RODNEY'S RAVINGS

Time to give the residential building industry a fair go

EXECUTIVE SUMMARY

Managing a business that is heavily reliant on the level of residential building activity must feel like being a cat on a hot tin roof because activity can grow 30% one year just to contract 30% the next year. The primary culprit is the Reserve Bank because of its inclination to slash interest rates excessively, resulting in an unsustainable upturn/boom in residential building activity, just to hike them once the upturn/boom has arrived. However, it is more than the vagaries of monetary policy the residential building and related industries have to deal with currently.

The level of residential building activity is running well below the level justify by population growth. Part of the explanation is the tighter lending criteria adopted by lenders following the bursting of the housing bubble they played a part in fuelling. Proposed changes to property taxes after the horse has bolted is also part of the problem, as are increased building costs associated with the government imposing double glazing etc. However, the route cause of the problem is excessively high section prices in the major urban/growth centres. It is no co-incidence that the councils in these centres have pursued "smart growth" (i.e. limited Greenfield subdivisions and forced people into higher density housing than they either desire or need to live in) and massively increased development and related fees for new subdivisions. As covered in the recent Raving on housing/section affordability, moves are afford by the government that may help resolve these problems, although we are not sure that the government has the stomach to take up the battle required to solve the underlying cause of the housing/section affordability problem.

This Raving presents views on how to reduce the massive volatility in residential building activity and how to solve the housing/section affordability problem. We are also doing our bit to help firms in the residential building and related industries manage the challenges by introducing **Residential Building Workshops**. The workshops will help business managers and owners better manage the inevitable cycles in residential building activity. They will be valuable to anyone needing an understanding of what drives cycles in residential building, including people working in related service industries, industry analysts and strategists, financiers and government officials. Click on the following link for information on the first two workshops being run in Auckland - http://www.sra.co.nz/pdf/BuildingWorkshop.pdf or contact Denise to register your interest in these or other workshops – denise@sra.co.nz. As part our business risk management education drive we will also run other workshops, including: **How to survive recessions and prosper from economic recoveries**, **What really drives the cycles in the NZD/USD** and **The essential guide to the housing market**.

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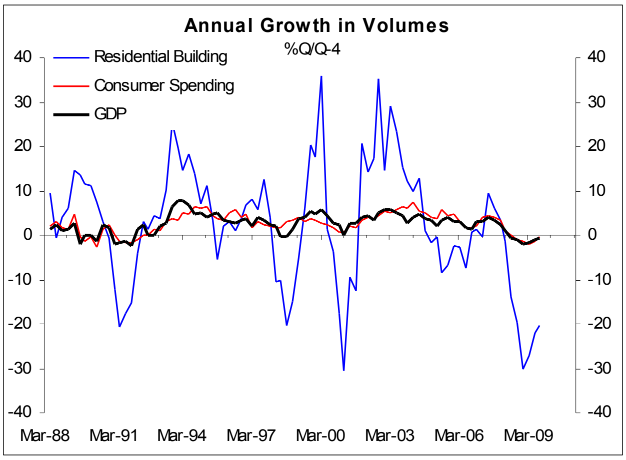
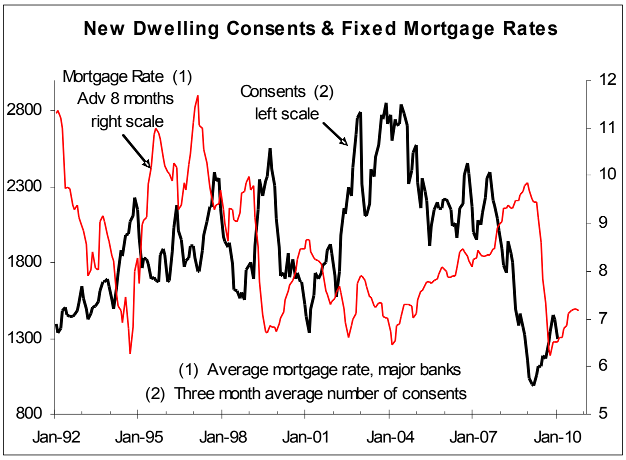
Residential building industry caught between a rock and a hard place

Managing a business that is heavily reliant on the level of residential building activity must feel like being a cat on a hot tin roof. The left chart compares annual growth in the volume of activity in residential building, consumer spending and overall economic activity/GDP. Managing a business in an industry that can grow 30% one year just to contract 30% the next year must be some challenge!

The primary culprit is the Reserve Bank because of its inclination to slash interest rates excessively, resulting in an unsustainable upturn/boom in residential building activity, just to hike them once the boom becomes apparent. The right chart shows the average mortgage interest rate charged by the major banks as a leading indicator of the number of consents for new dwellings. The best fit is with the mortgage interest rate line advanced or shifted to the right by eight months, reflecting how long it takes, on average, for changes in mortgage interest rates to filter through to the number of consents. As covered in our monthly **Building Barometer** reports (http://www.sra.co.nz/building.html), interest rates are not the only driver of residential building. However, the chart shows the major role that spikes and tumbles in interest rates have played in driving the massive volatility in the number of consents for new dwellings.





However, it is more than the vagaries of monetary policy the residential building industry has to deal with. The challenges include the following.

1. Government imposed changes in building requirements not associated with leaky building issues that have made new houses less affordable at a time when affordability was already a major challenge (e.g. double glazing, increased engineering requirements). This has contributed to the number of houses being built running well below the level justified by recent above average population growth, although the major cause is discussed below. As the right chart above shows, the average mortgage interest rate charged by the major banks is still below average despite increasing from super-low levels, while population growth is currently running at around 1.3%, which is a bit above average. However, even after a 40% increase in the number of consents for new dwellings from the trough level in early 2009, the number is still well below average.

2. The banking/finance sector has contributed to the major feast followed by famine cycle being experienced by the residential building industry. Yes, the mega-cycle, which still has some way to play out, is of biblical proportions. However, having worked for 26 years in various bits of the banking/investment banking sector, I know too well that lenders will always exacerbate cycles by changing their lending policies (i.e. chasing growth during booms and restricting lending in the downturns that inevitably follow). However, if the Reserve Bank wasn't doing its best to promote boom-bust cycles in residential building there would be less scope for the finance sector to exacerbate the cycles (i.e. the Reserve Bank is much more to blame). The tightening of capital adequacy etc requirements by the Reserve Bank is also playing a part.

3. The residential building and related service industries understandably scaled up their operations in response to the 2002 to 2007 mega-boom. However, this has left the industry with a level of capacity that is hard to sustain/justify, especially when the latest recovery, that

already appears to be petering out, won't get the level of activity back to even the historical average level. Looking at charts and focusing on the numbers can hide the human face of the problem. How can building firms offer stable job prospects to apprentices and employees more generally when faced with such major swings in demand? How can subcontractors continue to take on the cost of gearing up their businesses during boom phases just to struggle to pay the interest costs on capital equipment during the downturns? A wide range of industries service residential building and they face the same feast and famine challenges.

4. Most importantly, section prices in the major urban/growth centres are unaffordable for a sufficiently large proportion of the population that people are economising on housing. This issue was addressed in some detail in the last Raving, titled ***Housing affordability – is a solution in the wings?*** See http://www.sra.co.nz/pdf/AffordableHousing.pdf for this report. In brief, the "smart growth" approach adopted by most major councils (i.e. limiting Greenfield subdivision activity and trying to force people into higher density housing than they desire) and the approach to funding infrastructure via front-end-loading costs on to section prices, is the main cause of section prices being unaffordable in the major urban/growth centres. Faced with extremely high section prices (e.g. the median section price in the North Shore in the 2009 September quarter was $335,000 versus $125,000 in 2000), it should be no surprise that new housing building is being choked off. Compared to the 168% increase in section prices on the North Shore since 2000, the average national employee's income increased only 43% over the same period. Something smells fishy and the route cause of the smell is "smart growth".

5. The planned introduction of changes in property taxes to be announced in the 20 May Budget couldn't have come at a worse time for the residential building industry. It will impact via two main avenues: (1) pushing down existing house prices as investor buy less and some sell, resulting in housing and land packages being less attractive relative to existing house prices until the impact flows through to lower section prices; and (2) investors also played a part in new housing building and the feedback we have had suggests less investors are now willing to fund the building of new houses.

We work extensively with a wide range of firms in the residential building and related industries and to their credit, most take the hostile environment they are subjected to in their stride. It is probably because they are so used to a volatile business environment they believe it comes with the territory. However, I believe it was time someone aired the dirty linen, especially because much of the source of the problem lies with government/government agencies and is fixable.

If I was King for a day …

Top of the to-do list would be issuing a decree that all dairies that sell ice cream in cones must always be stocked with triple choc ice cream. It seems that despite choc ice cream being the most popular, dairies don't see the merit in stocking more choc ice cream than other flavours, meaning it runs out first. This is a clear market failure justifying government intervention. Once that and a few other issues of national importance were sorted I would turn my attention to solving some of the woes of the residential building and related industries.

My prescription is straight forward, with some of my plans also being on the government's agenda, as discussed in the housing/section affordability Raving.

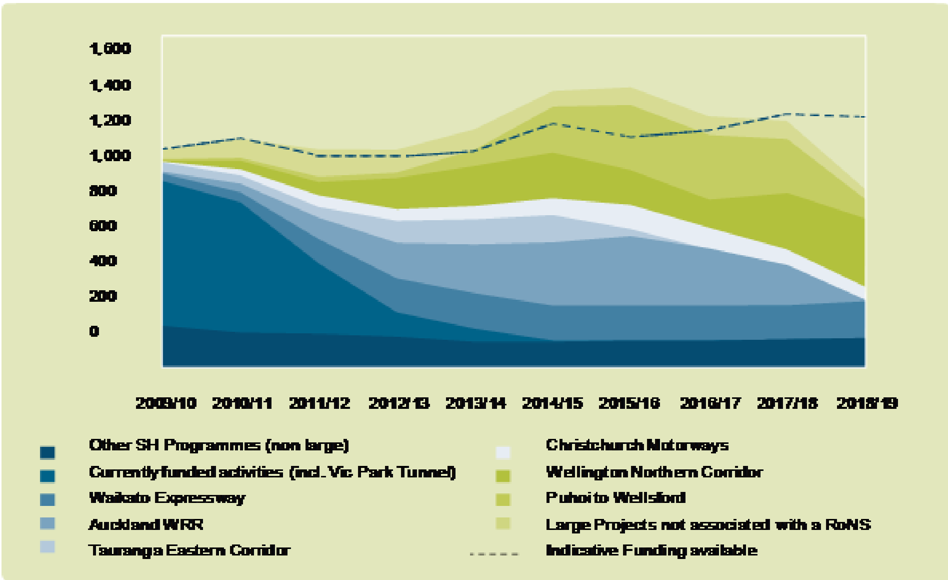
- Limit the ability of the Reserve Bank to make major changes in interest rates, with the exception being when we are faced with a once-in-a-lifetime-type crisis, like the international financial crisis. If the RBNZ focused more on what a sensible average level of interest rates should be rather than reactively hiking then slashing interest rates the residential building industry and many other industries would face a much less volatile business environment.

- Kick the "smart growth" approach to urban planning for touch and look very seriously at what can be learned from places like Dallas-Ft Worth, Atlanta and Houston, as Hugh Pavletich is promoting (see http://www.performanceurbanplanning.org/). These places have also faced strong population growth and increased demand for infrastructure, but without it resulting in unaffordable housing/sections. To achieve this will involve some changes to the Resource Management Act, with the government looking at both issues. There are some great alternatives to "smart growth" that can deliver the sorts of housing people want to live in and achieve better general outcomes, as discussed by Owen McShane in a report titled ***Alternatives to Smart Growth*** (click here to access this report - http://www.sra.co.nz/pdf/smartgrowthalternatives.pdf).

- Revamp how infrastructure associated with new subdivisions is funded and curtail the ability of councils to front-end-load massive costs on to developers. Massive increases in council fees have played a significant part in driving up section prices in many places. I understand that in some places council development fees and levies per section are now almost as much as a section cost 10 years ago. More generally, there is an urgent need for councils to be subject to some sort of competition and/or transparency in areas like development and compliance fees. For some horror stories on this read Owen McShane's latest article (click on the following link to view the article http://www.rmastudies.org.nz/columns/56-columns/437-taxing-property-to-death.

- Lack of roading infrastructure is part of the more general problem standing in the why of affordable residential and commercial development. Having been a founding director of Transit New Zealand I have some insights into the issue of roading funding. The lack of proper funding options for major roading projects from day one turned Transit into a rationing agency not a development agency. The figure below is from the New Zealand Transport Agency (NZTA) August 2009 report, ***National Road Transport Plan 2009-2012***. It provides an indication of planned expenditure on major new roads over the next ten years (the combination of the coloured slices). The dashed line is the "Indicative Funding availability" line, which provides an indication of "funding available from the NLTF and tolls". The government has made some noise about the roads of national significance, but at this stage does not appear to have sorted out how to fund all the increase in spending planned between 2012/13 and 2015/16. But it as much about sorting out the outstanding bypasses planned for many towns and cities so the towns/cities can develop in rational, efficient and cost effective ways as it is about major new highways. Possibly the financial constraints faced by the government will contribute to a better approach to funding major roading projects being found so New Zealand's towns and cities can achieve their growth potential.

Figure 1: State highway improvements aspirational financial forecast $m



There is no chance of me being elected King, not even of Icecreamland, so I am doing the second best thing. We are running workshops to help firms in the residential building and related industries understand the challenges that lie ahead so they can make better operational, financial and strategic decisions. For information on the workshops click on the following link (http://www.sra.co.nz/pdf/BuildingWorkshop.pdf) or contact Denise (denise@sra.co.nz).