CAPITAL CONTROLS

TRANSACTION VOLUMES ARE NEAR GFC LEVELS, BUT ANALYSTS ARE CONFIDENT THERE IS PLENTY OF CAPITAL WAITING IN THE WINGS. THE QUESTION ON EVERYBODY'S LIPS IS WHAT IS GOING TO MAKE INVESTORS ENGAGE, AND WHEN?

SLOWING INVESTMENT ACTIVITY, kept subdued by skyrocketing interest rates, has been the dominant feature of global commercial property markets in 2023 as the increased cost of debt keeps investors sitting on their hands.

The pervasive view of market analysts and commentators is that most investors, bar some private high-net-worth investors, are in a holding pattern, keeping their powder dry until market indicators shift and economies stabilise.

In September, global property insights company, and Bayleys' partner, Knight Frank released an update to its 2022/23 *Active Capital* report, examining how its predictions have played out and what lies ahead for Q4 2023 and beyond.

In the report update, Knight Frank head of capital markets research Victoria Ormond says many leveraged investors, from investment managers to private equity, are likely to be focused on reworking their existing assets that will come to be refinanced over the remainder of the year, rather than focused on buying.

"There is significant weight of money out there waiting for the right moment to be deployed. Some investors are waiting for repricing to catch up to where they perceive it needs to be. Others are waiting to call the bottom – notoriously difficult and usually swift. In some markets there is evidence of almost 'investor chicken', waiting for the key global names to step back into the market, signalling now is the time to buy," Ormond says.

She adds that part of the challenge for investors has come from not just the level of interest rate changes but the speed at which they have changed.

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VICTORIA ORMOND,
KNIGHT FRANK HEAD OF
CAPITAL MARKETS RESEARCH

"Indications are that we may be coming to the end of the hiking cycle, with both the US Federal Reserve and the Bank of England taking a rate hike pause at the time of writing (September 2023)."

In New Zealand, OCR rates have climbed from 0.25% percent in September 2021 to 3 percent in September 2022, and 5.5 percent by September 2023.

Bayleys senior director - capital markets Jason Seymour says the New Zealand active capital picture is generally consistent with Knight Frank's updated global snapshot.

"Like many countries around the world, high interest rates and the velocity of the increases over the past 12 months have been a major contributor to slowing investment activity.

"While a year ago there was some expectation that interest rates would level off and start reducing, the current sentiment favours 'higher for longer' in the face of stubbornly high inflation," Seymour says.

"Complex market forces including near-record net migration, high inflation, low unemployment, resilient consumer spending, currency fluctuations and continued global disruption including war in Ukraine and more recently the Middle East, will create both ongoing uncertainty for New Zealand, as well as opportunities for those investors unimpeded by leverage."

While there is some element of 'investor chicken' at play in the New Zealand market, as some investors wait for the big names to move first, Seymour believes experienced investors understand that patience is a virtue.

"To some extent, it's human nature to wait and see who goes first, but it's perhaps less of a factor for experienced investors who have lived through past periods of market uncertainty.

"Many of these groups have been largely inactive from an investment perspective over the past few years, patiently waiting for re-priced trophy or strategically important assets to be released to the market."

Seymour points to recent sales in Auckland of an 18-level office building at

55 Shortland Street, and The Warehouse development at 100 Pah Road as excellent examples of historically tightly held assets selling to highly experienced, patient capital.

"High-net-worth private investors able to commit higher levels of equity are by far the most active buyer group when we look at transaction volumes.

"Maybe more accurately, this buyer group remains active and engaged when perhaps many leveraged participants including developers, private investors, syndicators, real estate investment trusts (REITS) and international funds retreat and focus on reworking or re-weighting existing assets and portfolios. This includes refinancing and in some cases working through divestment strategies to pay down debt and restore comfortable margins relative to debt covenants.

"Certain types of buyers thrive in periods of reduced competition and I would expect that to continue until we see greater certainty in the global and domestic economic outlook," Seymour says.

In the updated Knight Frank report, Ormond also points to the thinner pool of capital globally creating opportunity with evidence of high-net-worth investors and sovereign wealth funds, which are not typically dependent on access to debt, picking up trophy assets which seldom come to market.

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Seymour adds another encouraging sign for the revival of investor activity lies in the level of offshore interest in New Zealand real estate. "It remains a live target market for investment mandates, although diluted in some cases by the growing number of opportunities in Australian domestic markets and other markets globally."

He cites Asia Pacific investment firm PAG's recent joint ventures with Precinct Properties for 40 and 44 Bowen Street in Wellington for a total purchase price of $240m as a prime example of recent active cross-border capital flows. A recently announced deal between Precinct Properties, PAG and Ngāti Whātua Ōrākei for Auckland's Te Tōangaroa precinct is another.

"The reasons to invest in New Zealand are compelling: indefeasibility of title, no land tax, stamp duty or capital gains tax and low levels of corruption all significantly reduce transaction risk and costs."

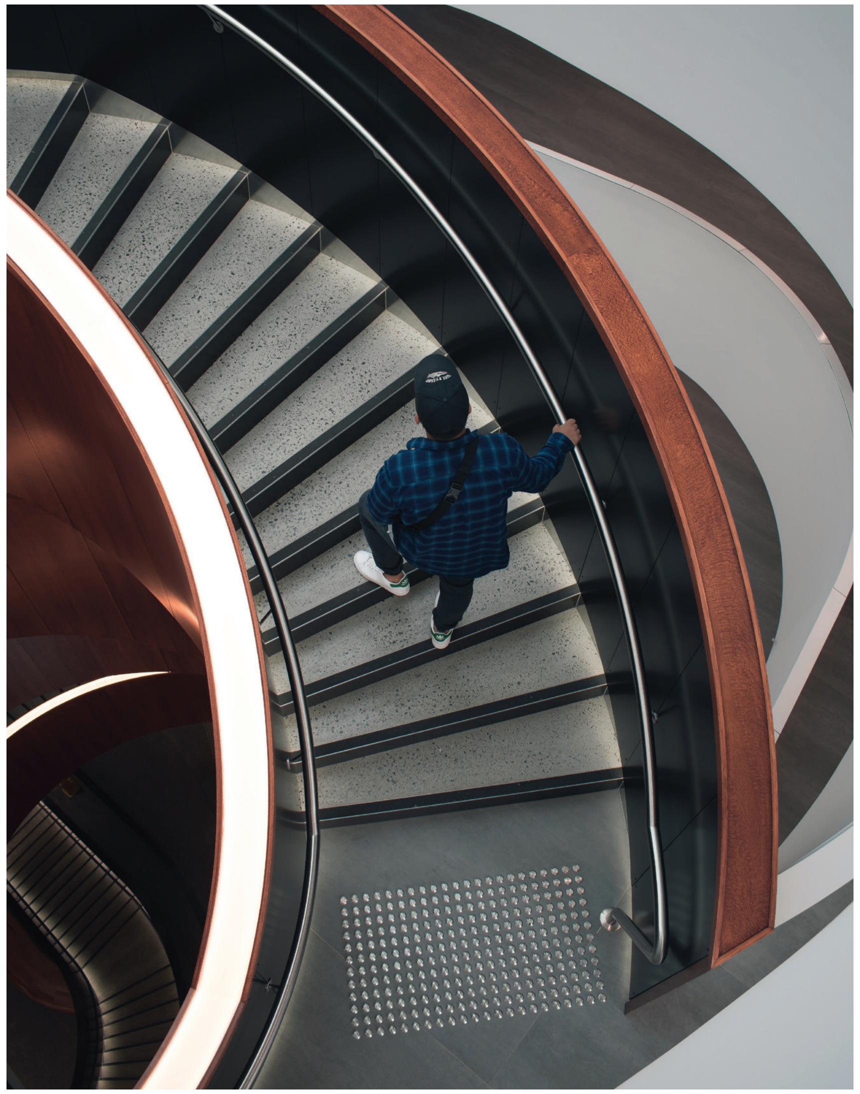
MANAGING UNCERTAINTY

One ongoing challenge for investors identified in the Knight Frank *Active Capital Q4 Outlook* is the divergence of opinions on what comes next.

"Base rate forecasts globally are typically looking at peaking over the end of 2023 and into the first quarter of next year, with the question then becoming when and how steeply will they reverse?" Ormond says.

In New Zealand for example, opinions of banks and other economic commentators are divided on whether the Reserve Bank will hold the OCR at 5.5 percent at its next announcement at the end of November, or raise it further.

For New Zealand, Seymour says, our economic drivers are heavily influenced by events beyond our borders, which have a relatively predictable impact on New Zealand in areas such as our export markets and capital flow.



> **"THE REASONS TO INVEST IN NEW ZEALAND ARE COMPELLING: INDEFEASIBILITY OF TITLE, NO LAND TAX, STAMP DUTY OR CAPITAL GAINS TAX AND LOW LEVELS OF CORRUPTION ALL SIGNIFICANTLY REDUCE TRANSACTION RISK AND COSTS."**
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His advice to buyers for navigating an unpredictable market is to be prepared and remain nimble so they're able to act quickly and smartly when opportunities are presented to market.

"We are in one of those periods in the cycle where those rarely seen, intergenerational, trophy assets come to the market – the types of assets usually locked up in domestic and international corporations and funds.

"My sense is that there is no shortage of capital to be deployed, just a lack of confidence around when is the best time to buy. Waiting to call the bottom of the market, may not be the best strategy as the current thin competition for most assets will ramp up quickly."

THE NEW ZEALAND SNAPSHOT

Though settled transaction volumes over $20 million in New Zealand are at levels not seen since the GFC years of 2010/2011, and total commercial/industrial transaction volumes in the first half of 2023 are down 33 percent on the same period last year, Seymour expects optimism - and active capital to return to the markets over the next 12 to 18 months.

"The current transaction volumes are to be expected given the economic headwinds of the past 12 months and I expect the remainder of this year to follow a similar pattern.

"Opportunity and optimism should increase over the next 12-18 months as transaction volumes increase and some degree of stability returns to the markets underpinned either by the levelling off or reliable forecasts of declining interest rates.

"Over that same period, markets will have greater clarity around the impacts of higher yields on 10-year US Treasury notes and the risk spread for alternative investments including real estate."

He points to the strength of the industrial and logistics sector, driven by compelling fundamentals of low vacancy, constrained land supply and ongoing, if slowing, rental growth as just one area of encouragement.

"Interest in the retail sector, troubled over the past few years by the global trend toward online spending coupled with COVID-19 impacts, has increased significantly this year off the back of asset repricing and recognition that many large retail assets sit on large, well-zoned landholdings with significant growth and development potential.

"Challenges in the office sector driven mainly by post-pandemic return-to-work strategies and uncertainty faced by many businesses, suggest this sector lags behind the retail sector in terms of asset re-pricing and deal volumes but interest is increasing in key locations as investors seek out value opportunities."

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Alternative asset classes such as student accommodation and other education assets, build-to-rent, life sciences, data centres and zoned development land all represent rapidly growing areas of opportunity for a range of investors, Seymour says.

LOOKING AHEAD

In the Knight Frank *Active Capital Q4 Outlook*, Ormond's prediction is that while a return to normal is not expected, an increase in activity relative to H2 is.

"As 'even higher for even longer' rates have pushed through into the base rate, in many countries, lenders and borrowers who were hoping to 'ride through' the period of higher rates are now starting to accept a higher-for-longer environment. This varies globally based on the average loan size, level of swap rates, bank health, degree of innovation in the lending sector and the extent to which rates increased, but to a greater or lesser degree, assets are likely to come to the market and investment volumes start to unlock, if not back to 'normal' levels before the end of the year."

Off the back of that, Seymour believes the New Zealand commercial property market is cautiously optimistic with green shoots appearing and more likely over the next few months.

"For some, the result of the recent general election resolves a significant hurdle to investment, and the growing number of market transactions shows a rapidly narrowing bid-ask spread as assets are re-priced and debt once again becomes accretive to investment decisions.

"Traditionally, the period around a general election tends to slow down activity in the real estate sector and this year was no different with many active and investors-in-waiting deciding to pause activity pending an outcome.

"With results now in, I think green shoots are already emerging, but the real sparks will be either confidence that interest rates will reduce, or have at least peaked, and asset repricing has caught up to where investors perceive it needs to be."