grow in response over the last 24 months. This is something we are excited to be involved in through the 50 percent stake we have taken in co-working operator Generator.

Christina Leung, *senior economist at New Zealand Institute of Economic Research*

Demand for commercial property remains robust, buoyed by continued strong population growth. Solid momentum in the New Zealand economy is encouraging people to come here to live. This should continue to support demand across a wide range of sectors. Interest rates are likely to rise over the coming years as rising capacity pressures support a lift in inflation. I expect the Reserve Bank to keep the OCR on hold until mid-2018 before embarking on a measured tightening cycle. Although the solid New Zealand growth outlook will be the key support for commercial property demand, higher interest rates will likely have some dampening effect.

Chris Green, *director of economics and strategy, First Capital New Zealand*

The economy is tracking at around 3.5 percent, but of that about 2 percent is population growth. The underlying real growth, in terms of per capita growth, is tracking at around 1.5 percent. That's below the long-term 1.7 percent trend growth in GDP per capita. Probably two thirds of New Zealand's population growth is migration. If New Zealand First leader Winston Peters secures some sort of king-making role after September's general election, then his agenda to restrict migration flows could pose a risk to that figure.

Connal Townsend, *chief executive of Property Council New Zealand*

The sector must continue to grow as the demands of the market dictate we keep moving ahead. Yes, credit is a constraint, and it will require that the industry

OWEN BATCHELOR, VICE PRESIDENT OF EQUITY RESEARCH AT FIRST CAPITAL NEW ZEALAND

takes a different approach to funding development. The good news is that New Zealand is perceived as a lucrative market for overseas investors. The money is there, but we need to work out how to access it to support development.

Does the "rock star economy" tag still apply, and has the property market made the most of the boom years?

Nick Tuffley, *ASB chief economist*

A big part of the boom is about accommodating people, literally, and meeting work premises and logistics demand. The property and construction sectors have ridden the wave, with strong construction activity, rising sales transactions and valuations. We expect around 3.5 percent growth over 2017 and 2018, a decent clip even after allowing for the extent of population growth.

Connal Townsend: "Rock star" was never an accurate description of New Zealand's economy. The "rock star" description implies superficiality and excess, and that is not where we are at. We have a strong, solid, diverse economy that is continuing to grow. It is on those fundamentals that the success of the property industry has been built. Those are unlikely to change in the near term.

Owen Batchelor: Landlords have really kicked into development mode over the last three years, making the most of the positive economic environment, low vacancy rates, firming yields, and rising asset values. A number of the listed property vehicles have taken advantage of the boom years by sensibly divesting non-core assets.

What needs to be done to sustain building activity in Auckland and make New Zealand more attractive to developers?

Nick Tuffley: Demand for new buildings should remain strong given the general strength of population growth. That, more than anything, will determine how long a high level of building activity is sustained. But there are a few challenges to overcome to make development in New Zealand more attractive.

Various costs and processes can be streamlined, particularly around consenting processes. Easy certification of foreign building products could help reduce New Zealand's relatively high construction costs, yet keep up standards.

International players are likely to retain interest in New Zealand while it continues to show good economic health and while interest rates in most other developed countries remain low and depress commercial rental yields elsewhere.

Simon Bridges: The high number of cranes on the Auckland skyline demonstrates how well the New Zealand economy is performing and the many opportunities that exist for development.

To help provide an environment for growth in our cities, the Government is advancing a significant programme of legislative reform aimed at creating a more enabling regulatory system for urban development and unlocking economic opportunities.

NICK TUFFLEY, ASB CHIEF ECONOMIST

Can Wellington bounce back from the effects of last year's earthquakes?

Grant Robertson: Yes (you wouldn't expect anything different from the Wellington Central MP!). Wellington will not only bounce back, it will do so in a way that makes it a more attractive place to live and work. Under Mayor Justin Lester, there is a clear plan to invest in housing, infrastructure and services.

Nick Tuffley: We have learnt the hard way that cities and people are astonishingly resilient to the devastation earthquakes can cause. The population in Christchurch and surrounding districts has grown healthily since the 2010 and 2011 earthquakes. But people want safety and security. From a property owner's perspective, that means giving the customer what they want. Tenants will expect to be kept informed about any issues with the buildings they occupy. There will, consequently, be clear rent and pricing differences between different strength grades of buildings.

Simon Bridges: After the earthquake, the Government provided financial assistance to Wellington businesses and their employees adversely affected by the natural event. It will continue to monitor the situation and provide assistance where it's needed. Wellington is an innovative and resilient city - it will continue to grow and thrive, and come out of this stronger than before.

Owen Batchelor: There's always going to be a demand for commercial property in Wellington. A large portion of the market in Wellington is occupied by government agencies, and a number of the listed property vehicles have signed long-term leases to the Crown, locking in government agencies for 15-plus years.

The corporately-occupied market is a lot more fluid. Over the last few years it has been relatively subdued, with rents, yields, and asset values remaining largely flat due to the rationalisation of office space occupied by the Government, the lack of any material expansion by corporate occupiers, as well as an increasing office supply pipeline.

However, the initial post-quake feedback is that there is a changing dynamic within the market. Occupiers are re-focusing on the importance of being located in seismically safe buildings. Vacancy levels have dropped in the CBD due to damage caused by the earthquake. The best placed landlords are those with prime quality, high seismically-rated buildings.

From an investment market perspective, prime office yields currently sit around 120-130 basis points higher than Auckland, which should continue to attract a certain level of investment.

John Milford, *chief executive of Wellington Chamber of Commerce*

In the past 12 months, we have seen an increase in the number of commercial properties converted to residential/accommodation blocks, and in the retail space we have seen major brands open stores along the Golden Mile. However, the November earthquake has shaken the commercial property sector, with several buildings deemed unsafe. Some landlords have been able

GRANT ROBERTSON,
LABOUR FINANCE
SPOKESMAN

to take advantage of the situation and leased space to businesses shut out of affected properties.

Will 2017 be the year for... buyers, sellers, developers, tenants or landlords?

Gareth Kiernan, *chief forecaster at economic analysts Infometrics*

The non-residential market tends to lag behind the general economic cycle, so 2017 is likely to be another good year for commercial and industrial property owners and investors. Rents will continue to come under upward pressure, and low interest rates will support continued investor demand and keep prices up. Perhaps the biggest risks lie further down the track, particularly in an area such as Auckland commercial property, where a significant pipeline of new space will become available over the next 18 months. As in any cycle, there is a risk some segments of the market will become oversupplied, particularly if economic growth slows while the rate of new space coming to market reaches a peak.

Nick Tuffley: In recent years, it has been a seller's and developer's market. Investors have also done well. This year the pendulum will swing back slightly from sellers and developers, with purchasers likely to be a little more focused on achieving a reasonable yield. As building activity starts to close the supply gap, the balance will be less favourable for landlords.

Scott Pritchard: Property values have grown by more than 25 percent in the last three to four years so I'd say owners are doing very well. The increase in demand and shortage of quality commercial office space will be beneficial for commercial owners. However, the innovative solutions that landlords will be forced to create will benefit tenants as their new environment and ways of working are created.

Spotlight ON...

BAY OF PLENTY Greg Simmonds, strategic projects manager at economic development group Priority One.

There is plenty of business-zoned land due to come on stream over the medium to long term, giving the region a considerable advantage for business relocations.

One of the challenges for the commercial property sector is that the majority of industrial users in the Bay of Plenty are focused on the western corridor at Tauriko, due to its proximity and connectivity to the Port of Tauranga and central North Island. Land values in the corridor have risen 20-25 percent over the past year, making industrial development more expensive.

Construction capacity is likely to be under considerable pressure in 2017 and I expect some large projects may struggle to find funding unless backed with blue chip tenants.

Smaller business owners may struggle to find sensibly priced premises, and rents will likely rise due to higher land and development costs and Tauranga's increasing popularity.

CHRISTCHURCH Tom Hooper, chief executive of Canterbury Development Corporation.

The challenge for the sector is understanding where the new demand, supply and price equilibrium will land. This is a still up for debate and creating some uncertainty in the market in general.

Christchurch is better equipped than it was before the earthquakes. Prior to the quakes, it had a lot of old commercial building stock that was becoming unsuitable, and there is an opportunity for the city, with the large amounts of greenfield land, to build "fit for purpose" stock.

Building programmes are at record levels, but the rebuild has peaked and the city needs to ensure its underlying economy and profile enable growth longer term.

There will be opportunities in all corners of the market, but tenants will be well-placed in the coming year as short-term supply looks strong.

QUEENSTOWN Jim Boult, Mayor of Queenstown Lakes.

CBD opportunities are limited by the lack of available space, with the most desirable commercial properties held by a limited number of owners. That situation is unlikely to change, although there are four moderate-scale developments underway within the CBD.

The industrial development sector is more open with opportunities, particularly around the Frankton industrial area. The best opportunities lie in hotel development and worker accommodation. There are numerous hotel development sites identified and many are consented. At least two hotel developments are expected to commence in the 2017 year, but there is substantial interest from both local developers and international developers.

Queenstown is going through probably the most prolonged period of prosperity I have witnessed in 35 years. Whilst nothing lasts forever, it looks to have a long tail.