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Accelerating build-to-rent in Australia

Introduction

The build-to-rent model continues to gain pace in Australia as several projects prove the local viability of this asset class. As interest accelerates, so too does the speculation about the benefits of this model for Australia.

For developers and institutional investors, the real opportunities are in the details – tax challenges, fund structuring and delivery mechanisms. Seizing these opportunities requires a keen understanding of the intricacies of this emerging asset class (which includes social, affordable, multi-family and retirement village premises).

This report looks at the current state of play for Australia's build-to-rent market, including:

- key barriers to market; namely tax challenges and the managed investment trust (MIT) conundrum
- structures for success and key differences in investor risk profiles, and
- lessons we can take from more advanced markets overseas, particularly the UK.

Overcoming challenges facing the build-to-rent market

There are some key challenges facing the build-to-rent market in Australia, but if you look closely, there are also positive developments and movements in market conditions that indicate this asset class is ripe for growth.

If these challenges are addressed, build-to-rent assets can provide steady income for investors, improve housing affordability in Australia, and give tenants greater certainty and amenity.

The MIT conundrum

Tax policy settings are often cited as an impediment to realising build-to-rent ambitions.

Focusing on institutional investors as the financial backers, and noting that Australia is an importer of capital, the rules impacting after-tax returns to eligible foreign investors are one factor.

Under the current announced policy settings, an eligible foreign investor (think foreign pension funds and sovereign wealth funds) will be able to invest in residential real estate for rental returns through the gold standard vehicle of an MIT. However, the returns will be taxed at 30 per cent instead of the concessional rate of 15 per cent for returns from any other kind of real estate (commercial, retail, industrial, leisure, etc).

The anomaly is obvious but there is some cause for optimism. Recent reforms mean that a subset of the residential real estate asset class, affordable housing, is now eligible for the concessional 15 per cent MIT rate. In our view, the softening in this position is evidence of the potential for more positive developments.

Catalysts to take MIT a step further

Possibly, the motivation to take the next step, of making returns from residential real estate eligible for the concessional 15 per cent MIT rate across the whole asset class, may come from:

1. The general softening of growth in residential housing values

Presumably, one reason for initially excluding residential assets from MIT eligibility was the potential for lost tax revenue from profits on 'turning over' build-to-sell residential assets during the recent long period of appreciation in value. Perhaps the slow-down in growth, and, in some cases, depreciation in values, may reduce the concerns about lost tax revenue from speculation in asset appreciation if the lower 15 per cent rate applied.

2. Potential changes to limit negative gearing benefits for investors

Under the proposed policy of the federal Australian Labor Party, changes to negative gearing may result in a fall in the supply of rental housing from the private investor market, leaving a larger gap to be filled by the build-to-rent model. The policy of denying the benefits of negative gearing to private investors may need to be counterbalanced by greater incentive for institutional investors to step in – eligibility for the 15 per cent MIT rate on residential assets might be likely in this environment. Of course, there is also a strong case for the 15 per cent MIT rate for institutional investors in parallel with negative gearing for private investors but, to date, that point seems to have been made without success.

Addressing other barriers for build-to-rent

Yields

Build-to-rent assets typically generate a lower yield than that of alternative asset classes such as commercial office buildings. However, as capitalisation rates for commercial office buildings continue to contract, build-to-rent yields will become more attractive to long-term investors looking for steady returns (such as superannuation and pension funds). Unlike commercial property investments, which are often reliant on an anchor tenant for security of income, build-to-rent assets will have a spread of tenants, minimising key tenant risk. Of course, this must be balanced against issues such as the likelihood of a high turnover of tenants and a shorter weighted average lease expiry (***WALE***).

The 'Australian dream' culture

There are significant cultural hurdles to overcome for Australia's build-to-rent market to take off. Historically, Australia has high rates of home ownership, which tend against build-to-rent projects as a legitimate alternative to build-to-sell. However, as housing affordability becomes an increasing issue, it is likely that younger generations of Australians will seek an alternative product offering. Build-to-rent projects can provide a convenient lifestyle, with greater access to amenities such as in-house cleaning, maintenance, landscaping and on-site property and facilities management provided by the asset's owner.

Tenure

One of the key issues to be resolved in establishing the build-to-rent market is improved tenant rights under the respective residential tenancies legislation in each state. Victoria has introduced a package of reforms in the Residential Tenancies Amendment Bill 2018 that broadly seek to increase tenants' rights. Such reforms will help shift the market's mindset about renting towards it being a secure, convenient and desirable lifestyle choice, ultimately resulting in tenants viewing build-to-rent as an attractive alternative to buying. We expect investors will prefer tenants to enter long-term leases, even if at a lower effective rent. It is unclear whether tenants will also prefer longer terms, or will be attracted by the lack of commitment that renting offers under a short-term lease. This natural tension may require build-to-rent products to be flexible, to cater for both short-term and long-term leases, or provide tenants with the flexibility of options to renew.

Financing constraints

Due to issues around security of income and low WALE, obtaining finance for a build-to-rent project could be difficult – we will explore this further when we look at structures for success.

GST

The GST treatment of build-to-rent and build-to-sell differs. Essentially, the GST embedded in acquisition and development costs is not creditable for build-to-rent but it is creditable for build-to-sell. While this accurately states the problem, it is difficult to see how a change could be made to this position without creating new anomalies in the GST treatment of housing - without broader GST reform.

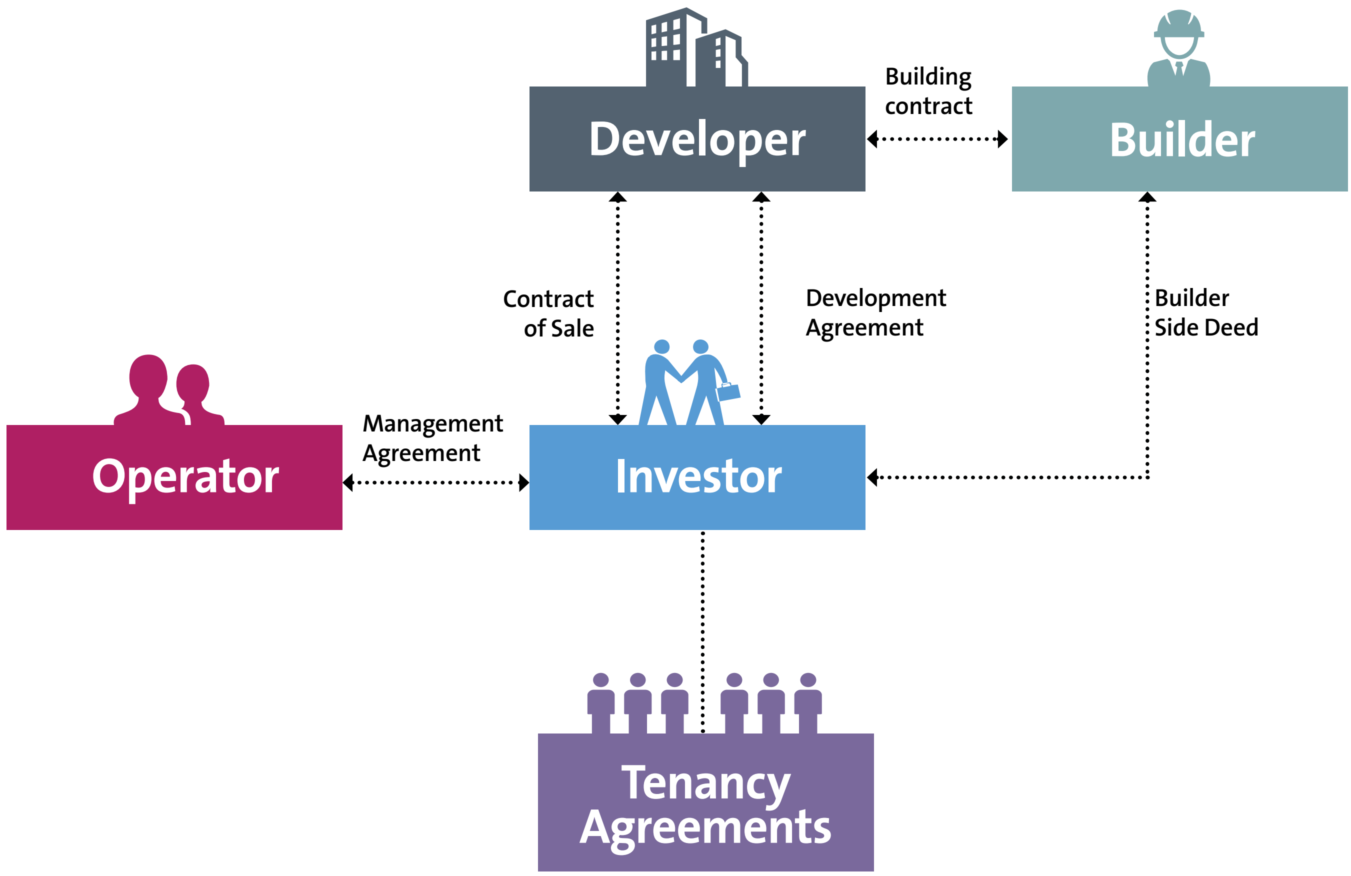
Structures for success and key differences in investor risk profiles

Australia's residential developers and investors have long favoured the build-to-sell model, where capital is tied up for a shorter period and returns are quicker and often greater. Build-to-rent assets also have a different risk profile to other asset classes, such as commercial office buildings. These differences will influence how build-to-rent projects will be structured and who the likely players in the sector will be.

Despite the different risk profile, we expect Australian banks will be willing to lend to build-to-rent developers and investors. However, we also expect that because of this risk profile, the debt-to-equity ratio will be less than for a more traditional commercial or residential development.

The appeal of a fund through model

As an alternative to bank finance, investors (such as superannuation funds and offshore funds) looking for steady returns, and that may be attracted to a lower yield, lower risk investment, could play a critical role in the establishment of this asset class in Australia. Such investors may be willing to fund development and enter the market using a fund-through model.



Key differences in risk profile for build-to-rent

Tenant pre-commitments

Unlike with other commercial developments such as office buildings or shopping centres, we think it is unlikely that a developer will be able to secure significant levels of tenant pre-commitment for a build-to-rent project. Investors and financiers will therefore need to rely mainly on market demand reports to determine feasibility of the project.

To partly mitigate this risk, developers may seek to attract pre-commitment from long-term tenants by offering incentives or bespoke apartments. To attract investors, developers may be willing to provide rental guarantees for a period of time following completion.

Shorter leases present risks and opportunities

Investors and financiers will also need to be comfortable that there will be a high turnover of tenants, requiring a significant level of management. Investors and financiers will need to have confidence that the building will remain attractive to tenants long term, to be sure that it will be easily re-let.

We expect that many tenants who would be attracted to the build-to-rent market will appreciate the flexibility of not owning a home. Such tenants will prefer to have a short-lease term to ensure they maintain that flexibility.

This will not provide comfort to a financier, as the WALE will, in most cases, be less than a year. As previously mentioned, we think developers will be able to attract long-term tenants in some circumstances, to partly mitigate this risk. Further, in a rising rental market, a low WALE will, of course, give investors the benefit of the reversionary rental uplift.

Amenity is key

One of the most attractive elements of a build-to-rent product for young inner-city renters will be the greater access to amenity and services such as in-house cleaning, maintenance, landscaping and onsite property and facilities management.

When structuring a fund through transaction with an investor, developers will have the opportunity to secure the management rights for the asset. Developers will be able to use the scale of their related management companies to provide exceptional services at a low cost, which will attract and retain tenants, as well as generate additional sources of revenue from the asset.

Ultimately, developers and operators will seek to establish brand loyalty, where renters will follow a brand throughout their renting life.

Insights and learnings from the UK

In the United Kingdom, the build-to-rent sector (known as the Private Rented Sector (PRS)) has grown steadily over the past decade from a largely standing start and is now the second largest form of tenure in the UK. Trends that have emerged in London, where the costs of home ownership are high and work and leisure opportunities are largely centralised in inner-city areas, may gain momentum in the Melbourne and Sydney housing markets.

Here's five key trends we've seen in the UK market which may provide insight to the future growth of the build-to-rent sector in Australia – including housing policies, funding scenarios and planning framework.

1. Housing policies pave the way

With the cost of home ownership becoming prohibitively expensive in major cosmopolitan cities, build-to-rent housing shapes as a key circuit breaker for housing affordability. This was recognised by the balanced approach taken by Theresa May's Government to housing, which has sought to encourage authorities to make it easier for build-to-rent developers to offer affordable private rental homes instead of other types of designated affordable housing.

This can be contrasted by the recently announced Australian Government initiative which seeks to promote housing affordability by allowing managed investment trust (MIT) status for eligible affordable residential housing. As mentioned in our previous article there is momentum for extending the MIT to include build-to-rent projects generally rather than specifically focusing on affordable housing and Australian authorities need to do more to stimulate the build-to-rent sector as a mechanism to improve housing affordability in Australia.

The UK experience suggests that simply focusing on affordable housing is not enough and greater gains can be achieved through policies that promote the entire build-to-rent sector and encourage embracing affordable housing as one of the many asset types within that sector – as is often said, a rising tide lifts all boats.

Stimulating the entire build-to-rent sector in Australia could be achieved, for example, through a combination of tax regimes that encourage offshore investment into the build-to-rent sector (given that Australia is an importer of capital) and planning policies that mandate minimum levels of affordable housing within projects.

2. A menu of funding options

In the UK, build-to-rent projects have traditionally been developed on a fund through basis. However, in more recent times banks have taken a pragmatic approach by offering a range of more traditional funding arrangements.

For example, our colleague, Mark O'Neill, Banking Partner, London, Linklaters has advised on build-to-rent projects which have been funded via development facilities which will convert into investment facilities when the project achieves practical completion and the rental income had stabilised. Mark has also advised on a recently completed development where the development facility was investment from the outset, but rentals still needed to stabilise.

Under these deals there are normally two sets of financial covenants. The first set limits the amount that can be borrowed. The second set apply as covenants and tend to kick-in at completion. The financial covenants are likely to be a little more relaxed than the drawdown covenants, so as to provide a degree of headway.

In Mark's experience, the **drawdown covenants** tend to be along the lines of:

- Loan to Gross Development Value (that is a market value of the property on the special assumptions that the development has completed and the rentals stabilised) of 60 – 65%; and
- Debt Yield (that is the estimated stabilised rental once the development is completed as a percentage of the Loans) of 8-9%,

The **ongoing covenants** are typically:

- Loan to Value (that is the Loans as a percentage of the market value of the property with no special assumptions) of 65 – 70%; and
- Debt Yield (that is the actual annual rental income as a percentage of the Loans) of 7.5 – 8%.

In addition, some lenders prefer Interest Cover (that is interest as a percentage of rental) as an alternative to Debt Yield.

As you can see, the Loan to Value levels are not dissimilar to the levels that one might expect for other asset classes. Development financing is invariably more conservative than investment financing. We expect that the Loan to Value levels will increase gradually over time, once the relevant build-to-rent project has been let for some years and so has a proven track record.

In the UK, non-bank lenders are often prepared to be more aggressive, which may be as much a consequence of the regulatory regime that banks operate under as it is the PRS market. This suggests that in Australia, developers will initially look to alternative sources of funding, including the non-bank lender market and the fund through model, and that like the UK, traditional forms of bank debt will follow once the market is more established. There is a good opportunity for institutional investors, such as Australia's large superannuation funds and insurance companies, to participate in the build-to-rent sector on either a debt or equity basis.

3. Case by case flexibility for planning

Build-to-rent housing has long been an established asset class in the United States (known as multi-family), where projects can be built to lower planning specification on the basis that they are largely designed and constructed to provide low income housing. The United States leads the UK and Australia in this space.

The UK has recently given build-to-rent formal policy recognition, defining it as:

> Purpose built housing that is typically 100% rented out. It can form part of a wider multi-tenure development comprising either flats or houses, but should be on the

same site and/or contiguous with the main development. Schemes will usually offer longer tenancy agreements of three years or more and will typically be professionally managed stock in single ownership and management control. [1]

A key area of negotiation in the UK, which varies from project to project, has been the proportion of apartments which are required to be made available on a discount-to-market rent. In this regard a range of policy positions is being advanced in the UK.

The Mayor of London's Draft London Plan, for example, recommends that build-to-rent should include at least 35% affordable housing, whereas the draft revised National Planning Practice Guidance recommends that 20% of any build-to-rent scheme should be affordable private rent homes, but also includes flexibility for viability to be considered on a case by case basis, and for the requirement to be met by other routes (such as commuted payments). This flexibility is likely to be very important to the success of build-to-rent in the UK, particularly outside London, because it is anticipated that if a blanket 20% affordable private rent approach were applied, then that might render many sites unviable for build-to-rent, unable to compete for land with alternative uses.

Translating this approach to 'affordable housing' as that term is used in Australia, needs to occur with caution. It is clear however that flexibility is critical and that a 'one size fits all' approach is unlikely to deliver the best outcome.

4. The right scale

Scale is a key factor in build-to rent projects, in order to achieve the efficiencies required to support the high level of customer service for which these projects are known. In Australia, there will likely need to be concessions to density requirements under planning laws in order to deliver build-to-rent projects consistent with the scale required in the locations where tenants want to live.

Those concessions could be offset by requiring build-to-rent projects to deliver higher level of amenity not only for residents but for the wider community. The UK experience indicates that amenity is one area where there is close alignment between local authorities and build-to-rent developers, as build-to-rent developers have a strong interest in ensuring that the community in which they operate is a desirable place to live.

In fact, the Mayor of London has recognised the potential for build-to-rent developers to deliver amenity uplift for the broader community in which they operate and requires that build-to-rent units be held for rental occupation for at least 15 years. If units are sold in breach of this covenant, then local authorities should be able to operate a clawback system where a set amount of the proceeds of sale is returned to the local authority to redirect into affordable housing.

Overlaying this in Australia is the application of design standards for apartment developments, such as those which have operated in NSW for some time under SEPP 65 and the Apartment Design Guide, and those introduced in Victoria in December 2016. These standards may need to be revisited to take account of some of the unique features of the build-to-rent model.

5. Give tenants a home with rights and a community culture

In the UK it has been recognised that legislative reform is required in order to strike a better balance between landlord and tenant rights.

At present, UK residential tenancy legislations is landlord-biased, resulting in tenants having short-term tenancies and at risk of being evicted on statutory grounds relatively easily.

This regime is at odds with the needs of tenants and financiers, who will typically require greater stability. For example, we understand that some of London's leading build-to-rent operators typically offer tenancies with a term ranging from six months to three years, with a tenant-only six-month break right (dropping to a rolling two-month notice after the first six months). They also do not require a security deposit and afford tenants the freedom to redecorate, along with a range of free upgraded amenities such as superfast fibre optic broadband.

This is a clever strategy by UK developers which recognises that the only way to attract and hold on to good tenants is to provide high quality, tenant-friendly accommodation and first class service. This also affords them greater flexibility in the management of the scheme going forward and enables them to avoid the costly burden of having to hold residential deposits in a government backed scheme, rather than by the developer or its letting agent.

Interestingly, initial market feedback from developers in Australia suggest a preference towards short term leases (6 – 12 months

1 UK National Planning Policy Framework, published July 2018

as standard) to allow for mobility of tenants across a developer's portfolio of build-to-rent projects, allowing the housing needs of a tenant to adapt with their work, family or lifestyle needs.

A key component of those projects is the on-site delivery of a range of amenities to occupants such as gyms, wellness activities, communal spaces and cafes which encourage a community atmosphere. Additionally, the premises are supported by full time operating staff with a customer-focussed operational model, this serves to foster a sense of ownership.

This illustrates the importance of creating a trusted brand centred on excellent operational performance and creating a culturally connected community around the build-to-rent project. It also suggests that there is an opportunity for joint venture arrangements between build-to-rent developers and investors and well-known lifestyle companies to build brand recognition and loyalty.

The UK market is still evolving

An interesting trend emerging in the UK market sees residential build-to-sell developers selling units within estates to build-to-rent developers and investors. Further, many of the early build-to-rent projects have been conversions of existing apartment estates. This is a means of build-to-rent developers avoiding the significant risks associated with obtaining planning approval for purpose-built build to rent projects. As they say, where there's a will, there's a way!

The coming of age of the build-to-rent sector in the UK, and strong interest from UK- and overseas-based institutional investors in the sector, shows what can be achieved when the correct policy settings are established at the federal, state and local government level.

While Australian authorities have taken small steps in the right direction, the UK experience shows that we must take a holistic view of the housing market and the role that build-to-rent can play within that market, in order to ensure that build-to-rent realises its full potential in Australia.

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