Breaking the shackles: the rise of BTR

2023

Exploring the rise of build-to-rent in Australia

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Executive summary

After a long wait, a build-to-rent sector is now emerging in Australia. A confluence of demand side pressures, intractable supply shortages and growing appetite from local and global investors are all now driving growth, and BTR is set to become a critical part of the rental market over the next decade.

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RISING BUILD-TO-RENT CONSTRUCTION IN AUSTRALIA

A build-to-rent (BTR) sector in Australia is now emerging with a wave of construction activity now underway. An estimated 8,350 dedicated BTR apartments were under construction nationally in September 2023 and a further 12,900 apartments are approved for development in the near term. The pipeline is most advanced in Melbourne and Brisbane, but activity is picking up across all major cities.

GLOBAL INVESTMENT IN RESIDENTIAL SECTORS

Across all regions globally, investors are seeking greater exposure to alternative sectors and the residential 'living' sectors are at the front of the queue, led by BTR. For the first time, residential is the most sought-after sector for global investors targeting the Asia Pacific region and Sydney and Melbourne are the preferred locations. However, contrary to widespread perception that the market is largely driven by offshore capital, many local groups are also jumping on board, with 65% of existing and proposed apartments currently owned by domestic capital and 35% by global capital either exclusively or through joint venture partnerships.

RESIDENTIAL SECTOR: A DEFENSIVE INVESTMENT

Investors are gravitating toward the residential sector partly because of its defensive characteristics, specifically the ability to adjust rental income streams more quickly than other sectors in response to high inflation. Residential rents have consistently kept pace with inflation over the long term, and also exhibited a high degree of correlation with fluctuations in inflation, in contrast with other major asset classes where the rental cycle has fluctuated more widely depending on the prevailing supply-demand dynamic.

DOMESTIC FORCES DRIVING BTR EXPANSION

BTR's expansion in Australia can also be explained by a range of domestically generated forces that have resulted in very tight supply in the rental market. Vacancy rates have fallen dramatically over the past two years, partly as a legacy of the pandemic-induced volatility in migration patterns, and partly because of a prolonged period of muted apartment completions. Not only is the market undersupplied now, but the housing market is forecast to remain in a supply deficit over the medium term.

ALIGNING INTERESTS: THE BTR MODEL

Facing a period of undersupply in the traditional build-to-sell market that is arguably structural, rather than purely cyclical, the case for BTR to play a part in redressing the imbalance is clear. The BTR model aims to align the interests of investors seeking to secure long-term income streams with the interests of tenants, and over time this will result in a more diverse product mix that promises to improve the service offering and widen the range of options for renters.

GOVERNMENT INITIATIVES BOOSTING BTR INVESTMENT

Recognising the need to unlock additional forms of private investment in apartment supply, state and Federal governments are now taking steps to enable greater investment in BTR. At state level, a number of state governments have announced tax changes to improve the viability of BTR, typically through lower rates of land tax. At the Federal level, the new government has recently announced the intention to bring the treatment of BTR under the MIT regime into line with other commercial sectors. Once the change is effective, foreign investors in qualifying jurisdictions will be eligible for the 15% withholding tax rate on fund payments in relation to BTR projects.

BTR GROWTH FORECAST IN AUSTRALIA

Based on the current pipeline of BTR developments in Australia and the demonstrated growth trajectory in the UK, by 2030 we forecast that around 55,000 dedicated BTR apartments will have been completed. If total stock grows to this level, BTR would still only represent 1.5% of total rental supply, underlining the potential for scale.

EVOLVING CONVERSATIONS ON BTR VIABILITY

As the sector matures, the focus of conversation is likely to morph away from whether BTR is viable to how to maximise substantial benefits it can bring to communities by deepening the pool of rental stock and broadening the type of supply on offer to tenants. Governments will be tempted to require developers to deliver affordable housing as part of BTR schemes. However, we expect that pragmatism will prevail, and that the risk of stemming the flow of supply to market more broadly will ultimately persuade government not to implement rigid requirements for BTR to deliver a fixed proportion of affordable housing. Instead, it is more likely to be considered on a case-by-case basis, with the potential for affordable housing to be encouraged in certain cases alongside other concessions to facilitate scheme viability.

LOCATION SELECTION FOR BTR STRATEGY

With attention now turning to the successful execution of a BTR strategy, location selection is increasingly in focus. Inner fringe locations in Melbourne and Sydney are natural candidates for the first wave of schemes, given their offer of amenity, close proximity to CBDs and a high proportion of potential tenants given their comparatively well-educated and young populations. Over time we expect to see a broadening of developer interest to encompass middle-ring suburbs with high levels of amenity and connectivity.

The rapid growth of Build-to-Rent in Australia

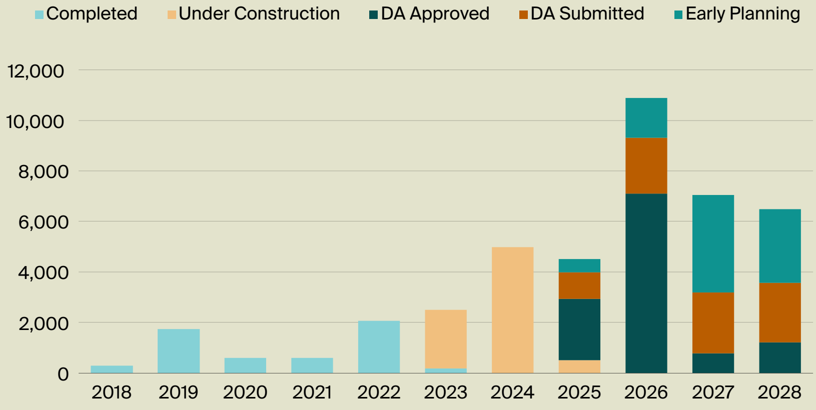
A BURGEONING PIPELINE

After a long gestation period, a build-to-rent (BTR) sector in Australia has sprung to life and the quantum of committed and planned development is increasing fast.

The underlying demand-side drivers have been in place for some time, but a combination of cyclical and structural supply-side impediments have, until recently, held back development. However, many of these constraints have either abated or been removed and the sector appears set to expand rapidly over the next decade. Given the size of the market for rental accommodation, investors and developers are able to access a market offering the potential for large scale capital deployment, while the community stands to benefit from an additional source of supply to help address Australia's structural undersupply of housing.

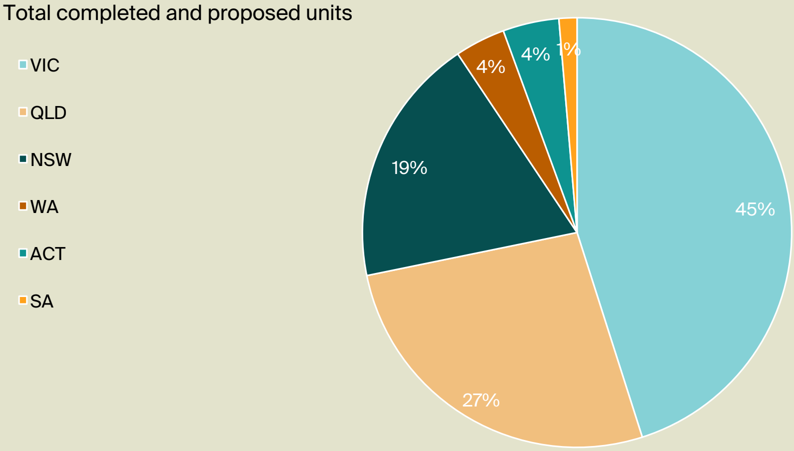
Notwithstanding elevated construction costs, a wave of construction activity is now underway, with an estimated 8,350 apartments under construction nationally (August 2023) and a further 12,900 apartments approved for development in the near term.

BTR development pipeline
Number of BTR units per year by planning status



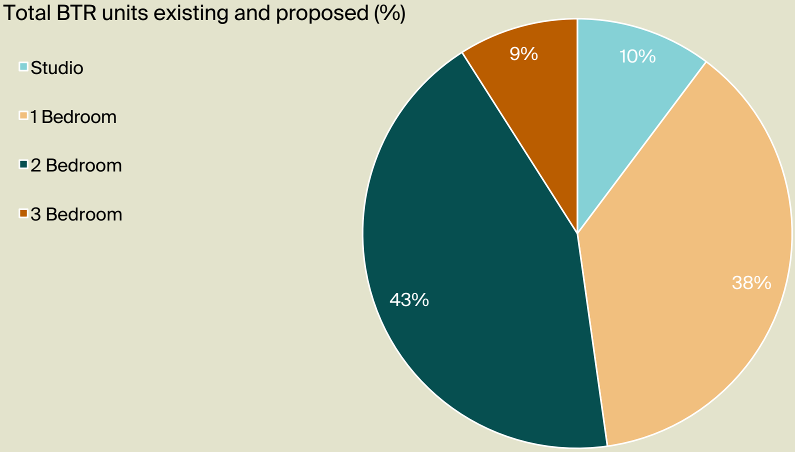
Source: Knight Frank Research, Cordell Connect

BTR pipeline by state
Total completed and proposed units



Source: Knight Frank Research, Cordell Connect

Split of BTR units by size
Total BTR units existing and proposed (%)



Source: Knight Frank Research, Cordell Connect

MELBOURNE THE INITIAL FOCUS BUT ACTIVITY RAMPING UP ACROSS ALL MAJOR CITIES

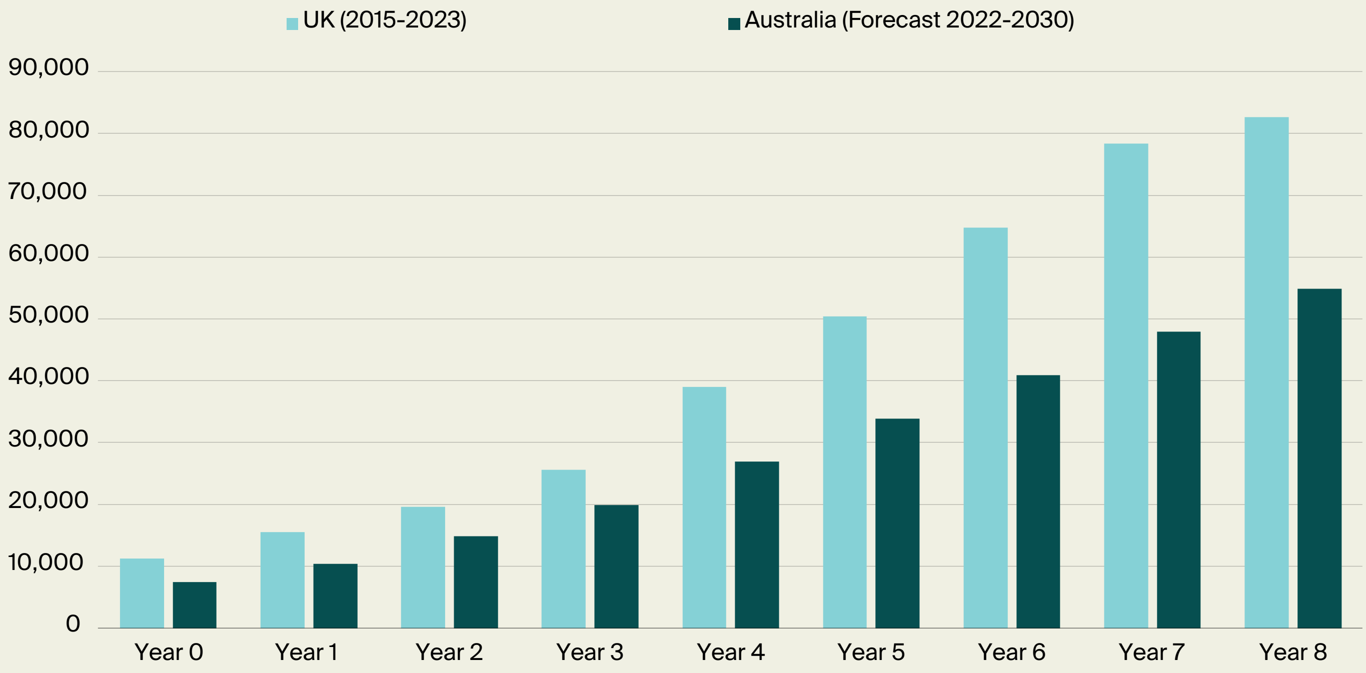
The BTR market is most advanced in Melbourne, which leads the way among the major cities with 4,920 under construction and 8,250 approved. Brisbane is next with 1,743 under construction and 2,567 approved, followed by Sydney with 1,529 and 965 apartments respectively. To date, development has focussed on one- and two-bedroom apartments, representing 36% and 44% of overall apartments respectively.

While activity has naturally coalesced around the largest cities in the first instance, many of the drivers of BTR apply equally to smaller cities. Contrary to popular perception that the market is largely confined to Melbourne and Sydney, cities like Perth and Canberra also seeing signs of growing interest, partly owing to relatively low land values and strong rental yields.

In coming months, the pipeline of potential development is likely to expand further as developers seek to position themselves to benefit from the current surge in rental growth, although the actual quantum of schemes under construction may be slower to accelerate until construction cost pressures ease.

Australia vs UK BTR stock expansion

Total stock growth during expansion phase



Source: Knight Frank Research

RAPID GROWTH WILL MIRROR THE UK TRAJECTORY

The current groundswell of activity points to a sustained expansion in total stock, and by 2030 BTR is expected to have emerged as a critical part of the housing supply mix, with Australia set to mimic the UK's BTR journey over the past decade.

The acceleration in development that we have seen in 2023 mirrors the beginning of the expansion phase that occurred in the UK from 2015 onwards. Over the following eight years to 2023, total UK stock has expanded from 11,312 to 82,636 apartments, reflecting average growth in the total stock of BTR apartments of 30% per year, or 9,450 apartments.

Based on the current pipeline of BTR developments in Australia and the demonstrated growth trajectory in the UK, by 2030 we forecast that around 55,000 dedicated BTR apartments will have been completed. This would imply an annual delivery of 5,900 apartments as supply accelerates from 2024 onwards, slower than the UK in terms of annual unit delivery but a similarly rapid expansion in proportionate terms.

Growth of BTR in the UK since 2015

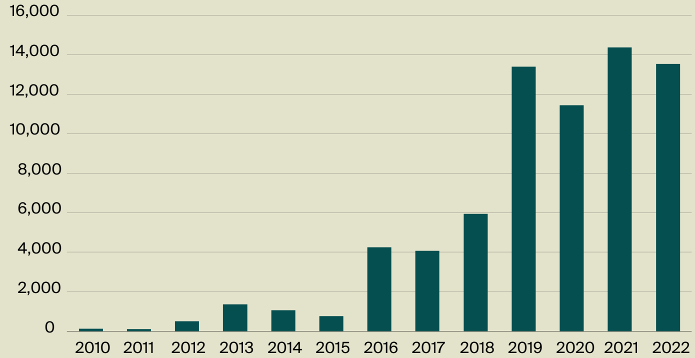
Over the past decade BTR has taken a foothold in the UK and expanded rapidly to become a significant and fast-growing part of the residential market. Similar to Australia, momentum took a long time to build, with the commissioning of a government review of the barriers to institutional investment in private rented homes in 2012 (the Montague Review), acting as a catalyst for changes in planning policy, the release of more land for development and ultimately the emergence of BTR as a distinct asset class.

Since 2015, the total stock of BTR apartments has expanded to 83,000 apartments, with the current development pipeline pointing to a further acceleration in development activity in 2024-25. From a standing start, BTR supply now accounts for 1.5% of the total rental market, with the expectation that this proportion will continue to increase rapidly as the sector matures.

London has been a natural focal point for BTR developments, with 38,000 apartments in the capital, representing 46% of total stock, but BTR has established a foothold in all major cities including Manchester, Birmingham, Leeds, Liverpool and Bristol.

BTR schemes have generally been very well-received by tenants, as evidenced by very low vacancy across the sector and short timeframes to fully lease new schemes. Survey evidence consistently finds that tenants rate the BTR experience more highly than the wider rental market.

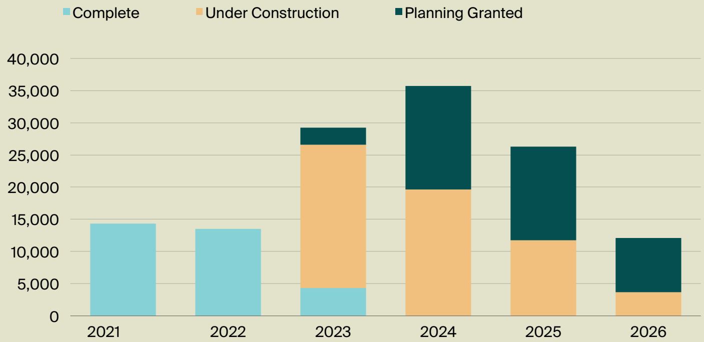
UK BTR unit completions
Number of unit completions per year



Source: Knight Frank Research

City	BTR apartments	Share of total
London	38,092	46%
Manchester	13,806	17%
Leeds	3,164	4%
Birmingham	3,059	4%
Liverpool	2,671	3%

UK BTR supply pipeline
Number of BTR units by year and status



Source: Knight Frank Research

Capital drivers of BTR expansion

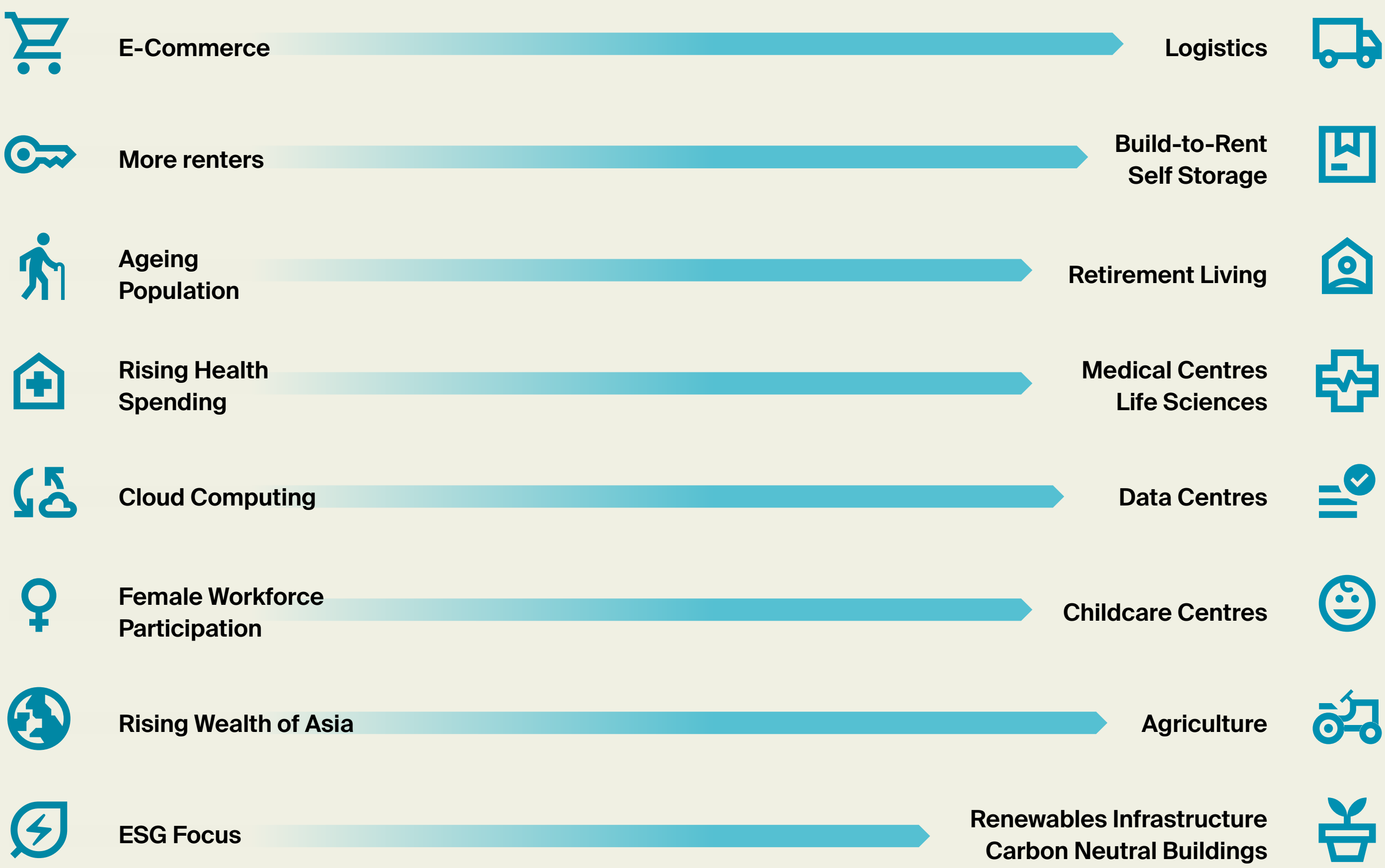
GROWING INTENT FROM GLOBAL AND LOCAL INVESTORS

The sudden expansion of the BTR pipeline in Australia is emblematic of a wider shift in the global investment landscape. Across all regions, investors are seeking greater exposure to alternative sectors and the residential 'living' sectors are at the front of the queue, led by BTR but also encompassing student accommodation and retirement living.

This was borne out in the most recent ANREV survey of global investor intentions, which highlighted that for the first time, residential is the most sought-after sector for global investors targeting the Asia Pacific region.

The shift to living sectors is part of a wider shift from major institutions globally to focus predominantly on core investment strategies in 2023 and commensurately reduce their allocation to value-add and opportunistic strategies. Survey evidence from the Asian Association for Investors in Non-Listed Real Estate Vehicles (ANREV) highlights this shift down the risk curve in response to a more uncertain global economic outlook and cyclical correction in other sectors. The tilt in strategic approach to focus on core investments stands in clear contrast with the late-cycle approach evident from 2018-20, when defensive investments were assigned a lower priority as investors pursued a more risk-on approach to take advantage of rapid rental growth and yield compression in other sectors.

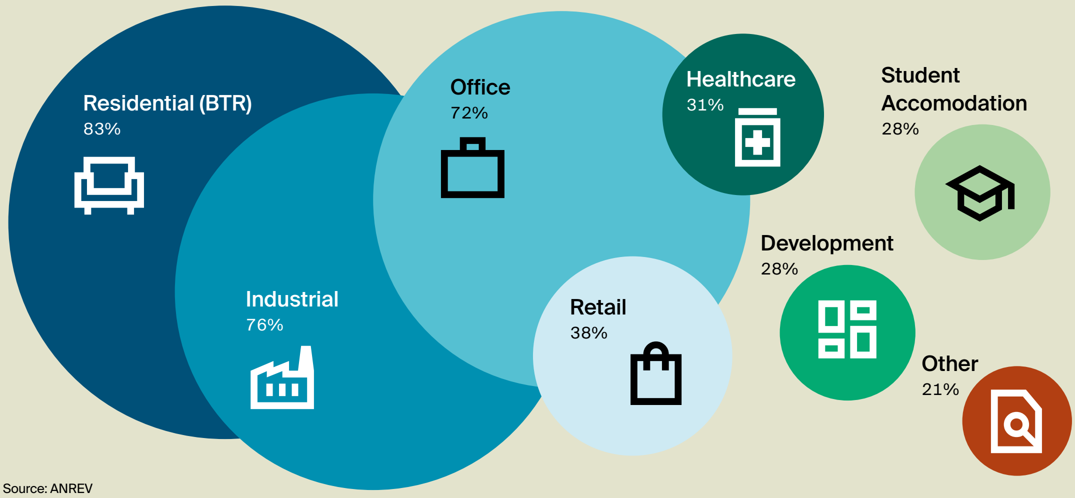
Allocating into acceleration: investors seeking to expand in emerging sectors



"Rents have exhibited a high degree of correlation with fluctuations in inflation, in contrast with other sectors like office and industrial where the rental cycle has fluctuated more widely depending on the prevailing supply-demand dynamic."

Preferred sectors for investment in the APAC region in 2023

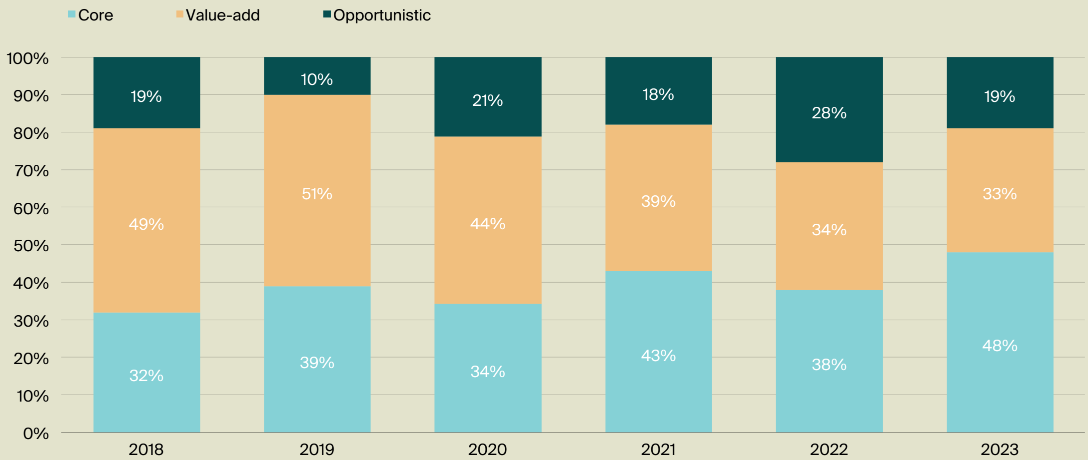
ANREV survey of global investors - proportion of respondents targeting each sector



Source: ANREV

Preferred investment style

Annual survey of APAC investor intentions



Source: ANREV

DEFENSIVE CHARACTERISTICS AND INCOME ALIGNED WITH INFLATION

Related to this, investors are gravitating toward the residential sector because of the perception that it offers the ability to adjust rental income streams more quickly than other sectors in response to high inflation.

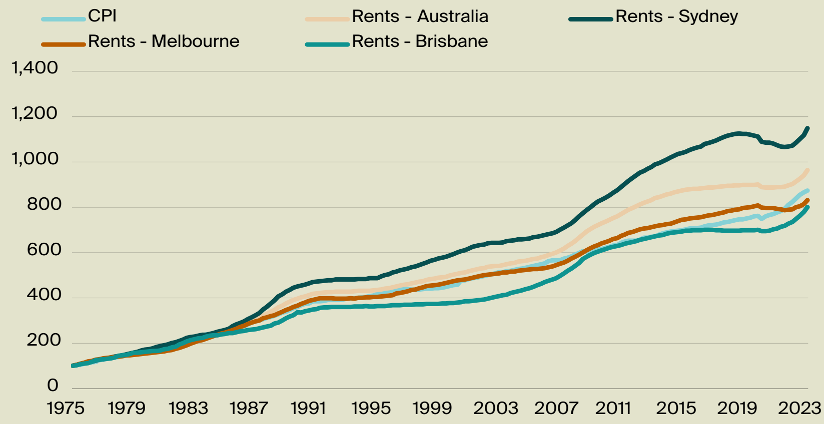
Historic experience certainly bears this out. Rents have consistently kept pace with inflation, with the ABS's index of rents growing by 3.0% on average over the past 20 years, slightly exceeding the 2.8% average growth in the overall CPI basket. Growth has been similar across cities, with slightly higher average growth in Brisbane (3.6%) and Canberra (3.5%), followed by Adelaide (3.1%), Sydney (3.0%), Perth (2.9%) and Melbourne (2.5%). Other rental indices suggest even stronger rental growth for apartments in particular.

Besides keeping pace with inflation, rents have also exhibited a high degree of correlation with fluctuations in inflation, in contrast with other major assets classes like office and industrial where the rental cycle has fluctuated more widely depending on the prevailing supply-demand dynamic. An analysis of the relationship between annual rental growth rates in the residential sector and annual movements in inflation reveals a very high degree of correlation. Importantly, this correlation remained high during periods of high inflation in the 1970s and 1980s, and in keeping with this experience, the current surge in inflation is once more being mirrored in the rapid growth of apartment rents.

Alongside consistent growth, investors are also assured by the relative resilience of residential rental performance during market downturns. Rents have rarely fallen in any major city, and the recent experience of this occurring in some CBDs during the pandemic was highly unusual. Rents were resilient during both the early 1990s downturn and in 2008-09 and this resilience in Australia was largely borne out globally, including in the United States where the well-established multifamily sector was also relatively stable during these episodes of wider economic turmoil. In contrast, the rental performance of other sectors tends to exhibit greater volatility and a weaker relationship with economy-wide inflation.

Rents versus overall CPI inflation

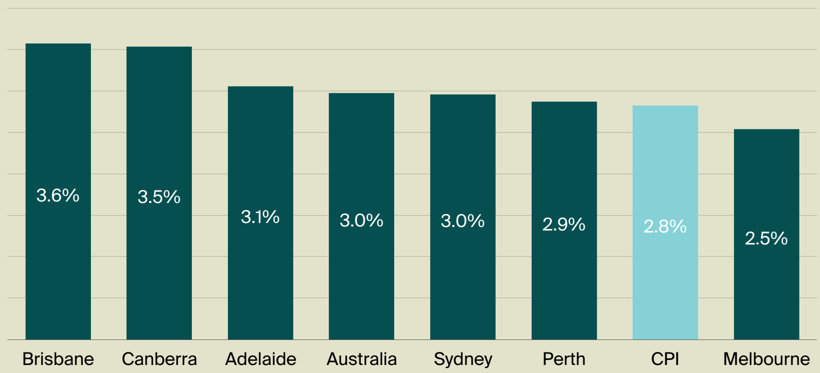
Index, 1972 = 100



Source: Knight Frank Research, ABS

Average growth in rents

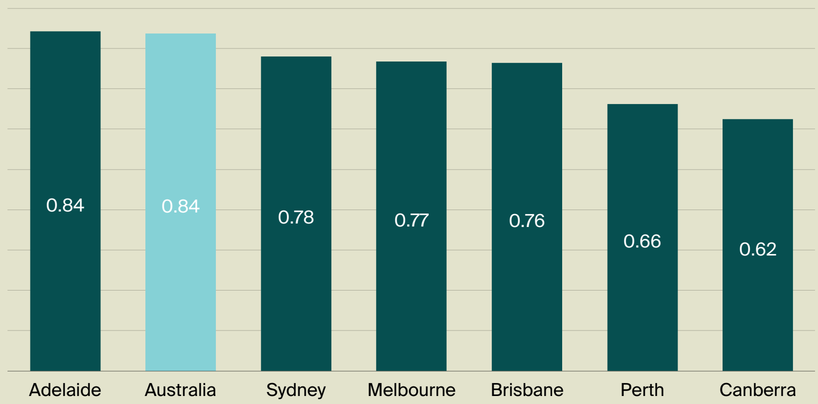
20 year annual average growth since 2003 (CPI measure)



Source: Knight Frank Research, ABS

Correlation - rent growth vs CPI inflation

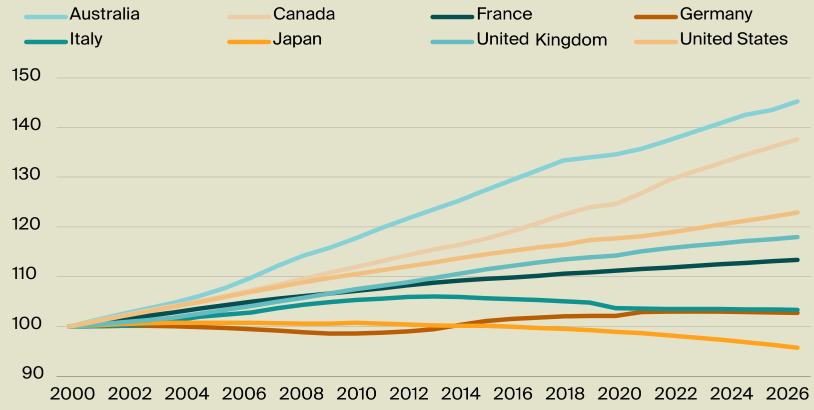
Correlation between annual growth rates and CPI since 1976



Source: Knight Frank Research, ABS

Historic and forecast population growth

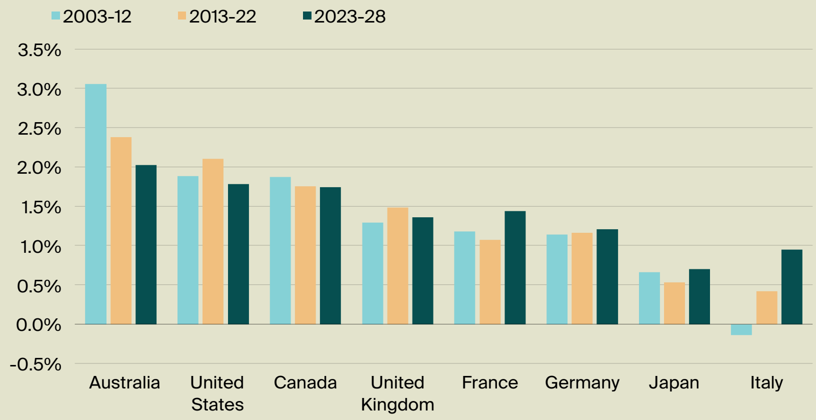
2000-2028, index 2000 = 100



Source: Knight Frank Research, IMF

Historic and forecast GDP growth

Average annual growth



Source: Knight Frank Research, IMF

Most favoured APAC city/sector combinations by year

Year	#1	#2	#3
2023	Sydney – BTR	Melbourne – BTR	Sydney - Office
2022	Tokyo – BTR	Sydney – Industrial Tokyo – Industrial	Seoul – Industrial
2021	Sydney – Industrial	Melbourne – Industrial	Tokyo – BTR
2020	Melbourne - Office	Sydney - Office	Tokyo – BTR
2019	Melbourne - Office	Sydney - Office	Sydney – Industrial
2018	Sydney - Office	Melbourne - Office	Sydney – Industrial
2017	Sydney - Office	Melbourne - Office	Sydney – Retail

Source: ANREV Investment Intentions Survey 2023

AUSTRALIA'S GROWTH POTENTIAL ATTRACTING GLOBAL ATTENTION

Amidst a global push toward the living sectors, Australia is firmly on the radar for domestic and cross-border capital. Our track record of strong economic performance, long-term growth potential and high average total returns historically across a number of asset classes all augur well for prospective investors.

Current forecasts indicate that despite an imminent slowdown in the pace of growth globally, Australia will continue to grow more quickly than other major advanced economies. This is due in large part to faster population growth which provides an ever-expanding market for BTR; Australia's population has grown by 1.4% per year on average over the past 20 years, well ahead of the US (0.7%), UK (0.7%), Canada (1.1%) and also much faster than the slower growing European economies.

Sustained growth in the size of the potential market for tenants, coupled with deep and liquid investment market, provide ideal conditions for BTR to emerge as the next large scale institutional asset class. The shift in investor focus toward to residential is likely to be more impactful in Australia because it is coming off such a low base. Whereas the sector is mature in the United States and Japan and already represents a large share of both residential stock and the portfolio allocation of major investors, the Australian market is miniscule in comparison, but widely recognised as having huge potential to scale up.

This potential for expansion is reflected in a shifting focus for capital allocation, with ANREV's annual investor survey also noting Sydney and Melbourne BTR as the most favoured city/sector combination within the region.

Major owners of BTR pipeline - number of apartments completed, under construction and planned

Owners	Principal source of capital	Completed	Under Construction	In planning	Total number of apartments
Home / GIC	Offshore	773	1,058	951	2,782
Mirvac / Mistubishi / CEFC	Offshore	677	1,002	527	2,206
Greystar / APG / Ivanhoe Cambridge / Ilmarinen	Offshore	-	1,128	800	1,928
Super Housing Partnership / HESTA / Make Ventures	Domestic	-	-	1,492	1,492
Pellicano Group	Domestic	318	260	894	1,472
Investa / Oxford Properties	Offshore	-	628	702	1,330
Gurner / Qualitas	Domestic	-	300	975	1,275
UBS /ADIC	Offshore	1,252	-	-	1,252
Make Ventures / Aware Super	Domestic	-	199	1,000	1,199
Brookfield	Offshore	-	-	1,120	1,120
Lateral Estate	Domestic	679	123	165	967
Local / Macquarie Asset Management	Domestic	-	467	445	912
AsheMorgan	Domestic	-	-	900	900
Salta Properties	Domestic	-	-	899	899
Hines / Cadillac Fairview	Offshore			870	870
Lendlease / Daiwa House	Offshore	-	-	797	797
Coronation Property	Domestic	-	790	-	790
Altis Property Partners / Aware Super	Domestic	-	-	736	736

Source: Knight Frank Research, Cordell Connect

EXPANSION IN CAPITAL PARTNERSHIPS TEAMING EQUITY AND EXPERTISE

Underpinning the growth of BTR on Australia are a proliferation of developers and investors driving the current pipeline and forming long-term plans to scale up. In many cases, local developers are forming partnerships with large global institutions. The developers play the lead role in driving scheme delivery and sourcing new opportunities, while the investors are able to grow their exposure in Australia, potentially at large scale, without having to establish sizable local teams to manage at an operational level.

Developers benefit from not only the financial backing of global asset managers, but also their experience in managing BTR investments in other countries. Examples include capital partnerships between Home and GIC, Mirvac and Mitsubishi, and Investa with Oxford Properties.

While overseas capital is playing a key role funding major developments, many local groups are also jumping on board. For many years, BTR was widely regarded as offering inadequate returns to compensate for the risk of investing in an emerging sector with uncertainty over the complexity of delivery, uncertainty over operational costs, the availability of debt and liquidity at the eventual point of sale. However, these initial misgivings have gradually given way to greater confidence that the challenges can be overcome, with investors such as Macquarie, HESTA, Aware Super, Pellicano Group and AsheMorgan now actively pursuing BTR.

At present, domestic investors account for an estimated 65% of existing and proposed apartments, with 35% owned by offshore capital sources either solely or in joint venture partnerships. However, over time, we expect the ownership mix to shift closer to an equal mix of domestic and offshore capital as more local developers form capital partnerships with international investors to help deliver approved schemes.

Demand drivers of BTR expansion

A DRAMATIC TIGHTENING OF RENTAL SUPPLY

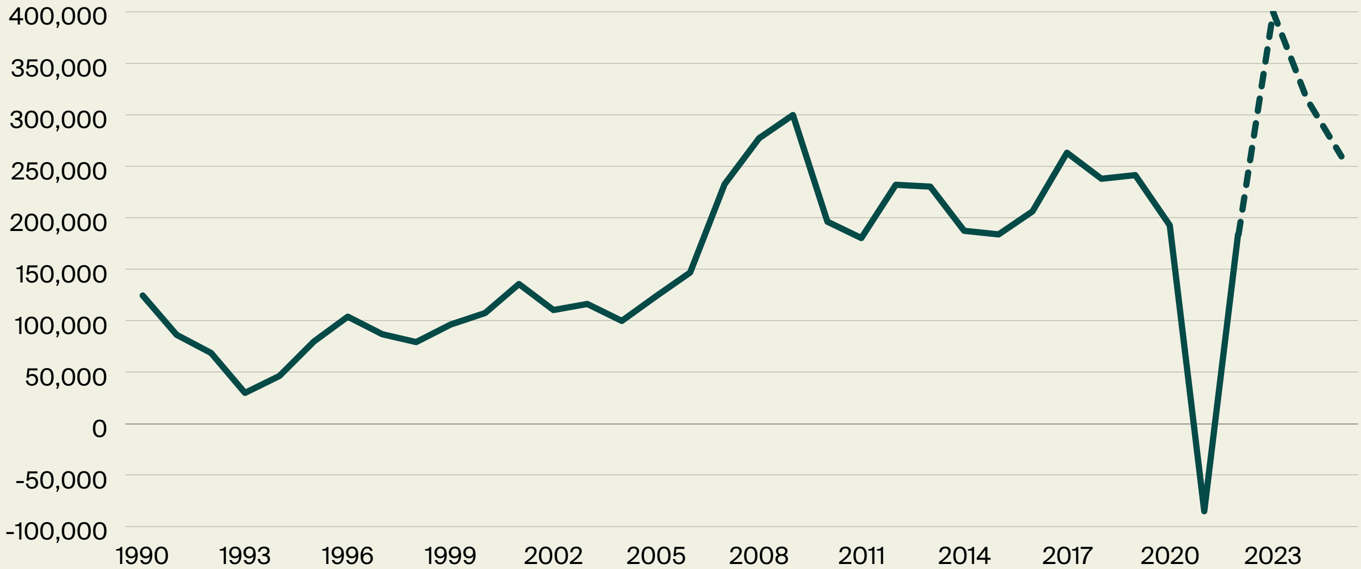
In addition to the global investment thematic driving the growth of living sectors, their expansion in Australia can be explained by a range of domestically generated forces, both cyclical and structural.

On the cyclical front, the current rental market is characterised by tight supply, with vacancy rates falling dramatically over the past two years, partly as a legacy of the pandemic-induced volatility in migration patterns, and partly because of a prolonged period of muted apartment completions.

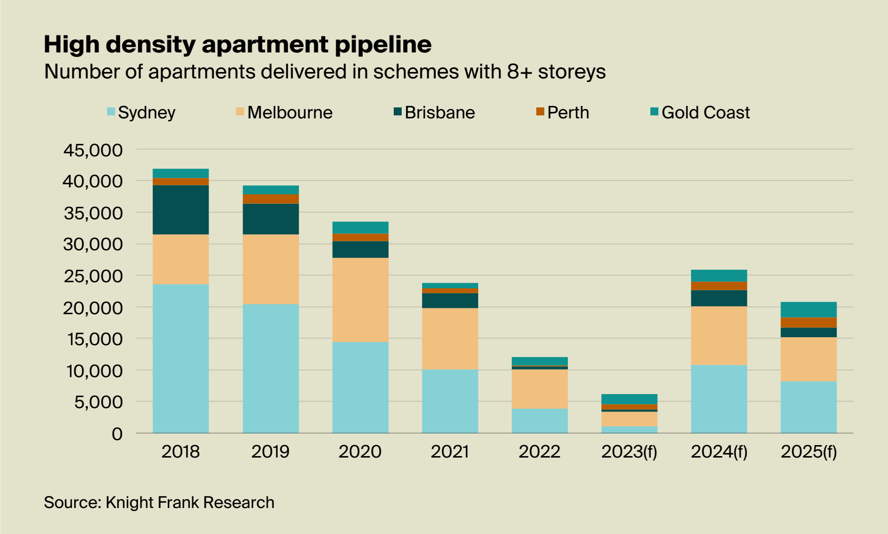
At the outset of the pandemic, vacancy rates in major cities rose, as the sudden reduction in student numbers and cessation of inward migration resulted in falling demand. In addition, a behavioural shift saw some people opt to take alternative options in order to secure more living space, whether through upsizing to houses instead of apartments or moving temporarily to regional centres.

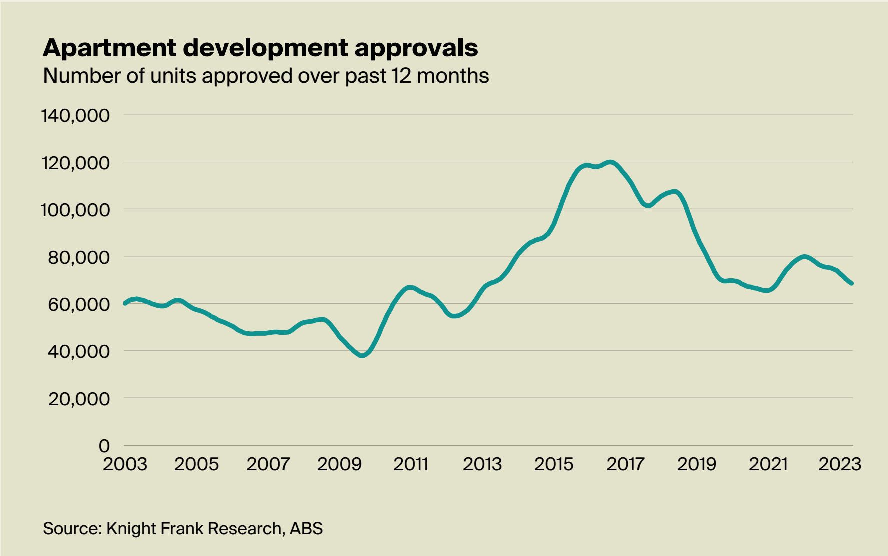
In 2022, however, as international students and inward migration returned – net inward migration jumped back to 184,000 in 2021-22 and is expected to hit a record 400,000 in 2022-23 – rental demand escalated sharply and vacancy rates began to tumble.

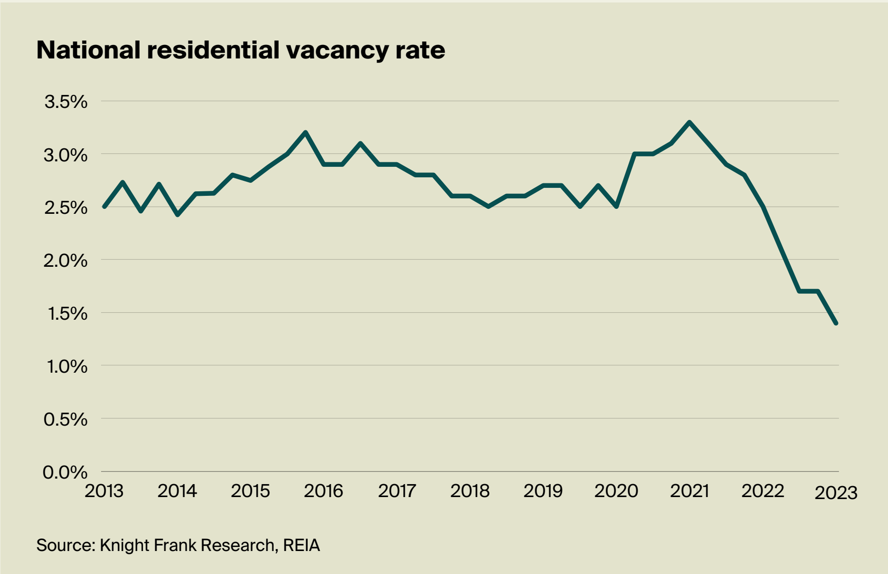
Net overseas migration - annual total



Source: ABS, Budget Paper 1







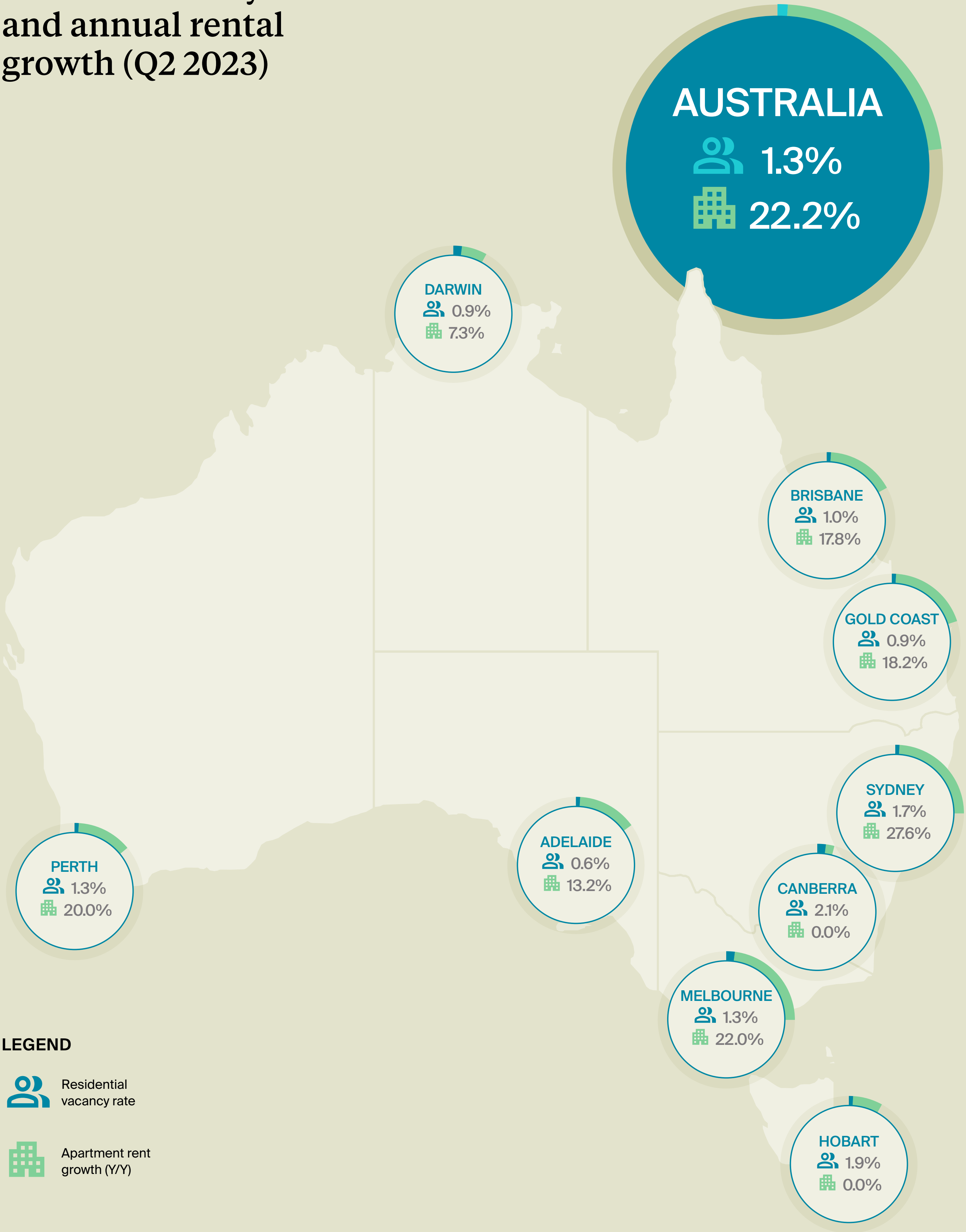
PROLONGED DROUGHT ON THE SUPPLY SIDE

Meanwhile, on the supply side, the total level of apartment completions nationally has failed to recover from the slowdown experienced after the boom conditions of 2015-17, when record levels of apartments were constructed. From 2019-22 the level of completions gradually dropped away, and notwithstanding the strong growth of apartment prices in 2021, the market failed to return to a high level of completions, as a combination of high construction costs, rising funding costs and difficulty securing presales in the weaker market conditions of 2022, all held back supply.

2023 is likely to mark the low point for high density completions, which are forecast to reach just over 6,000 in the four largest markets. A gradual pick-up is expected in 2024-25, but recent approvals data offers little prospect of a rapid escalation in supply, as apartment development approvals have dipped in the early months of 2023, with the monthly data pointing to the lowest levels of approvals since 2012.

The end result has been a sharp tightening of market conditions, with the rental vacancy rate nationally dropping from 3.3% at the start of 2021 to 1.4% in Q1 2023, and to below 1% in Brisbane, Adelaide and Perth. As conditions have tightened, median apartment rents have escalated sharply, growing by an extraordinary 18% on average nationally over the past year according to APM.

Current vacancy rate and annual rental growth (Q2 2023)



LEGEND

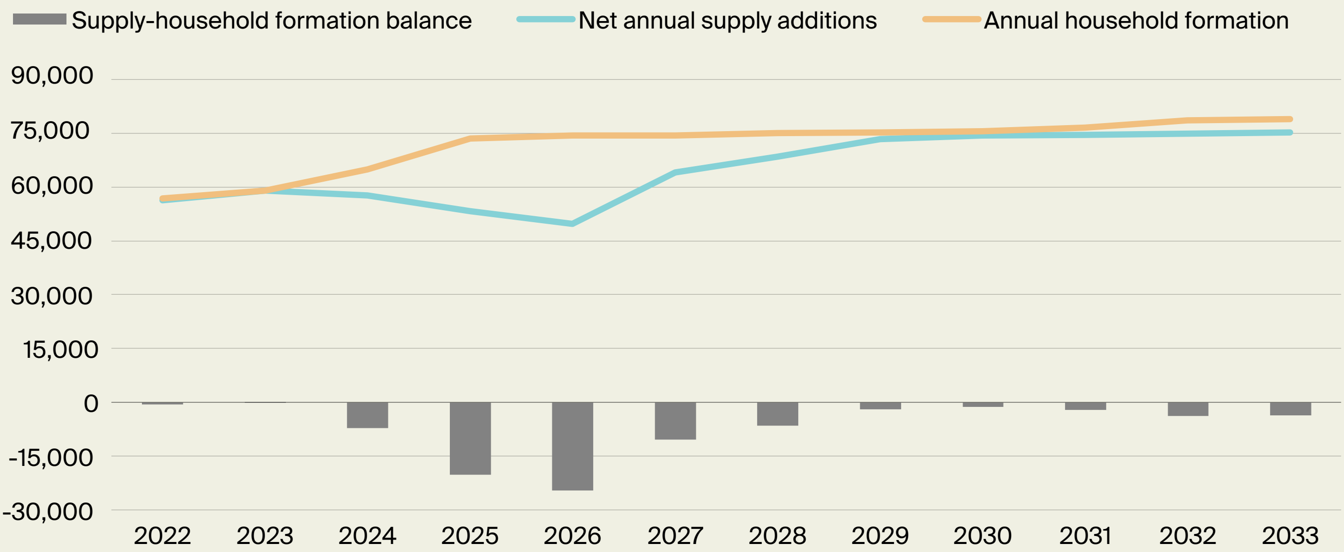
Residential vacancy rate

Apartment rent growth (Y/Y)

Source: APM, REIA, SQM Research

Supply demand imbalance for multi-unit dwellings

Number of dwellings per year



Source: NHFIC State of the Nation Report 2023

STRUCTURAL SUPPLY DEFICIT

Housing supply is a critical issue for the community and a prolonged rental crisis threatens social cohesion, so it is not surprising that the current dilemma is attracting wider attention in the media and the political sphere. Knight Frank and a number of other research bodies, including the Federal government's National Housing Finance and Investment Corporation (NHFIC) have observed the current undersupply and made the related point that Australia is simply not building enough dwellings to cater to the current rate of household formation.

Not only is the market undersupplied now, but NHFIC estimate that the housing market will remain in a supply deficit over the medium term. Their latest State of the Nation Report estimates that the shortfall of supply completions versus the formation of new households will worsen over 2024-26, before the gap is narrowed thereafter.

Facing a period of undersupply in the traditional build-to-sell market that is arguably structural, rather than purely cyclical, the case for BTR to play a part in redressing the imbalance is clear. There is clearly a potential alignment between the needs of developers and investors seeking to enter the market and governments at all levels seeking to unlock alternative forms for private market supply.

LONGSTANDING AFFORDABILITY CHALLENGE

The confluence of demand side pressures driving the Australian housing market sit uneasily against this backdrop of tight rental supply and a subdued development pipeline. These pressures continue to result in a substantial affordability challenge for many prospective buyers which is contributing to growing demand for rental accommodation.

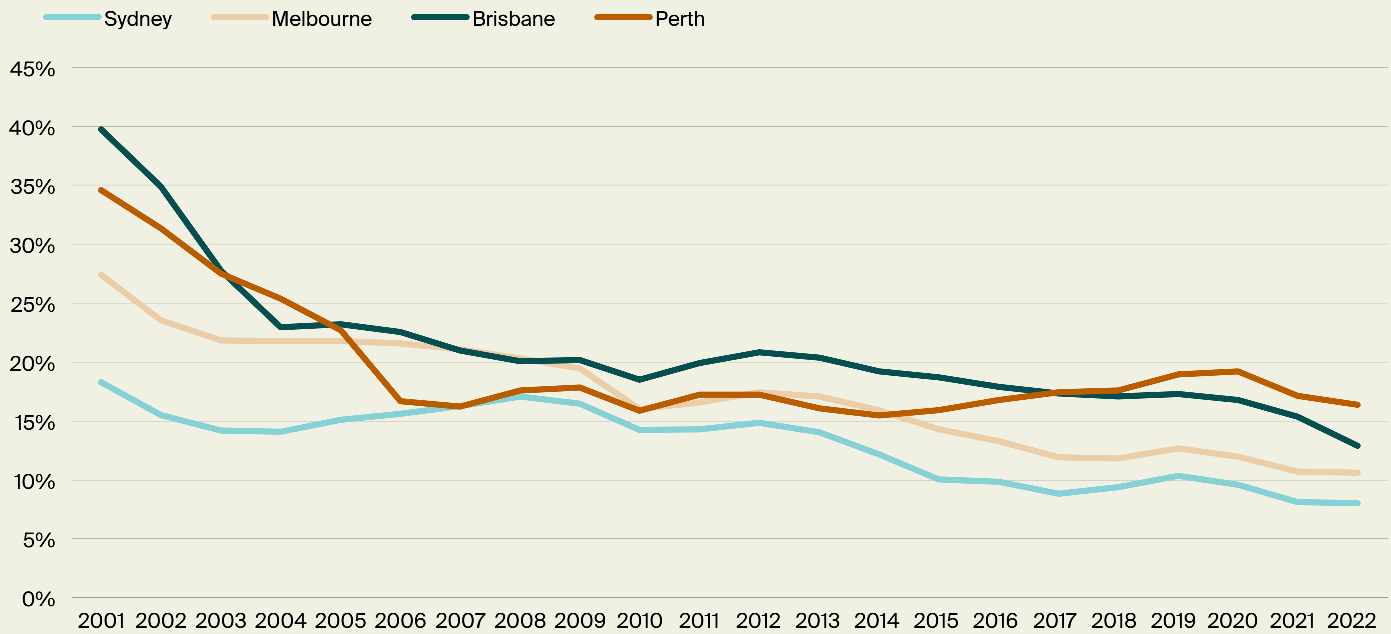
In addition to strong population growth and inward migration, the gradual shift to an economy revolving around services industries has led to a high degree of urbanisation, with abundant job opportunities in our major cities and consequently strong demand for housing.

As population and housing demand has increased, the historic pattern of relatively low-density development in our major cities, compared to other global hubs, has made it increasingly challenging to accommodate growth, particularly in Sydney. This has put pressure on land supply and infrastructure delivery which have increased the desirability of housing located within close proximity to key employment hubs in city centres.

On top of this, a prolonged period of low interest rates – prior to the current hiking cycle – and a strong preference for housing as a store of wealth and investment, in addition to owner occupation, have boosted demand.

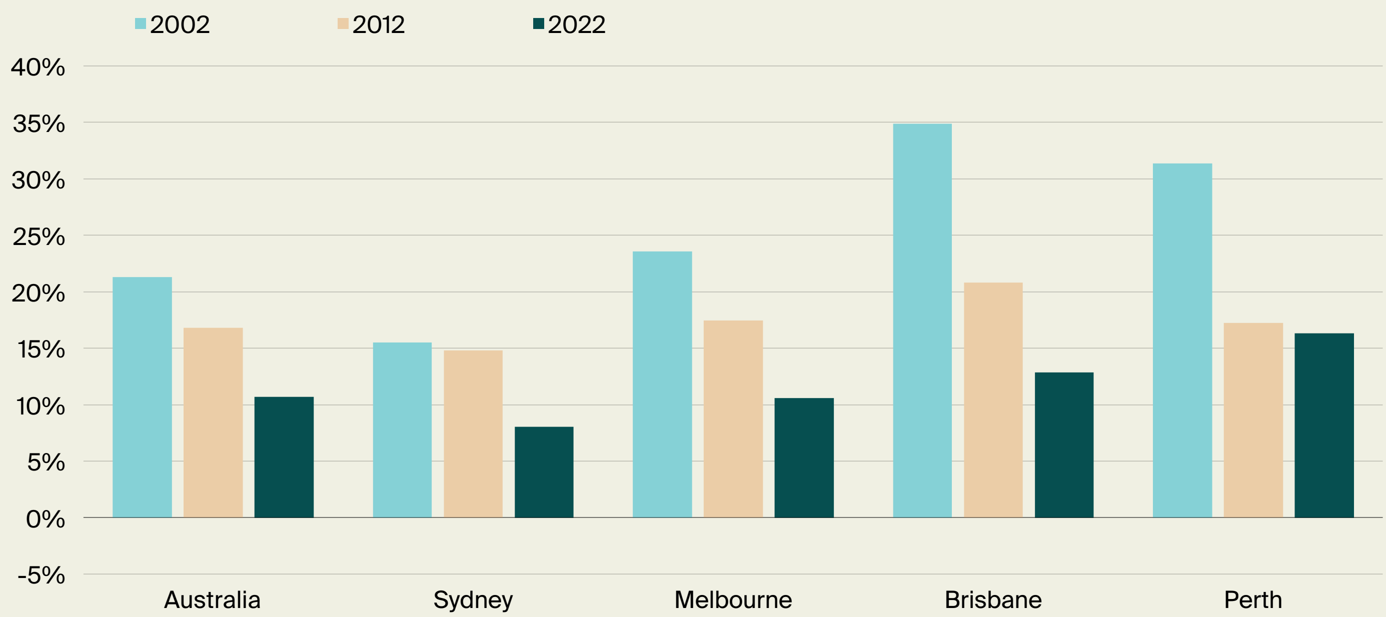
These factors have all contributed to strong growth in dwelling prices, particularly for free-standing houses. Over the 20 years to 2022, median Australian dwelling prices (reflecting both houses and apartments) rose by 203% on average, or 5.7% per year, compared to much lower growth in median household income, which grew by 53% over the same period, reflecting average growth of 2.1%. The pace of dwelling price growth was broadly consistent across the major cities, with the fastest growth in Brisbane (7.4% per

Median household income as a proportion of median dwelling price in major cities



Source: Knight Frank Research, ABS, APM

Median household income as a proportion of median dwelling price in major cities



Source: Knight Frank Research, ABS, APM

year), Adelaide (6.8%) and Melbourne (6.4%), followed by Sydney (5.5%) and Perth (5.5%).

Given substantially faster growth in dwelling prices, the relationship between household incomes and dwelling prices has changed substantially over time. In 2002, the median household income nationally was 21% of the median dwelling prices relative to household incomes has dropped to 11%, with similar drops across all major cities.

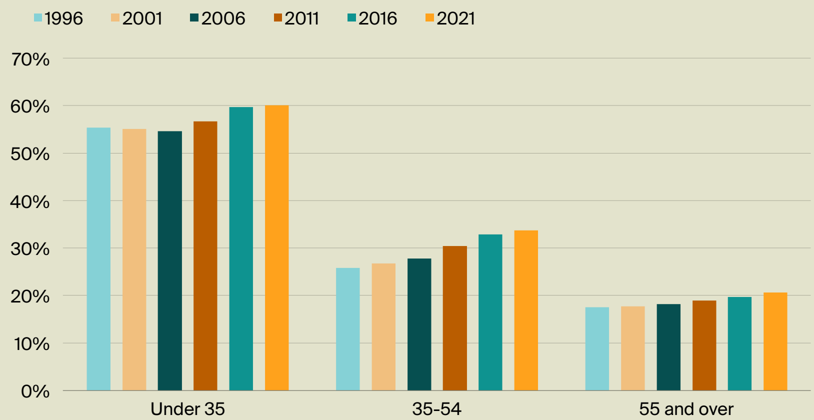
The rapid growth of dwelling prices relative to is has made saving for a deposit far more difficult and thereby contributed to growth in the number of households renting relative to those owning a home. The latest census reported

Change in housing tenure

	2021	1991
Owned outright	31.0%	41.1%
Owned with a mortgage	35.0%	27.5%
Rented	30.6%	26.9%

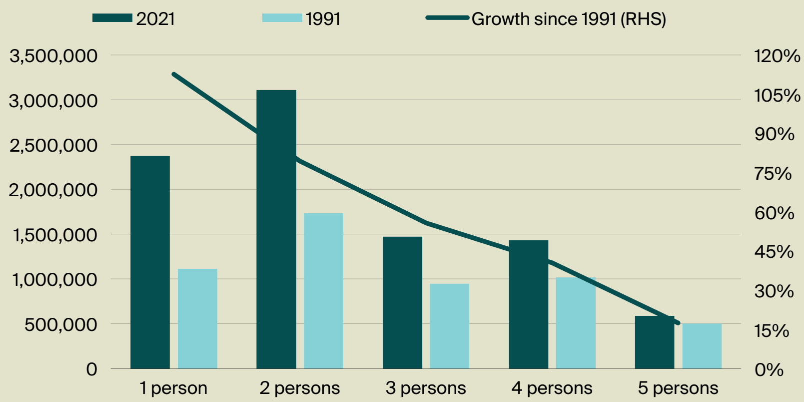
SOURCE: CENSUS 2021

Proportion of households renting by age bracket



Source: Knight Frank Research, ABS

Number of dwellings with each household size
Total number of dwellings and % growth (RHS)



Source: Knight Frank Research, ABS

that the proportion of households renting stood at 30.6% in 2021, up from 26.9% in 1991, while the number of households owning their home outright has fallen from 41.1% to 31.0% over the same period. The proportion of households renting has risen across all ages, with the steepest rise for those in the 35-54 bracket.

DEMOGRAPHIC TRENDS ALSO HELP TO EXPLAIN GROWING RENTAL DEMAND

The rise in the proportion of renters clearly reflects the affordability challenge at least in part, however, affordability is not the only consideration. The relative shift in the proportion of households renting versus owning is also a consequence of changing household composition. Over the past 30 years, the proportion of single-person households has grown at a far faster rate than larger household sizes. The number of single person households has more than doubled from 1.1 million to 2.4 million, while at the other end of the spectrum, the number of households with 5 or more people has only grown marginally. Single-person and dual-person households represent a high proportion of the underlying base of renters, particularly for apartments, whereas larger families tend to live in standalone houses. As such, rapid growth in this cohort is contributing to faster growth in the number of people renting compared to overall population growth.

Shifting sands: policy change to accommodate BTR

NEED FOR A NEW MODEL TO FACILITATE FASTER GROWTH IN RENTAL SUPPLY

In the face of the current rental squeeze, and with the supply-demand dynamic likely to remain challenging going forward, governments at all levels are coming under increasing pressure to take steps to encourage faster growth in supply.

Australia's existing policy framework effectively relies on traditional build-to-sell developments being sold to investors to enable rental supply. This model has for the most part allowed stock to grow adequately over time, but the current experience of very tight supply has exposed the shortcomings of sole reliance on this model.

When making decisions on whether to invest, buyers tend to be focussed on prospects of capital growth over the short to medium term, rather than the strength of underlying demand from tenants. As a result, supply tends to follow a cyclical pattern, accelerating during extended periods of capital growth – typically with a lag – and then contracting in periods of weaker market conditions. This was certainly evident in the acceleration of apartment supply in 2016-18 following an extended period of capital growth from 2013-17, but supply then diminished from 2019 as the sales market turned down during 2018-19.

Notwithstanding a period of very rapid capital growth during 2021, adequate levels of apartment supply have yet to return. This period of growth evidently did not persist for long enough to entice investors back into the market in large numbers to secure pre-sales on new developments, as it was quickly followed by a period of correction during 2022. In addition, developers have faced myriad challenges such as rising funding costs, rising construction costs, labour shortages and tighter regulatory requirements, which are all acting to limit the quantum of new development.

Meanwhile, the rental market has tightened and resulted in a period of strong rental growth, and while this may eventually feed through to a strong pick-up in investor demand, there is a groundswell of opinion that the community cannot afford to wait and that a new model of development is needed to align the quantum of future supply more closely with tenant demand rather than the capital growth expectations of prospective investors.

A PLACE FOR BTR TO ACCOMMODATE LONGER TERM TENANCY

Besides the quantum of supply, sole reliance on build-to-sell development arguably doesn't provide for an optimum product mix or for sufficient security of tenure, particularly from the perspective of longer-term tenants. BTR development on the other hand, by definition caters to long-term tenants and more readily enables them to 'feel at home', with the ability to customise elements of the apartment, benefit from shared amenity features and lock-in long term agreements without the fear of being forced to move out.

The BTR model aims to align the interests of investors seeking to secure long-term income streams with the interests of tenants, and over time this will result in a more diverse product mix that promises to improve the service offering and widen the range of options for renters.

STATE AND FEDERAL GOVERNMENTS NOW MOVING TO SUPPORT BTR

Recognising the need to unlock additional forms of private investment in apartment supply, state and Federal governments are now taking steps to enable greater investment in BTR.

At state level, a number of state governments have announced tax changes to improve the viability of BTR, typically through lower rates of land tax.

> "The Australian BTR market is attracting growing interest from international investors who are drawn to the sector's strong fundamentals and the government's recent announcement to harmonise BTR's tax landscape for international players. This move is expected to a herald rapid growth. As construction activities surge to meet escalating rental demand, international capital is a key part of the equation and interest will only grow as the sector matures."

Emily Relf
Capital Markets, APAC

State government tax relief for eligible BTR projects

50%
reduction in land tax until 2040

+

Exemption from foreign investor duty and land tax surcharges

50%
reduction in land tax for up to 20 years

+

Exemption from foreign investor lands tax surcharge for up to 20 years

+

Exemption from additional foreign acquirer duty for projects constructed before 30 June 2030

50%

reduction in land tax for up to 30 years

+

Exemption from absentee owner surcharge

50%

reduction in land tax for up to 20 years for developments completed before 1 July 2032*

50%

reduction in land tax until 2039-40*

*ANNOUNCED BUT YET TO PASS THROUGH PARLIAMENT

FEDERAL GOVERNMENT FINALLY MOVES ON MIT REGIME

At the Federal level, there has been substantial industry pressure over a number of years to revisit the managed investment trust withholding rate for BTR projects to bring them into line with the rate applying to other commercial sectors. This has been a barrier to BTR because it has made it less attractive for offshore capital compared to other asset types.

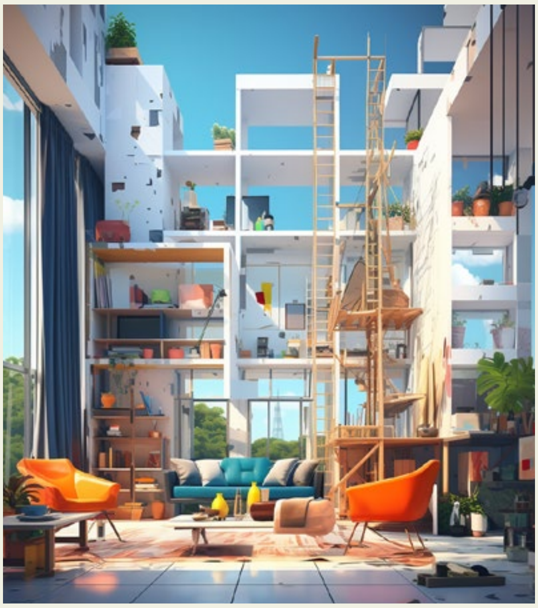
The MIT regime was introduced in 2008 in recognition that Australia needed to be competitive with other jurisdictions in competition for inward investment from global institutions seeking passive income derived from investment into real estate and other asset classes. Under the regime, a concessional withholding rate of 15% applies to offshore investment in offices, retail and logistics assets, similar to the rates applying in the United States and United Kingdom. However, under the current rules, BTR can only qualify for the concessional rate on affordable or key-worker elements of projects, otherwise a higher withholding rate of 30% applies. This reduces after-tax returns and has had been a major deterrent for offshore investors considering whether to undertake BTR developments in Australia.

At times, the treatment of BTR under the MIT regime has been caught up in the wider debate on supporting home ownership, with the former government preferring not to accommodate BTR within the regime on the basis that it was perceived to provide an advantage for offshore investors in the housing market over domestic investors. This was predicated on the view that investment in BTR was geared towards capital gains rather than passive income.

However, investors and wider property industry bodies have long contested this view and it is well accepted internationally that passive income is the predominant motivation driving investment in the BTR sector. The new government has accepted this and recently announced the intention to bring the treatment of BTR under the MIT regime into line with other commercial sectors by reducing the withholding tax rate for eligible new projects after 1 July 2024. Once the change is effective, foreign investors in qualifying jurisdictions (such as Singapore, Canada, Japan, Germany, the UK and US) will be eligible for the 15% withholding tax rate on fund payments in relation to BTR projects.

Under the changes, the capital works deduction will also be increased to 4% from the current 2.5%, allowing full depreciation over a shorter period to improve the tax profile of BTR investments and further encourage new development.

Where next for BTR?



A TRANSFORMATIONAL DECADE AHEAD

While the current macroeconomic climate is presenting challenges across all sectors, BTR is emerging as a relative winner on account of its ability to generate steady, inflation-linked income over the long term.

Investors are seeking out resilient markets with long term growth potential and the lack of an established BTR sector in Australia presents an opportunity to deploy capital into build-to-core strategies with the ability to achieve significant scale over time.

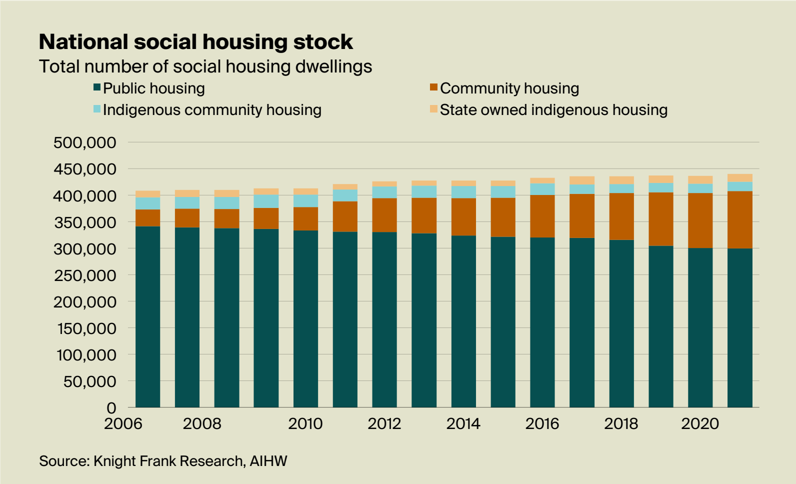
Of course, several challenges remain, such as elevated and uncertain construction costs, planning hurdles and a lack of local evidence to draw on when deciding the appropriate product specification. However, these challenges are increasingly over the right model to execute BTR rather than whether there is a case for development in the first place, and the first wave of schemes now coming through will add to the evidence base, unlocking a further wave of development later in the current decade.

If total stock grows to 55,000 apartments by 2030 as forecast, BTR would still only represent 1.5% of total rental supply, underlining the potential for scale. And as the sector matures, the focus of conversation is likely to morph away from whether BTR is viable, to the substantial benefits it can bring to communities by deepening the pool of rental stock and broadening the type of supply on offer to tenants.

LP-GP PARTNERSHIP MODELS OFFER OPPORTUNITY FOR THIRD PARTY CAPITAL

The change in the MIT regime makes BTR immediately more viable for offshore investors and will add further impetus to the current expansion. However, global limited partner (LP) investors generally wish to partner with local developers as general partners (GPs) for their experience sourcing suitable sites and delivering schemes that appropriately cater to specific locations and demographic profiles.

This presents challenges to create deal structures that align interests between parties that differ greatly in size and expertise. LPs are naturally attracted to large schemes which have potential to deliver greater efficiency and larger scale deployment, but these also imply the need for a large financial commitment from local developers which can tie up a large proportion of their capital and restrict their ability to pursue other opportunities. There is an opportunity here for third party capital to coinvest in major schemes to reduce the capital requirement for developers, and we expect to see this impact deal structuring as the sector expands.

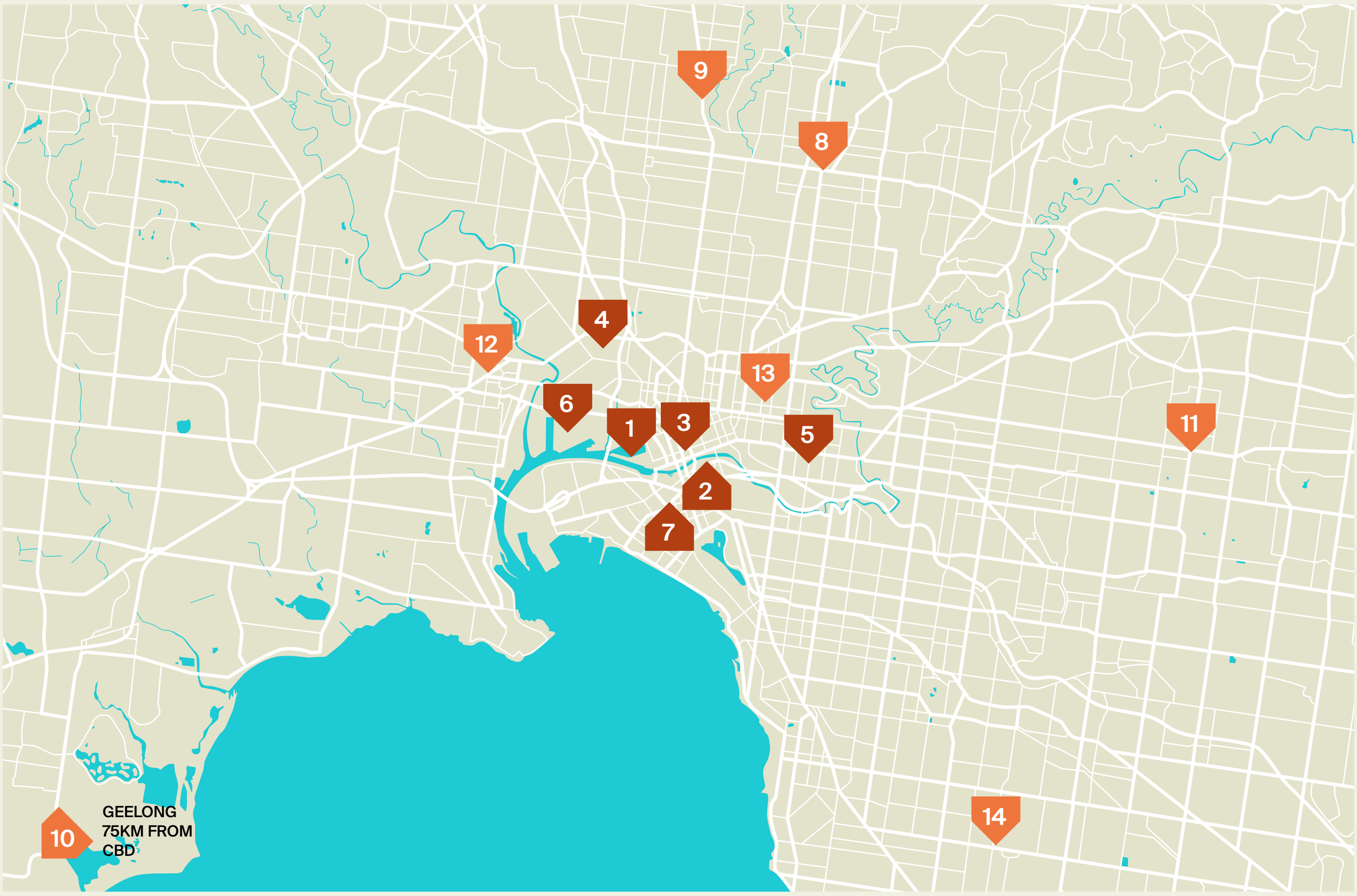


QUID PRO QUO: AFFORDABLE HOUSING IN THE MIX BUT GOVERNMENTS WILL BE WARY OF RIGID REQUIREMENTS

The shortage of social and affordable housing is well documented and stands out as a particularly sore point within the current supply squeeze. The nationwide stock of social housing has only grown very slowly over the past 20 years, rising by 8% since 2006, versus total population growth of 25% over the same period.

With growing community concern over the shortage, governments will be tempted to require developers to deliver affordable housing as part of BTR schemes. However, we expect that pragmatism will prevail, and that the risk of stemming the flow of supply to market more broadly will ultimately persuade government not to implement rigid requirements for BTR to deliver a fixed proportion of affordable housing. Instead, it is more likely to be considered on a case-by-case basis, with the potential for affordable housing to be encouraged in certain cases alongside other concessions to facilitate scheme viability.

Melbourne Build-to-Rent Hotspots



Melbourne Inner Ring

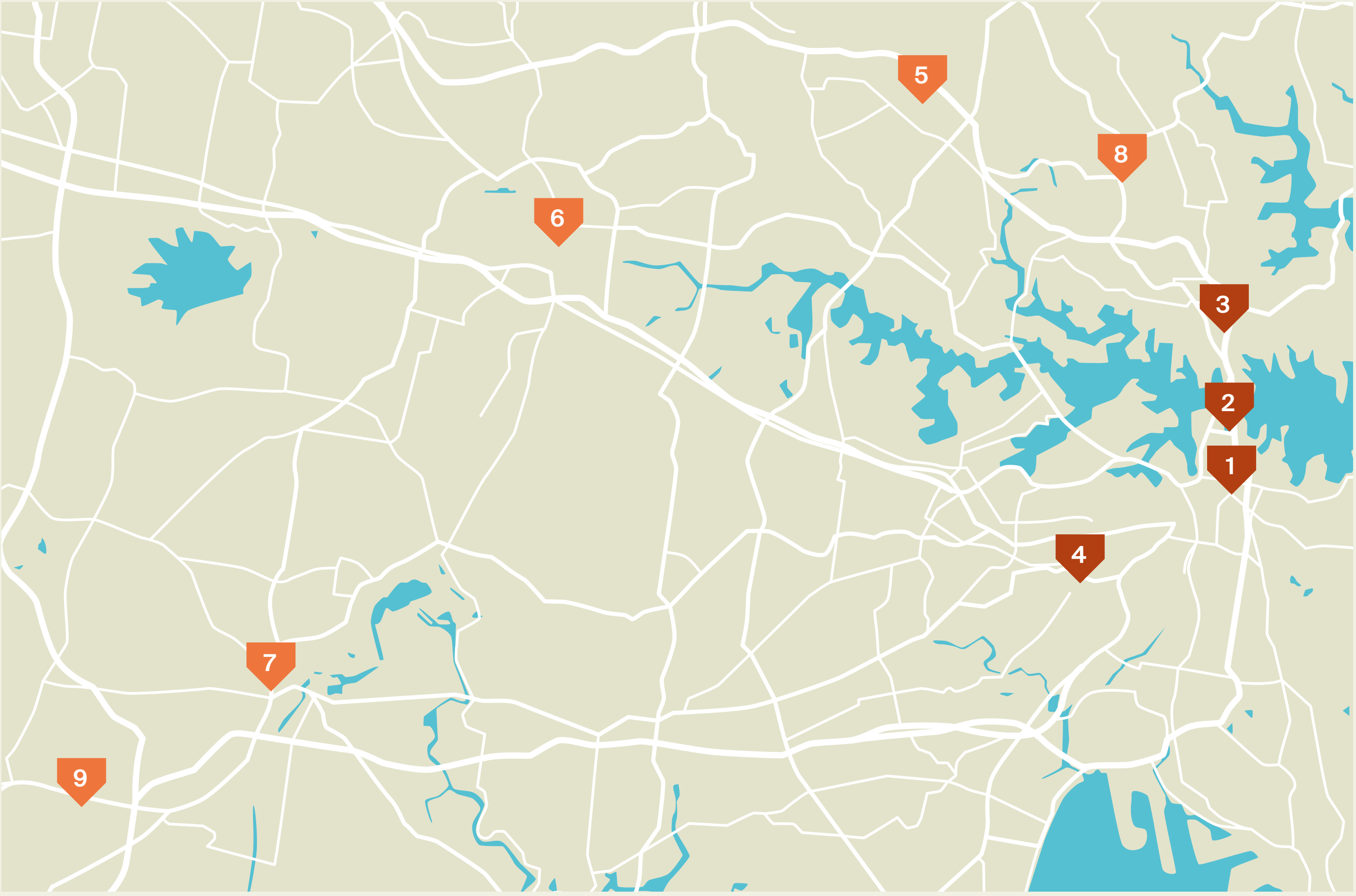
#	SUBURB	POPULATION UNDER 35 (%)	AVERAGE WEEKLY HOUSEHOLD INCOME ($)	AVERAGE NUMBER OF PERSONS PER HOUSEHOLD	BACHELOR DEGREE OR ABOVE (%)	MEDIAN APARTMENT RENT PER WEEK ($)	MEDIAN VALUE ($)
1	Docklands	58.4	$1,956	1.8	56.2	$500	$622,500
2	Southbank	65.1	$1,880	1.8	59.6	$500	$580,000
3	CBD	73.5	$1,306	1.7	51.8	$500	$680,000
4	Kensington	45.5	$2,216	2.1	54.7	$390	$513,500
5	Richmond	52.6	$2,577	2.1	57.8	$430	$540,000
6	West Melbourne	63.9	$2,135	1.9	56.4	$470	$545,000
7	South Melbourne	40.9	$2,103	1.9	50.2	$485	$660,000

Melbourne Next Tier

8	Preston	46	$1,787	2.3	38.1	$380	$570,000
9	Coburg (North)	44.2	$1,980	2.5	37	$410	$603,000
10	Geelong	43.2	$1,542	2.1	32.6	$470	$707,500
11	Box Hill	50.1	$1,441	2.3	41.7	$400	$506,888
12	Footscray	51.8	$1,763	2.1	43.2	$375	$465,000
13	Collingwood	55.3	$2,130	1.9	54	$490	$645,000
14	Bentleigh East	44.4	$2,250	2.8	40	$440	$660,000

Source: Knight Frank, APM, ABS

Sydney Build-to-Rent Hotspots



Sydney Inner Ring

#	SUBURB	POPULATION UNDER 35 (%)	AVERAGE WEEKLY HOUSEHOLD INCOME ($)	AVERAGE NUMBER OF PERSONS PER HOUSEHOLD	BACHELOR DEGREE OR ABOVE (%)	MEDIAN APARTMENT RENT PER WEEK ($)	MEDIAN VALUE ($)
1	Redfern	45.1	$2,116	1.9	48.7	$600	$963,750
2	CBD	57.9	$2,225	2.1	48.4	$750	$1,175,000
3	North Sydney	43.1	$2,463	1.9	61.2	$600	$1,072,500
4	Marrickville	54.8	$2,018	2.3	41.4	$500	$740,500

Sydney Next Tier

5	Macquarie Park	51.6	$1,924	2.2	52.9	$1,100	$858,000
6	Parramatta	64	$2,149	2.3	61.5	$480	$619,000
7	Liverpool	65.2	$1,345	2.3	24.6	$390	$500,000
8	Chatswood	44.5	$2,415	2.5	54.4	$1,220	$1,090,000
9	Edmondson Park	60.4	$2562	3.4	37.5	$520	$700,000

Source: Knight Frank, APM, ABS

> "Investors are seeking out resilient markets with long term growth potential and the lack of an established BTR sector in Australia presents an opportunity to deploy capital into build-to-core strategies with the ability to achieve significant scale."

SEARCHING FOR THE HOTSPOTS

With attention now turning to the successful execution of a BTR strategy, location selection is increasingly in focus. Inner fringe locations in Melbourne and Sydney are natural candidates for the first wave of schemes, given their offer of amenity, close proximity to CBDs and a high proportion of potential tenants given their comparatively well-educated and young populations.

Over time we expect to see a broadening of developer interest to encompass middle-ring suburbs with high levels of amenity and connectivity. In a search for relative value, and increasingly sizeable development sites, developers will use socioeconomic indicators and suburb analysis – connectivity, transport nodes, consumer spending patterns and employment opportunities – to guide the expansion of the BTR model.

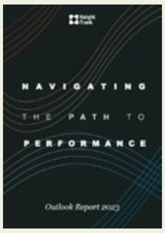
We like questions, if you've got one about our research, or would like some property advice, we would love to hear from you.

Recent Research

Australian Industrial Review Q1 2023

Australian Residential Development Review Q1 2023

Active Capital 2023



Outlook Report 2023

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