New Zealand's commercial property outlook.

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Overview.

In recent years, the combination of firm economic activity and very low interest rates has boosted both occupier and investor demand for commercial property. We're now seeing some of that positive momentum in the economy easing back, and that is likely to dampen demand on both of those fronts to some extent. Nevertheless, with interest rates likely to remain low for an extended period, we think that investors' appetite for commercial property will remain firm for some time.

New Zealand's commercial property sector has enjoyed a solid run in recent years. An extended period of economic growth and rapid increases in the population have fuelled the demand for commercial space. The related rise in rents and very low interest rates have made commercial property an attractive investment, boosting property sales and supporting firm levels of non-residential building activity.

These positive trends in the commercial property sector have continued through 2019. However, the underlying economic conditions that have supported demand have been changing. GDP growth has slowed from rates of over 3% through 2018 to 2.4% in the year to June 2019. Population growth has cooled from rates of around 2% in 2016 to 1.6% now. And on top of those developments, the global backdrop has become increasingly rocky.

Against this backdrop, business confidence has plunged and businesses' plans for expansion have been scaled back. We've also seen the Reserve Bank cut the Official Cash Rate to a record low of 1%, and we expect another cut in November.

In the near-term, the slowdown in economic growth and confidence will dampen tenants' demand for new space and could impact the extent of rent increases.

Nevertheless, the outlook for investor demand and commercial property prices over the coming few years is positive. Although the economy is slow, interest rates are very low and are likely to remain so for some time. That's making commercial property an attractive option compared to many other forms of investment.

A key risk to the outlook for commercial property is the potential for a continued deterioration in economic conditions, which could dent demand from both occupiers and investors.

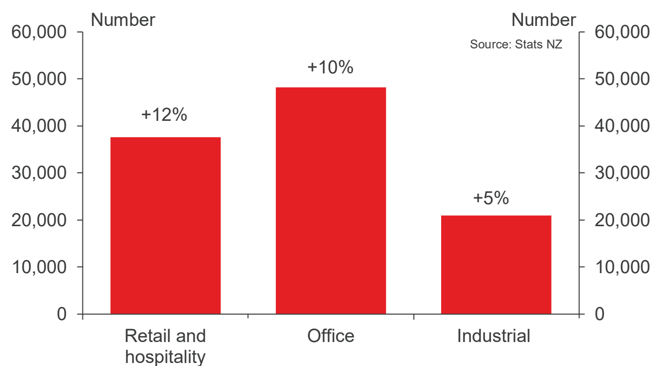
The commercial property landscape.

Conditions in the commercial property sector are primarily shaped by two interconnected factors: the strength of occupier demand and investor appetites.

Occupier demand.

In terms of occupier demand, recent years have provided fertile ground for growth in the commercial property sector. Over the past five years, economic activity has increased by 17%. During that time we've seen rapid population increases and solid jobs growth in industries that occupy commercial space: Around 48,000 more jobs have been added in occupations that traditionally occupy office space (up 10%); 38,000 jobs have been added in the retail and hospitality sectors (up 12%); and 21,000 jobs have been added in businesses that occupy industrial space (up 5%).

Employment growth by sector 2014 to 2019



Those conditions have fuelled strong demand for commercial space. And while there have been related increases in non-residential building activity, construction has not kept up with demand. That's seen vacancy rates falling to low levels, especially in Auckland and Wellington.

This combination of solid demand and low vacancy rates has resulted in face rents[1] pushing higher, especially for office and industrial space. Retail rents have been more mixed, with more desirable locations continuing to command a premium but overall rental increases relatively moderate in recent years.

While demand has been strong, recent years have also seen a number of structural changes in the business landscape that have affected the nature of space that tenants have been looking for. Those changes have been particularly stark in the retail sector, with an ongoing shift in consumer preferences away from physical goods and towards services, as well as continuing increases in online trading. Such developments have resulted in significant changes to business models, and in many cases reduced demand for retail floor space. It's also encouraged a shift towards 'destination retailing,' where traditional retail spaces are combined with other offerings to attract consumers (like entertainment or food and dining).

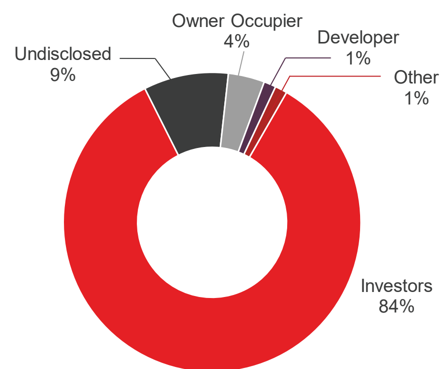
Changes in business practices have also tempered the demand for office space. That includes developments such as the increased use of flexible working arrangements and the shift towards agile teams, along with the continuing focus on the efficient use of space. These trends have contributed to a gradual reduction in the amount of space-per-worker that many businesses demand.

After a solid run in recent years, some of the positive conditions that have underpinned the demand for commercial property have eased off.

Investor demand

Purchases by investors account for over 80% of commercial property sales, and demand has been strong in recent years. Very low interest rates in New Zealand and abroad have seen investors hunting for assets that can provide higher returns. And with solid GDP growth and positive trends in occupier demand, investing in commercial space has been seen as an attractive option.

Purchaser purpose type (% of the number of sales)



Coming atop of firm occupier demand, strength in investor appetites has seen both the number of commercial sales and prices pushing higher. That's resulted in the value of commercial sales rising from a low of around $4bn in 2011 to around $9.9bn in 2018. Sales levels have eased back a bit through the first half of 2019. Nevertheless, they remain at firm levels.

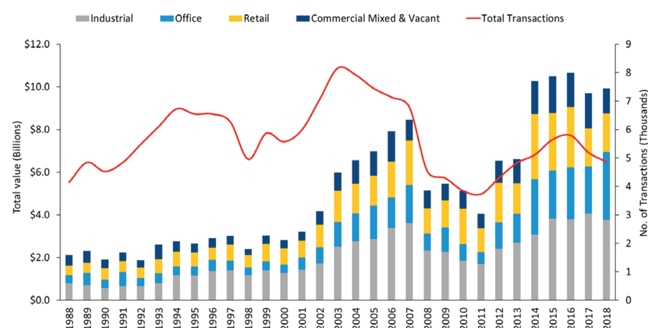
This strength in investor appetites has been reinforced by expectations that borrowing rates will remain low for an extended period, which has made it attractive to debt-fund asset purchases.

1 'Face rents' are rental figures that exclude inducements such as rent reductions or contributions to fitouts.

As well as demand from on shore, favourable conditions in the New Zealand market have also attracted growing interest from overseas investors. That includes large numbers of buyers from parts of Asia, Australia and the US.

Looking across sectors, demand has been particularly strong for office buildings (which account for around 40% of sales by value) and industrial properties (around 20% of sales). Sales of retail properties have also increased, though as noted above, changes in the nature of retailing globally have tempered the demand for space.

Commercial and Industrial transactions by sector

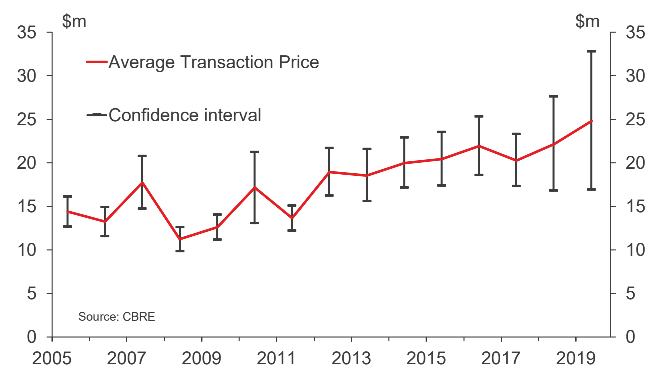


Investors have tended to favour the Auckland market, with conditions in the region, especially population growth, expected to support the continued demand for commercial space. The size of the Auckland market also makes it attractive in terms of the potential for resale.

Demand has also picked up in many other parts of the country. Wellington has been viewed as particularly attractive by investors, given expectations that public sector demand for office space will remain strong.

The vast majority of transactions continues to be at levels of less than $2m. However, recent years have also seen an increase in the number of higher value sales.

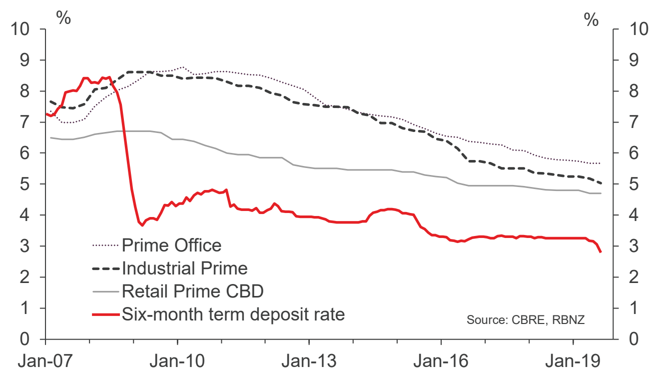
Average Transaction Price



With increases in demand pushing sale prices higher in recent years, there has been a corresponding moderation in yields.

Nevertheless, rental yields on commercial property remain well above what's on offer from standard bank deposits. Looking across the range of commercial property categories, gross yields in Auckland are currently averaging around 5.4% to 5.9% per annum, while in Wellington and Christchurch yields are averaging around 6.7% to 7.1%.[2] In contrast, the return on a six-month term deposit has slipped from around 4.7% at the start of 2011, to around 2.8% in late 2019.

Indicative yields on commercial property and term deposits



Yields on commercial property also look attractive compared to those on residential property. Gross rental yields on residential property are currently around 2.7% in Auckland and around 3.5% in other parts of the country. There have also been a number of regulatory changes in recent years that have eroded the attractiveness of residential property as an investment, such as the introduction of ringfencing tax losses.

Furthermore, commercial property capital values have been rising rapidly in recent years. Indeed, in Auckland commercial property values have been rising by around 7% per annum in recent years, while residential property prices have actually fallen. This is likely to have reinforced investors' appetites for commercial property.

An additional reason for the difference in yields on residential and commercial property is liquidity, with residential property tending to be easier to resell. In part, that's because purchase prices for residential assets are generally of a much smaller size and there are a much larger number of sales each year. The resale of commercial assets can also be more complicated due to ownership structures, with many assets having multiple owners and investment often occurring through syndicates. While the liquidity of both residential and commercial assets tends to fall at times of economic stress, the impact on the liquidity of commercial assets can be particularly severe.

Very low interest rates in New Zealand and abroad have made investing in commercial space an attractive option.

2 Based on an average of property types including prime and secondary office buildings, prime and secondary industrial buildings, and various retail properties.

Construction.

Strong demand for commercial property has supported firm levels of non-residential building in recent years. That includes a large number of new developments, as well as refurbishments. However, the pickup in building has lagged demand, resulting in increasing tightness in many corners of the property market. In addition, many of the projects that have been commissioned have required high levels of pre-commitment from tenants. That means even with large numbers of new developments, the change in unoccupied space available to rent has been more limited.

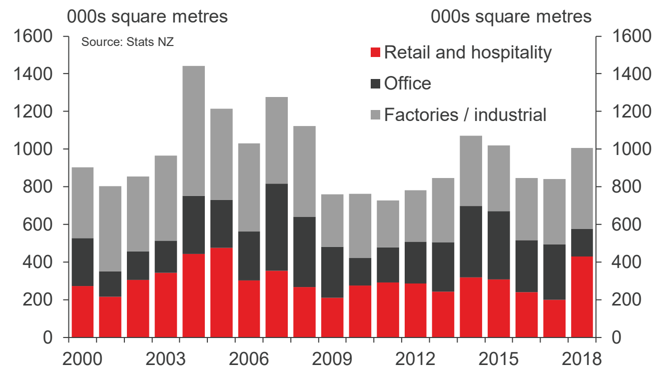
Looking at the breakdown of new developments:

- There's been a continued steady rise in the amount of new industrial space being consented. That's been supported by strong occupier demand that has pushed vacancy rates to very low levels. But even with a solid pipeline of work currently in train, the market for industrial space is expected to remain tight for some time, with the availability and cost of land constraining new developments.
- A large amount of new office space was consented between 2014 and 2017. Many of those projects have now been completed and the amount of available space is set to rise over the next few years. That's likely to result in vacancy rates lifting from what are currently extremely low levels. Consistent with that outlook, the amount of new projects being consented has started to wind back.
- New developments will see a large amount of additional retail space becoming available over the coming year. That includes space in a number of sought-after areas in Auckland and Wellington. This increase in space could see vacancy rates pushing up and will likely limit increases in rents, though more desirable locations will continue to command a premium.

A particular concern for developers in recent years has been the combination of lengthy delays between the start and completion time of projects along with the continued trend higher in build costs. Those conditions have meant that the final build cost of some projects has exceeded initial estimates by a wide margin.

A further challenge for developers has been the tightening in financial conditions since the 2008/09 financial crisis. More stringent lending criteria mean that developers now require higher levels of sales or tenant pre-commitment in order to access finance. That can make it harder to get some projects off the ground.

Floor area consented



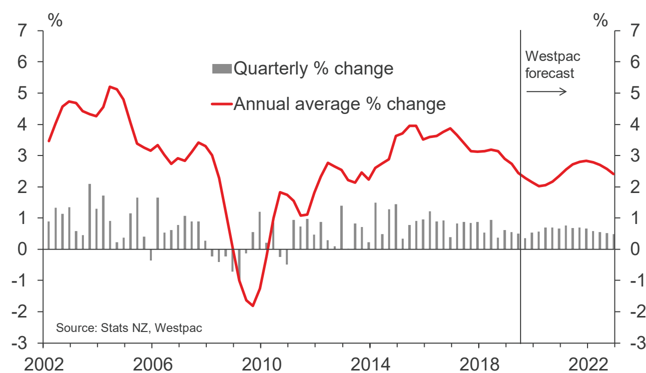
Lengthy delays between start and completion times has meant that the final cost of some projects has exceeded initial estimates by a wide margin.

Outlook.

While the commercial property sector has enjoyed a solid run in recent years, the underlying economic conditions that have supported demand have been changing. GDP growth has slowed from rates of 3% to 4% earlier in the decade, to just 2.4% in the year to June 2019. We've also seen population growth dropping back from rates of around 2% in 2016 to 1.6% now. And on top of those developments, the global backdrop has become increasingly rocky.

Looking to the year ahead, we are forecasting a pickup in the pace of GDP growth, although it will remain low compared to the rates seen in the mid-2010s.

GDP growth

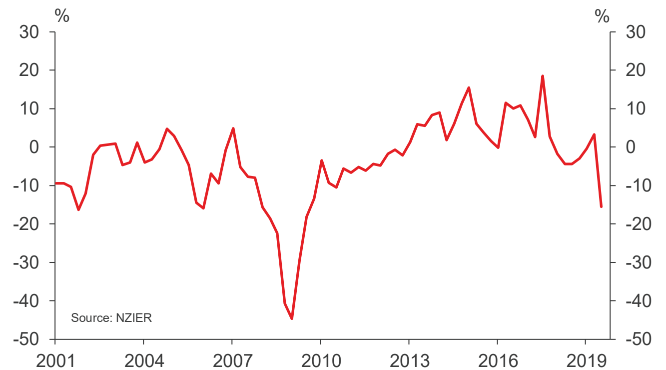


Providing some offset from the headwinds buffeting the economy has been supportive fiscal and monetary policy. Large increases in fiscal spending are already being rolled out, and we think more will be announced ahead of 2020's election. At the same time, the Reserve Bank has cut the Official Cash Rate to a record low of 1%. We think a further cut to 0.75% is on the cards before the end of this year, and that interest rates will remain low for some time.

In terms of occupier demand for commercial property, the downturn in the economy has seen business confidence slumping across all sectors. Importantly, businesses have wound back their plans for capital expenditure, including plans for investment in new buildings. That's coming at the same time as a number of new developments are expected to reach completion.

We expect that these conditions will dampen occupier demand for new space over the coming year and will result in some increase in vacancy rates from current low levels. Those conditions are also likely to constrain increases in rents.

Capital expenditure plans - buildings



The softening in economic conditions will also raise some flags for investors. Nevertheless, we still expect that investor demand will remain strong over the next few years, supported by favourable conditions in the commercial property sector. Looking at economic conditions, while the coming year is likely to see some softening in occupier demand for commercial space, that follows a marked tightening in vacancy rates over recent years. Furthermore, although GDP growth has cooled, the extent of the slowdown is expected to be moderate, signalling continued demand for space.

Most importantly, interest rates here and abroad are likely to remain low for an extended period. Over time, that's likely to boost demand and GDP growth. That also means that the yields on commercial property continue to look attractive relative to other forms of investments.

The key risk in terms of occupier and investor demand is the extent of the downturn in economic activity. While we currently expect the slowdown in the economy to be moderate, the downside risks for GDP growth in New Zealand have increased, especially given the softening in the global economy. A deeper downturn in growth could significantly dampen demand from occupiers. It could also prompt increased nervousness among investors, prompting a tilt towards 'safe haven' investments like bank deposits, even in the face of further interest rate reductions.

While economic conditions have been changing, we still expect that investor demand will remain strong over the next few years.

Regional trends.

Auckland.

Occupier demand for commercial property in Auckland has been strong in recent years. That's been supported by the combination of continued growth in economic activity and very large increases in the population, which together have boosted activity in many of the region's major sectors. That includes strong growth in areas like manufacturing and in services sectors (especially professional and scientific services). Auckland's size also means that, relative to other areas, it is well positioned to attract larger international brands.

Strength in occupier demand has pushed vacancy rates in Auckland to low levels. It's also seen a rise in the amount of new commercial space being developed, especially retail space. As that work is completed, we're likely to see some increase in vacancy rates. However, in the case of industrial space, where vacancy rates are extremely low, the availability and cost of land will remain an important constraint.

Auckland's positive economic fundamentals and the strength of occupier demand have also buoyed investor appetites for commercial property in the region. That includes demand from offshore. The region's size also makes it attractive to investors due to the greater potential for resale.

This strength in investor demand has seen solid growth in capital values, meaning that yields in Auckland tend to be lower than in the other main centres.

Wellington.

With Wellington home to central government, the city has been attractive to investors. Increases in government spending are boosting the demand for space. Importantly, such spending is likely to be resilient to the increasingly strong headwinds from offshore.

Wellington's property sector has enjoyed a solid performance in recent years. There has been particularly strong demand for office space, including demand from the public sector. That seen office vacancy rates falling to very low levels. Adding to that tightness in supply has been the reduction in space that followed the 2016 Kaikoura earthquake.

The increased focus on seismic resilience has had major implications for Wellington's property market, particularly in relation to older or lower grade properties. Recent years have seen significant amounts of strengthening work, and such work has often come with a hefty price tag. However, high levels of seismic resilience are often necessary to attract and retain tenants, especially in the public sector. This can also affect the cost and availability of insurance. As strengthening work is completed, available space and vacancy rates are likely to push higher.

Like other parts of the country, Wellington's retail sector is wrestling with changes in the commercial landscape. With online trading increasingly prevalent, the demand for retail space has fallen in areas like consumer electronics. However, demand has been firmer for goods where the ability to physically interact with a product before purchase is important (for instance cosmetics and high-end jewellery). The shift in consumers' preference in favour of services has also meant that hospitality offerings are increasingly nested with traditional retailing. This has meant that hospitality heavy areas (like the Cuba district) are popular for investors.

Christchurch.

The earthquakes in 2010 and 2011 resulted in significant disruptions to Christchurch's economy, including its property markets. Those events caused extensive damage to commercial properties in the region. The resulting shortages of commercial space prompted large increases in rents, with many tenants tied into longer than normal leases. We also saw businesses relocating away from the central city, with a large increase in new office space in other parts of the city.

It has now been nine years since the first of the major earthquakes that struck Canterbury, and over this time we have seen significant changes in the region. In terms of commercial property, the amount of available space has increased in recent years as damaged properties have been repaired and new developments have come to market. That includes large amounts of office, retail and industrial space. These developments have often been of a different character from pre-quake structures, with smaller footprints, fewer floors, and greater seismic resilience.

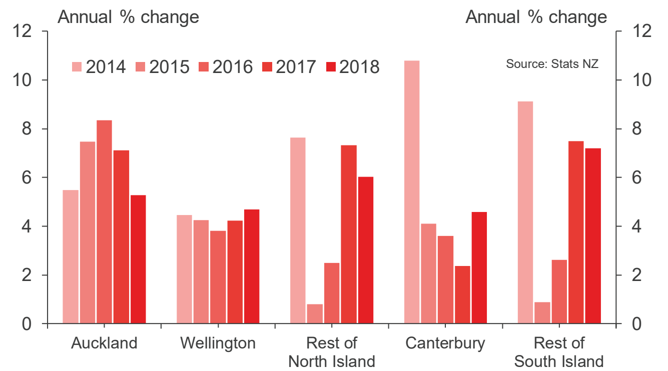
With a large increase in building activity in recent years, build costs have also increased. Those increases have been reinforced by changes in building standards aimed at improving seismic resilience. On top of those increases, insurance costs for many buildings have also increased (in some cases, by a large amount). All of this has added to operating costs for landlords and have added to the upward pressure on rents.

The combination of the above developments have been particularly important for Christchurch's commercial property market. Rental terms have been changing as new supply has come on to the market and earlier 'lock in' periods have come to an end. The related increases in vacancy rates have given tenants more power. Rents have been declining and incentives (like rent holidays and contributions to fit outs) have increased. The duration of tenancies has also shortened.

In terms of construction, the number of new developments in train has fallen, especially in the office space. Going forward, we're not expecting to see significant new developments for some time.

Canterbury's economy is continuing its transition away from rebuild led growth. The winddown of reconstruction spending has been a drag on economic demand. However, the redevelopment of the central city has helped bolster confidence. And going forward, economic conditions in the region will increasingly be dependent on how other sectors fare.

Regional GDP growth (nominal)



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