

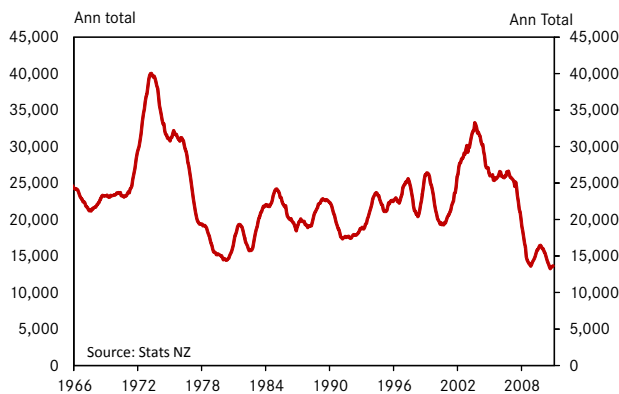
The construction sector: past, present and future

- Construction activity has been a notable area of weakness in the New Zealand economy over the last few years.
- We think there is evidence that activity in the sector has turned, and expect it to expand further over 2012.
- Even our expectation for a slow rebuild in Canterbury will provide a huge stimulus for the industry in 2012.
- And a shortage of housing in Auckland should spur new house building further North.

A weak starting point

New Zealand's construction sector is in the doldrums. During 2008, as house prices began to fall under the weight of high interest rates and tighter credit conditions, the residential building sector went into freefall and commercial building followed. By 2011, residential building activity was over 40% below 2007 levels and non-residential building around 16% below.

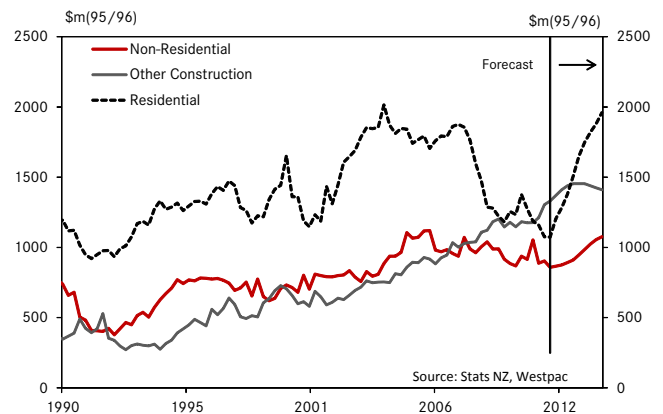
Figure 1: Number of new dwellings consents issued



Over the coming years we expect the construction industry as a whole will experience rapid growth off its depressed base, eventually taking the industry back to the level of activity seen in 2007. However, the coming boom will be distinct from the 2000s episode in type of building, means of finance, and region of focus. In a nutshell, we anticipate rapid growth in residential construction for Christchurch and Auckland (leading to 30%

growth in residential construction during 2012 compared to 2011), and a great deal of infrastructure work in Christchurch. However, we expect commercial construction to ramp up only gradually in Christchurch, and to remain weak elsewhere. Importantly, this article highlights recent evidence showing that at least some growth in construction has already taken place or is imminent – based on that evidence, we anticipate 7% growth in construction activity in the final quarter of 2011 alone.

Figure 2: Construction forecasts



Rising from the rubble

We expect Canterbury earthquake damage will add around \$20bn to nationwide construction activity in coming years (at 2011 prices). The bulk is in residential repair and rebuilding work (around \$13bn). The remaining question – and it is a critical one – is when the activity will occur. Recent data outlined below suggests the pace of activity in Christchurch has picked up in recent months. We estimate there will be around \$160m of residential activity, \$270m of other construction and \$25m of non-residential building work in Canterbury in the final quarter of this year.

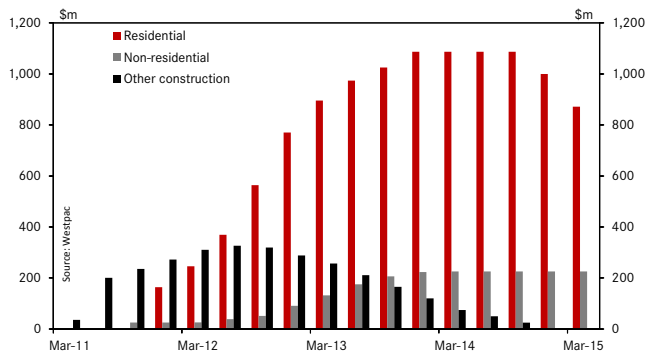
There is a fair amount of uncertainty as to the level of activity next year and beyond. Our views, summarised in the graph below, are based on conversations with informed parties¹ and the experience of previous construction booms.

1. Including the Canterbury Earthquake Recovery Authority, the Christchurch City Council, government officials, construction companies, insurance companies and bankers.

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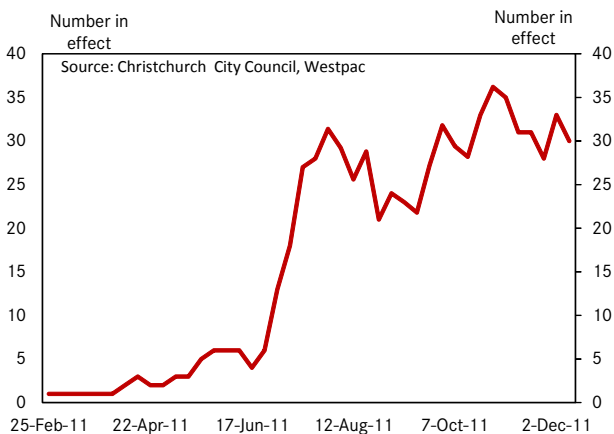
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Figure 3: EQ rebuild spend by sector



Non-building construction, which includes demolition and infrastructure repair, has been the first cab of the rank in Christchurch. Nationwide, this category surged by 11% in the first half of 2011. While there's no regional breakdown of the official figures, it's likely that Christchurch accounted for much of the increase. Before new buildings can be put up, damaged ones need to be demolished. That process is well under way. 645 commercial buildings have been demolished to date, with another 200 part-way through the process. Beyond the CBD, the demolition of the 6,540 Red Zone residential properties is due to kick-off in February and is expected to cost about \$150m over 2 years. And judging by work notices issued in the region since then (see figure 4), it appears that infrastructure repairs ramped up sharply in the second half of the year. While this probably understates the total amount of work done – there would have been some emergency repairs done without notice after the February quake – it highlights that there is a significant amount of work going on at the moment.

Figure 4: Work notices in effect, Christchurch



Residential construction has and will continue to face delays including slow resolution of insurance claims, administrative holdups, difficulty of obtaining new insurance, and anticipation of further seismic activity. Of course, not everybody will face these delays in equal measure. We expect residential construction activity will slowly ramp up over the next two years, and will peak in 2014. Our forecasts assume that about 10% of the total residential rebuilding programme will be completed in a year's time, while the vast majority is delayed beyond that point.

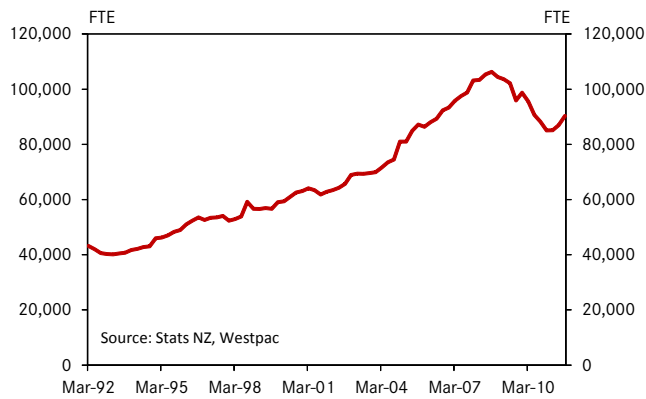
But even that small quantum of work is sufficient to induce a 40% increase in nationwide residential construction activity (Sep 2012 quarter compared to Sep 2011) with three quarters of this growth coming from rebuilding activity in Canterbury. To put that another way, even if 90% of people seeking to repair or rebuild their houses face delays of more than another year from today, the construction industry will still experience rapid growth in 2012.

A survey of the available evidence indicates there is already significant quake-related residential construction activity going on in Canterbury, and further suggests that residential construction is on track to meet our undemanding forecasts, at least in the near term.

- In the residential red zones, a substantial number of homeowners are gradually moving ahead with their plans. 2,600 property owners have already selected one of the two settlement options on offer from the government (759 have selected option 1 – selling both their home and land to the Government, 1,841 have selected option 2 – selling only their land to the government).
- There has been a 64% rise in the number of building consents excluding temporary dwellings in Canterbury, concentrated in Selwyn and Waimakariri districts.
- The Earthquake Commission has paid out \$2.2bn to claimants for building repairs.
- Difficulty obtaining insurance for new buildings does not affect the ability to repair a damaged-but-repairable house. And that category accounts for the majority of the damage in Christchurch. Already, 24,000 repairs have been completed or are in progress by Fletcher EQR (the scheme organised by Fletcher Building for managing EQC repairs worth \$10,000 and \$100,000). Fletcher EQR has paid approximately \$238m to contractors to carry out these repairs with payments currently running at \$500m annualised pace (that's around \$125m per quarter).
- Employment in the construction sector jumped an outsized 5.8% (s.a.) in the September quarter and job adverts in the Canterbury region are up over 40% on a year ago. Reflecting the repair (as opposed to rebuild) nature of current residential building activity, Fletcher Building reports that 40-50% of their current needs are or painters and plasters and there is also strong demand for carpenters and bricklayers.²
- A recent survey by the Department of Labour (A changing landscape: The impact of the earthquakes on Christchurch workplaces) reported that the construction sector was one of only two sectors to report that the earthquake had led to increased staffing levels (for most the quakes had led to a decline). And 56% of those surveyed in the construction industry reported an intention to hire more staff over the coming year – the highest proportion of any industry.
- Builders reported a strong lift in new orders over the second half of 2011, according to the NZIER's Quarterly Survey of Business Opinion.

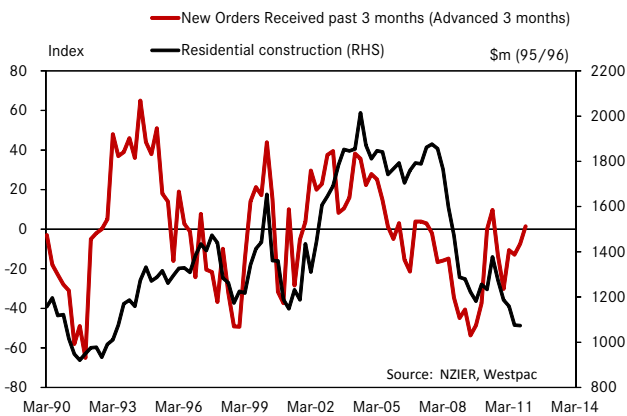
2. NZ Herald, Quake city needs army of rebuilders, Wednesday Nov 16, 2011

Figure 5: Employment in the construction sector (s.a)



As well as a rush to acquire labour, there are signs that increased demand for building is pushing up prices. Construction cost measures in the Producer Price Index were up strongly over the last two quarters. Measured producer output prices for heavy and civil engineering construction and construction services outputs climbed 4% and 2% respectively.

Figure 6: QSBO builders new orders received and construction activity.

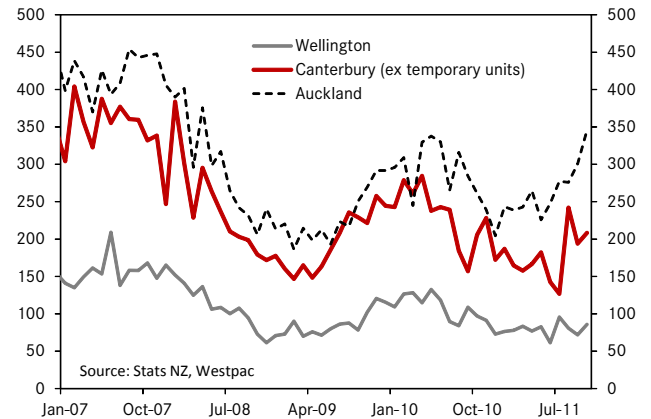


In contrast to residential and infrastructure work, commercial construction in Christchurch is currently slow and is expected to remain that way until late-2012. That said, we were surprised to learn recently that there is some commercial construction activity going on right now – we had expected zero at this early stage. It’s well-recognised that the CBD will be out of action for some time – demolition work is expected to carry through to around mid-2013 – but the surge in demand for space in the less-affected parts of the city is likely to spur some new building projects next year. Although an estimated \$4bn of commercial property was damaged or destroyed by the earthquakes, our forecasts assume that reconstruction will not reach this full amount; rather, this may be used as an opportunity to bring down vacancy rates from the cyclical highs seen before the earthquakes.

Easing the squeeze

The outlook for the construction sector is not just about Christchurch. There is also the issue of an emerging housing shortage, due to the prolonged period of low house building. We first began talking about the housing shortage in mid-2010. Recent evidence suggests that the shortage is most acute in Auckland, and that construction activity there is about to ramp up in response. Building consents (ex-apartments) in Auckland have increased almost 50% (s.a) since mid-year.

Figure 7: Residential building consents (s.a., ex-apartments)

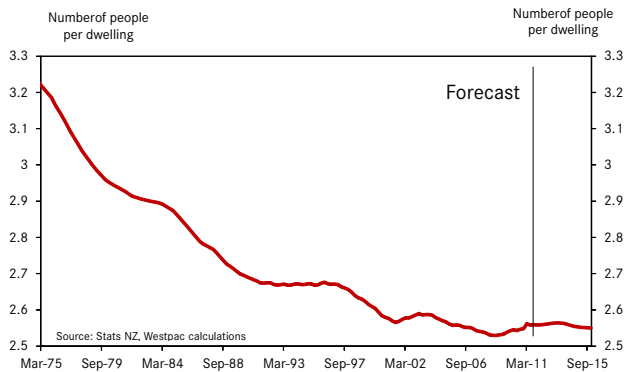


The shortage of housing is apparent in a measure of the average number of people per house (which simply divides the number of people in NZ by the estimated number of houses). This measure has been trending lower for decades as society gets richer, the population gets older and family size gets smaller.

During periods of economic duress, the number of people per house tends to temporarily plateau, or in some cases even increase slightly as the pace of building slows, and the rate of new household formation decelerates (students may choose to live at home instead of going flatting etc). But the number of people per house cannot go on rising forever – the downward trend always reasserts itself eventually. Normally, when the economy starts to improve households start to spread out again, and the construction of new dwellings is stimulated.

The extent of the trend decline in people per house (PPH) is evident in the graph below. (We have conservatively assumed that 10,000 dwellings were destroyed by the Canterbury earthquakes, and for illustrative purposes we’ve incorporated that in the PPH measure for the first quarter of 2011.) PPH has mostly been rising since 2008, and is now well above its previous trend. Our bullish residential construction forecasts are only enough to ensure that PPH rises no further over the next two years. It would take even more for the downward trend in people per house to reassert itself.

Figure 8: People per house



To be fair, the forecast of PPH depends on our forecast for population growth. Recently, net migration has been very weak and population growth has hit a 10-year low. If that were to persist, there would be less need for an increase in construction activity. However, we do not think the current weakness in net migration will persist. As we outlined in a recent bulletin we expect fewer kiwis to depart for Australia over the coming years as jobs become more difficult to find there (we expect about 11,000 fewer New Zealanders to move across the Tasman next year and about 18,000 fewer in 2013).

The housing shortage is most acute in Auckland, where housing consents dropped by around 77% from boom to bust, but population growth remained the highest of New Zealand's regions. There is now evidence that demand for housing has been reignited in Auckland, in the form of upward pressure on rents and house prices in the region. Over the last 6 months in particular, Auckland rents have risen much more sharply than New Zealand averages. Similarly, increasing house prices in Auckland have been at the forefront of the pickup in the housing market with both factors suggesting that demand has been outstripping available supply in the region.

Figure 9: Auckland rents compared to national average (indexed to 100 Aug 2006)

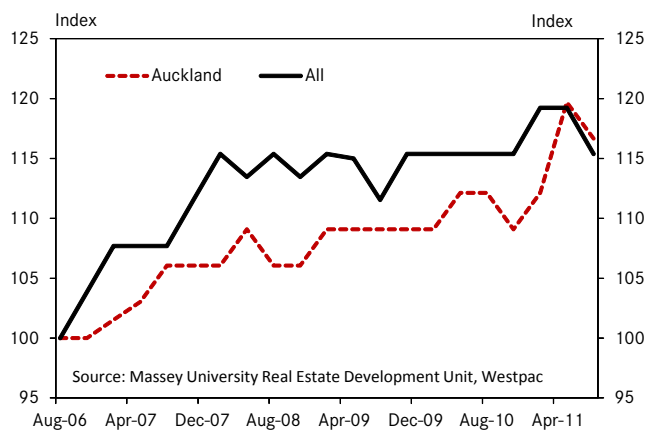
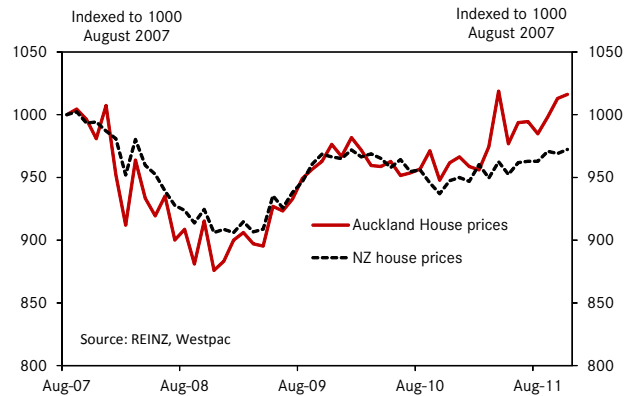
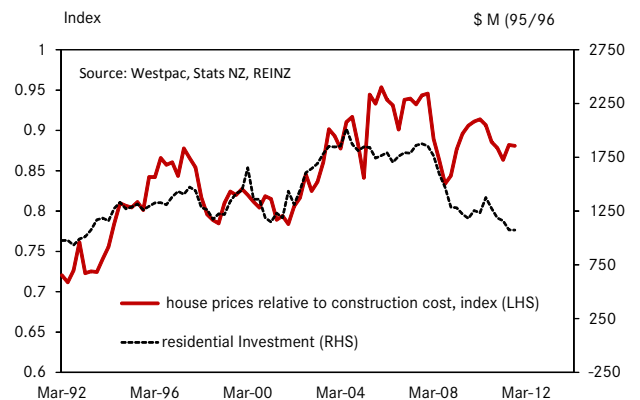


Figure 10: Auckland house prices compared to the national average



Of course, builders and developers are not necessarily incentivised by the number of people per house. They need house building to be profitable. New and existing houses can be considered substitutes. When the cost of buying an existing house is high relative to the cost of building a new house, then residential building tends to be relatively high and vice versa. The graph below shows that the cost of developing a new house currently compares reasonably favourably to the cost of buying an existing house. (Our proxy for the cost of new building is the average value of consents issued plus the REINZ section price index, while house prices are sourced from the REINZ house price index). Since 2007 house prices have fallen only a little while the price of bare land has fallen sharply. This has partially offset the rising cost of construction over the same period, leaving the index only a little below boom-time peaks.

Figure 11: Construction cost versus house price index, and residential construction activity



Leaky building repair work will also add to residential building activity. Price Waterhouse Coopers have estimated there are around 42,000 leaky homes (the majority in Auckland) with an outstanding repair bill in the order of \$6.3bn. It is likely this repair work will continue to trickle through over the coming years. To date there has been a fairly slow take-up of the Government's Financial Assistance Package launched at the end of July. Only 318 homes have so far been accepted with an estimated cost to the Government local authorities of \$26m each – a small fraction of the \$1-1.5bn the scheme was expected to cost the government and local authorities over the next 5 years.

Commercial and infrastructure work outside Canterbury: mostly slow

Commercial construction outside Canterbury is expected to pick up more slowly. Commercial property tends to go through very long and lagging cycles, and the industry is still working through the effects of a drawn-out recession, reduced access to development finance and the legacy of the previous building upturn. Different segments of the market are at different stages of this cycle, in what seems to be a fairly typical ordering. Demand for industrial property has been picking up in the last year or so, and there is evidence of building activity starting to follow suit. Vacancy rates for retail space are generally considered to be low and there has been a modest pickup in construction, perhaps most prominently by the major supermarket chains. In contrast, office vacancy rates are only just starting to settle at cyclical highs, and the pipeline for new projects is minimal following the recent completion of some major projects that were committed to during the boom.

There is a more active pipeline of infrastructure work planned for coming years. Investment in infrastructure remains a priority for the current government even with the move towards fiscal belt tightening. The electricity sector will also be a major contributor, with high prices in recent years encouraging generators to look into increasing capacity. Those projects already approved or under way, and due to be commissioned as early as 2013, add up to about 15% of current generation capacity. However, the imperative to repair Christchurch's infrastructure could constrain some forms of infrastructure activity in other parts of the country, for example in road building.

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