Westpac Institutional Bank

Home Truths

16 September 2016

It's been a busy few months for the housing market, with some big moves in house prices, another round of changes to lending restrictions, and a major milestone in addressing Auckland's chronic housing shortage. We'll touch on each of these developments in this issue of Home Truths.

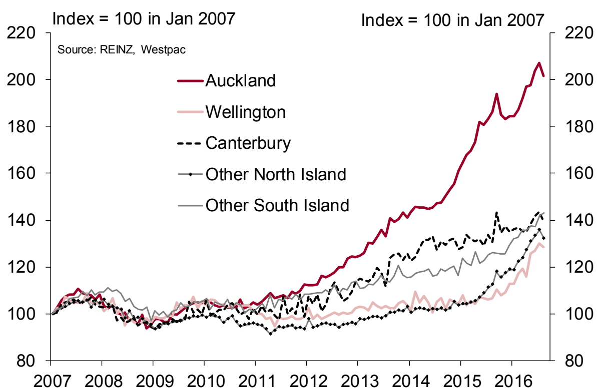
House prices eased in August

The REINZ house sales report for August was released earlier this week. This was the first complete month of data since the Reserve Bank's tighter loan-to-value ratio (LVR) restrictions, which were announced on 19 July and enforced by banks more or less immediately. Property investor loans are now effectively capped at a 60% LVR, while only 10% of owner-occupier loans nationwide can be at an LVR above 80%.

With previous measures to clamp down on housing demand, we've seen a strong run-up in prices in the months beforehand, followed by a cooler period that has proven to be short-lived. Ultimately, it's been difficult to judge whether the restrictions had a lasting impact on the level of house prices, or if they simply brought purchases forward.

This year has so far stuck to the script: while the RBNZ announced the LVR restrictions on short notice, it had strongly hinted at some further tightening measures in its May Financial Stability Report. House prices were already rising strongly by that time, and they accelerated even further between May and July.

REINZ house price indices, seasonally adjusted



So we weren't surprised to see a dip in the REINZ stratified house price index for August – down 2.2% in seasonally adjusted terms. That's a fairly mild response so far, not even reversing the 2.6% rise in prices in the July month. By way of comparison, prices fell by 4.2% after the 'bright line' test for capital gains tax was imposed last October, although that proved to be a one-month phenomenon. Prices fell by less than 1% after the first round of LVR restrictions in 2013, but with interest rates being hiked at the same time, prices were close to flat for most of the following year.

We were more surprised to see a slight lift in sales in August in seasonally adjusted terms, given that LVR restrictions should have a direct impact on the number of eligible buyers. That said, sales had already slowed in the previous three months, so the number of sales is well off its peak. This may be a sign that a lack of supply, rather than suppressed demand, is having the greater effect on housing turnover. The number of homes for sale as reported by realestate.co.nz has been falling sharply (except in Auckland), and the REINZ figures showed a further drop in the average time to sell to 30 days, a new low for this cycle.

LVR impact expected to be short-lived

Commentary around the August fall in house prices has been fairly low-key so far, which we think is appropriate. The reality is that it will take several more months of data to get the full picture of the impact of the latest LVR restrictions.

That said, we're on the side of expecting the impact on prices to be short-lived. Our assessment stems from our long-running 'investment value' approach to modelling the housing market. We assume that leveraged investors are the marginal buyers of houses – so they tend to set the pace for other potential buyers – and we assess their willingness to pay based on expected returns and costs.

LVR restrictions reduce the number of potential buyers who can qualify for a loan. But for those who do qualify, the LVR restrictions make little difference to their willingness to pay, which is based on factors like rental yields, borrowing costs and tax treatment – none of which are altered by the LVR rules.

So when LVR rules are tightened, we would expect to see an initial slowdown in the housing market – for instance, less competition at auctions would mean that buyers may not have to bid up to their maximum price, at least at first. But over time, competition among the remaining bidders will eventually reassert itself.

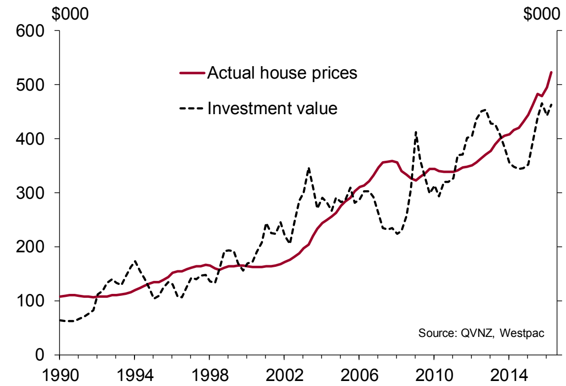
The end result would be a similar level of house prices as without the LVR restrictions, but with ownership becoming more concentrated in the hands of those who qualify for a loan. That's most likely to be multiple property investors, who can leverage off their existing portfolio to raise a deposit for a new purchase. Data from CoreLogic shows that this group of buyers has accounted for a rising share of house purchases since 2013, although it's hard to say whether this would have happened without the LVR restrictions anyway.

In theory, it's possible to tighten the LVR restrictions to the point that the number of eligible homebuyers falls below the number of homes for sale; that could have a more lingering impact on house prices. But if demand has to be squelched down towards zero in order to 'balance' the market, it's time to reflect on what that says about the supply side.

Fair value

Taking a step back, what does the 'investment value' approach tell us about the current state of the housing market? Based on current rental yields and mortgage rates, we judge that nationwide house prices are about 10% above fair value. This shouldn't be regarded as a forecast, but rather an assessment of the housing market's sensitivity to any changes in conditions. For instance, we'd say that house prices today are more vulnerable to a rise in interest rates than they would be if they were starting from an undervalued position.

House prices vs 'investment value'



This, however, is a national average figure. We're cautious about doing regional estimates, due to concerns about data quality (for rents in particular). But we suspect that a regional breakdown would show that houses are overvalued in Auckland, but actually undervalued in the rest of the country.

The latter shouldn't be too surprising when you consider how subdued the housing market has been in many parts of the country since the GFC, despite the stimulus of record low interest rates. Even centres such as Hamilton and Tauranga, which have seen prices rise almost 30% in the last year, are coming off a long period of flat or falling real house prices. A small number of regions are still going through this decline.

Build, baby, build

What's more, the 'overvaluation' in Auckland is not necessarily what it seems. Here, we return to our assessment of the Auckland housing market that we detailed in the May 2015 edition of Home Truths.[1] While people typically talk about house prices, what we're really discussing is property prices – that is, the value of the land plus the buildings on top of it. In Auckland, land accounts for more than half of the average property value, and likely accounts for much more than half of the rise in property prices in recent years.

That invites the question: what determines the value of land? In short, it's the value of what you can put on it. For instance, in Auckland there are many large sections with one house on them. It may be possible to tear down that house, replace it with several smaller units, and extract more rent per square metre of land. Even if the current owner has no intention of redeveloping in this way, the fact that a future owner may be willing to do so will be reflected in the market price of that land. (Of course, this perceived value is only justified if there are people to fill those new homes, an assumption that seems safe to make in Auckland but less so in the rest of the country.)

The all-but-finalised Unitary Plan greatly increases the scope for doing just that. The Plan allows for greater intensification across many central city suburbs, precisely where land prices have been rising the fastest. We suspect that anticipation of the Unitary Plan being passed explains a substantial part of the outperformance of Auckland property prices in recent years.

Discussions about how far Auckland house prices "need to" fall often fail to make this distinction between dwelling and land prices. Building a large number of compact, affordable homes on existing land is in itself the solution to the housing affordability crisis. In contrast to the view that a surge in homebuilding could crash Auckland property prices, we argue that a wave of homebuilding is needed to justify the prices that people are already paying for land.

We don't want to leave the impression that this is a win-win situation, however. The Unitary Plan has reduced the regulatory barriers to redevelopment, but the homebuilding industry still faces a number of constraints.

One is the question of how to finance new builds. On a positive note, the RBNZ has stepped up on this front. After a round of consultation on the new LVR restrictions, the RBNZ has decided that loans for homes that have been completed in the last six months, and are purchased from the developer, will be exempt from the high-LVR limits. Previously, the exemption for new builds only applied where the work had not yet begun or was only in the early stages. The uptake of that exemption appears to have been minimal, and many of the responses to the RBNZ's consultation made it clear that the scope of the exemption didn't reflect how the homebuilding industry operates.

[1] Available at http://www.westpac.co.nz/assets/Business/Economic-Updates/2015/Monthly-Files-2015/NZ-Home-Truths-Special-Edition-14-May-2015.pdf

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Another challenge is the mounting skills shortage in the building industry. Even at the current rate of building, employers are crying out for skilled workers, and quality is noticeably suffering – about a third of building inspections in Auckland are being failed. The high cyclicality of housing demand, and the predominance of small operators, have meant that the building industry has had a poor record of investing in and retaining skilled workers.

Finally, the cost of building new homes is substantial and rising rapidly. In Auckland, there have already been some instances of planned developments that have been cancelled as mounting costs have seen the developers' margins dwindle towards zero.

For these reasons, we believe that the building industry can plausibly deliver around 11,000-12,000 new homes per year in Auckland. This would be a sizeable step up from the current pace (9,600 new dwellings consented in the last year). But it would take many years of building at this pace to eat into Auckland's accumulated housing shortage, which we estimate at around 30,000 homes (and rising).

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