

# Build- to-Rent in Australia:

Product feasibility and  
potential affordable  
housing contribution

JULY 2019



Creating more affordable  
and sustainable communities

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## Preface

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# Contents

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<b>6</b>	<b>List of tables</b>		
—			
<b>7</b>	<b>List of figures</b>		
—			
<b>9</b>	<b>Executive Summary</b>		
9	Key findings		
10	Research background and aims		
11	BtR precedents		
12	The BtR concept: Australian interpretations and their feasibility		
12	Modelling BtR financial feasibility within existing taxation policy settings		
15	Policy levers		
17	BtR and affordable housing		
19	The future		
—			
<b>20</b>	<b>1. Introduction</b>	<b>30</b>	<b>2. The Emergence of build-to-rent in Australia</b>
20	1.1 Research origins and objectives	30	2.1 Chapter overview
22	1.2 Policy and housing market context	30	2.2 Multifamily and build-to-rent housing in the USA and the UK
28	1.3 Research methods	37	2.3 Australian BtR antecedents
29	1.4 Report structure	44	2.4 Drivers of growing BtR interest in Australia
		47	2.5 Chapter summary
		—	
		<b>48</b>	<b>3. The BtR concept: Australian interpretations and their feasibility</b>
		48	3.1 Key players and institutions in BtR development, finance and management
		53	3.2 BtR business models
		55	3.3 Locations and built forms
		57	3.4 Target markets and service offer
		58	3.5 Modelling five types of Australian BtR
		71	3.6 Chapter summary

<b>72</b>	<b>4. Build to Rent policy levers</b>	<b>106</b>	<b>6. Conclusions</b>
72	4.1 Status quo policy settings	106	6.1 Revisiting the research questions
73	4.2 Land tax	110	6.2 Implications for Landcom
76	4.3 Transfer duty	—	
77	4.4 Local government rates and fees	<b>112</b>	<b>Appendix 1: modelling assumptions, sources and method</b>
80	4.5 Goods and Services Tax	112	Development costs
82	4.6 Income tax, company tax, MITs withholding tax and depreciation	112	Operating costs and revenues
84	4.7 Land-use planning	113	Development and operating phase rates of return
87	4.8 Government land	—	
88	4.9 Compounded feasibility scenario	<b>114</b>	<b>References</b>
89	4.10 Chapter summary		
—			
<b>90</b>	<b>5. BtR, affordable housing and the possible roles of community housing providers</b>		
90	5.1 Chapter context		
91	5.2 Incorporation of affordable housing in BtR projects: Overseas benchmarks		
94	5.3 Stakeholder views		
99	5.4 Feasibility and subsidy options for achieving affordable housing		
104	5.5 Concluding points		

# List of tables

---

- 49** **Table 3.1:** Australian mainstream BtR projects: underway or publicly announced
- 60** **Table 3.2:** Overview of development parameters, per square metre of net lettable area
- 61** **Table 3.3:** Different required rate of return on operations, and the resulting return on development investment
- 63** **Table 3.4:** Different development cost scenarios, and the resulting return on development investment
- 64** **Table 3.5:** Different land cost scenarios, and the resulting return on development investment
- 65** **Table 3.6:** Different market contexts, and the resulting return on development investment
- 67** **Table 3.7:** Different revenue scenarios, and the resulting return on development investment
- 68** **Table 3.8:** Different rates of arrears and vacancy, and the resulting return on development investment
- 69** **Table 3.9:** Different operating cost scenarios, and the resulting return on development investment
- 70** **Table 3.10:** Different operating costs and revenue scenarios, and the resulting cost to revenue ratios
- 75** **Table 4.1:** Different land tax scenarios, and the resulting return on development investment
- 77** **Table 4.2:** Different stamp duty scenarios, and the resulting return on development investment
- 78** **Table 4.3:** Different local tax scenarios, and the resulting return on development investment
- 81** **Table 4.4:** Different development phase GST scenarios, and the resulting return on development investment
- 82** **Table 4.5:** Different operating phase GST scenarios, and the resulting return on development investment
- 85** **Table 4.6:** Different planning concession scenarios, and the resulting return on development investment
- 86** **Table 4.7:** Different land cost reductions, and the resulting return on development investment
- 87** **Table 4.8:** Different land cost reductions in a suburban market, and the resulting return on development investment
- 88** **Table 4.9:** Exemplifying development feasibility in advantageous conditions
- 99** **Table 5.1:** Comparison of return to equity for a for-profit versus a charitable provider of a basic apartment
- 100** **Table 5.2:** Impact of CHP-led mixed tenure scheme on investment return
- 101** **Table 5.3:** Comparing subsidy models for CHP-led BtR affordable housing provision

# List of figures

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- |           |  |           |  |
|-----------|--|-----------|--|
| <b>13</b> | <b>Figure ES1:</b> Base case estimated annualised return on development* by unit BtR archetype   | <b>25</b> | <b>Figure 1.3:</b> Loan approvals for investment housing, Australia 2000-2017            |
| <b>15</b> | <b>Figure ES2:</b> Impacts of different design, procurement and housing market scenarios on 'standard apartment' BtR development feasibility | <b>26</b> | <b>Figure 1.4:</b> Planning approvals in Greater Sydney, 2014-2018                       |
| <b>16</b> | <b>Figure ES3:</b> Impacts of posited tax changes on 'standard apartment' BtR development feasibility  | <b>43</b> | <b>Figure 2.1:</b> Stapled structures and passive income flows                           |
| <b>18</b> | <b>Figure ES4:</b> Impact of different delivery and funding scenarios for 'basic apartment' development                                      | <b>62</b> | <b>Figure 3.1:</b> Breakdown of development costs, per square metre of net lettable area |
| <b>23</b> | <b>Figure 1.1:</b> NSW population and private rental stock, 2000-2017  | <b>68</b> | <b>Figure 3.2:</b> Breakdown of operating costs, per square metre of net lettable area   |
| <b>24</b> | <b>Figure 1.2:</b> Dwelling commencements, 2000-2017 – Australia and NSW   |           |  |



Grocon - Parklands, Gold Coast, Qld



# Executive Summary

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## Key findings

- Coinciding with shifts in international investment markets, developments in Australia's demographic profile and 'residential consumer' sentiment have recently combined to enhance the prospects for the emergence of a 'mainstream market' Build-to-Rent (BtR) sector
- The eight BtR projects publicly announced across Australia since 2017 (see p49) are set to offer premium rental product in prestige locations. While some industry experts envisage diversification of product location and market targeting as the sector expands over time, the financial feasibility of this scenario – or, indeed, any major BtR expansion – remains questionable under current conditions
- Antecedents to (BtR) developments in Australia include the corresponding US and UK sectors, of which Australian stakeholders are increasingly aware; Australian commercial property sectors, in which international investors are increasingly active; and forerunners such as Meriton's rental business and purpose-built student accommodation (PBSA). PBSA has already generated over 90,000 newly-built units in Australia's cities over the past 10-15 years
- Pipeline BtR projects may presage the emergence of a significant new component within Australia's housing market. Under current Australian housing market conditions and policy settings, however, it remains difficult to envisage any rapid BtR take-off of the kind seen in the UK in recent years, or the establishment of a large and highly-embedded purpose-built-for-market-rental industry as in the USA
- Although Australian BtR project returns are impaired by both market conditions and policy settings, the industry tends to focus on the latter; highlighted in particular are land tax, GST and income tax as it affects overseas investors utilising Managed Investment Trust (MIT) vehicles
- Of these policy levers, evidence suggests that the single most significant impact on BtR returns would arise through re-balancing state/territory government land taxes to incentivise purpose-built professionally-managed rental (as opposed to small-scale letting of existing properties)
- The Australian Government's recent confirmation that overseas-based BtR investors are subject to a higher tax rate on market-rent residential investment than on investment in other asset classes could be a significant impediment to sector take-off given that such global funds would be likely 'first movers' in establishing a new institutional funding asset class
- Except where supported by some form of public subsidy or under rezoning, BtR will not generate affordable housing. Nor will it significantly ease wider housing affordability. However, it has the potential to fulfil other important public policy goals – including widened housing diversity, higher construction and management standards and a more secure form of private rental housing. It could also beneficially introduce a counter-cyclical economic component into the otherwise volatile residential construction industry. Therefore, a legitimate case can be made for facilitating the establishment and expansion of a BtR sector in Australia. This could be progressed by both state/territory and Australian Governments through

levelling the playing field in relation to other market players as regards development taxes and ongoing levies

- To fulfil the widely-held aspiration for an affordable component within primarily market rental developments, however, additional government support will be essential – support that land agencies such as Landcom should be empowered to make available primarily through discounted land grants to Community Housing Providers (CHPs).
- Without a strategic national framework that integrates tax reform, revenue support, land and planning levers, an emergent BtR sector will fail to generate rental at scale. In this regard Australia will continue to lag comparable countries like US and UK.

### **Research background and aims**

Build-to-rent (BtR) is a form of residential development involving apartment blocks or complexes purpose-built for rental occupation and held in single ownership as long-term revenue-generating assets. As such, BtR represents a significant departure from a traditional Australian residential development and ownership model where multi-unit blocks are typically built for, and sold to, individual owners – some of these for owner-occupation, others as rental investments.

In the main, however, Australia's private rental sector is composed of dwellings purchased second-hand by small-scale investor landlords mainly motivated by asset value appreciation rather than rental returns. This arguably generates a natural landlord inclination to favour minimal security of tenure – increasingly unsatisfactory for a sector accommodating growing numbers of family households and other low-income earners with little or no market power.

By engaging institutional investment in purpose-built rental construction an emergent

Australian BtR sector could potentially contribute to overall housing supply. This would fulfil the historically elusive policymaker aspiration to engage super funds, insurance companies and other financial institutions in rental housing provision. At the same time, such a shift could – its advocates contend – contribute to enhanced build quality (as incentivised by the prospect of long-term asset-holding) and also act as a rental housing market disruptor through providing a standard of property management more professional and customer-oriented than the established norm.

Recently intensified Australian interest in BtR more importantly reflects the post-Global Financial Crisis (GFC) compression of yields experienced in other investment asset classes. This has triggered finance sector interest in residential rental as a possible new departure. Similarly, funds managers have become more sensitised to the benefits of holding a low risk (even if relatively low yield) component within broader investment portfolios. Latterly, the (apparent) 2017 peak of the Sydney-Melbourne housing market cycle has naturally stimulated development industry interest in 'product diversification' so as to maintain output in the face of declining traditional demand. Growing awareness of BtR as a new development product also reportedly reflects dawning realisation of a longer-term structural shift whereby new demographics among renters has translated to deep, untapped demand for a new class of rental product.

A key aim of this research has been to assess the possible scope for a market-rate BtR product to act as a vehicle for affordable housing provision. In addressing this question, the research has, by necessity, sought to develop a wider understanding of BtR as it may emerge in Australia – within the current policy and housing market context. This has involved engagement with a wide range of industry stakeholders, policymakers and interest groups,



CastleRock capital New Generation Boarding House - Newtown, Sydney

as well as in-depth development feasibility modelling to gauge product viability and business case sensitivity to possible changes in the policy and market context.

### **BtR precedents**

While the possible emergence of a ‘mainstream market’ BtR product would represent a new departure for Australia, proponents have drawn inspiration from various precedents. These include the active purpose-built market rental housing sectors operative in the United States and the United Kingdom. The US ‘multi-family housing’ sector has seen 6.3 million apartments constructed since 1992, with these now accounting for some one in six of America’s rental homes. Although briefly interrupted by

the GFC, national output has been running at around 300,000 units annually for at least four decades.

In the UK, meanwhile, a rapid BtR sector takeoff has been seen in recent years. Some 68,000 BtR units have been completed since 2012 or were under construction as at Q4 2018. Planned developments with local council approval at the time of writing account for a further 64,000 units. Given the significance of the UK BtR experience as a reference point for the Australian development industry, the current research included primary fieldwork on the UK’s BtR sector, undertaken by LSE London colleagues and separately reported in the companion report ‘Build-to-rent in London’.

Closer to home, industry stakeholders have drawn encouragement from the rapid expansion of purpose-built student accommodation (PBSA) as seen over the past 10-20 years. Such (largely) institutionally-funded provision is estimated as totalling over 90,000 bedspaces, with a pipeline of some 8,000 units annually. While student housing benefits from certain tax and regulatory advantages, 'mainstream market' BtR development is seen by some as a natural progression.

Also effectively a precursor of BtR in Australia is the constellation of investment structures and associated legal regimes that have been developed for collective investment in large-scale property assets. Internationally and locally these structures are commonly referred to as real estate investment trusts (REITs). Australian REITs are now one type in a larger category of Managed Investment Trusts (MITs), the legal regime for which dates from 2008. MITs and the associated stapled structures are commonly used in PBSA and appear to be an obvious vehicle for broader BtR investment. However, especially regarding their use for schemes funded from overseas, this is complicated by recent controversies about their appropriate purposes and concessional tax treatment.

### **The BtR concept: Australian interpretations and their feasibility**

Among Australian development industry stakeholders and experts it is commonly anticipated that BtR in NSW and other jurisdictions will initially take the form of fairly large high-density developments (usually exceeding 200 dwellings) in inner city and well-located middle suburb capital city locations. An initial focus on Melbourne and Sydney is expected, although potentially spreading to other cities if the BtR concept is proven.

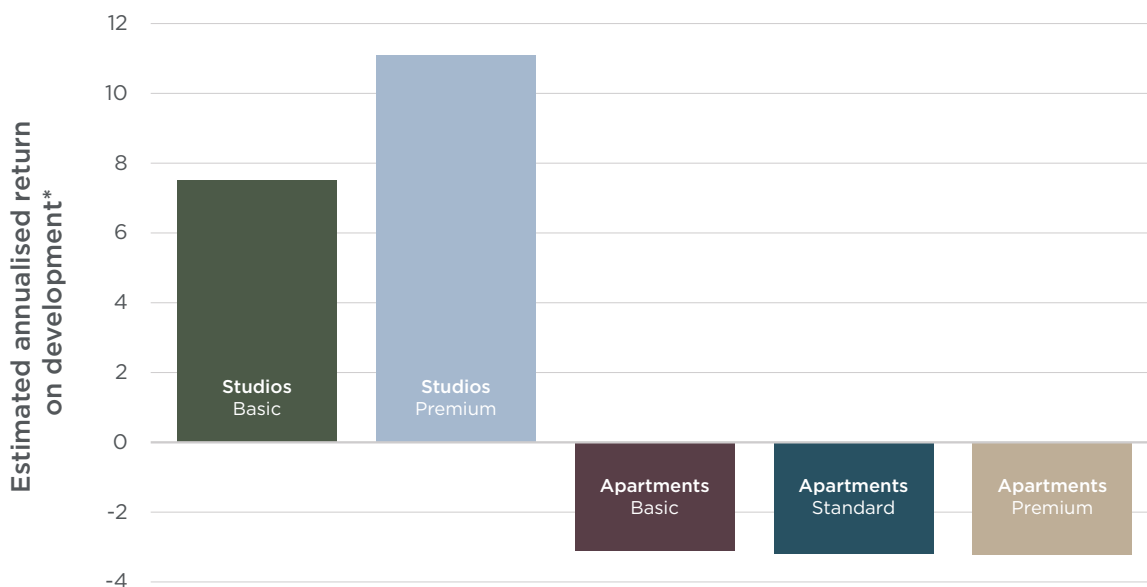
Some stakeholders emphasise the potential attractiveness of sites close to 'anchor institutions' such as hospitals and universities for schemes targeted to institution employees possibly willing to pay premium rents for convenience. Others favour integration of BtR in retail and other commercial developments, such as through exploitation of un-utilised airspace. In this scenario BtR could diversify site owner income streams, while benefiting from lower overheads – given development site costs will have been incorporated in the primary land use. At the same time, such schemes will likely need to overcome construction challenges in terms of both costs and complexity.

Many BtR proponents envisage the emerging sector as offering a high-quality product for relatively high-income target market. In mind here are 'young urban professionals'; well-educated and possibly occupationally mobile people prioritising lifestyle aspirations over home ownership and therefore willing to pay premium rents for a well-located, high-quality residential package including ancillary services. Others, however, see BtR developing as a more 'mid-market product' – 'not "affordable", not luxury' – but still offering premium locations and a higher quality service than currently provided by small landlords and real estate agents.

### **Modelling BtR financial feasibility within existing taxation policy settings**

Our development feasibility analysis modelled 'base case' prospects for five different BtR archetypes under current market conditions as these apply in the inner Sydney context (with the suburb of Redfern used to exemplify these). Sensitivity analysis examined the viability implications of a range of possible 'market change' and policy change scenarios.

**Figure ES1: Base case estimated annualised return on development\* by unit BtR archetype**



\*Based on an asset value implied by a required rate of return during operations (4.5%)

The archetypes refer to complexes composed of dwellings of different sizes and ‘grades’. Firstly, when it comes to studio blocks a distinction is made between basic studio units – the ‘new generation boarding house’ (NGBH) product that has recently flourished in Sydney (see Section 2.3.2) – and the off-campus purpose-built student accommodation (PBSA) blocks that we characterise as a ‘premium’ studio product (superior services, higher rents). Secondly, for apartment blocks we differentiate the ‘basic’ variant (exemplified by CHP-developed schemes), the ‘standard’ product (developers ‘business as usual’ mass-market specification) and the ‘premium’ apartment archetype (a high-amenity residential or serviced apartment product).

The modelling inputs drew on case-study fieldwork focused on rental housing developments already in operation, under construction or in the planning phase. Base cases, however, do not incorporate tax or planning concessions afforded to CHPs, NGBHs or PBSA. Nor do they factor in some of

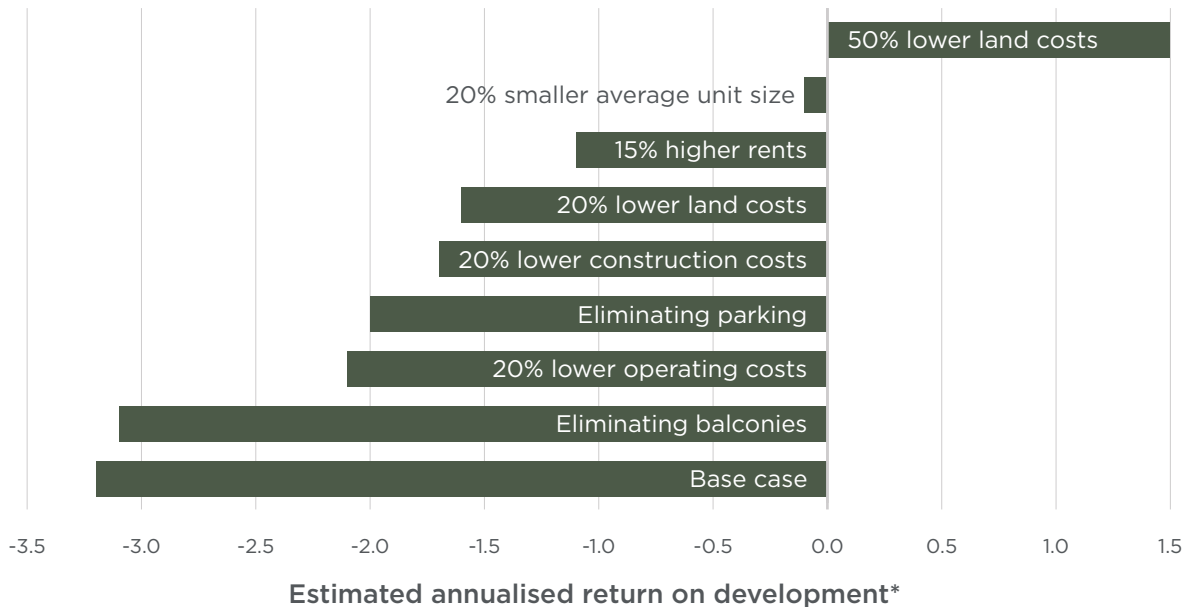
the purported advantages of BtR apartment blocks (e.g. around rent premiums or ‘efficient operation’). The impact of these on the base cases are explored in turn.

Three key findings emerge from the base case analysis as shown in Figure ES1. First, the highly advantaged status of studio blocks where, effectively, the somewhat lower rents that would be expected for each unit are hugely outweighed by the ability to accommodate much larger numbers of units on a given site. Second, all of the apartment variants record a negative return on development – in that the estimated capital value based on operating return is below the required capital to develop the project. Thus, apartments built under base-case parameters are generally not feasible. And third, apartment development prospects are more-or-less invariant across the three ‘grades’ – the higher rents that would be expected from the ‘premium’ product would do no more than offset the associated higher cost of such provision.



St George Community Housing, Sydney - Lawrence St affordable rental housing

**Figure ES2: Impacts of different design, procurement and housing market scenarios on ‘standard apartment’ BtR development feasibility**



\*Based on an asset value implied by a required rate of return during operations (4.5%)

Figure ES2 shows the estimated ‘feasibility’ impact of varying a range of factors with the potential to reduce development costs or enhance rental revenue. Of the scenarios tested, only a 50% drop in land costs would be – in isolation – sufficient to generate a positive, but still very low, return on the development. Combinations of scenarios (e.g. 20% lower construction costs and 15% higher rents) could of course potentially achieve this. However, the feasibility challenge posed for apartment block (as opposed to studio block) BtR is fairly stark.

### Policy levers

There are a number of existing (federal and state) taxation settings and components of land-use planning policy that impact on BtR financial feasibility. Each of these is discussed in detail in the main body of our report (see Chapter 4).

Several current policy settings have been highlighted by the industry as significantly

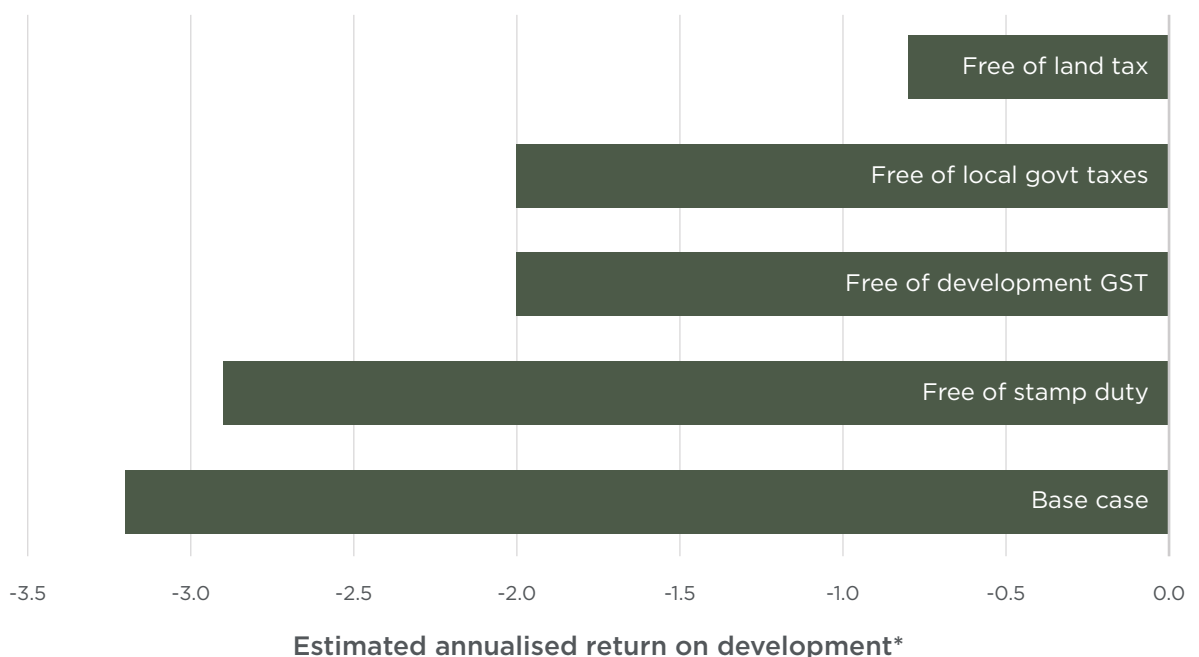
impeding the establishment of a mainstream market BtR sector. The case for adjustment of such policies has been made least contentiously in terms of the argument that there should be equal treatment for BtR and for other forms of market residential property development and/or for investment in other comparable asset classes. For example, it is reasonably contended that the ‘progressive’ structure of land tax as it applies in most states and territories impacts BtR landlords ‘unfairly’ by comparison with small scale individual landlords who are often effectively exempt. Similarly, once again we see merit in the case for GST reform to ‘level the playing field’ with respect to build to sell developments.

Much less justifiable, however, are adjustments to policy settings sought by BtR proponents which would place BtR providers on an equal footing with community housing providers who accordingly accept substantial ‘public policy’ obligations. Exemptions from income

tax, land tax and council rates, provision for GST input claims, density bonuses and reduced parking requirements are available to CHPs in NSW; CHPs may also occasionally have access to land at discounted prices or free of charge. In return CHPs must comply with government-designated affordable

housing obligations and special regulatory oversight and invest any surpluses in pursuit of their charitable mission. It does not seem appropriate to extend such advantages to a purely for-profit provider who is not subject to comparable social obligations and oversight.

**Figure ES3: Impacts of posited tax changes on ‘standard apartment’ BtR development feasibility**



\*Based on an asset value implied by a required rate of return during operations (4.5%)

Figure ES3 shows outputs from our BtR development feasibility modelling as these relate to the impact of possible tax changes on the business case for the ‘standard apartment’ archetype. While all such concessions could somewhat enhance viability, none would be sufficient in isolation to enable a standard BtR apartment project to be a viable development prospect.

Australian Government rules surrounding residential property investment by Managed Investment Trusts (MITs) have also formed a focus for vigorous debate involving BtR

proponents. Legislation currently before the Australian Parliament would clarify that MITs can invest in residential property, but that income from ‘residential housing’ (other than ‘affordable rental housing’) would be ‘non-concessional MIT income’, and distributions to foreign investors therefore subject to 30% withholding tax. Effectively, this means that overseas-based BtR investors using MITs will be taxed at a higher rate than domestic institutions and at a higher rate than overseas investors in other asset classes. From the industry perspective the more ‘highly taxed’ status of overseas BtR investors is considered



both important and problematic because it is expected that – all other things being equal – overseas investors would be otherwise likely to act as prime movers in the emergence of an Australian BtR sector.

Income tax exposure – and possible reforms for BtR development as requested by industry stakeholders – cannot be accommodated within our project-based modelling framework. However, according to modelling undertaken on a different basis by a real estate company (CBRE 2018a), this rule reduces BtR viability for overseas-based BtR providers by about half the amount of the land tax impact.

### **BtR and affordable housing**

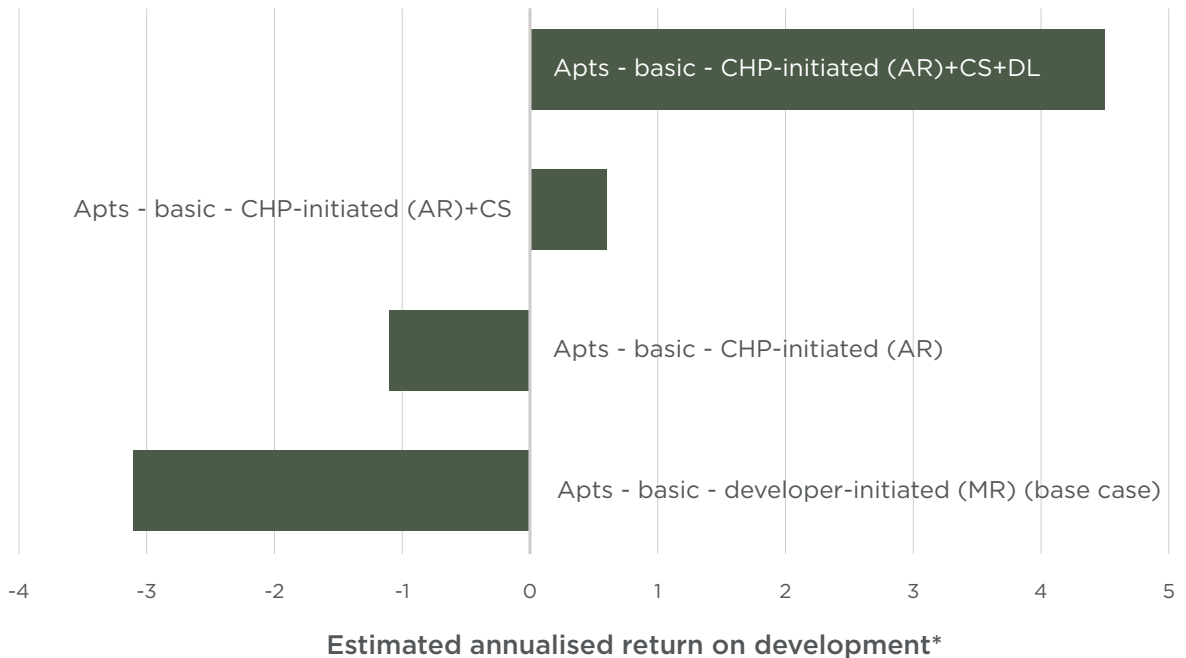
The viewpoint that BtR may be a pathway to procuring affordable housing at scale stems mainly from an assessment that: i) mixed tenure (affordable and market rental) projects may be easier to achieve than has proven the case in Build to sell (BtS) projects to date, and ii) that BtR at scale might trigger institutional investment in a residential asset class in Australia, which in turn would help to mobilise a long term flow of private finance into affordable rental housing.

Evidence from international systems of capital-market financed affordable housing, investment industry analysis and our own research indeed all show that affordable housing can be made to work in a BtR market with appropriate housing market conditions and a favourable policy approach. However, such conditions are not sufficiently established in Australia presently. As confirmed by our modelling, the production of basic apartments will call for substantial government support additional to the standard concessions available to non-profit developers and under the NSW AHSEPP (Affordable Housing State Environmental Planning Policy). In principle, such assistance could take the form of low-cost land, capital grant or ongoing revenue

subsidies. Recent Australian Government endeavours to incentivise investment in affordable housing will also assist.

To illuminate the policy and funding challenges, we used our BtR feasibility modelling to show how different options for delivering housing affordable to lower income households affected BtR project feasibility. As illustrated in Figure ES4, using organisations with the tax advantages conferred by charitable status and benefiting from existing planning provisions will improve the feasibility of a development scheme even after allowing for discounted rents (75% of market level). In isolation, however, this only reduces the level of losses (to -1.1% rather than -3.1%). Enabling a (charitable) CHP to undertake a (50/50) mixed tenure development and retain the revenue benefits will further improve financial performance such that there is a small positive return. However, while this remains insufficient to support private financing, the further addition of a 50% land price discount would enable the project to ‘stack up’ in terms of yielding the required rate of return (4.5%) – see Figure ES4.

**Figure ES4: Impact of different delivery and funding scenarios for 'basic apartment' development**



\*Based on an asset value implied by a required rate of return during operations (4.5%)

MR=market rent; AR=affordable rent (75% of market); CS=cross-subsidy derived through mixed tenure development (50% market rent; 50% affordable rent); DL=discounted land (50% of market price).

Looking at this another way, after taking account of existing concessions available to charitable organisations, our modelling indicates that a well-located inner-city site suitable for inclusion of 'essential worker' housing would require a land price discount of nearly \$130,000 per dwelling. Utilising the 50/50 cross-subsidy model reduces the necessary discount to around \$80,000 but increases developer risk. Layering-in other cost savings (such as through innovative construction methods or modified planning requirements) will also assist in further reducing the necessary land-price discount.

Under the same conditions as set out above, the annual subsidy required in lieu of a land price concession would be around \$9,000 per dwelling. Under this approach, however, retention of the housing procured for affordable rental would result in an ongoing cost to government. Therefore, an upfront subsidy will become progressively more cost-effective for governments and enable long-term retention of affordable housing without the need for additional outlays. Long-term low-cost renting of government land is also an option, as practiced in the ACT.

Our findings challenge the case for subsidising for-profit BtR provider developments to achieve ministerial affordable housing policy goals. There is a stronger argument for encouraging CHPs as affordable housing developers – including enabling them to operate a cross subsidy, mixed tenure model. This variant leverages off existing concessions and operates under established governance and compliance regimes, which help to ensure that a spectrum of needs can be addressed, that appropriate tenant support is provided, and that affordability benefits are optimised and preserved over the longer term where appropriate.

Under the right leadership and with sufficient subsidy, a not-for-profit-led affordable BtR model has the potential to attract institutional investors, beginning with those in both the retail and industry superannuation sectors, who have declared their interest in supporting the development of an affordable housing asset class in partnership with the CHP sector. There is ample evidence from elsewhere that, once established, this model can be scaled up.

## **The future**

As acknowledged above, there is a plausible case that an active and viable Australian BtR industry could contribute to desirable public policy goals. Should such a sector indeed emerge, however, it will be important to carefully monitor and evaluate the extent to which this potential is in fact realised.

# 1. Introduction

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## 1.1 Research origins and objectives

This research has been undertaken by a university research team in collaboration with Landcom through Landcom's University Roundtable Research program. It focuses on build-to-rent (BtR), a term that – at its simplest – normally refers to apartment blocks or larger developments purpose-built for rental occupation and held in single ownership as long-term revenue-generating assets. As such, BtR represents a significant departure from a traditional Australian residential development and ownership model where multi-unit blocks are typically built for, and sold to, individual owners – some of these for owner-occupation, others as rental investments.

To differentiate it from BtR, the 'traditional' development model described above is referred to in this report as build-to-sell (BtS). In some of our references to build-to-rent, we specify 'mainstream BtR'. This is to differentiate a product designed to appeal to a broad range of client cohorts (e.g. in terms of resident age, household size), from the very specifically targeted 'proto-BtR' products such as student housing (see Chapter 2).

If, in the Australian context, mainstream developers were to re-orient their activity away from BtS and towards BtR this would necessitate a major shift of approach. Such a departure would entail significant innovation in investment finance and funding, corporate

structures and functions, risk management, and property and customer relations practices.

The feasibility of a purpose-built rental product has been of interest to Landcom for many years. In part, this reflects the agency's role in industry leadership and promoting innovation – including through devising 'proof of concept' models for new approaches and products. More specifically, the agency's 'housing diversity' objective aims to facilitate a wider range of housing choices. Indeed, Landcom undertook extensive design and feasibility research in the mid-2000s under the agency's Rental Housing Portfolio Project (RHPP). However, while it was found difficult to evoke sufficient government/industry commitment

to making available large-scale investment-grade sites, the initiative was in any case shelved due to GFC disruption of the housing and finance markets.

Latterly, Landcom's interest in BtR has been renewed, particularly in connection with the possible inclusion of purpose-built rental in the large-scale NSW urban renewal projects for which it shares responsibility with the UrbanGrowth NSW Development Corporation and the NSW Land and Housing Corporation (LAHC). In seeking to better understand BtR potential in the Australian setting, Landcom's interest also accords with recently mounting BtR awareness across Australia's property and development industries and also within governments at both state and federal level.

Landcom also takes a special interest in 'housing diversity', latterly including an explicit commitment to the incorporation of affordable rental housing within mainstream residential development projects. Specifically, in terms of its own schemes, the agency has set 'a target of 5-10 per cent affordable housing for rent<sup>1</sup> as a proportion of all new housing provided' (Landcom 2017 p3).

With all of the above in mind, the ultimate aim of the research has been to develop a better understanding of the potential contribution that BtR schemes might make to the provision of affordable housing. However, such a question can really only be addressed within the context of an understanding of BtR as a market price product. Hence, the research objectives were agreed with Landcom in the form of a set of questions as follows:

- i.** How is the BtR concept being interpreted and defined in Australia?
- ii.** What can be learned from recent Australian

housing products pre-figuring BtR?

- iii.** What is the appetite for involvement in BtR projects in Australia's institutional investment community and among developers?
- iv.** In what geographical and housing market settings are BtR projects likely to be feasible in urban Australia? How could BtR projects be accommodated within renewal schemes?
- v.** What are the essential features of BtR as it might be exemplified in Australia?
- vi.** Where would a BtR product likely sit within the Australian housing market and within tenants' housing careers?
- vii.** What is the feasibility of incorporating affordable housing within BtR projects and what design/ownership configurations might facilitate this?
- viii.** What potential roles could be played by not-for-profit housing providers in BtR development and/or management?
- ix.** What possible policy and regulatory reforms could enhance BtR prospects?

Before explaining how the research to address these questions was undertaken, the next section contextualises the project within a broader policy and historic context.

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<sup>1</sup> Defined as 'appropriate for the needs of a range of very low to moderate income households and priced so that these households are also able to meet other basic living costs. As a rule of thumb, housing is usually considered affordable if it costs less than 30 percent of gross household income' (Landcom 2017p8).

## 1.2 Policy and housing market context

In this section we frame the research in relation to Australian policy and market developments that have implications for the possible emergence of 'mainstream BtR', the main subject of this report. Accordingly, we review recent housing market trends in terms of the ongoing decline in home ownership and rising rates of rental stress affecting lower income tenants. We go on to analyse new housing supply rates, a perennial concern not only for the development industry but also for government. Also, since these are considerations often cited as reform motivations, we also briefly summarise concerns around the quality of private rental housing management and the contended need for sector restructuring.

### *Falling home ownership affordability, and rising rental stress*

Political and policymaker concern in the housing sphere focuses substantially on the problem of home ownership affordability; for example, as highlighted in 2017 comments by both the NSW Premier and the (then) Federal Treasurer (Nicholls & Robertson 2017; Morrison 2017). Falling owner-occupation rates among young adult cohorts are widely considered a problematic consequence. Thus, in the 15 years to 2016, the home ownership rate for 25-34 year olds fell from 51% to 44% (Daley et al 2018). While higher house prices are substantially offset by the record low interest rates seen in recent years, they have imposed a growing 'deposit barrier' on access to home ownership. In Sydney the deposit required to secure a mortgage on a typical property grew from 1.39 times average annual earnings in 2000 to 2.38 times AAE in 2015 (using consistent metrics) (AIP 2016). Similarly, in Melbourne, the respective

multiples were 0.92 for 2000 rising to 1.76 times in 2015 (Ibid).

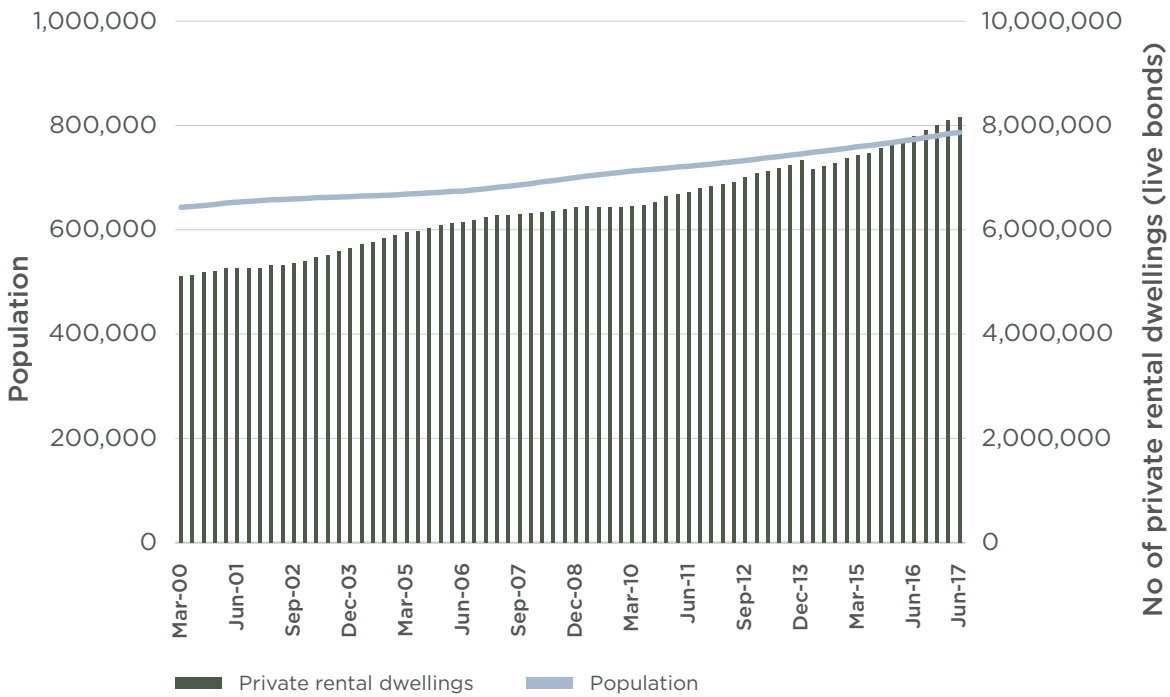
Growing stress in lower reaches of the housing market is also the subject of official concern (Morrison 2017). Perhaps the single best measure of this problem is that between 2007-08 and 2015-16, the proportion of low-income tenants paying 'unaffordable' rents (i.e. accounting for more than 30% of gross incomes) rose from 35% to 44% (ABS 2017). At the same time, Australia's social housing portfolio that provides a 'safety net' for severely disadvantaged groups has expanded only marginally over the past 20 years - despite rapidly rising population and accordingly increasing need<sup>2</sup>. Rising homelessness rates are one consequence of these trends, with recently published Census data showing homelessness - as officially defined - rising well ahead of general population growth in the five years to 2016 (Pawson et al 2018).

Substantially due to declining home ownership affordability, Australia has seen rapid growth in private renting over recent decades. Nationally, the private rental rate rose from 18% to 25% of all households in the 20 years to 2015-16 (ABS 2017). An aspect of this change is the tendency towards growing duration of private rental residence, with the proportion of Australia's household population defined as 'long-term renters' (those residing in private rental homes for at least 10 years) estimated as doubling from less than one in 20 (4.9%) to more than one in 12 (8.2%) 1994-95-2007-08 (Pawson et al 2017).

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<sup>2</sup> As a proportion of national stock across all tenures, public housing comprised 6% in 1995/96. By 2015/16, allowing for a market share of around 1% for community housing, the overall social sector had contracted to 4.5% (ABS 2017).

**Figure 1.1: NSW population and private rental stock, 2000-2017**



Sources: Private rental dwellings – NSW Rental Bond Board statistics (NSW Rent and Sales Report); Population – ABS Demographic Statistics Cat 3101.0 Table 4

Implicit in Australia’s rising rate of private rental is the trend of stock expansion running ahead of overall population growth, as exemplified for NSW in Figure 1.1. On average, the former has been expanding at an annual rate of 2.8% since 2000 while the latter has been rising at only 1.2% per year. Nevertheless, as argued by the former Federal Treasurer, ‘Progress must be made [in further] boosting and diversifying [the] supply of rental stock’ (Morrison 2017).

Such aspirations are motivated, in part, by the recognition of intensifying pressures affecting the lower end of the market (see above). As in other countries with similar economic systems, they may also reflect an understanding that adequate private rental provision is necessary for the ‘effective operation’ of flexible labour markets where workers can, if required, easily move home to take up job opportunities.

### New housing supply

The key issue usually considered as underlying stressed housing affordability across the housing market is a posited long run inadequacy of overall new housing supply (NHSC 2010; Koukoulas 2016; Daley et al 2018)<sup>3</sup>. Thus, while acknowledging strong

growth in the period 2012-2017 (see Figure 1.2), it is conventionally argued that national housebuilding output would need to be maintained at similar levels for some years before the previously accumulated 'supply deficit' is overcome (Property Council of Australia 2017).

**Figure 1.2: Dwelling commencements, 2000-2017 - Australia and NSW**



Source: ABS Building Activity, Australia Cat 8752.0 Tables 33 and 35

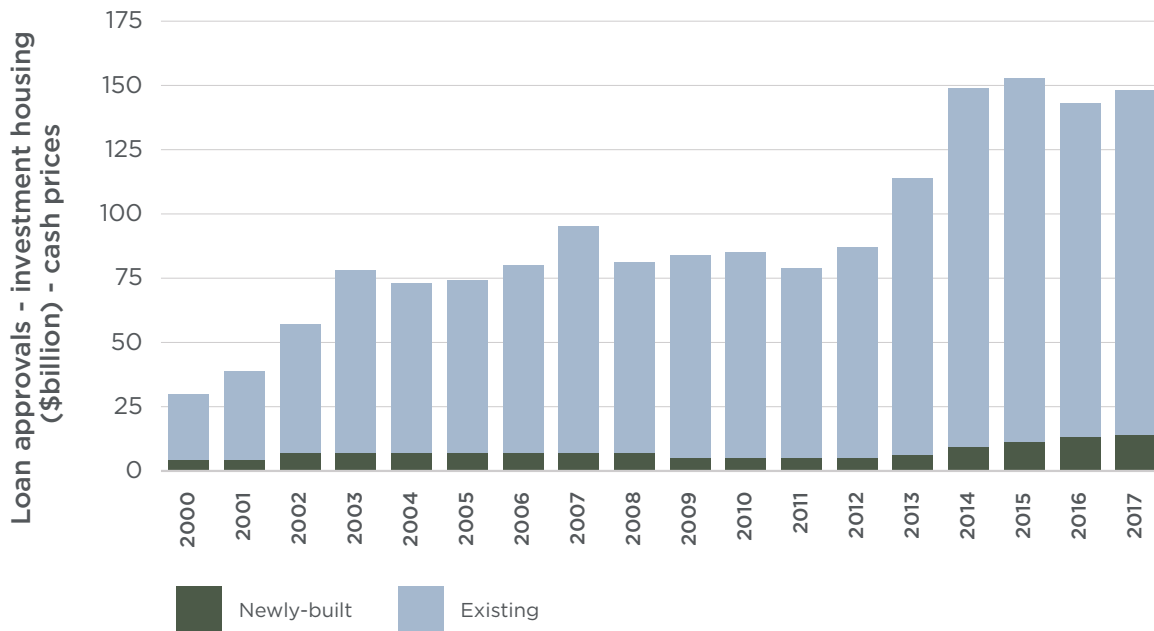
Beyond this, policymaker and academic concern about the private rental status quo is partly influenced by the nature of sector growth which has continued to be overwhelmingly dominated by the acquisition of existing – rather than newly-built – dwellings. As such, credit underpinning unproductive speculation vastly outweighs that being applied to new housing capital formation.

As shown in Figure 1.3, the proportion of investor housing finance accounted for by additional (newly-built) dwellings has averaged only 8% of total rental investor finance approved since 2000.

<sup>3</sup> It should be noted that such an analysis is not uncontested. See, for example, Phillips & Joseph (2017).



**Figure 1.3: Loan approvals for investment housing, Australia 2000-2017**

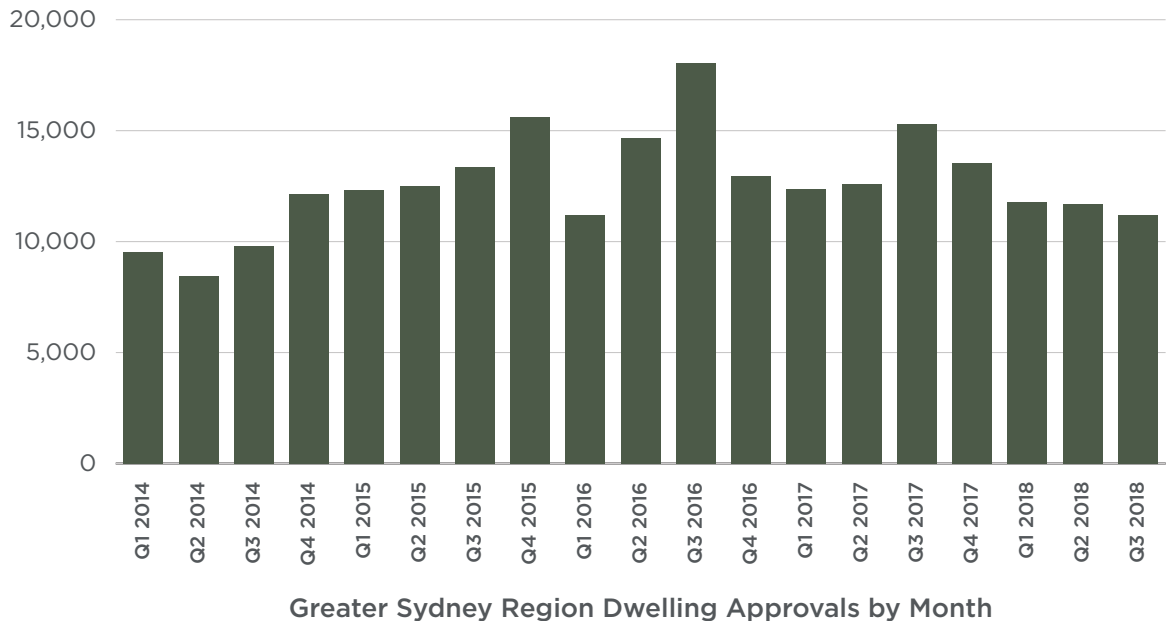


Source: ABS Housing Finance Cat 5609.0 Table 11

Consistent with the apparent peaking of dwelling commencements shown in Figure 1.2, the flow of residential planning approvals in Greater Sydney also appears to have begun to decline since 2016 - see Figure 1.4. In the two years to Q3 2018, approvals fell by almost 38%. In these circumstances it might be expected

that developers having ramped up their output since 2011 might be particularly interested in possible diversification into new products that could help to sustain output levels and cashflow.

**Figure 1.4: Planning approvals in Greater Sydney, 2014-2018**



Source: NSW Dept of Planning and Environment

***Private rental housing management***

Perceived failings of the private rental sector as currently configured also include dynamics which follow from its ownership structure, dominated as it is by small-holding individual landlords whose main priority is to benefit from asset value appreciation and tax minimisation strategies (Hulse et al 2018; Seelig et al 2009). This generates a natural landlord inclination to favour minimal security of tenure - increasingly unsatisfactory for a sector accommodating growing numbers of family households and other low-income

earners with little or no market power (Hulse et al 2012; Morris et al 2017). Although Sydney and Melbourne-based research evidence shows that only around 25% of private tenancies are ended at the instigation of the landlord rather than the tenant (Pawson et al 2017), the vast majority of Australian private renters sign up for 6-12 month contracts which provide little security of tenure, especially after conversion to periodic status at the end of a fixed term.

### ***Restructuring private rental housing provision***

While some of the above issues have become more pronounced in recent times, many of them are longstanding. Similarly enduring as an officially favoured policy response has been the aspiration to attract large scale institutional investment into rental housing (Pawson & Milligan 2013). This is true in Australia (Plibersek 2008, Australian Government 2010) just as in the UK (Kemp 2004). As voiced by the then Federal Treasurer in his above-cited 2017 speech, ‘attention must also be paid to how rented residential real estate can be better structured to provide more opportunities for institutional involvement’ (Morrison 2017). This was seen as attractive not least in ‘... create[ing] greater scope for longer term leases and potentially reduc[ing] the reliance of developers on attracting individual foreign investors to get projects off the ground’ (Ibid)<sup>4</sup>.

In a nutshell, as voiced by one UK commentator:

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**‘Institutions could [not only] support the necessary expansion of the sector ...[but also] shift the nature of the product the sector is able to provide because long-term security for tenants translates into predictable returns for investors’**

(Alakeson 2011 p14).

The last major Australian effort to channel institutional funding into the construction of new rental housing was the 2008 National Rental Affordability Scheme (NRAS). Loosely modelled on the US Federal Government’s Low-income Housing Tax Credit (LIHTC) mechanism, NRAS aimed to encourage affordable rental housing construction through an annual refundable tax offset offered to private investors or, in the case of charitable organisations, a cash grant for ten years. In return, for the same period, investors were required to apply specified eligibility guidelines in granting tenancies and to set rents at no more than 80% of the local market equivalent rate. At its inception NRAS was marketed strongly as an incentive for institutional investors which, if effective, would be expanded to 100,000 homes from its initial target of 50,000 after 2012/13. However, for reasons detailed more fully elsewhere (Milligan et al 2015), the scheme’s eventual design and administrative arrangements somewhat detracted from these initial ambitions.

In the event, NRAS was ended by the Australian Government in 2014 with the truncated program expected to generate 38,000 new affordable rental homes across Australia (Rowley et al 2016). However, while a number of super funds and other finance sector players had, by then, made moves towards scheme participation, none had yet committed investment (Milligan et al 2015).

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<sup>4</sup> Certain State Governments have also recently taken a keen interest in the possible emergence of an Australian BtR sector. In NSW, for example, cross-departmental and industry stakeholder working groups were convened by Property NSW in 2017-18, with their deliberations underpinned by in-depth real estate research undertaken in-house. Unfortunately, however, the resulting Property NSW report has remained unpublished and was unavailable to the research team.

### 1.3 Research methods

#### *Literature review*

A desktop review was undertaken to cover recent developments in the emergence of build to rent in Australia. This focused, in the main, on industry publications and media reports identified at an early stage of the work as well as many others which appeared during the course of the project.

#### *BtR stakeholder engagement*

The heart of the project involved structured engagement with a wide range of Australian industry, government and consumer advocacy stakeholders. This was achieved mainly by face-to-face indepth interviews. Research participants were selected to embody the following cohorts:

- Developers, developer advocates and sector experts (e.g. consultants)
- Government players - both NSW Government and Australian Government
- Funds managers and other finance industry players
- Affordable housing providers
- Consumer advocates

Interviews utilised a semi-structured topic guide drawn up to with respect to the specified research questions as set out in Section 1.1. In all, 30 stakeholders in NSW and Victoria (many of them senior players) were interviewed and/or consulted via round table sessions.

#### *Project level case studies*

This element of the research focused on a diverse set of four case study development projects relevant to the project. The chosen schemes were:

- A New Generation Boarding House
- A 'high end' large scale build to rent project in its planning phase

- A student housing project
- A new-build affordable rental housing project

Case study work involved a detailed focus on each chosen project in terms of landuse planning considerations, design, management and (to the extent that information could be divulged) finances. The main purpose of the project level case studies was to inform the development feasibility modelling work described below.

#### *Development feasibility modelling*

The modelling exercise was used to quantify the effects on BtR feasibility, such as market context, policy settings, and any identified points of difference in a particular BtR business model. The model is based on inputs and assumptions informed by Randolph et al (2018) and the case study projects, above. The exercise calculated the development costs, which established an initial capital input, and operating costs and revenues, which established an operating return. Then, by setting a required rate of return, that operating return established an implied capital value. The implied capital value could then be compared with the initial capital input, and an indication of development feasibility was possible. By varying inputs like land costs and rents charged, this indicative metric was compared in different scenarios, particularly those identified through the interviews and case studies. The method is described further in Chapter 3 and Appendix 1.

#### *UK research*

Although most of the Australian fieldwork was undertaken in and around Sydney, a number of interviews and some case study site visits were undertaken in Melbourne and Brisbane. However, the research also included a semi-autonomous sub-project undertaken in the UK. With a specific focus on BtR in London, this module, was commissioned as part of the

wider project in recognition of the significant role being played by the UK as an inspiration and reference point for many BtR stakeholders in Australia. It was carried out by Kath Scanlon, Fanny Blanc and Peter Williams (LSE and Cambridge University) in the first half of 2018 and focused on the following aspects of the London scene:

- The role of BtR in officially-sponsored urban renewal projects
- BtR and affordable housing
- The roles of not-for-profit housing providers in the BtR sector
- The BtR consumer experience

As explained in the separate report of the research, the study analysed London BtR statistics, reviewed recent publications, and interviewed 17 informed stakeholders. A small survey of tenants, and case studies of two recent BtR schemes were also conducted. More detailed information on these methods is included in the separate report.

#### **1.4 Report structure**

Following this introduction, the report is structured in five chapters. First, in Chapter 2 we look at the emergence of build to rent in Australia. Given the attention paid by many players to experience of ‘multi-family housing’ in the USA and – latterly – build to rent in the UK, the chapter begins by briefly reviewing experience in those countries. It goes on to discuss Australian products that pre-figured or, in some respects, embodied the ‘mainstream’ build to rent developments now being envisaged (and in some cases constructed). Finally, the chapter examines some of the drivers of growing interest in build to rent in Australia.

Next, in Chapter 3, drawing more squarely on our primary research evidence, we review the build to rent landscape in Australia.

Here we discuss the key stakeholders, the organisational models, the physical settings and the service offer likely to feature in the development of ‘mainstream’ build to rent schemes in Sydney, Melbourne and elsewhere. We then present our own interpretation of BtR in Australia, as a model of five possible types of BtR projects. This indicates the viability of each type in different market conditions.

Following on from this, in Chapter 4, we look at the policy levers and possible reforms which might influence the scale, shape and viability of the BtR sector that could emerge in Australia. In the main, these concern land use planning powers that are the preserve of state and territory governments, and the tax settings under the control of both states/territories and Australian Government departments. The effects of each of these policy levers, except the income tax levers, can be measured at the level of a BtR project. In discussing each such lever, we present a ‘sensitivity analysis’ illustrating how policy adjustments may affect viability of the five BtR types as presented in Chapter 3.

Building on the development feasibility modelling work in Chapter 4, as well as on stakeholder interviews, Chapter 5 then examines the scope that could be presented by BtR projects as a platform for affordable rental housing. The discussion considers both the prospects for inclusion of affordable housing dwellings in developer-led BtR projects and the related issue of what roles CHPs might play in the BtR space – whether as BtR developers, development partners or property and tenancy managers

Finally, in Chapter 6 we draw together some of the threads from the preceding chapters to address the stated questions the research was designed to explore.

# 2. The emergence of build-to-rent in Australia

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## 2.1 Chapter overview

The main purpose of this chapter is to explore the growing Australian interest in build-to-rent as a ‘mainstream’ housing market product, as this has unfolded since 2016. Drawing on industry literature, media reports and in-depth interviews undertaken for this project, it seeks to explain the various contributory factors.

Before moving to that discussion (Section 2.4), however, the chapter first places the growing Australian familiarity with BtR within a broader international context. The main focus of this consideration (Section 2.2) is the established purpose-built market rental housing industries of the USA and the UK. The particular relevance of this section of the report is that the development and business models operated in those countries have attracted extensive attention from Australian industry stakeholders and have undoubtedly inspired emulation in this country. In briefly summarising US and UK experience in this field we draw on industry literature, on Australian stakeholder interviews and (for the UK) on the research commissioned as part of this project from LSE colleagues – see Section 1.3.

Also briefly considered in the first part of this chapter (in Section 2.3) are the established Australian property development forms with features akin to those of BtR as a mainstream housing market product. These include student

housing and micro-apartment blocks (officially designated ‘new generation boarding houses’ in NSW Government planning terminology).

## 2.2 Multifamily and build-to-rent housing in the USA and the UK

The ongoing expansion of private rental housing in Australia needs to be seen within the context of similar trends recently apparent in many other OECD countries – among them, Ireland, New Zealand, the USA and the UK. Equally, such growth has for the most part involved the acquisition of individual existing dwellings by small-scale landlords – in Australia usually termed ‘rental investors’ or ‘mum and dad investors’. At least in a few comparator nations, however, the development of purpose-built apartment blocks for (market) rent has formed a component of recent sector growth. While our attention is focused here on the USA and the UK, it should be noted that similar trends have been observable in numerous other countries including France, Germany and Japan (Schlesinger 2017; PCA 2018).

### 2.2.1 Multifamily housing in the USA

Multifamily housing, the US term for residential buildings containing five or more rental apartments, is a long-established and steadily expanding component of the American housing system. Residential blocks are constructed or otherwise acquired by real estate companies or other financial institutions (or sometimes by individuals) primarily as income-generating assets to be held in single ownership for the long-term. As with owner-occupier mortgages, financing was historically mainly arranged through banks and thrift entities which raised and lent funds locally. However, the 1990s saw a shift whereby funds were increasingly raised direct from global capital markets and channelled through Real Estate Investment Trust vehicles (Bradley et al 1998). Hence, 'by the end of the 1990s multifamily rental housing could be treated more like a financial asset' (Fields & Uffer 2016).

According to the Harvard University Joint Center for Housing Studies, the 2017 US rental housing stock totalled 47 million units, of which some 43% - or 20 million - were in multifamily buildings, defined as above (JCHS 2018). Of these, 6.3 million were apartments in such buildings constructed since 1992 (National Multifamily Housing Council website). Although briefly interrupted by the GFC, the national output of multifamily housing has been running at around 300,000 units annually for at least four decades (ibid; Bradley et al 1998). At least in the recent past much of this new housing has been 'targeted to higher-income households and located primarily in high-rise buildings in downtown neighborhoods' (JCHS 2018 p2).

The US multifamily housing industry involves a number of very large players. As far as ownership is concerned, the largest is MAA, a Tennessee-based Real Estate Investment Trust with some 100,000 units on its balance sheet. Meanwhile, the largest manager entity is

Greystar, a South Carolina-registered company reporting 418,000 dwellings under its control in 2018. Notching some 5,600 new homes completed, Greystar was also the country's largest multifamily developer in 2017 (National MultiFamily Housing Council - NMHC - website).

NMHC data also provides some impression of industry structure. For example, 3.3 million units (of an estimated total of 20 million - see above) were under the management of the largest 50 management companies in 2018, while 2.1 million were owned by the 50 largest ownership entities. In terms of development, however, activity is somewhat more concentrated within a core of larger companies, with 76,000 newly-built units attributed to the largest 25 companies in 2017 (a year in which national output totalled 347,000 units - NMHC website).

While not necessarily typical of the sector, some impression of contemporary industry structure can be gained from the following self-description offered by Pinnacle, one of the largest multifamily housing management companies (162,000 homes in management in 2017):

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**'Pinnacle is a privately held organization that manages multifamily properties nationwide...Our clients [i.e. property owners] include pension funds, private partnerships, international investors, insurance companies, lenders, special servicers, syndicators, government agencies and high net worth individuals'**

Pinnacle website.



Iglu - purpose-built student housing - Redfern, Sydney



As implied here, the multi-family housing industry is a highly professionalised business involving an interlocking set of stakeholders developing and managing assets which, in the mature US market, are highly tradeable between asset holding entities. Likewise, property manager operations are highly tuned to optimise rental income in response to changing market conditions 'Revenue management systems ... used by nearly all major management companies... help determine optimal rent pricing based on market conditions, property occupancy, availability of units by size and other market and property-level criteria. [They] greatly assist in obtaining the best pricing for new leases and renewals, enhancing revenue for the owner' (CBRE 2018b p13). While it appears that there is strong and growing demand for accommodation managed in this way, such a business style is highly tuned to profit-maximisation. Consistent with that is the typical lease duration of only 6-12 months, motivated by the landlord imperative to maximise scope for raising rents whenever changing market conditions allow.

### **2.2.2 Build-to-rent housing in the UK**

This section is primarily drawn from the UK research undertaken as part of the current study, as reported in full in the companion report 'Build-to-rent in London' authored by Scanlon, Williams & Blanc.

### ***Scale of provision***

Private rental housing accommodates 19% of all UK households – a figure that has doubled over the past 20 years (Stephens et al 2018). The vast majority of the owners concerned are private individuals holding only one or two properties (Ronald & Kadi 2016). Until very recently, property acquisitions by such 'buy-to-let' (BtL) investors remained the overwhelmingly dominant source of sector growth. Especially since 2015, however, BtL acquisitions have declined – in part due to prudential lending restrictions and winding back of tax concessions (Wilcox and Williams 2018). At the same time, backed by government-policy initiatives, post-2012 UK housing and finance market developments have seen the rebirth of purpose-built-for-market-rental development last witnessed in the 1930s.

Across the UK, taking 2012 as a starting point, it is reported that by Q4 2018 some 67,535 BtR units had been completed or were under construction. Planned developments with local council approval accounted for a further 64,320 units (British Property Federation build-to-rent website)<sup>5</sup>. Initially, as BtR investment first emerged in the years from 2012, activity was concentrated in London. By 2018, however, the completed-units-plus-pipeline portfolio was divided almost exactly equally between London and other parts of the UK (ibid). Some of the major BtR asset-holders are US or Canadian companies bringing their experience of the North American multi-family sector, but there are also important UK-based players including pension funds and insurance companies, as well as a growing number of established not-for-profit housing association providers (Crook & Kemp 2018).

<sup>5</sup> While these numbers are significant, it is important to place them within the context of broader private rental sector growth. The six years to 2016 saw overall private rental sector growth of 876,000 dwellings (Stephens et al 2018). According to British Property Federation monitoring, BtR dwellings completed in the six years to mid-2018 totalled 22,000 (within the 56,000 recently completed or under construction at that time).

Numerous local councils have also begun to enter the industry, utilising newly-established local housing companies (Rugg & Rhodes 2018). Typically these entities are tasked with exploiting established municipal landbanks in developing market rental dwellings within the context of larger mixed tenure developments. In common with the standard housing association rationale, a key aspiration is to generate cross-subsidy to underpin sub-market rental incorporated within the development or provided elsewhere.

### ***Market targeting***

UK BtR developments cover quite a wide spectrum of homes ranging from the extremely luxurious to the relatively basic. Some informed observers are sceptical on whether the UK market will support the luxury end of the market as much as seen in the US multifamily sector – their view being that UK renters are less concerned about pools, gyms and club rooms in their own block, preferring to find such amenities in the surrounding area. It is clear rental markets vary around the world, as do sentiments regarding home ownership and private renting. This is bound to mean that BtR markets will differ.

Core demand for BtR housing in the UK market has come from so-called millennials, many of whom have been squeezed out of home ownership. As their circumstances improve, and the housing market goes through the inevitable cyclical downturn, some of them might be expected to move into owner-occupation, thus reducing demand. Indeed, government may still go further in its efforts to assist entry to home ownership. This will be a conditioning factor in the process. However, some of the constraining pressures are unlikely to change (e.g. tighter mortgage-market regulation has made it harder for first-time

buyers to access high LTV loans), so demand for rental homes may remain strong for some time even if the post-2017 slow deflation of the London housing market continues.

### ***BtR contribution to urban regeneration and affordable housing provision***

Within UK cities, BtR developments have tended to involve medium to high density schemes clustered in inner urban areas or otherwise close to transport hubs. Many such sites have been brownfield regeneration projects. As reported by industry informants and publications, BtR schemes build out faster than build to sell (BtS) (Savills & LSE 2017). Therefore, inclusion of the former can enable regeneration areas to be (re)populated more quickly. An influx of new BtR tenants is seen as bringing instant vitality, with associated demand for local services contributing to neighbourhood revitalisation momentum.

Many big London regeneration schemes therefore now incorporate a BtR component. Equally, however, BtR is increasingly featuring in council estate renewal projects elsewhere in the country. One large provider in the North of England (Sigma Capital), offers a product mix that consists mainly of low rise houses rather than medium to high density apartments (Crook & Kemp 2017).

The UK has a long history of government-subsidised development of affordable housing. Latterly, from the early 1990s, not-for-profit housing associations have constructed over 700,000 dwellings (UK Housing Review – various editions), mainly with assistance of government subsidy, and predominantly for sub-market rental. A substantial proportion of the associated developments will have involved apartment blocks designed to be held in single ownership as affordable housing in perpetuity.

However, there is as yet little evidence that the UK's new post-2012 generation of 'market oriented' BtR schemes will be major providers of affordable homes as conventionally defined. In England, landuse planning rules require that most residential developments include a proportion of affordable housing. In London the target is generally 35% (although this can include homes for shared ownership or other sub-market sale, as well as – potentially – for social rent).

By comparison with residential development for sale, UK BtR schemes typically generate a lower gross development value (GDV), where the GDV is calculated on the basis of a capitalised flow of rental yields over time. Given that completed dwellings will be retained rather than sold to the market, BtR developers see lower immediate profits. So – all other things being equal – they can afford to bid less than BtS developers for land. Or, if they are to rival the amount that a BtS developer is willing to pay for a site, BtR providers argue that their capacity to generate affordable housing will be inherently more constrained.

To the extent that UK BtR schemes do include an affordable housing component (often on a 'discounted market rent' basis), such units are generally retained in ownership and management by the scheme proponent, with tenancies allocated to applicants meeting criteria set by the relevant local authority.

All of the above topics are covered in more depth in the companion report 'build-to-rent in London'.

### ***UK BtR sector evolution to date – and future prospects***

BtR is becoming an established product in the UK but the first units were occupied only around 2014, so the sector is still in its infancy. Most of the homes to be provided are still at the planning stage and all parties involved are still learning about this market.

There are high expectations for how BtR will affect the PRS more broadly: the hope is that it will drive down rents for poorer quality homes and drive up standards. However, while it is easy to see how this might play out in the immediate neighbourhoods of BtR schemes or even in metropolitan areas, it may be too optimistic to expect to see effects spread to the very many local submarkets where BtR remains unrepresented (and may never be).

In terms of purchasing land it has been generally accepted that lower yields mean that BtR developers tend to be at a disadvantage to BtS rivals, although some post-2017 market commentary suggests this might be changing. The argument centres on the amount that developers can afford to pay for a site. But as market vitality oscillates, and as property values move, the balance of advantage can alter. Some observers have seen post-2017 falling house prices as creating an opportunity for BtR developers.

While there appears to be strong UK demand for BtR from both consumers and investors, it is unlikely it will ever dominate the PRS market. Most experts suggest that, by the 2030s it may – at best – come to comprise around 10% of the market, or a maximum of 500,000 homes. However, this is an informed estimate rather than any kind of data-underpinned forecast, given that there is as yet no experience of sector performance through all phases of the housing-market cycle.



UNSW on-campus student housing, Sydney

## 2.3 Australian BtR antecedents

### 2.3.1 Purpose-built student housing

As a residential development product designed for long-term rental use, purpose-built student accommodation (PBSA) has clear similarities with the 'build-to-rent' model for the mainstream market that is the main subject of this report. Many of our industry stakeholder interviewees volunteered that PBSA projects have pre-figured 'mainstream market BtR' albeit that – as explained below – the former have had some specific advantages that have enabled them to generate particularly high yields. For one NSW government interviewee, the link was even stronger: '[New generation] boarding houses and student accommodation are build-to-rent'.

'The development of the [PBSA] sector has gone hand in hand with the globalisation of higher education' Savills (2017a p3). This refers, in particular, to the growing numbers of overseas students within the rising overall student population seen internationally over the past 20 years. In Australia overseas student numbers rose quickly in the 2000s, before peaking in 2010 at 472,000. Subsequently, from 2013 numbers soared once more, with the 2018 total 70% up on five years previously, at 645,000 (Australian Government 2018a). Equally important in PBSA industry growth, however, has been the demand from global investors for income-generating assets and the interest of overseas-based PBSA companies in expanding their operations to Australia.

From its beginnings in the early 1990s PBSA provision expanded rapidly in Australia. Along the way, the growth trajectory was importantly underpinned by government support in the form of guaranteed income agreements (see below) and also through the issuing of NRAS incentives<sup>6</sup> (see Chapter 1). By 2014,

according to Knight Frank (2018a), PBSA bedspaces had already exceeded 75,000, with numbers projected to exceed 90,000 by 2018. Moreover, in the five years from 2017 it was anticipated that 40,000 additional bedspaces would be developed at the national scale

(Knight Frank 2017).

Universities themselves are active PBSA providers (i.e. facility managers) in Australia. However, according to Fell (2015) four 'private provider' PBSA models have been in evidence:

- Management-only providers – PBSA scheme operators partner with universities or private developers to operate completed blocks under contract
- Build, own, operate and transfer (BOOT) – Under this public-private partnership (PPP) style model, a PBSA provider partners with a university on long-term lease basis to build and operate the facility constructed on university-owned land. At lease termination (e.g. after 35 years), the facility reverts to the university. A key attraction of the BOOT model from the investor perspective is the security of income flow underpinned by the university covenant
- Develop, strata and manage (DSM) – PBSA blocks are developed on a strata subdivision basis and sold to individual investors. Building use is restricted for this purpose, with the block leased to the operating entity.
- Wholly integrated providers – providers who develop and manage the PBSA assets in-house, with the asset held for such use over the long-term.

Australia's top private providers (managing and/or owning schemes) in 2017 were Unilodge, Campus Living Villages, HRL Morrison and Urbanest (Savills 2017b).

6 Over 4,200 incentives are allocated to university entities in the NRAS data (Australian Government 2018b).

Early Australian 'private provider' PBSA projects – as seen in the 1990s – were often developed on the DSM model. With investors guaranteed a 6% gross yield, this was a product that 'sold like hot cakes' (with high take-up especially from overseas student families) in the words of one research interviewee. Later, with industry growth, the standard arrangement shifted to the unified ownership model, more closely prefiguring the mainstream market BtR approach emergent in 2018.

A key feature of PBSA development, shared across all of the above models, has been an exclusive focus on small units – recognising the typically higher returns that can be achieved from self-contained studios than from larger apartments. Compounding the yield advantages of this development style, student housing has benefited from the lack of landuse planning obligations on car parking provision and from GST relief. This latter provision enables PBSA schemes to be classed as 'commercial residential premises', subject to a concessional 5.5% GST rate on development expenditure (Cridland 2017). Finally, another component of the PBSA model that has sometimes enhanced customer appeal and helped to supplement yields has been the provision add-on services (charged by election) in addition to rent. This has informed thinking around market BtR.

PBSA in Australia has been underwritten by both overseas-based pension funds and sovereign wealth entities. For example, in both of the large off-campus PBSA schemes initiated in 2017 the underlying investment was sourced from Singapore – in one case involving the national sovereign wealth fund and in other, a private entity (Knight Frank 2018a). Globally, the Canadian Pension Plan Investment Board is another of the largest players but insurance companies such as the UK-based L&G are also important.

As characterised by one highly experienced research interviewee, PBSA development has tended to be viewed by the industry as 'pure infrastructure investment class'. Recently, however, changing attitudes in the Sydney PBSA industry have seen development behaviour shifting towards a 'property play' mentality. Increasingly, securing PBSA development sites is 'a play for property investors to secure sites in the inner city' which they get zoned and developed, and retain ownership on the basis of long-term gains via rising asset value.

Globally, PBSA yields tend to be significantly higher than returns in the mainstream residential market although Savills state they 'expect [this] to narrow' (Savills 2017a p6). At least in the UK, this might possibly come about partly as a result of (local) PBSA oversupply (Mulhearn & Franco 2018).

### **2.3.2 Other Australian BtR antecedents**

Four other Australian property forms and/or property market phenomena that have prefigured 'mainstream market BtR' are discussed below: firstly, the New Generation Boarding House model; secondly, the case of Defence Housing Australia; thirdly, the Meriton 'diversification' into rental housing provision; and finally, the development of purpose-built social and affordable rental housing by not-for-profit community housing providers (CHPs).



Boyce Group - New Generation Boarding House, Camperdown, Sydney

### ***New Generation Boarding Houses***

Closely paralleling the expansion of PBSA – and latterly enabling it in NSW – has been the emergence of a new planning designation, the so-called New Generation Boarding House. Effectively, the buildings constructed under this regime are ‘micro-apartment blocks’ of self-contained studio units of 18-25 sqm floorspace rather than the norm of around 50m<sup>2</sup> for a one-bedroom apartment.

The NGBH rules were established under a 2009 NSW government planning policy intended to facilitate ‘affordable housing’ development. As well as the permissibility of unusually small dwelling units, designated NGBH schemes can benefit – in project feasibility terms – from:

- Toleration for such multiple occupancy buildings in residential and mixed use zones
- Additional floorspace allowance – typically 20% over the normally permissible level for residential flat buildings
- Exemption from standard SEPP65 expectations – e.g. on ceiling heights, natural light
- Limited car parking requirements.

(Troy et al 2018).

Across Central and Southern Sydney alone, nearly 300 NGBH projects were approved for construction between 2009 and 2018. While ‘more than half’ of the associated rooms were targeted towards student housing, many of the smaller developments have not been constructed specifically for this purpose; these ‘built to hold’ schemes form a component of the wider private rental market (ibid).

### ***Defence Housing Australia***

The Defence Housing Authority (now Defence Housing Australia) was established in 1987 to provide housing and housing-related services to Defence Force members and their families. DHA is considered ‘a successful model of private investment in the large-scale provision of rental housing’ (Phibbs & Hanna p vi). Most of DHA’s 17,000 homes are head leased from private investors – usually for 6-12 years – usually on the basis of an income guarantee (irrespective of occupancy rate) and a contractual commitment to manage and maintain the homes.

DHA has been portrayed as successfully exemplifying the public-private partnership (PPP) model, and as providing possible inspiration for the structuring of affordable rental housing provision in Australia (Phibbs & Hanna 2010). Indeed, with its roles including those of mixed tenure housing development initiator and risk-taker, certain of DHA’s activities mirror those of NSW Landcom.

However, as regards the viability and affordability of extending this model, as noted in an earlier study, there are a number of qualifications that would need to be considered:

**‘Were DHA required to meet the gap between rents paid by its tenants and the market rents on properties itself, were its tenants dependent on welfare payments as their main source of income, and were it required to provide ongoing support services to sustain its tenancies, then its financial position would be very different’**

(Flanagan 2008 p16).

### ***Meriton as a landlord***

Although the company declined to participate in this research it is known that Meriton has, in recent years, accumulated a large portfolio of rental housing. According to the firm’s website, Meriton is Australia’s largest apartment developer and has ‘built more than 75,000 apartments across the east coast of Australia’. In the public mind, Meriton is strongly identified with a ‘build to sell’ business model and its founder Harry Triguboff has voiced scepticism about BtR as a viable asset class (Davies 2017). Nevertheless, Meriton Rental Apartments has been accumulating a portfolio since 2000, reportedly totalling some 6,000 units by 2017 (Chandler 2017), probably making the company the largest for-profit residential landlord in Australia. As viewed by a seasoned industry observer, this business strategy ‘... was and remains a classic counter-cyclical play to maintain development momentum and to ensure minimal developed value leakage’ (ibid). The extent to which the blocks concerned are specifically designed and built for purpose is unknown, as are company practices around trading of ex-rental stock.





Unity Housing, SA - St. Clair affordable rental housing project

### ***Purpose-built social and affordable housing***

Finally in this section it should be acknowledged that social and affordable housing developments constitute a form of build-to-rent housing, long established in Australia. Akin to the 'mainstream market BtR' model now emerging, such schemes are sited, designed and constructed in the expectation that they will be managed by a professional landlord organisation and held in ownership over the medium- or long-term. Organisational capabilities in this sector also typically include place making and community engagement.

The most recent relevant national program was the 2008-13 National Rental Affordability Scheme (NRAS), and the 2009-11 Social Housing Initiative (SHI). NRAS is described in Section 1.2. SHI was the element of the Nation Building Economic Stimulus Package (NBESP) implemented by the Australian Government

to counter the contractionary impacts of the Global Financial Crisis (GFC). Of the 19,000 dwellings consequently added to the national social housing stock, those constructed in Queensland, Victoria and Western Australia were developed by CHPs. Closer to home, NSW-based CHPs are on track to complete 2,700 dwellings in the period 2012-2020 (NSW Federation of Housing Associations 2017).

Given their experience in developing and managing purpose-built housing for let, there may be scope for CHPs to expand their housing system role as players in the more professionalised rental accommodation market anticipated as emerging through a BtR sector. To this end several of the larger CHPs in NSW and interstate have recently established real estate subsidiaries that specialise in letting services and facilities management.

### ***REITs, MITs and stapled structures***

Also effectively forerunners of BtR in Australia are the investment structures and associated legal regimes that have been developed for collective investment in large-scale property assets. Internationally and locally these structures are commonly referred to as real estate investment trusts (REITs), and Australia has a relatively long history of their use in commercial property (the first listed REIT, GPT, was established 1971). Australian REITs are now one type in a larger category of Managed Investment Trusts (MITs), the legal regime for which dates from 2008, though elements of it are older. This legal regime is complex: numerous amendments have been made in the decade since its establishment, and further proposed amendments are, at this writing, currently before the Australian Parliament. These proposed amendments are directly relevant to BtR.

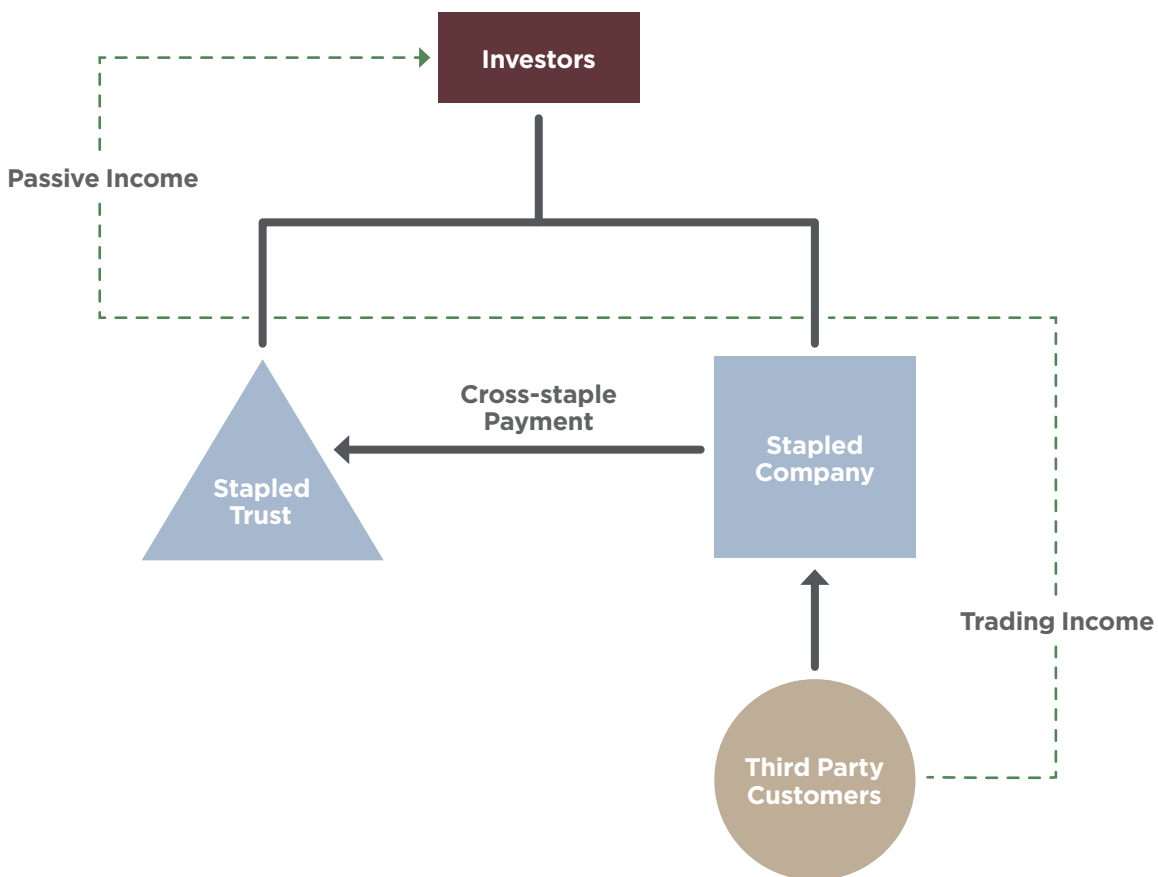
The MIT regime affords tax advantages to MITs relative to other Australian companies, which are generally liable to pay tax equivalent to 30% of their profits. By contrast, a MIT that operates an 'eligible investment business' is treated on a flow-through basis, such that investment incomes are generally not taxed at the level of the MIT and are instead assessed at the level of its unit-holders. 'Eligible investment businesses' include 'investments in land, for the purpose of deriving rents' and other characteristically 'passive' investments (s 102M ITAA 1936).

Where trust income is disbursed to foreign investors, it is subject to withholding tax, but at a lower rate: generally 15%, and less in certain circumstances (e.g. 'Clean Building MITs', which own energy-efficient commercial buildings, are subject to 10% withholding tax). The low rates of withholding tax were introduced specifically to encourage foreign investment and the development of the Australian finance sector as a global finance hub. MIT distributions may also include a tax-deferred component, representing trust income against which a non-cash cost – primarily depreciation – is set. Effectively a return of capital that reduces the investment's cost base for the purposes of capital gains tax, this component is taxed only when a capital gains event occurs (e.g. the investor sells their unit in the trust, or the trust sells the asset) and at a concessional rate (usually half the investor's marginal rate).

MITs typically engage another entity to carry out operations, such as property and tenancy management. In recent years, it has become increasingly common for property investment to employ a 'stapled structure', comprising a MIT and an operating company owned in common (i.e. the trust units and company shares are owned and traded together). Stapled structures take advantage of the different tax treatment of passive incomes and trading incomes, particularly where the MIT leases its asset to the operating company, and the operating company's trading income is paid to the MIT as rent.

Figure 2.1: Stapled structures and passive income flows

### Stapled Entity



Source: Australian Treasury (2017)

### The advantageous tax treatment of MITs and stapled structures confers a number of consequential advantages:

- Earlier access to cash returns (and hence a more 'bond-like' investment profile that appeals to some investors, such as pension funds)
- Quarantining operational liabilities
- Cheaper debt (because liabilities can be confined to the operating company)
- Higher leverage (because financiers can for servicing purposes disregard income tax liability at the project level).

(King & Wood Mallesons 2018)

MITs and stapled structures are commonly used in PBSA and appear to be an obvious vehicle for broader BtR investment too. However, this is complicated by recent controversies and policy concerns about the appropriate purposes and treatment of MITs and stapled structures.

In early 2017, the Australian Taxation Office issued an alert about the use of stapled structures to re-characterise trading incomes as rent, and raised the prospect of treating these arrangements as tax avoidance (ATO 2017). The Government subsequently released for discussion potential reforms to remove the tax advantages of stapled structures (Australian Treasury 2017). While those consultations proceeded, the Government proposed, as part of the 2017-18 Budget, legislation that would have prohibited MITs from owning residential housing, except for 'affordable rental housing'. This was presented by the then-Treasurer as a clarification of an existing bar – i.e. residential investment is for the purpose of trading for capital gains, rather than 'deriving rents' – and so, by making an exception to the bar, the government was providing an incentive to investment in affordable rental housing. The property sector, however, disputed that such a bar existed already, and contended that the proposal instead imposed a new restriction.

The Government subsequently proposed a resolution of both the affordable housing issue and wider stapled structures issues. The Treasury Laws Amendment (Making Sure Foreign Investors Pay Their Fair Share of Tax in Australia and Other Measures) Bill 2018, introduced into the Australian Parliament 20 September 2018, would distinguish 'concessional MIT income', to which the current 15% withholding tax for foreigners applies, from 'non-concessional MIT income', to which a 30% withholding tax for foreigners would apply. The latter category would include 'residential housing' income – expressly countenancing that residential housing is an eligible investment

business for MITs – but not income from 'affordable housing' or 'commercial residential premises'. 'Non-concessional MIT income' would also include cross-staple arrangement incomes (e.g. the rent paid to the MIT under a head-lease by an operating company), but not where the cross-staple arrangement income itself comes from rents paid to the operating company by third-party tenants.

The upshot is that, if enacted, the Bill will enable MITs and stapled structures to be employed in BtR investment, but a mainstream BtR housing product – and even PSBA – will be treated less preferentially than commercial property (e.g. offices and shopping centres), commercial residential (e.g. boarding houses) and 'affordable rental housing'.

## **2.4 Drivers of growing BtR interest in Australia**

In the year to September 2018 there were no fewer than 53 build-to-rent stories carried in the Australian Financial Review and 62 in The Australian. Hundreds of such entries have appeared in development industry and real estate trade press publications over that time. The deluge of media comment on the topic since 2016 has both reflected and stimulated growing interest across a range of stakeholder groups including various parts of government as well as the development and finance industries. Drawing mainly on industry literature and on our key stakeholder interviews, this section discusses some of the factors said to be triggering this growing interest.

### ***Housing demand side factors***

The development industry has been growing increasingly conscious of declining home ownership affordability and falling home ownership rates (see Chapter 1). These are trends which – as seen by one developer interviewee 'are starting to look powerfully worrying' – and which may point towards the need to re-orient industry output.

However, while acknowledging that rental housing demand is being problematically boosted by home ownership unaffordability, it is also argued from a real estate industry perspective that:

**‘There is ... an increasing desire from younger workers to be mobile, a cohort who take advantage of the flexibility of renting allowing them to move between locations, without the costs associated with buying or selling’**

(Knight Frank 2018b p2)

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Similarly, albeit with reference to the growth of US multifamily housing, the contention that:

**‘Compared to previous generations, renting an apartment [has become] far more socially acceptable, especially after a professional career has been established’**

(CBRE 2018b p8).

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In a similar vein, a developer interviewee opined that burgeoning BtR interest reflects industry awareness of changing demographics and a broader shift in housing demand preferences involving:

**‘...a generational change in attitudes to ownership – not just homeownership, but ownership in general.’**

From the perspective of another large consultancy, the case for BtR is partly built on growing unsatisfied rental property demand. Thus ‘there is an undersupply of suitable rental housing in inner-city locations favoured by the ‘millennial’ cohorts’ (EY 2017 p3).

The increasing need for a new rental housing asset class is argued by others largely on the grounds that the security offered in the traditional PRS is inadequate within the context of larger numbers of people living for longer periods of their lives in private rental housing:

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**‘A person needs to be provided with the stability that enables them to make the house they are living in their home’**

(PWC 2017 p4).

On the same theme, one of Australia’s largest developers Mirvac (2017) contends that if BtR offers long-term tenure security in a way that traditional private rental does not, then a tenant saving for a mortgage will benefit from the absence of house-move costs otherwise incurred in a market where the average tenancy lasts 2.5 years. Notably, these contentions find favour at the heart of government, according to a Treasury interviewee who judged that the potential benefit of BtR ‘come[s] from tenant outcomes – improved security’.

Another important public policy aspiration stimulating interest in BtR is the need to counter Australia's intensifying shortage of housing affordable to low-income households (Milligan et al 2017). Among our interviewees, such concerns were voiced not only by affordable housing providers, but also by many others – not least industry super fund spokespersons.

### ***Housing supply side factors***

From the developer perspective, BtR may be seen as potentially constituting a product with steadier and less volatile prospects than the traditional 'build to sell' model. Considering the recent residential construction boom in Sydney and Melbourne, establishing a BtR pipeline could provide developers with some insurance against the downturn in traditional market demand that has emerged since 2017. As seen by a number of interviewees this has largely resulted from two factors:

- More restrictive bank lending practices whereby, for example, banks will lend only 60% (rather than 80%) of construction costs when two thirds of a development is pre-sold
- Overseas pre-sales becoming more difficult due to a range of issues including higher stamp duty rates

'Additionality of supply' is a pro-BtR argument mounted by the Property Council of Australia on the grounds of counter-cyclical. Arguing the relevance of this contention in the current Australian context, the PCA notes that housing construction starts peaked in 2016 and are expected to 'contract significantly' over the next two years. This slowdown makes it 'imperative' that 'solutions like build-to-rent' are brought forward in the interests of maintaining economic and labour market stability (PCA 2018). On the counter-cyclical case, however, a NSW Treasury interviewee

in this research commented 'I'm not sure that we're convinced [of that]'. This debate is further explored in Section 3.2 in the context of the 'build to sell later' ethic.

However, while government might remain sceptical on this point, a developer interviewee believed that the 'counter-cyclical' quality of BtR activity could find favour with company shareholders if this helped to achieve a more consistent level of activity and output. Thus, as it was explained, BtR may have a particular attraction for listed developers because 'Equity investors don't like volatile income'.

Interest in the product was being boosted during early 2018 by the slowing state of the housing market, as exemplified by the steady stream of approaches made to one large 'premium status' developer by other developers concerned about a lack of pre-sales for planned projects.

Similarly, since government concerns about falling housing affordability tend to be articulated in terms of a professed faith in 'expanding housing supply', the usually implicit case that BtR could generate 'additional output' is potentially a powerful one. Again, however, commenting on industry advocacy of such claims, scepticism was expressed by the NSW Treasury participant in this research.

### ***Changing finance market conditions***

Recent years have seen the continuation of growing finance-sector interest in low risk assets that can offset their generally moderate returns by their highly reliable performance. For super funds holding many accounts moving from the accumulation phase into the pension phase such a quality is particularly attractive (Milligan et al 2013 p20).

A more recent development highlighted as significant by a developer interviewee is the recent appearance of a mortgage interest rate premium for mum and dad rental investors. This was seen as a significant structural change in the housing finance landscape. By reducing demand for off-plan purchase of newly-built apartments this may compound other factors dampening the BtS market. From that perspective, the emergence of a BtR product can be explained partly in terms of a new source of rental housing supply that will contribute to filling that gap.

Some interviewees perceived that, more fundamentally, rising attention to BtR reflected changing conditions in the capital markets:

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**‘At the heart of [the growing interest in BtR] is returns – falling yields on other asset classes’**

[Industry super fund].

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**‘Commercial real estate returns have come down so far as to make residential competitive’**

[Finance sector]

As voiced by a government stakeholder:

**‘...private sector investors are seeing a compression of yields in commercial property, making residential property more viable. And developers are seeing risks building in the build to sell (BtS) model, with the prospect of presales drying up. They want to keep the capacity they’ve assembled over past few years going forward’.**

## **2.5 Chapter summary**

The possible emergence of a ‘mainstream market’ BtR sector in Australia needs to be seen within the context of a number of residential products and financial structures that have pre-figured this development, both domestically and internationally. Australia’s PBSA industry, in particular, has demonstrated the scope for an institutionally-funded ‘build-to-hold’ rental product in cities such as Sydney, albeit aided by certain fundamental scheme features and generous concessional treatments not directly replicable by an apartment-block model targeted at a broader market.

# 3. The BtR concept: Australian interpretations and their feasibility

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In this chapter we consider how an Australian BtR sector might be constituted and operated, with reference to the evidence from our review of the grey literature and our interviews with BtR stakeholders. In the first four sections of the chapter, we discuss the following aspects of build to rent:

- Key players
- Business models
- Locations and built forms
- Service offer and target markets

In the fifth section, we present our own interpretation of BtR in Australia, as a model of five types of BtR projects. The modelling is based on our review of the grey literature and interviews, in-depth interviews and correspondence with BtR stakeholders specifically involved in several of the five BtR types, and additional data about property markets and construction costs. Our financial modelling indicates the viability of each type in different market conditions.

## 3.1 Key players and institutions in BtR development, finance and management

The emerging Australian BtR sector involves some familiar faces but also some new players in Australian housing.

### 3.1.1 Development

The familiar faces are the existing large residential BtS developers. Table 3.1 presents major BtR projects currently underway or publicly announced in media reports since mid-2017. Not included are numerous small projects (some less than 20 units) also reported in the media as 'Build to Rent', or the existing niche PBSA and affordable housing new build sectors. In total, the 'BtR' schemes and portfolios identified in Table 3.1 sum to just over 9,000 units. Exclusive of the Meriton portfolio, the six size-enumerated schemes sum to just over 3,000 – averaging just over 500 (or 350 if the Grocon Gold Coast Commonwealth Games Village is excluded).

The scale of the national BtR pipeline indicated by Table 3.1 may be set against the Property Council of Australia estimate that, 23 announced and unannounced projects 'under consideration' as at March 2018 summed to 14,600 units (PCA 2018)<sup>7</sup>.

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<sup>7</sup> It should be noted that the Property Council has more recently advised that, in the absence of what are considered justifiable and essential alterations to the Managed Investment Trusts taxation framework as this applies to overseas investors (see Section 4.6), it is believed that some of these schemes will have been subsequently dropped



**Table 3.1: Australian mainstream BtR projects: underway or publicly announced, December 2018**

<b>Developer</b>	<b>Project name and location</b>	<b>Size and form</b>	<b>Status</b>
Grocon	'Parklands', Gold Coast, Qld	1,252 units and townhouses (Commonwealth Games athletes village)	Development complete, BtR operations from 2019
Grocon	Southbank (Melbourne), Vic	410 units	Approved, yet to commence development
Grocon	St Leonards (Sydney) NSW	unknown	Approved, yet to commence development
Sentinel	'Element 27', Subiaco (Perth), WA	360 units	Under construction 2018
Mirvac	'Indigo', Sydney Olympic Park, NSW	257 units	Under construction 2018
Salta	Docklands (Melbourne), Vic	260 units (in tower with 150 hotel rooms)	Proposed project
Salta	'Victoria Gardens', Richmond (Melbourne), Vic	426 units	Approved, yet to commence, proposed BtR operation on hold
Gurner	South Melbourne, Vic	128 units	Proposed, yet to be approved
Meriton	Various Sydney sites, including 'Signia', Mascot	Total approx. 6,000 units, including 237 units in Signia	In operation

Source: media, interviews

In all cases, the proponents of the projects identified in Table 3.1 are the developers, for whom BtR is envisaged as an additional line of business to their continuing BtS activities. For almost all of these developers-cum-operators, BtR will mean making new financial arrangements with investors to accommodate their post-development interests, and acquiring new capacity in property and tenancy management.

Existing players in the student accommodation sector, which already have relationships with institutional investors and capacity in property and tenancy management, may also expand beyond their niche into a more mainstream BtR market: a number of stakeholder interviewees mentioned Urbanest as a possible player. New to Australia but well-established as a BtR provider internationally, the developer-manager Greystar is also actively looking to commence a BtR business in Australia, with backing from Macquarie (Greystar 2017).

### 3.1.2 Finance

BtR development and ownership requires finance on different terms from BtS. Australian BtS development is mostly debt-financed, with project-level finance provision dominated by Australian banks, while the larger BtS developers also borrow at a corporate level in money markets (Rowley et al 2014). Project-level bank finance typically requires the developer to contribute equity, which is often provided in the form of land previously purchased by the developer for the project, and to achieve certain thresholds of pre-sale agreements with prospective purchasers, both as a contribution to equity (purchasers' deposits) and to demonstrate that there is a market for the project (Rowley et al 2014).

By contrast, it is envisaged that BtR will involve a mix of debt and equity finance. Stakeholders indicated that this would mean looking beyond existing finance providers

- in particular, Australian banks - to a wider range of financial institutions, including superannuation funds, foreign pension funds and sovereign wealth funds. It is anticipated that, as in other asset classes, BtR investors (and the terms of investment) will change over the life of a BtR project. In particular, the initial phase of a project - from planning and construction, through to the early years of operations - will typically be more risky than the second phase of established operations. Initial, 'primary' investors will therefore expect a higher rate of return. They will seek to realise this reward by 'recapitalising' the asset through the post-scheme-completion sale of some or all of their interest to secondary investors. For these parties, the now-proven asset will be a lower-risk proposition, for which a lower rate of return on capital is therefore tolerable.

It should be noted, however, certain types of BtR investment - in particular, studio apartment complexes - may have a different profile of relative risks and associated need for recapitalisation - a point we will revisit in discussion of BtR business models (see Section 3.2). For the most part, however, it is expected that the primary investors in BtR will be the developers themselves, financed with debt from banks and other lenders and equity from themselves and international funds, and the secondary investors will be more heavily weighted towards international and local funds, with developers retaining a smaller equity stake.

The common view of stakeholders was that the finance sector generally (and especially the traditionally cautious Australian-based players) was still waiting to be convinced that there was a market for BtR - both among households to live in it, and among secondary investors to purchase BtR assets as ongoing rental businesses. Australian banks, in particular, had yet to 'get their head around it', as one stakeholder put it. Others noted

that awareness of Meriton's rental business and NGBH development had started to shift sentiment, though some banks remained wary of projects with the 'boarding house' label. Stakeholders also indicated that Australian funds, including the superannuation funds, had become more knowledgeable about BtR, but few had committed to projects. A notable exception is the Clean Energy Finance Corporation, a Australian Government-owned fund, that has committed to Mirvac's Australian Build to Rent Club (CEFC 2018).

One domestic fund manager commented:

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**'We want to [invest in BtR] but it doesn't align with the investment climate right now in Australia. Frankly we believe investors will be better off over the long-term, but they will not be getting the same returns in the short term as presently. So there's more education to happen about this.'**

**'Property people are some of the most conservative people around. If they are not sure how it's going to be valued, or what their return is, they don't like it. But once somebody does it, everybody piles in. And that's the experience of student accommodation. I know it will happen here – it just needs somebody to do it first'**

A sceptic could justifiably note that very similar sentiments were voiced by participants in our earlier research on this topic several years ago (Milligan et al 2013).

However – notwithstanding concerns around tax exposure associated with Managed Investment Trust vehicles (see Chapter 2) – many stakeholder interviewees in this research believed that overseas-based pension and sovereign wealth funds were poised to enter the field:

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**'They understand the asset class best, are more forward thinking and entrepreneurial...On the other side you've got the local investors – the super funds – who are much more risk averse, and after meetings with an army of people where they've ended up is: we don't want to be the first movers.'**

Some of these institutions are already active in Australian commercial property, including commercial residential and, in particular, the PBSA sector. Stakeholders suggested that these institutions would generally accept (net rental pre-tax) yields of about 4.5%, with some Asian funds accepting 3%.

Several stakeholders claimed that the tax treatment of MITs, which at the time of the interviews was under review by the government (discussed in Chapter 2), was a significant impediment for foreign funds, with one suggesting that pending investment had been frustrated by uncertainty on the government's approach. The Property Council of Australia has more recently advised that

the Council expects that the Australian Government's July 2018 decision on Managed Investment Trust tax rates will have led to a diminution in the BtR pipeline as previously estimated (see Section 3.1.1).

However, referring to the recent local experience of foreign investment in commercial property and to global conditions, another interviewee was confident that the current challenge of finance would be overcome:

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**‘There is so much capital available globally to invest in property – I don’t think there’s ever been a time like this before.... All these big investment houses, sovereign wealth funds, have got this constant cash coming in, and their portfolio says they’ve got to invest 10-12% in property, and the world is not getting bigger.... And because of the global nature of markets, and Australia being seen as exposed to Asia, but a stable investment site, there’s so much capital available to invest in property in Australia of any type.’**

### **3.1.3 Property and tenancy management**

Property and tenancy management for BtR also poses a challenge, and it is less clear how institutions will overcome current limitations in terms of management capacity. The UK experience (Chapter 2) indicates two models of BtR management: a ‘fully integrated’ model,

in which property and tenancy management is conducted in-house by the BtR operator (or the operating entity in a commonly-owned BtR group) (e.g. Get Living London; Greystar); and a semi-integrated model, in which the property and tenancy management is conducted by an external entity under contract with the BtR asset owners (BPF 2017: 27). Stakeholders indicated that both models are possibilities for Australian BtR.

Several developers were looking to develop in-house management capacity. One developer planned to bring in management systems, as well as managers and trainers, from international BtR operators, and to recruit from personnel from the domestic hospitality sector. Asked if BtR would look to the domestic real estate agent sector, one stakeholder quipped ‘Oh, for insights into how not to do it!’

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**‘Rental property agents don’t see themselves as service providers – it is not in the mindset.... We’ll more likely to recruit from other industries: hotels, serviced accommodation, hospitality.’**

As discussed by Hulse et al (2018), real estate agents dominate property and tenancy management in Australia, but practices have lately been undergoing significant change, with innovations in digital technologies – for example, in tenancy applications, inspection bookings, repair requests and rent collection and accounting – and the providers of those technologies becoming new intermediaries in management relations. To date, these technologies have been adopted and used

largely by real estate agents in ways that maintain their role in property and tenancy management, but which hold the potential to be used by landlords and tenants in ways that cut out agents. It may be that BtR operators will be able to build their in-house management capacity by assembling these technologies in comprehensive platforms.

Community housing providers are an existing source of professional property and tenancy management capacity. Other stakeholders expressed varying views as to whether CHPs might perform property and tenancy management functions for BtR businesses under the semi-integrated model. Some finance sector stakeholders had existing relationships with CHPs and were positive about their potential role as BtR managers. However, one developer doubted that CHPs could satisfy 'efficient management' requirements for large BtR assets, and was adamant that such efficiencies – on which BtR profitability depended – meant that the whole of a building had to be under one company's control, irrespective of whether it included a component of social or affordable housing.

### 3.2 BtR business models

What forms inter-institutional relationships within BtR operations might take is one aspect of a larger question on BtR business models: how does BtR make money? The grey literature and stakeholder interviews suggest that BtR in Australia will encompass a range of business models, including:

- Arrangements that focus solely on the rents yielded over the life of the building
- Businesses seeking both rental returns and capital gains from long-term rental use
- Operations where, by comparison with returns from sales, rental returns are uncompetitive over the long-term; thus, perhaps more accurately characterised as 'build to sell later'.

Cutting across this spectrum, there is also variation in the business models of specific institutions that are involved at different phases in the life of a BtR project (the primary and secondary investors, discussed above), and around and BtR's target markets and service offer (see Section 3.4).

The rental yield-only BtR business model is relatively circumscribed and specific to where the land is leased only, with the BtR developer-operator obliged to hand the asset over to the land-owner at lease expiry. This model is already used by not-for-profit housing providers in the development of affordable rental housing (including with a mix of market-rent and below-market apartments); it is also the model for on-campus student accommodation, and the proposed NSW Land & Housing Corporation Redfern BtR project (NSW LAHC 2018).

This model is a 'pure infrastructure investment', in the words of one stakeholder, with development viability entirely dependent on operating revenues over the term. Institutional

support for the project's customer base – e.g. a university promoting accommodation to students, or a social housing provider allocating tenancies from its waiting list – is likely to be an important aspect of the business. Such support for the rental operation reduces revenue risk, and because capital growth is not part of potential return, this business model is less likely to involve (post-scheme-completion) recapitalisation for developer profit-taking. For these reasons schemes of this kind would more likely attract investment from superannuation, pension and sovereign wealth funds for whom the stability of rental returns is paramount.

Along the BtR spectrum from 'infrastructure plays' are 'property plays', which encompass a wider variety of business models based on a mix of operating revenues and capital gains. Together, these business models appear likely to represent the larger part of the BtR sector, with already existing examples including the off-campus PBSA and NGBH models. There are, however, significant differences between some of the business models indicated by stakeholders. These differences turn, primarily, on whether BtR is a form of housing legally and materially distinct from the individually-owned private dwellings produced in BtS strata schemes.

Some stakeholders strongly believed that long-term rental operations required a specific built form that enabled efficiencies in management and maintenance, and that supported provision of additional services to tenants for enhanced revenues – in much the same way as PSBAs currently operate. This business model is premised on growth in rents and capital values but, according to proponents, their capital growth expectations reflected only the rising value of the rental business. One such stakeholder claimed that it was more important for this model to have a specific design guide and planning track than for the

buildings so developed to be suitable for strata subdivision, and would accept restrictions against strata subdivision as a condition for other special treatment by governments under tax and planning regimes.

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**'In a perfect world, there would be a development design code specific to BtR, that recognises the operational nature of the asset and what's required to maximum its efficiency and benefit to residents, and to enable investment – make investors comfortable. We're happy to say: give us a set of planning guidelines and lock it in as rental for an extended period – put a 15-year covenant on it so we can't break it up and sell it off. We've no issue with that.'**

Other stakeholders – including prospective developers and other sector observers – envisaged BtR operating in buildings capable of strata subdivision, if not actually strata subdivided. A number of practical reasons for this were suggested: it gave developers an exit route, in case the market for BtR is weaker than expected; it was also sought, for the same reason, by financiers, and was preferred by local government too.

According to some developers, the strata 'exit route' was not meant to be actually used, and BtR was intended to produce permanent rental housing businesses. However, some also characterised BtR as a counter-cyclical

strategy for maintaining output in the face of reduced demand from individual investors and owner-occupiers. Implicitly, this source of demand is apt to cycle back and, because these purchasers either do not require a return (i.e. owner-occupiers) or tolerate low yields (i.e. individual investors), precipitate a strata subdivision sell-off. The possibility of strata subdivision of BtR assets underlay one interviewee's scepticism on stated plans of the big BtS developers to create long-term BtR businesses: 'they're going to develop and get out. They're not really doing it to create a new asset class.' This BtR business model might properly be called 'build to sell later'.

Finally, some stakeholder identified another 'property play' BtR business model specifically in mixed-use developments: e.g. including a BtR residential component in a hotel development, or above a shopping centre. While the housing units so produced might be capable of strata subdivision, stakeholders suggested that they would be less likely to exit long-term rental because of the strategic value in retaining ownership in common with that of the commercial asset. This model also offered a welcome diversification of revenue streams.

### **3.3 Locations and built forms**

The common view across the grey literature and stakeholder interviews is that BtR will take the form of high-density multi-unit buildings in the inner city and middle suburbs of Australia's major cities. This accords with the BtR projects in development in Table 3.1. In interviews, stakeholders indicated some further factors about location and built form that may shape the emerging sector.

#### **3.3.1 Location**

Melbourne, Sydney, Brisbane and Perth were nominated by development and finance sector stakeholders as the most promising cities for BtR, with Canberra, Newcastle and Wollongong mentioned as second-generation

locations if the BtR concept was proven. In all cities, stakeholders thought BtR would need sites in the inner city or in middle suburbs well-served by public transport. While the high price of land in these locations would be a challenge to the rental yield-focus of BtR, stakeholders considered that these locations offered the deepest market for BtR housing, as well as scope for development at higher densities and with limited parking provision, which would improve yields. Several stakeholders also suggested sites around 'anchor institutions', particularly hospitals and universities, would suit BtR targeted to employees of the institution, who would pay a premium for the convenience.

Mixing BtR in retail and other commercial developments is another solution to the problem of high land costs. Typically, the current values of commercial sites do not reflect the potential of residential development in the airspace above, so BtR could be a profitable inclusion in shopping centre developments that did not compromise control of the whole property as a strata-subdivided residential component would. It might also be said that some currently proposed (or proceeding) inner city BtR projects appear to have avoided the problem of high land costs by developing sites acquired some time ago at much lower prices.



Mirvac, Olympic Park, Sydney - Pavilions build to rent project design



### 3.3.2 Built form

The consistent image of BtR from the grey literature and interviews is of a large apartment complex: ‘three-storey walk-ups won’t cut it’, said one interviewee, with others suggesting variously that minimum building sizes of 100, 200 or even 350 units would be required to achieve necessary operational efficiencies and attract investor interest.

Stakeholder views differed as regards whether BtR required a different built form from BtS developments. Some developers considered them as basically the same, with BtR buildings built to be capable of strata-subdivision and separate sale, on the Meriton model. Others insisted that BtR had to be built differently such that – as a long-term rental business – returns competitive with BtS development could be achieved. In particular, BtR would require more space for:

- Additional services (e.g. gyms, libraries, dog-walking areas, yoga classes)
- On-site management functions (e.g. leasing suites, community managers’ offices)
- Traffic (e.g. wider corridors, goods lifts, loading docks for deliveries and removalists).

To accommodate these features, BtR would require higher floorspace ratios, and ‘more relaxed’ requirements regarding solar access, cross ventilation, and apartment mix and size (as is already the case for NGBH developments – see Section 2.3.2). Typically, these stakeholders saw BtR offering more studios and one-bedroom apartments, and a smaller number of two-bedroom apartments (one developer, however, contemplated seven-bedroom apartments, to accommodate group households); and apartments that were generally smaller than BtS norms (though one developer acknowledged that the Australian market would not tolerate units as small as those developed in some overseas BtR sectors).

Both sides of the issue of the BtR built form issue agreed, however, that BtR offered more scope for incorporating energy efficiency design and facilities, and higher quality, more durable construction and fittings, as developers would realise the value of these investments in the long-term operating costs of their buildings. As one developer said, ‘it won’t necessarily look more shiny [than a standard BtS development] on Day 1, but it will be better designed to keep operating costs down’.

## 3.4 Target markets and service offer

### 3.4.1 Market targeting

BtR proponents have promoted the emerging sector as offering a high-quality product for relatively high-income target market. In interviews, stakeholders envisaged this target market as ‘young urban professionals’ or ‘the higher end of the market.... the well-educated population cohort valuing lifestyle’, who would pay a premium for well-located, high-quality housing, and for whom owner-occupation has become unaffordable or ill-suited to their occupational mobility.

Some interviewees went further, discerning a generation shift in attitudes to property ownership and consumption of experience and service. At least to begin with, BtR would pursue this market with a premium product – ‘like a five-star hotel’, said one developer – to ‘establish the BtR concept’, with a view to eventually realising premiums from the convenience and brand of their product. Related to this line of thinking, a number of stakeholders suggested that BtR tenancies might command charges 20% above local market rent for similar-size properties, based on experience of the PBSA Sector, and the multi-family sector in the US.

Other stakeholders, however, saw BtR developing as a more ‘mid-market product’ – ‘not “affordable”, not luxury’ – but still offering premium locations and a higher quality service

than currently provided by small landlords and real estate agents. This would be BtR ‘for the masses’, which one developer characterised as the deep market of 20-40 year-old professional households. Looking further ahead, and referencing US experience, one developer identified a potential target market in older ‘empty nesters and downsizers’.

### 3.4.2 Services

The ‘first principles’ of the BtR offer, as viewed by one developer, are ‘amenity and service’ In the grey literature and interviews proponents highlighted the promise of greater security tenure and more consistent, professional customer service for tenants than is currently offered by the rental sector’s smallholding landlords and real estate agents. It was widely envisaged that BtR buildings would be pet-friendly, attended by concierge and ‘community manager’ personnel, and equipped with package delivery and community facilities. Depending on target market and location, a range of additional commercial services were also contemplated – for example, laundry and cleaning services, child care, gyms and pools, car and bike hire, removalists – both as an enhancement of the service offer to tenants, and as a way of lifting project yields. The PBSA sector was pointed to as a model for the provision of additional income-generating services.

While many stakeholders viewed the capacity to provide additional services as an important selling point for BtR – both to tenants, and to investors – some emphasised that laying on of additional services remains largely untested and not all potential customers might be enthusiastic about paying for it.

Because of the emphasis on customer service, several stakeholders observed that BtR buildings would be intensively managed. While a 500-unit strata scheme might have 1.5 full-time equivalent employees, estimated one

stakeholder, the same size BtR building would have 11 or 12 staff in its initial leasing phase and around 10 on an ongoing basis, including a building manager, a concierge, leasing staff, maintenance staff and cleaners. It was generally expected that BtR’s target group tenants would live together peaceably, with managers imbuing a sense of community and setting expectations.

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### ‘It’s all pretty tightly managed and curated.’

Along these lines, one developer introduced the notion of ‘lifecycle renting’, with specific buildings customised for a particular group (such as young couples, key workers, retirees, high income workers), individual households moving between building as the life circumstances changed, and loyalty programs rewarding long-term customers of the BtR brand.

### 3.5 Modelling five types of Australian BtR

From our review of the grey literature and stakeholder interviews, we suggest that the emerging Australian BtR sector can be understood in terms of five types of development projects and resulting housing assets. The five types are described below, along with the data used in our development feasibility modelling, as reported later in this chapter and in Chapter 4.

- Basic studio complex: similar to a ‘new generation boarding house’ (NGBH) product
- Premium studio complex: similar to an off-campus PBSA product
- Basic apartment complex: similar to a CHP-led mixed affordable housing/market housing product

- Standard apartment complex: similar to a standard apartment product, developed as BtS. It is included in our modelling to benchmark the other types
- Premium apartment complex: similar to a high-amenity residential or serviced apartment product.

The modelling inputs were informed by case-study fieldwork of projects that are already operating – such as NGBH, PBSA and CHP-led rental housing – and the anticipated parameters for premium BtR projects currently in development. For these base cases, however, we do not assume that these models incorporate tax or planning concessions afforded to CHPs, NGBHs or PBSA. We also do not assume some of the purported advantages of BtR around rents that could be charged or operating expenses. The impact of these on the base cases are explored in turn.

### 3.5.1 Assumptions and limitations

Our modelling proceeds on the basis that most BtR businesses will depend on growth in the capital value of a housing asset, and that there will be a recapitalisation of the asset to allow primary investors to realise part of that growth arising from the asset's development. This development dividend is a 'one-off', so the longer the investment is held by the primary investors before recapitalisation, the lower the return to them will be in annualised terms. On the other hand, to realise a sufficiently high asset value, the secondary investors will need to be satisfied that operations are sound in terms of viability. This will be especially challenging in the current context of 'first movers'; with developers acknowledging the need to 'stick around' for longer than ideal to demonstrate the potential of the asset class.

Our modelling assumes that secondary investors will seek a 4.5% net return, comparable to current returns in other

property classes. This rate of return sets the value, or the 'price that will be paid', at the point of recapitalisation. From this price we can calculate the primary investors' returns. We also assume that the recapitalisation will occur at year 10 – that is, after a three-year development phase, and an initial seven-year operating phase. This is within the investment timeframes indicated by interviewees. Because the model sets the operating phase's balance sheets to return 4.5%, the 'price' at recapitalisation whenever that occurs will be the same in real terms (i.e. revenues and costs will rise in sync over time). In practice, however, the longer a business achieves the modelled returns, the more confidence secondary investors would have, and the higher the price they would pay. It should be noted that replacement costs, land values, rental revenue and operating costs are all assumed to escalate in line with inflation. Thus, while some BtR developers speak of an expectation that delivery of a superior product will enable the escalation of rents over time – ahead of both inflation and the wider market – that speculation is not factored in.

As noted in our discussion of BtR business models, some BtR businesses are less likely to involve development profit-taking through recapitalisation: in particular, affordable rental and on-campus PBSA 'infrastructure plays', and BtR in mixed-use developments (i.e. where there is a greater strategic interest in retaining ownership). There are also some BtR housing types – specifically, studio complexes – that are able to keep development costs low relative to the scale of development, and generate much higher operating revenues than apartments, such that they do not require a development dividend through recapitalisation. These are discussed further below.

Finally, we have also noted how BtR businesses may produce housing assets that have a distinctive built form, or that are basically the same as BtS. To the extent that the built forms are the same, there may be, however, additional factors relating to the entities involved that go to the feasibility of BtR relative to BtS, in particular: differences in corporate structures and associated overheads; differences in tax liabilities; differences in the availability and price of finance. These factors are outside the scope of our modelling, which deals in project-level factors. Some tax settings do impose liabilities that can be modelled at the project level, and we consider how adjustments in these settings may affect project viability in the next chapter.

### 3.5.2 Modelling outputs

#### *The base case*

Table 3.2 shows some overarching parameters for the five BtR types; detailed inputs are outlined in Appendix 1. The base case is a high-cost, inner-city (Sydney) housing market. This is largely because it is where most of the qualitatively argued ingredients for a successful project can be found – such as high volumes of young ‘millennials’ renting for lifestyle, rather than pure financial constraint reasons; and a ready supply of external amenities that reduce the expectation of onsite provision (e.g. local retail removing the need for full kitchens, local public transport removing the need for parking spaces, etc.). Other market contexts are considered in the next section as a point of comparison.

**Table 3.2: Overview of development parameters, per square metre of net lettable area**

<b>\$/sqm.nla</b>	<b>Studios (basic)</b>	<b>Studios (premium)</b>	<b>Apartments (basic)</b>	<b>Apartments (standard)</b>	<b>Apartments (premium)</b>
Development cost/equity	\$8,871	\$9,441	\$8,639	\$9,259	\$10,705
Operating revenue (annual)	\$841	\$1,044	\$468	\$501	\$585
Operating cost (annual)	\$310	\$364	\$264	\$287	\$332
Required rate of return (net yields on operation)	4.5%	4.5%	4.5%	4.5%	4.5%
Implied value of asset	\$11,800	\$15,118	\$4,534	\$4,764	\$5,629
Capital growth	\$2,929	\$5,677	-\$4,106	-\$4,495	-\$5,076
<b>Total development investment return (annualised)</b>	<b>7.5%</b>	<b>11.1%</b>	<b>-3.1%</b>	<b>-3.2%</b>	<b>-3.1%</b>

The key question for BtR development feasibility is what rate of return would primary investors regard as acceptable. Different figures have been cited, but the range is generally over 15%<sup>8</sup>. As Table 3.2 shows, apartments built under the base-case parameters are generally not feasible.

Note that the modelling base-case assumes a project is fully-funded through equity in the first instance. Depending on the cost of covering the costs of debt (servicing interest payments), even a small positive return here could amount to a more significant positive

outcome if debt leverage was incorporated. However, given the negative returns shown, any leverage would similarly increase the losses shown here.

One variable already exposed is the expected return of long-term and secondary investors. There are suggestions that tightening yields in other property classes will lead to acceptance of a figure lower than 4.5%. Table 3.3 shows how a different expectation of operating yields translates to different returns for a development investor.

**Table 3.3: Different required rate of return on operations, and the resulting return on development investment**

Needed yield (operating)	Studios (basic)	Studios (premium)	Apartments (basic)	Apartments (standard)	Apartments (premium)
4.5% (base case)	6.7%	10.0%	-3.6%	-3.7%	-4.4%
3%	14.1%	19.1%	-0.5%	-0.7%	-0.5%
6%	4.2%	7.1%	-4.4%	-4.5%	-4.4%

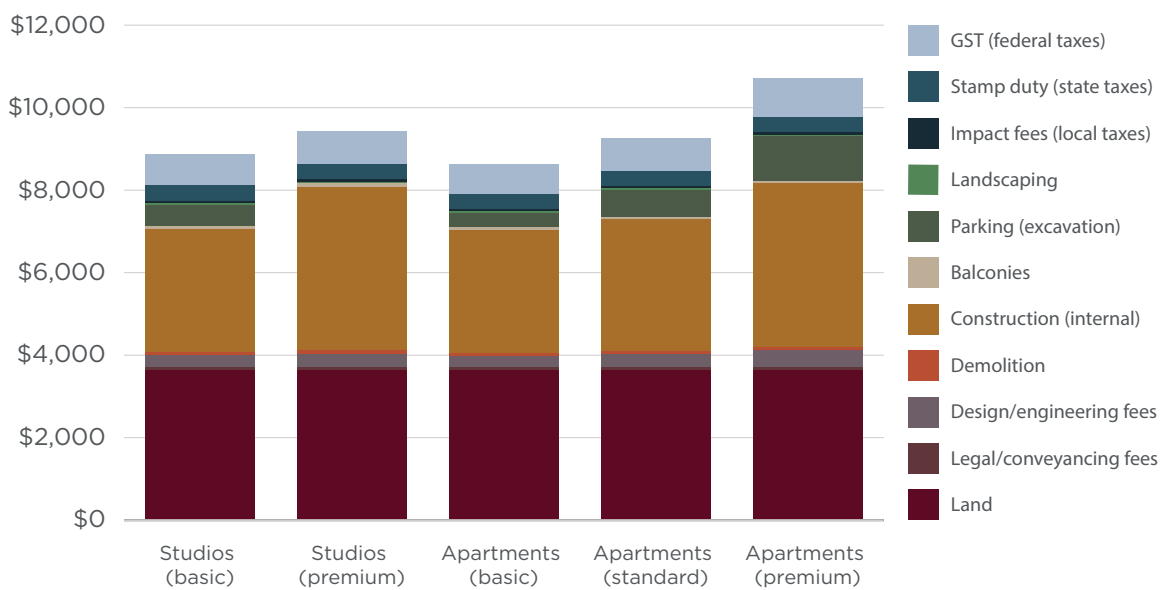
<sup>8</sup> Notes on the reported figures: The analysis is done in real terms – discounting future revenue and costs by inflation. The returns reported are net of project costs (including operating costs). This enables any return to be compared to alternative investments, which will likely have different operating costs (for a given gross return). However, they are gross of any fund/portfolio management overheads and tax liabilities, since different corporate structures and investors would have different returns on an identical project (the impacts of these tax liabilities are discussed, more generally, in the next chapter). Similarly, the differing mix of operating revenue and development dividends make a traditional internal rate of return figure potentially misleading in comparisons (since it assumes any return through operating yields is immediately invested in something else with identical returns but attributes those returns to the modelled project). Instead the total return (again in real terms, or net present value) is annualised to give an indicative figure of value created by the project.

### 3.5.3 Location and built form

#### Built forms

The evidence indicates that BtR will employ high-density built forms. The modelling incorporates construction cost estimates from Rawlinsons (2018), and uses industry heuristics for rates of development overheads, such as design and engineering fees. Figure 3.1 shows the breakdown of those development costs for the base cases.

**Figure 3.1: Breakdown of development costs, per square metre of net lettable area**



There are various claims that BtR has an edge in construction costs over other residential development, with economies of scale, higher building design efficiency (the proportion of floorspace that is rented out, cf. corridors or servicing areas), less parking (and therefore less excavation), etc., all reducing the cost/sqm of lettable area. The effect of adjusting these costs down – assuming it does not translate to higher operational costs or lower rental revenues received – is shown in Table 3.4.

**Table 3.4: Different development cost scenarios, and the resulting return on development investment**

	<b>Studios (basic)</b>	<b>Studios (premium)</b>	<b>Apartments (basic)</b>	<b>Apartments (standard)</b>	<b>Apartments (premium)</b>
Base case	7.5%	11.1%	-3.1%	-3.2%	-3.1%
Lower construction costs (20% lower from design through to landscaping)	10.1%	14.3%	-1.7%	-1.7%	-1.4%
Higher design efficiencies (90%; up from 75%)	12.0%	16.6%	-0.5%	-0.7%	-0.7%
Eliminating parking	9.3%	11.1%*	-2.4%	-2.0%	-1.3%*
Eliminating balconies	7.7%	11.3%	-3.0%	-3.1%	-3.0%
Smaller average unit size (20% smaller units)	13.1%	18.0%	0.2%	-0.1%	-0.1%

\*The base case for premium studios (based on student housing) had no parking included, and the premium apartments had the highest provision of parking, and so eliminating it had a higher impact on return. Again, the caveat here is the assumption that eliminating parking does not reduce the potential rental revenue, which is not realistic in most cases.

The factor that has most impact on the returns is size of units. In practice, a reduction in average unit size could be a function of either units with a given number of bedrooms being smaller (say, 75sqm for a 3-bed unit compared with the 95sqm modelled) or a function of a different unit mix (say, a higher proportion studios and 1-bed units over 2- and 3-bed units). In the markets explored, there was little difference in the revenue/sqm in units of different bedroom numbers, so adjusting the latter had little effect. However, in practice, it is likely there will be different depths of demand for different sizes units, meaning a different unit mix could have some effect on return.

However, the size of a unit for a given number of bedrooms is impactful, particularly assuming smaller does not translate to lower rental revenue (however this is a big assumption that would require validation in most contexts). This is largely why the returns for a complex of studios are much healthier. The modelling assumes studios in a block of apartments are 35sqm, whereas the studios in the student/boarding house scenarios are 22sqm, but deliver comparable rents. The higher number of units that can be rented out for a building of a given scale is almost double, meaning the rent/sqm is similarly almost double.

### Land and different housing markets

In Sydney, densities sufficient to build apartments at scale are permissible across different parts of the metropolitan area. Although construction costs do not vary significantly across the region (and are modelled at the same rates in all cases),

different housing market context has some effect on returns, largely because of differing land costs. In the model, land costs are calculated using a residual method, based on a BtS apartment development (and thus market prices for apartments). Table 3.5 shows what a reduction in land cost - all else being equal - means for returns.

**Table 3.5: Different land cost scenarios, and the resulting return on development investment**

	Studios (basic)	Studios (premium)	Apartments (basic)	Apartments (standard)	Apartments (premium)
Base case	7.5%	11.1%	-3.1%	-3.2%	-3.1%
20% lower land costs	10.3%	14.1%	-1.4%	-1.6%	-1.7%
50% lower land costs	16.1%	20.0%	2.1%	1.5%	0.9%
No land costs	33.2%	37.0%	12.9%	10.6%	7.6%

Lower land costs (per square metre of net lettable area) could be a function of the particular development model, relative to the (standard for-sale apartment) development model used to calculate the residual land value. For example, the higher return resulting from the 'higher design efficiencies' (in Table 3.4 above) is as much a function of spreading the fixed land cost across more square metres of lettable area (since the land value continued to be based on an assumed 75% efficiency of standard apartments), as it is a function of reducing the construction costs of non-lettable areas.

However, land costs could also be a function of broader market dynamics. An alternative way of understanding the effects of land price on the final return is to look at rents and sale prices in a particular housing market. In the model, a different location translates to two different

inputs: typical sale value of a unit (from which land cost is derived) and typical rental value of a unit (which affects revenues). The next section considers changing rents in more detail, but here the two are considered in concert.

In practice, sales prices and rents will move broadly together in different markets at a given point in time. The difference between these movements - typically measured for individual apartments as differences in 'gross yield' (52\*weekly rent/sale price) - is similarly revealing here. In the base case, this gross yield on an individual apartment was 4.0%. Table 3.6 compares the base case and the two 'lower land cost' scenarios shown in Table 3.5, as though they were different markets (with lower unit values). Table 3.6 also presents an actual lower cost (suburban) market with an actual predicted gross unit yield of 4.3%, as well as equivalent land discounts.



**Table 3.6: Different market contexts, and the resulting return on development investment**

	<b>Studios (basic)</b>	<b>Studios (premium)</b>	<b>Apartments (basic)</b>	<b>Apartments (standard)</b>	<b>Apartments (premium)</b>
<b>Base case (city)</b> unit sale: \$961,376 unit rent: \$747 unit yield: 4.0% land/dev costs: 28%	7.5%	11.1%	-3.1%	-3.2%	-3.1%
<b>20% off land (city)</b> unit sale: \$865,939 unit rent: \$747 unit yield: 4.5% land/dev costs: 25%	10.3%	14.1%	-1.4%	-1.6%	-1.7%
<b>50% off land (city)</b> unit sale: \$722,724 unit rent: \$747 unit yield: 5.4% land/dev costs: 19%	16.1%	20.0%	2.1%	1.5%	0.9%
<b>Suburban market</b> unit sale: \$606,427 unit rent: \$501 unit yield: 4.3% land/dev costs: 12%	8.6%	17.5%	-1.9%	-2.0%	-3.1%
<b>20% off land (suburban)</b> unit sale: \$582,001 unit rent: \$501 unit yield: 4.5% land/dev costs: 10%	9.7%	18.9%	-1.2%	-1.4%	-2.6%
<b>50% off land (suburban)</b> unit sale: \$545,279 unit rent: \$501 unit yield: 4.8% land/dev costs: 6%	11.6%	21.2%	0.0%	-0.3%	-1.8%

Several points may be made from Table 3.6. The first is that overall, as expected, the BtR return is highest (or, at least, the modelled losses are lowest) in markets with high rental yields, relative to unit prices. These markets would also be expected to appeal to individual apartment investors. This suggests that BtR would not fill a gap where individual apartment investors cannot make a return, so much as where they are absent for other reasons: e.g. a cyclical lack of finance, or the particular asset is legally or physically unsuitable for strata subdivision.

The second point is about the effect of underlying land costs on gross yields. In high-cost markets (i.e. where unit prices are high), a greater proportion of the overall development costs are attributable to land. As such, it takes a more significant movement in unit prices (and so yield) to translate to the specified 20% and 50% discounts on land value in high-cost markets than in low-cost markets. Conversely, a given land price variation (say 20%) translates to less movement in sales price and yields in lower-cost markets.

The third point is about differences between basic and premium products (studios and apartments) in the two markets relative to the respective standard apartments in those markets. This is a function of different yields (or different costs to build relative to rents that can be charged) for different sized units (including studios) and different quality units (basic, standard, premium). As in the second point above, where a development project is maximising its gross yields on individual units, it will most likely be feasible as BtR.

Importantly, in practice lower land prices can also result from other particulars of a given development project. In many case studies examined, development sites were 'land banked' years prior at a lower cost. They were

also bought speculatively at lower prices, with much lower densities (or even other land uses) permitted under planning controls. Finally, there were examples of land being purchased for some other development, as described above – BtS residential, hotel, retail, etc. In those cases, the BtR component effectively had no land cost, since it was largely accounted for in the cost/return profile of the original development planned. A reduced land price/sqm of lettable floorspace can also be a function of planning bonuses or government land concessions, which are explored next chapter.

#### **3.5.4 Service offer and target markets**

##### ***Rental revenues***

Another key point of difference posited for BtR is the expectation that brand premiums and service offerings will increase the rental returns over comparable units in the same market. Similarly, there are claims that BtR will meet a hitherto unmet housing market demand, setting expectation high that the limited supply will translate to higher rents and relatively little discounting caused by exhausting demand when building at scale. Predicting a quantification of this increase in revenue is largely speculative. However, all else being equal, Table 3.7 shows how higher rents translate to higher returns.

**Table 3.7: Different revenue scenarios, and the resulting return on development investment**

	<b>Studios (basic)</b>	<b>Studios (premium)</b>	<b>Apartments (basic)</b>	<b>Apartments (standard)</b>	<b>Apartments (premium)</b>
Base case	7.5%	11.1%	-3.1%	-3.2%	-3.1%
15% higher rents (4.6% gross unit yield)	11.2%	15.3%	-1.0%	-1.1%	-1.0%
30% higher rents (5.3% gross unit yield)	14.9%	19.5%	1.1%	0.9%	1.1%
15% lower rents (3.4% gross unit yield)	3.8%	6.8%	-5.2%	-5.3%	-5.2%
30% lower rents (2.4% gross unit yield)	0.1%	2.6%	-7.3%	-7.4%	-7.3%

Although these rental premiums could stem from any number of sources, note that a 15% increase is roughly the equivalent of getting premium rents in a standard building, and a 30% increase is roughly the equivalent of getting premium rents in a basic building. This relatively large effect suggests that the particular offer to occupants will be a crucial factor in BtR viability, more so than any other metric explored in the modelling.

Conversely, lower rental returns – potentially a function of the inclusion of affordable housing or contracting demand – also has a significant negative effect on returns. Again, the above reductions in rent could stem from different scenarios, but, approximately, a 15% reduction in rent equates to six in ten of the apartments let out as ‘affordable housing (75% of market rents), and a 30% reduction in rent equates to

equal thirds being market housing, affordable housing and ‘social housing’ (in this market, around 33% of market rents).

Other factors affecting rental revenue include arrears (uncollected rent) and vacancy (no tenant in place). These are modelled as proportions of rental revenue, at different rates according to market segment (with premium products having lower rates of both). However, as discussed below, this is effectively offset by marketing costs, which are similarly modelled as a proportion of rental revenue (with premium products having a higher rate). In any event, changing the rates within a broad range of expectations has – relative to a similar spectrum of base rental return – a smaller effect. This is shown in Table 3.8.

**Table 3.8: Different rates of arrears and vacancy, and the resulting return on development investment**

	Studios (basic)	Studios (premium)	Apartments (basic)	Apartments (standard)	Apartments (premium)
0%	8.5%	11.4%	-2.5%	-2.7%	-2.9%
1%	8.2%	11.1%*	-2.7%	-2.8%	-3.1%*
3.5%	7.5%*	10.2%	-3.1%*	-3.2%*	-3.5%
5%	7.1%	9.8%	-3.3%	-3.5%	-3.7%

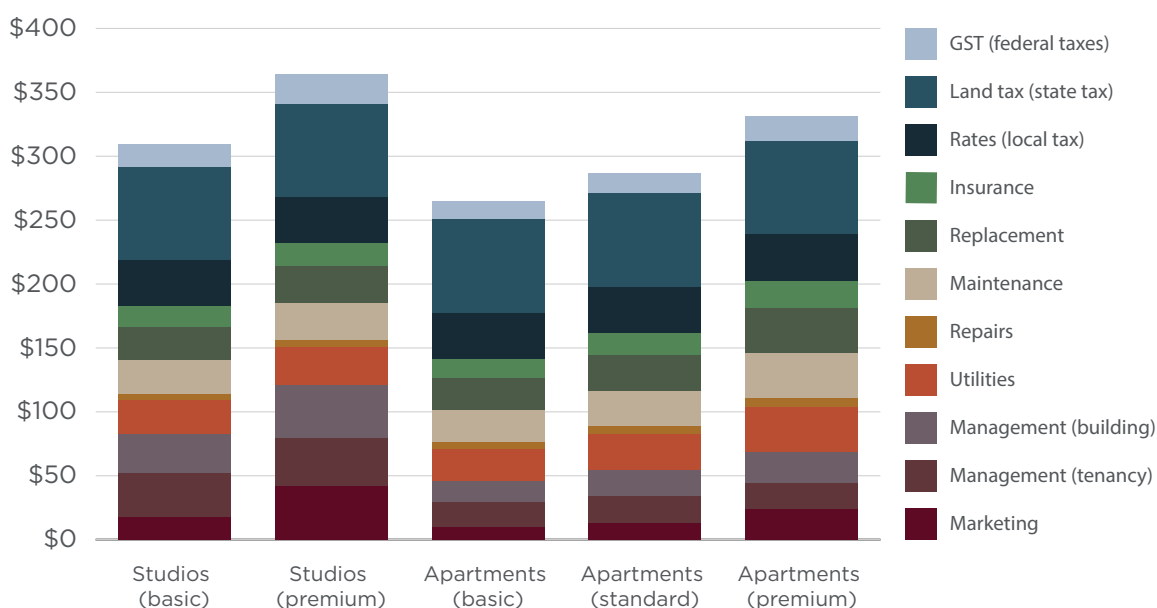
\* Base case

**Operating costs**

The above figures, particularly the potential to increase rent charged based on a higher service offering, need to be considered in concert with operating expenditure. Again, the figures for this are particularly speculative, since the kinds of services being offered (from concierge, gym and pool, through to

cleaning, furniture provision, and laundry) vary significantly. The base case for operating expenses is outlined in Figure 3.2. These figures are mostly derived as a proportion of replacement costs (construction), land value or revenue. As indicated in Figure 3.2, between one half to one third of costs are modelled to be through various taxes, which are discussed in the next chapter.

**Figure 3.2: Breakdown of operating costs, per square metre of net lettable area**



The expectation that BtR operational expenses can be restricted to low levels – potentially through control of supply chains and efficiencies of scale – can be tested. As with vacancy and arrears rates, some of the assumptions about operating costs reflect the market segment and business model. Marketing

and building management, in particular, are assumed to account for a higher proportion of revenue in premium products, given the expectation of more important role of brand and customer amenity in the business model. Table 3.9 shows the range of returns based on lower operating costs, all else being equal.

**Table 3.9: Different operating cost scenarios, and the resulting return on development investment**

	<b>Studios (basic)</b>	<b>Studios (premium)</b>	<b>Apartments (basic)</b>	<b>Apartments (standard)</b>	<b>Apartments (premium)</b>
Base case	7.5%	11.1%	-3.1%	-3.2%	-3.1%
20% lower operating costs	8.8%	12.6%	-2.0%	-2.1%	-1.9%
50% lower operating costs	10.8%	15.0%	-0.5%	-0.4%	0.0%

The limited effect of these adjustments reflects the fact that taxes account for a large proportion of operating costs, and are not adjusted down here. Overall, including vacancy, arrears and taxes, operating costs as a proportion of operating revenues range from 40% for studios, to 60% for apartments, with the premium models slightly more efficient

that the standard or basic models. The range in this ratio is much more an effect of lower revenues from apartments (per square metre of lettable area), with Figure 3.2 showing that studios and apartments having comparable operating costs. Table 3.10 shows this ratio for the scenarios in Table 3.7 and Table 3.9.

**Table 3.10: Different operating costs and revenue scenarios, and the resulting cost to revenue ratios**

	<b>Studios (basic)</b>	<b>Studios (premium)</b>	<b>Apartments (basic)</b>	<b>Apartments (standard)</b>	<b>Apartments (premium)</b>
Base case	37%	35%	56%	57%	57%
15% higher rents	33%	32%	50%	51%	51%
30% higher rents	31%	30%	46%	47%	47%
15% lower rents	41%	39%	64%	65%	64%
30% lower rents	48%	44%	76%	77%	76%
20% lower operating costs	32%	30%	50%	50%	49%
50% lower operating costs	25%	23%	40%	39%	38%

### 3.6 Chapter summary

This review of the different perspectives on BtR in the Australian context has highlighted some of the key perceived attractions of BtR as perceived by certain stakeholders. One apparent structural shift is that new demographics among renters has translated to deep, untapped demand for a particular rental product. This, in turn, has translated to a greater potential to build at scale without exhausting that demand for rental. Importantly, compared with BtS, maintaining demand is anticipated as involving a higher level of service provision and amenity – although there was no consensus on the extent to which BtR is fundamentally a ‘premium’ product. Further, the high level of service and high volumes required a high degree of building and tenant management efficiency: the extra rent is no good if it is chewed up by extra operating costs.

In financial terms, BtR’s key points of difference were its lower reliance on debt financing, and – conversely – ability to tap into capital investment in property and equity financing. The ongoing scepticism in some quarters of the property investment sector had yet to be overcome. However, initial inroads highlight the value of BtR as an adjunct land use to other property development – air space above commercial or retail, in particular, but also large residential precincts. In such cases, BtR offered diversity in property income streams, had lower overheads given development site costs had been incorporated in the primary land use, and did not restrict future capital growth through redevelopment, as a subdivided residential building might.

There was a degree of variation in the perspectives of the long-term prospects of BtR, which aligned with varying divisions over the expectation of returns to stem from development dividend or ongoing operational returns. Infrastructure-like models relied solely on the operational yield. Analogues to other property investments (commercial, retail, etc.) relied on a mix. And, where the shift to equity financing was seen as a cyclical pattern with debt financing inevitably returning, there was an anticipated liquidity event (subdivision and sell off of individual units) that would realise a similar degree of capital growth to traditional BtS.

The analysis has also revealed the key market fundamentals that will likely be necessary for BtR to emerge. In particular, the need for market conditions that generate strong gross rental yields but an absence of individual unit investors; a contraction in expected returns in other asset classes; and the need for superior service provision to translate to a prospect of rents escalating beyond the rest of the market. The modelling suggests these fundamentals do not yet exist: with a trite observation that if they did, BtR would be already flourishing at scale. The business models that do realise sufficient returns under current market conditions rely on much smaller units – such as new generation boarding houses and purpose-built student accommodation.

# 4. Build-to-Rent policy levers

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## 4.1 Status quo policy settings

This chapter considers the main policy levers identified in the grey literature and in our interviews with stakeholders affecting BtR viability.

Five of the levers relate to taxes and similar charges. At the state level, these are:

- Land tax
- Property transfer duty (stamp duty) and
- Local government rates.

At the federal level, relevant tax regimes are:

- Goods and services tax (GST) and
- Income tax – especially in relation to the taxation of companies and trusts, and depreciation.

The other two policy levers, both at state level, are planning, and the use of government-owned land.

The effects of each of these policy levers, except the income tax levers, can be measured at the level of a BtR project. In our discussion of each of these levers, we present a ‘sensitivity analysis’ that shows how policy adjustments may affect the viability of the five types of BtR in the model presented in the previous chapter.

Before discussing each of the levers in detail, it is useful to review Australian housing policy settings more generally. For decades federal and state governments have sought to promote homeownership through preferential treatment under various policies (Troy 2012). These include the Australian Government’s exemption of owner-occupied housing from

the asset test for the Age Pension, and from capital gains tax, and the exclusion of imputed rent (i.e. the value of the housing service produced by owner-occupied housing) from income tax. State governments exempt owner-occupied housing from land tax, and both levels of government have at times made available to first home buyers grants and other concessions (e.g. the Australian Government’s tax-preferred ‘First Home Saver Accounts’, and state transfer duty exemptions and concessions). State governments’ strata title legislation is facilitative of homeownership in multiple owner buildings, and there is also an argument – made by some stakeholders interviewed for this project – that the planning system, too, prefers homeownership, particularly through design guides for apartments that implicitly prioritise provision of sole occupancy space over shared space.

The preferential treatment, particularly exemption from capital gains and land tax, does not favour homeownership so much as existing home owners, whose untaxed housing wealth may be used to leverage investment in additional properties, particularly as rental investments. These properties are not directly subject to the same preferential treatment as owner-occupied housing, but because they usually can be traded between tenures, investors benefit from the capitalisation of owner-occupiers’ preferential tax treatment. They also benefit from tax settings in relation to investment incomes that entail a different set of preferential treatments relative to owner-occupiers: specifically, the deductibility of interest payments and other costs from their investment, including from non-asset income (i.e. negative gearing). This makes it easier



for investors to carry larger losses than they otherwise would – and, hence, take on higher levels of debt than they otherwise would, and pay higher prices than they otherwise would, to hold an asset in anticipation of capital gain. These settings also confer a greater advantage on those with higher incomes (i.e. those with higher marginal tax rates) and with higher levels of gearing.

As a result, policy settings that ostensibly prefer owner-occupation have driven a rise in private rental investment, as illustrated in Chapter 2, particularly from individual income earners prepared to tolerate relatively low rental yields in pursuit of capital gains. In interviews, numerous stakeholders referred to these stereotypical ‘mums and dads’ as one of the main reasons why BtR has not previously developed in Australia, and why it is still challenged: the ‘mums and dads’ hold residential rental yields below the level that investors have sought and realised in other property sectors, and it is generally more profitable for developers to sell properties to them. For the most part, this is not because the ‘mums and dads’ are treated preferentially to other investors – though there are exceptions to this, notably around land tax, discussed below. Rather, it is because of the capital advantage of housing relative to other assets, and the cashflow advantage of investors relative to would-be homeowners.

In interviews, stakeholders from the development and finance sectors argued strongly for a range of policy changes to foster BtR: the sector was, according to one, ‘completely dependent on policy change’ and, according to another ‘big incentives, whether by providing land, tax incentives or density incentives’, were required. In one of the most significant ‘grey literature’ contributions to the debate on the BtR viability impact of federal and state tax treatments, CBRE (2018a) reported modelling results demonstrating

the case that three tax provisions in particular were important:

- The thresholds and progressive structures of state land taxes
- The rules on reimbursement of GST outlays in the construction process
- The higher Trust tax rate applicable to overseas – as compared with domestic – BtR investors

According to the CBRE analysis the combined effect of the three taxes (in relation to a project involving an overseas funder) would deflate projected IRR by 2.42bps – or 25% of the projected return.

Some interviewees suggested that reliefs and other incentives might be laid on heavily to encourage first movers, and then reduced as BtR becomes an established asset class. When policy settings are examined in more detail, as we do in the sections below, we can see that there are some settings that open up differences between BtR and other forms of development and rental operations. However, in considering changes, we should also keep in mind the wider objectives and functions of these policy settings, and the issue of where in the life of a BtR development the benefit of a policy change may accrue. This is particularly important in light of the discussion, in Chapter 3, of the different business models going under BtR and the different phases of parties’ involvement in the development and operation of a BtR project.

## 4.2 Land tax

All Australian states, and the ACT, levy an annual land tax on some measure of the value of land owned within the jurisdiction, subject to significant exemptions. In New South Wales, land tax applies to the total unimproved value of a land owner’s taxable land holdings above a certain threshold, subject to exemptions for

- Land used for the owner's principal place of residence (PPR) – which represents about 60% of the potential tax base (AFTS 2010)
- Land used for primary production
- Land owned by charities (including community housing providers); and
- Land used for retirement villages and aged care, low-cost boarding houses and low-cost rental housing in inner Sydney.

The land tax threshold, currently set at \$629,000, means that many residential rental properties are also effectively exempt from land tax, as they are owned by small-holding landlords whose total portfolio value falls below this level and, in the case of properties in strata schemes, each unit's share of the scheme's land value is relatively small. As a result, land tax falls mainly on commercial property, and some rental housing (e.g. dwellings in the ownership of investor landlords with multiple properties).

New South Wales land values are determined according to the 'highest and best permitted use' of the land, exclusive of capital fixtures, and averaged over the current tax year and the two preceding years. For owners with taxable land holdings in excess of the threshold, land tax applies at a rate of \$100 plus 1.6% of value to the 'premium threshold' of \$3,864,000, and then 2% of value over that. Under recently enacted provisions, foreign owners of taxable residential land in New South Wales also pay a land tax surcharge of 2%. Foreign persons who are 'Australian-based developers' are exempt from the surcharge or entitled to a refund where the land is used for construction and sale of new homes. They are also exempt from the surcharge if the land is used for 'residential premises that are not dwellings', such as hotels, student accommodation, boarding houses and serviced apartments (Revenue Ruling G 011).

Because of the land tax regime's PPR exemption, and its structure of thresholds and

progressive rates, a site in single ownership – as in BtR – will be taxed more heavily than a site divided up amongst diverse small owners. This means that BtR returns are reduced relative to those of BtS landlords (CBRE calculates a 0.89 basis point reduction), which in turn generally reduces the site-bid of BtR developers relative to BtS developers.

Land tax is prominently identified in the grey literature (see, for example, Daley et al 2018; CBRE 2018a) and by stakeholders in interviews as a reform priority of crucial importance in enhancing BtR viability. As one developer said: 'land tax is so critical to what we do. It is the number one thing.' This developer's preferred reform was an exemption for BtR from land tax, arguing that this was essentially equivalent to the treatment of BtS under the present threshold and rates structure. This developer also proposed, as an integrity measure, that land tax-exempt BtR developments could be subject to covenants restricting use to that of rental housing for a specific time period, or clawback provisions for past land tax liabilities upon strata subdivision. Other reform options countenanced by stakeholders included a general flattening of the rate structure.

While some BtR proponents seek land tax exemptions and reductions, there is increasing acknowledgement by policymakers of the benefits of land value taxation, and that it would be better to make greater use of it through broadening the tax base (e.g. AFTS 2010; NSW Business Chamber, 2016; Ecclestone et al 2017). As a tax on the value of land (as distinct from capital improvements), land tax gets at unearned rents and, because it is payable regardless of whether income is actually received, it discourages speculative holding, and so tends to bring land to market and reduce costs. Both these aspects mean that land tax is generally 'pro-development' and therefore, it would be imagined, well in

tune with current official priorities at both Commonwealth and state/territory levels.

The progressive structure of land tax rates is associated with another purpose: the discouragement of large land holdings and the political power that historically comes with land ownership (Ryan-Collins et al 2017). There is a question as to whether this rationale is still good policy. As one government stakeholder contemplated in an interview, it may be that the general public purpose of land tax and the specific issue of equitable treatment of BtR are best addressed by a ‘levelling up’ of land tax through removal of the threshold and the PPR exemption.

#### 4.2.1 Sensitivity analysis

Land tax is difficult to model, considering the different valuation methods and rates structures across jurisdictions. It is modelled here as a single payment of 3% of land cost during construction (mostly because the base valuation will be lower than the calculated land cost at the point of development), and 2% annually of land value throughout operations. As shown in Table 4.1, the land tax paid throughout operations has a much larger effect on returns, both by increasing the costs up to recapitalisation and, in the model, reducing the return on operations and so the asset value to a second round of investors. Notably, not-for-profit providers are typically exempt from land tax, making their operating balance sheets reflect the tax-free returns here.

**Table 4.1: Different land tax scenarios, and the resulting return on development investment**

	<b>Studios (basic)</b>	<b>Studios (premium)</b>	<b>Apartments (basic)</b>	<b>Apartments (standard)</b>	<b>Apartments (premium)</b>
Base case	7.5%	11.1%	-3.1%	-3.2%	-3.1%
Without land tax during development	7.8%	11.4%	-2.9%	-3.1%	-3.0%
Without land tax during operations	9.9%	13.3%	-0.6%	-0.9%	-1.1%
Without any land tax	10.2%	13.7%	-0.4%	-0.8%	-0.9%

The fairly significant viability impact of land tax – as suggested by our modelling (Table 4.1) – is consistent with the CBRE (2018a) analysis showing that in a hypothetical BtR development of 250 units where land value is approximately \$27 million, land tax liability effectively reduces the internal rate of return by 89 basis points (bps). Expressed in different metrics, recent Grattan Institute analysis (Daley et al 2018 Figure 4.8) indicates that in the Sydney and Melbourne context, land tax exposure under current settings is liable to absorb nearly a quarter of a large landlord's net return (compared with a small portfolio holder who will enjoy complete exemption).

### 4.3 Transfer duty

Transfer duty – better known as stamp duty – is levied by state governments on certain 'dutiable transactions', primarily transfers of land. Transfer duty is payable by the purchaser on the sale price of the property according to a progressive rate structure: for practical purposes, the NSW rates range from 3% to 7%. Foreign purchasers of residential property are also liable to pay a surcharge of 8%, subject to exemptions for foreign-owned Australian-based developers, and for purchasers of 'commercial residential' property (e.g. boarding houses, student accommodation (Revenue Ruling No G 011)). For NSW first home buyers, a concessional rate applies to purchases priced \$650,000 - \$800,000, and purchases priced less than \$650,000 are exempt. Home buyers (but not investors) purchasing off-the-plan purchasers may defer payment of transfer duty for up to 12 months.

On one view, transfer duty appears to be a cost incurred by developers early in the development process (on the acquisition of land), with related finance costs carried through the development and, in the case of BtR, for the longer subsequent period of rental operations. On this view, BtR is at a disadvantage relative

to BtS and a reduction in transfer duty on purchases specifically for BtR development might level the treatment. However, although the legal obligation to pay transfer falls on the purchaser, research indicates that the economic incidence in fact falls on the vendor – i.e. the duty comes out of the price that the vendor would otherwise receive (Davidoff and Leigh 2013). This would mean that there is in fact no disadvantage to BtR relative to BtS – except, perhaps, inasmuch as the first home buyer exemption and concession might encourage BtS development for that market.

Two further aspects of the transfer duty regime are relevant to BtR, particularly after the development phase. 'Landholder duty' is levied on acquisitions of interests in 'landholders', which are private or public unit trusts and companies that own New South Wales land with a value of more than \$2 million – which would include a large BtR MIT. The effect, broadly speaking, is to make acquisitions of interests in landholders subject to duty as if the acquisition were a transaction in land itself. Also, in transactions for the sale of a business, transfer duty is payable on the value of any interest in land (including a lease) and, where there is land interest component, on plant and equipment too.

Both these further aspects of transfer duty would be applicable to different sorts of transactions in BtR businesses. Notwithstanding these provisions, however, it remains part of the basic case for BtR that there would be fewer transactions of properties than in a BtS development with diverse small-holding owners, which means less transfer duty revenue for the state government.

In interviews a few stakeholders mentioned transfer duty, and especially the foreign buyer surcharge, amongst the barriers to BtR investment. These stakeholders were, however, relatively confident this barrier

could be overcome, on the principle that foreign investors in BtR MITs should be treated equivalently with exempt foreign-owned Australian-based developers, and the Victorian Government has in fact very recently provided for exemptions for BtR investors from its land tax surcharge and additional transfer duty. Generally, changes to transfer duty settings were seen as less a priority than changes to land tax, MITs and GST settings.

#### 4.3.1 Sensitivity analysis

Like land tax, the changing rates of stamp duty make it difficult to approximate in a general model. Here it is incorporated as 7% of the land cost (see Table 4.2). As a one-off cost, it does not have as significant an effect on the operational balance sheets, and so does not change the asset value at recapitalisation. Rather, it simply reduces the dividend from development. Notably, the longer a development-phase investment is held, and so the more the overall return reflects operating returns, the less impact stamp duty concessions have on overall, annualised returns.

**Table 4.2: Different stamp duty scenarios, and the resulting return on development investment**

	<b>Studios (basic)</b>	<b>Studios (premium)</b>	<b>Apartments (basic)</b>	<b>Apartments (standard)</b>	<b>Apartments (premium)</b>
Base case	7.5%	11.1%	-3.1%	-3.2%	-3.1%
Without stamp duty	8.2%	11.8%	-2.7%	-2.9%	-2.8%

#### 4.4 Local government rates and fees

Local governments in Australia impose a range of charges on developers and property owners, such as local rates to fund the provision of services generally, developer contributions to fund additional service provision arising from the development specifically, and fees for the development approval process.

In New South Wales local government rates are levied by local councils according to provisions of the Local Government Act 1993 (NSW) (the LG Act). The LG Act sets out four categories of land use for rating purposes – farmland, mining, residential and business (this last being a residual category of land uses that do not fit into another category). It seems clear that a mainstream BtR product would be within the residential category, because the category is expressly wide enough to include

retirement villages, serviced apartments and time-share accommodation, and low-cost boarding houses and lodging houses (i.e. on the same criteria as the land tax exemption). Within the ‘residential’ category councils may establish subcategories for different ‘centres of population’. According to the NSW Office of Local Government, a centre of population ‘should not be a device intended to enable rating variations within a homogeneous suburb or suburbs, or by street’. (NSW DLG 2007: 23). The LG Act also provides for exemptions from local government rates, notably for public benevolent institutions, including CHPs.

Local government rates are mostly based on the unimproved value of land, subject to provisions for minimum amounts. The latter provision is important for apartments in strata schemes, where the land value component of

each lot is small; it means the total amount of rates paid on all properties on the site is higher than if the site were in single ownership (i.e. the opposite effect to the land tax threshold). Increases in the total quantum of a council's rates are subject to a peg revised annually by the Independent Pricing and Regulatory Tribunal (IPART).

The 'minimum amount' provisions confer an advantage on BtR relative to BtS – but because this advantage affects local government revenue-raising, it may prompt local resistance to BtR that ends up being costly in other ways. In 2016 IPART reviewed the NSW local government rating system and made numerous recommendations for reform. These include: removing provision for 'minimum amounts' and allowing councils to levy rates based on capital improved value (rather than unimproved value), allowing more flexibility around residential subcategories (in particular, allowing them to be defined by 'community of interest'); and removing exemptions for residential and business land. The NSW State Government is considering IPART's recommendations. The recommended shift from minimum rates to

Capital Improved Value (CIV) rates might equalise rating across BtR and multiple-owner sites. IPART's recommendations do not disclose whether provision for 'community of interest' subcategories might allow a specific BtR subcategory.

#### 4.4.1 Sensitivity analysis

Local government rates and other fees are smaller than other tax liabilities. As such they are not as impactful on the final rate of return, as shown in Table 4.3. These fees also vary somewhat, depending on the local council. Impact fees (called s7.12 contributions in NSW) are modelled at 1.3% development costs. This covers development application fees that are often applied on top of the typical 1% impact fees, but would not account for any other special infrastructure contributions that are at times payable as part of a development process. Rates are simply modelled at 1%pa of land value. These relatively modest costs result in little impact resulting from their removal. The application of commercial or residential rates could change this position, relative to other residential investment, but this is still expected to be minor.

**Table 4.3: Different local tax scenarios, and the resulting return on development investment**

	<b>Studios (basic)</b>	<b>Studios (premium)</b>	<b>Apartments (basic)</b>	<b>Apartments (standard)</b>	<b>Apartments (premium)</b>
Base case	7.5%	11.1%	-3.1%	-3.2%	-3.1%
Without impact fees (local taxes during development)	7.6%	11.2%	-3.0%	-3.2%	-3.0%
Without rates (local taxes during operations)	8.7%	12.2%	-1.9%	-2.1%	-2.1%
Without any local taxes	8.8%	12.3%	-1.8%	-2.0%	-2.0%



Grocon - St Leonards, Sydney design

#### 4.5 Goods and Services Tax

Goods and services tax (GST) is a federal tax levied on the sale of most goods and services at a rate of 10%. It is collected by businesses, which may also claim credits for the GST they pay on goods and services purchased in the course of making a supply of taxable goods and services. The application of GST to transactions involving property and accommodation services, however, is complex, because the regime distinguishes between 'residential premises' and 'commercial residential premises', and within each category makes different provision for different types of transaction.

Regarding residential premises, the sale of 'new' residential premises (less than five years old) is a GST taxable sale, which means a BtS developer can claim credits for GST paid on development inputs. By contrast, the letting of residential premises (regardless of whether they are 'new' or older at the beginning of the tenancy), is a 'input-taxed sale', on which no GST is levied, and no credits may be claimed for GST paid on development inputs. This means BtR development is at a disadvantage relative to BtS, because the BtR developer has to absorb the cost of GST on inputs (similarly, BtR development is at a disadvantage to commercial development, because commercial lettings are GST taxable and so allow a claim for GST paid on inputs). The disadvantage also applies where the BtR development is 'build to sell later', because sales of residential premises more than five years after construction are not GST taxable, so GST development costs cannot be recouped then.

Regarding 'commercial residential premises', this category includes 'a hotel, motel, inn, hostel or boarding house' and 'accommodation in connection with a school' (accommodation in connection with an educational institution other than a school is expressly excluded). According to the ATO's ruling Goods

and Services Tax Ruling 2012/6, student accommodation not in connection with a school or other educational institution will generally fit the definition of a 'hostel', and so come within the 'commercial residential premises' category.

Most of the PBSA sector operates as commercial residential premises on the hostel characterisation. Letting commercial residential premises is a GST taxable sale, so credits for GST paid on inputs by the developer-manager may be claimed (so, for the reasons discussed above, mainstream BtR development is at a disadvantage to PBSA development). However, special provisions apply where the premises provide 'long-term accommodation' (28 or more consecutive nights) (Division 87): at the choice of the operator, the letting may be treated as a taxable sale at concessionary rate (5.5%) with credits on inputs allowed, or as an input taxed sale (i.e. no GST is charged, and no input claims may be made).

It should be noted too that community housing providers, as charities, are subject to special provisions. Where community housing is provided at less than 75% of the market rent, the supply is GST-free and the CHP can claim input credits; however, where the rent is 75% of the market rent or more, the supply is input taxed.

The GST regime's preferential treatment of BtS over BtR has been highlighted by CBRE, which calculates a 'quite significant impact' on BtR investor returns of 0.99 basis points (2018) – larger than land tax. The GST regime was also raised in interviews by a number of stakeholders, with one claiming that 'changing GST rules could have a massive difference'. Another suggested that the provision for commercial residential to claim GST credits on inputs 'made a significant difference to the development feasibility of



student accommodation’, and that the same provision should be made for mainstream BtR. Others indicated that the property sector had identified GST as a possible reform item early in the promotion of BtR, but that it was difficult to frame as a matter of equal treatment with ‘mum and dad’ investors, so had become less a priority.

#### 4.5.1 Sensitivity analysis

GST is applied in the model during development and operations. Regarding development phase GST, the base case

assumes GST is paid on top of all inputs – land and construction. Access to a similar concession to the margin scheme available to build-to-sell developments would reduce the liability. Applying a similar concession – effectively removing the tax payable on land purchase – has a marginal impact on returns. As shown in Table 4.4, removing GST completely – effectively providing GST credits on all GST paid during development – further improves the expected return (all else being equal).

**Table 4.4: Different development phase GST scenarios, and the resulting return on development investment**

	<b>Studios (basic)</b>	<b>Studios (premium)</b>	<b>Apartments (basic)</b>	<b>Apartments (standard)</b>	<b>Apartments (premium)</b>
Base case	7.5%	11.1%	-3.1%	-3.2%	-3.1%
Tax only on construction (not on land)	8.5%	12.1%	-2.5%	-2.7%	-2.6%
No development GST (credits on any GST paid)	9.7%	13.6%	-1.9%	-2.0%	-1.8%

During operations, GST is modelled as an input tax: at 10% of operational costs (on the assumption that these services are outsourced). Currently student housing, and other long-term ‘commercial residential’, has access to a concessional GST arrangement, with the rate of GST on revenues set at 5.5%

and credit for any GST incurred on operating costs. In this model, this arrangement results in a similar rate of return. Finally, removing all GST liability – including enabling concessions or reimbursement for any tax paid to contractors – is shown in Table 4.5. This is the current arrangement applicable to CHPs.

**Table 4.5: Different operating phase GST scenarios, and the resulting return on development investment**

	<b>Studios (basic)</b>	<b>Studios (premium)</b>	<b>Apartments (basic)</b>	<b>Apartments (standard)</b>	<b>Apartments (premium)</b>
Base case	7.5%	11.1%	-3.1%	-3.2%	-3.1%
Concessional (5.5% tax on revenue, credits on GST paid to contractors)	7.2%	10.7%	-3.0%	-3.1%	-2.9%
No operating GST (credits on any GST paid)	8.1%	11.8%	-2.6%	-2.7%	-2.5%

The ‘full GST leakage’ scenario, as modelled by CBRE (2018a) in relation to a hypothetical 250 unit project, was estimated as reducing IRR by 99bps – on their analysis a larger effect than that of land tax (see above).

#### **4.6 Income tax, company tax, MITs withholding tax and depreciation**

Australia’s federal income tax regime encompasses company tax, the taxation of trusts, capital gains and depreciation, all of which are relevant to BtR.

We discussed the taxation of companies and trusts in Chapter 2. To recap, Australian tax law makes managed investment trusts (MITs) an attractive vehicle for holding property assets, because rental income is generally allowed to pass through without tax (in the case of domestic investors) or, in the foreign investors,

at low rates of withholding tax (mostly 15%; 10% for Clean Building MITs). Because this treatment applies only to passive income – i.e. rent – MITs are often part of a stapled structure that also includes an operating company, which uses the asset to generate income and pays rent to the MIT, whence it is distributed to investors. MITs and stapled structures are much used in commercial property investment, including in PBSA, but the prospect of their use in residential property investment has been controversial, as has the use of stapled structures to recharacterize trading incomes as passive incomes.

Legislation currently before the Australian Parliament would clarify that MITs can invest in residential property, but that income from ‘residential housing’ – including off-campus student accommodation<sup>9</sup>, but excluding

<sup>9</sup> Note that for the purposes of ‘residential housing income’, the Bill defines ‘residential dwelling asset’ to include ‘accommodation for students (other than in connection with a school (within the meaning of the GST Act))’. The Explanatory Memorandum for the Bill states that ‘this confirms... that tertiary student accommodation in Australia is a residential dwelling asset irrespective of whether it is also commercial residential premises’ (par 1.224). The Bill’s definition does not actually conform with the GST regime, which countenances three categories of student accommodation: 1) in connection with a school (this is commercial residential); 2) in connection with an educational institution other than a school (this is expressly not commercial residential); and not in connection with any educational institution (this is commercial residential, because it fits the definition of ‘hostel’). The Bill effaces the distinction between 2) and 3), and makes the latter not commercial residential. As such, most of the PBSA sector would be subject to the higher withholding tax rate.

'affordable rental housing' – would be 'non-concessional MIT income', and distributions to foreign investors subject to 30% withholding tax. By contrast, distributions to foreigners of rental income from affordable housing, commercial residential (other than student accommodation), and non-residential commercial property would be subject to 15% withholding tax (10% for Clean Building MITs).

Most of the grey literature referring to this issue and all of our interview data pre-dates the introduction of the legislation. Most of the interviews were undertaken in parallel with a government consultation during which other more restrictive reform options were floated. These included expressly disqualifying residential housing (other than affordable rental housing) from MIT eligible investments.

Reflecting the common view of stakeholders that international funds would be the most likely early investors in BtR (see Chapter 3), several interviewees said that the Australian Government's move had created a 'major road block' for the establishment of BtR. One property sector stakeholder claimed that a 'clear message' that the government did not support BtR had been received by international and domestic players alike, while another interviewee from the finance sector nominated as their first reform priority that the government should 'stop the MIT banter'. Interviewees from the Australian Government, however, considered that the treatment of MITs was secondary to expectations around rental yields, and that this remained the basic problem for BtR.

The less restrictive position adopted in the legislation has been welcomed by the Property Council, but the PCA still pushes for equivalent treatment across residential and

commercial property (i.e. 15% withholding tax across the board). In an interview, a stakeholder also suggested that a lower rate, per Clean Building MITs, should be considered, including on temporary basis to provide support for early movers.

Australia's income tax system makes special provision for incomes from capital gains. Generally, only half the gain is assessed as taxable income (the rationale being that this adjusts properly for the part of the gain attributable to mere inflation). Under a measure announced in the 2017 Budget, and for which legislation is currently before the senate (Treasury Laws Amendment (Reducing Pressure on Housing Affordability Measures No. 2) Bill 2018), a further discount – to a total of 60% – would apply to capital gains from housing assets that has been used to provide 'affordable housing': that is, rental housing managed by a CHP for not less than three years<sup>10</sup>. Furthermore, under the proposed MIT legislation, capital gains from 'affordable housing' managed by a CHP for not less than 10 years would be concessional MIT income and subject to the lower rate of withholding tax.

The income tax system allows for deductions against income to reflect the depreciation of buildings, appliances and furnishings. For most buildings built now, the depreciation rate is 2.5% per annum deductible over forty years: this applies to residential and commercial buildings alike.<sup>11</sup> Equipment depreciates according to schedules published by the ATO. The current treatment of depreciation for both buildings and equipment would be the same for BtR as for other rental investors, except that the latter are more likely to be affected by a rule, introduced in 2017, restricting deductions for 'second-hand' equipment. This provides,

<sup>10</sup> 'Commercial residential' accommodation is excluded, as is NRAS housing while it remains in receipt of an NRAS subsidy.

<sup>11</sup> Buildings used for manufacturing and hotels and apartment buildings providing 'short-term accommodation for travellers' depreciate faster, at 4% per annum. Different rates apply to some buildings built before 1997.

in effect, that where a residential property changes hands, the equipment transferred with it becomes second hand and no further deductions for depreciation may be made. By contrast, because a BtR property does not change hands, its equipment does not become second-hand and depreciation deductions can be made for the scheduled life of each item.

Because the various aspects of the income tax regime relate to factors outside the scope of an individual BtR project, we are not able to use our five-type model to conduct sensitivity analysis of changes to income tax settings. However, in relation to their hypothetical 250 unit project (under foreign ownership), CBRE estimates that the additional tax incurred would reduce IRR by 54bps.

#### 4.7 Land-use planning

All Australian states and territories regulate land uses through legislated systems of planning and development approval. In New South Wales, as in other states, much of the planning system is operationalised by local government, with local councils charged with making local plans, and with determining applications for development approval. However, in both respects local councils' responsibilities and powers are subject to state-level planning instruments, notably State Environmental Planning Policies (e.g. the Standard Instrument SEPP, the Affordable Rental Housing SEPP, and SEPP 65 – Design Quality of Residential Apartment Buildings), and to provision for some types of development to be assessed by other process and authorities (e.g. Regional Planning Panels or, in some cases, the Minister for Planning).

Generally speaking, Australia's state and territory planning systems make provision for residential premises – that is, the zones in which residential development will be allowed, and the standards residential developments are required to meet – without distinction

between premises that are intended for owner-occupation and premises that are intended for rental: both are 'private dwellings'. Similarly, the National Construction Code, which sets building standards picked up in the development approval process, classifies private dwellings according to whether they are houses (Class 1a buildings) or apartments (units in Class 2 buildings), without regard to tenure. There are some exceptions to this. Boarding houses are a land use category distinct from private dwellings, and are subject to different zoning requirements and different building standards (e.g. under the National Construction Code, boarding houses are Class 1b or Class 3 buildings). Also, under the AHSEPP, special provisions are made regarding the development of 'infill housing', boarding houses and social housing, all of which are specifically for rental.

The above provisions allow development at higher densities and with reduced parking, provided certain standards are met, and prevent local councils from insisting on higher standards; the 'infill housing' category also mandates affordability outcomes and management by a community housing provider. Mostly, though, the planning system's treatment of mainstream residential premises is at least ostensibly tenure-blind.

In interviews, many developers were very critical of state planning systems, particularly the New South Wales framework, and while many of these criticisms were generally stated (e.g. time delays and cumbersome processes), some indicated particular problems for BtR. Proponents of 'boarding house' projects were generally supportive of the provisions of the AHSEPP, but criticised recent changes to increase parking requirements, and suggested that local councils were protracting the development process, by declining approval because of 'political sensitivities', only for the courts to approve them subsequently. They were also dubious about the AHSEPP's

prescriptions about common areas and management, because most of the buildings they developed had self-contained units. Others suggested that provisions regarding private dwellings – specifically the SEPP 65 design guide for apartments – were implicitly biased to BtS, because the required minimum apartment sizes and mix did not contemplate the proportionally greater amount of shared space (e.g. wider corridors, more lifts, communal facilities) that BtR required for its operational efficiencies. It was also suggested that local councils would prefer development applications that entailed strata subdivision, with a view to the later levying of rates.

Developer interviewees commonly called for a specific development application track for BtR, and a specific BtR design guide. These stakeholders variously suggested that a BtR design guide should provide for:

- Smaller unit sizes
- Reduced apartment mix
- Greater building bulk and scale
- Planning bonuses and enhanced floor space ratios

- Reduced solar access and cross ventilation restrictions
- Reducing parking requirements.

For their part, state government stakeholders considered that there was nothing in the planning system that restricted BtR, but indicated openness to the arguments about allowing greater ‘flexibility’ around design requirements.

#### 4.7.1 Sensitivity analysis

As noted in Chapter 3, there are a number of design and construction changes that could change the anticipated return, shown again in Table 4.6. Many of these are current constraints of development control, and could be adjusted if appropriate for BtR. The first is concessions on the amount of parking required, which entails significant excavation costs. The second is concessions on minimum apartment size, which increases the revenue per square metre of let floorspace. It would need to be assessed more fully as part of any planning framework, but BtR does not lock in particular apartment sizes and mixes (since it is not subdivided), so such stringent controls on unit size and mix could be considered less important.

**Table 4.6: Different planning concession scenarios, and the resulting return on development investment**

	<b>Studios (basic)</b>	<b>Studios (premium)</b>	<b>Apartments (basic)</b>	<b>Apartments (standard)</b>	<b>Apartments (premium)</b>
Base case	7.5%	11.1%	-3.1%	-3.2%	-3.1%
Eliminating parking	9.3%	11.1%*	-2.4%	-2.0%	-1.3%
Smaller average unit size (20% smaller units)	13.1%	18.0%	0.2%	-0.1%	-0.1%

\*premium studios had no parking in the base case.

There is also the potential to increase the permissible floorspace with a 'density bonus' offered on a BtR scheme. This results in a larger development, and so reduces the fixed development costs, land costs in particular, in 'per square metre of net lettable floorspace' terms. For example, a 25% density bonus increases floorspace by a factor of 1.25. Sharing the same land costs across the larger amount of floorspace reduces the per square metre land costs by a factor of 1/1.25 (or 0.8). A bonus of 50% effectively reduces land costs by a factor of 1/1.5 (or 0.67).

The reduced land costs in Table 4.7, then, equate to a 25% and 100% floorspace bonus. Comparable effects can be created through zoning overlays that restrict the use of land for purposes other than BtR, such that BtR becomes the 'highest and best' use of land. Finally, land costs can be reduced directly where government is the land owner and sells to a developer at a reduced rate. Providing land for desired land uses, such as BtR, is particularly effective, as it removes land costs (and sundries linked to land value, such as land taxes).

**Table 4.7: Different land cost reductions, and the resulting return on development investment**

	<b>Studios (basic)</b>	<b>Studios (premium)</b>	<b>Apartments (basic)</b>	<b>Apartments (standard)</b>	<b>Apartments (premium)</b>
Base case	7.5%	11.1%	-3.1%	-3.2%	-3.1%
20% lower land costs	10.3%	14.1%	-1.4%	-1.6%	-1.7%
50% lower land costs	16.1%	20.0%	2.1%	1.5%	0.9%
No land costs	33.2%	37.0%	12.9%	10.6%	7.6%

It should be noted that, since the base case is in the inner-city, land costs were a significant proportion of development costs. Table 4.8 shows the effect of similar land cost discounts/density bonuses in an alternative suburban housing market, where land costs account for

a smaller proportion of costs. It shows that planning control variations in those contexts have less of an effect on the expected rate of return.

**Table 4.8: Different land cost reductions in a suburban market, and the resulting return on development investment**

	<b>Studios (basic)</b>	<b>Studios (premium)</b>	<b>Apartments (basic)</b>	<b>Apartments (standard)</b>	<b>Apartments (premium)</b>
Based on calculated land value	8.6%	17.5%	-1.9%	-2.0%	-3.1%
20% lower land costs	9.7%	18.9%	-1.2%	-1.4%	-2.6%
50% lower land costs	11.6%	21.2%	0.0%	-0.3%	-1.8%
No land costs	15.4%	25.6%	2.5%	1.8%	-0.3%

#### 4.8 Government land

Compared to the tax and planning levers discussed above, the provision of government land is a much more narrowly applicable policy lever – it will simply not be relevant to most BtR projects, which are proposed to be built on sites sourced from the market, including sites purchased by developers some time ago. However, in BtR industry events (e.g. the Property NSW ‘preview’ event) and in interviews, some stakeholders called for the government to provide land on favourable terms to BtR developers, especially in the start-up phase of the sector. The NSW State Government itself has also put government land in the policy mix, through its announcement that a LAHC-owned site in Redfern will be available, under a long-term

lease, for development of a BtR project, and its subsequent indication that other LAHC-owned sites may also be made available under ‘Communities Plus – Build to Rent’. In this scenario, the ‘government land’ policy lever is a synonym for BtR as a component of certain forms of urban renewal.

#### 4.8.1 Sensitivity analysis

We considered reduced-cost and free land as part of our sensitivity analysis of density bonuses. As Table 4.7 shows, these measures make a significant difference to returns. They also raise most starkly the question of the public purpose served by making government land available to support profit making comparable to commercial property sectors, when it might directly support affordable housing provision by non-profit providers.

#### 4.9 Compounded feasibility scenario

Up until now, all of the Chapters 3 and 4 feasibility modelling outputs have largely restricted consideration to altering individual parameters, singly. In practice, of course, it may be that policy settings and market conditions depart from the base case in two or more respects. While many permutations are of course possible we have chosen to exemplify just three tax settings/market conditions combinations in Table 4.9. However realistic (or otherwise) this might be, where all four of these 'advantageous conditions' are applied, the development investment return is transformed from -3.2% to +4.7%.

**Table 4.9: Exemplifying development feasibility in advantageous conditions**

<b>\$/sqm.nla</b>	<b>Base case - apartments standard</b>	<b>Advantageous tax settings*</b>	<b>Advantageous market conditions**</b>	<b>Advantageous tax settings and market conditions</b>
Development cost/equity	\$9,259	\$8,346	\$8,374	\$7,556
Operating revenue (annual)	\$501	\$501	\$576	\$576
Operating cost (annual)	\$287	\$195	\$270	\$195
Required rate of return (net yields on operation)	4.5%	4.5%	4.5%	4.5%
Implied value of asset	\$4,764	\$6,805	\$6,792	\$8,466
Capital growth	-\$4,495	-\$1,541	-\$1,582	\$909
Total development investment return (annualised)	-3.2%	0.7%	0.7%	4.7%

\*No Land Tax or development GST \*\*+15% rent, -20% land price



#### 4.10 Chapter summary

From our review of BtR policy levers and sensitivity analysis of policy adjustments, two main points stand out.

First, many of the adjustments to policy settings sought by BtR proponents have already been conceived of with respect to affordable housing. In particular, exemptions from land tax and council rates, provision for GST input claims, density bonuses and reduced parking requirements are already available to CHPs in NSW; CHPs may also occasionally have access to land at discounted prices or free of charge (e.g. under certain public housing stock transfer programs), and access to MIT concessional withholding tax rates is proposed in government legislation currently before the federal parliament. All have strings attached regarding affordability and other outcomes, which are provided for by regulation either directly (e.g. affordability requirements under the AHSEPP) or indirectly (CHPs' registration requirements under NRSCH or charitable status).

Secondly, the sensitivity analysis suggests that for most of the five types of BtR in our modelling – in particular, the three 'apartment' types – none of the policy adjustments currently contemplated by the sector will, by itself, lift returns sufficiently to make BtR competitive with BtS for the long-term.

However, the combined scenario shown in Table 4.9 – advantaged tax settings and more favourable market conditions – illustrates that this is theoretically possible. Moreover, studio blocks mostly offer competitive returns even on current policy settings.

For a private, for-profit BtR sector providing more-or-less mainstream housing units to stack up as a viable alternative to BtS, some other change outside the factors contemplated in the stakeholder interviews and in our sensitivity analysis would have to happen – say, a substantial decrease in property prices without a similar decline in rents (i.e. a credit crunch scenario). As things are, it is difficult to sustain the view that private, for-profit BtR will develop at such a scale that it will offer much of an opportunity for affordable rental to be layered in using existing subsidies – because BtR will have already used them.

# 5. BtR, affordable housing and the possible roles of community housing providers

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## 5.1 Chapter context

Numerous contributors to recent Australian media and industry debates on build to rent have asserted that the emergence of a viable BtR product will in some way enhance ‘housing affordability’ (see, for example: Allens Linklaters 2017; King 2017; Domain 2018). Such arguments have often formed part of the industry pitch for the reform of various federal and state taxes so as to enhance BtR financial feasibility – see Chapter 4.

More specifically, some contend that the establishment of a BtR sector will be of direct benefit in generating affordable housing (i.e. dwellings rented out to low or moderate income earners at below market rates). The Property Council of Australia, for example, argues that:

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**‘A healthy Build-to-Rent sector provides governments with the best opportunity to deliver affordable rental housing. Government incentives to attract institutional scale investment into the affordable rental housing sector are much more likely to be successful if there is a depth of market’**

(PCA 2018 p15).

In this chapter we explore connections between BtR and affordable housing. The discussion considers both the prospects for inclusion of affordable housing dwellings in developer-led BtR projects and the related issue of what roles CHPs might play in the BtR space – whether as BtR developers, development partners or property and tenancy managers.

First, to contextualise the Australian story, we reference the ways that affordable housing is (or can be) incorporated within BtR projects in the two countries – the USA and the UK – that have provided the most substantial inspiration for mainstream market BtR as envisaged in Australia. Here we draw especially on the companion UK research undertaken by LSE London colleagues and briefly summarised in Section 2.2.2. Next, in Section 5.3, we provide a precis of the stakeholder views on the potential for a BtR product to incorporate

affordable housing. This is followed, in Section 5.4, by an examination of the feasibility of procuring affordable housing in BtR schemes and discussion of the policy options for boosting affordable provision. For reasons explained below, that discussion focuses on the opportunities presented through the use of the CHP delivery model for this purpose.

In referring to affordable housing, we have based our research on the statutory definition applied under planning legislation in NSW: 'affordable housing means housing for very low-income households, low-income households or moderate income households' (EPA ACT 1979, as amended 2000). In practice, different programs and agencies of government codify and apply this definition in diverse or selective ways, which has resulted in some confusion and ambiguity in relation to what is meant by affordable housing. Generally speaking, however, the accepted benchmark of affordability (and the one adopted by Landcom – see Chapter 1) is housing that costs the occupying household no more than 30% of their gross household income.

## **5.2 Incorporation of affordable housing in BtR projects: Overseas benchmarks**

As in many other respects, the UK and USA BtR (multi-family housing) sectors may provide relevant reference points in the consideration of whether and how affordable housing could be incorporated within BtR projects in Australia. In both of those overseas jurisdictions land-use planning powers are used to a greater degree than in Australia to impose 'affordable housing' obligations on private developers – potentially impacting market rental as well as market sale projects. Such mandates – sometimes termed 'inclusionary zoning' are operated in a growing number of American cities including Chicago, Denver, New York, Philadelphia, Sacramento

and San Diego (Schwartz 2015). In the UK, there are national frameworks that empower local councils to negotiate affordable housing inclusion agreements with developers (known, in England and Wales as S106 agreements).

As noted in Section 2.2.2, the 'affordable housing' target in London residential developments is generally 35% - albeit that (in BtS projects) this can include homes for 'low cost' sale as well as for sub-market rent. Because a BtR project will generate a lower gross development value (GDV) than a BtS project, BtR developers argue that the scope to incorporate sub-market rental properties (funded through cross subsidy) is relatively constrained. It is therefore understood that the typical 'affordable rental' component of a BtR scheme (with the 'tariff' possibly settled through a viability assessment undertaken in conjunction with the planning authority) will be substantially lower than the stated target percentage (35%).

Provision of affordable units in traditional UK BtS projects – as mandated under S106 agreements in England and Wales – has involved such rental properties being assigned to a not-for-profit housing association. That is, affordable rental units have been developed as part of the BtS scheme for subsequent management and ownership by a designated housing association. In the context of BtR projects, however, developers and their financial backers generally prioritise retention of all units in unified ownership to maximise management efficiencies and control over the site. UK planning authorities have adjusted their expectations so that BtR for-profit operators may discharge affordable housing obligations without relinquishing ownership, provided they honour commitments to rent out a specified number (percentage) of units at sub-market prices to eligible households.

Within the UK BtR industry this affordable rental product is known by the more specific name of Discounted Market Rent (DMR) housing. As incorporated within BtR projects in London, DMR dwellings are made available at a maximum of 80% of market rents. Larger discounts may be agreed albeit that there will be a trade-off between the number of such units and the level of discount. Under the usual model, discounted rents can apply to any unit within the scheme – there is no dedicated affordable stock. When a DMR tenant vacates, the operator may maintain the specified ‘affordable rental’ proportion within the development by accommodating a new qualifying household in any vacant unit. This reflects the portfolio approach adopted whereby target returns are set for blocks/schemes which it is then down to the managers to achieve.

Most operators select ‘affordable housing’ tenants themselves on the basis of criteria agreed with the local authority—that is, the operator has the final say. If the tenants are taken from the local-authority housing waiting list the operator will undertake further vetting. Apart from income, the criteria might include local residence and/or employment in a ‘key worker’ sector—the exact requirements vary by council. The operator is normally required to report annually to the local authority about who has been living in the affordable units. UK affordable housing requirements applicable to BtR projects generally apply in perpetuity (unlike for example developments built using the US Low-Income Housing Tax Credit (see below), which generally have a time-limited lock-in period).

As noted above, the standard model for incorporating affordable housing provision within UK BtR projects differs from the

traditional way that UK S106 agreements have involved sub-market rental properties ascribed to a housing association operating in a subsidiary role to a private developer. For a small number of UK housing associations, however, the development of market rental housing has recently become an aspect of core business (Crook & Kemp 2018). For the organisations concerned this may be seen as a form of ‘business diversification’ that offers the prospect of cross-subsidising core social landlord activity. Thus, housing associations developed 24% of UK BtR units completed to 2017 (Future of London 2017). The motivations and business models that have featured in such activity are further examined in the companion report by Scanlon, Williams & Blanc.

In the United States (US) the most important instrument for generating affordable housing is the Low Income Housing Tax Credit (LIHTC). The LIHTC program is a longstanding (1986) national incentive to attract private investment in affordable rental, which has yielded 2,970,000 privately provided affordable rental dwellings and leveraged a US\$100b in private investment (Blessing 2018). The tax credit regime essentially works to encourage investors to provide equity for affordable housing developments for a compliance period in return for a reduction in their Federal tax liabilities. Tax credits, allocated by each state (from their per capita share of the total pool) are highly competed for and trade in a well-developed secondary market (ibid).

As the figures above attest, the LIHTC, alongside other complementary regulatory requirements,<sup>12</sup> has led to the development of a deep market in institutional investment in affordable rental housing which over time has become highly efficient (Schwartz 2015). Because of the program design, most LIHTC projects have

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<sup>12</sup> The most important of these is the Community Reinvestment Act (1977), which requires deposit taking lending institutions to demonstrate levels of social invest in local communities commensurate with their credit needs. It is the availability of LIHTC combined with CRA requirements that has driven institutional investment into affordable rental housing in the US (Blessing 2018).



Brisbane Housing Company - Lutwyche, Brisbane - affordable rental housing

not been mixed income but dedicated low income housing. Ownership and management arrangements include for profit and not- for-profit entities and consortia of both.

### 5.3 Stakeholder views

The potential for BtR schemes to include affordable housing was discussed with all stakeholder interviewees. The sub-sections that follow present respondent views around four main themes:

- Integrating affordable housing into BtR buildings
- Management of the affordable housing component
- Target groups
- Duration of affordability.

#### 5.3.1 How market rental and affordable rental could be combined in BtR schemes

The BtR business model under discussion in Australia offers a market-based rental product which, as such, is not intended to provide housing at rents affordable to lower income households, where this would require rent discounting.

There was little dissent across stakeholder groups that large-scale, purpose-built rental buildings could be designed to include a component of dwellings earmarked for specific target groups under an affordable housing scheme or policy. Equally, however, the common view, emphatically backed up by our analysis (Section 5.2), was that from a project feasibility point of view additional incentives (above and beyond any offered to the wider BtR asset class) would be required to overcome the resultant impairment to returns from lower-than-market rents.

**‘We’ve got to break the mixed-up argument that BtR is affordable housing – it could lead to that but [fundamentally] BtR is not affordable housing’**

(Expert).

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Institutional investors and a financial expert interviewed also offered some useful perspectives on the form of support they required:

**‘It is the certainty of the cash flow, not the long-term residual property value, which is the key interest for us’**

(Institutional investor).

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**‘Cash subsidies would be preferable to tax credits, which can be monetised in different ways by different classes of taxpayers’**

(Financial expert).

Regarding building morphology, developer interviewees posited that dwellings for affordable housing use could be ‘pepper-potted’ throughout a building (subject to retention of unitary ownership), or they could be provided as a separate stratum/section of a building. Dedicated buildings of affordable housing with separate entries could also be achieved, especially in multi-building urban renewal precincts, such as has occurred in London (Scanlon et al. 2018). Such a model

would also allow for buildings entirely comprised of social housing to be included in a multi-building development (see below).

There was also recognition by some that, by comparison with the standard BtS (multiple ownership) product, it may be easier to integrate affordable rental housing into a BtR (single ownership) scheme. Likewise, our recent review of evidence on the potential and the pitfalls of tenure integration noted that many of the challenges of mixed-tenure development stem from ownership arrangements that BtR has the potential to overcome (van den Nouwelant & Randolph 2016). These primarily include eliminating the risk of impairment to the profitability of market sales and the additional costs and risks that arise from strata management arrangements.

No strong views were expressed about the advantage of any one approach to integrating an affordable dwelling component in a BtR scheme. Concurring with the widely-held commitment to the 'tenure blindness' principle, stakeholders agreed that external designs of 'affordable dwellings' should be indistinguishable from those of market price dwellings, albeit that several private developers saw this as leaving scope for internal designs and fittings to be 'more basic' for designated affordable units. Striking a slightly different note was the investment company stakeholder interviewee who, unlike private developers, favoured partnering with CHPs (see below). In his view effective place-making and community development (roles that CHPs would claim as strengths) must be considered key success factors in mixed-tenure projects (van den Nouwelant & Randolph 2016).

### 5.3.2 Management of affordable dwellings in BtR

Several prospective BtR developers were emphatic that all dwellings in a BtR scheme should be managed (controlled) by one

entity, ruling out partnerships with CHPs as affordable housing owners and /or managers.

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**'Speaking candidly, there is no room for a community housing provider to manage product in our buildings. It ruins the management efficiency, and impedes the residents' experience'**

(BtR specialist).

This especially strong view was based on three underlying assumptions. Firstly, that BtR schemes would be developer-led projects involving companies with the capacity to manage completed blocks through another arm of the initiating firm; secondly, that it would be unviable for CHPs to manage a small share of units in a development; and thirdly that CHPs would lack the capacity to manage large-scale buildings with sufficient efficiency.

However, a dissenting view was put by a major investment company that had engaged intensively with leading CHPs over recent investment opportunities:

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**'There is less challenge there than in the other aspects (of BtR). Some CHPs are pro-actively offering market-facing management services. We are confident we have a good line of sight on costs and can set KPIs and step-in where necessary. So we don't have worries about CHP management efficiency'**

(Fund manager).



CityWest Housing – Zetland, Sydney – affordable rental housing



Another developer familiar with both the PBSA and CHP business models saw potential scale and corporate advantages to CHPs broadening their rental portfolios beyond a predominantly social housing client base. This would be consistent with housing associations moving into BtR development as recently seen in the UK (Scanlon et al. 2018) and, albeit to a much smaller extent in Australia, under recent, but now concluded, government programs (see Chapter 2).

Policymakers also saw advantages in CHPs as partners (e.g. as affordable housing managers and/or developers) in any government-assisted BtR schemes. These included their established governance and public accountability, their long-term community presence and their place-making capabilities.

One developer also recognised that compliance requirements (e.g. relating to eligibility and rent levels) would arise from the inclusion of affordable housing in a BtR project. As their company would not wish to manage those, a partnership with a CHP could be useful for that purpose.

CHP interviewees were undecided about whether moves into building management of mainstream BtR schemes (i.e. as a sole manager) would be suited to their business strategy. As noted in Chapter 2, several have recently developed real estate services, which could be a forerunner to such a role. Presently, however, CHP management costs are driven by the needs of social housing clients and community service obligations. Moreover, service levels are embedded in the regulatory regime (the National Regulatory System for Community Housing-NRSCH) which drives their service model. BtR management would,

therefore, likely need to be a discrete business component (falling outside the NRSCH).

As further discussed in Section 5.2, leading CHPs could expand their nascent development role<sup>13</sup> which could see them, under supportive policy settings, initiating more of their own BtR-type developments, potentially in partnership with institutional investors. In this case ownership and management would be seamlessly integrated, as proposed for mainstream BtR schemes. This model would be compatible with the interest expressed by industry superannuation stakeholders, whose BtR investment objectives included generating more housing affordable for their members and pursuing investment strategies aligned with their social responsibility values.

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**‘Given that the vast majority of industry super fund members are working Australians of modest means, the issue of housing affordability is vital to Industry Super Australia and our member funds’**

(ISA 2017 p. 12).

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<sup>13</sup> See Section 2.3.2. To date most Australian CHP developments in metropolitan areas have been multi-unit developments. Many of these have been retained as affordable and social rental dwellings by the initiating CHP, while a few (typically in a separate building) have been sold to market to provide subsidy to support the proportion of the development that is retained. For project examples, see Randolph et al. (2018) and NSWFA (2017).

### 5.3.3 Affordable housing for whom?

The most consistently cited target group that developers and some other stakeholders considered to be suited to inclusion in BtR projects was that of lower paid workers with most to benefit from the locations preferred for BtR (see Chapter 3.3.1). More affordable rents were also seen to help such groups to save a deposit for home ownership. Terms like 'key workers' or 'essential service workers' were also used.

In general, private providers and other opinion makers were not contemplating the eventual inclusion of social housing (i.e. accommodation for those on very low-incomes and/or support needs, who were seen as the responsibilities of public and/or community housing providers). Given the social housing role of other agencies, it was further argued by one expert that:

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**'Landcom's affordable housing focus must be to facilitate additional product that bridges the gap between 'affordable' (at 30% of income) and market-priced housing'.**

This means targeting to the group (above social housing eligibility) who have the potential to secure adequate market housing over time.

Some private sector interviewees had considered whether BtR could assist National Disability Insurance Scheme (NDIS) clients by providing accessible dwellings. This offer would, however, be limited to those with a physical disability requiring dwelling modifications but not to people with intellectual or mental health impairments.

Investors and fund managers in both the industry and retail sectors were more open to including social housing clients provided that the financial conditions were right.

One large funds manager highlighted both their commercial and social interests in the challenge of providing a more diversified suite of property investment opportunities, as has occurred in major renewal areas in the UK (Scanlon et al. 2018).

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**'[We] see sites where you could do some market-facing BtR, BtS, retail, office and social and affordable housing'**

(Fund manager).

Large government-owned or government-planned sites and other one-off sites, such as shopping centres, could be suitable for such a mix.

### 5.3.4 Duration of affordability

Most developers seemed to be anticipating that any affordable housing obligations within BtR projects would be time-limited as has applied under recent programs, such as NRAS,<sup>14</sup> and is foreshadowed in the Australian Government's reform to the MIT tax regime for affordable housing (see Section 2.3.2). However, no fundamental barrier to in-perpetuity affordable housing was identified. For investors, it was essential that exit strategies were not constrained – therefore the underlying economics of the scheme needed to be robust. Relatedly, the longer the housing is held as affordable the more future costs of refurbishment would need to be underpinned. For policymakers, ensuring value for money for any public subsidies was paramount.

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<sup>14</sup> NRAS Investors were entitled to tax offsets over a maximum of 10 years. Compliance with NRAS eligibility and rent setting regulations applied only to that entitlement period.

## 5.4 Feasibility and subsidy options for achieving affordable housing

In this section we examine the feasibility of a BtR development from the perspective of providing affordable housing at scale. To do so we build on the analysis on BtR project feasibility presented in Chapters 3 and 4 to illustrate the implications for achieving an affordable housing BtR product under different policy/subsidy options.

### 5.4.1 Findings of the indicative modelling

To explore what is required to produce ‘affordable housing’, we take as our starting point the parameters of the base case of a ‘basic apartment’ construction (Column 3 Table 3.2). As set out in Table 3.2, this product would not yield a return under prevailing policy and market conditions. Accordingly, it is not feasible for unsubsidised market supply – let alone affordable supply.

As explained in Chapter 4, however, a charitable housing organisation, such as CHP provider, may be able to improve on this performance using the set of existing tax concessions that apply to both their procurement and operating costs. In return, CHP charitable obligations require that they charge less than 75% of median market rents across their portfolio. After reducing project revenue to meet this requirement; removing the state and federal taxes and charges from which CHPs are exempt; and adjusting management costs to reflect the CHPs non-profit business model, losses applying to a basic apartment are reduced (Table 5.1). Existing concessions do help to offset the revenue impairment in delivering affordable housing in this location. However, at -1.1%, returns will still be well short of what would be required to attract an institutional finance partner, assuming a threshold rate of return of 4.5% on both development and operations.

**Table 5.1: Comparison of return to equity for a for-profit versus a charitable provider of a basic apartment**

	Apartment basic	Apartment basic - CHP initiated
Annual rental income per sq m	\$485	\$390*
Development phase taxes (one-off)	\$1,112	0
Operating phases taxes (annual)	\$87	0
Management fee (% of revenue)	7.5%	7.0%
<b>Total development investment return**</b>	<b>-3.1%</b>	<b>-1.1%</b>

\*Calculated as 75% of the area median market rent for a standard apartment rather than on the assumed market rent for the basic apartment.

\*\*Annualised return calculated over 10 years, benchmarked against an implied capital value and operating yield equalling 4.5% (see Section 3.5.1 for further explanation).

Nevertheless, there will be a significant advantage to governments layering in additional subsidy support to leverage existing CHP concessions (rather than subsidising for-profit development). Our analysis below, therefore, primarily considers CHP-led provision of 'affordable BtR'.

Before assessing additional subsidy requirements, we tested the improvement in investment return that could be achieved by a CHP adopting a cross-subsidy BtR development model, a model already successfully tried in the sector (Randolph et

al. 2018). This would entail the CHP initiating a mixed-tenure development in order to achieve additional revenue to help fund the affordable housing component of a project<sup>15</sup>. In our illustrative example, an (arguably ambitious) mix of 50% market rentals and 50% affordable rentals has been assumed. The total return to equity improves to the point of realising some positive capital growth (Table 5.2). While this approach assists viability, it nevertheless still falls well short of the target return of 4.5%. Note that this option also increases risk to the CHP (especially from exposure to market renting), for which we have not adjusted.

**Table 5.2: Impact of CHP-led mixed tenure scheme on investment return**

	<b>Apartment basic CHP initiated</b>	<b>Apartment basic CHP initiated with cross subsidy</b>
Annual rental income per sq m	\$390	\$437*
<b>Total development investment return**</b>	<b>-1.1%</b>	<b>0.6%</b>

\*This is the average sq m rental income, assuming half the dwellings rent at 75% of market median, and half at market price for a basic product.

\*\*Calculated as in Table 5.1

<sup>15</sup> In reality a cross subsidy model operates across a provider's portfolio rather than project- by-project (Randolph et al. 2018).

#### 5.4.2 Subsidy options for addressing the yield gap

The next iterations of the CHP model address how this gap could be funded. In our stakeholder interviews, two schools of thought emerged about the optimal way to subsidise inclusion of affordable housing, either via:

- Land price concessions to reduce upfront costs; or
- Long-term operating subsidy to underpin yield (similar to the approach exemplified by Industry Super Australia with respect to an ‘affordable BtR’ development in the Inner Melbourne housing market (ISA 2017 Figure 22)).

Continuing to use our core dataset, we now explore the impact on the CHP base case of these two different ‘ideal type’ policy models. Table 5.3 shows the subsidy cost per square metre to achieve a 4.5% annualised return on investment under each approach. In the first column, land price is set as the amount that a CHP could pay in order to achieve both the target ‘affordable rents’ and the target return on equity. Under the alternative policy scenario in column 2, the full costs of the development are met by the CHP but an annual operating subsidy is paid to achieve the necessary return. This could be realised through an enhanced Commonwealth Rent Assistance (CRA) payment<sup>16</sup> to the tenant and passed on to the landlord. Alternatively, it could be configured as an annual cash payment to the CHP<sup>17</sup>.

**Table 5.3: Comparing subsidy models for CHP-led BtR affordable housing provision**

<b>Apartment basic – CHP initiated</b>	<b>Land price subsidy</b>	<b>Cash operating subsidy</b>
Total required investment return (development and operations)	4.5%	4.5%
Land price discount per sq m	\$2,349	0
Annual operating subsidy per sq m	0	\$164

Applying the subsidy amounts in Table 5.3 to a standard unit of affordable housing provided under the prevailing CHP cost model reveals either an upfront subsidy requirement of around \$130,000 per basic apartment dwelling or an annual subsidy of around \$9,000 per dwelling, indexed.

Further consideration needs to be given to the cost-benefit of subsidising affordable housing via either key mechanism, from the differing perspectives of cost-to-government, desired community outcomes and investor requirements.

<sup>16</sup> In addition to the relative lack of types of policy instruments discussed in Section 5.1, it was also noted that in-house comparative analysis by the investment industry has shown that Australia’s current housing benefit payment regime (CRA) is of less value when compared to international instances where institutional investment in affordable housing has proved feasible (including the UK, US and NZ) (stakeholder interview).

<sup>17</sup> The latter envisages a scheme similar to the original NRAS where an annual cash grant was paid to charitable organisations (which had no direct use of tax credits) for the duration of dwellings rented as affordable housing (as defined under the scheme) for a maximum of 10 years.

Using the indicative figures in Table 5.3 an upfront subsidy of \$130,000 is equivalent to the NPV of a 14.5 year operating subsidy. In other words, upfront subsidies will be progressively more cost-effective for government and affordable supply will endure in perpetuity with no further outlays.

Regarding tenant affordability, the required rent for the project to be viable will be affordable (i.e. no more than 30% of household income) to households earning \$71,000 per annum or more. In other words, to reach low and very low-income households at a 30% benchmark additional subsidy would be required.

Under any subsidy model, institutional investors will also require assurance that future cash flows (from rental revenue and any operating subsidies) are secure and predictable and that future operating cost increases can be contained to increases in revenue. Of note here, Industry Super Australia has identified a lack of future certainty of government concessions as one key reason that NRAS did not attract institutional investors (ISA 2017). Without such long-term assurance (such as via a government guarantee – see below) or at least until the asset class is proven, financing costs will be greater than otherwise to offset this risk.

In practice it is likely that any subsidy system would be combined with other mechanisms to reduce the required subsidy. As emphasised by policymakers:

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**‘Before any subsidy would be forthcoming, governments would need to be fully satisfied that everything has been done by the proponents of BtR to make it cost-effective – including driving down the costs of development and maintenance, applying cross subsidy or CSR principles etc’**

(policy officials).

If a cross-subsidy approach is used (see above), for instance, the land subsidy required in our inner city location could be reduced to less than \$90,000. Similarly, planning concessions (especially on car-parking spaces and dwelling size) granted for affordable housing development (see Section 4.6) would reduce the direct subsidy cost to government. Or, in lieu of receiving the full market price for government land, those sites could be leased at peppercorn rent, enabling government to retain its equity interest in perpetuity. This is akin to the NSW Land and Housing Corporation model as announced for its Redfern site (see Section 3.2).

On the operational side, additional savings to the cost to finance (i.e. to reduce the required return below 4.5%) could also be delivered via the newly minted Australian Government Affordable Housing Bond Aggregator

(AHBA)<sup>18</sup> especially through the foreshadowed government guarantee on the yield on bonds to be issued by the AHBA<sup>19</sup>.

In the context of the development industry's focus on inner city BtR and to avoid over-complicating the broad brush findings above, we do not take the discussion or analysis of how to achieve affordable housing via BtR any further here. Readers are, however, referred to our previous research (Randolph et al., 2018) which presented an interactive

model (the Affordable Housing Assessment Tool (AHAT) designed to calculate the impact of different cost and subsidy parameters on housing affordability for the various types of lower income households in need of affordable housing across different housing market contexts. That study highlighted a variety of approaches to delivering financially feasible affordable rental housing projects founded on six key principles which we reproduce in Box 5.1.

### **Box 5.1: Principles for financing affordable rental housing**

- 1.** Government facilitated access to land is central to generating development opportunities and a key means of improving long-term project viability.
- 2.** Government equity investment offers considerable potential for delivering feasible projects and net benefit to government.
- 3.** Reducing upfront debt loads and lowering finance costs are critical to long-term project viability.
- 4.** Delivery across the housing needs continuum helps to meet overall social and tenure mix objectives as well as providing opportunities to improve project viability through cross subsidy.
- 5.** Planning policies can deliver additional sources of cash or land; however, the financial benefit of planning bonuses is limited.
- 6.** Increasing the scale of not-for-profit housing provision will offer financial benefits for the long-term delivery of affordable housing.

(Randolph et al 2018 p1)

<sup>18</sup> See <https://nhfc.gov.au/>

<sup>19</sup> Our 2015 study on financing affordable housing via institutional investment reported that the cost of finance for some UK housing associations was below 4% at that time. Government guarantees were one part of the mix of strategies being used to lower cost of funds to the sector (Milligan et al. 2015).

## 5.5 Concluding points

Among our stakeholders there was a general consensus that if the design, financing and management of BtR can be made to work at scale, affordable housing could be leveraged from this. Our findings, however, indicate that neither outcome is likely under current market conditions and policy settings. Moreover, requiring a small portion of dwellings within BtR developments to be reserved for affordable housing is likely to offer only a limited and partial response to the extent of need for a diversity of well-located affordable housing supply projects.

BtR as an affordable housing asset class will not take off unless there is a significant level of additional financial support from government beyond the standard concessions available to non-profit developers and under the NSW AHSEPP.

Our findings challenge the case for subsidising BtR developments in order to achieve government's affordable housing policy goals. There is a stronger case for encouraging CHPs as affordable housing developers – whether or not in association with for-profit developers on mixed-tenure projects. This variant leverages off existing concessions and operates under established governance and compliance regimes. CHPs can also layer in other subsidies available to them to help to ensure that a spectrum of needs can be addressed they also can offer appropriate tenant support, and through their enduring role safeguard affordability benefits.

Under the right policy settings this approach has the potential to attract institutional investors, beginning with those in both the retail and industry superannuation sectors, who have declared their interest in supporting the development of an affordable housing asset class in partnership with the CHP sector.

**An investible project would begin with a proposal from a CHP (perhaps acting with a private developer) proposing a mixed (market, affordable and social) housing project. Equity and debt funding for the project would be coordinated through the ... NHFIC or an equivalent body. The project promoter [a CHP] would be left to manage the construction risk and operation of the asset... because: they are non-profit bodies; and the [affordable] housing asset class ... requires an intensive level of client input to achieve desirable social and budgetary outcomes.**

(ISA 2017, p43)

Consistent with the conclusions reached by the ISA, the key requirements for institutional investment to flow into an affordable housing asset class are predictable returns, land concessions, a reliable delivery model, and certainty over subsidy payments to potential tenants or, alternatively, to providers (ibid 2017, p42). An integrated affordable housing policy framework operating with greater policy coordination between levels and agencies of government will be required to shape such a market in Australia. Both the UK and US affordable housing systems are instructive in this regard.





Port Phillip Housing Association (now Housing First), Ashwood, Melbourne - affordable rental housing

# 6. Conclusions

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## 6.1 Revisiting the research questions

- i. How is the BtR concept being interpreted and defined in Australia?

At least in its initial incarnation, mainstream market BtR is being generally interpreted as a fairly 'high end' product that will involve large developments sited in relatively prestigious locations. This is related to the 'premium market provider' status of the developers who have so far taken the strongest interest in this possible new line of business. It also follows from senior executive exposure to US multi-family housing projects which tend to cater for an up-market demand cohort. At least among some stakeholders, it is anticipated that – having established 'proof of concept' – future BtR projects will become more diverse in terms of market targeting and location.

- ii. What can be learned from recent Australian housing products pre-figuring BtR?

The 'mainstream market' BtR now possibly emergent has been prefigured over the past 10-20 years, in the commercial property sector, with international investors becoming more active in Australian markets and accustomed to the use of investment vehicles such as MITs and stapled structures. The PBSA sector, in particular, has inspired confidence that there is a substantial demand from young persons for relatively high-priced, high-density rental accommodation, and from overseas-based institutional investors for income-generating residential assets. Beyond that, the progression of the PBSA industry beyond the directly university-supported business model is instructive. Firstly, it demonstrates the way that a quasi-government guarantee

can assist a new asset class to establish itself. And, second it shows how such a sector can potentially outgrow the need for such support. As substantiated by our own project feasibility modelling, the PBSA experience importantly emphasizes the viability premium attached to studio-unit development.

- iii. What is the appetite for involvement in BtR projects in Australia's institutional investment community and among developers?

While a possible mainstream market BtR takeoff in Australia has attracted intense interest across the real estate industry, only a few – largely premium market – developers have as yet committed to 'first tranche' projects. Likewise from the funding side, Australian super funds and other finance companies have been paying keen attention to the possible emergence of the putative new asset class. In terms of actual project commitment, however, overseas-based funds have been further to the fore. It is perceived that – at least by comparison with some Asian investors – domestically-headquartered institutions tend to be intolerant of low-yielding assets. Also, as compared with international firms with established stakes in rental housing elsewhere in the world, Australian-based entities continue to be restrained by a 'novelty factor'.

- iv. In what geographical and housing market settings are BtR projects likely to be feasible in urban Australia? How could BtR projects be accommodated within renewal schemes?

The first tranche of mainstream market BtR projects in Australia are predominantly to be found in high value inner urban locations. The judgement appears to be that the expected rent premium and scope for intensifying yields in such locations is sufficient to outweigh higher land costs. Our own (Sydney-based) feasibility modelling, however, suggests that – other than for ‘premium’ apartments – the financial ‘base case’ may be less unfavourable in lower value suburban locations than in prestige inner city settings (see Table 3.6 – rows 1 and 4). BtR projects could form a valuable component of larger renewal schemes because – by comparison with for-individual-sale apartment blocks – they may be absorbed more quickly by the local market. Thus, a BtR element may help to more quickly ‘activate a site’, thus helping to compound development momentum. The NSW Government in 2018 announced Australia’s first BtR project to be progressed within the context of a public housing estate renewal scheme.

- v.** What are the essential features of BtR as it might be exemplified in Australia?

See point (i) above.

- vi.** Where would a BtR product likely sit within the Australian housing market and within tenants’ housing careers?

First tranche schemes are primarily targeting young, childless urban professionals. To the extent that the product becomes more physically and locationally diversified in future (see point (i) above) it may be that the industry will come to cater for a broader demand cohort, possibly including older down-sizers as well as working family households.

- vii.** What is the feasibility of incorporating affordable housing within BtR projects and what design/ownership configurations might facilitate this?

Industry stakeholders generally do not see BtR as a specifically affordable housing product, and our modelling indicates that most types of market-rent BtR would not offer competitive returns with BtS development, let alone an internally generated cross-subsidy for affordable rental. Any affordable rental component, therefore, could be achieved only through provision of substantial assistance by government. Thus, under the ‘indivisible asset ownership’ developer-preferred model such assistance would need to be provided to project-proponent for-profit entities. Our modelling however demonstrates the viability advantage of having affordable housing provided by not-for-profit community housing providers – not to mention the fact that such organisations are already subject to established regulatory regimes that can provide assurance on future management in the public interest.

- viii.** What potential roles could be played by not-for-profit CHPs in BtR development and/or management?

In principle there are several roles that could be played by CHPs within the context of the delivery of BtR projects.

The first option, and lowest risk, is as a fee-for-service tenancy and/or facilities manager of a scheme procured by a for-profit developer and held in developer ownership or on-sold to an institutional asset-holder. This is a serious possibility considering the sector’s proven expertise in affordable housing tenancy management. However, such a role does not seem to be envisaged as a possibility by the large ‘high end’ developers progressing ‘first tranche’ mainstream market BtR projects.

A second option is for a CHP to undertake a development itself with BtR as a component within a mixed tenure scheme and using the market rental component to cross-subsidise



Salta, Melbourne - Latrobe Street design

an affordable housing component also underpinned by significant subsidy (e.g. in the form of discounted government land). For most CHPs this model would involve 'business diversification' entailing exposure to higher market risk. Hence it would raise questions for regulators as well as for governing bodies. However, such an arrangement could maximise the affordable housing outcomes from any given subsidy arrangement.

A third alternative would be for a CHP to be the designated developer of the affordable housing component within a market rental development working in partnership with a for-profit BtR developer.

A fourth option – as demonstrated by some (large and asset rich) UK housing associations – is for a CHP to take upon itself the lead developer role for an entire market BtR scheme where affordable housing is only a minor component. However, this implies a much a greater scale and maturity of the CHP sector than is currently the case, and in any event, might raise questions about a CHP's charitable status.

Nevertheless, in the current context, Options 1 to 3 are distinct possibilities, with Option 2 potentially offering the best outcome in terms of efficiency for any given level of subsidy. It would also allow Landcom to support the further growth and maturity of the CHP sector, something that would have wider benefits for the affordable housing sector as a whole.

**ix.** What possible policy and regulatory reforms could enhance BtR prospects?

A number of land-use planning and tax policy reforms have been identified as potentially enhancing BtR project viability. On the planning side, these mainly concern concessions that would economise on land costs by facilitating the inclusion of more BtR apartments on a given site than

normally allowable. These include scaled-down car parking requirements and scaled-back design standards (e.g. on natural light, balcony provision). More fundamentally, a designated zoning-class for rental housing could effectively reduce land costs by insulating rental housing developers from BtS proponents who are generally able to bid higher for sites.

On the tax side, a range of state/territory and federal taxes are at issue. In the state/territory realm the most important of these is almost certainly land tax which tends to be structured in a way that impacts significantly on large scale rental providers while being effectively inapplicable for small mum and dad investors. Confirming industry analysis our own modelling demonstrates that, under current policy settings, land tax substantially affects scheme viability.

At issue in the federal realm are the goods and services tax (GST) and income tax as it relates to overseas investment firms. Again, the industry argues that current settings disadvantage BtR providers. With GST the argument relates to the liabilities that affect BtR developers but from which BtS proponents are effectively exempt (because the latter can recover GST outlays when the project is sold, but the former cannot). On income tax as it relates to revenues channelled through Managed Investment Trusts, sector stakeholders argue that the higher rate of withholding tax for residential assets (except for affordable housing) than for other property is inequitable.

From the research team's perspective, we see merit in the industry's arguments in favour of levelling the playing field for BtR developers with respect to small-scale private rental investors on the one hand, and BtS developers, on the other. Thus, the pitch to state governments to equalise land taxes is well-

justified. Similarly, advocacy for a Australian Government change to GST treatment of BtR development so that there is no disadvantage by comparison with BtS, seems a creditable contention. Regarding Managed Investment Trust income tax rules, the industry arguments for reform seem entirely logical in housing policy terms, provided that the rules retain the justifiable additional incentive for investing in affordable housing as opposed to market price dwellings.

However, we would question changes to policy settings that could place BtR for-profit providers on an equal footing with CHPs – e.g. as recipients of discounted government land to enable affordable housing provision. Where conferred on CHPs, such ‘privileges’ are provided in exchange for demanding regulatory expectations. Also, as shown by our modelling (see Table 5.1) the existing CHP legal and regulatory model significantly enhances the viability of CHP-delivered affordable housing compared with a for-profit provider.

Moreover, the market-rate BtR provision that is the province of for-profit providers could play a positive ‘public policy’ role in broadening housing diversity and raising property/tenancy management standards. Also, while as yet unproven, it may incentivise higher quality design, construction and energy efficiency. Especially with these possible ‘public goods’ in mind there is a case for land tax reform to remove the problematic distortions that unduly disadvantage BtR proponents compared with small scale ‘mum and dad’ investors. Beyond this, there could be a case for time-limited relaxation of certain tax provisions to assist the industry in its efforts to deliver ‘proof of concept’ projects which – if successful – could place BtR on a sustainable growth trajectory.

## 6.2 Implications for Landcom

Landcom's possible roles in relation to BtR follow from the agency's broader mission as the NSW Government land and development agency and, in particular, its specific housing objectives (Landcom 2017). Central here are Landcom's commitments to maximising housing affordability and diversity. Also relevant are the aspirations to counter market failure, to promote and lead innovative property development and management practice, and to engage in partnership working – most particularly in relation to community housing providers. More specifically, Landcom is committed to inclusion of 5-10% affordable rental housing in its residential developments.

As noted in Section 6.1, BtR as a market rental product could contribute to a more diverse, effective and efficient housing market. Helping to facilitate its establishment as a new asset class is therefore consistent with Landcom's corporate mission. Complementing the current developer-led push into BtR, Landcom actions could assist in beneficially diversifying the BtR product towards more of a middle market offering in scope for a wider range of developers in a wider range of market settings. The agency could assist by working with a diverse range of developers and smaller scale builders to “demonstrate” BtR feasibility in middle ring and/or regional centre settings, and by exploring scope for incorporation of important design elements, such as accessibility/universal design features. In this way the agency would be utilising its scope to control design and built form on its own sites. As part of this, developer-CHP partnerships could be mandated through master planning and site development specifications.

In its market shaping guise, Landcom could contribute to the establishment of a BtR sector through sponsoring a rental housing design guide and new typologies, including compact dwellings and hybrid tenure forms. Beyond

this, Landcom could play an important advocacy role in (i) informing local councils and communities about the role/importance of BtR (i.e. addressing stigma attached with boarding house development); (ii) arguing for sector-specific building/design codes (i.e. a rental housing SEPP); and (iii) collaborating with the National Housing Finance and Investment Corporation (NHFIC) on improving investment scale opportunities at reduced cost.

In pursuing its corporate mission on the inclusion of affordable housing, Landcom should be using CHP advantages wherever opportunity arises. For the reasons outlined earlier in this report (see Sections 5.3 and 6.1) Landcom should focus on CHPs as providers of affordable housing within any wider BtR projects.

Under current conditions, however, delivering on the agency's affordable housing pledge will be possible only if very substantial financial (or equivalent) support is provided to underpin sub-market rental properties. The thin feasibility of market-price BtR demonstrated by our research dispels any thought that affordable housing could be enabled through cross-subsidy (except that arising from re-zoning uplift). In the absence of direct subsidy from any other source, this will

necessitate discounted land provision. Given the cost-effectiveness advantage of the CHP model, the scale of the land price discounts required to generate any given amount of affordable rental housing will be lower via this option than via a for-profit provider. Additional support – e.g. density bonuses – might also be required. In some demonstration projects, Landcom has facilitated a 'subsidy' through 'innovative construction' cost savings. Carrying forward previous practice, positive covenants should be used to ensure that such savings are retained as affordable housing.

The reduction in land cost and/or provision of 'exceptional' planning concessions to enable affordable rental housing is justified given the NSW Government's commitment to a continuum of affordable housing supply responses and Landcom's mission as a 'market leading' change agent. A lower rate of return could and should be justified to NSW Treasury on this basis.

# Appendix 1: modelling assumptions, sources and method

## Development costs

The modelling first calculates development costs for a project. Construction costs for Sydney – including demolition, excavation, internal construction and landscaping – are taken from Rawlinsons (2018). On-costs, particularly design/engineering fees and legal/conveyancing fees are also included: as 8% of construction and 1.5% of land costs respectively.

Land costs are derived through a residual land valuation, based on a standard ‘build to sell’, development model (using the same construction cost inputs as above). Local market values for individual apartments are based on suburb level (Redfern) APM sales

data from 2015 (available through AURIN), and adjusted to 2018 prices using the ABS apartment price index.

Development phase taxes are modelled as 10% construction and land cost (GST), 10% land cost (3% land tax and 7% stamp duty), and 1.3% construction costs (local development contributions).

## Operating costs and revenues

The total development costs then translate to the capital input (equity). Rental revenue is based March 2018 Rent and Sales Report, for the local (postcode 2016) apartment market. And operating costs are modelled at the following rates:

Insurance	0.3%	replacement costs
Repairs	0.1%	replacement costs
Maintenance	0.5%	replacement costs
Replacement	0.5%	replacement costs
Utilities	0.5%	replacement costs
Rates (local tax)	1%	land value
Land tax (state tax)	2%	land value
GST (fed tax)	10%	Non-tax operating costs



Marketing	basic	2.0%	revenue
	medium	2.5%	revenue
	premium	4.0%	revenue
Vacancy	basic	1.0%	revenue
	medium	2.0%	revenue
	premium	1.0%	revenue
Arrears	basic	2.5%	revenue
	medium	1.5%	revenue
	premium	0.0%	revenue
Management (tenancy; e.g. RE agent)	basic	4.0%	revenue
	medium	4.0%	revenue
	premium	3.5%	revenue
Management (building; e.g. concierge)	basic	3.5%	revenue
	medium	4.0%	revenue
	premium	4.0%	revenue

Replacement costs, land values, rental revenue and operating costs are assumed to escalate in line with inflation, simplifying the analysis when done in real terms. Based on the calculated annual revenue and operating costs, a net operating return (yield) is calculated.

### **Development and operating phase rates of return**

This operating yield is taken to be a nominated percentage (4.5%) of the capital value, implying a particular value of the asset. Based on the change in capital value (from the initial capital input) and any operating returns recouped up to the point of recapitalisation, an effective (annualised) rate of return on the development is calculated.

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