



Valuable Advice from Workshop 4

What Would a Property Market Correction Mean for Business and the Wider Economy?

Held on Wednesday 14 September 2016

Executive Summary

Media reports on the Auckland property pricing boom have focussed mostly on its effect on owners and prospective first-time buyers. That makes sense, of course – property is an intensely personal business.

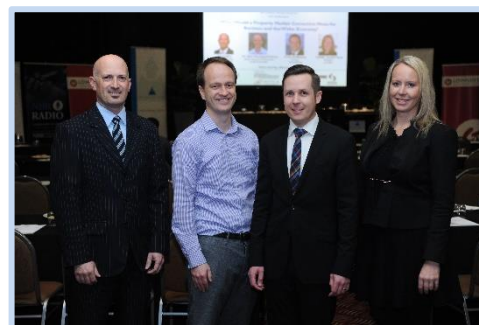
One question that's not had so much airplay is the impact of the boom on business and the economy. Even less attention has been given to the potential impact of a correction.

We think that's worth considering.

In July, former Reserve Bank Chairman Arthur Grimes called for a forty per cent drop in Auckland house prices. He was followed by former Reserve Bank Governor Don Brash, who upped the ante to a sixty per cent drop.

ANZ Chief Executive David Hisco added his voice to the conversation, noting that “salaries and wages have hardly changed whilst house prices have risen - this can't continue so it's a matter of when, not if, the market adjusts.”

To address the possible triggers and impacts of a market correction, we brought together three experts from the banking, academic and business advisory sectors.



(L-R) Nick Tuffley, Dr. Ryan Greenaway-McGrevy and Conor McElhinney with Jennifer Tunna (Chair)

The Speakers

Nick Tuffley, Chief Economist, ASB Bank since 2007, previously worked at Westpac and the Reserve Bank of New Zealand. Nick studied at Canterbury University, graduating with a Master of Commerce in Economics. He and the rest of the Economics team provide regular analysis of economic developments and the outlook through written publications and media comments. Their key objective is to help the bank's clients make better-informed business and personal finance decisions.

Dr Ryan Greenaway-McGrevy, Senior Lecturer of Economics, Auckland University, was previously a research economist in the Office of the Chief Statistician at the Bureau of Economic Analysis (BEA) in Washington DC. Ryan's research interests include asset pricing, bubble identification, and urban economics. His work has been featured in the New Zealand Herald, the Sunday Star Times and the Wall Street Journal's Real Time Economics Blog.

Conor McElhinney, Partner, McGrathNicol, helps companies through periods of change and to optimise their performance. Those companies often rely on residential property to secure corporate lending. Conor has worked in the advisory, restructuring, transactions, insolvency and forensic fields since beginning his career in Auckland with two Big 4 accounting firms.

CHAIR

Jennifer Tunna, Principal – Lowndes, has broad experience within the finance sector, particularly in insolvency and restructuring. She has been centrally involved with many of the largest and most complex corporate collapses in recent times. Jennifer has over 12 years' experience with leading firms in New Zealand and the United Kingdom.

What They Said

Nick Tuffley: Stretched but resilient?

Like David Hisco, Nick Tuffley says Auckland house prices are stretched when compared with the median income. The average house price to income ratio across all of New Zealand is 6.4. In Auckland, the ratio is a sobering 9.7. (If you want real value, he noted, buy in Southland where it's a mere 2.7!)

The Auckland experience draws inevitable comparisons with housing booms, followed by pricing collapses, in Spain, Ireland and the US.

Like Auckland, house price growth in each of those markets was supported by low interest rates, population growth and strong credit demand. Over time, house prices rose much faster than incomes, and price collapses of a third to a half followed.

But there are also important differences between those markets and Auckland, said Nick. Among them, poor lending standards and excessive construction growth.

- The US saw an increase in lightly regulated non-bank lenders during the boom. Ninja loans (no income, no job, no assets), also known as sub-prime mortgages, were common.
- In Spain construction from 1997-2008 accounted for 37% of GDP.
- In Ireland that figure was 55%.

When the bubble burst in those countries, coinciding with the Global Financial Crisis, the effect was sudden and extreme.

New Zealand, on the other hand, is subject to trends that argue against such a dramatic scenario. They include well-regulated lending standards, a sustained period of high migration levels (currently at three times 1995 levels) and 10 years of “underbuilding” in Auckland, which has resulted in a shortage of about 25,000 homes. (It will take about two years to have building rates move in the right direction, added Nick, let alone make up for the shortfall.)

Nonetheless, markets do go down as well as up. ASB Bank has “stressed tested” two scenarios that could feasibly trigger a downturn in New Zealand. One is a sharp downturn in China’s economic growth, and the other is a significant rise in local interest rates.

Both scenarios are bad news for anyone counting on house prices staying at their current levels. In the first scenario, New Zealand unemployment rises to 13%, and house prices fall by 40% across the country (and by more than 40% in Auckland).

In the second scenario, unemployment reaches 12% and house prices fall by 30%.

While either scenario would have serious repercussions for many people, the business impacts would not be as massive as in Spain, Ireland and US, said Nick. The reason? In New Zealand, banks would maintain sufficient capital ratios (or percent of risk-weighted assets) to survive and keep doing business.

The outtake from Nick’s presentation? Don’t be complacent, but don’t panic either.

Dr Ryan Greenaway-McGrevy: The benefits of a planned correction

Dr Ryan believes in affordable housing. Not simply as a matter of social justice but because, he says, “affordable housing is necessary to sustain long-term growth. Businesses need employees. Employees need somewhere to live.”

To illustrate the point, Ryan showed what happened to house prices vs population growth in two cities – San Francisco and Houston – between 1988 and 2015.

- San Francisco house prices grew almost two and a half times in real terms (inflation adjusted) over that period, while the population grew from approximately 3.7m to 4.6m.
- Houston house prices rose by about half in the same period, while the population took off from 3.7m to just over 6.5m.

Assuming we accept that affordable housing is necessary for long-term growth, who says that housing has to be affordable everywhere? Couldn’t prices be high in one place (Auckland, say) but affordable elsewhere?

No, said Ryan. Cities are more productive than other places – the value added per worker is 30-50% higher in Auckland than in other regions (interested readers can find the relevant research paper [here](#)), and services (versus low value commodities) thrive in cities.

Why such a difference in value per worker? “Knowledge transfer”, said Ryan. Technology is great, but skype and other communication tools will never replace face-to-face communication for things that really matter.

The second point is important too. New Zealand’s reliance on commodity exports is a lid on our prosperity. To flourish, we must grow service exports. And the formula for achieving that is simple: grow Auckland.

So we need to make Auckland affordable. And doing so in a planned way will be better than allowing it to happen in an unplanned manner.

But how to achieve this? Increased housing density is one critical element. The beauty of increased density is that it lowers dwelling prices while mitigating the fallout to land values.

Increasing housing density will be enabled by land assembly, the process in which a single site is created from a number of titles, usually for development. This will allow more apartments to be built.

The second critical element, said Ryan, is credibility: “It is important that deflation in dwelling prices is widely anticipated.”

Right now, credibility is missing, however. Auckland Council has stated that it wants to see a property-to-income ratio of five by 2030 (you can find the report [here](#)). Ryan questioned whether this is a credible aim, especially given the lack of a “commitment mechanism”. If Council fails in this goal, it suffers no consequences.

Where would such a mechanism come from? That question was addressed, in an indirect way, when a member of the audience asked whether we have the [political] will for a planned correction.

No, we don’t, replied Ryan. “Decentralised decision making rules it out.”

Conor McElhinney: It’s contagious

First things first: If Auckland suffers a housing pricing *collapse*, all bets are off. Conor was here to talk about a correction – a much softer landing and something that has happened in New Zealand before in the late 90s and during the GFC.

His first point was simply that a correction in the near future would hardly be a surprise. Markets are cyclical, and in recent history downturns have struck around about every 10 years.

His second point was equally straightforward: there’s a negative correlation between house prices and insolvency. In other words, when prices are high, insolvency rates are low. Conversely, when prices fall, insolvency firms like McGrathNicol get busier.

Conor also contended that in the current buoyant economy, a lot of “zombie” companies are being propped up by a combination of low interest rates and high property prices. Around 86% of SMEs McGrathNicol had worked with over the last four years were supporting their company borrowing with privately held property – when the bad times hit, and money’s no longer cheap and easy to borrow, a lot of those businesses will be in trouble.

That, said Conor, is a real risk to the economy – and we could see entire sectors impacted by what he called “the contagion effect”.

It happened during the Global Financial Crisis when many lending companies collapsed – Bridgecorp, Nathans, South Canterbury among them.

So what sector would be most impacted by a correction in Auckland house prices? Those at risk include such varied sectors as retail, property syndicates and the aged care industry.

In the last 18 months, property developers in Canterbury have already been hard hit with 160 liquidations in the last 18 months as the building boom has slowed, and apparent success stories like Stonewood Homes, Valiant Homes, Springpark and others have disappeared.

Tracking house prices and core retail sales since 2003 is like watching a dance – the two lines move in almost perfect unison. Should house prices fall, said Conor, expect to see appliance, hardware, building, garden supplies, furniture, floor coverings and houseware sales hit especially hard.

As for property syndicates, their exposure is a matter of timing and degree. Based on a sample of property syndicate offer statements, Conor calculates that a 10% fall in property prices would be enough to breach the common LVR covenant in recently formed syndicates. That would then require investors to come up with more cash (unlikely in a falling property market), or prompt banks to start charging penalty interest. Either scenario would raise the cost of doing business and lay the seeds of a slowdown in the economy.

The link between property prices and retail, and property prices and property syndicates is easy to see. But where's the link between property prices and the aged care sector? It's at the very core. Since 2007, on average a whopping 90% of net profit before tax for three big players, Ryman, Summerset and Metlifecare, was due to fair value movement in the property each owned (both realised and unrealised). The aged care sector has enjoyed super profits as property prices have climbed rapidly. Conor quoted John Collins, Executive Director of the Retirement Villages Association, who reminded us last month that "just as we have recently seen these large paper profits, those with slightly longer memories will recall equally large paper losses post-global financial crisis reported by many village companies."

So what should business owners do to protect themselves against a market correction? Conor recommended three steps. First, run some stress tests/scenario analyses so you're prepared. Second, renegotiate your banking facilities to reduce risk (remove covenants, renegotiate guarantees). If you're among the 86% of SME owners with business borrowings against your home, that includes segregating those two things now. Finally, he said, learn about the PPSR and register your interests. If your company owes you money, register that as a loan; conversely, if you owe the business money, bite the bullet and declare a dividend.

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