DECEMBER 2018

Is Australia Ready to Rent and Roll?

Build to Rent: The Emergence of a New Real Estate Asset Class

Highlights

- Media and property industry groups are buzzing with the hype surrounding build to rent and the asset class's perception as a solution to the growing affordable housing shortage.
- Unfavourable taxation treatment and unnecessarily restrictive planning regulations have created a hostile environment for Build to Rent (BTR) to blossom and transform the Australian landscape.
- Much of the growth of the asset class hinges on tax reforms and investor appetite as the demand is unquestionable with more than a third of Australians now renting and housing affordability forever being on a downward spiral.
- Perhaps the greatest hurdle that BTR projects must overcome is financial viability. Performance indicators such as project internal rate of return will always place BTR a distant second to a for sale development. Australian REITs will generally pursue a BTR project in an environment where selling off the plan has proved to be unsuccessful.
- The BTR market has immense potential to scale should current tax and planning hurdles be overcome, with a very conservative market value of $40 billion equating to less than 1% of all Australia's residential housing stock.
- BTR is unlikely to grow in the short term as the term bipartisan appears to be a foreign concept in Canberra, but in the medium to long term, market demand stemming from Millennials and their preferences for convenience, urban living and smaller, more affordable spaces will ultimately drive the sector.

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Introduction

The Build to Rent (BTR) asset class has become a significant part of institutional investors' portfolios in many global markets. In the US, BTR represents a whopping 25% of the total NCREIF Property Index and is second only to office for total market value. Interestingly, despite BTR's presence in the US and other global markets, the asset class in Australia practically does not exist!

In this paper, we explore the likelihood of BTR becoming an established asset class in light of the current political, legal, and economic conditions steering the direction of the market.

What is Build to Rent?

BTR is a widely interpreted term, which is unsurprising given the various stakeholders in the industry such as developers, investment managers, bankers, architects and local authorities. Arriving at an agreed definition is further complicated as a result of geographic differences, where BTR is known by various names around the world. For example, in the U.S. and Canada, the term BTR is referred to as Multi-Family Residential while in the UK the term is more commonly referred to as Private Rented Sector housing.

Trident Real Estate Capital defines Build to Rent as an asset class that meets the following criteria:

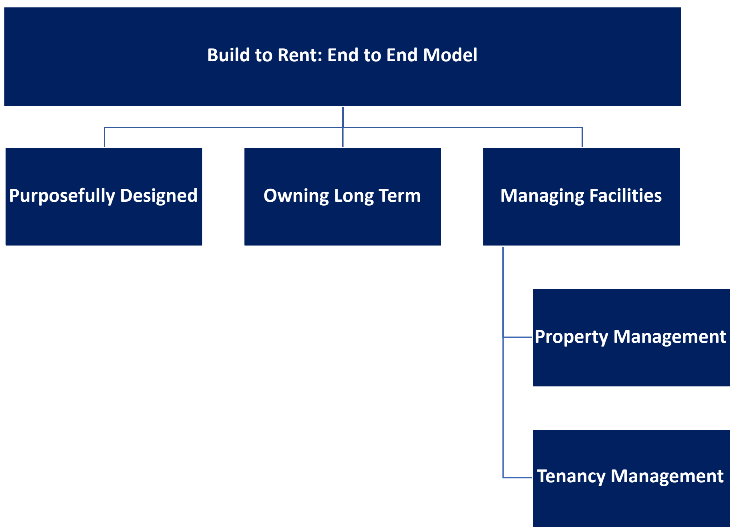
1. Purposefully designed: The asset is designed, constructed and delivered with a primary intention of holding the investment for the long term, rather than sale;

2. Single control and management: The asset must be under single control and management. This does not mean that that the asset must be owned by a single owner, quite to the contrary, the asset may be owned by a trust or a number of investors, however, the owners vest the control and management of the BTR asset in a single entity; and

3. Long term rental return: The business model's return for BTR is focused on deriving a long-term rental return. Accordingly, the capitalised value of the future rental scheme is the financial metric for measuring return without taking into account any potential future capital gains.

The following is a diagrammatic representation that has been adopted in many instances worldwide and represents the simplest model of BTR where an institution constructs, owns, operates and manages the asset.

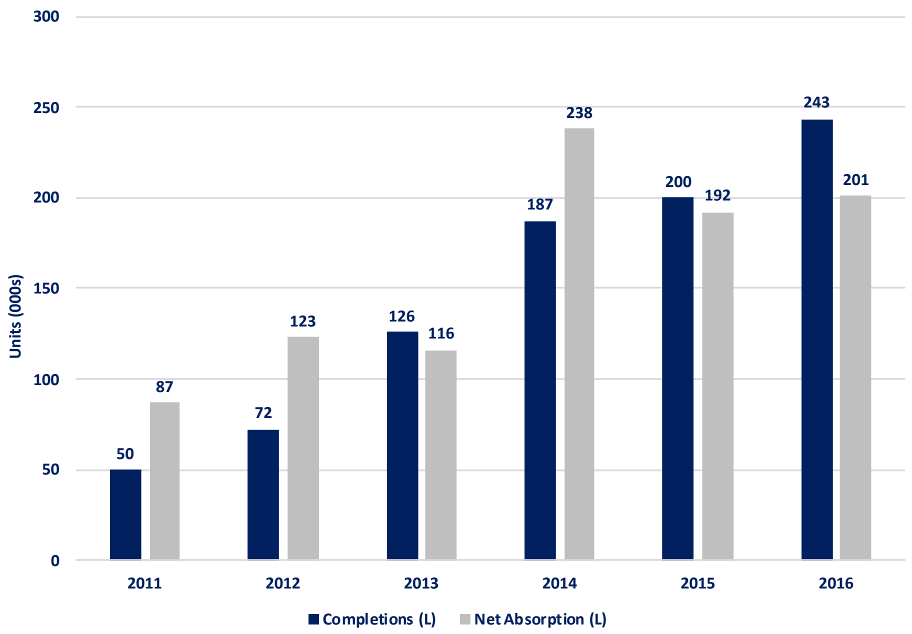
Figure 1. Build to Rent End-to-End Model. Source: Jones Lang LaSalle (JLL)



Why Build to Rent Is Becoming an Increasingly Attractive Asset Class

In markets like the US, Multi-Family Residential has become a very mature asset class and a significant part of institutional real estate portfolios. According to CBRE, in the US 25 years ago, multifamily assets represented only 11% of the NCREIF Property Index; retail, office and industrial all had substantially higher market shares. Today, the multifamily sector represents a significant 25% of the total and is second only to office for total market value. This overall success is largely made possible by the preferential mortgage market and readily available debt capital. Loan terms, leverage and pricing are more favourable for multifamily than other asset classes. This is partly as a result of multifamily benefiting from US government backed lending programmes such as Freddie Mac, Fannie Mae and the Federal Housing Administration. Typical loan to value ratios are in the 50-75% range and given the liquidity injected by government sponsored enterprises, average pricing is almost 30bps lower than other property types.[1] The US government, unlike our politicians in Canberra, has realised how instrumental multifamily has become, how it has provided accommodation for key workers within key city locations as well as accommodating rental demand for the whole spectrum of income levels.

Figure 2. US Multi-Family Completions and Net Absorptions 2011-2016. Source: CBRE

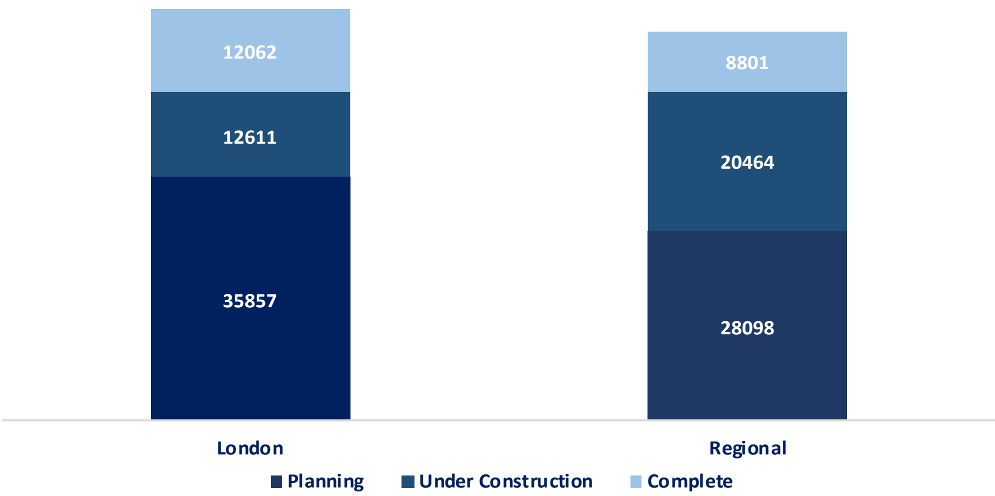


In the UK, the BTR sector is growing rapidly. According to the British Property Federation, 25,655 BTR units have been built, and 106,190 more units are either in planning or under construction.[2] Both local and national governments have recognised the benefits that BTR has to offer as a means of increasing the supply of high-quality housing in the UK. The Government Housing White Paper[3] released in February 2017 allowed for changing planning rules so councils could proactively plan for more BTR homes where there is a need, making it easier for BTR developers to offer affordable private rent in place of other types of affordable home. Furthermore, the draft New London Plan sets out a different approach to assessing the viability of BTR developments opening up a Fast Track Route - bypassing costly and protracted viability negotiations that have become the norm for applications in London through the planning system.

1 CBRE. "US Multifamily Housing: A Primer for Offshore Investors." CBRE, 2017, US Multifamily Housing: A Primer for Offshore Investors.
2 Fletcher and Stephanie Pollitt. "BPF Build to Rent Map of the UK." British Property Federation (BPF), 2018, www.bpf.org.uk/what-we-do/bpf-build-rent-map-uk.
3 Department for Communities and Local Government. "Fixing Our Broken Housing Market." Department for Communities and Local Government, 2017, Fixing Our Broken Housing Market.

The growth of BTR has also been rapid outside of the US and UK. Luxembourg-based real estate investment manager, Corestate Capital Holding, has recently invested AUD $1.5 billion of equity and debt in the co-living sector for the development of 35 co-living properties across Europe. The co-living properties will provide up to 6,000 units with communal kitchens, bathrooms and living areas.

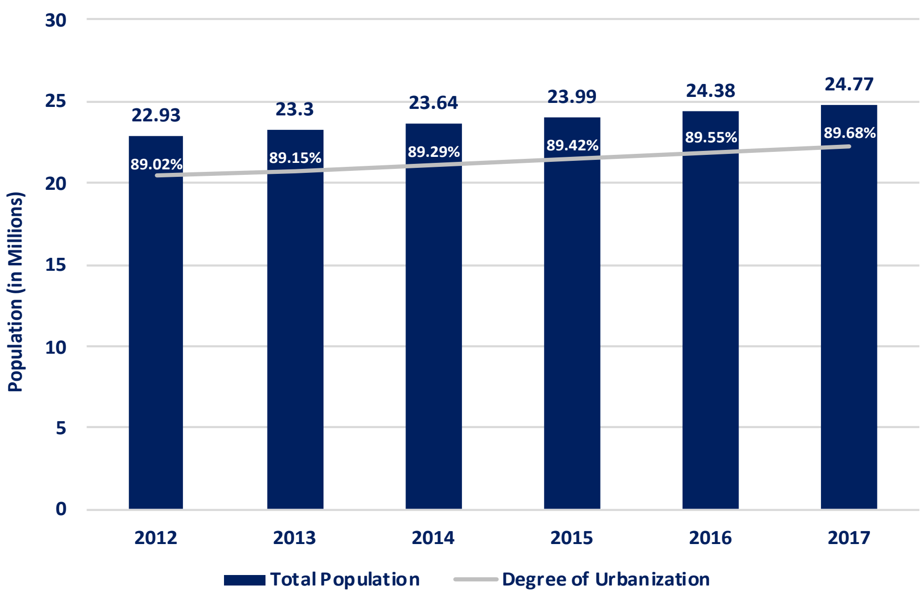
Figure 3. Build to Rent in the United Kingdom. Source: British Property Federation



BTR has become an attractive asset class for institutional investors for the following reasons:

1. Urbanisation: The world is becoming more urban. According to the UN, in 2018, 55 % of the world's population reside in urban areas.[4] According to the World Bank in Australia 89.6% of the country's population is urbanised. This combined with Australia's growing population (around 1.6% per annum) means that Australia's larger cities are growing quickly and densification is here to stay;

Figure 4. Total Population and Degree of Urbanisation in Australia 2012-2017. Source: Statista



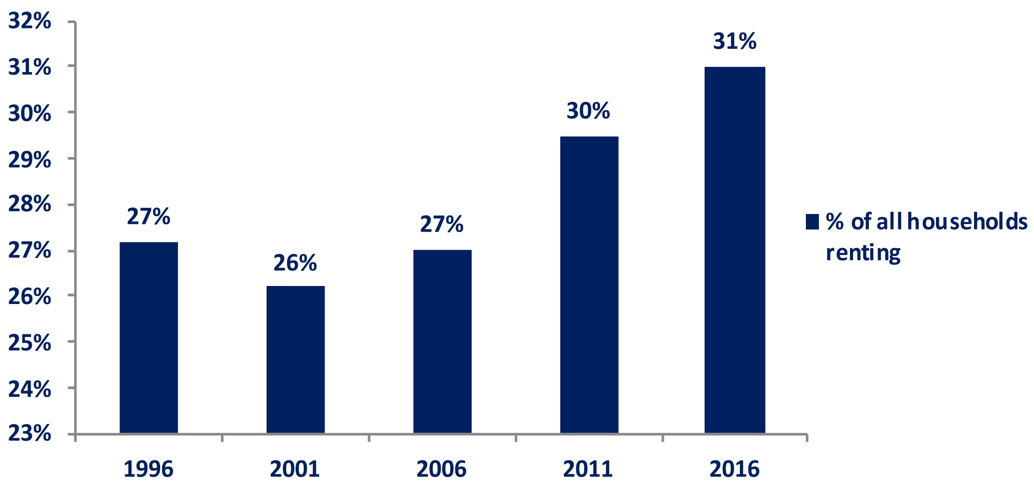
4 United Nations. "World Urbanization Prospects: The 2018 Revision." United Nations, 2018, World Urbanization Prospects: The 2018 Revision

2. Single family tract housing is outdated: The old model of producing single family tract housing on green fields in the outer suburbs is no longer sustainable. The future of housing, by necessity and preference, will need to be more dense and urban;

3. Millennials and Generation Z: The behaviour, attitudes and housing preferences of Millennials and Generation Z, have changed. Millennials and post-Millennials delay marriage, children and owning a home longer than previous generations. They care about proximity to amenity retail, restaurants and culture. They want instant gratification to live, work and play in close proximity. The principle of owning a home, which is fundamentally Australian, has now been shaken by the new generations, who are prioritising convenience and trendy inner city living over home ownership.

4. Exponential rise of house prices relative to wage growth: Housing prices have risen exponentially relative to median wage growth, rendering home ownership evermore unlikely. This appears to be a trend common in many developed countries. For example, since January 2000 on the West Coast of the US home prices have risen by more than 100%. According to CoreLogic, since January 2009, the median dwelling price in Sydney has surged by 113.7%. Unsurprisingly home ownership rates are trending downwards, with the national rates in the US and Australia currently sitting at 65%. In younger generations the rate of decline in home ownership is even more pronounced with only 45% of 25 to 35 year-olds owning a home, down a dramatic 16% from the 1980s. Close to a third of Australians already rent:

Figure 5. Proportion of Australian Households Renting. Source: JLL



In addition to the healthy demand and demographic drivers, institutional investors are drawn to BTR for the following reasons:

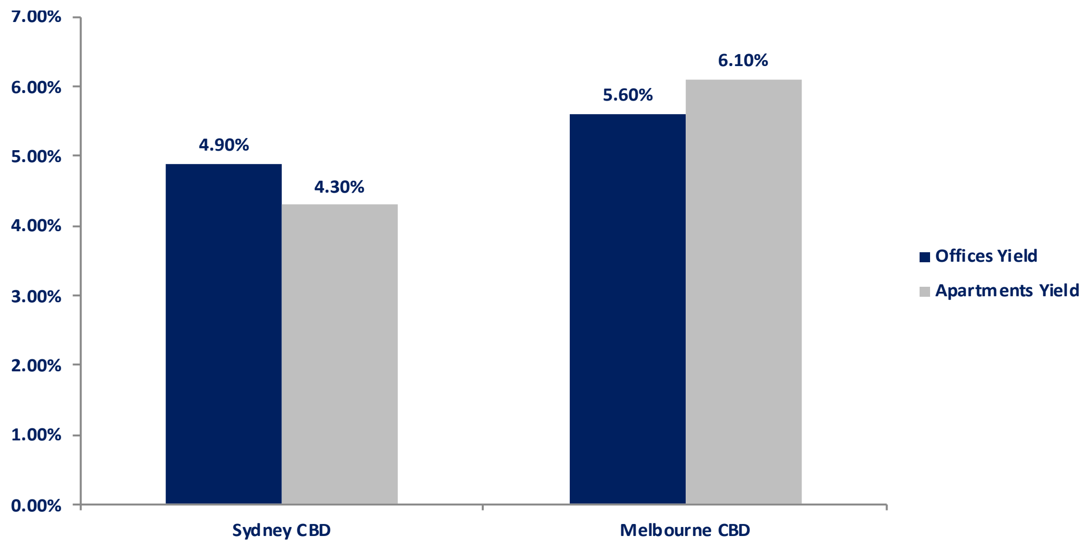
- Steady and predictable cash flows: BTR sector offers very steady and predictable cash flows and opens up diversification benefits, since the returns from the BTR sector are significantly less correlated to the traditional asset classes;

- Risk reduction: BTR is made up of a large number of leases over small spaces, credit risk is well spread across many leases and lease holders. Tenant portfolio default risk is therefore significantly reduced;

- Convergence of commercial and residential yields: As commercial yields compress and residential yields grow, BTR returns become more attractive. Initial comparisons between these yields are not strictly "like-for-like" as cyclical rent-free incentives for offices can materially affect yield.[5] However, after adjusting for rent-free leasing incentives, Capex, vacancy, and office rental specific factors, the true effective yields are not too far apart.

5 JLL. "Build to Rent Residential: Australia's Missing Sector." JLL Research Australia, 2017, Build to Rent Residential: Australia's Missing Sector.

Figure 6. Gross Effective Rental Yields - Prime Office vs. Residential. Source: EY



- BTR opens new investment opportunity: Australia's superannuation system as of December 2017 had $2.61 trillion funds under management.[6] Too much superannuation money is chasing too little core property in the traditional asset classes, resulting in cap rates compressing to all-time lows. Unsurprisingly, BTR opens up a significant volume of investment opportunity as the risk return equation begins to make more sense;

- BTR is counter cyclical: Multifamily is less impacted by cyclical downturns than other property types. In fact, JLL have described BTR as having a 'counter-cyclical boost' as more people move into the rental market during times of recessions. There is little argument that BTR was the first sector to recover following the GFC and has achieved superior returns (on a risk- adjusted basis) between 2012 and 2016.[7]

- Cooling property market: Market activity has begun cooling with house price growth tumbling in 2018. Off the plan purchases have been significantly impacted by the Royal Commission, lending restrictions, foreign investment restrictions and taxes on foreign investment. Coupling the Royal Commission's changes with the fall of year on year (YoY) demand in NSW by -22.5% and in VIC by -6.1%[8], BTS is now a difficult model.

- Purpose-Built Student Accommodation (PBSA) is a pre-cursor to BTR markets: PBSA is the closest comparable there is to BTR with the exception of its target market and configurations. The performance of PBSA projects like that of UniLodge at Central Park, with 237 professionally managed student apartments in one complex, serves as the pre-cursor to a BTR market given that PBSA encounters similar tax hurdles as those faced by BTR.[9] However, it should be noted that PBSA currently achieves 6-7%[10] yields as a result of the very compact 12 square metres studio configurations and insatiable international demand.

- Low supply of affordable housing: Between 2005 and 2014, over 80% of approvals for new houses and units were for properties above the median house price as returns from affordable housing are lacklustre relative to the other development options.[11]

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6 Australian Prudential Regulation Authority. "APRA Releases Superannuation Statistics for December 2017." Australian Prudential Regulation Authority, Australian Prudential Regulation Authority, Dec. 2017, www.apra.gov.au/media-centre/media-releases/apra-releases-superannuation-statistics-december-2017.

7 CBRE. "US Multifamily Housing: A Primer for Offshore Investors." CBRE, 2017, US Multifamily Housing: A Primer for Offshore Investors.

8 Conisbee, Nerida. "Australian Property Market Report – July 2018." Realestate.com.au, 2018, Australian Property Market Report – July 2018.

9 JLL. "Build to Rent Residential: Australia's Missing Sector." JLL Research Australia, 2017, Build to Rent Residential: Australia's Missing Sector.

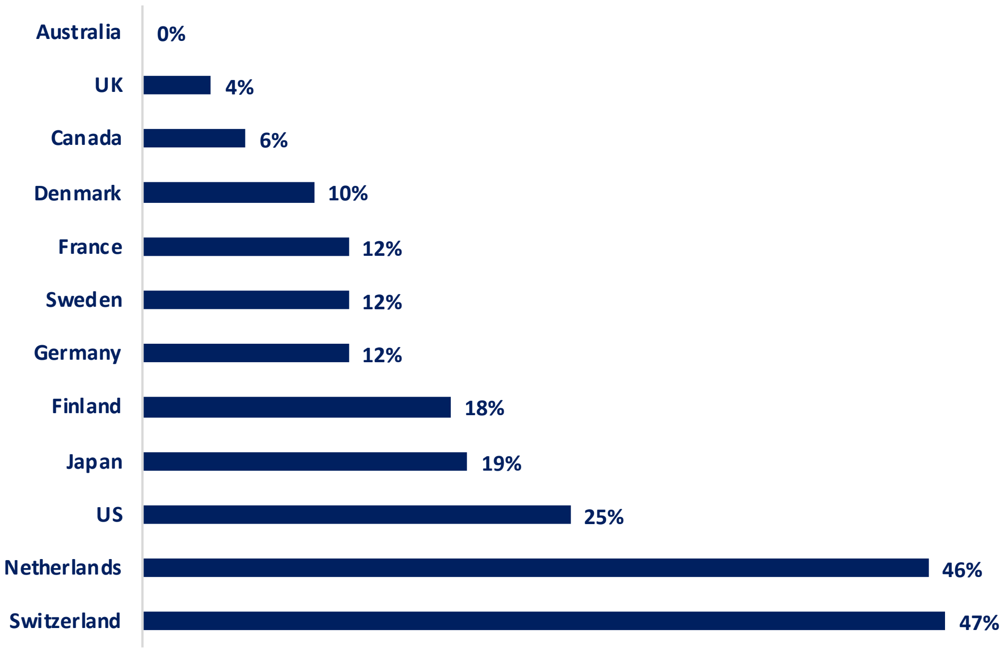
10 Colliers International. "Australian Student Accommodation Research Report."Colliers International, 2016, Australian Student Accommodation Research Report .

11 AHURI. "Does Building More Houses Fix Affordability for Low-Income Households?" Australian Housing and Urban Research Institute, 2017, Does Building More Houses Fix Affordability for Low-Income Households?

Why is Build to Rent Not Taking Off in Australia?

Despite the success and growth of BTR internationally, why does the sector practically not exist in Australia?

Figure 7. Residential as a Percentage of Institutional Real Estate Portfolios. Source: JLL



The short answer is a combination of inter-related factors including: (1) financial viability , (2) unfavourable taxation treatment (3) restrictive planning regulations, and (4) and the lack of Government policy support.

Financial Viability

Perhaps the greatest hurdle that BTR must overcome is financial viability. Performance indicators such as project internal rate of return will always place BTR a distant second to a for sale development. For a typical build to sell (BTS) project, a developer will establish likely income from the final product, known as gross sales revenue, and deduct all development costs and apply a target development margin to establish the residual land value which equates to the purchase price. BTR developers are at a disadvantage because the gross realisation value of a rental scheme is based on a 'cap rate'. It is the capitalisation of the net return/future rental stream achieved from the property without taking account of any potential future capital gains. This net yield-based figure for BTR, which Mirvac has forecasted to equate to 4.5% per annum[12], is significantly less than what a for-sale scheme would achieve (circa 15%-25%) , partly because capital is not being tied up for extensive periods of time and partly because of the high leverage permissible in a for sale development allowing equity internal rates of return to increase by multiples.

It is important to understand that a ground up development of a BTR asset has significant risk. All the relevant risks associated with construction remain pertinent including planning risks, availability and cost of debt, contamination, construction cost blow outs, delays with the programme, leasing risk including occupancy levels, management and operation costs and external shocks such as business cycles, the macroeconomy et al. In light of the various risks, it is unsurprising that developers elect to target projects with a higher net present value and understandable why a 4.5% net yield on a build to rent project is considered an unattractive return!

12 Thompson, Sarah, et al. "Mirvac to Pioneer Build to Rent Sector." Financial Review, Financial Review, 31 Aug. 2017, www.afr.com/street-talk/mirvac-to-pioneer-build-to-rent-sector-20170830-gy6vgb.

Unfavourable Taxation Treatment

Accounting for GST, Stamp Duty, FIRB application fees, and Land tax, a domestic investor incurs around a 12% cost premium upfront, while foreign investors can incur close to a 14% cost premium upfront on the same BTR project, in contrast to a for sale development. The following are the key tax pain points contributing to the leakage in BTR:

- GST: Ordinarily, when developing a project in Australia, a developer is liable for 10% GST on all construction costs. Notwithstanding, residential developers, who are offering BTS projects, claim back the input tax credit recovering the GST cost upon sale. On the other hand, BTR projects generate revenue through rental income, and not sales. The lease of new residential premises is an input taxed supply under Division 129 of the GST Act. Accordingly, the developer of a BTR project is not entitled to claim back the input tax credits on project costs, resulting in a kick in the guts and a 10% premium on the overall cost of the project.[13] Assuming yield on cost (without indirect tax leakages) of a standard BTR project falls between 4-5%[14], the effective yield will be driven down by 0.4-0.5% as a result of the indirect tax leakages, with that figure increasing should yield also increase.

- Operating Expenses: BTR projects retain ownership of the asset. Outgoings including land tax and council rates as well as repairs and maintenance are attributed to one owner rather than distributed across multiple lot owners in a strata scheme. This creates yet another taxation disadvantage as BTR owners are required to pay land tax bills levied annually on increasing land values. It is interesting to note that low cost accommodation and boarding houses are exempt from land tax. This raises interesting policy issues in connection with possible tax exemptions for BTR going forward and policy assistance should local authorities be that way inclined.

Restrictive Planning Regulation

Planning regulations in NSW and Victoria are riddled with complexity while the development approval process is dogged by delays and demands from Council planners. These factors increase costs and design uncertainty which in turn impact the financial viability of the BTR space.

One nasty hurdle that BTR developers struggle with are the requirements in the State Environmental Planning Policy No 65 - Design Quality of Residential Apartment Development (SEPP 65) which stipulate minimum apartment sizes.[15] The US and UK build to rent space has taught us that tenants are not necessarily willing to pay a higher rent for a larger apartment. Unfortunately, the SEPP 65 requires developers to build oversized apartments, that are not designed to meet the rental market demand but instead built to satisfy government design quality criteria.

SEPP 65 also contains provisions that dictate minimum parking requirements. These parking requirements provide for generous parking supply, reducing housing affordability and increasing sprawl. Experience has taught us that a tenant in a BTR space that is well located and in close proximity to public transport in metropolitan Sydney do not value car parking when compared to purchasers of an apartment. Providing car parking often means that developers must excavate and incur considerable substructure costs and unpredictable environmental remediation charges blowing out financial feasibility models for the BTR model. Paradoxically, on 1 June 2018 the NSW Government increased car parking provisions for boarding houses to 0.5 spaces per room.[16] This is more than double the current 0.2 car spaces per boarding room in some areas. By implementing such car parking requirements, the State authorities have unwittingly restricted the development of boarding houses and in turn impacted the development of affordable housing.

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13 Some developers are trying to avoid the inability to claim input tax credits through a buy-to-rent-to-sell model, which allows a developer to claim back the input tax credits on the BTR project costs assum ing the end product is sold within 5 years of operation. It should be noted that where an entity carries out a buy-to-rent-to-sell strategy, this dual purpose to rent and sell will only result in the input tax credits being partly claimable. See GSTR 2009/4 paragraph 25

14 Thompson, Sarah, et al. "Mirvac to Pioneer Build to Rent Sector." Financial Review, Financial Review, 31 Aug. 2017, www.afr.com/street-talk/mirvac-to-pioneer-build-to-rent-sector-20170830-gy6vgb.

15 Objective 4D-1 of the SEPP 65 requires one bedroom, 2 bedroom and 3 bedroom apartments to have a minimum internal area of 50sqm, 70sqm and 90sqm, respectively.

16 See clause 29(2)(e) of the State Environmental Planning Policy (Affordable Rental Housing) 2009

The Lack of Government Policy Support

BTR as an asset class competes with mum-and-dad investors operating buy to let schemes. In fact, BTR is often thought of as larger and more professional version of a mum-and-dad investor buying a single dwelling and renting it out. Unsurprisingly, politicians are reluctant to grant large institutions tax concessions and incentives for BTR projects to proceed. Understandably, such policies will not be popular with the electorate.

In September 2017, then Treasurer Scott Morrison ruled out the use of managed investment trusts (MITs) for BTR projects noting that such investment trusts are to be limited to commercial residential property (such as hotels and motels).[17] Prior to this date, MITs were a vehicle used by institutional investors to invest in at-market residential property and more importantly a structure resulting in only a 15% withholding tax rate. Mr Morrison's new legislation means that institutional investors acquiring build to rent assets would be taxed at the company rate between 27.5% and 30% instead of being taxed at 15% under an MIT ownership structure.[18]

In an attempt to boost GDP, Governments have placed heavy demand on the construction industry in the form of multi-billion dollar infrastructure projects including WestConnex and Sydney Metro. Government has unwittingly made BTR projects more costly to deliver by driving up construction costs, particularly in the structural trades. Adding to the concern, mounting steel and concrete prices stemming from the China – US trade wars, only furthers the risk of an oversized cost blowout on BTR projects. This concern is especially pertinent in NSW, as it leads in the amount of civil works projects being undertaken.[19]

Public Sentiment is Misguided

The current media and public sentiment towards BTR is positive, but faulted, given its heavy association with affordable/social housing.[20] The Minister for Social Housing, Pru Goward, has recently announced NSW's first BTR project in Redfern, deemed the Redfern Community Plus Project, aiming to integrate social housing in with market rental apartments at a respective 30%/70% blend.[21]

This integration of affordable and social housing in BTR is not ideal, and there is good reason for that. Occupants of BTR in the UK and North America generally have above median income and mixing their living space with those of a lower income is challenging. Compared to affordable housing, mainstream BTR buildings have materials and finishes designed for low maintenance and to withstand more abuse, high quality public space, excellent environmental performance and a focus on on-site amenities where residents are spoilt for choice and in some cases enjoy offerings such as concierge, catering services, gym, pool facilities and communal rooftops. In stark contrast, social/affordable housing is generally of lower design quality and amenities are very much subpar relative to pure play BTR developments.

Though most of the developers understand that returns are where the US and UK model of BTR are standing, the Government appears to only support BTR if it provides affordable and social housing. Financially, this impairs the growth of the sector as Government will unlikely provide the necessary tax concessions for the sector to blossom. As it is, the tax landscape and planning regulations surrounding BTR are the main hurdles the sector needs to overcome, specifically the GST and Land Tax consequences of BTR developments as well as the restrictive red tap of our planning system. It is unlikely the sector will advance should the Government not remove the tax disincentives and assist in capitalising the sector. Government appears to be only willing to assist if BTR developments are pepper potted with low-income affordable housing. Unfortunately, investors have traditionally veered away from affordable and social housing as the returns in that sector are very much lacking.

17 Cridland, Matthew. "Build-to-Rent Still Elusive: Australia's Tax Landscape Makes It So Financial Review", Financial Review, 3 July 2018, www.afr.com/real-estate/buildtorent-still-elusive-australias-tax-landscape-makes-it-so-20180703-h125xt.

18 BDO Australia. "Draft Law Includes Increased MIT Withholding Tax Rate for..." BDO Australia, 7 Sept. 2018, www.bdo.com.au/en-au/insights/tax/technical-updates/draft-law-includes-increased-mit-withholding-tax-rate-for-residential-and-agricultural-land-and-new.

19 Heaton, Andrew. "Australian Construction Costs Under Massive Pressure." Sourceable Industry News and Analysis, Sourceable Industry News and Analysis, 13 Mar. 2018, sourceable.net/australian-construction-costs-massive-pressure/.

20 Collinson, Alex. "2018 Real Estate Outlook: The Australian Perspective.". Deloitte Austalia, 2018, 2018 Real Estate Outlook: The Australian Perspective.

21 Property Council of Australia. "Build to Rent a Reality", Property Council of Australia, 27 July 2018, www.propertycouncil.com.au/Web/Content/News/NSW/2018/Build_to_Rent_a_Reality_.aspx.

From an investor perspective, a stable income-generating asset that can weather downturns in the market and hedge inflation is attractive. In recent years, BTS projects have provided much more favourable returns in light of booming housing prices, but as prices retreat and residential rental yields soften, the BTR development strategy is appearing more appealing.

Much of the growth of this sector in Australia hinges on tax reforms and investor appetite as the demand is unquestionable with more than a third of Australians now renting and housing affordability forever being on a downward spiral. That said, the returns for BTR will remain subpar relative to other global BTR markets given Australia's high cost of construction and the complexities and delays arising from Australia's planning regime.

New Build to Rent Development in Australia

Several recent major BTR projects in Australia have heralded the birth of a new sector. The Parklands Project by Grocon in conjunction with UBS Investment Management was Australia's first large-scale institutional grade multifamily project. The $550 million redevelopment of 1252 dwellings includes a mixture of one- and two- bedroom apartments and three-bedroom townhouses which were leased to the Gold Coast 2018 Organising Committee for use as the athletes village for the 2018 Commonwealth Games. Following the games, the development has been refitted into a housing complex open for lease, with the first residents expected to move in next year.

Salta Properties' recent Docklands Tower project is a $330 million redevelopment of 260 units on Latrobe Street in Melbourne's CBD. Salta Properties are also developing a $390 million mixed-use project in Richmond next to the Victoria Gardens shopping which will consist of 426 one to three-bedroom apartments.

Despite these recent projects, there remain significant growth hurdles to overcome before the sector can be said to have the legs to run.

The Future of Build to Rent

In the next 12-24 months, the tax and regulatory hurdles will likely stall BTR sector's growth. The 2017-18 Federal Budget aims to increase the supply of affordable housing in Australia and includes an increased capital gains tax discount for individuals investing in affordable housing, introduces an Affordable Housing MIT, but excludes long-term BTR products from the discount.

Yet, even if MITs were allowed to invest in the BTR sector, the indirect tax leakage places approximately a 12% premium on all BTR projects at minimum, enough to make most BTR projects infeasible. Despite discussions, conferences, and public awareness rising for the BTR sector, GST and land tax regulations are unlikely to change in the short-term.

Policy is driven by public demand, and as the Millennial and iGENs cohort move out of their parents' home, their lifestyle choices will shape the demand in the housing market. Growth of iGENs and Millennials opting to rent instead of purchase will increase as housing affordability decreases and the flexibility of renting becomes more attractive.[22]

Industry groups such as The Property Council of Australia see the BTR sector as a solution to growth in a market downturn and a welcome first step in creating a sector that will deliver high quality rental homes and provide greater security of tenure.[23]

The Labour Party has signalled strong support for the adoption of build-to-rent, pledging to work with the property industry to solve tax related issues surrounded government BTR incentives.[24] The Shadow Treasurer, Chris Bowen, has hinted that draft legislation is in the

22 Savitz, Paul. "Multihousing Tenant & Investor Survey 2018." Knight & Frank, 2018, Multihousing Tenant & Investor Survey 2018.
23 Property Council of Australia. "Build-to-Rent Builds Momentum." Property Council of Australia, Property Council of Australia, 3 Oct. 2018, www.propertycouncil.com.au/Web/Content/News/National/2018/Build-to-rent_builds_momentum.aspx.
24 Greber, Jacob. "Chris Bowen Slams Scott Morrison on Build-to-Rent Delay." Financial Review, Financial Review, 30 May 2018, www.afr.com/news/economy/chris-bowen-slams-scott-morrison-on-buildtorent-delay-20180530-h10qsp

works, and will be put to parliament as soon as it is ready.[25]

The 2018 abrupt downturn in the property market, the tightening of lending practices by the major banks as well as urbanisation and demographic drivers, might just be enough to catalyse a tax and legislative reform in the not too distant future and bring the BTR sector to fruition.

What Will Need to Occur for Build to Rent to be Feasible in Australia?

To understand how the BTR sector can overcome the hurdles it is facing in Australia, we look to the conditions that lead to the proliferation of a BTR market in the United States and in the United Kingdom:

Figure 8. Conditions Leading to BTR Growth.

US (Post GFC)	UK (Post 2012)
• Housing crisis	• Severe undersupply of housing
• Low interest rate environment	• Low housing affordability
• Urbanisation	• Low ownership rates
• Low cost of construction	• Government intervention with a specialised taskforce (Montague Review 2012)
• Restricted lending	• Formation of dedicated BTR fund
• Strong supply of apartments	• Tax concessions granted on BTR
• Advent of 'rent by choice'	• Faster development of BTR than BTS projects as development pace is determined by demand (i.e. sales rate vs. letting rate)

The market reforms required to allow the BTR asset class to establish itself in Australia include:

- Equalisation: Removing the tax disincentives, mainly GST and land tax, should be enough to raise yields to an investable level for developers and investors to move into this space. This will require tax reform at both the federal level (GST), and state level (land tax). As removing GST completely from the equation is unlikely, it has been suggested for input credits to be repaid progressively to reduce inhibitive upfront capital outlay. Though this will not stop the leakage, it reduces the pressure of paying all costs upfront. At a state level, exemptions could be made for foreign purchaser duty and land tax surcharges. Premium land tax doubles for a foreign investor, taking nearly 0.8% of their yield on BTR projects. Without the ~12% premium on development costs, the yield stands to increase significantly, and projects start to appear viable.

- Clarification of MIT policy: Though the government noted that MITs may now also own affordable housing, shadow treasurer Chris Bowen noted that a future Labor government may go further and allow MITs to own residential premises,[26] Provided the high capital intensity of each project, funding is critical for the growth of the sector. However, even if foreign capital was granted access to invest in BTR projects through MITs, the viability of the projects still hinge on changes to tax issues.

- Government funding programs: It has been suggested that the government considers supporting the growth of the BTR sector with further rental subsidies, and even shared ownership. Rental subsidies already exist in forms of welfare programs and would do well to support demand for BTR projects, but the concept of shared ownership is a concept that has yet been explored. In a shared

25 Ibid
26 Cridland, Matthew. "Build-to-Rent Still Elusive: Australia's Tax Landscape Makes It So." Financial Review, Financial Review, 3 July 2018, www.afr.com/real-estate/buildtorent-still-elusive-australias-tax-landscape-makes-it-so-20180703-h125xt.

ownership program, the government retains part of the equity in the home should the low-income earners not be able to afford the entire property, making it easier for them to enter the market.[27] With the federal election in sight, on 16 December 2018 the Australian Labor Party unveiled a plan to boost rental affordability through 15-year subsisidies of $8,500 a year to investors who build new houses, on the condition that the dwelling is leased to eligible tenants at 20% below market rent.

Will Build to Rent be Feasible Without Government Intervention?

As it stands, it appears unlikely the sector will move forward without government intervention, current tax schemes decimate the viability of BTR projects.

A new scheme that has been developed to bridge the gap and to overhaul the conventional off the plan development model has been coined the "Assemble Model". The model leases out a BTR apartment to a family for 5 years with the option to buy the property at the end of the 5 years for a fixed price established at the beginning of the lease. By selling the property before the end of the 5 years, a BTR developer will be able to partially recoup the input tax credits,[28] but at the cost of a fixed sales priced set during the off plan sale period before construction commences. As the property market is expected slump in the short to medium term, guaranteeing a price for the property now can be seen as hedging against the downturn. The "Assemble Model" may be praised for providing incoming residents with rent stability, transparency on price as well as financial coaching and community services to support a path to home ownership . In spite of the apparent benefits of this model for developer and investors, the likelihood of a Millennial to rent the same apartment for 5 years before buying for a fixed price is in our opinion not very probable. The Millennial cohort favour the flexibility associated with renting and a more likely to travel and explore and lease multiple spaces, before finally settling. A Millennial's lifestyle choices and preference for convenience and flexibility would seem to sit at odds with a model that requires 7 years of contractual commitment (2 years of construction plus 5 years of leasing)! Furthermore, the wild swings in property prices that may transpire over such a long extended option period will create heightened settlement risk, as well as other complications including developer default risk, issues arising from Home Building statutory warranties expiring and systematic risks.

Conclusion

New sectors attract investors because of their potential to scale. According to JLL, should Australia's BTR reach a representation of 10% of all institutional investments in real estate, it would equate with a $40 billion market, which is still less than 1% of all Australia's residential housing stock.[29]

In light of the regulatory impediments and uncertainties associated with BTR in Australia, it is difficult to gauge just how big the asset class may become. However, as structural shifts in demand unfold, BTR as an asset class does have the potential to scale, as has been the case for various other BTR markets globally.

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28 Tabet, Ted. "Developer Backs Innovative Build-to-Rent-to-Buy Model." The Urban Developer, The Urban Developer, 5 July 2018, theurbandeveloper.com/articles/competitive-build-to-rent-model-emerges-in-melbourne.

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Is Australia Ready to Rent and Roll?

Build to Rent: the Emergence of a New Real Estate Asset Class

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Our Team

Trident Real Estate Capital is a real estate investment and advisory firm which is active in the Australian commercial and residential property market. We draw upon 30 years of real estate market experience and utilise an advanced suite of property data and analytical tools to provide client tailored specialist real estate advice including market assessments and forecasts, due diligence and location analysis to a variety of corporate, investor and institutional clients.

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