INFLATION ON THE RISE

PROPERTY INVESTORS ARE FACING HEADWINDS AS INFLATION TAKES OFF AND THE RESERVE BANK HIKES INTEREST RATES – BUT THERE ARE SOME BRIGHT SPOTS ON THE HORIZON.

THE RESERVE BANK OF NEW ZEALAND (RBNZ) recently lifted the official cash rate (OCR) by 25 basis points to one percent, and in his first Monetary Policy Statement (MPS) for the year, Reserve Bank governor Adrian Orr indicated further rate hikes were coming.

"The Monetary Policy Committee agreed that further removal of monetary policy stimulus is expected over time given the medium-term outlook for growth and employment, and the upside risks to inflation," Orr said.

The RBNZ is now forecasting the OCR to peak above 3.25 percent by 2024. In its earlier November statement, it had forecast a peak of 2.5 percent. As a result, banks are raising borrowing and deposit rates.

For example, ANZ raised its home loan floating mortgage rate to 5.04 percent from March 1 for new loans and mid-March for existing mortgages, and was also planning to raise some deposit rates. Fixed loan rates are expected to follow suit.

However, independent economist Cameron Bagrie says there are winners and losers from the unfolding scenario.

"Offsetting interest rate and inflation rises, some manufacturing could come back to New Zealand benefitting commercial property. Central business district retailing isn't doing very well, but suburban retailing is doing better. And while working from home isn't great for office property, it's good for the suburbs.

"Industrial property has become popular, with online shipping warehouses coming to the fore during the COVID-19 pandemic, and in line with longer-term trends.

"So it's not one-way traffic, we're seeing some substitution effects. There will be bumps but markets will take it in their stride. Quality will count."

Bagrie says commercial property and land assets have traditionally offered some protection against inflation. Currently, the replacement cost of a building is sky-rocketing, he says.

"Interest rates are heading higher and if you believe the Reserve Bank, they'll be a lot higher in two years.

"We have a fundamental problem with inflation at 5.9 percent and still rising. COVID-19 accounts for some of that but a lot of it just reflects an economy that is overheating on many levels despite many sectors – such as tourism – struggling," Bagrie says.

The RBNZ is heading for an inflation battle and has said it will aim to return inflation to two percent.

"Government expansionist and ultra-low interest rate policies have worked well, but now it's morphed into a boom that no one expected. The follow up to a boom is inflation, and containing inflation is not growth or asset price friendly."

"FACING A RISING INTEREST RATE HEADWIND, INVESTORS NEED A STRONG FOCUS ON EXTRACTING ADDITIONAL INCOME AND ADDING VALUE TO THE ASSET."

CAMERON BAGRIE,
BAGRIE ECONOMICS

Bagrie doesn't think New Zealand will return "to the bad old days" of double-digit inflation but there will be challenges that suggest inflation could be more sticky and persistent, he says.

"Some of the forces that have kept inflation low for a long time are unwinding. Labour is in short supply and I think that's going to be around for a while. So there will be bigger pay rises and that will feed through to inflation. There's also rising benefit dependency and the Russian situation is not positive.

"People are starting to spend their retirement nest-egg as opposed to saving. Climate change policies will add to costs and we're in an era of big government. There are whole lot of things that are evolving and the Reserve Bank won't find it easy to get inflation back to two percent.

"I suspect we are headed for an awkward juncture when the costs of getting inflation back to two percent in the form of less growth and pressure on asset prices becomes too large and we end up with softer inflation targets," Bagrie says.

"Commercial property will face challenges over the next 24 months. When interest rates went down, capitalisation rates did too, which raised property prices. It works in reverse as well."

Markets were being a lot more selective, so landlords will look at what more they can do to get the best out of their assets, he says.

"Facing a rising interest rate headwind, investors need a strong focus on extracting additional income and adding value to the asset. There will be overs and unders," Bagrie says.

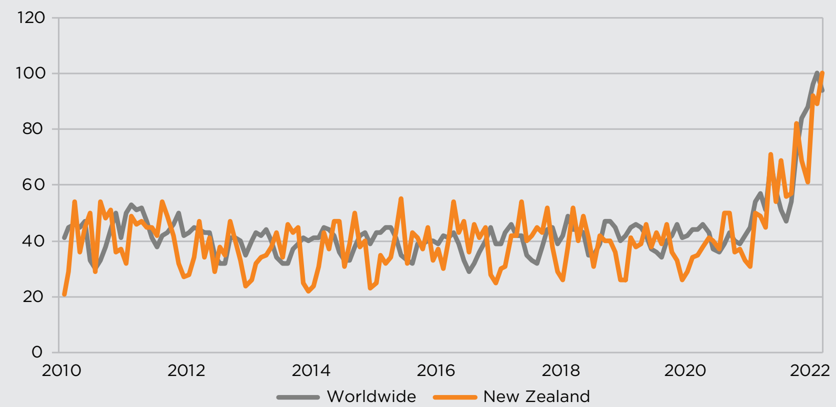
Bayleys Realty Group's head of insights, data and consulting, Chris Farhi, says one of the positive aspects of the current environment is rental growth is benefitting some commercial landlords.

"Assets with strong occupier demand and constrained supply are seeing strong rental growth. We're seeing this across industrial property generally, but also in quality assets where the flight-to-quality across a range of markets is benefiting the owners of higher quality properties. Rising construction costs are also affecting the delivery of new and refurbished commercial spaces.

"This compounds the flight-to-quality as it puts pressure on existing supply and means even higher rentals are needed for new spaces.

"Whilst all else being equal, higher interests rates will generally translate

GOOGLE SEARCH TREND INDEX



Inflation has become very topical during the pandemic. New Zealanders' and worldwide Google searches show a big growth in searches about inflation starting around January 2021. The period of the pandemic coincided with people becoming aware that many parts of the global economy were starting to boom and there was growing media coverage about the potential for inflation.

“THE FLIGHT-TO-QUALITY ACROSS A RANGE OF MARKETS IS BENEFITING THE OWNERS OF HIGHER QUALITY PROPERTIES.”

CHRIS FARHI, BAYLEYS' HEAD OF INSIGHTS AND DATA

to softer yields, there are complicating factors such as the flight-to-quality by both investors and occupiers, and the weight of capital seeking placement into real estate. This will help insulate some of the asset classes – particularly those that have proven resilient during the pandemic such as industrial property and large format retail with essential service tenants.”

“We’re also conscious that inflationary environments tend to benefit real estate and equities. Some investors view income generating real estate as an inflationary hedge, so it’s foreseeable we’ll see larger diversified investors increasing their exposure to real estate. This is likely to support the capital markets edge of the spectrum.

“All investors also need to consider their alternatives. Whilst we have seen increases in interest rates, the returns on term deposits remain poor and at the moment represent negative real returns after you account for inflation. Meanwhile, real estate provides the opportunity for both income growth and capital growth. For existing property investors, care will be needed in the short term around the rent review mechanisms applied in new leases. Market and CPI indexed reviews will likely deliver stronger income returns than the fixed growth arrangements that have been common over the past few years,” Farhi says.

Kevin Miles, property finance and commercial adviser with Vega Lend says these are uncertain times.

“The reality is we’re likely to have a difficult time coming up, even without the impact of issues in Europe. It’s always hard to know definitively, but it would appear we’re going to have a period of increasing interest rates to get inflation under control. What’s causing it is very complex, is it demand or supply driven?

“Global economies have been in an extended period of quantitative easing so inflation had to happen sooner or later. Personally, I don’t think inflation will stay around as long as some people think and I believe supply will sort itself out sooner rather than later.

“I agree with economist Tony Alexander’s view that part of the problem is the so-called toilet roll issue - many businesses are moving from just-in-time procurement to just-in-case and its adding stress to the supply lines.”

Miles says Vega has experienced lots of demand for warehousing from builders who are stockpiling. Instead of sitting on Bunnings shelves, materials are being stockpiled in warehouses to ensure builders have supplies to complete future projects.

“At some stage confidence of supply will return and this stock will be used, as holding it ties up capital, releasing pressure on supplies and hopefully reducing costs.”

However, in the meantime, funding of commercial and industrial investment is facing new constraints.

“Banks tend to use loan-to-value ratios (LVR), debt service cover ratios (DSR) or interest cover ratios (ICR) to work out the size of debt on investments.

“Historically, LVRs were the main constraint and typically sat at 60-65 percent. Over recent years this has given way to ICRs being the main constraint. As interest rates have declined banks have moved their ICR ratios from 1.6 times to two times. In a very low interest rate environment this made sense as an increase in interest rates has a relatively larger impact on cashflows at lower rates than at higher rates. Going from three percent to four percent might be the same dollars as going from six percent to seven percent but the relative increase is much more,” Miles says.

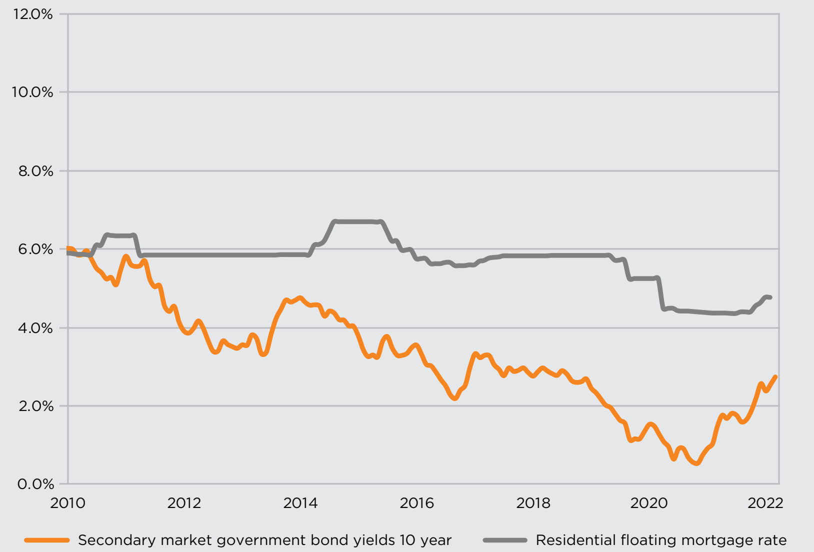
“Interest rates are now increasing but banks aren’t softening their ICRs, and in some cases there’s further tightening. One bank now requires 2.5 times cover for new customers assuming a six-percent interest rate.

“The effect of this is if you wanted to borrow $1 million you would need $150,000 in rental income a year, but if you had $150,000 of rent your property would be worth something like $3 million. So $1 million of debt on $3 million of property is a 33-percent LVR.

“If you want more leverage, unless you’re of a big scale with to access offshore non-bank funding, borrowing at New Zealand non-bank rates makes no sense if you are buying an asset yielding four to five percent. High equity requirements are driving buyers out of the market and prices down. As a result, yields will rise.

“As prices fall and yields rise investors will be able to get more leverage but, until such time as banks loosen their ICR requirements, we’re a long way from getting back to that 60-percent LVR level we used to see,” Miles says.

INTEREST RATES



Around January 2021 long-term government bond rates began to rise. This continued throughout 2021. While the RBNZ might have only recently raised the OCR, the financial markets have been pricing in increases since the start of 2021. These increases are also apparent in the long-term interest rates offered by banks. For example, the five-year fixed rate for home loans from the major banks has risen from around three percent during mid-2021 to around five percent in early 2022.

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KEVIN MILES, VEGA LEND PROPERTY FINANCE AND COMMERCIAL ADVISER