BTR SERIES PART 1: THE HOUSING CRISIS—A BIG PROBLEM IN SEARCH OF A SOLUTION

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The housing crisis in Australia has been brewing for more than a generation.

The symptoms are painful and obvious and include:

- The gap between supply (with supply-side problems) and increasing demand;
- Affordability slipping further out of the reach of younger Australians with high house prices, interest rates, and inflation outstripping wage growth; and
- Growing rental market pressures with record rent escalations.

Something has to give.

WHY ARE WE HERE?

There are many causes. Perhaps chief among them has been the lack of a coherent political policy aimed at resolving the multifaceted housing crisis - a complex and sensitive problem but a socially critical one to fix. In the absence of considered, integrated and well-administered government policy, the problem continues to grow.

Governments have pulled on a few levers, with funding, planning and tax concessions introduced to incentivise the private sector to find solutions with long-term capital. However, the tension between affordability and investor returns remains.

The rising volume of ringing alarm bells demands that Australian governments, investors and developers get serious about addressing the housing crisis.

It appears successive state and federal governments have baulked at calling 'time' on the Australian ideal of owning a quarter-acre freehold block, avoiding an acceptance that the system is broken. Is build-to-rent (BTR) the answer?

And if so, why now and what will it look like when it takes root in Australia?

In this multipart series, we will find out.

LOOKING AHEAD

In this series, a group of Australian K&L Gates partners with a broad range of experience in BTR projects will, together with insights from our UK and US colleagues, explore a number of topics relevant to property professionals involved in planning, structuring, developing, investing in, operating, and financing BTR projects in the changing and evolving Australian environment.

We will examine key BTR features, including tax, investment structures, affordable housing requirements, debt financing considerations, the impact of BTR on the tenancy and residential development market, sustainability initiatives, investment benefits, and foreign investment considerations.

FIRST THINGS FIRST - WHAT DO WE MEAN BY 'BTR ASSETS'?

Historically, 'build-to-own' has been the prevalent model for large-scale residential developments, in which a property developer builds an apartment complex and sells the units to individuals, who will either choose to live in them or rent them out as investment properties.

BTR apartment complexes are designed and constructed for the purpose of being held, managed and maintained as a long-term investment (by the developer or institutional investors) with individual units let to tenants rather than being sold.

Overseas, BTR is often referred to as 'multifamily housing.'

There are a number of similar types of investment-grade residential assets that could be said to be 'BTR.' Think student accommodation, retirement living, serviced apartments, hotels, manufactured housing estates (land lease projects), co-living, and boarding houses amongst others. What is fascinating is not what we already have, but what is missing and why.

WHERE ARE THE INSTOS?

There is a gap in the Australian property market.

Institutional investment in the residential market in Australia is a fraction of that compared to some other countries.

For example, in Australia, institutional investment totals just 3% of funding whereas in the United States and Germany it is closer to 35%. The size of the BTR sector as a percentage of the residential market as a whole tells a similar story. In Australia it is just 0.2% compared to 5% in the United Kingdom and 12% in the United States.

Understanding the barriers to institutional investment and addressing institutional requirements for long-term investing will be critical to developing a successful BTR solution.

HOUSING DEMAND

Rental housing demand has been on the increase in Australia, with a shift to long-term renting. Home ownership has become increasingly unaffordable with new housing supply arguably coming to a standstill. Several factors such as planning restrictions, population growth due to high levels of immigration and the recent collapse of some large home building companies have all contributed to national residential vacancy rates being the lowest on record.

It is apparent that Australia requires diversity in its housing options to accommodate the changing demographics and needs of Australia's population. Statistics strongly indicate that not only is the number of household renters increasing, but renters are also having to rent for longer, with around 43% of renters having rented for at least a decade (per Private Renting in Australia–A Broken System (PEXA & Longview)).

The twin factors of high demand and constrained supply mean that in the foreseeable future it is unlikely that home ownership will become more affordable or that the shift to long-term rentals will abate. Rather, we expect the shift to the permanent rental market to only grow stronger.

These factors, supported by the improved amenity (including from curated and green spaces in new projects) and additional landlord security benefits that high-quality BTR assets offer, suggest that BTR assets have a genuine and desirable role to play within modern Australia. BTR assets also have the benefit of accelerated supply to the market due to the removal of presale requirements.

GOOD PUBLIC POLICY

Adequate housing is critical to the proper functioning of any community.

State and federal governments need to provide a clear framework for BTR as an alternative to home ownership and to put roofs over the heads of our most disadvantaged.

These are two separate missions and may require different solutions.

The benefits of BTR also accrue to the government through reductions in homelessness and increased workforce mobility. This in turn provides social and mental health benefits. These benefits should flow through to financial benefits in the long term. As a result, the government has the opportunity to support this sector through public messaging and lowering or removing regulatory hurdles to stimulate domestic and foreign investor participation.

While the above seems like the perfect environment within which to encourage investment in and development of BTR assets to alleviate housing supply and demand challenges, adverse regulatory settings (most specifically tax and planning pathways) continue to present challenges.

Increasingly, the Australian property industry has advocated for an appropriate regulatory environment to allow the BTR asset class to flourish. State governments have responded with concessions that may support development in the space, usually coupled with affordable housing. However, these have only partially alleviated the frustrating environment faced by proponents of the asset class.

The United States provides an example of government support for the BTR sector, where close to half of all multifamily mortgage debts are said to be backed by US federal government agencies such as the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation and the Government National Mortgage Association (colloquially known as 'Fannie Mae,' 'Freddie Mac,' and 'Ginnie Mac' respectively).

Additionally, in the United States, around one third of all renters are tenants of BTR assets. There is plenty of scope for growth of the BTR sector in Australia.

REMOVING THE TAX BARRIERS TO BTR

A significant obstacle to the growth of BTR has been multiple tax and policy challenges, at both a federal and state level.

There are pools of capital in Australia, including superannuation funds, which are attracted to BTR assets. However, to access the required capital and manage risk, it is often necessary for Australian capital and asset managers to partner with foreign investment capital.

But, foreign investment has not for a number of years qualified for concessional withholding tax rates that apply to investments in other real property assets (such as passively leased commercial buildings). This had the effect of directing capital away from BTR as an asset class.

Finally, the Australian Government has announced that it will be reducing the managed investment trust (MIT) withholding tax rate for qualifying BTR projects (with more details on qualifying projects to follow). This will be examined further in part two of our series alongside other BTR tax considerations.

There has also been uncertainty as to whether the tax authorities would treat BTR as a 'trading' business ('flow-through' tax treatment for certain real estate trusts and MIT eligibility is only available for passive investments). Hopefully at least some of this uncertainty will be addressed by the MIT changes.

Two other significant tax impediments have been GST and land tax.

Developers constructing new residential premises for sale are entitled to full input tax credits (GST credits) on all land acquisition and development costs, and also cash flow alleviation via the margin scheme (if available).

In contrast, input tax credits are not available for acquisition, development and operating costs for BTR assets. This 'GST leakage' can be 'a deal killer.' Development opportunities that allow full credits offer competitive advantage and return ratios.

Additionally, land tax imposed on BTR assets held by institutional investors cannot be defrayed in the same manner as either traditional commercial real estate assets (outgoings pass through) or lower-scale residential property investors (with low land cost base).

Again, these material land tax costs can adversely impact the internal rate of return and financial viability of a proposed BTR project.

Some states have recently introduced non-uniform BTR incentives, with land tax reductions and exemptions from foreign investor duty and land tax surcharges. These concessions are available for qualifying projects but the rules are not harmonised across the states. There are other deficiencies with these regimes, which we will explore in more detail in part three of our BTR series.

These tax matters create feasibility issues for both local and foreign investors, preventing broader uptake. However, that has not stopped some from charging on.

OTHER CHALLENGES

There has been no shortage of advocacy for change to the regulatory settings for BTR assets. However, broadly speaking, these efforts have been met with resistance. There are concerns about being seen to be undermining the 'great Australian dream of home ownership' by providing concessions to increase institutional investment into the residential market, based on a concern that institutional investors will price out new home buyers.

There does also need to be a national discussion on the implications of the shift towards long-term rentals, given it means many people will not own and pay off a home by retirement age. Australia's social welfare settings presently assume most people will own their own home by retirement age, which is one reason why a principal place of residence is exempted from means testing.

While there are challenges, such political resistance seems both futile and short-sighted when considered against the clear trends of modern and developing societies, particularly where home ownership is challenging and long-term renting is increasingly normal.

WHERE TO NEXT?

It appears that policy makers are finally realising the opportunity that BTR assets present to assist with housing affordability and the rental crisis. This is a positive outcome and to be encouraged. The Australian Government has taken a positive step with its proposed MIT reforms.

As policies develop, we can expect to see 'impact housing' playing a core role in these assets and the development approval process, as well as being a criteria for tax concession qualification. This may include social, affordable or specialist disability accommodation (or a mixture of all three). The role of community housing providers is also important and needs to be considered.

Industry participants who are pursuing BTR platforms are becoming increasingly active with these current and pending developments, and the asset class is ready to find its home in Australia.

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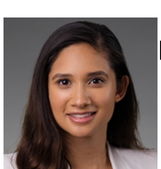

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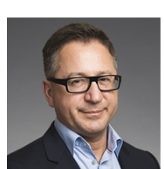

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