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International

Global research and insights from Frontier Advisors

Observations from the Real Assets Team

North American Property Research Trip

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ADVISORS

Frontier regularly conducts international research trips to observe and understand more about international trends and to meet and evaluate, first hand, a range of fund managers and products.

In conjunction with insights we share with our Global Investment Research Alliance partners, these observations feed into our extensive international research library.

This report provides a high-level assessment on the key areas and observations unearthed during this recent Real Assets' trip. We would be pleased to meet with you in person to provide further detail on these observations.

AUTHOR

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Jennifer joined Frontier in January 2018 and leads our property research program providing consulting and research for clients, both domestically and globally.

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Frankly my dear…I prefer to rent

Mature in some countries, nascent in others, the residential sector, primarily apartment living (Multi-Family), is increasingly buoyed by two game-changing trends around the globe: urbanisation and demographics which simultaneously provide investors with a menu of challenges and investment opportunities.

In Australia, the residential sector as we know it (Build-to-Rent or BTR) is non-existent in institutional real estate portfolios; however, it has been a growing topical storm in the past two years. Is this about to turn on its axis? The answer may be derived from lessons learned from offshore markets.

In this paper, we look at the mature Multi-Family sector in the US as a harbinger for the Australian market and catalysts of the UK Private Rental sector (PRS), which are essential lessons for Australian Federal and State governments in dealing with housing policy.

The global urbanisation trend is primarily a lifestyle one with Millennials being early adopters of the live-work-play concept integrating work nodes with dining hubs, entertainment, dog walks and open-air spaces in mixed-use precincts. Equally, Baby Boomers expect similar amenities as they head into retirement; however, co-living may mean a different spectrum of needs.

Multi-Family demand drivers are distinctly different from traditional commercial or retail sectors. Apartment demand is linked to population growth and household formations which exhibit relative stability during an economic cycle and even stronger demand in recessionary periods. Increasingly, housing unaffordability is creating a massive push in favour of the sector which, in offshore real estate portfolios, provides a strong diversifier due to its less cyclical characteristics and stable cashflows.

What does this mean for institutional investors wanting to capitalize on a potential secular shift? It is worthwhile examining the sector in geographies with a mature track record, enabled in some ways by governmental policy support.

Typical US high-rise buildings include tight security, rooftop pool and clubhouse, onsite delivery facilities, communal home theatre (watching Sponge Bob while baby-sitting grandkids), onsite dog grooming facilities and parks and medical facilities close at hand.

Source: PlayVista, California - Invesco Core Fund

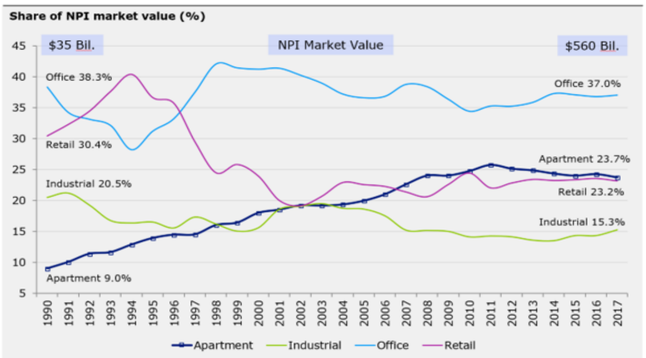
USA: Largest institutional apartment market

The United States rental housing sector is a mature one, evolving in the 1980s and appearing in institutional portfolios dating back to the 1990s.

Rental units now account for about 37% of all housing units, growing from circa 5% thirty years ago. 20-34 year olds represent the primary rental demographic, a cohort that is in the midst of its strongest growth in three decades.

Apartments are an accepted institutional investment sector representing nearly 24% of the industry index (NCREIF-NPI), the second largest property type.

Chart 1: Apartments emergence as an institutional



investment

Source: Investco Real Estate using date from NCREIF as of May 2018

Historically, apartments have maintained higher occupancy and have generated superior Net Operational Income (NOI) growth than traditional sectors (Total Returns: 20-Yr 9.2%; 5-Yr 9.0%; 3-Yr 8.0% and 1-Yr 6.4%)[1]. Only the Industrial/ Warehouse/Logistics and Senior Living sectors outperformed over similar periods.

Investors are attracted to the sector's long-term risk-return characteristics: attractive and stable returns with lower volatility. The sector is very liquid, supported by deep equity and debt markets.

Typical Multi-Family is characterised as apartment living whether Garden style, Mid-Rise or High-Rise. These are specifically built for rental purposes rather than ownership in a condominium block administered by a Home Owners' Association (in Australia referred to as an Owners' Corporation or Strata Association).

Home ownership levels in global cities such as New York and London are low (32.0% and 48.2%, respectively). Conversely, higher home ownership rates in major Australian cities act as a major brake in holding back BTR evolution. The majority of Australians still aspire to own their own house on a block of land. A number of US open-end funds, as well as specialist managers, have a long track record in this space including AEW, Berkshire, CBRE, Greystar, Heitman, Invesco, Lend Lease and Sentinel. Additionally, many private and public pension funds invest in stabilised and Build-to-Core strategies.

Returns: An indicative net yield on entry (stabilised portfolios) is circa 4.5% with 10-year returns of 10% gross and 8% net. Build-to-Core yield on cost is circa 6% providing a healthy yield differential of circa 150bps.The yield spread in Australia is reportedly much less, circa 50bps.

Garden style

Mid-rise

High-rise

1. NCREIF Total Annual Returns (Property-Level) NPI 1998 2Q-2018 1Q; Heitman

UK: Private Rented Sector (PRS)

Government initiatives and policy intervention were the critical lightning rod in the UK. Institutional investors quickly followed.

In the United Kingdom, investors historically owned residential investments, but the introduction of rent controls was the main factor that led to their withdrawal from the market in the 1970s.

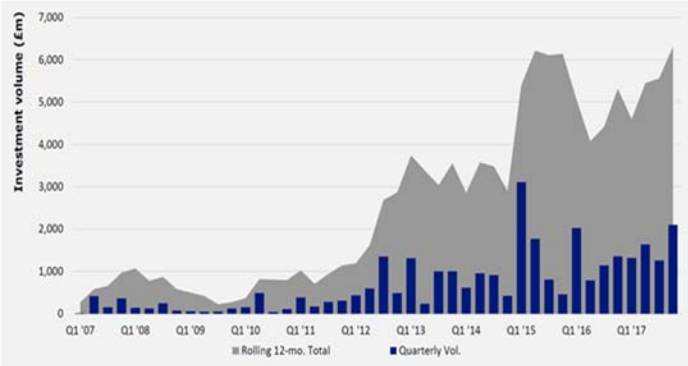
With over 1.8 million households on UK waiting lists for social housing[2], and only 1 per cent of residential stock in the UK owned by institutions (compared with around 10–15% in most European countries), the UK Government enacted "A Housing Strategy for England" in 2011 to provide fairer access to high quality homes including a specific goal to re-ignite PRS and encourage greater institutional investment.

Government initiatives have resulted in swift uptake by institutional capital[3]. Global pension funds reportedly active in UK PRS include the Canadian funds PSP, CPPIB, Ivanhoe Cambridge as well as Washington State, the Dutch funds APG and PGGM, and US players Washington State and Greystar. Several domestic and international funds managers are equally active, some with track records such as L&G, M&G, La Salle Investment Management, Grainger plc, Apache Capital, Invesco to name a few.

In recent times, median incomes in the UK have not kept pace with rising house prices. Housing unaffordability has been a key driver of growing demand for rented premises.

The undersupply and unaffordability challenge have created a significant tailwind for institutional PRS funds with appetite from institutional capital growing as depicted in Chart 2.

Chart 2: Growing investment in UK residential



Source: Invesco, Real Capital Analytics, Dec 2017

Returns: An indicative net yield on entry (stabilised portfolios) is circa 4.2% with 10-year leveraged IRR of 8% - 9% (circa 30% - 40% LTV).

Development is not common as the UK land use planning system severely restricts the release of greenfield sites for urban development and housing, in particular. For this reason, the UK PRS sector has outperformed the US and most domestic sectors (15-Yr 10.6%; 5-Yr 9.8%; 3-Yr 9.3% and 1-Yr 9%)[4] .

Lessons for the Australian BTR industry: Government initiatives and intervention are essential to kick-start the sector. Offshore investors, if adequately incentivised, generally are first movers, paving the way for other institutional investors.

Changes to the Stamp Duty Land Tax (SDLT, 2011) treatment of bulk purchases of homes addressed a long-standing tax distortion similar to the current Australian regime which previously favoured individual purchases ahead of large-scale investment. Property management companies and REITs were also incentivised to take on large scale residential portfolio investments.

2. Homes & Communities Agency of the UK Government
3. Real Capital Analytics, February 2018 reported in local currencies
4. Source: INREV and Invesco

What is Build-to-Rent (BTR) in Australia?

What does the US/UK experience mean for Australia?

Why hasn't it worked historically?

Cultural distinction: Home ownership across Australia is significantly higher than most developed countries with the rental market dominated by private investors. Many domestic households still aspire to own their own house on a block of land.

Culturally, young Australian university students tend to live at home or share flats until graduation. US college students on the other hand typically leave home for universities away from their home states renting on or off campus, creating a powerful psychological affinity for the rental sector often deferring household formation until student loans are paid off (8.8 years in Australia v 20 years in the US).

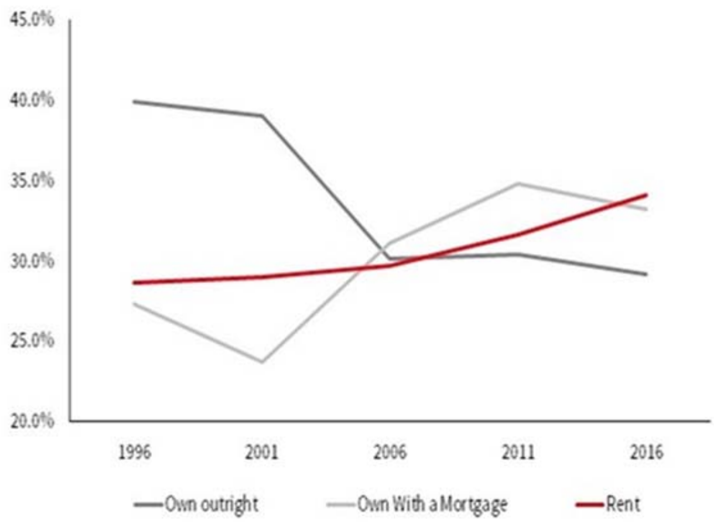
Home ownership in Australia is gradually falling [5] and attitudes are slowly shifting from suburban to urban lifestyles, largely impacted by rising unaffordability coupled with difficulty in saving for a 20% deposit (see charts below).

Historical impediments to the Australian investment thesis

In Australia, the investment case for BTR has been impeded by several obstacles:

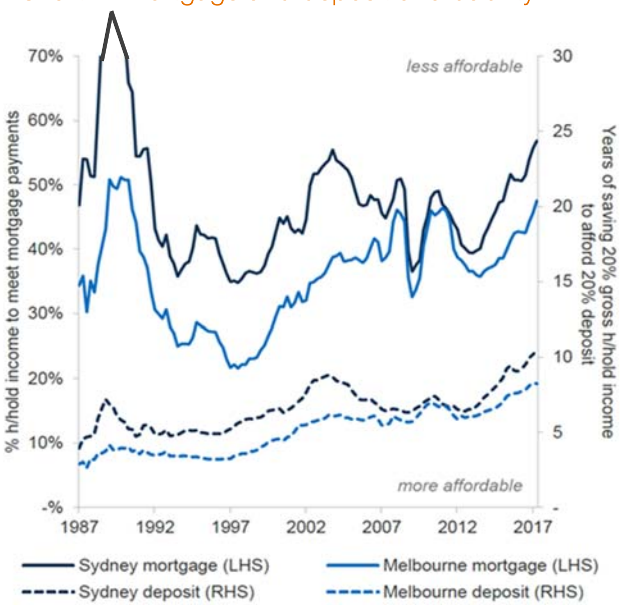
- Ownership of apartments is highly fragmented, poorly serviced and inefficient.
- Developer Build-to-Sell model (BTS): Historically, given circa 20% Development Profit Margin in the BTS model, developers have not been incentivised to convert to a BTR model for lower profit margins.
- Overall outgoings (land tax, transactions costs, stamp duty and other regulatory expenses) account for circa 32% of revenue with the land tax component alone being 10-12% . Offshore outgoings are comparatively much lower, usually around 20%. While domestic managers believe this proportion to be outsize relative to offshore outgoings, Frontier's research does not find this to be the case and we question whether local managers are overly optimistic on rental growth assumptions.
- Operational risk in establishing new management platforms is a very new experience and business. The challenge is in incorporating uniquely Australian preferences in what is essentially an overseas concept.

Chart 3: Home ownership v renting - Sydney



Source: JLL, Macquarie

Chart 4: Mortgage and deposit affordability



5. JLL July 2018 and Australian Bureau of Statistics

- Traditionally, financing for new developments has only been available for build-to-sell 'off-plan' projects. Lenders need to be educated on a new residential model.
- Since 1 July 2017, managed investment trusts (MITs) were only allowed to develop or acquire affordable housing for rent. A Federal Government policy concession has paved the way for institutional investment into Australia's emerging Build-to-Rent sector. A revision of draft legislation initially tabled in the 2017/18 Federal Budget means that institutional investors may be able to acquire residential property built for long-term rental through a managed investment trust (MIT) structure.
- Planning frameworks in many cities have been slow to embrace urban high-density housing until recently. Design guidelines under current legislation specify minimum area requirements that are inconsistent with demand for smaller spaces but generous common facilities.

What would Australian Returns from BTR look like?

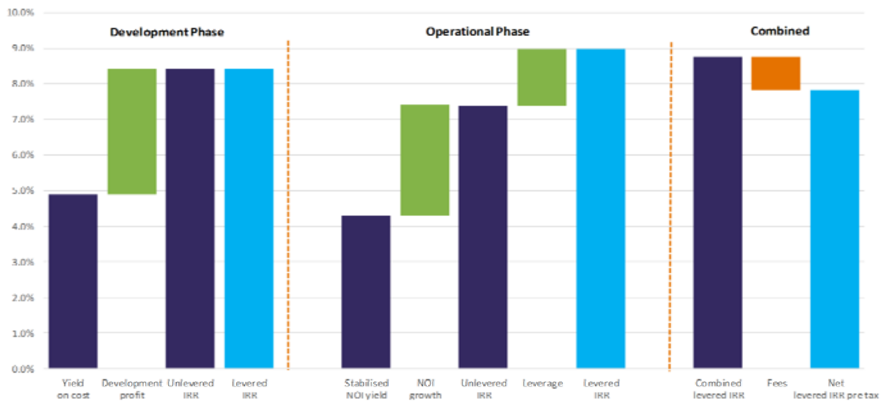
Gross yields for residential assets currently are as low as 3.9% in Sydney, 4.1% in Melbourne and 4.9% in Brisbane[6]. In comparison, Q17 yields on prime office assets in Sydney ranged from 4.6% to 5.25%, Melbourne (4.75% to 5.75%) and Brisbane (5.50% to 7.5%)[7]. On a 'yield on cost' basis if developer margins are forgone, BTR indicative returns (see below table) are generally being forecast as circa 4.9% with Gross Development IRRs (levered) circa 14.0% and Gross Investment IRR through the Operational phase (levered) circa 10.7% equating to a net levered Total 10-year IRR of 10.4%.

In other words, in Australia, developers of BTS would ordinarily expect a circa 20% profit margin. In the BTR model, given current tax and regulatory regimes, developer margins must drop to zero or low single digit margins to achieve an acceptable yield to institutional investors. This might offset earnings from an internally managed portfolio of long-term revenue streams.

The case for BTR can work with the support of State and Federal Governments agreeing to tax reform (primarily land tax), innovative zoning and planning changes and if developer profit margins are contained. Those interviewed by Frontier are proceeding on this basis.

The prospect for Capital Gain over time is uncertain and inherently difficult to forecast apart from capitalising future cash flows at growth rates that have no historical support. Developers and experienced managers of Multi-Family/BTR are underwriting future upside from cost management, maximisation of rental income (20% premium is being quoted by some operators) and economies of platform scale as an adjunct to the cash flows.

Chart 5: Model for BTR – Evolutionary to Maturity



Assumption: 50% post-development LTV, 3% p.a. rental growth, NOI margin 70%, 10% GST, Land tax 2.25%, 0.50% p.a. fee on GAV

6. CoreLogic
7. JLL September 2017

Fee structures

Fees structures are disparate as can be expected in an emerging sector. Proposed strategies span a number of stages: i) Development from ground up; ii) Operational lease-up post completion; iii) Stabilised portfolio. From our various discussions, some managers have adopted a more pragmatic approach to a complex array of scenarios, presenting a reasonably straight forward combination along the following lines:

- Investment Management: circa 45 to 50 bps on GAV
- Development Management: circa 5% on development cost (excluding land)
- Property Management: circa 5.5% + leasing fees

More complex structures contemplate fees at various stages including:

- Venture Management fees meaning Investment/Asset Management fees: circa 50bps on development cost / GAV; fees on uncalled equity;
- Performance fees are payable over the Development and Operational stages, generally 15—20% over certain hurdles.

At this early stage active managers are proposing small clubs. Should clients show interest in pursuing BTR, Frontier would engage with managers to secure an aggregated fee arrangement.

Characteristics to make BTR work in Australia

The maturation of any new sector is heavily reliant on first movers, visionary politicians and industry participants. The Property Council of Australia (PCA) is one such body that supports Build-to-Rent housing as a way of providing Australians with a variety of housing choices and is instrumental in bringing politicians and practitioners together in search of a much-needed solution. Additionally, a number of industry participants have collectively been lobbying Federal and State Governments to support BTR by way of land tax discounts, release of strategic land sites and changes to use and design guidelines which would allow for BTR to have a separate classification as it does in most US cities in London.

Physical and locational attributes of assets have been shown to be key determinants in users' rental choices in the US.

- Good rail or motorway access, central hubs or local hubs with an abundance of employment opportunities, retail and entertainment facilities and other essential infrastructure are of prime importance
- Physical requirements increasingly provide convenience, shared social experiences and property management service likened to that of the hospitality industry:
  - Secure car and bicycle parking
  - Onsite or adjacent gym facilities
  - Club room, pool, screening rooms and meeting rooms in luxury end buildings for home-office occupants
  - Quality private and public open spaces
  - Onsite management team and rapid maintenance response

Early movers in Australia

Managers actively seeking to enter the sector appear divided as to whether there is an advantageous position apart from access to sought-after sites and pricing entry points.

- Mirvac has announced the first purpose-built BTR asset in Australia. Indigo at Mirvac's Pavilions project at Sydney Olympic Park in NSW is the fourth building in that precinct. It expects to build and hold units in capital cities supported by major superannuation funds that derive returns from rentals paid by residents. The Clean Energy Finance Corporation has just committed a 30% interest as a cornerstone investor in Mirvac's first club.
- Fellow developers Lendlease, Grocon and Stockland have also expressed public support for developing BTR in Australia.
- Lendlease manages a portfolio of 50,000 units for the US Military in the US, a PRS mandate with CPPIB in the UK and is reportedly working on a US$1.0 billion pipeline project for US gateway cities for First State Super.
- Greystar, one of the largest managers of US Multi-Family, has established an Australian fund for local institutional capital with sites identified in Melbourne and Sydney. Greystar Asia Pacific is co-owned by Macquarie.
- Sentinel, a US Multi-Family specialist expects to complete its first development BTR project early 2019 in Subiaco, Western Australia, on behalf of a European Pension fund. It manages a large mandate for AustralianSuper.
- Other private operators:
  - Salta Properties
  - Meriton's Harry Triguboff
  - Fortis Development

Europeans are considered to be more price sensitive than other renters.

Will Australian renters easily adapt to offshore lifestyles? Will they want or be willing to pay a premium for concierge, gym, dog washes and club-houses?

The final word…

The share of people living in urban areas is forecast to rise globally. The speed of urbanisation is likely to have diverse demographic effects on the way cities deal with the social and philosophical demand for housing, whether it be Multi-Family, Senior Living or Affordable Housing. This has implications for large cities and metros evolving into mixed-use hubs that may re-shape the physical features of the asset-class.

Consequently, changing risk/return perspectives may potentially impact on clients' portfolio construction considerations and the shape of their portfolios. Already a number of pockets of the Australian market are increasingly resembling Asian mixed-use hubs.

Globally, yields and total return expectations in the residential sector compete favourably on a normalised basis relative to other traditional real estate sectors such as Office, Retail and Industrial/Logistics.

The viability of the sector in Australia seems to revolve around the argument for government tax concessions or favourable land treatment by Federal or State Governments. The trade off is often linked with an Affordable Housing component which could impede the commercial viability of any given project or emerging sector. In some cases, progress is constrained by party politics and, hence first mover advantage is questionable.

On a positive note, industry players are encouraged by the desire of both NSW and Victorian Governments to find a solution to social issues attached to increasing unaffordability. Frontier is of the view that demographic and supply/demand drivers present a strong case in favour of the Multi-Family/BTR sector.