FORSYTH BARR

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Equity Strategy
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ROHAN KOREMAN-SMIT CFA
rohan.koreman-smit@forsythbarr.co.nz
+64 9 368 0085

AARON IBBOTSON CFA
aaron.ibbotson@forsythbarr.co.nz
+64 9 368 0024

FORSYTH BARR RESEARCH TEAM
fb.research@forsythbarr.co.nz
+64 4 499 7464

The government has released its housing policy aimed at addressing strong investor demand. The key changes are (1) interest on investment properties will no longer be deductable for tax purposes, (2) the bright line for tax on capital gains has been extended to 10 years, (3) price and income caps for First Home loans and grants have been lifted, and (4) NZ$3.8bn of infrastructure funding for housing developments has been set aside. The Reserve Bank will also investigate the possible introduction of debt-to-income ratios and restrictions on interest-only mortgages with its findings due in May 2021. We see three key impacts (1) greater house price uncertainty as residential property investors digest the tax impacts on their personal financial situations, (2) limited impact on residential construction activity with greater demand for new builds from investors, and (3) a minor headwind to consumer spending reflecting the impost of higher taxes.

Potential significant impacts to the Aged Care sector

This announcement is likely to have the most significant near term impact on the Aged Care sector through three vectors. Firstly, expectations with regards to long term residential house price inflation is likely to moderate. Secondly and related, significant uncertainty with regards to near term house prices may result in increased lead times for selling residential homes, and by implications lead times to settle on acquired aged care units. Finally, looking at fundamentals, versus a counterfactual of no tax change there is likely to be more modest price increases put through by the aged care operators in the near term. We estimate that a 1% change in unit price growth impacts sector annuity EBITDA by c.1%.

Residential demand likely intact but mix may change

To support supply and the construction of new homes, residential investors are still able to deduct interest on newly built residential dwellings acquired as an investment. Investors purchased 42.5k homes in 2020 up +17% against the prior year, which compares to total residential consents of 39.9k up 6% over the same period. In addition, the NZ$3.8bn of infrastructure funding is aimed at bringing forward private and government led developments. As such, notwithstanding any greater than expected impact on house prices, we believe new residential construction will likely be sustained at current high levels. Historically, interest rates, housing turnover, and migration have been drivers of residential housing demand. Interest rates are likely to remain low near-term and anecdotes suggest migration will lift materially once borders reopen. We estimate a 1% change in residential consents impacts Fletcher Building's (FBU) EBIT by c.0.4%.

Minor impact on consumer spending

According to the RBNZ 27% or NZ$82bn of NZ's stock of NZ$304bn of residential mortgages was secured against investment properties as at January 2021. This suggests the removal of interest deductibility equates to a tax impost of around NZ$0.6bn or 0.6% of total retail sales (NZ$99bn in 2020). This impact will be phased in over four years. We estimate a 1% change in sales impacts retailers EBIT by c.5%.

Commercial property more attractive

These changes do not impact commercial property landlords. As such investment in lower dollar value industrial and retail assets are now likely more attractive. Also, with interest deductions still allowed for new rental stock there is little impact to Kiwi Property Group (KPG) build-to-rent aspirations and could potentially be a positive if stronger residential rent growth improves yield on cost.

The policy detail

The government has released its housing policy aimed at addressing strong investor demand. The key changes to housing policy include:

Interest costs can no longer be deducted when calculating taxable income/losses. This applies immediately for investment property acquired from 27 March 2021. For existing investment properties the deductibility of interest will be phased out over four years. The government is consulting on exemptions for new builds purchased as investment properties and if interest costs could be deducted from any taxes paid on the sale of the property (i.e. under the bright line test).

The bright line test for tax on gains in house prices will lift from five years to ten. The bright line test will remain at five years for newly built investment properties and the family home, and inherited property will continue to be exempt. These new rules apply to property acquired on or after 27 March 2021.

Price and income caps for First Home loans and grants have been increased. The First Home grant provides first home buyers up to NZ$5k for an individual and up to NZ$10k for two or more buyers purchasing an existing dwelling and up to NZ$10k for an individual and up to NZ$20k for two or more buyers purchasing a new dwelling. First Home loans are underwritten by the government which only require a 5% deposit. The maximum income to receive this assistance has been lifted from NZ$85k to NZ$95k for an individual, and from NZ$130k to NZ$150k for two or more buyers. The price caps on home that can be purchased using either form of assistance have been lifted by NZ$50–175k depending on the region the house is located.

The government will set aside NZ$3.8bn to help fund infrastructure around housing developments. The key components of the fund include (1) a fund to unlock a mix of private sector and government led developments, and (2) additional funding for the Land for Housing Programme to accelerate development of vacant or underutilised government owned land. The government will consider the detailed criteria of the fund in June and expects to be funding projects in the 2HCY21. The government will also help Kāinga Ora to borrow an additional NZ$2bn to bring forward strategic land purchases and developments.

In addition to today's changes the Reserve Bank will report back to the government on the possible introduction of debt-to-income ratio restrictions and restrictions on interest-only mortgages in May 2021.

Lower near-term demand from geared investors

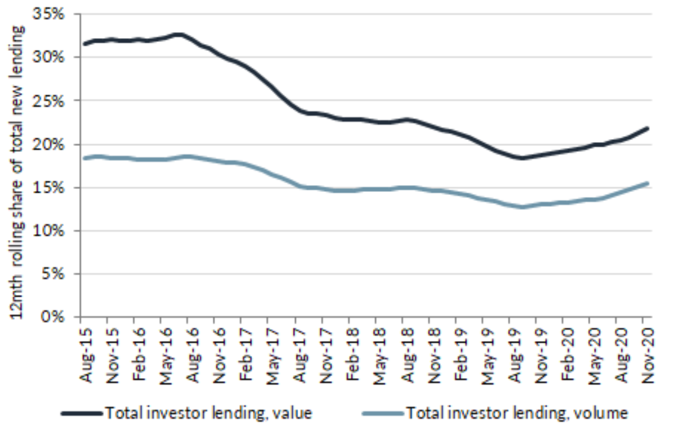
In our view the most significant change is the deductibility of interest on investment properties. This has changed the economics of owning a rental property. Property investors accounted for 25%/17% of the value/volume of December quarter mortgage lending. Near-term investor demand for existing dwellings is likely to be subdued. In our view, the economics of residential property investment will adjust by either (1) lower house prices, (2) higher rents and/or (3) landlord accepting lower cash returns with the eventual outcome likely a mix of all three. Assuming an NZ$1m Auckland rental geared at 70% and all else equal, we estimate rents will need to increase c.NZ$100 per week (or +5% per annum rent growth over the four year phase in period) or house prices to fall by 19% for an investment property to be cash neutral post these changes.

Recently purchased investment properties and landlords with multiple properties and high gearing will likely have the greatest leverage to these changes in tax policy while long-term investors with low gearing may see little change to their personal financial situation. The extent to which new and highly geared investors need to sell assets and lower debt will determine the impact on the supply of houses for sale and therefore any change in house prices.

Bifurcation of the housing market; an unintended (?) consequence

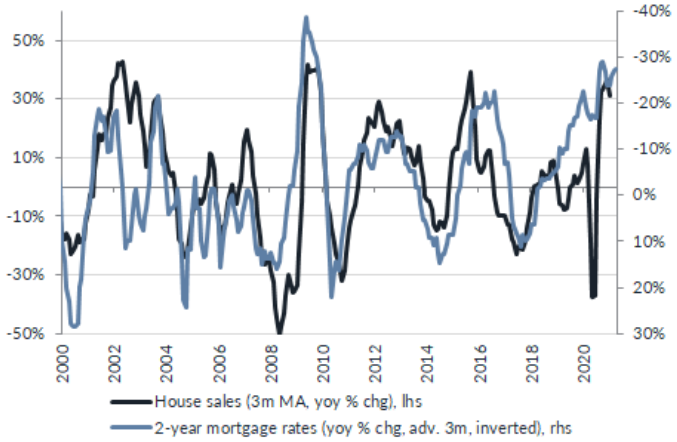
The idea of exempting new builds from the increased tax on investment properties is driven by the desire to continue to stimulate supply. However, long term we believe the substantial difference in tax treatment for new builds vs existing homes can create a semi permanent bifurcation of the residential housing market. New build areas may be dominated by leveraged investors as, all else equal (rent) it is significantly more attractive to buy new builds. Within the existing stock of "pre 27 March 2021" homes, the opposite may happen; where owner occupiers and unlevered investors price out levered investors. Over time builders may pivot towards the investment community, with different preferences in relation to size, number of bedroom, land size etc.

Figure 1. Investors account for c.25% of residential mortgages



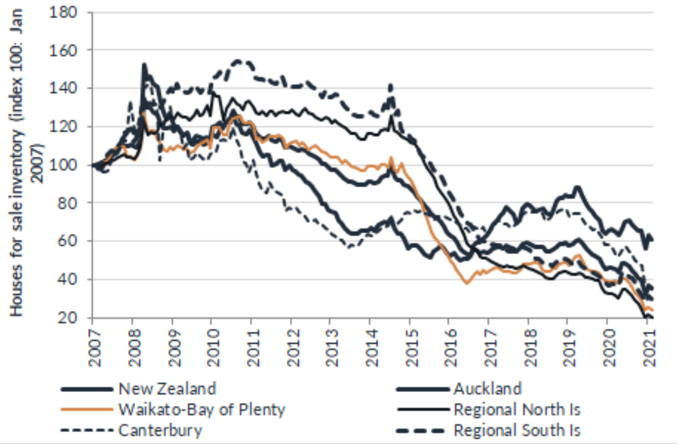
Source: RBNZ, Forsyth Barr analysis

Figure 2. Low interest rates and...



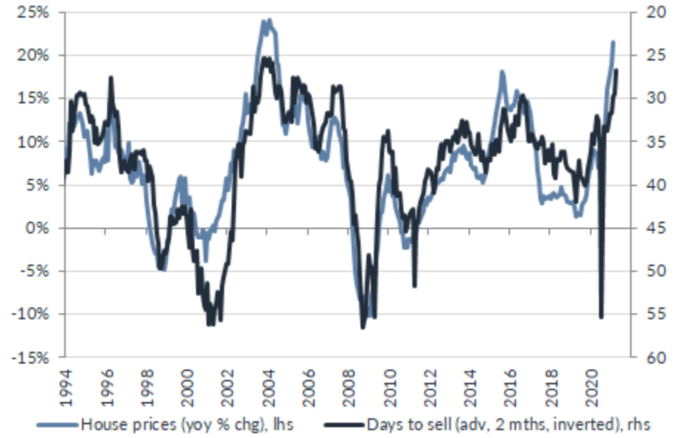
Source: REINZ, RBNZ, Forsyth Barr analysis

Figure 3. ...and tight supply have...



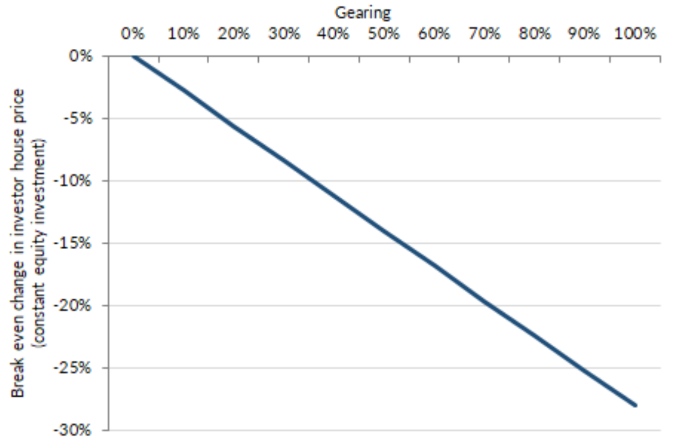
Source: realestate.co.nz, Forsyth Barr analysis

Figure 4. ...driven recent price growth



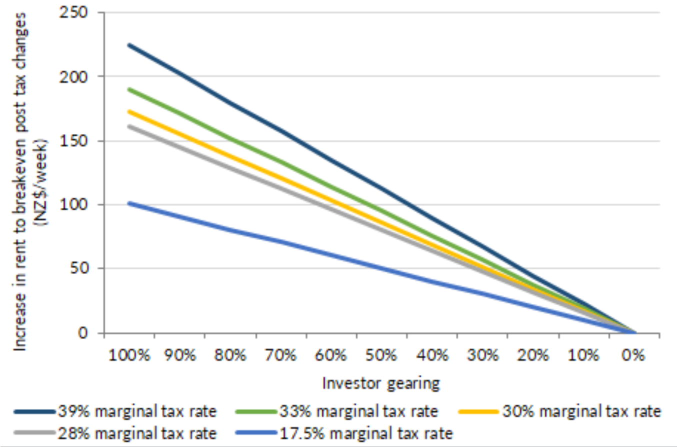
Source: REINZ, Forsyth Barr analysis

Figure 5. Break even change in house prices (28% tax rate)



Source: Forsyth Barr analysis

Figure 6. Break even change in rent



Source: Forsyth Barr analysis

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