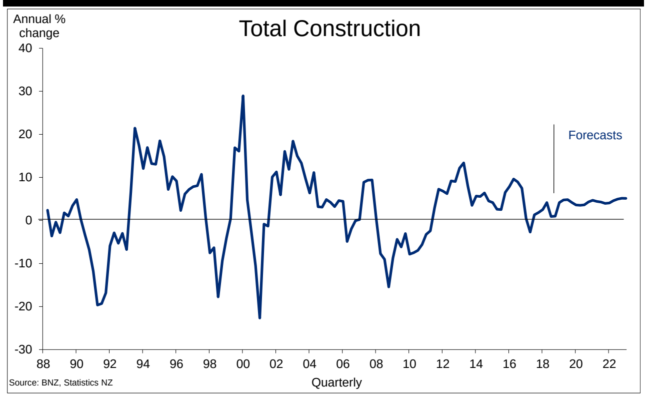
2 November 2018

NZ Construction Outlook

- **Construction is a key driver of ongoing GDP growth**
- **We forecast residential construction expanding 5.0% per annum over the medium term**
- **Non-residential construction expectations are a more modest 2.0% per annum**
- **Capacity issues are a major constraint to expansion**
- **Rising input costs will adversely impact business sector profitability**

If the New Zealand economy is to continue to grow, it is imperative that investment activity expands further. With a combination of increased uncertainty, weak business confidence and declining profit growth adversely impacting plant and machinery investment, a lot of the onus for further fixed capital formation will fall on the construction sector. There remain serious headwinds for this sector but we remain hopeful that it will continue to expand, albeit at a relatively modest rate.

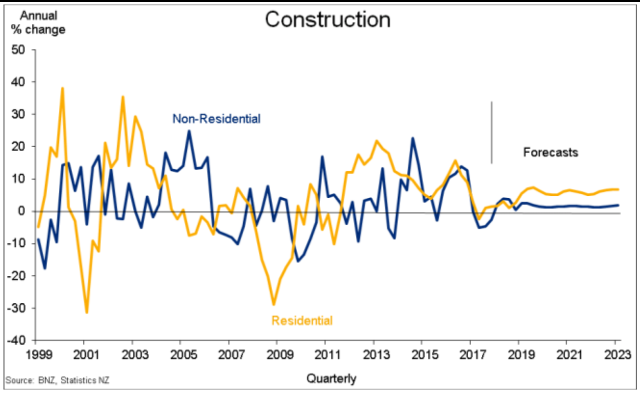
Solid But Unspectacular



Residential building is likely to be the most significant contributor to the expected increase in activity in part because it is the largest sub-sector in the industry but also because there is very clear demand growth ahead. Non-residential, by contrast, should continue to experience growth but with less obvious demand expansion and starting from an already relatively high base.

In considering the outlook for the sector, as much focus has to be put on the building industry's ability to supply as the economy's demand for new construction. In this regard, we are conscious that supply constraints are becoming more and more restrictive meaning the sector simply cannot produce output at the level that might be desired.

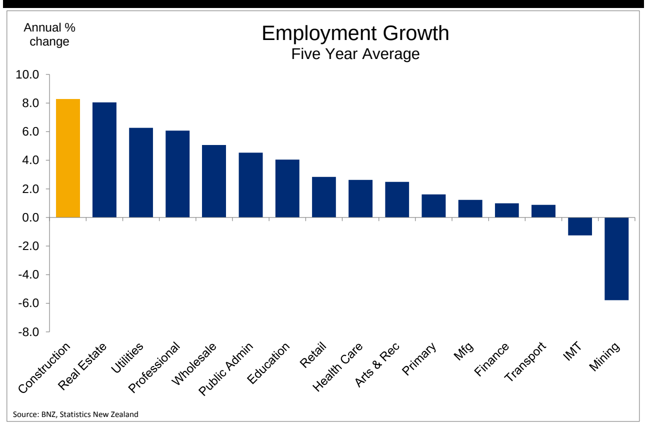
Residential Dominates



For the record, we are forecasting total construction growth averaging 3.7% per annum for the four years ended December 2021. We reckon such growth will require employment in the sector to rise by at least 2.5% per annum. This is a very big ask when businesses are already reporting significant difficulty in finding labour and the working age population in New Zealand is forecast to grow at a sub 2.0% pace.

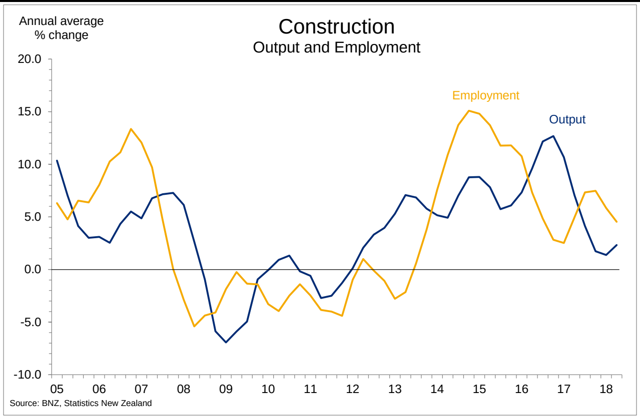
There is some precedent for this as employment growth in the construction sector has averaged 8.5% per annum over the last five years compared to a 3.3% rate for the total economy but you have to think the ability for the

Construction Job Growth Huge



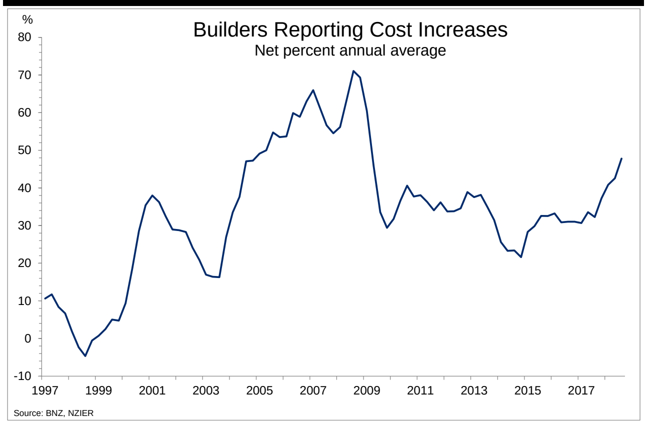
sector to continue grabbing market share must be reducing. Moreover, it would be fair to assume that the "better" workers have already been snapped up. Last but not least, the true demand for labour could be a lot higher than our conservative estimate given that construction output seems to have been tracking behind labour uptake in the sector over the last five years.

Productivity Issues?



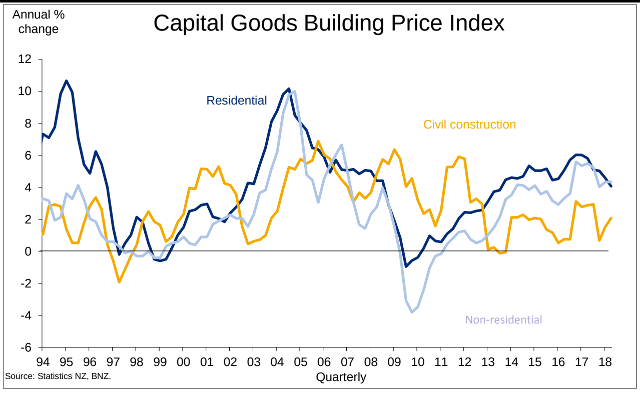
More generally, supply (or at least willingness to supply) will be being affected by rising costs – largely, we suspect, emanating from the labour market where not only will supply shortages be pushing wage costs up but so too will minimum wage movements. In September's Quarterly Survey of Business Opinion a net 52% of building sector respondents said they had faced rising costs. This was the highest reading in a decade.

Cost Increases A Worry



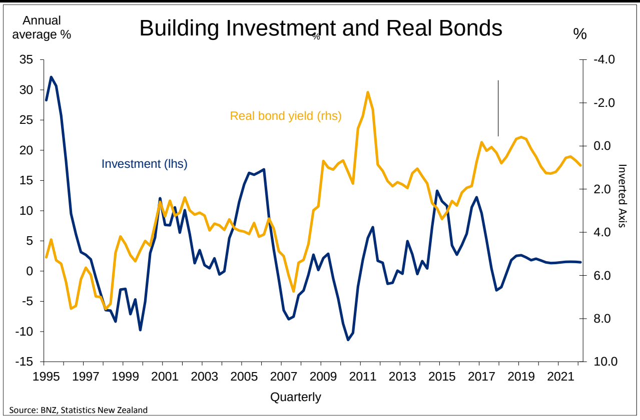
Interestingly though, the Capital Goods Price Index shows construction cost inflation moderating. The residential index fell to an annual 4.7% in the year to June from a peak of 5.9% a year earlier. Non-residential inflation was 4.3% compared to a peak of 5.5%. Nonetheless, these figures still sit at relatively high levels.

Capital Goods Inflation Elevated



Future increases in bond rates are likely to add to the construction industry's costs. However, real yields remain very low and we do not see them moving to prohibitively high levels in the foreseeable future.

Interest Rates Supportive



The other supply constraints facing the industry include the ability to gain access to land to build on, the speed at which consents can be processed, financing issues, infrastructure constraints and the industry's reliance on the scheduling of multiple sub-contractors to complete building (particularly in the stand alone housing sector).

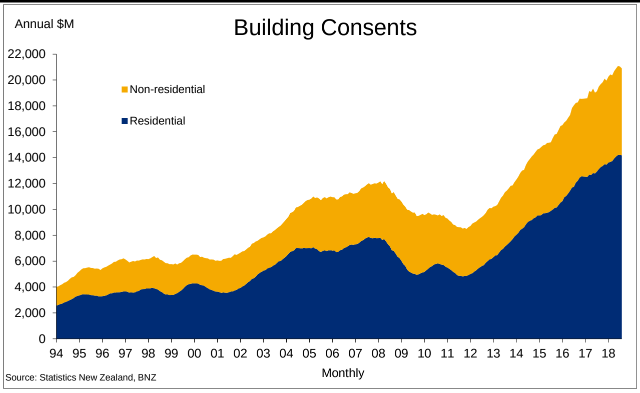
With supply restrictions as they are, it may be a blessing in disguise that demand growth is coming under some downward pressure.

While supply issues are affecting parts of the building sector, the demand conditions are far from homogeneous across the industry. We've thus broken our demand analysis down into its component parts.

Residential

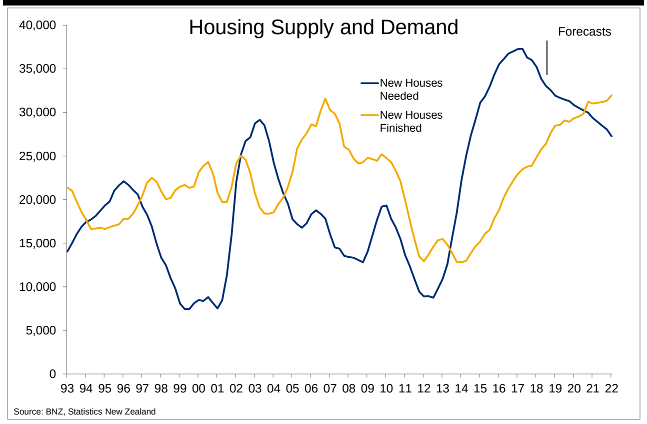
Residential is still the dominant type of construction currently accounting for 44% of total activity and sitting at 1.4x the quantity of non-residential construction.

Residential Dominates



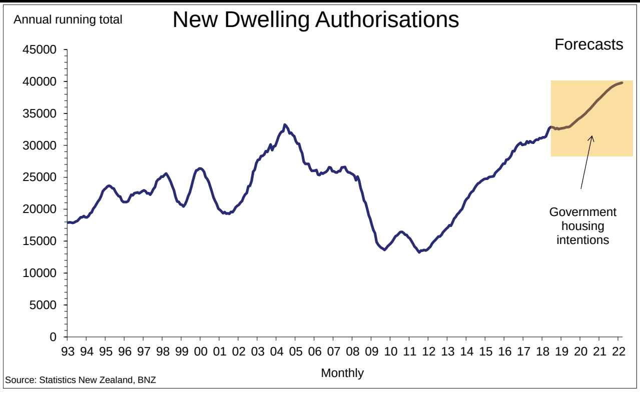
The starting point for residential construction is that excess demand already exists. You can argue as to the exact size of the housing deficit but it is fairly widely accepted that there is one and that it is, probably, significant. Moreover, whatever that gap is it continues to get larger as New Zealand's population growth is still outstripping the number of houses being built. By our estimates this will continue to be the case until late 2020 when the acceleration in building finally crosses over slowing population growth. But even then it will take several more years before the deficit can be overcome.

Excess Demand For Housing



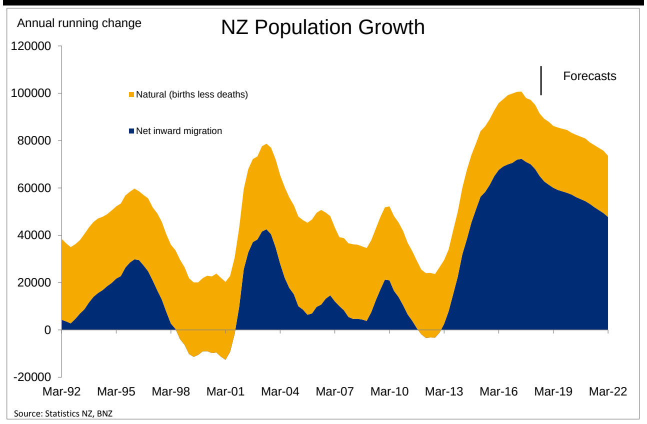
It is this that has encouraged us to forecast an average 5.0% per annum residential construction growth over the medium term despite the headwinds that face the sector. As an aside, this translates to new dwelling unit authorisations increasing to over 40,000, on an annual basis, in calendar 2022. By chance, this estimate is consistent with the findings of the National Construction Pipeline Report 2018 which picks new dwelling unit authorisations climbing to 43,000 in 2023. We are quick to note, however, that, given capacity constraints, our forecasts have very little upside risk and potentially quite a bit of downside potential.

Permit Numbers Head Ever Higher



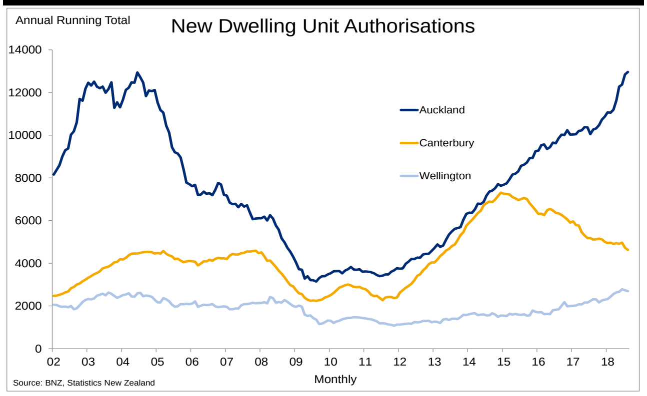
The major headwind is our expectation that population growth diminishes in line with weakening net migration. New Zealand's annual population growth peaked at 2.2% in late 2016/early 2017 as net annual migration inflows soared to over 72,000. By September this year the number had dropped to 62,700 and we are assuming that it will keep trending lower for the foreseeable future.

Population Growth Moderates



The other major negative for residential construction is the fact that the Christchurch post-quake residential rebuild is now well on its way to completion. Canterbury new

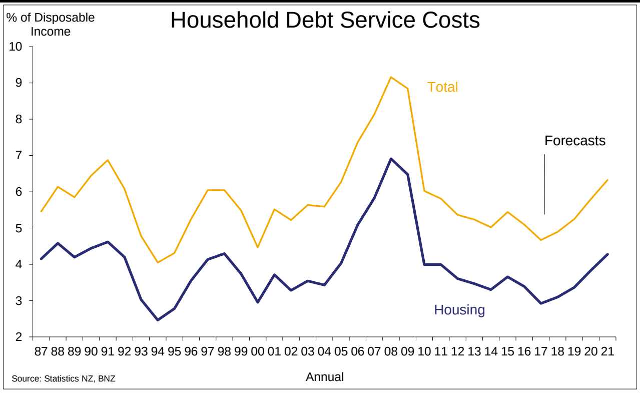
Canterbury Wilts



dwelling authorisations are now at their lowest annual level since May 2013 and are 37% down from their peak. Further declines can be expected.

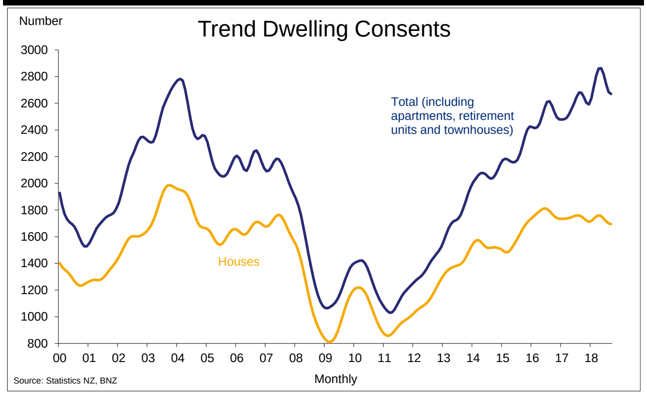
Our expectation that mortgage interest rates head higher will also have a constraining impact on demand. Real rates have already turned positive as house price inflation has diminished. They will probably rise further. Nonetheless, despite the very high levels of household debt that New Zealanders hold, debt servicing costs are very low. This being so, we do not believe the sort of interest rate moves that we are forecasting will put prohibitive pressure on households' ability to service their debt. Only if the unemployment rate started to rise would debt servicing issues become genuinely problematic for aggregate demand and we do not see this happening any time soon.

Debt Servicing Manageable



Note that the type of residential construction work being put in place is changing rapidly. Stand-alone housing growth appears to have peaked and is being replaced by rapid growth in multi-unit dwellings. We expect this trend to continue: as space becomes a premium; stand-alone dwellings remain prohibitively expensive; the Government ramps up its support for multi-unit dwellings; and the aging population further increases the demand for retirement homes.

Multi-Units Flourish

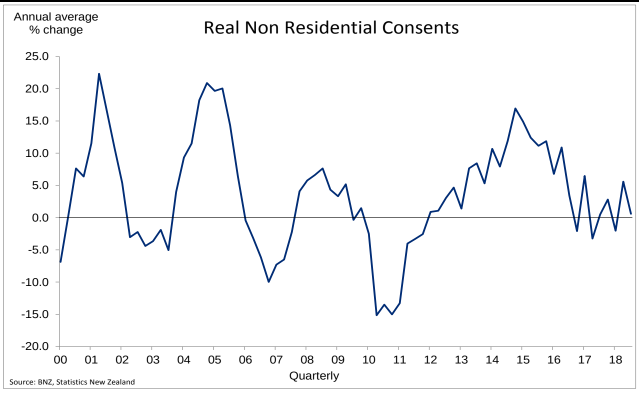


To cap things off, if the government is successful in seed-funding a prefabricated industry then this could have interesting implications for the structure of the building sector.

Non-residential

We are less optimistic about non-residential construction than we are about residential largely because the starting point reveals less excess demand and future demand growth will be more limited too. Furthermore, recent permit data are weak. The value of total non-residential consents was down an annual 16.3% September Quarter/ September Quarter. Consents were up just 3.7%, in value, on an annual average basis, which translates into a 0.5% real decline.

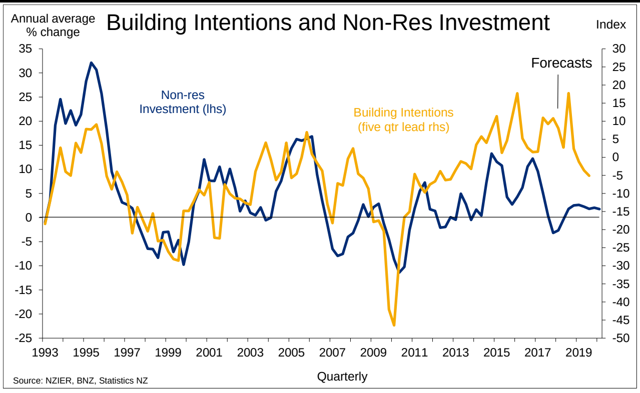
Non-Res Consents Flat



We are looking for real growth of around 2.0% per annum over the medium term. This is singularly unexciting but is stronger than current permit data suggest and still leaves total non-residential activity levels running above trend following spectacular growth over the three years ended December 2016.

The big risk to this sector is that the recent fall in business confidence results in a reduction in all types of investment

Building Intentions Weakening



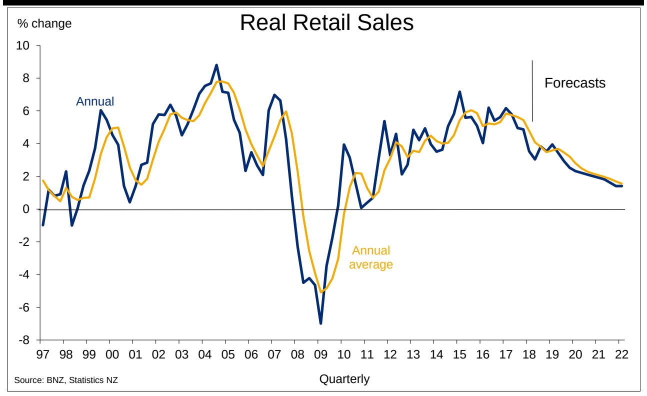
activity including construction. At -5% we note that building intentions (as measured in the QSBO) may already be being affected by this. This is the lowest reading since 2012. Having said that, this series is biased to the downside so remains consistent with modest growth in activity.

Retail

The supply pipeline, especially in Auckland, is very strong for retail construction. This is backed up with consents for the year ended August being 23% up on the previous year which, in turn, were 26% up on the year prior to that. Be that as it may, we can't help but wonder if once this work is complete things will soften up.

Retail spending is expected to be sustained at relatively high levels but we expect its expansion to slow. Short term it will be supported by significant government transfers and rising real wage growth but, ultimately, slowing population growth must slow things down.

Retail Sales Will Slow



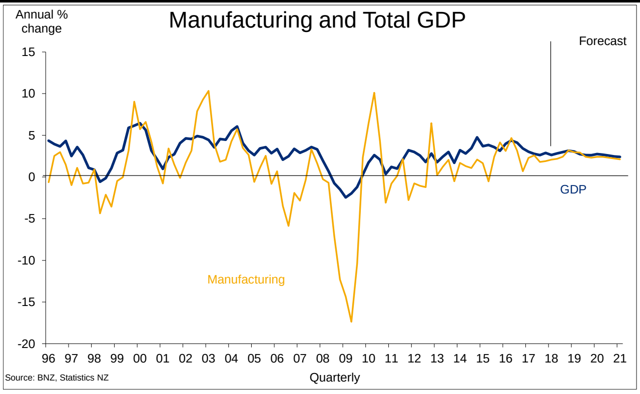
Additionally, retail margins are under pressure thanks to rising input costs and heightened on-line competition. The former is probably cyclical in nature but the latter is secular. The desire to invest in retail space will thus be restricted.

Nonetheless, there is continuing evidence that mall expansion is proving desirable and it may well be that rather than invest in shop floor space there will be a greater demand for distribution space and "new" ventures such as the so-called "ghost restaurants", which provide cooked food for home delivery.

Industrial

Industrial property demand is closely tied to manufacturing sector growth which, in turn, is leveraged to domestic retail sales, exports and construction. On this basis, we believe manufacturing activity will continue to trend higher in line with broader GDP growth, taking property demand with it. It's also worth noting that, ex food and beverages, manufacturing activity is still below past peaks suggesting there remains upside potential. Nonetheless, investment in the sector has been relatively strong and we are now seeing factory construction growth falling off its peak.

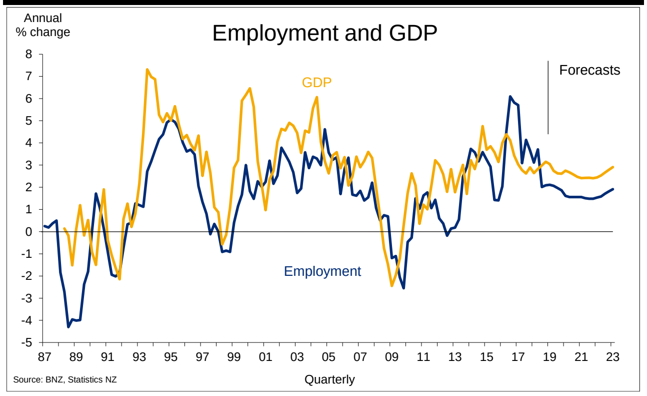
Manufacturing Leveraged to GDP



Office and admin

Consents have been fairly flat since 2015 and current permit numbers are in decline. Despite this, the sector is leveraged to employment growth and we expect further labour market expansion over the next few years albeit at a slower pace than the recent past because people are in short supply.

Employment Growth Slows

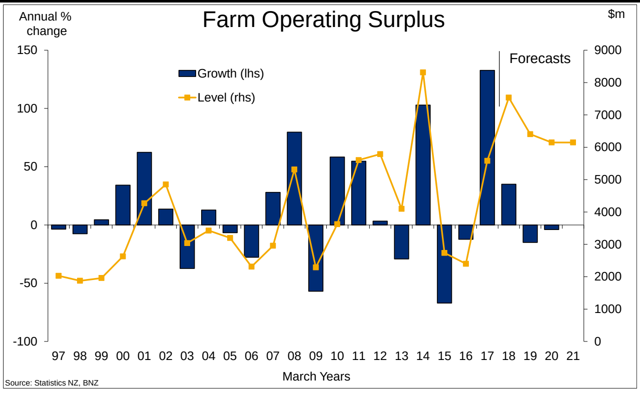


Rural

Growth in consents is slowing after a rapid expansion. We think that, on balance, New Zealand's agriculture economy will perform fairly well. However, we believe the extended period of expansion in the dairy sector may now be reaching maturity. We see conversions slowing and environmental issues preventing significant intensification. This augurs badly for on-farm construction.

Furthermore, the combination of rising farm input costs and a lower dairy payout will see less money available for investment purposes.

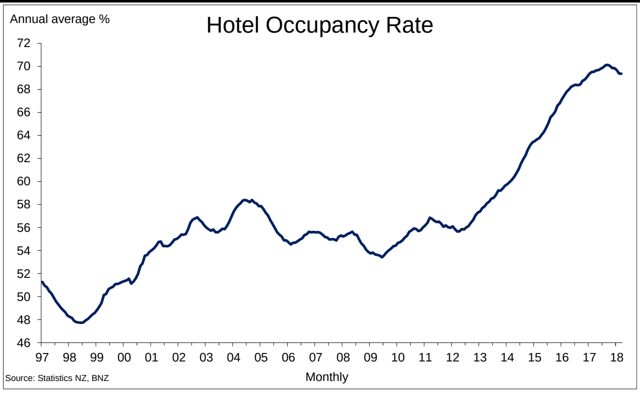
Farm Earnings Weaken



Hotels

There has been significant growth in consent issuance for hotel building. This is understandable as the New Zealand accommodation sector has been encountering significant capacity issues. However, with a lot of supply likely to appear in the next year or two and tourism growth slowing, it looks as if hotel construction activity will soon moderate. Nonetheless, given current occupancy rates and expected future tourism growth, demand for accommodation will remain elevated.

Occupancy Rates High



Infrastructure

Significant infrastructure spending by both local and central government is anticipated and will provide some anchor to the broader construction sector. With capacity constraints already apparent it will be interesting to ponder how much this may crowd out private sector investment. The other question for industry participants is, can they make sufficient margin on government contracts (especially on a risk-adjusted basis)? There is a long history of government austerity putting suppliers, of all types, under pressure.

In conclusion

Putting all this together, we remain hopeful that the growth cycle in construction activity can be extended for some time yet. Growth is likely to be dominated by residential building and, in particular, multi-unit dwellings. Nonetheless, the headwinds are growing and capacity constraints are becoming more binding both of which will limit the pace of the future expansion. And for those trying to make money in the sector frustration will grow further as staffing issues become more problematic and cost pressures increase. Finally, if a pre-fabricated industry does grow in New Zealand this has the potential to act as a disruptor to incumbents. We don't have a strong view on its likely success or failure but note that it should be watched closely.

And, last but not least, while fundamentals suggest further growth in the sector, slumping expectations and sentiment could yet become self-fulfilling.

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