NEW ZEALAND CONSTRUCTION

Residential & Non-Residential Market Update

COMMERCIAL & AGRI
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EXECUTIVE SUMMARY

"The market is booming but profits are getting leaner…"

Key findings:

- New Zealand's main economic sectors are performing well and this is translating into strong economic momentum. The construction sector has been a key beneficiary of the strong economy and we remain upbeat about New Zealand's prospects over the next 12-24 months.
- Higher property prices have helped to stimulate investment and spending. However, both consumers and lenders remain wary of over exuberance at this point in the cycle.
- The combination of a strong economy, positive annual net migration (+71k) and a persistent shortage of residential housing should continue to provide structural support for the residential and non-residential construction pipeline.
- However, despite record levels of activity profit margins are beginning to narrow. This is due to a combination of flattening property prices and a significant spike in construction costs.
- With current dynamics both developers and building construction companies are struggling to see how some of the numbers work - a view shared by banks.
- We see construction sector investment (per capita) nearing levels seen pre Global Financial Crisis (GFC). This highlights not only how strong growth has been over recent years, but also how the sector has reached a far more mature, and arguably, more vulnerable point in the cycle.
- While the construction sector outlook is well supported by structural dynamics (e.g. net migration) there is a mild risk in the aftermath of this year's general election that migration settings are tweaked.
- An increased focus on compliance and health and safety has driven up the regulatory costs associated with building projects. In addition, a shortage of skilled labour is becoming more problematic for project managers and this has both driven up sub-contractor wages and increased project delivery risk.
- We have analysed 130 New Zealand residential and non-residential building construction companies with Total Revenue between \$3.0m and \$120.0m. This analysis shows the median EBITDA margin falling by 0.9% to 4.0% of Total Revenue in FY-2017(f), representing a 15%-20% pullback from current margin levels - primarily a result of cost increases.
- While individual circumstances will vary, we estimate that on average building construction companies captured by the upcoming changes to the Construction Contracts Amendment Act 2015 (CCAA) will require additional working capital of circa 2-3% of Total Revenues in FY-2017(f). This figure is an initial estimate and does not take into account the market solving for a more capital efficient solution in the long term (e.g. performance bonds or other).

THE NEW ZEALAND GROWTH STORY

New Zealand's economic performance has been "top-drawer"…

Economic Performance

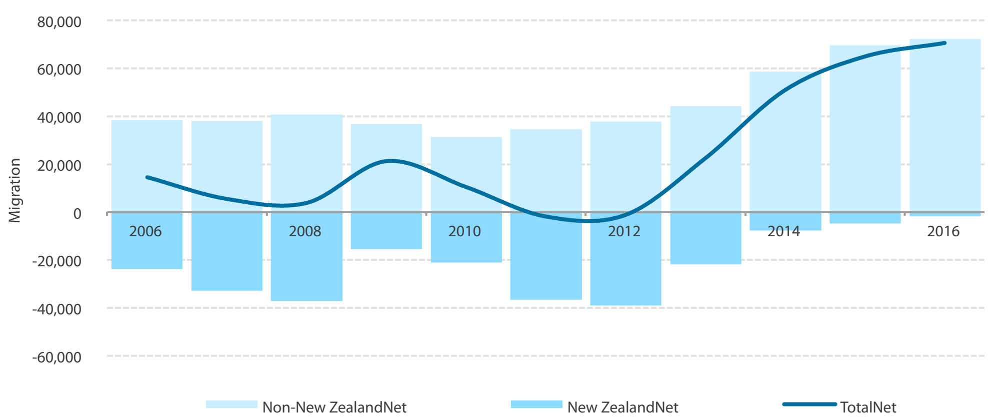
New Zealand has stood out as one of the top performing OECD economies in recent years. This has led to significant wealth gains from rising asset prices (e.g. property) and has stimulated both investment spending and the consumption side of growth story.

Tourism and migration have been key components of New Zealand's economic performance. A record number of tourists set foot in New Zealand over the past 12 months (3.5m) and the industry is now competing with dairy as our largest export earner. Similarly, annual net migration set a new record in early 2017 (+71k) and that rate looks set to continue with New Zealand remaining an attractive global destination. These themes should continue to stimulate economic growth and construction sector activity going forward.

Commodity price gains have assisted pockets of the New Zealand rural sector to de-leverage post GFC. However, we acknowledge this is not the case across the board and there is still much to be done to reduce debt levels to more sustainable levels. Our long term view is that the New Zealand agriculture sector is well positioned for future growth, providing value-add food products to an increasingly wealthy middle income market in Asia. This should underpin New Zealand's wider economic performance in future years.

New Zealand Net Migration (per annum)

Source: Statistics New Zealand, ANZ



Construction

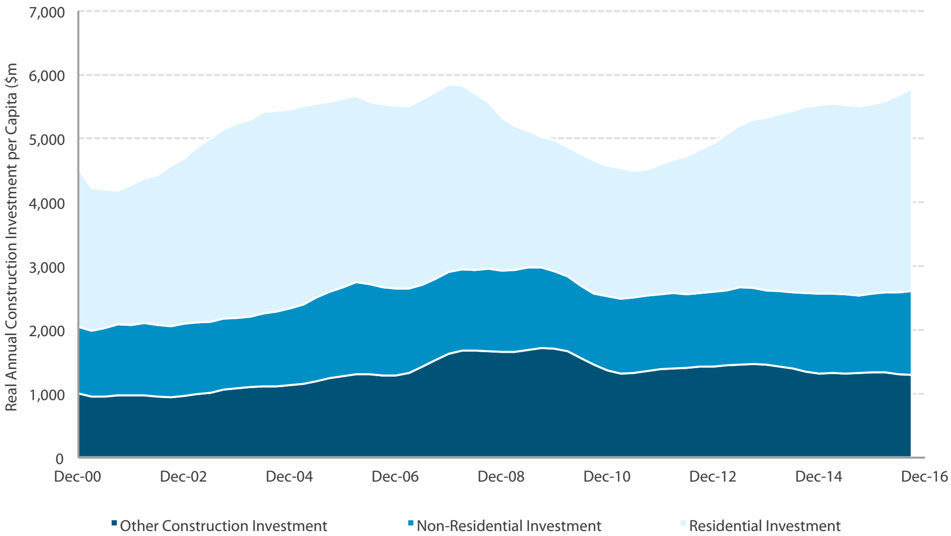
The construction sector has been a key beneficiary of New Zealand's strong economic momentum, including the increased infrastructure required to support a growing population.

But while construction activity has gone from strength to strength, evidence of a narrowing in project margins has emerged. Slowing property price growth combined with a significant spike in construction costs, such as raw materials and labour, has squeezed profitability and increased the risk/reward profile of new projects.

Structurally, we still believe in the construction story due to the rate of population growth and persistent housing supply shortage. However, the market is showing some signs of over-exuberance, the most obvious being a rapid rise in construction costs over the past 12 months. With the sector currently operating at full capacity and margin pressures emerging the construction sector is showing some typical late-cycle behaviour.

New Zealand Real Construction Investment per Capita ($m)

Source: Statistics New Zealand, ANZ



Further evidence of this theme can be seen in New Zealand's Real Construction Investment (per Capita). This chart measures the amount of investment in residential, non-residential and civil infrastructure per head of population. It also strips out the impact of annual inflation so that investment can be compared on a like for like basis across years.

The chart shows that the most recent cycle has been driven primarily by residential investment with the overall level of investment nearing the highs seen pre GFC, at $5.7k per Capita.

While structural dynamics point to the cycle having further to run, particularly in residential, we would see an orderly consolidation in investment as healthy for the sector. However, this may be at odds with the objectives of both developers and government given the persistent housing shortage.

BUILDING CONSTRUCTION SECTOR BENCHMARK

Analysis set-up

In the following pages we analyse the performance of a group of New Zealand building construction companies.

The analysis covers a series of financial performance metrics which enable us to identify current market trends and understand where potential risks may lie for the sector going forward.

Our sample set contains financial year end data for 130 construction businesses across New Zealand from 2013-2016. Total Revenue ranges from $3.0m to $120.0m capturing the core of the New Zealand construction market.

We also provide our FY-2017(f) forecast based upon industry trends and ANZ's economic forecasts over the next 12 months.

ANZSIC 2006 – Benchmark Industries
Source: Statistics New Zealand and the Australian Bureau of Statistics

4th Level ANZIC Description	3rd Level ANZSIC Description
House Construction	Building Construction
Residential Building Construction n.e.c.	Building Construction
Non-residential building construction	Building Construction

The companies in our sample set are classified under the Australian and New Zealand Standard Industrial Classification (ANZSIC) which is a widely recognised standard for industry classification.

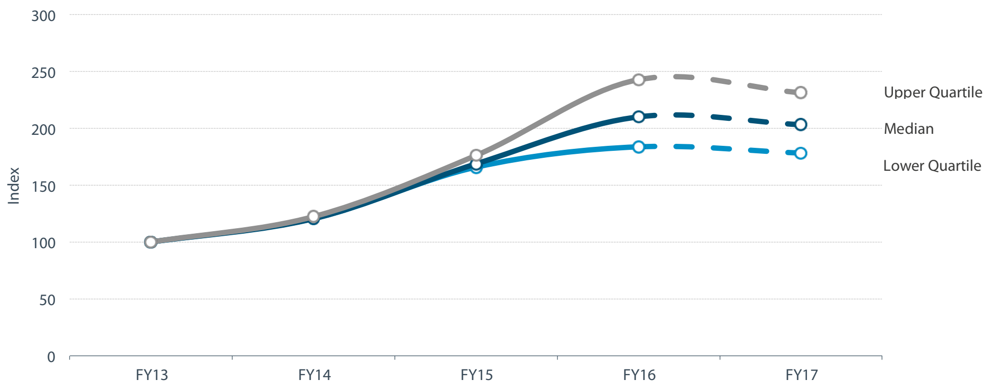
RESULTS

Income Statement

Total Revenue

Since 2013 Total Revenues from our sample set of building construction companies have grown strongly. This reflects not only increased construction activity (i.e. more work being done) but also includes the impact of increased raw material and labour costs which are typically included as part of the final invoice.

Revenue (indexed to 100)
Source: ANZ Analysis



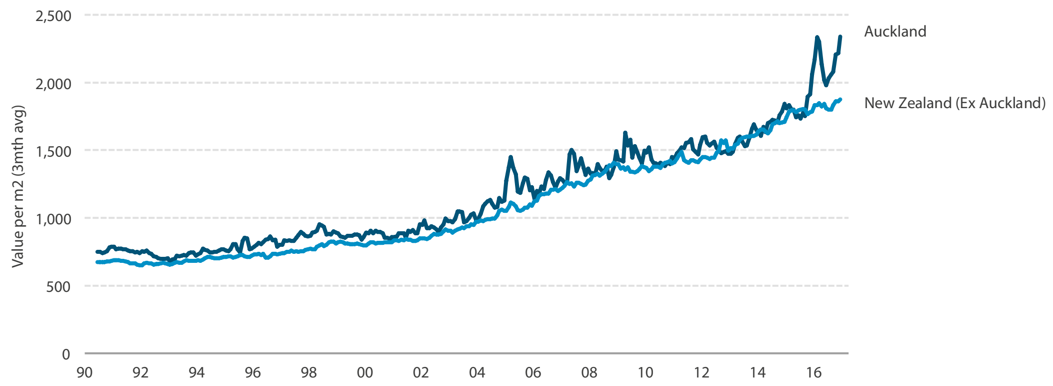
From 2013 to 2016 the median outcome for our sample set saw compound annual revenue growth of circa +20%, underscoring the immense volume of building work that has been undertaken, particularly in Christchurch and Auckland. Both upper and lower quartiles also experienced strong growth, indicating a sector wide expansion over these years.

Looking forward to FY-2017(f) the residential and non-residential pipeline still looks sound. However, we need to acknowledge weakness in new dwelling consent data late last year. The greatest impact of this will be in the Auckland and Wellington apartment markets with consents down -31% and -16% (m/m) for November and December 2016 respectively.

While this data would argue for a softer H1-2017 we remain of the view that there is still significant work to be done to support New Zealand's population growth at current rates. There is continued support from government to ensure that houses are built at record rates and this should underpin residential construction activity

Consent Value per Square Metre – New Zealand

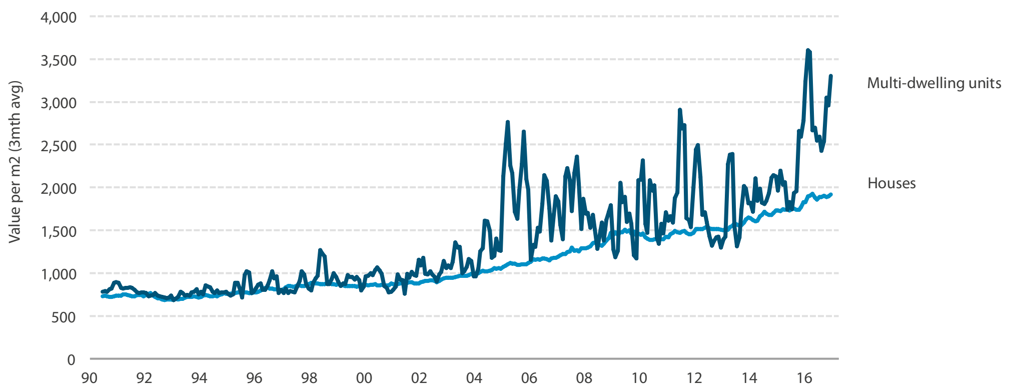
Source: ANZ Economics



Despite the volume of work remaining buoyant into FY-2017(f) we see the margin compression theme continuing. The emergence of this trend can be seen in the Consent Values per square meter charts – particularly for Auckland multi dwelling units. While some of the increase may be a result of higher spec projects, we see this as only a small part of the overall cost inflation theme at present.

Consent Value per Square Metre – Auckland Only

Source: ANZ Economics



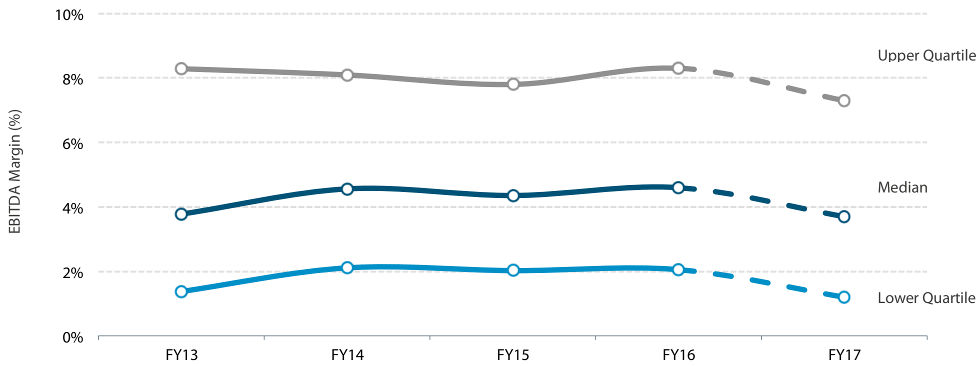
EBITDA[1] Margin

The New Zealand residential and non-residential construction market is highly competitive. This landscape is partially driven by market dynamics, but also by a desire for building construction companies to maintain a sufficient pipeline of work to keep teams together and staff employed. This dynamic can compress industry margins, significantly increasing the risk/reward profile for individual projects.

Due to the range of ways in which building construction companies produce financial statements, we provide a view of the competitive landscape by way of EBITDA[1] margin (%).

EBITDA[1] Margin (%)

Source: ANZ Analysis



From 2013-2016 EBITDA[1] margins for our sample set averaged around 4%. The fact that margins have been reasonably constant over this period while revenues have skyrocketed shows that underlying construction demand has been robust.

Interestingly, there was a weak relationship between EBITDA[1] margin and Total Revenue from 2013-2016 (+0.22) which suggests that increased turnover (i.e. just having a bigger company) does not lead to an improved ability to extract margin. As such, the residential and non-residential building construction market appears to be competitive right across the spectrum of company sizes we tested.

However, despite stable EBITDA[1] margins between 2013 and 2016 we believe median EBITDA[1] in FY-2017(f) will contract back toward the lower end of recent ranges under 4%. This view is supported by evidence of building construction companies quoting more aggressively for work while at the same time being squeezed by a rapidly increasing cost base over the past 12 months. This will impact lower quartile companies more dramatically with EBITDA[1] margins already as low as 1.5% in FY-2016.

Depreciation and amortisation for our sample set was negligible from 2013 to 2016 (i.e. on average 0.2% of Total Revenue). This reflects the tendency for building construction companies to lease assets. This is often done via a third party, although there are examples of related parties being set up to lease construction assets (i.e. trucks, diggers etc.) back to the building company.

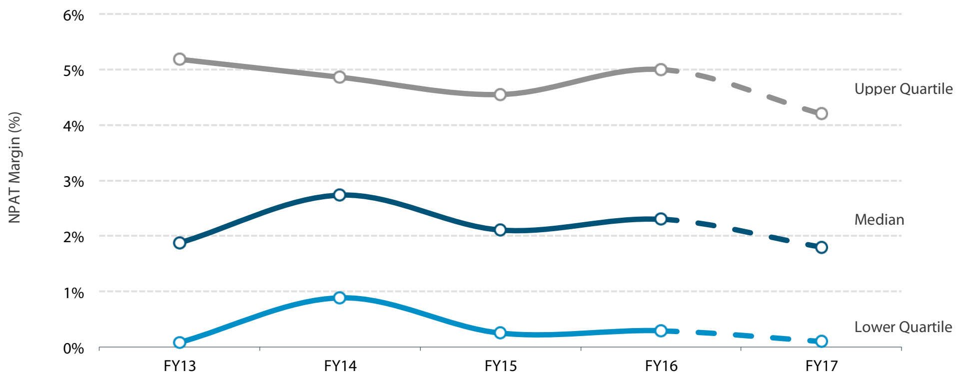
[1] EBITDA (before significant items) is our proxy for pre-tax cash flow. This is a measure that remains relatively consistent between operators regardless of accounting practices.

NPAT[2] Margin

Building construction companies tend to operate on low NPAT[2] margins. This leaves little in the way of capital for reinvestment back into the business, apart from the additional working capital needed to support a higher turnover base as the company grows.

NPAT[2] Margin (%)

Source: ANZ Analysis



The median NPAT[2] outcome for our sample set of companies averaged ~2.5% from 2013 and 2016. We see this dropping to a touch under 2.0% for FY-2017(f). We also see a higher incidence of lower quartile companies reporting nil (or negative) profit in FY-2017(f) which is primarily a result of the margin compression theme continuing.

[2] NPAT is Net Profit After Tax

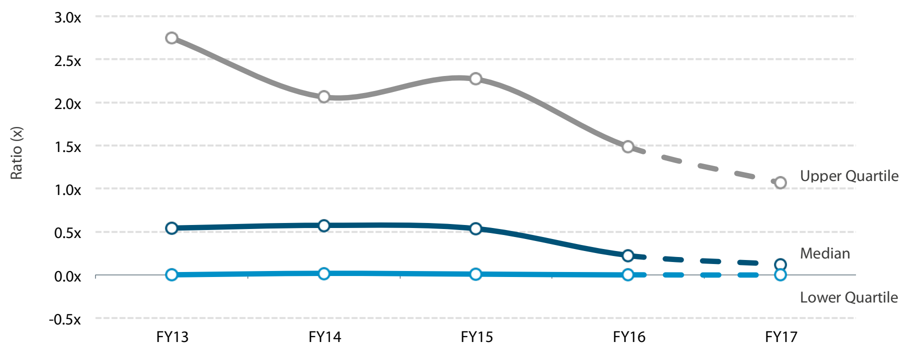
Balance Sheet and Leverage

External Debt[3] / EBITDA

As the cycle has matured building construction companies have tended to generate higher levels of EBITDA[1]. This has been achieved through rising revenues as opposed to widening margins. Since 2013, the median underlying EBITDA[1] result for our sample set increased at an annual rate of circa +26%, with lower quartile companies increasing at an annual rate of circa +10% and upper quartile companies by +30%. This indicated a sector wide improvement in earnings which helped reduce the industry's overall leverage ratio (e.g. External Debt[3] / EBITDA[1]).

External Debt[3] / EBITDA Ratio

Source: ANZ Analysis



External Debt[3]

Firstly, we need to acknowledge that in our sample set Shareholder Loans and Related Party Loans contribute around 2-3 times the level of External Debt[3] funding.

However, despite being markedly lower the External Debt[3] metric is important. It not only provides an overview of how the industry's external exposure might be changing over time, but also provides a generic snapshot of the appetite of banks and finance companies to lend into the industry.

In our analysis, the reduction in industry leverage has not been a function of building construction companies repaying External Debt[3]. In fact, current levels of External Debt[3] are much the same as they were in 2013, with most companies using this funding as part of core working capital.

[1] EBITDA (before significant items) is our proxy for pre-tax cash flow. This is a measure that remains relatively consistent between operators regardless of accounting practices

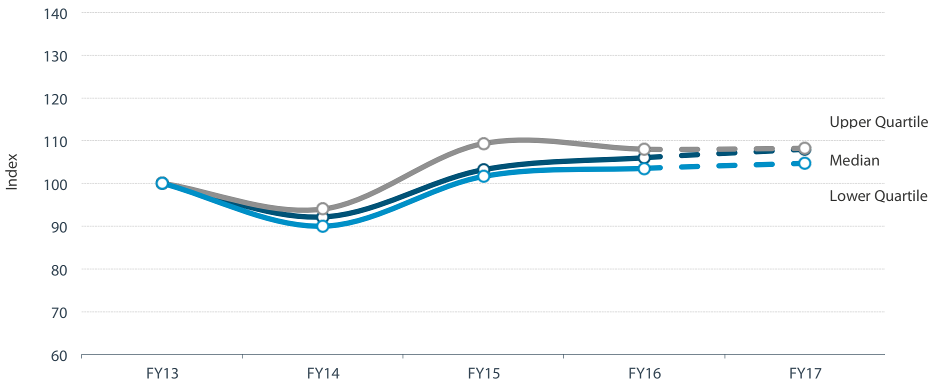
[3] External Debt is Debt excluding all Shareholder Loans and Related Party Loans

With External Debt[3] remaining reasonably constant from 2013 to 2016 it appears that companies may not have necessarily used profits to reduce debt, or improve balance sheet strength. Any profits retained in these companies have largely been used to fund the additional working capital required to support the industry's rapid growth.

Looking forward to FY-2017(f) we see similar levels of External Debt[3] for out sample set.

External Debt[3] (Indexed to 100)

Source: ANZ Analysis



[1] EBITDA (before significant items) is our proxy for pre-tax cash flow. This is a measure that remains relatively consistent between operators regardless of accounting practices

[3] External Debt is Debt excluding all Shareholder Loans and Related Party Loans

Adjusted Working Capital[4] (AWC)

An important part of any company is how working capital is managed.

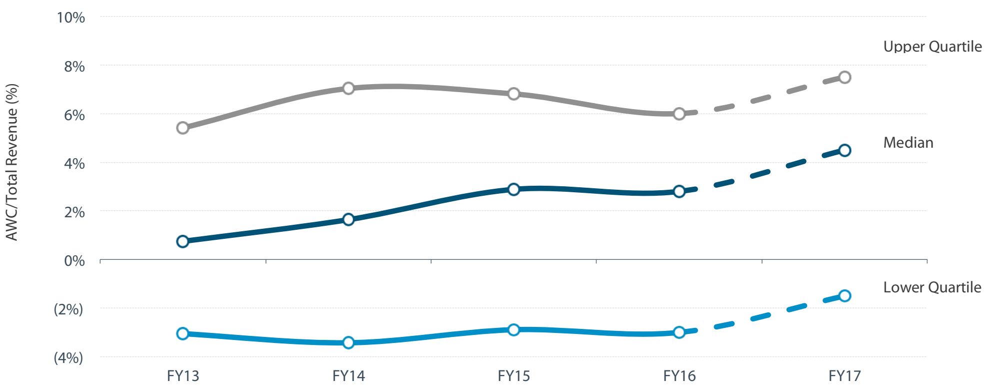
For our sample set we calculated an AWC[4]/ Total Revenue ratio which enabled us to understand how much working capital is tied up as a proportion of Total Revenue (per annum). This can assist in highlighting areas of strength / weakness in capital usage, with changes over time indicating how a company's cash conversion cycle may be improving or deteriorating.

From 2013 to 2016 the median AWC[4] requirement for our sample set was around1%-3% of Total Revenue. This is consistent with building construction companies generally matching inward and outward payments at a reasonably similar time. This timing offset result helps to reduce the overall working capital requirement, with residual working capital typically tied up in items such as inventory.

However, we need to acknowledge there was a large range in outcomes for this metric, due to the various ways in which companies account for construction projects. Having omitted these outliers the lower and upper quartiles ranged between -4.0% (i.e. generally paid in advance) and +7% (i.e. generally paid in arrears) of Total Revenue.

Adjusted Working Capital[4] / Total Revenue (%)

Source: ANZ Analysis



Looking forward we see AWC[4] increasing by around 2-3% of Total Revenues in FY-2017(f). While this is not a big number, as a proportion of Total Revenue it does represent a notable increase in working capital from where things are currently positioned.

The increase is mostly a result of the Construction Contracts Amendment Act 2015 (CCAA) legislation which requires retentions be held on trust in the form of cash or liquid assets. Building construction companies who are captured by the law will need to investigate new sources of funding to replace retentions, which were previously co-mingled as part of working capital.

While individual circumstances will vary, the FY-2017 forecast we have provided for our sample set set assumes that both retentions and any additional capital required are all recorded on balance sheet.

[4] Adjusted Working Capital = (Current Assets – Cash) - (Current Liabilities – Short Term Sources of Funds)

Retentions

Construction Contracts Amendment Act 2015

There has been much debate around how new legislation regarding retentions will be implemented and monitored.

Larger developers and construction companies have taken the lead to implement the new laws with many having already established processes to clearly identify and segregate out retentions into physical trust accounts.

While individual circumstances will vary we believe there will be a meaningful impact to the working capital cycle as a result of the law change. With 50% of companies in our construction benchmark having an NPAT[2] margin of less than 2%, developers and building construction companies will need to carefully consider how, and where, replacement working capital will be sourced from.

We estimate that building construction companies that are captured by the law change will on average require 2-3% of Total Revenue in additional working capital. Individual circumstances could vary significantly from this figure depending on the nature of construction contracts and payment terms.

It appears the market may eventually provide a solution which optimises capital usage for these types of companies (e.g. through performance bonds or other). However, any solution is likely to require additional equity support from shareholders due to the low capitalisation of balance sheets at this point in time.

Conclusion

As New Zealand enters its 8th consecutive year of economic expansion the outlook remains positive.

We remain supportive of the construction story due to the structural dynamics of the market - in particular regarding the residential housing shortage. However, we also remain cautious of circuit breakers at this point in the economic cycle. While current demand and supply dynamics suggest the cycle may still have time to run this needs to be carefully balanced against increasing signs of a market which is over-extended.

Overall, building construction companies have performed extremely well in the last few years. However, with margins showing signs of compression and the potential increase in working capital required, it may be a good time to sit back and consider the economics of new projects at current prices.

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