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PROPERTY INSIGHTS

Coastal Update – Whangarei County, Coromandel & Western BOP

EXECUTIVE SUMMARY

This report looks at the general states of the dwelling and section markets in three coastal areas: Whangarei County, Thames-Coromandel and the Western Bay of Plenty (BOP). It looks at whether these markets are cheap or expensive relative to the national market, how volatile they are through the cycle, the impact of interest rates on sales and the current state of demand and supply. In future reports details of our fact finding visits to these areas will be released.

But first the report discusses some general issues relevant to demand and supply prospects for the coastal property market. It highlights the importance of distinguishing demand by would-be holiday home owners from demand by get-rich-quick investors. Locations that have had massive supply responses to the transitory investor demand – particularly relevant to many coastal section markets – will be most at risk when the grim reaper comes knocking. It also discusses affordability issues relevant to future coastal property demand, including the affordability (or NOT) of New Zealand coastal property to foreigners.

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Untangling demand and supply for coastal property

The general theme over the last several years has been a massive increase in demand for coastal dwellings and sections which has resulted in prices more than doubling in most places, but in some locations this has resulted in a massive increase in supply. To understand what will ultimately happen to coastal property prices requires an untangling of demand and supply on a location-by-location basis, information on future supply and an understanding of what will drive future demand.

Critical to understanding demand in each location is a separation of demand by would-be holiday home owners (i.e. end-users) from demand by get-rich-quick investors and spec builders (the latter group is of some relevance in some coastal section markets). The locations where we see warning bells ringing loudly are those where demand has been dominated by get-rich-quick investors and this demand has resulted in massive supply increases (mainly relevant to section supply, but this will have implications for dwelling prices). See our reports on the Far North and the Mangawhai Area for examples of places where warning bells are ringing (this link will take you to where these **Property Insights** reports are stored on our website: <http://www.sra.co.nz/free.html>).

Modest deposits on proposed coastal sections and apartments (e.g. 5% or \$5,000 in many cases), the prospect of selling at a profit before title/settlement, and slick marketing has played an important part in luring many gullible investors into some coastal markets. The demand from these get-rich-quick investors, who have accounted for as much as 90% of demand in some extreme cases, will prove to be transitory while the increase in supply is not. Ring. Ring. Ring.

In locations where demand is predominantly from end-users and there has been no or little supply increase the downside risk to prices as demand falls due to higher interest rates and the constraint of affordability will be much less than in locations where swarming investors have fuelled a massive increase in supply. But even these places are not without eventual downside risk to prices.

In some places improved roads/access and/or improved facilities and/or new supply options will help insulate prices from the general fall in demand we are predicting and that has already started in some locations. But even these places, and locations that have not had a large increase in supply, will face increased competition from the at risk locations. On entering a real estate office on the Coromandel last week the agents were discussing this issue and concluded that their competition was as much from other parts of the Coromandel as from the other real estate agents in town. If prices for coastal dwellings and sections fall in competing locations, then local prices will not be immune.

Furthermore, the Coromandel, for example, also faces competition from parts of the Western Bay of Plenty (BOP), from parts of Northland and from elsewhere, and vice versa. Prime locations and locations that investors perceived as being cheap or affordable lead the charge up the hill. As prices in these locations sky-rocketed it made other locations look cheap on the relative basis, so prices were bid up most every where. However, when prices start falling in the “weak-link” markets it will make the other markets look expensive on a relative basis and the relative price game will get played on the downside just as it played out on the upside. Equally, if a large oversupply of sections relative to end-user demand ultimately drives section prices down materially in some locations it will impact on local dwelling prices.

On our fact finding trips we try and untangle demand and supply and gather information on future supply and factors relevant to future demand, while our analysis of the prospects for interest rates and housing demand drive our overall views on the outlook for coastal property demand. Unfortunately for current coastal property owners, it is most likely that general demand will fall dramatically at some stage over the next several years, with two major sources of downside risk, which spell especially bad news for the places where investors have fuelled massive supply increases.

As covered in our **Interesting Times** reports, the Reserve Bank has only started the real battle against inflation and it will be a drawn out affair. Higher interest rates will depress demand in many coastal property markets more so than in urban markets, but not in all segments or places. However, to solve the domestic inflation problem the Reserve Bank will have to get the unemployment rate up significantly and in the process a significant number of firms will come under at least some financial pressure. Such developments will dent demand in most if not all segments of the coastal property market.

As covered in our **Housing Prospects** reports, housing affordability will become a critical issue during the next downturn. In coastal property markets where demand is predominantly from holiday home owners, affordability has two faces: (1) the massive increase in coastal house and section prices makes them affordable to a much smaller group of people; and (2) the massive increase in house prices in general



means it will take the next generation of would-be holiday home owners much longer before they can afford a holiday home.

For example, the median house price in Auckland City in 2001 was \$291k, while the median house price in Thames-Coromandel was \$178k, so the combined prices for the average primary residence and average coastal property was \$469. As at today the median Auckland City house price is a bit over \$540k while the median Thames-Coromandel house price is just over \$380k, for a combined total of around \$925k (i.e. almost a 100% increase since 2001). The average household income has increased around 35% since 2001, but the average mortgage interest rate has increased from around 7% in 2001 to a bit over 9% today.

If an Auckland household had an after tax income of \$80,000 in 2001, a 20% mortgage on the average Auckland primary residence and 25% deposit to buy the average Coromandel property to use for a holiday home, it would face an interest cost equal to 17% of its after tax income. A household in the same circumstances today, after grossing its income up 35%, would face an interest bill equal to 33% of its after tax income. Based on this example, the affordability hurdle to own the average Auckland and average Coromandel property has roughly doubled since 2001, which means the number of new holiday home owners even in the medium-term future will be much smaller than in recent years.

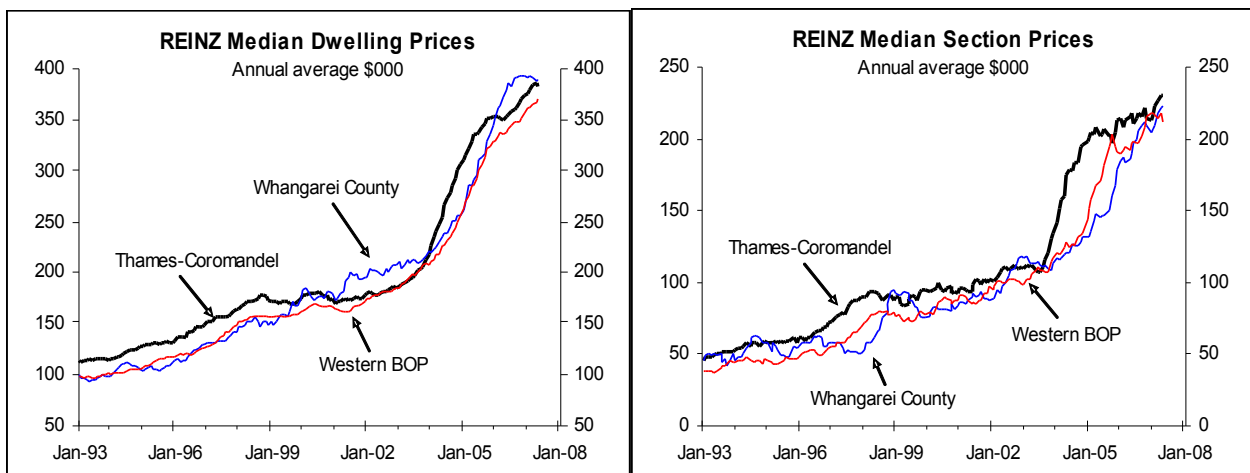
Will foreigners rescue the market? Martians are probably more likely to rescue most coastal property markets from falling local demand than are foreigners. For example, in 2001, when the NZD bought only 42 US cents, it cost an American just US \$75k to buy the average Thames-Coromandel property. Today, with the NZD buying 76 US cents, and the average Coromandel house price a touch over NZ \$380k, an American buyer would have to stump up around US \$290k (i.e. 287% more than in 2001). NZ property was exceptionally cheap in foreign currency terms in 2001, but it isn't any more, while central banks in many countries will spoil the party for international property investors over the next year or so.

Whangarei County, Thames-Coromandel and the Western Bay of Plenty Country

We have combined the overview analysis for these three areas because they are all roughly two hours drive from Auckland and therefore represent competition for each other. In future reports details of our fact finding visits to these areas will be released.

Whangarei County is the coastal and country areas around Whangarei City, with the main northern coastal places being Tutukaka, Matapouri, Ngunguru, Whangarei Heads, Parua Bay, McLeods Bay, Whananaki and Pataua, and the main southern coastal locations being Langs Beach, Waipu, Ruakaka and Tutukaka (the section market in the southern areas was covered in our report on One Tree Point and Ruakaka and you can use the following link to access that report from our website: <http://www.sra.co.nz/free.html>). The key coastal places we focus on in Thames-Coromandel District are Whitianga, Pauanui, Tairua, Cooks Beach and Matarangi, and in the Western Bay of Plenty Country the main coastal areas are Waihi Beach, Antenree, Whangamata, Whiritoa and Omokoroa. The full list of places included in these areas by REINZ is appended.

In both the house and section markets the Thames-Coromandel District lead the other two areas during the boom in prices that started in earnest in late-2003 (the two charts below). Thames-Coromandel includes the premium Pauanui and Matarangi locations and the rapidly developing Whitianga market. But the other two areas did not lag behind for too long and prices in all three areas, for both dwellings and sections, are now in the same ballpark.



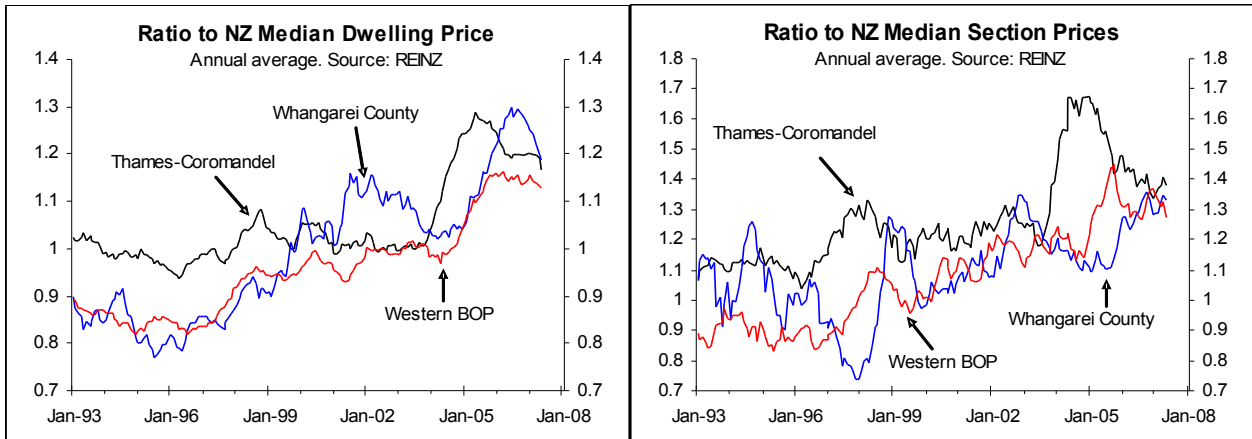
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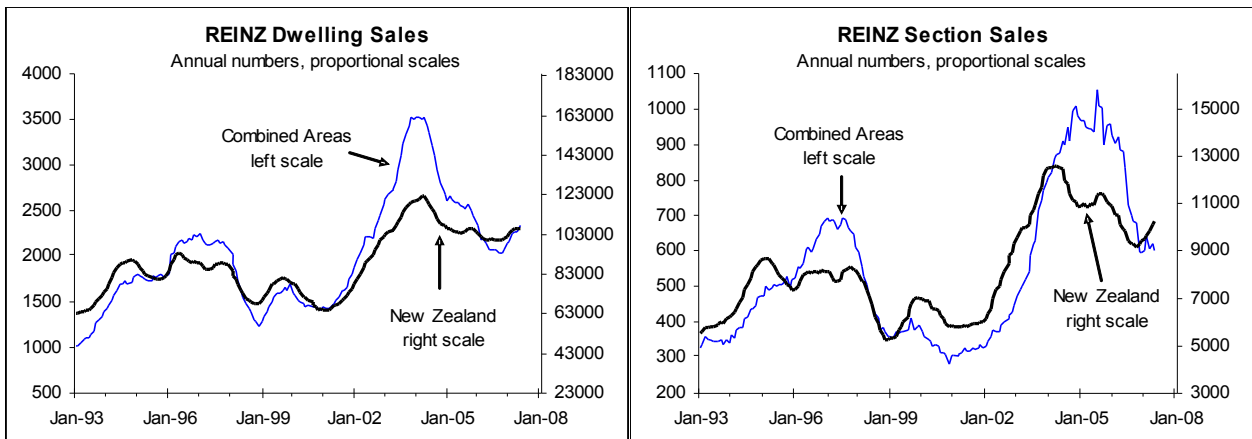
The REINZ data for dwelling sales is close to the total number of sales in the market, so the REINZ median dwelling price data will reflect market price movements reasonably accurately. Where developers sell sections direct to buyers, which is common in many coastal markets, the REINZ section sales data generally significantly understate the total number of sections sold. However, the REINZ section sales data captures the lion's share of secondary market section sales and so the REINZ data on median section prices should be reasonably reflective of section price developments in the overall market.

It is interesting to view the median prices in these three areas relative to the national median prices. The left chart below shows the ratios of the annual average median dwelling prices in these three markets to the annual average national median dwelling price, while the right chart does the same for section prices.

Dwelling prices in all three areas are currently between 10% and 20% above the national average (the left chart below), which is below the peak premiums experienced when these market were running exceptionally hot not long ago, but they are well above the historical average ratios. Sections prices in these locations are also higher than normal relative to the national average (the right chart). To some the rise in the level of prices in these locations relative to the national average over the last decade is because coastal property used to be undervalued and now better reflects the intrinsic value of coastal property, and this may be partly true but we suspect the main answer lies elsewhere.

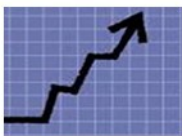


The two charts below show the annual average number of dwelling sales and section sales respectively for the three areas combined relative to the national numbers. The scales are set on a proportional basis so the movement in sales in the Combined Area relative to national sales is meaningful. And the charts, especially the section chart, shows it is normal for the number of sales in the Combined Area to outperform in strong markets, but to under-perform in weak markets. While national house sales and section sales experienced mega-booms between 2002 and 2004, sales in the Combined Area went ballistic. The obvious risk is that during the next downturn sales levels in the Combined Area, especially for sections, will collapse, just as they did during the last downturn in the national market.



As covered in our **Housing Prospects** reports, national house and section prices are extremely stretched relative to income levels and the rental yield on housing is the lowest on record. We believe this implies inevitable downside risk in prices of a larger magnitude than seen in market downturns over the last 20 years or more. With house and section prices in the three areas under review being high relative to even

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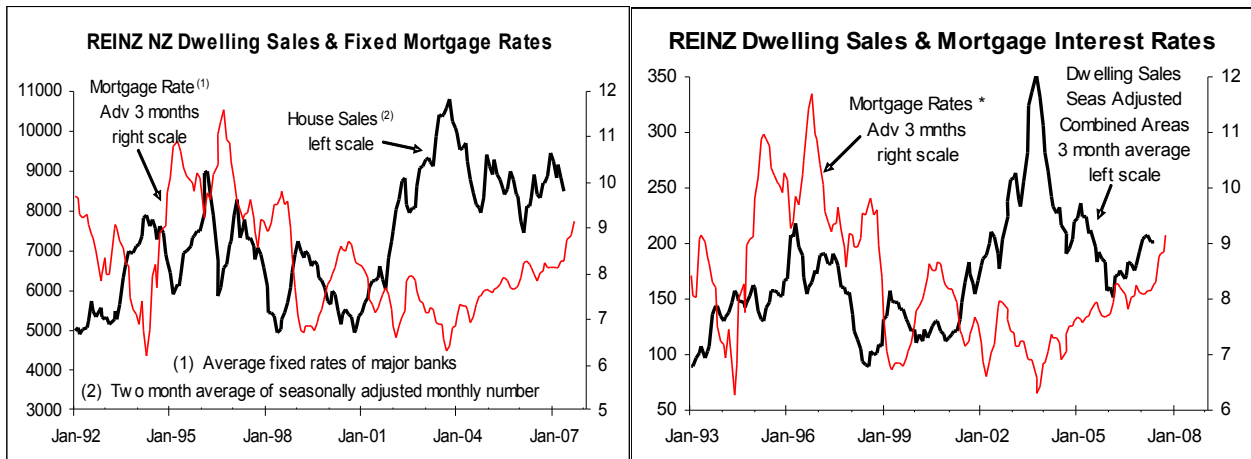


the extremely stretched national prices, and with the likelihood that demand will fall more in these areas than nationally during the next downturn, then the obvious implication is that there is more downside risk to prices in these locations than nationally.

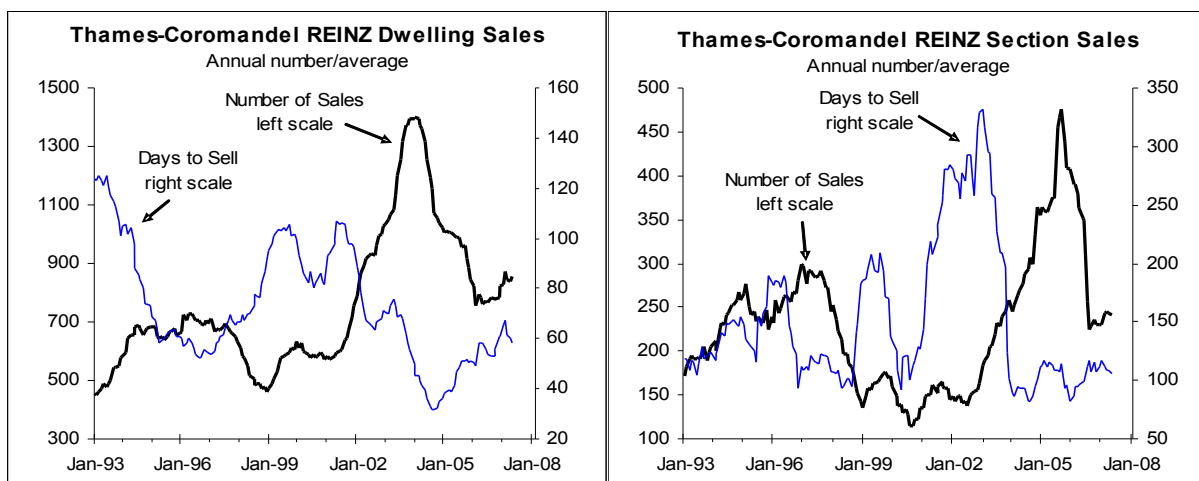
The left chart below shows that mortgage interest rates have a material impact on the national number of house sales (although our analysis of the prospects for housing demand and house prices contained in our **Housing Prospects** report shows that migration also needs to be taken into account). The best fit between the two lines is with the red interest rate line advanced or shifted to the right by three months to reflect how long it takes on average for changes in interest rates to impact on the number of house sales.

The left chart shows that house sales are starting to fall in response to the latest increase in mortgage interest rates that started in earnest in March, with significant further downside likely over the next three months. The right chart below is the same as the left chart but this time the black line shows the number of house or dwelling sales in the Combined Area rather than the national number. The fit in the right chart is not quite as good as in the left chart, but the right chart shows that changes in mortgage interest rates can have a material impact on dwelling sales in the Combined Area with a three month lag.

As covered in our **Interesting Times** and **Monetary Policy Briefing** reports, the Reserve Bank has only started the real battle against inflation. The housing market, and especially the coastal property market, face several negative risks: higher interest rates, extreme unaffordability, and the harsh reality that the only way the Reserve Bank can solve the domestic inflation problem is by stepping on the throat of the labour market, hurting many businesses along the way.



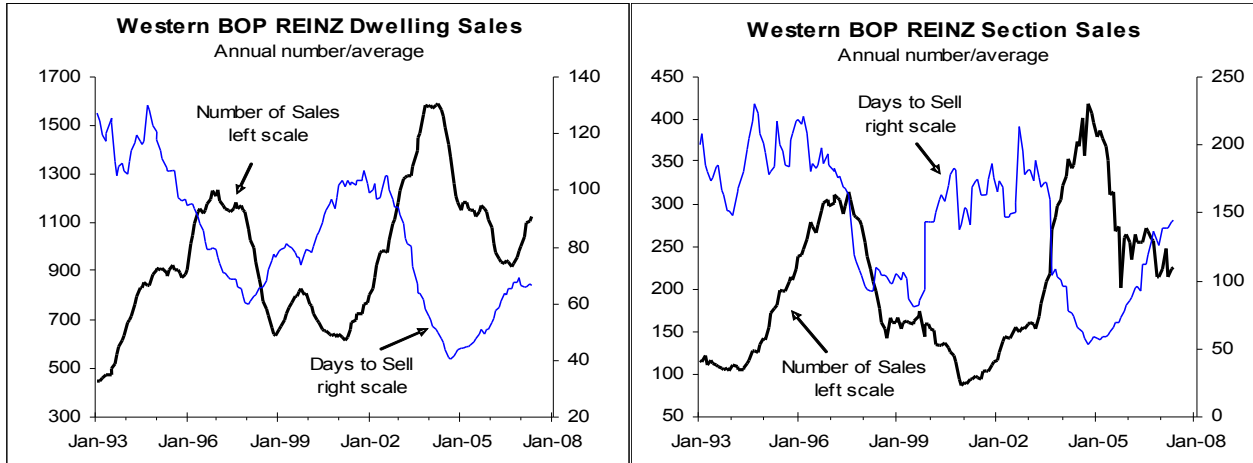
But we are getting ahead of ourselves, by historical standards the demand-supply balance in these three coastal markets is still reasonable good. The two charts below relate to the Thames-Coromandel District and show the annual number of dwelling and section sales (the two black lines) relative to the annual average number of days it is taking dwellings and sections to sell (the two blue lines). Sales levels over the last year have been above average and days to sell have been relatively low, although the right chart above predicts that things are about to deteriorate somewhat.



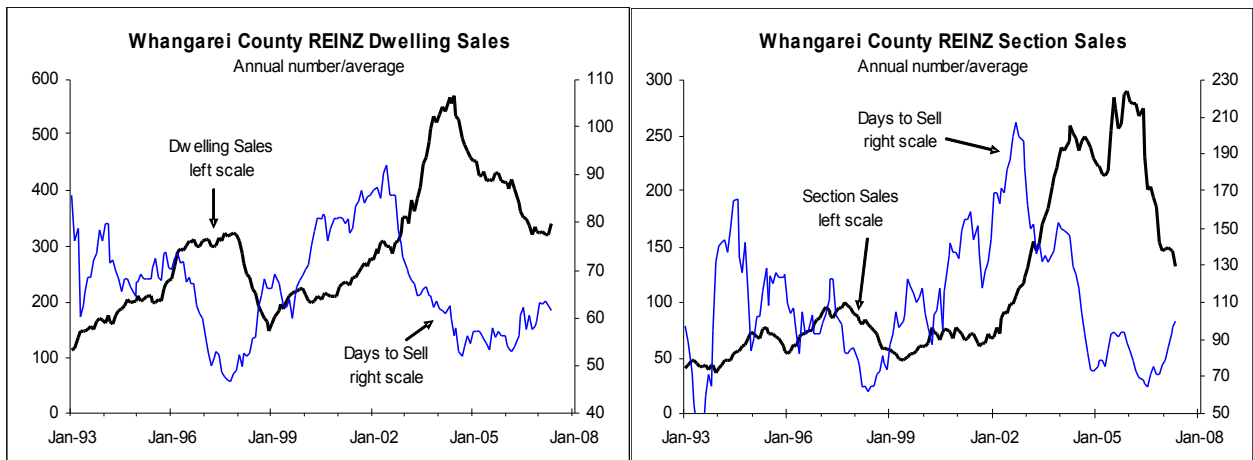
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The two charts below are the same as the two above but this time for the Western BOP Country. The dwelling chart for the Western BOP is much like the Thames-Coromandel chart, with the number of sales having experienced a resurgence and days to sell having risen but still being below average. However, the Western BOP section chart paints a less favourable picture, with the number of sales over the last year around an average level but days to sell significantly higher than in the Thames-Coromandel District.



While the number of dwelling sales and section sales in Whangarei County over the last year were down from the peaks levels of a couple of years ago they were still above the peak levels in the 1990s, while days to sell were still reasonable low by historical standards. The fat lady has not even arrived at the theatre yet and is renowned for taking a long time to warm up her magnificent voice. However, as covered in the recent Raving about the growing number of “motivated vendors” starting to spring up in the Whangarei market (<http://www.sra.co.nz/pdf/Housingcreaks.pdf>), and this will be the case elsewhere, if someone needs to sell in a hurry they could be unpleasantly surprised.



Once the real bad times arrive, the problem motivated vendors will face in all the three coastal markets covered in this report, and elsewhere, is that it will take much longer to sell properties in these markets than in the main urban markets. And the combination of motivated vendors and slow turnover rates are the sort of thing that can bring about significant price reductions.

Appendix – the locations within the three areas reviewed

Whangarei County

Glenbervie, Hikurangi, Kauri, Langs Beach, **Matapouri**, Maungatapere, **McLeod Bay**, **Ngunguru**, Oakleigh, One Tree Point, Pakotai, **Parua Bay**, **Pataua**, Pipiwai, Portland, Ruakaka, Ruatangata, Springfield - Whangarei District, Tamaterau, Tangiteroria, **Tutukaka**, Waitutu, Waipu, **Whananaki**, Whangarei Area, **Whangarei Heads**, Whangaruru, and Whareora.

Thames-Coromandel

Colville, **Cooks Beach**, Coroglen, Coromandel, Hahei, Hikuai, Hikutaia, Hot Water Beach, Kaihere, Kaimarama, Kauaeranga, Kennedy Bay, Kerepehi, Kopu, Kopuarahi, Kuaotunu, Little Bay, MacKaytown,

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Western Bay of Plenty Country

Athenree, Katikati, Kauri Point, Maketu, Ohauiti, **Omokoroa**, Onemana, Paengaroa, Pongakawa, Pukehina, Pyes Pa, Te Puke, Te Puna, Waihi, **Waihi Beach**, Waikino, Waimata, **Whangamata**, and **Whiritoa**.