SECOND QUARTER 2022

FORECAST REPORT 101

NEW ZEALAND TRENDS IN PROPERTY AND CONSTRUCTION

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Cover: Wakefield Hospital, Wellington

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With a network that covers the globe and a heritage spanning over two centuries, Rider Levett Bucknall is a leading independent organisation in cost management and quantity surveying, and advisory services.

Our achievements are renowned: from the early days of pioneering quantity surveying, to landmark projects such as the Sydney Opera House, HSBC Headquarters Building in Hong Kong, the 2012 London Olympic Games and CityCenter in Las Vegas.

We continue this successful legacy with our dedication to the value, quality and sustainability of the built environment. Our innovative thinking, global reach, and flawless execution push the boundaries. Taking ambitious projects from an idea to reality.

FORECAST 101

Prepared by the New Zealand Institute of Economic Research (Inc.) exclusively for Rider Levett Bucknall, Forecast is produced quarterly and provides detailed local construction market intelligence and knowledge.

CONSTRUCTION MARKET INTELLIGENCE

Forecast is supplemented by Rider Levett Bucknall's construction market intelligence publications: the International Report, regional (including the Oceania Report) and country specific reports.

KEY POINTS IN THIS ISSUE

Construction has led the rebound in economic activity as lockdown restrictions were relaxed in early December. There was a particularly strong recovery in non-residential and infrastructure construction, but recent indicators point to some slowing in the pipeline of these types of construction work over the coming year.

Activity rebounds as restrictions are relaxed, but illness and self-isolation weigh on the recovery

The spread of the more transmissible Omicron variant of COVID-19 continues to present challenges for the New Zealand economy, despite the relaxation of restrictions. People staying at home due to fear of actual infection or self-isolation has reduced both demand and supply in many sectors. For the construction sector, these effects are most apparent in worker shortages and supply chain disruptions.

Residential construction demand remains strong

Consent issuance data points to continued strong construction demand, with the annual number of dwelling consents issued rising to new record highs above 49,000 for the year to February 2022.

Higher interest rates present headwinds

However, intense inflation pressures have led the Reserve Bank to increase the Official Cash Rate (OCR), including a 50 basis points interest rate increase at the April meeting. Mortgage rates have already risen from the record lows seen in mid-2021 and are likely to rise further. Housing market activity has eased since late 2021, with lower house prices likely to weigh on residential construction demand from 2023.

Future outlook

Nonetheless, the property and construction sector’s longer-term outlook is positive. While more caution has crept in when it comes to business investment, underlying demand for non-residential and infrastructure construction is resilient, and as demand for residential construction moderates, this will free up capacity in the construction sector and allow other areas of construction to pick up.

Construction led to a bounce-back in economic activity as lockdown restrictions were relaxed in December 2021. In particular, other construction (which is often taken as a proxy for infrastructure construction) increased 17.2 percent in the December quarter following an 8.9 percent decline in September, while non-residential construction increased 16.6 percent following a 12.5 percent contraction in the previous quarter. Residential construction, which has grown strongly over the past year as higher house prices encouraged new housing developments, increased by a more modest 6.2 percent in the December quarter.

Auckland led the way in the rebound in construction activity in December, reflecting the greater negative impact of the prolonged lockdown and social distancing restrictions in the region in the previous quarter. However, the wide spread of the more transmissible Omicron variant of COVID-19 in recent months has posed new challenges to the construction sector. Building sector firms are grappling with even more acute worker shortages and supply chain disruptions due to people staying at home because of COVID-19 infection or self-isolation. This has affected the ability of building sector firms to return to operating at full capacity.

Dwelling consent issuance point to a continued solid pipeline of residential construction work over the coming year, as high house prices encourage new housing supply to come onto the market. The annual number of dwelling consents issued for the year to February 2022 increased

BUILDING ACTIVITY TRENDS

to a new record high of over 49,000. Growth in residential construction demand has been driven by stronger demand for medium-density housing such as townhouses and flats. We expect this housing intensification will continue over the coming years, given the increased population density.

Across the regions, demand remains particularly strong in Auckland, with annual dwelling consents issued for the year to February totalling over 20,500. The strong demand for residential construction in Auckland reflects the region's relatively strong population growth in the years before the COVID-19 outbreak.

Although non-residential construction activity rebounded strongly in the December 2021 quarter following the disruptions from the lockdown in the previous quarter, consent issuance points to variances in demand across the regions. Non-residential consent issuance in Auckland recovered from the easing seen over late 2021, while there are recent signs of easing in Canterbury. Nonetheless, non-residential consent issuance in both regions has increased from a year ago.

This growth in non-residential construction demand in Auckland has been broad-based across the sectors, with demand for healthcare facilities, office space and industrial buildings particularly strong. This is in contrast to the decline in demand for accommodation buildings in Auckland, which likely reflects the negative impact of international border restrictions on tourism activity.

In Canterbury, growth in non-residential demand primarily reflects stronger demand for education buildings. Demand for the construction of retail outlets in the region has also been solid over the past year.

The NZIER *Quarterly Survey of Business Opinion* (QSBO) shows cost pressures remain very intense in the construction sector, with over 90 percent of building sector firms reporting both increased costs over the March quarter and expectations of higher costs in the next quarter. These costs pressures likely reflect the impact of supply chain disruptions and labour shortages, with building construction firms reporting labour and materials as the primary constraint on their business.

These constraints have been exacerbated by the wide spread of the more transmissible Omicron variant of COVID-19, as many workers had to stay at home due to infection or self-isolation. Given the limited ability of much of the transport and construction workforce to work from home, the acceleration in positive COVID-19 cases over March led to significant disruptions in the construction sector. Building construction firms surveyed in the QSBO reported even more difficulty finding skilled and unskilled labour in the March quarter. This reflects the spread of Omicron exacerbating the labour shortages that were already acute as resulting from the impact of international border restrictions, which limited the ability of firms to bring in workers from overseas.

This tightness in the New Zealand labour market is reflected in the 3.3 percent growth in the annual labour cost index[1] of salary and wage rates for construction for the 2021 year. As the rate of COVID-19 infection declines and international borders are relaxed over the coming year, these labour shortages should also ease, and wage inflation should moderate.

Although half of the building sector firms surveyed in the QSBO raised prices in the March quarter and over 75 percent of firms intend to increase prices in the next quarter, profitability in the construction sector is deteriorating. Weaker profitability is weighing on confidence in the building sector.

1 The labour cost index measures changes in salary and wage rates for a fixed quantity and quality of labour input. Service increments, merit promotions, and increases (or decreases) relating to performance of the individual employee are not shown in the index. https://datainfoplus.stats.govt.nz/Item/nz.govt.stats/9007195c-8dc3-4dfb-b5da-1b12c32e90ac?_ga=2.75913564.817057502.1619417816-730143600.1617836679

BUILDING ACTIVITY OUTLOOK

Although construction activity is robust, the latest NZIER QSBO showed signs of softening in the pipeline of construction work. The NZIER QSBO architects' measure of work in their own office indicates some slowing in commercial and Government construction work over the coming year. On balance, architects surveyed expect commercial construction work to be flat, while a net 5 percent expect reduced Government construction work.

Meanwhile, a net 11 percent of architects expect stronger housing construction work over the coming year. This is still an easing from the 36 percent in the previous quarter, suggesting growth in residential construction will moderate over the coming year. REINZ data has shown a slowing in housing market activity since late 2021, as higher interest rates dampened demand for borrowing. The easing in house prices, albeit from record highs, should weigh on residential construction demand from 2023. With intense cost pressures reducing profitability in the construction sector, these factors are lessening the incentive for developers to bring new housing supply onto the market.

ECONOMIC BACKDROP

The latest NZIER QSBO showed that the Omicron outbreak across New Zealand negatively impacted economic activity and business confidence in the March quarter. Despite the relaxation of lockdown and other restrictions since early December, the spread of Omicron has led to people staying at home due to infection, self-isolation or fear of infection. This had a negative impact on both demand and supply across many sectors of the New Zealand economy. A net 9 percent of firms surveyed in the NZIER QSBO reported a decline in activity in their own business in the March quarter.

Meanwhile, a net 33 percent of businesses surveyed expect a weakening in general economic conditions over the coming months, on a seasonally adjusted basis. Across the regions, Wellington was again the only region where businesses were not feeling downbeat. This divergence in sentiment with the other regions likely reflects the concentration of the public sector in Wellington, with the greater ability of this workforce to work from home, meaning that the region faced less disruption from the spread of Omicron in the March quarter.

Despite the heightened uncertainty and weaker confidence, inflation pressures continued to surge. The latest CPI release showed annual inflation jumped to 6.9 percent for the year to March 2022. The price increases in the March quarter were broad-based across many goods and services, with further substantial price rises in fuel and construction contributing to the strong lift in CPI for the quarter. Residential construction cost increased by 3.5 percent in the March quarter to bring annual growth in this component to a record high of 18.3 percent.

A large part of this pick-up in CPI inflation reflects supply constraints in New Zealand and abroad, as higher global crude oil prices drive a surge in petrol prices here at the pump. Other global supply chain disruptions are also driving up costs. In addition to these factors, domestic supply chain disruptions resulted from workers staying at home due to COVID-19 infection or self-isolation.

Many firms have passed on these higher costs by raising prices, leading to a very high inflation environment. We expect annual CPI inflation to remain elevated for the remainder of the year before moderating back towards the Reserve Bank's inflation target band mid-point of 2 percent in the subsequent years.

Of particular concern to the Reserve Bank has been the lift in longer-term inflation expectations. The RBNZ Survey of Expectations shows a rise in 2-year-ahead inflation expectations to 3.3 percent in the March quarter – well above the Reserve Bank's inflation target band. There is a greater risk of longer-term inflation expectations becoming unanchored and igniting a wage-price spiral, which would make it harder to rein inflation back within the target band.

The high inflation environment, particularly with the lift in longer-term inflation expectations, presents the risk of high construction cost inflation becoming more persistent over the coming years. This risk is balanced against the impact of higher interest rates and more restrictive lending conditions on construction demand, particularly for residential construction developments.

INTEREST AND EXCHANGE RATES

The Reserve Bank increased the OCR by 50 basis points at its April meeting in response to the strong inflation pressures in the New Zealand economy. There had been a great deal of speculation heading into the April policy rate announcement over how much the central bank would increase interest rates, given the surge in inflation against the backdrop of heightened uncertainty over how the COVID-19 outbreak and war in Ukraine will evolve. The 50 basis points interest rate increase shows the Reserve Bank's focus on reining in longer-term inflation expectations. This focus suggests a follow-up 50 basis points OCR increase in its May meeting is likely.

Mortgage rates increased further following the April policy rate announcement, as markets priced in a faster pace of monetary policy tightening over the coming year. With almost 60 percent of mortgages in New Zealand not due for repricing until at least another six months, the impact of the recent rise in interest rates will not become apparent until later this year. As households reprice onto much higher fixed mortgage rates, retail spending will likely slow as households rein in discretionary spending in the face of higher mortgage repayments.

Monetary policy tightening by other central banks in the major economies in the face of high inflation is also pushing up interest rates at the longer end. The US Federal Reserve started its cycle of interest rate increases with a 25 basis points increase in the Fed funds rate in March, ending two years of the benchmark rate at record low levels. Minutes from the March meeting indicate interest rate increases of 50 basis points are possible over the coming year, given the strength of inflation pressures in the US economy. The minutes also discussed the central bank's intention to reduce its quantitative easing programme from May this year.

The Bank of England increased its policy rate in March but highlighted its concerns about the growth outlook. Nonetheless, market expectations are for another rate increase at its May meeting. Meanwhile, the Bank of Canada increased its policy rate by 50 basis points and announced it would cease asset purchases in April with the intention of reducing its balance sheet.

While the New Zealand dollar initially spiked higher on the 50 basis points OCR increase, the appreciation was brief as markets considered the longer-term implications for New Zealand interest rates. With other central banks also embarking on monetary policy tightening, we expect a slight easing in the New Zealand dollar over the coming year.

BUILDING INVESTMENT

There are signs of some slowing in the commercial and Government construction work pipeline. Heightened uncertainty over the COVID-19 outbreak and global growth outlook is driving more caution around business investment.

Despite some signs of easing in the pipeline of Government construction, there is already a large amount of infrastructure construction projects underway. This includes $800 million for water infrastructure, $400 million allocated to transport and $1 billion to community facilities – most of which will likely ramp up over the next two years. This growth in infrastructure construction will be underpinned by the implementation of the 3 Waters reform programme. The Australia New Zealand Infrastructure Pipeline (ANZIP) highlights the major projects underway. This includes the Auckland Airport Expansion, Auckland Hospitals Redevelopment, Auckland Light Rail, Canterbury Museum Redevelopment and Christchurch Hospital expansion[2].

2 Infrastructure pipeline by location - Infrastructure Pipeline

Cordis Hotel, Auckland

BUILDING CONSENTS

Stronger demand for healthcare, industrial and education buildings continue to drive growth in non-residential consent issuance over the past year. In contrast, the negative impact of international border restrictions on tourism activity continues to reduce demand for the construction of hotels.

Building consents by sector

Healthcare, industrial and education buildings remain the top three drivers of growth in non-residential construction demand over the past year. With the Government focused on infrastructure investment to support New Zealand's economic recovery, we expect demand in these areas to remain strong over the coming year.

There are signs of easing in global supply chain disruptions, with shipping costs falling over the past month. Nonetheless, developments over the past year have sharpened the focus on managing inventory and improving the resilience of logistics systems for many businesses. We expect this focus will continue to support strong demand for industrial buildings.

In contrast, higher interest rates present headwinds to the household sector, with retail spending likely to slow over the coming year. We expect this will flow through to reduced demand for new retail outlets. Although border restrictions will be relaxed progressively over the coming year, we expect the recovery in new hotels will be gradual as some caution remains over international travel.

Building consents by region

Non-residential construction consent issuance increased across most regions over the past year, with Waikato and Southland the only regions declining in consent issuance. The weakness in non-residential construction demand was broad-based across these regions' sectors.

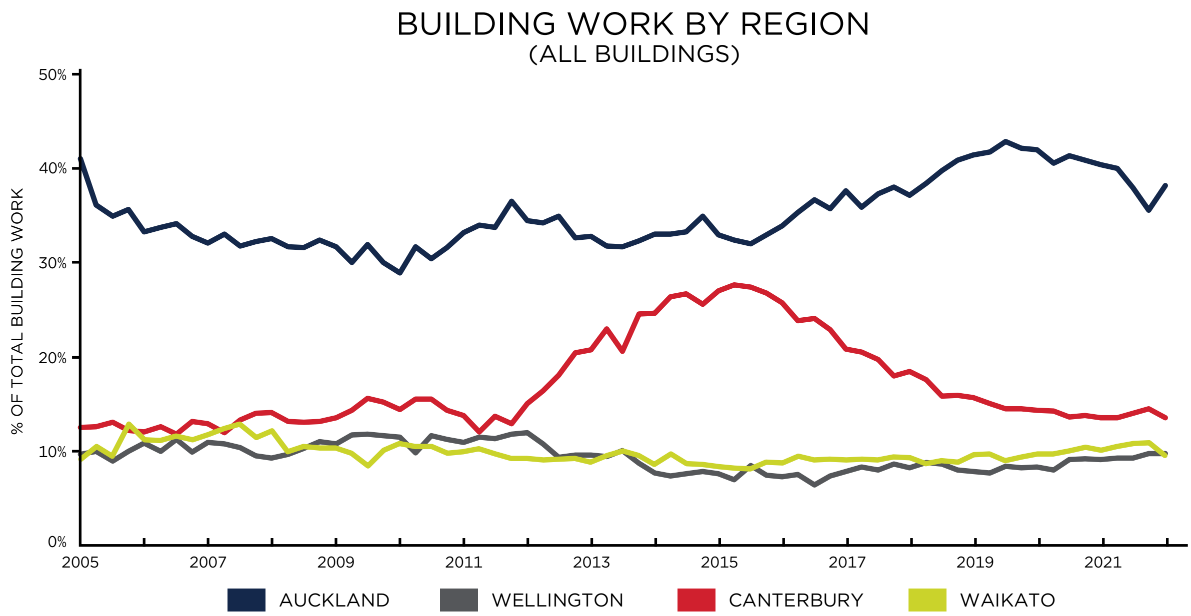
In contrast, non-residential consent issuance grew strongly in Auckland over the past year, reflecting stronger demand for healthcare facilities, office space and industrial buildings. In Canterbury, demand for education buildings was particularly strong over the past year. Meanwhile, stronger demand for healthcare facilities drove the increase in non-residential consent issuance in Taranaki.

Although weaker business confidence and higher interest rates present headwinds to demand for commercial buildings, underlying non-residential construction demand remains positive. We expect that as demand for residential construction eases from 2023, this will free up some capacity for non-residential and infrastructure construction across the regions.

FIGURE 1

Auckland leads the way in construction growth

% of nationwide building work

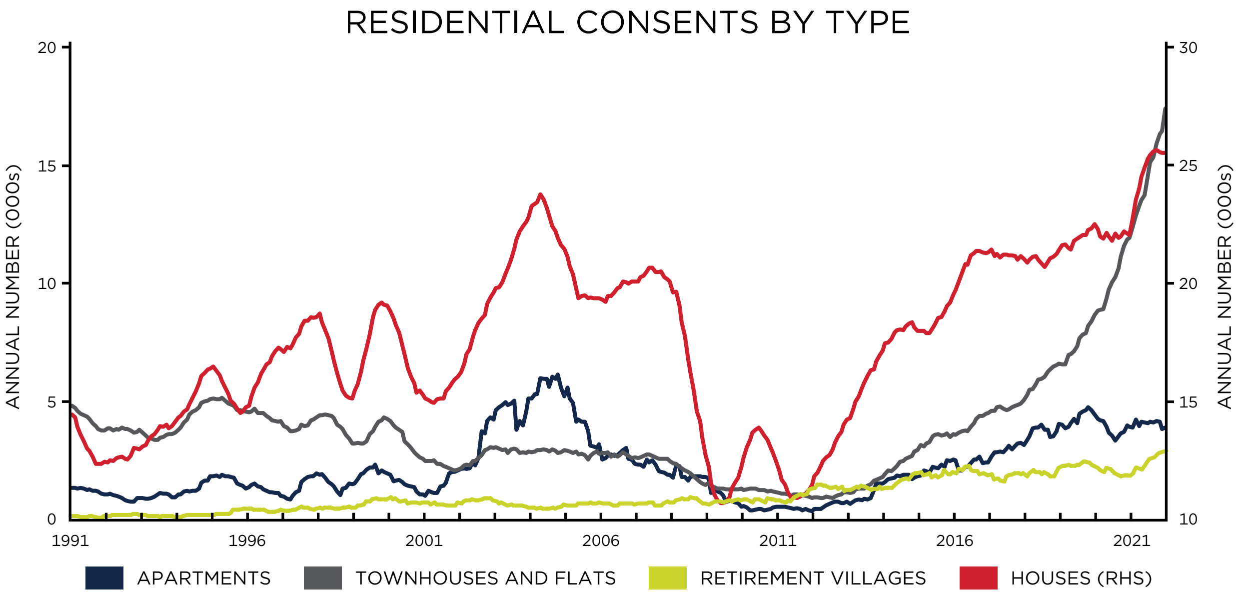


Source: Stats NZ

FIGURE 2

Continued strong demand for medium-density housing

Annual number of consents

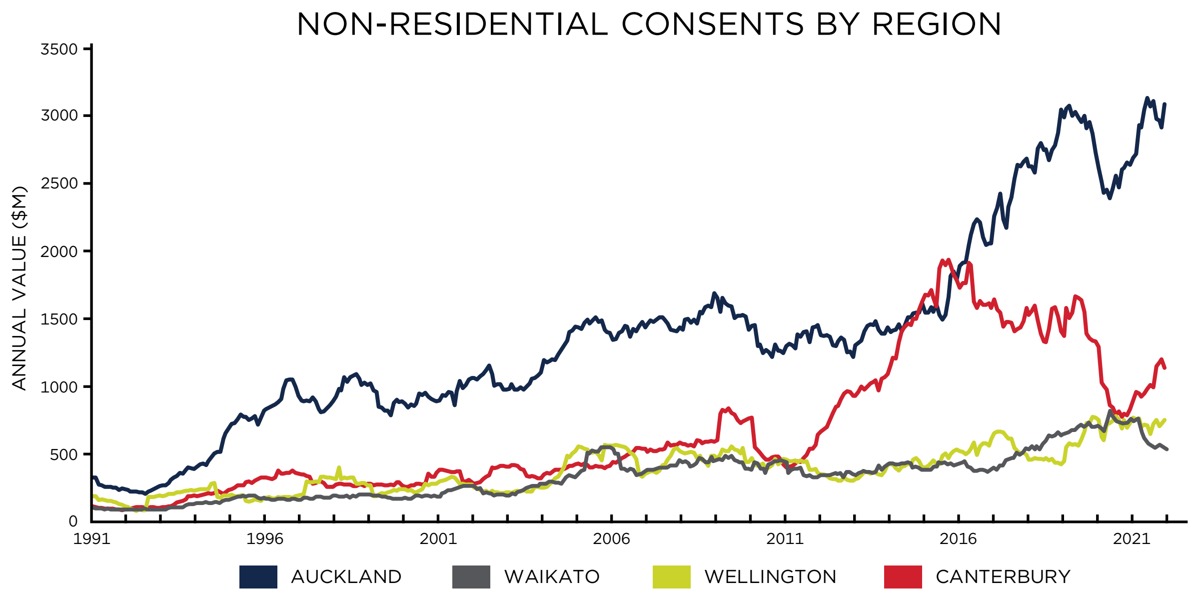


Source: Stats NZ

FIGURE 3

Relatively strong non-residential construction demand in Auckland

Annual value in consents $millions

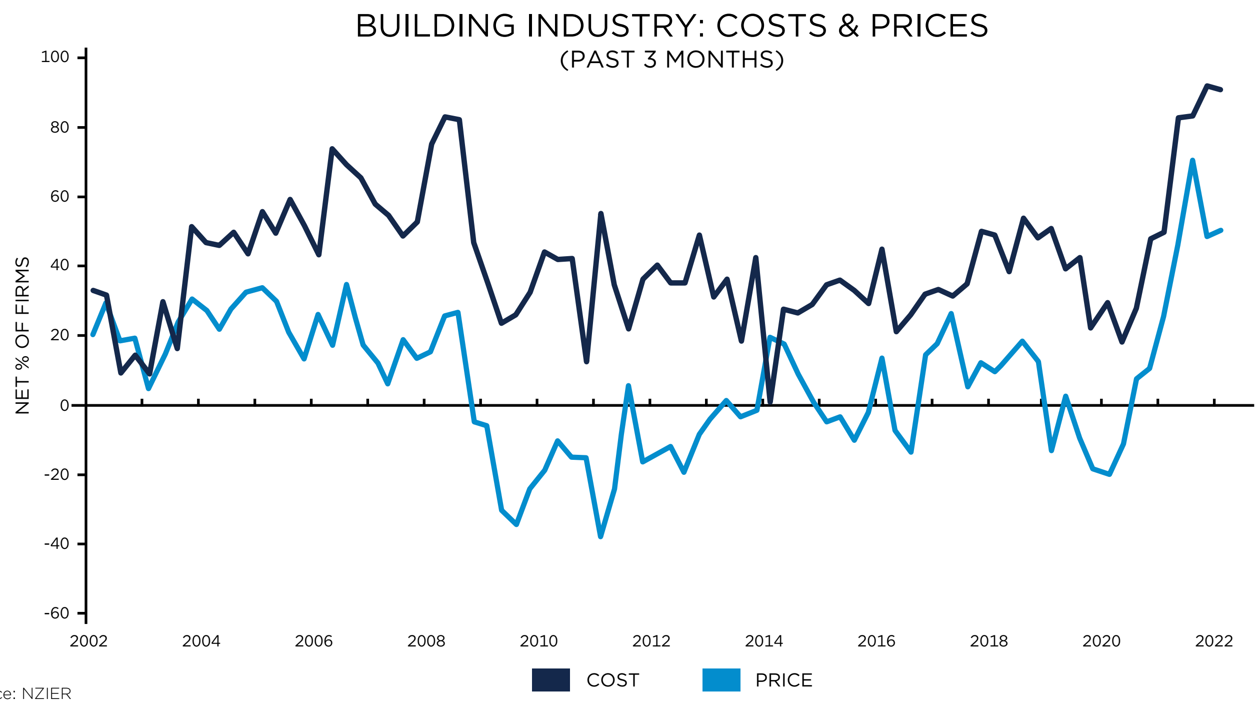


Source: Stats NZ

FIGURE 4

Construction cost pressures remain very intense

Net % of firms



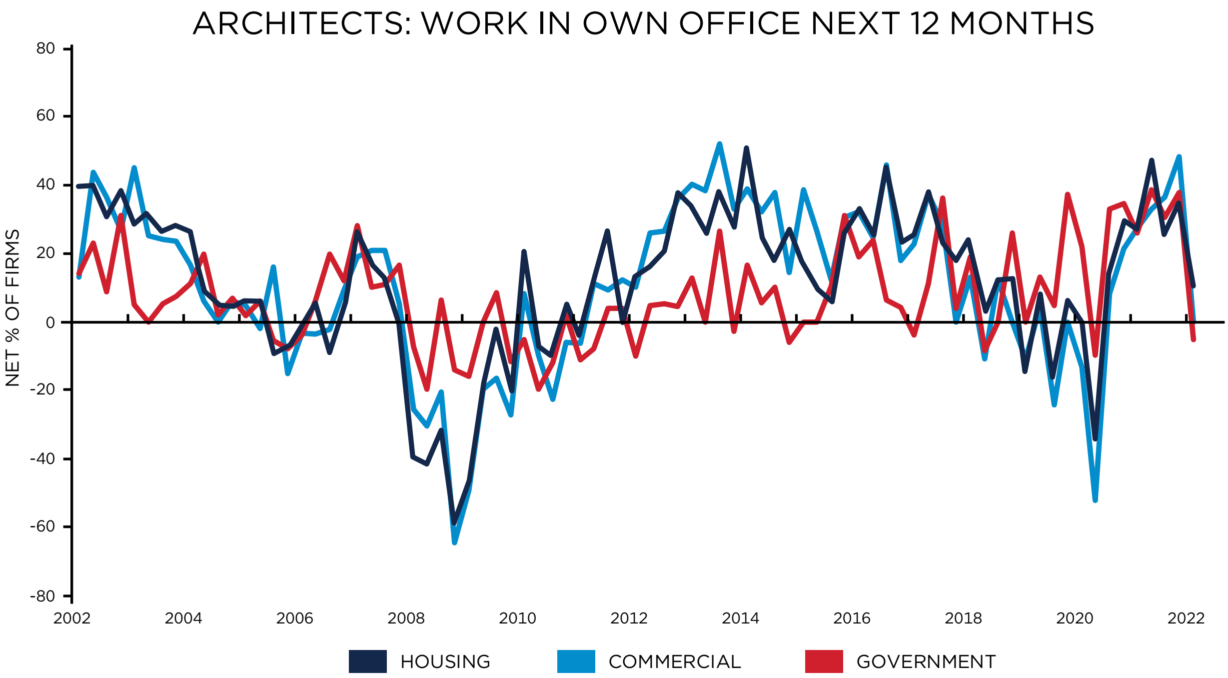
Source: NZIER


THE TERRACE CAFÉ
Aotea – Te

Te Pokapū Aotea Centre, Auckland

FIGURE 5

Slowing pipeline of commercial and Government work

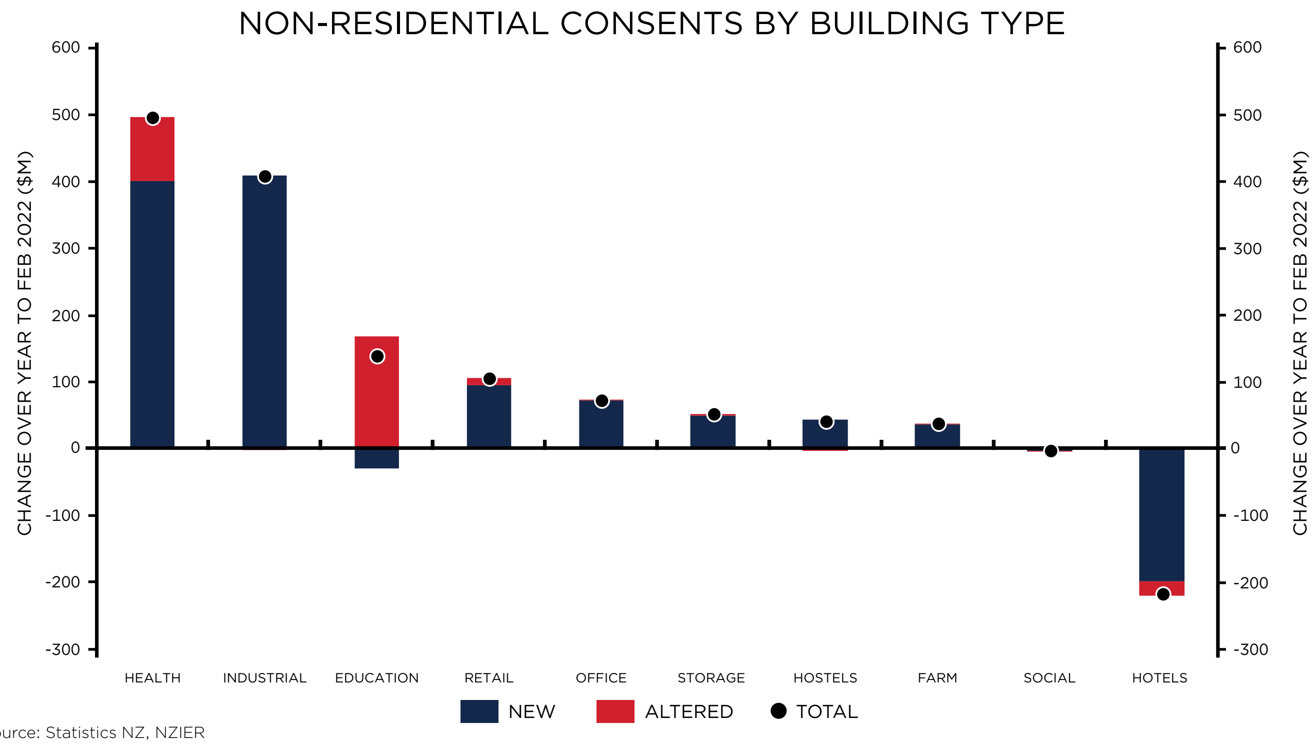


Source: NZIER

FIGURE 6

Demand for health and industrial buildings leads growth in non-residential construction demand

Change over year to February 2022



Source: Statistics NZ, NZIER

TABLE 1

Non-residential building consents by region and sector

$m of consents for the year ending December 2020; red colour shading for decline in consents from previous year

	SECTOR									
REGION	HOSTELS, PRISONS ETC	ACCOMODATION	HEALTH	EDUCATION	SOCIAL, CULTURAL, RELIGIOUS	RETAIL	OFFICE	STORAGE	INDUSTRIAL	FARM
NORTHLAND	0.0	2.1	49.6	28.2	18.6	43.6	34.9	45.9	20.4	16.6
AUCKLAND	129.9	132.9	356.8	622.4	108.6	275.6	490.4	592.2	357.1	27.4
WAIKATO	40.0	12.8	49.2	63.0	14.0	40.2	60.4	72.3	118.2	79.9
BAY OF PLENTY	3.8	1.4	61.0	57.7	51.6	61.6	36.9	83.8	178.5	15.1
GISBORNE	0.3	9.8	0.2	6.0	24.2	2.4	4.9	4.8	18.6	5.5
HAWKE'S BAY	14.8	28.6	39.4	30.2	57.0	35.7	18.6	28.7	76.3	6.6
TARANAKI	0.0	0.0	205.6	20.6	46.1	4.1	6.1	21.2	17.9	15.7
MANAWATU-WANGANUI	1.7	5.7	19.1	22.7	13.9	29.3	33.0	25.1	137.9	19.0
WELLINGTON	1.1	40.4	72.0	122.3	84.2	72.5	215.2	53.3	84.5	12.5
NELSON	0.0	0.2	8.7	10.3	2.0	4.0	4.0	3.1	9.8	0.2
TASMAN	0.1	2.4	1.8	7.7	4.0	4.8	2.1	12.2	21.5	3.0
MARLBOROUGH	4.7	0.1	17.2	6.3	1.9	5.8	5.3	6.1	24.7	4.8
WEST COAST	0.0	0.7	13.0	2.1	18.3	7.9	2.6	0.1	10.4	9.0
CANTERBURY	35.0	51.4	117.8	318.2	75.4	139.9	63.8	163.9	130.7	46.8
OTAGO	64.8	31.3	56.6	98.0	64.2	77.2	38.9	11.7	50.8	29.1
SOUTHLAND	0.0	0.9	3.3	11.8	18.8	4.0	6.7	15.7	7.7	25.2

Source: Statistics NZ, NZIER


Brandon House, Wellington

BUILDING COSTS

The Capital Goods Price Index for Non-Residential Buildings (CGPI-NRB) (the Index) is an official measure of cost movements in the sector. The Index excludes GST, and we use the Index as an indicator of cost escalation.

The Index is a national average across all building types. We, therefore, advise caution in applying the increase in the CGPI-NRB as an indicator of cost escalation for specific projects.

The Rider Levett Bucknall First Quarter 2022 Oceania Report provides local, regional comment and tender price relativity between the main New Zealand and Australian centres. This publication is available at www.rlb.com or on request from any Rider Levett Bucknall office.

Non-residential construction cost inflation picked up in the December 2021 quarter, with the 2.2 percent increase over the quarter bringing annual non-residential construction cost inflation to 7.7 percent for the 2021 year.

We expect a further pick-up in annual construction cost inflation, even as quarterly growth in non-residential construction costs stabilises at a high level over the first half of 2022. We forecast annual non-residential construction cost inflation will peak at 9.4 percent in March 2022. Beyond that, a relaxation of border restrictions later this year should alleviate labour shortages and drive a moderation in construction cost inflation from late 2022.

The forecast peak in annual construction cost inflation is lower than that seen in the 2004 building boom, but we are expecting a more protracted period of elevated construction cost inflation given the high inflation environment more broadly.

FIGURE 7

Non-residential building cost escalation

CGPI-NRB index, annual % change

Source: Statistics NZ, NZIER forecasts

TABLE 2

Non-residential building cost index

YEAR	QUARTER	INDEX	QUARTERLY % CHANGE	ANNUAL % CHANGE
2017	MARCH	1601	0.6	5.4
	JUNE	1618	1.1	5.5
	SEPTEMBER	1635	1.1	5.3
	DECEMBER	1656	1.3	4.1
2018	MARCH	1670	0.8	4.3
	JUNE	1689	1.1	4.4
	SEPTEMBER	1711	1.3	4.6
	DECEMBER	1731	1.2	4.5
2019	MARCH	1747	0.9	4.6
	JUNE	1762	0.9	4.3
	SEPTEMBER	1799	2.1	5.1
	DECEMBER	1825	1.4	5.4
2020	MARCH	1838	0.7	5.2
	JUNE	1841	0.2	4.5
	SEPTEMBER	1843	0.1	2.4
	DECEMBER	1860	0.9	1.9
2021	MARCH	1867	0.4	1.6
	JUNE	1925	3.1	4.6
	SEPTEMBER	1960	1.8	6.3
	DECEMBER	2003	2.2	7.7
2022	MARCH	2042	2.0	9.4
	JUNE	2079	1.8	8.0
	SEPTEMBER	2113	1.7	7.8
	DECEMBER	2145	1.5	7.1
2023	MARCH	2174	1.3	6.4
	JUNE	2200	1.2	5.8
	SEPTEMBER	2226	1.1	5.3
	DECEMBER	2249	1.1	4.9
2024	MARCH	2272	1.0	4.5
	JUNE	2295	1.0	4.3
	SEPTEMBER	2316	0.9	4.1
	DECEMBER	2337	0.9	3.9
2025	MARCH	2358	0.9	3.7
	JUNE	2377	0.8	3.6
	SEPTEMBER	2396	0.8	3.4
	DECEMBER	2415	0.8	3.3
2026	MARCH	2433	0.7	3.2
	JUNE	2450	0.7	3.1
	SEPTEMBER	2468	0.7	3.0
	DECEMBER	2486	0.7	2.9

Notes: The current and forecast CGPI-NRB is a national average, which does not differentiate between regions or building types. We therefore advise caution in applying the increase in the CGPI-NRB as a measure of cost escalation for specific building projects.

Source: Statistics NZ, NZIER forecasts

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