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# New Zealand's affordable housing dilemma

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# Introduction

*Affordable housing is a key challenge facing many developed cities, worldwide. Parts of New Zealand, particularly Auckland, are amongst the least affordable cities in the world. At present, for example, the median house price in Auckland is around 9.5 times the average household income; when this ratio exceeds 5:1, a market is said to be 'severely unaffordable'. But it's not only Auckland that has affordability issues; house prices in Tauranga, Queenstown and many other locations in New Zealand materially exceed the severely unaffordable threshold. Indeed, housing markets in most major cities globally are experiencing an expanding affordability gap. Economic fundamentals suggest that markets would, all else equal, provide a supply response that would address the issue. There are many complex reasons why this is not occurring, including in New Zealand; this paper largely focuses on the responses to alleviate the issue.*

Access to quality, affordable housing is fundamental to the health and well-being of people. It is important too for functioning economies. New Zealand's housing challenges include providing social housing for residents unable to house themselves and Housing New Zealand is seeking to address this issue with a ramp up in the delivery of social homes.

Providing housing at a reasonable (affordable) ownership cost for low- and middle-income populations is the focus of this paper; it's about providing sustainable housing options for the burgeoning low to middle income cohort where wage growth has fallen well short of the growth in the cost of housing.

Affordable rental options are also important. Rental growth throughout New Zealand is placing added stress on low to middle income families; the median rental in Auckland as at May 2018 was $550/week. As the affordability gap widens, rental options become relatively more attractive. We also touch on the emerging residential rental housing / multi-family housing sector.

It's little wonder therefore that local and central government, and some typically philanthropic entities, are exploring options to address this issue and provide a 'leg up' for first home buyers. The new Government's proposed Kiwibuild policy is ambitious, targeting delivery of 100,000 affordable homes in New Zealand within the next 10 years, 50,000 of which are planned for Auckland.

*Why is housing unaffordability so acute? The issues are complex and there is no simple answer, but there are three key dimensions; strong demand coupled with supply constraints has forced up the cost of housing and wage growth has not kept pace. More specifically:*

- underlying population growth, strong net migration and, in the case of Auckland, a 'coming of age' as a globally desirable city has driven demand;
- constrained access to readily available land with infrastructure in place, a lack of scale developers, regulatory challenges, a shortage of capacity within our construction industry which has resulted in construction cost escalation, and generally development feasibility challenges have fundamentally constrained supply. A 'hang over' from a period of severe undersupply post the GFC together with New Zealand's love affair with land hungry freestanding homes on 400m$^2$ plus sites have accentuated this issue;
- wage growth has not kept pace with the cost of housing. The median house price in Auckland has risen about 264 per cent (or 7 per cent per annum compounding) over the past 19 years while over the same period, wage growth has been anaemic, growing only about 98 per cent (or 3.65 per cent per annum compounding).

The cumulative effect of these issues has been to create "severely unaffordable" housing in many parts of New Zealand. The Government's current response is a multi-pronged approach to assist with feasibility challenges by underwriting developers through its buying off plans strategy (Kiwibuild), and it is also exploring options for addressing the inefficiencies in New Zealand's construction industry and driving a more streamlined regulatory environment.

*Affordable housing schemes are emerging in New Zealand, and they are taking their cue from overseas experience where such schemes are prevalent, particularly in the United Kingdom.*

*How do these schemes work?*

# *Some fundamentals*

There are many variations of affordable housing schemes, but they can essentially be grouped into two options; shared equity/ownership and rent to buy schemes.

## Shared equity/ownership:

*Objective*

- Shared equity structures are intended to provide entry level home buyers (typically 1st home buyers) with a 'leg up' to home ownership.
- Structures are intended to bridge the gap between the market price of an entry level home and the price which the home buyer can afford, with additional 'bridging' equity provided by a 3rd party Shared Equity Provider (SEP).
- The principle of this model is that the home buyer will buy out the SEP over time (this process is known as 'stair-casing') or in one transaction when the home buyer has grown their equity to the extent that they can refinance and buy out the SEP.

*Models*

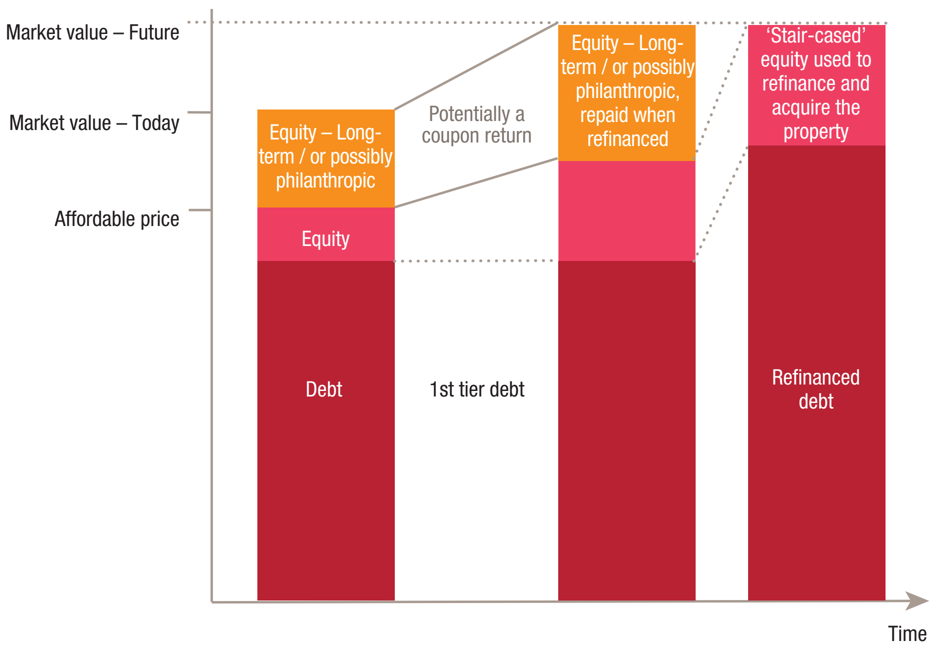
- Shared equity models are well established in the United Kingdom, with both central government and private sector support. They typically relate to newly built homes, but not exclusively.
- To be eligible, the home buyer must first meet pre-qualification hurdles essentially proving a household income below certain thresholds and, in some cases, displaying an acceptable credit history.
- Typically, the home buyer:
  - is required to hold the property for a minimum period.
  - contributes between 60 per cent and 80 per cent of the home's market value, achieved by providing a deposit (typically at least 5 per cent of market value, whereas banks typically require 10 per cent plus) and taking out a mortgage to fund its share of purchase price. The SEP owns the balance of the property, and the ownership arrangement is generally as tenants in common.
  - pays a discounted coupon (or interest rate) on the proportion of equity provided by the SEP, although in some cases this equity is provided by philanthropic entities where no coupon is payable.
  - pays all outgoings.
  - is required to buy out the SEP within a prescribed time frame (typically 10 years), or earlier, based on valuation.
- Where the home buyer has not been able to, and cannot, buy out the SEP, the property is typically placed on the market for sale and the proceeds are split pro-rata to the equity share established when the house was acquired.

One of the challenges with shared equity models is securing bank funding for the home buyer's initial acquisition. Banks typically seek security over the entire asset so that in the event of default they can control disposal and repatriation of their lending. Given that ownership is shared until the home buyer has elevated to full ownership, bank security could undermine the SEP's equity position.

It is for this reason that there is such a focus on pre-qualification / eligibility criteria before housing providers select candidate buyers. Ultimately these schemes require an element of partnership between the home buyer, funder and SEP.

In order to achieve market acceptance of this model, other jurisdictions have typically required a Goverment-led initiative to achieve alignment and agreed protocols.

### Shared equity – conceptual framework



## Rent to buy:

*Objective*

- Rent to Buy schemes are similar in concept to Shared Equity, although less common.
- They are sometimes referred to as 'try before you buy'.

*Models*

- Rent to Buy models are also well established in the UK, with central government and some private support.
- Typically, a prospective home buyer rents a newly built home at a discounted rental (typically 20 per cent below market rent) for 5 – 10 years.
- The schemes provide security of tenure and, ideally, prospective home buyers can save sufficient equity to enable them to borrow and buy the house. The below market rent, and in some cases additional 'leg ups' such as converting rent paid to equity, assists with building equity and the ability to establish a sufficient deposit to buy the house.
- During the period of rental tenure, the prospective buyer has the option to buy the property (or part of the property under a shared equity scheme). The purchase price can be fixed at the outset or subject to market valuation at the time of acquisition.
- At the end of the agreed period, the prospective buyer needs to either purchase the property or vacate. The acquisition price can be set at the commencement of the scheme or, more commonly, the prospective buyer has to pay the market value at the time of acquisition. If the prospective buyer cannot afford the market value in the future, in some cases they may convert to a shared equity scheme.

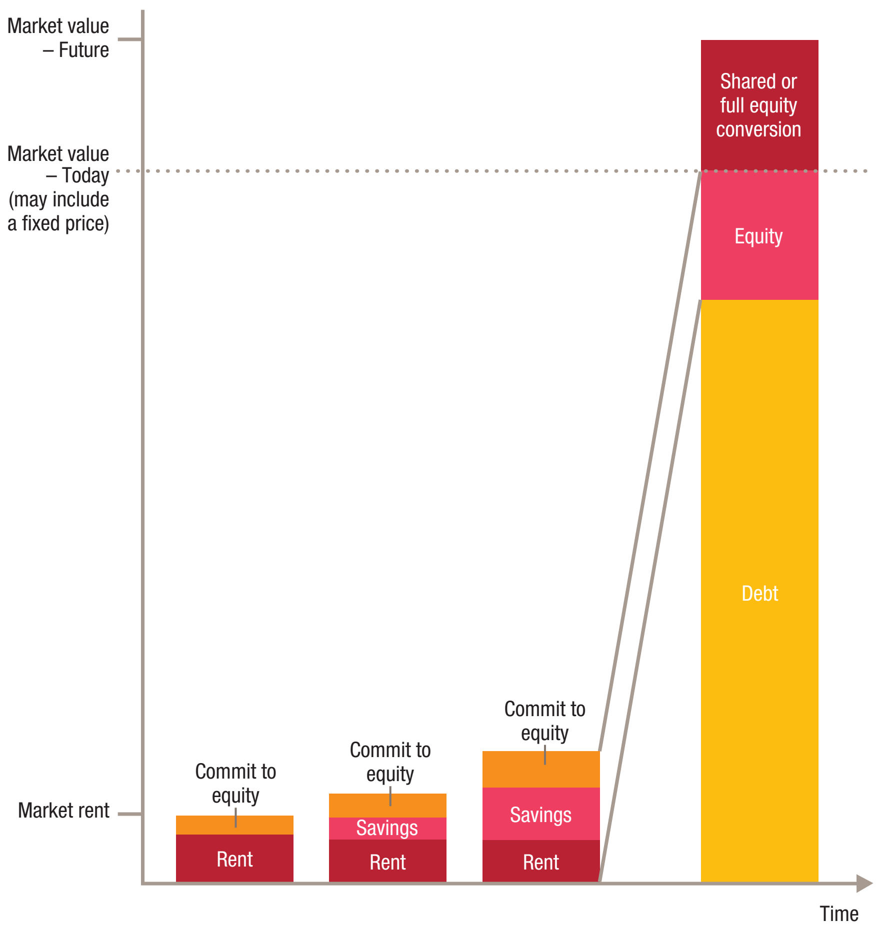
## *Market or non-market models?*

The models offered tend to be either:

- open market orientated, in which case the models can assist with increasing the pool of buyers for affordable housing product and, therefore, potentially assist with development feasibility; or
- funded via taxpayer support or philanthropic (or semi-philanthropic) equity. At one extreme such schemes will, subject to eligibility, literally comprise a non repayable grant or subsidy but, more typically, the original SEPs contribution is required, over time, to be repaid, and sometimes with a small interest (coupon) component as previously mentioned.

Common to both of the above scenarios, particularly the latter, is that 'wrap around' support is provided to prepare prospective buyers and support them, through the journey to home ownership.

### Rent to buy



# How does leasehold land fit into affordable housing?

For a large part of the 20th Century, leasehold land options (traditionally provided by church organisations) assisted with lowering the cost of housing and providing affordable entry homes in New Zealand. This worked for a period, while land prices remained relatively stable. Increasing land inflation toward the latter quarter of the 20th Century meant, however, that the land rent payable under these arrangements become relatively unaffordable. More recently, the market acceptance of traditional leasehold models where the land rent periodically resets to a full market rent, has come under pressure. As such, for residential development, contemporary ground leases in sought after locations are being structured as pre-paid leases; it is yet to be seen whether prepaid leases are 'market attractive' in lower cost housing locations where affordable housing is being targeted.

Community Land Trusts (CLTs) are emerging in the United States and United Kingdom. CLTs effectively provide leasehold tenure with 'friendly' lease arrangements, to the extent that they could also be compared to shared equity models; a household receives a grant and builds and owns the improvements and the ground rent is typically minimal or nil. When an interest is sold, there are mechanisms to share capital gain, designed to reflect the level of grant and lease terms.

Another option emerging in the market is Co-operative Housing, where a household owns or leases a share in a cooperative that owns a building - the share entitles occupants to a specific unit and the common areas, where the price of the share is typically related to the pro-rata value of the unit occupied. Affordability is achieved through economies of scale and construction efficiencies via design (they commonly incorporate shared facilities). These types of structures can however be challenging to fund.

# What happens if the housing market flattens or falls?

The concept of stair-casing is an important element of many affordable housing schemes, as it creates the opportunity for prospective buyers to build equity and over time, secure ownership.

The residential property market in New Zealand at present is arguably at its cyclical peak, which combined with the expectation of rising interest rates and the comparative unaffordability of housing suggests that there may be more downside than upside risk in the market.

While softening or falling values might improve affordability, elevation could take considerably longer and shared equity and rent to buy schemes may need longer term structures.

***Should the residential property market in New Zealand enter a period of low, flat or negative growth, 'stair-casing' could take considerably longer and shared equity and rent to buy schemes with 'stair-casing' structures may need longer term arrangements.***

## *Affordable housing schemes will not necessarily underwrite development*

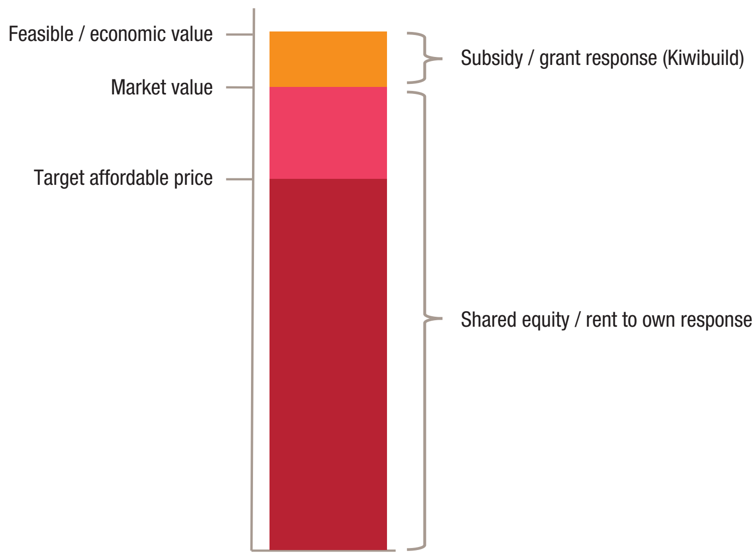
If, by way of example, Auckland were to target an affordable price point for family homes at say 5 times to average household income, this would currently suggest an affordable price point of circa $460,000 including GST. Kiwibuild, for example, is referencing price caps for Auckland as follows:

| | |
|---|---|
| 1 bedroom units | $500,000 incl GST |
| 2 bedroom units | $600,000 incl GST |
| 3 bedroom units | $650,000 incl GST |

Currently, family homes (three to four bedrooms) in Auckland are being delivered at an 'entry level' price point of $700,000 to $1,000,000 including GST. This threshold is significantly above the price range threshold targeted by Kiwibuild. The challenge for Government and the industry is to substantially lower market entry house prices to achieve Kiwibuild (or close to Kiwibuild) targets. As the chart adjacent illustrates, this may not be possible, at least in the short to medium term, without grant or subsidy.

That is, the difference between the market value and the feasible cost of delivery needs to be met by some mechanism other than shared equity or rent to buy schemes; this is presumably where Kiwibuild is targeting with its 'buying off the plans' schemes to provide assistance and ideally catalyse a change in the market to reduce the medium to long term cost of first home affordable housing.

**Affordable v market v feasible price points**



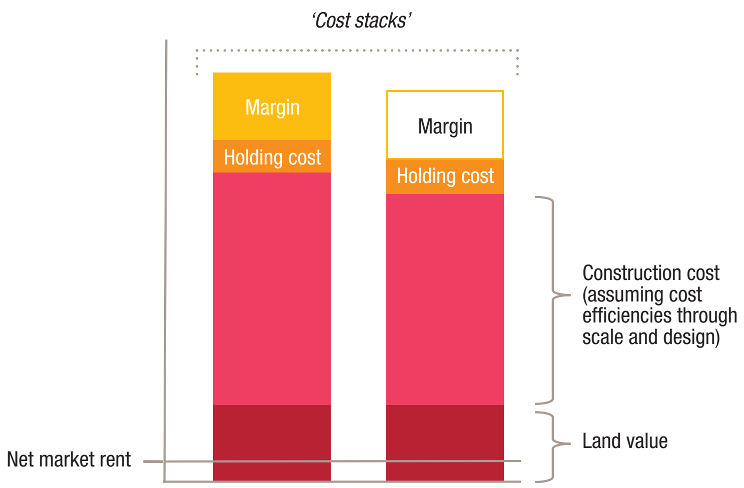

***Affordable rental housing is part of the solution for providing affordable housing options that enhance the health and well-being of New Zealanders.***

# *Why doesn't New Zealand have large-scale residential rental options, the likes of which are commonplace in the United States?*

Scale housing rental options (sometimes referred to as multi-family or build-to-own) housing are well established in some countries such as in the US, where the residential Real Estate Investment Trust (REIT) market comprises some 17 million housing units and has a market capitalisation of some US$139 billion (as at May 2018). There has been a surge in investment in this sector in Asia-Pacific over recent years where the capital committed to multi-family housing almost doubled between 2016 and 2017.

Multi-family housing is an emerging market in New Zealand and Australia. There is an expectation that privately held residential investment housing stock will gain traction in New Zealand. Some parties are already positioning to establish investment housing portfolios, albeit there is no depth in the market at present.

**Multi-family/build-to-own framework**




The challenge to date with this type of housing model in New Zealand (or more particularly Auckland) has been that yields (being the net rental income divided by the capital/market value of the housing units) have been insufficient to attract development and investment capital. The conceptual chart to the left illustrates (left hand bar) the 'cost stack' and indicative market return under a typical build to rent feasibility; a 3.75 per cent net return (after occupancy costs and management fees) is insufficient to underpin a project. Mooted / planned projects in NZ (and Australia) appear to be promoted on the basis that lower cost delivery can be achieved and potentially that the margin (and some of the holding costs) are folded back into the project to increase the return, to five per cent net in this example (shown as the right hand bar in the chart). We expect that a five per cent stabilised net yield would be sufficient to attract capital into this sector, which appears to be willing to trade development margin for the potential to establish a scale portfolio of assets and secure management rights.

Ultimately, affordable rental housing is part of the solution for providing affordable housing options that enhance the health and well-being of New Zealanders.

## *So what does all this mean?*

There is no 'silver bullet' to solving New Zealand's housing challenges. In our opinion, the key areas that, addressed in unison, could sustainably result in more affordable housing options, whether for ownership or rented, are:

- Increasing supply by incentivising intensification within existing built environs. Greenfield development has its place, but given the infrastructure issues associated with expanding beyond existing city limits, it needs to be carefully managed. In Auckland for example, the Unitary Plan has created considerable development capacity and unlocking new supply in locations with existing or proposed infrastructure will in our opinion deliver better long term outcomes.
- Achieving real wage growth; perhaps the most challenging problem of all, but fundamental in the long term.
- Addressing the inefficiencies in New Zealand's construction & development industry, which has seen construction cost escalation at unprecedented levels. This will require a multi-pronged approach on issues such as supply chain efficiency, construction technologies, the regulatory environment and incentivising the establishment of scale developers.
- Carefully managing net migration, balancing the benefits against the strong correlation to house price inflation in New Zealand, particularly Auckland.
- Incentivising multi-family-style rental housing to increase the supply of attractive, affordable, rental options.

Not an easy ask, but New Zealand needs a co-ordinated plan to establish a pathway to delivering sufficient affordable housing options for our growing population.

In the meantime, there is a requirement to support provision of a range of options to assist low to middle income families into suitable accommodation.

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