Hope and substance

With Q1 2024 almost done, what has the rest of the year got in store for vendors, investors, landlords and occupiers?

Economic reality is biting at every compass point nationwide, across all property sectors and impacting all consumer spending decisions. Inflation and interest rates dominate news headlines, and geopolitics is a spanner in the global economic works.

In his recent State of the Nation address, Prime Minister Christopher Luxon described the country's economic and societal condition as "fragile", stressing that a strong economy will fix a lot of the current woes.

Business sentiment has improved so there is hope according to Cameron Bagrie, chief economist with consultancy firm Bagrie Economics, but he cautions that we'll need more than that to right the ship.

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CAMERON BAGRIE
CHIEF ECONOMIST,
BAGRIE ECONOMICS

"Hope is not a strategy to rely on – we need to see substance," he said.

"New Zealand – not just the government – is facing a major repair job. The good news is that tough times can often bring bold and better decisions and an example is local authorities that have finally woken up to reality and taken steps to remedy structural weaknesses."

Bagrie said New Zealand's inflation rate is slowing down, but stressed that although the December quarterly inflation rate of 4.7 percent was the lowest seen since June 2021, it is still more than twice that of the midpoint of the Reserve Bank of New Zealand's (RBNZ) annual target range between one and three percent. It's keeping economists and banking entities on their toes.

"We are seeing disinflation, but the slow pace at which core inflation is waning has the central bank nervous.

"The longer it is away from the inflation target, the more potential for pricing behaviour to settle higher. If that happened, the central bank would need to restore its inflation credibility and that will mean higher interest rates and further hits to the economy."

The disinflation process, or getting inflation back to that two-percent midpoint, is not being helped by geopolitical influences that are disrupting supply chains, and adding to costs, or New Zealand's infrastructural deficits which are now holding back productivity, says Bagrie.

"We now reside in a world where political fracturing is taking place. Rules are being challenged by exercising power. On-shoring is replacing off-shoring. Then on top of that we have major infrastructure problems and addressing these it a big part of getting our economy back on track.

"It will not be cheap, and I'd prioritise infrastructure over tax cuts. New Zealand runs a current account deficit which is a gap between investment and our savings. We borrow that gap, and that gap is a large one."

The country's rising net migration figures have been touted as a saviour to the economy by some, but Bagrie again urges caution.

"The migration inflow has been huge, though the mix of migrants does not tend to support home buying given the largely lower-skilled composition and cost of housing, but migration is being reflected in increasing residential rents.

"We've seen record inflows of migrants, and record outflows of New Zealanders at the same time – at present, migration is adding to inflation more than it is adding to worker availability."

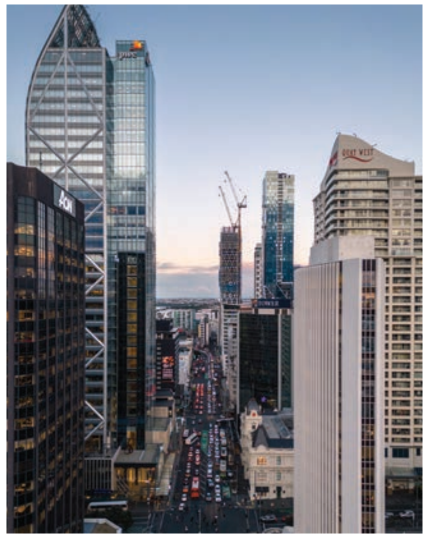
In the property world, Bagrie says quality stands tall in a weak market and there is continued bifurcation evident where one sector, or one part of a sector, performs better than another.

"In recent years we saw industrial property overachieve while office space struggled, for example. We also noted a rush to quality, partly driven by factors like transport connectivity and demand for well-located buildings with sustainability attributes.

"Commercial is currently lagging behind the residential sector which saw a Mexican standoff between buyers and sellers in 2022 where ultimately buyers won, and house prices fell as vendors met the market.

"The same standoff occurred in 2023 for commercial property and transaction volumes tanked. With interest rates a lot higher, buyers need higher cap rates to make the numbers stack up, but vendors naturally do not want elevated cap rates because values fall.

"The pendulum is swinging in favour of commercial buyers now and reality is sinking in for vendors as hope for lower interest rates any time soon starts to fade, piling on pressure to revisit price expectations."



Bank lending on commercial property has been shrinking, partly because fewer deals have been done and many concluded deals have gone to repaying debt, explains Bagrie.

"Although still relatively low, the percentage of non-performing commercial loans has risen rapidly to one percent of all commercial loans, and banks are likely to 'encourage' some divestment.

"That will support more deals, but those deals will need to be priced right for the bank to finance them.

"Banks cannot shrink their balance sheets to success so as the market becomes balanced and buyers and vendors align, the credit wheels will turn and we are starting to see pricing sharpen in the residential market."

SWINGS AND ROUNDABOUTS

Bayleys national director commercial and industrial, Ryan Johnson says in the last quarter, transaction volumes tracked up considerably on previous quarters with good activity from buyers across asset classes and across price bands.

"This is evidence that the previously gaping bid-ask spread has narrowed with vendors bowing more to buyers.

"Last year, we saw a number of managed work-outs as lenders took a red pen to debt levels and took steps to secure collateral from exposed clients.

"There was little evidence of fire sales, and while it's too early in the piece to know exactly how 2024 will play out on this front, the banks are likely to be leaning on over-leveraged landlords to take action."

Johnson says typically, Auckland has led the rest of the country in terms of an uplift in both transaction volumes and listing activity, with other main centres following in its wake.

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> **RYAN JOHNSON**
> BAYLEYS NATIONAL DIRECTOR COMMERCIAL AND INDUSTRIAL

"Hamilton, Tauranga, Wellington and Christchurch are expected to see a further pick-up in activity and opportunity. Wellington is an interesting one as the office market could be in for some significant rationalisation due to signalled public sector staffing and budgetary cuts.

"That could lead to more stock for sale, along with more sub-lease space and office vacancy.

"However, on the upside, the leasing market in Wellington and the rest of the country has been strong off the back of rising net migration numbers with small-to-medium businesses demonstrating confidence by signing leases.

"Prime assets continue to achieve high market rents but that upper end of the market could start to run out of tarmac as occupiers' post-pandemic business models are rigorously stress-tested in this normalised new world and AI starts to rattle operational cages."

There's evidence that the logistics and wider industrial sector is feeling some downward pressure off the back of a slowing economy, dwindling retail spend, less need to stockpile inventory, and deflation of the economy in China.

"Any structural weakness in China has downstream effects for its trading partners and supply chain dynamics so it's something to watch," says Johnson.

"Some core users of industrial property – such as the liquor industry – are needing less warehousing space given broader economic pressures and changing societal behavioural patterns and this has led to more sublease industrial space in the market.

"Yes, we were coming off a very low base given the strength of the industrial sector during the pandemic, but a cooling economy and still-high freight costs are really making themselves felt."

Providing the biggest opportunity in the market now, according to Johnson, are secondary assets ripe for redevelopment or refurbishment.

"That's because new supply still has feasibility roadblocks, including lending challenges, and while construction costs have largely stopped marching upwards, land values now need to come back somewhat in all property sectors.

"The Q Ratio, or Tobin's ratio comes into play here being the ratio between a physical asset's market value and its replacement value, calculated by dividing the market value of the asset by the replacement cost.

"An existing building in a good location has the potential to be upgraded for the more-savvy occupier market and good examples of this are commercial properties in the areas around the emerging Auckland City Rail Link stations."

SENTIMENT AT THE COALFACE

Bayleys head of insights, data and consulting, Chris Farhi says canvassing the agency's nationwide salesforce provides intel from the pointy end of the industry and results of a Q4 2023 sentiment survey showed Bayleys commercial and industrial salespeople expect a mixed bag of activity in 2024.

"Given that the real impact of interest rates has a long tail, with an up to 18-month lag in how sentiment translates through into sales data, tapping into the views of brokers and their take on the occupier and landlord market gives us a good overall gauge.

"It also helps us fine-tune approaches across the firm's business lines, tweaking how we operate, guiding the delivery of relevant and timely information and ensuring we deliver value to our clients."

Farhi said it's encouraging to see generally improving sentiment in the residential side of the business with the market strengthening and having more value in it.

"On the flip side, and despite being two years into a market correction, the commercial and industrial sector is seeing some weaknesses with interest rates and finance availability still problematic, and a level of disconnect between sellers and buyers.

"As the residential sector continues to rally, commercial and industrial could follow suit and there are good opportunities on the buying side with history showing that now could be an opportune time in the real estate cycle to purchase."

While leasing activity has been fairly robust, sentiment is leaning towards the neutral-to-weak end of the scale, particularly when considering secondary-grade space and the industrial sector.

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> BAYLEYS HEAD OF INSIGHTS, DATA AND CONSULTING

"Our survey showed an emerging softness in the industrial market which we weren't really expecting. Brokers put this down to a range of factors from the lower availability of quality stock for lease, to caution around the level of warehousing needed in the light of supply chain conditions."

The survey also showed that on the whole, tenants were looking for better quality premises, in better locations and with a bigger footprint – quashing the idea that businesses are wholesale downsizing and retrenching.

Around 23 percent of commercial salespeople thought market conditions are getting stronger, 42 percent thought there's no change, while 35 percent thought conditions are getting weaker compared to three months ago.

Farhi says many of the things influencing the market are out of landlords' control, but what they can manage is quality and this requires reinvestment.

"Occupiers are being more selective about the premises they commit to and more educated on sustainability matters. Along with aesthetics, function and seismic integrity – particularly in the Wellington market – the sustainability ethos is still underpinning much of the higher-end occupier movement.

"In reality, attaining accreditations like a NABERSNZ rating is not that cost prohibitive, if tackled proactively, so there are some 'easy wins' to be gained by owners of secondary-grade property looking to sure up occupancy.

"The real cost to landlords of not undertaking refurbishments is extended vacancy and with lenders striving to keep debt balance sheets favourable, this year could be crunch time for some building owners."

COMMERCIAL SALES

How are market conditions in your market right now?

Strong	6%
Neutral / balanced	29%
Weak	65%

Compared with 3 months ago, how has your market changed?

Getting stronger	23%
No change	42%
Getting weaker	35%

COMMERCIAL LEASING

How are market conditions in your market right now?

Strong	9%
Neutral / balanced	57%
Weak	34%

Compared with 3 months ago, how has your market changed?

Getting stronger	29%
No change	46%
Getting weaker	26%

Source: Bayleys Insights & Data