Paper / **Opinion**

UDINZ

Urban Development Institute of New Zealand Incorporated

Reimagining New Zealand's urban centres post-Covid

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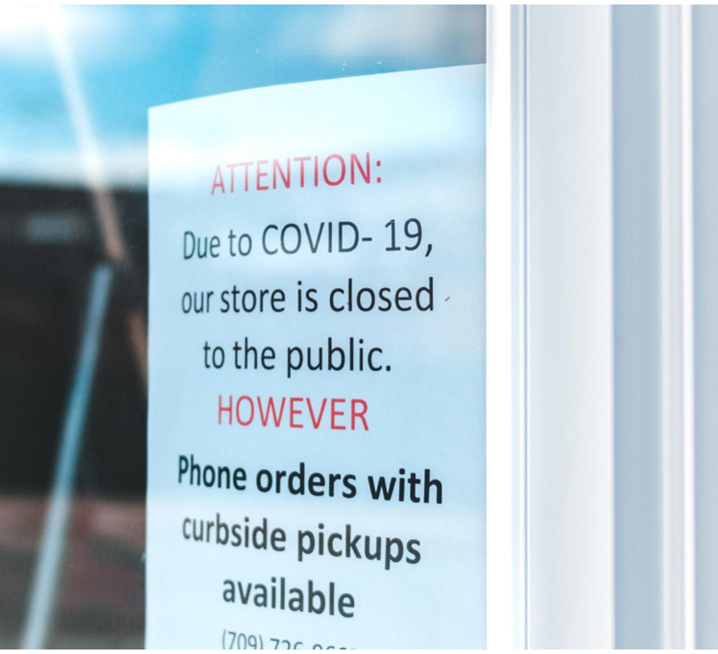
Six forces are converging in a post-COVID New Zealand that will fundamentally change our urban centres. Left unchecked, these forces could add untenanted building stock and distressed landlords to the now age-old housing affordability problem afflicting our younger generations.

But with development industry foresight — and councils and Government helping to front-foot — an alternate reality could see the rise of building stock repurposed as mixed-use vertical communities, creating new models of sustainable urban living.



1. Recession

We will unequivocally be in recession post-COVID — how deep, no one knows. But if we look at history and post-1987, we'll see a similar pattern in the drop-off in demand for commercial office space, with businesses taking smaller tenancies and vacancy rates spiking.

While the forces at play in 1987 were different, the recessionary effect is the same. On Black Monday — 19 October 1987, the biggest one-day fall in the history of the stock exchange — the Dow Jones fell 22% in one day. Compare that to the near 30% fall of the Dow Jones over two weeks in March this year, and you get some idea of what the COVID recession could look like in terms of severity.

Australian banks are forecasting that house prices will fall 10 per cent in the next year, and according to Australia's largest home lender (Commonwealth Bank, owner of ASB Bank in New Zealand), they could go down 30 per cent if the downturn continues into 2022.

In recession, we'll also see a pressure on people's incomes; where there were two incomes in a household, there may be one. Or perhaps two reduced incomes.

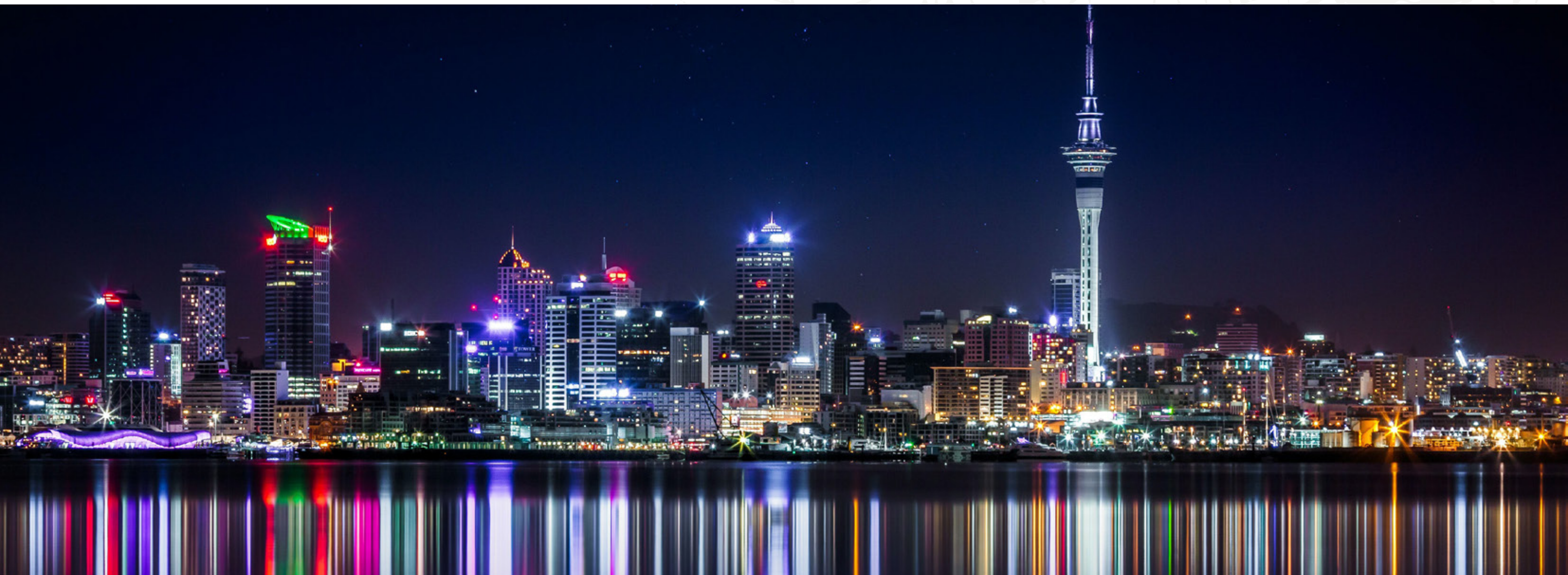
The ending of the New Zealand Government's wage subsidy — which to some extent has kicked the can down the road — will bring with it a wave of redundancies, liquidations, and unemployment that could make the GFC look like a training day out.

Recessions, unemployment, falling house prices, and building vacancy rates all go hand-in-hand.

2. The drift to A-grade stock

Combine this with an already-noticeable drift into newer, flashier A-grade buildings — as an example, 3,200 people in Auckland's CBD are still scheduled to move into the new $1 billion, 40-storey PWC tower in the Commercial Bay precinct this year — draining other areas like Shortland Street in Auckland of tenants and life.

In Auckland, pre-COVID vacancy rates in B- and C-grade space increased to over 15%. Businesses had already started 'trading up,' moving to new, modern, seismically safe premises. No surprise the Britomart precinct is fully occupied and has Auckland CBD's lowest vacancy.



The same is true of Wellington's CBD — and Christchurch, post-earthquakes, is all-new.

There will be more of this drift post-COVID, as businesses seek modern, high-tech, safe workplaces and as what was once A-grade stock becomes untenanted B- and C-grade.

3. Remote working uptake and 'downsizing'

Now that businesses and their staff have experienced remote working at full blast, they'll likely continue with it in various forms. And many staff, having had a taste, now want the flexibility of working between office and home.

Combine this with the current financial constraints businesses are under, with laid-off staff freeing up more office space and the move towards remote working for their remaining workforce, and it's obvious that businesses will be looking to downsize tenancies or move to smaller spaces.

The headline story in the 21 May edition of The Australian gives some indication of the carnage this will wreak on commercial landlords over the ditch, where "almost $50bn could be wiped from the value of commercial office properties across Australia's major cities as a surge in the number of work-from-home staff forces employers to reassess how they operate their businesses and dampens demand for a corporate footprint in central business districts."

The same will be true of New Zealand's city centres. Landlords will be competing for an ever-smaller supply of commercial tenants, with the new, seismically sound, high-tech buildings coming out on top. The 30- to 40-year-old 'old bods' of commercial will experience the pain, with tenants moving out.

According to economist Tony Alexander, "Few new office buildings are likely to be built in CBDs around the world. The trend to remote working is widely expected to lead to reduced demand for office space in city centres."

4. Hotel boom left under-utilised

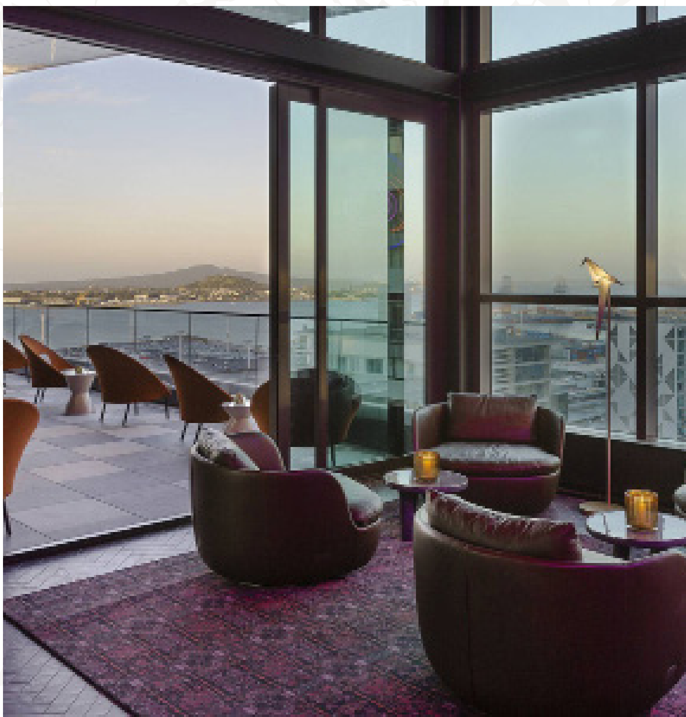
Combine these three forces with the 2017 to 2020 hotel construction boom, the biggest ever in New Zealand, where all cities saw a record number of new hotels either built or repurposed — hotels that now don't have the international tourists to occupy them, potentially for some years.

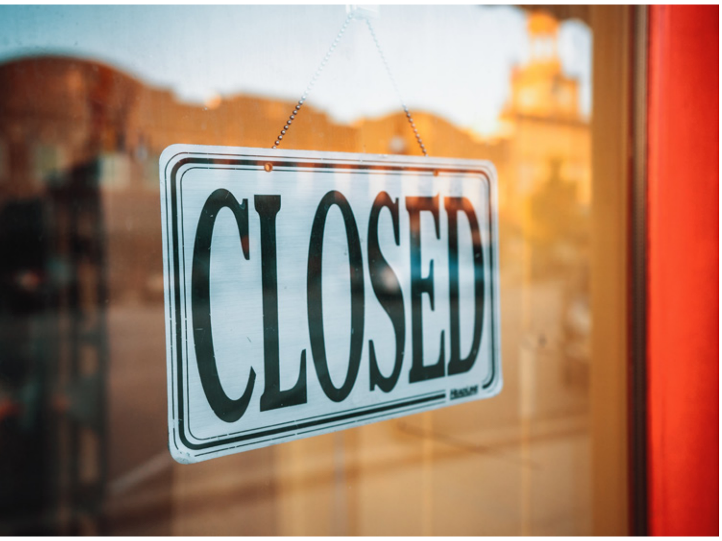
In 2019 alone, a $2 billion hotel construction boom created over 1,000 new hotel rooms in Auckland, Wellington, Queenstown, and Christchurch, with another 3,900 under construction into 2020 — some two-thirds in Auckland. This was all off the back of international visitor numbers soaring to nearly 3.9 million in July 2019.

That investment in building stock and hotel rooms was built on an international tourism forecast that has literally disappeared overnight.

And that's just the new stock. The majority of the country's hotel stock is dated, with many built in the late 1960s and early 1970s. Post-COVID, we hear of hoteliers talking about how to repurpose their older stock into strata title for private units and affordable housing.

▾ SO/ Auckland, luxurious urban hotel





If we don't expect a return to 2019 international tourism levels in the next two to three years, we need to rethink how to use this new and old hotel stock in meaningful ways.

5. Retail moving online

An increased shift to online retail in a post-COVID world will equally put pressure on the big retail landlords and malls, as reduced retail margins and online trading cause reduced retail tenancies.

Online sales are predicted to double in the wake of the pandemic, with up to 20 per cent of bricks-and-mortar stores expected to shut for good, according to a recent report from global financial services provider UBS.

The pivot to online shopping as a major trend is expected to continue post-health crisis.

And while retailers that survive won't abandon the clicks-and-mortar combination, they will be vacating existing tenancies, looking for smaller footprints and cheaper rents.

6. Housing affordability

Nothing alters the reality that house prices have risen over twice as fast as incomes in the past 10 years, and we have a whole generation priced out of the market. And with deposits of 20% and banks tightening up on credit, this generation continues to struggle to get into the market, even with historically low interest rates.

Out of COVID, the banks are 'spooked' by the very high numbers — some 100,000 in New Zealand and 730,000 in Australia — asking for and receiving some sort of mortgage holiday. This, combined with rising unemployment and precarious employment, means the banks will be even more reticent to lend to young people, the very people most likely to be laid off in this environment. It's very unlikely that the banks will relax their credit criteria — and they're actually more likely to tighten it as they go into risk-mitigation mode.

Millennials are often the worst affected — unable to own, and unable to save deposits due to high rents. They're also the generation most keenly seeking the amenity, convenience, and 'vibe' of living in the city centres.

Taken together...

These six forces lead to unforeseen issues in our city centres: people working from home, older B- and C-grade building stock left untenanted, and hotels and retail space (old and new) underutilised or not utilised at all.

At the same time, we're confronted with the age-old affordability issue, with young people left out of the property market and hamstrung by unaffordable rents.

Now, more than ever, we need to be thinking about innovative solutions to address these problems: both the landlords and hoteliers with unoccupied buildings and the young generation of COVID-affected struggling to own property and afford rents.

Many buildings in our cities are fine structurally. Yes, they need upgrades — often seismic — but they could be repurposed into what are relatively new concepts in NZ: vertical communities, mixed-use models, and models such as co-living.

A way forward: mixed-use and vertical communities

Good urban development post-COVID will involve repurposing old or distressed stock to flexible mixed uses.

Repurposing untenanted older stock isn't new. There was a spate of development around 2015 in Auckland, where older office buildings were repurposed into new residential apartments and snapped up by the market. Among the benefits were the large floor plates, high ceiling studs, views, carparks, and inner-city amenity.

The challenge for developers was primarily in making these developments viable, with structural and seismic strengthening and rezoning costs having to be factored into the development equation.

What we have now is an opportunity to do mixed-use in a way we've never done before.

Examples are ground-level activation with retail and hospitality, commercial mid-levels, and residential living at the top.

Mixed-use isn't new — but it's relatively new in New Zealand. And even mixing up more uses, such as co-working spaces and new residential models like co-living, will involve some innovative thinking.

Mixed-use has the benefit of being more resilient to market shocks as you have a variety of asset classes in one, e.g. retail, residential, and commercial. When one income stream goes down, you have the others to fall back on.

The trick is to do mixed-use well and create vertical, green communities. And that means a few things:

- Relaxing our planning rules to allow mixed-use and different business models to operate in one building.
- Drawing on international best practice and co-living models like those from California. International housing management models like co-living in repurposed city blocks for young professionals is a great solution for landlords and the millennial generation alike.
- Investing in urban design and our social and green connectedness. Think living walls, green rooftop gardens, shared amenities, and bringing nature into our cities.
- Investing in the right residential product mix for today's millennial generation.
- And opening up our capital markets to allow investment to make this a reality, as we don't have the capital depth in the New Zealand market to do this well.

Greening up

Regenerative design and repurposing old stock is the single most sustainable thing we can do in the construction sector.

The millennial generation are seeking green in design, in the economy, and as a way of living. They will also pay for it.

If there was one lesson out of COVID during lockdown it was the importance of bringing nature into our cities. When you can't get out to nature, it's vital to bring it in.

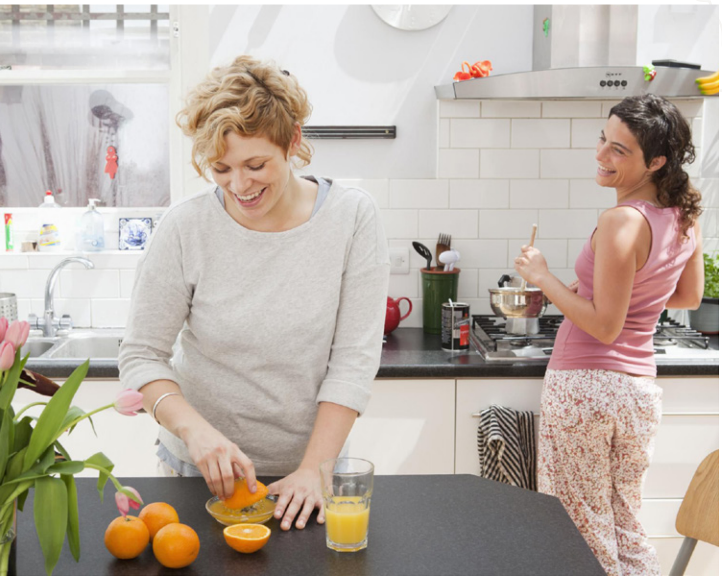
There's a whole mental health and well-being equation that goes along with bringing nature into our urban environment. What this could look like is green vertical communities with communal roof gardens, living walls, and the like.

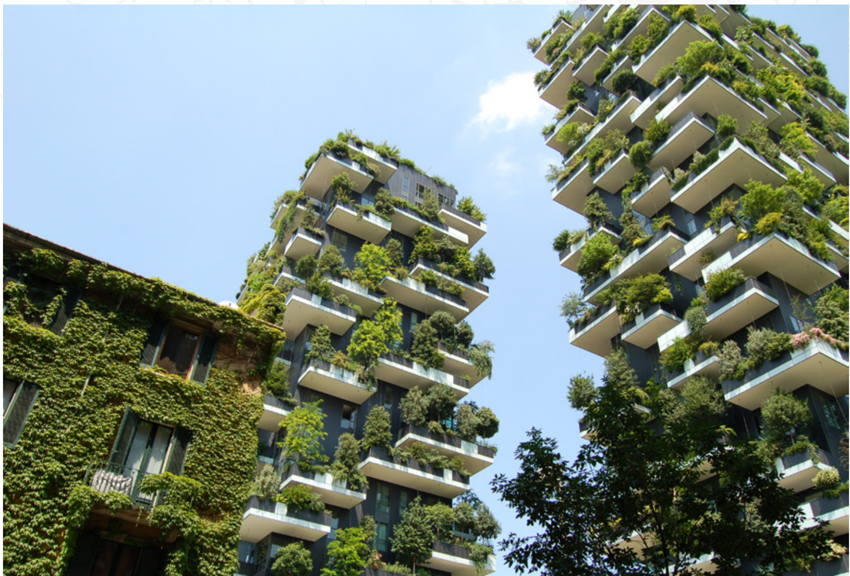
To enable all these things to happen, we need two things: capital flows to jumpstart development investment and a relaxation of RMA and planning rules to enable easy change of use. And there's a third: educating the development community on new models of mixed-use and new management models like co-living and co-working.

Enabling capital flows

Historically, New Zealand has a capital problem. Our start-ups look offshore for investment. Our capital markets are relatively shallow. And we have a well-intentioned Government that's currently positioning itself as the country's 'developer' on borrowed money.

Add to that the real post-COVID problem for development. Landlords are often developers, and when their rental incomes are diminished or uncertain, they don't have the confidence or leverage with financiers to get capital to invest in development. The net effect is a reduction in development finance and development activity.





To really unlock urban development, and to innovate and flourish in what is a much more tenuous, capital-poor world than pre-COVID, there needs to be a rethink on capital inflows.

Capital is ultimately the key enabler for good urban development. Unlocking it, and paths to it, is critical to reimagining our urban development and getting to 'better.'

The good news is there are plenty of people in the world that want to invest in New Zealand. Now, more than ever, we're positioned on the global stage as the country of choice — a COVID-free island haven. Let's leverage this.

While there was a review of the Overseas Investment Commission in late 2019, it really only addressed investments through a 'national interest' lens. Post-COVID, we believe the OIC and the rules in place for foreign capital flows need to be examined anew.

This goes both for New Zealand companies with shareholdings listed on other stock exchanges or in other markets, where the OIC rules can act as barriers to development, and for overseas investors looking to be part of New Zealand's development community.

A relaxing and opening up of the OIC rules, particularly in light of COVID, would enable offshore capital and investors to stimulate our urban development and investment in new models.

It doesn't mean allowing foreigners to come in and buy up housing, increasing house prices for New Zealanders. It means putting frameworks around enabling capital inflows into development and investment activity and streamlining rules for corporates with a mix of on and offshore ownership.

Relaxing our planning rules

The other big enabler for this to happen is that we need to simplify and relax our planning rules to enable flexibility of modes of use.

Local councils would need to get on board and help the development community work collectively to get to mixed-use mode. They'd need to enable repurposing and rezoning through simple, streamlined processes that enable different uses of a building, mixing strata titles with commercial and retail leases in models.

There are real challenges for developers converting older stock, and these developers need to be able to buy unlettable office and/or retail buildings at lower or discounted rates, to factor in the 'onion' effect.

The 'onion' effect reflects the myriad issues developers encounter when peeling back the layers of an older building — in bringing the building up to code seismically and structurally and upgrading it to align with today's fire and health and safety regulations. Big issues such as access, elevator upgrades, and seismic strengthening on old carcasses can be very expensive.

But the dividends are huge when you look at it from an asset return perspective (i.e. the building has a use again) and in terms of sustainability ROI and generational affordability ROI.

If we come together as a development community to think of ways we can solve these issues, encourage the opening of capital flows, and work alongside councils to simplify and streamline planning, we can be far more nimble going forward. And we can create better, greener, and more vibrant inner-city urban centres, with vertical mixed-use communities bringing a fresh flavour and vibe to the whole of New Zealand.

Out of every crisis comes opportunity.