Frontier International

Australian build-to-rent update

April 2022

About us

Frontier has been at the forefront of institutional investment advice in Australia for over 25 years and provides advice on $600 billion of assets across the superannuation, charity, public sector, insurance and university sectors.

Frontier's purpose is to empower our clients to advance prosperity for their beneficiaries through knowledge sharing, customisation, technology solutions and an alignment and focus unconstrained by product or manager conflict.

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Principal Consultant, Property Leader

Jennifer joined Frontier in 2018 and leads Frontier's property research program providing consulting and research for clients, both domestically and globally. Jennifer has held many senior positions, most recently as Country Head and Director of Business Development with Savills Investment Management. Before this Jennifer was Mercer's Head of Real Estate - Asia Pacific and worked with consultancy firm Pinnacle Property Group. Jennifer is a Senior Fellow of Finsia and sits on the Property Council's Market Trends Roundtable and Global Investment Group. She holds a Master of Finance and Bachelor of Business, Property (Distinction).

Callum Yule
Associate

Callum joined Frontier as an Associate in 2021. As part of the Real Assets Team, he has responsibility for undertaking manager and investment research with a focus on property, infrastructure, and private equity sectors. Prior to joining Frontier, Callum spent over three years at Lonsec where he conducted manager research across various asset classes, including property and infrastructure. He also spent three and a half years at the New Zealand Transport Agency, conducting due diligence on business cases for government infrastructure projects. Callum graduated from Massey University, in New Zealand, with a Bachelor of Applied Economics and is a CFA Charterholder.

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INTRODUCTION

Australian build-to-rent update

In September 2018, Frontier conducted an international research trip focused on multifamily property in the US and how it compared to the UK and Australian markets – where the asset class is known as private rented sector (PRS) and build-to-rent (BTR) respectively.

Our findings were summarised in Frontier International 36. This paper provides an update on the Australian sector and its evolution over the past few years fueled by growing interest from investors and new entrants to the sector.

We believe the residential sector, BTR in particular, will present Australian institutional investors with an ongoing opportunity as it develops and matures.

What has changed?

The BTR sector in Australia is unsurprisingly still nascent compared to other developed international markets, with ‘residential’ not given a meaningful allocation in institutional property portfolios.

Since 2018, some sector growth has evolved but is still not consequential in terms of completed and operational stock. The key challenges to investment metrics that restrict the progress of the sector are a lack of meaningful governmental initiatives and incentives. Cultural biases and the lack of appropriate stock also contribute to the slow evolution.

In 2020, both the New South Wales and Victorian Governments announced a reduction in land tax by 50 percent on BTR residential developments. This has been welcomed by developers and asset owners already investing in BTR, with reports suggesting it could provide a development premium of at least 100 basis points. While encouraging, other tax hurdles remain at the federal level including unfavourable GST treatment compared to build-to-sell (BTS) residential, as well as higher managed investment trust (MIT) tax of 30 percent for foreign investors in BTR compared to most other real estate sectors which are taxed at 15 percent.

It is too early to tell whether the modest changes in tax treatment will be enough to draw material new institutional investment into the sector. Further clarity around future reform across federal-levied taxes, along with performance evidence from more projects becoming operational, are likely to boost capital flows.

Investment metrics have changed somewhat with a heavy reliance on achieving a rental premium (to privately leased assets) between 15% to 25%+. Revenue streams are likely to be at risk if demand for premium rental accommodation falls well below underwriting projections.

> **Choose your rental options: dog run and walk, reserved BBQ spaces and entertainment precincts, all the bells and whistles. All for a premium of 15%.**

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Australian BTR investors

While Australian asset owners have been venturing into the domestic residential market, they have typically been focused on affordable housing.

Ventures have included AustralianSuper taking a 25 percent stake and two seats on the board of Assemble Communities in 2021, which provides a rent-with-the-opton-to-buy scheme for low-to-moderate income households. Additionally, Aware Super has partnered with Altis to focus on key workers' affordable housing and serviced apartments in Melbourne and Sydney, while HESTA has invested in affordable housing under its impact strategy through Nightingale and Social Ventures Australia (SVA).

Both state and federal governments continue to offer attractive PPP opportunities to build and manage affordable and social housing opportunities, which are akin to social infrastructure rather than real estate. We discussed this in greater detail in Frontier Line 177 [Australia lags on affordable and social housing.]

While these investors are focused on affordable housing in Australia, they have invested in traditional residential property offshore. There appears to be much more interest in Australian BTR from offshore investors with a lower cost of capital compared to Australian institutional investors, despite the higher MIT impost. This is perhaps in part due to offshore investors' greater familiarity with the sector, scale of investment pipeline and comfort adopting higher gearing. We have listed some key players in the emerging Australian BTR sector below.

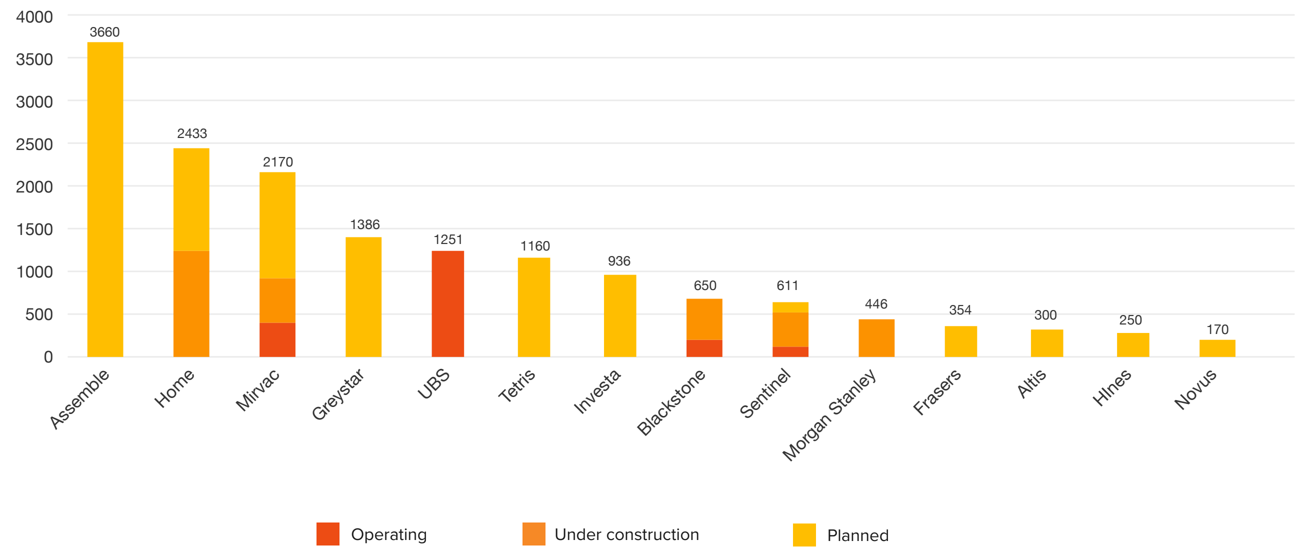
Table 1: Australian BTR key participants

Investment manager	Details
Mirvac (LIV)	In 2018, Mirvac launched its $1 billion Australian BTR club, with CEFC committing a 30 percent interest.
Greystar	US-based Greystar raised $1.3 billion for an Australian BTR fund, backed by three institutional investors including Ivanhoe Cambridge and APG Asset Management.
Lendlease	An international operator in mixed use and residential living. Considering converting its residential components at its Melbourne Quarter and Brisbane Showgrounds projects into BTR.
Grocon (Home)	Converted the 2018 Gold Coast Commonwealth Games athletes' housing village into BTR alongside UBS and LaSalle. Since then, has acquired various sites in NSW and VIC for future BTR development. Grocon has since gone into administration.
Investa (Indi)	Owned by and partnered with Oxford Properties to develop BTR in Australia. Oxford has a deep global track record in this sector.
Sentinel (Element 27)	Secured UK pension fund capital to develop Australian BTR through its Australia Multifamily Hold Trust backed by Hermes Real Estate.
Blackstone	Partnered with Melbourne developer Beck Property Group to develop BTR project in Caulfield Village, Melbourne.
Qualitas/Gurner	Launched a $1 billion BTR development fund.
Local/Macquarie (LABV)	Joint Venture with Local and Macquarie Asset Management. Two seed assets in Melbourne in a club raising $500 million of equity.

Source: Frontier, CBRE.

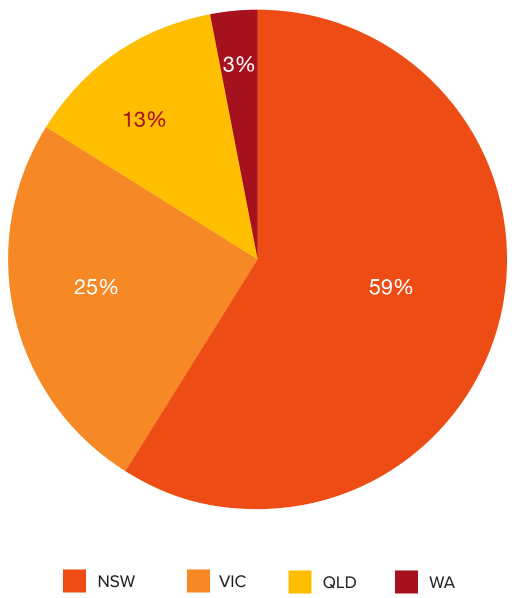
The total opportunity set for the sector is underpinned by population growth and number of renters. In Australia, growth is forecast to rebound following the re-opening of borders. New South Wales and Victoria are entering a period of low supply versus previous peaks. Mirvac analysis suggests the end value of the number of BTR units under construction to be circa A$9.6 billion whereas the size of the Australian apartment rental market is A$776.0 billion (Charts 1 and 2).

Chart 1: Expected number of BTR apartments in Australia (end value of A$9.6 billion)



Source: Frontier, Mirvac.

Chart 2: Value of the Australian apartment rental market (A$776 billion)



Source: Frontier, Mirvac.

Projects and COVID-19 impacts

Current BTR projects are concentrated in inner city areas of Sydney and Melbourne referred to as mid-markets or inner ring, where housing affordability issues are more prominent and there is greater acceptance of high density living.

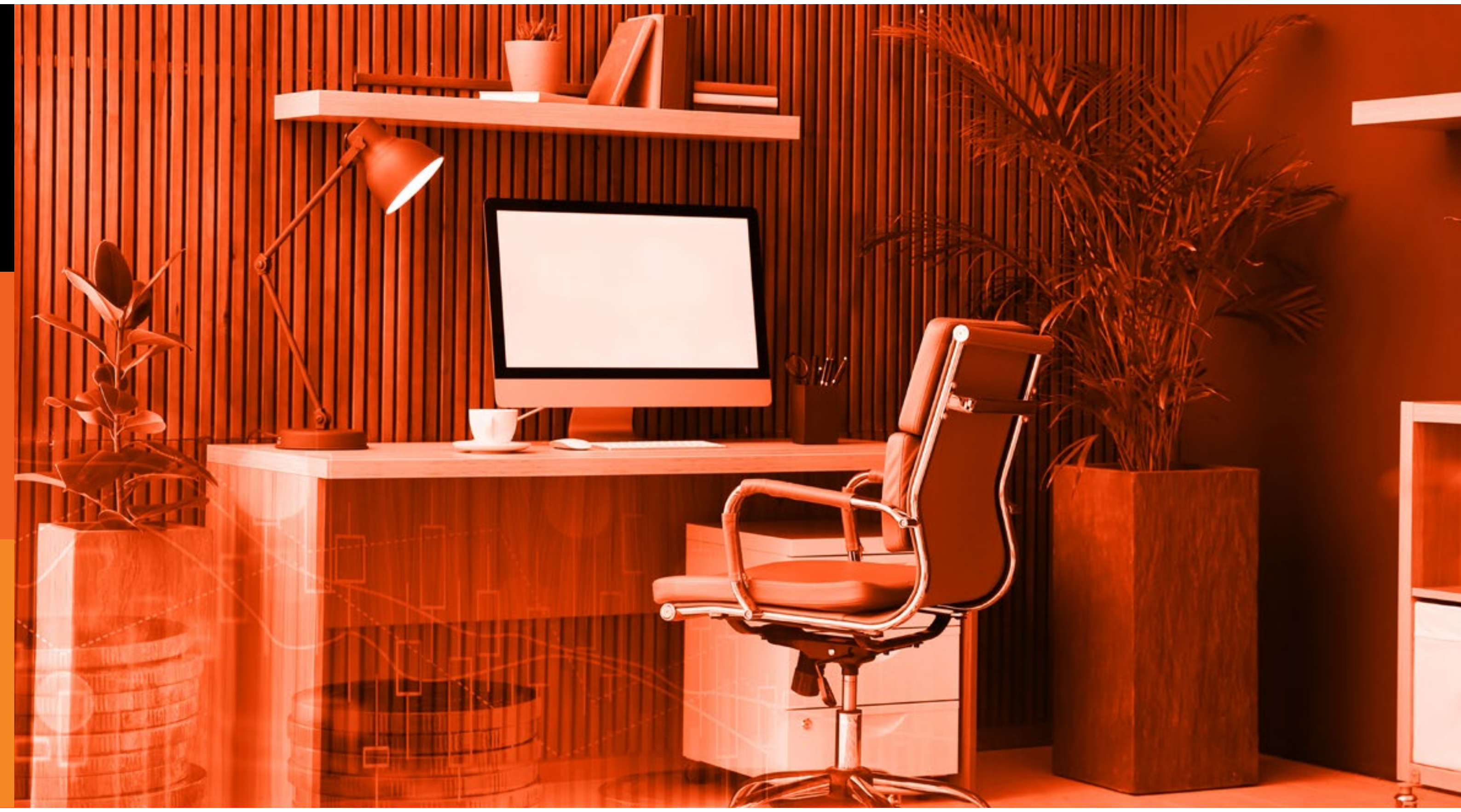
These cities are most like other international gateway markets with existing multifamily/PRS and are also the most progressed from a state tax perspective due to the land tax discounts now available. High land values in Australia, which impede the viability of BTR construction, have meant current projects are concentrated in Melbourne where land values are much lower than Sydney (reportedly, $1,800 to $2,200 per square metre and $3,500 to $4,000 per square metre, respectively).

There are now nearly 2,000 operational BTR units in Australia and over 4,000 under construction. As of Q4 2021, Melbourne accounts for 59 per cent of the national BTR pipeline.[1] This pipeline has increased over 100 percent in the past 12 months driven by aggressive acquisition strategies from the major players and new entrants that began to explore the sector in 2021.[2]

COVID-19 has only increased the desire to have lifestyle amenities and services within a short distance of sites. Proximity to transport nodes remains important, particularly for hybrid office workers who still need to commute part of the week. The pandemic has also resulted in a greater focus on design, particularly the inclusion of a dedicated workspace in apartments. This has not necessarily translated to larger apartment sizes, as the preference is to include a study nook rather than a separate study. There has been increased emphasis on shared amenity including coworking space.

There appears to be a divergence in managers keeping optionality to convert projects back to BTS and those creating dedicated BTR product focused on smaller units with greater shared amenity. Investa noted that while amenity in dedicated BTR can range from 4-7 sqm per unit, in BTS it is typically 1-1.5 sqm. These differing approaches would likely converge once there is more clarity around tax settings for BTR and future liquidity options.

1. JLL Australian Living Sectors 2022 Outlook.
2. JLL Australian Living Sectors 2022 Outlook.



Investment metrics – the more things change the more they stay the same

Profit margins, rent premiums, leverage and capitalisation rates

Transparency of individual/retail investor returns for the private rental market in Australia is limited. However, development projects across BTR is somewhat better. A target stabilised ungeared IRR of approximately 6%[3] provides an indication for expected returns, but given operational stock is limited, sector returns are not readily available.

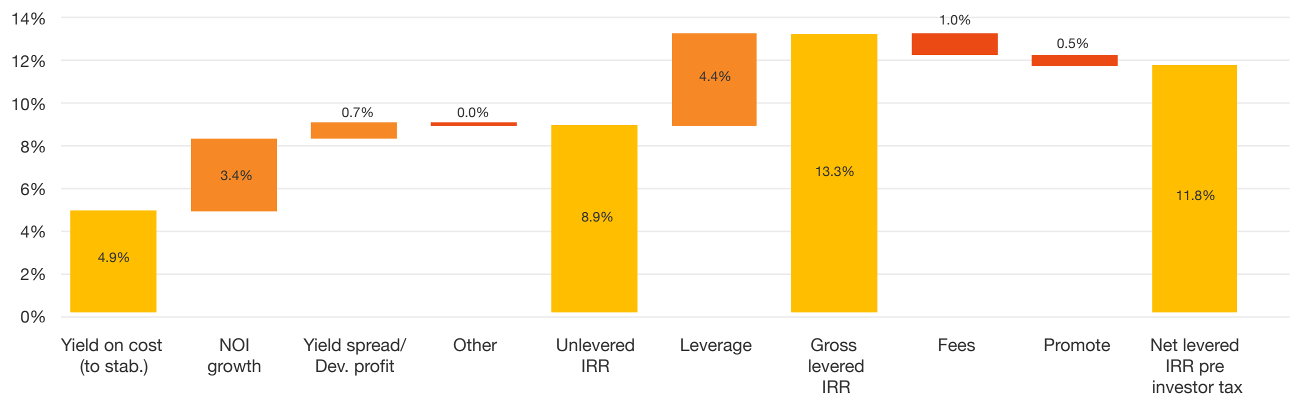
The typical Australian strategy for an institutional fund or club is build-to-hold (holding term circa ten years) with stabilisation achieved within a year from completion of a block of units all held on a single title (unlike the BTS model which is sub-divided into strata units). Market participants report yields on cost ranging from 4% to 5% whereas capitalisation (cap) rates are circa 4%, a high price for a developing sector. Managers' models assume rental premiums starting at 15% over privately rented units, with the highest we observed at 35%.

Typical vacancy projections from completion are circa 12 months with annual increases between 3% to 4%. We continue to question the rental growth assumptions in the early stages of a project's stabilisation.

In the following charts, we present the return profile for the project over a holding period of ten years (Chart 3). Each project typically is split into a development period and an operational period post-stabilisation with the return profiles shown in Chart 4.

Forecast IRRs have increased marginally in Sydney and Melbourne since Frontier's North America Research paper in September 2018. Currently, Development IRR over four years is 16% (up from 14%); IRR for the Operational Phase (holding period of circa six years) is 11.6% (up from 10.7%); with a combined IRR of 11.8% (up from 10.4%).

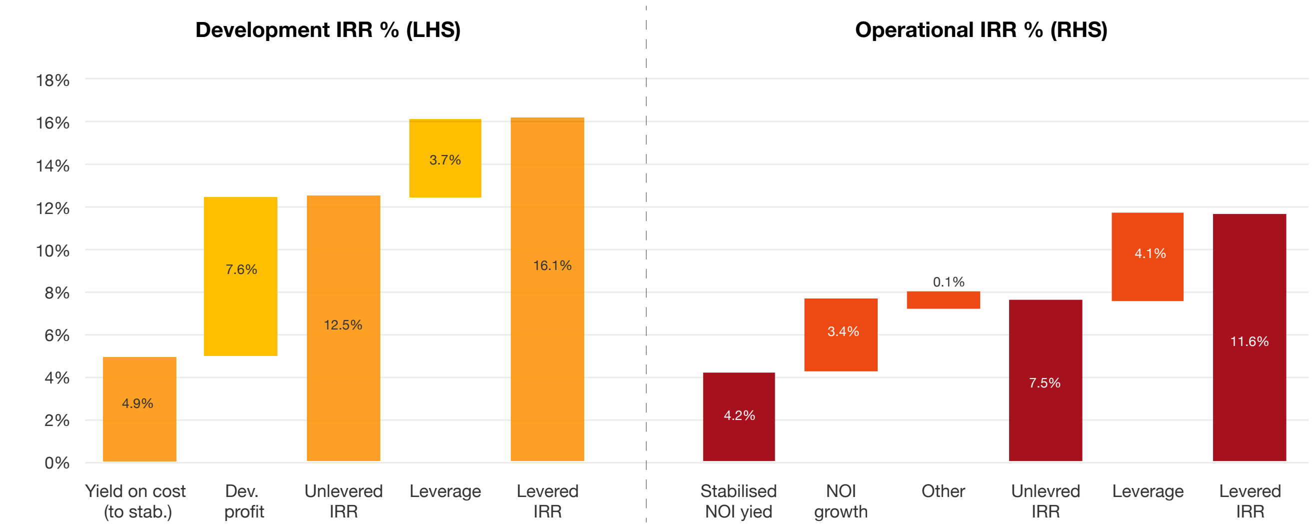
Chart 3: Ten year forward view (IRR %)



Source: Frontier, typical BTR managers. Assumptions: 55% post development LTV, 3% residential rental growth, 75% NOI margin, 10% GST, 2.6% land tax, management fee 0.5% of GAV 10-year investment period.

3. EY BTR Sector Update April 2021.

Chart 4: Development versus operational phase breakdown



Source: Frontier, typical BTR managers. Assumptions: 55% post development LTV, 3% residential rental growth, 75% NOI margin, 10% GST, 2.6% land tax, management fee 0.5% of GAV 10-year investment period.

Development margins make a significant proportion of returns in the development phase and are higher than those we have seen in the past. Profit margins on cost are approximately 20%, with leverage, which is comparable to the 'build to sell' (BTS) market.

Leverage is used in the development phase, up to 60% loan to value (LTV), which increases returns. In the operational phase, leverage is marginally higher than previously seen at a 55% LTV post completion (up from 50%).

Yield on cost in the development phase and the stabilised net operating income (NOI) yield in the operational phase are unchanged.

Frontier has observed that one manager's build to rent analysis assumes materially higher rents to that currently observed in the market from government rental data. Frontier's analysis using a proxy South Melbourne BTR project is below.

Table 2: South Melbourne project analysis

Flat/unit	BTR premium over market	BTR weekly rent (base case)[1]	South Melbourne weekly median rent[2]
1 Bedroom	51%	$512	$340
2 Bedroom	47%	$660	$450
3 Bedroom	65%	$990	$600
Net IRR (post fees, pre tax)	-	11.56%	1.06%

1.Typical BTR manager. 2. Victorian State Government, Department Families Fairness and Housing. Rent for year to December 2021.

The weekly rents provided by managers in the model are significantly higher than the median rent for the South Melbourne area. Lowering these rental assumptions has a material impact on the outcome of the project with a 1.06% IRR if the median rent is used, versus 11.56% net IRR if the BTR rents are used, all else equal.

Currently, the viability of the BTR business model relies on the asset obtaining significantly higher rents than the market. While the claim exists that tenants are willing to pay a premium under the BTR model, there is limited evidence of this occurring in Australia.

Key items to consider

Market adoption

Given the rental premium assumptions made for almost all proposed BTR projects we have seen, it will be important to monitor the market adoption of the product as a way to rent. While Mirvac's LIV Indigo project in Sydney Olympic Park has commanded ten percent rental premiums (as opposed to the BTR premia presented in Table 2),[4] it is yet to be tested more broadly how many tenants are willing to pay a premium for the amenity and professional management on offer in BTR. We believe it will take some time for the occupier market to understand and price in the benefits of living in BTR rather than renting in the private market. Initially, rental premiums could hold back occupancy levels.

Project size

From discussions with managers, project size is a critical factor for operating successful assets. Too small and it is difficult to gain any efficiencies of scale across operations. Too large and it is difficult to maintain very high occupancy. Thus, the ideal development size appears to be in the range of 300 to 500 units per project. That said, there is market evidence of medium size developments (circa 175 units, the Sentinel Element 27 project in Subiaco, Western Australia) achieving strong renter demand.

Exit liquidity

Another underlying assumption is that investors will be able to sell BTR assets at some point in the future, typically after ten years. While the asset class appears to have a long growth runway, with current forecasts moderate compared to the scale that could be achieved, it is unknown whether a deep liquidity pool will eventuate. However, from the evolution of PRS in the UK it appears so long as there continues to be large flows of capital seeking stable cash flows, the defensiveness of established BTR assets and steady cash flow will be attractive to many.

BTR operating models

The importance of BTR's customer-centric focus is becoming increasingly recognised as the sector evolves in Australia. This is evident among managers seeking to develop BTR platforms to build brand recognition and efficiencies, with the ability to offer tenants different products and locations as their needs change. External property management service providers lack the 'hospitality' mindset that is critical to building a loyal brand. We have observed a number of managers investing significant capital in building out their own branded capability, often hiring specialist from offshore to train local teams.

Financing and ESG

The BTR financing sector in Australia has evolved since 2018, with offshore banks and non-bank lenders having initially entered the market to provide construction financing. There is now increased interest from Australian banks who are starting to participate in the sector, which has seen the first green loan for a BTR project in Australia signed recently. Overall, the increase in available liquidity is favourable for the sector.

One manager noted there is greater scope for ESG reporting in the BTR sector to improve, with no current rating regime (NABERS, Green Star, etc.) suited to the model given common spaces are not typically factored in. Encouragingly, a focus on sustainability in BTR has advanced with a number of managers incorporating fully electrified buildings (for hot water and induction cooking) and split system air-conditioning units on balconies and podiums. Facades are said to be constructed of more energy friendly materials and solar power from PVs on roofs to contribute to renewable energy initiatives.

Other ESG targets include:

- 45% reduction in GHG emissions
- 100% renewable electricity via LGCs
- electric vehicle charging stations
- recycled water for landscaping and toilet flushing
- exploring construction phase and operational phase carbon neutral initiatives
- smart technology to drive tenant behaviour around sustainability.

4. Australian Financial Review, Rental markets more challenging than expected: Mirvac, 19 April 2022.

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Snapshot of an existing BTR project

Sentinel Real Estate Corporation, the US multi-family specialist, has begun its first foray into Melbourne with a 21-storey development comprising 157 apartments in a mix of sizes.

It developed and manages 175 units in Subiaco, Western Australia for the British pension fund Hermes Real Estate. Branded Element 27, it features studio, one-, two- and three-bedroom apartments in a wide variety of floorplans.

Sentinel's West Melbourne BTR project

Source: Sentinel, AFR March 29, 2021.

The final word

Changes in existing taxes, and improved clarity around state and federal support for BTR will be important for the sector to evolve and mature.

The most significant impact is that of land tax according to a number of managers we surveyed. Further, the Property Council of Australia continues to advocate for the reduction of the federal MIT tax for foreign investors to 15% related to the Australian BTR sector.[5]

Foreign investors continue to play an important role as early movers. Offshore operators such as Sentinel, Oxford Properties and Greystar continue to make inroads in the Australian BTR sector, with the local managers continuing to develop and deliver their project pipelines.

The cultural challenges of renting and paying premiums for facilities such as those offered in North America, UK, and some Asian cities, remain. Pleasingly, some strategies embrace the concept of mixed-use hubs with over-station locations and developments, adjoining local supermarkets and additional thought around precinct activations, delivering further value to occupants. Frontier expects the BTR sector will evolve as an institutional product over the next five to ten years. Demographic drivers, coupled with supply/demand dynamics present a strong case for the sector as well as the ability to incorporate sustainable and social outcomes into new developments. We continue to monitor the sector and identify compelling strategies for clients. We are very happy to chat with clients as we progress our research.

Want to learn more?

Frontier has undertaken extensive research on Australian build-to-rent and is well placed to advise investors on this theme. We encourage investors to reach out to Frontier's Real Assets Team for a discussion on how we may be able to help.

5. Australian Financial Review, Cut 30pc tax on build-to-rent in budget, property leaders say, 28 March 2022.

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