Build-to-rent: Australian market insights

October 2023

Frontier Advisors

One step forward, two steps back

A snapshot of key constraints to BTR

Frontier has been covering the build-to-rent (BTR) sector over the past five years – back to when it was in its infancy. Had governments taken strong decisive steps sooner, the sector might be more mature than it is today.

Much has been published about the need for housing, the supply and demand imbalance in this sector, and of housing unaffordability. In this paper, we share persistent, ongoing challenges faced by the managers/developers we monitor in this emerging sector and some of the key bottlenecks impeding meaningful progress.

Policy

Planning inconsistencies

Design

Attracting institutional capital

Institutional investors value certainty, consistency, reliable collaboration from all levels of government.

The housing sector (particularly BTR) is facing a number of headwinds:

- Land is in short supply in attractive areas near places of employment.
- Labour shortages – employee costs have surged by 14 percent.*
- Persistently high inflation and borrowing costs are impacting investment returns.
- Developers reportedly are finding it difficult to attract builders and may have to restructure risks and profitability.*
- Housing demand is expected to surge in Sydney, Melbourne, Brisbane and Adelaide with an aggregate of two million people added by 2041.*
- Innovation in building practices of residential accommodation must become a priority as existing practices are protracted, can take up to two years and are labour-intensive. Innovative policies for housing on construction and materials and design, including mass-manufactured ‘cross-laminated timber’, lead to quicker construction timeframes, better labour solutions and climate-friendly outcomes as has been shown in Europe and the US.

At a recent Financial Review Energy & Climate Summit, Vik Bansal, CEO of Boral stated, “the stuttering energy transition is forcing big industrial companies like Boral to temporarily shut down cement production to avoid peak electricity prices, putting at risk the nation’s build-out of housing and infrastructure stock.” He expanded he was “extremely nervous government plans to build housing, hospitals and even infrastructure for the Brisbane Olympic Games were vulnerable to an energy market that was at times incentivising the nation’s biggest cement maker to down tools.”

*Source: PEXA/Informed Decisions

BTR policy

Policy takes one step forward, and two steps back

Despite market-wide consultation over the past few years, market participants think the pace of change has been less than satisfactory and flawed.

- One step forward – the Federal Government's commitment to new housing in the form of the Housing Australia Future Fund (HAFF) was finally passed in September 2023. A $10 billion fund is estimated to generate $500 million each year to create social housing.
- Two steps back:
  - Managed Investment Trusts (MIT) withholding tax: Foreign investors are liable for a 30% impost. Treasury recently proposed a reduction to 15% following intense lobbying by the Property Council of Australia (PCA) and market participants. This is yet to be approved. This is at odds with other sectors such as Office and Retail (10%). With housing being so critically undersupplied, there is widespread consensus that BTR should at least be on an equal footing to incentivise investment.
  - Thin Capitalisation (Thin Cap) legislation: *Treasury Laws Amendment (Making Multinationals Pay Their Fair Share – Integrity and Transparency) Bill 2023* is in consultation stage. Essentially, the Federal Government is seeking to address risks to Australia's domestic tax base stemming from the use of excessive debt deductions by foreign multinationals. Offshore capital has historically been vital as first-movers globally. The fledgling BTR sector in Australia is predominantly seeded by foreign capital at this time. Thin Cap is likely to deter the very supporters who kick-start the sector by providing significant capital in the form of equity or debt. It is also likely to impinge on investment returns.

In monitoring various offshore residential initiatives, we found Canada's housing crisis exhibits similar parallels to Australia's dilemma, but lessons can be learned from Canada's proposed national housing strategy. 'The National Housing Accord – A Multi-Sector Approach to Ending Canada's Rental Housing Crisis' addresses a series of recommendations to unblock bottlenecks, innovate residential building practices and deliver two million purpose-built rental units between 2024 and 2030 (Canadian Mortgage and Housing Corporation).

The report makes a bold but unsurprising recommendation: "The Federal Government must create the conditions for the market using policy levers." It calls for all levels of government, builders, developers, and the higher education sector to share data, coordinate their actions and hold each other accountable.

BTR in policy and planning approvals

Policy and planning inconsistencies between federal and state governments

Uncertainty of planning regimes, dispensations and unclear expectations are consistently cited as a major hurdle.

- Land tax concessions are available in some, but not all states. NSW offers an exemption of 50% of surcharge purchaser duty until 2040.
- Time lost in the planning approval process directly impacts development and construction underwriting outcomes. For example, a six-to-twelve-month delay in achieving planning approval could add a material financial impost.
  - Construction cost is one of the biggest hurdles to timely development. Prolonged planning approval timeframes run the risk of volatility in pricing and reliable labour supply.
- Land availability in critical locations that are rich in transportation hubs, amenities such as schools, shopping destinations and leisure is severely low. Limited supply and high competition for land in suitable locations (for example in inner Melbourne) are also contributing to the cost of production.

The property industry and PCA have lobbied the Victorian Government for the following improvements to expedite development in the BTR sector:

- Exemptions from *Foreign Purchaser Additional Duty* and the *Absentee Owner Surcharge* through development phase (September 2018).
- Land tax concessions (50 percent) for eligible projects to 2040.

Addressing numerous barriers in the form of policy and planning is critical to ramping-up investment metrics and attracting capital.

BTR design

Lack of consistent and adequate definitions of BTR for design purposes

Premises for rent require some unique features unlike single homes for rent and other property sectors such as Office and Retail. Currently, there are no bespoke design guidelines at any state or municipal level. At the very least, market participants think the sector should be treated no differently from traditional sectors by explicitly allowing for this in building design.

BTR is expected to be under a single ownership (institutional investors) for a long-term hold. No Australian jurisdiction currently defines BTR in legislation. Positively, many states have established working groups that include market participants with domestic and foreign representatives – the latter are global investors with a long and established track record in BTR.

Examples of how BTR is defined at various state levels

- The Queensland Treasury in its procurement documentation for its BTR pilot project has identified BTR as:

  'Build-to-Rent is typically characterised by large scale developments with a single owner, held as a single asset for the long-term investment horizon, with a focus on tenancy management and tenant experience and satisfaction.' (Source: Qld Treasury, December 2018).

- In Victoria, the BTR Standing Advisory Committee (which provides recommendations to the Minister for Planning regarding planning permit applications under a BTR model) defines BTR as:

  'For the purposes of this Committee, 'Build-to-rent' development is defined as an apartment development or other multi-dwelling housing development and any associated ancillary uses, in which a substantial number of dwelling units is held within a single ownership, operated by a single management entity and offered for long term private rent.' (Source: planning.vic.gov.au).

BTR financial barriers

While federal and state governments aspire to attract superannuation capital, investment metrics must be improved:

- Yields to make BTR attractive relative to other investment opportunities.
- State and local government levers by way of incentives, exemptions, ease of planning and design guidelines through various stages of construction and stabilisation are essential, as demonstrated by the Victorian State Government's own modelling (shown below).
- Current BTR projects underwriting typically forecast an income yield of four to six percent and a stabilised IRR of 12%+ (ungeared, pre fees). These returns vary from state to state, depending on cost of land and incentives. Additionally, mangers forecast rent premiums from 15% to 30% for BTR.

Chart 1: Ten-year IRR ungeared waterfall (foreign capital)

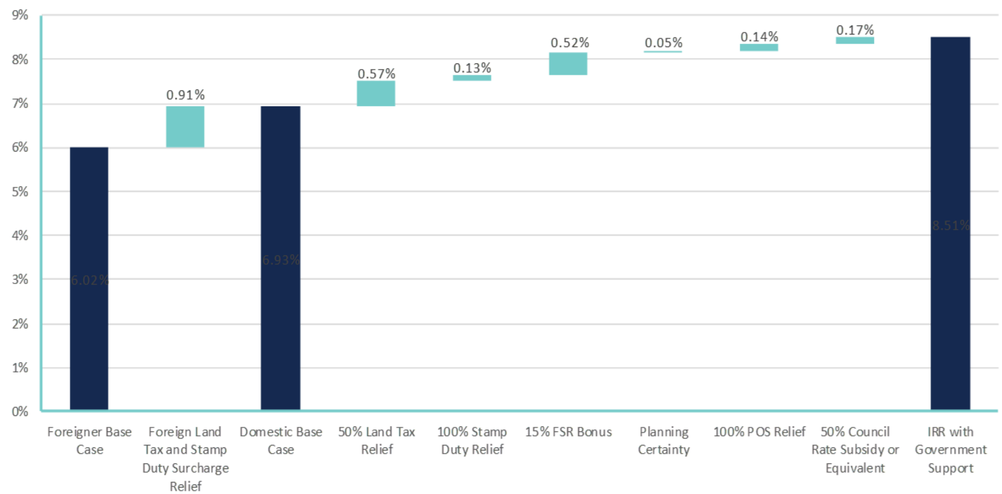


Table 1: Scenario analysis using government incentives

1	Base	1	2	3	4	5	6
	No Government Support	*Land Tax*	*Land Tax + Stamp Duty+ FSR Bonus*	*LT + SD + FSR + Subsidy*	*LT + SD + FSR + POS*	*LT + SD + FSR*	*Land Tax + FSR*
Land Tax Discount	0%	100%	75%	50%	50%	50%	50%
Stamp Duty Relief	0%	0%	100%	100%	100%	100%	0%
FSR Bonus	0%	0%	15%	15%	15%	20%	30%
Planning Certainty	×	✓	✓	✓	✓	✓	✓
Council Rate Subsidy	0%	0%	0%	50%	0%	0%	0%
Public Open Space Relief	0%	0%	0%	0%	100%	0%	0%
YOC	**4.08%**	4.49%	4.55%	4.52%	4.51%	4.50%	4.53%
IRR Ungeared (10 Year)	**6.84%**	8.07%	8.40%	8.32%	8.28%	8.29%	8.45%
IRR Geared (10 Year)	**7.87%**	9.48%	9.91%	9.81%	9.75%	9.77%	9.98%
Verdict	×	✓	✓	✓	✓	✓	✓

1. Scenarios assume the base unit mix. Functionality for sensitising the unit mix is built into the model.

Source: Victoria State Government – Treasury and Finance BTR Working Group

The final word

In our May 2021 paper on BTR, Frontier observed:

- The BTR sector in Australia is in its nascency compared to other developed international markets and housing is not a meaningful allocation in institutional real estate portfolios.
- There are a series of challenges to developing an Australian portfolio:
  - The capital gains tax discount of 50% available to individuals is not available for institutional investors.
  - Institutional investors cannot claim mortgage costs against residential assets as can individual investors (negative gearing).
  - Land tax and stamp duty frameworks are state and territory controlled and overall, disincentivise large scale investors. Land tax is assessed on the whole of the holding in BTR and cannot be passed on to renters.
  - GST in BTR cannot be claimed on construction costs, property management and other inputs.

In our April 2022 paper on BTR, Frontier observed:

- The most significant impact is that of land tax, according to a number of managers we surveyed.
- Federal MIT tax for foreign investors to 15% related to the Australian BTR. Foreign investors continue to play an important role as early movers. Offshore operators such as Sentinel, Oxford Properties and Greystar continue to make inroads in the Australian BTR sector, with local managers continuing to develop and deliver their project pipelines.
- The cultural challenges of renting and paying premiums for facilities such as those offered in North America, UK, and some Asian cities, remain. Pleasingly, some strategies embrace the concept of mixed-use hubs with over-station locations and developments, adjoining local supermarkets and additional thought around precinct activations, delivering further value to occupants. Frontier expects the BTR sector will evolve as an institutional product over the next five to ten years.
- Demographic drivers, coupled with supply/ demand dynamics present a strong case for the sector as well as the ability to incorporate sustainable and social outcomes into new developments.

Our key takeaway

We believe the Federal Government must create better policy levers in conjunction with state governments. Expedited tax reform is essential for attractive risk-adjusted returns which will appeal to institutional capital. Innovative policies for housing on construction and materials and design, including mass-manufactured ‘cross-laminated timber’, lead to quicker construction timeframes, better labour solutions and climate-friendly outcomes as has been shown in Europe and the US.

Institutional investors value certainty, consistency and attractive returns relative to other options. BTR in its current state presents unpredictable outcomes.

We continue to monitor the sector and identify compelling strategies for clients. We are happy to chat with clients as we progress our research.

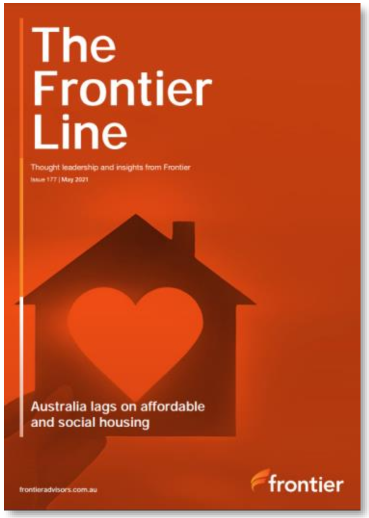
Frontier's thematic property research papers

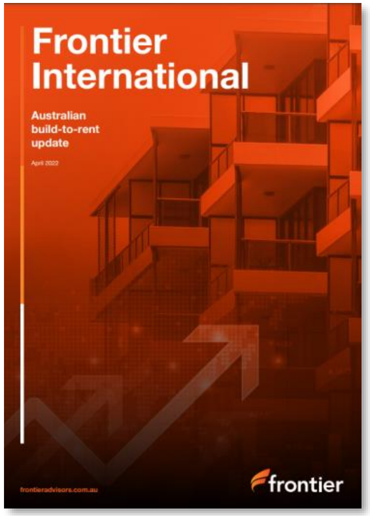
Best in class research providing investment views on emerging and existing investment thematics

Since 2019, Frontier's Real Assets Team has authored several research papers on thematics such as the Australian build-to-rent housing sector and Australian private market investment opportunities.

Want to learn more?

Frontier has undertaken extensive research on Australian build-to-rent and is well placed to advise investors on this theme. We encourage investors to reach out to Frontier's Real Assets Team for a discussion on how we may be able to help.





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