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Build to Rent Residential: Australia's Missing Sector

Summary

- Despite the challenges that have prevented 'build to rent residential' (or BTR) developing as an institutional investment class in Australia in the past, we believe there are powerful factors that are likely to drive its emergence locally over the next decade.

- For tenant demand, a combination of demographic and economic trends are changing attitudes towards home ownership and apartment living in Australia (and globally) among younger generations.

- This, combined with strong target market growth over the next decade and the potential amenity and service advantage of BTR product, are likely to result in a strong demand environment.

- The attractiveness of the current dominant strata investment model is also likely to be tested as tax benefits are squeezed and more investors question future capital growth prospects.

- For investors in BTR, the globalisation of capital markets is likely to result in continued strong competition for Australian core commercial property assets and BTR will create a much needed investment alternative. BTR is also easy for cross-border investors to understand and Australian superannuation funds are acquiring expertise in the sector through investment in offshore vehicles.

- Globally, investors are attracted to the potential portfolio diversification benefits, illustrated by stability of income combined with some evidence of counter-cyclical performance through the Global Financial Crisis.

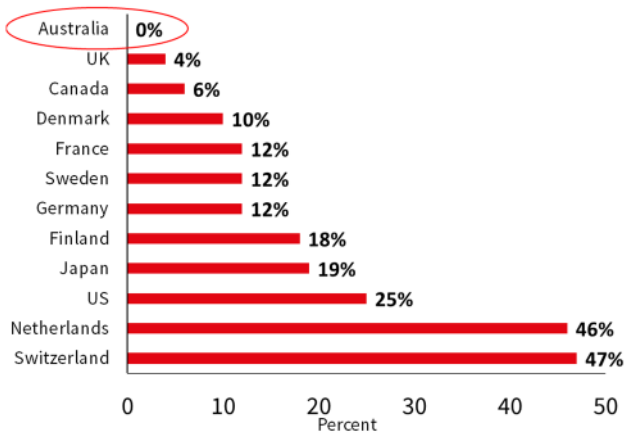
- Yields and total return expectations in other real estate sectors have adjusted to a 'low-growth world' and investors are realising that on a 'yield on cost' basis, BTR can offer similar risk-adjusted returns to other core sectors.

Background – what is BTR residential?

BTR residential is known by slightly different names globally, such as 'multi-family' in the US after local planning designations (a dwelling can be 'single-family' or 'multi-family') or the 'private rental sector' in the UK. However, 'build to rent' is the most accurate description as it essentially incorporates multi-unit residential dwellings built and designed specifically to be rented out by a longer-term single owner (institutional or private).

As Figure 1 shows, the sector is a very significant part of institutional investors' portfolios in many developed markets, including much of Europe, the US and Japan. There is recent evidence of the emergence of the sector in China. Given its market size, the US is the largest BTR market in the world and it accounts for around a quarter of all institutional investment in real estate in the US.

Figure 1: Residential as Percentage of Institutional Real Estate Portfolios



Source: IPD, NCREIF, LaSalle Investment Management, as at 2015

The US ‘multi-family’ sector is now a deep, mature market, with a liquid secondary market for assets. The sector in the US gained momentum in the 1990s in more low/medium density suburban markets (including what are termed ‘garden apartments’) and it has only been in the past few years that high-rise apartments have taken over as the dominate product type.

In the UK, BTR is still a relatively new market and accounts for only around 4% of institutional real estate investment, but the sector is growing rapidly and some parallels have been drawn as to the way it has developed in the UK relative to Australia. In particular, it is the rapid growth of the student accommodation market as a pre-cursor to a broader BTR market that has sparked comparison. The UK government has also heavily incentivised BTR as part of the solution to housing affordability problems, which also appears to now be happening in Australia.

The simplest model of BTR is an end-to-end model where a group is building, owning long-term and managing facilities. However, internationally there are many groups that have geared themselves to only participate in one or two of these three distinct parts of the process. Indeed, the management role can be further split into the property management and the tenancy management (particularly in an affordable or social housing scheme).

At present, it appears that most of the groups seriously looking at the sector in Australia need to at least keep the building part of the process in-house, which allows incorporation of the development profit. However, eventually a ‘tradable’ secondary market for properties should emerge and this is certainly true in the US and in some mature mainland European markets.

What does BTR offer tenants?

There is a number of real or perceived advantages for tenants that BTR could offer over renting from a private landlord. These include:

- **Very high levels of tenant amenity** – while this is becoming more prevalent the ‘for-sale’ market, BTR properties commonly offer facilities like pools, gyms, recreational/gathering spaces, movie rooms, quiet working spaces;
- **A high level of tenant service** – many facilities offer (and earn some income from) a range of household services such as dry cleaning, parcel delivery service and discounted bundled bulk utilities (internet, electricity/gas, cable television etc.). Some facilities offer a full ‘concierge’ type service as well. Potentially, financial services such as home and contents insurance could be included in a lease package.
- **Lease flexibility** – a large provider can offer flexibility within their portfolio for a tenant moving cities or just looking to upgrade to break a lease in one facility and go to another.

The aim of many large BTR operators overseas is create brand loyalty among their tenant and then to provide a pathway for long-term rentals to progress through their portfolio as they progress with their lifecycle. In this way, the student accommodation sector is a compliment to BTR as an entry point into the system and a place to create brand loyalty. Further development of the model might include a diversified portfolio in different cities, with different price points and different style of stock to create options for tenants as they build their career, start a family and so forth.

Why hasn’t BTR worked in Australia until now?

A range of inter-related factors explain why BTR has failed to establish itself as a viable sector in Australia. The proposition that BTR is now set to emerge therefore rests on the proposition that parameters around residential investment and ownership are now shifting.

Two key factors support have underwritten the residential investment profile in Australia.

Firstly, the strata title system, introduced in Australia in the 1960s facilitated the sale and (importantly) access to mortgage finance for investors in individual units in multi-apartment blocks.

Secondly, the interaction of generous “negative gearing” tax arrangements to residential investors, combined with an income tax system that imposes one of the steepest marginal tax gradients in the Western world, stimulated individual investors to seek exposure to leveraged investment in residential assets (mainly apartments).

The result is that the “average” residential investor owns only 1.4 properties, while the profile of negatively geared investors (dominated by registered nurses, secondary school teachers, electricians and other very common occupations) is testimony to the impact of sharply rising marginal income tax rates on employees on moderate incomes (ATO, 2014/15).

Availability of mortgage finance and taxation incentives are a powerful combination that encouraged individual investors to trade off rental income against short-term tax shelters and long-term capital gains (themselves tax-advantaged).

As a result, gross yields in Australia’s residential sector have been driven very low. According to Core Logic data, the average gross yield for apartments in 1Q17 was just 3.9% in Sydney, 4.1% in Melbourne and 4.9% in Brisbane. In comparison, 2Q17 yields on prime office assets in Sydney were 4.63% to 5.25%, Melbourne (4.75% to 5.75%) and Brisbane (5.50% to 7.50%).

However, the fact that most organisations looking at the sector are also looking at developing themselves, perhaps the most appropriate metric to compare returns is on a ‘yield on cost’ basis. When adjusting for all the differences in cost structures, it does appear that BTR is much more in line with other sectors on this basis than on an investment yield basis.

Historically, investors in Australia’s residential sector have enjoyed generous returns. Analysis by ASX/Russell Investments shows that over the fifteen years to 2015, investors in the residential sector experienced an average tax rate of 23% and for investors on the highest marginal tax rate an average annual return of 5.8% p.a., the highest of nine asset classes, including shares and listed property.

Are the tectonic plates shifting?

Yield comparisons between residential and commercial property are not strictly ‘like-for-like’. Rent-free incentives (which fluctuate cyclically) can materially impact on office market returns. In the strong Sydney office leasing market where 2Q17 vacancy was 6.4 %, average rent-free leasing incentives were 21% in a standard ten-year lease. Adjusting for incentives as well as other factors such as capital expenditure requirements, vacancy and let-up periods, true effective yields likely much closer than they seem. In addition, post-2007 commercial property yields have compressed, apparently to a lower plateau, while residential yields comparisons have remained relatively stable. Hence, the gap has narrowed.

Capital growth prospects are moderating. Historically capital growth has been the major driver of returns to residential property owners and investors. Australia is highly urbanised (around 89% of our population is categorised as ‘urban’ according the World Bank), but at the same time having among the lowest urban density of any major developed market. High levels of population growth, low density urban planning regimes and under-investment in urban infrastructure have all contributed to a rising premium for locations close to transport, workplaces and facilities such as schools and shops. Indeed, it is land values rather than house prices that account for the high historical returns on residential assets. These drivers will not reverse, but with rising infrastructure investment, increased casualisation of the workforce, increasing urban density and structurally lower inflation, the rate of capital growth can be expected to moderate. So, too, will the financial rewards of home ownership and residential investment.

At the same time the Commonwealth government is limiting the tax benefits available to residential investors, while the Labor Party opposition currently advocates some limitation on “negative gearing” as a whole.

The financial reward to home ownership and investment in Australia has been, historically, high. We do not expect this to be reversed any time soon, Nevertheless it seems likely that the balance is shifting from both the investment and tenant perspective. Younger generations priced out of the housing market may well choose to invest in 'partial' investments such as BrickX and indeed in BTR through REIT structures. Regardless, we believe a more stable price growth environment will help the emerging BTR sector and provide some scope to build the income yield in the residential sector steadily and slowly over the long-term.

Some other challenges the sector faces in Australia include:

- **Taxation treatment of BTR**, including GST and MIT status of the sector. In the build-to-sell market, GST can be recovered on sale, but in BTR it currently must be paid up front and is potentially very hard to recover via rents in a competitive market. However, similar treatment of BTR to commercial property assets eliminates this extra upfront impost on construction. Similarly, allowing BTR investment with Managed Investment Trust (MIT) structure appears a critical issue to encouraging institutional investment in the structure. Until recently private ATO rulings have suggested it is an allowable within a MIT structure, but recent draft affordability housing legislation specifically excludes BTR (except for affordable housing) from being held in an MIT structure as it deems the investment is not primarily for the income generated and is reliant on capital growth. Unless this is revised, it means a significantly higher taxation rate will be applied to the sector relative to commercial property investment within an MIT structure. This will potentially reduce short-term prospects for the emergence of the sector. Ironically, it will also potentially limit the development of affordable housing by community housing organisations within a BTR structure without the ability to cross-subsidise it with commercially focused BTR. The property industry is likely to lobby hard to reverse this policy.
- **Availability of long-term finance.** Longer-term debt is steadily becoming more readily available in Australia as more non-bank lenders are entering the market in competition with established lenders. For the major banks, a familiarisation process about the BTR sector is currently taking place, and they too should prove interested in supporting BTR once it is better understood. Overall, the volume of global capital seeking relatively safe and steady long-term returns should see 'market' solutions to perceived funding problems. However, in the short-term there may also be a role for Government in helping ensure that adequate long-term funding options are available to the sector.

How big could BTR be in Australia?

One of the key attractions of BTR for institutional investors is that it is one of the few 'new' real estate sectors with the potential to create scale.

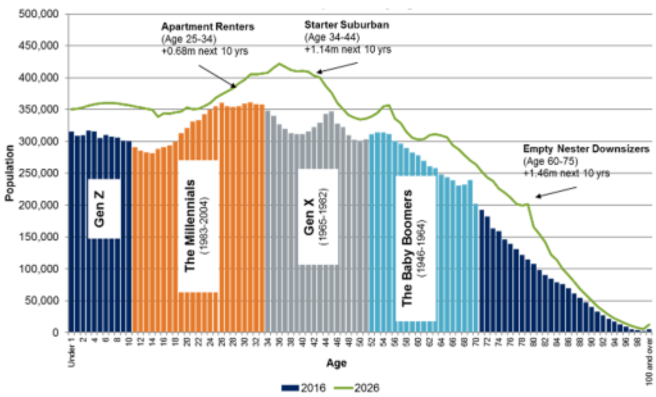
The ABS calculates that Australian housing stock was worth around $6.6 trillion at the end 2016, while CoreLogic estimate the market at around $7.2 trillion in mid-2017. In comparison, LaSalle Investment Management estimates that the total 'investable' universe of commercial real estate in Australia is only around $1.4 trillion, of which around 28% is actually institutionally owned.

Consequently, assuming that Australia were to reach a relatively moderate level where BTR represented 10% of all institutional investment in real estate, this would translate to around $40 billion and this is still less than 1% of all Australia's residential housing stock institutionalised. While it is near impossible to predict the growth profile of the BTR sector in Australia, it does have the potential to be very large and to grow relatively fast (as has been the case in many other markets globally).

What is driving tenant demand?

Australia's demographic profile should provide very strong growth in key target demographics for BTR tenants. Figure 2 shows Australia's population by age now and the ABS's projection for 2026. Very strong growth is projected in the key 25 to 45 age groups over the next decade, which are a key target market. There is also good growth in the 'empty nesters' demographic that is a prime target for 'downsizing' from large detached dwellings to apartments and are a target for BTR operators in some offshore markets.

Figure 2: Australian Population by Age

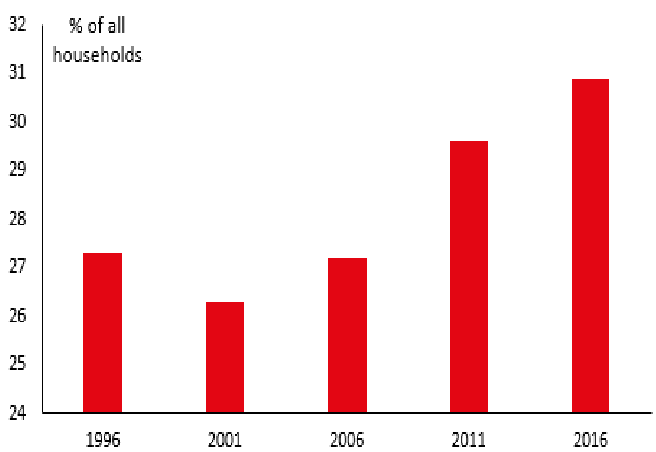


Source: ABS, JLL Research

Supporting these trend are two other important structural shifts in the way that Australians are living:

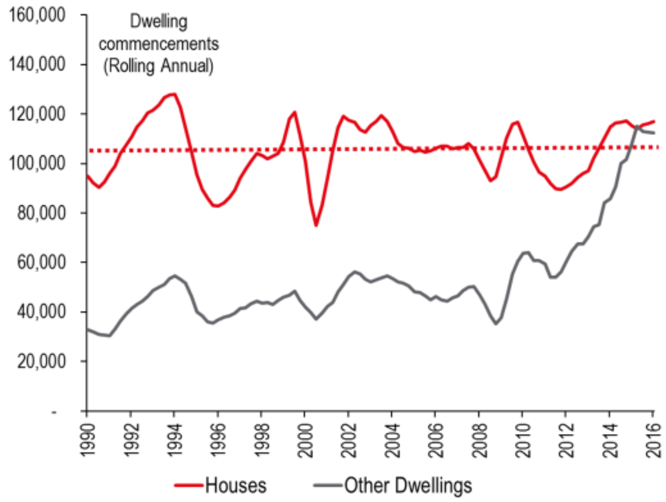
1. A clear upward trend renting (Figure 3) and a decline in the rate of home ownership; and
2. A shift towards apartment living relative to detached housing living (Figure 4).

Figure 3: Proportion of Australians Renting



Source: ABS Census Data, JLL Research

Figure 4: Building Commencements by Type



Source: ABS, JLL Research

While there is a cyclical element to both these trends, it is also likely that a structural change is underway, consistent with trends observed in many other major developed economies around the world.

To some degree both trends are a response to affordability pressures and the extra time it takes to save a house deposit, but there are also clearly larger social attitude changes that have occurred towards housing and renting. Younger generations appear to be rejecting their parents' 'great Australian dream' for a detached dwelling on a large suburban block and are genuinely looking to live differently. This means becoming more mobile and it incorporates a conscious decision that they would rather be in the vibrant inner city communities with lots of amenity, even if it means renting for much longer, if not permanently, and investing/spending their money in other ways.

The shift to apartments over detached dwellings is also strongly supported by Australian planning regimes that are now looking to encourage density and maximise existing infrastructure. Strong migration and foreign investment from locations accustomed to apartment living, particularly Asia, is also a silent driver behind this trend. Australia's net overseas migration averaged around 219,000 people per annum over the past decade and these are generally wealthier migrants than in Australia's post-WW2 immigration boom, who often can choose to live in inner and middle-ring suburbs rather than being pushed to the urban fringe.

These factors indicate a strong underlying demand for BTR. An emerging BTR sector is likely to offer strong competition to older apartment stock as tenants come to realise the benefits in terms of amenity, service and flexibility that BTR can offer over renting from a private individual through a third party agent.

What is driving investor demand?

BTR is a major investment class around the world and global investors are very comfortable with the asset class and are actively seeking it in Australia. For major cross border investors, the sector is also relatively simple to understand compared with some of the complexities of some local commercial real estate sectors.

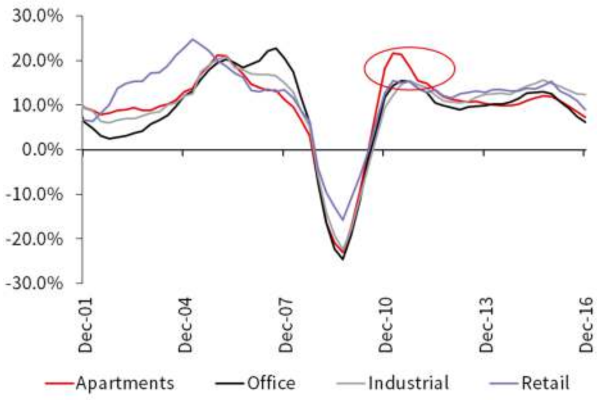
In an environment where capital markets are become much more globalised and inbound foreign investment into Australia has been at record levels over recent years, competition of core assets in the established institutional sectors (office, industrial and retail) is intense and stock creation is insufficient to keep pace with demand for assets.

While this offshore appetite for Australian assets is partly cyclical, an underlying demand for the relative stability and return of Australian assets is likely to be a recurring theme in coming decades. Supporting this is Australia's own large and still strongly growing superannuation system.

Australian superannuation funds themselves are also acquiring familiarity with BTR through exposure in their growing offshore portfolios. For example, Rest Superannuation has an interest in around 3,000 BTR apartments in the US through global operator Greystar (AFR, 31/08/2017). This exposure to the sector, which did not exist in previous cycles, will also greatly assist in developing the sector in Australia.

Internationally, analysis of the US, Japan and the UK shows that BTR residential has broadly delivered comparable returns to other sectors over the past decade, particularly on a risk-adjusted basis. US performance data (Figure 5) shows that despite the GFC being a housing-driven downturn and impacting on residential values significantly in the US, there was a counter-cyclical income boost in the BTR sector as more people moved into the rental market. This is also consistent with the Australian experience where rental vacancy fell and rental growth accelerated post-2007.

Figure 5: US Real Estate Total Returns



Source: NCREIF, JLL Research

The potentially counter-cyclical nature of BTR performance theoretically offers some portfolio diversification benefits. Further, it is capital growth that drives much of the volatility in total returns and from a purely income perspective, BTR can provide greater stability of returns. This is particularly the case relative to office markets, but the increasing prevalence of incentives in industrial and retail markets has added more volatility in true effective rents in these markets as well.

Longer-term, there is evidence that residential rents in Australia have exceeded inflation and this ability to achieve some 'real' rental growth is also a key attraction for some investor interested in the BTR sector.

What might BTR mean for the broader residential market?

Considering all these factors on the tenant and investor side, we do believe that the BTR sector will gain traction in Australia over the next decade. What impact the sector might have on the broader market is ambiguous, but below we have outlined a few potential impacts:

- **BTR may help drive rental growth long term** – at present the average residential investor only owns around 1.4 properties, so investors are likely to be highly negotiable in rental negotiations. Institutional investors will find vacancy risk much easier to manage across their portfolios, so may be willing to trade off some short term vacancy against longer term cash flow;
- **Tenant amenity becomes an even bigger source of competition** – while this is already occurring to some extent in the 'build-to-sell' market, BTR could lift the bar again on amenity and service and the loser is likely to be smaller, older stock where landlords cannot offer the same services to renters;
- **BTR could attract retail investors away from build-to-sell** – a REIT structure giving preferential treatment to tenants and offering portfolio diversification could prove very attractive for younger generations who wish to trade-off inner city living against direct exposure to the residential sector through s securitised vehicle;
- **BTR could help boost some retail shopping centre performance** – by creating extra income and demand for retail tenants while allowing the centre owner to maintain control of the asset;
- **It could help in addressing housing affordability** – while likely not a 'silver bullet', government incentives to improve the feasibility of BTR for social and affordable housing schemes may assist in addressing this complex issue. At a broader level, if private sector investment in housing does wane as investors re-assess future post-tax return expectations, then BTR may prove critical in replacing private investment with institutional investment to ensure continued growth in the availability of rented accommodation in the face of expected strong growth in rental demand.

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