



Aide-memoire

The role of the KiwiBuild underwrite			
Date:	3 rd May 2019	Security level:	In Confidence
Priority:	Medium	Report number:	AMI18/19050083

Information for Minister(s)
Hon Phil Twyford Minister of Housing and Urban Development

Contact for discussion			
Name	Position	Telephone	1st contact
Helen O'Sullivan	Head of KiwiBuild Delivery	s 9(2)(a)	✓
Brad Ward	Deputy Chief Executive, KiwiBuild and Large Project Transition		

Other agencies consulted
N/A

Minister's office to complete

<input type="checkbox"/> Noted <input type="checkbox"/> Seen <input type="checkbox"/> See Minister's notes <input type="checkbox"/> Needs change <input type="checkbox"/> Overtaken by events <input type="checkbox"/> Declined <input type="checkbox"/> Referred to (specify) <hr/>	Comments
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Date returned to MHUD:



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Purpose

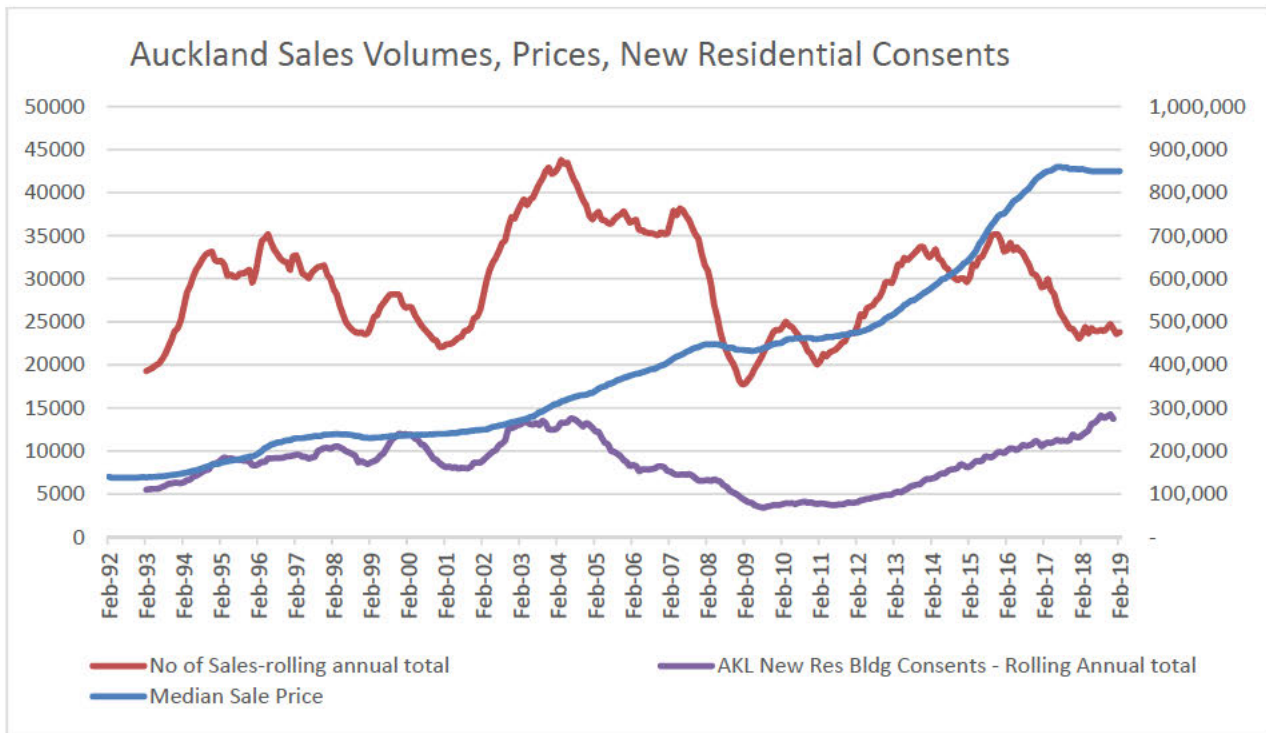
1. This aide memoire explains how the KiwiBuild underwrite can support increased provision of higher density, more affordable housing at pace and scale.

Market context

2. Large scale housing developments take several years to plan, consent and develop. The end-to-end timeframe is typically a minimum of three years, but often ten or more. Developers incur significant up-front costs before a single house is built, and before any revenue is received.
3. To reduce development and sales risks, projects are often staged. Banks will typically require that significant pre sales be secured before allowing funding to be drawn down for each stage, particularly for medium and higher density developments.
4. The pipeline uncertainty flowing from this 'stop-start' approach contributes to increased costs and reduced productivity. Examples include repeat tendering; scheduling complexities; increased downtime; and reluctance by developers and construction companies to invest in their own staff and technological capability (i.e. a heavy reliance on subcontracting).
5. From a housing supply perspective, the standard development model is particularly susceptible to economic downturns. This was evident following the global financial crisis in 2007/08, which was the catalyst for significant falls in house sales and construction activity and, arguably, the root cause of New Zealand's current housing supply and affordability issues. While construction activity fell across the board, medium and higher density developments were disproportionately impacted.
6. The resulting exodus of skilled labour to Australia and elsewhere meant we lacked the capacity to ramp up supply when demand returned. In this capacity constrained environment, developers naturally focussed their effort on the most profitable projects with the highest price points.
7. The latest ANZ Business Outlook Survey shows residential building intentions falling a further 4 points to a net 20% expecting lower activity. This is the most pessimistic outlook since 2009.¹
8. Sales volumes in the key Auckland market have been steadily falling over the past two years, as shown in the graph below. In the face of declining sales, pre sales become harder to

¹ <https://www.anz.co.nz/resources/f/3/f322b4d4-0555-4f83-8cf3-c413ba4356e4/ANZ-BusinessOutlook-20190430.pdf?MOD=AJPERES>

secure, reducing bank appetite to provide development funding, and increasing the cost of it where it is available.



Sources:

- Auckland Sales Volumes & Median House Price: REINZ data
- Auckland New Residential Building consents: Statistics New Zealand

The role of the KiwiBuild underwrite

9. The KiwiBuild underwrite can play a valuable role in addressing the issues outlined above.

Applied appropriately, it can:

- a. Encourage developers to refocus their effort towards building greater volumes of smaller, more affordable homes (as opposed to a smaller number of bespoke, larger, expensive homes) that utilise land and infrastructure more efficiently.
- b. Provide developers and their build partners with the confidence to build at pace and scale and invest in human and technological capability.
- c. Reduce the risk and the total cost of building, creating efficiency gains that can, through negotiation, be shared with the Crown and through that process, with home owners.
- d. Maintain activity in the construction market when slowing sales volumes (as we are currently seeing in Auckland) would otherwise lead to a reduction in activity and further loss of capability.
- e. Provide a platform for leading industry adoption of new technologies such as offsite manufacture and other innovative techniques.

10. In particular, the underwriting tool is expected to be crucial to securing the Crown’s housing supply and affordability objectives within the large scale greenfield and urban regeneration projects that it is facilitating in partnership with iwi, private developers and local councils in places like Tamaki, Mangere, Manukau and Porirua. The substantial capital requirements mean the success of these projects is heavily dependent on our ability to leverage non-government investment (e.g. to purchase and develop super lots in accordance with agreed schemes of development).

11. Initial feedback suggests that in the absence of an underwrite, developer appetite and ability to commit to the large volumes of KiwiBuild homes, particularly at the pace we are seeking, will be limited. This is especially the case in locations where we are seeking significant urban regeneration, such as Tamaki and Porirua. It is therefore an essential companion to other KiwiBuild tools, like deferred settlement, which provide insufficient incentive on their own against the backdrop of deteriorating market sentiment. Bank finance may become more of a constraint than buyer appetite.
12. A key advantage of the underwriting approach is the fact that all of the development and construction costs and risks rest with the development partner. As such, if used judiciously, underwrites represent an efficient use of Crown capital compared to direct procurement of construction services, and with the need to manage the entire sales process.

Managing the Crown's risk exposure

13. The KiwiBuild underwrite is not without risk. By its very nature, it involves the Crown assuming a degree of sales risk. There are also potential reputational risks.
14. In order to manage these risks and achieve its objectives, the use of the underwrite has to be pitched and price appropriately, based on the following broad rules:
 - a. *With credible, capable developers* prepared to engage on an open book basis and commit to long term outcomes that develop industry capability;
 - b. *In typologies and price points that match* as closely as possible the *KiwiBuild demand indicators*;
 - c. *In locations where Government policy objectives are supported*, such as:
 - i. increasing density around transport nodes;
 - ii. regenerating priority urban areas such as Tamaki, Mangere, Porirua;
 - iii. achieving industry transformation through greater use of offsite manufacture;
 - iv. leading industry change as targeted through the Construction Industry Accord.
 - d. *Priced to incentivise appropriate behaviour* by developers and builder partners.
15. By providing an undertaking to purchase homes of appropriate size and value, but pricing the put option so that the developer is still incentivised to sell the homes to the market through the build phase, the Crown is able to reduce its exposure over time. This enables it to facilitate more homes than it could otherwise do with an outright purchase option, while also avoiding the need for its own sales function.
16. MHUD acknowledges that the due diligence and commercial terms for some of the initial KiwiBuild underwrites were not as robust as they could have been. This was not due to any inherent problems with underwriting tool per se, but rather the manner in which it was applied. The KiwiBuild Unit has recently updated its operational guidelines to better manage the Crown's risk exposure and ensure strict adherence to the above principles [report number BRF18/19 040237 refers].
17. Despite our best endeavours, there will inevitably some underwritten homes for which eligible purchasers cannot be found. Hence, the importance of retaining the flexibility to rent or sell these houses on the open market if the need arises.