PROPERTY RESEARCH

Developer Perceptions

Greenfield residential subdivisions

REPORT OBJECTIVE

This report was commissioned as input in to the Hamilton Sub-Regional Growth Strategy being undertaken by Hamilton City Council (HCC), Waikato District Council, Waipa District Council and Environment Waikato. The report focuses on developer perceptions for Greenfield residential subdivisions and needs to be read in conjunction with our reports on intensification of Greenfield residential subdivisions, Greenfield industrial subdivisions, and the ***Hamilton Infill & Multi-Unit Housing Markets*** report we prepared for HCC (19 March 2008).

This report investigates the key land economic drivers for Greenfield residential subdivisions in the sub-region, especially the main urban areas. It investigates the future market opportunities and constraints for promoting Greenfield residential subdivisions in the sub-region, and the key economic and financial pre-requisites to achieve successful Greenfield residential subdivisions. To the extent possible it also contains information on the indicative development cost factors to enable locational comparisons for residential land development requirements.

Much of the information contained in this report was gained by interviewing local, Auckland-based and Tauranga-based developers and relevant property professional, including one Wellington-based developer. The relevant people to interview were identified in preliminary discussions with several local property professionals, based on our knowledge of relevant developers and included some suggestions from Gary Knighton (Team Leader City Strategy, Strategic Group, Hamilton City Council). It was not possible to interview all of the people identified but the vast majority of people identified as being relevant were interviewed, including what we believe to be a representative sample of local and out-of-town developers. Interviewees were asked a standard list of questions we designed to extract the relevant information, while we also offered the people interviewed the opportunity to express opinions about any relevant or related matters. We would like to express our thanks to the people interviewed who were generous with their time and provided many valuable insights.

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CONTENTS & SUMMARY

The price of blocks of land for residential subdivisions has sky-rocketed even more than residential section prices and this, combined with tumbling demand for sections, has made subdivision development uneconomic. It is likely that many of the resource consent applications the councils have received for subdivisions will go on hold while even some subdivisions that have gained resource consent will go on hold or proceed slowly because of “deteriorating market conditions”.

Tumbling demand for sections has helped expose the risky economics of new subdivision activity. Nationally section prices are extremely stretched relative to income levels while Hamilton section prices and to a lesser extent section prices in Waikato and Waipa Districts are expensive relative to national prices.

Competitive section prices are likely to be an important ingredient in the growth of the sub-regional economy. While the deterioration in market conditions is putting downward pressure on section prices it is also resulting in landowners-developers backing off subdividing so as to limit the oversupply of sections in an attempt to reduce downward pressure on prices. While current market conditions and the rezoning of residential land in the Rotokauri growth cell may help return local section prices to competitive and affordable levels, the extent to which section prices need to fall to be competitive/affordable again and the nature of land ownership in the north of Hamilton may well limit the required large fall in section prices.

Lost competiveness and lack of affordability is especially a feature of the Hamilton market but it also extends to a somewhat lesser extent to the Waipa District and the Waikato District. Developers’ opinions were divided, understandably in part reflecting their vested interests, but most saw Hamilton as the benchmark market for the sub-region and the best means of addressing the uncompetitive level of section prices in the sub-region seemed to be via rezoning more residential land around Hamilton.

It is our assessment that the Councils need to seriously consider rezoning land as residential in several areas in addition to Rotokauri in the near-term to facilitate local section prices again becoming competitive relative to the national market as well as relative to Tauranga and South Auckland. If the Councils wait until the next upturn in demand to rezone more residential land they risk locking in the current uncompetitive section prices for some years to come given the time lag involved between rezoning decisions and sections being ready to market.

In the case of Hamilton, most developers interviewed preferred future development to be in the north east of Hamilton and in the Rotokauri growth cell. It was generally expected that employment growth would remain focused around the Te Rapa area and in the areas zoned for industrial and employment use in Rotokauri. However, while there were some dissenting views on where future Greenfield residential development should be and significant number of developers believe there is a case for considering future residential development in several areas, especially if the Councils want to make local section prices competitive and affordable again.

The obvious choices include Peacockes (especially if done on a “stand-alone” basis for sewage), the area around Ruakura, land east of the extension of Wairere Road, and Ngarawahia and north of the planned Horotiu-Te Rapa industrial area. These four options have appeal from the perspective of offering the potential to access cheaper land than is currently available in north Hamilton, and they could fit in well with future industrial-commercial development and roading plans.

There are several subdivisions already planned for Ngarawahia, while there are plans for new subdivisions in Cambridge, Te Awamutu and Huntly. The focus of this report is particularly on the Hamilton market because of its central or benchmark roll in the sub-region, but the report also includes analysis of the other main urban centres in the sub-region and some comparisons with Morrinsville and Matamata.

The economics of Greenfield residential subdivisions

Residential land prices have sky-rocketed over the last several years

Blocks of land for residential development are sold infrequently making it hard to assess the state of the market. One person interviewed said the "feeding frenzy" of land buying ended in 2006 and the last significant block of land sold in Hamilton was in late-2006 or early-2007 for $800,000/ha. Another person observed that, "At the peak land was selling for $800,000/ha but it is now selling for $600,000/ha" (although we are not aware of any transactions at $600,000/ha). Another observed that, "Some big land holders have paid $500,000-700,000/ha" in recent years, "but that new purchasers have paid too much, including up to $1,000,000/ha". Another said he was not proceeding with further development in the Hamilton North area because land owners were asking $900,000/ha for land and this wasn't uneconomic.

One developer who is still marketing a couple of subdivisions in Hamilton is "keen to do more" but is not actively looking for land because "the price is too high". This developer said he could buy land for $300,000/ha five years ago but that it now costs around $900,000/ha (several people interviewed were aware of land Peacockes where the asking price was $900,000-$1,000,000/ha, while one person was aware of land in Rotokauri where the asking price was $1.5m per ha). This developer observed that subdivision could be viable at this sort of land price if he could subdivide and sell down the sections within two years, and at the recent higher section prices (i.e. around $230,000 per section), "which was not likely". He thought people buying land at these prices could only justify it if they thought section prices would increase 10-20% while they held the land.

Demand for blocks of land for residential subdivision was said to have dried up because of falling section demand. "People are left holding land, but if they sold it today the prices would be much lower." However, we were not made aware of any panic land sales or cheap land on offer, although while in town we heard rumours that two developers may be under financial strain.

We were told that, "Cambridge land prices are creeping up towards Hamilton levels at $700,000-750,000/ha depending on the location (e.g. 10 acres sold for $2.9m), but it is still viable for efficient developers if there are not unexpected council charges." However, like all developers, this person indicated that the number of section sales was down, while we heard that at least one Cambridge subdivision was holding back releasing sections because of the deterioration in demand.

Some developers have shifted their attention to Ngarawahia as a response to high land prices in Hamilton and elsewhere in the sub-region, where two developers are each working on three subdivisions, the largest of which involves 103 sections. One of these two developers said he had acquired land at Ngarawahia at "almost one quarter" of what it would have cost in Hamilton which meant that even if sections didn't sell fast his holding costs were much lower. Based on current asking prices the average 500-599 m^2 section in Ngarawahia is $125,000 versus $206,000 in North Hamilton. We were told of a five acre block in Ngarawahia that sold for $750,000, which equates to a price of around $375,000/ha. We did not manage to gain information on land prices in the other urban centres of the sub-region.

The economics of Greenfield residential subdivisions and developers' return requirements

The rule of thumb for developing residential sections appears to be 1/3 for raw land costs, 1/3 for development costs including council levies and selling costs, and 1/3 margin. This is the ideal world but in reality margins can end up significantly lower because of the inevitable details, seemingly too often associated with council holdups. A number of developers have experienced situations where resource consents have been processed slowly resulting in the seasonal window for doing earthworks being missed, meaning delays of up to a year getting titles for subdivisions, especially when delays getting final signoff are also common. For example, in the case of a 10 ha block of land that cost $700,000/ha, if gaining titles is delayed by a year it means the interest cost born by the developer can ends up being $700,000 higher than budgeted assuming 100% gearing and based on current interest rates.

Based on land prices of around $800,000/ha and assuming 10 sections per hectare, development costs of $75,000 per section, and section prices averaging $215,000, this implies a developer's margin of $60,000 per section assuming no delays or cost overruns. However, if the developer bears all the upfront cost of developing sections and the sections take two years to sell because of lack of demand, including paying rates the developer's cost per section escalates to around $190,000 at current interest rates. The alternative in the face of plummeting section demand is for developers to discount section prices, and we heard stories that some of this is occurring, but to sell a significant number of sections in the current environment would require material discounts that would quickly erode margins anyway.

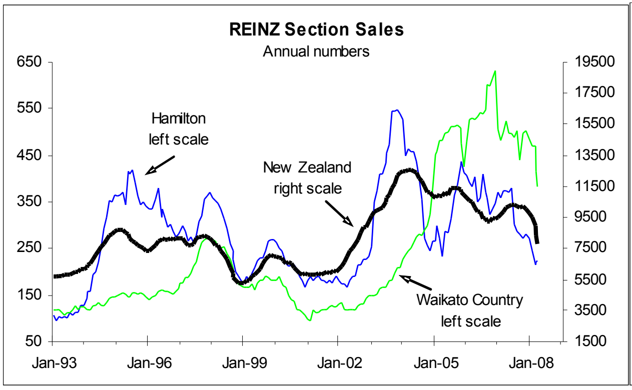
This example shows how precarious margins can be in the subdivision development business and why budgeted margins need to be high to justify undertaking the risk associated with such developments, especially when developers can be virtually guaranteed of seemingly unnecessary holdups along the way.

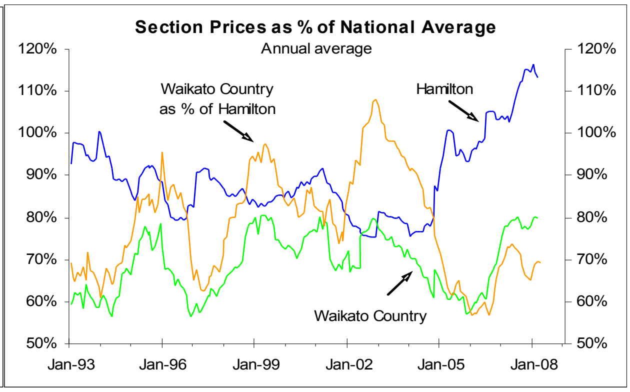
However, the challenge land owners and would-be developers currently face is not just the likelihood that some have paid too much for the land and now face high holding costs, but also the likelihood of a reasonably protracted period of low demand, competition from investors and spec builders trying to sell down sections, massive competition from the huge stock of existing properties listed for sale, and the fact that section prices at recent levels are not sustainable.

The demand for sections has tumbled, exposing the dubious economics of new subdivisions

It was unanimous that sales of sections in new subdivisions have "virtually dried up". "Demand is dead and there are no enquiries. It is not economic to develop more sections at the moment especially because we have to pay rates on sections that are not sold." One developer recently released a stage of 54 sections with none selling on the initial release. In another stage of the same development they had experienced seven buyers walking away from contracts so far and suspected they could end up with 20 walking away. "Hardly any newly developed sections are selling. There are some re-sales of sections but vendors have to discount 10% relative to the original prices to sell them."

The annual number of sections sold via real estate agents in Hamilton has fallen towards previous trough levels (blue line, left chart), with more downside ahead based on the analysis of demand for sections contained in our monthly **Housing Prospects** reports. The left chart shows section sales in Hamilton (blue line) are now under-performing the national market (black line). Between 1994 and 2005 median section prices in Hamilton were below the national median (blue line, right chart). Local section prices fell to around 80% of the national median in 2002-2004, which made Hamilton attractive or more competitive from a cost of living perspective. But the median section price in Hamilton, based on REINZ data, has risen to be 13% above the national median. Hamilton has become less attractive on a relative price basis and this is being reflected in the number of section sales under-performing.

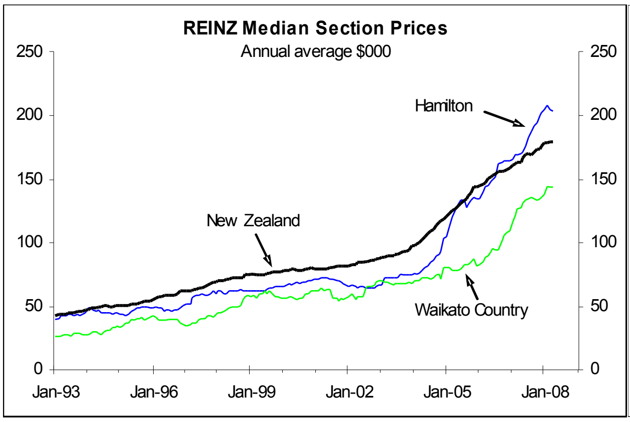


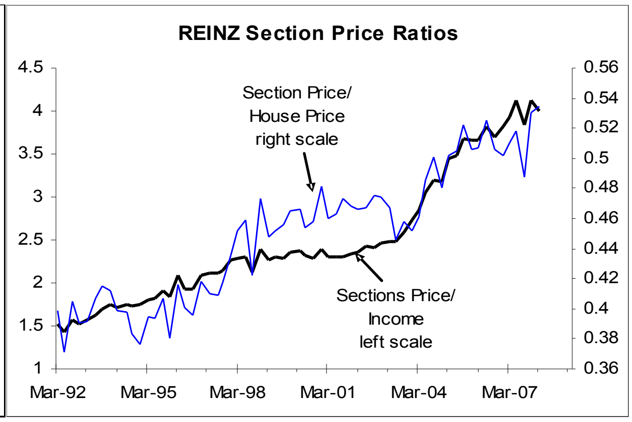


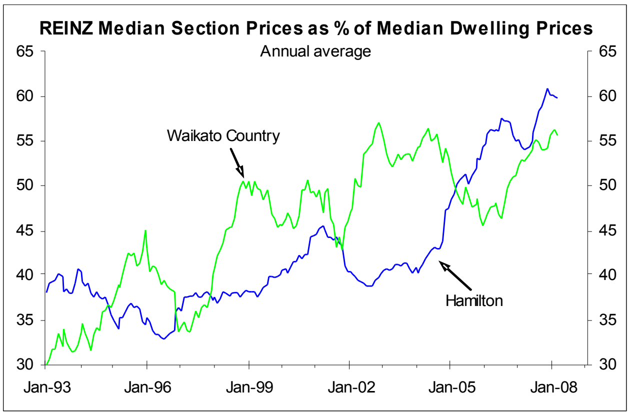
The biggest boom in the Waikato in the last few years has been section sales in Waikato Country, which covers Waikato excluding Hamilton (green line, left chart). This will partly be because section prices in Waikato Country fell significantly relative to national section prices between 2002 and 2005/06 (green line, right chart), but more particularly because section prices in Waikato Country fell dramatically relative to Hamilton section prices over this period (the orange line). Based on the REINZ data the Waikato Country median section price was $70,000 in 2002 versus $66,000 for Hamilton, but in 2005 the respective median prices were $83,000 and $134,000. While Waikato Country median section prices are still "cheap" compared to Hamilton prices – respective averages of $144,000 and $204,000 in the year to April 2008 – Waikato Country is now expensive relative to the national market on an historical relative basis.

During booms the focus is on relative prices (e.g. demand for Waikato Country sections goes through the roof because they are "cheap" relative to Hamilton sections), but during downturns the focus returns to absolute value (e.g. the affordability of sections relative to incomes) as well as relative value.

Between 2001 and now, the national, Hamilton and Waikato Country median section prices increased by 87%, 171% and 111% respectively (see the top left chart on the next page). Nationally the median section price has increased from 2.3x the income of the average employee in 2001 to 4x now (black line, right chart below). Relative to income levels it now costs almost as much to buy a section as it cost in 2001 to buy the national median dwelling with section attached (in 2001 the national median dwelling cost 4.5x the average employee's income). Sections have also become expensive relative to existing dwellings with the national median section price increasing from 47% of the national median existing dwelling price in 2001 to 53% most recently (blue line, right chart below).







Not only have Hamilton section prices increased significantly more than national price over the last few years, but the Hamilton median section price has increased to around 60% of the local median dwelling price (blue line, adjacent chart) versus 54% nationally. Hamilton sections have become extraordinarily expensive relative to existing dwelling prices and relative to incomes. Section prices in Waikato Country are not as extremely over priced as is the case in Hamilton. They are more in line with the national picture in terms of section prices as a % of dwelling prices (the green line), which still means they are unsustainably high.

Section prices were pushed to highly unaffordable levels to a significant extent because low interest rates helped fuel a speculative bubble[1]. The low interest rates created an environment conducive to investors achieving capital gains and capital gains continued as long as more investors were in the queue to buy than were trying to crystallize profits by selling. Investors chasing capital gains got drawn into buying sections because section prices were increasing more than house prices, land was perceived as the scarce resource, they could put down deposits of 10% or so and hope to resell the sections before title and because a much larger group of investors could afford to speculate on sections, especially sections in "cheaper" markets, than could afford to speculate in the likes of the Auckland housing market.

The low interest rates also helped fuel an excessive boom in new house building with an associated growth in spec building activity. Spec builders played a part in driving demand for sections above the level justified by population growth. High national net migration between 2001 and 2004 played a part in fuelling strong population growth in Hamilton, which was aided by local section prices being cheap at the time on a relative basis. These events – low interest rates, high national net migration and cheap sections in the sub-region – created the ingredients for a speculative bubble in the local section market.

Speculation has been a feature of the sub-regional section market. One person observed that in a Cambridge subdivision only seven sections were for sale on the primary market prior to the "doom and gloom setting in" but there were now "over 30 sections listed for sale by investors trying to exit". In Ngarawahia we found out that in stage one of one subdivision an Auckland-based investor had bought nine of the 19 sections and built spec houses on some of them but despite being advertised for $369,000-375,000 the houses were not selling, while a second Auckland-based investor had bought all 14 sections in stage two and was now trying to sell them for $129,000-135,000, three with spec houses attached, but with no success. In another Ngarawahia subdivision of 17 sections an Auckland-based investor had bought 11 sections that were now growing grass, while another investor bought four sections and built a 4-bedroom spec house on one that he is struggling to sell for $398,000 (a local agent assessed it would have to be priced at $350,000 to sell).

[1] For more information read the related reports in the Literacy Centre on our website (www.sra.co.nz).

A developer in Cambridge said when sections in stage one of his development were sold around four years ago they went for $80,000. At this price there was strong investor buying and some sections resold as many as three times before titles were issued. Section prices were said to have been bid up to around $120,000 two years ago and to around $180,000 before the downturn arrived.

As one person interviewed observed, “Previously the market was fuelled by speculative buyers. Auckland-based Asian investors played a significant part buying 3-4 sections at a time at the peak, but they have gone. Some buyers are walking away from contracts. Spec builders are starting to be forced to sell sections and are not buying more. The only buyers now are end-users, but they have many existing houses to choose from and existing house prices are now cheaper than house and land packages.”

The speculative boom in the section market is now dead but it will take some years for prices to come back into line with affordable levels and the levels that are desirable for the health of the sub-regional economy. It is hard to predict over what period and by how much section prices will fall, but there is the potential for a significant fall in prices. There is a large supply of sections relative to current and likely near-term demand. The REINZ website has 192 ads for sections for sale in Hamilton, which at around trough levels of demand is enough supply to satisfy around 14 months of demand. In Waikato Country there are 728 ads for sections for sale which is enough supply to satisfy 33 months of demand even at historical average levels of demand. As a natural consequence of the speculative market over the last few years there will inevitably be some investors, spec builders and possibly developers who end up being forced to sell, which is the main means by which the unfavourable demand-supply balance will be reflected in prices.

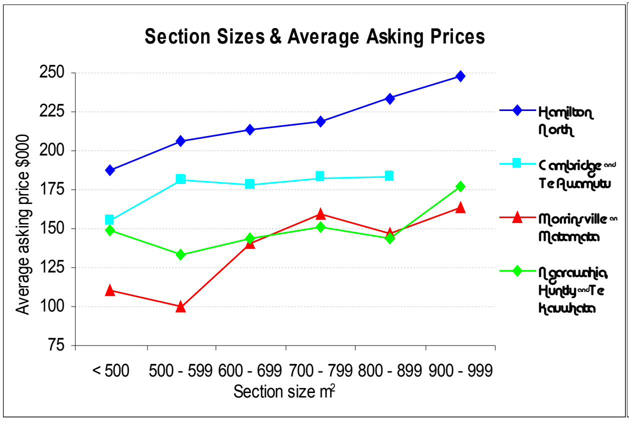
Developers generally believe the New Zealand economy faces some major challenges and could be at the start of what is likely to prove to be a reasonably extended period of sub-par economic growth, with few if any expecting significant interest rate cuts to be delivered by the Reserve Bank in the near-term. Consequently, a number of the developers we interviewed were preparing for a potentially protracted period of low demand for sections.

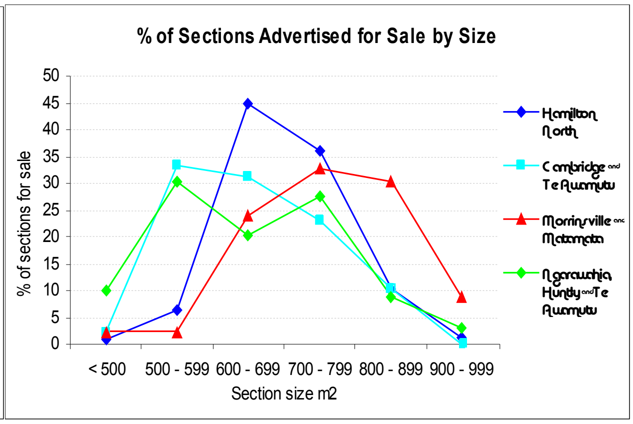
In our assessment a large fall in section prices is necessary for the medium-term health of the sub-regional economy, but in particular local section prices need to fall relative to national section prices to restore the competitive advantage of lower section prices. However, any downside in section prices will undermine the already shaky economics of developing new subdivisions especially in Hamilton but also in Waikato Country and stifle increases in supply.

One developer that operates in a number of markets in the central North Island said that house and land package prices in the likes of Hamilton need to “sub-$400,000” to be affordable by most would-be home owners. This is the “sweet spot in the market” and “what people want”. This developer said that to build a sub-$400,000 3-4 bedroom house on a 400 m^2 section the land price had to be $130,000-150,000 to make it work financially for a developer. With the median section price in Hamilton at just over $200,000 it shows how out of line section prices are with the sort of levels needed to make new housing affordable, which is critical to the medium-term health of the local economy. Hamilton is currently flush with new or near new houses advertised for sale in the $500000-600,000 range, which is too high for too many people.

To better understand the characteristics of the sub-regional section markets we have done some analysis of sections advertised for sale for each area and also in Morrinsville-Matamata (a competing market). The blue line in the left chart on the next page shows the average prices of sections advertised for sale in subdivisions in Rototuna and Flagstaff based on six size ranges (e.g. the average asking price for sections in the 600-699 m^2 size range was $213,000). Rototuna and Flagstaff are used as representative of the new subdivision market in Hamilton. The light blue line does the same for Cambridge and Te Awamutu, the green line is for Ngarawahia, Huntly and Te Kauwhata, and the red line is for Morrinsville and Matamata. As seems reasonable, section prices in general increase as the size of the section increases.

In Hamilton even the sections advertised for sale that were under 500 m^2 were priced well above the level needed to make building sub-$400,000 houses viable. But as the blue line in the right chart on the next page shows, there are virtually no sections advertised in new subdivisions in Rototuna and Flagstaff that are below 500 m^2. This chart shows the % of sections advertised for sale in the four areas broken down by section sizes. In the case of Rototuna and Flagstaff almost 45% of sections advertised for sale are 600-699 m^2, while just over 35% are 700-799m^2. The samples for the three other markets are significantly smaller than for Rototuna and Flagstaff, meaning the findings need to be taken with a grain of salt, although a common feature is the small % of sub-500 m^2 sections on offer, which goes some way to explaining why subdivisions in the Waikato have struggled to get above 10 sections per ha.





A heavy lid has been put on new subdivision development until demand recovers

Despite the substantial increases in section prices in the last few years subdivision development has become uneconomic especially in Hamilton but also to a reasonable extent in Waipa District and Waikato District because raw land prices have increased more than section prices. And the market is responding to the changed economics by dramatically curtailing increases in supply.

We understand that of the 1,800 or so sections in new subdivisions for which HCC has received resource application many will go on hold. One developer said he had “parked” two developments that have already been consented because of deteriorating market conditions. Another developer has delayed the launch of stage one of a large subdivision because of the downturn and will only proceed as demand permits. Another person interviewed said, “Most new resource consent applications will be mothballed by either the developers or the bankers.” Another said, “Only people with access to cheap money/land will do subdivisions in the current environment”. In addition there are a significant number of developers who are no longer looking for land for future subdivisions because land prices are uneconomic.

The new subdivisions we found out about that were still going ahead seemed to be either in the cheaper markets, like Ngarawahia and Huntly, those that have special features (e.g. an “eco-subdivision”) or those sponsored by councils (e.g. Te Awamutu). But with demand for sections tumbling we suspect some of the planned subdivisions even in Ngarawahia will go on hold or go slow, especially because even Ngarawahia with its much lower section prices is showing severe signs of section indigestion with asking prices said to be 10-25% above levels that will entice buyers.

Experienced developers are preparing for a protracted downturn in demand, with one observing that, “In a previous downturn we didn’t sell a section in one subdivision for 18 months.” A local firm has undertaken a study and found approximately 500 vacant sections in Greenfield subdivisions in Hamilton at the moment, including those where title will not be through until 2009. With demand for sections heading to the lowest level in many years 500 sections could be enough to satisfy demand for up to a couple of years, but with section prices well above levels that are healthy for growth in the sub-regional economy we believe the Councils would be ill-advised to be relaxed about zoning additional land for residential subdivision.

One developer observed that “all of the northern land is owned by parties that have long-term views” and in the face of the current downturn in demand for sections will “sit and wait and so section prices won’t come down to more affordable levels”. Based on our understanding of land ownership we believe this view has merit, although it is possible that the severity and duration of the unfolding downturn will be sufficient to result in at least a near-term fall in section prices. There will be some investors and builders forced to sell, but if the major land holders sit and wait for the next upturn in demand then the unfolding oversupply will be soaked up within the next few years.

Another person interviewed said, “Most large scale developers will survive the downturn because they are lowly geared, but some smaller developers with second tier financiers will struggle. Potential buying opportunities will arise.” So some developers may end up being forced to put more sections on the market for sale and if this occurs it will help get section prices back down towards levels that are desirable for the health of the local economy. But we would expect most developers to sit back patiently and wait for the next upturn in demand with the expectation that an upturn will absorb the current oversupply of sections reasonably quickly, meaning it would not take too long for the demand-supply balance to swing back in favour of land owners.

In general we would assess that the strategy of most large landowners is to make land available for new subdivisions at a rate that doesn't lead to a major fall in section prices. Some of the people interviewed suggested Hamilton has a "cartel" of land owners. As one person put it, "unless the land cartel in North Hamilton is smashed Hamilton is in trouble" and "Hamilton is now the worst market we are involved in because of greedy landowners."

One developer observed that, "In Rototuna land prices increased 25.5% in 2007 driven by landowners holding back supply, while building costs went up only 4.3%." In the developments that this firm has been involved in over this time – mainly outside the Waikato - they reportedly kept section prices stable at around $150,000 and continued to sell house and land packages at more affordable prices. Because of this approach (i.e. "not cranking up land prices") this company continues to sell new houses around the country at reasonable rates even in the face of the large fall in demand.

Obviously, such comments need to be considered with a grain of salt because they may just represent the views of a group with different vested interests than those of current land owners. However, when we consider how much local section prices have increased relative to national section prices over the last few years and the comments that land owners/developers plan to severely curtail new subdivision activity rather than sell sections at lower prices, these claims potentially have merits. Equally, it could be claimed that the Councils have not rezoned enough land for residential use to maintain a competitive market in land supply.

One developer made what we believe to be a valid and important point that the Councils shouldn't use the current downturn in demand for sections as a reason for slowing down the rezoning of new residential land. In his words, "Because the boom has stopped we are not going to run out of land, which gives breathing space for the Council to get rezoning/consenting in place before the next upturn." "It now takes 1-2 years to get resource consents when it used to take six months, with some heads of departments at Council making it unnecessarily hard on developers. We want a V8 attitude to subdivision development."

The economics of future Greenfield residential development

The starting point for the medium-term and longer-term future of the sub-region is one in which new subdivision activity in general is not economically viable, although there are some exceptions to this general rule. Reflecting this state, some subdivisions that have resource consents are in go slow mode because of lack of demand with most developers unwilling to drop asking prices much, and we understand that a number of subdivisions that have already had resource consent applications lodged will go on hold.

There are several means by which subdivision activity could become economically viable again.

(1) If there are lots of mortgagee sales of raw land and the land is sold at much lower prices it would be possible to subdivide profitably at lower section prices. There may be an element of this happening over the next 12-18 months, but based on our understanding of land ownership we do not expect large scale mortgagee sales of blocks of land.

(2) Current land owners may realise that high section prices are a thing of the past and in time re-evaluate market conditions and reinitiate subdivisions that have recently been put on hold but be willing to supply sections at significantly lower prices. There may be an element of this that occurs, but when we consider how much section prices would need to fall to make sections affordable again to the general population we question whether current land owners will be willing to drop prices enough, especially as a number of current land owners have probably paid too much for land to be able to subdivide profitably at significantly lower section prices.

(3) When the next upturn in section demand arrives the current surplus stock of sections will get soaked up reasonably quickly given the estimate of 500 empty sections in new subdivisions in Hamilton and our rough understanding of the number of vacant sections in the Waikato and Waipa Districts. The downward pressure currently on section prices would end and section prices would start recovering and at some point it would become profitable for current land owners/developers to resume subdivision activity. This is obviously the outcome current land owners would most prefer, especially those that have paid in the vicinity of recent peak prices for land. However, under this outcome there could be only a temporary reprieve from high section prices and the sub-region could be at risk of remaining uncompetitive on a relative section price or relative cost of living basis.

(4) The Councils and especially HCC zones significant new areas of land for residential subdivision. In doing this Councils would need to be mindful of land ownership and the

willingness and financial viability of land owners in the newly zoned areas to supply land for residential subdivision at significant lower prices than recent market prices.

The Councils can also make a reasonable contribution to improving the viability of new subdivision activity by addressing the various concerns raised by all developers about the at times significant delays and additional costs incurred by developers as a result of the handling of the consent process by Councils (for a discussion of this topic see **Appendix 3** in the ***Hamilton Infill & Multi-Unit Housing Markets*** report).

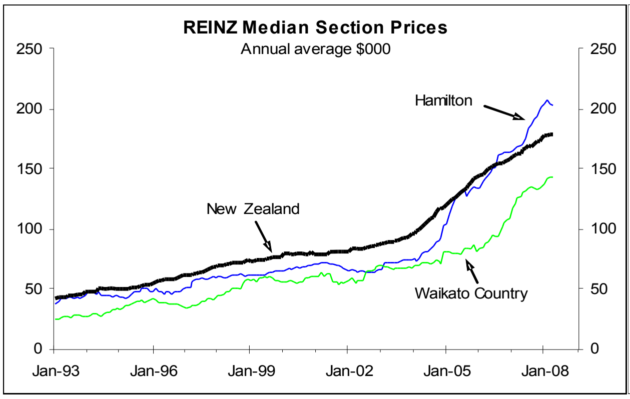
If we use the 1/3, 1/3 and 1/3 rule of thumb – see page 3 - we can give an indication of how much raw land prices need to fall to make Hamilton competitive again relative to the national market and to make sections more generally affordable again in absolute terms (i.e. relative to average incomes). We will do this first for Hamilton, which we see as the pivotal or price setting market in the sub-region, then make observations as to what it implies for Waipa District and Waikato District land prices.

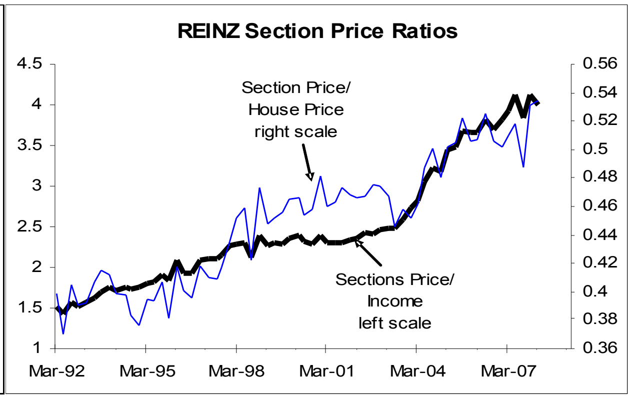
Based on REINZ data the median Hamilton section price is currently 13% above the national median. By comparison, since 1992 the local median price averaged 91% of the national median, but probably more importantly prior to local prices going crazy in 2005 the Hamilton median section price averaged 85% of the national median. Relative to a $180,000 national median section price the Hamilton median price needs to fall around 24% to $155,000 to restore the competitiveness Hamilton had on the section price front prior to the speculative market unfolding in 2005. Even to get the local median section price down to the historical 91% average of the national price would require a 19% fall back to around $165,000.

Based on the 1/3, 1/3 and 1/3 rule, a $165,000 section prices implies a budgeted margin for developers of just under $55,000 per lot. But based on our understanding that development costs, including council fees and levies etc, are $70,000-75,000 per site, this leaves only $35,000-40,000 per section for raw land costs. The downturn may bring down development costs while if we assume HCC sharpens its act which will help get costs down, so maybe all up development costs fall to $60,000-65,000 per section, which would leave $45,000-50,000 per section for raw land costs. At 10 sections per hectare this equates to raw land prices having to be $450,000-500,000 per ha to make subdivision activity economically viable, but this figure falls to $388,500-438,500 per ha if the starting point is a $155,000 section price. Obviously, if developers can achieve more than the traditional 10 sections per hectare then higher raw land prices can be justified and still achieve a median section price of $155,000 or $165,000.

These numbers are interesting relative to the insights provided by the developer who appeared to have done the most work assessing what best met market demand. This developer said new houses needed to be sub-$400,000 to be affordable for the bulk of new home buyers and that to build a sub-$400,000 3-4 bedroom house on a 400 m^2 section the land price had to be $130,000-150,000 to make it work financially for a developer. In the context of Hamilton, where section sizes are generally much larger than 400 m^2 (see the chart on page 7) and only around 10 sections are achieved per ha, lower section prices than $155,000-165,000 could be achieved by more intensive subdivisions. And more intensive subdivisions would make it possible to deliver affordable sections at somewhat higher raw land prices.

However, while a 19-24% fall in the Hamilton median section prices would bring it back down to competitive levels relative to the national market, these numbers need to be viewed in the context of a national market in which section prices are extremely unaffordable relative to incomes. The charts below are repeated from page 5 where we discussed how out of line the national median section price has got relative to the income of the average employee (black line, right chart). We expect market conditions nationally, possibly helped in some places by the actions of Councils, to bring section prices down relative to incomes.





Assuming no change in income levels the national median section price would have to fall from $180,000 to $106,000 to get it back down to the 2.3x of the average employee's income that prevailed between 1998 and 2002 (i.e. before the speculative boom in section prices) from the current 4x. And if the national median section price was $106,000 then the Hamilton median price would have to be $90,000-96,500 to make it competitive by historical standards.

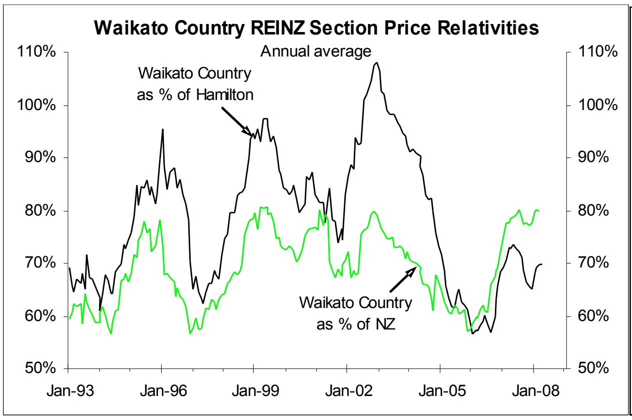
But this is "static" analysis that doesn't take account of the roll inflation will inevitably play in helping bring section prices down relative to incomes. If incomes keep growing at around 5% per annum over the next five years it will bring the national median section prices down from 4x the average employee's income to 3.1x if the national median section price doesn't change, which implies the national median section price would only have to fall to $135,000 to get the multiple back down to the pre-boom level of 2.3x. If we assume it takes 10 years to restore section prices to around 2.3x incomes and incomes grow at 5% per annum over that period, the national median section price would only have to fall to $172,000 to restore a 2.3x multiple. And maybe in the future the equilibrium multiple will be higher than 2.3x, like 2.5x or 2.8x, but even this still implies the need for a large fall in section prices relative to incomes nationally, and to make Hamilton section prices competitive again requires an even larger fall in real Hamilton section prices.

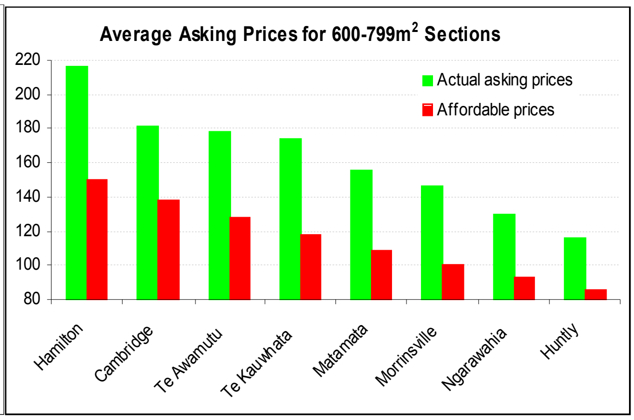
There are many ifs and buts when calculating how much section prices need to fall in actual or inflation-adjusted terms to restore housing affordability. Left to itself the market will eventually bring about a correction, although with downwardly sticky land prices it is likely to take quite a number of years to restore affordability if the Councils in the sub-region, and especially HCC do not rezone cheaper land.

In terms of Waikato Country section prices, which covers six districts (Waikato, Waipa, Matamata-Piako, Otorohanga, Waitomo and South Waikato), the REINZ median section price is already below the historical average relativity to the Hamilton median section price (black line, left chart). So Waikato Country section prices would not have to fall as much as Hamilton prices to restore competitiveness vis-à-vis national section prices. However, the median section price in the Country is still above the normal relativity to the national median section price (green line), so to return local section prices to affordable levels would still require significant falls in real terms if not also in actual terms.

We don't have access to REINZ section price data for individual districts but based on asking prices for sections in the main urban areas of the Waipa and Waikato Districts we can assess current relativities to Hamilton section prices. The markets are thin in some of the urban centres so in the right chart below we have used average asking prices for sections of 600-799m^2 as the best guide to relative section prices in the main urban centres in the sub-region and in the competing Morrinsville and Matamata markets (the green bars in the chart, sections in Rototuna and Flagstaff are again used as representative of Hamilton).

If we assume as a rough ballpark that the average price for 600-700m^2 sections in Hamilton has to fall to around $150,000 to restore affordability, which would take it back to around the level that prevailed in 2005, then the red bars in the right chart show where section prices in the other urban centres would have to fall to so affordability was also restored in these markets. We have assumed that section prices wouldn't have to fall as much in the other urban centres as in Hamilton because as the left chart shows sections prices in Waikato Country as less overpriced relative to national prices than are section prices in Hamilton.





Interestingly, the "affordable" section price for Ngarawahia, at $92,500, is close to the $95,000 a local real estate agent indicated section prices in some of the new subdivisions would have to be for them to sell. In this context Ngarawahia is a useful case study. In the company of a local real estate agent we inspected all of the current subdivisions (the photos below show some of them) and most of the sites of the planned subdivisions, with many sections owned by investors on the market for $125,000-135,000 not selling.



Preferences/options for future residential development in the sub-region

Most developers interviewed preferred future development to be in the north east of Hamilton and in the Rotokauri growth cell. It was generally expected that employment growth would remain focused around the Te Rapa area and in the areas zoned for industrial and employment use in Rotokauri. However, while there were some dissenting views on where future Greenfield residential development should be, many developers perceive there is a case for considering future residential development in other areas, especially if the Councils want to make local section prices competitive and affordable again.

The obvious options are rezoning the Peacockes growth cell earlier than currently planned, but there are also two prime options for residential subdivision east of the city that warrant further investigation. From the perspective of addressing the uncompetitive and unaffordable level of section prices not only in Hamilton but also in the broader sub-region we can see reason for the Councils to consider all three options simultaneously. We see a strong case for freeing up land on the urban fringe of Hamilton as a way to improve housing affordability, just as some Australia state governments are now doing to address the same problem in parts of Australia.

One developer made a strong case for the Peacockes residential growth cell being developed in the near-term. A major rationale for the near-term development of Peacockes was its close proximity to the city centre and the risk that the city centre, which has major existing infrastructure for accommodating employment growth, shopping and related services, would be “killed” if the primary focus of residential growth remained almost entirely north of the city. Other sources confirmed that the Hamilton CBD already has significantly under-utilised office space, although this was said to be partly related to HCC allowing service industries to setup office in previously residential areas like Boundary Road.

The same developer made the case for a “stand-alone” subdivision being permitted in the Peacockes area incorporating a water treatment plant so that major upgrades of the sewage link north were not required. Another developer involved in an industrial subdivision south of Hamilton said the sewage from Peakcockes could be processed at the Cambridge sewage treatment plant, as would be the case with the sewage from the industrial development, which would involve much lower infrastructure cost than piping the sewage north.

A common perception is that Peacockes is a “poor” or “low quality” area, which seems to be driven by the general perception of the socio-economics of neighbouring Melview and Glenview. However, in our assessment Peacockes is a sufficiently large area that it can create its own ambiance. The Addison development in Takanini is a good example of this (see the ***Intensification of Greenfield Residential Subdivisions*** report, pages 7-8).

One landowner-developer made a strong case for future residential development in the vicinity of Ruakura where around 500 ha of land is available adjacent to Hamilton. There is ample land supply there, it already has employment clusters in the vicinity and the potential for more industrial/commercial development (subject to zoning), it is relatively close to the city centre, and is in the vicinity of the planned Eastern Bypass and ring roads.

Another land owner-developer has 138 ha of land that can be accessed from the extension being made to Wairere Road. There are good reasons for considering this land as offering part of the solution to Hamilton and the sub-region’s residential land price problem. We understand that the land has close access to major sewage and water infrastructure, is not peaty, already has a drainage system in place, is close to current roading extension and to the planned Eastern Bypass, and the owners are experienced subdividers and welcome the opportunity to explore options for higher density housing and the best practises in urban design. The owners are willing to work with Councils and adjacent land-owners to develop a comprehensive roading plan. A subdivision in this area could make further sense if the councils explore the options for industrial-commercial development in the Ruakura area.

Another developer has moved his attention exclusively to Ngarawahia driven in part by lower land costs, and associated lower holding costs. However, if the industrial rezoning in the pipeline for the Horotiu area occurs, the Ngarawahia Bypass proceeds and Fonterra proceed with freeing up some of their surplus land around the Te Rapa factory for industrial-commercial use, we see a strong case for Ngarawahia offering a fourth option for the sub-region to accommodate future population with affordable housing.

The prospect of industrial development in the vicinity of the Hamilton International Airport and around Fonterra's factor at Hautapu make a further case for residential growth in Peakcockes, east of Hamilton and in Cambridge. We see it as being critical that future industrial-commercial and residential rezoning go hand in hand, and in that context Peacockes, east of Hamilton, Cambridge and Ngarawahia makes as much sense to us for future residential subdivisions as do Horsham Downs and Rotokauri.

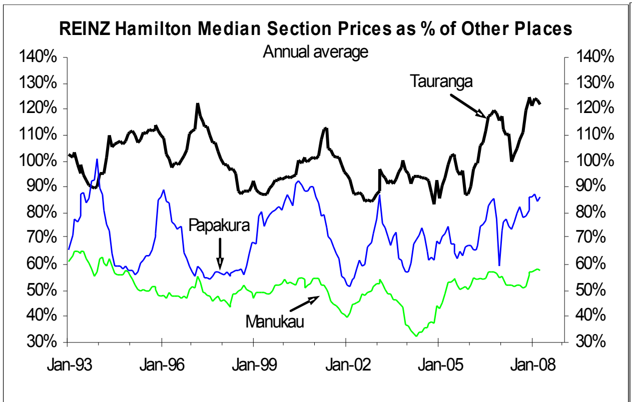
Cambridge is well placed to meet future demand for sections. There are a number of residential subdivisions in the pipeline or planned in Cambridge at various stages, including several large ones that we understand have gained resource consent (e.g. Cambridge Park with 300 lots, River Gardens with 136 lots and Transland Developments 151 lots subdivision), several subdivisions that have lodged consent applications (e.g. St Kilda Waterways with 285 lots and Twin Willows with 41 lots), at least one major subdivision of 407 lots that is "on hold Transit issues", and some smaller subdivisions and a proposed 137 unit retirement village. It is our opinion that if cheaper land can be found for subdivisions around Hamilton to address the uncompetitiveness and unaffordability of section prices in the sub-region then section prices in Cambridge and the other urban centres in the sub-region will follow suit. However, the cause of improving the sub-region's lost competitiveness would be helped if the Waikato and Waipa Districts were also able to identify competitively priced land for residential rezoning.

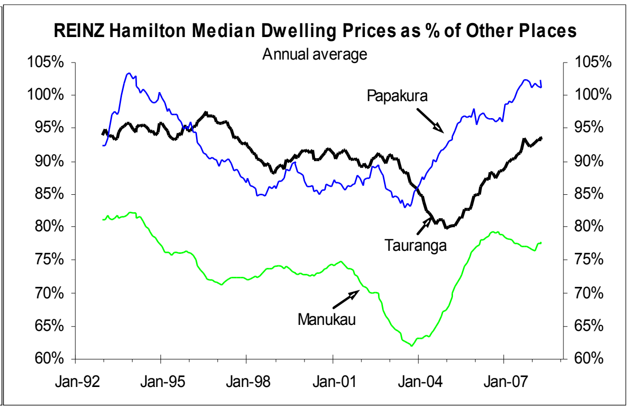
In Te Awamutu there are three significant subdivisions in the pipeline: 370 lots at the Picquet Hill subdivision that is under appeal but we expect to proceed as it is a Waipa District Council project; application for a 160 lot residential subdivision and 242 unit retirement village; and application for a 75 lot residential subdivision. There are also a number of medium-sized and smaller subdivisions in the pipeline and the potential to develop the residential zoned and serviced area north of Kihikihi.

The competitiveness of Hamilton versus Tauranga and South Auckland

It is also useful to consider the affordability of local sections and dwellings relative to Tauranga and South Auckland. The left chart shows Hamilton median section prices as a % of section prices in Tauranga excluding Mt Maunganui and Papamoa (black line), Papakura (blue line) and Manukau (green line). The right chart does the same for dwelling.

Relative to Tauranga the median section price in Hamilton is at the highest ever since 1993 while Hamilton dwelling prices are not far below previous peak levels relative to Tauranga prices. To the extent that Hamilton (and the sub-region) compete with Tauranga (and the Bay of Plenty more generally) in the retirement market, but also in the job market, it would be desirable to have Hamilton section prices below Tauranga section prices rather than over 20% higher.





The Hamilton median section price may seem low relative to Papakura and Manukau at 86% and 58% respectively, but by historical relative standards local section prices are at around peak levels. To the extent that historical relatives are relevant, Hamilton is now close to being as expensive as it has ever been relative to Papakura and Manukau. It is a similar story with dwelling prices.

Hamilton experienced strong demand for sections and existing dwellings in 2003-2005, and part of what was fuelling this demand will have been the relative cheapness of sections and existing dwellings. However, Hamilton, and by association the sub-region, is at risk of falling victim to its own success. With section prices and dwelling prices now expensive by historical standards compared to the likes of Tauranga and South Auckland it will no doubt place a drag on local population and employment growth.