Australian housing update

July 2024

Frontier Advisors

Introduction

A watching brief

In April 2022, Frontier examined the growing opportunity in the Australian build-to-rent (BTR) sector and our findings were summarised in a Frontier International: Australian build-to-rent update paper. At that point, nearly all BTR projects in Australia were still at the development stage with limited practical examples of how they would perform once stabilised, versus the assumptions used in underwriting the projects over their life cycles. Fast forward two years and there are now several operating and stabilised BTR assets, with more due to complete development in coming months.

Frontier has also been monitoring progress in affordable housing and the Housing Australia Future Fund (HAFF) initiatives, as well as the interplay between the Federal and State Governments in tackling the continuing imbalance between supply and demand.

In this paper we provide an update on several key aspects, including:

The changing dynamics and maturation of the BTR model.

Commercial impacts on the investment case for various types of housing given current capital markets (high inflation, high interest rates, high construction costs and home ownership unaffordability).

Fresh insights as the industry struggles with the challenges of finding fair, equitable and immediate solutions.

Affordable housing integrated in the BTR model is one such remedy but reliance on government concessions, subsidies and tax concessions seem to instill less confidence for investors who value track record, liquidity and a choice of different implementation approaches.

Both affordable housing and HAFF solutions can be skewed toward debt-like structures with limited equity ownership, control over housing operators and developers and long lockup periods (in the HAFF model).

Frontier has identified some HAFF participants that offer an equity-like model, i.e. full control over housing operators and builders, participation in rental upsides that can boost returns, no fixed termination date and access to residual value.

Key market developments

NSW (May 2024)

Premier Chris Minns announced a new state plan to deliver 750,000 new homes in five years, focussed on councils with the smallest housing pipelines.

Local councils will be held to state delivery targets. A system of 'red card' for failure to meet targets is rumoured.

Not much is known about whether these new homes are earmarked for home ownership or as rental accommodation or some combination of the two. Professionally managed institutional BTR is circa 0.2% of domestic housing stock. The largest segment in dire need of reasonable housing would remain disadvantaged.

Other state governments

Similarly, Victoria, Queensland and Western Australia race to address housing shortages via budget allocations, at the same time introducing an array of taxes (land, water and other imposts) which greatly impede investment in new housing stock.

Thin Cap legislation

Treasury Laws Amendment (Making Multinationals Pay Their Fair Share - Integrity and Transparency) Bill 2023 was passed on 27 March 2024.

The Bill impacts the most critical supporters and providers of capital – offshore investors.

While the bill purports to support the need for 150,000 BTR units by 2034, critical implementation appears to be disjointed across the various states.

The Property Council of Australia (PCA) has been a vocal critic of the Government's stance on this legislation. It refers to it as flawed. The PCA is working with the ATO on guidance materials for the legislation's application and the Government to secure changes in future amendments.

Investment in the BTR sector

Very little real progress has been made to date.

In the 2023/24 Federal Budget, the Government announced it would encourage investment and construction in the BTR sector whereby incentives would be offered such as:

- increase the rate for the capital works tax deduction from 2.5 percent to 4 percent per year
- reduce the final withholding tax rate on eligible fund payments from managed investment trust investments from 30 percent to 15 percent.

Following a consultation process in April 2024, the Government has introduced the legislation into Parliament as part of an omnibus legislation *Treasury Laws Amendment (Responsible Buy Now Pay Later and Other Measures) Bill 2024.*

The Legislation has been referred to the Senate Economics Legislation Committee with a report due on 26 June 2024.

Location, location, location

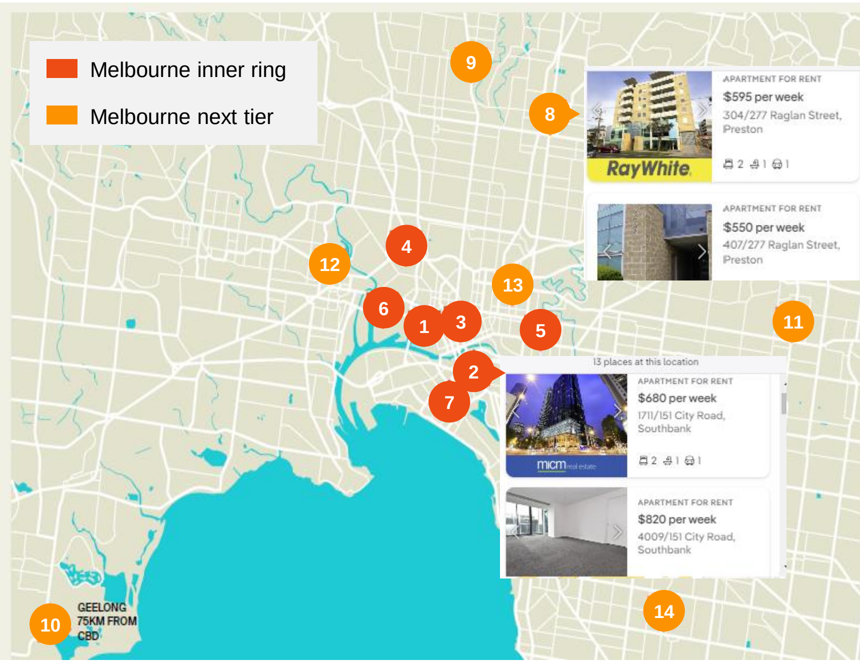
Melbourne leading the way for BTR, for now

Inner city locations in both Melbourne and Sydney have been the obvious candidates for the first wave of BTR schemes, offering close proximity to CBDs and existing amenities, employment and education hubs, and a deep pool of potential tenants.

Managers in the sector report construction costs are broadly similar across Australian capital cities and so acquiring suitable development sites at the right price is a key factor in identifying viable and attractive BTR opportunities. However, anecdotal evidence suggests it is currently challenging to find a construction partner in Brisbane that can deliver at an appropriate price. Currently, competition in the city from other large development projects makes Brisbane a less attractive BTR destination.

Within Australia, Melbourne has seen most progress to date, largely due to comparatively attractive prices, predominantly within the inner-ring of the city. Over time, we would expect to see further broadening of interest to encompass middle-ring suburbs with strong transport links and high amenity levels, potentially offering greater relative value compared to inner-ring locations.

Melbourne build-to-rent hotspots



#	Suburb	Median apartment rent per week ($)
1	Docklands	$500
2	Southbank	$500
3	CBD	$500
4	Kensington	$390
5	Richmond	$430
6	West Melbourne	$470
7	South Melbourne	$485
8	Preston	$380
9	Coburg (North)	$410
10	Geelong	$470
11	Box Hill	$400
12	Footscray	$375
13	Collingwood	$490
14	Bentleigh East	$440

Source: Knight Frank, APM, ABS

The economics of a BTR project

Expected rental income is a key input into the BTR economic model

Typical per unit delivery cost for a BTR project:

- $650,000, including the cost of land, development and finance.
- Working backwards and assuming a target 5.0% gross operating yield suggests an equivalent weekly rent of $625.
- Median weekly rents on two-bedroom units (the most common unit size across BTR developments) in inner-ring suburbs like South Melbourne are currently ~$650, leaving limited margin for improving the economic outcomes for a project.

Impact of escalation in construction costs:

- Even allowing for fixed price contracts, construction costs are largely out of the BTR managers' control and rent remains the main lever in the return equation.
  - In underwriting and scoping projects, many BTR managers allow for a conservative 'rental premium' – typically around 10-15%, and believe higher premiums are achievable over similar private rentals in the market.
  - Evidence from current operating assets supports this hypothesis with managers reporting strong demand and low vacancy rates for units rented at above markets rates, in some cases at up to 30% premium. *Frontier believes this will change as the sector achieves maturity, scale and increased supply.*

Impact on return forecasts:

- These will vary from structure to structure, BTR to affordable housing to HAFF
  - While IRRs have compressed in recent times due to rising construction/borrowing costs, high growth in market rents in major markets has offset these to some degree.

Example of a typical BTR project	
Estimated total cost per unit (including land and finance)	~$650k
Land cost	~10% of cost
Development cost	~90% cost
Assuming a target gross operating yield	~5.0%
Equivalent weekly rent	$625 to $850

Source: Managers, Frontier Advisors

Is a rental premium really a premium?

- The additional cost reflects higher amenity levels typically available in a BTR building and in many cases, represents extra costs which would normally be incurred elsewhere in a tenant's weekly budget, e.g. a gym membership.
- Current evidence from operating assets suggests it is a cost prospective tenants are willing to meet as a tradeoff, with occupancy rates in the high 90s and minimal reported downtime between tenants.
- Whether this will continue to be the case over the long-term remains to be seen, with further increases in the cost of living and the sheen wearing off new buildings in a competitive rental market, providing potential headwinds.

An example of BTR project returns

Higher development costs offset by strong rental growth and 50% land tax savings in most states

In our 2022 analysis of the BTR sector we considered the return profile (both at the development and operational stage) underpinning planning for a typical BTR project. In the intervening period, projects in progress have faced several challenging headwinds including significant increases in both financing and construction costs.

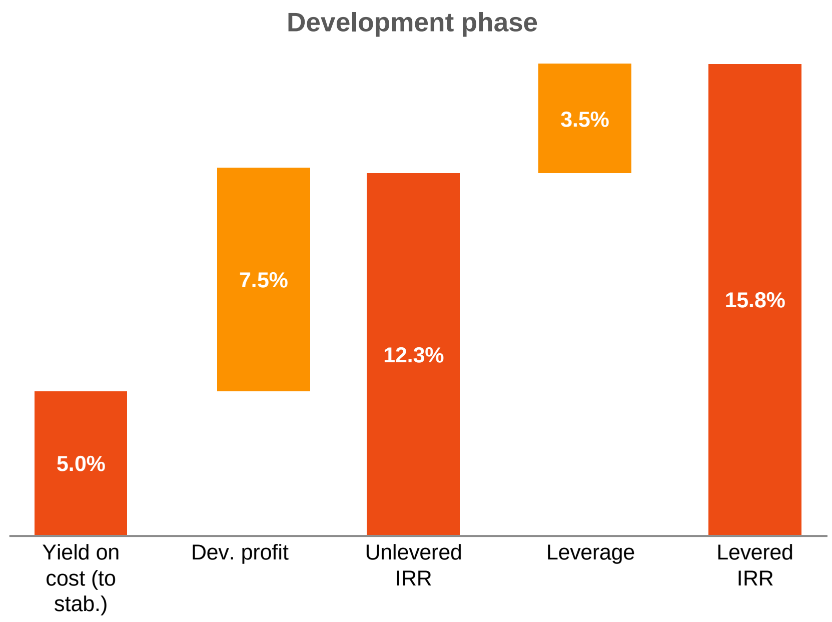
Despite the higher costs, several managers report expected returns for existing assets remain in line with initial project modelling and forecast profit margins remain intact.

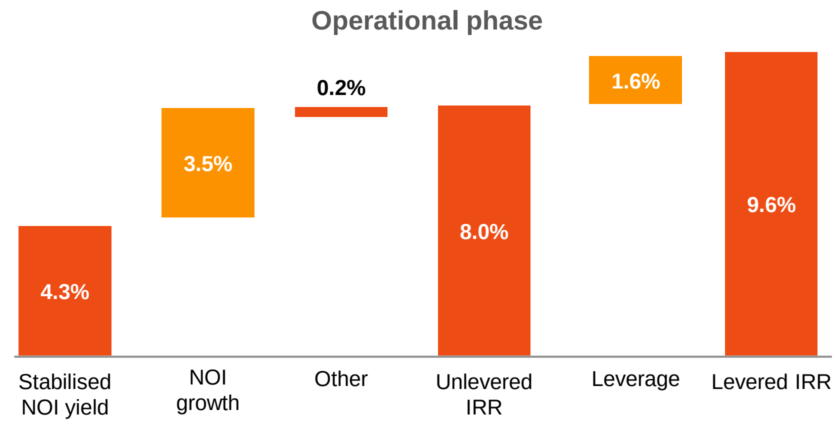
For existing assets or projects currently in progress, the impact of increased costs has been offset by a range of factors:

- Valuation uplift from lower-cost development sites acquired during COVID-19 from build-to-sell (BTS) developers, with minimal changes to the existing DA required for conversion to BTR and a subsequent higher valuation on completion.
- Benefit of fixed-cost development contracts struck at prices set before supply issues and high inflation and waiving of 50% of land tax by several states over the next 20 years.
- High rental inflation leading to higher rents and the forecast of continued strong rental growth.

In some cases, the rental market outlook and experience gained from completed projects have led managers to revise their return forecasts upwards for new BTR projects.

However, more broadly, Frontier expects elevated construction costs to remain a challenge and to continue to negatively impact expected returns for new and future projects.





Source: Managers, Frontier Advisors

Operating assets

Adjusting for experience to date

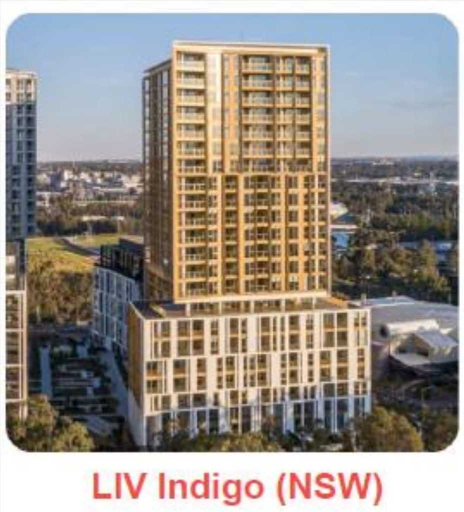
The existence of operating assets provides greater certainty around the range of potential investor outcomes from the sector including the opportunity for BTR managers to refine their offering; to improve return outcomes for investors; and the experience and value proposition for their tenants.

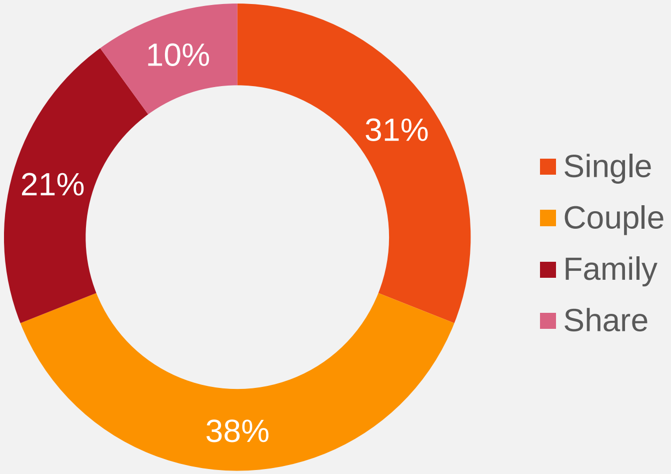
For example, targeted operating costs for new projects are reported to have reduced to ~25% of operational income from over 30% due to the insights and experience gained from existing assets.

Managers have also reported gaining significant insights around improving the appeal of future projects:

- Approach to leasing especially in the stabilisation phase is more focussed on price/amenity offerings and less on rental incentives.
- Identifying which amenities are most important to tenants and prospective tenants by analysing existing amenity usage and tenant feedback.
- More demand from families than expected which may lead to greater provision of larger three-bedroom units in future projects.

Example of a stabilised asset – LIV Indigo and breakdown by household type





Source: LIV, Mirvac

Affordable housing

Housing Australia Future Fund (HAFF)

To date, investment in Australian BTR has predominantly come from offshore investors, despite the higher managed investment trust (MIT) impost, with limited interest displayed from Australian institutional investors. Instead, Australian asset owners have prioritised what they consider a more attractive investment opportunity set in offshore BTR while domestically they seem more interested in affordable housing.

The recently established Housing Australia Future Fund (HAFF) has given extra impetus to efforts to support and increase social and affordable housing. Together with the National Housing Accord, the HAFF is a Federal Government initiative to improve housing outcomes for Australians and both initiatives will provide collective Federal Government support for the delivery of new social and affordable homes across Australia over five years.

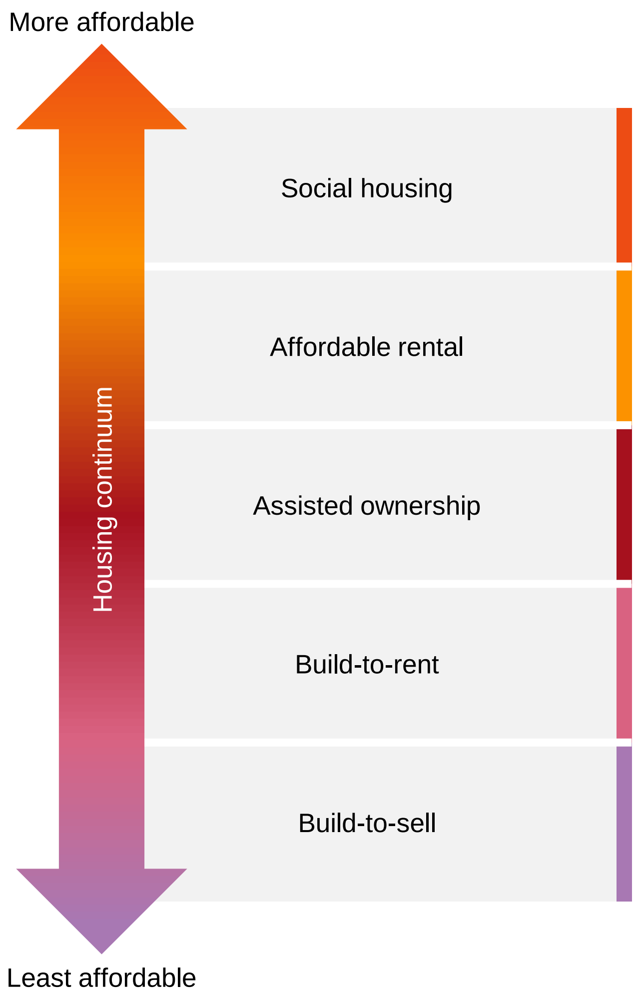
- The HAFF will be used to support the delivery of 20,000 social homes and 10,000 affordable homes under the Housing Australia Future Fund Facility (HAFFF).
- The National Housing Accord (2022) brings together all levels of government, investors and the residential development, building and construction sectors, to unlock quality, affordable housing supply over the medium term. The Accord includes a target to support the delivery of 20,000 affordable homes in total, equally split across both the Federal Government and the states and territories. The National Housing Accord Facility (NHAF) is the mechanism to provide Federal Government support for their share of the affordable homes.

To access funding through these programs, investors must apply via a special purpose vehicle which includes an appropriate registered charity (typically a community housing provider (CHP)) or State/Territory or Local Government involvement.

The funding products that can be applied for under the HAFFF and NHAF are:

- Availability payments (25-year term), effectively a debt structure with a long lock-up period.
- Concessional loans (zero interest, 25-year loan term plus any development phase where applicable).

On establishment, the HAFF was credited with $10 billion with applications for the first round of funding closing in March 2024. Frontier believes the program is at a very early stage of incubation, with complex structures and no direct ownership of the underlying assets.



Source: Local.

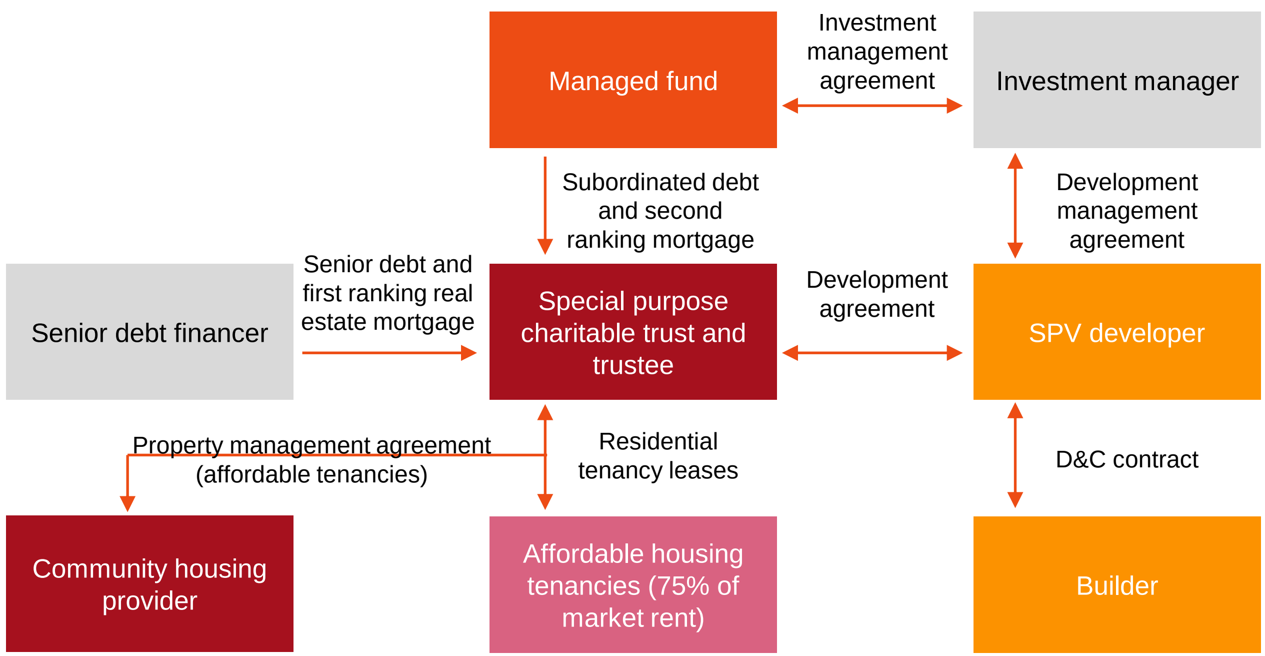
Partnering with a charity/CHP to access HAFF

Investment structured as debt rather than equity holding in the underlying property assets

The emergence of HAFF is intended to support a case for BTR in institutional property portfolios via investments in social and affordable housing. It is too early to tell whether this will be enough to draw meaningful investment into the sector due to its complex structure.

Several strategies have been launched to deliver projects by accessing funding from HAFF. Although the need to partner with a suitable registered charity or CHP necessitates a specialist structure, with investments typically structured as a debt rather than equity holding in the underlying property assets.

Indicative transaction structure with charity/CHP partner



Source: Local

Accessing the opportunity – other options excluding HAFF

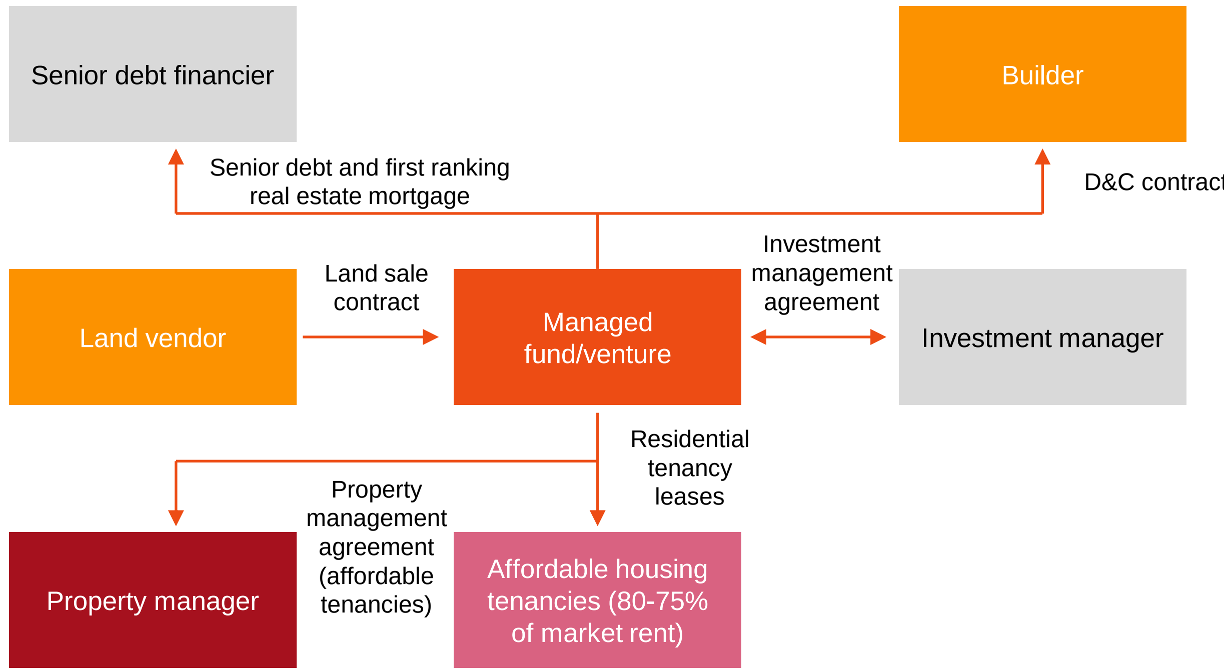
Option to structure as an equity holding in the underlying property assets

Partnering with CHP partners who lack the required scale, expertise and resourcing to help deliver large projects is a concern to capital providers. The requirement to structure the investment as a debt holding is also seen as a potential drawback, with many asset owners preferring an equity holding for their property investment.

Some managers developing opportunities in the affordable housing space have opted to not participate through HAFF. Instead, projects are structured so investors are the ultimate owners of the underlying BTR projects.

While they cannot access support through HAFF, these projects can still potentially qualify for GST credits on construction and operating costs and land tax savings (in Victoria only) if they establish or partner with a registered charitable trust to act as property manager and operate the affordable housing.

Indicative transaction structure without charity/CHP partner



Source: Local

Under this structure, investors would have equity ownership of the underlying assets but would be unable to utilise any tax concessions.

However, there are options to build a structure to access tax concessions while still retaining equity ownership of the assets.

The final word

What investors should do

Frontier has met with capital providers, fund managers and third-party operators active across BTR, affordable housing and HAFF.

Build-to-rent

Build-to-rent remains an evolving sector in Australia. There are some established models of stabilised operating assets which should provide strong cash flows. This potential income source should provide investors with more confidence around the investment case and the role of BTR in portfolios.

Despite the less supportive tax treatment which currently applies to offshore institutional investors, Frontier expects these asset owners will remain the most active in the near term. Announced tax changes, when legislated, should increase the attractiveness of the sector to offshore investors.

However, we expect that their investment horizon is unlikely to remain a long-term hold. *Frontier considers a positive outcome for creation of liquidity in the sector.*

Affordable housing

Affordable housing relies on a substantial uplift from tax incentives and rental discounts required to meet local/state government planning approvals. Regulatory risk is high.

Frontier continues to monitor the various models, operators and investment challenges.

HAFF

HAFF opportunities are heavily skewed toward debt structures. Concessions for up to 10- or 20-years from the Federal Government should provide residual uplift on maturity.

Operating partners, developers and/or community housing providers should be rigorously diligenced.

Learn more

Frontier has undertaken extensive research on the Australian housing sector over time and is well placed to advise investors on this theme. We encourage investors to reach out to our Real Assets Team for a discussion on how we can help.

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