

CUSHMAN & WAKEFIELD

REMOVING THE OBSTACLES TO BTR GROWTH IN AUSTRALIA

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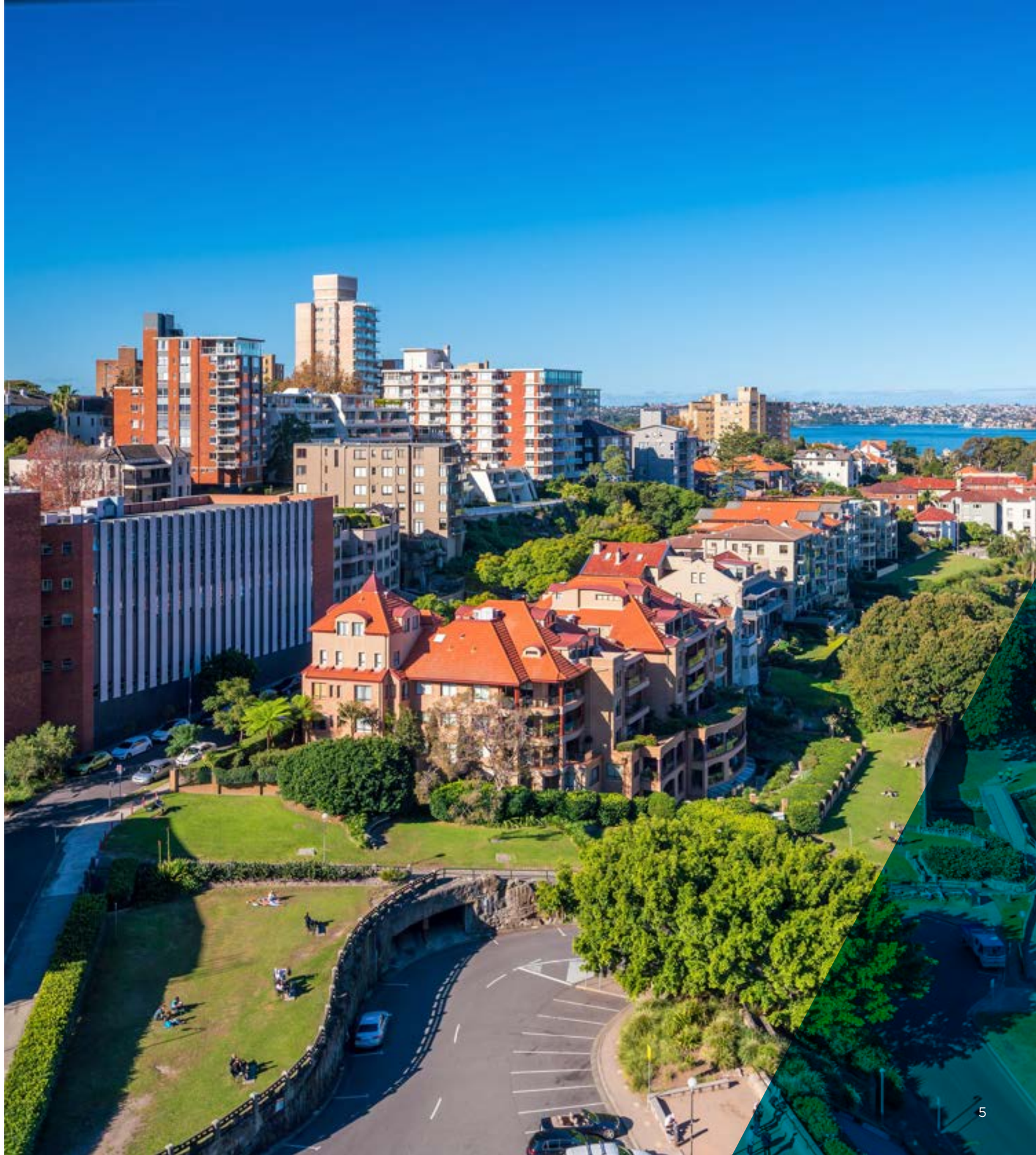
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EXECUTIVE SUMMARY

- Build to Rent (BtR) or Mulit Family properties are a popular institutional asset in many parts of the world. However, while the asset class is growing in Australia, it currently remains relatively small. This paper address some of the hurdles to institutional investment and how they might be overcome.
- National residential vacancy, at 1.1%, highlights the need for more capital to boost supply and ease Australia's housing supply crunch.
- Policies such as negative gearing have compressed residential yields in Australia making the residential sector unfavourable to institutional investors relative to other segments of the commercial real estate market.
- Meanwhile, the inability of BtR to claim GST or MIT concessions, as well as the length of the planning approval process pushes up the required economic rent of BtR projects, a cost burden that is passed on to tenants and reduces mass-market appeal.
- If BtR developments could take advantage of these concessions, we estimate rental premiums would be reduced by ~500 bps increasing the potential tenant pool of a hypothetical BtR development in a Sydney fringe market by more than 20%.
- BtR also needs to be considered as a key pillar to future housing supply in any planning processes; a formal definition as commercial residential would aid this.



THE CASE FOR BTR IN AUSTRALIA

Momentum behind Build-to-Rent (BtR), as it is known locally but globally as "Multifamily", continues to grow in Australia. Across the country, residential vacancy rates at close to historic lows. Data from CoreLogic shows that the national residential vacancy rate declined to 1.2% as at January 2023[1]. The vacancy rate is even tighter when looking at units, having declined to 1.1% nationally.

This is unlikely to change, at least in the near term, given Australia's chronic undersupply of housing and newly reopened borders fuelling population growth and therefore housing demand. Against this backdrop, an institutional presence in Australia's residential market is increasingly being viewed as a necessary force to increase the supply of housing to bring it into balance with demand.



[1] CoreLogic, "Quarterly Rental Review" Australia, Released January 2023

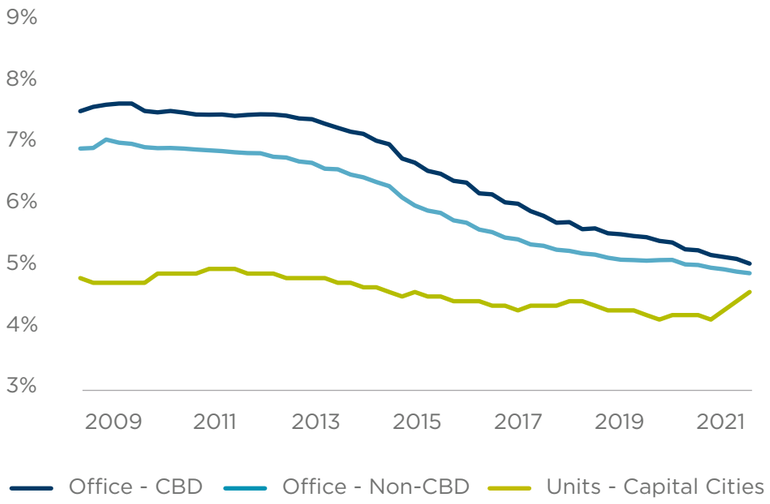
TAXING TIMES

A greater institutional presence in Australia's housing market would undoubtedly help in closing the gap between demand and supply. However, a more pressing question may be why this hasn't already occurred? The main impediment to institutional investment in the Australian residential market has been a taxation structure that suppresses yields in favour of capital growth and thus favours retail over institutional investors.

COMPRESSED YIELDS

One of the main drivers of this has been the tax provision known colloquially as 'negative gearing' and is based on the principle of offsetting investment costs against income. This policy has helped support leveraged investment by retail investors for residential property where capital growth is favoured over income return, thereby helping to limit residential yields at levels generally below that of other asset classes where institutional capital is more heavily deployed.

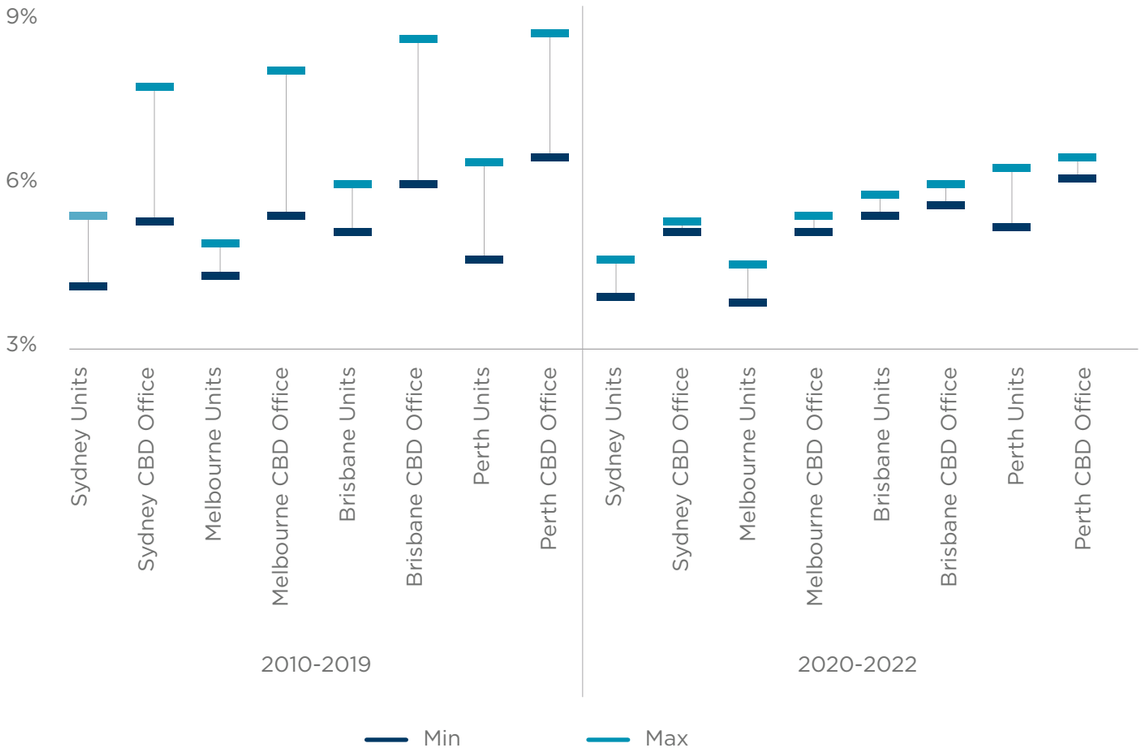
FIGURE 1A
Australian Office, Residential Unit Yields



Source: MSCI, SQM Research, Cushman & Wakefield

The main impediment to institutional investment in the Australian residential market has been a taxation structure that suppresses yields in favour of capital growth and thus favours retail over institutional investors.

FIGURE 1B
Australian Office, Residential Unit Yields



Source: MSCI, SQM Research, Cushman & Wakefield

Yield compression across other sectors of commercial real estate (CRE), as well as the sensitivity of residential prices to interest rates has more recently narrowed the yield gap between residential and offices. Although this has prompted more institutional interest in the residential market, the way that BtR assets are treated in the Australian tax code remains an issue. The main issues being that BtR properties are not currently classified as "commercial residential" assets for tax purposes and that foreign investors are currently not eligible for the Managed Investment Trust (MIT) tax concession that benefits other classes of CRE.

COMMERCIAL RESIDENTIAL

As it currently stands, a commercial residential property includes assets such as hotels, boarding houses and camping grounds, amongst others. The Australian Tax Office (ATO) defines commercial residential properties as having the following characteristics:

- The property is operated on a commercial basis or in a business-like manner.
- The property has the capacity to provide accommodation to several unrelated guests or residents at once, either in separate rooms or in a dormitory.
- Accommodation is offered to the public or a segment of the public.
- The main purpose of the property is providing accommodation.
- There is central management to accept reservations, allocate rooms and arrange services for guest.
- The operator of the property supplies accommodation in their own right, for example not as an agent.
- Management provides or arranges services and facilities for guests.
- Occupants usually have the status of guests.

BtR fulfills most of these requirements, though tenants are not usually referred to as guests. The advantage of being classified as a commercial residential premise is that BtR operators would be able to claim GST (goods and Services Tax) credits on the purchase price and be eligible for a concessionary GST rate. These benefits can then can be passed onto the wider housing market by lowering asking rents, while still maintaining the required returns of institutional investors.

MANAGED INVESTMENT TRUSTS

The other major tax issue being faced by potential BtR investors is that the sector does not qualify for the MIT concessions enjoyed by other classes of Australian CRE, which has limited foreign investment into Australian BtR projects. If BtR was granted the same MIT concession as enjoyed by other classes of Australian CRE, it would reduce the withholding tax faced by foreign investors from 30% currently to 15%. Similar to the GST concessions, reducing withholding taxes would reduce the rents required to achieve a suitable return.

An MIT concession would contribute more than just additional capital to Australia's residential market. Foreign operators would bring their experience in operating in more mature BtR markets such as the US or UK. Domestic operators would be able to learn from the lessons that foreign counterparts bring to market allowing for the market to operate more efficiently, known as the 'learning curve' in economics.



GAUGING THE IMPACT

To illustrate the impact of the GST and MIT concessions, we modelled an typical BtR development in a Sydney fringe market such as Alexandria, Waterloo, Zetland etc. The baseline model showed that in order to meet investors' target yield on BtR developments, rents would have to be circa 20% higher than current market rents in these suburbs.[2] This is in line with what has been observed when comparing operating BtR units to market rents; they typically are toward the premium end of the rental market.

However, if GST and MIT concessions are applied to this hypothetical BtR development, the rental premium drops by roughly 500 basis points (bps) so that rents are only circa 15% above market. Roughly 400 bps of this reduction is a result of the GST concession, and 100 bps of the reduction is a result of the MIT concession.

The impact of this reduction would be significant. It would mean that rent on a one bedroom BtR apartment would be 'affordable'[3] for more than 35% of non-family households in these suburbs,[4] versus 30% before the impact of GST rebates and MIT concessions. This would increase the potential market size for this type of development by more than 20%. The impact would be more modest for two-bedroom apartments, but the market size would still increase by an estimated 10%.



[2] This accounts for the existing 50% land tax concession offered by the NSW government. Rents were compared on a per-bedroom basis.

[3] Affordable rents are those that are 30% or less of after-tax income.

[4] According to 2021 census data.





Modelling a standard BtR development in a Sydney Fringe market such as **Alexandria, Waterloo or Zetland.**

Using estimates for land, build and operating costs and using a market target yield and investment horizon, a two-bedroom apartment would need to charge **$840/week in rent.**





To be affordable, a household would need to have a before-tax weekly income of more than **$3,500**

At these rents, a one-bedroom apartment in a BtR development would only be considered affordable to roughly **4,600 of the more than 18,000 households** in these suburbs.





Should a BtR development receive GST and MIT concessions, **rents could be reduced by circa 5%** to still achieve the hurdle rate.

This would increase the number of households that are able to afford these rents by more than **10% to roughly 5,200.**



Model estimates a 360 unit BtR development in Alexandria/Waterloo/Zetland suburbs of Sydney
Estimates $100 million land cost, build cost circa $500,000 per unit
Taxes, duties and rebates as would be applied in NSW
No financing costs, 4-4.5% target IRR
Based on current taxation rates
Incomes assumed to be uniformly distributed across census income bands
Uses median rental data as at November 2022

In less than a decade [following the introduction of the Planning Practice Guidance for BtR] the share of regional BtR units grew to more than 55% of the total stock...



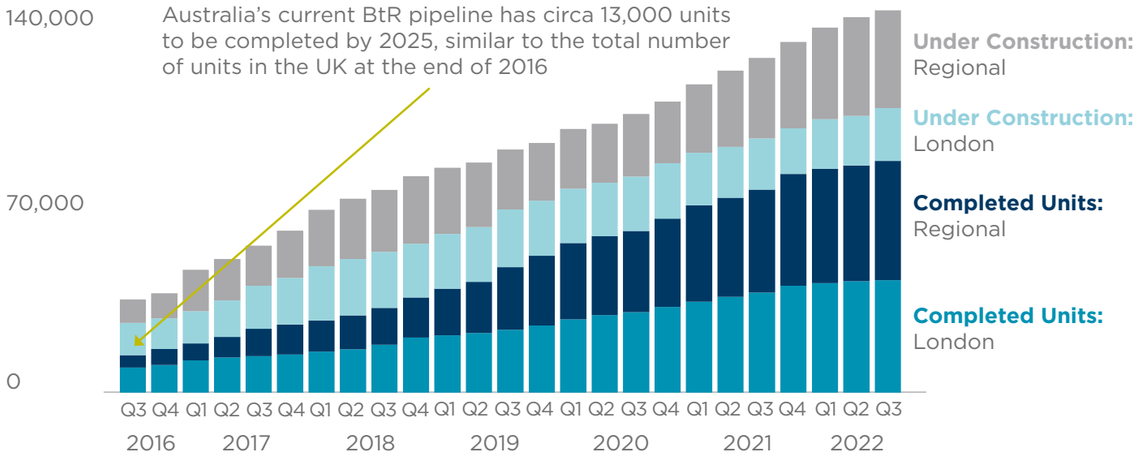
PLANNING MAKES PERFECT

The other issue generally faced by potential BtR developers in Australia is a lack of available land for development. This is, in part, due to a lack of consideration for BtR developments in government's (State and Local) planning instruments. The UK provides a potential resolution to this issue.

THE CASE OF THE UK

The comparisons between the UK and Australian BtR markets are warranted given similar underlying demographics, as well as supply and affordability issues. BtR in the UK is several years ahead of Australia in terms of the supply of units (Figure 2). The Australian pipeline for BtR looks similar to the UK's a decade ago, just prior to a rapid expansion in the supply of BtR units, notwithstanding the differential in population sizes.

FIGURE 2
UK BtR Stock & Pipeline



Source: BPF, Cushman & Wakefield

BtR in the UK was initially focussed on London, and the stock of units in London grew rapidly in the years leading up to 2019. BtR had difficulty gaining any traction outside of London, as of the end of 2016 "regional" BtR units, those units located outside of London, accouwwnted for circa 40% of total stock[5] despite housing more than 85% of the population.

One of the key factors limiting supply outside of London was that BtR as an asset class wasn't being considered in local authorities' planning schemes. As a result, there was a considerable amount of risk (relative to other classes of CRE) for a developer to acquire a parcel of land for a BtR development as there was no certainty regarding if and when the development would be approved.

Motivated in part by a critical housing shortage, the UK introduced the Planning Practice Guidance (PPG) for BtR. The PPG provided a formal definition of BtR and simplified planning requirements, thereby reducing the risk of acquiring land for BtR development and increasing the viability of BtR projects.

[5] Including pipeline.

The PPG looks to have had a significant effect on BtR development outside of London. While the construction pipeline of BtR units in London has more-or-less levelled off since 2018, outside of London the pipeline of development increased more than 20% year-over-year in 2022. In less than a decade the share of regional BtR units grew to more than 55% of the total stock, despite London's share of the UK population increasing over this period.

Similar guidance in Australia could help to increase the provision of BtR projects in Australia, setting it on a UK-type growth trajectory and have a positive impact on housing supply over the next decade. Melbourne is currently the epicentre of BtR in Australia containing roughly two-thirds of total supply. Formal guidance, including designating BtR as commercial residential, could help to spread BtR to other markets across Australia. This is particularly urgent given that vacancy rates are hovering around 1% in most state capitals.

THE PATH FORWARD

BtR has the potential to help ease Australia's housing supply crunch. To do so the following is recommended:

- Defining BtR as a commercial residential property for tax purposes. This would lower the rental premiums of BtR relative to market rents and allow for BtR to be more of a mass-market rather than premium product.
- Increase the provision of land and streamline the planning pathway for BtR development. As planners combat Australia's housing shortage, BtR should be a key pillar of the planning process.

Should these barriers be removed, it would not be unreasonable to expect a UK-style growth path for BtR in Australia, with more than 10% annual growth in the pipeline of products being sustained throughout this decade.





CASE STUDY:

NEW SOUTH WALES BtR DEFINITION

New South Wales (NSW) offers an example of how a clear definition of Build to Rent adapted to suit the market can make a significant impact. In 2021 the NSW Department of Planning and the Environment (DPIE) Housing State Environmental Policy (SEP) formally introduced Build to Rent into state planning policy. Importantly, most BtR developments would be considered 'state significant' developments which would allow them to be approved by the state government rather than individual councils*. This allowed for a uniform definition of BtR to be applied in NSW.

The DPIE received an uptick in interest following the Housing SEP, however, market participants soon identified an issue with the definition that was constraining development. This was that after 15 years a BtR development had to be converted back into a commercial property, which proved to be prohibitively costly for developers.

In response, the DPIE moved quickly to amend the definition so that a BtR development after 15 years could be converted into any approved use; this could be a commercial building but also could be residential, or accommodation such as a serviced apartment or hotel. This made BtR developments feasible for developers.

Following the amendment, the DPIE received a significant uptick in applications for BtR projects, predominantly around the commercial centres of Parramatta and St Leonards. The number of projects in the pipeline has risen to 14; 10 applications for BtR developments are in the 'pre-assessment' phase, a further 3 are currently under assessment by the NSW government, and another has just been approved. This development will add nearly 400 BtR apartments to Parramatta from 2024.

*Note that the exception to this is the City of Sydney, which still has rights to approve significant developments.

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