Economic Insight.

An impending double dip for the construction sector.

26 May 2020

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- The construction sector is currently springing back to life as the lockdown is lifted. However, we think the sector faces another significant downturn in 2021.
- Job losses, stretched balance sheets, and nervousness about the economic backdrop will result in home building falling 20% below pre-Covid levels over the year ahead.
- Slower population growth will also dampen construction activity. Even so, many parts of the country will still be wrestling with a large shortage of houses for an extended period.
- Commercial construction is set to fall by 15%, weighed down by weakness in tenant demand and increased investor nervousness.
- Beyond 2021, building activity is expected to pick up again, however the recovery will be gradual and varied across major market segments. Large increases in Government spending will support work on infrastructure projects and publicly owned buildings. In contrast, the recovery in privately funded residential and commercial building is likely to be slower.

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The shift to Alert Level 4 saw New Zealand's construction sector slowing to a standstill in March and April, with building projects put on hold for 33 days.

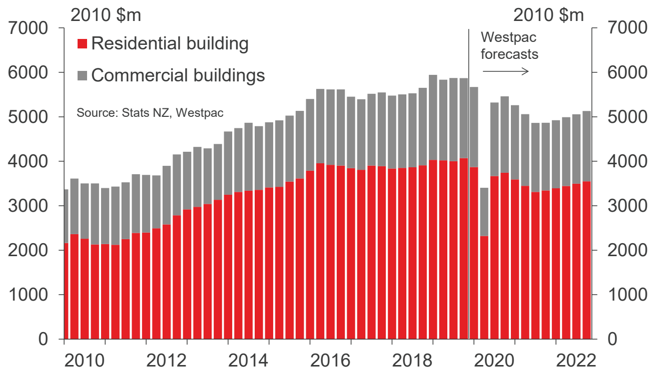
Now that the alert level has been dialled back, building work has picked up rapidly. Nevertheless, building activity remains below pre-lockdown levels and it's set to remain so for some time. Covid-19 safety requirements, such as physical distancing on worksites, have been a handbrake on how fast work can occur. Those restrictions could be in place for an extended period.

We expect a second downturn in construction activity over 2021 with sharp falls in both privately funded residential and non-residential projects. Those falls will more than offset the planned increases in public spending in areas like infrastructure.

The drop off in building activity is likely to be gradual, and its full extent won't be evident until late in 2021. That's because of the large pipeline of work that was already planned prior to the outbreak of Covid-19 and a backlog of work that built up during the lockdown period. However, the number of new construction projects coming to market or going through the consenting process will fall over the coming months. There is also likely to be a higher-than-usual number of planned projects that are cancelled. Given the usual lags between planning and building, this points to another slowdown in building activity over the year ahead.

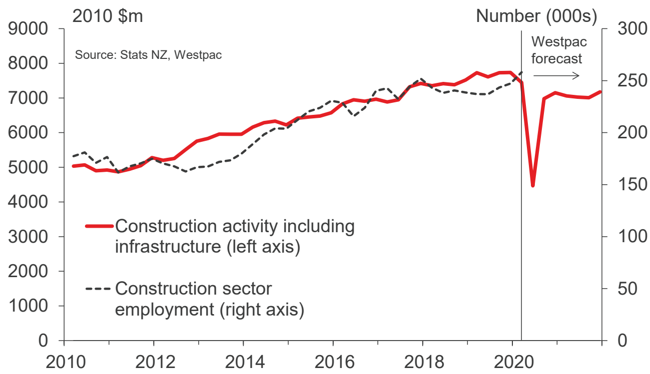
Beyond 2021, building activity is expected to pick up again. That will be supported by the combination of very low interest rates and large increases in Government spending, including massive increases in infrastructure spending. However, the recovery in privately funded residential and commercial building is still likely to be protracted. That's because the economic scarring to households and businesses' financial positions caused by the current downturn will take years to heal.

Figure 1: Volume of residential and commercial building (quarterly)



We think around 20,000 jobs could be at risk over the coming year due to the downturn in building activity. The construction sector directly employs 258,000 people. We've already seen a number of job losses, and many other workers have had their hours reduced. There's also a risk of job losses in related industries like architecture and professional services.

Figure 2: Volume of construction activity and employment (quarterly)

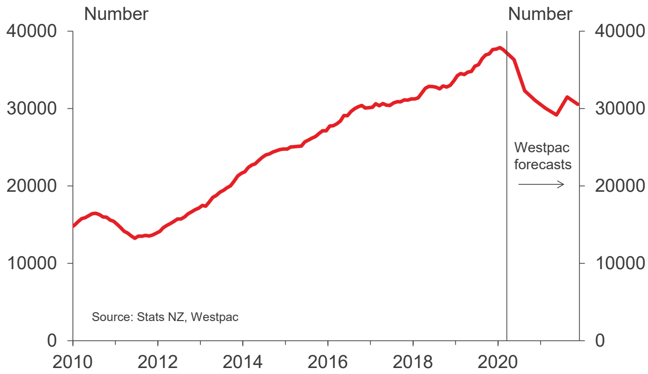


The coming year will see large falls in privately funded residential and commercial construction, putting large numbers of jobs at risk.

Residential building.

We expect home building will drop 20% below its pre-Covid-19 levels over 2021. The downturn will be seen in both owner occupier and developer funded projects, with the number of new homes consented set to drop from around 37,000 at the end of 2019 to just below 30,000 over 2021.

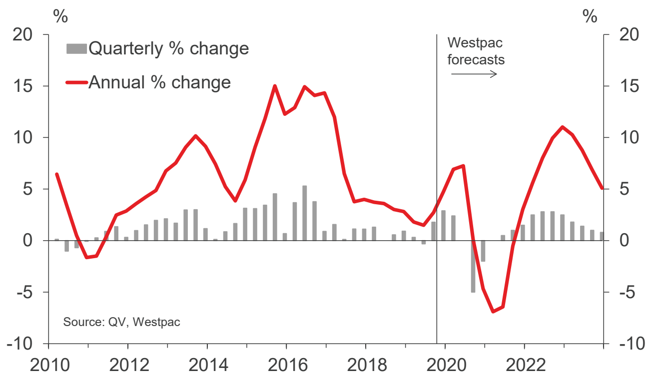
Figure 3: Residential building consents (annual)



For owner occupiers, concerns about job security, stretched household balance sheets and nervousness about the economic outlook more generally will mean that many projects go on hold. Unemployment is expected to rise to 9.5% later this year and it's likely to decline only gradually. Combined with slower wage growth, that will result in household earnings from wages and salaries falling by 3.5% over calendar 2020. In comparison, earnings have been growing by around 5% to 7% per annum in recent years.

Developers will also be reluctant to bring new residential projects to market until the economy is back to full health. Weakness in economic conditions will be a drag on new home sales, and we expect that house prices will fall 7% through the back half of 2020. For developers, that signals a squeeze on margins and the potential that capital could be left tied up in unsold homes.

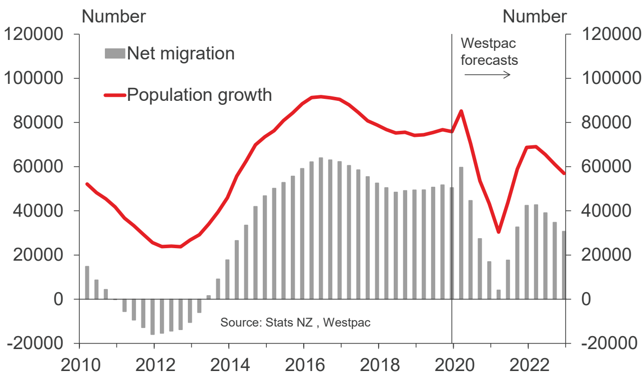
Figure 4: House prices



A slowdown in population growth will also be a drag on home building. We expect that population growth will fall from around 75,000 people per annum in recent years to just 30,000 in mid-2021. That's due to global restrictions on international travel and weakness in the labour market, which together will result in net migration falling sharply.

We do expect that net migration will pick up again further ahead, especially as many New Zealander's who have been living abroad are likely to return home. However, we still expect migration will remain well down on the levels seen in recent years. With unemployment likely to linger for some time, New Zealand will look less attractive to potential migrants. In addition, the coming years could see a tightening in migration policy to support the hiring and skills development of New Zealand workers in the wake of Covid-19.

Figure 5: Population growth and net migration (annual)



In this year's Budget, the Government announced plans to build 8,000 new state homes. It's an opportune time to do this given the freeing up of capacity in the building sector and the need to stimulate demand. However, the construction of these homes will be spread over several years, and won't be sufficient to offset the downturn in privately funded construction activity.

With the closure of New Zealand's borders and reduced domestic travel, the demand for tourist accommodation has fallen sharply. That includes demand for Airbnb properties, as well as accommodation in hotels and motels. This has meant that homes that were previously used for tourist accommodation are now available for longer term housing, which has helped to reduce the shortage of rental properties in areas like Queenstown. It's also freed up bedding for those in need in areas like Auckland where there has been growing homelessness. Some of these developments will reverse over time as tourism slowly recovers. But at least for now, the freeing up of accommodation in the tourism sector will be a further factor dampening the demand for new houses.

Population growth and housing shortages.

Since 2013 New Zealand has built around 50,000 too few homes, and even that estimate may be too low.

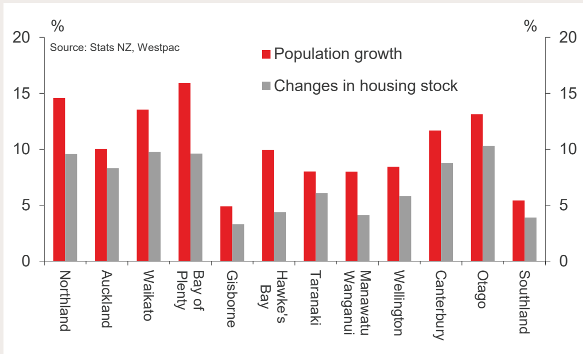
In recent years, New Zealand's population has rocketed higher, passing the 5 million mark earlier this year. While home building has also picked up, it's fallen short of what's needed to keep up with population increases. That's contributed to upwards pressure on rents and house prices. It's also contributed to a range of social challenges including increases in homelessness.

The underbuilding of housing is not just limited to Auckland. In fact, while Auckland still needs a lot more houses, building activity in the region has rocketed higher, with around 15,000 new homes consented in the region over the past year. That's enough to keep up with population growth and gradually erode the current shortfall (though that will still take several years).

But at the same time, other regions have seen growing housing shortages. That includes Northland, the Hawke's Bay and Bay of Plenty. There are also very tight housing markets in areas like Wellington and Queenstown, which have been struggling with shortages of affordable rental properties.

Delays and lower building as a result of Covid-19 mean that shortages of housing will be with us for some time yet, as will the related social stresses. However, the slowdown in population growth will help to cap the pressure on the housing stock.

Figure 6: Regional housing and population changes (2013 to 2019)

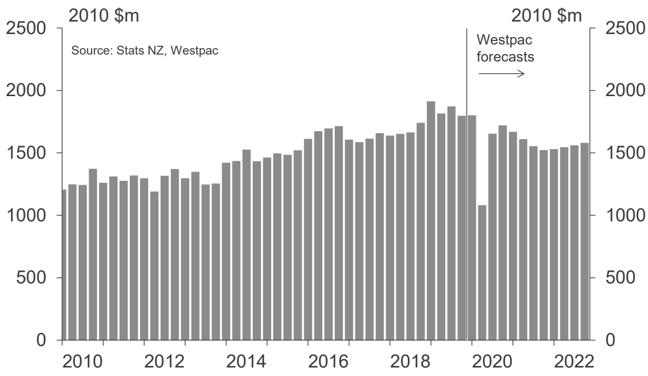


Lower building in the wake of Covid-19 means that the current shortage of housing will be with us for some time yet.

Commercial construction.

We expect that over 2021 and 2022, quarterly spending on commercial building activity will fall roughly 15% below pre-Covid-19 levels. In comparison to the fall in residential investment, the downturn in commercial construction is expected to be more protracted. That's because developers will be reluctant to initiate new projects until they are confident that the economy has entered a sustained upturn. This reluctance will be reinforced by the large cost of many commercial construction projects.

Figure 7: Volume of commercial building (quarterly)

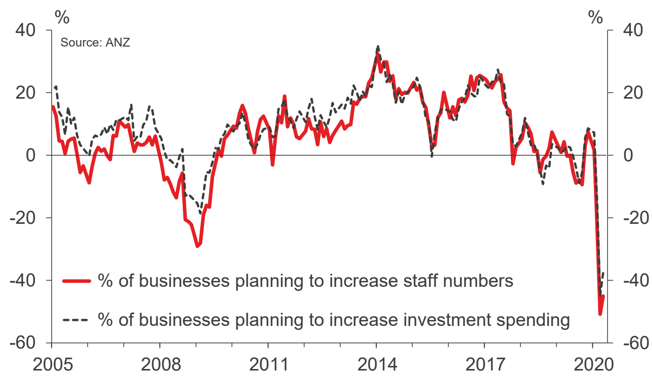


Tenant demand for commercial space is likely to be subdued for some time. Businesses are already wrestling with weak demand. In addition, many businesses will have increased their borrowing or run down their financial reserves to get through the current downturn. That will result in a period of reduced spending on premises and other assets as businesses rebuild their balance sheets. It's also likely to result in downward pressure on commercial rents and some increases in vacancies.

Looking across market segments:

- Tenant demand for space is likely to be especially weak in sectors linked to tourism and hospitality. That includes **hotels, motels, entertainment venues and eateries**. International visitor arrivals are likely to remain very low for some time. Potential increases in domestic tourism will only provide a partial offset, especially given the restrictions on capacity resulting from social distancing requirements.
- The demand for new **retail** space is also expected to be weak as households rein in discretionary spending. In addition, the outbreak of Covid-19 has reinforced the shift to online trading which continues to drive changes in many retail business models, including reduced demand for floor space.
- Demand for **office** space is likely to be less affected than the demand for retail space, but is still likely to be softer than in recent years, especially for lower grade properties. That's likely to result in vacancy rates lifting from what are currently extremely low levels. Demand for office space may be more resilient in Wellington than other regions, due to demand from Government departments.
- In recent years, the demand for office space has been tempered by changes in business practices, including the growing use of flexible working arrangements like working from home. The use of such arrangements has increased dramatically since the outbreak of Covid-19, and it's likely that many businesses will continue with such practices even as the economy opens up again. That will further moderate the demand for office space.
- The outlook for **industrial** space is less clear, but demand will be dampened by the broader downturn in economic conditions. The continued shift to online trading and related need for storage/distribution facilities could support demand for warehouse space.

Figure 8: Businesses' investment and hiring intentions



Reinforcing the downside for commercial construction is a likely fall in investor demand. In recent years, the combination of low interest rates and firm economic activity made the returns on commercial property very attractive for investors. Now, although interest rates have continued to fall, investors are becoming increasingly nervous about how the returns on commercial property will be affected by the downturn in the economy. Large numbers of businesses are already reporting difficulties paying their rent and many others will face tough trading conditions over the coming year. Against this backdrop, it will be difficult to increase commercial rents and vacancy rates are likely to rise. Landlords are conscious that it could be difficult to find good tenants over the coming years. As a result, some landlords are looking at freezing rents or some form of temporary rent relief.

Even before the outbreak of Covid-19, we expected that commercial construction would slow over the next few years. A large number of projects have been commissioned in recent years, and we were expecting a period of more moderate building activity as they were completed. Covid-19 related disruptions means that the coming slowdown is likely to be earlier and deeper than even we had been expecting.

Large falls in tenant demand will result in downward pressure on commercial rents and some increases in vacancies.

Access to credit.

Access to credit may also be a tougher hurdle for some building projects over the coming year. It's true that borrowing costs have fallen. We've also seen efforts by the Government and trading banks to support lending. Even so, the downturn in the economy will stretch the balance sheets of many households and businesses. Potential job losses and falls in revenue will also make it harder to service debt in some cases. As a result, some prospective borrowers may find it more difficult to access credit. This will be an issue for both residential and commercial building projects.

Infrastructure.

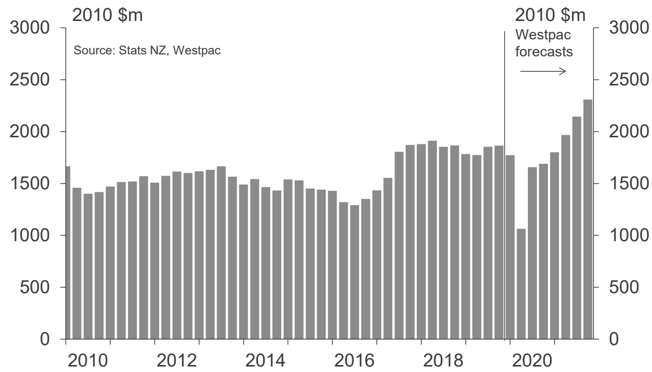
While privately funded building activity will drop sharply over the coming year, Government related spending on infrastructure is set to rocket higher over 2021 and 2022. That won't be enough to offset the fall in privately funded work, but it will nonetheless provide a significant boost to demand at a time when the economy needs it. It will also help to support a recovery in employment.

Last year the Government announced plans for $12bn of new spending on infrastructure and public buildings spread over several years. That was followed by the announcement of a further $3bn in the May Budget. We expect they'll announce even more over the coming year. That will leave us with a massive pipeline of planned projects.

Key areas that the Government will be spending on include roading and rail transport, with additional spending in areas like health and education. This spending will be spread across the country, with large amounts earmarked for Auckland, Waikato, the Bay of Plenty, Wellington, Canterbury and Queenstown.

Although we expect big increases in infrastructure spending over the coming years, this work is likely to take longer to ramp up than the plans included in recent Budgets assume. That's even with capacity being freed up in other parts of the construction sector. As we've often seen with large complex projects, delays can creep in through all phases of the planning and building process. That's likely to be the case with many of the projects that are initiated over the next few years also.

Figure 9: Volume of infrastructure construction activity (quarterly)



Big increases in publicly funded building have already been announced, and we think there is more to come. However, that won't prevent a downturn in overall construction activity over the coming year.

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