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PROPERTY INSIGHTS

The economics of the section market

EXECUTIVE SUMMARY

One of the most fascinating issues in the property market at the moment is the competition between existing dwellings and new housing and the role section prices play in balancing the cost of new housing versus existing house/dwelling prices. It is our assessment that section prices need to fall significantly more than the unfolding fall in existing house prices to restore the competitiveness of new housing. This will not be music to the ears of developers, land-bankers, or spec builders and investors sitting on sections that are surplus to requirements, but this is a time for informed not wishful thinking while falling section prices will play an important part in underwriting a recovery in residential building activity.

This is a time when one of the fundamental principles of economics applies: in a market economy participants cannot control both volumes and prices. If would-be section sellers ignore the new, much less favourable demand-supply balance and don't cut their asking prices then they can expect to sell very few sections, while if they respond to the new reality by cutting asking prices significantly they can expect to be the winners in terms of sales volumes. And hopefully somewhere along the way banks back off expecting would-be section buyers to front up with up to 50% deposits especially because as section prices fall the subsequent downside risk diminishes. We can understand why banks might require would-be section buyers to front up with 50% deposits for sections in some coastal, resort, and grossly oversupplied smaller urban markets, which is in general the parts of the market where we see the most downside risk to prices, but we struggle to see section prices falling anything close to 50% in the main urban markets.

The housing and section markets are living, breathing examples of how people respond to economic or financial incentives (although not always in a "rational" manner). For example, during the boom years investors travelled all over the country sniffing out "cheap" housing and section investments. For economic historians this is Adam Smith's "invisible hand" at work (see http://en.wikipedia.org/wiki/Invisible_hand). Dramatic swings in the interest cost associated with buying a house relative to the cost of renting have also resulted in behavioural changes. Only six months ago the economics were hugely in favour of renting over buying but with house prices having experienced more than half of the fall we expect and five-year fixed mortgage interest rates having fallen from 9.1% to 6.5% it would be understandable if quite a few people are tempted to buy rather than rent, and to lock in longer-term mortgages to give them certainty about their interest costs. Some people are clearly responding to the current economic incentive to buy existing houses rather than build, but this response will in turn drive section prices down relative to existing house prices and in so doing restore the competitiveness of new housing. These issues and more are covered in our regular pay-to-view **Housing Prospects** and **Building Barometer** reports (see www.sra.co.nz).

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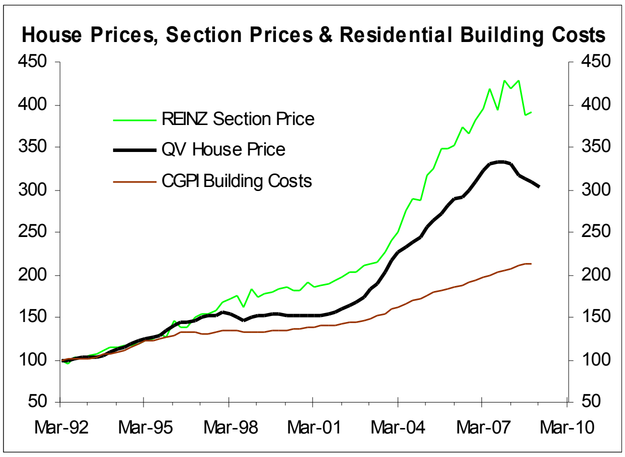
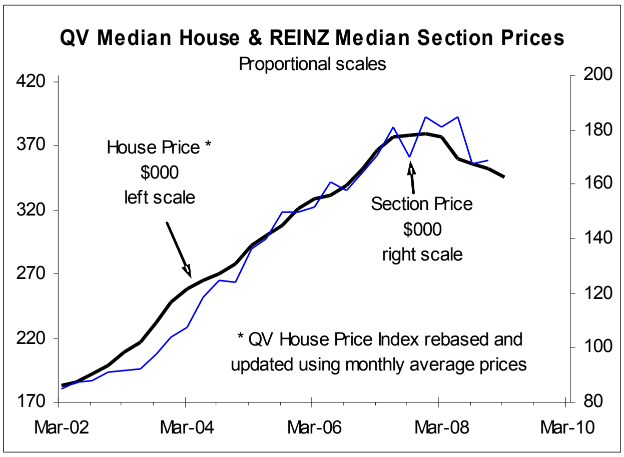
The economics of section prices

The left chart shows as best possible the relationship between section prices, existing house prices and building costs. So they can be compared directly and meaningfully on the same chart all three have been rebased so they are equal to 100 in the 1992 March quarter. The chart shows that the REINZ national median section price has increased almost 4x since 1992, the QV median existing dwelling price (updated using the QV monthly data) has increased a bit over 3x while building costs, based on the Capital Goods Price Index for Dwellings & Outbuildings, has increased around 2.2x.

Existing house/dwelling prices have increased more than building costs so section prices can increase more than existing dwelling prices while still meaning new housing costs, which are the combination of section prices and building costs, stay generally in line with existing dwelling prices. Put another way, this is the chart of a country with a reasonable rate of population growth meaning section prices will increase more than prices in general including construction costs because sections/land are the scarce resource. Section prices have increased more than construction costs because of the pressure from population growth (which is exacerbated if councils restrict Greenfield subdivision development), while existing property prices increase more than construction costs because implicit in an existing property is the price of a section. The prices of existing properties increase less than section prices because existing properties are made up of appreciating sections and depreciating capital assets (i.e. the house or dwelling). But if we looked at the chart for a country, region or urban area that was losing population it should show building costs increasing more than existing property prices and both rising more than section prices.





The right chart shows another feature of the behaviour of section prices relative to existing property prices. In the early years of the recent boom or speculative bubble existing property prices (house prices in the chart) increased ahead of section prices but section prices first caught up with the increase in existing property prices and then got ahead near the end of the boom/bubble. Equally, existing house prices started falling earlier than section prices but the fall in section prices, based on the more volatile and less representative REINZ median prices have started to catch up.

As an aside, only around half of sections are sold via real estate agents with the rest sold direct to builders or the public by developers, so the REINZ section price data are less representative than the QV house price data, with the latter incorporating all sales. The REINZ section price data are also subject to changes in the composition of sales from one month to the next (i.e. more high/low priced sections selling from month to month), which explains the greater volatility in section prices and means the monthly changes in the REINZ median prices may or may not accurately reflect underlying price movements.

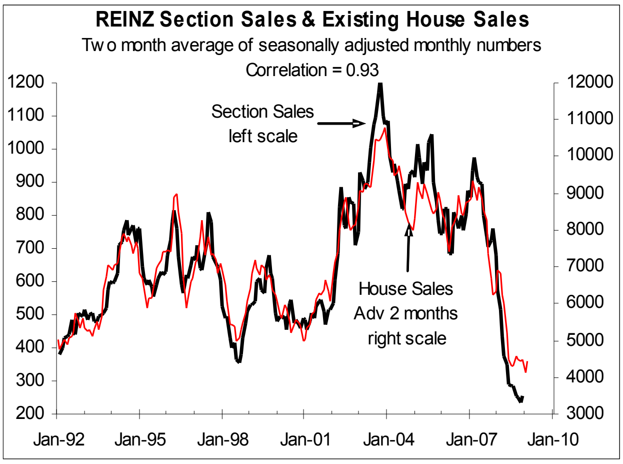
These qualifications aside we believe the chart reasonably reflects the tendency for section prices to be slower than house prices to adjust to changes in the demand-supply balance. Part of the explanation for the slower reaction of section prices is because it takes around two month longer for section sales to respond to changes in interest rates than it takes for existing house sales to respond, while it also takes section sales longer to respond to changes in net migration than existing property sales. This will reflect the more complex decision associated with buying a section and building than associated with buying an existing property. But section prices also general take a few months longer to react to changes in the number of sections being sold than existing house prices take to adjust to changes in the number of sales. These and other issues relevant to the outlook for house and section prices are covered in our regular pay-to-view **Housing Prospects** reports (see http://www.sra.co.nz/housing.html).

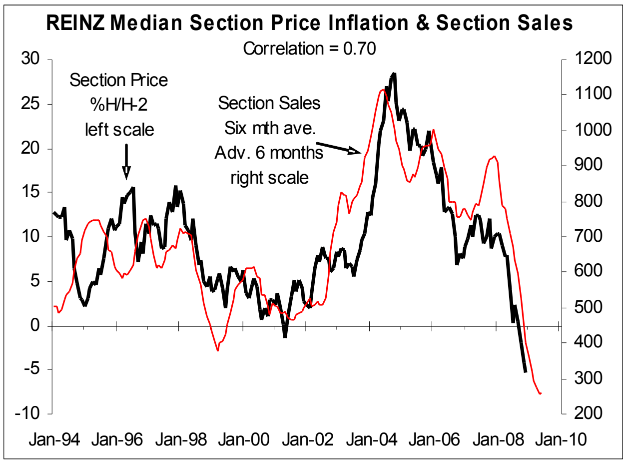
The near-term challenge for section prices

As covered in the **Housing Prospects** reports, we expect existing house prices to keep falling until around mid-year, which implies section prices will keep falling until later in the year given the slower reaction time of section prices. The outlook for section prices has been exacerbated by banks apparently requiring would-be section buyers to front up with up to 50% deposits based on the feedback we have had from some real estate agents. The tougher lending criteria for sections than for existing houses along with some other factors, as discussed in our regular reports, have contributed to the number of section sales falling more than the number of existing house sales (see the left chart). This implies greater ultimate downside risk for section prices than for existing house prices especially because the section market is more oversupplied than the existing housing market. In our regular reports we show the different demand-supply balances at a regional level for the section market and covering 24 cities/districts for the housing market.

In the left chart the red house sales line has been advanced or shifted to the right by two months to reflect the quicker response of existing property sales than section sales to the primary drivers of housing demand (i.e. interest rates and population growth/net migration). This means existing property sales are normally a leading indicator of section sales, but in the context of this report the key issue is that the black section sales line has fallen significantly more than the red house sales line, which implies more ultimate downside risk for section prices. The chart also shows the higher level of section sales than house sales in late-2003, 2004-05 and in early-2007 that resulted in section prices increasing more than existing property prices during the boom years.

The right chart shows that the number of section sales can be a useful leading indicator for the outlook for section price inflation over the next six months or so, although the relationship in this chart is less reliable/stable than the relationship in the left chart. But the right chart adds to the range of evidence/analysis contained in both the **Housing Prospects** reports and our **Building Barometer** reports (see http://www.sra.co.nz/building.html) that point to the downside risk for section prices intensifying.





There is no historical record of actual national house and section prices falling as much as they are in the process of doing. After the last mega-boom in the housing market in the early-1970s when the national median house price roughly doubled the mess was cleaned up by high general inflation. Between 1974 and 1979 the national median house price went up 5% per annum while general prices, as measured by the CPI, went up by around 15% per annum. So while actual prices didn't fall, relative to prices in general the national median house price fell 10% per annum over a five year period. The very different inflation backdrop today relative to the 1970s means we can't look at historical precedents for what might unfold over the rest of this year and beyond for actual house or section prices. However, without historical precedents we accurately warned clients about the downside risk to actual house prices that is now unfolding based on our unique and powerful analytical framework, so we are confident that our prediction that section prices will ultimately fall more than house prices will come true because this conclusion comes from the same analytical framework. And a useful part of this framework involves using the relationship between section prices, existing property prices and building costs presented on the previous page.

Construction prices tend to be downwardly sticky. In the current environment in which residential building activity has collapsed there will be some trimming of building costs but in part because the fall in the exchange rate is pushing up the cost of imported building materials and in part because labour costs tend to be downward sticky it is extremely unlikely that building costs will fall close to as much as the fall we expect in existing house prices. For anyone who saw the front page of the business section of the NZ Herald on 6 January that reported me as predicting a 42% fall in house prices I suggest you read the clarification of this gross misrepresentation of my view contained in the brief report that is stored on our website (see http://www.sra.co.nz/pdf/Housing42.pdf). But let's assume house prices fall 12-15% before the stage one adjustment we expect is over (see the **Housing Prospects** reports for our views on what will happen in stage two of the adjustment process). If we assume residential construction costs fall 5%, which is a guess not a prediction, it implies that the median national section price will have to fall around 19-25% from the peak level to keep new housing costs competitive with existing house prices. This assumes the section is half the cost of a new house and that construction costs make up the other half, which isn't exactly the case because of council and other charges associated with building a house, but this gives a ballpark of how much section prices will have to fall to restore the competiveness of new housing or house and land packages. And we expect enough people to respond to the current economic incentives that favour buying an existing house over build a new one to achieve this outcome.