Reserve Bank of New Zealand
Te Pūtea Matua

Commercial Property in New Zealand.

Financial Stability Report
Special topic August 2024

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Key points

- Historically, the commercial property sector has been sensitive to economic activity and can amplify financial sector impacts from economic downturns. A significant deterioration in the sector can impact financial stability through banks' and other lenders' exposure to the sector.
- Global property markets are currently facing significant headwinds from high interest rates and longer-term trends like working from home and online shopping. The impact of these headwinds on financial systems has been contained so far, although some overseas lenders with a concentrated exposure to the sector are facing difficulties.
- The New Zealand commercial property market is facing similar headwinds to those affecting other countries. The shift towards working from home during the pandemic has been less persistent, but online retailing has become relatively embedded.
- Property values have fallen from their peak over the past couple of years, primarily reflecting higher interest rates. Tenancy demand and rental growth has been divergent across subsectors:
    - A flight to quality in the **office sector** has contributed to a rise in vacancies in lower quality office buildings and weaker rent growth, while prime office properties have performed well.
    - The growth of online shopping and generally soft consumer spending are creating challenging market conditions for the **retail sector**, affecting rental growth.
    - **Industrial sector** rents have been relatively strong as supply continues to be constrained by land availability, while demand has remained robust.
- New Zealand's financial system has become more resilient since the global financial crisis (GFC), including to risks from the commercial property sector. Lenders are less exposed to commercial property than prior to the GFC, particularly in relation to property development. In addition, higher lending standards have built up greater resilience in the sector over recent years.
- Banks need to remain vigilant and continue to monitor developments in the commercial property market, particularly given the range of challenges and risks affecting large parts of the economy and the financial system. We will continue to monitor financial stability risks arising from commercial property exposures.

Commercial property matters for financial stability

Commercial properties provide the physical infrastructure such as office, retail and industrial premises for general economic activity and the performance of commercial property markets will reflect a country's economic conditions. In this special topic we outline the current state of commercial property and related risks to financial stability in New Zealand.

Commercial property lending carries risks

A deterioration in commercial property markets can affect lenders in several ways:

- For lending to finance existing buildings, reduced tenant demand, excess supply, rising vacancy rates, and high interest rates will lower the value of buildings used as collateral for loans and the rental cashflows available for debt servicing.
- The financing of new developments is inherently risky, as the viability of a project is uncertain and can be affected by construction delays, cost escalation, and potentially a lack of pre-committed tenancies prior to completion. Lenders are exposed to risk as the cashflows to service or repay the debt only become available on a project's completion, while the value of the asset being developed may fluctuate depending on market conditions.

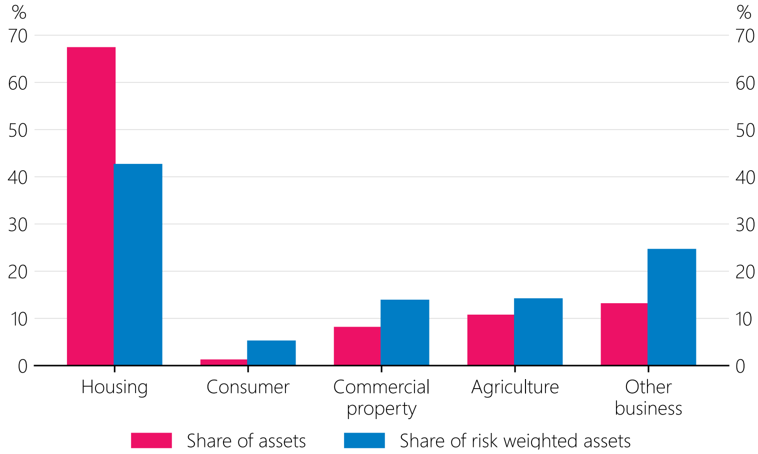
Where the above factors put property owners under acute stress they may default on their loans and not be able to fully cover their debts by selling properties, leading to losses for the lender.

Commercial property can also amplify economic downturns

The commercial property market is pro-cyclical in nature. This procyclical demand from investors is because commercial property is a relatively risky investment class. In periods of financial and economic upswings, borrowers' and lenders' risk appetite increases, and the demand and valuation of commercial property tend to increase. This process reverses during downturns, which puts stress on the financial system. A slowdown in commercial property can also spill over into other sectors of the economy through its impact on the construction industry and employment. A downturn in the commercial property market can be particularly damaging to the financial system if vulnerabilities are not managed during periods of strong economic activity.

The high-risk profile of the commercial property market is evident in historical episodes of financial system stress, including in the US, the Nordic countries, New Zealand, and Australia in the late 1980s, and the US andI reland in the late 2000s.[1] Default and loss rates for loans to commercial property are among the highest across sectors in economic downturns and in our stress testing of banks.[2] To manage the risk of their commercial property exposure, banks are required to hold more capital against this lending than against lending to sectors such as housing. This is done through having higher risk weights on commercial property lending than on lower risk lending, such as mortgages (Figure 1).

Figure 1
Sectoral exposures of four largest banks in New Zealand
(March 2024)



Source: RBNZ *Capital Satellite survey*.

1 See Dunstan, A. & Skilling, H (2015), Commercial Property and Financial Stability, RBNZ Bulletin

2 2022 Bank Solvency Stress Test, RBNZ Bulletin

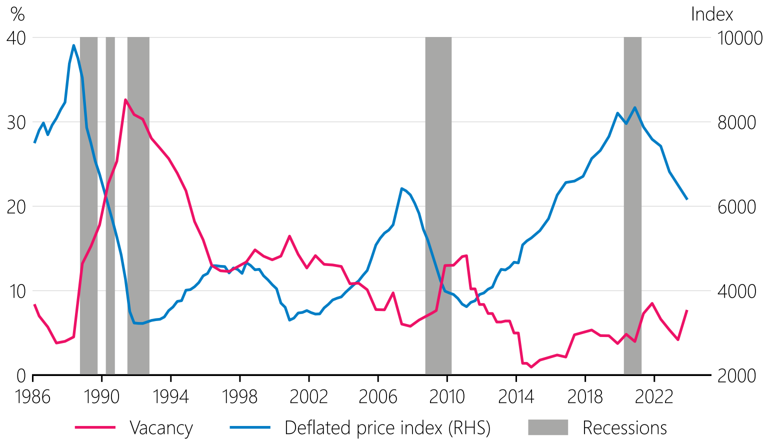
The impact on financial stability has been significant during previous crises

Historically, financial crises have often been exacerbated by downturns in the commercial property sector. During the GFC slowing economic activity triggered a sharp fall in commercial property prices. Although the US housing market was at the centre of the crisis, commercial property prices fell more sharply than house prices in most economies (Ellis and Naughtin, 2010)[3].

Commercial property played a central role during New Zealand's period of financial stress in the late 1980s.[4] Following financial liberalisation and deregulation, commercial property prices surged in the mid-1980s, leading to increased construction and development activity. After stock prices fell sharply in 1987, indebted companies experienced increased financial stress, which subsequently led to rising vacancy rates. Combined with a large amount of new supply entering the market, commercial property prices fell substantially (Figure 2). Subsequently, many commercial property loans defaulted, resulting in substantial losses for banks. New Zealand's system of prudential regulation of banks was only in the early stages of development during this period, allowing banks to lower credit standards and ultimately leading to the government bailout of the Bank of New Zealand.

Figure 2

Prices and vacancies in the Auckland prime office market



Source: JLL, Stats NZ, RBNZ calculations.

Note: Price index deflated by CPI.

3 Ellis, L., & Naughtin, C. (2010). Commercial property and financial stability–an international perspective. RBA Bulletin, June, 25-30.

4 See Hunt, C (2009). Banking Crises in New Zealand – An Historical Perspective, RBNZ Bulletin

Commercial property is currently facing significant headwinds

High interest rates and behavioural changes from the pandemic are dampening demand globally.

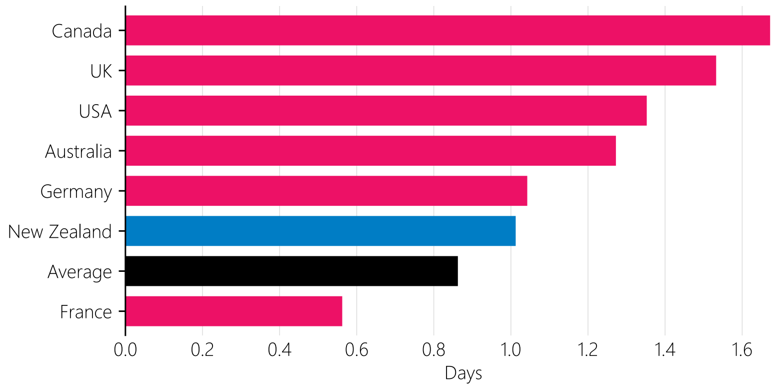
In recent years both cyclical and structural factors have driven global demand for commercial properties lower, with transactions falling by more than half in 2023 and commercial property prices decreasing as well.[5]

- Persistent high inflation has caused interest rates to remain elevated globally.[6] Higher interest rates have put strain on owners' cashflows, as well as slowed economic activity and therefore tenant demand. Additionally, the higher interest rate environment means investors demand higher yields when valuing a potential purchase, which results in lower property values.
- The pandemic has led to a persistent shift towards more working from home (Figure 3). As a result, companies are reducing their office space, leading to reduced demand and higher vacancy rates. Office vacancy rates have risen particularly in North America (Figure 5).
- Online shopping and provision of services has been a trend for some time, reducing the need for a physical retail footprint, but has been amplified by the pandemic (Figure 4). Around 40 percent of OECD retailers are currently engaging in e-commerce, and this is even higher in New Zealand.

Figure 3

Paid full days worked from home per week

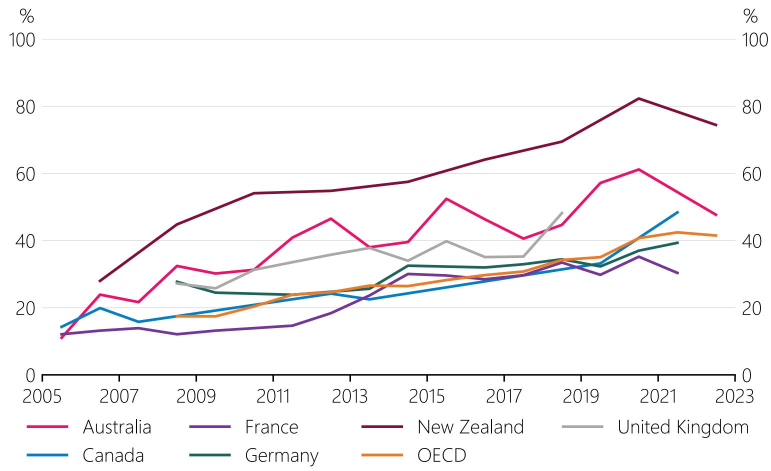
(April-May 2023)



Source: Aksoy, C. G., Barrero, J. M., Bloom, N., Davis, S. J., Dolls, M., & Zarate, P. (2023). Working from home around the globe: 2023 report (No. 53). EconPol Policy Brief.

Figure 4

Share of retail businesses making e-commerce sales



Source: Aksoy, C. G., Barrero, J. M., Bloom, N., Davis, S. J., Dolls, M., & Zarate, P. (2023). Working from home around the globe: 2023 report (No. 53). EconPol Policy Brief.

5 For more information, see *Global Financial Stability Report*, April 2024, International Monetary Fund

6 For more information, see *Financial Stability Report*, May 2024, RBNZ

The US office market has been especially weak

Current weaknesses in the US office market show the potential impact of these structural trends. Exacerbated by the pandemic, rising working from home rates have led to high office vacancy rates in many cities (Figure 5). As vacancy rates surpass typical levels caused by churn in the market, rental income falls and this increases stress on property owners. This can lead to more loan defaults. By putting downward pressure on rents, vacancies affect occupied buildings as well, leading to further debt servicing issues. Smaller US banks are especially exposed to their local commercial property markets.[7]

The New Zealand commercial property market has also been soft

The commercial property sector has seen a significant decline in property values since 2021, having fallen by approximately 10 percent since their recent peak. This decrease was driven by rising interest rates, which reduce investors' property valuations.

Notwithstanding the effect of higher interest rates, rental growth has underpinned property values across some subsectors (Figure 6). While rents fell overall during the pandemic period, they increased around 7 percent over 2023.

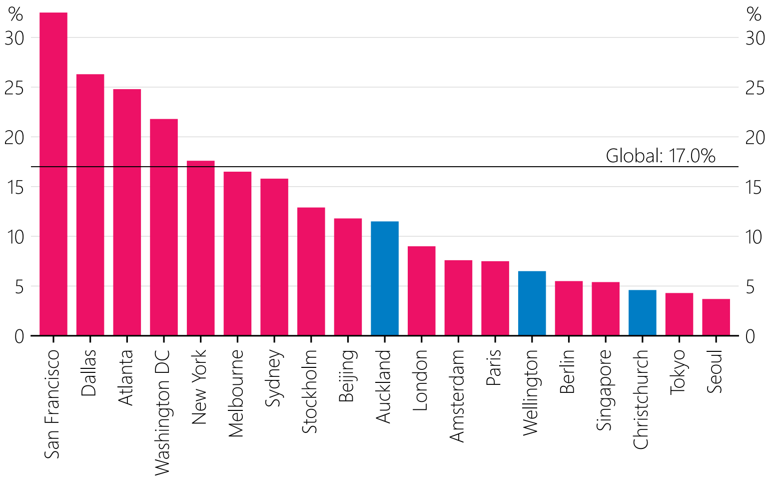
Rents have been supported by relatively muted supply growth in the context of robust population growth over the past decade. Currently, regulatory uncertainty, slowing economic activity, high interest rates and increased ownership costs are making new development projects less viable (Figure 7). The pipeline of new development is therefore likely to slow over coming years due to a lack of new projects.[8]

Higher local council rates and insurance premiums are affecting tenants and property owners. The ending of depreciation tax

Figure 5

Office vacancy rates of selected cities

(as of April 2024)

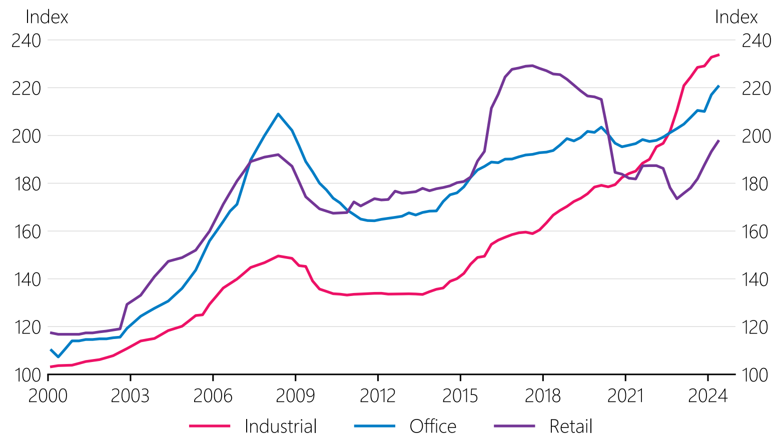


Source: JLL.

Figure 6

Rental indices for commercial property in New Zealand

(weighted average)



Source: JLL and RBNZ calculations.

Figure 7

Capital values and yields for commercial property in New Zealand

(weighted average)

Source: JLL and RBNZ calculations.

7 For further international comparison of bank exposure to commercial property, see An international perspective on the financial stability implications of higher interest rates, Special Topic 1, *Financial Stability Report*, November 2023.

8 For more information, see Pacifecon – New Zealand construction snapshot 2024.

deductions for commercial and industrial buildings came into effect in April 2024. Its overall market impact is small, but it could add to existing cashflow difficulties for owners given the challenging market environment.[9]

Sectoral differences

The situation in individual sectors of the commercial property market varies considerably

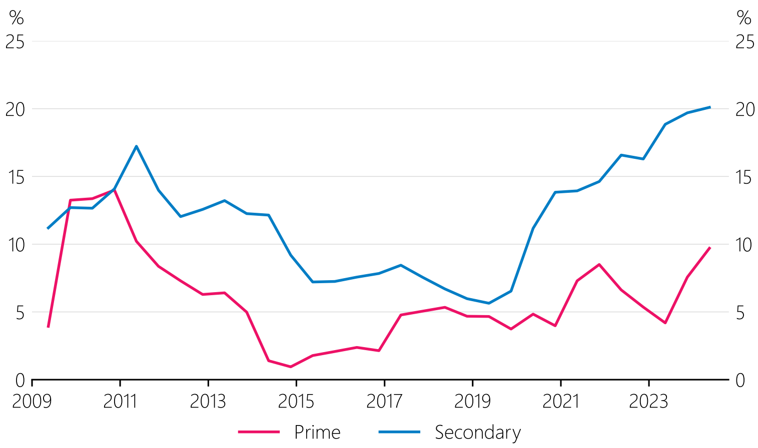
Commercial property can be broadly divided into industrial (factories and warehouses), office and retail (restaurants and shops).[10] Each of these can be further subdivided into prime and secondary (CBD and suburban for retail).

- The **industrial sector** accounts for the largest share of floor space and total property value. Demand has remained robust, while the supply of new industrial space is severely constrained by a lack of suitable land.
- In the **office sector**, market sentiment is more subdued. Recent structural changes, with the increasing importance of working from home (Figure 8), are also affecting the sector in New Zealand. A common phenomenon is the "flight-to-quality", with companies renting less office space but of a higher quality. In Auckland, this trend is reflected in substantially higher vacancy rates for lower quality office buildings since the pandemic and an increasing share of prime office space.

  Conversion of existing secondary office space into more lucrative residential assets is possible, but difficult due to high costs. The ongoing transformation of the office sector is putting pressure on owners of lower quality assets. They are struggling to sell or lease their properties and find it difficult to access funding on terms that would make it viable to redevelop, refurbish or renovate their buildings.

  Recently, market participants started to describe a shift in sentiment in the prime office sector as well. With rising vacancy rates and reduced buyer activity, a slowing economic outlook is also weighing on parts of the prime sector.
- The **retail sector** has been relatively resilient to the emergence of online competition. New Zealand retailers have been heavily involved in e-commerce since the early 2000s and this has grown in importance during the pandemic. Other factors are more challenging for the retail sector. High inflation and interest rates affect retailers in two ways. Firstly, through the affordability of their own business financing and, secondly, through constrained disposable incomes and subdued consumer discretionary spending. The poor economic outlook has also reduced consumer confidence, causing them to hold back on retail spending, especially for non-essential purchases. This puts further pressure on the retail sector, especially for smaller and discretionary retailers outside of core shopping areas. In some cases tenants have been able to renegotiate their rent to reflect the adverse conditions. While tourism has recovered, its impact is uneven across locations and tends to be seasonal.

Figure 8
Prime and secondary office vacancy rates in Auckland



Source: JLL and RBNZ calculations.

Regional differences

9 For more information, see Inland Revenue – Regulatory Impact Statement: Removing building depreciation.

10 Other forms of commercial property such as accommodation, healthcare or education buildings are outside the scope of this report.

Market challenges vary across regions

- **Auckland** is experiencing the most pronounced shift in demand from secondary to prime commercial properties, which has been exacerbated by a geographic shift in demand towards the waterfront and a reduction of private education facilities due to decreasing numbers of international students.
- The **Wellington** market is underpinned by the large public sector demand, which features long-term office leases. Reduced government spending could put downward pressure on office demand. Another challenge is ongoing revisions to seismic regulations. With uncertainty about the outcome of these changes, some developers are holding back on investments in seismic upgrades until the official regulatory framework is updated.[11] Geographic constraints have been limiting supply for the industrial market
- The market in **Christchurch** has been shaped by the 2010/11 earthquakes. Vacancy rates remain low across all sectors compared with the other two regions, while prices have been relatively stable. This reflects that demand and supply have been broadly matched through the city's rebuild.

Stresses to the New Zealand financial sector are increasing but remain manageable

Commercial property is connected to financial systems through various channels

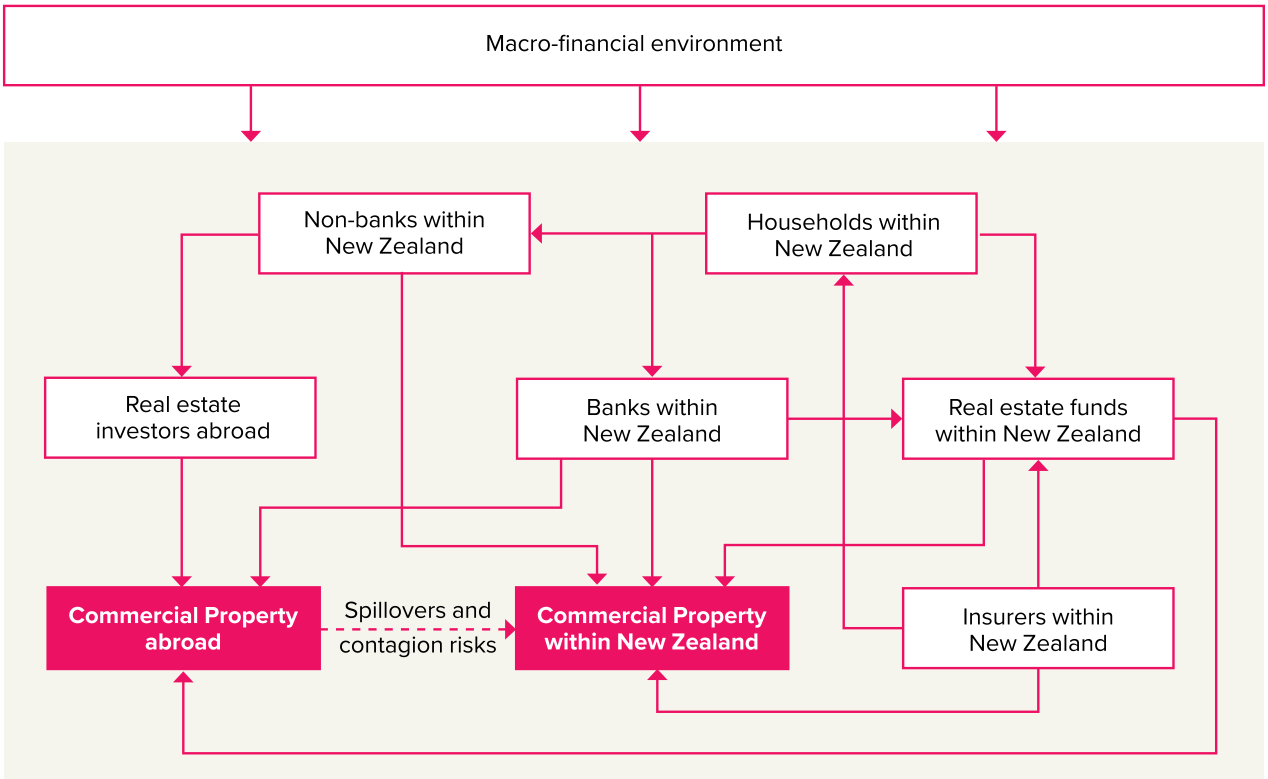
A key channel is through the lending activities of banks (Figure 9). In the first quarter of 2024, New Zealand banks had $44bn in lending to commercial property, around 8 percent of their total loans. Non-bank lenders play a smaller role in financing commercial property, and tend to focus on development lending.

Problems in offshore markets can also affect New Zealand's financial stability. Foreign capital plays a role in the New Zealand commercial property sector. The scale of these investments is hard to measure, but discussions with market contacts suggest it is largely concentrated in Auckland and generally limited to larger investments. A lack of liquidity in the rest of the market and increasing economic uncertainty have made foreign institutions reluctant to invest more widely. Weak conditions in global property markets could add to domestic slowdown if foreign investors prefer to invest in safer assets or in their own jurisdictions. However, to date international capital continues to view New Zealand as a relatively stable market that still offers higher returns.

11 For more information, see CBRE – Seismic strengthening rules lead to uncertain times.

Figure 9

The financial system and commercial property markets in New Zealand



Note: The arrows represent transmission of a shock from the macroeconomic and financial environment to the commercial property sector.

Source: RBNZ, Deutsche Bundesbank.

High interest rates and adverse market conditions have reduced new lending to commercial property markets

Growth in bank lending to the commercial property sector in New Zealand has been much weaker than in other sectors (Figure 10). The decline has been particularly sharp for commercial developing lending, which fell by more than 30 percent in early 2024. This can be explained by the repayment of development lending as current projects come to completion and a lack of new projects starting due to the adverse market conditions (Figure 11).

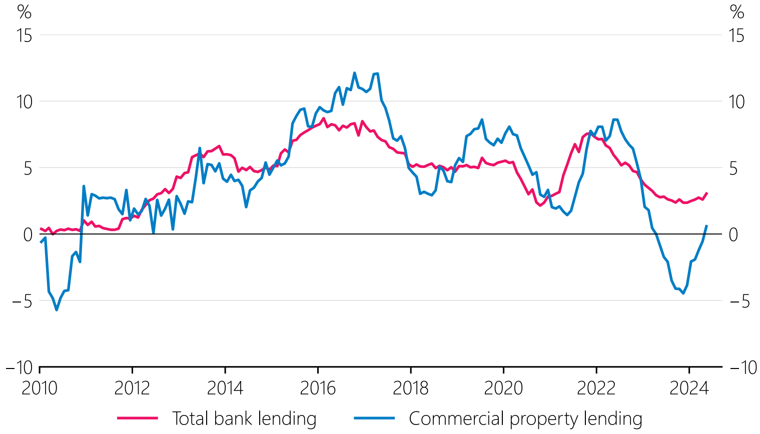
After the GFC, conservative lending standards to commercial property development projects have helped to avoid the pattern of a traditional boom-bust-cycle. With a muted supply over the last couple of years, risks of extreme oversupply and elevated high-risk exposure are limited during the current cooldown. Therefore, the recent reduction of development activity represents a natural regulation of supply, reacting to the weak demand. However, investors are still holding off on selling sites earmarked for future development, instead holding on to it for later development under more favourable market conditions.

A key source of financial stress is rising interest rates. Starting with the Official Cash Rate (OCR) increases in 2021, the share of potentially stressed loans in the commercial property sector rose to 3.8 percent in 2023 as lending repriced. The non-performing loan (NPL) ratio has also started to rise, reaching 1.1 percent (Figure 12). While NPL ratios have increased in various sectors, commercial property loans have seen the largest increase. However, the high interest rates are already priced into most commercial property loans. This is due to the relatively short refinancing cycle of most commercial property loans, around 80 percent of which are repriced in less than 3 months. The initial impact of higher rates is also more gradual for most firms, as they are well hedged against interest rate risks. While challenging for the market, the immediate risk of the high interest rate environment for commercial property loans is low.

Figure 10

Total bank lending and commercial property lending growth

(annual percentage change)

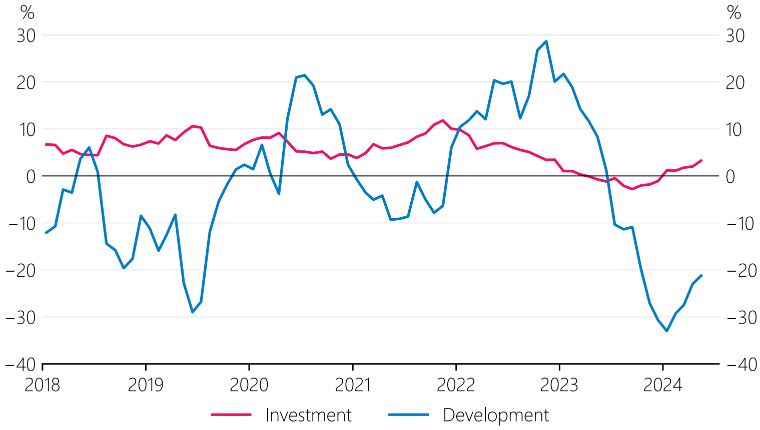


Source: RBNZ *Bank Balance Sheet survey.*

Figure 11

Commercial property lending growth

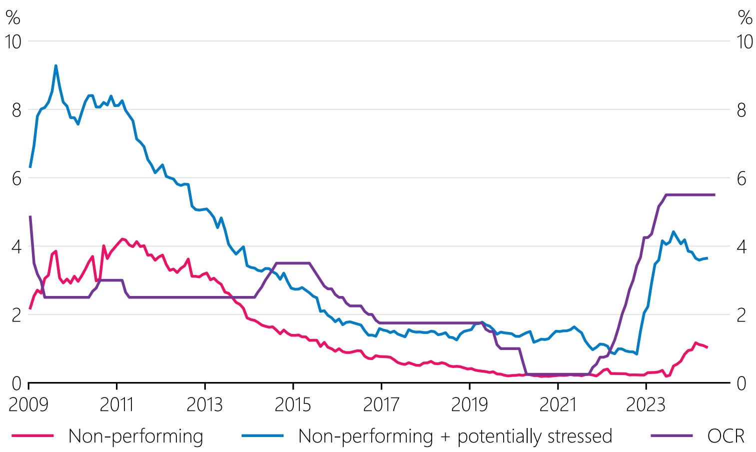
(annual percentage change)



Source: RBNZ *Bank Balance Sheet survey.*

Figure 12

Share of potentially stressed and non-performing commercial property loans

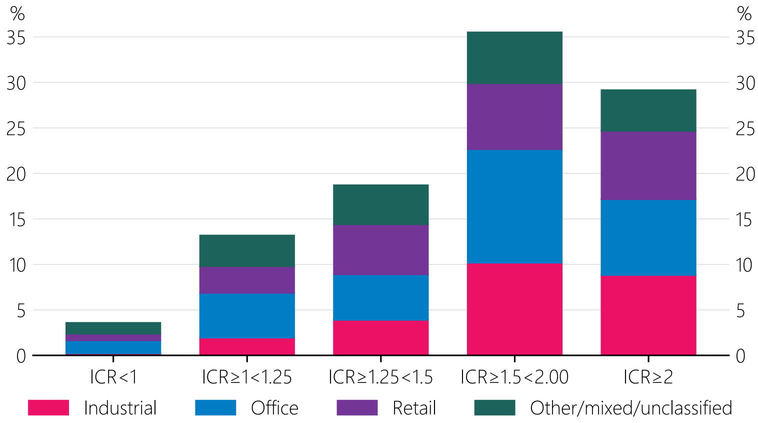


Source: RBNZ *Bank Balance Sheet survey.*

A key risk metric for the commercial property sector is the Interest Rate Coverage ratio, which is an indicator of borrowers' ability to service debt. The ratios for most commercial property investors who have borrowed from banks are above 1, showing that most borrowers' revenues (mainly rents) exceed their debt servicing costs (Figure 13). However, higher interest rates have pushed ICRs lower for many commercial property borrowers. Banks have responded by proactively engaging with commercial property borrowers who are facing debt servicing stress, and in some cases temporarily easing ICR covenants in their loan agreements.

Figure 13

Commercial property lending by interest coverage ratio



Source: RBNZ calculations.

Note: Data are from the four largest banks (ANZ, ASB, BNZ and Westpac).

The financial system has become more resilient to shocks from the commercial property sector since the GFC

Tighter lending standards have led to a reduction in risky lending. This has resulted in an overall less leveraged market and continued low levels of repossessions. Given the tight lending standards of recent years, banks continue to be lenient with borrowers struggling to meet their interest rate coverage covenants. This has helped to limit mortgagee sales and to stabilise market prices. Unlike the exogenous shocks that triggered previous crises, the increased OCR as a key driver of the deterioration in market conditions, is a predictable and manageable factor and has been well signalled for some time.

The outlook for commercial property remains weak but financial stability risks are currently contained

The New Zealand commercial property market is currently soft, but not under substantial stress. However, the high interest rate environment has left it in a vulnerable position. As the economy slows further, more and more businesses, financial institutions and commercial property market participants will be affected simultaneously. Overall bank exposure to commercial property in New Zealand is low and banks are well equipped to deal with the increased stress levels. This limits the direct risk to the financial system from the underperforming market. However, if other parts of the economy start to struggle financially, loan defaults could rise and put increasing pressure on New Zealand banks. Additional spillovers from the commercial property market could exacerbate stress in the financial system. This is particularly true as commercial property loans tend to perform poorly in stress scenarios.[12] Banks need to remain vigilant and continue to monitor developments in the commercial property market, particularly given the range of challenges and risks affecting large parts of the economy and the financial system

12 For more information, see 2022 Bank Solvency Stress Test, RBNZ Bulletin